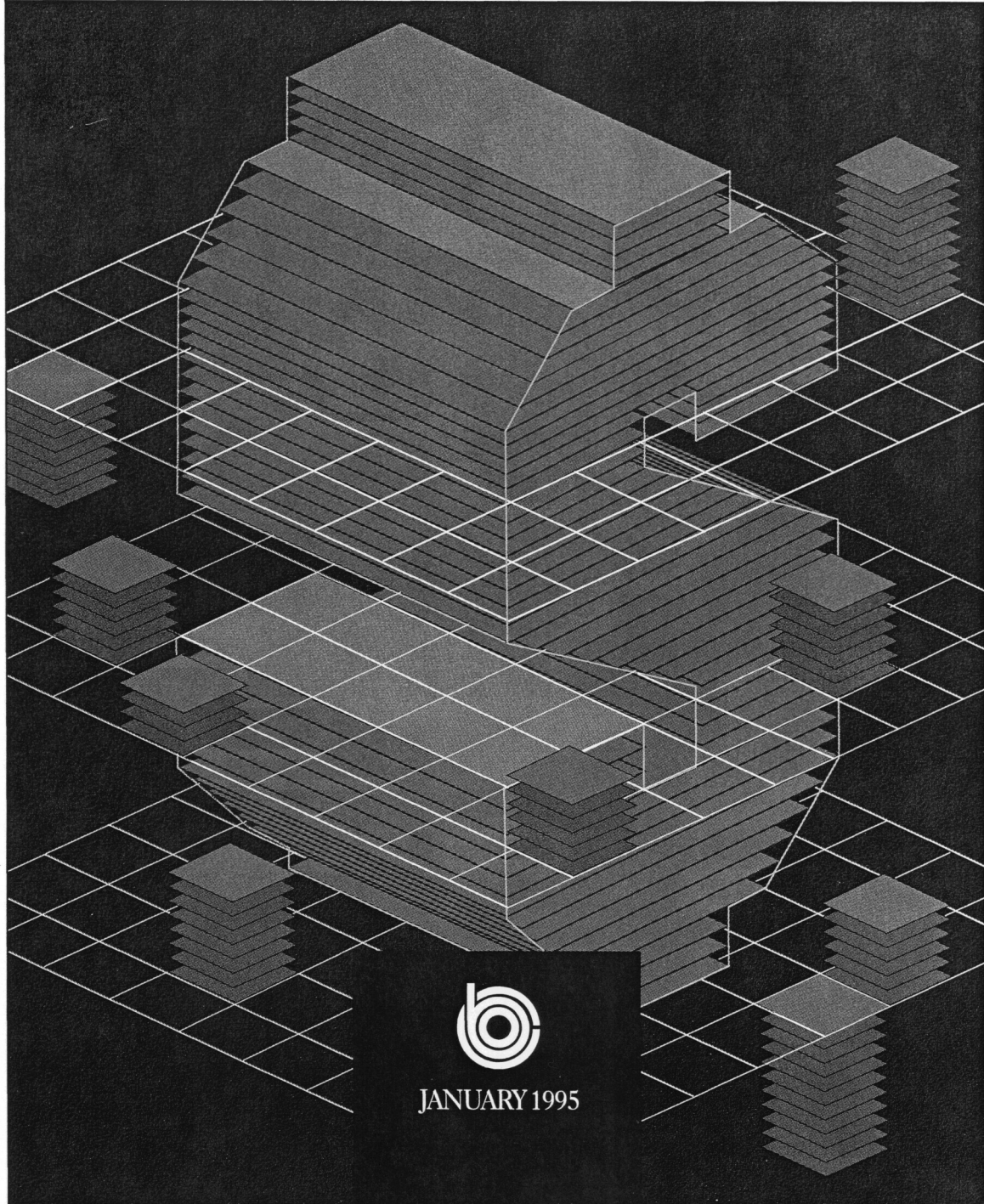


CONGRESS OF THE UNITED STATES
CONGRESSIONAL BUDGET OFFICE

The Economic and Budget Outlook: Fiscal Years 1996-2000

A Report to the Senate and House Committees on the Budget

As required by Public Law 93-344



JANUARY 1995

**THE ECONOMIC AND BUDGET OUTLOOK:
FISCAL YEARS 1996-2000**

The Congress of the United States
Congressional Budget Office

NOTES

Unless otherwise indicated, all years referred to in Chapter 1 are calendar years and all years in Chapter 2 are fiscal years.

Some figures in this report indicate periods of recession using shaded vertical bars. The bars extend from the peak to the trough of the recession.

Unemployment rates throughout the report are calculated on the basis of the civilian labor force.

Numbers in the text and tables of this report may not add to totals because of rounding.

National income and product account data shown in the tables do not incorporate the data for the fourth quarter of 1994, which were released on January 27, 1995.

Preface

This volume is one of a series of reports on the state of the economy and the budget that the Congressional Budget Office (CBO) issues each year. It satisfies the requirement of section 202(f) of the Congressional Budget Act of 1974 for CBO to submit periodic reports to the Committees on the Budget with respect to fiscal policy and to provide five-year baseline projections of the federal budget. In accordance with CBO's mandate to provide objective and impartial analysis, the report contains no recommendations.

The analysis of the economic outlook presented in Chapter 1 was prepared by the Macroeconomic Analysis Division under the direction of Robert Dennis and John F. Peterson. Christopher Williams wrote the chapter with contributions from Robert Arnold, Adrienne Kearney, and Frank Russek. Matthew Salomon carried out the economic forecast and projections. Robert Arnold, Laurie Brown, Douglas Elmendorf, Victoria Farrell, Douglas Hamilton, Adrienne Kearney, Kim Kowalewski, Joyce Manchester, Angelo Mascaro, Frank Russek, and Matthew Salomon provided background analysis and comments. Derek Briggs, Laurie Brown, John Romley, and Jennifer Wolfson provided research assistance.

The baseline outlay projections were prepared by the staff of the Budget Analysis Division under the supervision Paul N. Van de Water, Robert Sunshine, Paul Cullinan, Peter Fontaine, James Horney, Michael Miller, and Murray Ross. The revenue estimates were prepared by the staff of the Tax Analysis Division under the supervision of Rosemary D. Marcuss and Richard Kasten. Kathy A. Ruffing wrote Chapter 2, and James Horney wrote the summary of the report. The appendixes were written by James Horney (Appendix A), Kathy Ruffing (Appendix B), Bryan Grote (Appendix C), Jeffrey Holland (Appendix D), and Karin Carr (Appendix E).

An early version of the economic forecast underlying this report was discussed at a meeting of CBO's Panel of Economic Advisers. Members of this panel are Michael Boskin, Barry Bosworth, Robert Dederick, Martin Feldstein, Benjamin Friedman, Lyle E. Gramley, Robert Hall, Lawrence Klein, Robert Lawrence, John Makin, Burton Malkiel, Rudolph Penner, William Poole, Paul Samuelson, Charles Schultze, Robert Solow, James Tobin, and Murray Weidenbaum. Wynn V. Bussmann, Robert Crandall, William Gale, Edward Gramlich, Nicholas Lardy, Jonathan Skinner, and David Wyss attended as guests. Despite the considerable assistance afforded by these outside advisers, the analysis in this report does not necessarily reflect their views, nor are they responsible for any errors.

Paul L. Houts supervised the editing and production of the report, with the assistance of Sherry Snyder. Major portions were edited by Paul L. Houts, Leah Mazade, and Sherry Snyder. Christian Spoor provided editorial and production assistance. The authors owe thanks to Marion Curry, Dorothy Kornegay, and L. Rae Roy, who assisted in the preparation of the report. Kathryn Quattrone prepared the report for final publication.

Robert D. Reischauer
Director

January 1995

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Summary

No fundamental change in the economic or budget situation has occurred since the Congressional Budget Office (CBO) published *The Economic and Budget Outlook: An Update* in August 1994. The economy may be a bit more robust in 1995 than had been anticipated at that time, but a likely slowdown in growth in 1996 leaves the long-term economic outlook little different from last summer's. CBO expects that the high levels of business investment and purchases of durable goods that spurred the economy to a 3.7 percent real rate of growth in 1994 will continue into the first part of 1995. Because the economy is already operating close to its potential (the level of gross domestic product, or GDP, consistent with a stable rate of inflation), that growth is expected to result in somewhat higher rates of inflation and interest. In turn, those higher interest rates are likely to slow growth by the end of 1995--cutting it to 2.5 percent in 1995 and 1.9 percent in 1996 and dampening inflationary pressures. In CBO's longer-term projections, average annual growth after 1996 is close to the 2.4 percent rate of growth estimated for potential GDP; over the 1997-2000 period covered by those projections, inflation averages 3.4 percent and interest rates drift down.

CBO projects that the deficit will decline from the \$203 billion registered in 1994 to \$176 billion in 1995, the lowest level since 1989 and the lowest as a percentage of GDP (2.5 percent) since 1979. After reaching a trough in 1995, the deficit will rise to \$207 billion in 1996 (2.8 percent of GDP), grow again in 1997, and then level off in 1998. Those projections assume no change in current policies gov-

erning taxes and mandatory spending; they also assume compliance with the limits on discretionary appropriations that are in place through 1998. Under the assumption that spending for discretionary programs increases at the rate of inflation after 1998, deficits will grow to \$284 billion (3.1 percent of GDP) in 2000, the last year of CBO's regular projections. Under an alternative baseline that assumes that discretionary spending remains frozen at the dollar level of the 1998 caps, deficits increase only to \$243 billion in 2000.

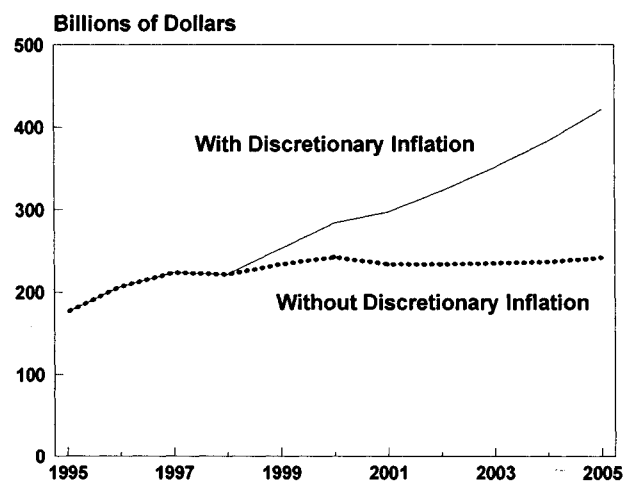
CBO's extended projections for 2001 through 2005, which are less detailed than those through 2000, show deficits continuing to mount in dollar terms through 2005 if discretionary spending is adjusted for inflation after 1998 (see Summary Figure 1). Deficits also grow as a percentage of GDP--to 3.6 percent in 2005. There is no reason to believe that this trend will be reversed in the years after that; indeed, the growth in the deficit is likely to accelerate in the second decade of the 21st century as large numbers of baby boomers become eligible for Social Security and Medicare benefits. Extended baseline projections that assume that discretionary spending is frozen at the 1998 level show deficits that are nearly constant from 2000 through 2005. As a percentage of GDP, the deficit in that baseline shrinks from 2.7 percent in 1998 to 2.1 percent in 2005.

Higher-than-anticipated interest payments and lower revenues, which are only partially offset by lower spending for medical care programs, have pushed up CBO's deficit projections for fiscal years 1995 through 1999 from last August's estimates by

an average of almost \$25 billion a year. After 2002, however, the deficits in the new extended projections are a little lower than the deficits projected in August.

The Congress is considering a constitutional amendment, which could go into effect as early as 2002, requiring a balanced budget. CBO currently projects a deficit of \$322 billion for that year (assuming that discretionary spending is adjusted for inflation after 1998), which is only \$3 billion more than the amount estimated last August. To illustrate the magnitude of the task facing those who would have to enact policies to comply with the balanced budget requirement, CBO has constructed an illustrative path leading to a balanced budget in 2002 that entails deficit reduction of \$1.2 trillion over the 1996-2002 period. Major changes in current policies would be required to achieve deficit reduction on that scale.

Summary Figure 1.
Comparison of CBO Projections With and Without Discretionary Inflation After 1998
(By fiscal year)



SOURCE: Congressional Budget Office.

NOTE: Caps on discretionary spending are set by law through 1998. Measures of the deficit "with discretionary inflation" assume that discretionary spending grows at the rate of inflation after 1998. Measures of the deficit "without discretionary inflation" assume that discretionary spending remains frozen in dollar terms at the level of the 1998 caps.

The Economic Outlook

CBO forecasts that the strong economic growth that the nation experienced throughout 1994 will continue into the first part of 1995. Because the economy is operating close to its potential, that growth will increase inflationary pressures and is likely to trigger additional efforts by the Federal Reserve Board to rein in the economy with higher short-term interest rates. In the CBO forecast, the resulting moderate slowdown at the end of 1995 and during 1996 will gradually bring GDP back in line with potential output without seriously disrupting the economy. Even with somewhat higher short-term growth and the slowdown in 1996, the current economic projections for 1997 through 1999 are little different from those CBO made last August.

The Forecast for 1995 and 1996

The robust growth that the U.S. economy experienced in 1994 is likely to continue through the first part of 1995 but will fade by the end of the year. The 3.7 percent increase in real output (on a fourth-quarter-to-fourth-quarter basis) and the creation of over 3 million new jobs in 1994 were achieved without an increase in inflation, but that performance is not likely to be repeated in 1995 (see Summary Table 1). Because the economy is already operating close to its potential, it cannot persistently expand faster than the growth of potential output--estimated at 2.4 percent a year by CBO--without triggering modestly higher inflation.

The Federal Reserve, which is determined to avoid any significant increase in inflation, raised the federal funds rate by 250 basis points (2.5 percentage points) in 1994 and is likely to further boost short-term interest rates in 1995. CBO forecasts that 90-day Treasury bill rates will average 6.2 percent in 1995--up from 3.2 percent in the first quarter of 1994. Rates for 10-year Treasury notes are expected to increase more modestly. The high rates of business investment and personal consumption of durable goods that drove the economy forward in 1994 apparently have not yet declined and will keep growth strong in the first part of 1995. However, by 1996,

Summary Table 1.
Comparison of Forecasts for 1995 and 1996

	Actual 1993	Estimated 1994	Forecast	
			1995	1996
Fourth Quarter to Fourth Quarter (Percentage change)				
Nominal GDP				
CBO	5.0	6.3	5.3	4.7
<i>Blue Chip</i>	5.0	6.5	5.7	5.4
Real GDP ^a				
CBO	3.1	3.7	2.5	1.9
<i>Blue Chip</i>	3.1	3.8	2.5	2.2
Implicit GDP Deflator				
CBO	1.8	2.5	2.8	2.8
<i>Blue Chip</i>	1.8	2.6	3.1	3.2
Consumer Price Index ^b				
CBO	2.7	2.8	3.2	3.4
<i>Blue Chip</i>	2.7	2.8	3.5	3.5
Calendar Year Averages (Percent)				
Civilian Unemployment Rate				
CBO	6.8	6.1	5.5	5.7
<i>Blue Chip</i>	6.8	6.1	5.6	5.7
Three-Month Treasury Bill Rate				
CBO	3.0	4.2	6.2	5.7
<i>Blue Chip</i>	3.0	4.2	6.2	6.1
Ten-Year Treasury Note Rate				
CBO	5.9	7.1	7.7	7.0
<i>Blue Chip</i> ^c	5.9	7.1	7.9	7.6

SOURCES: Congressional Budget Office; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (January 10, 1995); 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.

the cumulative effect of past and future hikes in interest rates should begin to bring the economy back in line with potential output. As a result, CBO expects that growth of real GDP will slow to 1.9 percent in 1996.

Unemployment will remain low in 1995--it is forecast to average 5.5 percent, compared with 6.1 percent in 1994--but will climb to 5.7 percent in 1996. Even at 1996's slightly higher level, unemployment will be below CBO's estimate of 6.0 percent for the nonaccelerating inflation rate of unemployment (NAIRU). A sustained unemployment rate below the NAIRU indicates a future increase in wage

inflation. With unemployment below the NAIRU and GDP exceeding potential output, inflation is expected to rise in 1995 and 1996. Because the economy has not become too overheated and is expected to cool down later this year, the forecast upswing in the consumer price index for all urban consumers (CPI-U) is modest--from 2.8 percent in 1994 to 3.2 percent and 3.4 percent in 1995 and 1996, respectively (see Summary Table 1).

CBO's forecast assumes that the recent and anticipated future increases in short-term interest rates engineered by the Federal Reserve will restrain the economy to an appropriate degree. If the continuing

Summary Table 2.
The Economic Forecast and Projections (By calendar year)

	Estimated 1994	Forecast		Projected			
		1995	1996	1997	1998	1999	2000
Nominal GDP (Billions of dollars)	6,735	7,127	7,456	7,847	8,256	8,680	9,128
Real GDP (Billions of 1987 dollars)	5,338	5,505	5,602	5,736	5,870	6,004	6,141
Real GDP (Percentage change)	4.0	3.1	1.8	2.4	2.3	2.3	2.3
Implicit GDP Deflator (Percentage change)	2.1	2.6	2.8	2.8	2.8	2.8	2.8
CPI-U (Percentage change) ^a	2.6	3.1	3.4	3.4	3.4	3.4	3.4
Unemployment Rate (Percent)	6.1	5.5	5.7	5.8	5.9	6.0	6.0
Three-Month Treasury Bill Rate (Percent)	4.2	6.2	5.7	5.3	5.1	5.1	5.1
Ten-Year Treasury Note Rate (Percent)	7.1	7.7	7.0	6.7	6.7	6.7	6.7

SOURCE: Congressional Budget Office.

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

strong growth that CBO foresees in early 1995 does not take place--if the economy has already started to cool off--the expected additional monetary tightening will slow growth sooner and more sharply than anticipated. Alternatively, if the economy proves stronger and more resistant than expected to the anticipated increases in interest rates and it surges well above potential output, the Federal Reserve will probably respond with even higher interest rates to combat the risk of inflation. That stronger-than-expected growth and the Federal Reserve's response to it could usher in a cycle of boom and bust for the economy.

Some economists argue that potential output may be greater than CBO estimates, in which case the economy could grow at its current rate for some time without triggering higher inflation. The Federal Reserve, however, is unlikely to allow such growth unless the evidence for a shift in potential output is more compelling than it currently is.

Projections for 1997 Through 2000

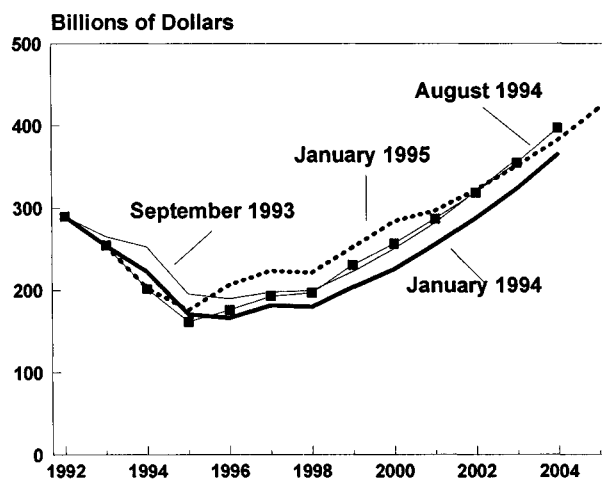
CBO attempts to forecast the cyclical fluctuations in the economy only for the next two years. Beyond 1996, its projections are based on trends in fundamental factors that determine the potential growth of the economy, including growth in the labor force, productivity, and national saving.

CBO's projections follow a path that has the gap between GDP and potential GDP reaching its historical average level--with GDP 0.6 percent below potential--at the end of the projection period in 2000. Because CBO estimates that the level of GDP will exceed potential output in 1996, the average annual real growth projected for 1997 through 2000 is slightly below the estimated 2.4 percent rate of growth of potential output (see Summary Table 2). Unemployment is expected to increase slightly to 6.0 percent, the estimated level of the NAIRU. Projected consumer price increases are assumed to average 3.4 percent a year over the period, with projected interest rates declining from the levels associated with efforts to slow the economy in 1995 and 1996.

The Budget Outlook

Although CBO now projects that the deficits for fiscal years 1995 through 1999 will be almost \$25 billion a year higher, on average, than it anticipated last August, the fundamental budget outlook is not very different from the one CBO projected then. Moreover, there has been no substantial change in CBO's deficit projections since its report in September 1993, which for the first time reflected the more than \$400 billion in deficit reduction enacted in the Omnibus Budget Reconciliation Act of 1993 (see Summary Figure 2). The deficit is still expected to fall in 1995 to its lowest level since 1989 and its lowest point as a percentage of GDP since 1979. As was also the case in August, the deficit is projected to begin rising again in 1996. CBO's extended budget projections show that trend continuing through 2005 if spending for discretionary programs increases at the rate of inflation after 1998. After 2002, currently projected deficits are slightly lower than the deficits forecast in August.

Summary Figure 2.
Comparison of CBO Deficit Projections
(By fiscal year)



SOURCE: Congressional Budget Office.

NOTE: The projections assume that discretionary spending rises with inflation after the caps expire in 1998.

The Outlook for the Deficit

Since 1992's record-high shortfall of \$290 billion, the deficit has declined to \$255 billion (4.0 percent of GDP) in 1993 and \$203 billion (3.1 percent of GDP) in 1994. (Although a record in dollar terms, the 1992 deficit as a percentage of GDP was far short--at 4.9 percent--of even a postwar record.) CBO projects that the deficit will decline for a third straight year to \$176 billion (2.5 percent of GDP) in 1995 (see Summary Table 3). That gratifying trend is expected to end the next year, however, with the deficit climbing under current laws to \$207 billion (2.8 percent of

GDP) in 1996 and \$224 billion in 1997 (2.9 percent of GDP) before leveling off in 1998.

The standardized-employment deficit, which is an estimate of the deficit that would occur if the economy was operating at its potential, is of interest because it is a measure of the fiscal posture of the federal budget without the cyclical effects of the economy. When the economy is operating below potential, the deficit swells as a result of reductions in revenues and increased spending for programs such as unemployment insurance. When the economy is operating above potential, revenues are in-

Summary Table 3.
CBO Deficit Projections (By fiscal year)

	1994	1995	1996	1997	1998	1999	2000
In Billions of Dollars							
Baseline Total Deficit							
With discretionary inflation after 1998	203	176	207	224	222	253	284
Without discretionary inflation after 1998	203	176	207	224	222	234	243
Standardized-Employment Deficit ^a							
With discretionary inflation after 1998	187	200	216	223	221	247	273
Without discretionary inflation after 1998	187	200	216	223	221	228	233
As a Percentage of GDP							
Baseline Total Deficit							
With discretionary inflation after 1998	3.1	2.5	2.8	2.9	2.7	3.0	3.1
Without discretionary inflation after 1998	3.1	2.5	2.8	2.9	2.7	2.7	2.7
Standardized-Employment Deficit ^b							
With discretionary inflation after 1998	2.8	2.8	2.9	2.9	2.7	2.9	3.0
Without discretionary inflation after 1998	2.8	2.8	2.9	2.9	2.7	2.6	2.6

SOURCE: Congressional Budget Office.

NOTE: Caps on discretionary spending are set by law through 1998. Measures of the deficit "with discretionary inflation" assume that discretionary spending grows at the rate of inflation after 1998. Measures of the deficit "without discretionary inflation" assume that discretionary spending remains frozen in dollar terms at the level of the 1998 caps.

- a. Excludes the cyclical deficit and spending for deposit insurance.
- b. Shown as a percentage of potential gross domestic product.

creased and spending is lower. Because in CBO's forecast the economy will be operating close to potential throughout the 1995-2000 period, the projected standardized-employment deficits differ little from the projected total deficits. Despite that, a look at the standardized-employment deficit as a percentage of potential GDP is illuminating. That measure varies only slightly from year to year during the 1994-1998 period, which makes it clear that the fiscal stance of the budget changes hardly at all during that time.

CBO's baseline projections for mandatory spending programs and taxes represent the outlays and revenues that will result if no changes are made in the laws governing those parts of the budget. The projections for discretionary spending (spending controlled by annual appropriations) assume compliance with the discretionary spending limits for 1996 through 1998 established for general-purpose appropriations in the Balanced Budget and Emergency Deficit Control Act of 1985 and for specific anti-crime appropriations in the Violent Crime Control and Law Enforcement Act of 1994. Because no level of discretionary spending is set by law for the years after 1998, CBO makes two different projections of the deficit for 1999 and later years. In one projection, discretionary spending grows at the rate of inflation; the purchasing power of the appropriations is thus held constant at the 1998 level. In the other, discretionary spending is frozen at the 1998 dollar level.

In the baseline projections with discretionary spending adjusted for inflation after 1998, the deficit resumes its upward path after the pause in 1998. By 2000, the last year of CBO's regular projections, the deficit of \$284 billion is almost back to the record level of 1992 (although at 3.1 percent, it is well below the 1992 deficit as a percentage of GDP). CBO's extended projections show deficits that continue to climb after 2000, reaching \$421 billion (3.6 percent of GDP) in 2005. The mounting deficits continue to be fueled primarily by increases in Medicaid and Medicare, even though projected costs for those programs are somewhat lower than CBO estimated last August. All spending other than that for Medicaid and Medicare is projected to grow at an average rate of about 5 percent a year between 1998 and 2005, slightly slower than the rise in revenues. Projected

spending for the two big federal health programs, however, increases at an average rate of almost 10 percent a year after 1998.

In the baseline projections without inflation adjustments for discretionary spending after 1998, deficits level off at around \$240 billion a year from 1999 through 2005. (The projected deficit of \$242 billion for 2005 is equal to 2.1 percent of GDP.) Freezing discretionary appropriations at the 1998 dollar level through 2005 would result in funding for discretionary programs in 2005 that had about 27 percent less purchasing power than the 1995 appropriations. If total discretionary spending was frozen at the nominal 1998 level but defense spending was preserved at the 1995 funding level adjusted for inflation, the money available for all other discretionary programs in 2005 would have less than half the purchasing power of the 1995 appropriations for those programs.

All mandatory spending is the same in both baselines, except that interest payments reflect the lower deficits and debt in the version that does not adjust discretionary spending for inflation after 1998.

Changes in the Projections

The deficits that CBO currently projects for 1995 through 1999 are almost \$25 billion a year higher, on average, than those projected last August (see Summary Table 4). Yet despite those increases, there has been no fundamental change in the deficit outlook. In fact, by 2003, the deficits in CBO's current extended projections are slightly lower than the deficits CBO projected in August.

Legislation enacted since then has had very little effect on the deficit outlook. The two most significant laws were an act making major changes in the federal crop insurance program in hopes of avoiding future ad hoc disaster assistance to farmers and an act implementing the Uruguay Round of the General Agreement on Tariffs and Trade (GATT). The crop insurance legislation increased estimates of the deficit by almost \$1 billion a year. Because CBO's baseline projections were made on the basis of current law, they did not include any spending that might result from the enactment of future ad hoc disaster bills. Therefore, reducing the likelihood of such leg-

islation did not produce savings that could offset the higher spending for crop insurance. The GATT implementing legislation added almost \$3 billion to deficits over the 1995-1999 period because losses in revenues from lower tariffs were not completely offset by other revenue increases and spending cuts.

Changes in the economic forecast since August have had a greater effect on deficit projections than did legislation. Those changes have pushed down

projected revenues by \$9 billion in 1996 and \$8 billion in 1997, largely because of lower wage and salary income than had been forecast in August. More significantly, the higher interest rates in the new forecast have driven up projected federal interest payments by more than \$15 billion a year, on average, in 1996 through 1999.

Taken altogether, technical reestimates--those changes that cannot be attributed to legislation or

Summary Table 4.
Changes in CBO Deficit Projections (By fiscal year, in billions of dollars)

	1995	1996	1997	1998	1999
August 1994 Baseline Total Deficit with Discretionary Inflation After 1998	162	176	193	197	231
Changes					
Policy changes	2	2	2	3	3
Economic assumptions					
Revenues ^a	2	9	8	3	b
Net interest	8	16	17	15	15
Other outlays	<u>b</u>	<u>b</u>	<u>1</u>	<u>2</u>	<u>2</u>
Subtotal	10	25	27	20	17
Technical reestimates					
Revenues ^a	6	5	6	9	11
Deposit insurance ^c	1	3	b	b	1
Medicaid and Medicare	-7	-6	-8	-11	-15
Net interest ^c	b	-1	b	b	1
Other outlays	<u>b</u>	<u>5</u>	<u>4</u>	<u>3</u>	<u>5</u>
Subtotal	1	5	2	2	2
Total	13	31	31	26	22
January 1995 Baseline Total Deficit with Discretionary Inflation After 1998	176	207	224	222	253

SOURCE: Congressional Budget Office.

NOTE: Caps on discretionary spending are set by law through 1998. Measures of the deficit "with discretionary inflation" assume that discretionary spending grows at the rate of inflation after 1998.

- a. Revenue reductions are shown with a positive sign because they increase the deficit.
- b. Less than \$500 million.
- c. Excludes changes in interest paid by deposit insurance agencies to the Treasury. These interest payments are intrabudgetary and do not affect the deficit.

revisions in the economic forecast--have had little impact on projections of the deficit. But looking only at the total effect masks some significant changes. Projected Medicaid spending is lower in every year--by as much as \$13 billion in 1999--than was estimated in August, reflecting actual 1994 outlays that were lower than expected and evidence that the rapid growth in that program has slowed. Medicare expenditures are down only slightly over the 1995-1999 period, but CBO's extended forecasts have significantly lower spending for Medicare as well as Medicaid in the years after 2000. The Medicaid reductions in 1995 through 2000, however, are more than offset by technical reestimates that bring down projected revenues to reflect smaller-than-anticipated tax collections in 1994 and increased spending for a variety of programs other than Medicare and Medicaid.

Illustrative Path to a Balanced Budget

A constitutional amendment requiring a balanced federal budget will be considered during the early days of the 104th Congress. If the Congress adopts such an amendment this year and three-quarters of the state legislatures ratify it over the next few years, the requirement could apply to the budget for fiscal year 2002. If the budget is to be balanced by 2002, it is important that the Congress and the President begin immediately to put into effect policies that will achieve that goal. According to CBO's latest projections of a baseline that adjusts discretionary spending for inflation after 1998, some combination of spending cuts and tax increases totaling \$322 billion in 2002 would be needed to eliminate the deficit in that year. The amounts of deficit reduction called for in the years preceding 2002 depend on both the exact policies adopted and when the process is begun.

For illustrative purposes, CBO has laid out one of many possible paths to a balanced budget in 2002 (see Summary Table 5). Starting from a baseline that assumes that discretionary spending is adjusted for inflation after 1998, that path first shows the savings that would be achieved by freezing discretionary

spending through 2002 at the dollar level of the 1998 cap. Such a freeze, along with the resulting debt-service effects, would produce \$89 billion of the required savings of \$322 billion in 2002. Under the freeze policy, the buying power of total discretionary appropriations in 2002 would be approximately 20 percent less than in 1995.

CBO also built into its illustrative path a possible course of savings from further policy changes. The amounts of those savings are not based on the adoption of any particular set of policies; they do assume, however, that policy changes are phased in between 1996 and 1999 in a pattern that is similar to the changes in mandatory spending enacted in the last two major efforts at deficit reduction in 1990 and 1993. After 1999, the assumed savings increase at the baseline rate of growth for entitlement and other mandatory spending, excluding Social Security--implying that the cuts implemented in earlier years have a permanent effect but no additional policy changes have been made. If those savings were achieved entirely out of entitlement and other mandatory programs (excluding Social Security), they would represent about a 20 percent reduction from current-policy levels for those programs.

Over the entire 1996-2002 period, the savings in CBO's illustrative path that result directly from policy changes total more than \$1 trillion (in relation to a baseline that adjusts discretionary spending for inflation after 1998). When the resulting savings in debt-service payments are included, the total exceeds \$1.2 trillion. As noted, this path and the resulting \$1.2 trillion in savings are illustrative only; the actual amount of cumulative deficit reduction over the 1996-2002 period will depend on the timing and exact nature of the policies enacted to achieve balance in 2002.

The required savings from policy changes would be smaller and the debt-service savings greater if, as CBO anticipates, ongoing deficit reduction efforts over this period result in lower interest rates. CBO believes that by 2000, interest rates could be as much as 1 percentage point lower than it currently forecasts if spending cuts and tax increases that would lead to a balanced budget have been enacted and the financial markets are convinced that policymakers will

Summary Table 5.
Illustrative Deficit Reduction Path (By fiscal year, in billions of dollars)

	1995	1996	1997	1998	1999	2000	2001	2002	1996- 2002
CBO January Baseline Deficit with Discretionary Inflation After 1998	176	207	224	222	253	284	297	322	n.a.
Freeze Discretionary Outlays After 1998									
Discretionary reduction	0	0	0	0	-19	-38	-58	-78	-193
Debt service	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>-1</u>	<u>-2</u>	<u>-6</u>	<u>-10</u>	<u>-19</u>
Total Deficit Reduction	0	0	0	0	-19	-40	-63	-89	-212
CBO January Baseline Deficit Without Discretionary Inflation After 1998	176	207	224	222	234	243	234	234	n.a.
Additional Deficit Reduction									
Policy changes ^a	0	-32	-65	-97	-145	-156	-168	-180	-843
Debt service	<u>0</u>	<u>-1</u>	<u>-4</u>	<u>-10</u>	<u>-18</u>	<u>-28</u>	<u>-40</u>	<u>-54</u>	<u>-156</u>
Total Deficit Reduction	0	-33	-69	-106	-163	-184	-208	-234	-998
Resulting Deficit	176	174	155	116	71	59	26	b	n.a.
Total Change from Baseline Deficit with Discretionary Inflation After 1998									
Policy changes	0	-32	-65	-97	-164	-194	-225	-259	-1,035
Debt service	<u>0</u>	<u>-1</u>	<u>-4</u>	<u>-10</u>	<u>-19</u>	<u>-31</u>	<u>-46</u>	<u>-64</u>	<u>-175</u>
Total Deficit Reduction	0	-33	-69	-106	-182	-225	-271	-322	-1,210

SOURCE: Congressional Budget Office.

NOTES: Caps on discretionary spending are set by law through 1998. Measures of the deficit "with discretionary inflation" assume that discretionary spending grows at the rate of inflation after 1998. Measures of the deficit "without discretionary inflation" assume that discretionary spending remains frozen in dollar terms at the level of the 1998 caps.

n.a. = not applicable.

a. These changes represent only one of a large number of possible paths that would lead to a balanced budget. The exact path depends on when deficit reduction begins and the specific policies adopted by the Congress and the President. The path illustrated in this table is not based on any specific policy assumptions but does assume that policies are fully phased in by 1999.

b. Surplus of less than \$500 million.

maintain those policies. CBO estimates that such a drop in interest rates would lower projected federal interest payments--and the amount of savings from policy changes needed to balance the budget--by almost \$140 billion over the 1996-2002 period.

may have to enact the spending cuts or tax increases needed to balance the budget by 2002. Although the long-term budget outlook is no worse now than it was last August, the new projections emphasize that the deficit can be eliminated only through major changes in current policies.

Conclusion

CBO's most recent economic and budget projections underscore the challenge facing policymakers who

The Economic Outlook

The U.S. economy grew vigorously throughout 1994. Spurred by business investment and spending on personal consumption, real output grew at a 4 percent pace, and over 3 million new jobs were created. With inflation subdued in spite of the rapid growth, 1994 was a banner year for the economy.

If rapid growth continues, however, inflationary pressures will mount. The economy is currently at a high rate of resource use--the unemployment rate has fallen to 5.4 percent, and the nation's factories are running close to capacity. The Congressional Budget Office (CBO) estimates that once the economy attains such a high rate of resource use, sustained growth exceeding 2.4 percent would strain the economy's productive capabilities and ultimately lead to higher inflation.

Anticipating some of the current pressures on the economy's capacity, the Federal Reserve tightened monetary policy during 1994, raising short-term interest rates in an effort to slow growth. The target federal funds rate--the rate that best reflects monetary policy actions--increased by 2.5 percentage points, and long-term rates largely followed suit. Short-term interest rates are likely to rise further, and the accumulated effect of higher rates will inevitably dampen growth.

CBO forecasts that the economy will forge ahead through much of 1995 but will then slow substantially in late 1995 and early 1996. Real (inflation-adjusted) gross domestic product (GDP) is forecast to grow at a rate of 2.5 percent during 1995 but

only 1.9 percent during 1996 (see Table 1-1 and Figure 1-1). The unemployment rate is expected to average 5.5 percent in 1995 and rise slightly, to 5.7 percent, in 1996.

CBO expects that strength in several sectors will encourage the Federal Reserve to tighten monetary policy further, pushing up short-term interest rates in the first half of 1995. The cumulative impact of higher interest rates--both the increases to date and the anticipated increases during the first half of this year--is likely to push the growth of GDP below 2 percent during late 1995 and early 1996.

Hence, CBO, along with most private forecasters, assumes that the Federal Reserve's monetary policy will effectively guide total spending in the economy between the shoals of inflation and recession. Because long-term interest rates are already high relative to expected inflation, further increases in short-term rates may not be echoed in long-term rates. The rate on 10-year government notes should not rise much above the 1994 year-end rate of 7.9 percent. Under CBO's forecast, inflation, as measured by the consumer price index (CPI), will increase to 3.2 percent in 1995 and to 3.4 percent in 1996.

The Federal Reserve's effort to slow growth is not without risks. It could result in a recession rather than in the relatively benign period of slow growth that CBO forecasts for late 1995 and early 1996. Such a scenario might evolve during those years if the monetary tightening to date, and the further modest tightening CBO anticipates, failed to cool the current pace of growth, and if the economy, already op-

erating at a high level of capacity use, continued to steam ahead. Changes in fiscal policy could increase the pressure on capacity if immediate tax cuts were enacted but were not paid for by simultaneous reductions in spending. Inflation would accelerate, and economic imbalances, such as high ratios of debt to income, would probably develop. Then, when monetary policy tightened further to slow inflation, the economy could contract rapidly.

In an alternative--though rather less likely--scenario, monetary tightening may have already been

sufficient to dampen economic growth in the first half of 1995. Last year's rapid growth may have been stimulated largely by transitory events, such as the one-time improvement in households' finances that stemmed from the refinancing of home mortgages during 1993. Because monetary policy has a delayed effect on the economy, the impact of the 1994 rate hikes may hit an economy that is already intrinsically weakening, in which case a period of slow growth or mild recession could occur during the first half of 1995.

Table 1-1.
The CBO Forecast for 1995 and 1996

	Actual 1993	Estimated 1994	Forecast	
			1995	1996
Fourth Quarter to Fourth Quarter (Percentage change)				
Nominal GDP	5.0	6.3	5.3	4.7
Real GDP ^a	3.1	3.7	2.5	1.9
Implicit GDP Deflator	1.8	2.5	2.8	2.8
Consumer Price Index ^b	2.7	2.8	3.2	3.4
Calendar Year Averages (Percent)				
Real GDP Growth ^a	3.1	4.0	3.1	1.8
Civilian Unemployment Rate	6.8 ^c	6.1	5.5	5.7
Three-Month Treasury Bill Rate	3.0	4.2	6.2	5.7
Ten-Year Treasury Note Rate	5.9	7.1	7.7	7.0

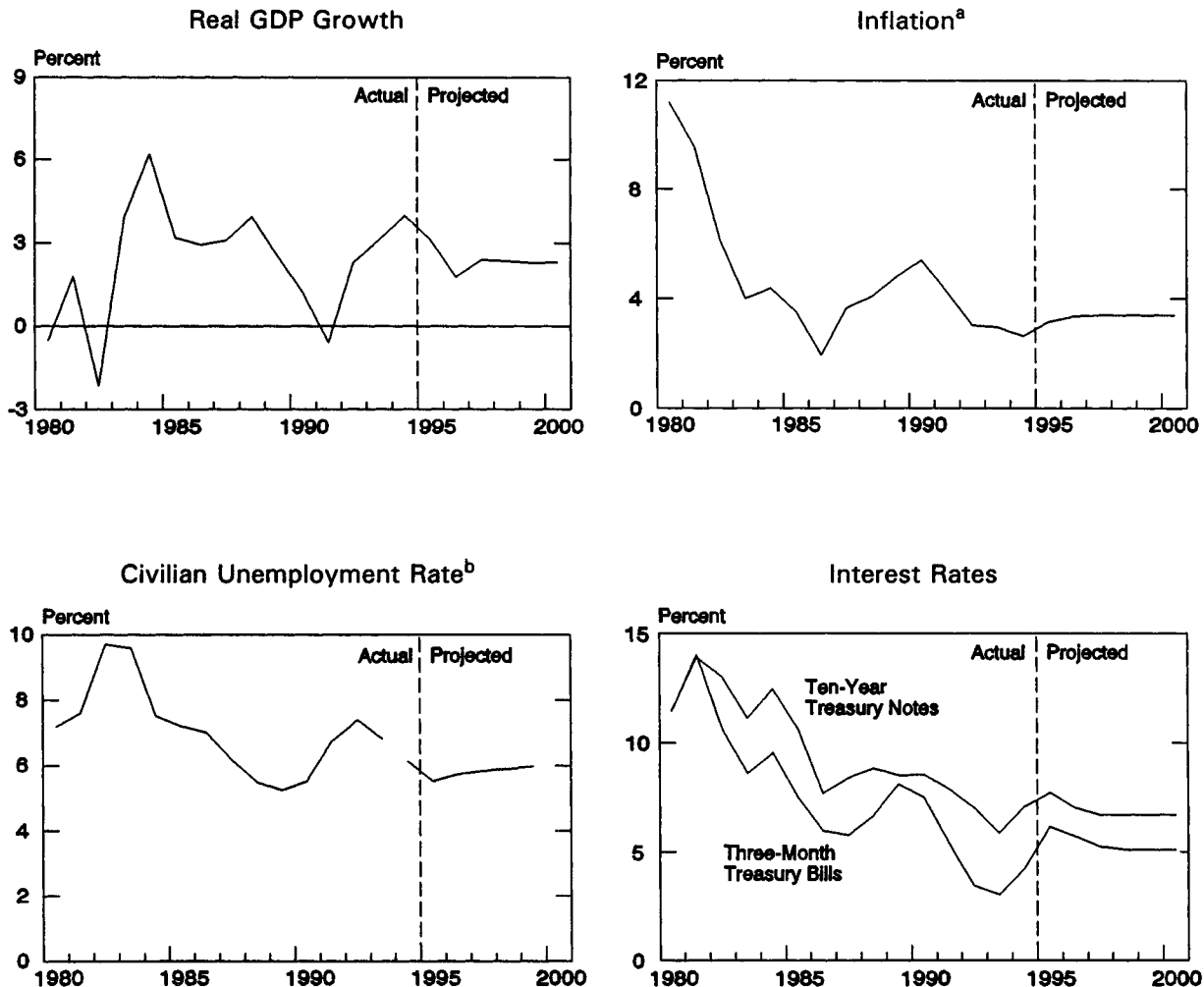
SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

a. Based on constant 1987 dollars.

