Federal Reserve Bank
of Minneapolis

Winter 1989

Quarterly Review

Federal Reserve Bank of Minneapolis

Quarterly Review

Vol. 13, No.1 ISSN 0271-5287

This publication primarily presents economic research aimed at improving policymaking by the Federal Reserve System and other governmental authorities.

Produced in the Research Department. Edited by Warren E. Weber, Kathleen S. Rolfe, and Inga Velde. Graphic design by Terri Desormey, Public Affairs Department.

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Gramm-Rudman-Hollings' Hold on Budget Policy: Losing Its Grip?

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Although significant progress has been made on the federal budget, further gains will be more difficult to achieve. Since the Gramm-Rudman-Hollings (GRH) deficit targets have been in place, federal spending has been constrained. Those targets, however, are in growing conflict with new pressures to spend. One implication is that the government will work harder to escape GRH's grip. Another implication is that actual deficit reduction will proceed at a reduced pace.

The Grip of Gramm-Rudman-Hollings . . .

The government got a grip on the budget in 1985, when Congress passed the 1986 budget resolution and the subsequent Gramm-Rudman-Hollings deficit-reduction act.[1] Based on policies in place before the resolution, projections by the Congressional Budget Office (CBO) showed a steadily rising path of deficits approaching $300 billion by fiscal 1990 (see Table 1). However, assuming that the policies in the 1986 budget resolution were implemented, the CBO projected deficits would steadily decline to a bit over $100 billion in fiscal 1990.

The assumption that the policies of the 1986 budget resolution would be implemented proved to be a good one: it was made good by GRH. A resolution is just a plan and by itself does not force action. After the 1986 budget resolution was passed in August 1985, Congress seemed unable to take any action on the budget. That changed with GRH, which was signed into law by President Reagan in December 1985.

The law contains two important provisions. The first sets out budget deficit targets over a five-year span and creates a mechanism to hit them. If projected deficits in the next fiscal year exceed the targets by $10 billion, then GRH mandates automatic spending cuts to reach them. The cuts are to come in equal shares from nonprotected defense and nondefense programs. The second important provision says that any new spending program must be explicitly financed, either by cutting existing expenditures or by raising revenues.

Almost immediately after its passage, GRH forced action on the budget. Since Congress had taken no action on the 1986 budget resolution, the projected deficit for fiscal 1986 exceeded the GRH target. In February, GRH forced spending reductions totaling $11.7 billion—a sizable cut for half a fiscal year. A few months later, the Supreme Court ruled that the original GRH was unconstitutional, but the government chose to retain the $11.7 billion in spending cuts.[2]

Although the mechanism of GRH has been changed

[1]The formal name for the budget resolution is the First Concurrent Resolution on the Budget for Fiscal Year 1986 and for GRH, the Balanced Budget and Emergency Deficit Control Act of 1985. For historical accounts of the events surrounding their passage, see Congressional Quarterly 1987 (pp. 579–80) and West 1988.

[2]After being found unconstitutional, GRH was amended in 1987 to give the Office of Management and Budget the responsibility for projecting future deficits and making the automatic spending cuts according to a congressional formula. The law's two important provisions were retained.

Table 1

Policy Changes in 1986 Budget Resolution as Estimated By CBO in August 1985

By Fiscal Year and in Billions of Dollars

	CBO Projection			CBO Extrapolation*	
Item	1986	1987	1988	1989	1990
CBO Baseline Deficit (August 1985 Estimates)	212	229	243	264	285
Deficit Reductions as Estimated by CBO					
Revenue Increases**	-3	-5	-8	-11	-11
National Defense	-11	-25	-41	-57	-74
Entitlements	-7	-13	-18	-19	-20
Nondefense Discretionary	-11	-20	-24	-25	-26
Offsetting Receipts†	-4	—	—	-1	-1
Net Interest	-1	-3	-10	-20	-33
Total Reductions§	-37	-66	-100	-132	-164
Deficit in Budget Resolution as Estimated by CBO	175	163	143	132	120

*Although the budget resolution covers only fiscal years 1986–88, its policies are extrapolated through 1990.

**Revenue increases appear as negative numbers because they reduce the deficit.

†Blanks indicate amounts less than $500 million.

§Items may not add to total because of rounding.

Source: CBO 1985, p.66

because of the Court's ruling and its targets have been raised once, the law has clearly restrained spending. This restraint is evidenced by the paucity of new spending programs adopted since GRH, the change in tenor of congressional discussions, and the attempts by Congress to circumvent the GRH targets. Perhaps the best evidence of restraint is that the government has basically adhered to the policies of the 1986 budget resolution—policies that GRH helped enforce.

