CHAPTER IV. THE ECONOMIC OUTLOOK

This chapter presents the CBO short-run forecast for 1983 and 1984 and discusses the uncertainties in it. The chapter also gives medium-term economic projections for 1985-1986 and compares them with both the Administration's latest economic projections and those assumed by the Congress in the first budget resolution for 1984.

A broadbased economic recovery began in the first half of 1983 and is widely expected to continue into next year, with little change in the underlying rate of inflation. The revised CBO forecast shows real gross national product increasing approximately 5.8 percent in 1983 (fourth quarter to fourth quarter), and 4.3 percent in 1984. The civilian unemployment rate is forecast to decline to approximately 8.9 percent by the end of 1983 and to 8.2 percent by late 1984. Prices, as measured by the GNP deflator, are forecast to rise approximately 4.6 percent during 1983 and 5.0 percent in 1984.

The projected upswing is somewhat more rapid than CBO forecast in February, but still below average for the early phases of postwar recoveries. Restrictive credit conditions are expected to contribute to its moderate pace, and the foreign sector is expected to be particularly weak. A major uncertainty in the forecast is the course of interest rates and credit conditions, which in turn significantly depend on the conduct of monetary and fiscal policies.

THE CBO ECONOMIC FORECAST

The CBO economic forecast is based on the following assumptions:

- o It uses budget estimates that reflect the policies of the first concurrent resolution for 1984. Budget outlays are assumed to be $807 billion in fiscal year 1983 and $860 billion to $868 billion in 1984, depending on whether the Congress decides to spend a "reserve fund" for antirecession assistance. (The difference would not have a large effect on the overall economic picture.) Revenues are projected at $600 billion in 1983 and $677 billion in 1984, reflecting tax increases of $12 billion for 1984.

- o In regard to monetary policy, money aggregates are assumed to grow within the target ranges set by the Federal Reserve.

However, if velocity growth deviates sharply from historical experience, CBO assumes that the Federal Reserve will adjust its money targets in an attempt to ensure moderate growth in nominal GNP.

- The price of crude oil is expected to be flat during the forecast period, implying a cost of approximately $29 per barrel through 1984.

- Food prices at retail are assumed to rise only about 2.8 percent this year, and to increase next year at about the same rate as consumer prices in general.

Given these assumptions, the CBO forecast shown in Table 13 may be summarized by using midpoints of the forecast ranges, as follows:

- Real GNP is forecast to increase about 5.8 percent in 1983, on a fourth-quarter-to-fourth-quarter basis, and 4.3 percent in 1984.

- The civilian unemployment rate is forecast to average 9.7 percent in calendar year 1983 and 8.4 percent in 1984.

- Prices, as measured by the GNP implicit price deflator, are forecast to rise about 4.6 percent from the fourth quarter of 1982 to the fourth quarter of 1983 and 5.0 percent in 1984.

- Short-term interest rates, as measured by the three-month Treasury bill rate, are projected to average 8.8 percent in 1983 and 8.6 percent in 1984.

The Anatomy of Continued Recovery

On balance, conditions are favorable for continued moderate recovery during the forecast period, although there are substantial uncertainties. Growth in demand is expected to be quite strong, for several reasons: the almost unprecedented fiscal stimulus; an easing of credit conditions compared with the first half of 1982; and large pent-up demands for housing, autos, and other consumer durable goods. However, high real interest rates are expected to keep the pace of growth somewhat below average for the first two years of a recovery.

The specific sectors accounting for growth are expected to change during the course of the recovery. Earlier this year, the recovery was propelled by a dramatic increase in residential construction, a substantial slowing of inventory drawdown by business, and (in the second quarter) large

TABLE 13. THE CBO FORECAST FOR 1983 AND 1984

	Actual		Forecast	
	1981	1982	1983	1984
Fourth Quarter to Fourth Quarter (percent change)				
Nominal GNP	10.8	2.6	8.6 to 12.6	7.5 to 11.5
Real GNP	2.0	-1.7	4.8 to 6.8	3.3 to 5.3
GNP Implicit Price Deflator	8.7	4.4	3.6 to 5.6	4.0 to 6.0
Consumer Price Index				
Urban consumers a/	9.6	4.5	2.2 to 4.2	3.7 to 5.7
Urban wage and clerical workers	9.4	4.4	2.4 to 4.4	3.7 to 5.7
Calendar Year Average (percent)				
Civilian Unemployment Rate	7.6	9.7	9.2 to 10.2	7.9 to 8.9
3-Month Treasury Bill Rate	14.0	10.6	7.8 to 9.8	7.6 to 9.6

a/ Reflects shift to new concept in 1983, based on the rental equivalent measure for the current housing component. The CPI-W index is scheduled to be based on this new measure in 1985.

