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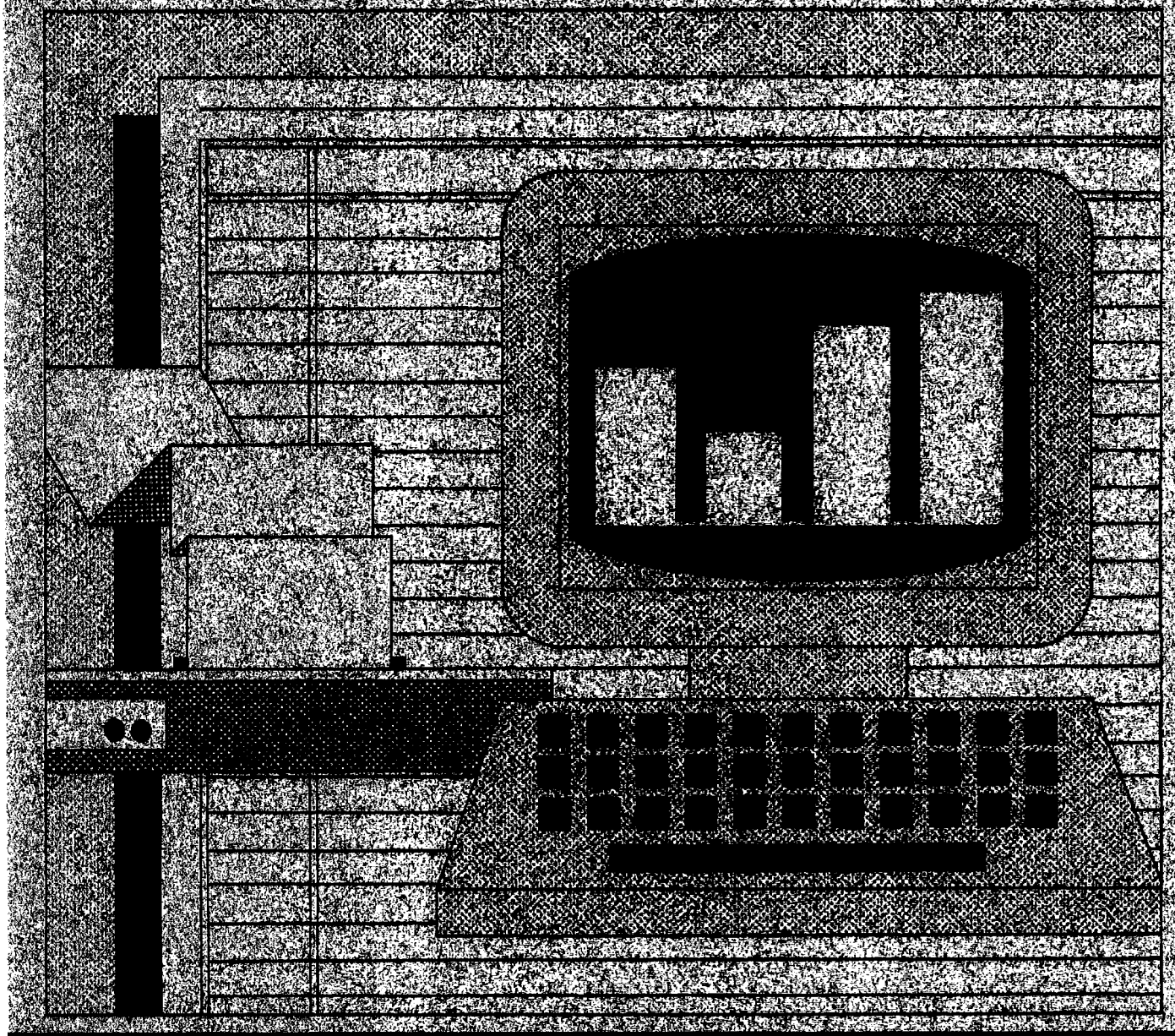
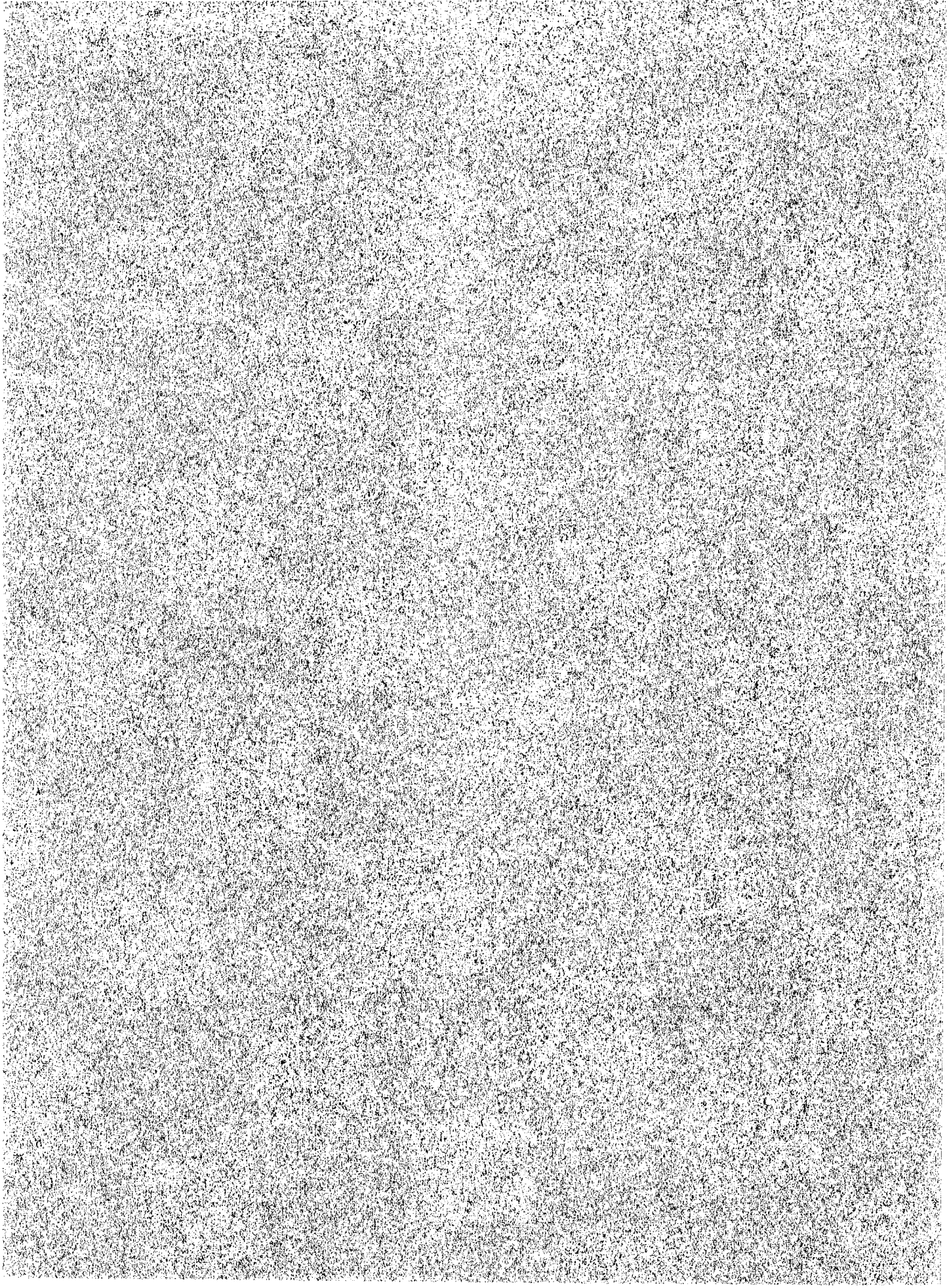
The Economic and Budget Outlook: An Update





THE ECONOMIC AND BUDGET OUTLOOK: AN UPDATE

A Report to the
Senate and House
Committees on the Budget

As Required by Public Law 93-344

The Congress of the United States
Congressional Budget Office

NOTES

Unless otherwise indicated, all years referred to in Chapter I are calendar years and all years in Chapter II are fiscal years.

Unemployment rates throughout the report are calculated on the basis of the civilian labor force.

Details in the text and tables of this report may not add to totals because of rounding.

In figures showing periods of recession, shaded areas indicate the months between cyclical peaks (P) and recession troughs (T).

The Balanced Budget and Emergency Deficit Control Act of 1985 (commonly known as Gramm-Rudman-Hollings) is also referred to in this volume more briefly as the Balanced Budget Act.

All National Income and Product Accounts data in this volume do not reflect the July 1990 revisions.

PREFACE

This volume is one of a series of reports on the state of the economy and the budget issued periodically by the Congressional Budget Office (CBO). While CBO typically releases updated projections each August, this year's schedule has been accelerated at the request of the Congressional budget negotiators, who are meeting with representatives of the Administration to develop a multiyear deficit reduction plan. In accordance with CBO's mandate to provide objective and impartial analysis, the report contains no recommendations.

The analysis of the economic outlook presented in Chapter I was prepared by the Fiscal Analysis Division under the direction of Frederick C. Ribe, Robert A. Dennis, and John F. Peterson. Douglas R. Hamilton wrote the chapter, and Robert Arnold, John F. Peterson, and John Sturrock carried out the forecast that is described therein. Background analysis was carried out by Trevor Alleyne, Victoria Farrell, George Iden, Kim Kowalewski, Angelo Mascaro, Frank S. Russek, Jr., Matthew Salomon, and Stephan S. Thurman. Research assistance was provided by Mark Decker, Jeanne Dennis, Nicholas Dugan, and Patricia Wahl.

The baseline outlay projections were prepared by the staff of the Budget Analysis Division under the supervision of James L. Blum, C.G. Nuckols, Michael Miller, Charles Seagrave, Robert Sunshine, and Paul N. Van de Water. The revenue estimates were prepared by the staff of the Tax Analysis Division under the direction of Rosemary D. Marcuss and Kathleen M. O'Connell. Chapter II was written by Kathy A. Ruffing. Paul N. Van de Water prepared the summary of the report.

Paul L. Houts supervised the editing and production of the report. Major portions were edited by Francis S. Pierce and Sherry Snyder. Nancy H. Brooks provided editorial support during production. The authors owe special thanks to Marion Curry, Janice Johnson, Dorothy Kornegay, Verlinda Lewis, and L. Rae Roy, who typed the many drafts. Kathryn Quattrone prepared the report for publication.

Robert D. Reischauer
Director

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SUMMARY

The Congressional Budget Office (CBO) projects that, under current taxing and spending policies, the federal budget deficit will approach $200 billion in 1990 and will average almost $160 billion over the next five fiscal years. These projections, however, do not include sufficient resources to resolve the hundreds of insolvent savings and loan associations whose deposits are federally insured. New legislation will be required to provide for these additional spending needs, which if included would push the projected budget deficit to more than $230 billion in 1991 and 1992.

At the request of the Congressional budget negotiators, CBO has based its economic projections on the premise that a substantial multiyear package of deficit reduction measures will be adopted later this year. Under this assumption, 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 and growth rates are likely to be lower than CBO has projected.

THE BUDGET OUTLOOK

CBO's baseline budget projections follow the rules laid down in the Balanced Budget Act. For revenues and entitlement spending, the baseline generally assumes that laws now on the statute books will continue. For defense and nondefense discretionary spending, the projections for 1991 through 1995 are based on the 1990 appropriations, including supplemental appropriations and rescissions, increased only to keep pace with inflation. The baseline projections provide a benchmark for analyzing alternative deficit reduction proposals.

Baseline Projections Through 1995

The federal deficit is projected to rise from its 1989 level of $152 billion to $195 billion in 1990 (see Summary Table 1). Most of this increase stems from the activities of the Resolution Trust Corporation (RTC), the agency established last year to resolve thrift institutions that are currently insolvent or expected to fail through August 1992. In rela-

SUMMARY TABLE 1. CBO BASELINE, REVENUES, OUTLAYS, AND DEFICIT (By fiscal year)

	1990	1991	1992	1993	1994	1995
In Billions of Dollars						
Baseline Revenues	1,044	1,123	1,188	1,260	1,337	1,417
Baseline Outlays	1,238	1,287	1,346	1,422	1,496	1,559
Baseline Deficit	195	164	158	162	160	142
Additional RTC Spending Needs[a]	0	68	81	33	-13	-3
Baseline Deficit with Additional RTC[a]	195	232	239	194	146	138
As a Percentage of GNP						
Baseline Revenues	19.1	19.3	19.1	19.0	19.0	18.9
Baseline Outlays	22.6	22.1	21.7	21.5	21.2	20.7
Baseline Deficit	3.6	2.8	2.5	2.4	2.3	1.9
Baseline Deficit with Additional RTC[a]	3.6	4.0	3.8	2.9	2.1	1.8
Reference: GNP (In billions of dollars)	5,472	5,832	6,215	6,620	7,053	7,514

SOURCE: Congressional Budget Office.

NOTE: The budget figures include Social Security, which is off-budget but is counted for purposes of the Balanced Budget Act targets. For comparability with the targets, the projections exclude the Postal Service, which is also off-budget.

a. Includes debt service costs resulting from additional Resolution Trust Corporation (RTC) spending.

tion to the size of the economy, the deficit rises from 2.9 percent of gross national product (GNP) in 1989 to 3.6 percent of GNP in 1990.

The savings and loan bailout greatly complicates the budget projections for 1991 and thereafter. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) provided RTC with $50 billion to close or subsidize the sale of hundreds of insolvent thrift institutions. The $50 billion was intended to pay for deposit insurance losses that would never be recovered. It has become increasingly clear, however, that the actual losses will far exceed $50 billion.

RTC will exhaust its $50 billion early in fiscal year 1991, by which time about 250 insolvent institutions will have been closed or merged. 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, and the ultimate cost of the savings and loan crisis would only escalate.

Clearly, RTC must be given more resources. Resolving the savings and loan problem is not a discretionary activity; the government is legally required to fulfill its deposit guarantees. CBO estimates that, through 1995, RTC will need almost $100 billion more to cover insurance losses. In addition, RTC will require substantial amounts of working capital, which RTC will recover in later years when it sells the assets of the failed institutions. CBO estimates that additional RTC spending needs 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. The deficit would remain near 4 percent of GNP through 1992. By 1995, the deficit would be $138 billion, or 1.8 percent of GNP.

Recent Changes in the Budget Projections

CBO's new budget projections differ markedly from those released last March, primarily because of a shortfall in tax collections and new information on deposit insurance spending. Aside from the 1990 supplemental appropriation, no legislation with significant budgetary impact has been enacted since the beginning of the year. When added to the baseline, the supplemental increases the deficit by less than $1 billion in 1991 and by less than $500 million in later years (see Summary Table 2).

CBO has updated its economic projections to reflect developments since the winter, especially higher interest rates and consumer price inflation, as well as the assumption of substantial deficit reduction. But the changes in the economic assumptions do little to alter the projected deficits. Higher debt service costs and cost-of-living adjustments in the near term push up the deficit by $1 billion in 1991 and $4 billion in 1992. Stronger growth and lower interest rates, however, reduce the deficit by $1 billion in 1994 and $5 billion in 1995.

The major changes in the deficit outlook stem from noneconomic factors. Tax collections in the key months of March, April, and May fell far short of expectations, even though the economy performed much as CBO and most private forecasters had been expecting. As a result, CBO has reduced its estimate of 1990 revenues by $27 billion for technical reasons. While the data needed to determine the precise reasons for the shortfall will not be available for some time, two major factors appear to be responsible. First, payroll tax collections and withheld income taxes are weaker than expected. This weakness may mean that wages and salaries are lower than have been reported in the national income data. Recent reports on wages and salaries for individual states indicate that earnings for the nation as a whole are lower than previously published by the Bureau of Economic Analysis. Second, most of the remaining shortfall occurred in nonwithheld personal taxes, primarily final settlements on 1989 income taxes. Since both of these factors will probably affect future revenues, CBO has reduced its estimates of revenues in 1991 through 1995 by an average of $16 billion per year.

Two major developments since March have caused CBO to revise its estimates of spending by the Resolution Trust Corporation. First, $3 billion of borrowing by the off-budget Resolution Funding Corporation (REFCORP) is likely to slip from 1990 to 1991. This development increases RTC outlays by $3 billion in 1990 and reduces them by a like amount in the following year. Second, the cases that RTC has resolved have involved substantially greater losses than previously projected. As a result, RTC will exhaust its $50 billion in loss money earlier than

SUMMARY TABLE 2. CHANGES IN CBO BASELINE DEFICIT PROJECTIONS SINCE MARCH
(By fiscal year, in billions of dollars)

	1990	1991	1992	1993	1994	1995
March Baseline Deficit	159	161	124	132	121	110
Changes						
Enacted legislation	a	1	a	a	a	a
Economic assumptions	-1	1	4	2	-1	-5
Technical reestimates						
Revenues[b]	27	19	16	15	15	17
Resolution Trust Corporation[c]	3	39	73	26	-20	-11
Other deposit insurance	2	1	2	-3	7	1
Income security	1	3	3	3	3	3
Net interest[d]	1	7	15	20	21	22
Other outlays	3	-1	1	a	a	1
Subtotal	36	69	110	60	26	33
Total Changes	36	71	114	62	25	28
June Baseline Deficit with Additional RTC	195	232	239	194	146	138

SOURCE: Congressional Budget Office.

NOTE: The budget figures include Social Security and exclude the Postal Service.

a. Less than $500 million.

b. Revenue decreases are shown with a positive sign because they increase the deficit.

c. Includes additional RTC spending.

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

expected and will be able to resolve fewer institutions unless the Congress provides additional funds. Assuming that the necessary funds are provided in a timely fashion, RTC net outlays are projected to rise to $70 billion in 1991 and $60 billion in 1992--$39 billion and $73 billion higher than previously estimated.

CBO has also upped its outlay estimates for the deposit insurance programs of the Bank Insurance Fund and the Federal Savings and Loan Insurance Corporation (FSLIC) Resolution Fund, which is responsible for resolving thrift institutions sold or liquidated before March 1989. Larger caseloads for Unemployment Insurance, Food Stamps, family support, and Supplemental Security Income are projected to increase spending on income security programs. Because all these factors increase the deficit, interest costs will also be higher.

