Presented to the 2002 Global Economic and
Investment Outlook Conference

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May 22, 2002

The Return of Federal Surpluses, Full Social Security Benefits for Baby Boomers, or Elvis: Which Will We See First?

The panel you heard from before the lunch hour covered the global economy. The panel that follows me, I see, is going to tell you where to put your money. Well, I'm not going to tell you anything as concrete as those two panels. Instead, I'm going to talk a little about how the federal government might influence the economy at large as well as future investments.

The nation's budget plays an important role in the country's economy. Tax and spending decisions—not to mention regulatory actions—influence the economy in numerous ways. Even seemingly minor decisions by federal policymakers can have profound consequences upon corporate America, local governments, small businesses, and individual citizens.

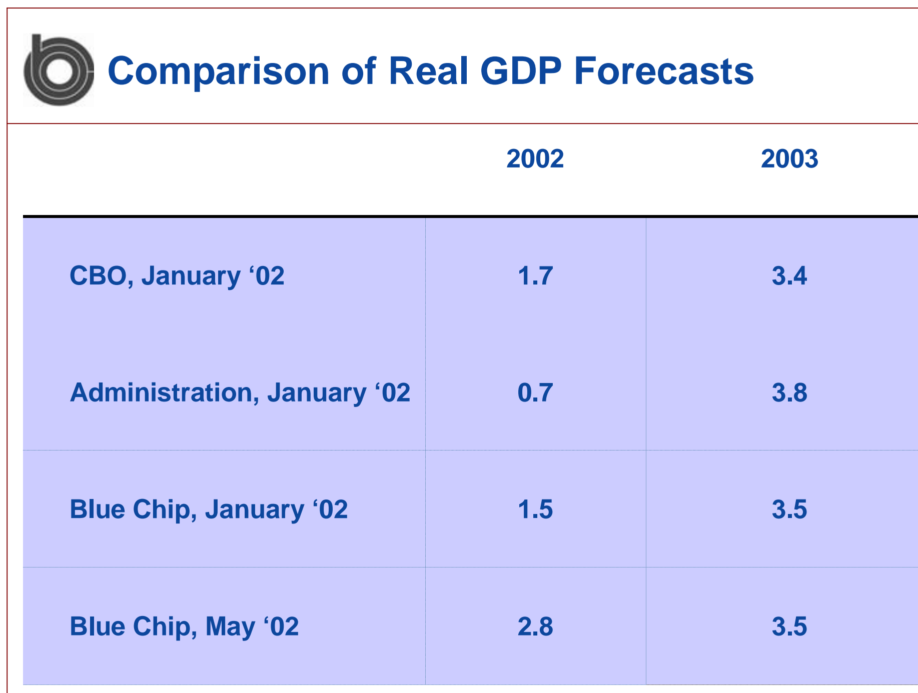
That being the case, many Americans who often pay little or no attention to federal fiscal policy, noticed the news in January of last year when we at the Congressional Budget Office released our annual budget and economic outlook that projected a budget surplus of $5.6 trillion over the 10-year period that followed. Perhaps some of you read the news stories that filled the papers about whether or not that $5.6 billion ever would occur. Maybe you scoffed in disbelief when we describe how such surpluses would allow the federal government to pay off all the debt it could by 2008.

In the little over a year since we made that $5.6 trillion projection, the outlook has changed considerably. We now are projecting a surplus of $1.6 trillion, $4 trillion less than before, but there are still nine years left in that 10-year window.

Our current fiscal forecast is somewhat pessimistic. Tax receipts, as you may have read in the press, are coming in much lower than expected. So far this year, receipts are 11 percent below last year's level and about $75 billion less than CBO anticipated. That dramatic fall off in revenue

contributed to a deficit of $66 billion for the first seven months of fiscal year 2002, the current fiscal year. That deficit is a sharp contrast to the $165 billion surplus recorded for the same period last year.

While tax revenues are flowing into the Treasury more slowly than we expected, the economy is growing faster than we thought earlier this year that it would be. Our forecast for real GDP growth in 2002 was only 1.7 percent, and we expected that rate of growth would about double next year. Last week, the *Blue Chip* consensus revised its forecast up to 2.8.


