

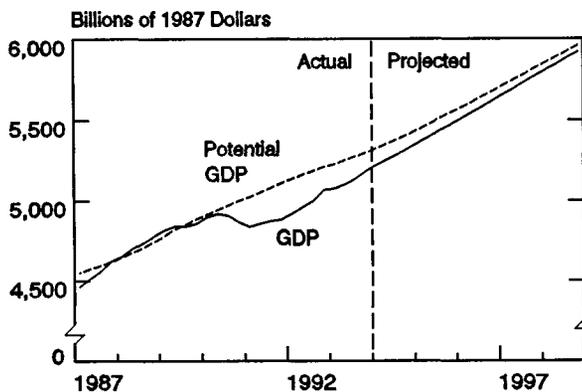
## Projections for 1996 Through 1999

Over the medium term, the 1996-1999 period, CBO projects that real GDP will grow at an average annual rate of 2.6 percent (see Tables 1-3 and 1-4). This GDP projection implies an average rate of unemployment of 5.8 percent over that period, measured by the old definition of unemployment. (The discussion in this section refers to calendar years, shown in Table 1-3 on page 15.)

The medium-term projections for growth do not reflect any attempt to estimate cyclical movements of the economy or the effect of fiscal policy on the year-to-year changes in economic activity. Instead, they are based on CBO's analysis of fundamental factors underlying the economy, including the growth of the labor force, national saving, and productivity. Real GDP is projected beyond the forecast period by assuming that it will grow smoothly to reach its historical relationship with potential GDP by 1999 (see Figure 1-10).

Inflation, as measured by the consumer price index, is projected to average about 3.1 percent throughout the medium term. Long-term interest rates should average 6.2 percent, and short-term rates are projected to rise from 4.3 percent in 1995 to 4.7 percent by 1999.

**Figure 1-10.**  
**Closing the Gap: GDP Versus Potential GDP**



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

## The Projection for Growth

The CBO projection for the growth of real GDP is historically low, but growth at the projected rate would be quite respectable given the slow growth in the labor force. The average annual rate of growth of 2.6 percent over the projection period contrasts with an average of 3.1 percent for the period from the 1960s through the 1980s. The projected growth in the labor force is 1.3 percent compared with 2.0 percent for the 1960-1989 period.

CBO's projection for the average growth of the economy between 1996 and 1999 depends primarily on the estimate of potential output for the economy. Potential output is the maximum level of output that can be maintained without igniting inflation. According to CBO's estimates, the economy operated about 2 percent below potential at the end of 1993, and potential output will grow at an average rate of 2.4 percent during the 1996-1999 period.<sup>3</sup> Under such estimates, real GDP could grow at an average annual rate of 2½ percent to 3 percent for several years without raising inflation.

Although all estimates of potential output have a large degree of uncertainty associated with them, recent economic conditions pose three particular problems: estimating the nonaccelerating inflation rate of unemployment (NAIRU), interpreting recent patterns of growth in the labor force, and forecasting the future gains in total factor productivity (TFP).

**How Low Is the NAIRU?** First, CBO may have underestimated the benchmark that is used to measure the state of the business cycle--the nonaccelerating inflation rate of unemployment (see Box 1-2 for a discussion of the NAIRU). Economists generally agree that the NAIRU increased during the 1960s and 1970s as ever-increasing numbers of younger, less-experienced workers entered the labor market. The same logic dictates that the NAIRU should have declined during the 1980s and early 1990s, which is

3. This rate of growth is approximately 0.3 percentage points faster than the estimate CBO made last summer. The change in the projection came about primarily because of the annual revision of the national income and product accounts by the Bureau of Economic Analysis, which raised the trend rate of growth of total factor productivity and lowered the level of capital consumption and the level of net foreign investment during the last three years.

### Box 1-2. The NAIRU

The nonaccelerating inflation rate of unemployment (NAIRU)--an estimate of the rate of unemployment that is consistent with a stable rate of inflation--is an important concept for estimating the potential level of output and for forecasting inflation. Implicit in the use of the NAIRU is an idea about how labor markets function--that the growth of total compensation is stable when the demand for and supply of labor are in rough balance and there are no random shocks. If that is the case, the growth of prices will also be stable. If overall demand for labor were to increase, then the unemployment rate would fall as firms increased employment, but compensation would be "bid up" as firms competed for workers, putting upward pressure on prices. The process would be reversed in the case of lower demand for labor; the unemployment rate would rise and the growth of compensation and prices would slow in the face of eased competition for workers.

It may seem odd that economists refer to a nonzero rate of unemployment as "full employment." However, some unemployment is unavoidable in even the healthiest market economy. People constantly flow into the labor force at all stages of the business cycle; few will find jobs immediately, even during a

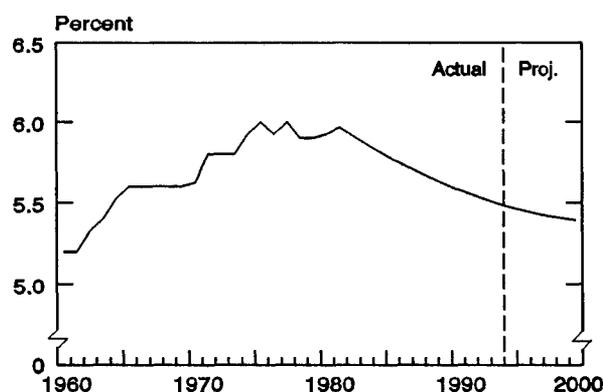
strong expansion. Workers can become unemployed at all stages of the business cycle. Quits, terminations, and layoffs all occur to varying degrees during booms as well as busts. In addition, long-term structural changes in the economy ensure that some industries decline as others are born. All of these factors imply that there will always be some unemployed workers no matter how robust the economy.

