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Briefing Paper

The Real Budget and the Real Budget Deficit

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August 26, 2003

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Executive Summary

Many economists and policy analysts have argued that the unified federal budget, the most widely reported accounting of the federal budget, does not give an accurate assessment of the nation's fiscal position. There is an alternative measure of the budget that can be readily constructed from widely available budget documents. This alternative measure – a core budget – pulls out programs that are financed by their own stream of revenue – most importantly Social Security, Medicare, the retirement programs for federal employees, and unemployment insurance – and focuses only on the portion of the budget which is financed by general revenue, primarily the personal and corporate income taxes.

Since there is currently a large surplus in most of the budget categories that have their own revenue source, the core budget has a considerably larger deficit than the more widely reported unified budget.

- The deficit for the core budget for 2003 is approximately $600 billion, compared to a $401 billion deficit in the unified budget;

- Measured as a share of this core budget, the deficit is 44.8 percent of total non-interest outlays, and more than 61.3 percent of non-interest non-defense outlays, meaning that cuts of this size would be needed to balance the core budget.

- The deficit in the core budget is more than 56.6 percent of current revenue, implying that income taxes would have to increase by 56.6 percent from their 2003 level to balance the core budget.

The paper notes that 2003 tax revenue is lower than normal because of the weak economy. It also notes that it is not necessary to balance the budget. It separately calculates the amount of deficit reduction that would be needed to keep the ratio of government debt-to-GDP constant, if the unemployment rate were at 5.2 percent (the long-term average projected by the Congressional Budget Office[CBO]). It shows that:

- It would still be necessary to reduce the core deficit by $200 billion to keep the debt-to-GDP ratio constant, even if the unemployment rate fell to the long-term average projected by CBO.

- This would require cuts in the core budget that are equal to 14.9 percent of total non-interest spending or 22.1 percent of non-interest non-defense spending.

- Alternatively, keeping the debt-to-GDP ratio constant would require a tax increase of approximately 18.2 percent compared to the 2003 level.

The budget situation looks worse when the segments of the budget that are financed by designated revenue sources are excluded because Social Security, Medicare, and the retiree programs for government employees all have surpluses at present. These surpluses are used to purchase government bonds. The bonds held by these programs add to the gross debt of the government, although they are not part of the "publicly held debt," which is more widely reported. For most purposes, the gross debt would be the better measure of the government's long-term financial situation.

While legally, the government could default on the bonds held by government programs, without defaulting on its publicly held debt, it is unlikely that this would be a politically viable scenario. The beneficiaries of these government programs are disproportionately low and moderate income people. Voters are likely to insist that if a default ever proved necessary, a portion of the cost should be borne by holders of the public debt, who are disproportionately wealthy. Therefore it is reasonable to treat the debt to the government programs in the same way as the publicly held debt, and use gross government debt as the measure of government indebtedness. (It is worth noting that the United States has never defaulted on any of its government debt in its entire history as a nation).

With the economy in a slump, it is actually desirable for the government to run a large deficit. If the deficit were smaller at present, the economy would be weaker and the unemployment rate would be higher. However, the current path of taxes and spending will lead to deficits that will not be sustainable over the long-run.

Introduction

Public debates over tax and spending policy have often been clouded by confusion over accounting issues. Many economists and budget analysts have argued that the unified budget – the budget that is most often cited in media accounts – does not give an accurate picture of the government's finances. For example, Federal Reserve Board Chairman Alan Greenspan recently complained that this budget does not count spending and liabilities on an accrual basis, but rather only counts current income and outflows.[2] This complication stems primarily from mixing income and spending flows from programs such as Social Security, Medicare, and the pension programs for government retirees, with the revenue and spending flows for the rest of the budget.

Republicans in Congress have alluded to a similar distinction between items in the budget when they argued that Social Security and Medicare contributions should not be viewed as taxes. In the design of the recent tax cut legislation approved by Congress, they determined that only people who paid income tax should be entitled to tax cuts, arguing that the Social Security and Medicare contributions are payments for the services provided by these programs.

There is a legitimate point to these complaints. There is a distinction between portions of the budget that are financed by the personal and corporate income tax and other components of general revenue and the portions of the budget that are financed by designated contributions such as Social Security and Medicare, or the pensions of government employees. It is a relatively simple task to reconstruct the budget in a manner consistent with the framework recommended by Mr. Greenspan and implicitly by the Republicans in Congress.

