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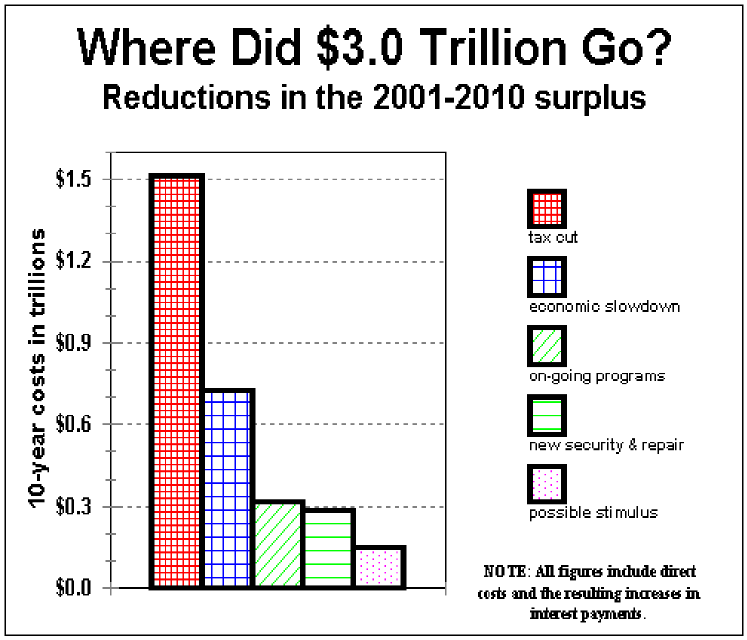
# WHERE HAS ALL THE SURPLUS GONE?

by Richard Kogan




Last January, the Congressional Budget Office projected a total budget surplus of $313 billion for fiscal year 2002 and of $5 trillion over the ten-year period 2001-2010.[1] But the projected surpluses have melted away. Fiscal year 2002 now looks as though it will end in deficit (the first deficit in four years), and according to the latest estimates of the Senate and House Budget Committees, the ten-year surplus has shrunk to $2 trillion, a decline of $3 trillion in less than a year.

Fully half of the shrinkage in the ten-year surplus was caused by last June's tax cut. Another quarter was caused by the downturn in the economy and other changes in budget estimates. The final quarter comes from three sources: 1) increases in existing programs, including added defense funding the President requested in June; 2) legislation enacted in response to the terrorist attacks of September 11; and 3) an assumption that Congress will shortly enact $100 billion in economic stimulus legislation.[2]

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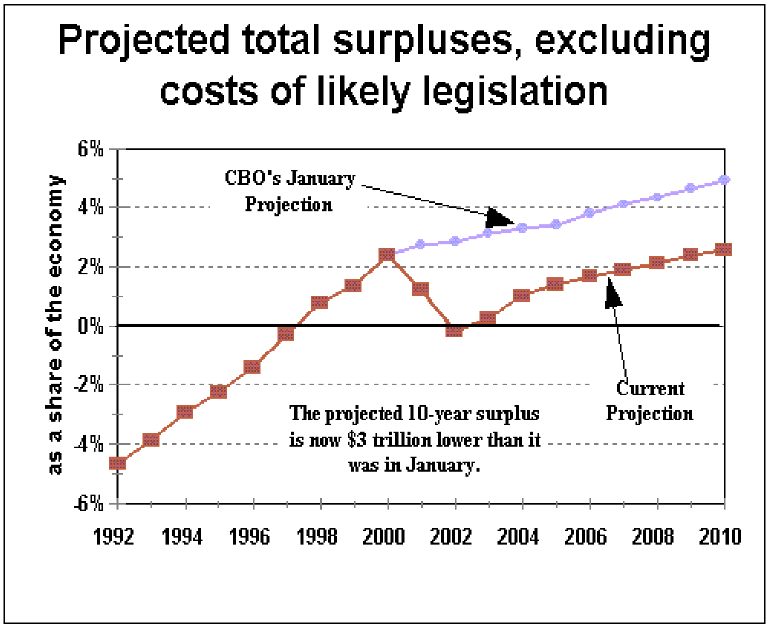
[1] Most ten-year budget analyses focus on the period 2002-2011. The ten-year period covered in this analysis instead covers 2001-2010, for two reasons. First, the 2001 surplus changed by a considerable amount — the surplus shrank by $160 billion in only nine months, a large and extraordinarily rapid change. (That change resulted from the tax legislation enacted in June and the rapid and unexpected deterioration of the economy after January.) Second, budget projections for 2011 are distorted by the fact that last June's tax cut expires in 2010; figures for 2011 therefore do not fully reflect the revenue losses caused by the tax cut.

