The Outlook for Net Exports. CBO forecasts a gradual turnaround in the foreign trade deficit. The real net export deficit (measured in 1972 prices) should bottom out this year, even though deficits on merchandise trade and on current account will continue to grow in nominal terms. The improvement will not be rapid, however, partly because one component of the current account--net factor income--will continue to decline. Net factor income flows are expected to decline in both nominal and real terms over the forecast horizon. This decline reflects the fact that the United States will still have to borrow abroad on a net basis in order to finance its large current account deficits. Another factor contributing to delay in the improvement in the balance-of-trade deficit is the fact that the decline in the dollar may be partly absorbed as smaller profit margins for importers and foreign exporters, rather than being fully reflected in rising import prices.

The U.S. trade position may also be buffeted by events overseas. Increasing balance of payments difficulties in third-world countries could lead to a flight of capital from these countries to the United States, tending to push the dollar upward again unless confidence in the U.S. banking system were severely eroded at the same time.

Other factors that make the outlook uncertain: If major trading nations fail to agree on new multilateral measures to reduce barriers to trade, protectionist tendencies could grow, restricting the level of trade worldwide. Or a further tightening of monetary policy abroad could cause the dollar to fall much more than it does in CBO's forecast. In that case,

TABLE I-15. GROWTH RATES OF REAL GNP AND GDP, 1982-1985
(In percents)

| | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|
| GDP | -2.5 | 3.6 | 6.9 | 2.6 |
| GNP | -2.5 | 3.4 | 6.6 | 2.3 |
| Difference | 0.0 | 0.2 | 0.3 | 0.3 |

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

BOX I-5

## NET FACTOR INCOME FLOWS

In the National Income and Product Accounts (NIPA), the gross national product (GNP) is the sum of gross domestic product (GDP) and income earned abroad by U.S. residents, minus income earned in the United States by foreign residents. In more succinct terms, GNP equals GDP plus net factor income flows. The growth rate of real GNP for the past four years has been significantly lower than that of real GDP because, on average, net factor income has declined.

Declining net factor income flows have been primarily the result of declining net flows of capital income--that is, interest and profits. The gross flows of capital income are determined by the stock of U.S.-owned foreign assets, the stock of foreign-owned U.S. assets, and their respective rates of return. (As a matter of convention, interest on U.S. government liabilities is treated as a transfer payment in the NIPA, rather than as a flow of income. Hence, in computing net factor income flows, interest payments to foreign holders of U.S. government liabilities are ignored.)

The United States has had to borrow abroad on a net basis in order to finance its large current-account deficits, and, consequently, foreign-owned U.S. assets have grown more rapidly than U.S.-owned foreign assets in recent years. As a result, sometime during 1985 the United States became a net debtor nation. The deterioration of the U.S. net foreign asset position has been accompanied by a decline in net factor income flows. This decline will continue in both nominal and real terms as long as the United States runs a trade deficit, implying a real GNP growth rate smaller than the real GDP growth rate well into the future.

A change in relative rates of return on U.S. and foreign assets can have a substantial impact on net factor income flows. If the relative rate of return on foreign-owned U.S. assets were to rise by a full percentage point in, say, 1986 (all other things being equal), then net factor income flows would fall by roughly $8 billion, subtracting about 0.2 percentage points from the real GNP growth rate but leaving GDP growth unchanged. Generally, converse movements in relative rates of return would yield symmetrically converse results.

Finally, changes in the portfolio composition of foreign-owned U.S. assets can have significant effects on measured net factor income flows. If foreign residents increase their holdings of U.S. government securities by shifting out of U.S. private securities, this raises both measured net factor income flows and the real GNP growth rate for the United States. Thus, as a result of an accounting convention, it is possible for measured net factor income flows to move in one direction even though net international receipts on total interest and profits move the other way. If foreign residents could convert their 1985 stock of U.S. private assets to U.S. government securities (all other things remaining equal), the resulting increase in net factor income would by 1987 raise the U.S. real GNP growth rate by a full percentage point above the growth rate of real output.

the competitive position of American producers would be enhanced, but the induced slowdown in foreign growth rates would tend to depress the demand for U.S. exports below the levels incorporated in CBO's forecast.

## Government Purchases

The growth of government purchases, excluding the activities of the Commodity Credit Corporation (CCC), slowed in 1985.

The Federal Sector. On a National Income and Product Accounts (NIPA) basis, the growth of real federal purchases (excluding the CCC) amounted to 5.3 percent in 1985, down from 5.4 percent the previous year and 6.1 percent in 1983 (see Table I-16). The growth in 1985 mainly reflected an increase in defense spending (concentrated in the third quarter), especially for durable goods such as ships and vehicles. Overall, defense purchases rose by 7.1 percent, the second highest annual growth since 1967.