Reconstructing the Budget

Reconstructing the budget in a manner consistent with these objections essentially requires pulling out the revenue and spending flows for the areas that are treated as distinct programs with their own funding source. The key items in this list are Social Security, Medicare, the pension programs for government workers, and unemployment insurance.[3]

Table 1 shows the main spending components and revenue sources for the unified budget – the one most often cited in the media – in column A. Column B shows the main spending components and revenue sources for the budget after these four large programs have been removed.[4] The spending categories shown in column B are only those programs that are supported directly by general tax revenue. This includes defense and non-defense discretionary

[2] Testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate February 11, 2003 [http://www.federalreserve.gov/boarddocs/hh/2003/february/testimony.htm].

[3] There are other government trust funds, most importantly the highway trust fund. These have not been included in this analysis both because they are considerably smaller than these other four funds, and also because their legal status is somewhat more ambiguous. For example, Congress has been widening the uses of the highway trust fund, so that the revenue raised for it (primarily through a fuel tax) is not very different from general revenue.

[4] The core budget excludes revenue and spending associated with Social Security, Medicare Part A, government retirement programs and unemployment compensation. Medicare Part B, which is financed primarily from general revenue, is treated separately from the rest of the Medicare program. It has been left in the budget shown in column B.

spending, means-tested entitlement programs, such as TANF and Medicaid, and non-means tested programs such as the supplemental portion of the Medicare program. The interest component of this budget would include all interest paid by the government, including interest paid to programs such as Social Security, Medicare, or the retirement program for government workers.

Alternative Views of the Fiscal 2003 Budget

Unified Budget	A	Core Budget	B
(billions)			
Outlays		**Outlays**	
Discretionary		Discretionary	
Defense[5]	433	Defense	433
non-defense	393	non-defense	393
Total Discretionary	826	Total Discretionary	826
Mandatory		Mandatory	
means-tested	319	means-tested	319
non-means-tested	969	non-means-tested	73
off-setting receipts	-100	Retirement programs	60
Total mandatory	1188	Total mandatory	452
Net Interest	157	Gross Interest	322
Total Outlays	2171	Total Outlays	1660
Revenue		**Revenue**	
Income Taxes (personal and corporate)	916	Income Taxes (personal and corporate)	916
Social Insurance Contributions	710	Other	144
Other	144	Total Revenue	1060
Total Revenue	1776		
Total Outlays	**2171**	**Total Outlays**	**1660**
Total Revenue	**1770**	**Total Revenue**	**1060**
Deficit	**401**	**Deficit**	**600**
Deficit as Percent of Outlays	**18.5**	**Deficit as Percent of Outlays**	**36.1**

As can be seen, the projected 2003 deficit is considerably larger in the core budget, with a deficit of $600 billion compared to a deficit of $401 billion in the conventional budget. The main reason for this difference is that the core budget excludes the $180 billion Social Security surplus projected for fiscal 2003. However, there are interest payments and employer contributions to

[5] Spending on homeland security is counted as defense spending in these calculations.

other trust funds and government retirement funds that are also excluded from the core budget, but are included in the conventional budget. These payments are excluded from the core budget because they will eventually have to repaid from general tax revenue. For example, the payment from the government to the federal government retirement fund in 2003 will ultimately have to be repaid from general tax revenue at some future point, when current government employees begin collecting their pensions. The current year's payment to the retirement fund is an asset for the government retirement account, but not to the general budget.

It is important to note that the switch of focus to the core budget not only increases the size of the deficit, it also reduces the size of the overall budget. If Social Security, Medicare, the federal employees' retirement system and unemployment insurance are viewed as separate programs, then total outlays are considerably smaller than they appear in the conventional budget. In this case, the reduction in outlays that results from changing the accounting methods is more than $500 billion.

The increase in the deficit combined with the reduction in the size of the budget has the effect of substantially increasing the ratio of the deficit to current outlays. While the deficit is equal to 18.5 percent of current outlays in the conventional budget, it is equal to 36.1 percent of outlays in the core budget. This means, in effect, that it would be necessary to cut all outlays by 36.1 percent from their 2003 levels in order to bring the budget into balance. However, it is not possible to cut interest payments unless the government takes the drastic step of defaulting on the national debt. Assuming that interest payments cannot be changed, it would be necessary to cut spending in the core budget by 44.8 percent to balance the core budget. Also, there are many people who would refuse to cut defense spending in the current circumstances. This analysis shows that it would be necessary to reduce non-defense spending by 66.3 percent in order to bring the core budget into balance.