[2] This analysis starts with budget figures issued by the House and Senate Budget Committees on October 4. See *Revised Budgetary Outlook and Principles for Economic Stimulus*, Senate and House Budget Committees, October 4, 2001, at http://www.senate.gov/~budget/democratic/press/2001/rev_bdgtoutlook100401.pdf. It then assumes enactment of a $100 billion stimulus package. (When interest costs are added, the cost of that package rises to about $150 billion over ten years.) The assumption of a $100 billion stimulus package may be conservative. The stimulus package agreed to by the House of Representatives on October 24 costs $161 billion over the decade, or $259 billion

(continued...)

While the tax cut is the largest single cause of the deterioration of the surplus, the tax cut's contribution to the shrinkage of the surplus becomes especially pronounced as the decade continues. By 2010, the tax cut accounts for more than two-thirds of the lost surplus, while the economy and other budget reestimates account for only 7 percent of it. (Although the economy is expected to recover fully from the current downturn, the budget surplus will be smaller in all years because of the downturn, since the federal debt — and interest payments on it — will remain higher in every year than if there had been no downturn.)

If we look just at the effects that legislation enacted this year (plus the stimulus package) will have on the surplus — and ignore the effect of the economic slowdown — we find that 71 percent of the costs of this legislation over ten years is attributable to tax cuts, while 17 percent comes from increases in defense funding, and 12 percent from increases in non-defense programs.[3] It should be noted that some of the non-defense increases reflected in these figures are costs related to the attacks of September 11; the non-defense increases include the costs of assistance to the airlines, payments to victims and their families, cleanup and reconstruction in New York, and additional domestic security.




Moreover, the current projection of $2 trillion in surpluses over ten years itself substantially overstates the size of the surplus. As the Budget Committees have pointed out, this projection does not take into account the costs that will result from legislation that Congress is either likely or virtually certain to pass in coming years, such as the extension of expiring tax credits that always are renewed, the farm bill, relief from the swelling individual alternative minimum tax (AMT), measures to respond to natural disasters, and a Medicare prescription drug benefit. In a report

[2] (...continued)
when the resulting increase in interest payments is counted. The tax-cut components of the stimulus package the Bush Administration is reported to favor — acceleration of tax rate reductions, elimination of the corporate AMT, 30 percent expensing of business purchases for three years, and a rebate for low-income workers — would cost approximately $175 billion over the decade, or almost $300 billion when interest costs are counted.

[3] We assume here that the $100 billion stimulus package will be 60 percent tax cuts and 40 percent program increases. We also assume that half of the $40 billion in emergency appropriations enacted on September 18 will be used for defense.

they issued on October 4, the Budget Committees identified these costs as “other possible claims on the surplus” and listed costs for these measures that total more than $1 trillion over ten years. (See footnote 2.)

### Trust Funds and the Surplus

All figures in this analysis reflect the size of the *total* federal budget surplus and therefore include the annual surpluses of the Social Security trust fund. In January, the Social Security surplus was projected to total $2.3 trillion from 2001 through 2010; the current estimate is $2.4 trillion. The entire $3 trillion deterioration in the total budget surplus has occurred outside Social Security. Since the total surplus is now projected to be $2.0 trillion over the decade, it can be seen that without the surpluses in the Social Security trust fund, the budget would be in deficit by $0.4 trillion over this period.

It also should be noted that the $2.0 trillion projected surplus includes the Social Security surplus, which is projected to be $2.4 trillion over the decade. Without the Social Security surplus, the current ten-year projection would show a *deficit* of $0.4 trillion. If the $1 trillion or more in additional costs from likely-to-pass or must-pass legislation are included, the budget surplus will be approximately $4 trillion smaller (rather than $3 trillion smaller) than was projected last January, and the budget outside Social Security will face deficits totaling about $1.5 trillion over the course of the decade.

