Statement of
Rudolph G. Penner
Director
Congressional Budget Office

before the
Committee on the Budget
United States Senate

January 28, 1987

NOTICE

This statement is not available for public release until it is delivered at 2:00 p.m. (EST), Wednesday, January 28, 1987.

Mr. Chairman, I am pleased to appear before you today. I will be discussing the economic and budget projections of the Congressional Budget Office (CBO) which were described in detail in the CBO report titled *The Economic and Budget Outlook: Fiscal Years 1988-1992*, and released last week. In my testimony this afternoon, I will discuss:

- o The economic forecast for 1987 and 1988 and projections for 1989-1992; and
- o The CBO baseline budget projection, and how it compares with the CBO projection made last August and with the deficit targets of the Balanced Budget and Emergency Deficit Control Act of 1985.

CBO'S ECONOMIC AND BUDGET PROJECTIONS

The Congressional Budget Office projects that, under current taxing and spending policies, the federal deficit will decline from its record high of $221 billion in 1986 to $174 billion in 1987, $169 billion in 1988, and $85 billion in 1992. In relation to gross national product (GNP), the deficit is projected to decline from 5.3 percent of GNP in 1986 to 3.6 percent in 1988 and 1.4 percent in 1992.

These budget projections are contingent on CBO's forecast of a moderate pickup in economic growth from its subdued pace in 1986, and a modest decline in both short-term and long-term interest rates over the projection period from their average levels in 1986. They also assume that both defense and nondefense discretionary appropriations are held to zero real growth. The budgetary outlook and the economic assumptions underlying the forecast are presented in Table 1.

The economic expansion has now entered its fifth year. Over the four quarters of 1986, the economy grew at a 2½ percent rate-about the same as in 1985 but substantially below its growth in the first two years of recovery. Unemployment in 1986 was slightly below that of 1985 but still averaged 7.0 percent. Total employment grew rapidly, however, by about 2.3 percent. Most of the new jobs were still in the service-producing sector. There was a continuing weakness in employment growth in the goods-producing sector, at least partially attributable to the widening trade deficit. Inflation decreased in 1986, especially as measured by the Consumer Price Index (CPI), largely because of the precipitous decline in oil prices at the beginning of the year. Despite the continuing depreciation of the dollar against most other currencies, prices of imports did not move up as sharply as many forecasters had anticipated, nor did the import surplus decline as had been expected. Interest rates--especially long-term rates-fell considerably as a result of the easing of inflation, the sluggish growth of the economy, and the expectation of lower federal deficits.

CBO forecasts a moderate pickup in economic activity in 1987 and 1988. Real GNP is expected to grow just under 3 percent annually, which should bring unemployment down to an average of 6.6 percent in 1987 and

TABLE 1. BASELINE BUDGET PROJECTIONS, DEFICIT TARGETS, AND UNDERLYING ECONOMIC ASSUMPTIONS

	Actual 1986 a/	1987	1988	1989	1990	1991	1992
Budget Projections (By fiscal year, in billions of dollars) b/							
Baseline Estimates							
Revenues	769	834	900	962	1,050	1,138	1,220
Outlays	990	1,008	1,069	1,124	1,184	1,247	1,305
Deficit	221	174	169	162	134	109	85
Deficit Targets	172	144	108	72	36	0	n.a.
Baseline Less Targets	49	30	61	90	98	109	n.a.
Economic Assumptions (By calendar year)							
Nominal GNP (percent change)	5.4	6.0	6.9	7.2	7.4	7.0	6.8
Real GNP (percent change)	2.6	2.8	3.0	3.0	3.1	2.7	2.5
CPI-W (percent change)	1.6	3.5	4.3	4.3	4.3	4.3	4.3
Civilian Unemployment Rate (percent)	7.0	6.6	6.5	6.3	6.1	6.0	6.0
Three-Month Treasury Bill Rate (percent)	6.0	5.6	5.7	5.6	5.5	5.3	5.2

SOURCE: Congressional Budget Office

NOTE: n.a. = not applicable.

a. 1986 data for nominal and real GNP and the CPI-W are CBO estimates. The estimates do not reflect the actual data for the fourth quarter of 1986 that were released on January 22, 1987.

b. The baseline estimates and deficit targets include Social Security, which is off-budget.

