A statistical adjustment will lower the measured rate of inflation, though recent official statements of the timing and effects of the adjustment differ slightly from the assumptions CBO used for the forecast. The Bureau of Labor Statistics (BLS), which gathers data on the prices that underlie the consumer price index (CPI) and many categories of the national income and product accounts (NIPAs), had announced late last year that it would change the manner in which new stores are brought into its calculation of the CPI. It felt that the old method imparted an upward bias to the growth of its price indexes. CBO's forecast therefore incorporated estimated effects of the change in the current forecast.

In early April, however, after CBO's forecast was completed, the BLS announced that the change would occur sooner than the date assumed by CBO, and it also indicated that the change would probably have a slightly smaller effect on the price index than CBO assumed. The differences, however, are minor. The change will begin in June 1996, instead of January 1997 as assumed by CBO, and the current best estimate of the effect is a reduction in the growth of the CPI by 0.1 percentage point, instead of CBO's assumed effect of a 0.16 percentage-point reduction.

The statistical change not only lowers the projected growth of the CPI from what would have otherwise been forecast, but it also raises the forecast of the real growth rate of the economy. Because the CPI price data are also used in calculating the chain-type GDP price index, the CBO forecast of that price measure was lowered by 0.1 percentage point a year starting in 1997 (the magnitude of the effect is smaller than the 0.16 that CBO assumed for the CPI because the GDP price index includes many prices that are unaffected by the change in the CPI). The change in the statistical methods for the CPI does not affect the forecast of nominal GDP. As a result, CBO raised the projection of real GDP growth by a corresponding 0.1 percentage point a year from 1997 onward.

Monetary policy has already eased off somewhat from its restrictive stance of 1994 and 1995. With growth moderate and few signs of impending inflation, CBO assumes that the Federal Reserve will adhere to its current target for the federal funds rate throughout the remainder of the year.

The hot pace of business investment set during 1993 and 1994 cooled during the last half of 1995 and may continue to flag in 1996. Lower rates of capacity use, the accumulation of capital stocks over the past three years, continuing moderate economic growth, and a lower profit rate (as growth in labor compensation rebounds) will combine to trim new spending on plant and equipment. Still, firms will need to continue to upgrade their capital stock, especially in computers and information technology, if they are to remain competitive in the world marketplace. Low interest rates and the high level of the stock market will lower the cost of funds to businesses, which will also help to avert a strong downturn in investment.

Consumers are expected to increase their spending in line with income growth over the next two years despite carrying a somewhat troubling level of debt. Although unemployment is forecast to inch up, incomes should also continue to rise, thereby boosting consumption.

The real trade deficit is projected to remain essentially unchanged over the next two years. Exports should continue to grow at a solid--but slightly slower--pace in 1996. Swifter growth during 1996 in Asia and Latin America (including a return to growth in both Japan and Mexico) should more than offset the impact of an economic slowdown in Europe on the overall growth of world income. Nevertheless, the rebound of the dollar against the yen--and to a lesser extent against the deutsche mark--that occurred in the second half of 1995 and early 1996 is expected to depress the growth of exports somewhat. A dip in the growth of orders for U.S. exports alsopoints to a slower pace than the high growth rate of 1995.

Imports are expected to rebound from the sharp slowdown that occurred in the second half of 1995. The bulk of inventory adjustment is over, and imports will strengthen as inventories are rebuilt. The delayed effects of the rebound in the dollar should also boost imports during 1996.

The share of national income going to profits is expected to decline over the next two years: growth in labor compensation is forecast to escalate, and long-term interest rates have increased. Growth in labor compensation may pick up because the cost of

Table 1-4.
Economic Projections Assuming Current Policy for Calendar Years 1996 Through 2006

	Preliminary[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.

Table 1-5.
Economic Projections Assuming Current Policy for Fiscal Years 1996 Through 2006

	Actual	Forecast		Projected								
	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Nominal GDP (Billions of dollars)	7,181	7,491	7,853	8,225	8,627	9,047	9,489	9,952	10,438	10,947	11,481	12,041
Nominal GDP (Percentage change)	5.1	4.3	4.8	4.7	4.9	4.9	4.9	4.9	4.9	4.9	4.9	4.9
Real GDP[a] (Percentage change)	2.6	1.8	2.0	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[b] (Percentage change)	2.8	2.7	3.1	3.1	2.9	2.9	2.9	3.0	3.0	3.0	3.0	3.0
Unemployment Rate (Percent)	5.6	5.7	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	5.0	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)	7.1	6.0	6.3	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	576	595	609	618	618	626	643	665	694	731	770	811
Other taxable income	1,509	1,578	1,643	1,731	1,834	1,933	2,033	2,132	2,233	2,340	2,453	2,573
Wage and salary disbursements	3,379	3,548	3,719	3,889	4,076	4,272	4,475	4,688	4,911	5,145	5,389	5,645
Total	5,464	5,721	5,972	6,237	6,529	6,831	7,151	7,485	7,839	8,215	8,612	9,029
Tax Bases (Percentage of GDP)												
Corporate profits	8.0	7.9	7.8	7.5	7.2	6.9	6.8	6.7	6.6	6.7	6.7	6.7
Other taxable income	21.0	21.1	20.9	21.0	21.3	21.4	21.4	21.4	21.4	21.4	21.4	21.4
Wage and salary disbursements	47.1	47.4	47.4	47.3	47.3	47.2	47.2	47.1	47.1	47.0	46.9	46.9
Total	76.1	76.4	76.0	75.8	75.7	75.5	75.4	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. Based on chained (1992) dollars.

