The Heritage Foundation Backgrounder UPDATE
214 Massachusetts Avenue N.E. Washington, D.C. 20002 (202)546-4400

10/3/90 Number 144

THE BUDGET SUMMIT AGREEMENT: PART V FAULTY ECONOMIC ASSUMPTIONS

(Updating *Backgrounder Update* No. 143, "The Budget Summit Agreement: Part IV, The Myth of Entitlement Reform," October 3, 1990; *Backgrounder Update* No. 142, "The Budget Summit Agreement: Part III, No New Taxes Needed" October 3, 1990; *Backgrounder Update* No. 141, "The Budget Summit Agreement: Serious Damage to the Economy, Part II," October 2, 1990; *Backgrounder Update* No. 141, "The Budget Summit Agreement: Serious Damage to the Economy, Part I," October 1, 1990; and *Backgrounder* 787, "Rx for the Federal Deficit: The Four Percent Solution," September 4, 1990.)

Supporters of the budget summit agreement contend that the package will bring spending down below 18.5 percent of Gross National Product (GNP) by 1995. This compares with the Administration's mid-session and pre-summit estimate that federal spending consumed nearly 22 percent of GNP in the recently-completed 1990 fiscal year. By allegedly holding down spending in this way, and enacting the largest first-year tax increase in American history, advocates of the agreement can claim that the overall package would balance the budget by 1995.

Their own economic assumptions show this to be a hollow claim. Achievement of the goal is based largely on unrealistic and dubious economic assumptions. Moreover, the proposed tax increase would certainly destroy the whole basis of these wildly optimistic projections. Yet without the spurious assumptions, the promised spending restraint evaporates and the goal of a balanced budget by 1995 collapses.

The "success" of the budget agreement hinges on the credibility of these economic assumptions. Sound and objective analysis, however, suggests that the assumptions are grossly optimistic and that the spending and revenue estimates are almost meaningless.

Among the economic realities likely to torpedo the summiteers' economic assumptions:

- The annual rate of economic growth is assumed to nearly double between 1990 and 1991, and almost triple between 1991 and 1992. Not only is this dramatic pickup in growth extremely unlikely, but it is supposed to occur on the heels of the largest first-year tax increase in American history.

- If economic growth does not meet the summit's rosy assumptions, the economic projections used in the agreement become invalid. That means a huge increase in the deficit. The Congressional Budget Office (CBO) estimated in January that a one percentage point reduction in the

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

SUMMIT ECONOMIC ASSUMPTIONS (calendar years)						
	1990	1991	1992	1993	1994	1995
Nominal GNP (billions)	5486	5807	6199	6670	7141	7607
Real GNP % change	0.7	1.3	3.8	4.1	3.7	3.5
Inflation % (GNP Deflator)	5.2	4.6	3.4	3.2	3.0	2.8
Short-term Interest Rate (%) (3 months)	7.7	7.2	5.7	4.9	4.4	4.2
Long-term Interest Rate (10 years)(%)	8.7	8.3	7.1	6.1	5.6	5.3

projected annual rate of real economic growth beginning in January 1990 would increase the expected deficit by $143 billion in 1995. The CBO also estimated that a one percentage point increase in the projected unemployment rate would boost the deficit by $81 billion in 1995.

- The Bush Adminstration is urging the Federal Reserve Board to adopt an easy money monetary policy to soften the effect of higher taxes. But a loose monetary policy, while perhaps temporarily lowering interest rates by creating the illusion of greater savings, ultimately results in higher inflation and interest rates. Thus, inflation is likely to rise, not fall, if the agreement is enacted and monetary policy loosened. The summit's economic assumptions show inflation, as measured by the GNP deflator, falling to 2.8 percent by 1995. This is hardly a realistic estimate if the Federal Reserve Board follows an inflationary policy. The last "pro-growth" easy-money period in American history, during the Carter Adminstration, resulted in inflation reaching 18 percent.
- Much of the supposed spending "savings" in the budget agreement are contingent on the inflation projection. Specifically, these savings assume lower cost of living adjustment (COLAs) payments to retired federal workers and smaller inflation adjustments in discretionary spending. These savings disappear when realistic inflation estimates are incorporated.
- The summit assumes long-term interest rates will fall to 5.3 percent. This would be the lowest level since 1967.
- The summit assumes that the short-term interest rate will plummet to 4.2 percent, a level not seen since 1972. The easy-money policies pursued during the Carter Administration led to the

prime interest rate climbing above 20 percent, long-term interest rates hitting 13.9 percent, and short-term interest rates peaking at 14.0 percent.

- The budget agreement claims to "save" more than $64 billion over five years because lower interest rates will reduce government borrowing costs. If realistic interest rate projections are used, these savings vanish. The potential magnitude of an error in projected interest rates is indicated in the CBO's analysis earlier this year, which estimated that a one percentage point increase in interest rates beginning in January 1990 would alone have increased the deficit by $31 billion in 1995.

- The Administration is attempting to sell the agreement by asserting that enactment of the package will result in a large drop in interest rates. But the most comprehensive analysis of the relationship between the deficit and interest rates, conducted by the Treasury Department during the Reagan Adminstration, found that the size of the deficit does not have a significant effect on interest rates. In seven out of the last nine years, the deficit as a percent of GNP and the prime interest rate have moved in opposite directions, completely contrary to conventional wisdom.

A budget agreement that assumes higher taxes will spur economic growth is not credible. A budget agreement that assumes an easy money policy will lower the inflation rate is not realistic. A budget agreement which assumes that interest rates will reverse historical patterns of behavior will not produce promised savings. And without these assumptions, the entire justification for a huge increase in taxes simply collapses.

Daniel J. Mitchell
John M. Olin Fellow in Political Economy