

CBO TESTIMONY

Statement of
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before the
Committee on the Budget
U.S. House of Representatives

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Chairman Sabo, Congressman Kasich, and Members of the Committee, I am pleased to be with you this morning to review the state of the economy and the budget. Last week the Congressional Budget Office (CBO) released a report, *The Economic and Budget Outlook: An Update*, that describes our current views in considerable detail. My testimony summarizes that report.

Enactment of the Omnibus Budget Reconciliation Act of 1993 has significantly brightened the budgetary outlook for the next several years. CBO now projects that the federal budget deficit will fall from an estimated \$266 billion in the current fiscal year to an average of \$200 billion in 1995 through 1998. Without reconciliation, the deficit would have swelled to nearly \$350 billion by 1998.

Reducing the deficit increases national saving and spurs economic growth in the long run, but it tends to dampen economic activity at first. The drop in long-term interest rates that has occurred this year, however, will offset some of the fiscal restraint from the reconciliation act. The 10-year Treasury note rate fell by roughly a full percentage point between December and August. To some extent this decline in rates stems from the prospect of lower deficits, but economic weakness abroad has also played a role. Whatever their cause, lower interest rates reduce the cost of borrowing, stimulate consumer spending on durable goods and business investment in plant and equipment, and will allow the economy to maintain its momentum during the remainder of 1993 and in 1994.

THE ECONOMIC OUTLOOK

In most major respects, the economic outlook has changed very little since last winter. The economic expansion has become self-sustaining, although the pace of growth is below average for this stage of the business cycle.

Forecast for 1993 and 1994

CBO forecasts that real gross domestic product (GDP) will grow at a rate of almost 3 percent in the second half of 1993 and in 1994. Although the economy grew at an average annual rate of only 1.2 percent in the first and second quarters of 1993, its growth was depressed by several transitory events, including unseasonable weather, changes in income tax refunds, and erratic defense spending. For 1993 as a whole, we project that GDP will grow by 2.3 percent (see Table 1).

The economy added an average of 170,000 new jobs each month during the first seven months of the year, and job creation is likely to keep on at a moderate pace. The unemployment rate will fall only slowly, however, as improving job prospects lure discouraged workers back into the labor market. Because the economy will be operating at less than its potential, inflation will remain at a modest annual rate of slightly more than 3 percent.

Even though our forecast implies that inflationary pressures are subdued, the Federal Reserve has indicated that it will eventually allow short-term interest rates to rise in order to hold inflation in check. In line with the Federal Reserve's policy, CBO forecasts that the three-month Treasury bill rate will rise from an average of 3.1 percent in 1993 to 3.6 percent in 1994. Long-term interest rates are expected to change little through 1994, however, and the yield curve--now unusually steep--will flatten somewhat.

CBO's forecasts of economic growth and unemployment for 1993 and 1994 are virtually the same as those of the *Blue Chip* consensus of private forecasters. But the consensus expects slightly higher inflation and correspondingly higher long-term interest rates in 1994.

Projections for 1995 Through 1998

CBO does not attempt to forecast cyclical fluctuations in the economy more than two years into the future. Beyond 1994, our projections are based on trends in the fundamental factors that determine the potential growth of the economy, including growth in the labor force, productivity, and national saving.

We have raised our estimate of the economy's potential rate of growth to 2.1 percent a year, in part because of the enactment of the reconciliation bill. Some of the reduction in the deficit (we estimate 30 percent) will be offset by reduced private saving, but the rest will be available to increase domestic investment or reduce borrowing from abroad. In either case, U.S. real incomes and living standards will rise more rapidly.

CBO assumes that between 1995 and 1998 the gap between actual and potential real GDP will gradually shrink to its historical average of 0.6 percent. As a result, real GDP will grow at an average annual rate of 2.6 percent over the 1995-1998 period, and unemployment will fall to 5.7 percent (see Table 2). Because GDP remains below its potential, no increase in inflation is projected.