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

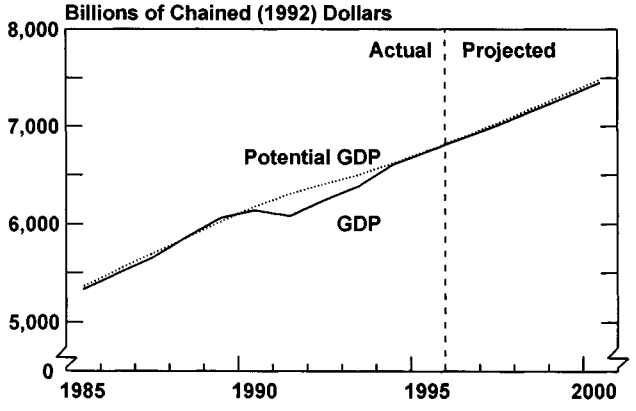
fringe benefits may head toward its traditional higher rate of growth in the coming years. If benefit costs continue their recent slow growth, wages--the major component of labor compensation--should pick up, keeping growth in labor compensation in line with productivity growth. Substantial evidence suggests that workers normally pay fully for their fringe benefits in the form of lower wages--so compression of fringe benefits ought to allow somewhat faster wage growth. Higher interest rates should also lead to lower profits because they increase the amount businesses must pay to service their debts.

Projections Assuming Current Policy for 1998 Through 2006

Growth in real GDP will average 2.1 percent between 1998 and 2006, according to CBO's projections (see Tables 1-4 and 1-5 on pages 14 and 15). That rate of growth, which matches the growth in potential output, would result in an average unemployment rate of 6 percent. Similarly, inflation is projected to average about 3 percent, and short- and long-term interest rates will average 4.8 percent and 6.4 percent, respectively.

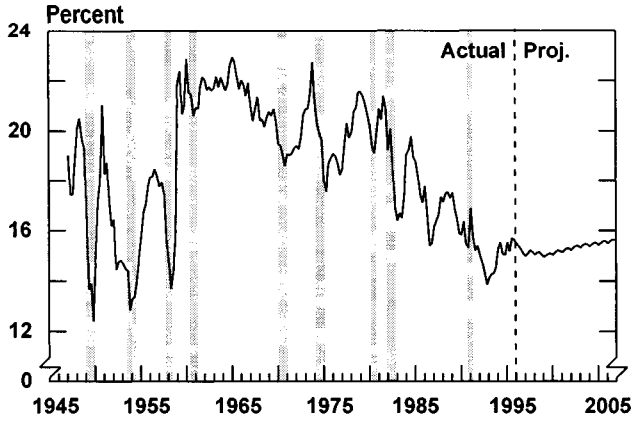
The Projection for Growth. CBO projects real GDP by assuming that it will reach its average historical relationship with potential GDP during the medium term. Output is forecast to grow slightly below trend during the next two years, which would leave the gap between actual and potential GDP at the end of 1997 equal to its historical average. Therefore, CBO projects that real GDP will grow at the same rate as potential output--about 2.1 percent--during the 1998-2006 period. That rate of growth would hold the GDP gap constant throughout the projection period (see Figure 1-8).

Figure 1-8.
GDP and Potential GDP



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

Figure 1-9.
The National Saving Rate



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

The projected 2.1 percent growth rate for potential output is about 0.2 percentage points slower than CBO assumed in its December projection. The revised outlook stems from three sources: the shift from a path toward a balanced federal budget (as assumed in December) to one that includes substantial deficits through 2006; a revised view of the labor market; and revisions to historical data series. The change from balanced budget to current-policy assumptions lops off about 0.1 percentage point a year from the growth of potential output, or roughly half of the total revision. The other two sources account for the remainder of the revision in roughly equal amounts.

A reexamination of labor market trends since 1990 has led CBO to reduce its projection for the growth in average weekly hours. Slower growth in the projection of total hours worked implies slightly lower growth in output over the projection period.