increases in consumer spending on durable goods. The contribution from housing and inventories may diminish, but households should continue to be in a very good position to spend. Their real disposable incomes are up sharply, because of the third phase of the tax cut that took effect in July, rising employment, and the moderate pace of price increases. Moreover, household net worth has also increased sharply. Correspondingly, measures of consumer confidence are very high as discussed in Chapter II of this report. In addition, business fixed investment is expected to strengthen in 1984—first equipment, followed by structures. The revival of business investment should be spurred by increases in sales, by an improved profit situation, and by a strong market for corporate equities; moreover, the net effect of the Accelerated Cost Recovery tax program, enacted in 1981, and the Tax Equity and Fiscal Responsibility Act, enacted in 1982, is substantially to reduce business taxes and raise after-tax returns on new business investment.

One major component of final demands, net exports, is expected to be off sharply during the forecast period. The sharp appreciation of the dollar has caused U.S. goods to become much less competitive in world markets, and foreign imports much more attractive. Since the effects of dollar appreciation on trade flows operate with lags, the weakness in net exports is expected to continue into next year.

The civilian unemployment rate is projected to decline gradually to about 8.9 percent late this year and 8.2 percent by late 1984. It will still be very high by historical standards. (Until the recent recession, the highest quarterly unemployment rate in the postwar period had been 8.9 percent in the second quarter of 1975.) Three factors tend to slow the decline in the unemployment rate during recoveries: a cyclical rebound in labor productivity (output per worker hour), increases in the average length of the workweek, and more rapid growth in the labor force in response to improved job prospects.

The Outlook for Prices and Interest Rates

The CBO forecast indicates only a small rise in inflation, notwithstanding two full years of recovery by the end of 1984. The GNP deflator is expected to rise approximately 4½ percent this year, about the same as last year. A slight acceleration is projected in 1984, primarily because some of the factors that have been holding down inflation are expected to be temporary. In particular, food and energy prices are not likely to have such a moderating effect on prices as in the recent past. The appreciation of the dollar in foreign exchange markets helped to hold down inflation temporarily, but many forecasters expect some weakness in the dollar next year that would tend to raise prices of imports and of import-competing goods. Finally, scheduled increases in payroll taxes seem likely to add about 0.3 percentage points to labor costs in 1984.

Prices are expected to behave moderately for three principal reasons. One is that no major supply price shocks seem likely. The world oil supply appears adequate to meet anticipated demand at or near current prices, and capacity is considerably above current levels of production. Very large stocks of grain should help to reduce the effects of recent adverse growing conditions.

A second reason for expecting relatively good price performance is the considerable slack in the economy. The unemployment rate will remain very high through 1984, with a moderating effect on wage increases. Indeed, it is difficult to point to any major categories of labor that seem likely to be in shortage during 1984. Capacity utilization rates, which were exceptionally low at the beginning of the recovery, are expected to rise only gradually during the forecast period. The availability of capacity, plus continued strong competition from abroad in some sectors, should help to slow price increases. 1/ A third reason for expecting moderate price performance is the assumption that the Federal Reserve will rein in money growth.

The CBO forecast shows interest rates drifting down slightly from current levels. The three-month Treasury bill rate, which is currently in the 9-1/4 to 9-3/4 percent range, is projected to average approximately 8½ percent next year. Several factors should help to moderate what otherwise would likely be a rising profile of interest rates associated with strongly rising GNP. One is a considerable improvement in business cash flow, which should help to slow private credit demands in 1984. The forecast also assumes that the deficit-reducing measures in the first budget resolution will be implemented, which should send an important signal to financial markets. Third, money velocity is expected to rebound somewhat for reasons other than higher interest rates, such as the end of the rapid decline in the inflation rate. This would help to allow the money aggregates to expand within their target ranges, without further tightening by the Federal Reserve. Finally, stable price performance should gradually contribute to lower interest rates, particularly long-term rates.

Uncertainties in the Outlook

The outlook for the current recovery is more uncertain than for the typical postwar recovery. Principal reasons include very high real interest rates, government borrowing that is projected to remain very high for a recovery period, and extremely weak net exports stemming from high U.S. interest rates and the strong dollar. 2/

1/ Most analysts also expect that rising productivity should reduce labor cost pressures—though much of the effect of the cyclical recovery in productivity can be expected to go into higher corporate profits rather than lower prices.

2/ These unusual characteristics for a recovery are not unrelated. For example, the high government deficits are being financed in part by inflows of foreign capital, leading to an appreciation of the dollar and the deterioration of net exports.

