BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

**STRICTLY CONFIDENTIAL (FR)**
**CLASS II - FOMC**

**TO:** Federal Open Market Committee **DATE:** February 20, 1991

**FROM:** Normand Bernard N.B.

Attached for the Committee's information is a memorandum on federal budget developments prepared by members of the Board's staff.

Attachment

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

# Office Correspondence

**Date** February 19, 1991

**To** Board of Governors

**Subject:** Federal Budget Developments

**From** David J. Stockton

The attached memorandum by the Fiscal Analysis Section discusses the budget estimates and analyses contained in the FY1992 Federal Budget and the Economic and Budget Outlook that recently were released by the Administration and the Congressional Budget Office, respectively. Section I summarizes the new budget estimates and policy proposals; it includes a discussion of the anticipated effect of Operation Desert Storm on the budget. Section II focuses on the expected consequences of the Administration's budget proposals on aggregate demand. The final section discusses recent and proposed budget accounting and reporting reforms. These changes aim to present a more meaningful and accurate accounting of the costs associated with credit, insurance, and pension-related federal programs.

CONFIDENTIAL

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

# Office Correspondence

**Date** February 19, 1991

**To** Board of Governors

**Subject:** Federal Budget Developments

**From** Division of Research and Statistics (Fiscal Analysis Section)

---For Information Only---

President Bush has submitted his FY1992 budget to the Congress. It shows much larger deficits than were expected only a few months ago. Nonetheless, the Administration continues to project a significant improvement in the deficit by the mid-1990s, in part because of the savings embodied in last fall's Omnibus Budget Reconciliation Act (OBRA). The Congressional Budget Office (CBO) also has raised its near-term deficit estimates; they, too, anticipate substantial improvement in coming years, although less than projected by the Administration.

## I. BUDGET ESTIMATES AND PROPOSALS

### Near-term Budget Developments and Prospects

As shown in table 1, the Administration now expects the deficit to reach $318 billion in FY1991 and to fall only slightly to $281 billion in FY1992; excluding outlays for deposit insurance, the deficit is projected to be around $200 billion in both years. The Administration's new figures are much larger than those in the Mid-Session Review; they also are noticeably above the estimates made shortly after OBRA was enacted. The revision since November primarily reflects the effects of the recession, as well as higher outlays for deposit insurance and the insertion of a "placeholder" for the incremental costs (net of foreign contributions) of Operation Desert Storm, which are assumed to add

$8 billion to the deficit in FY1991 and $5 billion in FY1992.[1] A small offset is provided in 1992 by the Administration's proposed changes in spending and taxes, which lower the deficit by $9 billion.

Table 1

EVOLUTION OF PROJECTIONS FOR THE BUDGET DEFICIT
(Billions of dollars)

| | Administration | | | CBO[3] |
|---|---|---|---|---|
| Fiscal year | Mid-Session Review Baseline | Post-OBRA[1] | February[2] | January |
| | ----Deficit including outlays for deposit insurance---- | | | |
| 1991 | 231 | 255 | 318 | 298 |
| 1992 | 205 | 233 | 281 | 284 |
| | ----Deficit excluding outlays for deposit insurance---- | | | |
| 1991 | 164 | 158 | 207 | 194 |
| 1992 | 159 | 153 | 193 | 186 |

1. Assumes that OBRA implies savings of $40 billion in FY1991 and $76 billion in FY1992.
2. Includes a "placeholder" for Operation Desert Storm of $8 billion in FY1991 and $5 billion in FY1992. Also includes $9 billion of proposed savings in 1992.
3. Assumes discretionary spending adheres to the caps established in OBRA. Mandatory spending and receipts are determined by current laws.

The Administration budget estimates are based on an economic forecast that shows the recession ending by midyear and real GNP growth over the four quarters of 1991 of about 1 percent (table 2). In 1992,

1. On February 14, the Administration announced that it will request a supplemental appropriation of $15 billion to fund the war, about the same as the "placeholder" for FY1991-92 combined. The request also will seek Congressional approval to spend $41 billion in allied contributions, bringing the total funding to $56 billion.

real GNP is expected to increase about 3-1/2 percent. Inflation, as measured by the consumer price index, is projected to be 4-1/4 percent in 1991 and 4 percent in 1992.

Table 2

ECONOMIC ASSUMPTIONS FOR 1991 and 1992
(Percent change, Q4 to Q4)

| | 1991 | 1992 |
|---|---|---|
| Real GNP | | |
| Administration | 0.9 | 3.6 |
| CBO | 1.3 | 3.4 |
| CPI | | |
| Administration | 4.3 | 3.9 |
| CBO | 4.0 | 3.5 |

CBO's assessment of the near-term budget picture is similar to OMB's, after accounting for differences in policy assumptions and in the treatment of Operation Desert Storm. In particular, CBO assumes that discretionary outlays will be held to the caps established by OBRA,[2] but does not incorporate the President's proposals for mandatory spending and receipts. Also, CBO assumes that the war in the Persian Gulf will have no net effect on the deficit. With respect to economic forecasts, CBO is a bit more optimistic than OMB about the prospects for real growth and inflation, but the differences are not great.

The new Administration and CBO deficit estimates are larger than the staff's projection in the January Greenbook. In FY1991, the difference between OMB's deficit estimate and ours largely reflects

2. CBO estimates that the FY1992 spending caps are $13 billion below FY1991 current services levels.

assumptions about outlays for deposit insurance and for Operation Desert Storm. For FY1992, the Adminstration's technical estimating assumptions (apart from deposit insurance and Desert Storm) are less favorable than the staff's; this factor more than offsets the savings implied by their policy proposals. As noted above, the Administration is expecting a deeper recession than is the staff, but they are projecting a stronger recovery and, on balance, the effects on the FY1992 deficit of differences in economic assumptions are small.

The President's Budget Proposals

Although the broad contours of the budget for FY1992 were shaped by last fall's legislation, the President has proposed further changes in spending and taxes that are estimated to reduce the deficit by $9 billion. The amounts are relatively small, but in the Administration's view, the proposals imply a shift in budget priorities over the next few years. Among other things, they want to focus entitlement spending more on lower-income groups--for example, the President is requesting a sharp increase in the Medicare (Part B) premiums paid by wealthy individuals, and there is a plan to limit farm subsidies received by individuals with high nonfarm incomes. On the receipts side, the Administration is offering proposals that it believes will help to stimulate saving and investment; these include a plan to reduce the effective tax rate on capital gains and a tax-preferred saving incentive (the Family Savings Account). And for state and local governments, they propose a consolidation of many individual programs into a single block grant, which they believe will improve management and innovation.

The President's proposals for discretionary spending programs are consistent with the requirements of the reconciliation act, which identified three major categories of discretionary spending (defense, international, and domestic) and set caps for budget authority and outlays for each through FY1993.[3] The cap on defense appropriations implies a small decline in nominal spending (excluding Operation Desert Storm) in FY1992, while the cap on discretionary domestic spending allows spending in these programs to rise 6 percent in nominal terms. Within discretionary spending, the Administration plans to increase funding for science, education, and the administration of justice, while scaling back funding for urban mass transit, low-income energy assistance, and community development block grants.

The act also established a "pay-as-you-go" constraint on certain mandatory spending programs and receipts; in effect, this provision

Table 3

ADMINISTRATION'S PAY-AS-YOU-GO PROPOSALS
(Fiscal years, billions of dollars)

| | 1992 | 1993 |
|---|---|---|
| Direct spending | -6 | -9 |
| Medicare | -3 | -4 |
| Receipts | 3 | 1 |
| Capital gains | 3 | 2 |
| Other | 0 | -1 |
| Deficit | -9 | -10 |

3. As specified in OBRA, the FY1992 Budget adjusted the caps for changes in inflation assumptions and for certain changes in concepts and definitions. In FY1994-95, the cap applies to total discretionary spending.

requires that the total of policy changes in these categories in any year not increase the deficit. The Administration's proposals are expected to reduce the deficit by $9 billion in FY1992.

On the spending side, the Administration's proposals are estimated to save $6 billion in FY1992 and $47 billion over the FY1992-96 period. About half of the savings are slated to come from Medicare, with the remainder scattered among other mandatory programs.

On the receipts side, the Administration has proposed a limited set of initiatives. Taken together, these proposals are estimated to increase receipts by $3 billion in FY1992. Several appeared in last year's budget document; these include the capital gains exclusion,[4] extension of the Medicare tax to all State and local government employees, and introduction of Family Savings Accounts. The capital gains proposal has the largest estimated revenue impact; however OMB acknowledges that such estimates are controversial and, thus, some tables in the budget document are presented with both their estimate and with a zero entry.[5]

4. The capital gains proposal, when fully phased in by 1993, would allow an exclusion from gross income of 30 percent of the realized gains on certain assets held for more than three years, with smaller exclusions for assets held for shorter periods. The proposal is estimated to raise $3 billion in FY1992.

5. In estimates of the revenue effects of the Administration's 1990 capital gains proposal, which was essentially the same as this year's proposal, the Joint Committee on Taxation also estimated small revenue gains during the first two years after enactment. Thereafter, however, the JCT estimated revenue losses that were larger than the revenue gains estimated by the Administration last year. For example, the Administration estimated that its proposal would increase revenues $1.4 billion in 1995, while the Joint Committee estimated a $3.1 billion revenue loss.

The effect of this proposal on the economic assumptions underlying the budget estimates is not documented.

