by William G. Gale and Peter R. Orszag

The Budget Outlook: Updates and Implications

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I. Introduction

The Congressional Budget Office (2004) has released new baseline budget projections, covering fiscal years 2005-2014. This article examines the baseline CBO projections, adjusts the official data in ways that more accurately reflect the current trajectory of tax and spending policies, and discusses some of the implications. We reach the following main conclusions:

- CBO now projects a 10-year baseline deficit of $1.9 trillion in the unified budget for fiscal years 2005 to 2014. The budget outside of Social Security faces a baseline deficit of $4.3 trillion.
- These figures represent staggering declines in the budget outlook. Since January 2001, the unified baseline for 2002 to 2011 deteriorated by $8.5 trillion (about $55 billion per week) from a projected *surplus* of $5.6 trillion to a projected *deficit* of $2.9 trillion currently.
- Most (64 percent) of the decline is due to lower revenue projections. The rest is due to higher spending on defense and homeland security (19 percent), and other outlay increases (17 percent). Alternatively, legislated changes account for 60 percent of the decline, economic and technical adjustments for 40 percent.
- Despite much misleading recent public discussion, the vast majority of the decline in the actual budget over the last four years is due to lower revenues, not higher spending; increases in nondefense discretionary spending have played an especially modest role in the budget reversal. Between 2000 and 2004, falling revenue accounts for about 75 percent of the increase in the actual deficit as a share of GDP, compared to about 7 percent for domestic discretionary spending outside homeland security. Revenues are currently the lowest share of GDP since 1950, while spending is at its average share of GDP over the past 40 years.
- As is now widely recognized, the baseline projections use mechanical assumptions that may not be the best representation of current policy. For example, the baseline assumes that all expiring tax provisions are allowed to expire, that the alternative minimum tax (AMT) will be allowed to grow explosively, and that real discretionary spending per capita will decline by 8 percent. If the expiring tax provisions are extended, the AMT is held in check (as described below), and real discretionary spending grows with the population, the 10-year unified budget deficit will be $5.5 trillion (3.7 percent of GDP), with deficits of 3.4 percent of GDP or more in every year. Those deficits emerge just from efforts to maintain the policy status quo. The differences between the CBO baseline and our adjusted unified budget projections grow over time. In 2014 alone, the difference is more than $740 billion (4.1 percent of GDP).
- The unified budget figures above include large cash-flow surpluses accruing in trust funds for Social Security, Medicare, and government pensions over the next 10 years. In the longer term, Social Security and Medicare face significant deficits. Outside of the retirement trust funds, the adjusted 10-year budget faces a deficit of $8.5 trillion over the next decade (5.7 percent of GDP).
- The simplest way to summarize the fiscal status of the government is to note that the retirement trust funds face substantial long-term deficits, and under realistic assumptions about current policy, the rest of government faces deficits in excess of 5 percent of GDP over the next decade.
- Sustained budget deficits are harmful. Under assumptions reported by President Bush's Council of Economic Advisers, the deterioration in the budget outlook since January 2001 will, by 2012, raise interest rates by 125 basis points, reduce annual national income by $340 billion (more than $2,900 per household), and increase U.S. indebtedness to foreign investors. The adverse effects would persist and grow over time.
- It is extremely unlikely that the economy will be able to grow its way out of the deficits, and

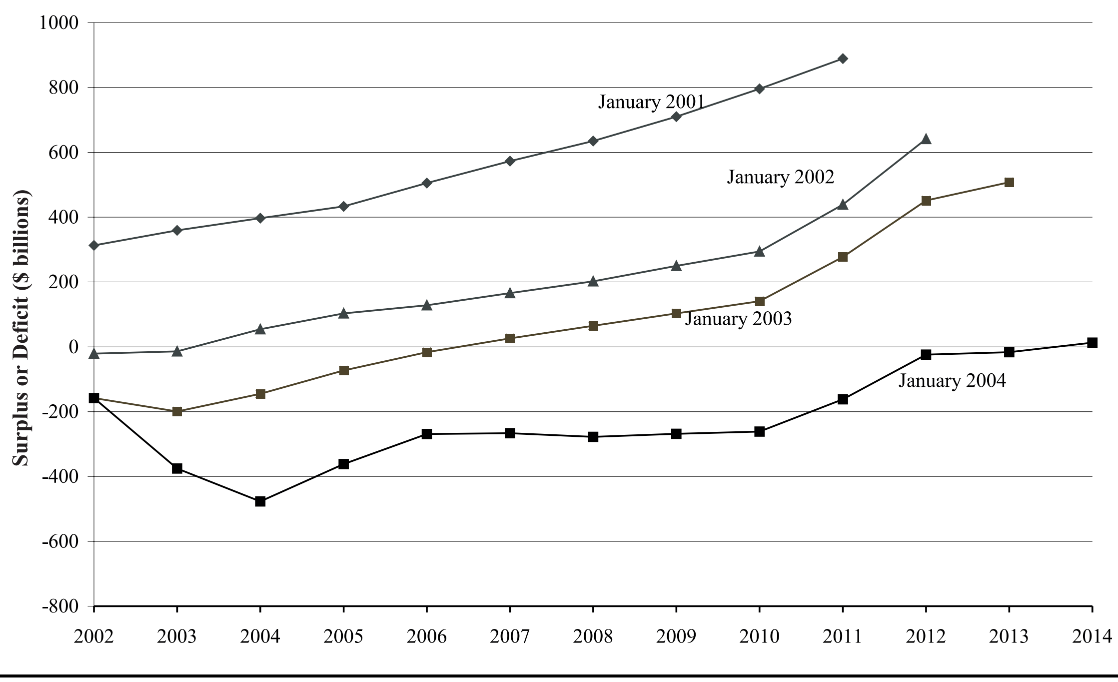
(Text continued on p. 917.)

Table 1
Changing Budget Projections
(Surplus or Deficit in Billions of Current Dollars)

Projection Date	Unified Budget	Non-Social-Security Budget	Non-Social-Security, Non-Medicare Budget
10-Year Baseline, 2002-11			
January 2001[1]	5610	3119	2727
January 2002[2]	1601	-745	-1127
January 2003[3]	20	-2219	-2551
January 2004[4]	-2876	-4873	-5090
10-Year Baseline, 2003-12			
January 2002[2]	2263	-242	-632
January 2003[3]	629	-1768	-2107
January 2004[4]	-2742	-4850	-5055
10-Year Baseline, 2004-13			
January 2003[3]	1336	-1231	-1580
January 2004[4]	-2383	-4608	-4805
10-Year Baseline, 2005-14			
January 2004[4]	-1893	-4250	-4438

[1]Congressional Budget Office. "The Budget and Economic Outlook: Fiscal Years 2002-2011." January 2001. Tables 1-1 and 1-7.
[2]Congressional Budget Office. "The Budget and Economic Outlook: Fiscal Years 2003-2012." January 2002. Summary Table 1, Tables 1-1 and 1-6.
[3]Congressional Budget Office. "The Budget and Economic Outlook: Fiscal Years 2004-2013." January 2003. Tables 1-2 and 1-5.
[4]Congressional Budget Office. "The Budget and Economic Outlook: Fiscal Years 2005-2014." January 2004. Tables X and Y.

