CENTER ON BUDGET AND POLICY PRIORITIES

820 First Street, NE, Suite 510, Washington, DC 20002
Tel: 202-408-1080 Fax: 202-408-1056 center@cbpp.org www.cbpp.org

Revised February 3, 2004

DOES THE PRESIDENT'S 2005 BUDGET REALLY CUT THE DEFICIT IN HALF?

by Richard Kogan, Joel Friedman, and John Springer

> **Key Findings**
>
> - The Administration's budget omits roughly $160 billion in likely costs for 2009 that the Administration itself supports.
> - When these omitted costs are taken into account, the projected budget deficit for 2009 is approximately $400 billion, well above the Administration's target.
> - To really cut the deficit in half by 2009 while continuing to pursue its tax-cutting agenda, the Administration would have to cut federal spending by an amount equivalent to twice the entire education budget.

The President's fiscal year 2005 budget claims to cut the deficit by more than half both as a share of the economy over the next five years, from 4.5 percent of GDP in 2004 to 1.6 percent in 2009, and in dollar terms, from $521 billion in 2004 to $237 billion in 2009. But the President's budget meets this goal only on paper. It omits a series of very likely or inevitable costs in taxes, defense spending, and other areas. When these missing costs — which likely total at least $160 billion in 2009 — are added in, the deficit for 2009 would be about $400 billion, or 2.8 percent of GDP, significantly above the Administration's self-constructed target.

Specifically, the budget omits the costs of extending relief from the mushrooming Alternative Minimum Tax after 2005, the costs of extending a series of very popular tax breaks, and the costs of fighting terrorism internationally after September 30, 2004. It also fails to reflect the full costs of the Administration's own "Future Year Defense Plan."

Furthermore, these estimates of omitted costs do not include any adjustment for non-defense discretionary spending, which the budget shows as being *lower* in 2009 than in 2005, even before adjusting for inflation. History shows that such sustained discretionary spending restraint is highly unlikely to be imposed, given the popularity of many of the affected programs, including education, child care, and health research programs, and the Administration's intention to increase spending for homeland security and international affairs programs. If non-defense discretionary spending were to grow by the rate of inflation and population growth starting in 2006, a more realistic assumption, the deficit in 2009 would be $35 billion higher than the figures we show above — or, when combined with the other omitted costs, about $200 billion more than the budget shows.

Thus, a more realistic estimate shows a deficit of $400 billion to $435 billion in 2009, a level more consistent with recent projections by Brookings Institution economists, Goldman-Sachs, and other analysts.

For the Administration to legitimately halve the deficit as a share of GDP by 2009 and continue to hold to its tax-cutting agenda, it would have to slash federal spending by an amount equal to the entire budget of the Department of Education or seven times the amount in the budget for environmental protection**.** Stated another way, it would require cutting by 22 percent all domestic programs outside homeland security that are funded by annual appropriations.

Does the Administration's Budget Overstate the 2004 Deficit?

In issuing its mid-session budget forecast last July, the Administration projected a considerably larger deficit for fiscal year 2003 than other analysts were projecting at that time. When the actual deficit for 2003 turned out to be $81 billion lower than the July estimate, the Administration trumpeted the difference as good news.

The new budget projects a deficit of $521 billion in 2004, the current fiscal year; OMB's figure is $44 billion higher than CBO's estimate of $477 billion. It appears likely that the Administration has again overstated the size of the deficit for 2004, as it did last July for 2003.

Overstating the deficit for 2004 would raise the "target deficit" for 2009 (since the target would be half of the overstated deficit number for 2004), making that target easier to reach. It also would allow the President to portray an actual 2004 deficit of $450 billion or more as "significant progress" on the deficit in late October — shortly before Election Day — when fiscal year 2004 has been completed and the figures for the year become final.[*]

[*] See Richard Kogan, "Does the Administration's Budget Overstate the Likely 2004 Deficit?" Center on Budget and Policy Priorities, February 2, 2004.

