805

94th Congress } JOINT COMMITTEE PRINT
2d Session }

AN ECONOMIC EVALUATION OF THE CURRENT SERVICES BUDGET, FISCAL YEAR 1978

A STAFF REPORT

PREPARED FOR THE USE OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

DECEMBER 21, 1976

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE
79-746 O WASHINGTON : 1976

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402 - Price 65 cents
There is a minimum charge of $1.00 for each mail order

JOINT ECONOMIC COMMITTEE

(Created pursuant to sec. 5(a) of Public Law 304, 79th Cong.)

HUBERT H. HUMPHREY, Minnesota, *Chairman*
RICHARD BOLLING, Missouri, *Vice Chairman*

SENATE	HOUSE OF REPRESENTATIVES
JOHN SPARKMAN, Alabama	HENRY S. REUSS, Wisconsin
WILLIAM PROXMIRE, Wisconsin	WILLIAM S. MOORHEAD, Pennsylvania
ABRAHAM RIBICOFF, Connecticut	LEE H. HAMILTON, Indiana
LLOYD M. BENTSEN, JR., Texas	GILLIS W. LONG, Louisiana
EDWARD M. KENNEDY, Massachusetts	OTIS G. PIKE, New York
JACOB K. JAVITS, New York	CLARENCE J. BROWN, Ohio
CHARLES H. PERCY, Illinois	GARRY BROWN, Michigan
ROBERT TAFT, JR., Ohio	MARGARET M. HECKLER, Massachusetts
WILLIAM V. ROTH, JR., Delaware	JOHN H. ROUSSELOT, California

JOHN R. STARK, *Executive Director*
RICHARD F. KAUFMAN, *General Counsel*

ECONOMISTS

WILLIAM R. BUECHNER	ROBERT D. HAMRIN	PHILIP MCMARTIN
G. THOMAS CATOR	SARAH JACKSON	RALPH L. SCHLOSSTEIN
WILLIAM A. COX	JOHN R. KARLIK	COURTENAY M. SLATER
LUCY A. FALCONE	L. DOUGLAS LEE	GEORGE R. TYLER

MINORITY

CHARLES H. BRADFORD	GEORGE D. KRUMBHAAR, Jr.	M. CATHERINE MILLER
	MARK R. POLICINSKI	

LETTERS OF TRANSMITTAL

December 20, 1976

To the Chairmen and Members, Committees on the Budget, United States Senate and House of Representatives:

Sec. 605 of the Congressional Budget Act of 1974 requires the Office of Management and Budget to submit by November 10 of each year "the estimated outlays and proposed budget authority which would be included in the Budget . . . for the ensuing fiscal year if all programs and activities were carried on during such . . . year at the same level . . . and without policy changes." It further requires that the Joint Economic Committee "shall review the estimated outlays and proposed budget authority so submitted, and shall submit to the Committee on the Budget of both Houses an economic evaluation thereof on or before December 31 . . ."

I am pleased to transmit herewith in accordance with Sec. 605 an economic evaluation prepared by the Joint Economic Committee staff at my instruction.

In addition to this staff evaluation the Joint Economic Committee has had the Congressional Budget Office review the Office of Management and Budget submission and has held hearings on the current services budget, receiving testimony from the Director of the Congressional Budget Office, the Deputy Director of the Office of Management and Budget, and public witnesses.

The Committee has been advised both by the Director of the Congressional Budget Office and by the Committee staff that the estimates submitted by the Office of Management and Budget have been carefully prepared and appear to comply fully with the letter and spirit of Sec. 605.

Because the current services budget estimates are prepared almost three months before the President's Budget recommendations, economic conditions and congressional action can change the base upon which the President's Budget is estimated. For these reasons I have been advised both by the Director of the Congressional Budget Office and by the Committee staff that it would be very helpful to the Congress for an updated version of the current services budget to accompany the President's Budget in January. If this is done, the Congress can more readily distinguish between budget revisions due to legislative and executive action and changes in economic conditions on the one hand, and the policy recommendations of the President on the other. I have urged the Director of the Office of Management and Budget to provide such updated current services budget estimates along with the President's Budget in January. I also understand that the Congressional Budget Office is preparing an updated version of their five-year projections which will be most helpful to Congress.

In order to make our evaluation of the current services budget as useful as possible to the Congress, I have asked the staff to analyze the probable impact of various possible changes in budget policy. The staff report transmitted herewith contains the first results of this analysis. As we all know, the budget is not a once-a-year event but a continuous process. The Joint

Economic Committee will be conducting further analyses of possible changes in budget policy and will make the results available periodically.

Hubert H. Humphrey, Chairman
Joint Economic Committee

December 20, 1976

The Honorable Hubert H. Humphrey
Chairman, Joint Economic Committee
Congress of the United States
Washington, D. C.

Dear Mr. Chairman:

In accordance with your request for the staff of the Joint Economic Committee to evaluate the Current Services Estimates for Fiscal Year 1978, prepared by the Office of Management and Budget, I am pleased to submit the attached report. This report was prepared by Douglas Lee, Beverly Park, and Courtenay Slater of the Committee staff.

The Congressional Budget Office has prepared five-year estimates of Federal receipts and outlays using economic assumptions supplied by the Committee staff. These estimates and an analysis of their implications are contained in the staff report transmitted herewith.

