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

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SUMMARY

Mr. Chairman, it is a pleasure to appear before this Committee to discuss the Congressional Budget Office's (CBO's) annual report on the economic and budget outlook.

Our economic outlook is quite optimistic. We expect fourth-quarter-to-fourth quarter real economic growth will accelerate from 1985's 2.5 percent to 3.6 percent in 1986, slowing slightly to 3.0 percent during 1987 (see Table 2 of the Statement). Inflation would accelerate very slightly as well, from 3.2 percent in 1985 to 3.9 percent in 1986 and to 4.1 percent in 1987. Short-term interest rates would decline somewhat in 1986 and remain roughly stable in 1987.

Our optimism is based on a number of factors. The most important of these are:

- o Declining interest rates and soaring financial markets, which should encourage consumer spending and business investment;

- o A falling exchange rate, which should with a time lag halt the deterioration of the trade balance; and

- o Falling oil prices, which should add to our real income and counter the inflationary impact of the falling exchange rate.

As always, there are uncertainties in a forecast. In this particular case, although our forecast projects falling oil prices, it uses a somewhat higher price than that prevailing today. That is on the positive side. On a more negative note, the credit situation is still worrisome. Thrift institutions continue to fail; the farm credit situation is precarious; the debt of less developed countries remains a major problem; and falling oil prices, while good for the economy on balance, are not good for those holding energy-based loans. In addition, our forecast for business investment is more optimistic than is supported by recent surveys of investment plans. We count on investment to move up quickly in the near future.

Given our forecast and economic projections, the baseline budget situation has improved markedly since we last reported in August 1985 (see Table 1 of the Statement). It is the first time since I have been at CBO that we have projected declining absolute deficits, although they remain very high relative to most of our fiscal history. According to our latest estimates, CBO projects a deficit of $208 billion in 1986, which would decline to $181 billion in 1987 and to $104 billion by 1991.

This improvement has led many people to think that it will not be as difficult to achieve the targets of the Balanced Budget Act as was believed even a month ago. I, myself, was surprised by the projected deficit for 1987. A word of warning, however, is in order.

The baseline projected in this report differs in several respects from past baselines. It is truly a barebones baseline. First, it reflects the effects of the 1986 sequestration. In other words, the baseline has already been cut once. Second, we have changed our approach to projecting the defense baseline. Defining the defense baseline always raises a number of difficult conceptual issues, especially for weapons systems. These pass through various stages of research, development and testing, through procurement in a series of "buys," and finally to needed operations and maintenance costs. The upshot is that any single year's defense appropriation is part of a multi-year plan. In recent years, therefore, we used the multi-year defense budget authority targets in the most recently passed budget resolution to provide our definition of current policy in defense.

We did not believe, however, that this definition was appropriate this year. The Balanced Budget Act made the deficit targets in the 1986 resolution obsolete. Moreover, after 1986 appropriation actions and the subsequent sequestration, budget authority for defense came out significantly below the target established by the resolution. Without the resolution for guidance, we decided to project defense budget authority at a constant real level--the same approach taken for most nondefense discretionary programs. Clearly, however, without any room for real defense growth, this baseline becomes harder to cut than those of the past.

The nature of the challenge ahead is illustrated by other numbers. If there were no legislative actions between now and next August, and if our forecast and technical assumptions remained constant, our sequestration report would show that an automatic outlay cut would amount to $37 billion compared with our baseline, an amount sufficient to bring total 1987 outlays to $989 billion. This figure is almost equal to the outlay level estimated for 1986 after the first sequestration. In other words, all COLAs, entitlement caseload growth, defense outlay growth resulting from prior-year appropriations, and other inflation adjustments would have to be paid for by program cuts elsewhere in the budget. In defense, new budget authority would be limited to $271 billion, or $30 billion below CBO's baseline and $49 billion below the Administration's budget request.

It is important to emphasize, Mr. Chairman, that these numbers are only illustrative of what may appear in our August report. First and most obviously, our calculations will be averaged with OMB's for that report. Second, legislation and changes in our forecast or technical assumptions can radically change the amount of a required sequestration. Because across-the-board cuts apply only to slightly more than a quarter of the total budget, estimating errors are magnified when the percentage across-the-board cuts are calculated. For example, a one percent error in estimating outlays--or $10 billion--converts into a 4½ percentage point change in the automatic cuts applied in the nondefense area.

In conclusion, Mr. Chairman, we have made considerable progress in reducing the deficit in recent years. Much remains to be done, however, if we are to ease the burden of debt on future generations. CBO's estimates suggest that the task ahead will be difficult. But the commitment to lower deficits has already improved credit market conditions and the business outlook, and that is why CBO feels it can project a fairly optimistic economic outlook.

