TABLE 6. COMPOSITION OF FEDERAL OUTLAYS (By fiscal year)

	Actual 1980	Projection 1985	Change
	Billions of dollars		
National Defense (except military retirement)	124	262	138
Pensions and Medicare a/	182	315	133
Other Entitlements	87	112	25
Nondefense Discretionary	140	138	-2
Net Interest	52	118	66
Other Spending	13	9	-4
Offsetting Receipts b/	-22	-44	-22
United Budget Outlays	577	910	333
Off-Budget Federal Entities	14	18	4
Total Outlays	591	928	337
	Percent of Unified Budget Outlays		
National Defense (except military retirement)	21	29	8
Pensions and Medicare a/	32	35	3
Other Entitlements	15	12	-3
Nondefense Discretionary	24	15	-9
Net Interest	9	13	4
Other Spending	2	1	-1
Offsetting Receipts b/	-4	-5	-1
Unified Budget Outlays	100	100	0

NOTE: Details may not add to totals because of rounding.

a/ Old-Age and Survivors Insurance, Disability Insurance, Railroad Retirement, Black Lung, Federal Employee Retirement and Disability, Hospital Insurance, and Supplementary Medical Insurance.

b/ Proprietary receipts from the public and employer share, employee retirement.

of the budget, over half of it would be eliminated. Outlays for other entitlements, nondefense discretionary programs and off-budget spending are projected to total about $270 billion in 1985. This part of the budget is made up of grants to state and local governments, farm price supports, research, pay in civilian agencies, and the means-tested programs such as food stamps and Medicaid. This is the portion of the budget already hardest hit by the budget resolutions of the last two years. It is likely, therefore, that budget cuts of the magnitude implied by the application of S.J. Res. 58 and H.J. Res. 350 would have to be made in large part in the national defense and pensions categories. Such reductions, in all likelihood, would result in lost benefits to current beneficiaries, elimination of all cost-of-living adjustments, and triggering of penalty payments to government contractors. Abrupt huge cuts in grants to states would prompt emergency state tax hikes and blunt caps on entitlements that could create inefficiencies and inequities that would have to be reversed later. In short, aside from the effect on the economy, an abrupt reduction in federal spending will lead to widespread inefficiencies. A similar case could be made against moving too abruptly in raising taxes to balance the budget. Almost all tax bills have phased-in tax changes over a period of years to avoid suddenly disrupting business and consumer plans.

LONG-RUN EFFECTS ON THE ECONOMY

Judging from history, neither unconstrained Congressional discretion in budgeting nor the proposed constraint of a balanced budget rule is an ideal alternative. Under existing procedures, the Congress can choose any type of fiscal policy. This Congressional flexibility has sometimes resulted in budgets that have been less than successful at achieving economic stability and growth than if they had been balanced. At other times, the Congress has chosen budgets that have been more successful than would have been the case with balanced budgets. The adoption of a balanced budget rule would be a decision to forego the more successful budgets in order to preempt less successful ones. A consideration in that decision, to which this section is addressed, is how a balanced budget rule would have affected the economy in the past and how it would affect it in the future.

Successful Budgets and the Conventional View of the Economy

Classifying budgets as more or less successful than mandated balanced ones requires a basis for evaluation. Conventional mac-

roeconomics provides an evaluative framework that can be summarized in three statements: one about the nature of the economy, another about the relationship between the budget and the economy, and a third that uses the first two to define successful budgets.

Nature of the Economy. A market economy does not constantly maintain high levels of employment and output or stable prices. Waves of consumer and investor optimism and pessimism, immoderate weather, supply interruptions from abroad, and labor unrest, among other causes, can subject the economy to a series of disturbances. With imperfect markets, which are often characterized by long-term commitments such as labor contracts, these disturbances can lead to fluctuations in output and employment, as well as prices.

