



tax break

by William G. Gale and Peter R. Orszag

The Real Fiscal Danger

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I. Introduction

The Bush administration's budget includes a chapter entitled "The Real Fiscal Danger," which highlights the projected imbalances in Social Security and Medicare. Ironically, the budget does not include any specific steps to eliminate or even reduce those imbalances. It does, however, propose substantial tax cuts that exacerbate the long-term budget deficits it so vividly displays. Especially since the tax cuts divert revenue that could have instead been used to grease the wheels of Social Security or Medicare reforms, the administration's attitude that tax cuts are the solution to every social and economic problem is itself a significant contributor to the real fiscal danger.

The administration's dogmatic stance on long-term tax cuts regardless of circumstances is at odds with history. Over the past 20 years, when projections of budget deficits grew significantly, policymakers often responded in a fiscally responsible manner, legislating combinations of tax increases, spending cuts, and stringent budget rules. In 2001, official projections of ever-growing surpluses generated bipartisan support for tax cuts. Currently, however, despite projections of increasing and substantial short- and long-term budget deficits, the Bush administration has proposed tax cuts that are large, permanent, and regressive. In economic terms, this strategy represents a substantial fiscal gamble.

A key question is the likelihood that this policy would succeed if it were implemented. For current purposes, we define success to mean that the policy at least (a) restores economic growth; (b) does not increase burdens placed on future generations; and (c) is at worst distributionally neutral. President Bush has

enunciated similar goals. In the 2003 State of the Union address, the president said that "lower taxes and greater investment will help this economy expand. . . . The best way to address the deficit and move toward a balanced budget is to encourage economic growth." He also emphasized that ". . . we will not pass along our problems to other Congresses, to other presidents, and other generations." In 1999, as a presidential candidate, then-Governor Bush criticized congressional Republicans for attempting to "balance their budget on the backs of the poor."¹ The combination of these statements suggests that by the president's own standards, the administration's budget strategy would be a success only if it generated significant economic growth and significant spending restraint, and the effects on lower- and middle-income households were neutral at worst.

This is the second in a series of columns that addresses this budget strategy. In Gale and Orszag (2003), we provide estimates of the budget outlook under the administration's proposals. Future columns will address the effects of the tax cuts on growth, spending levels, and distributional issues. In this column, we provide perspectives on the magnitude of the proposed tax cuts and the severity of the underlying budget situation.

Our principal conclusions include:

- The good news is that under the administration's proposals, the budget deficits and debt held by the public projected for the next 10 years (and scaled by GDP) would be well within the range experienced during the past 40 years. The bad news is that these comparisons are not particularly relevant or informative, for several reasons.
- Most importantly, the official debt and deficit figures ignore the looming problems in Social Security and Medicare. The liabilities of these programs represent implicit federal debt. The administration itself not only refers to Social Security and Medicare as "the real fiscal danger" (OMB 2003a, page 31); it also points out that current "long-run budget projections show clearly that the budget is on an unsustainable path" (OMB 2003b, page 40). In light of the mag-

¹Tom DeLay responded by saying that Bush ". . . obviously doesn't understand how Congress works." Weiner (1999). See Bush (2003) for the first two quotations in the text, and Weiner (1999) and Fournier (1999) for the third.

Table 1: Net Long-Term Cost of Reagan Tax Cuts	
	Percentage of GDP
ERTA 1981	5.6%
Minus: 40 percent adjustment for impact of inflation on baseline	-2.2%
Equals: ERTA cost against indexed baseline	3.4%
Minus: TEFRA 1982 increase	-1.2%
Equals: Net cost of Reagan tax cuts (as % of GDP)	2.1%
Note: Bush administration tax proposals	2.3%-2.7%
<i>Note: See Orszag (2001a) for further details.</i>	

nitude and increasing imminence of these problems, the nation needs to be preparing for the resulting fiscal pressures. As noted, however, rather than trying to shore up revenues, the administration's strategy is to cut taxes. The administration's proposals would reduce federal revenues in 2004 to 16.9 percent of GDP, the lowest share since 1959. Over the 2004-13 decade, the administration's tax cuts (combined with an AMT reform and with extension of the expiring tax provisions) would reduce revenues to 17.5 percent of GDP, lower than any decade since the 1950s. In the absence of the 2001 and proposed 2003 tax cuts, the administration's budget would run unified surpluses in the latter half of the decade.

- Even more strikingly, the administration's revenue proposals (assuming some AMT reform) would reduce long-term revenues by 2.3 percent to 2.7 percent of GDP over the next 75 years. That is more than three times the actuarial deficit in Social Security over the same period, and significantly larger than the combined actuarial deficits in Social Security and Medicare's Hospital Insurance program, over the same period. On a permanent basis, the tax cuts are substantially larger than the deficit in Social Security. By these measures, the administration's tax cuts deserve at least equal billing on the list of policies accounting for "the real fiscal danger."
- Against comparable baselines, the proposed tax cuts would roughly equal the net size of the Reagan tax cuts as a share of the economy. The nation, however, was much better prepared to deal with large tax cuts and fiscal deficits in the 1980s and early 1990s than it is now. The retirement of the baby boomers is 20 years closer now, giving the budget little time to recover before the fiscal pressures begin in earnest. Private saving was higher in the early 1980s than it is now, and the United States was an international creditor then. Marginal tax rates were also much higher in 1980, raising the economic benefit of marginal tax rate cuts relative to today. Finally, the nation was willing and able to respond to the 1981 tax cut by raising taxes in 1982, 1984, 1990, and 1993 and by restraining discretionary spending in the 1990s. Currently, however, the

administration shows no interest in considering corrective tax measures, and it is doubtful that the spending cuts that would be needed to finance the proposed tax cuts will emerge, especially since defense and mandatory spending are slated to increase as a percentage of GDP.

