CED THE CONCORD COALITION CENTER ON BUDGET AND POLICY PRIORITIES

POLICY BRIEFING: THE DEVELOPING CRISIS - DEFICITS MATTER

Monday, September 29, 2003, 9:00 a.m.
National Press Club

Panel

Robert E. Rubin, former Treasury Secretary (1995 – 1999); now a Director and Chairman of the Executive Committee of Citigroup, Inc. (Board member, Concord Coalition)

Warren B. Rudman, former Republican Senator from New Hampshire (1981-1993); Founding Co-Chairman of the Concord Coalition. Senator Rudman will also serve as moderator for the panel discussion.

Robert D. Reischauer, former director of the Congressional Budget Office (1989 – 1995); President of the Urban Institute. (Board member, Center on Budget and Policy Priorities)

Peter G. Peterson, former Secretary of Commerce (1972-1973); President of The Concord Coalition; Chairman, The Blackstone Group.

William W. Lewis, Trustee, the Committee for Economic Development; Director Emeritus, McKinsey Global Institute. Former Acting Secretary of Energy and Principal Deputy Assistant Secretary of Defense.

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NO END IN SIGHT TO RISING DEFICITS, EXPERTS WARN
Bipartisan Group of Budget Analysts and Former Senior Officials Call for Fiscal Discipline

Washington, D.C. — A bipartisan group of prominent budget analysis organizations, former senior government officials, and business leaders warned today of a "growing mismatch between what Americans are scheduled to pay to government and what they expect government to deliver in return." The group released a new analysis of the expanding federal budget deficit, projecting $5 trillion in total deficits over the coming decade. The group also released a joint statement calling on Congress and the President to develop "a realistic plan for putting the nation's fiscal house in order."

Issuing the statement were the Committee for Economic Development, an organization of business leaders and educators; the Concord Coalition, a bipartisan organization dedicated to sustainable fiscal policy; and the Center on Budget and Policy Priorities, a policy research organization that focuses on fiscal issues and issues affecting low- and moderate-income families. Joining them in releasing the statement were prominent board members of the three organizations, including Robert Rubin, Warren Rudman, Peter Peterson, Robert Reischauer, and William Lewis.

"Many in Washington now argue that escalating deficits do not really matter, that they are self-correcting, that they are unrelated to interest rates or future economic well-being, and that tax cuts will pay for themselves later by spurring economic growth," the statement noted, adding, "It would be wonderful if this were true. It is not." With just a few years remaining before the baby boomers' retirement, the government is on course to squander its final opportunity to prepare for that event by reducing the national debt.

Coming Decade "the Most Fiscally Irresponsible in Our Nation's History"

The three organizations project that combined deficits over the next decade (2004-2013) will total $5 trillion if the nation stays on its current path regarding tax and spending policies.

These projections start with the official Congressional Budget Office projections regarding revenues, expenditures, deficits, and economic growth over the coming decade, but make adjustments to reflect the continuation of current policies. Specifically, they assume that expiring tax cuts will be extended and relief from the Alternative Minimum Tax continued, that a prescription drug benefit costing $400 billion over ten years will become law, that the Administration's future-year defense plan will be fully funded, and that domestic appropriated programs will keep pace with inflation and population growth.

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Unless the federal government changes course, this coming decade will be "the most fiscally irresponsible in our nation's history," the organizations stated. The only other period in which the federal government has run deficits of this size (except during times of global depression or full-scale war) was the 1980s and early 1990s, a time when the retirement of the baby-boom generation was still a generation away. Today, with the first baby boomers due to start collecting Social Security in five years, it is just around the corner.

The annual deficit, rather than being cut in half in five years as is suggested by estimates that do not fully reflect the costs of continuing current policies, will grow over the ten-year period under the projections, reaching $610 billion in 2013.

The magnitude of the projected deficits can be seen in the fact that even with a full economic recovery and a decade of economic growth, balancing the budget by 2013 would entail such radical steps as:

- raising individual and corporate income taxes by 27 percent; or
- eliminating Medicare entirely; or
- cutting Social Security benefits by 60 percent; or
- shutting down three-fourths of the Defense Department; or
- cutting all expenditures other than Social Security, Medicare, defense, homeland security, and interest payments on the debt by 40 percent.

$9 Trillion Deterioration in the Budget Outlook in Just 32 Months

The emergence of massive projected deficits has happened in a startlingly short time. In January 2001, the Congressional Budget Office projected that the government would amass trillions of dollars in surpluses over the decade from 2002 to 2011. The organizations project that the budget outlook for this same 2002-2011 period is now $9 trillion worse than it was in January 2001.

More than a third of this $9 trillion decline can be attributed to tax cuts, with this share rising over time. Nearly one-third is attributable to new expenditures, most of which are for defense and homeland security. Changed assumptions about the economy and the amount of revenue generated for a given level of economic activity account for the remaining third.

Even Worse Problems Later, When Baby Boomers Retire

Even larger deficits are forecast for the decades after 2013 as the retirement of the baby-boom generation causes large increases in the cost of retirement programs such as Social Security and Medicare. If current tax and spending policies are continued, deficits will jump from an already high level of 3.4 percent of the nation's Gross Domestic Product in 2013 to 7.8 percent of GDP in 2023, according to the organizations' projections.

Unless brought under control, deficits will lead to slower economic growth by crowding out productive investment. They also will raise the cost of interest payments on the national debt. Annual interest payments will reach $470 billion in 2013 and much more in later years.

Large Deficits Will Not Disappear on Their Own

So large are the projected deficits, the organizations warned, that the economy cannot possibly "grow out of them," a message supported by reports from institutions such as the General Accounting Office and the Congressional Budget Office. The projected deficits are structural rather than cyclical — in other words, they reflect a fundamental mismatch between revenues and expenditures rather than the temporary (and self-correcting) effects of an economic downturn.

If the tax cuts are extended, federal revenues in the coming decade will be lower, as a share of the economy, than their average level in any of the last three decades. And while federal expenditures are not at historically high levels today as a share of the economy, they will be once the baby-boom generation retires in large numbers. The resulting imbalances will be very large.

Neither party is yet willing to make the difficult choices necessary to correct these imbalances, the organizations said. The Administration fails to acknowledge the relationship between its fiscal choices and the nation's long-term future, while Democratic alternatives tend to ignore the fact that existing commitments for retirement, health, and security exceed the revenues available to pay for them.

"In the end, our children will have to face higher taxes, reduced public services, or both," the organizations warned. "But if we wait until the crisis is upon us, the solutions will be more draconian."

As a first step, the organizations said, Congress and the President should "act immediately to stop digging the hole deeper." They also called on policymakers to develop a long-term plan to restore fiscal discipline, including a return to the "pay-as-you-go" budget rules that proved effective during the 1990s.

Joining in presenting the joint statement were:

- Robert E. Rubin, treasury secretary under President Clinton and now a director and chairman of the Executive Committee of Citigroup, Inc.,
- Warren B. Rudman, former Republican senator from New Hampshire and founding co-chairman of the Concord Coalition,
- Peter G. Peterson, secretary of commerce under President Nixon and current president of the Concord Coalition,
- Robert D. Reischauer, former director of the Congressional Budget Office and current president of the Urban Institute, and
- William W. Lewis, trustee of the Committee for Economic Development and director emeritus of the McKinsey Global Institute.

A transcript of the policy briefing will be posted at the groups' web sites. The joint statement, along with a detailed analysis are currently available at the web sites: www.cbpp.org, www.concordcoalition.org, www.ced.org.

September 29, 2003

THE DEVELOPING CRISIS — DEFICITS MATTER

JOINT STATEMENT

A Fiscal Crisis

A fiscal crisis is developing in the United States, and the risks of inaction are high. Without a change in current policies, the federal government can expect to run a cumulative deficit of $5 trillion over the next 10 years. Moreover, the fiscal situation will deteriorate markedly in the decades that follow, as the cost of the baby boomers' retirement and health care needs consumes a rising share of the economy and the budget. Deficits over the next generation will dwarf the already large deficits the nation faces in the decade immediately ahead.

Failing to address the growing imbalance between federal commitments and available revenues means squandering the best opportunity we will have to get our finances in order before the aging of America makes our fiscal situation far more difficult. It means our generation will bequeath to future generations spiraling debt that will shrink economic growth.

But instead of expressing alarm, many in Washington now argue that escalating deficits do not really matter, that they are self-correcting, that they are unrelated to interest rates or future economic well-being, and that tax cuts will pay for themselves later by spurring economic growth. It would be wonderful if this were true. It is not.

There are no easy solutions to the fiscal challenge facing the nation. But policymakers — and the public — must begin now to confront honestly the difficult trade-offs that are required to restore a sustainable fiscal policy.

The Likely Budget Path Under Current Policies

The baseline budget estimates issued by the Congressional Budget Office in August 2003, which cover the period 2004-2013, project a deficit of $480 billion in 2004 and a cumulative 10-year deficit of $1.4 trillion. As CBO itself is quick to point out, however, the "official" baseline projection is constrained by rigid rules. These rules lead the baseline to understate, by large amounts, the likely size of future deficits. For example:

- Official projections do not reflect the future costs of a number of policies currently in effect. In particular, CBO is required to assume that all tax cuts enacted since 2001 will simply be allowed to "sunset," or expire, as called for by current law.

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- Nor do the official projections include the costs of new policies that are very likely to be enacted, such as a Medicare prescription drug benefit.

- Official projections also assume that appropriations will grow only at the rate of inflation over the next 10 years. Yet there certainly will be faster growth in such areas as defense and homeland security, and probably in some domestic programs as well.

Our organizations have prepared an alternative, more realistic, projection that we believe provides policy makers with better insight into where current policies are leading us. Our projection starts with the official CBO baseline, but adjusts it to reflect a more realistic set of policy outcomes.

Specifically, it assumes that the expiring tax cuts will be extended and relief from the Alternative Minimum Tax continued, that a prescription drug benefit costing $400 billion over ten years will become law, that the Administration's multi-year defense plan will be fully funded, and that domestic non-defense programs will keep pace with inflation and population growth.

The figures below represent our joint estimate of the budget path the government now is following. They show a deficit of more than $500 billion in 2004 and a cumulative 10-year deficit of $5 trillion. They also show a non-Social Security deficit of $687 billion in 2004 and a 10-year non-Social Security deficit of $7.4 trillion.

Adjustments to CBO Deficit Projections
(in billions of dollars)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Total
CBO August projections	**-480**	**-341**	**-225**	**-203**	**-197**	**-170**	**-145**	**-9**	**161**	**211**	**-1,397**
Tax cut extension	3	-60	-117	-127	-128	-136	-141	-287	-413	-447	**-1,854**
AMT relief		-11	-31	-43	-56	-71	-90	-109	-129	-154	**-693**
Prescription drug plan	-7	-10	-34	-42	-49	-55	-62	-68	-75	-88	**-491**
Defense, homeland security, & international	-40	-13	-9	-9	-15	-29	-41	-60	-86	-92	**-395**
Domestic appropriations except homeland security	1	-1	-5	-9	-13	-18	-23	-29	-35	-42	**-172**
Resulting deficit projections	**-523**	**-436**	**-423**	**-433**	**-457**	**-478**	**-501**	**-561**	**-577**	**-611**	**-5,002**

Notes: Negative values indicate deficits or costs that increase the deficit, while positive values reflect surpluses or policies that reduce the deficit. All figures include both the policy's direct costs and the extra interest it causes.

Rather than cutting the deficit in half in five years, as projected in CBO's baseline, the more likely path under current policies is an *increase* in the deficit over this period. Policy makers could — and badly need to — alter this path. But we do not yet see any evidence that they will.

How Does This Level of Deficits Compare with Past Deficits?

If these budget projections are borne out, the coming decade is likely to rank as the most fiscally irresponsible in our nation's history.

Even assuming the economy recovers and the costs of operations in Iraq shrink, we project that the federal government is on track to run sustained deficits equal to about 3.4 percent of the size of the economy. With only one exception, the federal government has never run deficits of this size except during times of global depression or full-scale war. The exception is the 1980s and early 1990s, when deficits averaged roughly 4 percent of the size of the economy.

The fact that the federal budget ran large deficits in that period offers little comfort because the situation in the 1980s and early 1990s was very different from the situation today. For one thing, as the Cold War drew to a close, Congress was able to shrink the deficit through large reductions in discretionary spending, particularly for defense. A parallel situation is not present today. More importantly, in the 1980s, the retirement of the baby-boom generation was still a generation away. Today, with the first boomers due to start collecting Social Security in five years, it is just around the corner. We consequently face a much more difficult fiscal situation than we did twenty years ago.

Moreover, when large deficits emerged in the 1980s, a national consensus quickly developed that these deficits were not self-correcting and needed to be addressed. Policy makers worked hard for 15 years to craft revenue-raising and expenditure-reducing measures to erase the deficits. No similar consensus exists today. We run the risk that we will waste this decade's opportunity.

This Is Not a Self-correcting Problem

If the current budget deficit were a self-correcting or passing phenomenon, it would not be a cause for alarm. But that is not the case.

If the tax cuts are extended, federal revenues in the coming decade will be lower, as a share of the economy, than their average level in any of the last three decades. And while federal expenditures are not at historically high levels today as a share of the economy, they will be once the baby-boom generation retires in large numbers. At that point, expenditures will climb to higher levels, as a share of the economy, than in any of the last four decades, while the revenue base will have shrunk to lower levels. The resulting imbalances will be very large. For example, under current policies, by the 2020s, the cost just of mandatory programs and interest payments on the debt will exceed projected revenues even before expenditures for appropriated programs, including defense, are taken into account.

The long-term deficits we are facing are of such magnitude that the economy cannot possibly "grow out of them," a message that comes across clearly in the reports of institutions such as the General Accounting Office and the Congressional Budget Office. For economic growth to close the gap, productivity would have to increase — for decades on end — at levels far above what GAO, CBO, Administration economists, or private economists believe will occur.

