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WHAT DO THE NEW BASELINE BUDGET PROJECTIONS MEAN?
How Much Is Available for Tax Cuts and Program Initiatives?

By James Horney and Robert Greenstein

Summary

On January 26, the Congressional Budget Office (CBO) released new projections of federal revenues, spending, and surpluses for fiscal years 2001 through 2010. From some press reports, one might conclude that CBO has determined that surpluses in the non-Social Security part of the budget will total $1.9 trillion over the next 10 years and that tax cuts or entitlement benefit expansions costing as much as $1.9 trillion can safely be enacted.

In fact, CBO has projected that surpluses will total $838 billion over the next 10 years under reasonable assumptions about the path of discretionary (non-entitlement) spending over that period. (These assumptions regarding discretionary spending are probably conservative; as explained in this analysis, actual discretionary spending is likely to be higher.) Furthermore, CBO points out that the nation faces long-term budgetary problems related to the costs of growing numbers of baby-boom retirees and rising health care costs even if *all* of these projected surpluses are dedicated to debt reduction. Using a significant portion of the surpluses to fund large tax cuts or large increases in entitlement spending instead would exacerbate the long-term problem, unless meaningful reform of Social Security, Medicare, or other programs or tax expenditures is enacted at the same time.

The President's budget for fiscal year 2001 will be submitted February 7. Its baseline estimate of non-Social Security surpluses over the next 10 years is expected to be similar to, and probably a little smaller than, the $838 billion CBO projection.

According to CBO's projections, non-Social Security surpluses would total as much as $1.9 trillion over the next 10 years *only* on the assumption either that discretionary spending would comply with the statutory limits (or "caps") on such spending in 2001 and 2002 and grow at the rate of inflation thereafter or that discretionary spending will remain frozen at the 2000 level through 2010, without any adjustment for inflation for 10 years.[1]

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[1] Freezing appropriations at the level provided in fiscal year 2000 (without any adjustment for inflation) would produce outlays $46 billion higher than the amount allowed under the cap in 2001 and $57 billion higher than the cap for 2002. The surpluses for these years would consequently be smaller under a freeze than if discretionary spending were to comply with the caps. But the story is different for the latter part of the 10-year budget period. Under the CBO baseline that assumes adherence to the caps, discretionary spending after 2002 is assumed to equal the 2002 cap plus inflation. By contrast, under a baseline that assumes a 10-year freeze on discretionary appropriations, discretionary outlays do not grow with inflation and remain essentially flat all of the way through
(continued...)

Neither assumption is realistic. Total discretionary spending (which accounts for about one-third of all government spending) has kept pace with inflation for the past two years, despite caps that required deep cuts below the inflation-adjusted levels. Non-defense discretionary spending has grown faster than inflation in every year but one since the caps were instituted in 1991. (Non-defense discretionary appropriations provide funding for a wide array of government activities, including health and science research, veterans medical care, environmental programs, highway construction, Head Start, the Federal Bureau of Investigation, and the National Park Service.) *Total* discretionary spending grew more slowly than inflation from 1991 through 1998 only because defense spending was cut significantly in the years following the end of the Cold War. With a consensus apparently emerging among a majority in Congress and the President that defense spending should at least keep pace with inflation in coming years (and probably be increased above that level), it is exceedingly unlikely that total discretionary spending will grow more slowly than the rate of inflation over the next 10 years.

It is widely recognized that assuming adherence to the caps is unrealistic. Assuming a 10-year freeze on total discretionary spending is no less unrealistic. The new CBO report shows that a 10-year freeze would require making reductions in real discretionary spending (i.e., discretionary spending adjusted for inflation) *totaling $854 billion over the next 10 years*. By 2010, real discretionary spending would have to be cut more than 20 percent. If defense spending stayed even with inflation, a freeze in overall discretionary spending would require a cut in non-defense discretionary spending of close to 40 percent by 2010.

Under the more realistic assumption that discretionary spending will keep pace with inflation over the next 10 years, the projected non-Social Security surplus of $1.9 trillion that results from assuming adherence to the caps or a 10-year freeze is cut by more than half, to $838 billion. Even the assumption that discretionary spending will remain even with inflation is likely to prove conservative. If defense spending grows in real terms, as seems likely, non-defense spending would have to be cut in real terms for total discretionary spending to grow no faster than inflation. As former Congressional Budget Office director Robert Reischauer has observed, recent history suggests such reductions in non-defense discretionary programs are unlikely to occur. Moreover, as the nation's population and wealth grows, there is likely to be rising demand for increased spending on the non-defense side of the budget.

The $838 billion figure also overstates the likely non-Social Security surpluses over the next 10 years for another reason — it does not reflect certain entitlement and tax legislation that would continue policies currently in effect and is virtually certain to be enacted.

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[1] (...continued)
2010. In the latter years of the 10-year period, discretionary spending would be *lower* under the baseline that assumes a freeze — and projected budget surpluses consequently would be larger — than under the baseline that assumes adherence to the caps. For example, discretionary outlays would be *$74 billion lower* in 2010 under a baseline that assumes a freeze than under the baseline that assumes compliance with the caps. Total discretionary spending — and total surpluses — over the 10-year period as a whole would be roughly the same under both approaches.

In each of the past two years, Congress has provided $6 billion to $8 billion a year in additional farm support payments (i.e., payments beyond those the Freedom to Farm Act provides). Given the political pressures, Congress is very likely to continue providing such additional payments to farmers. Congress also regularly extends for a few years at a time a series of popular tax credits that otherwise would expire, and it is a foregone conclusion Congress will continue to enact a so-called "extenders" bill every two years or so. Since CBO's surplus projections are based on current law, however, they assume no such legislation will be enacted — and hence that no additional payments will be made to farmers at any time in the next 10 years and that all of these tax credits will be allowed to terminate. Anticipated action in these two areas alone could slice more than $10 billion a year from the surplus projections.

In addition, virtually all observers agree that Congress and the White House will act to prevent the Alternative Minimum Tax (AMT), which was designed to curb tax avoidance by high-income taxpayers through excessive tax sheltering, from hitting millions of middle-class families that do not use tax shelters (and thereby raising their taxes), as will occur if the law governing the AMT is not changed. The AMT currently affects about two million tax filers; it will hit about 15 million by 2009 if no action is taken. Congress and any Administration are virtually certain to address this problem, which could cost up to $20 billion a year by 2010.