The projections also assume that the interest rate on 10-year notes will remain steady at 6.1 percent from 1995 through 1998. Adjusted for inflation, this rate is lower than what we projected last winter because deficit reduction is expected to ease pressures on capital markets. The three-month bill rate is assumed to rise gradually to 4.6 percent, bringing the spread between long-term and short-term rates into line with its historical average.

THE BUDGET OUTLOOK

The Omnibus Budget Reconciliation Act of 1993 has made a substantial dent in the annual budget deficits and in the accumulation of federal debt. Last winter, CBO projected that the deficit would grow from \$290 billion to \$360 billion over the 1992-1998 period, and that debt held by the public would swell from 51 percent to 62 percent of GDP. Now, the deficit is projected to fall to \$200 billion over those years, and the debt is expected to reach only 55 percent of GDP.

But two threats cloud the budget outlook. First, experience teaches that budget projections can quickly go awry. Shortly after the 1990 budget agreement was enacted into law, we projected that the deficit would virtually disappear by 1995. But in actuality, slower-than-expected economic growth, unanticipated increases in Medicare and Medicaid spending, and other factors beyond the direct control of the President and the Congress swelled the deficit and necessitated another round of deficit reduction. Second, even if they hold up, the new projections suggest that rising health care costs will cause the deficit to grow again after 1998. By 2003, if current policies are maintained, the deficit would reach \$359 billion.

The Outlook for the Deficit

The deficit record of \$290 billion, set in 1992, is not likely to be broken soon. CBO estimates that the deficit will fall to \$266 billion in the current fiscal year, \$253 billion in 1994, and about \$200 billion a year in the 1995-1998 period (see Table 3). In relation to the size of the economy, the deficit will shrink from 4.9 percent of GDP in 1992 to 2.5 percent of GDP in 1998.

These baseline budget projections incorporate the provisions of the recent reconciliation legislation but assume no further changes in laws and policies affecting tax revenues and mandatory spending. They assume that discretionary spending (that is, spending controlled by annual appropriations) will be held to the limits set by law. The Budget Enforcement Act of 1990 capped discretionary budget authority and outlays through fiscal year 1995, and the Omnibus Budget Reconciliation Act of 1993 extended the caps through 1998. Under these caps, nominal discretionary outlays in 1998 would be no higher than in 1993; in real terms, discretionary outlays would be cut by 14 percent over this period.

Although the budgetary situation is more favorable than it has been for some time, the raw deficit figures exaggerate the improvement in the stance of fiscal policy, because much of the projected reduction in the deficit comes from the cyclical expansion of the economy. When the economy is operating at less

than its potential, tax collections shrink, and outlays for unemployment insurance and other benefits grow. As the economy expands, however, this cyclical component of the deficit contracts.

The standardized-employment deficit removes the cyclical deficit from the budget totals and is the best measure of the budget's effect on the economy. It also excludes net federal outlays for deposit insurance, which are highly volatile and do not affect spending by businesses or consumers. The standardized-employment deficit is expected to fall from \$200 billion (3.2 percent of potential GDP) in 1992 to \$154 billion (2.2 percent of potential GDP) in 1995. From 1995 to 1998, however, the standardized-employment deficit grows at about the same rate as the economy's potential output.

The figures on the federal debt paint a more encouraging picture. Since 1981, debt held by the public has quadrupled in dollar terms and has grown from 26 percent to 52 percent of GDP. In sharp contrast, the debt is now projected to grow only to 54 percent of GDP in 1994, 55 percent in 1998, and 59 percent in 2003. Although the reconciliation act has significantly slowed the accumulation of debt, it has fallen short of stabilizing the debt-to-GDP ratio, which many economists view as a minimal requirement for a sustainable fiscal policy.

Changes in the Projections

For the first time in two and one-half years, the deficit projections have taken a decided turn for the better. Last March, in our analysis of the President's budgetary proposals, we estimated that the deficit would total \$302 billion in fiscal year 1993 and would reach \$360 billion by 1998. We now project a deficit of \$266 billion in 1993 and \$200 billion in 1998. The reconciliation act deserves most of the credit for the improvement over the long run, but changes in the economic outlook and in technical estimating assumptions also make a small contribution. The lower deficit for 1993 results primarily from the continued failure to provide additional resources for resolving insolvent savings and loan institutions, a modest slowdown in the growth of spending for Medicare and Medicaid, and unexpected strength in revenues.