The single most important uncertainty in the forecast pertains to interest rates, which in turn are critically affected by monetary and fiscal policy. Interest rates could move substantially higher, or lower, than forecast. The combination of large government deficits and expanding private credit demands could produce higher interest rates than forecast. The optimism in the forecast is based on its assumption that the Congress will take steps to reduce the projected size of the deficits. If financial markets do not believe that such actions will be taken, or if such actions are not in fact realized, the result could be strong upward pressures on interest rates. Moreover, monetary policy is faced with the extremely difficult task of providing enough liquidity to sustain recovery, but not at the cost of reigniting inflation in 1985 and 1986. Large government deficits greatly complicate that task, as does the recent perplexing behavior of money velocity. Understandably, financial markets are uneasy in the current circumstances and tend to react strongly to each new piece of information about the speed of the recovery, inflation, and monetary and fiscal policies.

If interest rates were to move sharply higher, they could slow the recovery through several channels. Housing construction would be one of the sectors most adversely affected. A rise in interest rates would also dim consumer optimism, and with it the prospect for auto sales and other durable goods. Business fixed investment, particularly in structures, might also be weakened. Internationally, higher interest rates could exacerbate the debt problems of developing countries, weaken the economic recoveries that are beginning in other industrial countries, and reduce net exports from this country. 3/

Even if interest rates go no higher than projected in the forecast, they could slow the growth in demand more than forecast. There is much uncertainty about this relationship. Some analysts believe that in the early phase of recovery several major categories of spending, such as inventories, are not very sensitive to the level of real interest rates. But as the recovery matures, the impact of high real interest rates on interest-sensitive sectors, such as housing and business fixed investment, becomes much more severe.

To some extent, the uncertainties surrounding interest rates and economic growth may be symmetrical. The rapid growth in money during

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3/ The occurrence of higher interest rates than forecast would not inevitably mean weaker short run growth, since strong demand might be a contributing cause of the higher interest rates. However, the higher interest rates might still be a cause for concern because of their impact on the composition of output and on long-term growth. See the discussion of "crowding out" in Chapter III.

the past year could lead to a surge in economic growth, particularly if there is a snapback in velocity. Interest rates could turn out to be lower than forecast, or their effects on demand less pronounced. For one thing, the precise causes of the recent high interest rates are not well understood and they could prove to be a short-term historical aberration. For another, economists thus far in the current recovery have underestimated the strength of demand in the face of interest rates that seemed very high by historical standards.

Other significant uncertainties have to do with the foreign sector. Developing-country debt problems could lead to a sharp reduction in U.S. exports; or the large appreciation of the dollar could have a more devastating effect on U.S. trade flows than assumed in the forecast.

On the inflation front, the economy approaches a critical testing period. Some analysts question whether or not inflation is likely to remain stable in the 5 percent range during a period of sustained economic recovery at the projected rates. Here there are several imponderables. One is whether wage settlements will continue to be moderate as the recovery progresses. Another is the possible effect of the recent rapid growth in money on inflationary expectations. Still another is whether the Federal Reserve would attempt to rein in money growth at the price of substantially higher interest rates—given, for one thing, the precarious debt situation of several large developing countries such as Brazil and Mexico. If a typical cyclical recovery in velocity were to occur, continued rapid money growth would likely cause higher inflation.

THE ECONOMIC PROJECTIONS THROUGH 1986

While CBO does not forecast economic conditions beyond 1984, it develops noncyclical projections of the economy through 1986. The projections for 1985 and 1986 are based on assumptions about what appear to be attainable improvements in economic conditions. Among the principal assumptions used in making the projections are:

- Food prices (at retail) rise only slightly faster than prices in general.

- Crude oil prices are also projected to rise at about the same rate as prices in general, beginning in 1985.

- Productivity is assumed to trend upward at about 1½ percent a year, though actual productivity is expected to rise above this rate during the cyclical recovery.

