

January 6, 2003

SQUANDERED

CBO Figures Show How the Surplus of 2001 Became a Deficit in 2003

By Richard Kogan

“If we do not ... reaffirm our commitment to fiscal discipline, years of hard effort could be squandered.” - Alan Greenspan¹

Chairman Greenspan recently warned that a 15-year effort to restore fiscal health to the federal budget is in danger of being reversed. Unfortunately, more than half of the reversal has already occurred. Even after the effects of the current economic slump are factored out, more than half of the improvement in the fiscal picture from 1986 to 2001 has been reversed in just two years.

During the 15-year period from 1986 to 2001, big deficits turned to big surpluses. The reduction in deficits and subsequent increase in surpluses equaled an impressive 4.8 percent of the Gross Domestic Product during that period. Yet even if no further tax cuts or spending increases are enacted, almost three-fifths of the improvement made from 1986 to 2001 will have been reversed in 2002 and 2003. Tax cuts, losses in revenue for other reasons unrelated to the economic downturn, and increases in program expenditures (including expenditures for defense and homeland security) have caused the fiscal picture to deteriorate by 2.8 percent of GDP in two years, with surpluses turning to deficits.²

All figures used in this analysis reflect the *underlying structure* of the federal budget after the effects of the business cycle have been factored out. These figures on the underlying structure of the budget come from a September 2002 report issued by the Congressional Budget Office, which presents information on the budget after adjustments have been made to remove the transitory effects of the business cycle and other anomalies (see box on page 5). Because CBO's figures correct for the business cycle, one cannot cite the current recession as an explanation for the recent decline in revenues or increase in program costs as a share of GDP that shows up in these figures. For the same reason, one cannot cite the economic boom to explain the improvement in the fiscal picture from 1986 to 2001. (In fact, without these CBO adjustments, the reversal of fiscal discipline in 2002 and 2003 would appear even greater than this analysis shows it to be.)

¹ Chairman of the Board of Governors, Federal Reserve System, testimony before the Committee on the Budget, U.S. House of Representatives, September 12, 2002. Chairman Greenspan was advocating fiscal discipline generally and the extension of expiring budget enforcement procedures specifically. Available at <http://www.federalreserve.gov/boarddocs/testimony/2002/20020912/default.htm>.

² Figures for 2003 are based on the August 2002 baseline projections of the Congressional Budget Office. The figures used here consequently assume no additional tax or entitlement changes beyond those enacted by August. For annually appropriated programs, the figures for 2003 assume enactment of the levels requested by the Administration.

Table 1
Changes in the Budget from 2001 to 2003
Standardized expenditures and revenues as a share of potential GDP

	2001	2003	Percentage point change from 2001 to 2003	Note: 2001-2003 change <i>without</i> CBO adjustments
Revenues	19.1%	17.5%	-1.6%	-2.0%
Budget programs*	16.8%	17.9%	+1.2%	+1.6%
Defense, homeland security, and international affairs	3.4%	4.0%	+0.6%	+0.6%
Domestic appropriations outside homeland security	3.1%	3.3%	+0.2%	+0.2%
Entitlement or “mandatory” programs	<u>10.2%</u>	<u>10.7%</u>	<u>+0.5%</u>	<u>+0.7%</u>
Surplus (+) or deficit (-)*	+2.4%	-0.4%	-2.8%	-3.6%

* excluding net interest, may not add due to rounding. Data on standardized expenditures and revenues from CBO.

I. Overview of Findings

Previous analyses by the Center on Budget and Policy Priorities and other budget analyses have focused on the deterioration of projected budget surpluses *over the coming decade*. In January 2001, for instance, CBO projected a surplus totaling \$5.6 trillion over the ten-year period from 2002 to 2011. Today CBO projects that virtually the entire surplus for that ten-year period has disappeared.³

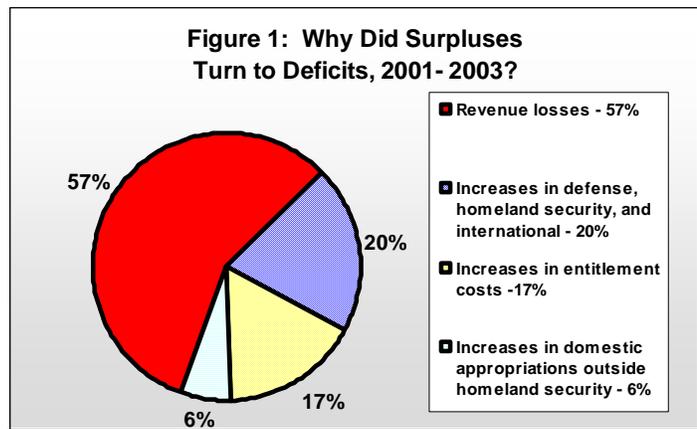
This analysis has a different focus: it looks backward rather than forward. It explains how the actual 2001 surplus has turned into a likely 2003 deficit. Looking further back, the analysis examines how deficits grew from 1981 to 1986 and then considers how 15 years of hard work first shrank the deficits and then turned them to near-record surpluses in 2000 and 2001. This analysis yields several findings.

