CBO TESTIMONY

Statement of
Robert D. Reischauer
Director
Congressional Budget Office

before the
Committee on the Budget
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NOTICE

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CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

Mr. Chairman and Members of the Budget Committee, thank you for inviting me here this afternoon to discuss the economic and budget outlook. Yesterday, the Congressional Budget Office (CBO) released the first volume of its annual report. The report reviews the current state of the economy, presents CBO's economic assumptions and budget projections for the next five years, and assesses the effects of alternative fiscal and monetary policies. My statement summarizes its conclusions.

Federal budgeting in 1992 is caught on the horns of a nasty dilemma. The immediate concern is an economy struggling to recover from recession. Of long-term consequence are the continued stagnation of personal incomes and a string of record budget deficits. Unfortunately, fiscal policies that would aid the economy's short-term recovery are all too likely to undercut its long-run performance.

Most economic forecasters, including the Congressional Budget Office, expect a strong rebound to begin in the spring. But even then, the pace of economic growth will probably fall well short of what normally occurs early in a recovery. Although a looser fiscal policy would do little to hasten the onset of recovery, tax cuts or increased government spending could strengthen the expansion late this year and early next year. An expansionary fiscal policy, however, will immediately add to the federal government's already mammoth borrowing requirements, and some proposals would spill more red ink down the road as well.

Fiscal year 1991 closed with a record deficit of $269 billion, but 1992 and 1993 seem certain to exceed even that figure. CBO projects that, under current budgetary policies, the deficit will reach $352 billion this year and $327 billion in 1993. Even adjusting for the size of the economy, those figures approach the highest levels ever.

The huge shortfalls will arise despite the stringent limits on discretionary spending that were imposed as part of the five-year, $500 billion deficit reduction agreement negotiated by the President and the Congress in 1990. During the 1980s, discretionary spending shrank from 10.5 percent of gross domestic product (GDP) to a postwar low of 9.5 percent. Under current policies, the ratio of discretionary spending to GDP will fall another 2 percentage points in the next five years. Achieving the reductions in discretionary spending mandated by the budget agreement will almost certainly require further substantial cuts in the defense budget, and will keep funds for new international and domestic initiatives in short supply.

Although deficit reduction is a critical goal, other budgetary claims tug in the opposite direction. Examples abound. For over a decade, the nation has curbed investment in infrastructure, education, and other forms of public capital that could increase long-term growth. Sixteen percent of people under age 65 have no health insurance coverage. The United States has a historic opportunity to help the emerging nations in Eastern Europe and the former Soviet Union develop strong market

economies and sound democratic institutions. And some analysts and politicians feel that the tax burden on middle-income families is too high, while others want to reduce the taxation of income from capital.

No single step can satisfy all of those concerns simultaneously, and the Congress must decide how to balance the competing demands. For fiscal stimulus, the most effective policy is one that can be carried out quickly, takes effect promptly, and promotes spending rather than saving. Although measures that increase the federal deficit temporarily tend to be less effective than those that raise it permanently, temporary measures are less likely to spook financial markets and raise interest rates. Encouraging growth, by contrast, calls for reducing the budget deficit and increasing the share of government spending devoted to investment in physical and human capital. And, obviously, demands for additional public spending cannot be satisfied while simultaneously cutting taxes and making further inroads into the deficit.

THE ECONOMIC OUTLOOK

Six months ago, CBO and most other forecasters expected the recovery to be fully under way by the start of 1992. Nineteen ninety-two is now here, but the recovery is not. What went wrong?

First, high vacancy rates for office buildings and rental housing continued to cast a pall over new construction, which declined during the second half of 1991. Second, an unusually large share of the spurt in demand that occurred in the late spring and summer was satisfied by imports rather than domestic production. Third, the decline in personal income and frequent announcements of job layoffs shook consumer confidence.