Even over the short term, strong economic growth alone will not be enough to close the gap. CBO's projections already assume a robust recovery in 2004, with real GDP growing at 3.8 percent, and an average annual growth rate of 3 percent through 2013. (These CBO economic projections are the ones we have used in developing the $5 trillion deficit estimate.) Economic growth is unlikely to be significantly higher than this. Annual real GDP growth has averaged 3 percent since 1970.

To get a sense of the magnitude of the deficits the nation is likely to face without a change in policies, consider that even with the full economic recovery that CBO forecasts and a decade of economic growth, balancing the budget by the end of the coming decade (i.e., in 2013) would entail such radical steps as: raising individual and corporate income taxes by 27 percent; or eliminating Medicare entirely; or cutting Social Security benefits by 60 percent; or shutting down three-fourths of the Defense Department; or cutting all expenditures other than Social Security, Medicare, defense, homeland security, and interest payments on the debt — including expenditures for education, transportation, housing, the environment, law enforcement, national parks, research on diseases, and the rest — by 40 percent. Beyond the next decade, the trade-offs become even more difficult. These mounting deficits represent a daunting challenge that we are yet to confront.

What Happened to the Surplus?

Less than three years ago, the Congressional Budget Office (CBO) projected cumulative budget surpluses of $5.6 trillion for the 2002-2011 horizon. Our assessment of current budget policy indicates the nation is now poised to run deficits over this entire period, totaling about $4.4 trillion. (The $5 trillion figure referred to above is for the period 2004 – 2013.) After adjustments to ensure comparability, this change represents a negative swing in the nation's expected fiscal position of more than $9 trillion in just 32 months.

This deterioration comes from a mix of legislative changes (tax cuts and spending increases), a weaker economic outlook, and changed assumptions about such matters as the level of revenue generated by a given level of economic activity. The fact that no single factor caused the rapid disappearance of budget surpluses means no single factor can be counted on to turn things around.

Overall, tax and spending legislation enacted since 2001 accounts for 65 percent of the more-than-$9 trillion decline in the surplus for 2002 – 2011 under our projections. Changed assumptions account for the remaining 35 percent. More than one-third of the decline can be attributed to tax cuts, with this share rising over time. Nearly one-third of the decline is attributable to new expenditures, the majority of which are for defense and homeland security.

Over the past three years, the economy has grown more slowly than anticipated, and this has had an important effect on the budget in the short term. But large deficits are expected to persist long after the economy has made a full recovery from the 2001 recession. In other words, our deficit problem is structural, not cyclical. It results from a growing mismatch between what Americans are scheduled to pay to government and what they expect government to deliver in return.

Ramifications of Large Chronic Deficits for Future Increases in Income and Living Standards, and for Government Finances

Deficits matter. Over the long term, large, persistent deficits absorb national savings and crowd out productive investment. They put upward pressure on interest rates. They reduce the fiscal flexibility to deal with unexpected developments. And they raise the cost of servicing the national debt.

The current deficits are providing some stimulus to today's weak economy. But if sustained over time at the levels projected, deficits ultimately will lead to slower growth and a lower standard of living. If they are financed by borrowing from domestic lenders, the economy will have less money available for investing in plant and equipment, education for our children and training for our workers, research and development, and the other building blocks of our economic future. If they are financed by foreigners, we will owe a mushrooming debt to the rest of world, with growing interest costs that must be serviced every year. However they are financed, sustained large deficits reduce our future standard of living. If left unchecked, the long-term deficits described in this report could leave future generations less well-off than their predecessors for the first time in American history.

One of the most worrisome effects of today's large projected deficits is that they threaten to squeeze out important government programs — for the young and the old, for infrastructure and education, for national defense. These deficits would drive up the national debt by large amounts. As a result, an increasing share of tax collections would have to be diverted from supporting needed programs to paying interest on the mounting debt. Under current policies, interest costs — which currently consume less than nine percent of tax revenue — will consume 15 percent of federal revenue by the end of the decade and much more in subsequent decades. We project that interest payments on the debt will reach $470 billion a year by 2013.

What Do These Deficits Mean for Future Generations?

A major demographic shift is nearly upon us. We are an aging society, and as we age, the declining share of the population that is made up of workers will have to support the retirement and health needs of the growing wave of baby-boom seniors. This demographic shift will place unprecedented strains on the budget.

After the baby boom generation starts to retire in 2008, the combination of demographic pressures and rising health care costs (which are affecting the public and private sectors alike) will result in the costs of Medicare, Medicaid, and Social Security growing faster than the economy. We project that by the time today's newborns reach 40 years of age, the cost of these three programs as a percentage of the economy will more than double — from 8.5 percent of GDP to over 17 percent.

As a nation we have yet to confront the difficult trade-offs this will require. Certainly, there is wide room for debate on how best to ease the fiscal challenge that future generations will face.

But adding to that challenge by running up the national debt over the next decade is not among the responsible options.

Because the demographic transition is entirely predictable, we have no excuse for failing to account for it in our fiscal policies. If we were to save more now — in part by running budget surpluses once the economy recovers — we could generate the resources to help meet part of the "age wave's" future cost. But instead, we are squandering the opportunity to do so by pursuing policies that will run up more debt just as we are nearing the start of this new and difficult period. In the end, our children will have to face higher taxes, reduced public services, or both. But if we wait until the crisis is upon us, the solutions will be more draconian.

Restoring Fiscal Responsibility

For 20 years, there was bipartisan consensus in Washington that large and rising budget deficits were damaging. The budget debate — from the Tax Equity and Fiscal Responsibility Act of 1982 to Gramm-Rudman in 1985, the Budget Agreement of 1990, the 1993 Clinton budget proposal, and the 1997 Balanced Budget Agreement — was often rancorous, but it was based on the shared goal of shrinking the large, damaging deficits that loomed.

Today, that consensus has evaporated. The absence of responsibility is widely shared: the Administration fails to acknowledge the relationship between its fiscal choices and our long-term future; Democratic alternatives tend to ignore the long-term mismatch between our commitments for retirement, health, and security on the one hand and the revenues available to pay for them on the other hand.

The Center on Budget and Policy Priorities, the Committee for Economic Development, and the Concord Coalition are joining to issue this call to action. Our failure to act responsibly on federal deficits is endangering our future and our children's future.

Today, as we are about to enter a new budget year, we urge in the strongest possible terms that our leaders begin work on a realistic plan for putting the nation's fiscal house in order as the economy fully recovers. All options should be on the table. Such a plan, to be credible, must also include budget enforcement mechanisms — at a minimum, the "pay-as-you-go" rule for taxes and entitlements that proved effective in enforcing fiscal discipline through much of the 1990s. Finally, as a first step, Congress and the President must act immediately to stop "digging the hole deeper."

September 29, 2003

MID-TERM AND LONG-TERM DEFICIT PROJECTIONS

Estimates and Projections Underlying the Joint Statement of September 29, 2003, issued by the Center on Budget and Policy Priorities, the Committee for Economic Development, and the Concord Coalition[1]

This analysis is presented in two sections. In the first, we examine federal deficits during the mid-term period — the next ten years, fiscal years 2004 through 2013.[2] In the second, we examine the long-term picture, looking out several decades to the time when the retirement of the "baby boom" generation will be complete and the consequent pressures on the budget and on the working-age population will be far greater than they are today.

I. The Mid-Term Picture: 2004-2013

In August, the Congressional Budget Office projected that the deficit would reach $480 billion in 2004 but decline thereafter and become a surplus by 2012. Over the ten-year period, CBO projected a net of $1.4 trillion in deficits.

Table 1

Effects on Projected 10-Year Deficit of Current Policy Path (in trillions of dollars)	
CBO August Projections	**-1.4**
Tax Cut Extension	-1.9
AMT Relief	-0.7
Prescription Drug Plan	-0.5
Defense, Homeland Security and International Spending	-0.4
Other Domestic Appropriations	-0.2
Resulting Deficit Projections	**-5.0**

May not add due to rounding. All amounts include associated interest costs.

In projecting deficits, CBO follows mechanical "baseline" rules that do not allow it to account for the costs of any prospective tax or entitlement legislation, no matter how likely the enactment of such legislation may be. This results in unrealistic, and overly optimistic, projections. For this and other reasons, CBO itself explicitly warns that its baseline projections should *not* be viewed as a prediction of policy outcomes. Nor should the CBO estimates be viewed as a projection of the budget path that we are currently following under realistic rather than mechanical assumptions.

A more plausible projection of current policy, which our three organizations have jointly prepared, shows deficits totaling $5.0 trillion over the ten-year period. Under this projection, deficits never fall below $420 billion, reach $610 billion — or 3.4 percent of Gross Domestic Product — by 2013, boost the publicly held debt to 51 percent of GDP by 2013, and cause federal interest payments to hit $470 billion, or 15 percent of revenues, in that year.

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[1] The calculations, tables, and figures in this document are based primarily on data provided by the Congressional Budget Office.

[2] Except when referring to the date of events, all years in this analysis are fiscal years.

Table 2

Adjustments to CBO Deficit Projections (in billions of dollars)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Total
CBO August projections	**-480**	**-341**	**-225**	**-203**	**-197**	**-170**	**-145**	**-9**	**161**	**211**	**-1,397**
Tax cut extension	3	-60	-117	-127	-128	-136	-141	-287	-413	-447	**-1,854**
AMT relief		-11	-31	-43	-56	-71	-90	-109	-129	-154	**-693**
Prescription drug plan	-7	-10	-34	-42	-49	-55	-62	-68	-75	-88	**-491**
Defense, homeland security, & international	-40	-13	-9	-9	-15	-29	-41	-60	-86	-92	**-395**
Domestic appropriations except homeland security	1	-1	-5	-9	-13	-18	-23	-29	-35	-42	**-172**
Resulting deficit projections	**-523**	**-436**	**-423**	**-433**	**-457**	**-478**	**-501**	**-561**	**-577**	**-611**	**-5,002**

Notes: Negative values indicate deficits or costs that increase the deficit, while positive values reflect surpluses or policies that reduce the deficit. All figures include both the policy's direct costs and the extra interest it causes.

In producing this more realistic projection of the path we are currently on, we adopt all of CBO's economic and technical assumptions. We make certain adjustments to CBO's assumptions about federal budget policy. (See Table 1 on the previous page and Table 2 above.) In its August report, CBO displays separately the costs of certain budget policies not reflected in its official baseline. For example, CBO displays estimates of the costs of extending tax cuts scheduled to expire, providing AMT relief, and providing a prescription drug benefit. In each of those cases, we use CBO's estimates. These three items by themselves bring the cumulative ten-year deficit to $4.4 trillion. CBO also estimates the cost of allowing appropriated programs — both defense and non-defense — to continue their growth at the rate of the last few years. This would raise the cumulative ten-year deficit from $4.4 trillion to $7.8 trillion. We assume somewhat slower growth for appropriated programs, and we remove the cost of treating this year's Iraq war supplemental as a recurring annual expense, which is why we come to a total of $5.0 trillion. The adjustments we make to CBO's official baseline are as follows.

Routine "tax extenders:" CBO's projection of revenue collections is based on current tax law, regardless of whether provisions that are scheduled to expire are virtually certain to be renewed. We adjust the CBO baseline to account for the extension of these provisions. Many tax provisions that are scheduled to expire have strong bipartisan support, have repeatedly been extended in the past, and are virtually certain to be extended again.

The 2001 tax cut: CBO's projections likewise assume that the large 2001 tax cut will expire on schedule in 2010. The President has proposed making that tax cut permanent, and the Congressional budget resolution adopted this year also assumes the extension of these provisions. We assume these provisions will be extended.

The 2003 tax cut: The tax-cut legislation enacted in May is advertised as costing $350 billion through 2013. That figure assumes, however, that seven of the eight tax-cutting provisions in that legislation will expire, or "sunset," in 2004, 2005, or 2008. If these expirations are removed and the tax cuts remain in place — a plausible assumption given that the President and Congressional Leadership have expressed their desire to extend most or all of the provisions — the costs of the new tax-cut legislation will grow far beyond the official estimate of $350 billion, for a total cost exceeding $1 trillion through 2013. We assume these provisions will be extended.

The costs from the routine extension of expiring tax breaks, the extension after 2010 of the 2001 tax-cut law, and the removal of artificial sunsets in the new tax-cut law produce a combined total of $1.56 trillion in additional revenue losses, as CBO shows in its August report.[3] With interest, such extensions would add $1.85 trillion to the 10-year deficit, as Table 2 indicates.

The Alternative Minimum Tax: Congress and the Administration have made clear that they support further efforts to provide relief from the individual Alternative Minimum Tax. Such relief was enacted in the 2001 tax legislation and made more generous in the 2003 tax cut, but expires after 2004. Virtually all observers consider the continuation of AMT relief inevitable. Without such relief, the number of taxpayers subject to the AMT would explode from about 2½ million today to 33 million in 2010 and almost 42 million by 2013, if the 2001 tax cut is extended past its 2010 expiration date.

The Administration has said it plans to address the AMT issue in 2005. Some policymakers call for the complete repeal of the AMT. CBO's August report shows that indexing the parameters of the AMT for inflation would cost about $580 billion through 2013, or about $690 billion counting interest, and we use that figure in our analysis.[4] Even under this policy, the number of tax filers subject to the AMT would rise from its current level of less than 3 million to more than 6 million, or 4 percent of all tax filers, by 2013.

National Defense, Operations in Iraq, the War on Terrorism, and Homeland Security: CBO's baseline projections assume discretionary (or non-entitlement) programs will continue to be funded at 2003 levels, adjusted only for inflation. This causes the baseline projections to overstate defense costs in some respects and to understate them in other respects.