Budget Prospects over the Longer Run

Despite the upward revisions to the deficits in the near term, both the Administration and the CBO look for considerable improvement in the budget picture over time (table 4). Some of the projected decline in the deficit stems from an anticipated swing in net outlays for deposit insurance. In fact, by the mid-1990s, the RTC is expected to become a net seller of thrift assets, thus helping to hold down the reported deficit.

More fundamentally, the anticipated improvement in the deficit reflects the spending restraint and tax hikes in last fall's budget legislation, which helped to put the structural deficit on a downward track, and a resumption of moderate economic growth, which will help to shrink the cyclical portion of the deficit. The Administration expects the budget (excluding deposit insurance) to be close to balance by the mid-1990s. CBO is less optimistic, in part because their longer-run economic assumptions are less favorable (table 5); even so, they project that the deficit excluding deposit insurance will fall to about $100 billion in FY1996, equivalent to about 1-1/4 percent of the GNP projected for that year (chart 1).[6]

6. Another measure that will receive attention in coming years is the "on-budget" deficit, which excludes the Social Security trust funds and the Postal Service and will be used to judge compliance with the deficit targets in FY1994-95. (Social Security also is exempted from the enforcement and sequester provisions that apply to other mandatory spending programs, but there are procedural barriers (points of order)

(Footnote continued on next page.)

Table 4

ADMINISTRATION BUDGET PROJECTIONS
(Fiscal years)

| | 1990a | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 |
|---|---|---|---|---|---|---|---|
| | Billions of dollars | | | | | | |
| Outlays | 1252 | 1410 | 1446 | 1454 | 1427 | 1470 | 1541 |
| Revenues | 1031 | 1091 | 1165 | 1253 | 1365 | 1467 | 1561 |
| Deficit | 220 | 318 | 281 | 202 | 62 | 3 | -20 |
| Memo: | | | | | | | |
| Deposit insurance outlays | 58 | 111 | 88 | 44 | -38 | -42 | -30 |
| Deficit exc. deposit insurance | 162 | 207 | 193 | 157 | 100 | 45 | 10 |
| | As a percentage of GNP | | | | | | |
| Outlays | 23.2 | 25.1 | 24.2 | 22.6 | 20.8 | 20.0 | 19.7 |
| Revenues | 19.1 | 19.4 | 19.5 | 19.5 | 19.9 | 20.0 | 20.0 |
| Deficit | 4.1 | 5.7 | 4.7 | 3.1 | 0.9 | 0.0 | -0.3 |
| Memo: | | | | | | | |
| Deposit insurance outlays | 1.1 | 2.0 | 1.5 | 0.7 | -0.6 | -0.6 | -0.4 |
| Deficit exc. deposit insurance | 3.0 | 3.7 | 3.2 | 2.4 | 1.5 | 0.6 | 0.1 |

CBO BUDGET PROJECTIONS[1]
(Fiscal years)

| | 1990a | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 |
|---|---|---|---|---|---|---|---|
| | Billions of dollars | | | | | | |
| Outlays | 1252 | 1391 | 1454 | 1466 | 1492 | 1473 | 1553 |
| Revenues | 1031 | 1094 | 1170 | 1251 | 1332 | 1416 | 1496 |
| Deficit | 220 | 298 | 284 | 215 | 160 | 57 | 56 |
| Memo: | | | | | | | |
| Deposit insurance outlays | 58 | 103 | 98 | 48 | 25 | -47 | -42 |
| Deficit exc. deposit insurance | 162 | 194 | 186 | 167 | 135 | 103 | 99 |
| | As a percentage of GNP | | | | | | |
| Outlays | 23.2 | 24.7 | 24.2 | 22.9 | 21.9 | 20.3 | 20.2 |
| Revenues | 19.1 | 19.4 | 19.5 | 19.5 | 19.5 | 19.5 | 19.4 |
| Deficit | 4.1 | 5.3 | 4.7 | 3.4 | 2.4 | 0.8 | 0.7 |
| Memo: | | | | | | | |
| Deposit insurance outlays | 1.1 | 1.8 | 1.6 | 0.7 | 0.4 | -0.6 | -0.5 |
| Deficit exc. deposit insurance | 3.0 | 3.4 | 3.1 | 2.6 | 2.0 | 1.4 | 1.3 |

1. Assumes that discretionary spending adheres to caps established by OBRA.

a--actual

1.5(2/14/91)

Table 5

ECONOMIC ASSUMPTIONS

| | Near-term forecast | | Long-term projection | | | |
|---|---|---|---|---|---|---|
| | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 |
| | --------Percent change, Q4 over Q4-------- | | | | | |
| Real GNP | | | | | | |
| Administration | 0.9 | 3.6 | 3.4 | 3.2 | 3.0 | 3.0 |
| CBO | 1.3 | 3.4 | 2.8 | 2.8 | 2.7 | 2.7 |
| GNP deflator | | | | | | |
| Administration | 4.3 | 3.8 | 3.6 | 3.5 | 3.4 | 3.3 |
| CBO | 4.1 | 3.6 | 3.5 | 3.5 | 3.5 | 3.5 |
| CPI-U[1] | | | | | | |
| Administration | 4.3 | 3.9 | 3.6 | 3.5 | 3.4 | 3.3 |
| CBO | 4.0 | 3.5 | 3.6 | 3.6 | 3.6 | 3.6 |
| | ------Percent, calendar year average------- | | | | | |
| Civilian unemployment rate | | | | | | |
| Administration | 6.8 | 6.7 | 6.3 | 5.9 | 5.5 | 5.2 |
| CBO | 6.8 | 6.4 | 6.2 | 6.0 | 5.8 | 5.6 |
| Three-month Treasury bill rate | | | | | | |
| Administration | 6.4 | 6.0 | 5.8 | 5.6 | 5.4 | 5.3 |
| CBO | 6.6 | 7.0 | 6.7 | 6.3 | 5.9 | 5.7 |
| Ten-year Treasury note rate | | | | | | |
| Administration | 7.5 | 7.2 | 6.8 | 6.6 | 6.4 | 6.3 |
| CBO | 7.9 | 7.7 | 7.6 | 7.4 | 7.3 | 7.2 |
| Corporate profits as a percent of GNP | | | | | | |
| Administration | 5.2 | 5.5 | 5.8 | 6.0 | 6.0 | 6.1 |
| CBO | 5.2 | 5.7 | 5.5 | 5.2 | 5.0 | 4.9 |

1. Administration forecasts the CPI-W.

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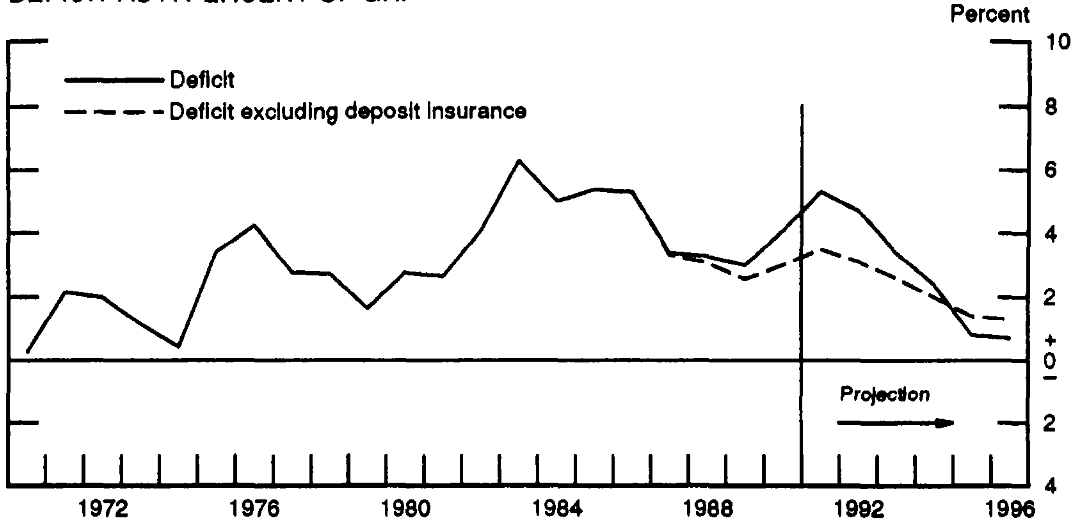
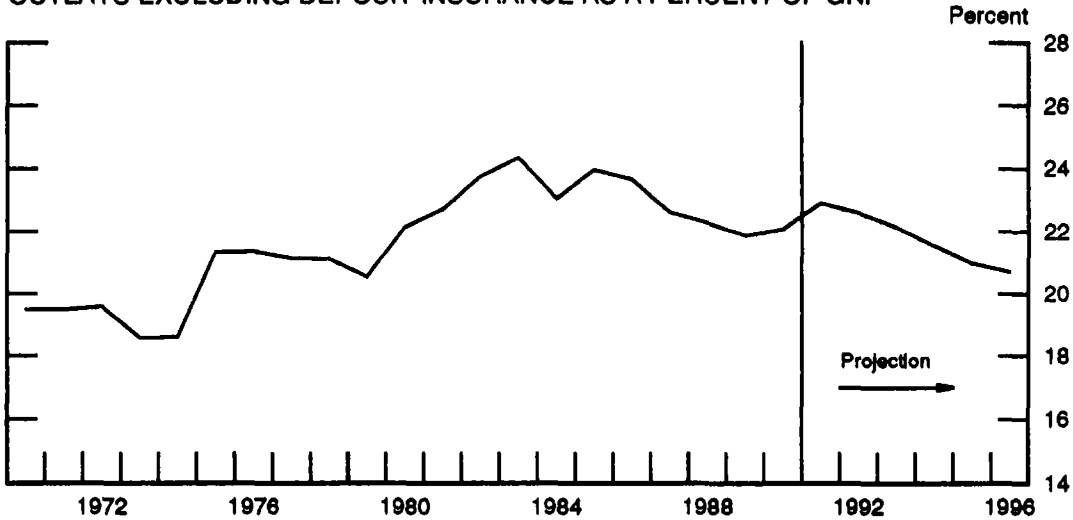
(Footnote is continued from previous page.)
in both the Senate and the House against legislation that would reduce projected trust fund surpluses.) According to CBO, the "on-budget" deficit still will be close to $200 billion in the mid-1990s. This concept has little meaning as an indicator of the government's effects on national saving; nonetheless, it highlights the enormous size of the remaining deficits in the non-Social Security portion of the budget.

