THE ECONOMIC AND BUDGET OUTLOOK:

FISCAL YEARS 1987-1991

The Congress of the United States
Congressional Budget Office

NOTES

Unless otherwise indicated, all years referred to in this report are calendar years.

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

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

The Balanced Budget and Emergency Deficit Control Act of 1985 is also referred to in this volume more briefly as the Balanced Budget Act.

PREFACE

The Congressional Budget Office (CBO) is required by section 202(f) of the Congressional Budget Act of 1974 to submit an annual report on budgetary options to the House and Senate Committees on the Budget. This year, the report is in two parts. This volume, Part I, presents projections of federal revenues and spending that would occur if current laws and policies continued unchanged for the next five years. It also examines the state of the economy and the economic outlook with these budget policies. Part II, *Reducing the Deficit: Spending and Revenue Options*, presents for Congressional consideration a number of broad strategies to reduce projected budget deficits and various specific options for cutting outlays and increasing revenues. In accordance with CBO's mandate to provide objective and impartial analysis, these reports contain no recommendations.

The analysis of the economic outlook presented in Chapter I was prepared by the Fiscal Analysis Division under the direction of William J. Beeman and Jacob S. Dreyer, with the assistance of Robert A. Dennis, Victoria S. Farrell, Douglas R. Hamilton, George R. Iden, Stephen A. Parker, John F. Peterson, Martin A. Regalia, Frederick C. Ribe, Frank S. Russek, Jr., Matthew A. Salomon, John R. Sturrock, Stephan S. Thurman, Lucia S. Foster, Stacy A. Miller, Jeffrey Steger, and Bragi Valgeirsson.

The baseline outlay projections were prepared by the staff of the Budget Analysis Division under the supervision of James L. Blum and C.G. Nuckols. The revenue estimates were prepared by the staff of the Tax Analysis Division under the direction of Rosemary D. Marcuss and Kathleen M. O'Connell with the assistance of Valerie Amerkhail, Neil Fisher, Robert Lucke, Preston Niblack, Linda Radey, and Jan Sundgren. Paul N. Van de Water and Rosemary D. Marcuss were the principal authors of Chapter II and Appendix A. The other appendixes were prepared by David A. Bashore, Paul T. Christy, Andrew F. Haughwout, Richard F. Krop, and Kathy A. Ruffing, who also prepared many of the tables and boxes in Chapter II. James L. Blum wrote Chapter III.

Paul L. Houts supervised the editing and production of the report, assisted by Nancy H. Brooks. Major portions were edited by Francis S. Pierce, Patricia H. Johnston, and Sherry Snyder. Debra M. Blagburn coordinated the preparation of the report. The authors owe special thanks to Dorothy J. Kornegay, Thelma L. Jones, Paula Gatens, Earnestine Miles, and L. Rae Roy, who typed the many drafts. Additional assistance was provided by Kathryn Quattrone.

Rudolph G. Penner
Director

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SUMMARY

The outlook for reducing budget deficits has improved dramatically since last summer, and financial markets have responded with a sharp rally. Although overall economic activity has not yet reacted to these improved financial conditions, the Congressional Budget Office (CBO) expects economic growth to pick up this year.

In 1985, the economy grew at a comparatively low rate of 2.3 percent, well below the substantial gains in the first two calendar years of the current expansion. Growth in productivity came to a halt as employment continued to grow rapidly. The unemployment rate edged down during 1985 and, despite three full years of recovery, the inflation rate remained almost unchanged from the moderate rates attained during the last recession.

Most forecasters, including CBO, anticipate that growth in real gross national product (GNP) will be somewhat faster this year--at about $3\frac{1}{2}$ percent--than it was in 1985. The tremendous rally in financial markets during the second half of 1985 and the sharp decline in the dollar have enhanced the prospects for a pickup in economic activity in 1986. The rise in stock prices and the decline in interest rates will encourage consumer spending and business capital spending, while the decline in the dollar should halt the deterioration in the trade sector. If lower oil prices are sustained, the sharp drop in prices early this year will contribute to growth in economic activity and restrain inflation.