We produce a more plausible projection of costs in this area by taking several steps, shown in Table 3. First, we remove from CBO's August baseline the mechanical annual repetition of the April 2003 supplemental appropriation for defense and international affairs. Second, we add to the resulting baseline the amount needed to bring the defense path to the levels in the President's budget, as estimated in March by CBO. Third, we add amounts to reflect CBO's estimate of the additional costs needed to cover a) Iraq, Afghanistan, and the war on terror, and b) full funding of the Pentagon's "Future-Year Defense Plan" for weapons procurement and operations and support. Finally, we add a small amount to reflect both inflation

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[3] Table 1-6, "The Budget and Economic Outlook: Update," CBO, August 26, 2003. Note that CBO's estimate, which we incorporate in our figures, assumes that the business depreciation tax cut in the 2003 tax law will be extended before it expires, along with all other recent tax cuts. There may be less pressure for extension of this tax break in its entirety than for extension of other recent tax cuts. However, the depreciation tax break is widely supported by the business community, was supported on a bipartisan basis when first enacted in 2002, and is scheduled to expire in an election year, all of which lends support to the idea it will be extended, at least to some degree or in some form.

[4] CBO table 1-6, op. cit. CBO estimates that the $580 billion cost for indexing the AMT would be about $180 billion smaller — $400 billion through 2013 — if the 2001 and 2003 tax cuts were not extended. Stated differently, CBO estimates that if the AMT were currently indexed for inflation, the cost of extending the 2001 and 2003 tax cuts would be not $1.85 trillion, as shown in Table 2, but $2.06 trillion, including interest.

and population growth in the homeland security programs (see discussion of domestic appropriations).

Step #1: CBO's August baseline projects that the supplemental appropriations bill enacted this April to fund the war in Iraq will be repeated in each of the next ten years, instead of treating the costs of the military engagement as a more temporary phenomenon. If we assume that the costs of Iraq will not be repeated every year for the next ten years, CBO's baseline projection of defense and international expenditures needs to be reduced by about $730 billion over the ten-year period.

Table 3

Adjustments for Defense, Homeland Security, and International Programs

(ten-year totals in billions of dollars)

Remove repetition of April supp (defense/ international)	-730
Bush February budget request	+210
Future-Year Defense Plan	+500
Future Iraq and related costs	+330
Homeland security	+10
Total without interest	+330
Total including interest	+400

(may not add due to rounding)

Step #2: The resulting baseline, after we back out the mechanical repetition of the April supplemental appropriation for Iraq, is too low for several reasons. One reason is that the resulting baseline does not reflect the cost of the increases the Administration's FY2004 budget proposes in the structure of the armed forces and the military hardware that the armed forces use. We incorporate those requested costs.

Step #3: In addition, analysis by CBO has found that the President's budget does not reflect the full costs of the Administration's multi-year defense plan. Also, the President's February budget does not include any funds after 2003 for operations in Iraq or Afghanistan or for the international war on terror. (For example, the President's recent request for $87 billion in additional funding for these purposes in fiscal year 2004 is not reflected in the Administration's February budget or in the July Mid-Session Review.)

In July, CBO published estimates of both the added costs for weapons procurement and operations and support levels that the Defense Department has planned, and the cost of operations in Iraq and Afghanistan and the war on terror. The Pentagon periodically publishes a "Future-Year Defense Plan," which essentially serves as the Administration's multi-year defense blueprint, and CBO regularly compares the specifics of this plan with the amount shown in the Administration's budget. CBO recently published an analysis in which it found that the Administration's budget does not reflect the full costs of the plan.

CBO estimated the amount of the funding shortfall, and the Center on Strategic and Budgetary Assessments then converted CBO's estimate of this shortfall in funding (or "budget authority") to a slightly smaller estimate of the shortfall in actual expenditures (or "outlays"). The shortfall totals $500 billion in expenditures over the next ten years, not counting interest.

As just noted, the Administration's February budget also does not include expected costs for the global war on terrorism, or any costs for operations in Iraq and Afghanistan after September 30, 2003. If the multi-year estimates of CBO and CSBA for these costs are accurate, expenditures for anti-terrorism and occupation efforts will add $330 billion over ten years, beyond the amounts reflected in the Administration's February budget.[5] (The $87 billion request for supplemental funding that the President announced on September 7 appears consistent with the CBO estimates. It would constitute the first increment of this $330 billion.)

Accounting for these various defense-related overstatements and understatements in the CBO baseline yields an estimate that defense-related expenditures will exceed CBO's baseline projection by $320 billion through 2013, not counting interest. If funding for homeland security also increases modestly above the 2003 level adjusted for inflation,[6] the total increase in this area will be about $330 billion. With interest, it comes to $400 billion over ten years.

Medicare Prescription Drugs: CBO projects entitlement costs based on current law, which does not include a Medicare prescription drug benefit. Leaders of both parties have promised to enact such a benefit and this year Congress approved a budget resolution calling for a prescription drug benefit costing $400 billion over ten years. The House and Senate have subsequently approved separate legislation costing almost that amount. We use the $400 billion figure in the budget resolution in this analysis, although there is reason to expect benefits and costs to be enlarged in future years.[7] With interest, the cost rises to $490 billion.

Domestic Appropriations other than Homeland Security: Finally, CBO projects that annually appropriated funding will grow only to cover inflation. Contrary to this assumption, in 11 of the last 15 years, funding for domestic appropriations has grown faster than inflation; in 10 of those years, it has grown faster than inflation *and* population growth combined. Although the Administration's budget and the congressional budget resolution assume that domestic appropriations will grow more slowly than inflation, the historical funding pattern may eventually reassert itself over the decade. Note also that the current baseline contains less funding for relief from natural disasters than is the historical average; this is an additional reason to expect domestic appropriations to exceed the level in the CBO baseline.

If domestic funding other than for homeland security grows with inflation and the increase in the U.S. population (rather than only with inflation) and thus stays even in real per-capita terms, expenditures for these programs will be approximately $180 billion higher over ten years than CBO's baseline currently shows, not counting interest. Partly offsetting this $180 billion increase is our assumption that the portion of the April Iraq supplemental appropriations bill that provides a subsidy to the airline industry is a one-time event. (CBO treats this like any other appropriation, assuming it will be repeated in each of the next ten years.) Our treatment of this item removes $30 billion in domestic expenditures from CBO's baseline. Our net increase in this category thus is $150 billion over ten years, or $170 billion counting interest. This may be a conservative assumption. In a recent analysis of the 10-year budget outlook, Goldman

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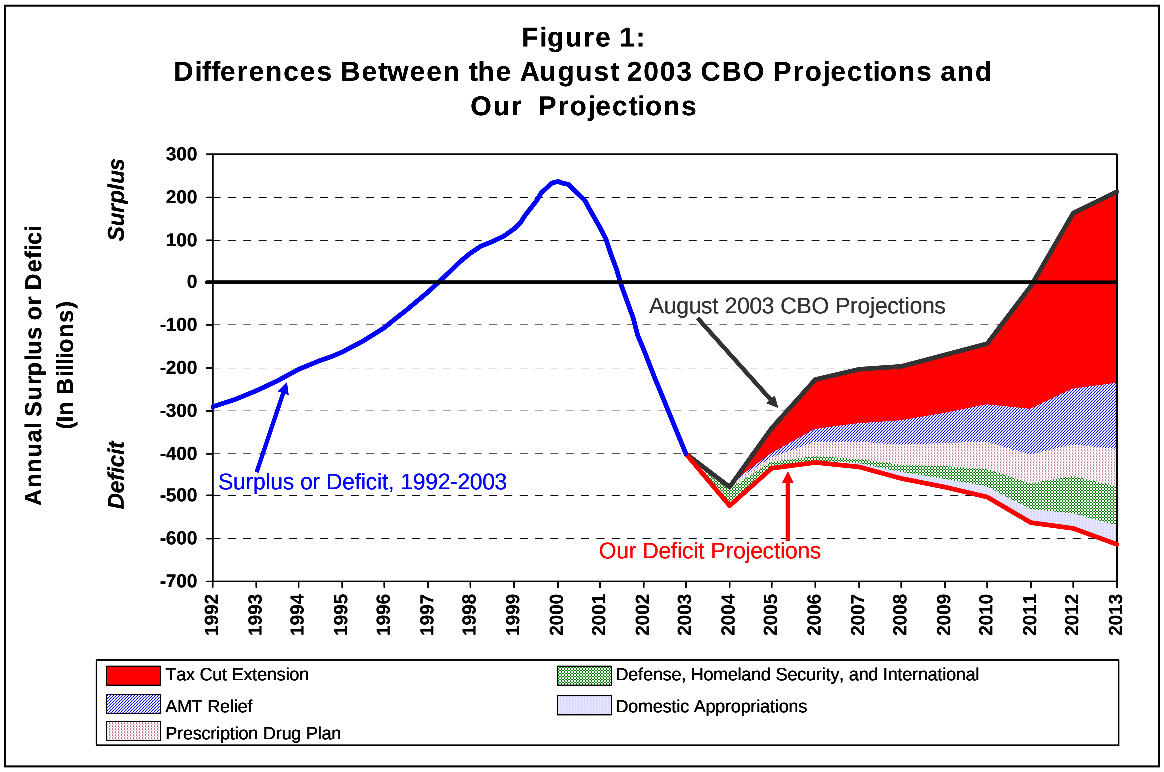
5 CBO, "The Long-Term Implications of Current Defense Plans: Summary Update for Fiscal Year 2004," July 2003, and Steven M. Kosiak, "Cost Growth in Defense Plans, Occupation of Iraq and War on Terrorism Could Add Nearly $1.1 Trillion to Projected Deficits," Center for Strategic and Budgetary Assessments, August 26, 2003.

6 Consistent with our general assumption for domestic discretionary programs, we assume that funding for homeland security will grow with inflation and population.

7 The year-by-year path of the prescription drug benefit in the congressional budget plan is shown in CBO, Table 1-6. See note 3.



Sachs assumes that non-defense appropriations will grow more than one percent per year faster than we assume.[8]

Comments on our Mid-Term Projection

Our adjustments to CBO's official baseline are not policy recommendations. Moreover, we do not view this projection as an "inevitable" path for fiscal policy. To the contrary, our purpose is to demonstrate that doing everything assumed in our baseline — without making any hard choices among popular initiatives — would be fiscally irresponsible.

The items not included in CBO's baseline are costly. Counting interest, they amount to $3.6 trillion over the decade (see Table 2) and raise deficits over the decade to $5.0 trillion. They would result in a publicly held debt of more than $9 trillion by the end of 2013. With the exception of a Medicare prescription drug benefit, the $3.6 trillion in additional costs can generally be viewed as representing *current policy* — tax policies and program policies that already apply to today's budget but that CBO does not project forward in some or all future years for technical reasons.

Our projections are far from being a "worst case" scenario. The policy adjustments we assume are for items that have strong political support and in some of these cases our estimates may underestimate costs. For example, if a prescription drug benefit of the type currently under discussion is enacted, the pressure to expand the benefit to cover a larger share of the costs of drugs may become intense. In addition, the Administration and the Congressional Leadership are likely to seek to enact a number of additional tax cuts not reflected in our analysis; either the

[8] Ed McKelvey, "The Federal Deficit: a $5.5 Trillion Red Elephant," Goldman Sachs, September 9, 2003.

full House of Representatives or the House Ways and Means Committee already has passed tax-cut measures that would result in $249 billion in additional revenue losses over the next ten years, beyond those reflected in our analysis. Finally, the CBO/CSBA estimate of the costs of operations in Iraq and Afghanistan assume these costs will diminish each year and end before 2008. That may or may not prove to be the case.

There is also reason to believe that our assumption regarding overall discretionary spending is on the conservative side. We project that total discretionary spending (defense and non-defense) will gradually decline from 8.3 percent of GDP in 2004 to 7.0 percent by 2013. This is below the 7.5 percent average level of the past 15 years. Other assumptions that result in higher spending are entirely plausible. If discretionary spending keeps pace with economic growth through 2013, the deficit would be $1.7 trillion greater than we project. Even using the GDP growth assumption adjusted to remove the recurring effects of the 2003 supplemental yields a higher average level of discretionary spending (7.8 percent of GDP) than we assume in our projection. Yet neither of these assumptions results in spending that is "off the charts." Total discretionary spending routinely topped 8 percent of GDP up until the mid 1990s.

Goldman Sachs has recently updated its own projection of future deficits, drawing on CBO's August projection and other information. Goldman Sachs now projects cumulative deficits over the ten-year period 2004-2013 at $5.5 trillion, one-half trillion above the $5.0 trillion ten-year total we show. Some of the difference results from the fact that Goldman Sachs takes a more pessimistic view of the near-term economy than CBO. We adopt CBO's economic assumptions and do not assume any negative economic feedback from running substantial deficits over the next 10 years. Goldman Sachs also projects higher levels of both defense and domestic appropriations than we do.[9]

How Big Are The Projected Deficits?

The deficits we project over the next decade are large by any standards. They average 3.5 percent of GDP over that period, a period that CBO projects to be one of economic health. This figure — 3.5 percent of GDP — may not be immediately meaningful to many people. Here are several ways to get a sense of its size.

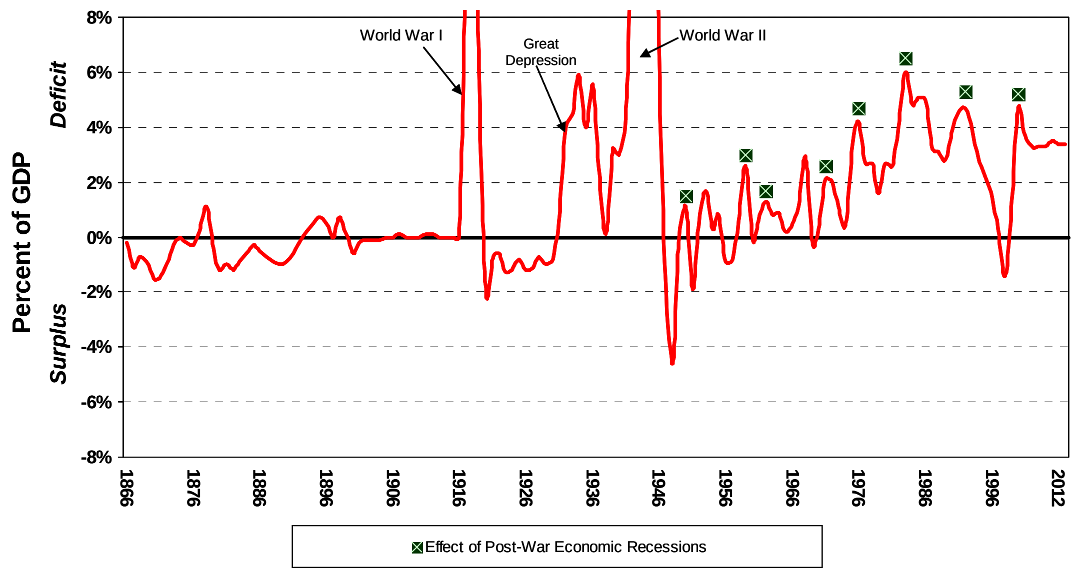
- In the current year, a deficit equal to 3.5 percent of GDP would be $374 billion. This is equivalent to $2,690 per household.