Chart 1

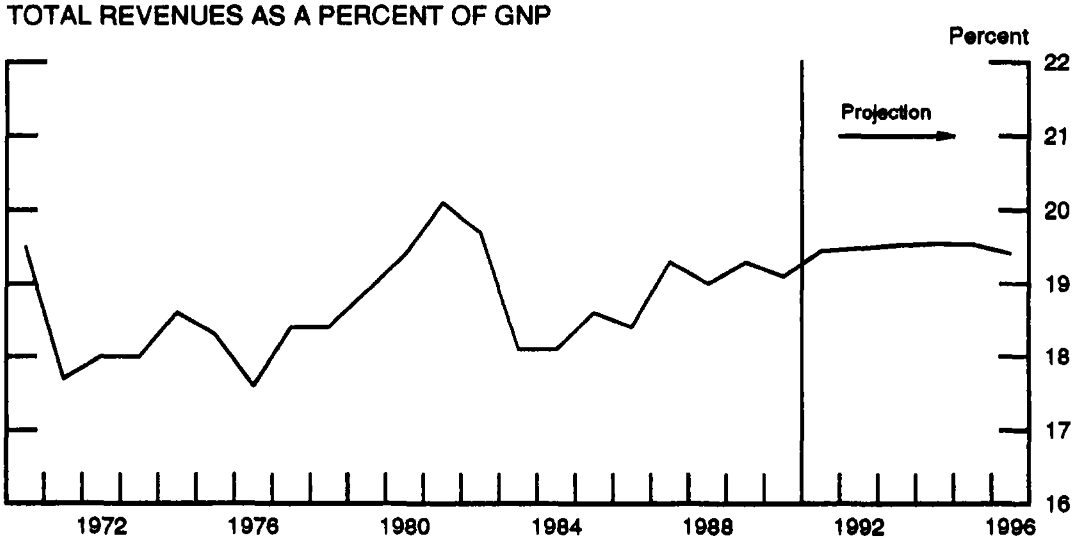
DEFICIT AS A PERCENT OF GNP




OUTLAYS EXCLUDING DEPOSIT INSURANCE AS A PERCENT OF GNP




TOTAL REVENUES AS A PERCENT OF GNP




Source: CBO, The Economic and Budget Outlook: Fiscal Years 1992–1996.

The broad trends in the composition of spending through 1996 are anticipated to resemble those of the past few years (chart 2). In particular, the defense budget has been falling relative to GNP since the buildup of the 1980s; despite the additional costs of Operation Desert Storm, the downtrend is anticipated to continue in the 1990s. Spending for entitlements and other mandatory programs (other than deposit insurance) has been fluctuating between 10 and 11 percent of GNP for some time, as efforts to restrain benefits and contain costs (especially in the health area) have roughly offset the effects of growth in the beneficiary population and sharp increases in the costs of medical care; that ratio is not expected to change much in the 1990s. Net interest is projected to decline relative to GNP because smaller deficits will slow the growth of federal debt. All told, federal outlays (excluding deposit insurance) are expected to decline as a share of GNP--from 23 percent in FY1991 to 21 percent in FY1996.

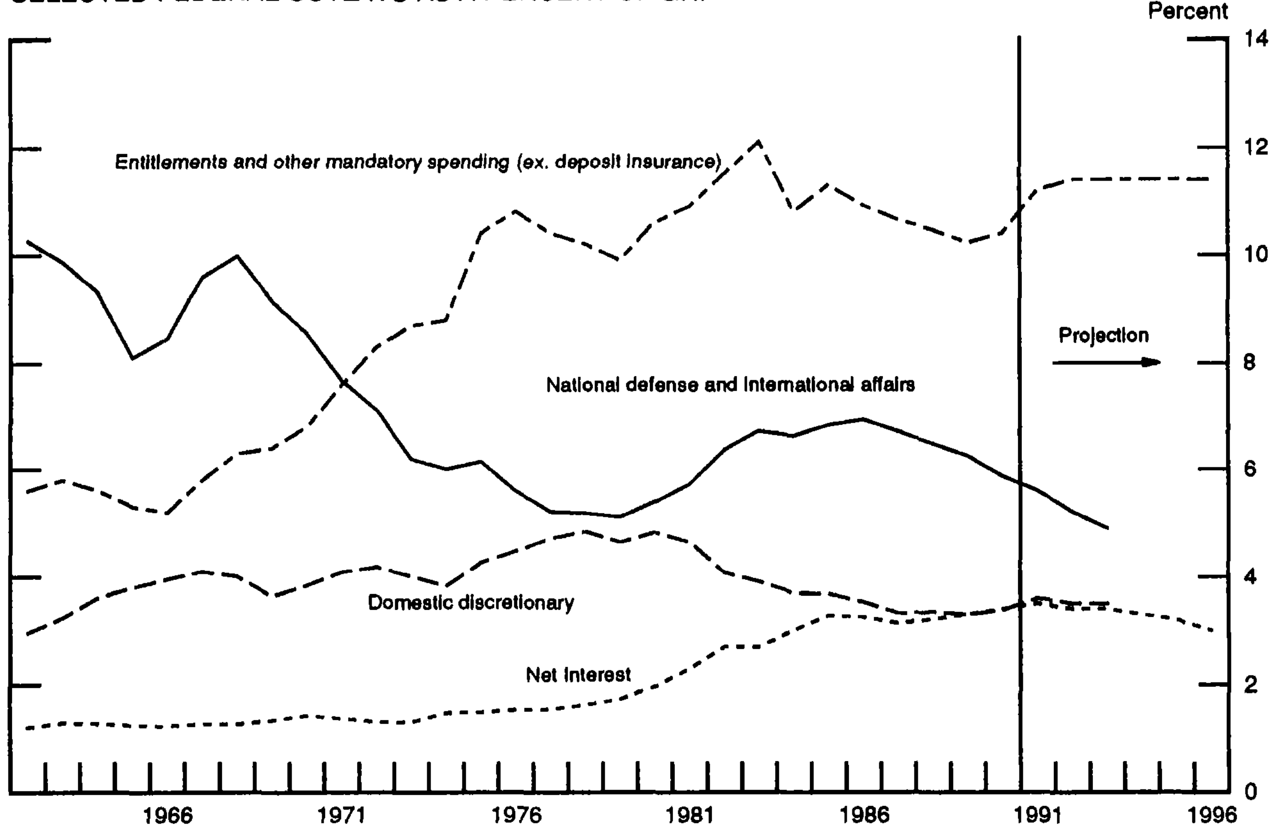
Discretionary spending. The FY1992 budget holds growth in total discretionary spending, excluding spending for Operation Desert Storm, to less than 2 percent in FY1992 and FY1993, in accordance with the spending caps put into place last year. The individual spending caps for FY1992 and FY1993 require annual reductions in nominal defense spending, but allow nondefense spending to rise a bit faster than inflation.[7]

Both international and domestic nondefense spending have been rising faster than inflation since 1987 after real reductions in the early 1980s (chart 3). The fastest growth has been in the science, health, education, housing assistance, and the administration of justice categories.