Relationship of the Budget and the Economy. The federal budget and the economy affect each other. When the economy slides into recession, the budget is affected by a decline in tax revenues (because of lower incomes), an increase in outlays (for income maintenance programs, such as unemployment compensation), and a bigger deficit (because revenues are lower and outlays are higher). But that is not the end of the story. By cutting taxes and increasing spending, the government can, in time, induce individuals and firms to raise their levels of spending and thereby counter the economy's recessionary tendency. Similarly, an inflationary boom raises tax revenues more than government spending and reduces the federal deficit (or increases the surplus). By raising taxes and cutting expenditures, the government can--after a lag--reduce the level of private spending and temper the runaway pace of economic activity.

Successful and Unsuccessful Budgets. A goal of fiscal policy is to dampen business cycles through the effect of the budget on the economy. When the budget is being pulled into deficit by a recession, a deficit is better than a balanced budget because the deficit will moderate the recession. When a booming, inflationary economy is moving the budget into substantial surplus, a surplus is more conducive to economic stability than a balanced budget. From a conventional economic statilization perspective, budget policies that increase the deficit during high employment and decrease the deficit during recession would be worse, however, than annually balanced budgets.

Successful and Unsuccessful Budgets in Recent Experience

Some of the recent stabilization successes and failures of fiscal policy have been identified in a study by the staff of the

Joint Economic Committee, in collaboration with Wharton Econometric Forecasting Associates. 3/ That study asked: What would have happened to the economy if an annually balanced budget policy had been followed over the period 1965-1974? 4/ The historical interval is divided into three subperiods: third quarter of 1965 to second quarter of 1969; third quarter of 1969 to second quarter of 1972; and third quarter of 1972 to second quarter of 1974. The first two subperiods, discussed below, are especially illustrative of some of the economic stability gains and losses arising from a balanced budget rule.

Balanced Budgets During High Employment, 1966-1969. As can be seen in lines 1 and 2 of Table 7, this period was marked by rapidly increasing deficits that contributed to a decline in the unemployment rate to levels not reached since the early 1950s. This excessive fiscal stimulus contributed to the doubling of the rate of increase of the Consumer Price Index (CPI) between 1965 and 1969. The increase in the CPI of 6.1 percent for the year ending in December 1969 was the highest in 20 years.

This stimulative policy was reversed late in the period. An income tax surcharge was adopted in June 1968 and the Federal Reserve sharply tightened monetary policy during 1969 in an attempt to slow down the boom. The result was the recession of 1969-1970.

During 1966-1969, a balanced budget would have been more consistent with economic stability than the budgets actually adopted. Line 3 of Table 7 shows the Wharton Model's estimate of the unemployment path that would have resulted from balancing the budget by reducing federal purchases in 1966-68 and by increasing them in 1969 (to eliminate the surplus in that year). Line 4 shows the

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3/ Congressional Joint Economic Committee, The Economic Impact of Alternative Fiscal Policies, Studies in Fiscal Policy, 1, August 16, 1976.

4/ Two other policy options were also evaluated: balancing the full-employment budget and a variable discretionary policy based on changes "which economists might have regarded as reasonable at the time." The study found that, because the full-employment budget was actually close to balance over the period, a policy of full-employment balance would not have made much difference. The discretionary policy was found to have been "significantly better" than the policy actually pursued in some cases.

TABLE 7. FEDERAL BUDGET DEFICITS AND UNEMPLOYMENT AND INFLATION RATES (ACTUAL AND SIMULATED), FISCAL YEARS 1966-1969

	1966	1967	1968	1969
Deficit (in billions of dollars)	3.8	8.7	25.1	+3.2 (surplus)
Unemployment Rate (in percents)				
Actual	4.1	3.8	3.8	3.4
With budget balance through changes in federal purchases a/	4.1	5.2	6.7	4.1
With budget balance through changes in federal taxes	4.1	3.9	4.3	4.1
Inflation Rate (GNP deflator, in percents)				
Actual	3.1	3.0	4.2	4.8
With budget balance through changes in federal purchases a/	3.2	3.2	4.3	4.1
With budget balance through changes in federal taxes	3.2	3.2	4.4	4.5