The current services estimates for 1978 presented as part of these five-year projections differ somewhat from the estimates submitted by the OMB. This is due in part to differences in economic assumptions, in part to technical differences in estimating techniques, and in part to the use of the Second Concurrent Resolution on the 1977 budget as a base for projections by the Congressional Budget Office. These differences in budget totals in no way imply that one set of estimates is "right" and the other "wrong." As we have all learned, budget estimation is a complex endeavor and variations among different sets of estimates are inevitable.

The views expressed in this document do not necessarily represent the views of the Members of the Joint Economic Committee.

John R. Stark, Executive Director
Joint Economic Committee

TABLE OF CONTENTS

79-746 O - 76 - 2

TABLES

I. INTRODUCTION

Submission of the 1978 Current Services Budget marks the first step in the official process of formulating the fiscal year 1978 budget. The Congressional Budget Act of 1974 calls for the preparation of current services estimates by the Office of Management and Budget and an economic evaluation of those estimates by the Joint Economic Committee. The following report presents an analysis of those estimates by the Committee staff.

The report that has been prepared by the Office of Management and Budget (OMB) focuses primarily on the budget estimates themselves and the manner in which they were derived. The Congressional Budget Office (CBO) has reviewed these estimates at the Committee's request and has advised the Committee that the OMB estimates appear to be free of any serious inaccuracies. The Committee staff concurs that OMB has done a professional and competent job. This review, therefore, will focus less on the numbers themselves and more on ways these numbers can be used in policy analysis.

In December of 1973, the Joint Economic Committee (JEC) published a staff study which presented current services estimates for fiscal year 1975. In transmitting that report, it was described as a "baseline" projection of 1975 expenditures. Essentially this is an estimate of what expenditures would be if existing programs were allowed to grow at rates predetermined by legislation already enacted and by current and anticipated economic conditions. It is in no sense a recommendation of what the expenditure total should be or of the allocations that should be made within that total. A similar JEC staff study was prepared in December of 1974 projecting the 1976 current services or "baseline" budget. The document presented by OMB, while it contains a great deal more detailed information, is of the same nature and purpose.

A "baseline" or current services budget is especially helpful in evaluating alternative budget proposals made by the President and Congress. Since the "baseline" assumes no policy changes, the difference between an up-to-date baseline and the budget estimates presented in the Presidential recommendations submitted in January would be the policy proposals of the President. Likewise, a comparison of an up-to-date current services budget with the First Concurrent Resolution on the Budget that Congress will prepare in the spring will show the policy decisions made by Congress.

All budget estimates, of course, need to be continually updated for unanticipated changes in economic conditions as well as for executive and legislative actions. Therefore, the budget submitted by the President in January will differ from the November 10 current services budget in two ways. First it will be updated to reflect a new judgment on the economic outlook, and second it will incorporate the policy recommendations of the President. It would be extremely helpful to the Congress to be able to separate the updating from the policy recommendations. The Director of the CBO testified before the Committee that she believes updated current services estimates should accompany the President's budget. The Committee staff concurs in this recommendation.

To repeat a point made in earlier JEC reports, it must be recognized that decisions reached by Congress during consideration of a particular year's budget can have only a limited impact on spending in that year. Current spending levels and resource allocations were largely determined a year or more ago by decisions incorporated into earlier budgets. It stands to reason that Congress should spend considerable time on future planning as it is in a much better position to influence future budgets and future priorities than current ones. Accordingly, earlier staff reports were described as interim steps toward a goal of five-year budget projections. This year the Congressional Budget Office has prepared five-year projections which were presented to the Congress on December 1, 1976. They have been made based on existing law, assumptions about the renewal of existing programs which are not temporary, and three underlying projections of the economy, one of which was supplied by the Joint Economic Committee staff.

These projections together with an update planned for January should be most helpful to the Congress as it prepares the 1978 budget.

The Spending Shortfall

During fiscal year 1976 and the transition quarter, spending fell substantially below the estimates prepared by the Office of Management and Budget and the Congressional Budget Office. Depending on how it is measured, spending fell as much as $10 billion below the estimates for fiscal year 1976 and $8 billion below the estimate for the transition quarter. The reasons for this shortfall have been thoroughly explained by the Director of the Congressional Budget Office and OMB. The relevant question for 1978 is: did the shortfall affect the base upon which the 1978 budget is calculated?

The answer to this question is both yes and no. The answer is no in the sense that spending now appears to be back on track as planned in the Second Concurrent Resolution on the FY 77 budget. The relatively small amount of spending which may spill over from 1976 and the transition quarter into 1977 in all probability will be be offset by downward reestimates in several programs. Therefore, the shortfall will have little direct effect on the 1977 and 1978 budgets. This assumes, of course, that the policies envisioned in the Second Concurrent Resolution are carried out as planned. If the new Administration and Congress decide that additional economic stimulus is required, a new concurrent resolution would be necessary.

The shortfall, however, has had a definite impact upon the growth of the economy in 1976. Director Rivlin testified that had the shortfall not occurred, real economic growth might have been as much as 1 percentage point higher (annual rate) in the second and third quarters of 1976. 1/ Thus, while the shortfall may not have affected the 1978 budget directly, it has weakened the economy which underlies any budget projection. To the extent that a weak economy causes increased expenditures for unemployment compensation and related programs, and lower tax receipts, the shortfall will have a budget impact which is likely to continue into 1978.

1/ Precise estimates of the economic impact of spending changes are always subject to dispute. Paul O'Neill, Deputy Director of OMB, testified that in his judgment the 1 percent estimate was too high.