TABLE 14. COMPARISON OF ECONOMIC OUTLOOKS (By calendar year)

Economic Variable	1983	1984	1985	1986
GNP (billions of current dollars)				
CBO revised	3,313	3,644	3,972	4,307
Administration revised	3,299	3,636	3,973	4,322
First budget resolution	3,292	3,621	3,948	4,269
CBO February 1983	3,266	3,580	3,903	4,221
Real GNP (percent change, year over year)				
CBO revised	3.1	5.0	4.0	3.5
Administration revised	3.1	5.2	4.2	4.0
First budget resolution	2.8	5.1	4.1	3.7
CBO February 1983	2.1	4.7	4.1	3.7
GNP Implicit Price Deflator (percent change, year over year)				
CBO revised	4.5	4.8	4.8	4.8
Administration revised	4.6	4.8	4.9	4.6
First budget resolution	4.7	4.6	4.7	4.3
CBO February 1983	4.6	4.7	4.7	4.3
CPI-U (percent change, year over year)				
CBO revised	3.2	4.7	4.7	4.7
Administration revised a/	3.1	4.4	4.6	4.6
First budget resolution	3.5	5.0	4.7	4.1
CBO February 1983	4.5	5.0	4.7	4.1
Unemployment Rate (percent, annual average)				
CBO revised	9.7	8.4	7.9	7.5
Administration revised b/	9.9	8.9	8.2	7.5
First budget resolution	10.1	9.3	8.5	7.9
CBO February 1983	10.6	9.8	9.0	8.4
3-Month Treasury Bill Rate (percent, annual average)				
CBO revised	8.8	8.6	7.7	7.4
Administration revised	8.6	8.5	7.8	7.2
First budget resolution	7.8	7.4	7.2	6.6
CBO February 1983	6.8	7.4	7.2	6.6

SOURCES: Conference report on the First Concurrent Resolution on the Budget—Fiscal Year 1984 (accompanying H. Con. Res. 91) reported June 21, 1983; Office of Management and Budget, Mid-Session Review of the 1984 Budget; CBO.

NOTE: The data for 1983 and 1984 represent midpoints of the CBO forecast ranges. The figures for 1985 and 1986 are projections based on assumptions.

a/ The Administration projects the CPI-W, rather than the CPI-U.

b/ The Administration projects the unemployment rate for the total labor force. The other projections in the table pertain to the civilian labor force.

- o Real GNP is assumed to grow 4.0 percent in 1985 and 3.5 percent in 1986 (year-over-year).

These projections implicitly assume that the recovery lasts longer than many postwar recoveries, despite considerable uncertainty over monetary and fiscal policy. There is no guarantee that current tax and spending policies will prove consistent with the path of the economy as shown in the outyear projections. For example, the projections of interest rates may not be consistent with the size of the government deficits estimated on the basis of current budget policies. Similarly, with respect to monetary policy, growth in money aggregates is assumed to slow gradually, but the future course of velocity is highly uncertain. In addition to the level of nominal GNP, the relative shares of income accruing to different economic agents (e.g., individuals and corporations) vary over the business cycle. Between 1983 and 1986, the corporate profits share is expected to continue to rise from the depressed levels of the past year.

The economic projections, shown in Table 14 and Figure 23, can be summarized as follows:

- o Nominal GNP growth is projected to decline gradually, from approximately 10 percent in 1984 to 8½ percent in 1986.

- o Economic recovery continues at a moderate and gradually slowing pace.

