COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET

Memo to: Board and Members
From: Carol Cox Wait
Date: March 13, 2003

SUBJECT: CBO ANALYSIS OF THE PRESIDENT'S BUDGET For Fiscal Year 2004

Deficits And Debt As Far As The Eye Can See

The budget situation continues to deteriorate. The Congressional Budget Office baseline budget deficit, over the next decade, is up $446 billion dollars since the *Economic and Budget Outlook* was published in January. Nearly 3/4 of that change is due to the omnibus appropriations bill enacted last month. Revenues also are down and could continue to decline unless the economy picks up soon.

The President's Budget only adds to the sea of red ink. We understand that deficits go up when the economy is weak. We know that the war against terrorism places demands on the public purse that must be met even if that drives up the deficit. We expect that the war with Iraq, if it happens, will make an already difficult budget situation much worse.

But when the war is over and the economy begins to grow the budget should return to balance. Debt held by the public should shrink as a percent of GDP. Today's budget decisions should alleviate, not exacerbate, the challenges that the country faces when the baby boom generation retires. The President's Budget does not meet these challenges. The hard choices have not been made.

The President's proposed policies would produce higher deficits and increase the national debt; deficits would grow nearly $1 trillion and the debt would rise $2.7 trillion through 2013. Debt held by the public would remain north of 30% of GDP through the end of the decade. Those outcomes assume substantial restraint on the rate of growth in discretionary spending, compared to recent years, and a healthy economy throughout the balance of the decade.

The Administration wants to cut taxes about $150 billion this year and next. Revenue reductions in the budget total about $450 over five years and nearly $1.5 trillion over the next decade. Mandatory spending would go up $600 billion over ten years and that is not as much as some in Congress want for prescription drugs.

The two fundamental disciplines that helped produce a balanced budget have been abandoned. Both "discretionary spending caps" and "paygo" should be included in any budget now--not later. If taxes are to be cut, pay for them with spending savings or other revenues or both. If prescription drugs are to be provided, include them with savings from Medicare reform. Tough discretionary spending discipline needs to be enforced in the appropriations process--not bargained away in omnibus appropriations bills. To abandon these disciplines virtually guarantees that the red ink will continue as far as the eye can see.

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The table below compares the President's Budget to the new CBO Baseline.

	CBO BASELINE			President's Budget*		
	fiscal years--totals may not add due to rounding					
	$ in billions					
	2004	**2004-08**	**2004-13**	**2004**	**2004-08**	**2004-13**
Revenues	2,024	11,741	27,860	1,907	11,287	26,405
Outlays	2,224	12,103	26,970	2,245	12,451	28,225
Deficit(-)/Surplus						
On-Budget	-373	-1,423	-1,678	-512	-2,225	-4,389
Off-Budget	173	1,061	2,568	174	1,061	2,569
Total	-200	-362	891	-338	-1,164	-1,820
	2004	**2008**	**2013**	**2004**	**2008**	**2013**
Public Debt**	**4,013**	**4,217**	**3,003**	**4,178**	**5,051**	**5,744**
	Percent of GDP					
	2004	**2004-08**	**2004-13**	**2004**	**2004-08**	**2004-13**
Revenues	17.9	18.6	19.3	16.9	17.9	18.3
Outlays	19.7	19.2	18.7	19.9	19.7	19.6
Deficit(-)/Surplus						
On-Budget	-303	-2.3	-1.2	-4.5	-3.5	-3.0
Off-Budget	1.5	1.7	1.8	1.5	1.7	1.8
Total	-1.8	-0.8	0.6	-3.0	-1.8	-1.3
	2004	**2008**	**2013**	**2004**	**2008**	**2013**
Public Debt**	35.5	**30.2**	**16.8**	**36.9**	**36.2**	**32.2**

* The numbers in the table are CBO re-estimates of the President's Budget. The differences between OMB and CBO estimates are small and using the CBO reestimates provides apples to apples comparisons.

** Five- and ten-year aggregate numbers for debt held by the public would be meaningless numbers. To complete our comparison, we include in the table single year numbers for 2008 and 2013.

Differences between CBO and OMB are Relatively Small

The differences between Administration and CBO estimates of both current services and the impact of the President's policies are small. The largest single-year difference in projections of Administration policies is $53 billion the amount of the deficit in 2005. By comparison, the CBO projects a $55 billion increase in the FY 2004 deficit between January and March this year. CBO and OMB economic assumptions also are very similar. These commonalties should reduce arguments about numbers and help to focus the upcoming budget debate on policy and policy differences.