The improvement in financial conditions and the decline in the dollar last year were, at least partially, the result of the dramatic change in the outlook for reducing future budget deficits. The implementation of the Balanced Budget and Emergency Deficit Control Act of 1985 (Public Law 99-177), together with earlier Congressional action, will reverse the recent trend of rising budget deficits. Although a federal district court recently ruled that certain aspects of the Balanced Budget Act are unconstitutional, the deficit targets established by the act still remain in effect. These targets would lower projected deficits from about $208 billion in the current fiscal year to $144 billion in fiscal year 1987, with annual reductions of $36 billion thereafter. The decline in the structural deficit from fiscal year 1986 to 1987 would be about 1.5 percent of potential GNP, the third largest such reduction in fiscal stimulus since the mid-1950s. By itself, such an abrupt shift in fiscal posture could temporarily slow the economic expansion in 1987. But several other factors--including the decline in the dollar, lower interest rates, and the fall in oil prices--are expected to counteract the contractionary effects of the budget shift.

CBO's new baseline budget estimates show much smaller deficits in the 1987-1990 period than the baseline projection of last summer (see Summary Table 1). While the policies of last year's budget resolution were not fully carried out, Congressional action to date has significantly lowered projected defense and nondefense spending. The projected decline in budget

SUMMARY TABLE 1. BASELINE BUDGET PROJECTIONS, DEFICIT TARGETS, AND UNDERLYING ECONOMIC ASSUMPTIONS

	Actual 1985	1986	1987	1988	1989	1990	1991
Budget Projections (By fiscal year, in billions of dollars)							
Baseline Estimates							
Revenues	734	778	844	921	991	1,068	1,144
Outlays	946	986	1,025	1,086	1,135	1,188	1,248
Deficit	212	208	181	165	144	120	104
Deficit Targets	N.A.	a/	144	108	72	36	0
Baseline Less Targets	N.A.	a/	37	57	72	84	104
Economic Assumptions (By calendar year)							
Nominal GNP, percent change	5.8	6.9	7.3	7.6	7.8	7.8	7.5
Real GNP, percent change	2.3	3.2	3.1	3.3	3.5	3.5	3.2
CPI-W, percent change	3.5	3.4	4.2	4.4	4.4	4.3	4.3
Civilian Unemployment Rate	7.2	6.7	6.7	6.5	6.3	6.1	6.0
Three-Month Treasury Bill Rate	7.5	6.8	6.7	6.4	6.1	5.7	5.4

SOURCE: Congressional Budget Office
NOTE: N.A. = not applicable.

a. The Balanced Budget Act set a target of $171.9 billion in fiscal year 1986, but limited the sequestration to $11.7 billion. CBO's fiscal 1986 baseline deficit estimate includes the $11.7 billion sequestration, and therefore the $208.3 billion deficit for that year fulfills the act's requirement.

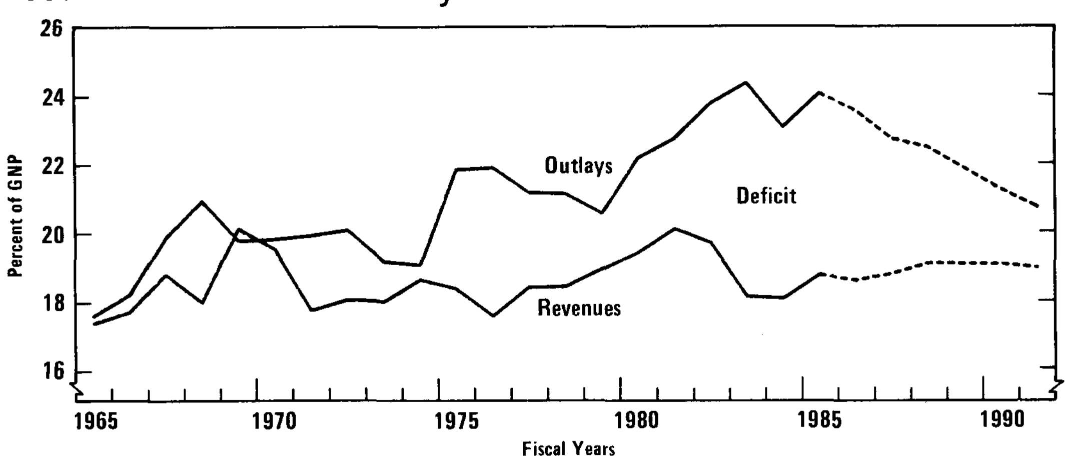
deficits under the policy assumptions of the baseline occurs because revenues are projected to grow in response to both inflation and growth in real incomes, while outlays are projected to grow only slightly faster than the rate of inflation (see Summary Figure 1). The baseline assumes no real growth in defense and nondefense appropriations above a base already cut by the 1986 sequestration called for in the Balanced Budget Act. The additional action needed to comply with the deficit targets amounts to about $37 billion in fiscal year 1987, or $354 billion over the 1987-1991 period.

