

The Budget Outlook and Options for Fiscal Policy

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ABSTRACT

This paper examines the federal budget outlook and evaluates alternative fiscal policy choices. Official projections of the federal budget surplus have declined dramatically in the past year. Adjusting such measures for the treatment of retirement trust funds, realistic estimates of future tax and spending levels, and longer time horizons implies an even bleaker picture. Freezing the tax cut passed last year would be a significant step toward fiscal responsibility. In contrast, the Bush Administration's budget proposes making last year's tax cut permanent and seeks further tax cuts that would exacerbate long-term fiscal problems.

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I. Introduction

The federal budget outlook has deteriorated dramatically over the past 12 months, due to last year's tax cut, the economic slowdown, and the terrorist attack on September 11, 2001. In addition, several key budget enforcement rules expire at the end of this fiscal year, and recent controversies regarding whether conventional accounting practices in the private sector accurately capture underlying realities raise awareness regarding the possibility of flaws in public sector accounting systems as well. In light of these events, this paper examines the federal budget outlook and evaluates alternative options for fiscal policy.

The first part of the paper examines the official budget outlook and alternative measures. The Congressional Budget Office's projected baseline budget surplus for 2002 to 2011 declined from \$5.6 trillion in January 2001 to \$1.6 trillion in January 2002. Outside of Social Security, the budget projections shifted from a surplus of \$3.1 trillion to a deficit of more than \$700 billion. About 40 percent of these changes is due to the tax cut enacted last year, another 40 percent to economic and technical changes, and the rest to changes in spending.

Federal budgeting methods, however, significantly misrepresent the government's fiscal position. Adjusting the official projections to separate retirement trust funds from the rest of the budget and to provide more realistic estimates of the future implications of current policy leaves a far bleaker picture—a deficit of more than \$3 trillion over the next decade. Over longer periods that capture the increase in entitlement spending that will occur as the baby boomers retire and the nation ages, the federal government faces very substantial fiscal deficits.

These budget trends present difficult choices, especially when combined with the need to finance a war on terrorism. Policy-makers generally agree that substantial increases in spending on defense and homeland security are warranted, and the Bush Administration's new budget

understandably includes such spending increases. The key question for budgetary purposes, though, is how the required spending will be financed and how the looming budget imbalance will be corrected. We address the effects of two options.

The Administration's budget proposes to finance the war on terrorism by reducing spending for low-income households and raising the burden on young and future generations. Indeed, the budget not only eschews tax increases, but also proposes new tax cuts. Principally, these cuts would make permanent the fully-phased-in tax cut provisions passed last year, instead of allowing them to expire in 2010 as currently scheduled. One might view this proposal as simply formalizing the underlying policy established when the 2001 tax cut was passed. But there was insufficient support to make the tax cuts permanent last year, and worsening fiscal conditions and the need to fight a war against terrorism present both the need and the opportunity to reassess fiscal choices. The President has chosen to seek extension of last year's tax cut and to add additional tax cuts; both actions would further exacerbate long-term financial pressures on the federal government.

One alternative approach would be to freeze last year's tax cut. Under a freeze, the changes that have already taken effect would remain in effect and be made permanent, but the provisions slated to take effect in future years would be repealed. We show that freezing the tax cut (relative to permanently implementing all provisions of the tax cut) would significantly reduce the long-term fiscal imbalance, and would save enough revenue to eliminate the Social Security actuarial imbalance through 2075. Allowing the tax cut to expire in 2010 as scheduled would save substantially more revenues.

The paper is organized as follows. Section II presents official budget surplus projections since the beginning of 2001. Section III explores adjustments to the official budget baseline.

Section IV extends the horizon of our analysis, considering the long-run fiscal gap implicit in current policy. Section V estimates the effects on the long-term gap of policy options, including imposing a freeze on last year's tax cuts. Section VI evaluates the Administration's budget proposals. Section VII is a short conclusion.

II. The Budget Outlook under the CBO Baseline

Table 1 reports the ten-year baseline projections made by the Congressional Budget Office (CBO) at various points since January 2001. Between January 2001 and January 2002, the projected ten-year unified surplus fell from \$5.6 trillion to \$1.6 trillion.¹ The decline is concentrated almost completely in the non-Social Security, non-Medicare part of the budget, which declined from a projected surplus of \$2.7 trillion in January 2001 to a projected *deficit* of \$1.1 trillion by January of this year.

Figure 1 shows the baseline unified budget surplus projections on an annual basis; Appendix Table 1 provides supporting detail. In January 2001, the projections showed surpluses in excess of \$300 billion annually in 2002 and 2003, with rising surpluses through the rest of the decade. By January 2002, the surpluses projected for 2002 and 2003 had disappeared, and those projected for subsequent years declined by roughly \$300 billion.² As we emphasize below, these official forecasts are based on a series of optimistic assumptions, and the structure of last year's tax cut exacerbates the bias. In particular, the significant increase in the surpluses projected for

¹ In March 2002, the CBO (2002b) issued updated baseline projections in conjunction with its analysis of the Bush administration budget. These projections reflect additional legislation and slight changes in technical assumptions and the economic forecast, and show a projected unified budget surplus of \$1.7 trillion between 2002 and 2011. We rely on the January 2002 figures for the bulk of our analysis, but the differences from incorporating the March update would be trivial.

² The projected deficits of \$21 billion and \$14 billion for 2002 and 2003 in the January forecast were replaced by projected surpluses of \$5 billion in 2002 and \$6 billion in 2003 in the March forecast. This change may be important for political reasons, but the economic consequences are small.

2011 and 2012 relative to 2010 (apparent in Figure 1's January 2002 projections) reflects the formal provision that all of last year's tax cut expires at the end of 2010. We return to this issue below.

Figure 2 shows that the non-Social Security budget was projected in January 2001 to run surpluses between \$124 billion and \$558 billion annually through 2011. By January 2002, these projections turned to deficits through 2009. Figure 3 shows that the January 2002 baseline budget outside of Social Security and Medicare is projected to be in deficit through 2010, returning to surplus only in 2011 and only because of the assumption that the tax cut will be terminated at that point.

Table 2 examines the sources of the decline in projected unified budget outcomes. Of the \$4 trillion decline in the cumulative 2002-11 projected surplus, about \$1.7 trillion is due to last year's Economic Growth and Tax Relief Reconciliation Act (EGTRRA), including the additional interest on induced increases in federal debt. Another \$1.6 trillion arises from economic and technical changes, and \$0.6 trillion is attributable to increased spending, primarily defense and homeland security outlays in the aftermath of the terrorist attacks.

Figure 4 shows similar figures on annual basis. The decline in the budget surplus over the next few years is due predominantly to economic and technical changes, which in turn are due chiefly to the economic slowdown. In later years, however, these changes decline in importance as EGTRRA phases in more completely. Thus, in the later years of the decade, last year's tax cut accounts for about 50 percent of the decline in surplus since January 2001 (Appendix Table 2).

III. The Budget Outlook under Alternative Baselines

The CBO baseline is intended to serve as a “neutral benchmark....constructed according to rules [that are] set forth in law and long-standing practices and are designed to project federal revenues and spending under the assumptions that current laws and policies remain unchanged” (CBO 2002a, p. xiii). These rules and practices, however, are not necessarily the most useful or appropriate choices if one wishes to gauge the government’s fiscal condition or to estimate the funds that might reasonably be considered available to finance tax cuts or new spending initiatives. Indeed, the official baseline seems particularly biased now, given the sunsets embodied in EGTRRA (which artificially increase the revenue figures shown in the official baseline projections).³

We focus on two of the baseline’s problems: the treatment of retirement trust funds and assumptions about how spending and tax policy will evolve.⁴ We address these issues first within the ten-year budget horizon and then by extending the horizon.

The first problem arises from the treatment of retirement programs. The baseline generally uses cash-flow accounting to measure the costs of programs. This is inconsistent with the accounting treatment of private pensions and can provide a distorted view of a program’s viability, particularly during a demographic transition to an increased dependency ratio. For example, trust funds for Social Security and Medicare Part A will run substantial cash-flow surpluses over the next decade, but substantial deficits over longer horizons.⁵ Likewise, trust

³ Reischauer (2002) expresses the view that “Rarely have the policies underlying the baseline projections been as disconnected from the policy makers’ agendas as they are today.”

⁴ Because many of the budget methods that we criticize are stipulated by law, our criticisms are not of CBO *per se*, but rather of the laws that guide the formation of the baseline budget and dictate how that budget should be used.

⁵ See Table 1 above, Board of Trustees, Federal Old Age and Survivors Insurance and Disability Insurance Trust Funds (2002), and Board of Trustees, Federal Hospital Insurance Trust Fund (2002).

funds holding pension reserves for federal military and civilian employees are projected to run significant cash-flow surpluses over the next 10 years (CBO 2002a, Table 1-5).

