Statement of
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before the
Committee on Ways and Means
U.S. House of Representatives

March 16, 1988

NOTICE

This statement is not available for public release until it is delivered at 9:30 a.m. (EST), Wednesday, March 16, 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 three reports that CBO has recently released: *The Economic and Budget Outlook, Reducing the Deficit*, and *An Analysis of the President's Budgetary Proposals for Fiscal Year 1989.* In my testimony I will summarize CBO's baseline budget projections, our analysis of the Administration's budget, and our short-run economic forecast and long-run economic assumptions.

CBO BASELINE BUDGET PROJECTIONS

CBO projects that the federal deficit would rise from $150 billion in 1987 to $161 billion in 1988 and $177 billion in 1989, if current budgetary policy policies are continued without change. CBO's baseline projections for federal revenues, outlays, and the deficit are shown in Table 1. The projected rise in the deficit 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

TABLE 1. CBO BASELINE BUDGET PROJECTIONS (By fiscal year)

	1988	1989	1990	1991	1992	1993
			In Billions of Dollars			
Revenues						
Individual income	390	415	455	495	533	575
Corporate income	99	107	119	126	130	134
Social insurance	331	352	381	408	433	465
Other	79	80	82	83	84	87
Total	898	954	1,036	1,111	1,181	1,261
Outlays						
National defense	287	295	306	320	333	346
Nondefense discretionary spending	176	193	203	207	215	222
Entitlements and other mandatory spending	500	536	573	610	650	694
Net interest	152	166	185	198	203	208
Offsetting receipts	-56	-59	-61	-64	-67	-70
Total	1,059	1,131	1,206	1,271	1,335	1,400
Deficit	161	177	170	159	154	139
Debt Held by the Public	2,046	2,222	2,391	2,547	2,700	2,838
			As a Percent of GNP			
Revenues						
Individual income	8.3	8.3	8.5	8.7	8.8	8.8
Corporate income	2.1	2.1	2.2	2.2	2.1	2.1
Social insurance	7.1	7.1	7.1	7.2	7.1	7.2
Other	1.7	1.6	1.5	1.5	1.4	1.3
Total	19.2	19.1	19.5	19.5	19.4	19.4
Outlays						
National defense	6.1	5.9	5.7	5.6	5.5	5.3
Nondefense discretionary spending	3.8	3.9	3.8	3.6	3.5	3.4
Entitlements and other mandatory spending	10.7	10.7	10.8	10.7	10.7	10.7
Net interest	3.2	3.3	3.5	3.5	3.3	3.2
Offsetting receipts	-1.2	-1.2	-1.2	-1.1	-1.1	-1.1
Total	22.6	22.7	22.6	22.3	22.0	21.5
Deficit	3.4	3.6	3.2	2.8	2.5	2.1
Debt Held by the Public	43.7	44.6	44.9	44.8	44.4	43.7

SOURCE: Congressional Budget Office.
NOTE: Totals include Social Security, which is off-budget.

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.

After 1989, the baseline deficit is projected to decline slowly from $177 billion in 1989 to $139 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 3.6 percent of the gross national product (GNP) in 1989 to 3.2 percent in 1990 and 2.1 percent in 1993. The ratio of debt held by the public to GNP rises slightly through 1990 and falls thereafter.

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 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 Balanced Budget Act 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.

Because the CBO baseline is a projection of current laws and policies, it incorporates only those elements of the budget summit agreement that have already been put in place. As shown in Table 2, 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. These steps

TABLE 2. THE BUDGET SUMMIT AGREEMENT
(By fiscal year, in billions of dollars)

