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An Analysis of the Administration's Deficit Reduction Goal

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Summary

The Bush Administration has set a goal of halving the deficit between FY2004 and FY2009. The Administration proposes to reduce the deficit from an originally forecasted $521 billion (4.5%) in FY2004 to $233 billion (1.5% of GDP) in FY2009.

The Administration can meet its deficit reduction goal if the following assumptions made in its FY2006 budget proposal occur. First, alternative minimum tax (AMT) relief is allowed to expire so that the AMT would take back most of the current reduction in the regular income tax for a large number of taxpayers. Second, discretionary spending falls from 8.2% of GDP to a historically low 6.1% of GDP. Third, spending on military operations abroad will be negligible by FY2009. Finally, the cost of creating individual accounts for Social Security as proposed by the Administration is not included in the budget.

CRS has constructed a modified baseline budget which, arguably, provides a "best guess" of the path of future deficits if current policy is extended. Under this alternative, the deficit is projected to rise to $425 billion in FY2009. Thus, the Administration's proposed FY2009 deficit is the result of budgetary savings of $192 billion compared to a baseline constructed by CRS reflecting current policy. This report will not be updated.

The Administration's FY2005 budget proposal set a goal of halving the deficit between FY2004 and FY2009. This goal was reiterated in its FY2006 budget proposal. To analyze how the Administration plans to meet its goal of halving the federal budget deficit, this report explains how the Administration's FY2006 budget differs from current policy using a modified baseline budget constructed by CRS.

The Congressional Budget Office (CBO) estimates a baseline budget based on simple rules prescribed by law. CRS has constructed a baseline budget incorporating alternative assumptions that arguably provides a "better guess" of the probable path of the federal budget when current policy is extended. CRS modified the CBO baseline by assuming that discretionary spending (excluding supplementals) will remain constant as a percentage of gross domestic product (GDP), that military operations in Iraq and Afghanistan will continue until FY2008, that expiring tax provisions will be extended, and that individuals will be held harmless from the alternative minimum tax (AMT). The alternative baseline is defined and estimated in CRS Report RS22045.[1]

The Administration's Deficit Reduction Goal

In the FY2005 budget, the Administration estimated that the deficit in FY2004 would be $521 billion, and proposed to reduce the deficit to $237 billion — less than half the FY2004 deficit — by FY2009.[2] The actual deficit in FY2004 turned out to be $412 billion, considerably lower than originally estimated. (The difference in the estimated and actual resulted from unexpected economic and technical adjustments, not from policy changes.) In the FY2006 budget, the Administration forecasts, based on its policy proposals, that the FY2009 deficit will be $233 billion. However in FY2005, the deficit is projected to rise to $427 billion, which indicates that, at least in the short run, the budget deficit is moving away from the Administration's goal.

While this forecast shows a FY2009 deficit that is half the FY2004 deficit forecast in the FY2005 budget, it would be more than half of the actual FY2004 deficit. However, as a percentage of GDP, the Administration can still meet its goal of halving the budget deficit since the actual FY2004 deficit was 3.6% of GDP while the forecast deficit in FY2009 would be 1.5% of GDP.

Discretionary Spending

The Administration's deficit reduction goals are partly dependent on discretionary spending following a particular path over the next five years. This path for discretionary spending shows a reduction in spending in nominal terms from FY2006 to FY2008, before increasing at the rate of inflation in FY2009. This would represent a reversal of past Administration policy since discretionary spending has been growing at an average annual rate of 8% over the last four years in real terms.

How does this pattern compare to current policy? Since the level of discretionary spending is determined through annual congressional appropriations, there is no obvious measure of current policy carried forward into the future. In its baseline projections, CBO is required to assume that discretionary spending under current policy remains constant in real dollar terms in the future. If discretionary spending grew at the rate of inflation, then it would be $116 billion higher than the Administration proposes in FY2009. However, if supplemental spending were removed from the projections, as CBO assumes, then it would be only $9 billion higher than the Administration proposes in FY2009.

The historical evidence, however, suggests that, over time, discretionary spending tends to remain fairly constant as a percentage of gross domestic product (GDP). At least in the case of non-defense spending, projecting discretionary spending as constant in real dollar terms would have consistently *underpredicted* historic spending levels. Under the

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[1] CRS Report RS22045, *Baseline Budget Projections Under Alternative Assumptions*, by Gregg Esenwein and Marc Labonte. For the CBO baseline, see Congressional Budget Office, *Budget and Economic Outlook: Fiscal Years 2006 to 2015*, Jan. 2005. Due to technical and economic differences, CBO baseline estimates vary slightly from the Administration.

[2] Office of Management and Budget, *Fiscal Year 2005 Budget*, Feb. 2004, p 37.

Administration's budget, discretionary spending would fall from 8.2% of GDP in FY2005 to 6.1% of GDP in FY2009. This would be discretionary spending's lowest share of GDP in the modern budget era; in the past 25 years, discretionary spending has fluctuated between 6.3% and 10.0% of GDP.