The Outlook for Fiscal Year 1977

Since the adoption of the Second Concurrent Resolution in September, the outlook for the economy has worsened. The spending shortfall contributed to this deterioration and investment growth failed to meet expectations.

Because of the weaker economy, the budget deficit for fiscal year 1977 probably will be $10-15 billion larger than the $50.6 billion planned in the Second Concurrent Resolution. The majority of this increase in the deficit is caused by the lower tax receipts generated by the weaker economy. On the spending side, higher unemployment-related expenditures will be partially offset by lower interest payments and other revisions. Since the policies set forth in the Second Concurrent Resolution would result in a $60-65 billion deficit, Congress probably will need to consider a Third Concurrent Resolution in early 1977 regardless of whether any additional stimulus is considered desirable. A Third Concurrent Resolution would, of course, present the opportunity for Congress and the incoming Administration to consider more stimulative fiscal policies.

II. ECONOMIC OUTLOOK

The rate of economic growth has dropped sharply in recent months and unemployment has risen. This has led to widespread discussion of the contribution which fiscal policy can make to more rapid growth in 1977 and 1978. Proposals to amend the 1977 Budget Resolution are expected to come under almost immediate consideration when the new Congress convenes in January.

An assessment of the economic outlook as it would be if current budget policies are maintained is a necessary starting point for the analysis of policy alternatives. The chairman of the Joint Economic Committee has therefore instructed the staff to prepare its best estimates of the <u>outlook as it would be based on current service levels of taxing and spending.</u> These estimates are discussed below.

<u>1977</u>

In its Midyear Report last September, the Joint Economic Committee stated that it expected growth of real output in 1977 to be between 4-1/2 and 5 percent, the inflation rate to be about 5 percent, and the unemployment rate to average more than 7 percent. Although some specific sectors of the economy -- notably business fixed investment -- now appear somewhat weaker than previously estimated, other sectors, such as residential construction, now appear somewhat stronger. On balance, the outlook appears little changed from the Committee's September estimates. At that time, the Committee noted that this "is not a satisfactory outlook. It represents a clear departure from the growth path which is essential if reasonably full employment is to be regained by the end of this decade."

The staff has compared its own most recent assessment of the outlook with the results produced by two well-known econometric forecasting models, in each case basing the forecast on current services budget assumptions. In all three forecasts, growth of real gross national product (GNP) in 1977 falls between 4-1/2 and 5 percent. Estimates of the inflation rate (as measured by the GNP deflator) range from 5.0 to 5.5 percent, and estimates of the unemployment rate in the fourth quarter range from 7.0 to 7.3 percent.

Impact of the Budget on the Economy. Purchases by the public sector (Federal, State and local) will grow a little less than 4 percent in real terms in calendar 1977. Federal transfer payments will remain roughly constant in real terms. Thus, the government sector will not provide the thrust needed to produce overall growth rates adequate to reduce unemployment.

Another way of describing the impact of the budget on the economy is to examine changes in the surplus or deficit which would result if the economy were to operate continuously at a constant level of resource utilization. Table 1 presents the budget surplus by half years as it would be if the economy were operating at the resource utilization level associated with a 4 percent unemployment rate. As shown in the table, the surplus would rise steadily from $3.4 billion in the first half of fiscal 1977 to $13.9 billion in the second half of fiscal 1978, meaning that fiscal policy will be exerting a restrictive influence on the economy.

79-746 O - 76 - 3

Table 1. Full Employment Receipts and Outlays (billions of dollars, National Income Account Basis)

	Fiscal 1977		Fiscal 1978	
	First Half	Second Half	First Half	Second Half
Receipts	400.8	422.6	445.5	467.9
Outlays	397.4	416.6	436.8	454.0
Surplus	3.4	6.0	8.7	13.9

SOURCES: Congressional Budget Office, Joint Economic Committee

This assessment assumes that Federal purchases are at levels provided in the Budget Resolution and that the entire increase occurs that has been planned for grants to State and local governments. In 1976, spending in both these categories unexpectedly fell short of the budget estimates. Should such a shortfall again occur, the Federal contribution to economic growth would be even less than the forecast assumes.

The Private Economy: Consumption. There is no present reason to expect that any unusual strength in the private economy is available to offset the slow growth of the government sector. The staff forecast assumes that personal consumption spending will rise a little more than 4 percent in real terms. This in turn rests on two crucial assumptions: first, that there will be some decline in the personal savings rate from the 1976 average and, second, that price increases for consumer goods and services will be no more rapid than the 4.8 percent rate of the past six months.

Business Fixed Investment. The latest Commerce Department survey of business spending plans indicates that, at least through the first half of next year, investment will continue to grow considerably more slowly than is usual in a recovery period. In real terms planned spending in the first half of next year would be about 8 percent above year earlier levels, and our forecasts assume this degree of strength continues in the second half. In previous recoveries, real fixed investment spending sometimes has grown at rates as high as 15 percent or more.

Residential Construction. Housing starts recently have risen to about a 1.8 million annual rate. Our forecast assumes this level is sustained throughout 1977.

Net Exports. The staff forecast assumes that, in real terms, the net export balance remains at its 1976 level, hence making no contribution at all to the growth of real GNP. In light of the recent weakening of the world trade outlook, even this must be regarded as a relatively optimistic assumption.