The sharp decline in long-term interest rates in 1985 seemed to reflect a market expectation of less Treasury borrowing in future years. Sectors of the economy that are interest-sensitive, such as residential construction, already show signs of increased strength. But the major benefit of reduced budget deficits will come, it is generally agreed, in their long-run effects on living standards. Other things being equal, lower deficits should reduce real interest rates and foreign capital inflows, thereby encouraging increased domestic capital formation and reduced foreign indebtedness.

THE ECONOMIC OUTLOOK

The slowing of economic growth in 1985 was largely the result of a reduction in inventory investment. Growth in real final sales was down only

Summary Figure 1.
Baseline Revenues and Outlays



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

slightly from 4.5 percent in 1984 to 4.0 percent in 1985, as weaker household and business spending was partially offset by strengthened government defense purchases and slower deterioration of the trade sector.

At year-end, most indicators began to reflect improving economic conditions. A major exception was net exports, which in December showed sharp further deterioration. But housing starts, retail sales, durable goods orders, employment, capacity utilization, and the overall index of leading indicators all rose sharply. The rally in the stock and bond markets, the decline in the dollar, and the growth of employment are likely to provide a boost to demand in 1986. Moreover, inventories were quite lean at year-end, except for autos, so that increased strength in final sales is likely to be quickly translated into output.

Another development that could have very favorable effects on both inflation and economic growth in the forecast period is the recent drop in oil prices. The CBO forecast was completed in December, before the recent sharp declines. Some decline was assumed in the forecast. By early February, however, short-term futures prices for crude oil were in the $15 to $19 range per barrel--about $6 below the refiners' acquisition cost assumed in CBO's economic projection for mid-1986. Oil prices have been very volatile, however, and some of the decline could be reversed if oil producers agree on a new distribution of output quotas.

The Forecast for 1986 and 1987

The first two years of CBO's baseline economic projections are a "conditional" forecast based on specific policy assumptions:

- The Balanced Budget Act of 1985 is assumed to be fully implemented. The budget deficit is $208.3 billion in fiscal year 1986, well above the $171.9 billion target because the automatic spending cut is limited to $11.7 billion this year. For fiscal year 1987, the forecast assumes that the $144 billion deficit target will be attained.

- The preliminary target ranges for the levels of the narrower monetary aggregates announced last July are assumed to be adjusted somewhat to reflect actual experience through late 1985.

In addition, dollar exchange rates are assumed to decline this year, though less rapidly than in the second half of 1985. Oil prices are assumed to decline about 18 percent from from the last quarter of 1985 to mid-1986, and food prices are assumed to rise less than the general price level.

Given these assumptions, CBO expects inflation-adjusted GNP to grow 3.6 percent in 1986 and 3.0 percent in 1987 on a fourth-quarter-to-fourth-quarter basis (see Summary Table 2). The unemployment rate is projected to remain steady at 6.7 percent through calendar 1987. Inflation is expected to rise gradually in the forecast period. The three-month Treasury bill rate is expected to decline from 7.5 percent in 1985 to 6.7 percent in 1987.

Medium-Term Economic Projections

The projections for 1988-1991 are not a forecast of economic conditions, but assumptions based on average historical experience. Specifically, the growth rate for real GNP from the fourth quarter of 1982 to the fourth quarter of 1991 is assumed to equal the average growth rate in the nine-year periods following earlier postwar recessions. These outyear economic assumptions are not predicated on specific budget policies, and may not be consistent with the budget policies now in place. The major characteristics of the 1988-1991 projections are shown in Summary Figure 2:

- o Real GNP grows moderately at an average rate of approximately 3.4 percent.

- o The unemployment rate declines gradually to 6.0 percent by 1991.

SUMMARY TABLE 2. THE CBO FORECAST (Fourth-quarter-to-fourth-quarter growth rates)

	Actual		Projected	
	1984	1985	1986	1987
Nominal GNP	9.0	5.8	7.6	7.2
Real GNP	4.7	2.5	3.6	3.0
GNP Implicit Price Deflator	4.1	3.2	3.9	4.1
CPI-W	3.6	3.2	3.5	4.5

- Inflation, measured by the CPI-W, holds at about 4.3 percent over the projection period.

