CBO PAPERS

THE 1990 BUDGET AGREEMENT:
AN INTERIM ASSESSMENT

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NOTICE

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During its final days, the 101st Congress enacted laws that significantly changed the budget outlook and the budget process. In this paper, the Congressional Budget Office (CBO) presents an interim assessment of the new legislation. The budget projections reported here reflect the revenue increases and spending reductions contained in the recent budget agreement, including the further reductions in discretionary spending that are required by law but remain to be achieved through future appropriations actions. The projections are based on an informal economic forecast prepared in October, when it became apparent that the Gulf crisis and other developments had rendered CBO's official June forecast too optimistic.

These budget estimates should be regarded as interim ones for three reasons. First, the economic outlook has weakened further since the underlying economic assumptions were prepared. Second, the projections do not incorporate the costs and contributions for Operation Desert Shield. Third, various changes in budgetary concepts and definitions required by the new legislation, such as subsidy-cost accounting for federal credit programs, remain to be made. These and other technical reestimates, as well as revised economic assumptions, will be included in CBO's 1991 annual report, which will be released in late January.

Under these interim assumptions, CBO projects that the recent budget agreement could reduce the total federal government deficit (including Social Security and the Postal Service) to around one-half of 1 percent of gross national product (GNP) by 1995. Over the next two years, however, massive spending to resolve insolvent savings and loan institutions will keep the deficit at record levels. Assuming that the new legal limits on discretionary spending are maintained, the total federal deficit will rise from $220 billion in fiscal year 1990 to over $250 billion in 1991 and 1992, before dropping to $170 billion in 1993, $56 billion in 1994, and $29 billion in 1995.

RECENT BUDGETARY DEVELOPMENTS

On September 30, after almost five months of talks, Congressional and Administration budget negotiators announced an agreement. The summit agreeement, as it was called, contained changes in substantive law and budgetary procedures designed to reduce the deficit by a total of $500 billion over five years. When first presented to the House of Representatives in the form of a concurrent resolution on the budget, the summit agreement was voted down. After some modifications, however, a budget resolution was ratified by the House on October 8 and by the Senate the next day.

The budget resolution contained reconciliation instructions directing House and Senate authorizing committees to reduce mandatory spending or increase revenues by a total of $246 billion over the 1991-1995 period. It also provided discretionary spending allocations to the Appropriations Committees in the amounts agreed upon by the summit participants. The Congress moved quickly to implement the budget resolution. In the following three weeks, it completed action on the 13 appropriation bills for fiscal year 1991. And on the weekend of October 27-28, it approved the Omnibus Budget Reconciliation Act of 1990, containing tax increases, entitlement cuts, and changes in budget enforcement.

The budget enforcement provisions in the reconciliation act include amendments to both the Balanced Budget Act (commonly known as Gramm-Rudman-Hollings) and the Congressional Budget Act, and closely follow the procedures outlined in the budget summit agreement. The new enforcement provisions shift the focus of Gramm-Rudman-Hollings away from deficit reduction, which was its original goal, and toward spending control. A pay-as-you-go requirement for fiscal years 1992 through 1995 will ensure that new entitlement and receipt legislation does not increase the deficit. Dollar limits (caps) are placed on defense, international, and domestic discretionary appropriations for 1991 through 1993, and on total discretionary appropriations for 1994 and 1995. Strengthened Congressional procedures are designed to assure that any new legislation conforms to these requirements. If these Congressional procedures fail, any spending overage will be eliminated through across-the-board cuts in the category that exceeds its limit.

The Budget Enforcement Act (Title XIII of the reconciliation act) also establishes revised deficit targets, extends the targets through 1995, and excludes the income and outgo of the Social Security trust funds from the deficit targets. The President is required to adjust the deficit targets for revised economic and technical assumptions when submitting the budget for fiscal years 1992 and 1993. The President is also given the option to make similar adjustments to the targets in the budgets for 1994 and 1995. Compliance with the discretionary spending limits and the pay-as-you-go requirements in 1992 and 1993 will assure that there will be no overall sequestration to achieve the maximum deficit amounts in those years. The same will be true in 1994 and 1995 if the President opts to adjust the maximum deficit amounts in the budgets for those years. If the deficit targets are not adjusted in the 1994 and 1995 budgets, the original Gramm-Rudman-Hollings sequestration procedures to enforce the maximum deficit amounts will apply.

