

**Statement of
James L. Blum
Acting Director and
Assistant Director for Budget Analysis
Congressional Budget Office**

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

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NOTICE

**This statement is not available
for public release until it is
delivered at 10:00 a.m. (EST),
Wednesday, February 17, 1988.**

Mr. Chairman, I am pleased to appear before this Committee to discuss the 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 1989-1993*, which was released last week.

In the closing days of 1987, the Congress and the Administration negotiated and largely put in place a plan to reduce the budget deficit for 1988 and 1989. At the same time, in the wake of the stock market collapse, signs of some temporary weakness in the economy began to emerge. The Congressional Budget Office now anticipates that the economy will experience a pronounced slowdown in growth in early 1988, but will regain strength in the second half of 1988 and in 1989. On the basis of CBO's economic assumptions and a continuation of current budgetary policies, the federal deficit will rise from \$150 billion in 1987 to \$157 billion in 1988 and \$176 billion in 1989, before dropping to \$167 billion in 1990.

The projected rise in the deficit in 1988 and again in 1989 is not the result of our new economic forecast; it was also a feature of our previous baseline budget projections. This deficit pattern largely results from the phase-in of the Tax Reform Act of 1986 and from various one-time outlay savings. Tax reform added substantially to

revenues in 1987, but reduces tax collections in 1988 and 1989 compared with prior law. Asset sales, loan prepayments, and other one-time spending cuts enacted to date hold down outlays by \$15 billion in 1987 and \$7 billion in 1988, but they make no contribution to deficit reduction in 1989. Were it not for these special factors, the deficit would fall from 1987 to 1988 and would remain roughly level in 1989.

THE SHORT-RUN BUDGET SITUATION

On November 16, as required by the Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987, CBO reported that the budget deficit for 1988 would be \$180 billion under laws then in effect. We also projected a deficit of \$186 billion in 1989. These estimates were based on our August economic and technical estimating assumptions. How have the budget estimates changed since November?

On November 20, Congressional leaders and the President announced that they had reached a budget agreement covering the next two fiscal years. This agreement, or budget summit, was intended to reduce the deficit by \$30 billion in 1988 and \$46 billion in 1989 from the Balanced Budget Act baseline. The results of the budget summit were almost entirely incorporated in two bills--the continuing resolution of appropriations (Public Law 100-202) and the Omnibus

Budget Reconciliation Act of 1987 (Public Law 100-203)--signed by the President on December 22. These laws reduced the 1988 deficit by \$34 billion, comprising \$15 billion in lower spending, \$8 billion in asset sales and loan prepayments, and \$11 billion in additional tax revenues. The projected deficit reduction will then grow to \$36 billion in 1989, assuming that spending programs subject to annual appropriation action are allowed to grow by only the rate of inflation (see Table 1).

TABLE 1. BASELINE DEFICIT PROJECTIONS FOR 1988-1990
(By fiscal year, in billions of dollars)

	Actual 1987	Projections	
		1988	1989
November 1987			
Base Deficit for Balanced Budget Act	150	180	186
Changes for:			
Enacted legislation	--	-34	-36
Updated economic assumptions	--	9	21
Technical reestimates	--	<u>2</u>	<u>6</u>
Total changes	--	-23	-9
February 1988			
Baseline Deficit	150	157	176
Further Savings Required by Budget Summit Agreement:			
Appropriations	--	--	-3
Asset Sales and other savings	--	--	<u>-4</u>
Total savings	--	--	-7
Deficit Assuming Budget Summit	150	157	169

SOURCE: Congressional Budget Office.

While policymakers were working hard to reduce the deficit, however, a deterioration in the economic outlook was eroding some of their improvements. CBO's updated economic assumptions add \$9 billion to the deficit in 1988 and \$21 billion in 1989, compared with the August forecast. Most of these changes result from lower tax revenues brought on by the forecast of a slowdown in economic growth.

Since CBO's November report, changes in technical estimating methods and assumptions have increased the projected deficit only slightly--by \$2 billion in 1988 and \$6 billion in 1989. These reestimates result primarily from newly available data that permit a better estimate of the effects of the Tax Reform Act of 1986 (Public Law 99-514). Technical revisions in outlay estimates, while large for some individual programs, are negligible in total.