TABLE I-16. GOVERNMENT PURCHASES OF GOODS AND SERVICES (By calendar year, on a national income accounting basis)

| | 1983 | 1984 | 1985 | 1985 I | 1985 II | 1985 III | 1985 IV |
|---|---|---|---|---|---|---|---|
| | | | **Billions of 1982 Dollars** | | | | |
| Federal a/ | 279.7 | 294.7 | 310.2 | 300.5 | 305.7 | 318.1 | 316.5 |
| Defense | 207.3 | 220.3 | 236.0 | 226.7 | 231.5 | 243.3 | 242.6 |
| State and Local | 372.2 | 383.3 | 394.2 | 387.1 | 393.6 | 398.1 | 398.0 |
| Structures | 42.9 | 45.6 | 48.9 | 44.2 | 49.2 | 51.9 | 50.4 |
| | | | **Percent Change b/** | | | | |
| Federal a/ | 6.1 | 5.4 | 5.3 | -5.9 | 7.1 | 17.2 | -2.0 |
| Defense | 7.0 | 6.3 | 7.1 | -2.1 | 8.7 | 22.0 | -1.1 |
| State and Local | 0.9 | 3.0 | 2.8 | 0.5 | 6.9 | 4.7 | -0.1 |
| Structures | -0.2 | 6.3 | 7.2 | -7.7 | 53.5 | 23.8 | -11.0 |

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

a. Excludes purchases and sales by the Commodity Credit Corporation.

b. For calendar years, the percent change is calculated year over year.

Real federal purchases are expected to show some growth in 1986, despite cuts in spending needed to meet the deficits targets of the Balanced Budget Act. In 1987, however, the level of purchases is expected to decline, especially if the deficit target in that year is achieved through sequestration.

The State and Local Sector. Real purchases of goods and services by state and local governments rose by 2.8 percent in 1985, compared with 3.0 percent in 1984 and 0.9 percent in 1983 (see Table I-16). Most of this growth was in construction spending, which increased by 7.2 percent--one of the fastest growth rates in more than two decades. Highway and school-related construction were two important components of it. Construction is expected to grow more slowly during the forecast period. As the level of construction expenditures flattens, the growth of total state and local purchases is also expected to slow.

The operating surpluses of states and localities declined from a record $15.9 billion in 1984 to an estimated level of roughly $5 billion in 1985. By the third quarter of 1985, these surpluses were at their lowest level ($3.3 billion) since the recession-related deficits of 1982. State and local operating balances are likely to remain small, and possibly (on a NIPA basis) turn into deficits during the forecast period. Already scheduled cuts in federal grants (including the elimination of general revenue sharing in 1987) and likely additional cuts in grants to achieve the targets of the Balanced Budget Act are therefore likely to lead to further retrenchment on the spending side or to increases in some state and local taxes.

CHAPTER II

# THE BUDGET OUTLOOK

The Congressional Budget Office projects that the baseline federal deficit will fall from $208 billion in fiscal year 1986 to $181 billion in 1987 and to $104 billion in 1991, assuming that defense and nondefense appropriations are held constant in real terms and that tax and entitlement laws are continued. While the federal debt will continue to grow as long as the government runs deficits, the rate of growth of the debt is projected to slow substantially. In relation to gross national product (GNP), the debt will increase from 38.4 percent at the end of 1985 to 42.7 percent by the end of 1988 but then begin to decline at a modest rate. Table II-1 summarizes the CBO baseline projections for total federal revenues, outlays, and the deficit, including off-budget items. Projections for on-budget and off-budget activities are shown separately in Box II-1.

Revenues grow more rapidly than outlays under the policy assumptions of the CBO baseline, because revenues are boosted by inflation and increases in real incomes, while outlays rise only slightly faster than the rate of inflation. Revenues rise somewhat more rapidly than nominal GNP in 1987 and 1988 and at about the same rate thereafter. Outlays are projected to rise at a rate of 4.8 percent per year--only slightly above the projected inflation rate of 4.1 percent. Revenues thus remain a roughly constant share of GNP, while outlays and the deficit fall, as Figure II-1 shows.

In 1987 outlays grow less rapidly than their 1986-1991 trend rate, while revenues increase more rapidly than trend. As a result, the deficit drops by $27 billion in 1987--more than in any later year. The major factor slowing 1987 outlay growth is a projected $6 billion drop in Commodity Credit Corporation (CCC) spending for farm price supports. The rapid rise in revenues in 1987 is caused by a pickup in personal income growth and the delayed effect of strong growth in corporate profits in 1986.

## BASELINE BUDGET PROJECTIONS

The CBO baseline budget projections assume CBO's short-run economic forecast and longer-run projections, as described in the previous chapter. They also assume that current taxing and spending policies will continue unchanged for fiscal years 1987 through 1991. The projections are not forecasts of future federal budgets, since those budgets will doubtless include numerous policy changes. They are, however, a baseline or benchmark against which proposed policy changes can be measured.

In preparing the baseline projections, CBO must adopt a number of conventions or assumptions as to what constitutes current budgetary policies. In many cases, the choice of assumptions can substantially affect the projections. This section summarizes those assumptions; they are described in detail in Apppendix A.

## Baseline Revenues

CBO baseline revenues are, with one exception, identical to the base revenues used to compute the excess deficit under the Balanced Budget and Emergency Deficit Control Act of 1985 (Public Law 99-177). (A detailed

TABLE II-1. CBO BASELINE BUDGET PROJECTIONS (By fiscal year)

| | 1985 Actual | 1986 Base | Projections 1987 | 1988 | 1989 | 1990 | 1991 |
|---|---|---|---|---|---|---|---|
| | | | **In Billions of Dollars** | | | | |
| 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 |
| Debt Held by the Public | 1,510 | 1,720 | 1,900 | 2,064 | 2,207 | 2,326 | 2,429 |
| | | | **As a Percent of GNP** | | | | |
| Revenues | 18.6 | 18.6 | 18.7 | 19.0 | 19.0 | 19.0 | 18.9 |
| Outlays | 24.0 | 23.5 | 22.8 | 22.4 | 21.8 | 21.2 | 20.6 |
| Deficit | 5.4 | 5.0 | 4.0 | 3.4 | 2.8 | 2.1 | 1.7 |
| Debt Held by the Public | 38.4 | 41.0 | 42.2 | 42.7 | 42.3 | 41.4 | 40.2 |
| Reference: GNP (In billions of dollars) | 3,937 | 4,192 | 4,504 | 4,838 | 5,214 | 5,619 | 6,047 |

SOURCE: Congressional Budget Office.

