PART 2

RECENT BUDGET HISTORY AND THE ECONOMIC OUTLOOK

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OVERVIEW

From very small beginnings, the Federal Government has become an immense and costly enterprise. This fiscal year the Federal Government will require nearly a quarter of all resources produced in the economy and, in the process, will incur a deficit exceeding $200 billion. That portion of the Federal debt held by the public passed $1 trillion in 1983 and will exceed $2 trillion before the end of this decade.

Americans already pay for a sizable Federal establishment. Federal receipts, including social security taxes, have averaged 18% of GNP over the past 20 years, much higher than at any previous time in American history. The 1981 tax program prevented this tax burden from escalating, but did not reduce the share of Federal receipts below its postwar average.

Unchecked Federal spending, and the failure to set spending priorities, is the source of the deficit problem. If the upward bias in Federal spending is not eradicated, it will continue to put stress on our political system. Although we all recognize the danger posed by large deficits, this has not prevented them from growing. Partly, this is because the damage they do is not always readily apparent in the short run. Over time, however, the effects of excessive Federal borrowing are progressively debilitating. In the competition for borrowed funds, the Federal Government always wins. Private savings absorbed by the Government are not available for lending to the private sector. In 1985, the Federal deficit was more than 60% as large as total net domestic saving. Continued Federal borrowing at this level threatens private capital formation and with it the economy's potential for future economic growth.

In addition, interest on the Federal debt is growing faster than nominal GNP and, therefore, faster than Federal revenues. If not stopped by reducing the deficit, interest costs in time may crowd other areas out of the budget.

If the deficit remains out of control, pressure to use monetary policy to accommodate the Government's borrowing needs will grow and, with it, the risk of rekindling inflation. Such a reversal in the trend of inflation could be disastrous.

The American political system faces a great test. At present, the benefits of Government programs tend to be concentrated on particular fiscal constituencies which lobby to defend their benefits, while the costs of such programs are spread over the population at large. The Balanced Budget and Emergency Deficit Control Act of 1985, better known as the Gramm-Rudman-Hollings amendment (GRH), was designed to cut through this Gordian knot and return the budget to balance by 1991. GRH sets deficit targets and provides incentives for the administration and the Congress to meet them. If there is no agreement, then GRH specifies a mechanical procedure—sequestration of funds—for reaching the deficit targets.

The sequestration mechanism has already been triggered for this year. For future years, however, it is neither necessary nor desirable that this rigid and arbitrary mechanism be invoked. It is only necessary that the declining deficit goals be reached. If Congress adopts the President's budget, sequestration need not occur.

The proposals in the President's budget do not treat each program alike. They allocate spending to meet national needs, and this includes providing increased spending where that is appropriate. The spending cuts proposed flow from a simple, consistent analysis pointing to the conclusion that many activities now performed by the Federal Government should be performed elsewhere or not at all. For those programs that should be provided by the Federal Government the budget proposes reforms that will produce significant cost savings. Many agencies and constituencies will have to get along with less—but essential services are not harmed.

By bringing down spending and reducing the deficit, we can help ensure continued economic growth over the next 5 years. Inflation induced sizable volatility in economic growth during the 1970's and early 1980's. Should such volatility return, it would be extremely difficult to achieve our projected growth in real GNP or the target path for the deficit.

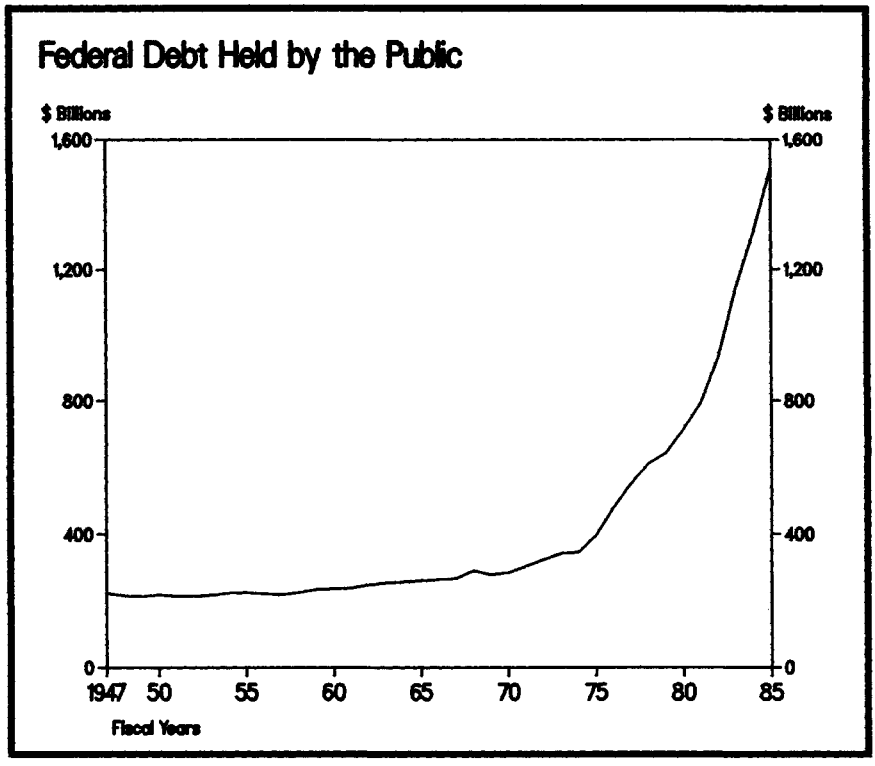
There are no tax increases in this budget. Incentives for economic growth are strengthened, not weakened. The administration's tax reform proposal calls for taxing all forms of income more evenly and equalizing the effective tax rates on all types of capital investment. It will improve prospects for economic growth and productivity in the United States. The administration strongly urges passage of a tax reform measure in 1986, but the final form of the measure has not yet been determined. Thus, estimates of receipts by source in this budget have not been adjusted for the effects of tax reform. Because the administration will only support a revenue-neutral tax reform, this decision will not affect overall figures for receipts or the budget deficit.

The administration will continue to reduce the Federal Government's "hidden taxes" as well—those additional costs imposed by

excessive Federal regulations, paperwork, and "red tape". Reducing these burdens will increase the productivity of our economy and promote prosperity. The benefits of reducing regulatory burdens are now manifest. The deregulation of the airline industry and other transportation and energy industries demonstrates that further deregulatory efforts are warranted. The administration's success in reversing the growth trend of Government regulatory intrusiveness and in cutting back on the preexisting glut of Federal forms and recordkeeping requirements indicates that much more can and should be done. The administration will continue to ensure, consistent with its responsibilities to carry out the law, that it imposes a regulatory or a paperwork burden only where it is necessary to address a market failure and only when Federal regulation is necessary to address such a failure.

BUDGET HISTORY

The First 200 Years.—For the first 150 years of our history, the prevailing—indeed unquestioned—belief was that the Federal



budget should be balanced. While deficits were unavoidable in wartime, all political parties, all Presidents, and nearly all members of Congress operated on the assumption that the "norm" would be budgetary balance, and the Government even ran sufficient surpluses to repay most of the debt accumulated during wars and depressions. The Federal Government ran surpluses for 28 consecutive years after the Civil War, and for 11 consecutive years after World War I.

The advent of Keynesian economics 50 years ago led to a new belief that a little "pump priming" could get the economy going again. It became the conventional wisdom that the Government could afford to run deficits in periods of subnormal economic activity, which then would be offset by surpluses in periods of prosperity. It was generally presumed that the budget would remain balanced over the cycle as a whole.