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

c. The Bureau of Labor Statistics changed the unemployment survey in January 1994. Data for 1993 use pre-1994 methodology.

Figure 1-1.
The Economic Forecast and Projections



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

NOTE: All data are on an annual basis; growth rates are year over year. For 1997 and subsequent years, the projections do not reflect cyclical patterns.

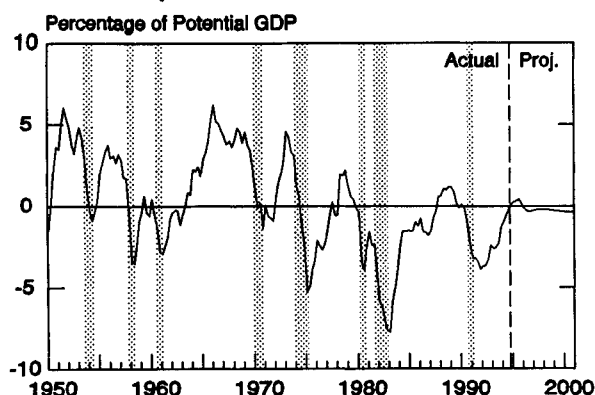
- a. Consumer price index for all urban consumers (CPI-U). The treatment of home ownership in the official CPI-U changed in 1983. The inflation series in the figure uses a consistent definition throughout.
- b. From 1994 on, the unemployment rate reported by the Bureau of Labor Statistics is not comparable with prior data. The discontinuity reflects an extensive revision of the survey methodology. The CBO forecast is based on the new methods.

The State of the Economy

The economy is operating at a high rate of capacity use and is still growing rapidly. If that situation continues, the economy could overheat and inflationary pressures could begin to mount. Just how serious a threat that is remains debatable, because measures of

the constraints on the economy's capacity are far from precise and the data are open to conflicting interpretations. For example, gains in business investment and productivity would raise the economy's capacity, whereas increased regulation would tend to lower it. Economists look to several measures to assess the situation.

Figure 1-2.
The GDP Gap: GDP Versus Potential GDP



SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

NOTE: The GDP gap is GDP minus potential GDP expressed as a percentage of potential GDP. Historically, expansions typically overshoot the mark so that GDP eventually exceeds potential GDP. The actions of the Federal Reserve Board influence that outcome.

Potential GDP is an estimate of the level of output that would obtain if the economy's resources were employed to the fullest extent possible without igniting inflation. If total spending in the economy runs above potential supply for an extended period, the excess demand bids up wages and prices in competition for scarce resources. The economy is now operating slightly above its potential (see Figure 1-2).

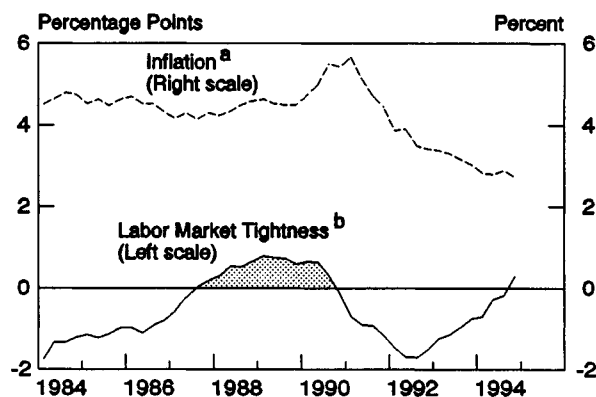
The unemployment rate also points to inflationary pressure. The current rate of 5.4 percent is below most estimates of the rate at which inflation might begin to develop (the nonaccelerating inflation rate of unemployment, or NAIRU). This tightness in the labor market indicates a future increase in wage inflation, which would in turn affect the CPI (see Figure 1-3). CBO uses an estimate of 6 percent for the NAIRU: the derivation of that estimate was explained in the summer update to CBO's 1994 outlook.

The Federal Reserve's index of capacity utilization reflects tightness only in the industrial sector of the economy, in contrast to the two broader measures mentioned above. Capacity utilization for all industries combined stood at 82.7 percent at the beginning of 1994, and the latest reported figure was 85.4 percent. An often-used rule of thumb is that inflationary pressures build when that index is above 84 percent.

Even as the constraints on capacity tighten, however, the economy remains strong. Growth of real GDP in the second half of 1994 was close to 4 percent--well above the 2.4 percent rate at which demand would grow in line with the economy's productive potential. The growth in employment and the rapid gains in industrial output also suggest continuing momentum.

Although the strength of the economy in 1994 was not entirely foreseen, the Federal Reserve tightened monetary policy last year in an effort first to end monetary stimulus and then to head off nascent inflationary pressures. It raised the target federal funds rate six times during the year, by a total of 2.5 percentage points. (The federal funds rate is the overnight rate at which depository institutions borrow from and lend to each other their monetary reserves--cash and deposits with the Federal Reserve that banks and thrifts must hold.) In doing so, the Federal Reserve steadily reduced reserves.

Figure 1-3.
Inflation and Tightening in the Labor Market



SOURCES: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics; Department of Commerce, Bureau of Economic Analysis.

NOTE: Shading indicates a period of inflationary conditions in the labor market.

- Consumer price index for all urban consumers (CPI-U), excluding food, energy, and used cars.
- Tightness in the labor market is measured by the excess of CBO's estimate of the nonaccelerating inflation rate of unemployment (NAIRU) over the actual unemployment rate. It is an indicator of future wage inflation.

Both short- and long-term interest rates rose during 1994, and late in the year the spread between them began to narrow. The rate on three-month Treasury bills moved up with the federal funds rate, sometimes rising faster in anticipation of the next increase. Yields on long-term government bonds rose in response to the health of the economy in the United States, signs of stronger activity abroad, and the specter of higher inflation. Long-term rates have risen less than short-term rates, however, suggesting that the markets believe that the tightening by the Federal Reserve will eventually succeed in restraining inflation.

The initial increase in interest rates in 1994 may not have had much effect on the economy, but the increases during the second half were significant. The Federal Reserve's initial moves shifted monetary policy toward a neutral stance, allowing interest rates to "snug up" as the economy strengthened. By the middle of the year, however, the Federal Reserve was seeking to tighten sufficiently to squelch the risk of inflation. The economy repeatedly proved stronger than expected as 1994 unfolded, and that led to a succession of rate hikes as monetary policy was tightened further.

Because of the lags with which monetary actions affect the economy, the full effects of the tightening during 1994 have probably not yet occurred. The delay is typically between nine and 18 months, so the monetary tightening in 1994 should begin to affect the economy during the first half of 1995.

CBO's Forecast for 1995 and 1996

CBO expects the pace of economic activity to slow over the next two years. This economic forecast is shaped by the interaction of two striking features of the current situation: the economy's strong momentum, and the Federal Reserve's determination to resist a surge in inflation. As a result, monetary policy is expected to become progressively tighter during much of 1995 until the economy cools down.

Fiscal policy, by contrast, should neither slow nor boost the economy. CBO bases its forecast for the economy on the fiscal policy implied by CBO's baseline budget projections, and hence the forecast does not incorporate possible changes in fiscal policy or budgetary practices that the newly elected 104th Congress may enact.

Federal Fiscal Policy Is Now Neutral

Federal fiscal policy reflects the tax policies and spending decisions made by the Congress and the Administration. CBO estimates that under current tax and spending policies, federal fiscal policy will have a neutral effect on economic growth in 1995 and 1996. Because fiscal policy is not holding back the economy as it did last year, it is no longer helping to slow inflation by reducing the growth of total spending in the economy. At the same time, however, the current stance of fiscal neutrality should not conflict with restraining inflation--the current goal of monetary policy.

CBO measures fiscal policy by changes in the standardized-employment deficit, which removes from the budget the effects of the business cycle on revenues and outlays. It also removes deposit insurance outlays because they primarily reflect an exchange of existing assets that has little effect on output and employment. Based on the new economic and budget projections presented in this report, CBO estimates that the standardized-employment deficit will show little change relative to potential GDP over the next two years or, indeed, through 2000 (see Table 1-2). By contrast, in fiscal year 1994 it fell to 2.8 percent of potential GDP from 3.4 percent in 1993, implying a significant amount of fiscal restraint.

The path of the standardized-employment deficit from fiscal years 1998 through 2000 depends on assumptions about discretionary spending. The standardized-employment deficit will rise to 3.0 percent of potential GDP by fiscal year 2000 if discretionary spending is assumed to rise with inflation after 1998, but will fall to 2.6 percent of GDP if discretionary spending is assumed to remain frozen at the level of the 1998 caps.

The projected pattern of the total federal deficit differs from that of the standardized-employment deficit in that it includes the effects of the business cycle. CBO estimates that under current budget policies, the total federal deficit will decline from \$203 billion in fiscal year 1994 to \$176 billion in

1995, then rebound to \$207 billion in 1996. Thereafter, the projected deficit will climb to \$284 billion in fiscal year 2000 if discretionary spending is assumed to rise with inflation after 1998, or to \$243 billion if discretionary spending is held constant in dollar terms.

Table 1-2.
The Fiscal Policy Outlook (By fiscal year, on a budget basis)

	Actual 1994	1995	1996	1997	1998	1999	2000
In Billions of Dollars							
<i>With Discretionary Inflation After 1998</i>							
Total Budget Deficit	203	176	207	224	222	253	284
Standardized-employment deficit ^a	187	200	216	223	221	247	273
Cyclical deficit	23	-8 ^b	c	5	6	10	13
<i>Without Discretionary Inflation After 1998</i>							
Total Budget Deficit	203	176	207	224	222	234	243
Standardized-employment deficit ^a	187	200	216	223	221	228	233
Cyclical deficit	23	-8 ^b	c	5	6	10	13
Memorandum:							
Deposit Insurance	-7	-16	-9	-5	-5	-3	-3
As a Percentage of Potential GDP							
<i>With Discretionary Inflation After 1998</i>							
Total Budget Deficit	3.0	2.5	2.8	2.9	2.7	2.9	3.1
Standardized-employment deficit ^a	2.8	2.8	2.9	2.9	2.7	2.9	3.0
Cyclical deficit	0.4	-0.1 ^b	0	0.1	0.1	0.1	0.1
<i>Without Discretionary Inflation After 1998</i>							
Total Budget Deficit	3.0	2.5	2.8	2.9	2.7	2.7	2.7
Standardized-employment deficit ^a	2.8	2.8	2.9	2.9	2.7	2.6	2.6
Cyclical deficit	0.4	-0.1 ^b	0	0.1	0.1	0.1	0.1

SOURCE: Congressional Budget Office.

NOTE: Caps on discretionary spending are set by law through 1998. Measures of the deficit "with discretionary inflation" assume that discretionary spending grows at the rate of inflation after 1998. Measures of the deficit "without discretionary inflation" assume that discretionary spending remains frozen in dollar terms at the level of the 1998 caps.

a. Excludes the cyclical deficit and deposit insurance.

b. Surplus.

c. Less than \$500 million.

The new Congress could, of course, point fiscal policy in other directions. It is considering some proposals, such as tax cuts, that would increase the deficit and stimulate the economy in the short term. The current budget process, however, places significant obstacles in the way of proposals that would raise the deficit. Other proposals, for cutting spending and balancing the budget, could reduce the deficit but restrain the economy in the short term. Balancing the budget would require difficult policy choices, would imply an exceptionally sustained path of fiscal restraint, and could complicate the future management of the economy in a recession. The short-term economic effects of the restraint could, however, be largely offset by the Federal Reserve, and bringing down the deficit would raise national saving and create substantial long-term benefits for the country (see Box 1-1). The fiscal policy choices of the new Congress could also affect future national income by altering the incentives for private saving, investment, and labor supply.

Strong Momentum Carries the Economy Well Into 1995

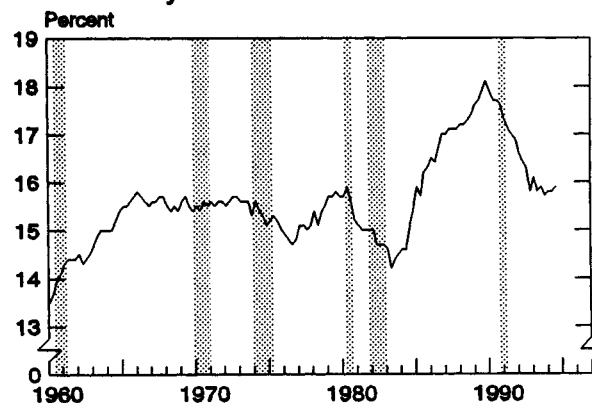
Although some sectors of the economy are slowing, major components of demand have enough momentum to carry through most of 1995. In particular, two components--personal consumption and business fixed investment--are likely to maintain a rapid pace through the first half of 1995. Net exports should also contribute to growth.

Consumer Spending Will Drive Growth During 1995. Strong growth in employment and personal income during the second half of 1994 and the reasonably solid situation of household finances will buoy consumption early in 1995. Employment and hours worked rose steadily in 1994, and households' real disposable income climbed 4.2 percent. Such growth made it possible for real spending on personal consumption to increase 3.5 percent over the year, even as the personal saving rate increased. The immediate prospect is for continued solid gains in employment and disposable income.

Even though installment debt and short-term interest rates increased last year, household finances are unlikely to dampen spending much in the first half of 1995. At the beginning of 1994, many households benefited from the substantial reduction in interest payments that was achieved by the refinancing of mortgages. Subsequently, consumer installment credit grew rapidly--about 15 percent in 1994 compared with 9 percent in 1993. Overall debt service, however, including the interest on mortgages and home-equity credit lines as well as installment debt, has not risen markedly; its share of disposable income has not changed much in the past two years, indicating that consumers have been prudent in taking on new debt (see Figure 1-4).

Spending on durable goods, such as furniture, appliances, and automobiles, has been strong for almost three years. Despite all that spending, some pent-up demand probably remains, particularly for motor vehicles, which have typically accounted for about 6 percent of consumer spending during expansions. Nominal expenditures on motor vehicles, for example, expressed as a share of disposable income, remain below the peak levels of previous cycles (see

Figure 1-4.
Household Payments on Debt



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

NOTE: Payments on debt are shown as a percentage of disposable personal income. The latest data are for the third quarter of 1994.

Box 1-1.**Fiscal Policy and the Goal of a Balanced Budget**

The 104th Congress is considering a constitutional amendment calling for a balanced federal budget. If the Congress adopts such an amendment, it would have to be ratified by the legislatures of at least three-fourths of the states within seven years before it would become part of the Constitution. While the states are considering the amendment, the Congress might consider it prudent to reduce the federal deficit steadily in anticipation of final ratification.

With or without a constitutional amendment, achieving and maintaining a balanced federal budget will have beneficial effects on the economy in the very long run. And gradually eliminating the deficit over several years will help to realize those benefits without the short-term economic disruptions that could result from eliminating a large federal deficit too quickly. But both the transition to a balanced budget and its maintenance over time would entail the risk of magnifying cyclical fluctuations in output and employment.

Economic Effects in the Very Long Run

Reducing the federal deficit would generate long-term benefits in the form of higher productivity, improved living standards, and less debt owed to foreigners. All of that would result from increased national saving. Deficit reductions would help to lower the cost of capital, which would increase the capital stock. With more capital to use, workers would be more productive and able to earn more income. A higher rate of national saving would also enable the United States to reduce its net indebtedness to foreigners, and future domestic investment would become less dependent on foreign sources of funding.

Some analysts also focus on the ratio of federal debt to gross domestic product (GDP) because its long-term implications are similar to those of federal deficits. A sustained fall in that ratio makes more room in investors' portfolios for productive capital assets. Based on CBO's current projections, balancing the federal budget by 2002 in the manner described on pages xix to xxi would reduce the federal debt to 44 percent of GDP in that year, compared with 56 percent under current budget policies.

Economic Effects During the Transition to a Balanced Budget

Based on the illustrative path of deficit reductions (see page xx), balancing the federal budget by 2002 would involve an

average fiscal restraint of roughly 0.4 percent of GDP per year, including savings from slower growth of interest payments on the federal debt. By historical standards, the average amount of restraint per year would be less than the average amount of 0.7 percent observed during the past four decades for those years in which fiscal policy was restrictive. Nevertheless, that is a very large amount of sustained fiscal restraint; fiscal restraint generally has been imposed only for one or two years, not steadily over a seven-year period.

For several reasons, however, the net result of the fiscal restraint from balancing the federal budget is likely to be only a small detraction from short-term growth in output and employment. First, expectations of a steady reduction in credit demands by the federal government would reduce interest rates and exchange rates, which would help to boost private domestic investment and exports to U.S. trading partners.

Second, as the deficit reductions unfolded, the Federal Reserve would attempt to offset their short-run contractionary effects. Deficit reductions would reduce inflationary pressures, permitting an easier monetary policy.

Finally, the automatic response of the budget to a slowdown in economic activity would also help to stabilize economic growth during the transition to a balanced federal budget. A decline in economic activity automatically causes the deficit to increase, and that, in turn, would partially offset the initial decline. By the same token, however, weaker economic activity would make it harder to achieve a balanced budget by 2002.

Economic Effects of Maintaining a Balanced Budget

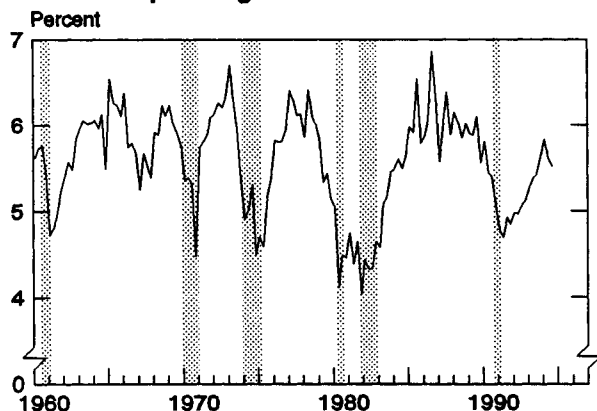
After 2002, efforts to maintain a balanced federal budget with a budget structure that is sensitive to cyclical factors could magnify downturns in output and employment unless the Congress made provisions for temporary deficits caused by recessions. Without such provisions, strict adherence to a balanced budget would mean that deficits stemming from economic slowdowns would have to be offset by cuts in discretionary outlays or by temporary tax increases. Such actions could worsen the economic slowdown unless their effects were offset by the Federal Reserve. If those offsets did not occur, the further deterioration in economic activity would increase the cyclical component of the deficit, which in turn would have to be offset by yet additional actions to lower outlays or raise revenues.

Figure 1-5). The average age of cars on the road is at a postwar high despite the large volume of new car sales in recent years, implying that households may still have a large stock of aging vehicles they would like to replace.

Judging the degree of pent-up demand is difficult, however, and several reasons for caution exist. The increased durability of cars and the shift toward pickup trucks, which last longer and are easier to repair, imply that consumers may be satisfied with slightly older vehicles. In addition, both the number of households and the number of vehicles per household are growing more slowly now than during the past two decades, and that will dampen demand for motor vehicles.

Business Investment Remains at High Levels. Business investment in both equipment and structures is expected to continue at a relatively fast clip for most of 1995. Business investment in equipment has been a driving force over the past two years, substantially outpacing growth in GDP. Real expenditures on equipment advanced at an average rate of 18 percent in 1993 and 1994. Expenditures on computers have been growing explosively, but investment in other equipment still increased at an average rate of about 12 percent over the same period. Overall in-

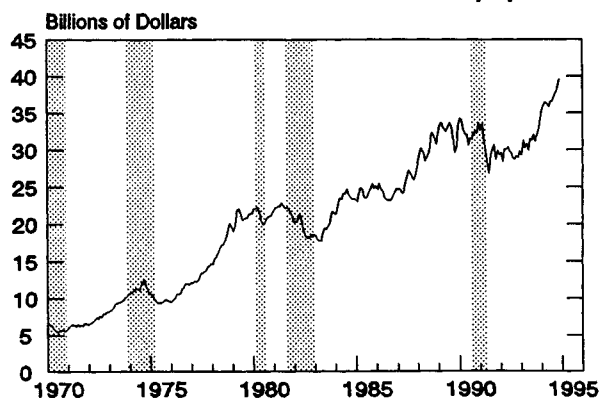
Figure 1-5.
Consumer Spending on Motor Vehicles



SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

NOTE: Total expenditures for buying, renting, and leasing motor vehicles are shown as a percentage of disposable personal income.

Figure 1-6.
New Orders for Producers' Durable Equipment



SOURCES: Congressional Budget Office; Department of Commerce, Bureau of the Census.

NOTE: The figure shows a three-month moving average of new orders for nondefense capital goods.

vestment may not continue at its recent double-digit rates, but it is still likely to be robust through much of 1995.

Prospects for business investment in the near term are strong given the volume of new orders for producers' durable equipment (nondefense capital goods such as machine tools and office equipment), which have yet to show signs of a slowdown. Orders eased during the first half of 1994 but snapped back after midyear (see Figure 1-6).

In contrast to spending on equipment, spending on nonresidential structures has only recently turned upward. Last year the sector began to recover, responding to a fall in the high vacancy rates left over from massive investment in office buildings, retail space, and hotels during most of the 1980s. Real business construction is likely to grow about 5 percent in 1995.

The increase in long-term interest rates in 1994 will sap some of business investment's strength during 1995. The rise in rates both increases the cost of capital to firms and creates expectations of slower growth in demand. Corporate profit margins remain healthy, however, providing firms with the means to finance much of their investment from internal cash flow. In addition, nonfinancial corporations have

strengthened their balance sheets in recent years by converting short-term debt to long-term debt, making them less vulnerable to interest rate hikes.

States' Fiscal Actions May Provide a Mild Stimulus. The strong economic growth of the past year and a half has given state governments an opportunity to cut taxes, even though their budgets remain tight. Revenues during 1994 were stronger than projected, and the fiscal condition of the states is much improved over that of the 1990-1993 period. Tax policies that states have enacted with their fiscal year 1995 budgets are likely to reduce revenues by about \$3 billion from what they would have been. States' actions have not lowered total state revenues since 1986, in marked contrast to the numerous tax increases states passed between 1990 and 1993.

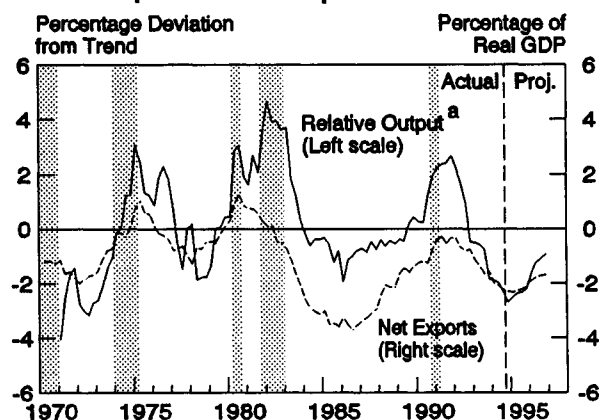
Total nominal spending by states, including spending from both their general funds and capital accounts (largely construction), is projected to grow at a slightly slower pace during 1995 than last year. States' general fund spending is projected to increase about 5 percent, with Medicaid spending continuing to capture a larger share of the growth in state budgets. Spending for employee compensation is also expected to increase about 5 percent. Pay raises account for most of that growth because state employment will inch up only 1 percent this year. Within the capital accounts, the strong growth of construction spending on highways and bridges, which has been bolstered by federal grants over the past few years, will weaken. Other capital spending, for schools and other structures, is expected to pick up.

Net Exports Will Gradually Improve. CBO forecasts that real net exports will reach a low point in the first half of 1995 before rebounding in 1996, when they are expected to contribute some \$20 billion to the growth in demand for U.S. output. The improvement in net exports next year reflects the strengthening of world demand relative to demand in the United States (see Figure 1-7). Trade-weighted growth in foreign economies, which ran at 3.3 percent in 1994, will be more robust in 1995 and 1996 and is likely to surpass that of the United States. (A trade-weighted measure weights the statistics for each foreign country by its share of trade with the United States.) As foreign economies continue to strengthen, they will import more goods from the United States. Meanwhile, as U.S. growth slows in

late 1995 and early 1996, so will U.S. imports of foreign goods. The turnaround in net exports will be aided by the delayed impact of the unexpected weakening of the trade-weighted dollar that occurred in 1994.

Many of the world's economies are now expanding. The pace of growth in the European economies increased more than expected last year. The economies of Germany and France grew moderately during 1994, but in both countries demand picked up noticeably in the second half, presaging growth of around 3 percent in 1995. How far output can expand and the high levels of unemployment can decline before the European economies reach inflationary levels of capacity remains to be seen. Japan's economy has barely moved out of its recession, and it continues to battle not only a strong yen but also the headwinds of the deflation of asset prices left over from the "bubble economy," when asset prices soared as a result of easy money, financial liberalization, and rapid economic growth. Yet the Japanese government has passed fiscal reforms that include a significant boost, and the economy is expected to grow at a faster clip. Elsewhere, growth remains very strong among Asia's newly industrialized countries.

Figure 1-7.
Relative Output and Net Exports



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

- a. Relative output is the ratio of the rest of the world's real GDP, measured by a 28-country trade-weighted index, to real U.S. GDP. Data on relative output have been adjusted to reflect the propensity of foreign countries to import less from the United States than the United States imports from them.

The picture is more mixed for Mexico and Canada, the United States' two closest trading partners. Analysts attempting to assess the implications of the peso crisis have revised downward their estimates of Mexico's growth for 1995 and 1996. But the economic situation in Mexico should carry only small implications for overall net exports from the United States (see Box 1-2).

At the same time, the Canadian economy has been expanding very rapidly as its currency has weakened and its restructured export sector has boomed. Export-led growth has compensated for the lackluster domestic demand that is hobbled by the exceptionally high real interest rates required by the condition of Canada's public finances. Growth is expected to moderate during 1995, following the U.S. economy but perhaps also checked by the tightening of fiscal policy, if the Canadian Parliament can agree

to a package of measures. Because Canada's economy is still expected to grow faster than the U.S. economy in 1995, its slowdown should not worsen U.S. net exports.

Although the prime factor determining net exports is the relative strength of demand between the domestic and foreign economies, movements in the nominal exchange rate can influence exports and imports over a period of a year or two. The decline of the dollar during 1994, though unexpected, was well within the range of recent experience (see Figure 1-8). The dollar has, however, declined enough to provide a slight lift to exports and a brake on imports.

The United States approved the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) in December 1994, and that agreement is

Box 1-2. The Currency Crisis in Mexico

Mexico is in the throes of a currency crisis, which has precipitated action on the part of domestic and foreign policymakers to dampen the economic repercussions. Although the crisis is likely to have significant effects on the Mexican economy, the overall effect on the U.S. economy will be small, particularly if stabilizing measures and reforms prove successful.

Before 1994, strong capital inflows, attracted by Mexico's economic reforms (including participation in the North American Free Trade Agreement) and by relatively higher real short-term interest rates, helped to sustain an overvalued peso and finance a large current-account deficit. During 1994, however, concern mounted that the ballooning current-account deficit, rising interest rates in the United States and the rest of the world, and political unrest in the state of Chiapas might lead to a devaluation. As a result, capital began to leave the country. The Mexican government increased interest rates during 1994 in an effort to encourage anxious investors to hold peso-denominated assets. But by December, the market's fears forced down the value of the peso.

Policymakers in Mexico, the United States, Canada, and the Bank of International Settlements have sought to stabilize the situation. President Zedillo has tried to re-

strain wages, reduce government spending, privatize government enterprises to attract foreign direct investment, and secure a rescue package from the international community. The global rescue package, to which the United States contributed \$9 billion, consists of an \$18 billion loan to replenish international reserves. In addition, the U.S. government is considering loan guarantees of up to \$40 billion to back up commercial bank loans to Mexico.

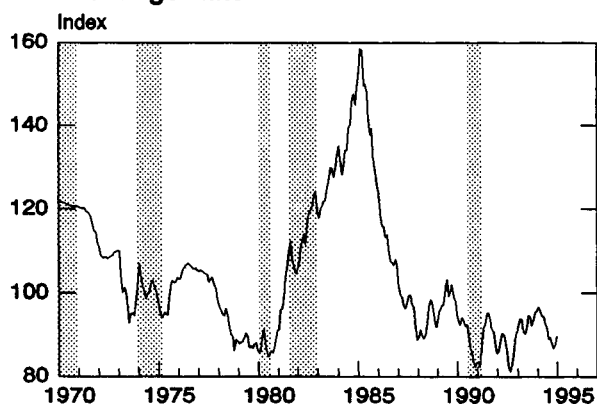
Although the currency crisis in Mexico has had a large impact on individual investors and corporations and will probably depress the growth of the Mexican economy next year, its overall impact for the United States appears to be small. In Mexico, the domestic reform package will require sacrifice in the short term. The policy initiatives mentioned above, along with an attempt to shrink the current-account deficit by 50 percent in 1995, could reduce Mexico's economic growth, and the lower value of the peso will raise import prices and cut the real wage. Because of the trade links between the countries, a sizable share of the reduction in Mexico's current-account deficit should translate into a reduction in U.S. net exports, but that impact should be small compared with the impact of other influences on U.S. net exports.

expected to boost U.S. exports and imports. The reductions in tariffs that will occur in foreign markets will be proportionately greater than those in the more open U.S. markets, and the United States should also benefit from the extensions of GATT's coverage to trade in services and protection for intellectual property rights. However, the agreement will probably produce only a small increase in exports and imports during the next two years. Some other countries still have to ratify the agreement, and the schedules for phasing out the trade restrictions are long enough that more substantial effects will not be realized for several years.

Housing Construction Should Slow. Despite considerable strength during 1994, construction of single-family housing appears to have reached a plateau. The growth of residential investment has been dampened by the rise in interest rates, and many private-sector forecasts of housing for 1995 and 1996 have been scaled back. CBO expects that after having risen by more than 8 percent in both 1993 and 1994, residential investment will fall over the next two years.

Higher mortgage rates have made housing less affordable. A commonly used measure of affordability is calculated as the median family income divided by the annual income needed to qualify for 80 percent fixed-rate financing for a median-priced home,

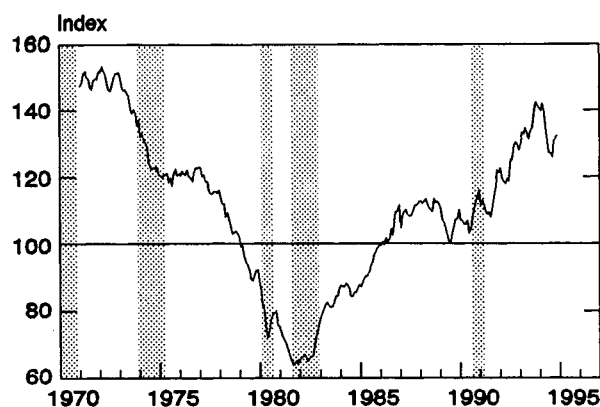
Figure 1-8.
The Exchange Rate



SOURCES: Congressional Budget Office; Federal Reserve Board.

NOTE: The 10-country trade-weighted index equals 100 in March 1973.

Figure 1-9.
Housing Affordability Index



SOURCES: Congressional Budget Office; National Association of Realtors.

NOTE: Figure includes data through November 1994. The index equals 100 when median family income is just sufficient to qualify the family to purchase a median-priced home.

assuming that monthly mortgage payments cannot exceed 25 percent of total income. Fixed-rate mortgages have risen two and a quarter percentage points since late 1993; as a result, the affordability index has fallen more than 10 percentage points from its peak, although it remains significantly above the levels of the 1980s (see Figure 1-9).

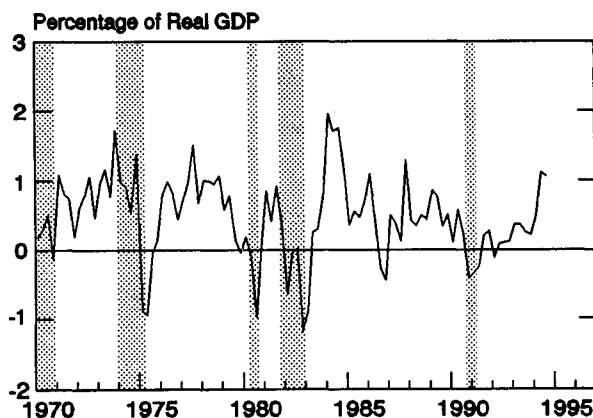
The affordability index may overstate the effect of rising rates on demand, however. More widespread use of adjustable-rate mortgages (ARMs) may make demand for housing less sensitive to short-term movements in interest rates than it was in the 1960s and 1970s. As long-term interest rates climbed last year, so did the proportion of new loans originated in the form of ARMs, diluting the adverse effect of the higher rates. In addition, mortgage lenders are offering increasingly favorable terms in the early years of the ARMs, and more lenders appear willing to accept low down payments.

Underlying demographic trends are not likely to bolster the demand for housing during the rest of the 1990s. Even though growth of the population in this decade will be slightly greater than during the past two decades, the number of households will not keep pace. Fewer households will be formed by marriage or by elderly people living independently, and the

average number of people in a household will increase. The number of households in the demographic group most likely to constitute first-time homebuyers--the group headed by people between the ages of 25 and 34--has been falling in recent years, a trend that is projected to continue through the end of the century.

The Pace of Inventory Growth Should Slow. Investment in inventories reached a seven-year high in the middle of 1994 (see Figure 1-10). To many analysts, that was a precursor of slower growth; they believed that the accumulation was unplanned and that firms would therefore slow production to bring inventories back in line. Cutbacks in production have not materialized, however, suggesting that inventories are not too high given the pickup in sales that businesses anticipate. CBO expects that inventories will grow more slowly in 1995 than in 1994, and more slowly still in 1996, but that the strong growth in sales projected for 1995 will forestall sharp cuts in production. If sales prove weaker than expected, however, abrupt cuts in production are more likely.

Figure 1-10.
Change in Investment in Inventories



SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

Wages and Prices Will Not Accelerate Rapidly

As demand continues to outpace capacity, inflationary pressures in the economy will gradually build. The response of wages and prices to excess demand is not, however, instantaneous, in contrast to the oil price shocks that spurred inflation in the 1970s. CBO's forecast for a slowdown in real GDP and for growth in the labor supply presages only a moderate upturn in the growth of wages and in inflation.

Labor costs are by far the largest component of total business costs, and therefore tightness in the labor market is the most important source of inflationary pressures on the prices of goods and services. When the labor market is tight--when unemployment is low--employers have difficulty filling job vacancies at existing wage rates. Because CBO expects the unemployment rate to remain near its current level in 1995 and to rise slightly by the end of 1996 as a result of the economic slowdown that will begin in the second half of 1995, wage inflation will not accelerate much during the forecast period.

An anticipated rebound in the growth of the labor force is one reason the unemployment rate will not decline much further. After having grown very slowly in recent years compared with the 1980s, and much more slowly than CBO expected, the labor force finally showed signs of recovery in the fall of 1994, increasing at an annual rate of 2.0 percent during the last quarter. CBO assumes the labor force will grow 1.8 percent in 1995 and 1.6 percent in 1996. Those rates keep the unemployment rate from falling further despite the forecast for rapid growth in employment during 1995, and the higher number of people seeking work dampens the upward pressure on wages.

Compared with previous late-expansion periods, demand is expected to exceed capacity only modestly in the coming years, and the resulting increase in CPI inflation should be commensurately small. A widely used rule of thumb that describes the inflationary implications of tight labor markets is the so-called point-year rule. If the unemployment rate is below the NAIRU by 1 percentage point for two years (two point-years), CPI inflation rises by 1 percentage

point. Thus, with the NAIRU estimated to be 6 percent and the unemployment rate forecast to remain near 5½ percent during 1995, inflation will accelerate by only about one-quarter of a percentage point.

Even though pressures on domestic demand do not seem to justify a big upturn in inflation, inflationary pressures could come from outside the U.S. economy. The general upswing in economic activity worldwide could drive up prices of manufactured goods exported to the United States, or it could further aggravate the price increases in raw materials, commodities such as metals, and petroleum. The falling value of the dollar during most of 1994 might also result in higher prices for imported goods; those prices have not yet shown a significant pickup, however, despite the recovery in Europe and the dollar's decline. Inflation in the economies of most U.S. trading partners is expected to remain mild, and the decline of the dollar was not large enough or prolonged enough to have a significant effect on U.S. prices.

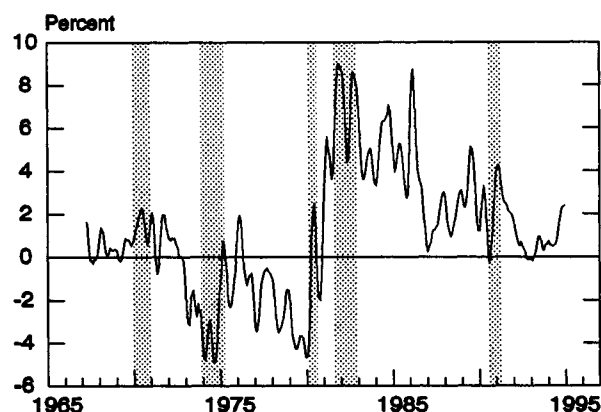
Some commodity price indices rose rapidly in 1994, and a number of analysts see that as a clear harbinger of a sharp increase in inflation. But such indicators are difficult to interpret. Commodity prices generally turn up before the CPI accelerates, but they have also given false signals of inflation. Furthermore, even when the signal is correct, the magnitude of the increase in commodity prices bears little relation to the magnitude of the subsequent increase in the CPI. One widely used index, the *Journal of Commerce* index of 18 commodities, turned upward in December 1993 and by the end of 1994 had risen 17 percent. That index has increased by roughly similar magnitudes six times over the past 30 years, but only three of the increases correctly signaled higher inflation. Therefore, although the commodity price increases of 1994 are important enough to warrant concern, particularly if continued growth in economies worldwide causes further sharp increases, they do not as yet provide strong evidence for a spike in CPI inflation this year.

A Substantial Slowdown in Late 1995 Should Follow Further Rate Hikes

If the economy is as strong as CBO expects during the first half of 1995, the Federal Reserve will probably tighten monetary policy further, which should precipitate a substantial slowdown by the end of 1995. Pointing in that direction are not only the probable strength of the economy but also the level of real interest rates and the slope of the yield curve--that is, the difference between short- and long-term interest rates.

Although real short-term interest rates rose during 1994, they only now are reaching the range in which they are likely to stem the economy's momentum. Real short-term interest rates, which were close to zero during 1993, rose above 2.4 percent in the final months of 1994 (see Figure 1-11). At the end of

Figure 1-11.
Real Short-Term Interest Rates



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

NOTE: The real short-term interest rate is calculated by subtracting from the three-month Treasury bill rate the growth (on an annual basis) of the consumer price index for all urban consumers (CPI-U) over the subsequent three-month period. For the last three months of 1994, however, the real interest rate is based on an estimate of 3 percent growth in the CPI-U for the first three months of 1995. The figure shows a four-month moving average.

the last business cycle in the late 1980s, when the Federal Reserve sought to check inflation as it is doing now, real short-term rates ranged between 3 percent and 4 percent. That level of real rates slowed an economy that was restrained by other forces--the headwinds of businesses' restructuring, defense downsizing, excessive debt burdens, weakened capital positions of banks, and so on. Such negative factors do not affect the underlying strength of the economy today, however, and still higher real interest rates may be necessary to rein in demand.

The shape of the yield curve reinforces that concern. Typically, as monetary policy is tightened near the end of a business cycle, the spread between nominal long-term rates and short-term rates narrows appreciably, mostly through an increase in short-term rates. That tightening raises current and expected real short-term interest rates while possibly reducing the expected inflation built into long-term rates. The spread between the rates on three-month Treasury bills and 10-year notes was about the same in early November as at the start of the year, but it has narrowed noticeably since the Federal Reserve raised the federal funds and discount rates in November. Nevertheless, it remains much wider than during the late-expansion phases of past business cycles. Judging from previous expansions, a rise in short-term rates may further narrow the spread.

Long-term interest rates will probably rise, but not as much as short-term rates. The recent narrowing of the spread between long- and short-term rates suggests that participants in bond markets may believe that monetary policy will soon be sufficiently tight. Moreover, long-term rates already incorporate expectations of stronger growth abroad. For both reasons, long-term rates are probably near their peak.

Even though long-term rates may rise only slightly, past increases, combined with the expected increases in short-term rates, will ultimately cool the pace of consumer and investment spending. Rising interest rates make it harder for consumers to continue making purchases; businesses, faced with the prospect of slowing sales and higher costs of borrowing, are likely to cut back their investment plans.

Risks to the CBO Forecast

This forecast reflects CBO's assessment that the Federal Reserve's preemptive strike will allow economic growth to continue without a significant increase in inflation. But the risks attending such a forecast are considerable.

The predominant risk reflects the uncertainty about how and when the monetary restraint will affect the economy. Will the economy slow before the middle of the year because of the recent rise in interest rates, or will the rapid growth of the past year and a half continue in the face of monetary restraint? If the economy continues to surge ahead, the odds increase that a boom in 1995 will be followed by a recessionary bust. A slowing in the first half of 1995, though possible, is less likely.

Another important uncertainty is whether the economy's potential for noninflationary growth has been over- or underestimated. If overestimated, then continued economic growth could cause inflation to come roaring back by late this year; if underestimated, inflation could remain subdued even with strong growth. In addition, the economy is subject to other uncertainties, such as changes in fiscal policy and in the international environment.

The Federal Reserve's job of providing an appropriate degree of monetary restraint is further complicated by changes in the historical relationships between monetary policy levers and the economy. As a result, the Federal Reserve in recent years has had to shelve monetary aggregates as gauges of the economy. The authorities, moreover, have little experience presiding over recovery and expansion in an arena characterized by the absence of regulated rates at depository institutions, a widely dispersed supply of credit from nonbank institutions, a banking sector operating under new regulations on capital and assets, and more open capital markets worldwide. As a result of such institutional developments, there can be no guarantee that the effectiveness of monetary policy will match that of the past.

A Cycle of Boom and Bust

A boom-and-bust scenario begins with growth that is stronger than expected during 1995, running above 4 percent well into the second half of the year. Such a troubling scenario could occur if the economy's momentum exceeds expectations and if interest rate hikes prove less effective in restraining demand in this business cycle than in previous cycles. Because the Federal Reserve is determined to stifle inflation, growth that is stronger than expected is likely to result in a sharp tightening of monetary policy, as it did in late 1994.