CBO's baseline does not reflect any of these costs. It effectively assumes Congress will stand by and allow millions of middle-class taxpayers to have their taxes increased by the AMT. The combined cost of the additional funding for farmers, legislation extending the expiring tax credits, and legislation to prevent such an increase in the impact of the AMT could be about $230 billion over the next 10 years. This would reduce projected non-Social Security surpluses that might be used for other purposes to about $600 billion over 10-years *if* total discretionary spending rises no faster than inflation despite likely defense spending increases.

It also is important to keep in mind that budget projections are inherently uncertain. As CBO notes, relatively minor changes in its assumptions about economic growth rates and growth in health care spending produce very large changes in projected surpluses. In its new budget forecast, CBO reports that under a somewhat more pessimistic scenario in which the economy generally performs as it did before 1996, the recent increases in personal income taxes as a share of taxable personal income prove temporary, and the annual growth rate of Medicare and Medicaid spending is just one percentage point higher than the CBO baseline assumes — assumptions that CBO describes as "clearly possible and also reasonable" — there would be non-Social Security *deficits* in each of the next 10 years, with those deficits totaling more than $2.9 trillion over the 2001-2010 period (and the national debt increasing rather than decreasing). Even a tiny change from CBO's forecast has consequences; if the economy grows at a rate just one-tenth of one percentage point lower over the next 10 years than CBO has forecast, the 10-year non-Social Security surplus would be about $150 billion smaller. Under a more "optimistic" scenario (which CBO believes to be as likely as the pessimistic scenario), in which the economy performs even better than the CBO baseline assumes, personal income taxes rise further as a share of taxable personal income, and Medicare and Medicaid grow more slowly than in the CBO baseline, budget surpluses would substantially exceed those CBO projects under its baseline assumptions.

Even if the baseline assumptions prove accurate, using the projected $838 billion in non-Social Security surpluses for large tax cuts or large spending increases is not without adverse consequences for the long-term budget outlook. CBO reconfirmed in December 1999 that even if there are no tax cuts or increases in entitlement spending — so that all of the *non*-Social Security surpluses, as well as all of the Social Security surpluses, are used to pay down debt — large and growing budget deficits will return several decades from now as large numbers of baby-boomers retire, with the deficits eventually mounting to levels dangerous for the economy. Unless significant progress simultaneously is made toward correcting the long-term budget imbalances, use of a large portion of the non-Social Security surplus to fund tax cuts or entitlement expansions would make the long-term problem still more serious.[2]

Reforms in Social Security and Medicare could somewhat ease these long-term imbalances. But enacting reforms that restore long-term Medicare and Social Security solvency and ease the long-term imbalances is likely to prove politically impossible unless a substantial portion of the projected non-Social Security surpluses is provided to Social Security and Medicare as part of these reforms. Restoring long-term solvency to Medicare and Social Security without any contributions from the non-Social Security surpluses would necessitate instituting Social Security and Medicare benefit cuts or payroll tax increases far beyond anything that is conceivable politically. Only if sizeable amounts from non-Social Security surpluses can be part of Medicare and Social Security solvency packages are such packages likely to enter the realm of political feasibility.

This is true for both "traditional" approaches and "privatization" approaches to addressing the long-term financing shortfalls in these programs. If a large portion of the projected non-Social Security surpluses are used for other purposes and too little is left for Social Security and Medicare solvency packages, enacting reforms in these two programs is likely to become even more difficult than it already is.

Ideally, until significant progress is made toward solving the long-term Medicare, Social Security, and overall budget problems, the President and Congress will abide by the current "pay-as-you-go" rules requiring that tax cuts or increases in entitlement expenditures be paid for by

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[2] Some public investment expenditures can, like private investment expenditures, increase total economic growth and ease the long-term budget problem. Most public investment is made through discretionary programs, which are funded on a year-to-year basis. This means that additional public investments can be made through certain discretionary programs for a number of years without permanently locking in that additional spending, as would be the case with tax cuts or entitlement expansions. Consequently, increases for discretionary programs carefully targeted on public investment activities that are likely to produce subsequent economic pay-offs have the potential to produce modest positive, rather than negative, impacts on the long-term budget outlook. Among the categories of spending generally thought to constitute public investments are education, job training, infrastructure, research and development, and early intervention programs for children. It should be recognized that not all programs in these categories are effective in producing long-term payoffs.

increases in other taxes or reductions in other spending. If as seems likely, however, meaningful Medicare and Social Security reform is delayed and pressure to tap the projected surpluses mounts, the President and Congress should proceed very cautiously. They should allocate only a relatively modest portion of the projected surpluses for other purposes to ensure that enough of the surpluses remains to facilitate Medicare and Social Security reform. They also should make sure the surplus is used only to address the highest priority needs, such as reducing child poverty and reducing the number of families without health insurance. Large general tax cuts and large but less-critical entitlement expansions should wait until reforms are implemented that improve the long-term budget outlook.

Baseline Budget Projections and the Budget Debate

On January 26, CBO released new projections of federal spending, revenues, and surpluses under current policies for fiscal years 2001 through 2010.[3] CBO projects that if current policies are unchanged — that is, there are no changes in laws governing taxes and entitlement programs and discretionary spending is maintained at current levels in real (inflation-adjusted) terms — total budget surpluses would equal $3.15 trillion over the next 10 years, comprising a little more than $2.3 trillion in surpluses attributable to the Social Security trust funds and $838 billion in "on-budget" surpluses (essentially the surpluses in the non-Social Security part of the budget). The Administration and Congress agreed last year that the Social Security surpluses should go toward debt reduction but fought over what to do with the projected non-Social Security surpluses. It is likely that this year's debate also will revolve around the use of those non-Social Security surpluses.

Realistic Assumptions About Discretionary Spending are Needed

Baseline budget projections will once again play an important role in framing this year's budget debate. And assumptions about the path of discretionary spending over the next 10 years will be a crucial element in determining the size of projected surpluses.

In its new report, CBO produced three different sets of baseline projections, varying only by the amount of discretionary spending assumed and the resulting differences in projected interest payments on the federal debt (see Table 1 and Figure 1). (Lower levels of discretionary spending would increase surpluses and, consequently, produce more debt reduction, thereby reducing the level of interest payments on the debt.) All three baselines generally assume that laws governing taxes and entitlement programs will remain unchanged. The three baselines are:

- A baseline that assumes that discretionary appropriations will be maintained over the next 10 years at the level enacted for fiscal year 2000, adjusted for inflation. Under this assumption, CBO projects that non-Social Security surpluses will total $838 billion over the next 10 years.