Projections for the Resolution Trust Corporation

The projections of RTC's total spending needs assume that its activities are not constrained by current legislation, and that additional resources are provided by Treasury appropriations to cover both permanent insurance losses and temporary needs for working capital (see Summary Table 3). RTC's caseload is assumed to comprise the 925 thrift institutions that have a capital-to-assets ratio of less than 3 percent on a book value basis, but that are estimated to be insolvent on a market value basis. CBO estimates that if all of these institutions could be resolved today, RTC's losses would total $90 billion to $130 billion. The projections assume losses of about $100 billion. Because RTC cannot resolve all these cases right away, however, many insolvent institutions will continue to operate for several more years, incurring further losses in the process. CBO estimates that, in present discounted value terms, the eventual cost of RTC's activities will reach $150 billion. This amount does not include the losses on cases covered by the FSLIC Resolution Fund and by the Savings Association Insurance Fund, which are estimated to have a present value of about $60 billion and $35 billion, respectively.

In the course of liquidating insolvent institutions, RTC will acquire many of their assets. These assets will eventually be sold, and

part of their book value will be recovered. But in the meantime, RTC will need substantial amounts of working capital. The present estimates assume that short-run needs for working capital slightly exceed the long-run losses. The outlay of working capital will swell RTC's net outlays to $70 billion in 1991 and $60 billion in 1992. By 1994, however, proceeds from asset sales are likely to make RTC's net outlays negative. Thus, the year-to-year swing in budgetary impact will be quite large.

Despite the seeming precision of these figures, the path of spending by the RTC is highly uncertain. The estimates depend on a host of interrelated factors that are extremely difficult to predict, including the number of institutions in the caseload, the number of cases that are resolved by liquidation or by merger, the order in which cases are re-

SUMMARY TABLE 3. PROJECTED OUTLAYS OF THE RESOLUTION TRUST CORPORATION ASSUMING UNLIMITED RESOURCES (By fiscal year, in billions of dollars)

	1990	1991	1992	1993	1994	1995
Insurance Losses[a]	35	41	32	28	4	3
Working Capital						
Asset acquisition	30	52	52	19	0	0
Receipts from asset sales	-1	-9	-24	-34	-34	-21
Repayments of advances	-12	0	0	0	0	0
Interest and Administrative Expenses	b	b	b	b	b	b
Proceeds from Resolution Funding Corporation	-16	-14	0	0	0	0
Net Outlays	36	70	60	13	-30	-18

SOURCE: Congressional Budget Office.

a. Includes administrative and transaction costs of receiverships, which increase insurance losses by reducing receipts from asset sales.

b. Administrative costs included in the budget are projected to be less than $500 million a year. The only interest costs included in these figures are for payments to the Federal Financing Bank in 1990. Starting in 1991, all financing costs are assumed to be borne by the Treasury and to be included in interest paid on the public debt.

solved, the pace of resolutions, and the timing and value of asset sales. Notably, the assumed RTC caseload does not include 792 thrift institutions that are tangibly solvent on a book value basis, and that have tangible capital-to-asset ratios greater than 3 percent, but are estimated to be insolvent when their assets are valued at market prices. These institutions are assumed to be the responsibility of the Savings Association Insurance Fund (SAIF), which must resolve thrifts that fail after August 1992. If many of these marginal institutions fail, as CBO expects, SAIF--like RTC--will need more resources than the law now provides.

Social Security Projections

The Balanced Budget Act requires that revenues and outlays of the two Social Security funds--Old-Age and Survivors Insurance and Disability Insurance--be shown as off-budget, a treatment that highlights their contributions to the totals. Viewed alone, Social Security indisputably helps to hold down the deficit during the 1990-1995 period. With tax receipts and other income to the trust funds exceeding benefits and other costs, the Social Security surplus, as conventionally measured, doubles from $59 billion in 1990 to $124 billion in 1995 (see Summary Table 4).

The Social Security surplus, however, is not an accurate measure of Social Security's effect on federal borrowing. A significant portion of the surplus is made up of transfers from other federal accounts, particularly interest payments from the Treasury. These transfers increase the apparent size of both the Social Security surplus and the non-Social Security deficit. In other words, the surplus that the Social Security trust fund is generating independently of the rest of the government is smaller than it appears and, similarly, the size of the deficit that the non-Social Security budget is running independently of Social Security is smaller than it seems. Even without intrabudgetary transfers, Social Security is projected to show a surplus of $37 billion in 1990 and $65 billion in 1995. This surplus measures the extent to which Social Security is reducing the government deficit and adding to national saving.

SUMMARY TABLE 4. SOCIAL SECURITY SURPLUS MEASURES
(By fiscal year, in billions of dollars)

	1990	1991	1992	1993	1994	1995
Total Surplus	59	73	83	95	109	124
Interest income	16	21	27	33	40	48
Surplus Excluding Interest	43	52	56	62	69	76
Receipts from government agency payments as employer	6	6	6	7	8	8
Estimated receipts from income taxes on benefits	3	5	5	6	6	7
Intrabudgetary payments[a]	-2	-4	-4	-4	-5	-5
Surplus Excluding All Intrabudgetary Transfers	37	45	49	53	59	65

SOURCE: Congressional Budget Office.

a. Primarily interest paid to Treasury and payments to Railroad Retirement, less credit for self-employment taxes.

THE ECONOMIC OUTLOOK

CBO projects that real GNP will grow by 2.0 percent in 1990, accelerating slightly to 2.5 percent in 1991. CBO's 1991 estimate is slightly above the *Blue Chip* consensus and slightly below the Administration's current projection, as Summary Table 5 shows, but the differences are small. CBO's forecast assumes that the Congress and the Administration will agree on significant reductions in the budget deficit--$40 billion to $60 billion below the baseline in 1991 and $400 billion to $600 billion over the 1991-1995 period. The projection that the economic expansion will continue in the face of such fiscal restraint depends critically on assumptions about developments in financial markets. In particular, the projection assumes that the Federal Reserve loosens monetary policy enough to offset the possible negative short-term effects of deficit reduction on the economic expansion. In addition, CBO has assumed that other participants in financial markets

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SUMMARY TABLE 5. COMPARISON OF CBO, ADMINISTRATION, AND *BLUE CHIP* ECONOMIC ASSUMPTIONS, CALENDAR YEARS 1990-1995

	1990	1991	1992	1993	1994	1995
Real GNP (Percentage change, year over year)						
CBO Summer	2.0	2.5	2.6	2.6	2.6	2.6
Administration June	2.0	2.8	3.2	3.2	3.1	3.0
Blue Chip	1.9	2.3	2.8	2.7	2.4	2.6
CBO Winter	1.7	2.4	2.5	2.5	2.4	2.4
Implicit GNP Deflator (Percentage change, year over year)						
CBO Summer	4.1	4.0	3.9	3.8	3.8	3.8
Administration June	4.2	4.2	4.0	3.7	3.4	3.1
Blue Chip	4.2	4.1	3.8	3.9	3.8	3.8
CBO Winter	4.0	4.0	4.0	4.0	4.0	4.0
Consumer Price Index[a] (Percentage change, year over year)						
CBO Summer	4.8	4.2	4.2	4.0	4.0	4.0
Administration June	4.8	4.1	4.0	3.7	3.4	3.0
Blue Chip	4.8	4.3	4.0	4.1	4.0	4.0
CBO Winter	4.0	4.3	4.3	4.3	4.3	4.3
Unemployment Rate[b]						
CBO Summer	5.3	5.4	5.4	5.5	5.5	5.5
Administration June	5.4	5.6	5.5	5.4	5.3	5.2
Blue Chip	5.4	5.5	5.6	5.5	5.4	5.3
CBO Winter	5.6	5.5	5.5	5.5	5.5	5.5
Three-Month Treasury Bill Rate (Percent)						
CBO Summer	7.6	6.9	6.7	6.2	5.6	5.4
Administration June	7.7	6.8	5.8	5.1	4.8	4.4
Blue Chip	7.7	7.5	7.0	7.0	6.9	6.7
CBO Winter	6.9	7.2	6.9	6.5	6.1	5.8
Ten-Year Government Note Rate (Percent)						
CBO Summer	8.5	7.8	7.4	7.2	6.9	6.8
Administration June	8.5	7.9	7.0	6.1	5.8	5.4
Blue Chip[c]	8.5	8.3	8.0	7.8	7.8	7.8
CBO Winter	7.8	7.7	7.6	7.5	7.4	7.3

SOURCES: Congressional Budget Office; Office of Management and Budget; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators*.

NOTE: The *Blue Chip* forecasts through 1991 are based on a survey of 50 private forecasters, published on June 11, 1990. The *Blue Chip* projections from 1992 through 1995 are based on a survey of 41 forecasters, published on March 10, 1990.

a. Consumer price index for all urban consumers (CPI-U) for CBO and the *Blue Chip*; consumer price index for urban wage earners and clerical workers (CPI-W) for the Administration.

b. The Administration's projection is for the total labor force, including armed forces residing in the United States, while the CBO and *Blue Chip* projections are for the civilian labor force excluding armed forces. In recent years, the unemployment rate for the former has tended to be 0.1 to 0.2 percentage points below the rate for the civilian labor force alone.

c. *Blue Chip* does not project a 10-year note rate. The values shown here are based on the *Blue Chip* projection of the Aaa bond rate, adjusted by CBO to reflect the estimated spread between Aaa bonds and 10-year government notes.

will view the reductions in the deficit as credible. Reflecting these assumptions, CBO projects that the yield on 91-day Treasury bills will average 7.6 percent in 1990 and 6.9 percent in 1991, while the interest rate on 10-year Treasury notes will fall from 8.5 percent to 7.8 percent over the same period. Because CBO assumes more deficit reduction than most private forecasters, CBO's interest rates are substantially below the *Blue Chip* average.

Financial developments in the United States and overseas have raised interest rates and slowed the economic expansion in recent months. Some long-term interest rates rose by a full percentage point between late 1989 and the early summer of 1990. The increases resulted from such developments as fears of monetary tightening in the United States in the wake of sharp increases in consumer prices during the early months of this year, speculation about the financial consequences of German unification, turbulence in Japanese financial markets, and tightening monetary policies abroad.

Partly as a result of higher interest rates in the last several months, growth has been sluggish in some interest-sensitive sectors of the economy. Reducing the deficit therefore risks slowing the economy further and even pushing it into recession. While CBO believes that such a slowdown is unlikely, it remains a possibility, especially if monetary policy does not loosen as is assumed in CBO's forecast, or if longer-term interest rates do not fall as much as the projection implies.

CBO projects that inflation in consumer prices will rise slightly to a rate of 4.8 percent in 1990 before subsiding to 4.2 percent in 1991. As Summary Table 5 shows, these projections are close to both the *Blue Chip* average and the Administration's latest figures. The bulge in inflation in 1990 reflects the sharp increases in prices of food and energy products during the first three months of this year. These extraordinary increases, however, should prove temporary; for the balance of this year and next, CBO projects that prices will increase at more moderate rates.

For 1992 through 1995, CBO's economic assumptions are not a forecast of cyclical developments but a projection of trends in the economy. The figures incorporate estimates of the ways in which significant

reduction in the federal deficit could improve longer-term economic performance. While CBO thus projects more favorable medium-term economic trends than it has in the past, its estimates fall short of the optimism embodied in the Administration's most recent figures.

CBO projects growth in real GNP at 2.6 percent a year in each year after 1991. This rate, which is slightly higher than CBO's previous estimates of longer-term growth but below the Administration's projections, reflects the effects of deficit reduction in increasing the amount of saving that is available to be invested in productive assets rather than being diverted to the financing of current government expenditures. The yield on three-month Treasury bills is projected to fall just below 5½ percent, and the yield on 10-year Treasury notes just below 7 percent, by 1995. Deficit reduction increases the national saving rate, and thereby reduces pressures on interest rates. The rate of inflation falls slightly as a result of the reductions in business costs that seem likely to stem from cutting the budget deficit. The trade deficit and U.S. indebtedness to the rest of the world also drop, reflecting the effects of deficit reduction in increasing national saving, competitiveness, and wealth.

CHAPTER I

THE ECONOMIC OUTLOOK

Despite unexpectedly high inflation and interest rates, the economy has grown in recent months at the moderate rates that CBO and many other forecasters predicted last winter. But high interest rates, together with increases in spending associated with the savings and loan bailout, have significantly increased projected levels of the budget deficit. These developments led the President to call a budget summit intended to make new efforts to cut the deficit sharply. To aid the participants of these negotiations, the Congressional Budget Office (CBO) has prepared an updated forecast of economic developments. At the request of the negotiators, the forecast reflects the effects of significant cuts in the deficit.

CBO projects that enactment of a large and credible multiyear deficit reduction package will bring substantial economic benefits in the medium term, including stronger economic growth, a lower deficit in the balance of payments, lower interest rates, and higher national wealth and standards of living than would otherwise be likely. CBO expects that the economy can withstand the short-term restrictive impact of large reductions in the deficit and avoid a recession. This forecast assumes that both short-term and long-term interest rates will fall significantly as a result of a stimulative monetary policy and a conviction among participants in financial markets that the Congress and the Administration have developed a credible package that truly puts the deficit on a declining course. This same conviction would lead financial markets to rally and allow long-term interest rates to fall sufficiently to offset the temporary weakening in economic growth that deficit reduction might otherwise imply.

CBO's short-term economic forecast for the next 18 months entails continued moderate economic growth between 2 percent and 2½ percent, together with rates of inflation between 4 percent and 4½ percent, and unemployment near its present rate of 5¼ percent. The interest

rate on 10-year Treasury notes averages 8.5 percent in 1990 and 7.8 percent in 1991, while the rate on 91-day Treasury bills averages 7.6 percent in 1990 and 6.9 percent in 1991.

CBO's economic projections for the years 1992 through 1995 show how deficit reduction and other assumptions may affect the trends in the economy. Over this period, CBO projects a speedup of economic growth to rates of 2.6 percent a year--modestly above the growth rates that had previously seemed likely. Long-term interest rates are projected to decline to about 7 percent by 1995, while the rate of inflation is projected to decline slightly, and unemployment is expected to remain near current rates.

The current CBO forecast carries a substantial amount of uncertainty. Financial markets may not view the package of deficit cuts as credible, and long-term interest rates may not fall enough to offset the contractionary effect of the deficit cuts. Monetary policy, which also helps to maintain economic growth in the forecast, affects the economy with uncertain and variable lags, making the job of setting monetary policy difficult. The Federal Reserve could do too little to stimulate growth, which could lead to a recession, or too much, which could lead to temporarily higher inflation.

RECENT ECONOMIC DEVELOPMENTS

Two major developments have affected the outlook for the economy since the CBO winter 1990 report: the possibility of large cuts in the deficit arising from the current budget talks, and the run-up in interest rates in early 1990, reflecting in large part financial developments abroad. Outside of these two areas, economic activity is roughly as CBO expected. Economic growth has shifted from the 3 percent rate of early 1989 to about 2 percent, and inflation, abstracting from the temporary price rises in the first quarter, remains relatively steady. Although higher interest rates raise some concern that economic growth could slow further, the economy appears to be balanced between recessionary and inflationary pressures.

The Budget Summit and the Outlook for Fiscal Policy

In early May of 1990, President Bush and Congressional leaders began a series of talks on ways to reduce the federal deficit. Although the outcome of these talks is far from certain, the participants are apparently willing to consider large reductions to the deficit not only in fiscal year 1991, but in subsequent years as well. Such reductions to the deficit, if enacted, would represent a historic political achievement.

The CBO forecast assumes that the President and the Congress agree to cut $40 billion to $60 billion from the baseline level of the deficit in fiscal year 1991, with cuts from the baseline rising to $130 billion to $170 billion by fiscal year 1995. The cuts are assumed to be achieved through a combination of reductions in defense, entitlements, and other nondefense programs as well as increases in personal and business taxes.

The Relative Size of the Budget Cuts. These reductions in the deficit would represent a significant tightening of fiscal policy. As reflected in the standardized-employment deficit--a measure of fiscal policy that excludes the effect of cyclical changes in economic activity on the budget as well as some purely financial transactions--the sharpest contractionary impact would be in fiscal year 1991 (see Table I-1). In that year, the standardized-employment deficit as a share of potential gross national product (GNP) falls by about one percentage point. The share declines in each of the subsequent years by about one-half of a percentage point.

Because cutbacks in government purchases of goods and services reduce final demand for output and higher taxes reduce the spending power of consumers, deficit cuts of this size could in principle reduce economic growth and lead to a recession, unless they are offset by lower interest rates. In the past, recessions have sometimes occurred soon after large deficit cuts, though in most cases, other factors--such as tight monetary policy or sharp increases in the price of imported oil--contributed to the decline.

The State of Economic Growth

Most economic indicators are broadly consistent with the view that the economy is growing at a slow but sustainable pace. Although the housing sector has weakened in recent months, the manufacturing sector is regaining strength, and the service sector continues to provide a steady source of growth. Some recent economic indicators, however, have sent mixed signals about the current strength of the economy, with some reports showing unusual strength and others showing exceptional weakness. But careful analysis of these reports suggests that special factors are largely responsible for these unusual strengths or weaknesses. This pattern of mixed signals is exactly what should be expected from an economy that is growing slowly.

TABLE I-1. STANDARDIZED-EMPLOYMENT DEFICIT (By fiscal year)

	1989	1990	1991	1992	1993	1994	1995
In Billions of Dollars							
Baseline Deficit Excluding Certain RTC Outlays	159	156	159	173	173	166	143
Deficit Assumed in the Economic Forecast	159	156	109	96	72	41	-6
As a Percentage of Potential GNP[a]							
Baseline Deficit Excluding Certain RTC Outlays	3.1	2.8	2.7	2.8	2.6	2.3	1.9
Deficit Assumed in the Economic Forecast	3.1	2.8	1.9	1.5	1.1	0.6	-0.1

SOURCE: Congressional Budget Office.

NOTE: Both deficit measures are on a budget basis and exclude net outlays by the Resolution Trust Corporation, except for interest and administrative expenses. The baseline deficits differ from the numbers shown in Table II-1 because they reflect adjustments to a standard level of employment.

a. Potential GNP is the estimated level of GNP that occurs when the unemployment rate is at NAIRU (the nonaccelerating inflation rate of unemployment).

How to Interpret Signals of Unusual Strength. The release of the GNP data for the first quarter of 1990 led some analysts to worry that the growth of the economy had picked up to a rate that could lead to higher inflation. Although the overall growth of the economy in the first quarter of 1990 was only 1.9 percent, growth was held down by a large liquidation of inventories of motor vehicles. The growth of final sales, which excludes the effects of inventory change, was 4.4 percent, suggesting to some that the underlying economy was very strong.

