107th Congress, 2nd Session: No.4 March 4, 2002

INFORMED BUDGETEER

THE LONG-TERM BUDGET OUTLOOK

- The Senate Budget Committee recently held a hearing on the long-term budget outlook. GAO Comptroller General David Walker testified that if major entitlement programs are not reformed they will absorb an increasing share of GDP over the next several decades. Spending on Medicare, Medicaid, and Social Security, which together account for 8% of GDP, could be 15% of GDP by 2050.

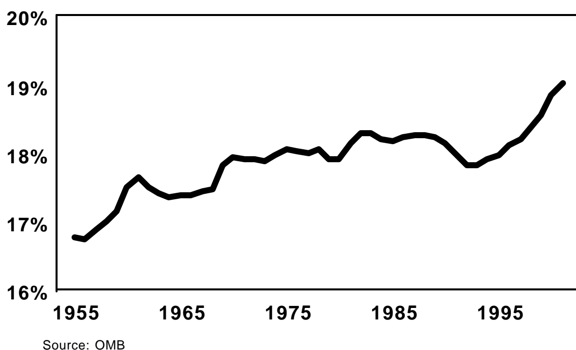
- No one disputes the trajectory of future entitlement spending if these programs are left unreformed, though many would disagree with the specificity of such estimates.

- A superficial review of Walker's testimony might convince someone that current tax and spending policies are leading to unsustainable deficits. The testimony also implies that Congress, among other things, must enact no more tax cuts and possibly must enact substantial tax increases.

- However, in constructing its various alternative scenarios, GAO did not assume we would maintain current tax laws unchanged, contrary to normal baseline procedures. Instead, GAO made the simplistic assumption that revenue would remain a fixed share of GDP after 2011.

- What the Comptroller did not explain to the Budget Committee is that in order to keep revenue a fixed share of GDP beyond 2011, one has to assume radical departures from the current law baseline, which would involve enormous future tax cuts yet to be enacted.

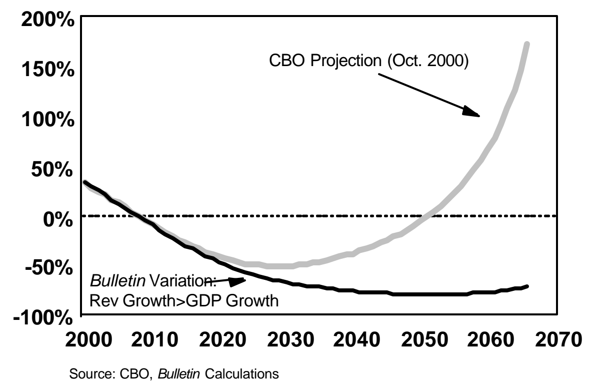
- Revenue has been trending upward as a share of GDP since the mid-1950s (see graph below). The reason revenue still tends to increase as a share of GDP is that productivity growth pushes more income into higher tax brackets. For example, let's say there's no inflation and a worker gets a 2% raise reflecting higher productivity. That worker will pay a higher average tax rate because more of his income is taxed at his highest marginal rate. Revenue will also tend to increase faster than GDP in the next several decades because more withdrawals will be made from IRAs and 401k's – specifically related to the demographic aging process.



- In short, to keep revenue at a fixed share of GDP, the Congress will have to enact substantial permanent tax cuts. For example, Congress would have to replace the annual inflation adjustment of tax brackets with an adjustment based on nominal income growth (inflation plus real income growth), apply these new adjustments to the alternative minimum tax, and exempt a large portion of as yet untaxed IRA and 401k accumulations from any future taxation.

- Let's look at another analysis, starting with CBO's last long-term budget outlook in October 2000. By assuming that all projected surpluses are used for debt reduction (or asset accumulation), discretionary spending grows at the rate of nominal GDP after 2010, and revenue remains a fixed share of GDP after 2010, CBO projected that the publicly-held debt would hit 100% of GDP by the mid-2060s and be headed much higher after that.

- A variation on this scenario performed by the *Bulletin* – modestly adjusting these assumptions so that revenue grows 10% faster than nominal GDP growth (for example 5.5% revenue growth when nominal GDP grows 5%) – altered the budget outcome dramatically. Not only did the debt disappear, it never returned. By the mid-2060s the federal government held zero debt and financial assets worth about 70% of GDP!



- Is this scenario likely? Of course not! Not because revenue couldn't grow at that rate if tax laws are left unchanged (it could), but because lawmakers would never stand idly by as the government accumulated so many assets. But that does not detract from the usefulness of the scenario in describing the extent of the purchasing power the government will have if tax revenue is not reduced.

- As currently designed, the tax laws of the United States are poised to bring in more than enough revenue to pay for all entitlement programs as well as discretionary spending that grows at the rate of GDP – and still have substantial sums left over. Tax revenue would gradually increase to 24.3% of GDP by 2060 (and grow more thereafter). That may seem like a big increase versus 20.8% in 2000, but consider that revenue was only 14.4% of GDP in 1950.

- Tax revenue alone would not pay for government spending beyond the mid-2030s. But to prepare for the retirement of the Baby Boom generation, the government could use surpluses in the next 30 years to accumulate massive amounts of financial assets. After that, even though spending would exceed tax revenue, the accumulated assets would generate enough interest to keep the budget in surplus for another 30 years, until the mid-2060s.

- Does this mean the long-term budget situation is nothing to worry about? Of course not! Even if the entitlement programs appear affordable, as long as the tax burden were allowed to increase unchecked, they would still lead to a much bigger government as a share of GDP.