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[3] Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2001-2010* (January, 2000).

Table 1

CBO's PROJECTIONS OF THE NON-SOCIAL SECURITY SURPLUS UNDER ALTERNATIVE ASSUMPTIONS ABOUT DISCRETIONARY SPENDING (in billions of dollars)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2001-2010
Discretionary Spending is Maintained at the Level Enacted for 2000, Adjusted for Inflation												
Non-Social Security Surplus	23	11	26	31	37	43	86	115	131	162	195	838
Discretionary outlays	603	635	650	669	684	702	716	730	750	768	786	7,089
Discretionary Spending is Frozen at the Level Enacted for 2000, Without Adjustment for Inflation												
Non-Social Security Surplus	23	22	50	76	102	129	194	245	288	346	407	1,858
Discretionary outlays	603	624	628	627	624	625	623	620	622	621	621	6,235
Discretionary Spending Equals the Caps Through 2002 and Grows at the Rate of Inflation Thereafter												
Non-Social Security Surplus	23	69	112	126	136	151	199	231	258	298	339	1,918
Discretionary outlays	603	578	571	585	600	615	630	646	662	679	696	6,262

SOURCE: Congressional Budget Office

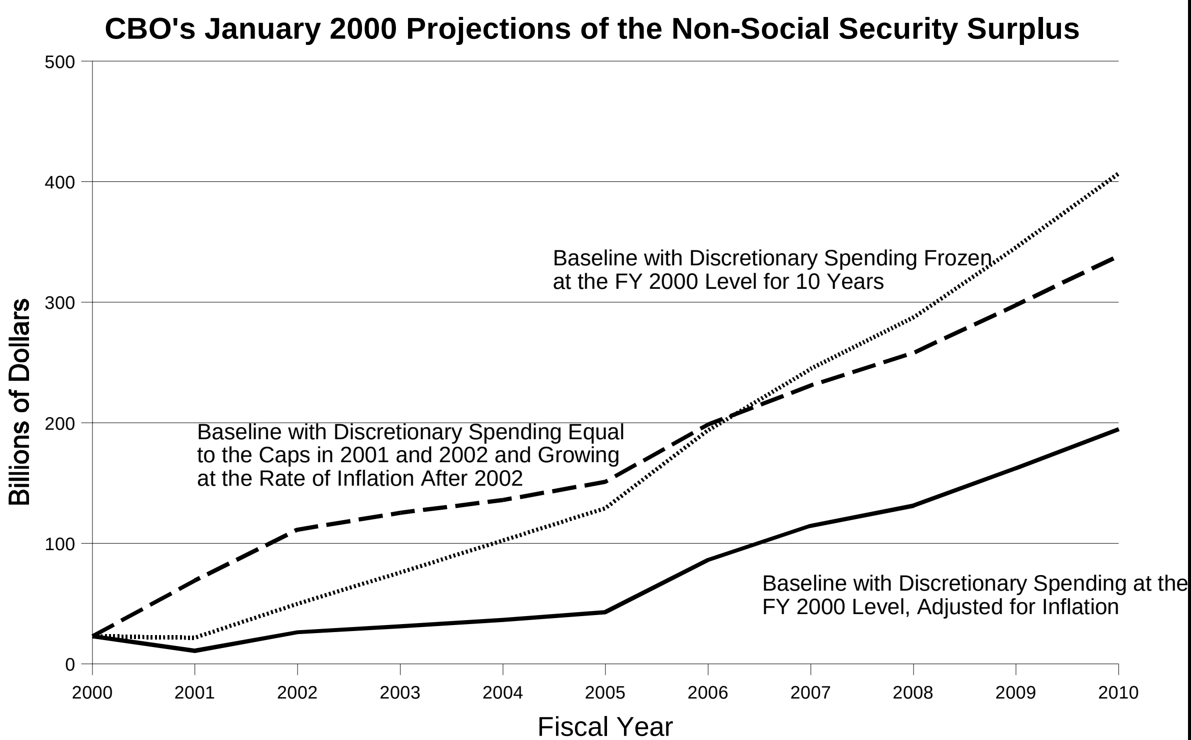
- A baseline that assumes that discretionary spending will comply with the statutory caps on such spending in 2001 and 2002 and grow at the rate of inflation thereafter. Under this assumption, CBO projects that non-Social Security surpluses will total $1,918 billion over the next 10 years.

- A baseline that assumes that discretionary appropriations will be frozen for the next 10 years at the level enacted for fiscal year 2000, without any adjustment for inflation. Under this assumption, CBO projects that non-Social Security surpluses will total $1,858 billion over the next 10 years.

Only the first baseline — which assumes that discretionary spending is held constant in real (i.e., inflation-adjusted) terms — does not dramatically understate both the cost of maintaining current policy and the level of spending likely to be enacted. Recent history clearly indicates that it is unlikely discretionary spending will be cut in real terms. Despite caps requiring substantial real reductions in discretionary spending for each of the last two years, actual appropriations have more than kept pace with inflation. Furthermore, *non-defense* discretionary outlays have increased in real terms in every year but one since the caps were instituted in fiscal year 1991. *Total* discretionary spending declined in real terms from 1991 through 1998 only because *defense* discretionary spending fell sharply after the end of the Cold War. With a seeming consensus among a majority in Congress and the President that defense spending should at least keep pace with inflation in the coming years — and a substantial possibility that it will increase in real terms — it is improbable that total discretionary spending over the next 10 years will fail at least to keep pace with inflation.

The best measure of current policy for discretionary spending in 2001 through 2010 is the "current services" baseline, which assumes that appropriations will be provided in these years at the fiscal year 2000 level, adjusted for inflation. An assumption that overall appropriations in future years will equal the 2000 appropriations level, adjusted only for inflation, is simply an assumption that approximately the same level of goods and services will be provided in 2001 through 2010 as was provided in 2000.

