taxanalysts tax break

by William G. Gale and Peter R. Orszag

The Outlook for Fiscal Policy

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I. Introduction

The new budget projections released by the Congressional Budget Office (2005) provide an opportunity to assess fiscal policy in the first four years of the Bush administration and to discuss prospects for the next four years and beyond. This report examines the baseline CBO projections, adjusts the official data in ways that more accurately reflect the current trajectory of tax and spending policies, and discusses some of the implications. We reach the following principal conclusions:

- The CBO now projects a 10-year baseline deficit of $855 billion in the unified budget for fiscal 2006 to 2015. The budget outside of Social Security faces a baseline deficit of $3.4 trillion.
- Over the first four years of the Bush administration, the 10-year fiscal outlook deteriorated by $8.2 trillion. In January 2001 the unified baseline for 2002 to 2011 projected a surplus of $5.6 trillion. The baseline for the same period now projects a *deficit* of $2.6 trillion.
- About two-thirds of the deterioration in the official baseline figures is due to lower revenues and one-third is due to higher spending. Specifically, the decline can be attributed to legislated tax cuts (29 percent), other declines in revenue (37 percent), legislated spending increases (29 percent) and other changes in spending (4 percent). Revenue declines have also accounted for the vast share of the decline in actual budget outcomes (as opposed to 10-year projections) between 2000 and 2005. Tax revenue has fallen dramatically since 2000, and is now an extremely low share of gross domestic product (GDP) relative to its average value between 1960 and 2000. Spending has risen somewhat since 2000, but nonetheless remains significantly below its average level between 1960 and 2000.
- As is now widely recognized, the baseline projections use mechanical assumptions that may not reflect the best representation of current policy. Among other things, the baseline assumes that (1) almost all expiring tax provisions are allowed to expire, (2) the alternative minimum tax will be allowed to grow explosively, (3) there will be no additional requests for funds to conduct the wars in Iraq and Afghanistan, and (4) real discretionary spending (including defense) will be held constant in real terms.
- If almost all of the expiring tax provisions are extended and the AMT is held in check (as described below), and real discretionary spending keeps pace with population growth, the 10-year unified budget deficit will be $4.1 trillion (2.5 percent of GDP), with deficits of 2.3 percent of GDP or more in every year, rising to 2.9 percent by 2015. The differences between the CBO baseline and our adjusted unified budget projections grow over time. By 2015 the annual difference is more than $709 billion (3.6 percent of GDP).
- The unified budget figures include large cash-flow surpluses accruing in trust funds for Social Security, Medicare, and government pensions over the next 10 years. In the longer term, Social Security and Medicare face significant deficits. Outside of the retirement trust funds, the adjusted 10-year budget faces a deficit of $7.4 trillion over the next decade (4.6 percent of GDP). Thus, the simplest way to summarize the fiscal status of the government is to note that the retirement trust funds face substantial long-term deficits, and under realistic assumptions about current policy, the rest of government faces deficits in excess of 4.6 percent of GDP over the next decade, with no reason to believe those deficits will decline after the next decade.
- Despite heated political debate, there is broad consensus that sustained budget deficits have detrimental consequences, reducing the capital stock and future national income and raising interest rates. It is unlikely that the economy will be able to grow its way out of the deficits, and delaying steps to deal with the problem simply makes it worse. Also, simply paying for the tax cuts embodied in the adjusted baseline would require massive cuts in other spending that are far beyond anything likely to be considered in the political arena. In such an environment, policymakers, especially those who support making the tax cuts permanent, will be sorely tempted to turn to budget gimmicks.
- The only real solution to the nation's fiscal imbalance is to reduce spending and raise taxes. Restoring fiscal discipline will require painful adjustments, and it is unrealistic to think that the required

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

Projection Horizon	Projection Date	Unified Budget	Non-Social-Security Budget
2002-11	January 2001	5,610	3,119
	January 2002	1,601	-745
	January 2003	20	-2,219
	January 2004[1]	-2,207	-4,204
	January 2005	-2,581	-4,602
2003-12	January 2002	2,263	-242
	January 2003	629	-1,768
	January 2004[1]	-1,937	-4,044
	January 2005	-2,352	-4,498
2004-13	January 2003	1,336	-1,231
	January 2004[1]	-1,431	-3,656
	January 2005	-1,891	-4,174
2005-14	January 2004[1]	-785	-3,142
	January 2005	-1,364	-3,796
2006-15	January 2005	-855	-3,422

Sources: CBO (2001, 2002, 2003, 2004, 2005).
[1]CBO (2004). All January 2004 figures are adjusted to remove supplemental spending for military operations in Iraq, Afghanistan, and the war on terrorism (see box).

adjustments can be undertaken entirely on one side of the budget or the other. The painful decisions necessary to restore fiscal balance would be easier to enact and especially to enforce if policymakers reinstated credible budget rules on *both* sides of the ledger.

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

II. The Changing Budget Outlook

Table 1 above and figure 1 (p. 843) report selected baseline projections made by the CBO since January 2001. The January 2005 baseline projects deficits of about $855 billion in the unified budget and $3.4 trillion in the non-Social-Security budget for fiscal 2006 to 2015. Under the January 2005 baseline projections, both the unified budget and the non-Social-Security budget improve over time. The unified budget goes from a deficit of $368 billion in 2005 to small surpluses beginning in 2012. The non-Social-Security deficit is $537 billion in 2005 and falls over time, but still remains $185 billion in 2014. As discussed below, all of those apparent improvements are based on a series of artificial and overly favorable policy assumptions.

