HOW BIG IS THE REMAINING SURPLUS?

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Overview

Mr. Chairman, Senator Domenici, and members of the Committee, thank you for inviting me to appear today to discuss the likely size of the federal budget surplus in light of the recently passed tax cut and other potential commitments. I am here representing the Concord Coalition, a bipartisan organization dedicated to strengthening the nation's long-term economic prospects through prudent fiscal policy. Concord's co-chairs are former Senators, Warren Rudman (R-NH) and Sam Nunn (D-GA).

The Concord Coalition is greatly heartened by the dramatic improvement in the federal government's fiscal condition over the past few years. When the 1990s began the nation was mired in large and growing deficits. Today, the budget is in surplus and is projected to remain there for several years. Debt held by the public has declined for three years running, and further reductions are expected in the years ahead.

Given all the good news, some may be tempted to conclude that fiscal discipline is no longer needed. Some may also be tempted to conclude that debt reduction is no longer important or that it will happen without effort. And others will assume that Social Security, Medicare, Medicaid and other age-related entitlement programs have been "saved" by the prosperity of recent years. Unfortunately, none of these conclusions are correct.

The challenges of an aging society include fiscal pressures that cannot be remedied simply by assuming that projected budget surpluses will bail us out. The inevitable growth in spending on age-related entitlement programs will put pressure on discretionary spending, revenues, and public debt. Tough choices will need to be made to avoid burgeoning public debt in the future.

In the years ahead, Congress and the Bush administration face the critical challenge of adopting a framework for using near-term budget surpluses to help fill the huge long-term gap in federal entitlement programs, and to further the nation's continued economic well being. This is certainly a more welcome challenge than eliminating budget deficits, but it is every bit as vital. And fiscal discipline is every bit as important.

So far this year the budget debate has not centered on the long-term challenge but on the extent to which taxes should be cut. Meanwhile, it has been assumed that spending will be reined–in. Turning that assumption into reality could prove to be a far more difficult task than cutting taxes — particularly in light of recent proposals to increase spending on defense, education, agriculture, Medicare and Social Security.

As Congress now turns its attention from tax cuts to spending it is an appropriate time to assess the size of the remaining surplus. Aside from the \$1.35 trillion 11-year tax cut, the FY2002 budget resolution assumed new mandatory spending of \$460 billion over 10 years, a "contingency fund" of \$897 billion, and \$2.4 trillion worth of debt reduction.

It all adds up on paper, but only if today's long-range economic projections are accurate and only if a number of questionable assumptions are made that tend to understate likely expenses and overstate likely revenues. Spending increases beyond the budget resolution level or additional tax cuts risk dipping into the Social Security and Medicare Part A trust fund surpluses, which lawmakers have promised to reserve for debt reduction and/or needed structural reform of these programs.

Hovering over all of this is the near certainty that the long-range projections on which these decisions are based will be wrong — perhaps by several hundred billion dollars in either direction. The immediate danger is not that the budget will quickly fall back into overall deficit, but that in such good times too many commitments will be loaded onto the thin ice of long-term surplus projections.

How big is the remaining surplus?

With that as background, let me turn to the question at hand: how big is the remaining surplus? There are really two ways of answering this question. It can be answered in a technical sense by looking at the most recent CBO baseline and subtracting the effect of the tax cut, which as of now represents the only legislated claim on the surplus. Using this calculation, the remaining 10-year surplus excluding Social Security and Medicare Part A is $1.08 trillion.

The second way of answering the question is to look not just at the effect of the tax cut but also at the spending assumptions contained in the budget resolution. The result is what might be called the "available surplus" because it accounts for claims on the surplus that have not yet been translated into legislation. Subtracting the effects of budget resolution policies reduces the available surplus to about $500 billion. It is important to note, however, that almost all of this supposedly available surplus comes in the final 5 years of the 10-year projection. There is a small surplus of about $26 billion in FY2002, not including the defense increase requested this week by the President. The available surplus in fiscal years 2003 through 2005 is essentially zero.