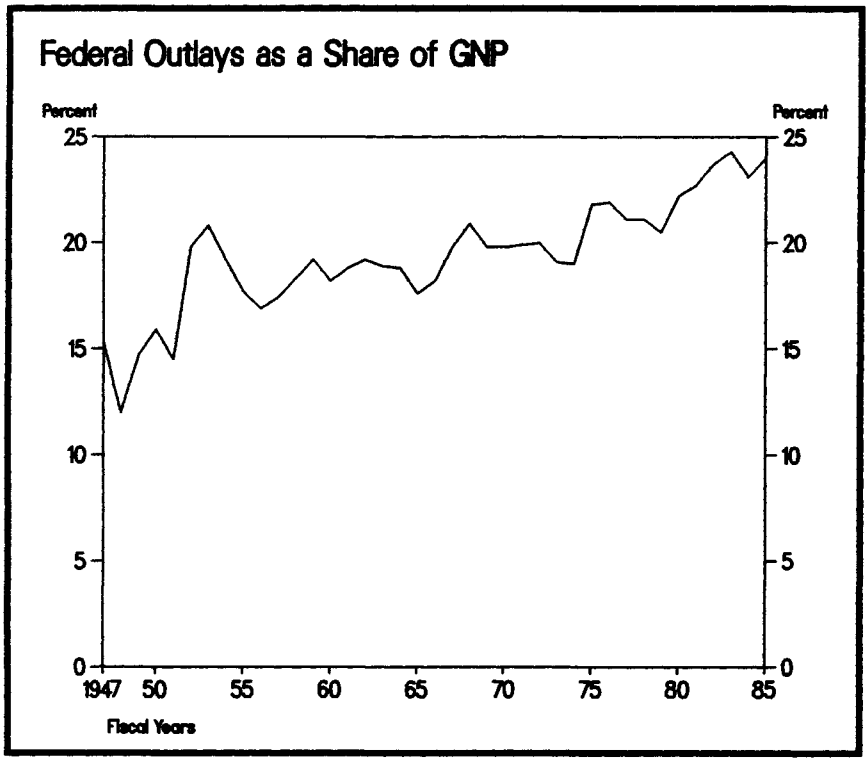
However, starting around the time of the Vietnam War and continuing long after that war wound down, even this degree of discipline began slipping away. Deficits gradually ceased to be a respectable countercyclical tool and turned into an escape valve for a lack of political will or for political gridlock. Indeed, the Government posted only one small surplus (in 1969) during the longest postwar recovery on record. In recent years, deficits have been large, chronic, and structural. It is not only that we have had deficits in 24 of the last 25 years; more importantly, they have recently become much larger—exceeding 2.5% of GNP in all but one of the past 10 years and averaging over 5% for the last 3 years.

As deficits increased, Federal debt mounted at an accelerating pace. By the end of World War II, that portion of Federal debt held by the public had risen to a then astronomical $235 billion, exceeding 1945 GNP. Unlike earlier postwar periods in our history, after World War II the Federal Government made little effort to repay its wartime borrowings. The debt remained at about the end-of-war level through 1960. By 1970, however, the debt held by the public had risen to $285 billion. By 1980 it was $715 billion, and in 1983 it passed the one trillion dollar mark; it will reach two trillion dollars well before the end of the decade.

The deficits have resulted from the rapid growth of Government spending, which has outstripped the growth of receipts. The problem is not a lack of receipts. During the past 20 years, Federal receipts have risen almost precisely in line with the economy as a whole. As a share of GNP, receipts (including social security taxes) have ranged from a low of 17.3% to a high of 20.1%. They have averaged slightly over 18% and stood at 18.6% in 1985. Thus, Federal receipts as a share of GNP are today running slightly above the historical norm.

In marked contrast, Federal spending as a share of GNP has been on an upward trend, rising from 18.2% in 1960 to 24.0% in 1985. Unfortunately, not only was the Federal Government growing too large during this period, but the spending priorities were also inappropriate. The share of the Nation's resources devoted to national defense was reduced to only 5% by the time this administration took office, about half of its share two decades earlier. On the other hand, nondefense spending's share doubled during this period, reaching 17.1% by 1980, as shown in the table below. Rapidly rising payments to individuals were largely responsible for this increase.

This trend of rapid increase in domestic spending, with little change in the share of income collected in taxes eventually produced the explosion of the deficit we have seen in the 1980s. Although the level of the deficit soared during the 1980 and the 1981-82 recessions and remains at record high levels, the seeds of the problem were sown in the breakdown of fiscal discipline in the preceding decades.

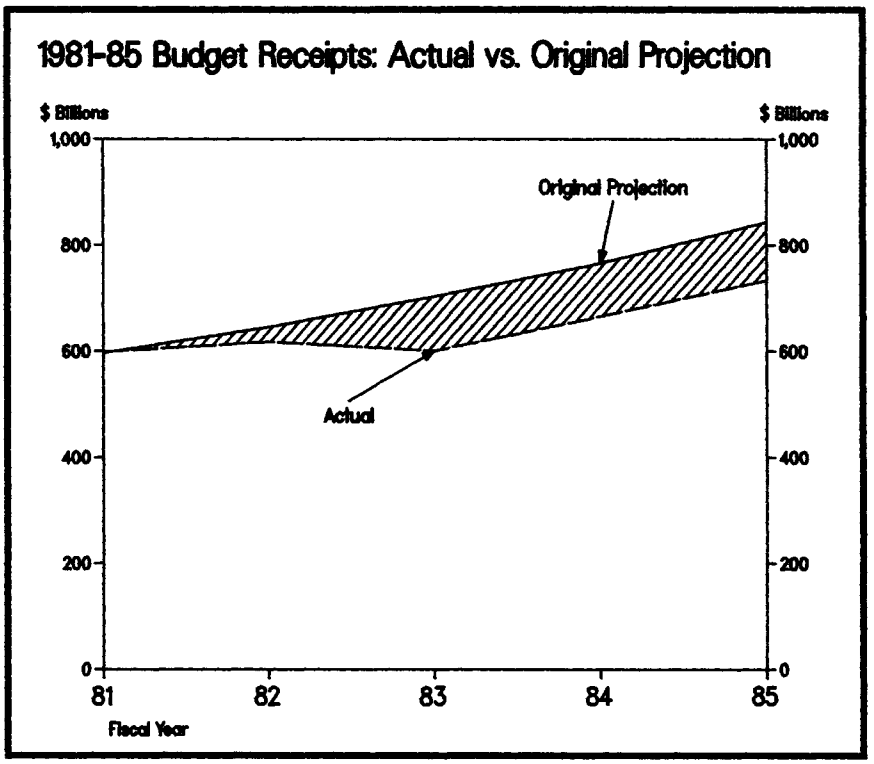


Post-1980 Rise in the Federal Deficit.—In 1981, President Reagan stated a goal of reducing the growth of overall spending by eliminating activities that were beyond the proper sphere of Federal responsibilities and by restraining the growth of spending for other activities. Increases in defense spending were proposed, while the rate of growth of domestic spending was to decline. In addition, the President proposed limiting tax burdens to the levels necessary to

THE COMPOSITION OF FEDERAL SPENDING

(Percent of GNP)

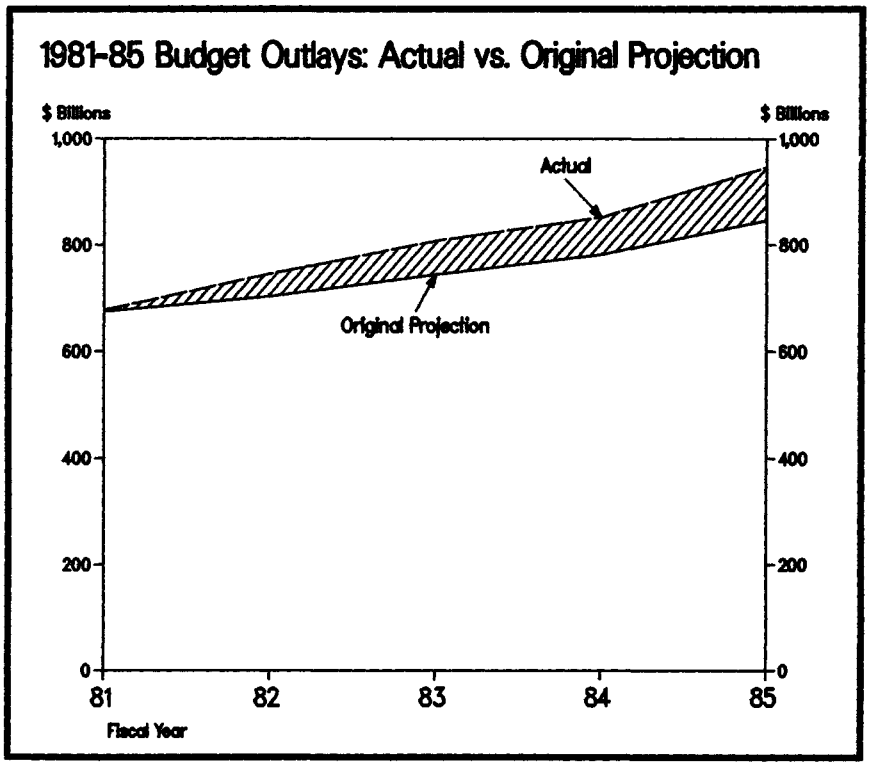
	1960	1970	1980	1985
Defense	9.5	8.2	5.0	6.4
Nondefense	8.7	11.5	17.1	17.6
Payments for individuals	4.8	6.5	10.4	10.8
Other grants-in-aid to State and local governments	0.9	1.6	2.2	1.5
Net interest	1.4	1.5	2.0	3.3
All other	2.6	2.8	3.3	2.9
Undistributed offsetting receipts	−0.9	−0.9	−0.7	−0.8
Total	18.2	19.8	22.2	24.0



finance only essential Government services, thereby strengthening incentives for work, saving, investment, productivity, and economic growth. The combined effects of the President's program were projected to produce a surplus in 1986 of $26 billion. Instead, the 1986 deficit is now expected to exceed $200 billion.