Comparison of Real GDP Forecasts

	2002	2003
CBO, January '02	1.7	3.4
Administration, January '02	0.7	3.8
Blue Chip, January '02	1.5	3.5
Blue Chip, May '02	2.8	3.5

Right now, it looks as if 2002 will be worse than we originally thought from a fiscal policy perspective but better economically. The result will be a budget deficit that will probably top $100 billion and could go even higher, depending upon what legislation President Bush and the Congress agree to in this election year. CBO will formally update its budget outlook and deficit forecast this summer.

Our 10-year economic forecast remains positive and may improve from last January's, so the outlook still will suggest a return to surpluses in a few years. The total surplus is projected to equal 1 percent of GDP by 2006 and grow to 3.7 percent of GDP by 2012. Long-term estimates should be viewed very cautiously, however, because future economic developments and technical changes could change the outlook substantially, as in the past year. In addition, future legislation is certain to alter the budgetary picture. Much of the 10-year surplus we now project will result from the expiration of last year's tax cuts, which under current law will expire in December 2010. Should the Congress and President Bush, or any future Congress and future president, decide to extend those tax cuts, a substantial amount of that surplus may not materialize.

Putting aside whatever impact legislative initiatives will have, there are other risks as well. Risks to the economy, both in the short and long terms, include the possibility of oil price shocks, terrorist attacks, or a drop in consumer confidence—the latter probably caused by one of the former events or the fear that one will occur.

Now, let us backtrack for a few minutes to understand how it is we began with a 10-year $5.6 trillion surplus and lost $4 trillion of it somewhere on the way to Graceland.

Let me begin with what a few folks have said lately in Washington:

"[They] tell you they want to get money out of Washington so it cannot be spent. They just don't tell you that it would be spent on Social Security and Medicare, health care, prescription drug coverage, and improving education. [They] will not openly attack such popular programs, but they will do what Reagan Budget Director David Stockman called 'starve the beast.' This tax plan is part of a strategy to eliminate the federal government's ability to finance these programs that have become

so vital in the everyday lives of so many Americans."

Here's another quote: "Their goal last year was not simply to return money to the hands of the American people, but to starve the beast, to take all the money off the table. They did a good job of it and not only are they not chastened, but they are emboldened to do more."

First, let's put the $5.6 trillion in its proper context. CBO's baseline projections are intended to serve as a neutral benchmark against which to measure the effects of possible changes in tax and spending policies. They are constructed according to rules set forth in law and long-standing practices and are designed to project federal revenues and spending under the assumption that current laws and policies remain unchanged. Although these baseline projections serve as an effective starting point for both the Congress and the public, lawmakers will in some way change tax and spending policies, and it is unlikely that the economy will follow the exact path CBO projects. It is important, therefore, that CBO's baseline be viewed not as a forecast or as a prediction of future budgetary outcomes but simply as the agency's best judgment of how the economy

and other factors will affect federal revenues and spending under *current* law.

So where did the $4 trillion go?

Why CBO's Budget Projections Changed (In trillions of dollars)

	2002-2011
January 2001 Projection	5.6
Economic and Technical Changes	-1.6
Legislative Changes	
Tax Law	-1.3
Appropriations & Economic Stimulus	-0.6
Debt Service & Other Costs	-0.7
Total Changes	-4.1
January 2002 Projection	1.5

Well, first, economic and associated technical changes took about a $1.6 trillion bite out of the $5.6 trillion. Then, Congress passed tax law changes ($1.3 trillion), general spending increases and an economic stimulus package (an additional $0.6 trillion). Add to those $0.7 trillion in debt service and other costs, and the 10-year price tag for legislative changes totals more than $2.4 trillion. Add the legislative costs to the

economic shift and you can see why CBO's projections changed by $4 trillion.

This, by the way, still leaves Congress and the President with about $1.5 trillion in projected surpluses to contemplate over the next decade. But I am <u>not</u> saying that those projected surpluses will actually materialize in the years ahead. Remember, they are projections—not forecasts—and they do not include estimates of future Congressional action. But Congress is acting even as we speak, to increase spending and perhaps cut taxes. The farm bill, new drug benefits, homeland security and defense spending—to name a few items—are eating up any near term potential surpluses very quickly. Unless the economy booms big time, the return of federal surpluses does not seem to be at hand.

