The Budget Outlook

The Newsletter of the Senate Budget Committee Majority Staff   Volume 1, Issue 5, February 2002

Also In This Issue:

Higher Debt Ceiling Requested by Bush Administration ... Page 2

Bush Tax Cut Keeps Interest Rates From Falling ... Page 3

Senate Budget Committee
624 Dirksen Senate Office Bldg.
Washington, DC 20510-6100
Tel: 202 224 0642
Fax: 202 228 2007
democratic_staff@budget.senate.gov
http://budget.senate.gov/democratic

Members of the Majority:
Kent Conrad, Chairman
Ernest Hollings
Paul Sarbanes
Patty Murray
Ron Wyden
Russell Feingold
Tim Johnson
Robert C. Byrd
Bill Nelson
Debbie Stabenow
Hillary Rodham Clinton
Jon Corzine

CBO Projects $4.0 Trillion Drop in Surplus and Return to Deficits

On January 23, the Congressional Budget Office (CBO) released new projections showing a serious deterioration in the fiscal outlook of the nation — a $4.0 trillion drop in the ten-year surplus — and confirming that we will face unified deficits for the next two years. Notably, while the war on terrorism and the recession contributed to the deterioration of the budget in the short-term, the single largest reason for the drop in the surplus over the next ten years is the tax cut pushed through last spring by President Bush.

Bush Tax Cut is Largest Reason for Drop in Surplus

According to CBO, since last January, when the Bush administration took office, the projected budget surplus for fiscal years 2002 through 2011 has dropped from $5.6 trillion to just $1.6 trillion. The Bush tax cut – including associated interest costs – reduced the projected surplus by nearly $1.7 trillion, or by 42 percent. The current economic slowdown, along with downward re-estimates of long-term productivity and economic growth, reduced the projected surplus by $929 billion, or by 23 percent. Increased spending – for defense ($301 billion) and nondefense ($249 billion) programs and associated interest costs – reduced the projected surplus by $738 billion, or by 18 percent. Finally, technical re-estimates reduced the projected surplus by another $660 billion, or by 17 percent.

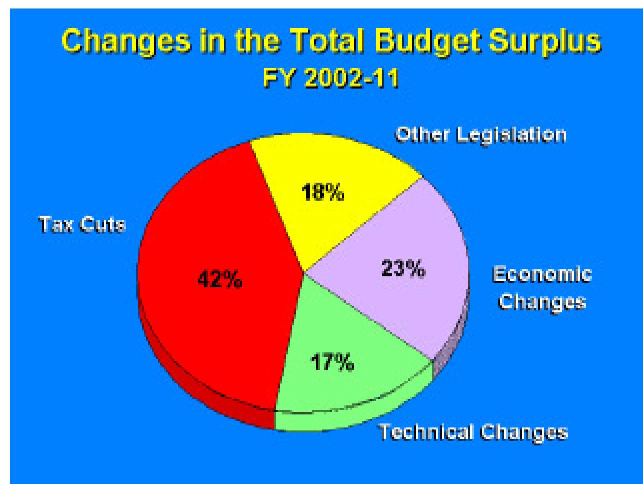

Figure 1-1. *Tax cuts are responsible for 42 percent of the drop in projected surplus.*

Deficits in the Short-Term, Bleak Outlook Over Long-Term

For fiscal year 2002, CBO now projects the nation will see a $21 billion deficit – a remarkable drop from its estimate last year of a $313 billion surplus for 2002. For fiscal year 2003, CBO projects a $14 billion deficit – compared with its estimate last year of a $359 billion surplus for 2003. When looking at the full ten-year period, fiscal years 2002-2011, CBO's projections show that $1.1 trillion of Social Security and Medicare trust fund surpluses will have to be used to pay for the Bush tax cut and other government expenses.

Long-Term Outlook is Actually Worse Than Figures Show

It is important to note that the new CBO figures actually represent an optimistic assessment of the nation's budget picture, because they leave out much-needed defense and homeland security investments, and the cost of the economic stimulus package still being debated in Congress. Once these and other anticipated expenses are factored in, the ten-year budget outlook is far worse, with deficits extending well beyond 2003.

