CBO TESTIMONY

Statement of
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on
The Economic and Budget Outlook
and the
President's Budgetary Proposals

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

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NOTICE

This statement is not available for public release until it is delivered at 10:00 a.m. (EST), Thursday, February 13, 1997.

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Mr. Chairman, Congressman Spratt, and Members of the Committee, I am very pleased to be here today to discuss the Congressional Budget Office's (CBO's) current outlook for the economy and the budget and our preliminary assessment of the President's budget. CBO's baseline projections are detailed in *The Economic and Budget Outlook: Fiscal Years 1998-2007*, which you have before you. We have just begun analyzing the President's budget, which was submitted a week ago. Our complete reestimate of that budget should be available by the end of February, with a published report on our analysis to follow a few weeks later.

THE ECONOMIC OUTLOOK

By all accounts the economy is doing very well. CBO sees no dark clouds on the horizon, and consequently, the short-run forecast assumes no significant changes in economic indicators. The nation's real GDP—gross domestic product adjusted for inflation—is expected to grow at an average annual rate of 2.2 percent in 1997 and 1998, about the same as it did over the past two years. Inflation and interest rates are also expected to remain close to current levels. CBO is not alone in those expectations. Our forecast for the next two years comes very close to the *Blue Chip* consensus, which is an average of some 50 private-sector forecasts.

CBO's longer-term economic projections reflect an underlying trend of moderate growth and continuing low inflation. Although CBO takes the possibility

of cyclical fluctuations in the economy into account when it projects the longer-term economic trends, it does not attempt to predict when such fluctuations will occur.

CBO's baseline economic projections are based on the assumption that current budgetary policies do not change. However, both the Congress and the President have pledged to change policies and balance the budget in 2002. As a result, CBO prepared an alternative set of economic projections that reflect the beneficial effects on the economy of balancing the budget—effects such as lower interest rates, slightly higher real growth, and corporate profits that represent a larger share of national income.

The Administration's economic projections are similar to CBO's alternative projections that incorporate the effects of balancing the budget (see Table 1). The Administration projects nominal gross domestic product that is some $80 billion higher in 2002 than CBO does—a very small difference in a $10 trillion economy. CBO assumes higher unemployment rates, but that largely reflects differences in projected GDP and has little effect on overall budget outlays. The two agencies differ a little on inflation and interest rates, and each of those differences has some budgetary effect. But from a budgetary standpoint, the most significant difference in economic assumptions involves shares of national income—the Administration assumes a slightly higher percentage of GDP in categories that tend to produce revenues, such as wage and salary disbursements and corporate profits.

TABLE 1. COMPARISON OF CBO AND ADMINISTRATION ECONOMIC PROJECTIONS, ASSUMING BALANCED BUDGET POLICY (By calendar year)

	Estimate	Forecast		Projected			
	1996	1997	1998	1999	2000	2001	2002
Nominal GDP (Billions of dollars)							
CBO	7,570	7,918	8,282	8,688	9,110	9,550	10,008
Administration	7,577	7,943	8,313	8,717	9,153	9,610	10,087
Real GDP (Percentage change, year over year)							
CBO	2.3	2.3	2.1	2.2	2.2	2.2	2.1
Administration	2.3	2.2	2.0	2.2	2.3	2.3	2.3
GDP Price Index (Percentage change)							
CBO	2.1	2.3	2.5	2.6	2.6	2.6	2.6
Administration	2.2	2.5	2.6	2.6	2.6	2.6	2.6
Consumer Price Index[a] (Percentage change, year over year)							
CBO	2.9	2.9	2.9	3.0	3.0	3.0	3.0
Administration	2.9	2.7	2.7	2.7	2.7	2.7	2.7
Civilian Unemployment Rate (Percent)							
CBO	5.4	5.3	5.6	5.8	5.9	6.0	6.0
Administration	5.4	5.3	5.5	5.5	5.5	5.5	5.5
Three-Month Treasury Bill Rate (Percent)							
CBO	5.0	5.0	5.0	4.6	4.2	3.9	3.9
Administration	5.0	5.0	4.7	4.4	4.2	4.0	4.0
Ten-Year Treasury Note Rate (Percent)							
CBO	6.4	6.2	6.1	5.8	5.5	5.5	5.5
Administration	6.4	6.1	5.9	5.5	5.3	5.1	5.1
Nominal Income (Percentage of GDP)							
Wage and salary disbursements							
CBO	47.9	48.0	47.7	47.6	47.4	47.3	47.3
Administration	47.9	47.9	47.9	47.8	47.8	47.8	47.7
Corporate profits[b]							
CBO	8.4	8.2	8.1	7.9	7.8	7.9	7.8
Administration	8.6	8.5	8.6	8.7	8.7	8.5	8.4