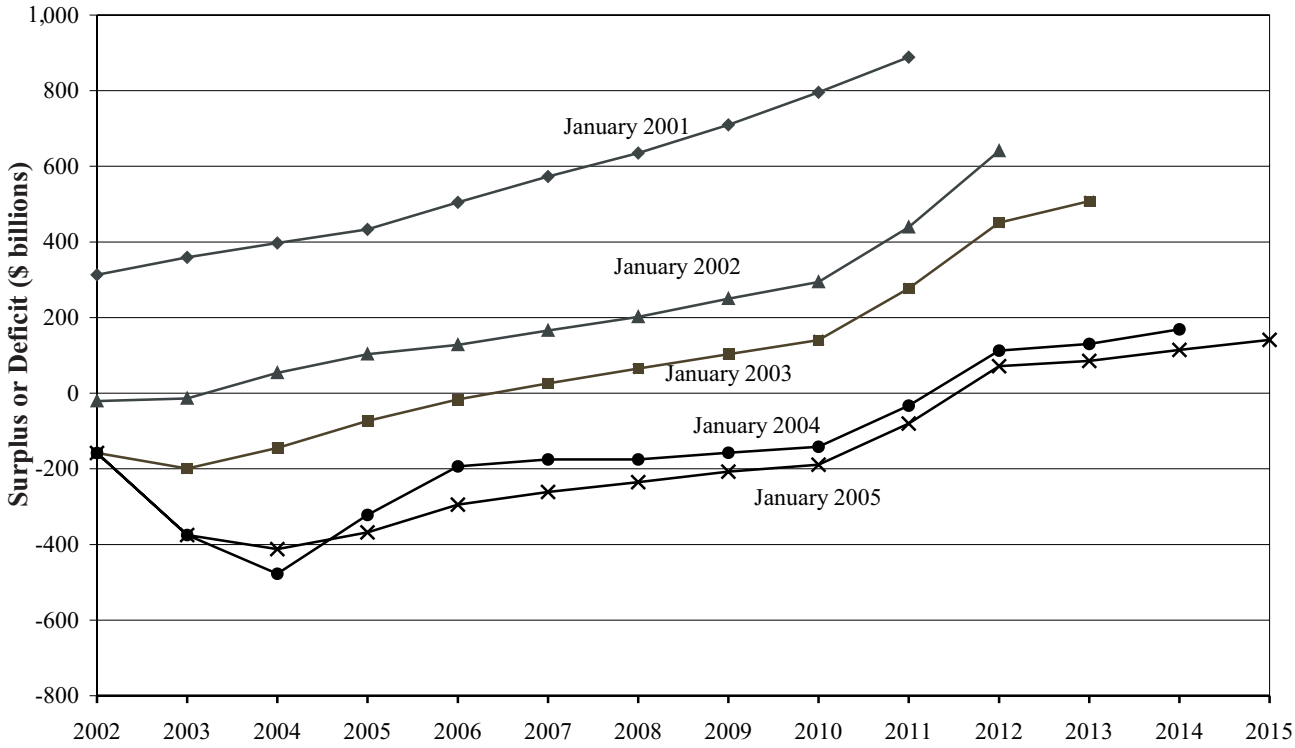
Projected budget outcomes have deteriorated dramatically since January 2001. The unified budget shows a cumulative decline of $8.2 trillion over the 2002 to 2011 horizon, the equivalent of 6.2 percent of projected GDP over the same period. The deterioration is neither temporary nor cyclical — there is a substantial downward shift in every year of the projections. For example, the projected outcome for 2005 declined by $800 billion, or 6.5 percent of GDP. The projection for 2011 fell by almost $1 trillion, or 5.9 percent of GDP. Moreover, the declines have been consistent, occurring in each of the past four years. (See the box below for discussion of the comparability of the estimates over time.) In the past year alone, the fiscal outlook for the 2002-2011 period declined by almost $400 billion, and the fiscal outlook for the 2005-2014 period by almost $600 billion.

Table 2 (p. 844) and figure 2 (p. 845) examine the composition of the decline since January 2001 in projected unified budget outcomes over the 2002-2011 horizon. About two-thirds of the decline is due to reductions

Consistent Baseline Projections Over Time

A simple comparison of baselines would inappropriately suggest that the budget situation has improved markedly over the past year: The January 2004 baseline projected deficits of $1.9 trillion over the 2005-2014 period and the January 2005 baseline projects deficits of $1.4 trillion over the same period. Because of the rules that govern the construction of baseline estimates, however, the January 2005 CBO baseline omits spending for U.S. military operations in Iraq and Afghanistan and for other aspects of the war on terrorism. In contrast, the January 2004 baseline included about $1.1 trillion in those outlays (including interest) over the 2005-2014 period. Once the estimates are put on a consistent basis, the budget situation is shown to have deteriorated over the past year. For example, taking out the war supplemental from the January 2004 baseline, the baseline deficit projected for 2005-2014 rises from $785 billion in January 2004 to $1.364 trillion in January 2005. All presentations and discussion of the January 2004 baseline in this report refer to the baseline adjusted to remove the supplemental war spending. (For further discussion, see CBO 2005.)

Figure 1. Changing Unified Budget Projections



Source: CBO (2001, 2002, 2003, 2004, and 2005).

in tax revenue, with the remaining 34 percent due to spending increases. Alternatively, 59 percent of the decline is due to legislative changes; 41 percent is due to economic and technical changes. Within the decline attributable specifically to legislative changes, tax cuts account for 50 percent, defense spending and homeland security spending account for 29 percent, and all (non-homeland-security) domestic outlays, including the Medicare prescription bill, account for the rest.

Whereas table 2 focuses on how projected outcomes have changed, table 3 (p. 846) examines the actual decline in budget outcomes between 2000 and 2005. Despite assertions that domestic spending is skyrocketing out of control, table 3 shows that the vast majority of the recent increase in budget deficits is due to lower taxes, not higher spending. Between 2000 and 2005, the budget changed from a surplus of 2.4 percent of GDP to a projected deficit of 3 percent of GDP. Of that 5.4-percentage-point-of-GDP change, 4 percentage points — just under 75 percent — is due to lower revenue. In contrast, nondefense discretionary spending (which includes international assistance and pieces of homeland security) accounts for less than 10 percent of the increase in the deficit as a share of GDP. Although not shown in the table, increased non-homeland-security domestic spending (that is, excluding both international assistance and nondefense homeland security) accounts for just 5 percent of the deterioration in the budget balance.

Other evidence discussed below also supports the view that revenue declines, not spending increases, are the main driving force behind the increase in deficits. Federal spending in 2004 was actually below its average share of GDP between 1960 and 2000. Federal revenue in 2004 was a smaller share of the economy than at any time since 1959.

III. Adjusting the 10-Year Budget Outlook

The CBO baseline budget projections dominate public discussions of the fiscal status of the government. As the CBO (2005, page 5) itself emphasizes, however, the baseline is not intended to serve as a prediction of likely budget outcomes. The set of default assumptions about current spending and tax policies used to develop the baseline are defined in part by statutory rules and hence are often unrealistic. Indeed, the CBO (2005, tables 1-3, 3-10 and 4-10) now prominently displays estimates of the budgetary implications of alternative assumptions.

A. Current Policy

We adjust the baseline budget figures in several ways.[1] That clearly involves a set of judgment calls, so we explain the adjustments and their justifications below.

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

(Footnote continued on next page.)

Table 2. Sources of Change in the Unified Budget Baseline, 2002-2011 January 2001 — January 2005[1, 2]		
	2002-2011	
	($ billions)	(% of change)
Legislative Changes		
Tax Cuts	2,415	29.5
Defense and HS Outlays	1,376	16.8
Other Outlays	1,035	12.6
Subtotal	4,826	58.9
Economic and Technical Changes		
Revenue	3,009	36.7
Outlay	358	4.4
Subtotal	3,367	41.1
Revenue — Total	5,424	66.2
Outlays — Total	2,769	33.8
Total Change in Surplus	8,193	100.0

[1]Columns may not sum to total due to rounding.
[2]*Source and notes:* CBO (2005). Supplemental Tables. Debt Service is apportioned to each of the categories based on authors' calculations. Legislative changes in projected revenue or spending are aggregated in each time period and applied to that year's debt service matrix. The resulting interest payments are scaled to sum to CBO's measure of interest changes due to legislation.