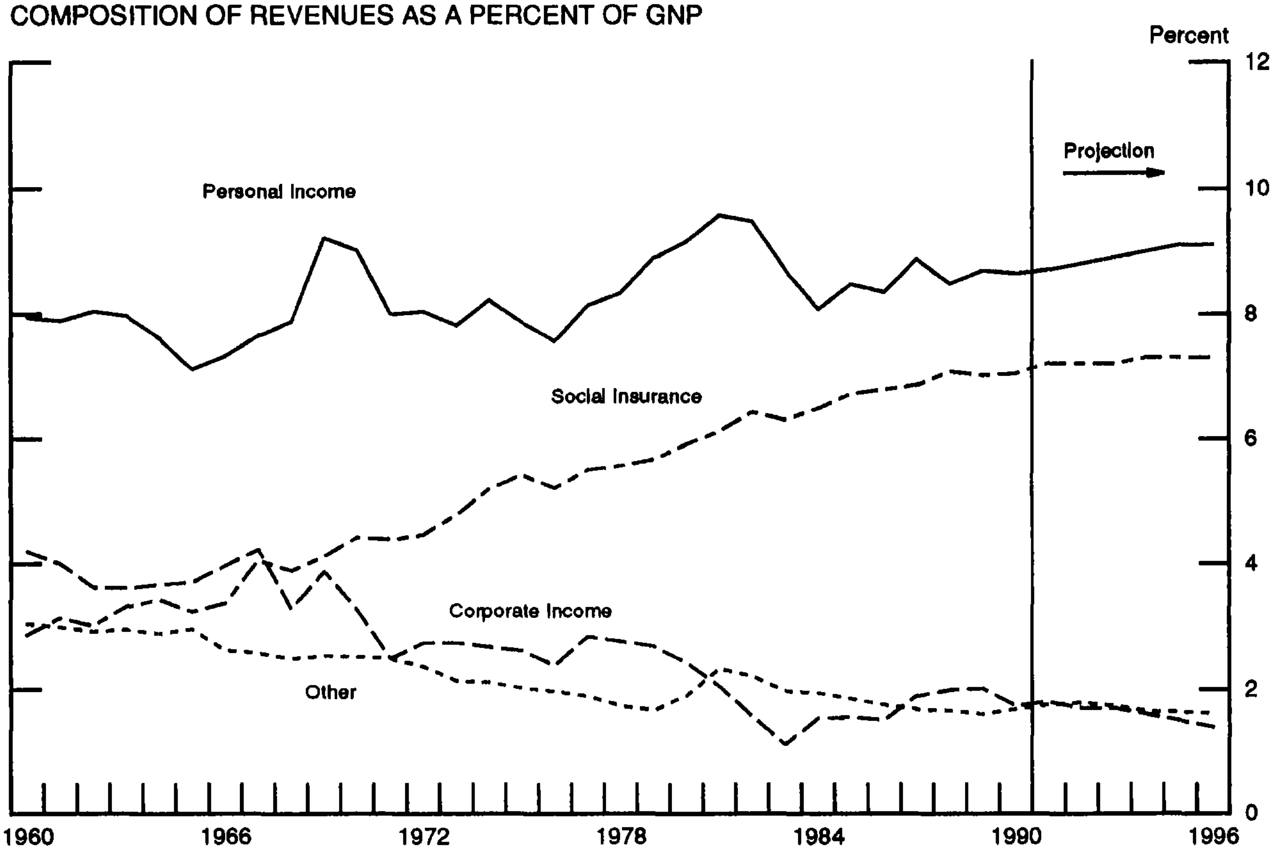
7. Total discretionary spending grows only 1 percent annually in FY1994 and FY1995. In these two years, there is only a cap for total discretionary spending, but the Administration plans that almost all of the required cuts in discretionary spending will come from defense in these years as well.

Chart 2

SELECTED FEDERAL OUTLAYS AS A PERCENT OF GNP



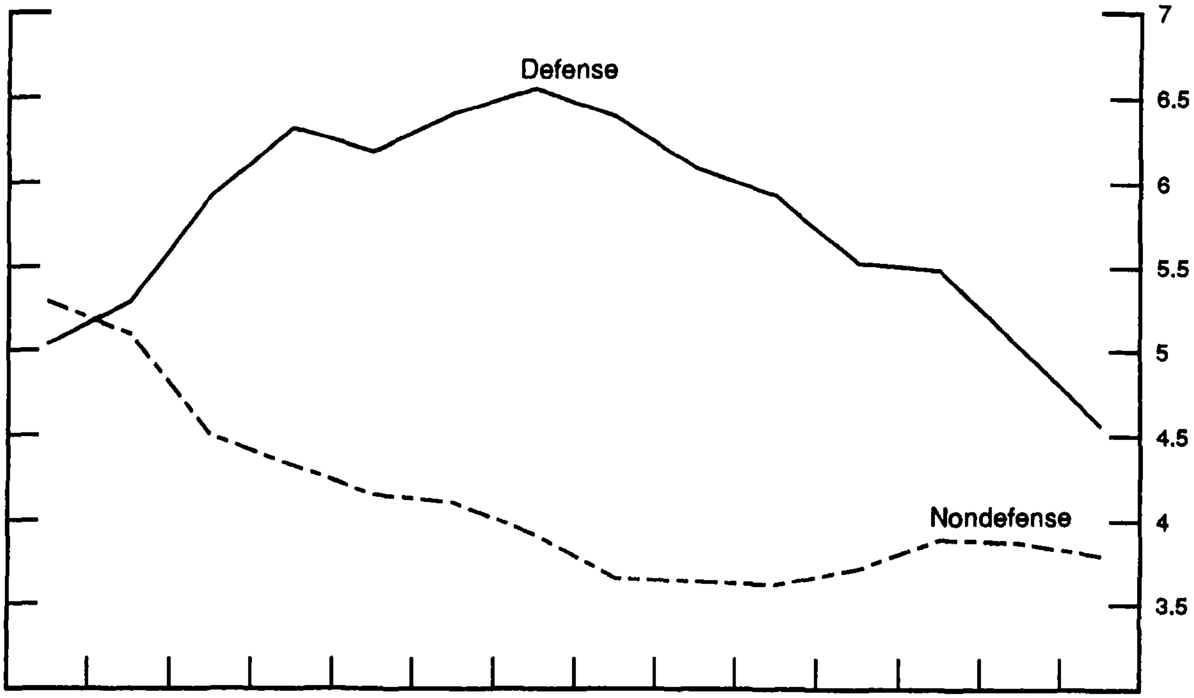

COMPOSITION OF REVENUES AS A PERCENT OF GNP



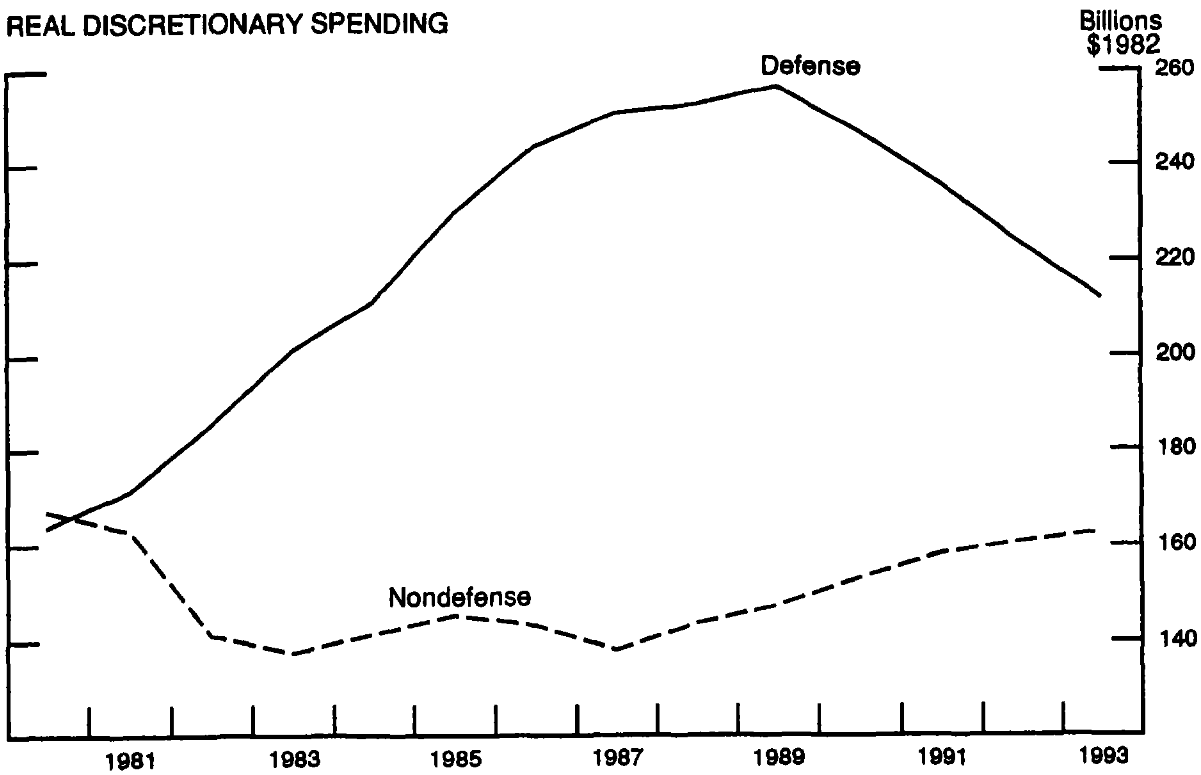

Source: CBO, The Economic and Budget Outlook: Fiscal Years 1992–1996.

Chart 3
# DISCRETIONARY SPENDING

DISCRETIONARY SPENDING AS A PERCENT OF GNP




REAL DISCRETIONARY SPENDING




Real spending was calculated using the GNP deflator for nondefense and OMB's real defense spending estimates.

Source: Budget of the U.S. Government: FY1992.

Relative to the FY1990 baseline estimated last July, defense expenditures are expected to be reduced about 3 percent in FY1991, another 4 percent in FY1992, and a total of 17 percent by FY1995 (table 6).[8] This reflects a scheduled reduction in active duty military personnel of 20 percent over the FY1990-FY1995 period.[9] In addition, there are similar reductions planned for the National Guard and reserve military personnel and Defense Department civilian personnel.

Almost all of the reduction planned for nominal defense outlays over the next five years falls in the procurement area. This reflects the results of the FY1991 budget negotiations, which cut FY1991 budget authority by over 20 percent from the FY1990 level. Most other accounts fall slowly over time as pay increases and other elements of inflation nearly offset the real reductions in purchases. Research and development receives a greater share of defense funding over time as its nominal funding levels rise, although not enough to keep up with inflation.

The discretionary spending caps will be adjusted upward by the amount spent on Operation Desert Storm. As noted above, the budget includes net spending of $8 billion in FY1991 and $5 billion in FY1992 as a "placeholder" for the supplemental appropriation request that will be sent to the Hill separately. The placeholder figures were based on $29 billion of additional defense budget authority (table 7), of which $23 billion

8. The FY1990 and FY1991 totals include $1.5 billion and $1.2 billion for Operation Desert Shield that was approved last year in a supplemental appropriation and incorporated in the defense spending caps. The estimates for this year's supplemental are not included in the spending caps or defense outlays presented here.

