CHARTING A COURSE FOR THE FEDERAL BUDGET

When this Administration took office, the budget forecast a surplus for 2004 of $387 billion. The outgoing Administration, the Congressional Budget Office (CBO), and most private sector analysts all predicted the same basic result. The Department of the Treasury, the Chairman of the Federal Reserve Board, and the financial markets were heavily focused on the question of whether it was wise or even possible to retire as much of the federal debt as the budget proposed. President Bush's first budget, recognizing the hazards and uncertainties of long-term forecasting, set aside $841 billion, or 15 percent, of expected surpluses as a contingent reserve to protect against shortfalls. It turned out to be not nearly enough.

The surpluses will not materialize, at least for the next few years, because circumstances changed radically. Though few believed it in January 2001, our economy was entering a recession. And, no one knew at the time that the 1997 to 2000 revenue surge, like the stock market that in large part created it, was a bubble already in the process of popping. Above all, no one could foresee the terrorism of September 11th, its detrimental impact on the economy, and the unplanned spending of scores of billions of dollars for response and recovery efforts.

Limiting and reducing the federal debt remains a priority for this Administration. But it is not the sole or even the top priority. Ahead of it come national security and economic security—protecting the nation from aggression and protecting the financial futures of America's families.

Instead of surpluses, we now face a period of budget deficits. By all historical standards, these deficits are modest and manageable. And the choices that contribute to them, winning a war against terror, building a homeland security infrastructure, and generating stronger economic growth, are indisputably necessary.

The re-emergence of deficits is not welcome news. The President continues to believe that, under normal circumstances, the federal budget should be in balance. But there are objectives of even greater importance the nation must confront immediately.

The federal government will spend $2.1 trillion in 2003, but this spending will not produce the investments, the businesses, and the jobs that are the heart of the American economy. The federal government should not imagine that its role is to "run the economy." Rather, it should remove obstacles standing in the way of economic growth and create an environment in which the American people can produce and enjoy maximum prosperity.

The President's Budget includes an aggressive economic growth and jobs package. Only a sustained period of strong economic growth will produce the kind of increases in federal receipts that will, if combined with restraint in spending growth, balance the budget once again. The President's Budget will hold the growth in federal appropriations to four percent, the same growth rate projected for family incomes in 2004.

New Policies to Meet New Challenges

Any budget and economic forecast is based on numerous assumptions, many of which will turn out to be wrong. But rarely has the world changed so completely, so unforeseeably, or in such a short period of time as it did in the first nine months of the Bush Presidency. These changes affected the economy, increased the need for federal spending, and drastically reduced the level of receipts flowing into federal coffers.

One of the early signs that the economy was in trouble was the decline in the stock market which began in March 2000, almost a year before the President took office. Significant ups and downs in the stock market are normal, so the general belief was that the market would shortly resume its previous strong upward trend. Instead, the U.S. stock market, like markets around the world, continued its decline through 2001 and on through 2002. The plunge in the market reduced the household wealth of millions of Americans and popped a government receipts bubble that had begun to appear in the mid-1990s.

Even with these early signs, the strong consensus of economists in January 2001 predicted a continuation of at least moderate growth. A few months later, it became apparent that the experts were wrong, and that the economy had slipped into a recession as 2001 began. Although the recession turned out to be shallow and mild and despite economic growth of 3.3 percent in 2002, the impact on federal tax collections defied history.

- Revenues declined two years in a row, the first such phenomenon in over 40 years.
- Revenues declined in 2002 by seven percent, the largest percentage decline since 1946.

The revenue bubble of the late 1990s was in large part due to the rise in the stock market, which caused capital gains receipts to soar. The revenue bubble also was a function of two other changes.

First, the federal government shifted the burden of federal income tax collections to rely more heavily on higher-income individuals. By 2000, the top one percent paid 37 percent of all individual income taxes and the top five percent paid 56 percent. Second, many employers changed the way they compensated their employees, particularly high-income employees, relying more heavily on bonuses and stock options tied to company profits and stock price. Because the recipients of all this new income paid much higher income tax rates than the average, the surge in income among upper-income taxpayers magnified the surge in tax revenues.

One unprecedented feature of the last two years was how rapidly this highly taxed income disappeared, taking with it tens of billions of dollars in federal revenue. Bonuses and stock options became widespread because of their flexibility. In good times, a company can generally reward top employees without building increases into its fixed cost structure. In fact, most such income automatically stops when business' performance or stock value drops. The rapid plummet in the total amount of highly taxed income helped produce the dramatic reduction in 2001 and 2002 tax receipts, a drop far beyond what historical experience would have predicted.