Beyond the budget resolution policies it is also relevant to look at the likelihood that certain assumptions made in the surplus projection will prove to be unrealistic. Prominent in this regard are the assumptions that discretionary spending will hold at the level of inflation for the nine years beyond 2002, and that the various sunset provisions in the tax cut will actually go into effect. If discretionary spending grows at 4 percent a year rather than 2.6 percent as assumed in the baseline, then the remaining $500 billion of available surplus would be consumed. If discretionary spending keeps pace with GDP growth by increasing at roughly 5 percent annually, then the surplus would be reduced by about $1 trillion. Either of these spending assumptions seems more realistic than the baseline. Discretionary budget authority has grown by an average of 6 percent over the past three years and will grow by 7 percent this year if the President's defense request is simply added to the $661 billon budget resolution total without offsets.

Another questionable assumption is that several expiring tax provisions, including the recently passed tax cut, will sunset before 2011. Adjusting the for the effects of the sunsets, including relief from the alternative minimum tax, would require an additional $500 billion of the surplus.

In short, the combined effects of the tax cut (adjusted for AMT relief and sunsets) the budget resolution mandatory spending policies, the extension of expiring tax breaks, and 5 percent annual discretionary spending growth would, if enacted, eliminate the entire "available" surplus and produce a deficit of approximately $1 trillion. This sum would be covered by the Medicare and Social Security surpluses, so there would still be a total, or unified, surplus under current economic projections even if all of this new spending and additional tax cuts took place. What would be lost, however, is the opportunity to use the full extent of the trust fund surpluses to better prepare for the demographically driven fiscal challenges ahead.

Remaining surplus in the short-term — Fiscal Years 2001 and 2002

The "off-budget" Social Security surplus seems safe this year and next. Moreover, the projected on-budget surplus seems sufficient to set the bar higher by also reserving the Medicare Part A trust fund surplus. While this goal is clearly within reach, it will require fiscal restraint and a cooperative economy.

The FY2001 tax rebate and the shift of $33 billion in anticipated corporate revenues into FY2002 leaves a thin margin of about $6 billion above the Social Security and Medicare Part A surpluses this year. In addition to the tax rebate, the budget resolution authorized $5.5 billion in additional mandatory spending for agriculture this year and about $3 billion more in discretionary outlays. On June 1, President Bush submitted a FY2001 supplemental spending request within the budget resolution limit. But there is little room to add anything to the President's request without offsets. Doing so would require dubious emergency designations, or a waiver of the discretionary spending limit contained in the budget resolution. While these options would get around the spending limit they would not change the bottom line, and so the surplus would be diminished.

Given that three-quarters of the fiscal year has already passed, it is unlikely that Congress will be able to spend too much more in FY2001 than currently anticipated even if it wants to. That does not mean, however, that a non-Social Security, non-Medicare surplus is assured. With a small margin for error any unexpected increase in the cost of current programs or a drop in projected revenues over the remaining months of FY2001 could cause an unintentional dip into the Medicare Part A surplus (See Appendix A.) As a practical matter, there is no available surplus remaining this year.

As for FY2002, Congress must struggle to maintain the tight budget resolution target of $661 billion in new discretionary budget authority — an increase of roughly 4 percent over this year, but a marked decrease from the 6 percent average annual growth of the past three years. Complicating the picture is the Bush Administration's recommendation for an increase of about $18 billion in defense spending. The budget resolution allows for an adjustment in defense spending, provided that it does not cause a non-Social Security, non-Medicare (HI) deficit. While there appears to be room for the President's request in 2002, the real question is the extent to which the on-going strategic defense review causes a higher discretionary spending assumption and lower surplus projection over the long-term. Presumably, the FY2002 request is only a down payment on higher increases to come, and it is not realistic to assume that higher defense spending can be entirely carved out of the existing non-defense baseline. In other words, the defense request for FY2002 should not be viewed in isolation. It is not intended to be a one-time plus-up, but the beginning of a higher defense baseline. This simply underscores the point that, absent a new surge in surplus projections, Congress will have some tough trade-offs to make between spending, tax cuts and savings.