9. The almost one-to-one ratio of outlay cuts to personnel reductions is much sharper than shown by Secretary Cheney last June. At that time, he presented estimates to the Budget negotiators that paired a 21 percent cut in personnel with a 10 percent reduction in real outlays.

Table 6

NATIONAL DEFENSE SPENDING--EXCLUDING OPERATION DESERT STORM PLACEHOLDER
(Billions of dollars, nominal)

| | Budget Authority | | | Outlays | | |
|---|---|---|---|---|---|---|
| | 1990 | 1991 | 1992 | 1990 | 1991 | 1992 |
| National defense function | 303.3 | 285.6 | 290.8 | 299.3 | 298.9 | 295.2 |
| Department of Defense-Military: | 293.0 | 273.0 | 278.3 | 289.8 | 287.5 | 283.0 |
| Personnel | 78.9 | 79.0 | 78.0 | 75.6 | 78.9 | 77.8 |
| Operations and maintenance | 88.3 | 86.0 | 86.5 | 88.3 | 86.2 | 85.7 |
| Procurement | 81.4 | 64.1 | 63.4 | 81.0 | 79.1 | 74.3 |
| Research, development, test and evaluation | 36.5 | 34.6 | 39.9 | 37.5 | 35.5 | 37.8 |
| Other DoD-military | 7.9 | 9.3 | 10.5 | 7.4 | 7.8 | 7.2 |
| Atomic energy | 9.7 | 11.6 | 11.8 | 9.0 | 10.5 | 11.4 |
| Defense related activities | .7 | 1.1 | .8 | .6 | 0.9 | .8 |
| Memo: | | | | | | |
| FY1992 budget reductions from July 1990 baseline | n.a. | -28.6 | -35.9 | n.a. | -7.9 | -22.4 |

PROPOSED FORCE LEVELS

| | 1990 actual | 1991 | 1992 | 1993 |
|---|---|---|---|---|
| Military personnel (thousands) | | | | |
| Active | 2069 | 1974 | 1886 | 1795 |
| Army | 751 | 702 | 660 | 618 |
| Navy | 583 | 570 | 551 | 536 |
| Air Force | 539 | 509 | 487 | 458 |
| Marines | 197 | 194 | 188 | 182 |
| Guard/Reserve | 1128 | 1176 | 1068 | 989 |
| General Purpose Forces: | | | | |
| Army divisions (Active/Reserve) | 18/10 | 16/10 | 16/9 | 14/8 |
| Naval vessels | | | | |
| Total | 545 | 528 | 477 | 464 |
| Aircraft carriers | 13 | 12 | 13 | 13 |
| Air Force wings (Active/Reserve) | 24/12 | 22/12 | 17/12 | 16/11 |
| Marine Corps | | | | |
| Divisions (Active/Reserve) | 3/1 | 3/1 | 3/1 | 3/1 |
| Wings (Active/Reserve) | 3/1 | 3/1 | 3/1 | 3/1 |

Source: Budget of the U.S. Government, Fiscal Year 1992.

was projected to be spent in FY1991 and mostly offset by $15 billion in allied contributions. The Administration announced in mid-February that the supplemental appropriation bill will provide $56 billion of spending authority for the Defense Department--$15 billion out of general Treasury funds and $41 billion from the Defense Cooperation Account, where the allied contributions are collected.

Table 7

OPERATION DESERT STORM
(Billions of dollars)

| | Budget Placeholder | Supplemental Appropriation |
|---|---|---|
| Defense budget authority | 29 | 56 |
| *less* | | |
| Allied contributions | 15 | 41 |
| *equals* | | |
| Net budget effect | 14 | 15 |

Operation Desert Storm is expected to have only a small impact on the budget deficit over the next several years. However, it should have a larger impact on the economy because--to the extent that it stimulates purchases of new domestically-produced items--the increase in defense purchases will increase aggregate demand, while the allied contributions (which are scored as negative foreign transfers in the GNP accounts) funding the purchases should have a negligible effect on demand.

Entitlements and other mandatory programs. Outlays for entitlements and other mandatory programs (excluding deposit insurance) account for roughly half of all federal spending. As noted above, they generally have fluctuated between 10 and 11 percent of nominal GNP since the mid-1970s. They are anticipated to edge above 11 percent in FY1991, in part because of the effects of the recession on unemployment insurance and other income support programs, but on the whole, are expected to grow about in line with nominal GNP through 1996. Nonetheless, the anticipated stability of that relationship masks the rapid expansion of spending for health care (table 8); Social Security outlays are expected to rise about in line with GNP over the next five years, while spending for income support programs is expected to subside as the economy recovers.

Table 8

FEDERAL OUTLAYS FOR MEDICARE AND MEDICAID
(Fiscal years)

| | 1970 | 1980 | 1990 | 1991 | 1996 |
|---|---|---|---|---|---|
| | Billions of dollars | | | | |
| Total | 10 | 48 | 149 | 163 | 284 |
| Medicare | 7 | 34 | 107 | 114 | 194 |
| Medicaid | 3 | 14 | 41 | 49 | 90 |
| | Percent of GNP | | | | |
| Total | 1.0 | 1.8 | 2.7 | 2.9 | 3.7 |
| Medicare | 0.7 | 1.3 | 2.0 | 2.0 | 2.5 |
| Medicaid | 0.3 | 0.5 | 0.8 | 0.9 | 1.2 |

Source: CBO, The Economic and Budget Outlook: Fiscal Years 1992-1996, January 1991.

Note: Outlays include benefits only. Outlays for administrative costs of the programs are classified as nondefense discretionary spending, and Medicare premium collections as offsetting receipts. CBO expects Medicare premiums to rise from $12 billion in FY1991 to $20 billion in FY1996.

Medicare, which provides health care to the elderly, and Medicaid, which provides care to the indigent, are the largest government health programs; over the course of the 1980s, federal outlays on these programs grew from about 2 percent of GNP to nearly 3 percent; by 1996, CBO expects that share to approach 4 percent.[10]

The pressures on Medicare are well known: They stem from several sources and include the growth in the elderly population, rapid increases in the cost of medical care, and the use by beneficiaries of more and increasingly complex covered services. Medicare spending would be even higher in the absence of the reforms instituted over the past decade. In particular, the switch to a prospective payment system for hospitals that was mandated by the Social Security Amendments of 1983 is believed to have resulted in considerable savings in the hospital insurance program.[11] On the physician side, provisions of the Omnibus Reconciliation Act of 1989 mandated the replacement, by 1996, of the current payment system with a resource-based fee schedule; under the new system, each fee will reflect the cost of the resources necessary to produce the services. The effectiveness of the new mechanism in controlling costs will be a key influence on the course of health spending in the 1990s.

10. Taken together, Medicare and Medicaid account for much of federal spending on health care. Other significant health expenditures are for military and veterans medical care, health research (mainly NIH), and health benefits for federal employees. Medicaid is a joint federal-state program, and the figures cited in the text include only the federal contribution. States currently spend about $40 billion per year on Medicaid.

11. Despite these changes, the longer-run outlook for the Medicare trust fund remains bleak. Unlike the OASDI trust funds, which already are running sizable surpluses in anticipation of the pressures associated with the aging of the Baby Boom next century, there is no comparable plan for the Medicare (HI) trust fund. It is expected to be exhausted shortly after the turn of the century.

In addition to these structural changes, a variety of other actions have been taken in recent years to curb payments to providers and to require greater cost sharing by beneficiaries. Notably, CBO estimates that last fall's budget legislation cut $43 billion from Medicare over the FY1991-95 period, including $33 billion in lower reimbursement payments to doctors and hospitals and $10 billion in higher premiums and deductibles for program beneficiaries. The FY1992 budget proposes further savings in payments to hospitals and a number of small changes that would increase beneficiary cost-sharing and trim payments for physician, medical equipment, and other services.[12] Other health-related initiatives in the budget include proposals to encourage malpractice reform and to foster preventive care.

Medicaid is administered at the state level, but the federal government provides much of the funding. (The federal share varies by state; it is determined in part by the state's per capita income and currently ranges from 50 percent to 78 percent.) Last fall's reconciliation act made several changes to Medicaid. Among other things, OBRA extended coverage to all children under the poverty level (by the year 2002), but it also contained savings, in part by requiring drug manufacturers to give discounts to state Medicaid programs and by allowing states to buy private health insurance for the working poor if the policies cost less than Medicaid benefits. The 1992 budget includes proposals that would further

12. The Hospital Insurance Program (Part A) is financed by payroll taxes on workers. The Supplemental Medical Insurance program (SMI, or Part B) covers physician and certain other professional services. About one-fourth of its costs are covered by premiums paid by participants, which will be $32 per month in 1992, and the rest by general revenues. The President proposes to increase the monthly premiums on the wealthy elderly to about $95 (three-fourths of average Part B costs). SMI premiums are treated as outlay-offsetting receipts in the budget.

expand coverage for pregnant women and young children; if enacted, the provisions would raise spending at both the federal and state levels.

Grants to state and local governments.[13] The Administration's proposal to consolidate $15 billion in individual federal grant programs into a block grant has received much attention. Potential candidates for consolidation are in the areas of education, the environment, health and human services, and housing and urban development. The plan is presented as being budget-neutral, but it is unclear whether total grants would rise or fall over time as a result of this shift. Also, the President announced a new highway program that would cover the existing Interstate System and other major roads. Under this proposal, federal aid for highways would rise in real terms over the next five years. The plan would require significant outlays by the states, but would give them more flexibility in constructing, maintaining, and repairing roads and bridges.

