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The Budget for Fiscal Year 2005

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Summary

For fiscal year 2005, the President's budget request reduces defense spending from FY2004, increases domestic discretionary spending, most of which goes to homeland security, leaving the rest to low or no growth, and proposes extending and making permanent many of the tax cuts adopted in 2001 and 2003. The deficit would drop from an estimated $521 billion in FY2004 to $364 billion in FY2005. The Administration's request shows the deficit falling to $237 billion in FY2009, the last year in the budget.

The budget proposals do not include estimates of the cost of the war on terror or reconstruction of Afghanistan and Iraq beyond FY2004 (September 30, 2004), do not provide estimates of the effect on the deficit or surplus of extending the tax cuts past FY2009 (which is when most of the effects would occur), and do not provide a proposal for alternative minimum tax (AMT) relief for the increasingly affected middle-class taxpayers, beyond the current expiration at the end of FY2005. These latter omissions, if addressed and accommodated in the future, would increase the deficit above what the Administration has estimated.

The Congressional Budget Office's (CBO) January 2004 budget report for FY2005 (the *Budget and Economic Outlook: Fiscal Years 2005-2014*) estimated the FY2005 baseline deficit at $362 billion, not much different from that proposed by the Administration. Selected alternative policies included in the CBO report, estimates for the cost of extending the tax cuts, reforming the AMT, and letting discretionary spending grow at the rate of gross domestic product (GDP) growth, would increase the deficit, particularly in the years beyond FY2009.

CBO's estimates of the Administration's proposals using CBO underlying assumptions and budget estimating methods, produces a deficit of $358 billion in FY2005, falling to $258 billion in FY2009. These estimates show the deficit climbing slightly after FY2010, moving to $284 billion in FY2014. CBO sees little chance that the Administration's proposals will produce a surplus.

The Senate Budget Committee reported its budget resolution (S.Con.Res. 95) on March 5, 2004. The resolution contained a smaller allocation funding for discretionary spending including defense than requested. It included room to make the tax cuts permanent. The Senate has scheduled the week of March 8, 2004 to debate its version of the FY2005 budget resolution. The House Budget Committee has indicated that it will consider its version of the FY2005 budget resolution, also during the week of March 8, 2004.

This report will be updated as events warrant.

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The Budget for Fiscal Year 2005

Background and Analysis

Presidents generally submit their budget proposals for the upcoming fiscal year (FY) early in each calendar year. The Bush Administration released its FY2005 budget (*The Fiscal Year 2005 Budget of the U.S. Government)* on February 2, 2004. The multiple volumes contained general and specific descriptions of the Administration's policy proposals and expectations for the budget for FY2005 and for the years through FY2009, with limited information on the revenue and mandatory spending changes through FY2014, and a section on long-term fiscal issues facing the nation. The full set of budget documents (*Budget, Appendix, Analytical Perspectives, Historical Tables*, among several others) contains extensive and detailed budget information, including estimates of the budget without the proposed policy changes (current service baseline estimates), historical budget data, detailed budget authority, outlay and receipt data, selected analysis of specific budget related topics, and the Administration's economic forecast. In addition to its presentation of the Administration's proposals, the budget documents are an annual basic reference source for federal budget information, including enacted appropriations.

The Administration's annual budget submission is followed by congressional action on the budget. This usually includes the annual budget resolution, appropriations, and, possibly, a reconciliation bill (or bills) as required by the budget resolution. During the months of deliberation on budget legislation, the Administration often revises its original proposals because of interactions with Congress and changing circumstances in the economy and the world.

The Current Situation

Both the House and Senate Budget Committees have begun their work on the FY2005 budget resolution. The Senate Budget Committee (SBC) reported its version of the resolution (S.Con.Res. 95) on March 5, 2004, on a party-line vote. The resolution included reconciliation instructions for an $81 billion, five-year tax cut, to fulfill the Administration's proposal to extend otherwise expiring tax cuts. The Senate began its debate on the resolution on March 8. The House Budget Committee is scheduled to begin deliberations on its version of the FY2005 budget resolutions on March 11. The House and Senate Appropriations Committees and the Senate Finance and House Ways and Means Committees have also begun their consideration of the budget. There are indications (from the press and statements by Members) that the very tight limits expected on spending, particularly discretionary spending, and efforts to extend the tax cuts, will make passing the budget resolution for FY2005 and other budget related legislation, including appropriations, more difficult than usual.

Budget Totals

Table 1 contains budget estimates for FY2005 from the Congressional Budget Office (CBO), the Administration (the Office of Management and Budget, OMB), and as they become available, revisions produced by OMB and CBO during the year, and data from congressional budget deliberations. Differences in totals occur because of differing underlying economic, technical, and budget-estimating assumptions and techniques as well as differences in policy assumptions. Most often, *policy*-generated dollar differences between various Administration and congressional proposals and underlying assumptions for an upcoming fiscal year are often relatively small compared to the budget as a whole. These small differences may grow over time, sometimes substantially, producing widely divergent budget paths. Budget estimates should be expected to change over time from those originally proposed or estimated by the President or Congress.

Table 1. Budget Estimates for FY2005
(in billions of dollars)

	Receipts	Outlays	Deficit(-)/ Surplus
CBO, BEO Baseline, Jan. 2004	$2,049	$2,411	$-362
OMB, Budget Proposals, Feb. 2004	2,036	2,400	-364
OMB, Budget Modified Current Services, Feb. 2004	2,037	2,397	-360
OMB, Budget Trad. Curr. Services, Feb. 2004	2,048	2,442	-393
CBO, Revised Baseline, March 8, 2004	2,050	2,414	-363
CBO, EPP, March 8, 2004	2,029	2,384	-356
SBC, Chairman's Mark, 3/3/04	2,025	2,363	-338

B&E Outlook – The *Budget and Economic Outlook*, CBO.
EPP – CBO's estimates of the President's proposals.
SBC – Senate Budget Committee.

The war on terrorism, the 2001 recession and the early slowness of the economic recovery, changes in policies (tax cuts; spending increases), and changes in the technical assumptions in the underlying budget-economic relationships, all contributed to the severe deterioration in the budget outlook since January 2001, when large and growing surpluses were expected throughout the forecast period (through FY2011).