As for mandatory spending, the budget resolution assumes increases for items such as agriculture and health insurance assistance totaling about $19 billion in FY2002. Legislation must be enacted to actually spend this money. If no such legislation is enacted, the surplus will be higher. Again, this involves a trade-off. But assuming that the budget resolution policies are enacted, the current non-Social Security, non-Medicare FY2002 surplus appears to be about $26 billion. (See Appendix B.) The defense increase will take a substantial portion of this, but the exact amount will depend on the outlays generated by the President's request for $18 billion in additional budget authority. Undoubtedly, legitimate emergency spending will also claim a portion of this small "available" surplus.

The shift of $33 billion in revenues from this year into next is a bookkeeping gimmick apparently designed to ensure a non-Social Security, non-Medicare surplus in FY2002. However, it undoubtedly will result in higher spending. If the revenue were to remain in FY2001 it would go to debt reduction because it is too late in the year to spend it. But when shifted into FY2002, most of it becomes available to spend.

Another complicating factor in next year's outlook is uncertainty about whether continued slow economic growth will cause a reduction in CBO's most recent revenue projections. In January, CBO estimated that a mild recession of about the same size as the 1990-91 recession would cause a $65 billion drop in the FY2002 surplus. While it does not appear that the economy has entered a recession, the slow growth experienced so far in FY2001 raises the possibility that FY2002 revenues will be lower than currently projected. To a certain extent, that effect has already been seen. Between January and May, CBO lowered its revenue projections by $20 billion for FY2001 and by $10 billion for FY2002.

Remaining 10-year surplus — FY2002-2011

The May 2001 CBO baseline update essentially confirmed the January surplus projection of $5.6 trillion over 10 years. Included in the $5.6 trillion total is the $2.5 trillion Social Security trust fund surplus and the $400 billion Medicare Part A trust fund surplus.[1] The non-Social Security, non-Medicare Part A projected surplus is $2.7 trillion. Under the budget resolution assumptions and policies, the Social Security and Medicare surpluses can theoretically remain untouched throughout the next 10 years. But there is very little room for error, and even though the projected surplus over the next 10 years is enormous, most of it has been spoken for or may be needed for things that were not included in the budget resolution's long-term assumptions. It is also important to note that the projected surplus excluding Social Security and Medicare is heavily backloaded, with only 28 percent of it coming in the next five years.

A. Uncertainty in surplus projections

Before reviewing in more detail the current and potential claims on the surplus, it is important to keep in mind that 10-year budget projections are highly uncertain. There is an unfortunate tendency to discuss these numbers as if they were a lottery payout, or money in the bank. They are projections, and as the CBO will be the first to say, they are highly uncertain projections.

Prior to 1992 CBO did not make 10-year projections. It is therefore impossible to establish a fair 10-year track record. However, CBO has been able to evaluate its track record of five-year projections. Its conclusions:

- Five-year projections have been off, on average, by 3.1 percent of GDP even after adjusting for the effects of legislation.

[1] For The Concord Coalition's perspective on the Medicare surplus see, "What Medicare Surplus?" Facing Facts Alert Vol. VII, No.2 March 22, 2001. Available under Facing Facts Alerts at concordcoalition.org.

- Applying that average error to the current baseline means that the projected total surplus of $508 billion in 2006 could be off by more than $400 billion in either direction.

- Ten-year projections are likely to be less accurate than five-year projections.

Given the historic error rate, Congress could well find itself with a much smaller surplus, and a non-Social Security *deficit* within the next five years, even without the tax cut, a prescription drug benefit, or any other surplus-eroding legislation. It is true that the numbers could also be wrong on the low side, as they have been in recent years. As a matter of prudent fiscal planning, however, it is best to err on the side of caution, particularly in light of the fiscal pressures that are certain to occur beyond the 10-year budget window as the baby boomers begin to draw their Social Security benefits and qualify for Medicare. Dealing with unexpected good news is much easier than dealing with unexpected bad news. The options are more pleasant.

It is also relevant to note that nearly two-thirds (64 percent) of the projected $5.6 trillion 10-year surplus comes in the *second* five years when, if history is any guide, the projection is likely to be off by several hundred billion dollars each year.