The level of the NAIRU changes for many reasons, including demographics, technological change, government regulations, and the generosity of unemployment insurance. But the only one whose effects can be readily tracked is the demographic makeup of the population. Since different groups in the labor force have different employment opportunities, a changing demographic profile would be expected to change the level of the NAIRU. For example, teens traditionally have had more limited opportunities for employment--and higher unemployment rates--than older workers. Therefore, if the share of the labor force composed of teens increased (as it did in the 1960s and early 1970s), one would expect the NAIRU to rise as well. It would take a higher unemployment rate than otherwise would be the case to ease pressure on wages and prices.

what CBO assumes (see Figure 1-11). CBO estimates that the NAIRU was 5.5 percent in 1993.

However, some analysts contend that the current level of the NAIRU is higher than CBO's estimate--perhaps close to 6 percent--which would imply that CBO's estimate of the level of potential output is also too high. Indeed, these analysts would argue that the NAIRU did not decline during the 1980s, maintaining that the decline as a result of demographic factors was offset by such influences as regional mismatches between the skills of workers and the skills required by jobs available. Under this alternate view of the NAIRU, CBO's estimate of potential output would be lowered and, given its current forecast, inflationary pressures would be expected to appear during 1995.

**Figure 1-11.**  
Nonaccelerating Inflation Rate  
of Unemployment



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

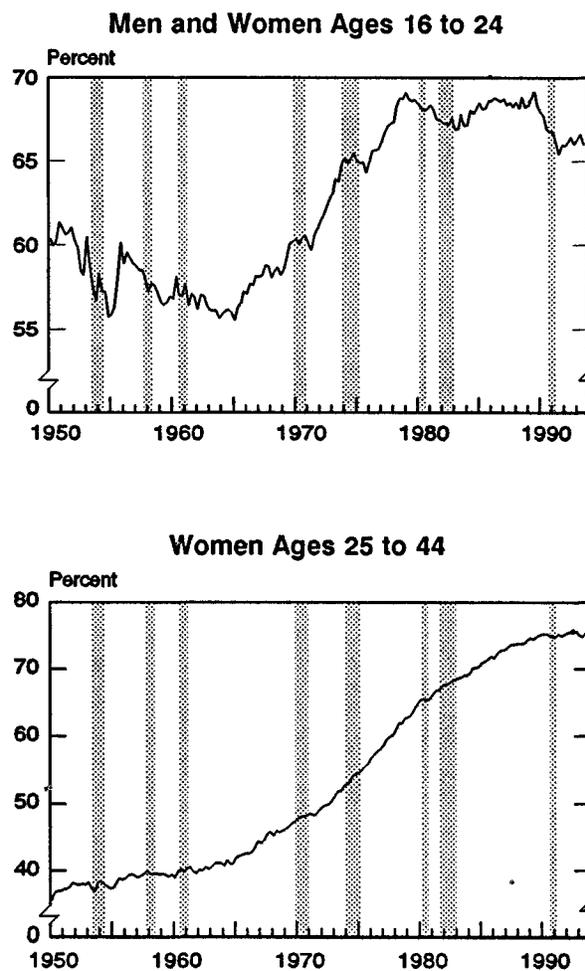
**Recent Growth in the Labor Force Has Been Slow.** The second source of uncertainty about the forecast stems from recent patterns of growth in the labor force. Growth of the labor force has been unusually slow during the past three years. This slowdown was caused not by a slump in population growth but by a leveling off of the growth in the percentage of the working-age population who desire to work--that is, the rate of participation in the labor force. The key question is whether the recent slowing of growth in labor force participation is an unusual short-run effect of the business cycle (the influence of slower growth in employment opportunities) or whether it reflects a fundamental shift in the long-run trend of labor force participation.

The answer to this question is important because the growth of the labor force during the past three years affects the estimate of potential output during the 1980s and 1990s. If, as CBO currently believes, the recent behavior of labor force participation was caused not by a change in the trend but instead by an unusually large cyclical response to slow growth in employment, then CBO's estimate of potential output is justified. If, however, the growth of the labor force is slower, then the level and growth rate of potential output is lower than CBO estimates and the point at which inflationary pressures would build is closer.

CBO has examined the data and believes that the evidence for a change in the trend is not conclusive, though the possibility cannot be ruled out. When participation rates are examined by age and sex categories, developments in two demographic categories appear to account for most of the slowing in the overall rate. The first is an outright decline in the rates for younger workers, ages 16 to 24, both male and female (see Figure 1-12). These workers may have been hit particularly hard by the recession. Jobs in retail trade--an important job market for younger workers--fell much more sharply in this recession than in previous recessions, and employment did not surpass the prerecession peak until May 1993. Participation rates of younger workers may rebound as demand for the skills of these workers grows.

