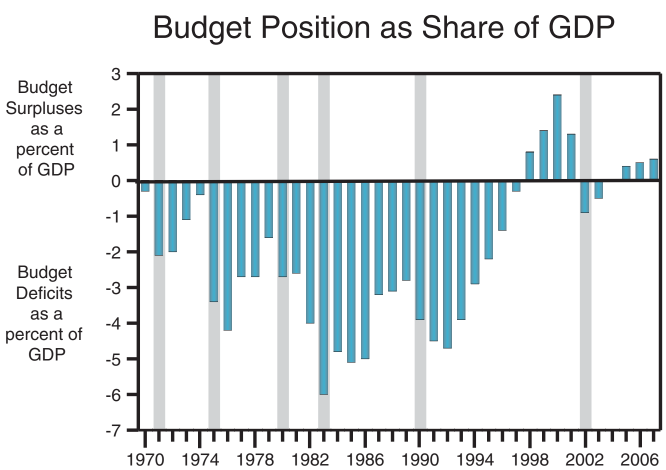
# BUDGET IMPLICATIONS OF THE WAR

The nation faces significant challenges in the near-term in prosecuting the war on terror abroad and defending our homeland from attack, in addition to rejuvenating economic growth. These efforts will require substantial budgetary resources. Fortunately, the United States has abundant resources to tap. However, in order to ensure that the fiscal outlook remains positive over the longer-term, tough fiscal choices must be made to direct funds toward priority endeavors and away from poorly performing government programs. New budget process reforms are needed to expedite this process.

## Overview



Shaded areas show fiscal years with recession troughs.

The response to the terrorist attacks, both at home and abroad, and the onset of recession have caused a notable shift in the near-term fiscal outlook. Deficits now look likely over at least the next two years. However, assuming the government pursues pro-growth policies and controls spending, the budget should be back in surplus by 2004 or 2005.

The overall fiscal position remains strong even with this temporary move into deficits. The 2003 deficit is projected to be less than one percent of GDP—this compares with a 4.5 percent deficit during the last recession. Indeed, despite simultaneous war, recession, and emergency spending, 2002's fiscal position will be better than that recorded in any year between 1975 and 1996.

### Impact of Recession

One would expect the fiscal picture to deteriorate as the economy goes into recession, even absent the multi-front war on terror. Tax receipts decline as activity slows, while expenditures rise for cyclically sensitive programs like unemployment insurance. Furthermore, it is good economic policy to reduce tax burdens explicitly during a recession, in order to limit the economic slide and hasten recovery. While such policy actions may worsen the deficit in the near-term, they will improve the fiscal outlook in the long run since it is growth that ultimately generates any surpluses.

Economic weakness has been the largest source of erosion in the current year's fiscal projection, followed next by spending stemming from the September 11th attacks. Economic changes accounted for two thirds of the deterioration in the projected baseline fiscal position since the last year. Spending accounted for an additional 20 percent of the decline.

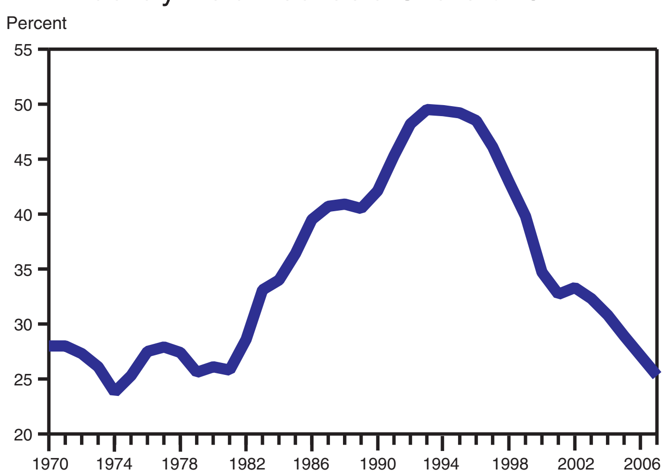
**Evolution of the 2002 Fiscal Projection**
(In billions of dollars)

| | 2002 |
|---|---|
| **2002 Budget Baseline Projection** | **283** |
| Weaker Economy | –197 |
| Enacted Spending | –54 |
| June Bipartisan Tax Relief Package | –40 |
| **2003 Budget Baseline Projection** | **–9** |