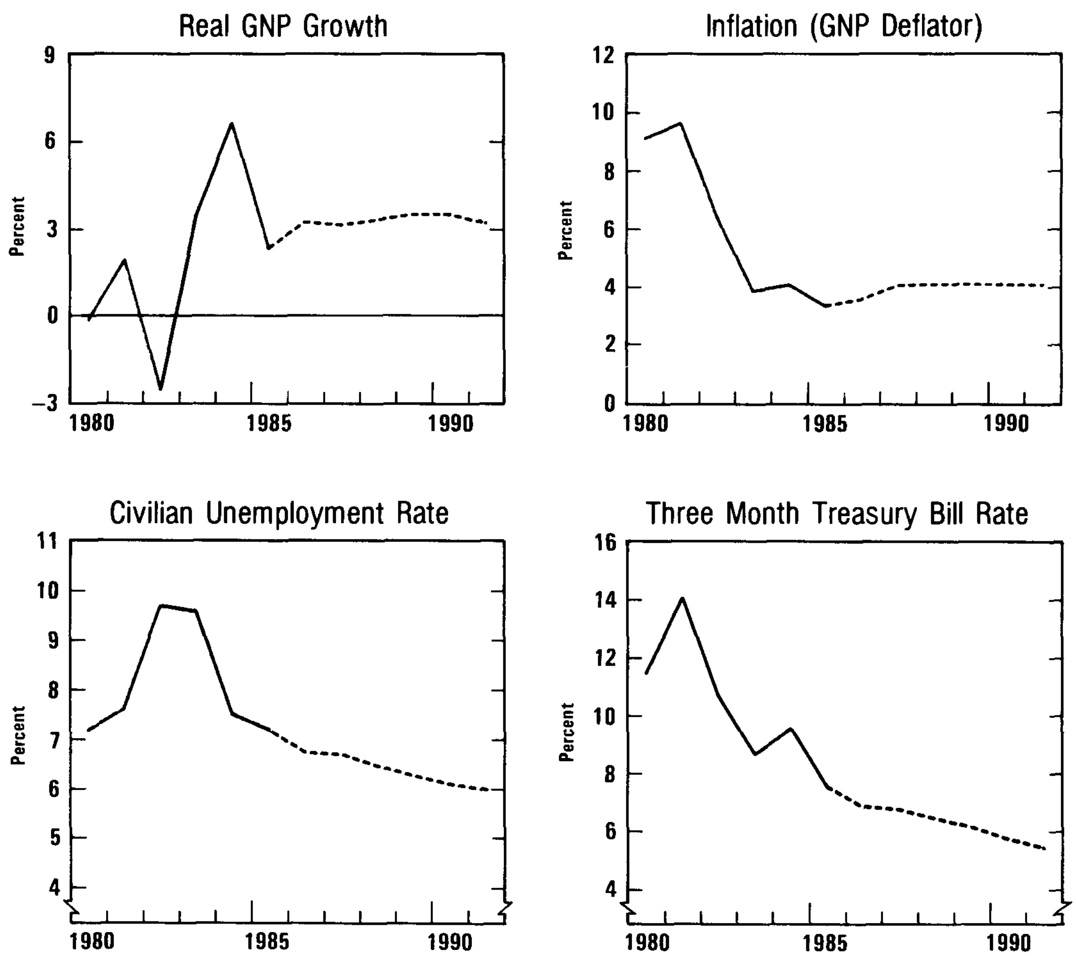
- Interest rates decline in the outyear projection. The three-month Treasury bill rate, for example, declines from 6.7 percent in 1987 to 5.4 percent in 1991.

Uncertainty in the Outlook

The performance of the economy could easily turn out to be much better or worse than CBO projects. The major uncertainties in the near term are

Summary Figure 2.

Major Economic Assumptions



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

related to oil prices, the trade sector, financial conditions, and federal fiscal policy. Should oil prices remain low, inflation could be significantly lower and real output higher than projected by CBO. The recent decline in interest rates has greatly improved the financial status of many financial institutions and reduced the debt-service costs of developing countries. But some countries will be made worse off by the drop in oil prices and some financial institutions still suffer from poor-quality loans. For this reason, a financial crisis that would significantly raise risk premiums and interest costs cannot be ruled out.

