Statement of
Edward M. Gramlich
Acting Director
Congressional Budget Office

before the
Committee on the Budget
United States Senate

July 14, 1987

NOTICE

This statement is not available for public release until it is delivered at 10 a.m. (EDT), Tuesday, July 14, 1987.

I am pleased to testify this morning on the Congressional Budget Office's (CBO's) preliminary summer economic and baseline budget projections. While CBO would normally not be making estimates public at this time, we are doing so this year at the request of the chairman and the ranking member of this committee. The figures are preliminary, however, and may change somewhat before we complete our summer update report and our sequestration report in mid-August. Moreover, the estimates were prepared without benefit of the Department of Agriculture's first crop survey for the current growing season. They also do not reflect actual data on the gross national product (GNP) for the second quarter of the year, which will not be released until July 24. Our final estimates will benefit from both these and other upcoming data.

BASELINE BUDGET PROJECTIONS

Table 1 shows our preliminary summer estimates of baseline outlays, revenues, and the deficit and compares them with CBO's winter baseline. While our winter baseline deficit projection declined steadily from $176 billion in 1987 to $84 billion in 1992, the new estimates show a different pattern. Because of unexpectedly strong revenue growth, the 1987 deficit is now estimated at $161 billion. The deficit then rises to $181 billion in 1988 and $198 billion in 1989 before beginning a slow decline.

This puzzling pattern of deficits is caused largely by the phase-in of the Tax Reform Act and by various one-time outlay reductions, as shown in Table 2. Tax reform has added about $18 billion to revenues in 1987, but

TABLE 1. PRELIMINARY REESTIMATES OF CBO BASELINE (By fiscal year, in billions of dollars)

	1987	1988	1989	1990	1991	1992
Outlays						
Winter baseline	1,010	1,071	1,126	1,188	1,248	1,306
Preliminary reestimates	3	7	25	30	38	46
Preliminary baseline	1,013	1,078	1,152	1,218	1,286	1,352
Revenues						
Winter baseline	834	900	962	1,051	1,139	1,222
Preliminary reestimates	18	-4	-8	-17	-26	-30
Preliminary baseline	852	897	954	1,034	1,113	1,192
Deficit						
Winter baseline	176	171	164	137	109	84
Preliminary reestimates	-15	11	33	47	64	76
Preliminary baseline	161	181	198	183	173	160

TABLE 2. EFFECT OF TAX REFORM AND ONE-TIME OUTLAY SAVINGS ON DEFICIT (By fiscal year)

	1987	1988	1989	1990	1991	1992
			In Billions of Dollars			
Preliminary Baseline Deficit	161	181	198	183	173	160
Adjustment for:						
Tax reform	18	-13	-17	-4	2	-1
One-time outlay savings a/	16	3	-2	-1	-1	-1
Total adjustments	34	-10	-19	-5	1	-2
Adjusted Deficit	194	171	179	178	174	157
			As a Percent of GNP			
Preliminary Baseline Deficit	3.7	3.9	4.0	3.4	3.0	2.6
Adjusted Deficit	4.4	3.7	3.6	3.3	3.0	2.6

a. Includes asset sales, loan prepayments, OCS escrow releases, military pay delay, Medicare payment delay, and advance of final revenue sharing payment.

will reduce revenues by $13 billion in 1988 and $17 billion in 1989. Asset sales, loan prepayments, the one-day delay of the military pay date, and other one-time outlay reductions total $16 billion in 1987 and $3 billion in 1988. Removing these two items yields an adjusted deficit that averages about $175 billion over the next several years. These adjusted deficits decline relative to GNP--from 4.4 percent of GNP in 1987 to 2.6 percent in 1992--but at a slower rate than in our previous projections.

