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The Budget Debate in Pictures: A Look at CBO Projections and the Role that Bush-Era Tax and Spending Policies Play in the Deficit

By
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Introduction

A picture may be worth a thousand words, but that doesn't make it any less misleading. Kathy Ruffing and James Horney of the Center on Budget and Policy Priorities (CBPP) made quite a stir with their May 10 report titled "Economic Downturn and Bush Policies Continue to Drive Large Projected Deficits,"[1] which features a graph of the projected deficit out to 2021 with the Bush-era tax cuts taking up the largest share, followed by the economic downturn. The report states that "the economic downturn, President Bush's tax cuts and the wars in Afghanistan and Iraq explain virtually the entire deficit over the next ten years." The graph purports to illustrate this claim. One of many enthusiastic commentators, James Fallows of the *Atlantic* called it "the chart that should accompany every discussion of deficits"[2] and Uwe Reinhardt in a *New York Times* piece called it "fascinating."[3]

While we applaud the CBPP's obvious success at bringing attention to the budget, it paints an incomplete picture to place only certain budget items in a graph of the deficit, as if that demonstrates causality. Why not throw entitlement spending in the deficit category, or defense spending, or certain initiatives from the Clinton years? Better yet, why not simply show the entire budget, and in a larger historical context? Indeed, the CBO report[4] on which the CBPP analysis is based does just that. A closer look at the CBO report will help illustrate the relative importance of tax cuts and spending (including spending through the tax code) in creating the projected deficits.

Historical Budget Data and CBO Baseline Projections

Reproduced below is the CBO's graph (also referenced by Reinhardt) of actual revenues and outlays from 1971 to 2010 and projections out to 2021. This is under CBO's baseline scenario, which primarily assumes that the Bush tax cuts will expire as planned in 2012.

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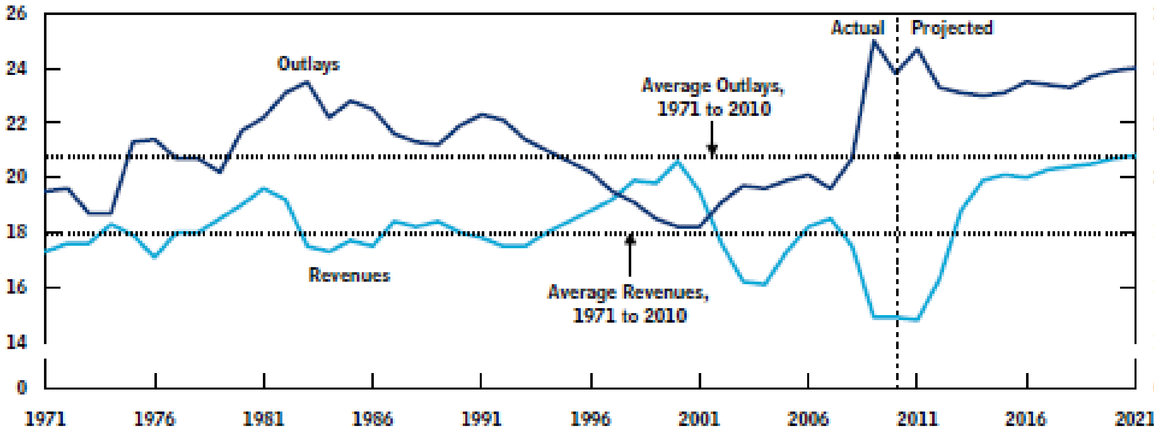
[1] Kathy Ruffing and James R. Horney, "Economic Downturn and Bush Policies Continue to Drive Large Projected Deficits," Center on Budget and Policy Priorities, May 10, 2011, http://www.cbpp.org/cms/index.cfm?fa=view&id=3490.
[2] James Fallows, "The Chart That Should Accompany Every Discussion of Deficits," The Atlantic, May 11, 2011, http://www.theatlantic.com/politics/archive/2011/05/the-chart-that-should-accompany-every-discussion-of-deficits/238786/.
[3] Uwe Reinhardt, "The Case for Higher Taxes." May 27, 2011, *New York Times,* http://economix.blogs.nytimes.com/2011/05/27/the-case-for-higher-taxes/.
[4] "The Budget and Fiscal Outlook: 2011 to 2021," January 2011, http://www.cbo.gov/doc.cfm?index=12039.

