Statement of
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before the
Committee on the Budget
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This document should not be released before its delivery, scheduled for 9:30 a.m. (E.D.T.), Wednesday, February 8, 1984.

Mr. Chairman, I am pleased to have this opportunity to testify on the economy and on the federal budget. We have distributed to you the three parts of the Congressional Budget (CBO) annual report. Part I on the economy and Part II on the budget were released yesterday. Part III, Reducing the Deficit: Spending and Revenue Options, is being released today. 1/

As you know, the condition of the U.S. economy has improved markedly since the recession. Output grew vigorously during the first year of recovery, and the unemployment rate declined at a near record pace from a level that was a post-World War II high. At the same time, the dramatically lower inflation rates that were achieved during the recession held firm in 1983 despite the pace of the recovery. At the end of 1983, economic growth appeared to be slowing, as is normal during the second year of a recovery.

In one respect, however, the recovery was unusual: interest rates remained at very high levels, apparently because of huge current and prospective federal deficits and the anti-inflationary policies of the Federal Reserve. As a result, some sectors--particularly the export and import-competing industries--did not fully participate in the recovery.

Despite the high interest rates and signs of unbalanced growth, most forecasters, including the CBO, believe that the near-term outlook

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1/ Congressional Budget Office, A Report to the Senate and House Committees on the Budget, Part I: The Economic Outook, Part II: Baseline Budget Projections for Fiscal Years 1985-1989, Part III: Reducing the Deficit: Spending and Revenue Options (February 1984).

remains favorable. The consensus forecast calls for economic growth in the 4 to 5 percent range during 1984, with inflation only slightly above the previous year's rate. But the horizon is clouded by uncertainty concerning federal economic policy.

Some have questioned whether continued recovery is possible given the huge deficits implied by current fiscal policy. Our own forecast implies that the economy can continue to expand robustly in the short run despite the level of federal borrowing. The real harm done by deficits involves their negative impacts on long-run growth and, therefore, on future living standards. In other words, the process is gradual and there is no easily identifiable, traumatic event that clearly illustrates the effects of deficits. There is an intense conflict between public and private borrowing needs, but the word "collision," which is often used to describe this clash may not be exactly appropriate. A collision is a readily observable, violent event. The gradual erosion of our future prospects is much harder to detect.

However, more than the usual degree of uncertainty must be attached to the short-run forecast and the foregoing analysis. CBO projects federal deficits rising from $190 billion in the current fiscal year to $326 billion in 1989 if budget policies are not changed. The projections imply that deficits will average 4.7 percent of the gross national product (GNP) during the 1980s. The comparable levels in the previous decades were: 0.4 percent in the 1950s, 0.8 percent in the 1960s, and 1.9 percent in the 1970s. We are operating so far outside of the range of recent historical experience that

any analysis must be put forward tentatively and the risks are enormous, even in the short run.

RECENT ECONOMIC DEVELOPMENTS

Output rose 6.1 percent during 1983, close to the average of previous postwar recoveries. The cyclical upturn in output began in the first quarter of last year, following a rebound in residential construction and consumer spending and an abrupt decline in inventories in the fall of 1982 (see Table 1). The impetus for this improvement in household demands was the easing of monetary policy beginning in the summer of 1982 and the cuts in income taxes. Defense spending also grew rapidly in 1982. Higher demands caused industrial production to increase sharply (16.1 percent) during 1983, and by year-end capacity utilization in manufacturing had risen from a post-World War II low of 68.8 percent to 79.4 percent. Business investment spending turned up in the second quarter of 1983 and grew rapidly in the second half of the year in response to rising capacity utilization and to the net stimulative effects of the business tax legislation of 1981 and 1982.

