Statement of
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before the
Committee on the Budget
United States Senate

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NOTICE

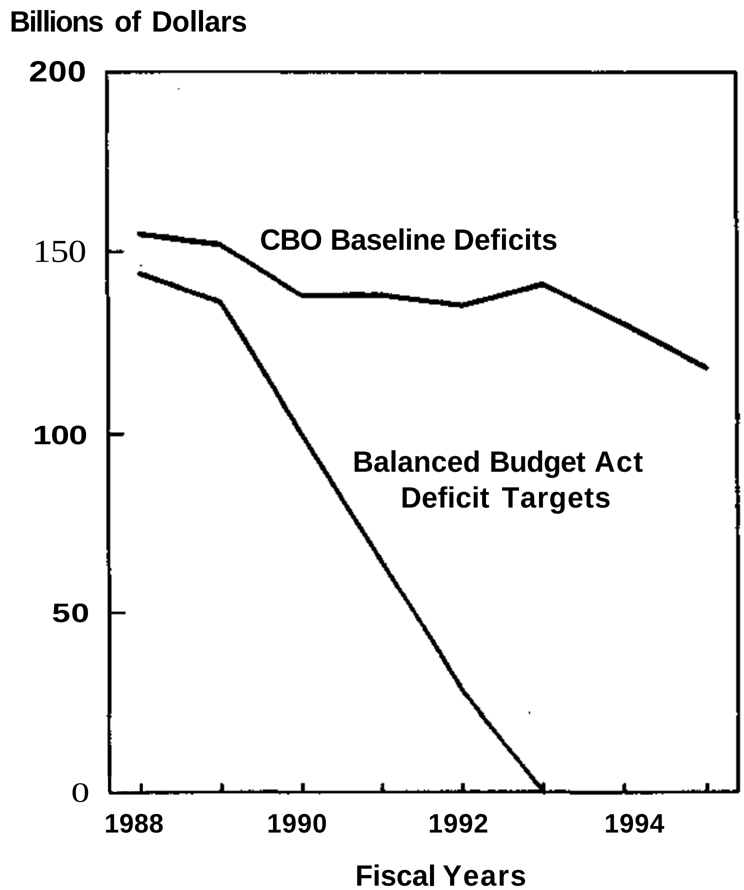
This statement is not available for public release until it is delivered at 10:00 a.m. (EST), Wednesday, January 24, 1990.

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 1991-1995*, which will be released on Wednesday, January 31.

CBO forecasts that the U.S. economy will grow by almost 2 percent in 1990 and slightly faster next year. The restrictive monetary policy that was in force from 1987 through mid-1989 is still tending to slow the economy, as will the tighter fiscal policy slated for 1990. The Federal Reserve began to loosen monetary policy in June 1989, and CBO expects that it will continue to encourage lower interest rates for most of this year. CBO forecasts that this policy will succeed in avoiding a recession in 1990 without boosting inflation.

CBO estimates that the federal budget deficit will fall from $152 billion in fiscal year 1989 to $138 billion in 1990. Over the next few years, no further progress in reducing the deficit can be expected under current budgetary policies. The Balanced Budget Act requires a deficit of $64 billion in 1991 and a balanced budget in 1993. But without spending cuts or tax increases, the deficit in 1993 is likely to be no lower than in 1990. Figure 1 compares CBO's baseline budget projections for 1990 through 1995 with the statutory targets.

Figure 1. Baseline Deficits and Targets



SOURCE: Congressional Budget Office.

CBO expects that the Federal Reserve will safely steer the economy between the shoals of a recession and higher inflation by further reducing interest rates this year. Most private-sector forecasters share this view, and the CBO forecast is close to the consensus for 1990 and 1991, as shown in Table 1.

CBO forecasts that real gross national product will grow 1.8 percent on a fourth-quarter-to-fourth-quarter basis in 1990. This is near the 1989 rate of 2.0 percent, when real GNP is adjusted to exclude the rebound of the farm sector from the previous year's drought. Lower interest rates in 1990 are expected to contribute to slightly faster growth of 2.5 percent in 1991. Short-term interest rates are projected to rise in 1991 as the Federal Reserve moves to head off inflationary pressures.