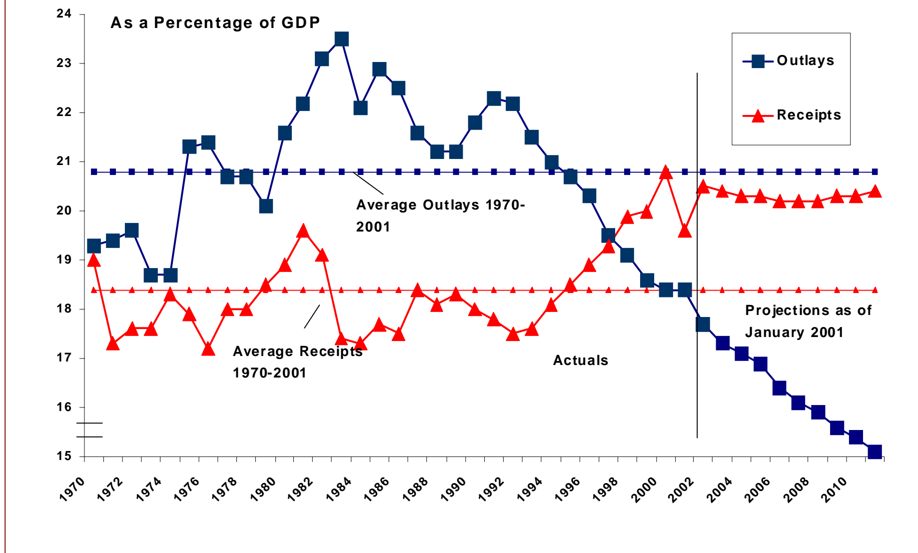
Some in the political arena complain that the reason so much of the surplus has disappeared can be set to rest at the feet of last year's tax cut:

"Supporters of the tax cut said the surplus was so massive and so certain that we could have a huge tax cut, increase spending on education and the

military, and provide prescription drug coverage. We could protect the Social Security surplus, pay off the entire federal debt in a decade, and still have enough money left over to get us through any unforeseen disasters. What we got instead was the most dramatic fiscal deterioration in our nation's history."

Congress never would have enacted the tax cuts, detractors say, if the downturn in the economy had been predicted. Well, let's look at that for a moment.

It is interesting to note that back in January 2001, federal receipts and outlays, when measured as a percentage of GDP, were trending away from the general directions they'd followed for most of the past 30 years.