Projections of growth in the nation's capital stock have also been revised downward since December. Revisions to the NIPAs published in January revealed that investment in plant and equipment was lower during recent years than was thought previously. Those revisions lower CBO's estimate of the size of the effective capital stock, which in turn lowers the estimate of potential growth during recent history and during the projection period. The rate of national saving averages 15 percent during the 1996-2006 period, just above its average since 1990, but well below its postwar average of 18 percent (see Figure 1-9). That rate of saving supports a net rate of capital accumulation of 3.2 percent during the same period, slightly lower than the 3.3 percent rate assumed in December.

An upward revision in total factor productivity (TFP) partially offsets the revision to the capital input. CBO estimates that the trend rate of growth of TFP will equal 0.5 percent annually, a shade higher than the 0.4 percent rate assumed in December. Growth in TFP has been faster than trend during the first half of the 1990s, leading some analysts to suggest that a new era of faster growth in productivity has dawned. However, the growth of TFP in recent years is consistent with its normal cyclical behavior, and most analysts who have studied the issue have concluded that it is too soon to proclaim a new trend in the growth of productivity.

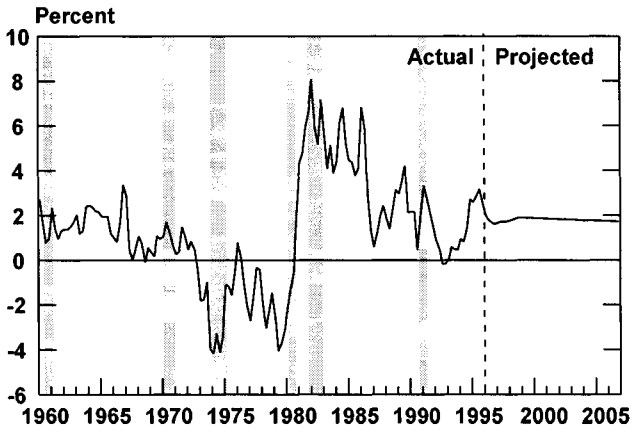
The Projection for Inflation. CBO projects that inflation, measured using the consumer price index for all urban consumers (CPI-U), will average about 3 percent between 1998 and 2006, about 0.3 percentage points faster than the projected rate of growth of the GDP price index. The gap between GDP and potential GDP is forecast to reach its average historical value by the end of 1997 (as is the gap between the unemployment rate and the NAIRU). With so small a gap, there is little pressure upward or downward on the rate of inflation. Indeed, CBO's current projection for inflation is virtually identical to its December projection.

Year-to-year rates of inflation vary between 1996 and 2006 as a result of statistical changes and measurement issues. The projection for inflation falls by 0.2 percentage points over the course of 1998 to account for the planned rebenchmarking of the CPI-U that will come on top of the 1996 revision to the CPI-U described earlier. The Bureau of Labor Statistics has announced that it will update the weights used to calculate the CPI-U in 1998, which will put more emphasis on goods and services with lower increases in price, thereby lowering the growth of the overall index.

Note, however, that CBO has assumed a slight upward drift in the growth of the CPI to account for an effect called the substitution bias. Any fixed-weighted price index such as the CPI will tend to overstate the true rate of inflation because it ignores the ability of consumers to substitute cheaper goods for more expensive ones over time. Studies have indicated that this effect, taken alone, causes the CPI to overstate the inflation rate by about 0.2 percentage points over 10 years, or 0.02 percentage points per year on average. CBO has built that upward drift into its projections of the rate of inflation. Therefore, over the 10-year horizon that the projections cover, the rebenchmarking in 1998 and the drift cancel each other out.

The Projection for Interest Rates. CBO projects interest rates by combining its projection of inflation

Figure 1-10.
The Short-Term Interest Rate Adjusted for Inflation



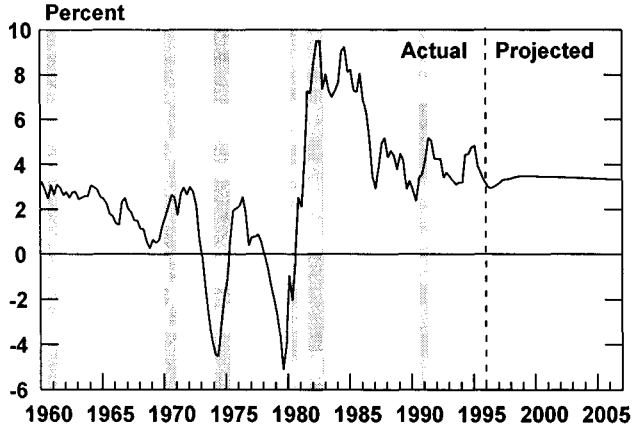
SOURCES: Congressional Budget Office; Federal Reserve Board; Department of Labor, Bureau of Labor Statistics.

