

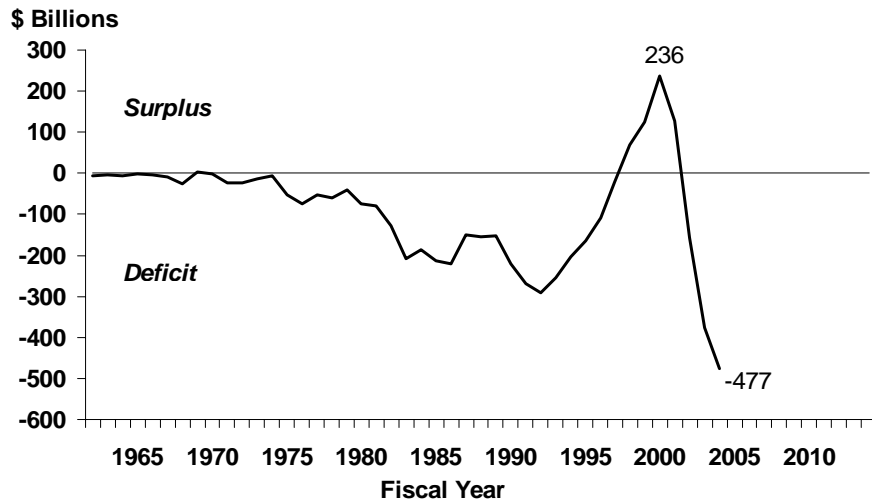
The Federal Budget: Developments and Outlook



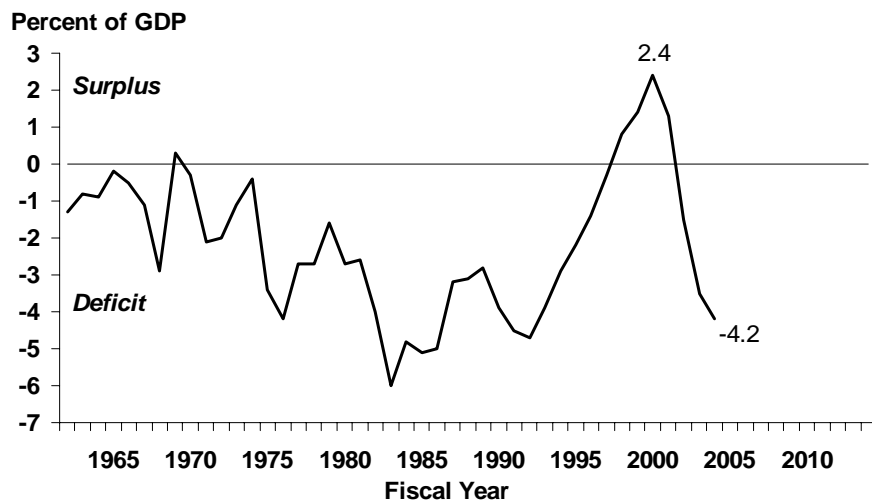
The federal budget: developments and outlook

- Recent developments
 - Growth of deficit
 - Economic factors and policy changes
- Economic impact of deficit
 - Reduction in government saving
 - Potential reduction in national saving
- Outlook over next decade
 - Deficit projected to shrink
 - Economic uncertainty and policy choices

Sharp swing from surplus to deficit

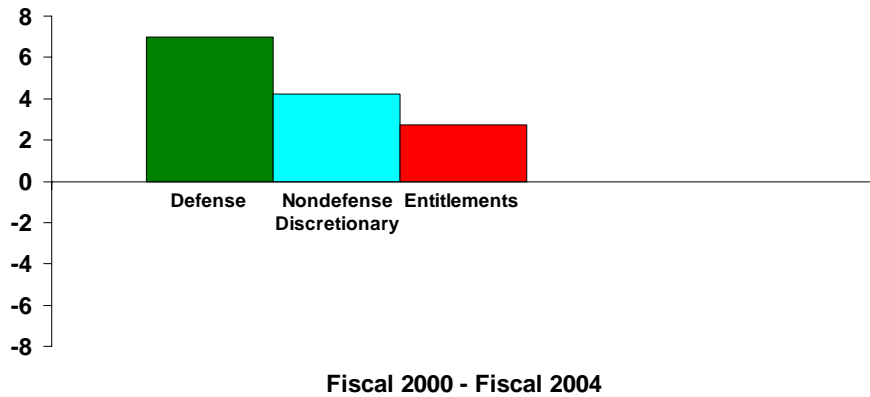


Sharp swing from surplus to deficit



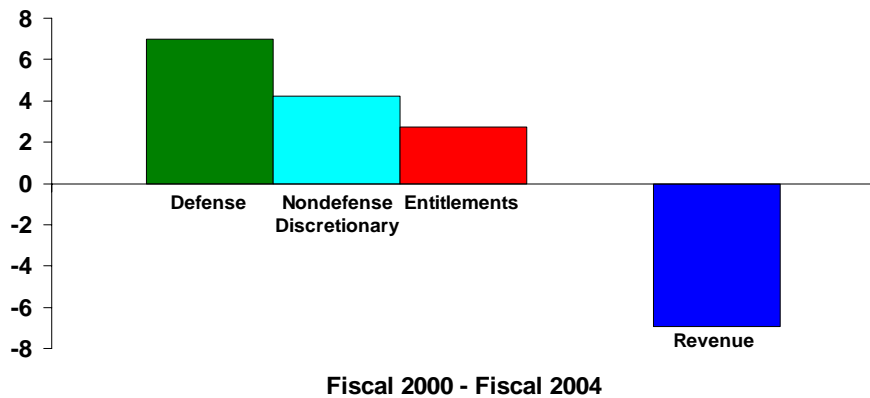
Since 2000, spending has risen, revenue fallen

Annual percent change
(relative to GDP)