BOX II-1

## ON-BUDGET AND OFF-BUDGET SPENDING AND REVENUES

The total outlays and revenues of the federal government include both on-budget and off-budget activities. On-budget and off-budget activities must be added together, however, to determine the total federal deficit that must be financed by borrowing from the public. The estimated total deficit is also used in calculating the excess deficit amount for purposes of the Balanced Budget Act.

In 1969, at the recommendation of the President's Commission on Budget Concepts, the government adopted a unified budget, which provided a comprehensive summary of federal revenues and spending. The unified budget was intended to give an accurate portrayal of the economic importance of government activities and to enable policymakers to control spending and tax policies more effectively. Starting in 1971, the unified budget concept became compromised by the exclusion of certain spending programs--primarily the lending activities carried out through the Federal Financing Bank and the purchase of oil for the Strategic Petroleum Reserve. The 1985 Balanced Budget Act returned all of these previously off-budget entities to the budget. Simultaneously, however, it moved off-budget the two Social Security trust funds--Old-Age and Survivors Insurance and Disability Insurance (OASDI).

This volume focuses on total federal government fiscal activities because of their significance for the economy and for implementing the Balanced Budget Act. Of the total amounts, however, Social Security represents roughly 19 percent of outlays and 25 percent of revenues. Moreover, the Social Security trust funds will be in surplus, while the on-budget activities will be running substantial deficits, as shown in the following table.

(In billions of dollars)

| | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 |
|---|---|---|---|---|---|---|
| Revenues | | | | | | |
| On-budget | 580 | 631 | 680 | 730 | 781 | 832 |
| Off-budget (OASDI) | 198 | 213 | 241 | 261 | 287 | 312 |
| Total | 778 | 844 | 921 | 991 | 1,068 | 1,144 |
| Outlays | | | | | | |
| On-budget | 802 | 827 | 876 | 913 | 953 | 999 |
| Off-budget (OASDI) | 184 | 198 | 210 | 222 | 235 | 249 |
| Total | 986 | 1,025 | 1,086 | 1,135 | 1,188 | 1,248 |
| Deficit (-) or Surplus | | | | | | |
| On-budget | -222 | -196 | -195 | -183 | -172 | -167 |
| Off-budget (OASDI) | 14 | 15 | 31 | 39 | 52 | 63 |
| Total | -208 | -181 | -165 | -144 | -120 | -104 |

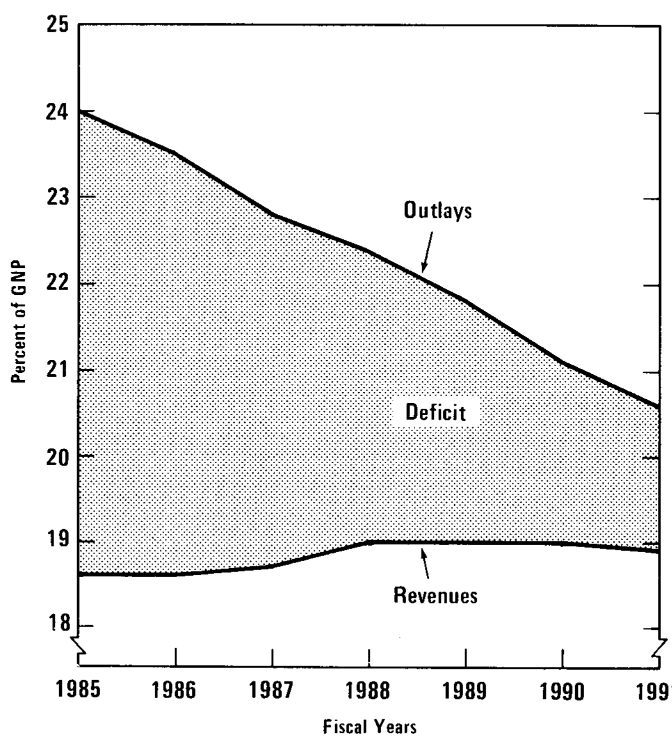
discussion of this legislation, called the Balanced Budget Act for short, may be found in Chapter III.) The act specifies that the revenue base is to assume that current tax laws continue unchanged and that expiring provisions will terminate as scheduled except for excise taxes dedicated to trust funds. In the same way, the baseline assumes that taxes for the Hazardous Substance Response (Superfund), Airport and Airway, and Highway Trust Funds are extended at the rates in effect on their expiration dates. In contrast to the revenue base for the Balanced Budget Act, however, the baseline assumes that the reduction in the civil service contribution rate for recently hired workers is extended beyond April 30, 1986.

## Baseline Outlays

Federal spending can be divided into two categories. The first category--mandated by existing law--includes spending for Social Security benefits and other entitlement programs, for permanent appropriations such as interest

Figure II-1.

