

CRS Report for Congress

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The Budget for Fiscal Year 2006

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The Budget for Fiscal Year 2006

Summary

The Senate (S. 1932, November 3) and the House (H.R. 4241, November 18) each passed spending reduction reconciliation bills (of \$35 billion and \$50 billion from baseline estimates over five years, respectively). A conference agreement (H.Rept 109-362) of approximately \$40 billion in reductions was reached on December 19, but has yet to clear Congress. The Senate passed a five-year revenue reduction reconciliation bill (S. 2020; \$58 billion) on November 18, while the House passed its reconciliation bill (H.R. 4297; \$56 billion) on December 8. The net effect of the legislation on the budget would be to raise the deficit in FY2006 and over the five-year period covered in the legislation.

The President's original FY2006 (February 2005) budget did not include estimates of the cost of the war on terror beyond FY2005. It did not include cost estimates of the Administration's proposals for changes in Social Security. It did include specific proposals that, over five years, would reduce spending among the non-defense discretionary programs, slow growth in defense spending, slow growth in selected categories of mandatory spending, and make further tax cuts along with making permanent the 2001 and 2003 tax cuts.

The Congressional Budget Office's (CBO's) March 2005 estimate of the President's policy proposals produced a smaller deficit (\$332 billion, 2.6% of GDP) than had the Administration. Slightly higher estimated revenues and slightly lower estimated outlays led to the difference. The cumulative amounts were similar in the respective estimates for receipts, outlays, and deficit for FY2006 through FY2010.

The House (H.Con.Res.95) and Senate (S.Con.Res.18) adopted their respective budget resolutions for FY2006 on March 17, 2005. After extensive leadership discussions, a conference reported (H.Rept. 109-62) an agreement on the resolution on April 28, which both the House and Senate adopted later that day. The conference agreement included reconciliation instructions for mandatory spending reductions, tax reductions, and an increase in the statutory debt limit.

The mid-year budget report from the Office of Management and Budget (OMB) had an improved deficit outlook through FY2010, while CBO's mid-year report included a somewhat worsened baseline deficit outlook. The reports were released prior to the hurricanes of late summer and the ensuing congressional response to them, which may raise the short-term deficit.

Congress passed three continuing resolutions (CRs) on appropriations during the fall and early winter, to fund otherwise unfunded activities. It needed the time to complete action on the regular appropriation bills for FY2006. The last two cleared Congress on December 21, almost three months after the start of fiscal year 2006.

This report will be updated as events warrant.

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The Budget for Fiscal Year 2006

Background and Analysis

Presidents submit their budget proposals for the upcoming fiscal year (FY) early in each calendar year. The Bush Administration released its FY2006 budget (*The Budget of the U.S. Government, Fiscal Year 2006*) on February 7, 2005. The multiple volumes contain general and specific descriptions of the Administration's policy proposals and expectations for the budget for FY2006 through FY2010. It includes a section on long-term fiscal issues facing the nation and provides limited information on the revenue and mandatory spending changes after 2010. 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.¹ In addition to its presentation of the Administration's proposals, the budget documents are an annual 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. Over the course of deliberation on the budget, the Administration often revises its original proposals as it interacts with Congress and as conditions change in the economy and the world.

The Current Situation

The start of FY2006 began with most regular appropriations unfinished. Congress passed a continuing resolution on appropriations (CR; P.L. 109-77; H.J.Res. 68), and signed by the President, on September 30, 2005, to fund otherwise unfunded federal activities as the new fiscal year began. The CR provided funding through November 18. By that deadline, only two of the regular appropriation bills had not cleared Congress (although more had yet to be signed by the President), necessitating

¹ Current services baseline estimates, and baseline estimates in general, 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 and enacted future changes into the future. Discretionary spending is increased by the rate of inflation. Their construction generally follows instructions in the Balanced Budget and Emergency Deficit Control Act of 1985 (DCA) and the Congressional Control and Impoundment Act of 1974.

a second CR. The second CR became law on November 19 (P.L.109-105) and funded otherwise unfunded activities through December 17. Congress needed a third CR (P.L.109-128; December 17, 2005; through December 31) to complete its work on the remaining two regular FY2006 appropriations. The last two cleared Congress on December 21.