SOURCE: Wharton Econometric Forecasting Associates.

a/ Federal spending is classified into two categories: transfers and the purchase of goods and services. This simulation achieves budget balance without changing transfers (essentially payments to individuals).

estimated effect on unemployment of achieving budget balance through tax changes. Both approaches to budget balance would have significantly limited the decline in the unemployment rate. A balanced budget rule would have avoided excessive fiscal stimulus and restrained the rate of inflation, thus permitting the adoption of more moderately restrictive policies in 1968-1969. 5/ The 1969-1970 slowdown could, therefore, have been milder or avoided altogether.

5/ The Wharton simulations show only a modest improvement in inflation with a tax-adjusted balanced budget: 4.5 percent in 1969 versus the actual 4.8 percent. However, a property of

Another notable feature of the JEC study is the suggestion that balancing the budget through changes in taxes (and transfers --not shown here) would have less effect on unemployment and inflation than doing so through variations in federal purchases.

Balanced Budgets During Recession and Recovery, 1970-1972. Implementing a balanced budget rule in fiscal year 1971 and adhering to it in 1972 would have substantially increased unemployment. Even if the numbers in lines 3 and 4 of Table 8 are overestimates, it is clear that the need to raise taxes and reduce expenditures to balance the budget during a recession would have worsened the recession and, in this simulation, done so without lowering the inflation rate.

Proponents of a balanced budget rule would protest that, if such a rule had been in force during 1966-1969, there need not have been a recession in 1969-1970 or a rise in unemployment in 1971-1972. One can agree that it is unfair to ask what the consequences of a balanced budget would be in circumstances that would have been much different with continuously balanced budgets. But one must also recognize instances when the attempt to force tax revenues to equal outlays would magnify economic disturbances.

A Balanced Budget in 1974-1977 (DRI Estimates). One of those occasions when a balanced budget rule clearly would have magnified an economic disturbance occurred after the shocks to the economy from the OPEC oil embargo and price increases and worldwide crop failures in late 1973. Estimates of the effect of annually balanced budgets on unemployment, according to one version of the Data Resources Inc. (DRI) model, are shown in Table 9. As can be seen, a balanced budget rule is estimated to increase the unemployment rate by over 2.5 percentage points in both 1975 and 1976. In addition, the recovery would have been delayed a year.

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the Wharton model used in this simulation is that one of the principal effects of a decline in aggregate demand is to lower labor productivity and raise prices. This property is not shared by most other large models. On average, these other models indicate that a 1 1/4 percentage point higher unemployment rate for three years (roughly corresponding to the purchases balance option) would reduce inflation by about 2 percentage points by the end of the period--or to 2 3/4 percent by 1969.

TABLE 8. FEDERAL BUDGET DEFICITS AND UNEMPLOYMENT AND INFLATION RATES (ACTUAL AND SIMULATED), FISCAL YEARS 1970-1972

	1970	1971	1972
Deficit (in billions of dollars)	2.8	23.0	23.4
Unemployment Rate (in percents)			
Actual	4.0	5.7	5.9
With budget balance through changes in federal purchases a/	4.0	8.5	9.7
With budget balance through changes in federal taxes	4.0	6.1	6.9
Inflation Rate (GNP deflator, in percents)			
Actual	5.1	4.6	3.1
With budget balance through changes in federal purchases a/	4.0	8.5 b/	9.7 b/
With budget balance through changes in federal taxes	5.2	5.5	4.0

SOURCE: Wharton Econometric Forecasting Associates.

a/ Federal spending is classified into two categories: transfers and the purchase of goods and services. This simulation achieves budget balance without changing transfers (essentially payments to individuals).

b/ These inflation impact estimates are implausible. See footnote 3.

