Reality Check

Turning Gold into Straw

How Huge Federal Surpluses Quickly Became Equally Massive Deficits

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Turning Gold into Straw

How Huge Federal Surpluses Quickly Became Equally Massive Deficits

In the final months of the Clinton administration, fiscal experts forecast that federal budget *surpluses* were on track to reach unprecedented heights. In 2001, the Congressional Budget Office (CBO) expected federal surpluses to grow from nearly $300 billion in 2002 to more than $700 billion in 2011, for a ten-year total of $5 trillion. Those estimates created optimism that the nation would be in good shape to tackle the challenges posed by our aging population as well as gaps in health care coverage. The budget outlook was as good as it had been in a half century.

Just two and a half years later, the federal budget is poised to run its biggest deficit since the end of World War II. In August 2003, the CBO projected a ten-year deficit of $1.4 trillion (from 2004 to 2013). Less than half a year later, in January 2004, the CBO once again revised its forecast downward. The cumulative deficit from 2004 to 2013 now is expected to reach about $2.3 trillion. But even the revised CBO figure greatly understates the deficits that the nation is likely to confront. The CBO estimate ignores the effects of population and income growth on federal spending, assumes questionably that the tax cuts of 2001 will be allowed to expire, and anticipates that the so-called alternative minimum tax (originally meant to apply only to high-income families who benefit inordinately from tax shelters) will be extended to a third of taxpayers. If President Bush has his way, the tax changes all will be made permanent, and the alternative minimum tax will be rolled back. The CBO forecast also underestimates spending related to the nation's military

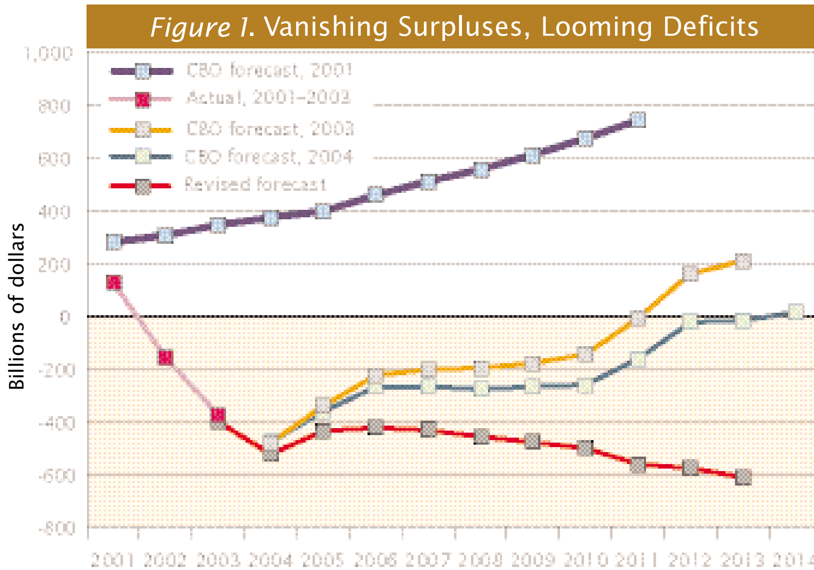
engagements abroad. A more realistic forecast has been assembled jointly by three reliable research organizations—the Committee for Economic Development, the Concord Coalition, and the Center on Budget and Policy Priorities. Their calculations indicate a ten-year budget deficit of nearly $5 trillion for the 2004–2013 period.

How did the federal budget's condition deteriorate so much, so fast? The short answer: two huge tax cuts, a recession, steep increases in military and domestic security outlays, and several other less significant factors.

A Tale of Four Budget Forecasts

Figure 1 depicts four long-term estimates for the federal budget. The top line represents the 2001 CBO projection showing growing surpluses as far as the eye can see. The next line is the 2003 CBO forecast, which begins with a 2004 deficit of $480 billion that gradually climbs to a surplus by the year 2011 and reaches a surplus of $200 billion in 2013—a combined ten-year deficit of $1.4 trillion. The third line shows the most recent CBO forecast, which looks worse than the 2003 forecast for every year and

Figure 1. Vanishing Surpluses, Looming Deficits



Source: Committee for Economic Development, the Concord Coalition, and the Center on Budget and Policy Priorities, "Mid-Term and Long-Term Deficit Projections," September 29, 2003.

extends annual deficits through 2013. The bottom line indicates the revised projection to 2013 produced by the Committee for Economic Development, the Concord Coalition, and the Center on Budget and Policy Priorities. The bottom line of that bottom line: a 2002–2011 deficit of about $4.4 trillion and a 2004–2013 deficit of almost $5 trillion.