Although the low level of consumer confidence raises the specter of a double-dip recession, CBO believes that a recovery, albeit mild and delayed, is a more likely prospect. Recent declines in interest rates should allow the economy to pick up steam by spring. A moderate recovery should take hold in the second half of the year and continue into 1993. But the pace of recovery will be slowed by structural adjustments in commercial real estate, financial services, state and local governments, and other sectors of the economy.

Forecast for 1992 and 1993

CBO forecasts that real gross domestic product in 1992 and 1993 will grow about 3 percent a year, slightly above the *Blue Chip* average of private-sector forecasts but only about half the rate that normally occurs in the first two years of recovery (see Table 1). This lukewarm performance will only gradually reduce the hardships that the recession

Table 1.
Comparison of Forecasts for 1992 and 1993

	Actual 1990	Estimated 1991	Forecast 1992	Forecast 1993
	Fourth Quarter to Fourth Quarter (Percentage change)			
Nominal GDP				
CBO	4.1	3.2	5.9	6.6
Blue Chip	4.1	3.4	5.7	6.5
Real GDP				
CBO	-0.1	0.0	2.8	3.3
Blue Chip	-0.1	0.2	2.4	3.0
Implicit GDP Deflator				
CBO	4.2	3.2	3.1	3.2
Blue Chip	4.2	3.2	3.1	3.4
Consumer Price Index[a]				
CBO	6.3	3.0	3.4	3.6
Blue Chip	6.3	3.0	3.5	3.8
	Calendar-Year Averages (Percent)			
Civilian Unemployment Rate				
CBO	5.5	6.7	6.9	6.4
Blue Chip	5.5	6.7	6.8	6.3
Three-Month Treasury Bill Rate				
CBO	7.5	5.4	4.4	5.1
Blue Chip	7.5	5.4	4.1	5.0
Ten-Year Treasury Note Rate				
CBO	8.6	7.9	7.1	7.1
Blue Chip[b]	8.6	7.9	7.0	7.5

SOURCES: Congressional Budget Office; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators;* Department of Commerce, Bureau of Economic Analysis.

NOTE: The *Blue Chip* forecasts through 1993 are based on a survey of 50 private forecasters, published on January 10, 1992. These forecasts are reported on a basis that is consistent with the recent revision of the national income and product accounts.

a. The consumer price index for all urban consumers (CPI-U).

b. *Blue Chip* does not project a 10-year note rate. The values shown here for the 10-year note rate are based on the *Blue Chip* projections of the Aaa bond rate, adjusted by CBO to reflect the estimated spread between Aaa bonds and 10-year Treasury notes.

has brought to many parts of the country. The unemployment rate will remain high for some time, averaging close to 7 percent in 1992, as the recovery gradually entices discouraged, jobless workers back into the labor force.

CBO projects that inflation, as measured by the change in the consumer price index, will be 3.4 percent in 1992 and 3.6 percent in 1993 on a fourth-quarter-to-fourth-quarter basis. Excluding food and energy prices, the underlying rate of inflation is projected to be 3.6 percent in 1992 and 1993, the smallest two-year increase since the mid-1960s. But that considerable achievement, it should be noted, has been purchased at the cost of low wage growth and high unemployment.

Short-term interest rates will remain close to 4 percent in early 1992, but they are likely to rise modestly--to about 4.8 percent--by year's end. A further rise to 5.1 percent is expected in 1993, as the recovery continues and the demand for borrowed funds grows. The recovery is not expected to produce any large changes in long-term interest rates, however. The 10-year Treasury note rate, which closed 1991 at 6.8 percent, should be only slightly higher in 1992 and 1993.

Projections for 1994-1997

CBO does not attempt to forecast cyclical fluctuations in the economy more than two years into the future. So beyond 1993, the projections are based on trends in the labor force, productivity, and saving. Over the 1994-1997 period, CBO projects that the substantial economic slack left by the recession will be gradually eliminated through growth in real GDP that averages 2.6 percent per year (see Table 2). By comparison, potential output grows at an annual rate of only 2.1 percent.