STATEMENT

Mr. Chairman, it is a pleasure to appear before this Committee to discuss the CBO economic and budget projections. These projections are described in detail in the CBO report entitled The Economic and Budget Outlook: Fiscal Years 1987-1991. In my testimony today, I will touch on:

- The economic forecast for 1986 and 1987 and projections for 1988-1991; and
- 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.

I will conclude with an illustrative calculation of the effects of alternative economic assumptions on the baseline budget estimates.

CBO'S ECONOMIC AND BUDGET PROJECTIONS

The outlook for reducing budget deficits has improved dramatically since last summer, and financial markets have responded with a sharp rally. Although overall economic activity has not yet reacted to these improved financial conditions, the Congressional Budget Office (CBO) expects economic growth to pick up this year.

In 1985, the economy grew at a comparatively low rate of 2.3 percent, well below the substantial gains in the first two calendar years of the current expansion. Growth in productivity came to a halt as employment continued to grow rapidly. The unemployment rate edged down during 1985 and, despite three full years of recovery, the inflation rate remained almost unchanged from the moderate rates attained after the last recession.

Most forecasters, including CBO, anticipate that growth in real gross national product (GNP) will be somewhat faster this year--at about 3½ percent--than it was in 1985. The tremendous rally in financial markets during the second half of 1985 and the sharp decline in the dollar have enhanced the prospects for a pickup in economic activity in 1986. The rise in stock prices and the decline in interest rates will encourage consumer spending and business capital spending, while the decline in the dollar should halt the deterioration in the trade sector. If lower oil prices are sustained, the sharp drop in prices early this year will contribute to growth in economic activity and restrain inflation.

The improvement in financial conditions and the decline in the dollar last year were, at least partially, the result of the dramatic change in the outlook for reducing future budget deficits. The implementation of the Balanced Budget and Emergency Deficit Control Act of 1985 (Public Law 99-177), together with earlier Congressional action, will reverse the recent trend of rising budget deficits. Although a federal district court recently ruled that certain aspects of the Balanced Budget Act are unconstitutional, the deficit targets established by the act still remain in effect. These targets would lower projected deficits from about $208 billion in the current fiscal year to $144 billion in fiscal year 1987, with annual reductions of $36 billion thereafter. The decline in the structural deficit from fiscal year

1986 to 1987 would be about 1.5 percent of potential GNP, the third largest such reduction in fiscal stimulus since the mid-1950s. By itself, such an abrupt shift in fiscal posture could temporarily slow the economic expansion in 1987. But several other factors--including the decline in the dollar, lower interest rates, and the fall in oil prices--are expected to counteract the contractionary effects of the budget shift.

CBO's new baseline budget estimates show much smaller deficits in the 1987-1990 period than the baseline projection of last summer (see Table 1). While the policies of last year's budget resolution were not fully carried out, Congressional action to date has significantly lowered projected defense and nondefense spending. The projected decline in budget deficits under the policy assumptions of the baseline occurs because revenues are projected to grow in response to both inflation and growth in real incomes. At the same time, outlays are projected to grow only slightly faster than the rate of inflation (see Figure 1). The baseline assumes no real growth in defense and nondefense appropriations above a base already cut by the 1986 sequestration called for in the Balanced Budget Act. The additional action needed to comply with the deficit targets amounts to about $37 billion in fiscal year 1987, or $354 billion over the 1987-1991 period.

The sharp decline in long-term interest rates in 1985 seemed to reflect a market expectation of less Treasury borrowing in future years. Sectors of the economy that are interest-sensitive, such as residential construction, already show signs of increased strength. But the major benefit of reduced

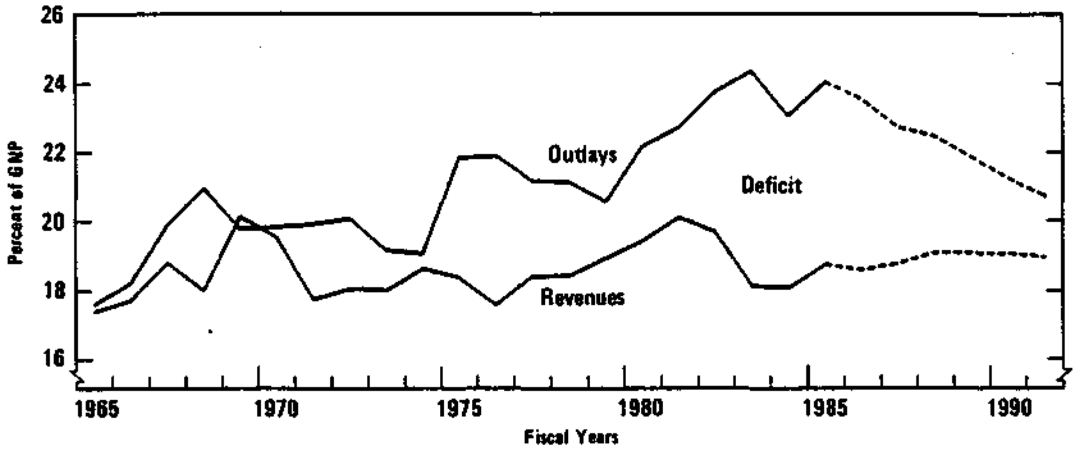
TABLE 1. BASELINE BUDGET PROJECTIONS, DEFICIT TARGETS, AND UNDERLYING ECONOMIC ASSUMPTIONS