The baseline budget projections incorporate only those elements of the budget summit agreement that have already been put in place. As indicated earlier, last December's appropriation and reconciliation measures reduced the deficit by \$34 billion in 1988 and \$36 billion in 1989. A few further steps remain to be taken, however, to carry out the budget summit agreement in full. Adhering to the appropriation caps contained in the reconciliation bill would further reduce 1989 outlays from the baseline by roughly \$1 billion in defense and \$2 billion in nondefense programs. These savings arise because the CBO baseline

for 1989 assumes more growth in discretionary appropriations than was provided by the summit agreement. The reconciliation bill also calls for selling an additional \$3.5 billion of federal assets in 1989. Finally, \$0.4 billion in revenues would result from further boosts in resources for Internal Revenue Service enforcement. Together with the resulting savings in debt service costs, these measures would save \$7 billion, bringing the 1989 deficit down to \$169 billion, as shown in the lower half of Table 1. These steps would bring the total two-year deficit reduction resulting from the budget summit to \$76 billion--exactly on target.

As in past years, CBO's baseline budget projections assume that revenues, offsetting receipts, and entitlement spending are projected according to the laws now on the statute books. Defense and nondefense discretionary appropriations are assumed to be held constant in real terms. The non-pay portions of the 1988 appropriations are inflated by the projected rise in the gross national product (GNP) implicit price deflator (4.0 percent for 1989). Personnel costs are also inflated using the GNP deflator, but with adjustments for pay absorption and increases in retirement costs.

Last fall, the Congress amended the definition of the Gramm-Rudman-Hollings budget base to make it conform closely to the traditional CBO baseline approach. Because the remaining differences were

small--less than \$200 million in 1989--CBO has made its new 1989 baseline identical to the baseline specified in the Balanced Budget Reaffirmation Act. We hope that this move will eliminate any confusion that resulted from having more than one baseline.

THE SHORT-TERM ECONOMIC OUTLOOK

Just as the stock market collapse of October 19 gave impetus to the budget summit, so will budgetary developments for 1988 and 1989 be driven by the economic aftermath of the crash. The drop in share values wiped out hundreds of billions of dollars of consumer wealth and contributed to a drop in consumer spending. Excluding automobiles, real personal consumption fell at a 1 percent rate in the fourth quarter of 1987--the first decline since 1981.

As a result of the weakness in consumption, business piled up unsold inventories throughout 1987, but especially in the fourth quarter. CBO expects that the attempt to reduce inventory accumulation will act as a drag on the economy in early 1988. Real federal purchases of goods and services are also expected to fall, reflecting successive years of budgetary stringency.

Some indications of strength, however, suggest that the economy will avoid a recession. Real net exports have started to improve as a result of three years of dollar depreciation, and net exports are likely to be the major engine of growth in 1988 and 1989. Because the saving rate has already increased substantially, further declines in consumption are not anticipated. Consumer spending is therefore expected to grow in 1988 and 1989, but at a slower rate than the economy as a whole.

The stock market collapse was the impetus for a major shift in monetary policy. From the Louvre accord in February 1987 through October, the Federal Reserve's stated aims were to support the value of the dollar and to dampen inflationary expectations. In pursuing these aims, the Federal Reserve was forced to keep up interest rates. After the crash, however, it permitted interest rates to fall even at the cost of a depreciating dollar. This depreciation is likely to create inflationary pressures by the end of 1988 that will cause the central bank to shift back to a less accommodating stance.

The CBO Forecast

CBO's short-run economic forecast for 1988 and 1989 is shown in Table 2. In addition to the monetary policy just described, the forecast

TABLE 2. CBO, ADMINISTRATION, AND CONSENSUS FORECASTS
FOR 1988 AND 1989 (By calendar year)

	Actual 1987	Forecast	
		1988	1989
Fourth Quarter to Fourth Quarter (Percent change)			
Real Gross National Product			
CBO	3.8	1.8	2.6
Administration	3.8	2.4	3.5
Consensus	3.8	1.8	2.1
GNP Deflator			
CBO	3.3	3.9	4.2
Administration	3.3	3.9	3.7
Consensus	3.3	3.7	4.4
Consumer Price Index (CPI-U)			
CBO	4.4	4.9	4.8
Administration	4.4	4.3	3.9
Consensus	4.4	4.1	4.8
Calendar-Year Average (Percent)			
Three-Month Treasury Bill Rate			
CBO	5.8	6.2	6.7
Administration	5.8	5.3	5.2
Consensus	5.8	5.9	6.4
Ten-Year Government Note Rate			
CBO	8.4	9.3	9.5
Administration	8.4	8.0	7.4
Consensus <u>a/</u>	8.4	8.9	9.1
Civilian Unemployment Rate			
CBO	6.2	6.2	6.1
Administration <u>b/</u>	6.1	5.8	5.6
Consensus	6.2	6.1	6.2

SOURCE: Congressional Budget Office, February 1988 economic forecast; Council of Economic Advisers press release, December 23, 1987; Blue Chip Economic Indicators, February 10, 1988.

