Informed Budgeteer

CBO'S ECONOMIC AND BUDGET OUTLOOK, 2002-2011

• The Congressional Budget Office released on January 31 its annual report with its latest economic assumptions and budget projections based on all legislation enacted through the end of last Congress.

CBO Baseline Projections- January 2001
($ in Billions)

	2001	2002	2002-2011
Revenues	2135	2236	27,887
Outlays	1853	1923	22,277
Surplus	281	313	5,610
On-budget	125	142	3,122
Off-budget	156	171	2,488

• Under this baseline – which CBO reminds is a neutral benchmark generally based on current law that can be used to *evaluate proposed changes* in law and is ***not*** *a prediction of what* ***will*** *happen* – surpluses continue to grow. This year, if no new laws are enacted, the surplus is expected to be $281 billion. Next year, the budget year-2002, the baseline surplus is $313 billion, and surpluses going out through 2011 would be expected to accumulate to $5.6 trillion.

• For projecting outlays, CBO follows the direction the budget law orders for building the baseline. For mandatory programs, CBO prepares its best estimate of the outlays that will occur under current law. For discretionary accounts, CBO's baseline reflects the level of budget authority enacted for 2001 in appropriation bills and projects those levels for each year thereafter with an adjustment for inflation so that the discretionary level for each year through 2011 represents the same level of purchasing power as the amount provided in 2001.

• Over the 10-year period, projected outlays are $22.3 trillion. But the annual growth in outlays is exceeded by the annual growth in revenues, thus yielding increasing surpluses.

• The new CBO baseline pegs 10-year revenues about $900 billion higher than their July baseline. Relative to July and over 2001-2010, economic changes resulted in an $800 billion upward adjustment, technical changes resulted in a $150 billion upward adjustment, and legislative changes resulted in a $37 billion downward adjustment.

• The economic changes are primarily due to CBO's assumption of faster GDP growth. More GDP translates into higher incomes and corporate profits, which in turn generate larger revenues.

• Much of the technical changes are due to upward reestimates of projected capital gains realizations, particularly in the near term.

• The legislative changes are mainly due to enactment of the Community Renewal Tax Relief Act and the Foreign Sales Corporations (FSC) repeal.

• Going forward, CBO projects revenue growth will moderate from its recent rapid pace. Revenues have grown at an average rate of 8.3 % over the past eight years, much faster than GDP. CBO projects revenues will grow slower than GDP for the next six years, then accelerate slightly.

• Under CBO's baseline, revenues peak at 20.7% of GDP in 2001, a postwar high. Revenues then level out at about 20.3% of GDP for the next ten years.

• Since 1997 debt has been reduced by $363 billion, and CBO's baseline shows debt continuing to fall. Under the baseline, all of the debt available to be paid down will be paid down by 2006. By 2011, the end of CBO's projection period, debt held by the public will fall to $818 billion.

• Because a certain amount of debt is not available for redemption and because surpluses continue to build, CBO projected a balance of uncommitted funds beginning in 2006 and rising to a level of $3.2 trillion by 2011. Uncommitted funds, or excess cash, are CBO's term for the surpluses remaining in each year after paying down debt available for redemption.

• By 2011, the level of uncommitted funds represents 18.7% of GDP. CBO's baseline assumes such funds are invested and earn a rate of return equal to the average Treasury bill and note rate. However, CBO makes no assumption about where those funds are invested.

NOT THE CBO BASELINE PROJECTIONS?

• Even before CBO released its baseline, some factions had been increasing the drumbeat that the CBO baseline was not a useful tool (savvy budgeteers know this started about a year ago), especially for discretionary spending, and that other methodologies were supposedly more worthy.

• This is important, and probably has come about, because of the history of the statutory caps on discretionary spending. To resurrect the discipline that the cap structure afforded during most of the 1990s, the caps need to be increased for 2002 and then extended thereafter. The baseline is a starting point for the debate that will occur on the appropriate level of those caps.