The recent strength in the economy has been supported by spending on consumer durable goods and business investment: if the desired stocks of both durable and investment goods are higher than CBO expects, then spending on those goods will continue to do better than anticipated, despite interest rate hikes. An unexpectedly vigorous economy could fuel further boomlike spending based on robust growth in employment, high levels of confidence among consumers and businesses, and further expansion of credit.

A prominent reason that consumer spending could grow faster than CBO expects comes from the automobile sector, in which, according to some analysts, substantial pent-up demand remains. Given solid growth in both employment and disposable personal income and in the share of disposable income spent on motor vehicles, ownership could rebound toward historical trends--the average age of cars could fall, and the number of vehicles per household could rise.

Higher demand could also be spurred by business investment that is stronger than in previous cycles and continues to surge throughout 1995. Some analysts predict that even after the substantial investment spending of the past two years, businesses could use more plant and equipment. With a healthy outlook for sales and profits, firms may continue to expand capacity, relatively unfettered by the rise in interest rates.

Several features of the economy in the past year have been identified as factors that might delay and

reduce the effectiveness of monetary policy. The proliferation of adjustable-rate mortgages in 1994 may have been associated with a delayed, if not a diminished, slowing in residential investment. The exchange rate, running lower than expected, has failed to translate the monetary tightening into a squeeze on demand for U.S. exports. Banks are lending more money, perhaps because the improvement in their balance sheets has allowed them to increase the supply of loans. Equity prices have remained higher than expected in the face of last year's monetary tightening. A larger fall in equities would reduce wealth, thereby slightly slowing the growth of consumer demand.

A Near-Term Slowdown

Alternatively, the economy could begin to slow early in 1995 if recent data have exaggerated its underlying strength--that is, if strong consumer spending and business investment have reflected temporary influences that will just as quickly be reversed. Indeed, advance estimates of retail sales in December 1994 fell back 0.1 percent compared with the Department of Commerce's full-sample estimate for November; in turn, that estimate had been revised sharply downward from its own advance estimate. Unexpected weakness in employment and spending could pour cold water on the confidence consumers and businesses have in the economy's vitality and could reinforce the effects of the interest rate hikes that should already be at work to curtail economic activity.

The prospects for a sharp slowing in consumer spending rest in part on the idea that the recent vigor of consumption, particularly in consumer durables, was buoyed temporarily by the refinancing of home mortgages. Mortgage rates were falling until late 1993, and many homeowners refinanced at lower rates, thus reducing their interest payments. Moreover, some households withdrew equity from their homes at the same time. Hence, refinancing probably enabled many households to buy new cars, furniture, and other durable goods. Refinancing was brought to a halt last year by the increase in long-term interest rates, leading some analysts to argue that consumers' temporary spending binge will also slow soon.

A dramatic drop in investment spending could also follow if the outlook for demand worsened rapidly—for example, if people sharply curtailed their spending. That drop could be amplified by a downswing in the inventory cycle, as businesses cut back on investment in new inventory in response to the unintended accumulation of unsold goods.

The expected downturn in housing activity will deepen if growth in employment slows or some of the vigor of late 1994 turns out to have been borrowed from 1995, perhaps as a result of home buyers attempting to enter the market before rates rose again. Further slowing could also occur if the increases in interest rates during 1994 are more effective than CBO anticipates at reining in spending on consumer durables and business investment early in 1995. The delayed impact of those rate hikes could be compounded if the Federal Reserve tightens monetary policy further in response to unexpectedly rapid growth.

Fiscal Policy Could Change Direction

The 104th Congress could make major changes in fiscal policy, and although any such changes would be unlikely to have major effects on the economy in 1995, they could have an appreciable effect in later years. The Congress appears ready to consider a long-term shift in fiscal policy, judging by its consideration of a balanced budget amendment to the Constitution. Further fiscal tightening is already possible within existing budget procedures, and the Congress may choose to begin a steady path of spending reductions and changes in tax law that, on balance, move the economy toward a balanced budget over the remainder of the decade. (See Box 1-1 on page 8.) The Federal Reserve would, however, take account of additional fiscal tightening and could ease monetary policy to try to avoid a sharp collapse in demand.

A concern of some economists and the bond markets, however, is that fiscal policy could still shift to expansion in 1996. Such a fiscal expansion could occur if the Congress passed broad-based cuts in taxes but failed to offset the resulting revenue losses with sufficient cuts in spending. Some analysts point to the 1980s to highlight the risk that cutting taxes

may once again prove to be easier than cutting spending. The Federal Reserve would almost certainly seek to tighten monetary policy in response to any shift toward expansionary fiscal policy, and yields in bond markets could rise.

Uncertainties Lurking in the Global Economy

The international economic and political environment remains a source of uncertainty for economic prospects in the United States. Shocks, both favorable and unfavorable, may be transmitted to the U.S. economy either through trade or through the capital markets.

Net exports offer considerable potential to boost the growth of demand in the U.S. economy. Growth of foreign economies was stronger than expected in 1994 and could exceed expectations again in 1995. That would enhance U.S. net exports, delaying the slowdown of demand in the United States and further straining the available resources of the U.S. economy. A further episode of weakness in the dollar could also spur demand for U.S. output.

Stronger-than-expected demand in the world economy may boost the prices of primary commodities such as agricultural products and minerals, but that need not presage a worldwide rise in general inflation. Many industrialized countries still have capacity for strong expansion in 1995, and in other countries, the monetary authorities have followed the Federal Reserve's moves with prompt tightening of their own.

The main downside risk in the foreign sector may be the political uncertainties that could hamper growth in foreign economies during 1995, resulting in lower-than-expected net exports. Although foreign growth has been strengthening, political turbulence clouds the horizon in many countries and may contribute to poorer economic performance than expected. European economies may be vulnerable to instability or conflict in Russia, the Balkans, and North Africa; in addition, many European governments are experiencing political difficulties at home. Disputes involving China and North Korea may harm

the business climate in Asia, and political changes continue in Japan. It is too early to tell how the devastating earthquake will affect Japan's economy and trade.

Closer to home, political uncertainties in Canada, including the status of Quebec, complicate the task of controlling high budget deficits. Mexico still faces political challenges associated with democratization and modernization; more immediately, the effectiveness of its new administration's policy response to the currency crisis remains to be proved (see Box 1-2 on page 11).

Net exports would also be lower than expected if imports from foreign producers captured a larger share of the U.S. market. A strengthening of the dollar--due to lower-than-expected growth and interest rates in foreign economies or, perhaps, to a "safe haven" effect in the event of political turbulence around the world--could improve the competitive position of imported goods. The resulting reduction in the demand for U.S. goods would mitigate inflationary pressure.

International developments can affect the U.S. economy through global capital markets as well as through trade. Increases in worldwide demand tend to raise real interest rates because financial capital is traded in global markets that are largely open. Real global interest rates could also come under pressure if countries that plan to tighten their fiscal positions are unable to reduce their government budget deficits, perhaps for political reasons. At least part of the rise in U.S. bond rates in 1994 reflected increases in real rates that were common to all international markets. If U.S. rates do not move with global rates, the exchange rate may fluctuate: for example, the prospect of higher returns offered in other currencies may have contributed to the unexpected weakness of the dollar during 1994.

Implications of Misestimating the Economy's Potential Output

The level and growth rate of the economy's productive capacity or potential output may be either stronger or weaker than the CBO forecast assumes. The recent strength of business investment may have raised the stock and productivity of existing capital--and so raised potential output--by more than standard measures of capacity indicate. Widespread anecdotal evidence points to increases in productivity resulting from corporate restructuring, and some analysts expect those increase to translate into an economywide rise in the growth rate of productivity. Persistence of slow growth in the labor force, increased regulation, and lower national saving could, however, reduce the economy's potential output.

Changes in the structure of taxation and government spending could also help or hinder the growth of productive capacity through their effects on incentives for labor supply, private saving, and investment. Such effects could have only a small impact on the forecast for 1995 and 1996 but might have a larger impact over a longer period.

In the near term, greater productive capacity could moderate the effects of strong demand on wage and price inflation. Measures of capacity provide the basis for estimates of excess demand. For a given level of demand, higher capacity spells less excess demand and so should translate into lower inflationary pressure; lower capacity spells higher excess demand and greater inflationary pressure. For example, anemic growth in the labor force may prompt employers to bid up wages as new workers become harder to recruit.

Even if the growth of potential GDP turns out to be robust, the Federal Reserve may still seek to keep the growth of spending under control. Federal Reserve Chairman Alan Greenspan has acknowledged that improvements in the economy's productive ca-

capacity could be under way, but argued that their impact on the economy would be "evolutionary" and "gradual." With its attention focused on the risk of inflation, the Federal Reserve would need to see strong evidence of improvements in the supply side of the economy before abandoning its restrictive monetary policy.

Comparison of the Forecast with the *Blue Chip* and the CBO Summer Forecasts

The *Blue Chip* consensus, which reflects the average of about 50 private-sector forecasters, indicates a steadier pattern of growth and higher inflation over the next two years than does CBO (see Table 1-3). Those forecasters expect that real growth will be 2.8 percent in the first half of this year, slowing gradually to 2.2 percent by mid-1996. Short-term interest rates increase about the same during the first half of this year as in the CBO forecast. If growth was only slightly above 2½ percent, the Federal Reserve would be less likely to raise interest rates. The *Blue Chip* expects the inflation rate to be higher than does CBO, with prices increasing by 3.5 percent over the four quarters of both 1995 and 1996.

Higher interest rates are the primary difference between CBO's current forecast and last summer's: the outlook for real growth and inflation has changed little. Long-term interest rates are now expected to be almost a full percentage point higher during 1995 than CBO anticipated seven months ago, and the forecast for short-term rates has also been raised. CBO's expectations for real growth over the 1994-1996 period have changed only slightly. Last summer's forecast correctly anticipated the strength of the second half of 1994 and was in line with the current expectation of continued solid growth through the first half of 1995. The current forecast, however, incorporates some weakening in real growth by early 1996 that was not in last summer's forecast. Inflation during the second half of 1994 materialized as predicted, and the current inflation outlook is virtually unchanged.

CBO's Projections for 1997 Through 2000

Real GDP is assumed to grow at an average annual rate of 2.3 percent between 1997 and 2000 (see Tables 1-4 and 1-5). That projection implies that the unemployment rate will average 5.9 percent during that period. Inflation, as measured by the annual rate of change in the CPI, is assumed to average 3.4 percent. The three-month Treasury bill rate, which is forecast to increase between now and mid-1995, is expected to decline gradually during 1996, averaging 5.1 percent for the projection period. The 10-year Treasury note rate averages 6.7 percent.

CBO's projections for 1997 through 2000 do not reflect any attempt to estimate cyclical movements of the economy or the effects of fiscal policy on the year-to-year changes in economic activity. Instead, the projections are designed to approximate the level of economic activity on average, including the possibility of above- or below-average rates of growth, inflation, and interest rates. CBO uses historical relationships to identify trends in fundamental factors underlying the economy, including growth of the labor force, the rate of national saving, and growth of productivity. The projections of variables such as real GDP, inflation, and real interest rates are then based on their historical norms.

The Projection for Growth

CBO projects the path for real GDP by assuming that it will grow smoothly to reach its average historical relationship with potential GDP by 2000. In the current projection, the slowing of growth during late 1995 and early 1996 leaves the gap between GDP and potential GDP only slightly smaller than its historical average at the end of 1996. Therefore, real GDP grows only a shade more slowly than potential GDP--2.3 percent compared with 2.4 percent--in order to restore the gap to its historical average by the end of 2000 (see Figure 1-12 on page 23). That growth leaves the level of real GDP about 0.4 percent below that of potential GDP in 2000, roughly equal

Table 1-3.
Comparison of Forecasts for 1995 and 1996

	Actual 1993	Estimated 1994	Forecast	
			1995	1996
Fourth Quarter to Fourth Quarter (Percentage change)				
Nominal GDP				
CBO current	5.0	6.3	5.3	4.7
<i>Blue Chip</i>	5.0	6.5	5.7	5.4
CBO Summer 1994	5.4	6.2	5.3	5.0
Real GDP ^a				
CBO current	3.1	3.7	2.5	1.9
<i>Blue Chip</i>	3.1	3.8	2.5	2.2
CBO Summer 1994	3.1	3.6	2.7	2.2
Implicit GDP Deflator				
CBO current	1.8	2.5	2.8	2.8
<i>Blue Chip</i>	1.8	2.6	3.1	3.2
CBO Summer 1994	2.2	2.5	2.5	2.7
Consumer Price Index ^b				
CBO current	2.7	2.8	3.2	3.4
<i>Blue Chip</i>	2.7	2.8	3.5	3.5
CBO Summer 1994	2.7	2.8	3.1	3.3
Calendar Year Averages (Percent)				
Civilian Unemployment Rate				
CBO current	6.8 ^c	6.1	5.5	5.7
<i>Blue Chip</i>	6.8 ^c	6.1	5.6	5.7
CBO Summer 1994	6.8 ^c	6.2	5.8	5.9
Three-Month Treasury Bill Rate				
CBO current	3.0	4.2	6.2	5.7
<i>Blue Chip</i>	3.0	4.2	6.2	6.1
CBO Summer 1994	3.0	4.1	5.5	5.1
Ten-Year Treasury Note Rate				
CBO current	5.9	7.1	7.7	7.0
<i>Blue Chip</i> ^d	5.9	7.1	7.9	7.6
CBO Summer 1994	5.9	6.8	6.8	6.5

SOURCES: Congressional Budget Office; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (January 10, 1995); Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

NOTE: The *Blue Chip* forecasts through 1996 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. The Bureau of Labor Statistics changed the unemployment survey in January 1994. Data for 1993 use pre-1994 methodology.

d. *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.

to the average historical gap between the two variables. The projected 2.4 percent rate for potential GDP is little changed from last summer's report.

One of three factors underlying CBO's projection for real GDP is the growth rate of the civilian labor force, which CBO assumes will increase at an annual average rate of 1.3 percent between 1994 and 2000, a rate that is unchanged from the summer projection. In its past two reports, CBO has highlighted an unusual decline in the overall labor force participation rate--the percentage of the working-age population that has been or is actively seeking a job--since the 1990 recession. That decline has caused the labor force to grow much more slowly since 1990 than

would be expected based on patterns experienced during previous expansions.

The crucial unresolved question is whether the slowdown in the labor force was caused by short-run factors, such as changes in the availability of jobs because of the business cycle, or by a fundamental change in attitudes toward work on the part of some members of the working-age population. Before last summer, CBO assumed that the slowdown in the labor force was a short-run phenomenon and that participation rates would eventually return to their previous trend. The slow growth persisted, however, and CBO accordingly lowered its projection of labor force growth to 1.3 percent. The current projection is the same as that in the summer report.

Table 1-4.
The Economic Forecast and Projections for Calendar Years 1995 Through 2000

	Estimated 1994	Forecast		Projected			
		1995	1996	1997	1998	1999	2000
Nominal GDP (Billions of dollars)	6,735	7,127	7,456	7,847	8,256	8,680	9,128
Nominal GDP (Percentage change)	6.2	5.8	4.6	5.3	5.2	5.1	5.2
Real GDP (Percentage change)	4.0	3.1	1.8	2.4	2.3	2.3	2.3
Implicit GDP Deflator (Percentage change)	2.1	2.6	2.8	2.8	2.8	2.8	2.8
Fixed-Weighted GDP Price Index (Percentage change)	2.7	3.0	3.3	3.4	3.5	3.5	3.5
CPI-U (Percentage change) ^a	2.6	3.1	3.4	3.4	3.4	3.4	3.4
Unemployment Rate (Percent)	6.1	5.5	5.7	5.8	5.9	6.0	6.0
Three-Month Treasury Bill Rate (Percent)	4.2	6.2	5.7	5.3	5.1	5.1	5.1
Ten-Year Treasury Note Rate (Percent)	7.1	7.7	7.0	6.7	6.7	6.7	6.7
Tax Bases (Percentage of GDP)							
Corporate profits	8.0	7.9	7.6	7.4	7.3	7.1	7.0
Other taxable income	20.2	20.4	20.4	20.4	20.5	20.5	20.6
Wage and salary disbursements	<u>48.7</u>	<u>48.9</u>	<u>48.9</u>	<u>48.8</u>	<u>48.7</u>	<u>48.6</u>	<u>48.5</u>
Total	76.8	77.1	76.9	76.7	76.4	76.3	76.1

SOURCE: Congressional Budget Office.

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

Table 1-5.
The Economic Forecast and Projections for Fiscal Years 1995 Through 2000

	Actual 1994	Forecast		Projected			
		1995	1996	1997	1998	1999	2000
Nominal GDP (Billions of dollars)	6,632	7,036	7,370	7,747	8,152	8,572	9,013
Nominal GDP (Percentage change)	5.8	6.1	4.8	5.1	5.2	5.1	5.1
Real GDP (Percentage change)	3.8	3.4	1.9	2.3	2.4	2.3	2.3
Implicit GDP Deflator (Percentage change)	2.0	2.6	2.8	2.8	2.8	2.8	2.8
Fixed-Weighted GDP Price Index (Percentage change)	2.7	2.9	3.3	3.4	3.5	3.5	3.5
CPI-U (Percentage change) ^a	2.6	3.0	3.3	3.4	3.4	3.4	3.4
Unemployment Rate (Percent)	6.3	5.6	5.7	5.8	5.9	6.0	6.0
Three-Month Treasury Bill Rate (Percent)	3.7	5.9	5.9	5.4	5.1	5.1	5.1
Ten-Year Treasury Note Rate (Percent)	6.5	7.8	7.2	6.7	6.7	6.7	6.7
Tax Bases (Percentage of GDP)							
Corporate profits	8.1	7.9	7.7	7.5	7.3	7.2	7.0
Other taxable income	20.1	20.4	20.4	20.4	20.5	20.5	20.5
Wage and salary disbursements	<u>48.7</u>	<u>48.8</u>	<u>48.9</u>	<u>48.8</u>	<u>48.7</u>	<u>48.6</u>	<u>48.6</u>
Total	76.8	77.1	77.0	76.7	76.5	76.3	76.1

SOURCE: Congressional Budget Office.

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

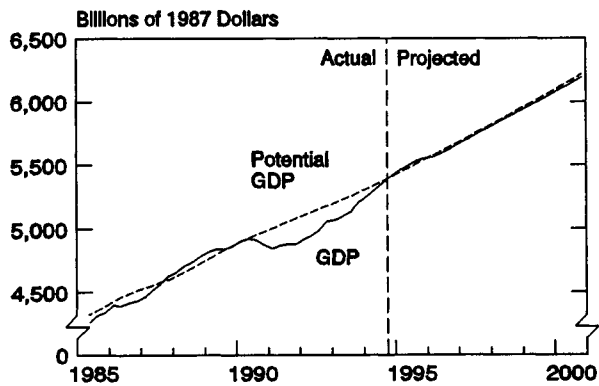
Two other factors that underlie the projection for potential GDP are the rate of national saving and the rate of growth of total factor productivity.¹ CBO projects that the gross rate of national saving, which is composed of private and public saving rates, will average about 13.1 percent during the 1995-2000 period, about 0.1 percentage point higher than was projected last summer. The projection for the rate of growth of total factor productivity is unchanged at 0.7 percent a year.

1. Total factor productivity is a measure of the productivity of both labor and capital. A more comprehensive measure than labor productivity, it is defined as the growth in real output that cannot be attributed to the growth of labor and capital.

The Projection for Inflation

CBO assumes that the forces that cause a modest rise in inflation in 1995 will dissipate and that the rate of inflation will level off by 1996. The rate of unemployment, which falls below the NAIRU in those years, is projected to approach its normal historical relationship with the NAIRU from 1997 through 2000. That level is consistent with a projection of inflation that does not change on average over those years. CBO projects that the CPI will grow at an average rate of 3.4 percent a year. Measured using the GDP deflator, inflation is expected to average 2.8 percent. Those projections are essentially unchanged from last summer's report.

Figure 1-12.
GDP and Potential GDP



SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

The Projection for Interest Rates

CBO projects interest rates by combining its projection for inflation with that for real interest rates. Real interest rates are projected by comparing current rates with historical averages and then adjusting for any special factors that make the 1990s different from the postwar period as a whole. For example, deregulation of financial markets, increased federal deficits, and increased international mobility of capital--combined with greater demand for capital among newly industrialized and newly liberalized economies abroad--all tend to boost real rates worldwide, compared with historical averages.

Real 10-year Treasury note rates, using the CPI as the measure of inflation, are assumed to average 3.3 percent from 1997 through 2000, and real three-month rates, 1.7 percent. With CPI inflation averaging 3.4 percent, nominal long-term yields average 6.7 percent, and short-term yields, 5.1 percent.

The Budget Outlook

The Congressional Budget Office projects that the deficit will decline in 1995 for the third year in a row. But according to CBO projections, that sanguine trend will then stop. Under current taxing and spending policies and under CBO's assumptions about the economy, the deficit will climb again--from \$176 billion this year to \$207 billion in 1996 and \$222 billion in 1998, the last year covered by the discretionary spending caps of the 1993 budget agreement. In relation to the size of the economy (as measured by gross domestic product), the deficit will stubbornly hover around 3 percent for the next five years.

The story told by those numbers is not new. As the 104th Congress convenes, it finds the budget outlook substantially the same as CBO has described for the last year and a half (see Summary Figure 2 on page xv). The last major reshaping of the budget took place in August 1993, when policymakers enacted a package of deficit reductions and reforms in the budget process in the Omnibus Budget Reconciliation Act of 1993 (OBRA-93). Legislation passed since then has had little effect on the budget outlook. Moreover, factors other than legislation that affect budget projections--namely, changes in the economic outlook and other, so-called technical factors--have on balance affected the deficit only slightly.

Budget projections are highly uncertain, of course, and there is no guarantee that CBO's latest projections will come to pass even if the Congress and the President do not enact any significant new legislation affecting the budget. But nothing has happened since August 1993 to undercut fundamentally the message broadcast then--that policymakers had

reined in the deficit but were still far from achieving budget balance.

This chapter summarizes CBO's new baseline projections. The baseline shows the outlook for federal revenues, outlays, and the deficit if current taxing and spending policies remain unchanged. It is not a forecast of likely budget outcomes, but is essential for sketching the consequences of today's policies and serves as a benchmark for weighing proposed changes. Crucially, the projections assume continued compliance with the Balanced Budget and Emergency Deficit Control Act of 1985. That law bars lawmakers from increasing the deficit, on balance, through revenue or entitlement legislation and sets stringent limits through 1998 on total appropriations for programs that are funded annually.

The Deficit Outlook

The simplest and most widely used measure of the deficit is the gap between all federal revenues and outlays. Nevertheless, several alternative measures exist, including one that omits the cyclical effects of the economy on the budget and one that excludes spending and revenues that have been designated in law as off-budget.

The Total Deficit and Its Variants

If today's policies remain unchanged, CBO expects the total deficit to reach a low this year before rising

Table 2-1.
CBO Deficit Projections (By fiscal year)

	Actual 1994	1995	1996	1997	1998	1999	2000
In Billions of Dollars							
Baseline Total Deficit							
With discretionary inflation after 1998	203	176	207	224	222	253	284
Without discretionary inflation after 1998	203	176	207	224	222	234	243
Standardized-Employment Deficit ^a							
With discretionary inflation after 1998	187	200	216	223	221	247	273
Without discretionary inflation after 1998	187	200	216	223	221	228	233
On-Budget Deficit (Excluding Social Security and Postal Service)							
With discretionary inflation after 1998	259	244	280	303	308	343	381
Without discretionary inflation after 1998	259	244	280	303	308	323	340
Memorandum:							
Deposit Insurance	-7	-16	-9	-5	-5	-3	-3
Cyclical Deficit	23	-8	b	5	6	10	13
Off-Budget Surplus							
Social Security	57	69	73	78	84	90	96
Postal Service	<u>-1</u>	<u>b</u>	<u>b</u>	<u>1</u>	<u>1</u>	<u>b</u>	<u>1</u>
Total, Off-Budget Surplus	56	68	73	79	85	90	97
As a Percentage of GDP							
Baseline Total Deficit							
With discretionary inflation after 1998	3.1	2.5	2.8	2.9	2.7	3.0	3.1
Without discretionary inflation after 1998	3.1	2.5	2.8	2.9	2.7	2.7	2.7
Standardized-Employment Deficit ^{a,c}							
With discretionary inflation after 1998	2.8	2.8	2.9	2.9	2.7	2.9	3.0
Without discretionary inflation after 1998	2.8	2.8	2.9	2.9	2.7	2.6	2.6

SOURCE: Congressional Budget Office.

NOTE: Caps on discretionary spending are set by law through 1998. Measures of the deficit "with discretionary inflation" assume that discretionary spending grows at the rate of inflation after 1998. Measures of the deficit "without discretionary inflation" assume that discretionary spending remains frozen in dollar terms at the level of the 1998 caps.

- a. Excludes the cyclical deficit and deposit insurance.
- b. Less than \$500 million.
- c. Expressed as a percentage of potential gross domestic product.

again (see Table 2-1). The deficit peaked at \$290 billion in 1992 but is expected to equal just \$176 billion in 1995. It then heads back up, topping \$200 billion in 1996 and \$220 billion in 1997 and 1998. What happens after that depends on what is assumed about discretionary spending, the label given to the funds that are controlled by annual appropriation actions. That particular one-third of federal outlays is governed through 1998 by overall caps.

Roughly speaking, the caps on discretionary spending--originally set in 1990 for the 1991-1995 period and in 1993 extended through 1998--have imposed a near freeze on such outlays during that eight-year period. The Congress makes decisions about the 900 or so discretionary spending accounts one year at a time, through the 13 regular appropriation bills and occasional bills that provide supplemental appropriations or rescind existing appropriations. That type of spending thus stands in sharp contrast to mandatory programs (such as Social Security) and interest spending, which simply continue on track under permanent law and do not require annual decisions about funding.

Since 1991, the 13 regular appropriation bills and any supplemental appropriations have had to stay under the caps. But once the caps expire, there is neither an overarching dollar total for discretionary appropriations set in law nor any mechanism to constrain such spending. What then? Traditionally, participants in the budget process have employed constant *real* funding--that is, resources adjusted for inflation--as a benchmark when weighing their decisions about future appropriations. That practice acknowledges that inflation, even at today's relatively low rate, gnaws away at the purchasing power of a fixed dollar total. But some analysts argue that constant *nominal*, or dollar, resources can also serve as a useful benchmark and point out that policymakers have essentially chosen that route from 1991 through 1998.

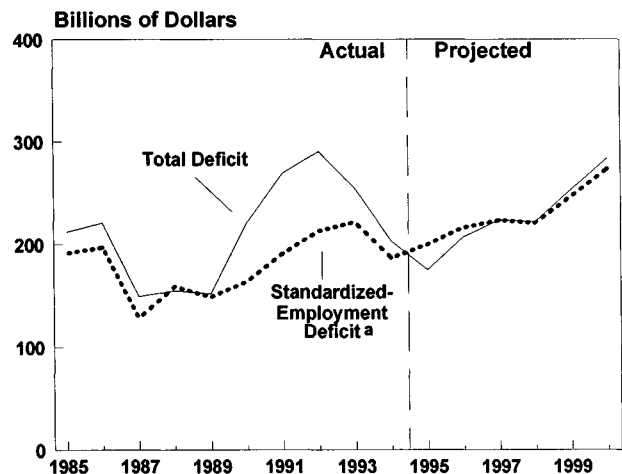
If discretionary programs are permitted to rise with inflation--that is, by about 3 percent a year--after 1998, CBO estimates that the deficit would climb from \$222 billion in that year to \$284 billion in 2000, simultaneously inching up in relation to GDP. By contrast, if discretionary outlays stay frozen, the deficit would still climb but less steeply--to \$243 billion

in 2000--and maintain the same 2.7 percent of GDP as in 1998.

The Standardized-Employment Deficit. Temporary and cyclical factors can obscure fundamental trends in the budget. When these factors are stripped away, the underlying trends in the deficit become more apparent. Although such factors are not very important in CBO's new projections for the 1995-2000 period, they do cast a somewhat different light on the experience of the past few years (see Figure 2-1).

One such transitory factor is spending for deposit insurance. CBO has long stressed that such spending--that is, money spent and recovered in the course of closing or merging insolvent savings and loan institutions and banks--does not spur the economy like other federal outlays. Insured depositors do not become richer when the government honors its commitment to them; rather, the transaction represents a rearrangement of the financial assets and liabilities already present in the economy. Recognizing the limited impact of the expenditures for deposit insurance, credit markets absorbed the Treasury securities is-

Figure 2-1.
The Federal Deficit (By fiscal year)



SOURCE: Congressional Budget Office.

NOTE: The projections assume that discretionary spending rises with inflation after the caps expire in 1998.

a. Excludes deposit insurance and the cyclical deficit. Also excludes contributions from allied nations for Operation Desert Storm in 1991 and 1992.

sued to pay for them with relative equanimity. The real economic loss that is symbolized by deposit insurance outlays occurred when institutions made bad loans and investments, well before the costs appeared in the budget.

As portrayed later in this chapter, outlays for deposit insurance have fluctuated widely in the past few years, soaring as high as \$66 billion in 1991 but plunging to net receipts (that is, negative outlays) of \$28 billion in 1993. CBO foresees small negative outlays for the 1995-2000 period. The massive losses associated with closing failed institutions have subsided, and the ongoing sales of assets (along with other receipts such as premiums from insured institutions) dominate the totals. But that volatile category of spending, notable for its relative lack of economic effect, should be isolated when analyzing the deficit's trend.

The transitory effects of the business cycle on the budget also affect the deficit and obscure its economic impact. Poor economic performance automatically worsens the deficit--principally because of lower revenues, less dramatically because of extra benefits for unemployment compensation and other programs. Those cyclical effects were very pronounced in the early 1990s when the economy was weak but have faded now that the economy is operating close to capacity.

The standardized-employment deficit is a measure of the imbalance in the budget that would exist if the economy were operating at capacity and tax collections and spending for such purposes as unemployment compensation reflected that robust economy. As explained in Chapter 1, changes in the standardized-employment deficit are used as a measure of the stimulus or drag exerted by fiscal policy. Because of the recession and the high level of outlays for deposit insurance in some years, the record-high total deficits posted in the early 1990s were partly bloated by temporary factors. The subsequent improvement is, therefore, somewhat less dramatic than it may first appear and cannot all be attributed to the deficit reduction measures adopted by policymakers (see Figure 2-1).

Just as outlays for deposit insurance fade into near insignificance in CBO's 1995-2000 projections, so do cyclical factors. An expected slowdown in the economy explains part of the rise in the 1996 deficit. Specifically, CBO estimates that the standardized-employment deficit climbs by just \$16 billion in 1996 (from \$200 billion to \$216 billion), in contrast to the \$30 billion jump in the deficit as conventionally measured (from \$176 billion to \$207 billion). Yet both measures tell the same story about the long-run outlook--namely, that the deficit will settle at just under 3 percent of GDP in the second half of the 1990s.

The On-Budget Deficit and Its Variants

A deficit sometimes cited by policymakers, the press, and the public is the on-budget deficit. Unlike the measures just discussed, this measure has no particular usefulness for macroeconomic analysis; rather, it is rooted in legislation that grants special, off-budget status to particular programs run by the government.

The two Social Security trust funds--Old-Age and Survivors Insurance and Disability Insurance--were granted off-budget status in the Balanced Budget and Emergency Deficit Control Act of 1985. Legislation enacted in 1989 excluded the much smaller net outlays of the Postal Service from on-budget totals.

The fiscal picture looks markedly different if off-budget programs are excluded (see Table 2-1). In isolation, Social Security runs a surplus; its income from the taxes paid by workers and their employers, interest, and a few other sources exceeds its outlays for benefits to the retired and disabled as well as for minor categories of spending. Thus, removing Social Security from the on-budget totals makes the remaining deficit bigger. The Social Security surplus is mostly in the Old-Age and Survivors Insurance (OASI) fund. The Disability Insurance (DI) fund was heading fast toward depletion but was rescued in the waning days of the 103rd Congress by the simple device of reallocating a small portion of the existing payroll tax from OASI to DI. About one-half of the

total Social Security surplus stems not from its excess of taxes over benefits but from interest on its holdings of Treasury securities.

Social Security's benefits alone account for more than one-fifth of federal spending, and its payroll taxes for more than one-fourth of government revenues. When they seek to gauge the government's role in the economy and its drain on the credit markets,

economists, credit market participants, and policymakers alike look at the total figures and do not ignore this huge program.

Many economists and policymakers, however, deliberately segregate the Social Security program along with Medicare for purposes of long-run analysis. They worry about the future demands that will be placed on the budget by demographic pressures,

Table 2-2.
CBO Projections of Trust Fund Surpluses (By fiscal year, in billions of dollars)

	1995	1996	1997	1998	1999	2000
Social Security ^a	69	73	78	84	90	96
Medicare						
Hospital Insurance	3	-2	-7	-12	-19	-25
Supplementary Medical Insurance	<u>-9</u>	<u>b</u>	<u>1</u>	<u>1</u>	<u>2</u>	<u>2</u>
Subtotal, Medicare	-5	-2	-6	-11	-17	-23
Military Retirement	5	4	4	2	1	b
Civilian Retirement ^c	29	31	32	33	34	36
Unemployment	8	7	5	4	3	3
Highway and Airport	-3	1	2	2	2	2
Other ^d	<u>4</u>	<u>4</u>	<u>4</u>	<u>4</u>	<u>4</u>	<u>4</u>
Total Trust Fund Surplus ^e	107	118	119	119	116	117
Federal Funds Deficit ^e	-283	-326	-343	-341	-369	-401
Total Deficit	-176	-207	-224	-222	-253	-284
Memorandum:						
Net Transfers from Federal Funds to Trust Funds	203	232	252	269	290	314

SOURCE: Congressional Budget Office.

- a. Old-Age and Survivors Insurance and Disability Insurance.
- b. Less than \$500 million.
- c. Civil Service Retirement, Foreign Service Retirement, and several smaller funds.
- d. Primarily Railroad Retirement, employees' health insurance and life insurance, Hazardous Substance Superfund, and various veterans' insurance trust funds.
- e. Assumes that discretionary spending reductions are made in non-trust-fund programs.

especially as the baby-boom generation joins the Social Security and, a few years later, Medicare rolls in droves beginning at the end of the first decade of the next century.

However, even for such analyses, focusing on the on-budget deficit--the deficit excluding Social Security--can lead to faulty conclusions. CBO and others have pointed out that the best way for the nation to prepare for future demographic pressures is to save and invest more now. Greater investment, the main engine of growth, would enlarge the future economic pie and somewhat diminish the relative sacrifices that will be demanded of future workers. Investment, in turn, fundamentally depends on the available pool of saving, whether private (personal and corporate) or government (federal, state, and local). Because government actions to encourage private saving have had, at best, very limited success, the most direct way for the government to foster investment is simply to cut the deficit or even run an overall surplus. As CBO has pointed out, what really matters is that policymakers accomplish this somehow--not whether they record the reduction as part of the Social Security surplus or in the rest of the budget.¹

The Federal Funds Deficit. The federal funds deficit is the deficit excluding the activities of all trust funds. The two Social Security funds share the trust fund label with many other federal programs. In total, there are more than 150 federal trust funds, though fewer than a dozen account for the vast share of trust fund dollars.

Viewed by themselves, trust funds run surpluses because their earmarked income (chiefly from social insurance taxes and from transfers within the budget, as explained below) exceeds spending for benefits, administration, and other activities. The total trust fund surplus is virtually flat in CBO's projections, climbing slightly from \$107 billion this year to about \$118 billion a year in 1996 through 2000 (see Table 2-2).

Nearly all public attention focuses on the Social Security and Medicare trust funds, which run combined surpluses of roughly \$70 billion a year, or two-thirds of the total trust fund surplus. Both Social Security and Medicare's Hospital Insurance (HI) fund collect taxes from workers and pay benefits to or on behalf of elderly and disabled recipients. The rising surplus in the Social Security trust funds is offset by a deepening deficit in Medicare's Hospital Insurance fund, which explains why their combined surplus is nearly flat at about \$70 billion annually.

A second Medicare program--Supplementary Medical Insurance, or SMI--runs a small surplus or deficit in every year by design. SMI gets roughly one-fourth of its income from enrollee premiums and taps the general fund of the government for the rest of its \$60 billion-plus outlays, generally permitting a small surplus. Apart from Social Security and Medicare, total trust fund surpluses run about \$40 billion a year and are concentrated in the federal employee retirement and unemployment insurance programs.

In 1995, the total deficit is expected to be \$176 billion. It can be divided into a federal funds deficit of \$283 billion offset by a trust fund surplus of \$107 billion. The line between federal funds and trust funds is not so neat, however, because trust funds receive a large portion of their income from transfers within the budget. Such transfers shift money from the general fund (thereby boosting the federal funds deficit) to trust funds (thus swelling the trust fund surplus). Those intragovernmental transfers total more than \$200 billion in 1995. Prominent among them are interest paid to trust funds (about \$86 billion in 1995), government contributions to retirement funds on behalf of present and past federal employees (\$67 billion), and contributions by the general fund to Medicare, principally SMI (\$41 billion). Clearly, each of those transfers was instituted for a purpose--for example, to force agencies to reflect the cost of funding future retirement benefits in weighing their hiring decisions. But it is equally clear that transferring money from one part of the government to another does not change the total deficit or the government's borrowing needs. Without those intragovernmental transfers, the trust funds would have an overall deficit in every year--ranging from about \$100 billion in 1995 to almost \$200 billion in 2000.

1. See Congressional Budget Office, "Implications of Revising Social Security's Investment Policies," CBO Paper (September 1994), and *The Economic and Budget Outlook: Fiscal Years 1990-1994* (January 1989), Chapter 3.

Changes in the Budget Outlook Since August

The budget outlook has worsened only marginally since CBO published its projections last August. Projected deficits are up in every year--by \$13 billion in 1995, \$31 billion in 1996 and 1997, and slightly smaller amounts thereafter (see Table 2-3). Most of

the revision comes from changes in CBO's outlook for the economy.

A Last Look at 1994

Last August, CBO projected a 1994 deficit of \$202 billion; two months later, the Treasury Department reported that red ink for that past fiscal year had totaled \$203 billion. Although CBO's estimate of the

Table 2-3.
Changes in CBO Deficit Projections Since August 1994 (By fiscal year, in billions of dollars)

	Actual 1994	1995	1996	1997	1998	1999
August 1994 Estimate	202	162	176	193	197	231
Legislative Changes						
Revenues	0	-1	1	1	3	3
Outlays	<u>1</u>	<u>3</u>	<u>1</u>	<u>a</u>	<u>a</u>	<u>a</u>
Deficit	1	2	2	2	3	3
Economic Changes						
Revenues	a	2	9	8	3	a
Outlays						
Net interest	a	8	16	17	15	15
Other outlays	<u>a</u>	<u>a</u>	<u>a</u>	<u>1</u>	<u>2</u>	<u>2</u>
Subtotal	a	8	16	19	17	17
Deficit	a	10	25	27	20	17
Technical Changes						
Revenues	8	6	5	6	9	11
Outlays						
Medicaid and Medicare	a	-7	-6	-8	-11	-15
Other major benefit programs	a	1	1	1	2	2
Deposit insurance	-2	1	3	a	a	1
Net interest	1	a	-1	a	a	1
Other outlays	<u>-6</u>	<u>-1</u>	<u>3</u>	<u>2</u>	<u>2</u>	<u>3</u>
Subtotal	-7	-5	a	-4	-7	-9
Deficit	1	1	5	2	2	2
Total Changes	2	13	31	31	26	22
Current Estimate	203	176	207	224	222	253

SOURCE: Congressional Budget Office.

NOTES: Reductions in revenues are shown with a positive sign because they increase the deficit.

The deficit projections assume that discretionary spending rises with inflation after the caps expire in 1998.

a. Less than \$500 million.

deficit was almost exact, CBO overestimated both revenues and outlays by about equal amounts (see Table 2-3). Revenues were approximately \$8 billion less than expected, with most of the shortfall coming in individual income taxes, and CBO overestimated outlays by more than \$6 billion. Except for deposit insurance, which came in \$2 billion lower than CBO expected, hardly any major program or category differed from CBO's projections by more than a few hundred million dollars.

Revisions to the 1995-1999 Projections

CBO traditionally traces the reason for its revisions to the budget outlook to three sources: newly enacted legislation; changes in the economic outlook; and other, so-called technical factors.

Recent Legislation. Legislation enacted since last August has added \$2 billion to \$3 billion a year to projected deficits, or \$12 billion altogether over the 1995-1999 period. Legislation to implement the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) added less than \$3 billion over that period. That legislation significantly reduced collections from tariffs but recouped much of the loss by accelerating tax deadlines, tightening the rules governing underfunded private pension plans, reducing farm subsidies, and cutting the interest rate paid by the government on certain tax refunds to corporations. Other new legislation granted disaster aid to farmers in 1995 and reformed the crop insurance program (a shift that may mitigate the future need for ad hoc emergency aid), relaxed the stringent provisions for payments of Federal Insurance Contributions Act (FICA) taxes on behalf of occasional household workers, and made other, smaller changes to numerous programs.

Discretionary appropriations for fiscal year 1995 conformed precisely to the outlay limits set by law.² Because CBO assumed such an outcome in the projections it issued last August, no adjustment--other than to reflect the few emergency appropriations for fiscal year 1995--is called for. While staying within

the outlay caps, the appropriators were able to increase budget authority by about 2 percent in dollar terms compared with 1994, equivalent to a reduction of about 1 percent in real terms. Deeper-than-average reductions were imposed on funding in the areas of space and science, energy, agriculture, and general government functions such as the Internal Revenue Service. Programs faring somewhat better were education, training, and social services; subsidized housing; and crime prevention.

Economic Changes. Revisions that stem from changes in the economic outlook largely explain the mild deterioration in the deficit picture. Projected revenues are down, outlays are up, and hence the deficit is bigger. CBO has shaved its projections of wage and salary income, the single biggest component of GDP. Consequently, projected revenues from two sources--individual income taxes and social insurance taxes--are weaker. The outlook for corporate profits remains strong, and CBO has upped its estimate of collections from that source. The net reductions in revenues from the new economic forecast are greatest in 1996 and 1997. That is no coincidence; CBO forecasts that an economic slowdown will begin in late 1995, as the Federal Reserve nudges growth back to a rate that is compatible with low inflation.

