CBO TESTIMONY

Statement of
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on
The Economic and Budget Outlook: Fiscal Years 1995-1999

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

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Chairman Sabo, Congressman Kasich, and Members of the Committee, I am pleased to be with you this morning to review the state of the economy and the budget. The Congressional Budget Office (CBO) last Thursday released a report, *The Economic and Budget Outlook: Fiscal Years 1995-1999*, that describes our current views in detail. My testimony summarizes that report.

The economic and budget outlook has not changed substantially since last September, but the deficit picture is significantly brighter than it appeared one year ago when the Congressional Budget Office projected that the deficit would soar above $350 billion by fiscal year 1998. CBO now projects that the federal budget deficit will fall from $223 billion in the current fiscal year to below $170 billion in 1996, then creep up to around $200 billion in 1999. The dramatic improvement since last January is largely the result of the enactment in August of a major package of tax increases and spending cuts--the Omnibus Budget Reconciliation Act of 1993 (OBRA-93).

Based on recent experience, some observers have doubted that deficits will actually decline as a result of OBRA-93. The Omnibus Budget Reconciliation Act of 1990, which implemented a multiyear deficit reduction plan negotiated by President Bush and Congressional leaders, also significantly improved the budget outlook. Yet despite the fact that the increases in revenues and cuts in spending that it promised were, for the most part, achieved, its deficit goals proved elusive. It quickly became evident that

deterioration of the economy, shortfalls in revenues, and unanticipated increases in spending for mandatory programs (largely for Medicare, Medicaid, other benefit programs, and net interest) would result in higher deficits than had been projected before the bill's enactment.

In contrast to that experience, CBO's current economic forecast and estimates of revenues and spending have changed very little from the ones it developed immediately after the passage of OBRA-93. Projected deficits are significantly lower than they were a year ago before OBRA-93 was enacted. But despite that improvement, deficits have not been put on the road to extinction. They begin to grow again as a percentage of gross domestic product (GDP) after 1998, pushed up by continued rapid growth in spending for Medicare and Medicaid and by expiration of the tight caps on discretionary spending set in the Budget Enforcement Act of 1990 (BEA) and OBRA-93.

As always, the economic forecast and the revenue and spending projections presented here are uncertain. Future economic and technical reestimates could still push up projected deficits as they did in 1991 and 1992. Alternatively, changes that are not currently anticipated could further improve the deficit picture.

The economic outlook is essentially unchanged since last September. With the economy settling into an expansion phase of the business cycle, CBO expects growth to continue at a moderate rate, unemployment to decline gradually, and interest rates to edge up.

Forecast for 1994 and 1995

CBO forecasts that real GDP will grow at an annual rate of nearly 3 percent through calendar year 1995 (see Table 1). The combination of moderate economic growth and an increasing number of people actively looking for work will result in a gradual decline in the unemployment rate--from the 6.4 percent reported for December 1993 to 6.0 percent at the end of 1995.

The persistence of excess domestic capacity and weak demand from sluggish economies elsewhere in the world will dampen inflationary pressures. The consumer price index is expected to grow at a rate of around 3 percent a year through 1995. But as the expansion continues, the Federal Reserve is likely to allow interest rates to rise in order to ensure that inflation does not heat up. CBO forecasts that the rate on three-month Treasury bills will

TABLE 1. COMPARISON OF FORECASTS FOR 1994 AND 1995

	Actual 1992	Estimated 1993	Forecast 1994	Forecast 1995
		Fourth Quarter to Fourth Quarter (Percentage change)		
Nominal GDP				
CBO	6.7	4.9	5.7	5.4
Blue Chip	6.7	5.0	5.6	5.7
Real GDP[a]				
CBO	3.9	2.3	2.8	2.7
Blue Chip	3.9	2.4	2.7	2.6
Implicit GDP Deflator				
CBO	2.8	2.5	2.8	2.6
Blue Chip	2.8	2.5	2.8	3.0
Consumer Price Index[b]				
CBO	3.1	2.7	2.9	3.0
Blue Chip	3.1	2.7	3.1	3.3
		Calendar Year Averages (Percent)		
Civilian Unemployment Rate				
CBO	7.4	6.8	6.4	6.1
Blue Chip	7.4	6.8	6.4	6.2
Three-Month Treasury Bill Rate				
CBO	3.4	3.0	3.5	4.3
Blue Chip	3.4	3.0	3.4	3.8
Ten-Year Treasury Note Rate				
CBO	7.0	5.9	5.8	6.0
Blue Chip[c]	7.0	5.9	5.9	6.1

SOURCES: Congressional Budget Office; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (January 10, 1994); Department of Commerce, Bureau of Economic Analysis.