The most important area in which the baseline makes unrealistic assumptions involves expiring tax provisions. The CBO assumes (by law) that Congress will extend some expiring mandatory spending programs,[2] but that all temporary tax provisions (other than excise taxes dedicated to trust funds) expire as scheduled, even if Congress has repeatedly renewed them. All of the tax cuts enacted in 2001, 2002, 2003, and 2004 expire or "sunset" by the beginning of 2011 (see Gale and Orszag 2005). A variety of other tax provisions that have statutory expiration dates are routinely extended for a few years at a time as their expiration date approaches. We assume that almost all of those provisions will be extended. The one exception is the temporary reduced tax rate on repatriated dividends that was enacted in 2004. That was explicitly designed and justified as a one-time, temporary provision, whereas almost all of the other expiring provisions appear to be designed to be permanent.[3]

The second issue involves the AMT, which offers a dramatic example of how the baseline projections generate unlikely outcomes (see Burman *et al.* 2003). Our budget estimates reflect current policy toward the AMT in two ways. First, we assume that provisions of the AMT that are slated to expire before the end of the budget window are granted a continuance.[4] Second, we index the AMT exemption, brackets, and phaseouts for inflation starting in 2006 at 2005 levels and allow dependent exemptions in the AMT starting in 2005.

The third area in which the CBO's baseline assumptions appear to be an unrealistic reflection of current policy involves discretionary spending, which typically requires new appropriations by Congress every year. The CBO baseline assumes that real discretionary spending will remain constant at the level prevailing in the first year of the budget period. Because population and income grow over time, that assumption implies that by 2015 discretionary spending will fall by 36 percent relative to GDP and by 9 percent in real per capita terms. This year, there is an additional concern, which is that the baseline contains no new expenditures for the wars in Iraq, in Afghanistan, and against terrorism (see box on p. 842).

Given those issues, baseline discretionary spending could be adjusted in any of several plausible ways. We adjust the baseline on the assumption that real discretionary spending grows at the same rate as the population, consistent with adjustments that we have made in earlier years. That assumption generates almost exactly the same 10-year spending level on discretionary outlays and interest payments as would occur if real discretionary spending remained constant (as in the baseline) except for an estimated $600 billion in expenditures (counting

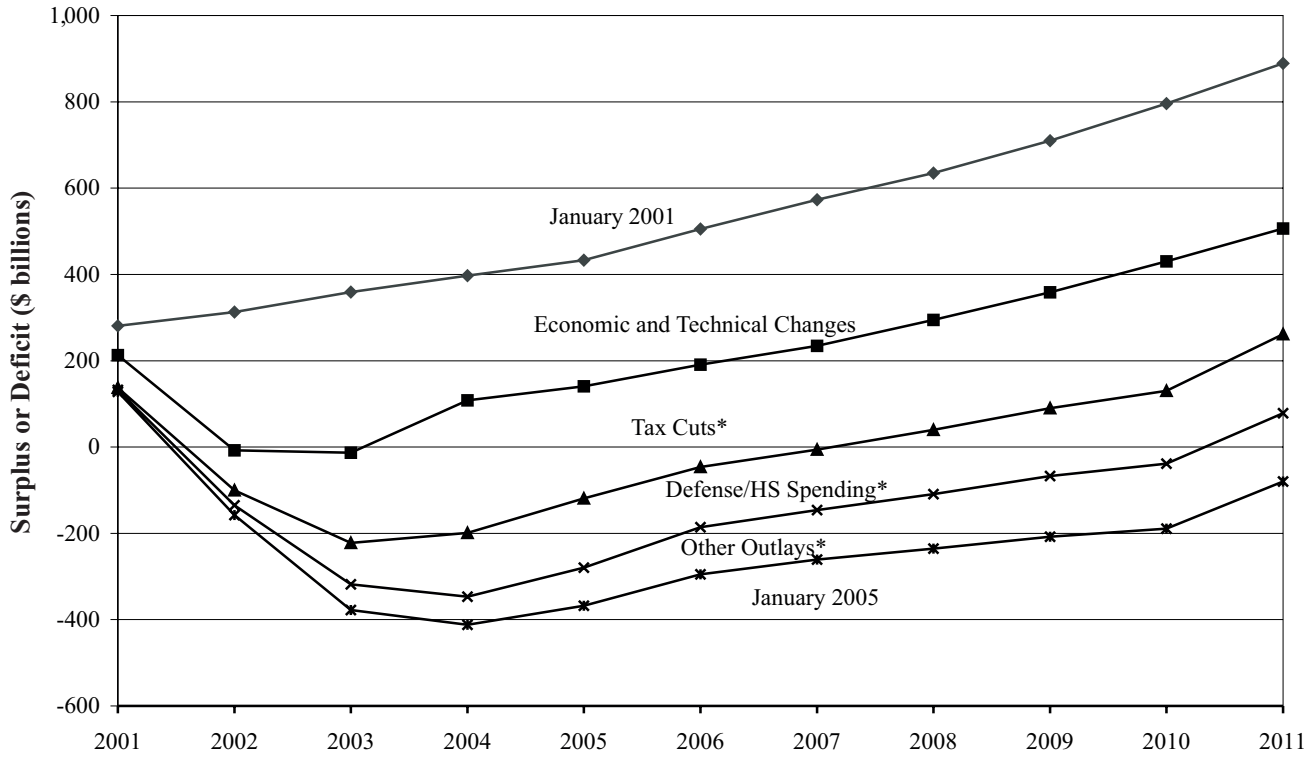
adjustments are similar in spirit and magnitude, though differing in some of the details, to those made by others, including the Committee for Economic Development, Concord Coalition, and Center on Budget and Policy Priorities (2003) and Goldman Sachs (2003). For earlier calculations of similar adjustments, see also Auerbach and Gale (1999, 2000, 2001), Auerbach, Gale, and Orszag (2002), and Gale and Orszag (2003, 2004).

[2]CBO (2005, table 3-9) reports that the baseline includes $682 billion in outlays, not including debt service costs, for mandatory spending programs that are assumed to be extended beyond their expiration dates.

[3]The temporary bonus depreciation provisions enacted in 2002 and expanded in 2003 have expired as of the end of 2004. They are not extended in our adjustments.

