

# The Changing Budget Outlook: Causes and Implications

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October 11, 2001

After more than twenty-five years of deficits, the federal budget began to show cash-flow surpluses in the late 1990s. By May 2001, the official baseline projections even suggested that the publicly held debt would be eliminated over the coming decade. To be sure, the longer-term deficits in Social Security and Medicare were clouds on the fiscal horizon, and the methodology used to construct the official projections continued to exaggerate the likely surpluses. Nevertheless, as of spring 2001, the short- and medium-term budget outlook was relatively auspicious.

A scant five months later, the situation has deteriorated dramatically. The rapid and substantial deterioration in the budget outlook has important implications for both short- and long-term policy debates. This paper examines these changes, their causes, and some implications. Our main findings are as follows:

## The budget outlook

- The projected unified surplus for fiscal year 2001 fell from \$275 billion in May to \$121 billion in October.<sup>2</sup>
- In May, the projected unified surplus for fiscal years 2002 to 2011 was \$5.6 trillion, including \$3.1 trillion outside of the Social Security Trust Fund. By October, those figures had fallen to \$2.6 trillion, and about \$50 billion, respectively. In other words, *virtually the entire projected non-Social Security surplus for the coming decade had disappeared by the time the decade was a week old.*
- A realistic budget assessment is even more pessimistic than these official figures suggest. The official figures omit the effects of any new stimulus package Congress may enact after the beginning of October, other items for which Congress has expressed strong support, a series of adjustments that generate more realistic baseline projections, and the long-term deficits in Social Security and Medicare.

## Causes

- The tax legislation enacted earlier this year accounts for the majority (55 percent) of the deterioration in the 10-year official outlook over the last six months. The response to the terrorist attacks and the slowing economy have also played significant roles.

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<sup>2</sup> See Congressional Budget Office, *Analysis of the President's Budgetary Proposals for Fiscal Year 2002*, May, 2001, table 3, and Congressional Budget Office, *Monthly Budget Review*, Fiscal Year 2001, September 26, 2001.

## Implications

- The long-run revenue impact of stimulus policies should be limited. This would reduce any adverse impact on interest rates.<sup>3</sup> But *even in the absence of an interest rate effect*, stimulus policies with significant long-term revenue costs could do substantial damage to long-term budget discipline, especially since the non-Social Security surplus is already virtually zero over the next 10 years.
- The ability to use the previously accrued surplus to finance emergency war efforts underscores the wisdom of having accumulated surpluses in the first place as a cushion against unexpected events.
- Under the current crisis circumstances, the bi-partisan Congressional agreement not to use Social Security and Medicare trust fund surpluses to finance current spending or tax cuts has sensibly been set aside to pay for the war. But the longer-term budgetary challenges facing the nation have only been deepened by the terrorist attacks. To meet these longer-term costs, budget discipline is essential.
- The underlying fiscal situation has changed dramatically. Policy-makers need to rethink the basic framework of tax and spending policy, including the advisability of allowing the previously enacted tax cut to be phased in as scheduled or at all.

### **I. Evolution of the budget baseline**

In estimates published by the Congressional Budget Office in May, the projected unified budget surplus was \$5.6 trillion for the next 10 years (Table 1). That figure fell to \$3.4 trillion in the CBO estimates released in August, and then to \$2.6 trillion in a bi-partisan estimate released on October 4 by the House and Senate Budget Committees (hereafter referred to as the “October baseline”).

Because the Social Security Trust Fund has been relatively unaffected by these changes, the changes in the rest of the budget have been proportionally much larger. The 10-year non-Social Security surplus has virtually disappeared, falling from \$3.1 trillion in May to \$846 billion in August and to \$53 billion by October.<sup>4</sup> Under the October baseline projection, the non-Social Security budget is expected to run a deficit of \$370 billion over the next five years, with deficits of about \$125 billion projected for 2002 and for 2003.

