THE ECONOMIC AND BUDGET OUTLOOK: FISCAL YEARS 1997-2006

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Congressional Budget Office

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NOTES

Unless otherwise indicated, all years referred to in Chapters 1 and 4 are calendar years and all years in Chapters 2 and 3 are fiscal years.

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

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

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

National income and product account data shown in the tables do not incorporate the revised data for the fourth quarter of 1995 that were released on April 2, 1996.

Preface

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

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

The baseline outlay projections were prepared by the staff of the Budget Analysis Division under the supervision of Paul N. Van de Water, Robert Sunshine, Paul Cullinan, Peter Fontaine, James Horney, Michael Miller, and Murray Ross. The revenue estimates were prepared by the staff of the Tax Analysis Division under the supervision of Rosemary D. Marcuss and Richard Kasten. Daniel Kowalski wrote Chapter 2, and James Horney wrote the summary of the report.

The analysis of the President's budgetary proposals for fiscal year 1997 contained in Chapter 3 was prepared by the staffs of the Budget Analysis and Tax Analysis Divisions at the request of the Senate Committee on Appropriations. The estimates of the President's revenue proposals were prepared by the Joint Committee on Taxation. Jeffrey Holland wrote the chapter.

The analysis of the long-term implications of current fiscal policy presented in Chapter 4 was requested by the Chairman of the Senate Budget Committee and was carried out by Douglas Hamilton, Benjamin Page, and John Sturrock of the Macroeconomic Analysis Division under the direction of Robert Dennis. Douglas Hamilton wrote the chapter, and John Romley and Laurie Brown provided expert research assistance. The appendixes were written by Frank Russek (Appendix A), Susan Strandberg (Appendix B), and Michael Simpson (Appendixes C, D, and E).

An early version of Chapter 4 was discussed at a meeting of CBO's Panel of Economic Advisers. Members of that panel are Michael Boskin, Barry Bosworth, Robert Dederick, Martin Feldstein, Benjamin Friedman, Lyle E. Gramley, Robert E. Hall, Marvin Kosters, Anne Kreuger, Burton Malkiel, Gregory Mankiw, Allan Meltzer, Rudolph Penner, James Poterba, William Poole, Robert Reischauer, Sherwin Rosen, Robert Solow, John Taylor, and James Tobin. Henry Aaron, Alan Auerbach, Stanley Fischer, Laurence Kotlikoff, Edward McKelvey, and Laurence Meyer attended as guests. In addition, Herbert Stein provided comments on an early draft of Chapter 4. Despite the considerable assistance afforded by those outside advisers, the analysis in this report does not necessarily reflect their views, nor are they responsible for any errors.

Paul L. Houts supervised the editing and production of the report. Major portions were edited by Paul L. Houts, Sherwood D. Kohn, Leah Mazade, and Sherry Snyder. Christian Spoor provided editorial and production assistance. The authors owe thanks to Derek Briggs, Marion Curry, Janice Johnson, Dorothy Kornegay, Linda Lewis, John Romley, and Wanda Sivak, who assisted in the preparation of the report. Kathryn Quattrone and Jill Sands prepared the report for final publication.

June E. O'Neill
Director

May 1996

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Summary

According to Congressional Budget Office (CBO) projections, the deficit will decline for the fourth straight year in fiscal year 1996 and the economy will continue to expand at a moderate rate. But if current policies for revenues and entitlements are not changed, and if discretionary appropriations keep pace with inflation, the deficit will begin to grow steadily in 1997. If discretionary spending is not adjusted for inflation, the deficit will level off in nominal terms at about $180 billion and shrink in relation to the size of the economy. Both the Congress and the President, however, have proposed changes in policies that would balance the budget by 2002.

In the budget that the President submitted in March, he presented a set of policy changes intended to eliminate the deficit by 2002. Under CBO's more cautious economic and technical assumptions, the basic policies outlined in the President's budget would bring the deficit down to about $80 billion by 2002 instead of producing the budget surplus that the Administration estimates. CBO estimates, however, that additional, contingent policies proposed in the budget, which are to be carried out if deficits are higher than those the Administration projects, would produce a small surplus in 2002.

Because CBO's detailed current-policy projections extend only through 2006, they do not reflect the aging of the baby-boom generation, which will first begin to affect deficits about 2010. The expected increase in the number of beneficiaries of federal programs for the elderly and a slowing in the rate of growth of the labor force--combined with the anticipated growth in the per-person cost of Medicare--will put enormous pressure on the budget. If those pressures are not dealt with by reducing spending or increasing taxes, the mounting deficits could seriously erode future economic growth. Balancing the budget by 2002 will help alleviate the pressures, particularly if the deficit reduction package that is enacted includes measures that would slow the growth of entitlement spending. But the size of the future problem is so great that simply eliminating the deficit by 2002 without making additional changes in spending and taxes would not ensure that future deficits will remain at an acceptable level.