The economic forecast assumes further movement toward the Balanced Budget Act target in 1991. Together with declines in long-term interest rates, this shift will reduce the fraction of the economy's real output devoted to personal and government consumption and increase the share going to business and residential investment. Continued depreciation of the dollar will increase real net

TABLE 1. COMPARISON OF CBO AND *BLUE CHIP* SHORT-RUN ECONOMIC FORECASTS

	Actual	Estimated	Forecast	
	1988	1989	1990	1991
Fourth Quarter to Fourth Quarter (Percentage change)				
Real Gross National Product				
CBO	3.4	2.5	1.8	2.5
Blue Chip	3.4	2.5	1.8	2.4
Implicit GNP Deflator				
CBO	4.0	3.9	4.1	4.0
Blue Chip	4.0	3.9	4.0	4.0
Consumer Price Index (CPI-U)[a]				
CBO	4.3	4.6	4.1	4.4
Blue Chip	4.3	4.6	4.2	4.2
Calendar-Year Averages (Percent)				
Civilian Unemployment Rate				
CBO	5.5	5.3	5.6	5.5
Blue Chip	5.5	5.3	5.6	5.6
Three-Month Treasury Bill Rate				
CBO	6.7	8.1	6.9	7.2
Blue Chip	6.7	8.1	7.1	7.2
Ten-Year Government Note Rate				
CBO	8.8	8.5	7.8	7.7
Blue Chip	8.8	8.5	7.7	7.7

SOURCES: Congressional Budget Office; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (January 10, 1989); Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics.

NOTE: The CBO forecast does not reflect preliminary 1989 fourth-quarter data for GNP published in January 1990.

a. CPI-U is 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 government notes.

exports. The increases in investment and net exports mirror a slightly higher national saving rate, which comprises saving by both the private sector and government. Nonetheless, the national saving rate next year will remain well below historical levels.

Low saving slows the growth in living standards by reducing the accumulation of productive capital by Americans. The low rate of saving is particularly disturbing because the retirement of the post-World War II baby-boom generation will also cause living standards to grow less rapidly starting in about 2010. A smaller portion of the population will be working then, and what those workers produce will have to be shared--through Social Security and other means--with the relatively large number of retired people. Taking steps to increase the size of the economy in the next century would help ease the period of transition.

The CBO forecast envisions little change in inflation. Continued high rates of employment and factory utilization and rising import prices, which tend to increase inflation, will be balanced by slower growth in labor costs stemming from higher productivity growth. The consumer price index is expected to rise 4.1 percent in 1990 and 4.4 percent in 1991, only slightly below the 1989 rate of 4.6 percent. The implicit GNP deflator is projected to rise 4.1 percent in 1990 and 4.0 percent in 1991, about the same as in the past two years.

For 1992 through 1995, CBO's economic assumptions are not a forecast of future economic conditions but are projections based on historical trends. Real GNP is projected to grow at an average annual rate of 2.4 percent, in line with labor force and productivity growth. Inflation and unemployment both hold steady. Interest rates are projected to decline throughout the 1992-1995 period until they reach the historical average of inflation-adjusted rates. CBO's five-year economic assumptions are shown in Table 2.

The short-run forecast and long-run assumptions do not reflect the goal of some policymakers to reduce the inflation rate to a negligible amount over the next five years. CBO's analysis suggests that inflation will not come down without a sharp or a prolonged increase in unemployment. Cutting the deficit, however, might reduce inflation in the longer term by increasing national saving, investment, and productivity growth.

THE BUDGET OUTLOOK

The budget baseline shows what would happen if current budgetary policies were continued without change. It is not a forecast of future budget outcomes, since many policy changes will doubtless be made