The new budget enforcement procedures have already shown their effectiveness. Because of a drafting error in the foreign operations appropriations bill, international discretionary spending for 1991 breached the limits by $395 million in budget authority. On November 9, after the required sequestration reports by CBO and the Office of Management and Budget (OMB), the President issued a sequestration order cutting international discretionary spending by 1.9 percent.

THE BUDGET OUTLOOK THROUGH 1995

Projecting the course of the federal budget requires making assumptions about future spending and taxing policies. Table 1 presents budget projections under two different assumptions about discretionary spending. The first alternative--the baseline--assumes that discretionary spending authority is held constant at its 1991 inflation-adjusted levels. The second, lower path assumes that discretionary appropriations are limited to the levels specified in the Budget Enforcement Act.

Prior to the 1990 budget agreement, the budget baseline was the most commonly used benchmark for assessing the future course of the budget. For revenues and entitlement spending, the baseline generally assumes that laws now on the statute books will continue. For defense, international, and domestic discretionary spending, the projections are based on the most recently enacted appropriations (in this case, for 1991), increased only to keep pace with inflation.

The discretionary spending limits in the Budget Enforcement Act, however, do not allow appropriations to grow as fast as inflation. As indicated in Table 1, adhering to the caps will require holding discre-

TABLE 1. CBO PROJECTIONS OF REVENUES, OUTLAYS, AND THE DEFICIT (By fiscal year, in billions of dollars)

	1990	1991	1992	1993	1994	1995
In Billions of Dollars						
Baseline						
Revenues	1,031	1,110	1,185	1,258	1,344	1,429
Outlays	1,252	1,363	1,462	1,453	1,453	1,531
Deficit	220	253	277	195	109	101
Required Reductions						
Discretionary spending	0	0	14	23	48	64
Debt service savings	0	0	1	2	5	9
Subtotal	0	0	15	25	53	72
Totals Assuming Discretionary Caps						
Revenues	1,031	1,110	1,185	1,258	1,344	1,429
Outlays	1,252	1,363	1,447	1,428	1,400	1,458
Deficit	220	253	262	170	56	29
As a Percentage of GNP						
Baseline Deficit	4.1	4.5	4.6	3.0	1.6	1.4
Totals Assuming Discretionary Caps						
Revenues	19.1	19.5	19.6	19.4	19.4	19.3
Outlays	23.2	24.0	23.9	22.1	20.3	19.7
Deficit	4.1	4.5	4.3	2.6	0.8	0.4
Memorandum: GNP (In billions of dollars)	5,407	5,687	6,046	6,467	6,915	7,393

SOURCE: Congressional Budget Office.

NOTE: The projections include Social Security and the Postal Service, which are off-budget. They are based on an informal CBO economic forecast prepared in October 1990.

tionary outlays below the new baseline by an estimated $14 billion in 1992, $23 billion in 1993, $48 billion in 1994, and $64 billion in 1995. In 1992 and 1993, three-quarters of the cumulative required outlay reductions are in the defense category, and a substantial portion of the reductions in 1994 and 1995 is likely to be in defense as well. These spending reductions will also produce debt service savings, which will reach $9 billion by 1995.

The savings from adhering to the discretionary caps cannot be estimated precisely, because the Budget Enforcement Act requires the caps to be adjusted every year for changes in actual inflation, changes in budgetary concepts and definitions, emergency appropriations, and other factors. Outlays are also permitted to exceed the caps by small amounts, as long as the budget authority caps are not breached. This special outlay allowance is designed to insulate the legislative process from differences in estimates between CBO (whose estimates are used for Congressional scorekeeping) and the Office of Managment and Budget (whose estimates are controlling for purposes of the Balanced Budget Act). No attempt has been made here to forecast these future adjustments to the caps.