The price effects of such a policy would have been salutary, however. With annually balanced budgets beginning in 1972, the rate of inflation, as measured by the GNP deflator, would have been below 4 percent in 1977, according to DRI estimates, rather than the actual 5.9 percent increase.

Bias in Unconstrained Budgeting

Advocates of a balanced budget rule do not base their case exclusively on the demonstration that, in some particular histori-

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TABLE 9. UNEMPLOYMENT AND INFLATION RATES (ACTUAL AND SIMULATED), CALENDAR YEARS 1974-1977

	1974	1975	1976	1977
Unemployment (in percents)				
Actual	5.6	8.5	7.7	7.0
Simulated with balanced budget	6.0	11.2	11.3	9.1
Inflation Rate (GNP Deflator, in percents)				
Actual	9.7	9.6	5.2	5.9
Simulated with balanced budget	9.0	8.6	2.5	3.3

SOURCE: Data Resources, Inc.

cal circumstances, a balanced budget would have been more consistent with economic stability than the budget actually adopted. They argue, more generally, that the politics of an unconstrained budget process is biased toward deficits and excessive fiscal stimulus. 6/ Of the 26 federal budgets since 1957, 24 have been in deficit (the $0.3 billion surplus in 1960 and the $3.2 billion surplus in 1969 were the exceptions). Senators and Representatives find it in their interest and in the interests of their constituencies to "vote for every appropriation, for every tax cut, and against every tax." 7/ These fiscally expansive pressures can be all the more intense just prior to national elections. 8/ The 1982 record of the Congress in raising taxes and lowering spending demonstrates, however, that fiscal tightening is not impossible even in an election year.

6/ J.M. Buchanan and R.E. Wagner, Democracy in Deficit: The Political Legacy of Lord Keynes (New York: Academic Press, 1977).

7/ Senator Russell Long, Congressional Record, April 28, 1977, S6676.

8/ Edmund R. Tufte, Political Control of the Economy (Princeton University Press, 1978).

Effects of Persistent Deficits

Persistent deficits are thought to have adverse consequences for inflation, unemployment, productivity (output per unit of labor input), and the size of the federal budget.

Deficits, Inflation, and Unemployment. Deficits raise the level of aggregate demand above what it would be with balanced budgets; consequently, unemployment is lower for a period of time but inflation is higher. One of the difficulties of choosing to trade higher inflation for lower unemployment is that the beneficial effects on employment from fiscal stimulus are much shorter-lived than the effects on inflation. 9/ Thus, over time, as this trade-off is continued, the beneficial effects on employment dissipate while inflation continues to rise. The inflation effects of deficits, moreover, are especially pronounced if accompanied by an increase in the money supply. 10/

Deficits and Productivity. If persistent deficits raise real interest rates and thereby reduce the rate of investment, they can slow down the rate of growth of output per worker. Actually, deficits have two distinct, potentially offsetting effects on investment. First, by absorbing private savings, deficits leave fewer and more costly funds, at any given income level, for productivity-enhancing investments. In this way, Treasury borrowing to

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9/ Congressional Budget Office, Understanding Fiscal Policy, Washington, D.C. (April 1978), Chapter III.

10/ One recent study finds that a substantial percentage of the growth of the monetary base is attributable to deficits. (Mickey D. Levy, "Factors Affecting Monetary Policy In An Era of Inflation," prepared for presentation to the 50th Annual Conference of the Southern Economic Association, Washington, D.C., November 6, 1980.) A monetarist might view such a result as one explanation why the beneficial impact of deficits on reducing the unemployment rate tends to be much shorter lived than the impact on inflation. Most studies, however, have found an insignificant correlation between deficits and money supply (see, for example, Robert Barro, "Federal Deficit Policy and the Effects of Public Debt Shocks," National Bureau of Economic Research, Working Paper No. 443 (February 1980); and William Niskanen, "Deficits, Government Spending, and Inflation: What Is the Evidence?," Journal of Monetary Economics, vol. 4, 1978, pp. 591-602).

finance the deficit is said to "crowd out" private investment. Second, deficits increase aggregate demand above the balanced budget level and thus increase income. As real income rises, people save more. Thus, deficits, by raising income and the profitability of investment, may result in a higher level of both saving and private investment. While the financing of deficits tends to crowd out private investment, but the income effect tends to "crowd in" investment.