Unemployment and Inflation

The unemployment rate declined dramatically last year, from the postwar record of 10.7 percent of the civilian labor force to 8.0 percent at the beginning of this year. The decline was much sharper than warranted by the increase in output, given past experience. In the first year of recovery, the labor force grew less than expected and growth in employment was

TABLE 1. RECENT ECONOMIC INDICATORS (Percent change from previous period at seasonally adjusted annual rates, unless otherwise noted)

	1981	1982	1983	1982 Q3	1982 Q4	1983 Q1	1983 Q2	1983 Q3	1983 Q4
Real GNP	2.6	-1.9	3.3	-1.0	-1.3	2.6	9.7	7.6	4.5
Final sales	1.8	-0.7	2.8	-1.5	4.5	0.6	6.8	5.1	3.5
Consumption	2.7	1.4	4.2	0.9	3.6	2.9	10.0	2.2	6.5
Business fixed investment	5.2	-4.7	1.1	-8.8	-6.6	-1.5	7.9	18.7	22.3
Residential investment	-5.2	-15.4	39.6	-13.0	53.2	57.3	79.5	35.9	-5.2
Government purchases	0.8	1.8	0.5	9.4	10.6	-8.8	-1.1	4.4	-2.7
Inventory Change (billions of 1972 dollars)	8.5	-9.4	-2.4	-1.3	-22.7	-15.4	-5.4	3.8	7.5
Net Exports (billions of 1972 dollars)	43.0	28.9	11.7	24.0	23.0	20.5	12.3	11.4	2.5
Industrial Production	2.7	-8.2	6.6	-3.4	-8.4	10.1	18.4	21.8	11.6
Capacity Utilization (percent)	80.2	72.1	75.4	71.7	69.8	71.2	73.9	77.3	79.1
Payroll Employment (millions)	91.2	89.6	90.0	89.3	88.8	88.8	89.5	90.3	91.4
Civilian Unemployment Rate (percent)	7.6	9.7	9.6	10.0	10.6	10.4	10.1	9.4	8.5
Inflation Rate									
CPI-U	10.4	6.1	3.2	7.7	1.9	-0.4	4.3	4.7	4.9
GNP deflator (fixed weight)	9.5	6.4	4.3	5.9	4.7	3.4	4.3	4.7	4.5
Productivity a/	1.9	-0.1	3.1	2.3	1.3	3.7	7.1	2.3	1.0
Interest Rates (percent)									
Treasury bill rate	14.0	10.6	8.6	9.3	7.9	8.1	8.4	9.1	8.8
Corporate AAA bond rate	14.2	13.8	12.0	13.8	11.9	11.8	11.6	12.3	12.4

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Board; Moody's Investors' Service.

a/ Output per worker hour, nonfarm business sector.

exceptionally rapid. In consequence, the rebound in productivity was somewhat less than in the normal cyclical rebound.

Inflation declined in 1983, though the rate of decline appeared to be slowing. The increase in the fixed-weight deflator, a broad measure of inflation, fell from a record 9.8 percent in calendar year 1980 to 6.4 percent in 1982 and to 4.3 percent in 1983. Although some of the decline in 1983 reflected temporary factors, present indications are that inflation will be quite moderate again this year.

The Distribution of Growth

High interest rates, the most unusual feature of this recovery, have not had as large an effect on overall economic growth as many expected (see Figure 1). They have, however, affected the composition of growth. Net exports have been particularly hard hit. The U.S. merchandise trade balance ran a record $69 billion deficit in 1983, and some forecasters expect it to exceed $100 billion this year. At the same time, capital inflows were very strong because relatively high interest rates in the United States attracted foreign investors. Of course, the capital inflows benefited domestic investments and prevented interest rates from rising further. But, at the same time, foreign demand for dollars to invest in the United States pushed up the international exchange rate of the dollar to record levels. This in turn reduced foreign demand for the products of U.S. exporters, while cheaper imports reduced demand in many domestic industries. Thus,

in 1983, net exports were effectively crowded out by tight credit conditions that arose, at least in part, from large budget deficits.

Interest rates also appear to be having an adverse effect on the recovery in residential construction, which at first was rapid. Between May and August of 1983, interest rates rose significantly, apparently because of strong economic growth and a tightening of monetary policy, and have since remained in a higher range than before. As a result, the growth in housing starts stalled in the fall and residential construction activity declined in the final quarter of 1983. The outlook for further growth in this sector now depends critically on the future course of interest rates and the resolution of the budget deficit problem.