Those policies called for the deficit to be reduced primarily by constraining spending. That constraint can be seen by comparing two projections the CBO made in August 1985 (see Table 1). One assumed that the policies in place before the 1986 budget resolution would continue. The other assumed policies would be changed to those in the budget resolution. By fiscal 1990 the resolution policies were projected to cut the deficit by $164 billion. Of that amount, only $11 billion was projected to come from higher revenues; the rest was to come from spending cuts, with defense taking the largest hit.

Contrary to some popular accounts, the rising surplus in Social Security trust funds had no effect on the turnaround in the deficit picture. That surplus had already been taken into account in the CBO's pre-budget resolution projections, which showed deficits rising to $285 billion by fiscal 1990.

Although the 1986 budget resolution was merely a plan, actual policies have not strayed far from it. To determine roughly how far, I compare the budget forecast the CBO made in August 1985 assuming the 1986 budget resolution policies were enacted with actual figures and the CBO's recent projections.[3] The forecast errors and revisions, which result from this comparison, stem from two root causes: incorrect assumptions about economic conditions and incorrect assumptions about policies.[4] If changes in economic assumptions account for the bulk of the forecast errors and revisions, it follows that actual policies have not differed much from those of the 1986 budget resolution. That is what my analysis concludes.

Over 1986–88, actual deficits were relatively close to those forecasted by the CBO in August 1985, and actual economic conditions were close to what the CBO had assumed. Over those three fiscal years, actual deficits turned out be to $221 billion, $150 billion, and $155 billion. The CBO had forecasted deficits of $175 billion, $163 billion, and $143 billion—or an average error of only $15 billion per year. Moreover, during the 1986–88 calendar years, actual economic conditions turned out close to what the CBO had assumed. Over 1986–88, the inflation-adjusted gross national product (real GNP) averaged 3.2 percent growth per year and 90-day Treasury bill rates averaged 6.2 percent. The CBO had assumed real GNP growth would average 3.4 percent and Treasury bill rates would average 7.3 percent. The recent CBO rules of thumb (shown in Table 2) suggest that errors in economic assumptions caused the CBO's deficit projections to be no more than

[3]Throughout this paper I take the CBO's recent projections to be those released in January 1989 (see CBO 1989). More recently, the *Wall Street Journal* reports that the CBO has since revised up its spending and deficit projections by about $5 billion per year through fiscal 1992 (Rogers 1989).

[4]I do not distinguish between incorrect assumptions about what policies are implemented and how policies are translated into spending and revenues, as the CBO does; rather, I combine the two into policy differences.

Table 2

Rules of Thumb Showing Effects on CBO Baseline Budget Projections of Selected Changes in Economic Assumptions

By Fiscal Year and in Billions of Dollars

Indicator	Change In	1989	1990	1991	1992	1993	1994
Real Growth							
Effect of One-Percentage-Point Lower Annual Rate Beginning Jan. 1989	Revenues	-6	-20	-39	-59	-79	-102
	Outlays	1	4	8	14	22	32
	Deficit*	7	24	48	73	101	134
Interest Rates							
Effect of One-Percentage-Point Higher Annual Rates Beginning Jan. 1989 (All Maturities)	Revenues	—	—	—	—	—	—
	Outlays	3	11	16	20	24	29
	Deficit	3	11	16	20	24	29

*Items may not add to total because of rounding.
Source: CBO 1989, p. 51

Table 3

CBO Assumptions for Real Growth and Interest Rates

By Calendar Year

Indicator	1988	1989	1990	1991	1992	1993	1994
Real Gross National Product (% Change)	3.8	2.9	2.1	2.2	2.2	2.3	2.3
Three-Month Treasury Bill Rate (%)	6.7	7.9	7.1	6.7	6.4	6.1	5.9

Source: CBO 1989, p.xv

$8 billion too high in any of those three years.[5] I therefore conclude that actual policies in 1986–88 were close to those in the budget resolution.

