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BUDGET POLICY AND FISCAL RISK:
IMPLICATIONS FOR DEFENSE

Dennis S. Ippolito

September 2001

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FOREWORD

Critics often charge that the major revision of U.S. military strategy which took place after the collapse of the Soviet Union was budget-driven rather than strategy-driven. Partially in response to this, the current strategic review, led by Secretary of Defense Rumsfeld, is intended to be "strategy-driven." Even so, the defense budget remains one of the central shaping features of U.S. national security and national military strategy. To understand what is possible in terms of defense transformation, one must first have a firm grasp of the budgetary context of strategic decisions.

In the monograph that follows, Dr. Dennis Ippolito, one of the leading experts on the American defense budget, assesses this context. He shows that defense will continue to compete with domestic programs for that portion of the budget allocated to discretionary spending, and argues that this is a competition in which defense needs have not fared especially well in the past and may not in the future. If accurate, this assessment will have tremendous implications for defense transformation. The leaders of the Army and the Department of Defense must therefore frame their transformation strategies within fiscal realities.

The Strategic Studies Institute is pleased to offer this study to enhance understanding of the defense planning and budgeting process and problems.

DOUGLAS C. LOVELACE, JR.
Director
Strategic Studies Institute

BIOGRAPHICAL SKETCH OF THE AUTHOR

DENNIS S. IPPOLITO is the Eugene McElvaney Professor of Political Science and Chairman of the Department of Political Science at Southern Methodist University (SMU). Prior to joining the faculty at SMU in 1982, he taught at the University of Virginia and at Emory University. Professor Ippolito's recent books on the federal budget include *Budget Policy and the Future of Defense* and *Uncertain Legacies: Federal Budget Policy from Roosevelt through Reagan*. He has presented annual lectures at the U.S. Army War College since 1990.

SUMMARY

The fate of defense budgets is closely tied to the size, composition, and balance of the federal budget. Over the past decade, efforts to reduce the relative level of federal spending and to eliminate deficits yielded disproportionate cuts in defense. Now that the federal budget is in surplus, and expected to remain so for the next decade, the prospects for more adequate defense funding appear more positive.

The reality, however, is that fiscal constraints have not disappeared. For the immediate future, defense will be competing with domestic programs for the approximately one-third of the budget allocated to discretionary spending. This is a competition in which defense needs have not fared especially well in the past and where future outcomes are problematical at best.

More important in terms of defense planning, however, is the long-term budget outlook. Unless current federal retirement and healthcare entitlements are scaled back substantially, the margin to support discretionary spending will begin to shrink dramatically after 2010. The United States, like other advanced democracies, is facing demographic changes that could generate enormous spending pressures in 10-20 years. The challenge, here and elsewhere, is to minimize fiscal risk by ensuring that policy decisions made today produce budgets that are flexible and sustainable over time.

The purpose of this monograph is to provide a fiscal perspective for short-term and long-term defense budgeting. The budget outlook for the federal government is more complex than current surplus projections might suggest. That complexity needs to be appreciated by defense leaders and planners.

BUDGET POLICY AND FISCAL RISK: IMPLICATIONS FOR DEFENSE

INTRODUCTION

Over the past decade, the federal government's fiscal outlook has been transformed. During the early 1990s, budget deficits were widely viewed as not just a chronic problem but a growing one.¹ From 1990 to 1994, annual deficits averaged almost \$250 billion, or nearly 4 percent of gross domestic product (GDP), but by FY 2000, the budget was in surplus by more than \$235 billion, and total surpluses of more than \$5.6 trillion for FY 2002-2011 have recently been projected.²

Many other advanced democracies have improved their fiscal balances in recent years, but the shift toward budget balance and public debt reduction has been especially pronounced in the United States.³ Multiyear deficit-reduction agreements enacted in 1990, 1993, and 1997 have reduced discretionary spending to historic lows and raised revenue levels to peacetime highs.⁴ As a result of these policy changes and unusually favorable economic conditions, the United States has ushered in a new era of surplus budgeting.

The budget policy debates of George W. Bush's administration will therefore take place in a fiscal environment very different from that of his predecessors. Rather than struggling to balance current budgets, the administration and Congress must decide how to minimize long-term fiscal risks—in effect, how to allocate surpluses among debt reduction, tax cuts, and spending increases without exacerbating the formidable entitlement financing problems that loom on the horizon.⁵ These problems represent the critical backdrop for today's budgetary deliberations.

Although budget projections for the coming decade have become much more favorable over the past few years, the

post-2010 outlook has actually worsened. The interaction between demographic trends—notably, increased longevity and population aging—and the federal retirement and healthcare commitments now in place will begin to generate extreme spending pressures in 10 to 20 years. According to the General Accounting Office’s (GAO) latest policy simulations, “demographics will overwhelm the surplus and drive us back into escalating deficits and debt,” unless these commitments are changed.⁶ Fiscal sustainability therefore depends upon entitlement reform. Reform is also necessary to preserve budgetary flexibility, by ensuring that adequate margins will be available to support defense and other essential national needs. Fiscal constraints have forced defense to absorb a disproportionate share of the deficit-reduction burden over the past decade. While these constraints have eased, they could soon reemerge and pose a serious threat to long-term defense planning.

The search for sustainable and flexible budget policy is likely to be challenging. That search should begin with a clear understanding of the recent past. Historical perspectives on how the deficit problem was created and how it has been solved are an essential component of prudent decisionmaking for the future.

THE DEFICIT-DEBT DYNAMIC

Budget deficits and federal debt are not modern inventions. The United States carried a very large debt at its constitutional inception, and, from that point until several decades ago, debt levels were closely tied to wars and recessions (see Figure 1). Wartime deficits produced high debt accumulations, which were then reduced through post-war surpluses. Economic recessions occasionally interrupted this downward trend in peacetime debt ratios, and the combined effects of the Great Depression and World War II generated debt levels that were unusually high. Protracted peacetime deficits, however, were fairly rare until the 1960s.

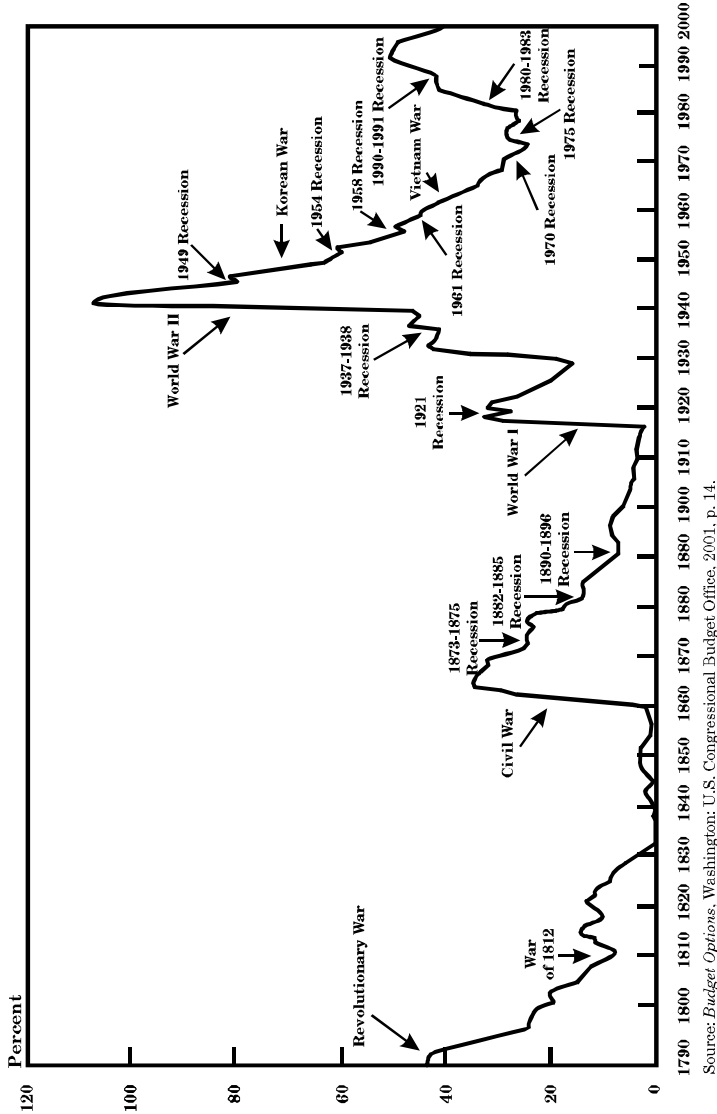


Figure 1. Publicly-Held Federal Debt as a Percentage of Gross National Product, Fiscal Years 1790-2000.