THE CBO ECONOMIC PROJECTIONS

The CBO baseline economic projections, which are used to generate baseline budget estimates, consist of two parts: (1) a short-run forecast for the 1984-1985 period conditional upon specific policy assumptions; and (2) longer-run projections based upon historical growth trends and the assumption that inflation will gradually decline.

The Short-Run Forecast

The short-run baseline forecast incorporates the following policy assumptions:

- The federal budget policies are those currently in place. Defense authority, in real terms, increases at roughly a 5 percent rate. Budget outlays are $853 billion in fiscal year 1984 and $928 billion in fiscal year 1985.

TABLE 2. THE CBO FORECAST FOR 1984 AND 1985

Economic Variable	Actual 1982	Actual 1983	Forecast 1984	Forecast 1985
Fourth Quarter to Fourth Quarter (percent change)				
Nominal GNP	2.6	10.4	10.3	9.0
Real GNP	-1.7	6.1	4.7	3.7
GNP Implicit Price Deflator	4.4	4.1	5.3	5.1
Consumer Price Index for Urban Consumers	4.5	3.3	5.1	4.9
Calendar Year Average (percent)				
Civilian Unemployment Rate	9.7	9.6	7.8	7.3
3-Month Treasury Bill Rate	10.6	8.6	8.9	8.6

- Federal government revenues are those associated with current law: $663 billion in fiscal year 1984 and $733 billion in 1985.
- Growth in the M1 money aggregate is assumed to be 6.0 percent over the four quarters of 1984 and 5.5 percent during 1985.

The forecast also assumes that there will be no price shocks or credit crises. Retail food prices are assumed to increase at about 4 percent in 1984 and 5 percent in 1985--reflecting the delayed effects of last summer's drought. Crude oil prices are assumed to remain constant, at about $29 per barrel, throughout the forecast period.

With these assumptions, real GNP is projected to rise 4.7 percent over the four quarters of 1984 and 3.7 percent during 1985 (see Table 2).

Average growth over the two years is slightly above the average for the second and third years of previous postwar recoveries. The civilian unemployment rate is projected to decline from 8.5 percent in the last quarter of 1983 to 7.6 percent by the end of 1984 and to 7.1 percent by late 1985.

As measured by the GNP deflator, inflation is expected to accelerate slightly from 4.2 percent in 1983 to 5.3 percent over the four quarters of 1984 and to average 5.1 percent during 1985. This increase in inflation reflects temporary factors--for example, the decline in oil prices last year that is not expected to be repeated this year, and a temporary acceleration in food prices later in 1984 stemming from last year's drought. In addition, the relatively rapid reduction of slack in the economy will tend to keep inflation from falling rapidly. However, nothing in the CBO forecast is inconsistent with the hypothesis that inflation is on a long-term downward trend.

The three-month Treasury bill rate is projected to average 8.9 percent this calendar year and slightly lower next year. Interest rates remain very high in real terms because of the exceptionally large amount of Treasury borrowing combined with strengthened private credit demands.

The Longer-Run Economic Projections

The baseline economic projections for the 1986-1989 period assume moderate noncyclical growth in output averaging about 3.4 percent per year (see Table 3). The projections for the long run are based on historical trends and are not meant to be necessarily consistent with the policies now in

TABLE 3. LONG-RUN ECONOMIC PROJECTIONS, CALENDAR YEARS 1984-1989

Economic Variable	1983 Actual	1984	1985	1986	1987	1988	1989
GNP (billions of current dollars)	3,310	3,651	3,995	4,339	4,704	5,084	5,481
Nominal GNP Growth Rate (percent change, year over year)	7.7	10.3	9.4	8.6	8.4	8.1	7.8
Real GNP (percent change, year over year)	3.3	5.4	4.1	3.5	3.5	3.4	3.3
GNP Implicit Price Deflator (percent change, year over year)	4.2	4.7	5.1	4.9	4.7	4.5	4.3
Consumer Price Index, CPI-U (percent change, year over year)	3.2	4.8	5.1	4.9	4.7	4.5	4.3
Civilian Unemployment Rate (percent, annual average)	9.6	7.8	7.3	7.0	6.8	6.6	6.5
3-Month Treasury Bill Rate (percent, annual average)	8.6	8.9	8.6	8.4	8.2	8.0	7.8

