The Economic and Budget Outlook: An Update

September 1981

A Report to the
Senate and House
Committees on the Budget

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THE ECONOMIC AND BUDGET OUTLOOK: AN UPDATE

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PREFACE

The Economic and Budget Outlook: An Update is one of a series of reports on the state of the economy issued periodically by the Congressional Budget Office. In accordance with CBO's mandate to provide objective analysis, the report contains no recommendations. The report was prepared by George R. Iden, Joan D. Schneider, Frank S. Russek, Jr., Stephen H. Zeller, Robert A. Dennis, Peter M. Taylor, Christopher D. Kask, Marvin M. Phaup, Jr., Joseph A. Ritter, John W. Straka, David M. Santucci, and Naif A. Khouri, under the direction of William J. Beeman and Lloyd C. Atkinson. Chapter IV was prepared by CBO's Budget Analysis Division under the direction of James L. Blum with the assistance of Rosemary Marcuss of the Tax Analysis Division. Robert L. Faherty and Francis S. Pierce edited the manuscript. Debra M. Blagburn, Dorothy J. Kornegay, and Marsha L. Mottesheard typed the many drafts. Art Services, Inc., prepared the graphic figures.

Alice M. Rivlin
Director

September 1981

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CHAPTER I. INTRODUCTION AND SUMMARY

The updated economic forecast of the Congressional Budget Office (CBO) shows substantial improvement in the economy compared with the lackluster performance of recent years. The slowing of inflation that began in the first half of 1981 is projected to continue into 1982. Real growth is expected to pick up late in 1981 and to be strong in 1982. The major reasons for the projected improvement in economic growth are the moderation of inflation and the reduction in taxes contained in the Economic Recovery Tax Act of 1981.

This forecast of strong real growth and moderating inflation depends critically on two highly uncertain factors. First, the economic projections assume that there will be no upsurge in commodity prices, such as the shocks in food and fuel prices that contributed to the economy's poor performance in the last several years. Second, money growth, consistent with Federal Reserve targets, could prove to be incompatible with strong economic growth.

Even with the projected improvement in the economy, CBO anticipates a budget deficit of about $65 billion in fiscal year 1982, declining gradually to about $50 billion in fiscal year 1984. These projections assume the spending policies of the First Concurrent Resolution on the Budget for 1982, which include still-unspecified spending cuts in 1983 and 1984. The CBO projections thus indicate that sizable spending cuts or revenue increases beyond those contemplated in the first resolution would be needed to achieve the target of a balanced budget in 1984.

The CBO Economic Forecast

Economic activity has been sluggish recently and is expected to show little or no improvement until the end of 1981. Correspondingly, for the remainder of the year, the unemployment rate is likely to remain near the 7 to 7-1/2 percent range experienced since the beginning of the year. Although inflation, as measured by the Consumer Price Index (CPI), may worsen a bit for a while before it gets better, by year's end a reduced pace of inflation should be in evidence. Interest rates are also expected to begin moving downward later in the year in response to the improved inflation picture.

The CBO economic forecast for 1982 indicates that real growth will be strong, compared with that in 1981 and in the last several years. Inflation is expected to continue to decelerate. From the fourth quarter of 1981 to the fourth quarter of 1982, real gross national product (GNP) is forecast to increase by about 4 percent, while inflation, as measured by the GNP implicit price deflator, is projected to moderate to a rate of about 7 percent. Interest rates, although lower than in 1981, should remain high in 1982 because of reduced money growth and strong credit demands. The unemployment rate is also expected to turn down in 1982 (see Table 1).

TABLE 1. THE CBO FORECAST

Economic Variable	Actual 1979:4 to 1980:4	Projected 1980:4 to 1981:4	 1981:4 to 1982:4
Nominal GNP (percent change)	9.4	9.2 to 13.4	9.3 to 13.5
Real GNP (percent change)	-0.3	1.5 to 3.5	3.1 to 5.1
GNP Implicit Price Deflator (percent change)	9.8	7.6 to 9.6	6.0 to 8.0
Unemployment Rate (percent, fourth quarter)	7.5	7.1 to 8.1	6.6 to 7.6
3-Month Treasury Bill Rate (percent, calendar-year average)	11.6	13.5 to 15.5	11.4 to 13.4

The strong growth projected for 1982 is a consequence of the slowed pace of inflation and the tax cut. The moderation of inflation is expected to reduce prices faster than wages thereby stimulating real income growth, which in turn will lead to stronger demands. At the same time, with less inflation, the assumed monetary policy will accommodate more real growth.

In the years beyond 1982, CBO assumes that inflation will continue to decelerate; real growth will remain relatively strong; interest rates will continue their downward trek; and the unemployment rate will decline somewhat. In brief, the CBO economic assumptions for the period 1982-1984 contrast sharply with the unfavorable economic developments of the past several years.

The basic outlook for economic activity--slow growth for the remainder of 1981 with improvement in 1982--has not changed since CBO's forecast of last winter. The actual pattern of real growth for the first half of 1981 was close to that anticipated by CBO's winter forecast: The very strong performance in the early months of the year was followed by substantial weakening in the spring. The projected slowness of growth for the remainder of 1981 has not changed significantly, largely because interest rates have remained high--even somewhat higher than in the CBO winter forecast.

On the other hand, inflation has moderated more than projected earlier. This has improved the outlook for economic activity as well as for inflation since CBO's winter forcast. The principal reasons for the improved inflation rate during the first half of 1981 were the very favorable price developments in the food and energy sectors and a higher value of the U.S. dollar on the world's currency exchanges. These favorable price "breaks" were not foreseen by forecasters six months ago. The CBO forecast of continued improvement in inflation is based on the assumption of no adverse movements either in world commodity prices or in the dollar exchange rate over the near term. Moreover, the reduced inflation momentum is expected to slow wage inflation and reduce interest rates, outcomes that make room for higher real growth and reduced unemployment rates.

Recognizing the critical importance of commodity prices in the CBO forecast highlights the elements of uncertainty involved in it. Food and energy prices, and the foreign exchange value of the dollar, have historically been volatile. Thus, if poor weather, unrest in the Middle East, or other uncontrollable factors should once again cause sharply increased food or energy prices, the economic outlook would be much less optimistic. On the other hand, a decline in energy prices would have a favorable impact on the economy.

Another area of uncertainty concerns the relationship between economic activity and money growth. Some analysts, apparently including the Federal Reserve, argue that the Federal Reserve's targets for money growth are not consistent with strong economic growth, given the rates of inflation projected by most forecasters. The CBO forecast may be optimistic on this issue, but--given the projection of a decline in inflation and prospective changes in financial regulations and institutions--not overly optimistic.

The Budget Outlook

The First Concurrent Resolution on the Budget for Fiscal Year 1982 assumed large tax cuts, sharply reduced growth in federal spending, and a reallocation of resources from nondefense to defense spending. The enactment of both the Omnibus Budget Reconciliation Act and the Tax Act of 1981 went a long way toward achieving the goals of the first resolution, though additional spending cuts will be required to achieve the deficit targets. Implicit in the first concurrent resolution targets are additional savings--over those in the Reconciliation Act--of about $15 billion in 1982, about $35 billion in 1983, and about $50 billion in 1984. (These figures include unspecified spending reductions of $20 billion in 1983 and $28 billion in 1984.) Even with these spending cuts, which are included in the CBO spending estimates, CBO anticipates a fiscal year 1982 budget deficit of about $65 billion (see Table 2). The deficit is projected to decline gradually thereafter to around $50 billion in fiscal year 1984. Nevertheless, if the spending cuts are realized, the deficit would be greatly reduced relative to GNP--from nearly 2 percent of GNP in fiscal year 1982 to about 1 percent in 1984, according to CBO's projections.

Comparison of CBO and Administration Economic and Budget Forecasts

Although the CBO forecast suggests that the economy's performance will improve sharply in 1982, CBO is not as optimistic as the Administration. In its Mid-Session Review, the Administration suggests that real growth through 1984 will be more rapid than CBO's projected increase, and that the unemployment rate will be slightly lower. Although the Consumer Price Index shows less inflation in the Administration's projections than in CBO's projections, the inflation projections are quite similar, when measured by the GNP implicit price deflator. Interest rates, on the other

TABLE 2. CBO AND ADMINISTRATION ECONOMIC AND BUDGET OUTLOOKS, 1981-1984

	1981	1982	1983	1984
	Economic Projections (calendar years, in percent)			
Real GNP Growth				
Administration	2.6	3.4	5.0	4.5
CBO a/	2.3	3.1	4.1	4.0
GNP Implicit Price Deflator				
Administration	9.6	8.0	7.0	6.0
CBO a/	9.1	7.7	7.0	6.6
Unemployment Rate				
Administration	7.5	7.3	6.6	6.2
CBO a/	7.4	7.3	6.9	6.5
3-Month Treasury Bill Rate				
Administration b/	13.6	10.5	7.5	6.8
CBO a/	14.5	12.4	11.4	10.1
	Budget Projections (fiscal years, unified budget basis, in billions of dollars)			
Revenues				
Administration	605.6	662.4	705.8	759.0
CBO c/	605	655	698	748
Outlays				
Administration	661.2	704.8	728.7	758.5
CBO c/	665	720	753	798
Surplus (+) or Deficit (-)				
Administration	-55.6	-42.5	-22.9	+0.5
CBO c/	-60	-65	-55	-50

SOURCES: Mid-Session Review of the 1982 Budget, July 15, 1981; Congressional Budget Office.

a/ The economic projections for 1981 and 1982 are the midpoints of the economic forecast ranges. The projections for 1983 and 1984 are not forecasts; they are assumptions.

b/ According to the Administration's Mid-Session Review, page 69, "These projections assume, by convention, that interest rates are linked to the rate of inflation. They are not forecasts of interest rates."

c/ Midpoints of CBO projection ranges. Assumes the spending policies of the First Concurrent Resolution on the Budget for Fiscal Year 1982, with the tax estimate adjusted to reflect the provisions of the Economic Recovery Tax Act of 1981.

hand, are substantially lower in the Administration projection. Table 2 highlights the differences between the CBO and Administration economic and budget projections. The differences in the budget estimates are largely on the spending side. In 1984, for example, higher outlays account for about 80 percent of the $50 billion difference in forecasts of the deficit.