**Federal Revenues, Outlays, and Deficit as Percents of GNP**




SOURCE: Congressional Budget Office.

on the public debt, and for most trust funds and other special funds. The baseline spending projections for these programs are comparable with the Balanced Budget Act's outlay base, which assumes continuation of current law and termination of expiring provisions. Unlike the outlay base in the Balanced Budget Act, however, the CBO baseline assumes that the general revenue sharing program will be continued beyond 1986 and that cost-of-living adjustments will be provided for veterans' compensation.

The 1986 outlay estimates for mandatory spending programs reflect the sequestration of 1986 spending authority as required by the Balanced Budget Act. For programs with cost-of-living adjustments (COLAs), sequestering the 1986 COLA also reduces outlays in all future years. For most other mandatory programs, such as Medicare or farm price supports, 1987 spending authority is assumed to return to presequestration levels, so that no long-run reduction in outlays occurs.

Federal spending not mandated by existing law is controlled through the appropriation process. The fiscal year 1986 spending level assumed for these programs is the level enacted by the Congress through December 1985 and reduced according to the provisions of the Balanced Budget Act. The 1987-1991 projections generally assume that the 1986 postsequestration program level is adjusted to keep pace with inflation.

The baseline for appropriated accounts differs from the outlay base defined in the Balanced Budget Act. If appropriations for the fiscal year have not been enacted, the outlay base estimates under the Balanced Budget Act are to assume appropriations equal to those enacted for the previous year. The outlay base for the Balanced Budget Act thus excludes discretionary inflation and other adjustments made to keep baseline program levels constant in real terms. The CBO baseline, in contrast, includes these adjustments.

## CHANGES IN BASELINE BUDGET PROJECTIONS SINCE AUGUST 1985

When CBO last published its budget projections in August 1985, baseline deficits were projected to continue growing in dollar terms and to remain a level 5.1 percent of GNP. In comparison with these baseline projections of six months ago, the present baseline projections seem surprising. (The major changes in the baseline are listed in Table II-2.) The projections are not strikingly different, however, from CBO's August reestimate of the Congressional budget resolution, which showed deficits declining from $175 bil-

TABLE II-2. CHANGES IN CBO BASELINE DEFICIT PROJECTIONS SINCE AUGUST 1985 (By fiscal year, in billions of dollars)

| | 1986 | 1987 | 1988 | 1989 | 1990 |
|---|---|---|---|---|---|
| August 1985 Baseline Deficit | 212.3 | 229.0 | 243.2 | 263.9 | 284.6 |
| Changes Caused by | | | | | |
| 1986 appropriations action a/ | | | | | |
| National defense b/ | -3.6 | -13.8 | -28.3 | -42.0 | -56.0 |
| Nondefense discretionary | -6.9 | -13.7 | -13.9 | -14.8 | -15.0 |
| Subtotal | -10.5 | -27.5 | -42.2 | -56.8 | -71.0 |
| Effect of 1986 sequestration a/ | | | | | |
| National defense | -5.5 | -9.1 | -10.6 | -11.4 | -12.0 |
| Nondefense discretionary | -3.5 | -5.1 | -5.9 | -6.3 | -6.7 |
| Entitlements | -2.5 | -2.1 | -1.6 | -1.6 | -1.7 |
| Subtotal | -11.4 | -16.3 | -18.1 | -19.3 | -20.3 |
| Assume zero real growth in defense spending a/ | -- | -3.2 | -9.5 | -18.0 | -28.1 |
| Net interest | | | | | |
| Lower interest rates | -3.3 | -7.5 | -11.0 | -18.4 | -30.6 |
| Debt service and other c/ | 3.6 | 0.2 | -5.3 | -12.5 | -20.4 |
| Subtotal | 0.3 | -7.3 | -16.3 | -30.9 | -51.0 |
| Farm price supports | 10.6 | 3.3 | 5.0 | 1.4 | -3.5 |
| Other outlays | -2.4 | -5.6 | -7.3 | -7.7 | -6.5 |
| Lower revenues | 9.5 | 8.9 | 10.1 | 11.0 | 16.0 |
| Total Changes | -4.0 | -47.7 | -78.2 | -120.3 | -164.5 |
| February 1986 Baseline Deficit | 208.3 | 181.3 | 164.9 | 143.6 | 120.1 |

SOURCE: Congressional Budget Office.

a. Excludes resulting changes in net interest.
b. Assumes 3 percent real growth after 1986.
c. Includes effects of lower deficits resulting from all other changes.

lion in 1986 to $120 billion by 1990. What has happened in the past six months that has effectively validated the budget resolution projections?

First of all, the Congress adopted a 1986 budget resolution that assumed zero real growth in defense spending in 1986 and 3 percent real growth in the next two years, as opposed to about 5 percent real growth assumed in the 1985 budget resolution and in CBO's August baseline. The 1986 defense appropriation was slightly below the budget resolution target and, together with the lower rate of growth in future years, this reduces projected spending by $13.8 billion in 1987 and $56.0 billion in 1990. Appropriation action in 1986 will reduce projected nondefense discretionary spending by $13.7 billion in 1987 and $15.0 billion in 1990.