Budget Estimates and Proposals

CBO's first budget report for FY2005, the *Budget and Economic Outlook: Fiscal Years 2005-2014* (January 2004), contained baseline estimates and projections for FY2004 through FY2014.[1] CBO's report showed that, under baseline assumptions, the budget would remain in deficit through FY2013 ($16 billion). The baseline showed a small surplus ($13 billion) in FY2014. Under the baseline assumptions, the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; P.L. 107-16, June 2001) would expire as scheduled on or before the end of calendar year 2010. After calendar 2010 (from a part of FY2011 through FY2014), the baseline experiences a revenue surge, which drives down the deficit.

The revised CBO baseline (March 8, 2004) projected a slightly deteriorated outlook for the budget. Mostly from technical changes since the January estimates, the deficit no longer disappears over the 10-year period. In FY2014, CBO's revised baseline projections have a deficit of $15 billion instead of the previous surplus of $13 billion.

President Bush's FY2005 budget called for extending and making permanent a large number of the tax cuts adopted in 2001 and 2003. The Treasury's estimates of the tax proposals produced a $213.3 billion revenue reduction (from Administration baseline estimates) between FY2005 and FY2009 and a $1,240.2 revenue billion reduction between FY2005 and FY2014. The Joint Committee on Taxation (JCT) estimated (March 3, 2004) that the President's tax proposals would reduce receipts by $226.7 billion between FY2005 and FY2009 and by $1,402.4 billion between FY2005 and FY2014.

The budget shows total mandatory outlays rise by $53.5 billion from FY2004 to FY2005. Discretionary defense outlays fall by $3.4 billion from FY2004 to FY2005. Nondefense domestic discretionary spending rises by $8.0 billion from FY2004 to FY2005. Net interest, driven by the increases in debt that are themselves driven by the large deficits, rises by $21.6 billion between FY2004 and FY2005.

The Administration also modified its presentation of its current services baseline estimates. Instead of closely following the directions for constructing baseline estimates in the Deficit Control Act, the Administration's FY2005 current services baseline assumes the extension of certain tax provisions (that by current law are scheduled to expire), excludes the future cost of one time events, such as the FY2004 emergency funding, and includes an adjustment to the calculation of federal pay. For FY2005, the Administration's modified current services deficit estimate is $33 billion smaller than the traditional baseline estimate. By FY2009, the Administration's modified estimated baseline deficit is $60 billion smaller than the traditional baseline deficit estimate.

The Administration's estimates do not extend beyond FY2009 except for cumulative proposed revenue changes and cumulative proposed mandatory spending changes, which are both shown for the period FY2005 through FY2014.

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[1] Baseline estimates are not meant to be predictions of future budget outcomes, but instead are designed to provide a neutral measure against which to compare proposed policy changes. In general they project current policy into the future. Discretionary spending is increased by the rate of inflation.

CBO's baseline estimates (the *Budget and Economic Outlook: Fiscal Years 2005-2014*) show FY2005 with a deficit of $477 billion. By FY2009, the baseline deficit estimate has fallen to $268 billion. Under the baseline assumptions, the CBO estimates increase discretionary spending at the rate of inflation, do not include extending the tax cuts, and allow the alternative minimum tax (AMT) relief to expire as scheduled. As CBO itself points out, the baseline estimates are not designed as predictions of the budget's future outcome. They provide a neutral benchmark against which proposed policy changes can be measured.

CBO includes the estimated budgetary cost of selected policy alternatives. These include extending expiring tax provisions (a $496 billion five-year increase in the deficit), reform the alternative minimum tax (a $376 billion five-year increase in the deficit), and several alternative assumptions about the growth rate of discretionary spending (including defense) that range from a freeze (a $257 billion five-year decrease in the deficit) to annual growth of 6.9% (a $590 billion increase in the deficit.[2]

The Administration argues that extending the tax cuts is still needed to ensure the economy continues its recovery and that to do otherwise would result in a tax increase. Extending the tax cuts becomes increasingly expensive over time and pushes the entire deficit reduction effort onto the spending side of the budget.

Uncertainty in Budget Projections

All budget estimates and projections are inherently uncertain. Their dependence on assumptions that are themselves subject to substantial variation over short time periods makes budget estimates and projections susceptible to fairly rapid and dramatic changes. The last couple of years have demonstrated this volatility. The original proposals and estimates for FY2002, made in early 2001, dramatically changed over the 20 to 21 months of congressional and presidential action on the budget. (The budget estimates in the OMB and CBO budget documents for five to 10 years in the future are subject to even greater variability.)

The early 2001 estimates for FY2002 estimated a *surplus* of $231 billion to $313 billion. The year ended on September 30, 2002 with a *deficit* of $158 billion. The September 2001 terrorist attacks on the United States, the legislation adopted in response, the bursting of the stock market bubble, the weak economy, and a shift in underlying budget relationships, all contributed to a large change in the year's budget outcome from the originally proposed or estimated amounts. There is little reason to expect this uncertainty to diminish in current or future budget projections.[3]

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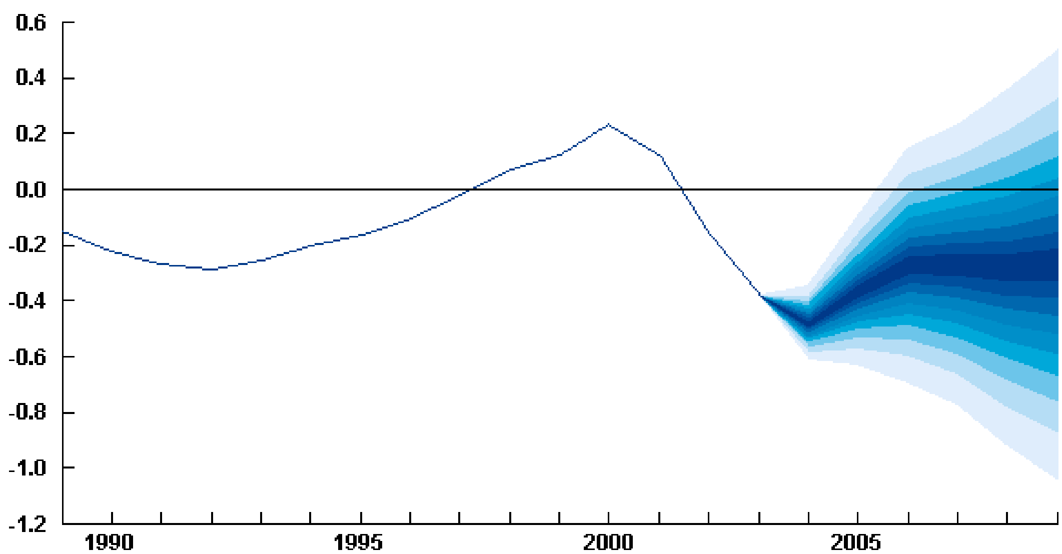
[2] As CBO states, "The 6.9 percent rate of growth is the historical average from 1999 through 2004, excluding $87 billion in supplemental appropriations for FY2004." CBO, *Budget and Economic Outlook: Fiscal Years 2005-2014*, Jan. 2004, p. 6.