The potential for crowding in, however, depends on the ability of the deficit to increase real income. When the economy is at high levels of employment, this potential disappears. During periods of high labor and capacity utilization, deficits are apt to crowd out and reduce productivity. During recessions, deficits are likely to crowd in.

Deficits and the Growth of the Public Sector. In a sense, deficit financing of expenditures reduces the perceived cost of government, compared to tax financing, and may thereby lead to a bias toward governmental growth. Deficit financing of larger government expenditures increases aggregate demand more than tax-financed expenditures, in part because the public, as taxpayer, perceives the cost of the larger budget as lower if taxes are not raised. Similarly, deficits may disguise the true resource cost of government spending, especially at high-employment levels, and induce the public to accept a larger budget than they would choose with full knowledge of the cost.

Few studies have attempted to quantify the magnitude of this "fiscal illusion" from deficits. One study that did attempt to do so found that, over the 30-year period 1947-1976, deficits increased the level of federal spending by about 2.8 percent. 11/

Economic Prospects Under a Balanced Budget Constraint

Using recent economic history and conventional macroeconomic models as guides, some qualitative statements can be made about the likely consequences of a balanced budget rule.

11/ William A. Niskanen, "Deficits, Government Spending, and Inflation: What is the Evidence?" Journal of Monetary Economics, vol. 4, no. 3 (August 1978), pp. 591-602.

Assuming that, in the absence of such a rule, fiscal flexibility would favor deficits over surpluses, a balanced budget rule would result in higher unemployment and lower inflation, on average. 12/ If the deficit bias persists during periods of high employment, some private investment may be crowded out, with adverse long-run effects on productivity and inflation.

Disturbances to the economy would generate business cycles of substantially greater intensity and duration with a balanced budget constraint. Conversely the potential for the budget to act as an independent source of economic instability would be reduced.

Although the foregoing constitutes CBO's "best guess" estimate of the consequences of adopting a balanced budget constraint, there is reason to believe that this estimate may be a "worst case" scenario. Two basic objections, in particular, might be raised to suggest that the disruptive effects of balanced budgets have been overstated. These involve the nature of the model used in the evaluation and the implicit assumption about the rigor of the balanced budget rule.

The CBO prognosis is based on a model of the economy which, though widely used by business and government economists, is not universally accepted as useful for policy evaluation purposes. 13/ One of the objections to this model is that it may overstate the effect of budget changes on real economic variables because it does not distinguish budget changes that can be anticipated by the public from those that cannot. The gist of this objection is that the private sector of the economy can adjust to--that is, minimize the disruptive effects of--budget changes that it can

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12/ Under the assumption that the unconstrained budget process in the future would tend toward surpluses, a balanced budget regime would raise inflation and lower unemployment.

13/ See, for example, "In Praise of the Business Cycle" (Interview with Professor Fischer Black), Fortune, October 22, 1979, pp. 155-157; Robert E. Lucas, Jr., "Econometric Policy Evaluation: A Critique," in K. Brunner and A H. Meltzer, eds., The Phillips Curve and Labor Markets, Carnegie-Rochester Conference Series on Public Policy; and R.E. Lucas, Jr. and Thomas J. Sargent, "After Keynesian Macroeconomics," Quarterly Review, Federal Reserve Bank of Minneapolis (Spring 1979).

anticipate. Assuming competitive behavior in most markets, if the public learns to anticipate various types of budget changes, such as countercyclical budget policy or cyclically unresponsive policy (as with annually balanced budgets), the effects of these vastly different fiscal regimes may be quite small.

