A Return to Deficits?

An Analysis of the Bush Administration's Mid-Session Review and the CBO Update to the Economic and Budget Outlook

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EXECUTIVE SUMMARY

New reports from the Bush Administration's Office of Management and Budget (OMB) and the Congressional Budget Office (CBO) confirm that the combination of the large tax cut and the worsened economic situation have essentially eliminated any expected on-budget surplus for the next five years. Indeed, there is a growing possibility that the government's fiscal position could be even worse, with no surplus at all by the end of the decade and with a national debt that might be even higher in ten years than it is now.

The increased risks to the budget reflect, in part, the considerable uncertainty inherent in any ten-year budget projection. However, now that the projected baseline surplus is much lower than it was in January, the probability of the budget slipping back into deficit over the medium term is much higher.

The primary short-run economic risk is that household spending, which has been relatively robust this year, will slow substantially or even fall – almost certainly tipping the economy into recession. Over the long run, the greatest risk is the uncertainty as to whether recent gains in productivity growth will persist.

With the enactment of the tax cut and the softer economy, CBO's baseline budget surpluses are now considerably smaller. An update of CBO's January analysis of the probability distribution of possible budget outcomes by the Democratic Staff of the Joint Economic Committee shows that *the probability that the overall budget could be in deficit in 2006 is now between 15 and 20 percent*.

A 15 to 20 percent chance of a deficit in 2006 may seem acceptable to some policymakers. However, higher than expected surpluses have few costs – it is easy enough to increase spending or cut taxes. But lower than expected surpluses can cause long-term distortions in economic and fiscal policies. Fiscal discipline, once lost, is difficult to restore.

Uncertainty in the budget forecasts implies a corresponding uncertainty about our ability to pay down debt. The JEC Democratic Staff analyzed the probability distribution of debt forecasts and found the following:

- The Federal government has about a 50-50 chance of still being a net debtor in 2011.

- There is an almost even chance (better than 45 percent) that the amount of debt that will be paid down by 2011 is less than the maximum that could be paid down.

- There is a 15 to 20 percent – or nearly one-in-five – chance that the debt held by the public in 2011 will be *greater* than it was at the end of 2000.

No one knows if the economy will continue to grow slowly or will rebound quickly. In either case, there is some chance that current surplus estimates will probably be too high. In the face of considerable downside economic risks and budget forecast uncertainties, it is extremely unwise for policymakers to treat projections of budget surpluses five and ten years out as if they were money in the bank.

The large tax cut will make it difficult to proceed with fiscal policies that could produce short-term economic stimulus if the current slowdown continues. In addition, the tax cut hampers the nation's ability to address important priorities such as health care, education, and defense, while also preparing for the retirement of the baby boom generation.

The CBO budget baseline analyzed in this paper assumes the continuation of current laws and policies. It does not include the Bush Administration's likely defense request or proposals included in the budget resolution but not yet enacted such as a new prescription drug benefit, home health care, expanded health coverage, agriculture, and veterans programs. Nor does it include tax changes such as extending provisions that will expire or fixing the growing alternative minimum tax problem that has been exacerbated by the tax cut. Action on these popular measures would further increase the probability of deficits re-emerging.

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INTRODUCTION

Recent reports from the Administration's Office of Management and Budget and the Congressional Budget Office confirm what most economic and budget observers have known for a while: the combination of the large tax cut and the worsened economic situation has greatly reduced anticipated budget surpluses.[1] Indeed, those factors have essentially eliminated any expected on-budget surplus for the next five years.

The tax cut makes it difficult to proceed with fiscal policies that could produce short-term economic stimulus if the current slowdown were to continue. In addition, the tax cut detracts from the nation's ability to address important priorities in the areas of health care, education, and defense, while at the same time preparing for the retirement of the baby boom generation.

What may be less widely recognized is that the risks of a much worse government fiscal position have increased noticeably. Those risks include the possibility that there will be no surplus at all by the end of the decade and that the national debt could be even higher in ten years than it is now.

The increased risks to the budget reflect in part the considerable uncertainty inherent in any ten-year budget projection. Now that the projected baseline surplus is much lower than it was in January, the probability of the budget slipping back into deficit over the medium term is much higher. Within the framework of that uncertainty, several specific risks stand out. One, short-run risk, is that household spending, a relatively robust source of demand so far this year, will slow substantially or even fall, which would almost certainly send the economy into recession. Another risk is that, over the long-term, the recent gains in productivity growth may not persist.

