



COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET

BUDGET UPDATE
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And So Budget Season Begins

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The President's budget projects a decline in the deficit from \$423 billion in FY 2005 (3.2% of GDP) to \$205 billion in FY 2011 (1.2% of GDP). The President has proposed further savings in mandatory spending this year—a positive step. However, the proposed savings in mandatory spending programs and the cuts in non-defense discretionary spending programs would be more than offset by the tax cuts and other increases in spending. Though the deficit is projected to decrease under the proposed budget in the short-term, the President's policies would actually increase the deficit over the five-year window from what it would otherwise be.

Furthermore, the budget relies on a number of unrealistic assumptions and gimmicks to limit the size of the proposed deficit. While the budget includes the full costs of expected military operations in Iraq and Afghanistan for FY 2006, the placeholder for costs in FY 2007 will not be sufficient. Additionally, the budget only has a one-year patch for the Alternative Minimum Tax in 2006. Under more realistic assumptions that include costs for Iraq and Afghanistan and remove the revenue windfall from the AMT after 2006, the projected deficit would be nearly \$500 billion higher over the next five years. The President's policies would increase the deficit by \$470 billion above OMB estimates of current law between 2006 and 2011, including \$179 billion for extension of expiring tax cuts, \$124 billion in additional tax cuts and \$143 billion in spending for Iraq and Afghanistan as well as further Katrina relief. Table 1 shows the impact of the President's policies on the deficit.

While the Committee for a Responsible Federal Budget is encouraged that the Administration continues to highlight the goal of deficit reduction, the current goal of cutting the deficit in half by 2009 is not only compromised by the unrealistic assumptions in the budget, it is far too timid given the fiscal challenges facing the nation. Furthermore, as the Administration has pointed out, the long-term challenges are even more severe than the short-term, yet under this budget, the deficit would begin to increase again after 2010 as the costs of the baby boom retirement and the additional tax cuts begin to hit the budget.

Table 1: Impact of the President’s Budget Policies on the Deficit as Re-estimated by CBO

(In Billions of Dollars)

	2006	2007	2008	2009	2010	2011	2006-2011	2007-2011
CBO baseline deficit (excluding emergencies)	336	222	183	142	122	14	1,017	682
EGTRRA extensions	0	1	7	19	14	155	196	196
Additional tax cuts ¹	8	29	8	14	19	23	101	93
Defense discretionary (excluding Iraq)	--	5	20	32	35	34	127	127
Non-defense discretionary (excluding emergencies)	--	-	(9)	(20)	(29)	(40)	(98)	(98)
Additional funds for Iraq and Afghanistan	22	66	24	6	2	1	121	99
Further Katrina relief ²	3	8	5	5	3	1	25	22
Avian flu supplemental	--	2	0.5	0.2	--	--	2	2
Mandatory savings ³	--	(2)	(9)	(14)	(13)	(17)	(55)	(55)
Social Security personal accounts	--	--	--	1	1	18	19	19
Debt service	1	4	7	9	11	17	49	48
Post policy deficit	371	335	236	194	165	204	1,504	1,133
Impact of president’s policies on deficit	35	113	53	51	44	191	487	453

Note: Numbers may not add due to rounding

¹ Includes costs of refundable tax credits

² Includes mandatory spending for flood insurance

³ Excludes costs of refundable tax credits

Tax and Spending Initiatives

Tax cuts

The President’s budget includes tax policies that would reduce revenues by \$15.9 billion in 2006, \$29.1 billion in 2007, \$301 billion through 2011, and \$1.74 trillion between 2007 and 2016; according to the Treasury Department estimates. Most of the tax proposals have been included in previous budgets. The primary new tax initiative in the budget is a package of tax changes to encourage greater use of Health Savings Accounts.

The major tax proposals in the President’s budget include:

- Permanent extension of the rate reductions, marriage penalty relief, child tax credit, estate tax repeal, and the capital gains and dividend tax cut enacted in 2001 and 2003. These extensions would decrease revenues by \$178 billion during the five-year budget window and \$1.4 trillion over ten years. The budget also proposes extension of other expiring tax cuts, including the research and experimentation tax credit and welfare to work tax credit.
- Tax free savings accounts, Retirement Savings Accounts (RSAs) and Lifetime Savings Accounts (LSAs). Contribution limits would be \$5,000 per person for each

of the accounts and income limits would not apply. The accounts, which are structured like Roth IRAs, where you pay taxes at the time of deposit but not withdrawal, would create a temporary increase in revenues in the short-term but drain the government of resources in the future. Thus, the real effects of these saving vehicles are in the out years and decades and are not reflected in the budget. The savings proposals in the President's budget would increase revenues by \$22 billion in the first five years, but reduce revenues by twice that amount in the second five years.

