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Projecting the Surplus: A Discussion of Issues

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Summary

Budget surpluses are currently projected to sum to \$5.6 trillion by the Congressional Budget Office (CBO) over the 10-year budget window. The CBO baseline that produces these results is a budget tool; it is not meant to be a “best guess” about future spending and taxation. It follows fairly mechanical rules about extending existing policy into the future and generates results using assumptions about future economic conditions and their interaction with existing policies. This report illustrates how highly sensitive the projected surplus is to relatively minor changes in underlying assumptions about policy or the economy.

Of the policy assumptions discussed, those concerning the rate of growth of discretionary spending have the largest effect on the size of the surplus. Baseline rules assume that discretionary spending grows at the rate of inflation. It has not grown this slowly since the early 1990s. CBO estimates that if discretionary spending rose at the rate of economic growth, outlays would rise by \$906 billion more than the baseline over the 10-year forecast, and reduce the surplus by more than that amount due to higher interest costs.

Lower interest payments from falling debt account for about one-sixth of the on-budget surplus. But this assumes that the entire surplus is saved. If on-budget surpluses are not saved, higher interest payments would lower the projected surpluses by an estimated \$624 billion.

The baseline assumes that various spending and tax programs, notably tax credits, will not be renewed when they expire. Many of these programs have been renewed several times. OMB estimates that renewing all expiring programs would reduce the surplus by \$181 billion over the 10-year baseline.

The Alternative Minimum Tax (AMT) is not indexed for inflation, and tax credits will not be exempt from the AMT after 2001. Under current policy, these factors will increase the number of taxpayers paying the AMT from 1.3% in 2000 to an estimated 15.7% in 2010. Should Congress choose to counter these effects, it would lower tax revenues by an estimated \$125 billion. An additional \$192 billion in revenue reductions over 10 years would be necessary to counter the expanded coverage of the AMT resulting from parts of the proposed \$1.6 trillion tax cut.

Much of the projected surplus is generated by the economic assumptions underlying the 10-year baseline. Changing those assumptions even slightly has a considerable effect on tax revenues and outlays. CBO generated an “optimistic” scenario which would nearly double the size of the on-budget surplus. Alternatively, its “pessimistic” scenario drops the on-budget portion of the budget into deficit.

Further, if the projected unfunded liabilities of the Social Security and Medicare programs, which occur beyond the baseline window, were accounted for, the budget would still be in deficit. In other words, saving the entire unified budget surplus is projected to be insufficient to meet all current policy obligations for future benefits. This report will be updated as events warrant.

Contents

Discretionary Spending	1
Interest Payments	4
Baseline Treatment of Expiring Programs	4
The Alternative Minimum Tax	5
Unfunded Liabilities	6
Economic Assumptions	8
Conclusion	9

List of Figures

Figure 1. Historical Discretionary Spending	3
Figure 2. Projected Government Debt	7

List of Tables

Table 1. Additional Interest Payments from Using the On-Budget Surpluses for Spending or Tax Cuts	4
Table 2. CBO's Optimistic and Pessimistic Scenarios	9
Table 3. Surpluses Under Alternate Budget Assumptions	10

Projecting the Surplus: A Discussion of Issues

This year, the Congressional Budget Office (CBO) and the Office of Management and Budget (OMB) produced 10-year budget forecasts using the “baseline” concept. As CBO explains,

The baseline is intended to provide a neutral, nonjudgmental foundation for assessing policy options. It is not "realistic," because tax and spending policies will change over time. Neither is it intended to be a forecast of future budgetary outcomes. Rather, the projections ... reflect CBO's best judgment about how the economy and other factors will affect federal revenues and spending under existing policies.¹

Instructions for creating the baseline estimates are contained in the Budget Enforcement Act (BEA) as amended. Budget baseline estimates and projections, like all budget estimates, are sensitive to relatively small changes in the underlying factors. These changes can have substantial effects on the surplus projections. Critics have argued that several of the underlying assumptions or rules followed by CBO and OMB in making the budget baselines are not as realistic as they could be.

Applying alternative assumptions to the baseline can significantly reduce the projected size of the surplus, especially when combined with other policy proposals. Policy assumptions concerning future discretionary spending, expiring tax and spending provisions, and the Alternative Minimum Tax have reasonable alternatives. Some alternative economic assumptions could push the on-budget surplus (that part of the surplus excluding Social Security and the Postal Service) back into deficit. On the other hand, making some reasonable changes in underlying economic assumptions can produce substantially larger surpluses within the 10-year budget window, although the long-term budgetary pressures caused by the retirement of the baby boomers remain. The rest of the report examines the effects that some of these changes could have on the budget outlook.