[4]Under current law, the AMT exemption is increased for 2001 to 2005, but after 2005 it reverts to its 2000 level. We assume that the temporary increase in the exemption is made permanent. Also, under current law, the use of nonrefundable personal credits against the AMT ostensibly expired at the end of 2003, but it is likely to be reinstated in 2004. We assume that provision is made permanent as well.

Figure 2. Source of Change in the Unified Budget Baseline, 2001-2011



* Legislated changes.
Source: CBO (2005) Supplementary Reconciliation Tables.

interest payments) that the CBO (2005, table 1-3) estimates as the continuing costs of the wars in Iraq, Afghanistan, and against terrorism. That projection may prove to be too conservative, however, because it does not reflect the full costs of the administration's future year defense plan.

B. Retirement Funds

Unified budget projections can provide a misleading picture of the long-term budget position of the federal government when current or past policies result in a spending-revenue imbalance after the end of the budget projection period. Under current laws, an important source of those imbalances is long-term commitments to pay pension and healthcare benefits to the elderly through Social Security, Medicare, Medicaid, and the federal employees retirement program. There are several potential ways to address that problem, each with different strengths and weaknesses. The approach we take here is to separate some of those programs from the official budget. In particular, we exclude the trust funds for Social Security, Medicare, and government pensions.[5]

[5]An alternative approach would maintain cash flow accounting, but extend the budget horizon to be long enough to capture the periods when cash flow turns negative. For one such example, see Auerbach, Gale, and Orszag (2004).

C. Implications of the Adjustments

Tables 4 (p. 848) and 5 (p. 849) and figure 3 (p. 847) show the sizable effects of adjusting the budget for current policy assumptions and retirement trust funds over the 10-year period. (Appendix table 1 provides annual figures.) As noted above, the CBO unified budget baseline projects a 10-year deficit of $855 billion, with deficits falling over time and turning to surpluses by 2012. Adjusting the CBO baseline for our assumptions regarding current policy implies that the unified budget will be in deficit to the tune of $4.1 trillion (2.5 percent of GDP) over the next decade. Rather than turning to surplus, the deficit reaches $426 billion (2.5 percent of GDP) in 2012 and rises to $568 billion (2.9 percent of GDP) by 2015. The adjusted unified baseline shows a deficit of at least 2.3 percent of GDP in every year through 2015 and is growing at the end of the budget horizon. By 2015 the annual difference between the official projected unified budget and our alternative unified deficit is $709 billion (3.6 percent of GDP).

The unified budget, moreover, includes retirement trust fund surpluses of more than $3.2 trillion. Excluding retirement funds, which already face long-term deficits themselves, the rest of government is projected to face a 10-year deficit of $7.4 trillion. The deficit outside of the retirement trust funds is projected to be at least 4.4 percent of GDP in every year through 2015 and grows to 4.8 percent of GDP by 2015.

Table 3. Sources of Change in Unified Budget, 2000 to 2005 (Percent of GDP)[1, 2]

	2000	2005	Difference	Share of Change (percent)
Unified Budget Surplus (or Deficit)	2.4	-3.0	-5.4	100.0
Revenues	20.8	16.8	-4.0	74.0
Spending	18.4	19.8	1.4	26.0
Net Interest	2.3	1.5	-0.8	-15.5
Noninterest Spending	16.1	18.4	2.3	41.5
Mandatory	9.8	10.8	1.0	18.0
Discretionary	6.3	7.6	1.3	23.5
Defense	3.0	3.8	0.8	13.9
Nondefense	3.3	3.8	0.5	9.6

[1]Due to rounding, columns may not sum to total.
[2]*Source and notes:* CBO (2001, 2005).

Thus, the simplest way to summarize the fiscal status of the government is to note that the retirement trust funds face substantial long-term deficits and that the rest of government is also well out of fiscal balance, facing deficits of 4.6 percent of GDP over the next decade, under reasonable assumptions about current policy.

Although the precise figures should not be taken literally because of uncertainty and other factors, the basic trends in the data are clear. First, the CBO baseline suggests that the budgetary future features deficits that decline and turn to surpluses within the 10-year window, while our adjusted unified budget baseline implies continual, substantial, and rising unified deficits through 2015. Second, adjusting for the fact that the retirement trust funds are running current surpluses but will run deficits in the future shows that the budget outlook is far worse than even the adjusted unified budget figures would suggest — and the difference grows over time. Third, given the increase in defense expenditures that is virtually certain to occur, our discretionary spending assumptions may prove conservative. If discretionary spending were to remain at its current share of GDP (7.6 percent) over the next decade, deficits would be $2.2 trillion (1.4 percent of GDP) larger over the next 10 years than our adjusted baseline.

It is worth exploring the effects of the adjustments in detail. The tax adjustments have a significant effect on revenue levels and trends. Making the tax cuts permanent would reduce revenue by $1.8 trillion over the next decade; including interest costs, the deficit would rise by $2.1 trillion. About 90 percent of those effects occur in the second half of the 10-year horizon, between 2011 and 2015. Extending the other expiring provisions, except the temporary rate on repatriated dividends, reduces revenue by another $250 billion and raises the deficit by $300 billion. The further adjustments to the AMT noted above (indexing for inflation and adding dependent exemptions) would reduce revenue by $218 billion and increase the deficit by $256 billion.[6]

All told, the tax changes would reduce the level of revenues by $2.3 trillion over the 2006-2015 period. That represents 1.4 percent of GDP and 7.6 percent of baseline revenues over the budget period. Moreover, those figures grow over time. In 2015, for example, revenue would decline by $466 billion, representing 2.4 percent of GDP and 12.1 percent of baseline revenue in that year. As a result, the adjustments not only change the level of revenues, they alter the trend as well. Under the CBO baseline budget, revenue rises from 17.2 percent of GDP in 2006 to 19.6 percent in 2015. Under our adjusted baseline, revenue is essentially flat as a share of GDP, at 17 percent in 2006 and 17.2 percent in 2015.[7]

