



EXECUTIVE DIRECTOR

Maya MacGuineas

CO-CHAIRMEN

Bill Frenzel

Leon Panetta

DIRECTORS

Roy Ash

Thomas Ashley

Charles Bowsher

Dan Crippen

Willis Gradison

William Gray, III

Ted Halstead

Jim Jones

James Lynn

James McIntyre, Jr.

David Minge

Marne Obernauer, Jr.

June O'Neill

Rudolph Penner

Tim Penny

Peter Peterson

Robert Reischauer

Alice Rivlin

Jim Slattery

David Stockman

Paul Volcker

Carol Cox Wait

Joseph Wright, Jr.

SENIOR ADVISORS

Henry Bellmon

Elmer Staats

Robert Strauss

To: Interested Parties

From: Maya MacGuineas, Executive Director, The Committee for a Responsible Federal Budget, at the New America Foundation

Date: February 2, 2004

Re: The President's FY 2005 Budget

The President's newly released FY 2005 budget projects spending of \$2.4 trillion and revenues of \$2.0 trillion, leaving a deficit of \$364 billion in fiscal year 2005. The projection for the FY 2004 deficit is \$521 billion – \$44 billion more than the Congressional Budget Office's January estimate of \$477 billion and an increase of \$146 billion from the prior year. Not including off-budget surpluses, (most of which are from Social Security) deficits would amount to \$675 billion in 2004 and \$543 billion in 2005.

Total spending for 2005 is projected to grow by 3.5% (compared to 7.5% in the previous year). Revenues are projected to increase by 13% due to continued strength in the economy.

The Administration now recognizes that deficits do in fact matter, and has set the goal for reducing them by half within five years. Deficits are projected to decline gradually under their plan throughout the 2004-2009 period, both in dollar terms and as a share of GDP. In fact, the plan meets the share of GDP goal by 2006 and the dollar goal by 2007.

However, this objective is met only if one includes Social Security's surpluses. If Social Security is taken out of the equation and only on-budget deficits are considered, the deficit is not cut in half – either in dollar terms or as a share of GDP. Furthermore, the goal of cutting the deficit in half over five years is probably unrealistic given what is left out of the budget (see below), and at the same time, too timid given the country's current fiscal condition.

Finally, the submitted budget includes some sensible and much needed budget process reforms. However, these restrictions would apply only to the spending side of the budget, exempting changes on the revenue side from the controls, both undermining the effectiveness of the budget mechanisms and making them a more difficult sell politically.

By the Numbers:

FY 2005 versus FY 2004 Budget (\$Billions)							
	<u>2003 A</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>
<u>President's Budget 2005</u>							
Receipts	1,782	1,798	2,036	2,206	2,351	2,485	2,616
Outlays	2,158	2,319	2,400	2,473	2,592	2,724	2,853
Surplus/(-Deficit)	(375)	(521)	(364)	(268)	(241)	(239)	(237)
Debt	3,914	4,421	4,792	5,074	5,333	5,589	5,844
<u>President's Budget 2004</u>							
Receipts	1,782	1,922	2,135	2,263	2,398	2,521	n/a
Outlays	2,158	2,229	2,343	2,464	2,576	2,711	n/a
Surplus/(-Deficit)	(375)	(307)	(208)	(201)	(178)	(190)	n/a
Debt	3,914	4,166	4,387	4,603	4,797	5,003	n/a
<u>Difference</u>							
Receipts	-	(124)	(99)	(57)	(47)	(36)	n/a
Outlays	-	90	57	9	16	13	n/a
Surplus/(-Deficit)	-	(214)	(156)	(67)	(63)	(49)	n/a
Debt	-	255	405	471	536	586	n/a

***** For more details, see Appendices 1 & 2 *****

Key Points:

Budget Windows

The truncated five-year budget windows used in the budget paint a somewhat misleading picture of the effects of many of the proposals. Yes, economic and budget projections are difficult to make well into the future and 10-year projections notoriously miss their mark. However, it is necessary to track the costs in out-years of proposals – particularly if they will be markedly different than in the shorter time frame. Such is the case with the new prescription drug program, the cost of making the tax cuts permanent, and the lost revenues due to the implementation of Retirement and Lifetime Saving Accounts, which are structured like Roth IRAs and thus generate new revenues in the short-run but large costs over time. Additionally, the shorter budget windows fail to convey what happens to deficits beyond 2009, when they would again begin to soar under the Administration's proposed policies.