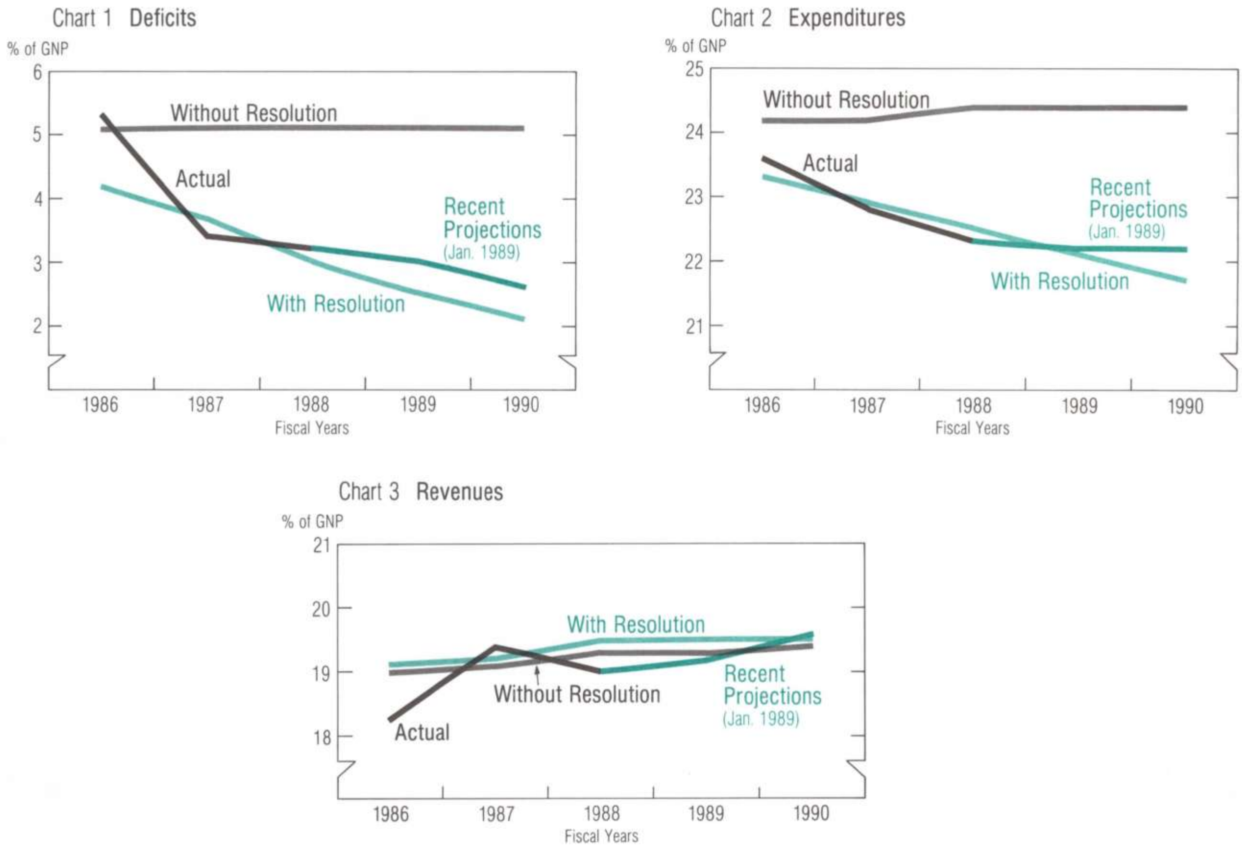
The CBO's recent deficit projections are higher than those forecasted back in 1985, but changes in economic assumptions account for the bulk of the difference. Over fiscal 1989 and 1990, the CBO's January 1989 projections call for deficits of $155 billion and $141 billion. In August 1985 it had forecasted deficits of $132 billion and $120 billion—or an average revision of $22 billion. However, changed economic assumptions can account for much of this revision. The CBO now assumes that in 1989–90, real GNP growth will

[5]As an approximation, the CBO's recent rules of thumb (Table 2) can be considered time invariant and linear. *Time invariant* means, for example, that I can substitute t for 1989, $t+1$ for 1990, and so forth, as long as t is within a few years of 1989. *Linear* means, for example, that we can determine the effects of a 2 percentage point increase in real growth by multiplying the appropriate entries in Table 2 by −2. To calculate the effects of changes in economic assumptions for 1986–88, I let $t = 1986$, $t+1 = 1987$, and $t+2 = 1988$.

Charts 1–3

The Government Has Kept Close to the Policies of the 1986 Budget Resolution

The CBO's August 1985 Projections
Compared With Actual Data and Recent Projections



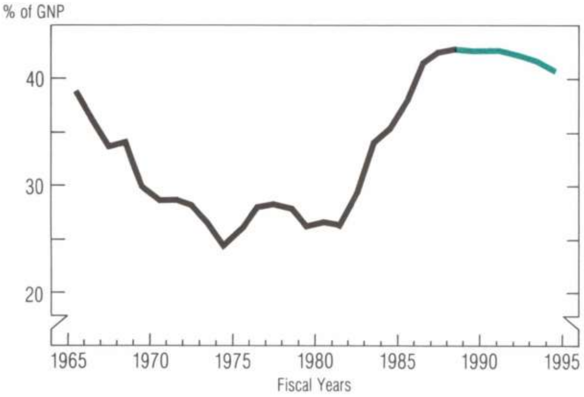
Sources: CBO 1985, 1989

average 2.5 percent per year and 90-day Treasury bill rates will average 7.5 percent (see Table 3). Back in 1985 the CBO's assumptions were 3.5 percent and 7.2 percent, respectively. According to the CBO rules of thumb (from Table 2), 1 percentage point lower real growth and 0.3 percentage point higher interest rates can account for an $18 billion average increase in deficit projections—the bulk of the actual revisions. So I conclude that current policies are close to those in the 1986 budget resolution as well.