Discretionary Spending

Discretionary spending, which accounts for about one-third of total outlays, presents a special problem to budget estimators. Since almost all discretionary funding comes through annual appropriations, Congress has significant control over the amounts involved. This means that there is no obvious growth rate of

¹ CBO, *The Budget and Economic Outlook*, Jan. 2001, p. 7. All CBO estimates come from this publication unless otherwise noted. OMB estimates come from *FY2002 Economic Outlook*, Jan. 2001.

discretionary spending to use in budget forecasts. In practice, however, most discretionary spending is effectively determined by the levels approved in previous years and the various ongoing commitments (such as contracts) that the government is tied to through its discretionary programs. Although the Budget Enforcement Act as amended (BEA) requires that OMB and CBO use an inflation adjustment for projecting changes in discretionary spending into the future in their respective baselines, such an adjustment is not necessarily the only reasonable one. For example, using historical averages, or GDP growth rates, or inflation plus population growth as the adjustment mechanism for discretionary spending would each produce somewhat different budget results for total discretionary spending, total outlays, and the surplus than the inflation-adjustment requirement. A smaller rate of increase would slow overall outlay growth, potentially increasing the size of future surpluses. A higher rate of increase would speed total outlay growth, potentially reducing future surpluses.

The inflation adjustments to discretionary spending called for in the baseline projections and in the Bush Administration budget proposals can be generated through the normal operations of the annual appropriations process without any substantial policy changes to discretionary programs.² In other words, Congress and the President could increase funding for existing discretionary programs by the amount of inflation without a need to significantly change existing programs to accommodate the higher level of spending.

In their budget reports this year, CBO and OMB, as required, assume that overall discretionary spending will stay constant in real, or inflation adjusted, terms. This has two implications. First, although discretionary spending keeps up with inflation, there is no adjustment for expected population growth. Under the baseline, therefore, future discretionary spending can buy the same amount of parks or roads or military equipment or government services, but there will be fewer of them per person. OMB estimates that adjusting discretionary spending for inflation and the rate of population growth would increase outlays by \$362 billion over the 10-year baseline.³

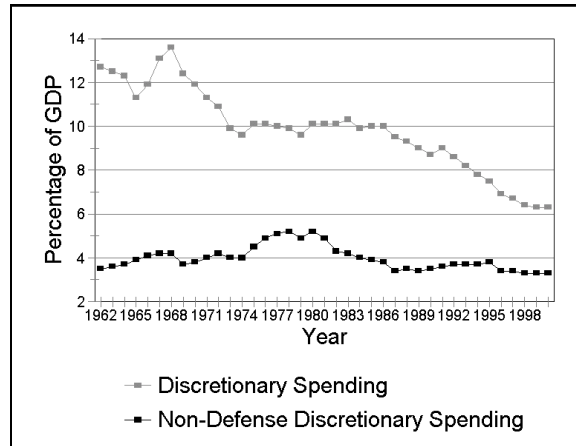
Second, since the economy, as measured by gross domestic product (GDP), is assumed to grow in real terms over the next 10 years, but real discretionary spending is assumed to remain constant, discretionary spending would fall as a percentage of GDP. One implication is that as society becomes wealthier, it will not want to spend any of its additional wealth on government-provided discretionary goods and services. Although there are undoubtedly some government-provided goods and services on which people may not wish to spend their additional wealth, it is not obvious why this would be true of total discretionary spending, as implied by the baseline. Over 10 years, adjusting discretionary spending for both inflation and GDP growth is estimated

² After an increase in discretionary spending that is higher than the rate of inflation in 2002, the Administration proposes to increase discretionary spending roughly at the rate of inflation throughout the rest of the 10-year budget projection.

³ OMB, *Op. Cit.*, p. 208.

by CBO to increase outlays by \$906 billion and by OMB by \$979 billion over their respective baseline levels.⁴

Figure 1. Historical Discretionary Spending



Source: CBO, *Budget and Economic Outlook*, January 2001.