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

NOTE: GDP = gross domestic product.

a. Consumer price index for all urban consumers (CPI-U).

b. Corporate profits reported are book, not economic, profits.

CBO projects that both of those categories will decline as a share of GDP. By contrast, the Administration projects that they will stay roughly unchanged through 2002. Three factors contribute to the different outlook. First, CBO's economic projections take into account the possibility of both recessions and economic booms, weighting them appropriately. That lowers the projected shares of GDP represented by profits and by wages and salaries because recessions tend to depress those shares. Second, CBO projects that wages and salaries will decline as a percentage of GDP because of a projected rise in the portion of labor compensation that takes the form of nontaxable benefits. Third, CBO projects that profits as a share of GDP will decline more than the Administration projects because CBO assumes that corporate interest payments will be higher. Those higher payments result from CBO assuming more growth in corporate debt and a more moderate decline in long-term interest rates than the Administration does.

CBO's projections of inflation are similar to those of the Administration: CBO projects a slightly lower rate of increase in the price index for GDP and about 0.3 percentage points more inflation in the consumer price index (CPI) than the Administration does. Although the difference is relatively small, CBO's higher projection of consumer prices has a noticeable effect on the budget: it increases the cost of programs indexed to the CPI and also keeps people in lower tax brackets, thus lowering revenues. The CPI is expected to grow faster than the GDP price index because the latter includes a number of categories—notably, computers and other

investment goods—whose prices have fallen or have risen less than consumer prices. For that reason, CBO projects that CPI inflation will exceed the growth of the GDP price index by an average of about 0.4 percentage points between now and 2002. In the past, the difference between the two measures has been that large or even larger—averaging 0.4 percentage points since 1980 and 0.5 percentage points since 1990. The Administration, by contrast, projects growth of the CPI that is only 0.1 percentage point above growth of the GDP deflator, which would represent a clear break with the past.

The Administration's projections of short-term interest rates are not very different from CBO's (though marginally higher), but its projections of long-term interest rates are noticeably more optimistic. However, both sets of projections assume that moves to balance the budget will reduce real long-term rates to levels that are lower than any since the 1970s.

THE BUDGET OUTLOOK

CBO anticipates that the federal budget deficit will rise modestly over the next decade if no changes are made in current policy. Using current-policy economic projections and assuming that discretionary spending keeps pace with inflation, CBO projects that the deficit will be $188 billion in 2002.

Those baseline projections, however, overstate the size of the task facing policymakers who are working on a plan to balance the budget in 2002, because they do not take account of the economic feedback from balancing the budget. CBO estimates that the economic benefits of balancing the budget would produce a fiscal dividend that would reduce the deficit by $34 billion in 2002. Thus, savings from changes in policies (including associated debt-service savings) would have to total $154 billion in 2002, instead of $188 billion, to achieve balance.