Much of the unusual strength in final sales during the first quarter, however, was the result of three special factors. First, the introduction of new sales incentives for motor vehicles in January 1990 temporarily boosted consumer spending on durable goods in the first quarter. Since January, sales of cars and trucks have been much weaker. Second, the weather affected the pattern of construction spending in the last two quarters. The combination of extremely cold weather in December of 1989 and unusually warm weather in January and February of 1990 boosted construction work sharply, raising investment in housing and nonresidential structures in the first quarter. Construction spending since February, however, has been weak. Third, the end of a strike at Boeing in the fourth quarter of 1989 temporarily raised spending on business equipment and net exports in the first quarter. Final sales excluding these special factors grew at a moderate pace in the first quarter.

How to Interpret Signals of Unusual Weakness. Recent economic reports on employment, disposable income, business investment, and housing have led some analysts to fear that the economy might be weakening. But careful analysis shows that only some of these reports point to genuine problems; others overstate the degree of weakness.

Employment in the private sector has not grown much since February. But a pickup in May of average weekly hours--especially overtime hours--in the manufacturing sector suggests that the economy is not as weak as these employment data indicate. Although the biggest gains in weekly hours took place in the steel and motor vehicle industries, increases were recorded across the board with 17 out of 20 durable and nondurable manufacturing industries showing gains. These gains brought the factory workweek to its highest level in more

than a year. If the current growth of output continues, firms would be expected to increase employment to reduce overtime costs.

Real disposable personal income rose at only a 1 percent annual rate in the first five months of 1990, which is much slower than its 4.1 percent annual rate in 1989. But this slower growth partly reflects the sharp increases in consumer prices that occurred during the first three months of the year. These price increases are likely to prove temporary, and if so, the growth of real disposable income should improve.

Business fixed investment shows some signs of weakness, but overall spending plans indicate continued growth. New orders for nondefense capital goods (excluding the volatile aircraft category), as well as the cash flow of domestic corporations--the cheapest source of financing new investment--have both declined in recent months. Although these developments raise concerns about the future outlook for investment, initial estimates of orders and cash flow are subject to large revisions (for example, the income side of the national income and product accounts (NIPA), of which cash flow is a part, is expected to undergo large revisions in July 1990). Other data on investment are more optimistic. Plans for business investment, although more modest than those in 1988 and 1989, are consistent with the moderate pace of economic growth that CBO expects for 1990, and do not signal a retrenchment in business investment. In addition, the use of capacity in manufacturing remains relatively high and continues to encourage investment in new plants and equipment.

Construction of new homes and commercial buildings has slowed considerably in recent months. The real estate market has a surplus of properties for sale or rent, and builders and developers are reporting difficulty obtaining credit. Although the credit crunch is serious for people involved with the construction industry, credit problems have yet to spill over into other sectors of the economy (see Box I-1).

BOX I-1
IS CREDIT BEING RATIONED?

Credit plays an important role in the day-to-day workings of all but a few businesses. Firms often need loans to cover short-term gaps between their revenues and expenditures. These loans are used to meet their payrolls, to pay creditors, and to stock inventories. They also need credit to finance long-term investments in plants and equipment. Credit is rationed when borrowers are unable to get new loans--even if they are willing to pay higher interest rates. If credit is partially rationed, firms cut back the overtime hours of their workers and cancel plans for new investment. If rationing is more severe, firms lay off workers and reduce the size of their operations.

A recent survey by the National Association of Home Builders shows that the housing industry is currently in a credit crunch. A majority of the builders, developers, and construction firms surveyed are reporting difficulty getting new credit from their usual lenders. Although many of these firms have been able to obtain financing from other lenders, a significant minority of firms apparently remains rationed.

Banks have become more cautious in real estate lending for a variety of reasons. First, the continued softening of real estate has increased the risk of default--a concern that has been boosted by the rise in nonperforming real estate loans in the portfolios of banks. Second, standards for real estate lending may have been too lax in the past, and some lending institutions are now doing what should have been done earlier. New regulations now prevent savings and loan associations (S&Ls) from providing any single borrower with a loan that is more than 15 percent of the bank's capital. Because so many of the S&L associations are poorly capitalized, this rule has prevented some borrowers, even those with good credit histories, from getting new loans from their traditional lenders.

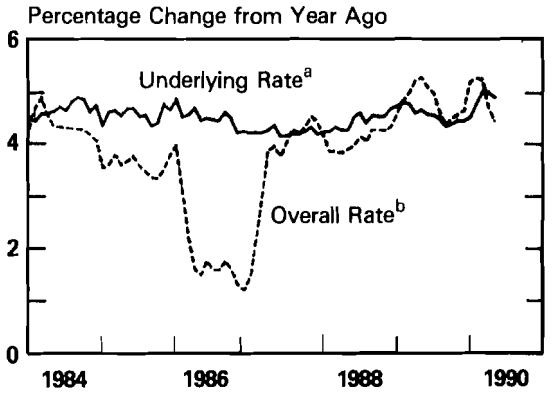
Outside the real estate sector, however, there is little evidence of widespread credit rationing. Although some corporations seeking leveraged buyouts and some smaller firms may be having trouble getting credit, the aggregate financial statistics do not show signs of reduced availability of credit. Furthermore, there is little evidence that the market's assessment of the risk of providing funds to U.S. corporations has risen. The spread between interest rates on commercial paper and three-month Treasury bill rates has not widened in recent months, but in fact has narrowed.

The Outlook for Inflation

Temporary factors have also affected inflation rates in recent months, but the evidence to date suggests that the underlying rate of inflation has not changed much. The sharp rise in the consumer price index for all urban consumers (CPI-U) in the first quarter of 1990 was largely the result of increases in the prices of food, energy, and apparel, which have been or soon will be reversed. The underlying rate of inflation as measured by the CPI-U less food, energy, and used cars increased slightly in early 1990, but is likely to return to the 4¼ percent and 4¾ percent range where it has been for about the past six years (see Figure I-1).

Temporary Factors Affecting Consumer Price Indices. Special factors are largely responsible for the sharp increase in consumer inflation during the first quarter of 1990. The cold weather in late December raised demand for heating oil and pushed up energy prices. The cold weather also damaged vegetable crops in the Southeast, causing prices of food to soar in January. In addition, the introduction of spring fashions resulted in large increases in apparel prices in the CPI-U, as it has in the past. This seasonal rise in apparel prices ideally should be removed from the CPI-U by the "seasonal adjustment" that is applied to these data. But the exact timing of the seasonal price hikes and

Figure I-1.
Recent Inflation



SOURCES: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics.

a. Consumer price index for all urban consumers (CPI-U) less food, energy, and used cars.

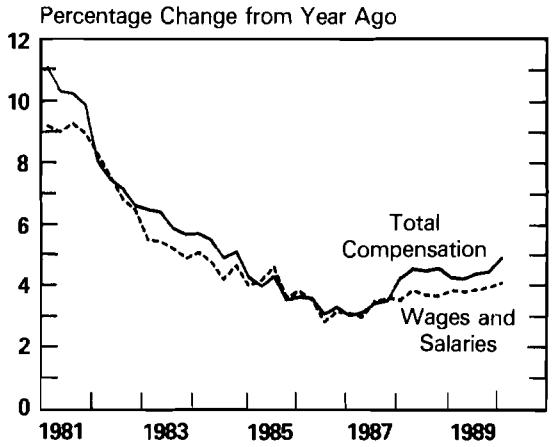
b. CPI-U.

discounts of clothing varies from year to year, so seasonal fluctuations in apparel prices were not fully purged from the CPI-U index this spring.

Prices of all of these commodities, however, have fallen or are expected to fall from their first-quarter peaks. Oil prices plunged during the second quarter, reflecting not only reduced demand because of warmer weather, but also the inability of the Organization of Petroleum Exporting Countries (OPEC) to restrain production in the face of declining demand. Food prices fell as new crops of vegetables and fruits filled the grocery stores. Apparel prices as measured by the CPI-U are poised for a decline sometime in the next few months as retailers start their summer sales.

Indicators of Underlying Inflation. Although many factors affect the underlying rate of inflation, a major factor is the state of the labor market. Labor costs are the biggest component of the total costs of businesses, and wage inflation, once started, is difficult to bring down without significant losses in output. Labor markets are tight at present, as they have been for the past few years, but wage inflation has remained relatively steady for the past year, after picking up slightly in mid 1987 to early 1988 (see Figure I-2). The relatively modest growth of

Figure I-2.
Wage Growth



SOURCES: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics.

NOTE: Employment cost index for workers in private industry, excluding sales occupations.

the money supply--and its effect on the economy--should help to contain further increases in wage inflation.

Total labor compensation has been rising faster than wages, largely because of increases in the costs of benefits provided by employers. But these increases in employers' costs should have only a temporary effect, and thus would not add significantly to the underlying rate of inflation. One component of benefit costs--employer-paid Social Security taxes--increased in January, but Social Security tax rates are not scheduled to rise again. A second component--health insurance costs--is rising sharply now, as it did in the early 1980s. But as that earlier experience showed, insurance costs are cyclical, and once premiums catch up to costs, total labor compensation should grow more moderately. The recent weakness in the growth of nonfarm business productivity and the associated rise of unit labor costs have raised some concerns about inflation, but it is not yet clear if these new developments represent a break from past trends.

A fall in the price of imported goods in the middle of 1989 helped to reduce inflation slightly in the second half of that year, while the subsequent pickup in the price of imported goods at the end of 1989 helped to add some inflationary pressure in 1990. Despite this swing in the price of imported goods, the underlying rate of inflation is roughly where it was in early 1989. Given the recent path of the dollar and foreign costs, the prices of imported goods will probably continue to rise at recent rates, but not faster. Thus, underlying rates of consumer inflation should remain relatively steady at current rates in the near term.

Interest Rates, Monetary Policy, and International Financial Developments

Long-term interest rates around the world increased sharply in late 1989 and early 1990, with significant economic ramifications (see Figure I-3). The rise in rates had more to do with tightening monetary policies and financial conditions abroad--especially in Japan and Germany--than with policies in the United States. Rising interest rates in other advanced countries can quickly cause similar increases

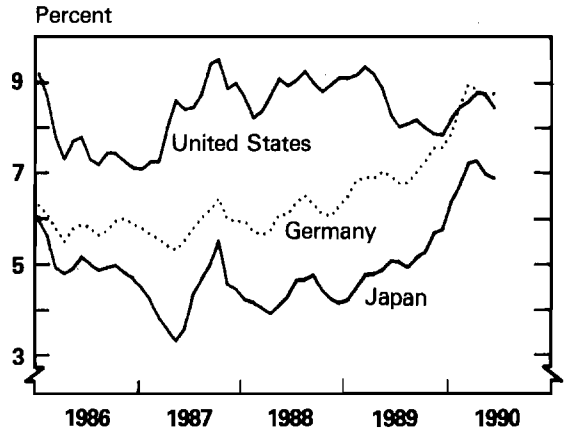
in the United States as investors shift away from financial investments in this country in search of higher yields abroad.

Developments in the United States. Some long-term rates in the United States rose nearly a full percentage point from their low points late last year to their peaks this spring, while short-term rates changed little. Although rates have been drifting downward since April, they remain high and continue to restrain economic activity. The rate on 10-year Treasury notes rose from 7.9 percent in November to nearly 8.8 percent in May. Recently, however, financial pressures receded, and the 10-year Treasury note rate fell to 8.5 percent in June.

The Federal Reserve faced pressures for both easing and tightening monetary policy and, on balance, it changed its stance little during the first half of 1990. Economic growth was sluggish throughout the spring, providing grounds for easier monetary policy. In contrast, price pressures had not abated, providing grounds for tighter policy. As Figure I-4 shows, one measure of the tightness of monetary policy--the interest rate on federal funds (overnight interbank loans)--changed little in the last six months.

Some observers have argued that interest rates also rose because of higher estimates of federal borrowing to finance the Resolution

Figure I-3. Long-Term Government Bond Yields

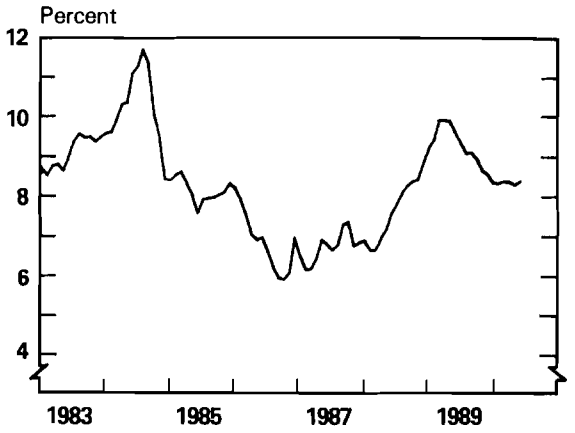


SOURCES: Congressional Budget Office; Federal Reserve Board.

Trust Corporation (RTC), which resolves insolvent thrift institutions. However, borrowing to finance resolution of thrift institutions is unlikely to affect rates for more than a short period. Such federal borrowing does not reduce the flow of credit available to nonfederal borrowers, and therefore should not push interest rates upward for sustained periods (see Box I-2).

Developments in Eastern Europe. The historic move toward democracy and free markets in Eastern Europe has also caused long-term interest rates around the world to rise, largely because of expectations that economic and political reforms in that region will eventually lead to higher demands for capital. These reforms, if successful, should increase the returns of investments made in these countries, leading to inflows of capital from the rest of the world. If so, interest rates would rise to reflect the stronger demand for the available supply of funds. In recent months, more sober assessments of the difficulties facing reform in Eastern Europe have tempered the initial enthusiasm and as a result have contributed to an easing of long-term interest rates. But the expectation of future capital demands should keep rates relatively high.

Figure I-4.
Federal Funds Rate



SOURCES: Congressional Budget Office; Federal Reserve Board.

BOX I-2
ECONOMIC EFFECTS OF FEDERAL EXPENDITURES TO PROTECT DEPOSITORS OF FAILED S&Ls

Estimates of potential federal borrowing to finance the thrift bailout have increased dramatically in recent months, and some have cited these borrowing prospects as reasons for the recent pressures on interest rates. To be sure, past and current *insurance losses* as well as perceptions of future losses have raised interest rates. But federal *borrowing* to pay for past losses or to raise "working capital" (used by the Resolution Trust Corporation to bridge its funding gap between the time it acquires and sells the assets of a failed thrift) does not add much *further* pressure on interest rates. Why? Because this borrowing does not reduce the amount of funds available to other borrowers. The money that the government receives from this borrowing (less the administrative and interest costs) is returned to financial markets. This money is redeposited in new accounts or invested directly in earning assets.

For some time now, such considerations have led to suggestions that federal borrowing for thrift resolution be excluded from the Balanced Budget Act targets for the federal deficit. This view holds that such borrowing exerts little economic effect because it only liquidates liabilities that the federal government already had. The true economic effects occur when thrift assets first go bad and federal liabilities under deposit insurance first accrue. Until recently, most of these effects appeared to lie in the past. Observers argue further that including borrowing for the thrift bailout under deficit targets could lead to unintended swings in fiscal policy, and could present budget policymakers with incentives for further manipulation of the accounts. (See Chapter II for a related discussion of these points.)

Others, however, have embraced a contrary view, concluding that federal spending for thrift resolution should be included under the targets for federal deficits. One reason for this conclusion is that the thrift crisis has reduced the capital stock because bad loans and fraud have diverted depositors' savings from productive uses. Increasing national saving by reducing the deficit is the most direct way of replacing this lost capital and the material well-being that it could make possible. In addition, many observers fear that unless the nation taxes itself or otherwise faces squarely up to the costs that the thrift crisis has had, it will not make the reforms to the regulatory structure and deposit insurance program that will be necessary to make sure that similar losses will not happen again.

If deficits are reduced to offset the thrift losses, there is little question that it should be done in a smooth way, and not by varying the amounts needed to meet the deficit targets to reflect the variable stream of annual net expenditures by the Resolution Trust Corporation. The size of these expenditures over the next several years is still uncertain, but it seems likely to swing sharply from year to year. There is likely to be little correspondence between the magnitudes of these expenditures and the underlying economic effects of the thrift problem during any particular year.

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Developments in Germany. The coming unification of East and West Germany has probably contributed to increases in world interest rates since December 1989. Unification is expected not only to raise future demands for capital, but also to result in a change in the mix of macroeconomic policies in Germany. Its monetary policy is expected to become tighter to combat the inflationary potential of unification, and its fiscal policy is expected to become looser with higher demands for government programs to ease the adjustment to free markets in East Germany. These two changes will both work to keep German interest rates high.

Developments in Japan. Two major financial developments in Japan have also helped to raise world interest rates. First, the Bank of Japan has been pursuing a tighter monetary policy for the past year and has raised the discount rate four times since March 1989 to contain the emerging inflationary pressures from the tight labor markets in Japan. Second, financial markets in Japan were exceptionally turbulent during the first quarter of 1990. The Japanese stock market lost about 25 percent of its value; and the yen depreciated sharply against the dollar, despite favorable interest-rate differentials, suggesting that perceptions of the financial risk of holding Japanese assets had risen sharply. As a result of these factors, long-term interest rates in Japan surged. More recently, some of these factors have partially reversed, and Japanese interest rates have fallen. Japanese monetary policy, however, is expected to remain relatively tight, and to keep long-term rates high.

THE FORECAST FOR 1990 AND 1991

CBO forecasts that even if large cuts in the federal deficit are enacted this year, the U.S. economy will avoid a recession during 1990 and 1991. Two important assumptions underlie this outlook: that the Federal Reserve will provide sufficient monetary stimulus to offset fiscal restraint, and that financial markets will view the deficit reduction package as a credible, multiyear program. As a result, CBO forecasts that long-term interest rates will fall, thereby increasing investment. Lower interest rates will also reduce the exchange rate of dollars for foreign currencies, making U.S. goods more competitive in world mar-

kets. Increased investment and an improved balance of trade will work to offset both lower government spending, as well as lower consumer spending as a result of any tax increases.

These assumptions are the driving forces behind the CBO short-term forecast (see Table I-2 and Figure I-5). Real GNP is expected to grow between 2 percent and 2½ percent in 1990 and 1991, while the rate of unemployment is projected to remain close to its 1989 average of 5.3 percent. Inflation rates remain relatively steady over the forecast--the modest pickup in the rate of inflation in 1990 largely reflects the run-up in prices during the first quarter. Short-term interest rates fall from 7.6 percent in 1990 to 6.9 percent in 1991, and long-term interest rates fall from 8.5 percent in 1990 to 7.8 percent in 1991.

Interest Rates and the Exchange Value of the Dollar

Deficit reduction is the major factor that affects both interest rates and the exchange rate in the forecast. Real and nominal short-term interest rates fall with the easing of financial market pressures brought about by two factors: the reduced demand for credit by the federal government and the increased supply of money by the Federal Reserve. Long-term interest rates also fall, reflecting anticipations by financial markets that initial deficit cuts are part of a credible, multiyear program and, as such, will lead to smaller credit demands and lower real interest rates in the future as well.