Of course, interest rates are the Federal Reserve's main tool for achieving that goal, and the federal government--as a major borrower--is directly affected. Extra interest costs will be \$8 billion in 1995 and \$15 billion a year or more in 1996 through 1999, compared with the estimates CBO made last August (see Table 2-3). Noninterest outlays will be up modestly, chiefly because of larger cost-of-living adjustments in Social Security and other indexed programs and greater costs for student loans, which are sensitive to interest rates.

Technical Reestimates. Technical revisions are any changes that are not ascribed to legislation or to macroeconomic variables. Such changes have little net effect on CBO's deficit outlook because downward revisions to revenues and outlays, primarily Medicaid, are roughly offsetting.

As noted before, revenues in 1994 fell short of CBO's August projection by about \$8 billion. Most

2. See Congressional Budget Office, "Final Sequestration Report for Fiscal Year 1995" (December 9, 1994).

of the technical revision on the revenue front comes from assuming that this weakness will persist. A small revision--less than \$300 million a year--stems from the expiration of taxes for the oil spill liability trust fund in December 1994. As required by the Balanced Budget Act, CBO had assumed in its previous baseline that those taxes--like all excise taxes dedicated to trust funds--would be extended, but that did not happen.

On the outlay side, the largest revision by far is in the Medicaid program, which is down by \$6 billion in 1995 and by growing amounts thereafter. Fiscal year 1994 witnessed Medicaid growth of just 8 percent--a remarkable slowdown for a program that had doubled in cost in just four years. Anecdotal evidence from the states, which administer the program and charge the federal government for matching payments, suggests that many states are limiting optional coverage and shifting enrollees into health maintenance organizations and other cost-saving arrangements. Disproportionate share payments to hospitals, designed to compensate institutions that care for large numbers of indigent patients, apparently did not grow at all in 1994 as states weighed how to respond to new limitations placed on the provider donation and tax schemes that some states had used to help fund their portion of those payments. In light of those developments, CBO has trimmed its projections of future Medicaid outlays.

A much milder slowdown is apparent in Medicare. That program continues to operate fundamentally on a fee-for-service basis with universal coverage for the eligible population, meaning that some tools wielded by other payers--notably restrictions on coverage and choice--have not been available to it. Although the growth of payments for hospitalizations and physician visits does appear to be decelerating, those reductions are roughly offset by fast-growing costs for care in other settings, particularly for home health care and skilled nursing facilities.

CBO has bumped up its projections of deposit insurance outlays modestly. That change reflects a diminished flow of money from liquidations and a larger-than-anticipated premium cut by the Bank Insurance Fund. Technical revisions to areas other than those mentioned are small.

The Spending Outlook

CBO expects that federal spending will top the \$1.5 trillion mark in 1995. For more than a decade, policymakers and budget analysts have divided the spending side of the huge federal budget into several convenient clusters. The categories were formalized in 1990's Budget Enforcement Act.

Discretionary spending denotes programs controlled by annual appropriation bills. For those programs--whether defense, international, or domestic--policymakers decide afresh each year how many dollars will be devoted to continuing existing activities and funding new ones. The baseline projections depict the path of discretionary spending as a whole, assuming that the Congress exactly complies with the caps on discretionary spending dictated by the Balanced Budget Act through 1998. Of course, the appropriators are free to spend less. There are no caps after 1998. Therefore, CBO presents two alternative paths--one in which discretionary spending is frozen in real terms, the other, more stringent one involving a freeze in dollar terms.

All other spending is controlled by existing laws, and the baseline presents CBO's best guess of spending if those laws and policies remain unchanged. *Entitlements and other mandatory spending* consist overwhelmingly of benefit programs, such as Social Security, Medicare, and Medicaid. Spending for those programs is generally controlled by setting eligibility rules, benefit levels, and so forth rather than by voting annually for dollar amounts. *Offsetting receipts*--fees and similar charges that are recorded as negative outlays--likewise are changed only when the Congress revisits the underlying laws. *Deposit insurance spending* reflects the net outlays caused by the government's pledges to protect depositors in insolvent institutions. And growth in *net interest spending* is driven by the government's deficits and by market interest rates.

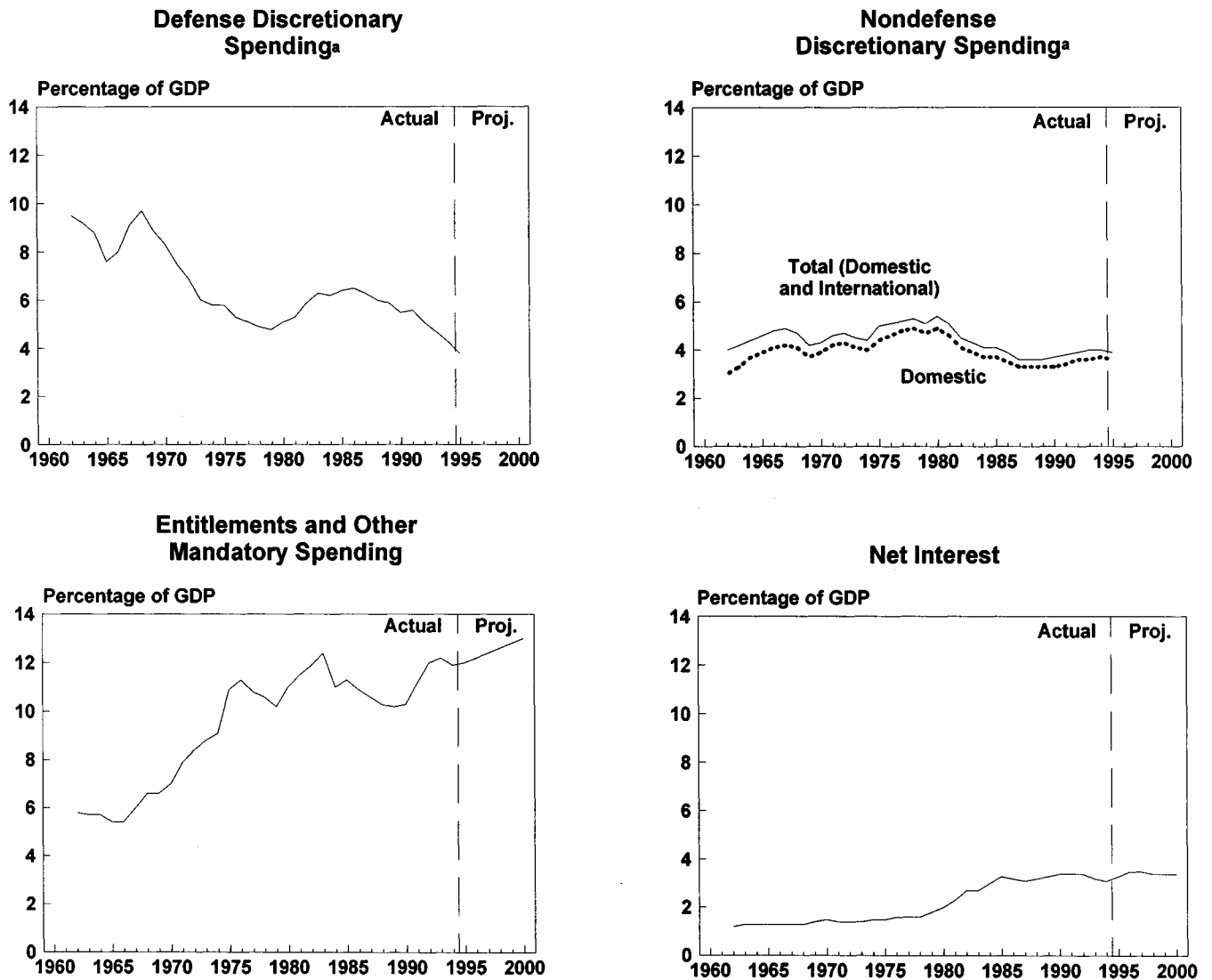
Federal spending now represents about 22 percent of gross domestic product and is expected to stay near that level over the next five years. In the 1960s, federal spending averaged about 19 percent of GDP; for the 1970s and 1980s, the figures were about

21 percent and 23 percent, respectively. Clearly, that percentage has not fluctuated violently. But a pronounced shift has taken place in the composition of federal spending. The government today spends more on entitlement programs and on net interest, and less on discretionary activities, than in the past (see Figure 2-2). More detailed historical data are contained in Appendix E, which lists annual totals for each of these broad categories of spending and for federal revenues.

Discretionary Spending: Defense, International, and Domestic

Each year, the Congress starts with a clean slate in the appropriation process. It votes on budget authority--the authority to commit money--for discretionary activities of the budget, and that authority translates into outlays with a lag. Discretionary programs cover virtually the entire defense and interna-

Figure 2-2.
Outlays by Category as a Share of GDP



SOURCE: Congressional Budget Office.

a. Assumes compliance with discretionary spending caps in the Balanced Budget Act.

tional affairs budgets, but only one-fifth of all domestic spending (the remaining four-fifths of domestic spending is mandatory). In 1995, discretionary spending is expected to total \$544 billion, half of it for defense.

Relative to the economy, total discretionary spending is down markedly from typical levels of the 1960s and 1970s. The fortunes of defense and domestic programs have waxed and waned several times over the past few decades. Comparisons with GDP, however, merely express how much a society devotes to public spending in relation to its resources; they tell nothing about the adequacy of such spending, especially as the needs of the nation and the threats faced by it have changed over time.

Defense Discretionary Spending. The share of GDP that is devoted to defense has gradually shrunk in the past three decades, with only two major interruptions: the Vietnam War of the late 1960s and the Reagan-era defense buildup of the early 1980s. Even the costs of Operation Desert Storm appeared as barely a blip against that downward trend. Today, defense outlays are just below 4 percent of GDP. In dollar terms, defense outlays peaked at about \$300 billion annually in 1989 through 1991 (not counting estimated spending on Desert Storm in that final year). At \$270 billion in 1995, defense outlays are down about 10 percent from those 1989-1991 levels in dollar terms and about one-quarter in real terms. Approximately 40 percent of the dollars devoted to defense go to compensate members of the armed services and civilian employees of the Department of Defense.

Domestic Discretionary Spending. Even as defense spending generally drifted down (in relation to GDP) in the 1960s and 1970s, discretionary spending for domestic programs climbed slowly. It peaked at 4.9 percent of GDP in 1980 before its rise was abruptly reversed. Today, it totals about 3½ percent of GDP, not quite three-fourths of its peak levels in the mid-1970s.

Domestic discretionary spending encompasses a wide variety of federal government activities. Of the \$253 billion in expected outlays for 1995, leading claimants are education, training, and social services

(\$39 billion); income security, chiefly housing subsidies and the administrative costs of running entitlement programs (\$39 billion); transportation (\$38 billion); the administration of justice and general government activities such as running the Internal Revenue Service (together, \$29 billion); natural resources and environment (\$21 billion); health research and public health (\$22 billion); veterans' benefits, chiefly medical care, other than direct cash payments (\$18 billion); and space and science (\$17 billion). Approximately one-fourth of domestic discretionary spending goes to pay the compensation of federal employees at nondefense agencies.

So far, domestic discretionary spending has not fared badly under the caps. Although the caps have roughly imposed a freeze on total discretionary outlays since 1991, the steady shrinkage in defense allowed modest increases in domestic programs. Domestic discretionary spending has claimed a steady 3½ percent of GDP since 1991, the first year of the caps, even as defense has shrunk by about a percentage point relative to GDP.

International Discretionary Spending. The smallest of the three major categories of discretionary outlays is international discretionary spending, totaling about \$21 billion in 1995. As a share of GDP, this spending has slipped steadily for the past three decades to 0.3 percent of GDP in 1995. This category chiefly includes aid to other countries for humanitarian or security purposes, contributions to international organizations such as the United Nations, and the conduct of foreign affairs.

Discretionary Spending and the Statutory Caps Through 1998. Since 1991, dollar caps set in the Budget Enforcement Act and in the Omnibus Budget Reconciliation Act of 1993 (as amendments to the Balanced Budget Act) have crimped spending for discretionary programs. In 1991 through 1993, separate caps applied to defense, international, and domestic appropriations. Since 1994, a single lid has applied to all three categories, sharpening the competition for resources.

As explained below, the caps will barely allow programs to grow in dollar terms from today's levels over the 1996-1998 period. Because inflation,

though subdued, continues at about 3 percent a year, appropriations for discretionary programs will therefore shrink by about 9 percent in real terms.

Separate caps apply to budget authority and outlays. *Budget authority* is the basic currency of the appropriation process; it represents the permission to commit funds. That commitment always precedes actual *outlays* or disbursements--with a short lag for fast-spending activities such as meeting payrolls or providing services directly, and a longer lag for slow-spending activities such as the procurement of weapons or other complex items. Because the caps limit both budget authority and outlays, the more stringent one prevails. In 1992 through 1995, appropriators found the outlay cap tougher to satisfy, and budget authority was therefore billions of dollars under its limit. During the 1996 appropriation cycle, however, that appears unlikely to be the case.

The appropriations debate has thousands of possible outcomes because so many programs are funded out of this single pot. But it is useful to compare the caps with two hypothetical paths for discretionary spending. Both paths take as their starting point the funds actually appropriated in 1995, or a little more than \$500 billion in total discretionary budget authority. The first path, a traditional *inflation-adjusted baseline*, preserves real resources at 1995 levels by assuming that future appropriations for each program grow in step with inflation (about 3 percent a year). The second path, an *across-the-board freeze*, restricts each program to the same dollars it received in 1995--forcing it to trim its activities by about 3 percent a year in real terms. Both paths omit any future spending for emergencies such as natural disasters, which cannot be anticipated, but focus instead on the nuts-and-bolts activities of the government.

In both paths, projected levels of budget authority for domestic programs appear slightly erratic from year to year because of fluctuations in the volume of long-term contracts for subsidized housing units that come up for renewal. CBO assumes, for example, that around \$10 billion in such contracts will come due in both 1996 and 1997--versus just \$3 billion in 1995 and \$19 billion in 1998. The Budget Enforcement Act directs CBO to incorporate such renewals, which merely maintain the current stock of subsidized housing units, into its baseline pro-

jections. All other domestic program in these illustrations are simply adjusted by inflation (in the first path) or by nothing at all (in the second).

Overall, the caps are barely more generous than a simple freeze on appropriations in 1996 and beyond (see Table 2-4). An across-the-board freeze would bring total discretionary budget authority to about \$516 billion and outlays to \$542 billion in 1996--within a billion dollars of the limit on budget authority. That approach would seemingly leave the appropriators with \$7 billion in allowable outlays to spare. Yet they could use hardly any of that elbow room without breaching the limits on budget authority, unless they drastically shifted money from slow- to fast-spending programs.

What about 1997 and 1998? The freeze on appropriations would essentially continue. Policymakers would have a mere \$1 billion to spare, over and above such a freeze, because of the outlay caps (see bottom panel of Table 2-4). That amount is a tiny fraction of the several tens of billions of dollars that they would need to shield all programs from real cuts.

The defense-versus-domestic competition does not promise easy trade-offs. The Clinton Administration will submit its proposed budget for 1996, including its requested funding for defense, in early February. CBO does not know what the President will propose. But a year ago, the Administration requested \$256 billion in defense budget authority in 1996. Granting such a request would leave \$261 billion for domestic and international budget authority--just enough, as suggested in Table 2-4, to preserve those two categories in real terms if the Congress so chose. But adding to the President's request for defense--as many advocates are now urging--obviously requires taking the dollars from elsewhere.

Discretionary Programs After 1998. The discretionary caps expire after 1998, when such spending will have been roughly frozen for eight years. The outlook for the deficit after 1998 hinges on what happens next.

Of course, the caps on discretionary spending are already playing a vital role in taming the deficit (see Table 2-5). If such programs were merely permitted

Table 2-4.
How Tight Are the Discretionary Caps? (By fiscal year, in billions of dollars)

	1996	1997	1998
Budget Authority			
Discretionary Caps ^a	517	527	531
Amount Needed to Preserve 1995 Real Resources			
Defense	272	282	291
International	21	22	23
Domestic	<u>241</u>	<u>250</u>	<u>268</u>
Total	534	554	582
Amount over or under (-) caps	17	27	50
Amount Needed to Freeze 1995 Dollar Resources			
Defense	263	263	263
International	20	21	21
Domestic	<u>232</u>	<u>234</u>	<u>242</u>
Total	516	517	526
Amount over or under (-) caps	-1	-10	-6
Outlays			
Discretionary Caps ^a	549	548	547
Amount Needed to Preserve 1995 Real Resources			
Defense	270	278	285
International	22	22	22
Domestic	<u>262</u>	<u>274</u>	<u>284</u>
Total	554	574	592
Amount over or under (-) caps	5	26	44
Amount Needed to Freeze 1995 Dollar Resources			
Defense	264	264	262
International	21	21	21
Domestic	<u>257</u>	<u>262</u>	<u>263</u>
Total	542	547	546
Amount over or under (-) caps	-7	-1	-1

SOURCE: Congressional Budget Office.

NOTE: Amounts needed to preserve 1995 real resources include adjustments for inflation of about 3 percent a year. Amounts needed to freeze 1995 dollar resources include no adjustment for inflation. Both paths include the budget authority necessary to renew expiring contracts for subsidized housing. There are no discretionary caps after 1998.

a. The estimated caps are based on those published in CBO's *Sequestration Preview Report for Fiscal Year 1996*, included as Appendix A of this volume, as modified for small adjustments that by law will be made at a later date.

Table 2-5.
Three Scenarios for Discretionary Spending and the Deficit (By fiscal year, in billions of dollars)

	1995	1996	1997	1998	1999	2000
Projections Assuming Full Discretionary Inflation After 1995						
Revenues	1,355	1,418	1,475	1,546	1,618	1,697
Outlays						
Discretionary	544	554	574	592	613	634
Net interest	235	260	272	283	300	320
All other	<u>752</u>	<u>816</u>	<u>881</u>	<u>942</u>	<u>1,012</u>	<u>1,086</u>
Total	1,531	1,630	1,727	1,817	1,925	2,040
Deficit	176	212	251	270	306	342
Deficit as a Percentage of GDP	2.5	2.9	3.2	3.3	3.6	3.8
Baseline Projections With Discretionary Inflation After 1998						
Revenues	1,355	1,418	1,475	1,546	1,618	1,697
Outlays						
Discretionary	544	549	548	547	566	585
Net interest	235	260	270	279	294	310
All other	<u>752</u>	<u>816</u>	<u>881</u>	<u>942</u>	<u>1,012</u>	<u>1,086</u>
Total	1,531	1,625	1,699	1,769	1,872	1,981
Deficit	176	207	224	222	253	284
Deficit as a Percentage of GDP	2.5	2.8	2.9	2.7	3.0	3.1
Baseline Projections Without Discretionary Inflation After 1998						
Revenues	1,355	1,418	1,475	1,546	1,618	1,697
Outlays						
Discretionary	544	549	548	547	547	547
Net interest	235	260	270	279	293	308
All other	<u>752</u>	<u>816</u>	<u>881</u>	<u>942</u>	<u>1,012</u>	<u>1,086</u>
Total	1,531	1,625	1,699	1,769	1,852	1,941
Deficit	176	207	224	222	234	243
Deficit as a Percentage of GDP	2.5	2.8	2.9	2.7	2.7	2.7

SOURCE: Congressional Budget Office.

NOTES: "Discretionary inflation" represents inflation in discretionary spending.

Caps on discretionary spending are set by law through 1998. The first scenario shows what would happen if discretionary outlays were permitted to rise with inflation after 1995, in violation of the caps. The second assumes that discretionary spending complies with the caps through 1998 and grows at the rate of inflation thereafter. The third assumes that discretionary spending complies with the caps through 1998 and is frozen thereafter.

to grow in step with inflation after this year, the deficit would be sharply higher than in CBO's baseline projections--\$270 billion (rather than \$222 billion) in 1998, and \$342 billion in 2000. The deficit would climb relentlessly as a percentage of GDP. The extra costs would appear not just in discretionary spending itself, but also in net interest costs as the Treasury would be forced to borrow more.

CBO's baseline, however, does assume compliance with the statutory caps through 1998. If discretionary spending then keeps up with inflation in 1999 and 2000--the last two years of the standard budget horizon--the deficit would climb from \$222 billion in 1998 to \$284 billion in 2000, and from 2.7 percent of GDP to 3.1 percent in those same years. Discretionary programs themselves would not absorb a growing share of GDP. Because they would grow no faster than inflation, they would actually shrink in relation to GDP. But they would not shrink enough to offset trends in mandatory spending, interest, and revenues--the subjects of the rest of this chapter--which tug in the opposite direction.

Finally, policymakers could opt to keep discretionary spending frozen at the 1998 level. That would keep the deficit at a flat 2.7 percent of GDP in 1998 through 2000. Clearly, that stability comes at the price of steady reductions in the activities and services funded by those appropriations; in real terms, discretionary outlays would shrink by about 6 percent between 1998 and 2000, and by a total of about 20 percent between 1991 (the first year of the caps) and 2000.

Last year, the Congress settled on one means of constraining the growth of discretionary spending and helping to comply with the caps: reductions in federal civilian employment. Nearly all civilian employees of the government are paid from discretionary funds. The Congress limited the employment of executive branch, non-postal civilians, measured on a full-time-equivalent basis, to 2.1 million in 1994 and to lower levels in each year thereafter--reaching 1.9 million in 1999. Between 1995 and 1999, the shrinkage in employment amounts to 8 percent. The Congress did not spell out reductions by agency or activity. Falling employment will permit reductions in agencies' appropriations. But the resulting year-to-year declines in payroll will be at least partly offset

if pay raises are granted to those still employed, as called for under current law.

Entitlements and Mandatory Programs

More than half the \$1.5 trillion of federal spending goes for entitlements and mandatory programs. If current policies remain unchanged, mandatory programs are expected to top \$1 trillion in 1998--almost twice as much as discretionary spending in that year, the last one governed by the caps (see Table 2-6). Mandatory programs make payments to recipients--usually people, but occasionally businesses, not-for-profit institutions, or state and local governments--who are eligible and apply for funds. Payments are governed by formulas set in law and are not constrained by annual appropriation bills.

The Balanced Budget Act lumps mandatory programs (other than Social Security) together with receipts and subjects them to a pay-as-you-go discipline; that is, liberalizations in those programs are supposed to be funded by cutbacks in other mandatory spending or by increases in taxes or fees. (Similarly, tax cuts must be offset by other tax increases or by savings in mandatory spending.) Social Security has its own set of procedural safeguards, erected to prevent policy actions that would worsen the long-run condition of the trust funds. In its baseline, CBO depicts the likely path of entitlement and mandatory spending if current laws remain unchanged.

Only about one-fourth of entitlement and mandatory spending, or one-eighth of all federal spending, is means-tested--that is, paid to people who must document their need based on low income or limited assets (and often other criteria, such as family status). The remainder, led by the government's big retirement-related programs, has no such requirements and is labeled non-means-tested.

Means-Tested Programs. Medicaid, the joint federal and state program providing medical care to some of the poor, makes up about half of means-tested entitlements. CBO projects that federal outlays for Medicaid will reach \$149 billion in 2000, with growth averaging a little over 10 percent a year in the intervening period (see Table 2-7).

Table 2-6.
CBO Projections of Outlays by Category, Assuming Discretionary Inflation After 1998 (By fiscal year)

Spending Category	Actual 1994	1995	1996	1997	1998	1999	2000
In Billions of Dollars							
Discretionary ^a							
Defense	282	270	270	278	285	295	304
International	20	21	22	22	22	23	24
Domestic	242	253	262	274	284	295	306
Unspecified reductions	<u>0</u>	<u>0</u>	<u>-5</u>	<u>-26</u>	<u>-44</u>	<u>-47</u>	<u>-49</u>
Subtotal	545	544	549	548	547	566	585
Mandatory Spending	789	845	899	962	1,026	1,097	1,173
Deposit Insurance	-7	-16	-9	-5	-5	-3	-3
Offsetting Receipts	-69	-77	-73	-76	-79	-82	-84
Net Interest	<u>203</u>	<u>235</u>	<u>260</u>	<u>270</u>	<u>279</u>	<u>294</u>	<u>310</u>
Total	1,461	1,531	1,625	1,699	1,769	1,872	1,981
On-budget	1,181	1,242	1,323	1,386	1,443	1,530	1,626
Off-budget ^b	279	289	302	313	326	341	355
As a Percentage of GDP							
Discretionary ^a							
Defense	4.3	3.8	3.7	3.6	3.5	3.4	3.4
International	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Domestic	3.7	3.6	3.6	3.5	3.5	3.4	3.4
Unspecified reductions	<u>0</u>	<u>0</u>	<u>-0.1</u>	<u>-0.3</u>	<u>-0.5</u>	<u>-0.5</u>	<u>-0.5</u>
Subtotal	8.2	7.7	7.4	7.1	6.7	6.6	6.5
Mandatory Spending	11.9	12.0	12.2	12.4	12.6	12.8	13.0
Deposit Insurance	-0.1	-0.2	-0.1	-0.1	-0.1	c	c
Offsetting Receipts	-1.0	-1.1	-1.0	-1.0	-1.0	-1.0	-0.9
Net Interest	<u>3.1</u>	<u>3.3</u>	<u>3.5</u>	<u>3.5</u>	<u>3.4</u>	<u>3.4</u>	<u>3.4</u>
Total	22.0	21.8	22.1	21.9	21.7	21.8	22.0
On-budget	17.8	17.6	18.0	17.9	17.7	17.9	18.0
Off-budget ^b	4.2	4.1	4.1	4.0	4.0	4.0	3.9

SOURCE: Congressional Budget Office.

- a. Discretionary spending caps are set in the aggregate through 1998. Projections for individual categories (defense, international, and domestic) show amounts that would be spent if 1995 funding levels were increased by the rate of inflation. Unspecified reductions show the cuts that would then be needed to satisfy the caps. Projections for 1999 and 2000 represent 1998 spending adjusted for inflation.
- b. Social Security and the Postal Service.
- c. Less than 0.05 percent of gross domestic product.

Table 2-7.
CBO Baseline Projections for Mandatory Spending (By fiscal year, in billions of dollars)

	Actual 1994	1995	1996	1997	1998	1999	2000
Means-Tested Programs							
Medicaid	82	90	100	111	123	136	149
Food Stamps ^a	25	26	27	29	30	32	32
Supplemental Security Income	24	24	24	29	32	35	40
Family Support	17	18	18	19	19	20	20
Veterans' Pensions	3	3	3	3	3	3	3
Child Nutrition	7	8	8	9	9	10	10
Earned Income Tax Credit	11	17	20	23	24	25	26
Student Loans ^b	3	4	3	3	3	3	3
Other	<u>3</u>	<u>3</u>	<u>4</u>	<u>4</u>	<u>5</u>	<u>5</u>	<u>5</u>
Total, Means-Tested Programs	177	194	208	229	248	268	290
Non-Means-Tested Programs							
Social Security	317	334	352	371	390	411	433
Medicare	<u>160</u>	<u>176</u>	<u>196</u>	<u>217</u>	<u>238</u>	<u>262</u>	<u>286</u>
Subtotal	476	510	548	587	628	673	720
Other Retirement and Disability							
Federal civilian ^c	40	42	43	46	48	50	53
Military	27	28	29	31	32	35	37
Other	<u>5</u>	<u>5</u>	<u>5</u>	<u>5</u>	<u>5</u>	<u>5</u>	<u>6</u>
Subtotal	72	75	77	81	85	90	96
Unemployment Compensation	26	22	23	24	26	27	28
Other Programs							
Veterans' benefits ^d	18	17	17	18	19	20	21
Farm price supports	10	10	9	9	8	8	8
Social services	6	6	6	6	6	6	6
Credit reform liquidating accounts	-7	1	e	-2	-3	-6	-6
Other	<u>11</u>	<u>11</u>	<u>11</u>	<u>10</u>	<u>10</u>	<u>11</u>	<u>9</u>
Subtotal	37	45	43	41	39	39	39
Total, Non-Means-Tested Programs	612	651	691	733	778	829	882
Total							
Total Mandatory Spending	789	845	899	962	1,026	1,097	1,173

SOURCE: Congressional Budget Office.

NOTE: Spending for major benefit programs shown in this table includes benefits only. Outlays for administrative costs of most benefit programs are classified as domestic discretionary spending; Medicare premium collections are classified as offsetting receipts.

- a. Includes nutrition assistance to Puerto Rico.
- b. Formerly known as guaranteed student loans.
- c. Includes Civil Service, Foreign Service, Coast Guard, and other retirement programs, and annuitants' health benefits.
- d. Includes veterans' compensation, readjustment benefits, life insurance, and housing programs.
- e. Less than \$500 million.

The growth in Medicaid has subsided from the sky-high rates of the early 1990s. The program jumped by 20 percent to 30 percent a year from 1990 through 1992, but its growth decelerated to 12 percent in 1993 and just 8 percent in 1994. The program's surge was fueled by population pressures, inflation in the medical care sector, liberalizations in Medicaid eligibility contained in legislation (especially coverage of poor children), the recession, court decisions that made the federal government raise its payments to institutions, and the fiscal pressures facing state and local governments that drove many of them to maximize funds from the federal government. One particular component of Medicaid--direct federal payments to hospitals that serve many charity cases, termed disproportionate share hospitals--soared from practically nothing in 1989 to almost \$10 billion in 1992 but then failed to grow at all in 1993 and 1994.

Several other means-tested programs have experienced rapid growth, although they do not rival Medicaid in size. Prominent among them are food stamps (up by two-thirds since 1990), which are available to virtually all who qualify on the basis of low income and assets regardless of age or family status; Supplemental Security Income for the aged, blind, and disabled, which has seen its caseload of disabled participants, especially children, and of elderly immigrants climb steeply; and the refundable portion of the earned income tax credit (EITC). A longtime supplement to the earnings of low-income families with children, the EITC was made more generous in OBRA-93 and broadened to cover some childless people. Although the EITC is a provision of the tax code, direct payments to recipients who otherwise owe no taxes--which make up more than 80 percent of the provision's total cost--are treated as outlays since they are equivalent to benefit payments.

One program categorized as means-tested fits somewhat uneasily into that category. That program, student loans, is making or guaranteeing ever-larger volumes of loans (estimated at \$13 billion in 1992, \$22 billion in 1994, and \$33 billion in 2000). And a growing fraction of that volume--projected to climb from 25 percent in 1992 to more than 40 percent in 2000--goes to students or parents who may borrow regardless of income or assets. Since 1992, under the reformed accounting for credit programs mandated

by the Budget Enforcement Act, the outlays for new loans that are recorded in the budget have not represented annual cash flows but rather the estimated long-run loss to the government, which takes into account subsidized interest charges, the expected default of some loans, and other expected costs over the loans' lifetime. That is why the student loan program displays costs of about \$3 billion a year, despite ever-growing volume. Those costs are primarily associated with students and parents who satisfy the income and asset tests. Although all borrowers have some propensity to default and all enjoy benefits such as caps on interest rates, only that subset of low-income borrowers qualifies for one of the most attractive (and, for the government, costly) features of the program--an interest-free period while the student remains in school.

Non-Means-Tested Programs. Social Security, Medicare, and other retirement and disability programs dominate non-means-tested entitlements. In fact, Social Security surpassed defense in 1993 to become the single biggest program run by the government. Most Social Security beneficiaries, who now number 43 million, also participate in Medicare.

Although Social Security is the larger program, Medicare has grown much faster despite repeated legislative modifications that have reduced spending for the health program significantly below what it would have been in the absence of those efforts. Over the past decade, Medicare grew by an average of 10 percent a year versus Social Security's 6 percent, and similar growth rates are projected for the next five years.

Other retirement and disability programs, at \$75 billion in 1995, are less than one-fourth the size of Social Security. They are dominated by benefits for the federal government's civilian and military retirees and Railroad Retirement. Outlays for unemployment compensation peaked at \$37 billion in 1992, a recession year, and are now less than two-thirds as large.

Other non-means-tested entitlements encompass a diverse set of programs, mainly veterans' benefits, farm price supports, and certain social service grants to the states. This category totals \$45 billion in 1995. It shrinks gradually through 2000, essentially mirroring one of its components: the so-called credit liqui-

Table 2-8.
Sources of Growth in Mandatory Spending (By fiscal year, in billions of dollars)

	1996	1997	1998	1999	2000
Projected 1995 Spending	845	845	845	845	845
Sources of Growth					
Growth in caseloads	15	28	41	55	68
Cost-of-living adjustments	10	26	43	62	80
Other automatic increases in benefits ^a	6	15	24	32	41
Other increases in Medicaid and Medicare ^b	20	38	60	85	112
Other growth in average Social Security benefits ^c	5	8	11	15	20
Irregular number of benefit payments ^d	-3	0	0	0	5
Change in outlays of credit reform liquidating accounts	-1	-3	-4	-6	-7
Other	<u>2</u>	<u>3</u>	<u>5</u>	<u>9</u>	<u>9</u>
Total	53	117	181	252	327
Projected Spending	899	962	1,026	1,097	1,173

SOURCE: Congressional Budget Office.

- Automatic increases in Food Stamp benefits, Medicare reimbursement rates, and the earned income tax credit under formulas specified by law.
- All growth not attributed to caseloads and automatic increases in reimbursement rates.
- All growth not attributed to caseloads and cost-of-living adjustments.
- Supplementary Security Income and veterans' compensation and pensions will pay 11 months of benefits in 1996, 13 in 2000, and 12 in other years.

dating accounts, set up to record the continuing cash flows from loans obligated or guaranteed before 1992, when credit reform first applied to new loans.

Why Does Mandatory Spending Grow? Spending for entitlement and mandatory programs has nearly doubled over the past decade, prompting many proposals to curtail costs. Some favor a mechanical approach for curbing growth--simply limiting annual growth in outlays, for example, to the sum of growth in caseloads plus inflation and enforcing the limit through across-the-board cutbacks. Such an approach skirts the need to reexamine the justification for each program and probe why some appear to be growing disproportionately.³ More targeted approaches would expand the principle of means-test-

ing by paring back benefits to less needy recipients--by making more benefits subject to income taxation, phasing out benefits depending on beneficiaries' total income, or simply barring the most affluent recipients altogether from eligibility.⁴ The Bipartisan Commission on Entitlement Reform recently considered whether to scale back promises to future beneficiaries but ultimately issued no recommendations to do so.

Why does such spending grow as fast as it does in the CBO baseline? One convenient way of analyzing such growth is to break it down by its major cause--growth in caseloads, automatic increases in benefits, growing use of medical services, and other factors (see Table 2-8).

3. Congressional Budget Office, "Mandatory Spending: Trends and Sources of Growth," CBO Staff Memorandum (July 1992).

4. Congressional Budget Office, *Reducing Entitlement Spending* (September 1994).

Mounting caseloads account for about one-quarter of the growth in entitlement programs--driving up spending by an estimated \$15 billion in 1996 and \$68 billion in 2000, compared with this year's outlays. More than half of that growth is concentrated in the Social Security, Medicare, and Supplemental Security Income programs and is largely traceable to the continued "greying" of the U.S. population and the growing prevalence of disability. Much of the rest of the growth is in Medicaid. Among the "big three" programs, caseload growth--even without other changes--is expected to push up outlays in 2000 by 7 percent relative to 1995 in both Social Security and Medicare and by 20 percent in Medicaid.

Automatic increases in benefits account for about one-third of the growth in entitlement programs. All of the major retirement programs grant automatic cost-of-living adjustments (COLAs) to their beneficiaries. COLAs, which are pegged to the overall consumer price index, are expected to average more than 3 percent a year through 2000. In 1995, outlays for programs with COLAs are already more than \$400 billion, and COLAs are expected to add an extra \$10 billion in 1996 and \$80 billion in 2000. Recent studies have suggested that the consumer price index overestimates the true level of inflation facing consumers. A change in the methods of collecting data on prices or calculating the index, or a legislative change that tied COLAs to something less than the increase in the consumer price index, could substantially reduce the projected costs of automatic increases in benefit programs. In addition, tax collections could be increased; tax brackets, the personal exemption, and the standard deduction are automatically adjusted for changes in the consumer price index. The potential overestimate of inflation by the index, and the possible savings from changes in the index itself or the use of the index in adjusting benefits or taxes, are discussed in more detail in Box 2-1.

Several other programs--chiefly food stamps, the two Medicare programs (Hospital Insurance and Supplementary Medical Insurance), and the earned income tax credit--are also automatically indexed to inflation (except for the EITC, the consumer price index is not the measure of inflation used for those programs). The first program pays annual adjustments according to changes in the Department of Ag-

riculture's Thrifty Food Plan index. Medicare's payments to providers (primarily hospitals and physicians) also climb, by law, in step with specialized price indexes for the medical sector. Moreover, the maximum EITC payment and the income thresholds above which the EITC begins to be phased out are automatically adjusted for inflation. Those indexation practices contribute an extra \$6 billion in outlays in 1996 and \$41 billion in 2000. The Medicaid program, however, is not reflected in those figures. The federal government essentially pays an agreed-upon share of the bills submitted to it by state programs, which obviously rise with inflation. Unlike Medicare, however, Medicaid has no federal reimbursement schedules that rise automatically. Medicaid thus falls into a category of programs that are indirectly, not directly, linked to inflation.

Another third or so of the growth in entitlement spending stems from increases in Medicare and Medicaid costs that cannot be attributed to growth in caseloads or automatic adjustments in reimbursements. First, as just noted, Medicaid grows with inflation even though it is not formally indexed. Second, the health programs have faced steadily rising costs per participant, a trend known in Medicare jargon as "use" or "intensity"--a combination of more services per participant, more technological sophistication, and so forth. The residual growth in Medicare and Medicaid amounts to \$20 billion in 1996 and \$112 billion in 2000.

In most retirement programs, the average benefit grows faster than the COLA alone would explain. Social Security is a prime example. Social Security benefits are tied to retirees' earnings during their working years, adjusted for increases in the cost of living since they retired. Because earnings have gone up faster than the cost of living, the average benefit for a new retiree exceeds the average monthly check of a long-time retiree whose last earnings may have been a decade or two ago and who has been getting only cost-of-living adjustments since then. In addition, the growth in participation in the labor force by women means that more new retirees get benefits based on their own earnings rather than a smaller, spouse's benefit. In Social Security alone, such phenomena are estimated to add \$5 billion in 1996 and \$20 billion by 2000.

Box 2-1.**The CPI as a Measure of the Change in the Cost of Living**

The consumer price index (CPI) probably overstates the increase in the cost of living.¹ Although the amount of overstatement is not known with certainty, the empirical evidence to date, which addresses many but not all of the potential areas of mismeasurement, indicates that the CPI has probably grown faster than the cost of living by between 0.2 and 0.8 percentage points in recent years. Other potential areas of mismeasurement that have not been subjected to empirical examination may offset or add to the overstatement that the empirical studies have found.

The Bureau of Labor Statistics (BLS), which compiles the CPI, is well aware of the possibility of an overstatement. In fact, the estimates of the overstatement depend largely on research conducted by the BLS. However, there is no obvious, simple way to correct the overstatement. The compilation of the CPI is a massive undertaking, requiring extensive surveys and periodic revisions, and there are numerous theoretical and practical difficulties associated with measuring changes in the cost of living. Over the years the BLS has sought to improve the CPI, but some problems defy easy or inexpensive solutions.

The overstatement occurs because a fixed market basket of goods, such as that tracked for purposes of calculating the CPI, will not fully represent current shopping patterns, and adjustments for improvements in the quality of goods are hard to make. The CPI does not reflect how, when the price of one item rises relative to others, people can change their mix of purchases, thereby reducing somewhat the adverse effect of the price increase on their standard of living. For example, the survey on which the CPI is based does not reflect the extent to which consumers have sought out lower-cost

stores such as warehouses or have shifted to lower-cost substitutes such as generic instead of brand name drugs. In addition, the items sampled for price quotes appear to be too heavily weighted toward items whose prices increase more rapidly.

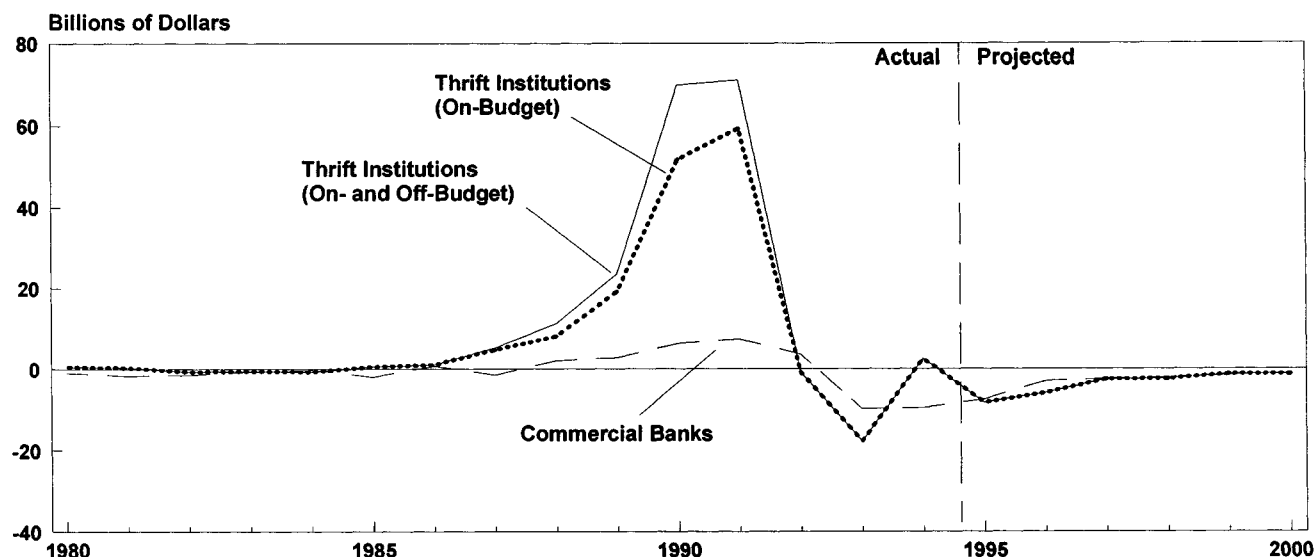
Price increases should be adjusted for changes in quality, and it appears that the CPI on balance underestimates improvements in quality. For example, if the durability of a tire increases, the price should reflect that increase in quality. Adjusting for changes in the quality of most goods and services--such as the quality of audio equipment or a physician's ability to make a correct diagnosis--is difficult to do, however, and the calculation of the CPI does not adjust for a change in quality for many of items used in the survey.

Because the CPI determines the size of the cost-of-living adjustment provided by a number of federal benefit programs and is used to adjust parameters in the personal income tax, the budget is substantially affected by any significant overstatement in its calculation. If the CPI grew 0.5 percentage points slower than the baseline assumes, but all other aspects of the economic forecast were unchanged, by 2000 tax collections would be about \$9 billion higher and spending would be \$13 billion lower than CBO currently projects. Including the debt-service effects of the cumulative savings, the deficit in 2000 would be about \$25 billion lower.