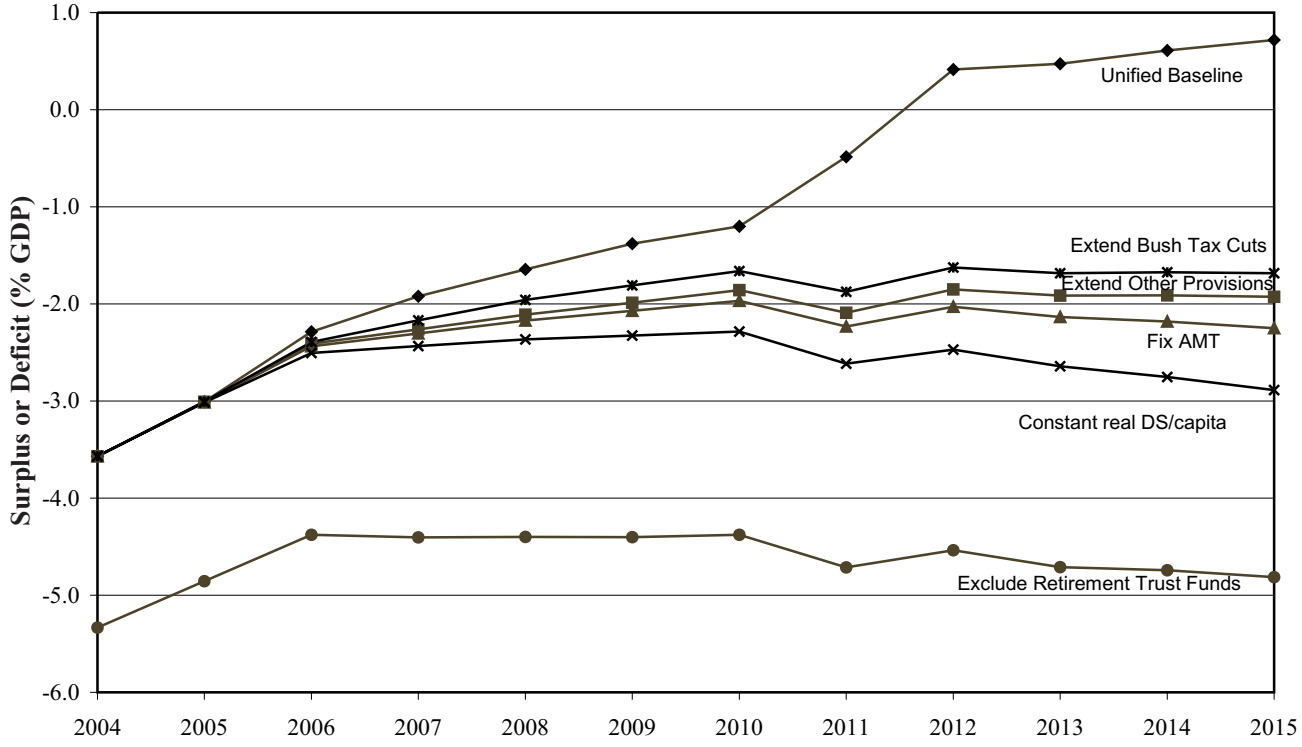
Adjusting real discretionary spending to grow with the population raises outlays by $508 billion relative to

[6]Assuming the other expiring provisions are made permanent, the total revenue loss from extending the AMT exemption and the treatment of personal credits, indexing the AMT for inflation, and allowing dependent exemptions is $759 billion, according to the Tax Policy Center (TPC) microsimulation model. Table 3 splits those costs into two components. The cost of extending the exemption and use of nonrefundable credits ($541 billion) is shown as an ''adjustment for expiring tax provisions'' and based on CBO estimates. The additional cost of indexing the AMT for inflation and adding a dependent exemption ($218 billion) are shown separately and are based on estimates using the TPC microsimulation model. Under those assumptions about five million taxpayers would face the AMT in 2015 assuming that the expiring provisions are extended. Our revenue estimates are similar to the CBO's. The CBO (2005) projects that under current law, the revenue loss from extending the exemption and indexing the AMT for inflation would be $395 billion (table 1-3) and the cost of extending the treatment of personal credits would be $50 billion (table 4-10). Those costs would increase by $247 billion if the Bush tax cuts were made permanent, for a total of $692 billion. In the TPC model, those policies would cost $716 billion. Our $759 billion figure above includes those policies plus adding dependent exemptions.

(Footnote continued in next column.)

[7]An implication of that result is that factors such as real bracket creep and projected increases in withdrawals from retirement saving accounts explain only a trivial share of the increase in the ratio of revenue to GDP in the CBO baseline. The vast majority of the increase in revenue as a share of GDP in the CBO baseline is due to the assumptions that the expiring provisions actually expire and that the AMT is allowed to grow explosively. Those sources of revenue increase are removed in the adjusted baseline, and revenue essentially becomes flat relative to GDP.

Figure 3. Baseline and Adjusted Budget Outcomes as Share of GDP, 2004-2015



Source: CBO (2005) and authors' calculations. See Appendix I Table 1.

the CBO baseline and raises the deficit by $606 billion. With that adjustment, discretionary spending still declines from 7.7 percent of GDP in 2004 to 6.1 percent in 2015, relative to 5.6 percent of GDP under the CBO baseline in 2015. Total expenditures in the adjusted baseline fall by about 0.4 percent of GDP from 19.8 percent in 2004 to 19.4 percent in 2015; the CBO baseline has spending falling from 19.8 percent to 18.9 percent.

Under the CBO's baseline, the ratio of public debt to GDP peaks at 39 percent in 2007 and then declines gradually to 29 percent by 2015. Under the adjusted baseline, the debt-GDP ratio rises to 45 percent in 2015, the highest level since 1997.

IV. Discussion

The projections above indicate that the nation faces substantial deficits in the short-term and the medium-term, with no apparent relief within the next 10 years. Several recent studies have similarly warned about the unsustainable fiscal conditions in the United States. Other projections show that budget outcomes will become significantly less favorable after 2014.[8] Taken together, the medium- and long-term estimates imply that the nation faces a substantial fiscal gap.

The primary driving force behind the deficit over the *long term* is increased spending due to demographics — in particular the retirement of the baby-boom generation, a smaller number of new entrants into the labor force, and lengthening life spans — coupled with increasing per capita healthcare expenditures. But the primary driving force behind the recent deficits and the deficits *over the next 10 years* is reduced revenue.

Revenue has been at historic lows in recent years as a share of GDP. In 2004 federal revenue was 16.3 percent of GDP, the lowest share since 1959. Income tax revenue was 7 percent of GDP, the lowest share since 1951. Looking ahead over the next decade, federal revenue in the adjusted baseline averages 17.1 percent of GDP. That is far below the 18.2 percent of GDP average from 1960-2000, during which revenue averaged at least 17.9 percent of GDP in each decade. In contrast, spending is below its historical average over the past several decades. Spending was 19.8 percent of GDP in 2004, would average about 19.6 percent of GDP for 2006-2015 in the adjusted baseline, and averaged 20.3 percent of GDP from 1960 to 2000.

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

[8]*See* Auerbach, Gale, and Orszag (2004), Committee for Economic Development *et al.* (2003), CBO (2003), Goldman Sachs (2003), and the International Monetary Fund (2004).

