



# tax break

by William G. Gale and Peter R. Orszag

## The Budget Outlook: Analysis and Implications

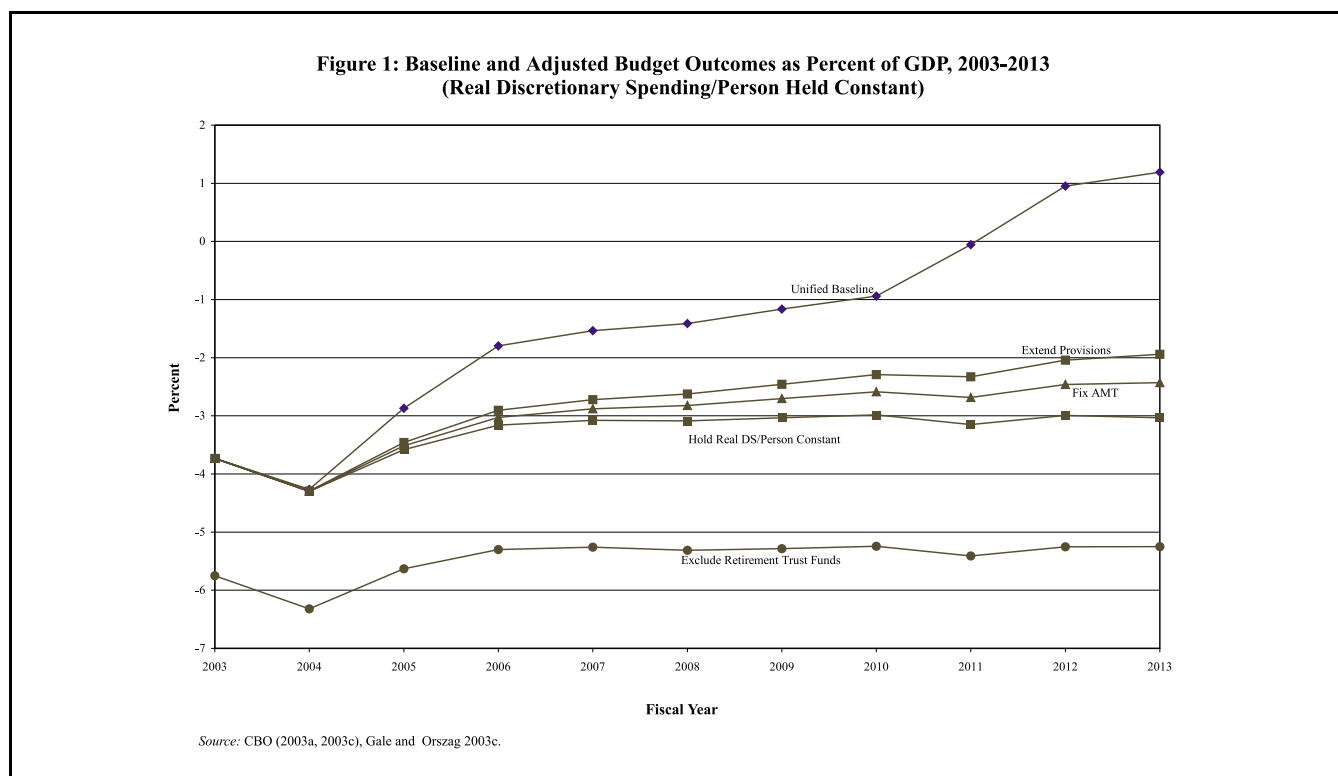
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The Congressional Budget Office's midyear update of the economic and budget outlook, released in late August, provides an opportunity to glean new perspectives on the fiscal status of the federal government. In a prior article, we adjusted the baseline projections to provide more appropriate measures of the implications of continuing current policy and of the underlying financial status of the government (Gale and Orszag 2003c). In this article, we assess the budget outlook and discuss implications for policy, with the following principal conclusions:

- Realistic budget projections show a fundamental, persistent, and growing shortfall of projected revenues relative to spending. This implies that the United States is on an unsustainable long-term fiscal path and an imbalanced medium-term path. Although the CBO baseline projects unified deficits that average 1 percent of GDP and shrink over the next decade, realistic assumptions about current policy imply persistent deficits in excess of 3 percent of GDP in the unified budget and in excess of 5 percent of GDP exclusive of retirement trust funds. Under reasonable assumptions about current policy, public debt will rise significantly and continually as a share of GDP over the next decade, and the full-employment deficit excluding the Social Security Trust Fund will remain near postwar highs as a share of GDP for the latter half of the decade. All budget projections deteriorate sharply and permanently after the current decade ends.
- The deterioration in budget outcomes over the next decade is due largely to a decline in revenues relative to prior projections and rela-

tive to earlier years. Revenues are projected to be more than 1 percent of GDP lower in the next decade than over the previous 40 years, whereas spending is projected to be at its average share of GDP. Between January 2001 and August 2003, the projected budget surplus for 2010 declined by \$941 billion, of which 43 percent is due to lower revenues and 17 percent is due to increased homeland security and defense spending. Net interest payments — allocated in rough proportion to the two items above — account for 39 percent of the decline. Increased spending on all other items accounts for just 1 percent of the decline.

- It is unlikely that any realistic revision to economic growth projections would be sufficient to make the budget problem disappear.
- If the unified budget, based on realistic assumptions, were to be balanced by spending cuts alone, the required reductions would be substantial. For example, eliminating the projected (adjusted) unified deficit in 2008 would require a 17 percent cut in all non-interest outlays in that year or a 57 percent cut in all outlays other than defense, homeland security, net interest, Social Security, Medicare, and Medicaid. (For purposes of illustration, these figures focus exclusively on policy changes in 2008 and assume no changes before then.)
- Extending the administration's tax cuts, which expire by 2011, and the other expiring provisions in the tax code would reduce revenues on a permanent basis by 2.5 percent of GDP. This decline is larger than the shortfalls in the Social Security and Medicare Hospital Insurance Trust Funds over the next 75 years.
- The administration essentially has no policy to address these issues. It claims its policy is to cut spending and to cut taxes to make the economy grow. But it is raising spending, and even if its tax cuts raise growth — which most studies find to be unlikely — the effects on growth will be insufficient to offset the direct revenue losses, as even the administration's own writings conclude. In other words, it is entirely implausible that the tax cuts are “part of the solution” to the projected budget imbalance, rather than part of the problem.
- A realistic policy response would (a) reimpose the budget rules that have expired, (b) trim spending, and (c) allow at least the bulk of the expiring tax provisions to sunset as scheduled



and roll back some of the more egregious features of the recent tax cuts before they are scheduled to sunset.

Section I summarizes key features of the budget outlook. Section II discusses the economic consequences of budget deficits. Section III compares recent and projected trends in deficits, debt, spending, and taxes. Section IV provides a framework for considering policy responses. Section V considers the administration's actions and other possible policy responses.

### I. The Outlook in Brief<sup>1</sup>

CBO (2003c) projects a 10-year baseline deficit of about 1 percent of GDP in the unified budget for 2004 to 2013, with the deficit reaching 4.3 percent of GDP in 2004 and then steadily declining and turning to a surplus by the end of the decade (Figure 1). This would be a relatively reassuring scenario if the baseline employed reasonable assumptions about current policy trajectories and reported informative measures of the fiscal status of the government. The baseline, however, is intended to be only a neutral benchmark against which to measure legislative changes.