place. Unemployment declines gradually to 6.5 percent by the last year of the projection. Inflation declines very gradually from 5.1 percent in calendar year 1985 to 4.3 percent in 1989, and interest rates decline with inflation. This may be somewhat optimistic since analysis based on past experience suggests that the inflation rate might cease its decline given the assumed reduction in the unemployment rate. However, the relationship between unemployment and inflation is highly unstable and it is our judgment that if unemployment falls smoothly and slowly--as is implied by our growth path--continued progress can be made against inflation.

Since the longer-term projection of real growth is based upon historical trends, it is not intended to be an implicit judgment about what would be appropriate growth. 3/ For the seven-year period beginning with the recession trough (1982:4 to 1989:4), growth in real GNP averages 4 percent in the CBO baseline projection, precisely the same as the average growth rate during the first seven years following previous postwar recessions.

Uncertainty in the Outlook

There is a great deal of uncertainty in the economic outlook, particularly with respect to inflation and interest rates.

3/ Although these longer-run projections for inflation and nominal GNP growth do not reflect specified goals for the economy, they appear to be broadly consistent with statements by both the Administration and monetary authorities. See Economic Report of the President (February 1983), p. 23, and Paul A. Volcker, "We Can Survive Prosperity," an address to the American Economic Association, December 18, 1983.

- Inflation is subject to unforeseeable events--a bad crop year, a cut in oil supplies, or a sharp change in the value of the dollar in international exchange markets. Some analysts claim the dollar is "overvalued" by 20 percent or more; a decline in the dollar by that amount would raise the cost of imported goods and raise domestic prices by, perhaps, 2 percent. Inflation is also affected to an uncertain degree by the relative effects of economic slack and rapid growth.

- Interest rates are very difficult to forecast accurately. In addition to economic policy, the interest rate outlook depends on: the course of expected inflation, the response of savings to recent tax law changes, foreign capital inflows, and the risk of credit market disruptions, perhaps resulting from payment problems in developing countries.

The major source of uncertainty lies in economic policy. Some analysts believe that monetary policy has been too tight since last summer, and fear that there will be a slowdown in economic growth during the first half of this year despite the fiscal stimulus. Others are concerned that the Federal Reserve will find it difficult to maintain moderate money growth in the face of large federal deficits and the developing-country debt crisis.

With regard to fiscal policy, the major question is whether deficits will be reduced soon and if so, how? It is difficult for businesses and individuals to make effective decisions about the future without knowing what deficit-reducing measures will be taken and the impact these measures are likely to have on their activities. Moreover, the competition between private and federal credit demands will be intense, if policies are not changed. Federal borrowing will decline relative to GNP only in the first years of the projection--and then only slightly--and will remain exceptionally high and increase relative to GNP in later years.

If action on the deficit is postponed, it is also possible that foreigners will lose confidence in U.S. policies and reduce their investments in this country. While the resulting decline in the exchange value of the dollar would benefit U.S. export and import-competing industries, it would also generate increased domestic inflation and--given a fixed rate of money growth--push up interest rates. It may even force the Federal Reserve to undertake a more restrictive policy in order to maintain stability in foreign exchange markets.

THE BUDGET OUTLOOK

Given baseline economic assumptions and no change in the budget policies now in place, CBO estimates that the federal deficit will rise from about $190 billion this year to $326 billion in fiscal year 1989 (see Table 4). Despite rapid growth in GNP, the budget deficit rises from 5.3 percent of GNP in fiscal year 1984 to 6.1 percent in 1989, matching the record level established last year. Federal spending remains very strong in the baseline projection: relative to GNP, it declines from 24.7 percent in fiscal year 1983 (a postwar record) to 23.9 percent this year, but then rises to a new record high by 1989. Revenues are projected to be 18.6 percent of GNP in fiscal year 1984, rising gradually to 19.0 percent in 1988.

