SUMMARY

President Carter's budget for fiscal year 1982 recommends outlays of $739.3 billion, revenues of $711.8 billion, and a unified budget deficit of $27.5 billion. The latest budget estimates for 1981 show a $30 billion increase in outlays over the level approved by the Congress in its second budget resolution, and a unified budget deficit of $55.4 billion. If the outlays of off-budget entities are included, the total budget deficits are $78.4 billion in 1981 and $45.8 billion in 1982, as shown in the following table. As a result of these deficits, the federal debt subject to limit is projected to exceed $1 trillion during the next fiscal year.

SUMMARY TABLE 1. THE FEDERAL BUDGET TOTALS FOR FISCAL YEARS 1980-1982 (In billions of dollars)

		1981 Estimates		President
	1980 (Actual)	Second Budget Resolution	President Carter's Budget	Carter's 1982 Budget
Revenues	520.0	605.0	607.5	711.8
Outlays				
Unified budget	579.6	632.4	662.7	739.3
Off-budget entities	14.2	22.0	23.2	18.3
Total outlays	593.9	654.4	685.9	757.6
Deficit (-)				
Unified budget	-59.6	-27.4	-55.4	-27.5
Off-budget entities	-14.2	-22.0	-23.2	-18.3
Total deficit	-73.8	-49.4	-78.4	-45.8
Debt Subject to Limit	908.7	978.6	987.3	1,053.6

THE ECONOMIC OUTLOOK

An acceleration of inflation and record interest rates in the last quarter of 1980 have caused most forecasters to predict a slowdown, if not a decline, in economic growth and rising unemployment during the first half of 1981. Some economists expect that the economy will bounce back vigorously after midyear, partly because of the enactment of tax cuts. Others believe that economic growth will be weak during the next few years given the momentum of inflation and the expectation that the Federal Reserve will pursue stringent monetary policies until the rate of inflation shows substantial improvement.

The Carter Administration expects that recovery from the 1980 recession will resume at a moderate pace in the second half of 1981, after a pause in the first half. Real growth is projected to be 1.7 percent during 1981 (fourth quarter to fourth quarter), and 3.5 percent during 1982. This forecast of economic growth over the two-year period is within the range of recent commercial forecasts and similar to CBO's preliminary assumptions.

Inflation generally is expected to remain at double-digit levels in 1981, with some moderation during 1982. The Carter Administration forecast for 1981 is somewhat higher than various commercial forecasts and CBO's assumptions. In part, this difference may be due to the ten cents a gallon increase in motor fuel taxes proposed by the Administration to begin June 1, 1981. The Carter budget spending estimates assume that the annual cost-of-living adjustment for Social Security and related benefits, which is tied directly to changes in the Consumer Price Index, will be 12.3 percent in 1981 and 11.3 percent in 1982.

The unemployment rate is generally projected to drift higher in the first half of 1981 and then to decline slowly for the next 18 months as economic growth picks up. The Carter budget predicts that unemployment will average 7.8 percent during calendar year 1981 and 7.5 percent in 1982. Interest rates are expected to be very volatile but remain at relatively high average levels throughout the next two years.

The economic outlook is particularly uncertain at this point, and there is a considerable dispersion of views among economic forecasters. Two of the most important sources of uncertainty are inflation and monetary policy. Another sizable boost in oil prices above the increases already assumed in the forecasts, or a year of bad crops, would substantially alter the outlook for the worse. With respect to monetary policy, the Federal Reserve faces the very difficult challenge of reducing inflation. Many believe that its credit policies are likely to choke off, or delay, the projected economic recovery.

The Carter Administration's proposed fiscal policy for fiscal year 1982 would not provide a significant restraint on inflation. The federal budget became strongly expansive in 1980, as the deficit rose sharply to nearly $60 billion from approximately $28 billion in 1979. The deficit rose in 1980 both because of policy changes and because of the recession, which reduced income and therefore tax receipts and increased outlays for unemployment insurance and other programs. The deficit in 1981 is expected to stay roughly at the same level as in 1980, and come down in 1982 as outlay growth slows and revenues are allowed to rise to an estimated 22.3 percent of the gross national product, partly as a result of continued high inflation.

While the Administration's proposed increase in motor fuel taxes would encourage fuel conservation and lessen dependence on foreign oil, it would also have a significant inflationary impact. CBO estimates that the proposed tax would yield motor fuel savings of around 100,000 barrels per day in fiscal year 1982, but would also increase the CPI by approximately 0.6 to 0.7 percentage points in 1982 and up to 1.0 percentage point thereafter.

The projected rapid growth in defense and other federal purchases would provide additional stimulus to the economy, despite the savings proposed in benefit programs and other federal expenditures.

THE 1981 BUDGET OUTLOOK

Less than one year ago, the Congress planned to balance the budget in fiscal year 1981. Now the budget is projected to have a deficit of at least $55 billion. Almost all of the deficit can be attributed to higher spending than contemplated by the first resolution, not to lower revenues. President Carter's 1982 budget projects 1981 outlays at $662.7 billion, almost $50 billion higher than the first budget resolution and $30 billion higher than the second budget resolution approved in November.

Most of the increase in estimated 1981 spending was the result of events over which the Congress has little or no control under current laws. While the first resolution was being debated, the economy took an unexpected nose dive as a result of tighter monetary policy. During the April-June quarter, the economy declined in real terms at a 9.6 percent rate, the sharpest single-quarter contraction of the postwar period. This pushed up unemployment to higher levels than expected, and triggered extended unemployment insurance benefits. The automobile industry was particularly hard hit, and trade adjustment assistance benefits were provided to unemployed auto workers. As a result, unemployment benefit costs rose sharply in 1980, and are projected to remain at fairly high levels in 1981. This accounts for over $7 billion of the increase in estimated spending from the first resolution.