A comparison of the administration's 1981 projections with events of the next four years shows that slightly more than half of the shortfall was accounted for by lower receipts, with the remainder a result of higher outlays. However, the receipts shortfall originated in the 1981–82 recession and the unexpectedly rapid deceleration of inflation from double-digit rates. Since then, receipts have been rising at about the rate originally forecast. In contrast, the gap between actual and projected outlays has climbed steadily throughout the years. Thus, while poor economic conditions raised the level of the deficit in 1981–82, it was the rapid growth of spending that increased the deficit in subsequent years.

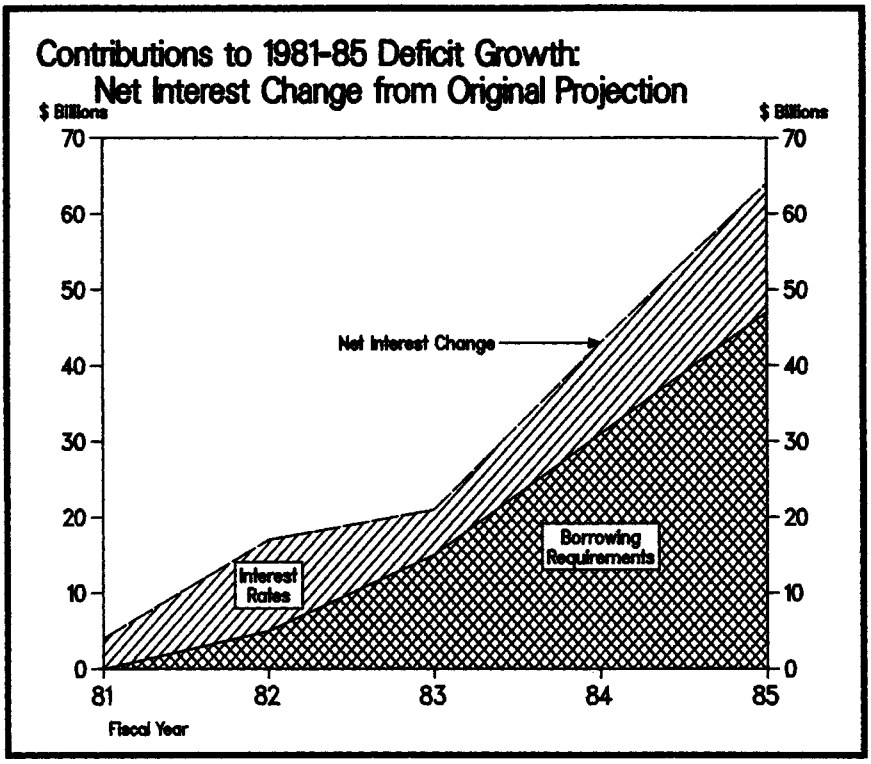
Interest on the Federal debt is a major component of the excess outlays. This accounted for $64 billion of the underestimate of 1985



outlays. However, only about one-quarter of the larger interest cost is accounted for by higher than anticipated interest rates. Most is attributable to the cumulative effect of higher than expected deficits and the resulting higher debt and debt service costs. Thus, most of the greater interest costs are a consequence of the excess spending and the shortfall of receipts.

Spending on entitlement programs surged during the 1981–82 recession, largely because of the rise in unemployment benefits, but slowed in the next several years as the economy expanded. By 1985 outlays for these programs were only $8 billion above what was envisaged for them in the original 1981 plan. In other words, these programs, while constituting 38% of all Federal outlays, accounted for only a small fraction of the deviation from the budget projection made in 1981.

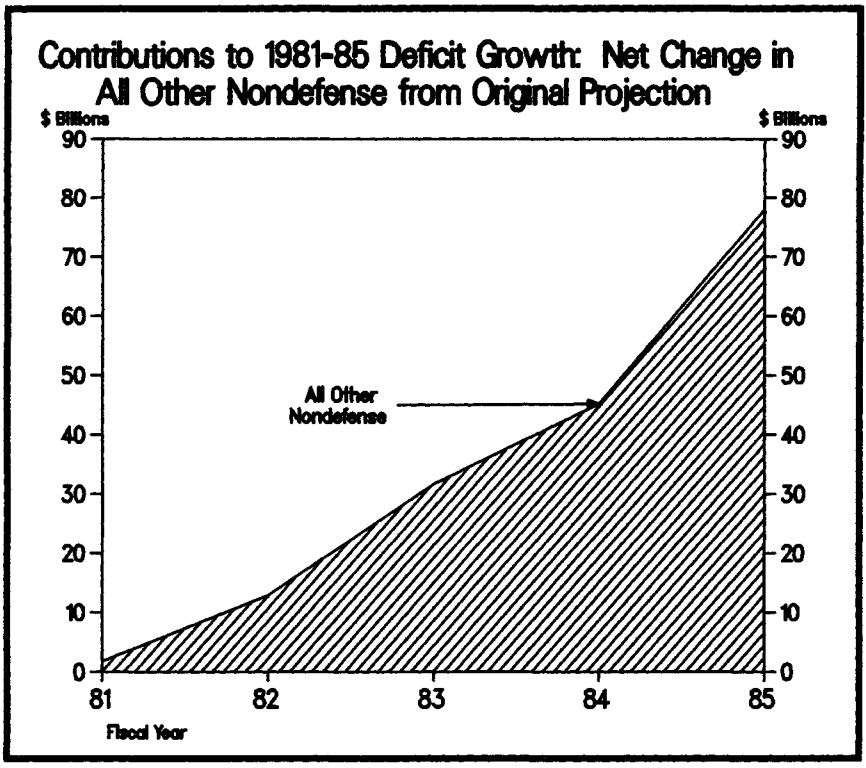
Defense outlays accounted for 25.4% of total outlays in 1985, compared with 22.7% in 1981. Although there was some increase in the share of Federal outlays going to defense, it fell short of the build-up requested in March 1981. Thus, defense spending also does not explain the rise in the projected deficit or the underestimate of



outlays. In fact, shortfalls in defense appropriations from the 1981 administration proposals partially offset other sources of increase in the deficit estimates. Put another way, if all other outlays and receipts had followed the path projected, the shortfall in defense spending would have meant a surplus $50 billion higher than originally projected for 1985.

By far the largest contributor to the deviation between actual outlays and the March 1981 budget estimates was in all other outlays. This category, total outlays minus defense, net interest and entitlements, accounted for 26.9% of outlays in 1981 and 22.3% in 1985. The largest part of the discrepancy in budget outlays resulted from inability to achieve planned reductions in this category. By 1985 the deviation from plan for other nondefense outlays had reached $78 billion, although some of the excess resulted from exceptionally high 1985 outlays for the Commodity Credit Corporation and purchases of housing notes.

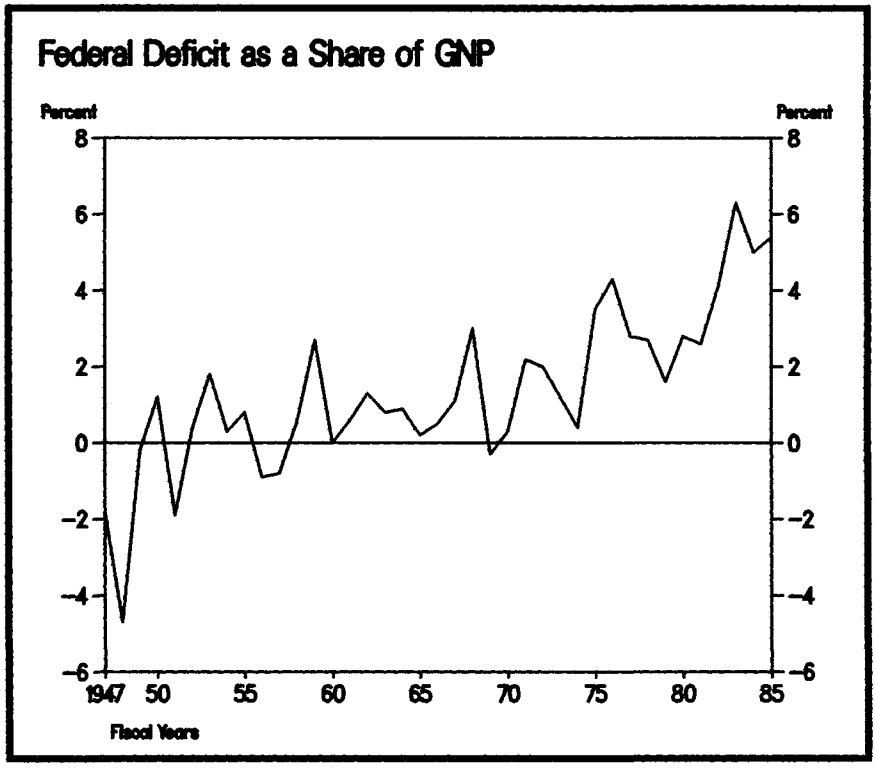
In brief, increases in all other outlays over and above those proposed by the administration in 1981 have substantially raised the deficit. They account for nearly half of the difference between



the actual 1985 deficit and that projected in 1981 for that year. A shortfall in receipts resulting from the recession and lower inflation accounted for most of the remainder. This is shown in the table on the next page.