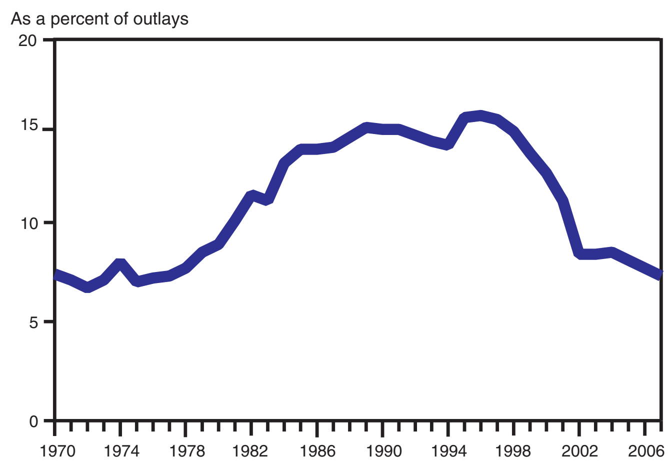
## Debt and Interest Savings

The combined effects of recession and war have interrupted progress in paying down our publicly held debt. Nonetheless, debt will continue to diminish as a factor in our fiscal affairs. The ratio of publicly held debt to GDP will decline steadily from 2002 onward. After hitting 50 percent in the mid-1990s, the debt/GDP ratio will be 33 percent in 2003 and is projected to fall to 25 percent by 2007. Further evidence of this constructive backdrop can be seen in the Treasury Department's decision last fall to discontinue issuance of the 30 year Treasury bond.

Publicly Held Debt as a Share of GDP




Interest Costs Continue to Fall




As the share of publicly held debt to GDP declines, interest costs will continue to fall as a share of total outlays. After totaling 15 percent of federal outlays in the mid-1990s, this burden will be only nine percent in 2002, dropping to eight percent by 2007.

## Debt Limit

The federal government issues debt to the public in order to finance its budget deficits. As noted, this debt is expected to be broadly stable in dollar terms over the next five years, while declining as a share of GDP. However, the government also issues special Treasury debt to the federal trust funds that generate surpluses, including Social Security. While debt held by the public is a more meaningful measure of the government's effect on private financial markets, Congress tracks the sum of publicly held and governmentally held debt, and imposes a limit on the amount of total debt outstanding. Since governmentally held debt rises steadily over time, the debt limit must be raised periodically even if debt actually owed to the public is not growing. In fact, debt subject to limit continued to rise during 1998–2001 even as the publicly held debt decreased.

The current limit on total debt is set at $5.95 trillion. In the Mid-Session Review for 2002, total debt was expected to breach this limit by 2004, due to ongoing trust fund purchases of Treasury securities. Given the deterioration in the near-term fiscal picture due to the war and recession, however, the debt limit now looks likely to be hit in early 2002.

## The Need for a Realistic Budget Window

The events of last year underscore the difficulty of making reliable budget estimates even one year ahead. No one expected the economic and fiscal fall-out that resulted from last September's terrorist attacks and the onset of recession. Similarly, no one knows what types of economic or political shocks will arise in the future. The uncertainty surrounding such events should make us cautious as we attempt to formulate our budget projections.

Indeed, over the last six years, the 10 year fiscal projections have varied to a stunning degree. In the 1997 Budget, rising deficits were forecast totaling $1.4 trillion over a 10 year horizon. By the 2002 Budget steadily rising surpluses were projected over a 10 year period, totaling $5.6 trillion. Due to the events of last year, the latest projections are in between these wildly divergent estimates. Such enormous swings over a short period of time raise doubts about the usefulness of 10 year projections and lead one to conclude that the recent experiment with 10 year budget projections has been a failure. Consequently, the Administration intends to phase out the use of 10 year budget projections completely by the 2004 Budget. This year's budget will still provide aggregate 10 year projections for those who follow and still find value in such numbers (see Summary Tables). However, agency totals and supporting detail will be limited to five year projections.

### Recent Experience

It is easy to forget that 10 year budget forecasts are a relatively new phenomenon. The 1996 Mid-Session Review was the first budget document to use 10 year projections. In the prior 25 years, five year budget windows were the norm. (In fact, prior to 1971, three year budget windows were used.)

Indeed, even five year estimates are fraught with uncertainty. The average absolute errors in projecting the surplus or deficit since 1982 have been large, and they increase in each year of the five year budget window. There has been a $75 billion average absolute forecasting error for the budget year alone (i.e., 2003 for this budget). This rises steadily to $205 billion by the fourth year following the budget year (i.e., 2007 for this budget). Since the experiment with 10 year budget projections has been brief, data are not yet available to assess the average miss beyond five years. However, the rising average absolute errors over the first five years point to steadily rising errors over the subsequent five years as well. (For more information on the historical record of differences between estimated and actual surpluses, see Chapter 18 of the *Analytical Perspectives* volume, Comparison of Actual to Estimated Totals.)

