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Testimony by

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before a

Joint Hearing

of the

Senate and House Committees on the Budget

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I am pleased to appear here today to address some of the most important issues involved in producing the Budget of the United States Government   The views I will be expressing are my own and not necessarily those of the Federal Reserve Board

The budget process has improved significantly in recent years   The caps on discretionary spending and the pay-as-you-go rules have restrained deficit-expanding programs far better than many had anticipated   Budget scoring is crucial to this process   Unless estimates of the outlays and revenues from budget initiatives are credible, the current system cannot work effectively   This joint hearing of the Congress's budget committees, unprecedented in my experience, attests to the importance of budget scoring

Accurate estimates of the effects of tax and spending policies on the budget are difficult to make, some more than others In particular, concern has been raised that current methods are too "static " As other witnesses have indicated, current scoring procedures already allow for some response in the spending, saving, and investment behavior of individuals and firms   Indeed, although it is difficult to measure, the budget scoring process has become increasingly dynamic over the years, and estimating techniques have improved   What is still generally not taken into account, however, is the effect of fiscal initiatives on macroeconomic variables like GDP, total labor compensation, and aggregate investment   Concerns that current estimating procedures do not fully track the effects of changes in behavior on aggregate economic activity, and hence on overall budget receipts and outlays, are justified   The current method is admittedly incomplete, especially for policy initiatives with broad economic impacts

One central issue with respect to a more dynamic scoring is whether cyclical, aggregate demand effects of fiscal changes should be taken into account--or only permanent effects on aggregate supply There are a number of ways of looking at this, but I would suggest that including aggregate demand effects would be confusing, if not misleading, in many contexts Among other things, the scope for realizing such demand effects on economic activity would be a function of the particular phase of the business cycle and could be viewed in a sense as transitory Particularly when we are addressing the problem of the long-run structural deficit, the focus should be on how fiscal actions affect the potential of the economy to produce greater output and taxable income on a sustained, ongoing basis Thus, if a more dynamic scoring were to be adopted, I would recommend limiting the analysis to appropriate supply-side effects

Apart from that consideration, full dynamic estimates of individual budget initiatives should be our goal. Unfortunately, the analytical tools required to achieve it are deficient In fact, the goal ultimately may be unreachable The estimation of full dynamic effects requires a model that both captures micro- and macroeconomic processes and produces reliable long-run forecasts of economic outcomes Unfortunately, no such model exists Indeed, no model currently in use can predict macroeconomic developments without substantial ad hoc adjustments that effectively override the internal structure of the model We should not assume that models can capture the long-run dynamic effects of specific tax and outlay changes any better than they can forecast the economy

Even current procedures require relatively sophisticated techniques to determine the budget consequences of particular tax and outlay programs Changes in the tax structure alter economic incentives in ways that may be extraordinarily complex For entitlement programs, one has to assess, for example, how greater public awareness of the existence of such a program will affect participation, and how behavior will change to take advantage of the entitlement The disappointing history of projections for Medicare and Medicaid attests to the difficulty of pinning down such responses The assumptions required for realistic estimates, in many instances, constitute little more than informed guesses, largely because accurate information is scarce and our understanding of human behavior is limited Not surprisingly, objective analysts often reach quite different conclusions about the impact of a specific outlay or tax program, even without trying to trace the feedback effects on the budget estimates from resulting changes in GDP and other macroeconomic variables.

This does not mean we have no judgments about the dynamic effect of various policy proposals Martin Feldstein and others have already made useful contributions to our understanding of the long-run effects of the tax structure on work, saving, and federal revenues Thus, we may know, or suspect, the direction of a long-run response But our knowledge of its magnitude and timing is imprecise For example, although the empirical evidence is admittedly mixed, I strongly suspect that the elimination of, or a major reduction in, the rate of taxation on capital gains would entail little, if any, loss of total tax revenue over the long run However, it is currently not possible to estimate with any degree of precision the impact of such a proposal on the deficit within the horizon of the current budget process