The Structural Deficit.—While the level of the deficit has not changed significantly since its dramatic surge in 1982 and 1983, the underlying problem has in fact grown more serious. The recession of 1981-82 produced a sharp increase in the deficit. Outlays for unemployment compensation rose substantially, and receipts fell far short of expectations. These developments reflected the cyclical downturn and were in large part reversed during the economic recovery. However, despite the resurgence in economic activity since the recession, the deficit has remained high.

Although a cyclical downturn helped push the deficit up, it is incorrect to assume that economic recovery will, by itself, eliminate the deficit. Economic growth will contribute significantly to reducing the deficit, but efforts to control Federal spending are imperative.



Budget projections on a current services basis—that is, assuming no further policy actions to curb spending growth—indicate that the deficit in 1991 would still remain quite substantial even with an unemployment rate below 6% and after the economy had been expanding for 9 years. Any attempt to achieve still lower levels of unemployment by monetary stimulus would be likely to lead to a reacceleration of inflation and could mean an end to sustainable economic recovery. Therefore, projected deficits at this level of unemployment are not "cyclical" or temporary. They are permanent or "structural" and will persist unless determined policy actions are taken to eliminate them.

The growing structural deficit problem has its roots in the strong momentum of Federal spending increases, and in the debilitating economic policies of the 1960s and 1970s. The excessive momentum of domestic spending programs in the early 1970s was partially masked by severe underfunding of our defense effort and by the effect of inflation in swelling receipts. Total outlays will keep growing because of rising interest costs and growing numbers of social

security retirees, as well as the need to provide an adequate level of defense funding. As a result, a substantial current services deficit is projected, even assuming a sustained economic expansion.

If no policy actions were taken to reduce spending, these large and persistent deficits would pose serious economic problems. If they were financed by money creation, they would renew inflation and again bring on the inefficiencies, misdirection of resources, and cyclical instability that led to the stagnant growth and recessions of the 1970s. If they were not monetized, then the credit demands of the Federal Government resulting from rising spending would crowd out productive private investment by absorbing domestic savings or foreign investment, or both. This would inhibit economic growth by generating excessive real interest rates.

SOURCES OF FEDERAL DEFICIT CHANGE

(In billions of dollars)

	1981	1982	1983	1984	1985
Receipts:					
Original Reagan projection [1]	596.9	646.2	704.5	765.5	844.2
Actual	599.3	617.8	600.6	666.5	734.1
Shortfall	2.4	−28.4	−103.9	−99.0	−110.1
Outlays:					
Original Reagan projection [1]	675.4	703.8	744.8	782.1	846.3
Actual outlays	678.2	745.7	808.3	851.8	946.3
Deviation from original	2.8	41.9	63.5	69.6	100.0
Defense	−2.8	−1.8	−15.8	−28.5	−50.4
Entitlements	−0.7	14.2	26.9	9.9	8.0
Net interest	4.5	16.6	20.7	43.0	64.3
All other	1.8	12.9	31.7	45.2	78.1
Deficit:					
Original Reagan projection [1]	78.5	57.6	40.3	16.6	2.1
Actual budget deficit	78.9	127.9	207.7	185.3	212.3
Deviation from projection	0.4	70.3	167.4	168.6	210.1

[1] March 1981 *Budget Revisions* adjusted for further reductions proposed in the Mid-Session Review of the 1982 Budget and for accounting changes required to be consistent with the structure of the 1987 Budget.

BALANCED BUDGET AND EMERGENCY DEFICIT CONTROL ACT OF 1985

By 1985 the budget deficit had become an intractable problem. In the face of this problem, Congress finally took steps to reform its budget-making procedures. The GRH amendment mandates declining deficit targets that will result in a balanced budget in 1991. It changes the budget process by creating a default mechanism to ensure that these targets are met. The declining deficit path targets are significantly lower than the current services deficits.

GRH simply requires that the President's budget meet the deficit targets. It does not impose any restrictions on how those targets are to be met. The President can propose as much or as little as he

GRAMM-RUDMAN-HOLLINGS DEFICIT TARGETS

(In billions of dollars)

Fiscal year:	*Deficit targets*	*Current services deficits*
1986	$171.9	$205.6
1987	144.0	181.8
1988	108.0	150.0
1989	72.0	138.9
1990	36.0	126.3
1991	0	103.9

deems necessary for defense or other budget categories. GRH does not mandate the budget mix, only the maximum deficit. The same freedom exists for the Congress. It may choose to reach the target in a different way from the one the President proposes in his budget. GRH only requires that should the Congress depart from the President's proposals, it must do so in such a way that the deficit still remains at or under the targets.

The automatic procedures for cutting the budget take effect only if the President and Congress fail to reach agreement on a budget that meets the targets. These automatic procedures begin each year with a joint report by the Congressional Budget Office and the Office of Management and Budget. The two agencies, after reviewing the economic outlook and taking into account budgetary actions to date, prepare a deficit forecast for the coming year. In 1986, since the fiscal year began before GRH was enacted, the reports were submitted in January; for 1987 and subsequent years the reports are due in August prior to the beginning of the fiscal year. If the estimated deficit exceeds the target by any amount in 1986 or 1991, or by more than $10 billion in 1987–90, the automatic spending reduction procedure is triggered.

For fiscal year 1987 and subsequently, the sequestration order is to be issued on September 1 to go into effect in October if, by that time, Congress has not acted to reduce the deficit by other means. In fiscal year 1986 only, the order was issued on February 1 and the spending reduction will take effect March 1. The purpose of the order is to impose mandatory funding reductions that will reduce spending by an amount equal to the excess of the forecast deficit over the GRH target for that year.

In 1986 the procedure differs. For this year only, Congress set a limit on the total size of the cuts. The limit set was $20 billion on an annual basis, or $11.7 billion considering that only 7 months of the year will remain by the time the sequestration order is to go into effect on March 1. Therefore, in 1986 the spending reductions in the order are insufficient to reduce the deficit to the target, but

this limitation does not apply to future sequestration orders, which must be large enough to achieve the targets.

The dollar amount of spending reductions called for in the sequestration order is to be split equally between defense and nondefense programs. The order applies to all but specifically exempted programs, the largest of which is social security. Interest on the debt is also excluded, as are six programs that primarily provide low-income assistance. A number of programs, although not excluded, are covered by special provisions that limit the percentage reduction that can be imposed by the sequestration order. For certain indexed programs, sequestration is limited to the automatic cost-of-living adjustments provided under an indexing formula. After allowing for these exclusions and special provisions, reductions required to reach the target are to be achieved by uniform percentage reductions in budgetary resources across the remaining programs, projects and activities.

Across-the-board spending reductions are arbitrary and do not reflect relative priorities of different programs. This budget proposes a far different set of reforms and spending reductions to achieve the mandated deficit target than would be called for under a series of sequestration orders. It should be noted that even after an order is issued, Congress and the President would still have time to produce a responsible alternative before the order went into effect. Nonetheless, the sequestration order mechanism is the ultimate fail-safe device that assures that progress toward a balanced budget will continue whether or not there is agreement about budget priorities.

The essence of GRH is that it provides an assurance that the deficit will decline. Previous efforts to set targets for the deficit lacked such an assurance because there were no procedures for enforcing the deficit targets. This helps to explain why GRH has had such a heartening effect on the Nation's financial markets. It is a credible plan to bring the budget back into balance. The economic consequences of this change in the fiscal policy outlook are discussed below. Steady reduction of the budget deficit offers assurance that the administration's expectation of sustained economic growth and low inflation will be realized in the coming years.