A more useful accounting approach would reflect both the accruing contributions *and* the ultimate liabilities of retirement programs. This is possible in a cash-flow framework only if the time horizon is extended beyond 10 years and the flows of different years combined, as we discuss below. But since the ten-year horizon has been standard practice for the last several years, it is also worthwhile to consider less extensive retirement trust fund adjustments that are possible within that window. Given that the ten-year window precludes adding future liabilities to the budget, it is less misleading to exclude the retirement programs altogether than to include only the accruing contributions. For Social Security, this logic is already codified in its off-budget status. But the logic applies with equal force to the other retirement programs and we employ this adjustment below.⁶

The second problem with the baseline involves the manner in which it projects revenues and outlays. A variety of statutory requirements, which may be at variance with reasonable expectations, define “current policy.” On the spending side, the main issue concerns discretionary spending. Because discretionary outlays require appropriations every year, judgments may reasonably differ about the extent to which current spending choices determine future spending. CBO assumes that real discretionary spending authority will remain constant over the budget period at the level prevailing in the first year. For the January 2001 baseline, for example, this assumption implied that discretionary spending would fall by 20 percent relative to GDP and by about 9 percent in real per capita terms by 2011. In a growing economy with

⁶ This economic logic may help explain the significant, bipartisan political support for the notion that retirement trust funds ought to be kept separate from the rest of the budget. Both Houses of Congress voted overwhelmingly in 2000 to support measures that protected the Medicare Part A trust fund from being used to finance other programs or

expanding defense needs and other concerns, this seems to be a particularly unrealistic projection. It would be more reasonable for real discretionary spending to grow with the population, to maintain current services on a per-person basis.⁷ An alternative, perhaps even more realistic, baseline would let discretionary spending grow with GDP.⁸

On the revenue side, at least three issues merit consideration. The first concerns the “sunset” provisions in EGTRRA. Under current law, which the baseline follows, all of the provisions of EGTRRA that had not already phased out by the end of 2010 are repealed at that time, and the tax code reverts to what it would have been had the tax bill never existed. For example, at the beginning of 2010, EGTRRA repeals the estate tax. At the end of 2010, the estate tax is re-established as if EGTRRA had never existed.

The sunset provisions came about because of the “Byrd Rule,” under which changes in revenues beyond the ten-year budget window require 60 percent of the vote in the Senate (Keith 1998). At the time EGTRRA was debated and passed, the budget window covered fiscal years 2002 through 2011. Because tax cuts in one year are estimated to have spillover effects in subsequent years, and because calendar and fiscal years overlap, the provisions were repealed at the end of calendar year 2010 to avoid revenue losses extending beyond the end of fiscal year 2011. The effect was not only to avoid a 60-vote requirement, but also to reduce the ten-year cost of EGTRRA, since the cost in 2011 was dramatically reduced by the sunset. Other aspects of EGTRRA—such as the late starting dates and slow phase-ins of many provisions, the early terminations of other provisions, the lack of adjustment of the alternative minimum tax

tax cuts (Mohr 2001). A recent legislative proposal would provide similar protection to military pensions (U. S. House of Representatives 2001). Almost all states already separate pension reserves from their operating budgets.

⁷ Indeed, as a Presidential candidate, George W. Bush made the same point, arguing that an “honest comparison” of spending growth should take inflation and population growth into account (Slater 1999, Calmes 1999).

⁸ In recent years, CBO has presented sensitivity analysis with a variety of alternative spending paths.

(discussed below), and timing shifts related to corporate taxes—similarly reduced its official ten-year cost.⁹

The sunset provisions complicate analysis of “current policy” toward taxation. Although CBO is required to follow current law—including the expiration of any provisions—virtually no one believes the tax provisions will sunset completely as stipulated by EGTRRA. Even prior to its current budget proposals, the Administration has indicated the expectation and desire that the tax cuts be made permanent.¹⁰ But exactly when or which parts of the bill might be extended is unclear. We assume that under “current policy,” the sunset provisions will be removed, and analyze the tax cut as if it were permanent.¹¹

The second tax issue relates to the alternative minimum tax (AMT). Designed in the late 1960s and then strengthened in 1986 to curb aggressive tax avoidance, the AMT operates parallel to the regular income tax system, using a broader measure of income, fewer deductions, lower tax rates, and a higher exemption. Taxpayers pay the AMT when their AMT liability exceeds their regular income tax liability. In other cases, taxpayers pay regular income tax, but have their use of credits limited due to the AMT. We refer to both groups as “on the AMT.”

The AMT is very complex and has become poorly targeted: most taxpayers who face the AMT do so because of the value of their personal exemptions or deductions for state and local taxes, not because of aggressive tax sheltering. In 2001, about 2 million taxpayers—or about 2

⁹ EGTRRA delayed the due date for \$33 billion in corporate tax receipts by two weeks and thereby shifted the revenue from fiscal year 2001, which was outside the budget window, to fiscal year 2002, which was inside the window (JCT 2001). The primary purpose was to increase the funds available to finance tax cuts in the 2002-2011 budget window even though there was no underlying improvement in government finances.

¹⁰ President Bush called for making the tax cuts permanent in his January 2002 State of the Union address (Bush 2002). But even before the tax cut was signed, Treasury Secretary Paul O’Neill indicated that “All these things are going to become permanent. They’ll all be fixed.” (USA Today 2001). Lindsey (2002) refers to the tax cuts as “permanent.”

¹¹ Kiefer et al (2002) make a similar assumption. CBO (2001a) makes the same assumption when it analyzes the economic effects of the tax cut, even though it cannot make that assumption when analyzing the budget itself.

percent of those with positive tax liability—faced the AMT. The number of AMT taxpayers was projected to rise to 17.5 million in 2010 under pre-EGTRRA law (JCT 2001). The main reason for that projected increase was that the AMT exemption threshold is not indexed for inflation. EGTRRA exacerbated this situation, by reducing regular income taxes but (after 2004¹²) not the AMT. The tax cut is projected to raise the number of AMT taxpayers to 35.5 million by 2010, or about one-third of all taxpayers (JCT 2001). It will also increase substantially the AMT liability of those already on the AMT under pre-EGTRRA law by pushing these taxpayers “deeper” into the AMT.

Along with the sunset provisions, the AMT is a second example in which no one seriously expects the Administration and Congress to allow current law to prevail. We define “current policy” towards the AMT as holding constant at 2 percent the share of taxpayers facing the AMT. We regard this as a reasonable benchmark because it maintains the share of taxpayers on the AMT at its level in 2001, when the tax bill was enacted. We estimate the cost of the implied AMT adjustments in the Appendix.

The third tax issue relates to a series of temporary tax provisions, a number of which are scheduled to expire over the next decade.¹³ For all taxes other than excise taxes dedicated to trust funds, statutory rules require the baseline to project that legislated expirations occur as scheduled. In the past, however, these “temporary” provisions have typically been temporarily extended each time the expiration dates approached. Indeed, CBO (2002a, p. 63) notes that the extensions have become almost a “matter of course.” In light of this practice, current policy is more aptly viewed as including the continuance of these so-called “extenders.”

¹² EGTRRA included temporary AMT relief through 2004.

¹³ These include, for example, the research and experimentation tax credit, which is due to expire on June 30, 2004, the Work Opportunity Tax Credit, the Welfare-to-Work Tax Credit, and a variety of other items.

Table 3 shows the sizable effects of adjusting the surplus for retirement trust funds and current policy assumptions. Removing the accumulations in retirement trust funds changes the January 2002 projection for the budget between 2002 and 2011 from a surplus of \$1.6 trillion to a *deficit* of \$1.6 trillion. Adjusting the revenue baseline to make EGTRRA permanent, hold the number of AMT taxpayers at 2 percent, and extend the other expiring tax provisions increases the deficit to \$2.9 trillion if discretionary spending is held constant on a per-person basis, and to \$3.7 trillion if discretionary spending is a constant share of GDP. For the 2003-12 horizon, the baseline surplus is higher, but the adjustments are also more substantial, with the resulting deficit about the same.

The cost of keeping the number of AMT taxpayers at 2 percent is particularly noteworthy, as it has grown rapidly in recent years, and it expands rapidly over the decade. The total cost is \$820 billion between 2003 and 2012, including \$700 billion in lost revenue (Table 3), plus another \$120 billion in interest payments (Appendix Table 5). These estimates are explained in detail in the Appendix.

Figure 5 shows the budget adjustments on an annual basis. Under the official forecasts, the unified budget surplus dips early in the decade, but then rises to over \$600 billion by 2012. Our adjustments alter both the level and trend. Removing the retirement trust funds reduces the surplus by roughly \$300 billion per year. Adjusting the revenue figures as described above essentially makes the projection flat over time, at a deficit of over \$200 billion per year. Allowing real discretionary spending to grow with population or the economy causes the budget deficit to deteriorate over the decade. The contrast between the official and adjusted figures is thus significant. In the year 2012 alone, the difference is about \$1 trillion if real per-capita discretionary spending is constant and \$1.2 trillion if spending grows with GDP. Perhaps more

importantly, the trends are quite different: the CBO baseline suggests that the underlying fiscal status of the government will improve over the coming decade, whereas the adjusted baseline suggests precisely the opposite.

IV. The Long-Term Fiscal Gap

The adjusted budget measures in Table 3 and Figure 5 are easily comparable to existing official figures and provide a more accurate picture of the government's underlying financial status, but they ignore the long-term implications of current fiscal choices. As noted above, Social Security and Medicare face substantial deficits over the next 75 years (and beyond). In the context of an aging population and rapidly rising medical care costs, incorporating the future imbalances is necessary to obtain an accurate picture of the fiscal status of the government as a whole. One way to recognize these problems but still maintain cash-flow accounting is to extend the planning horizon to include the years when the liabilities come due.

To implement this approach, analysts have estimated the “fiscal gap”—the size of the long-run increase in taxes or reductions in non-interest expenditures (as a constant share of GDP) that would be required immediately to keep the long-run ratio of government debt to GDP at its current level.¹⁴ The fiscal gap measures the *current* budgetary status of the government, taking into account long-term influences.