- Proposals to expand the use of Health Savings Accounts including an increase in the maximum HSA contribution to the out-of-pocket limit in the participant's high-deductible plan, a refundable tax credit to offset payroll taxes on contributions, an above-the-line deduction for premiums paid on high-deductible plans for individuals participating in HSAs, and a refundable credit for the costs of high-deductible plans for individuals under 65 who are not covered by employer health plans or a public program. These proposals would reduce revenues by \$59 billion over five years and \$156 billion over ten years.
- A one-year extension of the AMT "patch" increasing the AMT exemption amount to prevent more taxpayers from being subject to the AMT for 2006, but does not extend the patch for 2007 and beyond. Congress is considering a similar one-year extension in the tax legislation currently pending in Congress.
- A variety of other tax cuts including tax preferences for charitable giving and affordable housing construction and several pension changes.

Mandatory Spending

The President's budget would build on the modest entitlement savings enacted last year by proposing an additional \$67 billion in mandatory savings over the next five years. The major policies affecting mandatory spending in the President's budget include:

- \$35.9 billion in savings in Medicare through savings in payments to health care providers recommended by the Medicare Payment Advisory Committee (MedPAC) and elimination of the indexation of the income thresholds for means-testing the Part B premium.
- Strengthening the Medicare trigger established in the Medicare Modernization Act by establishing an automatic reduction in provider payments of 0.4% when the threshold of general revenue financing for Medicare is triggered.
- The budget does not address the scheduled cut in physician payments under Medicare in 2007 other than to express support for budget neutral changes for physician payments linked to quality measures. The Deficit Reduction Act enacted last year prevented this cut from taking effect in 2006.
- Savings of \$6 billion over five years from legislative changes to Medicaid, which are partially offset by proposals that would increase spending for Medicaid and the

State Children's Health Insurance Program by \$2.3 billion. The budget also contains regulatory changes that OMB estimates would achieve an additional \$12 billion in savings over five years.

- \$18.7 billion in savings from reforms of Pension Benefit Guarantee Corporation funding rules that would increase premiums in order to fully pay for pension plans.
- \$5 billion in agricultural commodity programs savings through reductions in crop payments, tightening payment limits and other changes.
- Opening a portion of the Arctic National Wildlife Reserve to oil and gas exploration, which would yield an estimated \$4 billion in receipts over the next five years.
- The President's proposal for Social Security individual accounts is included in budget totals.

In the State of the Union, the President called for a bipartisan commission to develop recommendations to deal with the impact of the baby boom's retirement on Social Security, Medicare and Medicaid. While it is easy to dismiss commissions in general as an excuse to avoid dealing with difficult issues, this particular commission could be helpful in breaking the logjam on entitlement reform. It will also be useful to take a comprehensive approach in looking at Social Security, Medicare and Medicaid to develop reform recommendations. In order to succeed, the commission will have to be truly bipartisan and the Administration will have to commit to working with Congressional leaders to follow through on the recommendations.

Discretionary Spending

Although the specific reductions in discretionary spending programs for FY 2006 have received the most attention, the President's budget assumes much more substantial unspecified savings in non-defense, discretionary spending in the following four years. Highlights of the discretionary spending proposals in the President's budget include:

- An increase of total discretionary spending for FY 2007 by 3.2%, not including the costs of the supplemental requests for military operations or hurricane relief. Appropriations for homeland security would increase by 3.3%, defense spending would increase by 6.9%, and spending on all other domestic discretionary areas would decrease by 0.5%.
- Eliminating or significantly cutting 140 discretionary programs for \$14 billion in savings, but these savings are mostly offset by increases in other programs. Net new budget authority for non-defense, discretionary program would decline by \$2.2 billion.
- The specific savings identified in the budget for FY 2007 in this year's budget fall short of the savings assumed for FY 2007 in last year's budget. This year's budget proposes \$398.3 billion in new budget authority for non-DOD, non-homeland

security, discretionary spending, \$9.3 billion more than assumed in last years budget. The failure to achieve the savings in last year's budget one year later calls into question the ability to achieve savings assumed four and five years out.