Does recent history suggest what growth rate is most accurate for discretionary spending? As seen in Figure 1, total discretionary spending has, in fact, fallen slowly as a percentage of GDP for decades. Much of the recent decline came from a decline in military spending. This is often called the “peace dividend” resulting from the end of the Cold War; given its source, the decline in defense spending seems unlikely to continue. Non-defense discretionary spending rose slightly as a percentage of GDP in the 1970s before falling slowly in the 1980s and 1990s.⁵

While discretionary spending grew more slowly than GDP, it grew more quickly than the rate of inflation in all but one year between FY1975 and FY1989. In the 1990s, it fell in real terms from FY1990-1995, but then grew in real terms from FY1996-2000. In 2000, real discretionary spending grew at the rate of economic growth. Removing the effect of the fall in defense spending, non-defense discretionary spending increased, with a dip in FY1996, throughout the 1990s. The baseline assumption that discretionary spending will grow at the rate of inflation through FY2011 – while maintaining absolute discretionary spending in real terms – would drop total discretionary spending to its lowest share of GDP since the early 1950s.

⁴ OMB, *Op. Cit.*, p. 208; CBO, *Op. Cit.*, p. 77.

⁵ This could be interpreted as evidence that, overall, people do desire less non-defense discretionary spending as their income rises.

Interest Payments

Any policy change that either increases spending or lowers revenues from the baseline automatically reduces the surplus. Smaller surpluses slow the shrinkage in publicly held federal debt which, in turn, increases the government's interest payments from the levels in the baseline projections. This increase in interest payments is part of the "cost" of policy changes or adjustments to baseline assumptions that reduce surpluses. (Alternatively, changes that increase the surplus would reduce interest costs from the baseline levels.)

If the on-budget surplus were fully used for tax cuts or spending increases, federal debt would be larger in each year by the size of the baseline on-budget surplus for that year. This larger amount of debt would generate additional interest payments for the government. Table 1 presents estimates of the higher interest payments over the next 10 years from not saving the on-budget surplus. About one-sixth of the baseline surplus comes from the interest payment savings resulting from using the on-budget surplus for debt retirement.

Table 1. Additional Interest Payments from Using the On-Budget Surpluses for Spending or Tax Cuts
(Billions of Dollars)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2002-2011
Extra Interest from Extra Debt	3.6	12.0	21.6	32.3	44.1	48.0	40.0	30.3	18.6	6.0	256.6
Forgone Interest Income from Uncommitted Funds					1.0	12.0	38.0	68.0	104.0	144.0	367.0
Total Extra Interest	3.6	12.0	21.6	32.3	45.1	60.0	78.0	98.3	122.6	150.0	623.6

Source: CRS calculation using assumptions from CBO, *Budget and Economic Outlook*, January 2001.

Note: These calculations somewhat underestimate the size of the interest payments because they use interest rates based on an assumption that the surpluses will be saved. If they are not saved, economic theory suggests that interest rates will be slightly higher.

Baseline Treatment of Expiring Programs

Some government spending and tax programs, especially tax credits, have expiration dates. Both CBO and OMB are required to assume in their baseline estimates that these programs will expire as scheduled, since that represents current policy. The baseline reflects this assumption by increasing revenues by the size of the expired credit or reducing spending by the size of the expired program. But most of these expiring programs, especially the tax credits, have proven very durable and are routinely extended. Some examples of expiring programs include deductions for clean-fuel vehicles, qualified zone academy bonds, welfare-to-work credits, medical savings accounts, the credit for research and development, and empowerment zone credits. In its January 2001 report, OMB estimated that if all expiring provisions were renewed, the 10-year surplus would be reduced by a total of \$181 billion from 2002-

2011, split between \$63 billion for higher outlays and \$118 billion for reduced tax revenues.⁶ CBO estimated the total from renewing tax provisions to be \$112 billion.

The Alternative Minimum Tax

The original purpose of the alternative minimum tax (AMT) was to assure that high-income taxpayers are not able to largely avoid paying taxes by using credits, exclusions, and deductions for which they are eligible.⁷ Pressure to alter the current AMT rules, which would have an effect on expected surpluses, may well grow over the next few years for a number of reasons.

