CURRENT SERVICES BUDGET

835

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CONGRESS OF THE UNITED STATES

NINETY-FOURTH CONGRESS

SECOND SESSION

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CONTENTS

WITNESSES AND STATEMENTS

THURSDAY, DECEMBER 2, 1976

FRIDAY, DECEMBER 3, 1976

SUBMISSIONS FOR THE RECORD

THURSDAY, DECEMBER 2, 1976

FRIDAY, DECEMBER 3, 1976

CURRENT SERVICES BUDGET

THURSDAY, DECEMBER 2, 1976

Congress of the United States,
Joint Economic Committee,
Washington, D.C.

The committee met, pursuant to notice, at 9:30 a.m., in room 1202, Dirksen Senate Office Building, Hon. Richard Bolling (vice chairman of the committee) presiding.

Present: Representatives Bolling, Long, and Brown of Michigan.

Also present: John R. Stark, executive director; William A. Cox, Robert D. Hamrin, L. Douglas Lee, and Courtenay M. Slater, professional staff members; Michael J. Runde, administrative assistant; and Charles H. Bradford, George D. Krumbhaar, Jr., M. Catherine Miller, and Mark R. Policinski, minority professional staff.

Opening Statement of Vice Chairman Bolling

Representative Bolling. The committee will be in order.

This morning the Joint Economic Committee convenes to take a hard look at the budgetary prospects for fiscal year 1978. This hearing will be the first congressional examination of the 1978 budget and will form the basis for a report to be issued before the end of the year.

As required by the new Congressional Budget Act, the Office of Management and Budget has recently submitted its current services budget estimates for 1978 and the Congressional Budget Office has submitted similar estimates for the years 1978 through 1982. These estimates tell us where the budget would go in the absence of policy changes. It should be clearly understood that the current services estimates are no one's prediction of what the actual 1978 budget will look like. Undoubtedly both Congress and the new administration will make policy changes. Indeed, the very purpose of the current services budget is to assist us in answering the question, "What policy changes are needed?"

This morning we are interested in evaluating the technical adequacy of the current services estimates prepared by the Office of Management and Budget and the Congressional Budget Office. But more important, we need to draw out the policy implications of these documents. Would a current servises budget policy be adequate to support economic recovery in the coming years? What changes are needed to reduce the growth of wasteful or inefficient programs? Realistically, how much room is there in the budget for changes initiated by Congress or the incoming Carter administration?

Clearly, we will not be able to produce definitive answers to these questions this morning. But it is important for Congress to begin thinking about these questions now. We must have a clear understanding of where the budget is already headed before we can make intelligent choices about alternative budget policies.

We were informed last night that the President had called a special meeting, a very important meeting that Mr. Lynn had to attend at 9 this morning. So we have a different witness than we expected. But we are very pleased to have as one of our witnesses the Deputy Director of the Office of Management and Budget, Mr. Paul O'Neill.

The other witness is of course Mrs. Alice Rivlin, the Director of the Congressional Budget Office.

My understanding is that Mr. O'Neill has no prepared or formal statement, whichever way you want to state it. And therefore I would like to ask Mrs. Rivlin to present her statement, and then we will give you an opportunity to comment, Mr. O'Neill, before the questioning.

STATEMENT OF HON. ALICE M. RIVLIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mrs. Rivlin. Thank you, Mr. Chairman. I do have a prepared statement. It is fairly long, and I would like to summarize it very briefly.

Representative Bolling. That will be fine. The full statement will appear in the record.

Mrs. Rivlin. Thank you.

The testimony deals with three subjects: First, with the Congressional Budget Office's newly issued 5-year budget projections; second, with a comparison of these projections for fiscal year 1978 only with OMB's recently issued current services budget; and finally, with the impact on our estimates of the recent shortfall in Federal expenditures.

First, the CBO projections. The assumption on which we are projecting the budget is essentially that nothing changes. With respect to the tax laws, that the same laws on the books continue, including the extension of temporary provisions of the current tax law. With respect to spending, that current programs remain in force, and that they respond to economic and demographic changes in the same way that programs have responded in the past. Price changes, where mandated, are included in the estimates. Where the increases to take care of inflation is discretionary, we have done the computations both ways, we have shown what costs would be with price changes and without these changes.

Clearly the most important ingredient in making projections of this sort is the assumption of what will happen to the economy. We have provided three alternative economic paths.

First, a baseline projection, which is fairly optimistic, assumes a fairly rapid rate of economic growth and shows the unemployment rate coming down to 4.1 percent by 1982. The details of these assumptions are shown in table 1 on page 4 of the report.

We have shown a second path that assumes less rapid expansion, under which the unemployment rate falls only to 5.5 percent by 1982, but under which there would be somewhat less inflation than in the baseline projection.

And finally, at the request of the Joint Economic Committee, we have shown a more rapid expansion for the years 1978 to 1979, under which the unemployment rate falls to 4.0 by 1981. A complete discussion of this path appears in appendix C of the report. This is a projection that brings the GNP to approximately the same point as our baseline projection by the end of the period, but with more rapid growth in the first couple of years.

It should be emphasized, as you said in your opening statement, Mr. Chairman, that these assumptions about the economy are not forecasts. Also, the current policy budget is not a forecast. It is simply a statement about what we think would happen to the Federal budget under assumed economic conditions.

Moreover, one cannot assume that a current policy budget itself is sufficient to bring about those economic conditions. We are simply responding to the following question: If the economy had behaved in the specified way, what would the budget look like if no new policies were undertaken?

The main response to that question can be seen in table 1 of my prepared statement. Basically, we anticipate that, with the baseline economic assumptions, receipts and outlays would grow over the period, and the deficit would decline because the receipts would surpass outlays under the assumptions of an expanding economy. Under these assumptions, the Federal budget would come into balance by fiscal year 1980.

Under assumptions of even more rapid expansion, receipts would of course grow more rapidly in the early years, and outlays would be about the same. Thus a somewhat larger balance would be produced by 1980.

Under assumptions of less rapid expansion, however, receipts would grow more slowly, and the balance in the budget would not be achieved before 1981.

The projections involve growth in taxes, which would change the relationship of the Federal Government's sources of income. The personal income tax in a growing economy grows especially rapidly.

On the spending side, there would also be changes. I think these can be seen most clearly in table 4 of the prepared statement. One can see in that table the major components of the outlay increase that will be implied by the different assumptions. A large proportion of the outlay increases would be accounted for by payments to individuals such as social security, medicare and medicaid programs, which grow as the population grows and increase as inflation increases on the average.

Other parts of the outlay increase that are very substantial would be pay for employees in the Federal Government, retirement pay—both military and civilian—interest payments, and defense purchases.

At the bottom of that table we can add the increases that would be implied by adjusting the discretionary programs of the Federal Government for inflation, those that were in adjustment where inflations were not mandated. That would also add substantially to the outlays by 1982.

These projections illustrate some facts about the built in changes in the Federal budget that are useful for policy decisions. As prices rise and the economy and population expand, Federal spending will grow even if current policies remain unchanged. Receipts, however, will rise somewhat more rapidly than outlays. This occurs because, as the economy grows, more people are working and paying taxes.

Also, given the progressive nature of the individual income tax, as individual incomes rise, a greater fraction of that income is paid for taxes. Hence with no change in policy and with economic growth, the current Federal budget deficit would disappear over time. The speed with which this occurs depends largely on the assumptions about economic growth and inflation.

Turning now to the comparison of the CBO and OMB projections. The CBO and OMB methodologies are very similar, although there are some differences in the treatment of inflation, the extension of certain programs that expire under existing law, and of congressional action anticipated under the second budget resolution. In general, OMB does not include discretionary inflation adjustments in its current services estimates; it assumes the special counter-cyclical revenue sharing program will not be renewed. Its current estimate of 1977 spending does not include $2 billion to $3 billion in additional outlays contemplated under the second budget resolution, which Congress did not act upon before it adjourned in October. The CBO projections include all three of these items.

The largest difference between the CBO and OMB projections is that CBO makes current policy projections for a period of 5 years, whereas OMB makes current services estimates for only 1 year beyond the current fiscal year.

This difference stems from the different statutory requirements under the Congressional Budget Act of 1974. I believe the longer time period is more desirable for assessing the implications of existing budgetary commitments and possible options for altering those commitments. Annual budget decisions often have little shortrun impact on budget totals or on the composition of the budget, but in the longer run, they can signficantly influence both the size and the relative priorities of the budget.

Both OMB and CBO have used a variety of economic assumptions to make their projections. Those are compared in table 5. And as we can see, they overlap very substantially.

Given that essentially the same methodology is used by CBO and OMB, it is not surprising that after adjusting for the minor differences, the CBO and OMB budget projections for fiscal year 1978 are very close. For purposes of comparison, OMB's path IV economic assumptions are closest to CBO's baseline economic assumptions. The CBO and OMB receipts estimates for fiscal year 1978 differ only by $3 billion as shown in table 6, and the CBO and OMB outlay estimates differ only by $1 billion when put on a comparable basis. While there are some differences in the components, the CBO and OMB estimates of total receipts and total outlays are remarkably similar, even though they are developed independently.

Let me turn finally, Mr. Chairman, to the shortrun budget and the economic outlook, particularly to the question of the shortfall.

You asked me, Mr. Chairman, to comment on the recent shortfall in Federal spending and the impact that this shortfall may have on future budget outlays. When I testified on this subject before the House Committee on the Budget on November 23, I made the following major points, which I would like to reiterate:

First, while the actual dollar effects on the economy of the shortfalls in Government expenditures have not yet been fully evaluated, it seems likely that the shortfalls were an important contributor to the current economic lull. They had the effect of lowering the growth of real GNP by roughly 1.0 percentage points (annual rate) during the second and third quarters of 1976.

Second, the shortfall in Federal spending in national income account (NIA) terms occurred primarily in the first 6 months of calendar year 1976, with the greatest shortfall occurring in the second quarter (April-June). However, in contrast to the reported shortfalls in the unified budget, the spending shortfall was sharply reduced in the third quarter in the NIA accounts. Federal sector spending in the third quarter, adjusted to annual rates, appears to be back on track and ready to move forward on the path contemplated by the second budget resolution for fiscal year 1977.

Third, the CBO estimates for fiscal year 1977 unified budget outlays are consistent with the second budget resolution level of $413.1 billion. We do not expect to experience a large net spillover of unexpected spending in fiscal year 1977 as a result of the recent spending shortfalls. While we expect some increases above our October spending estimates for a number of programs, these are likely to be offset by decreases in our estimates for other programs. Similarly, I do not expect a sharp reduction in our current scorekeeping estimates for 1977 outlays.

Finally, on the receipts side, however, we expect a downward revision on the order of $5 billion to $10 billion below the $362.5 billion estimated for the second budget resolution for fiscal year 1977. This is the result of a change in the economic outlook for the next year.

Even if Federal spending increases come close to the level set by the Congress for 1977, it is becoming clear that the economic assumptions underlying the second budget resolution were too optimistic. The economic lull that began this spring has been deeper and more prolonged than forecasters (including those at CBO) expected. Some reduction from the 7-percent growth rate during the first year of recovery was anticipated, if only because the shift from massive inventory liquidation in 1975 to accumulation in 1976 could not be expected to repeat itself.

But even the shortfall in Federal spending is not enough to explain several months of sluggish retail sales and no growth at all in real inventory investment. Weak demands in a number of sectors produced low real growth in the second and third quarters of calendar year 1976, with no pickup yet in sight during the fourth quarter.

As I indicated earlier, we expect the Federal spending shortfall to be a temporary factor, and, therefore, it should have only a temporary effect on economic growth and unemployment. But since the Federal shortfall was only one of a number of factors in the economic lull, its removal would not restore the economy to the GNP level assumed in the CBO current policy and OMB current services projections.

The consensus among business forecasters now appears to be that the rate of real economic growth in calendar year 1977 will be about 5 percent and the unemployment rate will average about 7 percent. These are somewhat more pessimistic than the assumptions in the OMB and CBO projections, which have been discussed earlier. Furthermore, a substantial number of business forecasters are assuming some additional fiscal policy stimulus early in 1977. Without the

84-240 O - 77 - 2

additional stimulus, the consensus among forecasters clearly would be for a growth rate below 5 percent and an unemployment rate in excess of 7 percent. On inflation, the consensus is in the neighborhood of a 5.5-percent rate of price increase.

If spending in 1977 is no stronger than forecasters are now projecting, the continuing gap between actual and potential output would probably have a dampening effect on investment spending in 1978. Indeed, econometric models are generally projecting an ever weaker 1978 than 1977. It is too early to talk about a consensus forecast for 1978, but what forecasts there are suggest that if a current policy budget is followed, the economy will be significantly weaker than the assumptions underlying either the OMB or the CBO budget projections for fiscal year 1978.

Fiscal stimulus early in 1977 could affect real growth and unemployment during the year, and hence could move the economy closer to the OMB and CBO economic assumptions. Most forms of stimulus would have a greater effect in 1978 than in 1977, but current projections suggest the economy will still require stimulus in 1978 if it is to achieve the economic assumptions.

Stimulative fiscal actions would require a new budget resolution for fiscal year 1977 and would cause an eventual increase in the rate of inflation, although not as large under current economic conditions as under a high utilization economy. CBO's next economic report, to be released in early January, when the new Congress comes in, will discuss a number of fiscal policy alternatives and analyze their effects on economic growth, unemployment and inflation.

[The prepared statement of Mrs. Rivlin follows:]

PREPARED STATEMENT OF HON. ALICE M. RIVLIN

Mr. Chairman and Members of the Committee: There has been wide spread interest in "current services" or "current policy" budget projections as a neutral baseline for evaluating budget alternatives. These projections provide estimates of what would happen to the federal budget if current policies and services were to continue unchanged. Without any alteration in legislation or policy, budget figures can shift from one year to the next. For example, social security payments may rise because more elderly people claim benefits and as benefits are automatically adjusted to increases in the cost of living. Similarly, individual income tax collections will increase as taxable income grows. Careful consideration of the base from which the budgetary change is to be made contributes to the soundness of budgetary decisions.

The Committee on the Budget have adopted current policy or current services projections as a useful analytical tool. The Senate Committee used the Congressional Budget Office (CBO) current policy projections as the base for developing its recommendations for the first concurrent resolution on the 1977 budget. The House Committee used this concept for making five-year projections of the budget in its reports on the 1977 budget resolutions.

My testimony today, Mr. Chairman, will focus on three areas. First, I will summarize the results of the CBO five-year projections for fiscal years 1978 to 1982, which we have just completed.

Second, I will compare the CBO projections with the OMB current services estimates for fiscal year 1978. Third, I will discuss briefly our estimate of the impact of the recent shortfalls in federal spending, the changing economic outlook for the next two years, and the economic impact of a current policy budget for fiscal 1978.

CBO Five-Year Budget Projections

The CBO five-year budget projections are estimates of the receipts and outlays that would occur if present tax laws and all ongoing federal programs were to continue to operate for five more years at the levels specified in the Second Concurrent Resolution on the Budget for fiscal year 1977 (S. Con. Res. 139) adopted by the Congress on September 16, 1976. We use the second budget resolution as the latest expression by Congress of current resource allocations.

The basic methodology used for making the projections is fairly straight forward and is quite similar to that used by the Office of Management and Budget (OMB). The basic assumption for projecting receipts is simple—the federal tax laws in effect in 1977 are assumed to continue unchanged. In particular, the provisions of the Tax Reform Act of 1976, including the tax cuts originally enacted in 1975, are assumed to continue in effect through fiscal year 1982, even though some of the tax reductions are scheduled to expire before then.

The spending projections assume that all current programs will continue except for those that are clearly temporary; that open-ended claims on the federal Treasury, such as interest on the public debt and social security payments, will respond to assumed economic and population changes in essentially the same way they have responded to such changes in the past; and that, for federal programs in which funding levels appear to be discretionary, funding is held constant in current dollar or, alternatively, in real terms.

Economic assumptions.—Inflation, unemployment, and other levels of economic activity have an effect on both receipts and outlays. In order to develop budget projections, therefore, explicit assumptions must be made about what may happen to the economy over the next several years. In view of the uncertainty surrounding the economic outlook between now and 1982, the CBO projections report presents overall budget projections on the basis of two alternative sets of economic assumptions.

One set, designated as the baseline assumptions, is a relatively optimistic set of assumptions that is consistent with the long-range economic assumptions used by both Committees on the Budget for the Second Concurrent Resolution on the budget for fiscal year 1977. This path assumes that real economic growth, as measured by the gross national product (GNP) in constant dollars, will average 5.5 percent during the next three years and then taper down to 4.5 percent by 1982, as the unemployment rate falls below 5.0 percent in 1980 and reaches 4.1 percent by the end of the projection period. The rate of inflation, as measured by the annual percentage change in the Consumer Price Index (CPI), is assumed to fall from 5.7 percent in 1976 to 4.8 percent in 1978 and 1979 and then rise to 5.8 percent by the end of 1982 as the unemployment rate falls below 5.0 percent.

The second set of assumptions has a less rapid economic expansion and is generally consistent with the long-term outlook contained in various commercial models of the economy. This path assumes that real economic growth will fall from 6.4 percent in 1976 to 4.0 percent by 1979 and remain at that level through the end of the projection period. The unemployment rate only falls from an average of 7.6 percent in 1976 to 5.5 percent in 1982. The annual percentage change in the CPI is assumed to remain stable at 4.6 percent throughout most of the projection period.

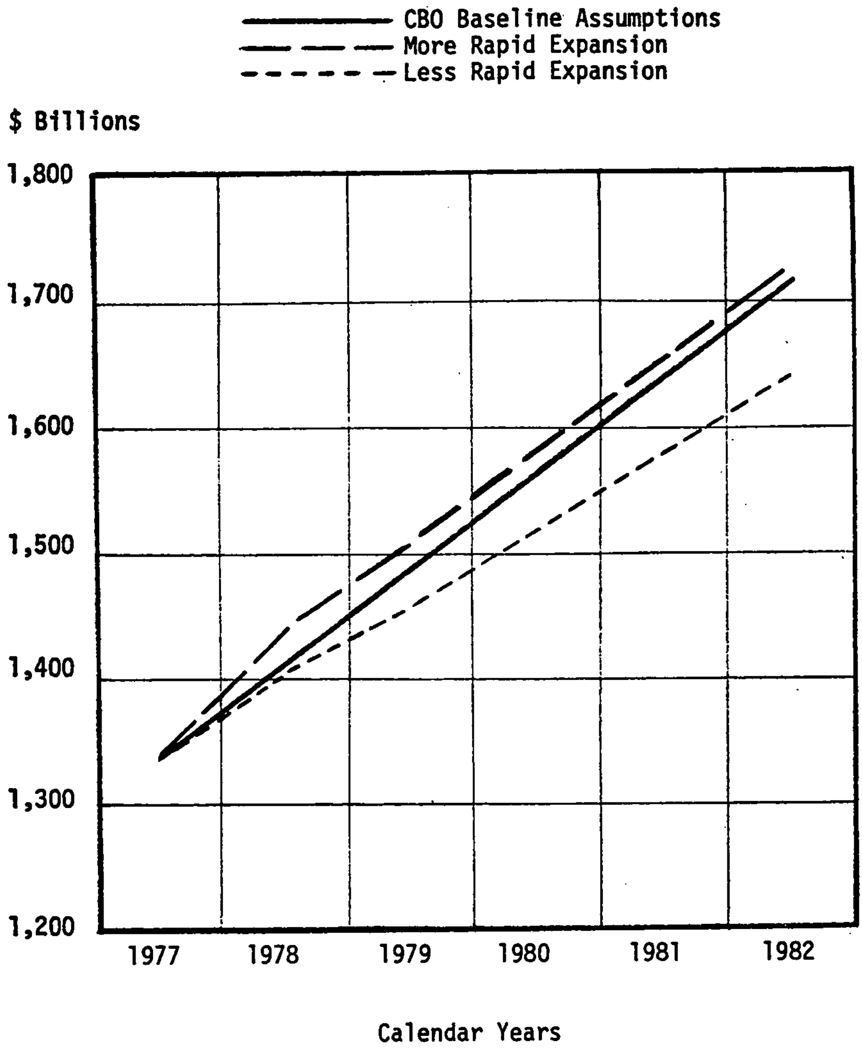
Mr. Chairman, we also developed projections of total budget receipts and outlays for a third set of economic assumptions for use by the Joint Economic Committee at the request of the Committee staff. This set assumes a more rapid economic growth in 1978 and 1979 than the CBO baseline assumptions, followed by a tapering down to a 3.9 percent annual growth in 1982. Under this path, the unemployment rate reaches 4.0 percent by the end of 1981, and the annual percentage change in the CPI rises from 5.0 percent in 1977 to 6.1 percent by 1982.

This third path, as shown in the chart that follows, produces only a slightly higher real GNP in 1982 than the CBO baseline assumptions, but the five year pattern of more rapid growth at first followed by slower growth later produces higher output and lower unemployment during the intermediate years. The Joint Economic Committee has argued that such a pattern of tapering growth reduces the danger of over shooting the full employment target and touching off a new burst of inflation.

None of the sets is an economic forecast by the CBO of how the economy is likely to behave over the projection period. Rather, they are three of many possible paths that the economy could follow during the next several years.

GROSS NATIONAL PRODUCT IN 1972 DOLLARS

THREE ALTERNATIVE ASSUMPTIONS, 1977-82



The paths do not represent a necessary or predicted consequence of the budgetary projections associated with it. The CBO budget projections simply show what the federal budget would look like if services were maintained at current levels and if the economy by some means—as a result of private consumption and investment, foreign demands, monetary policy, or some other developments—achieved any of these paths. In other words, these projections do not necessarily represent the budgetary policy that would be required to achieve any of these paths under particular assumptions about the rest of the economy.

The economic paths are basically trend projections for calendar years 1978 to 1982 based on an October CBO forecase for 1977. Dong-run historical patterns and relationships were used to generate the allocation of income shares, the required money stock growth, and other variables needed to project budget revenues and outlays.

Budget projections.—Table 1 summarizes the results of the budget projections using the three sets of economic assumptions.

TABLE 1.—PROJECTIONS OF FEDERAL BUDGET TOTALS, 1978–82

[Fiscal years; in billions of dollars]

	[1] 1977	1978	1979	1980	1981	1982
Baseline economic assumptions:						
Total receipts	362.5	407	464	526	594	668
Total outlays	413.1	451	480	514	548	586
Budget deficit (−) or surplus	−50.6	−44	−16	12	46	82
More rapid economic expansion:						
Total receipts	362.5	410	471	535	604	678
Total outlays	413.1	451	482	517	555	595
Budget deficit (−) or surplus	−50.6	−41	−11	18	47	83
Less rapid economic expansion:						
Total receipts	362.5	405	454	505	562	621
Total outlays	413.1	451	483	519	552	587
Budget deficit (−) or surplus	−50.6	−46	−29	−14	10	34

[1] 2d concurrent resolution on the budget for fiscal year 1977 (S. Con. Res. 139).

Under the baseline economic assumptions, federal receipts would rise from the second budget resolution level of $362.5 billion in fiscal 1977 to $668 billion in 1982. Under the more rapid economic expansion path, federal receipts would be slightly higher throughout the projection period (by $10 billion in 1981 and 1982). Under the assumption of less rapid economic expansion, receipts would be $57 billion lower in 1982 than under the baseline economic assumptions. Under all three paths, federal receipts would rise faster than GNP largely because inflation and growth in real incomes push individuals into higher income brackets.

Total outlays are projected to increase from $413.1 billion in fiscal year 1977 to $486 billion in 1982 under the baseline economic path and assuming that all federal programs are adjusted for inflation. Under the more rapid economic expansion path, total outlays in fiscal 1982 would increase at a slightly higher rate, largely due to the somewhat higher assumed rates of inflation. Projected total outlays under the less rapid economic expansion path also increase slightly more than under the baseline path, largely due to the higher assumed rate of unemployment. Under all three paths, federal outlays would not increase as fast as GNP so that the ratio of federal spending to GNP would fall from 22.5 percent in fiscal 1977 to 21.8 percent under the less rapid expansion path and to 19.3 percent under both the baseline path and the more rapid expansion path in 1982.

The federal deficit would be eliminated by 1980 under the baseline and more rapid economic expansion assumptions and assuming no policy changes. The potential budget surplus by 1982 would be quite large—over $80 billion—under both sets of economic assumptions. Under the less rapid economic expansion assumptions, the budget deficit would not be eliminated until fiscal year 1981, and the potential surplus in 1982 would be only about 40 percent of the amount projected under the other two economic paths.

As shown in table 2, almost three-fifths of the total increase in receipts between 1977 and 1982 under the baseline economic assumptions is accounted for by individual income taxes which are projected to more than double during this period. About one quarter of the increase is generated by rising social insurance taxes and contributions, which are projected to increase by 75 percent between 1977 and 1982.

TABLE 2.—PROJECTIONS OF FEDERAL BUDGET RECEIPTS BY SOURCE UNDER BASELINE ECONOMIC ASSUMPTIONS

[Fiscal years; in billions of dollars]

	1977	1978	1979	1980	1981	1982
Individual income taxes	161.7	188	219	255	295	341
Corporation income taxes	58.5	58	67	77	85	92
Social insurance taxes and contributions	107.1	124	139	152	170	188
Other taxes and receipts	35.2	37	39	41	43	46
Total receipts	362.5	407	464	526	594	668

On the spending side, over 50 percent of the projected increase in outlays between fiscal 1977 and 1982 (assuming no policy changes and the baseline economic path) is for benefit payments for individuals (e.g., social security, veterans' benefits, unemployment assistance, medicare and medicaid, civil service retirement, etc.), as shown in table 3. Outlays for national defense accounts for about one quarter of the increase, and the remaining one-fifth is for grants to state and local governments, net interest, and other Federal operations.

TABLE 3.—PROJECTIONS OF FEDERAL BUDGET OUTLAYS BY MAJOR COMPONENTS UNDER BASELINE ECONOMIC ASSUMPTIONS

[Fiscal years; in billions of dollars]

Major component	1977	1978	1979	1980	1981	1982
National defense	101	114	121	131	139	147
Benefit payments for individuals	184	196	212	231	252	275
Grants to State and local governments	48	49	48	48	50	53
Net interest	30	36	39	40	40	39
Other Federal operations	50	57	61	65	67	70
Total budget outlays	413	451	480	514	548	586

As shown in table 4, if discretionary inflation adjustments were not made for grants to State and local governments, veterans' benefits, and Federal purchases, total outlays would increase from $413 billion in fiscal 1977 to $542 billion in 1982, or $44 billion less than with full adjustment for anticipated inflation.

TABLE 4.—PROJECTED INCREASES IN FEDERAL OUTLAYS

[Fiscal years; in billions of dollars]

	1978	1979	1980	1981	1982
Fiscal year 1977 total outlays	413	413	413	413	413
Add commitments under existing law:					
Social security	8	16	25	35	47
Medicare and medicaid	6	11	18	25	34
Pay increases for Federal employees	4	8	11	16	20
Retired military pay and civil service retirement	1	3	4	6	8
Net interest	6	8	8	8	8
Defense purchases (lagged effect of prior appropriations increases)	8	8	11	11	11
All other Federal spending (net)			2	2	1
Subtotal, projected outlays under existing law commitments	445	467	492	516	542
Add further adjustments for inflation:					
Maintain 1977 value of grants to State and local governments	1	2	3	5	8
Maintain 1977 value of defense purchases	2	5	10	14	19
Maintain 1977 value of other Federal purchases	2	5	6	9	14
Cost of living increase for veterans benefits	1	1	2	3	3
Indirect effect on interest of further adjustments for inflation		1	1	1	1
Total, projected outlays with further adjustments for inflation	451	480	514	548	586

These projections illustrate some facts about the built-in changes in the Federal budget that are useful for policy decisions. As prices rise and the economy and population expand, Federal spending will grow even if current policies remain unchanged. Receipts, however, will rise somewhat more rapidly than outlays. This occurs because, as the economy grows, more people will be working and paying taxes. Also, given the progressive nature of the individual income tax, as individual income rises a greater fraction of that income is paid in taxes. Hence with no change in current policy and economic growth, the current Federal budget deficit would disappear over time. The speed with which this occurs depends largely on the assumptions about economic growth and inflation.

Comparison of CBO and OMB projections

The CBO and OMB methodologies are very similar, although there are some differences in the treatment of inflation, the extension of certain programs that expire under existing law, and of congressional action anticipated under the second budget resolution. In general, OMB does not include discretionary inflation adjustments in its current services estimates; it assumes the special countercyclical revenue sharing program will not be renewed, and uses a current estimate of 1977 spending that does not include $2 to $3 billion in additional outlays contemplated under the second budget resolution, which Congress did not act upon before it adjourned in October. The CBO projections include all three of these items.

The largest difference between the CBO and OMB projections is that CBO makes current policy projections for a period of 5 years, whereas OMB makes current services estimates for only 1 year beyond the current fiscal year. This difference stems from the different statutory requirements under the Congressional Budget Act of 1974. I believe the longer time period is more desirable for assessing the implications of existing budgetary commitments and possible options for altering those commitments. Annual budget decisions often have little short-run impact on budget totals or on the composition of the budget, but in the longer run, they can significantly influence both the size and the relative priorities of the budget.

Economic assumptions.—In its November report, OMB provides current services estimates under four sets of economic assumptions. These four sets of assumptions are based on two inflation paths and two unemployment paths. As I discussed earlier, CBO has developed current policy projections for three different sets of economic assumptions. The CBO assumptions are generally within the range covered by the OMB assumptions as shown in table 5, except that the real economic growth rate for 1978 under the CBO most rapid economic expansion is above the range used by OMB, and the inflation rate assumed by CBO for 1978 is below the OMB range.

TABLE 5.—COMPARISON OF CBO AND OMB ECONOMIC ASSUMPTIONS, CALENDAR YEARS 1977 AND 1978

	1977	1978
Current dollar GNP (billions):		
CBO	1,884	2,075–2,103
OMB	1,874–1,905	2,057–2,150
Real GNP growth (percent change from pervious year):		
CBO	5.4	5.1–6.4
OMB	5.2–6.0	4.5–6.0
Inflation (percent change, 4th quarter over 4th quarter, GNP deflator):		
CBO	5.3	4.8
OMB	5.0–6.5	5.0–6.5
Unemployment rate (annual average):		
CBO	6.8	5.7–6.1
OMB	6.4–6.9	5.5–6.5

Budget projections.—Given that essentially the same methodology is used by CBO and OMB, it is not surprising that after adjusting for the minor differences, the CBO and OMB budget projections for fiscal year 1978 are very close. For purposes of comparison, OMB's path IV economic assumptions are closest to CBO's baseline economic assumptions. The CBO and OMB receipts estimates for fiscal 1978 differ only by $3 billion as shown in table 6, and the CBO and OMB outlay estimates differ only by $1 billion when put on a comparable basis. While there are some differences in the components, the CBO and OMB estimates of total receipts and total outlays are remarkably similar, even though they were developed independently.