- Nor does the *Bulletin* support the federal government accumulating massive amounts of financial assets. If the government is generating enough revenue to retire the debt and accumulate a huge store of assets, politicians will be tempted to expand entitlement programs, create new ones, and increase discretionary spending faster than the economy – making the government even bigger and drawing off resources needed for the retirement programs.

LOCKING THE LOCK-BOX AFTER FARM BILL IS OUT OF THE BARN

- To review, the 2002 budget resolution allocated the Agriculture Committee $73.5 billion dollars for 2002-2011. This resolution was crafted almost one year ago based on economic and spending assumptions prior to September 11 and prior to the official acknowledgment of a recession that began in March 2001.

- For 2002, that budget resolution gave $7.35 billion to the Agriculture Committee, while $66.15 billion was held in reserve. This reserve fund was not to be released should it result in any of the Medicare Trust Fund surplus being used in any of the years covered by the resolution. Senate Budget Committee Chairman Conrad has been saying since the budget resolution was adopted that it "raided" Medicare, but that did not stop him from releasing the Farm Bill reserve fund.

- Further, budgeteers may ask if the Senate Agriculture Committee was allocated only $7.35 billion in 2002, how did they spend $9.54 billion? The additional $2.45 billion was spent because the provision addressing weather-related losses included an emergency designation making it immune to the spending limits in the budget resolution. Isn't heavily subsidized crop insurance suppose to address an issue like this?

- Astute bugeteers anticipate that when the Senate looks at the cost of this bill against the most recent CBO baseline it will creep BILLIONS higher due to an increasing baseline. So not only did trust funds get used for agriculture spending under an outdated baseline, but more programs were funded by the Agriculture Committee than would be possible with the same allocation under today's realities.

- The United States is blessed with wonderful agriculture resources. But sadly, the House and Senate-passed farm bills do little to move the farm sector towards a market-based system for the future, and they further complicate solving the longer-term issues of Social Security and Medicare.

Budget Authority for Farm Bill
($ in Billions)

	2002	2002 Emergency	2002-2006	2002-20011
FY 2002 Budget Resolution	7.4	—	40.3	73.5
House, HR. 2646	3.1	—	35.8	73.5
Senate, S. 1731	7.1	2.5	47.2	76.0
President, FY 2003 Budget	4.6	—	35.8	73.2

Source: H. Con. Res. 83, Concurrent Resolution on the Budget for Fiscal Year 2002, May 8, 2001; CBO final estimate, HR. 2646,October 9, 2001; CBO preliminary estimate, S. 1731, February, 26, 2002; OMB.

COMPLEXITY TOPS THE LIST

- In 1998, Congress created the position of "National Taxpayer Advocate" when it passed the IRS Restructuring and Reform Act. The law mandated that the Advocate – a kind of ombudsman– report to Congress the top 20 most serious problems encountered by taxpayers across the country and also identify the 10-most-litigated issues between taxpayers and the IRS.

- This year's list of most serious problems encountered by the taxpayers originated from the work experiences of Taxpayer Advocate Service employees who assist taxpayers every day. The Advocate also listened to tax practitioners and observed focus groups of taxpayers discussing their experiences with preparing their returns in the previous year.

Most Serious Problems Encountered by Taxpayers

Ranking	Issue
1.	Access to customer service toll free telephone service.
2.	Multiple definitions of "qualifying child."
3.	Determining Earned Income Tax Credit (EITC) eligibility.
4.	Answers to questions on customer service toll free lines.
5.	Documenting EITC eligibility.
6.	Refund inquiries.
7.	EITC examinations.
8.	Understanding estimated tax payments.
9.	Explanations on Math Error Notices.
10.	Processing claims for refund.
11.	Recertification for EITC.
12.	Computing income tax using schedule D (Capital gains/losses).
13.	Awareness and understanding federal tax deposits requirements.
14.	Obtaining employer identification numbers.
15.	Misapplied payments.
16.	Lack of access to free tax preparation for low-income taxpayers.
17.	Processing offer in compromise applications.
18.	Computing alternative minimum tax (AMT).
19.	Determination and notification of revised tax liability.
20.	Cost of electronic filing for low income taxpayers.

Source: IRS, National taxpayer advocate, FY 2001 report

- In putting together the second list, the Advocate consulted with the IRS Chief Counsel for a listing of cases considered "litigated" during 2001. The Chief Counsel used its case tracking system to identify all cases that were "submitted" - that is, cases which have been tried and are awaiting final deposition. The Chief Counsel then surveyed the attorneys who tried the cases and asked them to identify the primary issues. Analysis of the most litigated issues may reveal areas of the tax law that create burdens for taxpayers or areas requiring simplification.

- As Congress continues to make the tax code more and more complex, the IRS is forced to make more intrusive inquiries. For example, the thorny issue of family status (e.g., defining an eligible dependent under the tax code) appears in one form or another on both lists.

Most Litigated Issues

Ranking	Issue
1.	Unreported or underreported income.
2.	Trade or Business expenses.
3.	Exemptions, personal and dependency.
4.	Accuracy related penalties.
5.	Delinquency penalty.
6.	Collection due process.
7.	Earned income tax credit (EITC).
8.	Innocent Spouses.
9.	Entertainment expenses.
10.	Trust cases.

Source: IRS, National taxpayer advocate, FY 2001 report

CALENDAR

March 6 - HEARING: CBO's Analysis of the President's 2003 budget. Daniel Crippen, CBO Director 10:00 AM. SD-608.