Figure 1

Total Revenues and Outlays

(Percentage of gross domestic product)



Source: Congressional Budget Office. (Figure corrected on February 15, 2011.)

As the graph shows, revenues have largely tracked the economy and did not significantly drop below the historical average until the 2008 financial crisis, i.e. seven years after the first Bush tax cut and five years after the second Bush tax cut. Further, in the immediate response to the financial crisis, it is outlays, more than revenues, which have changed dramatically and diverged from the historical averages. Between 2008 and 2009, revenues dropped 2.6 percentage points, from 17.5 percent of GDP to 14.9 percent--3.1 percentage points below the historical average of 18 percent. Meanwhile, outlays grew 4.3 percentage points, from 20.7 percent of GDP to 25.0 percent--4.2 percentage points above the historical average of 20.8 percent.

Additionally, in 2000, before the Bush tax cuts, the CBO predicted 2010 outlays to be $2.457 trillion,[5] whereas actual outlays were $3.456 trillion – a $1 trillion under-prediction of spending. CBO predicted 2010 revenues to be $2.946 trillion, whereas actual revenues were $2.162 trillion – a $0.784 trillion over-prediction of revenues. Based on this, it seems logical to conclude that "Bush spending" more than "Bush tax cuts" are to blame for the deficit. Doing a similar analysis, Glenn Kessler at the *Washington Post* concludes the same.[6] This is also supported by another report recently issued by the CBO[7], in which they compare their projections from 10 years ago to the current reality and score the budgetary effects of various legislative items. In 2009, for instance, discretionary spending exceeded projections by $417 billion, and mandatory spending exceeded projections by $409 billion. This is far greater than the effect of the Bush tax cuts, which reduced revenues in 2009 by $181 billion.

Furthermore, a growing share of spending actually occurs within the tax code, via so called tax expenditures. For instance, the earned income tax credit and the child credit refunds to those who pay no income tax nearly doubled between 2000 and 2008, from $40 billion to $72.5 billion.[8] So, again, it would be closer to the truth to say that Bush-era spending rather than Bush-era tax cuts caused the deficit.

Going forward, there are a few points to keep in mind about the sustainability of projected spending and taxation:

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[5] http://www.cbo.gov/doc.cfm?index=1820&type=0&sequence=2

[6] Glenn Kessler, "Revisiting the Cost of the Bush Tax Cuts," Washington Post, May 10, 2011. http://www.washingtonpost.com/blogs/fact-checker/post/revisiting-the-cost-of-the-bush-tax-cuts/2011/05/09/AFxTFtbG_blog.html.

[7] "Changes in CBO's Baseline Projections Since January 2001," May 12, 2011. http://www.cbo.gov/ftpdocs/121xx/doc12187/ChangesBaselineProjections.pdf

[8] See the testimony of Tax Foundation President Scott A. Hodge before the Senate Budget Committee, March 9, 2011, http://taxfoundation.org/research/show/27099.html.

1) Between now and 2021, outlays as a percentage of GDP are projected to hover between 23 percent and 25 percent, well above the historical average of 20.8%, and higher than in any year prior to the 2008 financial crisis.
2) Likewise, average revenues between now and 2021 are projected to be 19.9 percent, significantly higher than the historical average of 18 percent.
3) There is no convergence between the revenue and outlay projections, i.e. deficits as far as the eye can see.
4) Additionally, it is quite likely that this baseline scenario significantly underestimates the growth in Medicare spending, since one of the assumptions is that "sharp reductions in Medicare's payment rates for physicians' services take effect as scheduled at the end of 2011." It is more likely the health care industry will successfully lobby to prevent any reduction in payments, as it has done every year since 2003. The CBO estimates that if payment rates remained at 2011 levels, this would add about 3 percent to Medicare outlays over the next 10 years.

While Ruffing and Horney argue this is sustainable, it seems doubtful that voters will accept this scenario of permanent deficits along with permanently higher levels of government spending and taxation.