- The President's budget relies on large, unspecified reductions in discretionary spending after FY 2007 in order to achieve \$120 billion in savings. The non-defense savings are more than offset by the \$75 billion increase in regular defense spending and \$120 billion in supplemental defense spending for Iraq and Afghanistan.

Budget Enforcement in the President's Budget

Although process alone will never be able to solve the nation's fiscal problems, budget mechanisms can bring greater accountability to the budget process and help provide Members of Congress with the political cover to make the tough choices that will be necessary to reduce the deficit. The budget includes a number of budget process proposals, most of which the Committee endorses.

The budget enforcement proposals outlined in the President's budget include:

- **Discretionary Caps** for 2006-2011 on net budget authority and outlays set at the discretionary spending levels in the President's budget and enforced by sequestration of discretionary programs. There would be separate caps for defense and non-defense spending through 2008 and a single discretionary cap for 2009-2011. In addition, there would be a separate category for transportation outlays for 2006 through 2009 at levels consistent with last year's highway bill. Previous experience has demonstrated that discretionary spending limits can be a useful tool for fiscal discipline if they are set at reasonable levels but can actually work against fiscal discipline if they are set at unrealistic levels. The discretionary spending limits enacted in 1990 and extended in 1993 were quite successful in restraining discretionary spending. By contrast, the much more restrictive spending caps enacted as part of the 1997 budget agreement proved to be unrealistic and were effectively ignored, leaving no credible restraint on discretionary spending in place.
- **Pay-As-You-Go** would be reinstated and required for mandatory spending but not revenue legislation. The Committee strongly supports pay-as-you-go requirements applied to both spending and tax cut legislation.
- **Controlling Long-Term Budget Costs** through a point of order against legislation that would cause a deterioration in the unfunded obligations of entitlement programs (Social Security, Medicare, federal civilian and military retirement, Veteran's disability compensation and Supplemental Security Income). Furthermore, accounting and reporting would be improved by requiring both the President's Budget and CBO to highlight any and all legislation that would worsen unfunded obligations within the specified programs.
- **Emergency Designation** where "emergency requirements" would be characterized as: necessary, sudden, urgent, unforeseen, and not permanent. The stricter

definition is intended to end the use of the emergency designation as a way of getting around spending caps.

- **Line Item Veto** The President calls for Congress to pass a line item veto “that would withstand constitutional challenge.” All savings from the line item veto would go to deficit reduction.
- **Joint Budget Resolution** that would set overall receipts and spending levels for discretionary and mandatory programs. The Committee has favored joint resolutions and believes they would encourage the President and Congress to agree on budget aggregates earlier in the process and then hold subsequent legislation to those limits.
- **Automatic Continuing Resolution** that would set in if appropriations were not enacted by the start of each new fiscal year. In order to avoid government shutdowns, programs would be funded either at the levels of the President’s budget or the prior year’s levels—whichever were lower.

Many of these proposals were included in last year’s budget but were not made a priority. Given that they can play such an important role in improving fiscal discipline, we hope the Administration will work with Congress to make their enactment a priority in the coming year. That said, a shortcoming of these recommendations is that while they would impose a measure of fiscal discipline on the budget process, the discipline would only apply to the spending side of the budget, exempting changes on the revenue side, both undermining the effectiveness of the budget mechanisms and making them more difficult to sell politically. Changing the pay-as-you-go provision to apply to both spending and taxes would greatly improve the package and the likelihood of its passage.

The President’s budget also contains seemingly arcane proposal to include extension of the expiring tax cuts in the baseline, which could have significant implications for budget enforcement. If the baseline assumes that current tax rates would be maintained, legislation making those tax cuts permanent would not be scored as increasing the deficit and therefore would not be subject to pay-as-you-go or other budget enforcement rules.