Table 3 details the changes to our baseline budget projections since our last report. The most significant changes stem from revisions to our economic projections. The supplemental appropriations bill, which allows prepayment of additional Rural Electrification Administration (REA) loans without penalty, lowers 1988 outlays. Technical reestimates resulting primarily from new data on taxable incomes have raised revenues a bit in all years. Our preliminary estimates also follow the recent General Accounting Office (GAO) opinion, and they assume that the thrift savings fund is not included in the budget totals. As a result, the thrift fund's receipt of voluntary employee contributions would no longer be treated as reducing the deficit, and agency contributions would add to the deficit.

TABLE 3. DETAIL OF PRELIMINARY BASELINE REESTIMATES (By fiscal year, in billions of dollars)

	1987	1988	1989	1990	1991	1992
			Outlays			
Enacted Legislation	2	-7	1	1	0	0
Economic Reestimates						
Interest rates	1	11	13	13	15	17
Cost-of-living adjustments	0	1	4	6	9	10
Discretionary inflation adjustments	--	0	1	1	1	1
Other	-1	-1	0	0	0	0
Subtotal	0	11	18	21	25	28
Technical Reestimates	0	1	2	1	2	3
Debt Service	0	-1	1	3	7	11
Thrift Fund Accounting	1	3	3	3	3	3
Total	3	7	25	30	38	46
			Revenues			
Economic Reestimates	-8	-13	-17	-25	-32	-38
Technical Reestimates	26	9	9	8	6	8
Total	18	-4	-8	-17	-26	-30
			Deficit			
Enacted Legislation	2	-7	1	1	0	0
Economic Reestimates	8	24	35	46	57	66
Technical Reestimates	-26	-9	-6	-7	-4	-5
Debt Service	0	-1	1	3	7	11
Thrift Fund Accounting	1	3	3	3	3	3
Total	-15	11	33	47	64	76

ECONOMIC PROJECTIONS

The major differences between our revised eeonomic projections and those in our January report are higher inflation and interest rates for 1987 and 1988 and lower real economic growth in all years. Table 4 summarizes our preliminary economic assumptions and compares them with the January figures.

Consumer price inflation is higher than we assumed in January for two reasons:

- Oil prices have risen much more this spring than we expected; and
- The dollar has fallen much more than expected.

The oil price increase has already shown up at the gasoline pump and elsewhere, but the lower dollar will continue to raise the cost of imported goods and other consumer purchases through the end of 1988. Because of the current amount of slack in the economy, however, we do not expect these price increases to touch off a wage-price explosion, such as happened in the 1970s. We assume, therefore, that the increase in inflation will be temporary.

Interest rates in our preliminary forecast are also higher than we assumed in January. In large part, this rise is a reflection of increases in interest rates that have already taken place. We expect that higher interest

TABLE 4. COMPARISON OF CBO WINTER ECONOMIC PROJECTIONS AND PRELIMINARY SUMMER PROJECTIONS (By calendar year)

	Actual	Forecast		Projected			
	1986	1987	1988	1989	1990	1991	1992
GNP (billions of current dollars)							
Summer	4,206	4,447	4,753	5,075	5,425	5,800	6,200
Winter	4,216	4,469	4,779	5,124	5,503	5,888	6,288
Real GNP Growth (percent change)							
Summer	2.5	2.5	2.5	2.5	2.6	2.6	2.6
Winter	2.6	2.8	3.0	3.0	3.1	2.7	2.5
CPI-W (percent change)							
Summer	1.6	3.8	5.6	5.0	4.5	4.5	4.6
Winter	1.6	3.5	4.3	4.3	4.3	4.3	4.3
Three-month Treasury Bill Rate (percent)							
Summer	6.0	6.1	6.6	5.9	5.9	5.9	5.9
Winter	6.0	5.6	5.7	5.6	5.5	5.3	5.2
Ten-Year Government Bond Rate (percent)							
Summer	7.7	8.4	8.7	7.6	7.2	6.8	6.4
Winter	7.7	7.2	7.2	6.6	6.2	5.9	5.6