The Budget Outlook Under Current Policies

CBO projects that the deficit will fall to $144 billion in 1996, or 1.9 percent of gross domestic product (GDP). That figure is $28 billion lower than the deficit that CBO predicted last winter in its report *The Economic and Budget Outlook: December 1995 Update.* The reduction in the estimated deficit is largely the result of enacted appropriations. Those appropriations are expected to reduce discretionary spending by almost $20 billion from the statutory limit on discretionary outlays that CBO used as the basis for its December baseline projections.

CBO's current outlook for the deficit after 1996 is not very different from the one it reported in December. On average, the deficits projected for 1997 through 2005 in the comparable current baseline are lower than CBO's December projections by about 0.2 percent of GDP.

Estimates of the size of the deficit in 1997 and its course after that depend heavily on assumptions about economic conditions and the level of discretionary spending that annual appropriation legislation will provide. For this report, CBO has produced four different baseline projections of spending and revenues, which vary according to assumptions made about the course of the economy and the growth of discretionary spending. For all four of the baseline projections, CBO assumes that current laws governing mandatory spending programs and revenues will not change.

Economic Assumptions

CBO has produced two sets of economic projections. The first set is the traditional one for the annual report, which assumes no change in current budgetary policies. Therefore, those economic projections are consistent with projections of the levels of spending, revenues, and deficits that will occur if budgetary policies do not in fact change.

A second set of projections incorporates the economic effects anticipated if the deficit is eliminated by 2002--a goal that both the Congress and the President have endorsed. CBO assumes that balancing the budget would lower interest rates and slightly increase economic growth. Consequently, federal interest payments would decrease and revenues would increase. As with CBO's economic forecast of last December, this set of projections was developed as an aid to policymakers considering plans to balance the budget by 2002. It does not represent an alternative projection of the course of the economy if no such plan is carried out.

The economic outlook has not changed significantly since December 1995. CBO continues to believe that the U.S. economy is fundamentally sound and estimates that the chances of a major downturn in the next two years are not high. CBO does not attempt to forecast cyclical economic patterns beyond two years. Hence, economic projections for 1997 through 2006 represent CBO's estimates of the average economic performance over the period, based on an assessment of the fundamental factors affecting the economy.

Under the current-policy economic assumptions, CBO projects that the economy, as measured by real (inflation-adjusted) GDP, will increase at slightly below its noninflationary potential rate of growth over the next three years. After that, CBO assumes that the economy will, on average, grow at the potential rate--estimated by CBO to be 2.1 percent a year (see Summary Table 1). The unemployment rate is expected to average 6 percent over the 1997-2006 period, 0.4 percentage points above the rate for the first quarter of 1996. The projected rate is also slightly above CBO's estimate of the rate of unemployment that is consistent with stable inflation (the nonaccelerating inflation rate of unemployment, or NAIRU) because the unemployment rate has, on average, been slightly higher than the NAIRU since 1960. Inflation, as measured by the consumer price index, will climb slightly over the next two years but will average a moderate rate of about 3 percent a year during the 1997-2006 period. CBO forecasts little change in long-term and short-term interest rates over the next two years. Similarly, it projects that the average level of interest rates for 1998 through 2006 will be close to current levels.

If, instead of assuming that current budgetary policies continue, CBO assumed that the budget will be balanced by 2002, projected interest rates would be 110 basis points (1.1 percentage points) lower by 2002, and real growth would be 0.1 percentage point a year higher (see Summary Table 2). The economic projections that assume a balanced budget are quite similar to CBO's December 1995 projections, which also assumed a balanced budget by 2002.

Assumptions About Discretionary Spending

As with the economic variables, CBO has made two different assumptions about the path of discretionary spending. Such spending is uncertain under current law because it is governed by annual appropriations instead of permanent law. The starting point for both

Summary Table 1.
Economic Projections Assuming Current Policy for Calendar Years 1996 Through 2006