	Actual 1985	1986	1987	1988	1989	1990	1991
Budget Projections (By fiscal year, in billions of dollars)							
Baseline Estimates							
Revenues	734	778	844	921	991	1,068	1,144
Outlays	946	986	1,025	1,086	1,135	1,188	1,248
Deficit	212	208	181	165	144	120	104
Deficit Targets	N.A.	a/	144	108	72	36	0
Baseline Less Targets	N.A.	a/	37	57	72	84	104
Economic Assumptions (By calendar year)							
Nominal GNP, percent change	5.8	6.9	7.3	7.6	7.8	7.8	7.5
Real GNP, percent change	2.3	3.2	3.1	3.3	3.5	3.5	3.2
CPI-W, percent change	3.5	3.4	4.2	4.4	4.4	4.3	4.3
Civilian Unemployment Rate	7.2	6.7	6.7	6.5	6.3	6.1	6.0
Three-Month Treasury Bill Rate	7.5	6.8	6.7	6.4	6.1	5.7	5.4

SOURCE: Congressional Budget Office
NOTE: N.A. = not applicable.

a. The Balanced Budget Act set a target of $171.9 billion in fiscal year 1986, but limited the sequestration to $11.7 billion. CBO's fiscal 1986 baseline deficit estimate includes the $11.7 billion sequestration, and therefore the $208.3 billion deficit for that year fulfills the act's requirement.

Figure 1.
Baseline Revenues and Outlays



SOURCES: Congressional Budget Office; Office of Management and Budget; U.S. Department of Commerce, Bureau of Economic Analysis.

budget deficits will come, it is generally agreed, in their long-run effects on living standards. Other things being equal, lower deficits should reduce real interest rates and foreign capital inflows, thereby encouraging increased domestic capital formation and reduced foreign indebtedness.

THE ECONOMIC OUTLOOK

The slowing of economic growth in 1985 was largely the result of a reduction in inventory investment. Growth in real final sales was down only slightly from 4.5 percent in 1984 to 4.0 percent in 1985, as weaker household and business spending was partially offset by strengthened government defense purchases and slower deterioration of the trade sector.

At year-end, most indicators began to reflect improving economic conditions. A major exception was net exports, which in December showed sharp further deterioration. But housing starts, retail sales, durable goods orders, employment, capacity utilization, and the overall index of leading indicators all rose sharply. The rally in the stock and bond markets, the decline in the dollar, and the growth of employment are likely to provide a boost to demand in 1986. Moreover, inventories were quite lean at year-end, except for autos, so that increased strength in final sales is likely to be quickly translated into output.

Another development that could have very favorable effects on both inflation and economic growth in the forecast period is the recent drop in oil prices. The CBO forecast was completed in December, before the recent sharp declines. Some decline was assumed in the forecast. By early February, however, short-term futures prices for crude oil were in the $15 to $19 range per barrel--about $6 below the refiners' acquisition cost assumed in CBO's economic projection for mid-1986. Oil prices have been very volatile, however, and some of the decline could be reversed if oil producers agree on a new distribution of output quotas.

The Forecast for 1986 and 1987

The first two years of CBO's baseline economic projections are a "conditional" forecast based on specific policy assumptions:

- The Balanced Budget Act of 1985 is assumed to be fully implemented. The budget deficit is $208.3 billion in fiscal year 1986, well above the $171.9 billion target because the automatic spending cut is limited to $11.7 billion this year. For fiscal year 1987, the forecast assumes that the $144 billion deficit target will be attained.

- The preliminary target ranges for the levels of the narrower monetary aggregates announced last July are assumed to be adjusted somewhat to reflect actual experience through late 1985.

In addition, dollar exchange rates are assumed to decline this year, though less rapidly than in the second half of 1985. Oil prices are assumed to decline about 18 percent from the last quarter of 1985 to mid-1986, and food prices are assumed to rise less than the general price level.

Given these assumptions, CBO expects inflation-adjusted GNP to grow 3.6 percent in 1986 and 3.0 percent in 1987 on a fourth-quarter-to-fourth-quarter basis (see Table 2). The unemployment rate is projected to remain steady at 6.7 percent through calendar year 1987. Inflation is expected to rise gradually in the forecast period. The three-month Treasury bill rate is expected to decline from 7.5 percent in 1985 to 6.7 percent in 1987.