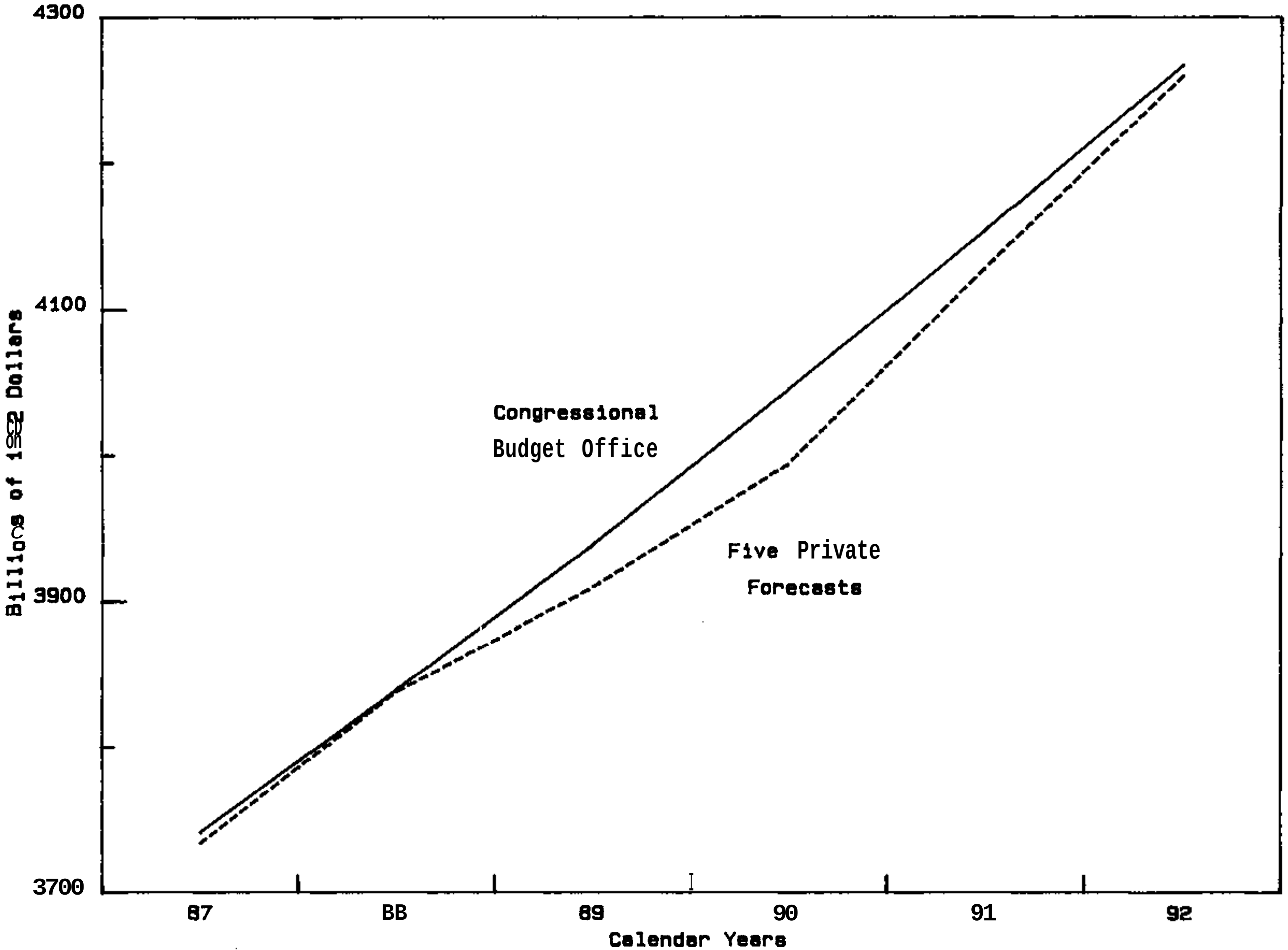
rates will persist through the end of 1988, both because of higher inflation and because of the Federal Reserve's announced intention to lean against further declines in the dollar.