Moreover, a balanced budget rule might not be so tightly binding as has been assumed here. First, most proposals contain override provisions. By a simple or super majority, the Congress might suspend the constraint. Several proposals discussed in Chapter IV permit unplanned deficits resulting from a decline in revenues after Congress adopts the budget. Finally, a balanced budget rule might be weakened by the increased use of regulatory and off-budget methods of achieving government objectives. Deviations such as these from the policy of rigorous balance, as outlined in Chapter VII, would reduce the effects of a balanced budget rule.

CHAPTER VI. THE EFFECTS OF EXPENDITURE LIMITATIONS ON THE ECONOMY AND THE SIZE OF THE FEDERAL SECTOR

As with the preceding discussion on the effects of annually balanced budgets, the analysis in this chapter is predicated on the successful implementation of proposals to check the growth of federal expenditures.

EFFECTS ON THE ECONOMY

In theory, limitations on expenditure growth that are not tied to a balanced budget requirement are not necessarily destabilizing, regardless of how they are designed. Appropriate degrees of fiscal restraint or stimulus could be provided through unconstrained tax changes.

The reality of fiscal policy under an expenditure limitation might be very different from abstract possibilities, however. When faced with a recession in the past, various Congressional committees reported out stimulus bills affecting programs within their jurisdictions. This created a stimulus package consisting of tax cuts and various types of expenditure increases. The mix in the package, in turn, helped to obtain enough votes for the passage of each individual bill in the package. The practical effect of a spending limitation would be to reduce the possibility of putting together a politically acceptable package. It could be argued, therefore, that expenditure limitations would, in effect, reduce the probability that the Congress would pass stimulus legislation. 1/

1/ On the other hand, if the total stimulus had to be provided through revenue reductions, the necessary coalition could also be created through the inclusion of a variety of tax rate cuts and tax expenditures benefiting different constituencies. The coalition thus created might not be as broad as one that also included spending increases, however, and the tax changes might be difficult to reverse in later periods of economic expansion.

If it is assumed that expenditure limitations would not affect the Congress' ability to enact a budget with a deficit, it follows that such limitations, in themselves, would not necessarily affect the long-term rate of inflation. One possible exception is the expenditure limitation proposed by Professor Milton Friedman and the National Tax Limitation Committee and introduced in the House as H.J. Res. 169 by Representative Jenkins and in the Senate as S. 58 2/ by Senator Heinz. This proposal seeks to offer policymakers an anti-inflation incentive by lowering its expenditure growth rate limit by one-fourth of the percentage by which inflation exceeds 3 percent. The effectiveness of such an incentive depends, of course, on the ability of federal officials to lower the inflation rate and the willingness of those officials and the public to accept the other economic consequences of the actions that would have to be taken to accomplish this task. Finally, to the extent that expenditure limitations would not affect the size of federal deficits, they would not reduce the possibility of federal borrowing and the crowding out of private sector investment during periods of high employment.

EFFECTS ON THE SIZE OF THE FEDERAL SECTOR

As indicated in Chapter IV, all expenditure limitation formulas can be modified either to limit the growth or to reduce the size of the federal sector. This section describes the budgetary consequences of S.J. Res. 58, H.J. Res. 350, and other examples of the more frequently proposed options to limit expenditure growth.

Options

Chapter IV set out four options for expenditure limitation formulas. For each of these options, at least one bill or amendment is analyzed below as representative of that type of approach.

Option I--Set a Fixed Maximum Percentage Rate of Growth for Federal Outlays. H.R. 650, a bill introduced by Representative Wylie, would limit growth of all federal outlays and new budget authority to 7 percent per year. Any bill or resolution that would cause the growth rate to exceed the limit could be considered only during a war declared by the Congress or by the passage of a concurrent resolution by a two-thirds vote of the total membership of each House.

2/ S. 58 is a statutory version of H.J. Res. 169, which is a proposed constitutional amendment.

