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THIS YEAR'S DEFICIT PICTURE LOOKS BETTER, BUT THE LONG-TERM DEFICIT PICTURE DOESN'T

In its Mid-Session Review released this week, the Office of Management and Budget (OMB) projected that the 2005 deficit will be $94 billion lower than the level it projected when it released the President's budget in February — $333 billion rather than $427 billion — primarily because of higher-than-expected revenues. This is welcome news, but the reduction in this year's deficit from a very large one to a large one has little bearing on the nation's shaky long-term fiscal foundation. In fact, the good news about this year's deficit might even turn out to have an adverse effect on the long-term budget picture if it leads policymakers to become even more resistant to start pursuing more responsible fiscal policies.

The surge in revenues does *not* indicate that that the President's "tax cuts are working" and substantially boosting economic growth.

Economic growth in 2005 has not been unusually rapid. Nor has it been stronger than was projected earlier this year. In fact, the Administration's estimate of real economic growth in 2005 is exactly the same now as it was in the February budget. Thus, the larger-than-expected revenue level this year cannot be due to faster-than-expected economic growth.

Some of the major causes of the revenue surge this year, in fact, are evidently "one-time" factors that have little to do with economic growth. Most notably:

- The *expiration* of a business tax cut at the end of 2004 has generated an increase in tax collections of about $50 billion this year, according to past estimates by the Joint Committee on Taxation. In this case, revenue collections are up because a tax cut has ended, not because an ongoing tax cut is generating growth. And since a tax cut can expire only once, another $50 billion jump next year as a result of this factor is not in the cards.

- Corporate tax legislation enacted last October allows businesses with foreign profits being held abroad to bring the profits back to the United States and pay taxes on them at a greatly reduced rate *if the companies do so in 2005.* This will increase revenues in 2005, as corporations rush to take advantage of this one-time windfall, but will result in modest revenue losses in later years, according to the Joint Committee on Taxation.

Another factor behind the recent increase in revenues was the rise in the stock market in 2004. That resulted in increased capital gains and other taxes paid earlier this year, when 2004 tax returns were filed. In 2005, however, the stock market has generally moved sideways rather than upwards.

A recent analysis by the investment firm Goldman Sachs explained that "The [revenue] bonanza … was mainly a reflection of the prior year's strength in economic growth and the stock market… . The fact is that both growth and stock market momentum have cooled in 2005." As a result, Goldman Sachs expects much of the revenue increase to fade.

Revenue growth always occurs during a recovery, whether the recovery is accompanied by tax cuts or not. This recovery has been unusually weak in a number of respects, and revenues remain low.

Even with the increase in revenues in 2005, revenues remain at low levels for this stage of an economic recovery — and continue to be well below the levels that were forecast for 2005 when the tax cuts were passed.

Moreover, since the recession hit bottom in November 2001, real *economic* growth has averaged 3.3 percent per year, which is significantly below the 4.2 percent average growth rate for other post-World War II economic recoveries.

The current recovery is weak in terms of employment as well. It took nearly four years — longer than in any other recovery since World War II — for the number of jobs to rise back to its pre-recession level. Even in 2005, job growth has continued to lag well behind that in prior recoveries. Among non-supervisory workers, moreover, average real wages have actually fallen since 2003 and are at their lowest level since the end of 2001.

Despite the added revenues, this year's budgetary situation is nothing to cheer about.

This year (2005) is the fourth year of the recovery. By this point in the business cycle, deficits should be small or nonexistent. Instead, OMB is projecting a deficit of $333 billion.

When measured as a share of the economy, the 2005 deficit will be at a higher-than-average level for this stage of an economic recovery. This will be the fourth consecutive year for which that is the case.

The budgetary outlook for future years has not significantly improved.

OMB now is assuming that a large portion of the unexpectedly high level of revenues in recent months will continue for each of the next five years. OMB now projects that total revenues over the next five years (2006-2010) will be $409 billion higher than it projected earlier this year.

That is likely to prove overly optimistic, given the large role that one-time factors have played in the recent revenue increase. But even in the unlikely event that OMB's revenue assumptions prove

correct, deficits over the 2006-2010 period still will be considerably higher than OMB is now assuming, because OMB's projections:

- include no funding whatsoever after 2006 for operations in Iraq and Afghanistan;
- also include no funding after 2006 for the broader war on terrorism; and
- assume no costs for continuing relief from the Alternative Minimum Tax (AMT).

These left-out costs will likely prove quite substantial. Simply extending the current form of AMT relief would cost more than $750 billion between 2006 and 2015, for example.

When these costs are taken into account, it is clear that the budget outlook for the next ten years and beyond under the President's proposed policies remains rather bleak, even if OMB's optimistic assumptions regarding future revenue growth are borne out. Deficits will begin to grow at the beginning of the next decade and mount to quite high levels by 2015. The budget situation will deteriorate further in the years after 2015 as increasing numbers of baby-boomers retire and per-person health care costs continue to grow faster than the economy.

As Congressional Budget Office director Douglas Holtz-Eakin noted earlier this month about the recent revenue surge, "I do hope people are taking this with a grain of salt. . . . There's simply no question if you take yourself to 2008, 2009, or 2010, that vision is the same today as it was two months ago."