Higher interest rates during the last several months account for an even larger part of the increase in 1981 estimated outlays. Net interest costs are now projected to be over $8 billion higher than assumed for the first budget resolution. The increase in interest rates also means that the cost of student loan insurance will be higher, that fewer federal loan assets will be sold to the public, and that federal assistance to failing thrift institutions will be more than expected a year ago. This adds another $3 billion to the 1981 outlay estimates.

Spending for various indexed benefit payments and other transfer programs that are affected by inflation and high unemployment is now projected to be almost $8 billion higher than estimated for the first budget resolution. The largest increases are for federal employee retirement benefits and health care services, partly as a result of the failure of the 96th Congress to achieve the cost savings contemplated for these programs in the first resolution.

Defense spending is also up about $7 billion from the level assumed for the first budget resolution. Part of this increase (10 percent) is a result of a larger October 1980 payraise for both military and civilian employees than was assumed for the resolution. Most of the increase, however, is the result of higher spending rates for procurement of weapon systems and stepped up defense activities and fuel costs.

Unexpected events also caused increases in federal spending. For example, disaster assistance and Corps of Engineers spending will be about $2 billion higher in 1981 than expected because of Mt. Saint Helens and other natural disasters last year. The heavy influx of Cuban/Haitian entrants last year will cause 1981 spending for refugee assistance to be higher than expected a year ago. The recent Penn Central settlement will add another $2.1 billion to federal outlays in 1981.

On the revenue side, there has been a slight fall-off in expected receipts because of lower incomes now being assumed. Current law revenues for 1981 are now projected to be about $605 billion. President Carter's 1982 budget proposes a net tax increase of $2.5 billion in 1981, largely as a result of his proposed increase in the federal motor fuels tax. The 1981 second resolution revenue estimate was also $605 billion, but this assumed a tax cut this year that would reduce fiscal year 1981 receipts by $10 billion. If the Congress were to pass such a tax cut, with little or no reduction in spending and no other tax changes, the 1981 budget deficit could approach $70 billion.

THE 1982 BUDGET OUTLOOK

The budget outlook for 1982 is little better than for the current fiscal year. CBO estimates that revenues under current law will grow by 17.2 percent in 1982, for an increase of $104 billion, largely as a result of legislated increases in Social Security taxes and continued high inflation which pushes people into higher tax brackets. CBO's preliminary projections for 1982 outlays under current policies show a falling off in spending growth to about 12.5 percent, compared to 14 percent in 1981 and over 17 percent in 1980. The projected deficit under these assumptions would decline to about $34 billion, as shown in the following table.

SUMMARY TABLE 2. CBO BASELINE PROJECTIONS AND REESTIMATES OF PRESIDENT CARTER'S BUDGET FOR FISCAL YEAR 1982 (In billions of dollars)

	CBO Baseline Projections	President Carter's 1982 Budget	CBO Reestimate of Carter Budget
Revenues	708.5	711.8	711.8
Outlays	742.9	739.3	745.0
Deficit (-)	-34.4	-27.5	-33.2

The net effect of the Carter budget proposals would be a small increase in both revenues and outlays above current law levels, adjusted for inflation, population growth, and other increased costs resulting from previous policy decisions. After CBO reestimated the Administration's revenue and spending proposals, adjusting for differences in economic assumptions and estimating methods, the President's proposed revenues would be about $3 billion above CBO's baseline projections, and outlays about $2 billion.

The budget presented by President Carter stresses increased spending for national defense, tax cuts, and spending increases to encourage capital formation and increased industrial productivity, and various measures--including a ten cents a gallon gasoline tax--to encourage energy conservation. To offset the projected $7 billion rise in Social Security taxes in 1982, the Carter budget proposes that individuals and employers be given an 8 percent income tax credit. Various budget reductions and proposed legislative savings, many of them requested in previous budgets, would offset most of the recommended spending increases above current policy levels.

Revenues

The composition and timing of the tax proposals in the Carter budget indicate that the major objective of the Administration's tax policy is to achieve faster economic growth over the long run rather than to provide stimulus to offset the projected weakness of the economy in the near term. The Carter $18.3 billion tax cut package emphasizes incentives for business investment, with about 70 percent of the tax relief going to business in fiscal year 1982 and about 60 percent in future years.

Tax relief for individuals in 1982 comes mainly from an income tax credit equal to 8 percent of Social Security payroll taxes. The tax saving to employees from this proposal in fiscal year 1982 would only be about $5.3 billion. Tax reductions would be concentrated on those workers with incomes between $10,000 and $30,000. Government workers, retirees, and others who do not pay Social Security taxes would not benefit from this tax credit.

All of these tax reduction proposals were contained in the economic revitalization program that the Carter Administration proposed last August. Effective dates for most of the individual tax cuts have been postponed to January 1, 1982, however, while the major business tax cuts are still scheduled to take effect retroactively on January 1, 1981.

The Carter budget also proposes $23.6 billion in tax increases for fiscal year 1982. After adjusting for the restrictive effect of the overall tax program, the Carter Administration tax proposals in the aggregate would raise revenues an estimated $3 billion over projected current law levels. Beside the 10 cents a gallon increase in the gasoline tax, which is estimated to raise $13.1 billion in revenues in 1982, the major tax increase proposals include withholding on interest and dividends ($3.9 billion), new funding for the expired airport and airway trust fund ($1.4 billion), increases in certain other excise taxes that support the highway trust fund ($1.4 billion), and taxation of commodity "straddles" and futures contracts ($1.3 billion).