In FY2009, the Administration's budget shows discretionary spending to be $952 billion. If discretionary spending (excluding supplemental military spending) remained constant as a percentage of GDP, it would be $1.06 trillion in FY2009. Thus, under these assumptions, the Administration's proposal would represent a 10% reduction in discretionary spending from current policy extended to FY2009. This reduction does not include additional debt service since higher spending, absent other changes, would increase the national debt.

Spending on Military Operations. In planning a five-year budget, military operations in Iraq and Afghanistan pose a particular problem because it is hard to predict what magnitude spending on these activities will take in the future. In light of this uncertainty, the Administration's approach is to not include or include only minor amounts reflecting future military operations in these theaters as supplemental spending.[3]

However, at least over the last budget year, this approach has led to a significant undercounting of spending on military operations. In its 2005 budget, the Administration included no supplemental military budget authority for FY2005. But through February 2005, the Administration requested, in total, $82 billion in supplemental budget authority to cover military operations over the next five years, not including accompanying debt service.

Supplemental outlays equaled $71 billion in FY2004 and are projected to equal $60 billion in FY2005. In the FY2006 budget, the Administration requests $25 billion in supplemental military spending in FY2006. Supplemental spending declines in the out-years, totalling only $1 billion in FY2009. If the Administration repeats in the future the practice it followed in FY2005 of financing military operations through supplementals, then the actual deficit will be larger than proposed, making it difficult for the Administration to meet its FY2009 deficit reduction target.

Social Security

The Administration has recently proposed creating individual accounts under the Social Security system. While many of the specifics of the proposal have not yet been announced, by all indications these accounts will significantly reduce federal revenues, at least in the short run. Yet none of these costs, nor accompanying debt service, is included in the Administration's FY2006 budget. As a result, if Social Security is altered as proposed by the Administration within the five-year budget window, then the goal of halving the deficit by FY2009 will not be met.

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[3] Likewise, supplemental spending on non-military emergencies (e.g., natural disasters) is assumed to be zero in the Administration's budget, unlike in the CBO baseline. While emergency spending can obviously not be accurately projected, it is almost always higher than zero. This assumption reduces outlays by $12 billion in FY2009.

The basis of the Administration's proposal is to allow workers to divert a certain percentage of their payroll taxes into individual accounts. This means that payroll tax receipts will decline by the full amount of funds diverted into these individual accounts and can, therefore, no longer be used to finance current Social Security benefit payments and other government expenditures. Social Security benefits for current retirees could be cut or taxes could be raised to offset the effects of these accounts on the deficit over the next five years, but the Administration has ruled out both options. If no other adjustments are made, the deficit will increase by the amount by which tax receipts are reduced.

On February 2, the Administration proposed that individual accounts equal to 4% of taxable payroll be introduced in 2009, slowly phased in over time, and participation in the accounts be on a voluntary basis. These conditions would significantly reduce their effects on the deficit in FY2009. However, if the proposal were fully implemented in FY2009, the effects on the deficit would be large. With full participation, individual accounts equal to 4% of taxable payroll — absent other changes — would increase the budget deficit by about 1.6% of GDP. In FY2009, 1.6% of GDP would equal $235 billion.

Revenue Issues

When comparing revenue totals under the President's budget proposal to current policy, a significant issue is the treatment of expiring tax provisions. Although the Administration includes an extension of the 2001 and 2003 tax cuts in its FY2006 budget, the major portion of the revenue loss from extending these tax cuts does not show up until after 2010. Hence, these extensions would increase the deficit by only $31 billion in the deficit-target year of FY2009, but by a cumulative $1,036 billion from FY2011 to FY2015 (not including associated debt service).

While the Administration proposes to extend the tax cuts, it does not include or does not extend through FY2009 the full array of expiring tax provisions (unrelated to the 2001 and 2003 tax cuts) in its budget. The most important expiring tax provisions that are omitted from the Administration's FY2006 budget relate to the individual alternative minimum tax (AMT). The AMT was originally enacted in 1969 to make sure that certain high-income taxpayers were not able to escape their "fair share" of the federal income tax through the use of special deductions, exemptions, and credits.[4] However, because of the recent reductions in the regular income tax and the fact that the AMT is not indexed for inflation, there will be a significant increase in the number of middle to upper-middle income taxpayers affected by the AMT in the near future. In 1999, about 1 million taxpayers were affected by the AMT, but estimates suggest that by 2009 almost 30 million taxpayers will be subject to the AMT under current policy.

To counteract the effects of the AMT, Congress has increased the AMT basic exemption and allowed certain personal tax credits to offset AMT tax liability. However, to minimize the future revenue loss, these changes have only been enacted for one or two years at a time, and are now scheduled to expire at the end of 2005. Allowing the increased AMT exemption to expire at the end of 2005 means that, by 2009, the AMT

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[4] See CRS Report RL30149, *The Alternative Minimum Tax for Individuals*, by Gregg Esenwein.

will "take back" much of the regular income tax relief provided in 2001 and 2003.[5] Because the revenue estimates of extending the expiring tax relief are based on the increased AMT exemption expiring after 2005, the revenue estimates of these extensions assume the AMT take-back effect will occur. As a result, the budgetary costs of the 2001/2003 tax cuts are understated relative to what they would be if taxpayers were held harmless from the AMT. To provide taxpayers with the full amount of regular income tax relief would require, at the least, that the AMT exemption increase be extended throughout the period that the Administration has set for its goal of halving the federal deficit.