Conclusion

The CBO economic and budget forecasts, which are less optimistic than those of the Administration, depend heavily on a number of highly uncertain developments. The economic projections contain favorable assumptions about food and fuel prices and about the response of the economy to reduced money growth. In addition, the budget projections incorporate large spending cuts not yet specified or enacted. With respect to economic activity, the downside risks now seem to be substantial. Under an alternative set of less favorable, but not unreasonable, economic and spending assumptions, the federal budget deficit in 1984 could exceed $50 billion by a considerable margin.

The economic impact of large deficits continuing through 1984 cannot be precisely estimated. On the one hand, if large deficits arise from a failure to achieve the spending cuts during a period of strong demands, the budget could become quite expansionary and thus contribute to inflation. If, on the other hand, they occurred because of weaker growth in demand, the enlarged deficit would not contribute significantly to inflationary pressures. Fiscal measures can also have favorable effects on productivity, which would reduce the adverse effects of deficits. Nevertheless, continued large deficits would imply higher interest rates than otherwise, which in turn would tend to deter investment and thereby reduce long-run growth.

CHAPTER II. RECENT ECONOMIC DEVELOPMENTS

The U.S. economy turned in a roller-coaster performance during the first half of 1981. The opening quarter saw real GNP rise at an 8.6 percent annual rate, followed in the second quarter by a 2.4 percent decline. The negative second quarter has caused some speculation that the economy may have moved into yet another recession; but this is not supported by evidence of major imbalances in the economy, such as excessive inventories or overbuilding of structures, that would lead one to project a prolonged decline in real economic activity. Indeed, there appear to be considerable pent-up demands for housing and other durable goods that could be released if financial conditions improve substantially. There is risk, of course, that continuation of present financial conditions could cause more sluggish growth than is now forecast by CBO. Barring such adverse developments, a deep recession in the near term is unlikely.

GNP GROWTH

Viewed in isolation, the inordinately large increase in real GNP in the first quarter and the negative growth in the second provide a distorted picture of the economy for the first half of 1981. A more accurate picture is this: Recovery from the very sharp drop in economic activity in the first half of 1980 continued at a robust pace through the fourth quarter of 1980 and into the first month or so of 1981, but slowed appreciably thereafter; since January, the economy has essentially been moving sideways at a level close to the peak value it attained at the beginning of 1980. Monthly data for real personal consumption expenditures and industrial production, displayed in Figure 1, tend to confirm this view.

The peculiar patterns of change of GNP and its components for the first half of 1981, documented in Table 3, can be partly explained by various "special" economic and statistical factors.

- o The 8.6 percent rate of growth of real GNP registered for the first quarter of this year overstates the growth that actually occurred <u>during</u> that quarter. Although economic growth during much of the first quarter was negligible, the

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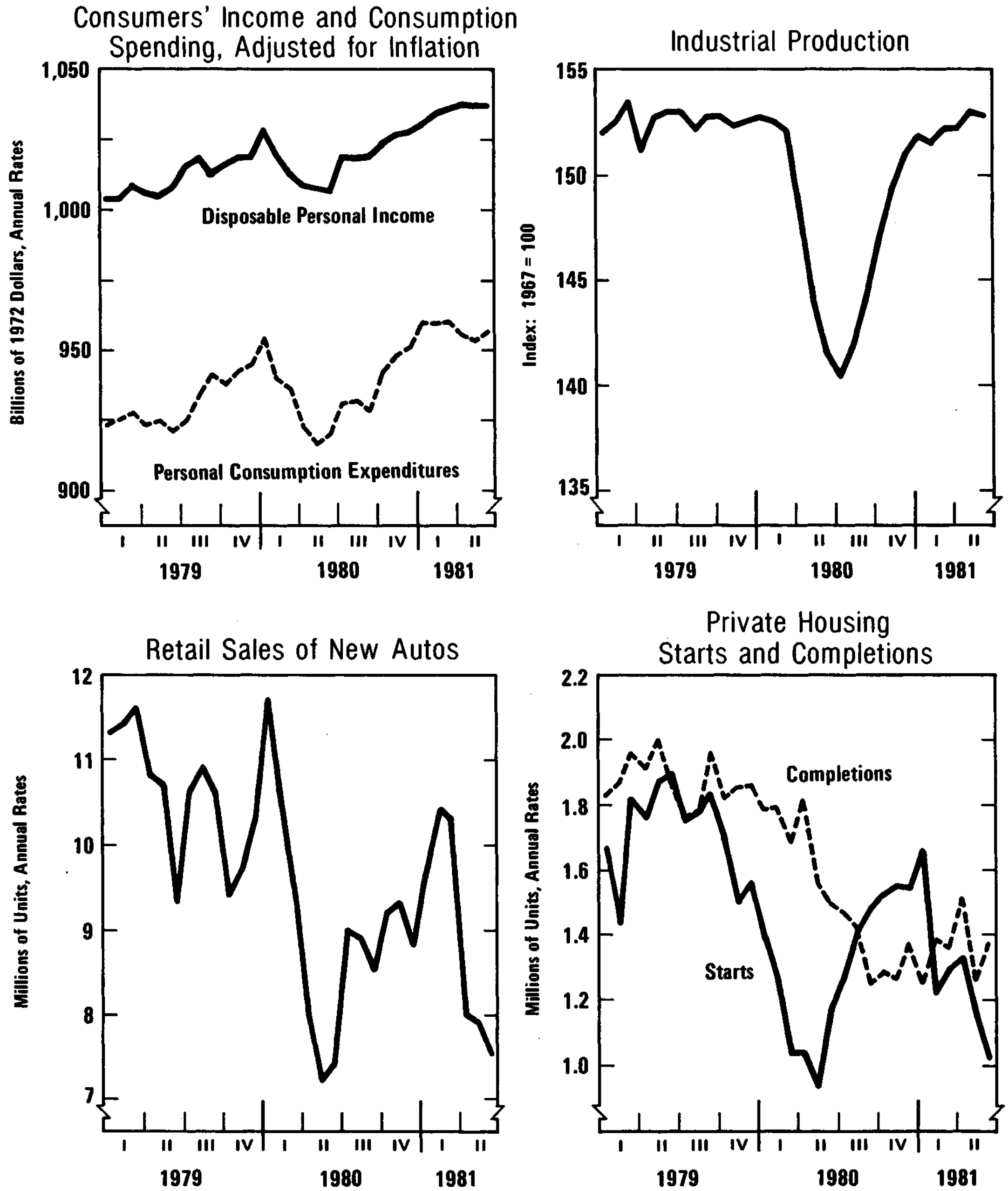
Figure 1.

Selected Indicators of Economic Activity



SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of the Census; Federal Reserve System, Board of Governors.

TABLE 3. INDICATORS OF ECONOMIC ACTIVITY (Percent change from previous quarter at seasonally adjusted annual rate, unless noted)

	1980:1	1980:2	1980:3	1980:4	1981:1	1981:2
Real GNP	3.1	-9.9	2.4	3.8	8.6	-2.4
Final sales	3.1	-10.4	4.1	4.4	6.9	-5.2
Personal consumption expenditures	0.8	-9.8	5.1	7.0	5.8	-2.0
Durable goods	-1.6	-43.3	21.7	21.2	24.1	-23.6
Motor vehicles and parts	12.5	-67.2	44.2	26.3	51.7	-47.8
Nondurable goods	0.2	-5.3	-1.8	6.3	4.6	2.4
Services	2.1	0.0	6.4	3.7	1.4	2.3
Fixed investment	-5.3	-31.8	2.1	15.7	10.8	-8.3
Nonresidential	2.2	-19.9	-1.5	4.0	13.3	-4.0
Structures	-1.4	-13.1	-15.3	9.0	16.6	5.1
Producers' durable equipment	3.8	-22.7	5.3	1.9	11.8	-7.8
Autos	50.8	-59.5	90.3	16.9	56.0	-41.7
Residential	-24.2	-60.2	16.0	64.2	3.6	-21.0
Government Purchases	6.9	2.5	-5.0	2.2	5.4	-5.8
Federal	18.9	11.9	-13.1	2.0	14.8	-9.0
Defense	9.8	6.2	-0.1	5.9	1.1	2.0
Nondefense	38.4	23.1	-33.1	-5.3	46.8	-27.0
State and local	0.6	-2.8	0.3	2.3	0.2	-3.8
Exports	32.0	12.3	-0.2	-7.4	13.6	-6.9
Imports	11.9	-21.9	-20.4	25.8	10.3	12.9
Change in business inventories (billions of 1972 dollars)	-0.9	1.3	-5.0	-7.2	-1.4	9.7
Real Disposable Personal Income	1.3	-4.9	4.1	2.9	3.0	1.2
Saving Rate (percent)	4.9	6.2	6.1	5.1	4.6	5.3
Industrial Production	-0.1	-19.2	-6.7	21.2	7.4	2.4
Labor Force	1.8	1.8	1.1	0.7	2.4	3.7
Unemployment Rate (percent)	6.2	7.3	7.5	7.5	7.3	7.4

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Federal Reserve System, Board of Governors; and U.S. Department of Labor, Bureau of Labor Statistics.

fact that production rose rapidly all through the fourth quarter of 1980 meant that the average level of GNP for the first quarter of 1981 was statistically much higher than the average GNP level for the fourth quarter of 1980, yielding a high rate of growth measured quarter over quarter.