Outlays

The major spending initiative in President Carter's budget for 1982 is increased spending authority for national defense programs. The budget proposes $200 billion in new budget authority for the national defense function, which CBO estimates would provide about 4 percent in real growth above 1981 levels. The proposed real growth for defense operations, construction, and research, however, masks a significant real decline in the number of major weapons to be purchased. Fewer aircraft, ships, and tanks would be procured at significantly higher costs per unit in 1982 than previously planned.

CBO also estimates that the 1982 defense purchases are underfunded by over $5 billion in President Carter's budget. As a result of higher inflation assumptions for defense purchases than those used by the Administration, CBO estimates that an additional $2 billion in new budget authority would be required for projected fuel consumption, $2 billion for full funding of proposed weapon purchases, and $1 billion for defense supplies and other purchases.

Nondefense spending would be held constant in real terms in 1982. To accomplish this result, the budget proposes a number of reductions in federal spending programs for 1982, many of which would require changes in existing law. The most prominent of the legislative savings proposals are federal employee compensation reform and changes in the indexing formulas for selected benefit programs. Under the pay reform proposals, the comparability increases for the October 1981 payraise would be an estimated 9.1 percent for military employees and 8.6 percent for civilian employees. The Carter Administration estimates that the pay reform proposals would save $3.5 billion in 1982 from the projected 13.5 percent comparability increase under current law. The Carter budget also assumes $1.5 billion in additional savings by limiting the October 1981 payraise to 5.5 percent for civilian employees.

The Carter budget also proposes a shift to annual cost-of-living increases for all indexed federal programs that are currently adjusted more than once a year. Under this proposal, the September increase for federal employee retirement programs would be eliminated for an estimated saving of $1.1 billion in 1982. Annual adjustments for dairy price supports and child nutrition programs, together with a change in the way food stamp benefits are adjusted for inflation, would save an additional $600 million.

72-339 O - 81 - 2

A limited number of new spending initiatives that would require legislative action are also proposed. These include a refundable investment tax credit to provide investment incentives to firms that have little or no earnings, and to those experiencing structural adjustment problems ($2.3 billion in 1982 outlays); making the 8 percent Social Security tax credit refundable to state and local governments, nonprofit organizations, and businesses, but not to individuals ($1.5 billion in outlays as reestimated by CBO); and renewing the Administration's youth education and training initiative to provide basic education and training for educationally disadvantaged, particularly minority youth who are poorly prepared for employment ($2.0 billion in budget authority and $925 million in outlays). A 12.3 percent cost-of-living increase for veterans' compensation benefits, effective in October 1981, is also proposed.

President Carter also recommended that interfund borrowing be authorized for the three major Social Security trust funds to meet the short-term cash flow needs of the old age and survivors insurance program. Such authority would only be sufficient to solve the Social Security financing problems for the next two to three years. Some additional action to increase trust fund revenues and/or curtail projected costs will be necessary before the end of fiscal year 1984.

THE CREDIT BUDGET

The federal credit budget, first instituted last year, records the estimates of new direct loan obligations and new loan guarantee commitments for both on-budget and off-budget agencies. For 1982, the credit budget totals $153 billion, about one-fifth of the size of the federal budget for spending. In addition, the Administration is requesting annual appropriation bill limitations for 67 percent of new credit activities. The purposes of the federal credit budget and the annual program limitations are to exercise greater control over the growth of federal credit activities, to ensure that the level of resources for these activities is justified, allocate resources among the various programs consistent with national priorities, and to give more careful consideration to the impact of total federal credit activity on the economy as a whole.

The credit budget totals shown in Summary Table 3 rise by $34 billion in 1981 and fall by $13 billion in 1982. If the projected decrease is achieved in 1982, it will be a marked departure from the steady growth in federal credit activities, which have grown about a third faster than budget outlays during the past decade. As originally estimated a year ago, the 1981 credit budget projected a 5 percent increase over 1980, compared to the 26 percent increase now estimated by the Carter Administration.

SUMMARY TABLE 3. THE CREDIT BUDGET (By fiscal year, in billions of dollars)

Credit Activity	1980 (Actual)	1981 Estimates: Second Budget Resolution	1981 Estimates: President Carter's Budget	President Carter's 1982 Budget
New Direct Loan Obligations				
Unified budget	37.8	44.6	42.1	34.1
Off-budget	23.6	28.9	32.2	26.1
Subtotal, direct loans	61.4	73.5	74.2	60.2
New Loan Guarantee Commitments				
Gross	134.2	135.8	164.3	166.7
Less secondary	-64.4	-53.0	-73.2	-74.3
Subtotal, primary loan guarantees	69.8	82.8	91.1	92.4
Total, credit budget	131.2	156.3	165.4	152.6

CHAPTER I. THE ECONOMIC OUTLOOK AND THE CARTER ADMINISTRATION'S FISCAL POLICY

The state of the economy has important implications for the federal budget, and budgetary decisions can in turn have significant effects on the economy. This chapter reviews the Carter Administration's forecast of the economy through 1982 and compares it to other economic forecasts, describes the fiscal policy proposed in the Administration's budget, and discusses the longer-term interaction between the economy and the budget.

In brief, the Carter Administration's budget for fiscal year 1982 is based on a forecast of weak growth, high inflation, and high unemployment. The economy is expected to show little, if any, economic growth until mid-year 1981, inflation is expected to continue at or near double-digit levels, and the unemployment rate is forecast to remain close to 7.5 percent through 1982.

The Carter Administration's budget proposal calls for a slowing--but nevertheless high--rate of growth of federal outlays. Spending, which rose by 17.4 percent in 1980, is projected to increase by 14.3 percent in 1981 and 11.6 percent in 1982. Receipts are expected to grow at an even faster pace --by 16.8 percent in 1981 and 17.2 percent in 1982.

