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October 11, 2006

DEFICIT ANNOUNCEMENT MASKS BIGGER STORY: LONG-TERM OUTLOOK REMAINS BLEAK

By Richard Kogan and James Horney

On Wednesday, October 11, the Treasury announced the final deficit figure for fiscal 2006. That figure is $248 billion.

This figure is $42 billion lower than the $290 billion deficit that the Office of Management and Budget estimated on July 11, which itself was lower than the deficit estimates that OMB and CBO issued last winter.[1] Consequently, the announcement seems like good news. But it is more of a temporary blip than solid progress. The improvement in the deficit may not extend even beyond this year, and the long-term outlook remains bleak.

- *The improvement in the deficit may not extend beyond this year.* As former CBO Director Douglas Holt-Eakin observed a few days ago about the new deficit figures, "The world doesn't end, but the deficit goes in the other direction next year."[2]

- *The outlook for the budget over the next 10 years remains bleak.* CBO's August projections show that if Congress makes the President's tax cuts permanent and extends relief from the alternative minimum tax, deficits will total *nearly $3.5 trillion* over the next 10 years (2007-2016), averaging $349 billion a year and never dipping below $280 billion a year even if costs for the wars in Iraq and Afghanistan fall substantially.[3] And the deficit outlook for subsequent decades, when increasing numbers of baby boomers will retire and, thus, receive Social Security and health care coverage, is substantially worse.

- *A deficit of $248 billion in 2006 means that the second largest six-year deterioration in the budget in 50 years has occurred, just behind the deterioration in the six-year period from 1998-2004.* In 2000, there was a

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[1] See Office of Management and Budget, *Mid-Session Review of the Budget for Fiscal Year 2007*, July 11, 2006, and Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2007*, March 2006. CBO's March baseline projection of the 2006 deficit under then-current policies was $336 billion. Legislation enacted since then (primarily additional funds for the war in Iraq and an extension of alternative minimum tax relief) has added an estimated $30 billion to the deficit. Thus, CBO's March projection implied a deficit of $366 billion under the policies that have actually taken effect.

[2] Quoted in David Wessel, "Deficit Progress Will Be Tough to Sustain," Wall Street Journal, October 7, 2006, page A2.

[3] Our adjustments to CBO's current-policy baseline projections (including an adjustment to reflect the assumption that emergency appropriations enacted in 2006 will *not* be repeated in each year through 2016) are based on estimates provided by CBO in Table 1-8 of the *Budget and Economic Outlook: An Update.*

Misleading Administration Claims to Have Cut in Deficit in Half

The Administration's claim that it has cut the deficit in half is misleading in several respects. First, the Administration uses a starting point of $521 billion, which was the deficit that it predicted for 2004 when it issued its proposed 2005 budget in February 2004. But analysts recognized from the outset that the $521 billion was inflated; the figure apparently was purposefully set high so the Administration could claim its policies were working when the actual 2004 deficit came in lower. At the same time that the Administration issued its $521 billion deficit forecast for 2004, CBO was estimating a deficit of $477 billion for that year. And the actual deficit for 2004 came in at $413 billion.

More importantly, compared to the fiscal picture the Administration inherited in 2001, the fiscal situation has worsened sharply rather than improved, hardly evidence that Administration polices "are working." The Administration has cherry-picked the deficit "high point" (selecting, in fact, a high point that never actually occurred) as well as what may be the deficit "low point" — the 2006 figure — as evidence of success. But deficits are expected to turn back up in 2007 or 2008. That deficits declined in 2005 and 2006 amidst an economic recovery tells nothing about the efficacy of Administration policies, especially considering that deficits turned to surpluses during the 1990s recovery, following tax *increases* in 1990 and 1993.

