# tax break

by William G. Gale and Peter R. Orszag

## Faith-Based Budgeting

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Current economic prospects feature a stagnant economy, a war, a rapidly deteriorating short-term fiscal outlook, and a substantial long-term fiscal problem. When faced with similar constellations of problems in the past, policy makers of both parties have often acted in a fiscally responsible manner, or at least in a fiscally responsible *direction*. Ronald Reagan agreed to income tax hikes in 1982 and 1984 (as well as Social Security tax hikes in 1983) when it became clear that the combination of the 1981 tax cuts, increased defense spending, and a slowing economy was wreaking havoc on federal finances. In 1990, in the face of continuing projected deficits, a bipartisan budget agreement raised taxes, cut spending, and imposed new restrictions on spending increases and tax cuts. In 1993, in the face of continuing economic and fiscal problems, Democrats in Congress raised taxes, cut spending, and extended the budget rules.

Faced with a similar set of economic problems — except that the current situation is more dire because the baby-boomers' retirement is more imminent — the Bush administration is taking a dramatically different approach. The administration's fiscal year 2004 budget proposes massive tax cuts.[1] Several features of this approach are worth noting. First is the existence of permanent tax cuts rather than any effort to shore up the long-term fiscal problem. Generally, in a situation with large and growing long-term deficits, one might expect a "moderate" strategy to involve a mix of long-term spending cuts and tax increases, and an "extreme" strategy to involve only spending cuts or only tax increases. The Bush administration, however, has gone much farther than the extreme strategy. Its proposed tax cuts imply either spending cuts that cover more than 100 percent of existing budget shortfalls or significant increases in long-term budgetary problems. (The budget does not specifically identify the relative emphasis on these two choices after five years, but that failure does not alter the underlying tradeoffs.) Second, the tax cuts are heavily weighted toward future years. That is, they are long-term tax cuts that will dramatically exacerbate long-term fiscal problems. Most of the proposed tax cuts have nothing to do with the current slowdown. Third, they are heavily weighted toward high-income taxpayers — that is, they are regressive.

The administration does pay lip service to the goal of cutting the deficit, but its words are hollow. The administration's own estimates show permanent, increasing deficits and an unsustainable budget path. And, on purely logical grounds, it is difficult to reconcile the administration's views that the tax cut in 2001 was needed to reduce the surplus, and that *the same* tax cuts, accelerated and made permanent, are needed in 2003 to raise the surplus (reduce the deficit).

> ***It's difficult to reconcile the administration's views that the 2001 tax cut was needed to reduce the surplus, and that the same tax cuts, accelerated and made permanent, are needed in 2003 to raise the surplus.***

In light of these glaring inconsistencies, the continual pursuit of large, regressive tax cuts under any and all circumstances can hardly be attributed to logic or any evidence that their effects will resolve underlying problems. Rather, the administration's fiscal policy seems to be operating on sheer faith — a political ideology that tax cuts for high-income households are always good.

Even faith-based policies, however, can and should be examined on economic criteria. In economic terms, the administration is taking a massive fiscal gamble that significant tax cuts in the face of large projected deficits are worth the risks. The gamble itself is based on several implicit claims: The tax cuts are relatively modest in size; the negative effects of such a policy are

[1]The budget resolution passed by the House of Representatives follows a similar outline, although with deficits that are ostensibly smaller because of assumed reductions in domestic discretionary spending and entitlements. The Senate passed a budget resolution that is described as more moderate, but that still entails significant tax cuts over the next decade.

manageable, even in light of the retirement of the baby boomers; the tax cuts will spur sufficient growth and spending restraint to bring about fiscal balance; and the impact on lower- and middle-income households either will be salutary or can be ignored.

This column is the first of several to examine the overall budget strategy put forth by the administration. In this column, we present the budget outlook under the March 2003 CBO baseline — an important precondition for analyzing the administration's budget strategy — and the budget outlook under the administration's proposals. Future columns will consider perspectives on the magnitude of the proposed tax cuts; the significance of the current deficit problem; the effects of tax cut proposals on growth, revenues, and spending restraint; and the merits of alternative strategies. Our conclusions in this column include:

- The March 2003 CBO baseline projects a 10-year surplus of $890 billion, with current deficits turning to surplus by 2008 and continuing to rise through 2013.
- Under more realistic assumptions regarding current policy toward discretionary spending and taxes than those contained in the official CBO projections, the adjusted unified budget shows a $1.6 trillion deficit over the next decade, with deficits of about 1 percent of GDP in the out years.
- Retirement trust fund programs included in the unified budget are expected to run surpluses exceeding $3 trillion over the next 10 years. Outside of these funds, the 10-year baseline deficit is projected to be $5 trillion, with deficits in excess of 3 percent of GDP in every year.
- Since it is well-known that the retirement funds face long-term shortfalls, the figures excluding retirement funds are probably the most informative. They show that the current stance of policy implies deficits for the foreseeable future.
- Relative to the CBO baseline, the administration's budget proposals would cost $2.7 trillion between 2004 and 2013, converting an $890 billion baseline unified budget surplus into a $1.8 trillion deficit.
- The revenue loss from the administration's tax cuts rises to 1.9 percent of GDP by 2013 (and thereafter). Taking account of the added interest payments on the debt, the tax cuts would reduce the surplus by 2.4 percent of GDP in 2013. This sets the stage for substantial long-term revenue shortfalls.
- The administration's budget is notably silent on key policies. The budget contains no long-term AMT fix. In addition, many of the expiring tax provisions were not extended, although they are likely to be extended in the future. Accounting for these omissions, the adjusted unified deficit would be $3 trillion over the next decade and at least 1.8 percent GDP in every year — almost twice the adjusted unified deficit under the baseline. (All of the figures in this column omit the costs of the war in Iraq.)
- Removing the retirement trust funds makes the forecast significantly worse. The administration's budget, adjusted for expiring tax provisions and AMT reform, would run deficits outside the retirement trust funds of $6.4 trillion over the next decade and more than 4 percent of GDP or more in every year for the foreseeable future. Thus, just as the nation needs to prepare for the retirement of the baby boomers and the pressure that will be placed on Social Security and Medicare, the government will be running massive deficits on a continuing basis in the rest of the budget under the administration's proposals.

## I. The Budget Outlook[2]

### A. The March 2003 CBO Baseline

CBO's March 2003 budget baseline projects a unified deficit of $246 billion in 2003, with the deficit then falling and turning to a surplus by 2008 that rises to $459 billion by 2013 (Table 1, p. 141).[3] The budget for 2004 through 2010 runs a cumulative deficit of more than $200 billion. The cumulative $890 billion 10-year surplus for 2004 to 2013 is more than accounted for by surpluses projected for 2011 to 2013 — and all of that is due to misleading assumptions about current policy, as explained below.[4]

These outcomes represent sharp, permanent declines from recent projections. For the 2002-11 period, the unified budget declined from a projected surplus of $5.6 trillion in January 2001 to a projected deficit of $378 billion by March 2003. The difference between the unified budget projection in January 2001 and the outcome projected in March 2003 is $605 billion for 2003 and $658 billion for 2011.[5]

### B. Adjustments to the Baseline

The CBO baseline is a mechanical forecast of current policy that is intended to serve only as a neutral benchmark, not as a prediction of likely budget outcomes or a measure of the fiscal status of the government. The baseline does not reflect likely budget outcomes because it assumes no new initiatives are enacted; it

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[2]This section updates parts of Gale and Orszag (2003) and Auerbach, *et al.* (2003), which use the January 2003 baseline. For details on the methodology and calculations we employ, see the earlier papers.

[3]These projections exclude both the effects of the administration's budget and the $75 billion supplemental appropriations proposal submitted to the Congress in March.

[4]In January, 2003, the projected 10-year unified budget has a surplus of $1.33 trillion. The change since then is due to passage of the Omnibus Appropriations Act of 2003 and technical revisions. *See* CBO (2003a).

[5]Outside of Social Security, the 10-year budget now faces a deficit of $1.7 trillion. Outside of the Social Security and Medicare Trust Funds, the budget is projected to stay in deficit until 2012, and has a cumulative deficit of $2 trillion over the next 10 years. Both of these budget measures have also declined markedly over the last two years.