The government's grip on the budget under GRH can also be seen by comparing the CBO projections made in August 1985 with actual figures and recent CBO projections (see Charts 1–3). Comparing the 1985 projections with and without the 1986 budget resolution policies indicates the extent of deficit reduction that was planned. Comparing the 1985 projections based on the resolution policies with actual figures and recent projections indicates the extent of deficit reduction achieved. (Because the charts show budgetary trends, the data are expressed as percents of GNP to account for changes in the scale of the economy.) Chart 1 shows that the deficit reduction planned by the resolution was essentially accomplished. Chart 2 shows that

Chart 4

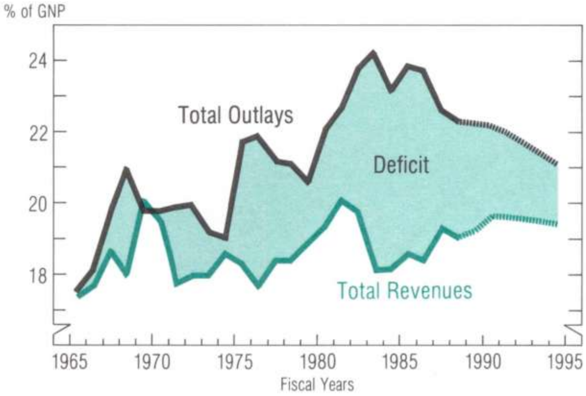
Federal Debt Held by the Public
Is Projected to Grow More Slowly



Source: CBO 1989

Chart 5

Spending Restraint and Stable Revenues
Are Expected to Reduce the Deficit



Source: CBO 1989

the sizable reductions planned to expenditures were largely achieved. And Chart 3 shows that little change was planned to revenues, and little change occurred.

. . . Is Loosening

The budget outlook seems less bright than in the recent past because GRH's grip on the budget is loosening. I reach this conclusion in a series of steps. First, I review recent budget trends and the CBO's recent baseline budget projections. Those projections provide one characterization of the current budget situation. Next, I argue that the current situation is worse than the CBO baseline indicates because the baseline does not adequately account for some prior commitments and new pressures to spend. Finally, I argue that because the current situation is so unfavorable, the government will make only a small advance toward the GRH targets. Although the government could go further, as it did in 1985, such progress seems more difficult this time around.

The Current Budget Situation

□ *The CBO's View*

Actual figures and the CBO's January 1989 baseline projections indicate that a corner has been turned on budget policy. Public debt, after rising much faster than total income (GNP) over the Reagan years, just kept pace with GNP in fiscal 1988 and is expected to rise more slowly than GNP through fiscal 1994 (see Chart 4). This turnaround is significant and important: A policy that implies a steadily rising debt-to-GNP ratio is not sustainable because eventually the cost of servicing the debt outstrips the resources available to service it. Thus, the turnaround signals that policy has shifted to a sustainable course.

The reason for the relatively slower growth in debt is that the CBO expects the deficit to shrink steadily, both in absolute terms (from $155 billion in 1989 to $122 billion in 1994) and, more dramatically, as a share of GNP (see Chart 5). The primary reason for the shrinkage is spending restraint; outlays are expected to steadily decline as a share of GNP. In contrast, revenues as a share of GNP are expected to remain stable at a fairly high rate.