To estimate the long-term gap, CBO uses the ten-year baseline budget discussed above to model the first decade (including the assumptions that discretionary spending is constant in real terms, and that EGTRRA, the AMT, and other temporary provisions expire as scheduled under current law). After the first decade, CBO assumes that taxes and discretionary spending remain

¹⁴ Over an infinite planning horizon, this requirement is equivalent to assuming that the debt-GDP ratio does not explode. See Auerbach (1994, 1997), Auerbach and Gale (1999, 2000, 2001), and Congressional Budget Office (2000).

constant as a share of GDP; Social Security and Medicare spending follow the intermediate projections of their respective trustee reports; and Medicaid grows according to predictions of how population and health care technology will change. Interest payments are determined endogenously by the pattern of debt accrual. For other details, see CBO (2000).

Under these assumptions and before EGTRRA was enacted, CBO (2000) projected a fiscal gap of 0.8 percent of GDP through 2070. Auerbach and Gale (2001), building on the CBO baseline and using slightly updated figures, projected a similar gap of about 0.7 percent. Despite the short-term surpluses then being forecast, a long-term fiscal gap existed because of the sharp projected rise in spending on Social Security, Medicare and Medicaid. The most recent CBO long-term analysis, based on the January 2002 budget forecast, projects that federal expenditures on these three programs will rise from about 9 percent of GDP in 2012 to 17 percent by 2040 and 25 percent by 2075, the last year of the long-term projection. No one expects these programs to be preserved in their current forms over the next seven decades; the projections imply that the three programs would absorb a larger share of GDP than all of the federal government does at present. But the projections indicate what will happen if action is not taken, thereby serving as a benchmark that indicates the size of the changes in spending and revenues that are needed.

The fiscal gap estimates are sensitive to assumptions about spending levels and time horizons. For example, Auerbach and Gale (2001) show that if discretionary spending remained a constant share of GDP starting in 2001, rather than 2011, the fiscal gap would be 1.45 percent of GDP through 2070. Estimates through 2070, furthermore, understate the longer-term problem because the budget is predicted to be in deficit in the years approaching and after 2070. The *permanent* fiscal gap was projected at between 3.3 and 4.1 percent of GDP, depending on assumptions about discretionary spending over the next decade (Auerbach and Gale 2001).

These estimates show the sensitivity of fiscal gap estimates to the time horizon and spending assumptions, but all of these estimates pre-date EGTRRA and the recent economic downturn. To incorporate these events, we provide new estimates of the fiscal gap in Table 4.

The first set of estimates uses CBO's March 2002 revenue and spending baseline figures for the next decade and the same longer-term assumptions as noted above. Under these assumptions, we estimate that the fiscal gap through 2075 is now 3.3 percent of GDP. This implies that an immediate increase in taxes or cut in spending of 3.3 percent of GDP—or over \$300 billion per year in current terms—would be needed to maintain fiscal balance through 2075. The fiscal gap is about 2.6 percentage points higher than the 0.7 percent of GDP gap estimated last year by Auerbach and Gale (2001). The change occurred largely because the projected ten-year surplus for 2002 to 2011 fell by \$4 trillion—or 3 percent of GDP (CBO 2002b, Table 5)—in the intervening year.¹⁵

The fiscal gap is sensitive to both the time horizon and the date when corrective actions commence. If the horizon is extended indefinitely, the fiscal gap rises dramatically, to 7 percent of GDP (Table 4). This occurs because the budget is projected to be substantially in deficit in years approaching and after 2075. Because the fiscal gap measures the size of the required *immediate* fiscal adjustment, the required adjustment rises if action is delayed. For example, if no actions were taken until 2012, the required adjustment rises to 8 percent of GDP. Thus, under the CBO baseline assumptions for revenue and spending, the fiscal gap varies between 3 and 8 percent, depending on the time horizon and when policy changes are implemented.

¹⁵ A secondary factor is that the projection now applies through 2075, rather than through 2070. Since the budget is projected to be running substantial deficits at the end of the projection period, the extension of the projection period tends to raise the projected imbalance. Through 2070, the baseline gap would be 2.91 percent.

The fiscal gap is also sensitive to changes in the revenue and spending assumptions underlying the CBO baseline. As shown in the first row of Table 4, using the CBO revenue assumptions but holding discretionary spending constant relative to GDP beginning in 2002 rather than in 2012 raises the fiscal gap by between 1.7 percent and 2.0 percent of GDP, depending on the time horizon and when policy changes begin.

Adjusting the revenue baseline has even larger effects. Under the adjusted revenue baseline, but still using the CBO spending baseline, the fiscal gap is significantly higher—5.35 percent of GDP through 2075, rather than 3.30 percent under the CBO baseline. Of this 2.05 percentage point change, 1.47 percentage points are due to the extension of EGTRRA, 0.40 percentage points are due to the costs of holding the number of AMT taxpayers at 2 percent, and the remaining 0.18 percentage points are due to the extension of other temporary provisions.¹⁶

Incorporating adjustments to both the spending and revenue baselines, which we regard as the most plausible scenario for defining current policy, the fiscal gap rises to 7 percent of GDP through 2075 and more than 11 percent of GDP on a permanent basis. If action is delayed for a decade, the permanent gap rises to 12.5 percent of GDP. These estimates imply that substantial increases in tax revenues or reductions in spending, relative to a realistic view of current policy, will be required to attain fiscal balance.

The most important caveat to the estimates above is that budget projections face considerable uncertainty (CBO 2002a). Longer-term estimates are sometimes even more uncertain than short-term estimates, but the uncertainty does not mean that the projections should be ignored. The serious consequences of a relatively bad long-term outcome should spur a precautionary response from policymakers now (Auerbach and Hassett 2001). In addition, the

¹⁶ The change in the fiscal gap due to extending the time horizon, or delaying corrective actions is roughly the same as under the CBO baseline.

longer-term budget problems are driven by demographic pressures that seem relatively likely to occur (CBO 2001b, Lee and Edwards 2001).

V. Alternative Policy Responses

The results above show that the nation's fiscal position is weak and has deteriorated substantially in the past year. The long-term imbalances imply either that taxes will have to rise and/or spending will have to fall in the future. The longer such changes are delayed, the more difficult and more extensive such changes will have to be.

One plausible way to reduce the fiscal gap is to reconsider the tax cut passed last year. A common justification for the tax cut was that it was affordable, since official surpluses were projected to be so high over the next decade. As noted above, the official figures are (and were) misleading. Nevertheless, even the official figures have shown substantial declines over the past decade. The adjusted figures are far bleaker and have declined even more. In short, whatever one thought about the affordability of the tax cuts last year, they are less affordable now.

One way to gauge the long-term effect of EGTRRA is to estimate the fiscal gap as if EGTRRA had never existed. Under the CBO baseline, the tax cut sunsets in 2010, so the effects of EGTRRA on the fiscal gap are relatively small—about 0.2 percent of GDP or less through 2075 (comparing the figures in the first two rows of table 4 to the figures in the next two rows). Under our adjusted baseline, however, the tax cut is permanent, and the share of AMT taxpayers is held to 2 percent. As a result, the tax cut has a much larger effect, expanding the fiscal gap by between 1.8 percent and 1.9 percent of GDP depending on the time horizon. These results refer to the fiscal gap under a counterfactual event—if EGTRRA had never existed—and are thus unrealistic. Nevertheless, the results serve to demonstrate two key points. First, there was a

fiscal gap even without EGTRRA—suggesting that the tax cut was not as affordable as it may have seemed to be. Second, EGTRRA substantially exacerbated the fiscal gap.

Rather than pretending that EGTRRA never existed, we focus on two ways to limit the tax cut. The first would simply let the tax cut expire as scheduled at the end of 2010. As noted above, this would reduce the fiscal gap by 1.47 percent of GDP through 2075, relative to a policy that made the tax cut permanent.

A second option would be to “freeze” the tax cut. This would involve allowing the tax cuts that have actually taken effect since EGTRRA was passed to remain in place and to be made permanent, but to repeal all of the cuts that are scheduled to take place in the future. Relative to our adjusted baseline—that is, relative to a permanent extension of EGTRRA—a freeze would reduce the fiscal gap by 0.7 percent of GDP through 2075, to 4.63 percent from 5.35 percent.

In either case—with the tax cut expiring or frozen—a sizable fiscal gap would still remain. Nevertheless, both policies would be clear steps toward fiscal responsibility. Interestingly, the estimated Social Security shortfall is 0.7 percent of GDP over the same period.¹⁷ That is, if the tax cut were frozen, the funds that were saved (relative to making the tax cut permanent) would be sufficient to eliminate the actuarial imbalance in Social Security through 2075. If the entire tax cut (including the components that have already taken effect) were allowed to expire in 2010, the resulting savings (relative to making the cut permanent) could pay for fixing the Social Security imbalance through 2075 plus much more.¹⁸

¹⁷See Board of Trustees, Federal Old Age and Survivors Insurance and Disability Insurance Trust Funds (2002, table VI.E5, p. 150) and Kogan, Greenstein and Orszag (2002).

¹⁸ We are not necessarily advocating using the revenue in this way. It is not clear that all the revenue saved by freezing the tax cuts should be devoted to Social Security, and even if it were, the Social Security system would still face substantial deficits beyond the 75-year window.