Real long-term interest rates in the United States are expected to fall relative to those in foreign countries, and to help lower the value of the dollar over the forecast horizon. Foreign real rates on average are expected to remain relatively high because of continued tight monetary policies abroad as well as the emerging capital demands of Eastern Europe. By favoring foreign assets relative to U.S. assets, the differences in real interest rates will reduce the inflows of capital to the United States, lowering the value of the dollar. The historical relationship between changes in the real value of the dollar and changes in real interest-rate differentials is shown in Figure I-6. In the CBO fore-

TABLE I-2. COMPARISON OF CBO, ADMINISTRATION, AND *BLUE CHIP* FORECASTS FOR 1990 AND 1991

	Actual 1989	Forecast 1990	Forecast 1991
Fourth Quarter to Fourth Quarter (Percentage change)			
Nominal GNP			
CBO	6.4	6.6	6.6
Administration	6.4	6.8	7.2
Blue Chip	6.4	6.5	6.5
Real GNP			
CBO	2.6	2.3	2.5
Administration	2.6	2.2	2.9
Blue Chip	2.6	2.0	2.4
Implicit GNP Deflator			
CBO	3.8	4.3	4.0
Administration	3.8	4.5	4.2
Blue Chip	3.8	4.4	4.1
Consumer Price Index[a]			
CBO	4.6	4.8	4.4
Administration	4.5	4.9	4.2
Blue Chip	4.6	5.0	4.3
Calendar-Year Averages (Percent)			
Civilian Unemployment Rate[b]			
CBO	5.3	5.3	5.4
Administration	5.2	5.4	5.6
Blue Chip	5.3	5.4	5.5
Three-Month Treasury Bill Rate			
CBO	8.1	7.6	6.9
Administration	8.1	7.7	6.8
Blue Chip	8.1	7.7	7.5
Ten-Year Government Note Rate			
CBO	8.5	8.5	7.8
Administration	8.5	8.5	7.9
Blue Chip[c]	8.5	8.5	8.3

SOURCES: Congressional Budget Office; Office of Management and Budget; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators*.

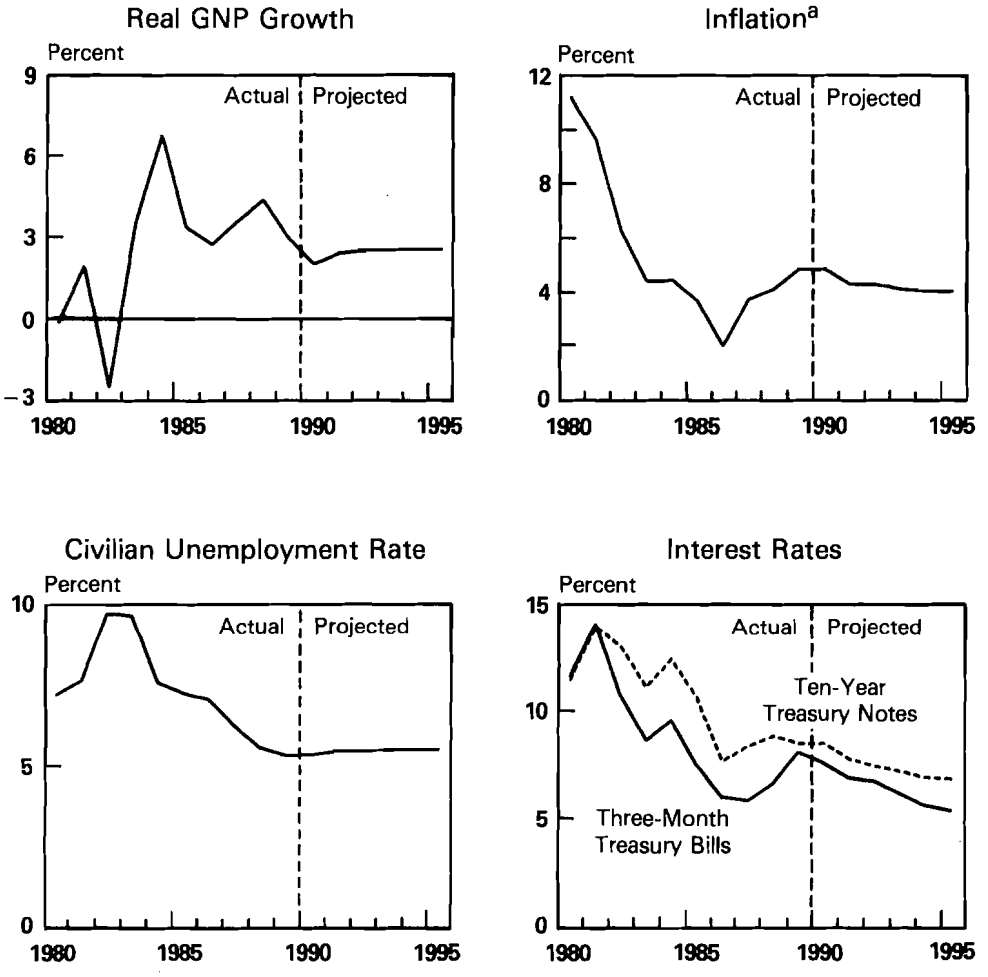
NOTE: The *Blue Chip* forecasts through 1991 are based on a survey of 50 private forecasters, published on June 11, 1990.

a. Consumer price index for all urban consumers (CPI-U) for CBO and the *Blue Chip*; consumer price index for urban wage earners and clerical workers (CPI-W) for the Administration.

b. The Administration's projection is for the total labor force, including armed forces residing in the United States, while the CBO and *Blue Chip* projections are for the civilian labor force excluding armed forces. In recent years, the unemployment rate for the former has tended to be 0.1 to 0.2 percentage points below the rate for the civilian labor force alone.

c. *Blue Chip* does not project a 10-year note rate. The values shown here are based on the *Blue Chip* projection of the Aaa bond rate, adjusted by CBO to reflect the estimated spread between Aaa bonds and 10-year government notes.

Figure I-5.
The Economic Forecast and Projection



SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Federal Reserve Board.

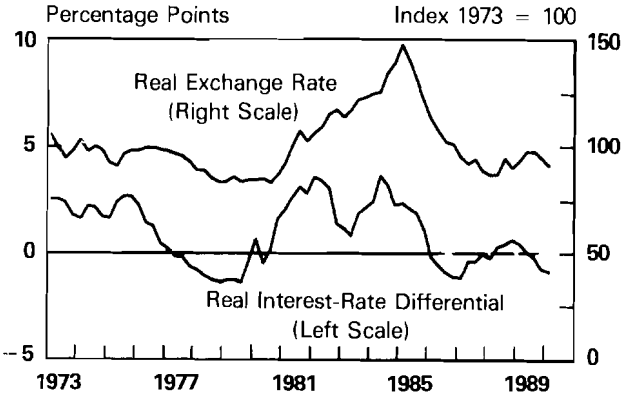
a. Consumer price index for all urban consumers (CPI-U) from January 1983 to present; before that time, the series incorporates a measure of homeownership conceptually similar to that of the current CPI-U.

cast, the real exchange rate drops 8 percent in 1991, following a 4 percent decline in 1990. But the exact path of the dollar is very uncertain and could be influenced by many unforeseeable factors.

The Composition of Real Output

CBO expects that deficit reduction will shift the composition of real output away from domestic consumption and toward business fixed investment and net exports. The two components of domestic consumption--expenditures for personal consumption and government purchases--are expected to fall as a share of real GNP while the deficit cuts are being carried out. The share of expenditures for personal consumption declines as disposable personal income is reduced by higher personal taxes and lower government transfers. Government consumption as a share of real GNP falls with the cutbacks in federal spending.

Figure I-6.
The Exchange Rate and the Interest-Rate Differential



SOURCES: Congressional Budget Office; Federal Reserve Board; International Monetary Fund.

NOTES: The real exchange rate is the level of U.S. consumer prices relative to consumer prices in 10 industrialized countries, weighted by trade shares and adjusted by dollar exchange rates against the currencies of those countries. Its movements are dominated by movements in exchange rates. An increase in the real exchange rate corresponds to dollar appreciation.

The real interest-rate differential is the difference between U.S. real long-term interest rates and an average of foreign real long-term rates weighted by gross domestic product. Real interest rates are nominal long-term rates less expected inflation, estimated by a centered two-year moving average of actual and forecast inflation rates.

Investment is expected to rise as a share of real GNP over the forecast period as a consequence of lower real interest rates. Spending on business equipment and inventories should respond quickly and strongly following the deficit cuts. Spending on housing and nonresidential structures, however, will increase much more slowly, reflecting not only the current depressed state of these two sectors, but also the fact that investment in new structures responds slowly to changes in interest costs.

The share of net exports in real GNP is expected to rise in the forecast for a number of reasons. First, the depreciation of the dollar makes U.S. goods more competitive on world markets. Second, the foreign demand for U.S. capital goods should continue to remain strong. The economic development of Eastern Europe will raise the demand for capital equipment worldwide, some of which will be supplied by the United States. Capital spending abroad will also be supported by the economic integration of Europe in 1992, which will break down many internal barriers to trade and boost investment demand as firms expand to meet the new markets. In any case, reduction in the federal deficit is expected to contribute to the rise in net exports by reducing domestic demands. This rise will reduce imports, and expand exports by freeing resources that otherwise would have been used to meet domestic demands.

The Outlook for Inflation

Although overall inflation as measured by growth in the CPI-U picked up in the first quarter of 1990, it is expected to moderate over the forecast period. The underlying inflation rate should remain roughly constant at around 4 percent to 4½ percent over the next two years, unchanged from its rate over the past six years. Despite this overall stability, deficit reduction may cause a temporary increase in inflation in early 1991 for two reasons. First, the decline in the dollar that results from reduction in the deficit leads to a slight increase in the prices of imported goods. Second, to the extent that the deficit reduction package relies on increases in excise taxes, it could raise the level of consumer prices. But the impact of these two factors on inflation is expected to be small and temporary.

Comparison with Other Forecasts

The CBO forecasts for interest rates in 1991 are considerably lower than what CBO predicted in January and what the *Blue Chip Economic Indicators*, an average of forecasts by 50 economists, is predicting now. But this difference occurs largely because the current CBO forecast incorporates the assumption of large cuts to the deficit, which were not assumed in the earlier CBO forecast and which private forecasters currently do not assume. The CBO forecasts for real GNP, unemployment, and inflation in 1991, however, are roughly similar to the consensus of the other forecasters. The CBO forecast is relatively close to the summer 1990 economic forecast made by the Administration, which also assumes large cuts to the deficit. Although the Administration expects slightly faster economic growth in 1991 than does CBO, the forecasts of other economic indicators are roughly similar.

The Risks to the Forecast

The CBO forecast faces two risks: that a sharp reduction in the budget deficit could lead to recession, and that the stimulative monetary policy aimed at offsetting the fiscal contraction could lead to higher inflation. But statistical indicators do not suggest that the probability of recession is high at present, and CBO expects that to the extent that deficit reduction is anticipated and incorporated into private decisions, the risk of a recession can be reduced. Furthermore, the increase in the growth of the money supply assumed in the forecast is not so large or prolonged that the risk of higher inflation is raised substantially. But neither of these risks is negligible.

Probability of Recession. Although the growth of the economy has slowed from its unsustainable pace in 1988, a recession in the near term does not appear likely according to two forward-looking indicators. The Index of Recession Probabilities developed by Professors Stock and Watson of the National Bureau of Economic Research, which shows the probability of a recession starting sometime during the next six months, stood at only 7 percent in May 1990. The Index of Leading Indicators developed by the Commerce Department did not fall in all of the past three months--the typical rule of thumb many forecasters

use to predict recessions. Although the index fell 0.1 percent in April, it rose 0.8 percent in May and 1.0 percent in March.

The Role of Credibility. The assumption that the deficit reduction package is credible, and thus anticipated by financial markets, is crucial to the content of the economic forecast and economic projections. Modern economic theory suggests that while large unanticipated cuts in the deficit could reduce growth in the short run, such a slowdown in growth can be attenuated if the deficit cuts are fully anticipated and incorporated into private decisions.

Most observers are skeptical that large deficit reductions will occur, and with good reason in the light of the experience of the 1980s. The decade started with large budget deficits that resulted from both the deep recessions of 1980 and 1981-1982, and changes in budget and tax policies. The Balanced Budget Act (or Gramm-Rudman-Hollings) targets, instituted in 1985, initially led to increased confidence that deficits would eventually fall. But after five years of Gramm-Rudman-Hollings discipline, these expectations have not been fulfilled. While there has been some modest reduction in the deficit, there has been even more budgetary legerdemain. By now, private forecasts routinely assume only modest policy changes that do not come close to meeting the deficit targets.

Such skepticism is a product of the 1980s. In earlier decades, deficits were large at times, especially during wars and recessions, but they were always eliminated: the federal deficit never remained large through a long peacetime period of economic expansion. In contrast, since the onset of the 1980s, the deficit has persistently continued to claim a large share of available funds even after nearly a decade of economic expansion and peace.

These changes between conditions in earlier decades and those in the 1980s help explain why long-term interest rates have been higher (after adjusting for inflation) since the beginning of the 1980s than earlier. Interest rates reflect the balance between the demand for credit by the federal government and other borrowers, on the one hand, and the supply of credit--largely through private saving--on the other. Interest rates in earlier decades were relatively low when extra-

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ordinary credit demands could be expected to subside. But in recent years the expectation that the federal government's credit demands will persist has no doubt helped sustain high real interest rates. The effect has been particularly pronounced because the federal government's appetite for credit has run up against the reduced supply that has resulted from the low private saving rates of the 1980s.

The assumption in the CBO forecast that expectations will revert to those earlier standards could turn out to be unrealistic if the budget summit does not soon yield a program of convincing changes in budget policy. CBO assumes that financial markets can be persuaded relatively quickly--say, nine months from the time that the program of deficit reductions is adopted--that the outlook for federal deficits is more like that of previous decades than that of the 1980s.

This outcome obviously requires more than simply revising or restating deficit targets. It requires a package of measures that specifies not only the policies required to cut next year's deficit, but also the additional policy changes required to keep the deficit on a steep downward path in subsequent years. New sources of one-time savings would not affect expectations about the course of deficits. Only if the budget agreement involves substantive and permanent changes in policy could such changes be realized. Bipartisan cooperation is clearly essential to the process in order to reassure financial markets that the major issues in budget policy that have divided the nation for the past decade are settled and are unlikely to be revisited in the near future.

A substantial delay in the enactment of the budget legislation could have serious effects. If the legislation to cut the deficit in fiscal year 1991 is not passed until a "lame duck" session of Congress near the end of 1990, the Federal Reserve would not have much warning of the impending cuts. As a result, it may be unable to offset the fiscal contraction fully. Furthermore, delays could make financial markets more skeptical about the future course of budget policy in the United States than they would otherwise be, and as a result long-term interest rates would not fall as much as CBO expects.

ECONOMIC PROJECTIONS IN THE MEDIUM TERM

CBO does not try to forecast short-term fluctuations in the economy more than two years into the future. Instead, it simply projects the trends in major economic variables, which are shown in Tables I-3 and I-4. The current projection differs from past projections, however,

TABLE I-3. MEDIUM-TERM ECONOMIC PROJECTIONS FOR CALENDAR YEARS 1992 THROUGH 1995

	Actual	Forecast		Projected			
	1989	1990	1991	1992	1993	1994	1995
Nominal GNP (Billions of dollars)	5,234	5,560	5,925	6,314	6,726	7,166	7,634
Nominal GNP (Percentage change)	7.2	6.2	6.6	6.6	6.5	6.5	6.5
Real GNP (Percentage change)	3.0	2.0	2.5	2.6	2.6	2.6	2.6
Implicit GNP Deflator (Percentage change)	4.1	4.1	4.0	3.9	3.8	3.8	3.8
Fixed-Weighted GNP Price Index (Percentage change)	4.5	4.5	4.2	4.3	4.1	4.1	4.0
CPI-U (Percentage change)	4.8	4.8	4.2	4.2	4.0	4.0	4.0
Unemployment Rate (Percent)	5.3	5.3	5.4	5.4	5.5	5.5	5.5
Three-Month Treasury Bill Rate (Percent)	8.1	7.6	6.9	6.7	6.2	5.6	5.4
Ten-Year Government Note Rate (Percent)	8.5	8.5	7.8	7.4	7.2	6.9	6.8
Tax Bases (Percentage of GNP)							
Corporate profits	5.8	5.3	5.1	5.1	5.2	5.2	5.2
Other taxable income	21.6	21.7	21.5	21.2	20.9	20.6	20.3
Wage and salary disbursements	50.3	50.6	50.7	50.7	50.7	50.7	50.7
Total	77.6	77.6	77.3	77.0	76.8	76.5	76.2

SOURCE: Congressional Budget Office.

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

because it embodies estimates of how much the trends would be affected by the significant reductions in the federal deficit that are assumed for the next five years.

In the past, CBO did not seek to forecast future changes in fiscal policy, and thus made projections of the economy's medium-term

TABLE I-4. MEDIUM-TERM ECONOMIC PROJECTIONS FOR FISCAL YEARS 1992 THROUGH 1995

	Actual	Forecast		Projected			
	1989	1990	1991	1992	1993	1994	1995
Nominal GNP (Billions of dollars)	5,153	5,472	5,832	6,215	6,620	7,053	7,514
Nominal GNP (Percentage change)	7.5	6.2	6.6	6.6	6.5	6.5	6.5
Real GNP (Percentage change)	3.2	2.1	2.4	2.6	2.6	2.6	2.6
Implicit GNP Deflator (Percentage change)	4.2	4.0	4.0	3.9	3.8	3.8	3.8
Fixed-Weighted GNP Price Index (Percentage change)	4.6	4.3	4.3	4.3	4.2	4.1	4.0
CPI-U (Percentage change)	4.7	4.7	4.3	4.3	4.1	4.0	4.0
Unemployment Rate (Percent)	5.3	5.3	5.4	5.4	5.4	5.5	5.5
Three-Month Treasury Bill Rate (Percent)	8.1	7.7	6.9	6.8	6.3	5.7	5.4
Ten-Year Government Note Rate (Percent)	8.8	8.4	7.9	7.5	7.3	7.0	6.8
Tax Bases (Percentage of GNP)							
Corporate profits	6.1	5.3	5.2	5.1	5.2	5.2	5.2
Other taxable income	21.4	21.6	21.5	21.3	21.0	20.7	20.4
Wage and salary disbursements	50.1	50.6	50.7	50.7	50.7	50.7	50.7
Total	77.7	77.6	77.4	77.1	76.9	76.6	76.3

SOURCE: Congressional Budget Office.