- a. Averages are calculated by using CBO's projection of the difference between the corporate bond rate and the 10-year government note rate.
- b. The Administration's projection is for the total labor force, including armed forces residing in the United States. In recent years, this rate has tended to be 0.1 to 0.2 percentage points below the civilian unemployment rate.

assumes that federal fiscal policies are consistent with CBO's baseline revenue and outlay projections. The immediate outlook for the economy is substantially weaker than CBO expected in August. With a sluggish first half, real gross national product is expected to grow by only 1.8 percent in 1988 (measured from fourth quarter to fourth quarter). The unemployment rate will average 6.2 percent for 1988 as a whole, the same as the previous year. In 1989, growth is expected to return to a 2.6 percent rate, roughly the same as that assumed in CBO's summer projections and only slightly lower than the actual growth in the last three years; unemployment should drop slightly. Consumer price inflation, which totaled 4.4 percent in 1987, is expected to reach 4.9 percent in 1988 and 4.8 percent in 1989. The GNP deflator is expected to increase more slowly than the Consumer Price Index (CPI), since the step-up in inflation is driven mainly by import prices, which do not add to the GNP deflator.

As a result of the slow real growth and the Federal Reserve's accommodative stance, there will be little immediate pressure on interest rates. Later in the year, we expect that the three-month Treasury bill rate will begin to rise in response to the higher inflation rate. For the year as a whole, the bill rate will average 6.2 percent. Ten-year government note yields will rise even more sharply, averaging 9.3 percent for the year, as they incorporate expectations of still greater inflation in the future. In 1989, the resumption of growth

and the Federal Reserve's anticipated tightening will cause short-term interest rates to continue rising. Long-term rates in 1989, however, are projected to be relatively flat.

Comparison with Other Forecasts

CBO foresees slower real growth, higher inflation, and higher interest rates during the next two years than does the Administration, as shown in Table 2. Because the Administration has not released all the details of its forecast, however, we can only speculate as to the sources of these differences. The Administration's forecast appears to assume that the dollar will remain relatively stable and that investors are relatively sanguine about inflation. CBO believes it improbable, however, that foreigners will willingly finance our large trade deficit at current exchange rates and interest rates. Private purchasers of dollar assets have generally been absent from the market for the past two years, and foreign central banks have had to take up the slack. We therefore believe that the dollar is likely to fall further and that interest rates are likely to rise. Compared with the CBO baseline, using the Administration's economic assumptions would lower the 1989 deficit by about \$25 billion to \$30 billion.

While CBO's growth forecast is weaker than the Administration's, it is about average for 1988 compared with the consensus of

private-sector forecasters, and it is actually above the average for 1989. CBO's interest rates are slightly above the consensus, as a result both of stronger 1989 growth and the continued fall of the dollar. The differences between the CBO and the consensus forecasts, however, are sufficiently small that they would have little effect on the budget estimates.

Risks to the Forecast

Economic forecasting is anything but a precise science. Like all forecasts, CBO's has certain critical elements. For one thing, it depends on the success of the Federal Reserve in supplying the economy with enough credit to avoid a recession, without reigniting inflation or undermining the dollar. Consumer spending is assumed to grow slowly but steadily. Finally, the forecast assumes that the long-awaited improvement in net exports has finally arrived and will accelerate in 1988. If any of these sources of strength fails to materialize, the probability of a recession would increase.

The effects of a recession on the budget projections cannot be determined in general but would depend on its specific shape and size. We can give an idea of the possible impact of a recession, however, by looking at a hypothetical recession developed by Data Resources, Inc. (DRI), a private forecasting firm. While neither CBO nor DRI is forecasting a recession, DRI believes that there is a 20 percent chance

that consumer retrenchment and a stringent monetary policy could lead to a recession in 1988. With a recession of the sort specified by Data Resources, the deficit would be about \$20 billion higher than the CBO baseline in 1988 and about \$30 billion higher in 1989.