Figure 1



SOURCE: Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2001-2010* (January 2000)

A wide array of budget analysts, united in their concern that assuming unrealistically low levels of discretionary spending — and, consequently, unrealistically large projected surpluses — could lead to fiscally imprudent policy decisions and possibly cause a return of non-Social Security deficits, concur that the baseline that assumes discretionary spending will grow with inflation provides the most realistic starting point for budget deliberations. For example:

- The Concord Coalition recently warned that lawmakers should not count on CBO's projected surpluses that are based on "the unlikely assumption that policy makers will adhere to the discretionary spending caps or freeze spending at this year's level."[4]

- The Blue Dog Coalition of conservative and moderate Democrats in the House of Representatives — which is known for recommending austere budget policies, especially with regard to discretionary spending — has warned that baselines that assume discretionary spending will either be held to the level of the caps or frozen in dollar terms are not "realistic because they do not assume Congress will provide funding to meet needs in defense, veterans, agriculture, education, and other priorities that both parties agree need to be funded. Until Congress and the President agree on new spending caps that set realistic discretionary spending levels to fund those priorities, the current services baseline represents the most realistic estimate of how much surpluses are available for tax cuts and new programs."[5]

In fact, the assumption that discretionary appropriations in 2001 through 2010 will equal the *currently-enacted* fiscal year 2000 appropriations, adjusted for inflation, is itself likely to prove conservative for several reasons. First, funding for fiscal year 2000 is almost certain to be increased by additional, supplemental appropriations enacted this spring or summer to fund assistance that the United States will provide in connection with Middle East peace efforts, peacekeeping activities in Kosovo and East Timor, additional disaster relief to respond to disasters that will occur in coming months, and other pressing needs. (CBO's baseline projections assume no such supplemental appropriations will be enacted over the next 10 years.)

In addition, there is significant pressure to increase defense discretionary spending above current levels in real terms. If that occurs, keeping *total* discretionary spending at the same level as in 2000, adjusted for inflation, would entail making real cuts in non-defense discretionary programs. That seems unlikely in light of the fact that spending for non-defense discretionary programs has grown about 20 percent in real terms over the last 10 years even under the discretionary cap regime and during a period of budget deficits.

[4] The Concord Coalition, "Concord Coalition Warns Against Surplus 'Expectations' Game" (January 24, 2000).

[5] The Blue Dog Coalition, "The Blue Dogs Respond to CBO's Revised Budget Projections" (January 26, 2000).

Furthermore, in the longer run, simply keeping overall discretionary spending even with inflation probably is not realistic in an increasingly wealthy nation that has a growing population and rising demands for government resources to be devoted to activities such as health research, infrastructure improvements, education, and defense weapons and readiness. Just as families spend more in real terms when their real income grows, the government is likely to spend more in real terms to provide the increased level of government services and investments that citizens are likely to expect and demand.

As former CBO director Robert Reischauer has pointed out, Congress let nondefense discretionary spending grow by 20 percent in real terms "during its decade-long jihad to balance the budget,"[6] and it is hard to imagine that Congress will be more closefisted when the budget is in surplus, the economy is robust, and voters are demanding more and better government services.

Assuming Compliance with the Discretionary Spending Caps is Unrealistic

Few observers expect policymakers to adhere to the current discretionary caps. Even John Kasich, the Chairman of the House Budget Committee, has been quoted as saying that "the caps are not a relevant limit today on spending."[7] The caps are not relevant because the cuts that would be required to comply with them are politically infeasible.

CBO projects that maintaining appropriations at the same level as has been enacted to date for fiscal year 2000, adjusted for inflation, will produce outlays of $635 billion in 2001 and $650 billion in 2002.[8] Since the cap on outlays is $578 billion in 2001 and $571 billion in 2002, complying with the caps would require real cuts in outlays of $57 billion in 2001 and $79 billion in 2002 (see Table 2 and Figure 2). To achieve the required outlay cut in 2001, budget authority (the amount actually appropriated) would have to be cut by about $100 billion, or about 15 percent, below the real level provided for 2000.[9] Under CBO's baseline that assumes compliance

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[6] Robert D. Reischauer, "The Phantom Surplus," *New York Times*, January 28, 2000, page A27.

[7] Bureau of National Affairs, *Daily Tax Report*, January 28, 2000, page G-11.

[8] According to CBO, discretionary outlays will total $603 billion in FY 2000. There are several reasons why outlays grow somewhat faster than the anticipated rate of inflation between 2000 and 2001, but the most important is that timing shifts imposed to help meet the legal requirements of the caps last year artificially decrease outlays by almost $8 billion in 2000 and increase them by the same amount in 2001.

[9] The cut in budget authority is greater than the cut in outlays because, on average, only about 60 percent of newly appropriated funds are expended in the initial fiscal year (this is usually termed a 60-percent "first-year spend-out rate"), with the remaining 40 percent of such funds being expended in subsequent years. In other words, an appropriation of $100 billion for 2001 would produce about $60 billion in outlays in 2001 and $40 billion in outlays in subsequent years. Thus, it would require nearly a $100 billion cut in budget authority to reduce outlays by $57 billion in 2001, assuming that the average first-year spend-out rate of the programs that are cut is close to the average
(continued...)

with the caps (known as the "capped baseline"), discretionary outlays would have to be cut a total of *$827 billion* over the 2001-2010 period.

It is virtually unthinkable that total discretionary appropriations would be cut by 15 percent in 2001 even if defense and non-defense spending both were subject to cuts. But if defense spending is maintained at the 2000 level in real terms — which is less than the President and a majority in Congress have called for — appropriations for non-defense discretionary programs would have to be cut much more sharply than that to comply with the caps. In short, the caps for 2001 and 2002 are even less realistic than the breached cap for 2000 proved to be.

Assuming a Freeze in Discretionary Spending Is Equally Unrealistic

Some policymakers argue that instead of assuming compliance with the caps, Congress should use baseline projections that assume that discretionary appropriations will be frozen in nominal terms for all years from 2001 through 2010 (i.e., funded at the same dollar level as in 2000 without any adjustment for inflation). Such an assumption may be politically appealing to some Members of Congress, because a freeze assumption would allow significantly more spending than the cap in 2001 but produce *roughly the same cumulative surpluses over the next 10 years* as a baseline that assumes discretionary spending will adhere to the caps for the next two years and grow at the rate of inflation thereafter. Using a 10-year freeze in making budget projections entails assuming approximately the same overall level of cuts in real discretionary spending over the next 10 years — more than $800 billion — as assuming compliance with the caps, while conveniently postponing the deepest cuts in discretionary spending until the latter part of the 10-year period (see Table 2 and Figure 2).

