FRBSF Weekly Letter

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Projecting Deficits

The Balanced Budget and Emergency Deficit Control Act of 1985 — better known as Gramm-Rudman-Hollings — has increased the scrutiny of deficit projections. Under the procedures established by Gramm-Rudman-Hollings, both the Congressional Budget Office (CBO) and the Office of Management and Budget (OMB) are required to project the deficit implications of each year's fiscal budget to determine whether the deficit will remain below the ceilings established by the legislation. If the CBO and OMB conclude the deficit will exceed the ceiling, spending would need to be cut.

Recently, large revisions in the projections of current and future federal budget deficits have called attention to the limitations of the deficit projection process and raised questions about relying too strongly on such projections in political decisionmaking.

The CBO currently is projecting a budget deficit for fiscal year 1989 that is $120 billion lower than what it projected just a year ago. In this *Letter,* we examine some of the reasons for the large changes in the projections of future deficits. A study of these recent revisions and actual experience suggests that projections should not be interpreted as forecasts of actual deficits. Projections are conditioned by assumptions about government policy and the economy. As a result, they may differ markedly from the deficits that subsequently occur.

Recent revisions

To illustrate the dramatic change that has recently occurred in the projections of future deficits, Chart 1 shows the CBO's baseline budget projections reported each February in 1984, 1985, and 1986 for the budget years 1986 to 1990. In February 1984, the CBO projected a federal deficit for fiscal year 1989 of $308 billion. One year later, in February 1985, CBO had cut its projected 1989 deficit by 9 percent to $280 billion. Then, in February 1986, the CBO slashed its projected 1989 deficit in half to $144 billion.

Another perspective on deficit projections is given by Chart 2 which shows the actual deficits for 1982 to 1985, together with the OMB's projections of the deficit one year and two years earlier. The actual deficit for fiscal year 1982, for example, was $128 billion, while two years earlier (in 1980), the OMB had projected a deficit of only $46 billion for 1982. An ensuing recession caused the actual deficit to increase substantially from that projected.

Sources of revisions

Revisions in projected future deficits arise from two sources. First, they come from differences between actual government actions and those assumed when the projections were made. Deficit projections depend on assumptions about the spending and tax programs that Congress will approve. If these assumptions turn out to be wrong, the deficit projections would have to be revised.

Second, revisions come from changes in economic forecasts. Any projection of future deficits must be based on an underlying set of assumptions about economic growth, inflation, and interest rates, for example, all of which are subject to change. Both these sources of revisions have been important in the recent dramatic change in the outlook for future deficits.

The CBO's projection for fiscal year 1989 provides a good example of how both policy changes and changes in economic forecasts affect budget projections. This February, the CBO cut its projected deficit for 1989 to $144 billion, from the $280 billion projection it made in February 1985. A major reason for this downward revision was a $73 billion reduction in estimated defense spending in 1989. Last February, the CBO assumed that growth in defense budget authority, adjusted for inflation, would average almost 6 percent from 1986 through 1990. However, in 1985, Congress froze inflation-adjusted defense spending for the 1986 fiscal year and reduced planned growth for future years. Consequently, the CBO now assumes there will be no growth in defense spending for the next five years.

A second major cause of the CBO's recent revisions in deficit projections was a change in the assumed path of interest rates. The CBO based its February 1985 budget projections on the assumption that the interest rate on three-month Treasury bills would average over 8 percent in 1986, and remain over 8 percent through 1989. In contrast, it based its February 1986 projections on the assumption that the three-month bill rate would fall to about 6 percent by 1989.

The downward revision in the pattern of future interest rates reduced future interest payments and thereby led to smaller projected deficits. Smaller deficits and lower borrowing further reduced projected interest payments in future years. Together, the revised assumptions about defense spending and the cumulative effect of interest payments reduced the projected deficit for 1989 by $123 billion.

Because assumptions about the future play such an important role in determining deficit projections, new information about the economy or about Congressional budget actions can quickly make projections obsolete. Since the CBO projections were published in February, interest rates have declined further and oil prices have dropped dramatically. For example, the rate on the three-month Treasury bill has fallen from 7.00 percent in early February to the current level of approximately 5.75 percent. Market prices for oil have declined about 35 percent from February levels. To the extent that these economic developments persist, they will lower projected future deficits even further.

Administration forecasts

The impact of alternative assumptions about economic conditions and Congressional actions on deficit projections is even more apparent in comparisons of projections prepared by the CBO and those prepared by the Reagan Administration. The February CBO deficit projection for 1989 is $144 billion whereas the Administration projects a $68 billion deficit — $76 billion lower than CBO's projection. Of this difference, $23 billion is due to differing assumptions about the economy, given the Administration's budget, while $53 billion reflects differing assumptions about the budget Congress will pass.

CBO projections are based on the assumption that the average growth rate of real GNP over the next six years will be 3.3 percent. In contrast, the Administration is assuming an average growth rate over this same period of 3.8 percent. Even a difference as small as ½ percent per year can have a sizable impact on the deficit outlook. For example, the CBO estimates that an additional 1 percent real growth in 1986 would cut $19 billion off the 1987 deficit; the effect of higher economic growth on the resulting deficit is even larger in future years.

Differing assumptions about interest rates constitute another reason the CBO is projecting much higher deficits than the Administration. In February, the CBO assumed that the three-month Treasury bill rate would decline gradually over the next five years and average 6.1 percent in 1989. It assumed the ten-year government bond rate would fall over the same period to 7.5 percent. The Administration, in contrast, assumed that these two key interest rates would decline more sharply — to 4.8 percent and 5.5 percent, respectively, by 1989. The lower interest rate assumptions combine with higher real growth assumptions to produce Administration deficit projections that are $15 billion lower in 1987, $23 billion lower in 1989, and $40 billion lower in 1991 than those the CBO projects would result from the Administration's budget.