	Prelimi- nary[a]	Forecast		Projected								
	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Nominal GDP (Billions of dollars)	7,248	7,584	7,943	8,324	8,730	9,156	9,603	10,071	10,563	11,078	11,619	12,185
Nominal GDP (Percentage change)	4.6	4.6	4.7	4.8	4.9	4.9	4.9	4.9	4.9	4.9	4.9	4.9
Real GDP[b] (Percentage change)	2.1	2.0	1.9	2.0	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1
Chain-Type GDP Price Index (Percentage change)	2.5	2.6	2.8	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7
CPI-U[c] (Percentage change)	2.8	2.8	3.1	3.0	2.9	2.9	2.9	3.0	3.0	3.0	3.0	3.0
Unemployment Rate (Percent)	5.6	5.8	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0
Three-Month Treasury Bill Rate (Percent)	5.5	4.9	4.8	4.8	4.8	4.8	4.8	4.8	4.8	4.8	4.8	4.8
Ten-Year Treasury Note Rate (Percent)	6.6	6.1	6.4	6.4	6.4	6.4	6.4	6.4	6.4	6.4	6.4	6.4
Tax Bases (Billions of dollars)												
Corporate profits	579	599	612	618	620	629	648	672	703	741	780	822
Other taxable income	1,529	1,595	1,662	1,757	1,859	1,958	2,058	2,157	2,259	2,367	2,482	2,604
Wage and salary disbursements	3,420	3,592	3,760	3,935	4,124	4,322	4,528	4,743	4,969	5,205	5,452	5,711
Total	5,528	5,786	6,035	6,309	6,603	6,909	7,233	7,572	7,931	8,313	8,714	9,137
Tax Bases (Percentage of GDP)												
Corporate profits	8.0	7.9	7.7	7.4	7.1	6.9	6.7	6.7	6.7	6.7	6.7	6.7
Other taxable income	21.1	21.0	20.9	21.1	21.3	21.4	21.4	21.4	21.4	21.4	21.4	21.4
Wage and salary disbursements	47.2	47.4	47.3	47.3	47.2	47.2	47.2	47.1	47.0	47.0	46.9	46.9
Total	76.3	76.3	76.0	75.8	75.6	75.5	75.3	75.2	75.1	75.0	75.0	75.0

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

a. Consistent with the first official estimate for 1995 published on March 4, 1996.

b. Based on chained (1992) dollars.

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

Summary Table 2.
Economic Projections Assuming Balanced Budget Policy for Calendar Years 1996 Through 2006

	Prelimi-nary[a]	Forecast		Projected								
	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Nominal GDP (Billions of dollars)	7,248	7,584	7,946	8,333	8,745	9,177	9,631	10,108	10,608	11,133	11,684	12,261
Nominal GDP (Percentage change)	4.6	4.6	4.8	4.9	4.9	4.9	4.9	4.9	4.9	4.9	4.9	4.9
Real GDP[b] (Percentage change)	2.1	2.0	2.0	2.1	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Chain-Type GDP Price Index (Percentage change)	2.5	2.6	2.8	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7
CPI-U[c] (Percentage change)	2.8	2.8	3.1	3.0	2.9	2.9	2.9	3.0	3.0	3.0	3.0	3.0
Unemployment Rate (Percent)	5.6	5.8	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0
Three-Month Treasury Bill Rate (Percent)	5.5	4.9	4.8	4.3	3.9	3.7	3.7	3.7	3.7	3.7	3.7	3.7
Ten-Year Treasury Note Rate (Percent)	6.6	5.7	5.5	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3
Tax Bases (Billions of dollars)												
Corporate profits	579	602	637	668	691	716	741	778	817	857	899	944
Other taxable income	1,529	1,590	1,635	1,700	1,779	1,860	1,946	2,032	2,127	2,227	2,334	2,448
Wage and salary disbursements	3,420	3,592	3,762	3,939	4,131	4,332	4,541	4,761	4,990	5,230	5,482	5,746
Total	5,528	5,784	6,034	6,307	6,601	6,907	7,228	7,570	7,933	8,315	8,716	9,138
Tax Bases (Percentage of GDP)												
Corporate profits	8.0	7.9	8.0	8.0	7.9	7.8	7.7	7.7	7.7	7.7	7.7	7.7
Other taxable income	21.1	21.0	20.6	20.4	20.3	20.3	20.2	20.1	20.0	20.0	20.0	20.0
Wage and salary disbursements	47.2	47.4	47.3	47.3	47.2	47.2	47.2	47.1	47.0	47.0	46.9	46.9
Total	76.3	76.3	75.9	75.7	75.5	75.3	75.0	74.9	74.8	74.7	74.6	74.5

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

a. Consistent with the first official estimate for 1995 published on March 4, 1996.

b. Based on chained (1992) dollars.

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

sets of projections is the level of appropriations enacted for fiscal year 1996 as of April 25, 1996. For departments and other agencies funded by the continuing resolution that was in effect through April 25, the projections assume 1996 appropriations at the level CBO estimated would have resulted from extending the continuing resolution for a full year. Appropriations enacted after April 25 are not reflected in these projections (see Summary Box 1).