**Table 1**
**CBO Baseline and Adjusted Budget Outcomes for 2003-2013**
**(Surplus or Deficit in $ billions)**

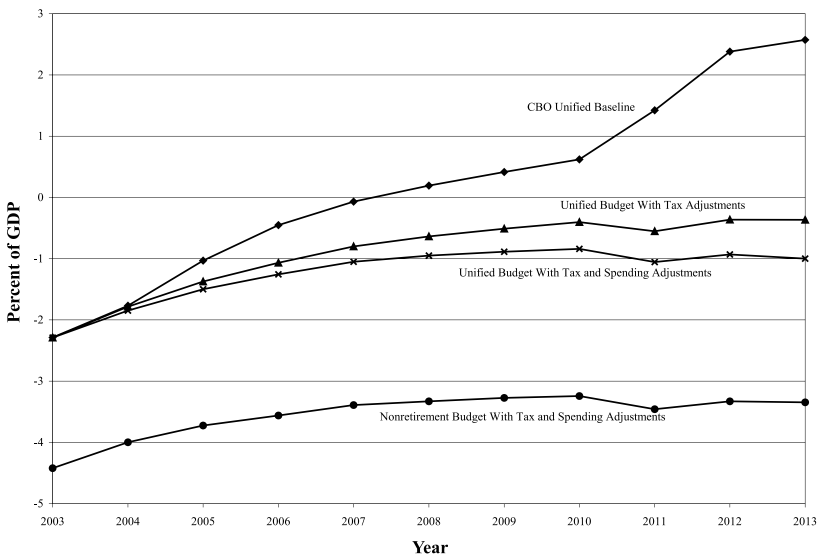
| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2004-13 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **CBO Unified Budget Baseline, March 2003**[1] | -246 | -200 | -123 | -57 | -9 | 27 | 61 | 96 | 231 | 405 | 459 | 890 |
| Expiring tax provisions | | | | | | | | | | | | |
| Revenue[2] | 0 | 0 | 34 | 61 | 69 | 73 | 74 | 76 | 206 | 308 | 321 | 1,222 |
| Interest[3] | 0 | 0 | 1 | 4 | 7 | 12 | 16 | 21 | 30 | 45 | 65 | 200 |
| Subtotal | 0 | 0 | 35 | 65 | 76 | 84 | 90 | 97 | 236 | 353 | 386 | 1,422 |
| AMT[4] | | | | | | | | | | | | |
| Revenue | 0 | 2 | 6 | 12 | 19 | 29 | 41 | 53 | 73 | 97 | 115 | 446 |
| Interest | 0 | 0 | 0 | 1 | 2 | 3 | 5 | 8 | 12 | 17 | 24 | 71 |
| Subtotal | 0 | 2 | 6 | 12 | 21 | 32 | 46 | 61 | 85 | 114 | 138 | 517 |
| **=Unified Budget With Tax Adjustments** | -246 | -202 | -164 | -134 | -106 | -89 | -75 | -62 | -90 | -62 | -65 | -1,050 |
| Hold real DS/person constant[5] | | | | | | | | | | | | |
| Outlays | 0 | 7 | 14 | 22 | 30 | 38 | 47 | 57 | 67 | 77 | 88 | 446 |
| Interest | 0 | 0 | 1 | 2 | 3 | 5 | 8 | 11 | 15 | 20 | 25 | 90 |
| Subtotal | 0 | 7 | 15 | 24 | 33 | 44 | 55 | 68 | 82 | 96 | 113 | 537 |
| **=Unified Budget With Tax and Spending Adjustments** | -246 | -209 | -179 | -158 | -139 | -133 | -130 | -130 | -172 | -158 | -178 | -1,586 |
| Retirement funds[6] | | | | | | | | | | | | |
| Social Security | 161 | 173 | 193 | 212 | 231 | 250 | 268 | 286 | 304 | 318 | 331 | 2,568 |
| Medicare | 26 | 27 | 28 | 33 | 33 | 34 | 35 | 36 | 34 | 37 | 33 | 330 |
| Government Pensions | 42 | 43 | 44 | 45 | 46 | 48 | 48 | 50 | 52 | 53 | 55 | 484 |
| Subtotal | 229 | 243 | 265 | 290 | 310 | 333 | 351 | 372 | 390 | 408 | 419 | 3,382 |
| **=Nonretirement Budget With Tax and Spending Adjustments** | -475 | -452 | -444 | -448 | -450 | -465 | -481 | -502 | -562 | -566 | -597 | -4,968 |
| **As percent of GDP**[7] | | | | | | | | | | | | |
| CBO Unified Budget Baseline | -2.3 | -1.8 | -1.0 | -0.5 | -0.1 | 0.2 | 0.4 | 0.6 | 1.4 | 2.4 | 2.6 | 0.6 |
| Unified Budget With Tax Adjustments | -2.3 | -1.8 | -1.4 | -1.1 | -0.8 | -0.6 | -0.5 | -0.4 | -0.6 | -0.4 | -0.4 | -0.7 |
| Unified Budget With Tax and Spending Adjustments | -2.3 | -1.8 | -1.5 | -1.3 | -1.1 | -0.9 | -0.9 | -0.8 | -1.1 | -0.9 | -1.0 | -1.1 |
| Nonretirement Budget With Tax and Spending Adjustments | -4.4 | -4.0 | -3.7 | -3.6 | -3.4 | -3.3 | -3.3 | -3.2 | -3.5 | -3.3 | -3.3 | -3.4 |