Some may conclude that these undesirable results reflect excessive growth of federal expenditures, but the data suggest otherwise. As a share of the economy, federal expenditures are now at much lower levels than in the 1980s and the 1990s and are projected to fall still further in coming years and to reach their lowest levels as a share of the economy since the mid-1960s. The disappearance of surpluses outside Social Security is occurring, despite the fact that expenditures are declining as a share of the economy, because revenues are slated to decline at a much faster rate. Even if all of the potential costs listed as threats by the Budget Committees are incurred, federal expenditures still will drop by 0.5 percent of GDP between 2000 and 2010. The budget surpluses are disappearing because federal revenues are expected to decline by a much larger amount — 1.8 percent of GDP — during the same period.

### The Treatment of Interest Payments in This Analysis

Every direct cost — such as a tax cut, a funding increase, or a revenue loss caused by the slowing economy — means that federal debt held by the public will be larger than CBO projected last January. As a result, every direct cost also produces the indirect result of higher-than-projected federal interest payments. In this analysis, all budgetary estimates combine both the direct cost of a change in the surplus *and* the resulting interest costs.

## Changes in the Budget Projections Since January 2001

This analysis examines the causes of the dramatic reduction in the projected budget surplus. As Table 1 shows, half of the reduction of $3 trillion between January and October in the projected, ten-year surplus results from the tax cut enacted in June. Another one-quarter results from the recession and other estimating changes, while the final one-quarter results from substantial increases in expenditures for defense, responses to the terrorist attacks, other increases in domestic spending (which constitute a small percentage of these spending increases), and economic "stimulus" legislation that Congress is expected to pass shortly.

**Table 1**
**Causes of the Shrinking Surplus, January Projections vs. Current Projections**
2001-2010 totals in billions of dollars

| | Direct costs | Interest payments | Total costs |
|---|---|---|---|
| Tax cut, June 2001 | 1,219 | 297 | 1,516 |
| Economic slowdown and CBO's technical reestimates | 483 | 237 | 719 |
| Net increases in on-going programs (increases in defense and non-defense appropriations, which are assumed to continue in future years, and ad hoc farm payments enacted for 2001 only) | 247 | 67 | 314 |
| Enacted $40 billion emergency funding ($20 billion assumed to be one-time funding and $20 billion in defense and security measures assumed to continue in future years), airline assistance, and victims compensation | 221 | 65 | 286 |
| Assumed $100 billion stimulus package. | 100 | 52 | 152 |
| Total decreases in the projected surplus, Jan.–Oct. | 2,270 | 718 | 2,988 |

May not add due to rounding

The projections used in this analysis were developed in two steps. CBO published updated projections in August that reflected the tax-cut and other legislation enacted to that point, as well as economic and technical reestimates.[4] CBO's August economic reestimates assumed a pronounced slowdown in the economy but not a recession. In the CBO analysis, the tax cut, the economic slowdown, and other factors reduced the projected 2001-2010 surplus by a total of $2.1 trillion.

[4] See *The Budget and Economic Outlook: an Update*, CBO, August 2001. Also available at http://www.cbo.gov/showdoc.cfm?index=3019&sequence=0&from=7.

On October 4, the Chairmen and ranking members of the House and Senate Budget Committees issued a revision of the CBO August update, which their staffs prepared after consulting with CBO. Their estimates reduced the 2001-2010 surplus by an additional $739 billion. In their analysis, the Budget Committees essentially factored in a mild recession, assuming additional reductions in the surplus for economic and technical reasons totaling $268 billion over the decade. The Budget Committees' estimates also reflected three other costs not included in CBO's August estimates:

- the expenditures expected to result from the agreement on defense and non-defense appropriations for fiscal year 2002 that Congress and the President reached on October 2 (which includes the $18 billion in further defense increases in fiscal year 2002 that the President requested in June), with the assumption that the increased level of funding in fiscal year 2002 will be maintained in subsequent years, with adjustment for inflation;

- the expenditures likely to flow from the $40 billion in emergency funding enacted in response to the terrorist attacks, with the assumption that half of these costs will be one-time costs and the other half will be maintained in future years, adjusted for inflation; and

- the expected one-time costs of legislation providing assistance to the airlines and compensation to victims of the terrorist attacks.