[3] Some things are known with certainty about the direction of future spending and receipts. Demographics can partly determine the shape of future budgets. The upcoming retirement of the baby boom generation will rapidly drive higher the spending for Social Security and Medicare as well as other federal spending or tax breaks for the elderly in the next decade.

(continued...)

Information in appendix A (The Uncertainties of Budget Projections) of CBO's budget report, *The Budget and Economic Outlook: Fiscal Years 2005-2014* (January 2004), indicates how greatly the budget outcome can be altered, especially over time, by changes in economic and the related technical factors that underpin the budget estimates. The chapter contains a discussion of optimistic and pessimistic alternative scenarios for CBO's baseline projection. The optimistic scenario assumes more favorable economic and budget conditions than the baseline while the pessimistic scenario assumes less favorable conditions than the baseline. CBO estimates that the 10-year cumulative optimistic and pessimistic baseline surpluses or deficits would be $8 trillion apart. According to CBO, two-thirds of the growth in the difference occurs in the last five years of the estimates. Figure 1 is from CBO. It represents the most likely budget outcomes clustered in the center, in the darkest part, of the figure. The lightest color, towards the edge of the graph, represents the less likely outcomes. The entire fan in FY2009 represents the range within which the budget balance has a 90% chance of occurring.

Figure 1. Uncertainty of CBO's Projections of the Budget Deficit or Surplus Under Current Policies
(in trillions of dollars)
(Source: CBO)



The President's budget includes, in the chapter, "Comparison of Actual to Estimated," in the *Analytical Perspectives* volume of the budget, similar information. The Administration used budget data from FY1982 to FY2003 to produce statistical measures of the differences between the estimated and actual surpluses or deficits over these years. According to the Administration's calculations, there is a 90% chance that the FY2009 budget will have a deficit or a surplus that falls within $500 billion above or below the Administration's currently proposed deficit for that year. This produces a range of outcomes from a deficit of approximately $740 billion to

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[3] (...continued)
Because virtually all those who will become eligible for these benefits are alive today, estimating the growth in these programs is relatively straightforward.

a surplus of approximately $260 billion, within which the deficit or surplus is most likely to fall.

Budget projections are very dependent on the underlying assumptions about the direction of the economy and expected future government policy and how these interact along with other factors (such as changing demographics) that affect the budget. Any deviation from the assumptions used in the budget estimates, such as faster or slower economic growth, higher or lower inflation, differences from the existing or proposed spending and tax policies, or changes in the technical components of the budget models can have substantial effects on changing the budget outcomes from earlier budget estimates and projections.

Budget Action

CBO and the Administration released their first budget reports for FY2005, in late January and early February 2004. CBO's report provided baseline estimates for fiscal years 2004 through 2014. OMB's documents provided estimates for FY2004 through FY2009 with a few instances of cumulative estimates for fiscal years 2004 through FY2014 (these were limited to revenues and mandatory spending and provided no data for the individual fiscal years after FY2009). The budget also lacked detailed data on program or account spending beyond FY2005. The *Analytical Perspectives* volume of the President's budget provided current services baseline estimates for the years through FY2009.

By late February and early March 2004, the House and Senate Budget Committees began discussing the budget resolution for FY2005. The Senate Budget Committee (SBC) reported its version of the FY2005 budget resolution on March 5. The Senate began considering the resolution the week of March 8. The House Budget Committee (HBC) is to consider its version of the FY2005 budget, also during the week of March 8, 2004.

CBO released slightly revised baseline estimates in its report, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2005*, on March 8. The report recalculated the Administration's proposals using CBO's underlying assumptions estimating techniques. CBO also extended the projections through FY2014. The CBO re-estimates produced smaller deficits in FY2004 and FY2005 than in the President's budget and, because of the smaller deficit in FY2004, did not show the deficit dropping by half in FY2009.

Outlays

The Administration's FY2005 budget proposed $2,400 billion in outlays for FY2005, rising to $2,853 billion in FY2009, the last year forecast in the President's budget. The Administration modified its method of calculating its current services baseline in this year's budget.[4] Under its modified assumptions, FY2005 baseline outlays are $2,397 billion, rising to $2,847 billion in FY2009. Under the traditional method of calculating the baseline, current services baseline outlay estimates would rise from $2,442 billion in FY2005 to $2,952 billion in FY2009. The modified current services baseline estimates, when compared to the proposals, show smaller changes than between the proposal and the standard current services baseline estimates.

Table 3. Outlays for FY2004-FY2009 and FY2014

(in billions of dollars)

	FY2003	FY2004	FY2005	FY2006	FY2007	FY2008	FY2009	FY2014
CBO Baseline, 1/26/04	*$2,158* [a]	2,294	2,411	2,525	2,652	2,783	2,912	3,616
President's FY05 Budget, 2/2/04		2,319	2,400	2,473	2,592	2,724	2,853	—
President's FY05. Current Services, 2/2/04		2,319	2,397	2,468	2,583	2,715	2,847	—
Pres.'s FY05 Trad. Current Services, 2/2/04		2,319	2,442	2,550	2,676	2,815	2,952	—
CBO, Revised Baseline, 3/8/04		2,296	2,414	2,528	2,658	2,791	2,924	3,635
CBO, EPP, 3/8/04		2,295	2,384	2,482	2,593	2,722	2,853	3,600
SBC, Chairman's Mark, 3/3/04		2,295	2,363	2,468	2,582	2,698	2,815	—

a. Actual outlays for FY2003.
EPP – CBO's estimates of the President's proposals.

