Statement of
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NOTICE

This statement is not available for public release until it is delivered at 10:00 a.m. (EST), Wednesday, January 18, 1989.

Mr. Chairman, I am pleased to appear before the committee this morning to discuss the latest economic and budget projections of the Congressional Budget Office (CBO). These projections will be described in detail in the CBO report titled *The Economic and Budget Outlook: Fiscal Years 1990-1994*, which will be formally released on Tuesday, January 24. Earlier, each of you received an advance summary of the report.

The American economy is making almost full use of both its labor force and its capital stock. The latest unemployment rate is 5.3 percent, the lowest level in 14 years, and factories are operating at high levels of capacity. Because these high operating rates threaten to increase inflation, monetary restraint is likely to slow the economy's growth from recent high rates to a more sustainable trend. As a result, further reductions in the federal budget deficit will probably be modest if spending reductions or tax increases do not take place.

CBO now estimates the budget deficit for 1989 to be $155 billion, about what it was in 1988. Under current budgetary policies, the deficit is projected to decline slowly thereafter--to $141 billion in 1990, $140 billion in 1991, and $122 billion in 1994. These figures exceed by increasing amounts the deficit targets specified in the Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987 (Public Law 100-119).

CBO's baseline budget projections portray what would happen if current budgetary policies were continued without change. They are not a forecast of future budget outcomes, since the future will include many policy changes. The methodology for the baseline projections follows closely the specifications contained in the Reaffirmation Act. For revenues and entitlement spending, the baseline generally assumes that laws now on the statute books will continue. For defense and nondefense discretionary spending, the projections for 1990 through 1994 are based on the 1989 appropriations, increased only to keep pace with inflation. As a result, the baseline makes no explicit allowance for activities not included in the 1989 appropriations, such as conducting the decennial Census of Population, building the manned space station or the superconducting super collider, fully resolving the savings and loan situation, renewing long-term subsidized housing contracts that are about to expire, buying more B-2 bombers, or modernizing nuclear weapons plants.

Baseline Budget Projections

CBO's baseline budget projections are presented in Table 1. The assumption of no real growth in discretionary spending causes both total outlays and the deficit to decline in relation to the growing economy. Outlays fall from an estimated 22.2 percent of gross national product (GNP) in 1989 and 1990, to 22.0 percent in 1991, and 21.1 percent in 1994. Revenues, on the other hand, are projected to increase from 19.2 percent of GNP in 1989 to 19.6 percent in 1990 and 1991, then taper off to 19.4 percent by 1994. The 1990 increase results primarily from the income tax surcharge on Medicare beneficiaries for catastrophic health insurance, a scheduled increase in Social Security

TABLE 1. BASELINE BUDGET PROJECTIONS (By fiscal year)

	1988	1989	1990	1991	1992	1993	1994
			In Billions of Dollars				
Revenues	909	983	1,069	1,140	1,209	1,280	1,359
Outlays	1,064	1,138	1,209	1,280	1,344	1,410	1,480
Deficit	155	155	141	140	135	129	122
Deficit Targets[a]	144	136	100	64	28	0	--
			As Percentages of GNP				
Revenues	19.0	19.2	19.6	19.6	19.5	19.5	19.4
Outlays	22.3	22.2	22.2	22.0	21.7	21.4	21.1
Deficit	3.2	3.0	2.6	2.4	2.2	2.0	1.7

SOURCE: Congressional Budget Office.

NOTE: The baseline estimates include Social Security, which is off-budget.

a. The Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987 established targets for 1988 through 1993.

payroll taxes, and the phasing in of certain provisions of the Tax Reform Act of 1986. The deficit falls from 3.0 percent of GNP in 1989 to 2.6 percent in 1990 and 1.7 percent in 1994. This improvement, however, falls short of that required by the Balanced Budget Act, which mandates a balanced budget by 1993.

For 1990, the deficit target is $100 billion, and the deficit must be held below $110 billion to avoid automatic spending reductions, or sequestration. CBO's deficit estimate of $141 billion exceeds the target by $41 billion. The Reaffirmation Act, however, gives CBO only an advisory role in the sequestration process. Under the terms of the act, the Director of the Office of Management and Budget (OMB) alone determines whether or not automatic spending cuts are necessary and how large the cuts must be. In President Reagan's fiscal year 1990 budget, OMB estimated that the 1990 base deficit for purposes of the Balanced Budget Act is $126 billion, ignoring statutory limitations on spendout rates. If OMB comes up with a similar estimate this summer, only $16 billion in deficit reduction will be required to avoid sequestration.

