CENTER ON BUDGET AND POLICY PRIORITIES
820 First Street, NE, Suite 510, Washington, DC 20002
Tel: 202-408-1080 Fax: 202-408-1056 center@cbpp.org http://www.cbpp.org

*Revised January 29, 2002*

# THE NEW CBO PROJECTIONS: WHAT DO THEY TELL US?

by Richard Kogan, Robert Greenstein, and Joel Friedman

The new projections the Congressional Budget Office released today are far less optimistic than the projections CBO issued only 12 months ago. CBO now projects that over the ten-year period from 2002 to 2011, the surpluses in the total budget will be $4.0 trillion smaller — and the debt $4.2 trillion higher — than it projected last January. The new CBO figures also show that the tax cut of last June is the largest single factor in the ten-year, $4.0 trillion deterioration of the surplus, accounting for 41 percent of it.

- Excluding the surpluses in Social Security, the budget is in *deficit* by $181 billion in the current fiscal year, 2002; such deficits are projected to continue for the following seven years, with surpluses not reappearing outside Social Security until 2010. The cumulative non-Social Security deficit over the period 2002-2011 is projected to total $700 billion. This outlook is a remarkable change from the projection CBO made only one year ago, when it projected surpluses outside of Social Security totaling $3.1 trillion over the ten-year period 2002-2011.

- In 2002 and 2003, the *total* budget, including Social Security, is projected to be in deficit, for the first time since 1997. The four-year run of budget surpluses is over. CBO projects total budget surpluses after that. Over the ten-year period 2002-2011, CBO projects a net cumulative surplus of $1.6 trillion.

- As noted, over the ten-year period 2002-2011, the total budget, including both Social Security and Medicare, has lost $4.0 trillion in projected surpluses compared to CBO's projections of a year ago. This is the biggest one-year deterioration in projected budgets since 1982, following enactment of the Reagan tax cut in 1981.

- The tax cut enacted last June is the largest single component of that $4.0 trillion reduction in projected total surpluses. The tax cut by itself cost $1.3 trillion over ten years. Including the higher interest payments that the tax cut generates — the tax cut loses revenues, thereby increasing the projected debt and requiring the Treasury to pay more interest than previously projected — the CBO figures show that the total ten-year cost of the tax cut is $1.7 trillion. This equals 41 percent of the $4 trillion reduction in the surplus. (See Table 1 on page 2.)

- The cost of the tax cut (and the resulting interest costs) grows over time, while the effects of the recession and other factors shrink over time. By 2010, the tax cut is

**Table 1**

**Why the Ten-Year Surplus Has Shrunk by $4.0 Trillion**

Cumulative deficits and surpluses in the total budget surplus, 2002-2011, in trillions of dollars

| | **trillions** | **% of total changes** |
|---|---|---|
| CBO's projected ten-year, cumulative surplus, January 2001 | 5.6 | |
| Legislation enacted last year, including resulting increases in interest | -2.4 | -60% |
| *tax cut* | *-1.7* | *-41%* |
| *programs funded through annual appropriations* | *-0.7* | *-18%* |
| *(defense)* | *(-0.4)* | *(-10%)* |
| *(non-defense, including homeland security)* | *(-0.3)* | *(-8%)* |
| *all other legislation* | *-0.1* | *-1%* |
| Results of a new economic forecast, including resulting increases in interest | -0.9 | -23% |
| Results of new "technical" estimates, including resulting increases in interest | -0.7 | -16% |
| Total changes in the ten-year projection | -4.0 | -100% |
| CBO's projected ten-year, cumulative deficits/surpluses (net), January 2002 | 1.6 | |

Source: CBO, January 2002. Distribution of interest increases among legislation by CBPP, using CBO's methodology for calculating interest. May not add due to rounding.

not only the largest single factor in the deterioration of the surplus but accounts for 52 percent of the deterioration — or more than all other factors combined.

- Last January, CBO projected surpluses so large that the federal debt held by the public would be fully paid off by early 2009 (except for Treasury securities that are impractical to redeem). CBO projected that after 2008, the Treasury would accumulate reserves that would earn interest. This January, in contrast, with $4.0 trillion less in net surpluses over the period 2002-2011, the Treasury's position at the end of 2011 is projected to be $4.2 trillion worse. Instead of being a net lender, the Treasury will be a net borrower.