Unfortunately, building in more reasonable policy assumptions and using more reasonable fiscal status measures generates trends that differ radically from the baseline projections. The baseline assumes that no new mandatory programs are established, discretionary spending programs grow with inflation, alternative minimum tax participation is allowed to skyrocket, and

expiring tax provisions are permitted to expire. We maintain the assumption that no new mandatory programs will be created, allow discretionary spending to grow with inflation and population growth, assume the growth of the alternative minimum tax is eliminated,<sup>2</sup> and allow expiring tax provisions to be made permanent. Under these adjustments, the federal government would face unified deficits that average more than 3 percent of GDP over the next 10 years and that persist even when the economy is projected to return to full employment (Figure 1).

These figures, however, include large cash-flow surpluses in Social Security, Medicare, and government pensions over the next 10 years. In the longer term, Social Security and Medicare face significant deficits. Separating the retirement trust funds from the rest of the budget reveals an even more troubling scenario: In addition to the well-known long-term imbalances in the retirement trust funds, the federal government also faces annual deficits in the rest of the budget in excess of 5 percent of GDP over the next decade.<sup>3</sup>

<sup>2</sup>Because the AMT is not indexed for inflation and was not cut on a long-term basis when income taxes were reduced in 2001 and 2003, AMT participation will rise from about 3 million today to about 33 million in 2010 in the absence of policy changes. We keep AMT participation roughly constant over time by making all temporary AMT provisions permanent, raising the AMT exemption, indexing the tax for inflation, and allowing exemptions for dependents.

<sup>3</sup>In dollar figures, the 10-year baseline deficit is \$1.4 trillion, the adjusted unified deficit is \$4.6 trillion, and the adjusted non-retirement-trust-funds deficit is \$7.7 trillion.

<sup>1</sup>This section is based on Gale and Orszag (2003c).

These adjustments are similar in spirit and magnitude, although differing in some of the details, to those made by others, including Kogan (2003), CED (2003), Goldman and Sachs (Dudley and McKelvey 2003), and most recently CED, *et al.* (2003). That is, there is broad consensus that the baseline projections over the next 10 years are too optimistic relative to any set of realistic policy adjustments. There is also broad consensus that the budget outlook deteriorates at an accelerating pace after 2013 (Auerbach, Gale, and Orszag 2003, Gokhale and Smetters 2003, Office of Management and Budget 2003a).

Another salient aspect of the budget outlook is the massive deterioration that has occurred since 2001. The official unified budget baseline for 2002 to 2011 deteriorated by about 6 percent of projected GDP over the same period, or \$7.9 trillion, from a projected surplus of \$5.6 trillion in January 2001 to a projected deficit of \$2.3 trillion currently.<sup>4</sup> The decline in budget outcomes in 2002 was due mostly to worsening economic conditions, but most of the projected decline from 2004 on was due to tax and spending legislation enacted since 2001.

## II. Which Deficits Matter and Why?<sup>5</sup>

Before analyzing the budget outlook, it is worth highlighting when and why deficits matter. The key economic issues hinge on the effect of deficits on national saving and the growth of future national income and living standards. The basic causal chain is straightforward. A large body of direct and indirect evidence indicates that, holding other factors constant, sustained deficits tend to reduce national saving. Given standard national accounting identities, the reduction in national saving must be matched by a reduction in domestic investment and/or a reduction in net foreign investment. In either case, the capital owned by Americans declines, which in turn reduces future national income and future living standards (relative to their level in the absence of the deficit).

Several aspects of this simple but robust chain of events are worth elaborating. First, deficits reduce future national income regardless of whether interest rates rise. A rise in interest rates suggests that some of the decline in future national income would occur through reductions in domestic investment. But even if interest rates do not rise, future national income falls because of the reduction in national saving. In other words, the effect of fiscal policy on national saving and future national income is the central issue, and the more common debate about how deficits affect interest rates is something of a sideshow.

Second, deficits reduce future national income regardless of whether enough foreign capital flows in to the country to maintain the domestic capital stock

at whatever level would have otherwise obtained. If capital inflows rose sufficiently to keep the domestic capital stock constant, domestic production would remain constant, but Americans' claims on that production would still decline, because of the mortgage on Americans' future income created by increased borrowing from abroad.

Third, deficits can boost the economy in the short run for the same reason they constrain the economy in the long run: They reduce national saving, that is, increase aggregate demand. In a slack economy, a short-term boost to aggregate demand can improve economic prospects by encouraging people to spend more and firms to use more of their existing capacity. Over the long term, however, a key to raising future national income is higher national saving and national investment, which deficits inhibit. This suggests that short-term deficits in a slack economy can be helpful and are of less concern than persistent deficits in a fully employed economy.

Fourth, plausible parameterizations imply that the recent fiscal deterioration implies substantial declines in future national income. For example, as noted earlier, the CBO baseline projections for 2002-2011 deteriorated by \$7.9 trillion from January 2001 to August 2003. That change reflects the cumulative deterioration in federal government saving between 2002 and 2011 under the official forecasts. We calculate the effect of those changes on future national income using a model developed in part by current CEA Chair Greg Mankiw (see Ball and Mankiw 1995, and Elmendorf and Mankiw 1999). We assume that one-third of the deterioration in government saving is offset by increased private saving, which implies that the budget shift reduces the stock of net assets owned by Americans at the end of 2011 by \$5.3 trillion (= 67 percent \* \$7.9 trillion). Assuming that this capital earns a pre-tax return of 6 percent implies a reduction in national income of \$318 billion (= 0.06 \* \$5.3 trillion) in 2012.<sup>6</sup> This translates into an average decline in income in that year of more than \$2,700 per household.<sup>7</sup> If one-third of the decline in national saving is offset by capital inflows, gross domestic product would decline by about \$212 billion, or more than 1.2 percent relative to its projected level in 2012 (CBO 2003b). Notably, the effect of deficits on national income and GDP would persist (and grow) over time.<sup>8</sup>

<sup>6</sup>Poterba (1998) estimates a pre-tax marginal product of capital of 8.5 percent for nonfinancial corporate capital, which is taxed at a higher rate than other capital and hence should be expected to have a higher pre-tax marginal product than other capital. Elmendorf and Mankiw (1999) suggest 6 percent for the return on aggregate capital.