Social Security accounts for almost three-quarters of the effect on indexed federal outlays, and four other programs--the outlay portion of the earned income tax credit, Supplemental Security Income, Military Retirement, and Civil Service Retirement--together account for about 20 percent of the remaining effect. Revenues would be higher because personal income tax brackets, the personal exemption, and the standard deduction are indexed to the CPI. If the CPI grows at a slower pace, the brackets move up less rapidly and a greater percentage of total income is taxed at the higher marginal rates.

1. See Congressional Budget Office, "Is the Growth of the CPI a Biased Measure of Changes in the Cost of Living?" CBO Paper (October 1994).

Figure 2-3.
Deposit Insurance Spending (By fiscal year)



SOURCE: Congressional Budget Office.

NOTE: Off-budget outlays for thrift institutions refer to the net borrowing of the Financing Corporation and the Resolution Funding Corporation, government-sponsored enterprises set up exclusively to borrow funds to pay for resolutions of failed savings and loan institutions.

Depending on calendar flukes, three programs-- Supplemental Security Income and veterans' compensation and pensions--may pay 11, 12, or 13 monthly checks in a fiscal year.⁵ That practice dampens outlays in 1996 and swells them in 2000. Finally, other growth in benefit programs has many causes: rising benefits for new retirees in the Civil Service, Military, and Railroad Retirement programs (fundamentally the same phenomenon as in Social Security); larger average benefits in unemployment compensation, a program that lacks an explicit COLA provision but that pays amounts that are automatically linked to the recent earnings of its beneficiaries; increases in family support costs, largely at the discretion of state governments; and others. All of those factors together, however, contribute just \$9 billion of the total \$300 billion-plus increase between 1995 and 2000. In sum, growth in caseloads, automatic adjustments for inflation, and growing use of medical services are the prime factors pushing up

outlays for entitlement and mandatory spending by almost 40 percent between 1995 and 2000.

Deposit Insurance

Deposit insurance played havoc with budget projections in the late 1980s and early 1990s. It barely registered in the budget totals before then, since for many years income to the deposit insurance funds roughly equaled the modest costs of covering failed institutions. That basically held true even in the early 1980s, when the first savings and loan crisis occurred--triggered by restrictions on institutions' investments and on the interest they could pay to depositors. But the choices made then to relax regulation and to delay shutdowns of troubled institutions proved to be costly. Deposit insurance outlays shot up to a record \$66 billion in 1991, and would have been even higher had policymakers not finessed the costs by creating a so-called government-sponsored enterprise to borrow for the effort (see Figure 2-3). Outlays then plunged to \$3 billion in 1992, and the agencies actually recorded negative outlays (that is, net receipts) of \$28 billion in 1993 and \$7 billion in

5. The number of monthly benefit payments made during a fiscal year depends on whether October 1, the first day of the fiscal year, falls on a work day. If October 1 falls on a weekend, October benefit payments are made on the last working day of September.

1994, indicating that their income from liquidations and other sources far exceeded their disbursements.

Not surprisingly, this extraordinarily volatile category of spending has been one of the biggest sources of uncertainty in Congressional budget projections over the past few years (see Appendix B). Those violent swings appear to be over. CBO expects that this category will continue to record net negative outlays, as documented in Table 2-9.

Savings and Loan Institutions. The Resolution Trust Corporation (RTC), the principal agency heading the savings and loan cleanup since 1989, suffered several prolonged interruptions in funding but finally got the green light in December 1993 to finish its

task. During the droughts in funding, notably from April 1992 until December 1993, the RTC had very limited authority to incur losses. It was largely confined to selling off its portfolio of assets and to tackling the occasional institution that could be closed or merged at little or no cost to the government. Hence, the RTC recorded negative outlays in both 1992 and 1993.

With permission to wrap up its work, the RTC again incurred net outlays (amounting to \$4 billion) in 1994. In July 1995, the RTC will turn over responsibility for future resolutions to the Savings Association Insurance Fund (SAIF), which inherits a much-shrunken but healthier industry.

Table 2-9.
Outlays for Deposit Insurance in the CBO Baseline (By fiscal year, in billions of dollars)

	Actual 1994	1995	1996	1997	1998	1999	2000
Savings and Loan-Related Outlays							
Resolution Trust Corporation	4	-9	-6	-2	-2	-1	-1
Savings Association Insurance Fund	-1	-1	a	a	a	a	a
FSLIC Resolution Fund	<u>a</u>	<u>2</u>	<u>a</u>	<u>a</u>	<u>a</u>	<u>a</u>	<u>a</u>
Total	3	-8	-6	-2	-2	-1	-1
Bank-Related and Other Outlays							
Bank Insurance Fund	-9	-8	-3	-2	-2	-2	-1
Other ^b	<u>a</u>	<u>a</u>	<u>a</u>	<u>a</u>	<u>a</u>	<u>a</u>	<u>a</u>
Total	-10	-8	-3	-3	-2	-2	-1
Total Deposit Insurance							
Total	-7	-16	-9	-5	-5	-3	-3

SOURCE: Congressional Budget Office.

a. Less than \$500 million.

b. Primarily activities of the National Credit Union Administration.

The total tab for the RTC lies somewhere between the sunniest and gloomiest projections made during its early years. CBO now estimates the total value of losses covered by the RTC and its successor through 2000 at about \$90 billion (expressed, by convention, in 1990 dollars). Such calculations exclude disbursements for working capital--funds that the government needs temporarily when it acquires troubled institutions but ultimately recoups when assets are sold. Together with about \$60 billion in losses covered by the Federal Savings and Loan Insurance Corporation and its successor, the FSLIC Resolution Fund--the fund charged with resolving institutions already in government hands before the RTC's creation--the total cost of the cleanup comes to about \$150 billion.

Four and a half years ago, CBO feared that the RTC's costs alone could be as high as \$185 billion, and some outside experts were even more pessimistic. (The Bush Administration, in contrast, originally stated that \$50 billion would be sufficient.) The extraordinarily favorable interest rate environment of the early 1990s is a major reason that the pessimists were pleasantly surprised. For several years, financial institutions enjoyed paying relatively low short-term rates on deposits even as they earned higher rates on their loans and other investments--enabling them to build up their capital or find merger partners more readily. Legislation passed after the RTC's creation further tightened regulatory procedures and required financial institutions to bolster their levels of capital. Also, the industry's shrinkage has eased conditions for survivors, as the most recklessly managed institutions were purged.

However, the RTC's successor, the Savings Association Insurance Fund, may encounter rough sailing. The Bank Insurance Fund, which covers commercial banks, is sufficiently flush with reserves that it is expected to slash insurance premiums for its members drastically in late calendar year 1995. SAIF-covered institutions will not benefit from such a premium cut. Their fund must continue to beef up its reserves even as it pays approximately \$800 million a year in interest on bonds that were issued in the 1980s to help pay savings and loan cleanup costs from that period. As a result, the thrift institutions that are stuck in SAIF will be at a competitive disadvantage. Among the possible consequences for the

institutions are difficulty in raising capital and greater reliance on nondeposit liabilities (such as borrowing from Federal Home Loan Banks), which further narrows the assessable base for premiums--hampering SAIF's ability to build up reserves as required by law.

Commercial Banks. Anxiety about the condition of commercial banks has abated. The government's fund for insuring commercial banks incurred positive outlays in 1988 through 1992 but is now back in the black. In both 1993 and 1994, the Bank Insurance Fund took in almost \$10 billion a year more than it spent, with a smaller excess (\$8 billion) expected in 1995. The fund's reserves are robust enough that CBO expects that its premium rates will be reduced significantly later this year, as permitted by law.

Offsetting Receipts

Offsetting receipts are income that the government records as negative spending. All are either intragovernmental (reflecting payments from one part of the federal government to another) or proprietary (reflecting voluntary payments from the public in exchange for goods or services).

A decision to collect more (or less) in offsetting receipts usually requires a change in the underlying laws generating such collections. In that regard, and in being subject to the pay-as-you-go discipline, offsetting receipts are more like mandatory spending and revenues than like discretionary appropriations.

About one-half of offsetting receipts are intrabudgetary transfers that represent agencies' contributions for their employees' retirement (see Table 2-10). Those contributions are paid primarily to Social Security, Hospital Insurance, the Military Retirement Trust Fund, and the Civil Service Retirement Trust Fund (including the newer Federal Employees Retirement System, which covers civil servants hired since 1983). Some contribution rates are set by statute; others are determined by boards of actuaries. Failing to charge agencies at all for those costs would clearly let them understate their personnel costs, as future retirement benefits are an important part of compensation for the 4½ million current military,

civilian, and postal employees of the U.S. government. To avoid such a perverse result, the budget treats the payments as part of agency budgets and the deposits in retirement funds as offsetting receipts. Those transfers thus wash out in the budgetary totals, leaving only the funds' disbursements--for retirement benefits and administrative costs--reflected in total outlays.

The biggest proprietary receipt collected by the government is premiums from the 35-plus million people who enroll in Supplementary Medical Insurance (Part B of Medicare), which primarily covers physician and outpatient charges. Premium collections from the elderly and disabled grow from an estimated \$20 billion in 1995 to \$28 billion in

2000, as the monthly charge climbs from \$46.10 now to an estimated \$59.00 in 2000. OBRA-93 temporarily reimposed the requirement that premiums cover one-quarter of the costs of SMI. But it stipulated that no beneficiary may suffer a dollar reduction in his or her Social Security check in any January, when the Social Security COLA and the SMI premium hike (usually deducted from the check) simultaneously take effect. Since the typical beneficiary gets a Social Security COLA that exceeds the scheduled increase in the SMI premium, that protection has not barred fairly steep premium increases for most recipients. That provision of OBRA, however, expires after 1998, and premiums will revert to growing no faster than the Social Security COLA.

Table 2-10.
CBO Baseline Projections for Offsetting Receipts (By fiscal year, in billions of dollars)

Category	Actual 1994	1995	1996	1997	1998	1999	2000
Employer Share of Employee Retirement							
Social Security	-6	-6	-7	-7	-8	-8	-9
Military Retirement	-13	-12	-11	-11	-11	-11	-11
Other ^a	<u>-16</u>	<u>-16</u>	<u>-16</u>	<u>-17</u>	<u>-18</u>	<u>-19</u>	<u>-20</u>
Subtotal	-35	-34	-34	-36	-36	-38	-39
Medicare Premiums	-18	-20	-21	-22	-25	-27	-28
Energy-Related Receipts ^b	-5	-5	-5	-5	-5	-4	-4
Natural Resource-Related Receipts ^c	-3	-3	-3	-3	-3	-3	-3
Electromagnetic Spectrum Auctions	d	-6	-1	d	d	-1	d
Other	<u>-9</u>	<u>-9</u>	<u>-9</u>	<u>-10</u>	<u>-10</u>	<u>-9</u>	<u>-9</u>
Total	-69	-77	-73	-76	-79	-82	-84

SOURCE: Congressional Budget Office.

- a. Primarily Civil Service Retirement.
- b. Includes proceeds from sales of power, various fees, and receipts from the naval petroleum reserves and Outer Continental Shelf.
- c. Includes timber and mineral receipts and various user fees.
- d. Less than \$500 million.

Other proprietary receipts come mostly from charges for energy, minerals, and timber and various fees levied on users of government property or services. A new entry--receipts from the Federal Communications Commission's auction of portions of the electromagnetic spectrum for use by telecommunications companies--is expected to bring in \$6 billion in 1995.

Net Interest

For the four years between 1991 and 1994, net interest costs were remarkably flat at about \$200 billion a year even as the government added \$1 trillion in debt. The government saved handsomely by refinancing its maturing debt at interest rates that were the lowest in three decades. That stability is now past: interest costs are expected to shoot up by almost \$30 billion a year in both 1995 and 1996 and by smaller amounts thereafter (see Table 2-11).

Even in the early 1990s, net interest costs were about 3 percent of GDP--two to three times the typical levels of the 1960s and 1970s. Because interest rates were so low, that growth is traceable squarely to the vastly bigger federal debt. The debt held by the public now stands at almost 52 percent of GDP, twice its level of the mid-1970s.

Interest costs are not governed by any provisions of the Budget Enforcement Act because they are not directly controllable. Rather, interest depends on the government's debt and on interest rates. The Congress and the President influence the former by making decisions about taxes and spending and hence about borrowing. Beyond that, they exert no direct control over interest rates, which are determined by market forces and Federal Reserve policy.

Interest rates have a powerful effect on budget projections, as illustrated in Appendix C. If interest rates are 1 percentage point higher in 1995 through 2000 than CBO assumes, net interest costs will be greater by about \$5 billion in 1995 and \$50 billion in 2000. The extra costs stem from the huge volumes of new financing and the rollover of existing debt by the Treasury.

In May 1993, the Treasury Department announced that it would shift some of its borrowing from longer- to shorter-term instruments. The move was a modest one; the government continues to borrow in a wide range of maturities ranging from three months to 30 years. That move was expected to save money though it marginally heightens the government's sensitivity to fluctuations in interest rates.⁶ Contrary to some common misperceptions, the rise in interest rates since May 1993 has not wiped out the rather small savings that were expected from the shift. CBO estimated at the time that the switch would save about \$7 billion over the 1993-1998 period and has no reason to revise that estimate materially. The saving occurs because long-term interest rates are typically higher than short-term rates. Despite the intervening rise in interest rates of all maturities, the difference between the short- and long-term rates remains, leaving the estimated savings largely intact. In fact, CBO's analysis showed that over any reasonably long period--such as five or ten years--the policy shift was extremely likely, although not certain, to save money.

CBO projects that net interest costs will climb gradually to \$310 billion in 2000, up more than 50 percent from the 1994 figure (see Table 2-11). Growth in debt held by the public--bills, notes, bonds, and other securities sold to raise cash--accounts for four-fifths of that growth, and higher interest rates essentially account for the rest. Higher rates principally affect the one-quarter of debt that carries maturities of one year or less; rates on three-month Treasury bills, for example, are expected to level off at 5.1 percent, up almost 1½ percentage points from their 1994 level.

Net or Gross? Net interest is the most useful measure of the government's current debt-service costs. Some budget watchers stress gross interest (and its counterpart, the gross federal debt) instead of net interest (and its counterpart, debt held by the public). But that choice exaggerates the government's debt-service burden because it overlooks billions of dollars in interest income received by the government.

6. Congressional Budget Office, *Federal Debt and Interest Costs* (May 1993).

Table 2-11.
CBO Baseline Projections for Interest Costs and Federal Debt (By fiscal year)

	Actual 1994	1995	1996	1997	1998	1999	2000
Net Interest Outlays (Billions of dollars)							
Interest on Public Debt (Gross interest) ^a	296	339	371	385	400	421	444
Interest Received by Trust Funds							
Social Security	-29	-35	-39	-45	-50	-55	-61
Other trust funds ^b	<u>-57</u>	<u>-62</u>	<u>-63</u>	<u>-63</u>	<u>-64</u>	<u>-64</u>	<u>-64</u>
Subtotal	-86	-96	-103	-108	-113	-119	-125
Other Interest ^c	<u>-8</u>	<u>-8</u>	<u>-8</u>	<u>-7</u>	<u>-7</u>	<u>-8</u>	<u>-8</u>
Total, Net Interest Outlays	203	235	260	270	279	294	310
Federal Debt, End of Year (Billions of dollars)							
Gross Federal Debt	4,644	4,942	5,280	5,641	6,001	6,392	6,814
Debt Held by Government Accounts							
Social Security	420	488	561	640	724	813	909
Other government accounts ^b	<u>792</u>	<u>836</u>	<u>882</u>	<u>924</u>	<u>960</u>	<u>989</u>	<u>1,014</u>
Total	1,212	1,325	1,443	1,563	1,684	1,803	1,923
Debt Held by the Public	3,432	3,617	3,838	4,077	4,317	4,589	4,891
Debt Subject to Limit ^d	4,605	4,902	5,240	5,599	5,959	6,349	6,771
Federal Debt as a Percentage of GDP							
Debt Held by the Public	51.8	51.4	52.1	52.6	53.0	53.5	54.3

SOURCE: Congressional Budget Office.

NOTE: Projections of interest and debt assume compliance with the discretionary spending caps in the Budget Enforcement Act. Discretionary spending is assumed to rise with inflation after the caps expire in 1998.

- a. Excludes interest costs of debt issued by agencies other than the Treasury (primarily the Tennessee Valley Authority).
- b. Principally Civil Service Retirement, Military Retirement, Medicare, unemployment insurance, and the Highway and the Airport and Airway trust funds.
- c. Primarily interest on loans to the public and to the Resolution Trust Corporation and the Bank Insurance Fund.
- d. Differs from the gross federal debt primarily because most debt issued by agencies other than the Treasury is excluded from the debt limit.

The government has sold more than \$3.4 trillion of securities to finance its cumulative deficits. But it has also issued more than \$1 trillion of securities to its own trust funds--mainly Social Security and the other retirement funds. Those securities represent the past surpluses of those trust funds, and their total amount grows roughly in step with the projected surpluses depicted earlier (see Table 2-2 on page 29). The funds can redeem the securities when needed to pay benefits; in the meantime, the government both

pays and collects the interest thereon. It also receives interest income from loans and cash balances. Broadly speaking, gross interest encompasses all interest paid by the government (even to its own funds) and ignores all interest income. Net interest, in contrast, is the net flow to those outside government.

Net interest is only about two-thirds as big as gross interest. CBO estimates that the government will pay \$339 billion in gross interest costs this year.

Box 2-2. The Debt Limit

Sometime next summer or fall, the Congress will need to raise the statutory limit on federal debt (which applies to securities issued to federal trust funds as well as those sold in the credit markets to raise cash). The current limit, last hiked in the Omnibus Budget Reconciliation Act of 1993 (OBRA-93), is \$4.9 trillion. Almost \$300 billion worth of room was left at the end of fiscal year 1994, but most or all will be used up in 1995 (see table below).

No one can predict when the Treasury will hit the debt limit. Relatively small errors in projecting either of

Growth in Debt Subject to Limit (By fiscal year, in billions of dollars)

	Actual 1994	1995	1996
Debt Subject to Limit, Start of Year	4,316	4,605	4,902
Changes			
Deficit	203	176	207
Trust fund surplus	95	107	118
Other ^a	-9	13	12
Total	290	296	338
Debt Subject to Limit, End of Year	4,605	4,902	5,240

SOURCE: Congressional Budget Office.

a. Changes in Treasury cash balances, net transactions of credit financing accounts, and other miscellaneous factors.

the major determinants--the deficit or the trust fund surplus--can easily swing the date by a month or two. But the period beginning in late July through about mid-November looks like the one to watch. The last day of every month--July 31, August 31, and so forth--is always a big borrowing day for the Treasury. So is the so-called mid-quarter refunding, a large package of securities that will be issued on August 15 and again on November 15. September is normally a surplus month, typically enabling the Treasury to pay down some debt and easing pressure on the debt ceiling. But large transfers to federal trust funds will take place on September 29 (the last weekday of fiscal year 1995) and October 2 (the first of fiscal 1996), and those investments will count against the limit. As the debt ceiling draws closer, budget analysts and participants in financial markets will watch such daily patterns with an eagle eye.

The debt limit is the quintessential "must-pass" legislation. Failure to enact it bodes a government shutdown or default. Increases may be for any duration; over the last decade, they have ranged from three days to two years. They may also be freestanding or attached to other legislation. Increases in the debt ceiling have sometimes been joined to deficit reduction packages or reforms in the budget process. Increases were contained in the Balanced Budget and Emergency Deficit Control Act of 1985 (better known as Gramm-Rudman-Hollings), its successor in 1987, the Budget Enforcement Act of 1990, and OBRA-93. And many other attempts were made to attach legislation--often unrelated to the budget--to the debt ceiling bill. Many analysts view the debt limit as archaic. The debt is merely an outgrowth of decisions that the Congress makes about federal spending and revenues. Before the Congressional Budget Act of 1974, the Congress never voted explicitly on those totals, but now it does.

Of that amount, however, \$96 billion is simply credited to trust funds and does not leave the government or add to the deficit. And the government collects \$8 billion in other interest income. Net interest costs therefore total \$235 billion.

Debt Subject to Limit. The Congress sets a limit on the Treasury's authority to issue debt. That ceiling applies to securities issued to federal trust funds as

well as those sold to the public. Hence, debt subject to limit is practically identical to the gross federal debt, which is why that figure, though less useful than debt held by the public, is more familiar. (The minor differences between gross debt and debt subject to limit are chiefly attributable to securities issued by agencies other than the Treasury, such as the Tennessee Valley Authority, that are exempt from the limit.)

Table 2-12.
CBO Baseline Projections for Revenues, by Source (By fiscal year)

Source	Actual 1994	1995	1996	1997	1998	1999	2000
In Billions of Dollars							
Individual Income	543	594	628	656	693	731	772
Corporate Income	140	149	151	155	161	167	173
Social Insurance	461	494	517	539	565	590	618
Excise	55	56	56	57	58	59	59
Estate and Gift	15	16	17	18	19	19	20
Customs Duties	20	21	21	21	21	22	23
Miscellaneous	<u>22</u>	<u>25</u>	<u>28</u>	<u>29</u>	<u>30</u>	<u>30</u>	<u>31</u>
Total	1,257	1,355	1,418	1,475	1,546	1,618	1,697
On-budget	922	998	1,043	1,084	1,135	1,187	1,245
Off-budget ^a	335	357	375	392	411	431	452
As a Percentage of GDP							
Individual Income	8.2	8.4	8.5	8.5	8.5	8.5	8.6
Corporate Income	2.1	2.1	2.1	2.0	2.0	2.0	1.9
Social Insurance	7.0	7.0	7.0	7.0	6.9	6.9	6.9
Excise	0.8	0.8	0.8	0.7	0.7	0.7	0.7
Estate and Gift	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Customs Duties	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Miscellaneous	<u>0.3</u>	<u>0.4</u>	<u>0.4</u>	<u>0.4</u>	<u>0.4</u>	<u>0.4</u>	<u>0.3</u>
Total	19.0	19.3	19.2	19.0	19.0	18.9	18.8
On-budget	13.9	14.2	14.2	14.0	13.9	13.9	13.8
Off-budget ^a	5.1	5.1	5.1	5.1	5.0	5.0	5.0

SOURCE: Congressional Budget Office.

a. Social Security

In OBRA-93, the Congress raised the limit on public debt to \$4.9 trillion. The new Congress will need to raise that figure sometime near the end of fiscal year 1995 (see Box 2-2).

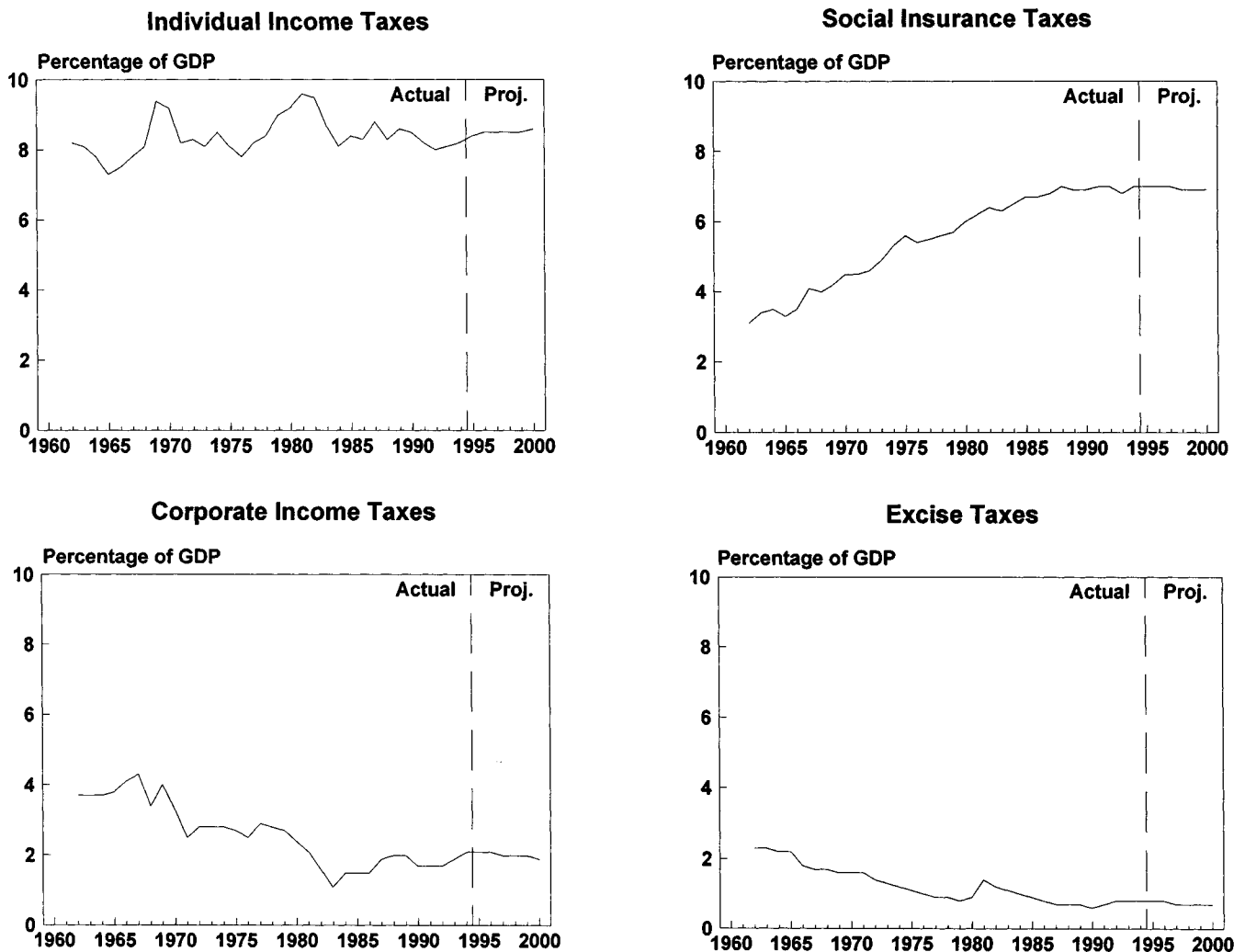
years, slipping to 18.8 percent of GDP by 2000 (see Table 2-12).

In relation to GDP, revenues will be slightly higher than typical levels of the past three decades. In 1960 through 1994, revenues averaged 18.6 percent of GDP. In only a few years did they reach or top 19 percent, and those years were unusual for one reason or another. In 1969 and 1970, taxes were hiked to help finance the Vietnam War; in 1979 through 1982--before the Reagan Administration's tax cut and the subsequent indexing of tax brackets to

The Revenue Outlook

Federal revenues are expected to be \$1,355 billion, or 19.3 percent of GDP, in 1995. They are projected to grow less rapidly than the economy in the next five

Figure 2-4.
Revenues by Source as a Share of GDP



SOURCE: Congressional Budget Office.

the price level--high inflation pushed up revenues; in 1987, taxpayers rushed to realize capital gains before tax reform, which repealed preferential rates on such income, took effect; and in 1989, collections were jointly boosted by final payments from the first full year of tax reform and by a strong economy. Last year, taxes once again reached 19 percent of GDP--the result of a robust economy and of OBRA-93. And they are expected to stay at or above 19 percent of GDP through 1998.

In an echo of the story on outlays, however, underneath the overall stability of the revenue-to-GDP ratio are some striking shifts in composition over the last three decades (see Figure 2-4). The most visible are the government's increased reliance since the 1960s on social insurance contributions, chiefly for Social Security and Medicare's Hospital Insurance (now about 7 percent of GDP), and its diminished reliance over that period on corporate income taxes and excise taxes (now about 2 percent and 1 percent of GDP, respectively). Those trends have not continued in recent years, however; social insurance contributions have been close to 7 percent of GDP since the mid-1980s. Over that same period, excise taxes have been more or less constant as a percent of GDP, and corporate income tax collections have actually gone up. Individual income taxes, the biggest contributor to government coffers, have mostly fluctuated in the range of 8 percent to 9 percent of GDP for more than three decades.

Baseline Projections

In the baseline, individual income taxes are the only source that is expected to grow even modestly as a share of GDP--from 8.2 percent in 1994 to 8.6 percent in 2000. Half of that increase occurs in 1995, when the full effects of OBRA-93 will truly be felt. (The act boosted revenues significantly in 1994, but its effects remained muted because the Congress permitted taxpayers to pay the extra first-year liability in three annual installments instead of all at once.) After 1995, the ratio of individual income taxes to GDP inches up as real economic growth gradually pushes income earners into higher tax brackets.

Social insurance taxes essentially hang onto their share of GDP--7 percent--in the projections. The slight decline (to 6.9 percent) occurs principally from the taxes that finance unemployment benefits. The states, which retain a great deal of latitude in setting taxes and benefits, will be free to reduce their tax rates as the unemployment trust fund is replenished. Furthermore, the Federal Unemployment Tax Act (FUTA) applies only to the first \$7,000 of each covered worker's salary--a figure that remains unchanged despite economic growth--and a FUTA surtax expires at the end of 1998.

The corporate income tax was 2.1 percent of GDP in 1994 but is expected to drift down to 1.9 percent in 2000, mirroring a decline in corporate profits as a share of GDP. Similarly, excise taxes--which were bolstered by increases in taxes on transportation fuels and by other provisions of OBRA-93--slip marginally as a share of GDP, mainly because most excise taxes are fixed in dollar rather than in percentage terms. Among small revenue sources, one--customs duties--contains a hidden story. Such receipts were expected to climb faster than GDP, in tandem with growing volumes of trade. But ratification of the Uruguay Round of GATT cut them by roughly \$4 billion a year by the late 1990s--enough to hold them to a constant 0.3 percent of GDP.

Expiring Provisions

CBO's baseline projections for revenues assume that current tax law remains unchanged. The projections take into account that some provisions are scheduled to change or expire during the 1995-2000 period. In general, the baseline assumes that those changes and expirations occur on schedule. One category of taxes--excise taxes dedicated to trust funds--constitutes the sole exception to this rule. CBO assumes that those taxes will be extended even if they are scheduled to expire (an assumption that is specified by the Balanced Budget Act). The current baseline thus assumes that several taxes will be extended: those devoted to the Highway Trust Fund, the Airport and Airway Trust Fund, the Hazardous Substance Superfund, and the Leaking Underground Storage

Table 2-13.
Effect of Extending Tax Provisions That Have Recently Expired or Will Expire in 1995 Through 2000
(By fiscal year, in billions of dollars)

Tax Provision	Expiration Date	1995	1996	1997	1998	1999	2000
Expired Provision							
Health Insurance Deduction for the Self-Employed	12/31/93	-0.5	-0.4	-0.5	-0.5	-0.6	-0.6
Deduction for Contributions to Private Foundations	12/31/94	a	-0.1	-0.1	-0.1	-0.1	-0.1
Targeted Jobs Tax Credit	12/31/94	-0.1	-0.2	-0.3	-0.4	-0.4	-0.5
Exclusion for Employer-Provided Education Assistance	12/31/94	-0.2	-0.5	-0.6	-0.6	-0.7	-0.7
Orphan Drug Tax Credit	12/31/94	a	a	a	a	a	a
Provisions Expiring in 1995							
Deny Deduction for Some Noncomplying Health Plans	5/12/95	-0.1	-0.1	-0.2	-0.2	-0.2	-0.2
Credit for Research and Experimentation	6/30/95	-0.2	-0.9	-1.3	-1.6	-1.9	-2.2
Rules for Allocation of Expenses for Research and Experimentation	7/31/95	-0.2	-0.5	-0.5	-0.5	-0.6	-0.6
Extension of Generalized System of Preferences	7/31/95	-0.1	-0.5	-0.5	-0.4	-0.4	-0.4
Commercial Aviation Exemption for the 4.3 Cent per Gallon Tax on Transportation Fuels	9/30/95	n.a.	-0.4	-0.4	-0.5	-0.5	-0.5
Corporate Tax Dedicated to Superfund	12/31/95	n.a.	0.3	0.5	0.5	0.6	0.6
Provisions Expiring in 1996							
Nonconventional Fuels Credit for Fuel from Biomass and Coal	12/31/96	n.a.	n.a.	a	a	a	a
Provisions Expiring in 1998							
FUTA Surtax of 0.2 Percentage Points	12/31/98	n.a.	n.a.	n.a.	n.a.	0.9	1.2
Provisions Expiring in 1999							
Recreational Trails Uses of Gasoline and Diesel, 2.5 Cents per Gallon	9/30/99	n.a.	n.a.	n.a.	n.a.	n.a.	a
Motorboat and Small Engine Gasoline, 2.5 Cents per Gallon	9/30/99	n.a.	n.a.	n.a.	n.a.	n.a.	a
Railroad Uses of Diesel Fuel, 1.25 Cents per Gallon	9/30/99	n.a.	n.a.	n.a.	n.a.	n.a.	a
Luxury Tax on Passenger Vehicles	12/31/99	n.a.	n.a.	n.a.	n.a.	n.a.	0.4
Noncommercial Motorboat Diesel Fuel, 20.1 Cents per Gallon	12/31/99	n.a.	n.a.	n.a.	n.a.	n.a.	a

SOURCE: Joint Committee on Taxation.

NOTES: No provisions are scheduled to expire in 1997. The list does not include expiring excise taxes dedicated to trust funds that are assumed to be extended.

n.a. = not applicable; FUTA = Federal Unemployment Tax Act.

a. Less than \$50 million.

Tank Trust Fund. By 2000, those taxes--assuming that they are extended at today's rates--contribute \$33 billion of CBO's baseline revenues, or more than half of the total excise taxes.

All other temporary provisions of the tax code, in contrast, are assumed to expire on schedule. Five tax preferences have expired recently--one at the end of 1993 and four at the end of 1994 (see Table 2-13). If the Congress extended all five preferences permanently, baseline revenues would be smaller by about \$1.9 billion in 2000.

Thirteen other tax provisions are slated to expire between 1995 and 1999. Five provisions that lose revenues expire this year. Extending them and a credit that expires in 1996 would cost about \$3.9 billion in 2000, relative to the baseline. Extending the other seven--including the corporate tax dedicated to Superfund that expires later this year--would raise almost \$2.3 billion in 2000.

The Budget Outlook Through 2005

The Congressional Budget Act of 1974 requires CBO to do five-year estimates of the budget outlook and of budgetary legislation. But there is a demand for longer-term extrapolations, particularly in light of the current debate over a constitutional amendment to balance the budget. Under current spending and taxing policies, CBO projects that the deficit will top \$400 billion in 10 years--more than twice today's level (see Table 2-14). That projection assumes that discretionary spending resumes growing with inflation after 1998, when the caps expire. (The effects of freezing such spending instead are spelled out below.) Because the economy will grow, the deficit will not climb quite as dramatically in relation to GDP. Still, it inches up fairly steadily, from 2.5 percent of GDP in 1995 to 3.6 percent in 2005.

CBO's extended budget projections are more streamlined than its five-year baseline. Instead of producing a detailed 10-year projection for every program and activity, CBO tries to gauge apparent trends in broad areas of the budget.

Why Does the Deficit Grow?

Discretionary spending decidedly does not explain why the deficit grows as a percentage of GDP. Such spending is held in check by the caps through 1998. Discretionary spending thus falls a full percentage point in relation to GDP between now and 1998--from 7.7 percent to 6.7 percent. Even if such spending is permitted to resume growing no faster than inflation after 1998, it would continue to slip as a percentage of GDP--to 6 percent in 2005.

Revenues also do not account for growing deficits after 2000. Although revenues slowly drift down from 19.3 percent of GDP in 1995 to 18.8 percent by 2000, they remain steady at that level through 2005.

The growing deficits, therefore, stem from entitlement spending, particularly by the major health care programs. Although growth has slowed somewhat, spending for both Medicaid and Medicare is still projected to rise by 10 percent a year through 2005, propelling them to a combined 6 percent of GDP by that time (up from 3.8 percent today). Those two big health care programs overtake in size another entitlement program--Social Security--by 2000 and even catch up to total discretionary spending by 2005. In relation to GDP, Social Security benefits barely change from today's level of 4.7 percent. In 2005, the final year of this extended projection, the first members of the baby-boom generation will still be several years away from eligibility for Social Security retirement benefits and Medicare.

Net interest is the only other major category of spending that rises in relation to GDP, though modestly--from 3.3 percent today to 3.5 percent in 2005. That increase results more from the government's large and growing debt than from any projected jump in interest rates. The debt held by the public reaches nearly \$6.8 trillion in 2005, or about 58 percent of GDP. The nation has not experienced such a large ratio of debt to GDP since 1955, when most of the debt still represented money borrowed to help pay for World War II. At that time, of course, the debt-to-GDP ratio was headed down instead of up.

At the end of fiscal year 1994, two large federal trust funds--Social Security and Medicare Hospital

Table 2-14.
The Budget Outlook Through 2005 With Discretionary Inflation After 1998 (By fiscal year)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
In Billions of Dollars											
Revenues	1,355	1,418	1,475	1,546	1,618	1,697	1,787	1,880	1,978	2,082	2,191
Outlays											
Discretionary	544	549	548	547	566	585	605	626	647	669	692
Mandatory											
Social Security	334	352	371	390	411	433	456	481	507	534	563
Medicare	176	196	217	238	262	286	314	344	379	417	460
Medicaid	90	100	111	123	136	149	164	179	196	214	234
Civil Service and Military Retirement	66	68	71	75	80	83	87	91	96	100	105
Other	179	183	192	199	208	220	224	231	239	247	256
Subtotal	845	899	962	1,026	1,097	1,173	1,245	1,328	1,417	1,513	1,617
Deposit insurance	-16	-9	-5	-5	-3	-3	-3	-3	-3	-3	-4
Net interest	235	260	270	279	294	310	325	344	365	387	412
Offsetting receipts	-77	-73	-76	-79	-82	-84	-88	-93	-97	-102	-106
Total	1,531	1,625	1,699	1,769	1,872	1,981	2,084	2,202	2,329	2,465	2,611
Deficit	176	207	224	222	253	284	297	322	351	383	421
Social Security Surplus	69	73	78	84	90	96	104	111	119	128	137
Hospital Insurance Surplus	3	-2	-7	-12	-19	-25	-32	-39	-48	-59	-71
Debt Held by the Public	3,617	3,838	4,077	4,317	4,589	4,891	5,207	5,547	5,917	6,318	6,757
As a Percentage of GDP											
Revenues	19.3	19.2	19.0	19.0	18.9	18.8	18.8	18.8	18.8	18.8	18.8
Outlays											
Discretionary	7.7	7.4	7.1	6.7	6.6	6.5	6.4	6.3	6.2	6.1	6.0
Mandatory											
Social Security	4.7	4.8	4.8	4.8	4.8	4.8	4.8	4.8	4.8	4.8	4.8
Medicare	2.5	2.7	2.8	2.9	3.1	3.2	3.3	3.5	3.6	3.8	4.0
Medicaid	1.3	1.4	1.4	1.5	1.6	1.7	1.7	1.8	1.9	1.9	2.0
Civil Service and Military Retirement	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9
Other	2.5	2.5	2.5	2.4	2.4	2.4	2.4	2.3	2.3	2.2	2.2
Subtotal	12.0	12.2	12.4	12.6	12.8	13.0	13.1	13.3	13.5	13.7	13.9
Deposit insurance	-0.2	-0.1	-0.1	-0.1	a	a	a	a	a	a	a
Net interest	3.3	3.5	3.5	3.4	3.4	3.4	3.4	3.4	3.5	3.5	3.5
Offsetting receipts	-1.1	-1.0	-1.0	-1.0	-1.0	-0.9	-0.9	-0.9	-0.9	-0.9	-0.9
Total	21.8	22.1	21.9	21.7	21.8	22.0	22.0	22.1	22.2	22.3	22.5
Deficit	2.5	2.8	2.9	2.7	3.0	3.1	3.1	3.2	3.3	3.5	3.6
Social Security Surplus	1.0	1.0	1.0	1.0	1.0	1.1	1.1	1.1	1.1	1.2	1.2
Hospital Insurance Surplus	a	a	-0.1	-0.1	-0.2	-0.3	-0.3	-0.4	-0.5	-0.5	-0.6
Debt Held by the Public	51.4	52.1	52.6	53.0	53.5	54.3	54.9	55.6	56.4	57.2	58.1

SOURCE: Congressional Budget Office.

a. Less than 0.05 percent of GDP.

Insurance--held more than \$540 billion in federal securities, representing about 45 percent of the \$1.2 trillion of debt issued to government accounts. CBO expects that the annual Social Security trust fund surplus will continue to grow slowly, reaching nearly \$140 billion, or 1.2 percent of GDP, by 2005. The trust fund balance invested in federal securities will balloon from more than \$400 billion today to \$1.5 trillion in 10 years. Of course, that balance will then be drawn down as the baby-boom generation reaches retirement age.

The drawdown will occur much sooner with Hospital Insurance. CBO projects that under current policies the HI trust fund will run a surplus for only one more year. Beginning in 1996, HI will experience growing annual deficits that will deplete the fund's current invested balance of \$130 billion by around the end of 2002. By 2005, the HI trust fund will run up a debt of more than \$180 billion.

Table 2-15.
The Budget Outlook Through 2005 Without Discretionary Inflation After 1998 (By fiscal year)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
In Billions of Dollars											
Revenues	1,355	1,418	1,475	1,546	1,618	1,697	1,787	1,880	1,978	2,082	2,191
Outlays											
Discretionary	544	549	548	547	547	547	547	547	547	547	547
Net interest	235	260	270	279	293	308	319	334	348	363	378
All other	<u>752</u>	<u>816</u>	<u>881</u>	<u>942</u>	<u>1,012</u>	<u>1,086</u>	<u>1,154</u>	<u>1,232</u>	<u>1,317</u>	<u>1,408</u>	<u>1,508</u>
Total	1,531	1,625	1,699	1,769	1,852	1,941	2,021	2,113	2,213	2,318	2,433
Deficit	176	207	224	222	234	243	234	234	235	237	242
Debt Held by the Public	3,617	3,838	4,077	4,317	4,570	4,831	5,084	5,336	5,589	5,844	6,105
As a Percentage of GDP											
Revenues	19.3	19.2	19.0	19.0	18.9	18.8	18.8	18.8	18.8	18.8	18.8
Outlays											
Discretionary	7.7	7.4	7.1	6.7	6.4	6.1	5.8	5.5	5.2	5.0	4.7
Net interest	3.3	3.5	3.5	3.4	3.4	3.4	3.4	3.3	3.3	3.3	3.2
All other	<u>10.7</u>	<u>11.1</u>	<u>11.4</u>	<u>11.6</u>	<u>11.8</u>	<u>12.0</u>	<u>12.2</u>	<u>12.3</u>	<u>12.5</u>	<u>12.7</u>	<u>13.0</u>
Total	21.8	22.1	21.9	21.7	21.6	21.5	21.3	21.2	21.1	21.0	20.9
Deficit	2.5	2.8	2.9	2.7	2.7	2.7	2.5	2.3	2.2	2.1	2.1
Debt Held by the Public	51.4	52.1	52.6	53.0	53.3	53.6	53.6	53.5	53.2	52.9	52.5

SOURCE: Congressional Budget Office.