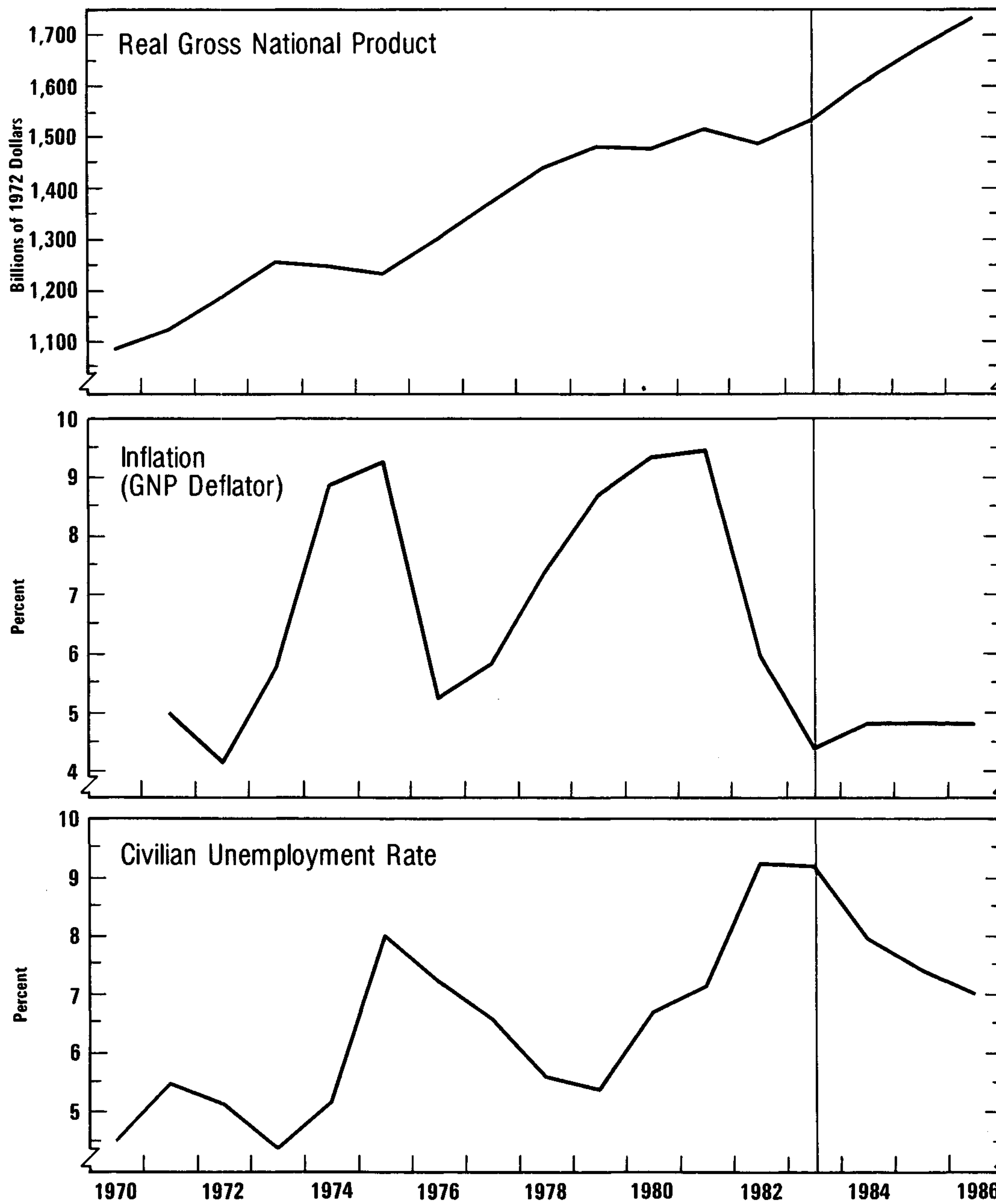
- o The civilian unemployment rate declines gradually to an average of 7.5 percent in 1986.

- o Inflation is fairly flat after edging upward slightly from 1983 to 1984.

- o The three-month Treasury bill rate declines by about 1½ percentage points between 1983 and 1986, implying a modest decline in real interest rates from current lofty levels.

Table 14 also compares CBO's revised economic outlook with three other sets of projections: those prepared by CBO last February, those used for the first budget resolution for 1984, and the Administration's economic assumptions contained in the Mid-Session Review of the 1984 budget. The revised forecast for 1983-1984 is somewhat more optimistic than the forecast CBO prepared last winter. In the new forecast, real growth is about one percentage point higher in 1983, and 0.3 percentage point higher in calendar 1984, while unemployment is roughly one percentage point lower in 1983 and 1½ percentage points lower in 1984. However, the forecast for the

Figure 23.
CBO Economic Projections



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

short-term Treasury bill rate is two percentage points higher for 1983 and about one percentage point higher for 1984, than seen earlier. Looking to the outyears, inflation is slightly higher in 1986 than projected earlier because economic slack has proved to be somewhat lower than expected.

The differences in the three sets of figures--the CBO revised projections, those used for the first concurrent resolution, and the revised Administration's—are quite small and well within the normal margin of error for such projections. Compared with the first resolution assumptions, the CBO revised outlook is somewhat lower for unemployment and higher for short-term interest rates—perhaps in part because the assumptions for the resolution were formulated several months earlier.

CHAPTER V. THE BUDGET OUTLOOK

After some delay and with considerable effort, the Congress adopted in late June a new budget resolution that revised the budget limits for fiscal year 1983 and set revenue and spending targets for 1984-1986. Under the policy assumptions of the resolution, CBO projects that the unified budget deficit would decline from $207 billion in 1983 to around $145 billion in 1986. About the same result would be obtained under the Administration's budget proposals, but the President has proposed more spending for defense programs and less for domestic programs than targeted by the Congressional budget plan.

While the Congress has made considerable progress in passing 1984 appropriation bills, action on the proposed revenue increases and spending reductions that are contained in the resolution reconciliation instructions has been delayed until September. With the budget policy differences between the Congress and the President unresolved, enactment of the deficit reduction measures assumed by the budget resolution is very uncertain. Without enactment of these measures, the unified budget deficit would remain close to $200 billion throughout the next three years. Even with enactment of these measures, however, the annual budget deficits are likely to be $12 to $19 billion higher than projected by the budget resolution, under CBO's latest economic and technical estimating assumptions. Furthermore, with the growing size of the federal debt and the consequent growing share of interest outlays in the budget, the deficit has become very sensitive to interest rates. If interest rates rise above projected levels as the result of increasing pressures on the credit markets, this would add further to the deficits.

