

## Auerbach and Gale

### How Big is the Prospective Budget Surplus?

After decades of deficits, the federal budget has recently yielded surpluses, and projections suggest that the surplus will rise significantly over the next decade. The most recent Congressional Budget Office (CBO) baseline forecast, released in July, projects cumulative surpluses between \$4.5 trillion and \$5.8 trillion between 2001 and 2010. Just as perennial budget deficits dominated policy discussions in the 1980s and early 1990s, choices regarding how to use the surplus play a central role in the current presidential election campaign and will shape fiscal debates for years to come.

These debates, however, are almost always framed in terms of the official “baseline” budget forecast. Although it provides a common and visible benchmark, the baseline forecast is limited in several crucial ways and does not provide sufficient information to assess various policy options.

This policy brief addresses some of these problems. We provide new estimates of the federal government’s underlying fiscal position after adjusting the baseline forecast to account for several of its key limitations. Between 2001 and 2010, these adjustments—for discretionary spending, tax policy, the Social Security trust fund, and other retirement trust funds—reduce the surplus available for new spending or tax cuts to about \$350 billion, or between 6 and 8 percent of the total surpluses reported in official documents.

We also consider the hazards of looking only at a 10-year horizon and show that under the most plausible long-term scenarios, the government faces an annual fiscal deficit, not a surplus, of between 0.3 percent and 1.4 percent of Gross Domestic Product (GDP). Without an understanding of the longer-run fiscal situation, it is difficult to see how intelligent policy choices about the surplus can be made. Our findings suggest that the official surplus calculations are misleading, and the current frenzy of proposals for allocating the surplus to additional spending and tax cuts is misplaced.



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# A New Look at

## The Next Ten Years

The Congressional Budget Office's baseline forecast is intended only to measure the implications of maintaining "current policy." But how one should project current policy into the future is not always obvious. The baseline forecasts project current policy subject to a variety of statutory requirements, which limit the scope of the forecast's underlying assumptions and time horizons and can be at variance with reasonable expectations. Revenues, offsetting receipts, and mandatory spending—e.g., entitlements, such as Social Security—are generally assumed to continue as they are currently structured in the law.

Discretionary spending, however, poses problems in this regard. Unlike mandatory spending, discretionary programs—e.g., defense, education, the environment, or infrastructure—are not automatically included in the annual budget, and require annual appropriations from Congress. As a result, no consensus exists about how to project current policy for discretionary programs. In light of this quandary, the CBO has recently presented three scenarios for current policy toward discretionary spending:

- The *capped* baseline assumes Congress complies with the statutory budget caps on discretionary spending through 2002 and then allows discretionary spending to grow at the rate of inflation thereafter.
- The *freeze* baseline holds discretionary spending at the nominal level enacted for the year 2000, plus any amounts already enacted for 2001.
- The *inflated* baseline allows discretionary spending to grow at the rate of inflation each year after 2000.

The CBO estimates that the cumulative budget surplus between 2001 and 2010 is \$5.77 trillion under the capped baseline, \$5.74 trillion under the freeze, and \$4.56 trillion under the inflated baseline. At first glance, these figures suggest the availability of massive amounts of resources to finance new spending initiatives or tax cuts. But further investigation suggests there is much less here than meets the eye. This investigation is summarized in figure 1, which—for reasons discussed below—uses the inflated baseline as the starting point.

**Social Security Trust Fund** A substantial portion of the budget surpluses are due to the Social Security trust fund. Over the next 10 years, Social Security will take in about \$2.3 trillion more in payroll tax revenues and interest received on its assets than it will pay out in benefits and administrative costs. However, leaders of both political parties agree that accruing Social Security trust fund balances should contribute to improving that program's

# the Official Numbers

long-term financial viability, and should not be used to finance tax cuts or other spending programs.

**Discretionary Spending** The three discretionary spending baselines outlined above are clear, but may not be very reasonable. Discretionary spending totaled 6.3 percent of GDP in 1999, already the lowest share since at least 1962. Under the capped, freeze and inflated baselines, discretionary spending would fall to 4.5 percent, 4.0 percent, and 5.2 percent of GDP, respectively, by 2010. Although the capped and freeze baselines are particularly unrealistic, it is reasonable to question whether any of these baselines are plausible. Certainly, the political history of the last few years suggests these types of cuts are unlikely to occur.