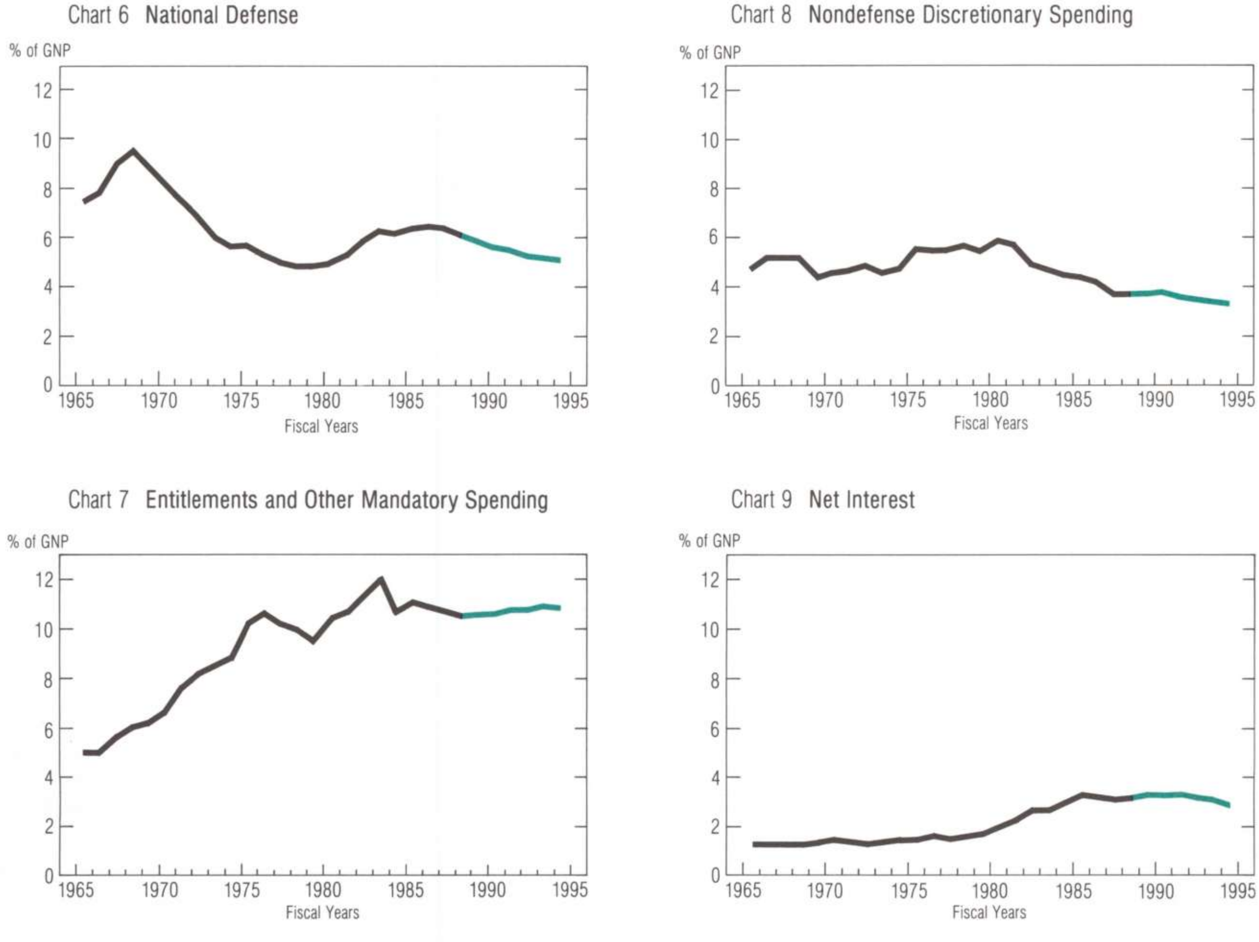
According to the CBO, spending restraint is expected to be fairly broad-based over the next five years (see Charts 6–9). The restraint is due primarily to two baseline assumptions. One is that real spending is constant on annually appropriated programs. This assumption together with a forecast of real economic growth (see Table 3) implies a decline in spending relative to GNP. The second is that interest rates will decline through 1994 (see Table 3). This results in declining interest expense relative to GNP.

Defense spending, after rising relative to GNP in the early Reagan years, has slowed and is expected to decline relative to GNP through 1994 (see Chart 6). The decline follows from the CBO's first primary

Chart 6–9

Spending Restraint Is Expected to Be Broadly Based

Outlays by Major Sources



Source: CBO 1989

assumption, since defense programs are subject to annual appropriations. The decline brings defense spending as a share of GNP almost down to where it was before the Reagan buildup.

Entitlements and other mandatory spending programs—such as Social Security, Medicare, and federal pensions—are expected to remain stable as a share of GNP (see Chart 7). These programs had taken a larger and larger share of the pie, rising from 5 percent of GNP in fiscal 1966 to 12 percent of GNP in fiscal 1983. Since then, however, spending has been more restrained and is expected to remain at close to 11 percent of GNP through 1994.

