

INFORMED BUDGETEER

FARMING THE BASELINE

- The controversial Farm Security and Rural Investment Act of 2002, the farm bill, will be decided this week with a final vote in the Senate. The torturous journey this bill has taken to get to the final vote on May 8, 2002 actually began this same week exactly one year ago when the Congress adopted the FY 2002 Budget Resolution.
- The FY 2002 Budget Resolution, a resolution adopted prior to the confirmed economic slowdown last year and prior to the September 11 attacks, was formulated based on CBO projections made in January 2001. Agriculture commodity prices and general economic assumptions, at that time, resulted in a projected baseline budget surplus of \$5.9 trillion even with an extension of the expiring farm programs costing \$114 billion for the period FY 2001-11.
- With these assumptions, a budget resolution was crafted that provided for tax cuts, prescription drug benefits and other spending, including \$79 billion for new farm program expenditures. In July 2001, Congress quickly enacted \$5.5 billion in new agriculture spending for FY 2001, leaving \$73.5 billion for later action.
- Since January 2001, changes in the general economic outlook and changes in farm prices have resulted in CBO's new long-term projections now projecting a \$1.8 trillion surplus with \$130 billion in baseline expenditures for farm programs from a simple extension of current law for the comparable period (FY 2001-11). But with no new budget resolution this year, the farm bill has been conferenced and scored relative to baseline estimates more than one year old.
- The two tables below present the estimated cost of the farm bill compared against last year's agriculture baseline assumptions and against an updated current agriculture baseline. While meeting the budget resolution allocation exactly (\$73.5 billion) using the old baseline and old estimates, the farm bill would instead exceed the budget resolution by \$9.3 billion using more current price and economic assumptions.

Increased Cost of Farm Bill Relative to April 2001 CBO Baseline (BA, \$ in millions)				
	2002	2003	02-06	02-11
Commodities	942	5,927	25,637	47,771
Conservation	706	1,088	7,230	17,079
Trade	23	95	391	1,144
Nutrition	-92	201	1,877	6,400
Rural Development	700	-90	810	870
Research	8	-120	317	1,323
Forestry	5	20	85	100
Energy	6	104	366	405
Miscellaneous	165	22	-49	-1,594
Total	2,464	7,247	36,663	73,497

Source: CBO, Preliminary Estimate, May 1, 2002

Increased Cost of Farm Bill Relative to March 2002 CBO Baseline (BA, \$ in millions)				
	2002	2003	02-06	02-11
Commodities	965	7,166	31,095	56,714
Conservation	706	1,088	7,230	17,079
Trade	23	95	391	1,144
Nutrition	-81	251	1,988	6,625
Rural Development	700	-90	810	870
Research	8	-120	317	1,323
Forestry	5	20	85	100
Energy	6	104	366	405
Miscellaneous	165	18	-41	-1,441
Total	2,498	8,532	42,241	82,819

Source: CBO, May 6, 2002

- The new mandatory spending for commodities, conservation, trade,

research and other farm related programs (excluding food and nutrition programs) will increase spending by 64 percent compared to a simple extension of current law. Even more important is how this additional spending is done.

- Significant increases result from raising the marketing loan rates for wheat and corn – a direct incentive to farmers to produce more. The loan rate for wheat would be increased 8.5 percent, and for corn 4.8 percent. The Food and Agricultural Policy Research Institute estimates that because of these and other provisions in the bill, there is a significant chance that the US will be in violation of WTO domestic trade distorting farm subsidies this year.
- Finally and equally as troubling are the trade distortions caused by this bill. Since it continues the practice of paying a handful of supported crops on the volume of their production, it is estimated that only 10 percent of the largest farmers will receive more than two-thirds of the money. Compared to a \$275,000 per year farm program payment limit in the Senate-passed farm bill, the conference bill increases this to \$360,000.