Grants are anticipated to increase around 15 percent in FY1991, owing primarily to a jump in aid for Medicaid. Federal grants for health care are expected to rise sharply over the next five years; in fact, the Administration expects Medicaid outlays to increase even more rapidly than CBO does. However, under the Administration's proposals, grants for other programs would grow only about 3 percent per year, on average, in nominal terms, which implies some decline in real terms (table 9). In addition to the new highway program, the Administration has built in increases in grants for nutrition programs and for subsidized housing, but payments for education and human services would be noticeably lower in real terms in 1996 than in 1991.

13. Currently, about 60 percent of grants are for mandatory programs.

Table 9

OUTLAYS FOR GRANTS IN THE FY1992 BUDGET
(Billions of dollars)

| | 1990a | 1991 | 1992 | 1996 | Memo: Percent change, Average 1991-1996 |
|---|---|---|---|---|---|
| Total | 136.9 | 158.6 | 171.0 | 223.2 | 7.1 |
| Medicaid | 41.1 | 51.6 | 59.8 | 99.8 | 14.1 |
| Excluding Medicaid | 95.8 | 107.0 | 111.2 | 123.4 | 2.9 |
| Transportation | 19.2 | 19.8 | 20.1 | 23.2 | 3.3 |
| Highway system | 14.2 | 14.4 | 15.2 | 17.9 | 4.5 |
| Education | 11.2 | 12.8 | 13.9 | 14.6 | 2.7 |
| Human Services | 7.5 | 9.4 | 9.0 | 9.8 | 0.9 |
| Nutritional programs | 9.8 | 11.1 | 11.8 | 14.5 | 5.5 |
| AFDC | 12.2 | 14.1 | 15.1 | 17.0 | 3.8 |
| Subsidized housing | 8.7 | 9.8 | 10.2 | 12.1 | 4.3 |
| Other | 27.2 | 30.0 | 31.1 | 32.2 | 1.5 |

a--actual.
Source: Budget of the U.S. Government, Fiscal Year 1992.

Receipts. According to CBO, taxes are projected to remain fairly constant at 19-1/2 percent of GNP over the period FY1991-FY1996. This is roughly one-half percentage point above the level that would have prevailed if the revenue-raising provisions in OBRA had not been enacted. Over this period, individual income taxes increase slowly as a share of GNP, as rising real incomes place taxpayers into higher tax brackets. This rising individual income tax share is offset by a falling corporate income tax share that reflects a projected decline in the corporate tax base as a percent of GNP. Other tax components change very little in relation to GNP. The Administration's estimated tax shares (total and components) are the same as CBO's between FY1991 and FY1993; thereafter, the projected individual and corporate income tax shares of the Administration exceed those of the CBO, the latter primarily reflecting the Administration's larger assumed corporate tax base.

## II. EFFECTS OF FISCAL POLICY ON AGGREGATE DEMAND

The new budget data from the Administration and CBO do not change the staff's expectation that the stance of fiscal policy will be restrictive through 1992. In effect, the restraint from the spending cuts and tax increases embodied in OBRA is likely to be offset only partially by the stimulus from Operation Desert Storm. A quantitative estimate of the net fiscal restraint is given by the staff's fiscal impetus measure, FI.[14]

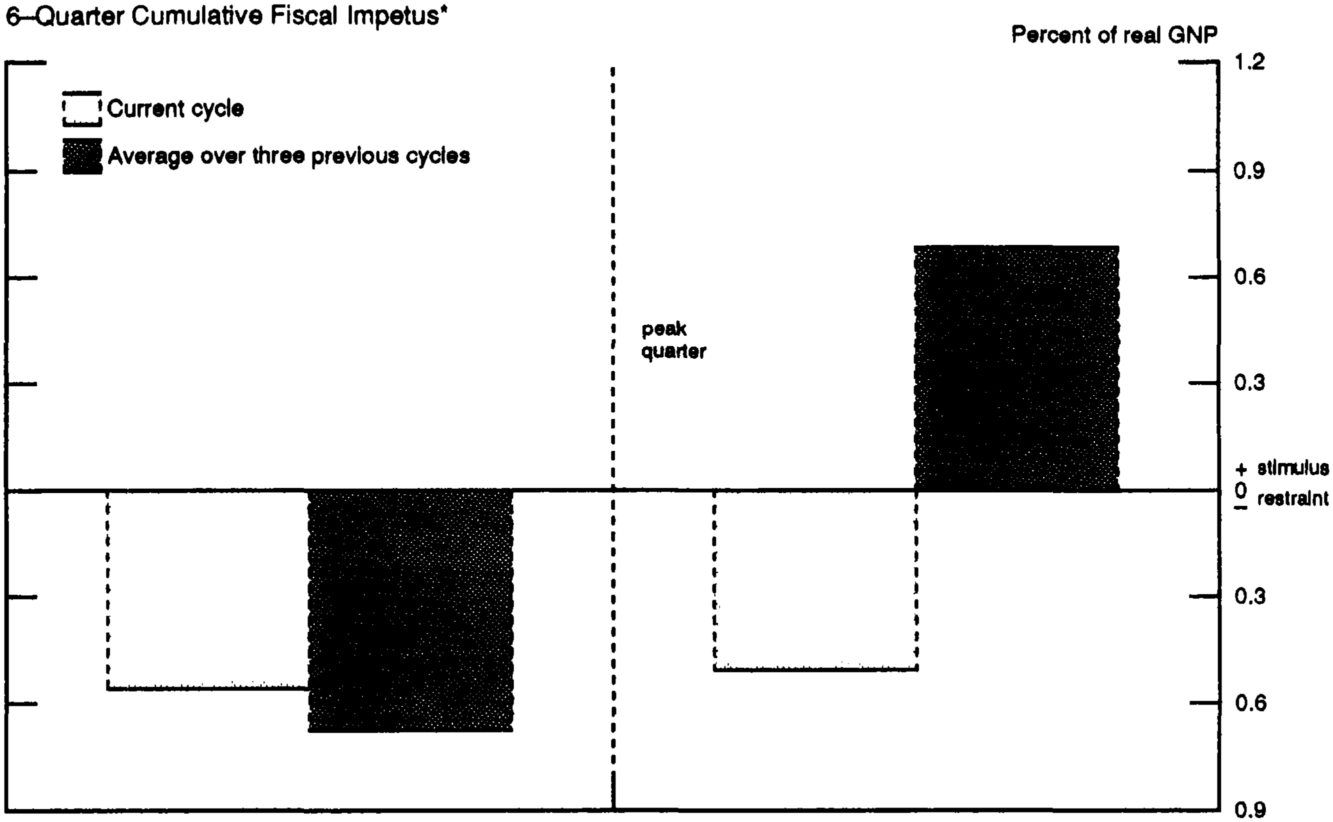
As seen in the chart 4, the cumulative constant dollar restraint (as indicated by FI) over the six quarters after the 1990:Q3 "peak" is equal to roughly 1/2 percent of real GNP.[15] Fiscal policy imposes little further restraint over the remainder of 1992. The estimated restraint would be a bit larger if the Administration's $9 billion deficit-reducing package were to be enacted. Also, CBO's NIPA projection shows larger declines in real federal government purchases than does the staff's; all else equal, this would imply additional restraint equal to about 1/4 percent of real GNP by the end of 1992. (The difference may reflect differences in assumptions about Desert Storm.)

The chart also contrasts the present episode to the average magnitude of discretionary fiscal policy actions around the cyclical peak

14. FI in any period is the weighted sum of the spending cuts and tax increases scheduled to occur in that period. FI (as well as the high-employment budget deficit) does not include swings in the budget balance induced by the business cycle and, thus, does not reflect the cushioning effects of the automatic stabilizers. In addition, FI does not capture the potential effect on current aggregate demand of changes in spending programs and tax schedules anticipated to occur in subsequent years (such as those expected to occur in future years as a result of OBRA).
15. This figure is based on quarterly estimates of FI taken from the January Greenbook. Administration numbers are not used for that period because of the implausible pattern of government purchases contained in their NIPA translation of the FY1992 Budget.

Chart 4

6–Quarter Cumulative Fiscal Impetus*




* The peak quarters for the previous business cycles follow the NBER dating process: 1969:4, 1973:4 and 1981:3; for the current cycle, the assumed peak quarter is 1990:3. Fiscal impetus is the weighted difference between discretionary changes in spending and in taxes. On this chart, it is summed over the six quarters preceding and following the peak and is shown as a percent of GNP.

quarters of 1969:Q4, 1973:Q4, and 1981:Q3.[16] It shows that policy--as measured by the cumulative sum of FI as a percent of real GNP over the six quarters preceding the peak quarter--was restrictive in both the current and earlier episodes. However, over the six quarters following the peak quarter, the stance of policy is seen as stimulative in the earlier episodes but restrictive in the current one.[17]

Table 10 provides additional historical perspective by comparing the current restraint to the five most restrictive periods since the early 1950s.[18] The restraint in 1991 and 1992 is similar in magnitude to that of the late 1950s and the early 1980s, but much less than was associated with the defense cutbacks after the Korean and Vietnam wars. Policy will remain restrictive through 1995 because of further cuts in discretionary spending programs slated to occur then.

