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Before the Committee on the Budget  
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Mr. Chairman, my statement this morning will cover four topics:

- o The economic outlook as projected by CBO;
- o The budget estimates included in the mid-session report on the fiscal year 1979 budget recently released by the Administration;
- o Fiscal policy options for fiscal year 1979 now receiving attention in Congress; and
- o The need for closer coordination of monetary and fiscal policies and/or structural approaches to controlling inflation.

#### THE ECONOMIC OUTLOOK

This Committee begins its consideration of the Second Concurrent Resolution on the Budget for Fiscal Year 1979 at what I believe to be the most difficult moment for economic policymakers since the beginning of the budget process. Inflation is accelerating just at the moment that the economic recovery is showing signs of running out of steam. Despite last month's drop, unemployment remains high by postwar standards. Most forecasters project little improvement in the jobless rate in the months ahead and some foresee deterioration. As a result, policymakers face a most troubling dilemma. On the one hand, the standard remedies for inflation may weaken economic growth--and, perhaps, trigger a new recession. On the other, actions designed to sustain the recovery run the risk of aggravating the already rapid increase of prices.



It is also a particularly difficult time to forecast the behavior of the economy. The contours of any economic projection depend critically on the resolution of this policy dilemma, and that final outcome is still very much in doubt. For the purposes of this forecast, we have made the following policy assumptions:

- o As is customary, we have taken as given the fiscal policies included in the First Concurrent Resolution.
- o With respect to monetary policy, we have assumed that short-term interest rates will not rise much further and that credit conditions will not become so restrictive as to abort the expansion.

Based on these assumptions, CBO expects economic activity to grow at a 3.5 to 4.5 percent rate during 1978, slowing by about one-half a percentage point during 1979. As shown in Table 1, the unemployment rate is forecast to range between 5.2 and 6.0 percent by the end of 1979. The most unpleasant side of this scenario is the outlook for prices. While inflation is likely to moderate from the double digit rates during the first half of 1978, the increase in the Consumer Price Index (CPI) for the entire year is expected to be in the range of 6.8 to 7.8 percent, substantially above the 6.6 percent rise during 1977. Prices are projected to continue to rise at a rapid rate in 1979, although, in the the absence of any unanticipated shocks, they will probably decelerate somewhat from this year's pace.

There are at least three aspects of this projection that deserve some further examination. First, in a period of relatively



TABLE 1. ECONOMIC PROJECTIONS BASED ON CURRENT POLICY, CALENDAR YEARS 1978 AND 1979

Economic Variable	Levels			Rates of Change (Percent)		
	1977:4 (actual)	1978:4	1979:4	1976:4 to 1977:4 (actual)	1977:4 to 1978:4	1978:4 to 1979:4
GNP (billions of current dollars)	1962	2160 to 2202	2354 to 2457	11.8	10.1 to 12.2	9.0 to 11.6
Real GNP (billions of 1972 dollars)	1360	1408 to 1421	1446 to 1481	5.7	3.5 to 4.5	2.7 to 4.2
General Price Index (GNP Deflator, 1972=100)	144	153 to 155	163 to 166	5.8	6.4 to 7.4	6.1 to 7.1
Consumer Price Index (1967=100)	185	198 to 200	210 to 214	6.6	6.8 to 7.8	6.2 to 7.2
Unemployment Rate (percent)	6.6	5.5 to 6.1	5.2 to 6.0	-	-	-





high unemployment, why has the outlook for inflation deteriorated so badly? Second, given the assumption of an accommodating monetary policy, why have we forecast a slowdown in the growth of economic activity? Third, if there is a slowdown, why won't it turn into a recession?

#### Outlook for Inflation

Inflation has accelerated sharply since the beginning of the year. The rate of increase of consumer prices between December and May was about twice the rate during the second half of last year. This upsurge did not reflect widespread shortages of labor and capital, but rather was associated with the simultaneous occurrence of three events: a rapid increase in food prices resulting from the harsh winter and the beginning of a cattle cycle, the depreciation of the dollar, and the January increases in payroll taxes and the minimum wage.

Although the CBO forecast assumes that no comparable food and depreciation shocks will occur next year, the rate of price increase is projected to moderate only slightly from this year's pace. The principal impetus to this continued high level is expected to be rising labor costs. If past behavior holds true, the recent jump in the CPI will cause a lagged acceleration of wage gains and a corresponding markup of prices late this year and in 1979. Past performance also indicates that restrictive



macroeconomic policies would have only a small effect on inflation during the first few years. Like the special factors that induced the price acceleration earlier this year, subsequent wage catch-up has proved to be relatively insensitive to variations in total demand. Under such circumstances, it takes many years of high unemployment to reduce inflation significantly.