NOTE: The inflation-adjusted rate is the nominal three-month Treasury bill rate less the growth of the three-quarter centered moving average of the consumer price index.

with a projection of real interest rates that is based on a comparison with the 1950s and 1960s, when inflation rates were similar to those today. Real rates are projected to be somewhat higher than their levels in the late 1950s and 1960s because deficits are now higher both in the United States and abroad. For example, the real rate on three-month Treasury bills averages 1.8 percent during the 1998-2006 period, about 0.5 percentage points higher than its average during the late 1950s and 1960s (see Figure 1-10 on page 17). The real rate on 10-year Treasury notes averages 3.4 percent, exceeding its average over the same period by 1.3 pecentage points (see Figure 1-11). Combined with a 3 percent projection for inflation, those real rates imply that the three-month bill rate will average 4.8 percent during the 1998-2006 period and the 10-year note rate will average 6.4 percent during the same period.

CBO has lowered the current-policy estimates of interest rates by 30 basis points since December. The revision reflects in part a recognition that foreign governments will have to address their own budget deficits: in fact, the Maastricht agreement mandates considerable fiscal retrenchment for a number of European countries.

Figure 1-11.
The Long-Term Interest Rate Adjusted for Inflation



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

NOTE: The inflation-adjusted rate is the nominal 10-year Treasury note rate less the growth of the five-quarter centered moving average of the consumer price index.

Because the current-policy projection excludes the effects of deficit reduction, interest rates are higher than CBO projected in December, using a balanced budget projection. CBO now estimates that reducing the deficit to zero would lower interest rates by about 110 basis points relative to the levels under current policy. By the later years of the projection period, the levels of both short- and long-term interest rates are about 90 basis points higher than CBO assumed in December.

The Projection for Unemployment. CBO bases its projection for unemployment, like other variables, on historical averages. The average rate of unemployment since 1960 has been 0.2 percentage points above CBO's estimate of the nonaccelerating inflation rate of unemployment. Though the unemployment rate has on average exceeded the NAIRU, that excess has not led to reductions in the rate of inflation on average because the economy has been hit by many positive price shocks, such as increases in the price of oil, that tend to accelerate the rate of inflation. CBO assumes that this historical pattern will continue. Therefore, it projects that the unemployment rate will average 6 percent throughout the projection period without affecting the average rate of inflation. Using that historical excess of unemployment over the NAIRU allows for the possibility of either recessions or booms over the projection period.

The Outlook Assuming a Balanced Budget by 2002

If the government adopted fiscal policies that balanced the federal budget by 2002 and kept it balanced thereafter, the economic outlook would differ from CBO's current-policy projections. CBO's analysis indicates that real economic growth would probably be slightly higher during the projection period on average, interest rates would be significantly lower, and a larger percentage of total income would fall in categories that tend to generate greater federal tax revenues (see Tables 1-6, 1-7, and 1-8).

Those macroeconomic effects would enhance efforts to reduce the deficit. More rapid growth,

Table 1-6.
Economic Projections Assuming Balanced Budget Policy for Calendar Years 1996 Through 2006

	Preliminary[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.

Table 1-7.
Economic Projections Assuming Balanced Budget Policy for Fiscal Years 1996 Through 2006

	Actual	Forecast		Projected								
	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Nominal GDP (Billions of dollars)	7,181	7,491	7,855	8,233	8,640	9,067	9,516	9,987	10,481	10,999	11,543	12,114
Nominal GDP (Percentage change)	5.1	4.3	4.9	4.8	4.9	4.9	4.9	4.9	4.9	4.9	4.9	4.9
Real GDP[a] (Percentage change)	2.6	1.8	2.0	2.0	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[b] (Percentage change)	2.8	2.7	3.1	3.1	2.9	2.9	2.9	3.0	3.0	3.0	3.0	3.0
Unemployment Rate (Percent)	5.6	5.7	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)	5.6	5.0	4.8	4.4	4.0	3.7	3.7	3.7	3.7	3.7	3.7	3.7
Ten-Year Treasury Note Rate (Percent)	7.1	5.8	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	576	596	627	662	686	709	735	768	806	847	888	932
Other taxable income	1,509	1,576	1,623	1,681	1,759	1,840	1,923	2,010	2,103	2,201	2,307	2,419
Wage and salary disbursements	3,379	3,548	3,720	3,893	4,082	4,281	4,488	4,705	4,932	5,169	5,418	5,679
Total	5,464	5,720	5,970	6,236	6,527	6,830	7,146	7,483	7,840	8,217	8,613	9,031
Tax Bases (Percentage of GDP)												
Corporate profits	8.0	8.0	8.0	8.0	7.9	7.8	7.7	7.7	7.7	7.7	7.7	7.7
Other taxable income	21.0	21.0	20.7	20.4	20.4	20.3	20.2	20.1	20.1	20.0	20.0	20.0
Wage and salary disbursements	47.1	47.4	47.4	47.3	47.3	47.2	47.2	47.1	47.1	47.0	46.9	46.9
Total	76.1	76.4	76.0	75.8	75.5	75.3	75.1	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. Based on chained (1992) dollars.