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<sup>3</sup> See William Gale, Peter Orszag, and Gene Sperling, “Stimulating the Economy Through Tax Policy: Principles and Applications,” <http://www.brook.edu/views/papers/gale/20011005.htm> and “Tax Stimulus Options in the Aftermath of the Terrorist Attack,” <http://www.brook.edu/views/articles/gale/20011008.htm>, or *Tax Notes*, October 8, 2001.

<sup>4</sup> The “non-Social Security” balance is slightly different from the “on-budget” balance because the latter excludes the Postal Service in addition to Social Security. The August projection for the on-budget surplus between 2002 and 2011, for example, was \$847 billion – slightly larger than the projection for the non-Social Security surplus. Our estimate of the non-Social Security surplus in the October baseline is predicated on the assumption that the projected Social Security surplus did not change from the August to the October baseline.

What accounts for these changes? The vast majority of the decline from May to August is due to the tax cut enacted last spring. The tax cut was estimated to reduce revenues between 2002 and 2011 by \$1.275 trillion, and create interest costs of \$383 billion.<sup>5</sup> The total cost of the tax cut—\$1.658 trillion—accounts for almost three-quarters of the deterioration in the projected surplus through August. Changes in economic and technical assumptions explained slightly more than 20 percent of the reduction between May and August, and increases in government spending (plus their interest costs) had a very small effect (5 percent of the total deterioration).

It is worth emphasizing that the budget situation had deteriorated substantially even before the terrorist attacks on September 11. The combination of the tax cut, the slowing economy and small changes in discretionary spending were sufficient to reduce the overall 10-year surplus by \$2.2 trillion, and push the non-Social Security baseline budget into a deficit of \$10 billion for 2001, with deficits also projected for 2003 and 2004.

The terrorist attack implies a further deterioration in the federal budget outlook for three reasons. First, in the short run, the federal government has already committed substantial resources to defense, rescue, and recovery efforts, as well as the airline bailout, and additional stimulus measures seem likely. Second, the attack seems likely to have slowed the economy, which would result in lower revenue and higher spending. Third, the longer-term policy response to the attacks is likely to involve changes in the nature and level of government spending.

The vast majority of the decline in the 10-year budget projection from August to early October -- which does not incorporate the tax cuts that have been proposed as part of an additional stimulus package -- is due to increased spending since the attacks. This spending includes additional defense expenditures, the projected cost of an emergency anti-terrorism bill that was passed, and assistance for the airline industry. The rest of the decline in the projected surplus since August is due to economic and technical adjustments, mostly reflecting the slowdown in the economy.

All told, the tax cut accounted for 55 percent of the change between May and October, the spending response to the terrorist attack accounted for 21 percent, economic and technical changes accounted for 20 percent, and new discretionary spending not related to the attacks accounted for just 4 percent (see Table 2).

## **II. Adjusting the baseline**

The Congressional Budget Office is careful to point out that its budget baseline reflects one definition of continuing “current policy” into the future. The baseline is in no way intended to be a prediction of *likely* budget outcomes.<sup>6</sup> To obtain a more reasonable measure of likely budget outcomes, one must consider additional items. For example, the October 4 budget committee estimates include a list of “consensus” items and others that have been passed by one or both Houses of Congress, but that have not been enacted into law and therefore are not

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<sup>5</sup> We obtained this estimate using the Congressional Budget Office’s interest rate matrix.

<sup>6</sup> Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2002-2011*, January, 2001, p. 5.

reflected in the official forecasts. The budgetary implications of passing these items are shown in Table 3. They total an additional \$1.5 trillion in reduced surpluses, inclusive of interest payments.