- From 1981 to 1986, the underlying structure of the federal budget deteriorated by 2.2 percent of GDP, going from near balance to substantial deficit. All of the deterioration was caused by revenue losses, the product of the 1981 tax cuts. Domestic programs were reduced during this period as a share of GDP, but defense spending was increased by an amount that largely offset the domestic program reductions.
- During the 15-year period from 1986 to 2001, the underlying structure of the budget improved by 4.8 percent of GDP. This is a far greater improvement than over any comparable period that CBO has analyzed. (CBO’s figures reach back to 1960.) Approximately 45 percent of the improvement came from tax increases

³ See Kogan and Greenstein, “The New Congressional Budget Office Forecast and the Remarkable Deterioration of the Surplus,” Center on Budget, September 3, 2002, 4 pages, available at <http://www.cbpp.org/9-3-02bud.pdf>. See also “An Examination of Recent Budget and Economic Projections by the Congressional Budget Office,” Center on Budget, September 10, 2002, 8 pages; available at <http://www.cbpp.org/8-29-02bud.pdf>.

and other sources of revenue growth, while 55 percent came from reductions in the cost of federal programs as a share of GDP. The reduction in federal expenditures was accomplished by reducing defense as a share of GDP and, to a much lesser extent, reducing international programs. The amassing of large stockpiles of weapons and munitions in the 1980s and the end of the Cold War facilitated the reduction in defense expenditures as a share of GDP during this period.

- The deterioration in the budget from 2001 to 2003 (i.e., the deterioration in 2002 and 2003, as compared with 2001 budget levels) totals 2.8 percent of GDP. The large tax cut enacted in 2001 and other revenue losses account for 57 percent of this budget deterioration. Increased expenditures for defense, homeland security, and international programs are the next largest cause, accounting for 20 percent of the deterioration. (See Table 1, previous page, and Figure 1.)



- The deterioration of the fiscal picture during 2002 and 2003 erased almost three-fifths of the improvement made over the previous 15 years from 1986 to 2001. It represents a larger deterioration in *two* years than occurred in the five years from 1981 to 1986.

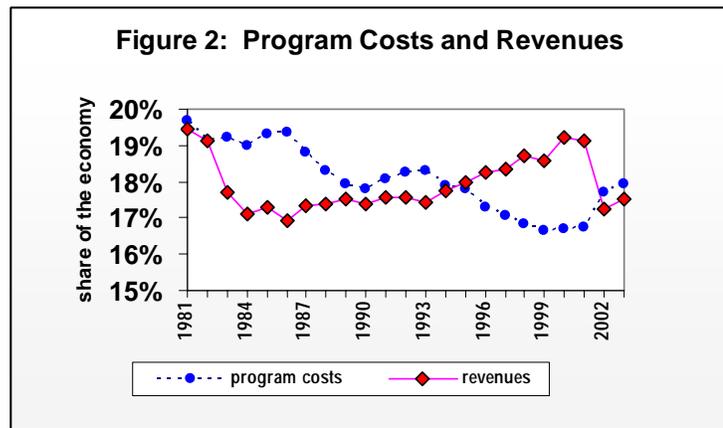
Virtually all of the deterioration in the budget that occurred in 2002 and 2003 took place in 2002. (CBO does not currently project further deterioration in 2003, although that projection could quickly change if the nation goes to war with Iraq.) In a recent analysis, CBO projected that the decline in revenues in 2002, measured in percentage terms, was the largest in 50 years, while the percentage increase in expenditures for federal programs in 2002 was the largest in 20 years.⁴

- Some may be tempted to blame the recession for the deterioration in the budget in 2002 and 2003. As previously noted, however, the figures used here have been adjusted by CBO to factor out the effects of recessions. The revenue implosion shown in these CBO figures must be attributed entirely to the tax cut and other

⁴ Congressional Budget Office, "Monthly Budget Review," October 9, 2002. CBO's observation was based on the percentage change from 2001 to 2002 in unadjusted revenue figures and in figures for expenditures other than interest payments on the debt. Adjusted for the business cycle and other anomalies — as is done in this analysis — and measured as the change in revenues or program expenditures as a share of the economy, the results are equally dramatic: measured in this manner, the 2002 revenue drop is the steepest on record (the adjusted data go back to 1960) while the increase in program expenditures in 2002 is the largest in 34 years.

revenue losses *beyond* those that can be explained by the recession, not to the recession itself. Similarly, the improvement in the underlying structure of the budget from 1986 to 2001 is essentially unrelated to the fact that 2001 came at the end of a major business-cycle boom.