TABLE 6.—COMPARISON OF CBO CURRENT POLICY AND OMB CURRENT SERVICES BUDGET ESTIMATES FOR FISCAL YEAR 1978

[In billions of dollars]

Major components	CBO baseline path	OMB path IV
Federal receipts:		
Individual income taxes	188	185
Corporation income taxes	58	59
Social insurance taxes and contributions	124	123
Other taxes and receipts	37	37
Total receipts	407	404
Federal outlays:		
National defense	114	112
Benefit payments for individuals	196	197
Grants to State and local governments	49	51
Net interest	36	34
Other Federal operations	57	57
Total outlays	451	450

[1] The earned income credit is subtracted from OMB receipt estimates to provide comparability with the CBO receipt estimates. The OMB outlay estimates include discretionary inflation adjustments and renewal of antirecession financial assistance, and excludes the earned income credit.

Short run budget and economic outlook

You asked me, Mr. Chairman, to comment on the recent shortfall in Federal spending and the impact that this shortfall may have on future budget outlays. When I testified on this subject before the House Committee on the Budget on November 23, I made the following major points which I would like to reiterate:

(1) While the actual dollar effects on the economy of the shortfalls in Government expenditures have not yet been fully evaluated, it seems likely that the shortfalls were an important contributor to the current economic lull, lowering the growth of real GNP by roughly 1.0 percentage points (annual rate) during the second and third quarters of 1976.

(2) The shortfall in Federal spending in NIA terms occurred primarily in the first 6 months of calendar year 1976, with the greatest shortfall occurring in the second quarter (April-June). However, in contrast to the reported shortfalls in the unified budget, the spending shortfall was sharply reduced in the third quarter in the NIA accounts. Federal sector spending in the third quarter, adjusted to annual rates, appears to be back on track and ready to move forward on the path contemplated by the second budget resolution for fiscal 1977.

(3) The CBO estimates for fiscal year 1977 unified budget outlays are consistent with the second budget resolution level of $413.1 billion. We do not expect to experience a large net spillover of unexpected spending in fiscal year 1977 as a result of the recent spending shortfalls. While we expect some increases above our October spending estimates for a number of programs, these are likely to be offset by decreases in our estimates for other programs. Similarly, I do not expect a sharp reduction in our current scorekeeping estimates for 1977 outlays.

(4) On the receipts side, however, we expect a downward revision on the order of $5 to $10 billion below the $362.5 billion estimated for the second budget resolution for 1977. This is the result of a change in the economic outlook for the next year.

Even if federal spending increases close to the level set by the Congress for 1977, it is becoming clear that the economic assumptions underlying the second budget resolution were too optimistic. The economic lull which began this spring has been deeper and more prolonged than forecasters (including those at CBO) expected. Some reduction from the 7 percent growth rate during the first year of recovery was anticipated, if only because the shift from massive inventory liquidation in 1975 to accumulation in 1976 could not be expected to repeat itself.

But even the shortfall in federal spending is not enough to explain several months of sluggish retail sales and no growth at all in real inventory investment. Weak demands in a number of sectors produced low real growth in the second and third quarters of calendar 1976, with no pickup yet in sight during the fourth quarter.

As I indicated earlier, we expect the federal spending shortfall to be a temporary factor and, therefore, it should have only a temporary effect on economic growth and unemployment. But since the federal shortfall was only one of a number of factors in the economic lull, its removal would not restore the economy to the GNP level assumed in the CBO and OMB current services and current policy projections.

The consensus among business forecasters now appears to be that the rate of real economic growth in calendar 1977 will be about 5 percent and the unemployment rate will average about 7 percent. These are somewhat more pessimistic than the assumptions in the OMB and CBO projections, which have been discussed earlier. Furthermore, a substantial number of business forecasters are assuming some additional fiscal policy stimulus early in 1977. Without the additional stimulus, the consensus among forecasters clearly would be for a growth rate below 5 percent and an unemployment rate in excess of 7 percent. On inflation, the consensus is in the neighborhood of a 5.5 percent rate of price increase.

If spending in 1977 is no stronger than forecasters are now projecting, the continuing gap between actual and potential output would probably have a dampening effect on investment spending in 1978. Indeed, econometric models are generally projecting an even weaker 1978 than 1977. It is too early to talk about a consensus forecast for 1978, but what forecasts there are suggest that if a current policy budget is followed, the economy will be significantly weaker than the assumptions underlying either the OMB or the CBO budget projections for fiscal year 1978.

Fiscal stimulus early in 1977 could affect real growth and unemployment during the year, and hence could move the economy closer to the OMB and CBO economic assumptions. Most forms of stimulus would have a larger effect in 1978 than in 1977, but current projections suggest the economy will still require stimulus in 1978 if it is to achieve the economic assumptions. Stimulative fiscal actions would require a new budget resolution for fiscal year 1977 and would cause an eventual increase in the rate of inflation, although not as large a one under current economic conditions as under a high-utilization economy. CBO's next economic report, to be released in early January, will discuss a number of fiscal policy alternatives and analyze their effects on economic growth, unemployment and inflation.

Representative BOLLING. Thank you very much.

Mr. O'Neill, would you like to comment or make a positive statement or whatever?

STATEMENT OF HON. PAUL H. O'NEILL, DEPUTY DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. O'NEILL. Thank you, Mr. Chairman. Just a few comments before we go to questions.

We have to face the inexorable upward movement of Federal spending, assuming a continuation of what, in effect, is current congressional spending policy, which is what we both reflected in our estimates. While we may find it interesting to show the percentage relationship of Federal spending to GNP, there is no denying that we are on a track moving up to higher and higher levels of Federal spending. It is worth noting just where we have been over the last few years. We are now facing Federal spending of around $412 billion for fiscal 1977, off a 1976 base of $365 billion. Moreover, based on the current services estimates that we have prepared for you, we are facing a further increase from $412 to $413 billion in fiscal year 1977, to somewhere in the range of $447 to $453 billion in fiscal year 1978, assuming we don't start any new programs.

I think it is important to look at those figures and to think how recently we were at $200 billion or $300 billion. In looking at the recent trend and the estimates that we have prepared for this year and next, I think you can take with a grain of salt the longer term current policy estimates that the CBO has put together, which suggest that there is going to be a dampening of the rate of increase in Federal spending.

This leads me to the second point, which I think is fairly important, based on the years I have been around, and as many of you have witnessed with me. There is a very interesting phenomenon vis-a-vis long-term estimates. We seem to be very much in the situation of a greyhound chasing a rabbit around the track, because when we look 5 years out we see a wonderful kind of situation where we will produce wonderful surpluses which can be used for either reduced taxes or increased spending. I was reminding myself this morning of some of the estimating experience that we have had in that regard. In the fiscal year 1973 budget, a surplus of $23 billion was projected for fiscal year 1977, the year for which we are now estimating a deficit of someplace in the range of $50 to $60 billion. Thus, I think we have to be fairly careful about inferring to much from longer term estimates of Federal spending and Federal receipts, and where we are going as a general matter.

Finally, in regard to the shortfall question. I testified before the House Budget Committee about 10 days ago on the shortfall question. I would be happy to make a copy of that available to the committee if you would like to have it. Frankly, I do not share, Mrs. Rivlin's view that the shortfall contributed in a major way to the pause. I am not prepared to say that it had no effect on our overall economic performance. But I do not share the conclusion that if you simply take the NIA numbers that are fairly attributable to the shortfall and plug them into the model, it will evaluate appropriately what the differences in the economy would have been without the shortfall. And I think it is an important point for the Congress to consider in deciding what an appropriate economic fiscal monetary policy should be. Our expereince on plugging numbers into models demonstrates the need to go deeper than to just take a $5 billion number, or a $10 billion number, or any number, and plug it into a model and derive an inference from it. Let me give you a couple of examples of why I think we need to be more cautious in our use of those numbers.

When one looks at the reasons why there was a shortfall in the checks drawn on the Treasury, one finds a whole variety of things that led to that shortfall. Consider, for example, the economic effect of litigation tying up final payments to defense contractors. It takes some stretch of the imagination to argue that, for work already performed the fact that the collections weren't drawn on the Treasury has an economic effect. One can argue in a theoretical way that it may have some effect, but the work has been done in an economic sense. Such litigation ought not to lead us to an inference about the economy. As an additional example, the Congress didn't act on the foreign aid bill until the end of the fiscal year. As a result, we in the executive branch didn't obligate the money or bring checks out of the Treasury on it in 1976. Obligations and spending could not start until the transition quarter. I don't think that one can draw an inference that this had a major effect on the economy. So, as I indicated, I would be very happy to make available a more detailed analysis.

Representative BOLLING. I would like to have the full statement in the record.

Mr. O'NEILL. All right, sir.
[The information referred to follows:]

STATEMENT OF HON. PAUL H. O'NEILL, DEPUTY DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET, BEFORE THE HOUSE COMMITTEE ON THE BUDGET, NOVEMBER 22, 1976

Mr. Chairman and members of the committee, believe it or not, I am pleased to be here today to discuss the now famous spending "shortfall". My pleasure springs from a hope that our discussion may help to dispel some of the fictions that have grown up around this subject. I am not confident we will succeed completely, because the subject requires more technical understanding of government finance than most people seem willing to suffer.

The outlay underruns can be measured in at least three ways: from the estimates in the budget that the Administration transmitted in January 1976, from the estimates in the Mid-Session Review issued in July 1976 (after fiscal year 1976 had ended but before the final data were available), or from the estimates in the Congressional Concurrent Resolutions of May 1976. The shortfalls that result from each of these measures are:

[Outlays, in billions of dollars]

	January 1976 budget	July 1976 mid-session review	Congressional concurrent resolutions
Estimates:			
Fiscal year 1976	373.5	369.1	374.9
Transition quarter	98.0	102.1	[1] 101.7
Total	471.5	471.2	476.6
Actual:			
Fiscal year 1976	365.6	365.6	[2] 364.8
Transition quarter	94.5	94.5	[2] 94.4
Total	460.1	460.1	[2] 459.2
Shortfall (—):			
Fiscal year 1976	—7.9	—3.5	—10.1
Transition quarter	—3.5	—7.6	—7.3
Total	—11.1	—11.1	—17.4

[1] May 1976 resolution. The fiscal year 1977 resolution, adopted in September 1976, changed the transition quarter amount to $102,200,000,000 and increased the shortfall to $7,800,000,000.

[2] Adjusted to exclude earned income credit that exceeds liability for tax. Concurrent resolutions treat this credit as a deduction from receipts.

The discussion that follows will be in terms of the differences from the budget issued in January 1976, although we can provide similar information on the differences from the Mid-Session Review estimates. We do not have the information needed to analyze the differences from the Congressional Concurrent Resolution.

Before we get into the necessarily technical discussion, I would like to make a few general observations. First, let me state at the outset that all of what I have to say is not to deny that the recent estimates were off or that we should not or cannot do better. Having said that, I must admit to some degree of amazement that so many people seem to be dismayed that Federal spending and the Federal deficit for fiscal year 1976 and the transition quarter turned out to be lower than originally estimated last January. Usually, it is cost overruns that arouse the wrath of the public, but in this instance, we are under attack for not having spent enough.

Before responding to the criticism—a portion of which is legitimate—I hope that you will permit me to take some pleasure in the good news implicit in the "shortfall". It is hard to be dismayed when interest rates are lower than predicted, we receive more for selling oil leases than was anticipated, and the requirements of income maintenance programs are less than we thought that they would be.

There are, however, those who are seriously concerned about the estimating errors, and for purposes of analysis, they can be divided into two groups:

1. Those technicians who don't like estimates to be off in either direction; and

2. Those traditional Keynesian macro-economists who believe that in current economic conditions, we should have had a larger Federal deficit.

In dealing with the concerns of the first group, it is useful to examine the budget estimating track record of the past ten years to find out whether our recent experience is significantly different. The facts show that in one respect our experience is different; the absolute size of the numbers we are dealing with are remarkably changed. For example, in fiscal year 1972, the final spending figure was $231.9 billion, $4.7 billion less than we estimated in the January budget. This year the final spending figure was $365.6 billion, $7.9 billion less than we estimated in January. There are several interesting things to note about these comparative numbers.

First, the fact that, in percentage terms the error of the estimate in 1972 and 1976 is almost precisely the same. A corollary point that we need to get used to is that 1% of $400 billion is $4 billion. While we may not like to be off in our estimates by $4 billion, we may have great difficulty in avoiding a 1 percent or even a 2% error.

Second, the 1972–1976 comparison is not a special case. Estimating differences were 2 percent or more in 1974 and 1975 as well. It is interesting to note in that regard that there was virtually no clamor about the estimates in those year. (Table A shows the estimating performance for the eight fiscal years for which the unified budget has been in use and for the transition quarter.)

Third, and perhaps most important, it seems abundantly clear to me that consolidations and program reforms of the type proposed by President Ford are imperative if we are to achieve smaller estimating errors for Federal spending and dificits. We find ourselves in a situation today where we are making estimates for about 1,200 different appropriations accounts. When one has to deal with that many different accounts and all of the compartmentalized activities within each of them, he starts with a major disadvantage. And we are not moving in the right direction. Last week we published the update of the Federal Domestic Assistance Catalog. As you know, the Catalog lists all of the domestic assistance programs of the Federal Government. When we published the catalog in May, it contained 1,026 programs. The new update lists some 1,040 programs—in spite of our best efforts to stop the proliferation. So, from an estimating point of view, the problem of complexity in government programs, and therefore in developing precision estimates, is getting worse not better.

TABLE A.—COMPARISON OF ESTIMATED AND ACTUAL OUTLAYS FISCAL YEAR 1969 TO THE TRANSITION QUARTER, 1976

[Dollar amounts in billions]

Fiscal period	Original budget	Subsequent: Budget	Subsequent: Mid-session review	Actual	Difference from—Original budget	Difference from—Subsequent: Budget	Difference from—Subsequent: Mid-session review
1969	$186.1	$183.7	$184.8	[1] $184.6	−$1.5	$0.9	[1] −$0.2
1970	195.3	197.9	198.2	196.6	1.3	−1.3	−1.6
1971	200.8	212.8	(2)	211.4	10.6	−1.4	(2)
1972	229.2	236.6	233.0	231.9	2.7	−4.7	−1.1
1973	246.3	249.8	249.8	246.5	.2	−3.3	−3.3
1974	268.7	274.7	269.5	268.4	−.3	−6.3	−1.1
1975	394.4	313.4	323.6	324.6	20.2	11.2	1.0
1976	349.4	373.5	369.1	365.6	16.2	−7.9	−3.5
Transition quarter	98.0	98.0	102.1	94.5	−3.5	−3.5	−7.6
Percentage differences:							
1969					−0.8	0.5	−0.1
1970					.7	−.7	−.8
1971					5.3	−.7	(2)
1972					1.2	−2.0	−.5
1973					.1	−1.3	−1.3
1974					−.1	−2.3	−.4
1975					6.7	3.6	.3
1976					4.6	−2.1	−.9
Transition quarter					−3.6	−3.6	−7.4

[1] A preliminary "actual" contained in a Sept. 17, 1969, report. The final actual was $184,600,000,000.
[2] None issued.

There was, of course, a large error in estimating outlays in the transition quarter. Quarterly estimates are difficult in the best of circumstances, because trivial changes in the timing of outlays can have major impacts on quarterly aggregates. This year we faced, in addition, the difficult task of estimating the effect of moving the fiscal year one quarter. Based on reports from the agencies, we expected that the surge in outlays that usually occurs at the end of fiscal year would be transferred to the transition quarter. Obviously, only a portion of the expected surge materialized.

To turn now to the concerns of the macro-economists, it is important to begin by putting the numbers in context. In unified budget terms, the fiscal year 1976 shortfall was $7.9 billion—in an economy of $1.6 trillion. I am not prepared to argue that the shortfall of ½ of 1% of the 1976 GNP is of no consequence, but I do think that it helps to put it in this perspective, especially when you dig more deeply into the reasons for the shortfall.

A significant reason for the shortfall in both fiscal year 1976 and the transition quarter was the activity in financial transactions—transactions like the sale of off-shore oil leases which, because of the conventions used in the budget, have the effect of reducing the spending numbers. In FY 1976 these transactions added $1.9 billion to the shortfall and a further $1.3 billion in the transition quarter. As a matter of fact, more than one-third of the transition quarter shortfall was a result of financial transactions. Such transactions have very little impact on the economy and do not appear in the national income accounting version of the Federal budget.

Going back to fiscal year 1976, it is noteworthy that $800 million of the $6.1 billion "real" shortfall—occurred in foreign economic assistance. Before any major economic policy conclusions are drawn from this information, it is useful to know that the primary reason for the foreign economic assistance shortfall is the single fact that the appropriations were not enacted by the Congress until the last day of the fiscal year and, therefore, it was not possible for the executive branch to obligate the money, let alone turn it into actual spending. Taken together, the financial transactions and the foreign assistance account reduce the "real" fiscal year 1976 shortfall to $5.3 billion.

(Table B shows additional detail on the composition of the shortfall.)

But one cannot stop even here in trying to assess the economic impact of the so-called shortfall because, as you all know, the factor that ultimately determines the Federal spending level is the level of obligations that are incurred by the Government, which is in turn determined by the accumulated budget authority available to agencies, whether from appropriations enacted by the Congress, receipts that constitute "automatic" budget authority (e.g., as in the case of social security), or from other sources.

In a simpler world, one could infer from the spending shortfall in fiscal year 1976 that the money was in the pipeline—moving from budget authority to obligations to outlays—and that it was going to be coming out and adding to the stream of spending in fiscal year 1977. And, for the bulk of the shortfall this is the most likely case. But, this is most assuredly not a simple world. While obligations and outlays were differing from earlier estimates in fiscal year 1976, and the transition quarter, many other things were happening.

TABLE B.—COMPARISON OF ESTIMATED AND ACTUAL OUTLAYS FOR THE 15-MONTH PERIOD JULY 1, 1975 TO SEPTEMBER 30, 1976

[In billions of dollars]

	Differences from 1977 budget estimates for—		
	Fiscal year 1976	Transition quarter	15-mo period
Open-ended programs and fixed costs:			
Payments for individuals	−1.2	−.4	−1.7
Other	−.7	−.2	−.9
Subtotal, open-ended programs and fixed costs	−1.9	−.6	−2.6
Major grant programs (excluding entitlements):			
Health and education	.4	.4	.8
Environmental protection	.1	.3	.4
Employment and training	−.7	.1	−.6
Transportation	−.3	−.3	−.6
All other	−.3	.1	−.2
Subtotal, other programs that are mainly grants	−.7	.6	−.1

TABLE B.—COMPARISON OF ESTIMATED AND ACTUAL OUTLAYS FOR THE 15-MONTH PERIOD JULY 1, 1975 TO SEPTEMBER 30, 1975—Continued

[In billions of dollars]

	Differences from 1977 budget estimates for—		
	Fiscal year 1976	Transition quarter	15-mo period
Other programs (mainly direct Federal activities):[1]			
Department of Defense, military:[2 3]			
Procurement and revolving funds	.3	−1.1	−.8
Other	−1.0	−1.1	−2.1
Subtotal, DOD, military	−.7	−2.2	−2.9
Other:			
Foreign affairs	−1.9	.8	−1.1
Water resources	−.3	−.1	−.4
Energy	−.4	−.2	−.7
Transportation	−.2	−.2	−.4
Health and education	.1	.2	.3
All other	−.1	−.4	−.5
Subtotal, other	−2.7	.1	−2.7
Subtotal of the above[3]	−6.1	−2.2	−8.3
Major financial transactions[3]	−1.9	−1.3	−3.1
Total	−7.9	−3.5	−11.4

[1] Excluding major financial transactions.
[2] Excluding military retired pay.
[3] The figures for these categories are revised from earlier ones issued by OMB, reflecting a more intensive review of defense outlays involving major financial transactions than was possible earlier.

Note: Detail may not add to totals because of rounding.

Most significantly, the Congress was adding $15.5 billion to the President's recommended spending level and rejecting the President's $10 billion deeper tax cut. At the same time, some programs were exceeding the earlier estimates of obligations and outlays while others were lagging behind.

Taking all of these factors into consideration, we published about 10 days ago the Current Services Estimates for fiscal year 1978. With the assumptions detailed in these estimates, we are now showing outlays of $412–$412.9 billion for fiscal year 1977. Once again, the assumptions are crucial. For example, this estimate does not include $2½ billion that is included in the Second Concurrent Resolution adopted by the Congress. Table C provides a bridge between the January spending estimate of $394.2 billion and the current services estimate of $412.9 billion. Of the $18.7 billion change since January, $15.5 billion is accounted for by congressional action or inaction. Lower receipts estimates from offshore oil land leases account for another $3.4 billion. This leaves a net decrease of $.2 billion for all other changes, including Administration initiatives and reestimates. I believe that these observations convey the complexity of the problem.

From all of these observations, my own conclusions are several:

1. While we should continue to strive for perfection in our estimates, we should face up to the fact that a small percentage error produces a huge absolute dollar number now that we have arrived at the rarified Federal spending level of $400 billion.

2. No matter how much we may strive to improve our estimating techniques, we are fighting an uphill battle unless we consolidate and streamline the programs and activities of the Federal Government.

TABLE C.—*Major changes in budget outlays in fiscal year 1977—January 1976 budget to November 1976 current services*

	Millions
January budget estimates	$394.2
Congressional changes:	
Action on 1976 appropriations:	
Labor-HEW appropriations	0.3
Second Supplemental	0.4
Other	0.1

Congressional changes—Continued	
Action on 1977 appropriations:	
Public Works Employment Act	2. 1
Labor-HEW appropriations	1. 7
Defense and military construction	−1. 2
All other (net)	1. 8
Other congressional changes:	
Rejection of proposed rescissions	1. 2
Inaction on medicare reforms	1. 3
Veterans programs	1. 7
Inaction on food stamp reform	0. 9
Inaction on child nutrition reform	0. 7
Inaction on GSA stockpile legislation	0. 7
Inaction on social security benefit changes	0. 8
All other	2. 9
Total congressional changes	15. 5
Administration reestimates and other changes:	
OCS rents and royalties (offsetting receipts)	3. 4
Interest on the public debt	−1. 8
Medicare and medicaid	2. 2
Highway programs	−0. 9
CCC price supports	0. 8
Petroleum reserves (offsetting receipts)	0. 6
EPA construction grants	0. 4
HUD block grants	0. 4
Social security and SSI	−0. 8
Defense	−0. 4
Contingencies	−1. 5
All other, net	0. 7
Total, Administration reestimates and other changes	3.2
Current services estimate, Path I (November)	412. 9

3. The fiscal year 1976 and transition quarter shortfall is not, in and of itself, an appropriate basis for making a shift in fiscal policy.

This concludes my formal statement. I will be pleased to answer your questions.

Mr. O'Neill. One more point I think it is important to make. It is related to the prepared statement of Mrs. Rivlin. She indicated that she expects that the CBO will be reducing its fiscal year 1977 receipts estimate by some $5 to $10 billion. But the tables she presented indicate expected receipts of $362 billion. I think as Congress considers whether we need more stimulus, it is important to put that new receipts estimate, with which I agree, into the numbers. The CBO tables show an expected fiscal 1977 deficit of $50 billion. But when the words are combined into the table, what we are really facing from CBO's point of view for fiscal year 1977 is a deficit somewhere between $55 and $60 billion, as compared to a fiscal year 1976 deficit of $65.6 billion. While the economy hasn't performed as well as we would like, it seems to me that it is performing somewhat better than it did in the fiscal year 1975. It therefore makes me wonder what the right mix of fiscal and program policy is that can give us some hope that we are going to come off of the practice of running deficits that, until a few years ago, none of us would have dared whisper to each other, let alone write down on a piece of paper.

Those are the general comments I wanted to make, Mr. Chairman.

Representative Bolling. Mrs. Rivlin, would you like to comment on the comments?

Mrs. RIVLIN. Yes; let me just comment briefly.

I certainly agree with Mr. O'Neill that we should be cognizant of the fact that the Federal budget is growing in absolute term.

It certainly is. I do think we have to put that in the perspective of an economy that is growing in dollar terms partly because of inflation. Mr. O'Neill reminded us of how recently the Federal budget outlays were only $200 million. We now have a $1.8 trillion GNP. A short while ago that figure was only a trillion, or a half a trillion. The numbers grow very, very rapidly, whether one is talking about the GNP or one is talking about the Federal budget. And it is useful to look at the relationship between them.

I am interested in Mr. O'Neill's skepticism about the impact of the shortfall. We too are skeptical of our ability to estimate exactly how much effect a reduction in Federal spending has on the GNP growth rate. But we do the best we can, which is to look at the econometric models and what they imply.

On a national incomes amount basis in the second quarter, the shortfall in Federal expenditures was very large, it was roughly $16 billion. That is almost 1 percent of the GNP. And it is hard to believe that a shortfall of that size would no effect on the economy.

Finally, I appreciate Mr. O'Neill's pointing out very explicitly what the anticipated revenue reduction would do to the 1977 deficit. He is quite right; it will increase the deficit assumed in the second concurrent resolution from $50.1 billion to something like $55 billion to $60 billion.

That is the starting point from which the Congress does have to consider whether additional stimulus is warranted or not.

Representative BOLLING. Thank you.

Mr. Brown.

Representative BROWN of Michigan. Thank you, Mr. Chairman.

Mr. O'Neill, I want to say that I am very sorry that Director Lynn couldn't be here. Please convey to him my best wishes and greetings. I don't think I have ever worked with anyone in the executive branch that was so cooperative and helpful and really tried to get a job done as Director Lynn, both as Secretary of HUD and Director of OMB.

I am always interested in these projections—and we won't call them predictions, just extrapolations of things we know.

In discussing revenues, we find that inflation pushes people into higher tax brackets, therefore resulting in greater revenue. But we never take that same fact and apply it on the other side. By moving into a higher tax bracket and paying higher taxes there is a less and less incentive to earn more income. The result is a purchasing power drag by the very fact—the good side of the coin if you will—of increased revenues.

Also, Mrs. Rivlin, with respect to the chart you have here, aren't these 5-year projections based upon the assumptions that were made last September with respect to revenues and other conditions? Shouldn't they, therefore, now be adjusted to take into consideration the actual economic facts that have occurred, reduction of revenues, et cetera?

Mrs. RIVLIN. Yes. The projections of this report do start from the assumptions made at the time of the second concurrent resolution.

Representative BROWN of Michigan. Which as of now we now are $5 billion to $10 billion short on the revenue side.

Mrs. RIVLIN. For fiscal 1977, yes, that is correct.

Representative BROWN of Michigan. But if you take what you know and apply it to figures in the original projections, can you still project the kind of surpluses that you show for 1980, 1981, and 1982?

Mrs. RIVLIN. We have not done a new shortrun forecast of the economy. We will do that in January. At present my estimate of $5 billion to $10 billion less in revenues is kind of a guess. We do, however, project for the 5-year period on two bases. The baseline projection is quite an optimistic one, which shows the unemployment rate dropping to 4.1 percent by the end of the period. We do offer a less optimistic set of assumptions. And those show, as you can see, a lower budget margin. And the budget would be balanced at a later date. It might be that one would want to look at even more pessimistic assumptions, but we have not done that at this moment.

Representative BROWN of Michigan. In the back of your prepared statement you appear to make an inconsistent conclusion. Under subparagraph 1 where you are talking about the shortfall and Federal expenditures you say: "While the actual dollar effects on the economy of the shortfalls in Government expenditures have not been fully evaluated, it seems likely that the shortfalls were an important contributor to the current economic lull, lowering the growth of real GNP by roughly 1 percentage point during the second and third quarters of 1976."

And then you say: "But even the shortfall in Federal spending is not enough to explain several months of sluggish retail sales and no growth at all in real inventory investment"—which of course is a big item in GNP.

Would you attempt to reconcile those two statements a little better for me?

Mrs. RIVLIN. I guess I don't see the inconsistency. The fact that the GNP grew less rapidly than all of us expected is a fact. It has come in at much lower rates than the CBO was projecting or the OMB was projecting. The question is why? We think part of the explanation was the shortfall in Federal expenditures. And I give that explanation more weight than Mr. O'Neill does. But the shortfall can't be the whole explanation. Something else happened to explain why things didn't go as well as we all expected.

I guess everybody has been mystified as to what that was. Apparently there has been an across-the-board weakness in demand. Neither retail sales nor housing nor automobiles nor investment nor anything else came in quite as strong as the projections had implied they would.

Representative BROWN of Michigan. In talking about shortfall in Federal expenditures, Mr. O'Neill has suggested that some part of the economic effect occurred even though the expenditure had not been made. Mr. O'Neill is talking about court actions and about the foreign aid bill. Do you have an answer to where the shortfall occurred?

Mrs. RIVLIN. Some particular accounts did not spend out as quickly as anticipated. I gave a fairly detailed explanation of that in my testimony before the House Budget Committee, which I would be delighted to make available to you.

But the short answer is, I guess, that about a quarter of the shortfall occurred in the open-ended programs such as unemployment compensation which are related to the state of the economy itself. The estimates prepared in advance had assumed that unemployment would be somewhat higher than it really was. And the numbers for the actual outlays for unemployment compensation came in lower. That is good.

Representative BROWN of Michigan. Therefore, with respect to at least that aspect of the shortfall, that didn't contribute to a lower growth rate of GNP, did it?

Mrs. RIVLIN. If the Federal Government is paying out less money than we expected it to, for whatever reason, that can affect the GNP. But the reason in that case was simply that the original figures had been based on a higher estimate of how many people would be unemployed.

Another example of this sort of situation shows up in the agricultural programs. When estimated in advance those programs have to be based on some assumption about food prices. Food prices were actually somewhat lower than had been anticipated and the outlays for the subsidy programs were not as high as expected.

That kind of thing accounts for about a quarter of the shortfall. About half of it is accounted for in less-rapid-than-expected spendout under such Federal programs as defense procurement, where money was simply not spent out under contracts, and so forth, as rapidly as expected. The rest can be accounted for in less rapid expenditures under certain kinds of State grant programs, such as the CETA program, in which the money was not spent by State and local governments as rapidly as had been anticipated. I don't think we have any disagreement with the OMB as to what happened, and which accounts fell short. We have perhaps some disagreement on what the impact of that spending on the economy might have been.

Representative BROWN of Michigan. Do you generally agree with that statement, Mr. O'Neill?

Mr. O'NEILL. Yes sir, I do not think that the CBO and the OMB have a major difference as to where the shortfall occurs, although as we both indicated, we do have some difference of view as to how important a contributor the so-called shortfall was to the pause in economic activity.