- o Because consumers and businesses took advantage of the sizable auto rebates that were offered mainly in February and March, consumer durable expenditures and business fixed investment in the first quarter of 1981 rose much more rapidly than would have occurred otherwise; consumer and business spending retrenched in the second quarter when the auto rebate programs were terminated. These volatile swings in real consumer and business spending for autos had negligible effects on real GNP growth in the first half of 1981 since they were largely mirrored by offsetting movements of auto stocks, the rundown of auto stocks in the first quarter being followed by an upsurge in the second. Auto production was little changed over first two quarters.

- o The sharp swing in real federal government spending--up 14.8 percent in the first quarter of 1981 and down 9.0 percent in the second quarter (at annual rates)--is explained almost exclusively by peculiarities in the timing of loan commitments and loan redemptions by the Commodity Credit Corporation (CCC). Total real federal purchases less CCC outlays were virtually unchanged over the first half of 1981.

- o The vigorous uptick in nonresidential construction and the more modest increase in residential investment in the first quarter of 1981 were largely the result of unseasonably warm weather.

- o The increase in real non-auto business inventories contributed to growth in the early months of 1981. Its impact, however, was masked by the dramatic swings in new auto stocks--down $6.2 billion in the first quarter and up $7.3 billion in the second quarter, after adjustment for inflation.

Other statistics support the view that the economy has followed a flat trajectory since the early months of 1981. The rapid pace of real expenditures for furniture and appliances in the first quarter turned negative in the second quarter; the double-digit rate of real growth for apparel reported in the first quarter was halved in the second quarter; and the essentially flat level of real purchases by state and local governments in the first quarter was followed by negative growth in the second quarter. This pattern of essentially no growth in the economy is expected to continue in the third quarter.

Reflecting the sluggish growth of the economy, the unemployment rate changed little over the course of the first eight months of 1981, hovering in the 7 to 7-1/2 percent range throughout. CBO expects the unemployment rate to increase modestly in the remainder of the year.

The sluggish performance of the economy in the spring and summer of 1981 should occasion little surprise in view of the record high interest rates and the increasing restrictiveness of fiscal policy; what is surprising, perhaps, is that economic activity continued at a fairly high level despite the monetary and fiscal policies then in place. By most measures, fiscal policy turned restrictive in the first half of 1981, mainly because of the large increase in Social Security taxes in January and the increase in the windfall profits tax resulting from the decontrol of domestic oil prices. But the dominant policy story in the first eight months of 1981 concerns the record high interest rates that contributed to the extreme weakness in both housing and auto sales, highlighted in Figure 2.

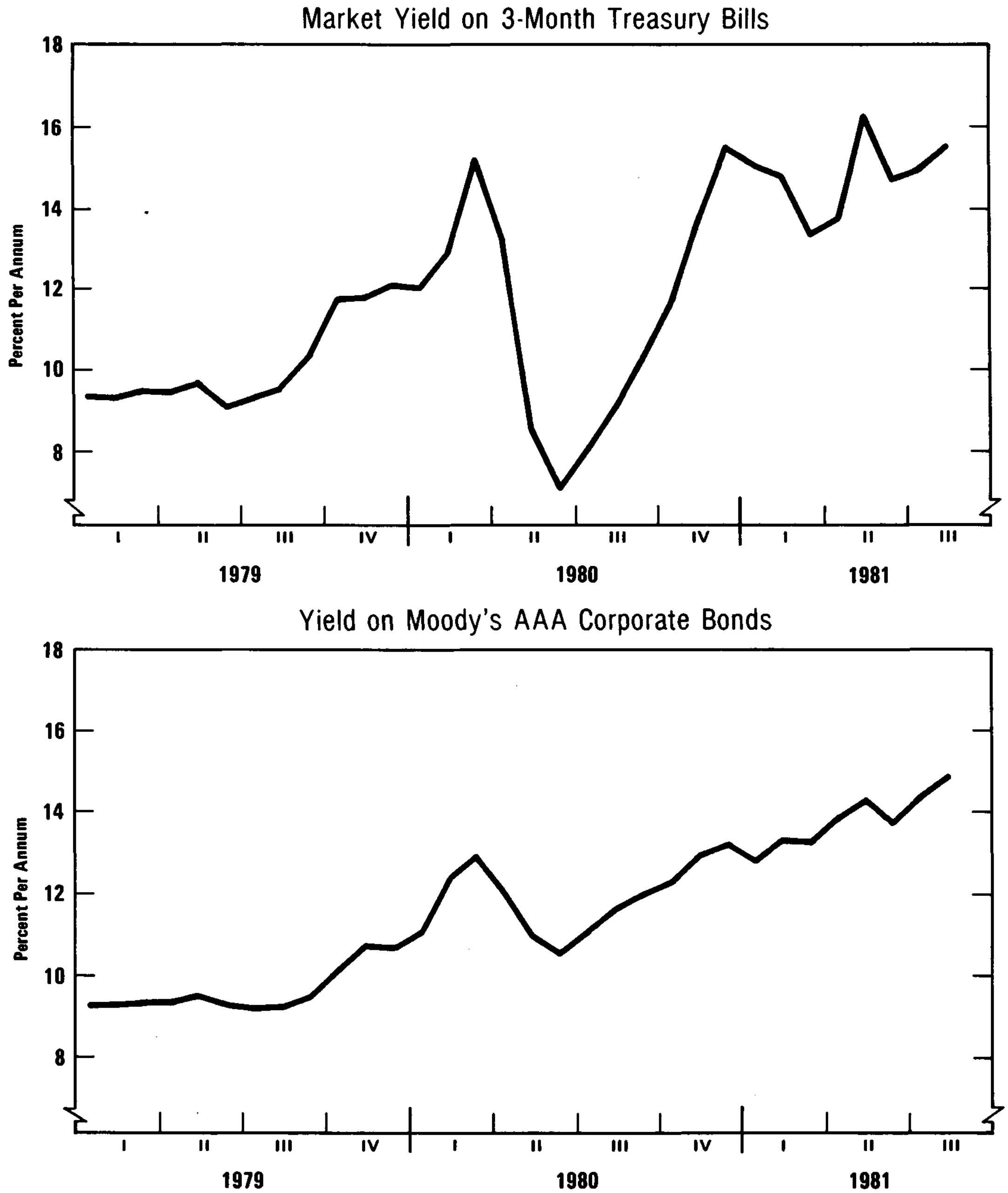
INTEREST RATES

The year began with short-term interest rates at or near record highs. They eased somewhat over the course of the first quarter, but resumed their uptrend early in the second; in early September, they were at or above the levels recorded at the beginning of the year. The pattern of change in the three-month Treasury bill rate, displayed in Figure 2, is typical. Many economists do not find this behavior of short-term interest rates surprising in view of the Federal Reserve's policies.

Long-term interest rates continued their upward advance through May. They eased somewhat in June but turned up again in July and continued upward through August. The continued upward movement of long-term interest rates is not easily understood in

Figure 2.

Interest Rates



SOURCES: Federal Reserve System, Board of Governors; Moody's Investors Services, Inc.

view of the moderated pace of inflation. Apparently inflationary expectations have not been dampened significantly.

- o The favorable developments in inflation have occurred in markets (food and energy) in which inflationary expectations may not figure prominently in the determination of the rate of price change.

- o The moderation of price inflation has yet to show up in a corresponding reduction in wage inflation, as will be noted below.

- o Belief in the Federal Reserve's ability to control the monetary aggregates may have been undermined, especially as a result of the volatile behavior of the money supply and interest rates during 1980.

- o A great deal of emphasis is being placed on expected heavy borrowing by the federal government in credit markets. Although the reduction in the federal deficit is a goal much emphasized by the Administration and the Congress, financial markets may be somewhat skeptical that it can be achieved.

CBO expects that both short-term and long-term interest rates will soon begin to fall. With the economy continuing its lackluster performance in the months ahead and inflation improving, CBO's assumption that the growth of the monetary aggregates will be within the Federal Reserve's target ranges should be consistent with a modest decline in short-term interest rates. Between calendar years 1981 and 1982, short-term interest rates decline about two percentage points in the CBO forecast. Long-term interest rates are also expected to decline gradually in response to reduced inflation.