Section II briefly summarizes the administration's proposals and presents comparisons of historical and projected budget outcomes. Section III examines the administration's proposals relative to the long-term financing gap in government in general, and Social Security in particular. Section IV examines the administration's proposals relative to the experience in the 1980s and 1990s.

II. The Administration's Proposals

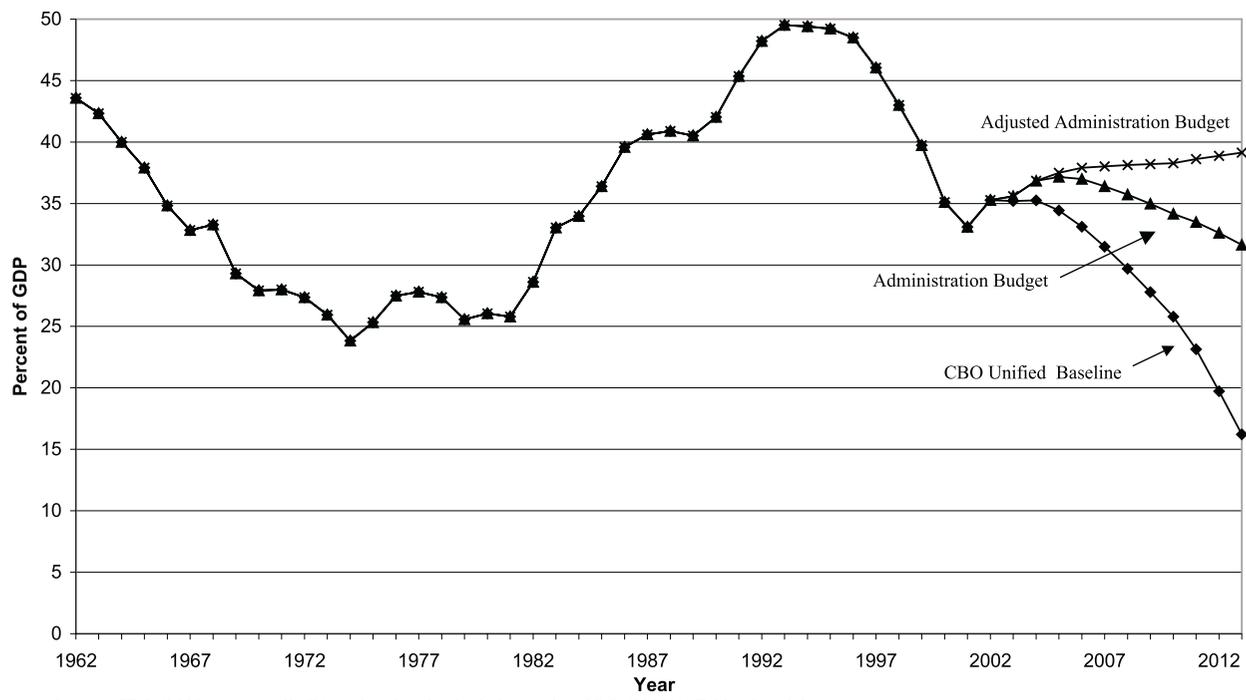
CBO (2003b) estimates that the administration's budget proposals would cost \$2.7 trillion over the next 10 years relative to the CBO baseline, and would generate unified budget deficits in every year for the next decade and an aggregate unified deficit of \$1.8 trillion over that time.² The shortfalls would represent 3 percent of GDP in 2004, decline to 0.6 percent by 2013, and average 1.4 percent of GDP over the whole period. By the administration's own estimates (OMB 2003b), the budget faces sharply increasing deficits after 2013.

The administration proposes tax cuts of \$1.6 trillion, which would reduce the surplus by \$2 trillion when the additional required interest payments on publicly held debt are included. The major provisions include making the 2001 tax cut permanent (it is currently scheduled to expire in 2010), excluding corporate dividends from double taxation, and accelerating the phase-in of certain features of the 2001 tax cut. The revenue loss would be \$39 billion in 2003 and roughly \$100 billion per year from 2004 to 2010. Revenue losses rise sharply after 2010, with the proposed extension of the 2001 tax cut, and reach almost \$340 billion (1.9

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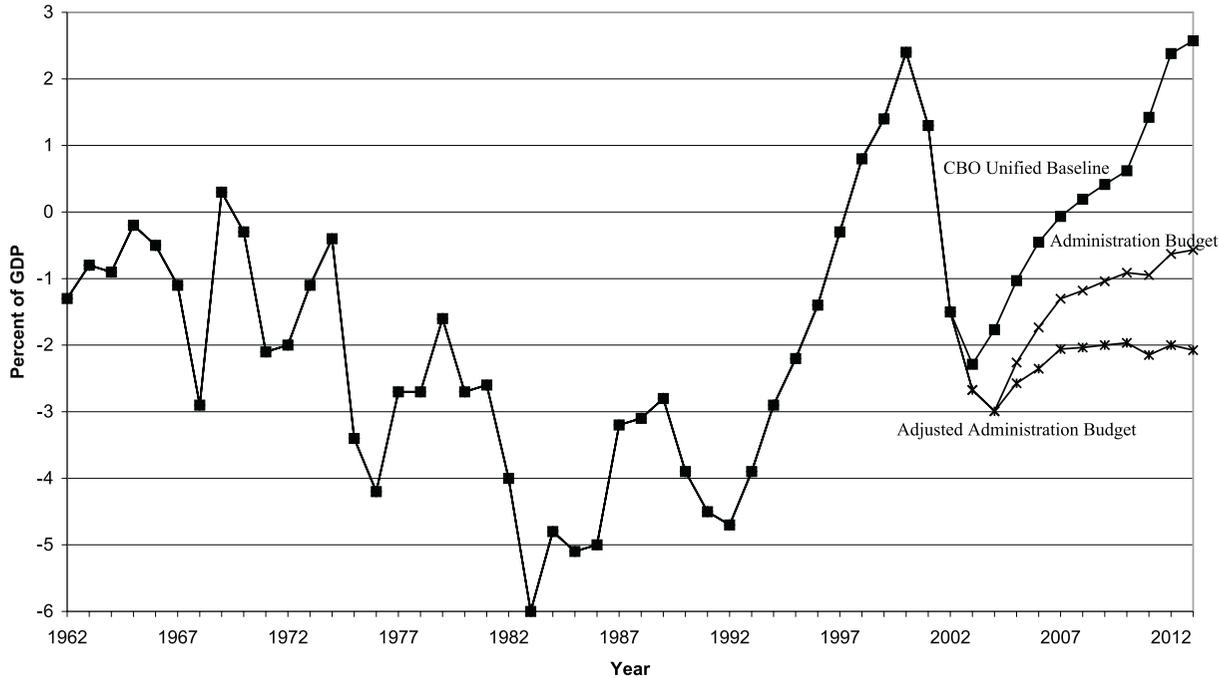
²All of the figures in this article exclude the potential costs of the military conflict and reconstruction in Iraq. The president's original budget proposals for FY 2004 contained no such requests, although a supplemental emergency spending request for \$75 billion was submitted in March. With interest costs, \$75 billion in expenditures in FY 2003 and FY 2004 would raise the 10-year deficit by about \$120 billion. (In April, Congress passed a \$79 billion version of the administration's request.)