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

lower interest rates, and a shift in income toward higher revenue-generating categories would result in higher revenues than CBO projects under its current-policy baseline. In effect, policies to reduce the deficit would gain an extra boost from the effects that deficit reduction induces in the economy.

Real Growth

By freeing up savings for use in productive investment, balancing the budget by 2002 could allow the economy to grow modestly faster--by less than 0.1 percentage point a year on average. By 2006, the annual level of gross national product (GNP) might be about 1 percent higher than it would be if deficits averaged 2.8 percent of GDP over the next 10 years. The level of GDP might be about 0.6 percent higher. GNP is affected more than GDP because the net flow of returns from foreign investment, which is included in GNP but not in GDP, is likely to be greater under a policy of balancing the budget. All of those beneficial effects on growth would continue after 2006. (See Chapter 4 for a discussion of the long-run deficit

Table 1-8.
Estimated Economic Effects of Balancing the Budget by 2002 (By calendar year)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Real Gross National Product											
Percentage change in level from base	0	0.1	0.2	0.3	0.4	0.5	0.6	0.7	0.8	0.9	1.0
Change in growth rate (Percentage points)	0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Real Gross Domestic Product											
Percentage change in level from base	0	0	0.1	0.2	0.2	0.3	0.4	0.4	0.5	0.6	0.6
Change in growth rate (Percentage points)	0	0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Interest Rates (Percentage points)											
Three-month Treasury bills	0	0	-0.5	-0.9	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1
Ten-year Treasury notes	-0.3	-0.9	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1
Income Shares (Percentage of GDP)											
Corporate profits[a]	0	0.3	0.6	0.8	0.9	0.9	0.9	1.0	1.0	1.0	1.0
Other taxable income	-0.1	-0.3	-0.7	-0.9	-1.1	-1.2	-1.3	-1.3	-1.3	-1.4	-1.4
Wage and salary disbursements	0	0	0	0	0	0	0	0	0	0	0
Memorandum: (Percentage of GDP)											
Federal Net Interest	0	-0.1	-0.2	-0.4	-0.5	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7
Business Interest	0	-0.3	-0.6	-0.8	-0.8	-0.8	-0.9	-0.9	-0.9	-0.9	-0.9
Dividends	0	0	0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.2
Depreciation	0	0	0	0	0.1	0.1	0.1	0.2	0.2	0.2	0.2

SOURCE: Congressional Budget Office.

a. Corporate profits are calculated using economic rather than tax depreciation.

outlook and how balancing the budget affects the economy over a 30-year period.)

Moving gradually to a balanced budget would cause productive resources to be redirected away from public and private consumption and toward investment. Investment is largely financed by national saving, which is composed of private saving plus government saving. When the deficit is reduced, government saving increases. The private saving rate is likely to decrease somewhat, however, as higher taxes or lower government services take a bite out of people's income, and the need diminishes to save for future taxes required to redeem or service federal debt. Still, private saving is unlikely to decrease as much as federal saving increases. In short, total national saving will probably increase.

How much private saving will respond to deficit reduction is uncertain; it will depend on the particular policies used to reduce the deficit and how they affect incentives to save. Without changes in saving incentives, a reasonable estimate of the fall in private saving in response to deficit reduction would lie between 20 percent and 50 percent of the reduction in the deficit. National saving would thus rise by between 50 percent and 80 percent of the reduction in the deficit.

The higher national saving rate would permit both a higher level of capital stock (increasing productive capacity in the United States) and a lower level of borrowing from foreigners (reducing the share of national output that is used to service foreign debt). Little consensus exists on how much each of those factors would change, but the range of possible increases in productive capacity over the next seven years is limited. CBO estimates that private investment would increase by about 20 percent of the reduction in the deficit, causing the capital stock to be about 4 percent higher in 2002.

The shift in resources from consumption to investment may not go smoothly. Fiscal restraint might have a contractionary effect in some years, even though GDP is likely to be higher at the end of the period than if no deficit reduction took place. Balancing the budget by 2002 implies an average restraint of 0.4 percent of GDP per year. On average, the Federal Reserve and financial markets could offset that modest restraint with lower interest rates, but the restraint could slow growth in some years.

CBO's balanced budget projection for inflation is the same as its current-policy projection. Some analysts maintain that deficit reduction would lower inflation in the long term because it would reduce the risk of a boom and the Federal Reserve would find it easier to reduce the underlying inflation rate. Conversely, inflation could climb temporarily if lower interest rates in the United States reduced the value of the dollar and raised the price of imports. Assuming no differences in inflation between the current-policy and balanced budget forecasts appears reasonable.