Discretionary spending — a key variable

Adding to the uncertainty of long-term projections is the assumption that must be made about the growth rate of discretionary spending. The 10-year surplus that is now being dedicated to tax cuts, new entitlement spending and debt reduction “lockboxes” is heavily dependent on the assumption that discretionary spending, which includes defense, will grow no faster than the rate of inflation. This is a very fiscally responsible goal, but it is far from certain to be achieved. The table below demonstrates how different today’s 10-year surplus projection is if it is assumed that discretionary spending grows at a higher, and probably more realistic, pace than assumed in the budget resolution. It will take a level of fiscal restraint not seen in recent years to simply validate the surplus that is now being divvied up.

Alternative scenarios for discretionary spending FY2002-2011*

Rate of Growth	Additional spending	Interest	Surplus decrease
4 percent	$430 billion	$70 billion	($500 billion)
5 percent**	$840 billion	$150 billion	($990 billion)
6 percent	$1,265 billion	$235 billion	($1,500 billion)
7 percent	$1,720 billion	$310 billion	($2,030 billion)

* Concord Coalition estimates based on the May 2001 CBO baseline
** Similar to anticipated GDP growth

B. Current claims on the surplus

Assuming that the 10-year surplus projection is accurate, it is clear that a substantial portion of it has already been claimed. To begin with, the projected $2.5 trillion "off-budget" Social Security surplus is dedicated to debt reduction or reform of the program. The budget resolution also sets up procedural protection for the $400 billion Medicare Part A trust fund surplus, although it permits use of this money for a Medicare reform plan that improves access of beneficiaries to prescription drugs.

By far, the largest claim on the remaining surplus is the tax bill signed into law by President Bush on June 7. This $1.35 trillion 11-year tax cut is heavily backloaded and riddled with gimmicks. Because most of its provisions are phased in slowly, nearly 60 percent of the tax cut occurs in the last five years (2007-2011), when today's surplus projections are in their most uncertain period. Many of the individual provisions are even more backloaded.

Tax provision	2001-2006 % of cost	2007-2011 % of cost	Year of full phase in
Overall plan	41	59	2010
Rate reductions	45	55	2006
Child credit	36	64	2010
Marriage penalty	29	71	2008
Estate and Gift	18	82	2010
Pensions and IRAs	44	56	2008

Source: Joint Committee on Taxation, May 26, 2001, Estimated Budget Effects of H.R. 1836.

Fitting the tax cut into the available surplus requires the following assumptions:

- Today's surplus projections are accurate or too pessimistic to begin with
- Discretionary spending will grow no faster than the rate of inflation for 10 years
- The sunset will be allowed to take effect, causing a massive tax increase in 2011
- Congress will do nothing as the number of Americans subjected to the Alternative Minimum Tax (AMT) grows from 1.4 million to 35.5 million in 2010, canceling out a portion of the tax relief the bill purports to give
- Congress will allow dozens of popular tax breaks, which have been routinely renewed in the past, to expire
- Social Security reform will not require resources from the non-Social Security surplus
- A Medicare prescription drug benefit will cost no more than the 10-year $300 billion set aside for this purpose in the budget resolution

Alone, each of these is a questionable assumption. It stretches credibility to believe that all of them will come to pass.

A cloudy sunset

One of the most confusing and controversial aspects of the tax bill is that the entire thing is presumed to "sunset" at the end of 2010. This remarkable assumption made it possible to cut taxes by a greater amount in the first 10 years of the plan than would otherwise have been possible without technically exceeding the $1.35 trillion 11-year limit imposed by the budget resolution. If taken literally, the sunset provision means that as of January 1, 2011:

- The top rate will rise from 35 percent back to 39.6 percent
- All other rates will go up by 3 percentage points
- The new 10 percent bracket will be eliminated
- The "marriage penalty" will reappear
- The maximum annual contribution limit for IRAs will revert to $2,000 from $5,000
- The child credit will revert to $500 after having risen to $1,000 just 12 months earlier
- The estate tax will come back to life, like Dracula rising from the grave, one year after its supposed demise in 2010

Obviously, the sunset provision should not be taken literally. The very absurdity of the result guarantees that it will never happen. The real significance of the provision is that it allowed lawmakers to temporarily avoid making hard choices about which tax cuts would have to be eliminated from the bill to fit within the carefully negotiated budget resolution limit of $1.35 trillion over 11 years.