CONGRESSIONAL BUDGET PLAN

The First Concurrent Resolution on the Budget for Fiscal Year 1984 that was adopted by the Congress on June 23, 1983, revised the Congressional budget totals for fiscal year 1983 and established new spending and revenue targets for fiscal years 1984, 1985, and 1986. The budget outlook under the policies of the first budget resolution as estimated by the CBO is summarized in Table 15. Under the Congressional budget plan, the unified budget deficit would decline from $207 billion in 1983 to about $145 billion in 1986, a reduction of 30 percent. Relative to GNP, the reduction in the budget deficit would be even greater, dropping from an estimated 6.4 percent in 1983 to about 3.5 percent in 1986.

TABLE 15. THE BUDGET OUTLOOK WITH POLICIES OF THE FIRST BUDGET RESOLUTION FOR FISCAL YEAR 1984
(By fiscal year, in billions of dollars)

	1982 Actual	1983 Estimate	CBO Projection 1984	1985	1986
Unified Budget					
Revenues	618	600	677	748	842
Outlays					
Including reserve fund a/	728	807	868	929	989
Excluding reserve fund	728	807	860	924	986
Deficit					
Including reserve fund a/	111	207	192	180	146
Excluding reserve fund	111	207	183	176	143
Off-Budget Outlays and Deficit	17	16	16	14	14
Total Deficit					
Including reserve fund a/	128	223	208	195	160
Excluding reserve fund	128	223	199	190	156

a/ Reserve fund for new initiatives in domestic programs provided for in the first budget resolution.

The improvement in the deficit outlook would result from considerably lower growth in federal expenditures and higher revenue growth than has been experienced lately. The growth in outlays during 1984-1986 would average 7 percent per year, compared to an average annual growth rate of close to 12 percent during the three preceding years 1981-1983. Outlays as a percentage of GNP would fall from an estimated 25.0 percent in 1983 to around 23.4 percent in 1986. Under the Congressional budget plan, revenues would grow by an average of 12 percent per year during the 1984-1986 period, compared to a 5.3 percent average annual growth between 1980 and 1983. Relative to GNP, revenues would rise from 18.6 percent in 1983 to 19.9 percent in 1986 (see Table 16).

TABLE 16. TRENDS IN REVENUES AND OUTLAYS a/
(By fiscal year, in percent)

	1983	1984	1985	1986
Revenues as a percent of GNP	18.6	19.0	19.2	19.9
Outlays as a percent of GNP				
With reserve fund b/	25.0	24.4	23.9	23.4
Without reserve fund	25.0	24.1	23.8	23.3
Deficit as a percent of GNP				
With reserve fund b/	6.4	5.4	4.6	3.5
Without reserve fund	6.4	5.1	4.5	3.4
Annual growth in revenues	-2.8	12.8	10.5	12.6
Annual growth in outlays				
With reserve fund b/	10.7	7.7	6.9	6.5
Without reserve fund	10.7	6.6	7.5	6.6
Reference: GNP ($ in billions)	3,230	3,562	3,890	4,222

a/ CBO estimates assuming the policies of the first budget resolution.

b/ Reserve fund for new initiatives in domestic programs.

Revenues

The projected rise in revenues during the next three years results mainly from the expected economic recovery. Under current tax laws, and CBO's latest economic assumptions, revenues are projected to grow as a percent of GNP. Between 1983 and 1986, CBO projects that revenues under current tax laws would rise from $600 billion to $796 billion, an annual average of 9.9 percent. The bulk of the projected growth in current law revenues between 1983 and 1986 is in income taxes and social insurance taxes and contributions. Social insurance taxes alone account for nearly one-half of the projected increase in revenues under current tax laws during the next three years. As shown in Table 17, social insurance taxes are projected to increase from $211 billion in 1983 to $300 billion in 1986, an increase of 42 percent over the period. This is due in part to the enactment earlier this year of the Social Security Amendments of 1983 which include future payroll tax increases as one means of solving the Social Security financing problem. Individual and corporate income taxes decline between

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1982 and 1983, but then pick up in 1984. By 1986, individual income taxes are $65 billion higher, and corporate income tax receipts have more than doubled.