ENERGY TAX INCENTIVES

- Since the Senate passed the Energy bill on April 25 (S. 517 by a vote of 88-11), a conference committee now will have to reconcile dozens of new or expanded energy tax incentives in the House and Senate-passed bills. *Bulletin* readers should use caution when comparing the tax provisions of the two bills – the scoring of the Senate package is over the 2003-2012 period and has been revised to reflect the passage of the stimulus bill, which affected some of the provisions considered to be “extenders.” The House bill (H.R. 4, including provisions of H.R. 2511, was passed August 2, 2001 by a vote of 240-189), is scored over the period 2002-2011 and has not been revised to reflect the passage of the stimulus bill.

Comparison of Energy Policy Tax Provisions S. 517 vs. H.R. 4 (Revenue costs, \$ in billions)		
	Senate 2003-12	House 2002-11
Extend & modify Sec. 45 credit (electricity production)	2.3	2.4
Alternative vehicles and fuel incentives	1.8	2.4
Conservation and energy efficiency provisions	2.2	3.4
Clean coal incentives	1.9	3.3
Oil and gas production incentives	4.4	12.3
Electricity industry restructuring	1.3	4.5
Tax incentives for Indian reservations	0.2	0.2
Repeal certain excise taxes (railroad & inland waterway fuels)	-	1.0
Tax exempt bond provisions	-	3.3
AMT provisions	-	0.7
Total Tax Relief	14.1	33.5

Source: Joint Committee on Taxation

- The Senate bill provides \$14.1 billion in ten-year tax relief; the House bill, scored last July, provides \$33.5 billion in ten-year tax relief. When rescored, the cost of the House bill should be several billion dollars lower today due to passage of the stimulus bill, which extended many of the same provisions that were extended in H.R. 4.
- The largest difference between the House and Senate bills relates to oil and gas production incentives, as the House provides more favorable depreciation treatment for gas distribution pipelines and petroleum refining property.
- The House bill provides relatively more tax relief for conservation and energy efficiency, particularly in the area of credits for energy efficiency improvements to homes and businesses. The House bill is also a bit more generous with production credits for clean coal technology. The House's more generous incentives for electricity restructuring arise from a provision in the House bill (but omitted in

the Senate bill) related to certain dispositions of transmission property.

- In addition, the House bill included a phase out of certain excise taxes on railroad diesel and inland waterway fuel, tax exempt bond provisions, and more favorable alternative minimum tax (AMT) treatment for energy production and investment credits.
- Both bills provide about the same amount of tax relief for electricity production incentives, alternative vehicle and fuel incentives, and tax incentives for Indian reservations.

REVENUE RECESSION

- In January 2001, CBO's *Budget and Economic Outlook* estimated a baseline budget surplus of \$313 billion for FY 2002 (and a surplus of \$5.6 trillion over the 2002-2011 period). Included in that outlook was a recession scenario that illustrated a mild downturn similar to the recession of 1990-91, resulting in an alternative surplus for 2002 that was \$63 billion lower at \$250 billion. (The alternative surplus estimate for the recession scenario for the entire 10-year period was only \$133 billion lower, with 60% of the reduction occurring over 2002-2003.)
- As it turned out, we did have a recession in 2001, although one that was even *less* severe than 1990-91 in terms of weakening real economic growth. And yet the budget has been affected much *more* severely than anticipated in CBO's recession scenario. The previously estimated surplus for 2002 is now a deficit likely to be more than \$100 billion (and CBO's economic and technical reestimates, reflecting the recession that we've experienced, are now at least \$1.2 trillion lower for revenues over the ten years, not \$0.1 trillion as the recession scenario suggested).
- Enacted legislation accounts for about half of the disappearance of the surplus and emergence of a deficit in 2002, compared to CBO's 2001 recession scenario. But the other half is attributable to economic and technical factors.
- Remember, the government doesn't tax GDP, it taxes income. When estimating revenue, changes in GDP are not nearly as important as changes in taxable income – wages, salaries, and corporate profits. And taxable income has dropped more than would normally be associated with a mild recession. Recent data from the Commerce Department suggest national income figures will be revised down significantly in July.
- In addition, when generating its recession scenario, CBO assumed capital gains and the distribution of income would not be affected very much by the recession. These assumptions may have been appropriate in light of past recessions, though CBO pointed out that "[l]ittle is known...about the effects of recessions on income distribution, so this cyclical scenario omits such effects." But, in hindsight, the assumption that income distribution or capital gains would be unaffected was inconsistent with the nature of the 2001 recession. So what might possibly explain recent developments?
- Compared to past business cycles, current stock market capitalization is much greater relative to personal income. The stock market capitalization of firms listed on the New York Stock Exchange exceeded annual personal income only since 1996 and was about 1.5 times personal income in 2000. Before the 1990s, stock market capitalization never exceeded annual personal income.
- Also, the share of income generated by top earners – which is taxed at the highest rates – likely became more cyclical and linked to the