Source: *Budget Options*, Washington: U.S. Congressional Budget Office, 2001, p. 14.

The Social Welfare Shift.

During the 1960s, the size and composition of the federal budget began to change in ways that undermined fiscal control. The Johnson administration's Great Society initiatives greatly expanded federal social welfare commitments, and the budget began to shift from discretionary programs, particularly defense, to mandatory entitlements. Since spending for the latter could not be easily controlled or changed, the federal government soon faced unanticipated and atypical deficit and debt problems. The fiscal gap between spending and revenues continued to grow during peacetime and essentially regardless of economic conditions. A similar pattern had emerged in other countries, where "decisions made in the 1960s and 1970s to create and enlarge public programs" proved impossible to reverse when budgets moved into deficit.⁷ Like the United States, these countries encountered unprecedented peacetime deficits.

The fiscal contrasts between the pre- and post-social welfare shifts are sharp. During the 1950s, defense spending was well over half the budget, but deficits were quite small. Even during the Korean War, deficits were minimized by retrenchments in nondefense spending.⁸ From the 1960s through the 1980s, the defense-GDP level plummeted and revenue levels rose, but deficits and debt soared (see Table 1). During the 1980s, when mandatory spending peaked, cumulative deficits totaled \$1.6 trillion, and the public debt ratio increased by 50 percent.⁹

Structural Deficits.

The emergency and cyclical deficits the government had dealt with through much of our history were essentially self-correcting. Once wartime conditions ended or the economy recovered, budgets moved back into balance, and debt ratios fell. The deficits that appeared from the 1960s through the 1980s, however, were structural, caused by policy imbalances between spending and revenue levels.

The structural, or standardized-employment, deficit measure removes “the influence of [economic] cyclical factors from the budget.”¹⁰ The size of this deficit represents the “policy gap” between spending and revenues.

| Fiscal Years | Annual Average Percentage of GDP Spending | | Receipts | Deficits |
|--------------|---|------------|----------|----------|
| | Defense | Nondefense | | |
| 1950-59 | 10.4% | 7.2% | 17.2% | -0.4% |
| 1960-69 | 8.7 | 9.9 | 17.8 | -0.8 |
| 1970-79 | 5.8 | 14.2 | 17.9 | -2.1 |
| 1980-89 | 5.8 | 16.5 | 18.3 | -3.9 |

Source: *Historical Tables, Budget of the United States Government, Fiscal Year 2002*, Washington: U.S. Government Printing Office, 2001, pp. 23-24, 45-49.

Table 1. Federal Spending, Receipts, and Deficits as a Percentage of GDP, Fiscal Years 1950-89.

Structural deficits began to emerge during the latter 1960s, but their severity rose sharply during the Reagan era (see Table 2). Attempts to reduce these structural deficits were frustrated by continuing disagreements over spending and tax policy during the course of the Reagan presidency. President Reagan was committed to a substantial reduction in the relative level of federal spending and to a shift of budgetary resources from nondefense to defense programs. Indeed, the budget program that he proposed to Congress in 1981 resembled, in its size and composition, pre-Great Society federal budget policy.¹¹ Congress supported Reagan’s defense buildup but rejected the administration’s proposed retrenchments in entitlement programs. The inevitable result was continued high levels of federal spending.

On the revenue side, the Reagan administration sponsored the Economic Recovery Tax Act (ERTA) of 1981, one of the largest tax reductions in modern history.¹² Congressionally-initiated tax increases followed in 1982,

1983, and 1984, but aggregate revenue levels still were substantially lowered as a result of the Reagan tax program.¹³ Revenue-GDP ratios during the 1980s averaged approximately 18 percent annually. These revenue levels were slightly higher than historical revenue trends, but they were far too low to finance the competing spending priorities of the 1980s. From 1981-1989, defense outlays went up by nearly \$150 billion, while social welfare spending rose by \$180 billion. As a result, annual total outlays averaged more than 22 percent of GDP over the period, and deficit-GDP ratios were extremely high.

| Fiscal Year | In Current Dollars (Billions) | | As a Percentage of GDP | |
|-------------|-------------------------------|--------------------|------------------------|--------------------|
| | Budget Deficit | Structural Deficit | Budget Deficit | Structural Deficit |
| 1981 | \$ - 79 | \$ - 17 | -2.6% | -0.5% |
| 1982 | -128 | - 52 | -4.0 | -1.5 |
| 1983 | -208 | -120 | -6.0 | -3.3 |
| 1984 | -185 | -144 | -4.8 | -3.7 |
| 1985 | -212 | -177 | -5.1 | -4.2 |
| 1986 | -221 | -212 | -5.0 | -4.8 |
| 1987 | -150 | -155 | -3.2 | -3.3 |
| 1988 | -155 | -127 | -3.1 | -2.5 |
| 1989 | -152 | -115 | -2.8 | -2.1 |

Source: *The Budget and Economic Outlook, Fiscal Years 2002-2011*, Washington: U.S. Congressional Budget Office, 2001, p. 139.

Table 2. Budget Deficits vs. Structural Deficits, Fiscal Years 1981-89.

The GRH Experiment.

Unable to resolve this budgetary impasse by other means, the Reagan administration and Congress agreed to experiment with “automatic” deficit reduction. The Balanced Budget and Emergency Deficit Control Act of 1985, popularly known as Gramm-Rudman-Hollings (GRH) for its Senate sponsors, established deficit ceilings that required the budget to be brought into balance over a 6-year period. If the President and Congress failed to enact a

budget that complied with the ceiling for a given year, GRH mandated automatic spending cuts, or sequesters, to reduce the deficit by the required amount.¹⁴ These sequestrations, however, could only be applied to certain types of spending—essentially discretionary programs, with a formula apportioning cuts between defense and nondefense on a roughly equal basis. Large entitlements were totally (social security) or partially (medicare and medicaid) exempted. Tax policy, and revenue levels, were entirely excluded from GRH coverage.

The GRH approach was admittedly unworkable if massive deficit reduction became necessary, since neither defense nor nondefense programs could feasibly absorb the required sequesters. In fact, GRH proponents assumed that the prospect of damaging cuts in important programs would force the executive branch and Congress to negotiate more balanced and comprehensive deficit-reduction measures. These assumptions were never tested under Reagan. A successful constitutional challenge to the enforcement mechanism under GRH forced Congress to redraft the GRH legislation in 1987 and to extend the balanced-budget deadline to 1993.¹⁵ The deficit ceilings for the final years of the Reagan presidency were sufficiently high to avoid serious compliance problems. Under Reagan's successor, however, the deficit problem took a sudden and unexpected turn for the worse, forcing George H. Bush and the Democratic-controlled 101st Congress either to abandon deficit reduction or to enact politically costly adjustments in tax and spending policies.