The Administration projects that savings of $101 billion in 2002 would balance the budget, but that estimate is not directly comparable with CBO's $154 billion estimate. The Administration's current-policy projections (which implicitly include the Administration's estimate of the fiscal dividend) assume that discretionary spending increases from the 1997 appropriated level at the rate of inflation, unconstrained by the statutory cap in 1998. Thus, savings from complying with the cap are included in the Administration's estimate of the policy savings required to balance the budget. In contrast, CBO's current-policy projections—which assume that discretionary spending is held at the level of the cap in 1998 and grows with inflation after that—already include the reductions from complying with the cap. If instead CBO takes the Administration's approach and simply inflates 1997 discretionary spending in its current-policy projections, those reductions from complying with the cap are added to CBO's estimate of the policy savings needed in

2002 to eliminate the deficit—increasing it from $154 billion to $167 billion (see Table 2).

A little more than half of the $66 billion difference between the Administration's estimate of $101 billion in required savings and CBO's comparable estimate of $167 billion comes on the outlay side of the budget (see Table 3). In contrast with recent years, estimates of spending for Medicare and Medicaid do not contribute much to the differences between the Administration and CBO—only about $2 billion separates the two agencies' projections of combined Medicare and Medicaid spending in 2002 (see Table 4).

Although CBO has not completed its analysis of the Administration's projections, clearly that the differences in comparable projections of both outlays and revenues stem largely from the relatively small differences in economic assumptions already discussed. CBO projects higher spending for a number of benefit programs, such as Social Security, because it assumes slightly greater increases in the consumer price index, which raises the projected amount of cost-of-living increases for those programs. CBO's projected net interest payments are also larger than the Administration's, in part because CBO assumes that long-term interest rates will be somewhat higher than the Administration does.

TABLE 2. CBO BUDGET PROJECTIONS USING ALTERNATIVE ASSUMPTIONS ABOUT DISCRETIONARY SPENDING (By fiscal year, in billions of dollars)

	1997	1998	1999	2000	2001	2002
CBO Projections with Balanced Budget Economic Assumptions and Capped Discretionary Spending[a]						
Outlays	1,632	1,687	1,778	1,868	1,931	2,025
Revenues	1,508	1,568	1,635	1,710	1,789	1,871
Deficit	124	119	143	158	143	154
Changes in Outlays						
Discretionary	0	15	14	15	7	9
Debt service	0	0	1	2	3	3
Total	0	16	15	17	10	13
CBO Projections with Balanced Budget Economic Assumptions and Inflated Discretionary Spending[b]						
Outlays	1,632	1,703	1,793	1,885	1,941	2,038
Revenues	1,508	1,568	1,635	1,710	1,789	1,871
Deficit	124	135	158	175	152	167

SOURCE: Congressional Budget Office.

NOTE: Numbers may not add to totals because of rounding.

a. Discretionary spending is held to the level of the statutory cap in 1998 and grows from that level at the rate of inflation in later years.

b. Discretionary spending grows from the 1997 appropriated level at the rate of inflation.

TABLE 3. COMPARISON OF CBO BUDGET PROJECTIONS AND ADMINISTRATION CURRENT-SERVICES PROJECTIONS (By fiscal year, in billions of dollars)

	1997	1998	1999	2000	2001	2002
CBO Projections with Balanced Budget Economic Assumptions and Inflated Discretionary Spending[a]						
Outlays	1,632	1,703	1,793	1,885	1,941	2,038
Revenues	1,508	1,568	1,635	1,710	1,789	1,871
Deficit	124	135	158	175	152	167
Administration Current-Services Projections[a]						
Outlays	1,631	1,693	1,785	1,859	1,922	2,002
Revenues	1,504	1,574	1,645	1,731	1,814	1,902
Deficit	128	120	140	128	108	101
Difference (CBO minus Administration)						
Outlays	b	9	9	26	19	35
Revenues	4	-6	-9	-21	-25	-31
Deficit	-4	15	18	48	44	66

SOURCE: Congressional Budget Office.

NOTE: Numbers may not add to totals because of rounding.

a. Discretionary spending grows from the 1997 appropriated level at the rate of inflation.

b. Less than $500 million.