• Although it is discretionary outlays that directly affect the calculation of federal surpluses, the Congress cannot directly control the level of outlays. Rather, such outlays flow from budget authority, the levels of which Congress does set each year in annual appropriation acts.

• The following table, therefore, summarizes recent trends in discretionary appropriations for defense and nondefense spending, and compares them to CBO's baseline going forward over the next 10 years, as well as alternate discretionary paths that CBO and others illustrate as alternatives.

Average Annual Growth Rates Compared to Projections
($ in billions)

Historical Average Annual Growth in BA				
% Change	1991-96	1996-2000	1999-2001	2000-01
Total Discretionary*	-1.6%	3.9%	1.6%	8.6%
Defense	-4.4%	3.3%	-0.7%	3.3%
Non-defense	2.1%	4.7%	4.3%	14.3%

Projections of Average Annual Growth in BA	
% Change	2001-2011
Inflated Baseline	**2.7%**
Defense	2.7%
Non-defense	2.8%
Nominal GDP growth	**5.1%**
Defense	5.1%
Non-defense	5.1%
Inflation +1% growth	**3.7%**
Defense	3.7%
Non-defense	3.8%

SOURCE: Senate Budget Committee. *Less IMF BA in 1993 and 1999.

• Because of the end of the cold war, declines in defense spending in the first half of the 1990s confounds the analysis of overall discretionary spending changes. So looking at nondefense spending alone, average annual growth remained below inflation from 1991-1996, and then rebounded strongly since then, with a kicker of a 14.3% increase in 2001alone.

• CBO's discretionary baseline increases the nominal level of resources by an average annual rate of 2.8% over the next 10 years to maintain the same level of purchasing power each year as provided in 2001. Proposals to have the discretionary baseline grow at the same rate as nominal GDP growth would see nondefense spending increase at an average annual rate of 5.1%. Since such spending has grown on average at only 4.3% annually over the last 10 years, there is little recent historical justification for this approach. Other alternatives to the CBO baseline might more closely resemble recent historical experience.

ECONOMICS

CBO'S CAUTIOUS ECONOMIC ASSUMPTIONS

- The economic and revenue assumptions CBO used in calculating the 10-year budget baseline are notable for their caution.

- CBO assumes the economy will grow at an average annual rate of 3.1% for FY 2002-11. By contrast, the consensus among Blue Chip economic forecasters is 3.3%. Putting aside forecasts and looking at hard data, the economy has grown at a 3.2% rate since the beginning of the last recession in 1990-91 and at a 3.3% rate since the beginning of the previous recession in 1981-82.

- For each 0.1 percentage point by which actual real economic growth exceeds CBO's forecast, the estimated surplus increases by about $244 billion during the 2002-11 budget window.

- CBO assumes the unemployment rate will rise from its current 4% rate to a long term trend of 5.2%. The Blue Chip consensus is for a gradual rise to 4.6% unemployment.

- CBO assumes that the surge in capital gains revenue during the past several years is essentially an anomaly and that capital gains revenue will gradually return over the next several years to the share of overall individual income tax receipts that existed in the early 1990s. An alternative assumption – that capital gains revenue after FY 2001 increases at the rate of nominal GDP growth – would yield about $600 billion in additional revenue from FY 2002-11.

Change in CBO Economic Assumptions
(by percent)

	July 2000 (2001-2010)	January 2001 (2002-2011)	Blue Chip (2002-2001)
Real GDP*	2.7	3.1	3.3
Nominal GDP*	4.7	5.1	5.6
GDP Price Index*	1.9	1.9	2.2
CPI*	2.6	2.6	2.6
Unemployment Rate**	4.7	4.9	4.6
3-month T-Bill Rate**	5.1	4.9	5.4
10-year T-note Rate**	5.9	5.7	6.0

*Average Annual % change. **Average.

IS THE STOCK MARKET DRIVING CBO'S REVENUE FORECASTS?