The first step of this analysis is to adopt the revised budget projections the Budget Committees issued.[5]

Second, this analysis assumes enactment of one additional piece of legislation: a stimulus bill that costs $100 billion over ten years. This assumption is likely to prove conservative. The stimulus package the House of Representatives passed on October 24 is estimated to cost $161

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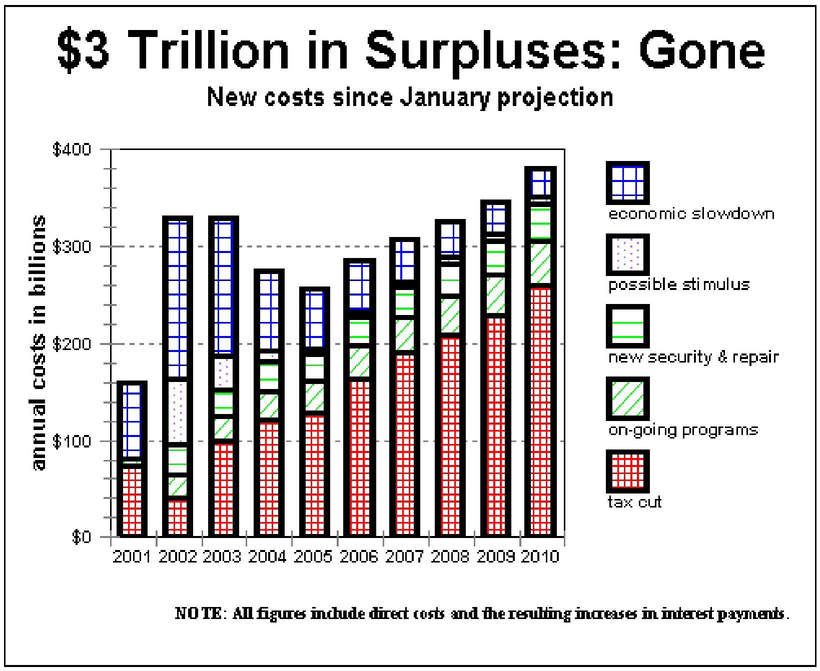
[5] Op. cit. In its analysis, the staff of the Budget Committees assumed that the airline assistance and victims' relief funding would be one-time costs, that the increase in defense and non-defense appropriations for 2002 would be permanent costs (i.e. would set a new, higher base level of appropriations that would grow with inflation in future years), and that $20 billion of the $40 billion in emergency supplemental funding would be temporary while the other $20 billion would be a permanent increase and would set a new, higher base level of appropriations that would grow with inflation in future years. Although the Budget Committees assumed the agreed-upon total of $686 billion in appropriations funding for fiscal year 2002, they did not reflect the likely increase of $2 billion in funding for highways and other programs financed from transportation trust funds, probably because such funding is not scored as "discretionary budget authority." This analysis assumes that a $2 billion increase in transportation programs will be enacted because both the House-passed and Senate-passed transportation appropriations bills include such an increase, and, like other regular appropriations, will continue into future years. This assumption costs $22 billion over the decade. Finally, this analysis incorporates the actual budget figures for 2001, which differ very slightly from the estimates used by the Budget Committees.

billion through 2010, not counting the cost of increased interest payments.[6] The tax-cut components of the stimulus package the Administration is reported to favor cost $175 billion over ten years. On the other hand, the stimulus proposal recently offered by Senator Max Baucus, chairman of the Senator Finance Committee, would cost $40 billion over ten years. (The Baucus plan would cost $70 billion in fiscal year 2002 but significantly less than that over the ten-year period. The Democratic leadership reportedly plans to add funding for increases in certain appropriated programs to the Baucus proposal, but the total cost of the Senate Democratic stimulus package is expected to be well under $100 billion over ten years.) For purposes of this analysis, we assumed a stimulus package that costs $100 billion over ten years, with 60 percent of that cost being attributable to tax cuts and 40 percent to expenditures. Counting interest, such a stimulus bill would reduce the ten-year surplus by approximately $150 billion.[7]

### The Short Term and the Long Term

In the short term, the recession is the biggest reason the surplus has shrunk. But by 2010, the tax cut is the biggest reason.