Administration Budget Would Increase Deficits After 2009

Far from constituting a plan to reduce the deficit, the Administration's budget would dig the nation's long-term fiscal hole deeper. The Congressional Budget Office shows the deficit shrinking modestly for a few years after 2004, as a natural byproduct of the economic recovery, and then more substantially after 2010, when the tax cuts expire. But the Administration's budget would *increase* the deficit above these levels by calling for new tax cuts and the extension of tax cuts scheduled to expire. Indeed, if the Administration succeeds in making the 2001-2003 tax cuts permanent, deficits would grow sharply after 2010. By 2014, the deficit would exceed $600 billion and the national debt might exceed $9 trillion or 50 percent of GDP.

Because the Administration's budget leaves out various costs that are likely to occur and because its budget extends only through 2009, it does not show the full effect of its budget policies over the coming decade. In addition, by the start of the following decade, the retirement of the baby-boom generation will be producing major cost increases in programs such as Social Security and Medicare, adding considerable strain to the budget. The Administration's budget is a recipe for large, unsustainable deficits over the long run.

Costs Omitted from the Budget

Items omitted from the budget that are likely or nearly certain to occur (and that the Administration itself favors and intends to propose in later budgets) include the following:

- The budget omits the large costs associated with providing relief from the individual Alternative Minimum Tax after 2005. The Administration proposes only a one-year extension of the AMT relief that expires at the end of calendar 2004, leaving out future-year costs even though it acknowledges that AMT relief is a long-term problem. As Treasury Department documents state: "Although

Items Omitted from the President's 2005 Budget But Supported by the Administration (costs include direct costs plus increased interest payments on the debt)		
	2009	
	in billions of dollars	as a % of GDP
Deficit in President's 2005 Budget	$237	1.6%
Costs left out of 2005 Budget:		
Relief from the Alternative Minimum Tax	$59	0.4%
Continuation of "tax extenders"	$15	0.1%
Future-Year Defense Plan and ongoing war on terrorism	$80	0.6%
Unspecified spending cuts ("magic asterisks")	$8	0.1%
Non-defense discretionary	$0 - $35	0.0% - 0.2%
Total costs left out	**$162 - $198**	**1.1% - 1.4%**
Deficit in President's 2005 Budget, including omitted costs	$400 - $435	2.8% - 3.0%
Amount above target of cutting the deficit in half as % of GDP	$70 - $105	0.5% - 0.7%

May not add due to rounding

these temporary changes will continue to ameliorate the AMT problem in the short-run, long-term change is needed."[1]

Under current law, unless the AMT relief that is scheduled to expire at the end of 2004 is continued, the AMT will explode into the middle class. Currently, about 3 million tax filers are subject to the AMT. If no long-term relief is enacted — as the Administration's budget estimates reflect — that number will reach 30 million by 2009, according to the Urban-Brookings Tax Policy Center.

Recent CBO estimates show that one of the least expensive of the likely paths of AMT relief — indexing the parameters of the AMT so the real burden of the AMT does not rise with inflation and extending the current AMT treatment of "non-refundable personal credits" — would cost $59 billion in 2009 alone (and about $721 billion through 2014; these figures include the costs of the increased interest payments that would have to be paid on the debt).[2]

[1] Treasury Department, "General Explanations of the Administration's Fiscal year 2005 Revenue Proposals," February 2004.

[2] See CBO, "The Budget and Economic Outlook, Update," August 26, 2003. For an explanation of the cost issues surrounding AMT relief, see Appendix B in Kogan, Kamin, and Friedman, "Deficit Picture Even Grimmer Than New CBO Projections Suggest," Center on Budget and Policy Priorities, revised February 1, 2004. AMT relief need not be expensive. The Tax Policy Center has designed a revenue-neutral AMT reform option that would remove the middle class from the AMT but restructure the AMT so the very well off, who currently are largely free from the AMT, would be subject to it if they combined too many special tax breaks. However, the Administration and Congress have, so far, chosen expensive but nominally temporary versions of AMT relief along the lines estimated

- The budget similarly omits some of the full cost of continuing an array of other tax breaks — the so-called tax "extenders" — that always are renewed for a year or two at a time on a bipartisan basis when their term is up. It proposes a permanent extension of the Research and Experimentation tax credit but only a one- or two-year extension of most of the other "extenders." As a result, the budget figures for 2009 assume these tax breaks have been terminated. Every knowledgeable observer expects, however, that these tax breaks will continue to be extended as they always have been in the past. The result is a further understatement of the 2009 deficit by $15 billion.