Under the freeze, discretionary outlays would be $46 billion *higher* than is allowed by the caps in 2001. But, by 2010, discretionary outlays under the freeze would be $74 billion *lower* than the amount assumed under CBO's capped baseline.

Assuming a freeze over 10 years thus is as unrealistic as assuming that discretionary spending will equal the caps through 2002 and grow at the rate of inflation thereafter. The level of goods and services that could be provided under such a freeze would be sharply reduced over time — by more than 20 percent in 2010 even if inflation remains at historically low levels. Moreover, if defense spending keeps pace with inflation, freezing total discretionary spending through 2010 would require a real cut in non-defense discretionary spending of *close to 40 percent* by 2010.

Any assertion that it is realistic to assume cuts of this magnitude in the level of goods and services that discretionary programs provide is virtually certain to be proven wrong. House Speaker Dennis Hastert has stated that "it's not realistic to say that we are going to freeze

[9] (...continued)
for all programs.

Table 2

Real Reductions in Discretionary Spending
Under the "Freeze Baseline" and the "Capped Baseline"
(in billions of dollars)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2001-2010
Reductions Below FY 2000 Level Adjusted for Inflation												
Baseline that Assumes a Freeze	0	-11	-23	-42	-60	-77	-93	-110	-128	-146	-165	-854
Baseline that Assumes Compliance with the Caps	0	-57	-79	-83	-84	-87	-86	-84	-88	-89	-90	-827

Source: Congressional Budget Office

budgets for the next 10 years."[10] Use of budget projections that assume such an unrealistic 10-year freeze produces a deeply flawed measure of the magnitude of the surpluses.

The misleading nature of assertions that a long-term appropriations freeze would simply represent maintenance of current policy can be easily seen. Consider, for example, developments over the last 13 years with regard to defense spending and the troops, weapons, and military bases that such spending supports. CBO estimates that defense outlays in 2000 will total $283 billion, the same amount in nominal terms (not adjusted for inflation) as outlays at the height of the Reagan defense buildup in 1987. But despite the same level of nominal spending now as then, since 1987 the number of active-duty military personnel has been reduced from 2.2 million to 1.4 million (a 36 percent reduction), the number of Navy ships has been reduced from 569 to 315 (a 45 percent reduction), the number of Air Force fighter wings (active and reserve) has been reduced from 38 to 20 (a 46 percent reduction), and the U.S. military has closed more than 900 facilities around the world and 97 major bases in the United States.[11] Why have those reductions — which virtually all policymakers would agree represent a significant change in defense policy — occurred when the dollar level of appropriations now is the same as in 1987? The answer is they have occurred because real (inflation-adjusted) spending for defense has fallen nearly one-third over the last 13 years. In discretionary programs, maintaining current policies generally entails staying even with inflation.

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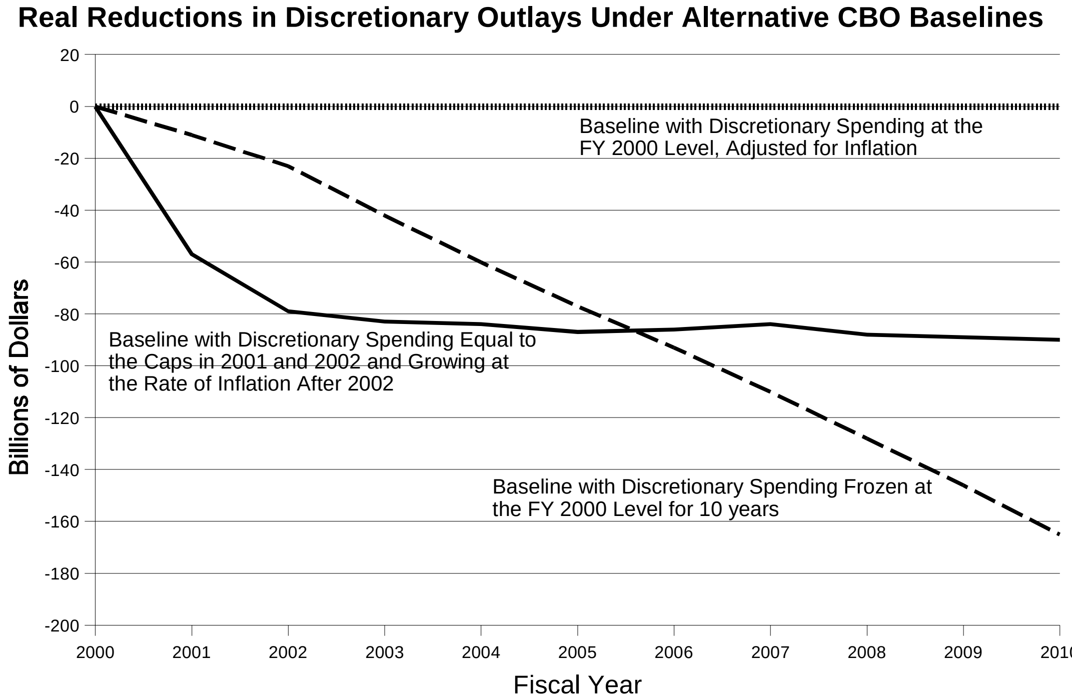
[10] Bureau of National Affairs, *Daily Tax Report*, January 28, 2000, page G-11

[11] Sources: House Armed Services Committee, "Defense Accomplishments of the 104th, 105th, and 106th Congresses," (November 18, 1999); Department of Defense, *Annual Report to the President and the Congress.*

Figure 2



SOURCE: Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2001-2010* (January 2000)

Curiously, some Members of Congress who have been vocal opponents of baseline budget projections in which the current level of discretionary appropriations is adjusted for inflation — and who claim that adjusting for inflation inappropriately entails assuming spending "increases" in the baseline — have been outspoken in opposing what they describe as deep "cuts" made in defense spending since the 1980s. These Members are correct in asserting that defense spending has been cut in real terms. (Whether or not they are correct in their belief that such cuts represent bad policy is another question.) But those Members apply a double standard when they argue that maintaining overall discretionary spending at current levels without adjusting for inflation — or maintaining non-defense discretionary spending at current levels without adjusting for inflation — does not constitute a cut.

