

# Comparison of Economic Forecasts

The economic forecasts of the Congressional Budget Office and the Clinton Administration for the 1993-1999 period are similar (see Tables 7 and 9). Moreover, with the exception of long-term interest rates, both forecasts resemble the consensus of private forecasters recently surveyed by the *Blue Chip Economic Indicators*.<sup>1</sup> The CBO and Administration forecasts differ slightly in their outlooks for inflation and interest rates, however. For both the short and medium terms, the CBO outlook indicates slightly higher interest rates and lower inflation. Although these differences appear to be minor, they have marked implications for the budget deficit projections. When CBO's economic assumptions are substituted for those of the Administration, the deficit projections are higher in every year except 1994 and amount to a cumulative difference of \$99 billion over the 1994-1999 projection period.

The Administration's economic forecast embodies the effects of the 1995 budget proposal (excluding health care reform), whereas CBO's forecast and medium-term assumptions are based upon current law. Because the proposed policy changes do not affect revenues and outlays significantly, however, the differences in the fiscal policy assumptions should not affect a comparison of the projections.

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## Short-Term Outlook

Both CBO and the Administration expect the U.S. economy to expand at an annual rate of nearly 3

percent (on a fourth-quarter-to-fourth-quarter basis) through 1995; both forecasts anticipate small declines in the unemployment rate and a rise in short-term interest rates.<sup>2</sup>

The most noticeable difference between CBO and Administration forecasts is in the outlook for short-term interest rates. CBO projections show slightly higher three-month Treasury bill rates over the 1994-1995 period. The forecast of a higher interest rate, in combination with the projections of steady inflation by CBO and the Administration, indicate that real (inflation-adjusted) interest rates are expected to rise. CBO's rationale for this rise in real rates is based on the current policy objectives of the Federal Reserve and future conditions in the capital market. To dampen future inflationary pressures, policymakers will probably allow short-term real rates to rise as the economy continues to grow. Moreover, CBO expects that there will be some upward pressure on real interest rates in the capital market because the supply of domestic savings will be more than offset by higher federal borrowing and an increase in the demand for capital, both domestic and foreign.

Since the forecast was made, economic data have shown an unexpectedly strong growth in real gross domestic product of 7.0 percent in the fourth quarter of 1993. The unusually high growth rate at

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1. Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (April 10, 1994).

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2. The Bureau of Labor Statistics changed the way it conducts the unemployment survey as of January 1994 [see Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1995-1999* (January 1994), p. 9]. The change raises the level of the unemployment rate by about 0.4 percentage points. The new measure is used here for the forecast years; the CBO and Administration forecasts, which were based on the previous methodology, have been adjusted upward by 0.4 percentage points in an attempt to make them comparable with recently released data.

**Table 7.**  
**Comparison of Congressional Budget Office, Administration, and**  
**Blue Chip Short-Run Economic Forecasts, Calendar Years 1992-1995**

	Actual 1992	Estimated <sup>a</sup> 1993	Forecast	
			1994	1995
<b>Fourth Quarter to Fourth Quarter (Percentage change)</b>				
Nominal GDP				
CBO	6.7	4.9	5.7	5.4
Administration	6.7	5.0	5.8	5.6
<i>Blue Chip</i>	6.7	5.5	5.7	5.8
Real GDP <sup>b</sup>				
CBO	3.9	2.3	2.8	2.7
Administration	3.9	2.3	3.0	2.7
<i>Blue Chip</i>	3.9	3.2	3.0	2.7
Consumer Price Index <sup>c</sup>				
CBO	3.1	2.7	2.9	3.0
Administration	3.1	2.8	3.0	3.2
<i>Blue Chip</i>	3.1	2.7	3.0	3.4
<b>Calendar Year Averages (Percent)</b>				
Civilian Unemployment Rate <sup>d</sup>				
CBO	7.4	6.8	6.8	6.5
Administration	7.4	6.8	6.9	6.5
<i>Blue Chip</i>	7.4	6.8	6.4	6.1
Three-Month Treasury Bill Rate <sup>e</sup>				
CBO	3.4	3.0	3.5	4.3
Administration	3.5	3.0	3.4	3.8
<i>Blue Chip</i>	3.4	3.0	3.7	4.3
Ten-Year Treasury Note Rate				
CBO	7.0	5.9	5.8	6.0
Administration	7.0	5.9	5.8	5.8
<i>Blue Chip</i> <sup>f</sup>	7.0	5.9	6.3	6.6

SOURCES: Congressional Budget Office; Office of Management and Budget (OMB); Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (April 10, 1994).

NOTE: The CBO and OMB forecasts are based on data available through December 1993 and do not reflect the fourth-quarter data for gross domestic product (GDP). The *Blue Chip* forecast is an average of 50 private forecasters.

- a. The *Blue Chip* forecast was prepared three months later than the other forecasts, so the *Blue Chip* data for 1993 are actual.
- b. Based on constant 1987 dollars.
- c. The consumer price index for all urban consumers (CPI-U).
- d. The Bureau of Labor Statistics changed the method for conducting the unemployment survey in January 1994, and the change increased the measured unemployment somewhat. The CBO and Administration forecasts for 1994 and 1995 are consistent with the old, pre-1994, methodology. The forecast tables reported here have been adjusted upward 0.4 percentage points to make the forecasts comparable with currently published figures. Data for 1992 and 1993, shown in italics, use pre-1994 methodology.
- e. CBO and *Blue Chip* project the secondary market rate for three-month Treasury bills, while OMB projects the auction average rate.
- f. *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.