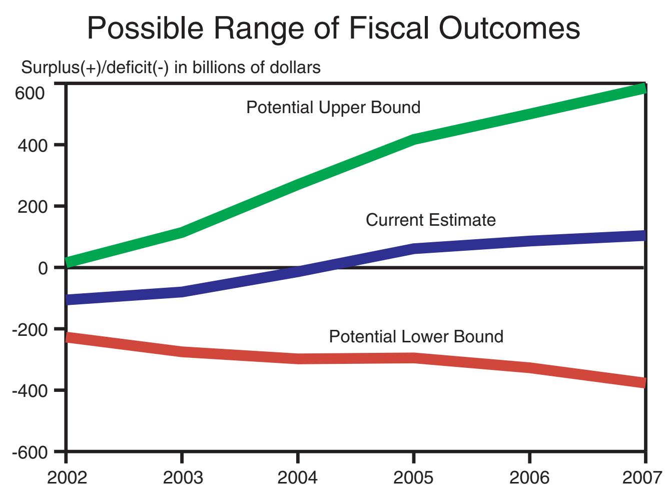
**Average Absolute Miss in Budget Projections: 1982 to 2001**
(In billions of dollars)

| Budget Year | Budget Year Plus One | Budget Year Plus Two | Budget Year Plus Three | Budget Year Plus Four |
|---|---|---|---|---|
| 75 | 109 | 147 | 179 | 205 |

History suggests that the current projections could be off by an enormous margin. A 90 percent confidence range around the current projections stretches from plus $480 billion to –$480 billion around the 2007 surplus estimate. Based on the trend seen in the first five years, this confidence range would be expected to widen further beyond 2007.

The Congressional Budget Office (CBO) has made similar calculations and has estimated even larger uncertainty bands.

## Responses to Uncertainty




There is widespread recognition of the difficulties involved in making multi-year projections. For instance, the Administration and CBO only attempt to forecast the economic cycle for the 18–24 month period following the budget submission. Thereafter, both simply assume that the economy returns to its long-run sustainable rate of growth. Most private economic forecasters do not project the economy beyond a one to two year horizon.

In light of the remarkable swings over the last several years, it is time to acknowledge the limitations of 10 year budget forecasts. Rather than continue to assign false confidence to these numbers, the Administration will begin shifting back to a maximum time horizon of five years.

## Budget Reforms

It is critical that the increased funding for the war on terrorism and restoring economic growth be matched with restraint in other areas. This is necessary in order to avoid a worsening of the nation's long-term fiscal and economic outlook. Budget reforms are needed to enforce such restraint.

### Recent Experience

The current budget process is flawed. Instead of coming to agreement on the broad outlines of the budget at the beginning of the year, there is often lengthy debate on spending levels that often culminates in an explosion of spending in a disorderly process of stop-gap funding measures and enormous omnibus bills, late and over budget.

Last year was an extraordinary year, and the Congress moved swiftly to send the President a $40 billion emergency appropriations bill within three days of the terrorist attacks. Thereafter, spending threatened to spin out of control until the President stated he would veto any appropriations bill that exceeded the funding levels he had worked out with the Congress. Ultimately, the President succeeded in keeping spending within the agreed-upon levels.

However, this achievement came at the cost of an extended delay in the enactment of the 13 regular appropriations bills that fund the government, with the last three bills being signed into law on January 10, 2002, over three months past the October 1, 2001 deadline. Two of the nation's departments with the highest priorities, the Departments of Defense and Education, had to wait over three months to get their budgets. Such delays are unfortunate during ordinary times, but are intolerable when the nation is fighting a war both at home and abroad.

### Need for Legally Enforceable Mechanisms

Last year's success in staying within preset budget limits should be institutionalized through the use of legally enforceable mechanisms. These mechanisms include making the budget resolution a law and extending statutory limits on spending. Such action is necessary if we are to maintain overall spending discipline, while allocating resources to our defense, homeland, and economic priorities in a timely fashion.

## Conclusion

Despite the simultaneous impact of the war on terror and a recession, the nation's fiscal outlook remains positive. The 2003 deficit is expected to be less than one percent of GDP. Furthermore, if growth-promoting policies are pursued and spending restraint is exercised, deficits will be both small and temporary.

As the nation addresses its defense, homeland, and economic priorities, however, growth in the rest of government must be restrained to prevent an explosion in spending. To achieve this goal, budget process reforms are needed. Greater efficiencies must also be demanded from government. This is a good idea at any stage, but is imperative in the current environment. By highlighting good and poor performers, this budget attempts to set such a process in motion.