Joint Economic Committee Democrats

Representative Pete Stark (D-CA) – Senior Democrat

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The Budget Outlook: Truth and Consequences

The latest *Budget and Economic Outlook* from the Congressional Budget Office (CBO) shows another sharp deterioration in the 10-year budget outlook of roughly $1 trillion. Compared with CBO's August 2003 projections for 2004-2013, total revenues are now projected to be $790 billion lower and total spending is now projected to be $196 billion higher.[1]

A deteriorating budget outlook has become the norm in the past three years. When President Bush took office in January 2001, CBO projected a $397 billion surplus for fiscal year 2004. It is now estimating a deficit of $477 billion—a turnaround of $874 billion. In January 2001, CBO projected a cumulative surplus of $5.6 trillion over the 2002-2011 period. Now it is projecting a cumulative deficit of $2.9 trillion over that same period—a turnaround of $8.5 trillion.

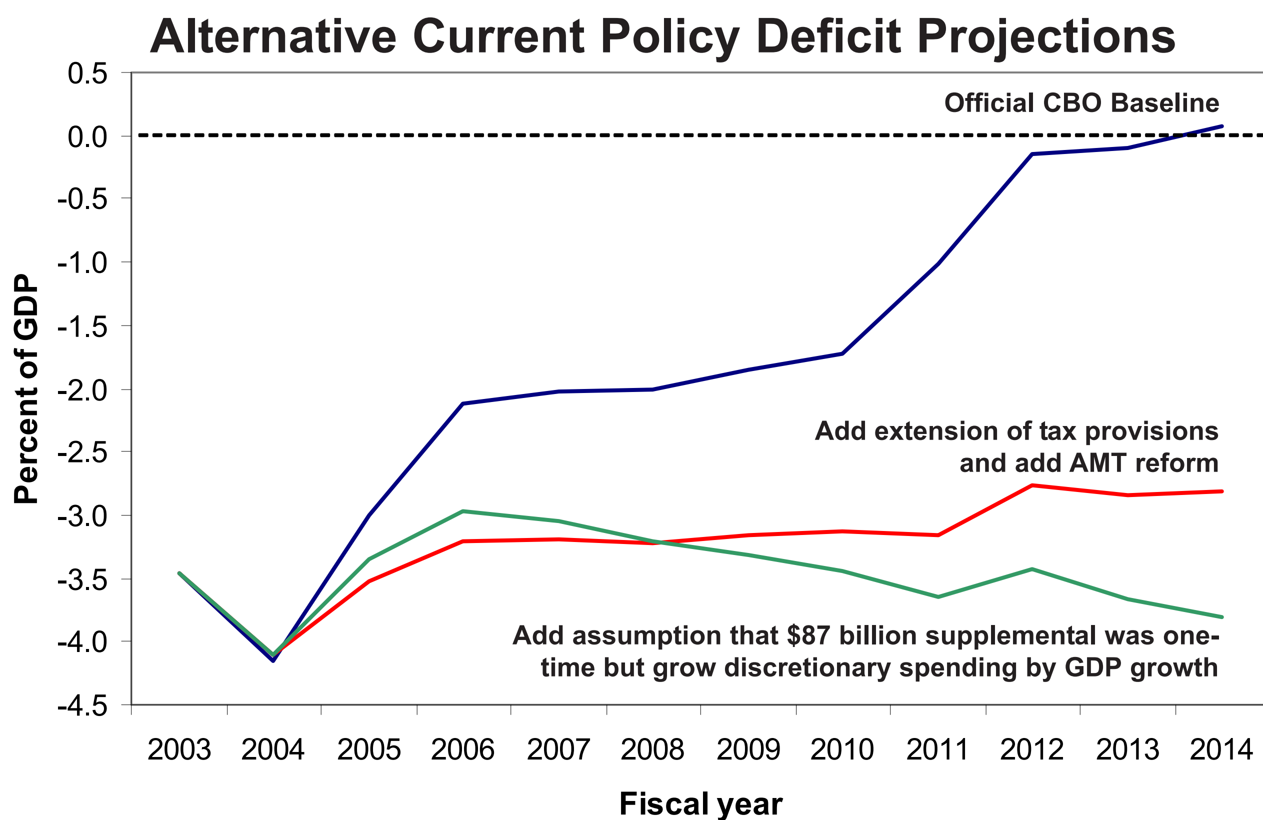
In more realistic projections, the budget deficit is likely to remain at 3 to 4 percent of GDP for the foreseeable future.

The deterioration in the budget outlook that has occurred thus far is disturbing. Moreover, for reasons discussed in the next section, the actual budget deficits over the next several years are likely to be much larger than those projected in CBO's baseline. President Bush continues to act as though the budget deficit is under control and poses no threat to the economy. Sober economic analysis says otherwise.

Baseline versus Realistic Deficit Projections

The projected budget deficits in CBO's new baseline are substantial, but the actual deficit path is likely to be worse still. That is because the baseline is not a prediction of future budget outcomes, but rather an estimate of what revenues and spending would be under current laws and policies. For example, the baseline assumes that all of the $1.9 trillion of tax provisions that are scheduled to expire over the next several years actually expire, rather than being extended—even though President Bush is committed to extending many of them. It also assumes that discretionary spending grows only at the rate of inflation (constant real spending)—even though growth has been substantially faster than that in the past few years.