Moreover, there are some mini-sunsets in the bill that also artificially depress the cost estimate. For example, the Alternative Minimum Tax (AMT) provision, which costs $14 billion from 2001-2005, terminates at the end of 2004. A new above-the-line deduction for higher education expenses is assumed to sunset after 2005. It is no more likely that these mini-sunsets will take effect than it is that the overall sunset will occur in 2010. They are simply scorekeeping gimmicks.

All of the sunset provisions, taken together, result in an artificially low cost estimate for the total bill. According to a preliminary estimate by the Joint Committee on Taxation, without the sunset provisions the 11-year revenue loss from the tax cut would rise by $138 billion to a total of $1.49 trillion. Adjusting the Alternative Minimum Tax to prevent the tax cut from causing an even more dramatic rise in the number of AMT ratepayers than under pre-tax cut law would add another $200 billion over 10 years. Finally, the cost of permanently extending a number of current tax breaks scheduled to expire including the research and development tax credit, adds another $120 billion. In other words, instead of the assumed $1.35 trillion revenue loss over 11 years, the number is closer to $2.2 trillion including higher debt service cost.

The combination of backloading and sunsets makes the ultimate fiscal effect of the tax cut difficult to assess. Its official cost estimate assumes that all of the phase-ins and sunsets will occur on schedule. But two Congressional elections and a Presidential election will take place before the final round of rate reductions is effective, and before most of the "marriage penalty" relief even begins. There will be four Congressional elections and two Presidential elections before the estate tax is repealed and the child credit reaches $1000. It is fair to question whether such delayed provisions will remain frozen in place over such a long period before taking effect. However, for purposes of assessing the 10-year budget outlook it must be assumed that they will.

Unfortunately, it must also be assumed by CBO that the sunset provisions will take effect as planned. This is a very troublesome assumption because it will artificially inflate future surplus projections, particularly for the years 2011 and beyond. If Congress chooses to maintain the sunset provisions as the ultimate "trigger" to protect against optimistic projections, it should also ensure that new policies be assessed against a baseline that accounts for the tax cut as if the sunset provisions didn't exist. The fiction that the sunsets will take place as planned should not be indulged to justify larger tax cuts or higher spending.

New mandatory spending claims

The tax cut is not the only current claim on the 10-year surplus, but it is the only one that has been enacted into law. The budget resolution assumes new mandatory spending of $460 billion over 10 years.[2] Most of it is contained in “reserve funds” designated for specific purposes. The fact that Congress has set aside these reserves in the budget resolution does not mean that the money will actually be spent. Specific legislation must be passed and signed into law by the President before the mandatory spending reserves will have an effect on the budget. However, for purposes of assessing the available surplus, it is appropriate to subtract the new mandatory spending contained in the budget resolution because it represents Congressional intent.

In the language of the budget resolution, aside from the Medicare prescription drug provision, legislation to unlock each of the reserves, “may not when taken together with all other previously enacted legislation reduce the on-budget surplus below the level of the of the Medicare Hospital Insurance Trust Fund surplus in any fiscal year covered by this resolution.”

C. Items not included in the budget resolution that may decrease the surplus

In addition to existing claims on the surplus, there are a number of other initiatives that enjoy substantial support in Congress or the Administration. Turning these initiatives into legislation will affect the surplus. Any such list involves subjective judgment, and cost estimates are dependent upon how each policy is actually implemented. But it would be surprising if the surplus were not reduced by legislative action on at least some of the following items:

[2] This number is $486 billion when measured against the May CBO baseline.