How does the federal government's budgetary stance affect the risks to the forecast? The most commonly used gauge of discretionary fiscal policy is the standardized-employment, or structural, deficit--a calculation that excludes the cyclical component of the deficit. At first glance, as shown in Table 3, fiscal policy appears to be slightly stimu-

TABLE 3. STANDARDIZED EMPLOYMENT DEFICIT
(By fiscal year)

	Actual 1987	Projections	
		1988	1989
In Billions of Dollars			
Deficit Assuming Budget Summit	118	130	139
Deficit Assuming Budget Summit and Excluding Tax Reform and One-Time Outlay Savings	155	127	126
As a Percentage of Potential GNP			
Deficit Assuming Budget Summit	2.6	2.7	2.7
Deficit Assuming Budget Summit and Excluding Tax Reform and One-Time Outlay Savings	3.5	2.7	2.5

SOURCE: Congressional Budget Office.

lative in 1988 and 1989. This initial impression is misleading, however, because it reflects the nonrecurring effects of tax reform, asset sales, and other one-time factors, which alter the deficit but may have little effect on aggregate demand and unemployment. Assuming implementation of the budget summit agreement but excluding these special factors, the standardized-employment deficit declines by 0.8 percent of GNP in 1988 and by only 0.2 percent of GNP in 1989. Because this decline represents very little fiscal restraint in 1989, and because we project that the economy will have regained its momentum by that time, modest cuts in the 1989 deficit should not precipitate a recession. Moreover, while cutting the deficit would initially tend to reduce domestic demand, it would also allow a somewhat more expansionary monetary policy, as well as more stimulative policies abroad.

LONGER-RUN BASELINE PROJECTIONS

Beyond 1989, CBO's economic assumptions are not a forecast of future conditions but are projections based on historical trends. The projections do not include business cycles. They assume that the economy's long-term growth will depend largely on the growth of the labor force and that output per worker will grow at about the same rate it has in recent years. CBO's five-year economic projections and the

corresponding baseline budget projections are presented in Table 4. They are illustrated graphically in Figure 1.

In the projections, real GNP grows at an average annual rate of about 2.7 percent from 1989 through 1993, while the civilian unemployment rate falls to about 5.8 percent. As measured by the GNP deflator, inflation stays at 4 percent, close to the post-World War II average. Consumer price inflation is slightly higher, however, because of further declines in the dollar and increases in import prices over the medium term. After 1989, real interest rates decline to levels consistent with their average since exchange rates began floating in 1971. Cyclical changes will presumably affect the level of activity during the projection years, but there is no way of predicting when they will occur or what will precipitate them. Thus, the projections should be considered as an average of a number of possible paths the economy might take.

In such an environment of continued real economic growth, the baseline deficit is projected to decline slowly from \$176 billion in 1989 to \$134 billion in 1993. The deficit shrinks because revenues are boosted by both inflation and real growth, while outlays rise only slightly faster than the rate of inflation. Compared with the size of the nation's economy, the baseline deficit falls from 3.1 percent of the gross national product in 1990 to 2.1 percent in 1993.