Thus, as an alternative, we estimate the effects of holding discretionary spending constant relative to the size of the economy. Under this scenario, discretionary spending would remain far below historical norms. But spending would rise by a cumulative total of \$744 billion between 2001 and 2010 relative to the inflated baseline. Counting the added interest costs, the surplus would decline by \$864 billion relative to the inflated baseline.

Our scenario has nominal discretionary spending growing at the rate of inflation plus about 2.7 percent—the latter being the projected growth rate of real GDP. An alternative assumption would have discretionary spending grow at the rate of inflation plus 1 percent, which would hold discretionary spending roughly constant on a per capita basis, after adjusting for inflation. Under this scenario, the surplus would fall by \$320 billion relative to the inflated baseline.

**Tax Policy** The alternative minimum tax (AMT) is one of the most complex areas of individual tax law and was implemented as a sort of backstop confronting the small number of taxpayers who are considered to be too aggressive in creating shelters and claiming deductions to avoid paying taxes.

In practice, the AMT has affected few taxpayers. This year, for example, only 1.3 percent of taxpayers will face the levy. Under current law, however, the Treasury Department projects that by 2010, 15 percent of taxpayers will be affected by the AMT. The main reason why is

**Figure 1**

## How Big Is the Available Surplus?

Budget Scenario	\$ Billions
CBO 10-year surplus (inflated baseline)	4,561
Minus Social Security trust fund surplus	-2,388
On-budget surplus (inflated baseline)	2,173
Minus adjustments for:	
Discretionary spending	-864
Alternative minimum tax	-94
Expiring tax provisions	-61
Medicare trust fund	-360
Government retirement trust funds	-442
Available surplus	352

Source: Congressional Budget Office, July 2000. *The Budget and Economic Outlook: An Update*, Table S-1, and authors' calculations.

that the AMT exemption is not indexed for inflation. This increase would be fought fiercely by the affected groups. Indeed, the problem has already received significant attention, even though only a small portion of taxpayers currently face the tax. Thus, we believe that “current policy” would be better represented by indexing the AMT for inflation. The lost tax revenue from this policy would total \$83 billion over the next 10 years. Counting the added interest, we estimate the net cost would be \$94 billion.

*The same logic that protects Social Security balances from tax cuts or spending should extend to Medicare and government pension reserves.*

A second tax issue relates to expiring tax provisions, a number of which are scheduled to sunset over the next decade. For all taxes other than excise taxes dedicated to trust funds, CBO assumes that legislated expirations occur as scheduled. In the past, however, these provisions were typically extended another few years each time the expiration dates approached. In light of this practice, current policy is more aptly viewed as assuming that these so-called “extenders” will be granted a continuance. Extending the provisions—except the one relating to AMT, which is addressed above—through the 10-year horizon would cost a net of \$52 billion in lost revenues plus an additional \$9 billion in interest costs.

**Retirement Trust Funds** Trust funds for government military and civilian employee pensions and for Medicare Part A, which covers hospital costs, are projected to run surpluses totaling \$802 billion over the next 10 years. Medicare accounts for \$360 billion, with government pension reserves accounting for the remaining \$442 billion. Under current procedures, these surpluses are a component of the budget surplus. Like Social Security, however, these trust funds represent current accumulations intended to provide retirement benefits to future workers. Thus, the same logic that protects Social Security balances from tax cuts or spending should extend to Medicare and government pension reserves as well.

Many states, in fact, already separate their pension reserves from funds available for tax cuts and other spending. In June, the House of Representatives approved by a vote of 420-2 a measure promising not to use the Medicare trust fund to finance other programs or tax cuts.

**Adding It Up** Figure 1 shows that the adjustments noted above have a profound effect on the amount of funds available for new spending. The total 10-year surplus under the inflated baseline is \$4.56 trillion. Removing Social Security trust funds reduces the surplus to \$2.17 trillion. Adjusting for discretionary spending and tax policy, and removing the possibility of using Medicare and government pension reserves to finance new spending or tax cuts reduces the available balance to just over \$350 billion. This figure is less than 8 percent of the overall surplus projected under the inflated baseline.