TABLE 2. MEDIUM-TERM ECONOMIC PROJECTIONS FOR CALENDAR YEARS 1992 THROUGH 1995

	Estimated 1989	Forecast 1990	Forecast 1991	Projected 1992	Projected 1993	Projected 1994	Projected 1995
Nominal GNP (Billions of dollars)	5,235	5,534	5,893	6,279	6,688	7,121	7,579
Nominal GNP (Percentage change)	7.3	5.7	6.5	6.5	6.5	6.5	6.4
Real GNP (Percentage change)	2.9	1.7	2.4	2.5	2.5	2.4	2.4
Implicit GNP Deflator (Percentage change)	4.2	4.0	4.0	4.0	4.0	4.0	4.0
Fixed-Weighted GNP Price Index (Percentage change)	4.5	4.1	4.3	4.3	4.3	4.3	4.3
CPI-U (Percentage change)	4.8	4.0	4.3	4.3	4.3	4.3	4.3
Unemployment Rate (Percent)	5.3	5.6	5.5	5.5	5.5	5.5	5.5
Three-Month Treasury Bill Rate (Percent)	8.1	6.9	7.2	6.9	6.5	6.1	5.8
Ten-Year Government Note Rate (Percent)	8.5	7.8	7.7	7.6	7.5	7.4	7.3
Tax Bases (Percentage of GNP)							
Corporate profits	5.7	5.6	5.7	5.7	5.6	5.7	5.6
Other taxable income	21.6	21.3	21.1	21.1	20.9	20.7	20.5
Wage and salary disbursements	50.2	50.5	50.5	50.5	50.5	50.5	50.6
Total	77.6	77.4	77.3	77.2	77.1	77.0	76.8

SOURCE: Congressional Budget Office.

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

over the next five years. The baseline methodology hews to the rules contained in the Balanced Budget 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 1991 through 1995 are based on the 1990 appropriations, increased only to keep pace with inflation.

Baseline Projections Through 1995

Under CBO's baseline budget projections, the deficit is projected to remain near its 1990 level of $138 billion in 1991 through 1993. The baseline deficit then falls to $130 billion in 1994 and $118 billion in 1995, as shown in Table 3.

The Balanced Budget Act calls for *a* deficit of $64 billion in 1991, $28 billion in 1992, and zero in 1993. CBO's 1991 projection of $138 billion exceeds the target by $74 billion. Unless other spending cuts or tax increases were enacted, the act would require eliminating the excess deficit through automatic across-the-board cuts of 19 percent in defense and 28 percent in nondefense programs. Under the terms of the Balanced Budget Act, however, the Office of Management and Budget, not CBO, determines whether automatic spending cuts are necessary and how large the cuts must be.

TABLE 3. BASELINE BUDGET PROJECTIONS

	1989	1990	1991	1992	1993	1994	1995
	In Billions of Dollars						
Revenues	991	1,067	1,137	1,204	1,277	1,355	1,438
Outlays	1,143	1,205	1,275	1,339	1,418	1,484	1,555
Deficit	152	138	138	135	141	130	118
Deficit Targets[b]	136	100	64	28	0	b	b
	As a Percentage of Gross National Product						
Revenues	19.2	19.6	19.6	19.5	19.4	19.3	19.3
Outlays	22.2	22.1	22.0	21.7	21.5	21.2	20.8
Deficit	2.9	2.5	2.4	2.2	2.1	1.8	1.6

SOURCE: Congressional Budget Office.

a. The budget figures include Social Security, which is off-budget but is counted for purposes of the Balanced Budget Act targets. For comparability with the targets, the projections exclude the Postal Service, which is also off-budget.

b. The Balanced Budget Act established targets for 1988 through 1993.

The budget outlook is not as gloomy if the deficit is compared with the size of the economy. As a share of gross national product (GNP), the baseline deficit falls from 2.5 percent in 1990 to 2.4 percent in 1991 and 1.6 percent in 1995. The assumption of no real growth in discretionary spending causes outlays to fall from 22.1 percent of GNP in 1990 to 20.8 percent of GNP in 1995. Revenues also decline slightly, however, from 19.6 percent of GNP in 1990 to 19.3 percent in 1995. Although personal income taxes keep pace with the growth in the economy, all other tax sources remain stable or decline relative to GNP.

Social Security Projections

The Balanced Budget Act currently includes Social Security in its calculations and makes Social Security subject to the same fiscal discipline as the rest of the budget. From an economic perspective, this approach makes sense. The purpose of reducing the deficit is to increase national saving, which can spur economic growth and capital formation. The federal budget deficit absorbs private saving, thereby impairing the growth of living standards. The annual balance in the Social Security programs affects national saving in exactly the same way as the balance in any other government account.