DEFICIT REDUCTION I: GEORGE H. BUSH

President Bush assigned a very high priority to deficit reduction. On February 8, 1989, he presented his first budget program to Congress and pledged to “work with the Congress, to form a special leadership group, to negotiate in good faith, to work day and night” to cut the deficit by “40 percent . . . and meet the targets set forth in the

Gramm-Rudman-Hollings law."¹⁶ Bush reiterated his opposition to new taxes, consistent with his controversial campaign pledge, but offered the Democratic-controlled Congress two important concessions. He agreed in advance to "a one-year freeze in the military budget" and to selective increases in a number of social welfare programs.¹⁷

This more conciliatory approach did not ease the partisanship that had dominated budget policy debates under Reagan. The administration and Congress negotiated a \$28 billion deficit-reduction plan, but Congress failed to enact most of the package. Long delays on budget legislation actually led to a small GRH sequestration on October 1, 1989, at the beginning of the 1990 fiscal year. By the time that appropriations and reconciliation legislation had finally been enacted, moreover, most of the anticipated deficit reduction had disappeared. Baseline deficits for fiscal years 1991-1993 remained above \$140 billion, even though the GRH deficit targets mandated that the budget be balanced over this same period.¹⁸

The Bush administration's fiscal 1991 budget was submitted to Congress on January 29, 1990, and the Omnibus Budget Reconciliation Act (OBRA 1990)—"the centerpiece of the largest deficit-reduction package in history"—was signed into law on November 5.¹⁹ The intervening 9 months were tumultuous, as the economy deteriorated, the deficit ballooned, the Persian Gulf crisis exploded, and congressional Republicans deserted Bush on crucial budget legislation. The GRH deficit ceiling for FY 1991 was \$64 billion, and the administration's original budget promised to meet this goal—and to balance the budget by 1993—"without raising taxes."²⁰ By March 1990, however, the projected deficit had risen to \$130 billion.²¹ Over the next few months, the economic and budgetary outlook continued to worsen. Congressional Budget Office (CBO) estimates issued in June put the baseline deficit for FY 1991 at over \$230 billion, and the FY 1992 estimate was even higher.²² With deficits of such magnitude, GRH sequestration was not a realistic option. Neither defense nor

nondefense programs could absorb the huge cuts—estimated at 25-40 percent for FY 1991 alone—necessary to bring the deficit down to the GRH ceiling.²³

On May 6, 1990, President Bush acknowledged that an alternative to GRH was urgently needed and invited congressional leaders to negotiate a bipartisan deficit-reduction agreement with “no preconditions.”²⁴ Negotiations then stalled for 7 weeks, as Democrats insisted that Bush explicitly endorse a tax increase as an essential part of any plan to reduce the deficit. After Bush agreed to do so, the 1990 budget summit began in earnest. Three months later, agreement was reached on a \$500 billion, 5-year deficit-reduction plan. This plan had two major components: (1) spending reductions and tax increases to lower baseline deficits over a multiyear period; and (2) budget process controls to prevent legislative actions that would diminish these deficit savings. For fiscal years 1991-1995, statutory ceilings on budget authority and outlays were set for defense and nondefense discretionary programs. In addition, legislation increasing entitlements or reducing revenues in any fiscal year was required to be deficit-neutral.²⁵ Separate sequestration controls would be triggered if either the discretionary spending limits or the revenue-entitlement procedures were violated.

On the policy side, this initial agreement was fairly balanced in terms of administration and congressional Democratic priorities. The tax increases that the administration agreed to did not raise marginal rates on individual income, and, in order to protect discretionary domestic programs, Democratic negotiators accepted substantial entitlement cutbacks. Both sides concurred that defense would supply all of the required discretionary spending savings for at least 3 years, but additional defense transfers to domestic programs were prohibited.

These policy compromises, however, failed to satisfy conservative Republicans and liberal Democrats in the House, who teamed together to defeat the budget

agreement in its first congressional test on October 5. With this defeat, the Bush administration decided to allow the Democratic leadership to formulate a new budget package that could pass the House and Senate. A revised budget resolution was quickly passed, and Congress then approved a budget reconciliation bill to implement the Democratic deficit-reduction program. This program, however, was quite different from the previous budget agreement. Revenue increases were larger, and much heavier tax burdens, including higher marginal rates, were imposed on upper-income taxpayers. Entitlement savings were sharply reduced. Of the approximately \$480 billion in 5-year deficit reduction, only \$75 billion came from entitlements and mandatory spending, compared to \$190 billion in discretionary spending savings.²⁶

In sum, the 1990 OBRA legislation was a policy victory for congressional Democrats. The administration's lone success was in persuading Congress to retain multiyear budget process controls. Discretionary spending caps and pay-as-you-go (PAYGO) limits on revenues and entitlements were the main enforcement provisions under this new approach to deficit reduction, and these same features were incorporated into the Clinton administration's deficit-reduction program 3 years later.

The impact of the 1990 law on budget deficits was obscured by the economic slowdown that continued through 1991 and 1992. When OBRA 1990 was enacted, for example, the deficit for FY 1993 was expected to be approximately \$215 billion. The actual deficit during FY 1993 instead reached \$290 billion. Thus, when the Clinton administration took office, deficit levels were even higher than they had been during the Reagan presidency, and structural deficits were expected to continue indefinitely.

DEFICIT REDUCTION II: BILL CLINTON

During the 1992 campaign, Bill Clinton had pledged to cut the deficit in half during his first term. After Clinton lost

the battle for his economic stimulus package in February 1993, the administration decided to adopt a straightforward approach to deficit reduction, calling for \$500 billion in revenue increases and spending savings over a 5-year period. Revenue increases were the most prominent part of the Clinton program, and Republican opposition to these increases was fierce. OBRA 1993 passed the House and Senate in early August by the narrowest of margins, and against unanimous Republican opposition in both chambers.²⁷

OBRA 1993 was more heavily weighted toward revenues than OBRA 1990. The revenue provisions in OBRA 1993 were expected to yield \$240 billion over 5 years, with tax increases affecting high-income taxpayers—a top marginal rate of 39.6 percent and increased medicare taxes—accounting for more than \$140 billion. Discretionary spending caps, extended through 1998, continued to be very tight (see Table 3). As with OBRA 1990, the 1993 deficit-reduction agreement avoided major entitlement reforms, thus extending the differential treatment of discretionary and mandatory spending programs. For fiscal years 1991-1998, discretionary spending growth was limited to \$25 billion. Over this same period, the mandatory spending baseline incorporated growth of more than \$400 billion. As a percentage of GDP, discretionary spending was expected to fall below 7 percent, while mandatory programs were projected to rise to 13 percent.²⁸

DEFICIT REDUCTION III: CLINTON AND THE REPUBLICANS

Deficit projections issued after OBRA 1993 was enacted were not particularly encouraging, since the deficit baseline remained at about \$200 billion from 1995 through 1998, with a subsequent rise to nearly \$360 billion in 2003.²⁹ One of the factors that exacerbated budget policy battles over the remainder of Clinton's first term was the failure of these early forecasts to capture the better-than-expected

| OBRA 1990 | | |
|-------------|-----------------------------|----------------------------|
| Fiscal Year | Mandatory Spending Baseline | Discretionary Spending Cap |
| 1991 | \$562 | \$521 |
| 1992 | 632 | 526 |
| 1993 | 687 | 536 |
| 1994 | 731 | 536 |
| 1995 | 776 | 541 |
| OBRA 1993 | | |
| Fiscal Year | Mandatory Spending Baseline | Discretionary Spending Cap |
| 1994 | \$808 | \$542 |
| 1995 | 855 | 542 |
| 1996 | 901 | 548 |
| 1997 | 969 | 547 |
| 1998 | 1035 | 547 |

Source: *The Economic and Budget Outlook: Fiscal Years 1992-96*, Washington: U.S. Congressional Budget Office, 1991, p. 82; *The Economic and Budget Outlook: An Update*, Washington: U.S. Congressional Budget Office, September 1993, p. 26.

Table 3. Mandatory and Discretionary Spending under OBRA 1990 and OBRA 1993 (in billions of dollars).

improvement in the deficit outlook under the 1990 and 1993 budget plans. The other factor was a surprising Republican victory in the 1994 mid-term elections that elevated deficit reduction to even greater prominence. After narrowly failing to pass a constitutional balanced-budget amendment in 1995, the Republican-controlled 104th Congress enacted a balanced-budget program to eliminate the deficit by 2002.³⁰ This program produced an especially bitter and prolonged confrontation with Clinton in late 1995 and early 1996. In the wake of that confrontation, a chastened Republican leadership joined the Clinton administration in formulating a bipartisan balanced-budget agreement.

The 1995-1996 Shutdown.

