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CBO Assumes *Faster* Economic Growth than Previously, and Therefore a Larger Ten-Year Surplus

by Richard Kogan

Some of the debate over tax cuts and the economy has become confused. The argument has been made that the weakening of the economy necessitates a large tax cut, like the one President Bush proposed in his campaign. Some also argue that the fact that the Bush tax cut will cost more than previously envisioned is not a problem because the projected surplus will be larger than earlier had been estimated. (Of course, other analysts have warned that despite the expanded surplus, the cost of the Bush tax cut still is likely to exceed the available non-Social Security surplus when realistic assumptions are used.[1]) The purpose of this short analysis is to explain a significant point related to the proposed tax cut and the projected surplus that has received little attention — that the principal reason CBO's new budget projections show larger surpluses over the coming decade than CBO previously assumed is that CBO now believes the economy generally will be *stronger* over the next 10 years than it previously thought. As a result, an argument that a large, permanent, and growing tax cut is needed because of a weaker economy does not stand up well under scrutiny.

As the table on the next page shows, CBO increased its 10-year surplus estimate of the non-Social Security surplus by about $900 billion, compared with the estimate it issued last July. *Essentially all of this improvement comes from greater optimism about the course of the economy over the next decade*.

Although the nation may currently be experiencing a slowdown in the rate of economic growth, all economists believe this slowdown will be temporary — part of the normal business cycle. Last July, CBO projected the economy would grow at an average annual rate of 2.7 percent over the coming 10 years, after adjusting for inflation. CBO's new forecast assumes an average rate of economic growth of about 3.1 percent per year. *Under CBO's forecast, the temporary slowing of economic growth that the nation is currently experiencing is expected to be short-lived — and to disappear without tax cuts.* Over the next decade as a whole, the economy is expected to be significantly stronger than CBO earlier assumed.

[1] The Center on Budget and Policy Priorities, the Concord Coalition, and Brookings Institution senior fellow William Gale have made this point. "Available Budget Surplus Is Smaller than Many Realize: Concord Coalition and Brookings Experts Join in Releasing New Center Analysis," Center on Budget and Policy Priorities, January 8, 2001. See also Robert Greenstein and Richard Kogan, "What the New CBO Projections Mean: Can the New Surplus Projections Accommodate a Large Tax Cut?," Center on Budget and Policy Priorities, January 31, 2001.

CBO Increases to the Ten-Year Surplus
Figures exclude Social Security; dollars in trillions

CBO's July 2000 ten-year baseline surplus, 2001- 2010	$2.2
Increase in surplus from assuming faster economic growth	1.1
Decrease in surplus due to legislation enacted since July 2000 and other factors	-0.6
Increase in surplus from shifting the budget window from 2001-2010 to 2002-2011	0.4
January 2001 ten-year baseline surplus, 2002-2011	3.1 [a]

[a] At least $1.1 trillion of CBO's projected non-Social Security surplus is unlikely to be available for tax cuts or program initiatives. Under the rules that CBO must follow in estimating the surplus, CBO does not reflect in its surplus estimate the costs of maintaining various popular policies that are virtually certain to be continued. For example, CBO surplus projections do not include the costs of extending about 20 popular tax credits (such as the business research and experimentation tax credit) that always are extended for about two years at a time and routinely renewed when their current term ends. The CBO projections also do not include the cost of maintaining payments to farmers. In addition, about $400 billion of the projected surplus will occur in the Medicare Hospital Insurance trust fund. Both the House and Senate voted by large margins last year to place this part of the surplus off limits for tax cuts or program increases. These issues are discussed in more detail in the analyses cited in footnote 1.

Tax Cut Will Have Little Immediate Effect on the Economy

If the projected rate of economic growth over the next 10 years is higher than CBO previously thought, what should one make of the argument that we need a very large tax cut that approaches or exceeds $2 trillion over 10 years to shore up a weak economy? The answer is that how large the tax cut is over the next 10 years — e.g., whether it costs $2 trillion, $1 trillion, or $500 billion over this period — will have little effect on the strength of the economy in the months immediately ahead. This is because the vast bulk of the cost and the impact of a large, permanent tax cut will come long after the current slowdown is over.