Table 4. Baseline and Adjusted Budget Outcomes for 2006-2015
January 2005
(in billions of $)

Projection Horizon	2006-10	2011-15	2006-15	Percent of GDP 2006-15
CBO Unified Budget Baseline	-1,188	333	-855	-0.5
Adjustment for Expiring Bush Tax Cuts				
Extend Estate and Gift Tax Repeal	-10	-261	-271	-0.2
Extend Reduced Tax Rates on Dividends and Capital Gains	-25	-136	-162	-0.1
Extend Other Non-AMT Provisions of EGTRRA, JGTRRA	-5	-841	-845	-0.5
Extend AMT Provisions of EGTRRA, JGTRRA	-169	-372	-541	-0.3
Interest	-21	-262	-283	-0.2
Subtotal	-229	-1,871	-2,101	-1.3
Adjustment for Other Expiring Provisions				
Revenue	-87	-161	-247	-0.2
Interest	-8	-48	-56	0.0
Subtotal	-95	-209	-304	-0.2
Adjustment for All Expiring Tax Provisions				
Revenue	-295	-1,770	-2,066	-1.3
Interest	-29	-310	-339	-0.2
Subtotal	-324	-2,080	-2,404	-1.5
=Unified Budget adjusted for expiring tax provisions	-1,512	-1,747	-3,259	-2.0
-Adjustment for AMT				
Index AMT and Allow Dependent Exemptions	-43	-176	-218	-0.1
Interest	-4	-33	-37	0.0
Subtotal	-47	-208	-256	-0.2
=Unified Budget adjusted for expiring tax provisions and AMT	-1,559	-1,956	-3,515	-2.2
Adjustment for holding real discretionary spending/person constant				
Hold real DS/person constant	130	378	508	0.3
Interest	12	85	98	0.1
Subtotal	142	463	606	0.4
=Unified Budget adjusted for expiring tax provisions and AMT with real DS/person constant	-1,701	-2,419	-4,121	-2.5
Adjustment for Retirement Funds				
Social Security	1,114	1,453	2,567	1.6
Medicare	118	144	262	0.2
Government Pensions	209	232	441	0.3
Subtotal	1,442	1,829	3,271	2.0
=Non-retirement-fund budget adjusted for expiring tax provisions and AMT with real DS/person constant	-3,143	-4,248	-7,391	-4.6

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

lower levels of national saving reduce future national income.[9] Heated political rhetoric about deficits hides the fact that there is widespread agreement among economists of all political views that sustained deficits are harmful. For example, even President Bush's Council of Economic Advisers (2003, box 1-4) acknowledges that ''one dollar of [public] debt reduces the capital stock by about 60 cents'' and ''a conservative rule of thumb based on this relationship is that interest rates rise by about 3

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

(Footnote continued in next column.)

Table 5. Baseline and Adjusted Budget Outcomes for 2005-2015 January 2005 Projections (percent of projected GDP)											
	2005	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
CBO Unified Budget Baseline[1]											
Surplus (or Deficit)	-3.0	-2.3	-1.9	-1.6	-1.4	-1.2	-0.5	0.4	0.5	0.6	0.7
Total Revenues	16.8	17.2	17.3	17.5	17.7	17.8	18.6	19.2	19.3	19.4	19.6
Total Spending	19.8	19.5	19.3	19.2	19.1	19.0	19.0	18.7	18.8	18.8	18.9
Discretionary	7.6	7.1	6.8	6.6	6.4	6.2	6.1	5.9	5.8	5.7	5.6
Public Debt	38.1	38.6	38.6	38.4	38.0	37.6	36.5	34.5	32.6	30.7	28.8
Adjusted Unified Budget[2]											
Surplus (or Deficit)	-3.0	-2.5	-2.4	-2.4	-2.3	-2.3	-2.6	-2.5	-2.6	-2.8	-2.9
Total Revenues	16.8	17.0	17.0	17.0	17.1	17.1	17.0	17.0	17.0	17.1	17.2
Total Spending	19.8	19.5	19.4	19.4	19.4	19.4	19.6	19.4	19.7	19.9	20.1
Discretionary	7.6	7.2	6.9	6.8	6.6	6.5	6.4	6.3	6.2	6.2	6.1
Public Debt	38.1	38.8	39.3	39.8	40.3	40.8	41.7	42.4	43.3	44.3	45.4

[1]CBO (2005). Table 1-2.
[2]Authors' calculations. See Appendix Table 1.

basis points for every additional $200 billion in government debt.'' Those estimates are quite similar to those in Gale and Orszag (2004), which in turn suggest that sustained deficits of the magnitude presented above will significantly reduce long-term national income and interest rates. Beyond those direct effects, sustained budget deficits can also reduce confidence and further hamper economic performance (Rubin, Orszag, and Sinai 2004). Ultimately, the U.S. role as the world's economic leader may also be threatened by long-term systemic fiscal shortfalls (Friedman 1988).

Faced with difficult choices, policymakers often attempt to finesse the situation in one of three ways: Invoke the benefits of economic growth, delay action, or resort to budget gimmicks. However appealing those options may seem to politicians, none would address the underlying problem.

Even significant economic growth will not solve the budget problem. Table 6 (p. 850) shows that the nation is unlikely to be able to grow out of the problem. Even if economic growth is a full percentage point faster than the CBO predicts (that is, the economy grows more than one-third faster than projected),[10] the adjusted budget would still show a deficit averaging 1.3 percent of GDP over the next decade, although it would reach balance by 2015. Nevertheless, the deficit excluding retirement trust funds would average 3.3 percent of GDP and amount to 1.9 percent of GDP in 2015.[11] In other words, more rapid economic growth can reduce the deficit, but even substantial increases in growth rate would not eliminate the average fiscal imbalance over the next decade, let alone the imbalances thereafter. Moreover, as even the president's economic advisers acknowledge, large sustained deficits are likely to be a drag on growth, not a boost, and as table 6 shows, if growth is slower than expected, deficits will skyrocket.

Delaying is also not a solution — it will just make the problem harder. Table 7 (p. 850) shows that if no action is taken before 2010, the required spending cuts or tax increases required to balance the adjusted budget in that year would be substantial: a 22 percent increase in individual and corporate income tax revenue, or a 38 percent reduction in all discretionary spending, for example. Eliminating 72 percent of all nondefense discretionary spending would produce a balanced budget. None of those choices seems likely to garner sufficient political support or to be equitable. Note, too, that 2010 is before the major revenue costs of extending the 2001, 2002, and 2003 tax cuts kick in (see table 4 and appendix table 1) and before the baby boomers begin to retire en masse.