**Table 8.**  
**Comparison of Federal Reserve, Congressional Budget Office,**  
**and Administration Economic Projections for 1994**

	Federal Reserve <sup>a</sup>	CBO	Administration
<b>Fourth Quarter to Fourth Quarter (Percentage change)</b>			
Nominal Gross Domestic Product	5.50 to 6.00	5.7	5.8
Real Gross Domestic Product	3.00 to 3.25	2.8	3.0
Consumer Price Index	About 3	2.9	3.0
<b>Average Level, Fourth Quarter</b>			
Civilian Unemployment Rate	6.50 to 6.75	6.6	6.8

SOURCES: Congressional Budget Office; Office of Management and Budget; Board of Governors of the Federal Reserve System, *Monetary Policy Report to the Congress Pursuant to the Full Employment and Balanced Growth Act of 1978* (February 1994).

a. The Federal Reserve figures are the ranges--known as the central tendency--that include the majority of the forecasts of Federal Open Market Committee members and other Federal Reserve Bank presidents.

the end of 1993 represents (1) a sizable increase in spending on producers' durable equipment, which grew at an annual rate of 26 percent during the fourth quarter, compared with 10 percent in the third quarter; (2) an increase in demand for U.S. exports, which in turn increased the net export component of total demand much more than anticipated; and (3) a 15 percent increase in spending for consumer durables--more than double its growth in the third quarter.

Although the economy's recent surge embodied some strong fundamentals, CBO does not anticipate that this spell of rapid growth will presage similarly rapid growth throughout 1994. The Southern California earthquake and adverse winter weather cut into economic activity in the first quarter. Economic growth this year will be dampened by slightly more restrictive fiscal policy. The Omnibus Budget Reconciliation Act of 1993 imposed higher tax rates on high-income individuals and will slow the growth of federal expenditures. Moreover, continued weakness in the economies of some of its major trading partners is likely to moderate economic activity in the United States. More specifically, several countries have assigned high priority to containing growing public debt and budget deficits de-

spite their current recessionary environment; in all likelihood, this restraint abroad will limit demand for U.S. exports in 1994.<sup>3</sup>

Monetary policy is also likely to be less accommodative this year. In early February, a time when concerns about future inflation were rising, the Federal Reserve lifted the federal funds rate by 25 basis points. This was followed by a further rise of 25 basis points in the funds rate in late March. These actions were generally anticipated in both CBO's and the Administration's forecasts. The rise signalled a major turning point in the policy of the Federal Reserve, which has been relatively accommodative during the past five years. The change in policy probably foreshadows further increases in short-term interest rates as the economic expansion in the United States continues.

3. For the Group of Seven industrialized countries (Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States) combined, the Organization for Economic Cooperation and Development predicts that, on average, fiscal policy will be as restrictive as that of the United States. Also note that while a stimulative fiscal package has been accepted in Japan, the recovery is expected to be gradual, since the stimulus is primarily based on an income tax cut that is temporary and financing decisions have been postponed until the end of 1994.

**Table 9.**  
**Comparison of Congressional Budget Office, Administration, and *Blue Chip* Economic Projections, Calendar Years 1993-1999**

	Estimated <sup>a</sup>	Forecast		Projected			
	1993	1994	1995	1996	1997	1998	1999
<b>Nominal GDP (Billions of dollars)</b>							
CBO	6,370	6,730	7,099	7,483	7,880	8,287	8,700
Administration	6,371	6,736	7,118	7,522	7,950	8,400	8,870
<b>Real GDP<sup>b</sup></b> (Percentage change, year over year)							
CBO	2.8	2.9	2.7	2.7	2.7	2.6	2.5
Administration	2.8	3.1	2.8	2.7	2.6	2.6	2.5
<i>Blue Chip</i>	3.0	3.6	2.8	2.6	2.5	2.4	2.8
<b>GDP Deflator (Percentage change)</b>							
CBO	2.6	2.7	2.7	2.6	2.5	2.5	2.5
Administration	2.6	2.6	2.8	2.9	3.0	3.0	3.0
<i>Blue Chip</i>	2.6	2.3	2.9	3.2	3.2	3.1	3.1
<b>Consumer Price Index<sup>c</sup></b> (Percentage change, year over year)							
CBO	3.0	2.7	3.0	3.1	3.1	3.1	3.1
Administration	3.0	2.8	3.2	3.3	3.3	3.4	3.4
<i>Blue Chip</i>	3.0	2.8	3.3	3.4	3.5	3.4	3.4
<b>Civilian Unemployment Rate (Percent)<sup>d</sup></b>							
CBO	6.8	6.8	6.5	6.3	6.2	6.1	6.1
Administration	6.8	6.9	6.5	6.3	6.1	5.9	5.9
<i>Blue Chip</i>	6.8	6.5	6.2	6.0	6.1	6.1	6.0

SOURCES: Congressional Budget Office; Office of Management and Budget (OMB); Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (March 10, 1994).

NOTE: GDP = gross domestic product.

a. The *Blue Chip* forecast was prepared two month later than the other forecasts, so the *Blue Chip* data for 1993 are actual.

b. Based on constant 1987 dollars.

(Continued)

The Federal Reserve's forecast for this year is compatible with the near-term outlook delineated by the Administration and CBO forecasts (see Table 8). The Federal Reserve predicts only slightly higher real growth than does CBO or the Administration. At the same time, the Administration's forecast for unemployment in the comparable 1994 fourth quarter is just outside the Federal Reserve's upper boundary at 6.8 percent, while CBO's forecast of 6.6 percent is in the middle of the Fed's

range.<sup>4</sup> Moreover, the Federal Reserve's projection for inflation has been lowered somewhat to "about 3" percent from the "3 to 3.5" percent given in July 1993.

4. The unemployment rates predicted by the Administration and CBO for the fourth quarter of 1994 were 6.4 and 6.2, respectively, on a prerevision basis. Both numbers were adjusted upward by 0.4 percentage points to make them roughly comparable to the Federal Reserve's forecast, which is based on the new methodology of the Bureau of Labor Statistics.