To be sure, it is possible that the economy has some unrecognized, serious, underlying problems that will cause it to be weak not just for a number of months or a year but throughout much of the coming 10-year period, although few economists believe this to be the case. But if this proves to be true, it will mean the CBO surplus projection is overstated and much of the projected non-Social Security surplus will never materialize. Under those circumstances, a tax cut the size of the one proposed by President Bush would no longer be "affordable" in the way that it is currently portrayed by its supporters.

Reacting to a Recession: What Economists Say

There is broad agreement in the economics profession that, at least in theory, the government can stimulate a weak economy in the short run by deliberately reducing surpluses or increasing deficits (because that puts cash in the hands of consumers who will spend it). Yet the economic profession opposes this approach in practice. Economists generally maintain that:

- In most cases, the Federal Reserve can provide as much or more stimulus than Congress by lowering interest rates and increasing the money supply.

- The federal budget's "automatic stabilizers" reinforce action by the Fed during an economic downturn by automatically putting cash into the hands of workers who are laid off (through the unemployment compensation system, which dispenses more benefits during a downturn as more workers lose their jobs), by automatically increasing food stamp benefits (for which more people qualify when employment contracts and income falls), and by automatically reducing the amount of money paid in taxes as the incomes on which taxes are paid decline.

- Working together, the Fed and the "automatic stabilizers" can provide sufficient stimulus to make most economic downturns short and mild.

- If economic stimulus through deliberate policy actions can work, it will be effective only when the economy is operating below capacity. Once the economy returns to normal, stimulus can be self-defeating as it can lead to inflation and Fed tightening, countering the stimulus provided by fiscal policy actions. To the extent that fiscal policy actions to fight a recession are appropriate, the actions should be temporary.

- Both the Fed and the automatic stabilizers act far more rapidly than Congress can, and Congressional action may come too late to do much good. Lawrence Lindsey, President Bush's chief economic advisor, himself wrote in 1999: "Government, particularly American government, is not designed to act quickly. First, it takes time for decisionmakers to realize what is going on. Economists refer to this as the "recognition lag...." Next comes a decision lag. In the United States, the budget procedure is a textbook in tedium.... Finally, once a tax or spending change is announced, it generally takes effect over an entire year. This is known as the "implementation lag." Tax changes usually take place through paycheck adjustments (withholding). The impact on the economy is generally slow to materialize....Thus, the median dollar of funds in an intentional countercyclical policy move is usually distributed six months into the fiscal year. By then, the recession may well be over" (*Economic Puppetmasters: Lessons From the Halls of Power,* AEI Press, 1999, p.29).

- While these points suggest that Congressional action to reduce surpluses or increase deficits is generally not the best, or an especially effective, way to stimulate a weak economy, such actions may be constructive if a major recession overwhelms the Fed and the automatic stabilizers.

Most economists believe the best way to stimulate a weakening economy is through reductions in interest rates, not through tax cuts or program increases. Furthermore, if tax cuts or program expansions are implemented as stimulative measures during an economic downturn, they can become self-defeating after the economy returns to normal, since they can induce the Federal Reserve to raise interest rates to stop the economy from overheating. Most analysts believe that to the extent that fiscal policy actions may be appropriate to combat a recession, such actions should be temporary and fade down or out as the economy rebounds. The argument that a tax cut is needed now to resuscitate a weakening economy thus is an argument for a temporary tax reduction, not for a large tax cut that expands instead of diminishes as the economy grows. (See box on page 3.)

When considered on their merits, the arguments for and against a large permanent cut remain essentially the same as they were last summer. Whether to enact a large permanent tax cut is fundamentally an issue of national priorities, not a question of how to shore up a weak economy. Policymakers must weigh the benefits of a large tax cut that consumes the lion's share (or all) of the realistically available non-Social Security surplus against the benefits of additional debt reduction, a Medicare prescription drug benefit, increased aid to education, health insurance for those who lack it, measures to reduce child poverty, additional resources to shore up Social Security and Medicare for the long term, continued modernization of the military, and the like.