Dynamic Analysis

The President’s budget contains funding to establish a Dynamic Analysis Division within the Office of Tax Policy to conduct dynamic analysis of major tax proposals. Dynamic analysis examines the potential macroeconomic effects of policy proposals and possible impact of those macroeconomic impacts on the budget. The Administration has indicated that it hopes to include a dynamic analysis of the President’s tax cuts as a supplement to the mid-session review. Dynamic analysis could serve a useful supplement to official cost estimates to provide policymakers with greater information about the potential impact of policy proposals. However, in order to provide meaningful information dynamic analysis must look at overall fiscal policy, examining the impact of spending and tax policies as well as the impact of those policies on government borrowing needs. Providing dynamic analysis of tax proposals in isolation from the rest of fiscal policy would present an incomplete and potentially misleading picture.

While providing greater information about the potential macroeconomic effects of policies could serve a useful function in the policymaking process, incorporating dynamic analysis into official cost estimates as some Administration officials and proponents of dynamic analysis in Congress have suggested would be an extremely dangerous and undesirable action. The macroeconomic impact of a particular policy involves many variables about the impact that policy will have on subsequent policy decisions and other assumptions on which there is not a consensus among economists. The lack of consensus about the proper assumptions to use in dynamic analysis as well as the subjective judgments that analysts would have to make could threaten the integrity of the scorekeeping process by creating a greater potential for politicization of the process.

Congressional Budget Office Baseline

In January the Congressional Budget Office issued its baseline estimates for revenues, spending and the deficit. On the surface, the new estimates appear to show a substantial improvement in the deficit outlook compared with baseline projections that CBO issued last August. Last August, CBO estimated that deficits would total \$2.1 trillion between 2006 and 2015. CBO now projects that deficits will total \$1.2 trillion over the same 10-year period.

Slightly more than one-fourth of the improvement is a result of applying baseline rules to the irregular pattern of funding for military operations in Iraq and Afghanistan. The use of supplemental appropriations bills to fund military operations creates misleading swings in budget projections under baseline rules.

The remaining change in the deficit projections is primarily the result of increases in revenue projections resulting from changes in CBO's economic assumptions. Although these changes are classified as "economic" adjustments, they do not reflect projections of stronger economic growth. In fact, CBO's projections for economic growth over the next five years are marginally lower than their projections last summer. The CBO report states that the increase in revenue projections, "occur mainly because of a rise in projected GDP, which derives from higher prices in the economy, not real economic activity." CBO also increased its assumptions regarding profits for technical reasons not related to overall economic growth.

Nonetheless, the revisions in the CBO revenue forecast brings CBO's revenue projections in line with the baseline revenue projections made by OMB, which had previously incorporated much of the recent revenue surge into future baseline projections. Although the specific technical reasons for the revisions are different for each agency, the revenue projections for both CBO and OMB effectively incorporate the recent revenue surge into the baseline. The fact that both agencies are projecting permanent structural deficits into the future even with the assumption that the revenue surge is not a temporary phenomenon is further evidence that policymakers cannot avoid tough choices by relying on stronger economic growth and increased revenue collections to close the budget gap.

Update on Congressional Action

Congress is still in the process of completing action on the tax reconciliation bill provided for in the budget resolution adopted last year. The House-passed tax reconciliation bill would reduce revenues by \$59 billion over 2006-2010. The size of the House-passed tax bill was limited so that it would fit within the constraints imposed by the Senate PAYGO scorecard prior to enactment of the spending reconciliation bill. Following enactment of the spending reconciliation bill the Senate approved an amended version of the tax reconciliation bill that would reduce revenues by the full \$70 billion allowed under the budget reconciliation instructions. The Senate was also able to approve a much larger gross tax cut because it included \$19 billion in revenue offsets not included in the House bill. While the House and Senate bills contain many common elements, there are several significant differences in priorities between the two bills that will need to be resolved in conference.

Table 2: Comparison of Major Provisions in Tax Reconciliation

Provision	House	Senate
AMT relief	No provision ¹	\$37 billion
Lower rate for capital gains and dividends	\$20.5 billion	No provision
Research and experimentation tax credit	\$9.2 billion	\$19 billion
Deductibility of state and local sales taxes	\$2.4 billion	\$5.5 billion
Tax incentives for charitable giving	\$2.8 billion	\$4.1 billion
Deduction for tuition and related expenses	\$1.7 billion	\$7.4 billion
Small business expensing	\$7.3 billion	\$7.3 billion
SAVR tax credit	\$2.8 billion	\$4.0 billion
Revenue Offsets	No provision	\$19 billion

¹ The House passed a separate bill providing a one-year extension of the AMT fix, with a cost of \$31.2 billion.