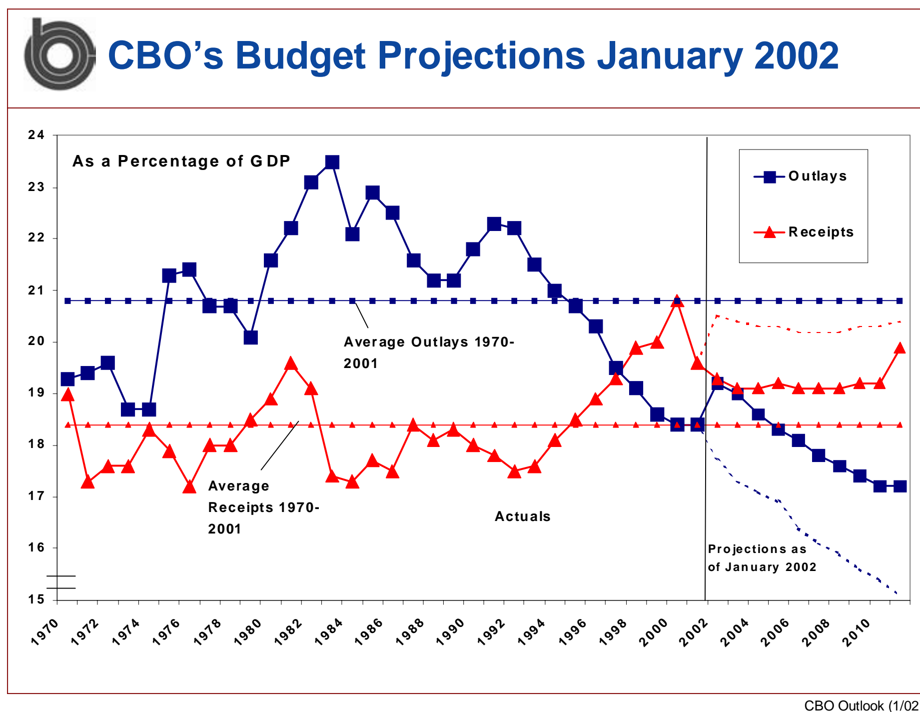


CBO Outlook (1/02)

Outlays, which had averaged slightly less than 21 percent of GDP over the period, were projected to fall from about 18.5 percent of GDP to 15 percent of GDP, a steep decline. Receipts had averaged a bit under 18.5 percent of GDP over the 30-year window. In 2001, they'd risen to just shy of their all-time high—20.9 percent of GDP, reached at the peak of World War II—and were projected to remain at about that rate for the next 10 years. The gap between those two lines, between receipts and outlays, money coming in to the government and money flowing out, is the projected surplus. In this case, the total projected over the next 10 years was $5.6 trillion. Those who viewed the federal government as a

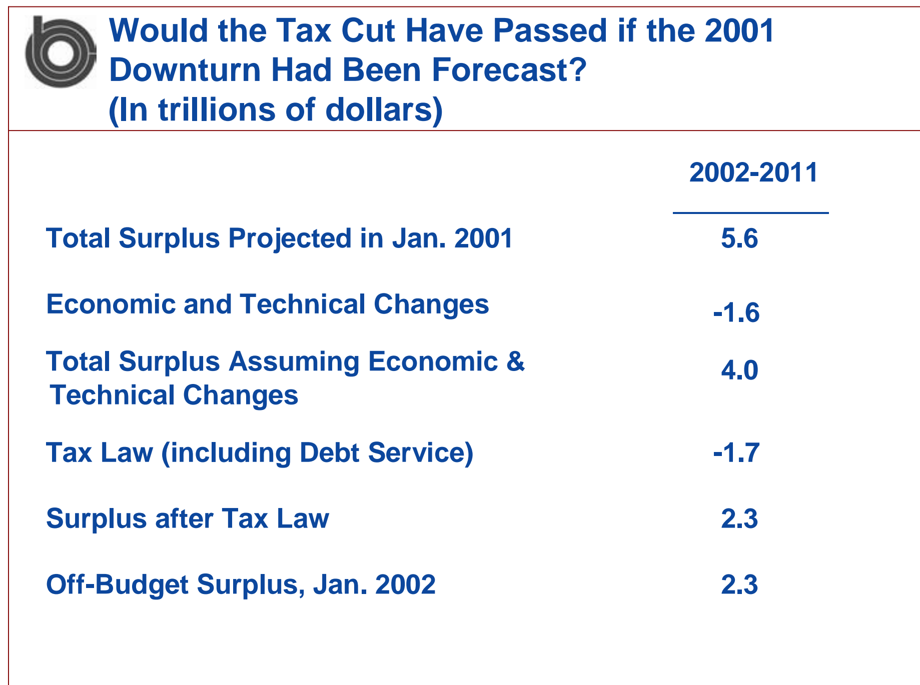
beast were quaking in their boots.

If we superimpose our current knowledge on top of what we projected last year, the gap between the two measures narrows substantially.



Receipts, which earlier were expected to top 20.5 percent, now are expected to hover somewhat above 19 percent of GDP. Outlays, instead of plummeting to 15 percent of GDP, still are on a declining path, albeit one that levels off at a tad over 17 percent off GDP. Between those two paths, still, is a substantial amount of unified budget surplus over the next 10 years.

O.k., let's do the math as to the effects of the tax cut.