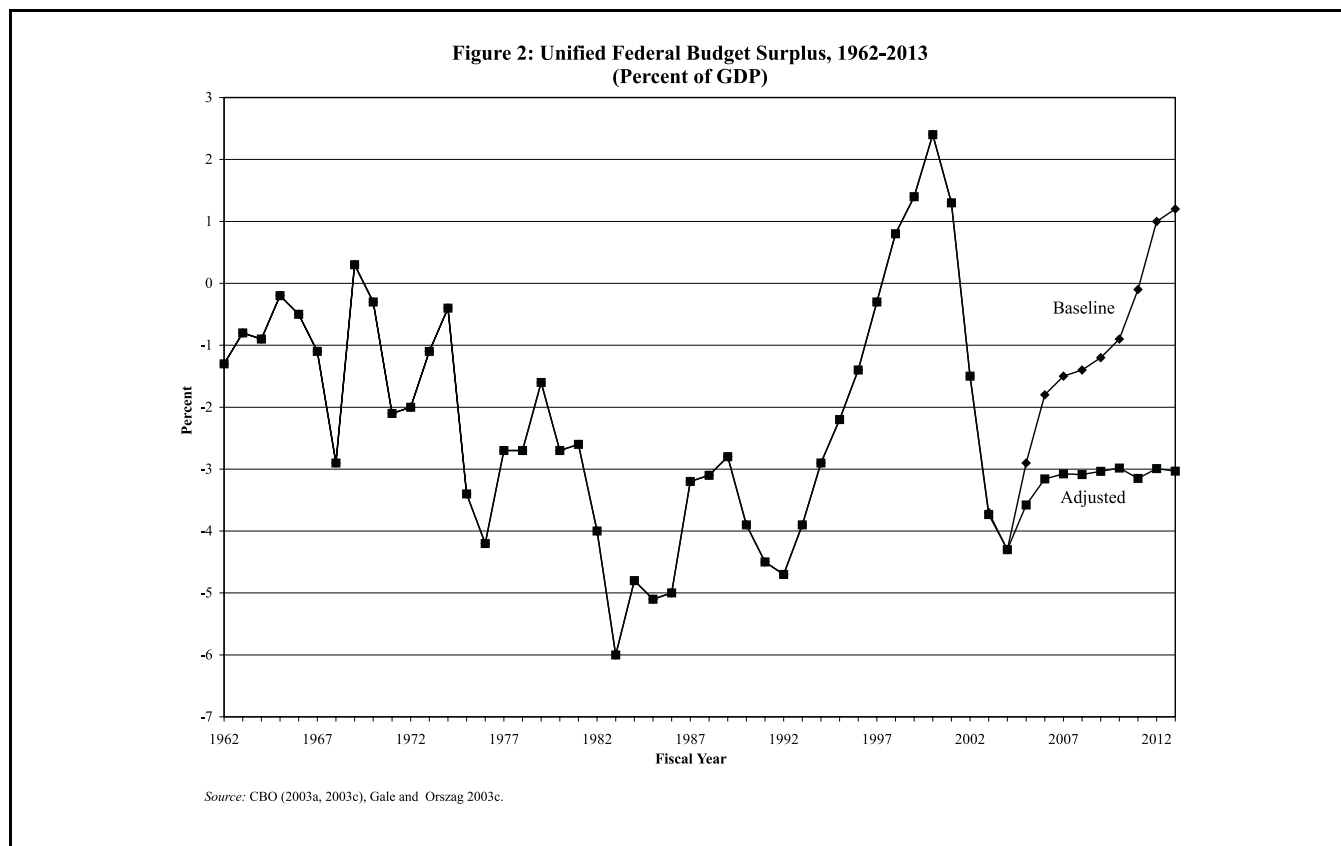
<sup>7</sup>The Census Bureau projects the number of households at 114.2 million in 2010. Assuming a growth rate of 1.05 percent per year after 2010, roughly the average over the prior three years, the number of households will reach 116.6 million in 2012. See <http://www.census.gov/population/projections/nation/hh-fam/table1n.txt>.

<sup>8</sup>Studies incorporating the best available information about expected future deficits tend to find an economically and statistically significant effect of expected deficits on cur-

(Footnote 8 continued on next page.)

<sup>4</sup>The decline in budget outcomes for 2002-11 under the *adjusted* unified budget is roughly \$9 trillion. The decline in the adjusted budget, excluding retirement funds, exceeds \$8 trillion.

<sup>5</sup>This section is based on Gale and Orszag (2003d).



Fifth, beyond their direct effect on national saving and interest rates, sustained budget deficits can also generate broader, albeit perhaps less tangible, costs. Uncertainty about how future deficits will be resolved could hamper long-term economic performance, above and beyond the direct effects of deficits delineated above. Ultimately, the U.S. role as the world's economic leader may also be threatened by long-term systemic fiscal shortfalls.

Sixth, all of the conclusions noted above hold other factors constant in analyzing the deficit. However, 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. Thus, the conclusions above do not imply that any deficit-creating policy is harmful to the economy in the long term, just that the impact of deficits is likely to be an important component of the overall effects from a policy shift that is not revenue-neutral. Reductions in marginal tax

rent bond yields, controlling for other factors. A rough range from this literature is that a sustained 1 percent of GDP rise in projected deficits would raise current yields by between 20 and 60 basis points, holding other factors constant. This suggests that the recent 6 percent of GDP deterioration in the budget outlook would raise long-term rates by at least 120 basis points. It also implies that the 2001 tax cut ended up raising the user cost of capital because the effects of lower tax rates in reducing the cost of capital were outweighed by the effects of increased deficits, which raised interest rates and raised the cost of capital.

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. We discuss the net effects of recent policy interventions on growth below.

With these considerations in mind, we examine the current status and recent changes in budget outlook.