Alternatively, it is possible to balance the budget through tax increases. To close the deficit indicated in the table it would be necessary to increase tax collections 56.6 percent above their current level. (This includes fees such as the premium for Medicare Part B.) Table 2 shows the range of tax increases or spending cuts that would be needed to bring the 2003 budget into balance.

Table 2

Unified Budget	**A**	**Core Budget**	**B**
Total Outlays	**$2171b**	**Total Outlays**	**$1660b**
Total Revenue	**1770**	**Total Revenue**	**1060**
Deficit	**401**	**Deficit**	**600**
Deficit as Percent of Outlays	**18.5%**	**Deficit as Percent of Outlays**	**36.1%**
Deficit as Percent of Non-interest outlays	**19.9%**	**Deficit as Percent of Non-interest outlays**	**44.8%**
Deficit as Percent of Non-Interest Non-Defense outlays	**25.4%**	**Deficit as Percent of Non-interest Non-Defense Outlays**	**66.3%**
Deficit as Percent of Revenue	**22.7%**	**Deficit as Percent of Revenue**	**56.6%**

Towards a Sustainable Budget

Table 2 shows a somewhat more dire picture than the actual situation implies. It is not necessary to actually balance the budget, only to keep the debt from expanding as a share of GDP. Also, the 2003 budget deficit is bloated due to fact that the unemployment rate is considerably higher than necessary. In order to determine the spending cuts and/or tax increases that would be necessary to produce a sustainable budget, the numbers in table 2 should be adjusted to allow the debt-to-GDP ratio to remain constant and also to take into account the fact that the unemployment rate in 2003 was substantially higher than the unemployment rate the economy is capable of maintaining.

Table 3A

	2003 actual A '03	2003 with 5.2 percent unemployment B
Total Outlays	**$1660b**	**$1660b**
Total Revenue	**$1060**	**$1100**
Deficit	**$600**	**$560**
Deficit as Percent of Outlays	**36.1%**	**33.7%**
Deficit as Percent of Non-interest outlays	**44.8%**	**41.8%**
Deficit as Percent of Non-Interest Non-Defense outlays	**66.3%**	**61.9%**
Deficit as Percent of Revenue	**56.6%**	**50.9%**

Tables 3a and 3b show budgets that are adjusted for these considerations. Column A in table 3a simply takes the figures from column B of table 2. Column B adjusts the figures under the assumption that the unemployment rate is 5.2 percent, the long-run rate projected by the Congressional Budget Office's most recent budget projections, instead of the 5.9 percent average assumed in the most recent set of projections.[6] The decline of 0.7 percentage points in the unemployment rate would be associated with an increase in government revenue of

[6] Congressional Budget Office, 2003, *Budget and Economic Outlook: Fiscal Years 2004-2013*, table 2-1. It is reasonable to believe that the economy can sustain an unemployment rate substantially lower than the 5.2 percent rate assumed by CBO. The unemployment rate was under 5.0 percent for more than four years from July of 1997 to September of 2001and there was no perceptible uptick in the core inflation rate. The unemployment rate averaged 4.0 percent for 2000. The budget situation, as well the general well-being of the work force, would be vastly improved if this target could be achieved again

approximately $40 billion.[7] As can be seen, lower unemployment leads to some improvement in the deficit picture, but closing the gap would still require a cut in spending of 33.7 percent or an increase in taxes of 50.9 percent.

Table 3B

	2003 actual	2003 with 5.2 percent unemployment
	A	**B**
	'03	
1) Total Outlays	**$1660**	**$1660**
2) Total Revenue	**$1060**	**$1100**
3) Deficit	**$600**	**$560**
4) Deficit consistent with constant debt/GDP ratio		**$360**
5) Deficit reduction needed to maintain constant debt/GDP ratio (row 3 minus row 2)		**$200**
6) Deficit reduction (row 5) as Percent of Outlays	**36.1%**	**12.0%**
7) Deficit reduction (row 5) as Percent of Non-Interest outlays	**44.8%**	**14.9%**
8) Deficit reduction (row 5) Percent of Non-Interest Non-Defense outlays	**66.3%**	**22.1%**
8) Deficit reduction (row 5) as Percent of Revenue	**56.6%**	**18.2%**

Column B in table 3b shows the extent to which the 2003 deficit exceeds the deficit that would be consistent with a stable debt-to-GDP ratio, assuming that the unemployment rate were at the 5.2 percent long-term level projected by the Congressional Budget Office. The current gross government debt is approximately $6.7 trillion. If the economy grows at a nominal rate of 5.4 percent, as projected by CBO, then the debt can grow by $360 billion annually without the ratio of debt to GDP increasing. As can be seen, even by this relaxed standard the government is still running a substantial deficit in 2003. To reduce the deficit to the point where the debt-to-