NOTE: The *Blue Chip* forecasts are based on a survey of 50 private forecasters.

a. Based on constant 1987 dollars.

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

c. *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.

increase from 3.1 percent at the end of 1993 to 4.5 percent at the end of 1995. It also expects that long-term rates will rise slightly over that same period.

Last Friday's report of 5.9 present growth in GDP for the fourth quarter of 1993 is heartening, but it does not necessarily mean stronger growth this year than CBO envisions. Quarter-to-quarter growth is often erratic. Strong fourth-quarter growth in 1992 was followed by two weak quarters in early 1993, a pattern that had also occurred in 1986. Although the economy is likely to perform well, weak foreign economies and fiscal restraint will dampen growth this year.

CBO's economic forecast for 1994 and 1995 is similar to the *Blue Chip* consensus of private forecasters. The consensus forecast shows slightly lower growth in real GDP and slightly higher inflation. In addition, the *Blue Chip*'s long-term interest rates are a little higher than CBO's, but the short-term rates are lower.

Projections for 1996 Through 1999

CBO does not attempt to forecast cyclical fluctuations in the economy more than two years into the future. Beyond 1995, its projections are based on

trends in fundamental factors that determine the potential growth of the economy, including growth in the labor force, productivity, and national saving.

CBO estimates that potential real GDP will grow at an average rate of 2.4 percent during the 1996-1999 period. Projected growth of real GDP exceeds that rate through 1999; CBO assumes average annual growth of 2.6 percent for 1996 through 1999 (see Table 2). As a result, the gap between actual and potential GDP shrinks from 2.0 percent at the end of 1993 to its historical average of 0.6 percent in 1999. Steady growth of 2.6 percent a year would push unemployment down to 5.7 percent in 1999. Because GDP, on average, remains below its potential, the projected rate of inflation is stable. The projections assume a slight increase in short- and long-term interest rates during the 1996-1999 period.

THE BUDGET OUTLOOK

The outlook for the budget is also essentially unchanged since last September, with the deficit somewhat below the September estimates in each fiscal year. The deficit will shrink from the $255 billion recorded in 1993 to around $170 billion in 1995 and 1996 and then rise slowly to about $200 billion in 1999. This distinctly rosier outlook, compared with a year ago, is mostly a conse-

TABLE 2. MEDIUM-TERM ECONOMIC PROJECTIONS (By calendar year)

	Estimated	Forecast		Projected			
	1993	1994	1995	1996	1997	1998	1999
Nominal GDP (Billions of dollars)	6,370	6,730	7,099	7,483	7,880	8,287	8,700
Real GDP (Billions of 1987 dollars)	5,125	5,274	5,418	5,566	5,717	5,867	6,011
Real GDP (Percentage change)	2.8	2.9	2.7	2.7	2.7	2.6	2.5
Implicit GDP Deflator (Percentage change)	2.6	2.7	2.7	2.6	2.5	2.5	2.5
CPI-U (Percentage change)	3.0	2.7	3.0	3.1	3.1	3.1	3.1
Unemployment Rate (Percent)	6.8	6.4	6.1	5.9	5.8	5.7	5.7
Three-Month Treasury Bill Rate (Percent)	3.0	3.5	4.3	4.6	4.6	4.7	4.7
Ten-Year Treasury Note Rate (Percent)	5.9	5.8	6.0	6.1	6.2	6.2	6.2

SOURCE: Congressional Budget Office.

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

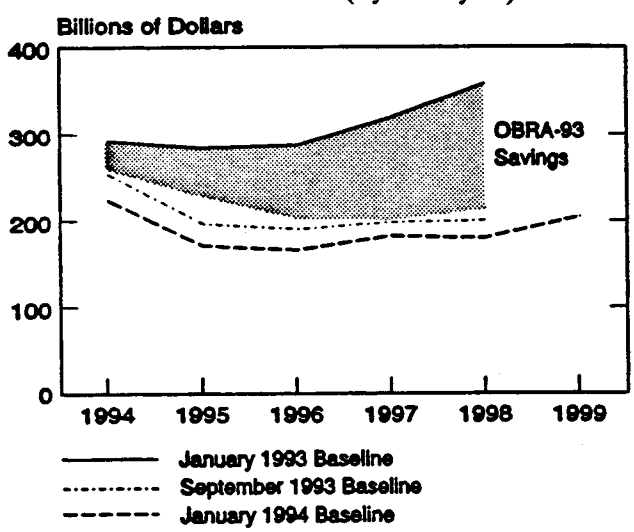
quence of the substantial tax increases and spending cuts enacted last August in OBRA-93 (see Figure 1). Last January, CBO projected deficits that dipped only a little below $300 billion before rising to more than $350 billion in 1998. Although much improved, the news this year is not all good; the deficit is not on a permanent downward path. In 1999, it begins to grow again as a

percentage of GDP, a trend that continues in CBO's extended 10-year projections. As a result, the deficit remains a significant drag on the standard of living in the United States for the foreseeable future.