Under baseline assumptions, the deficit would grow from $253 billion in 1991 to $277 billion in 1992, before dropping to $195 billion in 1993 and $101 billion in 1995. Assuming that discretionary spending is held to the caps, the deficit would be $262 billion in 1992, $170 billion in 1993, and $29 billion in 1995. In relation to the size of the economy, the deficit is estimated to represent 4.5 percent of GNP in 1991. By 1995, it would fall to 1.4 percent of GNP in the baseline and 0.4 percent of GNP if the discretionary spending caps are effective.

CHANGES IN THE OUTLOOK SINCE JULY

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

As indicated in Table 2, the policies in the budget agreement are estimated to reduce the deficit by $35 billion in 1991, $73 billion in 1992, and $163 billion in 1995, compared with CBO's July baseline. Over the entire 1991 to 1995 period, the package is estimated to save $496 billion--close to the target in the summit agreement. Excluding $60 billion in debt service savings, 64 percent of the deficit reduction ($278 billion) derives from cutting outlays below baseline levels, and 36 percent ($158 billion) stems from raising taxes.

Two-thirds of the five-year savings--$331 billion--has already been put in place. This comprises $158 billion in tax revenue increases, $80

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

	1991	1992	1993	1994	1995	Cumulative Five-Year Changes
July Baseline	232	238	196	145	138	--
Changes						
Policy changes						
Revenues	-18	-33	-32	-37	-39	-158
Entitlements and other mandatory spending	-11	-15	-16	-19	-20	-80
Enacted appropriations	-6	-6	-10	-12	-13	-48
Required reductions in discretionary spending	--	-14	-23	-48	-64	-149
Debt service savings	-1	-5	-10	-18	-27	-60
Subtotal	-35	-73	-91	-134	-163	-496
Economic assumptions	41	55	60	62	64	--
Technical reestimates	16	42	5	-17	-10	--
Total Changes	22	24	-25	-89	-109	--
November Deficit Assuming Discretionary Spending Caps	253	262	170	56	29	--

SOURCE: Congressional Budget Office.

NOTE: The projections include Social Security and the Postal Service, which are off-budget. They are based on an informal CBO economic forecast prepared in October 1990.

billion in reductions in entitlements and other mandatory spending (including additional user fees), $48 billion in lower discretionary spending, and $45 billion in reduced debt service costs. The remaining $164 billion in deficit reduction is to be achieved by holding discretionary appropriations to the specified limits ($149 billion in lower discretionary spending and $16 billion in resulting debt service savings).

The $158 billion in additional revenues includes the following big-ticket items:

- o $40 billion from income tax changes affecting high-income taxpayers, including a 31 percent marginal tax bracket, a phase-out of personal exemptions, and a reduction in allowable itemized deductions;

- o $27 billion from raising the cap on wages subject to the Medicare payroll tax to $125,000;

- o $25 billion from an additional five-cent-per-gallon tax on gasoline and other motor fuels;

- o $41 billion from raising or imposing excise taxes on telephone service, tobacco, alcohol, certain luxury goods, and airline travel;

- o $9 billion from extending Social Security coverage to all state and local government employees not covered by a public pension plan; and

- o $9 billion from limiting income tax deductions taken by insurance companies.

Many other, smaller tax increases and decreases were also en-acted. Increased appropriations for Internal Revenue Service enforce-ment activities are estimated by CBO to produce an additional $4 billion in revenues over the next five years. The revenue-losing provi-sions include extension of the credits for research and experimentation and for low-income housing, and creation of new incentives for energy production.

The major cuts in entitlements and other mandatory spending are:

- o $43 billion from Medicare, including $33 billion in lower reimbursement payments to doctors and hospitals and $10 billion in higher premiums and deductibles for program beneficiaries;

- o $14 billion from eliminating the lump-sum payment option for most federal retirees and from other changes in federal employee retirement and health benefits;

- o $12 billion from lower farm price support payments; and

- o $9 billion from administrative actions to increase deposit insurance premiums for banks.

Other, smaller savings were achieved by cutting Stafford student loans, Federal Housing Administration mortgage insurance programs, and veterans benefits, and by imposing various user fees. The entitlement savings were partly offset by a $17 billion increase in spending for the earned income tax credit, a change designed to help low-income workers pay for child care and health insurance.