CBO's baseline budget projections are designed to show what would happen to the federal budget if current policies were continued into the future. For revenues and for mandatory spending items, current policies are largely defined by the laws now in effect. For discretionary spending,

TABLE 4. BASELINE BUDGET PROJECTIONS (By fiscal year)

	1983 Actual	1984 Base	Projections 1985	1986	1987	1988	1989
In Billions of Dollars							
Baseline with 5 Percent Real Growth in Defense Authority a/							
Revenues	601	663	733	795	863	945	1,016
Outlays	796	853	928	1,012	1,112	1,227	1,342
Deficit	195	190	195	217	248	282	326
Budget Authority	867	923	1,019	1,116	1,231	1,374	1,504
Baseline with No Real Growth in Defense Budget Authority							
Revenues	601	663	733	795	863	945	1,016
Outlays	796	853	923	998	1,083	1,177	1,265
Deficit	195	190	190	203	220	232	249
Budget Authority	867	923	1,005	1,090	1,183	1,299	1,395
As a Percent of GNP							
Baseline with 5 Percent Real Growth in Defense Budget Authority a/							
Revenues	18.6	18.6	18.7	18.7	18.7	19.0	18.9
Outlays	24.7	23.9	23.7	23.8	24.1	24.6	24.9
Deficit	6.1	5.3	5.0	5.1	5.4	5.6	6.1
Baseline with No Real Growth in Defense Budget Authority							
Revenues	18.6	18.6	18.7	18.7	18.7	19.0	18.9
Outlays	24.7	23.9	23.6	23.5	23.5	23.6	23.5
Deficit	6.1	5.3	4.9	4.8	4.8	4.7	4.6
Reference:							
Gross National Product (In billions of dollars)	3,229	3,563	3,910	4,251	4,612	4,987	5,379

a/ Defense budget authority for 1985 and 1986 is assumed to be the amounts specified in the most recent Congressional budget resolution; defense budget authority for 1987-1989 is an estimate of the amounts required to achieve real increases of 5 percent per year.

however, the definition of current policy is not as clear, since appropriations are made for only one year at a time. The baseline projections for nondefense appropriations are generally based on fiscal year 1984 funding levels, with future increases to keep pace with inflation. The projections for defense are based on the fiscal year 1984 Congressional budget resolution, which not only allowed defense spending to keep pace with inflation but also provided for roughly 5 percent annual real growth in defense budget authority.

While our baseline projections assume 5 percent real growth in defense spending as the best approximation of current policy, CBO has also projected defense expenditures on the same basis as is used for nondefense discretionary programs. These alternative defense projections simply increase 1984 defense budget authority by the rate of inflation and thus allow for no real growth in defense spending. Even with no real defense growth, however, the deficit would still reach $249 billion by 1989 (see Table 4).

Changes in the Composition of Revenues and Spending

The composition of federal revenues is projected to change somewhat over the next five years. Individual income taxes and social insurance taxes rise faster than other taxes, growing from 80 percent of total revenues in 1984 to 85 percent by 1989. Corporate income taxes, excise taxes, and other receipts will continue to diminish in relative importance (see Table 5).

TABLE 5. BASELINE REVENUE AND OUTLAY PROJECTIONS BY SOURCE OR MAJOR CATEGORY (By fiscal year, in billions of dollars)