- A deficit of $374 billion is almost seven times as large as the entire budget for the Department of Education, or the Department of Veterans Affairs, or the Department of Transportation. It is 15 times as large as the budget for the Department of Homeland Security, some 25 times NASA's budget, and 47 times the budget for environmental protection.

- To balance the budget by 2013 would require raising individual and corporate income taxes by 27 percent; cutting Social Security by 60 percent; cutting defense by 73 percent; or cutting all programs *other than* defense, homeland security, Social Security, and Medicare by 40 percent.

[9] McKelvey, op. cit.

Figure 2:
Post-Civil War Deficits in Relation to the size of the Economy

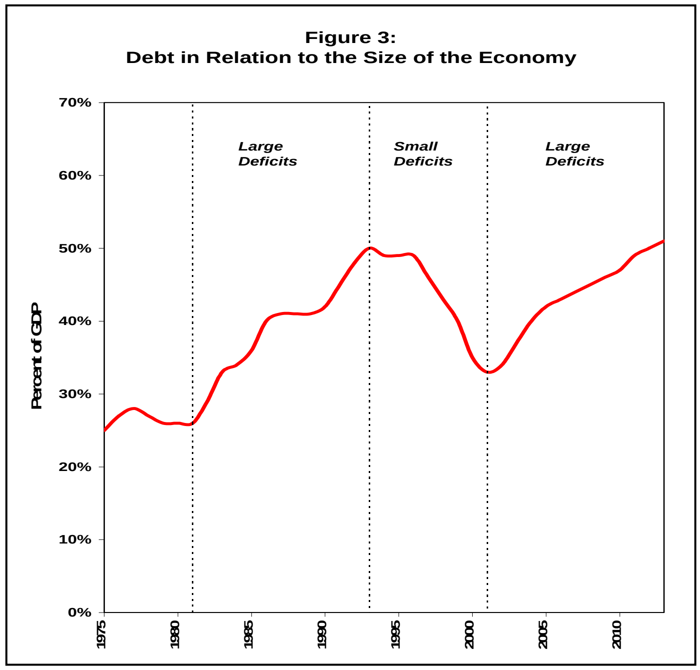


Large and Small Deficits

This raises a related question: Are deficits that average 3.5 percent of GDP large by historical standards? It goes without saying that the costs of major wars must be financed in part by borrowing. Experience and economic theory have also shown that during periods when the economy is operating well below normal, and especially during very deep recessions, borrowing can provide temporary stimulus exactly when it is most needed, doing more good than harm. But wars and recessions are the exceptions. How about periods of peace and prosperity? In fact, there has only been one period in the more-than-200-year history of this nation in which we have run sustained deficits at or near this level during a time of peace and prosperity. That occurred from 1984 through 1990. (See Figure 2.) The deficits that emerged at that time were considered so unacceptable that there was bipartisan consensus that taxes had to be increased and spending reduced in response. Moreover, we are much closer today to the exploding budgetary costs resulting from the baby-boom generation's retirement than we were in the 1980s and early 1990s.

Is there a meaningful way to differentiate a large from a small deficit? The answer is yes. All deficits cause the publicly held debt to grow, but small deficits allow the debt to grow more slowly than the economy and hence to shrink as a share of the economy. When the debt shrinks as a share of the economy (when the debt/GDP ratio declines), more resources are available for capital investments to raise living standards. In addition, the cost of paying interest on that debt generally shrinks, too, as a share of the economy or of revenues. The debt therefore becomes a shrinking rather than a growing burden on future society and current taxpayers.

In contrast, large deficits cause the debt to grow faster than the economy, which makes them ultimately unsustainable. Figure 2 displays deficits as a share of GDP since 1865. Only once during our nation's history have we seen sustained, large deficits in a period of peace and prosperity. This happened in the 1980s, after which difficult deficit-reduction programs were enacted. We are now on a course of rising debt. To keep debt from growing faster than the economy, deficits must not exceed 1.8 percent of GDP over the next ten years. Our projections show deficits averaging twice this level. Given the explosion of budget costs that lies just ahead when the baby boomers retire, our organizations believe we must adopt policies that will substantially *reduce* the ratio of debt to GDP during this decade (i.e., do much better than holding deficits to 1.8 percent of GDP in the decade ahead).



With large deficits, the debt-to-GDP ratio rises, productivity-enhancing capital investments are crowded out, and interest costs eat up an ever-increasing share of revenues. Less revenue remains available to pay for federal programs of any kind (from Social Security to education to defense) because more revenue is diverted to paying for interest on the debt. Over time, large deficits cannot be sustained. Nations, like individuals, simply cannot have their debt continually rise faster than their income. At some point, their creditors may cut them off, and before that point, creditors will insist on higher interest rates. During the current decade, before the baby boom generation retires, there is little excuse for persistent, large deficits once the economy recovers.

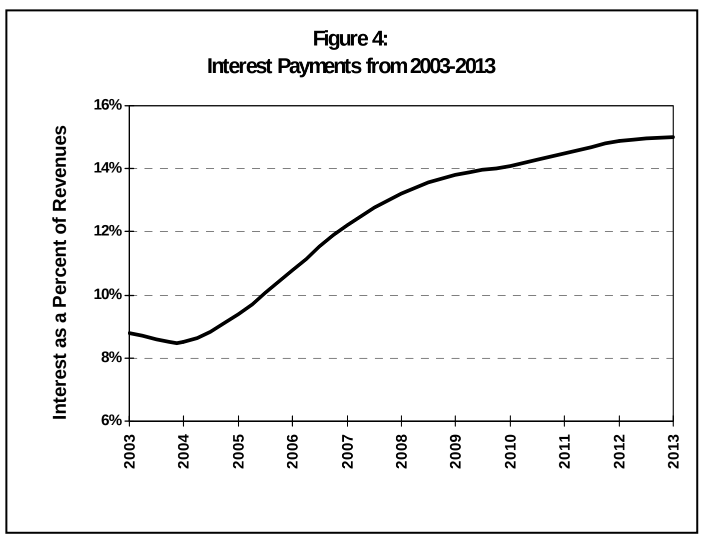


Figure 3 shows the debt as a share of the economy since the end of World War II. From 2004 on, the figures reflect our projections. As a society, we should now be reducing the debt-to-GDP ratio to prepare for the economic and budgetary burdens of the baby boomers' retirement. Instead, a rising debt burden is apparent, which also results in higher interest costs. The burden of interest payments on the national debt generally declined during the previous decade and has continued to decline recently as the recession and the Federal Reserve have pushed interest rates to unusually low levels. But when interest rates rebound to more normal levels, as CBO projects they will when the economy recovers, the large deficits and growing debt will cause a mounting interest burden. Our projections show that interest payments, measured as a share of total federal revenues, are expected nearly to double over the coming decade, rising from 8.5 percent of revenues in 2004 to 15.0 percent of revenues by 2013.

Comparable Projections

As discussed above, we have adjusted CBO's August 2003 baseline to make its policy assumptions more realistic. In January 2001, CBO projected a $5.6 trillion surplus over the ten-year period 2002-2011. To use that projection as a basis for comparison, we need to make similar adjustments to ensure comparability in it, as well. Doing so reduces the surpluses reflected in the January 2001 projection by $600 billion. (These adjustments result in a reduction of $0.1 trillion for AMT relief, $0.1 trillion for extending expiring tax provisions, and $0.4 trillion to reflect the assumption that appropriated programs will grow in accordance with inflation and population growth. After making these adjustments for comparability purposes, the difference between the adjusted surpluses projected in January 2001 and the deficits we project now equals $9.3 trillion over ten years from 2002-2011.

How Did These Deficits Come About?

In January 2001, CBO's baseline projection showed surpluses cumulating to $5.6 trillion over the ten-year period 2002-2011. Since that time, the budget world has turned on its head. Over the same ten-year period, we now foresee deficits totaling $4.4 trillion.[10]

From a $5.6 trillion surplus to a $4.4 trillion deficit is a swing of $10.0 trillion. On a comparable basis, however, the deterioration is $9.3 trillion, not $10.0 trillion (see box). A deterioration of $9.3 trillion in the budget outlook over a period of 32 months is remarkable. What are its components? They are shown in Tables 4 and 5 and discussed below.

Reestimates. The economic assumptions and budget models that CBO employed in January 2001 have proven to be too optimistic. In January 2001, CBO did not foresee the recession that was a few months off. The recession, however, is significant primarily in the short term. Over the mid term, the larger problem relating to reestimates seems to have been with CBO's budget models (or, to use CBO term, with its "technical assumptions"). The largest such error was that, for any given level of the economy, CBO's models predicted substantially more revenues than it now appears the government will actually collect. If the economy shrinks, or grows more slowly than expected, revenue collections are weaker, and CBO's models show that relationship. But CBO underestimated the amount by which revenues would drop once the revenue bubble of the late 1990s burst. Of the $3.3 trillion in downward reestimates for the 2002-2011 period between CBO's January 2001 projection and its August 2003 projection, CBO classifies only $0.7 trillion as economic, meaning that only that amount is directly attributable to a lower level of real economic growth (or lower levels of inflation and interest rates) than CBO projected in 2001. The remainder of the $3.3 trillion in downward reestimates relates to the budget models and primarily reflects lower revenue collections for reasons other than the direct effect of the economic slump.

Tax legislation. Of the overall $9.3 trillion deterioration we project in the deficit over the period 2002-2011, some $3.4 trillion — or 36 percent — stems from enacted or assumed tax legislation. Of that amount, $2.1 trillion has already been enacted; the remainder reflects CBO's estimates of the cost of extending the expiring tax provisions and AMT relief. By 2011, the

[10] The $5.0 trillion cumulative deficits we project if current policies are continued covers the period 2004-2013; over the period 2002-2011, our projection sums to $4.4 trillion.

share of the total budget deterioration attributable to tax cuts rises to 44 percent. (Note: These figures for the cost of tax legislation, like the figures for each of the components of the budget deterioration, include both the direct revenue losses and the associated increases in the cost of interest payments on the debt.)

Table 4

The Projected $9.3 Trillion Deterioration
(2002-2011 totals in trillions of dollars)

Economic reestimates	0.7	7%
Technical reestimates	2.6	28%
Tax legislation	3.4	36%
Rx drugs & other entitlement legislation	0.6	7%
Defense, homeland, & int.	1.8	20%
Domestic disc. Other than homeland	0.2	2%
TOTAL changes	9.3	100%

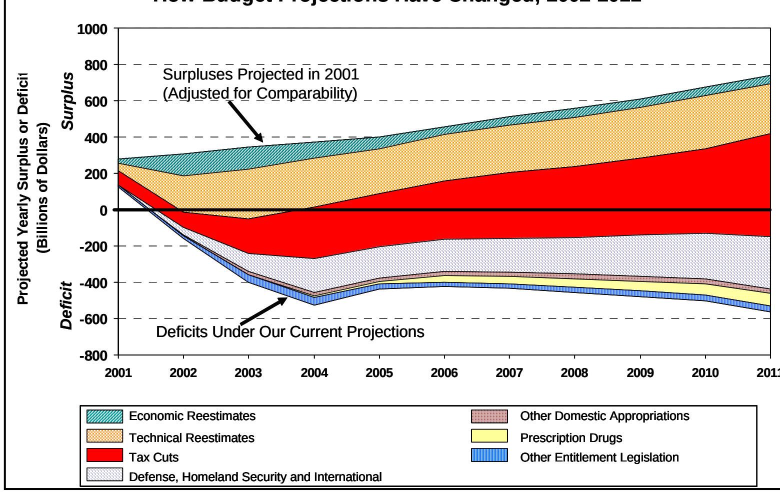
May not add due to rounding; all figures included associated debt service costs.

Prescription drugs and other entitlement legislation. Enacted entitlement increases plus an assumed prescription drug benefit account for $0.6 trillion of the $9.3 trillion deterioration in the ten-year budget picture. The bulk of this amount is for a prescription drug benefit. The enacted entitlement increases include the farm bill, the first airline bailout, compensation for victims of the terrorist attacks, two temporary provisions for extended unemployment benefits, temporary state fiscal relief, two bills increasing payments to Medicare providers, and "dual benefits" legislation for certain veterans.

Defense, Homeland Security, and International Affairs. Of the $9.3 trillion deterioration, more than $1.8 trillion, or about 20 percent, comes from enacted and assumed increases in funding for defense, homeland security, and international affairs. Of the $1.8 trillion, $1.6 trillion is for defense; practically all the rest is for homeland security.

Domestic Appropriations other than Homeland Security. Finally, an additional $0.2 trillion over ten years is attributable to increases in domestic "discretionary" programs other than for homeland security. This amount is one-ninth the increase in costs for defense, homeland security, and international programs.

Figure 5:
How Budget Projections Have Changed, 2002-2011



The Short Term vs the Mid Term. The components of the budget deterioration change over time. In the short term, the economic and technical reestimates are the more important factors. In the mid erm, the effect of the tax cuts continues to grow faster than the other factors. Some tax cuts phase in over time or do not take effect until later in the decade, such as the repeal of the estate tax or the elimination of the "Pease" and "PEP" provisions. Other tax cuts, such as the provision of relief from the AMT, grow faster than the economy in any case.