[1] An Analysis of the President's Budgetary Proposals for Fiscal Year 2004: An Interim Report. March 2003. Table 1.
[2] Author's calculations using: An Analysis of the President's Budgetary Proposals for Fiscal Year 2004: An Interim Report. March 2003. Table 8. The Budget and Economic Outlook: Fiscal Years 2004-2013. January 2003. Box 1-2, Table 3-11.
[3] CBO debt service matrix, March 2003.
[4] Author's calculations using Tax Policy Center microsimulation model.
[5] Author's calculations using: 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.
[6] The Budget and Economic Outlook: Fiscal Years 2004-2013. January 2003. Table 1-5. An Analysis of the President's Budgetary Proposals for Fiscal Year 2004: An Interim Report. March 2003. Supplemental Table 1-1.
[7] Author's calculations using The Budget and Economic Outlook: Fiscal Years 2004-2013. January 2003. Table E-2.

reflects questionable default assumptions about current spending and tax policies; and its economic forecast may be inaccurate. The unified budget does not reflect the fiscal status of the government because it includes the accruing cash-flow surpluses in retirement programs but ignores their long-term deficits. To obtain a better understanding of the current budget outlook, we maintain the assumption that no major new initiatives are enacted and that the economy evolves according to CBO's projections. But we make what we believe are more realistic assumptions than the baseline does about what constitutes current policy for spending and taxes, and we separate the retirement funds from the rest of the budget.

**1. Current policy.** CBO assumes that real discretionary spending will remain constant at the level prevailing at the beginning of the budget period. This implies, however, that by 2013 real discretionary spending will

**Figure 1**
**CBO Baseline and Adjusted Budget Outcomes for 2003-2013**
**(as a share of GDP)**




*Source:* See Table 1.

decline by more than 20 percent relative to gross domestic product (GDP) and by about 9 percent in per capita terms. To maintain current policy, an assumption that real discretionary spending grows at least at the same rate as the population seems more appropriate. This is the same criterion endorsed by George W. Bush as a presidential candidate.

CBO assumes that Congress will extend expiring spending programs, but that all temporary tax provisions (other than excise taxes dedicated to trust funds) expire as scheduled, even though Congress has repeatedly renewed them. The Internal Revenue Code currently contains several sorts of expiring tax rules: the 2001 tax cut, which "sunsets" by 2010; the 2002 economic stimulus package, most of which expires in 2004; relief from the alternative minimum tax, which we discuss below; and other provisions that have statutory expiration dates but that have been routinely extended in the past. We believe that assuming all of these expiring provisions will be extended is the most accurate characterization of current policy. Such an assumption is not, however, a statement of desired or optimal policy.

The alternative minimum tax (AMT) offers a dramatic example of how the baseline projections generate unlikely outcomes. Under current law, the number of AMT taxpayers will rise from about 3 million today to 36 million in 2010, and, if EGTRRA is extended, 43 million in 2013. This occurs because the AMT is not indexed for inflation and the 2001 tax cut reduced regular income taxes, but did not reduce long-term AMT liabilities (see Burman, *et al.*, 2002.) We adjust current policy toward the AMT in two ways. First, we assume that temporary AMT provisions are extended. The AMT exemption is increased for 2001 to 2004, but after 2004 it reverts to its 2000 level. The use of nonrefundable personal credits against the AMT is allowed through 2003. We assume the exemption increase and the use of nonrefundable credits are made permanent. Second, we index the AMT exemption, brackets, and phaseouts for inflation starting in 2004 and allow dependent exemptions in the AMT. Table 1 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 indexing and adding a dependent exemption are shown separately, based on estimates using the Tax Policy Center microsimulation model. Taken together, the adjustments would reduce revenues by $638 billion over the next 10 years and add $114 billion to debt service costs, for a total budgetary cost of $752 billion. Even so, they would leave 8.5 million taxpayers on the AMT in 2013 if EGTRRA is extended — well above current numbers but far below the 43.5 million slated to face the AMT without those changes.

**2. Retirement funds.** The budget includes the short-term cash-flow surplus in the Social Security and Medicare Part A Trust Funds, but not their long-term deficits. There are several potential ways to address this problem, each with different strengths and weaknesses. The approach we take here is to separate these programs from the official budget. We remove government pension trust funds for similar reasons.

**3. Implications.** Table 1 shows the sizable effects of adjusting the surplus for current policy assumptions and retirement trust funds over the 10-year period. (Figure 1, above, shows the figures as a share of GDP.) As noted above, the CBO unified budget baseline projects a 10-year surplus of $0.9 trillion, with surpluses rising sharply over time. Adjusting the CBO baseline for current policy regarding taxes and discretionary spending implies that the unified budget will be in deficit to the tune of $1.6 trillion over the next decade. Notably, the adjusted unified baseline shows a deficit in every year through 2013.