	1983 Actual	1984 Base	Projections				
			1985	1986	1987	1988	1989
Revenues							
Individual Income Taxes	289	294	329	362	396	438	478
Corporate Income Taxes	37	62	65	71	81	85	85
Social Insurance Taxes	209	237	269	296	320	354	382
Excise Taxes							
Windfall profit taxes	13	9	7	5	4	4	4
Other	22	29	31	27	28	28	29
Estate and Gift Taxes	6	6	6	5	5	4	5
Customs Duties	9	10	11	12	12	12	13
Miscellaneous Receipts	16	16	16	17	18	19	20
Total Baseline Revenues	601	663	733	795	863	945	1,016
Outlays							
National Defense	210	235	263	295	331	372	419
Entitlements and Other Mandatory Spending							
Social Security	165	173	184	197	211	227	243
Medicare	56	64	74	83	94	106	120
Other	179	162	167	177	186	197	208
Subtotal	400	400	425	456	490	530	570
Nondefense Discretionary Spending	144	156	161	168	178	189	198
Net Interest	90	108	127	145	168	194	219
Offsetting Receipts	-48	-46	-49	-52	-55	-59	-64
Total Baseline Outlays	796	853	928	1,012	1,112	1,227	1,342

Changes in the composition of federal spending are more substantial. The most rapidly growing category of spending in the baseline is net interest. With large and growing deficits and no reduction in inflation-adjusted interest rates after 1985, federal borrowing costs are projected to double over the next five years. The portion of gross spending (excluding offsetting receipts) devoted to interest rises from 12 percent in 1984 to 16 percent by 1989. Defense spending grows by 79 percent between 1984 and 1989, assuming real increases of 5 percent per year. The share of defense spending in the budget grows from 26 percent to 30 percent.

In our projections, domestic spending--the combination of entitlements and discretionary programs--grows by 38 percent between now and 1989. Because this is well below the rate of increase in total outlays, their share of the budget declines from 62 percent in 1984 to 55 percent in 1989. The dollar increase is still substantial, however, from $556 billion in 1984 to $769 billion in 1989. Of this $213 billion increase, $124 billion--or 58 percent--is in just two programs, Social Security and Medicare.

Perhaps the most important point to make about the spending side of the budget is that very few programs are responsible for the bulk of federal outlays. Our projections suggest that, by 1989, spending on defense, Social Security, Medicare, and net interest will be equivalent to almost 100 percent of total tax revenues.

Comparison of CBO and Administration Economic Assumptions and Budget Projections

The CBO and Administration economic forecasts for 1984 and 1985 are very similar (see Table 6). Projected growth rates for real GNP are almost identical. The Administration's short-run forecast for inflation is only slightly more optimistic. Interest rates are lower in the Administration's forecast, but by less than one percentage point.

However, the Administration's longer-run projections for the 1986-1989 period are considerably more optimistic than CBO's. The Administration's projection shows growth rates averaging about one half of one percentage point higher than CBO's, and inflation lower by a similar amount. However, the largest difference between the CBO and Administration's projections is in the area of interest rates. The Administration's projections show substantially lower interest rates than CBO's, with the differential growing.

The Administration's budget estimates, presented in Table 7, show substantially lower outlays and somewhat higher revenues than CBO's baseline budget estimates. CBO is now examining the Administration's budget to determine how much of the differential is due to differences in policy assumptions and how much is due to differences in economic assumptions or technical estimating methods. While the analysis is not complete, it appears that economic assumptions account for a large part of the difference in budget estimates in the 1986-1989 period. Interest-rate

TABLE 6. COMPARISON OF CBO AND ADMINISTRATION'S ECONOMIC ASSUMPTIONS (By calendar year)