The Administration's proposals, if adopted, would (under Administration estimates) raise outlays $81 billion (3.5%) above the Administration's proposed FY2004 level and $3 billion (0.1%) above its FY2005 current services baseline outlay estimate.[5] The difference between the current services baseline outlay estimate and the proposed outlay amount for FY2005 measures the "cost" of the Administration's proposed policies. The year-to-year change (the $81 billion increase) combines the effects of policy changes from year to year with the relatively automatic growth in large parts of the budget. These automatic increases include cost-of-living adjustments, growth in populations eligible for program benefits, and inflation driven increases. The President's budget does not include estimated costs of continued action in Afghanistan or Iraq after the end of FY2004. The Administration has indicated it will present a proposal for funding later in the year.

As shares of GDP, the Administration's proposals would reduce outlays from 19.9% of GDP in FY2005 to 19.4% of GDP in FY2009. CBO's estimate of the President's outlay proposals has them falling slightly from 19.7% of GDP in FY2005 to 19.6% of GDP for the fiscal years 2006 through 2010, before rising to 19.9% of GDP in FY2014. These levels are below both the average from FY1980 through

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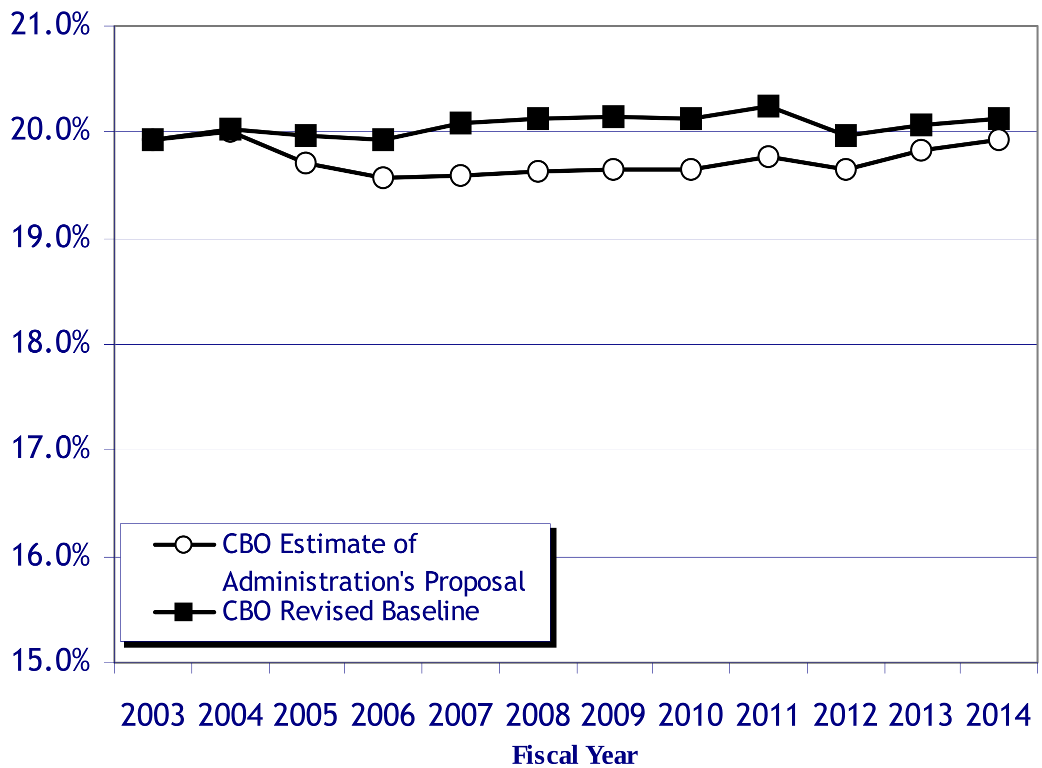
[4] The current services baseline estimates like CBO's baseline estimates are designed to provide "a neutral benchmark against which policy proposals can be measured." The modified baseline used this year assumes emergencies are one-time only, that federal pay adjustment assumptions reflect the (usual) January 1 start of inflation adjusted raises rather than October 1, and the debt service changes resulting from these (and revenue related) modifications.

[5] The FY2005 outlay proposals would be $42 billion (1.7%) *below* the traditional formulation of the baseline.

FY2003 (21.1% of GDP) or the average from FY1990 through FY2003 (20.2% of GDP). CBO's revised baseline estimates show outlays rising from 20.0% of GDP in FY2005 to 20.1% of GDP in FY2009 and remains at that level through FY2014. Using one of CBO's alternative scenarios for spending, one that assumes outlays grow at the rate of GDP growth rather than the slower rate of inflation, outlays would equal 20.1% of GDP in FY2005, rising to 21.0% of GDP in FY2009 and to 21.9% of GDP in FY2014. Figure 2 shows CBO's revised (March 2004) outlay baseline estimates and the CBO's estimate of the Administration outlay proposals as shares of GDP.

Figure 2. Outlays, FY2003-FY2014
(as percentages of GDP)



The major components of federal spending show different patterns of change in the President's budget. Mandatory spending grows from 10.9% of GDP in FY2005 to 11.0% in FY2009. The large deficits and resulting growth in debt-held-by-the-public drives net interest outlays higher. Net interest grows from 1.5% of GDP in FY2005 to 2.0% in FY2009. Defense spending, in spite of the Administration's proposals, falls from 3.7% of GDP in FY2005 (4.0% in FY2004) to 3.3% in FY2009. The 3.3% is a smaller share of the economy than in all but four years (FY1997 through FY2001) since World War II. Nondefense discretionary spending falls from 3.9% of GDP in FY2005 to 3.1% in FY2009.

CBO's estimates of the President's proposals show mandatory spending growing from 10.7% of GDP in FY2005 to 11.1% in FY2009 to 11.9% in FY2014. Net interest rises from 1.5% of GDP in FY2005 to 2.0% in FY2009 to 2.1% in FY2014. CBO's estimates of defense spending show similar patterns to those of the

Administration, with defense outlays continuing to fall as shares of GDP to 3.1% of GDP in FY2014. Nondefense spending falls from 3.8% of GDP in FY2005 to 3.2% in FY2009 to 2.6% in FY2014.[6]

Defense spending averaged 3.8% of GDP from FY1990 through FY2003; nondefense discretionary spending averaged 3.6% of GDP for the same years. Mandatory spending averaged 10.2% of GDP from FY1990 through FY2003; net interest averaged 2.7% of GDP over the same period.