Alternative Policy Assumptions

The CBO then considers a number of policy alternatives, including a) an extension of certain income, gift, and estate tax cuts set to expire in 2012, i.e. the "Bush tax cuts," and b) indexing the AMT to inflation. The combination of these alternative policies has the effect of reducing average revenues over the 2012-2021 period to 18 percent, which matches the 40-year historical average. In other words, this would not be a radical departure from history. On the other hand, projected spending, if left unreformed, would be. According to the CBO:

> Throughout the coming decade, spending on the government's health care and retirement programs will increasingly strain the federal budget. In CBO's baseline, total outlays for Medicare, Medicaid, the Children's Health Insurance Program (CHIP), and subsidies offered through new health insurance exchanges, are projected to increase at an average rate of about 7 percent a year between 2012 and 2021—much more rapidly than nominal GDP. Moreover, as more baby boomers become eligible for Social Security retirement benefits, costs for that program also will grow faster than the economy for most of the coming decade.[9]

And the longer term looks even worse if we do nothing about entitlement spending:

> Beyond the 10-year projection period, further increases in federal debt relative to the nation's output almost certainly lie ahead if current policies remain in place. The aging of the population and rising costs for health care will push federal spending as a percentage of GDP well above that in recent decades. Specifically, spending on the government's major mandatory health care programs—Medicare, Medicaid, the Children's Health Insurance Program, and health insurance subsidies to be provided through insurance exchanges—along with Social Security will increase from roughly 10 percent of GDP in 2011 to about 16 percent over the next 25 years. If revenues stay close to their average share of GDP for the past 40 years, that rise in spending will lead to rapidly growing budget deficits and surging federal debt. To prevent debt from becoming unsupportable, policymakers will have to substantially restrain the growth of spending, raise revenues significantly above their historical share of GDP, or pursue some combination of those two approaches.[10]

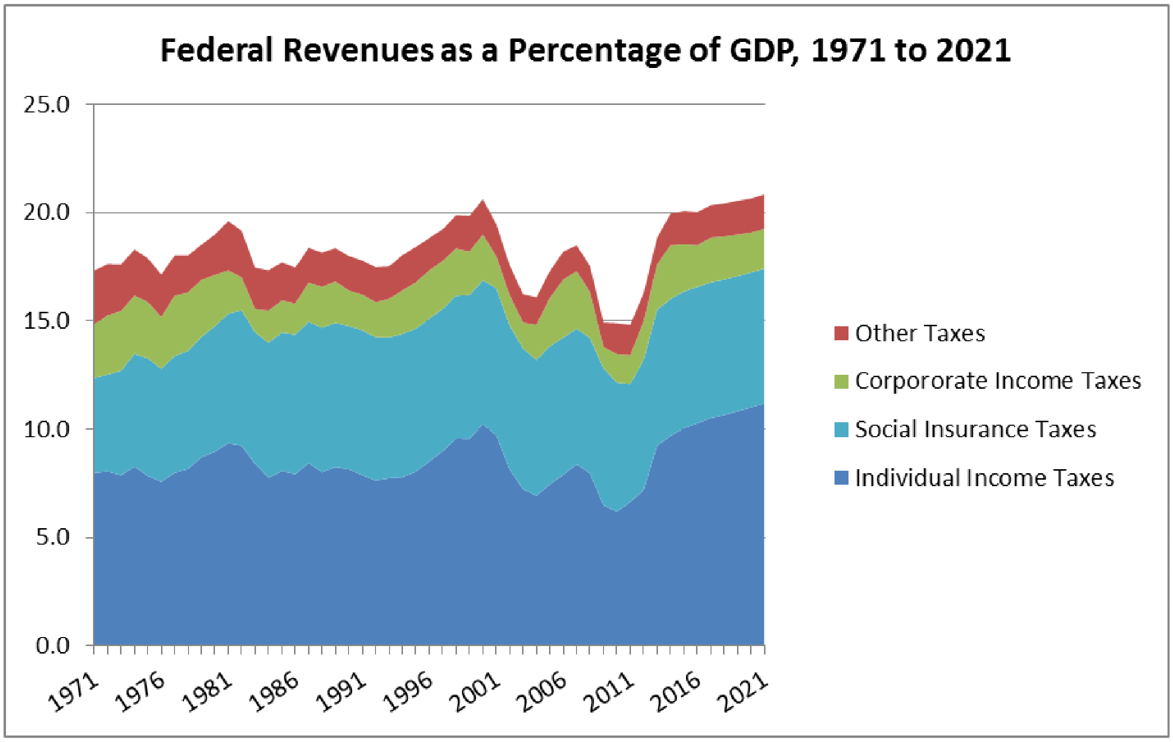
A closer look at CBO's data reinforces this conclusion.