### III. Historical and Projected Patterns

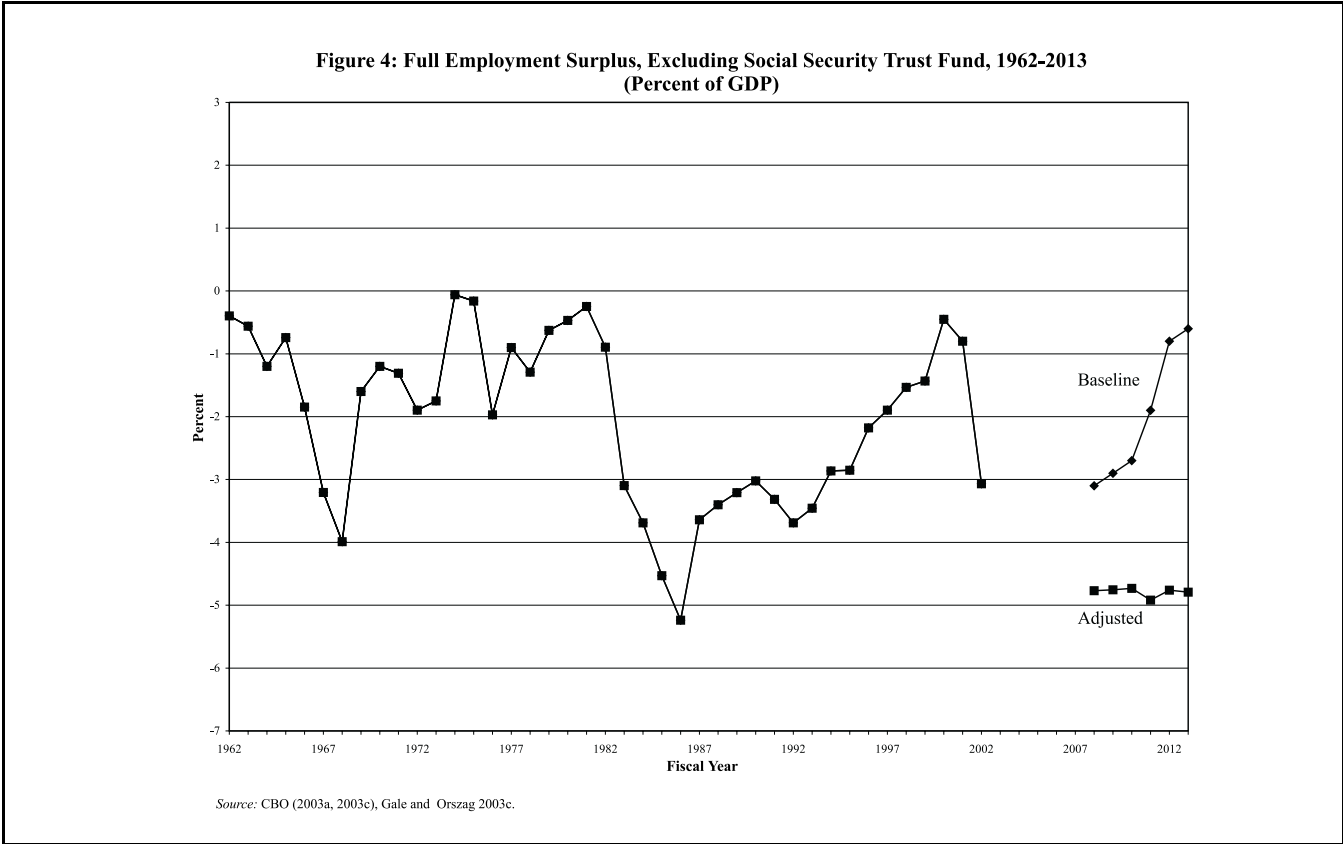
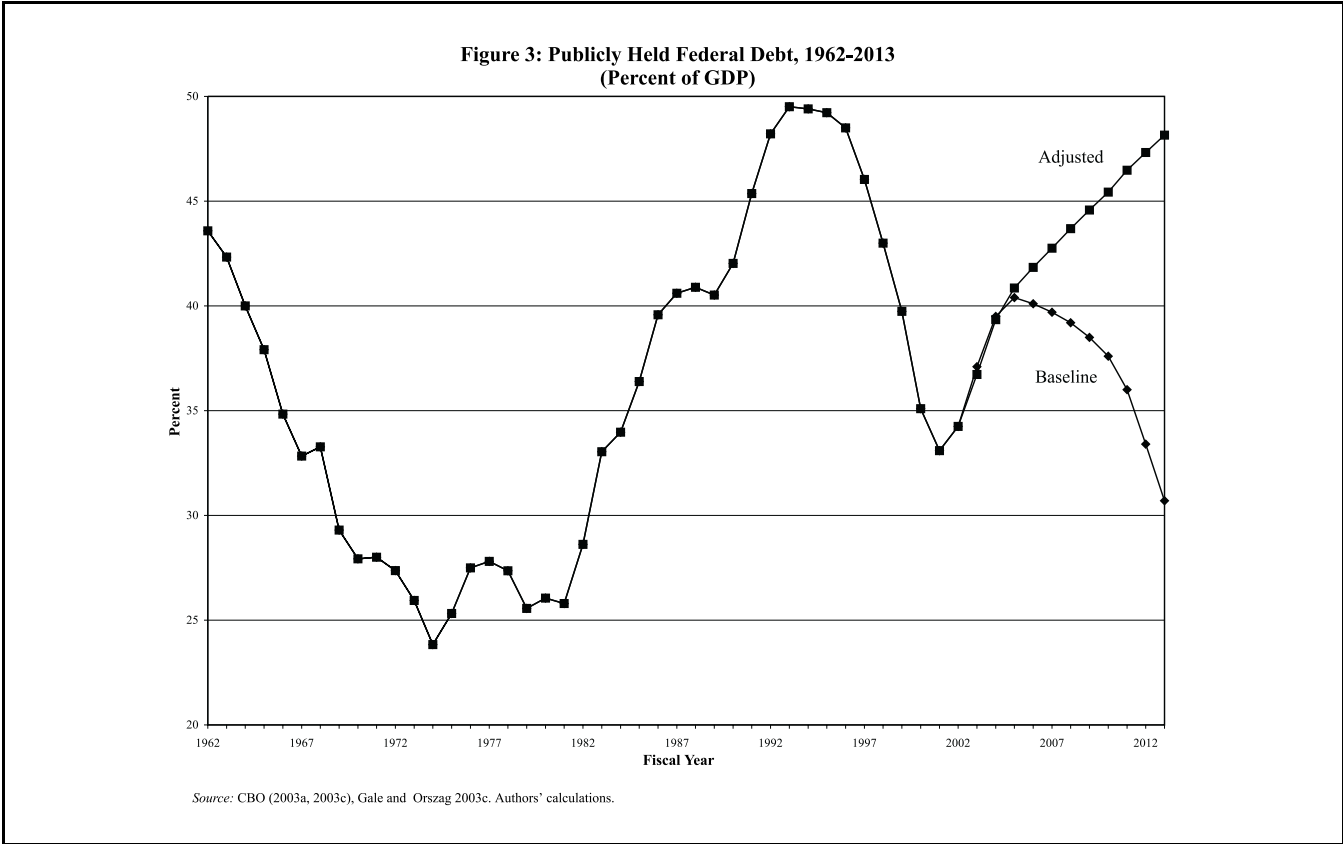
#### A. How Bad Are the Projected Deficits?

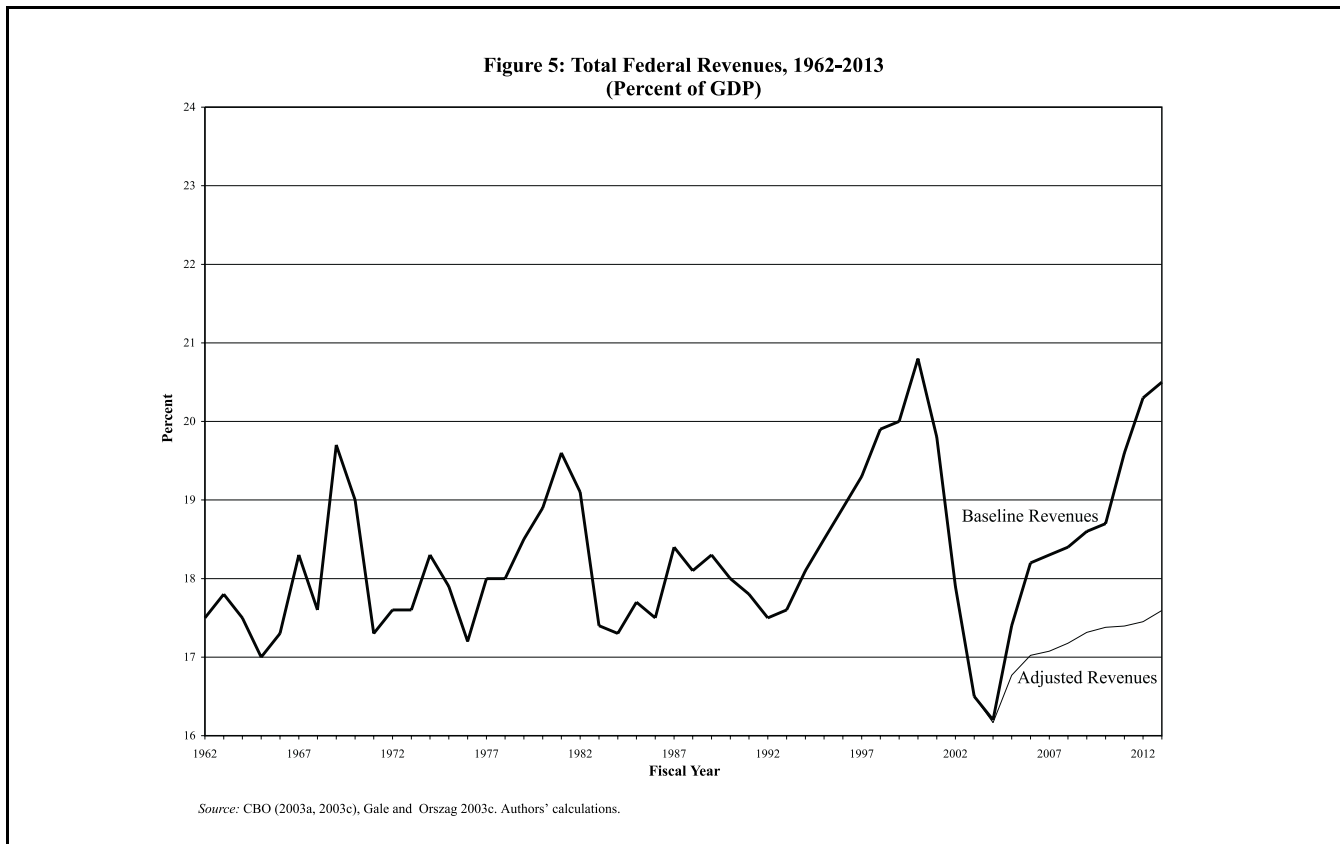
Figure 2 reports historical and projected unified budget surpluses and deficits. Under our adjusted baseline, the unified deficit hovers around 3 percent from 2005 on. The best thing that can be said about these deficits is that they are within the range of historical variation. They are problematic, however, in several regards.