Table 5

Differences Between the 2001 CBO Projections (Adjusted for Comparability) and Our Current Projections for 2002-2011

(in billions of dollars)

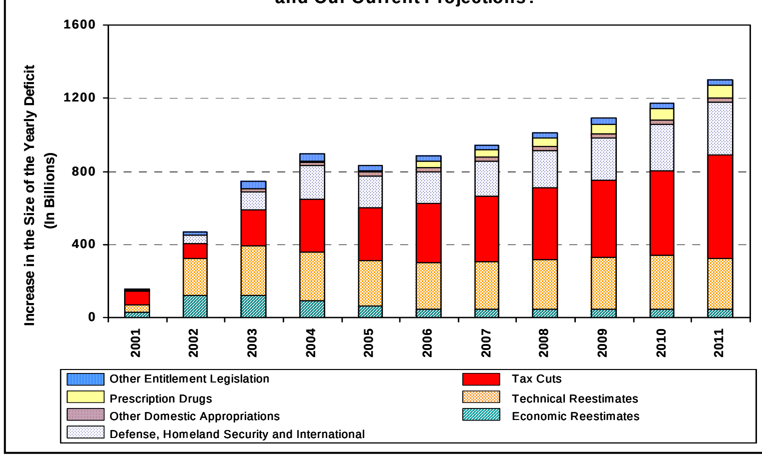
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2002-2011 Totals
CBO's 2001 surplus projection (adjusted for comparability)	281	307	346	374	398	458	511	556	611	673	741	**4,975**
Economic reestimates	-27	-120	-124	-90	-62	-44	-45	-48	-46	-46	-49	**-674**
Technical reestimates	-42	-201	-271	-269	-249	-254	-262	-269	-283	-292	-272	**-2,621**
Tax cuts, incl. extensions and AMT relief	-75	-83	-192	-287	-290	-324	-360	-391	-423	-466	-570	**-3,386**
Defense, homeland security, & international	-5	-44	-99	-184	-172	-177	-186	-204	-228	-251	-287	**-1,832**
Domestic appropriations except homeland security	3	-3	-16	-19	-21	-23	-23	-24	-25	-26	-24	**-204**
Rx drug benefits				-7	-11	-35	-42	-49	-55	-62	-68	**-328**
Other entitlements	-8	-14	-44	-42	-29	-25	-26	-29	-30	-31	-32	**-301**
Subtotal: changes from 2001 projection	**-154**	**-465**	**-746**	**-897**	**-834**	**-881**	**-944**	**-1014**	**-1089**	**-1174**	**-1302**	**-9,346**
Resulting deficits	**127**	**-158**	**-401**	**-523**	**-436**	**-423**	**-433**	**-457**	**-478**	**-501**	**-561**	**-4,371**

Notes: A negative value indicates a deficit or a cost that increases the deficit, while positive values reflect policies which create a surplus. All figures include both the policy's direct costs and the extra interest it causes.

The changing composition of the budget deterioration is illustrated by the two pie charts in Figure 7.

Revenue Losses vs Spending Increases. Some have attempted to characterize the exploding deficits as the result of a spending explosion. Spending has grown significantly and is projected to do so over the rest of the decade, primarily for defense but also for prescription drugs, homeland security, and to a lesser extent for other programs. Nevertheless, the increase in spending, while substantial, is smaller than the loss of revenues.

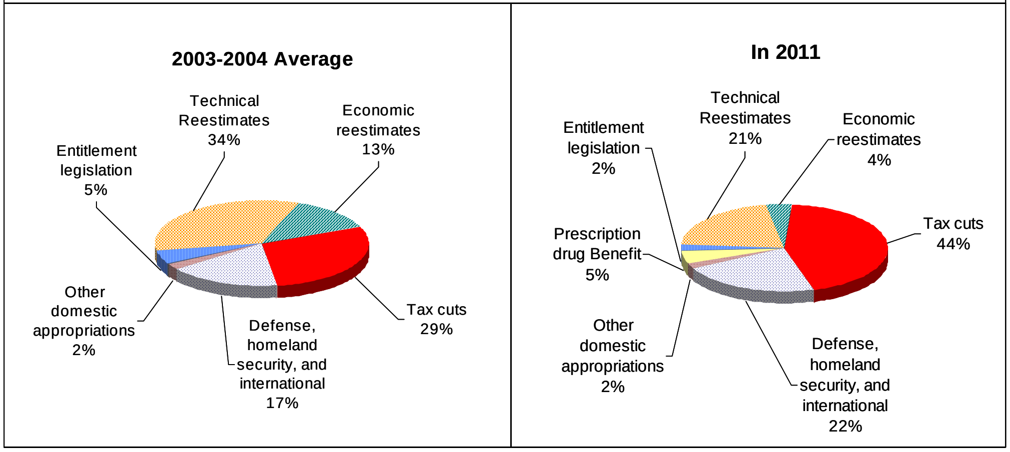
Figure 6:
What Has Caused the $9.3 Trillion Difference Between CBO's January 2001 Projections (Adjusted For Comparability) and Our Current Projections?



- As shown in Tables 4 and 5 above, the ten-year cost of tax cuts is greater than the ten-year cost of budget increases by 25 percent.

- The enacted and assumed tax cuts lose substantial revenue, as noted. In addition, CBO's economic and technical reestimates consist overwhelmingly of downward reestimates of revenues. Combining the tax cuts and the downward reestimates of revenues (and debt service costs), we see that three-quarters of the $9.3 trillion

Figure 7:
Short and Midterm Causes of the Differences Between CBO's January 2001 Projections (Adjusted for Comparability) and Our Projections



deterioration, or $7.0 trillion, comes from revenue losses; one-quarter comes from budget increases.

- Table 6 shows that, from 2004 through 2013, revenues will average around 17.2 percent of GDP. This is well below the 18.7 percent average over the previous business cycle, 1989 through 2000, which covers good times and bad and administrations of each party. In contrast, even with the sizable spending increases for defense and other programs built into our projections, spending will average 20.8 percent of GDP from 2004 through 2013, only somewhat higher than the 20.6 percent average of the years 1989 through 2000 (and significantly below its 22.2 percent average level in the 1980s). Relative to the period 1989 through 2000, and measured as a share of the economy, we expect revenues to be down far more than spending is up.

Table 6

As a Share of GDP

	89 - 00	04 - 13	change
Revenues	18.7%	17.2%	-1.5%
Spending	20.6%	20.8%	+0.2%
Deficits	-1.8%	-3.5%	-1.7%

May not add due to rounding

II. The Long-Term Imbalance Between Revenues and Expenditures

Without change in current policy, federal revenues are projected to fall far behind federal expenditures as the baby-boom generation retires. To examine the long-term budget trends — and the implications for federal fiscal policy of continuing down the current policy path — we use a long-term model of the budget and the economy. The basic structure of the model is the same as the structure of the model the General Accounting Office has developed and uses in its own long-term economic and fiscal simulations.[11]

[11] For further details, see General Accounting Office, *National Saving: Answers to Key Questions*, Appendix II, The Economic Model and Key Assumptions, June 2001, GAO-01-591SP. The simulations, assumptions, and results reported here are our own and not attributable to GAO.

Assumptions About the Federal Budget

As discussed in the earlier part of this paper, we have developed a 2004-2013 baseline. Our long-term model extends this baseline beyond 2013 by assuming that federal revenues and discretionary spending remain constant as a percentage of GDP in all years after 2013. (This is the standard approach that CBO and GAO use in making their long-term budget projections.) Revenues and discretionary spending are held at their projected 2013 levels of 17.8 percent and 7.0 percent of GDP, respectively. We also assume the continuation of current law for entitlement programs, plus the enactment of a prescription drug benefit in accordance with this year's Congressional budget resolution. Growth for the three major mandatory programs — Social Security, Medicare, and Medicaid — is derived from the Social Security and Medicare Trustees intermediate projections, as well as CBO assumptions. [12] In this manner, we can examine the long-term fiscal consequences of remaining on the current policy path.

The Results

The simulations conducted with the model produce stark and disturbing results:

- The federal government will begin running peace-time deficits of unprecedented and unsustainable size within the next 20 years.
- Deficits explode from 3.4 percent of GDP in 2013 to 7.8 percent of GDP in 2023. Deficits of that size are equivalent to the cost of all appropriated programs, including national defense, homeland security, education, transportation, environmental protection, and law enforcement.
- In relation to the economy, the federal government would be deeper in the red than at any time during the nation's history other than during wartime, and the fiscal situation would grow still worse in years after 2023.
- The simulation shows federal deficits reaching crushing levels of more than 20 percent of GDP by 2040, deficit levels not seen since the height of World War II. Unlike that of the 1940s, however, this fiscal crunch would not be temporary. Without a change in policy, these deficits would be sustained and would continue to mount, in part because of the spiral of growing debt. (Growing debt would lead to increases in interest payments, which in turn would further enlarge deficits and push up the debt to still higher levels.)

[12] Policymakers seem likely to provide a Medicare prescription drug benefit. Historically, expenditures for prescription drugs have grown faster than overall health care spending. Between 1980 and 2000, prescription drug expenses grew at an annual rate of 12.3 percent, compared with 8.7 percent for total health care expenditures. It is likely that this trend will continue for the foreseeable future and that outlays for a prescription drug benefit consequently would rise faster than other Medicare costs. For the purposes of this analysis, we assume that expenditures for a prescription drug benefit will grow faster than Medicare for the next three decades, and grow after that in tandem with Medicare's Supplementary Medical Insurance (SMI) program, at the rate that the Medicare trustees project SMI costs will rise.

The Fiscal Gap

We also measured the 75-year "fiscal gap" under a continuation of the current policy path. The long-term fiscal gap is defined as the (immediate and permanent) reduction in expenditures and/or increase in revenues required to hold the growth of federal debt to an economically sustainable rate over the next 75 years.[13]

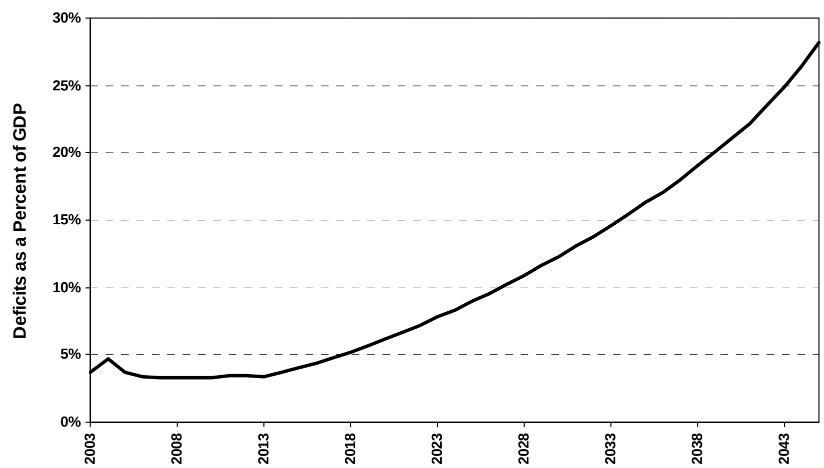
Table 7
Long-Term Simulation Illustrating the Unsustainability of Current Budget Policies (As a percent of GDP)

Fiscal Year	Unified deficit	Publicly held debt
2003	-3.7%	37%
2013	-3.4%	51%
2020	-6.2%	69%
2030	-12.3%	130%
2040	-21.1%	250%

Under our simulations, the "fiscal gap" stands at 6.5 percent of GDP. This means that to eliminate the fiscal gap, the federal government would have to immediately cut spending and/or raise taxes by 6.5 percent of GDP, or nearly $700 billion annually in the terms of today's economy.

No one, of course, proposes immediate policy changes of this enormous size, which would be both economically and socially disastrous. (The 75-year fiscal gap is about twice as large as the deficits projected over the next ten years, and, as described previously, shrinking this decade's projected deficits is in itself a difficult task.) But the large size of the fiscal gap is a good indicator of the enormous fiscal problem that lies ahead. It also indicates the importance of beginning to reduce the imbalance now, since delay will make the gap still larger and our future difficulties even greater.

Figure 8:
The Rise to Record Deficits
(Deficit as a Percent of GDP, 2003-2045)



[13] In technical terms, the growth of debt is said to be economically sustainable if the debt/GDP ratio is no higher at the end of the 75-year period than at the beginning.

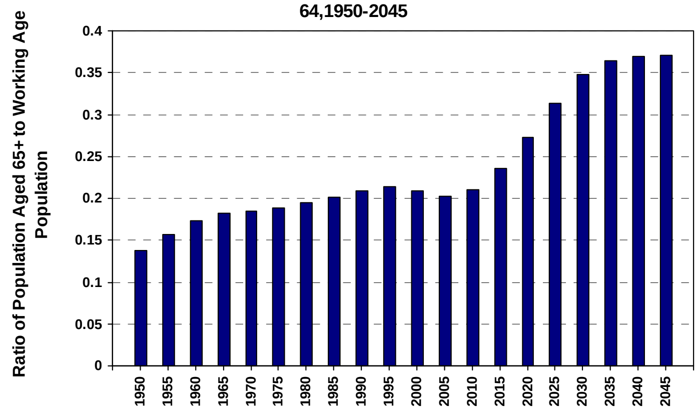
The Reasons for these Stark Results: The Aging of the Nation, the Rise of Health Care Costs, and the Erosion of the Revenue Base

These stark results stem from several critical factors.

- **The Retirement Boom:** The dramatic rise and then fall in fertility rates over the two decades following World War II produced the "baby boom" generation. In the years ahead, the baby boom will become a retirement boom. In recent decades, America has benefited from the baby boomers' productivity, as they have become the country's most experienced workers. But soon, America will begin to encounter costs related to the boomers' retirement. In 2008, the first of the baby boomers will qualify for early retirement under Social Security. By 2011, the first boomers will qualify for Medicare. And by 2025, the proportion of the U.S. population that is over the age of 65 will be greater than the proportion in the state of Florida today.