The changing significance over time of different causes of the reduction in the surplus is shown in Table 2, as well as in the bar graph on this page. By 2010, last June's tax cut accounts for nearly 70 percent of the reduction in the projected surplus.




6 Counting increased interest payments, the House-passed legislation would cost $259 billion through 2010. For a discussion of that legislation, see *Ways And Means Package Departs From Bipartisan Principles For Effective Stimulus and Offers Little Help to the Unemployed*, Joel Friedman and Robert Greenstein, Center on Budget, at http://www.cbpp.org/10-17-01tax.htm.

7 The direct costs of the bill, without interest payments, are assumed to be $65 billion in 2002, $30 billion in 2003, and $5 billion in 2004. This pattern results in a total cost, including interest payments, of slightly more than $150 billion over ten years.

**Table 2**
**Short-term and Long-term Budget Costs**
including both direct costs and interest payments

| | 2001/2002 average | | 2010 | |
|---|---|---|---|---|
| | billions | percent | billions | percent |
| Tax cut, June 2001 | $58 | 24% | $260 | 69% |
| Economic slowdown and CBO's technical reestimates | $120 | 50% | $28 | 7% |
| Net increases in on-going programs (defense and non-defense appropriations, assumed to continue in all future years, and 2001 farm payments), | $15 | 6% | $45 | 12% |
| Enacted $40 billion emergency funding ($20 billion assumed to be one-time funding and $20 billion assumed to continue in each future year), airline assistance, and victims compensation | $16 | 7% | $38 | 10% |
| Assumed $100 billion stimulus package | $33 | 14% | $8 | 2% |
| Total decreases in the projected surplus, Jan.–Oct. | $242 | 100% | $380 | 100% |

May not add due to rounding

## Recent Legislation

Another way to analyze the same data is to focus on legislation that has been enacted or, in the case of the stimulus package, is expected to be enacted soon. This approach examines the contribution that Congress and the Administration have made to the dissipation of the surplus. As Table 3 shows, 71 percent of the $2.3 trillion reduction in the surplus over ten years that has resulted from legislation enacted since January is due to tax cuts (primarily the tax cut enacted in June but also the assumption that three-fifths of the stimulus package will consist of tax cuts). Another 17 percent of the reduction in the surplus caused by legislation is due to increases in military spending, while the final 12 percent has been caused by increases in non-defense expenditures. These non-defense increases include the costs of rebuilding New York, aiding the victims of the terrorist attacks, assisting the airlines, and enhancing domestic security, such as through more FBI agents or through strengthening the ability of the Centers for Disease Control to respond to biological or chemical attacks. Thus, about three-fifths of the projected expenditure increases represent increases in defense spending, and a substantial portion of the remaining expenditure increases represent actions taken in response to the terrorist attacks.

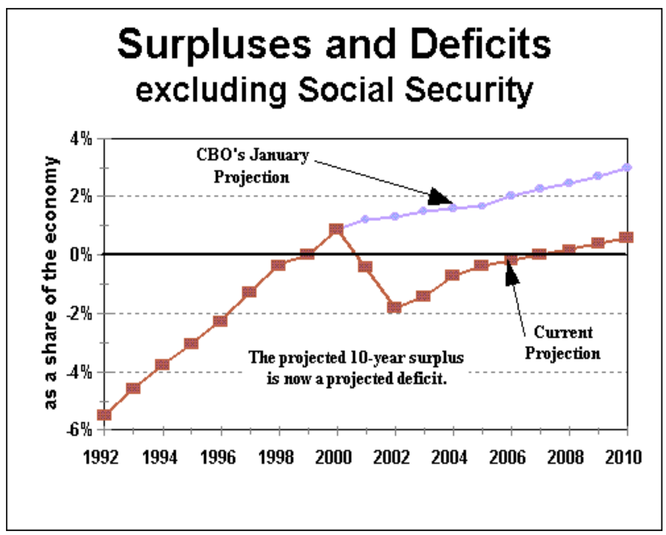
**Table 3**
**The Contribution of This Year's Legislation to the Deterioration of the Surplus**
ten-year total, 2001-2010, in billions, including interest costs

| | trillions | percent |
|---|---|---|
| Tax cut, June 2001, and revenue losses in a potential "stimulus" package | $1.6 | 71% |
| Increases in military expenditures | $0.4 | 17% |
| Net increases in non-defense expenditures, including responses to terrorist attacks and potential stimulus | $0.3 | 12% |
| Total decreases in the projected ten-year surplus from January 2001 to October 2001 due solely to legislation | $2.3 | 100% |

NOTE: This table does not show the effects of the recession.