Second, the sequestering of 1986 spending authority under the provisions of the Balanced Budget Act reduces spending not only in 1986 but, as indicated above, in later years as well. The sequestration reduces 1986 outlays by $11.4 billion. Because spending authority had to be cut by about twice as much as the required outlay reduction, and because most of this reduction in spending authority is assumed to continue in later years, the savings from the 1986 sequestration will grow to $16.3 billion in 1987 and to $20.3 billion in 1990.

Third, the new CBO baseline--as described earlier--projects defense spending for 1987 and beyond on the basis of no real growth in program level, rather than the 3 percent real growth assumed in the 1986 resolution. The defense growth assumed in the August budget resolution can no longer be taken as representing current Congressional policy, because the 1986 postsequestration appropriation for defense is $16 billion below the budget resolution level. Assuming zero rather than 3 percent real growth for defense reduces the projected deficit by $3.2 billion in 1987 and $28.1 billion in 1990.

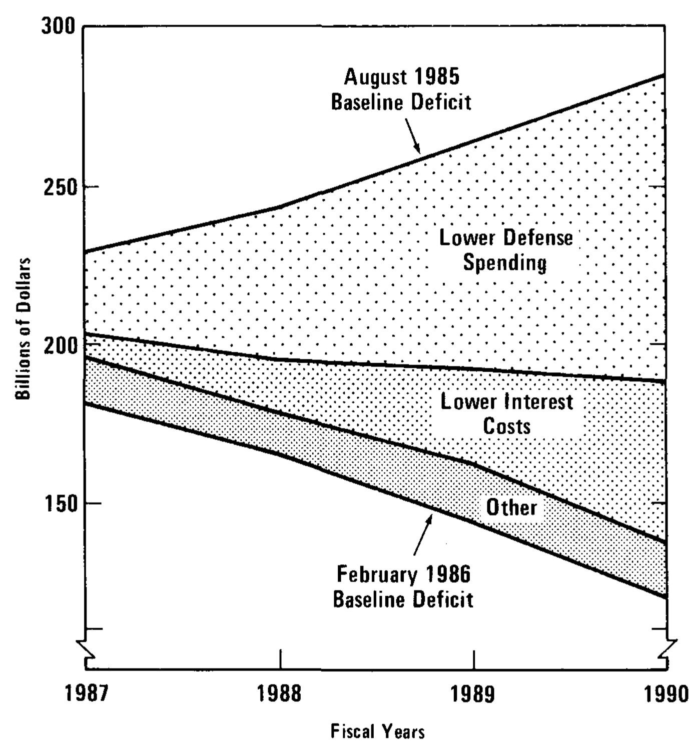
Fourth, the revised CBO short-term forecast and long-run economic assumptions feature interest rates substantially below those assumed in August. This change has been made because the Congress and the President are now committed by law to reducing the deficit in large steps each year so as to achieve a balanced budget by 1991. The reduction in assumed interest rates, together with a reduction in debt service costs from the other changes, will reduce net interest outlays by $7.3 billion in 1987 and $51.0 billion in 1990.

Figure II-2 adds up these changes and illustrates that almost all the reduction in the projected deficits stems from lower defense spending (both actual and assumed) and from lower interest costs. Most of the remaining reduction is attributable to decreased spending for nondefense discretionary programs. Small changes in the baseline deficits result from revised projections for farm price support spending and reductions in estimated outlays for other programs. In addition, a reduction in projected personal income reduces revenues from income and payroll taxes in every year. Higher projected corporate profits partially offset this reduction, but revenues are nevertheless $9 billion to $16 billion below the August baseline figures.

## DIFFERENCES BETWEEN CBO BASELINE AND ADMINISTRATION CURRENT SERVICES PROJECTIONS

As part of its annual budget submission, the Administration presents a current services budget projection. The current services projection, like the CBO baseline, is a picture of what would happen to the budget assuming a

Figure II-2.
Sources of Change in Baseline Deficit Projections




SOURCE: Congressional Budget Office.

continuation of policies now in place. While the Administration's current services deficit projections for 1987 through 1991 are very close to the CBO baseline figures, as shown in Table II-3, the similarities in deficit projections conceal offsetting differences in certain policy assumptions and in economic and technical estimating methods.

The current services projections are based on the budget authority figures for national defense contained in the Congressional budget resolution for fiscal year 1986 and in the Administration's Mid-Session Review of the 1986 budget. Roughly speaking, the current services figures for budget authority provide for 3 percent real growth in defense starting from the 1986 appropriation assumed in the budget resolution--not from the lower postsequestration defense appropriation, as assumed in the CBO baseline. These differences in assumed defense budget authority alone cause the baseline deficit to be $7.9 billion less than the current services deficit in 1987

TABLE II-3. DIFFERENCES BETWEEN ADMINISTRATION'S CURRENT SERVICES PROJECTIONS AND CBO BASELINE
(By fiscal year, in billions of dollars)

| | 1987 | 1988 | 1989 | 1990 | 1991 |
|---|---|---|---|---|---|
| OMB Current Services Deficit | 181.8 | 150.0 | 138.9 | 126.3 | 103.9 |
| Policy Differences | | | | | |
| National defense | -7.9 | -18.1 | -28.1 | -37.6 | -47.1 |
| Hospital insurance | -0.5 | -0.6 | -0.6 | -0.7 | -0.8 |
| General revenue sharing | 3.4 | 4.6 | 4.6 | 4.6 | 4.6 |
| Superfund taxes | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 |
| Subtotal | -4.6 | -13.8 | -23.7 | -33.4 | -42.9 |
| Economic and Technical Differences | | | | | |
| Interest rates a/ | -1.6 | 3.9 | 12.6 | 24.3 | 32.5 |
| National defense | 7.0 | 10.9 | 10.4 | 10.5 | 11.6 |
| Other | -1.2 | 13.9 | 5.4 | -7.6 | -0.9 |
| Subtotal | 4.1 | 28.7 | 28.4 | 27.2 | 43.3 |
| CBO Baseline Deficit | 181.3 | 164.9 | 143.6 | 120.1 | 104.3 |