The $48 billion in enacted savings from discretionary programs comprises a reduction of $91 billion in defense outlays and a $43 billion increase in nondefense discretionary spending. An additional $149 billion in discretionary spending reductions, mostly in national defense, remains to be made.

The October interim economic assumptions increase the projected deficit by $41 billion in 1991 and by about $60 billion per year thereafter, compared with CBO's summer baseline. The October forecast reflects significant signs of weakness that appeared in the economy after CBO completed its summer forecast in June. The Iraqi invasion of Kuwait in early August has caused a sharp increase in oil prices, which has boosted inflation. In addition, the revision of the national income and product accounts for the past three years suggests that the economy's potential rate of growth is lower than previously thought.

Taken together these economic developments reduce projected revenues by about $30 billion per year. Higher inflation increases cost-of-living adjustments for Social Security and other benefit programs, as well as discretionary inflation adjustments for defense and nondefense appropriations. Higher unemployment raises spending for unemployment compensation and for income-assistance programs. Finally, lower revenues and higher spending increase federal borrowing requirements and debt service costs, by amounts growing from $2 billion in 1991 to $17 billion in 1995.

During the final months of fiscal year 1990, the Resolution Trust Corporation (RTC)--the agency charged with resolving insolvent savings and loan associations--spent $10 billion more than CBO projected in July. This surge in spending suggests that the RTC is resolving cases more quickly and needs more working capital than previously thought. As a result, CBO has increased its estimates of deposit insurance spending in 1991 and 1992. Together with the resulting increase in debt service costs, deposit insurance reestimates increase the projected deficit by $16 billion in 1991 and $42 billion in 1992, have little effect in 1993, and reduce the deficit somewhat thereafter.

MEASURING THE DEFICIT

As noted earlier, the Budget Enforcement Act removed the income and outgo of the two Social Security trust funds from the calculation of the deficit targets. Nonetheless, the annual balance in the Social Security programs affects the economy in exactly the same way as the balance in any other government account. The total government deficit, including the Social Security and other trust funds, determines the government's fiscal stance, its drain on credit markets, and the amount of saving that it diverts from uses that promote growth in living standards. For this reason, the previous tables have displayed figures for total revenues, outlays, and the deficit.

Unlike Social Security, however, the year-to-year swings in federal deposit insurance spending are not a meaningful measure of changes in the federal government's effect on the economy. As shown in Table 3, federal spending on deposit insurance (including deposits at banks and credit unions, as well as savings and loan associations) is projected to rise from $58 billion in 1990 to $91 billion in 1991 and $107 billion in 1992, drop sharply in 1993, and turn negative in 1994 and 1995. Most of this spending is required to close or subsidize the sale of hundreds of insolvent thrift institutions. While financing the thrift bailout will add substantially to federal borrowing requirements in the next few years, this borrowing does not add much further pressure on interest rates. The money that the government borrows to resolve insolvent thrifts (less the administrative and interest costs) is returned to financial markets. The money is redeposited in new accounts or invested directly in earning assets. Excluding deposit insurance, the federal deficit is projected to stay roughly constant in 1991 and to decline slowly thereafter (see Table 3). In relation to the size of the economy, the deficit excluding deposit insurance declines from about 3 percent of GNP in 1991 to less than 1 percent of GNP in 1995.

TABLE 3. ALTERNATIVE MEASURE OF THE DEFICIT
(By fiscal year, in billions of dollars)

	1990	1991	1992	1993	1994	1995
Total Deficit Assuming Discretionary Caps	220	253	262	170	56	29
Deficit Excluding Deposit Insurance	162	162	155	143	100	58
On-Budget Deficit (Excluding Social Security and Postal Service)	277	320	337	252	156	143
Deficit Targets	n.a.	327	317	236	102	83
Memoranda						
Deposit Insurance	58	91	107	28	-44	-29
Off-Budget Surplus						
Social Security	58	66	74	83	98	114
Postal Service	-2	a	1	-1	1	a
Total	57	67	75	82	99	114

SOURCE: Congressional Budget Office.

NOTE: n.a. = not applicable

a. Less than $500 million.

