Statement of Alice M. Rivlin
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before the
Committee on the Budget
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In its report on the second concurrent resolution last September, this Committee noted that there was growing uncertainty about the vigor of the expansion, and concluded that:

> Congress should monitor the recovery in the immediate future with particular care and stand ready to provide additional stimulus if future weakness in the private sector requires it. The Committee is prepared to consider a subsequent resolution early next year if the economic data received by then do not indicate that the recovery is proceeding satisfactorily.[1]

Data during the last few months have confirmed fears of a disappointing recovery. Growth of GNP in dollars of constant purchasing power has fallen to approximately a 4 percent annual rate instead of the 5.5 to 6.0 percent path expected in framing the second concurrent resolution. The unemployment rate remains far above the 7.2 percent rate to which it was expected to fall by the end of 1976. The rate of inflation, while it is a bit more favorable than earlier assumptions, remains high by historical standards.

The most recent reports indicate that the worst of the 1976 lull is ending. Automobile sales and industrial production have picked up. The Commerce Department's index of leading indicators rose a strong 1 percent in November following a period of decline. Labor market indicators including initial claims for unemployment insurance, help-wanted advertising, and the layoff rate in

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1. Report of the Committee on the Budget, United States Senate, to accompany S.Con.Res. 139, September 1976, p. 15.

manufacturing, suggest that some welcome relief on the unemployment front may lie ahead.

To some extent, however, recent good news reflects the end of the Ford strike just as some of the more dismal reports in the fall reflected the strike's direct and indirect effects. Over the last six months as a whole, output and unemployment have clearly been disappointing.

To aid the Committee in its deliberations about possible additional fiscal action, the Congressional Budget Office has just issued a report analyzing the current economic situation and the way in which changes in fiscal policy might affect the economic outlook. Mr. Chairman, I will summarize that report in my testimony this morning, and ask that the entire report be placed in the record. CBO has also just issued a new scorekeeping report on the status of the budget for fiscal year 1977, and my testimony will also refer to highlights from that report.