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

trends solely on the basis of historical patterns. Real interest rates in those earlier reports were projected to move to their historical average levels, and thus may not have been consistent with the baseline budget deficits. The implied level of national saving in those projections was well below its historical average. The current projections go beyond these simple historical averages and describes an economic future consistent with a fiscal policy that substantially reduces the deficit.

Growth in Real GNP

CBO has derived its medium-term projection of real GNP using a framework of a "growth model" originally developed by economists at the Brookings Institution.[1] This framework projects the rate of growth in real GNP largely on the basis of federal deficits, private saving rates, rates of growth in labor input, and rates of technological progress.

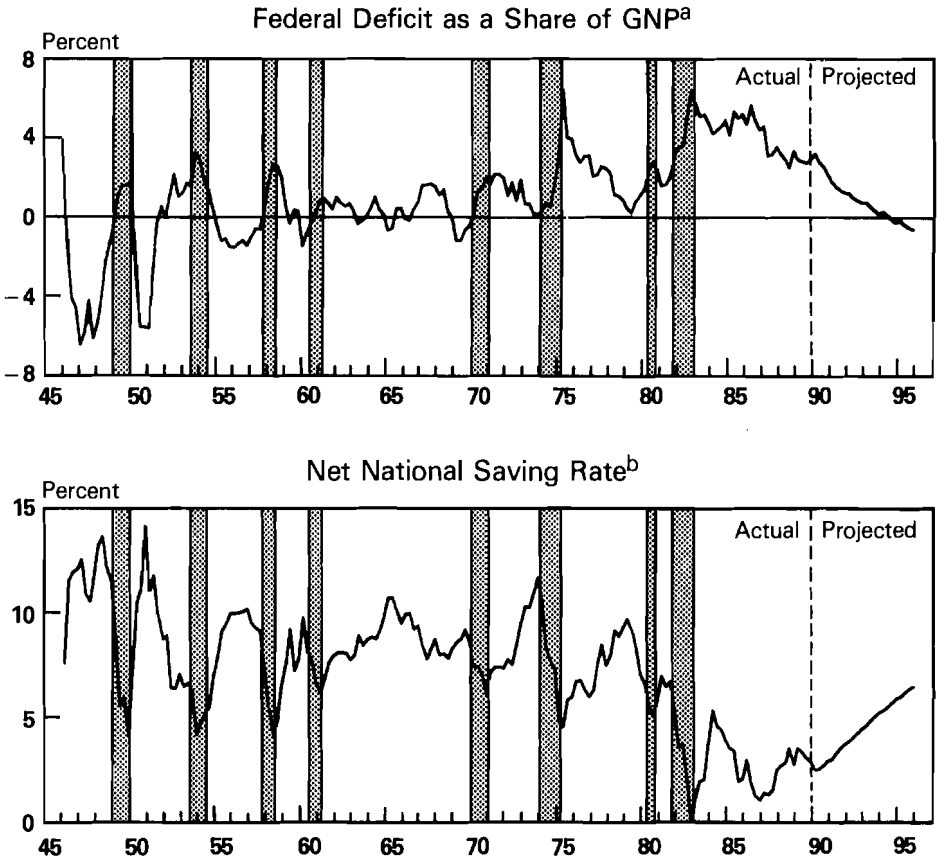
Reducing the federal deficit helps to raise the growth of real GNP in the medium term above what it would have otherwise been. The budget deficit diverts national saving from private investment to consumption by the public and private sectors. Cutting the deficit should increase the trend rate of growth of real GNP by reducing this diversion from productive investment.[2]

Other factors also contribute to CBO's projection of an increase in growth in the medium term. Rates of saving out of income in the private sector--which are currently very low--are assumed to move toward, but not reach, their historical average as the "baby boom" generation begins to save more. In combination with the deficit cuts, this development leads to higher rates of national saving over the projection period (see Figure I-7). The growth in the labor force is

1. For a description of CBO's adapted version of the Brookings framework, see Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1990-1994* (January 1989), pp. 125-127.

2. Public-sector investment also increases future output. The current and projected baseline deficits, however, do not finance unusual amounts of public investment, and the proposed deficit cuts do not generally include large cuts in public investment.

Figure I-7.
Federal Deficits and the Net National Saving Rate Assuming Large Deficit Cuts



SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

NOTE: The projections assume the large reductions in the deficit described earlier in this chapter.

a. Deficit as measured in the National Income and Product Accounts.

b. Saving less capital consumption adjustment divided by net national product.

assumed to follow the Bureau of Labor Statistics's mid-range projections. Finally, technical progress is assumed to proceed at its average rate since 1960.

The CBO projections of real economic growth in the medium term are somewhat lower than the Administration's. Over the 1992-1995 period, CBO projects that the economy will grow at a 2.6 percent rate, while the Administration projects a growth rate of slightly more than 3 percent rate. The Administration's growth rate projections reflect a more optimistic view of the likely growth of productivity.

Interest Rates

Another important effect of reducing the budget deficit should be a reduction in real rates of interest. As the discussion above has suggested, reducing federal borrowing should reduce demands for credit, and thereby reduce pressures on interest rates.

CBO's projection of the decline in long-term interest rates between 1991 and 1995 has been guided by treating as historical norms the real interest rates and increases in national wealth that existed during the 1960s. During that decade, real long-term interest rates averaged about 2.3 percent, while about 7.3 percent of real GNP was devoted to increases in wealth--that is, either invested in this country or loaned to foreigners. These norms were upset in subsequent decades by a number of developments. In the 1970s, real interest rates fell sharply on average because of large and unexpected increases in inflation. In the 1980s, by contrast, monetary policy was stringent, private saving rates declined, and the federal deficit was persistently large. As a result, the rate of national wealth accumulation fell sharply and real interest rates rose sharply.

In the 1990s, CBO projects that the assumed reduction in the federal deficit will raise the rate of accumulation of national wealth toward the rate that existed during the 1960s. Consequently, CBO projects that the real long-term interest rate will also move toward its rate of the 1960s. The rate of accumulation of national wealth and the real long-term interest rate, in fact, are both projected to move about

two-thirds of the way from their levels of the 1987-1989 period to the average levels of the 1960s by the end of the projection period.

It is not easy to find a similarly compelling norm for the relationship between short-term and long-term interest rates. In the 1960s, the spread between short- and long-term interest rates averaged about 70 basis points. For reasons that are not entirely clear, however, it has rarely been so low in the 1980s. In the CBO projections, the spread is assumed to average almost one and one-half percentage points. This spread is equal to the average experienced since the early 1970s, when capital controls and exchange rate supports began to be dismantled and U.S. interest rates became more clearly linked with those of other nations.

The Administration projects lower short-term and long-term nominal interest rates on average than does CBO. The difference between CBO and the Administration partly reflects the Administration's lower inflation projections, but in addition reflects its projections for lower real interest rates, especially long-term rates. Since both the Administration and CBO assume fiscal policies that substantially reduce the deficit (excluding spending for RTC), the Administration's lower projections apparently reflect different views of the other factors that determine interest rates.

CONCLUSION

Reducing the deficit can provide significant benefits to the economy in the long run. By raising the level of national saving, deficit reduction increases investment in productive capital and reduces foreign indebtedness. Over time, the nation will become richer and living standards will rise higher than they would otherwise have done.

In the short run, deficit reduction can have a restrictive effect on the economy. CBO has assumed, however, that this effect will be offset, because the package of deficit cuts will be viewed as credible by financial markets and because the Federal Reserve will provide sufficient and timely liquidity to money markets. A quickly enacted agreement to make large and permanent reductions to the deficit would play a

significant role in establishing the credibility of the package in financial markets and would give the Federal Reserve some time to offset the contractionary effect of deficit cuts.

CHAPTER II

THE BUDGET OUTLOOK

The Congressional Budget Office projects that the federal deficit will reach $195 billion in 1990, a level not seen since the mid-1980s. Under current policies, the deficit will jump to more than $230 billion in both 1991 and 1992 before subsiding, finally falling to $138 billion in 1995 (see Table II-1). These deficits exclude any savings that may yet emerge from the ongoing budget summit.

The deficit balloons in the next few years because CBO assumes the resolution of almost one thousand insolvent or marginal savings and loan institutions whose deposits are backed by the government. "Resolution" denotes a range of actions--from assistance agreements to outright liquidations--as the government safeguards depositors in institutions that are no longer viable. Such a concerted assault on the savings and loan problem, however, will require new legislation. Under current law, the agency charged with this task does not have enough resources to do the job. While CBO ordinarily bases its budget projections solely on current law, it has deviated in this instance because deposit insurance is a mandatory, not a discretionary, obligation of the government. If the government is not to renege on its commitments, new resources must be provided. In the absence of prompt legislation, the deficits would not be nearly so high in 1991 through 1993; however, such delays would cause the government's eventual costs to worsen.

The projected deficits far exceed the targets set in the Balanced Budget Act, which stipulates that the deficit should not exceed $64 billion in 1991 and must be zero by 1993. Even in the absence of new savings and loan legislation, the deficit would exceed the target by at least $100 billion in 1991. The gap will widen as the targets decrease.

Including savings and loan-related spending when gauging compliance with the deficit targets causes results that were not intended.

These outlays, which today are large and volatile, paint a misleading picture of the government's current impact on the economy. Most savings and loan-related outlays essentially reshuffle existing assets and liabilities, and do not stimulate additional spending by the recipients. CBO is not alone in raising these concerns. Policymakers are actively

TABLE II-1. CBO BASELINE REVENUES, OUTLAYS, DEFICIT, AND DEBT (By fiscal year)

	Actual		Projected				
	1989	1990	1991	1992	1993	1994	1995
In Billions of Dollars							
Revenues	991	1,044	1,123	1,188	1,260	1,337	1,417
Outlays[a]	1,143	1,238	1,355	1,426	1,455	1,483	1,555
Deficit[a]	152	195	232	239	194	146	138
Deficit Targets	136	100	64	28	0	b	b
Debt Held by the Public	2,189	2,378	2,607	2,844	3,038	3,183	3,321
Memorandum: Deficit Excluding Certain RTC Outlays[c]	143	159	162	179	182	177	157
As a Percentage of GNP							
Revenues	19.2	19.1	19.3	19.1	19.0	19.0	18.9
Outlays	22.2	22.6	23.2	23.0	22.0	21.0	20.7
Deficit	2.9	3.6	4.0	3.8	2.9	2.1	1.8
Debt Held by the Public	42.5	43.5	44.7	45.8	45.9	45.1	44.2
Memorandum: Deficit Excluding Certain RTC Outlays[c]	2.8	2.9	2.8	2.9	2.7	2.5	2.1
Reference: GNP (In billions of dollars)	5,153	5,472	5,832	6,215	6,620	7,053	7,514

SOURCE: Congressional Budget Office.

NOTES: The budget figures include Social Security, which is off-budget. For comparability with the Balanced Budget Act targets, the projections exclude the Postal Service.

RTC = Resolution Trust Corporation.

a. Includes necessary resources beyond current law to resolve savings and loan institutions.

b. The Balanced Budget Act established targets for 1988 through 1993.

c. Excludes outlays of the RTC other than interest and administrative costs.

weighing whether to exclude certain savings and loan-related spending when measuring compliance with budget targets, or whether to shift the focus entirely from fixed deficit targets to the amount of savings achieved. Such approaches would require changing the Balanced Budget Act, which currently makes no such distinctions between savings and loan-related spending and other outlays.

This chapter presents CBO's revised and updated budget projections. It summarizes the five-year outlook for federal revenues, spending, and the deficit, and briefly explains why the deficit outlook has deteriorated since CBO last published its projections in March. A special section outlines the need for additional money to solve the savings and loan problem. Another segment highlights the contribution of federal government trust funds to the deficit totals. The chapter concludes by casting the budget in the national income and product account (NIPA) terms often used for macroeconomic analysis.

THE BUDGET OUTLOOK UNDER CURRENT POLICIES

Baseline budget projections depict the outlook for revenues and outlays if current policies remain unchanged. They are not a projection of expected outcomes, because policymakers may adopt many changes. Baseline projections are important because they show the effects of unchanged policies, and they serve as a benchmark when analyzing alternatives.

Baseline Concepts and Assumptions

CBO's baseline closely follows specifications set out in the Balanced Budget Act, with only a few specific and narrow exceptions. On the revenue side, the projections assume the continuation of current tax law, including any revenue increases, phaseouts, and other changes scheduled under current law. The revenue baseline deviates from current law, however, by assuming the extension of excise taxes that are dedicated to trust funds and that are slated to expire. This assumption, mandated by the Balanced Budget Act, affects projections for taxes

dedicated to the Airport and Airway Trust Fund, the Highway Trust Fund, and three smaller funds in the 1991-1995 period.

Baseline assumptions vary for different types of outlays depending on how directly the Congress controls spending. The baseline reflects the likely path of entitlement and mandatory spending under current laws. These programs (of which Social Security and Medicare are the largest and best known) do not require annual decisions on funding levels, but instead continue to make payments to eligible participants until the Congress changes the underlying laws.

Most entitlement and mandatory programs are open-ended, but one critical exception is spending to carry out the government's commitments to depositors in failed savings and loan institutions. Last August, the Congress and the Administration passed legislation authorizing a fixed amount of resources for resolving the savings and loan crisis. It is now widely recognized that the funds are inadequate, even as the government's commitments to depositors remain intact. Therefore, this chapter shows the savings and loan-related spending that would result if the constraints were lifted and the government spent as much as necessary.

Unlike entitlement and mandatory programs, two other categories of spending--defense and nondefense discretionary spending--require annual appropriations; here, the baseline assumes that funding remains at 1990 levels, adjusted only for projected inflation. Offsetting receipts (such as receipts from oil leases and from Medicare premiums) are projected according to current laws and policies, while net interest outlays depict the levels that would result if the projected deficits and interest rates come to pass.

The Balanced Budget Act specifications were meant to set uniform rules for baseline projections. By design, the baseline does not contain enough funds for some discretionary programs or projects that may require future funding increases to complete because the Congress must make such decisions explicitly. Building a manned space station or a superconducting super collider, extending all expiring contracts for subsidized housing, or carrying out other discretionary activities could require extra increases in spending beyond the rate of inflation.

Similarly, the baseline does not reflect spending declines that are likely to occur in several areas, notably in disaster assistance (boosted in 1990 by Hurricane Hugo and the California earthquake) and census-related activities.

The baseline budget projections are based on the economic assumptions described in Chapter I. At the request of the participants in the budget summit, CBO developed a set of economic assumptions based on large reductions in the deficit. As explained in Chapter I, these reductions remain to be identified and achieved. The budget projections in this chapter depict the effects of unchanged policies. However, to bring about the improvements in economic growth, interest rates, and inflation envisioned in the economic forecast, the deficits must be reduced substantially.

Changes in the Baseline Projections Since March

CBO last published its baseline projections in March. The deficit outlook is markedly worse than CBO forecast last winter. The chief reason is that, for the first time, CBO has included in its baseline sufficient resources to tackle the savings and loan crisis during the next several years. Even apart from this additional deposit insurance spending, other factors--particularly a deterioration in the revenue outlook--have worsened the deficit.

In a nutshell, changes in the deficit outlook since last March can be ascribed to revenues, deposit insurance, and a handful of other activities (see Table II-2). Changes are almost wholly ascribed to technical factors rather than to new laws or changes in the economic outlook. No significant budgetary legislation has been enacted this year apart from a supplemental appropriation bill that adds less than $1 billion a year to spending. Changes in the economic assumptions, described in Chapter I, have fairly modest net effects on revenues, interest spending, and benefit payments.

In the case of revenues, however, the amounts ascribed to economic changes may be misleadingly small because of lags in revising

TABLE II-2. CHANGES IN CBO BASELINE ESTIMATES SINCE MARCH (By fiscal year, in billions of dollars)

	1990	1991	1992	1993	1994	1995
Revenues						
March 1990 Estimate	1,067	1,137	1,204	1,277	1,355	1,438
Enacted Legislation	0	0	0	0	0	0
Economic Reestimates	3	5	a	-2	-3	-4
Technical Reestimates	-27	-19	-16	-15	-15	-17
Total	-23	-14	-16	-16	-18	-21
Current Estimate	1,044	1,123	1,188	1,260	1,337	1,417
Outlays						
March 1990 Estimate	1,226	1,298	1,328	1,409	1,476	1,548
Enacted Legislation	a	1	a	a	a	a
Economic Reestimates						
Interest rates	3	5	2	-1	-4	-6
All other	a	1	2	1	a	-3
Subtotal	2	6	4	a	-4	-10
Technical Reestimates						
Resolution Trust Corporation[b]	3	39	73	26	-20	-11
Other Deposit Insurance	2	1	2	-3	7	1
Income Security	1	3	3	3	3	3
Net interest	1	7	15	20	21	22
All other	3	-1	1	a	a	1
Subtotal	10	50	94	46	11	16
Total	12	57	98	46	7	7
Current Estimate	1,238	1,355	1,426	1,455	1,483	1,555
Deficit						
March 1990 Estimate	159	161	124	132	121	110
Enacted Legislation	a	1	a	a	a	a
Economic Reestimates	-1	1	4	2	-1	-5
Technical Reestimates	36	69	110	60	26	33
Total	36	71	114	62	25	28
Current Estimate	195	232	239	194	146	138

SOURCE: Congressional Budget Office.

NOTE: For purposes of comparability with the Balanced Budget Act targets, the budget projections include Social Security but exclude the Postal Service.

a. Less than $500 million.

b. CBO's March baseline reflected only RTC spending permitted under current law. The new projections explicitly assume that new resources will be provided.

official economic data. Revenues are down significantly from earlier projections, with the shortfalls topping $20 billion in 1990 and somewhat less in later years. The revisions reflect the weakness in actual tax collections this year, particularly in final payments on 1989 tax liabilities (concentrated in the critical months of March through May). Because the economy, according to official statistics, appears to have performed much as CBO expected, the shortfall is classified as technical. However, the Commerce Department has informally acknowledged that official measures of employment, wages, and salaries have been too high and will be revised. This likely move is supported by other government data and by the unmistakable weakness in wage-based personal income and payroll taxes. Nonwithheld personal taxes (primarily final settlements on 1989 income tax liabilities) have also proved weaker than expected, as have corporate income taxes. Some of the factors behind 1990's lackluster collections will continue to operate in 1991 through 1995.