Further, CBO's figures assume that the Bush tax cut, in its entirety, is allowed to 'sunset' at the end of calendar year 2010, as it is scheduled to do under current law. (Readers may recall, the tax cut was designed to expire after just nine years to make it appear less costly.) If some or all of the tax cut's provisions are extended beyond 2010, the cost will rise substantially, with a corresponding drop in surplus figures.■

Higher Debt Ceiling Requested by Bush Administration

On December 11, Treasury Secretary Paul O'Neill sent a formal request to Congress that it expeditiously pass legislation to increase the debt ceiling – the statutory limit on the total amount of debt issued by the federal government – from $5.95 trillion to $6.7 trillion. This request represents a dramatic turn-around in the budgetary outlook for the country and illustrates how quickly Bush administration policies have reversed the fiscal progress made during the mid-to-late 1990s.

Last April, the Bush administration assured the American public that, even after assuming enactment of all of the President's legislative proposals, the $5.95 trillion limit on total federal debt would not be reached until "sometime in 2008." By August, after enactment of the President's tax cut, the administration revised that projection, acknowledging that the limit would be hit sometime in 2004. Less than four months later, in its December 11 request, the administration again revised its estimate, stating that the limit could actually be reached as early as February 2002.

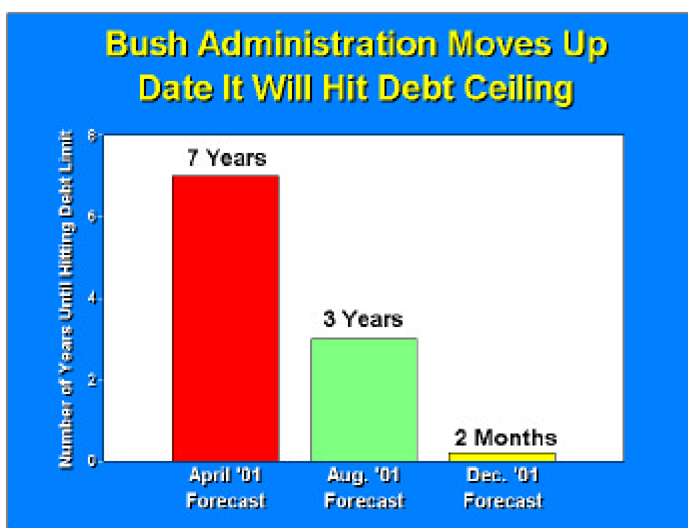

Figure 2-1. *The Bush administration now forecasts that it could hit the debt ceiling as early as this month.*

What Has Happened to the Debt Ceiling Historically?

The debt ceiling, established in 1917, provides a limit on virtually all federal debt, including debt issued to both the public and the federal trust funds, such as the Social Security and Medicare trust funds. (A minimal amount of debt issued by agencies other than Treasury is excluded from the limit.) Of the roughly $5.9 trillion in debt that was outstanding at the end of 2001, $3.4 trillion – or almost 60 percent of the total – was debt held by the public, with the remaining $2.5 trillion held by the federal trust funds.

The ceiling was raised to its current level of $5.95 trillion in August 1997 as part of the Balanced Budget Act of 1997. Historically, Congress has raised the ceiling every couple of years. But the significant improvement in the federal budget in recent years – marked by paying down close to $400 billion of publicly-held debt between 1998 and 2000 – pushed the projected date for the next increase further and further out.

What's Wrong With More Debt?

Now, seemingly overnight, the Bush administration has returned the nation to a path of rapidly rising debt. With higher debt come higher interest payments and a weakening of the federal government's ability to address crucial needs, such as strengthening Social Security and Medicare to prepare for the retirement of the baby boom generation. Relative to its January 2001 estimate, CBO's new projections show that higher-than-anticipated debt in 2002-2011, in part due to the Bush tax cut, will result in an extra $1 trillion in net interest costs.

Further, when the government increases its borrowing, it crowds out private sector borrowing and drives up interest rates for everyone. Higher interest rates, in turn, lead to less private sector investment and a reduction in economic growth.

Why Can't Congress Just Refuse to Raise the Debt Ceiling?

Sadly, Congress really has no choice but to approve some increase in the debt ceiling. The consequences of not raising the ceiling are severe.

(continued on page 4)

Bush Tax Cut Keeps Interest Rates From Falling

In his January speech on the economy to the Center for National Policy, Majority Leader Daschle noted that the tax cut pushed through by President Bush last spring had probably prevented long-term interest rates from dropping as much as expected. Senator Daschle got it exactly right.

Long-term interest rates have declined little in the past year despite eleven consecutive cuts in short-term rates by the Federal Reserve. Although they are low in absolute terms, long-term rates remain high relative to short-term rates and are about where they were when the Fed began easing monetary policy last January.