Medium-Term Economic Projections

The projections for 1988-1991 are not a forecast of economic conditions, but assumptions based on average historical experience. Specifically, the growth rate for real GNP from the fourth quarter of 1982 to the fourth

TABLE 2. THE CBO FORECAST (Fourth-quarter-to-fourth-quarter growth rates)

	Actual		Projected	
	1984	1985	1986	1987
Nominal GNP	9.0	5.8	7.6	7.2
Real GNP	4.7	2.5	3.6	3.0
GNP Implicit Price Deflator	4.1	3.2	3.9	4.1
CPI-W	3.6	3.2	3.5	4.5

quarter of 1991 is assumed to equal the average growth rate in the nine-year periods following earlier postwar recessions. These outyear economic assumptions are not predicated on specific budget policies, and may not be consistent with the budget policies now in place. The major characteristics of the 1988-1991 projections are shown in Figure 2.

- Real GNP grows moderately at an average rate of approximately 3.4 percent.

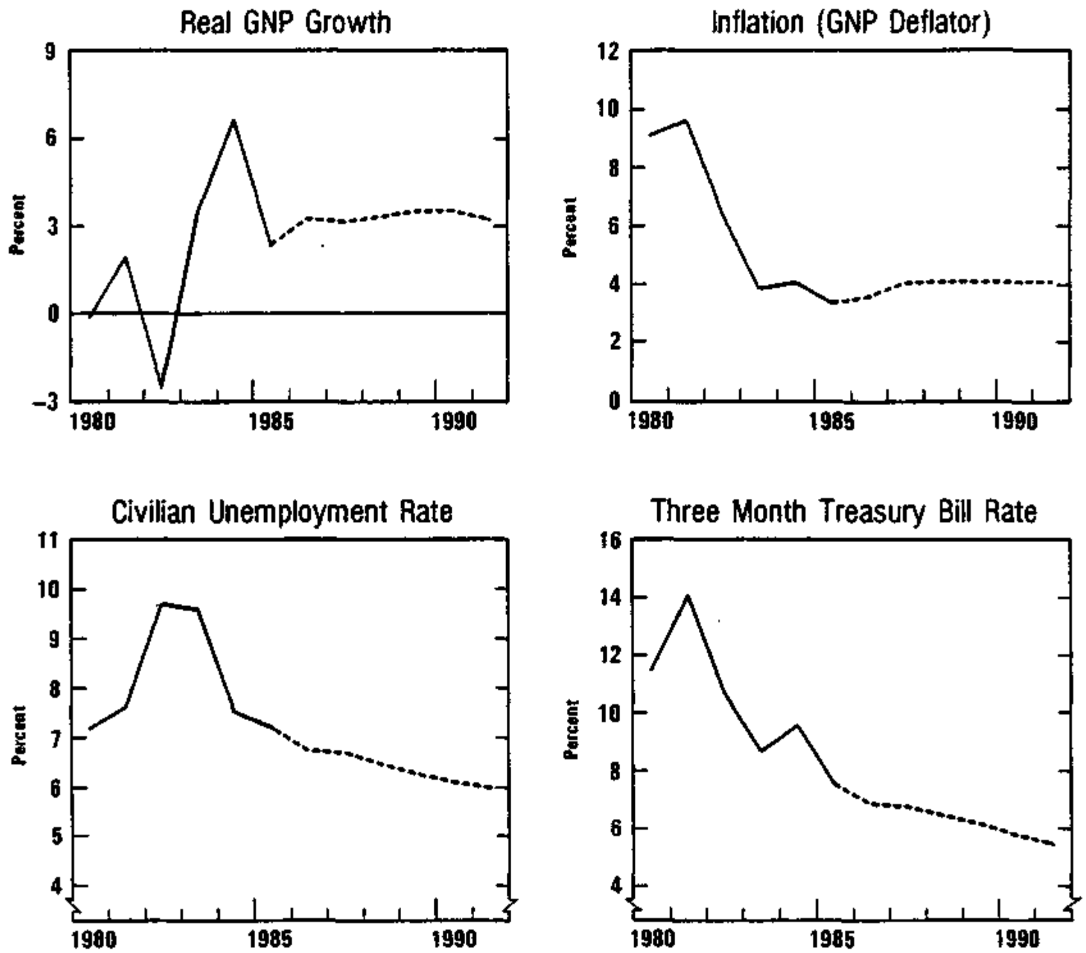
- The unemployment rate declines gradually to 6.0 percent by 1991. oInflation, measured by the CPI-W, holds at about 4.3 percent over the projection period.

- Interest rates decline in the outyear projection. The three-month Treasury bill rate, for example, declines from 6.7 percent in 1987 to 5.4 percent in 1991.