SOURCE: Congressional Budget Office.

a. Net interest function only.

and $47.1 billion less in 1991. There are also three other, smaller policy differences between the Administration's current services projections and the CBO baseline. The current services projections do not reflect the Administration's intention to limit the 1987 increase in hospital insurance reimbursement rates to 2 percent above the 1986 presequestration level, while the CBO baseline includes it. The current services projection assumes the termination of general revenue sharing, while the CBO baseline does not. And current services assumes extension of Superfund taxes at a higher level than does the CBO baseline.

These differences in policy assumptions are almost exactly offset by the Administration's more optimistic economic assumptions. Except for 1987, CBO assumes higher nominal interest rates than does the Administration. These differences in interest rates cause the baseline deficit to be $32.5 billion higher than the current services deficit by 1991. CBO also projects that the level of defense budget authority assumed in current services will result in higher outlays than does the Administration. These and other estimating differences between CBO and the Administration will be discussed in more detail in CBO's forthcoming report, *An Analysis of the President's Budgetary Proposals for Fiscal Year 1987.*

The preceding discussion has indicated three plausible assumptions for a defense baseline: (1) zero real growth from the 1986 program level after sequestration (as CBO assumes), (2) three percent real growth beginning in 1987, and (3) the defense budget authority assumed for 1987 and later years in the 1986 budget resolution (as in the Administration's current services projections). Table II-4 presents CBO's estimates of defense budget authority, defense outlays, and the deficit using these alternative defense baselines. Even with the two higher defense paths, the baseline deficit declines, although not as fast as in the zero real growth case. With 3 percent real growth in defense, the deficit falls to $185 billion in 1987 and $150 billion in 1991. Using the budget resolution figures for defense budget authority, the deficit declines to $190 billion in 1987 and to $160 billion in 1991.

## BUDGET PROJECTIONS UNDER ALTERNATIVE ECONOMIC ASSUMPTIONS

The choice of economic assumptions has a major effect on the baseline budget projections. To illustrate how changes in economic conditions can affect revenues, outlays, and the deficit, CBO has prepared two consistent alternative sets of economic assumptions, described at the end of Chapter I. These alternatives are designed to mirror typical interactions among various aspects of the economy. Table II-5 shows how the baseline deficit projections would differ under these high-growth and low-growth alternatives. This section also provides some rules of thumb for gauging the effects of changes in individual economic variables on the budget.

## High-Growth Alternative

In the high-growth case, revenues are greater than in the baseline, because of both increased real incomes and higher inflation. In the first few years of the projection, outlays are lower, as a result of reduced caseloads for entitlement programs, decreased interest rates, and lower debt service costs. But in later years, all categories of outlays exceed their baseline levels in order to keep pace with the higher assumed rates of inflation and higher interest rates. (Because the CBO baseline assumes that discretionary

TABLE II-4. BASELINE PROJECTIONS UNDER ALTERNATIVE DEFENSE ASSUMPTIONS (By fiscal year, in billions of dollars)

| | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 |
|---|---|---|---|---|---|---|
| CBO Baseline (Zero Real Defense Growth) | | | | | | |
| Defense budget authority | 287 | 301 | 315 | 330 | 345 | 362 |
| Defense outlays | 269 | 284 | 296 | 311 | 327 | 344 |
| Deficit | 208 | 181 | 165 | 144 | 120 | 104 |
| 3 Percent Real Defense Growth | | | | | | |
| Defense budget authority | 287 | 310 | 334 | 360 | 388 | 419 |
| Defense outlays | 269 | 287 | 306 | 329 | 355 | 384 |
| Deficit a/ | 208 | 185 | 175 | 163 | 152 | 150 |
| 1986 Budget Resolution Defense Budget Authority Targets | | | | | | |
| Defense budget authority | 287 | 323 | 347 | 371 | 397 | 423 |
| Defense outlays | 269 | 292 | 315 | 339 | 365 | 391 |
| Deficit a/ | 208 | 190 | 184 | 175 | 164 | 160 |

SOURCE: Congressional Budget Office.

a. Includes additional interest costs resulting from higher defense spending.

appropriations are held constant in real terms, the calculations adjust both defense and nondefense appropriations for differences in the price level.) Because of the higher real growth, however, the increase in revenues is greater than the increase in outlays, and the deficit falls. In fact, as pictured in Figure II-3, the budget would show a surplus of $70 billion in 1991 under these assumptions.