During the summer of 1995, the congressional Republican leadership pressed forward on two budget policy fronts—a multiyear balanced-budget reconciliation package and appropriations bills for FY 1996. The Republican reconciliation measure was quite different, in its policy mix and fiscal goals, from the 1990 and 1993 reconciliation initiatives.³¹ The Republican plan contained large tax cuts, estimated at \$245 billion for fiscal years 1996-2002. The balanced budget it promised in 2002 was therefore contingent on unusually deep spending cuts, including unprecedented and controversial savings from entitlements. The nearly \$900 billion in baseline spending reductions that Congress approved on November 20, 1995, included \$270 billion from medicare, \$160 billion from medicaid, and more than \$80 billion from means-tested (or low-income) welfare entitlements. The only major entitlement unaffected by the Republican plan was social security. Since the Republicans also wanted to raise defense budgets, proposed cuts in discretionary spending were aimed exclusively at domestic programs. This path to budget balance posed a direct challenge to the policy priorities of the Clinton administration and congressional Democrats, and Clinton responded by vetoing the budget reconciliation bill on December 6.

Over this same period, Republicans were mounting an effort to force discretionary domestic spending below the caps that had been set under the 1993 deficit-reduction agreement. Fiscal 1995 appropriations had been enacted in 1994, when the Democrats still controlled Congress, so the Republican leadership pushed through rescission legislation to reduce previously-approved spending by more than \$16 billion. The proposed cuts were sharpest for domestic programs that represented Democratic priorities. The first FY 1995 rescission bill was vetoed on June 7, but the President signed a compromise measure on July 27.

For FY 1996 appropriations, however, the Republicans wanted to impose even deeper cuts and to couple these to policy riders affecting environmental and other regulations, abortion restrictions, and domestic agency operations. Protracted and divisive congressional debates over these spending and policy issues took place on every domestic appropriations bill. When the 1996 fiscal year began on October 1, only two appropriations measures—military construction and legislative branch operations—had been sent to the President. The remaining 11 bills were stalled, threatening a government-wide shutdown. This threat was temporarily averted by a 6-week continuing resolution that Clinton signed on September 30, but 10 appropriations bills were still blocked when this first continuing resolution expired on November 13. Negotiations on a second continuing resolution broke down, and a 6-day government shutdown ensued. After Republicans agreed to drop their preconditions for a second continuing resolution, a 4-week extension was agreed to on November 20. When this second resolution expired on December 15, six appropriations bills still had not been passed, and budget talks between the administration and Republican leaders collapsed. A second shutdown, affecting nine cabinet departments and nearly 200,000 employees, was triggered.

Over the next 3 weeks, the political fallout from this second shutdown decisively favored Clinton, and congressional Republicans returned in January 1996 anxious to avoid further erosion in their public support. The shutdown was ended on January 6, and a series of continuing resolutions was enacted until the last of the FY 1996 appropriations bills was eventually passed on April 25. When it was finally over, the FY 1996 appropriations cycle had produced two government shutdowns, 14 continuing resolutions, and an overwhelming consensus that the Republican budget strategy had been a political disaster. Republicans had managed to impose only modest cuts in domestic programs, while Clinton had successfully blocked their reconciliation initiative, had refused to commit his

administration to any alternative balanced-budget program, and had won the battle for public opinion.

The fiscal 1997 budget cycle reflected Clinton's strengthened position and growing Republican worries about the upcoming elections. All of the FY 1997 appropriations bills were enacted on schedule, and the administration won most of the disputes over domestic spending levels and policy riders. Discretionary outlays increased by nearly \$15 billion from 1996-1997, with the greater share of the increase allocated to domestic rather than defense programs.

The 1997 Balanced Budget Agreement.

Republicans managed to retain control of the House and Senate in the 1996 elections, and Republican leaders of the 105th Congress renewed their pledge to balance the budget by 2002. This time, however, they offered to work with the Clinton administration on a compromise balanced-budget framework. Talks between White House and congressional representatives began in early February and were concluded on May 15. This bipartisan agreement was approved by Congress in its FY 1998 budget resolution and implemented in two budget-reconciliation measures that were signed into law on August 5.

The 1997 reconciliation package was decidedly modest, particularly in comparison to the 1996 legislation that Clinton had vetoed. Republicans secured a net tax cut of \$95 billion over 5 years along with \$260 billion in deficit savings from both discretionary programs and entitlements.³² With offsets for new spending that Clinton and congressional Democrats had insisted upon, net deficit reduction was estimated at only \$127 billion for fiscal years 1998-2002. Moreover, the combination of tax cuts and new spending was actually expected to increase the baseline deficit by more than \$20 billion in FY 1998.³³ Baseline deficits would then begin to drop very gradually, with the budget in surplus by \$32 billion in 2002.

The Aftermath.

When the 1997 reconciliation bills were signed, there was considerable skepticism about the prospects for actual—as opposed to projected—balanced budgets.³⁴ Before long, however, it became clear that the budget outlook was improving much more dramatically than even the most optimistic forecasters had believed possible. Instead of a \$60 billion deficit in FY 1998, the budget registered a \$70 billion surplus, and projected deficits for the next several years have given way to larger and larger surpluses (see Table 4). For fiscal years 1998-2002, these deficit-surplus “improvements” will likely average more than \$235 billion per year.

These improvements have occurred without additional policy retrenchments. In fact, legislative actions taken since the 1997 budget agreement was signed have increased baseline spending and reduced surpluses.³⁵ Rather than policy effects, the changed budget outlook reflects two primary factors: (1) revenues have grown much, much

| Fiscal Year | September 1997 Baseline Projections | Actuals or Current Estimates | Change |
|-------------|---|------------------------------------|--------|
| 1998 | -\$57 | +\$69 | +\$126 |
| 1999 | -52 | +124 | +176 |
| 2000 | -48 | +236 | +284 |
| 2001 (est.) | -36 | +281 | +317 |
| 2002 (est.) | +32 | +313 | +281 |

Source: *The Economic and Budget Outlook: An Update*, Washington: U.S. Congressional Budget Office, 1997, p. x; *The Budget and Economic Outlook: Fiscal Years 2002-2011*, Washington: U.S. Congressional Budget Office, 2001, pp. 4, 142.

Table 4. Post-Balanced Budget Agreement Deficit (-)/Surplus (+) Projections vs. Actual Surpluses, Fiscal Years 1998-2002 (in billions of dollars).

faster than projected; and (2) mandatory spending has risen much more slowly than expected. The revenue impact has been the more important, accounting for approximately 75 percent of the deficit-surplus improvement from 1998-2000 and for about one-half of the surplus growth expected over the next few years.³⁶ Analysts attribute this revenue surge to stronger-than-expected economic growth and to changes in the types or characteristics of income.³⁷ On the spending side, lower-than-expected inflation has reduced the growth rates in indexed entitlements, while medicare program savings have been much higher than policymakers assumed (or intended) in 1997.

The positive budget outlook now in place also reflects, however, the cumulative effects of policy adjustments over the past decade. Between 1990 and 2000, for example, the deficit-surplus change was \$457 billion, or 6.3 percent of GDP. As shown in Table 5, the policy-based factors that accounted for this change were the higher tax levels (especially for individual income) put in place in 1990 and 1993 and, on the spending side, the massive post-Cold War defense cutbacks that reduced the level and altered the distribution of discretionary spending. The discretionary spending-GDP ratio dropped by almost 30 percent as a result of the discretionary spending caps in place during the 1990s, with almost all of this decline absorbed by defense. The combination of defense cuts, interest savings from lower deficits, and the elimination of deposit insurance outlays previously needed to fund savings and loan insolvencies, more than offset a slightly higher GDP ratio for entitlement programs.