Would the Tax Cut Have Passed if the 2001 Downturn Had Been Forecast? (In trillions of dollars)

	2002-2011
Total Surplus Projected in Jan. 2001	5.6
Economic and Technical Changes	-1.6
Total Surplus Assuming Economic & Technical Changes	4.0
Tax Law (including Debt Service)	-1.7
Surplus after Tax Law	2.3
Off-Budget Surplus, Jan. 2002	2.3

In January 2001, CBO projected a 10-year budget surplus of $5.6 trillion. Subtract from that the $1.6 trillion in economic and technical changes we discussed earlier, which leaves you with $4 trillion. Now subtract the $1.7 trillion price tag for last year's tax law, including the debt-service cost associated with it (the additional interest the government has to pay on the $1.3 trillion that went to the tax bill instead of buying down an equal amount of debt held by the public). The remaining off-budget surplus is about $2.3 trillion over 10 years. The beast had been starved, or at least slimmed down considerably, but it may have been put on this

diet even if we had known about the 2001 downturn.

Let's look at the surplus even closer. After accounting for the tax bill, we had $2.364 trillion left over the next 10 years. Of that amount, $2.343 trillion is attributable to Social Security. If we assume, as many in the political arena did last year, that this money would be used to buy down debt and was not to be used for new spending or tax cuts, there was still an on-budget surplus, after accounting for the tax law, of $21 billion.

This shows why I believe that, even if economic downturn had been foreseen, the tax bill would have become law because the money was there to support it without "dipping into the trust funds."

Dipping into the trust funds is a phrase we hear a lot in Washington, from politicians and the press. In the time I have remaining I'd like to touch on those supposed trust funds and whether or not we're really dipping into them. Then I'd like to talk some about long-term fiscal pressures, especially Social Security, and how we're going to provide for the retirement needs of the baby boom generation.

What happened to the famous "lockbox" everyone was talking about? Many people don't realize that these two subjects—balances in the Social Security trust funds and paying future benefits—are distinct and separate issues. The former typically is cover for failing to plan for the latter. Consider this quote:

"For years, the Social Security and Medicare trust funds were used for government programs that had nothing to do with retirement security. That was wrong and [we] stopped the raid. . . . For those who would use these surpluses for non-retirement security purposes, the lockbox says: hands off the Social Security and Medicare surpluses."

Briefly, the Social Security trust funds are accounts the Treasury uses to track payroll taxes we send to Washington and the amount paid out in benefits. The analogy of a bank account may help illustrate this point. When you deposit money into a bank account, the bank records it as what it owes you, but it uses the money to make loans and investments to others. Like the bank, the government may use Social Security money for other functions, but it does not change the amount owed to the Social

Security trust funds. Specifically, it doesn't alter or dip in to them. During past periods of both budget deficits and surpluses, it has always made good on the balances it had recorded to those trust fund accounts.

Now let's see where we stand with regard to our long-term problems. Despite the surpluses projected for the later years of CBO's 10-year budget outlook, long-term pressures on spending loom just over the horizon. Those pressures result from the aging of the U.S. population, increasing life spans, and rising costs for federal health care programs.

Although policymakers have many goals, if they want to limit the growth of spending on the elderly as a share of GDP, they have only two options: slow the growth of total payments to the elderly or increase the growth of the economy. The nation's ability to sustain an aging population will ultimately depend on how many goods and services the economy will produce and how they will be distributed, not on how much money is credited to Social Security's trust funds.

The economic and budgetary consequences of the aging of the U.S. population can be viewed from three perspectives. The most common perspective is that of Social Security's financial structure.

According to the most recent report of the trustees responsible for the Social Security and Medicare trust funds, Social Security will be solvent until 2041, a date that is three years farther away than had been previously estimated. Medicare picked up one additional year, and will be solvent until 2030. The increased solvency of the funds has been attributed to improvements in productivity.

Regardless of these projections, the trust funds solvency is only on paper—they are nothing more than an accounting device, not a store of wealth. Even calling them trust funds can be misleading and confuses retirees, Members of Congress, and the media alike. The trust funds hold not money, out IOUs from the government to itself and no matter how healthy the trust funds are claimed to be, the economy must generate the cash needed to pay these IOUs to fund claims to eligible beneficiaries. We should constantly monitor the government's ability to pay benefits,

not any specific trust fund date. The only date that is really important is the date when payments to beneficiaries exceed taxes levied to cover them. The annual report of the trustees projects that 2017 will be the first year in which Social Security outgo exceeds income excluding interest.