TABLE 4. COMPARISON OF CBO AND ADMINISTRATION BASELINES FOR MEDICARE AND MEDICAID (By fiscal year, in billions of dollars)

	1997	1998	1999	2000	2001	2002
CBO Baseline						
Medicare[a]	192	209	229	253	265	292
Medicaid	99	105	114	123	133	144
Administration Baseline						
Medicare[a]	194	211	231	252	274	298
Medicaid	99	104	111	120	129	139
Difference (CBO minus Administration)						
Medicare[a]	-3	-3	-2	1	-9	-6
Medicaid	b	1	2	3	4	5

SOURCE: Congressional Budget Office.

NOTE: Numbers may not add to totals because of rounding.

a Includes benefit payments and mandatory and discretionary administrative expenses.

b. Less than $500 million.

On the revenue side, differences in economic assumptions account for more than the $31 billion difference in 2002 revenues shown in Table 3 (those economic differences are partially offset by other, technical differences). CBO projects lower revenues than the Administration does primarily because CBO assumes that a smaller share of national income will be in categories that produce higher revenues. In addition, CBO's more rapidly rising consumer price index—which is used to index brackets of the individual income tax—holds down its projection of revenues relative to the Administration's.

The baseline differences between CBO and the Administration are smaller now than they were a year ago. They are also quite small compared with the size of the budget: the difference in projected spending in 2002 represents less than 2 percent of total outlays. Nevertheless, the differences are significant for policymakers who are aiming to balance the budget in 2002.

THE PRESIDENT'S POLICY PROPOSALS

The President has proposed changes in policies that the Administration estimates will produce a $17 billion surplus in 2002 (see Table 5). Some of those changes would increase the deficit, and others would reduce it. As estimated by the Administration, the resulting $118 billion in net deficit reduction in 2002 would be composed of:

TABLE 5. THE PRESIDENT'S 1998 BUDGET PROPOSALS AS ESTIMATED BY THE ADMINISTRATION (By fiscal year, in billions of dollars)

	1997	1998	1999	2000	2001	2002	Total 1998-2002
Administration Current-Services Deficit	127.7	119.5	140.1	127.6	108.5	100.8	n.a.
Policy Proposals							
Revenues							
Tax relief	1.4	17.9	16.2	19.6	21.9	22.8	98.4
Extension of expired aviation taxes	-2.3	-5.0	-6.7	-6.6	-6.8	-7.0	-32.2
Other revenue proposals	-0.8	-5.9	-8.2	-9.3	-9.6	-10.9	-43.9
Subtotal	-1.6	7.0	1.4	3.7	5.5	4.9	22.4
Outlays							
Discretionary programs							
Defense	-0.7	-5.3	-14.6	-14.4	-21.9	-23.2	-79.5
Nondefense	a	-0.6	-3.3	-8.3	-18.8	-27.0	-58.0
Subtotal	-0.7	-5.9	-17.8	-22.7	-40.7	-50.2	-137.4
Mandatory programs							
Medicare	0	-4.3	-11.4	-22.2	-27.8	-34.6	-100.2
Medicaid							
New initiatives	a	1.2	2.0	2.6	3.4	3.9	13.2
Savings proposals	0	0.2	-1.6	-4.1	-7.3	-9.7	-22.4
Net savings, Medicaid	a	1.4	0.4	-1.4	-3.9	-5.8	-9.3
Spectrum auction receipts	0	-2.1	-1.8	-3.8	-6.3	-22.1	-36.1
Other mandatory programs	0.2	5.1	7.2	8.0	5.4	-1.4	24.3
Subtotal	0.3	0.1	-5.6	-19.4	-32.6	-63.8	-121.2
Debt service	-0.1	-0.1	-0.7	-2.1	-4.5	-8.5	-15.9
Total, policy proposals	-2.1	1.1	-22.7	-40.5	-72.3	-117.7	-252.1
Administration's Estimated Deficit or Surplus (-)	125.6	120.6	117.4	87.1	36.1	-17.0	n.a.