## Low-Growth Alternative

The pattern of spending and revenue changes in the low-growth alternative is generally the opposite of that in the high-growth case. Revenues are less

TABLE II-5. CBO BUDGET PROJECTIONS UNDER ALTERNATIVE ECONOMIC ASSUMPTIONS (By fiscal year, in billions of dollars)

| | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 |
|---|---|---|---|---|---|---|
| | | | **Revenues** | | | |
| High-Growth Alternative | 784 | 866 | 971 | 1,086 | 1,228 | 1,403 |
| CBO Baseline Projection | 778 | 844 | 921 | 991 | 1,068 | 1,144 |
| Low-Growth Alternative | 777 | 818 | 828 | 882 | 948 | 995 |
| | | | **Outlays** | | | |
| High-Growth Alternative | 985 | 1,020 | 1,082 | 1,147 | 1,229 | 1,333 |
| CBO Baseline Projection | 986 | 1,025 | 1,086 | 1,135 | 1,188 | 1,248 |
| Low-Growth Alternative | 987 | 1,042 | 1,111 | 1,153 | 1,185 | 1,232 |
| | | | **Deficit** | | | |
| High-Growth Alternative | 202 | 154 | 111 | 61 | 1 | -70 a/ |
| CBO Baseline Projection | 208 | 181 | 165 | 144 | 120 | 104 |
| Low-Growth Alternative | 210 | 224 | 282 | 271 | 238 | 237 |

SOURCE: Congressional Budget Office.

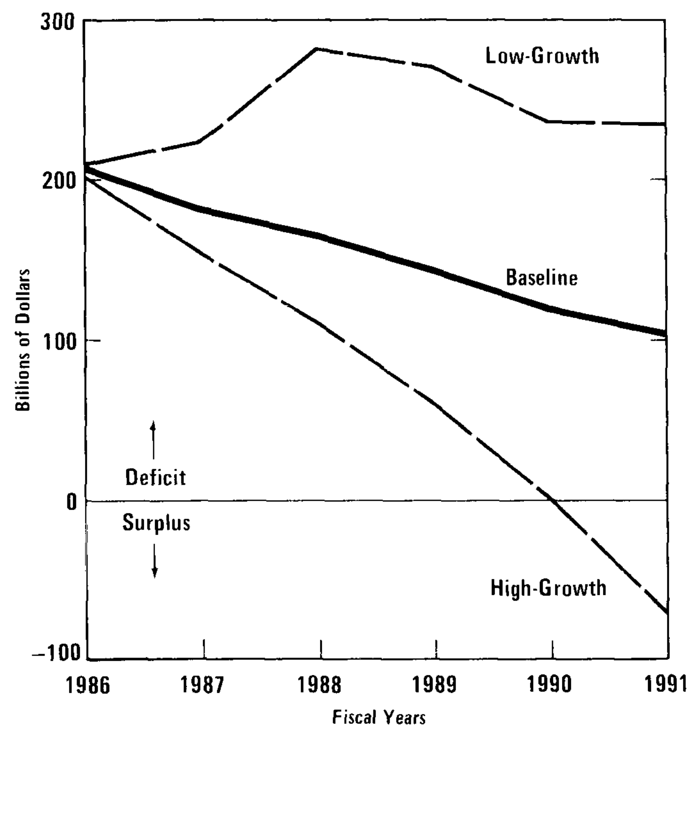
a. Surplus

than in the baseline. Defense and nondefense appropriations are about the same as the baseline in the first few years but lower after 1988, reflecting less inflation. The lower inflation also tends to reduce entitlement spending, but the increase in the unemployment rate works in the opposite direction. On balance, entitlement spending in the low-growth case is above the baseline for the first few years, when the unemployment effect predominates, but below the baseline in 1990 and 1991, when the inflation effect is more powerful. Net interest is higher in all years--initially because of higher interest rates and later, as interest rates drop, because of higher deficits. Total spending in the low-growth case is above the baseline through 1989 and only slightly below the baseline thereafter. As a result, the deficit is considerably higher in all years.

## Rules of Thumb

While the use of consistent alternative forecasts is one way to illustrate the sensitivity of the budget to the economy, the same point may be made in a

Figure II-3.
Federal Deficit Under Alternative Economic Assumptions




SOURCE: Congressional Budget Office.

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different fashion. Table II-6 provides some rough orders of magnitude, or rules of thumb, for gauging the effects on the baseline budget projections of changes in individual economic variables considered in isolation. Because CBO does not rely on rules of thumb for preparing its budget projections, they only approximate how the CBO baseline budget projections would change with such changes in the economic outlook.

TABLE II-6. EFFECTS ON CBO BASELINE BUDGET PROJECTIONS OF SELECTED CHANGES IN ECONOMIC ASSUMPTIONS (By fiscal year, in billions of dollars)

| Economic Variable | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 |
|---|---|---|---|---|---|---|
| **Real Growth**: Effect of One Percentage-Point Higher Annual Rate Beginning January 1986 | | | | | | |
| Change in revenues | 4 | 16 | 32 | 49 | 69 | 91 |
| Change in outlays | -1 | -3 | -6 | -12 | -18 | -26 |
| Change in deficit | -5 | -19 | -38 | -61 | -88 | -118 |
| **Unemployment**: Effect of One Percentage-Point Lower Annual Rate Beginning January 1986 | | | | | | |
| Change in revenues | 23 | 37 | 36 | 37 | 39 | 41 |
| Change in outlays | -3 | -7 | -11 | -15 | -19 | -22 |
| Change in deficit | -26 | -44 | -48 | -52 | -57 | -63 |
| **Interest Rates**: Effect of One Percentage-Point Higher Annual Rates Beginning January 1986 | | | | | | |
| Change in revenues | a/ | 1 | 1 | 1 | 1 | 1 |
| Changes in outlays | 3 | 10 | 16 | 19 | 23 | 27 |
| Change in deficit | 3 | 9 | 15 | 18 | 22 | 25 |
| **Inflation**: Effect of One Percentage-Point Higher Annual Rate Beginning January 1986 | | | | | | |
| Change in revenues | 5 | 15 | 27 | 39 | 52 | 68 |
| Change in outlays | 3 | 14 | 27 | 39 | 52 | 65 |
| Change in deficit | -2 | -1 | a/ | -1 | a/ | -3 |

SOURCE: Congressional Budget Office.

a. Less than $500 million.