First, the AMT is not inflation adjusted, so that as inflation raises nominal incomes over time, more taxpayers fall under the AMT even if their inflation-adjusted income remains constant. The Office of Tax Analysis (OTA) of the Treasury Department estimated that under current law, the percentage of taxpayers paying the AMT could rise from 1.3% in 2000 to 15.7% in 2010. Indexing the AMT to inflation to prevent this from happening could reduce revenues by an estimated \$83 billion (and result in a smaller surplus) over 10 years.⁸

Second, personal tax credits are currently exempt from AMT calculations, but this exemption is set to expire in 2001. CBO's baseline estimates indicate that extending this exemption would cost \$42 billion over 10 years. If the exemption is allowed to expire, then the adoption of any new personal tax credits, or expansion of existing credits, might trigger the AMT for some higher income individuals. The adoption or expansion of several credits were considered in the last Congress and in the Administration's FY2002 budget *Blueprint*.

Third, Congress appears to be interested in reducing marginal income tax rates (the House adopted an across-the-board rate reduction on March 8, 2001; H.R. 3). The Joint Tax Committee, when estimating the revenue impact of an income tax proposal, does not assume that a tax cut will spur a change in the AMT. Yet it appears that in some tax reduction proposals, such as H.R.3, many taxpayers will immediately fall under the AMT when their marginal rates are lowered. Thus, if a major tax reduction were to become law, it seems likely that pressure to reform the AMT would increase. The Joint Committee on Taxation estimates that addressing this issue in the Bush campaign proposal would reduce revenues by \$192 billion from 2002-2010.

⁶ Emergency farm spending accounts for the bulk of the estimated additional revenues. Since the passage of the Federal Agriculture Improvement and Reform (FAIR) Act (P.L. 104-127), there has been emergency farm spending each year. It is unclear how large this spending will be in the future, so OMB assumes that it will equal its average from the past three years.

⁷ For more information, see U.S. Library of Congress, Congressional Research Service, *The Alternative Minimum Tax for Individuals*, by Gregg Esenwein, CRS report RL30149.

⁸ Robert Rebelein and Jerry Tempalski, *Who Pays the Individual AMT?*, Office of Tax Analysis Working Paper 87, June 2000. These estimates were done under lower economic growth rates than currently being employed by CBO and OMB. Thus, by the new growth estimates, these figures are understated.

All of these issues will likely be considered at some point by Congress and the President. Some observers contend that a modified AMT that takes some of these arguments into account would be a more realistic baseline assumption.

Unfunded Liabilities

Unlike corporations, the government considers only current-year liabilities in its budget for two reasons. First, only the current budget balance, the surplus or deficit, affects aggregate demand in the current economy. Second, unlike corporations, the government has the power (theoretically) to alter its revenue (i.e., taxes) or spending levels as necessary to meet almost any future funding need. Nonetheless, long-range projections indicate that the government faces very large liabilities in its Social Security and Medicare programs (as currently structured) beginning in the second decade of this century. The retirement of the baby boom generation will put enormous pressure on government finances. The benefits of these “pay as you go” programs are funded by current workers. Over the next 30 years, the ratio of workers per beneficiary is expected to fall from 3.4 to about 2.

In its *Long Term Budget Outlook*, CBO (October 2000) calculates the long-range budget balance that includes the cost of these unfunded liabilities. While estimating errors over a time frame that long are likely to be large, CBO estimates that even if the total surpluses are saved, the budget contains an average annual “fiscal gap” of 0.8% of GDP over the next 75 years. In other words, on average the budget balance over the next 75 years is projected to be in deficit (by 0.8% of GDP), not surplus. Most fiscal experts believe that further spending reductions or tax increases will be required to eliminate the long term fiscal imbalance. CBO estimates that if only off-budget surpluses are saved, the fiscal gap would increase to 2.2% of GDP over the 75 years.

Figure 2 illustrates the explosive growth in federal debt in mid century that would result from the long-term budget imbalance, or fiscal gap, that currently exists in fiscal policy. The national debt is projected to be reduced quickly in the next few years if the entire unified budget is saved. After the debt is eliminated around 2010, the government would accumulate private assets until around 2030. But after 2030, the rapid retirement of the baby boomers will cause large budget deficits to reappear. These unfunded liabilities are forecast to exhaust the government’s stock of private assets in about 20 years. After that, the unfunded liabilities would cause the federal debt to rise to unsustainable levels above 200% of GDP in mid-century. Saving only the off-budget surpluses produces the same result, only sooner. Since the government’s stock of private assets would be much smaller, large budget deficits would return around 2020, pushing the debt above 200% 20 years earlier than if the entire unified surplus were saved.