If just those items were enacted—and no other changes were made—the unified budget surplus would fall to \$1.1 trillion over the next decade. The non-Social Security surplus would be in *deficit* to the tune of \$1.4 trillion, and the budget aside from Social Security and Medicare's Part A trust fund, which Congress has voted in the past not to invade, would face a deficit of \$1.85 trillion. The balance outside all the retirement trust funds would be a deficit of \$2.3 trillion.<sup>7</sup>

### **III. The budget outlook beyond the next decade**

The Social Security and Medicare trust fund balances and projected revenues fall far short of what would be needed to meet future liabilities under current policy. This longer-term imbalance is temporarily masked by the asymmetry in unified budget accounting practices that counts assets for these programs but not liabilities. Placing the assets off-budget – which would cause the projected surplus over the next ten years to become negative – represents an improvement, but still ignores the fact that the accruing assets are insufficient to finance the projected liabilities. An alternative way of recognizing these entitlement liabilities is to extend the planning horizon, to include the future years in which the liabilities come due and thus can no longer be ignored, even under the cash accounting method.

The use of long-term planning horizons is now standard for Social Security and Medicare. In the context of an aging population and rapidly rising medical care expenditures, such a long-term horizon is the only way to get an accurate picture of the fiscal balance of these programs, and hence the government's budget as a whole. To take these and other factors into account, analysts have estimated the long-term "fiscal gap" under different policies. The fiscal gap is the size of the permanent increase in taxes or reductions in non-interest expenditures (as a share of GDP) that would be required now to keep the long-term ratio of government debt to GDP at its current level. Over an infinite planning horizon, this requirement is equivalent to assuming that the debt-GDP ratio will not explode. The fiscal gap gives a sense of the *current* budgetary status of the government, taking into account long-term influences.

Last fall, the CBO estimated a fiscal gap of 0.8 percent of GDP through 2070.<sup>8</sup> Long-term estimates are subject to considerable uncertainty, and their precise magnitudes are less

<sup>7</sup> Government pension funds for military and civilian workers are structured similarly to Medicare and Social Security in that the pensions represent obligations that are accruing to current workers. The pension trust fund is currently running surpluses in the on-budget portion of the budget of about \$469 billion over the next decade. Congressional Budget Office, *The Budget and Economic Outlook: An Update*, August, 2001, table 1-9.

<sup>8</sup> Congressional Budget Office, *The Long-Term Budget Outlook*, October, 2000, table 5. Auerbach and Gale (2001) extend the CBO analysis and estimate a permanent fiscal gap -- what would be needed to prevent the national debt from exploding in the long run, rather than just through 2070 – of 3.33 percent of GDP. The permanent gap is so much larger because the budget is projected to be in substantial deficit during the years approaching 2070 (and those that follow). See Alan J. Auerbach and William G. Gale, "Tax Cuts and the Budget Outlook," Policy Brief No. 76, Brookings, April 2001.

important than the fact that the nation does face long-term budget pressures. Fundamentally, long-term estimates are inherently uncertain – and even more uncertain than short-term estimates. But the added uncertainty should not lead us to ignore long-term issues. Indeed, the serious consequences of a relatively bad long-term outcome should spur policymakers to take precautions now. Also, note that the sources of uncertainty differ in the long and short runs. Over the next ten years, the primary factor affecting surpluses will be the economy. Over the longer term, the demographic pressures of an aging population will play a more important role, although economic performance will remain relevant. The magnitude of this demographic shift is uncertain, but its occurrence is not.<sup>9</sup>

#### **IV. Implications**

The analysis above has several immediate policy implications. First, the budget outlook suggests that the long-run revenue impact of stimulus policies should be limited. Partly because the budget situation has already deteriorated so rapidly, a stimulus package with substantial long-term revenue costs could do more harm than good by raising interest rates, which would restrain business and housing investment and interest-sensitive consumption. But even in the absence of any effect on interest rates, tax cuts with significant long-term revenue losses would do significant damage to the long-term budget outlook.