<u>Changes Since August</u>

CBO's new baseline budget projections reflect all legislation enacted during the second session of the 100th Congress and are based on up-to-date economic and technical estimating assumptions. The new projections are only modestly higher than those published in CBO's August 1988 report, as shown in Table 2. The largest revisions stem from changes in technical estimating assumptions, which add between $6 billion and $11 billion annually to the baseline deficits.

TABLE 2. CHANGES IN CBO DEFICIT PROJECTIONS SINCE AUGUST (By fiscal year, in billions of dollars)

	1989	1990	1991	1992	1993	1994
August 1988 Projections[a]	148	136	131	126	121	121
Changes for:						
Enacted legislation	1	1	1	b	-1	-5
Updated economic assumptions						
Revenues[c]	-5	-6	-8	-7	-5	-5
Net interest	5	4	4	4	3	1
Other outlays	b	b	1	2	2	2
Subtotal	b	-3	-3	-1	b	-2
Technical reestimates						
Revenues[c]	1	2	2	1	b	b
National defense	-2	-2	-2	-2	-1	-1
Deposit insurance	7	8	10	6	5	5
Other outlays	1	-1	2	5	5	2
Subtotal	7	6	11	9	9	8
Total changes	7	5	9	9	8	1
January 1989 Projections[a]	155	141	140	135	129	122

SOURCE: Congressional Budget Office.

a. The baseline projections include Social Security, which is off-budget.

b. Less than $500 million.

c. Revenue increases are shown with a negative sign because they reduce the deficit.

Most of this increase is attributable to higher expected outlays for the deposit insurance activities of the Federal Savings and Loan Insurance Corporation (FSLIC) and the Federal Deposit Insurance Corporation. Although FSLIC has virtually no cash on hand, it is piecing together resources from a variety of sources to enable it to continue closing and selling insolvent institutions. While the new baseline has added more than $30 billion to FSLIC outlays over the next six years, mostly made possible by borrowing from the Federal Home Loan Bank System, thrift institutions are likely to need even more assistance during the early 1990s. The budgetary impact of the additional assistance would depend, however, on the specifics of the financing plan.

Recently enacted legislation adds $1 billion or less per year to the deficit through 1992, but decreases it by $1 billion in 1993 and $5 billion in 1994, primarily because of the delayed effects of lower 1989 defense appropriations. Changes in the economic outlook reduce the deficit by no more than $3 billion in any year. Revenues are higher by $5 billion to $8 billion per year, but the gain in revenue is largely offset by the increased costs of debt service resulting from higher interest rates.

Social Security Surpluses

Accurately measuring the government's borrowing needs and its impact on the economy requires counting all revenues and spending. The previous tables have therefore displayed figures for total revenues, outlays, and the deficit. At the same time, the Balanced Budget Act requires that the Social Security trust funds be shown as off-budget, a treatment that highlights their contribution to the totals. With income of the trust funds exceeding benefits and other costs, the Social Security surplus grows from $56 billion in 1989 to $117 billion in 1994, as shown in Table 3. The on-budget deficit, on the other hand, rises from $211 billion in 1989 to $239 billion in 1994.

An increasing portion of the Social Security surplus results from interest income earned on the growing trust fund balances, which are invested in government securities. Social Security's interest income grows from $11 billion in 1989 to $45 billion in 1994. These interest payments are an intragovernmental transaction; since they contribute identically to the on-budget deficit and to the off-budget surplus, they do not affect the total deficit. Ignoring these intragovernmental payments, the non-Social Security deficit declines slightly, and the Social Security surplus rises less rapidly.

TABLE 3. ON- AND OFF-BUDGET TOTALS
(By fiscal year, in billions of dollars)

	1989	1990	1991	1992	1993	1994
			Off-Budget (Social Security)			
Revenues	267	290	312	333	355	379
Outlays	211	222	234	243	252	261
Surplus	56	68	79	90	103	117
			On-Budget (All Other Programs)			
Revenues	715	779	828	876	925	980
Outlays	926	988	1,047	1,101	1,158	1,219
Deficit	211	209	219	225	233	239
			Total			
Revenues	983	1,069	1,140	1,209	1,280	1,359
Outlays	1,138	1,209	1,280	1,344	1,410	1,480
Deficit	155	141	140	135	129	122

SOURCE: Congressional Budget Office.

THE ECONOMIC OUTLOOK

The long-run rate of growth of the economy's productive capacity, CBO estimates, is about 2½ percent a year. In the aftermath of a recession, when much capacity is unused, the economy can easily grow more rapidly than this trend. But after six years of expansion, the American economy is now employing almost all its capacity. If the economy were to con-tinue growing at its recent rapid rate, inflation would probably increase. The Federal Reserve has therefore sought to slow economic growth to a pace that is sustainable over the long haul.