Receipts

The Administration's FY2005 budget proposed extending and making permanent many of the tax cuts adopted in 2001 and 2003 that would otherwise expire (as scheduled) over the next five or six years. These plus other proposals would reduce receipts by an estimated $213 billion over FY2005 to FY2009 period and by $1,240 billion over the FY2005 to FY2014 period.[7] CBO's estimate of these proposals put the cost at $181 billion for the FY2005 through FY2009 period and $1,299 billion for the FY2005 through FY2014 period.[8]

Table 4. Receipts for FY2003-FY2009 and FY2014

(in billions of dollars)

	FY2003	FY2004	FY2005	FY2006	FY2007	FY2008	FY2009	FY2014
CBO Baseline, 1/31/03	*$1,782* [a]	$1,817	$2,049	$2,256	$2,385	$2,506	$2,644	$3,629
President's F054 Budget, 2/2/04		1,798	2,036	2,206	2,351	2,485	2,616	—
President's FY04 Current Services 2/2/04		1,791	2,037	2,215	2,354	2,497	2,636	—
Pres.'s FY05 Trad. Current Services, 2/2/04		1,791	2,048	2,245	2,384	2,527	2,681	—
CBO, Revised Baseline, 3/8/04		1,817	2,050	2,255	2,384	2,505	2,643	3,620
CBO, EPP, 3/8/04		1,817	2,029	2,212	2,351	2,469	2,595	3,311
SBC, Chairman's Mark, 3/3/04		1,817	2,025	2,216	2,358	2,480	2,613	—

a. Actual receipts for FY2003.
EPP = CBO's estimates of the President's proposals.

Receipts would grow from an estimated $2,036 billion in FY2005 to $2,616 billion in FY2009. These increases follow three years of falling receipts from their

[6] The President's budget forecast data through FY2009; CBO extended discretionary spending through FY2014 by increasing it at the rate of inflation after FY2009.

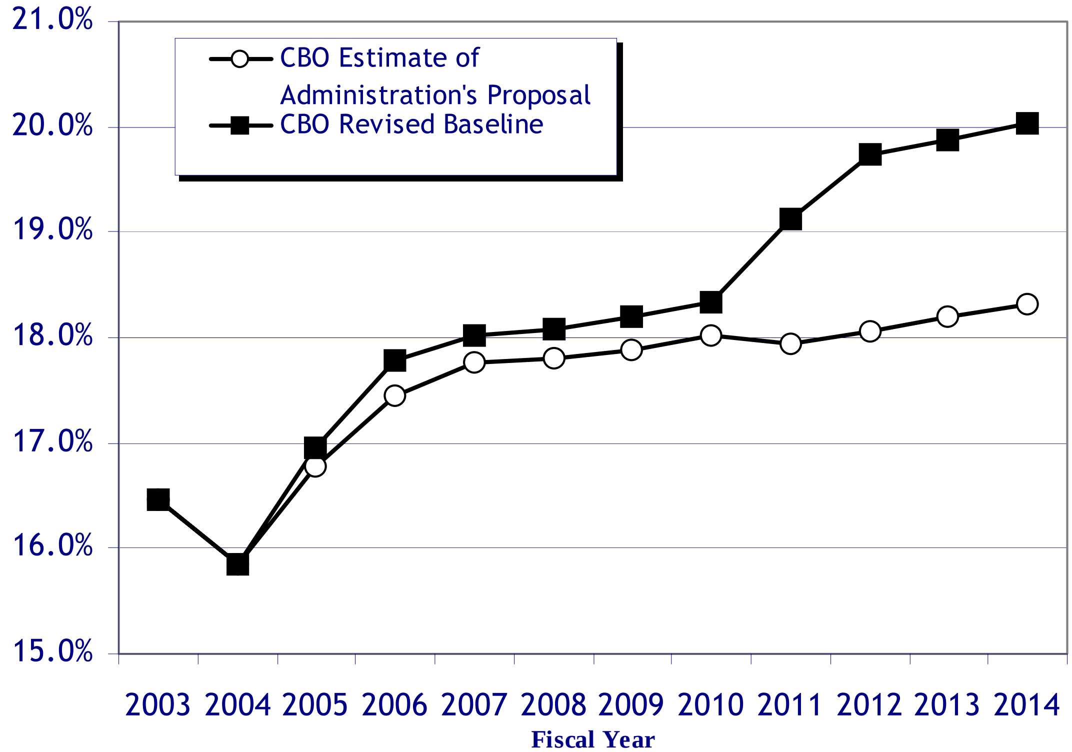
[7] These estimates are from the Treasury's *General Explanations of the Administration's Fiscal Year 2005 Revenue Proposals*. The President's budget showed a $175 billion revenue reduction (from baseline estimates) for the FY2005-FY2009 period and a $1,122 billion reduction for the FY2005-FY2014 period. The Treasury's estimates were produced after the release of the President's budget reflecting modifications to the proposals and adjustments to the estimates. See also the CRS Report RS21420, *President Bush's 2003 Tax Cut Proposal: A Brief Overview*, and the CRS Issue Brief IB10110, *Major Tax Issues in the 108th Congress* for more information on the proposals.

[8] These amounts from CBO do not include the outlay effects of the extensions or other proposals.

peak in FY2000 ($2,025 billion) through FY2003 ($1,782 billion) and an expected small increase in FY2004 ($1,798 billion). The Administration expects receipts to exceed the FY2000 dollar level in FY2005.

As shares of GDP, receipts would also rise over the FY2005 through FY2009 period, from 16.9% of GDP in FY2005 to 17.8% of GDP in FY2009.[9] The ratio remains below the FY1980 to FY2003 receipt average of 18.5% of GDP for the FY2005 through FY2009 period. CBO's estimates of the Administration's proposals show revenues rising from 16.8% of GDP in FY2005 (up from the 15.8% of GDP in FY2004) to 17.9% of GDP in FY2009 to 18.3% of GDP in FY2014. The CBO estimates of the President's proposals and the CBO baseline are shown in Figure 3.