Figure 1
Changing Unified Budget Projections



delaying steps to deal with the problem simply makes it worse. In such an environment, policymakers may be tempted to turn to budget gimmicks.

- The only real solution to the nation's fiscal imbalance is to cut spending and raise taxes. Restoring fiscal discipline will require painful adjustments, and it is unrealistic to think that the required adjustments can be undertaken entirely on one side of the budget or the other. The painful decisions necessary to restore fiscal balance would be easier to enact and to enforce if policymakers reinstated meaningful budget rules that restrict spending and tax changes.

Section II summarizes CBO's recent budget projections and discusses the size and sources of changes in the projections over time. Section III explores adjustments to the official budget baseline. Section IV discusses some of the implications.

II. The Changing Budget Outlook

Table 1 reports selected baseline projections made by the CBO since January 2001. (Appendix Table 1 contains the projections for each year, and Figure 1 plots the data on an annual basis.) The baseline projects deficits of $1.9 trillion in the unified budget and $4.3 trillion in the non-Social Security budget.

Both the unified budget and the non-Social Security budget improve over time. The unified budget goes from a deficit of $477 billion in 2004 to essentially zero in the last three years of the budget window. The non-Social Security deficit is $629 billion in 2004 and falls over time, but remains at $271 billion by 2014. As discussed below, all of these improvements are based on a series of artificial assumptions.

Projected budget outcomes have deteriorated dramatically since January 2001. The unified budget shows a cumulative decline of $8.5 trillion over the 2002 to 2011 horizon, the equivalent of 6.5 percent of projected GDP over the same period. By 2011, the decline totals more than $1 trillion.

These changes are not temporary — they clearly represent a fundamental downward shift in fiscal trajectories. For example, the projected outcome for 2005 and 2011 have each fallen by about 6.6 percent of projected GDP in those years.

Moreover, declines have occurred in each of the past three years. For example, in the past year alone, the fiscal outlook for the 2002-2011 period declined by $2.9 trillion, roughly the same rate as in the first two years. Likewise, the fiscal outlook for the 2004-2013 period declined by $3.7 trillion over the past year.

Table 2 examines the sources of the decline since January 2001 in projected unified budget outcomes over the 2002-2011 horizon. (Appendix Table 2 provides data by year. Figure 2 plots the data over time.) Almost two-thirds of the decline is due to reductions in tax revenues, with the remaining 36 percent due to spending increases. Alternatively, about 60 percent of the decline is due to legislative changes; 40 percent is due to economic and technical changes. Within the decline due specifically to legislative changes, tax cuts account for about 45 percent, defense spending and homeland security spending account for just under a third, and all (non-homeland security) domestic outlays, including the Medicare prescription bill, account for just under a quarter.

Table 2
Sources of Change in the Unified Budget Baseline, 2002-2011
January 2001-January 2004[1,2]

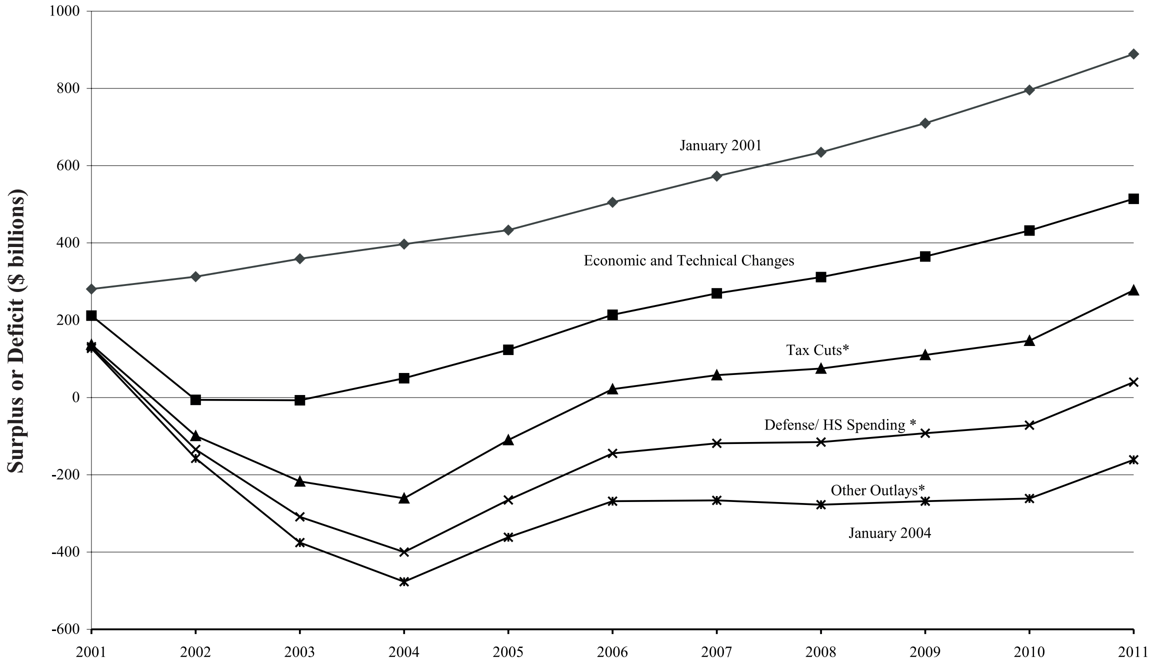
	2002-2011	
	($ billions)	(% of change)
Legislative Changes		
Tax Cuts	2,265	26.7
Defense and HS Outlays	1,614	19.0
Other Outlays	1,263	14.9
Subtotal	5,143	60.6
Economic and Technical Changes		
Revenue	3,202	37.7
Outlay	141	1.7
Subtotal	3,343	39.4
Revenue — Total	5,467	64.4
Outlays — Total	3,018	35.6
Total Change in Surplus	8,485	100.0

[1]Columns may not sum to total due to rounding.
[2]*Source and notes:* see Appendix Table 2.

The causes of the change in the budget shift over time (Appendix Table 2). About 50 percent of the decline in the budget in 2003 was due to changing economic and technical conditions. In 2004 and beyond, however, economic and technical revisions make up less than 40 percent of the changes, with changes in legislation accounting for the majority of the revisions.

Whereas Table 2 focuses on projected outcomes, Table 3 examines the actual decline in budget outcomes between 2000 and 2004. Despite recent assertions that domestic spending is skyrocketing out of control, Table 3 shows in a simple but compelling way that the vast majority of the recent increase in budget deficits is due to lower taxes, not higher spending. Between 2000 and 2004, the budget changed from a surplus of 2.4 percent of GDP to a projected deficit of 4.2 percent of GDP. Of the 6.6 percentage points of GDP change, 5 percentage points — slightly more than 75 percent — are due to lower revenues. Much attention has been focused in particular on the growth of domestic discretionary spending. Table 3 shows, however, that nondefense discretionary spending (which includes international assistance and pieces of homeland security) can account for less than 10 percent of the increase in the deficit as a share of GDP. The share of the deterioration attributable specifically to non-homeland security domestic spending (excluding both international assistance and nondefense homeland security) is less than 7 percent. (See the addendum to Appendix Table 3 for

Figure 2
Source of Change to Unified Budget Projection, 2001-2011



*Legislated Changes

data on domestic discretionary spending outside homeland security.)