Forecast for 1989 and 1990

CBO's short-term economic forecast for 1989 and 1990 is shown in Table 4. The forecast assumes that the Federal Reserve will be successful in holding the economy's growth to a rate that will avoid a sharp increase in inflation, and that the 1990 deficit will be reduced to satisfy the Reaffirmation Act's requirements.

The rate of growth of real gross national product, estimated to be 2.6 percent during the four quarters of 1988, is expected to rise to 2.9 percent in 1989 and drop back to 2.2 percent in 1990. Excluding the farm sector, which was hard hit by last summer's drought, the growth rate declines more smoothly--from 3.5 percent in 1988 to 2.1 percent in 1989 and 2.2 percent in 1990. Unemployment is expected to remain near its current level of about 5½ percent. Net exports and business fixed investment are expected to be the major sources of economic expansion in the next two years. Because of the temporary strength of the dollar in mid-1988, however, the rate of improvement in real net exports is likely to be slower in 1989 and 1990 than it was in 1988.

TABLE 4. COMPARISON OF ADMINISTRATION, CBO, AND *BLUE CHIP* SHORT-RUN ECONOMIC FORECASTS

	Estimated 1988	Forecast 1989	Forecast 1990
Fourth Quarter to Fourth Quarter (Percent change)			
Real GNP			
Administration	2.6	3.5	3.4
CBO	2.6	2.9	2.2
Blue Chip	2.8	2.3	1.9
Nominal GNP			
Administration	6.6	7.4	7.0
CBO	6.7	6.9	6.6
Blue Chip	6.9	6.7	6.3
Consumer Price Index[a]			
Administration	4.2	3.6	3.5
CBO	4.3	5.0	4.8
Blue Chip	4.4	4.8	4.7
Calendar-Year Averages (Percent)			
Three-Month Treasury Bill Rate			
Administration	6.7	6.3	5.5
CBO	6.7	7.9	7.1
Blue Chip	6.7	7.8	7.3
Ten-Year Government Note Rate			
Administration	8.9	8.3	7.2
CBO	8.9	9.3	9.0
Blue Chip[b]	8.9	9.0	8.4
Civilian Unemployment Rate			
Administration[c]	5.4	5.2	5.1
CBO	5.5	5.5	5.5
Blue Chip	5.5	5.4	5.7

SOURCE: Congressional Budget Office; Office of Management and Budget; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (January 10, 1989). The CBO forecast is based on preliminary 1988 fourth-quarter data published in January 1989.

a. Consumer Price Index for urban wage earners and clerical workers.

b. *Blue Chip* does not project a ten-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 ten-year government notes.

c. The Administration's projection is for the total labor force, including armed forces residing in the United States, while the CBO and *Blue Chip* projections are for the civilian labor force excluding armed forces. In recent years, the unemployment rate for the former has tended to be 0.1 to 0.2 percentage points below the rate for the civilian labor force alone.

CBO projects that consumer price inflation will increase from 4.3 percent in 1988 to 5.0 percent in 1989, both from increases in food prices and from higher import prices. Because wage growth is likely to accelerate, inflation is not expected to subside much in 1990. Interest rates will remain high in the first half of 1989, as restraint continues. Rates are forecast to ease somewhat later in 1989 and in 1990, reflecting the central bank's success in holding growth to the range of 2 percent to 2½ percent.

Uncertainty in the Forecast

CBO's short-run forecast represents only one of the many paths that the economy might take over the next two years. We believe, however, that the forecast lies roughly in the middle of the possible outcomes. It is also close to the average of the 50 private-sector forecasts summarized in *Blue Chip Economic Indicators*, as shown in Table 4.

Most forecasters agree that the Federal Reserve's effort to control inflation is the key source of uncertainty in the economy today. Even under the best of circumstances, it is difficult for monetary policy to slow the economy gradually. The economy may continue to grow rapidly in spite of monetary tightening, thereby provoking higher inflation, further tightening, a rapid increase in interest rates, and possibly a recession. Today the Federal Reserve's task is also complicated by the volatility of the dollar, the shaky condition of a number of thrift institutions and banks, the debt problems of developing countries, and the higher degree of corporate financial leveraging. Although CBO forecasts a smooth slowing in growth through 1989, a number of private forecasters expect a recession to begin this year.

Other forecasts, notably that of the Reagan Administration, are considerably more optimistic than CBO on the outlook for inflation and economic growth. The Administration forecasts fourth-quarter-to-fourth-quarter real growth rates that exceed CBO's by 0.6 percentage points in 1989 and 1.2 percentage points in 1990 (see Table 4). Inflation is more than a percentage point lower, as are interest rates. This more favorable outlook assumes that the potential for noninflationary growth is greater than estimated by CBO. The Administration projects that productivity will grow about 2 percent a year, which is near the post-World War II average. In recent years, however, the growth of productivity has been substantially less, and the CBO forecast assumes that growth of productivity will continue at the slower recent rates. If the Administration's view were to prove more accurate, continued strong growth may not be quickly followed by higher inflation, and the Federal Reserve may not feel the need to tighten further.