As I indicated earlier, I don't think it is sufficient to simply plug numbers into a model and derive from that model conclusions about the effect of the so-called shortfall on our overall GNP performance. As one sifts and sorts the things that contributed to the shortfall, just as your line of questioning was developing, it is very difficult to conclude that some of the shortfall, such as, for unemployment insurance payments, wasn't desirable or that some of it had anything to do with economic performance. An example of the latter point, which I mentioned earlier, is of litigation that ties up some of the defense money.

Representative BROWN of Michigan. That is one item that I have difficulty understanding. And that is, if the contracts are being performed, but just aren't being paid off, it seems that all the factors that go into it are there. If a person is receiving wages, so he is not receiving unemployment compensation, it seems to me that it is a wash insofar as its effect upon the rate of growth in gross national product. So I don't see how, when you start analyzing shortfall, you can say that it created a one percent difference in the rate of growth in the GNP.

Mr. O'NEILL. As I indicated in my House testimony, I don't think anyone who looke dat the details of where we spent money and where we didn't spend money in fiscal year 1976 and the transition quarter can fairly use the shortfall as a basis for recommending a change in fiscal policy. That is not to say that perhaps we shouldn't be thinking about some change in the mix or approach of fiscal policy. But I do not think careful analysis of the facts can lead to the conclusion that the shortfall is an excuse for or an analytical reason for more fiscal stimulus.

Representative BROWN of Michigan. Just one final question.

Haven't we placed too much emphasis on the impact of Federal stimulus, especially by unemployment?

Mr. O'NEILL. My view is that perhaps the greatest contributors to the lower-than-expected economic performance relate to confidence and stability. Those are very subjective kinds of things, but they are the great unexplained variables in the models that we all use. In my judgment those are the two factors that have affected our economic performance. We need a period of stability, a period of confidence. We are now in a period when we are wrestling day after day with considerations of major changes in tax policy that will affect individuals and businesses. A situation needs to be created where businesses can plan on a future that will have some stability, and not be sitting on their hands in the expectation that maybe they will get their additional investment tax credit, or that maybe some other change is going to be made in tax policy. I think confidence and stability are keys to getting the economy back on the track.

Representative BROWN of Michigan. Thank you.

Thank you, Mr. Chairman.

Mrs. RIVLIN. May I clarify one point?

Representative BOLLING. Certainly.

Mrs. RIVLIN. Mr. O'Neill slipped in the word "desirable." The statement that the shortfall occurred, and that it may have had a significant negative effect on the economy is not the same statement as, "all the items in the shortfall are undesirable." No one could do anything but cheer if unemployment compensation payments are lower than they were expected to be because there were fewer unemployed people. That is obviously good. But it is also true that a lower than expected expenditure by the Federal Government might have had an adverse effect on the economy.

Representative BOLLING. I would like to ask Mr. O'Neill one question on that subject. You felt that the effect of the shortfall was less than the 1 percent justified. I wonder if you could tell me what part of that 1 percent you think a shortfall might have accounted for or any part?

Mr. O'NEILL. As I indicated, Mr. Chairman, I am not prepared to say that it had no effect.

Representative BOLLING. What does that mean?

Mr. O'NEILL. It means I am not prepared to say that the shortfall was neutral, that the GNP would have been the same with or without the amount represented by the shortfall. But I really do believe, as

I indicated in my House Budget Committee testimony, that when we are talking about $4 billion or $5 billion in an economy of $1.6 trillion, we are really giving ourselves a little bit too much credit when we think we can tell you that the effect was 1 percent. I guess I would be prepared to say it probably had some effect. But I think it is arguable how much it was and I think 1 percent is too high an estimate. To assign a point estimate to it is to assign more of a science aspect to economics than I am prepared to assign to it. I think we are still in a dark age at this point as to how our economy really operates, and I offer as witness for that the performance that we have experienced over our history, and not just recent history either. We know a lot more about how the economy operates now than we did 50 years ago, but I think recent experience indicates that we have got a long way to go. When we think we can take a $4 billion Federal spending number and convert it into a point estimate for GNP, we are beyond our real capability.

Mrs. RIVLIN. May I say, the so-called point estimate is roughly 1 percent. And the estimate is very rough.

Representative BOLLING. I don't think either of you would object if we try to inform ourselves better.

I am going to pursue a different line of questioning. I am tempted, of course, to play the usual game of trying to find out about the budget, and so on. I don't even think that is proper at this time under the circumstances. So I am not going to do it. The differences between Mr. O'Neill and Mrs. Rivlin are, I think, apparent and clear. It is a question of the fundamental question of whether one believes that the Federal Government should intervene more or less, and if it does, whether it has more or less effect. And further, how much it is worth to try to do better. I think those are very important disagreements. And I think they are very clear. But I don't think it is worth pursuing them today.

What I would like to pursue, having had a good deal to do with writing the Budget Act, is how we can improve this attempt by the Congress to inform itself so that it can begin to proceed intelligently to deal with the budget. And this particular provision was thought about more than the language in the act would indicate. But it was a compromise of a compromise. I am curious, and I would like to hear from both of you as to how we can better devise language, an amendment to the Budget Act, that would provide more helpful information to the Congress as it seeks to continue its effort to deal responsibly with a budget, not necessarily the budget, but with a budget. And I am particularly interested in that approach. And I don't care which one of you starts.

Mrs. RIVLIN. I don't think I am prepared at this moment, Mr. Chairman, to offer very specific amendments. But let me talk in general terms about how I think the Budget Act might be improved.

I think there are two points. One is that the Congress, for all its new reforms, still deals with the budget 1 year at a time. There are a number of provisions in the Budget Act that help to bring to the attention of the Congress the future implications of decisions made on next year's budget. For example, the 5-year projections report that CBO is required to produce shows what would happen to the budget for the next 5 years if nothing changed. These estimates give the Congress a benchmark for considering changes. Our 5-year cost estimates produced for every bill reported are another indicator of the importance the authors of the Budget Act placed on the need to bring future implications of the current action to the attention of the Congress.

But I think the weakness of the act is still that it works on the budget for the next fiscal year, and the intention is still to focus only on decisions for the next fiscal year. Somehow we have to bring more consideration of future years into the actual decision process on the budget. This could be accomplished by a multiyear budget approach—a concurrent resolution, say, for 2 years or 3 years, which would of course have to be amended as the circumstances change. This or some other way would focus the attention of the Congress on the fact that decisions made this year make a lot of difference for the next year and the year after that.

This problem, I think, came forcefully to the attention of the Congress, particularly the Senate, this year in the discussions over the tax bill. Future revenue implications of a tax bill that was required for technical compliance with the budget resolution were at issue, and yet couldn't exactly be voted on.

I think the second direction we should all be working in while considering the budget process is to have some way of having a better debate on budget priorities, particularly budget priorities for the future. It seems to me that the success of the budget process has been primarily in being able to go through the whole process and make a budget. Get the thing done on schedule, get all the appropriations bills finished by the beginning of the fiscal year—which wasn't true before—and bring the discipline of a total picture to bear on individual situations.

The second success has been in the ability to debate and discuss and decide on fiscal policy, when the budget was being considered as a whole for the first time.

The weakness, perhaps, has been that the budget process has not generated very much debate on major priorities. The authors of the bill, including you, I think, had hoped that this budget process would be a forum for major debate on budget priorities. And it has been less successful in that respect than in being a forum for debate on fiscal policy.

I am not exactly sure yet how we amend the act to improve that. But I think those are the directions in which we ought to be going.

Representative BOLLING. Mr. O'Neill.

Mr. O'NEILL. Mr. Chairman, first I would like to say, as I have done on many other occasions, that I think the Congressional Budget Act may be the most important act that has been put on the statute books in a generation or maybe more. I really do believe it holds out the potential—although I don't think we have achieved it yet—for more reasoned, logical, analytical decisions, and certainly, I think, more public opportunity for discussion and understanding than we have had in the past. It is my hope that in the years ahead this process will become so ingrained that one will not consider its demise or lack of continuation, as you are indicating, but rather how it can be improved. I think it is important that the executive branch and the Congress work together to make that process work. In the absense of this new process, the Congress might have gone without ever making a collective decision that reflected where the country wanted to go, simply because of the way budgeting had previously been approached by the Congress.

I do think there are some desirable changes, and I certainly agree with most of the things Mrs. Rivlin just said.

But if I may, I would like to start with a comment about the current status of that process. I have been concerned from a parochial standpoint, from an institutional standpoint at OMB about the impact of the current service, as we indicated last year in our testimony before the committee, because in its preparation there comes a time when the President and his advisers are right in the middle of preparing the fiscal year budget for the upcoming year, and so it represents a competitive priority for work and attention. And I couldn't think that is a good excuse for changing it. But as I observed what happened to it last year, and frankly what I expect may happen to it this year, I am led to a conclusion that it may very well be desirable to change the current sevices estimate process to this extent. Last year it would seem to me that one difficulty we had is that we prepared a current estimate and came to the Congress early in November, and there was a flurry of interest, and then the President's budget came out, and nobody ever looked back at the current service estimate again. I doubt if there are 20 people in the whole world that read the whole book through.

Representative BOLLING. If you would yield at that point, I am afraid I do not have much impact, but I talked on the floor in a very serious part of the debate repeatedly just in those terms. And I'm sorry you missed it.

Mr. O'NEILL. Mr. Chairman, I would like to make the following point. The way the current service estimates are now put together, and the time that they come out, you necessarily put them in the background, because people start paying attention to the President's budget in January. Moreover, because the current service estimates aren't reflected in the President's budget, you can't really see the differences between such estimates and what the President recommends. Thus, the current services estimates lose that value. Since I am leaving, I am not going to have to carry the burden of any change that may be made in this regard. I would say that it would not be easy to incorporate the idea behind the current sevice estimates into the budget document. But I myself would encourage the committee and the Congress to consider some way to incorporate current services or current policy estimates into the budget document as a way of making them useful and putting them together with a Presidential forecast and estimates of overall economic performance over the next 5 years.

One of the difficulties I think all of us face with the present OMB and CBO estimates is that you are dealing with several different sets of economic assumptions and an equal number of spending and receipts estimates. They really don't represent anybody's proposal.

I therefore suggest that you might think about how the act could be amended to deal with some of those problems.

Second, I think we need to move, as Mrs. Rivlin indicated, in a direction that forces decisions to be made in a longer time context than just 1 fiscal year. We have made a little bit of progress, but we need to think more deeply about the possibility of detailed estimates and perhaps resolutions for not just 1 year, but for 2 years. Three years would be even better, but maybe we ought to start humbly with 2, to begin to get a little better control than we now have with the process. Overall, I think we have made some progress in the longer term estimates in the last few years because, for example, of the changes Mr. Brown worked on with the administration to reflect the budget authority commitment that we are making. For example, in our housing assistance programs, we are no longer doing partial funding as we had for years and years. If you look at this year's budget, you will find that the budget request for assisted housing is $17 billion. We used to show $2 billion. The programs haven't changed substantially in size; it is just that the budget accounts for them more accurately now. We ought to keep moving in those directions to get ourselves and the public to understand the commitments that we are making for a longer period of time than we now are.

Representative BOLLING. Mrs. Rivlin.

Mrs. RIVLIN. I would like to follow up on what Mr. O'Neill was suggesting about the usefulness of the current services concept. It seems to me that the reason the current services budget has not received more attention than it has is at least in part that the OMB has not built the current services idea into its own decisionmaking process and shown the Congress the budget changes that the President is proposing as different from the base of current services. It would be very useful to have the President's budget proposals in those terms. If the current services idea were really built into the OMB's own decision process, then I think they would not find it a competitive priority, as Mr. O'Neill has said, but something they really needed themselves.

I would think if one were President and were making up a Presidential budget, that one question would be: What would happen if we go on doing what we are doing, and then what are we proposing to do differently? That seems to me a logical way of making up a budget and sorting out and displaying the choices. And that apparently is not now done.

Now, up here at the Hill——

Mr. O'NEILL. May I interrupt to just say that as long as I have been in the OMB, which has been since January 1967, such estimates have been developed. What I was saying earlier is something a little bit different. We have current policy estimates internally, and in effect we do all this work, and have been doing it since I went there when Charlie Schultze was Director. However, it is one thing to use your own staff work and material for internal purposes; it is yet another to produce a public document. It is a lot of work and we do not have an enormous staff. The same people who do the analytical work and ask whether we ought to have a veterans hospital, and so forth, are the same people who work on the galleys from the Government Printing Office, and make sure that it all looks right, with the proper format, and all that.

Representative BOLLING. I would like to make a comment on this. The President's budget ought to be a political document and it is.

Mr. O'NEILL. Yes.

Representative BOLLING. In making up the President's budget, there is no reason that I can see why the OMB is interested in knowing what the current services will be in relation to the process of the President's budget. It would seem to me that that would be one of the fundamental indicators that the President would want to have as he made the political decision, policy decision.

Mr. O'NEILL. Yes; indeed he does. But what we do right now under the Congressional Budget Act is to prepare a document, "Current Services Estimates," and then in January, under the rules of the Congressional Budget Act, and under the Budget and Accounting Act of 1921 as amended several times, we produce a President's budget. All I am saying is that from a display point of view, and from a workload point of view, we should be working toward presentation of current services estimates in the President's budget in January of each year. I don't frankly understand the utility of these estimates in November as a separate document unrelated to a specific set of estimates of economic performance or program change. There may be some utility that is escaping me, but I don't see it.

Representative BOLLING. The dilemma—I would like to speak on that myself—the dilemma is that the Congress needs some leadtime. I think the dilemma has to be faced and realized. Unless we get started a little bit earlier than when the budget comes up with the President's policy decision—regardless of whether it is a Republican or Democratic President, regardless of the kind of Congress we are facing, we ought to be able to neutralize this document.

The differences between you and Mrs. Rivlin are fundamental in a very real sense, but they are not so overwhelming that you don't come out pretty close when you make your estimates. It seems to me that we have to reach a combination that is right. One which does not make the Congress dilemma in meeting the timing of its role under its act worse. That is of course one of the reasons why this language was written in the vague way it was, and that is one of the reasons why we were perfectly willing to experiment. Nobody had a better idea at the time, and we thought this was a good way to begin. But the concept, the thought of at least one of the people that was heavily involved in it, me, was that—and I have spent years on this committee—there wasn't any incompatibility. Even when you had a conflict between a Republican President and a Democratic Congress, with all the policy differences absolutely clear as a bell, we ought to be able to neutralize this aspect in such a way that the Congress came up with the information that the President was going to use as his base information when he made his policy decision. Now, really what we wanted, what we talked about, was speeding up the budget process and requiring a President to come in early with a pre-Congress budget. But it wouldn't sell.

And this is a substitute for that. And it seems to me that it is almost critical to our ability to keep our timetable, because you have got to direct attention to something, and it ought to be a neutral document, which ideally was, as strange as it may sound, almost worked out in cooperation between the OMB and the CBO. That is the thing I am getting at. When you are dealing with projections, when you are dealing with facts, I know it is possible to get the policy conflict out of it, not all of it, but most of it, so that you have an agreement that this projection makes some sense, and that projection makes some sense, and these are the alternatives. That is what I am interested in getting to—how do we get this worked out so that we don't have a constant conflict, not between the OMB and the Congress, but the President and Congress? I am not asking questions on the Budget Act. That would be the news of the year if I did. I am not asking because the law says he has to do it in a certain time. But I am pressing for an approach that says that what comes from OMB in the future is related specifically to the President's decisionmaking process. I don't think that is asking the President to give away the budget in advance. Is there anything wrong with that approach?

Mr. O'NEILL. Frankly, it is not clear to me how the numbers that we submitted this year, for example, would be different under your approach.

Representative BOLLING. Then why isn't it a part of the President's budget?

Mr. O'NEILL. That is another question. It goes to the statutory answer that I gave you. It is not required under the Congressional Budget Act.

Representative BOLLING. Last year we tried to get it in and we were told it couldn't go in, everybody was too busy.

Mr. O'NEILL. That is part of the answer, but there are more mechanical kinds of problems. You are, I am sure, familiar with the budget document right now, the displays that are provided for budget authority and for outlays, and so forth. They fill up the pages. We would have to go to a new kind of document, and add a few columns in order to present current services estimates. When one looks at the differences between a Presidential request, say, for the upcoming budget year, and current policy or current services, it may be more useful to go with differences of approach. All I was suggesting is that there is room for more thought as to how we meet the objective of giving the Congress advance opportunity to get into the budget process, and how we make current services in the Budget Act a more useful and important part of the process. I am not quarreling with you about your objective.

But one thing you have said raises an interesting point.

The estimates that have been developed by the CBO this year and the estimates we have prepared are not very far apart. It really makes me wonder, if one cares about efficiency and marshaling our resources, why in the world are we both doing it?

Representative BOLLING. I will tell you one of the reasons, and that is, when we were beginning to work on this act, I think we had a very real suspicion, not necessarily about the OMB, but the administration, as to willingness to produce facts. And it was, I believe, well founded. I think it has been demonstrated to have been well founded. That is one of the reasons it wasn't possible to go as far in demanding by law a cooperative relationship at that particular time. Action, you remember, started moving a little bit in 1972, and moved some more in 1973 when we got it founded. It passed in 1974. And the dilemma then was a different dilemma than we have had in the last couple of years. But it seems to me ridiculous that we can't move very quickly—and I am not critical of this document or this situation—to something that would be much more informative. My own view of the budget is that it has been a long time since the budget document approached what I believe it should be. And that is not critical of the technicians.

I believe that much of the budget documents in the last 20-odd years have been designed to obfuscate as much as to make clear. If the Budget Act is to survive in Congress, and if it is to survive in terms of its fiscal, as well as, its macro and micro economic policies, it is going to have to have a much clearer exposition of the implications of the policy proposal of the President and the policy responses of the Congress. That is what this is all about, if I understand it. We have gone through 2 very difficult years, and by the grace of God and good luck, we have survived, and the budget process has survived all political overtones that were involved. But it seems to me that the key here is that if we are going to get anywhere over time, we are going to have to work out some kind of effective cooperation.

Representative BROWN of Michigan. If the chairman would yield, it seems to me that, Mr. O'Neill, you are talking about a mechanical problem of the preparation of the document.

Mr. O'NEILL. Yes.

Representative BROWN of Michigan. I have been advocating for a long time that it is ridiculous that we have a 1-year budget, and go through this whole process each year. This is especially ridiculous because we keep hearing words from every administration about conflicting figures in every index and the uncontrollable budget, which means you have no real policy impact.

It seems logical to me that because you have a Congress which lasts for 2 years, why couldn't the executive branch go to a 2-year budget? Wouldn't that eliminate an awful lot of the work that you do now, or breaking your neck to go out under some deadline, or you ask for an extension? It seems to me that there is every argument for a 2-year budget, and I haven't heard good arguments against it.

What are the arguments against a 2-year budget? If you are talking about zero based budgeting, talking about sunset laws, all of these things, it seems to me that it makes it patently essential that you have a 2-year budget. What is wrong with a 2-year budget?

Mr. O'NEILL. There are arguments, I think, on both sides. The argument you put up for a 2-year budget is very powerful. On the other side, however, there is the argument that a 2-year budget takes away the Congress' opportunity in its appropriations process to consider each program each year.

Representative BROWN of Michigan. But each Congress would have an opportunity to look at each program, because each Congress serves for 2 years.

Mr. O'NEILL. Yes

Representative BROWN of Michigan. So every Congress would have an opportunity to work on its budget and the Nation's budget for that term.

After all, we have four or five supplementals now which can both repeal and add to budget determinations.

Mr. O'NEILL. Yes.

Representative BROWN of Michigan. It seems to me that would be one way to curb the Congress alteration of programs that affect expenditures in perpetuity. Congress would only have one chance then, or at least it would have fewer chances.

Mr. O'NEILL. There was a great deal of thought and consideration given to a 2-year budget, or to advance funding, when the Congressional Budget Act was being formulated. As you know, in some areas we have gone into advance funding, as in our educational program, for example. The thought that has been given to this subject—and the resulting literature—is fairly rich and deep. If you are interested it would be useful for you to obtain a collection of that literature. Frankly, I haven't come prepared this morning to respond in the deep, careful way I would like, to your question. It deserves a very careful answer, because it represents a very important change in the way that the Congress conducts its business.

I am not prepared to say that such a change is undesirable. Frankly, I think if the Members of Congress didn't have to attend and participate every year in some of the appropriations hearings that they now do as a matter of course, they would have more opportunity to argue about and think about the things that Mrs. Rivlin was suggesting, such as competing priorities, and to participate in oversight hearings. I think that would be very desirable.

Representative BROWN of Michigan. I expect that if we do it the Congress and even the executive branch would have more time to do a better job in preparing and submitting a budget.

Mr. O'NEILL. Yes, sir.

Representative BROWN of Michigan. And as you say, Congress would have a better opportunity to cross-examine it.

Thank you, Mr. Chairman.

Representative BOLLING. I regret I am going to have to leave. I have an urgent appointment in connection with another matter.

I am going to ask Mr. Long to take over. Very grateful to you both.

Representative LONG [presiding]. Thank you, Mr. Chairman.

If it is agreeable with the witnesses, I would like to go through three or four more questions we would like for the record, and if there is anything more Mr. Brown would like to ask, we would be happy to have it.

First, Mrs. Rivlin—all of these three are directed to you, and I would like your response first—and if it is in order, Mr. O'Neill, if you have any comment with respect to them—some might and some might not be particularly pertinent—inject your thoughts.

One, Mrs. Rivlin, on the 5-year projections that show under the present policy that we are following, receipts will exceed the outlays in 1980, as I read it, and the margin between receipts and outlays will become larger in the years that are following that. Now, what kind of tax burden does this project, imply for individual taxpayers and for corporate taxpayers, and what is the relationship of inflation to that? Would that cause a substantial increase in the effective tax rate?

And then related to that also, if we do allow the statutory tax rate to remain unchanged, if we don't change it, would the resulting fiscal drag that we have prevent the projected economic recovery which underlies, I guess, all the way across your projected 5-year estimates?

Mrs. RIVLIN. I think perhaps we might prepare a more detailed answer to those questions for you. In general terms, the revenue projections do imply an increasing reliance on the income tax, and the inflation is part of the reason for that. As one goes ahead several years, that margin increases. We have not done a detailed answer, but we will, to the question: Is the fiscal drag that is implied by this set of policies so great that it would knock the economy off the assumed growth path? In other words, would it be possible to attain the growth pattern assumed in the projections with a current policy budget? In the shortrun, the answer seems to be, no. For the next couple of years it does look as though a more stimulative budget would be necessary to get the economy back on the growth path assumed by the second concurrent resolution.

Representative LONG. Before I go into that, if you would be willing to expand upon that, or have your staff prepare something that you could expand upon that, I think it might do well to help me.

Mrs. RIVLIN. Certainly.

Representative LONG. Mr. O'Neill, before I go into an aspect of that, do you have any comments?

Mr. O'NEILL. No comment.

Representative LONG. Mrs. Rivlin, on that, if you studied and observed the trend in Federal receipts over the years, the share contributed by the social security taxes over the years has pretty generally risen, and the share contributed by personal income taxes has been relatively constant, and the corporate income tax share has fallen. Your 5-year projections with respect to these three points show some changes. As I look at it, you projected social insurance taxes to contribute 29.5 percent of total receipts in 1977, and 28.1 percent in 1982. Then you show the individual income tax rising from 44.6 percent in 1977 in a substantial increase to 51 percent in 1982, and the corporate share falling from 16.1 percent in 1977 to 13.8, which is again a substantial shift in 1981. Would you comment on the reasons for this shift, and especially the falling share of the receipts from the social security taxes. We would like your comments on those, please.

Mrs. RIVLIN. Yes. For the benefit of our audience, we are referring to the table on page 38 of the report, which shows revenues, both historically and projected, by major Federal taxes.

It is true that, in the past, the share of the individual income tax has been roughly constant over the years. But that is because every once in awhile Congress cut the rate. If the rates were held constant, the simple arithmetic of the situation would force the share of the Federal income tax to rise, for the reasons that were alluded to earlier: Economic growth and inflation force people into higher and higher tax brackets, and the yield of the Federal income tax rises faster than national income where national income is growing. The reason, therefore, that the percentage rises in our projections to 51 percent in 1982 is simply that we are assuming that the rates don't get cut over that period. If they were cut, the percentage would of course be lower.

Representative LONG. And you are saying that should Congress not have during the period cut them periodically, that they would have probably shown about as much of a projected increase as you are showing for the period in the next 4 or 5 years?

Mrs. RIVLIN. Yes; that is exactly what I am saying.

With respect to the social insurance taxes, those grow roughly at the same rate as the GNP or the national income, because they are flat rate taxes, they are not progressive. So you don't get this phenomenon of people being pushed into higher brackets.

Mr. O'NEILL. Mr. Long.

Representative LONG. Yes; Mr. O'Neill.

Mr. O'NEILL. I would make just one comment on that.

The line you see on social insurance taxes and contributions may be fairly characterized as a bankruptcy policy.

Representative LONG. Say that again.

Mr. O'NEILL. That is to say, if we do not do something along the lines proposed by President Ford last year to increase social insurance taxes, especially social security tax proceeds, we are not going to have any trust fund whatsoever in a very short period of time.

Representative LONG. Mrs. Rivlin, would you like to comment on that? I know we are going a little bit afield here, but it is something that is worth going into. I know you have done considerable study on that.

Mrs. RIVLIN. Yes. I am not sure I would characterize the current situation as a bankruptcy situation. But there is certainly cause for concern about the present mechanism of financing social security, both in the shortrun and in the longrun. Recently the social security reserves have been drawn down quite rapidly because of the combined impact of recession and inflation. In a recession less money is paid into the social security trust funds and social security benefits are increased to take care of the inflation. Thus we have had a graphic decline in the social security reserves. But that certainly doesn't mean that the system is going bankrupt in the sense that people don't get their checks. I think that there is a certain carelessness about the use of scare words like that. But it does mean that the Congress could consider very carefully what it wants to do about this situation. I don't think it is super urgent. I think it can wait a little while.

But there are various possibilities. One possible solution would be to allow the social security trust funds to borrow, if they run out of money temporarily. Another would be to allow for some general revenue financing. And another of course would be to increase the payroll tax. All of these possibilities merit very careful consideration.

We have a paper coming out of the CBO quite soon which discusses this problem. And it is really several different problems. A particularly serious situation exists in the disability trust fund, more serious than in the old age and survivors trust fund.

In addition to that, there is a longrun problem about social security. We ought to be thinking about what we do when the baby-boom babies reach retirement age. If the birth rate continues to fall there won't be as many people in the labor force to pay social security taxes. So we have to be thinking now about how to plan for that contingency in the future.

So while not associating myself with Mr. O'Neill's words about bankruptcy, I would certainly agree with him that very careful consideration of social security plans is in order right now.

Representative LONG. I share that view. I think that many Members of Congress have come to realize that it is a very serious situation. And I associate myself with the views that you express here.

Mr. Brown.

Representative BROWN of Michigan. I was just going to say, I don't think Mr. O'Neill is the first one to have used the terminology.

Mrs. RIVLIN. No, he isn't.

Representative BROWN of Michigan. But in your statement's estimate of receipts, Mrs. Rivlin, do you contemplate the same rates, the same base that is now the law?

Mrs. RIVLIN. Yes.

Representative BROWN of Michigan. Would you not agree, though, that if you use these, that would not be adequate to pay the benefits that are on the books and those that are contemplated to be entitled to benefits?

Mrs. RIVLIN. So far as the old age and survivor's insurance funds are concerned, estimates differ somewhat on whether we are in a really dangerous situation. It depends on what we assume about the course of the economy. If we do return to a healthy growth rate, and if inflation stays at what we have now come to consider a reasonable level, like 5 percent, then probably the old age and survivors fund will begin to recoup some of its reserves. I say "probably," because we are not quite sure, and a worse economic situation could put the fund in jeopardy. I think that is the question that Congress should have in mind: What do we do if things get worse, do we want to plan now for a hedge against a deteriorating economic situation which would indeed put that fund in jeopardy?

Representative BROWN of Michigan. All I am saying is that, looking back at the value of this document, taking any three of the paths for the economy that you have suggested in your statement, and projecting those with what would happen insofar as the receipts from social security and other considerations, is it not true that in 1982 we would be in an intolerable position?

Mrs. RIVLIN. No sir, it is not true, if you take optimistic assumptions about the economy. If you take very pessimistic ones, it is.

Mr. O'NEILL. Mr. Brown, if I may, I didn't mean to cause a controversy by calling attention to the social security number. My point was to indicate some caution in making percentage calculations about the contributions of the different sources of revenues that we look to in 1982, or even 1980, for that matter. Perhaps I should have made a similar point, in regard to the individual income tax figures that Mrs. Rivlin gave. If I were speaking as an individual, I wouldn't speak of the surplus of 1981 or 1982, because of the same pressure that has led to reductions in individual income taxes in the past. With regard to social insurance, our calculations show that the disability insurance fund is going to be empty in 1979, if some action isn't taken. And at sometime in the 1982 to 1985 period, we are going to be in serious difficulty. But my purpose was in saying that if you are interested in making a decision about the share of revenues from social insurance contributions, you really can't be satisfied with looking at the numbers that are here.

A simple extension of current policy, I think, is unacceptable to both of us, especially with regard to decoupling.

Mrs. Rivlin indicated that we don't have to worry about this issue in the short run. I respectfully disagree. It has been my experience that it happens to us very fast, and the longer you take with getting on with decoupling, the more dangerous our situation is going to be.

Mrs. RIVLIN. Excuse me, I was misunderstood. I do not think that the decoupling provision should be delayed. I think it is very important to do it now.

Mr. O'NEILL. I use the word dangerous for this reason. I think—at least I am concerned—that there may be a danger that we will slip into a position where there won't be any choice except to begin using general revenues for the purposes of financing social insurance, and that is not a position that I believe we should slip into. That was really my purpose in raising this issue. I have seen some speculation that perhaps we ought to give people a rebate of their social insurance taxes. Frankly, that scares me. If we let the system deteriorate without taking corrective action, there isn't going to be a choice. We could easily back into a decision on our social insurance program if we are not very careful.

Representative BROWN of Michigan. I think we have maintaining a kind of facade as far as the social security system is concerned, and it is getting to the point where it is 90 perecnt social welfare and 10 percent contractual.

Representative LONG. Mrs. Rivlin, related to this in overview, of course in the last year or 2 years, as we have hammered out this budget process, there has been a continuing amount of discussion, an increasing amount as to the share of the budget devoted to the social services and to income support types of services. As we all know, during the 1960s, and then I guess in the early 1970s, these expenditures grew very rapidly. And some projections at that time were showing them consuming a very, very large share, and it might even be described as a huge share, of the gross national product by the end of this century. The projections that your office has been making in this regard, as I recall them, have been far more reasonable than that. Would you describe the changes in the budget composition in that respect as shown by your 5-year estimates?