On November 3, 2005, the Senate passed its version of the first of three possible reconciliation bills (the Deficit Reduction Omnibus Reconciliation Act of 2005, S. 1932) as outlined in the FY2006 budget resolution. The bill would cut mandatory spending from baseline levels by approximately \$35 billion over five years. Although producing a net reduction in spending, the legislation contained both increases and decreases to mandatory spending.

The House passed its spending reconciliation bill (The Deficit Reduction Act of 2005, H.R. 4241) containing an estimated \$50 billion in mandatory spending savings over five years. The House leadership revised the contents of the bill several times to ensure enough support to pass the bill, which eventually passed, 417 to 415.

After some difficulty, the conferees on the spending reconciliation bill reached agreement on December 12. The House passed the conference report (H.Rept. 109-362) on December 19. The Senate upheld points of order against parts of the legislation, effectively amending the conference agreement and sending it back to the House for further action (expected in early 2006).

The Senate passed its tax reductions reconciliation bill (the Tax Relief Act of 2005, S. 2020) on November 18, which would reduce net revenue by an estimated \$58 billion over five years (from baseline estimates). The legislation contained revenue increases as well as reductions. The House Ways and Means Committee reported the second House reconciliation bill (the Tax Relief Extension Reconciliation Act of 2005, H.R. 4297) on November 17, which would reduce net revenues by an estimated \$56 billion over five years. The House passed the legislation on December 8. Both bills would extend or make permanent previously adopted tax cuts. A conference has yet to be called to resolve the differences between the House and Senate bills.

The overall effect of these bills on the budget would be to raise the deficit over the next five years from what it would have been without the legislation.

Budget Totals

Table 1 contains budget estimates for FY2006 from the Congressional Budget Office (CBO) and the Administration (the Office of Management and Budget, OMB); revisions produced by both during the year as they become available; and data from congressional budget deliberations (new estimates for FY2006 will be available from both CBO and OMB at the end of January and beginning of February 2006). Differences in totals result from differing underlying economic, technical, and budget-estimating assumptions and techniques, as well as differences in policy assumptions. The *policy*-generated dollar differences for an upcoming fiscal year can

be relatively small compared to the budget as a whole. These small differences may grow over time, sometimes substantially, producing widely divergent future budget paths. Budget estimates are generally expected to change over time from those originally proposed or estimated by the President, CBO, or Congress.

Table 1. Budget Estimates for FY2006

(in billions of dollars)

	Receipts	Outlays	Deficit (-)/ Surplus
CBO, BEO Baseline, 1/05	\$2,212	\$2,507	\$-295
OMB, Budget Proposals, 2/05	2,178	2,568	-390
OMB, Budget, Current Services Baseline, 2/05	2,178	2,539	-361
CBO, Revised Baseline, 3/05	2,212	2,510	-298
CBO, EPP 3/05	2,210	2,542	-332
House Budget Resolution, 3/05	2,195	2,571	-376
Senate Budget Committee, 3/05	2,197	2,559	-362
Senate FY06 Budget Resolution 3/05	2,193	2,562	-368
Conf. Rept. Budget Resolution 4/28/05	2,195	2,577	-383
OMB MSR 7/13/05	2,273	2,613	-341
CBO Update, Baseline, 8/15/05	2,280	2,595	-314

BEO — The *Budget and Economic Outlook*, CBO.

EPP — CBO's estimates of the President's proposals.

CSB — The Administration's current services baseline.

MSR — OMB's *Mid-Session Review*.

Update — CBO's *The Budget and Economic Outlook: An Update*.