INFLATION

The good news in the first half of the year was the marked slowing of inflation. After advancing at a seasonally adjusted annual rate of nearly 13 percent in the fourth quarter of 1980, the growth of the Consumer Price Index (CPI) slowed in the first quarter to an annual rate of 10.8 percent, and further still in the second quarter to an annual rate of 7.5 percent. As Table 4 makes clear, the GNP implicit price deflator, the GNP fixed-weighted

TABLE 4. PRICE INFLATION (Percent change, seasonally adjusted annual rate)

	1980:1	1980:2	1980:3	1980:4	1981:1	1981:2
CPI-U a/	16.5	13.1	7.7	12.9	10.8	7.5
CPI-U less Food and Energy	14.8	13.9	6.9	13.2	8.9	8.9
Producer Price Index for Finished Goods	16.5	10.5	14.0	8.9	10.7	8.3
GNP Implicit Price Deflator	9.3	9.8	9.2	10.7	9.8	6.6
GNP Fixed-Weighted Price Index	9.7	9.3	9.0	10.4	10.2	8.0

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of Economic Analysis.

a/ Consumer Price Index for all urban consumers.

price index, and the Producer Price Index (PPI) for finished goods showed the same kind of inflation moderation. The July increase in the CPI, 15.2 percent at an annual rate, contrasts sharply with these favorable trends, but the CBO forecast suggests that this rise represents only a temporary departure that may last only a month or two.

Why did inflation moderate so dramatically? Simply put, because of very favorable price developments in the food and energy sectors and the marked appreciation of the dollar in foreign exchange markets. In its January 1981 report, the Council of Economic Advisers anticipated a sharp acceleration in food prices during 1981--from 8.6 percent in 1980 to about 12 percent in 1981--principally because of the poor feed-grain harvests of 1980. The increased grain prices were expected in turn to cause reduced levels of meat production and dramatically higher meat prices. As it turned out, many cattle ranchers decided last winter to bypass feedlots and send some cattle directly to slaughter. This temporarily made more beef available for market and delayed until mid-1981 the expected increase in beef prices. At the same time, sugar prices in international markets fell rapidly from their peak values of last fall. Neither of these favorable movements in food prices is likely to be repeated in the second half of 1981: The reduction in beef supplies is now showing up in the form of higher wholesale and retail meat prices, and sugar prices at the wholesale level are not expected to fall any further because they are at or near their international support levels.

Largely as a result of the expected increase in retail meat prices, average food prices in 1981 should rise to a level about 8-1/2 percent higher than in 1980. For 1982, the prospects for moderation in food price increases are good because world grain harvests for the 1981 crop year are expected to be much better than those in 1980. Nevertheless, in the medium term, food prices are likely to continue to increase faster than other prices because world food demand is pressing upon agricultural capacity. The CBO forecast implies that food prices will rise about 1 percent faster than other prices in 1982.

Oil prices, too, have been falling in international markets for the past few months--a development that was not expected last winter. The emergence of an oil supply glut can be attributed to three factors:

- Slow economic growth in consuming countries;

- A relatively large drop in demand in response to last December's oil price increases, which was helped along in the United States by the decontrol of domestic oil prices, and in other countries by the sharp appreciation of the dollar that caused the foreign currency price of oil to rise despite a decline in its dollar price; and

- High oil production by Saudi Arabia and other oil-producing countries.

The softness in oil prices is expected to continue for perhaps a year. The abatement of upward price pressure is evident in the widely publicized price cuts by the United Kingdom and several OPEC producers following the August OPEC meeting. What happens to oil prices, however, will depend greatly on the production policies of Saudi Arabia and other OPEC countries.

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The price path chosen for the CBO forecast assumes a resumption of world oil price increases in the second half of 1982, running at about 8 percent (slightly above the rate required to keep oil prices constant in real terms). The experience of recent years suggests that this forecast is subject to much uncertainty. A variety of circumstances, ranging from renewed unrest in the Middle East to earthquakes to violent storms in the North Sea, could disrupt oil supplies enough to push prices up much faster. A resumption in demand growth in the industrialized countries could also increase oil prices. 1/ On the other hand, a lower oil price path is also possible if there is sluggish economic growth in the developed countries, or if Iran and Iraq resume high rates of production and other OPEC countries do not reduce production correspondingly.

Finally, some moderation of inflationary pressures has occurred as a consequence of the marked appreciation of the U.S. dollar internationally--up over 23 percent on a trade-weighted basis between December 1980 and August 1981. Sluggish U.S. economic growth, historically high U.S. interest rates, and lower U.S. inflation generally have all served to raise the foreign exchange value of the dollar. For the remainder of 1981 and 1982, the dollar is expected to remain fairly stable--in part because no significant changes in inflation and real growth differentials are expected between the United States and its trading partners, and in part because U.S. interest rates are expected to remain relatively high.

WAGE DEVELOPMENTS

The deceleration of inflation in the first half of 1981 has not yet been clearly matched by a reduction in the pace of wage advance. Indeed, trends in labor costs showed only slight moderation over the course of the first half of the year, which means that underlying inflationary pressures remained strong (see Table 5). Measured in terms of percentage change from one year earlier, the Index of Average Hourly Compensation--which includes

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1/ Recent forecasts by the Organization for Economic Cooperation and Development (OECD) and the International Monetary Fund (IMF) suggest that demand growth outside the United States will be very limited in the next few years.

TABLE 5. LABOR COSTS (Seasonally adjusted annual rate)

	1980:1	1980:2	1980:3	1980:4	1981:1	1981:2
	Percent Change from One Year Earlier					
Compensation per Hour a/	9.7	9.9	10.1	10.1	10.4	10.0
Employment Cost Index a/ b/	9.1	9.3	9.4	9.0	9.3	9.3
	Percent Change from Previous Quarter					
Average Hourly Earnings Index	9.1	10.0	9.1	10.4	9.7	8.3
Unit Labor Costs a/	9.9	14.6	5.3	10.1	7.0	8.8

SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

a/ Data are for the private nonfarm economy.

b/ Index for wage and salary component of compensation.

both employer contributions to social insurance and the costs of fringe benefits--rose at double-digit rates in the first and second quarters of 1981, little changed from the rate of advance in 1980. The Employment Cost Index for wages and salaries confirms the sustained high level of wage inflation observed in the compensation data: Measured in terms of percentage change from one year earlier, the Employment Cost Index has shown little change in the past 18 months. Although both of these measures showed a moderation in wage gains in the second quarter of 1981, following sharp increases in the first quarter, it is questionable whether the second-quarter decline reflects much of a moderation in wage gains. 2/

One measure of wage inflation--the Index of Average Hourly Earnings--did show moderation in the first half of 1981. This is a measure of wage trends for production and nonsupervisory personnel. It increased by 9.7 percent (at an annual rate) in the first quarter of 1981, followed by an 8.3 percent rate in the second quarter. This index slowed to an annualized rate of increase of 5.3 percent in July, but it jumped in August to a rate of 14.7 percent, virtually guaranteeing a rapid increase in the third quarter. Another labor cost statistic covering wage settlements reached in collective bargaining during the first six months of the year implied possibly more rapid wage inflation in 1981. The major collective bargaining settlements in the private sector provided for average wage adjustments of 11.4 percent for the first year of the contract exclusive of prospective wage changes that may occur under cost-of-living-adjustment clauses. This is less than the 13.9 percent rate reported for the first quarter of 1980, but is nonetheless substantial.

To date, therefore, there do not appear to have been substantial reductions in wage gains to match the reduced pace of price inflation. In large part, this reflects an effort to "catch up" with past high rates of inflation. CBO expects, however, that the growth of employee compensation will decelerate in 1982 in response to the declining inflation.

2/ Measured in terms of percentage change from one quarter to the next, the compensation statistics suggest that labor-cost inflation accelerated in the first quarter and plummeted in the second. Thus, growth of average hourly compensation in the nonfarm business sector rose from a 9.8 percent rate of increase in the fourth quarter of 1980 to an 11.6 percent rate of increase in the first quarter of 1981, followed by a 9.6 percent rate of increase in the second. This change distorts the labor-cost picture. The inordinately large first-quarter increase was attributable chiefly to the upward adjustment of both the rate and base increases for Social Security contributions that took effect in January; the second-quarter cost increase was, accordingly, much more moderate.

Recent gains in productivity growth have had some favorable effects on unit labor costs. One closely watched labor cost series is that for unit labor costs in the private nonfarm business sector (compensation per hour in the nonfarm business sector adjusted for productivity growth). After advancing at a rate in excess of 10 percent during 1980, unit labor costs slowed to a 7.0 percent annual rate of increase in the first quarter of 1981. This decline, however, was attributable almost exclusively to the 4.3 percent increase in labor productivity growth in the first quarter of 1981, the result of the unsustained increase in real GNP growth. The sharp slowdown in productivity growth to 0.7 percent in the second quarter resulted in a rebound of unit labor costs to an 8.8 percent annual rate of increase. Nevertheless, the unit labor cost picture improved in the first half of 1981. The CBO forecast presented in this report points to a continued deceleration of unit labor costs in 1982.

CHAPTER III. THE MIDYEAR ECONOMIC FORECAST

The CBO forecast, described below, anticipates a pickup in economic activity later this year and relatively rapid growth in 1982. The major reasons for the projected improvement in growth are a moderation of inflation and the reduction in taxes over the forecast period. The slowing of inflation is predicated on the considerably improved outlook for both food and fuel prices through next year. Price increases are expected to moderate faster than wage increases, thereby stimulating real income growth, which in turn will lead to stronger final demands. As inflation eases, the assumed tight monetary policy will accommodate more real growth.

This forecast, however, contains elements of uncertainty. First, the food and fuel sectors of the economy remain volatile and unpredictable. Second, the possibility remains that the Federal Reserve's announced targets for money growth may inhibit a resumption of growth in total spending in 1982. Third, the prospects for upward pressure on interest rates would be increased if Treasury borrowing is larger than projected because of the failure to achieve planned spending cuts.