	1988	1989
Deficit Reduction Already Achieved		
Revenues		
Taxes	9.2	14.2
IRS compliance (gross)	1.8	2.5
User fees	-0.5	-0.6
Total	10.5	16.1
Outlays		
National defense	5.1	7.4
Nondefense discretionary	2.5	1.6
Entitlements and other mandatory spending		
Medicare	2.1	3.8
Farm price supports	1.2	0.9
Postal Service and Civil Service	0.8	0.6
Pension Benefit Guaranty Corporation premiums	0.4	0.4
Veterans housing loan sales and fees	0.8	0.8
Guaranteed Student Loan balances	0.2	--
Other	0.2	-0.4
Subtotal	5.7	6.2
Other user fees (offsetting receipts)	0.8	0.9
Asset sales and prepayments	7.7	--
Net interest	1.3	3.4
Total	23.1	19.5
Deficit Reduction	33.6	35.6
Additional Deficit Reduction to be Achieved		
Revenues--IRS Compliance	--	0.4
Outlays		
National defense	--	1.2
Nondefense discretionary	--	1.8
Asset sales	--	3.5
Net interest	--	0.3
Total	--	6.8
Deficit Reduction	--	7.2
Total Deficit Reduction		
Deficit Reduction	33.6	42.8

SOURCE: Congressional Budget Office.

would bring the total two-year deficit reduction resulting from the budget summit to $76 billion--exactly on target.

Taking no action this year beyond that required by the budget summit, however, would leave the deficit well above the Balanced Budget Act targets. In 1989, the deficit would exceed the $136 billion target by $34 billion, according to CBO's current estimates. The problem would be even greater in 1990, when the deficit would exceed the $100 billion target by more than $60 billion.

THE ADMINISTRATION'S BUDGET PROGRAM

CBO's baseline projections provide a benchmark against which the Administration's budget program can be measured. Because the baseline and the CBO estimate of the budget employ the same economic and technical assumptions, differences between the two are solely the result of proposed policy changes. The Administration's budget would cut the projected deficits only modestly. CBO estimates that the Administration's budget proposals would reduce the 1989 deficit to $165 billion--$12 billion below the baseline level of $177 billion. The amount of deficit reduction grows to $13 billion in 1990, $19 billion in 1991, and $29 billion in 1993 (see Table 3).

TABLE 3. THE ADMINISTRATION'S BUDGET PROGRAM AS ESTIMATED BY CBO (By fiscal year, in billions of dollars)

	1989	1990	1991	1992	1993
CBO Baseline Deficit	177	170	159	154	139
Policy Changes					
Revenues a/	-1	-1	-1	-1	-1
National defense	-1	b/	1	3	5
Nondefense discretionary spending	-2	-2	-8	-12	-16
Entitlements and other mandatory spending	-3	-6	-6	-6	-6
Offsetting receipts	1	b/	-4	-4	-6
Asset sales and prepayments	-6	-3	b/	b/	b/
Net interest	b/	-1	-2	-4	-5
Total Policy Changes	-12	-13	-19	-23	-29
Deficit, President's Budget as Estimated by CBO	165	157	140	131	109
Deficit, President's Budget	130	104	79	51	23
CBO Reestimates					
Economic	25	41	59	75	86
Technical	11	12	2	5	b/
Total Reestimates	36	53	61	80	86

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

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

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

b. Less than $0.5 billion.

Almost all of the proposed deficit reduction is on the outlay side. By adhering to the appropriation caps contained in the reconciliation bill, the Administration budget reduces defense outlays by $1 billion and nondefense discretionary spending by $2 billion in 1989 compared with the baseline. After 1989, defense budget authority would grow by 1 percent in real terms, based on CBO economic assumptions. CBO estimates that defense outlays would be close to the baseline amount in 1990 and would exceed the baseline by $1 billion in 1991 and $5 billion in 1993. Nondefense discretionary savings would remain at about $2 billion in 1990, and would grow to $8 billion in 1991 and $16 billion in 1993.