- The underlying structure of the budget in 2003 bears an uncanny resemblance to the structure of the 1989 budget, before the Budget Summit Agreement of 1990 set in place the first of two major rounds of deficit reduction. Overall levels of revenues, program expenditures, and deficits in 2003 as a share of GDP are identical to the levels in 1989.
- Contrary to popular mythology, revenue increases and program reductions have tended to occur *at the same time*. Similarly, revenue *losses* and program *increases* have tended to occur at the same time. These patterns undercut the often-repeated argument that “if you leave money in Washington, they’ll just spend it.” Rather, the data indicate that there are periods in which fiscal restraint on *both* the revenue and program side of the budget is ascendant (such as 1986-2001), and shorter but very expensive periods in which there is significantly less restraint with regard both to tax cuts and federal expenditures (such as 1981-1986 and again in 2002 and 2003).



- Despite the dramatic deterioration in the budget in 2002 and 2003, the estimated imbalance in 2003 between program expenditures and revenues is not especially large, measuring 0.4 percent of GDP. With relatively minor adjustments, the current structure of the budget could be continued indefinitely, were it not for the pending retirement of the baby boom generation and the expectation that health care costs will continue to grow more quickly than the economy. But the baby-boomers’ retirement and continuing health care cost increases must be taken into account. And when they are, it becomes apparent that the underlying structure of the 2003 budget is not sustainable over the long run. Ultimately, tax increases and program reductions will be needed to close the long-term “fiscal gap” that looms.
- The continued phasing in of provisions of the 2001 tax cut throughout the decade, at very substantial cost, runs contrary to the need to close the long-term gap between revenues and programs expenditures. The sooner the long-term problem begins to be addressed, the better. Early action to address the nation’s long-term

budget problems would shrink the national debt and thereby reduce the annual interest payments that the Treasury must make on the debt. Smaller interest payments on the debt would moderate the degree to which large tax increases and program reductions ultimately will be necessary.

The Underlying Structure of the Budget

The figures in this paper show whether revenues or program expenditures are growing or shrinking as a share of the economy, as measured by the Gross Domestic Product. We display all budget levels as a share of the economy, an approach that takes on particular importance when examining trends over more than a quarter century. When we say that revenues or federal expenditures “shrink” or “increase,” we mean as a share of the Gross Domestic Product.

To minimize the effects of the business cycle, artificial shifts in the timing of receipts or expenditures, asset sales, and other transactions that have no economic significance, this analysis uses recently published CBO data that adjust for the business cycle and such anomalies.* (If this analysis did not use CBO’s adjusted data, the deterioration in the budget during 2002 and 2003 would appear even greater.) Also of note, this analysis does not include interest on the debt in its measure of trends in federal program expenditures. It does not include interest payments for four basic reasons.

- Interest is not a spending program like health care, infrastructure, education, or defense; it does not provide goods, services, or benefits to the public.
- An increase in interest expenditures can be caused *either* by increases in program expenditures *or* by decreases in revenues; either can cause the debt — and interest payments on the debt — to grow. Changes in interest costs thus can reflect changes in tax policy as much as changes in program expenditure policies.
- The level of interest payments in any year is largely a function of deficits and surpluses run in *prior* years. Including interest payments in the figures for a given year may distort the picture of that year’s budget policies.
- To decide whether a given level of spending and revenues is sustainable over long periods, it generally is sufficient to know whether revenues currently cover the cost of federal programs *excluding* interest. If they do, and if it is programmatically possible to maintain the current levels of revenues and program expenditures (excluding interest payments) over the long term, it is likely that future revenues will not need to be increased or future programs reduced as a share of the economy for fiscal reasons.

* This analysis uses “standardized” budget data, which correct for distortions caused by fluctuations in the economy and other anomalies. See Congressional Budget Office, *The Standardized and Cyclically Adjusted Budgets: Updated Estimates*, September, 2002, available at <ftp://ftp.cbo.gov/37xx/doc3743/09-03-StdBudget.pdf>. For additional details on the data used in this analysis, see the Appendix.

II. Tax Cuts and the Sudden Deterioration of the Budget: A Repeat of the Early 1980s?

In 1981, before the tax and spending policies of the Reagan Administration took effect, the underlying structure of the federal budget was in decent shape. The deficit (excluding interest⁵) was quite small — 0.2 percent of GDP — and at the beginning of 1981, the debt as a share of GDP was near a 50-year low. By 1986, however, the deficit had grown to 2.4 percent of GDP, and the debt-to-GDP ratio had swelled by more than 55 percent. All of the deterioration in the budget from 1981 to 1986 was caused by revenue declines, with revenues falling from 19.5 percent of GDP to 16.9 percent. The very large tax cut enacted in 1981, although somewhat scaled back in 1982, was the essential cause of the revenue losses. As shown in Table 2, overall program expenditures remained largely unchanged from 1981 to 1986. (They declined very slightly; domestic programs shrank, but defense expenditures grew by almost as much.)