In the first set of projections, discretionary spending is assumed to grow at the rate of inflation up to the statutory caps imposed on it through 1998. The cap that applies to appropriations from the Violent Crime Reduction Trust Fund (VCRTF) does not constrain the projections because CBO estimates that 1996 VCRTF spending adjusted for inflation will be below the limits in both 1997 and 1998. But the cap that applies to general-purpose discretionary spending (all discretionary spending other than VCRTF spending) does affect CBO's projections. Although 1996 general-purpose appropriations adjusted for inflation will fall below the cap in 1997, they will exceed the cap in 1998. Therefore, CBO assumes that general-purpose discretionary spending will be limited to the level of the cap in 1998 and will grow from that level at the rate of inflation in 1999 through 2006.

Summary Box 1.
Recent Budgetary Events

Two events that significantly affect the budget occurred after the Congressional Budget Office (CBO) had completed the projections detailed in this report and are therefore not reflected in it. First, the Congress passed and the President signed into law on April 26 the Omnibus Consolidated Rescissions and Appropriations Act of 1996 (P.L. 104-34). That law provided full-year appropriations for a number of agencies that had previously been funded on a temporary basis by a series of continuing resolutions. In addition, the law included supplemental appropriations and rescissions of previously appropriated funds for other agencies. CBO estimates that the bill will increase outlays by about $1 billion in 1996, $2 billion in 1997, and less than $1 billion in 1998, compared with CBO's baseline estimates.

Second, the Department of the Treasury reported April tax receipts that significantly exceeded the level that CBO expected under its baseline assumptions. Based on this new information, CBO expects that 1996 revenues could be about $15 billion higher than the baseline projections in this report. Because little information is available on the factors behind this unexpected increase in revenues (detailed information on 1995 tax year returns will not be available for at least a year), CBO is not yet able to assess how the higher 1996 revenues could affect projections of future receipts.

In the second set of projections, discretionary funding remains frozen at the dollar level that is provided in the 1996 appropriation bills for all years through 2006. In that case, the caps never become constraining.

Baseline Budget Projections

The combination of two alternative assumptions about the economy and two assumptions about discretionary spending produces four different sets of deficit projections (see Summary Table 3).

Under current-policy economic assumptions, the projected deficit will grow steadily, both in nominal terms and as a percentage of GDP, if discretionary spending is at the cap level adjusted for inflation. If discretionary spending policy is to freeze appropriations at the 1996 dollar amount, deficits will level off at around $180 billion a year and decrease as a percentage of GDP. Even at the relatively low levels of inflation that the Congressional Budget Office assumes over the next 10 years, such a freeze would cut the purchasing power of discretionary appropriations by more than 25 percent by 2006.

Under the balanced budget economic assumptions, the deficit will grow in both nominal terms and as a percentage of GDP if discretionary spending equals the cap in 1998 and keeps up with inflation after that. However, it will climb more slowly than under the current-policy economic assumptions. The deficit is held down by the so-called fiscal dividend--reductions in payments for interest on the debt and increases in revenues that flow from the lower interest rates and slightly faster economic growth under the economic assumptions that assume a balanced budget. If debt-service savings that stem from the lower deficits are included, the fiscal dividend would lower the deficit by $75 billion in 2002.

If discretionary spending is frozen, the deficit will rise in 1997 and 1998 but then begin to decline. Although the freeze would not produce a balanced

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

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
In Billions of Dollars												
Baseline Total Deficit with Current-Policy Economic Assumptions												
Cap discretionary spending (with inflation after 1998)	164	144	171	194	219	244	259	285	311	342	376	403
Freeze discretionary spending at 1996 dollar level	164	144	159	176	182	187	174	178	178	181	187	179
Baseline Total Deficit with Balanced Budget Economic Assumptions												
Cap discretionary spending (with inflation after 1998)	164	144	165	175	182	191	194	210	225	244	265	278
Freeze discretionary spending at 1996 dollar level	164	144	154	157	145	136	111	106	96	88	84	64
As a Percentage of GDP												
Baseline Total Deficit with Current-Policy Economic Assumptions												
Cap discretionary spending (with inflation after 1998)	2.3	1.9	2.2	2.4	2.5	2.7	2.7	2.9	3.0	3.1	3.3	3.3
Freeze discretionary spending at 1996 dollar level	2.3	1.9	2.0	2.1	2.1	2.1	1.8	1.8	1.7	1.6	1.6	1.5
Baseline Total Deficit with Balanced Budget Economic Assumptions												
Cap discretionary spending (with inflation after 1998)	2.3	1.9	2.1	2.1	2.1	2.1	2.0	2.1	2.1	2.2	2.3	2.3
Freeze discretionary spending at 1996 dollar level	2.3	1.9	2.0	1.9	1.7	1.5	1.2	1.1	0.9	0.8	0.7	0.5