Other evidence also supports the view that revenue declines, not spending increases, are the main driving force behind the increase in deficits. Federal revenue in 2004 will be a smaller share of the economy than at any time since 1950. Spending, in contrast, is at its average share of GDP over the past 40 years.

III. Adjusting the 10-Year Budget Outlook

The CBO baseline budget projections dominate public discussions of the fiscal status of the government. As CBO (2004, page 1) itself emphasizes, however, the baseline is not intended to serve as a prediction of likely budget outcomes. The set of default assumptions about current spending and tax policies used to develop the baseline are defined in part by statutory rules and hence are often unrealistic. As in its August 2003 budget update, CBO is now prominently displaying estimates of the budgetary implications of alternative assumptions.

A. Current Policy

We adjust the baseline budget figures in several ways.[1] This clearly involves a set of judgment calls, so we explain the adjustments and their justifications below. Our adjustments are similar in spirit and magnitude, although differing in some details, to those made by others, including the Committee for Economic Development, Concord Coalition, and Center on Budget and Policy Priorities (2003) and Goldman Sachs (2003).

The most important area in which the baseline makes unrealistic assumptions involves expiring tax provisions. CBO assumes (by law) that Congress will extend expiring spending programs,[2] but that all temporary tax provisions (other than excise taxes dedicated to trust funds) expire as scheduled, even if Congress has repeatedly renewed them. All of the tax cuts enacted in 2001, 2002, and 2003 expire or "sunset" by the beginning of 2011 (see Gale and Orszag 2003a). A variety of other tax provisions that have statutory expiration dates are routinely extended for a few years at a time as their expiration dates approach. We believe that the most accurate assumption of current policy, on balance, would be that all of these various provisions will be extended. This is not a statement of desired or optimal policy.

[1]The adjustments described in this section are described in more detail in Auerbach, Gale, Orszag, and Potter (2003).

[2]CBO (2004, Table 3-9) reports that the baseline includes $590.6 billion in outlays, not including debt service costs, for mandatory spending programs that are assumed to be extended beyond their expiration dates.

Table 3
Sources of Change in Unified Budget, 2000 to 2004
(Percent of GDP)[1,2]

	2000	2004	Difference	Share of Change
Unified Budget Surplus (or Deficit)	2.4	-4.2	-6.6	100.0
Revenues	20.8	15.8	-5.0	75.9
Spending	18.4	20.0	1.6	24.1
Net Interest	2.3	1.4	-0.9	-14.2
Non-Interest Spending	16.1	18.6	2.5	38.3
Mandatory	9.8	10.8	1.0	15.8
Discretionary	6.3	7.8	1.5	22.5
Defense	3.0	3.9	0.9	13.6
Non-Defense	3.3	3.9	0.6	8.9

[1]Due to rounding, columns may not sum to total.
[2]*Source and notes:* see Appendix Table 3.

Table 4 shows that making the Bush tax cuts permanent would reduce revenues by about $2 trillion over the next decade. Counting the added interest payments to service higher levels of federal debt, the total increase in the deficit would be $2.35 trillion. Making all of the expiring provisions permanent would reduce revenues by $2.3 trillion and increase the deficit by $2.75 trillion. Almost three-quarters of the costs of extending either the Bush tax cuts or all expiring provisions occur in the period from 2010 to 2014.

The second issue involves the AMT, which offers a dramatic example of how the baseline projections generate unlikely outcomes (see Burman, *et al.*, 2003). Our budget estimates reflect current policy toward the AMT in two ways. First, we assume that provisions of the AMT that are slated to expire before the end of the budget window are granted a continuance.[3] Second, we index the AMT exemption, brackets, and phaseouts for inflation starting in 2006 and allow dependent exemptions in the AMT starting in 2005. Table 4 splits these costs into two components. The cost of extending the exemption and use of nonrefundable credits is shown as an "adjustment for expiring tax provisions" and based on CBO estimates. The additional costs of raising the exemption, indexing the tax for inflation, and adding a dependent exemption are shown separately and are based on estimates using the Tax Policy Center microsimulation model.

Taken together, the AMT adjustments would reduce revenues by $788 billion and add $151 billion to debt service costs, for a total budgetary cost of $939 billion. Under those assumptions about 5.2 million taxpayers would face the AMT in 2014 assuming that the expiring provisions are extended.[4]

The two tax adjustments have a significant impact on the trend in tax revenues. Although the CBO baseline budget shows revenues rising from 15.8 percent of GDP in 2004 to 20.1 percent in 2014, our adjusted baseline, taking into account the expiring provisions and AMT reforms noted above, generates revenue of only 17.4 percent of GDP in 2014 (see Appendix Table 3). The 2.7 percent of GDP decline relative to the baseline leaves adjusted revenue in 2014 (and in every year in between) well below 18.2 percent of GDP, the average share of revenues to GDP since 1960.

The third area where CBO's baseline assumptions appear to be an unrealistic reflection of current policy involves discretionary spending, which typically requires new appropriations by Congress every year. The CBO baseline assumes that real discretionary spending will remain constant at the level prevailing in the first year of the budget period. Because population and income grow over time, this assumption implies that by 2014 discretionary spending will fall by 19 percent relative to gross domestic product (GDP) and by 8 percent in real per capita terms.

(Text continued on p. 921.)

[3]Under current law, the AMT exemption is increased for 2001 to 2004, but after 2004 it reverts to its 2000 level. We assume that the temporary increase in the exemption is made permanent. Also, under current law, the use of nonrefundable personal credits against the AMT ostensibly expired at the end of 2003, but it is likely to be reinstated in 2004. We assume that this provision is made permanent as well.