Estimates of the change in the high-employment budget deficit (as a share of nominal potential GNP) are shown in table 11. Through the end of 1992, the magnitude of restraint is roughly equivalent to that of the least restrictive of the major historical episodes of restraint. However, it is important to recognize that some of the restraint in the current episode is coming from the deficit-reducing effect of the contributions of coalition countries to help cover the costs of Operation Desert Storm. From the

16. Quarterly estimates of FI do not exist prior to 1959:Q1 and thus its behavior around the cyclical peaks occurring in the 1950s cannot be shown on the chart.
17. The calculations also have been done using a 4-quarter sum instead of a 6-quarter one; qualitatively, the results are similar.
18. To qualify for inclusion, the restraint had to last for at least one year; in the cases where the fiscal contraction lasted for more than a year, the value shown in the table is expressed at an annual rate. For the current episode, staff Greenbook estimates of FI are used for the period FY1990-FY1992; for the period FY1992-FY1995, the estimates provided are based on the policies embodied in the Omnibus Budget Reconciliation Act of 1990.

Table 10

**FISCAL IMPETUS (FI) DURING MAJOR HISTORICAL EPISODES OF FISCAL RESTRAINT**
(NIPA basis; negative sign implies fiscal restraint)

| Period of restraint | FI as a percent of real GNP (standardized to an annual rate) |
|---|---|
| 1. FY1954 - FY1955 (defense cuts) | -2.0 |
| 2. 1972Q4 - 1973Q4 (cuts in defense and grants) | -1.6 |
| 3. 1968Q2 - 1970Q1 (defense cuts, social security tax hike, income tax surcharge) | -.9 |
| 4. 1959Q1 - 1960Q1 (defense cut and social security tax hike) | -.7 |
| 5. 1980Q2 - 1981Q2 (social security and windfall profits tax increase) | -.6 |
| January 1991 Greenbook | |
| FY1990 - FY1991 | -.4 |
| FY1991 - FY1992 | -.4 |
| Omnibus Budget Reconciliation Act, 1990 | |
| FY1992 - FY1993 | -.3 |
| FY1993 - FY1994 | -.3 |
| FY1994 - FY1995 | -.1 |
| Memo: | |
| Early Gramm-Rudman period | |
| 1985Q3 - 1989Q4 | -.1 |

Note: Estimate for the period, FY1954-FY1955, is based on staff interpretation of information found in Pechman, Federal Tax Policy, The Brookings Institution, 1977; quarterly estimates are not available. All other estimates are computed by FRB staff.

Table 11

**CHANGES IN THE HIGH-EMPLOYMENT BUDGET DEFICIT**
**DURING MAJOR HISTORICAL EPISODES OF FISCAL RESTRAINT**
(NIPA basis; negative sign implies fiscal restraint)

| Period of restraint | Change in high-employment deficit as a percent of nominal potential GNP (standardized to an annual rate): |
|---|---|
| 1. 1958 Q4--1960 Q1 (cut in purchases and social security tax hike) | -2.4 |
| 2. FY1954--FY1955 (defense cuts) | -2.0 |
| 3. 1967 Q3--1969 Q2 (defense cuts, social security tax hike, income tax surcharge) | -1.7 |
| 4. 1972 Q4--1974 Q3 (cuts in defense and grants, fiscal drag from inflation) | -1.4 |
| 5. 1977 Q3--1979 Q2 (fiscal drag from inflation, overwithholding) | -1.0 |
| 6. 1980 Q2--1981 Q2 (social security and windfall profits tax increases) | -.8 |
| January 1991 Greenbook 1990 Q4--1992 Q4 | -.6 |
| Memo: Gramm-Rudman period | |
| 1985 Q4--1989 Q4 | -.2 |
| 1989 Q4--1990 Q4 | -.9 |

Note: Estimates for the post-1970 period are based on the staff's real potential GNP series. This series is based on the NIPA benchmark revisions and on an "Okun's Law" model developed by the staff; it is consistent with a six percent high-employment unemployment rate. Estimates for the pre-1970 period are based on a BEA potential GNP series (found in the Survey of Current Business, November 1980) in which the high-employment unemployment rate rises slowly from 4.5 percent in 1966 to around 5 percent in 1970.

perspective of effects on aggregate demand, this treatment of the contributions is anomalous because they can be viewed as a transfer of capital to the United States. In contrast, FI does not include these contributions.

Staff estimates are not available for the period beyond 1992. However, the CBO estimates that the high-employment or structural budget deficit (on a unified budget basis, excluding deposit insurance outlays) falls from 2 percent of nominal potential GNP in FY1992 to 1 percent in FY1995, while the Administration's measure of the structural deficit falls close to zero by the mid-1990s. The anticipated improvement in the structural deficit, which largely reflects the restraint from OBRA, accounts for more than half of the projected decline in the overall deficit.

## III. BUDGET ACCOUNTING REFORMS

The FY1992 Budget advances ongoing efforts to provide a more meaningful accounting of the costs associated with federal credit, insurance, and pension activities. The reporting of these activities on a cash outlay basis, as is the practice in much of the budget, can be misleading because decisions that have only small immediate outlay effects may involve large future cost commitments. Past reforms that have addressed the future costs associated with current decisions include the 1983 Social Security Amendments, which scheduled large increases in Social Security trust fund balances to provide for future pension liabilities, and the placement of military retirement programs on an accrual basis in 1985. In addition, OBRA improved the budgetary treatment of federal credit programs; the new system is discussed below. It is followed by a discussion of the accounting treatment of federal health and pension programs.

### Accounting for Federal Underwriting Risks

1. The Federal Credit Reform Act of 1990

The Federal Credit Reform Act of 1990 (part of OBRA) calls for a change in the method of accounting for federal credit programs beginning in FY1992, so that the subsidy conveyed in a direct or guaranteed loan is recorded as an outlay in the year the loan is disbursed. All loans extended prior to FY1992, and all loans of the Commodity Credit Corporation, will continue to be accounted for on a cash basis.

For each loan extended or guaranteed by the federal government, the loan subsidy is calculated as the present value of the government's expected net cash outlays (excluding administrative costs and including the initial disbursement) attributable to the loan, where the discount rate is the rate of interest paid on Treasury securities of similar maturity. This subsidy is included in the outlays of the program, the agency, and the function that conduct the credit program. The remaining unsubsidized cash flows attributable to the loan are recorded in separate financing accounts at Treasury; they do not count in the official deficit but are included in "means of financing the deficit, other than borrowing from the public."

Specifically, the subsidy amount calculated for a direct loan is charged to the program account and is part of the loan disbursement. The remainder of the loan is borrowed from a nonbudgetary Treasury financing account, where all future cash payments also are recorded. If direct loan subsidies are accurately calculated, the financing account will have a zero balance when all loans mature. For a guaranteed loan, the subsidy amount is charged to the program account and is deposited in a nonbudgetary Treasury financing account that covers future loan defaults. Again, if the guaranteed loan subsidies are accurately calculated, the Treasury financing account will be exactly depleted when all loans mature.

Estimates of loan subsidies will be periodically updated to reflect new information; an upward revision requires an additional appropriation charged to the program account, and a downward revision results in a credit to the program account.

2. Estimated 1992 Baseline Loan Subsidies

Table 12 gives CBO's loan subsidy estimates for 1992, assuming a current services type baseline of new loan commitments. The programs shown in the table include those with the largest estimated subsidy as a percent of loans extended. Note that the subsidy rates are higher for direct loans than for loan guarantees. The Administration argues that this is partially due to the fact that private lenders manage loans better than the government does, especially when loan guarantees are partial. For this reason, the

Table 12

1992 BASELINE SUBSIDIES AND LOAN VOLUMES
FOR SELECTED CREDIT PROGRAMS

| | Type | 1992 Loans[a] (Billions of dollars) | 1992 Subsidies[b] (Billions of dollars) | Subsidy rate[c] (percent) |
|---|---|---|---|---|
| | | **Direct Loan Programs** | | |
| Rural Housing Insurance Fund | Discretionary | 2.2 | 0.8 | 38 |
| Public Law 480 (Food for Peace) | Discretionary | 0.6 | 0.4 | 68 |
| Rural Electrification Administration Direct Loans[d] | Mandatory | 0.7 | 0.2 | 27 |
| Export-Import Bank | Discretionary | 0.8 | 0.2 | 21 |
| Small Business Administration (Disaster loans) | Discretionary | 0.4 | 0.1 | 31 |
| Rural Development Insurance Fund | Discretionary | 0.7 | 0.1 | 16 |
| Agricultural Credit Insurance Fund | Mandatory | 0.4 | 0.1 | 22 |
| Other | Mixed | 3.4 | 0.3 | 8 |
| *Total* | | 9.1 | 2.2 | 24 |
| | | **Guaranteed Loan Programs** | | |
| Stafford Student Loans | Mandatory | 12.2 | 3.0 | 25 |
| Federal Housing Administration (General and special risk insurance) | Discretionary | 6.3 | 0.3 | 5 |
| Small Business Administration (Business loans) | Discretionary | 4.2 | 0.2 | 6 |
| Veterans Administration Loan Guaranty and Indemnity Fund | Mandatory | 15.3 | 0.1 | 1 |
| Other Subsidized Programs | Mixed | 13.6 | 0.2 | 2 |
| Federal Housing Administration (Mutual mortgage insurance) | Discretionary | 44.1 | -0.9 | -2 |
| Government National Mortgage Association (Sale of mortgage-backed securities) | Discretionary | 83.2 | -0.4 | e |
| *Total* | | 178.9 | 2.7 | 1 |

Source: CBO, The Economic and Budget Outlook: Fiscal Years 1992-1996, January 1991.
a. Commitments made in fiscal year 1992. Disbursement (by the government or by a private lender) may occur later.
b. Subsidy budget authority associated with 1992 commitments.
c. Subsidy portion as a percentage of disbursements.
d. Loans made directly by the REA at interest rates of 5 percent (2 percent for financially needy borrowers).
e. Less than 0.5 percent.