Thus, the most appropriate measure of the impact of the federal budget on the economy is the total deficit, not any part of it. The total government deficit, including the Social Security and other trust funds, determines the government's fiscal stance, its drain on credit markets, and the amount of saving that it diverts from uses that promote growth in living standards.

Nevertheless, the Balanced Budget Act requires that the Social Security trust funds be shown as off-budget to highlight their contribution to the totals. With income of the trust funds exceeding benefits and other costs, the Social Security surplus grows from $66 billion in 1990 to $128 billion in 1995, as shown in Table 4. An increasing amount of this surplus, however, reflects interest payments received from the Treasury. Because these interest payments are merely intragovernmental transfers, they do not reduce the government's need to borrow in the market. Excluding interest, Social Security's contribution to holding down the total deficit looks much smaller--about $50 billion in 1990 and $78 billion in 1995.

TABLE 4. ON- AND OFF-BUDGET TOTALS
(By fiscal year, in billions of dollars)

	1990	1991	1992	1993	1994	1995
On-Budget (Excludes Social Security and Postal Service)						
Revenues	779	828	874	924	978	1,037
Outlays	984	1,041	1,095	1,163	1,220	1,283
Deficit	204	212	221	239	242	246
Off-Budget (Social Security)[a]						
Revenues	288	309	330	352	376	401
Outlays	222	234	244	254	264	273
Surplus	66	74	85	98	112	128
Total[a]						
Revenues	1,067	1,137	1,204	1,277	1,355	1,438
Outlays	1,205	1,275	1,339	1,418	1,484	1,555
Deficit	138	138	135	141	130	118

SOURCE: Congressional Budget Office.

a. For comparability with the Balanced Budget Act targets, the projections exclude the Postal Service, which is also off-budget.

Sources of Growth in Spending

Baseline revenues and outlays are both projected to grow by $70 billion in 1991. Table 5 shows that $59 billion of the growth in outlays occurs automatically under current law. These built-in increases stem from such factors as cost-of-living increases and growth of caseloads for Social Security and other retirement and disability programs. Spending for Medicare and Medicaid, two of the fastest growing programs, is driven up by increases in the price of medical care and by the wider use of more expensive medical technologies. Net interest outlays--arguably the least controllable component of spending--are determined by the government's deficit and by interest rates.

Figure 2 illustrates how just three programs contribute half of the growth in spending. Social Security and Medicare account for $29 billion, or over 40 percent of the growth in 1991. Another $6 billion--almost 10 percent of the growth--is added by net interest. Other increases required under current law total $24 billion. Only $11 billion of the projected increase in spending in 1991 stems from discretionary increases in appropriations that are assumed in the CBO baseline.

TABLE 5. COMPONENTS OF CBO BASELINE SPENDING PROJECTIONS (By fiscal year, in billions of dollars)

	1991	1992	1993	1994	1995
1990 Level	1,205	1,205	1,205	1,205	1,205
Current Law Increases					
COLAs for entitlement programs[a]	10	25	41	57	74
Increases in price of medical care[a]	4	9	16	24	32
Increases in entitlement program caseloads	7	14	22	30	40
Increases in use of medical care[b]	11	23	36	48	61
Rising benefits for new Social Security beneficiaries[b]	6	10	13	16	20
Expected changes in offsetting receipts	c	-3	-6	-9	-12
Increased interest costs	6	12	20	25	29
Other	14	15	22	16	13
Subtotal	59	105	164	209	257
Inflation Adjustments to Maintain Real Spending for Discretionary Programs					
Defense purchases	3	9	16	24	32
Defense pay	3	8	12	17	22
Nondefense purchases	3	8	15	22	29
Nondefense pay	1	3	5	7	9
Subtotal	11	28	48	70	93
Total Increases	70	134	212	279	350
CBO Baseline	1,275	1,339	1,418	1,484	1,555