TABLE 4. BASELINE BUDGET PROJECTIONS
AND UNDERLYING ASSUMPTIONS

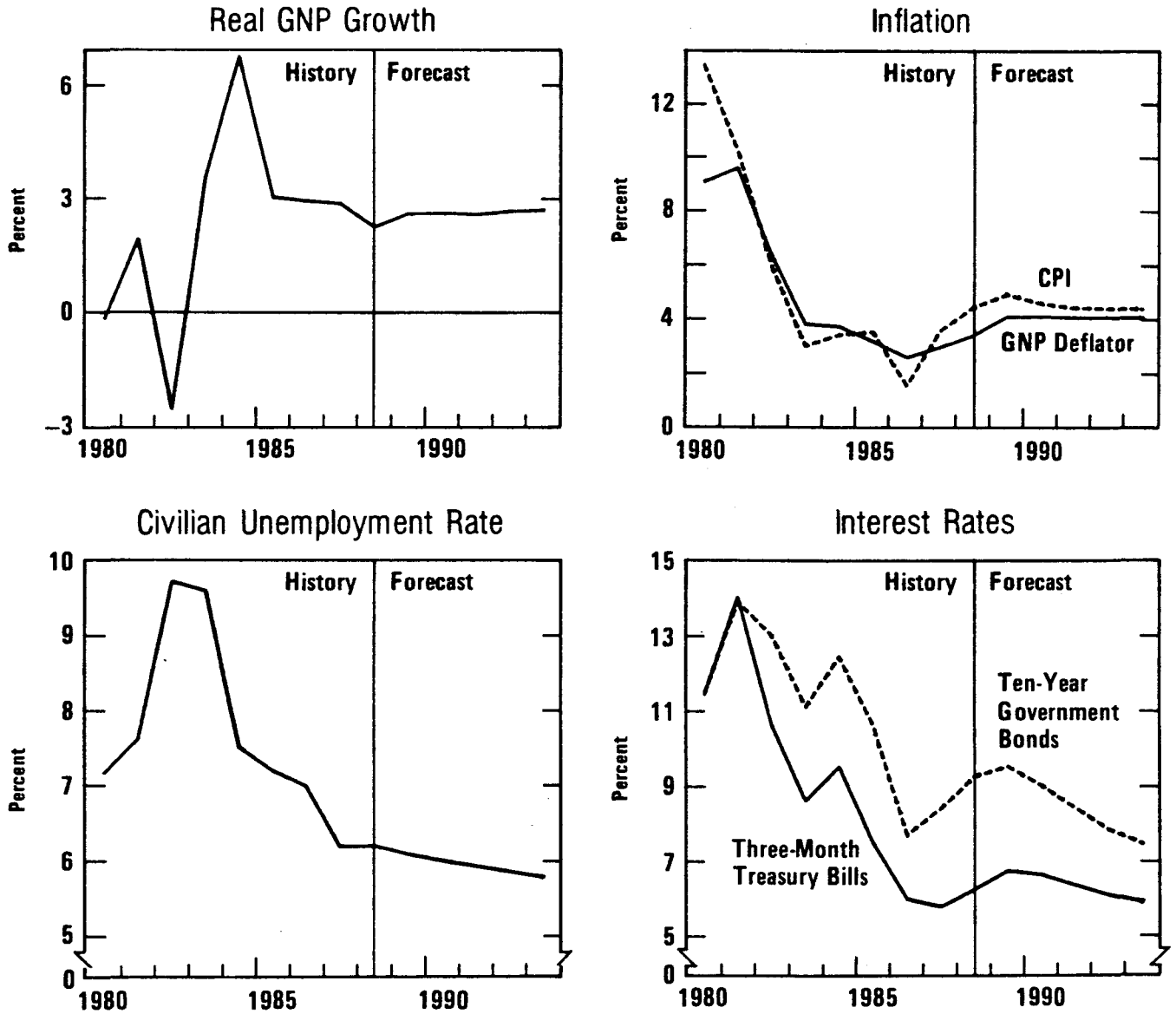
	Actual 1987	1988	1989	1990	1991	1992	1993
Budget Projections (By fiscal year, in billions of dollars) <u>a/</u>							
Revenues	854	897	953	1,036	1,112	1,181	1,262
Outlays	1,005	1,055	1,129	1,203	1,269	1,332	1,396
Deficit	150	157	176	167	158	151	134
Economic Assumptions (By calendar year)							
Nominal GNP Growth (percent change)	5.9	5.8	6.8	6.8	6.8	6.9	6.9
Real GNP Growth (percent change)	2.9	2.3	2.6	2.6	2.6	2.7	2.7
Implicit GNP Deflator (percent change)	3.0	3.4	4.1	4.1	4.1	4.1	4.1
CPI-W <u>b/</u> (percent change)	3.6	4.5	4.9	4.6	4.4	4.4	4.4
Civilian Unemployment Rate (percent)	6.2	6.2	6.1	6.0	5.9	5.9	5.8
Three-Month Treasury Bill Rate (percent)	5.8	6.2	6.7	6.6	6.4	6.1	5.9
Ten-Year Government Note Rate (percent)	8.4	9.3	9.5	9.0	8.4	7.8	7.4

SOURCE: Congressional Budget Office.

- a. The baseline estimates include Social Security, which is off-budget.
b. Consumer Price Index for urban wage earners and clerical workers.

Figure 1.

Major Economic Assumptions



SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

Budget Trends

Figure 2 illustrates the recent trends in the components of federal spending as shares of GNP in CBO's baseline projections. The defense buildup, which began in 1980, peaked in 1986, when defense outlays reached 6.5 percent of GNP. Assuming no real growth in appropriations, defense spending will continue to decline, falling to 5.3 percent of GNP by 1993--the same level as in 1981. Entitlement spending, which fell off sharply after the 1982-1983 recession, is projected to remain level at about 10.7 percent of GNP. Nondefense discretionary programs have borne the brunt of budget restraint in the 1980s, declining from almost 6 percent of GNP at the start of the decade to 3.7 percent at present and a projected 3.4 percent in 1993. Net interest outlays rose rapidly from 1980 to 1985, in tandem with rising deficits and interest rates, but the ratio of interest spending to the GNP has been relatively level since then.