Figure 1:
Public Debt, 1962-2013
(as a share of GDP)

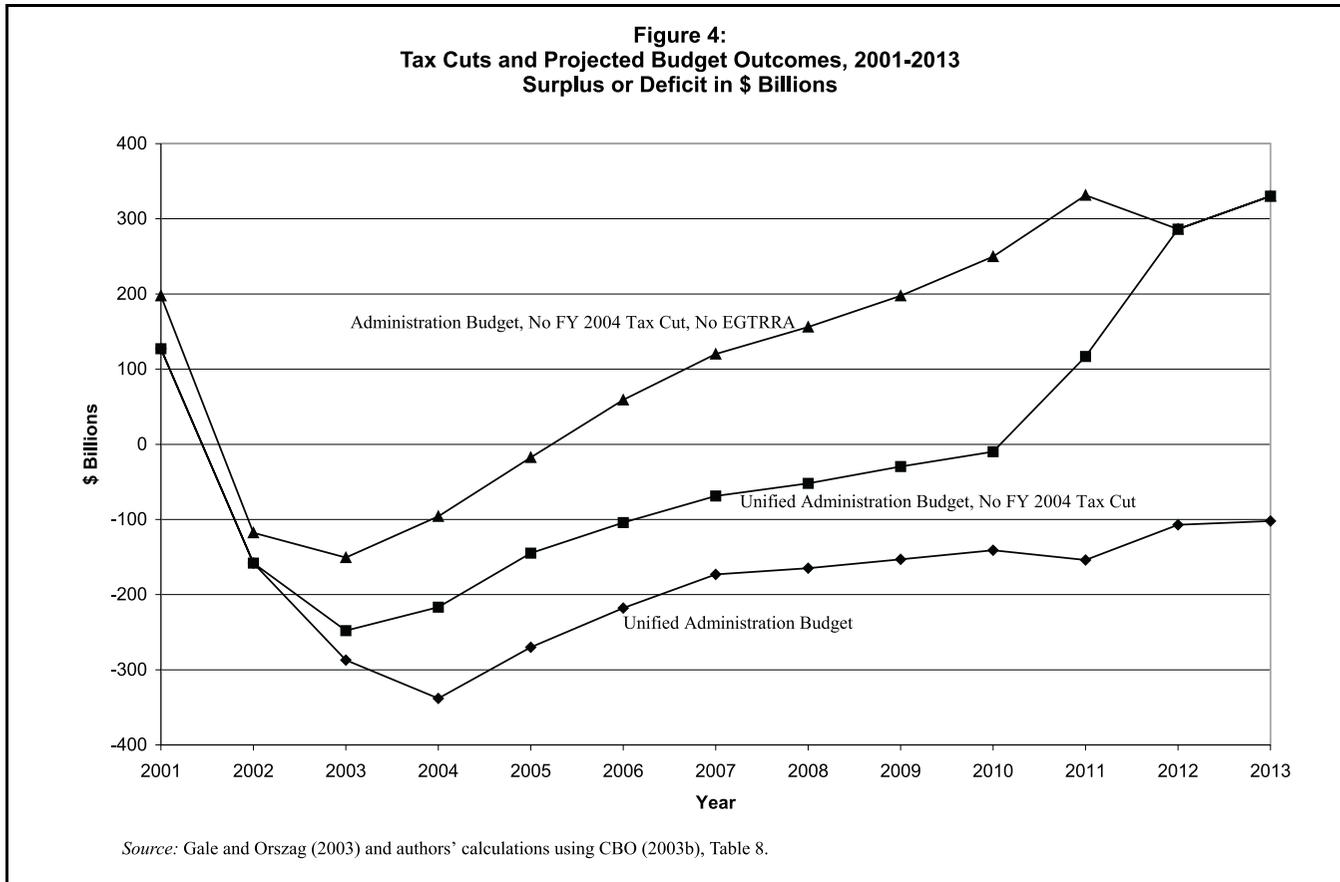
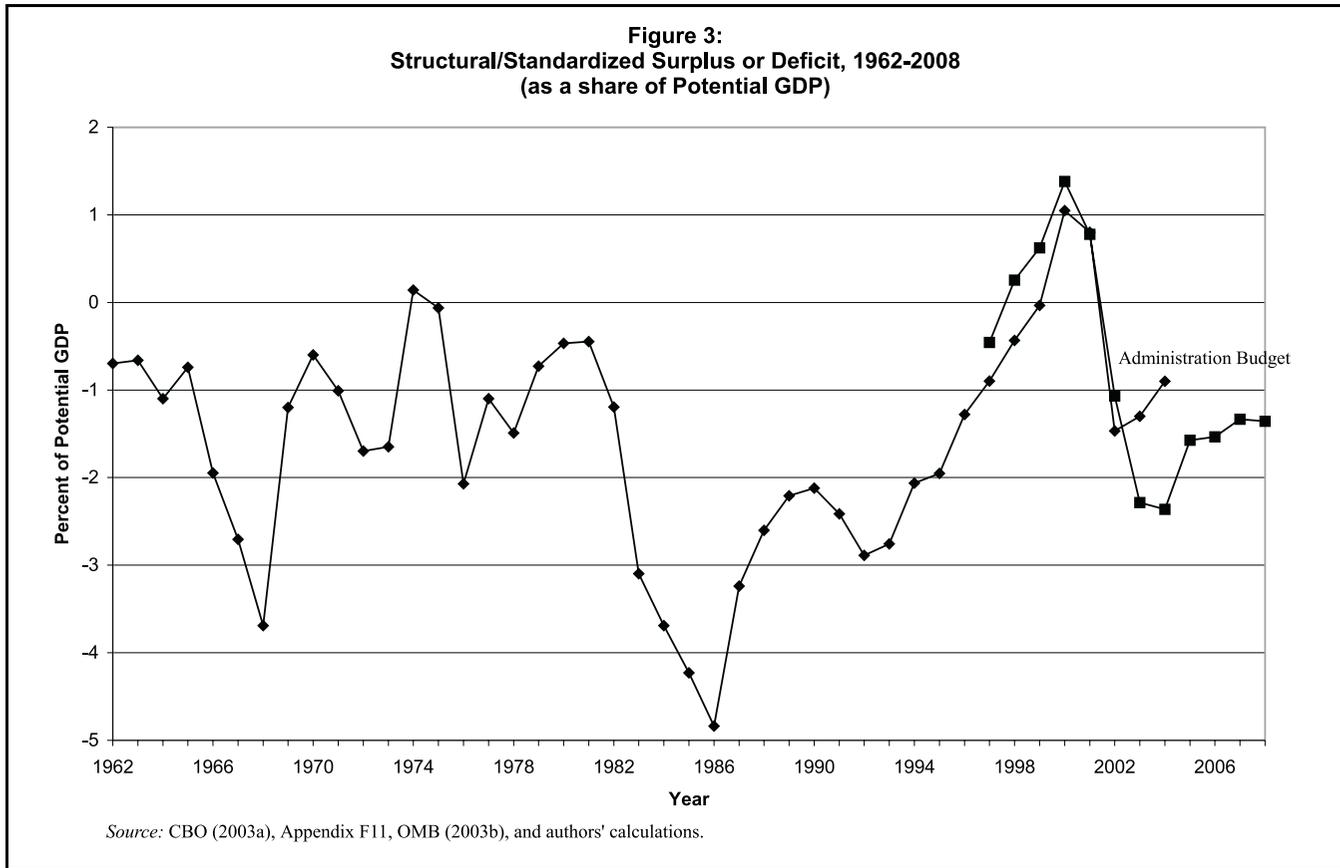