There are four main reasons why the CBO forecast of 2001 failed to account for the steep falloff that took place from 2001–2003, resulting in a new forecast of a $4.4 trillion deficit for the same 2002–2011 period covered by the CBO's 2001 forecast:

- the economy has grown more slowly than expected, and government revenues have fallen relative to the size of the economy ("economic shortfalls");
- tax cuts have reduced revenues and will do so further because the revised forecast assumes that President Bush will succeed in making the tax cuts permanent, overriding their scheduled expiration in 2010, while reducing the coverage of the alternative minimum tax;
- defense and other security spending has risen sharply after September 11, 2001, with the invasion and occupation of Iraq accounting for the largest share of this increase; and
- even with a tight rein on future spending, other domestic outlays such as a new prescription drug benefit for Medicare will exceed this year's CBO projections.

Figure 2 (see page 4) shows how these four adjustments together, applied only to the period from 2002 to 2011, turn the 2001 forecast of

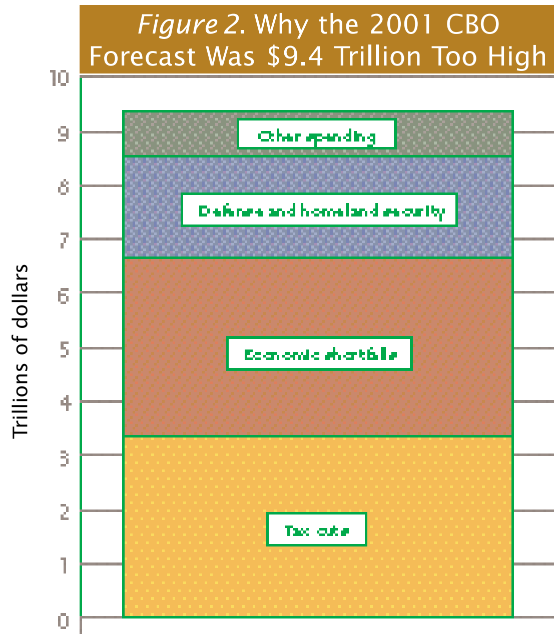


Figure 2. Why the 2001 CBO Forecast Was $9.4 Trillion Too High

Source: Committee for Economic Development, the Concord Coalition, and the Center on Budget and Policy Priorities, "Mid-Term and Long-Term Deficit Projections," September 29, 2003.

a nearly $5 trillion surplus into a $4.4 trillion deficit—a $9.4 trillion turnaround.

The tax cuts account for 36 percent of the total deterioration of the budgetary picture, the weakened economy is responsible for 35 percent, increased defense and security spending accounts for another 20 percent, and other spending is responsible for 9 percent. Further into the future, tax cuts loom larger and larger as the primary cause of huge deficits. In 2011, for example, tax cuts represent 44 percent of the added shortfall.

Without a change in policies, we are headed for a long period of large deficits. How do those deficits compare to the ones in the past?

Future Deficits that Rival Historical Shortfalls

In a nutshell, the nation's fiscal prospects today are similar to those we faced in the early 1980s—the deepest deficits since the end of World War II. As Figure 3 illustrates, we might think of our budget history as having three main segments. During the first segment, from 1960 (when the budget ran a small surplus) until 1984, annual deficits followed the ups and downs of the business cycle but tended to get increasingly large. The huge tax cuts at the beginning of the Reagan administration were largely responsible for deficits that sunk to a valley in 1984 of about 6 percent of the nation's economy.

During the second segment, which lasted from 1984 to 2000, the budget balance tended to improve. Propelled by the tax increases of 1986, 1991, and 1993—as well as government spending restraints and generally favorable economic conditions—deficits declined sharply after 1992, reaching a surplus greater than 2 percent of GDP in the year 2000.

Since then, budget shortfalls have plunged dramatically, close to the 1984 nadir, with a deficit forecast for 2004 of nearly 5 percent of GDP. The projection of the Committee for Economic Development, the Concord Coalition, and the Center on Budget and Policy Priorities suggests that the deficit will remain greater than 3.5 percent of GDP for the foreseeable future.