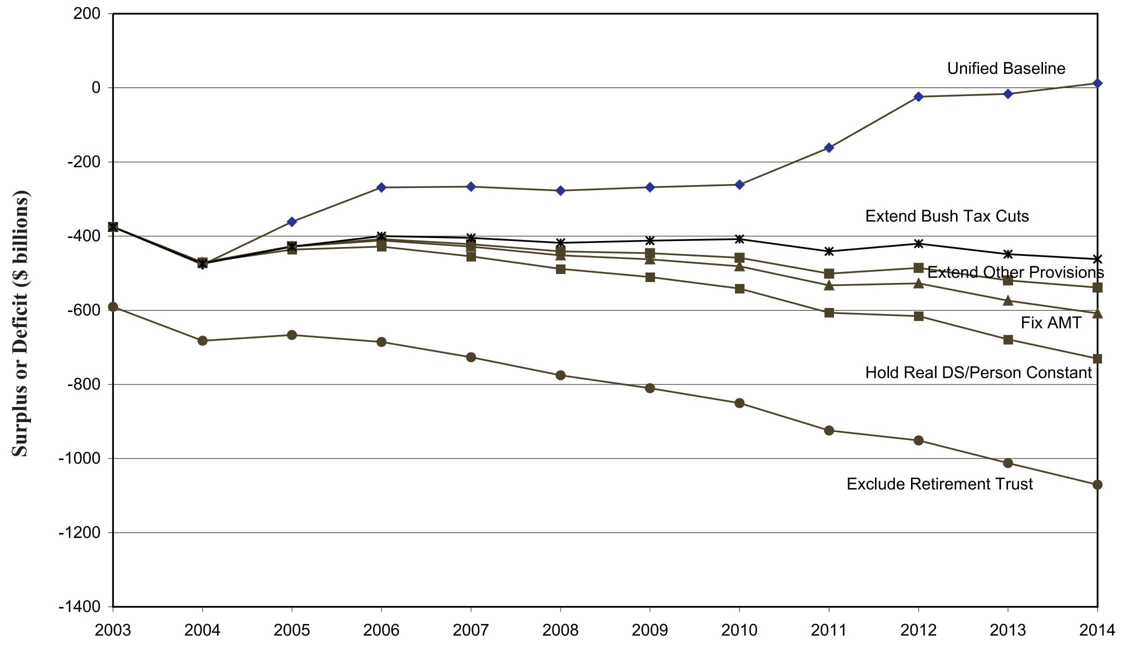
[4]Our AMT estimates do not incorporate the January 2004 economic projections. Incorporating these projections should reduce the costs of AMT reform, but the magnitude of the reduction is unclear. The cost of extending the current AMT exemptions, the current treatment of personal credits, and indexing the tax for inflation beginning in 2005 amounts to $721 billion, according to CBO estimates. (This includes $376 in revenues for extending the exemption, and indexing the tax for inflation (Tables 1-3), another $163 in revenues for interactions with making the tax cuts permanent (Tables 1-3), interest costs of $93 billion and $16 billion on those two items (Tables 1-3), $52 billion in revenues for extending the current treatment of credits (Tables 4-10), and an imputed $11 billion in interest payments.) Our estimate of this policy is $915 billion. Part of the difference has to do with different economic assumptions, but part of the difference reflects the fact that TPC model revenue estimates for AMT reforms are typically somewhat higher than CBO estimates, even with the same set of economic assumptions.

Table 4
Baseline and Adjusted Budget Outcomes for 2005-2014
January 2004

	$ Billions			Percent GDP
Project Horizon	**2005-09**	**2010-14**	**2005-14**	**2005-14**
CBO Unified Budget Baseline	-1,443	-451	-1,893	-1.3
Adjustment for Expiring Bush Tax Cuts				
Extend 50% Bonus Depreciation	-285	-155	-440	-0.3
Extend Estate and Gift Tax Repeal	-7	-199	-206	-0.1
Extend Other Non-AMT Provisions of EGTRRA, JGTRRA	-96	-652	-748	-0.5
Extend AMT Provisions of EGTRRA, JGTRRA	-168	-396	-564	-0.4
Interest	-66	-328	-394	-0.3
Subtotal	-621	-1,730	-2,351	-1.6
Adjustment for Other Expiring Provisions				
Revenue	-75	-266	-342	-0.2
Interest	-5	-56	-61	0.0
Subtotal	-80	-322	-403	-0.3
Adjustment for All Expiring Tax Provisions				
Revenue	-631	-1,669	-2,299	-1.5
Interest	-71	-384	-455	-0.3
Subtotal	-701	-2,053	-2,754	-1.8
=Unified Budget Adjusted for Expiring Tax Provisions	-2,144	-2,503	-4,647	-3.1
–Adjustment for AMT				
Index AMT and Allow Dependent Exemptions	-36	-189	-225	-0.2
Interest	-3	-31	-34	0.0
Subtotal	-39	-220	-259	-0.2
=Unified Budget Adjusted for Expiring Tax Provisions and AMT	-2,183	-2,723	-4,906	-3.3
–Adjustment for holding real DS / person constant				
Hold real DS / person constant	123	368	491	0.3
Interest	11	82	93	0.1
Subtotal	135	449	584	0.4
=Unified Budget Adjusted for Expiring Tax Provisions and AMT With Real DS/Person Constant	-2,318	-3,172	-5,490	-3.7
–Adjustment for Retirement Funds				
Social Security	1,030	1,327	2,357	1.6
Medicare	107	81	188	0.1
Government Pensions	210	228	438	0.3
Subtotal	1,347	1,636	2,983	2.0
=Nonretirement Fund Budget Adjusted for Expiring Tax provisions and AMT With Real DS/Person Constant	-3,665	-4,809	-8,473	-5.7
–Further adjustment if discretionary spending / GDP constant				
Outlays	184	637	821	0.5
Interest	15	131	146	0.1
Subtotal	199	768	967	0.6
=Nonretirement Fund Budget Adjusted for Expiring Tax provisions and AMT With DS/GDP Constant	-3,864	-5,577	-9,440	-6.3

[1]Due to rounding, columns may not sum to total.
[2]*Source and notes:* see Appendix Table 4.

Figure 3: Baseline and Adjusted Budget Outcomes, 2003-2014
(Real DS/Person Held Constant)



To maintain current policy, we believe that a baseline computed on the assumption that real discretionary spending grows at the same rate as the population would be more appropriate. This adjustment raises discretionary outlays by $491 billion and raises the deficit by $584 billion. With this adjustment, discretionary spending still declines from 7.8 percent of GDP in 2004 to 6.9 percent in 2014, relative to 6.4 percent of GDP under the CBO baseline. Total expenditures in the adjusted baseline rise by about 0.5 percent of GDP from 20 percent in 2005 to 20.5 percent in 2014; the CBO baseline has spending holding steady at 20 percent of GDP throughout the decade. The total expenditure figures are approximately equal or below the average share of spending in the economy since 1960, 20.4 percent.

We also report at the bottom of Table 4 the cost of holding discretionary spending constant as a share of GDP over the decade. Maintaining discretionary spending at 7.8 percent of GDP raises the deficit by about $1 trillion over the next 10 years relative to the assumption that real discretionary spending grows with inflation.[5]

B. Retirement Funds

Unified budget projections can provide a misleading picture of the long-term budget position of the federal government when current or past policies result in a spending-revenue imbalance after the end of the budget projection period. Under current laws, an important source of those imbalances is long-term commitments to pay pension and health care benefits to the elderly through Social Security, Medicare, Medicaid, and the Federal Employees Retirement program. There are several potential ways to address this problem, each with different strengths and weaknesses. The approach we take here is to separate some of these programs from the official budget. In particular, we exclude the trust funds for Social Security, Medicare, and government pensions.