The Outlook for the Deficit

A year ago, it seemed likely that the record-high 1992 deficit of $290 billion would be eclipsed in 1993, with deficits in later years near or above that level. Instead, the 1993 deficit came in at $255 billion, and the combination of OBRA-93 and continued economic growth keeps currently projected deficits

FIGURE 1. BASELINE DEFICITS (By fiscal year)



SOURCE: Congressional Budget Office.

NOTE: The shaded area represents the deficit reduction resulting from the Omnibus Budget Reconciliation Act of 1993.

well below $300 billion through the end of the century (see Table 3). As a percentage of GDP, deficits dip to 2.2 percent (compared with the 1984-1993 average of 4.2 percent) before beginning to climb slowly in 1999. Essentially the same pattern is seen in the standardized-employment deficit, which removes the effects of the business cycle from federal revenues and spending.

TABLE 3. CBO DEFICIT PROJECTIONS (By fiscal year)

	1992	1993	1994	1995	1996	1997	1998	1999
			In Billions of Dollars					
Total Deficit	290	255	223	171	166	182	180	204
Standardized-Employment Deficit[a]	206	215	179	144	149	164	164	191
			As a Percentage of GDP					
Total Deficit	4.9	4.0	3.4	2.4	2.2	2.3	2.2	2.4
Standardized-Employment Deficit[b]	3.3	3.3	2.7	2.0	2.0	2.1	2.0	2.2
Memorandum: Gross Domestic Product (Billions of dollars)	5,941	6,295	6,637	7,006	7,386	7,780	8,185	8,597

SOURCE: Congressional Budget Office.

a. Excludes the cyclical deficit, spending for deposit insurance, and contributions from allied nations for Operation Desert Storm. The last of those contributions were received in 1992.

b. Shown as a percentage of potential GDP.

These baseline budget projections assume that the Congress makes no changes in current laws and policies that affect tax revenues and mandatory spending. They also assume that discretionary spending (spending that is controlled by annual appropriations) for 1995 through 1998 will comply with the limits set in the BEA (for 1995) and in OBRA-93 (for 1996, 1997, and 1998). Those caps require the Congress to cut spending for discretionary programs by nearly 10 percent in real terms between 1994 and 1998. CBO assumes that discretionary spending will grow at the same pace as inflation after 1998, when the discretionary caps will have expired.

Increases in spending for Medicare and Medicaid are the dominant force pushing projected deficits back up as the 20th century nears its end. Estimated outlays for those two entitlement programs continue to grow at a rate of about 11 percent a year in 1999. Even with the expiration of the discretionary spending caps, outlays for everything other than Medicare and Medicaid grow only slightly more than 4 percent in 1999, a rate considerably slower that the assumed increase of 5 percent in nominal GDP. Without the rapid growth of federal health care spending, the deficits would probably decline steadily as a percentage of GDP. Adopting a plan that substantially reforms the nation's health care system might slow the future growth of such spending, but that positive effect on the deficit could be largely offset--at least

in the short to intermediate term--by the costs of extending health care coverage to people who are currently uninsured.

Changes in the Projections

The fundamental outlook for the deficit has changed little since CBO's projections last September, although projected deficits are lower for each year. Changes in CBO's economic forecast and technical reestimates are almost equally responsible for the reductions, which average about $20 billion a year (see Table 4). Legislation enacted since the summer has had virtually no effect on CBO's deficit projections.

Revising the economic forecast triggered an increase of $4 billion to $10 billion a year in projected revenues, stemming for the most part from increased wages and other personal income. In addition, CBO lowered its projections of spending for cost-of-living adjustments by $15 billion over the 1994-1998 period, primarily because inflation in 1993 was lower than previously assumed.

