CBO TESTIMONY

Statement of
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before the
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NOTICE

This statement is not available for public release until it is delivered at 10:00 a.m. (EDT), Tuesday, July 31, 1990.

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Mr. Chairman, I am pleased to appear before this Subcommittee this morning to discuss the federal debt limit. In my statement today I will summarize the Congressional Budget Office's (CBO's) new economic forecast and baseline budget projections. These are elaborated in CBO's summer report, *The Economic and Budget Outlook: An Update*. I will then consider the implications of our projections for the debt ceiling. Finally, I will focus on the economic effects and budgetary treatment of the savings and loan crisis.

THE BUDGET AND ECONOMIC OUTLOOK

CBO now expects that the fiscal year 1990 deficit will total at least $195 billion, which is almost $60 billion above the estimate just six months ago (see Table 1). In relation to the size of the economy, the deficit is projected to rise from 2.9 percent of gross national product (GNP) in 1989 to 3.6 percent of GNP in 1990.

For 1991 and thereafter, the budgetary picture is complicated by the savings and loan bailout. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) assigned the Resolution Trust Corporation (RTC) the task of closing or subsidizing the sale of hundreds of insolvent thrift institutions. It now appears, however, that RTC will exhaust its funds early in fiscal year 1991. If RTC were actually allowed to run out of money, the baseline deficit would fall to $164 billion in 1991 and remain

near $160 billion through 1994. In that event, however, almost 700 insolvent thrifts would be left unresolved; their losses would continue to mount and raise the government's eventual cost.

Clearly, RTC must be given more resources. CBO estimates that additional RTC spending needs, with associated debt service costs, would add $68 billion to the deficit in 1991, $81 billion in 1992, and $33 billion in 1993. Including the additional spending needs of the RTC, the federal deficit would reach $232 billion in 1991 and $239 billion in 1992, before slipping under $200 billion again in 1993. These deficit figures are far above the Balanced Budget Act targets of $64 billion in 1991, $28 billion in 1992, and zero in 1993.

If sequestration were to apply to the 1991 deficit estimates shown in Table 1, the cuts would boggle the mind. Excluding the additional RTC spending from the calculation, defense would be cut by 25 percent, and nondefense programs would be slashed by 38 percent. Including RTC's spending needs, the required cuts would be 42 percent for defense and 64 percent for nondefense programs.

As dismal as these budget projections appear, they could prove to be optimistic. At the request of the Congressional budget negotiators, CBO's

TABLE 1. BASELINE BUDGET PROJECTIONS AND UNDERLYING ASSUMPTIONS

	1990	1991	1992	1993	1994	1995
Budget Projections (By fiscal year)						
In Billions of Dollars						
Revenues	1,044	1,123	1,188	1,260	1,337	1,417
Outlays	1,238	1,287	1,346	1,422	1,496	1,559
Deficit	195	164	158	162	160	142
Additional RTC Spending Needs[a]	0	68	81	33	-13	-3
Deficit with Additional RTC	195	232	239	194	146	138
Deficit Targets	100	64	28	0	b	b
As a Percentage of GNP						
Revenues	19.1	19.3	19.1	19.0	19.0	18.9
Outlays	22.6	22.1	21.7	21.5	21.2	20.7
Deficit	3.6	2.8	2.5	2.4	2.3	1.9
Deficit with Additional RTC	3.6	4.0	3.8	2.9	2.1	1.8
Economic Assumptions (By calendar year)						
GNP (Billions of current dollars)	5,560	5,925	6,314	6,726	7,166	7,634
Real GNP Growth (Percentage change)	2.0	2.5	2.6	2.6	2.6	2.6
Implicit GNP Deflator (Percentage change)	4.1	4.0	3.9	3.8	3.8	3.8
CPI-U (Percentage change)[c]	4.8	4.2	4.2	4.0	4.0	4.0
Civilian Unemployment Rate (Percent)	5.3	5.4	5.4	5.5	5.5	5.5
Three-Month Treasury Bill Rate (Percent)	7.6	6.9	6.7	6.2	5.6	5.4
Ten-Year Government Note Rate (Percent)	8.5	7.8	7.4	7.2	6.9	6.8

SOURCE: Congressional Budget Office.

NOTES: For comparability with the Balanced Budget Act targets, the projections include Social Security but exclude net outlays of the Postal Service.