Both the future course of the dollar and the response of net exports to the dollar's recent fall are difficult to predict. Some forecasters believe that foreign exporters will try to maintain their market shares by reducing profit margins rather than raising prices, thereby causing a delay in the response of U.S. imports to the depreciation of the dollar. Finally, the Balanced Budget Act may not be fully implemented, especially if constitutional challenges to the act are successful. Moreover, exactly how the deficit targets will be met is unclear. These uncertainties make it difficult to predict the short-run economic consequences of the projected turnaround in fiscal policy.

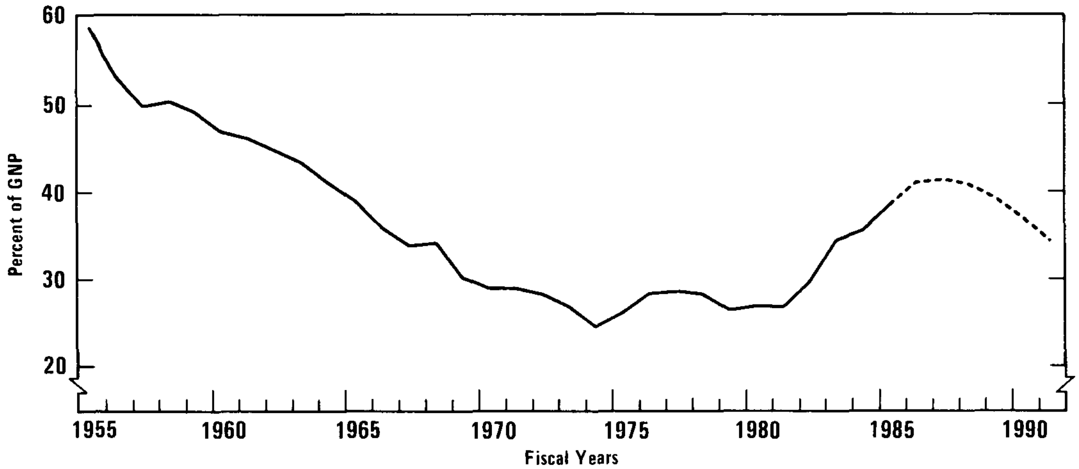
THE BUDGET OUTLOOK

Under CBO's baseline assumptions, which include no real growth in defense or nondefense appropriations, the total federal deficit would fall from $208 billion in 1986 to $181 billion in 1987 and $104 billion in 1991 (see Summary Table 1). The projected decline in baseline deficits parallels the deficit targets in the 1986 budget resolution, but falls increasingly short of the deficit targets in the Balanced Budget Act, which contemplates a zero deficit in 1991.

Over the next five years, revenues are projected to grow on average by 8 percent per year, slightly faster than the assumed average growth of the economy. On the other hand, outlays are projected to rise by an average of 4.8 percent per year, only slightly higher than the assumed rate of inflation. As a result, revenues would remain roughly constant as a percent of GNP, but federal outlays and the deficit would fall, as shown in Summary Figure 1.

The projected decline in budget deficits would slow the growth of federal debt and reduce the government's share of total credit demand. Under CBO's baseline assumptions, publicly held federal debt is projected to grow from $1.7 trillion by the end of 1986 to $2.4 trillion by the end of 1991.

Summary Figure 3.
Federal Debt Held by the Public



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

NOTE: The values shown for the 1986-1991 fiscal years are based on the assumption that the deficit targets of the Balanced Budget Act will be met.

In relation to GNP, debt held by the public would grow from 41.0 percent in 1986 to a peak of 42.7 percent in 1988 and then decline to 40.2 percent by the end of 1991. Of course, the decline in the debt-to-GNP ratio would be sharper if the Balanced Budget Act is implemented (see Summary Figure 3).

Changes in Baseline Projections

The budget outlook under baseline assumptions has changed dramatically from a year ago. In its 1985 annual report, and again in its update report last August, CBO projected that baseline deficits would rise from slightly more than $200 billion in 1985 to almost $300 billion by 1990. The basic change in the deficit outlook in this report has resulted from lower projections for spending, primarily for defense and nondefense discretionary programs and for net interest costs (see Summary Table 3).

CBO's baseline projections of last year assumed that defense appropriations would increase as specified in the 1985 budget resolution (and extended to 1990), at an average rate of 5½ percent in real terms--after