6.5 percent in 1988. Like most other forecasters, CBO anticipates that the trade sector will be the major contributor to the stronger growth.

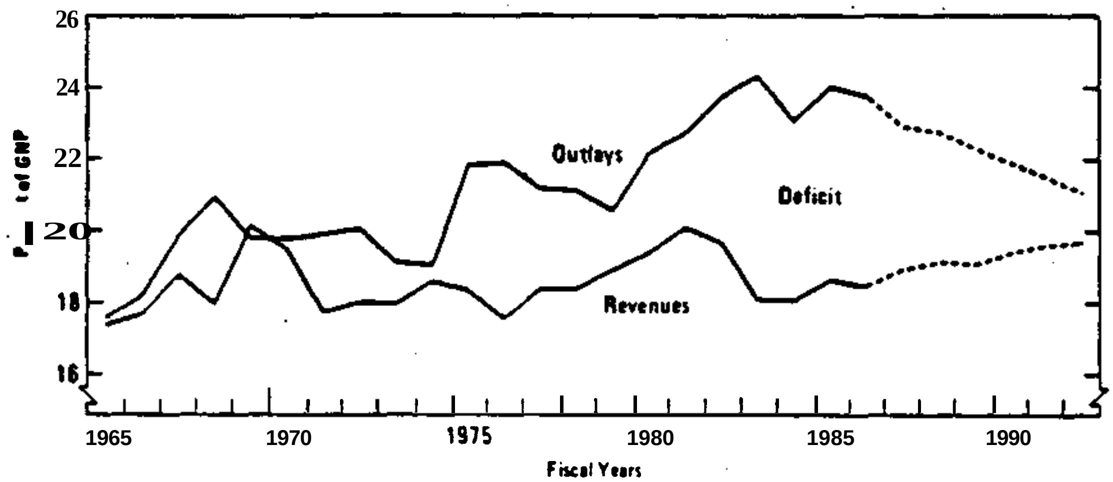
CBO's forecast calls for a rise in reported inflation, between 2 percent and 2½ percent in 1986 (as measured by the implicit GNP deflator) to about 3.7 percent in 1987-1988. On the consumer level, CBO sees inflation rising even more sharply--from the artificially depressed rate of about 1½ percent in 1986 to almost 4½ percent in 1987 and 1988. The rise in inflation will reflect, among other things, somewhat higher oil prices and rising import prices caused by the falling dollar. Nominal interest rates in 1987 and 1988 are expected to stay at about their present levels.

Under these economic assumptions, CBO projects a sharp decline of the baseline budget deficit in 1987 and a further moderate reduction in 1988. About half of the expected decline in the 1987 deficit results from one-time factors, including an increase in revenues under the Tax Reform Act of 1986, asset sales, and shifts of outlays into adjacent years. After 1987, revenues under current laws are projected to grow at an annual rate of nearly 8 percent--slightly faster than GNP--while baseline outlays grow only 5 percent per year, which is substantially below the 10 percent annual growth rate experienced earlier in the 1980s and less than the projected growth in the economy (see Figure 1).

Baseline budget deficits, although declining throughout the projection period, exceed by large amounts the targets established by the Balanced Budget Act. The 1988 deficit would have to be cut $61 billion below the

FIGURE 1.

Baseline Revenues and Outlays



SOURCES Congressional Budget Office, Office of Management and Budget, Department of Commerce, Bureau of Economic Analysis

baseline in order to reach the goal of $108 billion. For fiscal years 1989 through 1991, the baseline deficit averages about $100 billion over the statutory targets (see Table 1).

THE ECONOMIC OUTLOOK

Economic growth in 1986 turned out to be weaker than most forecasters had anticipated, mainly because of sluggishness in the manufacturing sector. Domestic demand remained fairly strong, growing about one percentage point faster than output. Growth of personal consumption, which accounts for about 65 percent of GNP, was faster than in the preceding year.