First, under the adjusted baseline, the ratio of public debt to GDP rises steadily and significantly, from 37 percent in 2003 to 48 percent by 2013, the end of the budget horizon (Figure 3). This would be the highest level since its most recent peak in the mid-1990s, and before that 1958, when the nation was still paying off the debt incurred to fight World War II.

Second, the current budget projections are not comparable to realized deficits in earlier years. The projections contain significant surpluses in the Social Secu-

(Text continued on p. 150.)





**Table 1: Composition of Revenues, 1962-2013  
(Percent of GDP)**

	Total	Personal Income	Corporate Income	Combined	Payroll	Other
1962-1970	18.0	7.9	3.7	11.6	3.6	2.7
1971-1980	17.9	8.1	2.6	10.8	5.2	2.0
1981-1990	18.1	8.3	1.6	10.0	6.4	1.8
1991-2000	18.8	8.6	2.0	10.6	6.6	1.6
2001-2003	18.1	8.5	1.4	9.9	6.8	1.4
1962-2003	18.2	8.3	2.4	10.7	5.6	2.0
2004-2013 Baseline	18.6	8.9	1.9	10.7	6.7	1.2
2004-2013 Adjusted	17.1	-	-	9.2	6.7	1.2

Source: CBO(2003a, 2003c). Gale and Orszag 2003c. Authors' calculations.

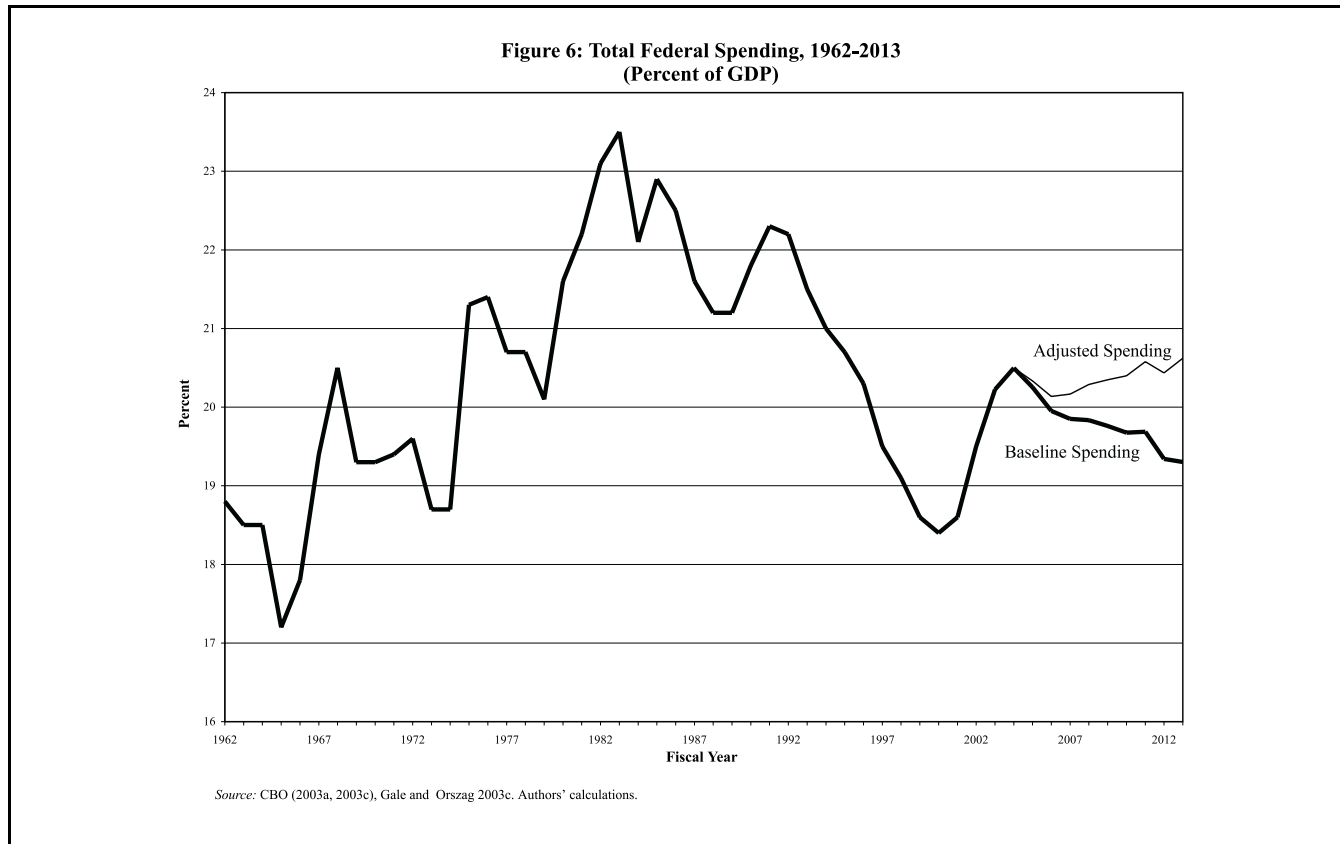
rity Trust Fund and assume the economy will be operating at full capacity by 2008 if not sooner. We correct for these discrepancies in Figure 4 by comparing historical and projected values of the full-employment surplus, excluding the Social Security Trust Fund. The figure omits values for 2003-2007 because we do not have full employment deficit figures for those years. We assume that by 2008, the economy has reached full employment, as does the CBO forecast. While Figure 2 shows that the projected unified deficits are well within the range of historical variation, Figure 4 shows that after correcting for the state of the economy and the surplus or deficit in the Social Security Trust Fund, the adjusted budget projections

throughout the 2008-13 period are almost as bad as the single worst fiscal outcome in the last 40 years.

Third, although we do not pursue the point here, it is worth emphasizing that budget projections deteriorate dramatically after 2013 (Auerbach, Gale, and Orszag 2003, Figure 1). Even the administration's budget projections show rapidly declining budget outcomes beyond the 10-year horizon and term the current fiscal path "unsustainable" (Office of Management and Budget 2003a).