CBO estimates that reforming the AMT by extending the higher AMT exemption and indexing the AMT for inflation, so that it does not take back the reductions in the regular income tax, would reduce revenues by $137 billion over the FY2006 through FY2009 period, not including debt service.[6] In FY2009 alone, holding the AMT harmless would reduce federal revenues by $50 billion.[7] If all expiring tax provisions, including the AMT, were extended, revenues would equal $2,576 billion in 2009 — compared to the Administration's proposal, under which revenues equal $2,650 billion in that year.

Conclusions

The Administration has produced a budget proposal that cuts the deficit in half from FY2004 to FY2009. To analyze how that goal is to be accomplished, this report compares the Administration's proposal to the budget under current policy. This report assumes that the "best guess" of current policy in FY2009 is represented by the CBO baseline, modified according to the following assumptions. First, that discretionary spending (excluding supplementals) will remain constant as a share of GDP. Second, that all expiring tax provisions will be extended throughout the five year budget window. Third, that expiring AMT relief will be extended rather than allowing the AMT to "take back" the reductions in the regular income tax. Fourth, that debt service will be higher in FY2009 because of the previous three modifications and because some spending on military operations was assumed to continue through FY2008. The alternative baseline does not include the costs of any modifications to Social Security (as is the case with the Administration's budget).

As is shown in the table below, when current policy is measured under this alternative, the budget deficit does not decline by half in dollar terms or as a percentage of GDP. Rather, the deficit increases in dollar terms (though not compared to the original

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[5] See CRS Report RS21817, *The Alternative Minimum Tax (AMT): Income-Entry Points and 'Take Back' Effects*, by Gregg Esenwein.

[6] CBO defines reform as extending the increased AMT exemption and indexing the exemption amount and AMT tax brackets for inflation. Allowing all personal tax credits to offset AMT tax liability would increase the revenue loss of this policy alternative.

[7] The Administration has indicated that it expects AMT reform will be addressed in the context of fundamental tax reform. The revenue effects, if any, of fundamental tax reform are not included in the FY2006 budget projections. The Administration has further stated that it wants fundamental tax reform to be revenue neutral which means that if the AMT is held harmless then other taxes would have to rise by $50 billion in FY2009 to offset the cost of AMT reform.

projection of $521 billion) and decreases modestly as a percentage of GDP between FY2004 and FY2009.

The Administration can meet its deficit reduction goal compared to the originally projected $521 billion deficit in FY2004 if the following assumptions made in the budget come true. First, AMT relief is allowed to expire so that the AMT takes back most of the reduction in the regular tax for a large number of taxpayers. Second, discretionary spending falls to its lowest levels in the modern budget era. Third, there will be negligible supplemental spending on military operations abroad by FY2009. Finally, the cost of diverting part of the payroll tax from Social Security to individual accounts, as outlined by the Administration, is not included in the budget. Significantly modifying any one of these assumptions would cause the deficit to remain above half of its FY2004 level in dollar terms or as a percentage of GDP. If the deficit reduction goal is expressed as a percentage of GDP, then the goal would be easier to achieve, but would still require large changes relative to current policy, as measured by the alternative baseline.

Budget Totals for FY2004 and FY2009 Under Different Assumptions

	2004 Projected in Feb. 2004	2004 Actual	2009	
			Administration's Budget	Alternative Baseline
Discretionary Spending				
billions of $	908	895	953	1,056
% of GDP	7.9	7.8	6.3	7.0
Revenues				
billions of $	1798	1880	2,650	2,576
% of GDP	15.7	16.3	17.5	17.1
Budget Deficit				
billions of $	521	412	233	425
% of GDP	4.5	3.6	1.5	2.8

Source: OMB, CRS calculations based on CBO data.

Notes: The alternative baseline is calculated by adding four assumptions to the CBO baseline. First, discretionary spending (excluding supplementals) will remain constant as a share of GDP. Second, all expiring tax provisions will be extended throughout the five year budget window. Third, expiring AMT relief will be extended. Fourth, debt service will be higher because of the previous three assumptions and because military operations were assumed to continue through FY2008. It does not include the costs of any modifications to Social Security. CBO baseline budget totals are slightly different from OMB.

Budget projections are by no means certain. Historically, actual budget deficits, adjusted to remove policy changes, have been much higher or lower than they were originally projected to be. The probability of meeting a specific budgetary target would increase by erring on the side of caution and budgeting more spending reductions and revenue increases than would be needed in a world of perfect certainty.

Even if policy follows the path proposed in the Administration's budget or the CBO baseline, deficits would begin to rise again outside the budget window at an arguably unsustainable pace. This occurs because the retirement of the baby boomers, longer life expectancy, and rising medical costs are projected to place upward pressure on spending for Social Security, Medicare, and Medicaid.