Mrs. RIVLIN. Yes. I think they are shown graphically in chart 3 on page 14 of the report, where you can see clearly that over the past period there has been a rather dramatic shift in the share of Federal expenditures going to major activities. Defense has gone down as a share of the budget. And the benefit payments to individuals have gone up. As you noted, the benefits for individuals went up very rapidly absolutely and relatively in the 1960's and in the early 1970's. I think there were several reasons for that.

One was an increasing number of eligible people coming into the various programs. The welfare rolls were rising rapidly, because a larger share of people who were poor were claiming benefits. Congress was also raising the benefits over that period rather substantially. Now, as we look ahead, we do not see a continuation of this relative growth in the individual benefits payments if—and I underline if—you assume that current programs are continued with an allowance merely for an increase in the number of potential beneficiaries, as well as a cost of living increase in the level of payment.

The reason that is true is that most of the people who are eligible for these programs are already getting them, and the eligible population is not increasing all that rapidly.

Now, of course this could change if Congress were to enact new programs of this sort, such as national health insurance. And it could also change if Congress increased the benefit levels faster than the price level, or faster than the wage level, perhaps. So that one has to keep in mind what these projections are. They simply say that there is nothing built into Federal laws now on the books that would continue the increase in the payments to individuals as a proportion of the budget.

Representative LONG. Thank you.

Mr. O'Neill, any comments?

Mr. O'NEILL. No sir.

Representative LONG. Mr. Brown, anything else?

Representative BROWN of Michigan. Just one thing.

Mrs. Rivlin, I don't think I gave you a chance to comment on my conversation to Mr. O'Neill about a 2-year budget.

Mrs. RIVLIN. No, you didn't.

Representative BROWN of Michigan. I am sorry.

Mrs. RIVLIN. I wanted to associate myself with the spirit of what Mr. O'Neill was saying. I think there are arguments for and against the 2-year budget. I am one of those who has thought for a long time that the Federal Government ought to institute a 2-year or perhaps 3-year basis for budgeting. And I have gone around saying that to quite a number of your colleagues. The arguments that I usually get are: Wouldn't a multiyear budget make it impossible to plan ahead? Wouldn't it be difficult to make up budget proposals for the year after next, because we don't know what is going to be happening then? Couldn't there be dramatic changes in the economy, or a war or something? These are relevant questions, obviously, and any multiyear budgeting plan would have to have built into it some kind of flexibility for making changes if something new happens.

But I think the fact remains that if the Congress makes decisions—even if they could be later amended—for a longer period, it will have more flexibility, not less, in making changes in the Federal budget, because it would then be possible to think ahead and to decide what needs to be phased out or what new programs should be implemented. Those are decisions which can really only be made if we look ahead. So I am a proponent of longer term budgeting.

Just to finish and advertise the joint product here, one of the features of the Budget Act is a requirement that OMB and CBO separately produce reports on the feasibility of advance budgeting, which are due in February, I believe. Our report will consider the question of multiyear budgeting. We will be just delighted to make it available to this committee.

Representative BROWN of Michigan. Mrs. Rivlin, let me be the devil's advocate for a second. Why not have a 6-months budget? That would give you an opportunity to view it even more often.

Mrs. RIVLIN. Oh, absolutely.

Representative BROWN of Michigan. And what did we have, five supplemental appropriation bills last year? Which gives you the opportunity to make all the adjustments and changes you wanted.

I wouldn't agree with a 3-year budget. I think it should be a congressional budget, a budget for the 95th Congress. And the executive would conform to that basic timeframe and have a 2-year budget. That way each Congress would have an opportunity to in effect determine the situation for 2 years. And any succeeding Congress in connection with the first—there would only be one overlap here, otherwise the 94th makes it—in effect it would determine the first year of the 95th, and the 95th would determine the first year of the 96th, et cetera under the 2-year arrangement. But through supplemental appropriations you could make all the changes you needed to.

Mrs. RIVLIN. I agree.

Representative Brown of Michigan. And if we have five with a 1-year budget I think we could just as well have seven with a 2-year budget.

Representative Long. Mrs. Rivlin, I had an opportunity last year to talk with the Finance Minister of Norway, who does a 5-year budget. It was very interesting to me what they do as a 5-year budgeting process and review it every year to try to bring it in line. He was remarking how well it had worked in his opinion in Norway—of course Norway is a much smaller country—but in principle how well it had worked.

And he made an interesting comment to me, that before World War II Norway had never done this. The reason that they had started it, and that they were well pleased with it, is because the U.S. Government required it for them to be able to participate under the Marshall plan.

Thank you, Mrs. Rivlin, and thank you, Mr. O'Neill. This hearing stands adjourned until 9:30 tomorrow morning in this same room.

[Whereupon, at 11:20 a.m., the committee adjourned, to reconvene at 9:30 a.m., on Friday, December 3, 1976.]

[The following information was subsequently supplied for the record:]

Response of Hon. Alice M. Rivlin to Additional Written Questions Posed by Senator Taft

Question 1. Mrs. Rivlin, you state in your testimony that Federal receipts would rise faster than GNP largely because inflation and growth in real income push individuals into higher tax brackets. Insofar as this effect is due to inflation, the individuals experience higher tax rates, both average and marginal, on the same real income. The higher marginal tax rates should cause them to be less willing to accept overtime, and induce them to demand longer vacations, since the reward to labor is reduced. Since the cost of hiring labor is inclusive of payroll and withholding taxes, and takehome pay is exclusive of both, higher tax rates should reduce the amounts of labor demanded and supplied. The higher rates should cause them to increase consumption at the expense of saving and investment, since they get to keep less of the interest and dividends. These effects should reduce our growth rate. Did the models on which the CBO based its projections take these supply side effects into consideration? Did they take Keynesian effects of taxes on aggregate demand into account?

Answer. The CBO projections do take account of the effects of tax changes on aggregate demand. With respect to supply side effects, the CBO projections assume that they are negligible. It is not clear whether supply side effects would act to increase or to decrease income. Putting an individual into a higher tax bracket reduces the real earnings he can expect from an additional hour of work, but at the same time it means that he has to work a larger number of hours in order to meet a real income target. Experts disagree on which of these two effects is stronger.

Question 2. Many economists regard these supply side effects as quite important, and state that major tax rate reductions have generally paid for themselves by stimulating the economy and increasing the real tax base. The Treasury predicted that the Kennedy tax cuts would produce a six-year revenue loss of $89 billion, when in fact there was a six-year revenue gain of $54 billion. Rep. Wilbur Mills still complains about the Treasury's attitude and their refusal to allow for the effect of tax rate reductions on the tax base in their predictions of the effect of tax rate changes on Government receipts and the deficit. Do Treasury's models take supply side effects into consideration? Do they allow for the standard Keynesian demand effects? Or do they simply apply the difference tax rates to some unalterable projected path of GNP in answering questions as to the cost or benefit of tax rate changes?

Answer. Our understanding is that the Treasury revenue estimates simply apply different tax rates to a fixed path of GNP.

CURRENT SERVICES BUDGET

FRIDAY, DECEMBER 3, 1976

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to recess, at 9:35 a.m., in room 1202, Dirksen Senate Office Building, Hon. Richard Bolling (vice chairman of the committee) presiding.

Present: Representatives Bolling and Brown of Michigan.

Also present: John R. Stark, executive director; William A. Cox, Robert D. Hamrin, Louis C. Krauthoff, L. Douglas Lee, and Courtenay M. Slater, professional staff members; Michael J. Rundle, administrative assistant; and Charles H. Bradford, George D. Krumbhaar, Jr., M. Catherine Miller, and Mark R. Policinski, minority professional staff members.

OPENING STATEMENT OF VICE CHAIRMAN BOLLING

Representative BOLLING. The committee will come to order.

This morning, the Joint Economic Committee continues its examination of the current services budget for fiscal year 1978. Yesterday, we heard from Mrs. Alice Rivlin, of the Congressional Budget Office, and Mr. Paul O'Neill, the Deputy Director of the Office of Management and Budget. They presented their estimates of what the budget would look like in 1978 and the following 4 years if present policies were maintained.

This morning we want to focus our attention on the impact that budget policy would have on the economy. Early next year, Congress will be faced with the decision to either continue present policies or adopt new ones. In order to make an intelligent decision, we must understand the impact that a continuation of present policies would have on the overall performance of the economy.

The witnesses this morning have been asked to discuss the impact of pursuing the current services fiscal policy and to suggest any alternative policies which they feel would be preferable.

Our first witness this morning will be Mr. Alvin J. Karchere, the director of economic research for the IBM Corp. He will be followed by Mr. Edward M. Gramlich, a professor of economics at the University of Michigan and former senior analyst with the Brookings Institution. The third witness will be Mr. Michael E. Levy, director of economic policy research for the Conference Board.

Mr. Karchere, please proceed with your statement as you wish.

STATEMENT OF ALVIN J. KARCHERE, DIRECTOR OF ECONOMIC RESEARCH, IBM CORP.

Mr. KARCHERE. I have used our econometric model to forecast the U.S. economic outlook, on the assumption that the current services budget as estimated last month by the Office of Management and Budget is adopted by the U.S. Government.

I have also prepared three other conditional forecasts using the current services budget as the base, the first on the assumption of a $15 billion national tax cut, and the second on the assumption of an additional $15 billion increase in the Federal Government expenditures, and the third a combination of the first two cases, an increase of $30 billion.

The forecast calculated on the current services budget assumption shows a moderate recovery to continue through 1977 and 1978. The growth in real GNP, after falling to about 3 percent annual rate in the current quarter, will accelerate to about a 5½-percent rate in the first half of next year, but then gradually decelerate to about a 2½-percent rate in the second half of 1978. On an annual rate basis, the real GNP will increase about 4.7 percent in 1977 and 3.8 percent in 1978. Those increases are modest compared with the 6.1-percent increase in 1976.

The improvement in the first half of 1977, following the slackening in economic activity during the second half of 1976, comes from five sources. First, retail sales in real terms, which have been flat since the spring, should rise in response to more rapid increases in household income. Wage increases in the nonunion sector will rise somewhat more rapidly than the recent period. And the decline in farm income will end, producing improvements in disposable income.

Second, net exports will improve in early 1977, also contributing to a better GNP performance.

Third, the shortfall in Federal expenditures from an already tight budget caused a shift from substantial fiscal stimulus in 1975 to restraint in 1976. There will be a faster rate of increase in Federal expenditures in calendar 1977 than in 1976, which will be maintained by the current services budget in 1978.

Fourth, State and local government expenditures will rise more rapidly than earlier this year in response to some easing in their budget positions and increased Federal grants.

Finally, recent data for capital goods orders and housing starts suggest that fixed investment will contribute significantly to economic recovery at least through the first half of 1977.

The recovery will decelerate again thereafter because of a relatively small increase in the volume of consumer spending, which will not be sufficient to sustain a high rate of growth in investment. The cause of the low growth in consumption is real disposable income, which is increasing slowly because of small gains in real earnings.

Our forecast under the current services budget assumptions implies continued high unemployment during the 1977–78 period. Unemployment will average 7.6 percent next year, and 6.9 percent in 1978. By the end of 1978, it will still be a relatively high 6.6 percent.

The improvement in the labor market will be modest because productivity gains and increases in the civilian labor force will keep the jobless rate high. The labor force will increase by 3.7 percent between the third quarter of 1976 and the end of 1978. And the productivity growth is estimated at 4½ percent. Productivity and labor force growth together will total 8.2 percent over that period. That leaves only a small portion of the total increase of 9.2 percent in real output to be absorbed by reducing unemployment.

With unemployment remaining high and enough idle plant capacity, inflation will remain in line with current rates during the current forecast period. The consumer price index will rise by about 6 percent in both 1977 and 1978.

Our forecast, based on the current services budget assumptions, results in a level of nominal GNP for 1977 and 1978 that is a little lower than OMB's path III, which is the lowest of their four alternatives. Our forecast for inflation is higher than OMB's path III, and therefore, our forecast for real GNP is lower, and our unemployment rate is higher. Our real GNP forecast is lower and unemployment rate is higher than in any of the four OMB alternatives.

To calculate the effects on the economy of various forms of fiscal stimulus, we generated three alternate runs which modify the current services budget case as follows. In alternative 1, we assume a $15 billion personal tax cut retroactive to January 1, 1977, but taking effect on April 1 and continuing through 1978.

In alternative 2, we assume a Federal spending increase package that starts at $7 billion at an annual rate in the second quarter of 1977 and phases up to a $15 billion annual rate by the first quarter of 1978, and remains at that level through the end of 1978.

In the third alternative, we assume essentially the sum of alternatives 1 and 2.

Under the first two policy alternatives to the current services budget—that is, the $15 billion tax cut and the $15 billion spending increase—the result is an increase in the real GNP growth rate of one-half of 1 percent in 1977 in both cases. In 1978, the increase in the tax cut case is a half of a percent, and 0.8 of a percent in the expenditure increase case.

As a result, there is very little improvement in the unemployment rate in 1977 in these two cases as compared with the OMB base case, and about 0.9 percent improvement in 1978 in the expenditure case, and only 0.4 of a percentage point in 1978 in the tax cut case.

The Federal deficit rises above the base case under both alternatives. The deficit, however, is higher in the tax cut case than under the Government spending case, because of the gradual phasing in of the expenditure case over the course of 1977 and because Government purchases have a higher multiplier for GNP and tax revenue than do tax cuts.

The minimal impact on economic growth and unemployment stems from the small size of the tax cut or expenditure increase. A $15 billion tax cut represents only 0.8 of 1 percent of the gross national product. Compared to the 1964 tax cut, it really is quite small. In 1964, the tax cut represented 2 percent of the GNP.

Since policy alternative 3 represents the sum of the fiscal programs under 1 and 2, the impacts on the economy are larger. Compared with the base case, the OMB case, the growth in real GNP is 1 percentage point higher in 1977 and 1¼ percentage points higher in 1978.

In response to the improvement in economic activity, the unemployment rate is down to 5.6 percent for 1978 as a whole, and 5.2 percent by the end of the year.

The additional stimulus in all three alternatives produces very little additional inflation relative to the current services budget case, and then only in the latter part of 1978.

This occurs for three reasons. First, much of the current and expected inflation is not of the excess demand variety. It results from unusually high nominal wage increases caused by the high rates of increase we have had in the cost of living and the slow winding down of inflationary expectation. This type of inflation cannot be significantly reduced by slow growth, nor does it accelerate sharply with faster growth.

Second, there is currently such a large amount of idle resources, both plant and labor, that somewhat faster growth will cause little increase in demand pressure on prices.

And third, some of the pressure from rising demand will be offset by larger gains in productivity induced by faster growth.

The current unemployment rate of 7.9 percent is higher than at any time since 1948, except during the 1974–75 recession and the early months of recovery. The peak rate in the 1960–61 recessions was only 6 percent. Even allowing for the change that has taken place in the age and sex mixture of the labor force, which would raise the 5 percent full employment target to between 4½ and 4 percent, the current rate of unemployment is about 3 percentage points higher than full employment.

Furthermore, much of the current unemployment is concentrated among breadwinners and the skilled segments of the labor force. For example, the rates for married men, household heads, and white males 20 years and over, are all at least twice as high currently as in October 1973, the peak month of economic activity prior to the 1974–75 recession. The overall unemployment rate, however, is only 1.7 percent times the peak rate. Only 22 percent of the currently unemployed are teenagers, as compared with 30 percent in 1973.

Thus, unemployment is not only very high currently, but it is relatively higher in those categories where people want and have to work and possess the skills to do so. By any measure, the supply of labor is currently ample to support a strong recovery. Even in the $30 billion stimulative policy alternative, the overall unemployment rate does not drop below 6 percent until the spring of 1978.

There also appears to be ample plant capacity to support the recovery without producing widespread inflationary shortages and bottlenecks. According to the latest Federal Reserve figures, the rate of capacity utilization was about 81 percent in the third quarter, both in overall manufacturing and in the basic materials category, where shortages developed in 1973.

On our calculations, it will require only about 2 percent a year growth in capacity in overall manufacturing and in basic materials to keep the operating rates below 90 percent at the end of 1978, even in the $30 billion stimulative case.

Historically, the capacity growth in manufacturing and in the materials industries has averaged about 4 percent a year. Our forecast for capital spending suggests increases in the range of 3 to 3½ percent for the next 2 years, depending on the degree of stimulus. Thus a 2-percent rate of increase appears quite conservative. And, yet, it is sufficient to keep operating rates below the 90-percent figure that does produce a significant escalation in inflation.

In conclusion, our forecast, based on the assumptions of the current services budget, shows high unemployment continuing through the end of 1978. With very little increase in inflation, a $30 billion program of economic stimulus would reduce the unemployment rate significantly. The major negative impact of such a stimulative program would be an increase in the Federal deficit by about $20 billion in 1978 compared to the current services budget case.

[The prepared statement of Mr. Karchere follows:]

Prepared Statement of Alvin J. Karchere

THE IMPACT OF THE CURRENT SERVICES BUDGET IN THE ECONOMY

We have used our econometric model to forecast the U.S. economic outlook on the assumption that the current services budget, as estimated last month by the Office of Management and Budget, is adopted by the U.S. Government. We have also prepared three other conditional forecasts using the current services budget as the base: the first, on the assumption of a $15 billion personal tax cut; the second, on the assumption of $15 billion additional Federal government expenditures; and the third, a combination of the first two cases.

We translated the current services unified budget into appropriate national income account Federal expenditure components, which our econometric model is geared to handle. The translation involved channeling the annual uified budget data into proper NIA categories and phasing them in on a reasonable quarterly basis expressed at seasonally adjusted annual rates.[1]

In addition to the current services budget expenditure and tax rate assumptions, we have also assumed a very gradual uptrend in short-term interest rates, an OPEC price increase of 10% in January 1977 and a somewhat smaller increase in early 1978, and a fairly steady uptrend in U.S. exports.

The forecast calculated on the current services budget assumptions shows a moderate recovery to continue through 1977 and 1978. The growth in real GNP, after falling to about a 3 percent annual rate in the current quarter, will accelerate to about a 5½ percent rate in the first half of next year, and then gradually decelerate to about a 2½ percent rate of rise in the second half of 1978. On an annual basis, real GNP will increase by 4.7 percent and 3.8 percent in 1977 and 1978, respectively. These increases are modest compared with the 6.1 percent gain in 1976.

The improvement in the first half of 1977 following the slackening in economic activity during the second half of 1976 comes from five sources. First, retail sales in real terms, which have been flat since the spring, should rise in response to more rapid increases in household income. Wage increases in the nonunion sector will rise somewhat more rapidly than in the recent period, and the decline in farm income will end, producing improvements in disposable personal income. Second, net exports will improve in early 1977, also contributing to a better GNP performance. Third, the shortfall in Federal expenditures, from an already tight budget, caused a shift from substantial fiscal stimulus in 1975 to restraint in 1976. There will be a faster rate of increase in Federal expenditures in calendar 1977 than in 1976, which will be maintained by the current services budget in 1978. Fourth, state and local government expenditures will rise more rapidly than earlier this year in response to some easing in their budget positions and increased Federal grants. Finally, recent data for capital goods orders and housing starts suggest that fixed investment will contribute significantly to economic recovery at least through the first half of 1977. The recovery will decelerate again thereafter because the relatively small increase in the volume of consumer spending will not be sufficient to sustain a high rate of growth in business investment. The cause of the low growth in consumption is real disposable income which is increasing slowly because of small gains in real earnings.

[1] We received assistance in this process from Darwin Johnson of OMB, but take full responsibility for any errors.

Our forecast, under the current services budget assumptions, implies continued high unemployment during the 1977–78 period. The unemployment rate will average 7.6 percent next year and 6.9 percent in 1978. By the end of 1978 it will still be a relatively high 6.6 percent. The improvement in the labor market will be very modest as productivity gains and increases in the civilian labor force will keep the jobless rate high. The labor force will rise by 3.7 percent betwen the third quarter of 1976 and the end of 1978, while productivity growth is estimated at 4.5 percent. Productivity and labor force growth will total 8.2 percent during that period. That leaves only a small portion of the total increase of 9.2 percent in real output to be absorbed by reducing unemployment. With unemployment remaining high, and with enough idle plant capacity, inflation will remain in line with current rates during the forecast period. The CPI will rise by about 6 percent in both 1977 and 1978, about the same as the average rate of rise in unit labor costs during this period.

Our forecast, based on the current services budget assumptions, shows the level of nominal GNP for 1977 and 1978 a little lower than OMB's Path III, which is the lowest of their four alternatives. Our forecast for inflation, however, is higher than in OMB's Path III; therefore, our forecast for real GNP is lower. Our unemployment rate forecast is higher, 7.6 percent in 1977 and 6.9 percent in 1978, compared with OMB's 6.9 percent and 6.5 percent. In fact, our real GNP forecast is lower and the unemployment rate is higher than in any of the four OMB alternatives. Our forecast, based on the current services budget, is given below.

FORECAST SUMMARY

	1976	1977	1978
Nominal GNP (billions)	$1,691.7	$1,869.0	$2,053.7
GNP deflator [1]	4.7	5.7	6.0
Consumer Price Index [1]	5.3	6.1	6.3
Real GNP growth rate [2]	6.1	4.7	3.8
Unemployment rate	7.7	7.6	6.9

[1] 4th quarter over 4th quarter percent change.
[2] Year over year percent change.

To calculate the effects on the economy of various forms of fiscal stimulus, we generated three alternative runs which modify the current services budget base case as follows.

Alternative 1.—A $15 billion personal tax cut, retroactive to January 1, 1977, but taking effect on April 1; withholding rates are adjusted to provide a $20 billion rate of reduction for the last three-quarters of 1977, but the effective rates for calendar 1977 are spread over the four-quarters of 1978. As a result of the greater demands for funds and some Federal Reserve response to the tax cut, interest rates are slightly higher than in the base case.

Alternative 2.—A Federal spending increase package starting at a $7.0 billion annual rate in the second quarter of calendar 1977, phasing up to a $15.0 billion rate by the first quarter of calendar 1978 and remaining at that level through the end of the year. The interest rate impact is similar to that assumed in Alternative 1. The assumed $15 billion package includes the following elements: $5 billion in Federal nondefense purchases of goods and services (none of which is compensation); $3 billion in Federal transfer payments to persons; $3 billion in grants-in-aid to State and local governments for public service jobs—$2 billion for compensation at $8,000 per employee and $1 billion for administration and overhead; and $4 billion in other types of grants-in-aid. While there is some time lag before the grants are converted to State and local government purchases, it is assumed that the full rate of increase in grants is reflected in such spending by the first quarter of 1978.

Alternative 3.—The tax cut of Alternative 1 and the spending increase package of Alternative 2 are combined. The interest rate impact is somewhat greater than in either of these alternatives.

The quarterly pattern of assumed additions to the levels of national income account components follows.

QUARTERLY PATTERN OF GOVERNMENT SPENDING PROGRAM

[In billions of dollars seasonally adjusted at annual rates]

	1977:2	1977:3	1977:4	1978:1	1978:2	1978:3	1978:4
Total Federal expenditures	7.0	10.0	13.0	15.0	15.0	15.0	15.0
Nondefense purchases	1.0	2.5	4.0	5.0	5.0	5.0	5.0
Transfers to persons	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Grants-in-aid	3.0	4.5	6.0	7.0	7.0	7.0	7.0
Public jobs program	1.0	1.5	2.3	3.0	3.0	3.0	3.0
Other	2.0	3.0	3.7	4.0	4.0	4.0	4.0
State and local government purchases	2.3	4.0	5.7	7.0	7.0	7.0	7.0
Compensation—Public jobs	.6	.9	1.5	2.0	2.0	2.0	2.0
Other	1.7	3.1	4.2	5.0	5.0	5.0	5.0
Public jobs administration	.4	.6	.8	1.0	1.0	1.0	1.0
Other	1.3	2.5	3.4	4.0	4.0	4.0	4.0

The key features of these three alternative forecast scenarios as well as a comparison with the base case are summarized in the following table.

SIMULATION COMPARISONS

	GNP current	GNP deflator [1]	CPI [1]	Real GNP [2]	Unemployment rate	Federal S or D
1976						
Base	1,691.7	4.7	5.3	6.1	7.7	−59.8
1977						
Base	1,869.0	5.7	6.1	4.7	7.6	−64.0
Alt. 1	1,877.2	5.7	6.0	5.1	7.5	−76.4
Alt. 2	1,877.8	5.6	6.1	5.2	7.4	−68.6
Alt. 3	1,885.8	5.6	6.0	5.7	7.3	−81.2
1978						
Base	2,053.7	6.0	6.3	3.8	6.9	−63.0
Alt. 1	2,072.1	6.0	6.5	4.3	6.4	−75.8
Alt. 2	2,078.5	6.1	6.5	4.6	6.1	−70.7
Alt. 3	2,097.4	6.2	6.6	5.0	5.6	−83.5

[1] Percent change 4th quarter over 4th quarter.
[2] Percent change year over year.

Under the first two policy alternatives to the current services budget base case, the $15 billion tax cut and the $15 billion spending increase, the increase in the real GNP growth rate in 1977 is one-half of a percent in both cases. For 1978 the increase in the tax cut case is one-half of a percent and .8 of a percent in the expenditure increase case. As a result, there is very little improvement over the base case unemployment rate in 1977. The improvement in the fourth quarter of 1978 is .4 percent in the tax cut case and .9 percent in the expenditure increase case. The Federal deficit rises above the base case under both alternatives. The deficit, however, is somewhat higher under the tax cut case than under the Government spending case because of the gradual phasing in of the expenditure case over the course of 1977 and because the model has a higher multiplier for government purchases than for tax cuts. The latter point means that Government revenues will be higher. In 1978 in the $15 billion tax cut case the Federal deficit on a NIA basis will be $12.8 billion higher than the base case, and in the $15 billion expenditure increase case it will be $7.7 billion higher.

The minimal impact on economic growth and unemployment stems from the small size of the tax cut or expenditure increase. A $15 billion tax cut represents only about .8 percent of the Gross National Product. Copared with the 1964 tax cut it is quite small. In 1964 the tax cut represented approximately 2 percent of the GNP.

Since policy alternative 3 represents the combination of fiscal programs 1 and 2, the impacts on the economy are more sizeable. Compared with the base case, the growth in real GNP is 1 percentage point higher in 1977 and approximately one and one-quarter percentage points higher in 1978. In lagged response to the improvement in economic activity, the unemployment rate is down to 5.6 percent for 1978 as a whole, and about 5.2 percent by the end of that year.

The additional stimulus in all three alternatives produces very little additional inflation relative to the current services budget case, and then only in the later part of 1978. This occurs for three reasons. First, much of the current and expected inflation is not of the excess demand variety. It results from unusually high nominal wage increases caused by the high rates of increase we have had in the cost of living and the slow winding down of inflationary expectations. This type of inflation cannot be significantly reduced by slow growth, nor does it accelerate sharply with faster growth. Second, there is currently such a large amount of idle resources, both labor and plant capacity, that somewhat faster growth will cause little increase in demand pressure on prices. Third, some of the pressure from rising demand will be offset by larger gains in productivity induced by faster growth.

The current unemployment rate of 7.9 percent is higher than at any time since 1948 except during the 1974–75 recession and the early months of the recovery. The peak rate in the 1960–61 recession was only 6.0 percent. Even allowing for the change in the age and six mix of the labor force, which would raise the so-called 4 percent full employment rate to between 4.5 percent and 5.0 percent, the current rate is about 3 percentage points higher than full employment. Furthermore, much of the current unemployment is concentrated among breadwinners and skilled segments of the labor force. For example, the rates for married men, household heads, and white males 20 and over, are all at least twice as high currently as in October 1973, the peak month of economic activity prior to the 1974–75 recession. The overall unemployment rate, however, is only 1.7 times the rate at the peak after six quarters of recovery. Only 22 percent of the currently unemployed are teenagers, as compared with 30 percent in October 1973. Thus, unemployment is not only very high currently but it is relatively higher in those categories where people want to and have to work, and possess the skills to do so. By any measure, the supply of labor is currently ample to support a strong recovery. Even in the $30 billion stimulative policy alternative, the overall unemployment rate does not drop below 6 percent until the spring of 1978.

There also appears to be ample plant capacity to support the recovery without producing widespread inflationary shortages and bottlenecks. According to the latest Federal Reserve figures, the rate of capacity utilization was about 81 percent in the third quarter both in overall manufacturing and in the basic materials category, where shortages developed in 1973. Based on our calculations, it will require only about 2 percent a year growth in capacity in overall manufacturing and in basic materials to keep operating rates below 90 percent at the end of 1978, even in the $30 billion stimulative case. In the current services budget case, 2 percent per year growth in capacity would produce an 87 percent operating rate as of the end of 1978, both for overall manufacturing and for basic materials.

Historically, capacity growth in manufacturing and in materials industries has averaged about 4 percent per year. Our forecast for capital spending suggests increases in the 3 to 3½ percent range for the next two years, depending on the degree of stimulus. Thus, a 2 percent rate of increase appears quite conservative, yet it would be sufficient to keep operating rates below the 90 percent figure that could produce a significant escalation in inflation, even with $30 billion of stimulus over and above the current services budget.

In conclusion, our forecast, based on the assumptions of the current services budget, shows high unemployment continuing through the end of 1978. With very little increase in inflation, a $30 billion program of economic stimulus would reduce the unemployment rate significantly. The major negative impact of such a stimulative program would be an increase in the Federal deficit, $17.2 billion in 1977 and $20.5 billion in 1978, compared to the current services budget case.

Representative BOLLING. Thank you very much for a very useful and helpful piece of work.

Mr. Gramlich.

STATEMENT OF EDWARD M. GRAMLICH, PROFESSOR, DEPARTMENT OF ECONOMICS, UNIVERSITY OF MICHIGAN

Mr. GRAMLICH. I don't have any econometric models at hand, and I don't have a large budgetary forecasting apparatus either, so I am going to tread a little less heavily on the current situation and talk more about the long run budget outlook, which I have studied more carefully.

Before I do that, however, I would like to make the point that I am in substantial agreement with Mr. Karchere's current outlook. The central point, as I see it, is that the economic recovery is lagging somewhat, and that unemployment is still very high, and that there is both room and need for additional fiscal stimulus over and above what is nonimplicit in the current services budget.

Now, of the three plans that he proposed, I would find myself somewhere between plan two and plan three. That is, my goal for the additional stimulus would be somewhere between $15 and $30 billion, depending on the programs chosen. But I do think that some additional stimulus is needed.

However, what I would like to talk about more today is the long run outlook, and to make the very simple point that the short run budgetary needs are in some sense inconsistent with the needs in the long run.