**Table 9.**  
**Continued**

	Estimated <sup>a</sup>	Forecast		Projected			
	1993	1994	1995	1996	1997	1998	1999
<b>Three-Month Treasury Bill Rate (Percent)<sup>g</sup></b>							
CBO	3.0	3.5	4.3	4.6	4.6	4.7	4.7
Administration	3.0	3.4	3.8	4.1	4.4	4.4	4.4
<i>Blue Chip</i>	3.0	3.5	4.0	4.3	4.4	4.4	4.3
<b>Ten-Year Treasury Note Rate (Percent)</b>							
CBO	5.9	5.8	6.0	6.1	6.2	6.2	6.2
Administration	5.9	5.8	5.8	5.8	5.8	5.8	5.8
<i>Blue Chip</i> <sup>f</sup>	5.9	6.0	6.2	6.6	6.4	6.3	6.4
<b>Nominal Income (Percentage of GDP)</b>							
<b>Wage and salary disbursements</b>							
CBO	48.4	48.8	49.0	49.0	48.9	48.9	48.8
Administration	48.4	48.4	48.3	48.3	48.4	48.5	48.4
<b>Other personal income<sup>g</sup></b>							
CBO	36.1	36.1	36.4	36.7	37.0	37.4	37.7
Administration	36.1	36.1	36.2	36.3	36.4	36.6	36.7
<b>Corporate profits<sup>h</sup></b>							
CBO	7.0	7.0	6.6	6.4	6.3	6.2	6.1
Administration	7.0	7.5	7.5	7.4	7.2	7.1	7.1

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

d. The Bureau of Labor Statistics changed the unemployment survey in January 1994. The CBO and Administration forecasts for 1994 through 1999 originally used 1993 methodology. The forecast tables reported here have been adjusted upward 0.4 percentage points to make the forecasts comparable with currently published figures. Data for 1993, shown in italics, use pre-1994 methodology.

e. CBO and *Blue Chip* project the secondary market rate for three-month Treasury bills, while OMB projects the auction average rate.

f. The *Blue Chip* does not project a 10-year note rate. The values shown here are based on the *Blue Chip* projection of the Aaa bond rate, adjusted by CBO to reflect the estimated spread between Aaa bonds and 10-year Treasury notes.

g. Personal income less wage and salary disbursements.

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

The recent behavior of long-term interest rates, however, may indicate that financial markets anticipate more rapid acceleration of inflation than the Federal Reserve, Administration, and CBO forecasts indicate. Ten-year Treasury note rates, which averaged below 5.8 percent during January, rose to roughly 7 percent by early April. Inflationary expectations have probably been building since late last year. As previously mentioned, the data for the fourth quarter of 1993 and the first quarter of 1994 indicate that the economy is stronger than previ-

ously anticipated, despite severe winter weather. In addition, commodity price indexes have been rising steadily. This information increases the possibility that, by 1995, the economy will approach the point at which significant supply bottlenecks will appear. Inflation, it is feared, could then jump into the 4 percent to 5 percent range, just as it did in 1989.

Several factors indicate that inflation is likely to remain low in the near term, however. Oil prices in the first quarter of 1994 are about 10 percent lower

than they were in the last half of 1993. Lower oil prices will dampen the rise in input prices and contain price pressures in finished goods. Moreover, although fourth-quarter growth moved the economy closer to the limits of its capacity, CBO estimates that the GDP gap, a summary measure of the degree of excess capacity, will remain large enough to keep inflation steady even though economic growth remains close to 3 percent.<sup>5</sup> In addition, CBO expects that there will be enough slack in the labor markets during the forecast period to keep unit labor costs--compensation growth adjusted for productivity gains--from rising rapidly. Furthermore, it is likely that more people will choose to enter the labor force as employment continues to grow. Faster growth of the labor force will slow the decline in the unemployment rate and curtail inflationary pressures from the labor market. Last, low inflation abroad will help to restrain U.S. inflation by keeping prices of imported goods low and holding down domestic price increases for U.S. goods.

Apart from inflationary expectations, other factors probably played a role in the rise in long-term rates. Long-term interest rates rose in early February against the backdrop of a monetary policy move by the Federal Reserve. The Federal Reserve's policy was apparently designed to dampen inflation expectations and long-term rates, but in fact, 10-year rates rose about three-fourths of a percentage point in almost two months after the policy action. The further increase in rates by the Federal Reserve in late March did little to allay these expectations.

At the same time, there has been a surge in long-term interest rates in Europe and Japan in 1994, even though economic conditions there differ from those in the United States. Some financial market analysts suggest that this unexpected behavior in the bond markets could have been the result of a massive sell-off by U.S. investors who originally invested abroad to capture higher yields when U.S. rates were low. Other analysts believe that some combination of economic uncertainties and

political tensions created uneasiness that resulted in the sell-off. Among the contributing factors were rapid growth in the German money supply; uncertainty about U.S. inflation and future Federal Reserve actions; the debt-financed fiscal stimulus in Japan that is expected to put upward pressure on long-term rates; trade frictions between the United States and Japan; and political uncertainties in Mexico, North Korea, China, and Russia.

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## Medium-Term Projections

The Administration and CBO outlooks for real GDP growth and unemployment are virtually identical for the 1996-1999 period.<sup>6</sup> Both forecasts indicate that real GDP will grow at an average annual rate of about 2.6 percent, while unemployment is expected to decline only slightly from the levels forecast for 1995 (see Table 9 and Figure 1).

The significant differences in the medium-term projections lie in the outlook for inflation-adjusted interest rates. CBO predicts that inflation will average 3.1 percent over the 1996-1999 period, and the Administration projects that inflation will average 3.4 percent. CBO's interest rate projections, by contrast, are about 0.4 percentage points higher than those of the Administration. Consequently, the Administration's projections for interest rates, adjusted for inflation, are significantly lower than CBO's projections, which tends to lower the estimated deficits for the medium term. If the Administration projected higher nominal interest rates--high enough to result in inflation-adjusted rates similar to those projected by CBO--its deficit projections would be more than \$20 billion greater by 1999.