## How Much Surplus Really Remains?

With $3 trillion of the starting surplus now gone, it would appear that $2 trillion in surpluses remain over the next decade (although no surplus remains in 2002). In reality, however, the ten-year surplus is likely to be far smaller than $2 trillion.




First, Congress has repeatedly affirmed in recent years that it planned to use the surpluses in the Social Security and Medicare Hospital Insurance trust funds solely for debt reduction; doing so implies balancing the budget outside Social Security and Medicare, at least on average over time. The President also agreed to set aside the Social Security surplus, although not the Medicare HI surplus.[8] There are several arguments for taking these trust fund surpluses "off the table" while aiming to balance the remainder of the budget, on average, over the decade. If this is done, the surpluses accruing in these trust funds will contribute to national saving and thereby increase future wealth and income, and the nation will be better prepared to face the costs of the retirement of the baby-boom generation. In addition,

[8] Congress stated it intended to balance the budget outside Social Security and Medicare *every* year, not just on average over time. The President stated he intended to balance the budget outside Social Security every year except during wars and recessions. These were the main, competing "lockbox" promises.

almost all of the publicly held debt will be paid off by the end of the decade, a matter of some significance since the budgetary savings secured by largely eliminating interest payments on the debt can offset most of the increase in Social Security costs that will occur as the baby boomers retire.

Over the ten-year period from 2001 through 2010, the Social Security surplus is projected to be $2.4 trillion. Because the remaining *total* budget surplus is projected to be only $2.0 trillion even before the costs of likely-to-pass or must-pass legislation are taken into account, the budget outside of Social Security is projected to be in deficit on average over the decade.

In addition, even when the Social Security surplus is counted, it is not clear how much of the projected $2 trillion total budget surplus actually remains. As the Budget Committee chairs and ranking members cautioned when releasing their new budget projections on October 4, their estimates of the surplus are unrealistically optimistic, because they do not include the costs of a number of items that are likely to be enacted, such as the extension of an array of expiring tax credits that always are extended when they are scheduled to expire, the farm bill, prescription drug legislation, the costs of responding to future natural disasters, and legislation to remedy serious problems in the individual Alternative Minimum Tax that, if not addressed, will cause the number of filers subject to the AMT to skyrocket from 1.4 million this year to 35 million by 2010. Their surplus estimates also do not include the cost of extending the provisions of the tax cut enacted this spring; all of the provisions of the tax cut expire between 2004 and 2010. Nor do the Budget Committees' estimates include the cost of any of the additional tax-cut bills that the House of Representatives has passed since June (such as those related to energy and charitable contributions) and that await action in the Senate.

**Table 4**
**The Disappearing Surplus**
2001-2010 totals in trillions of dollars

| | |
|---|---|
| CBO's projection of the total budget surplus, January 2001 | $5.0 |
| Sources of Reduction in the Surplus: | |
| Tax cut enacted June, 2001 | -1.5 |
| All other enacted and assumed legislation (three-fifths for the military) | -0.8 |
| Recession and other reestimates to date | -0.7 |
| Resulting total surplus | 2.0 |
| Other likely claims on the surplus identified by the Budget Committees | -1.1 |
| Setting aside the Social Security surplus | -2.4 |
| **Possible deficit outside of Social Security** | **-1.5** |

The total costs of all items the Budget Committees listed as "possible claims" equal $1.1 trillion (including interest) through 2010.[9] If these potential costs materialize, the *total* budget will be in surplus by only $0.9 trillion over the decade — and in deficit by $1.5 trillion if Social Security is set aside. (See Table 4 on page 9.) Under a realistic accounting, most of the total — or unified — budget surplus is gone.

