The Concord Coalition

1011 Arlington Blvd ♦ Suite 300 ♦ Arlington, VA 2209
(703) 894-6222 ♦ FAX (703) 894-6231
www.concordcoalition.org

Issue brief **August 31, 2005**

New Budget Outlook: A Little Good News and a Lot of Red Ink

I. Introduction

As Congress returns from its summer recess, there is at least one positive thing to report on the budget front: the deficit will be lower this year than it was last year. In its August Update of the annual *Budget and Economic Outlook*, the Congressional Budget Office (CBO) projects a fiscal year 2005 deficit of $331 billion — down $81 billion from the record $412 billion deficit set in 2004.[1]

That good news is only superficial. There is a lot of red ink in the projections. The lower deficit in 2005 does not appear to signal a new trend of steadily declining deficits or a positive shift on the part of policymakers to make deficit reduction a priority. As summarized by CBO, "The budget outlook for 2005 has improved noticeably since [the previous baseline projections], but the longer-term outlook has changed little."[2]

Unfortunately, the main conclusion to be drawn from CBO's August Update is that the federal budget remains mired in the deficit doldrums, both now and in the future. Assuming continuation of current laws and policies, CBO projects annual deficits in excess of $300 billion through 2010. Looking ahead, CBO warns that, "growing resource demands for [Social Security, Medicare and Medicaid] will exert pressure on the budget that economic growth alone will not eliminate."[3] Such pressure, says CBO, "is likely to make current fiscal policy unsustainable."[4]

II. The short-term improvement may be just that

The biggest change in CBO's budget outlook for fiscal year 2005 is an unexpected revenue boost of $85 billion. According to CBO's new projections, higher revenues this year will more than

---

[1] The President's Office of Management and Budget (OMB) reached a very similar conclusion in July, projecting a fiscal year 2005 deficit of $333 billion.
[2] CBO, *The Budget and Economic Outlook: An Update*, August 2005, p.1.
[3] Ibid. at *Summary*, p. X.
[4] Ibid. at p.3.

make up for new spending, primarily for operations in Iraq and Afghanistan. In total, CBO's deficit projection for this year has declined from $390 billion in March to $331 billion.[5]

The key consideration for policymakers is the extent to which this year's revenue surge justifies higher revenue projections in future years. In its Mid-Session Review (MSR), issued on July 13, the President's Office of Management and Budget (OMB), assumed that much of the increase would remain in the baseline and made an upward adjustment of revenues totaling $410 billion for fiscal years 2006 through 2010. The CBO August Update takes a more cautious approach, assuming that roughly three-quarters of the unexplained revenue growth this year is a temporary phenomenon. Over the same five fiscal years covered by the OMB baseline, CBO adjusted its revenue assumption upward by $157 billon — most of which is concentrated in 2006 and 2007.

Table 1
Comparison of economic and technical adjustments to revenue projections
Fiscal Years 2005-2010
In billions of dollars

	2005	2006	2007	2008	2009	2010	Total 2006-2010
OMB	87	95	84	81	77	73	410
CBO	85	68	41	20	16	13	157
Difference: OMB minus CBO	2	27	43	61	61	60	253

As the table above illustrates, OMB's more buoyant assumption about the staying power of this year's revenue boost has a significant affect on the baseline, particularly in the out years. According to CBO, the Administration's overall revenue assumption is now about $300 billion higher than its own over the next five years when adjusted for "conceptual and timing differences."[6]

Because detailed information on recent tax returns will not be available for another year or more, it is impossible for analysts at either CBO or OMB to say with certainty whether this year's unexpected revenue growth is likely to be temporary, permanent, or somewhere in between. However, preliminary indications and prudent fiscal planning argue in favor of CBO's cautious approach. As detailed in the following section, the baseline already contains a number of optimistic assumptions. There is no need to add a rosy outlook for future revenues in the absence of more solid evidence.