Residential construction was also stronger than in 1985. Business fixed investment, however, contracted during the year. Most important, real net exports continued their rapid deterioration; the widening of the trade deficit accounted for the divergence between the fairly strong growth of domestic demand and the weak growth of output.

While the trade picture at year-end remained bleak, import prices had begun to respond to the prolonged and substantial depreciation of the dollar against major foreign currencies. This rise in import prices suggests that the decline in real net exports is likely to bottom out in the first half of 1987. Also, as the federal budget deficits begin to contract in 1987 and beyond, the demand for real credit should decline, thus discouraging net international capital inflows. These developments should lead to further depreciation of the dollar--as expected by CBO--and, in time, should further improve our trade deficit.

Prospects for other components of demand are less buoyant. Business fixed investment is expected to remain lackluster, while growth in consumer spending, residential construction, and government purchases of goods and services is expected to be slower in 1987 than last year.

On the plus side, the difficulties in the manufacturing sector seemed to lessen toward the end of the year, as indexes of industrial activity began pointing toward better times ahead. The rebound in oil prices in the second half of 1986 helped stem the decline in activity in the oil industry and its suppliers, although higher oil prices will be costly for the economy in the longer run.

CBO's economic projection consists of two parts: a short-term forecast of economic conditions through 1988 contingent on specific policy and other crucial assumptions; and a medium-term projection for the period 1989 through 1992 based on historical trends and other assumptions about economic growth.

The Forecast for 1987-1988

CBO's two-year forecast, presented in Table 2, is based on the following assumptions as to fiscal and monetary policy:

- o Federal budget policies for fiscal year 1988 are assumed to be consistent with achieving the deficit targets specified in the Balanced Budget Act. Since the policies for that year are not known, CBO assumes equal across-the-board revenue increases and spending cuts, after incorporating an estimate for asset sales.

- o The Federal Reserve Board is assumed to pursue a policy that would allow the monetary aggregate M2 to remain within its target range.

In addition, the forecast assumes that:

- o The world price of oil will be close to $15 per barrel through the end of 1988.

- o By the end of 1988, the exchange rate (as measured by the Federal Reserve Board index) will be about 10 percent below its level at the end of 1986.

- o Food prices will rise by about 4 percent throughout the forecast period.

Given these assumptions, CBO expects real GNP to grow at about a 3 percent annual rate between the fourth quarters of 1986 and 1988, a bit faster than over the last two years. Inflation at the consumer level will rise to around 4½ percent in 1987-1988 from its exceptionally low level in 1986. Civilian unemployment is forecast to average 6.6 percent in 1987, and to

TABLE 2. THE CBO FORECAST FOR 1987 AND 1988

	Actual		Forecast	
	1985	1986 a/	1987	1988
Fourth Quarter to Fourth Quarter (percent change)				
Nominal GNP	6.3	5.1	6.5	7.1
Real GNP	2.9	2.5	3.0	2.9
Implicit GNP Deflator	3.3	2.6	3.4	4.0
CPI-W	3.2	1.1	4.4	4.4
Calendar-Year Averages (percent)				
Unemployment Rate	7.2	7.0	6.6	6.5
Three-Month Treasury Bill Rate	7.5	6.0	5.6	5.7
Ten-Year Government Bond Rate	10.6	7.7	7.2	7.2

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

a. 1986 data for nominal and real GNP and the CPI-W are CBO estimates. The estimates do not reflect the actual data for the fourth quarter of 1986 that were released on January 22, 1987.

drop further in 1988 to around 6.5 percent. The interest rate on three-month Treasury bills should rise slightly in 1987 from current levels, while yields on 10-year Treasury bonds are expected to remain at their current levels.

Medium-Term Economic **Projections**

CBO's medium-term projections for 1989 through 1992 are not a forecast of economic conditions, but projections based on historical experience. These out-year economic projections are not predicated on specific budget policies, and may not be consistent with the budget policies now in place. Real GNP is assumed to grow at about its post-war historical average until 1990. Thereafter, it is equal to CBO's projection of potential GNP. The projections of potential GNP thus plays a central role in CBO's economic projections. We have recently revised downward the projection of potential GNP, and thus of long-term growth. The reasons are discussed in Chapter 3 **of** our report.