Finally, alongside these economic sources of uncertainty are the uncertainties associated with projecting the budget when the economy is at a turning point from a period of rapid growth to a slowdown, as it is now. Budget projections are notoriously difficult at such turning points. The track record of past forecasts suggests a tendency for projections to be too optimistic (specifically, underestimating deficits) for a number of years during an economic slowdown, and to be too pessimistic (overestimating deficits) during times of rapid economic growth.

There is no way to know if the economy is facing a recession or a prolonged slowdown, or if it will rebound quickly. Even with a favorable outcome, surplus estimates may be too high. The alternative possibilities call for added caution from the users of the current budget forecasts. It is extremely unwise for policymakers to continue to treat projections of budget surpluses five and ten years out as if they were money in the

[1] See Office of Management and Budget, Mid-Session Review (August 2001), and Congressional Budget Office, The Budget and Economic Outlook: An Update (August 2001).

bank. Policymakers should be especially sensitive to downside risks, because it is generally difficult to restore fiscal discipline once the budget falls into a structural deficit.

In this report we consider the latest revisions to CBO's economic forecast and compare the new forecast to the economic forecast in the Administration's Mid-Session Review. We review the combined effect of economic changes and the tax cuts enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 on the short- and long-term projections for the budget surplus.

We highlight specific risks to the economic and budget forecast including a possible downturn in consumer spending in the near term, lower than expected growth in productivity over the longer term, and the possibility that recent positive "budget surprises" may unwind as the economy slows down. We then consider the effect of uncertainty on the distribution of possible outcomes for the budget and for federal government debt over the next ten years, using the same methodology as in CBO's January 2001 Economic and Budget Update.

THE REVISED ECONOMIC OUTLOOK

Both CBO and the Administration now expect the economy to perform less well in 2001 than they had anticipated at the beginning of the year, although neither expects the economy to slide into a recession. The Administration is much more optimistic than CBO for next year, expecting an immediate and strong rebound. CBO expects the sluggish economic performance of this year to continue at least into the first half of next year.

The CBO and the Administration outlooks for the longer term are largely unchanged from earlier this year, although the Administration continues to be more optimistic than CBO about unemployment and longer-term interest rates. Both expect the economy to grow at slightly over 3 percent per year in real (inflation-adjusted) terms, more than a full percentage point below the average annual growth over the past four years.

A Short-Term Slowdown in Economic Growth

Both CBO and the Administration expect that real (inflation-adjusted) gross domestic product (GDP) will grow by 1.7 percent over the course of calendar year 2001—the same as the August Blue Chip Consensus forecast, but significantly less than the 2.4 percent growth rate that CBO had expected in its January forecast **(Table 1)**.

A growth rate of less than 2 percent would be a significant drop from the annual growth rate of more than 4 percent that the economy has averaged since 1995, but it seems increasingly unlikely that the economy will meet even those diminished expectations. Revised estimates by the Commerce Department, released after publication

Table 1. Projection of Real GDP for Calendar Years 2001-2011 (Percentage Change)					
	Actual 2000	2001	2002	2003-2006	2007-2011
CBO (August)	4.1	1.7	2.6	3.2	3.2
CBO (January)	--	2.4	3.4	3.1	3.1
Administration (August)	4.1	1.7	3.2	3.3	3.1
Administration (April)	--	2.4	3.3	3.2	3.1

of the recent CBO and Administration forecasts, peg second quarter growth at a barely perceptible 0.2 percent annual rate. Combined with a 1.3 percent annual growth rate in the first quarter, the second-quarter slump means that the economy would need to grow at an average rate of better than 2.5 percent in the third and fourth quarters to reach 1.7 percent growth for the full year. With capital spending still declining, that outcome would imply an acceleration in household spending that is unlikely, given the weakened prospects for employment.

CBO is much less optimistic in its current forecast for 2002 than it was six months ago. CBO now projects that the economy will grow at a 2.6 percent annual rate in 2002, down from a projected growth rate of 3.4 percent in its January report. It expects that the unemployment rate will rise to 5.2 percent rather than the 4.5 percent it had previously forecast, and that interest rates on 10-year Treasury notes will be 30 basis points higher at 5.6 percent rather than 5.3 percent.