If real discretionary spending were held constant on a per capita basis, the net available surplus would be about \$896 billion. This is larger, of course, than the figure shown in

figure 1, but it is also far below the reported official surplus estimates, and reinforces the point that reasonable adjustments to the official figures can make a huge difference.

The uncertainty inherent in such forecasts is also worth noting. For example, if revenues turn out to be 1 percent lower or higher over the course of the decade, the cumulative surplus—including the change in interest costs—would change by about \$320 billion.

### The Candidates' Proposals

Both major party presidential candidates have proposed ambitious programs to reduce taxes and increase spending. How these proposals stack up against the baseline and adjusted surpluses is a key concern. However, because new proposals continue to be introduced and because only one proposal has been officially scored for revenue purposes, our analysis of the plans is limited.

Last fall, Republican George W. Bush proposed a detailed series of tax policy changes, including repealing the estate tax, boosting the child tax credit, and cutting income tax rates. Congress' Joint Committee on Taxation estimates that Governor Bush's proposals would reduce revenues by \$1.32 trillion between 2002 and 2010. Adding interest payments, the total cost would be \$1.54 trillion over the first 9 years of the tax cut. This cost is over four times as large as the available surplus would be under the definition of current policy employed in figure 1. However, these estimates understate the cost of the tax cuts for two reasons. First, they were calculated relative to an earlier CBO baseline with lower overall tax revenues. Using the most recent baseline—which projects revenues 8 percent higher than the old forecast—the estimated cost of the tax cut would almost surely be substantially higher. Second, the estimates do not include any AMT fix, and the cost of holding down the number of taxpayers affected by the AMT would rise if regular income taxes were cut.

Democratic nominee Al Gore has proposed a variety of targeted tax cuts for health, education, families with children, retirement saving, the environment, and other items. His estimates suggest the 10-year cost is on the order of \$500 billion. This is substantially less than Governor Bush's tax cuts. However, because information on the revenue costs of Gore's tax proposals over time was unavailable as of this writing, we are unable to estimate the 10-year interest costs.

Both candidates propose increases in discretionary spending relative to the inflated baseline described above. Bush has proposed new discretionary spending programs for defense, education, health care, crime prevention and other issues, with estimates placing the costs between \$200 billion and \$300 billion over the next 10 years. Gore advocates about \$475 billion in new or expanded programs, focusing in large part on education, health care, the environment, and defense. These proposals are good examples of the pressure that will continue to be placed on discretionary spending.

*The serious consequences of a relatively bad long-term outcome—for example, a protracted recession—should spur a precautionary response from policymakers now.*

Earlier, we said that raising discretionary spending by \$750 billion relative to the inflated baseline would be a realistic estimate. Both candidates are calling for smaller increases, but our estimate covers all discretionary spending programs enacted between 2001 and 2010, whereas the candidates are only discussing one year's worth or one administration's worth of proposals.

*Both candidates propose to allocate resources well beyond those projected to be available from the adjusted surpluses.*

The biggest uncertainty relating to budgetary costs concerns retirement saving and Medicare expansion. Bush has advocated diverting some Social Security contributions into private retirement accounts, but has provided almost no details. Gore has proposed voluntary, progressive, government-run "Retirement Savings Plus" accounts modeled on Individual Retirement Accounts. The cost of either program is highly uncertain, and estimates vary by hundreds of billions of dollars. Similar uncertainty applies to cost estimates for each campaign's recently unveiled plan to provide prescription drug benefits to Medicare recipients.

Thus, the candidates' proposals for allocating the surplus differ in crucial ways. Bush's tax cut is substantially larger, while Gore proposes somewhat more new government spending. The candidates differ significantly in their approach to retirement saving. What is clear, however, is that both candidates propose to allocate resources well beyond those projected to be available from the adjusted surpluses noted above.

### **The Long Term**

Looking beyond 2010 is particularly important because the rapid growth in entitlement programs driven by an aging population and by rapidly rising medical care expenditures is not projected to begin until later. To take these and other factors into account, we estimate the long-term "fiscal gap" under different policies.