Figure 3. Receipts, FY2003-FY2014
(as percentages of GDP)



The Administration arbitrarily reduced its FY2004 and FY2005 receipt estimates by $20 billion and $15 billion respectively, "in the interest of cautious and prudent forecasting."[10] The downward adjustment for "uncertainty," as the budget indicates, increases the estimated deficits for both years by $20 billion (in FY2004) and by $15 billion (in FY2005).

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[9] The FY2005 ratio rises from the FY2004 level of 15.7% of GDP, a level not even neared since FY1950, when it was 14.4% of GDP and the nature of federal spending and receipts was very different than it is now.

[10] OMB, *Budget of the U.S. Government for Fiscal Year 2003*, February 2004, *Analytical Perspectives*, p. 239.

The Administration's proposal extends the current relief from the alternative minimum tax (AMT) for many in the middle class for one year. Without a further extension, a growing number of middle class taxpayers will find themselves subject to the AMT. Preliminary estimates indicate that the AMT, which affected a little over 600,000 taxpayers in 1997, will, with the effects of inflation and legislative changes, grow to 33 million taxpayers in 2010.[11] CBO estimates that providing extended or permanent AMT relief would reduce receipts by $148 billion between FY2005 and FY2009 and by $376 billion between FY2005 and FY2014.

Deficits and Surpluses

Surpluses and deficits are the residuals left after Congress and the President set policies for spending and receipts. Surpluses reduce federal debt held by the public which leads to lower net interest payments; deficits increase government debt held by the public, increasing net interest payments (assuming no change in interest rates). Reducing the deficit and eventually reaching a balanced budget or generating and keeping a surplus (the government had its first surplus in 30 years in FY1998) was a major focus of the budget debates in the late 1980s and throughout the 1990s.

Table 5. Surpluses/Deficits(-) for FY2005-FY2009 and FY2014

(in billions of dollars)

	FY2003	FY2004	FY2005	FY2006	FY2007	FY2008	FY2009	FY2014
CBO Baseline, 1/26/04	*-375* [a]	-477	-362	-269	-267	-278	-268	13
President's F05 Budget, 2/2/04		-521	-364	-268	-241	-239	-237	—
President's FY04 Current Services 2/2/04		-528	-360	-253	-229	-218	-211	—
Pres.'s FY05 BEA Current Services, 2/2/04		-528	-393	-305	-292	-288	-271	—
CBO Revised Baseline 3/8/04		-477	-363	-273	-274	-286	-281	-15
CBO EPP 3/8/04		-478	-356	-270	-242	-252	-258	-289
SBC, Chairman's Mark, 3/3/04		-477	-338	-252	-224	-218	-202	—

a. Actual deficit for FY2003.
EPP = CBO's estimates of the President's proposals..

The President's FY2005 budget proposals included a deficit of $521 billion in FY2004 falling to $364 billion in FY2005. The deficit falls to an estimated $237 billion in FY2009, which fulfills the Administration's claim of reducing the deficit by half (starting from the FY2004 estimated deficit). Most of the deficit's fall occurs from FY2004 to FY2006, after which it shows relatively little change (in dollars).

CBO's estimates of the President's proposals put the FY2004 deficit at an estimated $478 billion and the FY2005 deficit at an estimated $356 billion. They show the FY2009 deficit at an estimated $258 billion, implying, in CBO's forecast, that the deficit will not quite be reduced by half as the Administration shows. Figure

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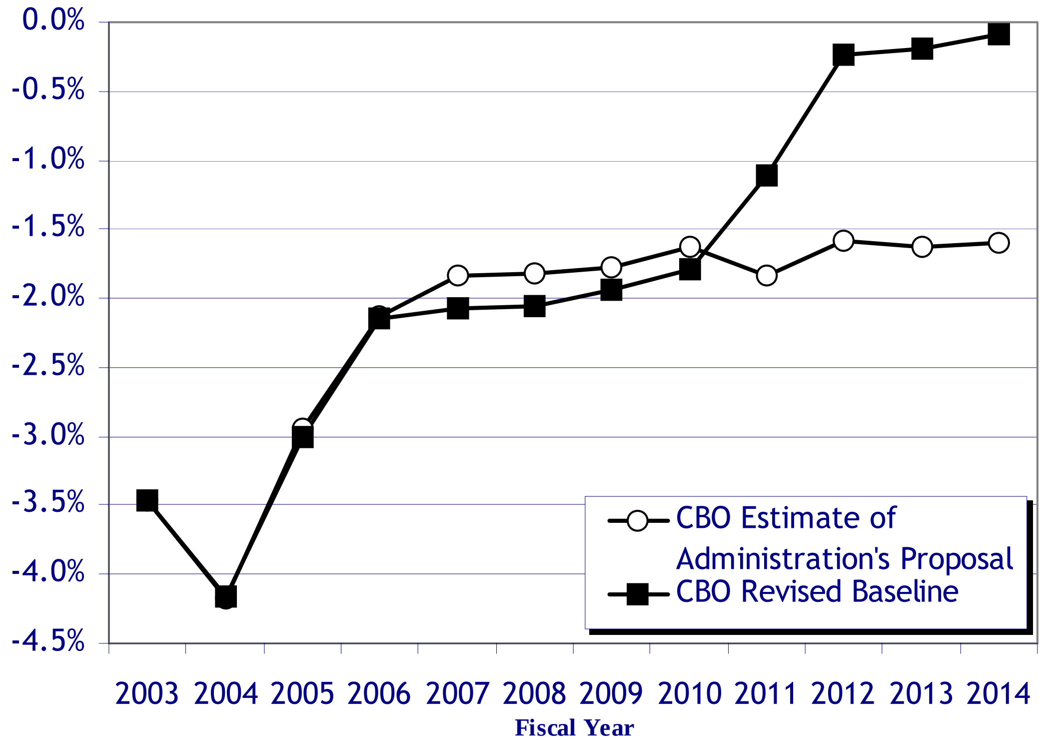
[11] See the CRS Report RL30149, *The Alternative Minimum Tax for Individuals*, by Gregg A. Esenwein, for a discussion of the AMT issue.

4 shows CBO's baseline deficit estimates and its estimates of the deficit resulting from the Administration's policies, both as shares of GDP.