	1984	1985	1986	1987	1988	1989
GNP (billions of current dollars)						
CBO	3651.2	3994.8	4339.0	4703.7	5083.5	5480.5
Administration	3642.4	3973.8	4319.2	4681.2	5059.0	5444.9
Difference	8.8	21.0	19.8	22.5	24.5	35.6
Real GNP, (1972 dollars, percent change, year over year)						
CBO	5.4	4.1	3.5	3.5	3.4	3.3
Administration	5.3	4.1	4.0	4.0	4.0	3.9
Difference	0.1	0.0	-0.5	-0.5	-0.6	-0.6
GNP Deflators (percent change, year over year)						
CBO	4.7	5.1	4.9	4.7	4.5	4.3
Administration	4.5	4.8	4.5	4.2	3.9	3.6
Difference	0.2	0.3	0.4	0.5	0.6	0.7
Consumer Price Index (percent change, year over year) a/						
CBO	4.5	5.0	4.9	4.7	4.5	4.3
Administration	4.4	4.6	4.5	4.2	3.9	3.6
Difference	0.2	0.4	0.4	0.5	0.6	0.7
Civilian Unemployment Rate (percent, annual average)						
CBO	7.8	7.3	7.0	6.8	6.6	6.5
Administration b/	7.9	7.7	7.5	6.9	6.2	5.8
Difference	-0.1	-0.4	-0.5	-0.1	0.4	0.7
90-Day Treasury Bills (percent, annual average)						
CBO	8.9	8.6	8.4	8.2	8.0	7.8
Administration	8.5	7.7	7.1	6.2	5.5	5.0
Difference	0.4	0.9	1.3	2.0	2.5	2.8

a/ Consumer price index for urban wage earners and clerical workers.

b/ The Administration publishes only the overall unemployment rate. The adjustment to civilian is made by CBO.

TABLE 7. ADMINISTRATION UNIFIED BUDGET ESTIMATES (By fiscal year, in billions of dollars)

	1983 Actual	1984	1985	1986	1987	1988	1989
Revenues	601	670	745	815	888	978	1060
Outlays	796	854	925	992	1068	1130	1184
Deficit	195	184	180	177	180	152	123

projections appear to account for about half ($80 billion) of the differences between the CBO and Administration outlay estimates in fiscal year 1989. The Administration's current services revenue estimates are above those of CBO, though the Administration, for the most part, assumes lower incomes. We will have a report on the Administration's budget in a few weeks when our analysis is complete.

The analysis produced by both the Administration and CBO shows that it is unlikely that a vigorous economic expansion will cure the deficit problem. The Administration's current services budget shows persistent deficits of around $200 billion annually in the projection period. CBO's analysis indicates that, even if economic growth matches the strong expansion of the 1960s, which appears unlikely, federal deficits will probably

remain at near-record levels unless policies are changed. 4/ The sheer magnitude of the projected budget deficits means that percentage errors in forecasting them are likely to be much smaller than in the past. 5/ It is noteworthy that CBO's projection of the deficit for fiscal year 1988 has changed very little from that of a year ago. 6/

CONSEQUENCES OF LARGE DEFICITS

Federal deficits of the magnitude shown in the baseline projection would have major consequences both for the economy and for future budgetary choices. Most economists agree that federal deficits of the size projected by CBO keep interest rates higher than they would be otherwise. The effect would be particularly strong as the economy approached full employment (or the limits to growth set by monetary policy), where public and private borrowing would compete for a relatively fixed level of saving.

4/ Congressional Budget Office, The Economic Outlook (February 1984). See CBO's high-growth path and associated budget estimates in Chapter I.

5/ Forecasts of deficits have shown large errors in the past because the deficits were a residual of two much larger numbers. Thus in the 1960s, when deficits averaged 4.6 percent of total outlays, a 5 percent error in the forecast of spending would have resulted in a 109 percent error in the projected deficit. But in 1983, when the deficit was 24.6 percent of outlays, a 5 percent error in the outlay estimate would have resulted in an error of only 20 percent in the deficit estimate, other things being equal.

6/ CBO currently projects a fiscal year 1988 baseline budget deficit of $282 billion, up from the $267 billion in CBO's February 1983 baseline budget projection for fiscal year 1988.

Even in the present situation of less than full employment, deficits are likely to raise interest rates. A few analysts contend that there is no historical evidence for a link between deficits and interest rates. But one should not expect to find in historical data a simple association between deficits and interest rates. Previous deficits experienced during peacetime have been much smaller than those now projected, and their impact on interest rates has often been overwhelmed by recessions, Federal Reserve policies, or international capital flows.