- As a result of the higher debt caused by last year's legislation, the economy, and technical factors, CBO now projects that the Treasury will pay *$1.0 trillion more* in net interest payments on the debt over the period 2002-2011 than it projected a year ago.

**New CBO Data Show What Would Happen If the Tax Cut is Made Permanent**

To make the cost of last year's tax-cut legislation appear to fit within budget constraints, Congress wrote a series of "sunsets" into that legislation. Some tax-cut provisions expire as early as the end of 2004. All remaining provisions of the legislation expire at the end of 2010.

No one really expects that these tax cuts will all die. In developing its budget projections, however, the Congressional Budget Office follows longstanding rules requiring it to assume that all of the tax cuts would expire. Fortunately, CBO also provided information on how the budget projections would be affected if the tax cut were extended.

- The CBO data show that if all of the provisions of the tax law were extended, the total budget surplus would be smaller, while the deficits outside Social Security would be larger. In particular, the budget outside Social Security would be in deficit in each year through 2011 and would show an overall deficit of $1.1 trillion over the 10-year period from 2002 to 2011.

- With all provisions of the tax cut extended, the tax cut's cost would total $2.0 trillion over this period (including the additional interest costs). The tax cut would account for nearly half — 46 percent — of the deterioration in the total budget surplus for the 2002-2011 period.

- The proportion of the deterioration of the surplus that was caused by the tax cut would rise with each passing year, reaching 63 percent in 2011. In other words, by 2011, the tax cut would account for nearly two-thirds of the deterioration of the surplus that year, or almost twice as much as all other factors combined. The figures for 2011 are significant, since they give the best picture of the permanent impact the tax cut would have on the nation's finances if the tax-cut provisions were all made permanent.

- CBO's new projections also show that federal expenditures will decline each year as a percentage of the economy (i.e., of the Gross Domestic Product), falling from 19.4 percent of GDP in 2002 to 17.2 percent by 2011. The 17.2 percent figure CBO projects for 2011 would represent the smallest share of the economy since 1965. By contrast, federal expenditures averaged 22 percent of GDP in the 1980s and 20 percent of GDP in the 1990s.

- CBO's new projection should put to rest claims that a "spending explosion" is responsible for the deteriorating surplus. As CBO's report shows, the tax cut is far larger than the budget increases that were enacted last year and that CBO projects to continue. In addition, CBO states that revenue shortfalls constitute the bulk of both the economic and technical reestimates to the budget. Over the ten-year period 2002-2011, CBO's new figures show: 1) a decline in projected revenues of more than $2.4 trillion, or 8.7 percent, compared with CBO's projection of a year ago; 2) an increase in expenditures for federal programs of less than $0.6 trillion, or 2.6 percent, a substantial majority of which is for defense and homeland security; and 3) an increase in outlays for interest payments on the debt of more than $1.0 trillion, or 166 percent. As noted, the increase in interest costs is primarily a result of the decline in revenues. Overall, for every dollar that projected program expenditures have increased over the ten-year period, relative to CBO's projection of a year ago, projected revenues have fallen by $4.38.

- The new CBO projections, though noticeably less optimistic than last year's, are themselves likely to prove unrealistically optimistic. Because CBO projections are based on current law, they omit the costs of an array of legislation that is likely to become law: the pending farm bill; Presidential requests to increase funding for defense and homeland security; the extension of expiring tax credits; the extension of at least some of the tax bill when it expires at the end of 2010; relief from the mushrooming individual alternative minimum tax; and other costs that are likely or inevitable. According to calculations made by the bipartisan staffs of the House and Senate Budget Committees last October, CBO projections for 2002-2011 exclude more than $1 trillion in budget costs that can reasonably be anticipated. (See box on page 5.)

Table 1 above shows the reasons that CBO's projected ten-year surplus for 2002-2011 is now $4.0 trillion smaller than it was last year. (For each item, the higher interest payments associated with legislation or with economic and technical revisions to CBO's projection are included in calculating the item's cost. This is done for two reasons. First, higher interest payments are a necessary and automatic consequence of legislation (such as tax cuts or spending increases) and of estimating changes (such as the revenue reductions caused by the recession). Second, an apples-to-apples comparison requires either including interest in every case or excluding it in every case; it is invalid to compare the cost of two items, *excluding* interest in one case and *including* it in the other. For a more thorough discussion of the traps to avoid when discussing the new CBO figures, see the appendix at the end of analysis.)