Table 2
Changes in the Budget over Three Periods: 1981 to 1986; 1986 to 2001; and 2001 to 2003
Standardized expenditures and revenues as a share of potential GDP

	1981	1986	1981 to 1986	2001	1986 to 2001	2003	2001 to 2003
Revenues	19.5%	16.9%	-2.5%	19.1%	+2.2%	17.5%	-1.6%
Budget programs*	19.7%	19.4%	-0.3%	16.8%	-2.6%	17.9%	+1.2%
Defense, homeland security, and international affairs ⁶	5.6%	6.6%	+1.1%	3.4%	-3.2%	4.0%	+0.6%
Domestic appropriations w/o homeland security	4.3%	3.3%	-1.0%	3.1%	-0.1%	3.3%	+0.2%
Entitlements	<u>9.9%</u>	<u>9.5%</u>	<u>-0.4%</u>	<u>10.2%</u>	<u>+0.8%</u>	<u>10.7%</u>	<u>+0.5%</u>
Surplus (+) or deficit (-)*	-0.2%	-2.4%	-2.2%	+2.4%	+4.8%	-0.4%	-2.8%

* excluding net interest; may not add due to rounding. Data on standardized expenditures and revenues from CBO.

The sudden deterioration of the budget in 2002 and 2003 is similar to the deterioration of the early 1980s in some ways and different in others. The similarities are striking: both periods are characterized by a large decrease in revenues (from 19.1 percent of GDP in 2001 to 17.5 percent in 2003) and a substantial increase in expenditures for defense, homeland security, and international affairs (from 3.4 percent of GDP in 2001 to 4.0 percent in 2003). But differences also should be noted.

- The tax cuts and defense increases in 2002 and 2003, though quite large, were not as large as in the 1981-1986 period.
- Domestic programs grew in 2002 and 2003, whereas they shrank from 1981 to 1986. (The next section of this analysis examines recent expenditure growth in more detail.)

⁵ For the reasons explained in the box on the prior page, this paper excludes the costs of interest from calculations of “budget programs,” “expenditures,” “surpluses,” and “deficits.”

⁶ Historical data for the costs of “homeland security” are somewhat sketchy. This analysis assumes that expenditures for homeland security (e.g. for protecting our borders by the INS and the Customs Service) constituted approximately two percent of domestic discretionary funding in years before 1998, as they did in that year.

- The overall deterioration in the budget in 2002 and 2003 is even greater than the deterioration from 1981 to 1986. The recent deterioration in the underlying structure of the budget is the largest two-year deterioration over the 40-year period that CBO's analysis covers and exceeds the deterioration in any two-year period of the Great Society or the Vietnam War.⁷
- While the underlying structure of the budget was in reasonably good shape in 1981 before the large 1981 tax cut, the underlying structure of the budget appeared to be in much stronger shape in 2001 before the large 2001 tax cut. In 2001, the underlying structural surplus stood at 2.4 percent of GDP.
- Because the structure of the budget was in such good shape before the 2001 tax cut, some thought the tax cut and proposed program increases were affordable. Unfortunately, that conclusion overlooked other essential differences between the 1981 and the 2001 situations. In particular, the retirement of the baby boomers is now less than a decade away. Moreover, we have a much more sobering view of the cost of the baby boomers' retirement today than we had in 1981. Longer life expectancies and lower birthrates were somewhat speculative at that time; now they are large and costly facts.

In short, in 1981 the relatively good budget picture deteriorated markedly as a result of an unaffordable tax cut. In 2001, an apparently far better budget picture was partly illusory because it ignored the reality of future health care and Social Security costs associated with the baby boomers. The combination of the 2001 tax cut and noticeable program increases, especially in defense and homeland security, may have looked affordable. In reality, it was not.

III. The Relationship between Revenues and Program Costs

One argument made on behalf of the 2001 tax cut was that it was needed to avoid large and undesirable federal program increases. "If you leave money in Washington, they'll just spend it" was a catch-phrase often heard. While the catch-phrase made an appealing sound-bite, it distorted historical experience. The data show that in the years before 2001, program expenditures declined as a share of GDP while revenues increased as a share of GDP. The pattern holds in almost every one of the 15 years from 1986 to 2001.