The government has three choices for reducing the funding shortfall for these future liabilities: 1) using the surplus to increase national saving; 2) reducing benefit levels; or 3) increasing future taxes. The first option can be done either through the retirement of the national debt, which frees up private saving for greater private investment, or through some method of government investment in the private sector. Government accumulation of private assets can occur either through funding private

accounts or directly by government purchase, as was assumed in Figure 2.⁹ Economic theory sees little difference in how the government uses the surplus to increase national saving, whether it be through direct investment in the private sector or through the funding of private accounts. While increasing the national saving rate does not directly reduce these liabilities, it can mitigate their future burden on the economy by spurring greater capital formation which increases the future size of the economy.¹⁰ A larger future economy would ease the problems of paying for these future obligations.

Figure 2. Projected Government Debt



Source: CBO, *Long-Term Budget Outlook*, October 2000

⁹ The government accumulation of private assets would become necessary if the budget remained in surplus after the national debt was retired.

¹⁰ This is the concept behind the Social Security trust fund. Increasing the trust fund holdings of U.S. Treasuries does not give the government any real financial assets because the government is lending to and repaying itself. Rather, many economists believe that if the Social Security surpluses are used to retire debt, as is currently done, the shrinking federal debt should increase the future size of the economy through increased private investment. The problem is that even the additional economic growth implied by the increase in national saving spurred by an increased trust fund does not appear to be enough to fund the current level of various program benefits (without severe economic disruption) for the large number of baby-boom retirees that become eligible in the first three decades of this century.

Similar arguments can be made for reserving the Medicare and federal retirement trust fund surpluses for debt retirement because these trust funds are meant to fund future liabilities. The Medicare trust fund, combining Part A and Part B, totals \$407 billion over the 10 year forecast. The civilian and military retirement funds total \$419 billion.

Economic Assumptions

One of the most remarkable facts about the surplus projections is that they have continued to grow by billions of dollars with each updated forecast over the last several years. In recent forecasts, much of the growth has come from more optimistic economic assumptions and their interaction with revenue estimates. Experience has demonstrated that long-term budget and underlying economic forecasts generally are widely off the mark.¹¹ From 1981-1999, the average absolute value of the error in CBO's estimated surplus for the following budget year was 1.1% of GDP, after adjusting for policy changes. In 2000, 1.1% of GDP equaled \$109 billion. The average error for five years in the future was 3.1% of GDP. This variation could nearly double or eliminate the projected surplus in FY2006. For FY2006, 3.1% of GDP would amount to \$412 billion, less than \$100 billion below the CBO baseline unified surplus for that year (\$505 billion) and \$100 billion more than the Administration's projected surplus for that year, \$307 billion.

Complicating the long-term projections further is the current uncertainty over whether or not the economy is undergoing a shift towards a permanently higher rate of productivity growth.¹² Additionally, the unemployment rate has fallen below a rate that most economists previously considered consistent with a stable inflation rate; no one is certain how long this change will last.¹³ Forecasters are uncertain about how much of the recent changes might be permanent, which makes the task of producing the underlying economic outlook for the 10-year budget projections very difficult. Yet these changes have a major influence on budget projections.

To illustrate the uncertainty underlying the baseline estimates, CBO created a pessimistic and an optimistic baseline scenario in its January 2001 budget report. Table 2, below, contains CBO's total and on-budget surpluses from the optimistic and pessimistic baseline scenarios. The optimistic scenario assumes that the higher rates of economic and productivity growth are permanent. This scenario also assumes a lower rate of increase for government health care costs than in the midrange baseline, and assumes that much of the recent unexpected growth in tax revenues is permanent. The pessimistic scenario assumes that there has been no permanent increase in productivity, and that labor productivity returns to its post World War II average annual rate-of-growth of 1.5%. It also assumes that a portion of the unexpected tax revenue growth in the 1990s fades away over the next five years and that the costs of

¹¹ For more information, see U.S. Library of Congress, Congressional Research Service, *Uncertainty in Budget Projections*, by Philip Winters, CRS report RL30854.

¹² See U.S. Library of Congress, Congressional Research Service, *The New Economic Paradigm: Is It New and Is It a Paradigm?*, by Marc Labonte and Gail Makinen, CRS report 98-90E; and *The U.S. Long Term Growth Rate: Has It Increased?* by Craig Elwell, CRS report RS20608.

¹³ See U.S. Library of Congress, Congressional Research Service, *Why Has the Unemployment Rate Fallen When Inflation Is Stable?*, by Marc Labonte, CRS report RL30738.