The second development is more difficult to explain--namely, a flattening since 1990 in the increase in the rates of participation of women ages 25 to 44 (see Figure 1-12). Although some analysts have attributed this phenomenon to increased numbers of women withdrawing from the labor force to raise families, it is still uncertain whether that will cause a change in the trend. It will be impossible to be sure that the recent behavior is caused by cyclical factors until an extended period of rapid growth in employment occurs. The response of the labor force will then provide an answer.

**Figure 1-12.**  
**Labor Force Participation Rates**



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

**Total Factor Productivity Rose at a Healthy Pace in 1992 After Paltry Growth in the 1980s.** In contrast to the uncertainties about the NAIRU and trends in the rate of participation in the labor force, the third source of uncertainty about the projections provides a reason to be optimistic. Total factor productivity posted a healthy 2.7 percent gain in 1992, the highest rate since 1984.<sup>4</sup> Indeed, this rate is well above the trend rate of growth of TFP observed during the period since the 1981 business cycle peak--0.6 percent on average. That trend reflects the annual revision of the national income and product accounts (NIPAs) conducted by the Bureau of Economic Analysis and released last August, which raised the estimated trend rate of growth in TFP by 0.2 percentage points. The growth of the past few years is strong enough to suggest that a new, faster trend may have started. Although not enough data are in hand to estimate a new trend reliably, faster growth in productivity raises the prospect of considerably faster growth of potential output.

### The Projection for Inflation

CBO assumes that inflation will average 3.1 percent during the projection period. This projection is based on the possibility of both adverse and favorable supply shocks as well as the possibility of periods of both excess and slack demand. Although the projections for real growth and the unemployment rate suggest excess capacity on average over the projection period, the average rate of inflation for the 1996-1999 period is projected to be slightly higher than that in 1994 and 1995. In CBO's judgment, the risk of a large adverse supply or demand shock during those years is slightly greater than the risk of a large favorable one.

### The Projection for Interest Rates

CBO projects that the interest rate on three-month Treasury bills will rise during the projection period

and that the rate on 10-year Treasury notes will hold steady. The average rate on three-month Treasury bills over the 1996-1999 period is projected to be 4.6 percent. The long-term rate remains at about 6.2 percent throughout the projection period.

CBO's projections of real interest rates are based on consideration of the supply and demand for capital. In the second half of the 1990s, after the current weakness in Japan and Europe is over, an increase in the world's demand for capital is expected to more than offset a more favorable domestic supply and to push up real interest rates. The supply of capital in the United States should increase--principally as a result of a stronger economy--but not by enough to offset the increased demand. Consequently, real short-term rates should rise.

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## Comparisons with Other Forecasts and Projections

Although CBO's near-term forecast for real GDP growth is similar to that of the *Blue Chip* consensus of forecasters, the medium-term projections are similar in some respects but quite different in others.<sup>5</sup>

CBO forecasts real growth through 1995 to be as strong as does the *Blue Chip* consensus survey (see Table 1-5). The forecasts for the unemployment rate are also similar. However, the CBO forecasts for growth of the GDP deflator and for consumer price inflation are below those of the consensus.

The CBO projections for real growth over the 1996-1999 period agree quite closely with the projections of the *Blue Chip* consensus, but CBO's projections of inflation and the unemployment rate are lower than those of the consensus (see Table 16). In contrast, CBO's projection of short-term interest rates is above that of the consensus.

CBO projects that real GDP will grow at an average annual rate of 2.6 percent over the period, as does the consensus. Rates on three-month Treasury

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4. These estimates of total factor productivity were calculated by the Congressional Budget Office. The Bureau of Labor Statistics of the Department of Labor publishes a closely related measure, multifactor productivity, but has released data only through 1990.

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5. See Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (January 10, 1994).

**Table 1-5.**  
**Comparison of Forecasts for 1994 and 1995**

|   | Estimated<br>1993 | Forecast |      |
|---|-------------------|----------|------|
|   |                   | 1994     | 1995 |
| <b>Fourth Quarter to Fourth Quarter<br/>(Percentage change)</b> |                   |          |      |
| Nominal GDP   |                   |          |      |
| CBO current   | 4.9               | 5.7      | 5.4  |
| <i>Blue Chip</i>  | 5.0               | 5.6      | 5.7  |
| CBO September 1993  | 5.2               | 5.2      | 5.3  |
| Real GDP <sup>a</sup>   |                   |          |      |
| CBO current   | 2.3               | 2.8      | 2.7  |
| <i>Blue Chip</i>  | 2.4               | 2.7      | 2.6  |
| CBO September 1993  | 2.3               | 2.7      | 2.7  |
| Implicit GDP Deflator   |                   |          |      |
| CBO current   | 2.5               | 2.8      | 2.6  |
| <i>Blue Chip</i>  | 2.5               | 2.8      | 3.0  |
| CBO September 1993  | 2.8               | 2.5      | 2.5  |
| Consumer Price Index <sup>b</sup>                               |                   |          |      |
| CBO current   | 2.7               | 2.9      | 3.0  |
| <i>Blue Chip</i>  | 2.7               | 3.1      | 3.3  |
| CBO September 1993  | 3.4               | 3.1      | 3.0  |
| <b>Calendar Year Averages<br/>(Percent)</b>                     |                   |          |      |
| Civilian Unemployment Rate <sup>c</sup>                         |                   |          |      |
| CBO current   | 6.8               | 6.4      | 6.1  |
| <i>Blue Chip</i>  | 6.8               | 6.4      | 6.2  |
| CBO September 1993  | 6.9               | 6.6      | 6.3  |
| Three-Month Treasury Bill Rate                                  |                   |          |      |
| CBO current   | 3.0               | 3.5      | 4.3  |
| <i>Blue Chip</i>  | 3.0               | 3.4      | 3.8  |
| CBO September 1993  | 3.1               | 3.6      | 4.1  |
| Ten-Year Treasury Note Rate                                     |                   |          |      |
| CBO current   | 5.9               | 5.8      | 6.0  |
| <i>Blue Chip</i> <sup>d</sup>                                   | 5.9               | 5.9      | 6.1  |
| CBO September 1993  | 6.0               | 6.1      | 6.1  |

