COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET

TO: Board and Members
FROM: Carol Cox Wait
DATE: November 20, 2001

SUBJECT: BUDGET ISSUE UPDATE—THANKSGIVING RECESS

Even in the aftermath of September 11, we have much for which to be thankful—

- By all accounts the war against terrorism is going well;
- Despite the war and a serious economic slump, the budget remains in remarkably good shape; and
- So far, Congress has failed to pass a stimulus package. Indeed, should Congress reach an impasse on the stimulus package we actually *could* run a surplus this year.

But there is plenty of bad news. Many in Washington are acting as if this is the last chance to cut taxes and spend money without regard to the impact on Social Security, Medicare, the budget surplus, or anything else—and they may be right!

A bad stimulus bill is worse than no stimulus bill at all. All the stimulus bills before Congress have two things in common: they cost a lot and they won't stimulate the economy. To make matters worse, many in Congress seem determined to bust right through the Appropriations ceiling that their leaders and the White House set just two months ago. We are on the way back to deficit spending and nobody knows how long that will last.

War Against Terrorism

Many in Congress want to appropriate more money for "emergency" needs associated with the war. The Administration says they don't need more money now. Surely, the President will ask for as much as he needs when he needs it; and surely Congress will make such resources available in a timely manner even if they have to return to Washington earlier than expected to do so. Additional appropriations above the $686 billion that Congress and the Administration agreed after 9-11 almost certainly would become a Christmas tree decked out with Members' favorite projects and that could continue to cost dearly long after this holiday season is over.

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The Budget

If Congress adjourns without passing a stimulus bill, we could still run a modest surplus this year—despite the war and economic downturn. The stimulus bills Congress is considering, however, likely would throw us back into deficit for some time. The chart and the table At Attachment 1 assume six quarters of zero growth, beginning in Q3 (calendar) 2001 and continuing through the end of calendar 2002. That is not a forecast. It is an assumption that produces outcomes consistent with a number of plausible scenarios.

Attachment 2 is a table that includes several private forecasts post 9-11. The CBO January forecast almost certainly will be somewhere near the mid-point of those published by leading private sector experts. OMB probably will be somewhat more optimistic than CBO. That has been the historical pattern. As you can see, all leading forecasters predict a return to growth next year.

I have not morphed into Pollyanna. The New Hard Choices Pie Charts at Attachment 3 illustrate the dilemma Congress and the President face. Five big pieces represent 100% of current budgetary resources. (We have allocated interest costs proportionately to each of the program categories.) But there are three categories of spending that we predict will compete for resources for some time to come. They are Homeland Defense, The War against Terrorism, and transition costs endemic to any serious attempt to address long-term shortfalls in Social Security and/or Medicare, not to mention tax reform. Of course, there will continue to be fires, floods, hurricanes, etc., i.e., demands on the public purse that nobody can anticipate today.

We do not know the dimensions of these new demands. Should they total half—or even one-quarter the cost of any of the pieces in the pie chart at the top of the page, they will require Congress and the Administration once again to make some very hard choices. The country should be able to cope with emergencies that add up to about 1 percent of GDP without great angst and anguish. But to do so, our political leaders must either re-order priorities and restrain spending for existing programs or raise revenues, else we will return to deficit spending as far as the eye can see.

There are very real reasons to run some deficits some times. The combination of recession and war may provide such justification. As the economy grows, we should expect the budget to return to surplus—even as we continue to fight the war. Prudent policy suggests we husband some resources now to help meet demands we know that the country will face as the baby boom generation retires. The current emergency almost certainly will put off the day when we focus on those demands. Thus our leaders should resist pressures to allocate all available resources to meet today's needs.

Economic Stimulus

It is worth repeating: a bad stimulus bill is worse than no stimulus bill at all. And history is replete with examples of bad stimulus bills. Almost always, almost all the money hits the economy at the wrong time. Such spending and tax cuts can contribute to inflationary pressures early in a recovery. Inflationary pressures can force the Federal Reserve to raise interest rates. Higher rates can threaten the very growth stimulus is supposed to produce. So we will not mourn if Congress and the President fail to agree on a stimulus bill. One can argue that the tax cut enacted earlier this year, new spending and tax policies enacted since 9-11, interest cuts effected by the Federal Reserve over the last year, and the revenue reductions/spending increases produced by automatic stabilizers in the budget would swamp any stimulus bill that might pass this Congress.