Interest Rates

CBO assumes deficit reduction would lower interest rates. Economists disagree about the effect of the deficit on interest rates: some argue that the openness of U.S. capital markets severely weakens the effect, whereas others maintain that substantial effects are still likely. Therefore, the range of estimates of the effect is wide. A few analysts estimate that reducing future deficits from the projected level under current policy of about 3 percent of GDP to zero in the early 21st century would not affect interest rates at all, whereas others argue that interest rates would be 200 basis points or more lower than they would otherwise have been.

CBO uses a midrange assumption--namely, that deficit reduction of that magnitude would reduce interest rates by 110 basis points by 2002. With inflation unchanged in the balanced budget forecast, real interest rates would also drop by 110 basis points--to 2.3 percent for long-term rates and 0.7 percent for three-month Treasury bill rates. Such a drop would put rates near their level in the late 1950s and early 1960s, when deficits were small relative to the economy and expectations of inflation were low.

How quickly rates would fall is also uncertain, but the drop in long-term rates could anticipate actual deficit reduction by a year or so. Long-term interest rates might respond to plans for future reductions in the deficit if those plans seemed credible. Clearly, as

the Congress proceeds along the path of deficit reduction, credibility is likely to increase.

Income Shares

Projections of the federal tax base are affected not only by the total level of nominal GDP but also by how total GDP is allocated among various categories of income. For example, wage and salary income is taxed, but income in the form of benefits such as company payments for health insurance premiums is not taxed either at the corporate or individual level. Therefore, projections that differ only in how GDP is allocated among those two income shares can have quite different implications for deficit projections.

The balanced budget forecast includes a different projection of income shares than does the current-policy forecast. The drop in interest rates and the decrease in the national debt that would accompany a policy of deficit reduction suggest a higher share of corporate profits in GDP and a lower share of interest income. In all likelihood, corporate costs for debt service would be smaller with lower interest rates. Hence profits, and thus corporate income taxes, would be higher. Dividends would also increase somewhat. Yet federal net interest payments would decline, reducing taxable interest income. Moreover, because deficit reduction would increase investment, corporate depreciation would also be higher.

On balance, the changes in income shares that are expected to accompany a policy of deficit reduction would work to increase revenues. Taxable corporate profits would make up a larger share of GDP. Interest income would be smaller, but a hefty portion of interest income accrues to organizations or pension funds that are not subject to tax. Therefore, the shift from interest income to profits would tend to increase revenues.

Unemployment

The balanced budget projections for unemployment are the same as the current-policy projections. In both cases, unemployment is forecast based on historical averages. The additional growth in output in the balanced budget projections stems solely from the higher level of investment and capital stock made possible by deficit reduction. Projections of labor-market variables are unchanged.

Changes in Estimates of the Economic Effects of Balancing the Budget

CBO's December 1995 projections estimated a larger economic effect of balancing the budget by 2002 than do the current projections. One reason the estimates differ is that there is one less year between now and 2002 for deficit reduction to affect the economy. Furthermore, the current-policy baseline incorporates the progress achieved this year in reducing the deficit. The effect of any further deficit reduction agreed on this year would not start to affect investment and real growth until 1997, though long-term interest rates may change this year.

CBO has also reevaluated how quickly interest payments by businesses would change in response to a drop in interest rates. As deficit reduction lowers interest rates, interest payments on new debt for firms drops and taxable profits rise. Long-term debt, however, will continue to carry the same interest rate until it matures or is called. CBO now estimates that the long-term debt structure of firms will delay the response of debt service to changes in interest rates more than CBO estimated last December.

In addition, the current-policy baseline projection of the ratio of the deficit to GDP for the early 21st century is lower than what CBO projected last year. The baseline deficit is now projected to be about 2.9 percent of GDP in 2002 compared with the 3.2 percent projection incorporated in CBO's January 1995 forecast. Therefore, the economic benefit to be gained by reducing the deficit to zero is proportionately smaller.

Alternative Outlooks

CBO's forecast is broadly similar in most respects to other widely cited economic forecasts. The future,

Table 1-9.
Comparison of Forecasts Assuming Balanced Budget Policy for 1995 Through 2006