1.8(2/13/91)

Administration's budget proposes to substitute partially guaranteed loans for the direct loans of several programs.[19]

The subsidy estimates for FHA and Ginnie Mae loan guarantees are negative--because, by law, they ignore administrative costs and because FHA insurance fees on new loans have recently been raised so as to generate surplus revenues covering expected losses attributable to loans already outstanding.

CBO estimates that credit reform increases baseline outlays by between $2 billion and $3 billion in 1992 and 1993, and by smaller amounts (perhaps negative) in later years. This pattern occurs because credit reform increases recorded outlays for guaranteed loans in the initial years, and guaranteed loans are the dominant form of federal credit assistance.

3. Potential Costs Due to Past Federal Credit and Insurance Activities

Table 13 gives OMB's preliminary estimates of expected costs to the federal government due to its past credit and insurance activities; only half of these expected costs are due to deposit insurance. Programs for which the government's potential losses are particularly high include the pension guarantees (administered by the Pension Benefit Guaranty Corporation), FHA loans to producers of multifamily housing, guaranteed student loans, and direct loans extended by the Farmers Home Administration and the Rural Electrification Administration (REA).

As required by OBRA, this year's budget includes an analysis of the financial condition of government sponsored enterprises and the potential financial exposure that they pose to taxpayers. As is shown in table 13,

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19. Among these programs are those of the Rural Housing Insurance Fund, the Rural Electrification Administration, and the Agriculture Credit Insurance Fund.

Table 13

POTENTIAL COSTS ATTRIBUTABLE TO PAST FEDERAL CREDIT AND INSURANCE ACTIVITIES
(In billions of dollars)

| | Face value 1970 | Face value 1990 | Percent real increase 1970-90 | Range of potential costs |
|---|---|---|---|---|
| | | | | ***Cumulative outlays 1991-1996*** |
| Deposit insurance: | | | | |
| Commercial banks and savings banks | -- | 1,911 | -- | 42-78 |
| Thrifts | -- | 726 | -- | 70-83 |
| Credit unions | -- | 178 | -- | -- |
| Total deposit insurance | 476 | 2,815 | 88.9 | 112-161 |
| | | | | ***Present value of future costs*** |
| Other insurance: | | | | |
| Pension guarantee | -- | 943 | -- | 6-20 |
| Other insurance | -- | 738 | -- | 3-6 |
| Total other insurance | 216 | 1,681 | 148.6 | 9-26 |
| Government Sponsored Enterprises: [1] | | | | |
| Sallie Mae | -- | -- | -- | -- |
| Freddie Mac | -- | 317 | -- | -- |
| Fannie Mae | -- | 372 | -- | -- |
| Federal Home Loan Banks | -- | 117 | -- | -- |
| Farm Credit System | -- | 50 | -- | 1-2 |
| Total GSEs | 24 | 855 | 1037.8 | 1-2 |
| Guaranteed loans: | | | | |
| FHA MMI (single family) | -- | 279 | -- | (6)-0 |
| FHA GI/SRI (multifamily) | -- | 77 | -- | 14-16 |
| VA mortgage | -- | 161 | -- | 3-6 |
| Guaranteed student | -- | 53 | -- | 30-37 |
| Small business | -- | 12 | -- | 1-3 |
| Farmers Home | -- | 6 | -- | 1-3 |
| Export-Import | -- | 5 | -- | 4-6 |
| Other guaranteed loans | -- | 37 | -- | 5-15 |
| Total guaranteed loans | 125 | 630 | 61.0 | 52-86 |
| Direct loans: [2] | | | | |
| Farmers Home | -- | 53 | -- | 19-33 |
| REA and RTB | -- | 37 | -- | 11-15 |
| Export-Import | -- | 9 | -- | 3-6 |
| Other direct | -- | 63 | -- | 17-23 |
| Total direct loans | 51 | 162 | 1.4 | 50-77 |
| Total of other insurance, GSEs, and loans | | 3,328 | | 112-191 |

Source: Budget of the U.S. Government, Fiscal Year 1992.
1. Net of borrowing from federal sources and federally guaranteed loans.
2. Excludes loans and guarantees by deposit insurance agencies, for which costs are captured in the top section of this table. *Excludes programs not included under credit reform* such as CCC farm price supports. Defaulted guarantees which become direct loans are accounted for in guarantee volume and costs.

1.7(2/12/91)

only the Farm Credit System (FCS) is found to pose an immediate risk to taxpayers. Supposing that all sources of farm income fall 10 percent each year for three years, it is estimated that the FCS would need cash infusions with a present value of about $1 billion.

Federal Health and Pension Programs

There has been a trend in the budget of the federal government towards an accrual treatment of retirement programs and away from a pay-as-you-go treatment. This trend is manifest both in accounting methods and expenditure and tax policies. The trend toward accrual, similar to that taking place in the private sector, means that the expected costs for retirement programs are increasingly charged and reserved as they accrue, rather than as benefits are paid. Because the demographic groups covered by the government programs are aging, accrual treatment produces a higher current expense than pay-as-you-go treatment, and creates a reserve. This treatment is more reflective of the true costs and obligations that the government has incurred in promising retirement benefits and provides an incentive to control costs.

The trend towards accrual treatment has occurred to differing extents among the various retirement programs. The Supplementary Medical Insurance (Part B of Medicare) program is still operated on a completely pay-as-you-go basis; thus, if the benefit promises of this program remain unchanged, premiums paid by the elderly and expenditures of the federal government for the program will have to increase dramatically as the population ages and as the cost of medical treatment continues to increase at a more rapid rate than the general cost of living. The Hospital Insurance (Part A of Medicare) program is also essentially run on a pay-as-you-go basis, as its Trust Fund is expected to run out of money by the year 2006, according to current projections, and payroll tax rates will have to be increased in future years to finance the current benefit structure. The actuarial deficiency of the HI program, as of December 1990, is $312 billion.[20]

The health insurance programs for federal civilian and military retirees also are expensed on a pay-as-you-go basis. The actuarial deficiency of the civilian retiree health program is about $150 billion.[21] In contrast, beginning in 1985, fully funded accrual accounting was established for military service pensions. In other words, the cost of pensions owing to new service from employees hired before 1985, as well as new hires, is expensed as incurred. In addition, the federal government makes payments from general revenues to amortize, by the year 2043, the unfunded liability, estimated at $591 billion in 1992, for pre-1985 military service.

The accounting and policy treatment of the Social Security System lies somewhere between pay-as-you-go and accrual approaches. The policy reforms of the program, implemented in the mid-1980s as it became increasingly apparent that some sort of accrual for the benefits of the Baby-Boom generation would be desirable, have led to significant and growing accumulations in the trust funds. Social Security was removed from the unified federal budget, although the surplus in the trust funds continued to be counted toward deficit estimates for purposes of sequestration under the Gramm-Rudman-Hollings Act. The Budget Enforcement Act of 1990 removed the trust funds from future deficit targets as well. The Act also established

20. The actuarial deficiency is the present value of prospective receipts less prospective outlays over the next 75 years.
21. An estimate of the actuarial deficiency of the military retiree health program is not available.

"fire walls" intended to make it difficult to spend the projected buildup of reserves on higher benefits or lower Social Security taxes. These actions have tended progressively to put Social Security on an accrual basis. Yet elements of a pay-as-you-go approach still apply to this program. Even after the policy reforms, Social Security shows an actuarial deficiency, as of December 1990, of $1.244 trillion, calculated under the Social Security actuaries' mid-range projections.[22]

Major reforms of the federal civilian retirement pension program also have been in the direction of accrual treatment. Elements of a pay-as-you-go approach, however, also remain. The new Federal Employee Retirement System (FERS), covering employees hired since 1984, charges the full accrual cost of the retirement plan to the employing agency, and the agency contribution for FERS is reflected in agency budgets. The old Civil Service Retirement System (CSRS), covering civilian employees hired before 1984, by contrast to FERS and the military pension system, is still run on a partial pay-as-you-go basis. Under CSRS, employees and their agencies each pay an amount equal to 7 percent of the employee's salary toward the accruing cost of future retirement benefits. The total actuarial cost, however, is estimated at 28 percent of payroll, so these contributions finance only half of the total cost. The actuarial deficiency of the CSRS, as of September 1989, is $643 billion.

In the 1992 Budget, the Administration suggests some further reforms in the area of retirement programs. The Administration supports the

22. The 1992 budget document devoted some discussion to the reasonableness of the assumptions in the actuaries' mid-range projections. Although it was thought that the actuaries had assumed unrealistically low rates of birth and immigration, an assumption of a unrealistically high rate of productivity growth probably makes the mid-range projections, on net, the most reasonable forecast available.

principle of charging agencies the full current cost of accruing obligations for civilian retiree pensions and all retiree health programs for civilian and military employees of the federal government. By charging agencies for the full funding cost for all future service of pre-1985 civilian hires, the actuarial deficiency of the CSRS would be reduced by $100 billion. Similarly, by charging agencies for the full funding cost for retiree health benefits, the unfunded liability for that program would be reduced and agencies would be provided with better information about employment costs.[23] The Administration also has proposed that the military retirement system be allowed to change its actuarial assumptions to reflect better and more quickly the actual experience in personnel retention, pay, and interest rates.

23. The Administration, however, has not proposed any mechanism for amortizing the civilian pension and retiree health obligations owing to past service.