SOURCES: Congressional Budget Office; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (January 10, 1994); Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

NOTE: The *Blue Chip* forecasts through 1995 are based on a survey of 50 private forecasters.

- a. Based on constant 1987 dollars.
- b. The consumer price index for all urban consumers (CPI-U).
- c. Unemployment rate based on 1993 methodology; published rates are likely to be higher (see Box 1-1).
- d. *Blue Chip* does not project a 10-year note rate. The values shown here for the 10-year note rate are based on the *Blue Chip* projections of the Aaa bond rate, adjusted by CBO to reflect the estimated spread between Aaa bonds and 10-year Treasury notes.

bills are projected to be about 4.7 percent on average in CBO's projections but only 4.4 percent on average in the consensus. According to CBO, inflation as measured by the CPI-U remains at 3.1 percent compared with 3.6 percent for the consensus. The unemployment rate falls from 5.9 percent to 5.7 percent in the CBO projections. In the *Blue Chip* projections, it starts at a slightly higher level but drops by the same amount.

## Risks to CBO's Economic Forecast

The world is changing, and consequently any forecast must be treated cautiously, with a realistic eye

to the likelihood of the unforeseen. This outlook, like most, has been put together under the assumption that business will be as usual. Thus, it recognizes uncertainties but does not pretend to anticipate catastrophes.

In addition to the uncertainties surrounding the estimate of potential GDP already discussed, three types of behavior seem especially difficult to forecast in this outlook: economic growth among the major U.S. trading partners; actions of the Federal Reserve as the economy continues to grow; and whether, and how fast, the rate of personal saving will rise. CBO's forecast sticks to the middle of the road in each of these areas, but the possibility of errors exists on each side.

**Table 1-6.**  
**Comparison of Projections for 1996 Through 1999**

|   | 1996 | 1997 | 1998 | 1999 |
|---|------|------|------|------|
| <b>Percentage Change (Year-over-year)</b>     |      |      |      |      |
| <b>Real GDP<sup>a</sup></b>                   |      |      |      |      |
| CBO current                                   | 2.7  | 2.7  | 2.6  | 2.5  |
| <i>Blue Chip</i>                              | 2.6  | 2.7  | 2.6  | 2.6  |
| CBO September 1993                            | 2.7  | 2.6  | 2.4  | 2.1  |
| <b>Consumer Price Index<sup>b</sup></b>       |      |      |      |      |
| CBO current                                   | 3.1  | 3.1  | 3.1  | 3.1  |
| <i>Blue Chip</i>                              | 3.6  | 3.7  | 3.6  | 3.6  |
| CBO September 1993                            | 3.0  | 3.0  | 3.0  | 3.0  |
| <b>Calendar Year Averages (Percent)</b>       |      |      |      |      |
| <b>Civilian Unemployment Rate<sup>c</sup></b> |      |      |      |      |
| CBO current                                   | 5.9  | 5.8  | 5.7  | 5.7  |
| <i>Blue Chip</i>                              | 6.2  | 6.2  | 6.1  | 6.0  |
| CBO September 1993                            | 6.0  | 5.8  | 5.7  | 5.7  |
| <b>Three-Month Treasury Bill Rate</b>         |      |      |      |      |
| CBO current                                   | 4.6  | 4.6  | 4.7  | 4.7  |
| <i>Blue Chip</i>                              | 4.3  | 4.4  | 4.4  | 4.4  |
| CBO September 1993                            | 4.5  | 4.6  | 4.6  | 4.6  |

SOURCES: Congressional Budget Office; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (October 10, 1993); Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

a. Based on constant 1987 dollars.

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

c. Unemployment rate based on 1993 methodology; published rates are likely to be higher (see Box 1-1).

A major uncertainty is the state of the world economy, which affects the market for U.S. exports and is also an important factor underlying interest rates. On the one hand, growth in the newly industrialized countries of Latin America and Asia could turn out to be stronger than anticipated. Those countries have in the past few years largely avoided the recession and could do even better once the developed economies begin to recover. China, in particular, is rapidly growing into an economic giant whose impact on the world economy is not yet clear. Moreover, the final agreement of the Uruguay Round of the General Agreement on Tariffs and Trade (GATT), which was concluded as this forecast was completed, offers a hope of increased world trade in which the United States will be well placed to participate.