THE ECONOMIC OUTLOOK AND ITS EFFECTS ON THE BUDGET

The economic recovery that began in December 1982 is now in its fourth year. Although it is a mature expansion, it shows no sign of ending. On the contrary, most of the evidence points to an acceleration of growth in 1986. Moreover, if the administration's policy proposals assumed in this budget are enacted, the economy could

grow above its recent trend rate through 1991, making this the longest period of uninterrupted growth on record.

LENGTH OF EXPANSIONS

Trough:	(Months)
October 1949	45
May 1954	39
April 1958	24
February 1961	106
November 1970	36
March 1975	58
July 1980	12
Average 1949–1981 (7 cycles)	46
Average 1854–1981 (30 cycles)	33
November 1982–present	38
November 1982–1991	109

A Sustainable Expansion.—As 1985 ended, there was increasing evidence in production, employment and income data that the economy was gathering momentum. Real GNP is projected to rise 4.0% this year. Faster growth is likely to place some upward pressure on short-term interest rates. Despite this pressure, long-term yields are forecast to continue to edge lower. While the inflation rate is projected to rise slightly, reflecting accelerated growth of the money supply last year and the decline in the dollar, it is now projected to be lower than was assumed in last year's budget.

For 1986 and the years beyond, real GNP growth assumptions in this budget are unchanged from those in last year's budget. Inflation and interest rate assumptions have been reduced in line with their better-than-expected performance in 1985.

COMPARISON OF FEBRUARY 1985 AND CURRENT ECONOMIC ASSUMPTIONS

(Calendar years; dollar amounts in billions)

	1985	1986	1987	1988	1989	1990
Nominal GNP:						
1985 assumptions	3,948	4,285	4,642	5,017	5,399	5,780
1986 assumptions [1]	3,888	4,174	4,522	4,878	5,234	5,576
Real GNP (percent change): [2]						
1985 assumptions	4.0	4.0	4.0	4.0	3.8	3.6
1986 assumptions	2.5	4.0	4.0	4.0	3.7	3.6
GNP deflator (percent change): [2]						
1985 assumptions	4.3	4.3	4.1	3.8	3.5	3.2
1986 assumptions	3.3	3.8	4.1	3.5	3.2	2.5
Interest rate on 91-day Treasury bills (percent):						
1985 assumptions	8.1	7.9	7.2	5.9	5.1	5.0
1986 assumptions	7.5	7.3	6.5	5.6	4.8	4.3
Unemployment rate (percent):						
1985 assumptions	7.0	6.9	6.6	6.3	6.1	5.8
1986 assumptions	7.1	6.7	6.5	6.3	6.1	5.8

[1] Not adjusted for December 1985 revisions.
[2] Fourth quarter to fourth quarter.

Several factors combine to bring about this projected improvement. In the very near term, the inventory cycle is entering a phase of stockbuilding that ought to provide an important, although temporary, stimulus to real GNP. In addition, the yearlong decline in the foreign exchange rate of the dollar should begin to restrain imports, while stimulating exports. Thus, stockbuilding and the foreign trade balance, which pulled down growth in 1985, should exert an upward push in 1986.

Beyond the near term, business and consumer spending is forecast to move forward, propelled by the return to sounder fiscal and monetary policies. The favorable effects of GRH have already been felt in financial markets. Interest rates have fallen, the stock market has set record highs, and the dollar has declined in an orderly manner. Market fears that Federal spending would remain uncontrollable have given way to the hope that fiscal discipline can be restored.

Fiscal restraint will permit the monetary authorities to pursue an anti-inflation policy directed at slowly reducing the rate of growth of the monetary aggregates. The administration remains committed to its long-run goal of restoring a stable price level. Fiscal responsibility is needed to reach that goal. If it is achieved, as assumed in this budget, there is reason for optimism in the economic outlook, not only in 1986, but also in the years beyond.

Inventory Accumulation.—The changing tempo of inventory accumulation has dominated the pattern of growth during the recovery. During the first six quarters of the upturn, stockbuilding added 2½ percentage points to overall real growth; during the next six quarters, it cut 1¼ points off the growth rate. Real final sales, which exclude inventory change, have grown much more steadily, rising at just over a 4% annual rate during the first phase of the recovery and somewhat under 4% during the next year and a half.

REAL GNP GROWTH AND INVENTORY INVESTMENT IN THE CURRENT EXPANSION

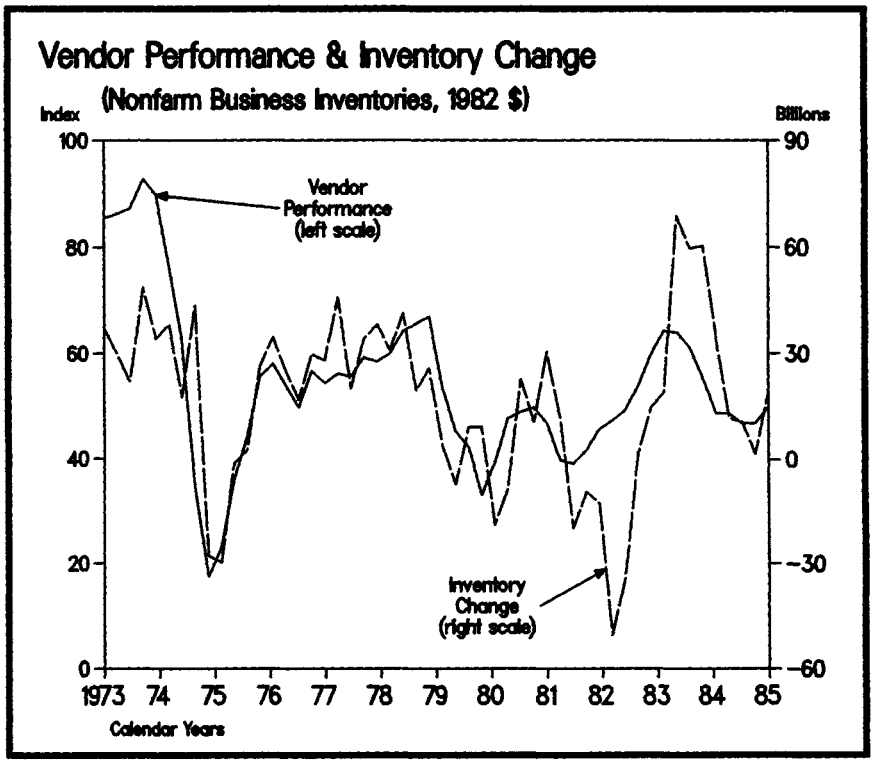
(Percent change at annual rate)

	1st 6 quarters	Next 6 quarters
Final Sales	4.3	3.4
+ Inventory contribution	2.6	−1.2
= Real GNP	6.9	2.1

Large swings in inventory accumulation cannot proceed for very long in one direction. After exerting a negative effect on growth for nearly 2 years, the process of slower stockbuilding appears to have run its course. This year, the impact of inventory change on growth will almost certainly be positive once again. The swing from a negative to a positive impact on real GNP is foreshadowed

by the shift at the end of 1985 from shorter to longer delivery times for goods ordered.

With delivery times on the rise, purchasing managers must quicken the pace of orders to be assured of adequate materials. The faster rate of ordering, in turn, will produce progressively larger positive changes in inventories, in terms of both goods in the process of production and finished goods. As the following chart shows, a reversal in delivery times (measured by vendor performance) is soon followed by a similar change in inventory accumulation.



The Foreign Sector.—The declining net export balance, which cut real GNP growth by over two percentage points during the first year and a half of the recovery and by one-half percentage point subsequently, now seems poised to stimulate growth in 1986. The substantial decline of the dollar over the past year should enable U.S. producers to compete more successfully against foreign-made goods both at home and in markets abroad.

REAL GNP AND NET EXPORTS IN THE CURRENT EXPANSION

(Percent change at annual rate)

	1st 6 quarters	Next 6 quarters
Gross Domestic Purchases	9.0	2.8
+ Net export contribution	−2.1	−0.7
= Real GNP	6.9	2.1

After soaring to record heights last February, the dollar retreated during the spring and summer of 1985. In September, the Finance Ministers of the Group of Five (G-5)—United States, Japan, West Germany, United Kingdom, France—agreed upon a program to encourage an orderly appreciation of foreign currencies relative to the U.S. dollar. This program called on the U.S. to initiate actions that would reduce future Federal deficits and on the other industrial countries to spur the growth of their domestic economies. The ministers also accepted occasional intervention in the foreign exchange markets. Following the meeting, several central banks sold large quantities of dollars for other currencies. These actions and the passage of GRH facilitated a sharp strengthening of foreign currencies, especially the Japanese yen, against the dollar. By the end of 1985, the dollar had declined 23% on a trade weighted average basis from its February peak.