Final Sales. Summing up all the above components, final sales of goods and services would rise just over 4-1/2 percent in real terms in 1977. This would be slightly above the expected 1976 increase of 4.2 percent. In 1976, however, the rebuilding of business inventories has contributed almost 2 full additional percentage points to GNP growth, so that total real GNP will rise about 6.1 percent. Inventories now seem well aligned with final sales, and next year's growth rate for total GNP will be little different than that for final sales.

In summary, final demand in 1977, assuming current fiscal policies, may be a little stronger than it has been in 1976. Nonetheless, its strength will be insufficient to achieve any but the most modest reduction in unemployment. Furthermore, the above assessment makes relatively optimistic assumptions for the various sectors of the economy. There is a significant risk that economic growth will be even less than we are forecasting.

It seems apparent that this prospect is widely regarded as unsatisfactory, and that the new Congress will be giving immediate attention to the examination of revised budget policies which might promote faster growth. Chapter III of this report discusses some of the alternatives which the Congress may wish to examine.

1978

Any assessment of the economic outlook for 1978 must, of course, be highly tentative. Econometric model simulations using current services budget assumptions suggest that real growth will fall within the range of 3.8 to 5.1 percent. An expectation of growth toward the upper end of this range rests on the following considerations:

- The current service outlay projections for fiscal year 1978 imply real growth of Federal spending of between 4 and 5 percent. 2/ Even so, tax receipts will rise even more rapidly and, as already noted, the surplus in the budget as it would be at full employment will be rising.

- Business fixed investment, so far rather slow to come back from the recession, could grow quite strongly in 1978.

- The underlying demand for housing is strong and with favorable credit conditions, housing starts could sustain 1977 levels or rise somewhat further.

A growth rate of 4 to 5 percent is sufficient to achieve only very small reductions in unemployment. If in 1977 the economy follows the path expected to be produced by current budget policies, the

---

2/ The reasons why spending grows in real terms, even under a definitional concept of maintaining current services, are discussed in Chapter IV.

unemployment rate would still be above 7 percent at the beginning of 1978 and would be hovering near 7 percent at the end of that year.

The following chapter describes alternative budget policies which would have the effect of promoting more rapid growth in both 1977 and 1978.

III. ALTERNATIVE BUDGET POLICIES FOR ECONOMIC GROWTH

As part of its review of the current services budget, the staff was asked to analyze the economic impact of a more stimulative budget policy over the 1977-78 period, to discuss some of the ways such a policy might be implemented, and to outline some of the difficulties and limitations associated with such a policy.

Impact of a More Stimulative Budget Policy

There appears to be general agreement that if additional stimulus is to be adopted it should be of a type which can be put in place quickly, so as to achieve an impact in 1977. Studies by the staff and testimony before the Committee further indicate that if sustained progress toward full employment is to be achieved, the budget stimulus should be continued in 1978.

To illustrate the full impact which might be achieved, the staff has analyzed a program similar to some of the more aggressive proposals to stimulate the economy which have recently entered public discussion. By comparing the estimated impacts of this program with the forecast based on current policies, the impacts of more modest proposals can be roughly interpolated.

The program analyzed by the staff consists of a $15 billion cut in personal taxes for both 1977 and 1978 and a $15 billion increase in Federal spending, phased in gradually beginning in the second quarter of 1977. The spending increases are distributed as follows:

nondefense purchases	$5 billion
grants to State and local governments	$7 billion
transfers	$3 billion

Since the increased spending would have to be phased in gradually, this program provides about $22.5 billion of added stimulus in calendar 1977 ($15 billion through lower taxes, $7.5 through higher spending). The full $30 billion of stimulus would be in effect during 1978.

Because of the time required for the economy to react to changes in budget policy, the full impact of this program would not be felt in 1977. Nonetheless, by the fourth quarter of 1977 real GNP would be about 1.5 percent higher and the unemployment rate about 0.5 percentage points lower than would otherwise be the case. In 1978 the impact is more substantial, with real GNP about 2 percent higher. With a program of this type it should be possible to reduce the unemployment rate to about 6 percent by the end of 1978.

Given the current and projected slack in the economy, a stimulative program of this magnitude should have a relatively small impact on the rate of inflation. Productivity gains which normally accompany more rapid growth would largely offset increased demand pressures. As the economy returns to full employment, this would no longer be true.

A cautionary note should be sounded with respect to these estimates. The staff believes that they capture the general magnitude of the effects which most probably would result from a program of the type described. However, precise estimation over a two-year time frame is not possible, and these estimates necessarily are quite approximate. Furthermore, the impact on the unemployment rate will be influenced by type of additional stimulus which is undertaken as well as by the total amount. Increases in direct Federal purchases and in grants to State and local governments have a somewhat more powerful effect on the economy than do changes in taxes and transfer payments. Studies indicate that spending on direct job creation programs can have a larger impact on unemployment than either tax cuts or other types of spending.

Alternative Types of Personal Tax Reduction

If the Congress should decide that some tax reduction is desirable, there are various ways in which this could be accomplished. Personal taxes could be reduced temporarily by means of a rebate of some portion of 1976 taxes, withholding rates for 1977 and 1978 could be reduced, or some combination of these two could be adopted.