The unified budget, however, includes retirement trust fund surpluses that exceed $3 trillion. Taking the retirement funds off-budget generates a 10-year deficit outside retirement funds of $5 trillion or 3.4 percent of GDP. This figure is perhaps the most revealing. Since it is well-known that the retirement funds face long-term deficits, a meaningful way to gain insight into the government's financial status is to examine the non-

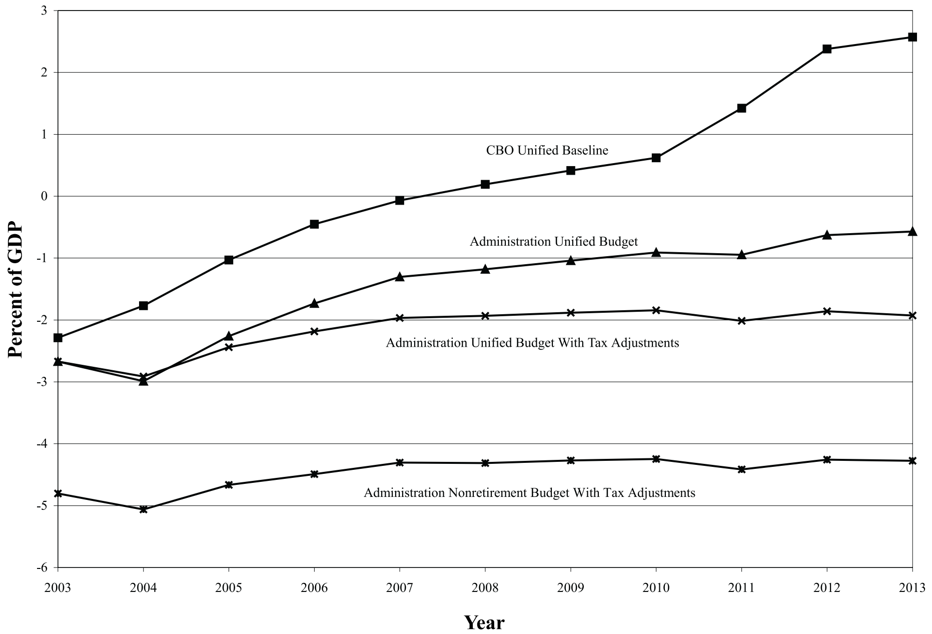
**(Text continued on p. 144.)**

**Table 2**
**The Budget Outlook Under the Administration's Proposals, 2003-2013**
**(Surplus or Deficit in $ billions)**

| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2003-13 | 2004-13 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **CBO Unified Budget Baseline**[1] | -246 | -200 | -123 | -57 | -9 | 27 | 61 | 96 | 231 | 405 | 459 | 644 | 890 |
| Administration's Tax Cut Proposals[2] | | | | | | | | | | | | | |
| Change in Revenues and Spending | 39 | 118 | 115 | 97 | 81 | 84 | 88 | 89 | 218 | 323 | 340 | 1,592 | 1,553 |
| Interest Payments[3] | 0 | 3 | 10 | 17 | 23 | 29 | 35 | 42 | 53 | 70 | 92 | 375 | 375 |
| Subtotal | 39 | 121 | 125 | 114 | 104 | 113 | 123 | 131 | 271 | 393 | 432 | 1,967 | 1,928 |
| Administration's Spending Proposals[4] | | | | | | | | | | | | | |
| New Outlays | 2 | 17 | 19 | 44 | 55 | 69 | 76 | 83 | 87 | 87 | 90 | 629 | 627 |
| Interest Payments | 0 | 0 | 3 | 3 | 5 | 10 | 15 | 23 | 27 | 32 | 39 | 156 | 156 |
| Subtotal | 2 | 17 | 22 | 47 | 60 | 79 | 91 | 106 | 114 | 119 | 129 | 785 | 783 |
| Total Effect on the Surplus | -41 | -138 | -147 | -161 | -164 | -192 | -214 | -237 | -385 | -512 | -561 | -2,752 | -2,711 |
| **Administration Unified Budget** | -287 | -338 | -270 | -218 | -173 | -165 | -153 | -141 | -154 | -107 | -102 | -2,108 | -1,821 |
| Other Expiring Provisions[5] | | | | | | | | | | | | | |
| Change in Revenues and Spending | 0 | -1 | 25 | 44 | 45 | 43 | 39 | 36 | 40 | 47 | 47 | 363 | 363 |
| Interest Payments | 0 | 0 | 1 | 2 | 5 | 8 | 10 | 13 | 16 | 19 | 22 | 96 | 96 |
| Subtotal | 0 | -1 | 26 | 46 | 50 | 50 | 49 | 49 | 56 | 66 | 69 | 459 | 459 |
| Adjustment for AMT[6] | | | | | | | | | | | | | |
| Revenue | 0 | -7 | -4 | 11 | 37 | 51 | 68 | 84 | 101 | 120 | 141 | 601 | 601 |
| Interest | 0 | 0 | 0 | 0 | 1 | 3 | 7 | 11 | 17 | 24 | 32 | 95 | 95 |
| Subtotal | 0 | -7 | -4 | 11 | 38 | 55 | 75 | 95 | 118 | 144 | 173 | 696 | 696 |
| **Administration Unified Budget With Tax Adjustments** | -287 | -329 | -291 | -275 | -261 | -270 | -277 | -285 | -327 | -316 | -344 | -3,263 | -2,976 |
| Adjustment for Retirement Funds[7] | 229 | 243 | 265 | 290 | 310 | 333 | 351 | 372 | 390 | 408 | 419 | 3,611 | 3,382 |
| **Administration Nonretirement Budget With Tax Adjustments** | -517 | -572 | -557 | -565 | -571 | -602 | -628 | -657 | -718 | -724 | -763 | -6,874 | -6,358 |
| **As Share of GDP:** | | | | | | | | | | | | | |
| Administration Tax Adjustments + Interest | 0.4 | 1.1 | 1.0 | 0.9 | 0.8 | 0.8 | 0.8 | 0.8 | 1.7 | 2.3 | 2.4 | 1.3 | 1.3 |
| Administration Spending Adjustments + Interest | 0.0 | 0.1 | 0.2 | 0.4 | 0.5 | 0.6 | 0.6 | 0.7 | 0.7 | 0.7 | 0.7 | 0.5 | 0.5 |
| Total Effect on Surplus | -0.4 | -1.2 | -1.2 | -1.3 | -1.2 | -1.4 | -1.5 | -1.5 | -2.4 | -3.0 | -3.1 | -1.8 | -1.9 |
| CBO Unified Budget Baseline | -2.3 | -1.8 | -1.0 | -0.5 | -0.1 | 0.2 | 0.4 | 0.6 | 1.4 | 2.4 | 2.6 | 0.4 | 0.6 |
| Administration Unified Budget | -2.7 | -3.0 | -2.3 | -1.7 | -1.3 | -1.2 | -1.0 | -0.9 | -0.9 | -0.6 | -0.6 | -1.4 | -1.3 |
| Adjusted Unified Budget With Tax Adjustments | -2.7 | -2.9 | -2.4 | -2.2 | -2.0 | -1.9 | -1.9 | -1.8 | -2.0 | -1.9 | -1.9 | -2.1 | -2.1 |
| Administration Nonretirement Budget With Tax Adjustments | -4.8 | -5.1 | -4.7 | -4.5 | -4.3 | -4.3 | -4.3 | -4.2 | -4.4 | -4.3 | -4.3 | -4.4 | -4.4 |