According to CBO, roughly two-thirds of the revenue surprise this year has come from corporate taxes.[7] CBO now expects corporate receipts to be up by or 42 percent ($53 billion) instead of 14 percent, as projected earlier this year. While some have argued that this shows the importance of recent tax cuts in stimulating the economy, CBO found that "very little of the unexpected

[5] The official baseline in March projected a 2005 deficit of $365 billion. That number, however, did not include proposed supplemental spending for operations in Iraq and Afghanistan. According to CBO, including such spending, which has since been enacted, would have brought the March deficit projection to $390 billion.
[6] CBO August Update, p. 50.
[7] OMB's revisions were more evenly spread between individual and corporate income tax receipts.

revenue can be attributed to changes in the economic projection."[8] Of the several other explanations CBO considered, only one — a higher ratio of gross profits to net profits — was deemed to be lasting. This conclusion is what accounts for CBO's decision to treat about one-quarter of this year's revenue surprise as permanent. As for other possible explanations, the August Update states: "On the basis of its analysis of those possible sources, CBO is treating most of the unexplained strength in receipts as temporary"[9]

III. Baseline adjustments show an alarming picture

The new projections for the 2006 to 2015 period show much higher deficits than the estimates CBO published in its last update of the official baseline (see Table 2). The March baseline showed surpluses reappearing in 2012 and a cumulative 10-year deficit of $980 billion. In contrast, the new report shows annual deficits remaining throughout the period totaling $2.1 trillion.

The change is not as dramatic as it appears. Roughly 80 percent of the apparent deterioration in the 10-year outlook comes from assuming annual repetition of the supplemental funds provided in May to pay for war-related costs, anti-terrorism activities and tsunami relief. As CBO is careful to note, these changes do not "indicate a significant shift in the budget outlook; rather they result mainly from extrapolating nearly $84 billion in supplemental appropriations enacted since March as required under the rules governing the baseline." [10]

In addition, CBO made upward adjustments in spending for Medicare and Social Security and additional debt service costs. Those higher outlays are partially offset by increased revenue projections that reflect revised estimates of growth in the economy and other technical factors.

Table 2. CBO Baseline Projections
(in billions of dollars)

	Actual 2004	Estimates 2005	2006	Total 2006-2015
March 2005				
Revenues	1,880	2,057	2,213	29,891
Outlays	2,292	2,422	2,511	30,871
Surplus(+) /Deficit (-)	-412	-365	-298	-980
August 2005				
Revenues		2,142	2,280	30,071
Outlays		2,473	2,595	32,180
Surplus(+) /Deficit (-)		-331	-315	-2,110
Change Since March				

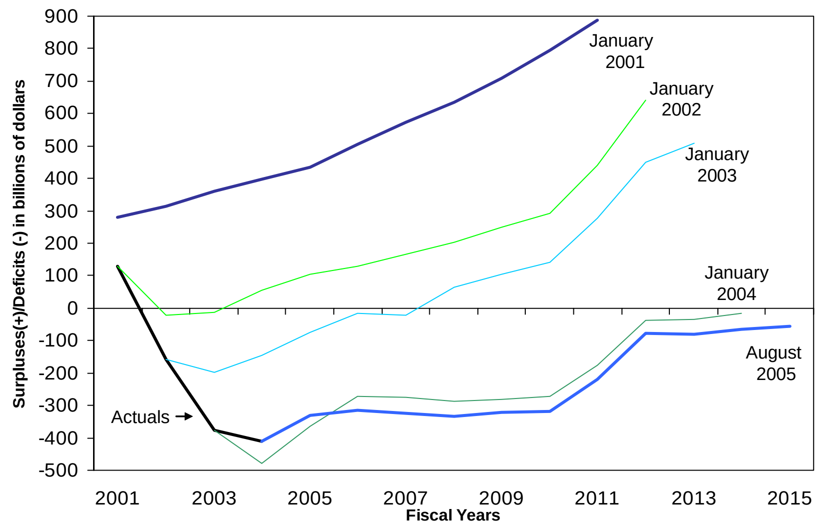
[8] CBO August Update, p. 12.
[9] Ibid.
[10] Ibid. at Summary, p. X.

Revenues	85	68	179
Outlays	51	84	1,309
Surplus(+) /Deficit (-)	33	-16	-1,130

SOURCE: Congressional Budget Office, March and August 2005.