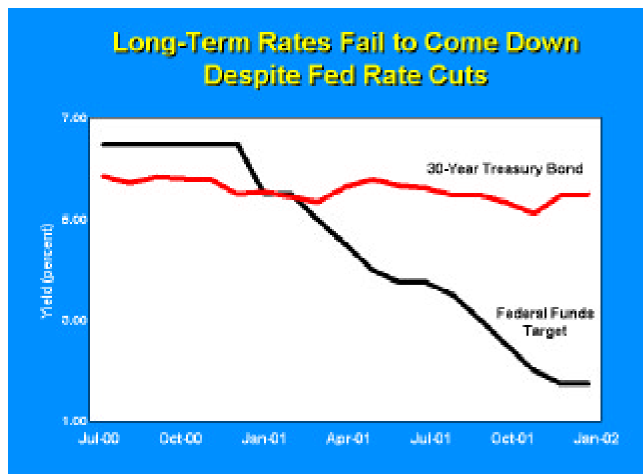

Figure 3-1. *Long-term rates have not come down despite eleven Fed rate cuts.*

While there are many reasons why long-term rates have stayed stubbornly high relative to the short-term rates set by the Fed, one of the most notable is the erosion of fiscal discipline brought on by the expensive out-year provisions of the Bush tax cut. With that tax cut set in place and continued talk of further tax cuts, financial markets have less reason to be confident that the federal government will pursue the sound fiscal policies that produced surpluses from 1998 to 2001. As Federal Reserve Chairman Greenspan remarked in a recent speech, "over the past year, some of the firmness of long-term interest rates probably is the consequence of the fall of projected budget surpluses and the implied less-rapid paydowns of Treasury debt."

How Are Short and Long-Term Interest Rates Determined?

The Federal Reserve eases monetary policy by reducing its 'target' for the federal funds rate – the rate banks charge each other for overnight loans. Other short-term rates quickly adjust to the new federal funds rate, because sharp differences between returns on similar assets are not sustainable. Long-term interest rates also tend to come down when the Fed eases monetary policy, though usually by less and with a lag. Long-term rates are typically higher than short-term rates; but, as we are probably seeing now, increased uncertainty about the future, particularly uncertainty about federal borrowing needs, can substantially widen this gap.

Economic Consequences of Higher Interest Rates

Higher long-term rates can create a drag on our economic recovery in the short-run and restrain investment over the long-run. Short-term rate cuts that are not accompanied by reductions in longer-term rates will not do much to stimulate the economy. It is long-term rates that have the greatest effect on business investment decisions and household spending on big-ticket items like home-buying and the purchase of consumer durables like cars and household furnishings. Over the longer-term, reduced investment translates into slower growth and a lower standard of living.■

For a comprehensive economic analysis of the relationship between the tax cut and long-term interest rates, see Brookings Institution Fellow Peter Orszag's January 29 testimony before the Senate Budget Committee — available on the Senate Budget Committee website:

http://budget.senate.gov/democratic

Higher Debt *(continued from page 2)*

If the debt ceiling were to be reached, the Department of the Treasury would be prohibited from further increasing the amount of outstanding debt, even if federal borrowing needs had not yet been met. This could result in the government defaulting on certain obligations, which could further weaken the financial markets, compromise the government's creditworthiness, and impair its ability to responsibly manage the federal trust funds.

What Does This Tell Us Going Forward?

The need to raise the debt ceiling so soon emphasizes again the importance of returning fiscal discipline to the federal budget. The problems of the budget will only get worse as the baby boomers begin retiring early in the next decade. The Bush administration missed a unique opportunity to pay down a substantial amount of the outstanding debt in preparation for the retirement of those baby boomers. Now, difficult choices will have to be made to put the budget back on the path of fiscal discipline that was begun in the 1990s. We must begin that process as soon as possible to avoid repeating the explosion in federal debt that we have seen in the past.■

Join our Mailing List

Your comments and feedback are always welcome. If you are not already on our mailing list and would like to receive copies of future issues, please send an email to:

steve_posner@budget.senate.gov

Find out more on the Internet

Get the latest budget news and analysis online at:

http://budget.senate.gov/democratic

Senate Budget Committee
Majority Staff
624 Dirksen Senate Office Building
Washington, DC 20510-6100

Kent Conrad U.S.S.