Budget Estimates and Proposals

CBO's first budget report for FY2006, the *Budget and Economic Outlook: Fiscal Years 2006-2015* (January 2005), contained baseline estimates and projections for FY2005 through FY2015. The report estimated a FY2006 deficit of \$295 billion (down from the estimated FY2005 deficit of \$368 billion). By FY2010, the baseline deficit estimate had fallen to \$189 billion. Under the baseline assumptions, CBO: increases discretionary spending at the rate of inflation; does not include extending the 2001 and 2003 tax cuts after 2010; and allows the alternative minimum tax (AMT) relief to expire as currently scheduled. The effects of these assumptions increase receipts in the near-term (because of the reversion of the AMT to previous law) and increase receipts by substantial amounts after FY2010 when most of the tax cuts from 2001 and 2003 expire under current law. The result of the assumptions that CBO must follow likely understates the size and persistence of the deficit over the next 10 years.

The CBO baseline assumptions showed the budget remaining in deficit through FY2011 (\$80 billion) followed by surpluses through FY2015 (\$141 billion). The reduction in the deficit after calendar year 2010, leading to the surpluses, is largely

explained by the required inclusion of the expiration of major tax cuts in the baseline estimates, producing a rapid increase in revenues.

CBO's budget reports generally include the estimates (including higher or lower debt-service costs) of selected policies not included in the baseline estimates. They usually reflect possible future policy, such as making the tax cuts permanent, fixing the expanding coverage of the AMT, or changing the rate of discretionary spending growth. In CBO's January 2005 report, making the tax cuts permanent increased the five-year (FY2006-FY2010) cumulative deficit (including higher debt-service costs) by \$156 billion, and by a cumulative \$1.9 trillion over the 10-year period, FY2006-FY2015). CBO's estimate of reforming the alternative minimum tax produced a \$218 billion five-year cumulative increase in the deficit and a \$503 billion increase over 10 years (FY2006-FY2015). If discretionary spending were to grow at the rate of GDP, rather than at the rate of inflation, the five-year cumulative deficit would increase by \$378 billion and the 10-year cumulative deficit would increase by \$1.7 trillion. Freezing discretionary appropriations at the FY2005 level would *reduce* the five-year cumulative deficit by \$294 billion and the 10-year cumulative deficit by \$1.3 trillion.

President Bush's FY2006 budget called for extending and making permanent most of the tax cuts adopted in 2001 and 2003. The budget showed this reducing receipts by \$53 billion between FY2006 and FY2010 and by \$1.1 trillion between FY2006 and FY2015 (these estimates do not include the resulting higher debt-service costs resulting from the change). The Administration's total receipt proposals, which include other revenue changes, would reduce five-year receipts by \$106 billion and 10-year receipts by \$1.3 trillion.

The Administration again this year used a slightly modified set of assumptions to produce the OMB current services baseline estimates, moving the proposed and baseline estimates somewhat closer together. Instead of following the traditional method of constructing baseline estimates, the Administration's FY2006 current services baseline assumed the extension of certain tax provisions (that by current law are scheduled to expire), excluded the future cost of one-time events, and included a timing adjustment to the calculation of federal pay increases. For FY2006, the differences produced an Administration current services baseline deficit estimate \$9 billion smaller than the traditional baseline estimate. By FY2010, the Administration's estimated baseline deficit is \$16 billion smaller than the traditional baseline deficit estimate.

The Administration's budget provided a limited amount of information for the years beyond FY2010. The budget did include estimates of the cumulative proposed revenue changes and proposed mandatory spending changes for the periods FY2006 through FY2010 and FY2006 through FY2015, but it contained no information for the individual years after FY2010.

The President's budget included a list of 150 discretionary program eliminations or reductions. According to Administration documentation, these changes would produce approximately \$11 billion in budget authority (not outlay) savings in FY2006. The documentation did not indicate the size of the outlay savings that would result from the reduced budget authority.

CBO's March 2005 report analyzed the President's policy proposals using CBO's own underlying assumptions and budget estimating methods. The analysis produced smaller deficits in the first couple of years of the five year period in the President's budget and somewhat larger deficits in the later years. CBO extrapolated the policy proposals through FY2015, finding the budget remaining in deficit throughout the period. In CBO's estimates and projections, the deficit falls as a percentage of GDP from an estimated 2.6% of GDP in FY2006 to approximately 1.3% of GDP in FY2012, where it remains through FY2015.