BASIC ASSUMPTIONS OF THE FORECAST

Policy Assumptions. The CBO forecast is based on the following assumptions about fiscal and monetary policies through 1982:

- Total federal government spending, on a unified budget basis, is \$665 billion in fiscal year 1981 and \$718 to \$723 billion in fiscal year 1982. These estimates embody the reductions in nondefense purchases, transfers, and grants, as well as the increases in defense purchases, included in the first budget resolution for fiscal year 1982.

- The tax policy embodies the major provisions of the Economic Recovery Tax Act of 1981. 1/ This includes a 25

1/ The economic effects of some provisions of the Tax Act, such as the All Savers Certificate, have not been estimated.

percent reduction in personal income tax rates--5 percent in October of 1981 and then 10 percent in July 1982 and July 1983--as well as the "15-10-5-3" accelerated capital cost recovery system.

- The rates of growth of the monetary aggregates are within the target ranges announced by the monetary authorities. Because of continued strong growth in current-dollar GNP, however, these aggregates are expected to lie close to the upper ends of their announced ranges.

Food and Fuel Price Assumptions. While the outlook for food and fuel prices is highly uncertain, the CBO forecast makes the following assumptions:

- Food prices increase by 8-1/2 percent in calendar year 1981 and by 9 percent in 1982, more than 1 percent faster than the overall price level.

- World oil prices remain flat through the first half of 1982 and then rise by about 8 percent for the remainder of the year.

Consequently, oil prices are assumed to place downward pressure on inflation in 1982, while food price developments are not expected to add much upward pressure over the forecast period.

THE FORECAST

The CBO current policy forecast is presented in Table 6.

- Real GNP is projected to rise by 1.5 to 3.5 percent from the fourth quarter of 1980 to the fourth quarter of 1981. Real growth is forecast to accelerate somewhat in 1982--with real GNP rising by 3.1 to 5.1 percent.

- Inflation, as measured by the implicit price deflator for GNP, is forecast to remain in the 7.6 to 9.6 percent range in 1981 and then to decelerate significantly, to the 6.0 to 8.0 percent range, in 1982.

- The unemployment rate is likely to lie in the 7.1 to 8.1 percent range in the fourth quarter of 1981 and then decline slowly to a range of 6.6 to 7.6 percent by the end of 1982.

TABLE 6. CBO'S ECONOMIC PROJECTIONS FOR 1981 AND 1982

	Levels			Rate of Change (percent)		
Economic Variable	1980:4 (actual)	1981:4	1982:4	1979:4 to 1980:4 (actual)	1980:4 to 1981:4	1981:4 to 1982:4
GNP (billions of current dollars)	2,730.6	2,982 to 3,098	3,259 to 3,516	9.4	9.2 to 13.4	9.3 to 13.5
Real GNP (billions of 1972 dollars)	1,485.6	1,508 to 1,538	1,555 to 1,616	-0.3	1.5 to 3.5	3.1 to 5.1
GNP Implicit Price Deflator (1972=100)	184	198 to 201	210 to 218	9.8	7.6 to 9.6	6.0 to 8.0
Consumer Price Index (1967=100)	257	278 to 283	294 to 305	12.5	8.2 to 10.2	5.7 to 7.7
Unemployment Rate (percent)	7.5	7.1 to 8.1	6.6 to 7.6	--	--	--
3-Month Treasury Bill Rate (percent, calendar year average)	11.6	13.5 to 15.5	11.4 to 13.4	--	--	--

- o The three-month Treasury bill rate is expected to moderate later in 1981, averaging between 13-1/2 and 15-1/2 percent over 1981 and about two percentage points lower over 1982.

Most forecasters, including CBO, do not expect any significant resumption of real growth until late this year. High interest rates and weak growth in real disposable income continue to provide considerable restraint on growth. At the moment, no serious imbalances are thought to exist between output and sales, so that a large adjustment in output to remedy an imbalance does not seem likely. Negative growth in the third quarter is possible, but CBO does not project a deep or prolonged decline in economic activity. The financial sector, however, is a source of considerable uncertainty. If interest rates continue at present levels for a prolonged period, a significant number of financial institutions (particularly thrifts) may be threatened, and small business failures could become more widespread. Moreover, spending by consumers and business could be further depressed if credit conditions remain very tight.

In the CBO forecast, however, the improving inflation outlook, combined with slow growth in the economy, is expected to lead to somewhat lower interest rates over the next few months. Lower interest rates and increased real wages set the stage for a resumption of consumer and business investment spending in the CBO forecast. The expected improvement in activity will be aided by the business tax reduction, retroactive to January 1, 1981, and the reductions in personal income tax rates starting in October. But while the average level of interest rates in 1982 is expected to be well below current levels, rates will remain high and will restrain growth somewhat.

Several factors that have worked to restrain the economy in the past have recently shifted in a more favorable direction, or are expected to do so soon:

- o The deceleration of inflation is expected to lead to gains in real wages and to lower interest rates;

- o The personal income tax burden will ease in the fourth quarter of 1981 and again in mid-1982, thereby contributing to the rise in real disposable income;

- o Defense purchases will strengthen later in 1981;

- The recently enacted capital cost recovery system provides strong incentives to invest; and

- There appears to have been no speculative buildup of inventories that would necessitate a large adjustment in output.

As these factors have their effects, the pickup in 1982--while still modest by historical standards--will represent a significant improvement in the performance of the economy as compared with the last three years.

The key components of the projected recovery in real activity are:

- A marked improvement in investment spending in response to the business tax cut and the resurgence of final demands;

- A sharp upturn in housing and automobile production from current depressed levels; and

- Strong defense purchases and orders leading to higher levels of production, utilization, and investment. The buildup in defense spending is assumed to proceed without any significant "bottlenecks" through 1982.

A COMPARISON OF FORECASTS

The most recent forecasts of CBO, the Administration, and the Federal Reserve, as well as earlier forecasts by CBO and the Administration, are summarized in Table 7. The new CBO forecast reflects the recent improvement in inflation; it sees inflation, as measured by the implicit price deflator for GNP, running 1-1/2 percentage points lower in 1981 and 2 percentage points lower in 1982 than was anticipated in the CBO winter forecast. Real growth is seen as somewhat stronger in 1981, largely because of rapid growth in the first quarter, and as significantly stronger in 1982. The unemployment rate is forecast to be 0.5 percentage point lower by the fourth quarter of 1982 than was foreseen last winter. Interest rates remain very high in the new CBO forecast.

The Administration has also reduced its inflation forecast for 1981 and 1982, but by less than the CBO. Its downward revision

TABLE 7. COMPARISON OF FORECASTS MADE BY CBO, THE ADMINISTRATION, AND THE FEDERAL RESERVE (Fourth quarter over fourth quarter)

	1981	1982
Nominal GNP (percent change)		
CBO	11.2	11.5
Administration	11.8	12.9
Federal Reserve	10.8	10.9
CBO, Winter	12.1	12.1
Administration, Winter	11.0	13.3
Real GNP (percent change)		
CBO	2.5	4.1
Administration	2.5	5.2
Federal Reserve	2.3	2.5
CBO, Winter	1.8	2.8
Administration, Winter	1.4	5.2
GNP Implicit Price Deflator (percent change)		
CBO	8.6	7.0
Administration	9.1	7.3
Federal Reserve	8.3	7.5
CBO, Winter	10.1	9.1
Administration, Winter	9.5	7.7
Unemployment Rate (percent, fourth-quarter average)		
CBO	7.6	7.1
Administration	7.7	7.0
Federal Reserve	7.9	7.8
CBO, Winter	7.8	7.6
Administration, Winter	7.7	7.0
3-Month Treasury Bill Rate (percent, calendar year average)		
CBO	14.5	12.4
Administration a/	13.6	10.5
Federal Reserve	N.A.	N.A.
CBO, Winter	12.8	13.8
Administration, Winter	11.1	8.9

NOTE: The CBO estimates are midpoints of ranges of economic projections; the Federal Reserve estimates are midpoints (rounded to one decimal place) of ranges of economic projections formulated by members of the Federal Open Market Committee.

SOURCES: Congressional Budget Office; Office of Management and Budget, A Program for Economic Recovery, February 18, 1981, and Mid-Session Review of the 1982 Budget, July 15, 1981; Federal Reserve System, Board of Governors, Midyear Monetary Policy Report to Congress, July 20, 1981.

a/ According to the Administration's Mid-Session Review of the 1982 Budget, "These projections assume, by convention, that interest rates are linked to the rate of inflation. They are not forecasts of interest rates."

amounts to about one-half of a percentage point in each year. Projections for real growth are higher for 1981 and unchanged for 1982. Interest rate projections have been raised substantially in the Administration's forecast.

The differences between the CBO and the Administration forecasts have been reduced since last winter. They are now very similar in their outlook for 1981. The Administration forecast still remains more optimistic for 1982. The Administration forecast of real growth is more than one percentage point higher than the CBO projection. Its forecast of nominal GNP is also well above the CBO forecast for 1982, and its three-month Treasury bill rate, at 10.5 percent for 1982, is nearly two percentage points lower than CBO's forecast.

The Federal Reserve forecast for inflation is close to what CBO and the Administration project. Its projection for nominal GNP in 1982 is substantially lower than the Administration's and somewhat lower than CBO's. Real growth in 1982 is lower than in the CBO and Administration forecasts--by 1.6 and 2.7 percentage points, respectively--and unemployment is substantially higher.