[1]An Analysis of the President's Budgetary Proposals for Fiscal Year 2004: An Interim Report. March 2003. Table 1.
[2]An Analysis of the President's Budgetary Proposals for Fiscal Year 2004: An Interim Report. March 2003. Table 8. Includes the effect of tax credits attributed to Outlays.
[3]Interest calculations, unless otherwise noted, are based on the author's use of the March 2003 CBO debt service matrix.
[4]An Analysis of the President's Budgetary Proposals for Fiscal Year 2004: An Interim Report. March 2003. Table 8. Excludes the effect of tax credits attributed to Outlays.
[5]The Budget and Economic Outlook: Fiscal Years 2004-2013. January 2003. Table 3-11. Excludes the provisions already proposed to be extended by the administration and AMT proposals addressed separately below.
[6]Author's calculation using the Tax Policy Center microsimulation model.
[7]The Budget and Economic Outlook: Fiscal Years 2004-2013. January 2003. Table 1-5.

**Figure 2**
**The Budget Outlook Under the Administration's Proposals, 2003-2013**
**(as a share of GDP)**




retirement portion of the budget. Table 1 and Figure 1 show that the adjusted baseline implies budget deficits in the nonretirement portion of the budget that exceed 3 percent of GDP in every year for the next decade and that show no signs of receding over time.

Although the precise figures should not be taken literally due to uncertainty and other factors, the basic trends are clear. The CBO baseline suggests rising surpluses within the 10-year window, while our adjusted unified budget baseline implies continual deficits through 2013. Second, the differences grow over time. By 2013, the annual difference between the official projected unified budget and our alternative unified budget projection is more than $600 billion. Third, the adjusted budget exclusive of retirement trust funds is projected to run deficits of $5 trillion over the next decade, and the difference between the official unified projection and our adjusted nonretirement trust fund budget exceeds $1 trillion in 2013 alone.

### C. Long-Term Estimates and Uncertainty

The adjusted budget figures above give a more accurate assessment of the government's fiscal status than the unified budget does, but focus only on the next 10 years. An alternative approach to addressing these issues is to extend the budget horizon beyond 10 years. Extending this approach to the entire budget suggests significant long-term budget challenges. Auerbach, *et al.* (2003), using estimates from the August 2002 CBO baseline, estimate that federal revenues are likely to fall short of federal spending by 4 to 8 percent of GDP in the long run. That is, it would require an increase in federal revenues of about 20 to 38 percent, a comparable decline in spending, or some combination of the two, to bring the long-term budget into balance.