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[5]A special consideration regarding discretionary spending in the current budget outlook is how to project defense spending. The CBO baseline inflates current-year discretionary spending, including the defense and international components of the $87 billion supplemental appropriations bill to finance ongoing military occupation and reconstruction efforts in Iraq. It seems unlikely that the United States will engage in similar new military initiatives every year for the next decade, suggesting that the baseline is overstated. But other factors suggest that military costs other than the sup-

(Footnote 5 continued in next column.)

plemental bill may be understated in the baseline by hundreds of billions of dollars (see Kogan, Kamin, and Friedman 2004, and Committee for Economic Development, *et al.*, 2003, both of which use data from the Center on Strategic and Budgetary Assessments on the future costs of defense and war on terrorism policies). Updated figures provided by Richard Kogan suggest that removing the supplemental from the baseline but increasing defense spending as under the Committee for Economic Development, *et al.*, 2003, assumptions would, on net, result in defense and international spending that is $88 billion above the CBO baseline in 2014. For simplicity, we adjust the CBO baseline figures to keep pace with population growth. The result is a lower level of defense and international spending than under the Committee for Economic Development *et al.* adjustments.

Table 5
Effect of GDP Growth Rates on Baseline and Adjusted Budget Outcomes for 2004-2014
January 2004 Projections
(Deficit in $ billions)

	Deficit as a Share of GDP			Deficit in $ Billions			2005-2014 Deficit	
	2004	2009	2014	2004	2009	2014	% of GDP	$ Billions
CBO Unified Budget Baseline								
GDP Grows 1% Faster	4.1	0.6	-2.7	467	87	-528	-0.3	-465
GDP Grows at Projected Rate	4.2	1.8	-0.1	477	268	-13	1.2	1893
GDP Grows 1% Slower	4.2	3.2	3.1	487	449	502	2.8	4251
Adjusted Unified Budget								
GDP Grows 1% Faster	4.0	2.2	1.1	461	329	216	1.8	3133
GDP Grows at Projected Rate	4.1	3.5	4.0	471	510	730	3.4	5490
GDP Grows 1% Slower	4.2	5.0	7.6	481	691	1245	5.1	7848
Adjusted Non-Trust Fund Budget								
GDP Grows 1% Faster	5.9	4.1	2.8	672	629	556	3.6	6116
GDP Grows at Projected Rate	5.9	5.6	5.9	682	810	1071	5.3	8473
GDP Grows 1% Slower	6.0	7.2	9.7	692	991	1586	7.1	10831

Source: Author's calculations based on Table B-1 in CBO (2004).

C. Implications of the Adjustments

Table 4 shows the sizable effects of adjusting the budget for current policy assumptions and retirement trust funds over the 10-year period. (Appendix Table 4 reports annual data, which are plotted in Figure 3.) As noted above, the CBO unified budget baseline projects a 10-year deficit of $1.9 trillion, with deficits falling sharply over time. Adjusting the CBO baseline for our assumptions regarding current policy implies that the unified budget will be in deficit to the tune of $5.5 trillion over the next decade if real discretionary spending per capita is held constant. Notably, the adjusted unified baseline shows a deficit of at least 3.4 percent of GDP in every year through 2014. The unified budget, however, includes retirement trust fund surpluses of almost $3 trillion. Adjusting further by taking the retirement funds off-budget generates a 10-year deficit, other than retirement funds, of $8.5 trillion.

Although the precise figures should not be taken literally due to uncertainty and other factors, the basic trends in the data are clear. First, the CBO baseline suggests that the budgetary future features falling deficits within the 10-year window, while our adjusted unified budget baseline implies continual, substantial, and rising unified deficits through 2014. By 2014, the annual difference between the official projected unified budget and our alternative unified deficit is $743 billion. Second, adjusting for the fact that the retirement trust funds are running current surpluses but will run deficits in the future makes the budget outlook far worse — and the difference grows over time. By 2014, the annual difference between the CBO unified budget baseline and our adjusted non-retirement-trust-fund budget exceeds $1 trillion.

IV. Discussion

The projections above indicate that the nation faces substantial deficits in the short-term and the medium-term, with no apparent relief within the next 10 years. Several recent studies — including those by the International Monetary Fund (2004), Committee for Economic Development, *et al.* (2003), and Goldman Sachs (2003) — have similarly warned about the unsustainable fiscal conditions in the United States.

Other projections show that budget outcomes will become significantly less favorable after 2014 (see, for example, Auerbach, Gale, and Orszag 2003 and CBO 2003). The primary driving force beyond 2014 is demographics — in particular the retirement of the baby-boom generation, a smaller number of new entrants into the labor force, and lengthening life spans — coupled with increasing health care expenditures. Taken together, the medium- and long-term estimates imply that the nation faces a substantial fiscal gap.

A. Economic Implications of Sustained Deficits

If allowed to persist, fiscal gaps will impose significant and growing economic costs over the medium term and potentially devastating effects over the longer term. The reason is that budget deficits reduce national saving, and lower levels of national saving reduce future national income.[6]

[6]To be sure, a complete policy analysis should take into account the direct effects of the change in spending or taxes that generate the deficit, as well as the indirect effects of the associated changes in the deficit. Reductions in marginal tax rates, for example, may spur supply-side responses that raise growth at the same time that the deficits created by the tax cuts would reduce growth. The net effect is ambiguous in theory and depends on the structure and magnitude of the tax cut. Most studies, however, have found that the net effects of the president's tax cuts on medium- and long-term growth will prove negative, unless the entire tax cut is financed with spending cuts, which seems unlikely given recent spending trajectories.

Table 6
What Would It Take to Balance the Budget in 2009?

	CBO Unified Baseline	Adjusted Unified Baseline	Adjusted Nonretirement Baseline
Projected Deficit	268	430	740
as % of GDP	1.8	3.0	5.1
Percent Cut in:			
All Noninterest Outlays	-10.3	-19.2	-31.7
All Mandatory Spending	-16.8	-32.1	-50.3
All Discretionary Spending	-26.2	-48.0	-86.0
All Nondefense DS	-55.6	-101.7	-183.8
All Spending Except:	-35.9	-66.6	-127.7
Interest, SS, Medicare, Medicaid, Defense, Homeland Security			
Percent Increase in:			
All Tax Revenues	10.1	20.6	32.7
Income Tax and Corporate Tax	17.7	38.0	60.3

Heated political rhetoric about deficits hides the fact that there is widespread agreement among economists of all political orientations that sustained deficits are harmful. For example, President Bush's Council of Economic Advisers (2003, Box 1-4) reports that "one dollar of [public] debt reduces the capital stock by about 60 cents" and "a conservative rule of thumb based on this relationship is that interest rates rise by about 3 basis points for every additional $200 billion in government debt." Applying the CEA calculations to the $8.5 trillion decline over the past three years in baseline projections for 2002-2011 implies that interest rates will rise by 125 basis points. The CEA calculations also imply that the domestic capital stock will fall by $5.1 trillion by 2012 because of the deterioration in the fiscal outlook, even allowing for foreign inflows of capital. This means that the stock of net assets owned by Americans at the end of 2011 will fall by more than $5.1 trillion. Our estimates suggest it will fall by $5.6 trillion and thus, if the return to capital is 6 percent, national income in 2012 will be $340 billion lower than it otherwise would have been. This translates into a cost of more than $2,900 per household *in that year alone*. The adverse effect of deficits would persist (and grow) over time.