CBO notes that long-term interest rates have remained relatively stable this year, despite the large cumulative cut by the Federal Reserve in its target for the federal funds rate. The failure of long-term rates to fall in line with short-term rates may reflect the bond market's unease about the long-term effects of the tax cut. CBO writes on page 32 of its current report that the relatively high long-term interest rates "may reflect investor's anticipation of economic recovery, or of future acceleration of inflation or both. It is also possible that slower economic growth and the new tax law, by lowering projected surpluses, have raised investor's expectations about the federal government's future demand for credit."

In contrast with CBO's short-term forecast, the Administration's mid-session review projects a robust economy next year. The Administration forecast calls for real GDP to grow at a rate of 3.2 percent for 2002. The Administration expects the unemployment rate to average 4.8 percent next year and the rate on ten-year Treasury notes to yield an average long-term interest rate of 5.2 percent (both are 0.4 percentage points below CBO's forecast).

Little Change in the Long-Term Outlook

The CBO projection for the long-term beyond 2002 is little changed since January. CBO projects a 3.2 percent annual growth rate of real GDP over the 2003-2011 period. For the 2003-2006 period, CBO projects a higher unemployment rate than it did six months ago (5.2 percent vs. 4.7 percent) and a slightly higher interest rate on 10-year Treasury notes (5.8 percent vs. 5.6 percent). The agency expects those rates to persist through 2011.

Also little changed since January, the Administration's long-term projection is slightly more sanguine about the long-term than CBO's. Although the projected growth rate in real GDP is nearly the same as the CBO forecast over the 2003-2011 period, the Administration expects lower long-term interest rates (5.2 percent vs. 5.8 percent) and lower unemployment rates (4.6 percent vs. 5.2 percent) over the entire period. By themselves, these differences would make the Administration's budget projections more optimistic than CBO's.

In the August forecast, CBO projects the same 3.3 percent average growth for potential GDP over the 2001-11 period as it had in January. That growth is an estimate of how much the economy can grow without causing the inflation rate to rise, and is determined by two factors: the size of the labor force (strictly speaking, number of hours worked) and labor force productivity (output per hour worked).

CBO has lowered its expectation for growth in potential labor force productivity (measured for the non-farm business sector) from an annual rate of 2.7 percent to 2.5 percent, but has increased its projection for labor force growth by an offsetting amount, keeping potential GDP growth unchanged. Just this past January, CBO had increased its projection of the growth in potential labor force productivity to 2.7 percent, up from the 2.3 percent growth forecast a year earlier.

CBO's unchanged long-term outlook reflects the agency's expectation that the recently enacted tax bill will have little effect on the long-term economic outlook. As noted on page 34 of CBO's report "The cumulative effects of the new tax law on the economy are uncertain but will probably be small. Labor supply may rise modestly as a result of the reductions in marginal tax rates (the rates that apply to the last dollar earned); however, national saving may fall. Whether the tax cut will raise or lower real (inflation-adjusted) gross domestic product (GDP) in the long run is unknown, but any effect is likely to be less than half of a percentage point in 2011."

THE OUTLOOK FOR REVENUES AND THE SURPLUS

The revenue picture is not as rosy as it appeared six months ago. The passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 in June of this year, coupled with the slowdown in economic growth and especially the recent declines in corporate profits, have greatly reduced expected revenues.

Anticipated revenues for 2001 are down by $124 billion from the amount projected by CBO in January. While $70 billion of that revision is the result of the tax bill enacted in June of this year, the remaining decline is due to economic and technical changes that reflect a weaker economy and lower-than-expected tax collections. Projected revenues for 2002 are down by $102 billion, and by $1.4 trillion over the entire 2002-2011 period. Most of the drop is from the tax legislation; the remainder is from worsening economic conditions and the expectation that weaker tax collections will persist into the future.

Cost of the Tax Bill

CBO estimates that the cost of the Tax Act, including new outlays for refundable tax credits, will reach $1.35 trillion over the 2001-2011 period. That estimate does not include the associated increase in interest payments, which could total nearly $400 billion over 2001-2011. About 70 percent of the direct cost of the Tax Act (some $932 billion) comes after 2005, and thus can hardly be justified as stimulus needed to meet the current economic slowdown. Indeed, less than 10 percent of the combined tax cut and increase in refundable credits occurs in 2001 and 2002.