The fiscal gap is the size of the permanent increase in taxes or reductions in non-interest expenditures (as a constant share of GDP) that would be required *now* to keep the long-run ratio of government debt to GDP at its current level. The fiscal gap gives a sense of the *current* budgetary status of the government, taking into account long-term influences.

To generate these estimates, we use the CBO 10-year forecast through 2010 and CBO long-term budget forecasts through 2070. After that, we assume all revenues and non-interest expenditures remain a constant share of GDP. Social Security and Medicare outlays follow the intermediate projections in the reports released by the trustees of the funds. Discretionary spending, federal consumption of goods and services, and all other government programs, with the exception of net interest, are assumed to grow with GDP after 2010. Tax revenues are a constant share of GDP, except for supplementary medical insurance premiums collected for Medicare, which grow relative to GDP.

Figure 2 shows that different measures of current policy can have a significant impact on the long-term fiscal status of the federal government, if these policies establish levels of spending or taxes that are preserved (relative to GDP) after 2010. Under the capped baseline, the fiscal gap is *negative*. In other words, the government is in *surplus* through 2070 and on a permanent basis. However, using the inflated baseline raises the gap by roughly three-quarters of a percent of GDP over either horizon. Thus, the permanent fiscal gap would be about 0.31 percent of GDP.

Allowing discretionary spending outlays to remain constant as a share of GDP raises the fiscal gap further, to 0.28 percent of GDP over the next 70 years and 1.36 percent on a permanent basis. Allowing the tax cut of the magnitude advocated by Governor Bush would raise these figures by about 1.5 percent of GDP over both horizons.

In light of the recent political pressure to raise spending and/or cut taxes, it seems highly unlikely that there will be any immediate action to reduce the fiscal gap. But delaying the implementation of necessary tax increases or spending cuts will simply raise the required fiscal correction at the time of implementation.

These estimated fiscal gaps are intended only to indicate the magnitude of the long-term budgetary imbalance. But the added uncertainty inherent in such long-term estimates should not lead us to ignore long-term issues. Indeed, the serious consequences of a relatively bad long-term outcome—for example, a protracted recession—should spur a precautionary response from policymakers now.

## Conclusions

These findings suggest some useful lessons for the current debate about how to allocate the surplus. First, the virtually exclusive emphasis given to baseline 10-year budget projections in current fiscal policy debates is inappropriate. The baseline forecast suggests the availability of trillions of dollars for tax cuts or new spending, but is based on a particular set of views of what constitutes current policy. More plausible notions of current policy reduce the available 10-year surplus to \$350 billion.

Second, despite the recent strong improvement in the government's fiscal position, there is still a long-term budget imbalance. This imbalance is a "future" problem only insofar as our chosen budget accounting rules ignore the existence of liabilities already accrued.

**Figure 2**

### Estimates of Long-Term Fiscal Gaps (Percent of GDP)

Spending and Tax Assumptions	Through 2070	Permanent
CBO Capped Baseline (through 2002)	-1.41	-0.44
CBO Inflated Baseline	-0.67	0.31
Constant DS/GDP	0.28	1.36
Capped Baseline + Tax Cut	0.06	1.09
Inflated Baseline + Tax Cut	0.81	1.84
Constant DS/GDP + Tax Cut	1.75	2.89

Source: Authors' calculations.

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Third, given this long-term imbalance, the fiscal climate may be more troubling now than in previous years. The short-term surplus and the decline in the long-term fiscal gap are no doubt improvements, but fiscal discipline may be especially difficult to impose under current conditions.

In the 1980s and early 1990s, when the country faced both short-term and long-term deficits, the short-term deficits helped focus attention in a way that also helped reduce long-term gaps. Today, the United States faces the same trade-off between current and future generations as in earlier decades, and it is still confronting a long-term shortfall. But the current policy discussion focuses on ways to use the surplus that would likely exacerbate the long-term situation. In light of how misleading the official surplus calculations are, the current focus on spending initiatives and tax cuts is misplaced.

## References

For information on the data sources and methodologies used in this report and for further analysis, see "Perspectives on the Budget Surplus," Alan J. Auerbach and William G. Gale.

<http://www.brookings.edu/views/papers/gale/20000717.htm>

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