These policies can also be examined under the 10-year budget horizon.¹⁹ Between 2003 and 2012, a freeze would raise revenues by \$301 billion (0.2 percent of GDP) relative to the CBO baseline and \$741 billion (0.5 percent of GDP) relative to the adjusted baseline. Had EGTRRA never existed, revenues would be higher by \$1.2 trillion (0.8 percent of GDP) under the CBO baseline for 2003-2012. This figure assumes the tax cut sunsets in 2010. Under the adjusted baseline, if EGTRRA had not been enacted, revenues would have been higher by \$2.2 trillion (1.5 percent of GDP) from 2003 to 2012. This includes the direct revenue loss from EGTRRA as well as the added cost of keeping the number of AMT taxpayers at 2 percent.

It is also worth noting that an expiration or freeze would impose the costs of the government's fiscal imbalance on those who are most able to afford it—high-income households. The tax cut in general, and the tax cuts that are scheduled to take place in future years in particular, are disproportionately weighted toward higher-income households (Gale and Potter 2002).

VI. The Administration's Budget Proposals

A. Fiscal aggregates

Relative to the CBO's baseline, the Administration's budget proposals would reduce the projected unified budget surplus by \$1.7 trillion (1.2 percent of GDP) and leave a surplus of \$681 billion from 2003 to 2012 (Table 1).²⁰ The non-Social Security budget would be in deficit by \$1.8 trillion, and the budget other than Social Security and Medicare would face a deficit of

¹⁹ Over the next decade, revenues would be 19.4 percent of GDP under the CBO baseline and 18.5 percent of GDP under the adjusted baseline.

²⁰ For consistency with the results and analysis above, we use CBO's estimates of the costs of the Administration's proposals (CBO 2002b). The Administration's economic projections and budget estimates differ only slightly from CBO's re-estimates. The CBO analysis (and thus ours) ignores the Administration's proposal to alter the accounting of employees' pensions and annuitants' health benefits in a manner that affects the discretionary spending figures.

\$2.2 trillion. As Table 1 indicates, the Administration's proposals exacerbate an already difficult budget situation.

Figure 1 shows annual unified budget outcomes under the Administration's proposals. The unified budget shows significant deficits in 2003 and 2004. The budget returns to surplus in 2005 and grows slowly to a surplus of about \$200 billion by 2012. The difference between how the Administration's budget changes from 2011 to 2012 and the how the baseline changes is due to the fact that the Administration proposes making last year's tax cuts permanent. Figures 2 and 3 show that the budget other than Social Security and Medicare is significantly in deficit in every year for the next decade under the Administration's proposals.

Table 5 considers the longer-term implications of the Bush budget. The two columns in the table present estimates for two different budget horizons, through 2075 and permanent, and all numbers in the table are based on the assumption of no delay in the policy adjustment's start date. For reference, the first two lines of the table repeat those from the first two columns of Table 4, for the March 2002 CBO revenue baseline and our adjusted revenue baseline (both estimates use the CBO spending baseline).

The third line in Table 5 shows that the Bush budget, if enacted, would increase the fiscal gap by almost 1.8 percent of GDP relative to the CBO baseline, to 5.1 percent of GDP through 2075 and 9 percent on a permanent basis. Most of this increase (1.5 percent of GDP) is due to the proposal to make the 2001 tax cut permanent. The Administration's budget actually generates a smaller fiscal gap than our budget with an adjusted revenue baseline and CBO spending assumptions. Although both the Administration budget and our adjusted revenue baseline include removal of the sunsets that are scheduled to occur in 2010 under the 2001 tax

cut, the Administration's proposals provide no adjustment for the AMT, do not extend other provisions of the tax cut that expire before 2010, and allow several temporary provisions expire.

Adjusting the Bush budget in the same manner as was done in forming the adjusted revenue baseline—namely, assuming that the number of AMT taxpayers is held at 2 percent and that all of the expiring provisions are extended—permits a more meaningful comparison to current policy. The results, in the fourth line of Table 5, show, the Bush proposals, with the revenue baseline adjusted, would increase the fiscal gap by about 0.3 percent of GDP. But even these estimates understate the fiscal gap implicit in the Bush budget. As discussed below, this budget stipulates *declines* in real discretionary spending (other than defense and homeland security) over the ten-year budget period. If one instead adopts the assumption that discretionary spending other than defense and homeland security will remain constant as a share of GDP, the adjusted fiscal gaps are those given in the last line of Table 5. These resulting fiscal gaps, roughly 1 percent of GDP above the adjusted revenue baseline, are enormous—6.33 of GDP through 2075 and over 10 percent of GDP on a permanent basis.²¹

B. Spending and tax proposals

The Administration's budget for FY 2003 features significant increases in spending on defense and homeland security, reductions in other discretionary spending, increases in mandatory spending, and further tax cuts.

(i) *Increases in spending for defense and homeland security.* The budget would raise defense spending by \$483 billion—or 12 percent above the inflation-adjusted baseline—between 2003 and 2012. Spending would rise by 0.3 percent of GDP by 2006, and by 2012 would be

²¹ Although not shown in the table, under the Administration's budget as proposed or adjusted for current policy, the effects on the fiscal gap of delaying corrective action are about the same as those under the CBO baseline or our adjusted baselines.

roughly 0.4 percent of GDP higher than in the baseline (Table 6). Although increased defense spending is widely supported in response to the September 11th attacks, the size and composition of the proposed increase has raised concern (O’Hanlon 2002).

The proposed net increase in non-defense homeland security spending is \$2.1 billion for 2003 and \$35 billion over the next decade (assuming that non-defense homeland security spending grows at the same rate as defense spending from 2004 forward).²² Larger amounts are likely to be proposed and enacted as the Administration completes its homeland security strategy this summer. All told, the Administration’s defense and homeland security proposals will raise spending by \$518 billion over the next 10 years and require an additional \$128 billion in interest payments, for a total budgetary cost of \$646 billion (Table 6).

Given the bipartisan agreement for an aggressive war on terrorism, the key issue is who will pay for the costs of the effort. Increased security can be financed in any of three ways: lower spending, higher taxes, or higher budget deficits (which simply defer the spending reductions or tax increases to the future). It is impossible to know in advance who would bear these costs in each case. But, to the extent that spending cuts come at the expense of the beneficiaries of current spending, low- and middle-income households are likely to be worse off

²² After the terrorist attack, the administration defined a comprehensive homeland security (HS) budget, under which spending would have been \$19.5 billion in FY 2002 under the policies in place before September 11th (Office of Homeland Security 2002). After the hijackings, \$9.8 billion was added in a supplemental appropriation, for a total of \$29.3 billion in FY 2002. In the budget, the Administration proposes a total of \$37.7 billion in homeland security. Of this total, \$7.8 billion is within the Department of Defense (and included in the defense figures above) and \$4.7 billion would be financed by user fees or other offsetting collections. Thus, the proposed non-defense spending that is not offset by user fees amounts to \$25.2 billion for 2003 (\$37.7 billion minus \$12.5 billion). The comparable figure for 2002 is \$21.7 billion (\$19.5 billion in initial projected expenditures, plus \$9.8 billion in the supplemental, minus \$2.9 billion in user fees and \$4.7 billion in defense homeland security spending.) The 2002 figure inflated into 2003 dollars would be \$23.1 billion. The proposed \$25.2 billion thus represents an increase of \$2.1 billion above the constructed baseline. (This increase is in budget authority, not outlays. We ignore the distinction here.) Since the Administration did not specify its homeland security proposals for years after 2003, we assume that homeland security spending increases at the same rate as defense spending from 2004 forward.

(Steuerle 2001). If tax increases come in proportion to current tax payments, higher-income households would typically be more likely to pay for the costs.

The Administration proposes to finance the new defense and security programs by increasing deficits and cutting discretionary spending (other than on defense and homeland security). The budget not only seeks to avoid any new tax increases and fails to freeze the already scheduled future tax cuts, but actually adds to the financing problem by proposing new tax cuts.

The major cuts in the budget are in “other” discretionary spending—that is, discretionary spending other than defense and homeland security. By 2012, other discretionary spending would decline by 6.5 percent in inflation-adjusted terms, 15 percent on a real per-capita basis, and 26 percent relative to GDP (with spending in this category falling from 3.5 percent of GDP in 2002 to 2.6 percent in 2012). The budget does not identify which programs would be reduced in 2012, but the proposed cuts for 2003 target community and regional development, low-income energy assistance, environmental protection, job training and many other initiatives. Such programs often provide disproportionate support to low- and middle-income households. Although the percentage cuts in these programs are substantial, the aggregate savings relative to baseline is only \$223 billion in spending and \$278 billion when interest is included (Table 6).

(ii) New tax cuts. The Administration would cut taxes by \$746 billion between 2002 and 2012, including revenue reductions of \$666 billion and increases in refundable tax credits (which are reported in the budget as outlays) of \$80 billion. With the added interest payments due to higher federal debt, the total budgetary costs would be \$932 billion (Table 7).

We emphasize several features of the tax cuts. First, notwithstanding the flag-wrapped cover of the budget, the proposed tax cuts are larger than the proposed increase in spending on

defense and homeland security. Second, the budget proposes a variety of targeted tax provisions. These include a deduction for certain charitable contributions made by non-itemizing tax filers, a refundable tax credit for health insurance purchased by low-income earners not covered by an employer-provided health plan, an expanded deduction for long-term care insurance, an above-the-line deduction for teachers who purchase classroom materials, and several others. These new tax incentives may be motivated by worthy concerns, but they further complicate the tax system and are often poorly designed to achieve their objectives.²³ Furthermore, their budgetary costs are in some instances obscured by slow phase-ins and artificial phase-outs.