The Federal Reserve's less positive outlook probably can be traced to its assumptions about the impact of monetary restraint on economic growth. As indicated below, however, there is considerable uncertainty about the economic impact of the Federal Reserve's announced money targets.

Two major uncertainties in the economic outlook for 1982 are the behavior of food and fuel prices and the impact of monetary policy. These topics are treated in the following two sections.

COMMODITY PRICES

Both food and fuel prices have traditionally been very difficult to predict. Their importance in the current inflation outlook means that CBO's inflation projection, and that of most other forecasters, must be treated with caution. If food and fuel prices were to increase about 10 percentage points more than assumed by CBO through 1982, they would have a significant impact on real growth, inflation, and unemployment (see Table 8).

On the other hand, developments in commodity prices might be more favorable than assumed. For example, absolute declines

TABLE 8. ESTIMATED ECONOMIC IMPACTS OF PESSIMISTIC FOOD AND FUEL PRICE ASSUMPTIONS--10 PERCENTAGE POINTS HIGHER THAN ASSUMED IN THE CBO FORECAST

Economic Variable	1982:4
Real GNP (billions of 1972 dollars)	-15 to -20
GNP Implicit Price Deflator (percent)	+1-1/4 to +1-3/4
Unemployment Rate (percentage points)	+0.4 to +0.5

in world oil prices over the forecast period cannot be ruled out. The OPEC meeting in Geneva in August 1981 indicated that oil price increases through 1982 will be lower than most forecasters had been expecting. A decline in world oil prices would have a favorable effect on economic activity.

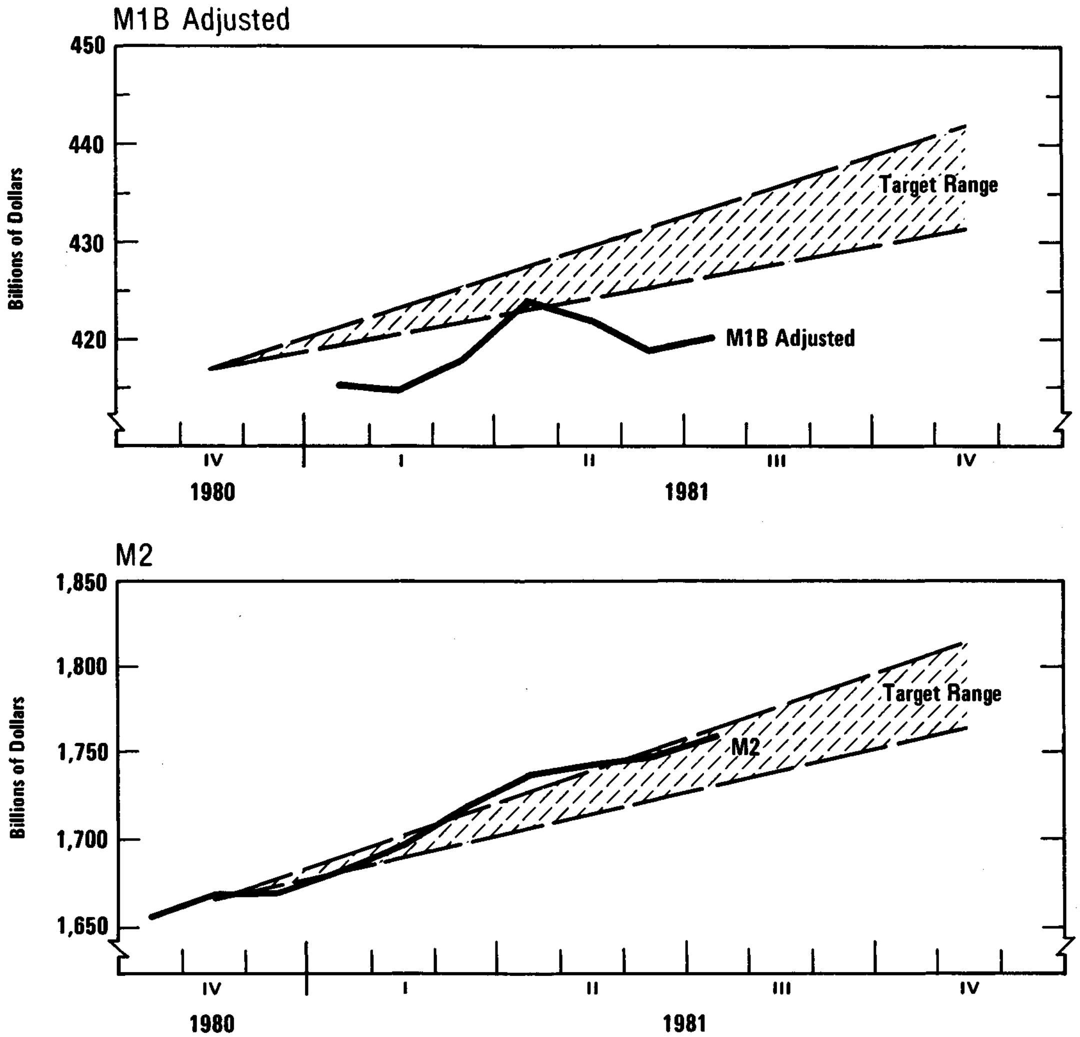
MONETARY POLICY AND INTEREST RATES

A major uncertainty in the economic outlook is the compatibility of the Federal Reserve's monetary policy targets and rapid economic growth. The Federal Reserve, with the urging of the Administration, has indicated that the major objective of its monetary policy is to reduce inflation. The Federal Reserve is attempting to achieve this goal by a steady reduction in the growth of the money aggregates. Recently it has made some progress in this direction. The growth of the narrow aggregate, M1B, the most closely watched money target, has evidently decelerated, particularly since April. 2/ In fact, the growth of M1B Adjusted has recently been below the low end of the Federal Reserve's target range for that aggregate (see Figure 3). The growth of the

2/ For a definition of M1B Adjusted and M2, see Figure 3.

Figure 3.

Monetary Aggregates: Target Ranges and Actual Levels



NOTE: **M1B Adjusted:** Averages of daily figures for (1) demand deposits at all commercial banks other than those due to domestic banks, the U.S. government, and foreign banks and official institutions less cash items in the process of collection and Federal Reserve float; (2) currency outside the Treasury, Federal Reserve Banks, and the vaults of commercial banks; (3) travelers checks of nonbank issuers; and (4) negotiable order of withdrawal (NOW) and automatic transfer service (ATS) accounts at banks and thrift institutions, credit union share draft accounts, and demand deposits at mutual savings banks. Adjusted by the Federal Reserve Board for major shifts into NOW accounts from interest-earning assets included in M2.

M2: M1B plus savings and small-denomination time deposits at all depository institutions, overnight repurchase agreements at commercial banks, overnight Eurodollars held by U.S. residents other than banks at Caribbean branches of member banks, and money market mutual fund shares.

SOURCE: Federal Reserve System, Board of Governors.

broader aggregate, M2, has been much stronger. But M1B is now considered to be a better indicator of monetary policy because M2 includes money market mutual funds, repurchase agreements, and money market certificates, which have grown rapidly in response to high interest rates. Moreover, the short-run volatility of these aggregates seems to have been somewhat less over the first half of 1981 than in 1980, probably a reflection of the Federal Reserve's increased determination to hold to its targets. 3/

Monetary Aggregates Targets. The Federal Reserve has stressed that its money targets will not be eased to accommodate additional growth in GNP. In fact, Chairman Volcker testified in mid-July that the Federal Open Market Committee (FOMC) has adopted a somewhat lower range for M1B Adjusted in 1982. The target range for M2 is to be left unchanged. (The target ranges are shown in Table 9.) Although the change in the M1B Adjusted target is small, Chairman Volcker indicated that actual growth is expected to remain in the lower half of its range in 1981. He also stated that actual growth in M2 in 1982 would be close to the midpoint of its range, in contrast to the growth at the upper end of the range that has occurred in 1981.

Velocity, Interest Rates, and Credit Demands. Many analysts believe that the Federal Reserve's money aggregate targets are not consistent with strong economic growth in 1982. An argument that these targets may inhibit real growth can be derived from the long-run relationship between money and total spending in the economy, combined with strong inflation momentum. (The ratio of current-dollar GNP to a money target is referred to as the "velocity" of that target.) If the trend growth in the velocity of M1B Adjusted is about 3-1/2 percent, and if money is allowed to expand at a steady 5-1/2 percent rate (the upper end of the Federal Reserve's target range), this argument holds that, over a period of a few years, total spending will only be able to expand at a 9 percent pace (that is, 3-1/2 + 5-1/2). At the same time, if the underlying rate of inflation persists at, say, 8 percent, little room remains for real growth in the economy. Velocity growth may exceed 3-1/2 percent for a time; but, based on historical relationships, this would likely be accompanied by high short-term interest rates, which would eventually crowd out real growth.

3/ The volatility in 1980 may have resulted partly from the imposition of credit controls in March.

TABLE 9. MONETARY AGGREGATES: TARGETS AND REALIZED GROWTH RATES (Percent change, fourth quarter to fourth quarter)

	Target Ranges	Actual
M1B Adjusted a/		
1980	4 to 6-1/2	6-3/4
1981	3-1/2 to 6	2-1/4 b/
1982	2-1/2 to 5-1/2	--
M2		
1980	6 to 9	9-1/2
1981	6 to 9	9-3/4 b/
1982	6 to 9	--

a/ M1B includes currency, demand deposits, and other checkable deposits at banks and thrift institutions. M1B Adjusted is lowered to account for shifts in deposits from time deposits (part of M2) to negotiable order of withdrawal (NOW) and automatic transfer services (ATS) accounts. It is estimated that these shifts added 1/2 to 3/4 percent to unadjusted M1B growth in 1980 and will add 2 to 3 percent in 1981.

b/ January to July 1981, at an annual rate.