The policy components of deficit reduction, then, have consisted of higher taxes and reduced defense spending. The former are partly accidental, since policymakers did not intend to raise revenues to their current levels. With regard to defense, however, the decisions of the past decade have been deliberate in direction and clear-cut in effect. While the Republican takeover of Congress in 1995 probably moderated the Clinton administration's initial plan to

transfer funding from defense to domestic programs, a substantial reallocation of discretionary spending has nevertheless taken place. Defense outlays, in current dollars, increased by \$22 billion from 1995 to 2000; over the same period, discretionary domestic spending rose by nearly \$50 billion. More important, real spending for defense has fallen by 30 percent since the end of the Cold War.³⁸

| | | | |
|---|----------------------|----------------------|---------------|
| | FY 1990 = -\$221 | FY 2000 = +\$236 | |
| | Revenues = 18.0% GDP | Revenues = 20.6% GDP | |
| | Outlays = 21.8% | Outlays = 18.2% | |
| | Deficit = -3.9% | Surplus = +2.4% | |
| | FY 1990 | FY 2000 | Change |
| Revenues | 18.0% GDP | 20.6% GDP | +2.6% GDP |
| Individual | 8.1 | 10.2 | (+2.1) |
| Corporation | 1.6 | 2.1 | (+0.5) |
| Payroll | 6.6 | 6.6 | (+0.0) |
| Other | 1.6 | 1.6 | (+0.0) |
| Outlays | 21.8% | 18.2% | -3.6% |
| Disc. Defense | 5.2 | 3.0 | (-2.2) |
| Disc. Nondefense | 3.5 | 3.3 | (-0.3) |
| Mandatory | | | |
| Programmatic | 9.9 | 10.5 | (+0.6) |
| Deposit Insurance | 1.0 | 0.0 | (-1.0) |
| Net Interest | <u>3.2</u> | <u>2.3</u> | <u>(-0.9)</u> |
| | 22.8 | 19.1 | -3.8 |
| Offsetting Receipts | <u>-1.0</u> | <u>-0.8</u> | <u>+0.2</u> |
| | 21.8 | 18.2 | -3.6 |
| ----- | | | |
| Source: <i>The Budget and Economic Outlook, Fiscal Years 2002-2011</i> , Washington: U.S. Congressional Budget Office, 2001, pp. 142-151. | | | |

Table 5. Components of Deficit Reduction, Fiscal Years 1990-2000 (in billions of dollars and percent of GDP).

The debate over how to allocate surpluses, then, begins with the tax and defense issues. Whether tax levels are too high involves political and economic policy judgments.

Whether defense budgets are too low is certainly a political judgment as well, but there are tangible considerations about the forces and funding needed to support the national security strategy. There is compelling evidence that defense has been underfunded for quite some time and that substantial increases are needed to sustain and modernize the nation's military forces. According to the CBO, for example, the FY 2000 defense budget was more than \$50 billion below the level required to "keep defense forces in a 'steady state'."³⁹ While the CBO analysis concluded that underfunding affected most categories in the defense budget, the shortfall in procurement was especially large—a sustaining budget estimate of \$90 billion compared to the \$53 billion in FY 2000 appropriations.⁴⁰

With the large surpluses now projected for the next decade, the fiscal framework within which defense budgets are determined should be more favorable than it was during the 1990s, and President George W. Bush has assigned a high priority to funding defense at more generous levels. Nevertheless, this new fiscal environment is not entirely positive. Surplus projections are encouraging but not guaranteed. In addition to the inherent uncertainties of 5-year or 10-year forecasts, policy decisions that substantially alter revenue and spending growth can erase budget balances very quickly. For the long term, the fiscal problems are more serious. Budgetary pressures from current entitlement commitments will begin to accelerate, making it difficult to preserve adequate discretionary spending margins. The defense budget, in sum, is likely to remain vulnerable to fiscal, as well as political, constraints.

THE UNCERTAINTIES IN BUDGET PROJECTIONS

An immediate concern is that surplus projections for the future, like deficit forecasts of the recent past, may prove illusory. Whether surpluses are realized, and how large those surpluses turn out to be, will depend on how the economy behaves, how benefit programs actually work, and

how Congress and the President change the revenue and spending policies currently in place. The surplus totals for the next decade can change markedly depending upon complex interactions among these controllable and uncontrollable factors.

Economic and Technical Assumptions.

Budget projections are based upon economic and technical assumptions that are subject to considerable uncertainty. Rates of economic growth, inflation, and productivity directly and indirectly affect federal spending and revenues, and unanticipated changes in these economic variables can substantially change even short-term budget forecasts. These effects become even more pronounced as forecasting periods lengthen. Errors in economic assumptions have caused considerable inaccuracies in previous budget forecasts, and the prospects for future errors remain high. The CBO, for example, acknowledges a "50 percent chance that such errors will cause [its] projection of the total budget surplus for the coming fiscal year to miss the actual outcome by more than 0.9 percent of GDP (or \$97 billion). . . ." ⁴¹ For its 5-year projection, the potential error is more than 1.8 percent of GDP, or nearly \$250 billion. ⁴²

Budget projections also incorporate assumptions about policy, and the baselines used in these projections assume that current policies will not be changed. Regardless of policy changes, however, revenue and spending estimates are far from precise. Over the past several years, revenues have been underestimated by very large amounts, reversing an earlier pattern of revenue overestimates. From 1981-2001, the average absolute difference between a 5th-year revenue projection and actual revenue levels—adjusted for any subsequent legislative changes—was 11.5 percent, or more than 2 percent of GDP. ⁴³ Outlay estimating errors have typically been smaller than revenue errors, particularly for outyears.

Nevertheless, the average difference between outlays projected 5 years ahead and actual spending has been 5.6 percent over the past 2 decades.⁴⁴ In addition, spending estimates have been especially susceptible to error for medicare, medicaid, and some means-tested entitlement programs that account for a growing share of future budgets.

The baseline surplus projections for FY 2002-2011 total more than \$3.1 trillion for "on-budget" accounts, that is, for spending and revenues other than social security. But a reversion to pre-1996 trends in key economic variables (such as GDP growth and productivity), personal tax liabilities as a share of taxable income, and medicare and medicaid spending could eliminate projected surpluses after 2003 and yield cumulative deficits of \$525 billion over the next 8 years.⁴⁵ Conversely, more favorable economic and policy assumptions more than double the estimated baseline surpluses. In view of these uncertainties, the CBO has cautioned that "the outlook for the budget can best be described not as the single row of numbers . . . but as a fan of probabilities around those numbers."⁴⁶

Discretionary Spending Decisions.

An additional unknown is posed by future decisions about discretionary spending. Surplus projections assume that discretionary spending outlays will grow only at the rate of inflation. If the President and Congress were to adhere to this baseline for the next decade, discretionary outlays would increase by \$220 billion, from \$646 billion in FY 2001 to \$866 billion in FY 2011.⁴⁷ Inflation-only adjustments, however, allow zero real growth and would result in a further decline in the discretionary spending-GDP ratio, from 6.3 percent in 2001 to 5.1 percent in 2011. A decline this severe is highly unrealistic, since most policy analysts agree that even the current 6.3 percent ratio cannot adequately fund the defense programs now in place and the nondefense spending priorities in areas such

as education, transportation, and health research and training. There is also widespread congressional support for raising discretionary spending growth to much higher levels. The cost implications, however, are substantial. The 10-year cost of the discretionary spending baseline is \$7.75 trillion.⁴⁸ If discretionary spending simply grows at the same rate as GDP, the additional cost is over \$900 billion.

The principal fiscal constraint on discretionary spending is that sustained levels of real growth greatly reduce projected surpluses, although this effect builds slowly for several years before beginning to accelerate. This delayed impact helps to explain the recent enthusiasm for boosting discretionary spending. Congress and the Clinton administration at first complied with the Balanced Budget Agreement's discretionary spending caps, but when surpluses began to appear, compliance ended. Although discretionary spending will remain capped at approximately \$560 billion through FY 2002, the caps have been breached by growing amounts—\$15 billion in 1999, \$50 billion in 2000, \$80 billion in 2001, and an estimated \$110 billion in 2002.⁴⁹ If discretionary spending grows more rapidly when the caps expire, outyear costs will begin to cut into projected surpluses, and fiscal constraints will likely tighten.