On the other hand, the economic situation in Europe and Japan, poor as it seems now, could turn out even worse than currently anticipated. In both Europe and Japan, political factors stand in the way of stimulative policies that are widely advocated. Thus, those governments would find it difficult to respond quickly if the outlook became bleaker, yet not doing so would enlarge the risk of these economies continuing their poor performance.

If the world economy turns out to be substantially stronger than CBO assumes, U.S. exports would benefit; a weaker world economy would weaken U.S. exports. Interest rates would also be affected, since the U.S. capital market is closely linked with world capital markets: broadly speaking, rates would be somewhat higher in the United States if the world economy is strong, and lower if the world economy fails to recover. Thus, forecast errors in projecting the demand for U.S. exports would be partly mitigated through movements in interest rates.

If the Federal Reserve adopts a policy toward short-term interest rates that differs from that assumed in the CBO forecast, such a policy would pose an additional risk. A stronger anti-inflation stance that raised interest rates rapidly would dampen

economic activity in the near term, while a stance that kept rates unchanged might add more stimulus than CBO assumes. Although the CBO forecast presumes the Federal Reserve will be able to assess correctly the degree of economic growth that will be compatible with stable inflation, in reality any such assessment is surrounded by uncertainty and consequently is prone to mistakes. Continued concerns about corporate restructuring or uneven growth in different parts of the country also contribute to diverse perceptions about potential output and inflation.

The amount that Americans save out of personal income could also tip the scale toward faster or slower growth. The personal saving rate appears to be at a very low level now compared with that of recent history, but that level may be understated because revisions to the data on wages and salaries often result in raising the rate. Moreover, various kinds of news regarding economic activity or global political stability can sometimes change the attitude of households toward saving over short periods of time. Any increase in personal saving rates would reduce consumption and thus slow the pace of economic activity in the short run, and any decrease would increase consumption and raise the rate of growth.

There remain the larger uncertainties, which a forecast cannot pretend to encompass. As this report was written, the locus of political power in Russia remained unclear following the Duma elections: how that turns out could determine whether Russia succeeds in reforming its economy. This uncertainty could already be affecting markets in many ways: weakening the deutsche mark, discouraging capital flows to Eastern Europe, and disrupting trade flows. A slowing of the economic changes in Russia, or a rising tide of nationalism, could have a new set of effects, including perhaps greater pressure on budgets in the United States and Europe to counter possible geopolitical instability. How these developments turn out could well be of greater import for the United States than most of the short-run economic factors discussed in this chapter.



## The Budget Outlook

In 1993, the federal deficit was \$255 billion--down sharply from the record of \$290 billion set just a year earlier. The Congressional Budget Office projects that if current taxing and spending policies remain unchanged, the deficit will keep falling for several years, dipping to \$166 billion in 1996 before climbing again. In relation to the size of the economy (as measured by gross domestic product), the deficit hovers just under 2½ percent in 1995 through 1999.

Last August, an ambitious deficit reduction package--the Omnibus Budget Reconciliation Act of 1993 (OBRA-93)--cleared the Congress and was signed by the President. Enacted with barely a month left in the fiscal year, the package was not responsible for the deficit's decline between 1992 and 1993. Instead, the main reason that the 1993 deficit lay below 1992's tally was a swing in spending for deposit insurance, down \$31 billion from the previous year's figure largely because of a hiatus in funding that delayed the cleanup of troubled savings and loan institutions. But OBRA-93 contributes enormously to holding down the deficit in 1994 and beyond. When OBRA-93 was passed, CBO credited its backers with having achieved \$433 billion in savings in 1994 through 1998--and, of course, most of the savings persist even after that period.<sup>1</sup>

The last time that the Congress and the Administration hammered out a major deficit reduction package, namely the budget summit agreement of

late 1990, the ink was barely dry before a spate of bad news hit. The 1990 summit slashed almost \$500 billion from the deficit over the 1991-1995 period, and CBO and others initially thought that it would succeed in virtually balancing the budget by the mid-1990s. That was not to be. Although policymakers did not backpedal on the savings achieved in 1990, slow economic growth, sagging revenues, and an unexpected explosion in spending for health care and other benefit programs swelled the deficit and created the need for additional rounds of budgetary surgery.

So far, however, this situation does not appear to be repeating itself. The budget outlook now is no worse, and in fact is slightly better, than CBO reported last September. The modest improvement stems from undramatic but favorable news on several fronts: strong revenues, subdued spending on net interest, lower outlays for deposit insurance, and a mild deceleration in the growth of benefit programs. Of course, these small revisions leave the underlying message broadcast by CBO last September intact: policymakers have cut the deficit but have by no means erased it.

This chapter summarizes CBO's new baseline projections. The baseline shows the outlook for federal revenues, outlays, and the deficit if current taxing and spending policies remain unchanged. It is not a forecast of budget outcomes but is essential for sketching the consequences of today's policies and serves as a benchmark for weighing proposed changes. Crucially, the projections assume continued compliance with the Balanced Budget and Emergency Deficit Control Act of 1985, which bars lawmakers from increasing the deficit, on balance, through

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

revenue or entitlement legislation and sets stringent limits through 1998 on total appropriations for programs that are funded annually. The chapter wraps up with a special look at trends in the progressivity of the tax system, which have been influenced over the years by many pieces of legislation including last year's reconciliation act.