Nondefense discretionary spending has taken a shrinking slice of the pie in the 1980s (see Chart 8). Grants to state and local governments have received the largest cuts. Since programs in this budget category are subject to annual appropriations, the CBO's assump-

Charts 10–12

Revenues Are Expected to Remain Stable

Revenues by Major Sources

Chart 10 Individual Income Taxes

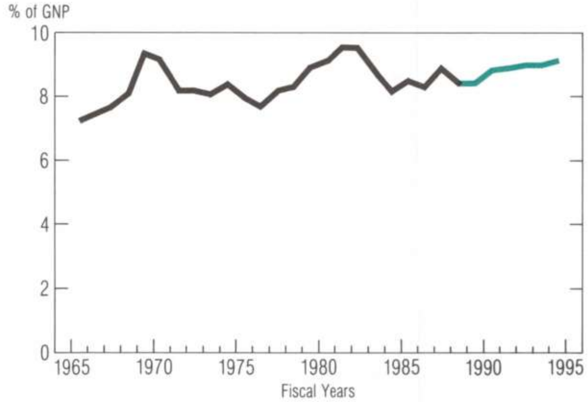


Chart 11 Social Insurance Taxes

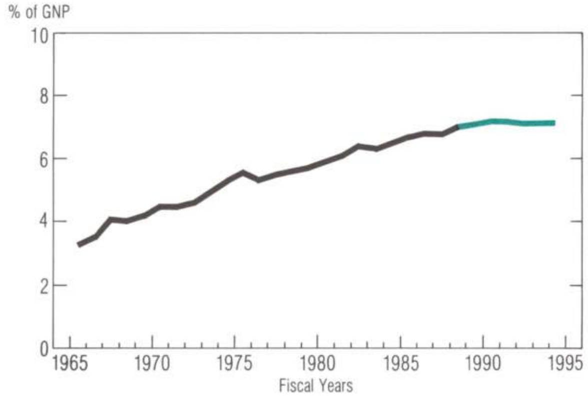
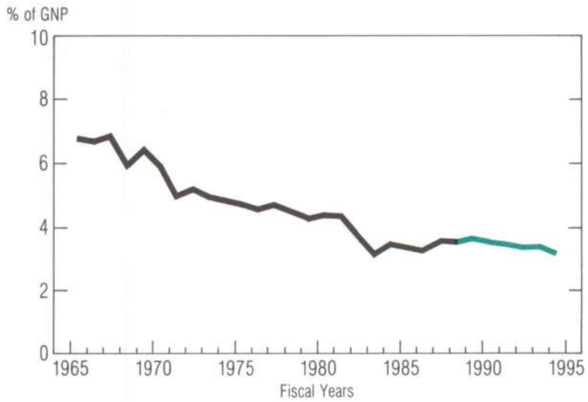


Chart 12 All Other Taxes



Source: CBO 1989

tions imply that such spending will shrink further as a percent of GNP.

With smaller deficits and declining interest rates assumed, the CBO projects that what had been the fastest-growing spending category—net interest expense—will flatten and then decline as a percent of GNP (see Chart 9). The rise in interest expense had mirrored the rise in public debt, and its leveling and decline reflect a similar pattern in debt.

While the CBO projects spending to decline, it projects revenues to remain stable through 1994 (see Charts 10–12). Individual income taxes are expected to rise modestly and then stabilize at 9 percent of GNP (Chart 10). That share is close to where these taxes were in the early 1980s, before tax reform temporarily reduced them.

Social insurance taxes have climbed to become the government's second major revenue source, making up

7 percent of GNP (Chart 11). Under current policies, the CBO expects social insurance taxes to remain at 7 percent of GNP.

All other federal taxes have declined in importance as sources of revenue. The largest relative declines have come in corporate income taxes and excise taxes. Combined, the taxes in this category are projected to decline to a little over 3 percent of GNP (see Chart 12).

In summary, the CBO projects that under current policies, the deficit will decline relative to GNP. As shares of GNP, outlays are projected to decline, while revenues are projected to be flat. Declines relative to GNP are projected for defense, nondefense discretionary spending, and net interest expense.

□ *A Worse View*

Due to past commitments and new pressures to spend, the budget situation seems worse than the one portrayed by the CBO's projections. At issue is how best to characterize the budget outlook under current policies. I have no quarrel with the CBO's economic assumptions, which seem entirely reasonable (see Table 3). But I doubt that the CBO's baseline convention of holding real spending fixed on appropriated programs (and some other technical assumptions, such as for the catastrophic health care program) adequately accounts for past policy commitments and some stated intentions.[6]

The CBO's defense projections assume no real growth in defense spending through 1994. That is consistent with its assumption for all programs funded by annual appropriations. Yet it is estimated that a 4 percent real increase per year is required to fund current defense operations and approved weapons systems (Silk 1988). More specifically, the CBO points out that its baseline assumptions make no allowance for the administration's plan to buy 132 B-2 (Stealth) bombers at a cost of about $0.5 billion apiece. Its baseline assumptions also make no allowance for the cleanup and modernization of nuclear armaments plants—tasks estimated by the Energy Department to cost about $6 billion per year over the next 20 years. Thus, the CBO's baseline projections incorporate large cuts in defense spending from what it would be if no operations or weapons systems were curtailed.