RTC = Resolution Trust Corporation.

a. Includes debt service costs resulting from additional RTC spending.

b. The Balanced Budget Act sets targets through 1993.

c. CPI-U is the consumer price index for all urban consumers.

budget projections are based on an economic forecast that assumes significant cuts in the deficit--$40 billion to $60 billion below the baseline in 1991 and $400 billion to $600 billion over the 1991-1995 period. The continuation of economic expansion in the face of such fiscal restraint depends critically on two assumptions. First, the Federal Reserve must meet the dramatic change in fiscal policy by loosening monetary policy. Second, the deficit reduction package must be sufficiently credible to convince financial markets that long-term interest rates will fall.

The assumed deficit reductions affect CBO's forecast of key economic variables--chiefly real economic growth and interest rates--in ways that improve the budget outlook. CBO expects that the U.S. economy will grow by 2.0 percent in 1990 and by about 2.6 percent a year in 1991 through 1995. The three-month Treasury bill rate is projected to fall from its current level of 7.8 percent to an average of 6.9 percent in 1991 and 5.4 percent in 1995. If significant deficit reduction measures of the sort assumed by CBO are not enacted, interest rates are likely to be higher; moreover, growth rates in the medium term are likely to be lower than CBO has projected. As a result, the 1995 deficit could be $40 billion to $50 billion higher than the estimates in Table 1 suggest.

IMPLICATIONS FOR THE DEBT LIMIT

The CBO baseline budget projections imply large increases in debt subject to the statutory limit in the next few years. The Congress must address this matter soon: if the current limit of $3,122.7 billion is not increased before the August Congressional recess, the government will almost certainly run out of cash during the recess. Among the payments that would be imperiled are Social Security and other benefits, interest and principal payments on the debt, and paychecks for civilian and military employees. Even a temporary default--that is, a few days' delay in the government's ability to pay back its debt holders--could also have serious financial market consequences, including a permanent increase in Treasury borrowing costs, a temporary rise in the overall level of U.S. interest rates relative to foreign rates, and a temporary decline in the value of the dollar.

When the current ceiling was enacted last November, it was expected to suffice roughly through September or October of this year. Subsequent increases in the deficit have accelerated the need for an increase in the debt limit. The chief culprits are unexpectedly large savings and loan-related outlays in 1990 and lackluster revenues.

Under CBO's baseline projections, debt subject to limit would total $3,133 billion at the end of September--$10 billion above the current limit.

(In fact, debt subject to limit would be even higher in early September, because of the daily patterns of borrowing and trust fund investment.) This estimate is conservative: it is predicated on CBO's baseline deficit estimate of $195 billion for fiscal year 1990, which was completed about a month ago. Since that time, deposit insurance spending and Treasury borrowing have outstripped our estimates, and the CBO deficit and debt estimates for the current fiscal year might be as much as $20 billion to $25 billion too low.

In fiscal year 1991, CBO projects that, without deficit reductions, debt subject to limit would climb by $363 billion (see Table 2). It may seem perplexing that debt subject to limit goes up by more than the amount of the deficit. The reason is that the debt limit applies not just to Treasury borrowing from the public--the familiar sales of bills, notes, and bonds and of other instruments such as savings bonds--but also to the holdings of federal government trust funds. In fiscal year 1991, trust fund holdings are expected to grow by about $135 billion, with Social Security alone accounting for more than half of the increase.

Of course, the Congress and the Administration hope to trim the borrowing needs of the government by concluding a successful deficit reduction pact. These savings, however, have yet to be identified and enacted. Even with a hypothetical deficit reduction package amounting to

TABLE 2. CBO PROJECTIONS OF FEDERAL DEBT
(By fiscal year, in billions of dollars)

	1990	1991	1992	1993	1994	1995
			Under Current Policies (Including additional RTC spending)			
Debt Subject to Limit, Start of Year	2,830	3,133	3,496	3,872	4,219	4,529
Changes in Debt Subject to Limit						
Deficit	195	232	239	194	146	138
Trust fund surplus	123	135	140	150	163	176
Other changes[a]	-14	-3	-3	2	1	2
Total change	303	363	376	347	311	317
Debt Subject to Limit, End of Year	3,133	3,496	3,872	4,219	4,529	4,846
Debt Held by the Public, End of Year	2,378	2,607	2,844	3,038	3,183	3,321
			With a $500 Billion Deficit Reduction Package[b]			
Debt Subject to Limit, Start of Year	2,830	3,133	3,446	3,747	3,994	4,179
Changes in Debt Subject to Limit						
Deficit	195	182	164	94	21	-12
Trust fund surplus	123	135	140	150	163	176
Other changes[a]	-14	-3	-3	2	1	2
Total change	303	313	301	247	186	167
Debt Subject to Limit, End of Year	3,133	3,446	3,747	3,994	4,179	4,346
Debt Held by the Public, End of Year	2,378	2,557	2,719	2,813	2,833	2,821

SOURCE: Congressional Budget Office.