The current and prospective deficits are extremely large relative to past history. In fiscal year 1983, the federal deficit was about 107 percent of domestic net private saving and 34 percent of gross private saving. Our forecast implies that federal deficits would be 79 percent of net private savings and 29 percent of gross private savings during the fiscal year 1984-1985 period. Fortunately, very large capital inflows from abroad have so far limited the rise in interest rates. It should be emphasized that these capital inflows are not a costless remedy for deficits. If the capital inflow continued for a long time, foreign claims on U.S. output could rise to such a level that it would reduce our standard of living significantly below what it would be if we decreased government borrowing and relied less on capital inflows.

High interest rates, if they persist, are likely to reduce capital accumulation. Although the cyclical rise in demands and increased capacity utilization rates are now providing a strong stimulus to investment, this may eventually be offset by the retarding effect of high interest rates on structures investment. Over time a reduction in the capital-output ratio

will retard growth in productivity, the major source of rising living standards.

The Interest Payment Bill

The most striking feature of the CBO budget baseline projections is the extremely rapid growth in outlays for interest on the debt (see Figure 2). Net interest costs, which were between 1 and 2 percent of GNP for decades, are projected to rise from 2.8 percent of GNP in fiscal year 1983 to 4.1 percent in 1989. In these circumstances, major spending cuts or tax increases are necessary just to avoid the possibility of explosive growth in interest outlays.

The rapid rise in the debt-to-GNP ratio also makes the future deficit outlook highly sensitive to interest rates, one of the hardest economic variables to forecast. A one-percentage-point error in the forecast, if continued through the projection period, implies a $30 billion error in the projection of the 1989 deficit.

REDUCING THE DEFICIT

I am pleased to be releasing today before this Committee part III of CBO's annual report on options for reducing the deficit. This is the fifth in a series of studies that presents options--not recommendations--for cutting spending or raising taxes. There is no really adequate way to summarize the approximately 138 options (98 in spending and 40 in revenues) presented, but

perhaps I can give some flavor of the analysis by culling one highlight from each substantive chapter.

In national defense, the options discussed contrast the difficult trade-off between short term readiness efforts and long-term buildup of conventional and nuclear weapons systems, with the sobering conclusion that to bring the Administration's defense budget down to 5 percent real growth--the rate incorporated in last year's budget resolution--will require $174 billion in cuts from defense budget authority between 1985 and 1989 (using the Administration's defense price assumptions). To freeze defense budget authority at the 1984 level--adjusting only for inflation--will take cuts of over $400 billion in the next five years.

In Medicare and Medicaid, the CBO analysts illustrate each of the variety of ways that federal costs can be held down: by restraining payments to hospitals and doctors, by making patients or taxpayers pay more, or by shifting more of the costs to state and local government. A key factor in cost control and in the solvency of the Medicare program will be how well the new prospective payment system works. It is much too early to tell.

Social Security and other entitlements (including agricultural price supports) are such a large part of budget outlays that a wide variety of proposals is already on the table. Our options cover limits on cost-of-living adjustments (COLAs), reductions in eligibility for some entitlements, restraints on federal employee retirement, and significant reductions in crop price supports.

The remainder of the noninterest budget--nondefense discretionary programs--is made up of hundreds of relatively small accounts. Correspondingly, each option discussed in this section of our study yields relatively small budgetary savings. To close a substantial fraction of the deficit from cuts in these programs would require moving on many fronts at one time.

Our study concludes with a discussion of revenue-raising options. Here we have made a distinction between relatively small, specific changes in the tax code that even if packaged together would raise only relatively small sums (these are listed as options starting on page 199) and the bigger steps that could be taken to modify our tax system to raise yields. These latter--including major base-broadening, surtaxes, dropping indexing, and consumption taxes--are discussed in the body of Chapter VI of our volume.

The analysis clearly brings out the difficulty of resolving the budget dilemma. The fact is that all spending does some good for someone and all taxes do some harm to someone, so there is never a good spending cut or tax increase in the eyes of the entire electorate. Nonetheless, our budgetary predicament requires that we make difficult choices and search for the least damaging package of deficit reduction options that can command majority support. I hope our discussion helps this search.