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The Changing Budget Picture

In January 2001, the Congressional Budget Office (CBO) reported that the federal government was projected to run a $313 billion surplus in 2002. Now, just a little over a year later, the CBO's latest reports indicate a major deterioration in the budget projections. In its February 2002 report, the CBO projected a deficit of $21 billion in 2002; in a revision released in March 2002, to account for the release of President Bush's federal budget for 2002–2003, the CBO projected a small surplus in 2002 under its baseline scenario and a $90 billion deficit under the President's proposals. Finally, when the economic stimulus bill passed Congress last week, the CBO again revised its baseline projection for 2002 to show a $46 billion deficit.

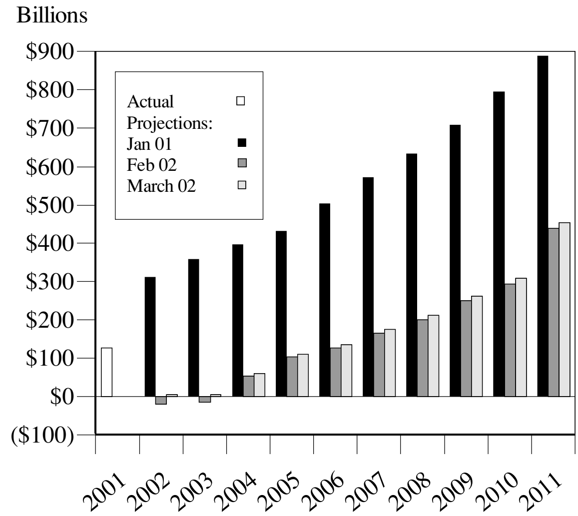
Although large changes in the budget outlook from year to year are not uncommon, the magnitude of the change for 2002 is unusually large. This *Economic Letter* examines the change in the budget outlook and discusses the causes of the revisions in the projections. Because the complete CBO baseline analysis of the Economic Stimulus Bill is not yet out, this *Letter* focuses on the projections released in early March.

The budget revisions

Figure 1 shows the large downward revisions in both the current and future surpluses that occurred between early 2001 and 2002. In January 2001, the CBO projected that the surplus would be $313 billion for 2002 and would rise significantly over the decade, reaching an annual level of $889 billion in 2011 and totaling $5.6 trillion for the entire decade.

Figure 1

Actual 2001 surplus and projections for 2002–2011



In the CBO's February 2002 projections, the surplus for 2002 was gone. In its place was a projected deficit of $21 billion. The CBO still projected a surplus over the entire decade, but the total fell from $5.6 trillion to just $1.6 trillion. In early March, the CBO revised its projections again and showed a small surplus of $5 billion for 2002.

What accounts for this large swing in the budget outlook?

To answer this question, it is important to recognize that the CBO's budget projections are different from forecasts of future budget surpluses and deficits. (See Walsh 1999 for a full discussion of the differences.) One of the most important differences is that the CBO projections assume that current laws and policies will remain unchanged. For example, though Congress was debating a tax cut in the first half of 2001, the CBO did not change its budget projections until the legislation actually passed. Therefore, the January 2001 projections assumed no tax cut, while the February 2002 projections incorporate the effects of the new tax bill. Similarly, the CBO's baseline projection released in March 2002 does not incorporate the proposals contained in the President's 2002–2003 budget. The CBO does provide estimates of the impact of the President's budget, however, and they show the budget swinging from a $5 billion surplus to a $90 billion deficit in 2002. Whenever major legislative changes in either taxes or spending occur, there will be large revisions in the CBO's projections.

Legislative changes did play an important role in altering the budget outlook between January 2001 and early 2002, reducing the projected surplus by $91 billion for 2002. The effect of these legislated changes grows over time; by 2011 they are projected to reduce the surplus by $319 billion. Figure 2 focuses on these legislative changes, distinguishing among tax, spending, and debt service factors. The tax cut passed by Congress in 2001 is the primary legislative reason for the downward revisions in the surplus. Increased discretionary spending also contributes to the smaller surpluses; for the period 2002–2011, the CBO has raised its projection for discretionary spending by $550 billion. Of this total, $301 billion is for defense spending and $249 billion is for nondefense outlays.