Beyond these direct effects on national income and interest rates, sustained budget deficits can also reduce confidence and further hamper economic performance (Rubin, Orszag, and Sinai 2004). Ultimately, the U.S. role as the world's economic leader may also be threatened by long-term systemic fiscal shortfalls (Friedman 1988).

B. Nonoptions

Faced with difficult choices, policymakers often resort to one of three options: invoke the benefits of economic growth, delay action, or resort to budget gimmicks. However appealing they may be to politicians, none of these options would address the underlying problem.

Even significant economic growth will not solve the budget problem. Table 5 shows that the nation is unlikely to be able to grow out of the problem. Even if economic growth is a full percentage point faster than CBO predicts (that is, the economy grows more than one-third faster than projected), the adjusted budget would still show a deficit averaging 1.8 percent of GDP over the next decade, and amounting to 1.1 percent of GDP in 2014 (and the deficit excluding retirement trust funds would average 3.6 percent of GDP and amount to 2.8 percent of GDP in 2014).[7] In other words, more rapid economic growth can reduce the deficit, but even substantial increases in growth rate would not eliminate the fiscal imbalance over the next decade, let alone the imbalances thereafter. Moreover, as even the president's economic advisers acknowledge, large sustained deficits are likely to be a drag on growth, not a boost, and as table 5 shows, if growth is slower than expected, deficits will skyrocket.

Delaying is also not a solution — it will just make the problem harder. Table 6 shows that if no action is taken before 2009, the spending cuts or tax increases required to balance the adjusted budget in that year would be substantial: a 38 percent increase in individual and corporate income tax revenue, or a 48 percent reduction in all discretionary spending, for example. Even *eliminating* all nondefense discretionary spending would not produce a balanced budget. None of these choices seem likely to garner sufficient political support or to be equitable. Note, too, that 2009 is before the major revenue costs of extending the 2001, 2002, and 2003 tax cuts kick in (see Table 4 and Appendix Table 4) and before the baby boomers begin to retire en masse.

Given the facts above, the temptation to turn to budget gimmicks may prove overwhelming. Policymakers and the public should be especially aware of at least four tricks: (a) policies that significantly raise long-term deficits; (b) policies that can reduce short-term deficits but significantly raise long-term deficits — the president's proposals to make the 2001-3

[7]These calculations are based on rules of thumb relating small changes in economic growth rates to changes in the projected budget outcomes, provided by CBO (2004, Appendix B). CBO cautions against using the rules of thumb to project the effects of large changes, and that caveat applies to the interpretation of our results as well.

tax cuts permanent and to create Lifetime Saving Accounts and Retirement Saving Accounts, for example, fit into this framework; (c) policies that shift attention away from long-term fiscal challenges — for example, focusing on a five-year budget window; and (d) policies that allow politicians to ignore budget issues — such as not reinstating budget rules that require spending and tax changes to be self-financing.

C. Taking the Deficit Seriously

The American public is not averse to deficit-closing measures. Indeed, in a recent survey, respondents preferred, by a 60-21 margin, to close the deficit by scaling back some of the recent tax cuts rather than cutting spending programs (Harwood 2004).

The single most important change that policymakers could adopt would be to recreate a set of workable budget rules that limit spending and tax changes. This would help create and enforce spending cuts and tax increases to close the deficit. In terms of particular programmatic changes, Rivlin and Sawhill (2004) describe several possible avenues for restoring fiscal balance in the medium term. These proposals combine spending cuts and tax increases, phase in gradually over time, and avoid budget gimmicks. Similar proposals, coupled with realistic reforms of the long-term entitlement programs (see, for example, Diamond and Orszag 2004) would be significant steps in the right direction.

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Appendix Table 1
Changing Annual Budget Projections
(Surplus or Deficit in Billions of Current Dollars)[1]

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Unified Budget													
January 2001[2]	313	359	397	433	505	573	635	710	796	889			
January 2002[3]	-21	-14	54	103	128	166	202	250	294	439	641		
January 2003[4]	-158	-199	-145	-73	-16	26	65	103	140	277	451	508	
January 2004[5]	-158	-375	-477	-362	-269	-267	-278	-268	-261	-162	-24	-16	13
Non-Social Security Budget													
January 2001[2]	141	171	195	212	267	316	359	416	484	558			
January 2002[3]	-184	-193	-141	-108	-99	-76	-56	-24	4	132	319		
January 2003[4]	-317	-360	-320	-267	-229	-205	-185	-165	-145	-26	134	177	
January 2004[5]	-317	-531	-629	-533	-461	-475	-500	-504	-507	-417	-294	-289	-271
Non-Social Security, Non-Medicare Budget													
January 2001[2]	105	132	154	172	223	275	318	377	447	524			
January 2002[3]	-217	-229	-179	-146	-141	-117	-96	-63	-34	95	278		
January 2003[4]	-349	-386	-348	-296	-263	-239	-222	-202	-183	-63	95	142	
January 2004[5]	-349	-553	-647	-551	-484	-497	-523	-525	-527	-434	-314	-303	-281

[1]Due to rounding, annual data from Appendix Table 1 may not add up to the CBO totals listed in Table 1.
[2]Congressional Budget Office. “The Budget and Economic Outlook: Fiscal Years 2002-2011.” Tables 1-1 and 1-7.
[3]Congressional Budget Office. “The Budget and Economic Outlook: Fiscal Years 2003-2012.” Tables 1-1 and 1-6.
[4]Congressional Budget Office. “The Budget and Economic Outlook: Fiscal Years 2004-2013.” Tables 1-2 and 1-5.
[5]Congressional Budget Office. “The Budget and Economic Outlook: Fiscal Years 2005-2014.” Table 1-1.

Appendix Table 2
Sources of Change in the Unified Budget Baseline, Year-by-Year
January 2001 to January 2004

