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

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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 are described in detail in the CBO report titled *The Economic and Budget Outlook: Fiscal Years 1990-1994*, which is being released today. 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.

THE BUDGET OUTLOOK

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--as shown in Table 1.

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).

Baseline Budget Projections

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

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.

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.

Tax revenues are projected to rise from $983 billion in 1989 to $1,069 billion in 1990, as shown in Table 1. The increase of $86 billion is more than in any other year in the projections. Three major factors contribute to this rapid revenue growth. All three result from provisions of previously enacted legislation that become fully effective in 1990. About $10 billion of the growth in revenues results from two scheduled tax increases--the income tax surcharge on Medicare beneficiaries for catastrophic health insurance (which adds $5 billion) and an increase in Social Security payroll taxes. The phasing in of the

Tax Reform Act of 1986 accounts for another $13 billion of the growth in receipts.

Sources of Growth in Spending

While baseline revenues grow by $86 billion in 1990, outlays are projected to increase by $72 billion. Table 2 shows that $61 billion of this 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 cost of medical care and by the development and wider use of new medical technologies. Net interest outlays--arguably the least controllable component of spending--are determined by the government's deficit and by interest rates.

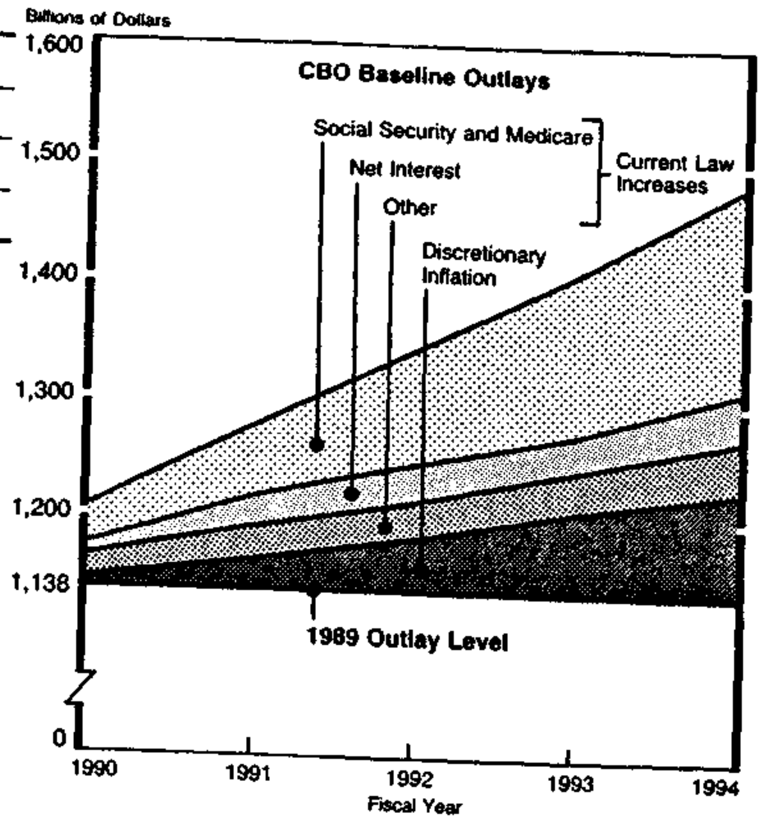
Figure 1 illustrates how just three programs contribute most of the growth in spending. Social Security and Medicare account for $32 billion, or almost half of the growth in 1990. Another $13 billion--about one-fifth of the growth--is added by net interest. Only $11 billion of the projected increase in spending in 1990 stems from discretionary increases in appropriations that are assumed in the CBO baseline.