Although several years normally are required before the full effects of a sustained change in the value of other currencies relative to the dollar are felt on trade flows, the peak impact is expected after approximately six quarters. Thus, growth this year and next should receive a sizable boost from an improving constant dollar net export balance. Elimination of the trade deficit, however, may require a continuing currency realignment. This could occur if the G-5 nations act on their agreed upon policy prescription. The U.S. has taken the first step toward reducing, and finally eliminating, the Federal deficit by passing GRH. With lower consequent U.S. interest rates, the other G-5 members will have room to reduce their structural rigidities and support their own growth. An acceleration of growth in these industrial economies would increase their attractiveness to foreign investments. This would begin to reverse the flow of international capital into the U.S. and increase the demand abroad for U.S. goods and services.

Financial Markets Signal an Improving Economy.—Over the past year and a half, interest rates have declined dramatically, and there has been a substantial increase in the price of stocks and bonds—climaxed in the fourth quarter by a stock market rally that raised the major indexes more than 15%.

The improvement in financial markets occurred in two distinct stages. The first stage started in the fall of 1984, shortly after the growth "pause" began, as the slowdown in U.S. economic activity reduced interest rates by weakening the demand for credit. At the same time, monetary policy, which had been quite restrictive earlier in 1984, eased substantially. Together, these forces acted to lower interest rates—especially short-term rates. After firming for a few months early in 1985, short-term rates resumed their decline until June 1985. That marked the end of the first stage.

The second stage of the financial market rally got underway in the late fall of 1985. This time, it was led by long-term interest rates. From late October to the end of December, the yield on 20-year Treasury bonds, as well as corporate bonds and mortgages, fell more than a hundred basis points, returning to levels not seen since 1979. These declines were not accompanied by falling short-term rates, which held steady in the 7% to 8% range, nor could they be traced to any obvious change in monetary policy.

One part of the explanation for the fall in long-term interest rates is that there was a growing belief that the GRH amendment would pass and that it would mean a significant improvement in the Federal budget deficit and, therefore, in the prospects for price level stability over the longer term. The timing of this rally is significant. It began when Senators Gramm, Rudman, and Hollings first proposed their budget reform in October of 1985. As the prospects for passage of the bill improved throughout November and December, the rally strengthened, with stock prices reaching new highs following the passage of the bill shortly before Christmas.

The increase in stock and bond prices, together with lower interest rates, is forecast to have a number of positive effects on the economy.

- Consumers' wealth has increased, raising their ability to spend and offsetting the restraining effects of high debt/income ratios. The stock market gain may have added a quarter of a trillion dollars to household net worth during the final three months of last year.
- The purchase of housing and consumer durables is forecast to increase. To some extent, this was already starting to occur in 1985 in response to the first stage of the interest rate decline, but the further decline in interest rates in November and December should stimulate additional consumer investment in 1986.
- The cost of capital to corporations has been reduced by the decline in interest rates and the rise in stock prices, and this should stimulate additional investment in capital goods.
- Even if the exchange value of the dollar falls no further, the prospect for improvement in the U.S. trade deficit should help

the competitive position of U.S. industry and ease the strain on many weakened sectors.

Low Inflation: Key to a Sustainable Expansion.—The sustainability of the current expansion depends heavily upon our keeping inflation under control. In this regard, the inflation performance of recent years has been exemplary and continues to surprise many observers. The Consumer Price Index rose only 3.5% over the four quarters of 1985. This is lower than its 4.1% increase between the last quarter of 1983 and the final quarter of 1984. Other broad measures of prices indicate a similar pattern, as shown in the table below. Indeed, sensitive commodity prices fell throughout most of 1985 after increasing sharply in the early stages of the recovery.

MEASURES OF INFLATION

(Percent change, fourth quarter to fourth quarter)

	CPI all urban	Average hourly earnings index	Producer price index	GNP fixed-weight price index
1980	12.6	9.6	12.3	9.8
1981	9.6	8.4	7.3	8.5
1982	4.4	6.2	3.5	5.0
1983	3.3	4.0	0.8	3.8
1984	4.1	3.1	1.7	4.2
1985	3.5	3.0	1.6	3.5

A number of factors have contributed to the good inflation performance. The most fundamental was the change in monetary policy in late 1979 that reversed more than a decade of accommodation to accelerating prices. Market participants are now apparently confident that the Federal Reserve will restrain future inflation; even the wide margin by which the narrowly defined money supply, M1, overshot its target for 1985 was taken in stride. From the fourth quarter of 1984 to the fourth quarter of 1985, M1 grew almost 12%, well above its 4% to 7% initial target range. The broader monetary aggregates, on the other hand, remained within their targets for the year. This suggests that the extraordinary surge in M1 growth may have a reduced significance compared to five or ten years ago.

Other factors that have contributed to the good inflation performance are the strength of the dollar in foreign exchange markets, the widespread availability of labor and other resources, and weaker oil prices. Between the fall of 1980 and early 1985, the dollar appreciated by 80%. Although it is difficult to measure precisely, the dollar's rise may have pulled the measured inflation rate down about one percentage point a year below what it would otherwise have been. The dollar has declined during the past year, but given the lags between exchange rate changes and infla-

tion, prices in 1985 were more affected by the dollar's earlier rise. Eventually the dollar's decline will be reflected in domestic prices, and this could temporarily stall the disinflation process. The trend rate of inflation, however, should continue to slow if the Federal Reserve pursues a policy of gradually reducing the rate of growth of the money supply.

Oil prices have dropped rather sharply during the 1980s following their explosive rise in the prior decade. This reflects a steady decline in oil and energy use worldwide, a marked rise in the volume of exports from non-OPEC countries, and a large increase in excess OPEC capacity. OPEC decided in December 1985 to abandon its unsuccessful effort to control prices through production quotas. The downward trend in oil prices should partially offset upward pressures on prices from other sources.

The strong dollar, sustained economic growth, deregulation and a resurgence of entrepreneurial activity have increased competition in many sectors of the economy. This has increased productivity growth. Because of earlier monetary restraint, U.S. workers have benefited from higher productivity in the form of rising real wages rather than through accelerating money wage claims that bring no increase in purchasing power.

Although some of the factors that restrained inflation in recent years may operate in reverse in 1986–87, inflation will ultimately be eliminated if we persevere. However, rapid growth in the money supply such as we had last year, if repeated, would undermine the credibility of the Federal Reserve and cause inflationary pressures to rebuild. On the other hand, care should be taken that the slowing of the monetary aggregates be gradual.

GRH should make the task of slowing growth of the money supply easier. Reduced Treasury borrowing is expected to help reduce interest rates. If these expectations are realized, the pressure on the Federal Reserve to use monetary tools to achieve the same effects would be reduced. The problem with using expansionary monetary policy to reduce interest rates is that it leads to more inflation in the long run. Accelerating inflation, in turn, is a major cause of the economic imbalances that precipitate severe recessions. Therefore, one of the most promising aspects of GRH is that it increases the probability that inflation will finally be wrung out of the economy, and thereby improves the chances that the current economic expansion will be prolonged.

Risks in the Outlook.—The major risks in the economic outlook stem from the financial consequences of the spiraling inflation of the 1970s and the subsequent disinflation of the past five years. These risks are a painful reminder of the dangers of undisciplined monetary and fiscal policy.

In the 1970s, many less developed nations experienced rapid increases in the prices of the basic commodities they produce and export. They borrowed heavily in the expectation that commodity prices would continue to rise. When commodity prices fell in the 1980s and the exchange value of the dollar rose, this debt became a heavy burden.

Somewhat similar risks, to a greater or lesser degree, are posed by thrift institutions and the farm sector. Thrift institutions suffered large losses when interest rates soared in the late 1970s and 1980–81. Their short-term cost of funds rose sharply, but the yield on their investments increased very little because their asset portfolios consisted largely of long-term fixed-rate home mortgages. Subsequent declines in interest rates have restored many thrift institutions to profitability, but a significant number have not recovered and, indeed, may have even aggravated their problems by undertaking new and riskier investments.

American farmers were also caught up in the cycle of financial upheavals. In the 1970s, when land values were soaring, many farmers borrowed heavily. Many of them are now finding it very difficult to service their debts. Financial institutions in rural areas have been shaken by the problems farmers have encountered in repaying their loans.