On the spending side, projections of net outlays of the Resolution Trust Corporation (RTC) are up by a mere $3 billion for 1990 but by a staggering $138 billion over the 1991-1993 period. These projections depend critically on granting RTC the resources it needs to do its job. Without such authority, the RTC is expected to run out of ability to take on new cases early in fiscal year 1991. Part of the added spending during the next three years represents working capital, spent to acquire the assets of failed institutions but recouped in later years as the assets are sold. Such sales occur over a prolonged period, up to eight years after the initial working capital is spent. As Table II-2 suggests, such sales succeed in driving down the deficits in 1994 and 1995; further proceeds would continue after 1995. Spending projections for other deposit insurance funds (notably the Bank Insurance Fund and the Savings Association Insurance Fund) are up in all years except 1993.

Spending for several income security programs--Supplemental Security Income (SSI), unemployment insurance, family support payments, and food stamps--is up, reflecting higher caseloads. Some of the extra spending results from a Supreme Court decision expanding SSI eligibility for disabled children. Finally, projections of net interest spending are up sharply, mainly reflecting the higher deficits that are expected to prevail through 1995.

The Five-Year Outlook for Revenues

In CBO's new projections, revenues total $1,044 billion in 1990, climbing by about 6 percent a year to $1,417 billion in 1995. Total revenues represent about 19 percent of GNP during this period, slightly surpassing typical levels of the past 30 years except for distinct periods of surtaxes or high inflation.

The government's sources of revenue are shown in Table II-3. The individual income tax remains the government's biggest revenue source, accounting for nearly half of total revenues and about 9 percent

TABLE II-3. CBO BASELINE REVENUE PROJECTIONS BY SOURCE
(By fiscal year)

Major Source	Actual 1989	Base 1990	Projected 1991	1992	1993	1994	1995
			In Billions of Dollars				
Individual Income	446	474	517	555	595	635	675
Corporate Income	104	99	104	105	107	112	117
Social Insurance	359	381	413	438	466	495	526
Excise	34	36	34	33	34	34	35
Estate and Gift	9	11	11	12	12	13	13
Customs Duties	16	17	18	20	21	22	24
Miscellaneous	23	25	26	26	25	26	26
Total	991	1,044	1,123	1,188	1,260	1,337	1,417
			As a Percentage of GNP				
Individual Income	8.6	8.7	8.9	8.9	9.0	9.0	9.0
Corporate Income	2.0	1.8	1.8	1.7	1.6	1.6	1.6
Social Insurance	7.0	7.0	7.1	7.1	7.0	7.0	7.0
Excise	0.7	0.7	0.6	0.5	0.5	0.5	0.5
Estate and Gift	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Customs Duties	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Miscellaneous	0.4	0.5	0.4	0.4	0.4	0.4	0.3
Total	19.2	19.1	19.3	19.1	19.0	19.0	18.9

SOURCE: Congressional Budget Office.

of GNP (both roughly in keeping with the experience of the last 30 years). Today, major features of the individual income tax are indexed to inflation--tax brackets, the standard deduction, and personal exemptions--and the rate-reducing and base-broadening provisions of the Tax Reform Act of 1986 are fully phased in. These features of tax law help explain why individual income tax revenues remain stable at about 9 percent of GNP in the absence of further tax law changes.

Corporate income tax revenues have declined markedly in importance since the 1960s, when they typically represented nearly 4 percent of GNP. Their decline was arrested temporarily by the Tax Reform Act of 1986, which raised the overall tax bill for corporations; today, they represent about 1.8 percent of GNP (up from 1.5 percent in the mid-1980s), but are projected to drift slowly down again to 1.6 percent of GNP over the 1991-1995 period.

Social insurance taxes are second only to the individual income tax among the government's revenue sources, and for many workers social insurance taxes exceed the income tax. Such taxes (dominated by the payroll taxes for Social Security and Medicare) represent a stable 7 percent of GNP in the projections, approximately twice their share during the early 1960s. Growth in social insurance taxes has roughly coincided with expansion of benefits under the entitlement programs for which they are earmarked.

No other tax source brings in revenues representing as much as 1 percent of GNP, though in one case--excise taxes--this has not always been true; excise tax revenues represented more than 2 percent of GNP in the early 1960s, but have declined more or less steadily in importance since then. Many excise taxes are levied on a per-unit basis (for example, cents per gallon), and some have not changed in many years even as prices have risen. Some are scheduled to expire or decrease. Today, excise tax revenues are about 0.7 percent of GNP; they are projected to fall to 0.5 percent by 1992 and drift down slowly thereafter. The remaining tax sources--estate and gift taxes, customs duties, and miscellaneous receipts--represent small, and slightly falling, shares of GNP.

The Five-Year Outlook for Spending

Total outlays, in the baseline, are projected to climb from $1,238 billion in 1990 to $1,555 billion in 1995. By 1995, the bulge in outlays attributable to savings and loan spending is largely past, and outlays are down modestly as a share of GNP--from 22.6 percent at present to 20.7 percent in 1995. Projections of federal government outlays for five broad clusters of spending are shown in Table II-4.

TABLE II-4. CBO BASELINE OUTLAY PROJECTIONS FOR MAJOR SPENDING CATEGORIES (By fiscal year)

Spending Category	Actual 1989	Base 1990	Projected 1991	1992	1993	1994	1995
In Billions of Dollars							
National Defense	304	298	306	316	326	342	351
Nondefense Discretionary Spending	193	209	222	232	239	247	255
Entitlements and Other Mandatory Spending[a]	542	607	690	734	738	740	796
Net Interest	169	182	196	207	217	222	224
Offsetting Receipts	-65	-58	-59	-62	-65	-68	-72
Total	1,143	1,238	1,355	1,426	1,455	1,483	1,555
As a Percentage of GNP							
National Defense	5.9	5.5	5.3	5.1	4.9	4.8	4.7
Nondefense Discretionary Spending	3.7	3.8	3.8	3.7	3.6	3.5	3.4
Entitlements and Other Mandatory Spending[a]	10.5	11.1	11.8	11.8	11.1	10.5	10.6
Net Interest	3.3	3.3	3.4	3.3	3.3	3.1	3.0
Offsetting Receipts	-1.3	-1.1	-1.0	-1.0	-1.0	-1.0	-1.0
Total	22.2	22.6	23.2	23.0	22.0	21.0	20.7

SOURCE: Congressional Budget Office.

a. Includes necessary resources beyond current law to resolve savings and loan institutions.

National Defense and Nondefense Discretionary Spending. The two categories of spending that require annual appropriations--defense and nondefense discretionary spending--together represent about 40 percent of spending, and less than 10 percent of GNP. As specified by the Balanced Budget Act, the baseline assumes that these programs continue to be funded at the 1990 level, with future adjustments only to reflect inflation. Under these explicit assumptions, both categories shrink gradually in relation to GNP. Yet, this result is the fruit of baseline assumptions; both categories, in fact, have exhibited distinct peaks and valleys in the past. Defense spending peaked in times of war and during the defense buildup of the early 1980s. Since 1985, however, defense budget authority--that is, the authority to commit funds--has grown less rapidly than inflation, and outlays have followed with a lag. The lessening of East-West tensions has amplified calls for further cuts in real defense spending.

Nondefense discretionary spending comprises a great variety of federal activities, encompassing space, science, and energy programs; environmental protection, transportation, general government, and administration of justice; and many programs in the areas of education, health, housing, and other social needs. In the aggregate, nondefense discretionary spending represented 5½ percent to 6 percent of GNP in 1975 through 1981, but fell sharply starting in 1982, today standing at 3.8 percent of GNP. Because the baseline assumes that future increases only match inflation, this category gradually shrinks further in comparison with GNP--to about 3.4 percent in 1995.

Entitlements. By far the largest chunk of federal government spending belongs to entitlements and other mandatory programs, which make up about half of federal spending and 11 percent of GNP. This category is dominated by the major benefit programs administered by the federal government, either alone or jointly with state and local governments. It also includes some activities not widely viewed as benefit programs, such as deposit insurance and farm price supports.

More information about this huge category of spending is provided in Table II-5. About one-sixth of entitlement and mandatory spending

TABLE II-5. CBO BASELINE OUTLAY PROJECTIONS FOR ENTITLEMENTS AND OTHER MANDATORY SPENDING (By fiscal year, in billions of dollars)

Category	Actual 1989	Base 1990	Projected 1991	1992	1993	1994	1995
Means-Tested Programs							
Medicaid	35	40	46	51	57	64	71
Food Stamps[a]	14	15	18	18	19	20	21
Supplemental Security Income	12	11	14	15	16	18	18
Family Support	11	12	14	15	15	16	17
Veterans' Pensions	4	4	4	4	4	4	4
Child Nutrition	5	5	5	6	6	6	6
Earned Income Tax Credit	4	4	4	5	5	5	5
Stafford Loans[b]	4	4	4	4	3	3	3
Other	1	2	2	2	3	3	4
Total, Means-Tested Programs	89	97	111	120	128	140	149
Non-Means-Tested Programs							
Social Security	230	246	264	281	299	316	334
Medicare	94	105	114	130	145	162	180
Subtotal	324	351	378	411	444	478	514
Other Retirement and Disability							
Federal civilian[c]	32	34	38	40	43	46	49
Military	20	22	23	24	26	27	29
Other	5	5	5	6	6	6	6
Subtotal	57	60	66	70	74	79	84
Unemployment Compensation	14	17	17	18	18	19	20
Other Programs							
Veterans' benefits[d]	15	14	15	15	16	17	17
Farm price supports	11	7	9	11	11	10	10
Deposit insurance[e]	21	46	77	71	29	-20	-14
Social services	5	5	5	6	5	5	5
Other[f]	7	9	12	12	12	11	10
Subtotal	57	81	117	115	73	24	28
Total, Non-Means-Tested Programs	453	510	579	614	609	600	646
Total							
All Entitlements and Other Mandatory Spending	542	607	690	724	738	740	796

SOURCE: Congressional Budget Office.

NOTE: Spending for major benefit programs shown in this table includes benefits only. Outlays for administrative costs of most benefit programs are classified as nondefense discretionary spending, and Medicare premium collections as offsetting receipts.

a. Includes nutrition assistance to Puerto Rico.
b. Formerly known as Guaranteed Student Loans.
c. Includes Civil Service, Foreign Service, Coast Guard, and other retirement programs, and annuitants' health benefits.
d. Includes veterans' compensation, readjustment benefits, life insurance, and housing programs.
e. Includes additional resources beyond current law to resolve savings and loan institutions.
f. Excludes Postal Service outlays after 1989.

is means-tested, benefiting participants who must prove eligibility on the basis of income (often with additional requirements regarding age or family status); this category, in turn, is dominated by the fast-growing Medicaid program. The remaining spending for entitlements and other mandatory programs, led by Social Security and Medicare, is not means-tested; Table II-5 displays other large programs meeting this description.

Entitlement and mandatory programs have doubled their share of GNP since the 1960s. Alone among the major categories of spending, they tend to keep pace with GNP in the baseline projections, as inflation, growth in eligible populations, and increases in the demand for medical services fuel further spending. The decline that is projected in the baseline (from 11.1 percent of GNP in 1990 to 10.6 percent in 1995) occurs solely because deposit insurance spending falls from its current, extraordinarily high levels. Entitlement programs other than deposit insurance actually grow slightly faster than does GNP.

Interest. Net interest today represents about one out of every seven dollars spent by the government and 3.3 percent of GNP (see Table II-4). Net interest was the fastest-growing major category of spending during the 1980s. Under current policies, net interest continues to grow as the government finances large deficits, but the growth is mitigated by the assumed declines in interest rates. By 1995, net interest is expected to total about $224 billion, or 3 percent of GNP.

Net interest, however, is the least controllable major category of spending, and its future path is highly uncertain. Policymakers influence net interest spending only indirectly, by affecting the deficits (and hence, borrowing) of the federal government; deficit reductions of the size contemplated by the summit negotiators would bring about substantial savings in debt service costs. But policymakers do not control the other key element in the equation--namely, market interest rates. The baseline projections depend critically on CBO's assumption that interest rates will decline in response to a large deficit reduction package emerging from the budget summit. If interest rates merely stay at today's levels, in contrast, net interest spending would be sharply higher than in the baseline: nearly $5 billion higher in 1991 and almost $50 billion higher in 1995.

Net interest outlays are closely linked to the government's outstanding debt. Baseline projections for federal debt, along with the associated components of interest spending, are depicted in Table II-6. Federal debt and interest costs generate great confusion because each is often measured in contradictory ways. By far the most useful measure of the government's indebtedness is the amount it has borrowed in the credit markets to finance its cumulative deficits; in turn, this borrowing determines interest payments to the public, payments that enter directly into the government's deficit. As Table II-6 shows, debt held by the public climbs from $2.2 trillion at the start of 1990 to more than $3.3 trillion in 1995, as the government finances deficits totaling well over $1 trillion during this period.

Borrowing from the public and the resulting interest payments are the most useful measures of debt and interest. But both measures enjoy less public recognition than larger, gross measures, which are muddied by practices that are unrelated to dealings with the public but stem from intrabudgetary trust-fund accounting. The government invests the balances of Social Security and other trust funds in special Treasury securities. These securities belong to the government, and the interest on them is an intrabudgetary payment: it is both paid and collected by the government and therefore cannot add to the deficit. These payments boost outlays for interest on the public debt, or gross interest (shown in Table II-6), but are immediately offset in another entry--interest received by trust funds. Similarly, trust-fund holdings of securities swell the gross debt but are absent from the far more appropriate and useful measure, debt held by the public. Emphasizing gross interest or gross debt greatly exaggerates the seriousness of the government's fiscal situation. The government's growing debt service burdens can be documented perfectly well by using the more appropriate measures.

Although the gross debt is of little use for economic and budget analysis, it is a highly familiar figure to many budget followers. The chief reason is its link to the government's statutory debt limit. The Congress caps the debt issuance authority of the government, tying this cap to the gross debt (with a few minor exclusions). Table II-6 shows CBO's baseline projections of debt subject to limit. At the end

TABLE II-6. FEDERAL DEBT AND INTEREST COSTS IN THE CBO BASELINE (By fiscal year)

	Actual 1989	Projected 1990	1991	1992	1993	1994	1995
Net Interest Outlays (In billions of dollars)							
Interest on Public Debt (Gross interest)[a]	241	264	286	306	324	338	351
Interest Received by Trust Funds							
Social Security	-11	-16	-21	-27	-33	-40	-48
Other[b]	-41	-46	-51	-55	-58	-61	-64
Subtotal	-52	-62	-72	-81	-91	-101	-111
Other Interest[c]	-20	-19	-18	-18	-16	-15	-15
Total, Net Interest Outlays	169	182	196	207	217	222	224
Federal Debt, End of Year (In billions of dollars)							
Gross Federal Debt	2,866	3,177	3,539	3,914	4,260	4,568	4,884
Less: Debt Held by Government Accounts							
Social Security	157	216	289	373	467	576	700
Other[b]	520	582	642	698	754	809	864
Subtotal	677	799	932	1,070	1,221	1,385	1,564
Equals: Debt Held by the Public	2,189	2,378	2,607	2,844	3,038	3,183	3,321
Memorandum: Debt Subject to Limit[d]	2,830	3,133	3,496	3,872	4,219	4,529	4,846
Federal Debt as a Percentage of GNP							
Debt Held by the Public	42.5	43.5	44.7	45.8	45.9	45.1	44.2

SOURCE: Congressional Budget Office.

a. Excludes interest costs of debt issued by agencies other than Treasury (primarily deposit insurance agencies).

b. Principally Civil Service Retirement, Military Retirement, Medicare, Unemployment Insurance, Highway, and Airport and Airway Trust Funds.

c. Primarily interest on loans.

d. Includes discount securities (such as Treasury bills and zero-coupon bonds) at initial purchase price plus accumulated interest.

of 1990, debt subject to limit is projected at $3,133 billion. With the current statutory limit at $3,123 billion, Congressional action to raise the debt limit will be necessary soon, almost certainly before the August Congressional recess.

Offsetting Receipts. The last major category in the spending totals is offsetting receipts. Such receipts appear in budget totals as negative outlays rather than as revenues, primarily because they stem from either intrabudgetary transactions or voluntary, business-type collections rather than from the government's taxing powers. About half of offsetting receipts are intrabudgetary, reflecting agencies' payments into retirement funds on their employees' behalf; these payments are recorded twice, once as a payment by the agency elsewhere in the budget and once as a receipt by the retirement funds. The other half reflects voluntary payments for Medicare premiums, timber and mineral leases, and so forth. Offsetting receipts represent a small and stable 1 percent of GNP through 1995.

DEPOSIT INSURANCE IN THE PROJECTIONS

Baseline projections portray the likely course of spending and revenues under current policies. In the area of deposit insurance, the government has promised to guarantee the money of depositors in insured banks, savings and loan institutions, and credit unions. Clearly, the government must make good on these commitments if the institutions fail. So far, the deposit insurance agencies have not been given enough resources to do the job. Capping the resources of these agencies does nothing to restrict the government's exposure; in fact, it drives up the long-run costs as marginal institutions remain open and keep losing money. This section presents two paths for deposit insurance spending--one with resources capped as under current law, another with enough resources to resolve the liabilities that are currently recognized.

Deposit Insurance in the Baseline

Assuming that sufficient resources are provided in a timely fashion, deposit insurance outlays are expected to total $46 billion in 1990 and $70 billion to $80 billion in both 1991 and 1992. The agencies involved and their budget outlays are shown in Table II-7. Deposit insurance for commercial banks is the responsibility of the Bank Insurance Fund. Several agencies share responsibility for savings and loan institutions, succeeding the defunct Federal Savings and Loan Insurance Corporation (FSLIC). The FSLIC Resolution Fund (FRF) does not insure deposits but is charged with spending for institutions that were already in government hands by early 1989. The Resolution Trust Corporation (RTC) started operations in mid-1989; in the absence of constraints on spending, it is assumed to continue taking on cases through mid-1993. Finally, the Savings Association Insurance Fund (SAIF) insures institutions that are still operating, and will assume responsibility for resolving marginal institutions beginning in 1992.

As Table II-7 suggests, current budget numbers understate the amount spent on deposit insurance. Some of the costs are effectively hidden off-budget, through the device of setting up government-sponsored enterprises to borrow funds and turn them over to the government. Last year's deposit insurance legislation created such an entity, the Resolution Funding Corporation (REFCORP), to borrow $30 billion in 1990 and 1991. (A predecessor, the Financing Corporation or FICO, operated similarly in 1988 through 1989.) Because REFCORP is technically private, the money it turns over to the Resolution Trust Corporation is counted as a collection, thereby offsetting the spending that it finances. Despite REFCORP's private veneer, the government pays the bulk of interest on REFCORP bonds and uses the proceeds to carry out a governmental responsibility. By issuing REFCORP rather than ordinary Treasury debt, the government ends up paying an additional cost of up to a third of a percentage point. During consideration of last year's deposit insurance legislation, CBO argued that structuring REFCORP as an off-budget enterprise was inappropriate and needlessly costly.