SOURCE: Congressional Budget Office.

budget by 2002 (the deficit would be $106 billion), it would go a long way toward achieving the policy savings that are needed to reach budgetary balance and produce the economic benefits that this baseline assumes. That outcome is not surprising. Freezing discretionary appropriations at the 1996 level produces discretionary outlays in 2002 close to the level assumed by the Congress in the budget resolution for 1996. Under its December economic assumptions, CBO estimated that, given the level of discretionary spending assumed in the budget resolution, the approximately $100 billion in net deficit reduction in 2002 resulting from changes in entitlement and revenue policies proposed in H.R. 2491, the Balanced Budget Act, would eliminate the deficit in 2002.

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

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
December Baseline Deficit	172	182	183	195	204	211	228	244	266	294
Legislative Changes										
Revenues	a	a	a	a	a	a	a	a	a	a
Discretionary outlays	-19	-8	0	0	0	0	0	0	0	0
Mandatory outlays	3	2	-1	-2	-2	-2	-2	-1	-1	-1
Deficit	-15	-6	-1	-2	-2	-2	-2	-1	-1	-1
Economic Changes										
Revenues	-2	1	1	2	5	6	8	11	13	15
Outlays	-4	-8	-8	-10	-11	-12	-17	-20	-25	-31
Deficit	-6	-7	-8	-7	-6	-6	-9	-9	-12	-17
Technical Changes										
Revenues	1	5	7	7	8	9	10	11	12	14
Discretionary outlays	0	0	-10	-9	-10	-10	-10	-10	-11	-11
Mandatory outlays	-8	-8	4	-1	-2	-6	-7	-8	-8	-12
Deficit	-7	-3	1	-3	-4	-7	-7	-7	-7	-9
Debt Service	a	-1	-1	-1	-1	-1	-1	-1	-2	-2
Total Changes	-28	-16	-8	-13	-12	-16	-18	-19	-22	-29
April Baseline Deficit with Balanced Budget Economic Assumptions	144	165	175	182	191	194	210	225	244	265
Changes from Adopting Current-Policy Economic Assumptions	a	5	19	37	53	64	75	86	98	111
April Baseline Deficit with Current-Policy Economic Assumptions	144	171	194	219	244	259	285	311	342	376

SOURCE: Congressional Budget Office.

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

a. Less than $500 million.

Of course, the full amount of the savings from the fiscal dividend would result only if the budget was in fact balanced. Therefore, a baseline that reflects the economic improvements from balancing the budget but predicts large deficits resulting from projections of revenues and spending under current policies is internally inconsistent. Such a baseline, however, is a useful tool because it indicates the amount of direct savings from policy changes that is needed to balance the budget.

Changes Since December

CBO's current baseline budget projections using balanced budget economic assumptions and capped discretionary spending (with inflation after 1998) do not differ much from its December baseline projections, which used the same concepts. The currently projected deficit for 1996 is $28 billion lower than the December projection. However, about two-thirds of that change results from actions on 1996 appropriation bills that the December baseline did not reflect (see Summary Table 4 on page xvii). The reductions in the deficit in the years after 1996 are smaller, except for a $29 billion change in 2005. Aside from the effects of the enacted 1996 appropriations on the 1996 and 1997 deficits, relatively little change comes from enacted legislation, since few bills affecting direct spending or revenues have been signed into law since December.

Much of the change in estimated deficits for 1998 through 2005 stems from reductions in projected discretionary spending. The reductions largely reflect an adjustment to the cap that the Office of Management and Budget (OMB) made under the provisions of the Balanced Budget and Emergency Deficit Control Act of 1985 to reflect the Administration's estimate of the measure of inflation used in the cap adjustments. That estimate was lower than a year earlier. Projected spending for a number of mandatory programs (particularly Medicare and Medicaid) is also down, as are interest costs.

Lower projected revenues, however, partially offset those reductions. The drop in revenues results in part from the expiration at the end of calendar year 1995 of the airline ticket tax, which CBO estimates will cost the government $5 billion in 1996 and $10 billion by 2005. Under baseline rules, excise taxes dedicated to a trust fund that are scheduled to expire during the projection period are extended in the baseline; however, those taxes are excluded from the baseline if they have already expired before the baseline is released. Thus, such taxes were included in the December baseline but are excluded from the current revenue projections.

The 1997 deficit is affected by a substantial increase in the estimate of the proceeds from ongoing auctions by the Federal Communications Commission of licenses to use parts of the electromagnetic spectrum. The reestimate reflects both a revised estimate of the likely bids in the auctions and a decision by OMB and CBO to record installment payments for the licenses under credit reform procedures on a net present-value basis when a license is issued.