**B. Spending or Tax Changes?**

The prospect of substantial budget deficits over the next 10 years implies either that projected spending or



**Table 2: Composition of Spending, 1962-2013  
(Percent of GDP)**

	Total	Non-Interest	Mandatory	Discretionary	Defense	Non-Defense Discretionary	Interest
1962-1970	18.8	17.5	5.1	12.4	8.6	3.9	1.3
1971-1980	20.2	18.7	8.6	10.2	5.6	4.6	1.5
1981-1990	22.2	19.3	9.6	9.7	5.8	3.9	2.9
1991-2000	20.4	17.4	10.1	7.4	3.9	3.5	2.9
2001-2003	19.4	17.7	10.6	7.1	3.4	3.7	1.8
1962-2003	20.4	18.2	8.6	9.6	5.7	3.9	2.1
2004-2013 Baseline	19.8	18.0	10.9	7.1	3.6	3.5	1.8
2004-2013 Adjusted	20.4	18.2	10.9	7.4	3.7	3.7	2.1

Source: CBO (2003a, 2003c). Gale and Orszag 2003c. Authors' calculations.

revenues or both are out of line with their historical figures. To be sure, there is nothing sacrosanct about historical averages, but comparing the historical and projected values for spending and revenues is nonetheless informative in explaining the source and dimension of the problems.

Several perspectives demonstrate that, scaled to take account of the size of the economy, the projected spending levels are typical of their historical norms, whereas revenue projections are substantially lower than revenues in previous years. Figure 5 and Table 1 report data on revenues. Over the past 40 years, revenues have averaged 18.2 percent of GDP. Under

the adjusted baseline, they would average 17.1 percent. The difference translates into \$1.55 trillion over the decade.

Revenue declines are also a chief culprit in the surge of deficits in 2003 and 2004. Revenues are projected to fall from 20.8 percent of GDP in 2000 to 16.2 percent in 2004. The latter would be lowest share since 1959. Revenues from the personal and corporate income taxes have dropped particularly rapidly. In 2004, they are projected to be 8.2 percent of GDP, the lowest share since 1942. Over the course of the decade, they are projected to be just 9.2 percent of GDP under the adjusted baseline, a full 1.5 percent of GDP below their

	FY 2004 Budget		FY 2010 Budget	
	\$ Billions	% of Change	\$ Billions	% of Change
<b>Projection Date</b>				
Surplus, January 2001	397	-	796	-
Surplus, August 2003	-480	-	-145	-
Difference	-877	-	-941	-
<b>Sources of Change</b>				
Reduced Revenue <sup>1</sup>	636	73	402	43
Increased Net Interest	13	1	363	39
Increased Defense	120	14	145	15
Increased Homeland Security <sup>2</sup>	20	2	20	2
Increased Other Spending	88	10	11	1

(1) Includes refundable tax credits.  
(2) Estimate based on O'Hanlon, *et al.* (2003).  
Sources: CBO (2003a, 2003c). Gale and Orszag 2003c. Authors' calculations.

historical average, representing a revenue loss of \$2 trillion over the next decade relative to revenues that would have accumulated had the two taxes maintained their historical relation to the economy.

Figure 6 and Table 2 show similar data for spending. Over the last 40 years, spending has averaged 20.4 percent of GDP, and non-interest spending — a better measure of current positions taken by legislators — has averaged 18.2 percent. These are exactly the figures that hold in the adjusted baseline over the next 10 years. This makes difficult the argument that the 10-year deficits are a “spending problem.”

Table 3 presents a third perspective, which shows in dramatic fashion that the looming budget shortfalls are due mainly to a revenue collapse rather than any alleged burst of welfare-state spending. The top panel of the table shows that CBO's January 2001 projections showed increasing surpluses as far as the eye could see, and that between January 2001 and August 2003, the projected surplus for 2004 declined by \$877 billion and the projected surplus for 2010 declined by \$941 billion.

The bottom panel explores the sources of the decline in the surplus. For 2004, more than 70 percent of the decline is due to revenue declines, another 16 percent is due to increased spending on defense and homeland security, and 1 percent is due to net interest. Changes in all other spending accounts for just 10 percent of the total decline in the surplus.

The results for 2010 are even more striking. Revenues, net interest payments, and defense and homeland security account for almost 99 percent of the decline. Changes in spending on items other than defense, homeland security, and net interest accounts for just over 1 percent of the \$941 billion decline in the projected surplus in 2010. Thus, those who have asserted that the deficits are caused primarily by a spending boom (*Wall Street Journal* 2003, Nussle 2003) need to be clear that the only items with any significant increase in projected outlays since 2001 are defense, homeland security, and net interest.

#### IV. Policy Issues

As a prelude to assessing alternative ways to address the looming budget shortfalls, we explore several additional issues in this section.

##### A. Can We Grow Our Way Out of the Problem?

CBO (2003c) projects that real GDP will grow at annual rates of 3.4 percent in 2004, about 3.4 percent between 2005 and 2008 and about 2.7 percent (the growth rate of potential output) between 2009 and 2013. Given the potentially painful nature of solutions to budget problems — that is, spending cuts or tax hikes — the first policy question is whether the problem might go away on its own accord, and in particular whether higher-than-expected economic growth could plausibly solve the budget problem.

Table 4 shows how alternative rates of economic growth — fueled by changes in productivity — would affect the budget, using adjustments supplied by CBO (2003a, Appendix C-1). The table shows that if the economy grew at 0.5 percentage points faster than currently projected, the adjusted budget would show a deficit of \$3.3 trillion over the next decade, or about 2.3 percent of GDP. By 2013, the deficit would be 1.4 percent of GDP, including the retirement funds, and 3.7 percent of GDP excluding the retirement funds. Even if economic growth exceeds projections by a full percentage point (that is, the growth rate is about 33 percent higher than projected), a significant deficit problem would still exist. The adjusted unified deficit would be \$2.1 trillion, or about 1.5 percent of GDP, over the decade. The adjusted unified budget would reach a very small surplus in 2013, but the adjusted budget excluding retirement funds would still face a deficit of 2 percent of GDP in that year.

Thus, large shifts in the economic growth rate due to changes in productivity growth can appreciably reduce projected deficits, but would still leave the country with a significant and persistent fiscal problem that will deteriorate further after 2013. Notably, the calculations do not assume any change in policy, just in the underlying rate of growth. If the higher growth



Alternative Growth Paths	2004-2013		2013	
	Percent of GDP	\$ Billions	Percent of GDP	\$ Billions
<b>CBO Baseline Growth</b>				
CBO Unified Budget Baseline	-1.0	-1,397	1.2	211
Adjusted Unified Budget	-3.2	-4,596	-3.0	-538
Adjusted Non-Retirement Budget	-5.4	-7,749	-5.2	-931
<b>CBO Baseline Growth + 0.5% a year<sup>1</sup></b>				
CBO Unified Budget Baseline	-0.1	-149	2.8	495
Adjusted Unified Budget	-2.3	-3,347	-1.4	-255
Adjusted Non-Retirement Budget	-4.5	-6,501	-3.7	-647
<b>CBO Baseline Growth + 1.0% a year<sup>1</sup></b>				
CBO Unified Budget Baseline	0.8	1,100	4.4	778
Adjusted Unified Budget	-1.5	-2,099	0.2	29
Adjusted Non-Retirement Budget	-3.7	-5,253	-2.1	-364

(1) Authors' calculations based on CBO (2003a, Appendix C-1).

rates were somehow achieved with tax cuts, for example, the deficits would be larger than reported in Table 4.