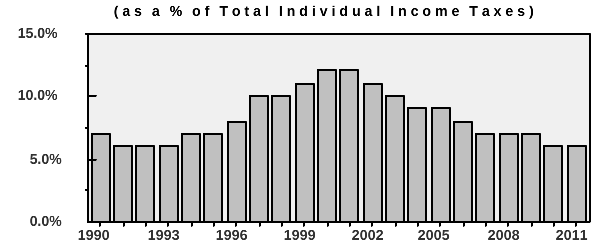
- In the past several years, capital gains realizations have contributed to our rising surpluses. But they had been in large part a surprise to CBO and others since most projections are based on the historical relationship of capital gains realizations as a share of GDP.

- Why did capital gains boost revenue in the past and ho do they impact projected revenues? In the past decade, realized capital gains boosted receipts substantially, and in fact realizations have nearly doubled over the last two years as a share of individual income taxes. These realizations were most likely boosted due to the dramatic appreciation of the stock market. CBO has calculated that capital gains realization has accounted for nearly 30% of individual tax receipts growth in excess of nominal GDP between 1995 and 1998.

- However for nervous budgeteers who are worried that last year's decline in the stock market will materially affect the surpluses, you must first consider that capital gains realization do not necessarily track movements in the stock market. In fact, a good deal of capital gains realizations may lag behind market movements.

- With that being said, CBO expects that capital gains realizations as a share of GDP will gradually decline back to historical levels in the final three years of their current projections. Then what are the major factors driving the growth of individual income taxreceipts? CBO believes that the most important factor behind the current healthy revenue projections are the effect of real bracket creep and the AMT on individual taxes.

Capital Gains Projected to Fall Back to Historical Levels
(as a % of Total Individual Income Taxes)



Source: CBO January 2001 Budget and Economic Outlook

CALENDAR

Senate Budget Committee Hearing Schedule

Unless otherwise noted, all hearings will be held in Dirksen 608 at 10:00 a.m. Additional hearings and witnesses will be scheduled.

February 6: Long Term Budgetary Issues; Witness: GAO Comptroller General, David Walker. **10:30 am**

February 7: The Impact of Demographic Trends on the Budget and Long-Term Fiscal Policy; Witnesses: Ben J. Wattenberg, Senior Fellow, American Enterprise Institute; Ronald D. Lee, Ph.D., Professor of Demography and Economics, University of California at Berkeley; Dr. Robert Friedland, Director, Center on an Aging Society, Georgetown University; and Dr. Peter Orszag, President, Sebago Associates.

February 8: The Budget and Economic Outlook; Witnesses: Robert Greenstein, Executive Director, Center on Budget and Policy Priorities; and Dr. Alice Rivlin, Senior Fellow, Brookings Institution. **10:30 am.**

February 14: The Future Defense Budget; Witnesses: Dr. Andrew F. Krepinevich, Executive Director, Center for Strategic and Budgetary Assessments; Adm. Bill Owens, former Vice Chairman of the Joint Chiefs of Staff; and Robert J. Lieberman, Deputy Inspector General, Department of Defense. **2:30 pm**

February 13: Hearing on the Budget Outlook and Tax Policy; Witnesses: Dr. Martin Feldstein, Professor of Economics, Harvard University; and Dr. Kevin Hassett, Resident Scholar, American Enterprise Institute.

February 15: Medicare Reform and Prescription Drugs; Witnesses: Kathy Means, Senior Health Policy Advisor, Patton Boggs LLP; and Dr. Gail Wilensky, Chair, Medicare Payment Advisory Commission.

CONGRATULATIONS ARE IN ORDER

- SBC staffs OMB! The *Bulletin* would like to extend its warmest best wishes to current and former SBC staff who have accepted positions with the Bush Administration.

Amy Smith   Associate Director for Economic Policy OMB

Jim Capretta	Associate Director for Health & Personnel OMB
Austin Smythe	Executive Assistant Director OMB
Mark Sumerlin	Deputy to National Economic Advisors

O A new SBC publication is available. "Tax Expenditures: Compendium of Background Material on Individual Provisions", December 2000. Senate print 106-65, available through the Budget Committee. The report will also be available on the GPO website.