THE CURRENT ECONOMIC SITUATION

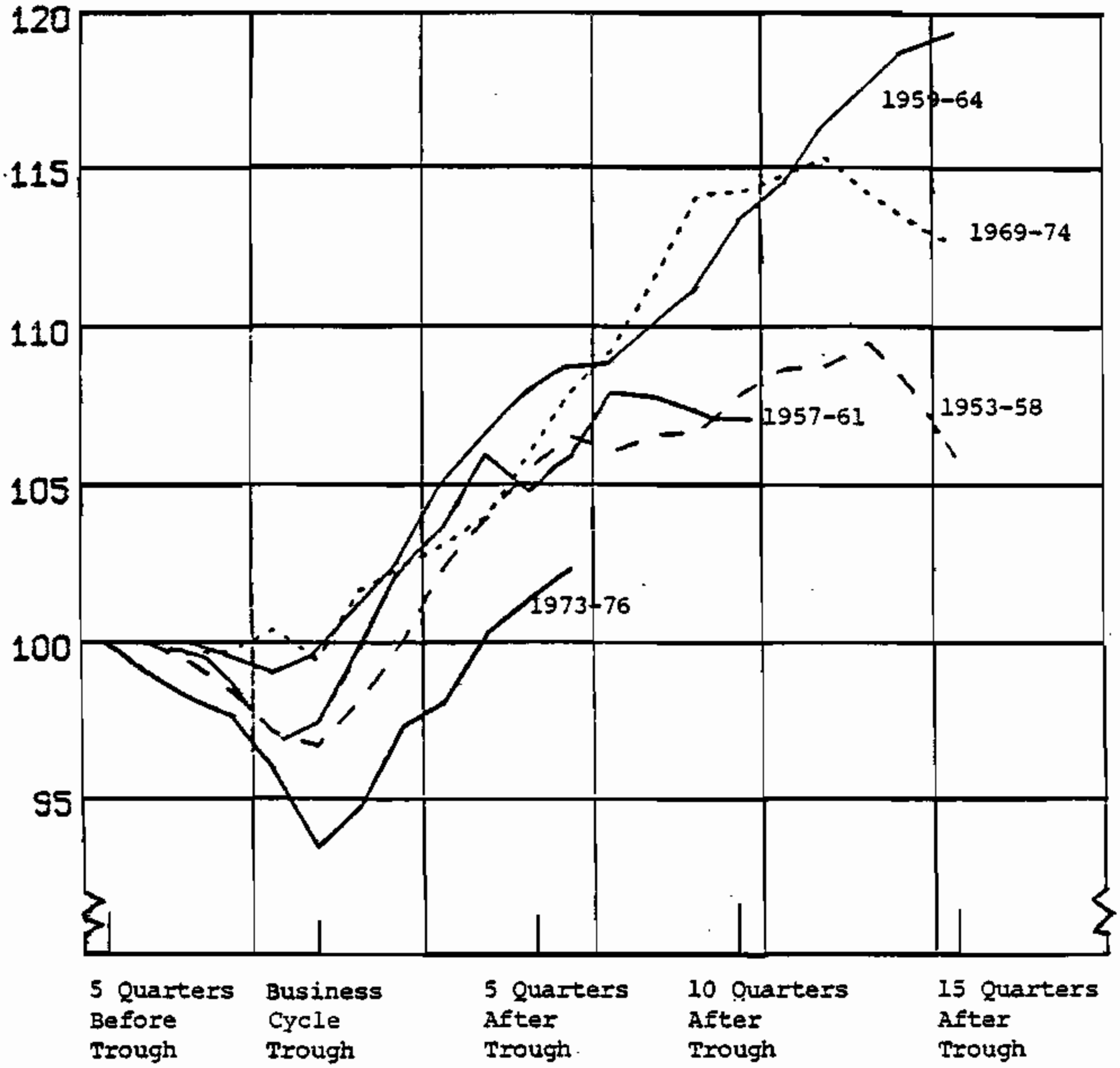
The recession that occurred between late 1973 and early 1975 was the sixth since World War II. It was the longest and deepest of the six, with national output (GNP in dollars of constant purchasing power) falling by nearly 7 percent instead of the usual 1 to 3 percent. It was widely expected that this deep recession would be followed by a stronger-than-average recovery; but in fact, since the bottom of the recession recovery has proceeded at a fairly typical rate. As a result of this deep recession followed by only an average recovery, the unemployment rate remains higher at the present time than it has been even at the bottom of previous recessions.

Even if this were a typical business cycle, the historical record would suggest some concern about its durability over the next two years. In previous upturns, as Figure 1 shows, recovery has come to an end as early as two years after the bottom of a recession, and only one of the four previous recoveries has lasted longer than 15 quarters--an interval which would bring us to the last quarter of 1978 in the current recovery. The duration of previous recoveries thus warns us to look for signs of stagnation or recession by 1978.

One of the disappointing sectors in the current recovery is investment in plant and equipment. According to the latest survey of plant and equipment spending plans by the Commerce Department, outlays are scheduled to increase only 4 percent from the second half of 1976 to the first half of 1977. When adjusted for likely price increases, this translates into only about a 2.5 percent annual rate of growth in real terms, far below the investment boom that many forecasters (including our own at CBO) were expecting. Probably the recent leveling-off of capacity utilization at relatively low levels has been a major contributor to this sluggishness in business investment.

Weak demands by state and local governments were another contributor to the severity of the recession and the failure of output to rebound more sharply. Continued financial difficulties and voter and governmental caution have held back real spending. In addition, one factor which used to contribute to steady growth

Figure 1.
INDEXES OF REAL GNP IN FIVE RECESSION-RECOVERY PERIODS
(Business cycle peak = 100)