#### Reasons for the Slowdown

The foreign trade and state and local government sectors are expected to provide moderate stimulus to the economy during the next year and a half. Thus, the outlook for slower growth through 1979 rests largely on the behavior of three sectors of the economy: housing, consumption, and business fixed investment.

Spending on residential construction provided significant impetus to the rise in real GNP last year. Such strength, however, probably will not continue through the projection period; this year's rapid tightening of credit markets has already limited the availability of funds for home mortgages. Savings and loan institutions have experienced a significant deceleration in deposit inflows, and, by May, commitments outstanding for future mortgage lending had fallen for five consecutive months.

The prospects for consumer spending also appear less bright. Personal debt has risen sharply relative to income, and tighter



mortgage conditions will reduce opportunities to convert real estate equity to cash--a practice that apparently helped sustain consumption throughout the expansion. Furthermore, consumer attitude surveys indicate that the recent surge in retail sales may be based in part on the attempt to avoid expected future price increases. Such buy-in-advance behavior would reduce consumer spending in the remainder of this year and, perhaps, in 1979.

The growth of housing and consumer spending typically slows as an expansion ages, but such slowing is usually somewhat offset by increased outlays for plant and equipment. According to the Commerce Department's survey of business anticipations, constant dollar business fixed investment is again likely to increase faster than overall growth, but less rapidly this year than last. Moreover, a slowdown in the overall pace of economic activity means less pressure on capacity utilization throughout the forecast period. As long as existing productive capacity remains underutilized, there is little likelihood of an investment boom.

#### Reasons for No Recession

Most forecasts agree that growth will slow, although many go further than the CBO projection and predict a recession within the next year and a half. This is admittedly a difficult call,



but--given our policy assumptions--CBO does not believe that current economic trends point to a recession. This assessment is based on a number of factors:

- o The tax cut included in the First Concurrent Resolution more than offsets the effects of rising payroll taxes and fiscal drag on disposable personal income and should help sustain consumer spending.
- o In addition, the tax package should stimulate business fixed investment.
- o The impact of higher interest rates on housing activity may be softened somewhat by the new option available to lending institutions to pay market interest rates on deposits of \$10,000 or more.
- o The recent depreciation of the dollar is expected to boost net exports.
- o Perhaps most importantly, there is little evidence of the kind of imbalances between production and final sales that typically characterize a period preceding a recession. Throughout the current expansion, businesses have pursued a cautious inventory policy, keeping stocks closely aligned with sales.

These reasons, however, do not touch on the principal difference between the CBO projection and those who foresee a near-term recession: the future course of monetary policy. As I noted earlier, CBO has assumed no significant further tightening of credit markets. By contrast, many forecasters anticipate a recession brought about by a credit crunch, as the Federal Reserve responds to the recent acceleration of inflation and rapid growth in the basic money supply.





## EVALUATION OF OMB JULY BUDGET ESTIMATES

In its mid-session review of the fiscal year 1979 budget released last week, the Office of Management and Budget (OMB) lowered its estimates of the budget deficits by over \$10 billion for both fiscal years 1978 and 1979, as compared with its January estimates. The reduction in the 1978 deficit estimate is almost entirely caused by lower outlay estimates as a result of the continuing shortfall in expenditures. For 1979, the deficit reduction results partly from lower spending estimates, but mostly from changes in the Administration's tax reduction proposals. Table 2 compares the latest OMB estimates for the budget totals with the 1978 Second Concurrent Budget Resolution limits and the 1979 First Concurrent Resolution targets.

We are now reviewing the new OMB estimates, and will submit the results of this review to the Budget Committees within the next 10 days. The review will also incorporate our new assumptions about the economic outlook, an analysis of actual outlay and receipt patterns in recent months, and other relevant programmatic information provided by the Administration. At this time, I can only provide a preliminary assessment of the budget totals.



