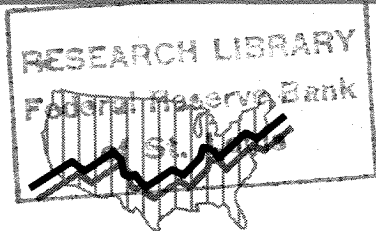


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JAN 22 1996

# National Economic Trends



## The Devil is in the Budget Details

Much of the recent debate on the attempt to balance the federal budget by 2002 has focused on whether to use the economic and budget projections of the Office of Management and Budget (OMB) or to use those of the Congressional Budget Office (CBO). The OMB works for the president while the CBO is a creature of Congress. Several apparently inconsequential discrepancies exist in the economic projections used by the CBO and OMB to predict future deficits: small differences in the average growth rate of the economy, the components of national income (for example, the share of corporate profits vs. wages) and the path of interest rates. These seemingly innocuous differences in assumptions about the performance of the economy are critical, however, and can create substantial discrepancies in projections of future revenues and expenditures.

To illustrate this point, let's consider one simple "back of the envelope" calculation: the CBO estimate of average real growth over the next seven years is 2.3 percent, while that of the OMB is 2.5 percent. How will this small difference affect the deficit in 2002?

First, slower growth will affect the deficit by directly lowering GDP and hence, federal revenues in 2002. Suppose that the increase in the GDP deflator will average 2.4 percent each year (in the ballpark of CBO estimates) and federal revenues are a constant 18.45 percent of nominal GDP (the average for 1990-1994). Then, GDP in 2002 would be \$143 billion<sup>4</sup> lower with 2.3 percent real growth than it would be with 2.5 real percent growth (see table). The growing GDP shortfall would

cause a revenue shortfall of about \$26 billion.

In addition, lower growth would also decrease revenues in each of the years 1996 to 2001, leaving the existing federal debt at the end of 2001 about \$75 billion higher than it would have been otherwise. Interest costs on this additional debt would raise the deficit another \$2.9 billion for a total increase in the projected 2002 deficit of \$29 billion, all from lower growth of just 0.2 percentage points!

Further, these calculations probably understate the true increase in the deficit projections, as we completely ignore the increased expenditures that may result from lower growth.

These simple calculations illustrate the sensitivity of deficit projections to very small changes in economic assumptions. Given the enormous uncertainty associated with most economic forecasts — and the sensitivity of long-term deficit projections to small changes in variables like output and interest rates — deficit projections must be taken with a grain of salt. In budget calculations, the devil is in the details.

— Christopher J. Neely

**MAKING MOUNTAINS OUT OF MOLEHILLS: AN ILLUSTRATION**  
(billions of current dollars)

Fiscal Year	GDP Shortfall	Revenue Shortfall	Additional Debt <sup>1</sup>	Additional Interest Costs <sup>2</sup>
1996	15.4	2.8	2.8	0.0
1997	32.3	6.0	9.0	0.1
1998	50.8	9.4	18.8	0.4
1999	71.1	13.1	32.7	0.8
2000	93.1	17.2	51.1	1.3
2001	117.2	21.6	74.7	2.0
2002	143.3	26.4	104.1	2.9

<sup>1</sup> Additional debt is calculated as of end of year.

<sup>2</sup> Additional interest costs are based on previous year's debt and CBO projections of three-month T-Bill rates.

Views expressed do not necessarily reflect official positions of the Federal Reserve System