Furthermore, one prominent policymaker who has argued strongly that inflation adjustments *should* be made in making projections of non-defense spending is none other than Republican presidential contender George W. Bush. In defending his budget record as governor of Texas, Bush has said that budget baselines should be adjusted to reflect the effect on government expenditures of both inflation and population growth, a point he repeated January 26 in a debate in New Hampshire (see box on next page).

Governor Bush Adjusts Texas Budget Figures for Inflation and Population Growth

The *Wall Street Journal* recently reported a charge by Republican Presidential contender Steve Forbes that under the administration of Governor George W. Bush, Texas state spending has grown 36 percent. The *Journal* also reported that Governor Bush has called the Forbes charge false, stating that Texas spending has increased only 2.7 percent.[a]

The Forbes campaign calculated the 36 percent figure by comparing Texas state spending in the current year with spending in 1995, when Governor Bush took office. By contrast, the *Journal* reported, "Mr. Bush calculates just 2.7 percent growth largely because he adjusts for inflation and population growth."

As the *Journal* explains, Governor Bush takes the level of state spending when he took office and adjusts it for both inflation and state population growth since that year. The resulting figure, after these adjustments are made, forms the baseline against which Governor Bush measures the spending that occurred to determine the extent to which spending increased. In a campaign debate in New Hampshire on January 26, Bush once again presented numbers on budget growth in Texas after adjustment for inflation and population growth and explicitly stated he was making these adjustments. As the *Journal* article notes, the Bush point is "Simply put, government has to spend more money just to provide the same services."

Applying the Bush methodology to the federal budget would produce somewhat higher baseline levels of discretionary spending — and smaller budget surpluses — than the figures we use in this analysis. In this analysis, we adjust only for inflation, and not for population growth as well. (Adjusting only for inflation causes a real reduction over time in the goods and services that discretionary programs provide on a *per capita* basis. Adjusting for both inflation and population keeps these goods and services constant on a per capita basis.) Robert Reischauer, a former Director of the Congressional Budget Office, has observed that adjusting current discretionary spending levels only for inflation without making any adjustment for population growth produces discretionary spending projections that themselves are likely to prove unrealistically low.

[a] Jackie Calmes, "On Spending, Forbes Takes Cue from Bush," *Wall Street Journal*, (November 5, 1999).

CBO Baseline Projections Do Not Reflect Likely Changes in Law

It also is important to keep in mind that CBO's baseline projections generally assume no changes will be made in laws affecting taxes or entitlements, no matter how likely it is that such changes will be enacted. For example, the projections do not include any new "emergency" spending for aid to farmers. Legislation has been enacted in each of the last two years that provided substantial funding for payments to farmers — about $6 billion for 1999 and $8 billion for 2000. These payments were largely aimed at offsetting the effects of low farm prices on farm income and were funneled through the existing farm support program, which is an entitlement. Under the rules CBO follows in making baseline budget projections, CBO's projections assume there will be no changes in current law governing entitlement programs and hence that *there will be no such payments made to farmers any time in the next 10 years*. In light of the legislation enacted the last two years — and with continuing low farm prices, substantial dissatisfaction with the Freedom to Farm Act among farm-state legislators, and the upcoming elections — it seems highly likely that substantial additional funding *will* be provided for payments to farmers in 2001 and succeeding years.

Similarly, CBO's projections generally assume no changes in tax laws. Some changes, however, are virtually inevitable. At the end of last year's session, for example, Congress passed legislation temporarily extending various expiring tax credits and other expiring provisions of tax law at a cost of about $5.5 billion in fiscal year 2002. (This does not include the cost of a provision related to the Alternative Minimum Tax, which is discussed below.) Congress passes this "extenders" legislation every time these tax credits are scheduled to expire, usually extending the credits for another year or two. Congress has been doing this for years, and all observers expect such legislation to continue being enacted in the future. The new baseline projections effectively assume, however, that no further extenders legislation will be enacted — and that these tax credits will consequently terminate after tax year 2001 (or in one case, after 2004), when they are scheduled to expire under the most recent extenders legislation. According to CBO, it would cost $50 billion over the next 10 years to continue to extend expiring revenue provisions (other than the AMT provision).

Just as likely as enactment of future "extenders" bills is legislation to alter the application of the alternative minimum tax (AMT) provisions of the tax code. The AMT provisions were enacted to address concerns that some high-income individuals were largely avoiding paying income tax by investing heavily in tax shelter activities. Because key features of the AMT are not indexed for inflation, the number of taxpayers affected by the AMT is expected to increase from about 2 million this year to more than 15 million by 2009. Although changing the law could eventually cost $20 billion a year, virtually no observer questions that policymakers will act to prevent millions of middle-class taxpayers from being subject to the complex AMT provisions and saddled with higher tax bills as a consequence. The baseline projections assume, however, that no such changes will be made — and thus that more than 15 million tax filers will be affected by the AMT by 2009. Legislation preventing a significant increase in the number of middle-class taxpayers affected by the AMT could cost as much as $80 billion over the next 10 years and as much as $20 billion in 2010 alone.[12]

Together with likely additional funding for farmers and the costs of extending expiring tax credits, legislation to prevent such an increase in the impact of the AMT provisions could cost about $230 billion over the next 10 years.[13] These costs are not included in CBO's baseline

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[12] Based on CBO and Joint Committee on Taxation estimates, the Center has calculated that it would cost about $80 billion to continue the current temporary provision allowing taxpayers to take full advantage of nonrefundable tax credits without regard to the AMT and to index the AMT exemption for inflation, starting in 1999.

[13] In addition to the $80 billion cost of the AMT provisions, the estimate of $230 billion includes the $50 billion that CBO estimates it would cost to extend the expiring tax provisions (excluding the provision related to the AMT),

(continued...)

projections. This is not to argue that CBO is doing anything inappropriate in constructing its budget baselines or that the baseline projections should include the costs of new tax and entitlement legislation that is very likely to be enacted. Making judgements about what will be enacted is not CBO's role. Besides, baselines are supposed to reflect current entitlement and tax law, not a revised version of the law. But policymakers, journalists, and commentators will mislead themselves and the public if they fail to take into account the costs of legislation almost certain to be enacted when they fashion budget proposals that would tap projected surpluses or they analyze such proposals and other matters relating to how the surpluses might be used.