The oft-stated proposition that a higher level of tax revenues corresponds with a higher level of program expenditures can be tested by standard statistical methods. As Figure 3 in the next page shows, over the period from 1983 to 2003, there is a *negative* correlation between revenues and expenditures.⁸ For every one percentage point increase in revenues as a share of

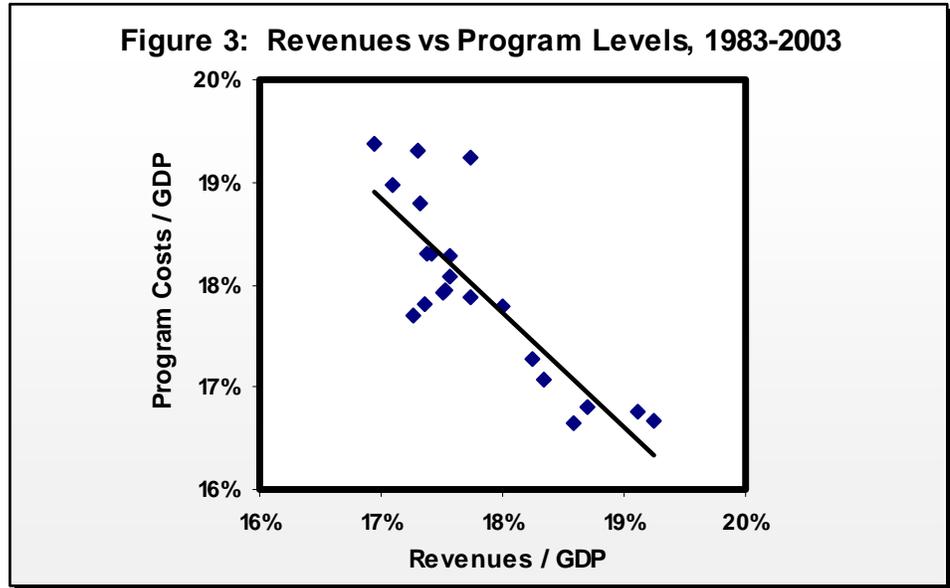
⁷ The underlying structure of the budget deteriorated by 3.0 percent of GDP from 2000 to 2002 and by 2.8 percent of GDP from 2001 to 2003. Since 1960, the largest previous two-year deterioration was 2.2 percent of GDP, during the Vietnam War.

⁸ Each small diamond in Figure 3 shows the levels of revenues and program expenditures as a share of GDP for a given year, as adjusted by CBO to remove the effects of the business cycle and other anomalies. The diamonds cluster around a line from the upper left of the Figure to the lower right. Years represented by diamonds in the upper left of the chart are years with low revenues but high program expenditures — i.e., years with significant

GDP, program expenditures fell by an average of 1.1 percent of GDP during this period. (Similarly, reductions in revenues tended to be correlated with increases in program costs.)

In the years from 1960 to 1982, in contrast to the period from 1983 to 2003, there was no strong relationship between the level of

expenditures and the level of revenues, although there was a very weak positive relationship. These data indicate that there used to be a bit of truth to the assertion that higher revenues were associated with higher spending, but for the past 20 years, the opposite has been the case.



What caused the two-decade correspondence between higher revenues and lower program expenditures (and vice versa) from 1983 to 2003? Policymakers apparently changed their approach to budgeting in the early 1980s. Perhaps policymakers in earlier decades had tried to match revenues and outlays, if possible, based on short-term budget estimates. In the early 1980s, however, the Congressional Budget Office and the Office of Management and Budget began to stress five-year budget projections rather than just estimates for the coming year. Moreover — and probably more important — within a year or two of enactment of the 1981 tax cuts, CBO and OMB projected deficits that were of unprecedented magnitude for times of peace and were expected to continue growing for years to come. It became apparent that the budget suffered from serious underlying structural problems. At that point, many policymakers concluded they should seek to reduce deficits in both the short term and the long term. They began to seek both revenue increases and program reductions that could be implemented and sustained indefinitely, efforts that culminated in the large deficit reduction packages of 1990 and 1993, which combined revenue-raising measures with changes that reduced program expenditures. Figure 3 shows the resulting strong correspondence between higher revenues and lower program expenditures. Figure 2, on page 4, shows that when policymakers concluded in 2001 that the process of raising revenues and reducing programs had gone beyond what was needed, they were willing both to cut revenues and to increase program expenditures.

deficits. Years represented by diamonds in the lower right of the Figure are years with high revenues and low program expenditures — i.e., years with surpluses. The Figure shows that when revenues were high as a share of GDP, program expenditures tended to be low as a share of GDP, and vice versa.

The negative correlation shown in the Figure is highly statistically significant. The T statistic for these data is almost 7, the F statistic is almost 47, and the “R squared” value is 71 percent.

IV. Expenditure Increases in 2002 and 2003 and Beyond

Table 2 shows that the largest expenditure increases in 2002 and 2003 are in the category of defense, homeland security, and international affairs. Expenditures for this category of programs are expected to increase by 0.6 percent of GDP between 2001 and 2003.⁹ This is the fastest two-year increase in this area since 1983 and, before that, since the Vietnam War. (If a war with Iraq is prosecuted, defense expenditures will be higher than assumed in this analysis and the two-year increase will be still greater.)