NOTE: The current debt limit is $3,122.7 billion.

a. Primarily changes in cash balances and in interest accrued but not paid.

b. Assumes illustrative deficit reductions amounting to $50 billion in 1991 and $500 billion over the 1991-1995 period. For simplicity, programs financed by trust funds are assumed to unaffected.

$50 billion in 1991 and $500 billion over the 1991-1995 period, debt subject to limit would continue to grow, as depicted in the bottom panel of Table 2.

Many analysts view the statutory limit on federal debt as archaic. Through its regular budget process, the Congress already has ample opportunity to vote on overall revenues, outlays, and deficits (an opportunity that did not exist before the Budget Act of 1974). Voting separately on the debt is hardly effective as a means of controlling deficits, since the decisions that necessitate borrowing are made elsewhere. By the time the debt ceiling comes up for a vote, it is too late to balk at paying the government's bills without incurring drastic consequences. In recent years, the debt limit has served mainly as a vehicle for other budgetary and unrelated legislation.

Even if there remains a justification for a separate ceiling on federal debt, many argue that it should not apply to trust fund holdings. Instead, they maintain, the debt ceiling should focus on debt held by the public--that is, the amount borrowed to finance deficits. Such borrowing is the chief concern of economists, financial market participants, and others who worry about the federal government's demands on credit markets. As Table 2 shows, debt held by the public climbs each year by approximately the amount of the deficit. The President's Commission on Budget Concepts in 1967 refined the concept of debt held by the public, and urged that the statutory limit on

federal debt be revised accordingly. More recently, Chairman Rostenkowski's plan for reducing the deficit and reforming the budget process uses debt held by the public as the appropriate measure for statutory ceilings.

SPENDING RELATED TO SAVINGS AND LOANS

Estimates of deficits and debt are even more uncertain than usual because of huge and volatile outlays for deposit insurance. No one can say for sure how fast the Resolution Trust Corporation can resolve failed or failing institutions, or what the costs will be. As noted earlier, CBO's deficit estimate of $195 billion for 1990 predated a surge in RTC spending. Two weeks ago, the Office of Management and Budget predicted that the 1990 deficit would be almost $24 billion higher than CBO's forecast, with RTC responsible for virtually all of the difference. These contrasting estimates underscore the great uncertainty about RTC spending. OMB states that outlays in individual years might be $30 billion higher or lower than projected.

Current Projections

The RTC spends money for several purposes, chiefly for insurance losses and working capital. Insurance losses represent money that will not be recouped by the government because insured deposits of failed institutions far exceed what can be recovered by selling the institutions' assets. In contrast, working

capital represents temporary financing needs: in the course of resolving institutions, the government holds many assets temporarily pending their disposition. The need for working capital results in budget outlays when assets are acquired and results in receipts (that is, negative outlays) when the assets are sold. Selling assets may take eight years or more. Until that time, the expected proceeds are conjectural. Thus, while the distinction between losses and working capital is conceptually clear, it is arbitrary in practice.

Under FIRREA, the RTC faces several constraints on its spending. One restriction caps the RTC's total losses at $50 billion; another, more complicated cap acts to restrict total outstanding working capital. The resources provided under FIRREA are insufficient. CBO projects that, unless new legislation is enacted providing the agency with extra resources, many RTC operations will grind to a halt early in fiscal year 1991. But new legislation must be passed sooner or later. Deposit insurance outlays are not discretionary; the government is legally required to fulfill its guarantees. CBO estimates that, through 1995, the RTC will need almost $100 billion more to cover losses than current law provides. CBO's projections of RTC outlays, assuming that new resources are provided soon, are depicted in Table 3. Clearly, RTC spending will be a source of great volatility in budget totals for the next several years, as projected outlays swing from a staggering $70 billion in 1991 and $60 billion in 1992 to -$30 billion in 1994.