Trends in federal revenues are depicted in Figure 3. Personal income taxes, which took 9.6 percent of GNP in 1981, fell to below 8½ percent of GNP in the wake of the Economic Recovery Tax Act of 1981. By 1993, under current laws, individual income taxes will grow to 8.8 percent of GNP. Although corporate income taxes fell from 2.0 percent of GNP in 1981 to about 1½ percent of GNP in 1984 through 1986, they

Figure 2.

Outlays by Category as Shares of GNP

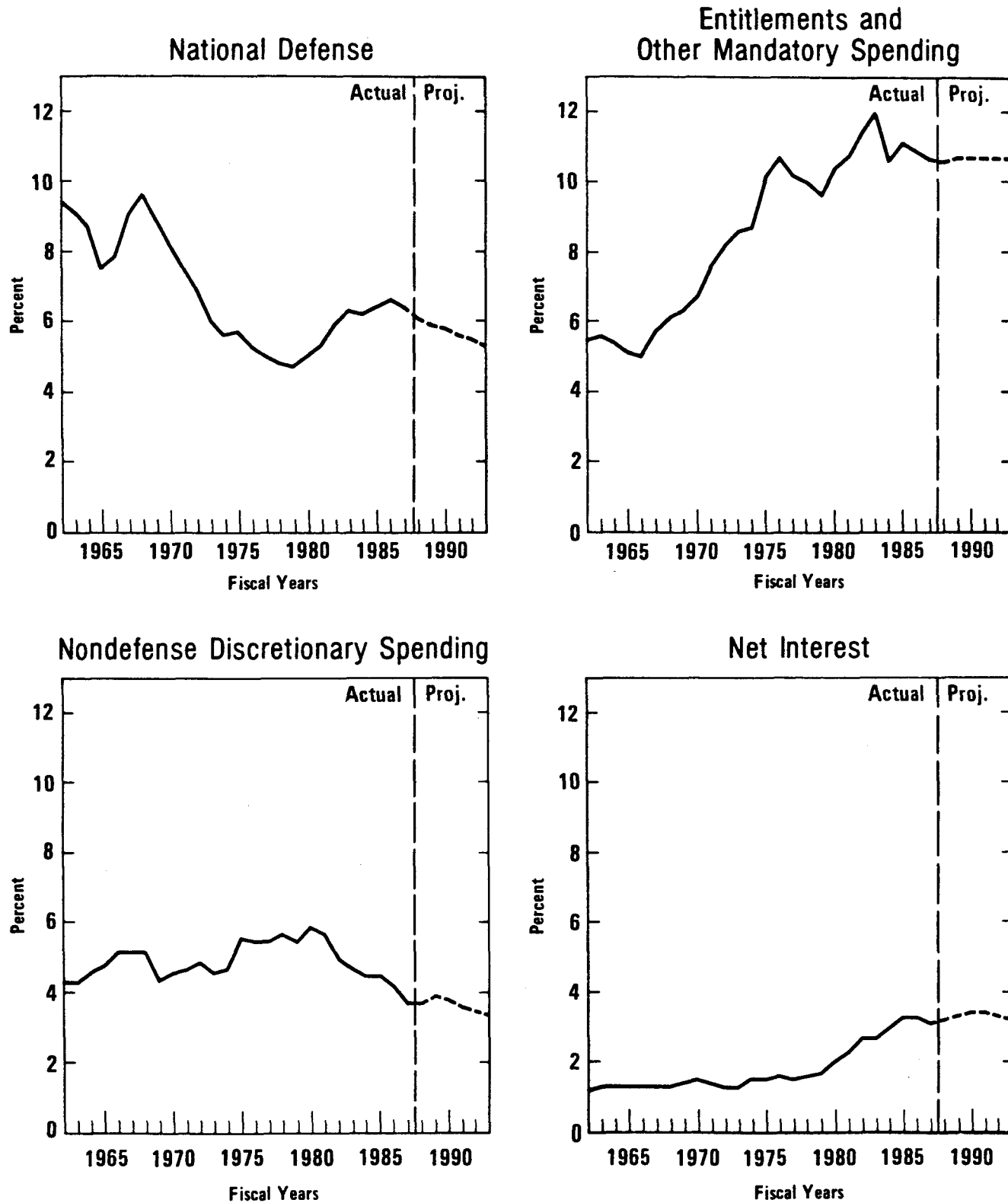
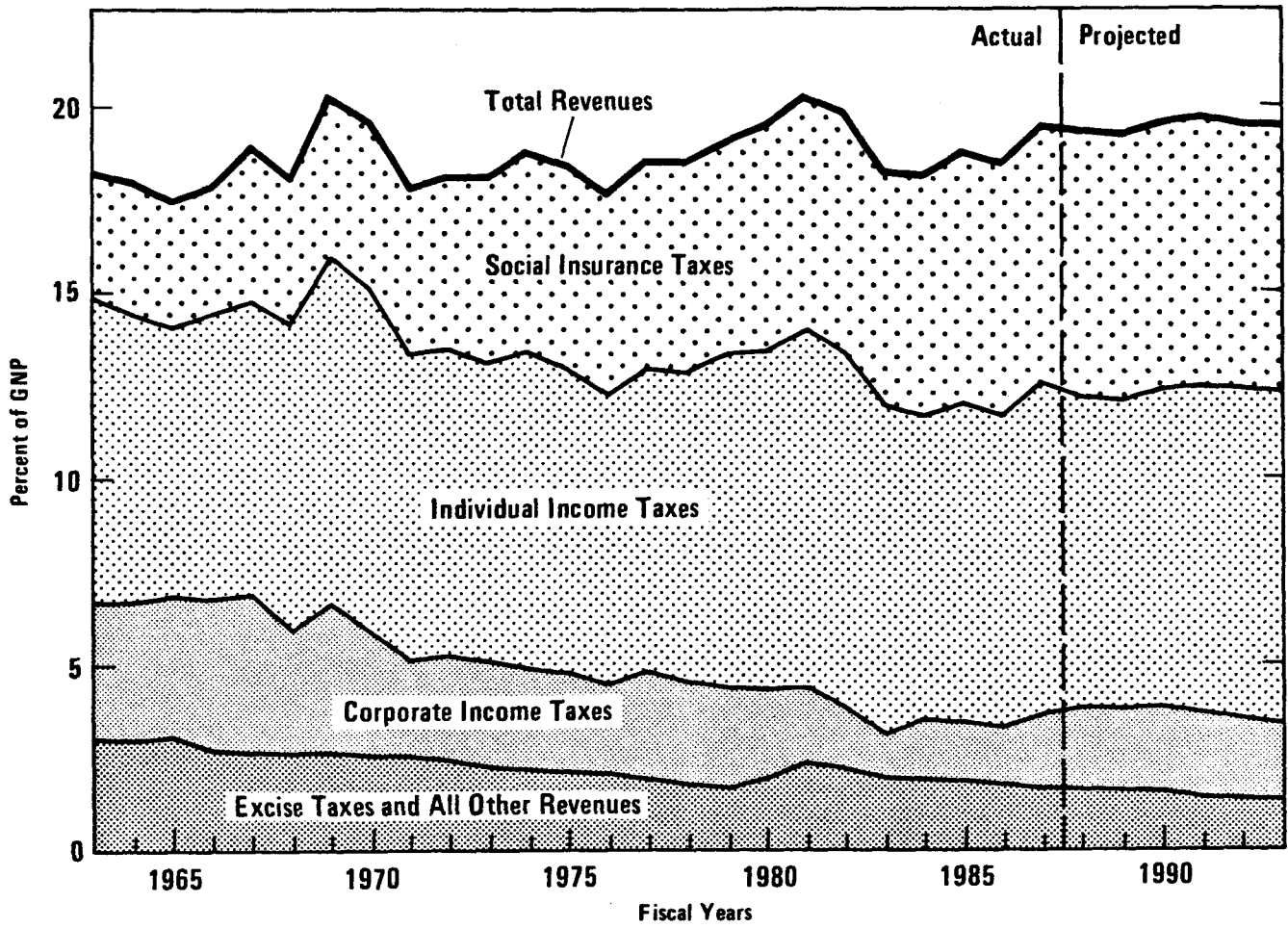


Figure 3.
 Revenues by Source as Shares of GNP



SOURCE: Congressional Budget Office.