Two federal programs--Social Security and the Postal Service--are officially designated as off-budget and are excluded from the Balanced Budget Act calculations. Social Security significantly reduces projected federal borrowing requirements. With tax receipts and other income to the trust funds exceeding benefits and other costs, the Social Security surplus, as conventionally measured, is projected to double from $58 billion in 1990 to $114 billion in 1995. The Postal Service, however, has only a small effect on federal borrowing, showing surpluses or deficits of no more than $1 billion per year during the 1991-1995 period.

Excluding Social Security and the Postal Service, as Table 3 shows, the on-budget federal deficit is projected to be $320 billion in 1991, $337 billion in 1992, and $143 billion in 1995. In comparison, the deficit targets specified in the Budget Enforcement Act are $327 billion in 1991, $317 billion in 1992, and $83 billion in 1995. This suggests that the deficit targets are likely to be revised in upcoming budgets.

THE ECONOMIC OUTLOOK

The economic assumptions underlying these projections, which were developed in mid-October, take substantial account of the weakening of the economic outlook and increases in inflation that began to emerge in the late summer. For 1990 through 1992, as Table 4 shows, the assumed rates of economic growth are similar to the Administration's September forecast and to the November *Blue Chip* consensus. For later years, CBO's growth rates are below the Administration's and slightly above the average of private forecasters.

The assumptions for 1990 and 1991 entail slower growth in real GNP and higher inflation than CBO projected last July, while short- and long-term nominal interest rates are largely unchanged. Over the medium term, the October figures entail slightly stronger real growth (to recover from the 1990-1991 downturn) but lower inflation rates and nominal incomes than the earlier projections. Many of the changes

TABLE 4. 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 October	1.0	0.6	3.0	3.0	3.0	3.0
Administration September	1.0	0.8	2.9	4.2	3.9	3.5
Blue Chip	1.0	0.5	2.6	2.7	2.7	2.5
CBO July	2.0	2.5	2.6	2.6	2.6	2.6
Implicit GNP Deflator (Percentage change, year over year)						
CBO October	4.3	4.6	3.8	3.8	3.8	3.8
Administration September	4.5	5.0	3.8	3.3	3.1	2.9
Blue Chip	4.3	4.5	4.1	4.0	4.0	3.9
CBO July	4.1	4.0	3.9	3.8	3.8	3.8
Consumer Price Index (Percentage change, year over year)[a]						
CBO October	5.4	5.3	3.8	3.8	3.8	3.8
Administration September	5.3	5.6	3.7	3.0	2.9	2.8
Blue Chip	5.5	5.2	4.3	4.3	4.2	4.1
CBO July	4.8	4.2	4.2	4.0	4.0	4.0
Unemployment Rate[b]						
CBO October	5.5	6.4	6.4	6.1	5.7	5.8
Administration September	5.6	6.1	6.4	5.6	5.3	5.1
Blue Chip	5.5	6.3	6.0	5.7	5.5	5.4
CBO July	5.3	5.4	5.4	5.5	5.5	5.5
Three-Month Treasury Bill Rate (Percent)						
CBO October	7.5	6.8	6.6	6.2	5.6	5.2
Administration September	7.7	7.2	5.7	4.9	4.4	4.2
Blue Chip	7.5	6.8	6.9	6.9	6.9	6.8
CBO July	7.6	6.9	6.7	6.2	5.6	5.4
Ten-Year Government Note Rate (Percent)						
CBO October	8.6	8.0	7.6	7.2	6.8	6.5
Administration September	8.7	8.3	7.1	6.1	5.6	5.3
Blue Chip[c]	8.6	8.4	8.2	8.2	8.0	7.9
CBO July	8.5	7.8	7.4	7.2	6.9	6.8

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 November 10, 1990. The *Blue Chip* projections from 1992 through 1995 are based on a survey of 43 forecasters, published on October 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.

from last summer's forecast reflect the effects of the sharp increases in the price of imported oil that resulted from Iraq's invasion of Kuwait last August.

CBO will publish new economic and budget projections in late January, and CBO's new forecast is likely to show a weaker economic outlook than is indicated in Table 4. Since October the economic landscape has been clouded by the persistence of high oil prices, weak real estate markets, and problems with the balance sheets of many banks and corporations. Unless these factors are offset by other developments, a more pessimistic economic outlook will worsen the budget projections as well.