I am using as my main text here the long run forecast of the CBO that just came out recently. And for most of this I will focus on the budget outlook in fiscal 1981, which is far enough away that it should be a reasonable planning horizon.

Page 7 of the CBO report gives the surplus, just extrapolating the current laws on the books, at $76 billion for fiscal 1981. And that seems like a very high number. It seems like there ought to be a lot of budgetary resources to be used over this time period for a combination of expenditure increases, tax increases and so forth.

But one thing that I think ought to be focused on right now is that that number may evaporate pretty quickly. The first thing—and the CBO actually does this right in the same table—is that if you vary the assumptions somewhat and say that some of the grant programs are adjusted for inflation, then immediately the surplus falls to $46 billion. In other words, you don't quite have as much as you thought you had.

And the second thing which the CBO did not do is to focus on personal income taxes. The reason these surpluses get so large in the long run is because when you have relatively rapid rates of real income growth and rapid rates, at least by historical standards of inflation, you find that because people get pushed into higher tax brackets. Because the rate structure is progressive, real tax revenues rise more than expenditures and the surpluses increase.

Historically, what has been a more accurate description is that as soon as that has begun to happen, the Congress has come along and cut personal income taxes. And if you look at numbers over a long historical span, you find that personal income taxes as a percent of GNP really do not change much. They go up a little and then down a little, and then up a little and down a little, but they don't rise consistently as implied in this forecast. I have just made a very crude adjustment to account for this phenomenon. Let us say, for example, that Congress were to keep personal income taxes at 9 percent of GNP in 1981, what would that surplus look like then? Then you find that the surplus disappears altogether.

People talk a lot about why these surpluses that we forecast never seem to be realized. The usual villain in the case is expenditures. Expenditures are alleged to get out of control, and that is why it happens. But in fact a better villain is the personal income tax cuts. That is why we never get these surpluses.

My central point is that any stimulus measures proposed for this year ought not make the longrun budgetary picture any bleaker. If a permanent cut in income taxes were made, you will find that the longrun budgetary resources, which I have tried to argue are meager enough already for any kind of new agenda of programs, become all that more meager. And so in my statement here I propose three or four types of stimulus measures that I think could be appropriate both for the shortrun and in the longrun. They all have the property that they go into effect now and for various reasons they will automatically phase out as the economy recovers to full employment.

Let me just review briefly what they are.

The first one is a one-shot tax reduction. This is something that has already been talked about a lot. There is an economic problem if you advertise strongly that the tax reduction is one shot, the risk is that consumers may find they may spend in response to that tax change less in proportion than they would respond in response to a permanent tax change. But it seems to me that there is a way to get around that problem and also the budgetary problem that the longrun cupboard is bare. If the tax reduction is made temporarily, and if there is some sort of implicit understanding that there is going to be a revenue raising reform soon, then the reduction can be made—the extension of the reduction can be made as a sweetner for the revenue-raising reform when that comes about, which I presume won't be for at least a year or so.

So the idea would be the fact that the apparent reduction may lapse, since they pledged to have some revenue-raising reform.

A second possibility which I would also think would be worthy of serious consideration is to beef up the countercyclical revenue sharing program. I personally have much more regard for countercyclical revenue sharing than I do for plain old revenue sharing. I think that the swings in economic activity in this country can cause large changes in the budget situation of local governments. Right now we are reading a lot about an urban fiscal crisis. A lot of that is brought on by poor budgetary planning, and a lot of that is brought on by underlying social problems. But some of that is brought on by the simple fact that we have had a recession, and that State and local budgets are shifted in an unfavorable direction. A more emphatic program along these lines would, I think, solve some of those fiscal difficulties in a way that I think most people could stand behind. And that program would also have the virtue of turning off as the economy recovers to full employment, or fuller employment.

A final type of program that I think should be under serious consideration now is the general area of stimulating employment. There are essesntially two ways to do that, one of which I am in favor of and one of which I would have some problems with.

The one that I personally would have some problems with is public service employment, on the grounds that I think that if those jobs are good enough to provide a decent alternative for the people who are now chronically unemployed, the program can easily get fairly costly. There are a lot of difficulties about having to pay a lot of money out of the Federal budget to stimulate the very modest levels of employment. I think that the experience with public employment programs would turn out that it is just not very cost effective in reducing employment.

What I think is likely to be more cost effective in reducing employment is some sort of a wage subsidy to the private sector. The weight of the empirical evidence, as I see it, is that private employers are sensitive to wage differentials, and that a wage subsidy could be designed to stimulate private employment and to reduce chronic unemployment in a way that should be very cost effective as compared with public employment. And that program could also be designed to turn off as the unemployment rate lowers.

Whatever is done in the way of specific programs, however, I think the important point to make is that the budgetary needs now and in the more remote future are somewhat at variance, and it is well to keep that in mind in making policy decisions. Right now I think what most people would say is needed is somewhat more stimulus. In the longrun coupling the CBO projections would some historical assumptions about what is likely to happen in fact, most people would agree that there aren't many budgetary dollars around to undertake the kind of new programs that some of us might favor. And so the need for the day is really to take the stimulus measures without worsening the longrun picture at all.

Thank you.

[The prepared statement of Mr. Gramlich follows:]

PREPARED STATEMENT OF EDWARD M. GRAMLICH

Mr. Chairman and Committee Members: I would like to thank you for the opportunity to present my views on the recently released Current Services Budget. What with both a change in political leadership and maybe in economic conditions in the offing, it makes sense for Congress to begin thinking about budget policy now, and I welcome the chance to participate.

While there is much to be discussed in this budget, there is in my opinion one overriding issue, and I plan to focus all my remarks on it. The $64,000 question is how to use fiscal policy to stimulate the economy in the short run, without aggravating what could potentially be a long run shortage of budgetary dollars to carry out new programs such as health insurance and welfare reform.

The short run budgetary outlook

Both the documents prepared by the Committee staff and the CBO cover one point very well, but it bears repeating because it is so important. To give an accurate picture of how the budget is affecting the economy, one should not look at the actual surpluses and deficits. These are so strongly influenced by movements in the economy it becomes impossible to tell what the budget is doing to the economy. The cause cannot be distinguished from the effect. To make such a distinction, one must standardize unemployment rates, and thus put budgets in terms of a common denominator.

The standardized, or full employment, budget totals implied by the Current Services Budget for 1974–79 are given in table 1.

TABLE 1.—CURRENT SERVICES BUDGET ON A FULL-EMPLOYMENT BASIS (NATIONAL INCOME ACCOUNTS, FISCAL YEARS)

[In billions of current dollars]

	1974	1975	1976	1977	1978	1979
Receipts	300	331	374	419	468	520
Outlays	287	336	386	419	457	492
Surplus	13	−5	−12	0	11	28

Source: JEC staff report, p. 29; and DRI for past data.

Over long periods of time the full employment surplus, in the third row of the Table, would normally average about zero—higher than that when the budget is in a restrictive phase, lower when the budget is expansionary. Remembering recent economic history, therefore, it is not surprising that the full employment surplus was positive in 1974. At that time the sharp rise in prices pushed people into higher tax brackets and the progressive personal income tax brought in more real tax payments. This restrictive shift in fiscal policy was one of the prime causes of the 1975 recession. But the recession was arrested largely by another shift in fiscal policy, the 1975 tax cut, which brought about a full employment deficit in both 1975 and 1976.

The Table indicates, however, that yet another shift in fiscal policy may be in the winds. According to the Current Services Budget Forecast, fiscal policy is slated to move back into neutral in fiscal 1974 and then into reverse gear in 1978 and 1979. We all know that the Current Services Budget is neither a forecast nor a proposal, and hence that nobody necessarily intends that the numbers of Table I will be realized. But the Current Services number is important information, in that it says that unless other changes are made, budget policy will again gradually become restrictive, beginning right now. Were the private economy moving forcefuly ahead, this would be appropriate; since the private economy appears to be recovering rather shakily from the 1975 recession, it does not seem appropriate. When combined with the lagging pace of economic activity, these budgetary numbers give a second argument for a combination of tax cut and expenditure increases (over and above those implicit in the Current Services Budget) of approximately $15 billion to sustain the recovery.

The long run outlook

If this were the only budgetary problem, there would be relatively straightforward remedies. Simply cut taxes or raise expenditures to add the requisite spending power, and be done with it. But unfortunately the long run budgetary needs conflict with the short run needs. The long run Current Services Budget projection of the CBO is for a surplus of from $47 to $77 billion in fiscal 1981, depending on the assumptions used, and the projection of the Committee staff implies barely any surplus at all. Moreover, should Congress follow its historical propensity to cut income tax rates even a few years to prevent price and income increases from raising real tax rates for very long periods, the surplus could be reduced (or the deficit increased) by an amount that could be as high as $60 billion. Even if these tax rate cuts are not made, there are now several potential claimants on scarce budgetary resources—welfare reform, health insurance, aid to cities, etc. The upshot is that while it is still possible to have a balanced budget by 1980, as the President-elect has promised, it will certainly require very strict long run budgetary planning and may require some new programs to be phased in very slowly.

However these problems are dealt with, the relevant point right now is that Congress try to take stimulative fiscal actions that do not use up relatively meager long run budgetary dollars. One can imagine several ways of doing this, but below I list four of the obvious ones, along with a brief list of their pros and cons:

(*a*) A one shot tax reduction. The advantage is that such a measure can be passed quickly and easily be made large enough to have a substantial impact.

The disadvantage is that there is now a political opportunity to make a set of revenue raising reforms in the tax structure, which reforms might more easily pass if coupled with a tax reduction. In other words, one might want to save the sweet tax reductions till later to make the bitter tax reforms more palatable. This situation suggests two strategies: (i) Make any tax reduction temporary, so there will at least be the sweetness of an extension to combine with tax reform; (ii) Make some revenue *reducing* reforms right now—continued tax credits for low income people; a partial rebate of regressive payroll taxes, etc.

(*b*) Countercyclical revenue sharing, a program already enacted by Congress in a small way last year. There is no need to document the fiscal difficulties now faced by many of our cities. What is sometimes not brought out in public debate is that it is not all their fault. I did a paper on New York City last year that suggested that the 1975 recession cost the city about $500 million, nearly all of the present deficit. The recession also cost other cities such as Detroit, Philadelphia, and indeed all state and local governments that rely heavily on income based taxes. Doesn't it make sense to centralize all economic stabilization programs at the federal level, and have countercyclical grants to local governments that would enable them to maintain service levels even if overall unemployment rises? These grants also have the nice property that they automatically decline when and if the economy recovers. An expanded program in this area would make a lot of sense, and would go at least partway to solve the vexing fiscal problems of many local governments.

(*c*) Public Service Employment. This I list only for completeness—I personally am not terribly enamored of the program. The potential advantage is to create jobs for people who may have little chance of getting a good job under present unemployment conditions. Like countercyclical grants, this program could also be designed to turn itself off once the economy recovers. The problem, it seems to me, is that in order to make the jobs very good, wages will have to be fairly high, many workers will be induced to leave private jobs, and any program with very ambitious employment goals can become quite costly. Another criticism of public service employment that is somewhat phony, I think, is the displacement issue. Sure there may be displacement, by which is meant that the public employment hirees simply displace (or are the same as) other workers that would normally be hired, with the grant having very little impact on total employment. But even if that is so, the local government still has more revenue and the program is at least as good as revenue sharing, as long as the money is given to governments in need of fiscal support.

(*d*) Employment Tax Credits. Often in the past we have (correctly in my opinion) made use of investment tax credits to stimulate the economy. There are grounds for doing so again. But there are also grounds for trying to stimulate private employment more directly, by subsidizing the wages that employers pay low wage employees, and thus raising low wage employment. If employers are at all sensitive to net wage differentials, and most empirical work indicates they are, this type of program should be much more cost effective than public employment. It could also be designed to turn off once the employment situation improves.

Summary

These are a few possibilities. There are, of course, more. While the specific action is obviously important, what may be even more important is for Congress to be alert to impending budgetary difficulties. In the short run, the big difficulty is that fiscal policy may be slowly creeping in a restrictive direction just when we don't want it to. In the long run, the difficulty is that there may not be sufficient budgetary resources to accomplish all of the programs that would be given a fairly high priority by many people. While it is not easy for Congress to solve the first problem without aggravating the second, it is both possible and desirable, and now is the time to begin.

Representative BOLLING. Thank you very much for a very helpful statement.

Next, Mr. Levy.

STATEMENT OF MICHAEL E. LEVY, DIRECTOR, ECONOMIC POLICY RESEARCH, THE CONFERENCE BOARD

Mr. LEVY. I have a prepared statement and also some supplementary material. If it is agreeable to the chairman, I would like to insert this into the record and summarize my remarks briefly.

Representative BOLLING. All statements will be included in the record.

Mr. LEVY. I would like to summarize my remarks and slightly enlarge on a few relevant points.

I have focused largely on the fiscal impact of the budget. Over the last few years, we have developed some measures of fiscal impact which are in my opinion better than full employment surplus or other measures. I don't want to go into detail, but want to briefly summarize what these measures show. This year, we have developed these measures for the first time on a quarterly basis, with the cooperation of the Bureau of Economic Analysis of the Department of Commerce. For these hearings, I have tried to provide not only quarterly measures for the fiscal 1977 budget according to the second congressional budget resolution, but I have also tried to extend the data to cover the current service budget for fiscal 1978.

Basically, we find that in recent times there seems to have been a reasonable synchronization or coordination between the pattern of economic performance and the fiscal stimulus provided by the budget. We had a very high level of stimulation during the early part of 1975 and extending through about the third quarter, which more or less coincided with the recovery of the economy from the most severe postwar recession—a relatively brisk initial recovery. Since the third quarter of 1975, the fiscal stimulation—the autonomous stimulation of the budget to which some kind of multiplier has to be applied—has gradually tapered down from the equivalent of about 1¼ percent of GNP in the earlier period, to a little less than three-quarters of a percent in late 1975, to about half a percent in early 1976, and to zero—or to a slight drag—which means severe fiscal restraint, during the second quarter of 1976.

This tapering down coincides with the so-called pause in the economic growth which basically refers to the fact that over the last three quarters, including apparently the last quarter of this year, the economy seems to have been growing at a rate that will average for the entire period probably somewhat below 4 percent. Historically, this is not exactly a disastrous growth rate. It is about in line with the long-term historical growth of U.S. economy, or slightly better. But in light of the large amount of underutilized capacity, in the light of the extremely high unemployment rates, this is certainly not a growth rate that is adequate in terms of our current economic needs.

By the way, let me say that a considerable part of the sharp fiscal restraint which we experienced in the second quarter of this year appear to have been unintentional and was related to the issue of so-called lost outlays. Actual spending was well below levels authorized, funds appropriated, and the expenditure targets indicated by the 1976 budget. In my prepared statement, I analyze these lost outlays and try to determine the causes and origins of these lost outlays. I raise the issue as to whether this kind of pattern, this tracking below budget levels, is likely to continue into the future.

Basically, I reach the conclusion that in the third quarter we still had some lost outlays, we are still tracking probably about $3 billion below what I consider the budget targets. While outlays are gradually returning to the budget targets, they are likely to track somewhat below the targets of the second budget resolution.

By the way, I measure all budget expenditures in terms of the national income accounts budget, which is more relevant to fiscal impact analysts. I think we are still tracking somewhat below the figures implied by the budget targets of the second budget resolution, but I do not see any indication of a sudden burst of spending, any recapturing of these past lost outlays; therefore, I expect no outburst of fiscal stimulation.

As I look into the future, in line with this kind of analysis, I find that the fiscal 1977 budget will retain a level of fiscal stimulation that is apparently being established in the third quarter—fiscal stimulation that is equivalent to about half a percent of GNP per quarter—at an annual rate. If I extrapolate the current services budget for fiscal 1978 on a quarterly basis—this is clearly a rather tricky exercise, looking that far ahead into the future, and the figures are not very reliable—I find that basically for the next nine quarters, starting with the third quarter of this year, we could expect a fairly steady degree of fiscal stimulation equivalent to about half a percent of GNP per quarter, give or take a bit.

Now, this is considerably less stimulation than what we had for a period from about mid-1974 through mid-1975. However, this degree of stimulation, in terms of magnitude and in terms of the length of the period for which we would provide it, compares relatively favorably with earlier periods when we had relatively good economic performance in the 1960's. I make this comparison on the basis of very preliminary quarterly estimates of fiscal thrust that we have developed going back to 1960. This comparison suggests that the pattern of the second budget resolution for fiscal 1977 and the current service budget for fiscal 1978 would provide a moderate but a significant amount of stimulation at a fairly steady pace—stimulation that under normal circumstances could support a good economic performance.

But in the concluding remarks of my prepared statement I stress the fact that these are not exactly normal circumstances. In particular, the problems that confront us at the present time are substantially more difficult than those which confronted us throughout the major part of the 1960's.

In particular I point out that the inflation rate, while sharply reduced from the double digit level of 1974 and early 1975, is still above the rates that prevailed in the 1960's, except for 1969. Moreover, the unemployment rate remains substantially above the levels of previous postwar recoveries, even when the figures are adjusted for recent changes in labor force mix which yield higher unemployment statistics, because now there are more teenagers and more women in the labor force.

Fear of accelerating inflation remains widespread and continuous to act as a depressant on consumer spending and business investment. Yet real economic growth since the second quarter of 1976, while approximately in line with the long term historical growth rate of the U.S. economy, is entirely inadequate if unemployment is to be reduced.

[This is also indicated by the extrapolations and stimulations which Al Karchere has presented here.]

This difficult setting presents serious policy dilemmas. Accurate "tuning," be it fine or crude, is likely to be insufficient to cope with the task at hand. Specific policy objectives and policy tools are likely to be at least as important for the performance of the U.S. economy over the next several years as the degree of aggregate fiscal or monetary stimulation. Moreover, the task of policymakers is made more difficult because there is little headroom for maneuvering. Five-year projections by the staff of the House Budget Committee and by the Congressional Budget Office indicate that sizable budget deficits can be expected for several more years, even in the absence of any new initiatives. (This, is of course, exactly the conflict between short-term and long-term policy considerations which Ned Gramlich pointed out.) As I see it, if we want to bring the unemployment rate down, which I assume we all want, we probably need more stimulation. But aggregate stimulation is likely to give us only moderate mileage. Al Karchere indicated in his statement that even $15 billion of stimulation will not do much for us in terms of reducing the unemployment rate. I think it will not do much if we rely solely on traditional aggregate measures of economic stimulation. Even if $30 billion of extra stimulation may do a great deal, it will probably accomplish less than many people would like to see in terms of reducing the unemployment rate.

This suggests to me that if you just use aggregate measures of economic stimulation, without addressing any programs more specifically to the kind of unemployment problems we have—in terms of the types of people unemployed and the particular bottlenecks and obstacles within the economy—we can provide a lot of stimulation to the economy and raise the danger of inflationary outbursts without getting a lot of mileage on the unemployment side.

On the other hand, if we put a lot of stimulation into the system, we are confronted by the fact that even without this stimulation the margin for new programs and new initiatives for 1980 and 1981 are very slim (as Ned Gramlich has pointed out, and as the Budget Committee and CBO studies show) the extra stimulation cuts deeply into these margins by increasing outlays or by giving away some of the future revenue. In view of this policy dilemma, I am in sympathy with the kind of stimulation that tries to combine the longer term considerations with the shorter term needs. This means, for example, combining additional tax cuts that may be provided with additional tax reform, as Ned Gramlich suggested. He also suggested some form of wage subsidies to create meaningful additional jobs in the private sector. This is worth looking into.

I have noted that this years major tax bill contains a great deal more tax reform, from a long term point of view than the public has given it credit for. [This is discussed in a supplementary analysis which I am substituting for the record.] Nevertheless, one shortcoming of this bill is, I think, that it provided little extra stimulation for business investment for the longer term. Yet quite a few studies suggest that from a longer term point of view of adequate growth and job creation, the percentage of savings and investment in our economy probably has to be stepped up somewhat—maybe by the equivalent of one percentage point of GNP.

In view of the longer term economic needs, therefore, I think a wage subsidy program to create more private jobs, and other forms of tax cuts or expenditure programs that are specifically related to meaningful job creation—particularly for the young, the disadvantaged, and for women, whose unemployment is very high—is promising. But some measures to stimulate future investment also deserve serious consideration, in my views. If we stimulate in this way, we don't necessarily "give away" all of this extra margin—this very small margin that we have in terms of new initiative for the next several years, instead we phase it in, we utilize it more effectually by stimulating the economy selectively—rather than using the fairly blunt aggregate measures that were commonly used in the past. I think this is a way for resolving the conflict between short term and long-run economic policy target. The fact, that even sizable aggregate demand stimulation yields only slow and limited reductions of our severe unemployment, suggests that the general approach which I have outlined here might be fruitful in the pursuit of future economic policies.

Thank you.

[The prepared statement of Mr. Levy, together with the supplemental material referred to follow:]

PREPARED STATEMENT OF MICHAEL E. LEVY

When I was invited to testify before this Committee on the Current Services Budget for fiscal 1978, I suggested that my statement focus mainly on the impact of the budget on the U.S. economy. This is an area in which we have done some original research. In particular, in recent years we have developed an improved measure of the direct autonomous stimulation of the budget on the economy—I have called it "fiscal thrust"—which may be of interest to this Committee.

This year, for the first time, with the cooperation of the Bureau of Economic Analysis of the Department of Commerce, we have been able to develop quarterly data for this measure of "fiscal thrust" which proved to be very valuable in understanding the behavior of the U.S. economy during the last two years.

I would like to review this record briefly, because I believe that future fiscal policy decisions are likely to benefit from a closer understanding of the recent past. The record is consistent with the view that fiscal policy has exerted a potent influence on the economy over the last two years and that much of this influence was felt relatively quickly, within the first two or three quarters of the budgetary action taken.

The turn-around of the economy from its worst postwar recession and the fairly vigorous initial phase of the current recovery coincide with, or was preceded by a few quarters, by an exceedingly strong fiscal stimulation during the major part of 1975. One measure of fiscal thrust indicates that the autonomous economic stimulation initiated by the budget averaged roughly the equivalent of 1¼ percent of GNP or better during the first three quarters of 1975, compared with about ¾ percent during the final quarter. All these figures represent annual rates of direct stimulation which give rise in turn, to the traditional Keynesian "multiplier," as consumers and businesses spend and respend most of their additional income. (For details on quarterly data of fiscal thrust, see Table 1.)

During the first quarter of 1976 the fiscal thrust of the budget declined slightly below ½ percent of GNP, and by the second quarter all autonomous fiscal stimulation had ceased (fiscal thrust became slightly *negative*). This sharp curtailment of fiscal stimulation preceded by a mere quarter or two the present economic "pause"—i.e., the decline in the real growth rate of the economy to 4 percent or less—that appears to have persisted from the second quarter of the current year into the fourth quarter.

Not all of this sharp reversal from strong fiscal stimulation in 1975 to fiscal restraint by mid-1976 was planned and intended. In fact, my estimates of last May, based on the fiscal 1976 budget as generally perceived at that time by the Administration and the Congress, indicated a far more limited reduction in fiscal stimulation—a fiscal thrust equivalent to about ¾ percent of GNP in the first quarter and about ¼ percent in the second. The discrepancy between this earlier estimate and my latest revised figures is due largely to "lost outlays." Hence, the patterns of past and future "lost outlays" ought to become an essential component in one's assessment of the U.S. economy. "Lost outlays," in this context, are outlays that had been authorized and anticipated, and for which funds had been appropriated, but that—to the surprise of everybody, including the Office of Management and Budget—failed to materialize by the end of fiscal 1976 (or during the recently completed transitional quarter).

TABLE 1.—MEASURING THE FISCAL IMPACT OF THE FEDERAL BUDGET [1]

[NIA accounts data; billions of dollars at seasonally adjusted annual rates]

	NIA budget expenditures	Adjustments: Add: Offsetting receipts and defense progress payments	Adjustments: Deduct: Increases in regular unemployment benefits [2]	Adjusted NIA budget expenditures (4)=(1)+(2)−(3)	Expenditure contribution to fiscal thrust (quarterly changes in (4))	Structural tax increases (+) or reduction (−): Personal income tax	Structural tax increases (+) or reduction (−): Corporation income tax	Structural tax increases (+) or reduction (−): Contribution for social insurance [3]	Structural tax increases (+) or reduction (−): Indirect business taxes	Tax-change contribution to fiscal thrust (10)= −(6)−(7) −(8)−(9)	Fiscal thrust: Billions of dollars (11)= (5)+(10)	Fiscal thrust: As percent of GNP
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
1975 I	337.0	−0.1	5.4	331.5	11.7	0	−1.8	−1.9	0.3	3.4	15.1	1.04
II	354.3	3.6	1.9	356.0	24.5	−39.7	−.8	.1	1.2	39.2	63.7	[4] 1.51
III	363.7	2.4	−1.1	367.2	11.2	27.5	−0.3	.5	1.6	−29.3	−18.1	
IV	376.0	2.3	−.9	379.2	12.0	.6	−.2	1.9	0	−2.3	.7	.61
1976 I	380.3	.8	−.8	381.9	2.9	−2.8	.8	−0.5	−3.0	5.5	8.4	.51
II	378.7	1.0	−1.3	381.0	−.9	.6	−.2	.1	0	−.5	−1.4	−.08
III	391.1	1.5	−.2	392.8	11.8	1.3	−.2	1.3	0	−2.4	9.4	[5] .55
IV	402.6	1.5	0	404.1	11.3	−.1	−.1	1.1	0.1	−1.0	10.3	[5] .59
1977 I	414.5	1.7	−.2	416.4	12.3	.8	1.3	−.4	0	−1.7	10.6	[5] .59
II	422.3	1.9	−.3	424.5	8.1	0	0	.1	0	−.1	8.0	[5] .43
III	432.7	2.1	−.6	435.4	10.9	−.1	−.1	1.2	0	−1.0	9.9	[5] .53
IV	443.9	2.1	−.7	446.7	11.3	0	0	.9	0	−.9	10.4	[5] .53
1978 I	457.3	2.1	−.8	460.2	13.5	.1	0	4.9	−.1	−4.9	8.6	[5] .43
II	465.6	2.1	−.9	468.6	8.4	0	0	.2	−1.5	1.3	9.7	[5] .47
III	477.1	2.1	−1.0	480.2	11.6	0	0	1.5	−1.5	0	11.6	[5] .55

[1] Author's estimates derived from the best available published and unpublished sources.

[2] Includes regular benefits and extensions, but excludes Federal Supplemental Benefits and Supplemental Unemployment Assistance. Author's estimates based on various published and unpublished sources.

[3] Timing of the effect of increase in tax base on employees' part of contribution changed by author to concentrate increase mainly in last 2 calendar quarters.

[4] 1975 II and 1975 III are averaged to smooth the effects of the 1974 tax rebates and the 1975 tax reductions.

[5] Author's projections.

Source: Office of Management and Budget; Bureau of Economic Analysis; Council of Economic Advisers; U.S. Congress; The Conference Board.

Under more normal circumstances, these lost outlays might be a source of joy, because they result in a lower budget deficit than had been projected only a few weeks before the final figures became available. For example, last July 16, the Administration's latest estimate for the fiscal year ending June 30 showed receipts at $299.4 billion, expenditures at $369.1 billion, and the budget deficit at $69.6 billion. On July 26, the final fiscal 1976 figures were released: receipts were $300.0 billion; outlays, $365.6 billion; and the deficit, $65.6 billion. Thus, within 10 days in July, $3.5 billion in outlays and $4.0 billion of the budget deficit were "lost." Moreover, when the final budget figures are compared with last January's estimate by the Office of Management and Budget, the corresponding "losses" are $7.9 billion and $10.4 billion, respectively. (A variety of other estimates for "lost outlays" have figured in recent public discussions; such estimates vary with the particular budget concepts and benchmarks used.)

Unfortunately, the shrinkage in the budget deficit was not the only perceived consequence of lost outlays; the timing of the lost outlays has coincided with the troublesome "pause" in the growth of economic activity and with the elimination of all "fiscal thrust" from the budget. In this setting, it is important to know whether the growth in federal expenditures is likely to continue below projected budget levels, or whether a recouping of "lost outlays" through a spurt in federal spending is in the making.

In order to answer this question, we tried to establish the origin, size and composition of outlays "lost" during the second and third quarters of 1976. My own analysis of lost outlays draws mainly on data from the national income accounts (NIA) budget (rather than the unibudget), because those data are better suited for fiscal-impact analysis and serve as the basis for estimating "fiscal thrust." Last May, we estimated NIA budget expenditures for the second and third quarters of calendar 1976 at $387.6 billion and $394.2 billion, respectively. These estimates serve as the basis for assessing subsequent downward revisions in NIA budget expenditures.

In the July Survey of Current Buiness, the Bureau of Economic Analysis of the Department of Commerce estimated second quarter NIA budget expenditures at $383.1 billion—a reduction of $4.5 billion from our May figures. (Third quarter outlays were estimated at $391.8 billion—down $2.4 billion from May.) The July estimate was based on actual data for only two months: April and May. In August when actual data for the entire second quarter became available, NIA budget expenditures were revised to $378.7 billion—down $4.4 billion from the preliminary July figures. Thus, by our count, NIA budget spending for the second quarter of 1976 turned out to be approximately $9 billion below the best estimate available last May.

One half of this $9 billion reduction cannot be broken down by origin or components because detailed information is lacking. However, limited sources of information indicate that this initial shortfall of $4.5 billion appears to have been spread more or less across the board—apart from substantial underspending for national defense. There is merit to the speculation of specialists and the press that lower-than-expected inflation rates—which tend to reduce the costs of various programs below original estimates—were partly responsible. But it is worth keeping in mind that "inflation adjustments" in the original budget requests often serve to inflate budget requests and build in safety margins. Separate information on National Defense (a function that has benefited recently from rapid increases in both authorizations and appropriations) indicates a continuing lag. The entire defense spending process—from obligating the funds and making progress payments, to the final delivery of defense purchases—appears to have advanced more slowly than had been expected and would have been permissible under existing legislation. This lag appears to have continued into the third quarter but is rapidly being eliminated.

The other half of the second-quarter expenditure shortfall—$4.4 billion on an NIA basis between the July estimates and the final tabulations in August—can be traced more clearly with the help of figures from the Bureau of Economic Analysis (see Table 2). Almost all of this downward revision was concentrated in two major categories: outside purchases (i.e., nonpayroll expenditures) for the Defense Department; and grants-in-aid to state and local governments. Defense purchases from the private sector were revised down by $1.5 billion; grants to state and local governments, by $2.7 billion. Revenue sharing was on target and the revisions were small for highway grants (slightly up) and for public assistance and urban renewal (slightly down); among the major categories of grants, only education grants were revised downward substantially (by roughly $0.5 billion). Therefore, almost all of the numerous scattered smaller grant programs must have tracked well below projected levels, resulting in a cumulative shortfall of nearly $2 billion. Such widespread and systematic shortfalls depart from past experience and, jointly with the wide distribution of the earlier shortfalls, suggest a definite pattern. Perhaps the general attitude within the Ford Administration that government frugality would be timely and desirable conveyed a notion that "holding back" below authorized spending targets would be appreciated.