If, as many advocate, outlays are reduced well below current service levels in the years ahead, the debate over scoring is likely to move off center stage This will occur because the outlay cuts will free up significant revenues for tax cuts, regardless of whether the current or a more dynamic scoring is employed And, if total revenues turn out to be greater than current procedures project, deficits will trend lower than estimated If we inadvertently produce a budget surplus by such miscalculations, the implications will be positive for long-run economic growth More to the point, if we fail to achieve adequate reductions in outlays, budget scoring will not substitute for hard political choices

Clearly, our political process has a bias toward deficit spending Accordingly, we should be especially cautious about adopting technical scoring procedures that might be susceptible to overly optimistic assessments of the budgetary consequences of fiscal actions Currently, real long-term interest rates remain relatively high, partly because of the expected growth of budget deficits later in this decade and thereafter Upward revisions to market expectations of deficits resulting from a perception that tax and outlay choices were being driven by optimistic scoring would only exacerbate this trend, with negative consequences for financial stability and economic growth In current circumstances, the risks of more conservative assessments, which might overstate the loss in revenues, for example, seem modest Moreover, should the budget deficit turn out smaller than expected, the resultant favorable effect on real interest rates would tend to stimulate private investment

We must avoid resting key legislative decisions on controversial estimates of revenues and outlays Should financial markets lose confidence in the integrity of our budget scoring procedures, the rise in inflation premiums and interest rates could more than offset any statistical difference between so-called static and more dynamic scoring

In summary, the current, relatively straightforward scoring system has served us well in many regards In particular, its very straightforwardness may limit the possibilities for major estimating differences Nevertheless, current scoring does fail to reflect potentially important long-term structural supply-side benefits, and accordingly unfavorably biases the choice of fiscal programs At a minimum, these supply-side effects should be estimated Thus, even if not officially scored, they might influence policy choices The Congress may choose to pass a tax cut with highly favorable supply-side effects on the economy and be willing to cut spending to accommodate it In any event, in the longer run, we should seek to find a way to embody such effects in our official scoring

Let me reiterate that, although scoring is a major factor in the budget process, process does not mean much if real deficit control is not achieved I do not intend to get into the deeper programmatic issues involved in deficit reduction--and I probably could not add very much to the knowledge of these committees in that regard I would, however, like to comment briefly on the sensitivity of deficits to the particular cost-of-living measure used to index entitlement programs and the income tax structure Many difficulties have arisen in the past and doubtless will continue to arise in the future For example, as you may know, the BLS made a significant change in how it calculates the CPI in 1983, when it shifted from a method in which the price index for housing was constructed as if each household was paying the current home price and mortgage rate on its residence to one that is a more realistic measure of the cost of home occupancy Because of the run-up in house prices and interest rates between the late 1960s and early 1980s, the official CPI rose about 9 percent more than indicated by the newer, superior measure By the time the index was changed, this overstatement had added substantially to the level of outlays in the large indexed federal programs--social security, SSI, veterans' pensions, military retirement, and civilian pensions Once the additional interest outlays required to finance the cumulatively higher federal debt are added in, a rough estimate suggests that, all else equal, the deficit for FY1994 would have been smaller by $50 billion had the overindexing not occurred

Although little can be done to remedy the errors of the past, greater efforts should be made in the future to ensure that the indexing of spending and tax programs accurately reflects trends in the cost of living In that regard, concerns have been raised that, for a variety of reasons, the official CPI may currently be overstating the increase in the true cost of living by perhaps 1/2 percent to 1-1/2 percent per year To be sure, the overstatement may be a little less for retirees, whose spending patterns differ from those of younger age groups and who are the main recipients of indexed federal benefits But even for this group, it doubtless remains significant Thus, when the Congress reviews the methods of indexing spending programs and taxes, attention should be given to the biases in the price indexes that are used Removing the bias in the CPI would have a very large impact on the deficit For example, if the annual inflation adjustments to indexed programs and taxes were reduced by 1 percentage point--and making the admittedly strong assumption that there are no other changes in the economy--the annual level of the deficit will be lower by about $55 billion after five years, including the effects of lower debt levels