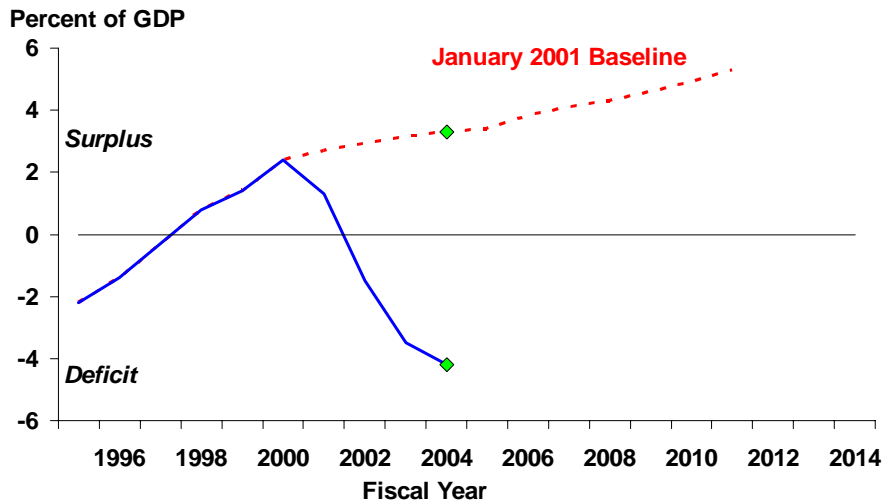


Since 2000, spending has risen, revenue fallen

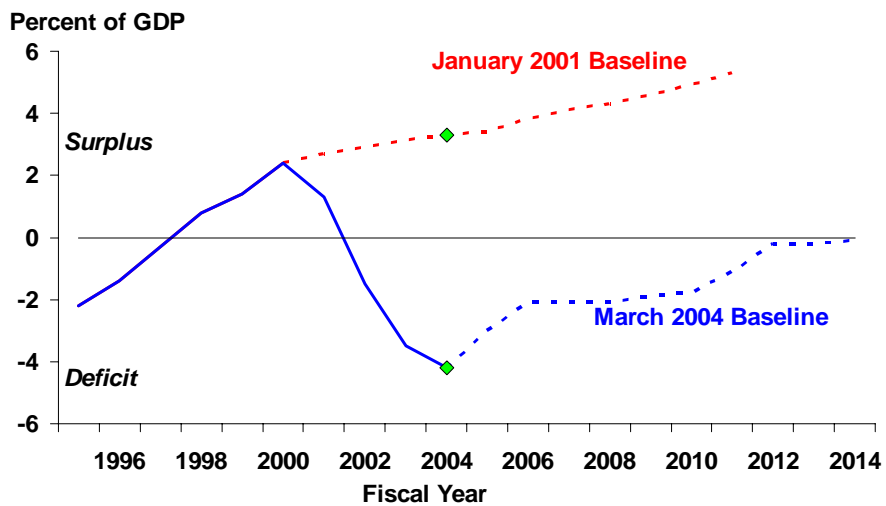
Annual percent change
(relative to GDP)



Budget outlook has deteriorated since 2001



Budget outlook has deteriorated since 2001



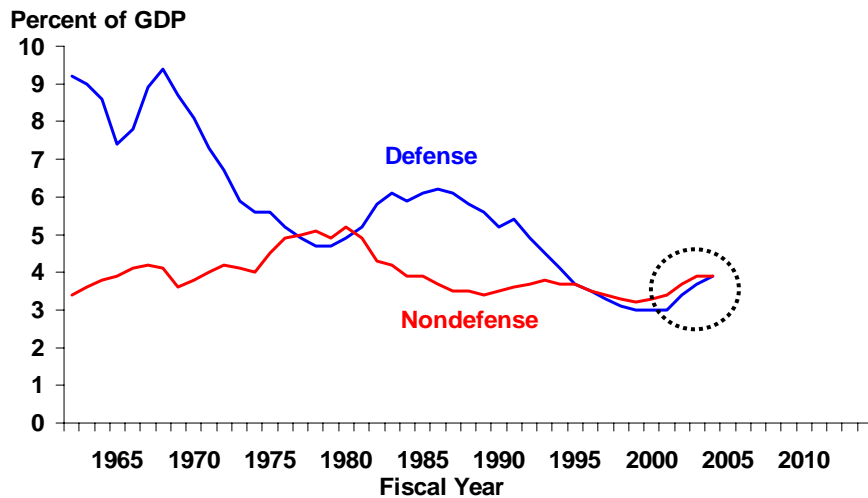
What turned projected 2004 surplus into deficit?

- 40 percent of revision due to economic factors
- Other 60 percent due to policy changes
 - 27 percent spending increases
 - 33 percent tax cuts

Policy changes

- Increases in discretionary spending (defense and nondefense)

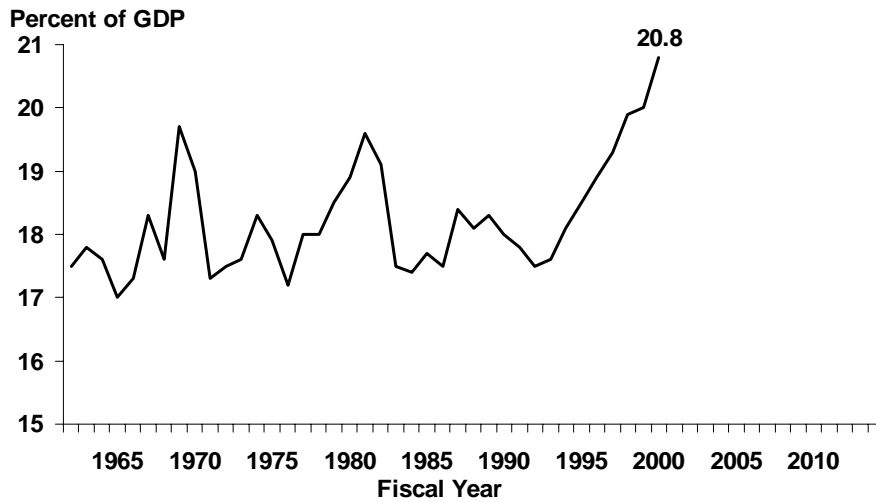
Discretionary spending has turned upward