Source: CBO (2003a), Appendix F1, and authors' calculations using CBO (2003b), Tables 2 and 4.

Figure 2:
Federal Surplus or Deficit, 1962-2013
(as a share of GDP)



Source: CBO (2003a), Appendix F2, and authors' calculations using CBO (2003b), Tables 2 and 4.



	Present Value Over the Next 75 Years, % of GDP	Present Value Over the Next 75 Years,* \$ trillion
2001 tax cut if made permanent	1.5% to 1.9%	\$7.9 trillion to \$10.0 trillion
Dividend / capital gains proposal	0.30%	\$1.6 trillion
Tax-free savings accounts	0.30%	\$1.6 trillion
Other proposed tax cuts	0.20%	\$1.1 trillion
Total, administration tax cuts	2.3% to 2.7%	\$12.1 trillion to \$14.2 trillion
Social Security actuarial deficit*	0.73%	\$3.8 trillion
Medicare Hospital Insurance actuarial deficit*	1.11%	\$6.2 trillion
Combined Social Security and Medicare HI deficit*	1.84%	\$10.0 trillion

* Assumes level of GDP and interest rates projected by the Social Security actuaries. For further details, see Orszag, Kogan, and Greenstein (2003).

percent of GDP) in 2013. Counting interest costs, the proposed tax cuts would be 2.4 percent of GDP in 2013.

From some historical perspectives, these outcomes do not seem particularly troubling. Figure 1 shows actual debt held by the public as a share of GDP from 1962 to the present, and projected debt through 2013 under the CBO baseline, the administration's budget proposals, and the administration's budget adjusted to include AMT reform and extension of expiring tax provisions (as explained in Gale and Orszag 2003). Figure 2 reports similar figures for the unified budget surplus or deficit. In both cases, the CBO baseline generates projected fiscal prospects that are relatively auspicious by historical standards, and the administration's budget, with or without the tax adjustments noted above, generates projected outcomes that are well within the range of historical patterns. Likewise, Figure 3 reports historical and projected standardized and structural surpluses.³ The projected structural deficits are small relative to the experience in the 1980s and early to mid-1990s. These historical perspectives apparently explain the administration's views that the projected budget shortfalls are "small by historical standards," and that "the nation can clearly sustain budget deficits at the projected level" (OMB 2003a, pages 1 and 28).

Our central critique of these figures and the resultant conclusions is that the comparisons are misleading, and that incorporating other relevant factors makes the projected shortfalls and proposed tax cuts look more ominous than the perspectives above indicate. Before turning to those considerations, however, it is worth noting that even in the reassuring confines of the comparisons above, there are clouds on the horizon.