The political constraint affecting discretionary spending is the competition between defense and nondefense programs. As shown in Table 6, defense has been faring poorly in this competition for quite some time. Whether the current Bush administration can arrest this shift is arguable. While President Bush may be more inclined than Bill Clinton to shift budgetary resources to defense, he will undoubtedly face strong congressional opposition to a defense buildup that comes at the expense of domestic programs. Indeed, the strong bipartisan support that has emerged in Congress for increasing domestic discretionary spending suggests that defense may be fortunate to receive a proportional share of discretionary growth.

| Fiscal Year | Defense Outlays | | Nondefense Outlays | | Total Discretionary Outlays (in billions of dollars) |
|------------------------|------------------------|--|------------------------|--|--|
| | In Billions of Dollars | As a Percentage of Total Discretionary Outlays | In Billions of Dollars | As a Percentage of Total Discretionary Outlays | |
| 1991 | \$320 | 60% | \$214 | 40% | \$533 |
| 1992 | 303 | 57 | 232 | 43 | 535 |
| 1993 | 292 | 54 | 249 | 46 | 541 |
| 1994 | 282 | 52 | 262 | 48 | 544 |
| 1995 | 274 | 50 | 272 | 50 | 546 |
| 1996 | 266 | 50 | 269 | 50 | 534 |
| 1997 | 272 | 49 | 277 | 51 | 549 |
| 1998 | 270 | 49 | 284 | 51 | 555 |
| 1999 | 275 | 48 | 300 | 52 | 575 |
| 2000 | 295 | 48 | 322 | 52 | 617 |
| 2001 ^(est.) | 301 | 47 | 345 | 53 | 646 |

Source: *The Budget and Economic Outlook, Fiscal Years 2002-2011*, Washington: U.S. Congressional Budget Office, 2001, p. 75.

Table 6. Defense and Nondefense Discretionary Outlays, Fiscal Years 1991-2001.

The Policy Mix.

The broad policy options for using projected surpluses include retiring publicly-held debt, financing tax cuts and spending increases, or implementing some combination of these three. The Bush administration and Congress have pledged to commit the off-budget, or social security, portion of the total surplus to debt reduction. The approximately \$2.5 trillion in off-budget surpluses projected for the next decade would permit the federal government to retire virtually all of its publicly-held debt.⁵⁰ The debt held by government accounts—i.e., the social security trust funds—would then rise by a roughly equivalent amount.

On-budget surpluses, by comparison, are available to finance tax cuts and spending initiatives, but these surpluses can be quickly depleted as the outyear effects of reduced taxes or additional spending multiply. A useful benchmark for these effects is provided by the baseline

on-budget surplus projected for 2011—\$558 billion or 3.3 percent of GDP. The \$1.35 trillion, 10-year tax cut that Congress passed in May 2001 will reduce the 2011 surplus by more than 1 percent of GDP.⁵¹ On the spending side, holding constant the current discretionary spending-GDP ratio through 2011 subtracts an additional 1.2 percent. Thus, the projected surplus for 2011 would be reduced by two-thirds, without any additional tax cuts or spending increases. Since the list of other pending spending demands is long and costly—e.g., a prescription drug benefit for medicare—additional encroachments on the baseline surplus are probably inevitable.

The flexibility promised by large on-budget surpluses, then, disappears very quickly when permanent tax cuts and permanent spending increases are implemented. The Bush administration's FY 2002 budget acknowledges this problem and proposes to deal with it through a \$1.4 trillion reserve fund for additional needs and contingencies over the next 10 years.⁵² In order to create this reserve, however, the administration must convince Congress to exercise extremely strong control over current spending. Under the Bush plan, discretionary spending would be allowed to grow by less than 3 percent annually after 2003, and mandatory spending would have to be reduced by more than \$1.1 trillion under the current policy baseline from 2002-2011.⁵³ The reserve fund proposal therefore underscores the central point that future surpluses do not eliminate the need for current budgetary tradeoffs. If the administration and Congress want to preserve budgetary flexibility—either to accommodate new programs or to provide a hedge against estimating uncertainties—they must agree to limit current spending growth.

These considerations notwithstanding, budgetary margins potentially available for defense are larger under surplus scenarios than under the deficit-reduction constraints of the 1990s. It is unlikely, for example, that defense will continue to decline in real terms, but it may be difficult to reverse this decline quickly and permanently.

The administration's 2002 budget program, for example, allows several years to bring real defense outlays back to the levels in place in 1994-1995.⁵⁴ If the 2001 Quadrennial Defense Review and the Defense Department's internal strategic reviews demonstrate the need for considerably larger budget allocations, this timetable would need to be shortened, at which point the outyear implications of a defense buildup would become more pronounced and more contentious.

How well defense fares in the competition for available funds over the next decade will be determined, in large part, by political factors. The Bush administration must be able to articulate a credible national strategy and to insulate defense against domestic spending demands that have more immediate and tangible political benefits. Congressional support will have to be organized at the several stages of the annual budget process—budget resolutions, authorization bills, and appropriations bills. Unless the partisan and ideological balance in Congress were to shift decisively in favor of defense over the next several years, the congressional budget process will almost certainly yield small, incremental changes. Then, in the not-too-distant future, the fiscal environment could become less hospitable to defense and other discretionary spending requirements, making it even more difficult to sustain real growth.

THE POST-2010 OUTLOOK

The long-term budget outlook is dominated by projected growth rates for federal retirement and healthcare programs—notably social security, medicare, and medicaid. These three programs currently account for approximately 7.5 percent of GDP, more than double the GDP ratio 30 years ago. Over the next decade, retirement and healthcare entitlements are expected to grow moderately, to just under 9 percent of GDP, but growth rates for social security and especially for medicare and medicaid will then begin to climb much more rapidly. Under “midrange assumptions,”

spending for these programs would exceed 12 percent of GDP in 2020 and then rise to nearly 17 percent by 2040 (see Figure 2).⁵⁵ With revenue baselines at approximately 20 percent of GDP, funding these entitlements would leave policymakers with two options—either to reduce all other spending to a steadily narrowing GDP margin or to run deficits. (Raising revenues well above 20 percent of GDP is generally viewed as infeasible, in terms of negative economic effects as well as political considerations. The upper limits of “acceptable” tax levels in the United States are considered to be wartime emergencies, but the revenue-GDP level even during World War II never exceeded 21 percent.)

The starting point for these sobering projections is current policy, with the cost escalations a function of population aging and healthcare requirements. The demographic trends are clear-cut—the baby-boom

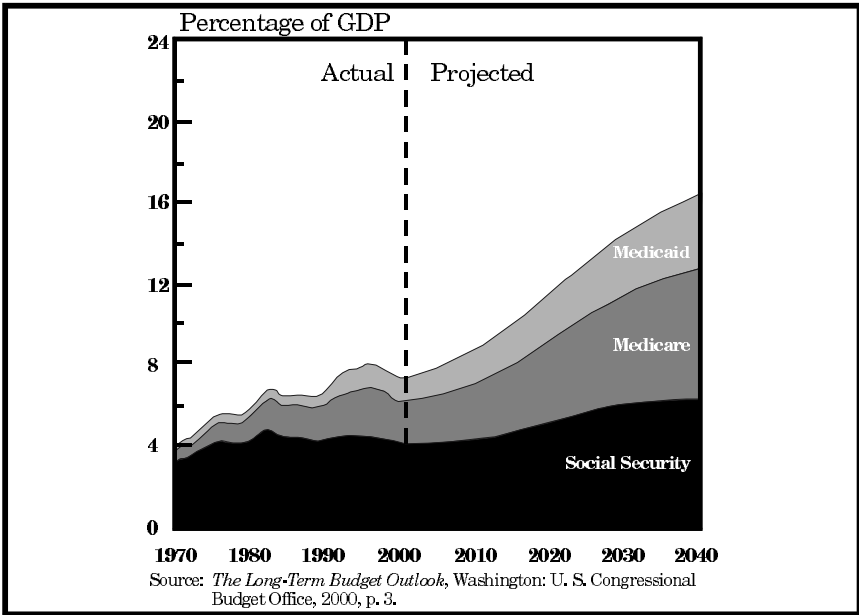


Figure 2. Spending for Social Security, Medicare, and Medicaid under CBO’s Midrange Assumptions.

generation will begin to reach retirement age around 2010, and this expanding pool of retirees will also have longer life expectancies than past generations. Costs per retiree are expected to increase as a consequence of more years of receiving benefits and, with respect to healthcare, from the greater intensity of demand for healthcare services among the very elderly.