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Total
Legislative Changes[1]												
EGTRRA												
Revenue Provisions	70	31	84	101	100	126	142	151	158	176	117	1186
Outlays	4	6	7	7	7	10	10	9	10	11	12	89
Debt Service[2]	0	4	8	14	21	29	38	49	60	73	86	382
Subtotal	74	41	99	122	128	164	190	209	228	260	216	1657
Economic Stimulus												
Revenue Provisions	0	43	39	29	4	-16	-17	-16	-14	-10	-7	35
Outlays	0	8	4	0	0	0	0	0	0	0	0	12
Debt Service	0	1	3	6	7	7	7	6	6	5	5	53
Subtotal	0	52	46	35	11	-9	-10	-10	-8	-5	-2	99
JGTRRA												
Revenue Provisions	0	0	53	135	78	21	14	17	11	4	-4	328
Outlays	0	0	9	12	5	0	0	0	0	0	0	26
Debt Service	0	0	0	3	8	12	16	19	21	23	24	126
Subtotal	0	0	62	151	90	33	30	35	32	27	20	480
Other Revenue Changes												
Revenue	1	1	3	3	4	3	2	1	1	2	2	21
Debt Service	0	0	0	0	1	1	1	1	1	1	1	8
Subtotal	1	1	3	4	4	4	2	2	2	3	3	29
Defense Spending												
Outlays	5	35	82	119	126	126	126	129	131	135	142	1151
Debt Service	0	1	4	9	16	24	33	41	51	61	72	311
Subtotal	5	36	86	128	142	150	159	170	182	196	214	1462
Nondefense Homeland Security												
Outlays	0	-1	6	11	12	15	15	16	16	16	17	124
Debt Service	0	0	0	0	1	2	3	4	5	6	7	27
Subtotal	0	-1	6	12	13	16	18	20	21	22	24	151
Medicare Act												
Outlays	0	0	0	4	6	27	40	44	47	50	53	272
Debt Service	0	0	0	0	0	1	3	5	8	11	14	42
Subtotal	0	0	0	4	6	28	43	49	55	61	67	314
Other Outlays												
Outlays	4	22	63	66	79	79	83	86	88	89	87	743
Debt Service	0	1	3	7	11	16	21	27	33	40	47	207
Subtotal	4	23	66	73	90	95	105	113	122	129	134	950
Economic and Technical Changes												
Revenue	72	308	381	367	336	299	290	297	306	314	304	3202
Outlay	-3	11	-15	-21	-26	-8	13	26	39	50	71	141
Subtotal	69	319	366	347	310	291	303	323	345	364	375	3343
Total Change in Surplus	154	471	734	874	795	774	839	913	979	1057	1050	8485
As Percent of Change in Surplus[3]												
EGTRRA	48	9	13	14	16	21	23	23	23	25	21	20
Economic Stimulus	0	11	6	4	1	-1	-1	-1	-1	0	0	1
JGTRRA	0	0	8	17	11	4	4	4	3	3	2	6
Other Revenue Changes	1	0	0	0	1	1	0	0	0	0	0	0
Defense Spending	3	8	12	15	18	19	19	19	19	19	20	17

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Total
Homeland Security	**0**	**0**	**1**	**1**	**2**	**2**	**2**	**2**	**2**	**2**	**2**	**2**
Medicare Act	**0**	**0**	**0**	**0**	**1**	**4**	**5**	**5**	**6**	**6**	**6**	**4**
Other Outlays	**3**	**5**	**9**	**8**	**11**	**12**	**12**	**12**	**12**	**12**	**13**	**11**
Economic/Technical Changes	**45**	**68**	**50**	**40**	**39**	**38**	**36**	**35**	**35**	**34**	**36**	**39**
Total	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**

[1]All non-interest figures are derived from supplemental tables used by the Congressional Budget Office for "The Budget and Economic Outlook: Fiscal Years 2005-2014." January 2004.
[2]Debt Service is apportioned to each of the categories based on the authors' calculations. Each major legislative change is ascribed interest based on that year's CBO debt service matrix. Other legislative changes in projected revenue are aggregated in each time period and applied to that year's debt service matrix. A residual is calculated and attributed to outlay changes.
[3]Percents may not add up to 100 due to rounding.

Appendix Table 3
Baseline and Adjusted Budget Outcomes for 2000-2014
January 2004 Projections
(Percent of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
CBO Unified Budget Baseline[1]															
Surplus (or Deficit)	2.4	1.3	-1.5	-3.5	-4.2	-3.0	-2.1	-2.0	-2.0	-1.8	-1.7	-1.0	-0.1	-0.1	0.1
Total Revenues	20.8	19.8	17.9	16.5	15.8	16.9	17.8	18.0	18.1	18.2	18.3	19.1	19.8	19.9	20.1
Total Spending	18.4	18.6	19.5	19.9	20.0	19.9	19.9	20.0	20.1	20.1	20.1	20.2	19.9	20.0	20.0
Net Interest	2.3	2.1	1.7	1.4	1.4	1.5	1.7	1.9	2.0	2.1	2.1	2.1	2.0	1.9	1.9
Mandatory	9.8	10.1	10.7	10.9	10.8	10.7	10.7	10.8	10.8	11.0	11.1	11.3	11.3	11.6	11.8
Discretionary	6.3	6.5	7.1	7.6	7.8	7.7	7.5	7.3	7.2	7.0	6.9	6.8	6.6	6.5	6.4
Defense	3.0	3.1	3.4	3.7	3.9	3.9	3.8	3.6	3.6	3.5	3.4	3.4	3.3	3.3	3.2
Nondefense	3.3	3.4	3.7	3.9	3.9	3.9	3.8	3.7	3.6	3.5	3.4	3.4	3.3	3.2	3.2
Adjusted Unified Budget[2]															
Surplus (or Deficit)	2.4	1.3	-1.5	-3.5	-4.1	-3.6	-3.3	-3.3	-3.3	-3.3	-3.2	-3.4	-3.2	-3.2	-3.2
Total Revenues	20.8	19.8	17.9	16.5	15.9	16.4	16.7	16.9	17.0	17.1	17.2	17.2	17.2	17.3	17.4
Total Spending	18.4	18.6	19.5	19.9	20.0	20.0	20.0	20.2	20.3	20.3	20.4	20.6	20.3	20.5	20.5
Net Interest	2.3	2.1	1.7	1.4	1.4	1.5	1.8	2.0	2.2	2.3	2.4	2.5	2.6	2.7	2.8
Mandatory	9.8	10.1	10.7	10.9	10.8	10.7	10.7	10.8	10.8	11.0	11.1	11.3	11.3	11.6	11.8
Discretionary	6.3	6.5	7.1	7.6	7.8	7.8	7.7	7.5	7.4	7.3	7.2	7.2	7.0	7.0	6.9
Defense	3.0	3.1	3.4	3.7	3.9	3.9	3.8	3.7	3.7	3.7	3.6	3.6	3.5	3.5	3.5
Nondefense	3.3	3.4	3.7	3.9	3.9	3.9	3.8	3.8	3.7	3.7	3.6	3.6	3.5	3.5	3.4
Addendum															
CBO Unified Budget Baseline (in percent GDP)															
Discretionary Spending															
International	0.2	0.2	0.3	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Homeland Security	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Other	3.0	3.1	3.4	3.5	3.4	3.4	3.3	3.2	3.2	3.1	3.0	2.9	2.9	2.8	2.8
Adjusted Unified Budget (in percent GDP)															
Discretionary Spending															
International	0.2	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2
Homeland Security	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Other	3.0	3.1	3.4	3.5	3.4	3.4	3.4	3.3	3.3	3.2	3.2	3.1	3.1	3.0	3.0

[1]Congressional Budget Office. "The Budget and Economic Outlook: Fiscal Years 2005-2014." Tables 1-2 and 3-1.
[2]Author's calculations based on the cost of extending expiring tax provisions in Table 1-3 of CBO (2004), an AMT adjustment calculated using the TPC microsimulation model, an adjustment to discretionary spending such that real DS/person remains constant based on U.S. Bureau of Census projections of population growth, and an adjustment to interest outlays using the CBO January 2004 debt service matrix.