One source of significant change in both mandatory spending and revenue projections--though not shown in Summary Table 4 because it has no net effect on the deficit--is the Telecommunications Act of 1996, which calls for expanding a fund to provide universal telephone service. Although the receipts and expenditures of the fund do not pass through the government, they clearly would not exist except for action taken by the federal government and thus are ultimately under its control. OMB and CBO therefore concluded that the transactions of the fund should be recorded as revenues and outlays in the budget. Those transactions include both ones provided for by law before the Telecommunications Act was passed and new transactions resulting from the act. Because the projected revenues equal the projected outlays in every year, including those transactions in the budget does not affect the deficit.

Budget Projections Under the President's Policies

The President submitted a budget in March that is intended to eliminate the deficit by 2002. To help ensure that the goal is achieved, the budget included two sets of policies: one set that the Administration estimates will balance the budget if its economic and technical assumptions are borne out, and a set of contingent policies that will have to be carried out if the Administration's assumptions prove too optimistic and additional deficit reduction is required to balance the budget.

Using economic projections that assume a balanced budget, CBO estimates that the basic policies proposed in the President's budget would lower the deficit substantially below CBO's baseline projections but that the deficit would still total $81 billion in 2002 (see Summary Table 5). The proposed budget would reduce the deficit by holding the growth of discretionary appropriations below the rate of inflation, cutting the growth of Medicare and Medicaid

Summary Table 5.
CBO Reestimate of the President's Budget (By fiscal year, in billions of dollars)

	1996	1997	1998	1999	2000	2001	2002	Total, 1996-2002
CBO Baseline Deficit[a]	144	165	175	182	191	194	210	n.a.
President's Basic Budgetary Proposals								
Revenues[b]								
Tax relief	0	18	16	18	23	26	28	129
Extend expired excise taxes	0	-4	-6	-6	-6	-7	-7	-36
Other revenue provisions	1	-6	-8	-10	-10	-10	-12	-54
Subtotal	1	8	2	3	7	9	9	38
Outlays								
Medicare	c	-5	-8	-14	-20	-26	-31	-103
Medicaid	0	2	-2	-6	-10	-16	-22	-54
Welfare reform	0	-4	-6	-6	-7	-7	-8	-38
Other mandatory policy	-1	-6	-1	-4	-7	-10	-24	-52
Discretionary appropriations	2	-4	-6	-26	-42	-46	-38	-161
Debt service	c	c	-1	-3	-6	-11	-16	-35
Subtotal	1	-17	-23	-59	-91	-116	-138	-444
Total Changes	2	-9	-21	-57	-84	-107	-129	-405
Deficit Under the President's Basic Budgetary Proposals as Estimated by CBO	146	156	153	125	108	87	81	n.a.
President's Contingent Budgetary Proposals	0	-1	-2	-2	-2	-33	-84	-124
Total Changes from Baseline	2	-11	-23	-59	-86	-140	-213	-530
Deficit Under the President's Budgetary Proposals as Estimated by CBO	146	155	152	123	105	54	-3	n.a.

SOURCE: Congressional Budget Office.

NOTES: n.a. = not applicable.

a. This baseline is based on economic projections that assume the budget will be balanced by 2002. It assumes that discretionary spending is equal to 1996 appropriations adjusted for inflation up to the caps that are in effect through 1998. General-purpose discretionary spending is equal to the cap in 1998 and grows from that level at the rate of inflation after that.

b. Revenue losses are shown with a positive sign because they increase the deficit.

c. Less than $500 million.

below current-law projections, reducing projected spending for welfare programs, and limiting other mandatory spending. It would also shrink the deficit through sales of government assets and auctions of additional portions of the electromagnetic spectrum. The savings would be partially offset by a net reduction in revenues resulting from a combination of tax cuts and increases.

CBO's estimates of the deficits under the President's basic policies are higher than those of the Administration, largely because CBO's baseline projections of the deficit are higher than the Administration's. The Administration's economic assumptions are not strikingly different from CBO's economic projections under a balanced budget. The Administration assumes a slightly higher rate of real growth, slower growth in the consumer price index in relation to the overall price inflation in the economy, and greater profits and wages (which constitute the major tax bases). Although apparently slight, such differences do produce noticeably different deficit projections. The largest difference is in the estimates of revenues: CBO projects current-policy revenues that are $73 billion lower under its balanced budget economic assumptions than under the Administration's economic forecast. CBO also assumes that Medicaid and some other mandatory programs will grow more rapidly under current policy than does the Administration. In addition, CBO estimates that a number of the President's proposed policy changes would reduce the deficit less than the Administration assumes. For instance, the Administration assumes that the proposed changes in the Medicaid program would cut spending by $27 billion in 2002. CBO estimates that the proposal would save $22 billion.