Why Deficits Matter

In essence, a deficit means that the government is saving less and borrowing more than when the budget is balanced

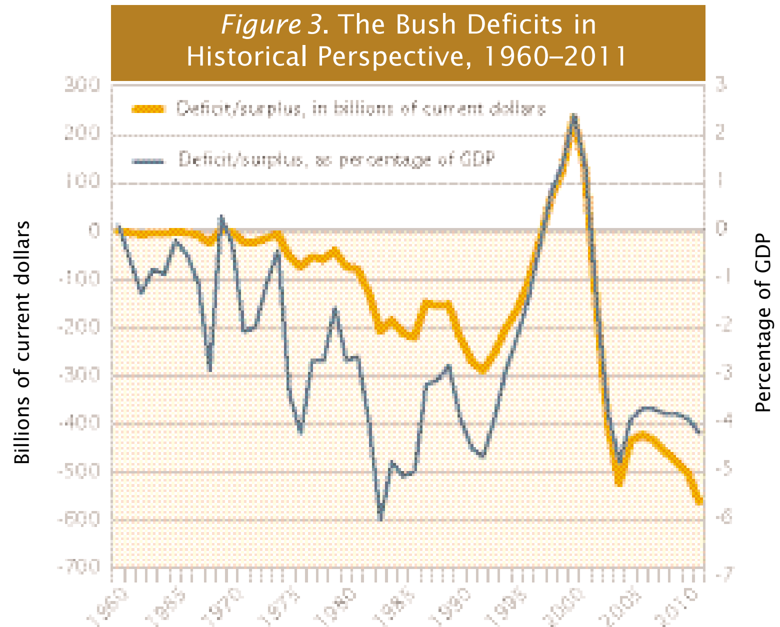


Figure 3. The Bush Deficits in Historical Perspective, 1960–2011

Source: Council of Economic Advisers, *Economic Report of the President, 2003* (Washington, D.C.: Government Printing Office, 2003); Committee for Economic Development, the Concord Coalition, and the Center on Budget and Policy Priorities, "Mid-Term and Long-Term Deficit Projections," September 29, 2003.

or in surplus. If a deficit prevails at a time of high employment, with active private competition to borrow money, it raises interest rates and drains resources that otherwise would be available for business investment. Reduced private investment, in turn, leads to slower growth of productivity and output. As a result, deficits can deprive future generations of capital equipment and technology that would enable them to earn more at work. A $9.4 trillion reduction in domestic resources available for private investment is roughly equivalent to 8 percent of total projected production for the 2001–2011 period. The lurch into massive deficits represents a profound reduction in potential American-owned private investment.

Unless new policies are put in place, the deficits that are now built into the federal budget will continue after the economy has fully recovered and the unemployment rate has fallen. Every year into the foreseeable future, the government will be borrowing heavily, competing with private borrowers, driving up the cost of investment. That drag on the economy will be substantially greater than any positive effect of tax cuts on work incentives and saving.

How the United States Compares to Other Countries

Reducing the deficit will require a combination of raising taxes, curtailing government spending, and strengthening economic growth. Figures 4 and 5 (pages 7 and 8) show how the United States compares to the other major countries and the Euro area of Europe[1] from 1999 to 2005, with the final two years estimated using uniform methods by the Organization for Economic Cooperation and

1. Germany, France, and Italy are the dominant economies of the Euro area, along with most of the rest of mainland Western Europe.

Development (OECD). As Figure 4 illustrates, before the first Bush tax cuts were enacted in 2001, the United States had one of the lowest tax rates among the world's leading economies. Only Japan had a slightly lower tax rate. In European countries, tax rates ranged from six percentage points (Britain) to seventeen percentage points (Euro area) greater than the tax rate in the United States. Government revenue in the Euro area took nearly half again as much of pretax income as in the United States. Yet we cut taxes much more steeply than any other country, leaving us with the lowest level of support for government among all the major countries.