## Interest Rates Adjusted for Inflation

Real short-term rates, approximated by the difference between the three-month Treasury bill rate and the average annual growth in the consumer price

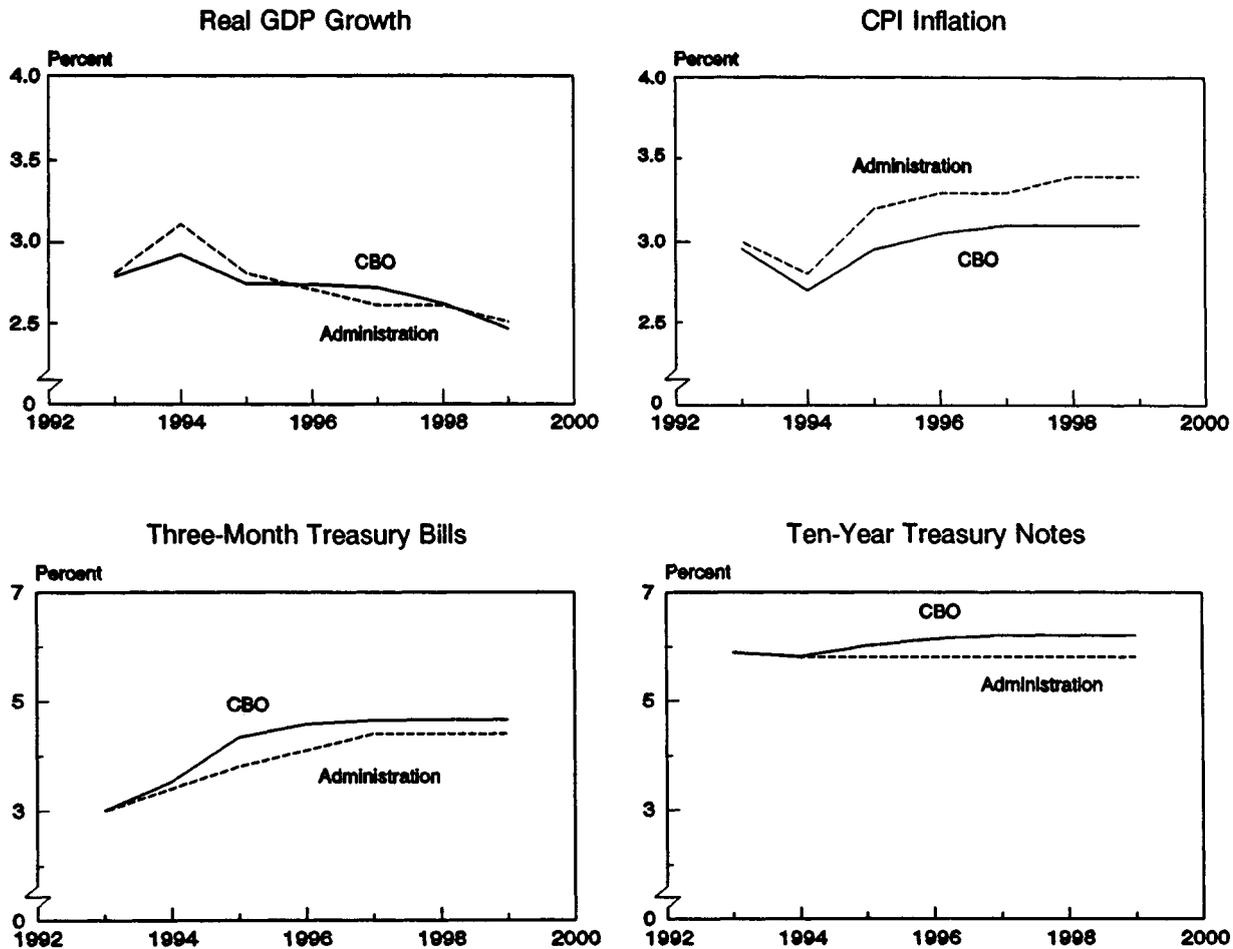
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5. It should be noted, however, that estimates of the GDP gap are highly uncertain. See Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1995-1999*, pp. 17-20.

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6. The medium-term projections of CBO, the Administration, and the *Blue Chip* consensus do not attempt to forecast cyclical fluctuations beyond 1995. These projections are based on long-run trends extrapolated from recent developments.

**Figure 1.**  
**Comparison of Congressional Budget Office and Administration**  
**Economic Assumptions**



SOURCES: Congressional Budget Office; Office of Management and Budget.

NOTE: GDP = gross domestic product; CPI = consumer price index for all urban consumers.

index over the following quarter, are relatively low and widely expected to rise. Neither CBO nor the Administration, however, expects real short-term rates to rise to the heights that prevailed in the mid-1980s. CBO estimates that real short-term rates will be 0.6 percentage points higher in the 1998-1999 period than the Administration's estimate.

Several factors suggest that short-term real rates will generally be higher in the next decade than they were during the 1953-1982 period when they

averaged 1 percent (see Figure 2).<sup>7</sup> Most important, despite the progress in deficit reduction embodied in OBRA-93 and the President's budget, the deficit will still bulk larger in relation to GDP than it did in the 1950s, 1960s, and 1970s. In those years, the total federal deficit averaged just 1.1 percent of GDP, but by both CBO's and the Administration's

7. This period is chosen for reference in order to facilitate comparison with the discussion of inflation-adjusted interest rates in the *Economic Report of the President* (February 1994), p. 81.

projections, the deficit will average 2.5 percent of GDP over the next six years. The higher federal borrowing comes, moreover, out of a domestic capital pool that reflects substantially lower private saving. Gross saving by businesses and households averaged 17.3 percent of GDP between 1953 and 1982, but fell sharply in the mid-1980s and has recently been averaging about 15.8 percent of GDP. The continued high level of government borrowing, combined with low private saving, suggests some upward pressure on interest rates compared with the 1953-1982 period.