The rules of thumb illustrate the budgetary effects of a one percentage-point change, beginning in January 1986, for four variables: real economic growth, unemployment, interest rates, and inflation. The rules of thumb show that:

- o An increase in the real growth rate or a drop in the unemployment rate will increase revenues and decrease outlays and the deficit.

- o An increase in interest rates, assuming no change in inflation or GNP, will raise outlays and the deficit by about the same amount and will have only a small positive effect on revenues.

- o Assuming that discretionary spending and interest rates respond to inflation, an increase in inflation will raise outlays and revenues almost equally and, therefore, have little effect on the deficit. If discretionary appropriations were not adjusted for the increased inflation, the deficit would be $4 billion lower in 1987 and $30 billion lower in 1991.

The estimates shown in Table II-6 are similar to those published by CBO in its last two annual reports (*Baseline Budget Projections for Fiscal Years 1985-1989,* pp. 55-68, and *The Economic and Budget Outlook: Fiscal Years 1986-1990,* pp. 73-76). The reader is referred to those earlier volumes for a discussion of the assumptions, implications, and limitations of these rules of thumb.

## SPENDING PROJECTIONS BY MAJOR CATEGORY

Baseline outlays are projected to grow by $262 billion, or 4.8 percent annually, over the 1986-1991 period. Relative to the size of the economy, however, both total spending and all its major components decline. Total outlays fall from 23.5 percent of GNP in 1986 to 20.6 percent in 1991 (see Table II-7).

### National Defense

National defense programs include not only the military activities of the Department of Defense but also the nuclear weapons programs of the Department of Energy and miscellaneous activities, such as maintaining defense stockpiles and administering the Selective Service. The projected decline in national defense spending as a share of GNP is in sharp contrast with recent CBO baseline projections. CBO's August 1985 baseline assumed the budget authority figures for defense contained in the Congressional budget resolution for fiscal year 1985, adopted in September 1984. That resolution provided for about 5 percent real growth over the 1985 appropriation. As a result, the August baseline projected that defense outlays would rise each year relative to GNP and reach 7.6 percent by 1990.

TABLE II-7. CBO BASELINE OUTLAY PROJECTIONS FOR MAJOR SPENDING CATEGORIES (By fiscal year)

| Major Category | 1985 Actual | 1986 Base | Projections 1987 | 1988 | 1989 | 1990 | 1991 |
|---|---|---|---|---|---|---|---|
| | | | **In Billions of Dollars** | | | | |
| National Defense | 252.7 | 269.5 | 284.0 | 296.4 | 310.9 | 326.9 | 343.9 |
| Entitlements and Other Mandatory Spending | 440.2 | 453.7 | 473.6 | 509.0 | 536.4 | 566.5 | 604.1 |
| Nondefense Discretionary Spending | 172.1 | 173.2 | 174.3 | 182.6 | 188.3 | 195.9 | 204.0 |
| Net Interest | 129.4 | 138.6 | 145.0 | 154.4 | 157.6 | 159.1 | 160.3 |
| Offsetting Receipts | -48.1 | -48.8 | -51.5 | -56.4 | -58.4 | -60.7 | -64.4 |
| Total Outlays | 946.3 | 986.1 | 1,025.3 | 1,085.9 | 1,134.9 | 1,187.6 | 1,247.9 |
| On-Budget Outlays | 769.5 | 801.7 | 827.0 | 875.7 | 912.9 | 952.8 | 998.5 |
| Off-Budget Outlays | 176.8 | 184.4 | 198.3 | 210.2 | 221.9 | 234.9 | 249.4 |
| | | | **As a Percent of GNP** | | | | |
| National Defense | 6.4 | 6.4 | 6.3 | 6.1 | 6.0 | 5.8 | 5.7 |
| Entitlements and Other Mandatory Spending | 11.2 | 10.8 | 10.5 | 10.5 | 10.3 | 10.1 | 10.0 |
| Nondefense Discretionary Spending | 4.4 | 4.1 | 3.9 | 3.8 | 3.6 | 3.5 | 3.4 |
| Net Interest | 3.3 | 3.3 | 3.2 | 3.2 | 3.0 | 2.8 | 2.7 |
| Offsetting Receipts | -1.2 | -1.2 | -1.1 | -1.2 | -1.1 | -1.1 | -1.1 |
| Total Outlays | 24.0 | 23.5 | 22.8 | 22.4 | 21.8 | 21.1 | 20.6 |
| On-Budget Outlays | 19.5 | 19.1 | 18.4 | 18.1 | 17.5 | 17.0 | 16.5 |
| Off-Budget Outlays | 4.5 | 4.4 | 4.4 | 4.3 | 4.3 | 4.2 | 4.1 |

SOURCE: Congressional Budget Office.