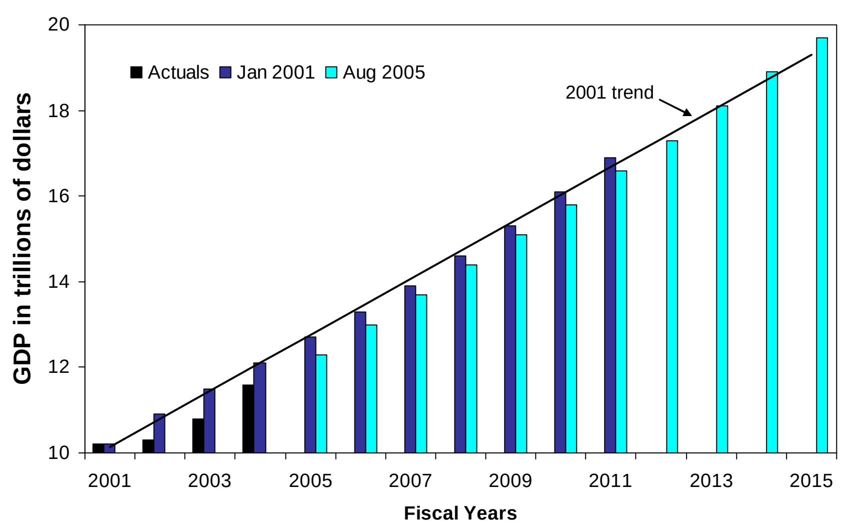
Viewed from a different perspective, however, the new projections reveal a worsening trend for the budget outlook. CBO's projections for the bottom line have steadily deteriorated since January 2001 (see figure 1) despite an economy that has long since recovered from the effects of the 2001 recession and the September 11 terrorist attacks (see figure 2).

Figure 1. CBO's Deficit (-)/Surplus (+) Projection



Source: Congressional Budget Office

Figure 2. CBO's Baseline Projections for GDP



Source: Congressional Budget Office

Actual budget outcomes tend to be worse than CBO's baseline projections, which assume no changes to current polices.[11] The experience of the last several years demonstrates that legislative activity is likely to increase deficits, particularly since there is no consensus to balance the budget and strong enforcement measures that would hold the budget in check are absent.

This year will be no exception. The Fiscal Year 2006 Congressional Budget Resolution contains instructions that allow tax cuts of $106 billion over 5 years - three times the amount of cuts called for in mandatory spending. On the discretionary side of the budget, Congress and the President have already approved a $10.5 billion supplemental spending bill in response to the devastation of Hurricane Katrina. Significantly higher amounts can be expected as the full extent of the damage to the Gulf Coast region becomes apparent. While no one would suggest that the government should not fully respond to such natural disasters because of the deficit, these added costs point up the disingenuous tendency of policymakers to budget on the assumption that hurricanes, earthquakes, floods and the like will never occur - even tough they do occur with regularity.

Current baseline projections are unusually complicated by a number of other factors as well — some on the spending side and some on the revenue side. On the spending side, the baseline is complicated by the treatment of operations in Iraq and Afghanistan. The Bush Administration has chosen to treat each year's expense as a one-time event on the theory that future costs are unknowable. This has the effect of understating outlays in the President's budget projections because it assumes no continuing costs in Iraq and Afghanistan even though, as the Administration acknowledges, that will not be the case.

On the other hand, CBO's August baseline probably overstates likely costs for these operations because, in keeping with the scoring conventions of budget laws, it assumes that this year's level of appropriations (including the war costs) will continue each year adjusted for inflation. The effect of this is to assume that operations in Iraq and Afghanistan will continue at their current level for the next 10 years. While this outcome is not impossible, a more probable projection would fall somewhere between 10-year costs at the current level and the Administration's official assumption that there will be no further costs.

The revenue side of the baseline is complicated by two factors; the scheduled expiration in 2011 of the tax cuts enacted since 2001 and the growing toll of the alternative minimum tax (AMT), which if not adjusted will apply to roughly eight times as many taxpayers by 2010 as it does today. In preparing its baseline, CBO must assume that current law is carried out; it cannot assume policy changes. Thus, however politically improbable, the baseline assumes a revenue windfall from expiring tax cuts in 2011 and rapidly growing receipts from the AMT.

Taking all these factors together, CBO's August baseline is probably too optimistic. A more plausible deficit path based on recent experience would:

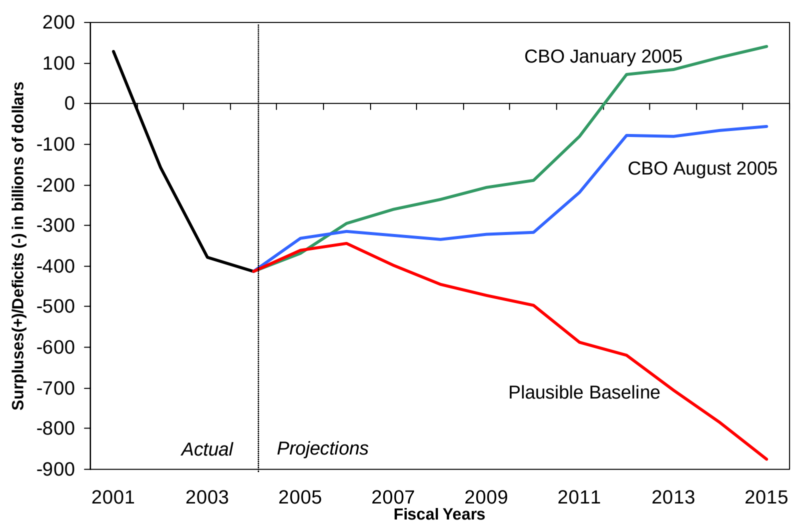
---

[11] The exception was 1993 through 1998, when CBO's projections were too pessimistic. Budget surpluses developed much sooner that CBO anticipated and were larger than expected.

- Assume a phase-down of supplemental funding for Iraq and Afghanistan and assume that regular appropriations grow with the economy instead of at the rate of inflation as assumed in the baseline (net added spending of $840 billion)
- Assume continuing relief from the AMT by adjusting it for inflation ($640 billion revenue loss)
- Assume that expiring tax cuts are extended as proposed by the President and Republican majority in Congress ($1.63 trillion revenue loss)
- Deduct another $500 billion for added debt service cost on the above changes

Under that scenario, deficits would total $5.7 trillion over the 2006 to 2015 period, instead of the $2.1 trillion projected by CBO's official baseline (see figure 3).

Figure 3. Plausible Baseline Deficits



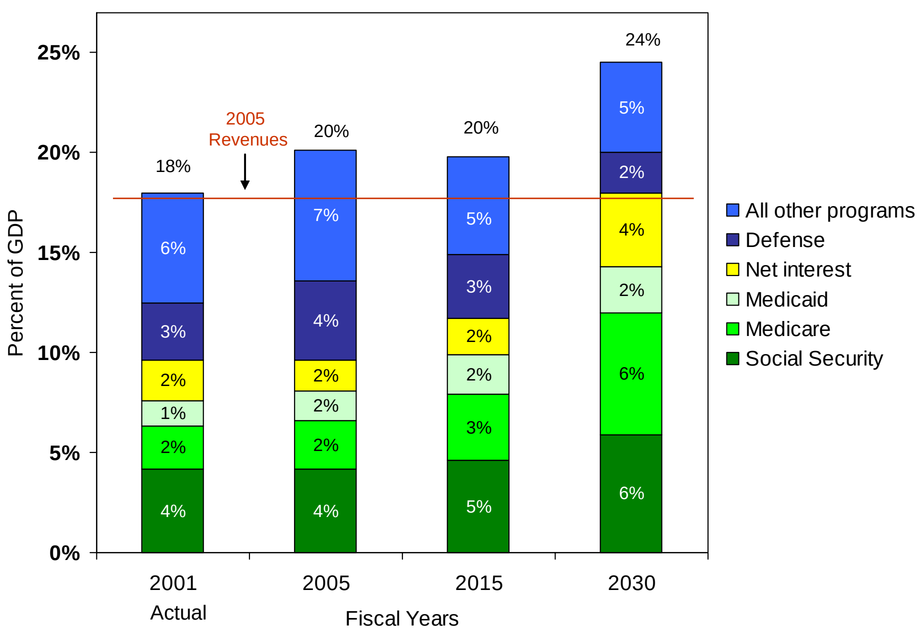
IV. Trouble Ahead

Deficits of the size that appear likely in the coming years are problematic because they cause federal debt to grow faster than the economy. Under the August Update baseline assumptions, debt held by the public grows from 37.7 percent of the economy (GDP) to 39.7 percent by 2010. It then begins to decline, primarily because of the assumed revenue windfall from expiring tax cuts and the AMT. However, under the more plausible scenario outline above, debt held by the public would reach 43 percent of GDP in 2010 and 53 percent by 2015. The last time debt held by the public was over 50 percent of GDP was in the 1950s. At that time, however, debt was on the way *down* from the heights it had achieved to pay for World War II.

Over time, unless current policies change, deficits and debt would rise to unsustainable levels that would threaten the nation's future economy. As the government's debt increases, its interest costs grow as well. Those costs use up precious resources that could be directed to other purposes. CBO estimates that the federal government's interest costs will be $182 billion in 2005—equivalent to the federal cost of the Medicaid program. In 2015, net interest costs will rise to $355 billion, according to the baseline projections—equivalent to one and a half times the projected cost of all federal income support programs (e.g., unemployment compensation, food stamps, child nutrition, and supplemental security assistance) or more than half of projected Medicare costs. Under the plausible scenario outlined above, interest costs by 2015 would exceed $500 billion.