Rebate. The argument in favor of a rebate is that it implies no permanent loss of revenue, thus preserving maximum budget flexibility for future years. Being clearly temporary, however, a rebate would have only a temporary impact on the rate of economic growth, with most of the effect petering out within a 12 month period. Even the temporary impact probably would be somewhat less than that of a permanent cut in the form of a withholding reduction, since the evidence suggests that individuals save a higher fraction of an increase in disposable income which they regard as clearly temporary. In short, while a rebate could be effective in increasing GNP growth in 1977 and early 1978, it almost surely would need to be followed by additional stimulative actions if rapid progress toward full employment is to be sustained beyond that period.

Withholding Reduction. A reduction in 1977 and 1978 personal income tax liabilities, reflected in lower withholding rates, would provide more sustained support for economic growth. One possibility would be for such a reduction at first to be enacted for 1977 only, with renewal considered annually in light of economic conditions, as has been done with respect to the tax cuts first enacted in 1975. This procedure implies a high probability that such tax reductions would be continued for as long as the economy remains below full employment. When and if a situation should emerge, however, where a more restrictive fiscal policy is required, the decision not to renew these tax reductions would be a ready means of achieving the desired tightening of policy.

A tax reduction enacted in early 1977 probably could be reflected in withholding only during the last eight months or so of the year. If the full annual amount of the tax cut was achieved through lower withholding spread evenly over only 8 months, the annual dollar amount of tax reduction would have to be enlarged by approximately 50 percent in 1978 to keep withholding rates from rising. For example, if withholding rates were such that they produced a $15 billion personal tax cut in the last 8 months of 1977, maintaining these rates for all 12 months of 1978 would cause the tax reduction to grow to $22.5 billion.

When this situation arose with respect to the 1975 tax cut, the decision was made to enlarge the cut sufficiently to prevent withholding rates from rising. Since unemployment inevitably still will be quite high as 1978 begins, it seems unlikely the Congress would decide to let tax withholding rise at that point. Yet many in Congress may wish to limit the 1978 revenue loss which might follow from 1977 tax reductions.

In addition to the 1976 rebate already mentioned, two other ways of approaching this situation are available. One would be to combine a rebate on 1976 taxes with a cut in withholding during the final eight months of 1977 <u>at an annual rate</u> equal to the 1978 tax reduction thought likely to be desirable. For example, a $7 billion rebate of 1976 taxes combined with an $8 billion cut in 1977 personal tax liabilities (entered into withholding at a $12 billion annual rate during the last eight months of the year) would produce a $15 billion tax cut in 1977 and a $12 billion cut in 1978 if withholding rates were left unchanged.

A similar 1978 result could be achieved by enacting a $12 billion cut in 1977 taxes, reducing withholding during, say, May and June by an amount sufficient to rebate to taxpayers the amounts overwithheld during the January-April period, then lowering withholding rates by the $12 billion annual rate from July forward. However, this approach is administratively somewhat more complex than the other alternatives discussed.

<u>Distributional Considerations</u>. Either a rebate or a withholding cut could be structured in a variety of ways, including some which would extend the benefits to include many low-income families who

have no tax liability. For example, a rebate of some fixed dollar amount could be paid to each family or individual filing a tax return, including those who have no liability but file in order to obtain a refund of taxes withheld.

Similarly, a 1977 withholding cut could be based on a "refundable" per person credit. That is, the present $35 per person credit could be enlarged by some appropriate amount and made available in full to all who file tax returns, including those whose tax liability is less than the amount of the credit. This would involve actual end-of-year cash payments to some persons, typically in conjunction with the refund of overwithholding.

Though the above devices would reach many low-income families, many others would receive no benefit -- including the low-income aged, those on welfare, and casual laborers who have no tax withheld. Possible methods of extending benefits to these groups include: urging them to file tax returns purely for the purpose of obtaining a rebate, providing a special application procedure, or -- as was done in 1975 -- distributing a one-time social security "bonus." 3/ It should be noted,

---

3/ The past two years' experience with the earned income credit shows that in order for such a tax cut to be successful the Internal Revenue Service would need to conduct a very aggressive (and perhaps quite expensive) outreach program in connection with local community groups (which, unlike the IRS, are accustomed to dealing with low-income people).

however, that the latter method involves a double benefit for those social security recipients who also file tax returns.

Other possible ways of reducing 1977 taxes include increasing the personal exemptions, reducing all tax liabilities by a fixed percentage, or lowering the tax rates. The first two of these methods tend to provide progressively larger reductions for higher income groups. The third -- lowering tax rates -- can be structured to provide larger benefits to taxpayers in the lower rate brackets. It cannot, however, be used to benefit those who have no tax liability.

Business Tax Reduction

Recently a number of proposals for business tax reduction have been made. While many of these would have important longer run consequences, few with which the staff is familiar would have very much immediate economic impact or appear especially suitable as a counter-cyclical device. One exception to this would be the proposal to delay scheduled increases in the unemployment insurance tax. Another tax change which could have some immediate effect on employment would be the provision of an employers' income tax credit against the employers' share of social security taxes paid.

In considering any business tax changes which may be proposed for 1977 or 1978, the Congress may wish to give greater attention to the long-run consequences of such legislation as, with the exceptions noted above, the immediate impact is likely to be minimal.

Investment Tax Credit. A temporary enlargement of the investment tax credit above its present 10 percent level has been suggested. Economists differ sharply as to the short-run effect on business investment of temporary variations in this tax. Whatever the truth of this controversy, Congress in the past has shown a strong preference for continuation of any enlargement of this credit, making it in effect a permanent tax change. The temporary 1975 enlargement of the credit from 7 to 10 percent has now been extended through 1980.