The recession and the popping of the revenue bubble played the two major roles in the return to deficits, but explicit policy decisions also contributed. For example, the Administration's original budget for 2002 envisioned a modest and steady increase in defense spending. The war on terrorism has required still higher spending on traditional defense, and has given birth to a new priority we call homeland security. All together, unanticipated spending to recover from the September 11th attacks, prosecute the war against international terror, and construct a homeland defense has totaled some $100 billion through 2003. The recurring costs of the struggle amount to at least $50 billion each year for the foreseeable future.

Investments and Economic Recovery

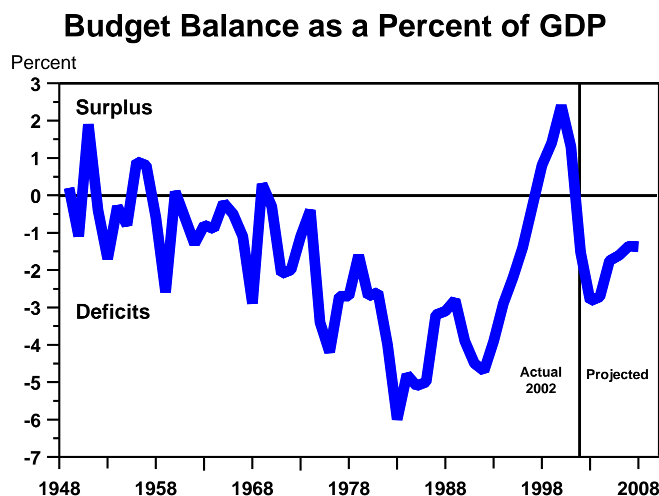
President Bush came to office advocating major tax relief for everyone who pays income taxes to strengthen the economy for the long run. As it turned out, the 2001 tax cut was also the right policy response to the immediate circumstances of a recession already underway. By reducing tax rates, increasing the child tax credit, and other changes, the 2001 tax bill provided tax relief just when it was needed most to support the economy and America's families. A common misconception (or distortion) is the suggestion that today's deficit is a consequence of the 2001 tax cut. In fact, if the tax cut of 2001 had never become law, the budgets for 2002 and 2003 would have been in deficit by $117 billion and $170 billion respectively. (In reality, the outcome would have been worse because the economy would have been even weaker.)

As the effects of the 2001 recession became clearer, the President called upon the Congress to enact a second measure to stimulate jobs and growth. In March 2002 the President signed into law legislation that included a temporary tax cut on new business investment, as well as an extension of benefits to meet the needs of the unemployed.

The tax relief laws enacted in 2001 and 2002 were vital to avoiding a longer, deeper recession, and to getting a recovery started. That recovery is over a year old. But its growth, at around three percent, is not sufficient in the President's judgment. Therefore, he has proposed a jobs and growth package to be enacted as soon as possible. This package would accelerate to 2003 critical provisions from the 2001 tax bill that otherwise would not take effect for one to three years. It would provide much greater leeway for small businesses to invest and expand, and strengthen investor confidence by ending the double taxation of shareholder dividends. See the chapter "For Everyone Willing to Work, A Job" for more details.

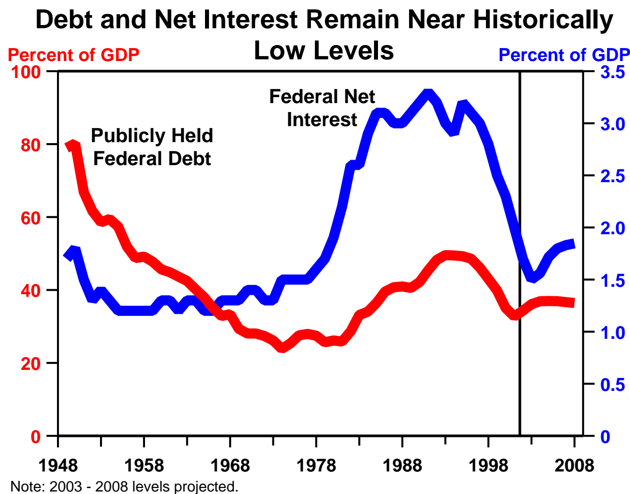
Putting the Deficits in Perspective

Through unavoidable, unfortunate, and unwelcome events, the budget has returned to deficits. But these deficits must be seen in perspective. Economists of virtually all viewpoints agree that modest deficits are tolerable and even appropriate during periods when the economy is underperforming. The question is, are today's deficit levels unacceptable? Should they be reduced even if that means less money invested in national security, homeland security, or the nation's economic growth?



By any measure, the projected deficit for 2004 must be judged as moderate. As a share of the economy (GDP), it would be smaller than in 12 of the last 20 years.

Perhaps the best indicator of the deficit's current impact is the interest costs it imposes on the budget. Due to today's extraordinarily low interest rates, the carrying costs of outstanding debt will actually fall this year from $171 billion to $161 billion.