³The structural deficit adjusts for the state of the business cycle. The standardized deficit also adjusts for other temporary influences on budget outcomes, including "unusually large discrepancies between tax payments and liabilities, swings in collections of capital gains taxes, changes in the inflation component of the government's net interest payments, and temporary legislative changes in the timing of revenues and outlays." See CBO 2003(c).

Figure 3, for example, shows that even after the economy returns to full employment, the administration's own estimates show that the budget will show a structural deficit under the administration's proposals — that is, a fundamental imbalance between taxes and spending. This imbalance would be even larger if AMT reform or extension of expiring tax provisions were included. The existence of such a deficit after the economy is projected to be back at full employment belies the administration's claims that the "President continues to believe that under normal circumstances, the federal budget should be in balance" and that "none of this is to accept deficits as a permanent fiscal condition" (OMB 2003a, pages 25 and 28).

The structural deficit in 2013 shown in Figure 3 is smaller than the tax cuts proposed by the administration. That underscores the effect of the tax cuts on the projected budget balance, which is highlighted in Figure 4: Without the proposed tax cuts, the administration's budget would return to surplus in 2008. Without the proposed tax cuts and EGTRRA, the budget would return to surplus even sooner and be stronger.

III. Forward-Looking Perspectives

The most important flaw in the argument that the administration's budget is fiscally sound (because the resultant deficit or public debt figures as a share of GDP are within their historical ranges) is that such an argument ignores the costs associated with the coming retirement of the baby boomers. As one pundit has put it, it is as if a family with no accumulated savings and two children about to enter college were congratulating itself for borrowing only small amounts on its credit card.

A. Long-Term Fiscal Obligations

CBO projections suggest that Social Security, Medicare, and Medicaid expenditures are expected to rise from about 9 percent of GDP in 2012 to 16 percent by 2040 and 21 percent by 2075.⁴ In the context of an aging population and rapidly rising medical care expenditures, an accurate picture of the government's

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⁴Congressional Budget Office (2002).