Figure 4. Deficits, FY2003-FY2014
(as percentages of GDP)



CBO's January 2004 baseline estimates had the budget returning to surplus in FY2014 ($13 billion). CBO's baseline revisions in March 2004 showed a slight worsening of the budget outlook (because of technical factors) that eliminated the expectation of a surplus throughout its 10-year forecast. A small deficit of $15 billion would remain in FY2014. This result occurs in spite of the increase in receipts expected after the scheduled expiration (in law) of many of the tax cuts adopted in 2001 and 2003.

CBO's Alternative Policies Not Included in the Baseline

CBO's January 2004 budget report included estimates of the "budgetary effects of policy alternatives not included in CBO's baseline." The alternatives are policies that seem likely to be enacted or seriously debated. They include extending expiring tax provisions, the reform of the AMT, and four variations on the growth of discretionary spending, including: increasing it at the growth rate of nominal GDP; increasing it at the average rate of discretionary spending growth from FY1999 through FY2004 (excluding the $87 billion FY2004 supplemental from the average); raising it at the rate of inflation after FY2004 (and excluding the $87 billion FY2004 supplemental from the calculation); and freezing discretionary spending at the FY2004 spending level (including the FY2004 supplemental).

The alternatives that reduce receipts or increase spending are all fairly costly when compared to CBO's baseline, running from $148 billion for AMT reform over FY2005 through FY2009 to $590 billion for increasing discretionary spending at its average historical growth rate for the same years. These amounts do not include the higher interest costs associated with larger deficits and debt. Freezing discretionary spending would reduce spending by an estimated $237 billion for the FY2005 through FY2009 period, while increasing discretionary spending by the rate of inflation would save an estimated $379 billion in spending over the same years. The numbers become substantially larger over the 10-year period, FY2005 through FY2014. The amounts for these alternatives for the five and 10 year periods are shown in Table 6 (reproduced from a CBO table). Figure 5 presents the CBO baseline deficit and the baseline adjusted for the costs of extending the tax cuts, reforming the AMT, and increasing discretionary spending at the rate of GDP growth (as percentages of GDP).

Figure 5. Alternative Deficit Paths, FY2003-FY2014
(as percentages of GDP)

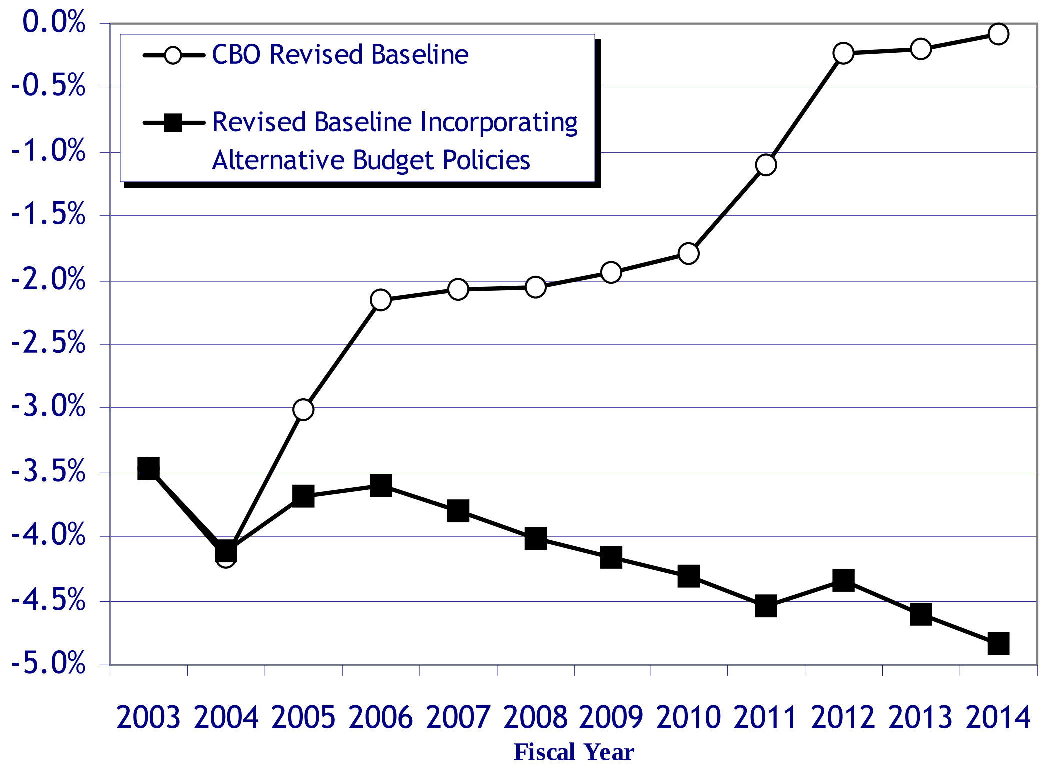


Table 6. The Budgetary Effects of Policy Alternatives Not Included in CBO's Baseline

(Billions of dollars)

	Total, 2005-2009	Total, 2005-2014
Policy Alternatives That Increase the Deficit or Reduce the Surplus[a]		
Extend Expiring Tax Provisions[b]		
Effect on the deficit or surplus		
EGTRRA and JGTRRA	-155	-1,233
Partial expensing	-285	-440
Other	-56	-195
Total	-496	-1,868
Debt service	-57	-363
Reform the Alternative Minimum Tax[c]		
Effect on the deficit or surplus	-148	-376
Debt service	-14	-93
Increase Discretionary Appropriations by the Growth Rate of Nominal GDP After 2004		
Effect on the deficit or surplus	-342	-1,360
Debt service	-31	-258
Increase Discretionary Appropriations by 6.9 Percent a Year After 2004[d]		
Effect on the deficit or surplus	-590	-2,682
Debt service	-51	-475
Policy Alternatives That Reduce the Deficit or Increase the Surplus		
Increase Discretionary Appropriations (Excluding supplemental appropriations for 2004) by the Rate of Inflation After 2004[e]		
Effect on the deficit or surplus	379	880
Debt service	42	227
Freeze Total Discretionary Appropriations at the 2004 Level ($876 billion)		
Effect on the deficit or surplus	257	1,117
Debt service	23	203
Memorandum:		
Total Deficit (-) or Surplus in CBO's January 2004 Baseline	-1,443	-1,893

Sources: Congressional Budget Office; Joint Committee on Taxation. CBO, *Budget and Economic Outlook: Fiscal Years 2005-2014*, Jan. 2004, p. 6-7.