Population aging also means there will be fewer workers to support these retirees. There are now approximately 3.4 workers per social security beneficiary, compared to 5.1 as recently as 1960.⁵⁶ By 2040, however, the old-age, or dependency, ratio is projected to fall to 2.1 workers per beneficiary. As spending for social security and medicare begins to grow very rapidly, payroll tax revenues to fund this growth will lag well behind. By about 2016, according to current projections, social security and medicare payments will exceed revenues, and accumulated trust fund surpluses would be depleted by 2029 for medicare and 2038 for social security.⁵⁷

Using social security surpluses to retire existing publicly-held debt does reduce net interest obligations and improves budget flexibility for a time, but the long-term budget outlook cannot be fundamentally changed if current retirement and healthcare commitments are maintained. After 2010, larger and larger shares of federal revenues would be absorbed by social security, medicare, and medicaid. Unless offsetting reductions were made in all other spending programs, deficit and debt problems would reemerge. If, for example, discretionary spending were simply to be maintained at baseline levels—i.e., inflation adjustments but no real growth—the fiscal gap between revenues and outlays would become extremely large and lead to unsustainable debt levels over time.⁵⁸

These long-term scenarios illustrate the potential fiscal checks on discretionary spending and on the many remaining means-tested and nonmeans-tested entitlement programs. The current GDP share for these various types of

spending is approximately 9.5 percent. Once the retirement and healthcare entitlements climb above 10 percent of GDP, the budgetary margin for all other spending will begin to shrink. By 2030, the projected margin is less than 5 percent of GDP.⁵⁹ By 2050, social security, medicare, and medicaid would, by themselves, be well over 20 percent of GDP.

The uncertainties in short-term projections obviously apply to the long-term budget outlook, but the demographics that drive the latter are formidable. In the absence of retrenchments that greatly reduce the rates of projected growth in social security, medicare, and medicaid, the funding requirements for these programs would eventually eliminate any budgetary flexibility. Flexible and sustainable budget policy therefore depends upon policy changes that lower the relative burdens of retirement and healthcare entitlements.⁶⁰

Concerns about future budget policy, then, have immediate relevance. Even though entitlement financing problems do not become severe until after 2010, reforms that would reduce the benefits available under existing law must give future retirees sufficient time to adjust.⁶¹ This adjustment period is particularly important for social security reforms, such as privatization or retirement age increases, that would affect virtually all future beneficiaries.⁶²

The necessity for reform is also unrelated to the surplus trust fund balances that social security will accumulate over the next 10 years. When social security benefits begin to exceed payroll tax receipts, the government must fund the difference through higher taxes, through borrowing, or by reducing other spending. The trust fund surpluses make social security's claim on budgetary resources stronger—since the government “owes” money to the trust funds for the securities being held—but the actual funds to satisfy that claim must be provided when benefits are due.

CONCLUSION

The fiscal problems posed by retirement and healthcare entitlements are not confined to the United States. Demographic trends in most of the advanced democracies will make it extremely difficult for them to maintain the social welfare systems now in place and to fund other needed programs without excessive deficits or excessive taxation.⁶³ These deficit and tax options, moreover, are probably more limited than in the past. The internationalization of financial markets has created strong incentives to avoid deficit and debt financing, while globalization has made tax systems more competitive—a country's ability to impose higher tax rates than its economic competitors is constrained by the growing mobility of capital and skilled labor and by the attendant effects on productivity and growth.⁶⁴

The fiscal challenge for the United States is arguably less severe than that faced by its major economic competitors. Its demographic problems are not quite as serious, and its social welfare system is comparatively narrow. At the same time, the United States has defense requirements that are unique, and these requirements need to be taken into account as the President and Congress shape future budgets. The immediate problems are well understood. Underfunding of defense programs under the Clinton administration has compromised readiness and, especially, modernization. Redressing these deficiencies, while accommodating the Bush administration's proposed missile defense system and other new initiatives, would require substantial real growth in defense budgets for an extended period.

The FY 2002 budget plan submitted by the Bush administration and the corresponding congressional budget resolution adopted this spring contain "placeholder" numbers for defense, with funding levels almost flat in real terms over the next decade. Once the administration completes its defense strategy review, a revised and

presumably larger defense program will be proposed for fiscal years 2003-2011. The President's determination to have "our defense vision . . . drive our defense budget" is certainly justified, but the severity of potential funding problems is daunting.⁶⁵

If, for example, the strategy and programs now in place under the 1997 Quadrennial Defense Review are reaffirmed, defense funding requirements could exceed the current placeholder budgets by more than \$200 billion over the next decade.⁶⁶ If, on the other hand, a different strategy is pursued, these funding shortfalls could be reduced. The tradeoffs, however, would inevitably include substantial reductions in force levels—Army divisions, Navy carrier battle groups, and Air Force fighter wings—and a highly selective program of weapons modernization. Without these tradeoffs, and a diminished regional war capability, large budgetary reductions cannot be realized. In addition, defense needs do not disappear in 2011. If long-term fiscal flexibility is not protected, the nation's ability to fund defense at needed levels will eventually be impaired.

The deficit-debt dynamic that the federal government encountered after the 1960s was caused by the unexpectedly high costs of expanded social welfare entitlements. That dynamic has been brought under control, at least for the immediate future, through defense cuts and tax increases. The entitlement financing problem, however, remains unresolved, and unless meaningful reforms are enacted fairly soon, spending pressures will become more concentrated and more intense. Adequate budgetary margins to fund discretionary programs, notably defense, will not be available. For the defense community, the decisions that the President and Congress make regarding defense budgets over the next several years will be extremely important. The long-term prospects for defense, however, will be shaped by broader decisions that determine the composition of future spending budgets.

During the Cold War, when the Soviet threat was clear and immediate, defense funding was volatile. A well-developed and widely-supported national military strategy could not insulate defense from competing budgetary pressures. In the post-Cold War world, the threat is less urgent, the strategic consensus is weaker, and competing budgetary needs are more politically potent. Despite budget surpluses, defense remains vulnerable to short-term political fluctuations and long-term fiscal trends.

ENDNOTES

1. From the end of World War II through 1960, there were seven budget surpluses and seven deficits. Over the next 3 decades, the budget was in deficit in all but 1 year (FY 1969). Publicly-held debt for this 30-year period rose from \$237 billion to \$2.4 trillion. By the time that the budget was again balanced in FY 1998, the debt had climbed to \$3.7 trillion. See *Historical Tables, Budget of the United States Government, Fiscal Year 2002*, Washington: U.S. Government Printing Office, 2001, pp. 21-22, 116.

2. *The Budget and Economic Outlook: Fiscal Years 2002-2011*, Washington: U.S. Congressional Budget Office, 2001, p. xiv.

3. See James D. Savage, "Budgetary Collective Action Problems: Convergence and Compliance under the Maastricht Treaty on European Union," *Public Administration Review*, Vol. 61, January/February 2001, pp. 43-51.

4. Discretionary spending, which includes defense and non-social welfare domestic programs, is determined by annual congressional appropriations. Mandatory spending, which includes social welfare entitlement programs, is governed by laws other than appropriations acts (e.g., entitlement authorizations) and continues until and unless these laws are changed. Mandatory spending also includes net interest outlays. In the early 1960s, discretionary spending was nearly 13 percent of GDP; the current level is just over 6 percent. Over the same period, mandatory spending levels have roughly doubled—from 6 percent of GDP to 12 percent. Since FY 2000, revenues have been at or above 20 percent of GDP, the highest levels since World War II.

5. See *Long-Term Budget Issues: Moving from Balancing the Budget to Balancing Fiscal Risk*, Washington: U.S. General Accounting Office, February 2001.

6. *Ibid.*, p. 1.

7. *Deficit Reduction: Experiences of Other Nations*, Washington: U.S. General Accounting Office, December 1994, p. 28.

8. On the nondefense spending patterns during World War II and Korea versus those during Vietnam, see Dennis S. Ippolito, *Uncertain Legacies: Federal Budget Policy from Roosevelt through Reagan*, Charlottesville: University Press of Virginia, 1990, pp. 167-169.