Are the past shortfalls likely to persist? Will they be wiped out, or will they even be made up through a spurt that pushes spending temporarily above the projected trend? The latest estimate by the Bureau of Economic Analysis for third quarter budget expenditures provides important clues (see Table 2). At $391.1 billion it falls $3.1 billion below our best estimates of last May and is $0.7 billion below the BEA's July estimate. Thus, the latest Commerce Department figures clearly indicate that the recent shortfalls in outlays is not being made up. At present there is no discernible "spurt" in government spending. Instead, the latest figures for the third quarter suggest a gradual return of federal spending to a trend that continues to track about $3 billion below the projections of last May.

TABLE 2.—FEDERAL EXPENDITURES, NATIONAL-INCOME-ACCOUNTS BASIS

[Dollar amounts in billions; fiscal years]

	1976 2d quarter		1976 3d quarter (November 1976)
	Preliminary (July 1976)[1]	Actual (August 1976)	
Expenditures	$383.1	$378.7	$391.1
Purchases of goods and services	132.3	131.2	134.5
National defense	88.4	86.9	88.5
Compensation of employees	41.7	41.7	42.0
Military	24.3	24.3	24.3
Civilian	17.5	17.5	17.7
Outside purchases	46.7	45.2	46.5
Nondefense	43.9	44.2	46.0
Compensation of employees	20.8	20.8	21.1
Outside purchases	23.1	23.4	24.8
Transfer payments	158.8	158.7	163.1
Grants-in-aid	59.0	56.3	60.1
Net interest paid	27.5	27.4	27.7
Subsidies	5.5	5.2	5.6

[1] Based on data of 1st 2 mo of the quarter.
Source: Department of Commerce.

What are the reasons for this lower spending trend? For National Defense, unibudget outlays (which include payments on work in progress) as well as NIA expenditures (which are measured on a "goods delivered" basis) continue below earlier estimates even though this "shortfall" is shrinking. One important consequence is that lower-than-projected defense inventories in the private sector have curtailed real economic growth during the second and third quarters, thus contributing to the recent economic "pause." Grants-in-aid appear to be rebounding toward the third-quarter target levels of earlier projections; but there is no evidence of any additional "spurt" that would make up for the shortfall in grants that occurred in the second quarter.

Moreover, the $413.1 billion outlay target of the Second Budget Resolution presumes passage of additional supplemental appropriations that translate into approximately $11 billion of unibudget outlays. Of this amount, $2–$3 billion are in spending programs that have been evolved and supported less firmly than the rest (especially $2.6 billion in Public Employment Assistance). The target of $413.1 billion in unibudget outlays for fiscal 1977, set by the Second Budget Resolution, may not be fully attained. This target would translate into about $421 billion NIA budget outlays; our own current estimate for fiscal 1977 NIA expenditures is $418 billion. This "adjusted" figure (rather than $421 billion NIA budget outlays) is used in developing our quarterly estimates of "fiscal thrust" for fiscal 1977. (This figure does not, of course, include an allowance for any additional tax cuts which Congress may pass next year, but which are not covered by the Second Budget Resolution.)

Our latest revised estimates of fiscal thrust indicate a return to a moderate level of fiscal stimulation—equivalent to about ½ percent of GNP—during the third quarter of 1976, a stance that should prevail throughout fiscal 1977 under the Second Budget Resolution. This restoration of a moderate degree of fiscal stimulation should make it easier for the economy to regain momentum—but it does not provide a real "head of steam."

For the Hearings of this Committee, we have attempted to extrapolate our quarterly estimates of fiscal thrust through the end of fiscal 1978, using the Current Sevices Budget of the Office of Management and Budget as the basis for these projections. Needless to say, any exercise of this kind (which extends two years into the future) is highly conjectural and lacks in precision; nonetheless, it generates information that is likely to be useful for policy planning purposes.

According to our quarterly estimates, the Current Services Budget for fiscal 1978 would continue to provide a steady fiscal thrust equivalent to about ½ percent of GNP (see Table 1). In essence, then, the transition quarter, the Second Budget Resolution for fiscal 1977, and the Current Services Budget for fiscal 1978 would provide nine consecutive quarters of fairly stable fiscal stimulation. This fiscal thrust would be somewhat below the average for the period from the second quarter of 1974 through the third quarter of 1975 but, in magnitude and duration, it appears to compare favorably with most of the 1960's. (This comparison is based on preliminary, and relatively "fragile," quarterly data on "fiscal thrust" which we have developed recently back to 1960.)

But the economic problems that confront us at present are, in some ways, more difficult than those of the 1960's. The inflation rate, while sharply reduced from the double-digit levels of 1974 and early 1975, is still well above the rates that prevailed in the 1960's (except for 1969), and the unemployment rate remains substantially above the levels of previous postwar recoveries—even when the figures are adjusted for the recent labor-force-mix which yields higher unemployment statistics because of more teenagers and women in the labor force. Fear of accelerating inflation remains widespread and continues to act as a depressant on consumer spending and business investment; yet, real economic growth since the second quarter of 1976—while approximately in line with the long-term historical growth rate of the U.S. economy—is entirely inadequate if unemployment is to be reduced. This difficult setting presents serious policy dilemmas; aggregate "tuning"—be it fine or crude—is likely to be insufficient to cope with the task at hand. Specific policy objectives and policy tools are likely to be at least as important for the performance of the U.S. economy over the next several years as the degree of aggregate fiscal or monetary stimulation.

Moreover, the task of policy maker is made even more difficult because there is little headroom for maneuvering. Recent five-year projections by the staff of the House Budget Committee and by the Congressional Budget Office indicate that sizable budget deficits can be expected for several more years—even in the absence of any new program initiatives.

The Federal Budget: Its Impact on the Economy

No. 1 Fiscal 1977
The President's Budget Proposal

No. 2 Fiscal 1977
First Congressional Budget Resolution

No. 3 Fiscal 1977
Second Congressional Budget Resolution

By Michael E. Levy, Assisted by Delos R. Smith
Economic Policy Research, The Conference Board

The Second Budget Resolution—which passed the Senate on September 15 and the House on September 16—set the following targets for fiscal 1977: $362.5 billion receipts; $413.1 billion expenditures; $50.6 billion budget deficit; $451.55 billion total budget authority; and $700.0 billion public debt.

That the targets for receipts, expenditures and the deficit were virtually identical with those of the First Budget Resolution of May 13, attest to the effectiveness of the Congressional Budget Act of 1974, which is being fully implemented for the first time. Even more impressive is the fact that outlays by major function have changed only slightly during the four months spent by Congress in reshaping the President's 1977 budget (see Table 1). These changes reflect mainly revised estimates for mandatory spending programs and the elimination of the one percent "kicker" in federal retiree benefits (see insert on page 3).

There is no historical record with which to compare this year's performance, since the traditional procedure of Congress used to be one of piecemeal legislation, adding authorization upon authorization, appropriation upon appropriation, and passing new tax legislation without any clear conception of the size of budget outlays or the deficit. Rarely was the appropriations process completed in former years before the second half of the new fiscal year, and there were a few occasions when the last appropriations bill had not yet been enacted by the end of the fiscal year. This year, by contrast, the last regular appropriations bill was enacted on September 30, just before the start of fiscal 1977, when Congress overrode President Ford's veto on the bill appropriating $56 billion for the Departments of Labor and Health, Education and Welfare, and other related agencies.

An even more impressive achievement was the passage of the Tax Reform Act of 1976. The First Congressional Budget Resolution called for an extension of the 1975-76 income tax cuts through fiscal 1977; but it also specified that $2 billion in offsetting revenues should be raised from tax reforms. The tax bill prepared by the House Ways and Means Committee was substantially in compliance with this provision. The Senate Finance Committee's bill, by contrast, was only in "technical compliance" while violating the spirit of the First Concurrent Resolution: It proposed to raise the so-called tax-reform revenue by extending the income tax cuts only through the first nine months of fiscal 1977 (rather than through the entire fiscal year). Moreover, the two bills differed in so many other fundamental respects

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A decade of annual federal budget analysis came to an end this past May with the publication of the tenth edition of *The Federal Budget: Its Impact on the Economy*. The previous report, *Fiscal 1977, No. 2*, marked the beginning of a new format, and the present report, *Fiscal 1977, No. 3*, completes the first series of The Conference Board's new monitoring program of the federal budget.

In the future, the Board's Economic Policy Research will issue three annual reports on the federal budget, each in the present format: *No. 1, The President's Budget Proposal; No. 2, First Congressional Budget Resolution; No. 3, Second Congressional Budget Resolution.*

We hope that this new monitoring system, developed in response to the recent reform of the congressional budget process, and the speedier publication made possible by the new format, will improve our service to Associates. Comments will be welcome.

Michael E. Levy, Director
Ecomomic Policy Research

TABLE I: PERSPECTIVE ON THE 1977 FEDERAL BUDGET

($ Billions)

		Fiscal 1977				Second Budget Resolution Change From:	
	Fiscal 1976 Budget	*President's Budget Proposal*[1]	*First Congressional Budget Resolution*	*Revised President's Budget Proposal*[2]	*Second Congressional Budget Resolution*	*First Congressional Budget Resolution*	*Revised President's Budget Resolution*
Receipts	**$300.0**	**$351.3**	**$362.5**	**$352.5**	**$362.5**	**$0.0**	**$10.0**
Outlays	**365.6**	**394.2**	**413.3**	**400.0**	**413.1**	**−0.2**	**13.1**
Deficit	**−65.6**	**−43.0**	**−50.8**	**−47.5**	**−50.6**	**−0.2**	**−3.1**
Receipts by source	**300.0**	**351.3**	**362.5**	**352.5**	**362.5**	**0.0**	**10.0**
Individual income taxes	131.6	153.6	160.9	152.6	160.9	0.C	8.3
Corporation income taxes	41.4	49.5	57.8	53.1	57.8	0.0	4.7
Social insurance	92.7	113.1	106.7	111.0	107.1	0.4	−3.9
Other receipts	34.3	35.1	35.1	35.8	35.1	0.0	−0.7
Tax reform	0.0	0.0	2.0	0.0	1.6	−0.4	1.6
Outlays by function	**365.6**	**394.2**	**413.3**	**400.0**	**413.1**	**−0.2**	**13.1**
National defense	90.2	101.1	100.8	101.6	100.7	−0.1	−0.9
International affairs	4.4	6.8	6.6	7.1	6.9	0.3	−0.2
General science	4.1	4.5	4.5	4.6	4.5	0.0	−0.1
Natural resources and energy	12.0	13.8	15.7	15.1	16.2	0.5	1.1
Agriculture	2.0	1.7	2.0	1.8	2.2	0.2	0.4
Commerce and transportation	17.2	16.5	17.7	16.5	17.4	−0.3	0.9
Community development	5.0	5.5	7.8	6.0	9.1	1.3	3.1
Education and manpower	18.0	16.6	23.0	18.4	22.2	−0.8	3.8
Health	34.0	34.4	37.9	36.5	38.9	1.0	2.4
Income security	127.0	137.1	139.3	136.2	137.2	−2.1	1.0
Veterans' benefits	18.4	17.2	19.5	17.8	19.5	0.0	1.7
Justice	3.3	3.4	3.5	3.5	3.6	0.1	0.1
General government	3.0	3.4	3.5	3.5	3.5	0.0	0.0
Revenue sharing	7.1	7.4	7.4	7.4	7.7	0.3	0.3
Interest	36.0	41.3	40.4	40.2	39.6	−0.8	−0.6
Allowances	0.0	2.3	1.2	0.8	0.8	−0.4	0.0
Undistributed offsetting receipts	−15.0	−18.8	−17.4	−16.8	−16.8	0.6	0.0

[1]Original budget estimates of January 21, 1976.

[2]Revised July 16, 1976.

Sources: Office of Management and Budget; Congressional Budget Office; The Conference Board.

that any reconciliation in conference appeared virtually impossible. But the Conference, determined to make the new congressional budget process work, produced a tax reform bill acceptable to both Budget Committees, which was approved by both houses of Congress, and signed by President Ford.

Tax Reduction and Tax Reform

The Tax Reform Act of 1976 extended the income tax cuts and the small business provisions through the end of calendar year 1977, and the 10 percent investment tax credit through 1980, at a total estimated revenue loss of $17.3 billion. Under "tax reform," it also included numerous changes in tax provisions, most of which will result in relatively small revenue gains or losses over each of the next five years (see Table 2).

The revenue gain from all "tax reforms" is projected to rise gradually from $1.6 billion in fiscal 1977 to $2.5 billion by fiscal 1981. Virtually this entire net revenue gain is accounted for by only two sets of provisions: the tightening of "tax shelters" and changes in the minimum and maximum tax provisions. The revenue loss from most of the other domestic tax revisions is largely recouped through amendments affecting tax deferral benefits for Domestic International Sales Corporations (DISC) and other amendments affecting the treatment of foreign income. These will generate $618 million in fiscal 1977, rising to an estimated $926 million by fiscal 1981.

In addition to the extension of the income tax cuts and the tax reforms, the Act also provided for the inte-

THE ONE PERCENT "KICKER"

In the 1960's, the Civil Service Retirement and Disability Fund incurred increasingly large unfunded liabilities, as the Fund's liabilities or commitments to pay future retirement benefits greatly exceeded its projected assets. Between July, 1960 and July, 1969, the unfunded liabilities of the Fund rose from $31.1 billion to $61.1 billion. After two years of efforts by Congress and the Executive Branch to restore the Fund to a sound financial footing, Congress enacted, and the President signed on October 20, 1969, reform legislation (P.L. 91-93).

The main purpose of this bill was to stabilize the unfunded liabilities. To accomplish this, the bill increased payroll contributions by federal employees and government agencies and authorized appropriations to the Fund. As a sweetener to the increased payroll contributions by employees, the benefits were also liberalized.

One provision that seemed innocuous at the time —but grew to be the subject of increasing subsequent controversy—has become known as the one percent "kicker." It provided for increases in annuities equal to the percentage increase in the Consumer Price Index (CPI) "plus 1 percent," any time the CPI increased by 3 percent or more for three consecutive months. This 1 percent "kicker" was added to make up for the time lag between the changes in the CPI and the effective date of the increase.

The purpose was to try to protect the purchasing power of federal retirees. At that time, a 3 percent annual rise in the CPI was considered an unusual occurrence—and not a way of life. In 1968, for the first time in 20 years, the CPI rose by more than 3 percent (4.2 percent); it has risen in excess of 4 percent every year since.

The 1 percent "kicker" was granted not only to civil service retirees, but also to military retirees (Armed Forces Retired Pay Adjustment Act, P.L. 91-179) and to foreign service retirees (State Department Appropriations Act, P.L. 91-153). Over the past five years, because of this "kicker," federal retirement pay has increased by 63 percent, although the cost of living has increased by only 50 percent.

Other federal programs which are indexed for price changes do not provide such a "catch-up" feature. For example, social security payments are adjusted once a year with a five-month lag; food stamps are indexed twice a year with a five-month lag; and white-collar civilian and military pay is adjusted once a year with a six-month lag.

On October 1, 1976, the "kicker" was repealed (Legislative Branch Appropriations, P.L. 94-440, for civil service retirees; Department of Defense Appropriations, P.L. 94-419, for military retirees; and State Department Authorization Act, P.L. 94-350, for foreign service retirees). The House Budget Committee estimated the saving from the repeal at $200 million for fiscal 1977, and at $3.5 billion over the next five years.

gration of gift and estate taxation and for major estate tax revisions. Most important, estate tax exemptions will be liberalized by substituting a tax credit that rises gradually from $30,000 in 1977 to $47,000 in 1981; generation skipping will be phased out, as will the avoidance of capital gains taxes on gains not realized prior to death. (For a fuller discussion, see the insert on *The New Tax Bill.*)

Unnoticed by most commentators, the Tax Reform Act of 1976 contained several major and meaningful tax reforms. These reforms have received inadequate attention because of (1) the history of the Act (it got its lease on life through unexpected last-minute compromises); (2) the size and complexity of the Act (it covers over 1,000 printed pages and contains many minor provisions and amendments that are of little economic or revenue consequence); and (3) the fact that two of the major reforms (elimination of "generation skipping" and the changed treatment of capital gains at death) will not raise significant amounts of revenue for years to come.

Two major revenue-producing measures — the tightening or dismantling of "tax shelters" and the increased taxation of certain other forms of "preferential income" — contribute both to greater uniformity and increased progressivity of the income tax.

Two further reforms—because they are far-reaching — are being phased in slowly over time in order to allow for a gradual adjustment; therefore, they will not generate any substantial revenue over the next decade. The elimination of "generation skipping" through special trusts and similar devices had long

THE NEW TAX BILL

The Tax Reform Act of 1976 (P.L. 94-455)—signed by the President on October 4, 1976—is the most extensive redrafting of the nation's tax laws since the Tax Reform Act of 1969. The bill has 28 titles, runs over 1,000 printed pages, and will affect almost every individual and business taxpayer.

The Act consists of three major sections: tax reform; estate and gift taxes; and a modified extension of the 1975-1976 tax cuts.

The tax reform section, consisting of 16 titles, is projected to raise net revenue of $1.6 billion in fiscal 1977. (This revenue gain should increase gradually to a high of $2.5 billion in fiscal 1981.) Virtually the entire net gain in revenues is attributable to two titles on tax shelters and the title on the minimum and maximum tax.

Tax Shelters

The bill toughens the tax treatment of tax-shelter ventures, which doctors, lawyers, corporate executives and other high-income persons use to create deductions to offset their regular income. These ventures include real estate, farming, oil and gas, movies, equipment leasing, and sports franchises.

Investors in oil and gas will be limited to deducting losses from amounts they personally invest. This "at risk" rule will eliminate the use of nonrecoverable loans, or loans the investor is not liable to repay. When an investor sells a well, the IRS will "recapture" as ordinary income (rather than as a capital gain) all deductions for intangible drilling costs to the extent they exceeded the deductions that would have been allowed if the costs had been capitalized and amortized.

Real estate investors will no longer be allowed to take as many fast deductions as in the past. Starting in 1976, investors in commercial real estate ventures can deduct only half of construction-period interest and taxes. The other half must be capitalized and amortized over the next four years. In 1977, they will have to amortize all construction-period interest and taxes over five years; in 1978, over six years; and so on, until 1982, when amortization reaches its permanent level of ten years.

For residential housing, current law will apply through 1977. In 1978, investors will be required to spread 100 percent of their construction-period interest and taxes over four years. The amortization period will increase, a year at a time, until it reaches ten years in 1984.

Low-income housing projects will continue to get the current fast write-off of interest and taxes through 1981. Four-year amortization will be required starting in 1982, rising to ten years in 1988.

Farming operations — except those involving trees other than fruit or nut trees — will also be subject to a new at-risk requirement.

Deductions for movie ventures will also be limited to the amount for which the investor is at risk. The same at-risk provision would apply to equipment-leasing shelters.

When a sports franchise is sold, the bill requires that the purchaser can not allocate any more to player contracts than does the seller, and—unless the taxpayer can persuade the IRS otherwise— a maximum of 50 percent of the price may be allocated to player contracts. Moreover, at the time of the sale, the government will recapture as ordinary income any previously unrecaptured depreciation on player contracts—even for contracts of players who have retired or are cut from the team.

Finally, the bill applies the "at risk" limitation to any shelters not specifically mentioned in the bill. This is designed to guard against any new shelters the legislators had not thought of.

Revenues gained from the tax shelter titles are estimated at around a half billion dollars each year over the next five years.

Minimum and Maximum Tax

The bill tightens up the minimum tax on individuals, which is designed to make sure that everyone pays some tax—even when income is from tax "shelters" and other items to which Congress has given "preference." The minimum tax rate will be increased to 15 percent from the current 10 percent. The exemption will be reduced to $10,000, or half the taxpayer's regular taxes, whichever is greater. (Current law provides a $30,000 exemption and also allows a taxpayer to deduct all regular taxes before figuring the minimum tax.)

Also, the bill tightens the current 50 percent maximum tax on wages, salaries and other forms of "earned" income. Taxpayers in brackets above 50 percent often use the maximum tax.

The minimum and maximum tax provisions are estimated to raise $1.1 billion in revenue in 1977, and are scheduled to rise about $200 million a year —reaching an estimated $1.8 billion in revenue by fiscal 1981.

Revisions of DISC

The amendments affecting a DISC (Domestic International Sales Corporation) are another major source of revenue. Revenue gains, rising from $500 million in fiscal 1977 to $700 million in fiscal 1981, are forecast. Exporters will now be rewarded only for increased sales abroad. Current law permits companies to defer tax on up to 50 percent of their export profits allocated to a DISC. The new rules will permit this tax break only on exports exceeding 67 percent of the annual average during 1972 to 1975. In 1980, the four-year base period will start moving forward, one year at a time.

Tax Simplification

The major revenue loss of the Tax Reform Act titles concerns tax simplification for individuals. Revenue losses are estimated to rise gradually from about $400 million in fiscal 1977 to $500 million in fiscal 1981.

Some of the major provisions of tax simplification are replacing 12 optional individual tax tables, based on adjusted gross income above $10,000, with four tables, based on taxable income up to $20,000; changing the existing deduction for alimony payments from an itemized deduction to a deduction from gross income and making it available to taxpayers who use the standard deduction; revising the existing 15 percent tax credit on retirement income to apply it to earned income as well as pensions or other forms of retirement income of persons age 65 and older; replacing an existing itemized deduction with a 20 percent tax credit for child care within or outside the home necessary to allow an individual to work; revising the existing sick-pay exclusion to provide a maximum $5,200 a year exclusion available only to retired taxpayers under age 65 who were permanently and totally disabled; and revising and liberalizing certain moving-expense deductions.

Other tax reform titles include business-related income tax provisions; changes in the treatment of foreign income; treatment of certain capital losses; pension and insurance taxation; railroad provisions; capital formation provisions; and many miscellaneous provisions.

Estate and Gift Taxes

The second major section of the Tax Reform Act of 1976 deals with estate and gift-tax reform. The Act increases the amount of money that can be given away or left tax free. Current law provides a $60,000 estate-tax exemption and a $30,000 exemption for lifetime gifts. The new Act combines the estate and gift-tax exemptions and converts them into a single credit, which is subtracted from the taxpayer's computed estate tax.

The new unified credit will rise to $120,666 in 1977; $134,000 in 1978; $147,333 in 1979; $161,563 in 1980; and $175,625 in 1981. The estate and gift-tax rates will be combined into a single schedule ranging from 30 percent to 70 percent.

The Act also increases the tax-free amount a husband or wife can leave or give to a spouse.

Also, if certain conditions are met, an executor may elect to value an estate consisting of a family farm or a closely held small business on the basis of "current" use rather than "highest and best" use, as under current law. Estates consisting of farms or closely held small businesses will be given up to 15 years to pay the estate tax, instead of the present 10 years.

The Act changed the basis of evaluation for capital gains taxation of inherited property. Under the old law, all inherited property was valued for capital gains taxation on the basis of "fair market value" in the "highest or best use" at the time of death. This meant that unrealized gains that had accrued to the decedent permanently escaped all capital gains taxation. Under the new Act, the value from all assets acquired by the decedent prior to December 31, 1976 is "stepped up" from its original price to the "fair market value" on December 31, 1976, which then becomes the basis for future capital gains taxation at the time of sale by the heirs. (Thus, all capital appreciation after 1976 is "recaptured" at the time of sale.) Assets acquired by the decedent after 1976 will be evaluated for capital gains taxation at their original purchase price.

"Generation-skipping" transfers under a trust or similar arrangement, which now escape tax, will be subject to tax; but an exclusion is provided for transfers of up to $250,000 to a grandchild.

Revenue losses of the estate and gift section are estimated at $0.7 billion in fiscal 1978, escalating to $1.6 billion in fiscal 1981.

Tax Reduction

The last section consists of a permanent extension of the individual tax cuts; extension through 1980 of the 10 percent investment tax credit; and the extension through calendar 1977 of the small business tax provisions.

TABLE 2: REVENUE ESTIMATES OF THE TAX REFORM ACT OF 1976 (P.L. 94-455)

($ Millions; fiscal years)

Public Law Titles		1977	1978	1979	1980	1981
	Tax reform	$ 1,593	$ 1,719	$2,038	$2,118	$2,470
	Estate and gift tax	–	–728	–921	–1,134	–1,449
	Extensions of tax cuts	–17,326	–13,776	–7,966	–8,348	–7,212
	Total	–15,733	–12,785	–6,849	–7,364	–6,191
	Tax reform	1,593	1,719	2,038	2,118	2,470
I and II	Limitations on artificial losses and other amendments related to tax shelters	417	395	501	488	527
III	Minimum and maximum tax	1,095	1,283	1,464	1,603	1,758
V	Tax simplification in the individual income tax	–409	–442	–457	–478	–499
VI	Business-related individual income tax provisions	215	231	273	306	315
X	Changes in the treatment of foreign income	150	108	182	197	198
XI	Amendments affecting DISC	468	553	559	598	728
XII	Administrative provisions	88	55	55	55	55
XIV	Treatment of certain capital losses; holding period for capital gains and losses	–2	35	104	98	83
XV	Pension and insurance taxation	–8	–19	–20	–22	–22
XVII	Railroad provisions	–87	–139	–118	–98	–80
VIII	Capital formation	–157	–287	–336	–383	–255
XIII, XXIII, XVI, XVII	Miscellaneous provisions and additional amendments	–177	–54	–169	–246	–338
	Estate and gift tax	–	–728	–921	–1,134	–1,449
XX	Carry-over provisions	–	–	36	93	162
XX	Other estate and gift tax provisions	–	–728	–957	–1,227	–1,611
	Extension of tax cuts	–17,326	–13,776	–7,966	–8,348	–7,212
IV	Extension of individual income tax reductions	–14,350	–9,293	–4,506	–4,731	–4,968
VIII	Investment tax credit	–1,300	–3,306	–3,460	–3,617	–2,244
IX	Small business provisions	–1,676	–1,177	–	–	–

Note: Title VII, accumulation trust; Title XVI, real estate investment trusts; and Title XXV, additional miscellaneous provisions, each has revenue gains or losses of less than $5 million. Title XXI, tax-exempt organizations, has revenue losses of $5 million in 1977 and 1978 and less then $5 million in the other years. Titles XVIII, XIX, XXII, and XXIV were deleted in the House-Senate conference.

Sources: Joint Committee on Internal Revenue Taxation; The Conference Board.

been an elusive target of most public finance experts concerned with tax equity and progressivity. It has finally been accomplished by the 1976 Act. Repeated attempts in the 1950's and 1960's to tax capital gains not realized prior to death had also invariably failed; until now, such gains permanently escaped any income tax. The new Act will gradually close what many consider one of the most unjustifiable "loopholes" of the federal income tax, by requiring that — after a gradual phasing in—all assets continue to be carried by the heirs at the basis of the decedent.

One important shortcoming of the Act from the point of view of tax reform is the failure to provide extensive new incentives for capital investment. According to a widely held view— buttressed by several recent studies on future U.S. capital needs—the rate of U.S. capital formation as a percent of GNP will have to increase moderately over the next decade, if the economy is to achieve sustained high employment at tolerable inflation rates. On behalf of the Administration, Treasury Secretary Simon, in particular, has stressed the need for tax reform as a means for attaining this goal. Yet the extension of the investment tax credit at 10 percent (otherwise it would have dropped to 7 percent in 1977) was the only significant incentive to capital formation provided by the Act. Since other major reform provisions tend to increase tax equity and tax progressivity, they are likely to reduce gradually the private savings rate. Thus the conflict of the past decade between the need for more saving and investment and the drive toward greater equity (and reduced income inequality) is continuing.

CONGRESSIONAL BUDGET ACT OF 1974: THE NEW BUDGET PROCESS IN TEN STEPS

(1) To give Congress an earlier and better start in reviewing and reshaping the budget, the Executive Branch must submit a "current services budget" by November 10th for the new fiscal year that starts the following October 1st. The current services budget should project the spending required to maintain ongoing programs throughout the following fiscal year at existing commitment levels, or at commitment levels specified by existing legislation based on current economic assumptions. The Joint Economic Committee should review and assess the current services budget and report to Congress by December 31st.

(2) The President will continue to submit his new budget to Congress in late January or early February. In addition to the traditional budget totals and breakdowns, the budget document must include a list of existing "tax expenditures" – i.e., estimates of revenues lost to the Treasury through preferential tax treatment – as well as any proposed changes in tax expenditures. The budget must also contain estimates of expenditures for programs for which funds are appropriated one year in advance and five-year budget projections of all federal spending under existing programs.

(3) Reports of all standing committees to the House and Senate Budget Committees of the spending plans of those committees on all matters under their jurisdiction, including spending under new legislation, are required by March 15th for the upcoming fiscal year.

(4) An annual report of the Congressional Budget Office to the Budget Committees on alternative budget levels and national budget priorities is required on or before April 1st.

(5) By April 15th, the Budget Committees must report concurrent resolutions to the House and Senate floors, and Congress will have to clear the initial budget resolution by May 15th. This initial budget resolution sets target totals for appropriations, outlays, taxes, the budget surplus or deficit, and the federal debt. Within these overall targets, the resolution will break down appropriations and outlays by the functional categories used in the President's budget document, as well as by classifications used by the appropriations subcommittees for the 13 appropriations bills. The resolution will include any recommended changes in tax revenues and in the level of the federal debt ceiling.

(6) Committees report bills or resolutions authorizing new budget authority by May 15th.

(7) The basic appropriations process proceeds within the Appropriations Committees, but is subject to targets of the budget resolution.