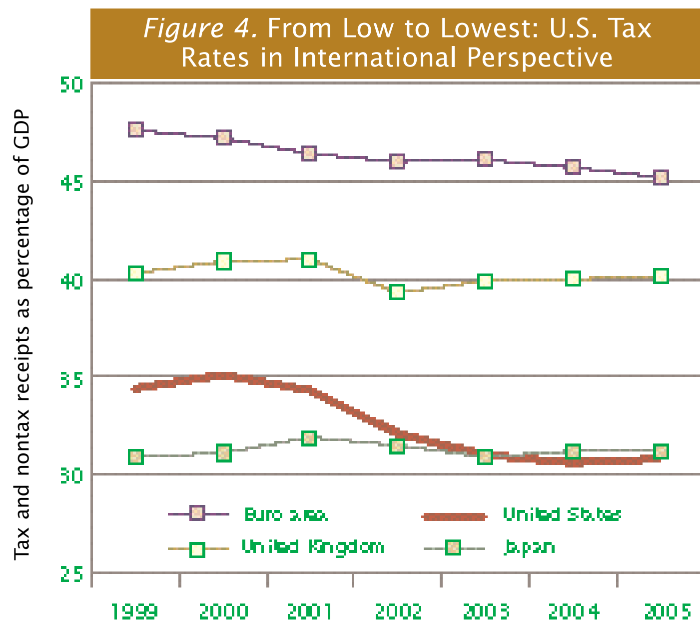


Figure 4. From Low to Lowest: U.S. Tax Rates in International Perspective

Source: OECD, *Economic Outlook* 74 (December 2003): Annex Table 28, "General Government Financial Balances."

The result of our tax cutting is evident in the budget deficit comparisons in Figure 5. Since 2001, the budget not only has moved from surplus to deficit but also has slipped from one of the strongest positions among the leading nations of the world into almost the weakest. And remember, the U.S. surpluses in 1999 and 2000 were achieved with tax rates far below those in most of the advanced economies. Today, only Japan is running a larger deficit, representing an effort by the Japanese government to absorb some of Japan's extra private saving in order to stimulate the economy. In the United States, in contrast, the private saving rate is lower than in any other major economy.

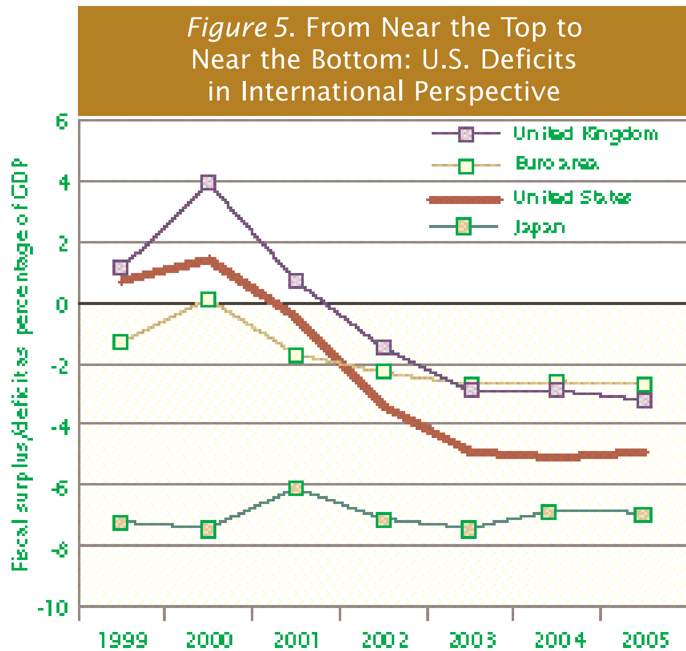


Figure 5. From Near the Top to Near the Bottom: U.S. Deficits in International Perspective

Source: OECD, *Economic Outlook* 74 (December 2003): Annex Table 27, "General Government Total Tax and Non-tax Receipts."

Together, Figures 4 and 5 demonstrate that before the tax cuts of 2001 and 2003, which have plunged us into a profound fiscal mess, our budgets were flush and we had nearly the lowest tax rates among all the leading economies of the world.

The challenge before us is to reverse the pattern of the past three years, to undo both massive tax cuts and spending increases. We seem to have lost sight of the simplest truth of budget arithmetic: over the long run, a nation needs to collect enough taxes to cover its planned spending.

Prepared by Bernard Wasow, Century Foundation Senior Fellow.

Reality Check is a series that separates the facts from the political rhetoric about the important policy issues of our time. You can find this series, plus more public policy information, opinion, and analyses, on The Century Foundation Web site at **www.tcf.org.**

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