TABLE II-7. OUTLAYS FOR DEPOSIT INSURANCE IN THE BASELINE (By fiscal year, in billions of dollars)

	Actual 1989	1990	1991	1992	1993	1994	1995
Spending Included in the Budget							
Commercial Banks							
Bank Insurance Fund (BIF)[a]	3	4	3	2	1	1	b
Savings and Loan Institutions							
Federal Savings and Loan Insurance Corporation (FSLIC)	9	c	c	c	c	c	c
Resolution Trust Corporation[d]	9	36	70	60	13	-30	-18
FSLIC Resolution Fund	b	6	4	6	5	4	4
Savings Association Insurance Fund (SAIF)	b	b	0	3	10	5	0
Subtotal	18	42	74	69	28	-21	-14
Total, On-Budget	21	46	77	71	29	-20	-14
Amount Financed by Off-Budget Borrowing							
Financing Corporation (FICO)[e]	4	0	0	0	0	0	0
Resolution Funding Corporation (REFCORP)[e]	0	16	14	0	0	0	0
Total, Off-Budget	4	16	14	0	0	0	0
Total Outlays							
Total, On- and Off-Budget	25	63	91	71	29	-20	-14

SOURCE: Congressional Budget Office.

NOTE: The table excludes relatively small outlays for credit union share insurance.

a. Formerly the Federal Deposit Insurance Corporation (FDIC) trust fund.

b. Less than $500 million.

c. Defunct.

d. Includes additional resources beyond current law to resolve savings and loan institutions.

e. FICO and REFCORP were established as off-budget, government-sponsored enterprises in order that the funds they borrow and transfer to the on-budget deposit insurance agencies could be counted as government collections, offsetting the associated spending. CBO believes that this budgetary treatment is inappropriate.

Of all the agencies listed in Table II-7, the Resolution Trust Corporation currently draws the keenest attention. The RTC was created by last August's Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) with authority to incur $50 billion in losses over its lifetime--an amount that CBO and others viewed as inadequate from the start. Early this year, the RTC received permission to borrow through the Treasury for its working capital needs--that is, money needed temporarily in the course of liquidating institutions but expected to be recovered.

Alternative Projections for the Resolution Trust Corporation (RTC)

RTC's net outlays are expected to total $36 billion in 1990, but their path in 1991 and beyond hinges on whether the agency hits barriers imposed by current law or receives additional authority to spend as needed. Table II-8 shows total outlays of the RTC, from its inception in August 1989 through 1995, in these two contrasting cases.

RTC Spending Under Current Law. Under current law, the RTC would incur net outlays of about $23 billion in the 1989-1995 period (other than for administrative and interest costs). As Table II-8 shows, these net outlays consist of $48 billion in insurance losses; $54 billion in working capital spending, offset by $36 billion in asset sales and $12 billion in repayment of advances; and, as further offsets, $30 billion in proceeds from REFCORP borrowing and $1 billion from the Federal Home Loan Banks. Relatively small proceeds from continued asset sales would trickle in after 1995.

The agency would spend about $200 million to $300 million a year for direct administrative expenses. These costs primarily reflect the costs of running RTC's headquarters and regional offices; they do not reflect administrative costs of institutions in receivership, which are included in insurance losses. Finally, interest costs for the agency's working capital borrowing peak at $4 billion a year. Under current law, the Treasury finances RTC's working capital requirements by borrowing funds in its own name and lending them to the RTC; the RTC, in turn, pays interest to the Federal Financing Bank (FFB), the

TABLE II-8. ALTERNATIVE PROJECTIONS FOR THE RESOLUTION TRUST CORPORATION (By fiscal year, in billions of dollars)

Outlays	Actual 1989	1990	1991	1992	1993	1994	1995	Total 1989-1995
Under Current Law								
Insurance Losses	1	35	12	0	0	0	0	48
Working Capital								
Asset acquisition and repayable advances	10	30	14	0	0	0	0	54
Receipts from asset sales	0	-1	-8	-13	-7	-4	-3	-36
Repayment of advances	0	-12	0	0	0	0	0	-12
Proceeds from Resolution Funding Corporation (REFCORP)	0	-16	-14	0	0	0	0	-30
Payment from Federal Home Loan Banks	-1	0	0	0	0	0	0	-1
Subtotal, outlays excluding interest and administrative expenses[a]	9	36	4	-12	-7	-4	-2	23
Interest and Administrative Expenses[b]	c	c	4	3	2	2	2	13
Total	9	36	8	-9	-5	-2	-1	36
With Sufficient Resources								
Insurance Losses	1	35	41	32	28	4	3	142
Working Capital								
Asset acquisition and repayable advances	10	30	52	52	19	0	0	163
Receipts from asset sales	0	-1	-9	-24	-34	-34	-21	-123
Repayment of advances	0	-12	0	0	0	0	0	-12
Proceeds from Resolution Funding Corporation (REFCORP)	0	-16	-14	0	0	0	0	-30
Payment from Federal Home Loan Banks	-1	0	0	0	0	0	0	-1
Subtotal, outlays excluding interest and administrative expenses[a]	9	36	70	60	13	-30	-18	139
Interest and Administrative Expenses[b]	c	c	c	c	c	c	c	2
Total	9	36	70	60	13	-30	-18	140

SOURCE: Congressional Budget Office.

a. Amount proposed to be excluded from the deficit for Balanced Budget Act purposes.

b. Administrative costs included in the budget are projected to be $200 million to $300 million a year. Administrative costs associated with institutions in 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.

c. Less than $500 million.

arm of the Treasury that handles such transactions. By charging interest to the RTC, the Treasury effectively bills the agency for some of its own debt servicing costs, although these costs are, of course, ultimately borne by the taxpayer. Under current law, many RTC operations would grind to a halt early in 1991, as the agency hits its statutory cap. At that time, CBO estimates, the RTC will have incurred $48 billion in insurance losses and will have spent another $2 billion on administrative and interest costs (both of which count against the $50 billion cap).

RTC Spending Without Constraints. CBO estimates that, if the RTC were not constrained by the caps contained in FIRREA, it would fund about $95 billion more in losses during the 1991-1995 period than current law permits. Under these circumstances, the RTC would also have huge working capital needs; unlike losses, however, working capital is expected to be recovered.

Projected RTC spending for losses, working capital, and other purposes if its resources are unlimited is depicted in the bottom panel of Table II-8. This alternative scenario depicts what would happen if RTC pushed to resolve most of its potential caseload by 1993. RTC's caseload would then total about 925 institutions, almost 700 more than under current law. The agency would incur $142 billion in losses in 1989-1995 (compared with $48 billion under current law); require $163 billion in working capital (versus $54 billion under current law); and collect $135 billion (instead of $48 billion) in proceeds from asset sales and repayment of advances, with additional proceeds after 1995. The projections assume that the RTC's working capital needs, and the associated debt service costs, are financed directly by the Treasury, dispensing with the need to channel borrowing and interest through the FFB. Compared with spending under current law, RTC's net outlays would be sharply higher in 1991-1993 but lower in later years as assets from closed institutions were sold.

The Costs of Delay

At present, the government continues to insure deposits in a savings and loan industry that is crowded with weak institutions. Delaying

the cleanup increases the ultimate costs. Marginal institutions that remain in business continue to incur losses by paying greater returns on their deposits than they are earning on their assets (chiefly loans). Future losses further erode their net worth and--if the institutions eventually fail--increase the government's costs. It is cheaper to close or merge the institutions quickly to prevent future losses.

Unavoidable delays are already built into CBO's projections. CBO estimates that the cost of cleaning up thrift institutions--other than those already resolved before FIRREA's passage--would total $120 billion if the crisis were literally resolved overnight. (About $100 billion is borne by the RTC, with a caseload of about 925 institutions; and the remaining $20 billion by the Savings Association Insurance Fund, expected to handle nearly 800 more institutions.) But the government faces human and other constraints in carrying out its tasks, constraints that would remain even if RTC's financial resources were assured. CBO expects that resolving institutions and disposing of their assets will take at least six to ten years. Thus, on a present value basis, the actual cost of RTC's activities in the baseline is $150 billion; of SAIF's, $35 billion. Using the same methods, the present value of the FSLIC Resolution Fund's activities amounts to $60 billion, although, unlike the other two agencies, FRF is funded directly through the Treasury and is not vulnerable to delays. Failing to grant additional resources quickly will only worsen the delays and further increase the costs of RTC and SAIF.

Uncertainties in the Estimates

While these estimates appear precise, they conceal a great deal of uncertainty about the costs of resolving the savings and loan crisis. CBO's estimate of the cost of resolving the crisis instantaneously, at $120 billion, is in the middle of a range that could be as low as $90 billion (consisting of $90 billion for RTC and zero for SAIF) or as high as $150 billion ($130 billion for RTC and $20 billion for SAIF). The added costs resulting from delay are also conjectural, depending on the length of the delay and on the rate at which marginal institutions deteriorate. (To date, little evidence suggests that sick institutions can recover.) Finally, the timing of outlays and of asset sales is highly uncertain.

The distinction between losses and working capital, while clear in concept, is highly uncertain in practice. Working capital is simply money that the government expects to recover. Officials will not know for many years whether their expectations are correct. CBO expects that it will take eight years or more to sell assets of failed thrift institutions, with about three-quarters sold in the first four years following resolution.

Resolution Trust Corporation Spending and the Balanced Budget Act

Spending by the RTC differs fundamentally from most other government activities in its economic effects, as discussed in Box I-2. Unlike a benefit check, salary payment, or interest payment, deposit insurance payments do not reflect current income to their recipients. Depositors do not become wealthier at the moment 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 arrangements.

Of course, over a broader time span, the components of RTC spending depicted in Table II-8 have definite implications for the economy and for the distribution of resources. The availability of deposit insurance clearly has stimulated 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, and depositors earned unsustainable rates of return, even as federal guarantees protected them from loss and subsidized thrift managers and owners. This process is still going on, though in a sharply diminished fashion, as evidenced by the current operating losses of many institutions that remain open. By this analysis, the money that the government will never recover--the amounts identified as insurance losses in Table II-8--spurred the economy, but the stimulus took place largely in the past. Many economists believe that an ideal budget would recognize such losses as they accumulate. But this ideal is dauntingly hard to attain and in any event bears no resemblance to current budgetary accounting.

Working capital outlays and receipts are unrelated to current income and production. They reflect simply a temporary transfer of ownership, as the government acquires the assets of failed institutions and eventually sells them to other buyers. Only the administrative costs and the interest costs associated with deposit insurance spending closely resemble other, similar government spending.

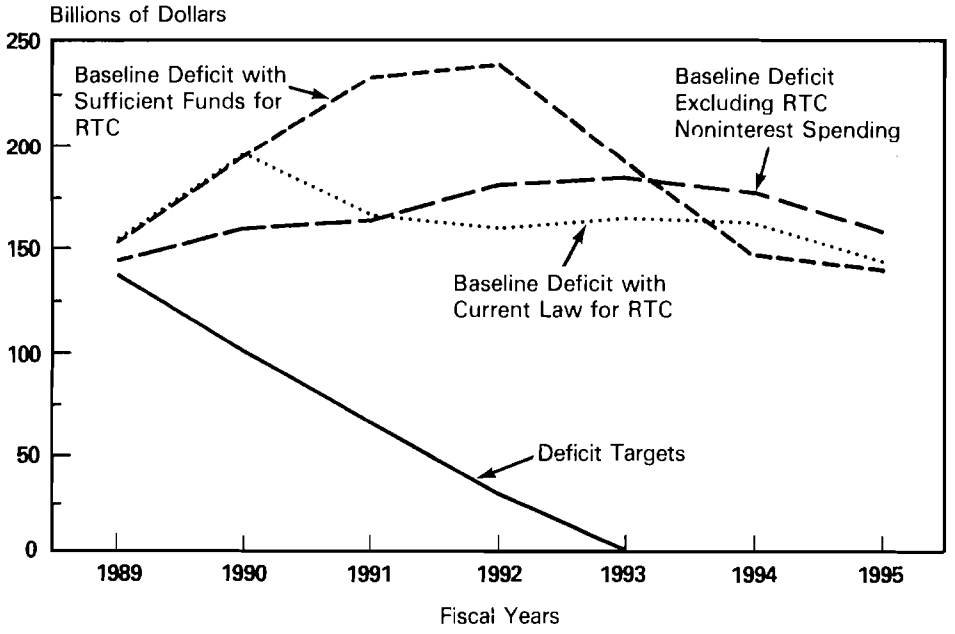
RTC outlays emphatically belong in the deficit, because the budget is meant to present a comprehensive summary of the government's spending and revenues. But an argument exists for excluding most RTC spending in gauging compliance with the Balanced Budget Act deficit targets. When they were incurred, deposit insurance losses reduced national saving, just as the federal deficit reduces saving. But cash outlays do not correctly measure the current economic impact of deposit insurance. Furthermore, because the future course of RTC spending is highly uncertain and volatile, including RTC in the deficit targets could lead to unexpected and inappropriate swings in fiscal policy, as well as additional opportunities for manipulating the budget estimates.

These dilemmas highlight some of the problems posed by fixed deficit targets. As this section implies, one solution would be simply to exclude outlays of the RTC (other than for interest and administrative expenses) when judging compliance with the Balanced Budget Act targets. As Table II-8 indicates, such outlays could total $70 billion in 1991 if the RTC was given sufficient resources. Alternatively, policymakers seeking to reduce the government's appetite for credit could opt to focus on the amount of deficit reduction--that is, on the multiyear savings (or costs) brought about by legislative action--rather than on fixed deficit targets. Both approaches would effectively insulate short-term fiscal policy from huge swings in savings and loan-related outlays. In settling on multiyear fiscal policy goals, however, policymakers will inevitably decide which generation of taxpayers will bear the costs of resolving the savings and loan crisis.

THE BALANCED BUDGET ACT AND THE PROJECTIONS

Whatever the conceivable spending path for the Resolution Trust Corporation or its budgetary treatment, the deficit under current policies will far exceed the targets set in the Balanced Budget Act. The law sets a maximum deficit of $64 billion in 1991, and mandates a balanced budget by 1993. The gap between these targets and the deficits that will prevail under current policies widens steadily (see Figure II-1).

Figure II-1.
Deficits Compared with Balanced Budget Act Targets



SOURCE: Congressional Budget Office.

NOTE: RTC = Resolution Trust Corporation.

A Closer Look at 1991

The Balanced Budget Act provides for automatic across-the-board cutbacks, known as sequestration, if deficit projections at the start of the fiscal year indicate that the target will be violated by more than $10 billion. Much spending is exempt (including Social Security and many other benefit programs, as well as outlays from commitments already in place). Cutbacks are limited in several nonexempt programs, notably Medicare, Stafford student loans, and veterans' medical care. Net interest is exempt because it cannot be controlled directly. Automatic cutbacks, then, fall almost wholly on defense and nondefense discretionary programs, and are achieved by canceling agencies' budgetary resources--that is, their ability to commit funds.

Under the Balanced Budget Act's specifications, CBO must project the deficit that would result from current policies as narrowly defined. That is, CBO must assume that the Resolution Trust Corporation runs out of resources early in 1991 and halts many of its operations. Under these conditions, CBO projects a deficit in 1991 of $164 billion, a full $100 billion over the ceiling. Cutting $100 billion in spending wholly through sequestration would involve cutting budgetary resources by about 38 percent in nondefense, nonexempt programs and by 25 percent in defense. If the President exempted military personnel, as he is permitted to do, sequestration in the rest of the defense budget would balloon to 41 percent.

Sequestration, however, does not hinge on CBO estimates but on projections made by the Office of Management and Budget (OMB). OMB has often issued projections that were markedly more optimistic than CBO's, but it appears that differences between the two agencies' estimates for 1991 may be sharply narrower than in the past. OMB will make its first binding estimates at the time of its midsession review, scheduled for mid-July, at which time it will select its economic and technical assumptions. The estimates will be updated twice--once in mid-August and again in mid-October--only to reflect any intervening legislation. A preliminary sequestration order would be issued in August, and a final one on October 15.

TRUST FUNDS IN THE PROJECTIONS

In recent years, federal government trust funds have attracted great attention from budget watchers. The government operates about 170 trust funds, though the largest and best known number fewer than a dozen. They include several major benefit programs (Social Security, Medicare, and the government's own civilian and military retirement programs) as well as the Highway and Airport and Airway Trust Funds.

Trust funds in the budget essentially play a bookkeeping role, serving to keep track of earmarked income and spending. The Congress clearly retains the power to change the terms of the trust--for example, by changing benefit formulas, eligibility rules, or financing.

Most of the large trust funds are currently running surpluses, a fact that gives rise to charges that their surpluses are being used to mask the "real" deficit. From the perspective of economists and financial market participants, this charge is false. The real deficit is the difference between total revenues and total spending, including trust funds and other programs alike. The spending financed by trust funds--encompassing income security, medical care, and infrastructure investment--overlaps that of many non-trust-fund programs; and trust-fund revenues affect the economy no differently from other taxes. Finally, much of the trust-fund surplus is illusory, made possible by transfers within the budget.

Social Security

The Balanced Budget Act required that activities of the two Social Security trust funds--Old Age and Survivors Insurance and Disability Insurance--be displayed separately from the remainder of the budget. Table II-9 fulfills this requirement. The surplus in the two funds combined climbs steadily from $59 billion in 1990 to $124 billion in 1995, while the deficit in the rest of the budget levels off at about $260 billion, after ballooning during years of peak deposit-insurance spending.

But simply segregating the totals into on-budget and off-budget (Social Security) components masks the sources of the growing Social Security surplus. The funds' surplus, while still substantial, looks more modest if it is recast to include only taxes collected, and benefit and other payments to the public--that is, the actual contribution of the program to the government's cash flows. Such a view of the Social Security surplus is presented in Table II-10.