Uncertainty in the Outlook

The performance of the economy could easily turn out to be much better or worse than CBO projects. The major uncertainties in the near term are

Figure 2.
Major Economic Assumptions



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

related to oil prices, the trade sector, financial conditions, and federal fiscal policy. Should oil prices remain low, inflation could be significantly lower and real output higher than projected by CBO. The recent decline in interest rates has greatly improved the financial status of many financial institutions and reduced the debt-service costs of developing countries. But some countries will be made worse off by the drop in oil prices and some financial institutions still suffer from poor-quality loans. For this reason, a financial crisis that would significantly raise risk premiums and interest costs cannot be ruled out.

Both the future course of the dollar and the response of net exports to the dollar's recent fall are difficult to predict. Some forecasters believe that foreign exporters will try to maintain their market shares by reducing profit margins rather than raising prices, thereby causing a delay in the response of U.S. imports to the depreciation of the dollar. Finally, the Balanced Budget Act may not be fully implemented, especially if constitutional challenges to the act are successful. Moreover, exactly how the deficit targets will be met is unclear. These uncertainties make it difficult to predict the short-run economic consequences of the projected turnaround in fiscal policy.

THE BUDGET OUTLOOK

Under CBO's baseline assumptions, which include no real growth in defense or nondefense appropriations, the total federal deficit would fall from $208 billion in 1986 to $181 billion in 1987 and $104 billion in 1991 (see Table 1). The projected decline in baseline deficits parallels the deficit targets in the 1986 budget resolution, but falls increasingly short of the deficit targets in the Balanced Budget Act, which contemplates a zero deficit in 1991.

Over the next five years, revenues are projected to grow on average by 8 percent per year, slightly faster than the assumed average growth of the economy. On the other hand, outlays are projected to rise by an average of 4.8 percent per year, only slightly higher than the assumed rate of inflation. As a result, revenues would remain roughly constant as a percent of GNP, but federal outlays and the deficit would fall, as shown in Figure 1.

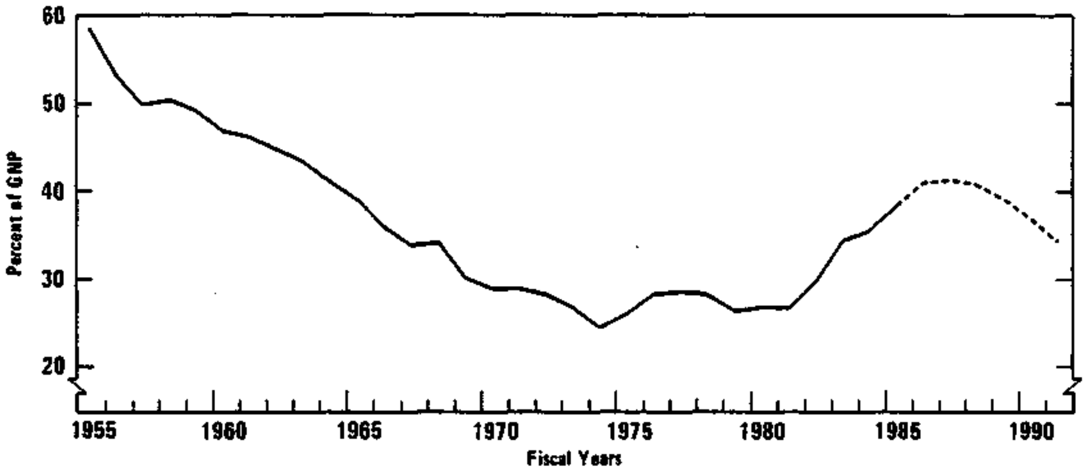
The projected decline in budget deficits would slow the growth of federal debt and reduce the government's share of total credit demand. Under CBO's baseline assumptions, publicly held federal debt is projected to grow from $1.7 trillion by the end of 1986 to $2.4 trillion by the end of 1991. In relation to GNP, debt held by the public would grow from 41.0 percent in 1986 to a peak of 42.7 percent in 1988 and then decline to 40.2 percent by the end of 1991. Of course, the decline in the debt-to-GNP ratio would be sharper if the Balanced Budget Act is implemented (see Figure 3).

Changes in Baseline Projections

The budget outlook under baseline assumptions has changed dramatically from a year ago. In its 1985 annual report, and again in its update report

Figure 3.

Federal Debt Held by the Public



SOURCES: Congressional Budget Office; Office of Management and Budget; U.S. Department of Commerce, Bureau of Economic Analysis.

NOTE: The values shown for the 1986-1991 fiscal years are based on the assumption that the deficit targets of the Balanced Budget Act will be met.

last August, CBO projected that baseline deficits would rise from slightly more than $200 billion in 1985 to almost $300 billion by 1990. The basic change in the deficit outlook in this report has resulted from lower projections for spending, primarily for defense and nondefense discretionary programs and for net interest costs (see Table 3).