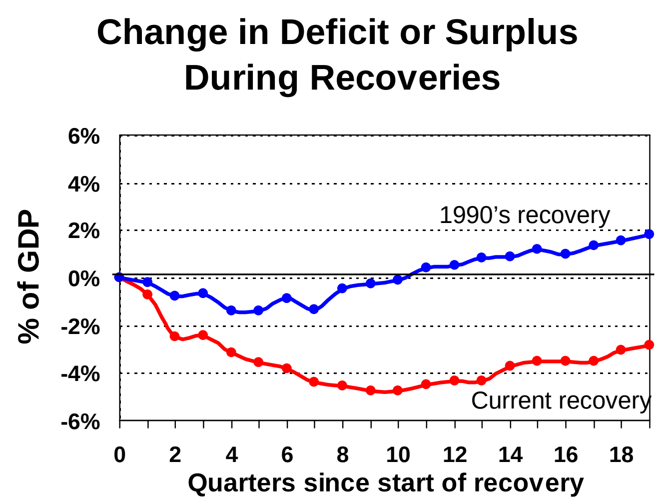
budget *surplus* equal to 2.4 percent of Gross Domestic Product. A deficit of $248 billion in 2006 equals 1.9 percent of GDP. This 4.3 percentage point deterioration in the budget is the second-largest six-year deterioration in half a century, just behind the 4.4 percentage point deterioration between 1998 and 2004.

The Administration is essentially celebrating a deficit that is lower in 2006 than in 2004 or 2005, even though deficits typically shrink during recoveries. More noteworthy is that the budgetary record during the current recovery is worse than during any other recovery in recent decades. (See graph on the next page.)

- *The deficit announcement does not signify recent improvement in the economy.* Of the $42 billion improvement in the deficit from OMB's July figure of $290 billion, about $30 billion comes from slower spending. In some cases, that simply means that the government will spend some of the funds in 2007 rather than in 2006. In addition, the Blue Chip has just *reduced* its consensus economic-growth estimate, and Goldman-Sachs says "The economy has clearly downshifted further in the third quarter." Also, on October 6, the Bureau of Labor Statistics reported that job growth so far in 2006 has been considerably slower than in 2005, and the job growth in September was the lowest of any month this year.

Total Real Per-Capita Revenue Growth in 22 Quarters after the Last Business Cycle Peak	
Current Business Cycle	-0.4%
Average for All Previous Post-World War II Business Cycles	9.8%
1990s Business Cycle	10.7%

- *Despite persistent claims to the contrary, revenue growth over the current business cycle actually has been negative*, after adjusting for inflation and population growth. Specifically, per capita revenues were lower in real terms in 2006 than in 2001, when the last recovery ended and the current business cycle started. While revenues have grown since 2004, this growth has not yet fully compensated for the fall in revenues that occurred in 2001, 2002, and 2003. Indeed, the overall lack of revenue growth over the current business cycle is almost unprecedented for economic recoveries since the end of World War II. It stands in stark contrast to claims that the President's tax cuts have boosted economic and revenue growth to remarkable levels.



12-month rolling average deficit or surplus at the end of each quarter, as a percent of GDP for that quarter, relative to the deficit at the start of the recovery. Sources: Treasury monthly statements and Bureau of Economic Analysis.

- *The economy's overall performance has been weaker during the current recovery than in an average recovery, which also stands in contrast to claims of a tax-cut fueled boom.* Economic data, available through the second quarter of 2006, show that the current economic expansion remains weaker than the average post-World War II economic recovery -- with GDP and non-residential investment growth falling below, and employment and wage and salary growth falling far below, historical norms.[4]

- *Finally, the announcement provides more evidence of the central role that recent tax cuts have played in the current deficit picture.* Based on Joint Committee on Taxation estimates, the total cost in 2006 of tax cuts enacted since January 2001 was $251 billion (including the increased interest costs of the debt that resulted from borrowing to offset the lost revenues). This means that even with the spending for the wars in Iraq and Afghanistan and the response to Hurricane Katrina, the federal budget would have been in virtual balance in 2006 if the tax cuts had not been enacted.

[4] See Isaac Shapiro, Richard Kogan, and Aviva Aron-Dine, "How Good is the Current Economic Recovery," Center on Budget and Policy Priorities, revised October 6, 2006.