- The budget also omits the full cost of the Administration's own "Future Year Defense Plan." Last year, the Congressional Budget Office estimated the cost of funding the Plan, and the Center on Strategic and Budgetary Assessments converted the CBO funding figures into estimates of total expenditures for each year if the Plan were fully funded.[3] Comparing these CBO/CSBA estimates to the amounts in the Administration's new 2005 budget indicates that a significant shortfall in this area remains.

- The budget also omits most or all of the costs of fighting terrorism internationally after September 30, 2004. One hopes there will no longer be costs for activities in Iraq and Afghanistan by 2009, but no one expects that all costs of other aspects of the war on terrorism will vanish. Moreover, the budget also omits all costs for activities in Iraq and Afghanistan after September 30, 2004. While there may no longer be such costs in 2009, there almost certainly will be costs in 2005 and perhaps some later years, and those costs will raise deficits in 2009 because they

Omission of Social Security Privatization

The Administration budget also omits the costs of any proposal to partially privative Social Security, even though the press reports that the President intends to push vigorously for the concept as part of the coming campaign.

It is uncertain whether such a plan could be enacted, and the details and costs of such a plan are vague and unlikely to be elucidated during the campaign. Nevertheless, it is instructive to examine recent proposals for partial privatization. According to the actuaries of the Social Security Administration, Senator Lindsay Graham's plan of November 18, 2003 — said to have been designed with encouragement from the White House staff — would increase the federal deficit by almost $200 billion in 2009. Representative Clay Shaw's plan of January 7, 2003, would increase the deficit by more than $200 billion in 2009. The plan proposed recently by conservative activist Peter Ferrara and supported by some conservative organizations would increase the deficit by almost $450 billion in 2009.

---

by CBO. Moreover, it seems clear that the Administration will not propose anything remotely like the revenue-neutral AMT option, which would raise taxes on high-income filers.

[3] CBO, "The Long-Term Implications of Current Defense Plans: Summary Update for Fiscal Year 2004," July 2003, and Steven M. Kosiak, "Cost Growth in Defense Plans, Occupation of Iraq and War on Terrorism Could Add Nearly $1.1 Trillion to Projected Deficits," Center for Strategic and Budgetary Assessments, August 26, 2003. The figures used in this analysis are slightly smaller than those published by CSBA, as the figures used here reflect actual appropriations for 2004.

will increase the national debt, and thus the level of interest payments that must be paid on the debt each year.

It is difficult to estimate precisely the impact that the expected budget omissions related to terrorism (and to Iraq and Afghanistan) will have on 2009 costs for the Future-Year Defense Plan, Iraq, Afghanistan, and the war on terrorism. The CBO and CSBA analyses previously cited indicate that the combined amount of the omitted costs is likely to be somewhere in the neighborhood of $80 billion in 2009, including interest.

- The budget also assumes certain reductions in entitlement costs without making any proposals for how to achieve such savings. Specifically, the budget proposes a health insurance tax credit that it says would increase expenditures by $65 billion over ten years. It then subtracts out the full $65-billion cost on the grounds that these costs will somehow be offset, but does so without proposing any offset to achieve the savings. The budget merely states that “the Administration will work with the Congress” to find such an offset. Such unspecified cuts often fail to materialize and have long been regarded as a budget gimmick. Such a gimmick, dubbed a “magic asterisk” when employed by the Reagan Administration, reduces the size of the deficit on paper but not in the real world. Adding the cost of the tax credit back into the budget increases the deficit by $8 billion in 2009, including the related interest payments.