Based on CBO's estimates of the budgetary effects of policy alternatives not included in its baseline, it is hard to see how President Bush will make good on his pledge to cut the deficit in half by 2009, whether the deficit is measured in dollars or as a share of the gross domestic product (GDP). CBO's baseline shows the deficit falling from 4.2 percent of GDP in 2004 to 1.8 percent of GDP in 2009 (see **Chart 1**). However, if all expiring tax provisions are made permanent and the number of taxpayers subject to the alternative minimum tax (AMT)



remains roughly the same, the deficit does not drop below 3 percent of GDP until 2012. If, in addition, discretionary spending is allowed to grow at the same rate as GDP (and the $87 billion Iraq supplemental passed last year is not treated as a recurring expenditure), the deficit drops to 3 percent of GDP in 2006 but begins worsening again and is close to 4 percent of GDP in 2014. Thus, in these more realistic projections, the budget deficit is likely to remain at 3 to 4 percent of GDP for the foreseeable future.

Under the more realistic tax and spending assumptions outlined above, the on-budget defecit—which excludes the Social Security trust fund surplus—would be 5.4 percent of GDP in 2004 and also in 2014. The only year in which the on-budget deficit was higher (as a share of GDP) was 1983. Every dollar used to extend the President's tax cuts would be a borrowed dollar, and on-budget deficits would total $7.5 trillion over the 2005-2014 period.

Economic Effects of Large Budget Deficits

The President has refused to take any responsibility for the sharp deterioration in the federal budget deficit since he took office, arguing that his tax cuts have benefited the economy and will continue to do so. The latest evidence from CBO about the continued worsening of the long-term budget outlook makes it all the more important to examine closely the arguments about how budget deficits affect the economy.

Short-Term Effects

President Bush has argued that the contribution of his tax cuts to raising the deficit was necessary to

keep the 2001 recession from being worse. Economists recognize that an appropriate and well-timed dose of fiscal stimulus (tax cuts or spending increases) can prop up aggregate demand and dampen the short-run output and employment losses that occur in a recession. However, several analyses of the Bush tax cuts, including those by the Joint Economic Committee Democrats and the private forecasting group Economy.com, have raised serious questions about whether the Bush tax cuts were the right tools for fighting the recession.[2]

Those analyses found that several key provisions of the Bush tax cuts, especially cuts in marginal income tax rates for very high-income taxpayers, have very low fiscal bang-for-the-buck. In other words, their effectiveness in softening the economic impact of a recession is small relative to the amount they add to the long-term budget deficit. In contrast, policies favored by Democrats that put money in the hands of middle- and lower-income taxpayers, unemployed workers, and cash-strapped state and local governments are much more cost-effective as anti-recessionary fiscal policy.[3]

Long-Term Effects

Budget deficits erode long-term prosperity by reducing national saving. Reduced saving can translate directly into a lower future standard of living by raising interest rates and discouraging investment. With less investment in new plant and equipment, future generations inherit a smaller capital stock than they otherwise would. Output, productivity, and income are all smaller than they would be with smaller budget deficits. As long as private investment demand is weak as a result of the recession, upward pressure on interest rates is also likely to be weak. But once a strong economic recovery is underway, large budget deficits produce higher interest rates and lower investment than would occur with a more prudent fiscal policy.

The second channel through which budget deficits can erode long-term prosperity is indirectly through foreign borrowing and the trade deficit. As long as the rest of the world is willing to supply the saving that we are unwilling to do ourselves, we can borrow from abroad and interest rates do not have to rise. However, repaying that borrowing will lower national income in the future. In the meantime, the value of the dollar will be higher and the trade deficit larger than would be the case with a more prudent long-term fiscal policy. Financing our budget deficit with foreign borrowing has the additional danger that foreign lenders may suddenly abandon the dollar, which could cause an international financial crisis, a sharp deterioration of the dollar, and a rise in interest rates that would discourage investment.

Missed Opportunities

In addition to the economic effects discussed above, permanent budget deficits threaten the country's ability to meet its commitments to the future economic well being of the population. Before the end of the 10-year budget window the fiscal pressures from the retirement of the baby boom generation will be upon us. The Bush administration squandered a golden opportunity to prepare for that challenge by paying down federal debt. When President Bush took office in 2001, CBO projected that publicly held federal debt would fall to 18 percent of GDP by 2004 and effectively be paid off within the decade. Now the CBO expects that publicly held debt will remain above 35 percent of GDP through 2014. Under more realistic assumptions about future tax and spending policies, publicly held federal debt could easily top 60 percent of GDP by the end of the projection period. Paying down the debt is the one sure way to increase national saving and reduce the fiscal burden passed on to future generations.

Endnotes

[1] Changes in economic assumptions account for the bulk of the revisions to revenues. Changes in economic assumptions alone work in the direction of reducing overall outlays and offsetting a substantial part of the revenue change. However, legislative changes, most notably the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, and additional debt service outlays are large enough that there is a net increase in outlays that adds to the deficit.

[2] Joint Economic Committee Democrats. March 2003. "Policies to Restore Full Employment and Promote Long-term Growth: Comparing the President's Jobs and Growth Initiative with the Democratic Alternative": Joint Economic Committee Democrats. and Economy.com. February 2003. "The Economic Impact of the Bush and Congressional Democratic Economic Stimulus Plans,": Economy.com

[3] For more details and evidence that Democratic policies would be cost effective, see Joint Economic Committee Democrats. March 2003. "Policies to Restore Full Employment and Promote Long-term Growth: Comparing the President's Jobs and Growth Initiative with the Democratic Alternative": Joint Economic Committee Democrats.

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