Even these totals understate the true cost of the Administration's tax policies. The Tax Act contained a number of provisions that expire before the end of the ten-year budget window. All the remaining provisions expire at the end of 2010. It is very unlikely that the tax cuts will be allowed to expire as scheduled. Extending these expiring provisions would add an additional $255 billion to the cost of the Tax Act in 2002-2011, according to estimates by the Joint Committee on Taxation. In addition to the expiring provisions in the Tax Act, there are a number of other popular provisions of the tax code, enacted before this year, that will expire before 2010. These include the welfare-to-work and work opportunity tax credits, scheduled to expire this year, and the research and experimentation tax credit, which expires in 2004. Permanently extending these other expiring provisions would cost another $142 billion over 2002-2011.

Disappearing Corporate Profits

The CBO forecast for revenues in 2001 is also down by $54 billion from the January forecast for economic and technical reasons unrelated to the Tax Act. The revenue projections are down by $71 billion in 2002 and $63 billion in 2003 because of those

economic and technical factors. A sizeable portion of that decline stems from the recent drop in corporate profits. The annualized profits of non-financial corporations have fallen by nearly $60 billion so far this year. CBO expects that corporate profits will remain weak over the next few years: it expects corporate profits as a share of GDP to drop by 1.5 percentage points to 7.9 percent this year and 7.5 percent in 2002 before rebounding to 7.8 percent in 2003 and 8.1 percent in 2004 **(Table 2)**.

Table 2. Projection of Corporate Book Profits for Calendar Years 2001-2011 (Percentage of GDP)

	Actual 2000	2001	2002	2003-2006	2007-2011
CBO (August)	8.6	7.9	7.5	8.0	8.1
CBO (January)	--	8.9	8.5	8.2	8.0
Administration (August)	8.6	7.7	8.9	8.9	8.0
Administration (April)	--	9.1	8.9	8.8	8.2

The Administration, in contrast, sees a strong and immediate recovery in corporate profits, projecting corporate profits of 8.9 percent of GDP in 2002, and over 2003-2006. The stronger outlook for corporate profits boosts the Administration near-term revenue projections. Its forecast for corporate income tax revenue is higher than CBO's by $19 billion in 2002 and $26 billion in 2003.

A Lower Surplus in 2001 and Beyond

Largely as a result of the drop-off in revenues in 2001 and later years, the CBO projection for the budget surplus is down dramatically from three months ago **(Table 3)**. For FY 2001, CBO projects a total budget surplus of $153 billion, compared with $281 billion projected in January and $275 billion projected in May. The surplus projection for 2002-2011 is now $3.4 trillion, down by over $2.2 trillion since May. Nearly three-quarters of the decline in the projected surplus over the 2002-2011 period since the May forecast is the result of the tax cut and its associated higher interest payments.

The Administration projects a slightly higher surplus than CBO in 2001 and over the 2002-2011 period **(Table 4)**. In contrast to the Administration, CBO projects a small on-budget deficit of 9 billion for FY2001. (The on-budget account excludes spending and revenues of Social Security and the Postal Service). Part of this difference reflects a controversial change in accounting procedures by the Administration.

Table 3.	Change in CBO's Projection of the Surplus From May 2001 to August 2001				
	2001	2002	2002-2006	2007-2011	2002-2011
Total Surplus (May)	275	304	2,002	3,627	5,629
Legislative	-81	-52	-603	1,168	-1,771
Tax Act[a]	-74	-41	-554	-1,103	-1,657
Other[a]	-7	-10	-49	-65	-113
Economic	-25	-48	-224	-59	-283
Technical	-16	-27	-93	-84	-177
Total Surplus (August)	153	176	1,082	2,314	3,397

a. Includes the increase in debt-service costs resulting from legislative actions.