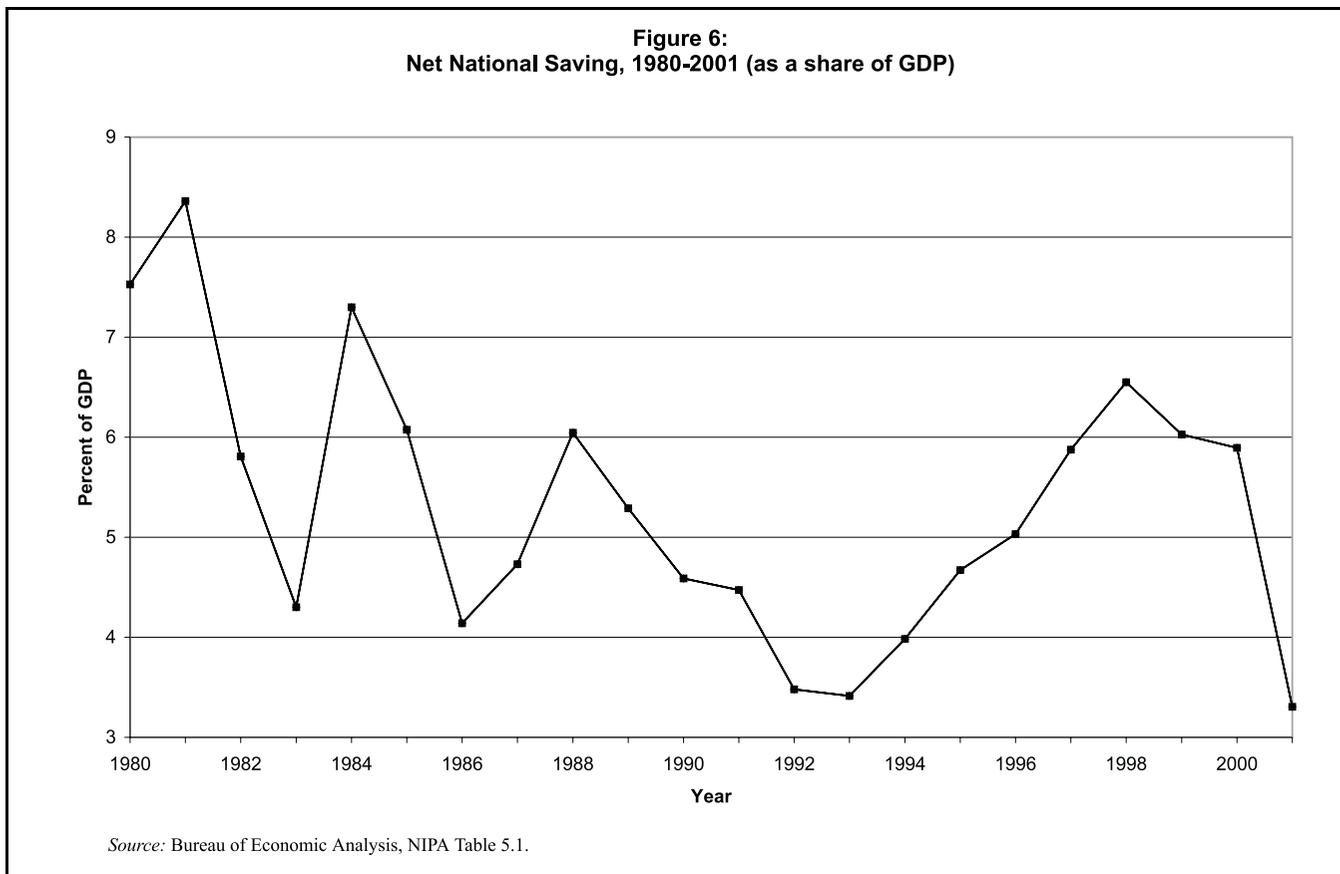
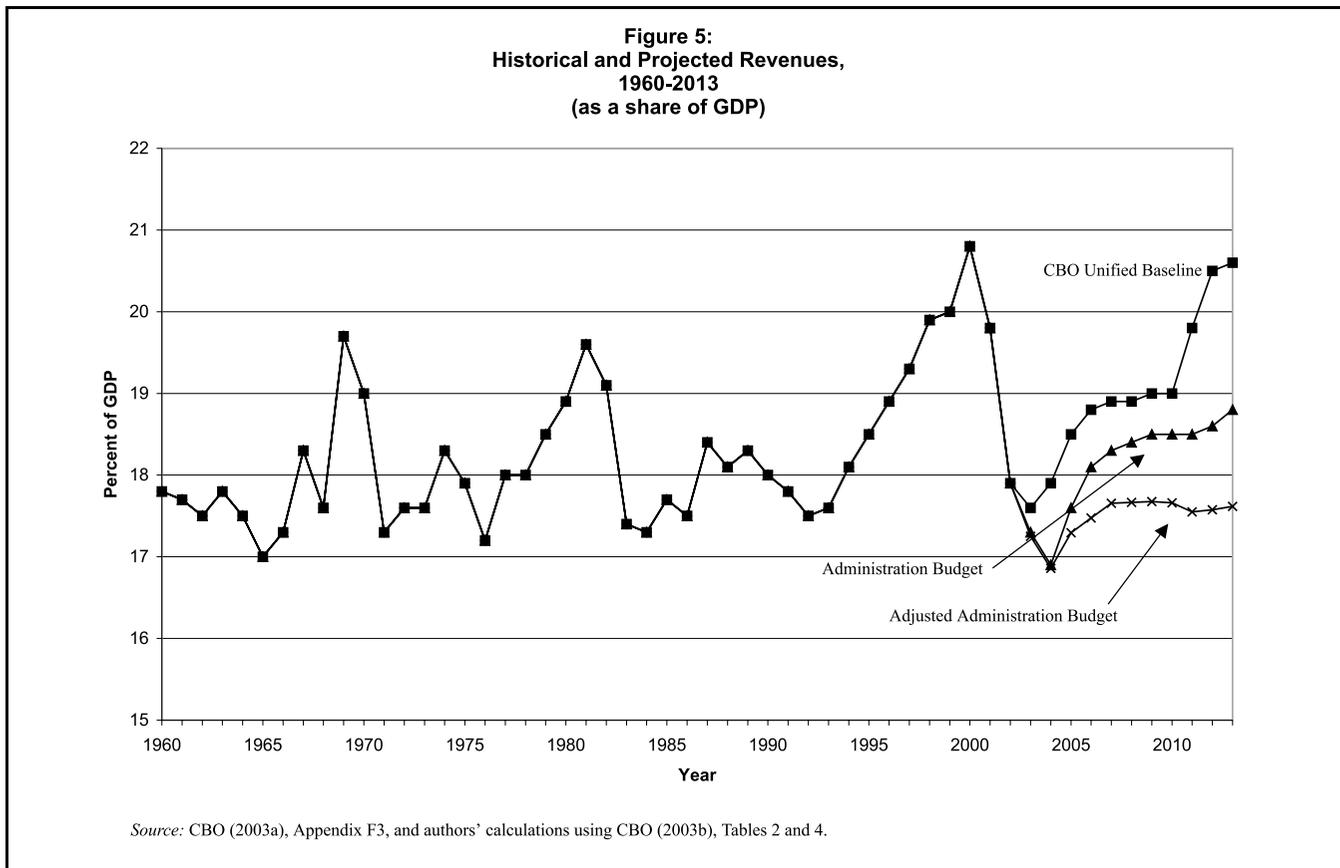
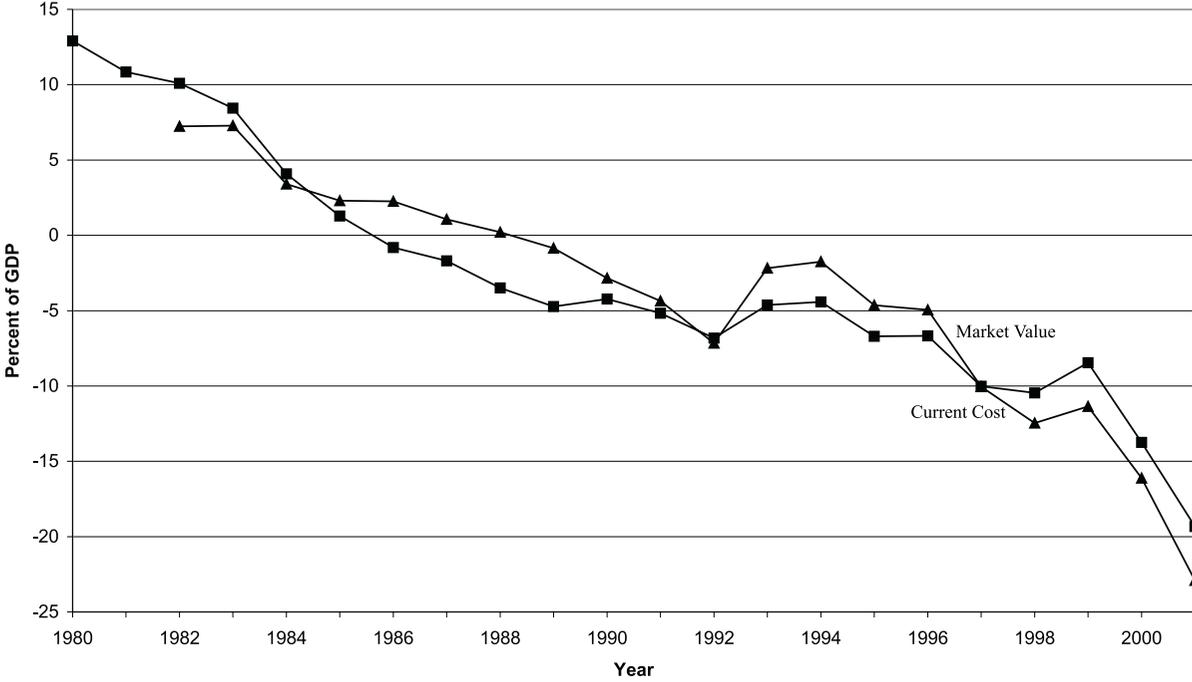


Figure 7:
Current Account Balance, 1980-2001
(as a share of GDP)



Source: Council of Economic Advisers (2003), Table B-103.