9. In 1980, publicly-held federal debt was 26 percent of GDP. Ten years later, the level was 42 percent. *Historical Tables, Fiscal Year 2002*, p. 116.

10. *The Economic and Budget Outlook: Fiscal Years 2000-2009*, Washington: U.S. Congressional Budget Office, 1999, p. 154.

11. See *Fiscal Year 1982 Budget Revisions*, Washington: U.S. Government Printing Office, 1981, pp. 124-125.

12. The individual and corporate tax reductions under ERTA were estimated at \$750 billion for fiscal years 1981-1986.

13. Tax increases passed during 1982-1984 trimmed the ERTA reductions by about one-third. The other major tax bill of the Reagan presidency, the Tax Reform Act of 1986 (TRA), greatly lowered the top marginal rates on individual and corporation income but also repealed or modified numerous tax preferences. TRA net revenue effects were expected to be deficit-neutral. Ippolito, *Uncertain Legacies*, pp. 72-87.

14. The deficit ceilings under GRH I were: FY 1986 = \$172 billion; FY 1987 = \$144; FY 1988 = \$108; FY 1989 = \$72; FY 2000 = \$36; FY 2001 = \$0.

15. Under GRH II, the revised deficit ceilings were: FY 1988 = \$144 billion; FY 1989 = \$136; FY 1990 = \$100; FY 1991 = \$64; FY 1992 = \$28; FY 1993 = \$0.

16. *Congressional Quarterly Almanac, 1989*, Washington: Congressional Quarterly, 1990, p. 10-C.

17. *Ibid.*, p. 12C.

18. *The Economic and Budget Outlook: Fiscal Years 1991-1995*, Washington: U.S. Congressional Budget Office, 1990, p. xxii.

19. This was President Bush's description at the signing ceremony. *Congressional Quarterly Almanac, 1990*, Washington: Congressional Quarterly, 1991, p. 166.

20. *Budget of the United States Government, Fiscal Year 1991*, Washington: U.S. Government Printing Office, 1990, p. 3.

21. *An Analysis of the President's Budgetary Proposals for Fiscal Year 1991*, Washington: U.S. Congressional Budget Office, 1990, p. 42.

22. *The Economic and Budget Outlook: An Update*, Washington: U.S. Congressional Budget Office, July 1990, p. xiii.

23. *Ibid.*, p. 56.

24. *Congressional Quarterly Almanac, 1990*, p. 130.

25. The pay-as-you-go (or PAYGO) procedure required that legislation enacted in any year that reduced revenues below the revenue baseline be completely offset by revenue increases or mandatory spending reductions. Similarly, legislation increasing mandatory spending above the baseline had to be offset by reductions in mandatory programs or by revenue increases. If these offsets were not enacted, automatic sequesters in mandatory spending were triggered.

26. *The Economic and Budget Outlook: Fiscal Years 1992-1996*, Washington: U.S. Congressional Budget Office, 1991, p. xvii.

27. The vote was 218-216 in the House. In the Senate, Vice President Al Gore cast the tie-breaking 51-50 vote.

28. *The Economic and Budget Outlook: An Update*, Washington: U.S. Congressional Budget Office, September 1993, p. 27.

29. *Ibid.*, p. 26.

30. The House passed HJ Res 1—the Balanced-Budget Constitutional Amendment—by a vote of 300-132. The Senate vote was 65-35, two votes short of the required two-thirds majority.

31. *Congressional Quarterly Almanac, 1995*, Washington: Congressional Quarterly, 1996, pp. 2-44, 2-58.

32. *Congressional Quarterly Almanac, 1997*, Washington: Congressional Quarterly, 1998, p. 2-27.

33. *The Economic and Budget Outlook: An Update*, Washington: U.S. Congressional Budget Office, September 1997, p. x.

34. For the various critiques of the agreement, see Daniel J. Palazzolo, *Done Deal? The Politics of the 1997 Budget Agreement*, New York: Chatham House, 1999, pp. 198-204.

35. *The Budget and Economic Outlook: Fiscal Years 2002-2011*, p. xv.

36. See *The Budget and Economic Outlook: An Update*, Washington: U.S. Congressional Budget Office, July 2000, p. 7.

37. *Ibid.*

38. Constant dollar defense outlays dropped from \$362 billion in 1991 (in FY 1996 dollars) to \$270 billion in 2000. *Historical Tables, Fiscal Year 2002*, p. 124.

39. *Budgeting for Defense: Maintaining Today's Forces*, Washington: U.S. Congressional Budget Office, September 2000, p. xi.

40. *Ibid.*, p. xii.

41. *The Budget and Economic Outlook: Fiscal Years 2002-2011*, p. 93.

42. *Ibid.*

43. *Ibid.*, p. 96.

44. *Ibid.*

45. *Ibid.*, pp. 99-100.

46. *Ibid.*, p. 93.

47. *Ibid.*, p. 77.

48. For fiscal years 2002-2011. *Ibid.*

49. Based on the \$667 billion discretionary spending cap in the concurrent budget resolution Congress has enacted for FY 2002.

50. *The Budget and Economic Outlook: Fiscal Years 2002-2011*, pp. 2-3.

51. The GDP estimate for 2011 is approximately \$17 trillion. The Bush administration's original \$1.6 trillion tax cut would have cut baseline revenues by approximately \$215 billion, or 1.3 percent of GDP, in 2011.

52. *Budget of the United States Government, Fiscal Year 2002*, Washington: U.S. Government Printing Office, 2001, p. 7.

53. See *ibid.*, p. 240, for the Bush program totals. The current policy baseline is provided in *The Budget and Economic Outlook: Fiscal Years 2002-2011*, p. 80.

54. During the 1980s, real defense outlays climbed from \$246 billion to \$370 billion. The post-Cold War defense reductions in real spending during the early 1990s cut outlays below \$300 billion in 1994 and to \$283.5 billion in 1995. The initial defense budget proposals from President Bush would bring real spending for defense to \$287 billion in 2005 and 2006. *Historical Tables, Fiscal Year 2002*, p. 124.

55. *The Long-Term Budget Outlook*, Washington: U.S. Congressional Budget Office, 2000, p. 3. For an explanation of midrange assumptions, see pp. 12-13.

56. *Ibid.*, p. 1.

57. These projections are contained in the 2001 Report of the Social Security and Medicare Boards of Trustees. *Congressional Quarterly Weekly Report*, Vol. 59, March 24, 2001, p. 665.

58. *The Long-Term Budget Outlook*, p. 10.

59. *Long-Term Budget Issues*, p. 10.

60. *Ibid.*, p. 18.

61. For an examination of social security and medicare reform proposals, see *Budget Options*, Washington: U. S. Congressional Budget Office, February 2001, pp. 28-40.

62. The retirement age for social security is scheduled to be raised from 65 to 67, with a phase-in period from 2003 to 2027. Early retirement benefits will be reduced from 80 percent to 70 percent of full benefits over this period.

63. See Vito Tanzi and Ludger Schuknecht, *Public Spending in the 20th Century*, Cambridge: Cambridge University Press, 2000.

64. *Ibid.*, pp. 252-253.

65. President Bush's address to a joint session of Congress on February 27, 2001. *Congressional Quarterly Weekly Report*, Vol. 59, March 3, 2001, p. 498.

66. Estimates of budgetary shortfalls for current strategy and programs vary. Recent Congressional Budget Office analyses have placed the strategy-funding mismatch at approximately \$25-40 billion annually. The Center for Strategic and Budgetary Assessments, an independent policy research organization has issued a series of reports with roughly similar assessments. A much larger, and therefore more controversial, estimate was reported by the Center for Strategic and International Studies (CSIS) in 1999. Its analysis of funding shortfalls for the Clinton defense program was \$100 billion per year for fiscal years 2001-2005, with substantially larger funding gaps thereafter. For FY 2001-2020, the CSIS placed the funding requirements for existing programs at 4.0 percent of GDP. See Daniel Goure and Jeffrey M. Ranney, *Averting the Defense Train Wreck in the New Millennium*, Washington: CSIS, 1999, pp. xiv, 124.

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