Table 4.	Comparison of Current Service Surplus Projections For Fiscal Years 2001-2011					
	Actual 2000	2001	2002	2002-2006	2007-2011	2002-2011
CBO (August)						
On Budget	87	-9	2	49	799	847
Off Budget	150	162	174	1,034	1,516	2,549
Total	236	153	176	1,082	2,314	3,397
Administration (August)						
On Budget	87	2	18	235	1,068	1,304
Off Budget	150	156	169	1,058	1,481	2,538
Total	236	158	187	1,293	2,549	3,842

UNCERTAINTIES IN THE ECONOMIC OUTLOOK

A number of risks beset the budget outlook. Risks to the near-term economic outlook center on factors that might impede a smooth recovery. Although there are many downside risks to the short-term outlook – such as further weakening in foreign economies, or an even slower rebound in capital spending than most analysts currently expect – the most important risk for the near term is the possibility that household spending might slow sharply. Once into the medium term, however, the paramount economic risk is that the productivity improvements of the late 1990s may not persist as projected. In addition to those economic risks, policymakers must also take into account the possibilities that fortuitous circumstances – such as recent "revenue surprises" – may unwind in coming years.

Will Consumer Spending Continue to Sustain the Economy in the Short Run?

So far this year, consumer spending has sustained the economy. As business investment, and particularly investment in information technology, has collapsed, growth in household spending has held up. If consumer spending were to slow sharply, however, the economy could slip into a recession.

Since 1992, growth of real consumption expenditures has tended to outpace increases in real personal disposable income. As a consequence, the measured rate of household saving has declined. But these measures do not incorporate the influences of changes in household wealth on consumption. For most of the past decade, household net worth has been on the rise, owing mostly to skyrocketing equity values. That rise in household equity wealth may account for the increase in household spending and the corresponding decline in measured household saving since 1995.

If so, what happens when stocks stop rising, or, worse, when equity prices come down? Some of that has already begun—equity prices are nearly twenty percent below their levels just a year ago. It's possible that a portion of that decline may only now be working through the lagged impacts of wealth on consumption. A further sharp decline in equity prices coming at a time when labor markets are weakening and credit demands are tightening might lead to a sharp spending retrenchment by households.

Will Productivity Growth Hold-Up Over the Longer Term?

A major source of uncertainty for the longer-term projection centers on whether or not productivity will continue to grow at the accelerated pace that it did during the latter half of the 1990s. Between 1996 and mid-2000, growth in nonfarm business output per hour averaged 2.6 percent at an annual rate, a pickup from the 1.5 percent annual rate that had

prevailed since 1990. However, since the middle of last year productivity growth has slipped back to a 1.5 percent average pace.

Most analysts would agree that some of the slower growth in productivity since mid-2000 is due to the slowing of the economy–for most of the postwar period, productivity has tended to grow during economic upswings. But there is no consensus among economic analysts as to whether the acceleration in productivity growth during the late 1990s was permanent. As a result, alternative assumptions within a relatively wide range of prospective growth paths currently seem equally plausible.

When sustained over ten years, small changes in productivity growth can have enormous implications for the budget. According to CBO rules of thumb, a sustained decline in productivity growth that would produce a permanent 0.4 percentage point reduction in the growth rate of real GDP, would result in cumulative reductions in the budget surplus of just under a trillion dollars after 10 years, if other factors do not change. Given the sensitivity of the budget to even slight changes in productivity growth, a prudent course would be to avoid presuming that the higher rate of productivity growth the nation has enjoyed in recent years will continue.

Will Favorable Budget Surprises Unwind?

Over the late 1990s, the budget surplus was boosted by unusually favorable trends in revenues and spending–even unusual relative to a particularly robust economy. These unusual trends led to repeated positive "surprises" in the budget surplus over those years. Given recent changes in the economy, CBO now predicts (prudently) that these trends will unwind somewhat over the 10-year forecast window. But having to project the relationship between budgetary variables and economic ones adds yet another layer of uncertainty to the budget projections, and yet another way in which actual outcomes could turn out worse than predicted.

For example, on the revenue side, personal income tax revenues grew faster than GDP over the late 1990s. This was largely the result of two factors. First, a dramatic growth in capital gains realizations, closely tied to the run-up in the stock market. Second, real income gains among higher-income households pushed more income into the higher marginal tax rate brackets, increasing the amount of tax collected from each additional dollar of income. This rise in revenues occurred even though there were no increases in statutory tax rates.