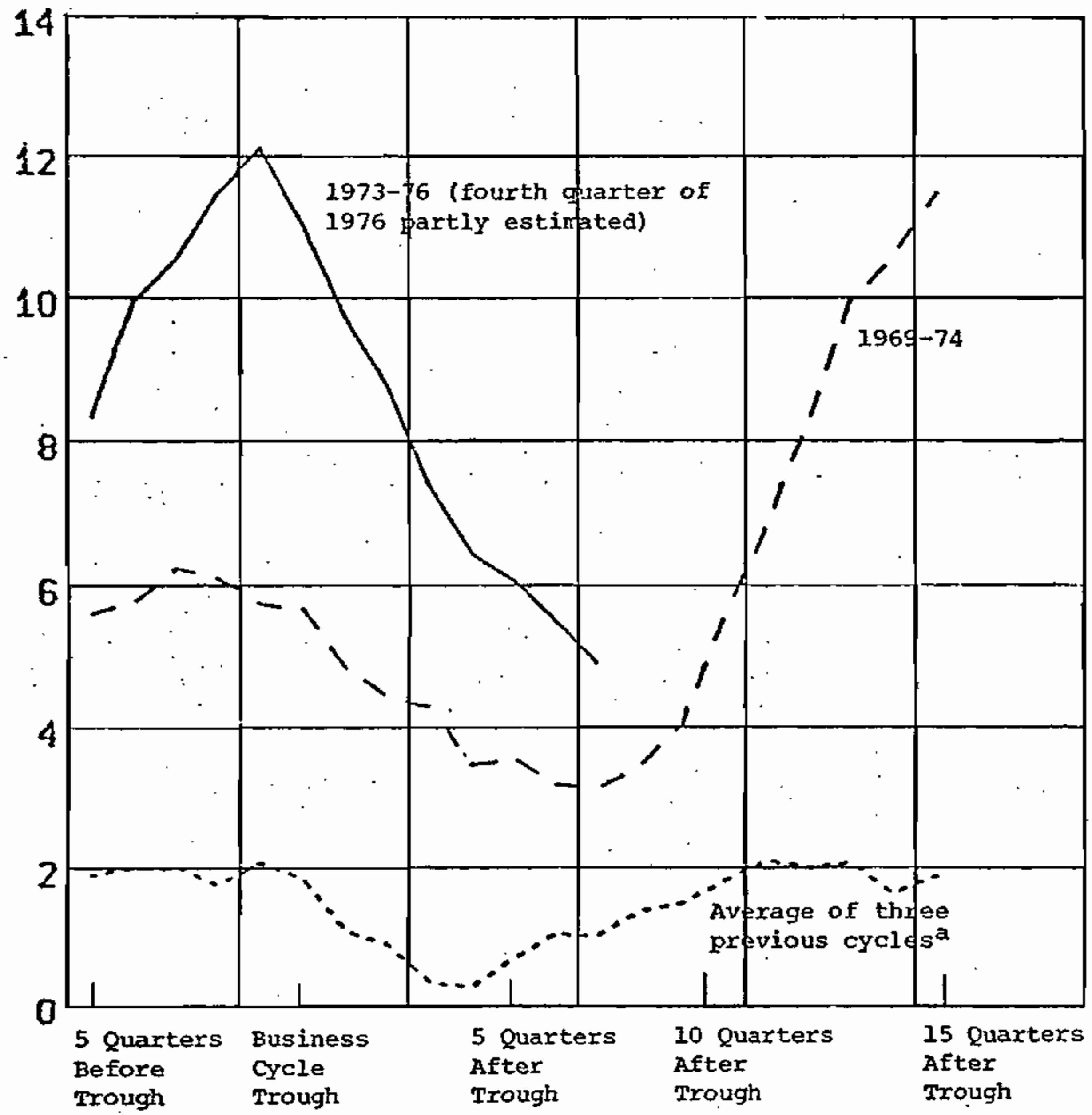


in state and local spending--the growing school population--is no longer present. The sustained fall in the birth rate has caused a decline in school populations.

Export demands, while they have grown at a normal rate during the recovery so far, are not expected to expand at anything like a normal rate next year. Continuing increases in oil prices limit the ability of other oil-importing countries to buy U.S. goods. Furthermore, the slowdown in recovery which has been occurring in other industrialized countries will curtail their purchases from the United States.

The rate of inflation, meanwhile, has come down a great deal from the double-digit rates of 1974, although as Figure 2 shows it remains high by comparison with previous recoveries. In our judgment, only a small portion of the lessening of inflation in the last year is due to the high margins of unemployment and excess capacity. Most of the decline is due to the absence of special inflationary shocks of anything like the magnitude affecting the economy in the early 1970s. Indeed, two of the shocks have been partly reversed; farm prices have been declining recently and the value of the dollar is now significantly higher than it was in early 1975, relative to an average of 10 other major currencies. Increases in world oil prices, while they continue to take place, have not approached the magnitude of the quadrupling of the early 1970s.