- Finally, the budget reflects very low levels of funding for non-defense programs that receive annual appropriations. In 2005, the Administration proposes that these programs grow by 0.5 percent. In years after that, the budget for these programs becomes increasingly harsh; by 2009, spending on these programs would be lower than the 2005 level. Furthermore, within this category of spending are programs, such as in the area of homeland security and international affairs, that the Administration is proposing to increase. This will result in the remaining programs being squeezed even more. But sustaining such tight funding levels for these programs — which include education, child care, environmental protection, veterans’ health care, and transportation programs among others — for an extended period would be unprecedented. In previous budgets, the Administration itself showed these programs growing with the rate of inflation.

  Use of a more realistic assumption, based on past experience, would result in the budget showing higher levels of spending after 2005 than the President’s budget does. For purposes of this paper, we assume a range — with the Administration’s budget assumptions at one end, and an assumption that nondefense discretionary programs will grow after 2005 at a rate equal to inflation and population growth at the other end. This produces an estimate of omitted costs that ranges from zero to $35 billion in 2009, including the associated interest costs.

The above adjustments increase the 2009 deficit by between $162 billion and $198 billion. Adding these omitted costs raises the 2009 deficit from the Administration’s projection of $237 billion to a more realistic projection of $400 billion to $435 billion, or from 1.6 percent of GDP to a more realistic 2.8 to 3.0 percent of GDP.

Not only is a deficit of 2.8 to 3.0 percent of GDP in 2009 well above the Administration's target, but it is likely to be as low as deficits get for many years to come. Deficits will rise considerably after 2010, especially if the Administration's proposal to make its tax cuts permanent is enacted. In that event, the deficit is likely to reach $600 billion or more by 2014.

This more pessimistic assessment of the fiscal outlook is consistent with an array of recent analyses, all of which estimate deficits of more than $5 trillion over the next decade, from 2005 to 2014. For instance, a Center analysis based on new Congressional Budget Office data projects a ten-year deficit of $5.2 trillion.[4] A recent Brookings Institution book estimates deficits of $5.3 trillion over the decade, assuming continuation of current policies.[5] Wall Street analysts Goldman-Sachs and Decision Economics (an economic forecasting firm headed by economist Allen Sinai) have produced similar estimates.

It also should be noted that these various analyses reflect the costs only of continuing current policies or enacting proposals whose costs can be estimated with some confidence. If the nation suffers one or more major contingencies — such as another recession, a major natural disaster, another terrorist attack, or another round of military engagements — the deficits likely will be even higher.

What Would It Take to Cut the Deficit in Half by 2009 for Real?

Suppose the Administration wanted to cut the deficit in half for *real,* while maintaining (and expanding) its tax cuts and maintaining its defense build-up and anti-terrorism spending. The Administration would reflect the missing costs noted above in its budget and then reduce spending enough to cut the deficit in half by 2009. The Administration is unlikely to cut Social Security or Medicare benefits. That means that cutting the deficit in half — to about 2.3 percent of GDP in 2009 — would require cutting $60 billion to $90 billion from other programs. The lower amount is equivalent to:

- The entire veterans budget; or
- The entire education budget; or
- 7 times the environmental budget.

Alternatively, if policymakers were to cut every domestic program that is funded annually through the appropriations process other than homeland security, such programs — which include education, veterans health, and environmental protection — would have to be cut in 2009 about 22 percent below their current levels, adjusted for inflation. These results show the effects of taking the tax side of the budget "off the table" for deficit-reduction purposes.

[4] See Kogan, Kamin, and Friedman, *op.cit.* The Center projections reflect higher levels of non-defense discretionary spending for years after 2005 than are contained in the Administration's budget and do not include the additional tax cuts the Administration has proposed, such as for tax-free savings accounts and for purchasing health insurance.

[5] See Alice Rivlin and Isabell Sawhill, eds., *Restoring Fiscal Sanity,* Brookings Institution, January 2004, p. iv.