Freezing Discretionary Spending After 1998

The extended budget outlook differs markedly if discretionary spending is frozen after 1998--though that produces nowhere near enough change to balance the budget. In dollar terms, the deficit would be practically flat at about \$240 billion (see Table 2-15). In relation to GDP, the deficit would peak at 2.9 percent in 1997 and then gradually fall to about 2.1 percent by 2005. The debt held by the public would grow more slowly, reaching \$6.1 trillion by 2005--about \$650 billion less than under the scenario discussed above. As a percentage of GDP, the debt held by the public would remain fairly steady after 1997 at about 53 percent. Net interest would peak at 3.5 percent of GDP in 1997, then edge down to 3.2 percent by 2005.

Freezing discretionary spending after 1998 would save more than \$650 billion in the following seven years compared with the first path: \$558 billion in lower discretionary outlays and \$94 billion in lower interest costs. In conjunction with the current spending caps, which hold discretionary outlays virtually constant through 1998, such a freeze would keep discretionary spending below \$550 billion for the next 10 years. Discretionary spending would dwindle steadily as a percentage of GDP, from 7.7 percent today to 4.7 percent in 2005--a level not seen since before World War II. Given current estimates of inflation, the freeze would force a decline of nearly one-third in real discretionary spending over the next 10 years.

The Uncertainty of Extended Projections

The extended projection of the deficit has changed remarkably little over the past year. Last January, CBO projected that the deficit in 2004 would total \$365 billion, assuming that discretionary programs kept pace with inflation after the caps expire. In Au-

gust, that estimate was upped to \$397 billion, mostly as a result of higher costs for net interest. Today, still higher outlays for net interest in 2004 are more than offset by lower Medicaid and Medicare costs, the result of a slight deceleration in the growth of health care spending. But the deficit for that year remains little changed at \$383 billion.

All such extrapolations, however, involve a great deal of uncertainty, particularly concerning the performance of the economy. As explained in Chapter 1, CBO's medium-term projections of key economic variables are based on historical relationships and reflect CBO's judgment about such fundamental factors as growth in the labor force, productivity, and investment. They do not reflect any attempt to estimate the economy's inevitable ups and downs. CBO's assumptions about the 2001-2005 period resemble those employed for the late 1990s. CBO assumes that real economic growth will continue to average 2.3 percent a year and that unemployment will hover around 6 percent. Short-term interest rates (measured by three-month Treasury bills) will average 5.1 percent; long-term interest rates (measured by 10-year Treasury notes) will average 6.7 percent. Inflation will continue at about 3.4 percent. Although those assumptions appear reasonable from today's vantage point, the economy is bound to deviate from that path in ways that cannot now be anticipated. The potential budgetary effects of any such deviations are large.

Aside from the economy's performance, other factors create significant uncertainties about the budget projections. A flare-up in international tensions, unexpected changes in the caseloads and costs of health care programs and other entitlements, and unanticipated costs for open-ended commitments such as deposit insurance are just a few examples. Surprises could operate to make things better or worse. But the deficit will not simply fade from view without concerted action by policymakers.

Appendixes

Sequestration Preview Report for Fiscal Year 1996

The Budget Enforcement Act of 1990 amended the Balanced Budget and Emergency Deficit Control Act of 1985 (the Balanced Budget Act) and the Congressional Budget Act of 1974 to add new enforcement procedures for direct (mandatory) spending, receipts, and discretionary spending for fiscal years 1991 through 1995. The Omnibus Budget Reconciliation Act of 1993 further amended the two acts to apply the new procedures through 1998. The law requires the Congressional Budget Office (CBO) to issue a sequestration preview report five days before the President's budget submission in January or February, a sequestration update report on August 15, and a final sequestration report 10 days after the end of a session of Congress. The sequestration preview report must contain estimates of the following items:

- o The discretionary spending limits and any adjustments to them; and
- o The amount by which direct spending or receipt legislation enacted after the Budget Enforcement Act has increased or decreased the deficit and the amount of any required pay-as-you-go sequestration.

This report to the Congress and the Office of Management and Budget (OMB) provides the required information. In addition to the material presented here, reports in previous years were required to specify the amount of the adjusted maximum deficit for the coming fiscal year. That requirement is no

longer in effect because the Budget Enforcement Act specified maximum deficit amounts only through 1995. Thus, there is no maximum deficit amount set by law for fiscal year 1996 or any subsequent year.

Discretionary Sequestration Report

The Omnibus Budget Reconciliation Act of 1993 (OBRA-93) established new limits on total discretionary budget authority and outlays for fiscal years 1996 through 1998. But it left in place the existing discretionary spending limits for 1993 through 1995 and the existing enforcement procedures, including the specific requirements for adjusting the discretionary limits. The Violent Crime Control and Law Enforcement Act of 1994, enacted in September 1994, excluded spending from the Violent Crime Reduction Trust Fund (VCRTF) from the constraints of the existing caps. It also lowered those caps by the assumed amount of trust fund spending for each year that the caps would be in effect and established separate limits through 1998 on outlays resulting from VCRTF appropriations.

For several reasons, current estimates of the limits on total general-purpose (non-VCRTF) discretionary spending for 1995 through 1998 differ from those in CBO's December 1994 final sequestration report (see Table A-1). First, the estimates have been re-

Table A-1.
CBO Estimates of Discretionary Spending Limits for Fiscal Years 1995 Through 1998 (In millions of dollars)

	1995		1996		1997		1998	
	Budget Authority	Outlays	Budget Authority	Outlays	Budget Authority	Outlays	Budget Authority	Outlays
General-Purpose Spending Limits in CBO's December 1994 Final Report	518,050	547,437	514,344	547,549	522,555	544,220	524,592	542,427
Adjustments								
Technical differences from OMB's December 1994 final report	-1,027	-1,005	0	-270	0	-73	0	-48
Contingent emergency appropriations designated since OMB's December 1994 final report	44	6	0	14	0	17	0	5
Concepts and definitions								
Wetlands reserve	0	0	-37	-4	-37	-29	-37	-37
Conservation reserve	0	0	-20	-20	118	118	-6	-6
Market promotion	0	0	0	12	0	0	0	0
Morrill-Nelson	0	0	3	3	3	3	3	3
Cottonseed and sunflower	0	0	-30	-27	0	-3	0	0
Emergency preparedness grants	0	0	-9	-5	0	-4	0	0
Pipeline safety fees	0	0	18	18	19	19	20	20
Members of Congress's pay	0	0	2	2	2	2	2	2
Judges' pay	0	0	6	6	6	6	6	6
FHA Mutual Mortgage Insurance	0	0	3	3	3	3	3	3
FHA nonjudicial disclosure	0	0	4	4	5	5	5	5
Subtotal	0	0	-60	-8	119	120	-4	-4
Change in 1994 inflation	0	0	-1,393	-571	-1,440	-1,008	-1,490	-1,252
Total	-983	-999	-1,453	-835	-1,321	-944	-1,494	-1,299
General-Purpose Spending Limits as of January 23, 1995	517,067	546,438	512,891	546,714	521,234	543,276	523,098	541,128
Violent Crime Reduction Trust Fund Spending Limits	2,423	703	4,287	2,334	5,000	3,936	5,500	4,904
Total Discretionary Spending Limits ^a	519,490	547,141	517,178	549,048	526,234	547,212	528,598	546,032

SOURCE: Congressional Budget Office.

NOTE: OMB = Office of Management and Budget; FHA = Federal Housing Administration.

a. The limits assumed in CBO's January 1995 baseline, discussed in Chapter 2, are higher than those shown here for 1997 and 1998 because the baseline caps include estimated adjustments that will be made in later sequestration reports.

vised to reflect differences between the spending limits in that report and those in OMB's final report. Second, the limits have been increased slightly to account for emergency funds made available since OMB issued its final report. Third, they have been adjusted to reflect changes in concepts and definitions. Finally, the limits for 1996 through 1998 have been reduced because inflation in 1994 was lower than had been anticipated when those limits were set by OBRA-93. CBO's estimates of the limits for this report do not include any prospective adjustments--changes that cannot legally be made until future sequestration reports. The limits on VCRTF outlays are not subject to any adjustment. (The CBO baseline for discretionary spending in 1996 through 1998 detailed in Chapter 2 equals the sum of the VCRTF limits and an estimate of the general-purpose limits. That estimate does include CBO's projections of prospective adjustments for differences between anticipated and actual inflation, which will be made in future preview reports. As a result, the estimated caps described in Chapter 2 are slightly higher than the caps depicted here. The baseline caps do not include the adjustment contained in this preview report for contingent emergency designations that the President made after the baseline had been completed.)

Differences Between the Limits in CBO's and OMB's Final Reports

The Balanced Budget Act requires both CBO and OMB to calculate changes in the discretionary spending limits specified in the act. OMB's estimates of the limits are controlling, however, in determining whether enacted appropriations are within the limits or whether a sequestration is required to eliminate a breach of the limits. CBO's estimates are advisory. In acknowledgment of OMB's statutory role, when CBO calculates changes in the limits for a report, it first adjusts for the differences between the limits in its most recent report and the limits in OMB's most recent report--in effect, using OMB's official estimates as the starting point for the adjustments that CBO is required to make in the new report.

The differences between estimates of spending limits by the two agencies in their December 1994

final reports result almost entirely from different estimates of emergency spending that was made available after the agencies had issued their update reports in August 1994 (see Table A-1). The Balanced Budget Act requires that the discretionary spending limits be increased for appropriations that are classified as emergency spending by the law providing them and designated as such by the President. Most of the emergency spending reflected in the final reports comes from appropriations provided in seven of the regular appropriation acts for 1995. The remainder reflects the release of appropriations that had been enacted previously. Those contingent emergency appropriations (funding that becomes available for obligation only if and when the President designates it as emergency spending) were enacted before OMB issued its update report on August 19, but they were designated by the President after that report was released.

The discrepancy between the estimates of emergency budget authority in the two final reports largely results from the different ways in which CBO and OMB account for contingent emergency appropriations in their estimates of appropriation bills. OMB includes only the effects of the contingent emergency appropriations that the President designates as emergency spending when he signs the bill. CBO, however, includes the cost of all contingent emergency appropriations in its estimate of a bill, both because it must often issue its estimates before the President has signed the bill and in order to reflect the full amount of spending that could result from Congressional action.

Since OMB does not include the cost of undesignated contingent emergency appropriations in its estimates of bills, it adjusts the spending limits for all such appropriations subsequently designated by the President. Because CBO includes the effects of the undesignated contingent emergencies in its bill estimates, it makes a further adjustment only for designations that relate to contingent appropriations enacted before OMB's most recent sequestration report. That adjustment is necessary because the effects of those appropriations are included neither in the limits from that OMB report--which represent the starting point for CBO's adjustments--nor in CBO's adjustments for newly enacted emergency legislation.

As a result of the different treatment of contingent emergencies, CBO estimated almost \$1 billion more in 1995 emergency spending than OMB estimated and attributed more of the emergency spending to the appropriation acts and less to the release of contingent funds. The different estimates of 1995 emergency budget authority also produced differences in outlays for 1995 through 1998.

Emergency Funding Made Available Since OMB's Final Report

In addition to the adjustments resulting from differences between the caps in CBO's and OMB's final reports, changes are made in the discretionary spending limits to reflect emergency appropriations made available since OMB's final report. The only new emergency funds were made available by two new designations of previously appropriated funds: a December 27, 1994, designation of \$32 million of contingent emergency budget authority enacted in 1995 appropriation bills for community development grants and economic development assistance programs, and a January 9, 1995, designation of \$12 million appropriated to the President in a 1994 supplemental appropriation act for unanticipated needs related to natural disasters.

Changes in Concepts and Definitions

The Balanced Budget Act provides for adjustments that reflect changes in budgetary concepts and definitions. All such adjustments in this report are of one kind: reclassifications of spending from one budget category to another. The category changes reported here derive from the practice of assigning certain legislated changes in mandatory spending to the discretionary spending side of the Balanced Budget Act ledger and certain legislated changes in discretionary programs to the pay-as-you-go (PAYGO) side, which is generally supposed to deal with mandatory spending and tax legislation. OMB and the budget committees have determined that any costs or savings that result from provisions in an appropriation act should be reflected in enforcing the discretionary spending limits, even if the costs or savings are in a mandatory spending program. Similarly, any appro-

priation for a discretionary program provided in authorizing legislation is included on the PAYGO scorecard.

Changes in current year or budget year mandatory spending that are made in appropriation acts are included in the estimate of discretionary spending for that year, but appropriations provided in authorizing legislation for those years are not. Estimates of discretionary spending attributed to future appropriation acts will include all such spending provided in previous years--whether in appropriation or authorization acts--and exclude mandatory spending provided in previous appropriation acts. Consequently, the discretionary spending limits for future years are adjusted to ensure that the appropriations committees are held responsible for the future effects of changes in mandatory programs included in their legislation but are not affected by appropriations for discretionary programs provided by other committees. Without compromising enforcement of the Balanced Budget Act, adjustments of that sort offer a simple alternative to permanently tracking all mandatory spending effects of appropriation actions and all discretionary spending enacted in authorizing legislation.

For example, the fiscal year 1995 Rural Development, Agriculture, and Related Agencies appropriation act (Public Law 103-330) contained a provision that reduced 1995 spending for the mandatory wetlands reserve program by \$186 million in budget authority and \$20 million in outlays. One result of that provision, however, is that in 1996, 1997, and 1998, budget authority in the program will increase by \$37 million a year; outlays for those later years will increase by \$4 million, \$29 million, and \$37 million, respectively. The 1995 savings were included in the estimate of the appropriation act, but rather than attribute the 1996-1998 costs to the appropriation acts for those years, the discretionary limits for 1996 through 1998 have been reduced by the appropriate amounts.

Change in 1994 Inflation

The Balanced Budget Act requires that the discretionary spending limits for 1996 through 1998 be adjusted for the difference between the actual inflation rate in 1994 and the rate for that year anticipated

when the 1996-1998 limits were enacted in 1993. Because actual inflation (measured by the implicit gross domestic product deflator) was lower in 1994 than had been expected in 1993, the adjustment reduces the spending limits--for budget authority, by close to \$1.5 billion each year, and for outlays, from \$571 million in 1996 to \$1,252 million in 1998.

In estimating the adjustment for inflation, CBO used the method that OMB adopted in its 1993 sequestration preview report issued in January 1992. That method entails adjusting only nonpersonnel costs instead of adjusting all discretionary spending. Although CBO has consistently disagreed with OMB's interpretation of the inflation adjustment provision in the Balanced Budget Act, OMB's cap adjustments are controlling. Therefore, CBO follows its lead in order to avoid confusion.

Pay-As-You-Go Sequestration Report

If changes in direct spending programs or governmental receipts enacted since the Budget Enforcement Act increase the combined current and budget year deficits, a pay-as-you-go sequestration is triggered at the end of the Congressional session, and nonexempt mandatory programs are cut enough to eliminate the increase. The pay-as-you-go provisions of the Balanced Budget Act had applied through fiscal year 1995, but OBRA-93 extended them through 1998.

The Budget Enforcement Act requires both CBO and OMB to estimate the net change in the deficit

Table A-2.
Budgetary Effects of Direct Spending and Receipt Legislation Enacted Since the Budget Enforcement Act (By fiscal year, in millions of dollars)

	1995	1996	1997	1998
Total from OMB's December 1994 Final Report ^a	-2,009	-148	-357	-9
Adjustments Due to Legislation Enacted Since OMB's Final Report ^b	0	0	0	0
Total Change in the Deficit Since the Budget Enforcement Act	-2,009	-148	-357	-9

SOURCE: Congressional Budget Office.

NOTE: OMB = Office of Management and Budget.

- a. Section 254 of the Balanced Budget and Emergency Deficit Control Act of 1985, as amended, calls for a list of all bills enacted since the Budget Enforcement Act that are included in the pay-as-you-go calculation. Because the data in this table assume OMB's estimate of the overall changes in the deficit resulting from bills enacted through the end of the 103rd Congress, readers are referred to the lists of those bills included in Table 6 of the *OMB Final Sequestration Report to the President and Congress for Fiscal Year 1995* (December 16, 1994) and in previous sequestration reports issued by OMB.
- b. The Congressional Accountability Act of 1995 (S. 2) passed the Congress on January 17, 1995, but had not been signed or vetoed by the President as of January 20, 1995. Since that bill affects direct spending by less than \$500,000 in any year through 1998, no adjustment to the effect on the deficit of direct spending or receipt legislation is made.

resulting from direct spending or receipt legislation. As is the case with the discretionary spending limits, however, OMB's estimates are controlling in determining whether a sequestration is required. CBO therefore adopts the estimates of the changes in the deficit specified in OMB's December final report as the starting point for this report. Table A-2 shows CBO's estimates of changes in the deficit for 1995 through 1998 that result from direct spending or receipt legislation enacted since the Budget Enforcement Act. Those figures reflect OMB's estimates of changes caused by legislation enacted through the end of the 103rd Congress. The estimates do not include any changes in the deficit for 1996 through 1998 resulting from legislation enacted before OBRA-93 because the pay-as-you-go procedures did not apply to those years until OBRA-93 was enacted. Because the only legislation affecting direct spending or revenues that has been enacted thus far in the 104th Congress--the Congressional Accountability Act of 1995 (S. 2)--increases spending by less than \$500,000 in any year, there is no adjustment to the estimates from OMB's final report.

The changes in direct spending and revenues reported by OMB in December 1994 yield a net de-

crease in the combined 1995 and 1996 deficits of more than \$2 billion and smaller decreases for each of the two subsequent two-year periods. According to OMB's estimates, if no further changes are made in laws governing direct spending or receipts, no sequestration would be required for 1996, 1997, or 1998. In its December final report, CBO also determined that legislation enacted thus far should not trigger a sequestration in 1996. That report concluded, however, that a pay-as-you-go sequestration would be required in 1997 and 1998 unless legislation was enacted to reduce direct spending or increase revenues. The difference between OMB's and CBO's conclusions is largely the result of different estimates of the costs resulting from enactment of the Federal Crop Insurance Reform and Department of Agriculture Reorganization Act of 1994 (Public Law 103-354). OMB estimated that increased annual costs for the crop insurance program resulting from that legislation would be largely offset by savings from eliminating ad hoc disaster assistance. Because CBO did not include any costs for ad hoc disaster assistance in its baseline, it estimated that the legislation would increase the deficit by about \$350 million in 1995 and \$1 billion a year in 1996 through 1998.

An Analysis of Congressional Budget Estimates

In March 1993, the Congress adopted a budget resolution for fiscal year 1994 that anticipated a deficit of \$254 billion in that year--a target that necessitated the passage of an ambitious deficit reduction package. Over the next five months, the Congress crafted and passed the substantive legislation needed to carry out the resolution's goals. And over the ensuing year, the deficit outlook steadily improved; when fiscal year 1994 ended, the Treasury Department announced an actual deficit of \$203 billion--more than \$50 billion smaller than the figure in the resolution.

Fiscal year 1994, like 1993 before it, stands in contrast to the historical pattern. Beginning in 1980, the actual deficit exceeded the figure in the budget resolution for 13 years in a row. Fiscal year 1993 ended that streak. But a single, notoriously unpredictable category of spending--deposit insurance--more than explained the 1993 overshoot. In 1994, in contrast, a broad variety of spending programs and revenues contributed to the story.

Sources of Differences

The Congressional Budget Office (CBO) divides the differences between budget resolutions and actual outcomes into three categories: policy, economic, and technical.

Policy differences reflect the passage of legislation that was not explicitly anticipated in the budget

resolution or legislation that cost (or saved) more money than was assumed. An example is emergency appropriations, such as those for Operation Desert Storm and aid to victims of natural disasters, which are by definition difficult to anticipate. Policy differences can also reflect the failure to enact legislation that was assumed in the resolution. For example, had the Congress failed to pass the Omnibus Budget Reconciliation Act of 1993 (OBRA-93) or some equivalent, it would have seriously breached the 1994 budget resolution.

Economic differences can be blamed on the failure to anticipate the actual performance of the economy. Every budget resolution contains assumptions about several key economic variables--chiefly gross domestic product (GDP), unemployment, inflation, and interest rates--that are needed to develop estimates of revenues and spending for benefit programs and net interest. Typically (as for the 1994 budget resolution), the economic assumptions are drawn from a CBO forecast, although in about one-third of the cases--notably in 1982 and for most of the years between 1988 and 1992--the Congress chose a non-CBO forecast, generally one from the Administration.

Soon after the end of the fiscal year, CBO judges how much of the difference between the budget resolution and the actual revenue and outlay totals should be ascribed to economic factors, using information available at that time; that allocation is not subsequently changed, even though revisions to data about GDP and taxable incomes continue to trickle in

Table B-1.
Comparison of the CBO March 1993 Baseline, the 1994 Budget Resolution, and Actual Outcomes for Fiscal Year 1994 (In billions of dollars)

	CBO March 1993 Baseline	Budget Resolution	Actual	Actual Minus CBO March 1993 Baseline	Actual Minus Budget Resolution
Revenues	1,214	1,242	1,257	43	15
Outlays	1,501	1,496	1,461	-41	-35
Deficit	287	254	203	-83	-50

SOURCE: Congressional Budget Office using data from the Concurrent Resolution on the Budget--Fiscal Year 1994 (March 1993) and Department of the Treasury, *Final Monthly Treasury Statement, Fiscal Year 1994* (October 1994).

NOTE: Totals include Social Security and the Postal Service, which are off-budget.

thereafter. Only the differences that can be linked rigorously to those major variables are labeled economic. Other differences that might be tied to economic performance (for example, higher support payments to farmers in response to weak agricultural exports) are not included in this category because their relationship to the published forecast is more tenuous.

Technical differences are all other types of discrepancies. The portions of the budget that have contributed the biggest technical differences since 1980 are noted at the end of this appendix. Not surprisingly, technical misestimates are concentrated in revenues and in open-ended commitments of the government such as entitlement programs. By convention, nearly all of the differences in deposit insurance outlays are classified as technical--even if the misestimates stemmed in part from Congressional delays in enacting the funds necessary to forge ahead with the savings and loan cleanup.¹ Large technical differences often prompt both CBO and the Administration to review their methods of projection, but some such differences are inevitable given the size and complexity of the budget.

The Budget Resolution for Fiscal Year 1994

The Congressional budget process for fiscal year 1994 began soon after President Clinton's inauguration in January 1993. Under the terms of the Budget Enforcement Act of 1990, policymakers could have chosen to do nothing about the huge deficits that were projected to pile up. After all, the deficit's growth was not traceable to any actions taken by the Congress after the 1990 budget summit but instead to factors outside policymakers' direct control, such as the rapid growth of health care spending.²

Nevertheless, the Congress and the Administration agreed that the deficit outlook was too grim to permit inaction. Thus, the new Administration submitted a package of budget recommendations in February 1993.³ The Congressional budget resolution, which drew many of its elements from the Administration's proposals, followed a little over a month later. It called for a deficit of \$254 billion, \$33 billion below CBO's baseline of that time (see Table B-1). It also assigned responsibility for drafting

1. For a fuller discussion of why the misestimates of deposit insurance are labeled technical, see Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1995-1999* (January 1994), Appendix B.

2. See Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1994-1998* (January 1993), Box 6-1.

3. See Congressional Budget Office, "An Analysis of the President's February Budgetary Proposals," CBO Paper (March 1993).

language that would achieve the deficit reductions to Congressional committees with jurisdiction over particular areas of the budget. The committees responded to that mandate; their contributions were stitched together into OBRA-93, which was enacted in August. Ultimately, revenues came in higher, outlays lower, and the deficit smaller than envisioned in the resolution.

Changes in Policies

Over the 18-month period following the budget resolution's passage, OBRA-93 was by far the most important budget-related legislation. Relative to CBO's baseline of early 1993, the reconciliation act chopped an estimated \$33 billion from the 1994 deficit--the first installment of a package estimated by CBO to

Table B-2.
Sources of Differences Between Actual Budget Totals, CBO March 1993 Baseline Projections, and the Budget Resolution for Fiscal Year 1994 (In billions of dollars)

	Policy				Economic	Technical	Total
	OBRA-93	Emergencies	Other	Subtotal			
Actual Minus CBO March 1993 Baseline							
Outlays							
Discretionary spending	0	7	0	7	0	a	6
Entitlements and other mandatory spending	-4	3	1	1	-3	-24	-27
Deposit insurance	a	0	0	a	0	-12	-12
Net interest	-1	0	a	-1	-6	-1	-8
Offsetting receipts	<u>-2</u>	<u>0</u>	<u>a</u>	<u>-2</u>	<u>a</u>	<u>2</u>	<u>-1</u>
Total	-6	10	1	5	-9	-36	-41
Revenues	26	0	a	26	12	4	43
Deficit	-33	10	1	-22	-21	-41	-83
Actual Minus Budget Resolution							
Outlays							
Discretionary spending	0	7	a	7	0	a	6
Entitlements and other mandatory spending	-1	3	1	3	-3	-24	-24
Deposit insurance	a	0	0	a	0	-12	-12
Net interest	a	0	a	a	-6	a	-6
Offsetting receipts	<u>a</u>	<u>0</u>	<u>a</u>	<u>a</u>	<u>a</u>	<u>1</u>	<u>a</u>
Total	-1	10	1	10	-9	-36	-35
Revenues	-1	0	a	-1	12	4	15
Deficit	a	10	1	11	-21	-40	-50

SOURCE: Congressional Budget Office.

NOTE: OBRA-93 = Omnibus Budget Reconciliation Act of 1993.

a. Less than \$500 million.

save more than \$400 billion over five years (see Table B-2).⁴ Of course, because OBRA-93 produced the deficit reduction called for in the resolution, it saved nothing further when compared with that document.

Other legislation addressed mostly emergency needs. Under the terms of the Balanced Budget and Emergency Deficit Control Act of 1985, emergencies are a valid reason for extra spending and do not require revenue increases or offsetting cuts in other programs. Emergencies are accommodated by upward adjustments to the caps on discretionary spending or--in the case of mandatory spending--by keeping such outlays off the official pay-as-you-go scorecard. Ultimately, emergency legislation caused spending to top the budget resolution by \$10 billion. Specifically, an extra \$7 billion in discretionary spending went mainly to aid victims of the Midwest floods and the California earthquake, and \$3 billion in mandatory spending was dominated by an emergency extension of unemployment benefits (estimated to cost \$2 billion) to recipients who would otherwise have exhausted their eligibility and emergency aid to farmers (nearly \$1 billion). Nonemergency legislation--chiefly a separate, and final, extension of unemployment benefits--added less than \$1 billion.

Economic Factors

In most respects, the economy performed better than had been assumed in the 1994 budget resolution. Based on data available in late 1994, CBO judges that economic developments caused the deficit to be \$21 billion smaller than envisioned in the budget resolution (see Table B-2). Slightly more than half (\$12 billion) of that amount came from higher revenues as buoyant growth pushed up taxable incomes. The rest (\$9 billion) came from lower spending for interest and benefits. Interest rates on medium- and long-term Treasury securities were lower than expected, trimming the government's debt-service costs. And outlays for a variety of benefit programs--notably unemployment compensation, food stamps, and So-

cial Security and other indexed programs--were dampened by lower-than-expected unemployment and inflation.

Technical Factors

Technical factors--the label given to any misestimates that cannot be traced to legislative actions or inaccurate economic assumptions--account for \$41 billion of the overestimate of the deficit in the 1994 budget resolution. Most (\$37 billion) of that misestimate fell on the outlay side.

The bulk of the overestimate lay in two large categories of outlays: mandatory spending and deposit insurance. The first was overestimated by \$24 billion. The government's two big health care programs--Medicare and Medicaid--spent \$5 billion and \$10 billion less in 1994, respectively, than CBO anticipated in early 1993. Both remained among the fastest-growing federal programs, but their pace of growth slackened from the high levels that had been recorded in 1992.

Another \$5 billion of the misestimate of mandatory spending is traceable to a one-time event: the Student Loan Marketing Administration, nicknamed Sallie Mae, unexpectedly repaid its entire debt to the Treasury in 1994, a repayment that was recorded as a negative outlay. Since repayment was expected in any event in a few years, that action helped to hold down the 1994 deficit but clearly has no effect on the fundamental deficit outlook. Much smaller misestimates appeared in a variety of other mandatory spending programs.

The \$12 billion overestimate of deposit insurance spending breaks down into a \$9 billion overestimate of outlays for the Bank Insurance Fund and a \$3 billion overestimate of savings and loan-related outlays by a trio of agencies (the Resolution Trust Corporation, the FSLIC Resolution Fund, and the Savings Association Insurance Fund). The recovery of the commercial banking sector continued, confounding the dire predictions that were widespread in the early 1990s (although CBO was never a member of the most pessimistic camp). The late stages of the savings and loan cleanup, too, appear to be costing the

4. See Congressional Budget Office, *The Economic and Budget Outlook: An Update* (September 1993).

Table B-3.
Sources of Differences Between Actual Budget Totals and First Budget Resolution
Estimates for Fiscal Years 1980 Through 1994 (In billions of dollars)

	Policy	Economic	Technical	Total
Revenues				
1980	6	8	-4	11
1981	-4	5	-13	-11
1982	13	-52	-1	-40
1983	-5	-58	-3	-65
1984	-14	4	-4	-13
1985	a	-20	3	-17
1986	-1	-23	-2	-27
1987	22	-27	7	2
1988	-11	4	-17	-24
1989	1	34	-8	26
1990	-7	-36	9	-34
1991 ^b	-1	-31	-24	-56
1992	3	-46	-34	-78
1993	4	-28	3	-20
1994	-1	12	4	15
Average	a	-17	-5	-22
Absolute Average	6	26	9	29
Outlays				
1980	20	12	16	48
1981	25	6	16	47
1982	1	24	8	33
1983	18	a	8	26
1984	1	7	-18	-9
1985	23	-5	-13	5
1986	14	-12	20	22
1987	7	-12	13	8
1988	-2	12	12	22
1989	17	14	12	43
1990	13	13	59	85
1991 ^b	-19	1	-22	-40
1992	15	-21	-60	-66
1993	16	-19	-90	-92
1994	10	-9	-36	-35
Average	11	1	-5	6
Absolute Average	13	11	27	39
Deficit				
1980	13	4	19	37
1981	28	1	29	58
1982	-12	76	9	73
1983	22	59	11	91
1984	15	3	-14	4
1985	23	15	-16	22
1986	16	11	22	49
1987	-15	15	6	6
1988	9	8	29	46
1989	17	-20	20	17
1990	20	49	50	119
1991 ^b	-19	32	2	15
1992	12	25	-26	11
1993	12	9	-93	-72
1994	11	-21	-40	-50
Average	10	18	a	28
Absolute Average	16	23	26	45

SOURCE: Congressional Budget Office.

NOTES: Differences are actual outcomes minus budget resolution assumptions. The allocation of revenue differences between economic and technical factors is done soon after the fiscal year in question and is not changed later to incorporate revisions in economic data.

a. Less than \$500 million.

b. Based on the fiscal year 1991 budget summit agreement, as assessed by CBO in December 1990.

government somewhat less than CBO expected when the budget resolution was developed in early 1993. Nevertheless, the \$3 billion error is quite small relative to the tens of billions of dollars in gross spending and receipts coursing through the agencies' coffers.

Budget Resolutions in 1980 Through 1994

In 1980 through 1992, the deficit consistently exceeded the figure in the budget resolution by amounts ranging from a negligible \$4 billion to a staggering \$119 billion (see Table B-3). The 1993 budget resolution broke that string. The good news was muted, however, because the misestimate was more than explained by smaller-than-expected deposit insurance spending (see Figure B-1). But in 1994, the deficit again came in below the resolution's assumption--and this time the improvement was more broadly based.

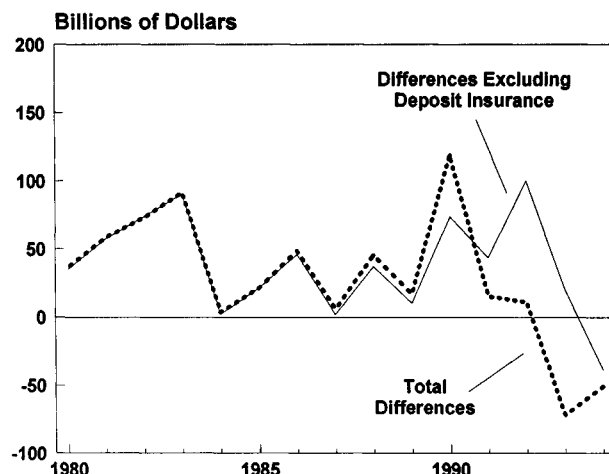
Policy action or inaction (the failure to achieve savings called for in budget resolutions) has generally added to deficits by an average of \$10 billion a year. There were only three major episodes in which policymakers trimmed the deficit more, or added to it

by less, than the resolution permitted: in fiscal year 1982 in the first Reagan-era budget, which occurred mainly because the first-year tax cut contained in the Economic Recovery Tax Act of 1981 was smaller than the resolution had assumed; in 1987, principally because the new Tax Reform Act temporarily swelled collections; and in 1991, chiefly because \$43 billion in contributions from foreign nations to help finance Operation Desert Storm streamed in, dampening total outlays commensurately. Since 1991, the Congress has hewed quite faithfully to the strictures of the Budget Enforcement Act, and nearly all additions to the deficit have been for emergencies.

Because the budget process for a fiscal year begins about nine months before the year starts, economic performance is a regular source of uncertainty. Constant revisions to economic data, which continue long after the fiscal year in question, often make it hard to disentangle economic and technical errors. Nevertheless, with only two exceptions (in 1989 and 1994), budget resolutions over the 15-year span used short-term economic assumptions that proved overly optimistic. The worst errors, not surprisingly, were in years marked by recession or early stages of recovery--namely, in 1982 and 1983 and again in the 1990-1992 period. The economic differences occurred chiefly in revenues and, on the spending side of the budget, in net interest. On average, they caused Congressional drafters to err on the optimistic side to the tune of \$18 billion.

Technical misestimates of the deficit have surprisingly averaged zero--although in absolute terms, disregarding whether they were positive or negative, they caused the estimate of the deficit to be off by \$26 billion. The causes of large technical errors have varied over the years. On the revenue side, such errors were generally not very great through 1990, but they ballooned in 1991 and 1992, when tax collections were even weaker than economic data would seem to justify. On the outlay side, farm price supports, receipts from offshore oil leases, defense, and benefit programs dominated the errors through the mid-1980s. Such errors briefly faded at decade's end. Underestimates of benefit outlays, especially for health care, swelled once again in 1991 and 1992. As noted above, Medicare and Medicaid together were overestimated by \$15 billion in the 1994 budget resolution; yet in the early 1990s, the CBO estimators

Figure B-1.
Differences Between Actual Deficit and Deficit in First Budget Resolution (By fiscal year)



SOURCE: Congressional Budget Office.

tended to underrate the growth in those two programs. And during the 1990-1993 period, as Figure B-1 implies, under- or overestimates of deposit insur

ance virtually swamped all other technical misestimates.

How the Economy Affects the Budget

The federal budget is highly sensitive to the economy. Revenues depend on taxable incomes--including wages and salaries, interest and other nonwage income, and corporate profits--which generally move in step with economic growth. Many benefit programs are pegged to inflation, either directly (like Social Security) or indirectly (like Medicare); others (primarily unemployment insurance) are linked to the unemployment rate. And the Treasury continually borrows and refinances the government's debt at market interest rates.

The Congressional Budget Office (CBO) has distilled the links between key economic assumptions and federal budget projections into four rules of thumb. Those rules generate estimates of the impact on budget totals of changes in real growth, unemployment, inflation, and interest rates. Each rule assumes that the economic variable in question differs from CBO's baseline assumption by 1 percentage point, starting in January 1995. As noted below, such rules of thumb are highly simplified and should be used with caution. Budget projections are also subject to other kinds of errors that are technical in nature and not directly related to economic forecasting. However, there is no similarly easy way to encapsulate the variability of budget outcomes that can stem from technical uncertainty.

Real Growth

Strong economic growth narrows the federal budget deficit, and weak economic growth widens it. The

first rule of thumb produces an estimate of the budgetary impact of economic growth that is significantly weaker than that assumed in CBO's baseline.

In its baseline, CBO assumes that the strong economic growth experienced in 1994 continues into the first part of 1995 before slackening. That assumption results in a rate of growth in real gross domestic product (GDP) that averages 3.1 percent in 1995. Real GDP growth falls below 2 percent in 1996, then levels off at about 2.3 percent thereafter. Subtracting 1 percentage point from the rate of real growth beginning in January 1995 implies more moderate growth in that year, followed by fairly anemic growth in the succeeding years. Under that slow-growth scenario, by 2000, GDP lies more than 5 percent below CBO's baseline assumption.

Weak economic growth also dampens the labor market--the unemployment rate inches up as businesses employ fewer workers in response to weak demand. By 2000, the slow-growth scenario produces an unemployment rate of just over 8 percent, more than 2 percentage points above the baseline.

This scenario significantly impedes growth in taxable incomes, leading to revenue losses that mount from \$9 billion in 1995 to \$125 billion in 2000 (see Table C-1). The loss in revenues in 2000 is more than 7 percent of baseline revenues, somewhat greater than the 5 percent loss in GDP. Outlays for benefit programs--chiefly unemployment insurance--rise by only \$1 billion in 1995. In the following years, however, they climb by larger amounts,

Table C-1.
Effects on CBO Budget Projections of Selected Changes
in Economic Assumptions (By fiscal year, in billions of dollars)

	1995	1996	1997	1998	1999	2000
Real Growth: Effect of 1-Percentage-Point Lower Annual Rate Beginning January 1995						
Change in Revenues	-9	-27	-49	-72	-97	-125
Change in Outlays						
Net interest (Debt service)	a	2	5	9	15	24
Mandatory spending	<u>-1</u>	<u>-3</u>	<u>-5</u>	<u>-7</u>	<u>-10</u>	<u>-12</u>
Total	1	4	9	16	25	36
Change in Deficit	10	32	59	88	122	161
Unemployment: Effect of 1-Percentage-Point Higher Annual Rate Beginning January 1995						
Change in Revenues	-35	-51	-54	-56	-58	-61
Change in Outlays						
Net interest (Debt service)	1	5	9	13	17	23
Mandatory spending	<u>-3</u>	<u>-5</u>	<u>-6</u>	<u>-6</u>	<u>-6</u>	<u>-6</u>
Total	4	10	14	19	23	29
Change in Deficit	39	61	68	74	81	89
Inflation: Effect of 1-Percentage-Point Higher Annual Rate Beginning January 1995						
Change in Revenues	7	21	37	54	72	92
Change in Outlays						
Net interest						
Higher rates	5	17	24	29	34	40
Debt service	a	a	a	1	1	2
Discretionary spending	a	a	1	3	9	14
Mandatory spending	<u>-3</u>	<u>-7</u>	<u>-15</u>	<u>-25</u>	<u>-37</u>	<u>-49</u>
Total	8	24	40	58	81	105
Change in Deficit	1	3	3	4	9	13
Interest Rates: Effect of 1-Percentage-Point Higher Annual Rates Beginning January 1995						
Change in Revenues	0	0	0	0	0	0
Change in Outlays						
Net interest						
Higher rates	5	17	24	29	34	40
Debt service	a	1	3	5	7	10
Mandatory spending	<u>-2</u>	<u>-1</u>	<u>-1</u>	<u>-1</u>	<u>-1</u>	<u>-1</u>
Total	8	19	28	35	42	50
Change in Deficit	8	19	28	35	42	50

SOURCE: Congressional Budget Office.

a. Less than \$500 million.

culminating in \$12 billion of extra spending in 2000. Over time, net interest produces even more extra spending. As revenues falter, the government borrows more and incurs greater debt-service costs. In sum, the deficit in 2000 would be an estimated \$161 billion--nearly 60 percent--bigger than CBO's baseline if real growth was 1 percentage point lower than projected.

Unemployment

The second rule of thumb demonstrates the simplified effects on the budget of a 1-percentage-point increase in unemployment. As illustrated by the first rule of thumb, economic growth and unemployment are often related. Like the first, this second rule quantifies that relationship based on the work of economist Arthur Okun. It posits that an extra percentage point of unemployment is associated with a 2.5 percent reduction in GDP.

In CBO's baseline, the unemployment rate inches up from 5.4 percent in 1995 to 5.9 percent in 2000. This second rule of thumb assumes instead that unemployment jumps to 6.4 percent in 1995 and averages 6.9 percent by 2000. In keeping with the generalized relationship between economic growth and unemployment, GDP is 2.5 percent below its baseline levels throughout the six-year period. As expected, revenues drop, benefits rise, and interest costs climb relative to the baseline. Together, those effects push up the deficit by \$39 billion in 1995 and \$89 billion in 2000.

It is illuminating to compare this example with the first rule of thumb, which depicted the effects of sluggish economic growth. Given the assumed relationship between economic growth and unemployment, it takes about two and one-half years of lower growth--as described under the first rule--to generate an extra percentage point of unemployment. GDP and taxable incomes in the first rule's scenario thus lie above their counterparts in the second rule's scenario through mid-1997, but they fall farther and farther below them thereafter. The budgetary effects closely follow that pattern.

Inflation

Inflation produces effects on the federal budget that largely offset each other. The third rule of thumb generates estimates of the budgetary impact of inflation that is 1 percentage point higher than CBO's baseline assumption. If other economic variables are unaffected, higher inflation leads to larger taxable incomes and hence revenues. But higher inflation also boosts spending. Nearly all benefit programs would cost more, although with a lag; so would discretionary programs, unless policymakers decided to ignore the steady erosion of real resources. And interest rates would almost surely rise with inflation, fueling higher debt-service costs.

Higher inflation has virtually no effect on the deficit initially, as revenues rise almost in tandem with outlays. The extra spending gradually overtakes the additional revenues, however, nudging up the deficit by an estimated \$13 billion in 2000. Of course, nominal incomes and GDP are commensurately larger under this high-inflation scenario. Relative to GDP, the deficit in 2000 is 3.1 percent--the same as in the baseline.