## The Deficit Outlook

The simplest and most widely used measure of the deficit is the difference between federal revenues and

outlays. Nevertheless, there are several alternative measures, some more useful than others.

## The Total Deficit and Its Variants

If today's policies remain unchanged, CBO expects the total deficit to drop through 1996 before rising again (see Table 2-1). This figure--the comprehensive measure of the gap between federal spending and revenues--peaked at \$290 billion in 1992 and fell to \$255 billion in 1993. It sinks again to \$223 billion in 1994, drifts down to \$166 billion in 1996, and then heads back up; its ascent picks up steam in

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

|  | Actual<br>1993 | 1994      | 1995     | 1996     | 1997     | 1998     | 1999     |
|--|----------------|-----------|----------|----------|----------|----------|----------|
| <b>In Billions of Dollars</b>                                    |                |           |          |          |          |          |          |
| Total Deficit Assuming Discretionary Caps                        | 255            | 223       | 171      | 166      | 182      | 180      | 204      |
| Deficit Excluding Deposit Insurance                              | 283            | 228       | 182      | 180      | 189      | 184      | 208      |
| Standardized-Employment Deficit <sup>a</sup>                     | 215            | 179       | 144      | 149      | 164      | 164      | 191      |
| On-Budget Deficit (Excluding Social Security and Postal Service) | 301            | 284       | 242      | 245      | 267      | 272      | 304      |
| <b>Memorandum:</b>   |                |           |          |          |          |          |          |
| Deposit Insurance  | -28            | -5        | -11      | -14      | -6       | -4       | -4       |
| Off-Budget Surplus   |                |           |          |          |          |          |          |
| Social Security  | 47             | 62        | 70       | 76       | 84       | 92       | 100      |
| Postal Service   | <u>-1</u>      | <u>-2</u> | <u>1</u> | <u>2</u> | <u>1</u> | <u>b</u> | <u>b</u> |
| Total, Off-Budget Surplus  | 46             | 61        | 71       | 79       | 85       | 92       | 100      |
| <b>As a Percentage of GDP</b>                                    |                |           |          |          |          |          |          |
| Total Deficit Assuming Discretionary Caps                        | 4.0            | 3.4       | 2.4      | 2.2      | 2.3      | 2.2      | 2.4      |
| Deficit Excluding Deposit Insurance                              | 4.5            | 3.4       | 2.6      | 2.4      | 2.4      | 2.2      | 2.4      |
| Standardized-Employment Deficit <sup>a,c</sup>                   | 3.3            | 2.7       | 2.0      | 2.0      | 2.1      | 2.0      | 2.2      |

SOURCE: Congressional Budget Office.

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

1999, after expiration of the strict dollar caps on discretionary spending set in the Balanced Budget Act.

Temporary and cyclical factors, though, can obscure underlying trends in the budget. When these factors are stripped away, the improvement in the deficit that occurs over the 1992-1995 period looks slightly less impressive.

**Deposit Insurance.** One measure that eliminates such transitory factors is the deficit excluding deposit insurance. CBO has long stressed that spending for deposit insurance--that is, money spent and received in the course of closing or merging insolvent savings and loan institutions and banks--does not spur the economy like other federal spending. Insured depositors do not become richer when the government honors its commitment to them; rather, the transaction represents a rearrangement of the financial assets and liabilities already present in the economy. Recognizing this, credit markets absorb the Treasury securities issued to pay for deposit insurance with relative equanimity. The real waste--the squandering of resources that deposit insurance outlays symbolize--largely occurred in the past, when institutions made bad loans and investments.

Deposit insurance outlays have fluctuated widely in the past few years, marked by spurts of spending or asset sales and interrupted by funding cutoffs. Deposit insurance barely registered in the budget totals before 1988 but then soared to \$66 billion in 1991. The government then chalked up outlays of just \$3 billion in 1992 and negative outlays (that is, net receipts) of \$28 billion in 1993, chiefly because policymakers allowed the spending authority of the Resolution Trust Corporation to lapse for more than a year and a half.

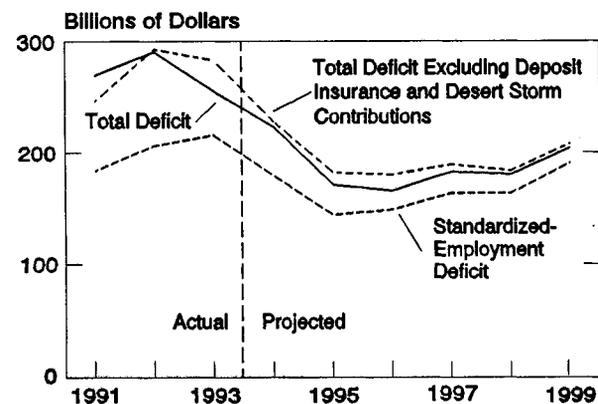
Future deposit insurance outlays are not terribly volatile in CBO's new projections. Small negative outlays in all years signal that the massive losses associated with closing failed institutions have subsided and that the ongoing sales of assets dominate the totals. But this is a notoriously uncertain category of spending and should be isolated when sketching the deficit's trend.