**CBO Projections Likely To Overstate Surpluses**
**Because They Leave Out Large Costs That Are Very Likely To Occur**

The new CBO baseline estimates are a projection of future expenditures and revenues, calculated according to a set of rules. These projections are the basic benchmark for assessing the fiscal impact of proposed and actual changes in policy. But they do not necessarily provide the most realistic assessment of the future fiscal outlook. By following the baseline rules, the new CBO projections present a rosier picture of the future than is likely to occur.

The rules require CBO to estimate the future cost of annually appropriated programs — discretionary, or non-entitlement, programs — by assuming that their funding levels in the future will equal their funding levels in the most recent year, growing only enough to cover inflation. As a result the baseline projections do not take into account the significant increases in defense and homeland security expenditures that are certain to be proposed and enacted.

Moreover, the baseline rules require CBO to estimate revenue collections and entitlement expenditures based on enacted laws, even if those laws are scheduled to expire or are virtually certain to be changed. So even if an expiring tax provision has strong bipartisan support, has repeatedly been extended in previous years, and is virtually certain to be extended again, CBO is required to project that the provision will expire.

In October 2001, the chairmen and ranking members of the House and Senate Budget Committees released an analysis that highlighted program expansions and tax reductions, most of which have strong bipartisan support, that are *not* included in the CBO baseline projections. The major items on the list included:

- Enactment of a farm bill;
- Extension of an array of expiring tax provisions that are routinely extended, such as the research and experimentation tax credit;
- Extension of the provisions in last year's tax-cut measure, all of which artificially expire in 2010;
- Provision of relief for the individual Alternative Minimum Tax, without which the number of taxpayers subject to the AMT will explode from just over 1 million today to 35 million by the end of the decade; and
- a Medicare prescription drug benefit.

The cost of these various legislative changes — from increases for defense and homeland security to enactment of a farm bill and extension of expiring tax provisions and of much or all of last year's tax-cut bill — is likely to be in excess of $1 trillion over ten years. In fact, the impact on the budget is likely to exceed substantially $1 trillion when the associated interest costs are added. Because the new CBO projections do not reflect any of these costs, they are likely to overstate projected surpluses by a substantial margin.

## Appendix

## Three Mistakes To Avoid In Analyzing the New CBO Projections

Although CBO's new report provides a table showing how and why the projected surplus changed from last January to this January, some readers may misunderstand CBO's figures. This analysis describes the possible distortions that policymakers, journalists, and the public should avoid as they seek to understand what happened to the projected $5.6 trillion surplus. There are three main traps for the unwary.

- *Confusing the short-run deterioration of the surplus with the long-run deterioration*. In the next few years, the recession is the biggest reason the surplus disappeared. Later in the decade, after the economy has recovered — and over the ten-year period from 2002 to 2011 as a whole — the tax cut is the biggest reason for deteriorating surpluses, as shown in Table 1 of this analysis.

- *Confusing a ten-year total for 2002-2011 with a ten-year total for 2003-2012.* Last year, CBO's projection covered the ten-year period from 2002 to 2011 and showed a cumulative surplus in the total budget of $5.6 trillion. The new CBO projections cover the ten-year period from 2003 to 2012, and show a cumulative surplus in the total budget of $2.3 trillion. But comparing figures that encompass 2002-2011 with figures that encompass 2003-2012 is an apples-to-oranges comparison. To find out why the surplus shrank, one must be sure to analyze changes in the surplus for the same period of time, 2002-2011.

- *Failing to attribute increases in interest payments on the debt to the actions or changes in conditions that caused those payments to increase*. A tax cut reduces federal revenues and thus reduces projected budget surpluses. Similarly, increases in funding for federal programs boost federal expenditures and thereby reduce the surpluses. Decreases in revenues and increases in expenditures that are occurring as a result of the recession also shrink the surplus. In each of these cases, the reduction in the surplus results in an increase in the federal debt, compared with the level of debt that CBO had assumed in its previous budget projections. This increase in the debt automatically causes federal interest payments to rise, since interest must be paid on a higher level of debt. Moreover, the increase in the amount the federal government must pay in interest itself causes the surplus to shrink further. The new CBO estimates show that interest payments on the debt will cost the government $1 trillion more between 2002 and 2011 than CBO projected just one year ago.

  These increases in interest payments are a major factor in the deterioration of the surplus. To measure accurately the budgetary consequences of a tax cut, a spending increase, or any other change in the budget, one must include the resulting increase in interest payments caused by the tax cut, spending increase, or change in economic or other conditions.