stock market than in the past. This is at least a plausible explanation for both a portion of the late-1990s revenue boom and the early-2000s revenue slump. According to the Department of Labor, 1.7% of all private sector employees received stock options in 1999. Among those earning more than \$75,000 and working for publicly-held businesses, 26.8% had stock options.

- The timing of refunds may be another sign the revenue problem is coming from the top end of the income distribution. Refunds to individuals were up 19% in February and March but up 25% in April. It stands to reason that those who file in April tend to have more complicated tax situations, which is a greater problem among higher earners. Perhaps some of the people who usually owe taxes in April waited to pay as usual and then were pleasantly surprised that they had over-withheld.
- Unfortunately, our understanding of these events won't improve beyond these educated guesses until we know more when the IRS tabulates the tax take from each marginal rate bracket.

BUDGET QUIZ

Question: Estimates of the number of Transportation Security Administration (TSA) employees necessary to secure our aviation system have soared from about 40,000 in January to over 70,000 more recently. But even now, TSA still does not know how many employees it will need to screen passengers and their checked luggage. How can the TSA not know the number of employees it will really need in 2003—even after it has submitted its request for both 2003 and the 2002 supplemental? Why has this estimate almost doubled in 4 months?

Answer: The number of employees depends on how the TSA to comply with the Aviation and Transportation Security Act requirement that 100 percent of checked baggage must be screened for explosives by December 31, 2002. The law mandates that checked luggage be screened using explosive detection systems (EDS), but it allows alternate means of screening if sufficient EDS machines are not available. EDS machines use a combination of X-rays and computer tomography to check bags for explosives. These machines are costly – about \$4.2 billion total – to purchase (about \$1 million each) and to install (about \$2 billion to install 2,200 machines).

Because of the cost and vendors' uncertainty about whether they can manufacture enough machines in time, the TSA plans on using explosive trace detection systems to supplement EDS machines. These small and relatively cheap (about \$41,000) machines are able to detect minute traces of explosives on swabs that the operator runs throughout the luggage. This process is slower and more labor intensive than using EDS machines. The DOT Inspector General has testified that using 100 percent EDS screening would require about 23,000 FTEs, while using only the open bag method of trace detection would require about 50,000 FTEs.

Since TSA has not finalized the mix of EDS and trace detection, there will be a great variation in estimates of the number of necessary employees and total cost. The more TSA relies on EDS machines, the larger the up front capital costs, but the lower the long-term labor costs. Greater use of trace detection will increase the likelihood of TSA meeting the December 31, 2002 deadline, but also will significantly increase the number of TSA employees.

Editor's Note: Senator Domenici and his staff of the Senate Budget Committee congratulate their staff director, Bill Hoagland, for receiving last week the James L. Blum Award for Distinguished Service for Budgeting in 2002 from the American Association for Budget and

Program Analysis (AAPBA). The award, which has previously been given to Leon Panetta, Alice Rivlin, Bob Reischauer, and Pete Domenici, among others, recognizes someone with a distinguished record of accomplishment in public budgeting, who is a respected leader in the budgetary community, has significantly advanced the state of budgetary knowledge, and has set by personal example an exceptionally high standard of achievement, professionalism, and ethics for all public servants. It is a privilege to work with you Bill! Bill's keynote speech (delivered to the AAPBA symposium on May 2 before the surprise award), entitled "Priorities and Budget Challenges in a Nation at War", can be found on our website.