Some analysts note, however, that since the United States operates in an international capital market, its interest rates can be dampened by international sources of financing. On examination, this offset is unlikely to be large. World interest rates are likely to be substantially higher in the mid-1990s, when the European countries and Japan are likely to have recovered from their current economic difficulties. CBO has long anticipated that world capital demands, driven by development needs in Germany, Eastern Europe, and the former Soviet Union, are likely to increase. The North American Free Trade Agreement is also likely to encourage capital investment in Mexico, although

this demand will be small in relation to the size of the world capital market.

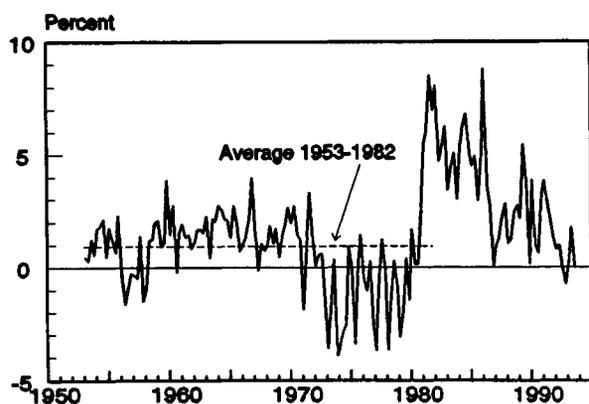
None of these factors are easily quantifiable, but all point to higher interest rates (in relation to inflation) in the 1990s than in the 1953-1982 period. Moreover, this earlier time period may be somewhat misleading as a standard of comparison; it includes a substantial period in the 1970s when real short-term interest rates fell below zero--the result of a combination of stimulative monetary policy and inflation that frequently exceeded expectations (see Figure 2). Few analysts would expect a return to such an extended period of negative real rates when the economy is expanding, and even fewer would advocate it. A more prudent projection, therefore, would set real short-term rates at a level somewhat above those prevailing in the 1953-1970 period, when real rates on short-term Treasury bills averaged 1.3 percent.

## Labor Productivity and Unit Labor Costs

The medium-term projections of CBO and the Administration for labor productivity growth are virtually identical, a major reason for the similarity of real growth projections (see Table 10). Accelerating from the 1970s and 1980s, productivity will grow at an average annual rate of 1.4 percent from the third quarter of 1990 to the fourth quarter of 1999, according to CBO's projections, and will return to its long-term trend. This rate of growth is associated in part with a surge in investment in plant and equipment that CBO believes will be the wellspring of economic growth for the next few years. Investment will be stimulated primarily by corporate restructuring and the need to innovate. Besides the gains in manufacturing, recent anecdotal evidence suggests that accelerating investment will enhance productivity in services such as communications, insurance, banking, and finance.

Many economists believe that gains in productivity have held inflation in check during the past two years. An increase in the growth of productivity, given wage growth, implies a smaller rise in unit labor costs; because unit labor costs account for approximately two-thirds of total production ex-

**Figure 2.**  
Quarterly Real Short-Term Interest Rates



SOURCE: Congressional Budget Office.

NOTE: The real short-term rate equals the three-month Treasury bill rate minus the next quarter's consumer price index.

**Table 10.**  
**Growth in Labor Productivity in the Nonfarm Business Sector (In percent)**

Period	Average Annual Growth Rate
<b>Actual Growth</b>	
1960:II to 1973:IV	2.3
1973:IV to 1981:III	0.6
1981:III to 1990:III	0.9
1960:II to 1990:III	1.5
<b>Projected Growth: 1990:III to 1999:IV</b>	
Congressional Budget Office	1.4
Administration	1.5

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

NOTE: 1960:II, 1973:IV, 1981:III, and 1990:III are National Bureau of Economic Research cyclical peaks.

penses in the United States, they can help hold down price pressures in the economy. Although total compensation per hour (wages, salaries, and benefits) grew by 3.6 percent in 1993, unit labor costs grew by only 2.1 percent because of the offsetting gain of 1.6 percent in productivity growth.

## Economic Implications of Health Care Reform

The Administration's health care reform proposal was not accounted for in either CBO or Administration economic projections. CBO believes that the main effect on the economy during the next few years could come from the proposal's excise tax on cigarettes and other tobacco products, applied in the fourth quarter of 1994. The tax could cause a one-time increase in the level of the consumer price in-

dex of approximately 0.6 percent, temporarily raising inflation. Although the Administration's economic projections generally predict higher inflation than those of CBO, the effect of this tax increase does not appear in the Administration's forecast for 1995.

Additional effects that could have an impact on the total economy as early as 1996 are difficult to quantify. Eventually, the proposal would cut total business spending on health insurance, but the effects would be uneven and some firms would face cost increases.<sup>8</sup> Since the firms that face cost increases might not be able to reduce the nominal wages of their workers, their prices could be slightly higher for a time. Moreover, the incentives of the plan would encourage some workers to leave the labor force. This reduction in labor supply would reduce actual and potential output over the longer term, but only by very small amounts. In CBO's best judgment, the net effects of the Administration's health plan on the economic projections are small. Thus, the projections over the medium term will not be materially affected.

## Effect of CBO's Economic Projections on the Administration's Budget

Other economic assumptions can have a significant impact on budget deficit projections. When CBO's economic assumptions are substituted for those of the Administration, the estimated deficits are increased in every year except 1994 (see Table 11).