Much of the growth in the Social Security surplus during the 1990-1995 period stems from interest income, which climbs from $16

TABLE II-9. CBO BASELINE PROJECTIONS FOR ON-BUDGET AND OFF-BUDGET REVENUES AND OUTLAYS
(By fiscal year, in billions of dollars)

	Actual 1989	1990	1991	1992	1993	1994	1995
Off-Budget (Social Security)							
Revenues	264	283	309	329	351	374	399
Outlays	211	223	235	246	256	266	275
Surplus	52	59	73	83	95	109	124
On-Budget (All Other Programs)[a]							
Revenues	727	761	815	859	909	962	1,018
Outlays	931	1,015	1,120	1,181	1,199	1,217	1,280
Deficit	204	254	305	322	289	255	262
Total							
Revenues	991	1,044	1,123	1,188	1,260	1,337	1,417
Outlays	1,143	1,238	1,355	1,426	1,455	1,483	1,555
Deficit	152	195	232	239	194	146	138

SOURCE: Congressional Budget Office.

NOTE: For comparability with the Balanced Budget Act targets, the projections exclude the Postal Service, which is also off-budget.

a. Includes additional resources beyond current law to resolve savings and loan institutions.

TABLE II-10. CBO BASELINE PROJECTIONS OF SOCIAL SECURITY INCOME AND OUTLAYS (By fiscal year, in billions of dollars)

	1990	1991	1992	1993	1994	1995
Income						
Income from Public						
Off-budget revenues	283	309	329	351	374	399
Intrabudgetary Income						
Interest	16	21	27	33	40	48
Employer share of employee retirement	6	6	6	7	8	8
Taxes on benefits	3	5	5	6	6	7
Other	2	a	a	a	a	a
Subtotal	26	32	39	46	54	63
Total Income	309	341	368	397	429	462
Outlays						
Payments to Public						
Benefit payments	243	261	278	295	313	331
Administrative and other expenses	2	3	3	3	3	3
Subtotal	246	263	280	298	315	334
Intrabudgetary Payments[b]	4	4	4	5	5	5
Total Outlays	250	267	285	302	320	338
Surplus						
As Conventionally Measured	59	73	83	95	109	124
Surplus Excluding Interest	43	52	56	62	69	76
Surplus Excluding All Intrabudgetary Transfers	37	45	49	53	59	65

SOURCE: Congressional Budget Office.

a. Less than $500 million.

b. Primarily interest paid to Treasury on normalized tax transfers and payments to Railroad Retirement.

billion in 1990 to $48 billion in 1995. Like other trust funds, Social Security invests its cumulative surpluses in special Treasury securities and collects interest at market rates. These holdings, amounting to $157 billion at the end of 1989, are expected to reach $700 billion by 1995. But this interest is both paid and collected by the government. Like any other intrabudgetary transfer, it leaves the total deficit unchanged. The same is true of the other, smaller intrabudgetary transfers depicted in Table II-10. Excluding such transactions yields a surplus much smaller than that usually cited: $37 billion (rather than $59 billion) in 1990, and $65 billion (rather than $124 billion) in 1995.

Other Trust Funds

Social Security is so big that it dominates both the numbers and the discussions of federal trust funds. All other trust funds combined run surpluses, as conventionally measured, of $64 billion in 1990 (about as much as Social Security alone), and surpluses for most funds other than Medicare are relatively stable in the 1990-1995 period (see Table II-11).

Yet, other trust funds are, by and large, even more dependent than is Social Security on intrabudgetary transfers. Major transfers from the general fund to trust funds are shown in Table II-12. Interest paid to all trust funds climbs from $62 billion in 1990 to $111 billion in 1995. In theory, interest payments compensate trust funds for their past surpluses. In practice, the balances on which the funds earn interest result so overwhelmingly from general fund transfers that interest has no clear-cut meaning. The government's payments to retirement funds on behalf of its own employees--mainly to the Civil Service and Military Retirement funds--climb steadily from today's $61 billion level. The Medicare program receives massive general fund subsidies, growing from $37 billion this year to $64 billion in 1995, mostly because the Supplementary Medical Insurance program covers only a small (and shrinking) fraction of its spending from the premiums it receives from beneficiaries.

In reality, trust funds run deficits, not surpluses. When their genuine dealings with the public (taxes, premiums, benefits, and other payments) are isolated from their intrabudgetary transactions, trust funds are seen to contribute greatly to the government's deficit. Viewed in this unfamiliar light, trust fund programs today contribute $42 billion to the government's deficit, and this drain nearly doubles by 1995 (see Table II-12).

TABLE II-11. TRUST FUND SURPLUSES IN THE CBO BASELINE
(By fiscal year, in billions of dollars)

Trust Fund	Actual 1989	1990	1991	1992	1993	1994	1995
Social Security	52	59	73	83	95	109	124
Medicare[a]	22	18	17	14	13	11	9
Military Retirement	14	13	13	13	14	14	14
Civilian Retirement[b]	20	21	21	22	23	23	24
Unemployment	7	6	6	5	5	4	5
Highway and Airport	4	3	2	1	c	c	c
Other[d]	4	3	2	2	1	1	1
Total Trust Fund Surplus	124	123	135	140	150	163	176
Federal Funds Deficit[e]	-276	-317	-367	-379	-345	-309	-315
Total Deficit[e]	-152	-195	-232	-239	-194	-146	-138

SOURCE: Congressional Budget Office.

a. Hospital Insurance and Supplementary Medical Insurance.

b. Includes Civil Service Retirement, Foreign Service Retirement, and several smaller funds.

c. Less than $500 million.

d. Primarily Railroad Retirement, Employees' Health Insurance and Life Insurance, and Hazardous Substance Superfund.

e. Includes additional resources beyond current law to resolve savings and loan institutions.

Trust Funds and the Balanced Budget Act

Although efforts persist to remove trust funds from the deficit calculation for purposes of the Balanced Budget Act, doing so could seriously distort fiscal policy. Removing trust funds would understate their contribution to the deficit for the reasons stated above; it would also overstate other programs' responsibility; and finally, it would divert attention from the government's total dissaving--the logical focus of any deficit-reduction effort.

Calls to reduce the federal deficit draw their urgency from the fact that the deficit drains national saving and hampers investment. Thus,

TABLE II-12. MAJOR TRANSFERS FROM THE FEDERAL GOVERNMENT GENERAL FUND TO TRUST FUNDS
(By fiscal year, in billions of dollars)

	Actual 1989	1990	1991	1992	1993	1994	1995
Total Trust Fund Surplus	124	123	135	140	150	163	176
Transfers from the General Fund to Trust Funds							
Interest	52	62	72	81	91	101	111
Government contributions to retirement funds[a]	60	61	64	67	70	73	76
Payments to Medicare trust funds[b]	32	37	35	40	48	56	64
All other (net)	4	5	5	5	6	6	7
Total Transfers	148	165	176	194	214	236	259
Trust Fund Deficit Excluding Transfers from the General Fund	-24	-42	-42	-54	-64	-73	-82

SOURCE: Congressional Budget Office.

a. Includes lump-sum amortization payments to the Civil Service and Military Retirement trust funds.

b. Primarily the general fund contribution to Supplementary Medical Insurance (Medicare Part B).

the deficit must include all government taxes and spending. In gauging compliance with official deficit targets, policymakers may legitimately exclude some savings and loan-related spending, because such spending essentially leaves total saving unaffected. But such exceptions can rarely be justified for trust-fund programs.

THE FEDERAL SECTOR OF THE NATIONAL INCOME AND PRODUCT ACCOUNTS

In analyzing the government's role in the economy, many macroeconomists bypass the usual budget totals in favor of the national income and product accounts (NIPA) measures. These accounts, maintained by the Commerce Department, provide the basic information about activity in all sectors of the economy. While similar to those of the budget, the NIPA measures are generally superior when examining the government's interactions with other sectors of the economy. Differences between the budget and NIPA totals fall into five categories: the netting and grossing of receipts, the exclusion of lending and financial activities, timing adjustments, geographic coverage, and the inclusion of off-budget spending by the Postal Service (see Table II-13).

Netting and grossing adjustments move certain collections from the expenditures to the receipts side of the federal government's ledgers. Two types of receipts are affected: intrabudgetary receipts representing the government's contributions to its own employees' retirement, and voluntary, business-type collections (such as Medicare premiums). In the budget, both count as negative outlays, reducing total spending. Clearly, moving these collections does not change the government's deficit, but yields an alternative view of the government's receipts from all sources and of its spending.

By far the most important factor causing the budget and NIPA measures of the deficit to diverge is lending and financial exclusions. Transactions that amount to the exchange of existing assets and liabilities are generally excluded from the NIPA because they do not generate current income or production. Thus, loans extended by the government, loan repayments, and the sale of assets do not enter the

TABLE II-13. RELATIONSHIP OF THE BUDGET TO THE FEDERAL SECTOR OF THE NATIONAL INCOME AND PRODUCT ACCOUNTS (By fiscal year, in billions of dollars)

	Actual 1989	Base 1990	Projected 1991	1992	1993	1994	1995
Receipts							
Total Revenues (Budget Basis)[a]	991	1,044	1,123	1,188	1,260	1,337	1,417
Differences							
Netting and grossing							
Government contributions for employee retirement	42	44	47	50	54	57	61
Medicare premiums	12	11	12	12	13	14	15
Other	9	8	8	8	8	9	9
Geographic exclusions	-2	-2	-2	-2	-2	-3	-3
Other	-4	-10	-9	-5	-2	-1	1
Statistical discrepancy	-15	b	b	b	b	b	b
Total Differences	41	52	56	64	70	76	83
Total Receipts (NIPA Basis)	1,032	1,096	1,179	1,252	1,330	1,413	1,500
Expenditures							
Total Outlays (Budget Basis)[a]	1,143	1,238	1,355	1,426	1,455	1,483	1,555
Differences							
Netting and grossing							
Government contributions for employee retirement	42	44	47	50	54	57	61
Medicare premiums	12	11	12	12	13	14	15
Other	9	8	8	8	8	9	9
Lending and financial transactions							
Deposit insurance	-25	-47	-79	-73	-32	16	9
Other	1	-10	-10	-10	-9	-10	-9
Defense timing adjustment	-3	6	2	2	1	-3	c
Geographic exclusions	-6	-7	-7	-8	-8	-8	-9
Postal (off-budget)	d	2	c	-1	1	-1	c
Other	3	4	1	1	1	-2	1
Statistical discrepancy	7	b	b	b	b	b	b
Total Differences	40	12	-27	-18	28	72	77
Total Expenditures (NIPA Basis)	1,183	1,250	1,328	1,408	1,483	1,554	1,631
Deficits							
Total Deficit (Budget Basis)[a]	152	195	232	239	194	146	138
Differences							
Lending and financial	-24	-56	-89	-84	-41	7	c
Defense timing adjustment	-3	6	2	2	1	-3	c
Geographic exclusions	-4	-5	-5	-5	-6	-6	-6
Other	7	16	9	5	4	-2	c
Statistical discrepancy	22	b	b	b	b	b	b
Total Differences	-2	-40	-83	-82	-42	-5	-6
Total Deficit (NIPA Basis)	151	155	149	156	152	141	132

SOURCE: Congressional Budget Office.

a. Includes Social Security.
b. After 1989, no discrepancy is projected.
c. Less than $500 million.
d. The Postal Service was on-budget in 1989.

NIPA spending totals. In the 1990-1995 period, spending by the deposit insurance agencies dominates this category of exclusions. NIPA expenditures essentially exclude all but the premium income, interest, and administrative costs of the deposit insurance agencies--paralleling the limited exemption suggested by CBO for Resolution Trust Corporation (RTC) outlays under the Balanced Budget Act.

Remaining differences between the budget and NIPA concepts are much smaller but can take on great importance at particular times. Timing differences occur because the budget records most transactions

TABLE II-14. PROJECTIONS OF BASELINE RECEIPTS AND EXPENDITURES ON A NATIONAL INCOME AND PRODUCT ACCOUNTS BASIS
(By fiscal year, in billions of dollars)

	Actual 1989	Base 1990	Projected 1991	1992	1993	1994	1995
Receipts							
Personal Tax and Nontax Receipts	448	486	529	567	608	648	689
Corporate Profits Tax Accruals	111	106	119	122	127	133	140
Indirect Business Tax and Nontax Accruals	58	60	59	59	61	64	66
Contributions for Social Insurance	415	444	472	503	534	568	604
Total Receipts	1,032	1,096	1,179	1,252	1,330	1,413	1,500
Expenditures							
Purchases of Goods and Services							
Defense	302	308	314	324	334	347	362
Nondefense	101	110	121	128	133	137	141
Subotal	404	418	434	452	467	484	503
Transfer Payments	463	499	535	575	614	656	700
Grants-in-Aid to State and Local Governments	117	127	140	150	159	168	179
Net Interest Paid	167	182	197	209	219	225	227
Subsidies Less Current Surplus of Government Enterprises	33	25	22	22	24	21	21
Total Expenditures	1,183	1,250	1,328	1,408	1,483	1,554	1,631
Deficit							
Deficit	151	155	149	156	152	141	132

SOURCE: Congressional Budget Office.

on a cash basis, while the NIPA often substitutes an accrual basis. (This approach has generally left NIPA expenditures impervious to shifts of a few days in benefit payments or federal employees' pay.) In the projections, timing differences are most important in the corporate profits tax accruals and, on the spending side, in defense purchases. Geographic differences stem from the NIPA's exclusion of Puerto Rico, the Virgin Islands, and other areas in computing GNP and other national economic data. Finally, last year's reconciliation act mandated that the net outlays of the Postal Service be excluded from official budget totals starting in 1990; no such exclusion applies to the NIPA.

Table II-14 on the preceding page divides receipts and expenditures into their NIPA categories. The federal sector of the NIPA generally divides receipts according to their source, and expenditures according to their purpose and destination. Defense and nondefense purchases of goods and services enter directly into GNP. The other categories of expenditures--transfer payments, net interest, subsidies less current surpluses of government enterprises, and grants to state and local governments--do not involve the delivery of goods or services to the government; their effect on GNP depends on the recipients' use of the funds and is less direct.

APPENDIX A

MAJOR CONTRIBUTORS TO THE REVENUE AND SPENDING PROJECTIONS

The following analysts prepared the revenue and spending projections in this report:

Revenue Projections

Mark Booth	Corporate income taxes, Federal Reserve System earnings, NIPA receipts
Maureen Griffin	Social insurance contributions, excise taxes, estate and gift taxes
Richard Kasten	Individual income taxes
Eric Nicholson	Excise taxes
Linda Radey	Individual income taxes, excise taxes
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Spending Estimates

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Spending Estimates (continued)

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Other

Janet Airis	Appropriation bills
Edward Blau	Appropriation bills
Paul Christy	Other interest
David Elkes	National Income and Product Accounts
Betty Embrey	Appropriation bills
Kenneth Farris	Computer support
Danila Girerd	Credit budget
Glen Goodnow	Authorization bills
Vernon Hammett	Computer support
Sandra Hoffman	Computer support
Richard Krop	Civilian agency pay
Fritz Maier	Computer support
Rodney Rasmussen	Net interest on the public debt
Kathy Ruffing	Treasury borrowing, interest, and debt
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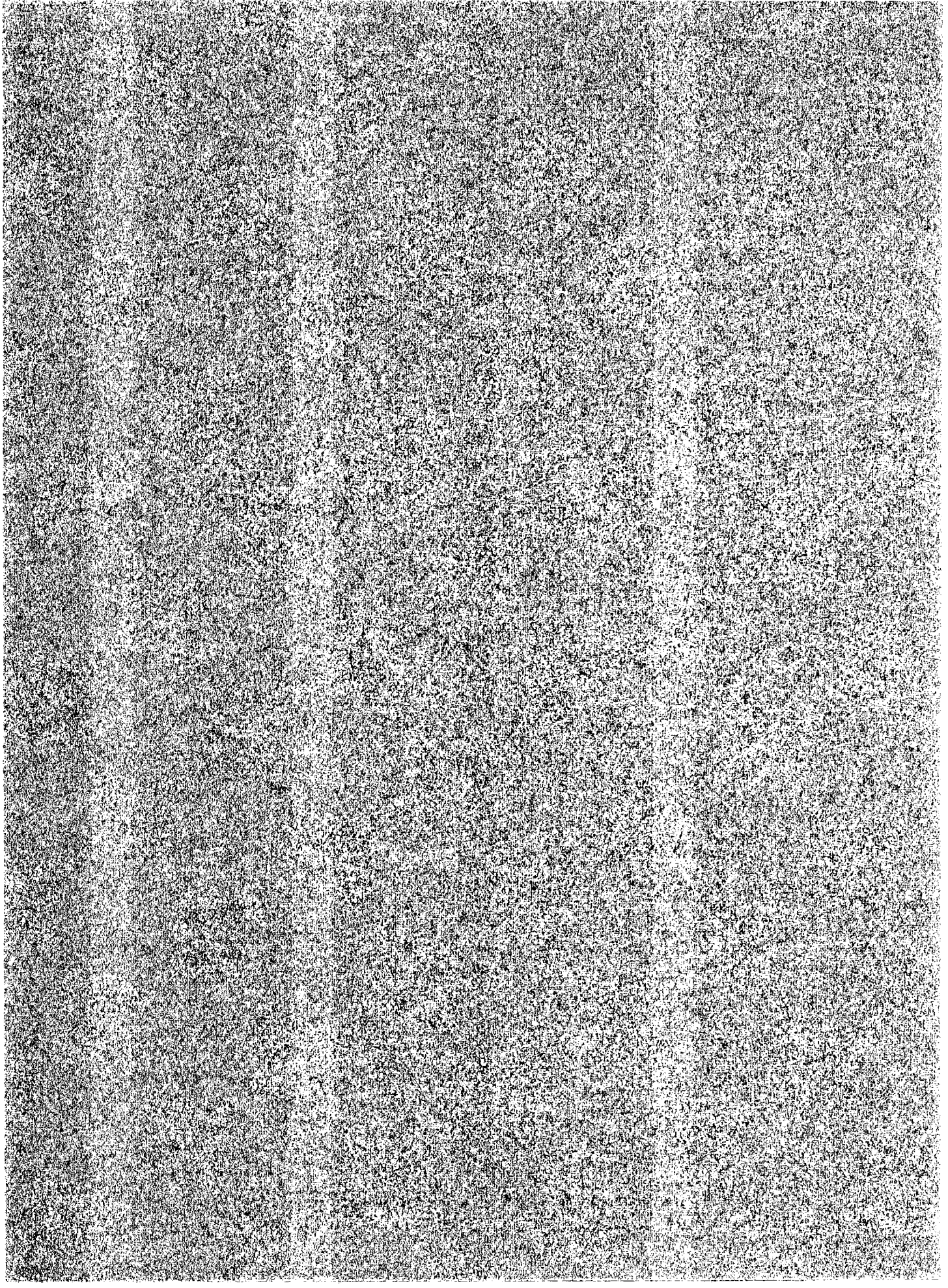

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