**Table 2**

**Adjusting the Budget Window**

| | |
|---|---|
| Jan. 2001 CBO projection, 2002-2011 | $5.6 trillion |
| Reduction in the projected 2002-2011 surplus from all causes | -4.0 |
| Resulting 2002-2011 surplus | 1.6 |
| Change budget window: remove estimate for 2002 but add estimate for 2012 | +0.7 |
| Jan. 2002 projection, 2003-2012 | 2.3 |

May not add due to rounding

Table 2, above shows that CBO's new projection of $2.3 trillion in cumulative surpluses over ten years is not directly comparable to last year's projection of $5.6 trillion in ten-year surpluses, because the two projections do not cover the same time period.

Changing the budget window by dropping estimates for 2002 and adding projections for 2012 make the ten-year picture look $0.7 trillion better, as shown above. But adding a projected, large surplus for 2012 is unrealistic, both because the figure for 2012 is so far in the future and because that figure is based on the assumption that the entire tax cut will expire. As CBO's testimony points out, "over half [the $2.3 trillion, ten-year] total comes from the surpluses projected for 2011 and 2012 — the last two years of the projection period and therefore the most uncertain. The surpluses for those years also reflect the scheduled expiration in December 2010 of the tax cuts enacted last June."

The third trap that can lead to misapplication of the CBO numbers occurs when someone includes the resulting increase in interest payments when measuring the effect on the surplus of some budget changes — such as the reduction in revenues and increase in expenditures that has occurred because of the recession — but then *excludes* the resulting interest increases when measuring the effects of other budgetary changes such as the tax cut. Such inconsistent treatment of interest payments leads to invalid, apples-to-oranges comparisons when assessing the relative impact of various factors on the change in the surplus.

The last point is especially significant given the figures in CBO's report. Through confusion or an attempt to "spin" the data, someone is bound to assert that the combined economic and technical reestimates that CBO shows in its January 23 testimony — and later in its formal report, due January 31 — are larger than the tax cut and therefore constitute the largest "single" cause of the $4.0 trillion deterioration in the 2002-2011 surplus. Such a person would assert that the tax cut cost $1.3 trillion over ten years while the economic and technical reestimates together cost $1.6 trillion.  But the comparison not valid.  As CBO makes abundantly clear, the $1.3 trillion figure for the tax cut *excludes* the increase in interest payments that the tax cut necessarily generates, while the $1.6 trillion figure for the economic and technical reestimates *includes* the increase in interest payments generated by those reestimates.  On an apples-to-apples basis, the tax cut is larger: the tax cut costs $1.7 trillion including increased interest, while the combined reestimates cost $1.6 trillion including interest.[1]  (Furthermore, the economic and technical reestimates are not really a “single” cause.  The economic reestimates are driven by changes in CBO’s economic forecast, whether caused by the recession or by other changes in CBO’s view of future economic growth, interest rates, and the like.  Technical reestimates, in contrast, do not derive from changes in the economic forecast.)

Alternatively, excluding interest in both cases, the tax cut costs $1.3 trillion while the combined economic and technical reestimates cost $1.1 trillion.

Either way, the tax cut is the largest single reason that CBO’s ten-year budget projections have deteriorated so dramatically.

---

[1] That the economic and technical reestimates in CBO’s report include the higher interest payments that those reestimates engender is evident from the testimony.  CBO notes: “Changes in the economic outlook since January 2001 account for another $929 billion decline in the 10-year surplus. About three-quarters of that total reflects lower revenue projections, mostly resulting from the substantially weaker economic growth expected in the near term and the slightly lower average growth rates projected for the following several years. *Much of the rest of the decline attributable to the economic outlook represents additional debt-service costs resulting from the reduction in anticipated revenues.*  Technical changes--those not driven by new legislation or by changes in CBO's economic forecast--have reduced the projected 10-year surplus by a total of $660 billion since last January. As with the economic changes, revenues account for over 75 percent of the technical changes, *and debt service accounts for much of the rest*. The technical changes to revenues stem primarily from revised projections of capital gains realizations and adjustments for lower-than-expected tax collections in recent months” (emphasis added).  CBO uses the term “debt service” to refer to the increased interest payments on the debt .  See CBO, *The Budget and Economic Outlook: Fiscal Years 2003-2012*, Testimony before the Senate Budget Committee, January 23, 2002, available at http://www.cbo.gov/showdoc.cfm?index=3275&sequence=0.