SUMMARY

When this report was published last year, the nation was in the midst of a recession that, predictably, was already having detrimental effects on the government's finances. What no one could predict was that just 20 days later, a lethal attack on America would exacerbate the recession and trigger extraordinary military, homeland defense, and repair expenditures that would at least temporarily make an enormous difference in the fiscal outlook.

By the February 2002 submission of the Budget for fiscal year 2003, the budgetary effects of the recession and the war on terror were well understood. It was also becoming apparent that the flood of revenue that produced record surpluses in the late 1990s was driven both by underlying economic growth, the traditionally decisive factor, and, in ways not yet fully grasped, by the extraordinary boom in the stock market. The markedly greater dependence of revenues on stock market developments was not yet understood by experts either inside or outside the government.

The economic recovery appears to be underway, the one-time costs of recovery are being paid, and the expense of war-fighting abroad and new protective resources at home have been incorporated in budget plans. Taking all these changes into account, the federal government is now projected to spend $165 billion more than it receives in revenues in 2002, up from the $106 billion projected nearly six months ago. Table 1 below comparing February and July estimates shows a return to the pre-recession pattern of surpluses in 2005, and growing surpluses thereafter. Future improvements, however, depend to a significant extent on two key factors: 1) restraint of the recent rapid growth in federal spending; and 2) a resumption of growth in tax payments produced by a stronger economy and a stronger stock market.

Moving Forward Amid the Backdrop of War

President Bush placed two purposes above all others in his 2003 Budget: Winning the war on terror and restoring the economy to health. On both fronts, initial progress has been encouraging. Military action in Afghanistan has depleted the ranks and greatly weakened the operational capabilities of the terrorists. On the economic front, the nation's gross domestic product (GDP) grew at an impressive 6.1 percent annual rate in the first quarter of 2002, making the recession both shorter and shallower than most and the early recovery far stronger than assumed in February's budget.

For the future, we can be certain only of the intentions of our adversaries and our own resolve to defeat them. We know neither the length of the conflict nor the budgetary expense of victory. Nor can we be certain the economy will not be weakened by further shocks. To preserve the flexibility to respond to future events while maintaining a fiscal framework that will return the budget to surplus, it is imperative that spending,

Table 1. CHANGES FROM 2003 BUDGET
(In billions of dollars)

	2002	2003	2004	2005	2006	2007	2003–2007
2003 Budget policy surplus	–106	–80	–14	61	86	104	157
Enacted legislation	34	33	17	33	4	2	89
Supplemental and other adjustments to Administration policy	–13	–7	–6	–3	–4	–3	–25
Economic and technical reestimates	–80	–54	–45	–37	–26	–18	–181
Total changes	–59	–29	–34	–8	–26	–20	–117
Mid-Session Review policy surplus	–165	–109	–48	53	60	84	41

Table 7. BUDGET SUMMARY BY CATEGORY

(In billions of dollars)

	2002	2003	2004	2005	2006	2007	2003–2007
Outlays:							
Discretionary:							
Defense	332	371	388	408	423	437	2,028
Nondefense	379	399	413	418	424	432	2,086
Subtotal, discretionary	711	771	801	826	847	870	
Emergency response fund	36	17	8	3	2	1	
Mandatory:							
Social Security	453	473	494	515	538	566	2,587
Medicare	223	232	242	260	282	307	1,324
Medicaid	147	161	173	188	205	223	950
Other mandatory	291	305	302	307	319	323	1,556
Subtotal, mandatory	1,114			1,270	1,345	1,419	6,417
Net interest	171			198	197	194	965
Total Outlays	2,032	2,138			2,390	2,483	11,526
Receipts	1,867	2,029			2,451	2,567	11,567
Surplus	–165	–109					41
On-budget surplus	–322	–282					–1,031
Off-budget surplus	157	173					1,072

Table 20. FEDERAL GOVERNMENT FINANCING AND DEBT

(In billions of dollars)

	2001 Actual	Estimate					
		2002	2003	2004	2005	2006	2007
Financing:							
Unified budget surplus (+)/ deficit (–)	127	–165	–109	–48	53	60	84
Financing other than the change in debt held by the public:.							
Premiums paid (–) on buybacks of Treasury securities [1]	–11	–4	....	....	....	....	....
Net purchases (–) of non-Federal securities by the National Railroad Retirement Investment Trust	....	–6	–11	–*	*	*	*
Changes in: [2]							
Treasury operating cash balance	8	–6	–5	....	....	–5	....
Checks outstanding, deposit funds, etc. [3]	–13	–12	10	....	....	....	....
Seigniorage on coins	1	1	1	1	1	1	1
Less: Net financing disbursements:							
Direct loan financing accounts	–19	–15	–15	–15	–15	–15	–15
Guaranteed loan financing accounts	–4	–2	3	3	4	5	5
Total, financing other than the change in debt held by the public	–37	–44	–17	–11	–9	–14	–8
Total, amount available to repay debt held by the public	90	–209	–126	–58	44	47	76
Change in debt held by the public	–90	209	126	58	–44	–47	–76
Debt Subject to Statutory Limitation, End of Year:							
Debt issued by Treasury	5,743	6,155	6,535	6,897	7,195	7,506	7,805
Adjustment for Treasury debt not subject to limitation and agency debt subject to limitation [4]	–15	–15	–15	–15	–15	–15	–15
Adjustment for discount and premium [5]	5	5	5	5	5	5	5
Total, debt subject to statutory limitation [6]		6,145	6,524	6,887			
Debt Outstanding, End of Year:							
Gross Federal debt: [7].							
Debt issued by Treasury	5,743	6,155	6,535	6,897	7,195	7,506	7,805
Debt issued by other agencies	27	27	26	26	24	24	23
Total, gross Federal debt	5,770	6,182	6,561	6,923	7,219	7,530	
Held by:.							
Debt securities held by Government accounts	2,450	2,654	2,906	3,210	3,550	3,908	
Debt securities held by the public [8]	3,320	3,529	3,655	3,713	3,669	3,622	

* $500 million or less

[1] Includes only premiums paid on buybacks through April 2002. Estimates are not made for subsequent buybacks.

[2] A decrease in the Treasury operating cash balance (which is an asset) would be a means of financing a deficit and therefore has a positive sign. An increase in checks outstanding or deposit fund balances (which are liabilities) would also be a means of financing a deficit and therefore would also have a positive sign.

[3] Besides checks outstanding and deposit funds, includes accrued interest payable on Treasury debt, miscellaneous liability accounts, allocations of special drawing rights, and, as an offset, cash and monetary assets other than the Treasury operating cash balance, miscellaneous asset accounts, and profit on sale of gold.

[4] Consists primarily of Federal Financing Bank debt.

[5] Consists of unamortized discount (less premium) on public issues of Treasury notes and bonds (other than zero-coupon bonds) and unrealized discount on Government account series securities.

[6] The statutory debt limit is $6,400 billion.

[7] Treasury securities held by the public and zero-coupon bonds held by Government accounts are almost all measured at sales price plus amortized discount or less amortized premium. Agency debt securities are almost all measured at face value. Treasury securities in the Government account series are measured at face value less unrealized discount (if any).

[8] At the end of 2001, the Federal Reserve Banks held $534.1 billion of Federal securities and the rest of the public held $2,785.9 billion. Debt held by the Federal Reserve Banks is not estimated for future years.

The difference is $412 billion -- the real deficit.