- **Defense increases —** The budget resolution includes $3.65 trillion in budget authority for defense over the next 10 years. But Secretary of Defense Donald Rumsfeld is conducting a broad ranging review of national security policy, and many expect him to conclude his review by requesting substantial increases in the defense budget. This year's request for an additional $18 billion is the first installment, but the potential fiscal impact of the defense review will likely not be seen until the President's FY2003 budget request is submitted in February 2002. However, making room for an increase without raising the overall level of discretionary spending or without making corresponding cuts in the defense budget would require a virtual freeze in non-defense discretionary spending. That is not a realistic prospect.

- **Education increases —** The Senate version of the budget resolution contained nearly $300 billion over 10 years in new mandatory spending for education, much of it earmarked for guaranteed funding of the Individuals with Disabilities Education Act (IDEA). Ultimately, this provision was removed in the House-Senate conference before final passage of the budget resolution. But shortly thereafter, the Senate voted to increase IDEA funding by $150 billion over 10 years in an amendment to its bill reauthorizing the Elementary and Secondary Education Act (ESEA). The House version of the education bill does not include 10-year guaranteed funding for IDEA. Regardless of whether the Senate or House position prevails on the question of guaranteeing IDEA funding, it seems likely that more money will be spent on this and other education programs than is contemplated in the budget resolution.

- **Alternative Minimum Tax reform —** The AMT, which was designed to prevent wealthy taxpayers from using a combination of deductions and tax breaks to pay little or no income taxes, is not indexed for inflation. Over the years, the number of taxpayers subject to the AMT has been slowly increasing. But without reform, the number of taxpayers subjected to the AMT will shoot up from 1.4 million this year to 35.5 million in 2010. The recently passed tax bill is responsible for about 15 million of these prospective new AMT ratepayers. As a result, a growing number of taxpayers will not receive the full amount of the tax cut they have been led to believe they will get. Given that the goal of the tax cut is to give money back to the taxpayers, it seems unlikely that Congress will take away with one hand what it gives back with the other. Correcting this problem is estimated to cost about $200 billion according to the Joint Committee on Taxation. Even with this correction, the number of taxpayers subjected to the AMT will rise to over 20 million by 2011. Thus, it is likely that additional modifications will have to be made to address the AMT problem that already existed before the tax cut.

- **Expiring tax provisions —** Several tax provisions ("extenders") are scheduled to expire between 2002 and 2011. The largest is the research and development tax credit. Although most observers believe that these provisions will be extended most of them were left out of the tax bill. Permanently extending the provisions scheduled to expire this year along with the popular research and development tax credit would lower revenues by about $120 billion over 10 years.

- **Social Security reform —** While President Bush has appointed a Commission to recommend actions to ensure the long-term sustainability of Social Security, the budget resolution does not reserve anything from the non-Social Security surplus for this purpose. Strictly speaking, Social Security reform need not require a contribution from the non-Social Security surplus. But if, as reported, the Social Security commission recommends that personally owned accounts be created within the system the thorniest question will be how such accounts should funded. As a frame of reference, using 2 percent of taxable payroll to fund a personal account reform plan would require roughly $1 trillion over the next ten years. One source of such funding is the Social Security surplus, which by definition is already dedicated to the payment of future retirement benefits. However, given the strong desire of many lawmakers to reserve the Social Security surplus for debt reduction only, and the clear need for a source of up-front funding to make the personal account concept work, it seems very likely that a contribution from non-Social Security revenues will be necessary.

- **Emergency spending —** Supplemental emergency appropriations are designed to allow Congress to fund natural disaster relief, military operations, and other unforeseeable events that develop after the regular appropriations bills have been passed. The President's Office of Management and Budget (OMB) estimates that the average annual amount spent on natural disaster relief is $5.6 billion. According to CBO, the average annual amount of total emergency appropriations, excluding Gulf War expenses, between 1991 and 1999 was $8.9 billion. Nevertheless, the budget resolution contains no earmarked funding to deal with natural disasters, or other emergency needs. A House provision setting up a designated emergency fund of $5.6 billion in the FY2002 budget was deleted in conference with the Senate. If history is any guide, however, the money will be needed whether it is recognized in the budget resolution or not. Over 10 years, routine emergency spending is likely to cost anywhere from $50 to $90 billion.

What about the "contingency fund"?