The difference between the CBO and Administration deficit projections is primarily the result of disparities in inflation and interest rate assumptions. CBO's lower inflation forecast decreases taxable incomes and tax revenues. Moreover, lower inflation projections decrease outlays for benefits that are influenced by cost-of-living adjustments. These inflation effects do not offset each other, however.

8. See Congressional Budget Office, *An Analysis of the Administration's Health Proposal* (February 1994).

CBO's higher interest rate projections result in a net increase in outlays from higher interest costs in financing government expenditures and servicing the

debt. The combination of lower receipts and higher outlays, therefore, adds \$99 billion to the deficits over the 1994-1999 period.

**Table 11.**  
**Effects of CBO's Economic Projections on Estimates of the Administration's Budget (Differences by fiscal year, in billions of dollars)**

	1994	1995	1996	1997	1998	1999	Cumulative Six-Year Change
Revenues <sup>a</sup>	-1	1	5	12	22	34	73
Outlays							
Benefit programs	-1	-1	-2	-3	-4	-6	-16
Net interest							
Due to higher interest rates	-1	1	6	8	9	11	34
Due to additional debt- service costs	<u>b</u>	<u>b</u>	<u>b</u>	<u>1</u>	<u>2</u>	<u>4</u>	<u>8</u>
Total	-2	b	5	5	7	10	26
Deficit	-2	1	10	17	29	43	99

SOURCE: Congressional Budget Office.

a. Revenue losses are shown as positive because they increase the deficit.

b. Less than \$500 million.

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# The Administration's Defense Budget

**T**he budget request for 1995 represents the Clinton Administration's effort to match financial resources with its strategy for national security in the post-Cold War world. It comes on the heels of former Defense Secretary Les Aspin's Bottom-Up Review of force requirements. To fund that force, the Administration's defense budget calls for appropriations totaling \$264 billion for 1995. Outlays in 1995 would total about \$272 billion--an amount that exceeds the appropriation request because much of the outlay total reflects past appropriations that have been at higher levels.

Most of the transition to the lower force levels of the Bottom-Up Review will be accomplished by 1996 when the force will consist of 1,496,000 active-duty troops, declining to 1,453,000 in 1999. In nominal terms, budget authority would bottom out at \$253 billion in 1997 before returning to a level of \$266 billion in 1999--which is about 10 percent lower than in 1995 after adjusting for inflation. Outlays would level off at about \$257 billion for the three years from 1997 through 1999, again reflecting the pattern of budget authority in previous years.

The current budget plan has two clear risks: that inflation will be higher than planned and that anticipated savings from base closings and other cuts in infrastructure will not materialize. Moreover, the defense budget contains reductions in budget authority and outlays that remain to be specified in future budgets.

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## Priorities in the Current Request

The Administration points to readiness as its top priority in the defense budget, and it also assigns a high priority to science and technology programs designed to keep the qualitative advantage enjoyed by U.S. weaponry. Consequently, operation and maintenance (O&M) and research, development, test, and evaluation (RDT&E) are the only major portions of the defense budget receiving more money than is needed to cover the costs of inflation in 1995. After 1995, the plan calls for substantial increases in funding for weapons purchases.

## Maintaining Readiness

Readiness is a term reserved for programs that contribute to the immediate effectiveness of weapons and forces.<sup>1</sup> It involves such activities as the training provided to individuals and units as well as the resources committed to keeping existing weapons in working order. The O&M accounts incur most of these costs, but O&M is not synonymous with readiness. For example, building maintenance

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1. For more information, see Congressional Budget Office, "Trends in Selected Indicators of Military Readiness, 1980 Through 1993," CBO Paper (March 1994).

and environmental programs do not contribute to readiness despite their overall value. Nevertheless, the Administration strives to enhance readiness through its budget for 1995 by requesting \$3.3 billion, or about 4 percent, more in real terms than the 1994 budget for O&M programs.

As shown in Table 12, the growth in O&M funding would come to a halt in 1996. In fact, these accounts would suffer real declines through 1999, since nominal funding is nearly frozen through 1998 and grows a bit more in 1999, but by less than the expected costs of inflation. The Administration does not expect this funding restraint in

O&M to cause any shortfall in readiness as measured by the time military forces spend using or maintaining their equipment. Rather, the Administration expects to achieve substantial savings from cutting forces, closing bases, and reducing other elements of the Department of Defense's (DoD's) infrastructure funded through O&M accounts.

## Technological Superiority

The fortunes of the Defense Department's RDT&E accounts generally indicate the priority given to improving the overall quality of U.S. weaponry. In

**Table 12.**  
**The President's Budget for National Defense for the 1995-1999 Period as Estimated by CBO (By fiscal year, in billions of dollars)**

Discretionary Account	1994	1995	1996	1997	1998	1999
<b>Budget Authority</b>						
Military Personnel	70.8	70.5	66.2	65.7	66.1	67.3
Operation and Maintenance	88.0	92.9	88.0	88.0	88.5	90.6
Procurement	44.5	43.3	48.4	49.8	57.1	60.1
RDT&E	34.8	36.2	34.8	32.1	30.9	30.2
Other Discretionary Programs	23.6	21.5	24.9	22.3	21.6	20.7
Future Adjustments	<u>0</u>	<u>0</u>	<u>-6.4</u>	<u>-5.4</u>	<u>-5.0</u>	<u>-3.3</u>
President's 1995 Budget as Estimated by CBO	261.5	264.3	255.9	252.6	259.2	265.7
<b>Outlays</b>						
Military Personnel	71.0	70.3	66.2	65.5	65.9	67.0
Operation and Maintenance	88.3	88.4	88.4	87.6	87.9	89.6
Procurement	60.8	55.1	49.3	48.7	49.9	52.8
RDT&E	35.5	36.1	35.2	33.4	31.7	30.6
Other Discretionary Programs	24.2	21.8	22.3	22.8	23.1	23.2
Future Adjustments	<u>0</u>	<u>0</u>	<u>0.2</u>	<u>-1.0</u>	<u>-1.4</u>	<u>-5.1</u>
President's 1995 Budget as Estimated by CBO	279.8	271.7	261.6	257.0	257.1	258.1

SOURCE: Congressional Budget Office.