SOURCE: Office of Management and Budget.

NOTE: Numbers may not add to totals because of rounding. n.a.= not applicable.

a. Less than $50 million.

- A $5 billion reduction in revenues in 2002, the result of $23 billion in tax cuts partially offset by $18 billion in tax increases (including $7 billion from extending aviation excise taxes that expired last December).

- Savings of $50 billion in 2002 from reducing discretionary spending below the level needed to keep pace with inflation. In 2002, slightly more than half of the savings come from nondefense spending, but more than half of the total savings over the 1998-2002 period come from defense.

- Savings of $35 billion in Medicare and net savings of $6 billion in Medicaid in 2002 from the spending levels projected under current policies (Medicaid savings of $10 billion are partially offset by proposed program expansions that cost an estimated $4 billion).

- Offsetting receipts totaling $22 billion in 2002 from authorizing the Federal Communications Commission to auction additional parts of the electromagnetic spectrum.

- Net savings of $1 billion in 2002 from a variety of proposals that affect mandatory spending. Those savings reflect proposals that

would increase spending (such as relaxing some of the provisions of last year's welfare reform legislation) as well as those that would reduce spending (such as selling various assets of the federal government).

- o Debt-service savings of $9 billion.

Since the President's budget came out late last week, CBO has been working to estimate the effects of the President's proposals using its own economic and technical assumptions. Completing that reestimate will probably take two more weeks. However, it is possible to get a rough idea of the likely outcome simply by adding the Administration's estimate of the effects of those proposals to CBO's current-policy budget projections. CBO projects a deficit of $167 billion in 2002 using concepts that are comparable to those used by the Administration in its current-policy projections. Thus, if the President's policies save the $118 billion in 2002 that the Administration estimates, the deficit will be almost $50 billion in that year. Of course, if CBO concludes that the proposed policies would save less, the deficit would be higher.

In addition to the policy changes already discussed, the Administration has proposed a mechanism that would automatically "sunset" proposed tax cuts and reduce spending across the board if CBO's assumptions prove correct and the specific

policies detailed in the budget do not eliminate the deficit in 2002. Although that mechanism is supposed to ensure that the budget is balanced no matter what, the effectiveness of such a procedural approach to budget cutting is uncertain.