Expenditures for annually appropriated domestic programs *outside* homeland security grew by less than 0.2 percent of GDP from 2001 to 2003, which is within the range of normal fluctuation. At 3.3 percent of GDP, these programs will cost the same amount in 2003 as a share of the economy as they averaged during the eight years of the Reagan Administration.

Will Appropriated Programs Continue to Grow at Recent Rates?

If the budget deteriorates in the future at the same pace as in 2002 and 2003, the short-term budget picture will become very serious. One question this raises is whether costs for appropriated programs will continue to grow at the pace they have increased in 2002 and 2003, when they have grown faster than the economy. The short answer seems to be “no.” This can be seen by looking first at defense, homeland security, and international affairs and then at domestic appropriations outside homeland security.¹⁰

First, the “appropriations explosion” in 2002 and 2003 occurred primarily in the area of defense, homeland security, and international affairs. This is significant, because much of the proposed increase between 2002 and 2003 in funding for defense, homeland security, and international programs reflects Administration requests for immediate increases to fight terrorism. That the Administration is seeking, and Congress has largely approved, a 13 percent increase (before adjustment for inflation) in funding for defense, homeland security, and international affairs for 2003 does *not* mean this part of the budget will increase at a 13 percent rate every year for the next decade. A more plausible scenario is a rapid buildup in this area followed by an indefinite period during which the new, higher funding levels are maintained and adjusted for inflation but are not increased dramatically to still higher levels.

A rapid buildup to a new, higher *plateau* is what President Bush proposed in his defense budget. Although the President proposed a 13 percent increase in defense funding for 2003, the President’s defense budget grows at an average rate of 3.2 percent per year in years *after* 2003. A rate of growth of 3.2 percent per year is slightly more than the projected inflation rate, but is

⁹ Estimates of expenditures for homeland security are based on OMB data on funding, or “budget authority,” for homeland security programs.

¹⁰ The 2003 level of funding for annually appropriated programs, both defense and non-defense, is discussed in more detail in “Will Congress Reduce Funding for Domestic Programs Outside Homeland Security?” Center on Budget, September 30, 2002, available at <http://www.cbpp.org/9-30-02bud.pdf>.

below the 5.3 percent average growth rate (before adjustment for inflation) that CBO projects for the U. S. economy over the coming decade.

(If the United States fights a war with Iraq, defense spending in 2003 will be higher than shown in this analysis by as much as 0.5 percent of GDP. In addition, defense and international affairs will likely cost more for the rest of the decade, given additional costs for an occupation in Iraq of some duration and foreign assistance and nation-building in Iraq and perhaps elsewhere. These extra costs are not included in the President's future-year defense plan. Finally, the costs of a national missile defense system are only partially reflected in the President's future-year defense plan.)

While there are uncertainties surrounding the future growth of domestic appropriations outside homeland security, it seems very likely that funding for these programs will grow more slowly than GDP in the years ahead. The President's budget proposes that 2003 funding for these programs actually be cut \$2 billion *below* the dollar level for 2002 enacted 15 months ago, even before inflation is taken into account. In addition, even with the 2003 funding level for domestic appropriations outside homeland security proposed in the spring of 2002 by the Senate Budget Committee — which is about \$16 billion above the level requested by the President — funding for these programs would grow more slowly than GDP between 2002 and 2003. These programs would increase at a rate of 3.9 percent (before adjustment for inflation) under such a plan, below CBO's projected economic growth rate of 4.4 percent for 2003.¹¹

In other words, even if Congress rejected the reductions in appropriations for domestic programs outside homeland security that the President has proposed for 2003 and adopted the overall levels for these programs that the Senate Budget Committee majority and the full membership of the Senate Appropriations Committee approved last spring, expenditures for these programs still would likely decline as a share of the economy rather than increase. In addition, based on the President's budget, expenditures for defense, homeland security, and international affairs may stop rising as a share of the economy within a year or two. The level of expenditures for defense, homeland security, and international affairs, however, depends in part on events in Iraq and decisions about national missile defense, among other uncertainties.