Medicare and Medicaid grow one percentage point faster than the mid-range baseline.¹⁴

Table 2. CBO's Optimistic and Pessimistic Scenarios
(Billions of Dollars)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2002-2011
Pessimistic												
Total Surplus	257	238	215	175	140	152	156	148	144	136	122	1,627
On-Budget Surplus/Deficit(-)	103	73	39	-8	-57	-56	-64	-87	-102	-120	-143	-525
Optimistic												
Total Surplus	310	386	485	583	676	797	913	1,031	1,168	1,323	1,494	8,856
On-Budget Surplus/Deficit(-)	153	212	291	373	444	543	638	733	848	981	1,129	6,193

Source: CBO, *Budget and Economic Outlook*, January 2001.

Even without any policy changes, the CBO optimistic scenario would roughly double the 10-year cumulative *on-budget* surplus over the baseline amount. The pessimistic scenario, without a tax cut or other policy changes, would reduce the on-budget surplus, pushing it into deficit in FY2004 with increasingly large on-budget deficits for the remaining years of the 10-year period. It produces a 10-year cumulative on-budget *deficit*.

Conclusion

Budget estimates and projections are highly uncertain. Most recently the estimates have consistently underestimated the size of the surpluses; during much of the 1980s they consistently underestimated the size of the deficit. The baseline estimates produced by CBO and OMB, as for all such estimates, are the result of choices about how to interpret the myriad of variables that are necessary to produce an estimate of the federal budget. The rules that CBO and OMB must follow in producing their estimates are in many cases determined by law (the Balanced Budget Act of 1985 and the Congressional Budget Act of 1974) regardless of the accuracy of the estimates these rules produce. The topics highlighted in this report are not exhaustive; there are other factors that could be mentioned. For example, OMB estimates that if guaranteed spending for certain transportation and conservation programs had been included in the baseline, it would increase outlays by \$31 billion over 10 years.

Table 3 summarizes the estimated cost effects of the selected components of the baseline over the 10 year period, FY2002 through 2011, that were discussed here. When combined, the estimated cost of these components, plus the associated increase in interest payments, could reduce the on-budget surplus by about one-third. The remaining on-budget surplus would be roughly \$2 trillion.

¹⁴ CBO has a separate baseline estimate that assumes the U.S. will undergo a recession similar to 1990-1991. Interestingly, this assumption has very little effect on the size of the surpluses over the 10-year window, although it reduces the surplus significantly in the recession year.

Table 3. Surpluses Under Alternate Budget Assumptions

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2002-2011
CBO Baseline Surplus	313	359	397	433	505	573	635	710	796	889	5,610
CBO Baseline On-Budget Surplus	142	171	196	212	267	316	359	417	484	558	3,122
All Expiring Tax Provisions Renewed	-2	-4	-5	-8	-10	-12	-14	-16	-19	-22	-112
AMT Indexation	-1	-2	-3	-5	-7	-10	-14	-18	-24	NA	-83
Discretionary Spending Grows with GDP	-6	-19	-35	-55	-74	-95	-118	-142	-167	-195	-906
Additional Interest Payments	0	0	-1	-3	-4	-6	-7	-9	-10	-11	-53
Remaining On-Budget Surplus	133	146	151	141	172	194	206	232	264	330	1,968

Source: CBO, Budget and Economic Outlook, January 2001; OTA, *Who Pays The Individual Alternative Minimum Tax?*, June 2000; CRS calculations using CBO assumptions.

Note: Expiring totals include only tax provisions, not expiring spending provisions. AMT correction would index the taxable income amounts by the rate of inflation (renewing the tax credit provision of AMT is included in the expiring tax provision category.) It does not consider an AMT correction to account for changes in income tax rates. Discretionary Spending remains a constant percentage of GDP after 2001. The estimated increase in interest payments was based on the three assumptions made in the table.

Under the pessimistic economic assumptions, shown in Table 2, even without any policy changes, the on-budget surplus falls into deficit in FY2004. Under optimistic economic assumptions, the baseline would remain comfortably in surplus, even after major policy initiatives. Under any set of reasonable assumptions, however, the total baseline unified surplus cannot produce a sufficiently large increase in national savings to produce a future economy big enough to meet all of the budget's long-term unfunded liabilities that will accrue when the baby boomers retire.