CBO's Projections Are Uncertain

Budget projections are inherently uncertain. The substantial change in CBO's projections since last July is an indication of that. Indeed, CBO devotes a chapter of its new report to an assessment of how much budget outcomes could differ from the current projections under reasonable alternative assumptions.[14]

CBO analyzes the difference between actual budget outcomes in fiscal years 1986 through 1999 and CBO's projections for those years. CBO finds that the average absolute error in projections of the total budget deficit or surplus made five years in advance (the size of the error without regard to whether it is an overestimate or an underestimate) equaled 2.4 percent of GDP. If the projections made today for fiscal year 2005 are off by the average amount that CBO projections made five years in advance have been off in the past, the surplus projection for 2005 will be off by *almost $300 billion* for that year. CBO also points out that the projections it makes for years ten years in the future are likely to be less accurate than its five-year projections. The high degree of uncertainty surrounding projections for years beyond 2005 is of special significance in the debate over use of the projected surpluses, since *about 80 percent* of the total surpluses CBO projects for the next 10 years would occur in 2006 through 2010.[15]

In its new report, CBO also presents budget projections based on assumptions that differ from those CBO used in making its baseline projections but that CBO considers to be "clearly plausible and also reasonable." A "pessimistic" alternative assumes that the economy performs

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[13] (...continued)
$60 billion in additional farm aid, and the increased debt service payments that would result from the effect of these costs on the federal debt.

[14] Congressional Budget Office, "The Uncertainties of Budget Projections," Chapter 5 of *The Budget and Economic Outlook: Fiscal Years 2001-2010* (January 2000).

[15] About 80 percent of the surpluses projected over 10 years would occur in 2006 through 2010 under either the assumption that discretionary spending is maintained at the 2000 level, adjusted for inflation, or the assumption that discretionary spending is frozen at the 2000 level, without any adjustment for inflation. Under the assumption that discretionary spending is equal to the caps in 2001 and 2002 and grows at the rate of inflation thereafter, about 70 percent of the projected surpluses would occur in 2006 through 2010.

as it did before 1996. It assumes that the recent increase in productivity will prove temporary and that productivity will grow at the average historical rate of 1.6 percent per year. It also assumes that personal tax liabilities as a share of total taxable personal income will return over the next four years to the lower level that existed in 1994. Finally, it assumes that spending for Medicare and Medicaid will grow at an average annual rate one percentage point higher than the baseline assumes. Assuming that discretionary spending is maintained at the 2000 level adjusted for inflation, this pessimistic scenario produces cumulative non-Social Security *deficits* of more than $2.9 billion in 2001 through 2010 (a swing of almost $3.8 trillion from the $838 billion in surpluses over the 10 years under the baseline assumptions). Under this scenario, there would be a non-Social Security deficit of $504 billion in 2010 instead of a surplus of $195 billion, a difference of almost $700 billion in that year alone.

CBO also produced an "optimistic" alternative scenario, which it believes is about as likely as the pessimistic scenario. That scenario assumes that recent productivity gains are not temporary, that tax liabilities would continue to rise as a percentage of total taxable personal income, and the average annual growth of spending for Medicare and Medicaid will be one percentage point lower than the baseline assumes. Under this scenario, non-Social Security surpluses over the next 10 years would be $3.6 trillion higher than the baseline forecast projects.

The Use of Projected Non-Social Security Surpluses Will Have Long-term Fiscal Impacts

Even if projected non-Social Security surpluses are based on realistic assumptions about discretionary spending, policymakers should be cautious about using those projected surpluses to fund large tax cuts or large expansions in entitlement programs. Unless such tax cuts or entitlement increases are "paid for" or are accompanied by meaningful Medicare and Social Security reforms, they would exacerbate the existing long-term imbalance in the budget.

Under Current Law, Deficits Will Return

CBO's updated *long-term* budget projections released in December 1999 confirm that the current favorable budget outlook is not expected to endure.[16] CBO projects that even if the full array of cuts in discretionary spending needed to comply with the caps were to be enacted and all of the resulting non-Social Security surpluses (as well as all of the Social Security surpluses) were used to pay down debt — an unlikely set of developments — mounting pressures from the baby-boomers' retirement would produce a return of deficits in the overall budget by 2028. This would be followed by rapidly growing debt that would reach 100 percent of GDP by 2062, about 2 ½ times the current debt level, and continuing growing after that. With debt continuing to accumulate at an accelerating rate, such a fiscal imbalance would impose a severe strain on the

[16] Congressional Budget Office, *The Long-Term Budget Outlook: An Update* (December 14, 1999).

U.S. economy, limiting funds available for private investment and significantly slowing economic growth.

CBO also projected that under the alternative (and more plausible) assumption that the non-Social Security surpluses will be consumed by tax cuts and/or spending increases but the non-Social Security budget will be kept in balance over the next 10 years, these deficit problems would arise a number of years earlier.

When CBO updates its long-term projections a month or so from now, the outlook may be somewhat brighter because of the improvement in the economic outlook for the next 10 years described in its January 26 report. The improvement, however, is likely to delay the onset of serious long-term budget problems only by a few years. In the January 26 report, CBO states that "even substantial surpluses over the next several years would not eliminate the budgetary tensions that coming demographic changes and rising health care costs will bring."[17] It is unlikely that the long-term budget problems will go away without any changes in policies to increase taxes and/or reduce projected expenditures for Social Security, Medicare, and/or the long-term care component of Medicaid.

Any legislation enacted now that would substantially reduce taxes or substantially increase promised entitlement benefits will make the anticipated long-term problem more severe unless such legislation is "paid for" or accompanied by reforms in Medicare or Social Security. Not only would the reduction in the federal debt be smaller, but the reduction in the revenue base or the increase in the level of entitlement expenditures would make the projected long-term imbalance between revenues and expenditures still larger.

Non-Social Security Surpluses Will Be Needed in Reforms of Medicare and Social Security

Using a large portion of the projected surpluses to cover big tax cuts or increases in entitlement spending before enacting reforms aimed at ensuring long-term Social Security and Medicare solvency could make it harder to enact such reforms in the future. Solving both the long-term problem in the overall budget and the long-term solvency problems of the Medicare and Social Security trust funds almost certainly will require some mix of reductions in Social Security and Medicare benefits and, particularly in the case of Medicare, some increase in payroll taxes. (Despite the rhetoric of proponents of Social Security lock-box legislation, simply ensuring that all of the Social Security surpluses are used to pay down the federal debt held by the public will not affect Social Security solvency.)