The effects of inflation on the budget are subtle, and different conclusions are possible if one or two key assumptions are changed. The assumption that interest rates rise in step with inflation is crucial--it contributes \$40 billion in extra spending by 2000. The treatment of discretionary programs is also critical. Spending for such programs is limited by the caps initially established in the Budget Enforcement Act of 1990 and subsequently extended through 1998 by the Omnibus Budget Reconciliation Act of 1993. Those caps are partially adjusted to reflect increases (or decreases) in inflation, and CBO assumes that discretionary spending changes by the relatively small amount of the cap adjustments through 1998.

As discussed in Chapter 2, CBO looks at two alternative paths for discretionary spending after 1998, when the caps expire. The first path assumes that policymakers would attempt to preserve the real resources available to the programs they fund by appropriating more dollars in response to a jump in in-

flation. The second path assumes that such appropriations are simply frozen at 1998 nominal levels, forcing annual reductions in the real resources available to discretionary programs. The budgetary effects of inflation shown in Table C-1 are based on the first spending path, in which discretionary spending changes by the amount of the cap adjustments through 1998 and increases with inflation in the following years. Under that assumption, a 1-percentage-point increase in inflation generates extra discretionary spending of \$1 billion in 1997 and \$14 billion in 2000.

Under the second spending path, discretionary spending still changes by the amount of the cap adjustments through 1998 but remains level in the years that follow. Those assumptions result in very little additional discretionary spending by 2000--only about \$3 billion compared with the \$14 billion generated under the first path (see Table C-2). Thus, the second path has a slightly beneficial effect on the deficit but with a hidden cost: an even greater erosion of real resources for discretionary programs than the caps already cause. Under both paths, higher inflation has a negligible impact on the deficit.

Interest Rates

The final rule of thumb illustrates the sensitivity of the budget to interest rates. The Treasury finances the government's large and growing debt at market interest rates. Assuming that interest rates are 1 percentage point higher than in the baseline for all maturities in each year would drive up interest costs by over \$5 billion in 1995. That initial boost in interest costs is fueled largely by the extra costs of refinancing the government's short-term Treasury bills, which make up almost one-fourth of the marketable debt. More than \$700 billion worth of Treasury bills are now outstanding, and none of them have a maturity of more than a year.

The bulk of the marketable debt, however, consists of medium- and long-term securities, mainly those with initial maturities of 2 to 10 years. Inevitably, many of those securities will come due for refinancing over the next few years. And the Treasury continually adds new debt to finance the deficit. Thus, the budgetary effects mount as more and more debt is hit with higher interest rates. By 2000, the

Table C-2.
Effects on CBO Budget Projections of a Change in Inflation,
Keeping Discretionary Spending Level After 1998 (By fiscal year, in billions of dollars)

	1995	1996	1997	1998	1999	2000
Change in Revenues	7	21	37	54	72	92
Change in Outlays						
Net interest						
Higher rates	5	17	24	29	34	40
Debt service	a	a	a	1	1	2
Discretionary spending	a	a	1	3	3	3
Mandatory spending	<u>3</u>	<u>7</u>	<u>15</u>	<u>25</u>	<u>37</u>	<u>49</u>
Total	8	24	40	58	75	94
Change in Deficit	1	3	3	4	3	2

SOURCE: Congressional Budget Office.

NOTE: The change in inflation assumed here is a 1-percentage-point higher annual rate beginning in January 1995.

a. Less than \$500 million.

vast majority of the debt would be affected. Of the marketable debt outstanding at the end of that year, CBO estimates that nearly 31 percent would have been originally borrowed in the 1995-2000 period and therefore would be affected by higher rates. About 54 percent would have been outstanding in early 1995 and then refinanced during the 1995-2000 period. Only about 15 percent of the debt would be unaffected by higher interest rates. The deficit in 2000 increases by \$50 billion as a result of the interest rate hike. This final rule of thumb incorporates small changes in other interest-sensitive spending, primarily student loans, but does not include any changes in revenues or deposit insurance spending. For both of those categories, the impact of higher interest rates is not obvious.

Conclusions

The rules of thumb are useful for illustrating the budgetary effects of key economic assumptions. They are roughly symmetrical: higher growth, lower unemployment, lower inflation, and lower interest rates would alter budget projections by about the same amount but in the opposite direction as the scenarios depicted in Table C-1.

CBO presents rules of thumb each year in its annual report. They always change somewhat from year to year because of the intervening growth in the

economy (principally affecting revenues), changes in interest rates, and new projections of growth in benefit programs, among other reasons. The results of applying this year's rules of thumb are nearly identical to those of last year.¹ The effects on revenues of the rules dealing with lower growth, higher unemployment, and higher inflation are slightly greater this year because of intervening growth in the economy. This year's calculations also indicate a slight increase in the budget's sensitivity to changes in interest rates, mostly as a result of more debt over the 1995-2000 period.

Although rules of thumb are a simple way to express the relationship between economic performance and budget outcomes, they have their limitations. Sustained errors of 1 percentage point are used for the sake of simplicity; they do not represent typical forecasting errors. Neither the size nor the timing of actual errors is likely to match the smooth paths assumed in these examples. Some variables, such as interest rates, are notoriously harder than others to predict. A sustained error of 1 percentage point in interest rates is much likelier than a similar error in the projection of real growth. In addition, because economic variables are interrelated, changes do not occur in isolation.

1. See Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1995-1999* (January 1994), Appendix C.

The Federal Sector of the National Income and Product Accounts

In addition to the usual budget presentation, the economic influence of the federal government can be portrayed through the national income and product accounts (NIPAs). The NIPAs provide a picture of government activity in terms of production, distribution, and use of output. That approach recasts the government's transactions into categories that affect gross domestic product, income, and other macroeconomic aggregates, thereby helping to trace the relationship between the federal sector and other areas of the economy.

Relationship Between the Budget and the NIPAs

A handful of major differences distinguish the NIPA version of federal receipts and expenditures from its budgetary counterpart. One example is the shift of selected dollars from the spending to the receipts side of the budget. Such shifts are referred to as netting and grossing adjustments. For the most part, they affect certain receipts that the budget records as negative outlays because they are voluntary or intrabudgetary in nature and are not deemed to result from the government's taxing power. To give a more comprehensive picture of receipts from all sources, the NIPAs shift those negative outlays from the expenditures to the receipts side of the ledger (see Table D-1). That shift does not affect the deficit.

Foremost among netting and grossing adjustments are intrabudgetary receipts for retirement contributions on behalf of federal workers (\$59 billion in 1995) and voluntary premiums for Medicare coverage (\$20 billion in 1995). Another relatively large item is deposit insurance premiums. Deposit insurance outlays are financed in part by premiums levied on banks and thrift institutions; those premiums correspondingly boost the netting and grossing adjustment by \$7 billion in 1995 but by just \$2 billion a year thereafter, when the Congressional Budget Office (CBO) anticipates a reduction in the premiums levied on commercial banks.

In contrast, another difference between the federal budget and the NIPAs--the treatment of lending and financial transactions--does affect the deficit. The NIPA totals exclude transactions that involve the transfer of existing assets and liabilities and that therefore do not contribute to current income and production. Prominent among such adjustments are those for deposit insurance outlays and direct loans made by (or repaid to) the government. Other, relatively small factors driving a wedge between budget and NIPA accounting include geographic adjustments (the exclusion of Puerto Rico, the Virgin Islands, and a few other areas from the national economic statistics) and timing adjustments (such as correcting for irregular numbers of benefit checks or paychecks because of calendar quirks). Preliminary actual figures for 1994 show a particularly large "other" difference on the receipts side. The \$16 bil-

Table D-1.
Relationship of the Budget to the Federal Sector of the
National Income and Product Accounts (By fiscal year, in billions of dollars)

	Actual 1994 ^a	1995	1996	1997	1998	1999	2000
Receipts							
Revenues (Budget basis) ^b	1,257	1,355	1,418	1,475	1,546	1,618	1,697
Differences							
Netting and grossing							
Government contributions for employee retirement	57	59	61	65	68	72	76
Medicare premiums	18	20	21	22	25	27	28
Deposit insurance premiums	7	7	2	2	2	2	2
Other	3	7	1	c	c	-1	-3
Geographic exclusions	-2	-3	-3	-3	-3	-3	-3
Other	16	4	3	4	3	5	5
Total	98	94	85	91	96	102	106
Receipts (NIPA basis)	1,355	1,449	1,503	1,566	1,642	1,721	1,803
Expenditures							
Outlays (Budget basis) ^b	1,461	1,531	1,625	1,699	1,769	1,872	1,981
Differences							
Netting and grossing							
Government contributions for employee retirement	57	59	61	65	68	72	76
Medicare premiums	18	20	21	22	25	27	28
Deposit insurance premiums	7	7	2	2	2	2	2
Other	3	7	1	c	c	-1	-3
Lending and financial transactions							
Deposit insurance	1	10	7	2	2	c	-1
Other	-1	-4	-2	-1	c	2	2
Defense timing adjustment	1	1	1	1	1	1	1
Geographic exclusions	-9	-9	-10	-10	-11	-11	-12
Other	-8	-4	-2	-7	-7	-7	-11
Total	68	86	78	75	81	85	83
Expenditures (NIPA basis)	1,529	1,617	1,704	1,774	1,849	1,956	2,065
Deficit							
Deficit (Budget basis) ^b	203	176	207	224	222	253	284
Differences							
Lending and financial transactions	c	6	4	2	2	1	c
Defense timing adjustment	1	1	1	1	1	1	1
Geographic exclusions	-6	-7	-7	-7	-8	-8	-9
Other	-24	-8	-5	-11	-10	-12	-15
Total	-29	-8	-7	-16	-15	-18	-23
Deficit (NIPA basis)	174	168	201	208	207	236	261

SOURCE: Congressional Budget Office.

NOTE: The budget projections assume that discretionary spending rises with inflation after the caps expire in 1998.

- Differences estimated by CBO. Actual NIPA receipts, expenditures, and deficit for 1994 are subject to revision by the Department of Commerce, Bureau of Economic Analysis.
- Includes Social Security and the Postal Service.
- Less than \$500 million.

lion entry in that category is primarily due to timing differences and early estimates of corporate liabilities based on incomplete information from the Bureau of Economic Analysis. When updated data become available, CBO expects the "other" difference to diminish.

NIPA Receipts and Expenditures

The federal sector of the NIPAs generally portrays receipts according to their source and expenditures according to their purpose and destination (see Table D-2).

The leading source of receipts for the federal government in the 1995-2000 period is taxes and fees paid by individuals. Following that category closely are contributions (including premiums) for social insurance such as Social Security, Medicare, unemployment insurance, and federal employees' retirement. Each source is expected to raise around \$600 billion in 1995. The remaining categories are corporate profits tax accruals, including the earnings of the Federal Reserve System, and indirect business tax and nontax accruals (chiefly from excise taxes and fees).

Classifying government expenditures according to their purpose and destination is more complicated. Defense and nondefense purchases of goods and services clearly enter directly into gross domestic product (GDP). The effects of the remaining expenditure categories are less straightforward, however, because their effects on GDP hinge on the recipients' use of the funds. For example, transfer payments (led by Social Security) may be used for a variety of purchases--from durable goods to services--and will not be counted as part of GDP until the funds are spent. Another category, grants to state and local governments, ultimately translates into state and local transfers (such as Medicaid) or purchases (such as highway construction).

Although both the budget and the NIPAs contain a category labeled "net interest," the NIPA figure is smaller. A variety of differences cause the two mea-

asures to diverge, the greatest of which is the contrasting treatment of interest received on late payments of personal and business taxes. In the budget, both types of payments are counted on the revenue side, as individual income taxes and corporate income taxes, respectively. In the NIPAs, those differences appear as offsets to federal interest payments, thereby lowering net interest payments by \$12 billion to \$15 billion each year through 2000. Also, recent data on federal net interest expenditures from the Bureau of Economic Analysis contain a fairly large downward adjustment (about \$8 billion) without obvious explanation.

The category labeled "subsidies less current surplus of government enterprises" contains two components, as its name suggests. The first--subsidies--is defined as monetary grants paid by government to businesses, including state and local government enterprises such as local public housing authorities. Subsidies are dominated by housing assistance, which accounts for approximately two-thirds of 1995 subsidy outlays.

The second portion of the category is the current surplus of government enterprises. Government enterprises are certain business-type operations of the government--for example, the Postal Service. The operating costs of government enterprises are mostly covered by the sale of goods and services to the public rather than by tax receipts. The difference between sales and current operating expenses is the enterprise's surplus or deficit. In 1995, the current surplus of government enterprises will be approximately \$1 billion. *Government enterprises* should not be confused with *government-sponsored enterprises* (GSEs), private entities established and chartered by the federal government to perform specific financial functions, usually under the supervision of a government agency. Examples of GSEs include the Federal National Mortgage Association (Fannie Mae) and the Student Loan Marketing Association (Sallie Mae). As privately owned organizations, GSEs are not included in the budget or in the federal sector of the NIPAs.

As emphasized in Chapter 2, policymakers must comply with discretionary spending caps in future years, but they may do so in any number of ways. Unspecified savings of \$5 billion in 1996 and larger

Table D-2.
Projections of Baseline Receipts and Expenditures Measured by the
National Income and Product Accounts (By fiscal year, in billions of dollars)

	Actual 1994 ^a	1995	1996	1997	1998	1999	2000
Receipts							
Personal Tax and Nontax Receipts	556	606	641	670	707	745	787
Corporate Profits Tax Accruals	162	165	168	173	179	186	192
Indirect Business Tax and Nontax Accruals	91	100	91	91	92	94	95
Contributions for Social Insurance	<u>546</u>	<u>578</u>	<u>604</u>	<u>632</u>	<u>663</u>	<u>695</u>	<u>729</u>
Total	1,355	1,449	1,503	1,566	1,642	1,721	1,803
Expenditures							
Purchases of Goods and Services							
Defense	296	289	288	298	307	320	331
Nondefense	<u>144</u>	<u>151</u>	<u>155</u>	<u>163</u>	<u>169</u>	<u>175</u>	<u>182</u>
Subtotal	439	440	443	461	476	495	513
Transfer Payments							
Domestic	660	702	752	802	854	911	968
Foreign	<u>16</u>	<u>15</u>	<u>15</u>	<u>15</u>	<u>16</u>	<u>16</u>	<u>17</u>
Subtotal	676	717	767	817	869	927	985
Grants-in-Aid to State and Local Governments	195	209	224	239	256	274	291
Net Interest	186	216	239	248	256	269	285
Subsidies Less Current Surplus of Government Enterprises	32	34	36	36	36	39	40
Required Reductions in Discretionary Spending	<u>n.a.</u>	<u>n.a.</u>	<u>-5</u>	<u>-27</u>	<u>-45</u>	<u>-47</u>	<u>-49</u>
Total	1,529	1,617	1,704	1,774	1,849	1,956	2,065
Deficit							
Deficit	174	168	201	208	207	236	261

SOURCE: Congressional Budget Office.

NOTES: The budget projections on which the NIPA projections are predicated assume that discretionary spending rises with inflation after the caps expire in 1998.

n.a. = not applicable.

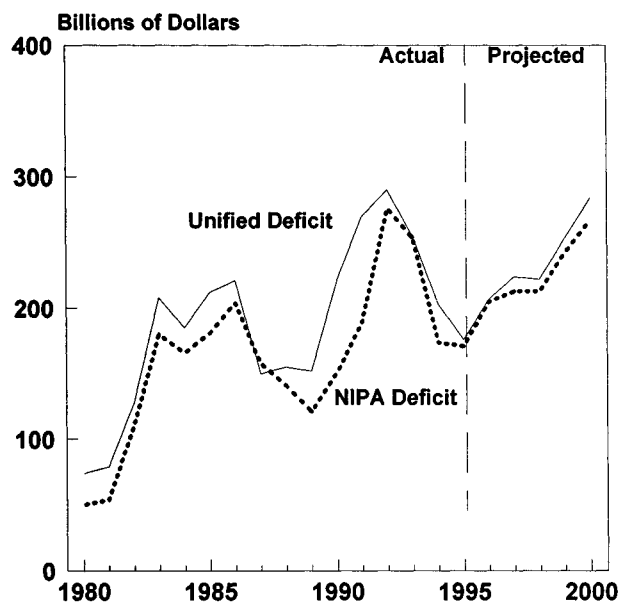
a. Subject to revision by the Department of Commerce, Bureau of Economic Analysis.

amounts thereafter will thus be required (see Table D-2). The savings cannot be assigned to particular NIPA categories; however, they are most likely to come from defense and nondefense purchases and grants.

NIPA Deficits

In the early and mid-1980s, the NIPA deficit and the unified budget deficit generally paralleled each other, with the NIPA deficit several billion dollars lower than its budgetary counterpart (see Figure D-1). Since then, the wedge between the two has fluctuated widely because of large swings in lending and financial exclusions. For example, sizable deposit insurance outlays in 1989 through 1991 widened the gap between the NIPA and unified budget deficit significantly. Since 1992, when deposit insurance spending plummeted, the gap between the NIPA and unified budget measures has narrowed. In CBO's new projections, the budget and NIPA deficits move pretty much in tandem, with the NIPA deficit generally running \$5 billion to \$10 billion below its budgetary counterpart.

Figure D-1.
A Comparison of NIPA and Unified Budget Deficits, Fiscal Years 1980-2000



SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

NOTE: NIPA = national income and product accounts.

Historical Budget Data

This appendix provides historical data for revenues, outlays, and the deficit. Estimates of the standardized-employment deficit and its revenue and outlay components for fiscal years 1956 through 1994 are reported in Table E-1, along with estimates of potential gross domestic product (GDP), actual GDP, and the nonaccelerating inflation rate of unemployment (NAIRU). The standardized-employment deficit and its components are also shown as a percentage of potential GDP. Data consistent with the budget projections in Chapter 2 are available for fiscal years 1962 through 1994 and are reported in Tables E-2 through E-11. The data are shown both in nominal dollars and as a percentage of gross domestic product.

The change in the standardized-employment deficit, as shown in Table E-1, is a commonly used measure of the short-term impact of discretionary fiscal policy on aggregate demand. The standardized-employment deficit--which is often called the structural deficit--excludes the effects on revenues and outlays of cyclical fluctuations in output and unemployment. More specifically, standardized-employment revenues are the federal revenues that would be collected if the economy was operating at its potential level of GDP. Those revenues are greater than actual revenues when GDP is below its potential level, because the tax bases are then cyclically depressed. Standardized-employment outlays are the federal outlays that would be recorded if the economy was at an unemployment rate consistent with stable inflation--the NAIRU, which is also the benchmark used to compute potential GDP. These outlays are less than actual outlays when the rate of unemployment is higher

than the NAIRU, because transfer payments for unemployment insurance and other programs are then cyclically swollen.

Federal revenues, outlays, deficit or surplus, and debt held by the public are shown in Tables E-2 and E-3. Revenues, outlays, and the deficit have both on-budget and off-budget components. Social Security receipts and outlays were placed off-budget by the Balanced Budget and Emergency Deficit Control Act of 1985; the Postal Service was moved off-budget beginning in 1989 by the Omnibus Budget Reconciliation Act of 1989.

The major sources of federal revenues (including off-budget revenues) are presented in Tables E-4 and E-5. Social insurance taxes and contributions include employer and employee payments for Social Security, Medicare, Railroad Retirement, and unemployment insurance, and pension contributions by federal workers. Excise taxes are levied on certain products and services such as gasoline, alcoholic beverages, and air travel. The windfall profits tax on domestic oil producers, enacted in 1980 and classified as an excise tax, brought in large amounts of money in the early 1980s but by 1987--in the face of declining oil prices--generated nothing, paving the way for its repeal in 1988. Miscellaneous receipts consist of deposits of earnings by the Federal Reserve System and numerous fees and charges.

Total on- and off-budget outlays for major spending categories are shown in Tables E-6 and E-7. In order to compare historical outlays with the projections discussed in Chapter 2, the historical data have

been divided into the same categories of spending as the projections. Spending controlled by the appropriation process is classified as discretionary. Tables E-8 and E-9 divide discretionary spending into its defense, international, and domestic components. Entitlements and other mandatory spending include programs for which spending is governed by laws making those who meet certain requirements eligible to receive payments. Additional detail on entitlement programs is shown in Tables E-10 and E-11. Deposit insurance represents the net costs of dealing with insolvent banks and savings and loan institutions; such

outlays were especially volatile beginning in 1988. Net interest is identical to the budget function with the same name (function 900).

Offsetting receipts include the federal government's contribution toward employee retirement, fees and charges such as Medicare premiums, and receipts from the use of federally controlled land and offshore territory. In 1991 and 1992, this category was swelled by contributions from allied nations to help pay the costs of Operation Desert Storm.

Table E-1.
Standardized-Employment Deficit and Related Series, Fiscal Years 1956-1994

	Standardized-Employment ^a						Gross Domestic Product (Billions of Dollars)		NAIRU ^b (Percent)
	In Billions of Dollars			As a Percentage of Potential GDP			Potential	Actual	
	Revenues	Outlays	Deficit (-)	Revenues	Outlays	Deficit (-)			
1956	71	71	-1	17.6	17.7	-0.2	403	416	5.5
1957	77	78	-1	18.0	18.1	-0.1	428	439	5.5
1958	82	82	-1	18.0	18.1	-0.1	454	448	5.5
1959	80	92	-11	16.7	19.0	-2.4	481	478	5.5
1960	93	92	c	18.3	18.2	0.1	507	506	5.5
1961	98	97	1	18.6	18.3	0.2	530	517	5.6
1962	101	107	-6	18.0	19.1	-1.1	559	554	5.6
1963	107	112	-4	18.3	19.0	-0.7	588	585	5.6
1964	110	119	-9	17.8	19.3	-1.5	617	627	5.6
1965	112	119	-7	17.1	18.3	-1.1	654	671	5.7
1966	121	137	-16	17.2	19.5	-2.3	702	739	5.8
1967	140	160	-20	18.5	21.2	-2.7	758	791	5.8
1968	144	182	-37	17.7	22.2	-4.6	816	850	5.8
1969	176	188	-12	19.8	21.2	-1.4	888	926	5.9
1970	189	200	-11	19.4	20.6	-1.1	970	986	5.9
1971	189	211	-22	17.9	20.0	-2.1	1,057	1,052	6.0
1972	207	232	-25	18.1	20.2	-2.1	1,146	1,146	6.0
1973	219	249	-30	17.7	20.1	-2.4	1,236	1,278	6.1
1974	255	273	-18	18.6	19.9	-1.3	1,376	1,404	6.2
1975	293	329	-36	18.7	21.0	-2.3	1,567	1,511	6.2
1976	312	365	-53	18.0	21.0	-3.1	1,737	1,685	6.2
1977	361	407	-46	18.6	21.0	-2.4	1,940	1,920	6.3
1978	396	459	-64	18.5	21.5	-3.0	2,141	2,156	6.3
1979	456	507	-52	18.9	21.1	-2.1	2,406	2,432	6.3
1980	531	589	-58	19.7	21.8	-2.1	2,700	2,645	6.3
1981	618	672	-54	20.4	22.2	-1.8	3,032	2,965	6.2
1982	668	732	-64	20.1	22.0	-1.9	3,322	3,125	6.2
1983	660	785	-125	18.6	22.1	-3.5	3,551	3,317	6.1
1984	688	840	-152	18.2	22.2	-4.0	3,785	3,697	6.1
1985	748	940	-192	18.6	23.3	-4.8	4,027	3,971	6.1
1986	784	981	-197	18.3	22.9	-4.6	4,276	4,220	6.1
1987	868	997	-129	19.3	22.1	-2.9	4,504	4,453	6.0
1988	898	1,057	-159	18.8	22.2	-3.3	4,771	4,810	6.0
1989	978	1,127	-149	19.1	22.0	-2.9	5,133	5,176	6.0
1990	1,036	1,200	-164	18.8	21.8	-3.0	5,498	5,483	5.9
1991	1,104	1,252	-191	18.9	21.4	-3.3	5,853	5,675	5.8
1992	1,154	1,363	-213	18.8	22.1	-3.5	6,152	5,927	5.8
1993	1,199	1,421	-222	18.7	22.1	-3.5	6,426	6,266	5.8
1994	1,274	1,461	-187	19.0	21.8	-2.8	6,687	6,632	6.0

SOURCE: Congressional Budget Office.

- a. Excludes deposit insurance and contributions from allied nations for Operation Desert Storm (which were received in 1991 and 1992).
- b. The NAIRU is the nonaccelerating inflation rate of unemployment. It is the benchmark for computing potential GDP. The increase in the NAIRU in 1994 stems from a change in the employment survey.
- c. Less than \$500 million.

Table E-2.
Revenues, Outlays, Deficits, and Debt Held by the Public,
Fiscal Years 1962-1994 (In billions of dollars)

	Revenues	Outlays	Deficit (-) or Surplus			Total	Debt Held by the Public ^a
			On-Budget	Social Security	Postal Service		
1962	99.7	106.8	-5.9	-1.3	b	-7.1	248.0
1963	106.6	111.3	-4.0	-0.8	b	-4.8	254.0
1964	112.6	118.5	-6.5	0.6	b	-5.9	256.8
1965	116.8	118.2	-1.6	0.2	b	-1.4	260.8
1966	130.8	134.5	-3.1	-0.6	b	-3.7	263.7
1967	148.8	157.5	-12.6	4.0	b	-8.6	266.6
1968	153.0	178.1	-27.7	2.6	b	-25.2	289.5
1969	186.9	183.6	-0.5	3.7	b	3.2	278.1
1970	192.8	195.6	-8.7	5.9	b	-2.8	283.2
1971	187.1	210.2	-26.1	3.0	b	-23.0	303.0
1972	207.3	230.7	-26.4	3.1	b	-23.4	322.4
1973	230.8	245.7	-15.4	0.5	b	-14.9	340.9
1974	263.2	269.4	-8.0	1.8	b	-6.1	343.7
1975	279.1	332.3	-55.3	2.0	b	-53.2	394.7
1976	298.1	371.8	-70.5	-3.2	b	-73.7	477.4
1977	355.6	409.2	-49.8	-3.9	b	-53.7	549.1
1978	399.6	458.7	-54.9	-4.3	b	-59.2	607.1
1979	463.3	503.5	-38.2	-2.0	b	-40.2	639.8
1980	517.1	590.9	-72.7	-1.1	b	-73.8	709.3
1981	599.3	678.2	-74.0	-5.0	b	-79.0	784.8
1982	617.8	745.8	-120.1	-7.9	b	-128.0	919.2
1983	600.6	808.4	-208.0	0.2	b	-207.8	1,131.0
1984	666.5	851.8	-185.7	0.3	b	-185.4	1,300.0
1985	734.1	946.4	-221.7	9.4	b	-212.3	1,499.4
1986	769.1	990.3	-238.0	16.7	b	-221.2	1,736.2
1987	854.1	1,003.9	-169.3	19.6	b	-149.8	1,888.1
1988	909.0	1,064.1	-194.0	38.8	b	-155.2	2,050.3
1989	990.7	1,143.2	-205.2	52.4	0.3	-152.5	2,189.3
1990	1,031.3	1,252.7	-278.0	58.2	-1.6	-221.4	2,410.4
1991	1,054.3	1,323.8	-321.7	53.5	-1.3	-269.5	2,687.9
1992	1,090.5	1,380.9	-340.5	50.7	-0.7	-290.4	2,998.6
1993	1,153.5	1,408.2	-300.0	46.8	-1.4	-254.7	3,247.2
1994	1,257.2	1,460.6	-259.0	56.8	-1.1	-203.4	3,432.4

SOURCE: Congressional Budget Office.

a. End of year.

b. During fiscal years 1962 through 1988, the Postal Service was on-budget and included in the on-budget total.

Table E-3.
Revenues, Outlays, Deficits, and Debt Held by the Public,
Fiscal Years 1962-1994 (As a percentage of GDP)

	Revenues	Outlays	Deficit (-) or Surplus			Total	Debt Held by the Public ^a
			On-Budget	Social Security	Postal Service		
1962	18.0	19.3	-1.1	-0.2	b	-1.3	44.7
1963	18.2	19.0	-0.7	-0.1	b	-0.8	43.4
1964	18.0	18.9	-1.0	0.1	b	-0.9	41.0
1965	17.4	17.6	-0.2	c	b	-0.2	38.8
1966	17.7	18.2	-0.4	-0.1	b	-0.5	35.7
1967	18.8	19.9	-1.6	0.5	b	-1.1	33.7
1968	18.0	21.0	-3.3	0.3	b	-3.0	34.1
1969	20.2	19.8	-0.1	0.4	b	0.4	30.0
1970	19.6	19.8	-0.9	0.6	b	-0.3	28.7
1971	17.8	20.0	-2.5	0.3	b	-2.2	28.8
1972	18.1	20.1	-2.3	0.3	b	-2.0	28.1
1973	18.1	19.2	-1.2	c	b	-1.2	26.7
1974	18.8	19.2	-0.6	0.1	b	-0.4	24.5
1975	18.5	22.0	-3.7	0.1	b	-3.5	26.1
1976	17.7	22.1	-4.2	-0.2	b	-4.4	28.3
1977	18.5	21.3	-2.6	-0.2	b	-2.8	28.6
1978	18.5	21.3	-2.5	-0.2	b	-2.7	28.2
1979	19.1	20.7	-1.6	-0.1	b	-1.7	26.3
1980	19.6	22.3	-2.7	c	b	-2.8	26.8
1981	20.2	22.9	-2.5	-0.2	b	-2.7	26.5
1982	19.8	23.9	-3.8	-0.3	b	-4.1	29.4
1983	18.1	24.4	-6.3	c	b	-6.3	34.1
1984	18.0	23.0	-5.0	c	b	-5.0	35.2
1985	18.5	23.8	-5.6	0.2	b	-5.3	37.8
1986	18.2	23.5	-5.6	0.4	b	-5.2	41.1
1987	19.2	22.5	-3.8	0.4	b	-3.4	42.4
1988	18.9	22.1	-4.0	0.8	b	-3.2	42.6
1989	19.1	22.1	-4.0	1.0	c	-2.9	42.3
1990	18.8	22.8	-5.1	1.1	c	-4.0	44.0
1991	18.6	23.3	-5.7	0.9	c	-4.7	47.4
1992	18.4	23.3	-5.7	0.8	c	-4.9	50.6
1993	18.4	22.5	-4.8	0.7	c	-4.1	51.8
1994	19.0	22.0	-3.9	0.9	c	-3.1	51.8

SOURCE: Congressional Budget Office.

a. End of year.

b. During fiscal years 1962 through 1988, the Postal Service was on-budget and included in the on-budget total.

c. Less than 0.05 percent.

Table E-4.
Revenues by Major Source, Fiscal Years 1962-1994 (In billions of dollars)

	Individual Income Taxes	Corporate Income Taxes	Social Insurance Taxes	Excise Taxes	Estate and Gift Taxes	Customs Duties	Miscel- laneous Receipts	Total Revenues
1962	45.6	20.5	17.0	12.5	2.0	1.1	0.8	99.7
1963	47.6	21.6	19.8	13.2	2.2	1.2	1.0	106.6
1964	48.7	23.5	22.0	13.7	2.4	1.3	1.1	112.6
1965	48.8	25.5	22.2	14.6	2.7	1.4	1.6	116.8
1966	55.4	30.1	25.5	13.1	3.1	1.8	1.9	130.8
1967	61.5	34.0	32.6	13.7	3.0	1.9	2.1	148.8
1968	68.7	28.7	33.9	14.1	3.1	2.0	2.5	153.0
1969	87.2	36.7	39.0	15.2	3.5	2.3	2.9	186.9
1970	90.4	32.8	44.4	15.7	3.6	2.4	3.4	192.8
1971	86.2	26.8	47.3	16.6	3.7	2.6	3.9	187.1
1972	94.7	32.2	52.6	15.5	5.4	3.3	3.6	207.3
1973	103.2	36.2	63.1	16.3	4.9	3.2	3.9	230.8
1974	119.0	38.6	75.1	16.8	5.0	3.3	5.4	263.2
1975	122.4	40.6	84.5	16.6	4.6	3.7	6.7	279.1
1976	131.6	41.4	90.8	17.0	5.2	4.1	8.0	298.1
1977	157.6	54.9	106.5	17.5	7.3	5.2	6.5	355.6
1978	181.0	60.0	121.0	18.4	5.3	6.6	7.4	399.6
1979	217.8	65.7	138.9	18.7	5.4	7.4	9.3	463.3
1980	244.1	64.6	157.8	24.3	6.4	7.2	12.7	517.1
1981	285.9	61.1	182.7	40.8	6.8	8.1	13.8	599.3
1982	297.7	49.2	201.5	36.3	8.0	8.9	16.2	617.8
1983	288.9	37.0	209.0	35.3	6.1	8.7	15.6	600.6
1984	298.4	56.9	239.4	37.4	6.0	11.4	17.0	666.5
1985	334.5	61.3	265.2	36.0	6.4	12.1	18.5	734.1
1986	349.0	63.1	283.9	32.9	7.0	13.3	19.9	769.1
1987	392.6	83.9	303.3	32.5	7.5	15.1	19.3	854.1
1988	401.2	94.5	334.3	35.2	7.6	16.2	19.9	909.0
1989	445.7	103.3	359.4	34.4	8.7	16.3	22.8	990.7
1990	466.9	93.5	380.0	35.3	11.5	16.7	27.3	1,031.3
1991	467.8	98.1	396.0	42.4	11.1	15.9	22.8	1,054.3
1992	476.0	100.3	413.7	45.6	11.1	17.4	26.5	1,090.5
1993	509.7	117.5	428.3	48.1	12.6	18.8	18.5	1,153.5
1994	542.7	140.4	461.5	55.2	15.2	20.1	22.1	1,257.2

SOURCE: Congressional Budget Office.

Table E-5.
Revenues by Major Source, Fiscal Years 1962-1994 (As a percentage of GDP)

	Individual Income Taxes	Corporate Income Taxes	Social Insurance Taxes	Excise Taxes	Estate and Gift Taxes	Customs Duties	Miscel- laneous Receipts	Total Revenues
1962	8.2	3.7	3.1	2.3	0.4	0.2	0.2	18.0
1963	8.1	3.7	3.4	2.3	0.4	0.2	0.2	18.2
1964	7.8	3.7	3.5	2.2	0.4	0.2	0.2	18.0
1965	7.3	3.8	3.3	2.2	0.4	0.2	0.2	17.4
1966	7.5	4.1	3.5	1.8	0.4	0.2	0.3	17.7
1967	7.8	4.3	4.1	1.7	0.4	0.2	0.3	18.8
1968	8.1	3.4	4.0	1.7	0.4	0.2	0.3	18.0
1969	9.4	4.0	4.2	1.6	0.4	0.3	0.3	20.2
1970	9.2	3.3	4.5	1.6	0.4	0.2	0.3	19.6
1971	8.2	2.5	4.5	1.6	0.4	0.2	0.4	17.8
1972	8.3	2.8	4.6	1.4	0.5	0.3	0.3	18.1
1973	8.1	2.8	4.9	1.3	0.4	0.2	0.3	18.1
1974	8.5	2.8	5.3	1.2	0.4	0.2	0.4	18.8
1975	8.1	2.7	5.6	1.1	0.3	0.2	0.4	18.5
1976	7.8	2.5	5.4	1.0	0.3	0.2	0.5	17.7
1977	8.2	2.9	5.5	0.9	0.4	0.3	0.3	18.5
1978	8.4	2.8	5.6	0.9	0.2	0.3	0.3	18.5
1979	9.0	2.7	5.7	0.8	0.2	0.3	0.4	19.1
1980	9.2	2.4	6.0	0.9	0.2	0.3	0.5	19.6
1981	9.6	2.1	6.2	1.4	0.2	0.3	0.5	20.2
1982	9.5	1.6	6.4	1.2	0.3	0.3	0.5	19.8
1983	8.7	1.1	6.3	1.1	0.2	0.3	0.5	18.1
1984	8.1	1.5	6.5	1.0	0.2	0.3	0.5	18.0
1985	8.4	1.5	6.7	0.9	0.2	0.3	0.5	18.5
1986	8.3	1.5	6.7	0.8	0.2	0.3	0.5	18.2
1987	8.8	1.9	6.8	0.7	0.2	0.3	0.4	19.2
1988	8.3	2.0	7.0	0.7	0.2	0.3	0.4	18.9
1989	8.6	2.0	7.0	0.7	0.2	0.3	0.4	19.1
1990	8.5	1.7	7.0	0.6	0.2	0.3	0.5	18.8
1991	8.2	1.7	7.0	0.7	0.2	0.3	0.4	18.6
1992	8.0	1.7	7.0	0.8	0.2	0.3	0.4	18.4
1993	8.1	1.9	6.8	0.8	0.2	0.3	0.3	18.4
1994	8.2	2.1	7.0	0.8	0.2	0.3	0.3	19.0

SOURCE: Congressional Budget Office.

Table E-6.
Outlays for Major Spending Categories, Fiscal Years 1962-1994 (In billions of dollars)

	Discretionary Spending	Entitlements and Other Mandatory Spending	Deposit Insurance	Net Interest	Offsetting Receipts	Total Outlays
1962	74.9	32.3	-0.4	6.9	-6.8	106.8
1963	78.3	33.6	-0.4	7.7	-7.9	111.3
1964	82.8	35.7	-0.4	8.2	-7.7	118.5
1965	81.8	36.1	-0.4	8.6	-7.9	118.2
1966	94.1	39.9	-0.5	9.4	-8.4	134.5
1967	110.4	47.4	-0.4	10.3	-10.2	157.5
1968	122.1	56.1	-0.5	11.1	-10.6	178.1
1969	121.4	61.2	-0.6	12.7	-11.0	183.6
1970	124.6	68.7	-0.5	14.4	-11.5	195.6
1971	127.1	82.7	-0.4	14.8	-14.1	210.2
1972	133.1	96.8	-0.6	15.5	-14.1	230.7
1973	135.0	112.2	-0.8	17.3	-18.0	245.7
1974	142.5	127.1	-0.6	21.4	-21.2	269.4
1975	162.5	164.4	0.5	23.2	-18.3	332.3
1976	175.6	189.7	-0.6	26.7	-19.6	371.8
1977	197.1	206.6	-2.8	29.9	-21.5	409.2
1978	218.7	228.4	-1.0	35.5	-22.8	458.7
1979	240.0	248.2	-1.7	42.6	-25.6	503.5
1980	276.5	291.5	-0.4	52.5	-29.2	590.9
1981	308.2	340.6	-1.4	68.8	-37.9	678.2
1982	326.2	372.7	-2.1	85.0	-36.0	745.8
1983	353.4	411.6	-1.2	89.8	-45.3	808.4
1984	379.6	406.3	-0.8	111.1	-44.2	851.8
1985	416.2	450.0	-2.2	129.5	-47.1	946.4
1986	439.0	459.7	1.5	136.0	-45.9	990.3
1987	444.9	470.2	3.1	138.7	-53.0	1,003.9
1988	465.1	494.2	10.0	151.8	-57.0	1,064.1
1989	489.7	526.2	22.0	169.3	-63.9	1,143.2
1990	501.7	567.4	58.1	184.2	-58.8	1,252.7
1991	534.8	634.2	66.3	194.5	-106.0	1,323.8
1992	536.0	711.7	2.6	199.4	-68.8	1,380.9
1993	542.5	762.1	-28.0	198.8	-67.1	1,408.2
1994	545.3	788.7	-7.3	202.9	-69.1	1,460.6

SOURCE: Congressional Budget Office.

Table E-7.
Outlays for Major Spending Categories, Fiscal Years 1962-1994 (As a percentage of GDP)

	Discretionary Spending	Entitlements and Other Mandatory Spending	Deposit Insurance	Net Interest	Offsetting Receipts	Total Outlays
1962	13.5	5.8	-0.1	1.2	-1.2	19.3
1963	13.4	5.7	-0.1	1.3	-1.3	19.0
1964	13.2	5.7	-0.1	1.3	-1.2	18.9
1965	12.2	5.4	-0.1	1.3	-1.2	17.6
1966	12.7	5.4	-0.1	1.3	-1.1	18.2
1967	14.0	6.0	-0.1	1.3	-1.3	19.9
1968	14.4	6.6	-0.1	1.3	-1.2	21.0
1969	13.1	6.6	-0.1	1.4	-1.2	19.8
1970	12.6	7.0	-0.1	1.5	-1.2	19.8
1971	12.1	7.9	a	1.4	-1.3	20.0
1972	11.6	8.4	-0.1	1.4	-1.2	20.1
1973	10.6	8.8	-0.1	1.4	-1.4	19.2
1974	10.2	9.1	a	1.5	-1.5	19.2
1975	10.8	10.9	a	1.5	-1.2	22.0
1976	10.4	11.3	a	1.6	-1.2	22.1
1977	10.3	10.8	-0.1	1.6	-1.1	21.3
1978	10.1	10.6	a	1.6	-1.1	21.3
1979	9.9	10.2	-0.1	1.8	-1.1	20.7
1980	10.5	11.0	a	2.0	-1.1	22.3
1981	10.4	11.5	a	2.3	-1.3	22.9
1982	10.4	11.9	-0.1	2.7	-1.2	23.9
1983	10.7	12.4	a	2.7	-1.4	24.4
1984	10.3	11.0	a	3.0	-1.2	23.0
1985	10.5	11.3	-0.1	3.3	-1.2	23.8
1986	10.4	10.9	a	3.2	-1.1	23.5
1987	10.0	10.6	0.1	3.1	-1.2	22.5
1988	9.7	10.3	0.2	3.2	-1.2	22.1
1989	9.5	10.2	0.4	3.3	-1.2	22.1
1990	9.2	10.3	1.1	3.4	-1.1	22.8
1991	9.4	11.2	1.2	3.4	-1.9	23.3
1992	9.0	12.0	a	3.4	-1.2	23.3
1993	8.7	12.2	-0.4	3.2	-1.1	22.5
1994	8.2	11.9	-0.1	3.1	-1.0	22.0

SOURCE: Congressional Budget Office.

a. Less than 0.05 percent.