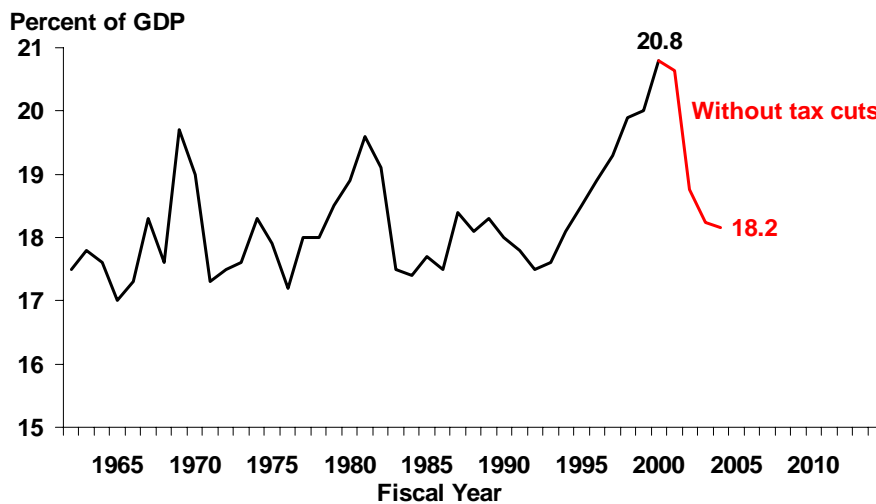
Policy changes

- Increases in discretionary spending (defense and nondefense)
- December 2003 Medicare drug law (takes effect in 2006)
- June 2001 tax cut – expires December 31, 2010
- March 2002 stimulus package
- May 2003 tax cut

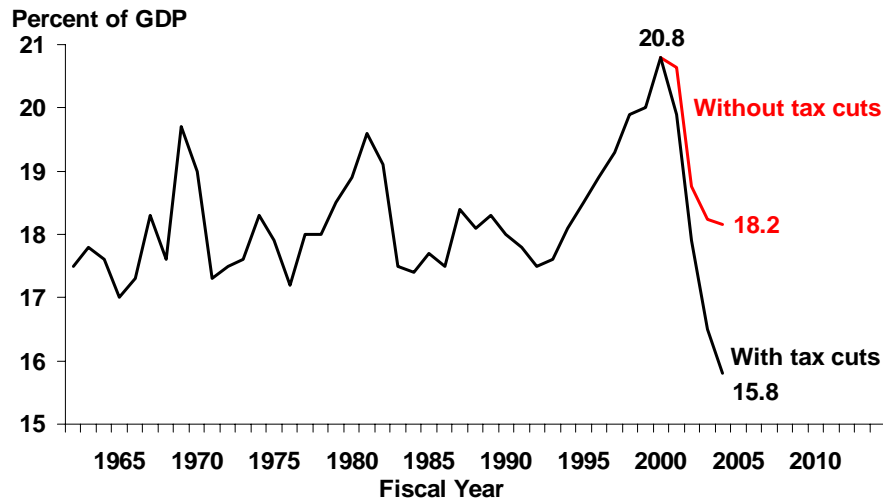
Revenue share at historic low, 4 years after historic high



Revenue share at historic low, 4 years after historic high



Revenue share at historic low, 4 years after historic high



Revenue loss from tax cuts may be overstated

- Official estimates hold GDP fixed
- Tax cuts may boost GDP
 - Revenue feedback partly offsets direct loss
 - Doesn't fully offset

Economic impact of deficit

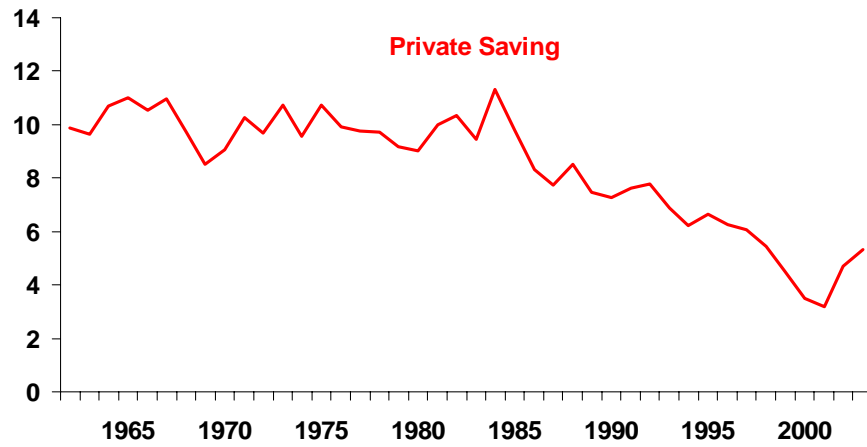
- Lower government saving
 - Tax cuts or spending increases today
 - Tax increases or spending cuts tomorrow
- Lower national saving (unless private saving rises one-for-one)
 - Higher living standards today
 - Lower living standards tomorrow

Lower national saving reduces future income

- Impact in closed economy
 - Raise interest rates, reduce investment
 - Smaller capital stock, lower future income
- Impact in open economy
 - Capital inflow (financed by trade deficit)
 - Capital stock, output inside U.S. need not fall
 - But Americans' future income still falls