Although the adjusted baseline allows for the recent tax cuts to be made permanent, for sizable AMT adjustments, and for extensions of other expiring provisions, it should not be presumed that those adjustments would be painless or optimal. In fact, the costs of paying for those tax cuts would be immense. Paying for the tax cuts in 2015 would require any one of the following, or cuts of a

[10]The CBO (2005) projects that potential output will grow at an average rate of 2.9 percent per year over the decade. That is somewhat lower than the 3.5 percent annual rate prevailing from 1950 to 2004. The difference is explained largely by the fact that the potential labor force is expected to grow much more slowly over the next decade (0.8 percent per year) than in the past (1.6 percent per year). The CBO's projections of actual growth through 2010 match the administration's, at 3.2 percent per year.

[11]These calculations are based on rules of thumb relating small changes in economic growth rates to changes in the projected budget outcomes, provided by the CBO (2005, Appendix A). The CBO cautions against using the rules of thumb to project the effects of large changes, and that caveat applies to the interpretation of our results as well.

Table 6. Effect of GDP Growth Rates on Baseline and Adjusted Budget Outcomes for 2005-2015 January 2005 Projections

	Surplus in % of GDP			Surplus in $ Billions			2006-2015 Surplus	
	2005	2010	2015	2005	2010	2015	% of GDP	$ Billions
CBO Unified Budget Baseline								
GDP Grows 1% Faster	-2.9	0.1	3.7	-358	11	721	0.7	1,185
GDP Grows at Projected Rate	-3.0	-1.2	0.7	-368	-189	141	-0.5	-855
GDP Grows 1% Slower	-3.1	-2.5	-2.2	-378	-389	-439	-1.8	-2,895
Adjusted Unified Budget								
GDP Grows 1% Faster	-2.9	-1.0	0.1	-359	-160	12	-1.3	-1,475
GDP Grows at Projected Rate	-3.0	-2.3	-2.9	-369	-360	-568	-2.5	-3,515
GDP Grows 1% Slower	-3.1	-3.6	-5.8	-379	-560	-1,148	-3.8	-5,555
Adjusted Non-Trust Fund Budget								
GDP Grows 1% Faster	-4.8	-3.1	-1.9	-584	-490	-366	-3.3	-5,351
GDP Grows at Projected Rate	-4.9	-4.4	-4.8	-594	-690	-946	-4.6	-7,391
GDP Grows 1% Slower	-4.9	-5.6	-7.8	-604	-890	-1,526	-5.8	-9,431

Source: Authors' calculations based on Table A-1 in CBO (2005) and Appendix Table 1.

Table 7. What Would It Take to Balance the Budget in 2010?[1]

	CBO Unified Baseline	Adjusted Unified Baseline	Adjusted Nonretirement Baseline	Memo: Baseline Revenues and Spending, 2010[2] ($ Billions)
Projected Deficit (in $ billions)	-189	-360	-690	—
as % of GDP	-1.2	-2.3	-4.4	
Percent Cut in:				
All Noninterest Outlays	-7.3	-14.0	-26.7	2,580
All Mandatory Spending	-11.7	-22.2	-42.6	1,620
All Discretionary Spending	-19.7	-37.5	-71.9	959
All Non-Defense DS	-37.7	-71.7	-137.4	502
All Spending Except: Interest, SS, Medicare, Medicaid, Defense, Homeland Security	-29.6	-56.4	-108.0	638
Percent Increase in:				
All Tax Revenues	7.1	13.5	25.9	2,662
Income Tax	13.9	26.4	50.6	1,362
Corporate Tax	76.0	144.6	277.0	249

[1]Authors' calculations using CBO (2005). See Appendix Table 1.
[2]CBO (2005). Tables 1-2, 3-1, 3-3.

similar magnitude (see table 8, p. 851): a 14 percent reduction in all noninterest outlays; a 96 percent reduction in domestic discretionary spending (other than homeland security); a 52 percent cut in Social Security benefits, a 61 percent reduction in Medicare payments, complete abolition of the Medicaid program, or a 60 percent cut in all federal spending other than Social Security, Medicare, Medicaid, defense, homeland security, and net interest. Those reductions are obviously far beyond the scope of what has been considered politically feasible.

Given the facts above, the temptation to turn to budget gimmicks may prove overwhelming. Policymakers and the public should be especially aware of at least five tricks: (a) policies that significantly raise long-term deficits such as the president's proposals to make the 2001 and 2003 tax cuts permanent, (b) policies that can reduce short-term deficits but significantly raise long-term deficits — the president's proposal to create lifetime saving accounts and retirement saving accounts, for example, (c) policies that incur massive short-term borrowing and promise, but have no credible way of enforcing, spending cuts in the distant future — like proposals to finance individual accounts in Social Security with benefit cuts many decades in the future; (d) policies that shift attention away from long-term fiscal challenges — for example, focusing on a five-year budget window; and (e) policies that allow politicians to ignore budget issues — such as not reinstating budget rules that require spending and tax changes to be self-financing, or even worse, the administration's proposal in last year's and this year's budget to allow the tax cuts to be made permanent without showing any change in the budget baseline.

Table 8. Paying for Permanent Tax Cuts in 2015		
	Extend Tax Cuts and Adjust AMT[1]	**Memo: 2015 Baseline Revenue/Spending ($ Billions)[2]**
Revenue Loss in 2015 (in $ billions)	466	
Required Percentage Change in*		
All Noninterest Outlays	-13.7	3,403
Discretionary Spending	-42.3	1,101
Defense, HS, International	-75.7	615
Other	-95.9	485
Mandatory Spending	-20.2	2,303
Social Security	-52.4	888
Medicare	-60.8	766
Medicaid	-118.8	392
All Three	-22.8	2,046
All Spending Except: Interest, Social Security, Medicare, Medicaid, Defense, and Homeland Security	-59.7	779
Revenue		
Payroll Tax	37.2	1,253
Corporate Tax	159.4	292

[1]Authors' calculations. See Appendix Table 1.
[2]CBO (2005).
* Percentage cuts that exceed 100 are arithmetic artifacts. No program can be cut more than 100 percent.

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

Yet Congress and the Bush administration have either been unable or unwilling to act on deficit reduction. Not only have taxes been cut repeatedly, but the large majority of the Republican members of Congress, as well as the president, have signed the ''No New Taxes'' pledge. At the same time, spending has risen in recent years, not only in defense, but in nondefense discretionary spending as well. The largest entitlement program in 40 years, the new Medicare prescription drug benefit, was enacted in 2003. Those spending increases received the overwhelming support of signers of the ''No New Taxes Pledge'' (Gale and Kelly 2004). Clearly, a majority party and a president who have cut taxes repeatedly, want to cut taxes more, are unwilling to raise taxes, and have continually increased spending, are not pursuing a fiscally responsible path.