Note: EGTRRA = Economic Growth and Tax Relief Reconciliation Act of 2001; JGTRRA = Jobs and Growth Tax Relief Reconciliation Act of 2003; * = between -$500 million and $500 million.

a. Negative amounts indicate an increase in the deficit or a reduction in the surplus.

b. This estimate does not include the effects of extending the increased exemption amount for the alternative minimum tax, which expires in 2004. See the policy alternative for the alternative minimum tax.

c. This alternative assumes that the exemption amount for the AMT, which was increased through 2004 in JGTRRA, is extended at its higher level and, together with the AMT tax brackets, is indexed for inflation after 2004. The estimates are shown relative to current law. If this alternative was enacted jointly with the extension of expiring tax provisions, an interactive effect would occur that would make the combined revenue loss greater than the sum of the two separate estimates by about $173 billion (plus about $16 billion in debt-service costs) over the 2005-2014 period.

d. The 6.9 % rate of growth is the historical average from 1999 through 2004, excluding $87 billion in supplemental appropriations for 2004 enacted in November [2003]. In this alternative, however, those supplemental appropriations are included in total budget authority for 2004 and are extended through 2014.

e. This alternative does not extend the $87 billion in supplemental appropriations enacted in November [2003] but includes the outlays resulting from them.

The Longer Run

Over a longer time period, one beginning in the next decade and lasting for decades into future, both CBO and the Administration indicate (in their respective budget documents) that they expect, under existing policies and assumptions, that demographic pressures will produce large and persistent deficits. CBO states,

> The aging of the baby-boom generation will cause a historic shift in the United States' fiscal position in the decades beyond CBO's projection period. Over the next 30 years, the number of people ages 65 and older will double... costs per enrollee in federal health care programs are likely to continue growing much faster than inflation. CBO projects that [these factors] will cause federal spending for Social Security, Medicare, and Medicaid combined to increase (even under moderate growth assumptions) by more than two-thirds as a share of the economy–from more than 8 percent of GDP in 2004 to over 14 percent in 2030 and almost 18 percent in 2050.
>
> Those budgetary pressures will ultimately require choices involving some combination of a substantial reduction in the growth of federal spending, an increase in taxation–possibly to levels unprecedented in the United States–and a dramatic boost in federal borrowing.... economic growth alone is unlikely to bring the nation's longer-term fiscal position into balance–making reform of programs for the elderly or substantial tax increases (or both) necessary.[12]

OMB echoed the CBO comments in the President's budget documents. The document included the comments that,

> Social Security and Medicare are critical programs for ensuring the financial security and health of elderly Americans ... Unless these programs are reformed however, over the long run they will overwhelm the rest of the budget and place an unsustainable burden on future generations.
>
> Although projections of the budget over the next few decades and beyond are subject to enormous uncertainty, fundamental forces are at work that will create serious fiscal problems if left unaddressed.
>
> The main source of the long-run fiscal problem is demographics. As Americans live longer and the birth rate falls, the ratio of workers to retirees is decreasing....
>
> Because the Nation's two largest entitlement programs, Social Security and Medicare, are based in large part on the principle that current workers pay the benefits of retirees, these programs are heavily influenced by this decline in the ratio of workers to retirees.... In the next several decades, however, the impact of lower birth rates and longer life expectancy will begin to take a visible toll on both Social Security and Medicare....

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[12] CBO, *The Budget and Economic Outlook: Fiscal Years 2005-2014*, Jan. 2004, p. 8-9.

> The result of this demographic shift is a steady worsening of the finances of the Social Security and Medicare programs....[13]

The short-term budget outlook can change as it is buffeted by economic or policy changes. As indicated by CBO and OMB, the long-term budget outlook, while still buffeted by economic and policy changes is expected to be dominated by the effects that the retirement of the baby boom generation, beginning in large numbers within a decade, will have on spending for Social Security, Medicare, Medicaid, and other programs for the elderly. Not only will these programs be affected, but their constant growth will put great stress on the rest of the budget, the government's ability to finance its obligations, and the ability of the economy to provide the resources needed. The tax cuts and spending increases of the last few years did not produce the grim fiscal future, but they appear to have made the solution more difficult.

The Budget and the Economy

The budget and the economy affect each other unequally. Small economic changes have a more significant effect on the budget than the effect large policy changes have on the economy. The worse-than-previously-expected economic conditions that lasted from 2001 into 2003, played a substantial role, directly and indirectly, in the deterioration of the budget outlook over those years. The rebound from that slower-than-normal growth results, according to CBO, in expectations of faster than normal growth in 2004 and 2005. For the period 2006 through 2014, CBO projects that real gross domestic product (GDP) will grow about as fast as potential GDP.[14]

Under governmental policies that are in fiscal balance, a return to economic growth that is close to the growth of potential GDP, should reduce or eliminate a deficit or produce a surplus. In both the President's budget and in CBO's budget reports, the budget remains in deficit (or barely reaches surplus in FY2014 in CBO's January budget report) throughout the forecast period. The lack of fairly rapid reduction or elimination of the deficit during a time of normal economic growth implies that the budget has a fiscal imbalance and that the current policies of the government are producing outlays that are too large or receipts that are too small to produce a balanced budget or one in surplus.

The positive budget outlook forecast in early 2001 was substantially based on the favorable future economic conditions that were then expected, along with government policies that would continue producing surpluses. That outlook extended the expected overall improvement in the budget situation that had occurred since the early 1990s. Much of the improvement in the 1990s had come from strong and sustained economic growth (and the rest from policy changes to reduce the

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[13] OMB. *Budget of the United States Government for Fiscal Year 2005,* Feb. 2004, p.38-39.

[14] Potential GDP represents an estimate of what GDP would be if both labor and capital were as fully employed as is possible.

deficit). When those favorable economic conditions faltered, so did the string of positive forecasts for the budget outlook. What good economic conditions give, bad economic conditions can take away. The unexpectedly lengthy economic weakness into 2003, the start of a recession in March 2001, the lengthy fall in the stock market, the policy responses to the September 2001 terrorist attacks, along with negative changes in the technical components of the budget estimates, raised outlays, reduced receipts (beyond policy changes), and eliminated the previously expected surpluses.

For Additional Reading

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