	Preliminary[a]	Forecast		Projected								
	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
					Year over Year (Percentage Change)							
Nominal GDP												
Current CBO	4.6	4.6	4.8	4.9	4.9	4.9	4.9	4.9	4.9	4.9	4.9	4.9
December 1995 CBO	5.1	4.8	5.0	5.0	4.9	5.0	4.9	5.0	5.0	5.0	5.0	5.0
Administration	4.7	5.1	5.1	5.1	5.1	5.1	5.1	5.1	5.1	5.1	5.1	5.1
Blue Chip[b]	4.6	4.2	4.5	4.4	4.5	4.9	4.7	4.8	4.8	4.8	4.8	4.8
Real GDP[c]												
Current CBO	2.1	2.0	2.0	2.1	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2
December 1995 CBO	2.5	2.2	2.2	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Administration	2.1	2.2	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Blue Chip[b]	2.1	1.9	2.1	1.9	2.0	2.4	2.3	2.3	2.3	2.3	2.3	2.3
Chain-Type GDP Price Index												
Current CBO	2.5	2.6	2.8	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7
December 1995 CBO	2.7	2.6	2.7	2.6	2.6	2.6	2.6	2.6	2.6	2.6	2.6	2.6
Administration	2.5	2.8	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7
Blue Chip[b]	2.5	2.3	2.4	2.4	2.5	2.5	2.4	2.5	2.5	2.5	2.5	2.5
CPI-U[d]												
Current CBO	2.8	2.8	3.1	3.0	2.9	2.9	2.9	3.0	3.0	3.0	3.0	3.0
December 1995 CBO	2.9	3.0	3.1	3.0	2.9	2.9	2.9	3.0	3.0	3.0	3.0	3.0
Administration	2.8	2.8	3.0	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8
Blue Chip[b]	2.8	2.7	2.9	2.9	2.8	2.9	2.8	2.8	2.9	2.9	2.9	2.9
					Calendar Year Average (Percent)							
Civilian Unemployment Rate												
Current CBO	5.6	5.8	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0
December 1995 CBO	5.6	5.9	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0
Administration	5.6	5.7	5.7	5.7	5.7	5.7	5.7	5.7	5.7	5.7	5.7	5.7
Blue Chip[b]	5.6	5.8	5.9	6.3	6.3	6.1	6.1	6.0	5.9	5.9	5.9	5.9
Three-Month Treasury Bill Rate												
Current CBO	5.5	4.9	4.8	4.3	3.9	3.7	3.7	3.7	3.7	3.7	3.7	3.7
December 1995 CBO	5.5	5.3	5.0	4.7	4.2	3.9	3.9	3.9	3.9	3.9	3.9	3.9
Administration	5.5	4.9	4.5	4.3	4.2	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Blue Chip[b]	5.5	4.8	4.8	5.2	5.1	5.0	4.9	4.9	5.0	5.0	5.0	5.0

SOURCES: Congressional Budget Office; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (March 10, 1996); Office of Management and Budget; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

Table 1-9.
Continued

	Preliminary[a] 1995	Forecast 1996	Forecast 1997	Projected 1998	Projected 1999	Projected 2000	Projected 2001	Projected 2002	Projected 2003	Projected 2004	Projected 2005	Projected 2006
					Calendar Year Average (Percent)							
Ten-Year Treasury Note Rate												
Current CBO	6.6	5.7	5.5	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3
December 1995 CBO	6.6	5.8	5.6	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5
Administration	6.6	5.6	5.3	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Blue Chip[b]	6.6	5.8	5.9	6.4	6.3	6.3	6.2	6.2	6.2	6.2	6.2	6.2
					Income Shares (Percentage of GDP)							
Current CBO												
Corporate profits[e]	8.2	7.9	8.0	7.9	7.7	7.5	7.5	7.4	7.4	7.4	7.4	7.4
Personal income	84.2	84.4	84.1	84.0	84.0	83.9	83.7	83.7	83.7	83.7	83.7	83.8
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
December 1995 CBO[f]												
Corporate profits[e]	8.1	8.4	8.5	8.4	8.3	8.3	8.2	8.1	8.1	8.0	7.9	7.9
Personal income	85.5	84.9	84.4	84.4	84.3	84.2	84.3	84.3	84.4	84.5	84.6	84.7
Wage and salary disbursements	48.7	48.6	48.6	48.6	48.6	48.5	48.5	48.5	48.5	48.5	48.5	48.5
Administration												
Corporate profits[e]	8.3	8.5	8.8	8.9	9.0	9.1	9.0	8.9	8.9	8.8	8.8	8.7
Personal income	84.1	84.2	83.9	83.5	82.9	82.5	82.2	82.1	82.1	82.0	81.9	81.9
Wage and salary disbursements	47.2	47.3	47.5	47.5	47.4	47.4	47.4	47.4	47.3	47.3	47.2	47.1

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

b. The *Blue Chip* forecasts are based on a survey of 50 private forecasters. Not all of the forecasts that make up the *Blue Chip* necessarily reflect a balanced budget policy.

c. Based on chained (1992) dollars.

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

e. Corporate profits before tax.

f. The level of GDP was revised upward significantly in January 1996 because of a definitional change as part of the comprehensive revision of the national income and product accounts. Therefore, income shares in CBO's December projection are not strictly comparable with those in the current CBO and Administration projections.

however, is inherently uncertain. The CBO forecast should be viewed as a weighted average of different possibilities, encompassing both more positive and more negative economic outcomes.