Because these legislative changes reduce the surplus available to repay the government's outstanding

Figure 2

Changes in the surplus due to legislative sources

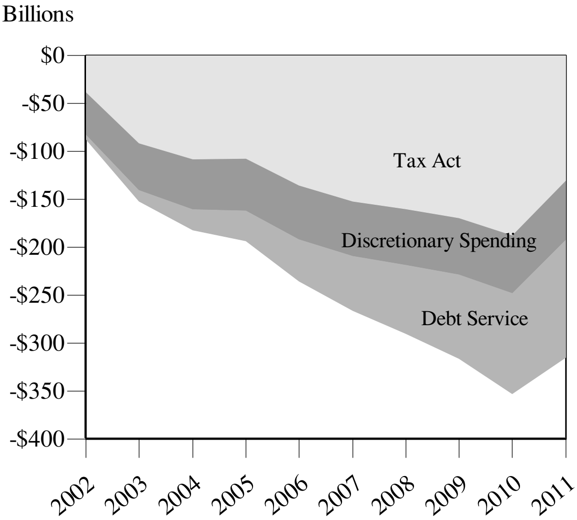
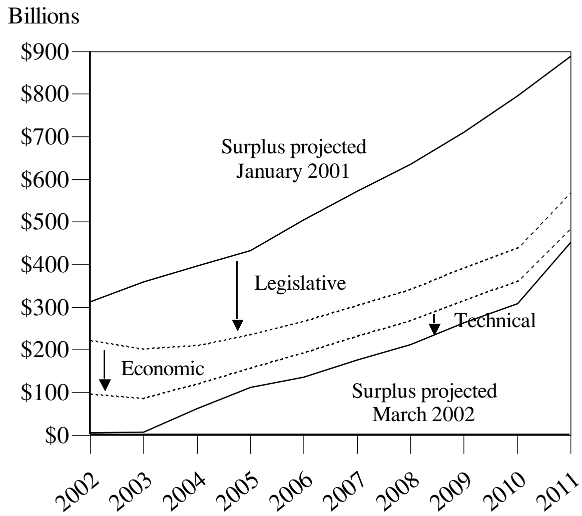


Figure 3

Sources of the fall in projected surpluses



debt, the debt will fall more slowly than had been projected earlier. As a result, federal interest payments are now likely to be significantly higher than were assumed in the CBO's January 2001 projections. This debt service component grows to become a major source of the changing outlook for the surplus, accounting for $124 billion of the $319 billion reduction in the surplus projected for 2011.

While the CBO projections assume current laws and policies remain unchanged over the horizon of the projection, the CBO does incorporate their forecasts of economic conditions. And the near-term economic outlook has changed significantly since January 2001. The long economic boom the U.S. enjoyed through most of the 1990s officially ended in March 2001. An economic recession has major implications for budget projections. As overall income declines, the government's tax revenues fall, contributing to a fall in the budget surplus. During February 2002, the outlook for economic activity improved. As a result, between February and March 2002, the CBO revised its baseline projection for 2002 from a deficit of $21 billion to a surplus of $5 billion.

A final source of changes in the budget projections arises from what the CBO classifies as technical changes. This category is a catch-all for any changes in the budget outlook that are related neither to legislative changes nor to the CBO's economic forecast. In the February projections, most of the technical changes are due to downward revisions in revenue estimates. One major factor contributing to these lower revenue forecasts is the weak performance of the stock market during 2001 and early 2002. This weakness has caused the CBO to reduce its estimate of the government's revenue from such sources as capital gains realizations.

Figure 3 puts together these three sources of revisions—legislative, economic, and technical—to show how each has contributed to the reduction in projected surpluses.

The relative importance of each component varies over the projection horizon. For 2002, for example, changing economic conditions and related factors, such as the decline in capital gains realizations, account for more than 70% of the deterioration in the budget projection. Of the $308 billion reduction in the projected surplus for 2002, $125 billion is the result of changes in the CBO's economic forecasts. Technical changes account for a further $92 billion reduction, while legislative changes are estimated to reduce the 2002 surplus by $91 billion. As the decade progresses, legislative changes become the major reason for the downward revisions in the surplus projections. In 2010, for example, $357 billion of the $488 billion change in the projection is due to legislative changes, and, as Figure 2 showed, most of these legislative changes reflect the impact of the tax cut.