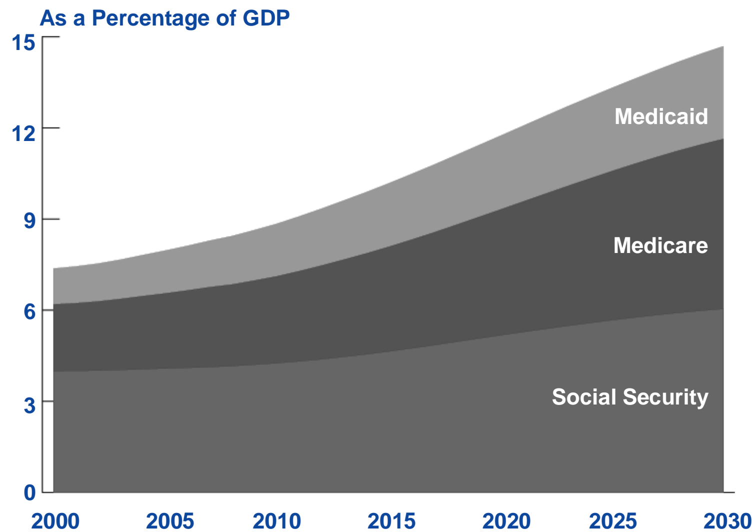
A better perspective on long-term needs would take into account the pressures on the total federal budget, not just the part of the budget specific to Social Security. In particular, as the population ages, spending on Medicare and Medicaid will rise rapidly because of increases in federal costs per beneficiary as well as in the percentage of the population eligible for benefits.

Medicare provides health insurance to most U.S. residents age 65 and older and to eligible disabled people. Most of its participants also receive Social Security benefits. Medicaid is a joint federal/state program that provides medical assistance to low-income people. In recent years, a large share of its payments have gone to provide long-term care for elderly or disabled people. In fiscal year 2001, the federal government spent a total of about $370 billion on Medicare and Medicaid. Those

programs, together with Social Security, already account for nearly half of all federal spending, excluding interest payments on federal debt. If the programs are not changed, by 2030 they could consume two-thirds of the federal budget. That could dramatically decrease the amount of funds available for all other spending, such as on defense, education, and infrastructure.

The broadest perspective, and the one that should be emphasized, takes into account what might happen to the overall U.S. economy, not just to the federal budget, as the population ages. CBO projects that federal spending for Social Security, Medicare, and Medicaid will account for about 15 percent of the nation's total output by 2030, twice the current share.

Projected Federal Spending for Social Security, Medicare, and Medicaid



CBO Outlook (1-02)

That large increase in spending, combined with any taxes or federal debt needed to finance it, could have significant effects on the economy. Examining how changes to those programs could affect the future size of the economy is important because the goods and services baby boomers will consume in their retirement will be produced largely by future workers. The nation's ability to sustain an aging population will ultimately depend on how many goods and services the economy will produce and how they will be distributed—not on how much money is credited to the trust funds.

Deciding how to prepare for an aging population probably will require weighing the interests of today's workers and Social Security beneficiaries against the interests of future workers and beneficiaries. No matter how it is packaged, any plan to increase national saving today means that the U.S. population will consume fewer goods and services now so that consumption can be greater in the future, when a larger share of the population is retired.

That bears repeating. Any plan to increase saving now means you and I must consume less now so that there can be more consumption tomorrow. Gone are the days when expansion of the labor force could pay for the growth of Social Security benefits. In past decades, Social Security's payroll tax revenues grew substantially as the baby-boom generation and women of various ages entered the labor force in large numbers. As Congress looks at policy changes, one consideration is that future workers and Social Security beneficiaries probably will have higher standards of living, on average, than current workers and beneficiaries do, because of future increases in productivity.

Different options for reform would have different effects on economic growth. To the extent that those options boosted the future size of the economy and increased the nation's accumulation of assets, they could lessen the burden on future workers from government programs that serve the elderly.