Comparing Forecasts

One way to assess the range of different outcomes is to review other economic forecasts making similar fiscal policy assumptions. The CBO balanced budget forecast can be compared with the *Blue Chip* consensus forecast and the Administration's forecast, which also assumes a path to a balanced budget.

The *Blue Chip* forecast is based on a survey of about 50 private-sector economists; each one uses a personal estimate of future fiscal policy in making a forecast. Consequently, the consensus forecast is neither a purely balanced budget nor a purely current-policy forecast. The *Blue Chip* consensus forecast is generally more pessimistic than both the CBO and the Administration forecasts (see Table 1-9 on pages 24-25). Between 1996 and 2000, the *Blue Chip* consensus expects lower inflation and higher interest rates; average growth in real GDP is about the same as CBO's but less than the Administration's forecast. After 2000, the *Blue Chip* consensus projections for the growth of real GDP and the CPI are the same as the Administration's, whereas CBO projects slightly slower growth in real GDP and a bit faster growth in the CPI. Moreover, interest rates in the *Blue Chip* consensus remain above those in the CBO and Administration projections after 2000. The higher interest rates projected by the *Blue Chip* consensus suggest that few members of the *Blue Chip* group expect significant actions to cut the federal budget deficit over this 11-year period.

The projection of the relative growth of the two major price measures--the CPI and the GDP price index--is important for budget projections. The lower the CPI growth rate is relative to the GDP price index growth rate, the more optimistic the deficit projection. The personal income tax brackets and a large part of federal outlays are indexed to the CPI. Thus, lower CPI growth means higher revenues and lower outlays. The projection of the GDP price index, however, affects the projected levels of the tax base. Therefore, a higher GDP price index means a higher revenue projection and a lower deficit projection.

The Administration projects a relationship between the CPI and GDP price index that is optimistic relative to the *Blue Chip* and CBO forecasts. The Administration projects the CPI to grow only 0.1 percentage point faster than the CPI, whereas the *Blue Chip* projects a difference in growth rates of 0.4 percentage points and CBO projects a difference of 0.3 percentage points. Between 1978 and 1995, the CPI grew faster than the GDP price index by an average of 0.4 percentage points per year.

CBO's estimate of the sum of profits and wages, the major tax bases, is less than the Administration's, and the difference between the two forecasts widens over time. In 1996, CBO projects that sum to be 55.3 percent of GDP, whereas the Administration's projection is 0.5 percentage points higher at 55.8 percent. By 2002, the difference rises to 1.8 percentage points, with CBO projecting 54.5 percent and the Administration 56.3 percent.

Risks to the Forecast

As is the case for any forecast, the risk exists that CBO's estimates will not be borne out in reality. The CBO forecast, although it incorporates the possibility of sharply slower or faster growth, shows the economy growing smoothly over the next two years. History has shown, however, that the economy is rarely so well behaved for any long period of time.

Although CBO judges that the economy is fundamentally sound, there is some risk that the economy may be weaker than anticipated. Investment in new equipment was quite strong during 1994 and early 1995, providing much of the horsepower that kept the economy moving. Firms that built up excess capacity during that time might now cut investment spending sharply, leading to layoffs in the investment goods sector and lower incomes. Consumers, burdened by a relatively high level of debt, might respond by limiting their spending. Exports could also weaken if the recent upturn in Japan's growth proves ephemeral. If those events occurred, inventories

could pile up, production could be slashed, and a serious downturn might ensue.

However, the current forecast also may underestimate the strength of the economy and inflationary pressures. Firms are undergoing major restructuring to remain competitive in a computer-age world economy. That influence, together with relatively low interest rates, could lead to a renewed investment boom that would bring the economy roaring back in 1996 and 1997. Recovery in Mexico and other major trading partners could boost net exports, further fueling growth. Lower unemployment, higher wage demands, and production bottlenecks could result in renewed inflation. The recent run-up in the price of petroleum and other commodities could exacerbate inflationary pressures in the short run. Elevated rates of inflation would force the Federal Reserve to respond with higher interest rates, which could choke off growth by late 1997 or beyond.

CBO may also have overestimated the level of the NAIRU. If the NAIRU is below CBO's estimate of 5.8 percent, the economy could grow faster in the short run without raising inflation. That faster growth could probably only occur, however, if the Federal Reserve was convinced that it was not inflationary. Moreover, once the unemployment rate reached the NAIRU, growth would revert to the same underlying potential rate. If the true NAIRU was 5.5 percent, the addition to employment could raise real output by 0.3 percentage points in 2002 under either current-law or balanced budget assumptions. A lower NAIRU would also imply less inflation in the short run. In addition, if the Federal Reserve recognized it, a NAIRU below CBO's estimate would mean lower interest rates until unemployment fell to its long-run level.