Table E-8.
Discretionary Outlays, Fiscal Years 1962-1994 (In billions of dollars)

	Defense	International	Domestic	Total
1962	52.6	5.5	16.8	74.9
1963	53.7	5.2	19.3	78.3
1964	55.0	4.6	23.1	82.8
1965	51.0	4.7	26.1	81.8
1966	59.0	5.1	30.0	94.1
1967	72.0	5.3	33.1	110.4
1968	82.2	4.9	35.1	122.1
1969	82.7	4.1	34.6	121.4
1970	81.9	4.0	38.7	124.6
1971	79.0	3.8	44.3	127.1
1972	79.3	4.6	49.2	133.1
1973	77.1	4.8	53.0	135.0
1974	80.7	6.2	55.6	142.5
1975	87.6	8.2	66.7	162.5
1976	89.9	7.5	78.2	175.6
1977	97.5	8.0	91.5	197.1
1978	104.6	8.5	105.5	218.7
1979	116.8	9.1	114.1	240.0
1980	134.6	12.8	129.1	276.5
1981	158.0	13.6	136.5	308.2
1982	185.9	12.9	127.4	326.2
1983	209.9	13.6	130.0	353.4
1984	228.0	16.3	135.3	379.6
1985	253.1	17.4	145.7	416.2
1986	273.8	17.7	147.5	439.0
1987	282.5	15.2	147.2	444.9
1988	290.9	15.7	158.4	465.1
1989	304.0	16.6	169.0	489.7
1990	300.1	19.1	182.5	501.7
1991	319.7	19.7	195.4	534.8
1992	302.6	19.2	214.2	536.0
1993	292.4	21.6	228.5	542.5
1994	282.4	20.5	242.4	545.3

SOURCE: Congressional Budget Office.

Table E-9.
Discretionary Outlays, Fiscal Years 1962-1994 (As a percentage of GDP)

	Defense	International	Domestic	Total
1962	9.5	1.0	3.0	13.5
1963	9.2	0.9	3.3	13.4
1964	8.8	0.7	3.7	13.2
1965	7.6	0.7	3.9	12.2
1966	8.0	0.7	4.1	12.7
1967	9.1	0.7	4.2	14.0
1968	9.7	0.6	4.1	14.4
1969	8.9	0.4	3.7	13.1
1970	8.3	0.4	3.9	12.6
1971	7.5	0.4	4.2	12.1
1972	6.9	0.4	4.3	11.6
1973	6.1	0.4	4.1	10.6
1974	5.8	0.4	4.0	10.2
1975	5.8	0.5	4.4	10.8
1976	5.3	0.4	4.6	10.4
1977	5.1	0.4	4.8	10.3
1978	4.9	0.4	4.9	10.1
1979	4.8	0.4	4.7	9.9
1980	5.1	0.5	4.9	10.5
1981	5.3	0.5	4.6	10.4
1982	6.0	0.4	4.1	10.4
1983	6.3	0.4	3.9	10.7
1984	6.2	0.4	3.7	10.3
1985	6.4	0.4	3.7	10.5
1986	6.5	0.4	3.5	10.4
1987	6.3	0.3	3.3	10.0
1988	6.0	0.3	3.3	9.7
1989	5.9	0.3	3.3	9.5
1990	5.5	0.3	3.3	9.2
1991	5.6	0.3	3.4	9.4
1992	5.1	0.3	3.6	9.0
1993	4.7	0.3	3.6	8.7
1994	4.3	0.3	3.7	8.2

SOURCE: Congressional Budget Office.

Table E-10.
Outlays for Entitlements and Other Mandatory Spending,
Fiscal Years 1962-1994 (In billions of dollars)

	Means-Tested Programs			Non-Means-Tested Programs						Total Entitlements and Other Mandatory Spending	
	Medicaid	Other	Total Means-Tested Programs	Social Security	Medicare	Other Retirement and Disability	Unemployment Compensation	Farm Price Supports	Other		Total Non-Means-Tested Programs
1962	0.1	4.2	4.3	14.0	0	2.7	3.5	2.4	5.3	28.0	32.3
1963	0.2	4.6	4.7	15.5	0	2.9	3.6	3.4	3.5	28.8	33.6
1964	0.2	4.8	5.0	16.2	0	3.3	3.4	3.4	4.4	30.7	35.7
1965	0.3	5.0	5.2	17.1	0	3.6	2.7	2.8	4.7	30.9	36.1
1966	0.8	5.0	5.8	20.3	a	4.1	2.2	1.4	6.1	34.1	39.9
1967	1.2	5.0	6.2	21.5	3.2	4.8	2.3	2.0	7.4	41.2	47.4
1968	1.8	5.7	7.5	23.1	5.1	5.7	2.2	3.3	9.2	48.6	56.1
1969	2.3	6.4	8.6	26.7	6.3	5.2	2.3	4.2	7.8	52.6	61.2
1970	2.7	7.4	10.1	29.6	6.8	6.6	3.1	3.8	8.6	58.6	68.7
1971	3.4	10.1	13.4	35.1	7.5	8.3	5.8	2.9	9.8	69.3	82.7
1972	4.6	11.7	16.3	39.4	8.4	9.6	6.7	4.1	12.4	80.5	96.8
1973	4.6	11.4	16.0	48.2	9.0	11.7	4.9	3.6	18.8	96.2	112.2
1974	5.8	13.7	19.5	55.0	10.7	13.8	5.6	1.0	21.6	107.7	127.1
1975	6.8	18.5	25.4	63.6	14.1	18.3	12.8	0.6	29.7	139.0	164.4
1976	8.6	21.7	30.3	72.7	16.9	18.9	18.6	1.1	31.2	159.4	189.7
1977	9.9	23.5	33.3	83.7	20.8	21.6	14.3	3.8	29.0	173.2	206.6
1978	10.7	24.8	35.5	92.4	24.3	23.7	10.8	5.7	36.0	192.9	228.4
1979	12.4	26.5	38.9	102.6	28.2	27.9	9.8	3.6	37.3	209.3	248.2
1980	14.0	32.0	45.9	117.1	34.0	32.1	16.9	2.8	42.8	245.6	291.5
1981	16.8	37.1	53.9	137.9	41.3	37.4	18.3	4.0	47.8	286.7	340.6
1982	17.4	37.4	54.8	153.9	49.2	40.7	22.2	11.7	40.3	318.0	372.7
1983	19.0	40.3	59.3	168.5	55.5	43.2	29.7	18.9	36.6	352.4	411.6
1984	20.1	41.2	61.3	176.1	61.0	44.7	17.0	7.3	38.9	345.0	406.3
1985	22.7	43.3	66.0	186.4	69.7	45.5	15.8	17.7	48.8	384.0	450.0
1986	25.0	44.9	69.9	196.5	74.2	47.5	16.1	25.8	29.5	389.8	459.7
1987	27.4	45.5	72.9	205.1	79.9	50.8	15.5	22.4	23.6	397.3	470.2
1988	30.5	50.0	80.5	216.8	85.7	54.2	13.6	12.2	31.3	413.8	494.2
1989	34.6	54.2	88.8	230.4	94.3	57.2	13.9	10.6	31.0	437.4	526.2
1990	41.1	58.8	99.9	246.5	107.4	59.9	17.5	6.5	29.8	467.5	567.4
1991	52.5	69.7	122.2	266.8	114.2	64.4	25.1	10.1	31.4	512.0	634.2
1992	67.8	78.7	146.5	285.2	129.4	66.6	36.9	9.3	37.9	565.2	711.7
1993	75.8	86.5	162.3	302.0	143.2	68.7	35.4	15.6	35.0	599.7	762.1
1994	82.0	95.0	177.0	316.9	159.5	72.1	26.4	9.9	26.9	611.6	788.7

SOURCE: Congressional Budget Office.

a. Less than \$50 million.

Table E-11.
Outlays for Entitlements and Other Mandatory Spending,
Fiscal Years 1962-1994 (As a percentage of GDP)

	Means-Tested Programs			Non-Means-Tested Programs						Total Entitlements and Other Mandatory Spending	
	Medicaid	Other	Total Means-Tested Programs	Social Security	Medicare	Other Retirement and Disability	Unemployment Compensation	Farm Price Supports	Other		Total Non-Means-Tested Programs
1962	a	0.8	0.8	2.5	0	0.5	0.6	0.4	1.0	5.0	5.8
1963	a	0.8	0.8	2.6	0	0.5	0.6	0.6	0.6	4.9	5.7
1964	a	0.8	0.8	2.6	0	0.5	0.5	0.5	0.7	4.9	5.7
1965	a	0.7	0.8	2.5	0	0.5	0.4	0.4	0.7	4.6	5.4
1966	0.1	0.7	0.8	2.7	a	0.6	0.3	0.2	0.8	4.6	5.4
1967	0.1	0.6	0.8	2.7	0.4	0.6	0.3	0.2	0.9	5.2	6.0
1968	0.2	0.7	0.9	2.7	0.6	0.7	0.3	0.4	1.1	5.7	6.6
1969	0.2	0.7	0.9	2.9	0.7	0.6	0.2	0.5	0.8	5.7	6.6
1970	0.3	0.7	1.0	3.0	0.7	0.7	0.3	0.4	0.9	5.9	7.0
1971	0.3	1.0	1.3	3.3	0.7	0.8	0.5	0.3	0.9	6.6	7.9
1972	0.4	1.0	1.4	3.4	0.7	0.8	0.6	0.4	1.1	7.0	8.4
1973	0.4	0.9	1.3	3.8	0.7	0.9	0.4	0.3	1.5	7.5	8.8
1974	0.4	1.0	1.4	3.9	0.8	1.0	0.4	0.1	1.5	7.7	9.1
1975	0.5	1.2	1.7	4.2	0.9	1.2	0.8	a	2.0	9.2	10.9
1976	0.5	1.3	1.8	4.3	1.0	1.1	1.1	0.1	1.9	9.5	11.3
1977	0.5	1.2	1.7	4.4	1.1	1.1	0.7	0.2	1.5	9.0	10.8
1978	0.5	1.1	1.6	4.3	1.1	1.1	0.5	0.3	1.7	8.9	10.6
1979	0.5	1.1	1.6	4.2	1.2	1.1	0.4	0.1	1.5	8.6	10.2
1980	0.5	1.2	1.7	4.4	1.3	1.2	0.6	0.1	1.6	9.3	11.0
1981	0.6	1.3	1.8	4.7	1.4	1.3	0.6	0.1	1.6	9.7	11.5
1982	0.6	1.2	1.8	4.9	1.6	1.3	0.7	0.4	1.3	10.2	11.9
1983	0.6	1.2	1.8	5.1	1.7	1.3	0.9	0.6	1.1	10.6	12.4
1984	0.5	1.1	1.7	4.8	1.6	1.2	0.5	0.2	1.1	9.3	11.0
1985	0.6	1.1	1.7	4.7	1.8	1.1	0.4	0.4	1.2	9.7	11.3
1986	0.6	1.1	1.7	4.7	1.8	1.1	0.4	0.6	0.7	9.2	10.9
1987	0.6	1.0	1.6	4.6	1.8	1.1	0.3	0.5	0.5	8.9	10.6
1988	0.6	1.0	1.7	4.5	1.8	1.1	0.3	0.3	0.7	8.6	10.3
1989	0.7	1.0	1.7	4.5	1.8	1.1	0.3	0.2	0.6	8.5	10.2
1990	0.7	1.1	1.8	4.5	2.0	1.1	0.3	0.1	0.5	8.5	10.3
1991	0.9	1.2	2.2	4.7	2.0	1.1	0.4	0.2	0.6	9.0	11.2
1992	1.1	1.3	2.5	4.8	2.2	1.1	0.6	0.2	0.6	9.5	12.0
1993	1.2	1.4	2.6	4.8	2.3	1.1	0.6	0.2	0.6	9.6	12.2
1994	1.2	1.4	2.7	4.8	2.4	1.1	0.4	0.1	0.4	9.2	11.9

SOURCE: Congressional Budget Office.

a. Less than 0.05 percent.

Major Contributors to the Revenue and Spending Projections

The following Congressional Budget Office analysts prepared the revenue and spending projections in this report:

Revenue Projections

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Drew McMorrow	Excise taxes
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Melissa Sampson	Customs duties, miscellaneous receipts
David Weiner	Individual income taxes

Spending Projections

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Edward Blau	Authorization bills
Jodi Capps	Appropriation bills
Karin Carr	Budget projections, historical budget data
Betty Embrey	Appropriation bills
Kenneth Farris	Computer support
Bryan Grote	Credit programs, other interest
Vernon Hammett	Computer support
Sandra Hoffman	Computer support
Jeffrey Holland	Net interest on the public debt, national income and product accounts

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Computer support
Treasury borrowing, interest, and debt
Appropriation bills
Budget projections, civilian agency pay

Glossary

This glossary defines economic and budgetary terms as they relate to this report. Some entries sacrifice precision for brevity and clarity to the lay reader. Where appropriate, sources of data for economic variables are indicated as follows:

BLS denotes the Bureau of Labor Statistics in the Department of Labor;

CBO denotes the Congressional Budget Office;

FRB denotes the Federal Reserve Board; and

NBER denotes the National Bureau of Economic Research.

adjustable-rate mortgage: Mortgage whose interest rate is not fixed for the life of the mortgage but varies in a predetermined way with movements in a specified market interest rate.

aggregate demand: Total purchases of a country's output of goods and services by consumers, businesses, government, and foreigners during a given period. (Bureau of Economic Analysis)

appropriation act: A statute under the jurisdiction of the House and Senate Committees on Appropriations that provides budget authority. Enactment generally follows adoption of authorizing legislation unless the authorization itself provides the budget authority. Currently, 13 regular appropriation acts are enacted each year. When necessary, the Congress may enact supplemental or continuing appropriations.

authorization: A substantive law that sets up or continues a federal program or agency. Authorizing legislation is normally a prerequisite for appropriations. For some programs, the authorizing legislation itself provides the authority to incur obligations and make payments.

Balanced Budget and Emergency Deficit Control Act of 1985: Also known as Gramm-Rudman-Hollings or the Balanced Budget Act, this law set forth specific deficit targets and a sequestration procedure to reduce spending if the targets were exceeded. The Budget Enforcement Act of 1990 established new budget procedures through fiscal year 1995 as well as revised targets, which exclude the Social Security trust funds. The Omnibus Budget Reconciliation Act of 1993 further extended various provisions of the Balanced Budget Act, without including fixed deficit targets beyond fiscal year 1995. See **discretionary spending caps** and **pay-as-you-go**.

baseline: A benchmark for measuring the budgetary effects of proposed changes in federal revenues or spending. As specified in the Budget Enforcement Act of 1990 (BEA), the baseline for revenues and entitlement spending generally assumes that laws now on the statute books will continue. The discretionary spending projections are based on the discretionary spending caps set by the BEA in 1995 through 1998. The *baseline with discretionary inflation* adjusts discretionary appropriations for inflation after 1998; the *baseline without discretionary inflation* does not.

Blue Chip consensus forecast: The average of about 50 economic forecasts surveyed by Eggert Economic Enterprises, Inc.

budget authority: Legal authority to incur financial obligations that will result in the spending of federal government funds. Budget authority may be provided in an authorization or an appropriation act. Offsetting collections, including offsetting receipts, constitute negative budget authority.

budget deficit: Amount by which budget outlays exceed budget revenues during a given period.

Budget Enforcement Act of 1990 (BEA): Title XIII of the Omnibus Budget Reconciliation Act of 1990. This act amended both the Congressional Budget Act of 1974 and the Balanced Budget and Emergency Deficit Control Act of 1985. The BEA provides for new budget targets, sequestration procedures, pay-as-you-go procedures, credit reform, and various other changes. The discretionary spending caps and the pay-as-you-go process were extended through 1998 by the Omnibus Budget Reconciliation Act of 1993. See **discretionary spending caps** and **pay-as-you-go**.

budget function: One of 20 areas into which federal spending and credit activity are divided. National needs are grouped into 17 broad budget functions, including national defense, international affairs, energy, agriculture, health, income security, and general government. Three functions--net interest, allowances, and undistributed offsetting receipts--do not address national needs but are included to complete the budget.

budget resolution: A resolution, passed by both Houses of Congress, that sets forth a Congressional budget plan for the next five years. The plan must be carried out through subsequent legislation, including appropriations and changes in tax and entitlement laws. The resolution sets guidelines for Congressional action, but it is not signed by the President and does not become law. The Congressional Budget Act of 1974 established a number of mechanisms that are designed to hold spending and revenues to the targets established in the budget resolution.

budgetary resources: All sources of budget authority that are subject to sequestration. Budgetary resources include new budget authority, unobligated balances, direct spending authority, and obligation limitations. See **sequestration**.

business cycle: Fluctuations in overall business activity accompanied by swings in the unemployment rate, interest rates, and profits. Over a business cycle, real activity rises to a peak (its highest level during the cycle), then falls until it reaches its trough (its lowest level following the peak), whereupon it starts to rise again, defining a new cycle. Business cycles are irregular, varying in frequency, magnitude, and duration. (NBER)

capacity constraints: Limits on the amount of output that can be produced without also significantly increasing prices. Causes of capacity constraints include shortages of skilled labor or of capital needed for production.

capacity utilization rate: The seasonally adjusted output of the nation's factories, mines, and electric and gas utilities expressed as a percentage of their capacity to produce output. Capacity is defined as the greatest output a plant can maintain with a normal work pattern. (FRB)

capital: *Physical capital* is the output that has been set aside to be used in production rather than consumed. According to the national income and product accounts, private capital goods are composed of residential and nonresidential structures, producers' durable equipment, and business inventories. *Financial capital* is the funds raised by an individual, business, or government by issuing securities, such as a mortgage, stock certificate, or bond. *Human capital* is a term for education, training, health, and other attributes of the workforce that increase its ability to produce goods and services.

central bank: A government-established agency responsible for conducting monetary policy and overseeing credit conditions. The Federal Reserve System fulfills those functions in the United States.

civilian unemployment rate: Unemployment as a percentage of the civilian labor force--that is, the labor force excluding armed forces personnel. (BLS)

commercial paper: Short-term, unsecured debt obligations that are issued by large corporations with good credit ratings and that are actively traded in financial markets. By selling such obligations, issuers of commercial paper borrow directly from the public rather than indirectly through financial intermediaries such as commercial banks.

compensation: All income due to employees for their work during a given period. Compensation includes wages and salaries as well as fringe benefits and employers' share of social insurance taxes. (Bureau of Economic Analysis)

constant dollar: Measured in terms of prices of a base period--currently 1987 for most purposes--to remove the effect of inflation. Compare with **current dollar**.

consumer confidence: A measure of consumer attitudes and buying plans indicated by an index of consumer sentiment. One such index is constructed by the University of Michigan Survey Research Center based on surveys of consumers' views of the state of the economy and their personal finances, both current and prospective.

consumer durable goods: Goods bought by households for their personal use that, on average, last more than three years--for example, automobiles, furniture, or appliances.

consumption: Total purchases of goods and services during a given period by households for their own use. (Bureau of Economic Analysis)

cost of capital: The total expected rate of return that an investment must generate in order to provide investors with the prevailing market yield consistent with risk after accounting for corporate taxes (if applicable) and depreciation.

countercyclical: Acting to moderate the ups and downs of the business cycle.

CPI-U: An index of consumer prices based on the typical market basket of goods and services consumed by all urban consumers during a base period--currently 1982 through 1984. (BLS)

credit crunch: A significant, temporary decline in the normal supply of credit, usually caused by tight monetary policy or a regulatory restriction on lending institutions.

credit reform: A revised system of budgeting for federal credit activities that focuses on the cost of subsidies conveyed in federal credit assistance. This process was authorized by the Federal Credit Reform Act of 1990, which was part of the Budget Enforcement Act of 1990.

credit subsidies: The estimated long-term costs to the federal government of direct loans or loan guarantees calculated on the basis of net present value, excluding administrative costs and any incidental effects on governmental receipts or outlays. For direct loans, the subsidy cost is the net present value of loan disbursements less repayments of interest and principal, adjusted for estimated defaults, prepayments, fees, penalties, and other recoveries. For loan guarantees, the subsidy cost is the net present value of the estimated payments by the government to cover defaults and delinquencies, interest subsidies, or other payments, offset by any payments to the government, including origination and other fees, penalties, and recoveries. See **present value**.

currency value: See **exchange rate**.

current-account balance: The net revenues that arise from a country's international sales and purchases of goods and services, net international transfers (public or private gifts or donations), and net factor income (primarily capital income from foreign-located property owned by residents less capital income from domestic property owned by nonresidents). The current-account balance differs from net exports in that the former includes international transfers and net factor income. (Bureau of Economic Analysis)

current dollar: Measured in the dollar value--reflecting then-prevailing prices--of the period under consideration. Compare with **constant dollar**.

cyclical deficit: The part of the budget deficit that results from cyclical factors rather than from underlying fiscal policy. The cyclical deficit reflects the fact that, when GDP falls, revenues automatically fall and outlays automatically rise. By definition, the cyclical deficit is zero when the economy is operating at potential GDP. Compare with **standardized-employment deficit**. (CBO)

debt held by the public: Debt issued by the federal government and held by nonfederal investors (including the Federal Reserve System).

debt restructuring: Changing the characteristics of an entity's outstanding debt, such as maturity or interest rate. Such changes can be effected by issuing long-term debt and retiring short-term debt (or vice versa), or by negotiating with creditors.

debt service: Payment of scheduled interest obligations on outstanding debt.

deflator: See **implicit deflator**.

deposit insurance: The guarantee by a federal agency that an individual depositor at a participating depository institution will receive the full amount of the deposit (up to \$100,000) if the institution becomes insolvent.

depository institutions: Financial intermediaries that make loans to borrowers and obtain funds from savers by accepting deposits. Depository institutions are commercial banks, savings and loan institutions, mutual savings banks, and credit unions.

depreciation: Decline in the value of a currency, financial asset, or capital good. When applied to a capital good, depreciation usually refers to loss of value because of obsolescence or wear.

direct spending: The Budget Enforcement Act of 1990 defines direct spending as (a) budget authority provided by an authorization, (b) entitlement authority (including mandatory spending contained in appropriation acts), and (c) the Food Stamp program. A synonym is **mandatory spending**. Compare with **discretionary spending**.

discount rate: The interest rate the Federal Reserve System charges on a loan that it makes to a bank. Such loans, when allowed, enable a bank to meet its reserve requirements without reducing its loans.

discouraged workers: Jobless people who are available for work but who are not actively seeking it because they think they have poor prospects of finding jobs. Because they are not actively seeking jobs, discouraged workers are not counted as part of the labor force or as being unemployed. (BLS)

discretionary spending: Spending for programs whose funding levels are determined through the appropriation process. The Congress has the discretion each year to determine how many dollars will be devoted to continuing

current programs and funding new ones. The Budget Enforcement Act of 1990 divided discretionary spending among three categories: defense, international, and domestic. Compare with **direct spending**.

discretionary spending caps: Annual ceilings on budget authority and outlays for discretionary programs defined in the Balanced Budget Act of 1985, as amended by the Budget Enforcement Act of 1990 and the Omnibus Budget Reconciliation Act of 1993. For fiscal years 1991 through 1993, the caps were divided among the three categories of discretionary spending--defense, international, and domestic. For fiscal years 1994 through 1998, there is one cap for all discretionary spending. Discretionary spending caps are enforced through Congressional rules and sequestration procedures.

disposable (personal) income: Income received by individuals, including transfer payments, less personal taxes and fees paid to government. (Bureau of Economic Analysis)

domestic demand: Total purchases of goods and services, regardless of origin, by U.S. consumers, businesses, and governments during a given period. Domestic demand equals gross domestic product minus net exports. (Bureau of Economic Analysis)

entitlements: Programs that make payments to any person, business, or unit of government that seeks the payments and meets the criteria set in law. The Congress controls these programs indirectly by defining eligibility and setting the benefit or payment rules. Although the level of spending for these programs is controlled by the authorizing legislation, funding may be provided in either an authorization or an appropriation act. The best-known entitlements are the major benefit programs, such as Social Security and Medicare; other entitlements include farm price supports and interest on the federal debt. See **direct spending**.

excess reserves: Total monetary reserves in excess of required reserves. See **monetary reserves** and **reserve requirements**.

exchange rate: The number of units of a foreign currency that can be bought with one unit of the domestic currency. (FRB)

excise tax: A tax levied on the purchase of a specific type of good or service, such as tobacco products or telephone services.

expansion: A phase of the business cycle that extends from the trough to the next peak. See **business cycle**. (NBER)

federal funds: See **trust fund**.

federal funds rate: Overnight interest rate at which financial institutions borrow and lend monetary reserves. A rise in the federal funds rate (compared with other short-term rates) suggests a tightening of monetary policy, whereas a fall suggests an easing. (FRB)

Federal Open Market Committee (FOMC): The group within the Federal Reserve System that determines the direction of monetary policy. The open market desk at the Federal Reserve Bank of New York implements the policy with open market operations--the purchase or sale of government securities--which influence short-term interest rates and the growth of the money supply. The FOMC is composed of 12 members, including the seven members of the Board of Governors of the Federal Reserve System and five of the 12 presidents of the regional Federal Reserve Banks.

Federal Reserve System: As the central bank of the United States, the Federal Reserve is responsible for conducting the nation's monetary policy and overseeing credit conditions.

final sales to domestic purchasers: Gross domestic product minus both net exports and the change in business inventories during a given period. (Bureau of Economic Analysis)

financial intermediary: An institution that indirectly matches borrowers with lenders. For example, depository institutions, such as commercial banks or savings and loan institutions, lend funds that they have accepted from depositors. Nondepository institutions, such as life insurance companies or pension funds, lend or invest funds that they hold in reserve against future claims by policyholders or participating retirees.

financing account: Any account established under credit reform to finance the portion of federal direct loans and loan guarantees not subsidized by federal funds. Since these accounts are used only to finance the nonsubsidized portion of federal credit activities, they are excluded from the federal budget and considered a means of financing the deficit.

fiscal policy: The government's choice of tax and spending programs, which influences the amount and maturity of government debt as well as the level, composition, and distribution of national output and income. An "easy" fiscal policy stimulates the short-term growth of output and income, whereas a "tight" fiscal policy restrains their growth. Movements in the standardized-employment deficit constitute one overall indicator of the tightness or ease of federal fiscal policy; an increase relative to potential gross domestic product suggests fiscal ease, whereas a decrease suggests fiscal restriction. The President and the Congress jointly determine federal fiscal policy.

fiscal year: A yearly accounting period. The federal government's fiscal year begins October 1 and ends September 30. Fiscal years are designated by the calendar years in which they end--for example, fiscal year 1995 began October 1, 1994, and will end on September 30, 1995.

fixed-weighted price index: An index that measures the overall price level (compared with a base period) without being influenced by changes in the composition of output or purchases. Compare with **implicit deflator**.

GDP: See **gross domestic product**.

GDP gap: The difference between potential real GDP and real GDP, expressed as a percentage of potential real GDP. See **potential real GDP**.

General Agreement on Tariffs and Trade (GATT): A multilateral organization of over 100 member countries, established in 1948, that has provided the framework for formulating and enforcing rules that govern international trade. A major focus of the organization has been to reduce barriers to trade on a nondiscriminatory basis. The Uruguay Round of negotiations, the eighth and most recently concluded round conducted under the auspices of GATT, established the World Trade Organization. That body will eventually replace GATT and will oversee a wider variety of trade agreements and alter certain decisionmaking procedures.

GNP: See **gross national product**.

government purchases of goods and services: Purchases from the private sector (including compensation of government employees) made by government during a given period. Government purchases constitute a component of GDP, but they encompass only a portion of all government expenditures because they exclude transfer payments (such as grants to state and local governments and net interest paid). (Bureau of Economic Analysis)

government-sponsored enterprises (GSEs): Enterprises established and chartered by the federal government to perform specific financial functions, usually under the supervision of a government agency, but in all cases wholly owned by stockholders rather than the government. Major examples are the Federal National Mortgage Association, the Student Loan Marketing Association, and the Federal Home Loan Banks.

grants: Transfer payments from the federal government to state and local governments or other recipients to help fund projects or activities that do not involve substantial federal participation.

grants-in-aid: Grants from the federal government to state and local governments to help provide for programs of assistance or service to the public.

gross domestic product (GDP): The total market value of all goods and services produced domestically during a given period. The components of GDP are consumption, gross domestic investment, government purchases of goods and services, and net exports. (Bureau of Economic Analysis)

gross investment: A measure of additions to the capital stock that does not subtract depreciation of existing capital.

gross national product (GNP): The total market value of all goods and services produced in a given period by labor and property supplied by residents of a country, regardless of where the labor and property are located. GNP differs from GDP primarily by including the excess of capital income that residents earn from investments abroad less capital income that nonresidents earn from domestic investment.

implicit deflator: An overall measure of the price level (compared with a base period) given by the ratio of current-dollar purchases to constant-dollar purchases. Changes in an implicit deflator, unlike those in a fixed-weighted price index, reflect changes in the composition of purchases as well as in the prices of goods and services purchased. See **fixed-weighted price index**. (Bureau of Economic Analysis)

index: An indicator or summary measure that defines the overall level (compared with a base) of some aggregate, such as the general price level or total quantity, in terms of the levels of its components.

inflation: Growth in a measure of the general price level, usually expressed as an annual rate of change.

infrastructure: Government-owned capital goods that provide services to the public, usually with benefits to the community at large as well as to the direct user. Examples include schools, roads, bridges, dams, harbors, and public buildings.

inventories: Stocks of goods held by businesses either for further processing or for sale. (Bureau of Economic Analysis)

investment: *Physical investment* is the current product set aside during a given period to be used for future production; in other words, an addition to the stock of capital goods. As measured by the national income and product accounts, private domestic investment consists of investment in residential and nonresidential structures, producers' durable equipment, and the change in business inventories. *Financial investment* is the purchase of a financial security. *Investment in human capital* is spending on education, training, health services, and other activities that increase the productivity of the workforce. Investment in human capital is not treated as investment in the national income and product accounts.

labor force: The number of people who have jobs or who are available for work and are actively seeking jobs. *Labor force participation rate* is the labor force as a percentage of the noninstitutional population age 16 years or older. (BLS)

liquidating account: Any budgetary account established under credit reform to finance direct loan and loan guarantee activities that were obligated or committed before October 1, 1992 (the effective date of credit reform).

liquidity: The characteristic of an asset that permits it to be sold on short notice with little or no loss in value. Ordinarily, a shorter term to maturity or a lower risk of default will enhance an asset's liquidity.

long-term interest rate: Interest rate earned by a note or bond that matures in 10 or more years.

M2: A measure of the U.S. money supply that consists of M1 (the nonbank public's holdings of currency, traveler's checks, and checking accounts), plus small (less than \$100,000) time and savings accounts, money market deposit accounts held at depository institutions, most money market mutual funds, overnight repurchase agreements, and overnight Eurodollar accounts held by U.S. residents. (FRB)

mandatory spending: Another term for **direct spending**.

marginal tax rate: Tax rate that applies to an additional dollar of taxable income.

means of financing: Sources of financing federal deficits or uses of federal surpluses. The largest means of financing is normally federal borrowing from the public, but other means of financing include any transaction that causes a difference between the federal (including off-budget) surplus or deficit and the change in debt held by the public. The means of financing include changes in checks outstanding and Treasury cash balances, seigniorage (that is, government revenue from the manufacture of money), and the transactions of the financing accounts established under credit reform.

means-tested programs: Programs that provide cash or services to people who meet a test of need based on income and assets. Most means-tested programs are entitlements--for example, Medicaid, the Food Stamp program, Supplemental Security Income, family support, and veterans' pensions--but a few, such as subsidized housing and various social services, are funded through discretionary appropriations.

merchandise trade balance: Net exports of goods. The merchandise trade balance differs from net exports by excluding exports and imports of services. (Bureau of Economic Analysis)

monetary policy: The strategy of influencing movements of the money supply and interest rates to affect output and inflation. An "easy" monetary policy suggests faster money growth and initially lower short-term interest rates in an attempt to increase aggregate demand, but it may lead to a higher rate of inflation. A "tight" monetary policy suggests slower money growth and higher interest rates in the near term in an attempt to reduce inflationary pressure by reducing aggregate demand. The Federal Reserve System conducts monetary policy in the United States.

monetary reserves: The amount of funds that banks and other depository institutions hold as cash or as deposits with the Federal Reserve System. See **reserve requirements**.

money supply: Private assets that can readily be used to make transactions or are easily convertible into those that can. See **M2**.

NAIRU (nonaccelerating inflation rate of unemployment): The unemployment rate consistent with a constant inflation rate. An unemployment rate greater than the NAIRU indicates downward pressure on inflation, whereas a lower unemployment rate indicates upward pressure on inflation. Estimates of the NAIRU are based on the historical relationship between inflation and the aggregate unemployment rate. CBO's estimating procedures are described in Appendix B of *The Economic and Budget Outlook: An Update* (August 1994).

national income and product accounts (NIPAs): Official U.S. accounts that detail the composition of GDP and how the costs of production are distributed as income. (Bureau of Economic Analysis)

national saving: Total saving by all sectors of the economy: personal saving, business saving (corporate after-tax profits not paid as dividends), and government saving (budget surplus or deficit--indicating dissaving--of all government entities). National saving represents all income not consumed, publicly or privately, during a given period. (Bureau of Economic Analysis)

net exports: Exports of goods and services produced in a country less its imports of goods and services produced elsewhere.

net interest: *In the federal budget*, net interest includes federal interest payments to the public as recorded in budget function 900. Net interest also includes, as an offset, interest income received by the government on loans and cash balances. *In the national income and product accounts (NIPAs)*, net interest is the income component of GDP paid as interest--primarily interest that domestic businesses pay, less interest they receive. The NIPAs treat government interest payments as transfers, so they are not part of GDP.

net national saving: National saving less depreciation of physical capital.

NIPAs: See **national income and product accounts**.

nominal: Measured in the dollar value (as in nominal output, income, or wage rate) or market terms (as in nominal exchange or interest rate) of the period under consideration. Compare with **real**.

nonresidential structures: Primarily business buildings (such as industrial, office, and other commercial buildings) and structures (such as mining and well shafts). (Bureau of Economic Analysis)

off-budget: Spending or revenues excluded from the budget totals by law. The revenues and outlays of the two Social Security trust funds and the transactions of the Postal Service are off-budget and (except for discretionary Social Security administrative costs) are not included in any Budget Enforcement Act calculations.

offsetting receipts: Funds collected by the federal government that are recorded as negative budget authority and outlays and credited to separate receipt accounts. More than half of offsetting receipts are intragovernmental receipts that reflect agencies' payments to retirement and other funds on behalf of their employees; these receipts simply balance payments elsewhere in the budget. An additional category of receipts (proprietary receipts) come from the public and generally represent voluntary, business-type transactions. The largest items are the flat premiums for Supplementary Medical Insurance (Part B of Medicare), timber and oil lease receipts, and proceeds from the sale of electric power.

Organization of Petroleum Exporting Countries (OPEC): The group of oil-rich countries that tries to determine the price of crude oil (given demand) by agreeing to production quotas among its members.

outlays: The liquidation of a federal obligation, generally by issuing a check or disbursing cash. Sometimes obligations are liquidated (and outlays occur) by issuing agency promissory notes, such as those of the former

Federal Savings and Loan Insurance Corporation. Unlike outlays for other categories of spending, outlays for interest on the public debt are counted when the interest is earned, not when it is paid. Outlays may be for payment of obligations incurred in previous fiscal years or in the same year. Outlays, therefore, flow in part from unexpended balances of prior year budget authority and in part from budget authority provided for the current year.

pay-as-you-go (PAYGO): A procedure required in the Budget Enforcement Act of 1990 to ensure that, for fiscal years 1991 through 1995, legislation affecting direct spending and receipts does not increase the deficit. Pay-as-you-go is enforced through Congressional rules and sequestration procedures. The pay-as-you-go process was extended through fiscal year 1998 by the Omnibus Budget Reconciliation Act of 1993.

peak: See *business cycle*.

personal saving: Saving by households. Personal saving equals disposable personal income minus spending for consumption and interest payments. *Personal saving rate* is personal saving as a percentage of disposable personal income. (Bureau of Economic Analysis)

point-year of unemployment: An unemployment rate that is 1 percentage point above the NAIRU for one year. For example, if the unemployment rate averaged 2 percentage points above the NAIRU for one and one-half years, that would be three point-years of unemployment. See *NAIRU*.

potential real GDP: The highest level of real GDP that could persist for a substantial period without raising the rate of inflation. CBO's calculation relates potential GDP to the nonaccelerating inflation rate of unemployment, which is the unemployment rate consistent with a constant inflation rate. (CBO)

present value: A single number that expresses a flow of current and future income (or payments) in terms of an equivalent lump sum received (or paid) today. The calculation of present value depends on the rate of interest. For example, given an interest rate of 5 percent, today's 95 cents will grow to \$1 next year. Hence, the present value of \$1 payable a year from today is only 95 cents.

private saving: Saving by households and businesses. Private saving is equal to personal saving plus after-tax corporate profits minus dividends paid. (Bureau of Economic Analysis)

producers' durable equipment: Primarily nonresidential capital equipment--such as computers, machines, and transportation equipment--owned by businesses. (Bureau of Economic Analysis)

productivity: Average real output per unit of input. *Labor productivity* is average real output per hour of labor. The growth of labor productivity is defined as the growth of real output that is not explained by the growth of labor input alone. *Total factor productivity* is average real output per unit of combined labor and capital inputs. The growth of total factor productivity is defined as the growth of real output that is not explained by the growth of labor and capital. Labor productivity and total factor productivity differ in that increases in capital per worker would raise labor productivity but not total factor productivity. (BLS)

program account: Any budgetary account that finances credit subsidies and the costs of administering credit programs.

real: Adjusted to remove the effect of inflation. *Real (constant-dollar) output* represents volume, rather than dollar value, of goods and services. *Real income* represents power to purchase real output. *Real data* are usually constructed by dividing the corresponding nominal data, such as output or a wage rate, by a price index or deflator. *Real interest rate* is a nominal interest rate minus the expected inflation rate. Compare with **nominal**.

receipt account: Any budget or off-budget account that is established exclusively to record the collection of income, including negative subsidies. In general, receipt accounts that collect money arising from the exercise of the government's sovereign powers are included as revenues, whereas the proceeds of intragovernmental transactions or collections from the public arising from business-type transactions (such as interest income, proceeds from the sale of property or products, or profits from federal credit activities) are included as offsetting receipts--that is, credited as offsets to outlays rather than included in receipts.

recession: A phase of the business cycle extending from a peak to the next trough--usually lasting six months to a year--characterized by widespread declines in output, income, employment, and trade in many sectors of the economy. Real GDP usually falls throughout a recession. See **business cycle**. (NBER)

reconciliation: A process the Congress uses to make its tax and spending legislation conform with the targets established in the budget resolution. The budget resolution may contain reconciliation instructions directing certain Congressional committees to achieve deficit reduction through changes in tax or spending programs under their jurisdiction. Legislation to implement the reconciliation instructions is usually combined in one comprehensive bill. The reconciliation process primarily affects taxes, entitlement spending, and offsetting receipts. As a general rule, decisions on discretionary programs are determined separately through the appropriation process, which is also governed by allocations in the budget resolution.

recovery: A phase of the business cycle that lasts from a trough until overall economic activity returns to the level it had reached at the previous peak. See **business cycle**. (NBER)

reserve requirements: The amount of funds that banks and other depository institutions must hold as cash or as deposits with the Federal Reserve System. The Federal Reserve specifies reserve requirements depending on the level of deposits. Such requirements reduce the risk of bank failure and allow the Federal Reserve to influence the money supply. (FRB)

reserves: See **monetary reserves**.

residential investment: Investment in housing, primarily for construction of new single-family and multifamily housing and alterations plus additions to existing housing. (Bureau of Economic Analysis)

Resolution Trust Corporation (RTC): An agency created by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) to close, merge, or otherwise resolve insolvent savings and loan institutions whose deposits are insured by the federal government.

retained earnings: Corporate profits after tax that are used for investment rather than paid out as dividends to stockholders. (Bureau of Economic Analysis)

revenues: Funds collected from the public arising from the sovereign power of the government. Revenues consist of receipts from income taxes (individual and corporate), excise taxes, and estate and gift taxes; social insurance contributions; customs duties; miscellaneous receipts such as Federal Reserve earnings, gifts, and contributions; and fees and fines. Revenues are also known as federal governmental receipts but do not include offsetting receipts, which are recorded as negative budget authority and outlays.

RTC: See **Resolution Trust Corporation**.

sequestration: The cancellation of budgetary resources to enforce the discretionary spending caps and pay-as-you-go process established under the Budget Enforcement Act of 1990 and the Omnibus Budget Reconciliation Act of 1993. Sequestration is triggered if the Office of Management and Budget determines that discretionary appropria-

tions exceed the discretionary spending caps or that legislation affecting direct spending and receipts increases the deficit. Changes in direct spending and receipt legislation that increase the deficit would result in reductions in funding for entitlements not otherwise exempted by law. Discretionary spending in excess of the caps would cause the cancellation of budgetary resources within the discretionary spending category.

short-term interest rate: Interest rate earned by a debt instrument that will mature within one year.

standardized-employment deficit: The level of the federal budget deficit that would occur under current law if the economy was operating at potential GDP. It provides a measure of underlying fiscal policy by removing the influence of cyclical factors from the budget deficit. Compare with **cyclical deficit**. (CBO)

structural deficit: Same as **standardized-employment deficit**.

supply shock: A large and unexpected change in the production of a good or service. Examples include bumper crops, crop failures, or sudden restrictions on the supply of oil as occurred in 1973-1974 and 1979-1980. A supply shock that restricts output will raise the price of the good in short supply; a surfeit will lower the price of the good.

ten-year Treasury note: Interest-bearing note issued by the U.S. Treasury that is redeemed in 10 years.

three-month Treasury bill: Security issued by the U.S. Treasury that is redeemed in 91 days.

thrift institutions: Savings and loan institutions and mutual savings banks.

transfer payments: Payments in return for which no good or service is currently received--for example, welfare or Social Security payments or money sent to relatives abroad. (Bureau of Economic Analysis)

trough: See **business cycle**.

trust fund: A fund, designated as a trust fund by statute, that is credited with income from earmarked collections and charged with certain outlays. Collections may come from the public (for example, taxes or user charges) or from intrabudgetary transfers. More than 150 federal government trust funds exist, of which the largest and best known finance several major benefit programs (including Social Security and Medicare) and certain infrastructure spending (the Highway and the Airport and Airway trust funds). The term "federal funds" refers to all programs that are not trust funds.

underlying rate of inflation: Rate of inflation of a modified CPI-U that excludes from the market basket the components most volatile in price--food, energy, and used cars.

unemployment: Joblessness. The measure of unemployment is the number of jobless people who are available for work and are actively seeking jobs. The *unemployment rate* is unemployment as a percentage of the labor force. (BLS)

yield: The average annual rate of return on a security, including interest payments and repayment of principal, if held to maturity.

yield curve: The relationship formed by plotting the yields of otherwise comparable fixed-income securities against their terms of maturity. Typically, yields increase as maturities lengthen. The rate of this increase determines the "steepness" or "flatness" of the yield curve. Ordinarily a steepening (or flattening) of the yield curve is taken to suggest that relatively short-term interest rates are expected to be higher (or lower) in the future than they are now.

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