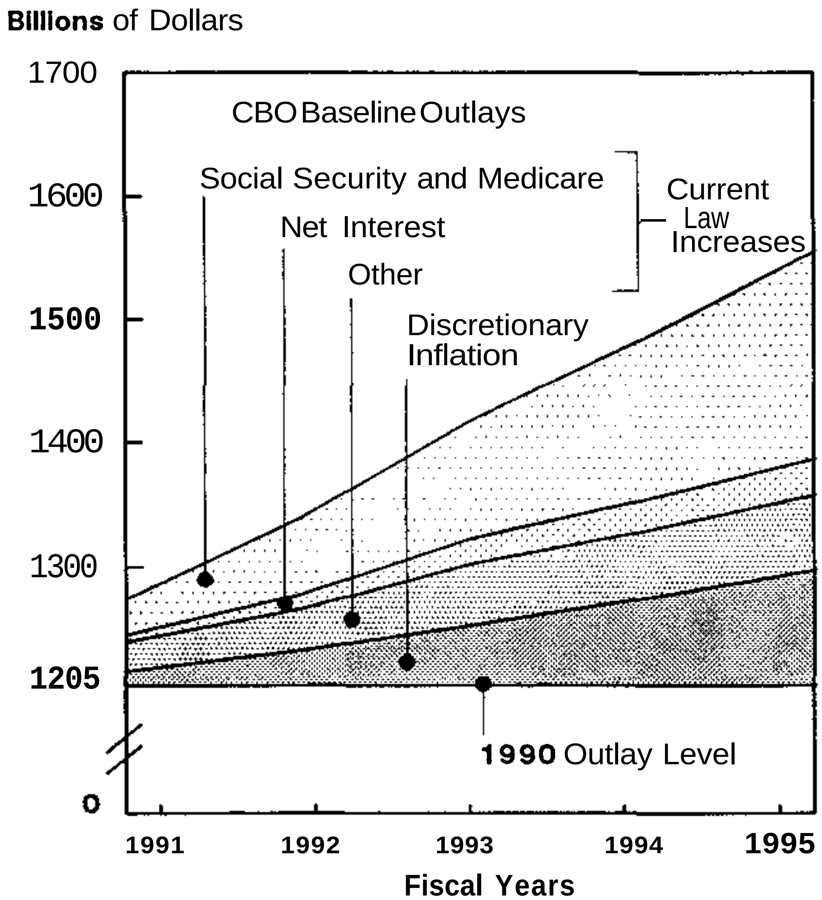
SOURCE: Congressional Budget Office.

a. Represents program growth that could be eliminated by freezing cost-of-living adjustments and certain medical reimbursement rates.

b. All growth not explained by increases in caseloads and prices.

c. Less than $500 million.

Figure 2. Sources of Growth in Outlays



SOURCE: Congressional Budget Office.

Alternative Spending Paths

As noted earlier, the baseline projections for discretionary spending simply adjust the 1990 appropriations to allow for inflation. As a result, the baseline makes no explicit allowance for activities not covered in the 1990 appropriations, such as renewing long-term subsidized housing contracts that are about to expire. Conversely, the baseline for 1991 through 1995 includes money for items that were funded in 1990 but may not be needed in the future, such as the decennial census and hurricane and earthquake relief. Adjusting the baseline for these special situations, however, would have little effect on the totals.

Of greater consequence are the assumptions about defense spending. The CBO baseline assumes that defense appropriations are adjusted fully for inflation, the same treatment that applies to nondefense discretionary spending. Nevertheless, real defense appropriations have been falling since 1985. Many observers assume that future appropriations will likewise fail to match inflation. In their view, large federal deficits will join with reduced East-West tensions to restrain the defense budget.

Table 6 shows two hypothetical paths for defense spending relative to the CBO baseline. The first involves annual real declines in defense budget authority at roughly the rate of the last three years. A 2 percent annual real decline in defense budget authority would generate up to $4 billion in defense outlay savings next year, growing to about $30 billion in 1995, compared with the CBO baseline. Annual real declines of 4 percent double the savings and roughly correspond to a five-year freeze in nominal defense budget authority. This second path would reduce federal spending by $33 billion in 1993 and $68 billion in 1995, including reductions in interest costs. Even if all these savings were devoted to cutting the deficit, however, they would be only a quarter of what is needed to balance the budget in 1993.