Growth in Entitlement Programs

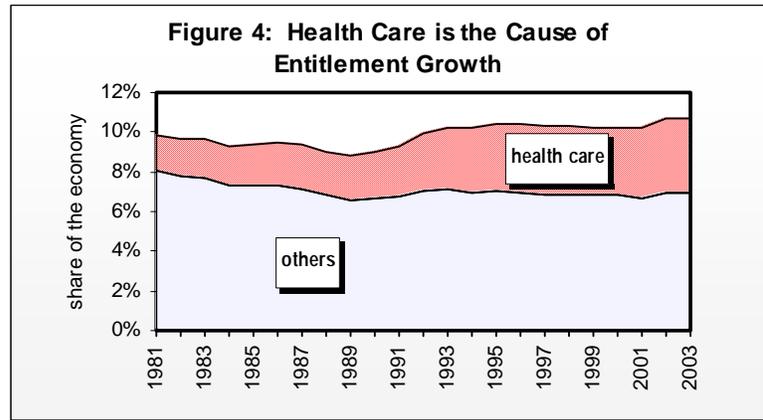
Expenditures for entitlement programs will grow by a bit less than 0.5 percent of GDP between 2001 and 2003. Most of this growth reflects "natural growth" within these programs; only one-sixth of this growth can be attributed to legislation enacted in the last two years.¹² This two-year growth rate is within the range of normal fluctuations for entitlement programs.

¹¹ Adjusting for inflation, CBO projects *real* economic growth of 2.9 percent for 2003 and 3.2 percent per year, on average, after 2003.

¹² The most expensive entitlement bill enacted in the last two years was the farm bill. Although some of the agricultural and conservation policies in that bill are quite controversial, the total cost of farm entitlements will fall slightly as a share of GDP from 2001 to 2003 even after enactment of the new farm bill. Entitlement expenditures also were increased somewhat in the large 2001 tax cut, which expanded the child tax credit and made it partly "refundable." By convention, refundable tax credits that exceed a family's federal income tax liability are treated as expenditure increases. In addition, small temporary increases in entitlements were enacted in the "stimulus" bill (to

Nevertheless, this rate of growth is a source of concern. The natural growth in this area of the budget (i.e., the growth that occurs without any legislated changes in entitlement programs) cannot continue indefinitely at this pace without eventually causing serious budgetary problems. For these reasons, it is worth examining the sources of entitlement growth over the last two years, as well as over longer periods.

As Figure 4 indicates, over long periods of time, the health care entitlements (Medicare and Medicaid) have grown as a share of GDP while other entitlements have shrunk in total, but not usually by enough to offset the growth of the health care entitlements. The two years of 2002 and 2003 are similar to



the historical trend in that most of the growth in entitlement expenditures as a share of GDP can be explained by growth in the health care entitlements.¹³ Because the health care entitlements are becoming a larger share of the budget each year, and especially because the retirement of the baby boomers at the end of the decade will intensify this trend, health care costs pose long-term issues that cannot be ignored.

V. Conclusion

The majority of the budget gains achieved laboriously over the 15-year period from 1986 to 2001 have been squandered in the last two years. The period from 1986 to 2001 demonstrated that the nation can turn deficits to surpluses through balanced fiscal plans that involve both revenue increases and program reductions (including reductions in defense expenditures). The period from 1986 to 2001 also demonstrated that revenue increases do *not* inevitably lead to increases in federal expenditures as a share of GDP.

The need for fiscal discipline today is related to the impending retirement of the baby-boom generation and the resulting increases it will bring in expenditures for health care

provide extended unemployment benefits) and in the airline bailout bill (primarily to provide compensation to families victimized by the terrorist attack of September 11, 2001).

¹³ Health entitlements and especially Medicaid actually have grown at a somewhat faster rate in 2002 and 2003 than their average rate of growth over the past two decades. History suggests that Medicaid, Medicare, and private-sector health insurance costs go through years of faster per-person cost growth followed by years of slower growth. The early 1990s was a period of even faster growth in the cost of health entitlements (and in private-sector health care costs) than the current period. During the late 1990s, in contrast, growth in health insurance costs was exceptionally slow. In fact, the combined costs of Medicare and Medicaid actually shrank as a share of GDP from 1997 through 2000, so it was probably inevitable that those programs would grow more quickly than usual after that shrinkage, as they are now doing.

programs, and to a lesser extent for Social Security. The budget data indicate that in retrospect, the massive budget surpluses that appeared to be available at the start of 2001 were partly illusory, and the belief that tax cuts of the magnitude that were enacted in 2001 could be afforded, alongside a large-scale defense build-up and increases in expenditures for such areas as prescription drugs and education, was mistaken. Because of the demographic challenges that lie ahead, a desirable fiscal goal would be to return, once the economy has recovered, to underlying structural budget surpluses in the years before the baby boomers begin retiring in large numbers. History shows that such a goal can be achieved if a strong policy consensus develops around it and policymakers have the insight and courage to act both on the revenue side and on the expenditure side. Whether policymakers will once again chart such a course, however, remains to be seen.

Appendix Data Used in This Analysis

As discussed previously, this analysis relies on data that CBO issued in September 2002 on the “standardized” budget. For the reasons discussed in the box on page 5, we exclude net interest from the analysis. We also make two modifications to the CBO data.