To account for these and other uncertainties involved in any 10-year budget, the budget resolution reserves approximately $900 billion in what has been called a "contingency fund." This $900 billion simply represents the portion of the non-Social Security surplus that is not committed to tax cuts, new spending, and interest costs.

The first claim on the contingency fund is the Medicare Part A trust fund surplus, which unlike Social Security is an "on-budget" item. Removing the Medicare Part A surplus from the contingency fund lowers the total to about $500 billion. There is ample reason to doubt whether the likely costs of anticipated defense and education increases, AMT reform, renewal of expiring tax provisions, Social Security reform, emergency spending, and interest costs, can all be covered by this $500 billion contingency fund.

IV. Beyond the 10-year budget window

Today’s major budgetary decisions must not be viewed through a short-term lens. Fiscal discipline is the key to providing for the unmet needs of the future. Somehow, sufficient resources must be set aside to meet the huge retirement and health care costs associated with the coming “senior boom.” The time to address the long-term challenge is now, while the demographics are favorable and the budget is in surplus. The surpluses provide an opportunity to help meet this challenge — but only if we are careful to preserve them.

Absent from the budget debate so far is the one issue that will determine government's size and shape in the new century--the long-term growth in entitlement spending. Neither side has any plan to slow that growth. In fact, to the extent that leaders are talking about entitlements at all, it is to advocate adding new ones. Nevertheless, in advance of developing a plan for dealing with the future financing requirements of Social Security and Medicare, Congress and the President have enacted a tax cut that, if all the questionable sunsets are ignored, totals almost $2 trillion.

The current trend in entitlement spending remains unsustainable.

- The three biggest benefit programs for seniors—Social Security, Medicare, and Medicaid—now consume 43 percent of the federal budget, up from 15 percent in 1965. On the current course they will consume roughly 80 percent of budget outlays by 2040.

- All told, OMB projects that these three programs will nearly double as a percent of GDP by 2040, from about 7 percent to over 14 percent.

- According to the 2001 Trustees’ report, Social Security outlays will exceed earmarked tax revenues by a widening margin starting in 2016. By 2025, Social Security will face an *annual* cash shortfall of over $400 billion. By 2038, the last year the trust funds are technically solvent, the *annual* shortfall will be over $1 trillion.

- To cover these deficits, the trust funds will have to redeem their IOUs from the Treasury. And to come up with the cash, Congress will have to hike taxes, cut other spending, consume surpluses if they exist, or borrow from the public—exactly as if the trust funds never existed.

- This year, all Social Security benefits could be paid for with a tax rate of 10.5 percent of payroll. By 2040, the Trustees project that they will cost 17.7 percent of payroll. Add in Medicare Part A and the projected burden rises to 24 percent of each worker's taxable paycheck.

- The recent prosperity has not lowered Medicare's long-term cost rate. Nor has it altered the demographic, social, and technological forces driving up the future cost of health care. Far from it: Following the recommendation of an official technical panel, the Trustees this year increased their projection of Medicare's long-term cost rate by a staggering 60 percent.

This year's dynamic of cutting taxes while planning to raise spending creates the threat of renewed non-Social Security, non-Medicare deficits and may result in failure to reduce the public debt to the low levels now projected. Savings from deficit reduction, and now surpluses, have helped provide the capital to increase the productivity of American workers — a major factor in the record growth of the last 10 years. Further gains in productivity will become especially urgent when the retirement of the huge baby boom generation virtually halts the growth in the size of the U.S. work force.

But even improved productivity is not a complete solution.[3] Closing the gap between what government promises and what it can afford will require someone to give

[3] See, Concord Coalition Facing Facts Alerts, "The New Economy: No Fiscal Cure-All," Vol. VII, No. 5, June 11, 2001 and "The Budget Issue Everyone Is Avoiding," Vol. VII, No.4, April 26, 2001.

something up. The one way to mitigate the sacrifice is to boost national savings in advance of the age wave. Continued debt reduction is the government's most direct contribution to net national savings. Increasing national and personal savings is the single most effective policy the government can pursue to promote long-term economic growth and retirement security. As public debt is reduced, other policies such as retirement savings accounts also play an important role. Household savings are nowhere near adequate to prepare for ever-lengthening retirements.