An improved business climate for banks and thrift institutions led to a technical reestimate of spending for deposit insurance. The reestimate

lowered projected outlays by $18 billion in 1994 and by $21 billion over the 1994-1998 period. CBO made smaller technical reductions in estimates of

TABLE 4. CHANGES IN CBO DEFICIT PROJECTIONS (By fiscal year, in billions of dollars)

	1994	1995	1996	1997	1998
September 1993 Baseline Deficit	253	196	190	198	200
Changes					
Policy changes	2	a	a	a	-1
Economic reestimates					
Revenues[b]	-4	-6	-8	-8	-10
Net interest	-2	-2	-2	-3	-3
Other outlays	-2	-3	-3	-2	-1
Subtotal	-9	-12	-13	-13	-13
Technical reestimates					
Revenues[b]	-3	a	a	a	2
Deposit insurance[c]	-18	-1	-4	2	a
Medicaid and Medicare	-2	-5	-5	-6	-8
Net interest[c]	a	-2	-1	-1	-1
Other outlays	-1	-6	a	1	1
Subtotal	-24	-14	-11	-3	-5
Total Changes	-30	-25	-24	-16	-20
January 1994 Baseline Deficit	223	171	166	182	180

SOURCE: Congressional Budget Office.

a. Less than $500 million.

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

c. Excludes changes in interest paid by deposit insurance agencies to the Treasury. These interest payments are intrabudgetary and do not affect the deficit.

spending for Medicaid, Medicare, and net interest. Technical revisions reduced all other outlays combined by about $4 billion over the period.

CONCLUSION

The difficult step taken by the President and the Congress in adopting a major deficit reduction package last August seems likely to achieve the desired outcome--significantly lower deficits than were projected a year ago. There is no indication at this time that the hard-fought gains on the deficit front will be offset by economic decline or unanticipated changes in spending or revenues.

The point needs to be emphasized, however, that the deficit may have been brought under control temporarily, but it has not been tamed. Measured as a percentage of GDP, the deficit falls to 2.2 percent by 1996, but under the relentless pressure of rapidly growing Medicare and Medicaid spending, the decline is cut short. The deficit climbs a bit in 1999 and continues to grow in CBO's extended 10-year projections. Unless health care reform legislation successfully reins in federal spending for health, or the Congress takes other major deficit reduction steps, high deficits are likely to continue into the foreseeable future.

The large federal deficits of recent years have been particularly troubling because they coincided with levels of private saving that were much lower than those prevailing before the 1980s, thereby limiting the domestic resources available for investment. Similarly, unless the high deficits projected under current policies are offset by private saving that is substantially higher than the current rate, they will constrain the improvement in the standard of living that can be expected in the United States in the early 21st century.

The presumption that high deficits will not be offset by increased private saving--and will continue to be a drag on economic growth--has prompted calls for a constitutional amendment requiring a balanced budget. These calls have come even though existing procedures and political pressures have combined to produce two substantial deficit reduction efforts in the past four years.

At least one of the proposed versions of such an amendment could be in effect for 1999 if it is passed by the Congress this year and promptly ratified by three-fourths of the states. Under CBO's current budget projections, balancing the budget in 1999 would require $204 billion in deficit reduction in that year. If the Congress adopts an amendment requiring a balanced budget beginning in 1999, it should not ignore the need to enact a multiyear package of tax increases and spending cuts to provide some hope

of achieving that goal in an orderly, gradual way. The longer the Congress and the President delay passage of such a package after the Congress has proposed the amendment for ratification, the harder it will be to eliminate the deficit by 1999. In fact, at some point it would become virtually impossible to reach a balanced budget that year without a substantial risk of triggering an economic downturn--which would make it even harder to balance the budget.

A deficit reduction package with cuts beginning in 1995 that was designed to reduce the 1999 deficit by about $200 billion would probably lower the total deficit over the 1995-1999 period by about $600 billion--a substantially larger decrease than the $433 billion achieved by OBRA-93. Deficit reduction of that magnitude is not impossible, but it would be politically difficult. The Congress narrowly enacted the $433 billion in savings in OBRA-93 only after an arduous legislative struggle--and that bill quite naturally included the relatively less painful options from among the tax increases and spending cuts available, leaving the more painful ones for future deficit reduction efforts. Reducing the deficit by an additional $600 billion clearly would require abundant political resolve.

Although CBO has often made the case for deficit reduction, it has also warned against procedural fixes (including a balanced-budget constitutional amendment) that promise action in the future to reduce the deficit

(see Chapters 5 and 6 of CBO's January 1993 *Economic and Budget Outlook).* Instituting a constitutional requirement to balance the budget is problematic in any case: it is not clear that achieving balance in every year is an obtainable or even desirable goal. It would be a particular folly to pass a balanced-budget amendment and ignore the need to expeditiously enact legislation that would offer some hope of complying with it.