On balance, the Administration's budget proposes net tax increases in both 1981 and 1982; the revenue gains which include the proposed 10 cents a gallon motor fuel tax and withholding on interest and dividends more than offset the proposed tax reductions--which include faster depreciation, reduction in the marriage tax penalty, and an 8 percent income tax credit for Social Security taxes. The composition and timing of the Administration's proposed tax reductions indicate that the major objective of tax policy is to boost the capital stock so as to achieve faster economic growth over the long run, rather than to provide a stimulus to offset the projected weakness of the economy in the near term.

THE ECONOMIC OUTLOOK

The Carter Administration's Forecast

The Carter Administration's economic forecast predicts that after a period of little or no growth during the first half of 1981, the economy will continue its recovery from the 1980 recession. Real growth (measured fourth quarter to fourth quarter) is expected to be 1.7 percent in 1981 and 3.5 percent during 1982 (see Table 1). This scenario for economic growth leaves the unemployment rate little changed by late 1982, compared with recent levels; unemployment is projected to inch higher, reaching 7.7 percent in late 1981, before declining slowly to 7.4 percent in late 1982.

Under the Carter Administration's forecast, inflation is expected to remain very high in 1981—about the same as in 1980. Some improvement in inflation rates is expected in 1982, but the increase in the Consumer Price Index will remain near double-digit levels. The Carter Administration's economic projections assume that interest rates will remain very high, consistent with the forecast of continued high inflation. Specifically, the average interest rate on new 91-day Treasury bills is projected at 13.5 percent in 1981 and 11.0 percent in 1982. These projections assume that interest rates decline with the rate of inflation.

The Carter Administration's forecast is broadly in line with that of other economic forecasters and with the preliminary economic forecast used by CBO to generate the budget estimates contained in this report. 1/ The Carter Administration's estimates for nominal GNP growth and the unemployment rate fall within the range of estimates made by four large commercial forecasters (see Table 1). Its forecasts of economic growth and inflation lie close to the range of the commercial forecasts.

Comparisons with other forecasts should, however, be interpreted with great caution. 2/ Forecasts can differ because of differences in the assumptions that underlie the forecasts. The fiscal policy assumptions incorporated in both the commercial forecasts and that of CBO depart substantially from the fiscal policy assumed by the Carter Administration.

1/ The CBO preliminary economic forecast was prepared in November 1980, before the Commerce Department's recent revisions in GNP were available. CBO's formal forecast is being prepared for release in March.

2/ For convenient summaries of recent economic forecasts of 1981, see "The Year Should Improve With Age," Business Week (December 29, 1980), pp. 72-74; and Eggert Economic Enterprises, Inc. Blue Chip Economic Indicators (January 10, 1981). The average forecast for 1981, as reported in these sources, tends to be quite close to that of the Carter Administration. Other forecasters, however, seem to be about one percentage point lower on inflation (some of that difference could be due to the Administration's assumption of higher gasoline taxes).

TABLE 1. THE CARTER ADMINISTRATION'S ECONOMIC FORECAST, CBO'S PRELIMINARY PROJECTIONS, AND THE FORECAST RANGE OF FOUR LARGE-SCALE COMMERCIAL FORECASTERS, 1981-1982

Economic Variable	Administration Forecast a/	CBO Preliminary Projections b/	Range of Four Commercial Forecasts c/
Nominal GNP (percent change)			
1980:4 to 1981:4	12.3	12.8	11.3 to 12.6
1981:4 to 1982:4	12.6	14.1	12.1 to 15.4
Real GNP (percent change)			
1980:4 to 1981:4	1.7	2.2	1.0 to 3.2
1981:4 to 1982:4	3.5	4.0	3.7 to 5.8
Inflation (percent change in GNP deflator)			
1980:4 to 1981:4	10.4	10.3	9.1 to 10.2
1981:4 to 1982:4	8.8	9.7	8.0 to 10.2
Consumer Price Index (percent change)			
1980:4 to 1981:4	12.6	10.0	10.9 to 12.4
1981:4 to 1982:4	9.6	9.7	8.8 to 10.4
Unemployment Rate (percent)			
1981:4	7.7	7.9	7.1 to 8.2
1982:4	7.4	7.1	6.1 to 7.7

Note: The forecasts are not directly comparable because of differences in economic and policy assumptions, and in forecast dates.

a/ Budget of the United States Government Fiscal Year 1982, p. 3.

b/ CBO's preliminary projections were prepared in late November 1980, for the purpose of analyzing the Carter Administration's budget. CBO's formal forecast for 1981-1982 will be available in March 1981.

c/ The models and dates of forecasts are:

Chase Econometrics, Inc., January 7, 1981
Data Resources, Inc., December 24, 1980
Evans Economics, January 7, 1981
Wharton Econometric Forecasting Associates, Inc., December 3, 1980

All of the commercial forecasts assume that individual income taxes will be cut in 1981, and none assume an increase in the motor fuel tax or the withholding of taxes on interest and dividends, which are incorporated in the Carter Administration's forecast. Three of the four commercial forecasts expect growth to be from 1.0 to 1.8 percent in 1981, close to the Carter Administration's estimate, but their forecasts would probably fall below that of the Administration's if they used the same assumptions for tax policy. On the other hand, the Carter Administration's forecast for inflation in 1981 is slightly higher than that of the four commercial models. This difference may be due to the 10 cents a gallon increase in motor fuel taxes proposed by the Carter Administration.

Risks to the Forecast

At present the economic outlook is very uncertain. Two important sources of this uncertainty are inflation and monetary policy. With respect to inflation, another sizable boost in oil prices above that assumed in the forecast, or a year of bad crops, would substantially alter the forecast for the worse. With respect to monetary policy, the Federal Reserve faces the very difficult challenge of reducing inflation without choking off or unduly delaying the recovery. Consumer spending, another source of uncertainty, could be greater than anticipated, as was the case before the 1980 recession. This could produce a stronger economy than currently expected.