Changes in the Projections Since August

CBO's new baseline projections reflect all legislation enacted during the first session of the 101st Congress and are based on up-to-date economic and technical estimating assumptions. The new projections differ little from those published in CBO's August 1989 report (see Table 7). Recently enacted legislation has reduced the projected deficits, but in most years these legislative changes are largely offset by economic and technical revisions.

TABLE 6. HYPOTHETICAL SAVINGS FROM ALTERNATIVE DEFENSE BUDGET PATHS COMPARED WITH THE CBO BASELINE (By fiscal year, in billions of dollars)

	1991	1992	1993	1994	1995
2 Percent Annual Real Decline in Budget Authority					
Change in Defense Spending	-4	-9	-15	-22	-30
Change in Interest Spending	a	-1	-2	-3	-5
Total Change in Deficit	-4	-10	-17	-25	-35
4 Percent Annual Real Decline in Budget Authority					
Change in Defense Spending	-8	-18	-30	-43	-57
Change in Interest Spending	a	-1	-3	-6	-10
Total Change in Deficit	-8	-19	-33	-50	-68

SOURCE: Congressional Budget Office.

a. Less than $500 million.

TABLE 7. CHANGES IN CBO BASELINE DEFICIT PROJECTIONS SINCE AUGUST (By fiscal year, in billions of dollars)

	1990	1991	1992	1993	1994
August 1989 Baseline Deficit[a]	141	144	141	143	128
Changes					
Enacted legislation					
Appropriations	-1	4	6	6	6
Reconciliation					
Sequestration	-3	-4	-4	-4	-4
Other	-11	-5	-7	-7	-8
Repeal of catastrophic health insurance	5	1	-2	-2	-2
Other legislation	-1	-1	-1	-1	-1
Debt service	b	-1	-1	-2	-3
Subtotal	-12	-5	-8	-9	-12
Updated economic assumptions					
Revenues[c]	2	-1	b	6	13
Outlays	-3	-8	-10	-14	-19
Subtotal	-1	-9	-10	-8	-6
Technical reestimates					
Revenues[c]	1	b	1	4	4
Farm price supports	-2	b	1	1	1
Deposit insurance	8	2	2	-2	-3
Medicaid and Medicare	1	2	4	5	7
Social Security	1	1	2	2	2
Net interest	2	1	1	3	4
Other outlays	b	1	2	2	4
Subtotal	11	8	13	16	20
Total changes	-3	-6	-5	-2	2
January 1990 Baseline Deficit[d]	138	138	135	141	130

SOURCE: Congressional Budget Office.

a. Includes Social Security.

b. Less than $500 million.

c. Revenue decreases are shown with a positive sign because they increase the deficit.

d. Includes Social Security and excludes the Postal Service.

Before adjourning in November, the Congress cleared all 13 regular appropriation bills, adopted a reconciliation bill, and repealed catastrophic health insurance under Medicare. In total, this legislation cut the deficit by an estimated $12 billion in 1990 but by only $5 billion in 1991. The savings shrink in 1991 for two reasons. First, the reconciliation bill contained $7 billion in nonrecurring savings in 1990--$4 billion from accounting changes and timing shifts, such as taking the Postal Service off-budget, and another $3 billion from speeding up payroll and certain excise tax collections. Second, the appropriation bills reduced outlays temporarily in 1990 because of $2 billion in receipts from foreign military sales prepayments, which will not be repeated in later years. The appropriation bills actually increased nondefense spending authority and raised outlays in 1991 and later years.

CBO's updated economic assumptions reduce the deficit by $1 billion in 1990, $9 billion in 1991, and similar amounts thereafter. By itself, lower projected inflation reduces baseline outlays and revenues in tandem and has little effect on the deficit. But the robust performance of financial markets increases receipts from taxes on capital gains, which reduce the overall loss in revenues.

All other revisions, termed technical reestimates, boost the deficit by $11 billion in 1990, $8 billion in 1991, and $20 billion in 1994. The

1990 increase is dominated by higher deposit insurance outlays, which result from additional spending for troubled banks, the outlay of money appropriated for savings and loans in 1989 but not spent, and a reduction in receipts from borrowing by the off-budget Financing Corporation. In later years, the technical **reestimates** arise from various sources. Notably, higher Medicaid outlays add to the deficit by increasing amounts, as spending continues to outstrip previous projections. Projected spending is also higher for Social Security and other benefits, revenues are slightly lower, and debt service costs therefore rise.