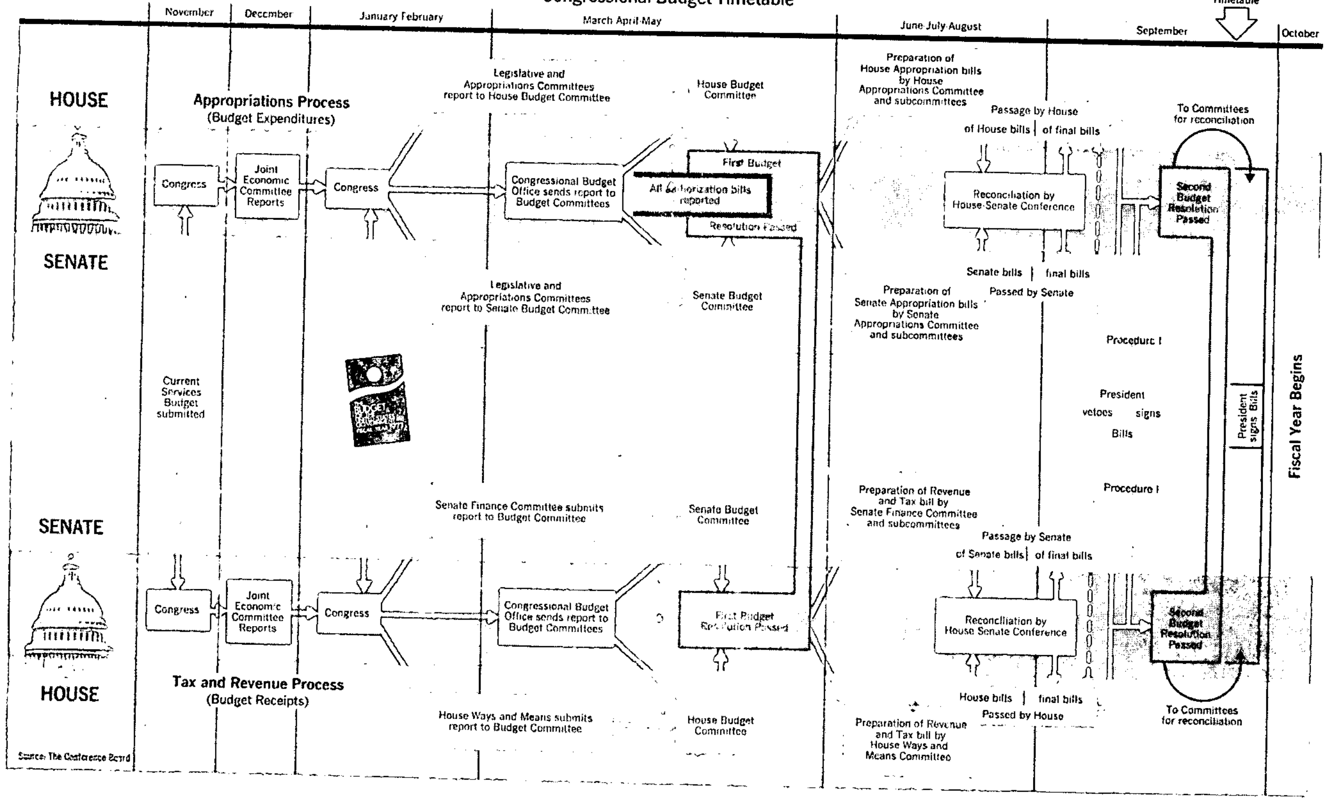
(8) Scorekeeping reports will be issued periodically by the Congressional Budget Office on the status of budget authority, revenue, outlays and debt legislation, comparing the amounts and changes in such legislation with the First Congressional Budget Resolution.

(9) Subject to prior authorization, all appropriations bills have to be cleared by the middle of September – no later than the seventh day after Labor Day. By September 15th, after finishing action on all appropriations and other spending bills, Congress must adopt a second, and final, budget resolution that may either affirm or revise the budget targets set by the initial resolution. This resolution must provide for a final budget reconciliation by changing either one or more of the following: (1) appropriations (both for the upcoming fiscal year or carried over from previous fiscal years) and/or entitlements; (2) revenues; and (3) the public debt. The final resolution will direct the committees that have jurisdiction over these matters to report the necessary legislative changes. The Budget Committees will then combine these changes and report them to the floor in the form of a reconciliation bill.

If Congress has withheld all appropriations and entitlement bills from the President until passage of the final reconciliation bill, then this bill becomes the final budget legislation, subject to Presidential signature (or veto). If, on the other hand, each individual appropriations bill has been signed by the President upon passage by the Congress, the final reconciliation bill – upon signature by the President – supersedes all the previously passed individual bills.

(10) The new fiscal year begins on October 1st.

Congressional Budget Timetable



CRITICAL LONG-RUN ISSUES

"Perhaps the most critical long-run issue facing the Congress with respect to the budget process is the lack of any requirement of consistency between monetary and fiscal policy. The Congress can act to expand the economy, and the Federal Reserve can by its actions restrict or even reverse that policy determination. Any tax and expenditure program's effectiveness is dependent on monetary policies which will work in tandem with that plan. . . ."

"Coordination of effort between monetary and fiscal policy is vital. Unless some such integration takes place, the likelihood of achieving levels of economic growth for a period sufficient to return the nation to anything like full employment is very small indeed. . . ."

"None of the major economic forecasts suggests that there is good prospect for return to full employment by 1980. In order to keep pace with the normal growth in the civilian labor force, nearly 8½ million jobs must be created between now and the end of 1980. A 4 percent unemployment rate would require the creation of nearly 4½ million more jobs. This implies a 7 percent rate of growth in real GNP in each year after 1976. The highest average annual rate of growth we have achieved since WWII for any five year period was 5.4 percent between 1961 and 1966. . . ."

"Over the past year there has been a number of studies done either affirming or denying the existence of a 'capital shortage.' A distinction must be made between short and long-term capital needs. It makes little sense to talk about a capital shortage at a time when existing capital is under-utilized and the economy is just beginning to recover from the deepest recession since WWII. . . ."

"Despite the low rate of manufacturing capacity utilization and the moderate pace of the recovery, most current longer-term projections call for an increase rather than a decrease in the amount of capital required by business during the decade 1975-1985. Those projections call for a 1 percent expansion in investment as a percent of GNP. One of the main reasons for such an increase is to provide tools for our expanding labor force. Another reason is the increased investment needed to cover the cost of pollution control. The projected requirements for increased capital by businesses, along with concern over where the capital is to come from, have given rise to the concern over capital shortages. This concern has been increased by the size of current and prospective Federal deficits. . . ."

"It is not adequate to look only at the unified budget's surpluses or deficits. The off-budget agencies and government sponsored enterprises have become increasingly important in recent years. Of the $84 billion of Federal government borrowing for calendar year 1975, $75 billion was the result of the unified budget deficit. If the borrowing for off-budget agencies is added to the other agency issues, a total of $19 billion was borrowed in excess of the official deficit. Moreover, for fiscal year 1977, the off-budget agencies and government sponsored enterprises are expected to borrow $26 billion in addition to the $43 billion unified deficit."

(From a *Report of the Task Force on Economic Projections to the Committee on the Budget, U.S. House of Representatives*, March 24, 1976.)

Fiscal 1976 Revised: The "Lost Outlays" Issue

Usually, as a new fiscal year gets under way, all eyes are focused on the upcoming numbers — and the budget figures for the fiscal year that has just ended retain little interest. This year, by contrast, the "lost outlays" issue has been the subject of extensive detective work and continuing heated debate. "Lost outlays," in this context, are outlays that had been authorized and anticipated, and for which funds had been appropriated, but that — to the surprise of everybody, including the Office of Management and Budget — failed to materialize by the end of the fiscal year (or the recently completed transitional quarter).

Under more normal circumstances, these lost outlays might be a source of joy, because they result in a lower budget deficit than had been projected only a few weeks before the final figures became available. For example, last July 16, the Administration's latest estimate for the fiscal year ending June 30 showed receipts at $299.4 billion, expenditures at $369.1 billion, and the budget deficit at $69.6 billion. On July 26, the final fiscal 1976 figures were released: receipts were $300.0 billion; outlays, $365.6 billion; and the

TABLE 3: FEDERAL EXPENDITURES, NATIONAL-INCOME-ACCOUNTS BASIS
($ Billions; fiscal years)

	1976 2nd Quarter		1976 3rd Quarter
	Preliminary[1] *(July, 1976)*	*Actual (August, 1976)*	*Preliminary*[1] *(October, 1976)*
Expenditures	**$383.1**	**$378.7**	**$390.5**
Purchases of goods and services	132.3	131.2	134.4
National Defence	88.4	86.9	88.6
Compensation of employees	41.7	41.7	42.0
Military	24.3	24.3	24.3
Civilian	17.5	17.5	17.7
Outside purchases	46.7	45.2	46.6
Nondefense	43.9	44.2	45.7
Compensation of employees	20.8	20.8	21.1
Outside purchases	23.1	23.4	24.6
Transfer payments	158.8	158.7	163.4
Grants-in-aid	59.0	56.3	59.5
Net interest paid	27.5	27.4	27.7
Subsidies	5.5	5.2	5.5

[1]Based on data of the first two months of the quarter.
Source: Department of Commerce.

deficit, $65.6 billion. Thus, within 10 days in July, $3.5 billion in outlays and $4.0 billion of the budget deficit were "lost." Moreover, when the final budget figures are compared with last January's estimate by the Office of Management and Budget, the corresponding "losses" are $7.9 billion and $10.4 billion, respectively. (A variety of other estimates for "lost outlays" have figured in recent public discussions; such estimates vary with the particular budget concepts and benchmarks used.)

If the shrinkage in the budget deficit were the only perceived consequence of lost outlays, or if this "loss" would have occurred at a time of rapid economic advances, the issue would probably have generated little heat. However, the timing of the lost outlays has coincided with a troublesome "pause" in the growth of economic activity. The rate of real growth of the economy slowed from 9.2 percent in the first quarter to 4.5 percent in the second, and 4.0 percent in the third. There has been widespread speculation that this recent slowdown in economic growth may, in part, be related to the slower-than-expected rise in federal spending. In this setting, it is important to know whether the growth in federal expenditures is likely to continue below projected budget levels, or whether a recouping of "lost outlays" through a spurt in federal spending is in the making. In order to answer this question, we must first establish the origin, size and composition of outlays "lost" during the second and third quarters of 1976.

Size and Composition of the "Lost Outlays"

The Conference Board's analysis of lost outlays draws mainly on data from the national income accounts (NIA) budget (rather than the unibudget), because these data are better suited for fiscal-impact analysis and serve as the basis for estimating "fiscal thrust," the author's preferred measure of fiscal impact. Last May, NIA budget expenditures for the second and third quarters of calendar 1976 were estimated at $387.6 billion and $394.2 billion, respectively (see Table 4 in the preceding issue of this publication). These estimates may serve as the basis for assessing subsequent downward revisions in NIA budget expenditures.

In the July *Survey of Current Business*, the Bureau of Economic Analysis of the Department of Commerce estimated second quarter NIA budget expenditures at $383.1 billion—a reduction of $4.5 billion from our May figures. (Third quarter outlays were estimated at $391.8 billion—down $2.4 billion from May.) The July estimate was based on actual data for only two months: April and May. In August when actual data for the entire second quarter became available, NIA budget expenditures were revised to $378.7 billion—down $4.4 billion from the preliminary July figures. Thus, by our count, NIA budget spending for the second quarter of 1976 turned out to be approximately $9 billion below the best estimate available last May.

One half of this $9 billion reduction cannot be broken down by origin or components because detailed information is lacking. However, limited sources of information indicate that this initial shortfall of $4.5 billion appears to have been spread more or less across the board. There is merit to the speculation of

TABLE 4: MEASURING THE FISCAL IMPACT OF THE FEDERAL BUDGET[1]

(NIA accounts data; $ billions at seasonally adjusted annual rates)

	FY 1975				FY 1976			
	1974 III	1974 IV	1975 I	1975 II	1975 III	1975 IV	1976 I	1976 II
Federal Budget Outlays								
(1) NIA outlays	$306.5	$318.2	$337.0	$354.3	$363.7	$376.0	$380.3	$378.7
(2) Add: Offsetting receipts	2.8	2.2	1.6	2.1	1.4	2.1	0.8	1.0
(3) Adjust: increase (−) in "regular" unemployment benefits[3]	−0.5	−1.9	−5.4	−1.9	1.1	0.9	0.8	1.3
(4) Equals: Adjusted NIA outlays	308.8	318.5	333.2	354.5	366.2	379.0	381.9	381.0
(5) Quarterly increase in adjusted outlays	14.8	9.7	14.7	21.3	11.7	12.8	2.9	−0.9
Federal Tax Changes[4]								
Personal income tax:								
(6) Tax Reduction Act of 1975				−40.5[a]	−12.3	−11.9	−2.6	−1.9
(7) Revenue Adjustment Act							−12.1	−12.2
(8) Tax Reform Act of 1976								
(9) Administration proposal								
Corporation income tax:								
(10) Tax Reduction Act of 1975			−1.8[a]	−2.6[a]	−2.9	−3.1	−0.4	−0.5
(11) Revenue Adjustment Act							−1.9	−2.0
(12) Tax Reform Act of 1976								
(13) Administration proposal								
Social Security[5]								
(14) Base from $10,800 to $13,200 (1/1/74)	5.6	7.4	5.0	5.2	5.4	5.6	5.8	5.9
(15) Base from $13,200 to $14,100 (1/1/75)			0.7	0.8	1.7	2.2	1.6	1.7
(16) Base from $14,100 to $15,300 (1/1/76)							1.1	1.2
(17) Base from $15,300 to $16,500 (1/1/77)								
(18) Rate increase 11.7% to 12.3% (1/1/77; Administration proposal)								
Other taxes and levies:								
(19) Unemployment insurance (Administration proposal)								
(20) Excise tax reduction							−0.2	−0.2
(21) Oil import duty			0.5	1.7	3.3	3.0	0.2	0.2
(22) Total tax changes	5.6	7.4	4.4	−35.4	−4.8	−4.2	−8.5	−7.8
(23) Quarterly increase (−) or reduction (+) in (22)	−2.8	−1.8	3.0	39.8	−30.6	−0.6	4.3	−0.7
Fiscal Thrust								
(24) Fiscal thrust [(5) + (23)]	12.0	7.9	17.7	61.1	−18.9	12.2	7.2	−1.6
(25) Fiscal thrust as percent of GNP	0.84%	0.55%	1.22%	1.39%[1]		0.77%	0.44%	−0.10%
(26) Weighted Fiscal Thrust [(5) + (0.9 × (23)]	12.3	8.1	17.4	57.1	−15.8	12.3	6.8	−1.5
(27) Weighted Fiscal Thrust as percent of GNP	0.85%	0.56%	1.20%	1.36%[1]		0.77%	0.42%	−0.09%

[1]Author's estimates derived from the best available published and unpublished sources.

[2]The President's original budget proposals of January 21, 1976, except for technical revisions made March 25 and July 16.

[3]Includes regular benefits and extensions, but excludes Federal Supplemental Benefits and Supplemental Unemployment Assistance. Author's estimates based on various published and unpublished sources.

[4]Unpublished estimates of the Bureau of Economic Analysis, except (a) as published in the *Survey of Current Business*.

[5]Timing of the effect of increase in tax base on employees' part of contribution changed by author to concentrate increase mainly in last two calendar quarters.

Sources: Office of Management and Budget; Bureau of Economic Analysis; Council of Economic Advisers; U.S. Congress; The Conference Board.

Transitional Quarter		FY 1977								
1976 III		1976 IV		1977 I		1977 II		1977 III		
President's Original Budget Proposal[a]	Preliminary	President's Original Budget Proposal[a]	Second Budget Resolution	President's Original Budget Proposal[a]	Second Budget Resolution	President's Original Budget Proposal[a]	Second Budget Resolution	President's Original Budget Proposal[a]	Second Budget Resolution	
$391.8	$390.5	$398.3	$400.6	$405.3	$412.5	$410.1	$420.3	$418.9	$430.7	(1)
1.5	1.5	1.5	1.5	1.7	1.7	1.9	1.9	2.1	2.1	(2)
0.2	0.2	0.0	0.0	0.2	0.2	0.3	0.3	0.6	0.6	(3)
393.5	392.2	399.8	402.1	407.2	414.4	412.3	422.5	421.6	433.4	(4)
5.1	11.2	6.3	9.9	7.4	12.3	5.1	8.1	9.3	10.9	(5)
−0.4	−0.4	−0.4	−0.4	−0.5	−0.5	−0.5	−0.5	−0.5	−0.5	(6)
	−12.4[b]		−12.5[b]	−3.0	−12.7[b]	−3.0	−12.7		−12.8	(7)
					1.1[c]		1.1[c]		1.1[c]	(8)
−20.7		−21.0		−21.7		−22.0		−22.4		(9)
−0.6	−0.6	−0.7	−0.7	2.8	2.8	2.8	2.8	2.8	2.8	(10)
	−2.1		−2.1		−4.8[d]		−4.8[d]		−4.9[d]	(11)
					0.5[c]		0.5[c]		0.5[c]	(12)
−4.1		−4.1		−9.0		−9.1		−9.1		(13)
6.0	6.0	6.1	6.1	6.2	6.2	6.3	6.3	6.4	6.4	(14)
1.8	1.8	1.9	1.9	2.0	2.0	2.1	2.1	2.2	2.2	(15)
2.6	2.6	3.7	3.7	2.4	2.4	2.5	2.5	2.6	2.6	(16)
				0.9	0.9	1.0	1.0	2.8	2.8	(17)
				4.6		4.6		4.6		(18)
				1.6		1.6		1.6		(19)
−0.3	−0.3	−0.3	−0.2	−0.7	−0.3	−0.7	−0.3	−0.7	−0.3	(20)
0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	(21)
−15.4	−5.1	−14.5	−3.9	−14.1	−2.1	−14.1	−1.7	−9.4	0.2	(22)
7.6	−2.7	−0.9	−1.2	−0.4	−1.8	−0.0	−0.4	−4.7	−1.9	(23)
12.7	8.5	5.4	8.7	7.0	10.5	5.1	7.7	4.6	9.0	(24)
0.74%[e]	0.50%[e]	0.31%[e]	0.49%[e]	0.39%[e]	0.57%[e]	0.27%[e]	0.41%[e]	0.24%[e]	0.47%[e]	(25)
11.9	8.8	5.5	8.8	7.0	10.7	5.1	7.7	5.1	9.2	(26)
0.70%[e]	0.51%[e]	0.31%[e]	0.50%[e]	0.39%[e]	0.59%[e]	0.27%[e]	0.41%[e]	0.27%[e]	0.48%[e]	(27)

[a]See footnote 4.

[b]Congressional expansion of the Revenue Adjustment Act includes annual total of $2 billion for tax return and $1.8 billion for refunds of overwithholding.

[c]Only the titles of the Tax Reform Act of 1976 dealing with tax reform are included in lines 8 and 12. Titles dealing with the extension of the tax cut are included under Revenue Adjustment Act (lines 7 and 11).

[d]Congressional extension of the Revenue Adjustment Act; also includes the extension of the 10% investment tax credit covered by the Tax Reduction Act of 1975 through the end of 1976.

[e]Estimated by the author, based on CEA's GNP projections.

[f]1975 II and 1975 III are averaged to smooth the effects of the 1974 tax rebates and the 1975 tax reductions.

specialists and the press that lower-than-expected inflation rates—which tend to reduce the costs of various programs below original estimates — were partly responsible. Separate information on National Defense (a function that has benefited recently from rapid increases in both authorizations and appropriations) indicates a continuing lag. The entire defense spending process—from obligating the funds and making progress payments, to the final delivery of defense purchases—appears to have advanced more slowly than had been expected and would have been permissible under existing legislation.

The other half—a $4.4 billion shortfall in NIA expenditures between the July estimates and the final tabulations in August—can be traced more clearly with the help of figures from the Bureau of Economic Analysis (see Table 3). Almost this entire downward revision was concentrated in two major categories: outside purchases (i.e., nonpayroll expenditures) for the Defense Department; and grants-in-aid to state and local governments. Defense purchases from the private sector were revised down by $1.5 billion; grants to state and local governments, by $2.7 billion. Revenue sharing was on target and the revisions were small for highway grants (slightly up) and for public assistance and urban renewal (slightly down); among the major categories of grants, only education grants were revised downward substantially (by roughly $0.5 billion). Therefore, almost all of the numerous scattered smaller grant programs must have tracked well below projected levels, resulting in a cumulative shortfall of nearly $2 billion. Such widespread and systematic shortfalls depart sufficiently from the past pattern so that some process of "holding back" or "slowing down" may be presumed.

Are the past shortfalls likely to persist? Will they be wiped out, or will they even be made up through a spurt that pushes spending temporarily above the projected trend? The latest preliminary estimate by the Bureau of Economic Analysis for third quarter budget expenditures provides important clues (see Table 3). At $390.5 billion—it is based again on data for the first two months of the quarter—it falls $3.7 billion below the best estimate available last May and is $1.3 billion below the BEA's July estimate. Thus, even if the latest Commerce Department figures prove to be right on target (another downward revision cannot yet be ruled out), they clearly indicate that the recent shortfall in outlays is not being made up. At present there is not yet any discernible "spurt" in government spending. Instead, the latest figures suggest a gradual return of federal spending to a trend that continues to track about $3-$4 billion below the projections of last May, as well as below those implied by a "literal translation" of the Second Budget Resolution into NIA budget expenditures.

What are the reasons for this lower spending trend? For National Defense, unibudget outlays (which include payments on work in progress) as well as NIA expenditures (which are measured on a "goods delivered" basis) continue below earlier estimates — even though this "shortfall" is shrinking. One important consequence is that lower-than-projected defense inventories in the private sector have curtailed real economic growth during the second and third quarters, thus contributing to the recent economic "pause." Grants-in-aid appear to be rebounding toward the target levels of earlier projections; but there is no evidence of any additional "spurt" that would make up for the shortfall in grants that occurred in the second quarter.

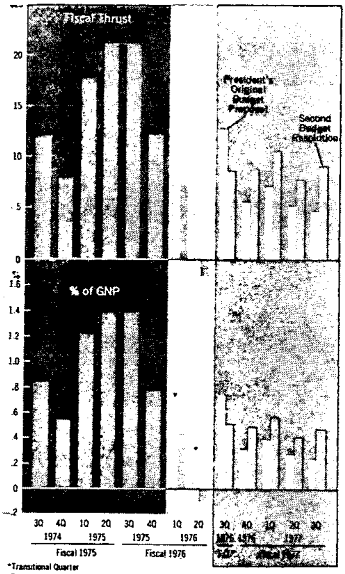
Moreover, the $413.1 billion outlay target of the Second Budget Resolution presumes passage of additional supplemental appropriations that translate into approximately $11 billion of unibudget outlays. Of this amount, $3-$4 billion are in spending programs that have been evolved and supported less firmly than the rest (especially $2.6 billion in Public Employment Assistance). For these various reasons, the target of $413.1 billion in unibudget outlays for fiscal 1977, set by the Second Budget Resolution, may not be attained. This target would translate into about $421 billion NIA budget outlays; whereas our own best current estimate for fiscal 1977 NIA expenditures is $416 billion. This "adjusted" figure (rather than $421 billion NIA budget outlays) is used in developing our quarterly estimates of "fiscal thrust" for fiscal 1977. (This figure does not, of course, include an allowance for any additional tax cuts which a newly elected President might propose early next year, but which are not covered by the Second Budget Resolution.)

"Fiscal Thrust" and the 1976 "Pause"

The previous issue of this publication contained, for the first time, quarterly information on "fiscal thrust"—our preferred measure of the initial expansionary impact of the federal budget. These quarterly estimates covered the fiscal years 1975-1977 and included a separate comparison of President Ford's original budget proposals for the transitional quarter and for fiscal 1977 (slightly revised last July) with the First Congressional Buget Resolution. All figures have now been revised and updated, and the comparison is with the Second Budget Resolution (see Table 4). The most trenchant changes are the sharp downward revisions in fiscal thrust for the first two quarters of calendar

Measuring the Fiscal Impact of the Federal Budget

(NIA accounts data; $ billions at seasonally adjusted annual rates)



*Transitional Quarter

'Based on May estimates of NIA budget expenditures

'Average of second and third quarter in order to smooth the 1974 tax rebate and 1975 tax reduction.

Sources: Office of Management and Budget; Bureau of Economic Analysis; Council of Economic Advisers; The Conference Board

1976 (see Chart). The result is a precipitous drop in fiscal stimulation during the first half of 1976 — particularly during the second quarter — a significant factor in explaining the recent economic "pause," i.e., the slowdown in real growth.

A budget that was fairly expansionary in its economic impact during the last half of 1974 (and the last quarter of 1975) became highly expansionary during the first three quarters of 1975 — aided by the economic stimulation from the 1974 income tax rebates and the 1975 tax reductions. During the first quarter of 1976, the budget shifted to only a modest degree of economic stimulation; by the second quarter, the budget actually exerted a *drag* on the economy—a rare and highly unusual occurrence.

If the preliminary outlay estimate for the transitional quarter holds, the budget is now returning to a position of modest economic stimulation—a stance that should prevail throughout fiscal 1977 under the Second Budget Resolution. (By contrast, the Administration's original budget program would have been only marginally expansionary.) This restoration of a modest degree of fiscal stimulation should make it easier for the economy to regain momentum — but it does not provide a real "head of steam."

More specifically, the "fiscal thrust" of the budget, which averaged a high 1.2-1.4 percent of GNP during the first three quarters of 1975 and about 0.8 percent of GNP during its last quarter, dropped to about 0.4 percent of GNP in early 1976 and became *slightly negative* during the second quarter of 1976. The third quarter appears to have reversed the severe fiscal restraint of the second quarter: Fiscal thrust appears to have risen again to about 0.5 percent of GNP and should remain close to this level throughout fiscal 1977 under the Second Budget Resolution.

In recent years, it has become fashionable to discount, or even dismiss, any short-term impact of fiscal policy on the economy — and inadequate measurement of fiscal impact has reinforced widespread skepticism about the effectiveness of fiscal policy. Yet, the initial recovery from the most severe postwar recession benefited from an unusually high level of fiscal stimulation, while the recent economic "pause" was preceded by severe fiscal restraint. This pause in the wake of drastic fiscal restraint may serve as a reminder that fiscal policy is still alive — though not well.

October 27, 1976

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Representative BOLLING. Thank you very much.

I would like to say that as far as I am concerned this has been one of the most useful sets of provisions that I have heard in a long time of listening to such presentations. And I hope that my colleagues will take the opportunity to peruse it and absorb it.

I have a series of questions. Some of them are sort of minute, and some of them are rather broad. In this discussion of specific kinds of job creation, which is what I think is the problem, there is a lot of generalized conversation about our having something like the old CCC or the old WPA. Now, those are not programs that I am ashamed of as a Democrat, to be a little political about it. It seems to me that they performed an enormously useful service. I represent an urban area where the unemployment among the young, the disadvantaged young, the black young, and among women is fantastic. That unemployment generates a number of extremely expensive side effects. In order to convince everybody in the Congress that this is so, we commissioned a study which was quite conclusive. But I think that the effect of the young not having any real hope that they are going to have a productive job, much less a career, is perhaps the most inflamatory social problem that we have.

And, therefore, I heartily agree with the notion that we ought to be doing some specific work to reach a certain type of unemployment as well as other more general approaches.

I would be interested in the comments of the members of the panel on what are the—eliminating for the moment the political difficulties, the political difficulties with regard to the wages, which would not be terribly high necessarily, eliminating that type of thing—what would be wrong with these kinds of programs revisited?

Do you mind starting, Mr. Karchere?

Mr. KARCHERE. No; I don't mind starting. But I would like to preface my remarks by referring to some of the things Mr. Levy said and then come back to your question.

Representative BOLLING. Fine.

Mr. KARCHERE. I think if we are able to get the unemployment rate down to 5.2 percent in the fourth quarter of 1978, that is pretty good. And we can do that, I think, with a program of $30 billion stimulus over and above the current services budget.

I think, in a sense, we have a problem of getting over a hump. And let me try to explain what I mean. We are trying to come out of the worst inflation we have had in 30 years. And one of the consequences of coming out of that inflation is a relationship between money wage rates and the cost of living that produces a very small increase in real wages. This is not a problem we are going to have forever. It happens to be a problem that we and many other countries that are coming out of the inflation have.

During a period of this kind, the self-generating expansion forces of the economy are very low. And I think during this period we do need expansionary fiscal policy. It doesn't mean that we need it forever. We need it to get us over this period where the growth in real wages is as slow as it is.

Now, I agree with you that the social consequences of extremely high employment rates among the young people is just disastrous And a meaningful employment for those people, particularly when accompanied by training, I think would be a good thing. But I think as long as the overall unemployment rate approaches 8 percent, the ability of specific programs to deal with specific cases is extremely limited. We really need to get the overall unemployment rate down to some kind of respectable level. Then we are left with the structural problems. And at that point it seems to me you deal with the structural problems. I think what we need now is a period of very hard thought as to what those programs should be when we get the overall employment rate down to some reasonable level. In the meantime, for the young people, we should have a program that links employment with education, so that they are not under the impression that they are being put into dead end kinds of activity. A program of that kind it seems to me, would be a very useful thing.

Representative BOLLING. Would you comment, Mr. Gramlich?

Mr. GRAMLICH. Yes.

Let me comment first on some of the things that are not similar about the depression type programs and the problems of today. From the historical reading I have done, which is not much, I, too have the feeling that the public employment programs of the depression were very successful. But I think we all have to recognize that a lot of things are different today which at a minimum make the problems infinitely more difficult.

The first thing is that the general level of wages is a lot higher. The second thing is that most people today have jobs where there is a lot of capital required for them to do the work. And it really is, I think, a little bit naive to expect that we can just hire teams of unemployed youths, for example, and have them go out and build the roads and the parks that they did in the depression.

A lot of the studies of public employment have raised a number of critical questions about the program. It seems to me that the most telling one is that right now the local government sector in this economy is on an average very highly educated, the general level of education is above that for most other jobs. And so it seems to me that there is a big risk that you would be building a two tier system right into the local governments, because you would be hiring people who, if they were able to get jobs, would probably not be there. You would be hiring them into in fact the wrong place.

I would dissent modestly from Mr. Karchere. While I agree with him that the problem can in effect be broken up into two segments, one is just getting back to something close to full employment and one is doing something structural at that point. I don't think that we have to wait until we get back to full employment before we think about the structural problems. According to all these budget projections that is going to be another 3 or 4 years. I think we know enough to know that there are still going to be structural problems in the labor force once we do get back to full employment. And I don't see why we can't begin trying to work on them now.

My favorite candidate along these lines is to have some sort of a wage subsidy for private employers. I believe that while the evidence is murky on this, the papers that I believe most indicate that those employers ought to be sensitive enough to wage differentials that there could be a fair amount of hiring for relatively modest budget costs. As I mentioned in my testimony, the program could be turned off once we got to better levels of employment, or scaled down at least. And I think also that that would be a more natural home for many of the people who are unemployed, that would be easier for them to work within the firms, and that there would be less risk of just creating a permanent two tier system, which I think would be just what we don't want to do.

Representative BOLLING. Mr. Levy, would you like to comment?

Mr. LEVY. With regard to Mr. Karchere's comment, I feel of course that in order to soften the structural unemployment problem, we have to ultimately have a reasonably prosperous economy. We have found in 1960, that the greatest headway has been made by blacks and disadvantaged in terms of their income levels and employment during periods when the economy as a whole was prosperous. So the two approaches are really complementary, in a sense.