Changes in law since March have added \$4 billion to the deficit in 1993 but have reduced it by \$26 billion in 1994 and \$143 billion in 1998 (see Table 4). The reductions stem entirely from the Omnibus Budget Reconciliation Act of 1993, which increased taxes, pared entitlement spending, and extended the limits on discretionary spending through 1998. Two pieces of emergency legislation--the Emergency Unemployment Compensation Amendments of 1993 and the Emergency Supplemental Appropriation for Midwest Flood Relief--add slightly to outlays and the deficit.

The revisions to CBO's economic assumptions, described above, also reduce the projected deficits in most years. By 1998, the reduction reaches \$11 billion, thanks mostly to lower long-term interest rates.

Other changes in estimating assumptions, termed technical reestimates, lower the projected deficits by amounts ranging from \$2 billion in 1994 to \$39 billion in 1993. Revised estimates of deposit insurance spending account for the jagged pattern of these changes. In addition, CBO has slightly increased its estimate of tax revenues in all years and has shaved its projections of spending for Medicare and Medicaid.

CONCLUSION

The 1993 reconciliation act has temporarily subdued the deficit, but the deficit threatens to rise again after 1998 unless further steps are taken. This year's bill, like 1990's effort, relied heavily on increasing taxes on upper-income individuals, curtailing payments to physicians and hospitals, and freezing discretionary spending. Achieving further savings in these areas will be more difficult, however, and the next round of deficit reduction is therefore likely to prove even more painful than the last. The budget dilemma will be made still more acute by the Administration's desire to increase access to health insurance and health care,

reform the welfare system, and address such domestic needs as crime control, education, and job training--all without imposing major tax increases.

TABLES

Table 1.
Short-Term Economic Forecasts for 1993 and 1994

	1992	Forecast	
		1993	1994
Fourth Quarter to Fourth Quarter (Percentage change)			
Nominal GDP			
CBO summer	5.7	5.2	5.2
<i>Blue Chip</i>	5.7	5.1	5.9
CBO winter	5.1	5.4	5.4
Real GDP			
CBO summer	3.1	2.3	2.7
<i>Blue Chip</i>	3.1	2.2	2.7
CBO winter	2.7	2.8	3.0
Consumer Price Index^a			
CBO summer	3.1	3.4	3.1
<i>Blue Chip</i>	3.1	3.3	3.4
CBO winter	3.1	2.8	2.7
Calendar Year Averages (Percent)			
Civilian Unemployment Rate			
CBO summer	7.4	6.9	6.6
<i>Blue Chip</i>	7.4	6.9	6.6
CBO winter	7.4	7.1	6.6
Three-Month Treasury Bill Rate			
CBO summer	3.4	3.1	3.6
<i>Blue Chip</i>	3.4	3.1	3.6
CBO winter	3.5	3.1	3.7
Ten-Year Treasury Note Rate			
CBO summer	7.0	6.0	6.1
<i>Blue Chip^b</i>	7.0	6.1	6.3
CBO winter	7.0	6.7	6.6

SOURCES: Congressional Budget Office; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (August 10, 1993).

NOTE: The CBO summer forecast does not incorporate either the advance estimate of second-quarter GDP released by the Bureau of Economic Analysis in late July or the effects of the regular annual revision to the national income and product accounts released by BEA in late August. The *Blue Chip* forecast is an average of about 50 private forecasts.

a. The consumer price index for all urban consumers.

b. *Blue Chip* does not project a 10-year note rate. The values shown here are based on the *Blue Chip* projection of the Aaa bond rate, adjusted by CBO to reflect the estimated spread between Aaa bonds and 10-year Treasury notes.