There are limits, however, to the benefit reductions and payroll tax increases that are politically achievable. As a result, it is extremely unlikely that either Medicare or Social Security

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[17] Page 7, *The Budget and Economic Outlook: Fiscal Years 2001-2010* (January 2000).

solvency can be restored without significant infusions of general funds into these trust funds. These infusions of general funds would have to come from non-Social Security surpluses. If, however, a substantial share of the projected non-Social Security surpluses is consumed by large tax cuts or large increases in entitlement expenditures, there may be insufficient surplus funds remaining to help achieve long-term Social Security and Medicare reform.

Consider the situation of Medicare. The controversial Medicare plan that Senator John Breaux and Representative Bill Thomas put forward last year would significantly reduce projected Medicare spending. Yet it would close only one-fourth of the gap between projected Medicare expenditures and anticipated revenues over the next 30 years. That even so controversial a proposal as the Breaux-Thomas plan would close no more than a fraction of the long-term Medicare financing gap makes clear that some non-Social Security surplus funds will be needed to help achieve Medicare solvency. For these reasons, a politically diverse panel of Medicare experts that the National Academy of Social Insurance recently convened concluded unanimously that the provision of new revenues for Medicare must be part of the debate on long-term Medicare solutions.[18]

Similarly, any politically feasible plan to ensure the solvency of Social Security will almost certainly require a substantial amount of revenues from the non-Social Security surpluses. That is true not only for plans that explicitly call for a transfer of general funds to the Social Security trust funds, such as the plan the President proposed last year, but also for most plans that propose the establishment of individual private accounts that eventually would partially replace Social Security benefits. Since most members of Congress seem unwilling to agree to sizeable Social Security benefit reductions, most existing "privatization" plans on Capitol Hill (various versions of which have been proposed by Representatives Bill Archer and Clay Shaw, Senator Phil Gramm, and Harvard professor Martin Feldstein) promise to establish individual accounts, restore Social Security solvency, and increase total government-funded retirement income without *any* benefit reductions or tax increases. The only way to achieve such an outcome is to use a substantial portion of non-Social Security surpluses to fund the new private accounts, on top of the existing tax revenues that flow into the Social Security trust funds.

Under the Archer-Shaw plan, for example, the government would deposit into an account in each worker's name an amount equal to two percent of the worker's wages, up to the Social Security payroll tax cap (now $76,200). When a worker retired, his or her account would be converted into an annuity, administered by the Social Security Administration, that would provide a monthly benefit payment until the worker died. If the annuity is less than the Social Security benefit to which the worker otherwise would be entitled — as would be the case for the overwhelming number of retirees — Social Security benefit payments would make up the difference.

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[18] Members of the National Academy of Social Insurance Study Panel on Medicare Financing, *The Financing Needs of a Restructured Medicare Program* (September 1999).

In the long term, Social Security solvency could potentially be achieved because the Social Security trust funds would make substantially smaller benefit payments than under current law; the Social Security benefit payments that most beneficiaries receive from the Social Security trust funds would be reduced one dollar for each dollar the beneficiary received in monthly annuity payments from his or her individual account. But reductions in total Social Security benefit payments would not reach substantial levels until many years from now. As a result, there would be a multi-decade "transition period" during which the federal government's contributions to these individual accounts would require much higher levels of federal spending. That spending, in turn, would lead to higher levels of debt and larger interest payments on the debt than would otherwise be the case. The Social Security actuaries have estimated that the net costs of the Archer-Shaw plan — the costs of the government's deposits into the individual accounts and the higher interest payments the government would have to make on the debt, minus the savings the plan would produce in Social Security costs — would total more than $1.4 trillion over the next 10 years and equal between $300 billion and $700 billion each year from 2016 through 2042.[19] This money would have to come from non-Social Security surpluses, while such surpluses last.[20]

Conclusion

In the coming debate on the budget, the focus should be on CBO's projections of the surplus that are based on the more-realistic assumption that discretionary appropriations over the next 10 years will remain at the level appropriated for fiscal year 2000, adjusted for inflation. Projections which assume that discretionary spending will comply with the caps in 2001 and 2002, or will be frozen for 10 years at the 2000 level without any adjustment for inflation, significantly understate the spending and overstate the surpluses likely to develop. They do not represent a reasonable starting point for this year's budget debate.

Furthermore, whatever the level of projected non-Social Security surpluses under realistic assumptions about discretionary spending, policymakers should not assume that a significant portion of those surpluses is available to fund large tax cuts or large increases in entitlement spending without any regard to the long-term budget outlook. Simply ensuring that all of the Social Security surpluses are used to pay down the debt does not solve the long-term budget

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[19] These figures are in current dollars. See Stephen C. Goss, Deputy Chief Actuary, Social Security Administration, "Long-Range OASDI Financial Effects of the Social Security Guarantee Plan — INFORMATION," April 29, 1999.

[20] Privatization plans would achieve solvency in the Social Security trust funds only if all of the surpluses of the trust funds continue to be used to purchase securities that are credited to the trust funds. Pretending these surpluses also can be used to purchase securities that are credited to private accounts would constitute the type of "double counting" of which many privatization proponents accused the President last year. In addition, the Social Security surpluses will disappear in about two decades; the Social Security Trustees project the trust funds will begin to run deficits in 2022.

problems that the baby-boom generation's impending retirement will engender. Unless substantial tax cuts or entitlement expansions financed from the non-Social Security surpluses are accompanied by meaningful reforms of Medicare, Social Security, or other programs or tax expenditures, they will exacerbate the long-term budget problem. Large tax cuts or entitlement expansions of this nature also would probably make it harder to achieve reforms in Medicare and Social Security at a later date.

Ideally, until significant progress is made toward solving the long-term Medicare, Social Security, and overall budget problems, the President and Congress will abide by the current "pay-as-you-go" rules requiring that tax cuts or increases in entitlement spending be paid for by increases in other taxes or cuts in other spending. If, however, as seems likely, meaningful Medicare and Social Security reform is delayed and pressures to tap into projected surpluses mount, the President and Congress should proceed very cautiously. They should allocate only a relatively modest portion of the projected surpluses for other purposes (other than debt repayment) to ensure that enough of the surplus remains to facilitate Medicare and Social Security reform. They also should use the surplus to meet only the highest priority needs, such as reducing child poverty and the number of families without health insurance. Large general tax cuts and large, less-critical entitlement expansions should wait until reforms are implemented that improve the long-term budget outlook.