[7] The estimate of the revenue increase is taken from the *Economic and Budget Outlook, Fiscal Years 2004-2013* (Congressional Budget Office, 2003), table 5.2. This table shows estimates that a 1.7 decline in the growth rate would be associated with a $55 (0.505 percent of GDP) billion reduction in tax revenue. This reduction in the growth rate is approximately equal to the amount that would be associated with a 1.0 percentage point increase in the unemployment rate. (The table shows roughly symmetrical projections for an increase in the growth rate.) Based on this estimate, Table 3B assumes that a 0.7 percentage point decline in the unemployment rate would increase tax revenue by an amount equal to 0.35 percent of GDP.

GDP ratio is stable would require a cut in total spending of $200 billion or 12.0 percent of total spending. Assuming that interest payments are not cut and that military spending is not reduced, then the rest of the budget would have to be cut by 22.1 percent to keep the debt-to-GDP ratio from rising, or alternatively taxes could be increased by 18.2 percent, measured against their current levels.

The Off-Budget Items and the Budget

While a consistent budget would pull programs financed by separate revenue flows, such as Social Security, Medicare, and government retiree programs off budget, there is still a possibility that the nation's current budgetary difficulties could be solved at the expense of these programs. All three programs have accumulated substantial amounts of government debt as a result of the fact that they have taken in far more revenue than has been needed to finance their current expenditures. The explicit intention has been to use the government bonds that are currently being accumulated by these programs to help pay for their expenses in future years.

However, it is possible that the government will default on some or all of this debt. This is precisely the path that was suggested by the late Senator Daniel Patrick Moynihan and Richard Parsons, when they became co-chairs of President Bush's Social Security Commission, or more recently *Washington Post* columnist Allan Sloan.[8] Obviously the government's fiscal situation will be improved insofar as it is allowed to default on a portion of its debt. Such a default would amount to a massive transfer from lower and middle income workers who receive the bulk of the benefits from these programs to the higher income families who pay the bulk of the personal and corporate income tax. (see Baker 2001 [http://www.cepr.net/Social_Security/defaulting_ss.htm]).

While it would be legally possible for the government to default on its debt to Social Security and other government programs, at the same time that it continued to make payments on its other debt, it is not clear that this would be a politically viable course. The U.S. government has never defaulted on any of its debt in more than two hundred years of existence as a nation. It is not clear that it could justify defaulting on debt to its working population at the same time that it was paying in full the government bonds that are held disproportionately by the nation's wealthiest families. If the government did succeed in defaulting on the bonds held by Social Security or other government programs – without defaulting on its publicly held debt, this would be the most massive upward redistribution of wealth in the nation's history.

Conclusion

The recent round of tax cuts passed by Congress has left the government budget seriously out of balance. The true extent of the deficit is somewhat concealed by the fact that the media usually reports on the unified budget, which includes programs such as Social Security and

[8] Moynihan and Parsons suggested defaulting on the bonds held by Social Security trust fund in a *Wall Street Journal* column (6-15-01). Allan Sloan made a similar suggestion in his business section column of the *Washington Post* (3-25-03; E3).

Medicare that are financed by distinct revenue streams. Pulling these components out of the budget, as recommended by many budget analysts, shows the 2003 deficit to be $600 billion. It would take spending cuts of 36.1 percent of the core budget or tax increases of 56.6 percent to bring this budget in the balance.

The large budget deficit of 2003 is in part driven by high unemployment. It is also not necessary to balance the budget. But even if the unemployment rate fell to the long-term average assumed by CBO and the budget target was simply to keep the debt-to-GDP ratio from rising, substantial spending cuts and/or tax increases would still be necessary.

It is worth remembering that the large deficit in 2003 is not a problem. If the deficit were smaller in the current year, then the economy would be weaker, since the budget deficit has helped sustain demand. However, the long-term tax and spending structures imbedded in the 2003 budget are not sustainable. The extent to which taxes and spending are now out of balance can be more clearly seen by presenting the budget along the lines shown in this analysis.

Appendix

The calculations in table 1 rely primarily on the data in *The Budget and Economic Outlook: An Update: August 2003* (Congressional Budget Office, 2003). The data for dividing Medicare expenditures between Part A and Part B were taken from the 2003 Medicare Trustees report Medicare Trustees, Table I.F.1. The measure of the Social Security surplus used in this analysis, which includes the surplus in the disability program, was taken from the 2003 Social Security trustees report.