[9] "The Budget and Fiscal Outlook: 2011 to 2021", January 2011, page 3, http://www.cbo.gov/doc.cfm?index=12039
[10] "The Budget and Fiscal Outlook: 2011 to 2021," Congressional Budget Office, January 2011, page XV, http://www.cbo.gov/doc.cfm?index=12039

A More in-Depth Analysis of Revenues and Outlays

Shown below are actual outlays and revenues from 1971 to 2010 with projections out to 2021, broken down by major component.

Figure 2



Source: Congressional Budget Office

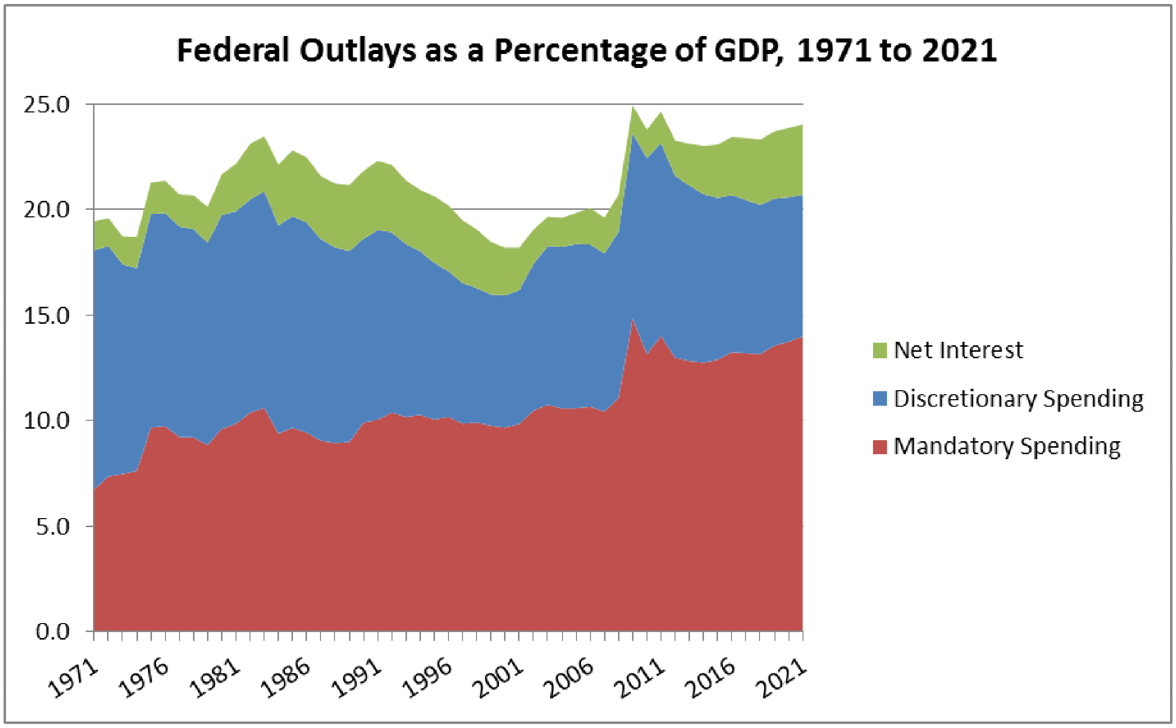
First, let's look at revenues. Although there is a conspicuous "W" pattern in the Bush years, this is more a reflection of the 2001 and 2008 recessions than the Bush tax cuts. Note that the Bush tax cuts altered only the individual income tax code. However, in 2003-2004 revenues dropped most dramatically in the category of corporate taxes, which peaked in 1998 at 2.2 percent of GDP and dropped to 1.2 percent in 2003--a 41 percent decline. Compare this to individual income tax revenues, which peaked in 2000 at 10.2 percent of GDP and dropped to 6.9 percent in 2004--a 32 percent decline. Payroll and other taxes remained relatively stable, such that total revenues declined by 22 percent over this period.