CBO's baseline projections of last year assumed that defense appropriations would increase as specified in the 1985 budget resolution (and extended to 1990), at an average rate of 5½ percent in real terms--after adjustments for projected inflation. The 1986 budget resolution specified

TABLE 3. CHANGES IN CBO BASELINE DEFICIT PROJECTIONS SINCE AUGUST 1985 (By fiscal year, in billions of dollars)

Major Changes	1986	1987	1988	1989	1990
August 1985 Baseline Deficit	212	229	243	264	285
Major Changes:					
Lower defense outlays	-9	-26	-48	-71	-96
Lower nondefense discretionary program outlays	-10	-19	-20	-21	-22
Lower net interest costs	a/	-7	-16	-31	-51
Other outlay changes	6	-4	-4	-8	-12
Lower revenues	9	9	10	11	16
Total changes	-4	-48	-78	-120	-165
February 1986 Baseline Deficit	208	181	165	144	120

SOURCE: Congressional Budget Office.

a. Less than $500 million.

zero real growth for defense appropriations in 1986 and 3 percent real growth thereafter. Actual 1986 defense appropriations, however, fell short of the budget resolution target, and the 1986 sequestration will reduce the amount of new budget authority even further, to below the 1985 level. CBO's latest baseline projections assume zero real growth in defense appropriations from the 1986 postsequestration level. Because the Balanced Budget Act lowered the outyear deficit targets contained in the 1986 budget resolution, the assumptions of the resolution can no longer be taken as necessarily representing current Congressional policy. The combination of these factors reduces projected defense outlays by $250 billion for 1986 through 1990 compared with CBO's baseline projections of last August.

Even with 3 percent real growth in defense appropriations in 1987 and beyond, baseline deficits would decline over the next five years, although not as sharply. Instead of baseline deficits declining from $208 billion in 1986 to $104 billion in 1991, they would decline to $150 billion.

The latest baseline projections for nondefense discretionary programs are also lower than those made last year, reflecting reductions made in 1986 appropriations and the effects of the 1986 sequestration. The reduction from CBO's baseline projections of last August is almost $92 billion for the five-year period 1986-1990.

CBO's latest short-term forecast and long-run economic assumptions also feature lower interest rates than were assumed last year. These lower rates, together with a reduction in debt service costs because of other changes, reduce net interest outlays by over $100 billion for 1986-1990 compared with last August's baseline projections. Relatively small changes in baseline deficits result from revised projections for farm price supports and Medicare and other entitlement programs, and from slightly lower projected revenues.

Trends in Federal Spending

Baseline outlays are projected to grow by $262 billion, or 4.8 percent annually, over the 1986-1991 period. Relative to the size of the economy, however, both total spending and all its major components decline. Total outlays fall from 23.5 percent of GNP in 1986 to 20.6 percent of GNP in 1991 (see Table 4). The trends in federal spending are illustrated in Figure 4.

Because the CBO baseline projections assume no real growth in defense budget authority over the 1986 program level, the defense share of GNP hits a maximum of 6.4 percent in 1985 and 1986 and then drops. By 1991, under baseline assumptions, the ratio of defense to GNP would be 5.7 percent--less than in fiscal year 1982.

Spending for entitlement and other mandatory programs is projected to decline from 10.8 percent of GNP in 1986 to 10.0 percent by 1991--about the level of the late 1970s. Nondefense discretionary spending, which already has declined to about the same share of GNP as it represented in 1962, falls further throughout the projections period to 3.4 percent of GNP in 1991.

Because of declining deficits and interest rates (which are predicated on reaching the deficit targets in the Balanced Budget Act), net interest declines from its 1985-1986 peak of 3.3 percent of GNP to 2.7 percent in 1991.