Earlier this year, The Concord Coalition's urged Congress to consider establishing a system of mandatory, individually owned retirement accounts to help families build a more ample nest egg while alleviating concerns that future budget surpluses will result in either higher spending or in a large build up of government-owned private sector financial assets. We still believe that this would be the best way to use our prosperity of today to prepare for the fiscal challenges of tomorrow. But funding such a savings program will be far more difficult, if not impossible, if the bulk of the surplus is devoted to new spending programs or large escalating tax cuts.

Budget surpluses must not be used as an excuse to abandon fiscal discipline. But as the recently passed tax cut demonstrates, the temptation is great. The following Surplus Scorecard demonstrates how easily today's surpluses could be consumed. *It is not a prediction*. Congress may or may not take action on several of the items listed. The Surplus Scorecard is intended to be a hard choices reality check. Large as the surplus appears, policymakers must still set priorities. And they must do so within the context of two very important caveats:

- The surplus is only a projection, and the further out it goes the more uncertain it becomes
- More certain, because it is driven by demographics, is the challenge of affording the baby boomers' retirement and health care costs.

Relying on today's surpluses to enact a series of large escalating new commitments, such as the recently passed tax cut or a Medicare prescription drug benefit, in advance of developing a plan to fund the unfunded entitlements we already have is to rely on the unreliable while ignoring the inevitable.

The Surplus Scorecard FY2002– 2011 as of June, 2001

Unified budget surplus		**$5.6 trillion**	
Social Security surplus	**-**	**$2.5 trillion**	
On-budget surplus	**=**		**$3.1 trillion**
Reserve Medicare Part A surplus	**-**	**$400 billion**	
Available surplus	**=**		**$2.7 trillion**
Actions to date			
Tax Cut (H.R. 1836) **(including debt service)**	**-**	**$1.66 trillion**	
Remaining available surplus	**=**		**$1.08 trillion**
Budget resolution spending commitments			
New mandatory spending	**-**	**$460 billion**	
Non-reconciled tax cuts	**-**	**$20 billion**	
Discretionary savings	**+**	**$10 billion**	
Debt service	**-**	**$110 billion**	
Remaining available surplus	**=**		**$500 billion**
Potential actions			
Discretionary spending grows at five percent per year	**-**	**$840 billion**	
Ignore tax cut sunsets	**-**	**$140 billion**	
Renew expiring tax breaks	**-**	**$120 billion**	
Adjust Alternative Minimum Tax	**-**	**$200 billion**	
Guarantee IDEA funding (S.1)	**-**	**$150 billion**	
Veterans' retirement/disability (S170)	**-**	**$40 billion**	
Debt service on the above actions	**-**	**$300 billion**	
Potential new commitments	**=**	**$1.79 trillion**	
Remaining available surplus (assuming all of the above)	=		**-$1.29 trillion**

APPENDIX A

FY2001 Surplus at-a-glance*

Total:	$275 billion	
Social Security:		-$156 billion
On-budget surplus:	$119 billion	
Medicare Part A:		-$28 billion
Remaining surplus:	$91 billion	
Tax cut (H.R. 1836):		-$41 billion
Corporate tax shift:		-$33 billion
Agriculture increase:		-$5.5 billion
Supplemental, etc.:		-$3 billion
Debt service:		-$2 billion
		-$84.5 billion
Remaining surplus:	**$6.5 billion**	

*Based on the May 2001 CBO baseline.

APPENDIX B

FY2002 Surplus at-a-glance*

Total:	$304 billion	
Social Security:		-$172 billion
On-budget:	$132 billion	
Medicare Part A:		-$38 billion
Remaining surplus:	$94 billion	
2001 revenue shift:	$33 billion	
Remaining surplus:	$127 billion	
Tax cut:		-$71 billion
Mandatory increase:		-$19 billion
Discretionary increase:		-$4 billion
Debt service:		-$7 billion
		-$101 billion
Remaining surplus:	**$26 billion****	

* Based on the May 2001 CBO baseline.
** Does not include defense increase