TABLE 17. CBO PROJECTIONS OF REVENUES BY SOURCE
(By fiscal year, in billions of dollars)

Major Source	1982 Actual	1983 Estimate	CBO Projections 1984	1985	1986
Individual Income Taxes	298	288	293	324	353
Corporate Income Taxes	49	36	60	68	78
Social Insurance Taxes	201	211	243	272	300
Excise Taxes					
Windfall profit taxes	19	12	8	7	6
Other	17	23	29	31	27
Estate and Gift Taxes	8	6	6	6	5
Customs Duties	9	8	10	10	10
Miscellaneous Receipts					
Federal Reserve earnings	15	15	15	15	15
Other	1	1	1	1	1
Subtotal, Current Law	618	600	665	733	796
Resolution-Proposed Increases	---	---	12	15	46
Total	618	600	677	748	842

The budget resolution also assumes legislative action to increase revenues by $46 billion in 1986, and a total of $73 billion over the 1984-1986 period. These revenue increases were included in the resolution reconciliation instructions to the House Ways and Means Committee and the Senate Finance Committee, and constitute the major part of the deficit reduction policy changes proposed by the budget resolution (see Table 18).

Outlays

The projected deceleration of spending growth during 1984-1986 results primarily from spending reductions enacted in 1981 and 1982, and from projected declines in unemployment and inflation rates. It is also due in part to further policy changes assumed in the latest Congressional budget plan. These changes from CBO's baseline projections for spending are described in the Appendix.

The 1984 budget resolution includes reconciliation instructions to seven House committees and four Senate committees to report legislation to achieve outlay savings totaling $12 billion over the next three years. As shown in Table 4, about half of these savings would be achieved by holding federal employee pay raises to 4 percent annually during 1984-1986 and by changing the effective date for these pay raises from October to January. Approximately one-quarter of the reconciliation spending reductions are assumed to result from delaying the cost-of-living adjustments for federal employee retirement programs and veterans compensation benefits to January, consistent with a similar change made for Social Security benefits in the Social Security Amendments of 1983. The remaining one-quarter of spending reductions assumed for the reconciliation instructions are for savings in the Medicare program and the Small Business Administration's disaster loan program.

TABLE 18. BUDGET RESOLUTION RECONCILIATION INSTRUCTIONS (By fiscal year, in billions of dollars)

	1984	1985	1986	Cumulative 3-Year Total
Revenue Increases	12.0	15.0	46.0	73.0
Spending Reductions a/				
Federal pay raises	-1.4	-2.0	-2.7	-6.0
COLA delays	-0.8	-1.0	-1.6	-3.4
Medicare savings	-0.4	-0.5	-0.8	-1.7
SBA disaster loans	-0.3	-0.5	-0.4	-1.2
Total	-2.8	-3.9	-5.5	-12.3
Deficit Reduction	-14.8	-18.9	-51.5	-85.3

a/ The reconciliation instructions do not specify reductions for specific programs, only amounts to be saved from programs under the jurisdiction of certain committees. The reductions shown here are those assumed for the resolution.

The 1984 budget resolution also provides for nearly $20 billion of spending increases during 1983-1986 for several new initiatives in domestic programs. These increases have been put into a "reserve fund," and would be released upon enactment of authorizing legislation. This reserve fund for domestic programs includes $5.4 billion in outlays for fiscal year 1983 and nearly $14 billion for 1984-1986 (see Table 19). The largest element in the reserve is for an economic recovery program to provide jobs for the long-term unemployed ($8 billion for 1983-1984). Other major elements include a program to provide health insurance benefits for unemployed workers and their families, a program to improve the nation's physical infrastructure, and the extension of federal supplemental compensation benefits for the long-term unemployed. Also included in the reserve are funds for increased benefits or expanded eligibility for food stamps, loan foreclosure relief to farmers, and emergency mortgage foreclosure relief to aid the unemployed. The CBO budget projections do not include any reserve fund outlays for 1983 because the authorizing legislation has not yet been enacted. The budget totals for 1984-1986 under the resolution are projected with and without the reserve fund initiatives, consistent with the conference report on the first budget resolution.

TABLE 19. BUDGET RESOLUTION RESERVE FOR NEW INITIATIVES IN DOMESTIC PROGRAMS (By fiscal year, outlays in billions of dollars)

Program	1983	1984	1985	1986
Economic Recovery Program	4.5	3.5	—	—
Health Insurance for the Unemployed	0.4	2.0	1.6	—
Physical Infrastructure Program	—	0.1	0.8	1.3
Extension of Supplemental Unemployment Benefits	—	1.5	—	—
Other New Initiatives	0.5	1.4	1.0	0.7
Total	5.4	8.5	3.4	2.0

Source: Conference Report on the First Concurrent Resolution on the Budget for Fiscal Year 1984 (H. Con. Res. 91).