TABLE 2. FEDERAL BUDGET TOTALS: BY FISCAL YEARS, IN BILLIONS OF DOLLARS

	1978		1979	
	Second Resolution Limits	OMB July 6 Estimates <u>a/</u>	First Resolution Targets	OMB July 6 Estimates
Revenues	397.0	400.3	447.9	448.2
Outlays	458.25	451.4	498.8	496.6
Deficit	61.25	51.1	50.9	48.5
Budget Authority	500.1	502.9	568.85	571.4
Public Debt	775.45	768.3	849.1	847.8

a/ The OMB July 6 estimates have been adjusted to treat the earned income credit payments as income tax refunds, as was done for the Second Budget Resolution for 1978. The First Concurrent Resolution for 1979 and the OMB July 6 estimates classify these payments in excess of an individual's tax liability as outlays and budget authority.

On the spending side, the July OMB estimates of total outlays for both 1978 and 1979 appear to be realistic in terms of our analysis of spending patterns. For our latest economic forecast, we assumed that total outlays in fiscal year 1978 would be \$451 billion, almost precisely the same level as the latest OMB estimate, adjusted for the treatment of earned income credit payments. For 1979, we assumed that budget outlays would total \$495 billion, only slightly less than the OMB mid-session review estimate.



OMB's downward reestimates of \$4.5 billion for fiscal year 1979 about matches the outlay figures incorporated in the First Concurrent Resolution. Based on the new OMB information and other factors, I expect that we will propose some further downward adjustments in 1979 outlay estimates in the range of \$2 to \$4 billion.

For fiscal year 1978, the Administration revenue estimates remain virtually unchanged from the January budget, but slightly above the CBO figures. CBO now estimates 1978 receipts at \$397.7 billion, compared with \$400.3 billion for OMB. Of the \$2.6 billion difference, about \$1.5 billion is because of higher wage assumptions by the Administration, and about \$1.0 billion is attributable to differences in estimating techniques.

OMB has revised its fiscal year 1979 receipts estimates upward from its January estimates. Changed legislative assumptions increase revenues by about \$10 billion, but revised economic assumptions and technical estimating adjustments reduce revenues by over \$2 billion, leaving a net increase of about \$8 billion. While CBO has not yet completed its revenue estimates for the Second Concurrent Resolution, our preliminary work suggests that the adjustment OMB has made for economic assumptions and estimating revisions is not out of line. CBO's revenue estimates will be ready for the Committee's mark-up of the Second Concurrent Resolution.



## POLICY OPTIONS

Recognizing the need for stimulus to sustain economic growth, the Congress enacted a First Concurrent Resolution last spring with several new initiatives, including a sizable tax cut. With these measures, the deficit is expected to be about \$50 billion in fiscal year 1979, about the same as in the current year. The full-employment budget deficit, one measure of fiscal stimulus, would increase slightly from fiscal year 1978 to 1979:

### FULL-EMPLOYMENT BUDGET BALANCE (National Income Accounts Basis)

<u>Fiscal Year</u>	<u>Billions of Dollars</u>
1977	-14.5
1978	-17.9
1979	-20.7

The Congress now has an opportunity to review that earlier decision in the light of changing economic conditions. Recent economic developments are mixed. Inflation is considerably worse than expected, while the unemployment rate has declined more rapidly than anticipated. At the same time, however, most forecasters believe the outlook for economic growth has not improved--if anything, it has worsened. Hence, the policy dilemma: measures aimed at reducing inflation could slow growth and risk a new recession, while policies designed to sustain economic growth could accelerate inflation.





### Restrictive Fiscal Policy Options

If the Congress feels that continuing the current fiscal policy provides too much stimulus at this stage of the economic expansion--particularly in light of the persistence of inflation--it can take steps to reduce the fiscal year 1979 deficit. Perhaps the easiest way to achieve a more restrictive budget at this time would be to forego all or part of the \$15 billion tax cut for fiscal year 1979 (\$20 billion annual rate) that was included in the First Resolution to take effect in January 1979.

The CBO forecast described earlier includes this tax cut (assumed to be \$11.4 billion in personal and \$3.6 billion in corporate taxes). What would the outlook be without the tax cut? CBO's guess is that the effect on our forecast by the end of 1979 would be to reduce real growth by about three-fourths of one percentage point and to raise the unemployment rate by about two-tenths. A policy of no tax cut would not reach its maximum restrictive effects on real economic activity until the end of 1980, however, when the impact would be somewhat larger. In terms of inflation, prices might be 0.2 percent lower by the end of 1980. Inflation reacts to stabilization policies more slowly than unemployment.