TABLE 2. COMPONENTS OF CBO BASELINE SPENDING PROJECTIONS (By fiscal year, in billions of dollars)

	1990	1991	1992	1993	1994
1989 Level	1,138	1,138	1,138	1,138	1,138
Current Law Increases					
COLAs for entitlement programs	13	29	45	61	77
Increases in entitlement program caseloads	8	16	25	33	42
Increases in costs of medical care	5	10	17	25	34
Increases in use of medical care	12	22	30	40	50
Rising benefits for new Social Security beneficiaries	4	6	9	12	16
Expected changes in offsetting receipts and asset sales	0	-3	-7	-10	-14
Increased interest costs	13	24	29	35	38
Other	6	10	8	7	8
Subtotal	61	114	157	202	250
Inflation Adjustments to Maintain Real Spending for Discretionary Programs					
Defense purchases	4	10	17	25	34
Defense pay	3	8	13	18	23
Nondefense purchases	3	8	14	20	27
Nondefense pay	1	3	5	7	9
Subtotal	11	29	49	70	92
CBO Baseline	1,209	1,280	1,344	1,410	1,480

SOURCE: Congressional Budget Office.

Figure 1. Sources of Growth in Outlays



Although the baseline deficit falls slowly in dollar terms, the assumption of no real growth in discretionary spending causes both total outlays and the deficit to decline more rapidly 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 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.

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 continue 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 3. 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 3. 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 3.

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 point in 1989 and 1.2 percentage points in 1990 (see Table 3). 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 4, 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 4. 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.

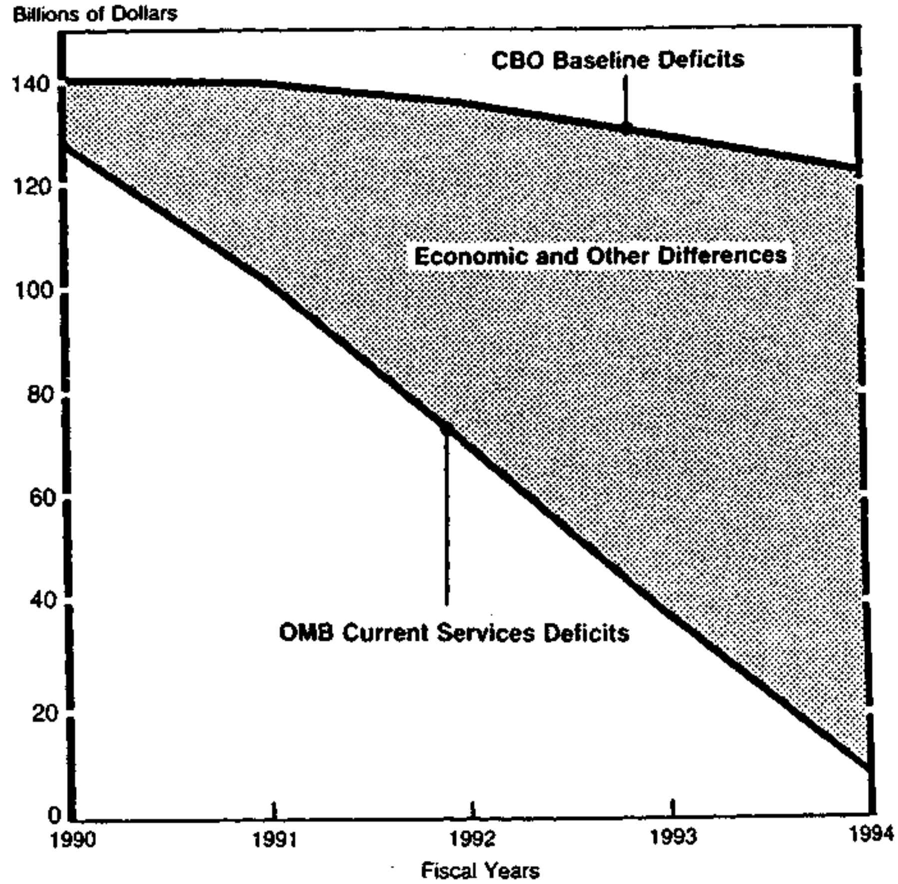
The long-run assumptions of the Reagan Administration, on the other hand, are substantially more optimistic than recent experience would lead one to expect. The Administration assumes that unemployment during the 1991-1994 period will remain at 5 percent and that the economy will achieve an average growth rate of 3.2 percent a 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.

Economic Assumptions and Budget Projections

The differences between CBO's economic assumptions and those of the Administration lead to substantially different budget projections, as illustrated in Figure 2. While CBO's baseline deficit declines only slowly, reaching $122 billion by 1994, the Administration projects that the budget would be almost in balance by then, even with no change in policies.