Substantial uncertainty surrounds both the short-term and long-term projections. CBO (2003a) publishes a very useful "fan" graph that shows that the range of possible baseline budget outcomes is large. The source of this variation, though, is that the economy (and associated technical factors affecting the budget) may evolve differently than anticipated. This source of uncertainty does not significantly affect our adjustments: The difference between the official projections and our adjusted outcomes would remain largely intact even in very different underlying economic conditions. In addition, although there is significant uncertainty in the longer-term forecasts beyond 10 years, most studies have concluded that even adjusting for the contingencies, the likelihood of a significant fiscal gap is high (see Auerbach, *et al.*, 2003).

## II. The Administration's Budget Proposals

Our analysis of the administration's budget uses estimates provided by the CBO (2003b).[6] Although the administration provided only five-year budget totals, the CBO estimated the analogous 10-year figures.

### A. 10-Year Budget Aggregates

According to the CBO, the administration's proposals would reduce the surplus or raise the deficit by $2.7 trillion between 2004 and 2013, converting an $890 billion baseline unified budget surplus into an $1.8 trillion deficit. The unified deficit would decline over time, from 3 percent of GDP in 2004 to 0.6 percent of GDP by 2013, but it would remain in deficit throughout the decade (Table 2, p. 143 and Figure 2, above). (These figures, and all the other figures in this article, do not include the FY 2003 supplemental appropriations proposal submitted by the administration in March.)

The administration proposes $1.6 trillion in new tax cuts between 2003 and 2013.[7] With interest costs, the

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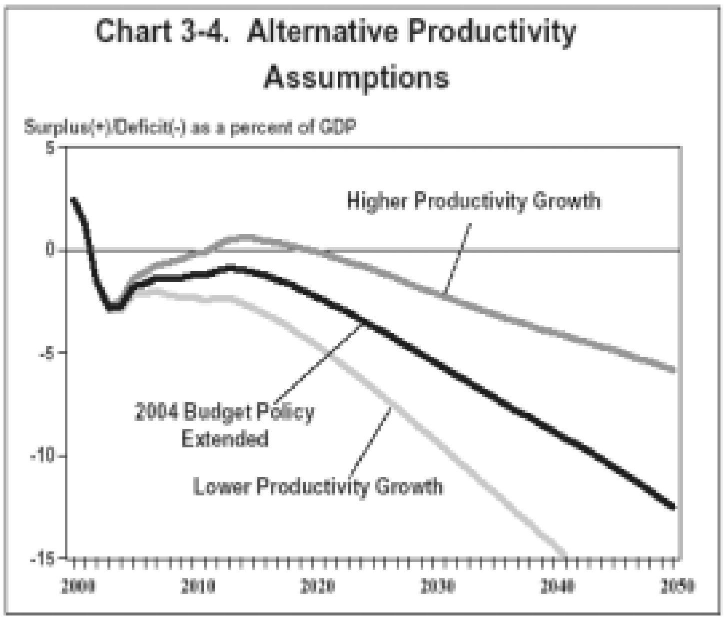
[6]In this article, we also focus exclusively on CBO's traditional estimating methodology. The effects of examining macroeconomic feedback — that is, dynamic analysis — will be examined in the companion article on taxes and growth.

[7]This figure includes $51 billion in health care tax credits, and $49 billion in earned income tax credits that CBO classifies as outlays. *See* CBO (2003b, Table 8). These programs are excluded from the outlay figures discussed below.

**Figure 3**
**Administration's Long-Term Budget Projections**




tax cuts would reduce the surplus by almost $2 trillion. The major tax cut provisions include:

- Making EGTRRA permanent ($602 billion in revenues between 2003 and 2013);
- The "Growth and Jobs" Package
  - Provide a dividend exclusion ($396 billion);
  - Accelerate many, but not all, provisions of EGTRRA to 2003 ($264 billion);
  - Increase expensing limits for small business ($28 billion); and
  - Partial AMT relief through 2005 ($37 billion).
- A variety of new deductions and credits and extensions of existing provisions.

The revenue loss from the tax cut provisions rises from $39 billion in 2003 to $118 billion in 2004, then hovers in the neighborhood of $100 billion per year through 2010. In 2011, with the extension of EGTRRA, the revenue loss rises sharply to more than $200 billion, followed by further increases to $340 billion in 2013. By 2013, the revenue loss from the proposed tax cuts would equal 1.9 percent of GDP. Taking account of the added interest payments on the debt, the tax cuts would reduce the surplus by 2.4 percent of GDP.