Second, the rapid deterioration of the budget projections over the past six months underscores the benefits of surpluses as a cushion against unexpected events. The budget surpluses of the late 1990s meant that the nation was much better positioned to meet the costs of the recent terrorist attacks and the economic slowdown than otherwise would have been the case. As Ari Fleischer, President Bush's press secretary, has noted, the nation was fortunate to enter this period having money available from the surplus to work fighting terrorism and reinvigorating the economy.<sup>10</sup> The benefits of preserving projected surpluses for unexpected contingencies have been highlighted by recent events.

Third, under the current crisis circumstances, the Social Security “lock-box” (as well as the Medicare “lock-box”) has sensibly been set aside. That is a necessary step right now, to pay for the war. But the longer-term budgetary challenges facing the nation have, if anything, only been deepened by the terrorist attacks. To meet these longer-term costs, budget discipline is essential. The primary way to reduce the future burdens imposed by Social Security, Medicare, and other government programs is to raise national saving, which is the sum of government saving and private saving. Budget surpluses, which represent government saving, are one of the most auspicious approaches to raising national saving. The key point is that policy-makers must re-establish some guiding principle for budget discipline, as has been provided by the Social Security lock-box over the past few years. Indeed, the October 4 bi-partisan Congressional statement sets the goal of restoring the Social Security lock-box.

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<sup>9</sup> Because the CBO estimate is based on budget projections from last fall, the estimated fiscal gap would be even larger if the budget revisions since then were included.

<sup>10</sup> See Richard Stevenson, “In Rapid Shift, a Budget Surplus Is Expected to Turn Into a Deficit,” *New York Times*, October 1, 2001, page A1.

Fourth, the budget outlook is affected by the need to respond to the terrorist attacks. There is significant talk now of a return to bigger, more active government. The first few weeks after the attacks showed new government initiatives for defense, rescue and recovery spending, an airline bailout, a push for new federal authority to regulate airport security, and expanded powers of law enforcement. All of these items have budgetary implications.

Finally, whatever one's view of the affordability of the tax package enacted last spring, it was passed before the nation realized it would need to finance a new war. After "the dust has settled" on the first round of stimulus packages, and the policy debate turns to focusing on longer-term issues, it will be clear that the underlying fiscal situation has changed dramatically – as the analysis above highlights. Policy-makers will therefore have to rethink the basic framework of tax and spending policy, including the advisability of allowing the previously enacted tax cut to be phased in as scheduled.

The potential savings from freezing parts of the tax cut are substantial. According to the Joint Committee on Taxation, for example, just freezing the 38.6 marginal tax rate would save roughly \$100 billion between 2002 and 2011 (excluding debt service savings).<sup>11</sup> Such a freeze would not represent a change relative to current law until 2004, well after the nation's short-term economic challenges are likely to have passed. It would also affect only 1.1 million taxpayers, who have an average adjusted gross income of \$1.025 million. Even those high-income taxpayers would only forgo a future marginal tax cut, rather than experiencing a tax increase relative to today's rates, and would still enjoy a reduction in average tax rates (since the tax rates applying at lower levels of income would decline). More expansive freezes of the tax cut will likely be necessary to preserve fiscal discipline over the longer term.

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<sup>11</sup> Letter from Bernard Schmitt, Joint Committee on Taxation, to Senator Barbara Boxer, September 4, 2001. The Joint Committee estimate applies specifically to the projected cost of reducing the 38.6 percent rate to 35 percent, given the tax code prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001. The savings from freezing the 38.6 percent rate at this point may be somewhat smaller than this estimate, since other provisions of that Act interact with the marginal tax rate revenue effects.