Most analyses of the Social Security dilemma focus on the three strategies for preparing for an aging population that have generated the most public attention: paying down federal debt, creating private retirement accounts, and making changes to the benefits or revenues of the current Social Security program. Those approaches are not mutually exclusive. They can be combined in any number of ways. In addition, many people have put forward proposals for curbing the rising costs of federal health care programs. Such proposals could also help the nation deal with its impending demographic changes, but there is no easy way known today to achieve that result.

One strategy for preparing for the needs of an aging population is to pay down federal debt. If the government spends less than it receives in

revenues and private saving does not fall too much in response, national saving will rise, boosting the stock of private capital and expanding the productive capacity of the economy in the long run. Indeed, federal debt held by the public has fallen sharply in recent years—from about 50 percent of GDP in 1995 to about 33 percent today. That decline has freed up funds for investment in private capital.

If the surpluses projected in the current baseline materialize, debt held by the public will fall to about 15 percent of GDP in 2010—its lowest level since 1917, but again, our baseline is merely a projection of taxes and spending under current laws.

Nevertheless, even paying off all of the federal debt available for redemption would not fully address the pressures created by Social Security, Medicare, and Medicaid spending over the long run. In principle, the government could continue to run surpluses and use them to buy nonfederal assets, such as stocks and bonds, although that prospect seems less likely than it did a year ago. It also would require changing current laws that restrict the Treasury's investment choices.

Such asset accumulation could increase the funds available for capital investment and boost economic growth; but it would be unprecedented for the federal government to hold a large stock of private assets. The possibility of such holdings raises important questions. Would it be appropriate for the government to own shares in and possibly control private companies? Could the government's involvement distort market signals and corporate decisionmaking? Moreover, is it politically realistic to assume that the government could build up a stock of private assets and that policymakers would refrain from spending more or cutting taxes further. The same concerns apply to Social Security investment in private securities, whether total federal debt held by the public is paid off or not.

Another approach is to modify the Social Security program. Changes that have been discussed include reducing benefits by raising the retirement age, lengthening the period over which benefits are computed, reducing annual cost-of-living adjustments, or means-testing benefits. The effects that programmatic changes would have on the economy depend on the particular kind of change.

Some types of benefit reductions could increase the size of the economy in the long run because they could encourage some people to save more. However, those long-term gains could take a couple of decades to materialize fully, and the effects in the near term would be uncertain. Slowing the growth of Social Security benefits could reduce the lifetime resources of some transitional generations, but it could also lead to higher wages and lower tax burdens for later generations. If benefits were to be cut, changing the law now rather than later would give workers time to adjust their plans for saving and retirement.

Raising taxes to pay for future Social Security benefits would have an uncertain effect on the size of the economy in the long run. Moreover, the effect would depend on the type of tax increase and other factors. If the revenues from a tax increase did not change the government's decisions about other spending or taxes, national saving could rise. But the extra revenues could encourage more government spending, which would limit any rise in national saving. Moreover, increases in marginal tax rates on payroll or income could reduce people's incentives to work or save, also dampening any increase in national saving.

Spending increases also could be viewed as investments in economic growth. Perhaps spending on infrastructure or education, or research would promote future productivity. But the long term returns from federal spending, even in areas such as those, are far from clear.

So what are we doing now to support full benefits for boomers in the future? Nothing. In fact, we are making things worse! We are considering new drug benefits for the elderly that, although perhaps an excellent short term public policy, would make the long term problems more severe. We are expanding spending at a rapid pace, but its long-term impact is dubious at best. And we are not running surpluses.

Moreover, in my 30 years in Washington, I have never seen a more poisonous atmosphere on Capitol Hill. Republicans are fearful of projected surpluses because they believe surpluses are an open invitation to increase spending. Democrats (and some Republicans) feed their fears by constantly talking about the needs for increased spending and the tax cut's impact on the government's ability to respond to those needs.

So, with this view of the current fiscal and political situation, I return to the title of my talk. A return of surpluses? Full benefits for Baby Boomers? Or Elvis? Which will we see first? I'll bet on the King!