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NEW CONGRESSIONAL BUDGET OFFICE ESTIMATES SHOW CONTINUED HIGH DEFICITS AND FURTHER FISCAL DETERIORATION

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Executive Summary

On September 7, the Congressional Budget Office released new estimates showing that the budget deficit will grow to $422 billion in fiscal year 2004.[1] This is $46 billion higher than the 2003 deficit, which stood at $375 billion.

Despite the economic recovery, the deficit has continued to rise. 2004 will be the fourth consecutive year of fiscal deterioration, following eight consecutive years of fiscal improvement. Moreover, outside the surplus in the Social Security Trust Fund, CBO estimates the 2004 deficit at $571 billion.

CBO's latest figures reinforce a number of concerns.

- **The deficit is rising when it should be falling, indicating the emergence of a structural deficit:** At this point in previous economic recoveries, deficits have almost invariably begun to shrink rather than continued to rise. The current economic recovery, however, is different; it has featured the largest deterioration in the government's fiscal position of any recovery since World War II. A substantial "structural" deficit has developed that will persist as the economy grows, unless policies change.

- **Realistic assumptions indicate deficits will total $4.4 trillion over the next decade:** Although CBO's official projections show deficits declining over the next ten years to $65 billion by 2014, CBO notes that its official projections do not reflect the costs of extending the tax cuts beyond their scheduled expiration dates. As CBO director Douglas Holtz-Eakin testified in July, "...baseline revenue projections are made less reliable by the existence of expirations that few people expect to occur as written in current law."[2] In addition, while CBO's projections overstate likely future costs of military operations and reconstruction in Iraq and Afghanistan, they otherwise include defense levels below those CBO estimates to be needed to fully fund the Administration's multi-year defense plan.

  CBO's new report and other CBO documents include additional estimates indicating that if the tax cuts are continued and projected defense expenditures are adjusted to make them more realistic (including both a downward adjustment to

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[1] CBO, "The Economic and Budget Outlook: Summer Update," September 7, 2004.

[2] Testimony of Douglas Holtz-Eakin before the House Budget Committee, July 22, 2004.

reflect an assumption that operations in Iraq and Afghanistan will phase down over the next few years and an upward adjustment to reflect the full cost of the Administration's multi-year defense plan), projected deficits will not fall below $340 billion in any year, will average more than $440 billion per year over the next decade, and will total approximately $4.4 trillion over the ten-year period. (A recent Goldman-Sachs analysis concludes that the ten-year deficit is likely to be higher and could total between $5 trillion and $6 trillion.)

- **The fiscal picture has deteriorated markedly since 2001:** The 2004 deficit of $422 billion reveals a budget in much worse shape than CBO projected in early 2001. At that time, CBO projected a *surplus* in 2004 of $380 billion.[3] As can be seen, the actual result for 2004 is $800 billion worse than projected in 2001. Nor is this result peculiar to 2004: over the ten-year period from 2002 to 2011, our current projections are about $870 billion worse on average each year than the projections issued in early 2001, or $8.7 trillion worse over the decade as a whole.

  Calculations based on CBO and Joint Tax Committee data show that of the $8.7 trillion deterioration over the 2002-2011 period, $5.5 trillion is attributable to tax cuts, defense funding increases, and domestic program increases enacted by Congress. (The rest is due to economic or technical factors.) Tax cuts account for the majority of the $5.5 trillion deterioration that is due to the actions of policymakers. In other words, the tax cuts have increased the deficit more than all program increases combined.

- **New figures do not reflect the return of fiscal discipline or stronger economic growth:** Earlier this year, CBO projected a deficit of $477 billion; the new projection is $422 billion. The lower projection is not an indication of a return of fiscal discipline; no policy changes have been enacted since February that would reduce the deficit this year by more than a marginal amount. Nor does the lower projection stem from stronger economic growth; real GDP growth has been 4.8 percent over the first three-quarters of the fiscal year, the same as the 4.8 percent growth CBO earlier projected.[4] While the factors accounting for the lower deficit projection are not entirely clear, some of the change is likely be due to *adverse* economic developments — higher-than-expected inflation and greater-than-expected concentration of income among those high on the income scale. Both of those developments result in somewhat higher tax revenues than would otherwise be collected.