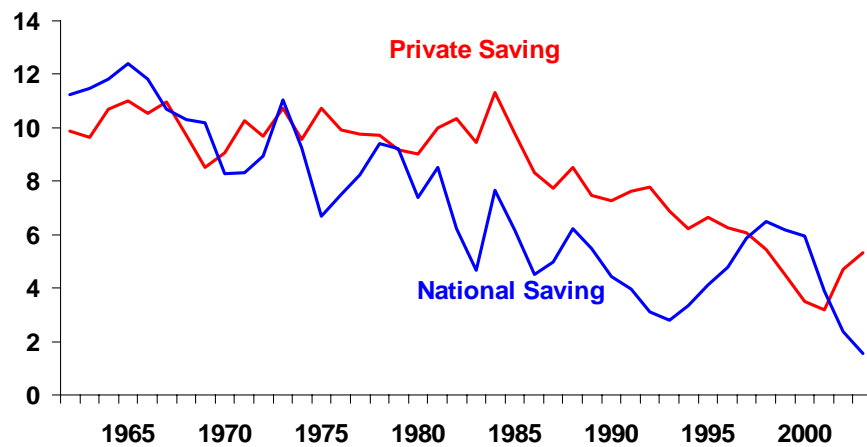
National saving falls to historic low

Percent of GDP



National saving falls to historic low

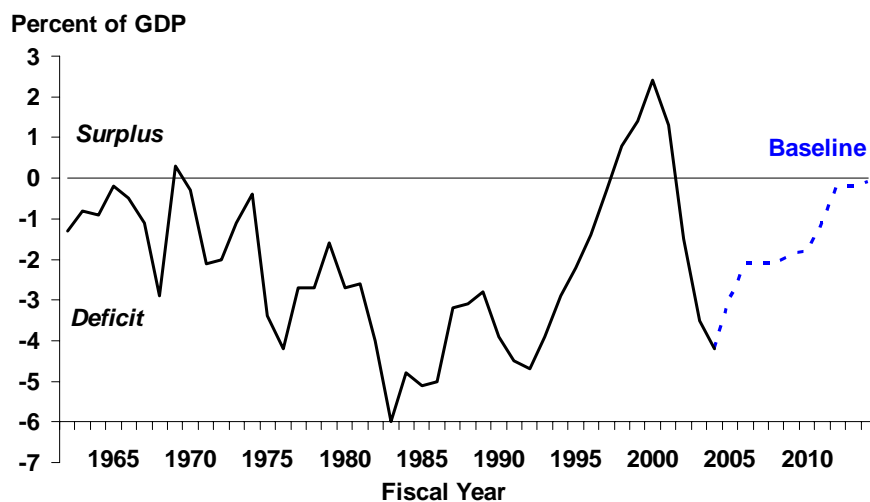
Percent of GDP



Deficits are not all that matter

- Types of spending
- Incentives to work, save, invest
- Distribution of disposable income
- Business cycle
- Transfers between age groups

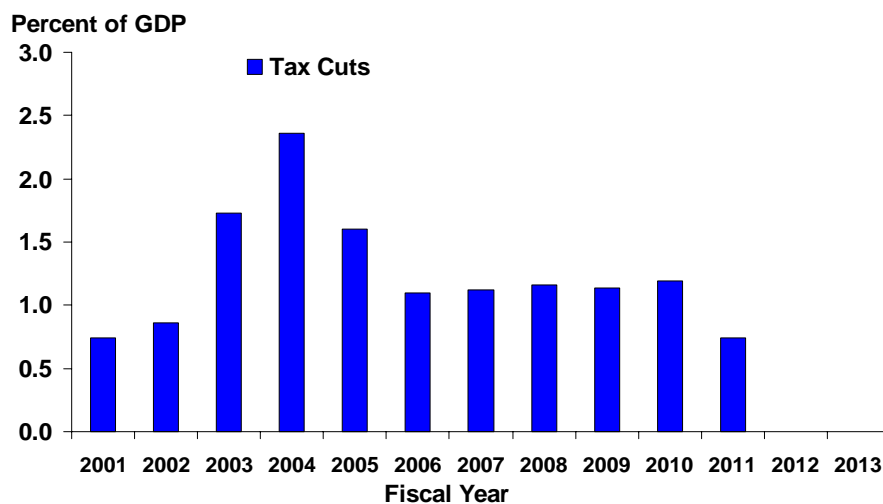
Baseline: deficit projected to shrink over next decade



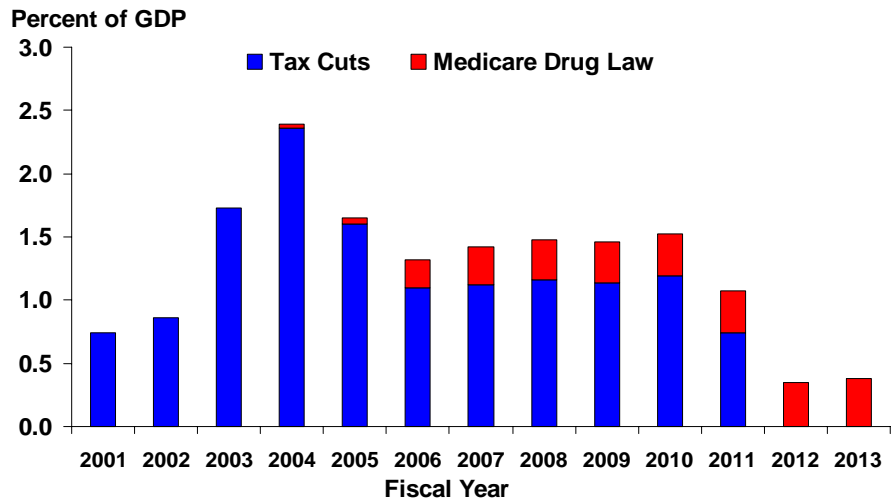
Deficit projected to shrink under baseline

- Discretionary spending declines relative to GDP
- Revenue rises relative to GDP
 - Real bracket creep
 - Sharp rise in AMT payments
 - Tax cuts smaller after fiscal 2004, expire during fiscal 2011

Tax cuts become smaller, expire



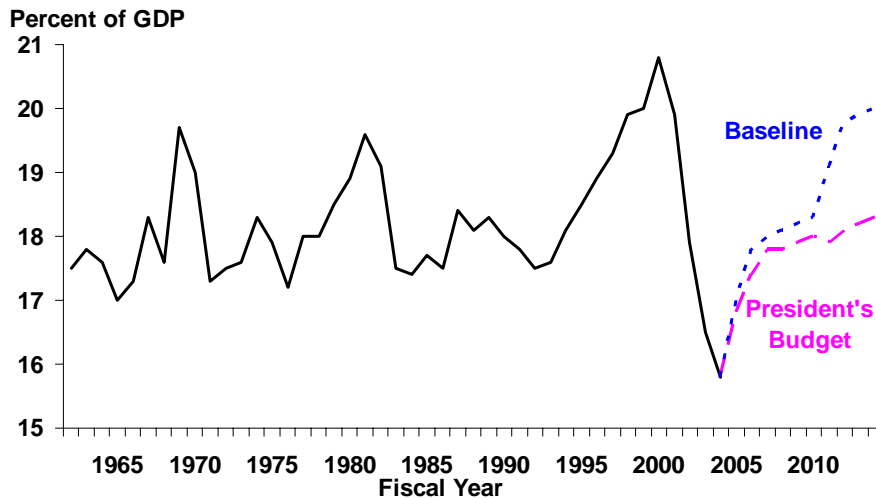
Tax cuts become smaller, expire



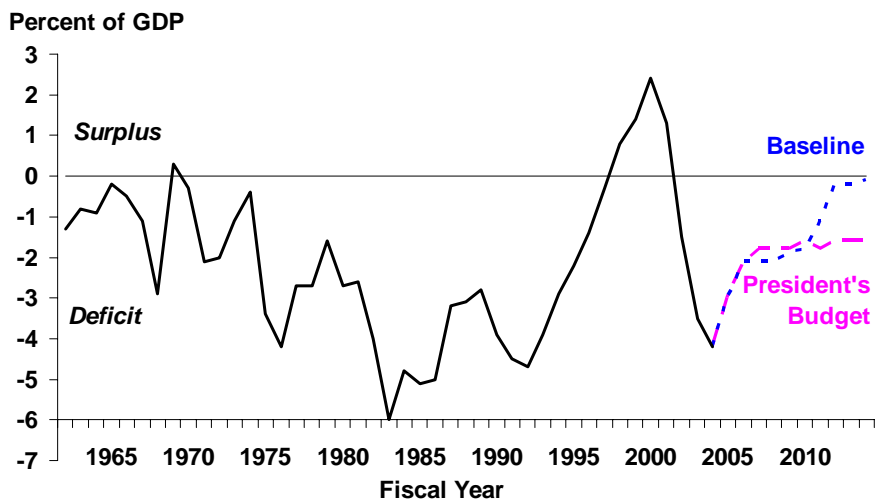
Key proposals in President's 2005 budget