The House-passed budget resolution (H.Con.Res. 95) closely followed the President's budget. The Senate passed budget resolution (S.Con.Res. 18) deviated from the House resolution by including smaller mandatory spending cuts in reconciliation instructions, larger tax cuts in reconciliation instructions, and a higher discretionary spending cap. The Senate made these changes to the Senate Budget Committee's reported resolution. The changes moved the House- and Senate-passed resolutions further apart, making reaching an agreement difficult and time consuming.

The conference agreement on the budget resolution passed by the House and Senate on April 28, 2005, included revenues of \$2,195 billion, outlays of \$2,577 billion, and a deficit of \$383 billion. The resolution also included three reconciliation instructions that would, over five years, reduce mandatory spending (with the sources of the savings spread among several committees of jurisdiction in the House and Senate) by \$35 billion, reduce total revenues by \$70 billion, and raise the debt limit to \$8.965 trillion. Over the five years covered by the budget resolution, its proposals would produce larger deficits than would have occurred without the included policy changes. CBO's March 2005 baseline deficit estimate was \$298 billion while the resolution had a proposed deficit of \$383 billion. Under the budget resolution proposals, the cumulative five-year deficit (for FY2006 through FY2010) was \$1,797 billion; under CBO's March baseline (no policy changes), the five-year cumulative deficit was \$1,232 billion, more than \$550 billion smaller than the amounts proposed in the budget resolution.

The July 13, 2005 OMB release of the *Mid-Session Review* had reduced deficits in FY2006 and subsequent years (through FY2010) because of the higher than expected receipts flowing into the Treasury in 2005. CBO's August 2005 Update had a similar pattern of changed deficit estimates. CBO expected less persistence in the higher receipts and no long-term improvement in the budget outlook (compared to its March budget report).

The federal response to the devastation caused by Hurricane Katrina and the lesser damage from Hurricane Rita will produce a substantial, but unknown, budgetary response. The higher spending and lower revenues will raise the FY2006 deficit to as much as \$500 billion (as some press reports are speculating). Smaller deficit increases, compared to the mid-year budget reports, may follow for several years as funding for recovery from the hurricanes continues into the future.

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.² Small changes in economic conditions, particularly the rate of GDP growth (from those used in the estimates) can produce large changes in the budget estimates. According to CBO, a persistent 0.1% increase in the growth rate of real GDP (beginning in January 2004) would reduce the deficit (including interest costs) by \$51 billion cumulatively over a five-year period. This change would reduce the cumulative deficit by \$236 billion over the next 10 years. Reductions in the rate of growth would increase the deficit by similar amounts over the same time periods.

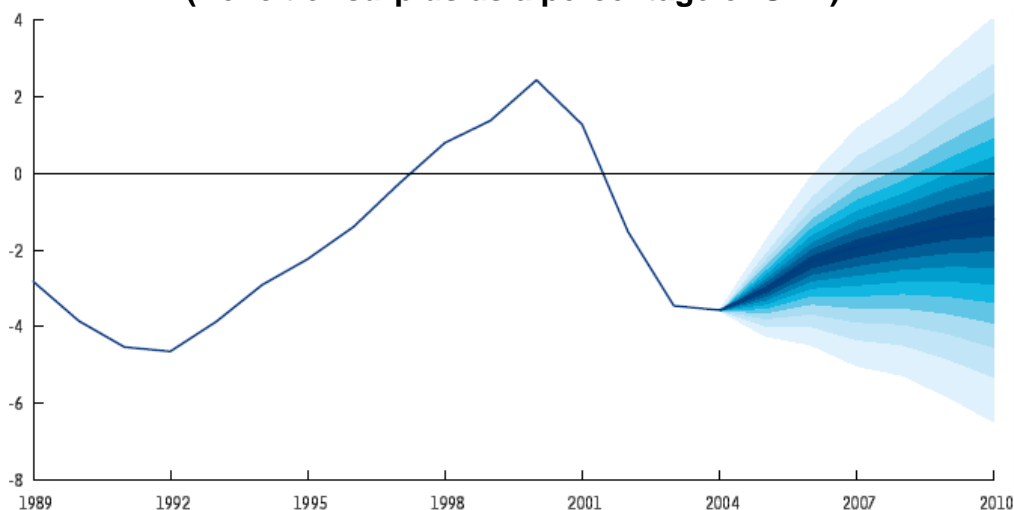
Figure 1 is from CBO's January 2005 *Budget and Economic Outlook*. CBO indicates that the most likely deficit or surplus outcomes (as percentages of GDP), through FY2010, are clustered in the center of the figure, in the darkest area. The lighter shades indicate the less likely outcomes. The distance from the top to the bottom of the image in the chart (the fan) represents the range within which CBO predicts that the deficit (or surplus) has a 90% chance of occurring. In FY2010 this ranges from a surplus of 4% of GDP to a deficit of 5% of GDP.