I am not quite as optimistic as Mr. Karchere is that the stimulation which he recommends would necessarily get us down to almost the 5 percent unemployment level by the end of 1978. But I am pleased to hear that and hope that he will be right.

In any case, the gradual return to full employment, even under the best of circumstances, would take more than 2 years, and not only should we utilize this interval to look at the special problems, the structural problems, but we should also be aware that the early call is for more planning and study than we have done in the past.

I do not think that the experience of the Great Depression with the special employment programs of that period is likely to be particularly useful and relevant, manly because the unemployment problem at that time was a very different one. First, it was much more massive to begin with. Second, it involved mostly people who had been in the labor force who had had normal work experiences, and for whom we had to create jobs in order to put them to work in any kind of productive work. By contrast our current unemployment problem includes important structural elements. For example, some of the structural problems in the labor force involve inner-city teenagers which you mentioned specifically. We find that a good many of them never had any consistent work experience. Many of them have never held a job for longer than half a year at a time. Hence there is the problem of integrating them into the normal labor force and the normal work experience. This cannot be done simply by providing a paycheck, the problem, I am afraid, is a far more serious one. Therefore, I would like to see us attack this structural unemployment problem and experiment with innovative programs while we stimulate in order to get aggregate unemployment down. Let's not wait with such experiments and simply stimulate until we are down to the structural problem before we phase in such structural programs.

The wage subsidy idea which Ned Gramlich mentioned, the idea of trying to rely on the private sector, has considerable merit and deserves experimentation, because it is far less expensive to the Federal Government than putting these persons to work in public employment jobs. Moreover, there is the advantage that the private sector, even with the subsidy, is reluctant to hire employees unless there is a meaningful job there, or unless the trainees are likely to become productive in the normal sense of our labor force and our job opportunities. And I think the problem of absorbing these persons into the normal labor force would suggest that this is the kind of training and these are the kinds of jobs we ultimately should evolve for them, rather than segregating them in public service jobs.

If we do have special public employment, if we develop some kind of dead-end jobs or quasi-jobs for second-class citizens. At least these jobs and workers may be viewed in this way, particularly if such programs continue in a relatively prosperous economy. We may create another kind of quasi-welfare program. I think in designing employment programs we should shy away from this approach.

Representative BOLLING. I certainly agree with that. I wouldn't want to leave the impression that I didn't believe that we had to have a broad gage stimulus to get the economy back to a reasonable level of unemployment.

But I feel very strongly that while we have made some improvement in our attempt to attack the problems of structural employment, we have been remarkably late in our approach, mainly on the Hill, in Congress. I can remember the early power training program, when we forgot the fact that in order to be trained a person had to be able to read and write. And we haven't done really a brilliant job. I think in the past our efforts were somewhat better.

But in this whole discussion, we are talking about a stimulus in which the biggest program suggested has been $30 billion, which is less, I think, than equivalent to the tax stimulation of the 1964–65 period. That was, I understand, somewhere in the range of $14 billion to $15 billion, so you have to have $35 billion to $40 billion, if I am correctly informed, to achieve the same degree of general stimulation in this economy.

So, although I am very conscious and worried about the peculiarities of the current inflation, if that is what they are, I am not at all sure that we shouldn't be thinking in larger terms, and perhaps trying to devise newer techniques for dealing with certain aspects of inflation. I have been here long enough to have gone through the phase of the attempt to control wages and prices in the OPS, both in the legislative phase and in the actual administrative phase. And I was never particularly thrilled by our success. But there has been a lot of thought and a lot of discussion. I don't know whether this is the right way to say it, but it might be possible to do a more effective kind of job of dealing with inflation with a less blunt and detailed set of instruments. I would like you to comment on that aspect. Is it conceivable that we could have more stimulus, more general stimulus, at the same time as we begin to devise the ongoing programs that would lead to hope among the young, particularly in the inner cities, so that they would have a period of training and education and work for pay that might then lead into the regular labor market, with a system, perhaps, of tax subsidies for employment? In other words, take everything and try to time it so that you have a rational approach to the next 4 or 5 or 10 years. I am not suggesting that we could be accurate in our predictions. But is there any reason why we shouldn't be thinking in terms as integrated as that or as complex as that?

Mr. KARCHERE. Do you want me to start, sir?

Representative BOLLING. Sure.

Mr. KARCHERE. I think we have a view of the American economy that goes back over the past 5 years that is imprinted in our memory.

And the record over the past 5 years has been abysmal. There have been two recessions, and the worst inflation in 30 years. As a consequence, we tend to forget that we really went through a 10-year period of expansion, from 1961 on. The first 5 years of that expansion were basically noninflationary. We forget that. And I am really suggesting to you that where we are now is about where we were in 1962.

As a matter of fact, we are better off in terms of having a cushion for a noninflationary expansion. We have more unemployment, and as deplorable as it is, we are not going to be bumping up against scarcities in the labor supply. We have at least as much excess plant capacity. So it seems to me that we view the world with unnecessary alarm.

I think that it is not difficult to have reasonably successful economic policy when there is a cushion of unused resources. It is very hard to keep the economy on an even keel when there is full employment and no excess capacity. But we don't have that problem. We have a problem where we have ample excess capacity, we have a problem where, in terms of the argument I made earlier, the private sector of the economy has a tendency to run down, not to develop a kind of huge upward movement that is going to run us into an excess demand kind of inflation. So the problem of economic policy over this period is to kick the economy along to a decent growth path. And I guess I feel reasonably confident that we can do that without developing a great deal of inflation.

Now, to get back to the unemployment problem, it would seem to me that this general program that you have just suggested, getting the economy going, providing jobs and education, and then hopefully having a labor market which would support the graduates of that program in jobs which they were proud to have, that, it seems to me, is a very reasonable and sensible approach.

Representative BOLLING. Before I leave you and go on, what about the business of exploring the techniques—I don't know how to say this—of dealing with inflation in a less than across the board approach? What we have done, for a variety of reasons, most of which are political, is some experimentation, and then backed away and done a lot of talking. Then for reasons that are wholly political, the whole thing disappeared from the conversation, at least at the political level. It seems to me that we need some experimentation in terms of technique.

Mr. KARCHERE. It seems to me that managing noninflationary growth when we were very close to full employment and very close to full capacity is something that we, or any of the other industrial countries, except some of the small ones, have really learned very much about.

Representative BOLLING. Don't you think we ought to try pretty hard to not get in a lot of trouble when we hopefully get to the——

Mr. KARCHERE. I agree with you.

Representative BOLLING. But you don't know how to do it anymore than I do, do you?

Mr. KARCHERE. No; I don't.

Representative BOLLING. Mr. Gramlich.

Mr. GRAMLICH. You haven't heard much disagreement this morning, so I will throw the first stone here.

A lot of what Mr. Karchere just said I could agree with. It is true that we have lots of slack in both the labor and product markets, and there is a way to go before I think most of us would stay awake nights thinking about inflation. However, I think that it is impossible to put inflation aside after what we just have been through. There are a number of things I think are different about the present situation than was true in the 1960's. And all of them point in the wrong direction. The first is that we have unfortunately had a fairly long period of rapid inflation. And so inflationary expectations aren't what they used to be. They used to be basically not much of the problem. But now at the first outbreak of new inflation it is liable to become a very serious problem, simply because we have been there once.

The second thing is that the United States is now much more at the mercy of movements in international economic forces than we ever were before. For one thing, we have flexible exchange rates, which I am in favor of. But that means that it becomes more difficult to control our own inflation rate. And we all know about the oil problem. And as far as I can tell, this is nothing to prevent OPEC from putting us through the ringer again.

So for those reasons I think that is really impossible to think only about the unemployment problem. If we don't solve the inflation problem, we are just never going to have a very good and satisfactory solution to the unemployment problem.

Now, I think there are ways of doing that. And I agree that since we have got new problems, it is time to think about new solutions. There are some things that have been suggested about making payroll tax cuts in exchange for responsible wage behavior, and I think it might even be time to take another look at some sort of modest form of—I hate to say the word—but guideposts or price and wage controls. But I do think that we do have to recognize that we are in a different world now, and despite the fact that there is lots of unemployment around, you can't just forget about inflation and believe it won't be there, because it just might. And then we would be in trouble.

Representative BOLLING. Thank you.

Mr. Levy, do you want to comment?

Mr. LEVY. Well, I am glad to find an opportunity to disagree, since we have all been agreeing so much.

I would like to disagree with a number of points Mr. Karchere made. The comparison with the 1960's is a useful one, but, as I indicated in my prepared statement, we are in a much different environment at present. Let us not only remember that we have good growth and reductions in unemployment during the first half of the 1960's, let's also remember that we had price stability. We started the Vietnam inflation period in 1965 with inflation rates that were in the 1 to 2 percent range.

We have come down recently from double-digit inflation, and all of us are very happy at present that we are in the 5 to 6 percent inflation range. But in 1965 if you had talked about 5 to 6 percent inflation, people would have asked whether the country can survive that level of inflation. So our starting point is what in 1965 would have been considered a disasterous inflation rate. Therefore, even though we have some headroom in terms of underutilized capacity, even though we have a lot of slack in the labor force, the inflationary specter is still with us, as Ned Gramlich has pointed out. Moreover, we probably suffer from a great deal more inflation at present than we can live with. Also, we have no experience as to whether our economy can stabilize for any length of time at 5 to 6 percent inflation without having inflation accelerate again.

We have also noticed—some studies have found—that in the United States inflation seemed to have a depressing effect on real output and growth. The American consumer, in contrast to many European consumers, does not rush out and go on a buying spree when he feels that his purchasing power is being eroded by inflation. The American consumer becomes very anxious, very fearful, and tends to hold back on spending. Business does not rush out and invest in a highly inflationary environment. I think part of the recent sluggishness of our economy is related to the fear that inflation might take off again. I think therefore, that there has to be much more concern about inflation at present than during the 1960's.

I want to look now at this $30 billion stimulation mentioned by Mr. Karchere, $30 billion to $40 billion annual stimulation gives you about a $7.5 to $10 billion quarterly, on the average. As I looked at my figures of fiscal thrust $7 billion to $10 billion quarterly would be equivalent to about a half a percent of GNP in extra simulation each quarter. This would raise my estimates of fiscal thrust from about half a percent of GNP per quarter to about 1 percent per quarter. This degree of stimulation would probably compare favorably with the 1964–65 experience, if you adhere to it for a year or more. The highest levels of stimulation which were mentioned by Mr. Karchere—$30 billion in terms of tax cuts combined with extra spending programs—would probably make the budget as expansionary, relative to the present size of the economy, as it was in the midsixties.

But let us also not forget that Mr. Karchere was tracking his simulations roughly along path 3 of the current services budget for fiscal 1978. His simulation, if I recall correctly what he said, would add about $20 billion to the budget deficit. Path 3 of the current services budget projects a $56 billion deficit in fiscal 1978. Add $20 billion to this and you are talking in terms of a $76 billion deficit. I hate to think of a deficit in 1978 of $76 billion when Congress may be deliberating whether to phase in an important new program such as, say, national health insurance, or some other programs that have a high priority, in the thinking of many persons.

Over the past year we have seen that Congress is sensitive to large deficits, that the voter is sensitive to them. And when deficits reach such an order of magnitude, the economy drive dominates the public sector and it becomes vertually impossible to introduce major new initiatives. From this point of view, our leeway for short-term stimulation seems to be far less—taking into account the interaction of economic and political forces—than has been indicated in some of our discussions.

This is exactly where the conflict between short-term and longer term policy targets come in which was mentioned earlier. This is exactly the reason why, in designing stimulation, we should also keep longer term trajectories of the public sector in mind, why we should interphase tax cuts with tax reform, and general stimulation with structural employment programs. This way we don't need additional dollars for each purpose and component, but that some of these dollars will do double and triple duty.

Representative BOLLING. Thank you.

Mr. Brown.

Representative BROWN of Michigan. Thank you, Mr. Chairman.

I think it is wonderful to discuss these things in kind of a "macroway" instead of a "microway."

Let me just report a couple of experiences that happened to me in the last 2 or 3 weeks. A county engineer in on of the counties in my district, who is kind of a general superintendent over all public works projects, said that the funds that are presently pretty much assured to that college, under the public works bill, the EDA program, and all other programs presently pending, are of such a magnitude there probably aren't the tradesmen to perform the work under the kind of time schedule that is required by the legislation.

I had coffee with a welder who didn't have a job temporarily in that area. He would have had to drive 40 or 50 miles to be able to find work. He would be getting his full scale, of course, but he figured out that would take him an hour and a half drive both ways. And he figured that to get in an 8 hour day he would have to be spending 11 or 12 hours. With the unemployment compensation that he was getting he just couldn't see that it was worth while. He knew his position was going to be temporary, because his unemployment comp would last until the middle of January or February, and by that time there would be jobs close to home. So it just wasn't worth while for him to go out and do it.

To digress a little further, the chairman regularly, and quite rightly, I think, has emphasized our concern about the really high unemployment areas of teenagers, minorities, et cetera. It seems to me that we have got to have specific programs if we are going to add stimulation, so that we just don't add stimulus willy-nilly. The kind of stimulus that is going into this one county, is going to be stimulus that is not going to be cost effective in the end, I believe, because it is going to dry up the demand for tradesmen. It is not going to be as cost effective as if it were funding that could be fully utilized without putting an excess demand in the market later.

So the unemployment compensation arrangements stop this one tradesman that I was telling you about from going to a job 40 miles away. When I was working on construction, I used to drive 60 miles morning and night. So if all of the things you are talking about don't do something to help the minorities and the teenagers, that have high unemployment, we are still going to have bad unemployment.

Aren't we looking at this too much in the way of figures, and not looking at the institutional problems within our employment?

Mr. GRAMLICH. Could I try to comment on that?

I am going to make a little bit of an apology for macroeconomics. And I make it because I believe it. The first thing is, you are always going to find stories, no matter how high——

Representative BROWN of Michigan. I don't think these are isolated incidents.

Mr. GRAMLICH. It is a big country, and you always will be able to find a lot of pockets in the labor market where firms can't get labor, can't get the right type of labor, and so forth. Nobody denies that. And nobody denies that right now there aren't some pockets of tight unemployment. That would be another reason which I didn't mention why it would be worth thinking about inflationary pressures, even though general unemployment is high.

The second point you made was about unemployment insurance. And there is no question that our whole view of unemployment has to be different now that we have a fairly comprehensive unemployment insurance program, as contrasted with the old days in the thirties when we didn't. On the other hand, I don't know what to do about that. I don't think that I would want to strip away unemployment insurance. I think, for example, that there is nothing wrong with a system that allows people to take awhile and find a job that they like. I don't really believe in the forced shotgun marriage approach to labor markets. I think that if we have unenmployment insurance we may have to reinterpret the statistics but I think it is a good thing to have.

The third thing I would like to say is that basically I think you are suggesting the kinds of things we are, too. I think all of us are maybe a little more for general stimulation than you are. The reason for that is, as it has been shown, that if you have general stimulation of the economy, that that really opens up the labor market all along, and people get promoted into better jobs, and that sort of thing. Those benefits of full employment should not be dismissed. And we ought to keep striving for them. But at the same time, it is clear that there are a lot of structural balances in the labor market. And that is really why some of us are recommending programs to try to get at that problem.

Mr. KARCHERE. I should like to say something about this general problem, if I may.

I know when one looks at the unemployment rate, the rates for minorities, particularly the black young people, you will find it just horrible. And we have a tendency as a consequence to think that that is where the unemployment problem is. And it really isn't. The bulk of the unemployed are men in the prime of their life who are willing to work.

I went through a list of these unemployment rates for men over 20. For experienced workers and similar categories which indicates the unemployed are those people who are able and willing to work. The unemployment rates for those groups as compared to the previous cyclical peak have doubled. And the rates for the smaller groups, which have very high rates, have not doubled. The bulk of the labor force are essentially experienced workers. And that is where the unemployment is. We have horror stories of 40 percent rates for black young people, and they are horror stories. And we tend to focus on that. But, really, our problem is that we have too much unemployed for everybody, and the people who are out of work are a fair representation of the labor force. And since the bulk of the labor force really are men, the bulk of the unemployed are men. And it seems to me that at a rate of unemployment close to 8 percent, we have something that really is close to a national disgrace. So it seems to me the focus of policy really has to be to get that down.

Now, I agree with you that unemployment compensation can be abused. And it would be nice to find an unemployment compensation scheme that was abuse free. And perhaps one can be designed. But I don't think the fact that there are people who abuse the unemployment compensation scheme is a reason to think that we really don't have a serious unemployment problem.

Representative BROWN of Michigan. I don't consider this fellow abusing it, he is just doing the thing that is more economical for him. He is utilizing that which is available. But you see, when you tie those two things together, here is a fellow who has a job 40 miles away, and you have a county with jobs begging, you get the full force of the problem. Because the unemployment program is such that it doesn't provide an incentive for him to go and get that job, he is an unemployed person 40 miles from a job going begging.

Mr. KARCHERE. I understand.

Representative BROWN of Michigan. I listened to your figure about the bulk of where the unemployment is. As I recall, the last time we had the unemployment figures, white male adults I think were something like 4.1 percent. And if you take the temporary noncyclical unemployment which Mr. Shiskin runs from two percent up to 3.8 percent, that is, the unemployment that is unrelated to economic cycles. An example is the unemployment that exists because a fellow just decides he wants to change jobs and wants to improve himself, so he is temporarily unemployed. And that percentage is always there in our unemployment.

Don't you think that our attention to the figure is a little overboard?

Mr. KARCHERE. You can look at a lot of figures. The figure that I think would be forth looking at is the unemployment rate for experienced workers. And that is over 7 percent. There are a whole series of these things that one can look at. I just don't think, by parceling out that 8 percent unemployment rate, that you can really come up with a conclusion that we don't have a very serious problem. I think we do have a very serious problem, almost any way you can cut it.

Mr. LEVY. May I just add a comment on this.

I think if you adjust the unemployment rate at present to account for the fact that we do have more women and more teenagers in the labor force these have higher unemployment rates than the prime male labor force, traditionally and for a variety of reasons—after that adjustment for comparability with the 1960's, I think the unemployment rate would still be at present in the 6.75 to 7 percent range. I don't think it would be any lower than 6.25 percent even after the most generous downward adjustment for comparability to the mid-1960's in terms of shifting the labor force composition. Thinking back to the period of the 1960's such an adjusted unemployment rate of 6.75 to 7 percent at that time would clearly have been considered excessively high. Therefore, apart from the structural unemployment problem, there is clearly a great deal of room for more rapid economic growth as a means for absorbing those who are unemployed and comprise part of the prime labor force.

This does not of course eliminate the need for structurally targeted employment programs. But I would also like to point out that while a more structural attack on our unemployment problem probably is necessary and important in the longer run, it is easier to inflate aggregate demands than to design good structural programs.

I have read, with interest that some Governors seem to favor supplemental revenue sharing based on unemployment rates, so that States and regions suffering from very high unemployment receive a larger share. Given the regional differences as well as structural differences in unemployment, this approach would appear to merit serious review and consideration. But the moment you get into structural or regional employment programs, one is bound to look at the regions, the States, and the communities that are likely to benefit. At that point, as we all know, the political aspects become much more intricate.

In conclusion, there is great need for a more detailed structural approach, but it is difficult to design viable programs along these lines.

Representative BROWN of Michigan. Let me suggest, it is easy to design them, but it is very hard to get any benefit out of them.

I had a pure countercyclical job program that didn't get much support because there were many areas that were below the triggering device. But at the same time these same people will make political decisions to pay unemployment compensation to those same areas, where it is grossly disproportionate to other areas where there is not as much unemployment. It is awfully hard for me to understand that incongruity. They are willing to allocate unemployment compensation dollars on a regional basis, but not job dollars.

Mr. LEVY. Sometimes I am glad that I am an economist and not a political scientist.

Representative BROWN of Michigan. If you attempted to do something, as the chairman has suggested many times, and I concur with him, in attempting to help the teenager along in pursuit of the hope that he can work into the work force, what would you suggest? You talked about maybe a wage subsidy, a wage training subsidy. But, how do you implement this program?

Mr. Gramlich.

Mr. GRAMLICH. I have to confess I am ignorant on just how you would design a wage subsidy. One thing I did want to say to an earlier question, which is right in this area, is that in fact there is a very simple way, that wouldn't use any budgetary dollars, to stimulate teenage employment. It is something that a lot of economists have talked about for a long time, something that never gets anywhere politically. But it is introducing a youth differential in the minimum wage. I have just completed a research project on that. And I do find that for teenagers, minimum wages have detrimental effects. There may be some important social reason for them, but it is really hard to find it, because on the one hand teenagers themselves seem to be worse off in having reduced probability of full-time job employment that appears to more than overbalance the higher wages they get. And the second thing is that the income distribution consequences of wage subsidy programs for teenagers are entirely different than they are for adults, and essentially not favorable. In any case that is one good way of stimulating employment—which will raise the hackles of the unions, but if we are going to think seriously about the problem, that is one thing that ought to be considered. That would be relatively easy, because you don't need any bureaucracy or anything like that.

Representative BROWN of Michigan. Why should an employer be required to pay a wage which is not reflective of the productivity of the person involved and the hours involved. Because the nation in a general social consciousness decides that there should be a decent hourly wage? If there is a general social consciousness that says that a person should receive a decent wage, should not the employer be required to pay the portion of that wage which reflects productivity in his particular industry, and the Government make up the difference between that wage and the wage that we have decided is a decent wage?

Mr. GRAMLICH. That is the general rationale for either one of these programs.

Representative BROWN of Michigan. Differentials don't do it, because a differential still requires the employer to pay the wage even if there isn't productivity.

Mr. GRAMLICH. What I am talking about is having the lower minimum wage for the teenagers.

Representative BROWN of Michigan. I understand.

Mr. GRAMLICH. The employer may still have to pay too much in your view, but exactly where we put the teenage minimum wage is something we can argue about.

Representative BROWN of Michigan. Let me ask you this. We have of course the investment tax credit. As I recall, the investment tax credit is paid for plant expansion, equipment modernization and everything else, irrespective of whether or not that capital expenditure is job producing or job eliminating. Am I not correct?

Mr. GRAMLICH. Yes.

Representative BROWN of Michigan. Why shouldn't the investment tax credit only be applied to those kinds of capital improvements which are job producing when we have the unemployment structure and the problem that we have today? If you were going to purchase a machine that will replace two people, really is it in the national interest that there should be a tax credit for it?

Mr. GRAMLICH. I guess I would——

Representative BROWN of Michigan. I am just being the devil's advocate.

Mr. GRAMLICH. An investment tax credit for employment is kind of a double edged sword. On the one hand, it may stimulate some substitution away from employment and in favor of capital. But on the other hand, it will stimulate economy. And usually, if you look historically, usually an investment tax credit is imposed in periods when the economy is lagging. And there is no question in my mind that the employment stimulus of that in getting the economy back toward full employment far outweighs the substitution effort. But with an employment credit, on the other hand, you have both going in your favor. And I certainly don't want to say that the investment credit is better. I would prefer an employment credit to an investment credit.

Representative BROWN of Michigan. Does anyone else have a comment?

Mr. KARCHERE. I have a view on that. We focus on the problem of unemployment and providing jobs. And it seems to me that when you look at the problem that way you put the cart before the horse. Our problem is the problem of stimulating demand. If you stimulate demand, then we will produce more. If we produce more, we are going to hire more people. And so it is extremely difficult, it seems to me, to basically provide legislation on the employment side, and it seems to me also that in large measure, except for isolated structural problems, it is unnecessary, that the way to get more employment is to get more production, and the way to get more production is to get the economy moving. And then some of these problems that we have, that we really can't deal with when we have an 8-percent unemployment rate, some of these unemployment problems go away all by themselves. And eventually we are left with the real tough ones. And it seems to me that we ought to use this time as we are getting the economy moving to do the work that will enable us to handle the tough problems. But the clear priority in my mind really is to get the bulk of the people who are out of work, at work. And the way you do that is to get the economy moving, get the demand for goods and services up.

Representative BOLLING. Gentlemen, we are very grateful to you. I think it has been a very useful hearing. And unless some of you have a further comment you would like to volunteer, I propose to adjourn the committee for probably 15 minutes. We will reconvene at 11:30 with a different subject, our monthly discussion of the employment situation. We thank you very much.

The committee stands adjourned.

[Whereupon, at 11:15 a.m., the committee adjourned, subject to the call of the Chair.]

[The following information was subsequently supplied for the record:]

RESPONSE OF EDWARD M. GRAMLICH TO ADDITIONAL WRITTEN QUESTIONS POSED BY SENATOR TAFT

Question 1. Mr. Gramlich, in your prepared statement, you mention the effect of inflation on the tax rate structure as a major cause of the last recession. Treasury says that current rates of inflation are pushing people into higher brackets by $5 billion in extra real tax burden each year, and Congress failed to offset this for three years before the last recession.

Since we have had a full year of inflation, higher wages, and increased withholding taxes since the tax cut of 1975, is it not likely that this same inflation impact is partly responsible for the current economic pause?

Do you favor indexing the personal income tax to adjust automatically for inflation to avoid this danger of periodic recessions, assuming that Congress does not learn to adjust the rates annually itself? We would still be free to set the overall level higher or lower should new programs or policies be agreed upon.

Answer. I think the $5 billion inflation-induced increase in real income tax payments is clearly one of the causes of the current pause, though probably of less importance than the mysterious slowdown in expenditure growth.

The question of explicit indexing is more difficult. I would favor various kinds of measures to eliminate inflation-induced distortions in investment behavior—current cost depreciation, taxation of only real interest earnings and deduction of real interest costs, and the like. For rates in general, I don't feel strongly but would be inclined to oppose indexing because I would like Congress to be forced to reexamine the tax structure periodically and to have some revenue to be "given back" as an inducement to eliminating many tax expenditures that I feel are unwarranted.

Question 2. You suggest a temporary tax cut to stimulate the economy. Prof. Friedman recently won the Nobel Prize in part for his work on consumer responses to tax cuts. His "permanent income hypothesis" states that consumers do not adjust their spending habits very much unless they perceive a permanent change in their income. A permanent tax cut is largely spent. A temporary tax cut is largely saved. Since our main concern right now is for a quick improvement in economic activity, shouldn't we favor a peramnent tax cut? A permanent tax cut would not have to be as large as a temporary one to have the same impact, and we could offer further cuts next year as an inducement to tax reform.

Answer. A permanent cut would indeed be more effective per dollar than a temporary cut, for the reason you suggest. Yet a temporary cut can still have a strong impact on the economy for two reasons:

(a) Much of what Friedman would define as saving is really expenditure on consumer durables, which would stimulate employment;

(b) I think consumers will probably assume, rightly, that a temporary cut will be extended and therefore is, in effect, a permanent cut. I would thus predict it to have effects on spending nearly as large as that of a permanent cut. But at the same time the fear that the temporary cut will lapse should spur Congress to eliminating some tax expenditures and raising other revenues in the future. Total tax revenues would then be lower for a time, and then back up; and the law would read as a temporary cut.

Question 3. Since the cost of labor to the firm is inclusive of payroll and withholding taxes, and take home pay is exclusive of these taxes, doesn't any kind of payroll or income tax increase drive up labor costs, or reduce take home pay? Doesn't this have a directly adverse effect on employment?

Answer. I think you could probably argue that all taxes really imposed on the employee (income taxes and the employee contribution) are paid by that employee and don't affect the firm much one way or the other (apart from their impact on overall aggregate demand). The employer contribution does indeed raise the price of all labor and is probably passed through to product prices. I would expect the main impact to be on price levels, not on employment.

Question 4. You mention employment tax credits. If we have both investment tax credits and labor tax credits, don't we in effect have a sort of corporate income tax reduction on aditional output? Capital and labor are the two largest factors of production used by corporations, aren't they? Would a cut in corporate taxes, with perhaps the repeal of the investment tax credit, do more to stimulate hiring?

Answer. If the employment tax credits were general, as say a cut in the payroll tax, they would indeed have the effects you say. I was talking about a selective credit on hiring low wage or disadvantaged laborers. There would be a price inducement for hiring capital (investing) and unskilled workers, but against hiring skilled workers.

Response of Michael E. Levy to Additional Written Questions Posed by Senator Taft

Question 1. Mr. Levy, inflation is pushing taxpayers into higher brackets and increasing their real tax burden by $5 billion a year, at current inflation rates, according to the Treasury Department. How does your measure of "fiscal thrust" record this effect, since it does not involve a Congressionally legislated change in the tax rates?

Answer. You noted correctly, Senator Taft, that the additional tax revenue generated by inflation does not represent a structure tax change. Therefore, it is not a part of our measure of "fiscal thrust." Of course, this should not imply that the extra tax bite does not exert a restraining influence on aggregate demand, real growth and inflation. This inflation-induced extra tax revenue represents a feedback from the economy into the budget just as, say, increased unemployment compensation that is caused by a weak economy and higher unemployment represents a feedback on the expenditure side. Economists usually consider these feedbacks under the heading of "built-in stabilizers"; these are not part of autonomous fiscal stimulation or restraint, but they affect the size of the so-called Keynesian multiplier. Specifically, because of the larger tax bite, autonomius fiscal stimulation of a given size (as measured by our "fiscal thrust") may result in fewer rounds of subsequent spending and responding in the private sector of the economy than if we had, for example, a proportionate income tax with a single tax bracket and rate. The larger the tax bite of the tax system, the smaller the "leverage" of autonomous fiscal stimulation.

Question 2. Mr. Levy, Mr. Gramlich mentioned the effect of inflation on the progressive tax rate structure as a major cause of the last recession. We have had 5 percent inflation since the tax cut of 1975. Can you provide an estimate of how much of the current pause in GNP is due to the $5 billion real tax increase since 1975, and how much is due to the Federal spending shortfalls?

Answer. I don't think we know enough about the effects of inflation on our economic system to answer your question. As I had mentioned earlier, the American experience shows that inflation tends to act as a depressant on consumer spending and business investment—and, therefore, on real economic growth. This is independent of the tax effect which you have mentioned, but our current research is not sufficiently sophisticated to separate out these two effects. Moreover, inflation increases Federal revenue not only because it pushes taxpayers into higher brackets; nominal corporate profits also get inflated and result in higher corporate profits taxes. I have estimated that the inflation component of the growth in GNP during the last five quarters since the 1975 tax cut amounted to about $113 billion. This, in turn, has added roughly $25–$35 billion in extra revenues to the Federal government—compared with a situation of perfect price stability during this period. In this connection, it is worthwhile to remember that the so-called built-in stabilizers of the Federal budget provide a cushion to the private sector when the economy is sliding—but they also slow down the space of the economic advance when the economy is recovering and moving ahead.

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