TABLE 3. PROJECTIONS FOR THE RESOLUTION TRUST CORPORATION ASSUMING UNLIMITED RESOURCES (By fiscal year, in billions of dollars)

Outlays	Actual 1989	1990	1991	1992	1993	1994	1995
Insurance Losses	1	35	41	32	28	4	3
Working Capital							
Asset acquisition and repayable advances	10	30	52	52	19	0	0
Receipts from asset sales	0	-1	-9	-24	-34	-34	-21
Repayment of advances	0	-12	0	0	0	0	0
Proceeds from Resolution Funding Corporation (REFCORP)	0	-16	-14	0	0	0	0
Payment from Federal Home Loan Banks	-1	0	0	0	0	0	0
Subtotal, outlays excluding interest and administrative expenses	9	36	70	60	13	-30	-18
Interest and Administrative Expenses[a]	b	b	b	b	b	b	b
Total	9	36	70	60	13	-30	-18

SOURCE: Congressional Budget Office.

a. Administrative costs included in the budget are projected to be $200 million to $300 million a year. Administrative costs associated with institutions in Resolution Trust Corporation (RTC) receivership are not included. Interest costs reflect only the payments from the RTC to the Federal Financing Bank (FFB), an intrabudgetary arrangement stemming from the RTC's working capital agreement. The projections assuming unlimited resources dispense with this intrabudgetary arrangement, and all debt service costs are presumed to be borne directly by the Treasury.

b. Less than $500 million.

Economic Consequences

There is disagreement over how policymakers should deal with the economic consequences of the savings and loan crisis. Everyone agrees that RTC outlays do not affect the economy quite like other government spending. Unlike a benefit check, salary payment, or a purchase of military hardware, deposit insurance payments do not represent current income to their recipients. Depositors do not become wealthier the instant their savings and loan institution is closed or merged by the government. They are exactly as well-off as before, undergoing only minor changes in their banking habits. Thus, the year-to-year outlay fluctuations depicted in CBO's baseline paint a seriously misleading picture of the government's current impact on the economy.

This conclusion--that RTC spending has little short-run economic impact--is mirrored in the financial markets. Currently, a large fraction of federal borrowing is done on behalf of the RTC. Nearly all the money that the government raises is directly recycled in the financial markets, as recipients deposit the funds in new accounts or invest them in other assets. The government's borrowing does not reduce the funds available to other borrowers, and there is little reason for it to boost the level of interest rates.

Because savings and loan-related spending is not like other federal spending in its short-run economic impact, many argue that annual spending for this purpose ought to be excluded from the Balanced Budget Act targets for the federal deficit. The spending's volatility, these advocates argue, could lead to inappropriate swings in fiscal policy as well as rich opportunities for manipulating the budget estimates.

Of course, over a broader time span, deposit insurance losses have had definite implications for the economy and for the distribution of resources. The availability of deposit insurance helped to spur certain types of spending. For much of the past decade, savings and loan institutions made wasteful loans backed by their deposits. Borrowers and their suppliers benefited; the wealth of depositors was protected from loss even as many earned unsustainable rates of return; moreover, thrift managers and owners were subsidized. Thus, the thrift crisis has reduced the nation's capital stock as bad loans and fraud diverted the saving of depositors from productive uses. While the high-flying institutions that now require resolution were geographically clustered, all regions of the country shared these impacts--particularly as nationwide capital markets imply that both deposit-taking and lending effectively cross borders.

Resolution of failed thrifts simply recognizes past financial losses. It does not repair the damage that the thrift crisis has done to our capital stock. Some argue that the government should recoup its losses, perhaps with a tax surcharge over several years. This approach is the most direct way of replacing the lost capital and the material well-being that it could have provided. In addition, many observers fear that unless the nation explicitly taxes itself or otherwise faces up squarely to the costs of the thrift crisis, it will not make the needed reforms to the regulatory structure and the deposit insurance system to ensure that such a situation never recurs. But other analysts, even as they acknowledge the harm to the U.S. capital stock done by the crisis, point out that its effect pales beside the $1-1/2 trillion in federal debt accumulated during the 1980s. The underlying problem, in this view, is the government's large overall deficit and accumulated debt; the savings and loan debacle only makes the problem bigger.

CONCLUSIONS

My testimony has pointed to a clear need for Congressional action in three separate areas. First, the Congress needs to enact a new statutory debt ceiling before its August recess. Second, the Congress, in cooperation with the Administration, should enact a plan to reduce the deficit in 1991 and later years. The payoff to deficit reduction is not immediate and dramatic, but long-run growth in our capital stock and standard of living should result.

And third, policymakers must swiftly provide more resources to the Resolution Trust Corporation to enable it to continue its work. Further delays will tend only to boost the long-run costs of resolving the savings and loan crisis.