Figure 8:
Net International Investment Position, 1982-2001
(as a share of GDP)



Source: Nguyen (2002), Table 2.

long-term fiscal status is impossible without inclusion of this sharp rise in expenditures.

Auerbach, *et al.* (2003) presents estimates of the “fiscal gap,” the increase in taxes or reductions in noninterest expenditures, measured as a share of GDP, required to hold constant the ratio of government debt to GDP. They conclude that the fiscal gap over the long term amounts to between 4 percent and 8 percent of GDP. Since it seems implausible that the entire adjustment would occur on the spending side, the administration’s push for additional long-term reductions in revenue is the opposite of what would be required to address the nation’s long-term budget imbalance.

B. Revenues as a Share of GDP

Figure 5 shows that under the administration’s budget, revenues in 2004 would be 16.9 percent of GDP, the lowest in several decades. The official budget projections show a significant increase in revenue over the next decade, but that largely reflects unrealistic assumptions about expiring tax provisions and the alternative minimum tax. Under our adjusted revenue figures (Gale and Orszag 2003), which assume that expiring tax provisions are extended and which assumes an AMT reform that leaves 8.5 million taxpayers on the AMT in 2013 (well above current numbers but far below the 43.5 million slated to face the AMT without reform), revenues would be 17.5 percent of GDP over the next decade, the lowest decade average since the 1950s.

C. Tax Cuts vs. Social Security Shortfalls

In FY 2013, as noted above, the tax cuts would amount to approximately 1.9 percent of GDP.⁵ That 1.9 percent of GDP figure understates the permanent revenue loss from the administration’s tax proposals, since it is artificially restrained by failing to address the looming alternative minimum tax problem and since it does not fully reflect the long-term revenue loss of the proposed savings accounts.

To put the long-term revenue losses from the tax cuts in perspective, it may be helpful to compare the fiscal dimensions of the projected long-term actuarial deficit in Social Security and the long-term revenue loss from the administration’s tax cuts. To compute the long-term revenue loss from the administration’s tax proposals, we assume some form of long-term fix to the individual alternative minimum tax (AMT); the range of revenue losses for the administration’s tax proposals primarily reflects the interactions between the AMT and the 2001 tax legislation. We also assume that the revenue loss from all tax cuts will remain constant as a share of GDP after 2013. For further details on the calculations, see Orszag, Kogan, and Greenstein (2003).⁶

As Table 1 shows, the projected 75-year cost of the administration’s tax cuts is more than three times the

projected 75-year actuarial deficit in Social Security shortfall. The administration’s tax cuts would cost between 2.3 percent and 2.7 percent of Gross Domestic Product (GDP) over the next 75 years in present value; the Social Security actuarial deficit over the next 75 years amounts to 0.7 percent of GDP in present value. (The tax cuts are also larger than the combined actuarial deficits in Social Security and Medicare’s Hospital Insurance program.)

Extending the projection horizon beyond 75 years narrows the difference between the Social Security imbalance and the cost of the tax cut, but not the conclusion: The present value of the tax cut in perpetuity remains substantially larger than the permanent actuarial deficit in Social Security deficit. In particular, the present value of the cost of the tax cut in perpetuity, estimated as above but extending the analysis beyond 75 years, amounts to between \$18 trillion and \$21 trillion. According to the Social Security actuaries, the present value of the Social Security actuarial deficit in perpetuity is \$10.5 trillion.

It is worth noting that the actuarial imbalance within Social Security is smaller than the present value of the additional future cash flow required to finance scheduled benefits, because the current value of the Trust Fund is subtracted in computing the actuarial deficit.⁷ Some analysts prefer to ignore the value of the Trust Fund and examine only the value of the future cash flows. Altering the comparison in this manner, however, does not change the fundamental conclusion. The Social Security Trust Fund currently amounts to approximately \$1.4 trillion; increasing the Social Security deficit figures by \$1.4 trillion changes none of the implications.⁸

IV. Comparisons With the 1980s and 1990s

Further insight into the administration’s budget can be obtained through other comparisons to the 1980s and 1990s.

A. Tax Cuts Compared to Reagan Tax Cuts

For example, the administration’s tax cuts can be compared in size to the Reagan tax cuts of the early 1980s. Such a comparison is complicated by two factors: the lack of indexation in the tax code before the 1981 tax cut and the partial reversal of the 1981 tax cuts in 1982.

First, before the Economic Recovery Tax Act of 1981, the tax code was not indexed to inflation. The result was a natural upward creep in tax collections over time, as ongoing inflation pushed individuals into higher tax brackets. Policymakers cut taxes every few

⁵According to the Joint Committee on Taxation, the revenue loss (including outlays associated with tax credits) in FY 2013 is \$339 billion. The CBO forecast of GDP in FY 2013 is \$17,851 billion. The tax cut is thus 1.9 percent of GDP in FY 2013. See CBO (2003b) and JCT (2003).

⁶Orszag, Kogan, and Greenstein (2003).

⁷Partially offsetting this, the actuarial deficit calculation also imposes an end-period constraint on the Trust Fund.