The reduction in the underlying rate of inflation, brought about by the recession and the tight monetary policy that preceded it, is likely to persist through much of the 1990s. The consumer price index is projected to grow by 3.6 percent a year. The implicit GDP deflator will grow a bit less rapidly, reflecting a continued drop in the price of computers and their mounting importance in the economy.

The CBO projections assume that real (inflation-adjusted) interest rates will remain below prerecession levels. Long-term rates are projected to be flat, with short-term rates rising slightly after 1993. By 1997, real interest rates are projected to be about 1 percent below the 1986-1989 average.

Table 2.
Medium-Term Economic Projections for Calendar Years 1992 Through 1997

	Estimated	Forecast		Projected			
	1991	1992	1993	1994	1995	1996	1997
Nominal GDP (Billions of dollars)	5,671	5,931	6,337	6,714	7,104	7,520	7,961
Nominal GDP (Percentage change)	2.9	4.6	6.9	5.9	5.8	5.9	5.9
Real GDP (Percentage change)	-0.8	1.6	3.6	2.7	2.5	2.6	2.6
Implicit GDP Deflator (Percentage change)	3.7	2.9	3.2	3.2	3.2	3.2	3.2
Fixed-Weighted GDP Price Index (Percentage change)	3.7	3.0	3.3	3.4	3.4	3.4	3.4
CPI-U (Percentage change)	4.2	3.3	3.6	3.6	3.6	3.6	3.6
Unemployment Rate (Percent)	6.7	6.9	6.4	6.2	6.0	5.9	5.7
Three-Month Treasury Bill Rate (Percent)	5.4	4.4	5.1	5.2	5.4	5.5	5.6
Ten-Year Treasury Note Rate (Percent)	7.9	7.1	7.1	7.1	7.1	7.1	7.1

SOURCE: Congressional Budget Office.

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

THE BUDGET OUTLOOK

The course of the budget through 1995 was set by the 1990 budget agreement. It included tax increases and spending reductions totaling almost $500 billion over the 1991-1995 period. New budgetary procedures attempted to guarantee that the savings would not be eroded by future legislation.

The new budget process is spelled out in the Budget Enforcement Act of 1990. Dollar limits apply to discretionary spending. Defense, international, and domestic discretionary spending have separate caps through 1993, and a single aggregate limit applies in 1994 and 1995. A pay-as-you-go requirement provides that, taken together, changes in mandatory spending programs and tax laws must not increase the deficit in any year.

Although the Budget Enforcement Act contains deficit targets, they are irrelevant through at least 1993, and the law contains no requirement that the deficit fall to any specified level.

The Outlook for the Deficit

CBO projects that the federal deficit will exceed $350 billion in 1992, setting a new record for the second year in a row (see Table 3). In

Table 3.
CBO Deficit Projections (By fiscal year)

	1990	1991	1992	1993	1994	1995	1996	1997
			In Billions of Dollars					
Total Deficit	220	269	352	327	260	194	178	226
Deficit Excluding Deposit Insurance and Desert Storm Contributions	162	246	290	258	227	210	222	254
Standardized-Employment Deficit[a]	150	172	191	189	178	170	191	234
Deficit Excluding Social Security and Postal Service	277	321	404	391	337	281	276	335
			As a Percentage of GDP					
Total Deficit	4.0	4.8	6.0	5.2	3.9	2.8	2.4	2.9
Deficit Excluding Deposit Insurance and Desert Storm Contributions	3.0	4.4	5.0	4.1	3.4	3.0	3.0	3.2
Standardized-Employment Deficit[a]	2.7	2.9	3.1	2.9	2.6	2.4	2.5	3.0
Deficit Excluding Social Security and Postal Service	5.1	5.7	6.9	6.3	5.1	4.0	3.7	4.3
Memorandum: Gross Domestic Product	5,460	5,627	5,846	6,237	6,621	7,004	7,414	7,849

SOURCE: Congressional Budget Office.

a. Excluding deposit insurance and Desert Storm contributions. Shown as a percentage of potential gross domestic product.

relation to the size of the economy, the 1992 deficit will amount to 6.0 percent of GDP, just shy of the postwar high reached in 1983. By the mid-1990s, the deficit will drop back to about $200 billion, or about 3 percent of GDP.