THE ADMINISTRATION'S BUDGET PROPOSALS AND THEIR IMPACT ON THE ECONOMY

The impact of the federal budget on the economy became strongly expansive in fiscal 1980. The deficit for the year rose sharply to $59.6 billion from $27.7 billion in 1979 (see Table 2). The deficit rose both because of discretionary policy changes and because the recession reduced income and therefore receipts, while increasing outlays for such programs as unemployment insurance.

The Administration's budget projects a deficit of $27.5 billion in 1982, about one-half of the $55.2 billion deficit anticipated in 1981. The reduction in the 1982 deficit would be attained in part by reducing the growth in outlays to 11.6 percent, from 14.3 percent in 1981, and in part by allowing receipts to increase by 17.2 percent in 1982 over 1981. As a percent of gross national product, outlays would fall from 23.3 percent in 1981 to 23.0 percent in 1982 while receipts would climb from 20.3 percent in 1980 to 21.4 percent in 1981 and to a historic high of 22.1 percent in 1982.

TABLE 2. THE FEDERAL UNIFIED BUDGET FOR FISCAL YEARS 1980-1982

	1980 (Actual)	Administration Estimates 1981	Administration Estimates 1982
	Budget Totals (billions of dollars)		
Revenues	520.0	607.5	711.8
Outlays	579.6	662.7	739.3 a/
Deficit	59.6	55.2	27.5
	Growth Rates from Year Earlier (percent change)		
Revenues	11.6	16.8	17.2
Outlays	17.4	14.3	11.6
Outlays in Constant 1972 Dollars	4.4	0.8	1.0

SOURCE: The Budget of the United States Government Fiscal Year 1982, Table 22.

a/ CBO's preliminary reestimates for the Carter budget are $745.0 billion in outlays. For discussion see Chapter 3.

Despite the reduction in the size of the deficit, the slowing in the rate of growth of outlays, and the decline in spending as a fraction of gross national product, the Carter Administration's proposed fiscal policy for 1982 is not expected to restrain inflation significantly. The tax proposals, the rapid growth in defense and other purchases, and the lagged impact of previous fiscal stimulus lie behind this judgment.

The Administration's Policy Proposals

The Administration's tax proposals in the 1982 budget emphasize stimulating longer-term growth, lowering inflationary pressures, and reducing dependence on foreign oil, rather than short-run stimulus to reduce unemployment. The "economic revitalization" program includes proposals to stimulate business capital spending and an income tax credit for Social Security taxes to reduce employers' costs and individuals' tax burdens. The spending initiatives emphasize increases for defense, measures to enhance productivity, and steps to curb the growth of income security outlays.

The Administration's major tax proposals include:

- Faster depreciation for tax purposes on business capital—a 40 percent reduction in depreciation lives, effective retroactively to January 1, 1981;

- Income tax credit of 8 percent for Social Security taxes paid by both employers and employees, effective January 1, 1982;

- Withholding of income taxes on interest and dividend income, effective January 1, 1982;

- A motor fuel tax increase of 10 cents per gallon, effective June 1, 1981;

- Reduction in the marriage penalty for income taxes, effective January 1, 1982; and

- Allowing the Targeted Jobs Tax Credit to expire on December 31, 1981.

These tax proposals are analyzed in Chapter 2. Two of them—the gasoline tax and withholding on interest and dividends--were made by the Administration in 1980, but rejected by the Congress.

The Administration's principal spending proposals, which are analyzed in Chapter 3, include:

- A substantial increase for defense;

- Allowing refunds of 30 percent of the investment tax credit earned by corporations with no corporate income tax liability, effective January 1, 1981;

- An increase for federal support of basic research and development;

- Reductions in the growth of federal employee compensation; and

- Curbing the growth of spending for income security programs through policies such as making cost-of-living adjustments once, rather than twice, a year for federal retirees, and modifying the index used to adjust benefits for inflation.

Impact of the Proposals on the Economy

The Carter Administration's budget proposals provide both higher taxes and higher spending than the CBO baseline budget estimates, which are extrapolations of the policies adopted in the second budget resolution for fiscal year 1981. On balance, the policies proposed by the Carter Administration in the short run will lead to higher unemployment, lower real GNP, and higher inflation than would the policies reflected in the baseline estimates.

With respect to taxes, the second budget resolution incorporated a sizable, but not clearly defined, tax cut. CBO's baseline estimates assume the tax cut includes the 2-4-7-10 depreciation proposal developed by the Senate Finance Committee (effective January 1, 1981) and a 10 percent reduction in personal income taxes (effective July 1, 1981). The differences between the baseline and the Carter budget with respect to the broad categories of spending are quite small (Table 3). 4/

The economic impact of the Carter proposals, compared to the CBO baseline assumptions, is shown in Table 4. The personal and excise tax increases in 1981 would work quickly to reduce economic activity. In the fourth quarter of 1981, real gross national product (in 1972 dollars) would be about $10 billion (0.7 percent) lower and the unemployment rate 0.2 percent higher than the CBO baseline. In addition, because of the motor fuel tax, the price level as measured by the implicit deflator for gross national product would be 0.5 percent higher in the fourth quarter of 1981. The payroll tax credit would keep the economy from weakening further in 1982 and offset the tendency of the gasoline tax to push up the level of prices still further. 5/

4/ The constant rate depreciation proposal of the Carter budget is not shown in Table 2 since it is roughly of the same magnitude as the depreciation package assumed by CBO, and the short-run implications for the overall economy are probably quite similar.

5/ The business portion of payroll taxes is thought by many economists to represent a component in the price of a firm's output. Thus, a reduction in these taxes will lower business costs and could be passed forward to consumers in the form of lower prices.