One important side effect of reducing Federal deficits should be to relieve some of the strain on these troubled sectors of the economy and reduce the risks in the economic outlook. Lower interest rates and a more competitive value for the dollar should help farmers to sell more of their output abroad, thereby increasing farm incomes and making farm debts more manageable. Third world borrowers would find it easier to meet their loan payments if world interest rates were to continue downward. The thrift institutions have already found that lower interest rates are helping their profits and increasing the value of their assets.

ECONOMIC ASSUMPTIONS

This section describes the economic assumptions that underlie the budget estimates. The current services estimates displayed in this budget also are based on the same economic assumptions as the budget itself. Allowing the budget to proceed on a current services basis—that is, with no future policy action to change program spending in line with the GRH targets—would change significantly, and for the worse, the economic performance from what is assumed for the budget. However, the convention of basing both the budget estimates and the current services estimates on a common set of economic assumptions does limit the differences between them to only the direct effects of proposed policy actions.

SHORT-RANGE ECONOMIC FORECAST

(Calendar years; dollar amounts in billions)

Item	Actual 1984	Forecast		
		1985	1986	1987
Major economic indicators:				
Gross national product, percent change, fourth quarter over fourth quarter:				
Current dollars	9.0	5.8	8.0	8.3
Constant (1982) dollars	4.7	2.5	4.0	4.0
GNP deflator (percent change, fourth quarter over fourth quarter)	4.1	3.2	3.8	4.1
Consumer Price Index (percent change, fourth quarter over fourth quarter) [1]	3.6	3.3	3.7	4.1
Unemployment rate (percent, fourth quarter) [2]	7.1	6.9	6.7	6.5
Annual economic assumptions:				
Gross national product:				
Current dollars:				
Amount	3,775	3,992	4,274	4,629
Percent change, year over year	11.0	5.8	7.0	8.3
Constant (1982) dollars:				
Amount	3,492	3,574	3,695	3,842
Percent change, year over year	6.6	2.3	3.4	4.0
Incomes:				
Personal income	3,112	3,294	3,486	3,756
Wages and salaries	1,835	1,961	2,078	2,247
Corporate profits before tax	238	228	281	330
Price level:				
GNP deflator:				
Level (1982=100), annual average	108.1	111.7	115.7	120.5
Percent change, year over year	4.1	3.3	3.5	4.2
Consumer Price Index: [1]				
Level (1967=100), annual average	307.6	318.5	329.5	343.1
Percent change, year over year	3.4	3.5	3.5	4.1
Unemployment rates:				
Total, annual average [2]	7.4	7.1	6.7	6.5
Insured, annual average [3]	2.8	2.8	2.7	2.6
Federal pay raise (percent):				
Military (October) [4]	4.0	7.0	4.0	4.8
Civilian (January)	4.0	3.5	.....	3.0
Interest rate, 91-day Treasury bills (percent) [5]	9.6	7.5	7.3	6.5
Interest rate, 10-year Treasury notes (percent)	12.4	10.6	8.9	8.5

[1] CPI for urban wage earners and clerical workers. Two versions of the CPI are now published. The index shown here is that currently used, as required by law, in calculating automatic cost-of-living increases for indexed Federal programs. The manner in which this index measures housing costs changed significantly in January 1985.

[2] Percent of total labor force, including armed forces residing in the U.S.

[3] This indicator measures unemployment under State regular unemployment insurance as a percentage of covered employment under that program. It does not include recipients of extended benefits under that program.

[4] The 1984 pay raise occurred in January. There were 2 military pay raises in calendar year 1985: 4.0% in January and 3.0% in October.

[5] Average rate on new issues within period, on a bank discount basis.

This permits the current services estimates to serve their purpose as a baseline against which to measure the direct budgetary effects of individual policy proposals.

The Outlook for 1986-1987.—The forecast for 1986 and 1987 assumes that monetary *growth* will decline gradually following its acceleration last year, while providing sufficient liquidity to sustain a healthy expansion. It also takes account of the

LONG-RANGE ECONOMIC ASSUMPTIONS

(Calendar years; dollar amounts in billions)

	Assumptions			
	1988	1989	1990	1991
Major economic indicators:				
Gross national product, percent change, fourth quarter over fourth quarter:				
Current dollars	7.7	7.0	6.2	5.6
Constant (1982) dollars	4.0	3.7	3.6	3.5
GNP deflator (percent change, fourth quarter over fourth quarter)	3.6	3.2	2.5	2.0
Consumer Price Index (percent change, fourth quarter over fourth quarter) [1]	3.5	3.2	2.5	2.0
Unemployment rate (percent, fourth quarter) [2]	6.2	6.0	5.7	5.5
Annual economic assumptions:				
Gross national product:				
Current dollars:				
Amount	4,995	5,359	5,709	6,036
Percent change, year over year	7.9	7.3	6.5	5.7
Constant (1982) dollars:				
Amount	3,996	4,151	4,301	4,454
Percent change, year over year	4.0	3.9	3.6	3.5
Incomes:				
Personal income	4,012	4,266	4,506	4,748
Wages and salaries	2,418	2,587	2,743	2,901
Corporate profits before tax	366	394	424	430
Price level:				
GNP deflator:				
Level (1982=100), annual average	125.0	129.1	132.7	135.5
Percent change, year over year	3.7	3.3	2.8	2.1
Consumer Price Index: [1]				
Level (1967=100), annual average	356.0	367.7	378.0	386.0
Percent change, year over year	3.7	3.3	2.8	2.1
Unemployment rates:				
Total, annual average [2]	6.3	6.1	5.8	5.6
Insured, annual average [3]	2.5	2.3	2.2	2.0
Federal pay raise (percent):				
Military (October)	5.1	4.9	4.5	NA
Civilian (January)	3.0	3.0	3.0	3.0
Interest rate, 91-day Treasury bills (percent) [4]	5.6	4.8	4.3	4.0
Interest rate, 10-year Treasury notes (percent)	7.3	5.5	4.8	4.5

[1] CPI for urban wage earners and clerical workers. Two versions of the CPI are now published. The index shown here is that currently used, as required by law, in calculating automatic cost-of-living increases for indexed Federal programs.
[2] Percent of total labor force, including armed forces residing in the U.S.
[3] This indicator measures unemployment under State regular unemployment insurance as a percentage of covered employment under that program. It does not include recipients of extended benefits under that program.
[4] Average rate on new issues within period, on a bank discount basis. These projections assume, by convention, that interest rates decline with the rate of inflation.

effects of the large spending cuts proposed in this budget, which are consistent with the targets set in GRH. In keeping with the usual practice, the assumptions are presented for calendar years, rather than fiscal years.

The highlights of the forecast are as follows:

- Real GNP is expected to grow 4.0% in both 1986 and 1987. This is consistent with a return to healthy expansion following a year and a half of relatively sluggish growth.

- The GNP deflator is projected to rise by 3.8% in 1986 and 4.1% in 1987. This is a slight acceleration from the remarkably low 1985 rate of increase (3.2%), but it is still moderate. The rapid growth of the money supply last year and the recent appreciation of other currencies relative to the dollar are the main factors behind the projected slight rise in inflation. Slower monetary growth in 1986 and 1987 is assumed to help slow and then reverse the rise in the GNP price deflator during the course of 1987.
- The unemployment rate is expected to decline moderately in 1986 and 1987 consistent with the pace of economic growth.
- The recent downward trend in long-term interest rates is expected to continue, but at a slower pace, during 1986 and 1987. Short-term rates are expected to rise moderately in 1986 as a result of stronger economic activity, and then to resume their downward trend in 1987.

The Long-Term Assumptions: 1988–1991.—The long-term economic assumptions are not intended as forecasts of future economic conditions. They are extrapolations of trends for the relevant economic variables. These projections are based on two assumptions: that the fiscal policy proposed in this budget will be enacted and that the Federal Reserve will pursue a policy of gradually reducing the rate of growth of the monetary aggregates.

In constant 1982 dollars, real GNP is projected to grow at an annual rate of 4.0% in 1988, progressively slowing to 3.5% in 1991, which is close to the economy's postwar average. This is consistent with a decline in the unemployment rate to 5.6% by 1991. Underlying the real growth assumptions are continuing strong increases in employment and a 2% per year improvement in output per hour worked in the nonfarm business sector over the 1988–1991 period.

Although the population over age 16 will grow by only 1% a year over the next five years, the economic assumptions call for a substantially faster increase in employment. There are three reasons for this assumption:

- Demographic and social trends have produced substantial gains in female labor force participation; these are expected to continue through 1991.
- The number of people in the prime working ages, 25 to 54, will be growing rapidly, so that they will constitute an increasing share of the labor force. This will raise the average rate of labor force participation for the total population. Also, their greater work experience should tend to raise productivity.
- The unemployment rate is projected to decline gradually between now and 1991.