Having said that, we recognize the political pressure for leaders to do something for constituents when things look bad. What could they do with minimal risk? That is the question.

Programs such as extended unemployment compensation should be limited to areas of high unemployment. Some parts of the country still enjoy unemployment rates as low as 3 percent. It does not make sense to extend unemployment compensation payments to people in those areas.

Some unemployed people have working spouses and health insurance coverage. Some have access to coverage and can afford it. Some are pretty well off. Millions of folks who work do not have health insurance and cannot afford to purchase it. The stimulus bill should not treat unemployed workers better than those who have jobs but are otherwise in similar financial circumstances.

Good long-term tax policy and effective stimulus often are mutually exclusive. To have the desired effect, policies enacted to stimulate the economy must—

- Start soon
- End quickly; and
- Not create an expectation or demand for more of the same.

If mainstream economists are right, and the economy is likely to recover next year, the goal of stimulus should be to put money into the economy right now. There is only one approach that we can think of to do that: declare a Social Security tax holiday. Simply stop collecting Social Security taxes for some period between now and Christmas. That would benefit both employers and employees. It would benefit mainly low- to middle-income workers. (High-income workers don't pay Social Security taxes this late in the year.)

If the stimulus works—if the economy begins to grow even a little earlier and/or grows a little faster than it otherwise would do—there would be little or nor impact on Trust Fund balances. In any event, there would be no affect at all on benefits. Benefits tie to work in covered employment—not to taxes paid. If it is politically necessary to transfer general funds to the trust fund to make up foregone revenue so be it. That would simply continue current confusion about the Trust Fund. But the confusion already exists and it cannot get much worse than it is. This approach is better than writing checks, simply because writing checks takes time.

Extended unemployment compensation limited to areas of high unemployment, plus a Social Security tax holiday, would cost far less than any of the proposals currently circulating on Capitol Hill. We think that would be a good thing. Also, it would speak to the most pressing targets of any economic stimulus: immediate purchasing power and income replacement for the unemployed. The problem is that such a bill likely would get larded down with a lot of other pet projects. So we circle back to where we began; the best possible outcome may be no stimulus bill at all.

With all respect to all of our good friends on both sides of the aisle and on both sides of the Hill, it should be obvious that the House-passed bill bears little resemblance to the policies described above. Nor does the Senate-Democratic entry, nor what we have seen so far of the proposed compromise to be offered by Moderates in the Senate.

Budget Process

The Committee has spent years working on fundamental budget process reform. Before September 11, we thought that, with the BBA enforcement provisions due to expire in this budget year, there would be an opportunity to make major improvements in the near-term. The current budgetary environment is not conducive to a sensible discussion about budget process. But one process issue has become a major priority for the Committee since 9/11. We are encouraging Congress and the Administration to do everything possible to segregate war-related and other emergency spending (and revenue changes) from the base.

The budget baseline should reflect as nearly as possible ongoing activities of government and their cost. It will be easy to migrate specific items into the base, if and when both Houses of Congress and the Administration agree they represent permanent commitments. But once an item is in the base, it is a permanent part of our budget debates. We do not want to replicate the experience of the late 1970's and early 1980's, when the scheduled phase-out of CETA countercyclical public service jobs was described as a "cut".

We need to distinguish between a permanent and ongoing commitment to increased defense spending and war-related outlays. We need to distinguish between emergency expenditures for Homeland Defense and ongoing commitments. We need to determine whether and to what extent commitments to Homeland defense needs replicate existing activities and functions and what is both new and permanent. The same holds true, if Congress and the President agree on emergency tax measures.

In short, we need to meet emergencies quickly and that may mean short-circuiting normal budgetary scrutiny. But over the longer-term, there should be a return to the kind of priority setting, trade-offs and hard choices that are the hallmarks of sound budget process.