Almost half of the projected spending increase under the policies of the budget resolution for 1984-1986 is for national defense programs. The resolution provides for 5 percent real growth in budget authority for national defense in each of the fiscal years 1984-1986. As shown in Table 20, outlays for national defense under the resolution targets are projected to rise from $213 billion in 1983 to $296 billion in 1986, an increase of $83 billion or nearly 40 percent.

TABLE 20. CBO PROJECTIONS OF OUTLAYS BY MAJOR SPENDING CATEGORIES (By fiscal year, in billions of dollars)

Major Spending Categories	1982 Actual	1983 Estimate	CBO Projections 1984	1985	1986
National Defense	187	213	239	266	296
Entitlements and other Mandatory Spending	344	391	389	413	440
Nondefense Discretionary Spending	137	145	158	162	165
Reserve for New Initiatives	—	—	9	3	2
Net Interest	85	89	106	117	126
Offsetting Receipts	-24	-31	-32	-34	-40
Total Budget Outlays with Reserve	728	807	868	929	989
Total Budget Outlays without Reserve	728	807	860	924	986
Off-Budget Federal Entities	17	16	16	14	14
Total Outlays with Reserve	746	823	885	943	1,002
Total Outlays w/o Reserve	746	823	876	938	999

Another major source of outlay growth during the next three years is entitlements and other mandatory spending. These programs include Social Security, Medicare and Medicaid, unemployment benefits, and federal civilian employee retirement benefits; they account for about one-quarter of the projected growth in outlays during 1984-1986. By 1986, outlays for

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entitlements and other mandatory spending programs are projected to reach $440 billion, an increase of $49 billion or 13 percent from the 1983 level of $391 billion.

A third major source of outlay growth is net interest payments. These are projected to rise from $89 billion in 1983 to $126 billion in 1986, an increase of $37 billion or more than 40 percent. The share of the budget allocated to net interest costs would rise from 11 percent in 1983 to 13 percent by 1986. The projected rise in net interest outlays results mainly from growing federal debt levels. Under CBO's projections, the level of federal debt is projected to rise from $1.4 trillion at the end of fiscal year 1983 to $2.1 trillion by the end of 1986 (see Table 21.)

TABLE 21. BUDGET FINANCING AND DEBT OUTSTANDING a/
(By fiscal year, in billions of dollars)

	1982 Actual	1983 Estimate	CBO Projections 1984	1985	1986
Budget Financing					
Unified budget deficit	111	207	192	180	146
Off-budget deficit	17	16	16	14	14
Total	128	223	208	195	160
Means of financing other than borrowing from the public	-7	-10	*	-1	-1
Borrowing from the public	135	213	208	194	159
Debt Outstanding, End of Year					
Held by government agencies	218	244	274	314	363
Held by the public	929	1,143	1,351	1,545	1,704
Total, gross federal debt	1,147	1,387	1,625	1,858	2,067
Debt Subject to Limit, End of Year					
Total debt subject to statutory debt limit	1,143	1,383	1,621	1,854	2,063

* Less than $500 million.

a/ Based on CBO's estimates of the budget under the policies of the 1984 budget resolution, including the reserve fund amounts for 1984-1986.

As a result of the very large projected debt levels for 1984-1986, the sensitivity of the budget estimates to interest rate assumptions has become quite large. Table 22 shows the estimated effects on the federal deficits for 1984-1986 of one-percentage-point higher interest rates for all government securities beginning in October 1983 than projected by CBO for this period. This calculation assumes for illustrative purposes that the change in interest rates is not associated with any other changes in the economic assumptions. It is unlikely, however, that a change in interest rates would occur without changes in other economic variables. If these changes were taken into account, the effects on budget deficits would differ from those shown here.

Higher interest rates primarily affect the costs of new issues of government securities. Thus, the outlay effect of an interest rate change in the economic assumptions shown in Table 22 builds up over time as more and more securities are issued, including the refinancing of previous borrowing. The direct effect of the higher rates would be to add $19 billion to the unified budget deficits for the three-year period. This reflects substantially higher costs of servicing the public debt, offset in part by slightly higher Federal Reserve System earnings returned to the Treasury. The indirect effect of having to finance these higher deficits would be to add another $3 billion.

TABLE 22. THE EFFECT ON BUDGET DEFICITS OF ONE-PERCENTAGE-POINT HIGHER INTEREST RATES (By fiscal year, in billions of dollars)

	1984	1985	1986	Cumulative 3-Year Total
Caused Directly by Higher Interest Rates	3	7	9	19
Caused by Resulting Increase in the Deficit	*	1	2	3
Total	3	8	11	22

* Less than $500 million.