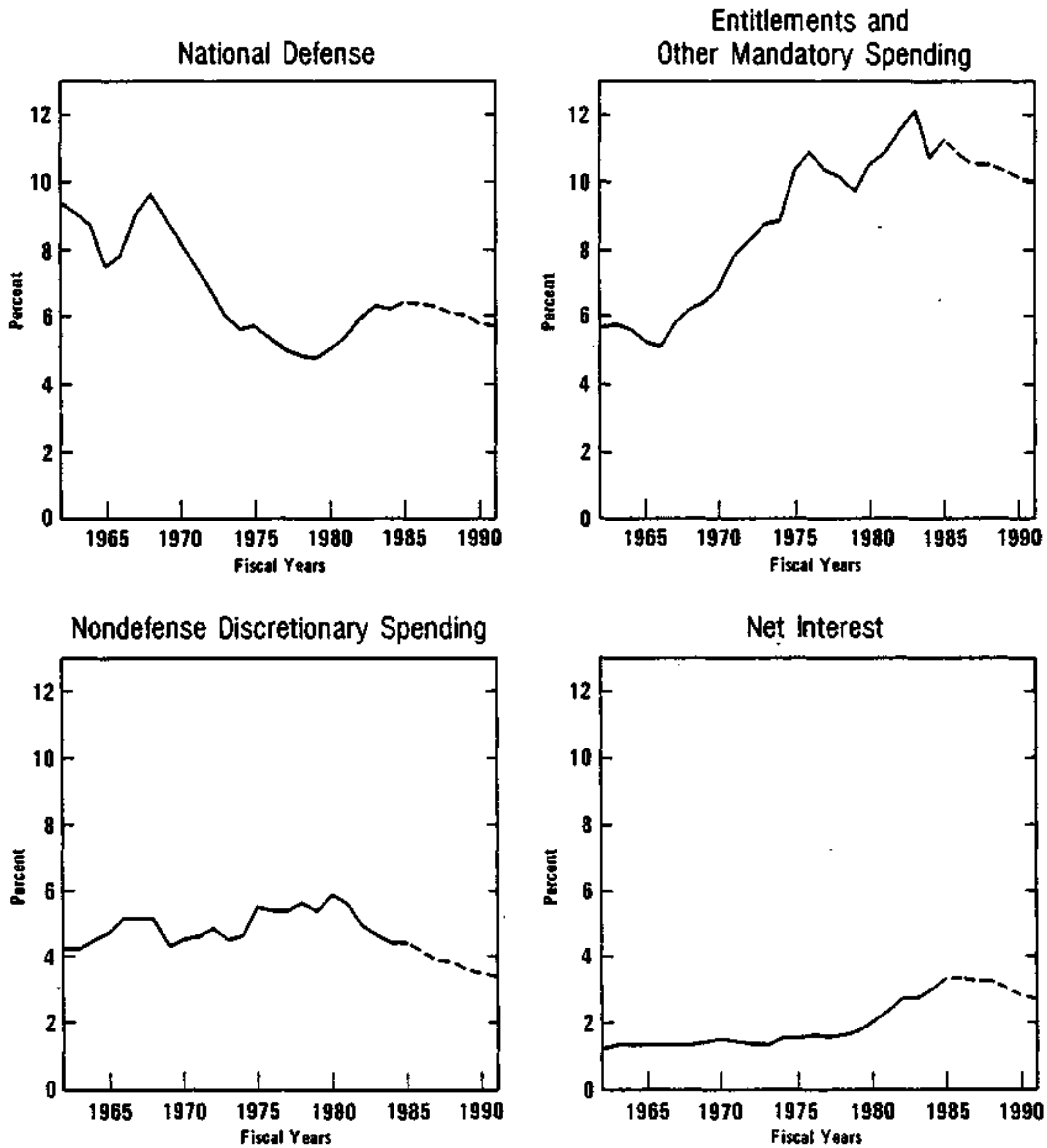
TABLE 4. CBO BASELINE BUDGET PROJECTIONS (By fiscal year)

	1986	1987	1988	1989	1990	1991
			In Billions of Dollars			
National Defense	269.5	284.0	296.4	310.9	326.9	343.9
Entitlements and Other Mandatory Spending	453.7	473.6	509.0	536.4	566.5	604.1
Nondefense Discretionary Spending	173.2	174.3	182.6	188.3	195.9	204.0
Net Interest	138.6	145.0	154.4	157.6	159.1	160.3
Offsetting Receipts	-48.8	-51.5	-56.4	-58.4	-60.7	-64.4
Total Outlays	986.1	1025.3	1085.9	1134.9	1187.6	1247.9
Revenues	777.8	844.0	921.0	991.3	1067.5	1143.6
Total Deficit	208.3	181.3	164.9	143.6	120.1	104.3
Debt Held by the Public	1720.1	1900.4	2064.4	2206.9	2326.1	2429.4
			As A Percent of GNP			
National Defense	6.4	6.3	6.1	6.0	5.8	5.7
Entitlements and Other Mandatory Spending	10.8	10.5	10.5	10.3	10.1	10.0
Nondefense Discretionary Spending	4.1	3.9	3.8	3.6	3.5	3.4
Net Interest	3.3	3.2	3.2	3.0	2.8	2.7
Offsetting Receipts	-1.2	-1.1	-1.2	-1.1	-1.1	-1.1
Total Outlays	23.5	22.8	22.4	21.8	21.1	20.6
Revenues	18.6	18.7	19.0	19.0	19.0	18.9
Total Deficit	5.0	4.0	3.4	2.8	2.1	1.7
Debt Held by the Public	41.0	42.2	42.7	42.3	41.4	40.2
Memorandum: GNP	4192	4504	4838	5214	5619	6047

SOURCE: Congressional Budget Office.

Figure 4.

Outlays by Category as Percents of GNP



SOURCE: Congressional Budget Office.

Alternative Projections

To show how changes in economic assumptions can affect budgetary outcomes, CBO has prepared two alternative sets of projections (see Table 5). They are intended to illustrate what could happen if economic growth turns out to be higher or lower than projected over the next six years.