Whereas in 1996 over 15 cents of each dollar of federal spending went to interest expense, this year interest payments will amount to only eight cents of each dollar, the lowest level in 26 years. Even a significant increase in interest rates as the economy strengthens will leave this figure far below its levels of the 1980s and 1990s. Meanwhile, the total national debt on which the nation must pay interest remains at a historically moderate level and far below the average in other major countries.

None of this is to accept budget deficits as a permanent fiscal condition, or to minimize the importance of controlling and eventually eliminating them. It is only to note that the nation can clearly sustain budget deficits at the projected levels, and that the primary goal of policy should be to control them through spending restraint until a resurgent economy can restore fiscal balance.

A Cautious Forecast

The Administration estimates that if the President's policies are enacted the federal government will run a deficit of some $307 billion this year. In view of the unprecedented revenue plunge of 2001–2002, the Administration has opted for a cautious revenue projection. After selecting conservative economic assumptions, the Administration further reduced its receipts forecast for 2003 and 2004 below what the economic and tax models indicate. The Administration has reduced its forecast for 2003 income tax receipts by $25 billion below the models' predictions, and for 2004 the forecast for income tax receipts was reduced by $15 billion. The net effect is that projected receipts remain flat this year when fiscal history suggests a sharp increase.

Although this forecast should protect against a negative surprise on the receipts side, one cannot know what sudden additional spending the war on terrorism might require. The budget's economic assumptions likewise are conservative, but uncertainties and the risks of further economic slowing cannot be ignored, as the President concluded in advancing his latest growth proposals.

A More Reasonable Timeframe for Forecasting Deficits and Surpluses

In keeping with the intention announced in last year's budget submission, this budget limits its forecast to five years (see page 38 of the 2003 President's Budget and page 8 of the 2003 Mid-Session Review). This change returns to the practice that prevailed for the 25 years prior to 1996. Prior to 1971, budgets looked ahead only *three* years. Since 1996, when the Office of Management and Budget made its first 10-year projection, these forecasts have varied to a stunning degree. The experiment with 10-year estimates led to many lengthy and unproductive debates on information that proved to be erroneous and unreliable.

Even five-year projections 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 $90 billion average absolute forecasting error for the first year alone.

A 90-percent confidence range for 2008 would stretch all the way from a $281 billion surplus to a $661 billion deficit, a range of nearly $1 trillion. Based on the trend over the first five years, this confidence range would be expected to widen further beyond 2008.

CBO has made similar calculations and has estimated even larger uncertainty bands. CBO also has noted the problems with making five- and 10-year forecasts by stating, "Looking forward five or 10 years allows the Congress to consider the longer-term budgetary implications of policy changes. But it also increases the likelihood that budgetary decisions will be made on the basis of projections that later turn out to have been far wrong."

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.

Of course, it is appropriate to analyze the long-term impact of policies, particularly pension and other entitlement programs, where costs are driven by predictable populations and benefits that are defined in law. "The Real Fiscal Danger" chapter in this volume and the "Stewardship" chapter in the *Analytical Perspectives* volume extensively analyze and review these issues.

Meeting Priorities While Restraining the Growth in Spending

One conclusion is inescapable; the federal government must restrain the growth in any spending not directly associated with the physical security of the nation. Amid the return of deficits, uncertainty about revenue patterns, economic growth rates, and war costs, a posture of stern caution about spending is the only defensible policy.

There is no single gauge of whether spending is growing too fast or not, but certain guidelines are helpful. One requires that the path of spending should lead to a steady reduction in the deficit once the economy is growing vigorously again. Under the President's 2004 Budget, this would be the case, as the deficit is projected to reach its peak of $307 billion in 2004 and decline thereafter.

In directing the preparation of this budget, the President chose a common sense yardstick in establishing the boundary for new spending. At a time of both economic and fiscal difficulty, he believes that the government's budget ought not grow faster than that of the American family. With estimates of family income growth clustered around four percent, the President's budget chooses that as its benchmark, and proposes to fund the nation's ongoing priorities within that reasonable limit.

To start the budget on a firm course back toward balance, the President further proposes to extend the Budget Enforcement Act controls that expired in 2002. He requests that the Congress impose, for 2004 and 2005, statutory caps on discretionary spending limited to the four percent growth in family income, along with a renewal of the "pay-as-you-go" requirement to constrain the growth of the non-essential spending during this period of unique economic and international uncertainty.

As important as controlling yearly deficits is, a vastly greater fiscal threat awaits the nation's attention. We must not lose sight of the long-term challenge to modernize and reform Medicare and Social Security to ensure these vitally important programs can serve the needs of future generations. See "The Real Fiscal Danger" chapter for more details.