- We assume that 2003 appropriations will be at the levels requested by the President, rather than at the level assumed in CBO’s August baseline. The August baseline simply reflects the 2002 appropriations levels, adjusted for inflation; it does not, for example, include the increases in defense and homeland security that the President has requested for fiscal year 2003, most of which Congress has already approved and the rest of which are pending.
- We do not include the revenue loss in 2001 from last year’s tax cut in our 2001 figures. This is done so that the 2001 data in our analysis may represent the structural budget policies in effect under the prior (106th) Congress and the prior Administration. The advantage of this approach is that the change from 2001 to 2003 in the underlying structure of the budget fully reflects changes occurring during the 107th Congress and the current Administration. As Table 3 shows, this adjustment to CBO’s figures makes only a small difference in the results.

**Table 3
Changes in the Budget from 2001 to 2003**

Standardized expenditures and revenues as a share of potential GDP

	Figures used in this analysis, which do not reflect the 2001 revenue loss from the 2001 tax cut	Alternative ‘01-‘03 figures that <i>do</i> reflect the 2001 revenues loss from the 2001 tax cut.	Alternative figures showing the changes from 2000 to 2003
Revenues	-1.6%	-1.2%	-1.7%
Budget programs*	+1.2%	+1.2%	+1.3%
Defense, homeland security, and international affairs	+0.6%	+0.6%	+0.6%
Domestic appropriations outside homeland security	+0.2%	+0.2%	+0.2%
Entitlement or “mandatory” programs	<u>+0.5%</u>	<u>+0.5%</u>	<u>+0.5%</u>
Surplus (+) or deficit (-)*	-2.8%	-2.4%	-3.0%

* excluding net interest, may not add due to rounding. Data on standardized expenditures and revenues from CBO.

It is possible that additional legislation will be enacted that alters expenditures or revenues in 2003 and thus changes this analysis. For example, a number of tax cuts passed the House in 2002 and the President is requesting additional tax cuts that would lose revenues in 2003. In addition, the March 2002 “stimulus” legislation established a temporary federal program that provides additional weeks of unemployment benefits to workers whose regular unemployment benefits have run out. Although that program expired at the end of December, it is likely to be extended in some form in calendar year 2003. Moreover, increases may be

provided for drought relief, for Medicare providers, and/or for individuals who qualify for both military retirement benefits and veterans' compensation benefits. Similarly, the ultimate level of funding for domestic appropriations outside homeland security may not include all of the President's proposed reductions, although changes in this area would likely add less than 0.1 percent of GDP to expenditures for domestic appropriated programs. Finally, the 2003 figures will understate defense expenditures if the United States goes to war against Iraq.

It should be noted that CBO periodically reexamines the adjustments it makes in converting official budget and GDP figures to standardized figures. For this reason as well, the underlying structure of the 2003 budget may turn out to be modestly different when examined retrospectively in future years.

The magnitude of the adjustments that CBO makes in deriving "standardized" data and the effect that has on this analysis are shown in Table 4. The table compares the unadjusted changes in revenues and expenditures as a share of unadjusted GDP with the adjusted CBO data used here. As can be seen, when the standardized data are used, the deterioration in the fiscal picture from 2001 to 2003 is shown not to be quite as large as it appears when unadjusted data are used. Similarly, use of the standardized data shows that the improvement in the fiscal picture from 1986 to 2001 was not quite as large as would appear based on the unadjusted data. In addition, the policies of the early 1980s are shown to have had a somewhat more adverse effect on the budget than appears to be the case based on the unadjusted data. One noteworthy point that emerges from Table 4 is that only about one-fifth of the deterioration in the *unadjusted* budget from 2001 to 2003 is due to the current economic slump and other similar factors.

Table 4
Changes in the Budget: Adjusted versus Unadjusted Figures

	1981 to 1986		1986 to 2001		2001 to 2003	
	Unadj.	Adj.	Unadj.	Adj.	Unadj.	Adj.
Revenues	-2.1%	-2.5%	+2.7%	+2.2%	-2.0%	-1.6%
Budget programs*	-0.5%	-0.3%	-2.9%	-2.6%	+1.6%	+1.2%
Defense, homeland security, and international affairs	+1.0%	+1.1%	-3.3%	-3.2%	+0.6%	+0.6%
Domestic appropriations w/o homeland security	-1.1%	-1.0%	-0.2%	-0.1%	+0.2%	+0.2%
Entitlements	<u>-0.4%</u>	<u>-0.4%</u>	<u>+0.6%</u>	<u>+0.8%</u>	<u>+0.7%</u>	<u>+0.5%</u>
Surplus (+) or deficit (-)*	-1.6%	-2.2%	+5.6%	+4.8%	-3.6%	-2.8%

* excluding net interest; may not add due to rounding. Both adjusted and unadjusted figures are based on CBO data. Unadjusted figures show expenditures and revenues as a share of GDP; adjusted figures show "standardized" expenditures and revenues as a share of potential GDP.