What is Missing

Alternative Minimum Tax – The budget only includes a one-year patch for the downward creep occurring in the Alternative Minimum Tax, which is starting to affect middle-income earners in a way in which it was never intended. Fixing the AMT in a comprehensive manner will be quite costly – tens of billions of dollars a year. The Administration has expressed its intention to fix the alternative tax, but apparently chose to defer developing a long-term fix.

Security Costs – It is a pretty safe bet that security costs will be higher than budgeted for in this budget. The Administration included no funding for military operations in Iraq or Afghanistan. If the specific needs are not yet known, a better approach would have been to create a security reserve paid for in the budget and to be tapped as needed. Instead, supplemental requests, which would worsen the deficit picture, are highly likely in coming months.

Furthermore, it is becoming apparent that growing security needs and, thus, costs are here to stay at least in the foreseeable future. Therefore, it is time to shed the mindset that defense and homeland security costs don't have to be paid for – they do. Just as in other areas of the budget, choosing not to pay for those costs today means somebody else will have to tomorrow. Higher security costs can be offset by lower spending elsewhere or higher taxes, but borrowing to pay for predictable costs is neither prudent budgeting nor a fair policy.

Social Security – In his budget the President reaffirmed his commitment to modernizing Social Security by including an individual accounts component as part of the program. However, the budget sets aside *zero* dollars to help pay for the transition to such a plan. All three of the proposals developed by the President's Commission would require upfront revenues in order to achieve longer-term cost savings and a credible commitment to reforming Social Security would at the very least include a place holder in the budget as was done for the Medicare prescription drug expansion.

New Medicare Estimates

Given that the Administration has produced cost estimates associated with the recently passed Medicare prescription drug legislation that are significantly higher than what they initially agreed to spend or what the Congressional Budget Office estimated the costs would be, the least the Administration could have done would have been to find offsetting costs within their proposed budget. (The differences in the OMB and CBO estimates are primarily due to different assumptions about participation rates, market behavior, cost growth rates, and timing issues.) Medicare is projected to be the fastest growing area of the budget in future years. Costs will simply have to be contained. This past year instead of discussing much needed reforms for the program, Congress and the President chose to expand it. The country must come to terms with the spiraling costs of entitlement programs and finding offsetting costs for the new higher projections for the prescription drug program would have been a (relatively small) necessary first step given the size of the overall task.

Deficits Do Matter

We welcome the President's recognition that deficits do matter. And it is extremely important that the Administration was willing to pick a specific fiscal goal – reducing the deficit by half over five years. A widely shared goal is a necessary first step to putting the country back on the path to responsible fiscal policy making.

That said, there are a number of shortcomings with the Administration's approach. While given the current political environment, reducing the deficit by half may be as aggressive a goal as is politically realistic (it is after all an election year, which never bodes particularly well for responsible policy making), given the fiscal environment, it falls far short of what is needed. The Committee has always maintained that budget balance over the business cycle should be the goal. Thus, the federal government has room to run deficits when the economy is in need of stimulus and later run surpluses once conditions improve. The Administration's timetable, however, is not nearly aggressive enough given that the economic projections assume the recovery is already underway.

Moreover, additional measures are now in order given that the retirement of the Baby Boomers is just around the corner. Accordingly, a goal of balancing the budget over the business cycle – excluding the Social Security surpluses – would be more appropriate and would require additional changes on either the spending or revenues sides well beyond what the Administration has proposed.