In its current projection, CBO assumes that capital gains realizations relative to GDP will gradually level off to the historic average. But nothing guarantees that this share will not dip below that average, at least temporarily, as might be expected in a prolonged stock market decline. If this were to happen, revenues would turn out to be lower than CBO now predicts. In fact, since January of this year CBO has revised downward its prediction of individual receipts for 2001 by $15 billion, to "reflect

weakness in current revenue collections that is not explained by current measures of economic activity."

On the spending side, an important contributor to the growing budget surplus over the late 1990s was unusually slow growth in health care spending, particularly through stricter compliance with Medicare payment rules after the Balanced Budget Act of 1997. Although Medicare outlays had grown by an average of 11 percent a year during the first half of the 1990s, between 1997 and 1999 the rate of growth slowed each year, with outlays actually declining by 1 percent in 1999. These declines were associated with increased enforcement of anti-fraud rules, which may have produced a short-term "windfall" for the Medicare program.

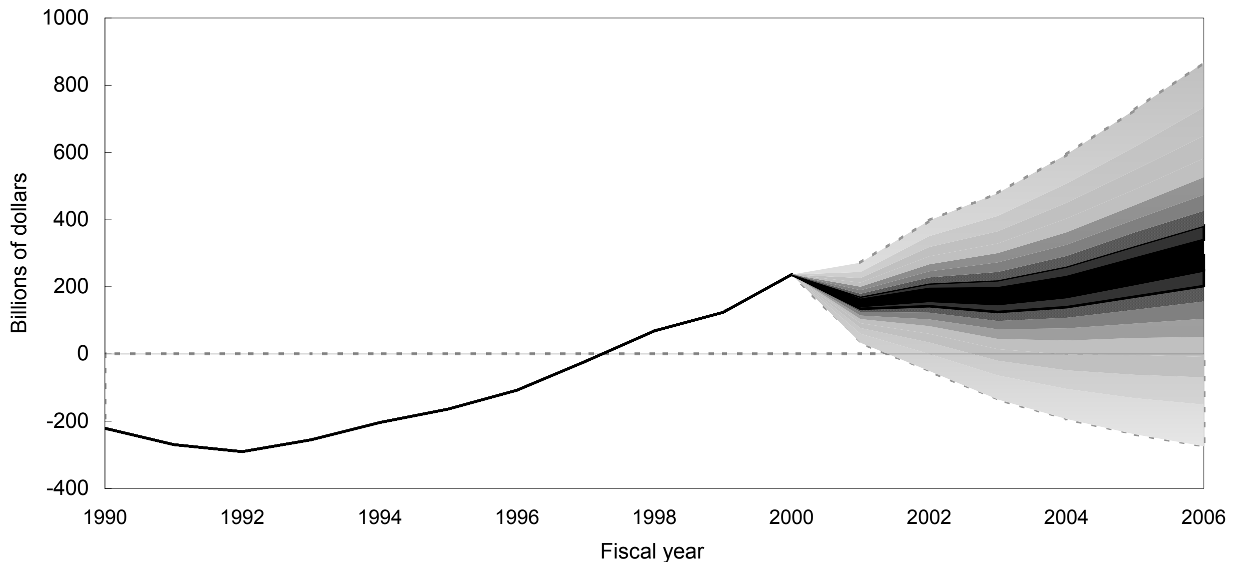
But recent legislation has increased payment rates and the natural market forces are expected to continue their upward pressure on health costs. As a result, in January 2001 CBO projected that Medicare spending will grow by more than 10 percent in 2001 and by an average of 7.2 percent per year for the period from 2001 through 2011. Although this is a reasonable prediction, it does not allow for the possibility that health care service providers may try to make up some of the losses they recently suffered, or that health care costs may rise faster than average in the near future for other reasons. If so, growth in Medicare spending could turn out to be higher – yet another factor that could lead to actual surpluses that are lower than now predicted.

A RETURN TO DEFICITS?

In the Budget and Economic Outlook released in January, the CBO included an analysis that showed the uncertainty in its budget forecasts through 2006 based on its own past forecasting errors. At that time, the cumulative baseline budget surpluses were $5.6 trillion, and the baseline surpluses were large and growing over time. CBO's analysis showed, however, that there was sufficient uncertainty in its forecast that the normal margin of error included the possibility that the budget would be in deficit as soon as 2004.