A set of workable budget rules may encourage more fiscal discipline among policymakers; after all, policymakers have displayed little willingness to embrace that discipline in the absence of those rules. Those rules would help create and enforce spending cuts and tax increases to close the deficit. But they need to be imposed on both spending and revenue changes. The administration has so far refused to consider rules limiting tax cuts, even though declines in revenue have been the source of most of the recent resurgence of deficits. In terms of particular programmatic changes, Rivlin and Sawhill (2004) describe several possible avenues for restoring fiscal balance in the medium term. Those proposals combine spending cuts and tax increases, phase in gradually over time, and avoid budget gimmicks. Similar proposals, coupled with realistic reforms of the long-term entitlement programs (see, for example, Diamond and Orszag 2004) would be significant steps in the right direction.

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Appendix Table 1. Baseline and Adjusted Budget Outcomes for 2004-2015
January 2005 Projections
(Surplus or Deficit in $ billions)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	All
1. CBO Unified Budget Baseline[1]	-412	-368	-295	-261	-235	-207	-189	-80	71	85	115	141	-855
as percent of nominal GDP	-3.6	-3.0	-2.3	-1.9	-1.6	-1.4	-1.2	-0.5	0.4	0.5	0.6	0.7	-0.5
Adjustment for Expiring Bush Tax Cuts													
Extend Estate and Gift Tax Repeal[2]	0	0	-2	-2	-2	-2	-2	-29	-51	-55	-61	-65	-271
Extend Reduced Tax Rates on Dividends and Capital Gains[2]	0	0	0	0	-3	-13	-10	-25	-25	-27	-29	-31	-162
Extend Other Non-AMT Provisions of EGTRRA, JGTRRA[2]	0	0	0	-1	-2	-1	-1	-101	-178	-182	-187	-192	-845
Extend AMT Provisions of EGTRRA, JGTRRA[3]	0	0	-11	-30	-36	-42	-50	-57	-66	-74	-83	-92	-541
Interest[4]	0	0	0	-1	-3	-6	-10	-17	-32	-50	-70	-93	-283
Subtotal	0	0	-14	-34	-45	-65	-73	-229	-352	-389	-430	-472	-2101
as percent of nominal GDP	0.0	0.0	-0.1	-0.2	-0.3	-0.4	-0.5	-1.4	-2.0	-2.2	-2.3	-2.4	-1.3
Adjustment for Other Expiring Provisions[5]													
Revenue	0	0	-2	-12	-21	-24	-27	-30	-31	-32	-33	-34	-247
Interest	0	0	0	0	-1	-2	-4	-6	-7	-9	-12	-14	-56
Subtotal	0	0	-2	-13	-22	-27	-31	-36	-39	-42	-45	-48	-304
Adjustment for All Expiring Tax Provisions													
Revenue	0	0	-16	-45	-62	-83	-90	-242	-352	-371	-393	-413	-2066
Interest	0	0	0	-2	-5	-9	-14	-23	-39	-59	-82	-107	-339
Subtotal	0	0	-16	-46	-67	-91	-104	-265	-391	-430	-475	-520	-2404
2. Unified Budget adjusted for expiring tax provisions	-412	-368	-311	-307	-302	-299	-293	-345	-319	-345	-360	-378	-3259
as percent of nominal GDP	-3.6	-3.0	-2.4	-2.3	-2.1	-2.0	-1.9	-2.1	-1.9	-1.9	-1.9	-1.9	-2.0
Adjustment for AMT[6]													
Index AMT and Allow Dependent Exemptions in 2005	0	-1	-3	-5	-8	-11	-15	-21	-26	-34	-42	-53	-218
Interest	0	0	0	0	-1	-1	-2	-3	-4	-6	-8	-11	-37
Subtotal	0	-1	-3	-6	-9	-12	-17	-24	-31	-40	-51	-64	-256

(Table continued on next page.)

Appendix Table 1 (continued)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	All
3. Unified Budget adjusted for expiring tax provisions and AMT	-412	-369	-314	-313	-311	-311	-310	-368	-350	-385	-410	-442	-3,515
as percent of nominal GDP	-3.6	-3.0	-2.4	-2.3	-2.2	-2.1	-2.0	-2.2	-2.0	-2.1	-2.2	-2.3	-2.2
Adjustment for holding real DS/person constant[7]													
Hold real DS/person constant	0	0	9	17	26	35	44	54	64	75	86	98	508
Interest	0	0	0	1	2	4	6	9	12	16	21	27	98
Subtotal	0	0	9	18	28	38	50	63	76	91	108	125	606
4. Unified Budget adjusted for expiring tax provisions and AMT with real DS/person constant	-412	-369	-323	-331	-338	-350	-360	-431	-426	-476	-518	-568	-4,121
as percent of nominal GDP	-3.6	-3.0	-2.5	-2.4	-2.4	-2.3	-2.3	-2.6	-2.5	-2.6	-2.8	-2.9	-2.5
Adjustment for Retirement Funds[8]													
Social Security	151	169	185	205	225	242	258	273	284	293	300	304	2,567
Medicare	13	13	16	22	24	27	29	30	27	33	28	25	262
Government Pension	40	43	41	41	42	42	43	44	45	47	47	49	441
Subtotal	204	225	242	268	291	312	330	346	356	373	375	379	3,271
5. Non-retirement fund budget adjusted for expiring tax provisions and AMT with real DS/person constant	-616	-594	-564	-598	-630	-661	-690	-777	-782	-849	-893	-946	-7,391
as percent of nominal GDP	-5.3	-4.9	-4.4	-4.4	-4.4	-4.4	-4.4	-4.7	-4.5	-4.7	-4.7	-4.8	-4.6
Nominal GDP[9]	11,553	12,233	12,888	13,586	14,307	15,029	15,757	16,494	17,245	18,023	18,826	19,652	161,806

[1]The Budget and Economic Outlook: Fiscal Years 2006-2015. Summary Table 1.

[2]The Budget and Economic Outlook: Fiscal Years 2005-2014. January 2005. Table 4-10.

[3]Authors' calculations using microsimulation model of Tax Policy Center. AMT cost is stacked on extension of EGTRRA and JGTRRA to include interaction.

[4]Authors' calculations using January 2005 CBO debt service matrix.

[5]Authors' calculations so the subtotal (excluding interest) equals CBO estimate in Table 4-10 of The Budget and Economic Outlook: Fiscal Years 2006-2015. Does not include repatriated dividends.

[6]Authors' calculations using microsimulation model of Tax Policy Center. The indexing of the AMT and allowing dependent exemptions to be counted against taxable income for AMT purposes slows, but does not stop, the increase in AMT taxpayers.

[7]Authors' calculations using Census 2000 projections of population growth.

[8]The Budget and Economic Outlook: Fiscal Years 2006-2015. January 2005. Table 1-6 and Supplementary Tables.

[9]The Budget and Economic Outlook: Fiscal Years 2006-2015. January 2005. Table 1-2.