Tax and Spending Initiatives

While the submitted budget has a number of new initiatives, many are relatively small in terms of their impact on the budget. Some of the more important changes include:

- Extending Tax Provisions – (\$11.5 billion in 2005, \$79.0 billion from 2005-2009, and \$87.5 billion from 2005-2014.) Provisions include: Child tax credit, marriage penalty relief, and the 10% individual income tax rate bracket.
- Make Permanent Tax Provisions - (\$11.8 billion in 2005, \$131.6 billion from 2005-2009, and \$936.3 billion from 2005-2014.) Provisions include the new dividend tax rate structure, the new capital gains tax rate structure, expensing for small businesses, marginal individual income tax rate reductions, education incentives, and the estate tax.
- New Saving Incentives – (\$3.6 billion in 2005 (increase), \$18.2 billion from 2005-2009 (increase), and \$7.6 billion from 2005-2014.) The Administration decided to move forward with its plan for Retirement Saving Accounts and Lifetime Saving Accounts, which it first floated just before last year's budget. 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 costs of these saving vehicles are in the out years and decades and are not reflected in the budget.

- Additional tax proposals include:

	<u>2005</u>	<u>2005-09</u>	<u>2005-14</u>
Health Care	0.3	19.8	54.7
Charitable Giving	1.9	8.7	18.5
Education	--	2.5	16.4
Energy	1.4	6.8	7.2

Total tax changes would increase the deficit by \$12 billion in 2005, \$175 billion from 2005-2009, and \$1.1 trillion from 2005-2014.

- Total discretionary spending would increase by 3.9%, not including the costs of the supplemental. Spending for homeland security would increase by 9.7%; defense spending would increase by 7.1%; and spending on all other domestic discretionary areas would increase by 0.5%.
- The Agencies that would see the largest budget reductions (in percentage terms) from 2004 include the Department of Agriculture, the Corps of Engineers, and the Small Business Administration. The largest increases would go to the Department of Defense, the Department of State, and the Judicial and Legislative Branches.

Budget Process

The budget includes a number of budget process proposals, most of which the Committee whole-heartedly endorses. While specific policy choices are also a necessary component of responsible budgeting – process alone will never be able to solve the nation’s fiscal problems – budget mechanisms can help provide politicians with necessary cover for the hard choices involved in getting out of deep budget holes.

The budget enforcement legislative package that the Administration plans to send Congress in the near future includes:

- **Discretionary Caps** - for 2005 – 2009 on net budget authority and outlays. (Caps on discretionary spending, which were first put into place in 1990, expired at the end of 2002.) There would be a single discretionary cap and a required three-fifths vote in the Senate to exceed limits.
- **Pay-As-You-Go** – would be reinstated and required for mandatory spending but not revenue legislation. **The Committee strongly supports PAYGO requirements applied to both spending and tax cut legislation.**
- **Controlling Unfunded Liabilities** – 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.
- **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.
- **Other Changes** – include: capping advance appropriations at the 2002 levels; making changes to how the baseline is estimated; and providing the President with a line-item veto linked to deficit reduction.

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.

Conclusion

We are encouraged that the Administration recognizes that deficits do matter and accordingly, has chosen a specific fiscal goal, which is the first step in resurrecting the commitment to fiscal discipline. Furthermore, the budget includes a number of important budget process initiatives that would be extremely helpful in getting the process underway and we hope the President will encourage members of Congress to adopt these reforms. (Though they need to apply to both the spending and the revenue sides of the budget to be effective.)

However in the end, it is real policy choices that will return the budget to balance, or better yet, surplus. In that vein:

- **It is not the time for tax cuts.** Tax cuts are not affordable in the short run, when any plans to pay for them would be better used to reduce the deficit, or the long run, since a reduction in future revenues should not precede comprehensive reforms to the country’s over-promised health and retirement entitlement programs.