Figure 2.
INFLATION IN RECESSION AND RECOVERY
(Percent Change From a Year Earlier in Quarterly Average Consumer Price Index)



a. Recession-recoveries of 1953-58, 1957-61, and 1959-64.

THE FEDERAL BUDGET

An additional factor in the 1976 lull was the unexpected shortfall in federal spending. We estimate that the shortfall as measured against Congressional targets lowered the rate of growth of GNP in constant dollars by about 1 percent (at an annual rate) during the second and third quarters of 1976. This depressing factor is not expected to operate during 1977; our latest estimate is that federal outlays for fiscal year 1977 will fall only slightly below the overall target in the second concurrent resolution.

The budget outlook for fiscal year 1977 has been reviewed in the light of our analysis of the spending shortfalls for fiscal year 1976 and the transition quarter, the revised economic outlook, and the new 1977 spending estimates contained in the Administration's current services estimates report submitted in November. This analysis has resulted in a number of budget reestimates for fiscal year 1977 that are incorporated in the scorekeeping reports released today by the Senate Budget Committee and the CBO. Table 1 provides a sumary of the revised budget outlook for 1977 contained in these reports.

The lower rates of economic growth now projected for 1977--to be detailed below--result in a lower revenue estimate than was made for the second concurrent resolution--$356 billion compared to $362.5 billion. The revenue reduction of $6.5 billion is concentrated in the individual and corporate income taxes.

On the outlay side, there have been a number of reestimates both up and down for various programs, but the net effect is a

TABLE 1. FY 1977 BUDGET ESTIMATES (In billions of dollars)

	Second Concurrent Resolution	CBO Scorekeeping Report *	Senate Scorekeeping Report **
Revenues	362.5	356.0	356.0
Outlays	413.1	409.1	411.1
Deficit	50.6	53.1	55.1
Budget authority	451.55	435.1	446.4

* Reflects action completed to date plus additional mandatory items for parliamentarian status report (see CBO Scorekeeping Report No. 4).

** Also includes possible discretionary items that Senate Budget Committee staff judge may eventually occur under the second budget resolution (see Senate Budget Scorekeeping Report No. 77-12 as of January 10, 1977).

reduction of $1.6 billion from the earlier CBO estimate and $1.9 billion from the Senate Budget Committee staff estimate. Table 2 provides a summary of the major spending reestimates that have been made as a result of the revised economic outlook and other factors.

The CBO estimate of $409.1 billion for total outlays is based on action completed last session by the Congress plus estimates of additional mandatory items that Congress will have to act upon this session. The Senate scorekeeping report shows potential outlays of $411.1 billion which includes an additional $2 billion for possible discretionary spending items that were contemplated under the second budget resolution on which Congress has not yet acted. All of these estimates are subject to change based on new information on 1977 spending that will be provided in President Ford's budget for 1978.

In the absence of any new fiscal policy being adopted by the Congress, and allowing for uncertainties in both the spending and revenue estimates, the estimated budget deficit for fiscal year 1977 is likely to fall in the $54 to $58 billion range, compared to $50.6 billion specified in the second concurrent resolution.

While there now appears to be some room within the second budget resolution level for additional spending measures above those contemplated last September, it is clear under the Budget Act prodcedures that a third resolution would be required for any

TABLE 2. SPENDING REESTIMATES FOR FY 1977 (In billions of dollars)

	Budget Authority	Outlays
CBO scorekeeping report *		
Unemployment compensation	-1.0	+2.1
Offshore oil leases	+0.4	+0.4
Farm price supports	--	+0.3
Medicare and medicaid	+0.1	+0.3
Interest on the public debt	-1.9	-1.9
Social security (OASDI)	-1.6	-0.8
GNMA special assistance fund	--	-0.7
Veterans readjustment benefits	-0.5	-0.7
Federal highway programs	--	-0.3
All other, net	+1.4	-0.3
Total, CBO report	-3.1	-1.6
Senate scorekeeping report **		
Reestimates listed above	-3.1	-1.6
CETA Title VI public service jobs	-1.2	-0.6
Higher education programs	+0.6	+0.3
All other, net	+0.3	--
Total, Senate report	-3.4	-1.9

* Parliamentarian status report, reflecting action completed to date plus additional mandatory items.