As a permanent device, the investment tax credit introduces certain distortions into the tax system. It is available only for investment in capital equipment. While it is true that other tax preferences are available for investment in business structures, no preferential treatment is given to investment in research and development. These special tax devices cause distortions in investment decisions which may be detrimental to our long-run productivity growth.

Accelerated Depreciation. Another suggestion often heard is to provide accelerated depreciation either for all business investment or for certain types of investment, such as investment in high unemployment areas or in energy-saving devices. An argument frequently presented is that current depreciation schedules do not adequately reflect replacement costs.

Additional problems are associated with the use of accelerated depreciation on a selective basis. Selectivity by geographic region might have some effect on where investment takes place. It would have little if any effect on the total amount of business investment. To the extent that this or any other special tax treatment was successful in influencing the location of investment, it would represent an inducement to business to make decisions which would not be justified on normal criteria of economic efficiency and low-cost production. In short, it would represent an attempt to deal with the problem of high unemployment by encouraging investment which, in a strict economic sense, would be inefficient. Despite this problem, the proposal merits careful study because considerations which are not strictly economic may prove important.

Use of accelerated depreciation (or any other tax preference) to encourage investment in certain types of equipment raises difficulties of deciding which types of equipment are deserving of preference. A further difficulty is that these preferences tend to remain in the tax law long after the social desirability of encouraging a particular type of business activity has passed.

Reducing the Corporate Tax Rate. A simple reduction in the corporate tax rate would provide business with a higher after tax rate-of-return and over a period of years would encourage increased investment. It also avoids the problem of biasing the investment decision in ways that might cause efficiency losses. However, it is unlikely that increased investment would be immediate. There is little evidence that lack of available funds is inhibiting investment. Corporate cash flow in the third quarter of 1976 was 55 percent above year-earlier levels. Credit appears readily available and interest rates have been falling. The major discouragement to investment at the present time is uncertainty over future consumer demand. Policies designed to stimulate consumption would represent a stronger immmediate stimulus to investment than would corporate tax reduction.

<u>An Income Tax Credit against Social Security Taxes</u>. One type of business tax change which might have some short-run impact on employment would be the provision of an employer's income tax credit against some fraction of the employer's share of social security taxes paid. This would be a relatively simple tax change, could be made available to both corporate and noncorporate employers, would have no impact on social security trust fund receipts and, by directly reducing employment costs, would both stimulate employment and help limit price increases.

A study by the staff of the Senate Budget Committee indicates that a tax change of this type would have a significantly more powerful employment effect per dollar of revenue loss than other types of tax changes examined. 4/ Since this tax change would also be anti-inflationary, it is hard to imagine a situation in which, once instituted, it could easily be removed, since removal would have the opposite effect of increasing business costs. Such a tax change, however, could be reconsidered in the context of comphrehensive social security tax reform.

4/ See "Government Policies to Reduce Inflation" in <u>Budget Issues: Staff Studies for Fiscal 1977</u>, Committee on the Budget, United States Senate, June 28, 1976.

Unemployment Insurance Taxes. Recently enacted legislation will increase the Federal tax imposed on employers. The tax rate will rise from 0.5 to 0.7 percent in January 1977 and the wage base on which this tax is collected will rise from $4,200 to $6,000 in January 1978. Taken together, these tax changes will double the Federal tax paid for each employee. The revenue to be raised by these tax changes is minimal, $0.3 billion in fiscal 1977 and $0.7 billion in 1978. The added cost to employers is significant, however, and is further exacerbated by widespread increases in State unemployment insurance taxes. These tax increases are being occasioned by the depletion of the unemployment insurance trust funds resulting from recent and continuing high unemployment.

A one-time transfer of general revenues to the unemployment insurance trust funds would make these tax increases unnecessary. The fund transfer in itself would have no impact on the Federal deficit, and, as noted above, the loss of revenue from failure to collect the higher tax would be minimal. In short, significant pending increases in employer costs, which would increase both inflation and unemployment, could be avoided by a relatively simple transfer of funds among budgetary accounts.

Changes in Outlays

Realistically, the amount of money which can be spent in addition to current plans is limited. Because of the lead time required to start new programs, expansion of existing programs is likely to produce a more immediate economic impact. The changes discussed below could be made in a relatively short period of time and thus effect the economy in both 1977 and 1978.

Title VI of the Comprehensive Employment and Training Act (CETA). This Title, revised and reauthorized by Congress last fall, provides for emergency public service employment. Provision was made in the Budget Resolution for expansion of this program to roughly a 500,000 job level, but an appropriation of $2 to 2-1/2 billion is still required to continue and enlarge this program. As revised, the program emphasis will be on special community work projects of one-year duration. Priority in hiring will go to low-income persons and the long-term unemployed.

Emergency Public Works. Last fall Congress authorized and appropriated $2 billion for this program. Applications for more than $20 billion have been received from localities. Because of the time required for project start-up, even if the program size were to be increased by an additional $2 billion, only about $400 million in added outlays would be expected to occur in fiscal 1977. However, prompt action will be required if this program is to be expanded in 1978 and beyond.

Counter-cyclical Aid to State and Local Governments. An existing program, enacted this year, makes assistance payments to State and local governments on the basis of a formula which takes into account the national and the local unemployment rate. The program is designed to phase out entirely at national rates below 6 percent. Because it now appears that unemployment will be higher than was anticipated when appropriations for this program were enacted, an additional appropriation of $300 million probably will be needed to carry out the formula in the present law.