It is worth stepping back from these specific provisions, though, to contemplate the overall message of the combined spending and tax proposals. In the aftermath of last year's tax cut and the massive deterioration of the government's financial status, the Administration proposes to finance a war on terrorism by cutting social programs and raising borrowing from young and future generations that were already saddled with substantial fiscal burdens. It then proposes further to make the required program cuts and borrowing larger by implementing further tax cuts. What could justify this constellation of proposals? Boosting the economy out of recession is not the reason, for adopting the President's stimulus plan does not require permanent extension of EGTRRA beyond 2010.

The Administration invokes history to justify its approach (OMB 2002), but its analogies are flawed. While claiming it wishes to avoid the "guns and butter" approach of the 1960s (when President Johnson expanded war and domestic spending at the same time), the Administration is instead proposing a "guns and caviar" approach: increasing defense spending while sustaining *lower* taxes for high-income households. The Administration also claims that

²³ Friedman and Greenstein (2002) examine the proposed charitable deduction. Gruber (2001) examines tax subsidies for health insurance.

Franklin D. Roosevelt cut non-war-related spending to help finance World War II, but spending cuts played only a small part in financing the war. President Roosevelt also tripled the level of taxes, a move that President Bush is unlikely to suggest.

The most telling comparison may be with President Reagan. Like the current Administration, President Reagan dramatically cut taxes and raised defense spending upon entering office in 1981. But unlike the Bush Administration to date, Reagan also assented to adjustments to his tax cut when the situation demanded it. He agreed to a significant tax increase in 1982, after it became clear that, contrary to initial claims, the earlier changes would decimate the budget. Unfortunately, even with those modifications, the net result was huge budget deficits throughout the 1980s.

The Administration's focus on new tax cuts forces it to ignore real tax problems that the nation should address. The Administration acknowledges that 39 million (34 percent of) taxpayers will be ensnared in the complexities of the AMT by 2012 (OMB 2002, p. 77), but offers no proposals to resolve this problem and in fact makes the problem worse by proposing to make the tax cut permanent. Failing to address the looming AMT problem is politically convenient since the revenue and interest cost of holding the share of AMT taxpayers at 2 percent is roughly \$820 billion over the next decade (Appendix Table 5). In addition, not fixing the AMT artificially reduces the official cost of the tax provisions proposed for 2011 and 2012 (because the failure to change the AMT means that many taxpayers would not benefit from the proposed tax provisions).

Nor does the Administration attempt to simplify taxes. Although the Administration pays lip service to simplification proposals, its own tax cut last year made taxes more complex (Gale and Potter 2002). Moreover, the new proposals outlined above and others in the budget would

complicate taxes further. Leaving one-third of all taxpayers on the AMT adds significant complexity, too.

Finally, the budget omits the Administration's own proposals for Social Security reform. The President's Commission to Strengthen Social Security (2001) recently outlined three reform plans. Analysis by the Office of the Chief Actuary at the Social Security Administration indicates that any of the three plans reduce the unified budget surplus by more than \$1 trillion over the next decade, assuming all eligible participants choose to contribute to individual accounts (Goss and Wade 2002). Such costs would put the Administration's unified budget into deficit. To be sure, two of the plans would restore long-term solvency to Social Security and thereby provide longer run fiscal benefits. But their short-run impact underscores another cost of the substantial tax cuts passed last year and proposed in the current budget: by dramatically reducing the unified budget surplus and eliminating the non-Social Security surplus over the next several years, the tax cuts impede the political viability of Social Security reform.²⁴

C. Budget process proposals

The Administration's budget also puts forward a variety of ideas regarding budget rules and process.

(i) Budget horizon. The budget documents place primary emphasis on five-year budget totals, noting that "the 2003 Budget parts ways with Washington's six year experiment with 10 year forecasting. Previous budgets' attempts to look out a decade in the future have varied wildly from year to year. But 2001 showed finally how unreliable and ultimately futile such estimates are" (OMB 2001).

²⁴ Permanent extension of the tax cuts would also directly reduce the revenue credited to the Social Security and Medicare trust funds through the income taxation of Social Security benefits. If EGTRRA were permanently extended, the 75-year deficit in Social Security would rise from 1.87 percent of taxable payroll to approximately

Although ten-year budget forecasts are indeed uncertain, the Administration's shift to five-year figures is problematic for several reasons. First, the President justified his tax cut last year on the basis of a ten-year budget horizon. As the President stated in February 2001:

Many of you have talked about the need to pay down our national debt. I listened, and I agree. We owe it to our children and grandchildren to act now, and I hope you will join me to pay down \$2 trillion in debt during the next 10 years. At the end of those 10 years, we will have paid down all the debt that is available to retire...We should also prepare for the unexpected, for the uncertainties of the future...And so, my budget sets aside almost a trillion dollars over 10 years for additional needs. That is one trillion additional reasons you can feel comfortable supporting this budget...And we still have money left over...I hope you will join me in standing firmly on the side of the people. You see, the growing surplus exists because taxes are too high and government is charging more than it needs. The people of America have been overcharged and, on their behalf, I am here asking for a refund. (Bush 2001)

If the Administration now believes that such a basis is inappropriate, it undercuts its own arguments for the tax cut. Second, the Administration this year proposes important new proposals that take place beyond the five-year horizon—as highlighted above by the proposal to eliminate the 2010 sunset in EGTRRA and the \$1.2 trillion reduction in surplus in the second five years of the decade. If the ten-year budget outlook is so uncertain as to undermine the benefits of presenting ten-year numbers, it is unclear why it is certain enough to facilitate policy proposals. Policy-makers should link budgeting choices to the budget horizon, rather than presenting budget figures for one horizon and then proposing items that have substantial revenue or outlay implications that take effect outside that horizon.

Third, suggesting that events taking place over the next 10 years are too uncertain to be used for policy forecasts implies that one should ignore the looming financing problems in Social Security and Medicare. But the Administration argues that Social Security is in crisis because of

1.93 percent. See Orszag (2002).

events that are not expected to take place for several decades (Council of Economic Advisers, 2002, pages 86-92).

Fourth, about 60 percent of the deterioration in the ten-year budget outlook between January 2001 and January 2002 was due to legislative changes, principally EGTRRA, and the associated debt service costs (CBO 2002a, Table 1-3). It is therefore disingenuous to argue that the decline in the 10-year surplus highlights the inherent uncertainty in medium-term projections, when most of the shift reflects the Administration's own policies (which were, in turn, justified in part by the ten-year budget projections last year). And if volatility by itself undermines the validity of a budget horizon, it is unclear why the one-year or five-year windows are appropriate either. After all, between January 2001 and January 2002, the non-legislative deterioration in the projected one-year surplus (for 2002) amounted to 77 percent of the surplus projected in January 2001, the non-legislative deterioration in the projected five-year surplus was 44 percent of the figure projected in January 2001; the non-legislative deterioration in the ten-year surplus was just 28 percent of the surplus projected in January 2001 (CBO 2002a, table 1-3). Non-legislative factors thus moved the surplus projections by relatively more at shorter horizons than at longer horizons. It is difficult to see why the 2001 experience should lead one to place more emphasis on the one-year or five-year budget figures.

(ii) Budget process. The Administration also put forward a variety of other budget process proposals, including changing the current status of the Congressional budget resolution to make it law, which would require the President's signature. The Administration also proposed discretionary spending caps that would reflect the budget's proposed discretionary spending levels for years after 2003. But as noted above, those spending levels represent significant

reductions on a real per-capita basis. The Administration has indicated no enthusiasm for budget rules that limit tax cuts.

The Administration's budget reform suggestions thus appear dubious, inconsistent with the views espoused last year to justify tax cuts, and aimed primarily at facilitating the chosen policies of the Administration rather than improving the budget process. Since many of the budget enforcement rules will expire at the end of September, these issues demand increased attention from analysts and policy makers.

VII. Conclusion

Over the past twelve months, the nation's fiscal outlook has deteriorated substantially according to official budget forecasts. In addition, adjusted figures that provide more realistic and economically appropriate measures of available funds and financial status suggest a far less optimistic picture. The sizable fiscal gaps estimated above imply that tax cuts are not simply a matter of returning unneeded or unused funds to taxpayers, but rather a choice to require other, future taxpayers to cover a substantial long-term deficit that last year's tax cut significantly exacerbates. Likewise, the notion that the surplus is "the taxpayers' money" and should be returned to them omits the observation that the fiscal gap is "the taxpayers' debt" and should be paid by them. Thus, the issue is not whether taxpayers should have their tax payments returned, but rather which taxpayers—current or future—will be required to pay for the liabilities and spending obligations incurred by current and past taxpayers.

Faced with the massive deterioration in the fiscal situation and the need to defend the country after the terrorist attacks, the Administration has understandably raised current spending on homeland security and defense and sought to further this policy through its budget proposals. But the Administration offers no realistic program for financing this spending increase, instead

worsening the problem through further proposed tax cuts. As outlined above, a tax cut freeze would be one option for taking a major step toward fiscal responsibility.

In addition to addressing the fiscal imbalance via tax and spending corrections, Congress and the Administration will need to revisit budget process and rules in the near future. Although the current budget rules have many evident defects, they likely contributed to the successful fiscal discipline of the 1990s. Abandoning them without an adequate replacement would be a mistake, as would reducing the budget horizon to 5 years, especially when politicians consistently propose tax cuts that do not take place until beyond that time frame. With a long-term budget gap that reveals itself fully only over an extended period of time, it is hard to imagine a more inappropriate budget “reform” than shortening the time horizon.