  Moreover, while the aging of the population will slow once the baby boomers "work their way through the system," the aging phenomenon will not disappear. (See Figure 9.) This is, in part, because the graying of America stems not only from the baby boom but also from the rise in elderly life expectancy and the reduction in fertility. Over the last 50 years, the life expectancy of a 65-year-old male has risen by 22 percent, a trend that is expected to continue. Low fertility rates are also expected to continue. For both these reasons, the American populace will continue to grow older, on average. In the decades ahead, the federal government will be faced with the costs of providing Social Security benefits and health care coverage to a growing population of retirees who will be living longer than ever before. And the resources to cover these costs must come from the production of a relatively small workforce.

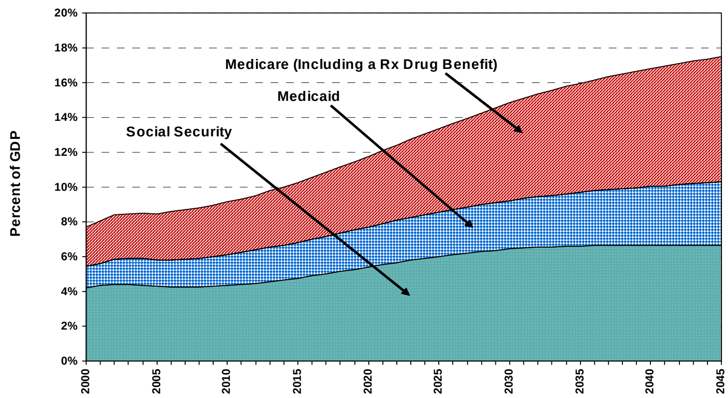
Figure 9:
America is on the Verge of a Dramatic Demographic Transition: Ratio of Population Aged 65+ to Working Age Population Aged 20-64,1950-2045



- **The Rise in Health Care Expenditures:** The aging of the population is not the only trend that will push up federal expenditures over the long term. The continuing increase in health care costs that affects the private and public sectors alike also will lead to rising federal expenditures over time. During the 1980's and 1990's, national health care spending per capita increased at an average rate of over seven percent annually, nearly 1.5 times the rate of per capita economic growth. Both the aging of the population (older people have higher average health costs than younger ones) and continued advances in medical technology (which improve health and prolong life, but add significantly to health care costs) raise health care spending. Experts generally expect the trend of significant growth in health care costs in both the private and public sectors to continue for the foreseeable future.

- **Social Security, Medicare, and Medicaid:** The continued rise in health care costs and the aging of the population will push up federal expenditures for Social Security, Medicare, and Medicaid.

Figure 10: Medicaid, Medicare, and Social Security are Expected to Rise Rapidly (2000-2045)



Today, the cost of these three programs equals 8.5 percent of GDP. This amounts to over 40 percent of all federal spending. As Figure 10 shows, expenditures for these programs are expected to rise over time to much higher levels as a share of GDP.

Moreover, the costs of the health care programs will continue climbing after the full retirement of the baby boomers by 2030. In the short and mid term, the retirement of the baby boomers is the driving force behind the projected rise in expenditures for these programs. Over the longer term, mounting health care costs become the main factor. Social Security expenditures are expected to remain relatively stable after 2035 as a share of the economy. But expenditures for Medicare and Medicaid are projected to continue rising as a result of the continued increases expected in health care costs.[14]

- **A Diminished Revenue Base:** If the recently enacted tax cuts are extended and relief from the Alternative Minimum Tax is continued, federal revenues are projected to equal 17.8 percent of GDP by 2013, if no further tax cuts are enacted. (Passage of further tax cuts would reduce this percentage to still lower levels.) The 17.8 percent-of-GDP level is below the average levels for revenue collections for the 1970s, the 1980s, and the 1990s. In other words, at the very time that the federal government will face unprecedented fiscal obligations due to the aging of the population and rising health care costs, federal revenues are on track to be significantly below their modern average.

[14] Costs for Medicaid, as well as Medicare, are affected strongly by the aging of the population. Although elderly and disabled people composed only 27 percent of Medicaid beneficiaries last year, they accounted for 70 percent of Medicaid benefit expenditures and have accounted for the lion's share of the growth in Medicaid costs in recent years. Average costs per Medicaid beneficiary are much higher for elderly and disabled beneficiaries than for parents and children and have been rising at a faster rate, due to the sharp increases in costs for items such as prescription drugs.

- **Compounding the Problem: The Slowdown in Workforce Growth:** Not only will federal expenditures rise in response to the increasing retirement and health care costs of an aging population, but recent and continuing lower fertility will markedly slow workforce growth and thereby slow economic growth. In the second half of the 20th century, the U.S. working-age population grew at an annual rate of 1.2 percent. In the first half of the 21st century, this growth rate is expected to fall by nearly two-thirds, to a tepid 0.4 percent annual rate. Since the economic growth rate is essentially the sum of the rate of workforce growth and the rate of productivity growth, the coming slowdown in the growth of the workforce is expected to lead to slower economic growth. The resulting slowdown in economic growth will, in turn, make the federal government's burden even heavier.

The Importance of Today's Budget Policy for the Long-Term Fiscal Picture

We recognize the uncertainty of these projections. But while our grim projections are far from certain, they are the most likely outcome of current policy. The demographic picture is unlikely to change; the baby boomers will reach retirement age, and elderly Americans are virtually certain to live even longer as medical progress continues. In addition, the rise in health care costs shows no sign of ebbing. And tax cuts, which have already reduced federal revenues to their lowest level in decades, are likely to continue eating away at the revenue base.

Measurements such as the fiscal gap are sensitive to the assumptions used. Under any reasonable assumptions, however, two conclusions are incontrovertible: America faces a very large long-term fiscal gap; and delaying action to reduce this gap will cause it to grow still larger. If no action is taken for ten years, the fiscal gap will rise by one-sixth, to 7.6 percent of GDP. After twenty years, it will rise to 9.5 percent. Fiscal imbalances of this size would be extremely difficult to deal with, either economically or socially.

If we act soon, we will be better able to spread the necessary tax increases and program reductions over time. In addition, the benefits of prompt action are magnified by the reductions in future interest costs that such actions would bring. Deficits avoided today are deficits further reduced tomorrow.

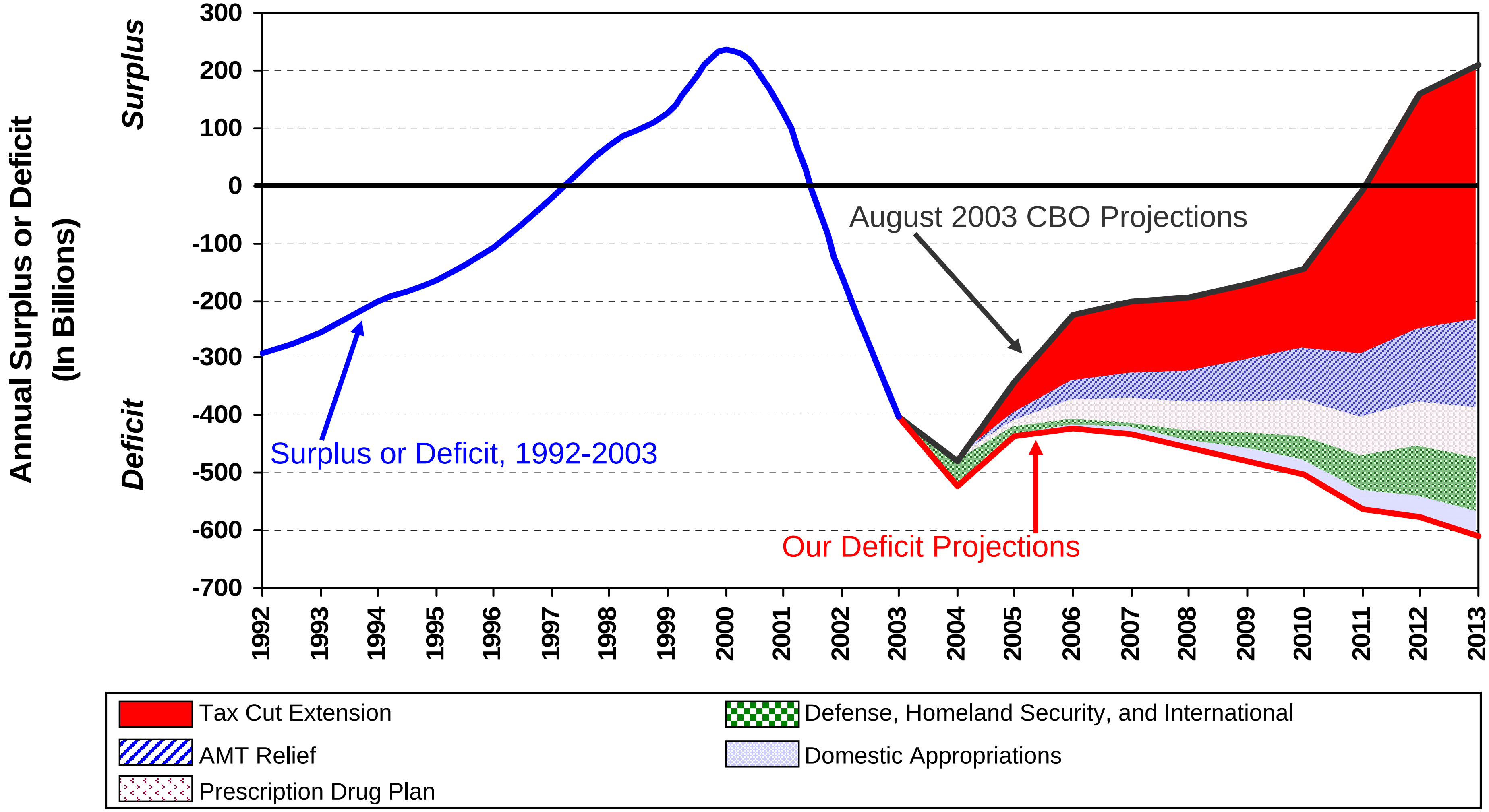
Conclusion

Our analysis adjusts CBO's official ten-year projections for more realistic assumptions about the costs of budget policies. We conclude that the cumulative deficit over the ten-year period 2004-2013 is more likely to be $5 trillion than the $1.4 trillion projected by CBO. Large deficits will remain even when the economy recovers. Only once before in the nation's history has the country run deficits of this size without a war or recession.

The deficits we project would drive up the national debt continually relative to the size of the economy. Yet we should, instead, be reducing the debt, which should be as low as feasible before the coming retirement of the baby-boom generation. That retirement will impose a permanent, large strain on the budget that will be exacerbated if we enter the baby-boomers' retirement with an unnecessarily large debt.

We measure the current size of the 75-year fiscal gap at 6.5 percent of GDP. Allowing a fiscal imbalance of this magnitude to continue will do significant harm to the budget and the economy, but reducing it will require large adjustments in budget policy. The more we delay addressing the problem, the more intractable it will become.

Figure 1:
Differences Between the August 2003 CBO Projections and Our Projections