With the passage of the tax cut and the softer economy, CBO's baseline budget surpluses are now considerably smaller. CBO has not updated its January analysis of the distribution of budget outcomes, but the Democratic Staff of the Joint Economic Committee has. Using the CBO methodology (see Methodology), the JEC estimates that the probability that the overall budget could be in deficit in 2006 (the final year of the original CBO analysis) is now between 15 and 20 percent **(Figure 1)**.

Figure 1.
Uncertainty in CBO's Budget Surplus Projections



Source: JEC Democratic staff based on budget and economic projections from Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2001).

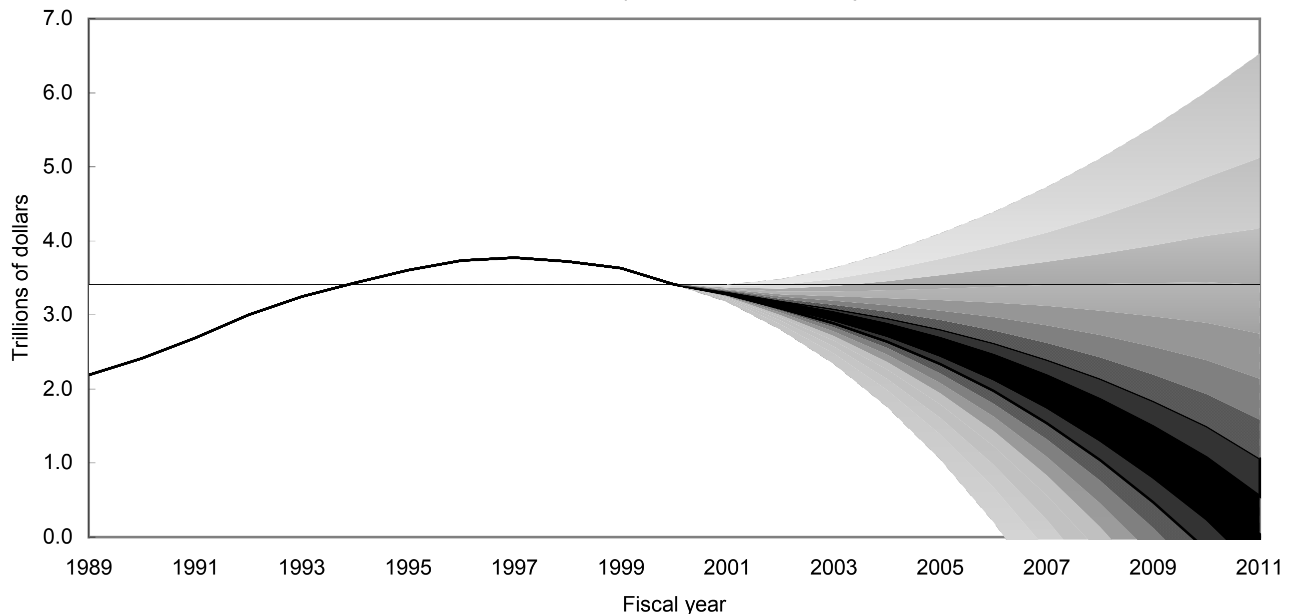
Note: The figure shows the estimated likelihood of alternative surplus projections using CBO's past track record in projecting the surplus. CBO's August baseline falls in the middle of the darkest area. The distribution indicates that under current policies, there is about a 20 percent probability that the budget will be in deficit by fiscal year 2006.

Debt held by the public was $3.4 trillion at the end of fiscal year 2000. In CBO’s baseline budget forecast (which assumes that current policies remain in place), this debt could theoretically be mostly extinguished by 2011. In practice, however, some of this debt cannot easily be retired, including some debt that matures after 2011, some special-purpose bonds held by states, and some savings bonds.

Thus, CBO assumes that the net indebtedness of the Federal government of $56 billion in 2011 will be composed of $876 billion of debt held by the public and a balance of $820 billion of uncommitted funds (assets) held by the government. However, a former Treasury Department official in charge of debt management has estimated that the amount of debt that would be truly hard to redeem is smaller than the CBO estimate (about $500 billion).

The analysis of uncertainty in the budget forecasts can be used to infer uncertainty about the debt. This requires extending the CBO methodology to project probability distributions of budget surpluses in each year from 2001 to 2011 and calculating the resulting probability distributions of debt.