A significant restrictive economic effect could also be attained by cutting expenditures. For example, the House of Representatives has voted to reduce spending by 2 percent in



a number of fiscal year 1979 appropriation bills. If such a reduction were applied to the First Concurrent Resolution outlay target for 1979, total outlays would be lowered by about \$10 billion, to \$489 billion. The CBO economic forecast already assumes a shortfall of almost \$4 billion from the First Concurrent Resolution. To achieve further reductions, however, would require difficult actions, such as foregoing, or requiring full absorption of, the October pay raise for federal employees, and foregoing or reducing sharply the planned new spending initiatives for defense, agriculture, urban aid, veterans' benefits, and other programs that have not yet been enacted.

Alternatively, savings could be sought in existing programs to achieve the spending reduction and still provide for some needed new spending initiatives. One way of achieving this would be an across-the-board cut in budget authority provided in all 1979 appropriation bills for nonmandatory payments under existing law. Assuming that the Congress could achieve a cut in spending of, say, \$10 billion beyond the estimated shortfall, the effect on economic activity would be roughly similar to that described above for eliminating the tax cut, depending on the composition of the reductions.

If the Congress were to forego the tax cut or take comparable action on the spending side, fiscal policy would be more restrictive in 1979 than in 1978. To the extent that the economy



is approaching full employment, such a reduction in fiscal stimulus could reduce the risk of generating excess demand inflation. But we must recognize that real growth appears to be slowing, and there is a substantial danger that monetary and fiscal policies will become restrictive simultaneously, a shift that in the past has generally been followed by recession.

#### Expansive Fiscal Policy Options

In contrast to these various restrictive measures, the Congress has before it a proposal for substantial tax reductions. H.R. 8333 (the Kemp-Roth Tax Reduction Act) proposes large tax cuts over a period of three years without comparable reductions in spending. Conventional economic analysis indicates that, as a result of such a policy, the budget deficit would rise sharply. With the economy likely to reach full employment during this period, a large stimulus of this kind would be highly inflationary.

Some of the proponents of this policy option, however, argue that the conventional view is incorrect. They contend that large tax cuts increase incentives to work, save, and invest to such an extent that the cuts would pay for themselves in the first or second year and, therefore, would not be inflationary.

CBO does not know of any empirical evidence for the view that the supply-side effects of tax cuts are so large and so



quick. The evidence available to us supports the conventional view that the stimulative effects of most types of tax cuts occur primarily through increased aggregate demand and that these effects are not large enough for tax cuts to be self-financing.

#### THE COORDINATION OF STABILIZATION POLICIES AND STRUCTURAL MEASURES

Past experience suggests that some incidences of poor performance by the economy have resulted from excessive shifts of monetary and fiscal policies in the same direction. The fiscal and monetary authorities each assumed that the other would not take appropriate action in response to current economic trends; together they overreacted. Such an overreaction appears to be possible at this time. If monetary and fiscal policies are both used to reduce inflationary pressures, the chances for a recession are great.

Closer coordination of monetary and fiscal policies might result in a more desirable mix of policies. For example, the long-run performance of the economy might be improved by a tighter fiscal policy and an easier monetary policy. That policy mix might:

- o Reduce federal deficits and, perhaps, decrease the size of the federal sector as well; and
- o Encourage investment spending, with the resulting growth in capacity reducing inflationary pressures.





At present, adequate arrangements for choosing specific economic goals and implementing a coordinated policy do not exist. Although attempts at closer coordination of fiscal and monetary policies are not without their risks, the benefits in terms of stabilization could be substantial. Hence, this is an appropriate time to examine mechanisms for improving coordination of monetary and fiscal policies, such as requiring the Federal Reserve to:

- o Clearly specify its money and credit targets for the ongoing and upcoming fiscal year before enactment of the budget resolutions;
- o Reveal its estimates of the level of unemployment, production, and prices for the end of the fiscal years; and
- o Explain periodic revisions of its objectives and plans.

In addition, the dilemma facing policymakers today could be made less acute by improving the tradeoff between inflation and unemployment through the use of structural programs, including:

- o Skill training;
- o Public service employment;
- o Reform of government regulations;
- o More vigorous enforcement of antitrust legislation;
- o Reducing the minimum wage for youth;
- o Incomes policies, such as TIP (tax-based incomes policies); and
- o Reductions in payroll taxes.



Even with structural improvements and better coordination, however, simultaneous inflation and unemployment will continue to present difficult choices for macroeconomic policy. Measures to deal with one of these problems may well worsen the other. Ultimately, the resolution of this dilemma will depend on whether the Congress gives greater emphasis to inflation or to sustaining economic growth.