Entitlement reductions total $3 billion in 1989 and $6 billion per year thereafter, about a third of which would be in Medicare. Proposed changes in offsetting receipts would increase outlays by $1 billion in 1989, have little net effect in 1990, and reduce outlays by $4 billion in 1991 and $6 billion in 1993. The 1989 increase results primarily from a proposal to reclassify certain customs user fees as revenues rather than as offsetting receipts. Over the 1989 through 1993 period, higher premiums for Supplementary Medical Insurance account for about half of the proposed deficit reduction in this category.

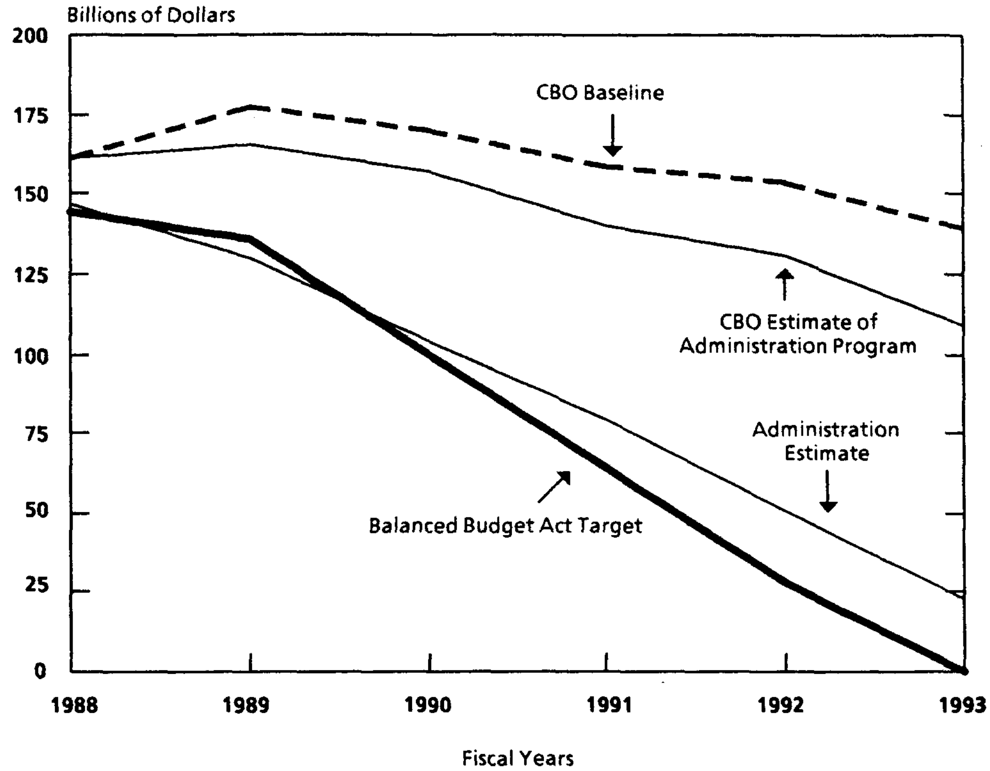
Asset sales account for $6 billion, or more than half, of the 1989 deficit reduction. Slightly more than $3 billion derives from the prepayment and sale of Rural Electrification Administration and other loans. Sale of the Naval Petroleum Reserve and the Alaska Power Marketing Administration would yield somewhat less than $3 billion. Proposed asset sales contribute $3 billion to deficit reduction in 1990 and little thereafter.

CBO estimates that the federal deficit under Administration policies would be $165 billion in 1989, $157 billion in 1990, and $109 billion in 1993. These CBO estimates exceed the Administration's figures by $36 billion in 1989 and increasing amounts in later years, as shown in Figure 1. In 1989, $25 billion of the $36 billion in reestimates is attributable to differing economic assumptions, and $11 billion stems from technical estimating differences. In 1991 through 1993, virtually all of the reestimates are economic.