The reduction in the real GNP growth forecast for 1987 and 1988 results from the higher interest rates and the adverse effect of higher inflation on household real incomes. The change in the growth assumptions after 1988 arises from a reappraisal of the long-run growth prospects of the economy, which CBO initiated late last year. Our analysis has also benefited from new long-run labor force projections, which were released by the Bureau of Labor Statistics in June.

The revised long-run growth path assumes that, after adjusting for cyclical changes, growth of gross domestic product(GDP) will exceed growth of the labor force by about one percentage point, the same amount as in the 1981-1987 period. Nonfarm productivity, as conventionally measured, grows by close to 1½ percent per year. In addition, CBO assumes that by 1992 the economy will reach an average operating rate--that is, a level somewhat below its full capacity. The level of real GDP that we project as a result of these assumptions is still slightly above the average of five private forecasts, as shown in Figure 1.

We have not seen any new information that would call for significant changes in this preliminary economic forecast, which we developed in mid-June. We are, however, particularly concerned about movements in prices,

Figure 1.
Projected Real Gross Domestic Product



NOTE: The private forecasts are Chase Econometrics, Data Resources, Townsend-Greenspan, Wharton Econometric Forecasting Associates, and Washington University (St. Louis).

the exchange rate, and interest rates. Many private forecasters expect lower consumer price inflation for 1987 and 1988 than is in our preliminary forecast, apparently because they expect smaller increases in import prices. Interest rates have also fallen a little since mid-June, and this drop will probably lower our short-term interest rate projections by a few tenths of a percentage point in August.

Small changes in these economic assumptions may have a large effect on the budget. In particular, as the federal debt has grown rapidly during the 1980s, outlays have become increasingly sensitive to both the level and term structure of interest rates. As Table 5 shows, a change of one percentage point in all government interest rates would affect net interest outlays by amounts growing from $5 billion in 1988 to $25 billion in 1992. Even if short-term interest rates could be projected exactly, a one-percentage-point difference in medium- and long-term rates would still change outlays substantially.

CONGRESSIONAL BUDGET RESOLUTION

Let me also report the effects of our reestimates on the recently adopted Congressional budget resolution for fiscal year 1988. Under CBO's winter assumptions, the policies of the budget resolution would have resulted in deficits of $134 billion in 1988, $115 billion in 1989, and $72 billion in 1990. Under our new economic and technical assumptions, the deficit figures would be $151 billion in 1988, $147 billion in 1989, and $117 billion in 1990,

TABLE 5. EFFECTS ON CBO BASELINE BUDGET PROJECTIONS OF SELECTED CHANGES IN ECONOMIC ASSUMPTIONS (By fiscal year, in billions of dollars)

	1988	1989	1990	1991	1992
Interest Rates					
Effect on Net Interest Outlays of a One-Percentage-Point Change in All Interest Rates Beginning October 1987	5	11	16	20	25
Effect on Net Interest Outlays of a One-Percentage-Point Change in Medium- and Long-Term Rates Beginning October 1987	2	6	10	14	17
Consumer Prices					
Effect of a 0.5 Percentage-Point Change in Cost-of-Living Adjustments in January 1989 and 1990	0	1	3	4	4

as shown in Table 6. The reestimates reflect mainly the revised economic assumptions discussed previously. Recently enacted legislation does not affect the budget resolution estimates, because most of the items included in the supplemental appropriation, including the REA prepayments, were already assumed in the budget resolution. An additional $30 billion in deficit reduction measures called for by the budget resolution, however, remain to be enacted.

TABLE 6. PRELIMINARY REESTIMATES OF CONGRESSIONAL BUDGET RESOLUTION (By fiscal year, in billions of dollars)

	1988	1989	1990
Budget Resolution Deficit under CBO Winter Assumptions	134	115	72
Preliminary CBO Reestimates			
Economic reestimates	24	34	45
Technical reestimates	-9	-6	-7
Debt service	-1	1	4
Thrift fund accounting	3	3	3
Total reestimates	17	32	45
Preliminary Reestimate of Budget Resolution Deficit	151	147	117