The numbers are so large they boggle the mind. The *increase in the FY 2004 deficit projection* is greater than the total general fund budget of all but two States (California $67 billion and Texas $56 billion.)

Budget projections are volatile by their very nature. One-year projections are less susceptible to wild swings than five-year numbers and ten-year estimates are much more volatile than nearer-term estimates. The impact of legislative change on debt service costs and the impact of even small changes in economic assumptions compound throughout the forecast period. (CBO estimates the debt service costs associated with the omnibus appropriations bill to add 25% to the cost of that legislation over 10-years.) But recession and the war against terrorism have combined with recent tax cuts and spending increases to produce larger-than-average swings in near-term projections. War in Iraq and/or spending increases more in line with recent history than either the CBO baseline assumptions or the President's budget policies could make the near-term projections contained in this report look rosy.

What Happened to the Norm of Budget Balance?

For as long as any of us can remember, budget balance was the pot of gold at the end of the fiscal policy rainbow. The budget actually balanced only 12 times since the end of WW II and only 5 times in the last quarter century. But almost everyone agreed that budget balance should be the goal, over the business cycle, if not every year. The norm of budget balance served the country well, if only as a framework to impose some discipline on fiscal policy. Have we abandoned the norm of budget balance?

There is no objectively right level for federal spending and/or revenues. But if the country is to abandon the goal of budget balance, what will take its place? What is to be the guiding principal? Will the public and/or Congress rally around a standard expressed in terms of deficits or debt relative to GDP?

Both CBO and OMB predict that under the President's proposed policies, deficits would decline in nominal dollars and as a percent of GDP throughout the forecast period. The budget would not balance in any year through 2013. Debt held by the public would rise in nominal dollars and remain north of 30% of GDP throughout the forecast period*.

By contrast, CBO projects that, under current laws and policies debt would decline by 2013 to $3 trillion and 16.8 percent of GDP.

Budget Process

In the absence of an overall fiscal policy goal that commands broad and deep support, budget process is more important that ever before. Congress and the President must reach agreement on a budget, then keep spending and revenue legislation within the budget or adopt a new plan. That is the only way that anyone can anticipate the consequences of individual spending and tax decisions: whether deficits go up or down and by how much; what happens to the public debt; what resources likely will be available in future years to meet new priorities as they arise. That information is vitally important as we move toward the retirement of the baby boom generation and the pressures changing demographics will begin to exert on the budget before the end of the decade.

* 36.9% of GDP in FY 04, 37.4% in FY 05, 36.2% in FY 08 and 32.2% of GDP in FY 13.

The President's Policies

Administration estimates of the impact of the President's policies are similar to CBO's. Both anticipate that deficits would peak in 2004. Cumulative 2004-2008, CBO projects deficits totaling $1.2 trillion; the Administration estimate for the same period is $1.1 trillion. The Administration does not provide estimates beyond 2008. CBO projects that the deficit would decline in most years, reaching a low of $102 billion (0.6 percent of GDP) in 2013.

Revenues

Proposals to accelerate and make permanent the changes enacted as part of the 2001 tax cut account for about 55% of the revenue reductions in the President's Budget. Currently, all provisions of the 2001 law are set to expire January 1, 2011.

The President would permanently extend all those provisions including--

- Marginal income tax rate reductions;
- Child tax credit;
- Marriage penalty relief;
- Education incentives;
- Estate tax repeal (and associated modifications of gift and other taxes);
- Retirement income provisions; and
- Other incentives.

The impact of these changes would be to reduce revenues about $600 billion and increase outlays $22 billion over 10 years. In the case of estate taxes, some of the change is expected to occur soon after enactment of the President's proposals, as taxpayers alter estate planning. Otherwise, all of the above changes impact the budget after 2010.

Other Revenue Provisions

The largest single revenue change the President proposes is to eliminate dividends from double taxation. The provision would be effective for distributions beginning January 1, 2003 and would reduce revenues by nearly $8 billion 2003 and $388 billion through 2013.

Accelerating income tax rate cuts scheduled to take place in future years under the 2001 tax cut would reduce revenues by $25 billion in 2003 and $211 billion over the next decade. Those provisions include--

- Expansion of the 10 percent bracket scheduled to go into effect in 2008;
- Rate reductions scheduled to go into effect in 2006;
- Provisions addressing the marriage penalty due to phase in from 2005 to 2009; and
- An increase in the child credit due to go into effect in 2010.

Increasing the amount of the Alternative Minimum Tax (AMT) Exemption in 2003 and 2004 and extending it through 2005 is estimated to reduce revenue by $1 billion in 2003 and $36 billion through 2006.