### **B. Comparisons With the 1980s<sup>9</sup>**

A second question is how the current budget outlook relates to earlier episodes and how policymakers responded in those episodes. The projected baseline deficits for 2003 and 2004 equal 3.7 and 4.3 percent of GDP, respectively. These deficits are not as large a share of GDP as in 1983, when a recession, increases in defense spending, and the Reagan tax cuts pushed the deficit to 6 percent of GDP. But that should be little comfort: 1983 is, to say the least, a weak standard against which to compare fiscal prospects — indeed, it is the weakest standard since World War II. Moreover, as shown in Figure 2, adjusted for the state of the economy and the Social Security Trust Fund status, the projected deficits are as substantial as those in every year in the 1980s with the exception of 1983.

A number of factors, however, make the current situation more troubling than the 1980s. Most obviously, the retirement of the baby boomers is imminent now, but was 25 years away in the early 1980s. As the boomers begin retiring, spending on Medicare and Social Security will rise steadily. In addition, if current deficit trends continue, the U.S. may find it harder — that is, more expensive — to borrow from international capital markets now than in previous decades. The U.S. was a creditor nation in 1980, with a net international investment position of about 10 percent of GDP. Currently, due to 20 years of more or less continual current account deficits, the U.S. is now a debtor nation with a net position of about -25 percent of GDP. The nation's degree of reliance on foreign investors is reflected in the fact that foreigners purchased 58 percent of new

<sup>9</sup>Parts of this section derive from Gale and Orszag (2003a).

Treasury debt issued in 2002 (Office of Management and Budget 2003b). In 1980, the U.S. national saving rate was significantly higher than today and the debt/GDP ratio was significantly lower. All of these factors make the economy's toleration of debt more difficult today than in the past.

Finally, it is worth noting that the nation escaped from the fiscal hole dug in the early 1980s only through a succession of tax increases, spending cuts, and budget rules, and — eventually — good luck. Taxes were raised significantly in 1982, 1984, 1990, and 1993. Significant spending cuts were part of the latter two budget packages. Deficit control rules were introduced in the 1980s and changed in 1990 to caps on discretionary spending and pay-go (self-financing) rules for mandatory spending and tax changes. These rules were extended through the 1990s. Even so, budget balance came about only because policymakers also got lucky in addition to making these difficult policy changes. In particular, the peace dividend allowed substantial reductions in defense spending, and the technology boom generated unexpected economic growth and revenues.

### **C. How Big Would the Spending Cuts Have to Be?**

Given the current political environment, in which the administration has not only argued against any significant tax increases but pushed for continual tax cuts, a natural question is whether budget balance can be obtained by cuts on the spending side alone. As a matter of arithmetic, the answer is yes. But as a matter of policy, the answer is no: The cuts would have to be implausibly large.

Table 5 shows the magnitude of cuts that would be required in 2008 if budget balance were achieved solely through reductions in spending in that year. (We assume no changes in interest payments in that year, which implicitly assumes no policy changes before then.) Balancing the adjusted unified budget would require a 17 percent across-the-board cut in all non-

<b>Table 5: What Would It Take to Balance the Budget in 2008?</b>			
	<b>CBO Unified Baseline</b>	<b>Adjusted Unified Baseline</b>	<b>Adjusted Non-Retirement Baseline</b>
<b>Projected Deficit</b>			
in \$ Billions	197	430	740
as % of GDP	1.4	3.1	5.3
<b>Percent Reduction in:</b>			
All Non-interest Outlays	8	17	29
All Mandatory Spending	13	29	47
All Discretionary Spending	20	42	76
All Non-Defense Discretionary Spending	44	93	170
All Spending Except:	27	57	109
Interest, SS, Medicare,			
Medicaid, Defense,			
Homeland Security			
<b>Percent Increase in:</b>			
All Tax Revenues	8	18	31
Income Tax and Corporate Tax	14	33	58
<i>Source: CBO (2003a, 2003c). Gale and Orszag 2003c.</i>			

interest outlays in 2008, a 29 percent cut in all mandatory spending, or a 42 percent reduction in all discretionary spending. If the adjusted unified budget were balanced by cutting just non-defense discretionary spending, these outlays would have to be reduced by more than 90 percent. Finally, if some categories of spending were placed off-limits — including interest payments, defense, homeland security, Social Security, Medicare, and Medicaid — all other outlays would have to fall by more than half — 57 percent — to balance the budget without tax increases.

If the goal were to balance the adjusted budget, excluding retirement funds, the numbers are even more dire. A 29 percent cut in all non-interest spending would be required. If defense, homeland security, Social Security, Medicare, and Medicaid were held harmless, even the complete elimination of every other government program would not be sufficient to balance the budget.

To be clear, the point of the table is not to advocate those spending cuts. We believe, in fact, that the resultant dramatic reduction in the government's role in the economy would be unproductive, inequitable, and inappropriate. Rather, the goal is to show that those who advocate retaining and making permanent the existing tax cuts are implicitly calling for substantial spending cuts that they have so far been unwilling to specify.

#### **D. The Role of the Expiring Tax Provisions<sup>10</sup>**

The magnitude of the required spending cuts in Table 5 shows that it is highly improbable, and we would argue undesirable, for budget balance to be achieved through spending cuts alone. It would also be unprecedented — in the 1980s and early 1990s,

<sup>10</sup>See Gale and Orszag (2003b) for additional discussion of the expiring provisions.

policymakers combined spending cuts with tax increases and budget rules to stem the red ink.

A key tax issue is the treatment of the expiring tax provisions. Although expiring provisions used to be a relatively minor part of the tax code, they have exploded in magnitude in recent years, beginning with the 2001 tax cut, which was then exacerbated by the 2002 and 2003 tax cuts. All of the newly enacted laws expire by the beginning of 2011 and the more “traditional” expiring provisions sunset much earlier.

Extending the expiring provisions through the end of the budget window in 2013 would reduce revenues by \$2 trillion and require additional interest payments on the swollen federal debt of almost \$400 billion. Even more strikingly, in 2013 alone, extending the expiring provisions would reduce revenues by 2.5 percent of GDP (CBO 2003c) or \$446 billion. About 90 percent of the resulting revenue loss would be related to extending the expiring provisions that have been newly enacted in the 2001, 2002, and 2003 tax cuts. If the president's tax cuts were made permanent, the long-term costs would exceed the sum of the average annual shortfall in the Social Security Trust Fund and the Medicare Hospital Insurance Trust Fund over the next 75 years and would exceed the permanent shortfall in the Social Security Trust Fund.

## **V. Policy Options**

### **A. Administration Policy**

A discussion of the administration's policy toward medium- and long-term deficits should by rights be extremely short: The simple truth is that the administration has no policy to address these issues. Explaining that conclusion, however, requires discussion.

The president asserted in his State of the Union address that “We will not deny, we will not ignore, we

will not pass along our problems to other Congresses, to other presidents, and other generations.” At that time, the president faced a 10-year CBO baseline budget surplus of \$1.3 trillion. Since then, the president proposed \$2.7 trillion worth of tax cuts and spending increases in his Fiscal Year 2004 budget (CBO 2003b). Key elements of those proposals including making the recent tax cuts permanent — a call the president repeated earlier this month, just before asking the nation to endure sacrifices to fund military conflict in Iraq — and providing a Medicare prescription drug benefit. Both of these would add dramatically to long-term costs, though they are not equivalent — the tax cuts would cost far more than the drug benefit. In addition to his budget requests, the president has also made several supplemental requests for additional funding for the war in Iraq. In short, although the president’s rhetoric may be uplifting, leaving fiscal problems to future generations and administrations is exactly what the current administration is doing.