- Stringent restraint of discretionary spending (defense and nondefense)
- Make tax cuts permanent

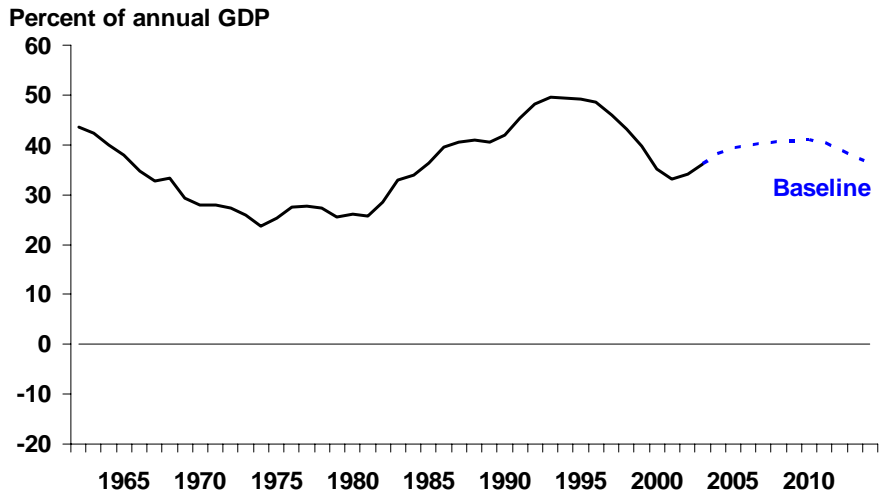
Revenue share projected to rise



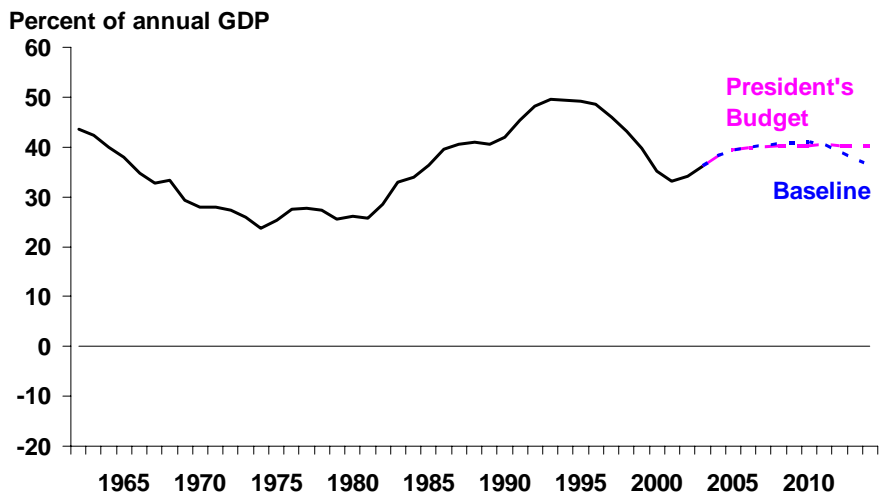
Deficit shrinks less under President's budget



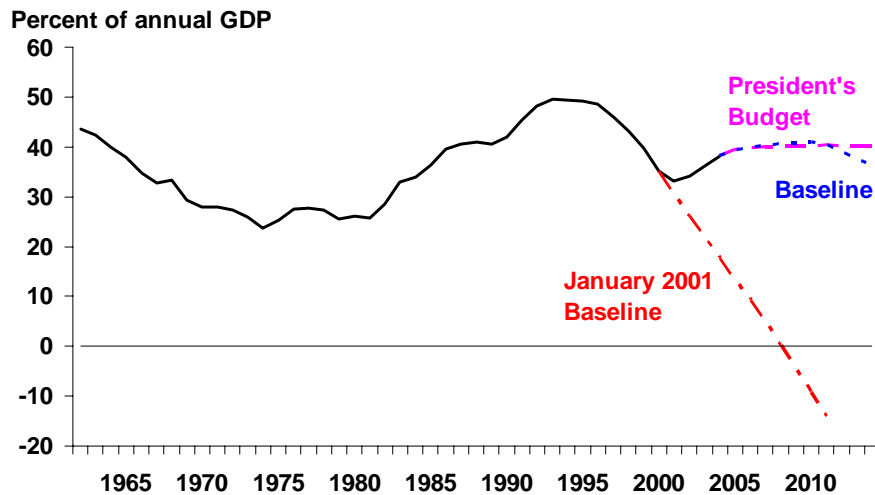
Debt burden projected to remain within historical range



Debt burden projected to remain within historical range



Debt burden projected to remain within historical range



Factors affecting budget outlook

- Economic uncertainty
- Policy choices
 - Permanent AMT relief
 - Pressure to increase discretionary spending
 - Pressure to expand Medicare drug benefit
 - Possible Social Security changes