Assumptions about Congressional action also play important roles in explaining differences between the CBO and Reagan Administration deficit projections. While the CBO assumes that appropriations and tax laws will remain unchanged, the Administration assumes that all of its legislative proposals will be approved by Congress. Hence, even if both the CBO and the Administration employed the same economic assumptions, they would arrive at different estimates of the deficit. For example, while CBO projects a $144 billion deficit for 1989, the Administration budget, adjusted to reflect the CBO's assumptions about the economy, shows a 1989 deficit of only $91 billion. The Administration projection thus incorporates the assumption that policy actions will cut $53 billion from the deficit by 1989.

Even for 1987, the impact of alternative assumptions about policy action is substantial. Under CBO's economic assumptions, the Administra-

Chart 1
CBO Baseline Budget Deficit Projections

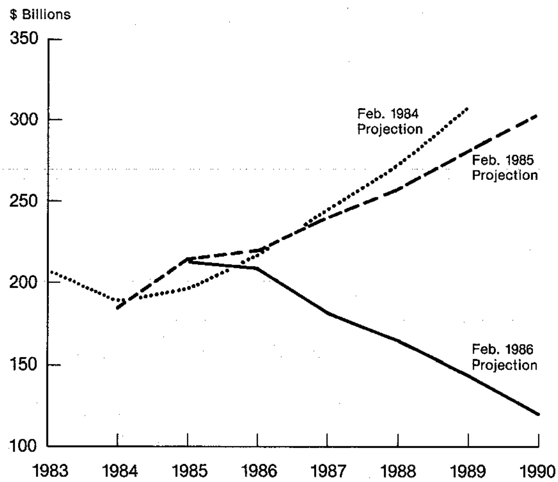
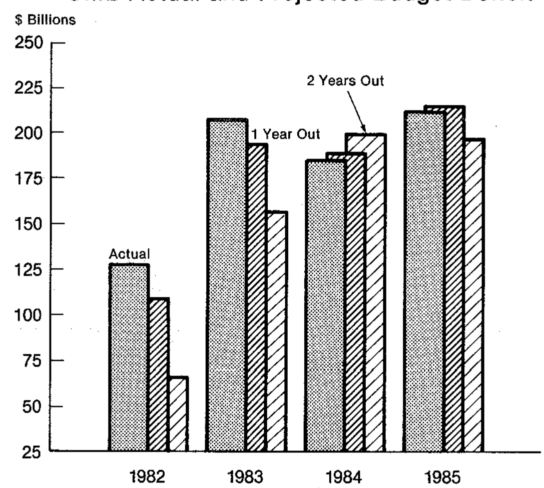


Chart 2
OMB Actual and Projected Budget Deficit



tion's projection of a $160 billion deficit incorporates proposed policy changes that amount to a deficit $20 billion lower than what the CBO projects. The proposed policy changes incorporated into the Administration's projections affect both budget outlays and revenues. For example, the Administration anticipates an additional $20 billion in revenue over the 1987-1991 period from staffing decisions that strengthen the Internal Revenue Service among other actions, and savings of $46 billion in reduced Medicare and Medicaid expenditures.

Conclusion

The federal deficit depends on developments in the national economy and on Congressional actions, neither of which can be projected without making specific assumptions about the future. Thus, it is not surprising that large revisions in projected future deficits occur from one year to the next. Nor is it surprising that projections prepared by different agencies can differ greatly. As long as the behavior of both the economy and Congress is unpredictable, the deficit also will be unpredictable.

In other words, projections of deficits several years ahead must be viewed as conditioned by assumptions that may or may not be confirmed by the actual turn of events. While deficit projections prepared by the CBO or OMB are often interpreted outside these agencies as forecasts, such interpretations are unwarranted.

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Editorial comments may be addressed to the editor (Gregory Tong) or to the author .... Free copies of Federal Reserve publications can be obtained from the Public Information Department, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 974-2246.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 7/9/86	Change from 7/2/86	Change from 7/10/85 Dollar	Percent[7]
Loans, Leases and Investments[1 2]	200,765	- 168	7,803	4.0
Loans and Leases[1 6]	183,010	- 87	9,058	5.2
Commercial and Industrial	51,629	119	65	0.1
Real estate	66,726	39	3,089	4.8
Loans to Individuals	39,257	- 107	4,508	12.9
Leases	5,572	2	151	2.7
U.S. Treasury and Agency Securities[2]	10,413	- 92	- 1,754	- 14.4
Other Securities[2]	7,342	12	497	7.2
Total Deposits	206,384	- 3,487	8,151	4.1
Demand Deposits	52,810	- 3,285	5,483	11.5
Demand Deposits Adjusted[3]	36,614	-14,836	4,771	14.9
Other Transaction Balances[4]	16,629	155	2,647	18.9
Total Non-Transaction Balances[6]	136,945	- 358	22	0.0
Money Market Deposit Accounts—Total	47,087	- 9	2,388	5.3
Time Deposits in Amounts of $100,000 or more	35,256	- 338	- 2,488	- 6.5
Other Liabilities for Borrowed Money[5]	22,218	- 535	- 376	- 1.6

Two Week Averages of Daily Figures	Period ended 6/30/86	Period ended 6/16/86
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (−)	123	59
Borrowings	80	15
Net free reserves (+)/Net borrowed(−)	43	44

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change