Appendix Table 4
Baseline and Adjusted Budget Outcomes for 2003-2014
January 2004 Projections
(Surplus or Deficit in $ billions)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
1. CBO Unified Budget Baseline[1]	-375	-477	-362	-269	-267	-278	-268	-261	-162	-24	-16	13
as percent of nominal GDP	-3.5	-4.2	-3.0	-2.1	-2.0	-2.0	-1.8	-1.7	-1.0	-0.1	-0.1	0.1
Adjustment for Expiring Bush Tax Cuts												
Extend 50% Bonus Depreciation[2]	0	3	-41	-71	-66	-58	-48	-40	-33	-28	-26	-28
Extend Estate and Gift Tax Repeal[2]	0	-1	-1	-1	-2	-2	-2	-2	-29	-51	-55	-61
Extend Other Non-AMT Provisions of EGTRRA, JGTRRA[2]	0	0	-13	-25	-23	-19	-16	-10	-103	-177	-180	-182
Extend AMT Provisions of EGTRRA, JGTRRA[3]	0	0	-10	-28	-35	-43	-51	-60	-69	-79	-89	-99
Interest[4]	0	0	-1	-5	-13	-20	-27	-34	-45	-62	-82	-105
Subtotal	0	3	-67	-131	-138	-141	-144	-147	-280	-397	-432	-475
as percent of nominal GDP	0.0	0.0	-0.6	-1.0	-1.0	-1.0	-1.0	-1.0	-1.8	-2.4	-2.5	-2.6
Adjustment for Other Expiring Provisions[5]												
Revenue	0	3	1	-8	-16	-21	-31	-45	-52	-54	-57	-59
Interest	0	0	0	0	-1	-2	-3	-5	-8	-11	-14	-17.96
Subtotal	0	3	1	-8	-17	-23	-34	-50	-60	-65	-71	-77
Adjustment for All Expiring Tax Provisions												
Revenue	0	6	-65	-134	-142	-142	-148	-158	-287	-389	-407	-429
Interest	0	0	-1	-5	-13	-21	-30	-39	-53	-73	-97	-123
Subtotal	0	6	-66	-139	-155	-163	-178	-197	-339	-462	-503	-551
2. Unified Budget Adjusted for Expiring Tax Provisions	-375	-471	-427	-408	-422	-441	-446	-458	-501	-486	-520	-539
as percent of nominal GDP	-3.5	-4.1	-3.5	-3.2	-3.2	-3.2	-3.1	-3.0	-3.2	-2.9	-3.0	-3.0
Adjustment for AMT[6]												
Index AMT and Allow Dependent Exemptions in 2005	0	0	-1	-4	-6	-10	-15	-20	-28	-36	-46	-58
Interest	0	0	0	0	0	-1	-2	-2	-4	-6	-8	-11
Subtotal	0	0	-1	-4	-7	-11	-16	-23	-31	-42	-54	-70
3. Unified Budget Adjusted for Expiring Tax Provisions and AMT	-375	-471	-429	-412	-428	-452	-462	-481	-533	-527	-574	-608
as percent of nominal GDP	-3.5	-4.1	-3.5	-3.2	-3.2	-3.3	-3.2	-3.2	-3.4	-3.2	-3.3	-3.4
Adjustment for Holding Real DS/Person Constant[7]												
Hold Real DS/Person Constant	0	0	8	16	24	33	42	52	62	73	84	96
Interest	0	0	0	1	2	3	5	8	12	16	20	26
Subtotal	0	0	8	17	26	37	48	60	74	88	105	122
4. Unified Budget Adjusted for Expiring Tax Provisions and AMT With Real DS/Person Constant	-375	-471	-436	-428	-455	-488	-510	-541	-607	-616	-678	-730
as percent of nominal GDP	-3.5	-4.1	-3.6	-3.4	-3.4	-3.5	-3.5	-3.6	-3.8	-3.7	-3.9	-4.0
Adjustment for Retirement Funds[8]												
Social Security	156	152	172	192	208	223	235	245	255	270	273	284
Medicare	22	19	18	24	22	22	22	21	17	20	14	9
Government Pensions	38	41	41	42	42	42	43	43	45	46	47	47
Subtotal	216	211	230	258	272	287	300	309	318	336	334	340
5. Nonretirement Fund Budget Adjusted for Expiring Tax Provisions and AMT With Real DS/Person Constant	-591	-682	-667	-686	-727	-775	-810	-850	-924	-951	-1012	-1071
as percent of nominal GDP	-5.5	-5.9	-5.5	-5.4	-5.5	-5.6	-5.6	-5.6	-5.8	-5.7	-5.8	-5.9

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Further Adjustment for Holding DS/GDP Constant												
Outlays	**0**	**0**	**1**	**20**	**38**	**53**	**71**	**90**	**103**	**131**	**146**	**167**
Interest	**0**	**0**	**0**	**1**	**2**	**4**	**8**	**12**	**18**	**25**	**33**	**43**
Subtotal	**0**	**0**	**1**	**21**	**40**	**57**	**79**	**102**	**121**	**156**	**179**	**210**
6. Nonretirement Fund Budget Adjusted for Expiring Tax Provisions and AMT With DS/GDP Constant	**-591**	**-682**	**-668**	**-707**	**-766**	**-833**	**-890**	**-953**	**-1045**	**-1107**	**-1191**	**-1280**
as percent of nominal GDP	**-5.5**	**-5.9**	**-5.5**	**-5.6**	**-5.8**	**-6.0**	**-6.1**	**-6.3**	**-6.6**	**-6.7**	**-6.9**	**-7.1**
Nominal GDP[9]	10829	11469	12091	12682	13236	13862	14519	15187	15862	16562	17301	18070

[1]"The Budget and Economic Outlook: Fiscal Years 2005-2014. January 2004." Summary Table 1.
[2]"The Budget and Economic Outlook: Fiscal Years 2005-2014. January 2004." Table 4-10.
[3]Authors' calculations using microsimulation model of Tax Policy Center. AMT cost is stacked on extension of EGTRRA and JGTRRA to include interaction.
[4]Authors' calculations using January 2004 CBO debt service matrix.
[5]Authors' calculations so the subtotal (excluding interest) equals CBO estimate in Table 4-10 of "The Budget and Economic Outlook: Fiscal Years 2005-2014."
[6]Authors' calculations using microsimulation model of Tax Policy Center. The indexing of the AMT and allowing dependent exemptions to be counted against taxable income for AMT purposes slows, but does not stop, the increase in AMT taxpayers.
[7]Authors' calculations using the following sources: "An Analysis of the President's Budgetary Proposals for Fiscal Year 2004: An Interim Report, Table 4." U.S. Bureau of the Census. Annual Projections of the Total Resident Population as of July 1: Middle, Lowest, Highest, and Zero International Migration Series, 1999 to 2100. February 14, 2000.
[8]"The Budget and Economic Outlook: Fiscal Years 2005-2014." January 2004. Table 1-6.
[9]"The Budget and Economic Outlook: Fiscal Years 2005-2014." January 2004. Table E-2.

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