[3] In 2001, CBO projected a surplus of $397 billion for fiscal year 2004. That projection, after adjustment to make it comparable to other projections used here (e.g., after adjustment to assume continuation of certain expiring tax provisions), equals $380 billion.

[4] This calculation compares the average size of the economy in the first three quarters of this fiscal year with the average size of the economy in the first three quarters of the previous fiscal year. Alternatively, one could compare the size of the economy in the third quarter of fiscal year 2004 with the size of the economy in the last quarter of fiscal year 2003. By this method, the economy has grown at a real annual rate of 4.0 percent, noticeably slower than CBO's earlier projection for a real annual rate of growth of 4.4 percent through the third quarter.

Goldman-Sachs on OMB's Deficit Estimates

"The Office of Management and Budget has perfected the art of under-promising and outperforming in terms of its near-term budget deficit forecasts. For example, in its semiannual review, the OMB lowered its deficit forecast for fiscal 2004 to $445 billion from $521 billion. This creates the impression that the deficit is narrowing when, in fact, it will be up sharply from the $375-billion imbalance of a year earlier. This process is likely to continue in October, when the fiscal 2004 deficit turns out to be lower than the current OMB forecast.

"In contrast, the OMB's longer term forecasts — a deficit that falls in half in five years — appear to be too optimistic for two reasons. First, spending will almost certainly be higher than projected, both due to the added funds needed for Afghanistan and Iraq and because the assumed freeze in real domestic discretionary spending has no historical precedent. Second, some of the tax law changes sought by the administration, such as relief from the Alternative Minimum Tax (AMT), are not built into the current projections."

Source: Goldman Sachs, "US Economic Analyst," August 6, 2004, p. 3.

- **The growth of deficits has largely reflected stunning revenue declines:** Some tax-cut advocates continue to claim that the deficit problem is caused primarily or exclusively by spending increases. The CBO data show this is not the case; as just noted, the tax cuts enacted since the beginning of 2001 have contributed more to the deficit than the spending increases. The CBO data also show that federal spending in 2004, measured as a percentage of the economy (i.e., of the Gross Domestic Product), is slightly *below* its average level of the last four decades. The deficits thus cannot be said to be due to unusually high levels of spending. What the data show instead is that the emergence of large deficits stems largely from a stunning drop in revenues. The CBO data indicate that federal tax revenues this year will be at their lowest level, measured as a share of the economy, since 1959. (Under CBO's projection of last spring, revenues this year would have been at their lowest level, as a share of the economy, since 1950.)

Is the Administration Being Straightforward with its Deficit Forecasts?

Finally, the new CBO figures raise fresh concerns about how straightforward the Administration is being with its budget estimates. The Administration appears to have massaged its deficit estimates. Last February, the Administration produced an overstated deficit estimate of $521 billion for the current fiscal year. When the Administration issued its most recent estimate on July 30 — an estimate of a $445 billion deficit for 2004 — the Administration claimed that the drop from $521 billion to $445 billion was good news that showed its policies were working. As noted, however, economic growth has not exceeded earlier expectations. Moreover, the long-term budget picture has failed to improve. The change in the projected level of the deficit in 2004 only indicates that short-term deficits were overestimated to begin with.

Moreover, the Administration's current official estimate — that the deficit will be $445 billion in the current fiscal year — itself appears to be overstated. Only three days after OMB issued the $445 billion estimate, the Treasury quietly issued an estimate that the deficit would be

$418 billion this year, about the same level CBO is projecting. When the actual deficit is announced at about $422 billion shortly before the election, the Administration may contend that the $422 is “good news” that shows further progress has been made since July, because the 2004 deficit has been “reduced” further from $445 billion to $422 billion.