TABLE 3. DIFFERENCE BETWEEN THE CARTER ADMINISTRATION'S SPENDING AND TAX PROPOSALS AND THE CBO BASELINE ESTIMATES (NIA basis, billions of dollars)

Budget Changes	Calendar Years 1981	Calendar Years 1982
Spending		
Purchases of goods and services	-1	8
Transfer payments	6	-2
Grants to state and local governments	2	-2
Total spending	7	4
Taxes		
Income	15	18
Payroll	(0)	(-12)
Other	(15)	(30)
Excise	7	14
Total taxes	22	32

These economic impact estimates help to explain why the Carter Administration's forecast of economic growth lies toward the low end of the range of 1982 forecasts presented in Table 1. In short, its proposed tax package would slow the recovery. 6/

6/ The likely response of the monetary authorities to increased upward pressure on the price level is unclear. Monetary policy could become even more restrictive and set the stage for a lackluster performance of the economy in 1982 as well.

TABLE 4. SHORT-RUN ECONOMIC IMPACTS OF PRESIDENT CARTER'S FISCAL PROPOSALS

Economic Indicator	1981:IV	1982:IV
Gross National Product (Billions of 1972 dollars)	-10	-12
Unemployment Rate (Percent)	0.2	0.3
Implicit Price Deflator (Change from baseline, percent)	.5	.5

LONGER-TERM ECONOMIC AND BUDGET PROJECTIONS

The longer-run performance of the economy has profound implications for the budget, and vice versa. By several important measures, the performance of the U.S. economy has been slipping since the mid-1960s and especially since 1973 (see Table 5). Economic growth averaged 3.8 percent per year during the 1948 - 1973 period, then declined to 2.7 percent during the subsequent five-year period. From 1978 to 1980, there was hardly any growth--due in part to the 1980 recession. Productivity growth declined steadily while inflation continued on its long-term upward trend.

These longer-term economic trends have intensified the pressures on the federal budget. For example, slower economic growth tends to reduce the growth in receipts, while reduced productivity growth tends to lower the growth in real earnings and to weaken the financial condition of the Social Security system.

Economic Projections

The Carter Administration's longer-run economic assumptions are required to be in accord with the goals established by the Full Employment and Balanced Growth Act (P.L. 95-523). Last year, the Administration postponed the timetable for achieving the specific employment and inflation goals of this Act, as it is permitted to do. This year, the Administration

TABLE 5. LONGER-TERM TRENDS IN OUTPUT, PRODUCTIVITY, INFLATION, AND UNEMPLOYMENT, 1948 -1980

	1948 to 1965	1965 to 1973	1973 to 1978	1978 to 1980
	(Average annual changes, in percent)			
Gross National Product in Constant 1972 Dollars	3.8	3.8	2.7	1.5 a/
Output per Hour, Private Business Sector	3.2	2.5	1.0	-.4 b/
Inflation				
GNP Deflator	2.0	4.5	7.3	8.7 a/
Personal Consumption Deflator	1.9	4.0	7.2	9.6 a/
Consumer Price Index	1.6	4.4	7.9	12.5 c/
	(Average annual percent)			
Unemployment Rate	4.9	4.5	6.6	6.3

SOURCE: Computed from data in the Economic Report of the President 1981, Tables B-2, B-3, B-29 and B-39; and Budget of the United States, p. 3.

a/ Data for 1980 are preliminary.

b/ 1978 to 1979.

c/ The 1980 figure is an estimate based on incomplete data.

again postponed attainment of these goals, citing as one reason the huge oil price increases that occurred in 1979.

The budget's longer-range economic assumptions include real growth slightly above 3-1/2 percent over the 1983-1986 period, with unemployment falling to 6.0 percent and inflation declining to a little over 6 percent in 1986 (see Table 6). Unless the performance of the economy improves markedly, however, even these longer-term projections will be extremely difficult to meet.

Budget Outlook, 1983-1986

In the Carter Administration's longer-term projections, the budget comes close to balance in fiscal 1983, and shows large and growing surpluses in 1984-1986. As the Administration pointed out, these projections should not be interpreted as realistic expectations that large surpluses will in fact develop. The projections assume that tax laws are not changed despite rising nominal incomes. The Administration recognized that tax cuts may be necessary to offset the fiscal drag produced by rising tax burdens, but left their timing and make-up unspecified.

TABLE 6. ADMINISTRATION'S LONG-RANGE ECONOMIC ASSUMPTIONS, CALENDAR YEARS 1983-1986

Year	Real GNP (1972 dollars, percent change)	Inflation (percent change in GNP deflator)	Unemployment Rate, Annual Average (percent)
1983	3.5	8.5	7.1
1984	3.7	7.8	6.7
1985	3.7	7.0	6.3
1986	3.7	6.3	6.0

SOURCE: Budget of the United States Government, Fiscal Year 1981, p. 5.

A critical longer-term issue is the extent to which tax reductions will stimulate aggregate demand as against aggregate supply. The Carter fiscal strategy calls for a combination of business tax cuts focused on investment rather than on large, across-the-board cuts in personal taxes. Sustained economic slack would be tolerated during the early years. The Carter Administration doubted that large tax cuts for individuals would have a significant effect in increasing aggregate supply. Moreover, it argued that increases in supply resulting from tax stimulants to investment would likely be relatively small, though significant, and that the increment in supply would occur very gradually. 7/ Some others, however, believe that economic conditions can be improved more rapidly by reducing marginal tax rates on individuals.

7/ See Economic Report of the President 1981, pp. 78-84 and 156-78.