Table 2.
CBO's Medium-Term Economic Projections (By calendar year)

	1992	1993	1994	1995	1996	1997	1998
Nominal GDP (Billions of dollars)							
CBO summer	5,951	6,267	6,605	6,951	7,317	7,696	8,078
CBO winter	5,943	6,255	6,594	6,942	7,288	7,627	7,953
Real GDP (Billions of 1987 dollars)							
CBO summer	4,923	5,051	5,190	5,330	5,476	5,620	5,755
CBO winter	4,918	5,054	5,204	5,354	5,497	5,628	5,740
Real GDP (Percentage change)							
CBO summer	2.1	2.6	2.7	2.7	2.7	2.6	2.4
CBO winter	2.0	2.8	3.0	2.9	2.7	2.4	2.0
CPI-U (Percentage change)							
CBO summer	3.0	3.3	3.2	3.0	3.0	3.0	3.0
CBO winter	3.1	3.0	2.7	2.7	2.7	2.7	2.7
Unemployment Rate (Percent)							
CBO summer	7.4	6.9	6.6	6.3	6.0	5.8	5.7
CBO winter	7.4	7.1	6.6	6.2	6.0	5.8	5.7
Three-Month Treasury Bill Rate (Percent)							
CBO summer	3.4	3.1	3.6	4.1	4.5	4.6	4.6
CBO winter	3.5	3.1	3.7	4.4	4.7	4.8	4.9
Ten-Year Treasury Note Rate (Percent)							
CBO summer	7.0	6.0	6.1	6.1	6.1	6.1	6.1
CBO winter	7.0	6.7	6.6	6.6	6.5	6.5	6.4

SOURCE: Congressional Budget Office.

NOTES: The CBO summer forecast does not incorporate either the advance estimate of second-quarter GDP released by the Bureau of Economic Analysis in late July or the effects of the regular annual revision to the national income and product accounts released by BEA in late August.

CPI-U is the consumer price index for all urban consumers.

Table 3.
CBO's Projections of the Federal Deficit and Debt (By fiscal year)

	1992	1993	1994	1995	1996	1997	1998
In Billions of Dollars							
Total Deficit	290	266	253	196	190	198	200
Cyclical Deficit	93	81	65	52	40	27	18
Deposit Insurance Spending	3	-26	14	-10	-10	-8	-4
Standardized-Employment Deficit ^a	200	211	175	154	160	180	186
Debt Held by the Public	2,999	3,249	3,507	3,713	3,919	4,137	4,357
As a Percentage of GDP							
Total Deficit	4.9	4.3	3.9	2.9	2.6	2.6	2.5
Standardized-Employment Deficit ^{a,b}	3.2	3.3	2.6	2.2	2.2	2.3	2.3
Debt Held by the Public	51.1	52.5	53.8	54.1	54.3	54.4	54.6
Memorandum:							
Gross Domestic Product	5,869	6,189	6,522	6,862	7,224	7,601	7,984

SOURCE: Congressional Budget Office.

NOTE: The projections include Social Security and the Postal Service, which are off-budget.

a. Excludes the cyclical deficit, spending for deposit insurance, and (in 1992) contributions for Operation Desert Storm.

b. Shown as a percentage of potential gross domestic product.

Table 4.
Changes in CBO's Deficit Projections (By fiscal year, in billions of dollars)

	1993	1994	1995	1996	1997	1998
Winter Baseline Deficit	302	287	284	290	322	360
Changes						
Legislative changes	4	-26	-54	-82	-117	-143
Economic assumptions	a	-5	-3	1	-2	-11
Technical reestimates						
Deposit insurance	-18	10	-18	-9	6	6
Other	<u>-21</u>	<u>-13</u>	<u>-14</u>	<u>-10</u>	<u>-11</u>	<u>-12</u>
Subtotal	<u>-39</u>	<u>-2</u>	<u>-31</u>	<u>-19</u>	<u>-5</u>	<u>-6</u>
Total	-36	-33	-88	-100	-124	-160
Summer Baseline Deficit	266	253	196	190	198	200

SOURCE: Congressional Budget Office.

NOTE: The projections include Social Security and the Postal Service, which are off-budget.

a. Less than \$500 million.