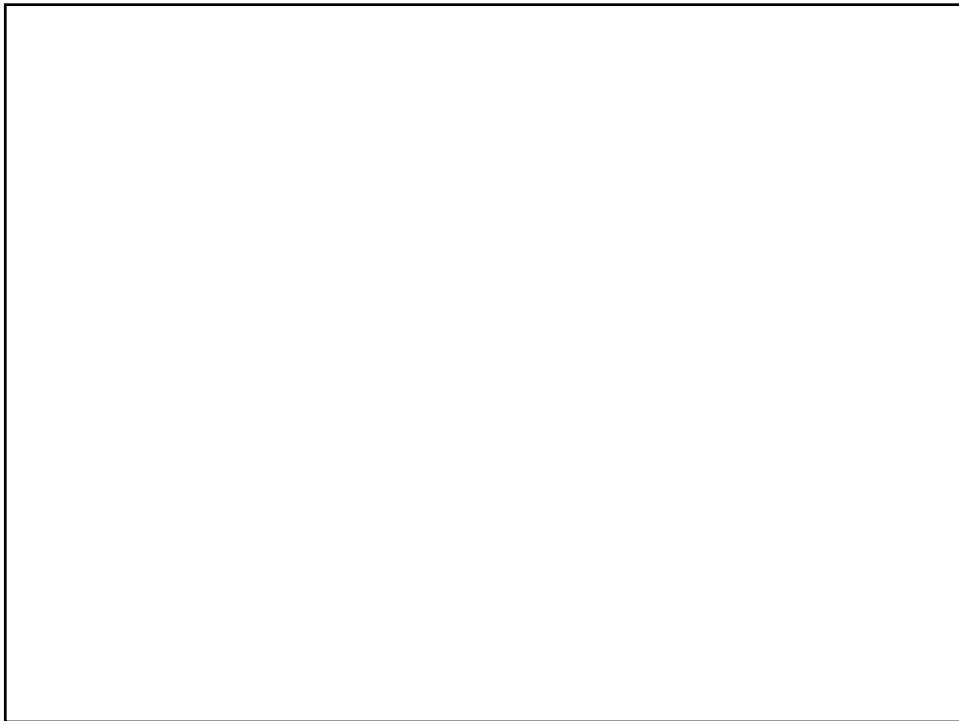
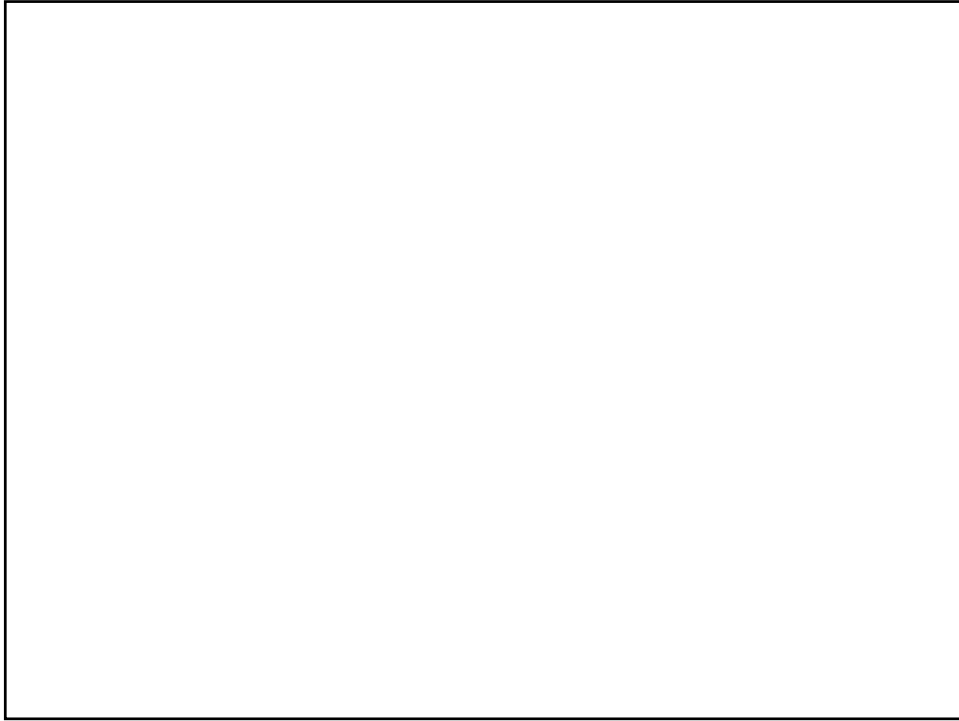
Conclusion

- Sharp swing from surplus to deficit
 - Probable reduction in national saving
 - Sacrifice of future national income
- But, downward trend in national saving driven by downward trend in private saving

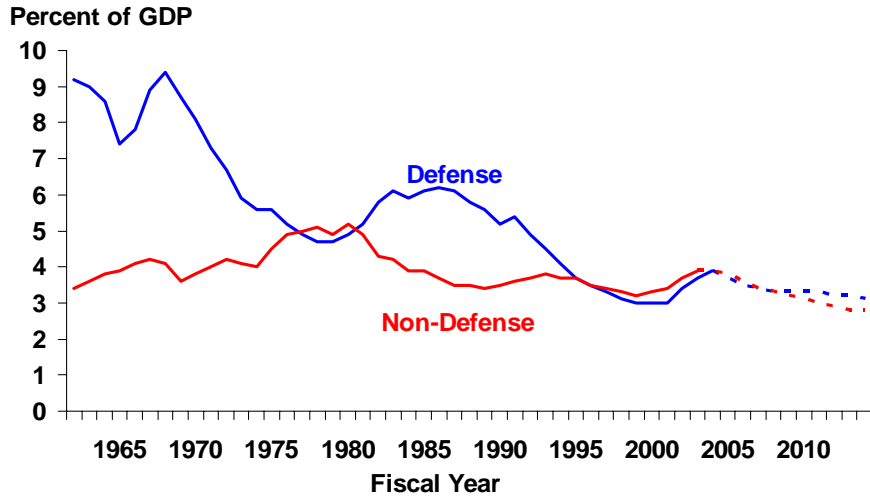
Conclusion

Cont'd

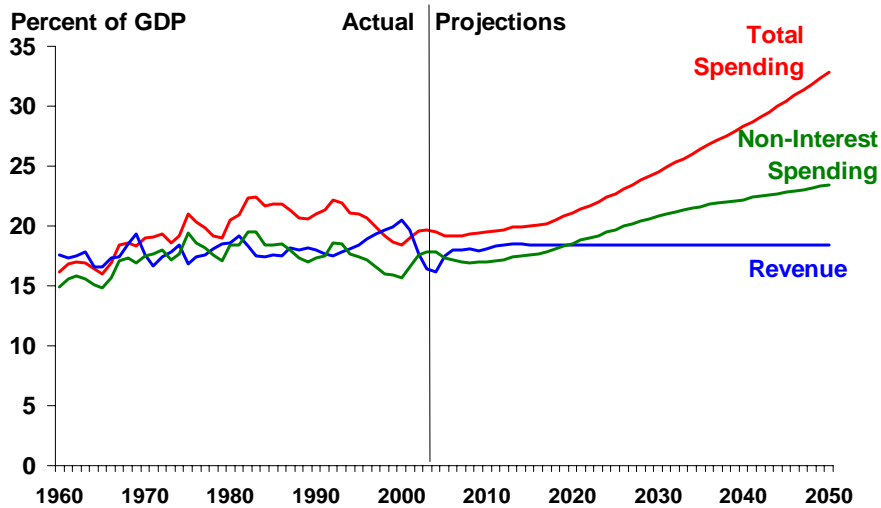
- Current and 10-year deficits not crises
 - Deficit and debt within historical ranges
 - Deficit projected to shrink over next decade
- Overshadowed by looming Social Security-Medicare challenge