As a result of the different priorities in the House and Senate tax bills, the total amount of tax cuts in play in conference is approximately \$118 billion. This creates an incentive for gimmicks and mischief to reach agreement on a conference agreement that fits within the \$70 billion limit. The most obvious avenue for budgetary evasion would be to leave the AMT fix and other politically popular tax breaks out of reconciliation and move it as a freestanding bill with the expectation that it would receive 60 votes to waive the budget act and allow tax cuts in excess of the budget resolution limits.

The Committee has repeatedly called on Congress not to proceed with any tax cuts without including offsets so that they do not increase the deficit and has recommended that Congress evaluate all expiring tax cuts as part of a comprehensive review of tax and fiscal policy, instead of continuing to extend tax cuts financed by borrowing on an *ad hoc* basis.

However, if the Senate passes a freestanding AMT fix the Committee believes that the costs should be included on the PAYGO scorecard and subtracted from the amount of room available for tax cuts under reconciliation.

2007 Budget Resolution

With the submission of the President's FY 2007 budget, the budget process for this year has begun in Congress. Budget Committee Chairmen Nussle and Gregg both expressed support for the President's effort to achieve further savings in mandatory spending—an effort the Committee applauds. However the prospects for Congress considering entitlement savings in an election year are uncertain at best. The budget resolution reported by the Senate Budget Committee assumed \$14 billion in mandatory savings, but did not contain reconciliation instructions. While it is unlikely that the budget resolution will include reconciliation instructions for savings as large as the President has requested, achieving some level of savings will be useful in keeping focus on the need to find savings in the mandatory area of the budget.

There will be pressure for another tax bill this year to include any provisions that are not included in the tax reconciliation conference currently underway as well as additional tax cuts such as a further extension of AMT relief. Such a tax bill could become a vehicle for various other tax cuts that could be packaged with politically popular provisions such as AMT relief. In addition, efforts to permanently extend the tax cuts scheduled to expire in 2010 will take on renewed significance as the sunset date approaches, particularly with regard to estate tax repeal.

As Congress begins work on the FY 2007 budget, the Committee makes the following recommendations:

- **Entitlement programs are in need of significant reforms.** As troubling as the near term deficits are, the long-term fiscal outlook is far bleaker as spending on Social Security, Medicare, and Medicaid increases much faster than revenues. The longer inevitable reforms to the country's major entitlements programs are delayed, the more expensive they will be. Congress should give serious consideration to the proposals in the President's budget for savings in entitlement programs as well as other options for entitlement savings. Furthermore, Congressional leaders in both parties should work with the Administration in establishing the proposed entitlement commission that can help develop a bipartisan consensus on the issue of entitlement reform.
- **Spending discipline needs to apply to all areas of the budget.** No longer should policymakers look at defense, homeland security, or entitlement spending as exempt from attempts to contain costs or requirements to pay for spending. When the economy is weak or unforeseen emergencies occur, borrowing oftentimes makes sense. But no program should be exempt from scrutiny, considered untouchable, or left on autopilot indefinitely.
- **Consideration of extension of tax cuts should be done as part of broader considerations of tax reform and the fiscal environment.** Given the tight fiscal

environment, there is no justification for cutting taxes in a way that would increase the deficits. Instead, extensions of expiring tax cuts and any new cuts should include offsets and be evaluated within the context of the short- and long-term government imbalances.

- **The fiscal goal should be more aggressive than cutting the budget in half over five years.** The goal of cutting the deficit in half by 2009 is far too timid given the looming budgetary pressures. Policymakers should be working toward establishing the strongest fiscal condition possible before the full force of the baby boom retirement hits the budget. It is important to note that the only budget goal that has been effective in recent years is the goal of balancing the budget.
- **Those who do not support the policies in the President's budget should produce alternatives.** There are many legitimate differences of opinion regarding the policy priorities that should be funded (or defunded) in the budget. In order to have an honest and serious debate over those differences and the related tradeoffs, those who oppose the President's recommended policies should put forward alternatives rather than merely opposing the proposed budget.
- **There should be a Budget Summit in 2006.** Incremental changes will not be sufficient to rebalance the budget. A comprehensive plan should be developed and all parts of the budget—taxes, entitlements, defense and domestic programs—must be on the table to bring together all sides to craft a realistic plan.