These alternative views of developments in the next two years indicate the range of possibilities. Neither a recession nor a spurt in productivity can be completely ruled out. The CBO forecast, however, gives some weight to both views and should be a prudent guide to policy planning. In CBO's judgment, the economy's actual growth over the next two years is equally likely to be lower or higher than our forecast.

Projections for 1991 Through 1994

For 1991 through 1994, CBO's economic assumptions are not a forecast of future economic conditions but are projections based on past trends. Real GNP is projected to grow at an average annual rate of 2.2 percent, as shown in Table 5, and the unemployment rate remains close to current levels. The inflation rate as measured by the Consumer Price Index is projected to decline moderately after 1990 and stabilize around 4 percent. Interest rates are projected to decline throughout the 1991-1994 period until they reach levels consistent with the average of inflation-adjusted interest rates since 1973. In 1994, the three-month Treasury bill rate is assumed to be 5.9 percent, and the ten-year government note rate is projected to be 7.4 percent.

TABLE 5. COMPARISON OF ADMINISTRATION AND CBO ECONOMIC ASSUMPTIONS, 1989-1994 (By calendar year)

	Estimated	Forecast		Projected			
	1988	1989	1990	1991	1992	1993	1994
Nominal GNP (Billions of dollars)							
Administration	4,857	5,211	5,570	5,939	6,296	6,640	6,968
CBO	4,859	5,209	5,542	5,902	6,281	6,685	7,117
Real GNP (Percent change, year over year)							
Administration	3.8	3.2	3.2	3.3	3.2	3.2	3.2
CBO	3.8	2.9	2.1	2.2	2.2	2.3	2.3
Consumer Price Index[a] (Percent change, year over year)							
Administration	4.0	3.8	3.7	3.2	2.7	2.2	1.7
CBO	4.0	4.9	4.9	4.6	4.4	4.4	4.4
GNP Deflator (Percent change, year over year)							
Administration	3.4	3.9	3.6	3.2	2.7	2.2	1.7
CBO	3.4	4.2	4.2	4.2	4.1	4.1	4.1
Three-Month Treasury Bill Rate (Percent)							
Administration	6.7	6.3	5.5	4.5	4.0	3.5	3.0
CBO	6.7	7.9	7.1	6.7	6.4	6.1	5.9
Ten-Year Government Note Rate (Percent)							
Administration	8.9	8.3	7.2	6.0	5.0	4.5	4.0
CBO	8.9	9.3	9.0	8.6	8.1	7.7	7.4
Unemployment Rate[b]							
Administration	5.4	5.2	5.1	5.0	5.0	5.0	5.0
CBO	5.5	5.5	5.5	5.5	5.6	5.6	5.6
Tax Bases							
Wage and salary disbursements							
Administration	2,434	2,605	2,780	2,969	3,159	3,342	3,515
CBO	2,435	2,615	2,787	2,969	3,163	3,370	3,590
Other personal income[c]							
Administration	1,618	1,721	1,853	1,955	2,043	2,119	2,204
CBO	1,626	1,754	1,870	1,977	2,090	2,211	2,346
Corporate profits[d]							
Administration	301	351	396	442	475	498	522
CBO	299	328	351	378	390	401	424

SOURCE: Congressional Budget Office; Office of Management and Budget.

a. Consumer Price Index for urban wage and clerical workers.

b. The Administration's projection is for the total labor force, including armed forces residing in the United States, while the CBO projection is for the civilian labor force excluding armed forces. In recent years, the unemployment rate for the former has tended to be 0.1 to 0.2 percentage points below the rate for the civilian labor force alone.

c. Other personal income is personal income less wage and salary disbursements.

d. Corporate profits reported are book, not economic, profits.

The long-run assumptions of the Reagan Administration, on the other hand, are substantially more optimistic than recent experience would lead one to expect, especially in terms of their budgetary impact. The Administration assumes that unemployment during the 1991-1994 period will remain at 5 percent and that the economy will achieve an average growth rate of 3.2 percent per year. Despite this assumed rapid growth, the Administration projects that inflation will fall to less than 2 percent by 1994. Short-term interest rates are projected to drop to 3 percent in 1994 and long-term rates to 4 percent--lower than at any time since the early 1960s. While the combination of high real growth and low inflation in the Administration assumptions produces nominal incomes and tax revenues close to the CBO baseline, low inflation and low interest rates produce much lower federal outlays over the next five years than CBO projects. As with the short-term forecast, we believe that CBO's long-run economic assumptions provide a more prudent basis for making multiyear budget plans.