NOTE: RDT&E = research, development, test, and evaluation.

1995, total growth in RDT&E funding would outpace inflation by about \$0.5 billion, or slightly more than 1 percent. This increase is about evenly split between pure science and technology and research into ballistic missile defenses (BMD); both programs would receive \$0.3 billion more than is necessary to cover inflation--about 4 percent in real growth for science and technology and about 11 percent for BMD. Funding for all other RDT&E programs would suffer a real decline of about 1 percent in 1995.

Like O&M funding, the relative priority enjoyed by RDT&E accounts would erode in 1996 and every year through 1999. By 1999, funding would total \$30.2 billion, or 25 percent less in real terms than the \$34.8 billion provided for 1994. By 1999, the change in emphasis within total RDT&E funding would be more dramatic; science and technology programs would continue to receive 4 percent more than the inflation-adjusted 1994 level, while BMD would be 5 percent lower, and all other RDT&E would be 36 percent lower.

## Purchases of Weapons

The budget for purchases of new weapons dips in 1995 for the 10th straight year, but it recovers in 1996 and exceeds the inflation-adjusted 1994 level by \$9 billion in 1999. As the number of divisions, ships, and air wings has fallen, DoD has had more weapons than it needs for post-Cold War threats. Consequently, it can defer purchases of new equipment. The Administration's plan would replace obsolete equipment selectively. The modernization program is most evident in the plan for aircraft procurement for the Navy and Air Force, shipbuilding, Air Force space programs, and upgrades to Abrams tanks.

The procurement budget also aims at preserving the industrial capacity of the United States to produce critical items. The Administration cites the capability to produce nuclear-powered ships in its request to use \$3.7 billion to build an aircraft carrier; it also wants \$3 billion through 1999 for 19 cargo ships in further recognition of industrial as well as mobility needs. Other critical items for which production capabilities would be preserved

include tracked combat vehicles, such as Bradley Fighting Vehicles and Abrams tanks, and ammunition.

## Procurement Reform

The Administration's overall budget anticipates savings of \$0.7 billion in 1995 and \$3 billion a year by 1999 from changing the way the federal government buys things. Drawing on the National Performance Review led by Vice President Gore, the Administration seeks to "reinvent" federal procurement practices, which affect the Defense Department far more than any other agency and almost as much as the rest of the government combined. Nevertheless, the original budget request did not show savings for any particular agency; rather, the amounts that the Administration expects to save from procurement reform are left undistributed in a consolidated account in function 920. Recently, however, the Administration indicated that procurement reform would lower its request for DoD by \$315 million. The amendment for 1995 distributes to DoD almost 45 percent of the expected savings and suggests that in 1999 DoD's budget authority could be about \$1.4 billion lower.

Still, the budgetary effects of procurement reform are most uncertain. The Congressional Budget Office is unable to estimate the savings from recent and wide-ranging proposals to change laws affecting government contracts, including negotiations, administration, reporting, and product development. Clearly, changes that lead to greater use of commercial items (in contrast to items designed to federal specifications) and to less onerous demands on the accounting systems of contractors would offer budgetary savings. The amount of savings, however, has escaped objective measurement by the Congressional Budget Office and other institutions.

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## The Risk of Higher Inflation

Inflation stands as the most obvious threat to the viability of the current defense budget and the

forces it would support. A year ago, the Administration and CBO projected that inflation over the 1995-1999 period would average about 2.2 percent. Now, both expect inflation as measured by the implicit GDP deflator to be a bit higher over that period--2.5 percent a year for the CBO forecast and 3.0 percent a year for the Administration's (see Table 13). The cost to defense programs of the Administration's new inflation forecast is about \$20 billion over the five years.

Yet despite the new estimates of inflation, the Administration has held its total defense budget down instead of revising a real program that may have to be further revised each year as the inflation projections change. Not using the new assumptions now has a cost to programs in 1995, but fortunately the first year's cost is relatively small--about \$0.4 billion.

Federal pay policies pose another price-related risk to the DoD budget. Last year, the Administration proposed to freeze federal salaries--both military and civilian--in 1994 and to reduce the future rates of increase relative to current law. The Congress, however, insisted that pay not be frozen in 1994, forcing other defense programs to bear the

costs--about \$1.8 billion in 1994 and more than \$2 billion a year thereafter.

A similar risk looms for 1995 through 1999 as the Administration proposes to hold military and civilian pay raises below those called for under current law (see Table 14). DoD's budget includes just enough money to provide its employees with an across-the-board pay raise equal to the change in the employment cost index less 1.5 percentage points. That amount is less than what current law provides for across-the-board raises by 1 full percentage point each year.

Moreover, as discussed in Chapter 1, current law holds that civilian employees receive locality-based raises designed to close the gap gradually between federal and nonfederal salary levels. The Administration's budget includes funds for salary growth, but does not distinguish between across-the-board and locality pay raises. If the Congress adheres to current law only on across-the-board pay raises, then DoD would need about \$13.9 billion more. Adhering to current law also on locality pay would add another \$12.1 billion. If the additional funding was not available, DoD would have to cut back on other expenses.

**Table 13.**  
**Estimated Increases in the GDP Deflator (By fiscal year, in percentage change)**

	1995	1996	1997	1998	1999
Administration and CBO Estimates of a Year Ago	2.3	2.3	2.2	2.2	n.a.
Current CBO Estimates	2.7	2.6	2.5	2.5	2.5
Current Administration Estimates	2.8	2.9	3.0	3.0	3.0

SOURCES: Congressional Budget Office and the Department of Defense.