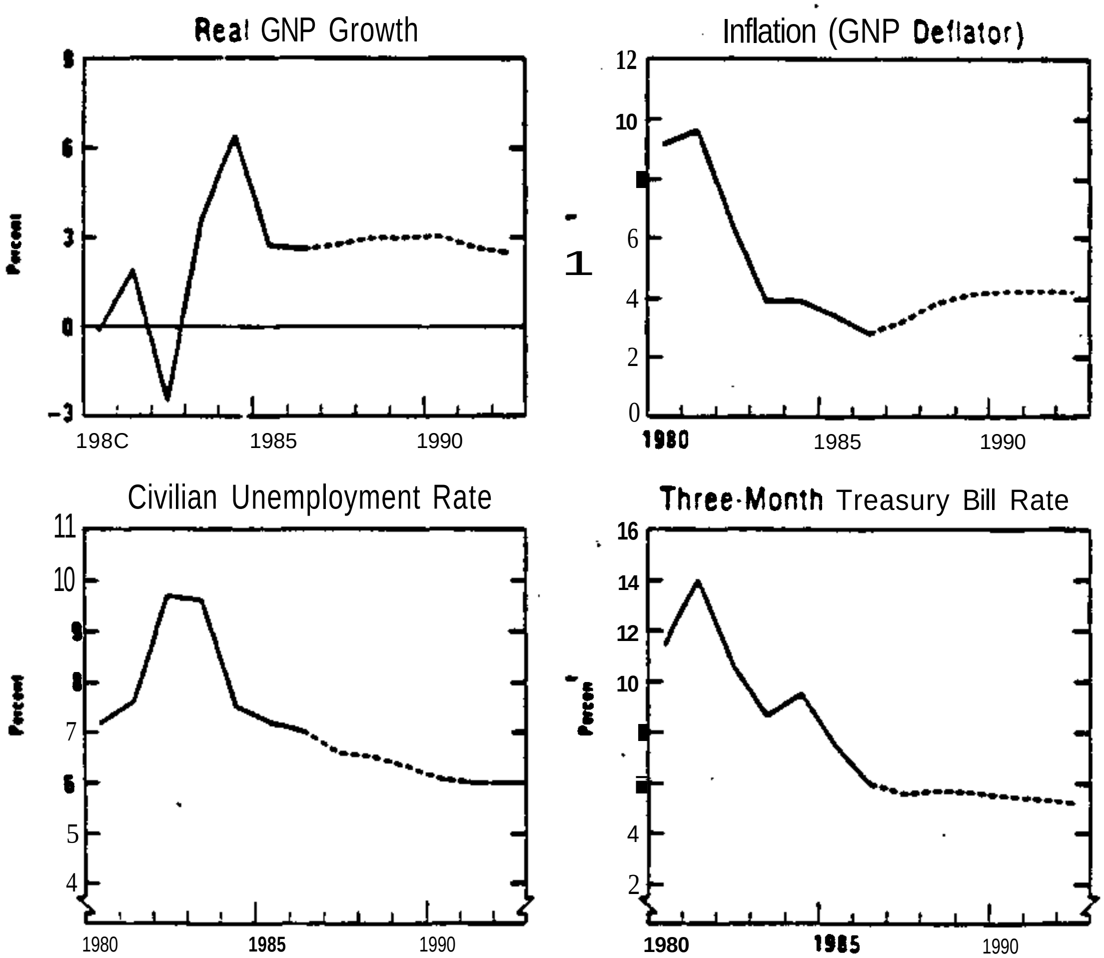
The major characteristics of the 1989-1992 projections are shown in Figure 2.

- o Real GNP grows at an average rate of 2.7 percent.
- o Unemployment declines to about 6 percent in 1990 and remains near this level in subsequent years.
- o Inflation, as measured by the **CPI-W,** holds at 4.3 percent throughout the projection period.