APPENDIX

In this appendix, we estimate the cost of reducing the AMT so as to keep the share of AMT taxpayers at 2 percent.²⁵ We divide the overall cost of this change into two parts: the cost of reducing the number of AMT taxpayers (a) from post-EGTRRA law levels to pre-EGTRRA law levels, and (b) from pre-EGTRRA law levels to 2 percent.

Our method can be summarized in a straightforward manner. First, to obtain the overall revenue costs of reducing the number of AMT taxpayers to 2 percent, we interpolate, based on figures in Tempalski (2001). Tempalski reports the cost of abolishing the AMT (R1), the cost of indexing the AMT (R2), and the percent of taxpayers on the AMT in the case of indexing (x). Using these figures, the revenue cost of reducing the number of AMT taxpayers to y percent can be interpolated as:

$$R3 = R2 + (R1-R2) (x-y)/x.$$

We set y=2. Second, to obtain the cost of reducing the number of AMT taxpayers from pre-EGTRRA to post-EGTRRA levels, we use JCT (2001) and CBO (2002a) figures for the revenue costs of changes to the AMT that would achieve that goal. Third, to obtain the cost of reducing the number of AMT taxpayers from pre-EGTRRA law levels to 2 percent, we simply subtract the numbers obtained in the second step from those obtained in the first step. Finally, we attribute interest costs to each of the revenue figures, using CBO's interest rate matrix. These calculations are shown in detail in Appendix Table 5.

²⁵ The share of AMT taxpayers could also be held at 2 percent by raising the regular income tax (see Burman, Gale and Rohaly, forthcoming).

Table 1

Changing Budget Projections
(Surplus or Deficit in Billions of Current Dollars)

<u>Projection Date</u>	<u>Projection Horizon</u>	<u>Unified Budget</u>	<u>Non-Social Security Budget</u>	<u>Non-Social Security, Non-Medicare Budget</u>
<u>10-Year Baseline</u>				
January 2001 ¹	2002-11	5,610	3,119	2,727
August 2001 ²	2002-11	3,397	846	442
January 2002 ³	2002-11	1,602	-744	-1,126
January 2002 ⁴	2003-12	2,263	-242	-632
March 2002 ⁵	2003-12	2,380	-125	-515
March 2002 Administration ⁵	2003-12	681	-1,824	-2,214
<u>5-Year Baseline</u>				
January 2001 ¹	2002-06	2,007	986	786
August 2001 ²	2002-06	1,082	46	-162
January 2002 ³	2002-06	250	-725	-912
January 2002 ⁴	2003-07	437	-617	-812
March 2002 ⁵	2003-07	489	-565	-760
March 2002 Administration ⁵	2003-07	-33	-1,087	-1,282

¹Congressional Budget Office. "The Budget and Economic Outlook: Fiscal Years 2002-2011." Tables 1-1 and 1-7.

²Congressional Budget Office. "The Budget and Economic Outlook: An Update." Tables 1-1 and 1-9.

³Congressional Budget Office. "The Budget and Economic Outlook: Fiscal Years 2003-2012." Summary Table 1, Tables 1-1 and 1-6.

⁴Congressional Budget Office. "The Budget and Economic Outlook: Fiscal Years 2003-2012." Tables 1-1 and 1-6.

⁵Unified budget numbers are from Congressional Budget Office. "An Analysis of the President's Budgetary Proposals for 2003." Testimony of Dan L. Crippen before the U.S. Senate Budget Committee. Washington, DC: March 6, 2002. Table 1. Social security and Medicare numbers are from Congressional Budget Office. "The Budget and Economic Outlook: Fiscal Years 2003-2012." Table 1-6.

Table 2

**Sources of Change in the Unified Budget Baseline, 2002-2011
January 2001, August 2001, and January 2002¹**

	January-August 2001 ²		August 2001-January 2002 ³		January 2001-January 2002 ⁴	
	(\$ billions)	(percent of change)	(\$ billions)	(percent of change)	(\$ billions)	(percent of change)
Legislative Changes						
EGTRRA						
Revenue Provisions	-1,187	53.6	0	0.0	-1,187	29.6
Outlays	-88	4.0	0	0.0	-88	2.2
Debt service	-383	17.3	0	0.0	-383	9.6
Subtotal	-1,658	74.9	0	0.0	-1,658	41.4
Other Revenue Changes						
Revenue	0	0.0	-19	1.1	-19	0.5
Debt service	0	0.0	-6	0.3	-6	0.1
Subtotal	0	0.0	-25	1.4	-25	0.6
Other Outlays						
Outlays	-83	3.8	-481	26.8	-564	14.1
Debt service	-33	1.5	-144	8.0	-177	4.4
Subtotal	-116	5.3	-625	34.8	-741	18.5
Economic Changes	-283	12.8	-645	35.9	-929	23.2
Technical Changes	-158	7.1	-501	27.9	-660	16.5
Total Change in Surplus	-2,213	100.0	-1,795	100.0	-4,008	100.0

¹Columns may not sum to total due to rounding.

²Congressional Budget Office. "An Analysis of the President's Budgetary Proposals for Fiscal Year 2002." May 2001.; Congressional Budget Office. "The Budget and Economic Outlook: An Update." August 2001.

³Congressional Budget Office. "The Budget and Economic Outlook: Fiscal Years 2003-2012." January 2002.

⁴See Appendix Table 4.

Table 3

Baseline and Adjusted Budget Outcomes for 2001-2012
(Surplus or Deficit in \$ Billions)¹

Projection Date	January 2001 ²			January 2002 ³			January 2002 ³		
	<u>02-06</u>	<u>07-11</u>	<u>02-11</u>	<u>02-06</u>	<u>07-11</u>	<u>02-11</u>	<u>03-07</u>	<u>08-12</u>	<u>03-12</u>
Projection Horizon									
CBO Baseline	2,007	3,603	5,610	250	1,351	1,601	437	1,826	2,263
-Adjustment for Retirement Funds									
Social Security	1,021	1,470	2,491	975	1,371	2,346	1,054	1,451	2,505
Medicare	200	192	392	187	195	382	195	195	390
Government Pensions	198	221	419	218	247	465	223	253	476
=Surplus or deficit, adjusted for retirement funds	588	1,720	2,308	-1,130	-462	-1,592	-1,035	-73	-1,108
-Adjustment for current policy									
Repeal sunset provisions	---	---	---	9	160	169	15	387	402
Reduce AMT taxpayers to pre-EGTRRA law levels	---	---	---	20	225	245	47	273	320
Reduce AMT taxpayers from pre-EGTRRA law to 2 percent	18	96	113	45	255	300	76	301	377
Extend expiring provisions	20	50	69	24	83	107	34	108	142
Hold real discretionary spending/person constant	95	284	379	69	266	335	105	311	416
Interest	13	97	110	12	165	177	25	238	263
=Surplus or deficit, adjusted for retirement funds and current policy with real DS/person constant	443	1,193	1,636	-1,309	-1,615	-2,924	-1,337	-1,691	-3,028
-Further adjustment if discretionary spending/GDP constant									
Outlays	94	433	527	104	519	623	170	620	790
Interest	7	83	90	8	98	105	15	134	149
=Surplus or deficit, adjusted for retirement funds and current policy, with DS/GDP constant	342	677	1,020	-1,421	-2,232	-3,653	-1,523	-2,445	-3,968

¹Due to rounding, columns may not sum to total.

²Source and notes: see Appendix Table 3.

³Source and notes: see Appendix Table 4.

Table 4

**Estimates of the Fiscal Gap
(As Percent of GDP)**

<u>Forecast Horizon</u>	<u>Revenue Assumption, 2003-12</u>	<u>Start Date</u>	<u>Spending Assumption, 2003-12</u>			
			<u>CBO¹</u>	<u>Permanent</u>	<u>Adjusted²</u>	<u>Permanent</u>
			<u>2002-2075</u>	<u>Permanent</u>	<u>2002-2075</u>	<u>Permanent</u>
	CBO ³	2002	3.30	7.10	5.01	8.88
		2012		8.05		10.07
	No EGTRRA	2002	3.13	6.99	4.83	8.77
		2012		7.92		9.94
	Freeze	2002	3.27	7.08	4.97	8.86
		2012		8.02		10.04
	Adjusted ⁴	2002	5.35	9.29	7.06	11.07
		2012		10.53		12.56
	No EGTRRA	2002	3.49	7.38	5.20	9.16
		2012		8.36		10.38
	Freeze	2002	4.63	8.54	6.33	10.32
		2012		9.68		11.70

Source: Authors' calculations.

¹The CBO spending baseline holds discretionary spending authority constant in real terms from 2003 to 2012 at the level prevailing in 2002.

²The adjusted spending baseline holds discretionary spending outlays constant as a share of GDP from 2003 to 2012 at the level prevailing in 2002.

³The CBO revenue baseline assumes current law: EGTRRA sunsets as legislated, other temporary tax provisions expire as scheduled, and no AMT adjustments are made.

⁴The adjusted revenue baseline assumes that the phaseout and sunset provisions of EGTRRA are repealed, other temporary tax provisions are made permanent, and the share of taxpayers facing the AMT is held constant at 2 percent, the level prevailing in 2001.