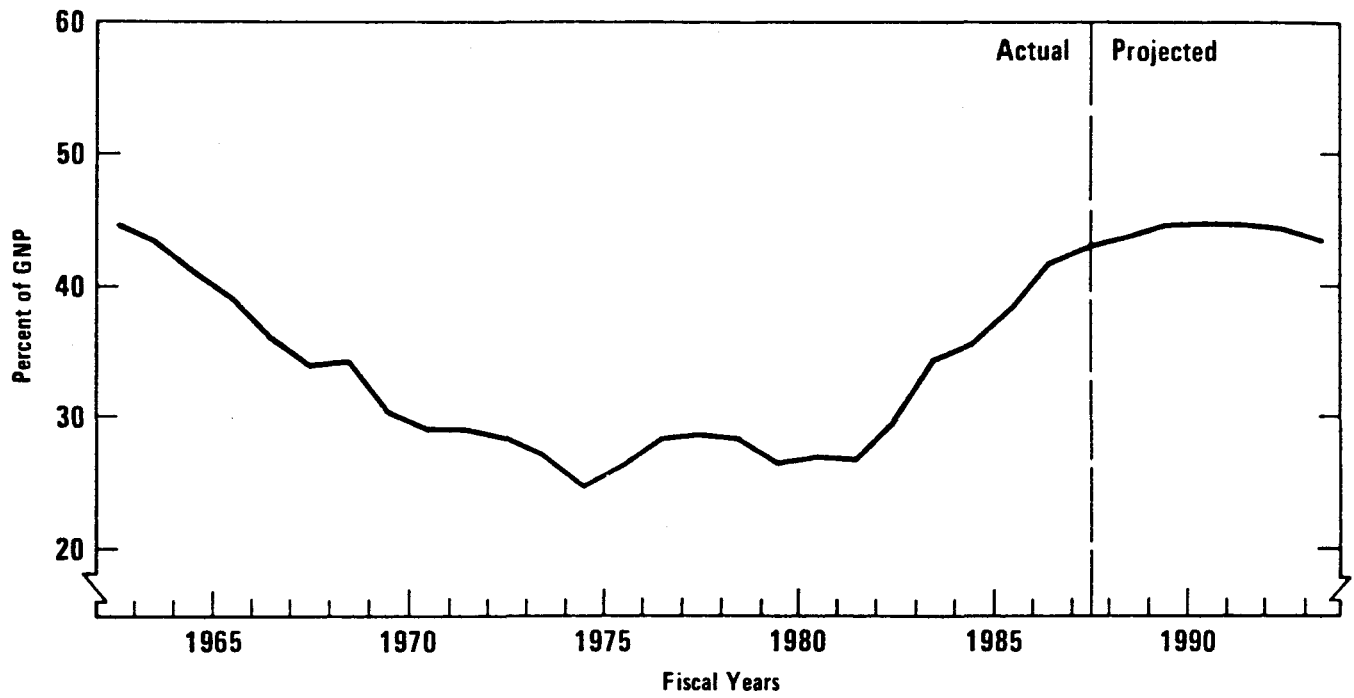
are now back to a little over 2 percent of GNP. Social insurance contributions, however, have shown a fairly steady rise, primarily because of increases in payroll tax rates for Social Security and Medicare.

Projections of federal debt held by the public are shown in Figure 4. This is the measure of federal debt that receives the most attention from economic and financial analysts. The increases in debt held by the public are equal to federal government borrowing, which is roughly equal to the annual deficit. Relative to the size of the economy, debt held by the public has grown from 27 percent of GNP at the end of 1981 to 43 percent of GNP today. In CBO's baseline projections, the debt-to-GNP ratio rises slightly through 1990 and falls thereafter.

Uncertainty of Long-Run Projections

The uncertainty inherent in these long-term economic and budget projections increases as the time horizon lengthens. In our new report, we have attempted to quantify this uncertainty. We find that there are about two chances in three that the level of real GNP in 1993 will turn out to be within 7 percent of its projected value, or that the average real growth rate between 1987 and 1993 will be between 1.6 percent and 3.6 percent. As a result, there is a two-in-three chance that the 1993 deficit

Figure 4.
Federal Debt Held by the Public



SOURCE: Congressional Budget Office.

will be within \$125 billion of its projected value of \$134 billion. This large degree of uncertainty confirms that the longer-run projections should be viewed only as a general indicator of budgetary trends and not as a forecast of future budgets.