- **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.
 - **Entitlement reform.** In the President's budget, the long-run projections show that on its current path, the budget is not expected to reach balance between now and 2080. Spending on Social Security, Medicare, and Medicaid is projected to grow from 8.8% of GDP in 2010 to 14.3% by 2030 and continue to grow thereafter. The deficit is projected to grow from 1.4% of GDP in 2010 to 31.6% in 2080. The longer inevitable reforms to the country's major entitlements programs are delayed, the more expensive they will be. While the President's budget alludes to these looming problems, it does nothing to address them.
 - **Hard choices.** Budgeting is about making choices. Rarely are they easy. Given that we are looking at half-trillion dollar deficits in the face, and that the budget picture gets even bleaker over time, everything needs to be on the table – taxes, defense, domestic discretionary spending, and entitlements including Social Security and Medicare. Politicians need to stop promising what they will not do and get to work figuring out what they will do to improve the deteriorating fiscal condition of the country. While there are some good ideas in the President's FY 2005 budget, far more will have to be done to really improve the deteriorating fiscal environment.
-

Appendix 1 – Budget Details

Budget Details (\$Billions)							
	<u>2003 A</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>
<u>President's FY 2005 Budget</u>							
Receipts							
Individual Income	794	765	874	957	1,049	1,133	1,210
Corporate	132	169	230	250	251	252	256
Social Insurance	713	732	794	834	879	919	960
Other	144	132	138	165	172	181	191
Total Receipts	1,782	1,798	2,036	2,206	2,351	2,485	2,616
Outlays							
Discretionary							
Defense	388	433	429	415	426	447	467
Non-Defense	438	475	485	478	479	476	476
Total Discretionary	826	908	914	892	904	923	942
Mandatory							
Social Security	470	492	510	529	552	576	608
Medicare	246	266	290	336	372	393	418
Medicaid and SCHIP	165	183	188	198	213	232	251
Other	298	314	320	305	305	325	335
Total Mandatory	1,179	1,254	1,308	1,368	1,441	1,527	1,612
Net Interest	153	156	178	213	246	275	299
Total Outlays	2,158	2,319	2,400	2,473	2,592	2,724	2,853
Surplus/(-Deficit)	(375)	(521)	(364)	(268)	(241)	(239)	(237)
On-Budget	(536)	(675)	(543)	(470)	(466)	(487)	(501)
Off-Budget	161	154	179	202	225	248	263
Deficit / GDP	-3.5%	-4.5%	-3.0%	-2.1%	-1.8%	-1.7%	-1.6%

Appendix 2 – Economic Assumptions

Economic Assumptions (Calendar Year)						
	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>
GDP (billions of current dollars):						
CBO	11,629	12,243	12,814	13,389	14,023	14,686
Blue Chip	11,660	12,291	12,929	13,588	14,292	15,045
2005 Budget	11,612	12,187	12,796	13,449	14,151	14,890
Real GDP (chain-weighted):						
CBO	4.8	4.2	3.1	2.7	2.8	2.8
Blue Chip	4.6	3.7	3.3	3.1	3.2	3.2
2005 Budget	4.4	3.6	3.4	3.3	3.2	3.1
Chain-weighted GDP Price Index:						
CBO	1.1	1.1	1.5	1.8	1.9	1.9
Blue Chip	1.4	1.6	1.8	1.9	2	2
2005 Budget	1.2	1.3	1.5	1.7	2	2
Consumer Price Index (all-urban):						
CBO	1.6	1.7	2	2.2	2.2	2.2
Blue Chip	1.7	2.1	2.3	2.4	2.4	2.4
2005 Budget	1.4	1.5	1.8	2.1	2.4	2.5
Unemployment rate:						
CBO	5.8	5.3	5	5.1	5.2	5.2
Blue Chip	5.8	5.5	5.4	5.3	5.3	5.2
2005 Budget	5.6	5.4	5.2	5.1	5.1	5.1
Interest rates:						
91-day Treasury bills:						
CBO	1.3	3	4	4.6	4.6	4.6
Blue Chip	1.3	2.6	3.7	3.9	4.1	4.1
2005 Budget	1.3	2.4	3.3	4	4.3	4.4
10-year Treasury notes:						
CBO	4.6	5.4	5.5	5.5	5.5	5.5
Blue Chip	4.7	5.4	5.5	5.6	5.6	5.6
2005 Budget	4.6	5	5.4	5.6	5.8	5.8
Source: President's FY 2005 Budget; Congressional Budget Office; Aspen Publishers, Inc., Blue Chip Economic Indicators.						