Business provisions in the President's Budget include permanent extension of the Research and Experimentation Tax Credit, Expensing for Small Business and a Tax Credit for Developers of Affordable Single-Family Housing. Those provisions would reduce revenues respectively by $56 billion, $27 billion and $15 billion through 2013.

Above-the-line deductions for long-term care insurance, charitable deductions for nonitemizers, refundable tax credits for health insurance, expansion of tax-free savings plans, non-refundable credits against AMT would reduce revenues respectively by $18 billion, $15 billion, $51 billion, $7 billion, and $1 billion. The expansion of tax-free retirement savings actually would increase revenues in 2003 and 2004 but it would reduce revenues in future years due to untaxed withdrawals.

Other proposals include a variety of incentives for charitable giving and health care, incentives for education, energy and environment, tax simplification, changes in tax administration, extending additional provisions of tax law due to expire and unemployment compensation reform. Altogether, those proposals are estimated to reduce revenues $66 billion through 2013.

Discretionary Spending

The President's Budget does not include the omnibus appropriations bill. Starting from the base before that bill was enacted, the President proposed to increase new discretionary budget authority at an average annual rate of 4.7 percent for defense and 2.7 percent for non-defense activities. The CBO baseline grows at specified rates of inflation--increasing both defense and non-defense discretionary spending at an average annual rate of 2.6 percent.

Since 2000, new budget authority for discretionary defense activities has increased at an average rate of 8% per year. Non-defense budget authority has grown an average of 8.8% per year.

Neither the President's Budget nor the CBO reestimates include costs associated with armed conflict. CBO now estimates that the costs of deploying a heavy ground force to the Persian Gulf (beyond amounts already budgeted for routine operations) would be about $14 billion. Beyond that, incremental costs of war in Iraq could reach just over $10 billion in the first month and about $8 billion per month thereafter. Returning the force to home bases would cost approximately $9 billion. The incremental cost of occupation following combat operations could vary from $1 billion to $4 billion per month. CBO had no basis to estimate how long a war would last nor any reconstruction costs, nor foreign aid that the U.S. might choose to extend after conflict had ended. CBO's estimates exclude any costs associated with decontamination of areas or equipment affected by chemical or biological weapons.

Mandatory Spending

The President's Budget would add $621 billion to mandatory spending over the next decade, mostly for Medicare and Medicaid.

The Budget includes $400 billion to modernize Medicare. The Budget also would increase funding for Medicaid and the State Children's Health Insurance Program (SCHIP) and convert both programs to block grants. The conversion would be voluntary for States. CBO does not have sufficient information to provide an independent estimate of the cost of either proposal.

Homeland Security

The budget includes about $35 billion in net discretionary budget authority for homeland security. About $27 billion of that amount goes to the Department of Homeland Security. The balance would go to other departments that have homeland security responsibilities--$7 billion to Defense, $4 billion to HHS, and $2 billion to Justice.

Of the $27 billion that goes to the Department of Homeland Security, $19 billion would provide funding for activities classified within the OMB definition of homeland security.

The remaining $8 billion would go to activities such as maritime safety and immigration services that are outside of the OMB definition of Homeland Security.

Committee Activities

Save the Date. On May 8, the Committee will host a symposium on the current status of the budget and budget process debates, and our annual dinner in Washington. We hope that all of you will put those events on your calendar.

The Committee co-sponsored an *Exercise in Hard Choices* with the Denver *Post*, in Denver on February 22. We cannot know now whether the audience at that meeting reflected the mood in Washington as the FY 2004 budget debate begins. But if the Denver results were any predictor, there is a lot of confusion--even schizophrenia--around the upcoming budget debate. Our audience wanted to increase defense and other discretionary spending in the near-term but they did not want to commit to the higher numbers over the long-term. They were skeptical about homeland security spending--indeed would cut funding for transportation security and science within that category. There was no consensus around any plan to stimulate or grow the economy nor for large new tax cuts. And there was no agreement around any plan to reform Social Security, Medicare or the tax system--though most of our "budget committees" agreed that all three need reforming.

We continue to work with the University of Akron on electronic versions of the *Exercise in Hard Choices*. We will be able to conduct *Exercises* at a remote site or sites this year. We will develop distance learning curricula around the electronic version of the *Exercise*--probably for use first and/or foremost in post-secondary education. And we may be close to developing a version including artificial intelligence that would permit individuals to complete the *Exercise* alone and closely replicate the group dynamic that is so important to make the program successful.