September 29, 2003

CED The Concord Coalition Center on Budget and Policy Priorities

Figure 2:
Post-Civil War Deficits in Relation to the size of the Economy

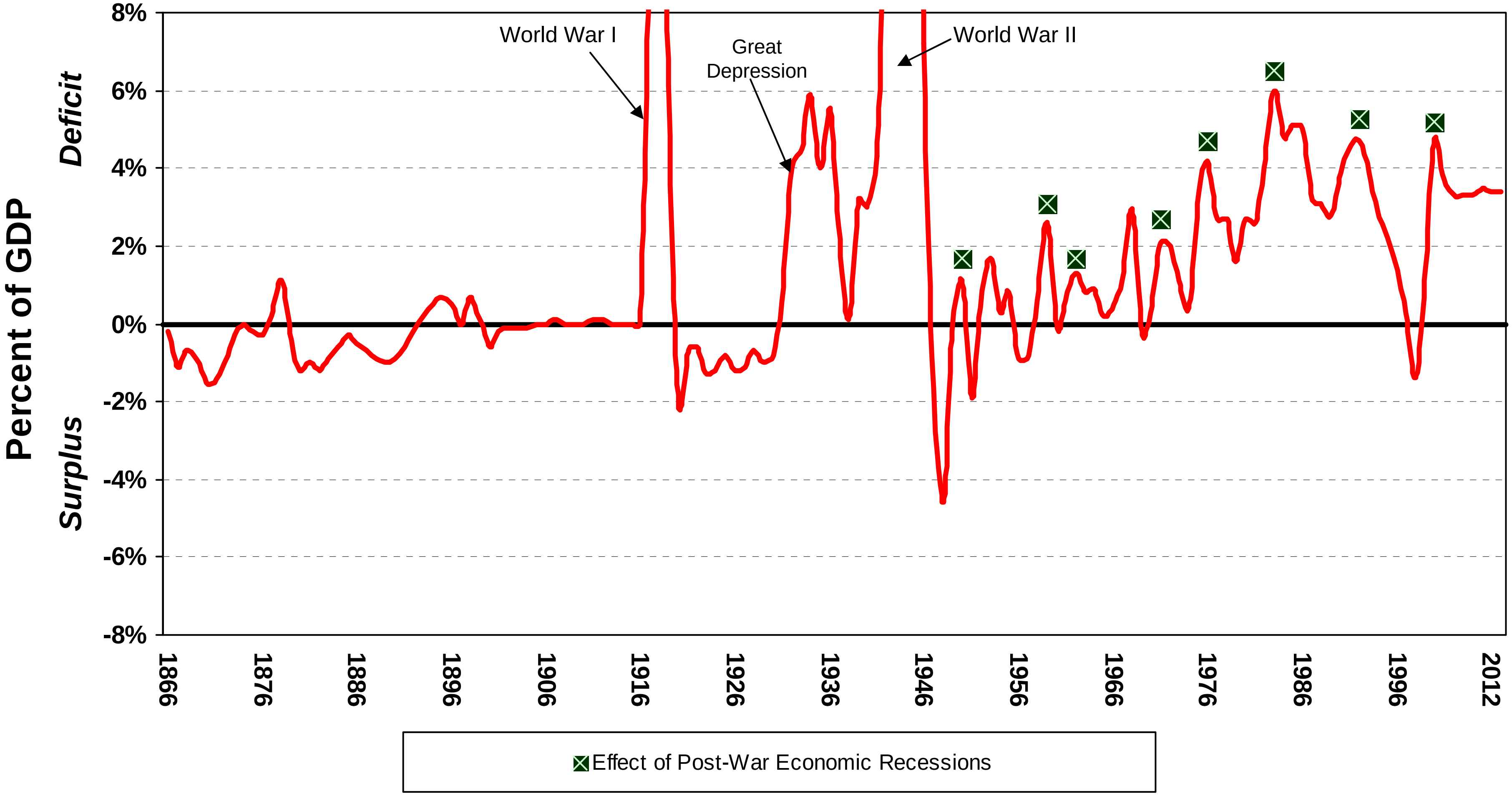


Figure 3:
Debt in Relation to the Size of the Economy

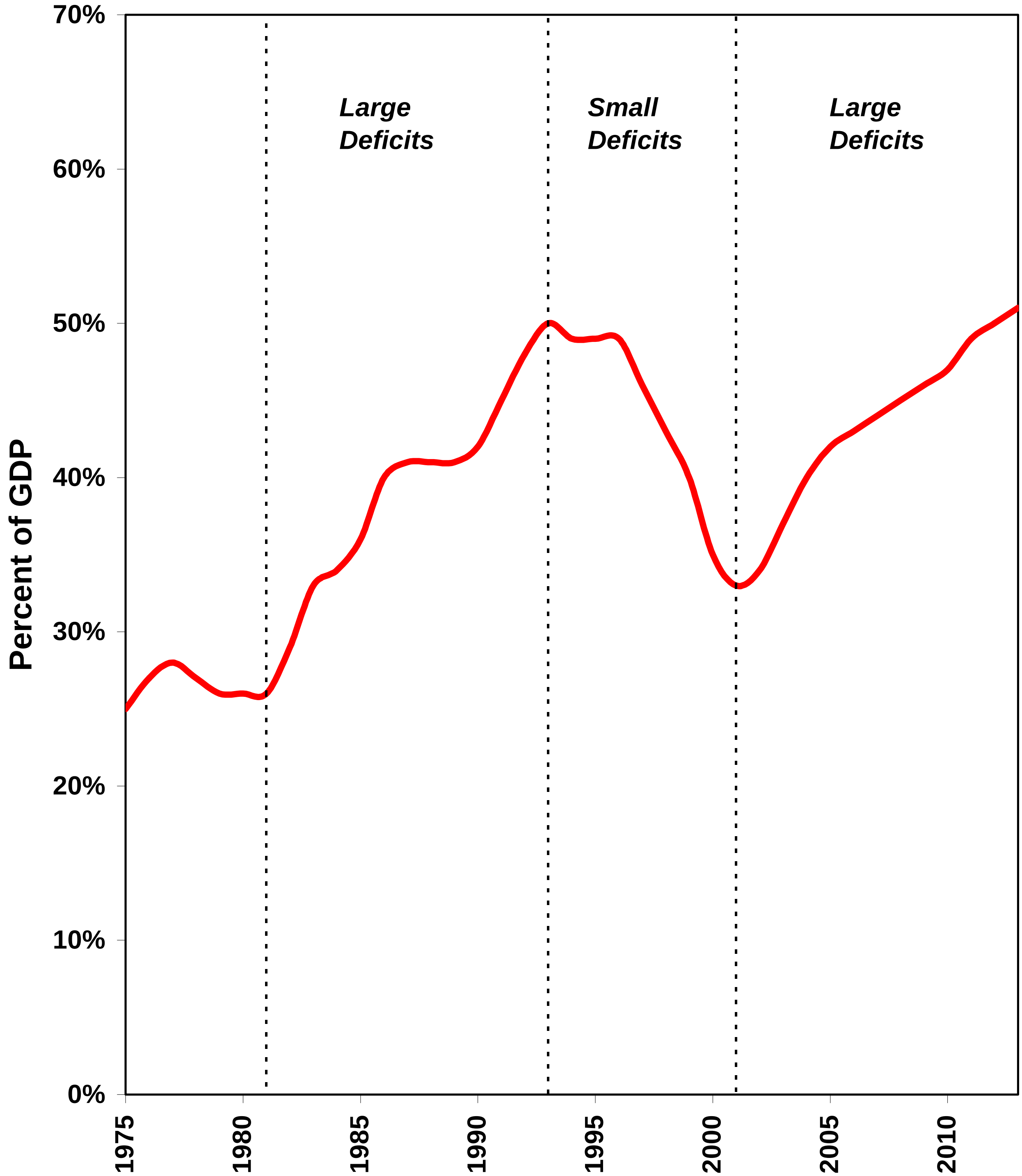


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Figure 4:
Interest Payments from 2003-2013