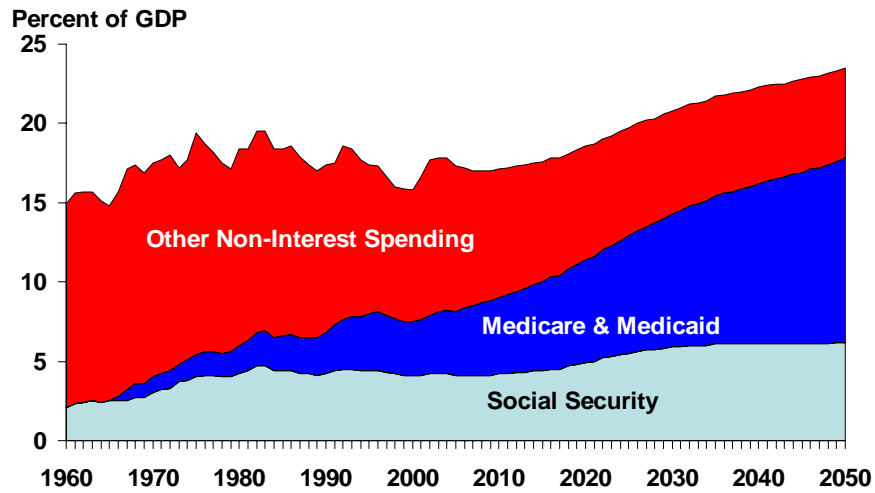
President proposes restraint of discretionary spending



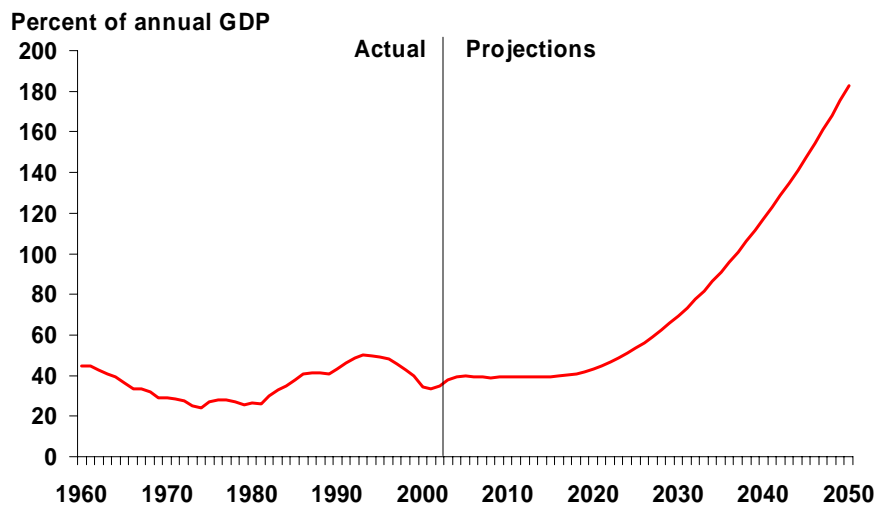
Federal spending projected to surge in upcoming decades



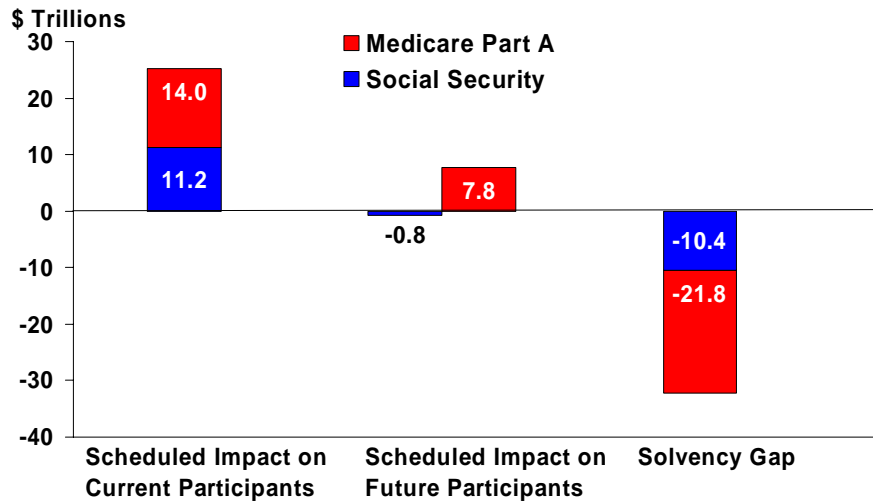
Spending surge driven by Social Security, Medicare & Medicaid