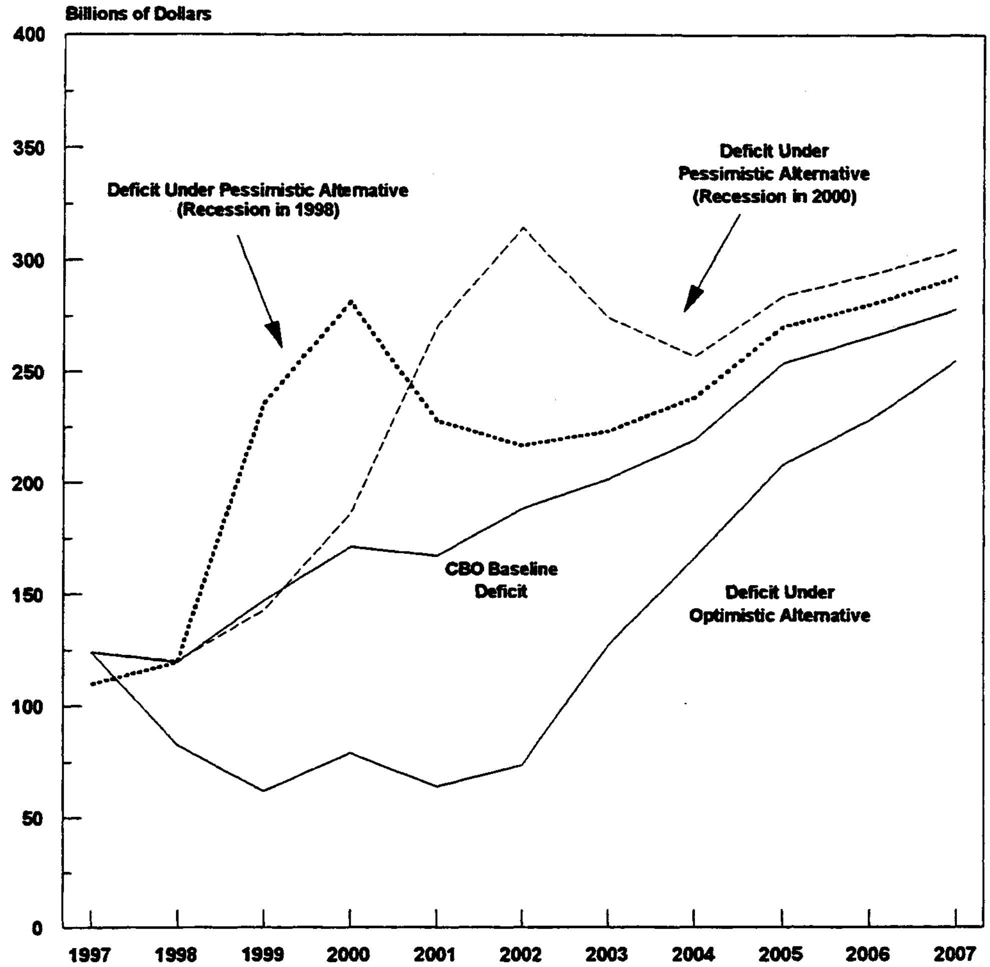
UNCERTAINTY IN BUDGET PROJECTIONS

CBO's projections represent its estimate of the most likely path for the economy and the budget over the next decade under current policies, but the actual path could easily be more or less favorable.

To illustrate how deviations from its economic assumptions could affect the projected deficit, CBO has developed a set of alternative scenarios that incorporate cyclical swings in the economy. In the optimistic alternative, the economy experiences a boom that mimics that of the late 1960s, although only half as large. If the boom extended through 2002, the projected deficit in that year would be more than $100 billion lower than in CBO's baseline (see Figure 1).

In the two pessimistic alternatives, the economy experiences a downturn roughly the size of the 1990 recession. If the economy entered such a recession in the second half of 1998, it would probably recover fully by 2002. In that case, CBO projects, the deficit would be only about $30 billion higher in 2002 than in the

FIGURE 1. DEFICITS UNDER ALTERNATIVE CYCLICAL PROJECTIONS OF THE ECONOMY (By fiscal year)



SOURCE: Congressional Budget Office.

baseline. If the recession instead began late in 2000, the maximum effect on the budget would be felt in 2002, when the projected deficit would be more than $100 billion higher than in the baseline.

Of course, departures from the economic assumptions are not the only reason that CBO's projections could be off the mark. Changes in how fast spending grows for programs such as Medicare or Medicaid, or unexpected events such as a savings and loan crisis, could significantly alter the budget. Indeed, the likelihood that the budget will veer off its plotted course should make policymakers wary of staking too much on the accuracy of any projections of what the deficit will be in a particular year in the future.

CONCLUSION

I would like to conclude on a cautionary note. First, although CBO's budget projections are more favorable than they were a year ago, balancing the budget by 2002 may not be much easier this year than last—partly because there is one less year to get there, and partly because reaching agreement on the hard choices will most likely continue to be difficult. Second, the current baseline projections run only through 2007, so they do not show the detrimental budgetary effects of the retirement

of the baby-boom generation and the continuing growth in per-person health care costs after 2007.

The second of those cautions highlights the need to make a major effort to reduce the deficit in the near term. Taking action now would contribute to ensuring budgetary stability in the next century, particularly if the policy changes that are adopted deal with the problems of federal health care and other retirement benefits. Doing so would make the additional policy changes required in the future much less painful.