** Includes possible discretionary items that Senate Budget Committee staff judge may eventually occur under the second budget resolution.

further tax reductions for 1977, and for major outlay increases above the $2-4 billion level.

THE ECONOMIC OUTLOOK UNDER CURRENT POLICY

Putting all these recent trends together and adding some assumptions about the future, we come up with a projection of only moderate economic growth in the absence of any change in policy. Since changes in fiscal policy are under active consideration, it is very important to emphasize that this is a no-policy-change forecast. Later, I will discuss how these projections might be altered by changes in taxes or in spending.

Under current policy our judgment is that the economy will achieve only 3.5 to 5.0 percent real growth from the end of 1976 to the end of 1977. We would expect the growth rate to be about the same during 1978. The rate of unemployment is projected above 7 percent during the entire year 1977 and above 6.5 percent even by the end of 1978. The rate of inflation is projected as well below the double-digit rates of 1974 but little changed from recent experience. We expect the general price index (the GNP deflator) to rise by 4.5 to 6.0 percent in 1977 and about the same in 1978. Table 3 summarizes our forecast.

The assumptions underlying this forecast, in addition to the critical one of no change from current Congressional fiscal policy include:

TABLE 3. ECONOMIC PROJECTIONS BASED ON CURRENT POLICY, 1977-78

Economic Variables	Levels			Rates of Change (percent)	
	1976:4	1977:4	1978:4	1976:4 to 1977:4	1977:4 to 1978:4
GNP (billions of current dollars)	1745 to 1755	1890 to 1950	2040 to 2170	8.0 to 11.0	7.0 to 11.5
GNP (billions of 1972 dollars)	1282 to 1287	1325 to 1350	1370 to 1420	3.5 to 5.0	3.0 to 5.5
General Price Index (GNP deflator, 1972 = 100)	136 to 137	142 to 145	148 to 154	4.5 to 6.0	4.0 to 6.0
Consumer Price Index (1967 = 100)	173 to 174	181 to 184	188 to 195	4.3 to 5.8	3.8 to 5.8
Unemployment Rate (percentage points)	7.9	7.1 to 7.8	6.6 to 7.6	--	--

- monetary growth as measured by the broadly defined money supply (M_2) near the upper end of the 7.5 to 10 percent range announced by the Chairman of the Federal Reserve Board;
- increases in consumer food prices averaging 4 percent per year;
- increases in wholesale fuel prices of 11 percent in 1977 and 8.5 percent in 1978; and
- growth of about 3.5 percent per year in the constant-dollar volume of U.S. exports.

The forecast is based on a combination of statistical models of the economy, recent information on key variables such as business capital spending plans and consumer attitudes, and CBO staff judgment about key relationships such as inventory-sales ratios and household saving rates.

With excess capacity and high unemployment continuing, demand pressures do not seem likely to lead to a reacceleration of inflation. Wage increases are projected to decelerate slightly during the forecast period because of continuing high unemployment; but the deceleration is quite small, due to the persistence of inflationary expectations and to the process of catching up with earlier cost increases. Furthermore, the benefits of this deceleration are offset by continuing price rises for oil and natural gas.

POLICY ALTERNATIVES

Changes in policy could move the economy closer to the output and employment levels used in framing the second concurrent resolution. CBO has analyzed five widely discussed fiscal policy options:

- A \$16 billion personal tax rebate paid out in the third quarter of calendar year 1977;
- A \$10 billion (annual rate) permanent reduction in personal taxes beginning in the third quarter of 1977;
- A \$5 billion (annual rate) business tax reduction beginning in the third quarter of 1977, divided between an increase in the investment tax credit and a corporate rate reduction;
- A \$5 billion increase (annual rate) in countercyclical revenue sharing and public employment, the former beginning in the second quarter of 1977 and the latter building gradually during the second half of 1977;
- A \$6 billion authorization of public works projects, with outlays rising slowly during 1977 and 1978.

Some of the key estimated economic impacts of these policies are shown in Table 4.