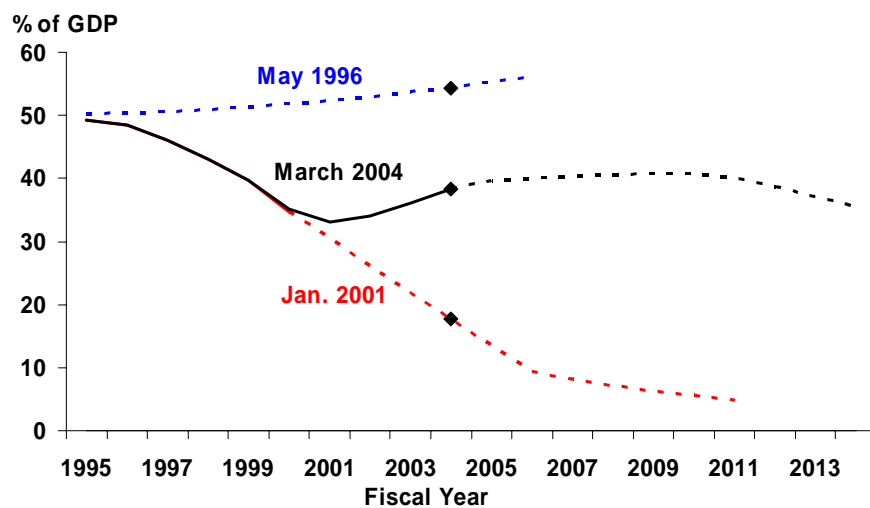
Federal debt projected to soar



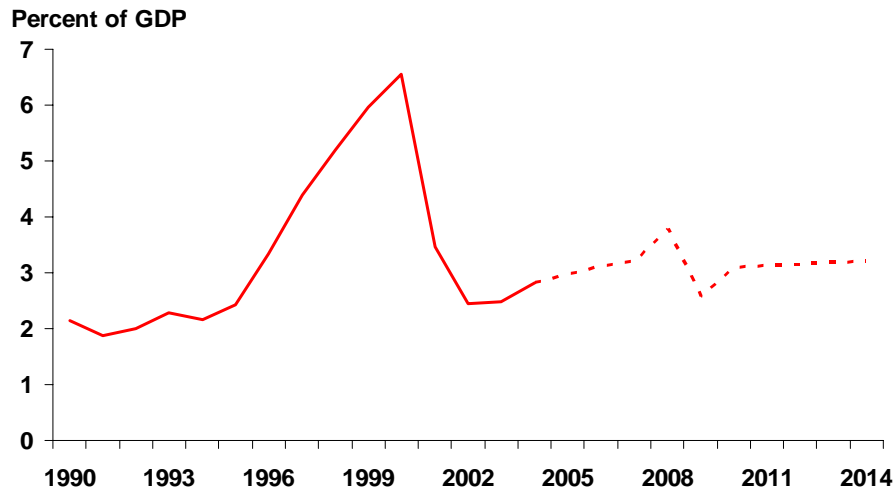
\$30 trillion Social Security-Medicare burden



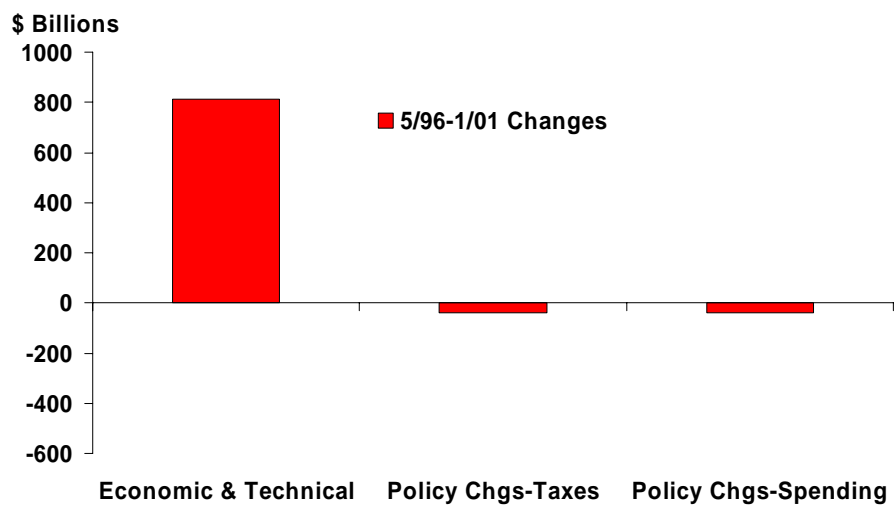
Debt lower than projected in 1996



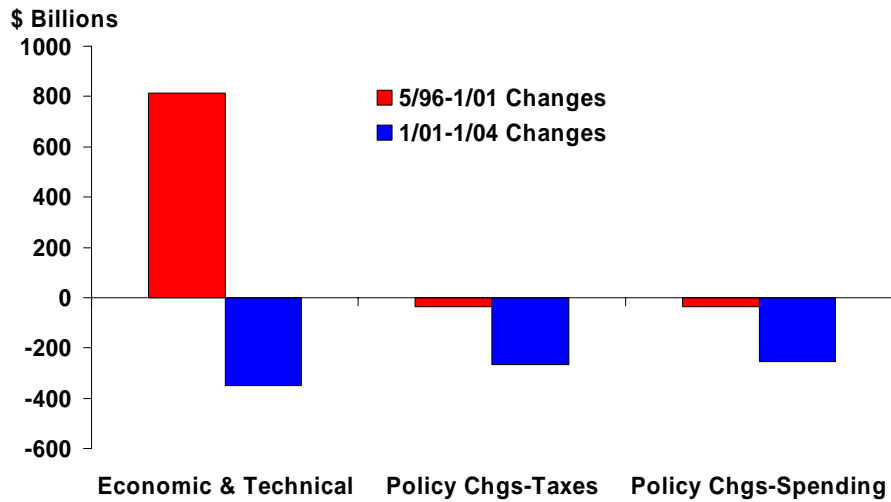
Capital gains realizations have returned to normal levels



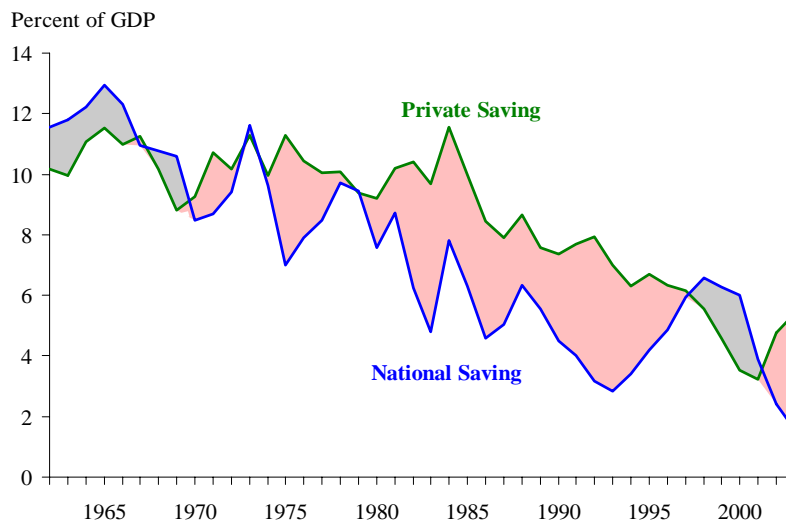
Sources of change in budget projection for 2004



Sources of change in budget projection for 2004



National saving falls as government saving turns negative



Proposed tax cuts add to deficit, spending cuts reduce deficit