- Nominal interest rates on short-term Treasury bills decline gradually to 5.2 percent by 1992, while rates on long-term Treasury bonds decline a bit more sharply to 5.6 percent by the end of the projection period.

FIGURE 2.

Major Economic Assumptions



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

Uncertainty in the Outlook

While every economic forecast is subject to great uncertainty, a number of special factors combine to render forecasts made at this time particularly uncertain. For **example:**

- The impact on the economy of the shift in fiscal policy toward greater restraint, as mandated by the Balanced Budget Act;
- The economic impact of the Tax Reform Act of 1986, which changes the composition of federal receipts and substantially alters incentives for many economic activities;
- The ability of OPEC oil producers to maintain oil prices at their current levels; and
- The speed and strength of the response of exports and imports to the dollar depreciation.

THE BUDGET OUTLOOK

CBO's baseline budget projections reflect the new economic forecast and medium-term projections, the latest information on tax collections and spending patterns, and estimates of the effect of recently enacted legislation. As they did last year, the projections assume that both defense and nondefense discretionary appropriations are held constant in real terms and that current tax and entitlement laws are not changed. Under these assumptions, the deficit, as I mentioned earlier, is projected to decline from $221 billion in 1986 to $85 billion in 1992 (see Table 1).

The 1988 baseline deficit of $169 billion exceeds the Balanced Budget **Act's** target by **$61** billion. The deficit targets decline at a faster rate than the baseline in future years so that the gap between the baseline and the annual deficit targets grows to $109 billion by 1991. Under the Balanced Budget Act, the Congress could choose to meet the 1988 deficit target by across-the-board spending cuts referred to as sequestration. Under CBO's baseline assumptions, these cuts would have to be 14 percent for defense programs and 20 percent for nondefense programs from 1987 appropriation levels.

As the result of continuing budget deficits, debt held by the public is projected to grow from $1.7 trillion at the end of 1986 to over $2.5 trillion by the end of fiscal year 1992. The federal government's debt has grown faster than the economy since the early 1980s, but CBO's baseline projections of declining deficits show an end to this trend. The ratio of debt to GNP under CBO's baseline assumptions peaks at 44 percent in the 1988-1990 period and then falls to 41 percent in 1992--very close to its current level (see Figure 3). The decline in the debt-to-GNP ratio will obviously be sharper if the deficit targets of the Balanced Budget Act are met.

Changes in Baseline Projections

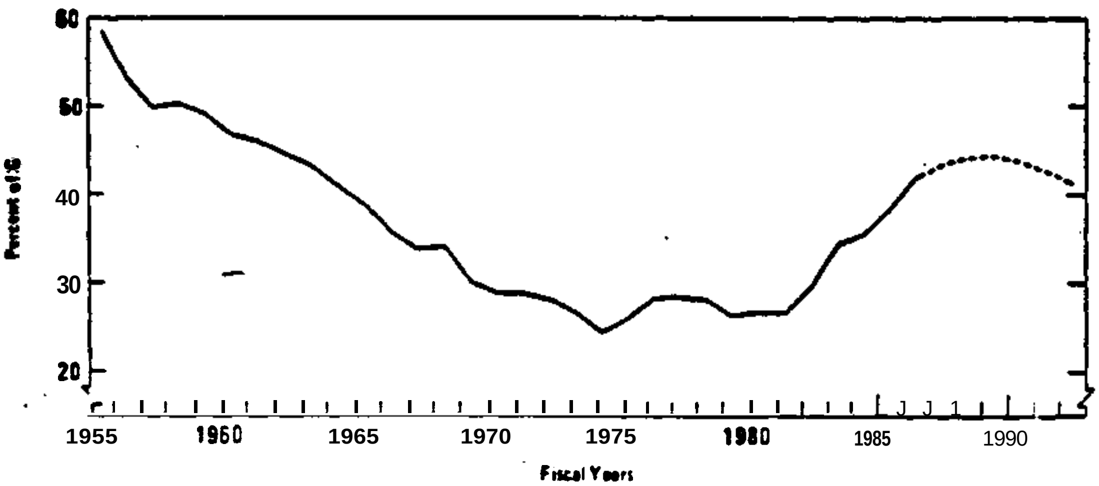
Projected baseline deficits for 1988-1991 are higher than projected by CBO last August despite the enactment of legislation in October to reduce spending and increase revenues. Under CBO's August 1986 economic and technical assumptions, the Omnibus Budget Reconciliation Act, the Tax Reform Act, and the continuing resolution for appropriations would have reduced the 1987 deficit to about **$151 billion--within** $10 billion of the Balanced Budget **Act's** target. But CBO's new economic and technical assumptions raise the 1987 deficit estimate to $174 billion. Moreover, most of the budgetary savings from enacted legislation last year were one-time savings. While the savings attributable to legislation were $32 billion in 1987, the annual savings average only $6 billion in 1988-1991 (see Table 3).