CBO ECONOMIC ASSUMPTIONS

CBO expects slower real growth, higher inflation, and higher interest rates during the next two years than does the Administration, as shown in Table 4. The CBO forecast for real

Figure 1.
Federal Deficit Projections and Targets



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

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

TABLE 4. COMPARISON OF ADMINISTRATION, CBO, AND BLUE CHIP SHORT-RUN ECONOMIC FORECASTS (By calendar year)

	Actual 1987	Forecast 1988	Forecast 1989
Fourth Quarter to Fourth Quarter (Percent change)			
Real GNP			
Administration	3.8	2.4	3.5
CBO	3.8	1.8	2.6
Blue Chip	3.8	1.8	2.2
Nominal GNP			
Administration	7.2	6.4	7.3
CBO	7.2	5.7	6.9
Blue Chip	7.2	5.5	6.7
Consumer Price Index a/			
Administration	4.5	4.3	3.9
CBO	4.5	4.9	4.8
Blue Chip	4.5	4.1	4.7
Calendar Year Averages (Percent)			
Three-Month Treasury Bill Rate			
Administration	5.8	5.3	5.2
CBO	5.8	6.2	6.7
Blue Chip	5.8	5.9	6.4
Ten-Year Government Note Rate			
Administration	8.4	8.0	7.4
CBO	8.4	9.3	9.5
Blue Chip b/	8.4	8.8	9.0
Civilian Unemployment Rate			
Administration c/	6.1	5.8	5.6
CBO	6.2	6.2	6.1
Blue Chip	6.2	6.0	6.1

SOURCE: Congressional Budget Office; Office of Management and Budget; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (March 10, 1988). The CBO forecast is based on preliminary 1987 fourth-quarter data published in January 1988; the February revisions were small and are not included.

a. Consumer Price Index for urban wage earners and clerical workers.

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.

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.

growth is similar to the current consensus of private-sector forecasters. The somewhat better-than-expected gains in employment in the two months since the CBO forecast was prepared have not significantly changed private forecasts for real growth in 1988 and 1989, although many forecasters have raised their expectations for the current quarter.

The consensus forecast for consumer price inflation is lower than CBO's, perhaps in part because of lower projected petroleum prices. The recent weakness in oil prices tends to support this view, but prices remain volatile and could easily return to the level in the CBO forecast for 1988. For 1989, the CBO and the consensus inflation forecasts are similar.

While the Administration projects that the annual averages of short- and long-term interest rates will decline in 1988 and 1989, CBO and most private forecasters expect interest rates to rise in both years. The consensus forecast, however, does not have as rapid an increase as foreseen by CBO, particularly in 1988. This difference, as well as the difference between CBO's and the Administration's forecasts, roughly corresponds to differing views about inflation. CBO's inflation and interest rate forecast for 1988 assumes a further weakening of the dollar this year. While the dollar has been stable recently, continuing trade and budget deficits make CBO's forecast of a weaker dollar and higher inflation and interest rates a likely prospect.

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. On the other hand, the economy could prove stronger than in this forecast if consumers return to the abnormally low saving rates of the past few years.