**Table 1**  
**The Changing Baseline Budget: May, August, October 2001**

(\$ Billions)

**Ten-Year Baseline Budget Surplus, 2002-2011**

	Unified Budget	Social Security Budget	Non-Social Security Budget	Non-Social Security, Non-Medicare Budget
May 2001 <sup>1</sup>	5629	2485	3144	2751
August 2001 <sup>2</sup>	3397	2551	846	442
October 2001 <sup>3</sup>	2604	2551	53	-351

**Five-Year Baseline Budget Surplus, 2002-2006**

	Unified Budget	Social Security Budget	Non-Social Security Budget	Non-Social Security, Non-Medicare Budget
May 2001 <sup>1</sup>	2002	1020	982	782
August 2001 <sup>2</sup>	1082	1036	46	-162
October 2001 <sup>3</sup>	666	1036	-370	-578

<sup>1</sup>Congressional Budget Office. "An Analysis of the President's Budgetary Proposals for Fiscal Year 2002." May 2001.

<sup>2</sup>Congressional Budget Office. "The Budget and Economic Outlook: An Update." August 2001.

<sup>3</sup>House Budget Committee and Senate Budget Committee. "Revised Budgetary Outlook and Principles for Economic Stimulus." October 4, 2001.

**Table 2**  
**Sources of Change in the Unified Budget Baseline, 2002-2011**  
**May, August, October 2001**

(\$ Billions)  
[Percent of Change]\*

	May-August		August-October		May-October	
Economic and Technical Changes	-460	[20.6]	-144	[18.2]	-604	[20.0]
Legislative Changes						
Tax Act						
Revenue Loss	-1275	[57.1]	0	[0]	-1275	[42.1]
Debt Service	-383	[17.2]	0	[0]	-383	[12.7]
Subtotal	-1658	[74.3]	0	[0]	-1658	[54.8]
Outlays						
New Spending	-83	[3.7]	-413	[52.1]	-496	[16.4]
Debt Service**	-34	[1.5]	-236	[29.8]	-270	[8.9]
Subtotal	-117	[5.2]	-649	[81.8]	-766	[25.3]
Total Change in Surplus	-2232	[100.0]	-793	[100.0]	-3025	[100.0]

\*Percentages may not sum to 100 due to rounding.

\*\*For the August-October changes, this may include debt service on economic and technical changes.

Sources: Congressional Budget Office. "The Budget and Economic Outlook: An Update." August 2001. Congressional Budget Office. "An Analysis of the President's Budgetary Proposals for Fiscal Year 2002." May 2001. House Budget Committee and Senate Budget Committee. "Revised Budgetary Outlook and Principles for Economic Stimulus." October 4, 2001, and authors' calculations using the CBO interest rate matrix.

**Table 3**  
**Implications of Other Possible Claims on the Budget, 2002-2011**  
**as of October 2001**

(\$ Billions)

	Cost	Remaining Surplus/Deficit
October 2001 Baseline Unified Surplus	-	2604
- Social Security Trust Fund	2551	53
Other Possible Claims on the Budget		
- Budget resolution policies <sup>1</sup>	67	-14
- Budget Resolution Reserve Fund policies <sup>2</sup>	431	-445
- House- and Senate-passed bills <sup>3</sup>	225	-670
- Natural disasters	55	-725
- Permanent extension of expiring tax provisions	142	-867
- Elimination of EGTRRA sunsets	113	-980
- Alternative Minimum Tax	208	-1188
- Debt Service on Possible Claims	258	-1446
- Medicare (Part A) Trust Fund	404	-1850
- Government pensions	469	-2319

<sup>1</sup>One-year extension of tax provisions expiring in 2001; veterans programs; other revenue policies; all other resolution policies.

<sup>2</sup>Prescription drugs; farm bill; expanded health coverage; Home Health, student loans, Family Opportunity Act.

<sup>3</sup>Faith-based initiative (House-passed); railroad retirement (House-passed); energy (House-passed); Patients Bill of Rights (Senate-passed); elementary and secondary education (Senate-passed).

Sources: House Budget Committee and Senate Budget Committee. "Revised Budgetary Outlook and Principles for Economic Stimulus." October 4, 2001. Congressional Budget Office. "An Analysis of the President's Budgetary Proposals for Fiscal Year 2002." May 2001, and authors' calculations using the CBO interest rate matrix.