The package of contingent policies outlined in the President's budget would further reduce deficits, producing a surplus of $3 billion in 2002. Those policies call for the expiration of proposed tax-relief provisions after 2000, additional savings from further restraining Medicare costs, deeper cuts in discretionary spending, and new fees levied on television broadcasters to offset any shortfall in anticipated receipts from the proposed auction of the right to use the electromagnetic spectrum.

Impacts of an Aging Population on the Budget

The aging of Americans born between 1946 and 1964 will dramatically affect the federal budget in the coming century. Because the first members of that baby-boom generation will turn 62 in 2008, those effects are not reflected in CBO's projections of spending and revenues through 2006. In the decades after 2010, however, the demographic shift will push up the deficit rapidly if no changes are made in entitlement benefits for the elderly or in taxes on the working population. Because escalating deficits would reduce investment, increase interest rates, and eventually choke off economic growth, such a path is not sustainable. The problem must ultimately be dealt with, and it will be less painful to deal with it sooner rather than later.

Demographic Changes

The trustees of the Social Security Old-Age and Survivors and Disability Insurance (OASDI) Trust Funds estimate that the number of citizens 65 or older in 2030 will be more than double the number in 1990, while the number of working-age Americans (20 to 64 years old) will increase by only about 25 percent. As a result, the number of retirees to be supported per worker will jump sharply.

The increase in the number of elderly people after 2010 will drive up the costs of Social Security. It will also put pressure on Medicare, which provides basic health care coverage for most people 65 and over, and Medicaid, which provides long-term care and other medical assistance for the poor elderly. At the same time, revenues will grow more slowly because the growth in the number of workers will slow.

Budgetary and Economic Assumptions

The concept of a current-policy baseline is somewhat ambiguous even for the 10-year projections of spending and outlays described earlier. Over a much longer period, the approach used in those projections would produce misleading results. For instance, freezing discretionary spending at the 1996 dollar level over the next 10 years is one possible interpretation of current policy in CBO's 10-year projections, even though that level of spending would purchase only about three-fourths as much in 2006 as it did in 1996. But if such a freeze were continued for another 40 years, even at the relatively low inflation rate of 3 percent, discretionary appropriations would cover less than one-fourth of the cost of the armed forces, law enforcement officials, highway construction, and other goods and services that are being provided in 1996 although the population would be significantly larger.

Therefore, CBO did not attempt to extend its regular budgetary projections beyond 2006. For Social Security, Medicare, and federal retirement programs, CBO simply adopted the long-term projections made by trustees of those programs (or the Office of Personnel Management and the Department of Defense in the case of federal retirement) and adjusted for any differences between CBO's economic assumptions and those of the trustees. Various broad categories of other spending in the national income and product accounts (NIPAs) were assumed to grow according to simple rules applied to each category. For instance, transfer payments (other than those included in the trustees' projections) were assumed to grow with demographic changes, labor productivity, and inflation. In the case of discretionary spending, CBO used two alternative assumptions. In one scenario, expenditures grow at the same rate as the economy (real growth plus inflation). In the other, they increase only at the rate of inflation. CBO assumes that most revenues will remain stable as a share of GDP. The exceptions are taxes collected on income from interest on the federal debt and premiums for Medicare's Supplementary Medical Insurance, which are treated as revenues in NIPA accounting.

Similarly, in order to assess the effect of long-run budget policies, CBO had to make assumptions about fundamental forces in the economy over the coming decades. Reflecting the anticipated slowing in the growth of the labor force, CBO's base scenario assumes that annual growth in the total hours of work will drop virtually to zero by 2020. Assuming further that total factor productivity continues to grow at the average rate experienced from 1952 to 1989 (two years in which the economy was operating at full capacity), annual growth of real GDP is projected to slip from 2.1 percent in 2005 to 1.3 percent in 2030 before factoring in any effects that increasing deficits will have on growth.

Long-Term Budget Projections

Because of the great uncertainty about both the budgetary and economic assumptions, CBO looked at several different scenarios and tested the sensitivity of its results to changes in the assumptions. Under an array of plausible scenarios that assume no change in budget policies, the deficit would grow significantly as a percentage of GDP after about 2010. The level of the deficit in relation to the size of the economy would depend on the specific assumptions about growth in spending and revenues and on assumptions about population growth, increases in productivity, and the effects of mounting deficits on the economy.