Revised economic assumptions add to the deficit by amounts growing from $10 billion in 1987 to $25 billion by 1991. Lower levels of nominal GNP and changes in the composition of national income cause estimated revenues to be lower by amounts growing from $13 billion in 1987 to

---

FIGURE 3.

Federal Debt Held by the Public



SOURCES Congressional Budget Office, Office of Management and Budget, Department of the Treasury, Department of Commerce, Bureau of Economic Analysis

NOTE The values shown for the 1987-1991 fiscal years are consistent with the CBO baseline

$22 billion in 1991. Lower projected interest **rates,** however, reduce debt-service costs and attenuate somewhat the budgetary effect of lower revenues.

Technical reestimates, primarily on the spending side, increase the projected deficits substantially in all years. Medicaid and Medicare spending in 1986 exceeded expectations; this growth is expected to continue, adding $3 billion to spending in 1987 and $7 billion by 1991. Changes in the outlook for U.S. agricultural exports and other factors increase outlays for farm price supports by $3 billion in 1987 and about $6 billion per year in the 1988-1991 period. Revised defense spending estimates add less than

TABLE 3. CHANGES FROM CBO AUGUST BASELINE DEFICIT PROJECTIONS (By fiscal year, in billions of dollars)

	1987	1988	1989	1990	1991
CBO August 1986 Baseline Deficit	184	150	127	96	69
Enacted legislation	-32	-9	a/	-5	-10
Revised economic assumptions	10	11	15	19	25
Technical reestimates	13	17	20	24	25
CBO January 1987 Baseline Deficit	174	169	162	134	109

SOURCE: Congressional Budget **Office.**

a. Less than $500 million.

$1 billion to 1987 outlays but about $3 billion per year thereafter. Projected outlays have also risen by an average of $1½ billion per year for unemployment compensation and $1 billion per year for assistance payments and Supplemental Security Income. Those increases reflect recent spending experience. Finally, based on spending plans of the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation, estimated federal assistance to troubled financial institutions will grow by more than $4 billion in 1987.

Uncertainty of Budget Estimates

The changes in the baseline deficit projections because of revised economic assumptions and technical reestimates demonstrate the uncertainty of budget estimates. Relatively small changes in forecasts of outlays and receipts can result in a large percentage change in a deficit estimate. For example, a 1 percent increase in estimated outlays combined with a 1 percent reduction in estimated receipts would raise the estimated 1988 deficit by $20 billion or 12 percent. Finding another $20 billion of program cuts or tax increases is immensely difficult, and thus changes in budget estimates that seem small to a forecaster become extremely important politically.

Changes in the magnitude described above can result from very small changes in the economic outlook. For example, a one-percentage-point increase in the interest rate on the government debt would increase outlays by $11 billion in 1988 and $26 billion in 1992.

Significant changes in the estimates can also occur for reasons unrelated to the health of the overall economy. For example, unexpected increases in the cost of farm price supports, federal health programs, financial deposit insurance programs, and unemployment compensation have added $12 billion to CBO's estimate of the 1987 deficit since last August. In recent years, errors in technical estimating assumptions have caused the targets in first Congressional budget resolutions to differ from actual deficits by an average of $17 billion.