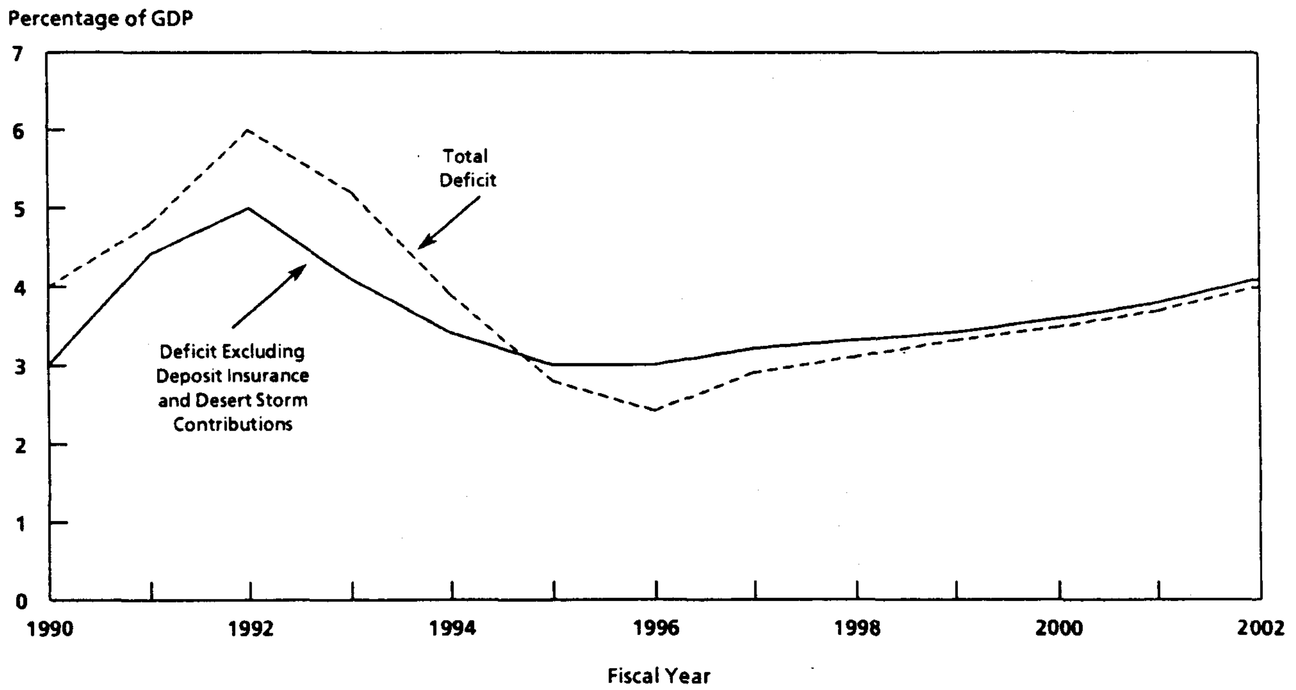
If budgetary policies are not changed, that may prove to be the acme of success in deficit reduction. Without additional spending cuts or tax increases, the improvement will cease, with the deficit likely to grow faster than GDP in the second half of the decade (see Figure).

Yet the total deficit is not the most relevant measure for policy discussions. Its ups and downs obscure an underlying stability in federal fiscal policy. To appreciate the fundamental pattern, some temporary factors must be removed from the budget totals.

First, federal spending in recent years has been swelled by the cost of bailing out or closing hundreds of insolvent thrift institutions and commercial banks, whose deposits are insured by the federal government. Deposit insurance costs are expected to remain enormous through 1993, drop sharply in 1994, and turn negative in 1995, when proceeds from selling the assets of previously failed institutions will exceed the spending required to resolve new failures.