The CBO's projections also incorporate restraint on spending for the catastrophic health care program—but this time it's the public who is expected to show restraint. The CBO assumes that the public will not increase its demand for expensive health care, such as care for the terminally ill, when there is 100 percent coverage of expenses (after a moderate deductible). On a program structured in this way, expenditures could be expected to steadily outstrip static projections and insurance premiums to follow up, a step behind expenditures.

The CBO's projections also ignore pressures for new spending, and the costs seem significant. The cost of President Bush's kinder, gentler nation—his new initiatives for health, education, and other social programs—is estimated in the Bush budget to be about $7.3 billion (President . . . , 1989, p. 181). The cost of bailing out the Federal Savings and Loan Insurance Corporation (FSLIC) under Bush's plan is now estimated by the CBO to cost around $11 billion per year (Duke 1989), but the CBO baseline only allocates $5 billion yearly.

Moreover, as the CBO points out, its baseline assumptions make no allowance for conducting the decennial Census of Population, building the manned space station or the superconducting super collider, or renewing long-term subsidized housing contracts that are about to expire (CBO 1989, p. xiii).

The Budget Outlook

Even if the current budget situation were not worse than the CBO's baseline projections suggest, major policy actions would still need to be taken on the budget to conform to the GRH targets and avoid triggering automatic spending cuts (see Chart 13).

The actual budget outcome will probably be better than what the current budget situation suggests. That is because policymakers will take some actions to improve the situation. Baseline projections are conditional statements of what will occur if no further policy changes are made. To predict what the actual budget outcome will be, one then has to predict what policy changes will in fact be adopted.

□ *Confrontation, Compromise, and Chicanery*

No matter what new budget policies are adopted, the complex political process by which they are chosen is apt to involve confrontation, compromise, and chicanery. Confrontation seems likely, since some strong political forces are facing off in the budget process. One force, of course, is GRH, which requires the fiscal 1990 deficit to be brought down to $100 billion and requires any new spending programs to be funded explicitly by higher revenues. A second force is the Democratic Congress, which will attempt to preserve social programs by asking for further defense cuts and revenue

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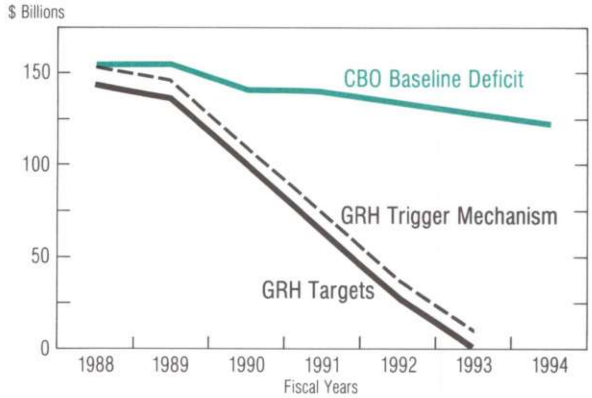
[6]The General Accounting Office reached this same conclusion, according to the *New York Times* (see Tolchin 1988).

Chart 13

Major Policy Actions Are Needed to Reach the Gramm-Rudman-Hollings Targets

CBO Baseline Deficit Projections Versus GRH Targets



Source: CBO 1989

increases in any deficit-reduction package. A third force is the Bush administration, which has promised not to cut real defense spending, not to touch Social Security, and not to raise taxes.[7]

In the years before GRH, the opposing forces in Congress and the administration would have been expected to lead to a gridlock on the budget. But that can't happen now. If the government can't reach a compromise within the limits of GRH, then spending will be cut to reach the GRH targets, coming 50-50 from nonprotected defense and nondefense programs. If large cuts were required, neither the administration nor Congress would be pleased with the outcome. The administration would not like to see large cuts in defense, and Congress would not like to see large cuts in social programs.

Congress and the administration could seek a way out by raising the GRH targets, but that outcome seems unlikely. The targets were raised once before, and to do so again would be to effectively repeal the law. Moreover, public opinion and the financial market's response might make such an option unattractive.

So to stay within the GRH targets, Congress and the administration will have to compromise. And the road to compromise is likely to involve confrontation. But compromise alone is not likely to do the whole job. That's where chicanery comes in. The government can take fewer real budget-cutting actions by using bookkeeping tricks. These tricks help the reported budget meet the GRH targets, but they do nothing to alter the budget's claims on private resources.