**Cyclical Factors.** A deficit measure widely used by economists goes one step further by removing the effects of the business cycle on the budget. Poor economic performance automatically worsens the deficit--principally because of lower revenues, less dramatically because of extra benefits for unemployment compensation and other programs. These cyclical effects were very pronounced in the early 1990s but are now fading.

Changes in the standardized-employment deficit are used as a measure of the stimulus or drag exerted by fiscal policy (see Chapter 1). This practice throws light on the part of the deficit that policymakers fundamentally influence, in contrast to the part that simply reflects the cyclical fluctuations of the economy. The standardized-employment deficit indicates that the very big deficits posted in the early 1990s were partly bloated by temporary factors, and the subsequent improvement is therefore somewhat less dramatic than it may first appear (see Figure 2-1).

By whatever measure, the 1990s got off to a bad start, from a fiscal policy standpoint, before things got better. CBO's baseline projections end in 1999, when the deficit appears to be back on an upswing. Thus, they raise the question: what next? A broad-brush picture of the budget outlook for a full 10-year period suggests that the deficit would worsen again under current policies, for reasons that are explained in Box 2-1.

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



SOURCE: Congressional Budget Office.

**Box 2-1.**  
**The Ten-Year Budget Outlook**

If current policies stay unchanged, the federal deficit will climb steadily after the late 1990s, according to the Congressional Budget Office's latest look at the 10-year picture. CBO projects that the federal deficit (excluding deposit insurance) will be essentially flat in 1995 through 1998. But it climbs every year after that, ultimately topping \$360 billion in 2004 (see table). Of greater concern is the deficit's trend as a share of gross domestic product: from 2.2 percent in 1998, it inches up in every year, approaching 3½ percent of GDP in 2004.

What accounts for the escalating deficits after 1999? The answer lies basically in the outlook for one fast-growing and one slow-growing area of spending: health care and discretionary spending.

Outlays for the two big health care programs, Medicare and Medicaid, climb steadily by 10 percent or more every year over the 10-year period. Thus, they also climb as a percentage of GDP: from 3.7 percent in 1994 to 6.3 percent in 2004. Discretionary spending, in contrast, sinks as a share of GDP throughout the entire period. Constrained by caps through 1998, it barely grows at all in dollar terms through then and falls from 8.2 percent to 6.7 percent of GDP--more than offsetting the climb in health care spending. But the caps expire after 1998, and appropriations are assumed to rise again in step with inflation (in keeping with standard baseline methodology). Thus, although discretionary programs continue to sink as a share of GDP in 1999 through 2004, their decline (to 6 percent in 2004) is less precipitous than in the earlier period and is not sufficient to overcome the unrelenting rise of health care spending.

Most other areas of the budget change little in relation to GDP over the 1999-2004 period. Revenues slip from 19 percent to 18.8 percent of GDP. Mandatory spending other than Medicare and Medicaid is expected to stay roughly constant as a share of GDP. The biggest such

program, Social Security, remains at 4.8 percent of GDP; even by 2004, the first members of the post-World War II baby boom are still four years from eligibility for retirement. Net interest outlays hover around 3 percent of GDP, and the ratio of debt to GDP--which is basically flat in 1994 through 1999--creeps up by about 3 percentage points (from 52 percent to 55 percent) in the five years thereafter.

A year ago, CBO projected that the deficit would top \$650 billion in 2003; by last September, CBO had chopped its projection to \$359 billion. The enormous improvement during that six-month period was almost wholly attributable to the enactment of an ambitious deficit reduction package. The newest projection for 2003, a deficit of \$324 billion, is only a minor revision in comparison. Of the \$35 billion revision, two-thirds stems from higher revenues as CBO has upped its estimate of potential growth, and one-third from lower interest costs as CBO has trimmed its estimate of federal debt.

Of course, these extrapolations are not as detailed as CBO's usual five-year estimates. Rather than produce a meticulous 10-year projection for every program in the budget, CBO attempts simply to judge the likely trends in broad clusters of spending and revenues. And great uncertainties surround such long-range extrapolations. The economy's performance is a big question mark; these projections are predicated on continued growth in real GDP of 2.3 percent annually in 2000 through 2004, on inflation of 3.1 percent, and on short-term and long-term interest rates (specifically, rates on three-month Treasury bills and 10-year Treasury notes) of 4.7 percent and 6.2 percent, respectively. The economy is bound to deviate from these assumptions in ways that cannot be anticipated. And other major uncertainties abound, most notably about future trends in health care spending and about other open-ended commitments, such as the pledges for deposit insurance that proved so costly in the recent past.