The assumed 2% average productivity growth is more rapid than that which occurred in the 1970s. A variety of administration

policies, private initiatives and demographic factors have helped foster a climate that favors increases in efficiency. For example:

- Tax changes since 1981 have reduced the cost of capital and fostered a high rate of real nonresidential fixed investment.
- A considerable part of the capital spending in recent years has gone into computers, which play a particularly important role in productivity improvements.
- Stable, moderate inflation has reduced uncertainty about future profitability, encouraging capital investment.
- Lower inflation expectations have helped moderate wage and salary demands; more flexible work rules and fewer strikes have helped raise labor productivity.
- Deregulation in transportation, energy, and finance has increased productivity in these sectors and lowered their relative prices, transmitting the benefits of deregulation and higher productivity to other sectors.
- The increase in research and development investment since the late 1970s has produced a stream of new innovations that can help sustain productivity growth. Since 1978, the share of GNP going to research and development expenditures has increased 16%.
- Cost-cutting measures by businesses are likely to continue, spurred in part by foreign competition.

The administration assumes that the rate of inflation, as measured by the GNP deflator, will increase to 4.1% in 1987, and then decline gradually, falling to 2.0% in 1991. The administration is committed to a policy of price stability. By 1991, the economy should be close to achieving that goal.

Changes in Economic Assumptions and the Budget.—Had economic assumptions and conditions not changed since last year, the 1990 deficit would have been $10.6 billion rather than the current estimate of $35.7 billion. The shortfall in receipts, which are $37.7 billion lower, is partly offset by $12.6 billion lower outlays. The larger deficit in 1990 is almost entirely attributable to economic performance in 1985, as opposed to changes in the forecast for 1986–1990 (see addendum in following table). The combination of lower-than-projected levels of real GNP, inflation and interest rates last year are estimated to have added $21.3 billion to the 1990 deficit.

EFFECTS ON THE BUDGET OF CHANGES IN ECONOMIC ASSUMPTIONS SINCE LAST YEAR

(Fiscal years; in billions of dollars)

	1986	1987	1988	1989	1990
Budget totals under February 1985 economic assumptions and February 1986 policies:					
Receipts	798.1	870.5	956.8	1,026.2	1,095.8
Outlays	983.7	1,005.4	1,038.7	1,073.3	1,106.4
Deficit (−)	−185.6	−134.9	−81.9	−47.0	−10.6
Changes due to economic assumptions:					
Receipts	−21.0	−20.1	−23.6	−30.1	−37.7
Outlays:					
Inflation and pay raises	−2.7	−5.9	−7.0	−8.9	−11.5
Unemployment	−0.3	−0.4	−0.1	.....	.....
Interest rates	−2.5	−7.9	−8.5	−4.9	−6.1
Interest on changes in borrowing	1.6	2.9	3.6	4.1	5.0
Total, outlays	−3.8	−11.4	−11.9	−9.7	−12.6
Increase in deficit (−)	−17.2	−8.7	−11.7	−20.5	−25.1
Budget totals under February 1986 economic assumptions and February 1986 policies:					
Receipts	777.1	850.4	933.2	996.1	1,058.1
Outlays	979.9	994.0	1,026.8	1,063.6	1,093.8
Deficit (−)	−202.8	−143.6	−93.6	−67.5	−35.7
Addendum:					
Increase in deficit (+) due to:					
Actual 1985 economic performance	21.0	16.3	15.4	18.6	21.3
Change in the forecast for 1986–1990	−3.8	−7.6	−3.7	1.9	3.8
Percent due to 1985 economic performance	(122)	(187)	(132)	(91)	(85)

Sensitivity of the Budget to Economic Assumptions.—Both receipts and outlays are significantly affected by changes in economic conditions. This sensitivity seriously complicates budget planning because the inevitable errors in forecasting the performance of the economy lead to errors in the budget forecast. Since the budgetary impacts of changes in economic assumptions are fairly predictable, a set of rules-of-thumb can be useful for analysis of the budget.

For example, a one percentage point higher rate of inflation beginning in October 1986 and sustained for the forecast period would raise total outlays by $41.6 billion and receipts by $57.6 billion by 1991. Outlays for indexed entitlement programs would be raised $19.5 billion, and those for nonindexed entitlement programs that rise automatically with the rate of inflation, such as medicare and medicaid, would be $3.3 billion higher. Discretionary spending would increase by $18.8 billion, assuming that appropriations were provided through the budget process to maintain real program levels. These effects assume that nominal GNP would increase one percentage point to reflect the higher rate of inflation, while real economic growth and unemployment remained unchanged.

SENSITIVITY OF THE BUDGET TO ECONOMIC ASSUMPTIONS

(Fiscal years; in billions of dollars)

Budget effect	1987	1988	1989	1990	1991
INFLATION					
Sustained one percentage point higher rate of inflation beginning October 1986:					
Outlays, entitlements:					
Indexed programs	0.4	2.6	5.8	9.5	19.5
Non-indexed programs	0.3	0.9	1.6	2.4	3.3
Outlays, discretionary programs:					
Defense	1.4	3.6	6.3	9.3	12.9
Nondefense	0.5	1.5	2.9	4.4	5.9
Receipts	6.5	17.6	29.3	42.5	57.6
REAL GROWTH					
Sustained one percentage point lower real GNP growth beginning October 1986:					
Receipts	−6.2	−17.7	−30.5	−44.7	−60.6
INTEREST RATES (EFFECT ON NET INTEREST)					
Sustained one percentage point increase in interest rates under budget policy deficits, beginning October 1986 [1]	5.1	10.3	13.0	14.1	15.3
INTEREST COST OF HIGHER FEDERAL BORROWING					
Effect of $100 billion borrowing in 1987 [2]	4.8	8.4	7.9	7.0	6.6
UNEMPLOYMENT RATE					
One percentage point higher rate beginning October 1986:					
Unemployment benefits	4.7	2.8	2.4	2.6	2.7
Other unemployment-sensitive outlays	1.8	2.0	2.0	2.0	2.0
FEDERAL PAY RAISES					
Outlay effect of one percentage point increase:					
Military personnel (October 1986)	0.5	0.5	0.5	0.5	0.6
Civilian employees (January 1987)	0.4	0.6	0.7	0.7	0.7
Employer share, employee retirement	−0.1	−0.1	−0.1	−0.1	−0.1
COMBINED EFFECTS					
Effect of a one percentage point higher annual rate of inflation (and interest rates) beginning October 1986, current services basis:					
Change in receipts	6.5	17.5	29.3	42.5	57.6
Change in outlays	7.9	20.2	32.7	44.7	64.5
Increase in deficit (−)	−1.4	−2.7	−3.5	−2.2	−6.8
Effect of a one percentage point lower annual rate of real growth, with higher unemployment, beginning October 1986:					
Change in receipts	−6.2	−17.7	−30.5	−44.7	−60.6
Change in outlays	1.1	4.3	8.5	12.6	17.6
Increase in deficit (−)	−7.2	−22.0	−39.0	−57.3	−78.2

[1] Omits increase in receipts due to higher Federal Reserve System deposits of earnings.
[2] Includes subsequent interest on borrowing incurred to pay for previous interest costs.

Higher inflation is likely to affect other economic factors that influence the deficit, such as interest rates and Federal pay. The direct and indirect effects of a one percentage point higher rate of inflation beginning October 1986 are shown in the lower part of the accompanying table. Note that the effects of the higher inflation rate

on outlays and receipts are roughly offsetting and the net effect on the deficit is small.

The second set of figures shows the impact of a rate of real and nominal economic growth one percentage point lower than in the budget for the 1987-91 period. By 1991, the budget deficit would be $78 billion higher. Inflation and interest rates are assumed to be unchanged, but the unemployment rate is assumed to rise by one percentage point for each two percentage points that the level of real GNP falls below its base path. Outlay effects include the interest costs due to the increased deficit. From this analysis, it is clear that threats to the economy's real growth potential are also threats to progress on the deficit.

The effects of changes in economic assumptions in the opposite direction are approximately symmetric. The impact of a percentage point lower inflation or higher real growth would be of about the same magnitude as shown, but of opposite sign.

These rules-of-thumb ignore possible changes in the assumed income share composition of GNP that would be likely to accompany any changes in real growth, inflation, or interest rates. Because different income components are subject to different taxes and tax rates, estimates of total receipts can be affected significantly by changing the income shares. These relationships are too complex, however, to reduce to simple rules-of-thumb.