***A discussion of the administration’s policy toward medium- and long-term deficits should by rights be extremely short: The simple truth is that the administration has no policy to address these issues.***

The administration claims that its approach to addressing the deficit is to reduce spending, and to cut taxes to make the economy grow and thereby bring in more revenue. In fact, however, as noted above, the administration is raising spending, not cutting it, and there are two problems with the claim that tax cuts will generate enough growth so that they will raise revenue. First, the administration’s tax cuts will reduce revenues even if they do generate growth. Second, the tax cuts are unlikely to generate much if any growth. We take those points in turn.

**1. Taxes and revenues.** For the moment assume that tax cuts do generate economic growth. As shown in Table 4, economic growth induced by *something other than tax cuts* makes the economy bigger and generates more revenue since revenue would continue to be roughly the same share of the economy as before. But economic growth generated by tax cuts typically does not raise more revenue — the economy is bigger, but the ratio of revenue to the size of the economy is smaller. Thus, for example, if a 10 percent cut in taxes causes the economy to become 1 percent larger — a generous estimate, as discussed below — revenues do not rise. Instead, they fall by about 9 percent.

To say that the administration’s tax cuts will raise revenue is essentially to embrace the Laffer curve doctrine that is rejected not only by all mainstream economists but by the administration itself in its written documents. In this year’s *Economic Report of the President*, the Council of Economic Advisers (2003, pages 57-8) writes:

Although the economy grows in response to tax cuts (because of higher consumption in the short

run and improved incentives in the long run), it is unlikely to grow so much that lost tax revenue is completely recovered by the higher level of economic activity.

Moreover, in 2001, of course, the administration argued that one of the key reasons to cut taxes was that the surplus was too big, and that cutting taxes would *reduce* the surplus. It is clearly hypocritical to argue now that the same tax cuts — recall that the 2003 tax cuts accelerated the 2001 tax cuts and the president continues calls to make the 2001 tax cuts permanent — will *raise* the surplus (reduce the deficit).

**2. Taxes and growth.** All of the above assumes that the administration’s tax cuts will generate economic growth. But a growing body of studies suggests that the medium- and long-term effects of the president’s tax cuts will be to leave the economy unchanged in size or possibly smaller than it otherwise would have been, and in either case, of course, the economy would have substantially more public debt.

Why might tax cuts not generate economic growth? The direct effects of tax cuts on private behavior often — but not always — spur economic activity. For example, tax cuts can induce people to increase labor supply, save more, invest more, etc. Of course, tax cuts also give people more after-tax income for working or saving as much as they did before and so may induce people to cut back on their labor supply or reduce their saving. In any case, the direct effects of tax cuts are one channel through which tax cuts operate. But tax cuts also increase the budget deficit and hence reduce national saving and future national income, as described above. The net effect of tax cuts on growth is then the sum of the (usually positive) direct effects on individual behavior and the (negative) indirect effects that operate via the increase in deficits.

Most studies 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. (See Auerbach 2002, CBO 2001, 2003b, 2003c, Elmendorf and Reifschneider 2002, Gale and Potter 2002, House and Shapiro 2003, and JCT 2003.)

In particular, the JCT (2003) found that the 2003 jobs and growth package as passed by the House would generate zero or negative effects on jobs and growth in the second half of the decade. CBO (2003b) found that the president’s budget would have almost no impact on economic growth. CBO (2003c) finds that, “The revenue measures enacted since 2001 will boost labor supply by between 0.4 and 0.6 percent from 2004 to 2008 and up to 0.2 percent in 2009-2013 . . . but the tax legislation will probably have a net negative effect on saving, investment, and capital accumulation over the next 10 years. . . . The laws’ net effect on potential output . . . will probably be negative in the second five years.”

## **B. Addressing the Problem**

One key issue is the need to address both spending and tax options. As noted in the past, policymakers have responded to deficits by cutting spending, raising

taxes, and tightening budget rules. The fact that these items have been undertaken simultaneously suggests the importance of reaching a political agreement in making deficit reduction credible and sustainable. Considering both sides of the budget at the same time is not only equitable, but also allows discipline to be established across the board — for both spending and tax cuts. Granting large tax cuts to some groups may make it less politically feasible to rein in the desires of other favored constituencies to obtain increases in spending programs. Indeed, by eliminating any semblance of fiscal discipline, the onslaught of tax cuts over the past three years may have encouraged those who want to spend more to go ahead and do so. As a result, tax cut advocates who bemoan proposals to increase spending need to recognize that they likely helped sow the seeds of these proposals.

A second key issue has to do with the state of the economy. In 1982 and 1993, policymakers introduced fiscal austerity packages even though the economy was weak. In the current downturn, policymakers have been reluctant to do so; indeed, they have enacted an enormous amount of stimulus. Fortunately, a credible and helpful deficit reduction plan does not require massive immediate changes, especially since it is the medium- and longer-term deficits that do the most damage.

**By eliminating any semblance of fiscal discipline, the onslaught of tax cuts over the past three years may have encouraged those who want to spend more to go ahead and do so.**

The single most important act Congress and the administration could take to rein in the budget would be to re-establish the budget rules that existed in the 1990s. These put caps on discretionary spending, and they required that cuts in taxes or increases in mandatory spending be paid for with other tax increases or spending cuts. The administration has advocated the re-establishment of the rules but only in a selective manner. This is not helpful, since the rules must apply on a broad basis or they won't be seen as being either fair or effective.

Better budget rules will help the process but ultimately the budget choices come down to some combination of spending reductions and revenue increases. We have shown that expecting the entire adjustment to come on the spending side is unrealistic. We have also shown that projected adjusted spending levels over the next 10 years are in line with historical averages over the last 40 years. Nevertheless, some trimming of outlays can help improve budget outcomes as well as make room for added resources to address priorities that are new or are currently unmet.

On the tax side, there are at least two threshold issues. The first is whether to make the expiring tax provisions permanent. The second is whether to roll back some of the enacted tax cuts. As noted, making the tax cuts permanent would dig a gigantic fiscal hole

and would permanently reduce revenues to a level well below their historical norm just as the country enters a period (after 2013) with increased spending needs.

The case for making most of the tax cuts permanent or even maintaining the bulk of them through 2010 is getting weaker every year. Many of the supposed rationales for the original tax cut are gone. Taxes are not at all-time highs. No one talks about the government "overcharging" now. There is no longer any danger (if one ever existed) of paying off the entire public debt. In addition, the tax cuts were extremely regressive and so rolling them back or letting them expire would allow the most affluent Americans to pay for the costs of the war on terrorism and the deteriorating budget prospects.

Even the argument that we need the tax cuts to enforce spending cuts seems to be spurious. Consistent and comprehensive budget rules would do a far better job of controlling spending than tax cuts would, and those who complain most about increased spending currently are precisely the ones who promised that tax cuts would force Congress to hold the line on spending. If one wants to control spending, there are better ways — budget rules and reporting of reformed budget outcomes — that would be both more effective and less risky than cutting taxes.

Even if the tax cuts were affordable when enacted in 2001 (and it is not obvious that they were — see Auerbach and Gale 2001), they are not affordable now. Opponents of increased funding for terrorism are sometimes referred to as "September 10" Americans, who do not recognize that needs and priorities have changed. Likewise, supporters of making the tax cuts permanent should be billed the same. Their advocacy of the policy under any and all circumstances undermines the credibility of their own proposal.

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