CHAPTER II. REVENUE ESTIMATES AND PROPOSALS

The Carter Administration budget for fiscal year 1982 proposes revenues of $711.8 billion, including a net tax increase of $5.3 billion consisting of $18.3 billion in proposed tax reductions and $23.6 billion in proposed increases. If all the proposals were enacted, however, their restrictive effect on the economy would reduce the net increase over current law to $3.0 billion.

CBO estimates current law revenues for fiscal year 1982 at $708.5 billion, $104 billion above CBO's estimate of current law revenues for fiscal year 1981. 1/ CBO's estimates are very close to those of the Administration for both years.

Under the proposed Carter 1982 budget, revenues as a percentage of Gross National Product (GNP) will increase to 22.3 percent, the highest level in history, (see Table 7). With no tax cuts beyond those proposed in the budget, the Administration estimates that revenues as a percentage of GNP will continue to increase, rising to 24.0 percent by fiscal year 1986.

The Carter tax cut package emphasizes incentives for business investment, with about 70 percent of the tax relief going to business in fiscal year 1982 and about 60 percent in future years. The main tax relief for individuals in 1982 comes in the form of a $5.3 billion Social Security tax credit. The tax increase proposals include a $13.1 billion increase in the federal gasoline tax and $3.9 billion from withholding on interest and dividends, proposals the Congress has rejected in the past.

This chapter compares the revenue estimates of the Carter Administration with those of CBO, and discusses the revenue proposals contained in the budget and other options currently being considered by the Congress and President Reagan.

1/ Current law revenues reflect projected levels of economic activity that would prevail in the absence of changes in fiscal policy.

72-339 0 - 81 - 3

TABLE 7. BUDGET REVENUES BY SOURCE AND CBO ESTIMATES OF PRESIDENT CARTER'S BUDGET REQUESTS (By fiscal year)

Source	1966	1971	1976	CBO Estimates of President's Budget a/ 1981	CBO Estimates of President's Budget a/ 1982
			(In billions of dollars)		
Individual Income Taxes	55.4	86.2	131.6	280.9	326.0
Corporation Income Taxes	30.1	26.8	41.4	68.2	72.9
Social Insurance Taxes and Contributions	25.6	48.6	92.7	183.7	213.0
Excise Taxes b/	13.1	16.6	17.0	44.9	68.5
Other	6.7	10.2	17.3	28.4	31.4
Total	130.9	188.4	300.0	606.1	711.8
			(As a percent of GNP)		
Individual Income Taxes	7.6	8.4	8.0	9.9	10.2
Corporation Income Taxes	4.1	2.6	2.5	2.4	2.3
Social Insurance Taxes and Contributions	3.5	4.7	5.6	6.5	6.7
Excise Taxes b/	1.8	1.6	1.0	1.6	2.1
Other	0.9	1.0	1.1	1.0	1.0
Total	18.0	18.2	18.3	21.3	22.3

a/ Includes CBO reestimates of two Administration legislative proposals, as shown in Table 9.

b/ Excise tax receipts include preliminary CBO gross windfall profit tax estimates of $23.0 billion in 1981 and $35.5 billion in 1982.

ESTIMATES OF CURRENT LAW REVENUE FOR FISCAL YEARS 1981 AND 1982

CBO's estimate of current law revenues for fiscal year 1981, based on the preliminary CBO economic forecast, is $604.5 billion, $1.4 billion below the comparable Carter Administration estimate, (see Table 8). CBO's estimate is slightly below the $605.0 billion revenue floor established in the Second Concurrent Resolution on the Budget for Fiscal Year 1981 which assumed a nex tax reduction of $10.1 billion in 1981.

For fiscal year 1982, CBO estimates current law revenues at $708.5 billion, virtually identical with the Carter Administration estimate of $708.8 billion. The $104 billion increase in estimated current law revenues between fiscal years 1981 and 1982 includes $17 billion from inflation-induced increases in individual income taxes, $7 billion from increases in Social Security taxes legislated in 1977, and $12.5 billion from increased windfall profit tax collections. The remaining $63.5 billion comes from increased real growth and increases in corporate and other taxes.

TABLE 8. ADMINISTRATION AND CBO ESTIMATES OF THE CARTER REVENUE REQUEST (By fiscal year, in billions of dollars)

	1981	1982	1983	1984	1985	1986
Administration						
Current Law a/	605.9	708.8	817.1	932.4	1,057.2	1,190.7
Budget Proposals	2.5	5.3	-7.9	-15.0	-15.1	-17.8
Reflows b/	-0.9	-2.3	*	4.9	10.5	15.6
Total	607.5	711.8	809.2	922.3	1,052.6	1,188.5
CBO						
Current Law	604.5	708.5	819.2	932.8	1,057.8	1,191.7
Budget Proposals	2.5	5.9	-8.1	-15.7	-15.9	-19.4
Reflows	-0.9	-2.6	*	4.9	11.1	17.0
Total	606.1	711.8	811.1	922.0	1,053.0	1,189.3

* $50 million or less.

a/ Current law revenues reflect projected levels of economic activity which would prevail in the absence of changes in fiscal policy. The 1985 and 1986 numbers are CBO estimates.

b/ Revenue reduction or increase resulting from restrictive or stimulative effect of tax proposals on economic activity. The 1981 through 1984 reflows are Administration estimates and those in 1985 and 1986 are CBO's. The Administration's current services receipts are equal to its current law estimates plus these reflows.

CARTER ADMINISTRATION LEGISLATIVE PROPOSALS AND OTHER OPTIONS

The Carter budget for fiscal year 1982 includes $18.3 billion in tax reduction proposals, all of which were contained in the economic revitalization program proposed by the Administration last August. Effective dates for most of the individual tax cuts have been postponed to January 1, 1982, however, while the major business tax cuts are still scheduled to take effect retroactively on January 1, 1981.