From another vantage point, some forecasters expect high interest rates to persist in 1982, even without a strong pickup in economic activity, because of strong credit demands in some sectors. Heavy business borrowing for investment and individual borrowing for residential ownership are expected to limit any decline in interest rates. Compounding this situation, state and local and federal governments are also expected to be heavy borrowers.

CBO projects a unified budget deficit of about $65 billion in fiscal year 1982, but total borrowing from the public by the Treasury should significantly exceed the budget deficit (see Table 10). Off-budget borrowing, primarily to fund the Federal Financing Bank's loan activities, will add about $20 billion to Treasury borrowing in 1982. Total Treasury borrowing is, therefore, expected to reach $80 to $90 billion. The federal government's presence in the credit markets will also be felt as a result of $80 billion in new federal guarantees of private credit.

TABLE 10. FEDERAL BUDGET DEFICITS AND BORROWING FROM THE PUBLIC (By fiscal year, in billions of dollars)

		Estimates	
	1980	1981	1982
Unified Budget Deficit	59.6	60	65
Off-Budget Deficit	14.2	24	20
Total Deficit	73.8	84	85
Means of Financing Other Than Borrowing from the Public a/	3.3	8.6	1.7
Borrowing from the Public	70.5	75.4	83.3
New Loan Guarantee Commitments b/	69.8	87	80

a/ Changes in cash balances, checks outstanding, and seigniorage on coins. Estimates from Mid-Session Review of the Budget, July 1981.

b/ Estimates from OMB, July 1981.

For a number of reasons, however, credit conditions may not be as limiting to economic growth as some forecasters expect. First of all, the Federal Reserve may not achieve its targets for money growth. Even if it does, financial conditions may not inhibit fairly strong growth in 1982:

- Monetary velocity has historically been quite unstable for periods as long as two years. High interest rates are often associated with rapid velocity growth. With record high interest rates providing a strong incentive to economize on money use, it would not be surprising if velocity growth also proceeded at record rates.

- o Given the recent development of new financial instruments, such as six-month certificates and money market mutual funds, and with further changes expected as a result of recent legislation deregulating financial institutions, the relationship between money aggregates, interest rates, and GNP is changing. Many observers believe that a given level of money will now accommodate more growth in GNP than in the past.

- o For business firms and individuals in high income-tax brackets, real after-tax interest rates may not have risen sufficiently to dampen their business activities severely. The impact varies greatly, however, depending on the tax situation. For business firms that have little or no profits, the real costs of borrowing are significantly higher.

- o If inflation moderates quickly, as some forecasters expect, the Federal Reserve's monetary targets will be able to accommodate real growth more easily.

- o The impact of high interest rates on business investment may be offset, at least in part, by recently enacted cuts in business taxes.

The CBO forecast for 1982 may be based on favorable assumptions about prices and about the velocity-interest rate issue. These assumptions are not, however, unreasonably optimistic. Nevertheless, the risks that economic growth will fall short of the CBO forecast are substantial.

CHAPTER IV. THE BUDGET OUTLOOK

This chapter discusses the budget outlook through 1984 using CBO's updated economic forecast and longer-range assumptions. It also examines the Administration's latest budget estimates presented in its Mid-Session Review of the 1982 budget. CBO's budget projections incorporate the changes in tax law resulting from the enactment of the 1981 Tax Act and the spending policies proposed by the Administration and included in the first budget resolution for 1982. They include the spending reductions enacted to date in the Reconciliation Act of 1981 as well as substantial further spending reductions assumed by the first budget resolution and the Administration's July budget estimates.

The CBO projections indicate that federal budget deficits will decline gradually over the next several years, but that budget balance will not be attained by 1984 unless the proposed growth of defense spending is curtailed, nondefense spending is scaled back even further, or increases in revenues are generated.

NEW BUDGETARY POLICIES

At the beginning of the year, the Administration proposed dramatic policy changes designed to slow inflation, encourage saving and investment, stimulate economic growth, and strengthen national defense. 1/ Toward these ends, the President proposed to reduce sharply the growth of federal spending over the next five years, cut personal taxes over the next three years, reduce business taxes through accelerated depreciation, and increase significantly the relative share of the budget allocated to national defense. The Administration also set a target of achieving a balanced budget by 1984. Its budget estimates were based on the assumption that real economic growth would average close to 4.5

1/ For a discussion of the Administration's budgetary proposals and economic assumptions, see Congressional Budget Office, An Analysis of President Reagan's Budget Revisions for Fiscal Year 1982 (March 1981).

percent annually over the 1982-1986 period, and that there would be a steady decline in inflation, unemployment, and interest rates.

In May, the Congress adopted nearly all of the Administration's budgetary proposals and most of its economic assumptions as part of its first budget resolution for 1982--the major exception was that the Congress assumed less rapid declines in interest rates. The first budget resolution specified sharp reductions in federal spending and revenues from their projected baseline levels. If realized, the resolution spending targets would hold the average growth in federal outlays during the next three years to less than 6 percent annually, or less than one-half of the average growth rate since 1976. Outlays as a percentage of GNP were projected to fall from over 23 percent in 1981 to 19.2 percent in 1984, the lowest level since 1966. The resolution also specified a change in spending priorities by increasing funds for national defense above projected baseline levels and reducing funds for nondefense programs. As a consequence, defense outlays would increase from about 24 percent of total budget outlays in 1981 to 32 percent in 1984.

The budget resolution specified large cuts in revenues that would reduce the average annual growth in tax receipts to less than 9 percent during 1982-1984, as compared with a projected growth rate of 14.5 percent under tax laws existing at the beginning of the year. Tax revenues were projected to fall from 21.1 percent of GNP in 1981 to 19.2 percent in 1984, a level that was last attained in 1977. As shown in Table 11, the first budget resolution also projected a rapid decline in the federal deficit and a small budget surplus by 1984. 2/

REVISED ADMINISTRATION BUDGET ESTIMATES

The Administration's Mid-Session Review of the 1982 budget reestimates revenue and spending for fiscal years 1981 to 1984. These new estimates, shown in Table 11, are based on revised

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2/ For a further discussion of the first budget resolution targets and projected baseline outlays and revenues, see Congressional Budget Office, Baseline Budget Projections: Fiscal Years 1982-1986 (July 1981).

TABLE 11. FEDERAL BUDGET ESTIMATES FOR FISCAL YEARS 1981-1984 (In billions of dollars)

Budget Aggregates	1981	1982	1983	1984
First Budget Resolution				
Revenues	603.3	657.8	713.2	774.8
Outlays	661.35	695.45	732.25	773.75
Surplus or deficit (-)	-58.05	-37.65	-19.05	1.05
Administration				
Revenues	605.6	662.4	705.8	759.0
Outlays	661.2	704.8	728.7	758.5
Surplus or deficit (-)	-55.6	-42.5	-22.9	0.5
CBO a/				
Revenues	605	653-658	693-703	740-755
Outlays	665	718-723	748-758	790-805
Deficit	60	60- 70	45- 65	35- 65

SOURCES: First Concurrent Resolution on the Budget for Fiscal Year 1982 (H. Con. Res. 115, approved May 21, 1981); Mid-Session Review of the 1982 Budget, July 15, 1981; Congressional Budget Office.

a/ Based on existing tax law as revised by the Economic Recovery Tax Act of 1981 and the spending policies specified by the first budget resolution.

economic assumptions, recent experience with the rate of spending for federal programs, completed Congressional action, and policy changes proposed by the Administration since March.

The Administration's earlier economic assumptions were revised to reflect actual experience during the first half of the year. The major changes included an expectation of somewhat higher real growth for 1981 (based on higher-than-expected growth in the first quarter), an improved outlook for inflation over the next several years, and higher interest rates for 1981 and 1982 (about matching the interest-rate assumptions used for the first budget resolution). The longer-run economic assumptions were changed very little. Table 12 compares the Administration's July economic assumptions with those used by the Congress for its first budget resolution for 1982.

The main budgetary implications of the Administration's revised economic assumptions, relative to its earlier budget estimates, are: lower automatic cost-of-living adjustments for indexed benefit programs, particularly in 1983 and subsequent years; and higher outlays for interest on the public debt and for programs that are sensitive to interest rates, in 1981-1983.

The Administration raised its estimated budget deficit for 1981 by less than $1 billion, to $55.6 billion, and lowered the projected 1982 deficit from $45.0 billion to $42.5 billion. For 1983, its projected budget deficit remains at $23 billion, and it continues to project a balanced budget for 1984. To achieve the 1983 and 1984 budget targets, however, the Administration postulates further spending cuts, of which about $30 billion in 1983 and $44 billion in 1984 are still unspecified.

CBO BUDGET PROJECTIONS

CBO's midyear economic forecast and its longer-run economic assumptions, summarized in Table 12, are very similar in basic pattern to those of the Administration and those assumed for the first budget resolution. CBO projects slightly lower economic growth in 1982-1984 than either the Administration or the first budget resolution. CBO also projects lower inflation in 1981-1982 than assumed for the resolution, but assumes a somewhat slower moderation of inflation in 1983 and 1984 than projected by the Administration and the resolution. The three sets of assumptions differ hardly at all with respect to the unemployment rate for the entire 1981-1984 period. CBO projects a slower decline in interest rates over the four years, the differences being especially large for 1982-1984.