New Initiatives in 1978. Obviously, a great deal more flexibility remains with respect to fiscal 1978 than 1977. Even so, a number of constraints exist on the extent to which program changes can be accomplished. Under the budget procedures, authorizing legislation for fiscal 1978 must be reported out of Committee by May 15, 1977. Thus, time is already short for the consideration of new legislation. Even when enacted, start-up time often means that outlays are relatively modest during the first year of a new program.

The hypothetical expansionary budget policy described earlier in this chapter assumed a $15 billion outlay increase in 1978. It appears unlikely that anything approaching this amount could be spent efficiently on new program initiatives. Hence, an expansionary budget policy for 1978 might continue to rely, to a considerable extent, on the temporary programs already mentioned, all of which are designed to phase out as full employment is regained. Also, there is scope for expansion of some existing permanent programs. Such expansions, however, often have the effect of setting a higher base for future program levels and hence limit future budget flexibility.

The Budget Deficit

As noted, a weaker than expected economy is now expected to produce a budget deficit of as much as $60 to $65 billion in fiscal 1977, assuming current budget policies are continued. Tax cuts and/or additional spending would further enlarge the deficit, although much of the added budget cost would eventually be recovered through higher tax receipts stemming from more rapid economic growth.

The illustrative program described in this chapter would enlarge the fiscal 1977 deficit by about $13 billion ($15.5 billion in tax reductions and outlay increases, offset by $2.5 billion in savings from lower unemployment). This would bring the deficit into the $73 to $78 billion range.

Without additional stimulus, the fiscal 1978 budget deficit is estimated at $55-65 billion. The program described would enlarge the deficit by about $21 billion ($29.5 billion in tax reductions and outlay increases, offset by $8.5 billion in savings from lower unemployment). This would shift the full employment budget from the $11.3 billion surplus shown in Table 1 to a deficit of about $9.7 billion. This does not mean, however, that the budget would necessarily be in deficit in future years when a situation of full employment might actually exist. Tax receipts respond more strongly to economic growth and inflation than do outlays. In the absence of further tax reduction, there would be a built-in tendency for the budget to return to full employment surplus. In addition, a significant portion of added spending in 1977 and 1978 might be of the type designed to phase out automatically as unemployment declined.

IV. FIVE-YEAR PROJECTIONS

Any projection of budget outlays and receipts must be based on some underlying projection of economic conditions. Cyclical fluctuations in output and changes in the rate of inflation will affect both receipts and expenditures. For the purpose of making five-year projections, the Congressional Budget Office has examined three alternative economic growth paths. One of these growth paths approximates the targets recommended by the Joint Economic Committee in its Midyear Review. This path would have the economy moving toward full employment fairly rapidly in 1978 and 1979 with the growth rate then tapering toward the long-term trend rate of growth. The second set of assumptions is designated as the baseline assumptions and is a relatively optimistic set of assumptions, consistent with those used by the Budget Committees in preparing the Second Concurrent Resolution. This path assumes that real economic growth will average about 5-1/2 percent during the next three years, moving toward 4-1/2 percent by 1982. The third set of assumptions is the least optimistic. This path assumes that real economic growth falls from 6.4 percent in 1976 to 4.0 percent by 1979 and remains at that level throughout the projection period.

Table 2 shows the budget paths which are produced by each one of these different sets of economic projections. As the table shows, changing the assumptions can change the projected surplus in 1982 by almost $50 billion. Because the economic assumptions have such a large impact on the estimated budget surplus projected five years hence, it is very important to understand the meaning of these projections.

The projections made by CBO have assumed that the growth of the economy occurs independently of what happens in the Federal Budget. As Director Rivlin testified, "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."

This is an extremely important point, because it means that the projected surplus might never develop if we pursue current services policies. For example, if current services expenditure policies produce economic growth in 1979 of 4 percent (assumed in the less rapid economic expansion path) instead of 5.8 percent (assumed in the more rapid expansion path) the deficit for that year would double. The increase in the deficit would result entirely from the lower level of receipts produced by the weaker economy and the higher outlays needed for unemployment compensation and the like.

As discussed in Chapter II, the current services budget levels would be inadequate to produce in 1977 and 1978 either of the more optimistic growth paths shown in Table 2. Nor is the current services budget likely to be consistent with good economic performance in the 1979-1982 period. Two reasons for this conclusion can be identified. First, full employment budget estimates based on current services assumptions show the surplus growing rapidly over time. Table 3 shows that the full

Table 2. Projections of Federal Budget Totals, 1978-1982
(Fiscal years, In billions of dollars)

	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

SOURCE: Congressional Budget Office
* Second Concurrent Resolution on the Budget for FY 1977 (S. Con. Res. 139)

Table 3. The Full Employment Surplus

Fiscal Year	Full Employment Surplus	Full Employment GNP	Surplus As percent of Full Employment GNP
	(billions of dollars)		
1977	-.9	2004.4	-.04
1978	6.2	2179.6	.28
1979	19.3	2390.2	.81
1980	34.8	2596.6	1.34
1981	57.7	2830.2	2.04
1982	85.0	3172.4	2.74

SOURCE: Congressional Budget Office and Joint Economic Committee employment surplus increases from an approximate balance in 1977 to 2.7 percent of GNP in 1982. This increasingly restrictive fiscal policy would be most unlikely to allow the assumed optimistic growth rate to actually occur.