Contributions from U.S. allies to help finance Operation Desert Storm represent a second transitory item. Those contributions lower the

Figure.
Federal Budget Deficit (As a Percentage of GDP)



SOURCE: Congressional Budget Office.

deficit by $43 billion in 1991 and $5 billion in 1992. The large year-to-year swings in deposit insurance spending and the allies' contributions have little current effect on the economy and on interest rates.

Excluding deposit insurance and Desert Storm contributions, the deficit peaks at 5.0 percent of GDP in fiscal year 1992 and then declines gradually to 3.0 percent in 1995 and 1996. But even these deficit estimates are not the most relevant because they contain a cyclical element that should be less troubling than a structural imbalance. The standardized-employment deficit, which removes the cyclical component, hovers around 3 percent of GDP for the rest of the decade.

The Budget Process

Three major budgetary issues face the Administration and the Congress as they grapple with the 1993 budget. How should the discretionary spending limits be met? Should the existing categorical limits be changed? And should some sort of countercyclical tax cut or spending increase be enacted?

Meeting the discretionary spending limits for fiscal year 1993 will require holding defense and domestic appropriations below their 1992 levels, after allowing for inflation. By CBO's calculations, the required

cuts in defense budget authority amount to $15 billion, or 5 percent below the 1992 level. For domestic discretionary programs, the budget authority cut is $6 billion, or 3 percent. Required outlay reductions total almost $9 billion, which amounts to 4 percent of total domestic discretionary outlays and 8 percent of outlays from new budget authority (see Table 4).

As the Budget Enforcement Act now stands, funds cannot be shifted from one category of discretionary spending to another in 1993. If spending in any category is held below the legal limit, the shortfall must be applied to deficit reduction. Since October 1990, when the act was adopted, however, the world has changed in ways that could not have been foreseen. One now hears arguments that the caps on 1993 defense spending are too high and that additional defense cuts should be used to pay for tax reductions or higher domestic spending.

The third question involves whether to attempt to use the budget to boost the economy. Chapter 5 of CBO's annual report concludes that fiscal measures could strengthen the recovery in the latter half of 1992 and throughout 1993, but might impair economic growth in the long run. Among the measures that might provide relatively rapid stimulus with relatively few long-term side effects are personal tax rebates for 1991 tax liabilities, a temporary investment tax credit, and temporary, unrestricted fiscal assistance to states and localities.

Table 4.
CBO Estimates of Discretionary Spending Limits, Excluding Emergencies, for 1992 and 1993 (In billions of dollars)

	1992		1993	
	Budget Authority	Outlays	Budget Authority	Outlays
	Defense			
End-of-Session Limits as Estimated by CBO	291.4	302.5	287.4	294.4
1992 Level	291.0	302.5	302.0[a]	306.7[a]
	International			
End-of-Session Limits as Estimated by CBO	22.2	19.8	22.5	20.5
1992 Level	20.7	19.5	21.5[a]	20.3[a]
	Domestic			
End-of-Session Limits as Estimated by CBO	200.3	212.2	205.1	223.6
1992 Level	199.9	212.0	211.3[a]	232.4[a]

SOURCE: Congressional Budget Office.

NOTE: The 1992 outlay estimates are based on CBO's Final Sequestration Report for fiscal year 1992. The outlay estimates for 1992 and 1993 include spending from emergency appropriations in previous years.

a. Adjusted for inflation.

CONCLUSION

Although the recession has made further deficit reduction inadvisable this year, the deficit should return to the top of the political agenda in 1993. Excluding deposit insurance, the deficit is likely to exceed $200 billion for the foreseeable future and move higher toward the end of the 1990s. Deficits of those magnitudes cripple economic growth by reducing national saving and capital formation. They also create a vicious cycle of more federal borrowing and higher debt service costs, which in turn make it still more difficult to reduce the deficit.

Another round of spending reductions and tax increases, rivaling the $500 billion achieved in 1990, must come soon if the deficit is to be reduced to reasonable levels.