CBO TESTIMONY

Statement of
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before the
Committee on the Budget
U.S. House of Representatives

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NOTICE

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Thank you, Mr. Chairman, for inviting me here this morning to discuss the Congressional Budget Office's (CBO's) interim assessment of the economic and budget outlook. In its final days, the 101st Congress hammered out a reconciliation bill and 13 appropriation bills, which together will set the federal government on a new fiscal course for the 1990s. As you know, the 1990 reconciliation bill is very complicated, and CBO and the Office of Management and Budget are still in the process of interpreting its provisions. In addition, the economy appears to be near a turning point--a time when predicting its course is particularly difficult. Such uncertainties make it impossible to paint a definitive picture of the new legislation at this point. Nonetheless, we can sketch the broad outlines of the new budgetary landscape.

My statement summarizes a staff paper entitled "The 1990 Budget Agreement: An Interim Assessment" that CBO is releasing today. CBO's new budget projections reflect the revenue increases and spending reductions contained in the recent budget agreement, including the further reductions in discretionary spending that are required by law but remain to be achieved through further appropriations action. The projections are based on an informal forecast prepared by CBO in October, when it became apparent that the Gulf crisis and other developments had rendered CBO's official June forecast too optimistic. Since October, however, the economic outlook has weakened further. CBO's new budget estimates include preliminary reestimates of deposit insurance spending, but they do not incorporate the costs and contributions for Operation Desert Shield or any other technical reestimates.

THE BUDGET OUTLOOK THROUGH 1995

CBO projects that the recent budget agreement could reduce the total federal government deficit (including Social Security and the Postal Service) to less than 1 percent of gross national product (GNP) by 1995. Over the next two years, however, massive spending to resolve insolvent savings and loan institutions will keep the deficit at record levels. Assuming that the new legal limits on discretionary spending are maintained, the total federal deficit will rise from $220 billion in fiscal year 1990 to more than $250 billion in 1991 and 1992. Under CBO's October forecast, the deficit would then drop to roughly $170 billion in 1993, $60 billion in 1994, and $30 billion in 1995. Even allowing for some additional deterioration in the economic outlook, by fiscal year 1995, the total federal deficit is likely to fall below $100 billion for the first time in 14 years and below 1 percent of GNP for the first time in 20 years.

While the short-term budget outlook is worse than when CBO issued its report last July, the longer-run picture has improved. These changes reflect both recent developments in the economy and in deposit insurance, which have increased the deficit, as well as the reconciliation and appropriation bills, which have reduced it.

CBO estimates that the policies in the budget agreement have reduced the projected deficit by $35 billion in 1991, $73 billion in 1992, and $163 billion in 1995. Over the entire 1991-1995 period, the package is estimated to save $496 bilion--close to the target in the summit agreement. Excluding $60 billion in debt service savings, 64 percent of the deficit reduction derives from cutting outlays below baseline levels, and 36 percent stems from raising taxes. Two-thirds of the five-year savings--$331 billion--has already been put in place. The remaining $164 billion in deficit reduction is to be achieved by holding future discretionary appropriations to the specified limits.

The foregoing deficit figures include Social Security, because the balance in the Social Security programs affects the economy in exactly the same way as the balance in any other government account. Unlike Social Security, however, the year-to-year swings in federal deposit insurance spending are not a meaningful measure of changes in the federal government's effect on the economy. CBO projects that federal spending on deposit insurance will rise from $58 billion in 1990 to $91 billion in 1991 and $107 billion in 1992, before dropping sharply in 1993, and then turning negative in 1994 and 1995. The 1991 and 1992 figures are higher than CBO projected in July, because a surge of spending by the Resolution Trust Corporation (RTC) in late 1990 suggests that the RTC is resolving insolvent savings and loans more quickly and needs more working capital than previously thought.

While financing the thrift bailout will add substantially to federal borrowing requirements in the next few years, this borrowing does not add much further pressure on interest rates. The money that the government borrows to resolve insolvent thrifts (less the administrative and interest costs) is returned to financial markets. The money is redeposited in new accounts or invested directly in earning assets. Excluding deposit insurance, the federal deficit is projected to remain slightly above $160 billion in 1991 and to decline slowly thereafter.

THE ECONOMIC OUTLOOK

The economic assumptions underlying these projections, which were developed in mid-October, take substantial account of the weakening of the economic outlook and increases in inflation that began to emerge in the late summer. The assumed rate of real economic growth is 1.0 percent in calendar year 1990 and 0.6 percent in 1991. These rates are similar to the

Administration's September forecast and to the November *Blue Chip* consensus.

The assumptions for 1990 and 1991 entail slower growth in real GNP and higher inflation than CBO projected last July, while short- and long-term nominal interest rates are largely unchanged. Over the medium term, the October figures show slightly stronger real growth (to recover from the 1990-1991 downturn) but lower inflation rates and nominal incomes than the earlier projections. Many of the changes from last summer's forecast reflect the effects of the sharp increases in the price of imported oil that resulted from Iraq's invasion of Kuwait last August. The October interim forecast also incorporates the revision of the national income and product accounts, which suggests that the economy's potential rate is lower than previously thought. At the request of the Congressional budget negotiators, the economic effects of the $500 billion deficit reduction package were already incorporated in CBO's July economic forecast.

CBO will publish new economic and budget projections in late January, and CBO's new forecast is likely to show a weaker economic outlook than assumed in CBO's interim projections. Since October the economic landscape has been clouded by the persistence of high oil prices, weak real estate markets, and problems with the balance sheets of many banks and corporations. Unless these factors are offset by other developments, a more pessimistic economic outlook will worsen the budget outlook as well.