⁸Medicare’s Hospital Insurance Trust Fund amounts to approximately \$250 billion. Even ignoring the value of the Trust Funds for both Social Security and Hospital Insurance, the tax cut thus remains larger than the combined deficits in Social Security and Medicare’s Hospital Insurance program over the next 75 years, and it remains significantly larger than the present value of the permanent deficit in Social Security.

years to offset much or all of the tax increases that otherwise would occur, but CBO assumed in its revenue baseline projection that taxes would rise significantly over time, reflecting the lack of indexation in the law. In effect, the baseline against which the 1981 Reagan tax cut and other earlier tax cuts were measured thus was much different as a result of the lack of indexing in the tax code, making comparisons to current tax proposals difficult.⁹ CBO estimates described in Orszag (2001a) suggest that by 1987, some 45 percent of the projected cost of the Reagan tax cut simply reflected the effects of inflation on the baseline.¹⁰ Given the differences in the baseline for the 1981 tax cut and current tax proposals, it is difficult to compare their relative sizes. One approach, however, is simply to measure the 1981 tax cut against an indexed baseline.

The second issue is that policymakers in the Reagan administration quickly realized that the 1981 tax cut was excessive. As a result, the administration worked to scale back the tax cut one year later. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) increased revenue by closing some loopholes broadened in the 1981 act, altering depreciation deductions, tightening safe harbor leasing rules, and making several other changes. For many purposes, the net cost of the 1981 tax cut and 1982 tax increase may be a more appropriate measure of the “Reagan tax cuts” than the cost of the 1981 tax cuts alone.

Table 2 displays these two adjustments to the revenue estimates for the Reagan tax cuts. The net result is that the adjusted cost of the Reagan tax cuts amounted to 2.1 percent of GDP — slightly lower than the 2.3 percent to 2.7 percent of GDP cost estimate for the adjusted size of the Bush administration’s overall tax cuts and slightly higher than the official revenue loss estimate for the Bush administration’s tax cuts in 2013. In other words, under reasonable interpretations of the size of the Reagan and Bush tax cuts, the long-term size of the Bush administration’s tax proposals is roughly the same (or perhaps even larger than) the net size of the 1981 and 1982 tax acts.

B. Economic Environment Then and Now

In comparing the tax cuts now to the tax cuts of the early 1980s, it is also important to remember that the net cost of tax cuts was likely lower then. First, the boomers’ retirement was 20 years further in the future then; the nation had more time to prepare for that event. Second, as shown in Figure 1, publicly held debt was a smaller share of GDP then. Figures 6, 7, and 8

⁹As CBO noted when the Reagan tax cut was first proposed, “While the Administration proposal would reduce revenues by large amounts in those years, it is important to keep in mind that, without a tax cut, income taxes rise continually because of the effects of inflation on the graduated income tax rate schedule . . . a large share of the Administration’s proposed tax cut would simply offset these tax increases [emphasis added].” Congressional Budget Office, “An Analysis of President Reagan’s Budget Revisions for Fiscal Year 1982,” March 1981, page 19.

¹⁰Orszag (2001a).

also show that national saving, the current account balance, and the nation’s net international investment position were all more positive in the early 1980s than they are today. Assuming an increasing risk premium associated with government debt or with the nation’s net indebtedness to foreigners, the fact that publicly held debt is a higher share of GDP now and that the net international investment position has declined markedly since the early 1980s increases the marginal cost of a tax cut now, relative to then.

The cost of a marginal tax cut was thus arguably lower in the 1980s than today. The economic benefit, furthermore, was likely higher, because marginal tax rates were substantially higher then. A marginal tax cut of 5 percentage points has a more pronounced effect the higher is the initial marginal tax rate. A variety of economic activities are affected by the after-tax return, which depends on $(1-t)$. Since $(1-t)/(1-t-0.05)$ is larger the larger is t , the effect of a 5 percentage point tax cut is larger the higher the initial tax rate. For example, reducing tax rates from 70 percent to 65 percent raises the after-tax return from 30 percent to 35 percent, or by one-sixth; reducing tax rates from 40 percent to 35 percent raises the after-tax return from 60 percent to 65 percent, or about one-twelfth. Similarly, the distortions caused by a tax are proportional to the square of the tax rate.¹¹ A given reduction in tax rates therefore produces a larger efficiency gain the higher is the initial tax rate; for example, $(0.7)^2 - (0.65)^2$ is larger than $(0.4)^2 - (0.35)^2$. The implication is that even if marginal tax cuts have the potential to stimulate growth and improve economic performance, a given marginal reduction is less likely to do so now than when marginal rates were higher.

V. Conclusion

On a comparable basis, the administration’s tax cuts are about the same size as the net reduction from the 1981 tax cut and the 1982 partial reversal. But the baby boomers are closer to retirement, private saving has fallen, the public debt is higher, and marginal tax rates are lower now — all of which raise the net cost of a tax cut now compared to the early 1980s. Furthermore, the adverse fiscal effects of the 1980s tax cuts were attenuated by the peace dividend (of the 3 percentage point decline in noninterest spending as a share of GDP from 1990 to 2000, 2.4 percentage points was due to defense) and by subsequent tax increases (in 1983, 1984, 1990, and 1993). We are unlikely to experience another substantial peace dividend, and mandatory spending is slated to rise markedly as a share of GDP over the next 20 to 30 years. Tax cuts thus appear to be an even larger gamble now than in the 1980s.

The tax cuts embraced by the administration, furthermore, are significantly larger than the long-term deficit in Social Security. Perhaps more importantly, the tax cuts undermine the political viability of entitlement reform in the near term by consuming revenue necessary for any realistic reform plan to work (Orszag

¹¹See Rosen (2001) for a textbook exposition.

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2001b). The administration's tax cuts are thus an integral part of the real fiscal danger facing the nation.

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