TABLE 5. ALTERNATIVE ECONOMIC AND BUDGET PROJECTIONS

	1986	1987	1988	1989	1990	1991
Economic Projections (By calendar year)						
Real GNP (percent change)						
High-growth alternative	4.0	4.3	4.4	4.6	4.6	4.6
Baseline	3.2	3.1	3.3	3.5	3.5	3.2
Low-growth alternative	3.0	-0.7	-0.8	5.4	3.4	3.2
CPI-W (percent change)						
High-growth alternative	3.4	4.3	5.2	6.3	7.5	9.1
Baseline	3.4	4.2	4.4	4.4	4.3	4.3
Low-growth alternative	3.6	4.4	3.9	3.0	2.5	2.5
Civilian Unemployment Rate						
High-growth alternative	6.6	6.3	5.8	5.5	5.1	4.6
Baseline	6.7	6.7	6.5	6.3	6.1	6.0
Low-growth alternative	6.9	8.4	9.9	8.9	8.8	8.7
Three-Month Treasury Bill Rate						
High-growth alternative	6.5	6.1	7.5	8.5	9.7	11.1
Baseline	6.8	6.7	6.4	6.1	5.7	5.4
Low-growth alternative	7.6	7.7	5.9	5.6	4.9	4.3
Budget Projections (By fiscal year, in billions of dollars)						
Deficit (-) or Surplus						
High-growth alternative	-202	-154	-111	-61	-1	70
Baseline	-208	-181	-165	-144	-120	-104
Low-growth alternative	-210	-224	-282	-271	-238	-237

SOURCE: Congressional Budget Office.

The high path assumes growth almost equal to that of the strongest nine-year expansion of the postwar period, which occurred after the recession of 1957-1958. Because the pace of economic expansion up to now has been close to that in an average recovery pattern, this path implies unusually strong growth from now through 1991. As a result, unemployment falls to 4.6 percent in 1991, while the inflation rate more than doubles. Interest rates also rise sharply after 1988, paralleling the higher inflation rate. Interest rates also rise sharply after 1988, paralleling the higher inflation rate.

The low path incorporates a recession starting in 1987, which has the depth and duration of the 1973-1975 recession, and is followed by an average economic recovery. The weaker growth results in lower inflation and lower interest rates than in the CBO economic assumptions after 1987, and higher unemployment rates.

Under the high-growth economic assumptions, the deficit drops swiftly to near balance by 1990 and a sizable surplus in 1991. Under the low-growth assumptions, however, the deficit grows sharply. For example, in fiscal year 1989, the year following the recession incorporated in the low-growth path, the deficit is more than $125 billion above the CBO baseline projection.

If the Congress fails to reduce the 1987 deficit to $144 billion before the start of the fiscal year, an automatic procedure could be invoked that would make the reduction by sequestering budgetary resources. Under CBO's February assumptions, a 1987 sequestration would reduce total outlays to $989 billion--$37 billion below the baseline projection. As shown in Table 6, there would be almost no growth in total outlays beyond the 1986 estimated level of $986 billion.

The sequestration procedures under the Balanced Budget Act for 1987 would begin in August 1986 when CBO and the Office of Management and Budget send their initial budget estimates either to the Comptroller General or to a special joint committee of the Congress. The CBO estimates presented in this report are made for illustrative purposes and are subject to significant revision over the next six months as the result of legislative actions, changes in the economic outlook, and other factors. These estimates show that relying on the sequestration procedures to reach the $144 billion deficit amount for 1987 would mean reductions of $18 billion in outlays for defense programs and $17 billion for nondefense programs from CBO's projected baseline levels, which include the effects of the 1986 sequestration. The result would be to hold outlays for both defense and nondefense programs to roughly the same levels as estimated for 1986.

TABLE 6. EFFECT OF SEQUESTRATIONS ON BUDGET OUTLAYS FOR 1986 AND 1987 (By fiscal year, in billions of dollars)

Category	1986	1987
Defense Programs a/		
Presequester baseline levels	275	293
1986 sequester	269	284
1987 sequester	269	266
Nondefense Programs b/		
Presequester baseline levels	618	639
1986 sequester	612	632
1987 sequester	612	615
Net Interest and Undistributed Offsetting Receipts c/		
Presequester baseline levels	105	111
1986 sequester	104	109
1987 sequester	104	107
Total Outlays		
Presequester baseline levels	998	1,043
1986 sequester	986	1,025
1987 sequester	986	989

SOURCE: Congressional Budget Office.

a. Budget function 050, national defense.
b. Budget functions 150 through 850, and 920.
c. Budget functions 900 and 950.

To achieve these outlay reductions, defense appropriations for 1987 would have to be reduced 6.2 percent below 1986 postsequestration levels, and nondefense discretionary appropriations would have to be cut by 8.4 percent. The reductions in real terms would be even greater because of the loss of any adjustment for inflation in 1987. For defense programs, new budget authority for 1987 would be limited to $271 billion, which is $30 billion below CBO's baseline projection and $49 billion below the Administration's budget request.