Second, and related to the rise in the full employment surplus, is the increasing personal tax burden which results from holding statutory tax rates constant. From 1957 through 1972, the individual income tax burden fluctuated between 8 and 8-1/2 percent of GNP. If statutory tax rates remain unchanged the effect of inflation on the progressive tax structure will cause this tax as a share of GNP to rise to 11.3 percent by 1982. If, however, we assume that Congress periodically chooses to enact discretionary income tax cuts as it has in the past, tax receipts would be substantially below the level projected in the current services estimates. Table 4 shows a comparison of individual income tax receipts assuming unchanged statutory rates and receipts assuming that discretionary tax cuts are such that receipts remain at 8-1/2 percent of GNP. If Congress decides that in order to produce the projected baseline GNP path the ratio of individual income taxes to GNP must remain constant, then the surplus projected for 1982 would disappear. The "budget margin" or "fiscal dividend" indicated in the current services projections is sometimes viewed as the amount which will become available for new program initiatives. This view is misleading in that it overlooks the possibility that the margin could be drastically reduced by either slow economic growth or by fiscal stimulus designed to produce more rapid growth.

Table 4. Tax Receipts and Deficit with Varying Assumptions*
(billions of dollars)

Calendar Year	Individual Tax Receipts (current service)	Individual Tax Receipts (8.5 percent of GNP)	Difference	Budget Surplus or Deficit (assuming taxes are a constant share of GNP)
1977	168.3	160.2	8.1	-57.1
1978	195.8	177.2	18.6	-55.6
1979	228.0	195.9	32.1	-41.1
1980	265.0	216.5	48.5	-28.0
1981	306.5	238.7	67.8	-12.8
1982	350.6	263.7	86.9	0.0

SOURCE: Congressional Budget Office and Joint Economic Committee
*Calculations are made using CBO's baseline economic assumptions

Outlay Trends

The current services projections show very clearly how outlay trends would develop over the next five years if policy remains unchanged. As Table 5 illustrates, the two most rapidly growing parts of the budget are national defense and benefit payments for individuals.

National defense is scheduled to rise $13 billion or 13 percent from fiscal year 1977 to fiscal year 1978. This large increase is primarily a result of past years' spending plans taking effect in 1978 and of the projected rate of price increase. Approximately $5 billion of the scheduled increase will occur in defense procurement. These programs have been approved by Congress in the past, and to halt or greatly reduce this spending would be difficult. Most of the remaining increase is caused by the effect of inflation on pay, retirement benefits, operations and maintenance, research and development, construction, etc. Defense spending is projected to grow slightly more rapidly than total spending, causing its share of the budget to rise over the next five years.

Benefit payments for individuals are estimated to increase substantially over the next few years. The primary reason for this increase is inflation, although this is partially offset by the projected decline in unemployment. Despite the fact that benefit payments are projected to consume a larger share of the budget dollar, the share of our gross national product devoted to these payments will fall because the economy is assumed to grow faster than the budget.

Table 5. Budget Outlay Projections (fiscal years)

	Percentage Increase				
	1977-78	1978-79	1979-80	1980-81	1981-82
National Defense	12.9	6.3	8.3	6.4	6.0
Individual Benefit Payments					
Health care	17.5	15.2	14.8	15.1	14.9
Retirement & other	4.2	6.8	7.1	7.3	7.9
Grants to State & local governments	1.7	-2.7	1.5	4.4	5.8
Net Interest	17.8	7.8	2.3	0.0	0.0
Other	13.2	7.2	6.4	4.2	4.3
TOTAL	9.1	6.5	7.0	6.6	6.9
	Dollar Increase (billions)				
National Defense	13.0	7.2	10.0	8.3	8.3
Individual Benefit Payments					
Health care	5.6	5.7	6.4	7.5	8.5
Retirement & other	6.4	10.8	12.0	13.2	15.4
Grants to State & local governments	.8	-1.3	.7	2.1	2.9
Net Interest	5.4	2.8	.9	0.0	-.1
Other	6.6	4.1	3.9	2.7	2.9
TOTAL	37.6	29.4	33.8	33.9	37.9

SOURCE: Congressional Budget Office and Joint Economic Committee

*Fully adjusted for inflation; calculations are made using CBO's baseline economic assumptions.

In the past, benefit payments have risen rapidly because new programs such as medicare, medicaid, and food stamps have been enacted and because existing programs such as social security and unemployment compensation have been expanded to cover more people. The current services projections assume that no new programs are added and that eligibility criteria remain fixed. Given these assumptions, program growth is caused by direct inflation adjustments, indirect adjustments due to a higher wage base, and a larger number of beneficiaries. Unless new programs are added, individual benefit payments should grow more slowly in the foreseeable future than they have in the recent past.

The increases in health care programs and retirement programs 5/ explain almost 96 percent of the total benefit payment increase. Medicare and medicaid expenditures have been rising much more rapidly than the general Consumer Price Index in the past few years. This trend is expected to continue through 1982 although the gap between the two is projected to narrow. Over half of the projected increase in retirement programs is caused by inflation, and the remainder is the result of an increase in the number of retirees and disabled persons receiving benefits.

5/ Retirement programs include social security, railroad retirement, and civil service retirement. Military retirement is classified under National Defense.

O