BUDGET ESTIMATES DURING THE 1980s

The start of the 1990s provides a good opportunity to review the accuracy of budget estimates over the past decade. Again this year, as it has for the past 10 years, CBO has analyzed the most recent Congressional budget resolution estimates to see to see how and why they differed from the actual outcome.

The Congressional budget resolution for fiscal year 1989, adopted in June 1988, called for a deficit of $135.3 billion, slightly below the Balanced Budget Act target of $136 billion. When fiscal year 1989 ended last September 30, however, the red ink totaled $152.1

billion--$16.8 billion over the budget resolution. The 1989 error was less than the average error for the decade, which was $40.2 billion. Nonetheless, 1989 marked the tenth straight year that the actual deficit exceeded the budget resolution.

Table 8 divides the differences between the actual outcomes and the budget resolution estimates of revenues, outlays, and the deficit into those resulting from policy, economic, and technical assumptions. Use of optimistic economic assumptions accounts for $17.2 billion, or 43 percent, of the average error in budget resolution estimates during the 1980s. The remaining difference between the budget resolution estimate and the actual outcomes stems equally from policy actions that did not conform to those assumed and from errors in technical estimating assumptions. Fiscal Year 1989 marks the first time that the economic assumptions used for the budget resolution were not too optimistic. The technical differences, however, were above average.

CBO believes that its current economic assumptions and baseline budget projections represent a prudent basis for making budget plans for 1991 and the following years. Using more optimistic assumptions will increase the risk that, once again, the Congress will fail to achieve the budgetary targets that it has set for itself.

TABLE 8. SOURCES OF DIFFERENCES BETWEEN ACTUAL BUDGET TOTALS AND FIRST BUDGET RESOLUTION ESTIMATES FOR FISCAL YEARS 1980-1989 (In billions of dollars)

Fiscal Year	Assumptions Policy	Economic	Technical	Total
		Revenues		
1980	6.2	8.4	-3.5	11.1
1981	-3.7	5.0	-12.6	-11.2
1982	13.0	-51.9	-1.1	-40.0
1983	-4.6	-58.0	-2.7	-65.3
1984	-13.7	4.5	-3.9	-13.1
1985	-0.2	-20.0	3.3	-16.8
1986	-1.5	-23.0	-2.1	-26.6
1987	22.1	-27.0	6.7	1.7
1988	-10.9	3.6	-16.5	-23.8
1989	0.7	33.5	-7.8	26.4
Average Difference	0.7	-12.5	-4.0	-15.8
Average Absolute Difference	7.6	23.5	6.0	23.6
		Outlays		
1980	19.6	12.4	15.6	47.6
1981	24.5	6.4	16.0	46.9
1982	1.2	24.1	7.7	32.9
1983	17.6	0.5	8.1	26.2
1984	1.5	7.1	-18.0	-9.4
1985	22.8	-5.2	-12.9	4.8
1986	14.2	-12.1	20.1	22.2
1987	6.8	-11.9	13.0	7.9
1988	-2.0	11.7	12.0	21.7
1989	17.5	13.9	11.8	43.2
Average Difference	12.4	4.7	6.4	24.4
Average Absolute Difference	12.8	10.5	13.5	26.3
		Deficit		
1980	13.4	4.0	19.1	36.6
1981	28.2	1.4	28.6	58.1
1982	-11.8	76.0	8.8	73.0
1983	22.2	58.5	10.8	91.5
1984	15.2	2.7	-14.1	3.7
1985	23.0	14.8	-16.2	21.6
1986	15.7	10.9	22.2	48.8
1987	-15.3	15.1	6.3	6.2
1988	8.9	8.1	28.5	45.5
1989	16.8	-19.7	19.6	16.8
Average Difference	11.6	17.2	11.4	40.2
Average Absolute Difference	17.0	21.1	17.4	40.2

SOURCE: Congressional Budget Office.

NOTE: Differences are actual outcomes less budget resolution assumptions.