Option II--Limit Federal Outlays to a Fixed Percentage of an Economic Indicator. Two proposals are analyzed under this option. The first, H.R. 702, introduced by Representative Brown, would limit total federal unified budget outlays in the second concurrent resolution on the budget to 21 percent of that fiscal year's GNP during the first year of implementation, 20 percent during the second year, 19 percent during the third year, and 18 percent during the fourth year. As introduced, H.R. 702 would only apply to fiscal years 1982, 1983, 1984, and 1985. In order to compare it to the other options, it is assumed that it would be implemented in fiscal year 1983 and would apply to the entire five-year period 1983-1987, with the 18 percent GNP limit on the fourth and fifth fiscal years.

A disadvantage of formulas that limit outlays to a percentage of a single year's GNP is that the limit would rise and fall with economic cycles. As illustrated below, those formulas that limit expenditures to a percentage of actual GNP (or to a growth rate of actual GNP) would require outlay reductions during a recession.

One possible way to avoid this procyclical effect would be to limit outlays to a measure of trend GNP. The second proposal under Option II, S. 1848, introduced by Senator Gorton, follows this strategy. It would limit total budget outlays in budget resolutions to a percentage of an adjusted GNP based on average growth rates over a completed five-year period. The limit would be 22 percent of this adjusted GNP during the first year of implementation, 21.5 percent during the second year, 21 percent during the third year, 20.5 percent during the fourth year, and 20 percent thereafter. 3/

3/ The adjusted GNP would be obtained by multiplying current dollar GNP for the most recently completed fiscal year by one plus a five-year average growth rate of current dollar GNP and then multiplying that result by one plus the five-year average growth rate a second time. For example, to obtain the limit for fiscal year 1983, one would multiply current dollar GNP for fiscal year 1981 (the most recently completed fiscal year since the concurrent resolutions for fiscal year 1983 would be enacted during fiscal year 1982), by one plus an average of the current dollar GNP growth rates for fiscal years 1977, 1978, 1979, 1980, and 1981. One would then multiply that result by one plus the same five-year average growth rate. Finally, the adjusted GNP figure would be multiplied by 0.22 since the limit would be 22 percent of adjusted GNP in the first year of implementation.

By using the five-year average growth rate, S. 1848 attempts to smooth the effect of economic cycles. To the extent that it succeeded, it would avoid the need to reduce federal expenditures during economic downturns.

The use of the five-year average has a second advantage--it avoids the difficulties associated with those formulas that employ estimates of economic indicators for periods that have not been completed. Thus, to produce the limit for fiscal year 1983, S. 1848 would use data from fiscal years 1977 through 1981. Although the Commerce Department is continually revising its estimates of economic performance, the use of indicators from past years would eliminate most of the reestimating problems in producing the limit. It would not, however, avoid the possibility that "optimistic" estimation techniques would be used to ensure that the upcoming fiscal year's outlays would remain under the limit. 4/

Option III--Limit the Growth Rate of Federal Outlays to the Growth Rate of an Economic Indicator. As previously stated, H.J. Res. 350 is a balanced budget amendment to the Constitution that also contains provisions to limit expenditure increases to the growth of a current dollar measure of national income--such as GNP --during the most recently completed calendar year. For example, in fiscal year 1983 total federal outlays could not increase more than the growth of GNP between calendar years 1980 and 1981. 5/

H.J. Res. 350 would limit expenditure growth by limiting the growth of total federal receipts, by requiring that planned outlays not exceed planned revenues (unless the Congress waives this provision with three-fifths votes of the entire membership of each House), and by requiring that the Congress and the President take whatever steps are necessary to ensure that actual outlays do not exceed planned outlays.

4/ S. 1848 also addresses the estimating problem by allowing estimated outlays to exceed the calculated limit by up to two-tenths of one percent of adjusted GNP before a point of order is applicable. In fiscal year 1982 this would have created a margin of error of about $6 billion.

5/ S.J. Res. 58 is not analyzed here because, as described in the previous chapter, amendments adopted on the floor of the Senate have made it a balanced budget amendment rather than one to limit spending.