The JEC staff has done such an analysis and found that there is about a 50-50 chance that the Federal government will still be a net debtor in 2011. There is an almost even chance (better than 45 percent) that the amount of debt that will be paid down is less than the maximum that could be paid down (based on the assumption of $500 billion of truly hard-to-redeem debt). Finally, there is a 15 to 20 percent chance – nearly one chance in five – that the debt held by the public in 2011 will be *greater* than it was at the end of 2000 **(Figure 2)**.



Source: JEC Democratic staff based on budget and economic projections from Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2001).

Note: The figure shows the likelihood of alternative projections of the publicly held debt using CBO's past track record in projecting the surplus as well as CBO's current assumptions about how much of net federal obligations are financed by means other than issuing debt to the public. CBO's August baseline falls in the middle of the darkest area. The distribution indicates that under current policies there is about a 20 percent probability that debt held by the public in 2011 will exceed $3.4 trillion, the amount of publicly held debt at the end of fiscal year 2000.

CONCLUSION

CBO forecasts a budget surplus of $3.4 trillion over the next ten years. The Administration's projection is a somewhat higher $3.8 trillion. These estimates are within a reasonable range, given what we know today about the outlook for the future of the economy. But budget forecasting is a highly uncertain business, particularly when the economy is at a turning point, as it appears to be now. And while these surpluses appear large, so are our future commitments. As a result, there will be little room to maneuver should economic growth be weaker than now projected.

The retirement of the baby boom generation is only a few years away. We must meet the commitments we have made to the workers of that generation to provide retirement security and health care coverage in their old age. If our surplus estimates turn out to be too high, we will have many fewer options in meeting those commitments.

While there is a case to be made that economic stimulus is needed in the short run, justifying tax cuts now, the Administration's long-term fiscal policy puts us on a risky path. It could destroy the fiscal discipline we have so recently achieved. Given the uncertainty of our surplus projections—indeed, the 15 to 20 percent possibility of a deficit by 2006—it would be prudent to take a more conservative budget path. Ensuring that we will be able to pay down our debt will put us in a stronger position to meet our future commitments in Social Security and Medicare, as the Administration has promised we will do.

METHODOLOGY

The analysis by the JEC of the uncertainty in projecting budget outcomes updates and extends research released by CBO earlier this year.* Using CBO's methods, the JEC updated CBO's estimates of the distribution of budget outcomes through 2006, based upon CBO's latest budget baseline and economic assumptions. The most significant revision was CBO's lower baseline projection for the federal surplus, which had the effect of lowering the center of the distribution from its levels in CBO's previous analysis. CBO's revised projections for interest rates had a slight effect on the estimated debt burdens associated with the alternative surplus paths.

The JEC extended the CBO's original analysis in two respects. First, the JEC calculated the distribution for the years 2001 through 2011, not through 2006 as CBO had done originally. This extension required an additional assumption beyond those made by CBO: the JEC assumed that the probability distribution for *changes* in the surplus errors (relative to revenues) for the years 2007 through 2011 is identical to that used by CBO for the years 2002 through 2006. Given that CBO's published track record of budget projections for ten years is rather small, that assumption seemed to be the most natural way of extending CBO's analysis through 2011.

Second, the JEC extended the original CBO analysis to calculate a distribution of debt outcomes. Assuming that the amount of new federal obligations financed by means other than issuing debt to the public was held constant at the levels currently projected by CBO, each one of the simulated paths for the budget balance was cumulated into a corresponding path for the publicly-held federal debt.

The original CBO estimates treated the budget outcomes for fiscal year 2001 as completely uncertain. While a legitimate assumption in January, that assumption is far less plausible in the last month of the fiscal year. For that reason, the JEC recomputed the distribution of budget outcomes two ways, first following the CBO procedures from January, and second assuming that the fiscal year 2001 federal surplus was equal to CBO's baseline projection with complete certainty. The latter assumption, of course, narrowed the range of uncertainty in each of the years from 2002 through 2011 relative to the estimates based on the assumption of a completely uncertain surplus in fiscal year 2001. JEC reports the ranges of uncertainty from the alternative estimates in the text. The figures are based on the assumption that CBO used in its original analysis, namely, that the budget outcome for fiscal 2001 is uncertain.

* See Congressional Budget Office, *Uncertainties in Projecting Budget Surpluses: A Discussion of Data and Methods*, February 2001.