Furthermore, in issuing their new budget estimates, the Budget Committees pointed out that because the economic and other estimating assumptions that underlie these projections are highly uncertain, there is a 50 percent likelihood that the projected, ten-year surplus will be at least $1.9 trillion lower or higher than the projections.[10] Since the projections imply a ten-year deficit of $1.5 trillion outside of Social Security if the additional likely costs identified by the Budget Committees are incurred, the budget outside of Social Security is likely to fall within a range that extends from a $0.4 trillion surplus at the optimistic end to a $3.4 trillion deficit at the pessimistic end.

## A Spending Explosion?

The budget appears to be in worse shape than anyone imagined earlier this year. Some already have begun to try portraying the stunning deterioration of the surplus as being the result of a "spending explosion." An analysis of the data clearly demonstrates, however, that the main culprit is falling revenues, not swelling expenditures.

- Federal expenditures averaged 22.1 percent of GDP during the 1980s and 20.1 percent of GDP during the 1990s. If all of the potential expenditures that the Budget Committees listed are incurred, federal expenditures will rise as a share of GDP in 2002 but then resume their long-term decline. From 2002 through 2010, expenditures will average 18.4 percent of GDP, well below their average levels in recent decades. By 2010, expenditures will equal 17.7 percent of GDP, their lowest level since 1965. Moreover, if the likely expenditure items the Budget Committees listed are not *all* enacted, expenditures will be even lower than this. (Note: Part of the temporary increase in expenditures as a share of GDP in 2002 is due to GDP's being unusually low this year as a result of the recession; much of the rest of the increase in expenditures as a share of GDP in 2002 is caused by such factors as the costs of rebuilding New York, assisting the airlines,

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[9] The Budget Committee's estimate of potential, additional costs that are omitted from baseline projections is consistent with estimates of potential, additional costs made by the Center on Budget. See, for example, *CBO Projects Near-Term Deficits Outside Social Security: CBO "Baseline" Estimate Exclude Substantial Pressures on the Federal Budget*, revised September 10, 2001, available at http://www.cbpp.org/8-28-01bud.htm.

[10] The Budget Committees derived these estimates from CBO's detailed explanation of the uncertainty of budget projections contained in Chapter 5 of *The Budget and Economic Outlook, Fiscal Years 2002-2011*, CBO, January 2001.

compensating victims of the terrorist attacks, and conducting the military campaign in Afghanistan.)

- In addition, under the scenario that assumes that all of the likely expenditures the Budget Committees have identified will occur, *average* expenditures over the coming decade would constitute about the same percentage of GDP as they did in 2000, when the budget surplus reached its high point.[11] By contrast, revenues would average 1.6 percent of GDP *less* than they did in 2000. By 2010, revenues would be 1.8 percent of GDP below their 2000 level.[12]

- As noted above, nearly three-fourths of the $2.3 trillion deterioration in the surplus that has been caused by legislation that was enacted this year (along with the anticipated stimulus package) is the result of tax cuts, not spending increases.

In short, the deterioration in the surplus is due much more to revenue losses than to increases in program spending. Moreover, even under the most costly budget scenario — the scenario that assumes all of the expenditure items the Budget committees identified are enacted — federal expenditures will decline as a share of the economy. Compared with their levels over the past two decades, federal expenditures now constitute a relatively small share of the economy and are projected to account for a still smaller share in the years ahead, when federal expenditures will fall to their lowest level as a share of the economy since the mid-1960s. Except in 2002, a year marked by a combination of recession and war, federal expenditures are on a decade-long downward path as a share of the economy and will continue to shrink even if a farm bill, a prescription drug benefit, expanded health insurance, and other such items become law. Measured as a share of the economy, the federal budget already is considerably smaller than it was in the decade of the 1980s when Ronald Reagan was President, and federal expenditures are projected to grow more slowly than they did in the 1980s. Mostly because of the very expensive tax cut, however, the hoped-for surpluses are largely or entirely gone.

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[11] Average expenditures over the decade would be 0.2 percent of GDP above their level in 2000.

[12] Another way to look at this issue is consider the rate of growth of federal expenditures. Assuming, once again, that all of the potential expenditures the Budget Committees identified are enacted, federal expenditures will grow an average of 2.1 percent per year over the coming decade, after adjusting for inflation. This is slower than the average real growth rate of the 1980s — which was 3.1 percent per year — although faster than the average real growth rate of the 1990s, which was 1.2 percent per year.