H.J. Res. 350 contains a provision that would allow the Congress to raise outlays above the limit; but this could be accomplished only through the passage of a law allowing for or raising additional receipts to cover the expenditures above those in the planned budget. In this analysis, it is assumed that the Congress would not enact such a law during the next five years and thus would be forced to stay within its planned revenue-outlay limits.

As does S. 1848, H.J. Res. 350 would avoid many estimation problems by using an economic indicator from a completed year to establish the growth rate. But unlike S. 1848, H.J. Res. 350 would apply that growth rate to a revenue base for a fiscal year that would be only half over when the planned budget was developed and approved by the Congress. This could lead to some optimistic estimating by future Congresses that might overestimate current revenues in order to inflate the base used to develop the limit for the planned revenues (and thus the planned and actual outlays) for the upcoming fiscal year. Even inadvertent small errors in estimates can lead to rather large budgetary effects in future years.

Since the models that are used to forecast future GNP produce estimates within a statistical confidence interval of plus or minus 4 percent, it would not be difficult for future Congresses to shift their forecasts to the appropriate end of that interval in order to increase the estimate of planned revenues and, therefore, the outlay limit.

Option IV--One of the Above Options Plus a Provision to Reduce the Maximum Rate of Growth Unless the Federal Government Meets an Inflation Target. Under H.J. Res. 169, introduced by Representative Jenkins, total federal outlays could not increase at a greater rate than the percentage increase of actual GNP during the calendar year preceding the beginning of the fiscal year under considedration. In addition, the growth rate would be reduced by one-fourth of the amount by which the inflation rate in the preceding calendar year exceeded 3 percent.

Estimates and Assumptions

In analyzing the effects of an expenditure limitation on the size of the federal sector, two questions are of paramount importance:

- Will the expenditure limitation formula cause the public sector to remain stable, contract, or grow over long periods of time?

- If the economy shifts from a period of expansion to one of contraction, will the expenditure limitation allow for additional outlays to counteract the economic downturn, or will it require outlays reductions as the economy worsens?

To answer these questions, the effects of the five expenditure limitation proposals discussed above were analyzed under two sets of economic and budgetary conditions drawn from CBO's five-year current policy projections for the fiscal year 1983 budget cycle (see Table 10). These sets of economic and budgetary conditions are not forecasts. They were chosen to illustrate what might occur under these five expenditure limitations if the Congress adopted a budget policy assuming vigorous economic growth only to find out as the years unfolded that the actual economy performed poorly.

Optimistic Assumptions. The limitations first were analyzed under a five-year set of economic assumptions that assumes real economic growth in the 4 to 5 percent range as the economy recovered from the current recession. In this hypothetical scenario, real GNP growth would be 5.3 percent in fiscal year 1983, 5.2 percent in fiscal year 1984, 5.0 percent in fiscal year 1985, 4.6 percent in fiscal year 1986, and 4.0 percent in fiscal year 1987. The unemployment rate would decline from 7.9 percent in fiscal year 1983 to 5.6 percent in fiscal year 1987. In this strong recovery, the rate of inflation would also decline, from 6.4 percent in fiscal year 1983 to 5.2 percent in fiscal year 1987.

While these hypothetical assumptions are very optimistic, similar economic scenarios have been adopted recently by the Congress and the Administration. Under an expenditure limitation, future Congresses might be tempted to adopt such a rosy view of the future economy in order to minimize the estimate of outlays (since outlays for programs such as unemployment insurance will fall as the economy improves) and increase the estimate of revenues.

Pessimistic Assumptions. The actual world, of course, could turn out to be much less favorable than the scenario outlined above. The second hypothetical set of economic assumptions illustrates what might happen if the economy makes only a very weak recovery from the present recession. In this pessimistic scenario, real GNP growth is in the 2 to 3 percent range--2.9 percent in fiscal year 1983, 2.2 percent in fiscal year 1984, and 2.0 percent