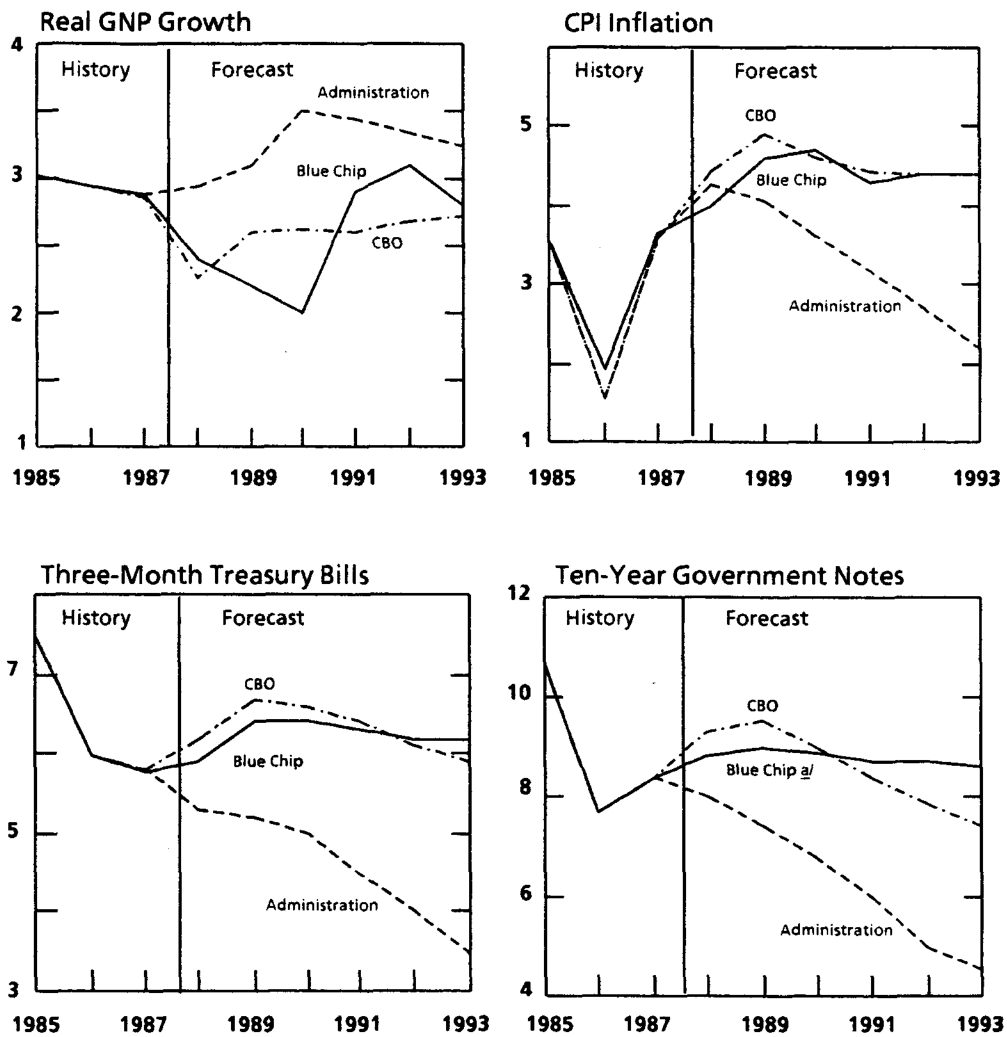
How does the federal government's budgetary stance affect the risks to the forecast? The most commonly used gauge of discretionary fiscal policy is the standardized-employment, or structural, deficit--a measure that excludes the cyclical component of the deficit. This year the calculation should also exclude the nonrecurring effects of tax reform, asset sales, and other one-time outlay savings, which alter the pattern of the deficit but may have little effect on aggregate demand and employment. Assuming implementation of the budget summit but excluding these special factors, the standardized-employment deficit would decline by only

0.3 percent of potential GNP in fiscal year 1989. Because this represents very little fiscal restraint, and because we project that the economy will have regained its momentum by 1989, 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, and perhaps encourage more stimulative policies abroad.

Beyond 1989, neither CBO nor the Administration attempts to forecast the economy. Rather, both agencies make projections based on historical trends. As in the short-term outlook, CBO's long-run economic assumptions are less optimistic than those of the Administration but similar to those of the consensus of private-sector forecasters. Figure 2 provides a comparison of CBO, Administration, and Blue Chip economic assumptions.

The uncertainty inherent in these economic and budget projections increases as the time horizon lengthens. In our annual report, we have attempted to quantify this uncertainty using a statistical approach. 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 will

Figure 2.
Comparison of Administration, CBO, and Blue Chip Economic Assumptions



SOURCE: Congressional Budget Office; Office of Management and Budget; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (March 10, 1988).

a. *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.

be within $125 billion of its projected value of $139 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.