NOTE: n.a. = not available.

## The Risk of Not Cutting Infrastructure

The second risk to the Administration's plan is that DoD will not be able to reduce its infrastructure as quickly as it is planning. Funding to meet infrastructure costs are found mostly in the O&M accounts, where most readiness activities are also funded. Infrastructure costs for this purpose are defined as the costs of bases and other support activities that do not change as force levels change, much as business overhead does not readily change with the volume of sales.

Failure to realize the expected savings in infrastructure may threaten funding for readiness. For example, each year the Congress promotes readiness by funding force operating tempos (optempo) such

as flying hours for aircraft and steaming days for ships. In the Army, optempo is often expressed in terms of how many miles each tank could be driven, and for 1994 the Congress funded an optempo of 800 miles per tank. Nevertheless, other demands on its funding within the O&M account have forced the Army to cut its tank use to 620 miles. The plan for the 1995-1999 period calls for returning to 800 miles a tank a year, but that plan, like the 1994 plan, could be jeopardized by a failure to reduce infrastructure that causes the Army to restrict optempo.

How much are the expected savings? In 1999, the Administration's estimate for O&M falls short of the 1994 level by about \$10 billion in real terms. The force reductions of the Bottom-Up Review explain about half of this reduction, and the remainder can be attributed to expected savings in infrastructure.

**Table 14.**  
**Estimated Pay Raises for Military and Civilian Employees (By fiscal year, in percentage change)**

	1995	1996	1997	1998	1999
<b>Across-the-Board Pay Raises for Military Personnel</b>					
Current Administration Policy	1.6	2.2	2.5	2.5	2.5
Current Law					
CBO estimates	2.6	3.0	3.2	3.0	2.8
Administration estimates	2.6	3.2	3.5	3.5	3.5
<b>Across-the-Board and Locality Pay Raises for DoD Civilians</b>					
Current Administration Policy	1.6	2.2	2.5	2.5	2.5
Current Law					
CBO estimates <sup>a</sup>	4.7	4.9	5.2	5.1	5.0
Administration estimates	n.a.	n.a.	n.a.	n.a.	n.a.

SOURCES: Congressional Budget Office and the Department of Defense.

NOTE: n.a. = not available.

a. These figures are weighted averages for various locations and employee categories.

Can the Defense Department find these savings? The evidence is mixed. DoD is now conducting the first three of four rounds of base closings. For the first two rounds, DoD is realizing O&M savings that overall are about 15 percent less than it estimated near the beginning of each round (the first round is saving more than expected, but the second round is saving less). The one-time costs of closing bases, borne elsewhere in DoD's budget, are running higher than expected. The jury is still out for both rounds, and the final results could be better or worse. Yet the first two rounds of base closures clearly demonstrate the uncertainty over savings estimates. Perhaps the Administration will pursue rounds three and four more vigorously and achieve greater savings sooner, but even then the savings offered by base closures alone may be insufficient to meet DoD's goals for infrastructure.

Whether the bases are closed or not, the effect on the budget may be much the same if DoD can lower its civilian payroll. Savings in O&M from closing bases stem primarily from lower employment of civilians (about one out of four DoD civilians works in a base support function.) In 1999, DoD would employ 129,000 fewer civilians than in 1994, and about 80,000 of these may serve in positions related to bases and other infrastructure, the rest being attributable to force reductions. Moreover, DoD's plan calls for achieving nearly 40 percent of the total cut projected for 1999--about 50,000 people--in 1995.

Recent experience suggests that DoD may be able to reduce its payroll as planned; in 1993, its payroll fell by nearly 70,000 civilians. If attrition alone is an inadequate device for managing the work force in terms of skills, hierarchy, and involuntary job loss, then DoD may also use separation incentives through 1997 to meet its goals.

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## Future Adjustments to the Defense Budget

The five-year plan for the defense budget actually exceeds what the Administration has pegged as the Pentagon's slice of the fiscal pie except for what it

calls "future adjustments." DoD's financial blueprint, which is shown in Table 12, calls for unspecified reductions of \$20.1 billion in budget authority and \$7.3 billion in outlays in the four years from 1996 through 1999.

The amount of budget authority approximates the total funding necessary to cover the change in inflation estimates, but the adjustments would occur in the wrong years. The difference in inflation assumptions would start out small in 1996 at about \$2 billion in budget authority and grow to about \$7.5 billion in 1999, as the costs of the assumptions of higher prices cumulate. By contrast, the Administration's "future adjustments" to budget authority start at \$6.4 billion in 1996 and dwindle to \$3.3 billion in 1999. Clearly, the future adjustments to budget authority indicate funding problems beyond the question of inflation estimates.

The future adjustments that the Administration expects to make to outlays show an apparent imbalance with the future adjustments to budget authority. First, the reduction in 1996 budget authority is paired with a slight increase in outlays for that year. Second, by 1998 the reduction in budget authority accumulates to about \$17 billion, while the outlay adjustments add to only \$2 billion for that period--an abnormally low number.

How will these future adjustments affect current priorities if the Administration adheres to its totals in budget authority and outlays for DoD? First, the increases in budget authority planned for weapons procurement could be cut back, with the effect of retarding plans to equip forces with new weaponry and sustain DoD's industrial base. But even then, there would still be room for programs generating immediate outlays such as O&M and RDT&E. By trading slow-spending budget authority for fast-spending budget authority, both targets can be met. Although weapons purchases could tumble by as much as \$30 billion through 1999, more money could be available for readiness and technology programs funded in O&M and RDT&E, which could increase by \$12 billion and \$2 billion, respectively, over the five years. Alternatively, the cuts in procurement could lead to higher pay raises for military and civilian employees if the Congress chose to continue with current law.