It is much the same story in the aftermath of the 2008 recession, except the numbers are larger and more discouraging. Corporate tax revenues peaked in 2007 at 2.7 percent of GDP and bottomed out at 1 percent in 2009 -- a staggering 63 percent drop. Compare this to individual income tax revenues, which peaked in 2007 at 8.4 percent of GDP and dropped to 6.2 percent in 2010--a 26 percent decline. Again, payroll and other taxes remained relatively stable, such that total revenues declined by 19 percent over this period.

In fairness, it is not quite this simple, since a large share of businesses file under the individual income tax code and would have had a greater incentive to do so following the Bush tax cuts. Nevertheless, it remains true that the recent collapse in revenues is largely due to the economy. For instance, at the 2007 peak, individual and corporate tax revenues combined were 11 percent of GDP, which is above the 40-year historical average of 10.2 percent.

Going forward, if the Bush tax cuts expire as planned in 2012, the CBO projects individual income tax revenues will hit 9.2 percent of GDP in 2013 and reach 11.2 percent of GDP in 2021, well in excess of the 40-year historical average of 8.2 percent. Even if the Bush tax cuts continue and we assign all of the CBO projected revenue losses to individual income taxes, individual income tax revenues will exceed the historical average, reaching 8.5 percent of GDP in 2013 and 9.2 percent in 2021.[11]

Figure 3



Source: Congressional Budget Office

Now let's turn to spending. It should be apparent from the graph of outlays above that we are currently in record territory in terms of spending as a percentage of GDP, and the CBO projects no return to normalcy. Mandatory spending, i.e. entitlement spending, has roughly doubled as a share of GDP, from 6.7 percent in 1971 to 13.2 percent in 2010. The CBO projects it to hit 14 percent next year and remain close to that level through 2021. Again, however, the CBO assumes a sharp reduction in Medicare payment rates at the end of this year, which has been pushed off repeatedly since 2003. They estimate that if payment rates remained at 2011 levels this would add about 3 percent to Medicare outlays over the next 10 years. Discretionary spending has actually declined as a share of GDP, from 11.3 percent in 1971 to 9.3 percent in 2010. It is projected to decline further to 6.7 percent in 2021. However, net interest payments are projected to increase, such that total outlays will remain well above the historical average of 20.8 percent of GDP. Based on CBO projections out to 2021, as well as their longer term projections out to 2035[12], in every year spending as a share of GDP is expected to exceed any year prior to the financial crisis.

Conclusion

The CBPP has chosen a provocative set of budgetary items and policy alternatives which imply that projected deficits through 2021 are largely the result of the Bush-era tax cuts and the economic downturn. It is more instructive, however, to look at the bigger picture by reading the underlying CBO report,[13] or perhaps trying a handy tool[14] from the *New York Times*, based in part on CBO data, which allow users to switch in and out various budgetary items to fill the deficit.

[11] If instead, we look at total revenues with the continuation of the Bush tax cuts, they climb to 18.02 percent of GDP in 2013 and 18.92 percent in 2021, also exceeding the historical average of 17.98 percent.
[12] http://www.cbo.gov/doc.cfm?index=11579
[13] http://www.cbo.gov/doc.cfm?index=12039
[14] "Budget Puzzle: You Fix the Budget," New York Times, Nov. 13, 2010, http://www.nytimes.com/interactive/2010/11/13/weekinreview/deficits-graphic.html

The CBO report gives us two critical facts which should form the basis of any future budget debate:

1) Tax revenues have fluctuated largely with the economy, dropping precipitously in the aftermath of the 2008 recession, but are projected to remain close to historical norms with or without expiration of the Bush tax cuts in 2012.

2) Entitlement spending has roughly doubled in the last 40 years as a percentage of GDP and is projected to remain there through 2021, pushing total spending well above any historical precedent. Thus, the CBO projects deficits as far as the eye can see.

Should we blame Bush (or rather, all that happened during his presidency) for this? In a sense, yes, but not for the reason the CBPP would have us believe; the role of Bush-era policies in the projected deficits is mainly on the spending side of the equation, not the tax side. However, only the future can be changed, and to paraphrase the CBO, if we are to reduce the deficit we must either accept an unprecedented level of taxation or significantly reduce projected growth in spending.

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