REAL BUDGET DEFICIT IMPLICATIONS
OF GRAMM-RUDMAN-HOLLINGS

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My article in the November/December 1985 issue of this *Review* explained how implementing the August 1985 Congressional Budget Resolution would have virtually eliminated the deficit in real (or inflation-adjusted) terms in the next few years.[1] In December, the Gramm-Rudman-Hollings (GRH) balanced-budget law was enacted. It mandates reducing the nominal budget deficit by about $35 billion per year, achieving balance in 1991. The present note translates GRH nominal deficit targets into real terms on the basis of Congressional Budget Office (CBO) inflation projections made in February 1986. This conversion is important to the extent that real-not nominal-deficits influence saving, investment, and international capital flows. There are two equivalent ways to measure the real budget deficit correctly :

- One is to calculate the annual change in the outstanding federal debt in real terms. As the table shows, at the beginning of fiscal 1986, the nominal federal debt was $1,509.9 billion. At the end of fiscal 1986, if the CBO deficit projection is achieved, the debt will be $1,714.6 billion, an increase of $204.7 billion. Given the 3.4 percent projected inflation rate for 1986, that debt would be worth only $1,658.2 billion ($1,714.6 billion/1.034) in terms of 1985

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[1] William G. Dewald, "CBO and OMB Projections, Adjusted for Inflation, Show Federal Budget Deficit under Control.," Federal Reserve Bank of Richmond, **Economic Review** (November/December 1985), pp. 1.5-22.

prices. Hence the real deficit in terms of 1985 prices would be $148.3 billion ($1,658.2 billion - $1,509.9 billion).

- The other way to calculate the real budget deficit is to subtract from the nominal deficit the depreciation in the value of outstanding federal debt due to inflation. For example, the projected 1986 nominal deficit of $204.7 billion is adjusted for inflation by subtracting the 3.4 percent projected depreciation in the value of outstanding federal debt due to inflation. Then this difference is deflated by the price level in terms of 1985 prices to obtain, as before, a $148.3 billion real deficit,

$$\frac{\$204.7 \text{ billion} - (.034 \text{ x } \$1,509.9 \text{ billion})}{1.034}$$

If annual inflation should stabilize at 4.1 percent by 1991 as CBO projected and GRH nominal deficit targets are met, these calculations show that the outstanding federal debt-to-GNP ratio would peak at 41.3 percent in 1987 and then begin to decline. The debt to GNP ratio is recorded in the table and plotted in Chart 1. Correspondingly, the real deficit would decline each year beginning this year until it was eliminated in 1989, two years before the nominal deficit is eliminated. The real deficit is also presented in the table and plotted in Chart 2. By 1991, when GRH targets a balanced budget, these calculations based on CBO inflation and GNP projections show that there would be a real federal budget surplus equal to 1.4 percent of GNP. Thus, even moderate inflation, once taken into account, has a substantial effect on the measurement of federal budget deficits, which was the main point of my earlier article.

GRAMM-RUDMAN-HOLUNGS REAL DEFICIT PROJECTIONS

(Fiscal Years, Billions of Dollars, and Percent)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Fiscal Year	Nominal Deficit	Publicly Held Debt[d]	Inflation[e]	Price Level 1985=100	Real Deficit	GNP[e]	Real GNP	Nominal Deficit/ GNP (1)/(6)	Real Deficit/ Real GNP (5)/(7)	Publicly Held Debt/ GNP* (2)/(6)
1984[a]	185.3	1,141.8	3.8	96.5	147.1	3,695	3,829	5.0	3.8	35.5
1985[a]	212.3	1,312.6	3.6	100.0	165.0	3,937	3,937	5.4	4.2	38.4
1986	204.7[b]	1,509.9[a]	3.4	103.4	148.3	4,192	4,054	4.9	3.7	40.9
1987	144.0[c]	1,714.6	4.0	107.5	70.2	4,504	4,190	3.2	1.7	41.3
1988	108.0[c]	1,858.6	4.1	111.9	28.4	4,838	4,324	2.2	0.7	40.6
1989	72.0[c]	1,966.6	4.1	116.5	-7.4	5,214	4,476	1.4	-0.2	39.1
1990	36.0[c]	2,038.6	4.1	121.3	-39.2	5,619	4,632	0.6	-0.8	36.9
1991	0.0[c]	2,074.6	4.1	126.3	-67.3	6,047	4,788	0.0	-1.4	34.3

Source: Congressional Budget Office, **The Economic and Budget Outlook,** February 1985 and 1986 except as noted.

[a] **Actual.**

[b] CBO, **An Analysis of the President's Budgetary Proposals for** Fiscal Year 1987, February 1986, Summary Table 1, p, viii.

[c] Legislated targets.

[d] Beginning of fiscal year. Projected financing other than borrowing from the public 1987-1991 assumed zero.

[e] CBO projections, 1986-1991.

[f] Publicly held debt, end of fiscal year.
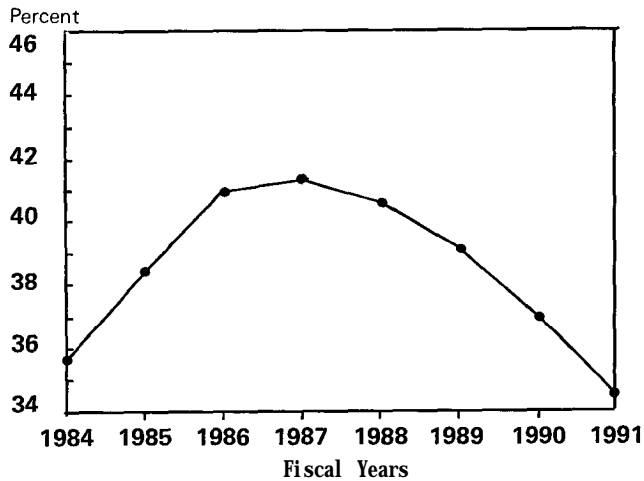
Chart 1

PUBLICLY HELD DEBT RATIO

Percent

Fiscal Years

Chart 2

GRAMM-RUDMAN-HOLLINGS
Deficit Projections

Billions of Dollars

☐ Nominal Deficit
○ Real Deficit

Fiscal Years