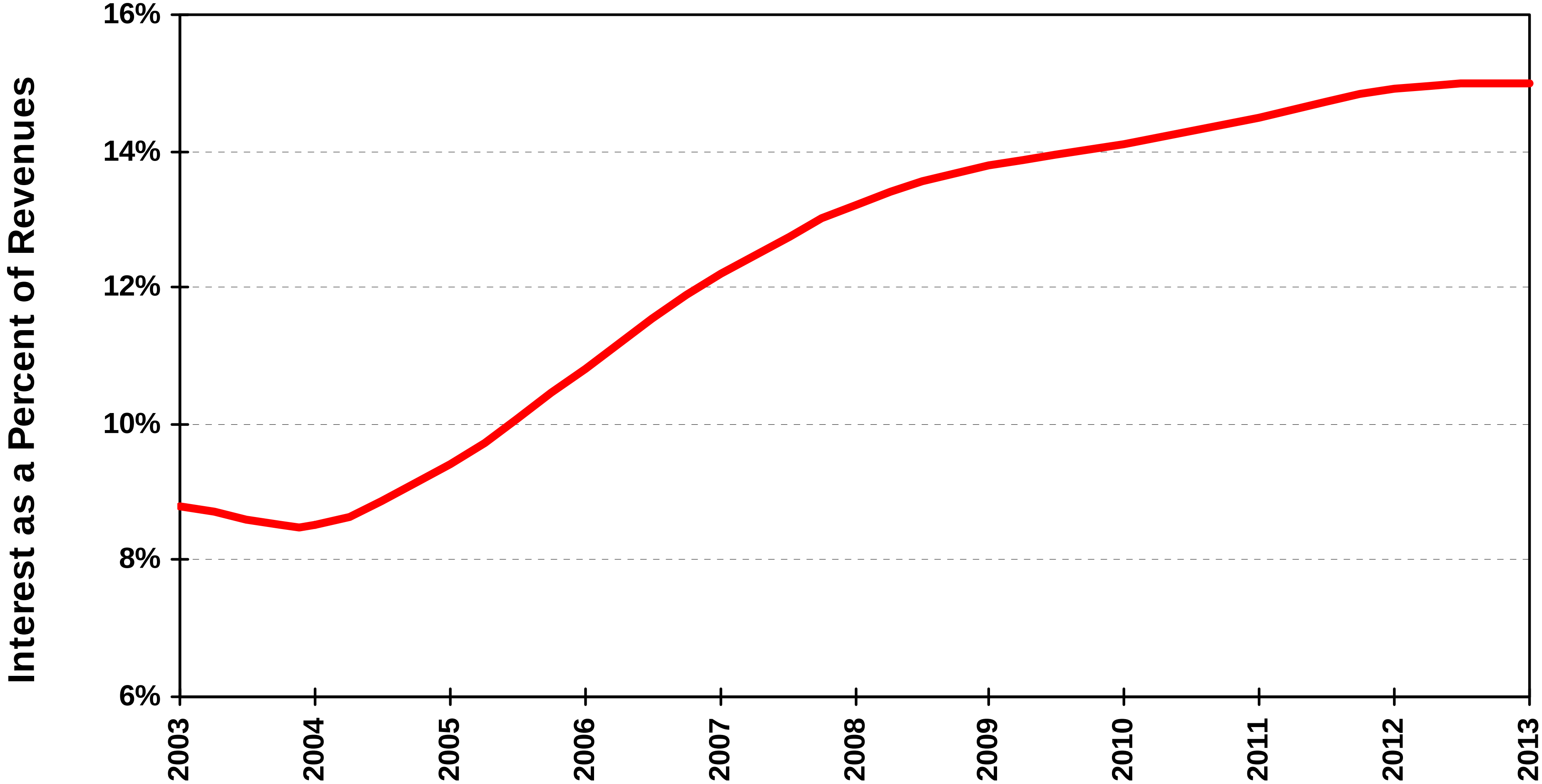


Figure 5:
How Budget Projections Have Changed, 2002-2011

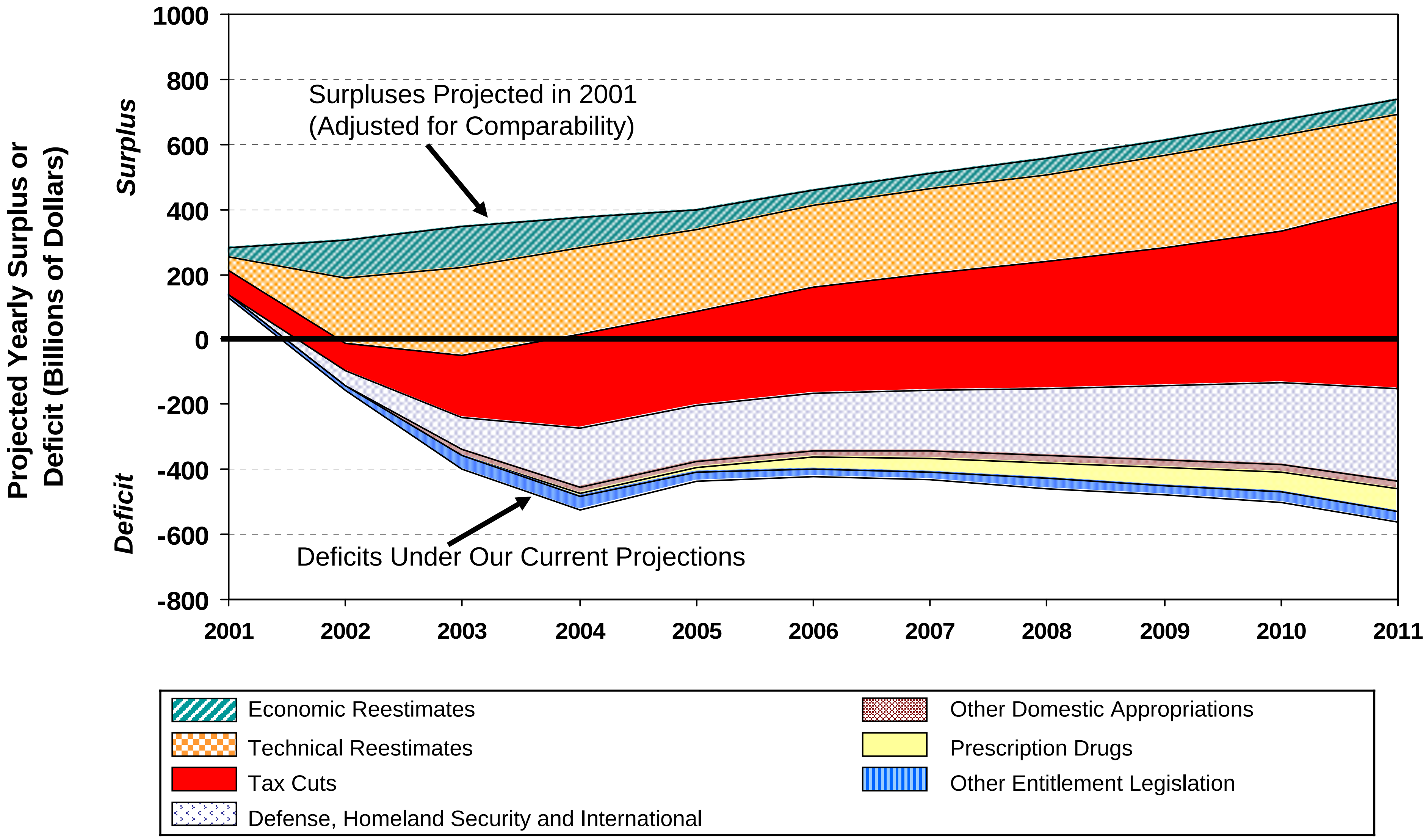
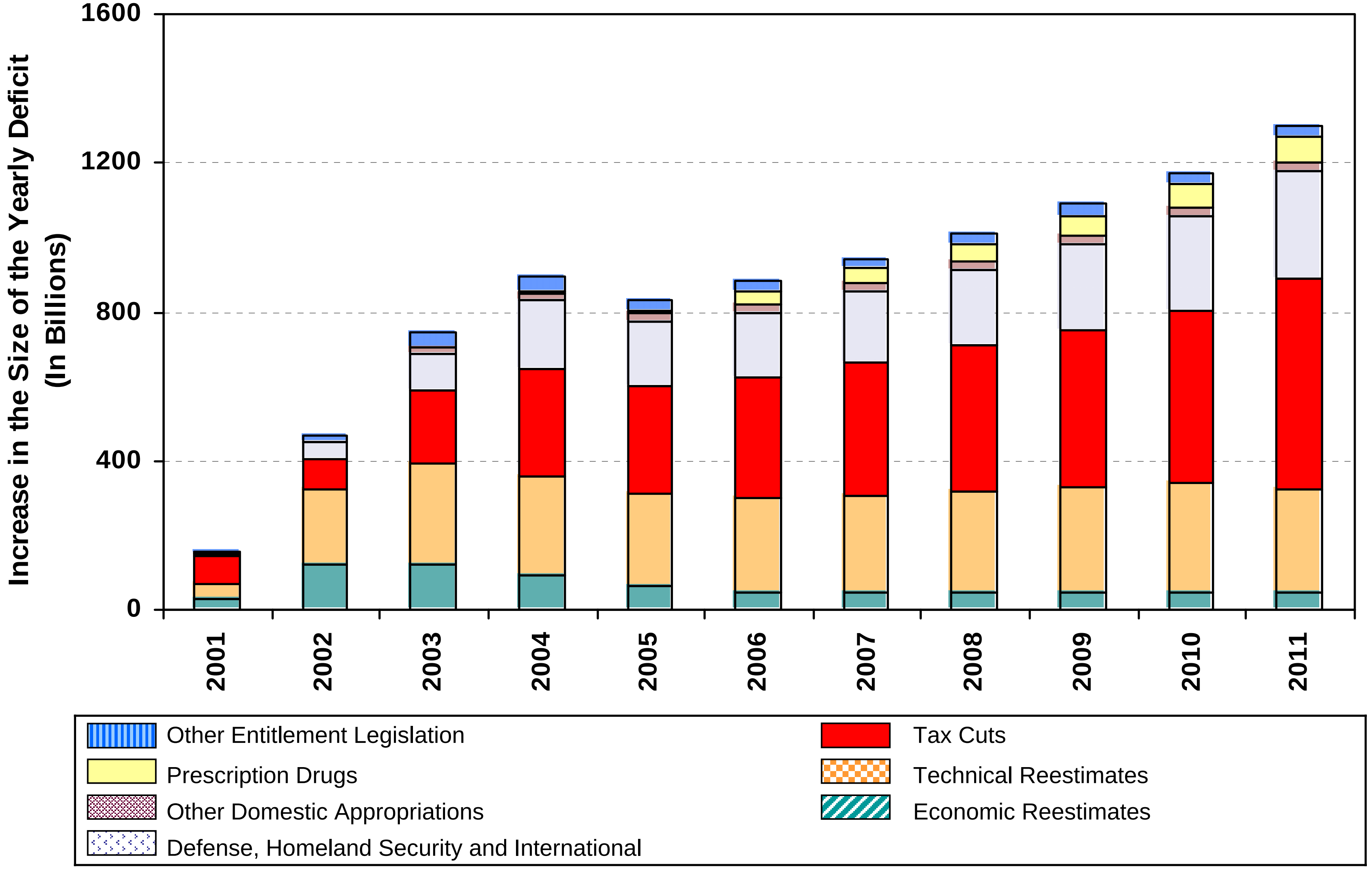
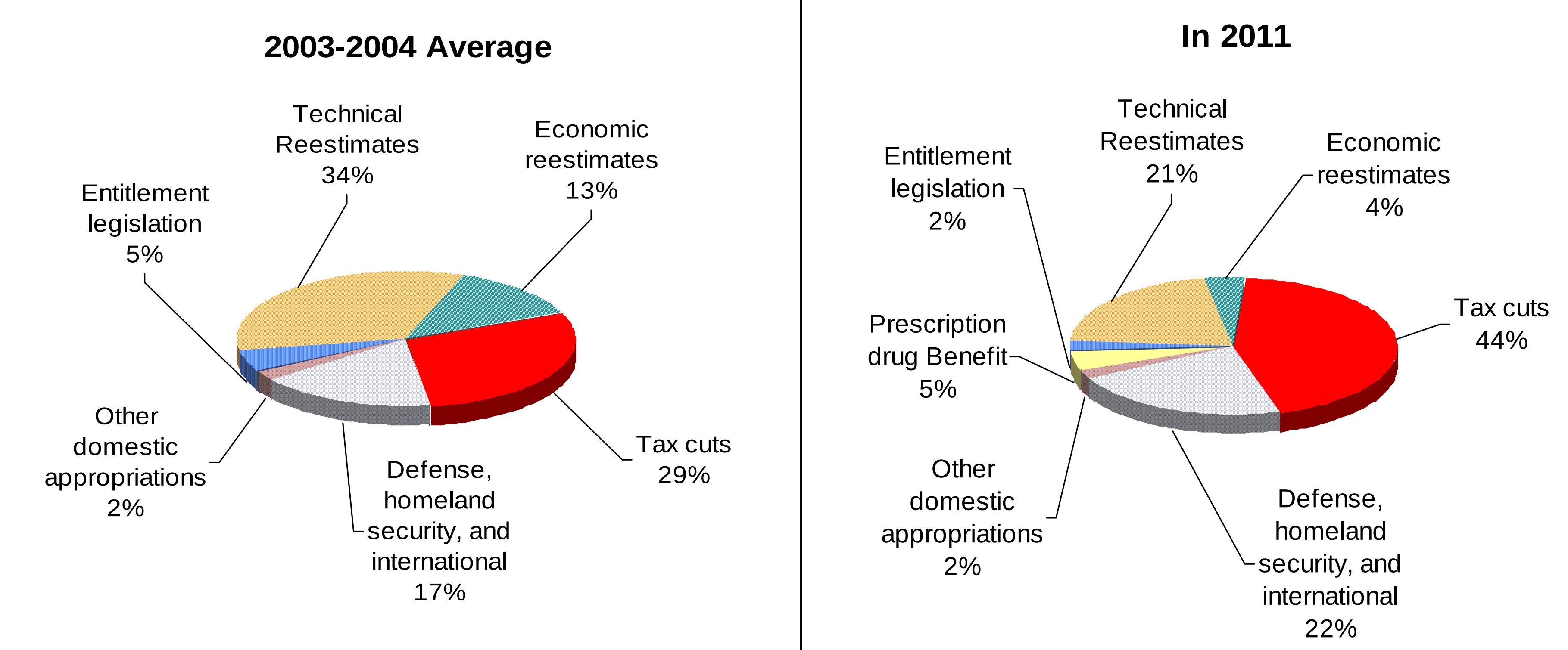


Figure 6:
What Has Caused the $9.3 Trillion Difference Between CBO's January 2001 Projections (Adjusted For Comparability) and Our Current Projections?



September 29, 2003

Figure 7:
Short and Midterm Causes of the Differences Between CBO's January 2001 Projections (Adjusted for Comparability) and Our Projections



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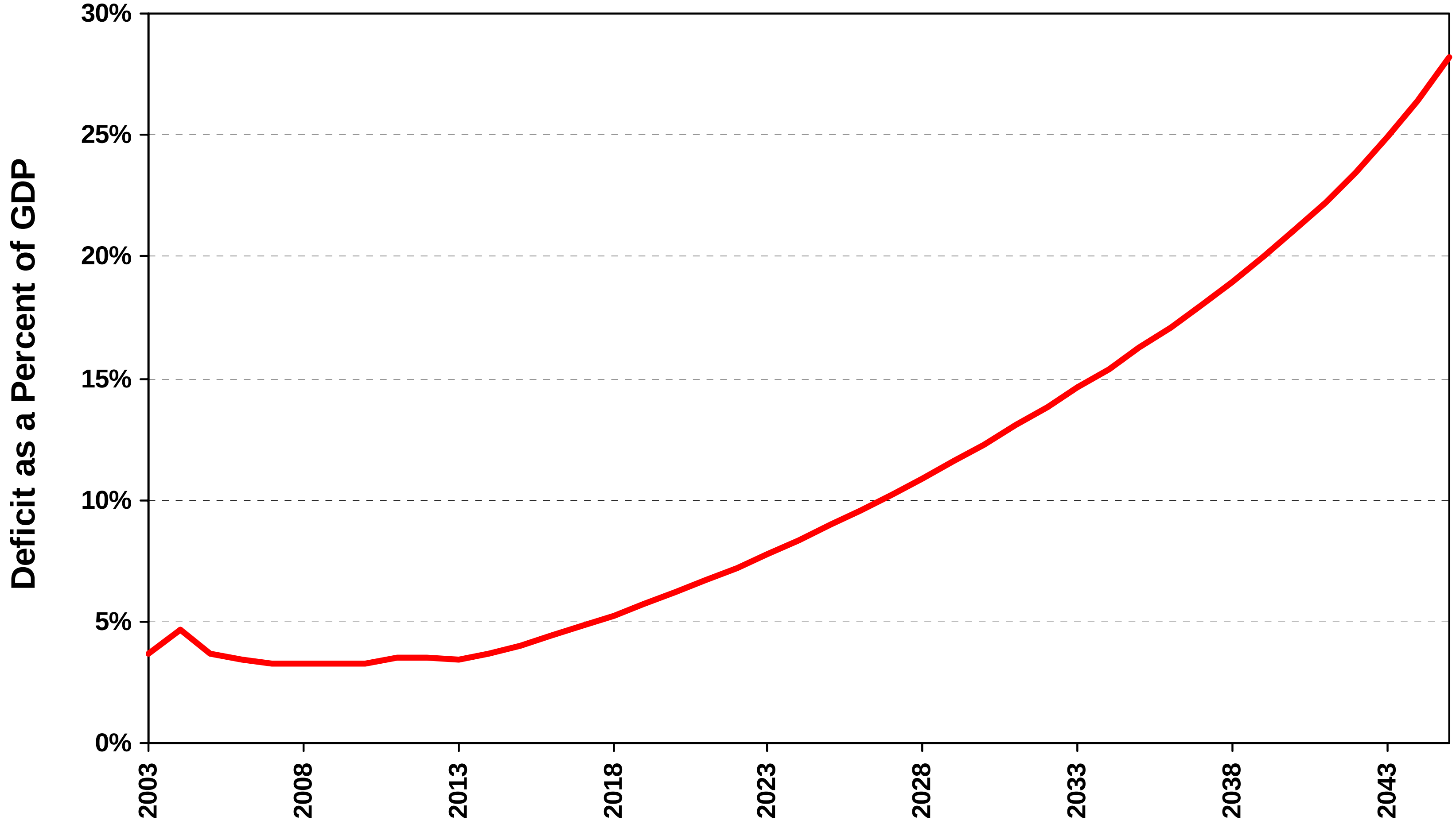

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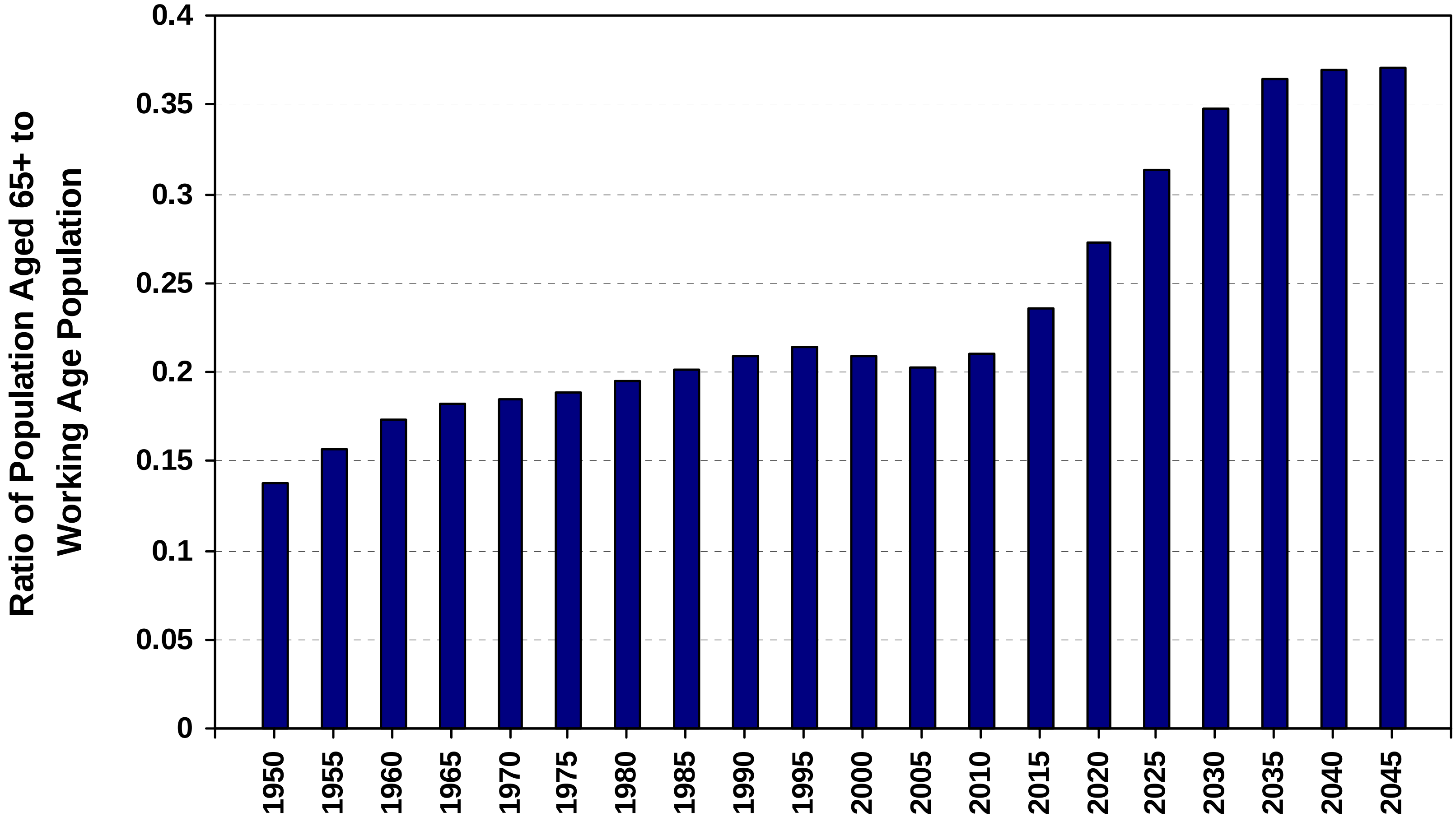

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