Table 5 divides the differences between Administration current services and CBO baseline projections into those resulting from economic and other factors. Almost all of the differences are economic.

Figure 2.
Comparison of OMB and CBO Deficit Projections, 1990–1994



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

The combination of lower real growth and higher inflation in CBO's assumptions produces nominal incomes and tax revenues close to the Administration's. CBO's higher inflation and higher interest rates, however, bring about much higher outlays and deficits over the next five years than the Administration projects. As with the

TABLE 5. DIFFERENCES BETWEEN ADMINISTRATION CURRENT SERVICES AND CBO BASELINE BUDGET PROJECTIONS (By fiscal year, in billions of dollars)

	1990	1991	1992	1993	1994
Administration Current Services Deficit	127	102	70	37	9
Differences in Economic Assumptions					
Revenues[a]	-6	b	2	5	-5
Net interest	12	23	39	53	67
Entitlement outlays	5	12	20	29	40
Other outlays	2	5	9	17	27
Subtotal	13	41	70	104	129
Technical and Policy Differences	1	-2	-5	-11	-16
Total differences	14	39	65	92	113
CBO Baseline Deficit	141	140	135	129	122

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

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

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

b. Less than $500 million.

short-term forecast, we believe that CBO's long-run economic assumptions provide a more prudent basis for making multiyear budget plans.

BUDGET DEFICITS AND ECONOMIC GROWTH

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 6. 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. If one ignores these intragovernmental payments, the non-Social Security deficit declines slightly, and the Social Security surplus rises less rapidly.

The Balanced Budget Act requires that the total government deficit, including Social Security, be eliminated by 1993. A balanced total budget, however, is not necessarily an appropriate longer-term target for the years after 1993. Some analysts believe that, because

TABLE 6. 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.

much federal spending provides benefits that extend over a long period of time, limited deficits are acceptable. Others argue that the federal government should add to national saving by moving the total budget into surplus after 1993. Chapter III of our new report considers one issue involved in choosing a long-run deficit target--the potential contribution of deficit reduction to economic growth.

Current demographic projections imply that American living standards will improve less rapidly during the first half of the twenty-first century than during the second half of the twentieth century. In large part, this slower growth is caused by the retirement of the post-World War II baby-boom generation. A smaller part of the population will be working, and what they produce will have to be shared with the increasing part of the population who will be retired. As a result, consumption of goods and services per capita, which has been growing at about 1.9 percent a year since 1950, could increase by only 1.3 percent a year after the year 2000. If saving rates and productivity growth remained below historical averages, as they have recently, consumption per person would grow even more slowly.

One way of maintaining the growth of consumption would be to pursue policies that expand the labor force--for example, by delaying retirement or increasing immigration. Chapter III of our report focuses on another approach--increasing national saving. An increase in saving would raise economic growth in the long run by increasing the capital stock. Net saving in the 1980s has fallen by about 4 percent of net national product from its average postwar level. This decline is accounted for about equally by reductions in private saving--mostly personal saving--and by the increase in the federal deficit.

Reducing the federal deficit, or going beyond that and running a budget surplus, would increase saving and improve economic growth in the longer run. Of course, it might slow the economy in the first year or two if the Federal Reserve did not intervene, but the longer-run effect would be positive. If the federal government were to run a surplus of 2 percent of GNP after 1993 instead of a balance, private and public consumption would initially be reduced by a little more than 2 percent, as the government reduced spending or increased taxes. The higher saving will raise capital accumulation and output, and eventually consumption will also increase. How long this would take, and how much consumption per capita would increase in the long run, cannot be estimated with certainty. Depending on the contribution additional investment makes to the economy's output, between five and ten years would be required for per capita consumption to be as high as it would have been had the government not run a surplus. By the year 2040, the increase in per capita consumption could range from 2 percent to 14 percent.

These technical calculations, of course, cannot provide a final answer to the question of how much the government should contribute to national saving. Reducing the deficit, or moving the budget into surplus, involves sacrificing consumption now to increase well-being in the future. The choice is ultimately a political one.