The first two options, the personal tax rebate and the permanent personal tax reduction, differ greatly in timing. The net budget cost of the rebate is \$15 billion in fiscal year 1977 but -\$3 billion in fiscal year 1978, when the economic stimulus continues to raise revenues but none of the rebate is paid out. The net budget cost of the permanent reduction rises from \$2 billion in fiscal year 1977 (when it is in place for only one quarter) to \$7 billion in fiscal year 1978. As Table 2 shows, this timing contrast carries over to the estimated employment and unemployment impacts, with the effect of the rebate fading out as the effect of the permanent reduction builds up.

The remaining three options in the table, like the permanent reduction in personal taxes, all have budget costs and employment impacts which increase from 1977 to 1978. The tax rebate thus complements all of the other program options in the table in the

TABLE 4. ESTIMATED IMPACTS OF EXPANSIONARY FISCAL POLICY OPTIONS

Options	Net Budget Cost[a] (billions of dollars)		Unemployment Rate Impact (percentage points reduced unemployment)		Inflation Impact (percentage points additional inflation)	Employment Impact (thousands of additional jobs)	
	Fiscal Year 1977	Fiscal Year 1978	1977:4	1978:4	1980	1977:4	1978:4
1. $16 Billion Personal Tax Rebate	+15	-3	-0.4	-0.1	0.0	500	170
2. $10 Billion Permanent Personal Tax Reduction	+ 2	+7	-0.1	-0.3	0.1 to 0.2	110	350
3. $5 Billion Business Tax Reduction	+ 1	+3	0	-0.1	0.1 to 0.2	10	190
4. $5 Billion Increase in Countercyclical Revenue Sharing and Public Service Employment	+ 1	+2	-0.2	-0.3	0.1 to 0.2	260	410
5. $6 Billion Authorization for Accelerated Public Works, Spending Rising Slowly to $3 Billion Rate	0	+1	0	-0.1	0.1	40	140

a. The net budget cost of each option equals its direct spending increase or tax reduction _minus_ the estimated higher revenues and lower income-support payments it causes.

sense that combining a rebate at some level with one or more of the other options can give a smoother pattern of economic effects than any of the options by itself.

The inflation effects of these spending options are estimated as fairly small. The rebate, because it is only a one-time payment, is estimated to have virtually no effect on the rate of inflation. Each of the other options has an inflation effect which builds gradually to an estimated 0.1 to 0.2 percentage points by 1980.[2] In other words, if inflation under current policy were 4.5 percent in 1980, enactment of one of the last four options would raise it to an estimated 4.6 to 4.7 percent. These estimates reflect the view that expansionary policies at a time of substantial unemployment and excess capacity are much less inflationary than these same policies would be in a high-employment economy.

Combinations of these options could add substantially to the number of jobs. Three illustrative policy combinations analyzed in the report would add an estimated 310,000, 610,000 and 920,000 jobs, respectively, by the end of 1977, and more in 1978.

The three combinations are:

- Half of each of the three tax options in the table, adding 310,000 jobs by the end of 1977 and 355,000 by the end of 1978, with a net budget cost of $9 billion in fiscal year 1977 and $3.5 billion in fiscal year 1978;

2. Estimates are based on a simplified two-equation wage-price model. A description is available on request to the Fiscal Analysis Division, Congressional Budget Office.

- Half of the three tax options plus all of the two spending options in the table, adding 610,000 jobs by the end of 1977 and 905,000 by the end of 1978 with a net budget cost of $10 billion in fiscal year 1977 and $6.5 billion in fiscal year 1978; and
- All of the options in the table at full strength adding 920,000 jobs by the end of 1977 and 1,260,000 by the end of 1978, with a net budget cost of $19 billion in fiscal year 1977 and $10 billion in fiscal year 1978.

Under present margins of unemployment and unused capacity, expansionary measures would have relatively little effect on the rate of inflation. Expansionary fiscal policies would, however, entail a higher federal deficit. For fiscal year 1977, the deficit even in the absence of policy changes is now estimated at $54 to $58 billion, higher than the $50.6 billion in the second Congressional resolution because of the weaker economy than was foreseen last September. The three policy combinations analyzed in the report would add another $9 to $19 billion to the 1977 deficit.

The three illustrative policy combinations analyzed in our report represent only a few of the numerous ways in which taxes and spending could be altered to increase output and reduce unemployment. Mr Chairman, as other combinations are considered, the Congressional Budget Office is prepared to assist this Committee in analyzing their impacts on the economy and the budget.