The key to the tricks is one special feature of GRH: the automatic cuts are based on projected deficits for just the next fiscal year. Thus, bookkeeping tricks that either move spending increases or tax cuts up into the current fiscal year, back into future fiscal years, or off the books indefinitely can help the budget hit the GRH targets. At least three tricks will be used.

One trick is to make overly optimistic assumptions about the economy. The CBO's recent assumptions pall in contrast to the optimistic assumptions proposed by the Office of Management and Budget (OMB), whose projections are used for the GRH budget calculations. The OMB assumes real growth will average 3.3 percent per year over 1989 and 1990 (nearly 1 percentage point higher than the CBO assumes), while the 90-day Treasury bill rate will fall to 5.5 percent in 1990 (over 1.5 percentage points lower than the CBO assumes). The OMB assumptions make the budget look better than it really is without changing policy in any way. (To see how much better, apply the CBO rules of thumb from Table 2.) These assumptions affect the projected deficits, which are the target of GRH, but not the actual deficits.

A second trick is to change the timing of expenditures and revenues. The government, for instance, can move deficit increases forward. Last February the OMB projected a deficit for fiscal 1989 of $130 billion, which was in accord with the GRH target. That deficit is now estimated to be over $160 billion. The government could move spending now scheduled for fiscal 1990 up into 1989. This would reduce the projected deficit for 1990 and raise the deficit for 1989. But the 1989 deficit is just spilt milk under GRH.

The government can also move deficit increases back into the future. It can finance current spending, such as the FSLIC bailout, with off-budget bonds; then only the interest on the bonds shows up as spending in the budget.[8] Or instead of paying out subsidies directly, it can accomplish the same thing with direct loans and

[7]Another force was supposed to be the National Economic Commission, which tried to devise a bipartisan plan for deficit reduction but failed.

[8]In fact, according to the administration's plan, such a ploy shows up on the budget as a $14 billion surplus in fiscal 1989. The bonds sold are off-budget, but when the proceeds are turned over to the Treasury they are counted as revenues. Since the cost over time to the Treasury is not reduced by this ploy, a surplus in the current year implies higher deficits in future years.

loan guarantees. Then the subsidies show up only after time, as the expected loan losses actually occur. At the end of fiscal 1988 the government had outstanding $222 billion in direct loans and $550 billion in guaranteed loan commitments (OMB 1989, p. 118). Budget experts claim that "the hidden losses embedded in the Government's huge portfolio of subsidized loans and loan guarantees have reached startlingly high levels . . . ."[9]

A third trick is to simply move expenditures or revenues off budget. The government, for example, may favor some form of universal health care. If it were to run the program, any payments it made would be considered federal expenses and any income it received would be considered tax revenue. However, if it were simply to require private firms to provide health care service to their employees, the program would not be included in the federal budget. Yet, in either case, the program would make exactly the same claim on private resources.

□ *Escaping the Grip*

Given the magnitude of the problem—on the order of $45 billion in cuts according to the CBO to get to the GRH fiscal 1990 target of $100 billion—some real actions will have to be taken. One might even argue that the outcome may resemble what happened in 1985: then the government, faced with a troubling budget situation, was able to get a grip on the budget. But there are some differences now which make that outcome less likely.

One difference is that in 1985, action was necessary to put the budget on a sustainable path. Now projected deficits with no change in policy seem sustainable; they imply no further increases in debt relative to GNP. The problem now is that deficits seem too large for the attainment of other economic objectives—such as a higher national savings rate or a lower trade deficit—so the issue now concerns what is desirable rather than what is essential.

A second difference is that in 1985, cuts were made from a rising baseline projection. Now those cuts must be made from a flat baseline. It seems easier, for instance, to go from a 4 percent real defense growth baseline to zero, as was done in 1985, than to go from zero to negative, as would be the case now.

A third difference is that over the years the government has learned ways to escape the grip of GRH. When the law was new, the government wasn't aware of all the accounting tricks to avoid it, so more real action had to be taken.

Slower Progress Ahead

Given public sentiment, the government is still likely to take some meaningful action on the budget to attempt to move toward the GRH targets. But, given the size of the problem, actual deficit reduction is likely to be slower in the next few years than it was in the last few.

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[9]Quoted from the *New York Times* (Nash 1988). The article goes on to report that the General Accounting Office has begun auditing the government's credit programs. In its first audit, released in December 1988, it found that the Farmers Home Administration had "cumulative losses equal to $36 billion on its $90 billion of loans and other obligations."

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