### The Budget Outlook Through 2004 (By fiscal year)

|                                       | 1994  | 1995  | 1996  | 1997  | 1998  | 1999  | 2000  | 2001  | 2002  | 2003  | 2004  |
|---------------------------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| <b>In Billions of Dollars</b>         |       |       |       |       |       |       |       |       |       |       |       |
| Revenues                              | 1,251 | 1,338 | 1,411 | 1,479 | 1,556 | 1,630 | 1,706 | 1,783 | 1,868 | 1,958 | 2,054 |
| Outlays                               |       |       |       |       |       |       |       |       |       |       |       |
| Discretionary                         | 543   | 541   | 547   | 547   | 547   | 564   | 582   | 600   | 619   | 638   | 658   |
| Mandatory                             |       |       |       |       |       |       |       |       |       |       |       |
| Social Security                       | 318   | 335   | 352   | 370   | 388   | 408   | 429   | 450   | 473   | 497   | 523   |
| Medicare                              | 160   | 177   | 195   | 215   | 238   | 264   | 290   | 320   | 354   | 392   | 435   |
| Medicaid                              | 86    | 96    | 108   | 121   | 135   | 151   | 168   | 186   | 206   | 227   | 250   |
| Civil Service and Military Retirement | 62    | 65    | 67    | 70    | 73    | 78    | 81    | 85    | 89    | 92    | 96    |
| Other                                 | 177   | 171   | 168   | 184   | 191   | 199   | 205   | 211   | 218   | 225   | 232   |
| Subtotal                              | 803   | 844   | 890   | 960   | 1,026 | 1,099 | 1,173 | 1,253 | 1,339 | 1,433 | 1,536 |
| Deposit insurance                     | -5    | -11   | -14   | -6    | -4    | -4    | -3    | -3    | -2    | -2    | -2    |
| Net interest                          | 201   | 212   | 228   | 239   | 249   | 261   | 270   | 283   | 298   | 315   | 334   |
| Offsetting receipts                   | -69   | -77   | -74   | -78   | -83   | -86   | -90   | -94   | -98   | -102  | -106  |
| Total                                 | 1,474 | 1,509 | 1,577 | 1,661 | 1,736 | 1,834 | 1,931 | 2,039 | 2,156 | 2,282 | 2,419 |
| Deficit                               | 223   | 171   | 166   | 182   | 180   | 204   | 226   | 256   | 288   | 324   | 365   |
| Deficit Excluding Deposit Insurance   | 228   | 182   | 180   | 189   | 184   | 208   | 229   | 258   | 290   | 326   | 367   |
| Debt Held by the Public               | 3,462 | 3,642 | 3,822 | 4,021 | 4,218 | 4,441 | 4,686 | 4,961 | 5,268 | 5,611 | 5,995 |
| <b>As a Percentage of GDP</b>         |       |       |       |       |       |       |       |       |       |       |       |
| Revenues                              | 18.8  | 19.1  | 19.1  | 19.0  | 19.0  | 19.0  | 18.9  | 18.9  | 18.8  | 18.8  | 18.8  |
| Outlays                               |       |       |       |       |       |       |       |       |       |       |       |
| Discretionary                         | 8.2   | 7.7   | 7.4   | 7.0   | 6.7   | 6.6   | 6.5   | 6.3   | 6.2   | 6.1   | 6.0   |
| Mandatory                             |       |       |       |       |       |       |       |       |       |       |       |
| Social Security                       | 4.8   | 4.8   | 4.8   | 4.8   | 4.7   | 4.7   | 4.8   | 4.8   | 4.8   | 4.8   | 4.8   |
| Medicare                              | 2.4   | 2.5   | 2.6   | 2.8   | 2.9   | 3.1   | 3.2   | 3.4   | 3.6   | 3.8   | 4.0   |
| Medicaid                              | 1.3   | 1.4   | 1.5   | 1.6   | 1.7   | 1.8   | 1.9   | 2.0   | 2.1   | 2.2   | 2.3   |
| Civil Service and Military Retirement | 0.9   | 0.9   | 0.9   | 0.9   | 0.9   | 0.9   | 0.9   | 0.9   | 0.9   | 0.9   | 0.9   |
| Other                                 | 2.7   | 2.4   | 2.3   | 2.4   | 2.3   | 2.3   | 2.3   | 2.2   | 2.2   | 2.2   | 2.1   |
| Subtotal                              | 12.1  | 12.0  | 12.1  | 12.3  | 12.5  | 12.8  | 13.0  | 13.3  | 13.5  | 13.8  | 14.1  |
| Deposit insurance                     | -0.1  | -0.2  | -0.2  | -0.1  | a     | a     | a     | a     | a     | a     | a     |
| Net interest                          | 3.0   | 3.0   | 3.1   | 3.1   | 3.0   | 3.0   | 3.0   | 3.0   | 3.0   | 3.0   | 3.1   |
| Offsetting receipts                   | -1.0  | -1.1  | -1.0  | -1.0  | -1.0  | -1.0  | -1.0  | -1.0  | -1.0  | -1.0  | -1.0  |
| Total                                 | 22.2  | 21.5  | 21.3  | 21.4  | 21.2  | 21.3  | 21.4  | 21.6  | 21.7  | 21.9  | 22.1  |
| Deficit                               | 3.4   | 2.4   | 2.2   | 2.3   | 2.2   | 2.4   | 2.5   | 2.7   | 2.9   | 3.1   | 3.3   |
| Deficit Excluding Deposit Insurance   | 3.4   | 2.6   | 2.4   | 2.4   | 2.2   | 2.4   | 2.5   | 2.7   | 2.9   | 3.1   | 3.4   |
| Debt Held by the Public               | 52.2  | 52.0  | 51.7  | 51.7  | 51.5  | 51.7  | 52.0  | 52.5  | 53.1  | 53.9  | 54.9  |

SOURCE: Congressional Budget Office.

a. Less than 0.05 percent of GDP.