Even without assuming any economic feedback effects from increasing deficits, one seemingly plausible path of revenues and spending (with discretionary spending growing at the rate of the economy after 2006) would produce a deficit equal to 15 percent of GDP by 2030 and debt held by the public equal to 180 percent of GDP. The deficit has reached levels that high only during World War I and World War II, and the debt has never been that large. The path of spending and revenues in this scenario clearly cannot be sustained because the debt-to-GDP ratio spirals out of control after 2030. Interest payments would consume an ever larger share of federal spending.

For a path of spending and revenues to be sustainable, the resulting debt must eventually grow no faster than the economy. One measure of the size of the problem presented by burgeoning deficits is the increase in revenues (or reduction in spending) needed to keep the debt as a percentage of GDP from exceeding its current level for the foreseeable future. Assuming that discretionary spending grows at the rate of the economy, CBO estimates that increasing revenues by an amount equal to 5 percent of GDP would achieve that goal. Since revenues in the scenario equal 20 percent of GDP, that amount would represent a hike in revenues of about 25 percent. If discretionary spending is assumed to grow only at the rate of inflation after 2006, a revenue increase equal to about 3 percent of GDP (or 15 percent of revenues) would keep the debt as a percentage of GDP at or below its current level.

Other assumptions about the growth of spending produce lower projected deficits and debt. However, taking economic feedbacks into account will produce projected deficits that are significantly higher, reaching about 37 percent of GDP by 2030, assuming that discretionary spending grows with the economy. Those projections are much worse because they assume that burgeoning deficits will crowd out capital, which pushes up interest rates and slows the growth of the economy. As a result, the federal tax base is weaker and federal interest costs are higher. Although the precise path of deficits and debt as a percentage of GDP depends on particular assumptions about demographics, productivity, and the growth of discretionary spending, the projected deficits and debt in all of the scenarios that incorporate the economic feedbacks and assume no change in policy eventually soar to levels that are clearly not sustainable.

Those results reinforce the conclusions of other analysts that the aging of the baby-boom population will eventually force policymakers to make difficult decisions about paring entitlement benefits or other spending or increasing taxes. CBO's analysis also shows that making those changes now will yield significant benefits. For example, cutting deficits now trims future debt and interest payments on the debt, thereby reducing the programmatic cuts that would be needed later to cut deficits to the desired levels. In addition, if policies involving retirement age or benefit levels are changed, workers should have a chance to plan for their retirement with those changes in mind. Regardless of what policy changes are made, the economic benefits of achieving a long-term, sustainable budget policy would be great. For example, permanently balancing the budget could raise real incomes in the United States by 10 percent to 15 percent by 2025 and by larger percentages in years thereafter.

Effect of Proposed Policy Changes

Both the Congress and the President have proposed policies that CBO estimates would balance the budget by 2002. Because of the lack of details about the policies after 2002 and the imprecision of long-term budget projections, it is impossible to determine precisely the long-term effects of adopting the proposals. Even if the rates of growth of spending and revenues after 2002 did not change compared with CBO's assumptions based on no change in policy, the long-term picture would be brighter if those proposals were adopted because of the reduction in accumulated debt in 2002. Achieving a fiscal policy that is sustainable in the very long run, however, would require further increases in revenues or reductions in the growth of spending after 2002.

The Administration asserts that, in addition to balancing the budget by 2002, the President's proposed policies would hold the growth of spending for Medicaid to the rate of growth of the economy for the foreseeable future. Using that assumption, and the Administration's assumption that discretionary spending will increase at the rate of inflation, CBO projects that the budget would remain nearly balanced for another 20 years and the ratio of debt to GDP would gradually shrink over that period. But CBO also projects that the pressure of the baby-boom retirees would eventually push the budget out of balance if no further changes in spending or revenues were adopted. Clearly, some set of policies would hold deficits and debt in check despite the demographic pressures on the budget, but those policies would not be painless. CBO will examine the pros and cons of several alternative policies for addressing the long-term budget problem in a chapter of its forthcoming report *Reducing the Deficit: Spending and Revenue Options*.

Conclusion

The relatively moderate deficits that CBO projects through 2006 under current policies are not particularly alarming. In relation to the size of the economy, the deficit either rises modestly or decreases slightly, depending on the assumed level of discretionary spending. In the longer run, however, the retirement of the baby-boom population starting about 2010 will put severe pressure on the budget. CBO projects that, if spending and revenue policies are not changed, deficits and debt will soar to unprecedented levels in the following 20 years.

Eliminating the deficits projected for the next 10 years will provide noticeable economic benefits during that time period and will ameliorate the longer-term budget problem. But the real payoff will come from taking steps to prevent the impending demographic pressures from pushing the deficit up dramatically in the next century. Because the deficits and debt that would result if there are no changes in policy are not sustainable, such changes are inevitable. But the changes will be less painful, and the benefits greater, if the problem is dealt with sooner rather than later.