Budget principles

Changes in the CBO's budget projections help explain why the outlook for future federal surpluses has changed dramatically over the past year. The projections allow one to separate the im-pacts of the 2001 recession from the 2001 tax cut. What the projections do not provide, though, is any assessment of whether the changes are desirable or not. For that, one needs some basic principles for assessing the government's financial condition.

For instance, most economists believe governments should aim to balance their budgets, not year to year but over longer time horizons. When the economy is in a recession and tax revenues decline, it is appropriate to run a deficit (or a smaller surplus). When the economy booms and tax revenues rise, the government should run a larger surplus. These short-run fluctuations that occur as the economy experiences business cycles can cloud the longer-run budget picture. The decline in the projected surpluses caused by the economic slowdown in 2001, and reflected in the changes in the CBO's economic forecasts, does not signal any fundamental change in the government's financial health.

To abstract from budget fluctuations associated with the business cycle, economists often focus on what is variously called the full-employment, high-employment, or structural budget. This measure is designed to show what the budget surplus would be if the economy maintained full employment. Currently, the full-employment budget is still in surplus; if economic activity had not declined during 2001, the federal government would be running a budget surplus.

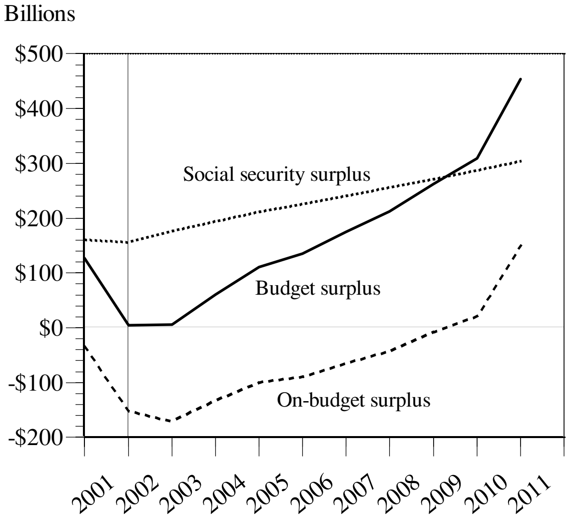
That still raises the issue of whether, at full employment, the government's surplus is too large or too small. To assess this issue, a second budget principle is helpful. The government should take into account *all* the implications of current policies, not just their implications for this year or the next few years. For example, no assessment of the federal government's budget outlook can ignore the looming retirement of the baby boom generation and the effects this will have on the Social Security System. Because of the need to build reserves to fund the projected Social Security payments to the baby boomers, the Social Security Trust Fund currently takes in more revenues than it pays out in current benefits. Figure 4 shows that when these Social Security surpluses are separated out of the overall budget, the remaining budget, referred to as the on-budget surplus, was actually in deficit in 2001, despite an overall surplus of $127 billion, and the on-budget balance is projected to remain in deficit until 2010. Thus, the Social Security System masks deficits in the rest of the budget that are projected to continue for almost the entire decade.

Finally, any assessment of the budget outlook must bear in mind the uncertainty inherent in projecting future revenues and spending. The events of September 11, 2001, and their impact on defense and security-related federal expenditures are telling reminders of the difficulties of accurately looking into the future. Economic conditions will change as well and, as they do, so will the budget outlook.

Projections like those shown here, with a single line extending into the future, do not provide a sense of the *range* of possible outcomes. To overcome this difficulty, the CBO has begun to produce "fan charts" like those used by the Bank of England for its inflation forecasts. A fan chart shows a range of projections emanating from the most recent actual data, and the width of the fan is based on an estimate of the uncertainty in the projection. For example, it can show the range of outcomes that, under current laws and policies, will include the actual budget outcome with 90% probability. For 2002, this range extends from a surplus of $108 billion to a deficit of $149 billion. As one looks further into the future, the range gets even wider. For 2007, the 90% range goes from a surplus of $901 billion to a deficit of $568 billion. These wide bounds serve as useful reminders that the CBO budget projections are like snapshots, based on current policies and economic forecasts. But these projections are likely to be subject to major revisions in the future, just as they have been in the past, as Congress legislates changes in taxes and spending and as economic conditions evolve.

Figure 4

Social Security and on-budget surpluses



Carl E. Walsh
Professor of Economics, UC Santa Cruz, and Visiting Scholar, FRBSF

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