Table 5

**Estimates of the Fiscal Gap
(As Percent of GDP)**

<u>Forecast Horizon</u>	<u>2002-2075</u>	<u>Permanent</u>
CBO Baseline	3.30	7.10
Adjusted Revenue Baseline	5.35	9.29
Bush budget	5.08	8.97
Bush budget with Adjusted Revenue Baseline	5.64	9.57
Bush budget with adjusted revenue baseline and “other” discretionary spending constant relative to GDP, 2003-2012 ¹	6.33	10.30

Source: Authors’ calculations.

¹“Other” discretionary spending includes all discretionary spending except spending for defense and homeland security.

Table 6

**Effects of Administration's Proposals on the Budget Surplus, 2003-2012
(\$ Billions)**

	<u>Direct outlay or revenue effect</u>	<u>Change in interest payments⁴</u>	<u>Total</u>
All proposals	-1333	-366	-1699
Defense spending and homeland security ¹	-518	-128	-646
Other discretionary spending	223	55	278
Mandatory spending ^{2,3}	-356	-110	-466
Tax cuts ³	-682	-183	-865

Source: Congressional Budget Office. "An Analysis of the President's Budgetary Proposals for 2003." Testimony of Dan L. Crippen before the U.S. Senate Budget Committee. Washington, DC: March 6, 2002. Table 11.

¹Assumes that homeland security spending grows at the same rate as defense spending in fiscal year 2004 and thereafter, and equates budget authority and outlays.

²Accruals not included.

³Refundable tax credits that are reported in the budget as mandatory spending are included in this table as tax cuts.

⁴Authors' calculations.

Table 7**Costs of the Administration's Tax Cut Proposals, 2002-2012
(\$ Billions)**

<u>Provision</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2002-12¹</u>
Extension of provisions expiring in 2010 ¹	0	-1	-1	-2	-2	-3	-3	-3	-4	-125	-229	-373
Economic stimulus	-62	-65	-48	-10	17	18	15	12	9	6	3	-106
Extension of research and experimentation tax credit	0	0	-1	-4	-5	-6	-7	-7	-8	-8	-9	-54
Charitable deductions for non-itemizers	*	-1	-1	-2	-3	-3	-3	-3	-3	-4	-5	-29
Health care tax credit	0	*	-2	-3	-3	-3	-3	-3	-4	-4	-4	-29
Enhanced deduction for long-term care insurance	0	0	*	-1	-1	-2	-3	-3	-3	-4	-4	-20
Other revenue provisions	-2	-5	-7	-7	-8	-10	-8	-7	-7	-7	-6	-75
Health care tax credit	0	-1	-5	-6	-7	-6	-7	-7	-7	-7	-7	-60
Total revenue loss ²	-64	-74	-64	-33	-13	-14	-19	-23	-28	-153	-260	-746
Additional interest payments	-1	-4	-9	-12	-14	-16	-18	-20	-22	-29	-41	-186
Total costs ²	-65	-78	-73	-45	-27	-30	-37	-43	-50	-182	-301	-932

Source: Congressional Budget Office. "An Analysis of the President's Budgetary Proposals for 2003." Testimony of Dan L. Crippen before the U.S. Senate Budget Committee. Washington, DC: March 6, 2002. Table 11.

*Less than \$500 million.

¹Includes the extension of refundable tax credits, which are scored as increases in outlays, rather than revenue reductions.

²Rows and columns may not sum to total due to rounding.