Beyond fiscal imbalance, the policies embedded in today's budget threaten to place ever-tighter constraints on the ability of future citizens and policy makers to determine their own fiscal priorities. The share of federal resources pledged to aging baby boomers and the generations immediately preceding them is growing, leaving shrinking amounts for all other purposes (see figure 4). CBO projects that federal revenues in 2005 will reach 17.5 percent of the economy (GDP). Spending for Social Security, Medicare, Medicaid and net interest will claim more than half (57 percent) of that amount. In 2015, if revenues remain at today's levels relative to GDP, more than two-thirds of all federal receipts would be used for those costs. By 2030, CBO projects that the cost of Social Security, Medicare, Medicaid and net interest — alone — will require a higher percentage of revenues as a share of GDP than is required today for the *entire* federal government.

Figure 4. Increasing Rigidity in Federal Spending



Source: CBO, January 2001, December 2003 and August 2005.

Policy makers find it difficult to cut spending for Social Security, Medicare and Medicaid. They have to pay debt service — the one true item of "mandatory" spending in the budget. As a result, unless future taxpayers are willing to raise taxes considerably, they will either have to accept much lower spending for other public purposes—including national defense and homeland security—or they will face larger and larger deficits and the resulting negative consequences for the economy and future standards of living.

V. Greater Uncertainty and Risk

Conventional economic wisdom holds that persistent deficits should result in higher interest rates, lower investment and slower growth. However, despite the sharp reversal in fiscal fortunes and despite rising short-term rates, long-term interest rates have remained low. That circumstance has allowed some pundits to claim that deficits don't matter. In the absence of "pain" or a clear crisis, elected officials seem unwilling to take the actions necessary to reduce the budget's red ink.

CBO explains that interest rates have remained low because foreign sources of capital are, thus far, willing to finance federal deficits (as well as make up for our low private savings rates). However, that foreign investment has distinct downsides. For example, through the interest rate function, it increases the budget's exposure to international capital markets and decisions made by foreign interests. The current favorable environment could change quickly — driving down the value of the dollar and driving up domestic interest costs for the federal government and everyone else. In addition, debt service payments go to bond holders from abroad and drain financial resources away from the U.S economy and taxpayers.

VI. Wishful thinking is not a prudent fiscal strategy

We could cross our fingers and hope that the U.S. economy is sufficiently resilient to overcome anticipated fiscal challenges without any change to current policies. However, as CBO points out, this outcome seems unlikely. A far more prudent and secure path to bettering the fiscal outlook would be to once again undertake constructive action to reassert control over fiscal policy and to restore budget discipline. There is no shortage of warning signs:

- Economic growth, while strong today, will slow as the proportion of retirees to active workers increases. CBO projects that real economic growth will decline from an annual rate of 3.8 percent to 2.5 percent between 2005 and 2015. As the economy expands more slowly, it will be harder to fulfill the needs of a growing and aging population.

- CBO projects that real growth in Medicare and Medicaid will outpace the annual growth in the economy: Medicare by more than 2 percent and Medicaid by 1 percent. Those estimates don't anticipate costly advances in treatment and technology that could drive costs even higher and place greater pressure on the budget.

- Private employers also face pressures as a result of the aging population. Many private defined benefit pension plans are underfunded and require additional employer contributions to bring plan assets more into line with liabilities. In addition, rising health insurance costs make it harder for employers to maintain benefit levels for their retirees.

If the private sector cuts back its support for retirement income and health insurance, there will be greater pressure to increase public programs.

- The economy faces many uncertainties. Oil and energy prices are rising and are unpredictable. World events may affect the international economy and place additional demands on U.S. resources. The United States would be in a stronger position to weather difficult times if it had greater flexibility and strength in its fiscal position.

- The strength of the future economy depends on an educated workforce, productive capacity, sources of energy and solid infrastructure. If there is no financial slack in public budgets because available resources are already committed to supporting the standards of living of older people and paying debt service, it will be harder to find the funding to invest in children, research and development, transportation and communication, and other factors that will promote future growth.

Policymakers could credibly claim that the budget outlook is improving if their proposals and actions progressively closed the gap between spending and revenues. As long as they are content to ignore the unsustainable long-term trend and to keep near-term revenues at 17 to 18 percent of GDP, while spending 19 to 20 percent of GDP, they are a long way from being able to declare victory.

There is much more work to be done.