The major budgetary implications of the CBO economic assumptions relative to the Administration's July estimates and the first budget resolution targets are: lower revenues, largely as a result of lower economic growth, and higher outlays for interest on the public debt and other interest-rate-sensitive programs. CBO also projects higher spending rates for defense and other programs

TABLE 12. A COMPARISON OF ECONOMIC ASSUMPTIONS (By calendar year)

Economic Variable	1981	1982	1983	1984
GNP (billions of current dollars)				
First budget resolution	2,941	3,323	3,734	4,135
Administration	2,951	3,296	3,700	4,097
CBO a/	2,931	3,255	3,624	4,018
Real GNP (percent change, year over year)				
First budget resolution	2.0	4.1	5.0	4.5
Administration	2.6	3.4	5.0	4.5
CBO a/	2.3	3.1	4.1	4.0
GNP Implicit Price Deflator (percent change, year over year)				
First budget resolution	9.7	8.6	7.0	6.0
Administration	9.6	8.0	7.0	6.0
CBO a/	9.1	7.7	7.0	6.6
CPI (percent change, year over year) b/				
First budget resolution	11.1	8.3	6.2	5.5
Administration	9.9	7.0	5.7	5.2
CBO a/	10.1	7.2	7.0	6.2
Unemployment Rate (percent, annual average)				
First budget resolution	7.5	7.2	6.6	6.4
Administration	7.5	7.3	6.6	6.2
CBO	7.4	7.3	6.9	6.5
3-Month Treasury Bill Rate (percent, annual average)				
First budget resolution	13.5	10.5	9.4	8.2
Administration	13.6	10.5	7.5	6.8
CBO a/	14.5	12.4	11.4	10.1

SOURCES: Conference report on the First Concurrent Resolution on the Budget--Fiscal Year 1982 (to accompany H. Con. Res. 115, reported May 15, 1981); Mid-Session Review of the 1982 Budget, July 15, 1981; Congressional Budget Office.

a/ The economic projections for 1981 and 1982 are the midpoints of the economic forecast ranges. The projections for 1983 and 1984 are not forecasts; they are assumptions.

b/ The Consumer Price Index used by the Administration is for wage earners and clerical workers in urban areas; the index used for the first budget resolution and CBO assumptions covers all urban dwellers.

than assumed by the Administration and the first resolution. As shown in Table 11, CBO projects that the 1981 budget deficit will be about $60 billion, almost the same level as for 1980 and only slightly higher than estimated for the first budget resolution. Subsequently, CBO's projections indicate that the budget deficit could rise to about $65 billion in 1982, falling gradually over the next two years to about $50 billion in 1984. Relative to GNP, however, the projected deficit would fall from nearly 2 percent of GNP in 1982 to about 1 percent in 1984.

Revenue Projections

The CBO revenue projections are based on current tax law as revised by the Tax Act of 1981, signed into law on August 13. The Tax Act provides for an unprecedented three successive annual reductions in personal income tax rates, with annual adjustments for the effects of inflation thereafter. It also provides for a large business tax cut, with scheduled step increases in the rates of depreciation in 1985 and 1986. The Tax Act will reduce projected fiscal year 1982 revenues by an estimated $38 billion, 1983 revenues by $93 billion, and 1984 revenues by $150 billion. Individual tax burdens will be decreased by $27 billion in 1982, and business taxes by $11 billion. Other measures that reduce projected revenues are essentially offset by revenue-raising provisions.

CBO's projections of current law revenues based on the CBO midyear economic forecast and longer-range assumptions are summarized by major source in Table 13. Total revenues are projected to rise from an estimated $605 billion in 1981 to about $750 billion in 1984, an average annual growth rate of about 7 percent--less than one-half the average growth rate since 1976. Relative to GNP, tax revenues are projected to decline from about 21 percent in 1981 to about 19 percent in 1984, virtually the same reduction as specified by the first budget resolution.

The CBO current law revenue projections are very close to the first resolution targets for 1981 and 1982, but are lower by about $15 billion for 1983 and $27 billion for 1984. The lower revenues for 1983 and 1984 are largely the result of lower projected personal income levels. The CBO revenue projections are also lower than the Administration's July estimates, by about $7 billion in 1982, $8 billion in 1983, and $11 billion in 1984. Again, the differences are largely attributable to less optimistic assumptions about income levels.

TABLE 13. CBO PROJECTIONS OF CURRENT LAW REVENUES BY SOURCE (By fiscal year, in billions of dollars)

	1981	1982	1983	1984
Individual Income Taxes	286	300	307	324
Corporate Income Taxes	62	67	79	85
Social Insurance Taxes	188	211	235	258
Excise Taxes and Other	69	77	77	82
Total	605	655	698	748

NOTE: The projections are midpoints of projected ranges.

Outlay Projections

The enactment of the Omnibus Budget Reconciliation Act of 1981 was a major step toward achieving the spending reductions specified by the first budget resolution. Implicit in the budget resolution targets, however, are additional savings--over and above those obtained in the Reconciliation Act--to be made through the appropriations process and by other legislative and administrative means. These additional savings amount to about $15 billion in 1982, about $35 billion in 1983 (of which $20 billion are unspecified), and about $50 billion in 1984 ($28 billion unspecified).

CBO's projections of outlays for 1982-1984 are based on the spending targets of the first budget resolution and assume that these additional spending reductions will be made. Total unified budget outlays are projected to rise from an estimated $665 billion in 1981 to between $718 and $723 billion in 1982 and to between $790 and $805 billion in 1984. This would represent an average growth rate of about 6 percent annually, close to the growth rate set by the first resolution targets. Relative to GNP, outlays would fall from over 23 percent in 1981 to about 20 percent in 1984.

The CBO outlay projections exceed the first resolution outlay targets by over $20 billion in 1982, and by similar amounts in 1983 and 1984. They are also higher than the Administration's July estimates--by a somewhat smaller amount in 1982, by over $20 billion in 1983, and by over $30 billion in 1984. CBO's outlay projections are higher for two major reasons: higher estimates of interest on the public debt and other interest-related costs, and higher estimates of defense outlays.

Interest rates used for the CBO projection of outlays for 1982-1984 are about two percentage points higher than the rates underlying the first resolution targets for each year. The differences between the CBO interest-rate assumptions and those used for the Administration's July estimates are even larger, as shown in Table 12. The higher CBO interest-rate assumptions add about $40 billion to the Administration's outlay estimates for the 1982-1984 period.

The higher CBO defense outlay projections represent technical estimating differences resulting from the use of different spending rate assumptions. CBO's projections assume that historical spending rates, especially for major procurement programs, will continue to apply to 1982-1984 outlays. CBO's defense outlay projections are about $5 billion higher than the Administration's for 1982 and over $6 billion higher for 1984, using CBO's spending rate assumptions and the mix of budget authority included in the Administration's July estimates. They are about the same amounts higher than the first resolution outlay targets for these years.

Other differences between the CBO outlay projections and the first resolution targets and Administration estimates result from somewhat different assumptions about the size of the annual cost-of-living adjustments for Social Security benefits and other indexed programs, and from technical reestimates for farm price supports, food stamps, medicare and medicaid, and assistance payments. These technical reestimates are based on recent events--such as the larger-than-expected corn crop--and spending trends.

Uncertainty of Budget Projections

Budget projections are very uncertain for several reasons. First, changes in economic conditions can have dramatic effects on the federal budget. If the economy does not grow as much as projected over the next several years, federal revenues will be lower than estimated and outlays higher. Budget outlays also have become increasingly sensitive to interest rates because of the growth in the federal debt. If interest rates, for example, are one percentage point higher than assumed by the CBO projections, interest-related costs would be increased by over $2 billion in 1982 and over $6 billion by 1984. Forecasting future economic conditions is subject to a great deal of uncertainty, and the longer the forecast period, the greater the range of uncertainty. 3/

A second element of uncertainty is that budget estimates can be off the mark for various programmatic and other technical reasons. Harvests can vary unexpectedly, natural disasters can occur, program spending patterns can change, and international events can lead to unanticipated changes in spending. The ranges shown in Table 11 for the CBO budget projections are intended to represent possible estimating errors arising from these factors. The ranges are less than 1 percent for projected revenues and outlays in 1982 and about 2 percent in 1984.

Third, the CBO outlay projections assume substantial additional spending reductions in 1982-1984 beyond those already enacted as part of the Omnibus Reconciliation Act. A large portion of these additional reductions are yet to be specified. Also, some of those that have been identified, such as the Administration's Social Security proposals, may be substantially modified. If the Congress does not approve the Administration's proposals for further program reductions, and if the federal agencies are unable to achieve the administrative savings assumed for the budget projections, budget outlays and the federal deficits could be much higher than estimated.

Conclusion

The differences in economic assumptions used for the first budget resolution, the Administration's Mid-Session Review of the budget, and the CBO budget projections are not very great. Neither

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3/ For a further discussion of the sensitivity of budget estimates to economic assumptions, see Congressional Budget Office, Baseline Budget Projections: Fiscal Years 1982-1986.

are the differences in revenue and spending estimates, considering the uncertainties involved. Nevertheless, these differences do affect the outlook for a balanced budget by 1984. The CBO budget projections imply that the federal budget is likely to remain in deficit in 1984 unless the projected growth in defense spending is scaled back, nondefense programs are cut further, and/or additional revenues are generated.