Table 2 also shows that the administration would provide new spending programs of $627 billion relative to the CBO baseline. This includes an increase in $211 billion in defense spending, an increase of $400 billion in Medicare, and an increase of $127 billion in other mandatory spending. It also includes a reduction of $104 billion in nondefense discretionary spending. This reduction implies that by 2013, real per capita nondefense discretionary spending would fall by about 12 percent relative to its current value.

**B. Omissions and Adjustments**

Just as the CBO baseline estimates require adjustments to provide more realistic measures of the fiscal path of the government, the administration's budget requires adjustments, too. The administration's budget is notably silent on a number of tax and spending policies.

The budget itself had no provisions for war with Iraq. Since the budget was submitted in February, the administration has requested $74.7 billion in an FY 2003 emergency supplemental bill for war-time expenses. Many analysts believe that additional funds will be requested in the future. We do not explicitly account for the costs of war with Iraq because of the current uncertainty about how much will be provided and in what year. But it is worth noting that a $75 billion appropriation for spending in 2003 would raise the deficit by about $120 billion over the course of the decade, counting interest payments.

Although it refers to Social Security and Medicare as "the real fiscal danger," the budget does not include the costs or effects of any proposals for reducing the long-term shortfalls in these programs. We adjust for this by looking at the nonretirement budget below.

Likewise, although it recognizes the expected growth of AMT coverage as a looming issue, the budget contains no long-term fix for the AMT problem. In addition, many of the expiring tax provisions were not extended in the budget, although they are likely to be extended in the future. To account for these items, we apply the same policy adjustments as in the previous section.[8]

Unlike in section I, however, we do not hold real per capita discretionary spending constant. As noted above, the administration's budget proposes sharp declines in real per capita nondefense spending. Those reductions are a key policy component of the budget,

[8] Note that the revenue loss for the adjustments will be different relative to the CBO baseline than it is relative to the administration's budget, because the administration's budget contains policies that are not in the baseline. For example, the administration's budget accelerates the 2001 tax cut. In addition, the administration budget contains a short term AMT "fix." To estimate the cost of long-term AMT reform given the administration's short-term proposal, we assume an identical long-term AMT reform as in Table 1 and then subtract the revenue cost of the administration's short-term proposal. This approach ensures that in the long run, the same number of taxpayers are on the AMT under the administration's adjusted budget in table 2 and under the adjusted CBO baseline in table 1, while also avoiding double-counting the revenue cost of the administration's temporary AMT provision.

and removing them would not fairly represent the administration's proposals. That is, the purpose of section II above is to obtain a realistic measure of *maintaining current policy*, so we keep discretionary spending constant in real per-capita terms. In this section, however, the purpose is to understand the effects of the administration's proposals, and the administration very clearly would like to enact sharp reductions in domestic discretionary spending.

Table 2 and Figure 2 show the effects of these adjustments. Under the administration's budget, adjusted only for extension of expiring provisions and AMT reform, the cumulative unified deficit would be $3 trillion over the next decade. Unlike the unified budget under the administration's proposals, the adjusted administration unified budget shows deficits of 1.8 percent of GDP or higher in every year.

Removing the retirement trust funds makes the forecast significantly worse. The administration's budget, adjusted for expiring tax provisions and AMT reform, would run deficits outside the retirement trust funds of $6.4 trillion over the decade and 4.2 percent of GDP or more in every year for the foreseeable future.

### C. Long-Term Estimates of the Administration's Budget

Although the administration provided formal budget estimates for only five years, the administration's own budget shows substantial out-year deficits, as depicted in Figure 3 (p. 145), which reproduces Chart 3-4 from the *Analytical Perspectives.* The figure shows that significant unified deficits beyond 2013 are expected even if productivity growth turns out to be higher than currently expected. (The baseline productivity growth rate assumption is 2.2 percent per year; the "higher" and "lower" productivity growth projections are 2.7 and 1.7 percent per year, respectively.) As the figure shows, the *peak* of the official unified budget projection occurs near the end of the 10-year budget window; beyond the 10-year window, large and increasing unified deficits are projected.

## III. Conclusions

The economy faces a familiar set of problems — economic slowdown, short-term fiscal deficits, and long-term fiscal gaps. The central feature of the administration's approach to resolving these problems is to cut taxes. With moderate adjustments for expiring provisions (which the administration has advocated in the past) and AMT reform (which the administration has claimed it will address in 2005), the administration's proposals would result in deficits in excess of 4 percent of GDP for each of the next 10 years in the nonretirement trust fund portion of the budget. Given the impending shortfalls in the retirement trust funds, this does not appear to us to be a prudent fiscal strategy. Despite its relentless cheerleading for tax cuts, the administration has provided no coherent strategy for addressing the nation's fiscal problems in the medium term or long term.

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