Figure 1
Changing Unified Budget Projections

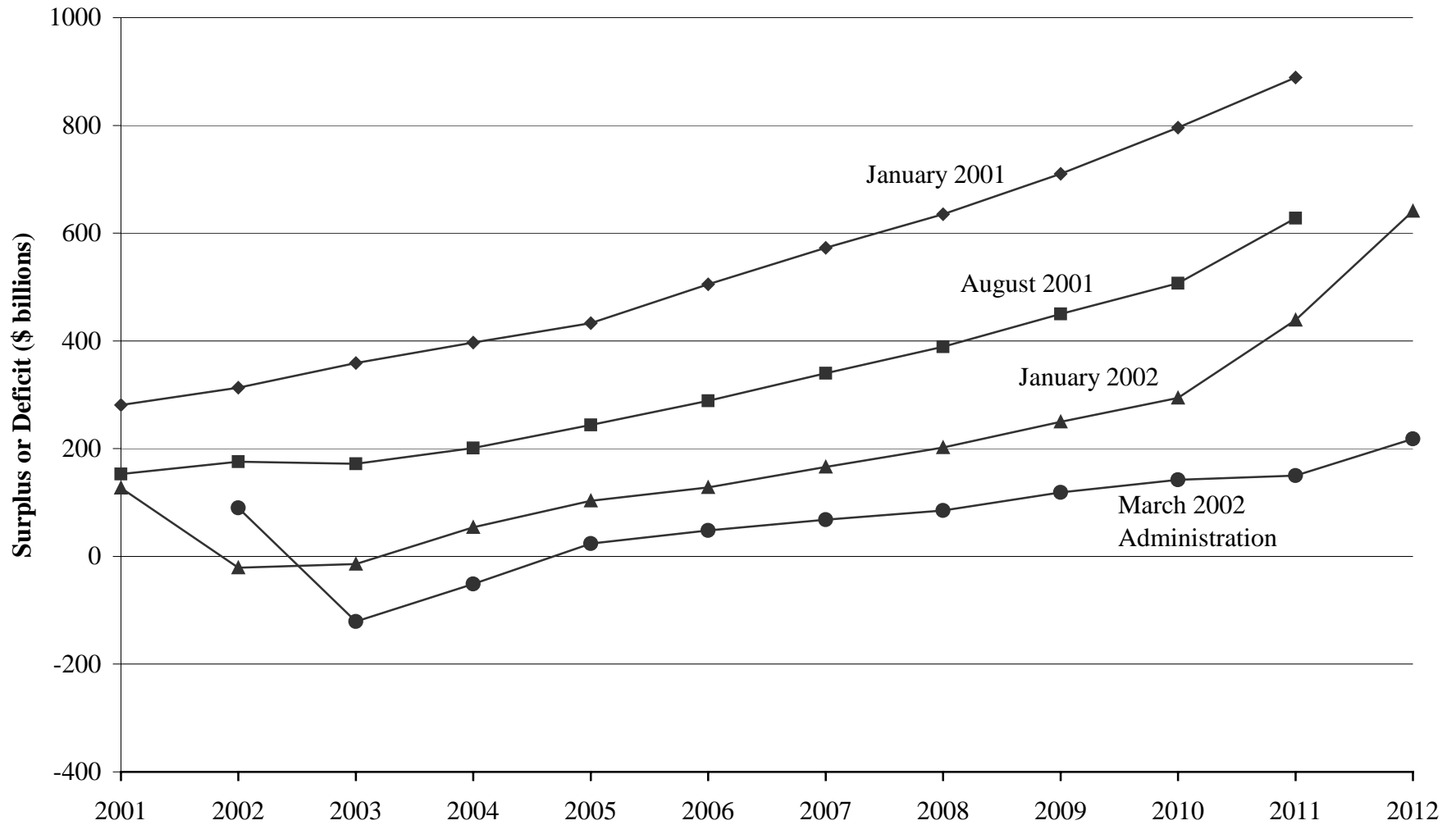


Figure 2
Changing Non-Social Security Budget Projections

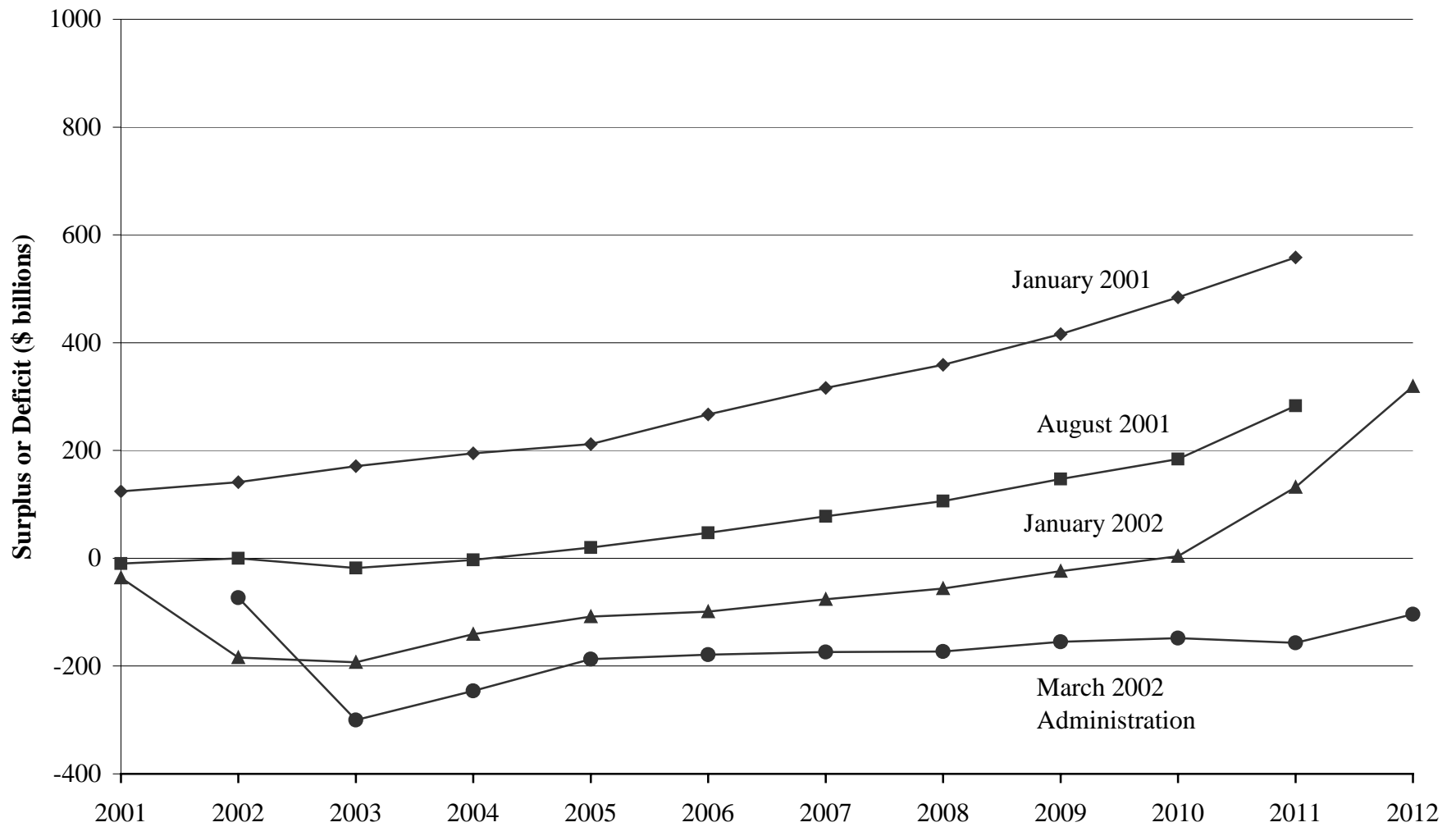


Figure 3
Changing Non-Social Security, Non-Medicare Budget Projections

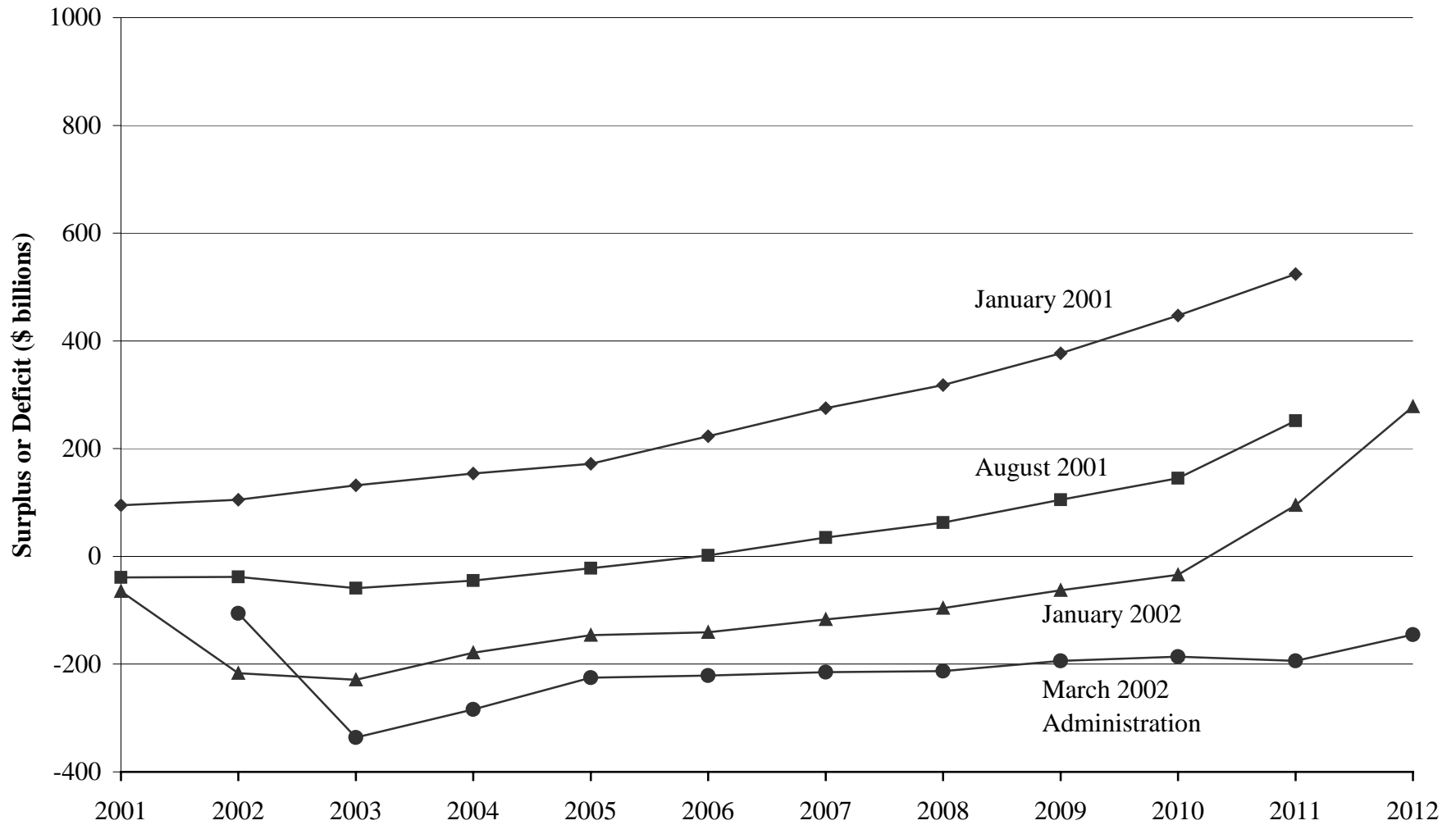


Figure 4
Sources of Change in the Unified Budget Baseline from January 2001 to January 2002

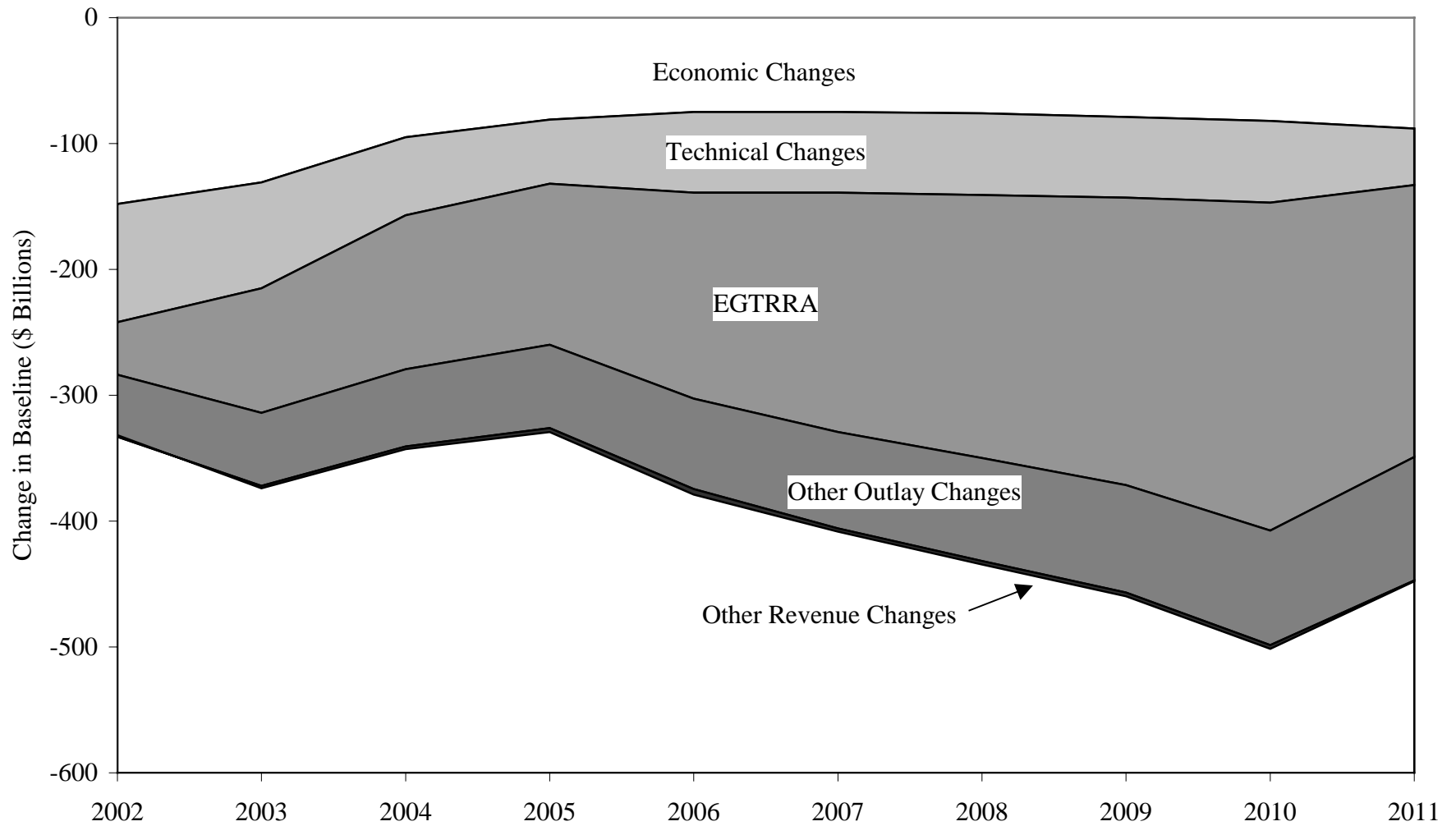


Figure 5
Baseline and Adjusted Budget Outcomes, 2001-2012