The Carter budget also proposes $23.6 billion in tax increases for fiscal year 1982, resulting in a net increase from proposed tax changes of $5.3 billion. As shown in Table 8, the restrictive effect of the overall tax program on the economy reduces revenues by $2.3 billion (shown as negative "reflows"), resulting in a net increase in taxes over current law of $3.0 billion. As the tax program becomes more stimulative in later years, the reflows become positive indicating increased tax collections.

The tax reduction proposals emphasize cuts in business taxes and incentives for business investment. About 70 percent of the total tax relief in fiscal year 1982 goes to business. This pattern continues in the later years, with about 60 percent of the total relief going to business in fiscal year 1986. Tax relief for individuals in 1982 comes mainly from an income tax credit equal to 8 percent of Social Security payroll taxes. The tax saving to employees from this proposal in fiscal year 1982 would be about $5.3 billion. Proposed relief from the marriage penalty would reduce taxes by large amounts in later years.

The tax increase proposals include an increase of 10 cents a gallon in the gasoline tax ($13.1 billion in fiscal year 1982) and withholding on interest and dividends ($3.9 billion). Similar proposals have been submitted before and rejected by the Congress. The budget proposals dealing with the foreign tax credit, independent contractors, railroad retirement taxes, and the airport and airway trust fund have also been made before. New proposals dealing with commodity "straddles" and tax-exempt bonds would raise significant amounts of additional revenues if adopted. The revenue effects of all the Carter budget proposals for fiscal years 1981 to 1986 are shown in Table 9.

The remainder of the chapter discusses the Carter budget proposals for revenues and other major tax proposals being considered in the Congress and by President Reagan.

TABLE 9. CARTER BUDGET LEGISLATIVE AND ADMINISTRATIVE PROPOSALS FOR REVENUES (By fiscal year, in billions of dollars)

Proposal	1981	1982	1983	1984	1985	1986
Revenue Reductions						
Constant-rate depreciation	-2.9	-9.0	-14.2	-18.4	-22.2	-25.4
Refundable investment tax credit a/	-0.1	*	0.2	0.3	0.5	0.7
Social Security tax credit a/ b/	--	-8.5	-13.1	-14.5	-16.6	-18.5
Earned income tax credit a/	--	*	-0.2	-0.1	-0.1	-0.1
Marriage penality relief	--	-0.4	-4.4	-9.1	-10.9	-12.5
Exclusion for Americans working abroad	-0.1	-0.3	-0.3	-0.3	-0.3	-0.4
Other	*	*	*	*	*	*
Subtotal, reductions	-3.1	-18.3	-32.0	-42.1	-49.6	-56.2
Revenue Increases						
Motor fuels tax	3.5	13.1	14.4	15.9	17.9	19.7
Highway excise tax and user charges	--	1.4	1.7	1.7	1.7	1.9
Extension of existing Highway Trust Fund taxes	--	--	--	--	3.9	4.0
Withholding on interest and dividends	--	3.9	2.8	3.1	3.5	3.9
Foreign tax credit	1.4	0.5	0.6	0.6	0.6	0.7
Independent contractors	--	0.7	0.7	0.9	1.1	1.2
Railroad retirement taxes	--	0.3	0.3	0.3	0.3	0.3
Airport and airway trust fund	0.2	1.4	1.6	1.8	2.0	2.3
Commodity straddles	0.1	1.3	0.8	1.0	1.1	1.4
Tax-exempt bonds c/	*	0.5	1.0	1.6	2.1	2.7
Other	0.2	0.4	0.2	0.2	0.2	0.2
Subtotal, increases	5.6	23.6	24.1	27.1	34.5	38.4
Total	2.5	5.3	-7.9	-15.0	-15.1	-17.8

* $50 million or less.

a/ These estimates do not include the budget outlays associated with these proposals.

	CBO Estimates (In Billions of Dollars) 1981	1982	1983	1984	1985	1986
b/ Social Security tax credit	--	-7.7	-12.8	-14.4	-16.5	-18.9
c/ Tax-exempt bonds	*	0.3	0.5	0.8	1.2	1.5

REVENUE REDUCTIONS

Accelerated Depreciation

The constant-rate depreciation proposal in the Carter budget is similar to a plan approved last year by the Senate Finance Committee, called the 2-4-7-10 plan. An alternative, the Capital Cost Recovery, or 10-5-3, proposal has been sponsored by a large number of Congressmen and Senators. These proposals share the goals of encouraging business investment, simplifying depreciation calculations, and offsetting the erosion of depreciation deductions by inflation. None of these proposals would exactly offset the effects of inflation unless the depreciation rates were constantly adjusted, since the rate of inflation varies from year to year. The proposals also vary significantly in their effects on different industries and types of assets. Their revenue effects for fiscal years 1981-1986 are shown in Table 10.

Constant-Rate Depreciation. The Carter constant-rate depreciation (CRD) proposal would allow businesses a 40 percent increase in depreciation deductions for each type of investment. The proposal would significantly reduce the number of separate depreciation accounts businesses would have to maintain, and allow them to apply a constant annual depreciation rate to each account.

TABLE 10. REVENUE EFFECTS OF ALTERNATIVE PROPOSALS TO LIBERALIZE DEPRECIATION (By fiscal years, in billions of dollars) a/

Proposals	1981	1982	1983	1984	1985	1986
Constant-Rate Depreciation	-2.9	-9.0	-14.2	-18.4	-22.2	-25.4
2-4-7-10	-4.3	-13.7	-18.6	-19.0	-19.7	-21.0
10-5-3	-2.9	-10.8	-22.1	-37.8	-56.3	-74.5

SOURCE: Joint Committee on Taxation, Treasury Department, and Congressional Research Service.

a/ Assumes a January 1, 1981 effective date.