The President's (FY2006) budget included a chapter in the *Analytical Perspectives* volume titled "Comparison of Actual to Estimated Totals." The chapter examined the causes of the changes from the initial budget estimates for FY2004 through the actual results for that year. Like the CBO information, this provides another example of the uncertainty surrounding budget estimates. The chapter included a chart based on historical experience, that indicates the possible range of budget balance (surplus or deficit) outcomes with a 90% certainty. The range for the current year and following year (which the Administration calls the budget year) rise from \$256 billion to \$548 billion.³ By five years beyond the current year, the range exceeds \$1 trillion.

² Some things are known with certainty about the direction of future spending and receipts. Demographics can partly determine the shape of future budgets. In the next decade, the growing retirements in 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. Because virtually all those who will become eligible for these benefits are alive today, estimating the growth in the populations eligible for these programs is relatively straightforward.

³ The current year is the fiscal year we are in: 2005. The budget year is the year that the President's budget covers — 2006 — and that Congress will pass legislation to implement.

**Figure 1. Uncertainty in CBO's Projections of the Surplus or Deficit Under Current Policies
(Deficit or surplus as a percentage of GDP)**



Source: Chart created by CBO; from *The Budget and Economic Outlook: FY2006-FY2015*, January 2005, p. 11.

Note: This figure, calculated on the basis of CBO's forecasting track record, shows the estimated likelihood of alternative projections of the budget deficit or surplus under current policies. The baseline projections described in this chapter fall in the middle of the darkest area of the figure. Under the assumption that tax and spending policies will not change, the probability is 10% that actual deficits or surpluses will fall in the darkest area and 90% that they will fall within the whole shaded area. Actual deficits or surpluses will be affected by legislation enacted in future years, including decisions about discretionary spending. The effects of future legislation are not reflected in this figure.

Budget projections are very dependent on the underlying assumptions about the direction of the economy, 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 expected or proposed spending and tax policies, or changes in the technical components of the budget models can have substantial effects on the budget estimates and projections.

Budget Action

CBO and the Administration released their first budget reports for FY2006, in late January and early February 2005, respectively. CBO's report provided baseline estimates for FY2005 through FY2015. The CBO baseline estimates, following the instructions mandated by law, did not include any estimated cost for ongoing operations in Afghanistan and Iraq after FY2005 or any estimates of the Administration's proposed, but undefined, change in Social Security. The estimates assumed that the tax cuts adopted over the Administration's first term will expire in 2010 as required by current law and that the Alternative Minimum Tax (AMT) will revert to its previous incarnation when the temporary relief provisions expire at the end of FY2005.

OMB's documents provided estimates for FY2005 through FY2010 with a few instances of cumulative estimates for FY2006 through FY2015 (these were limited to revenues and mandatory spending and provided no data for the individual fiscal years after FY2010). The budget also lacked detailed data on program or account spending beyond FY2005. The *Analytical Perspectives* volume of the President's budget provided the Administration's current services baseline estimates for the years through FY2010.

On March 4, 2005, CBO provided its preliminary estimates of the President's 2006 budget. These estimates take the policies in the Administration's budget and recalculate their effect using CBO's underlying assumptions and budget estimating methods. CBO's estimates produced smaller deficits than the Administration for FY2005 through FY2007. They were essentially the same in FY2008 and were larger than the Administration's deficits in FY2009 and FY2010. The full CBO report (*An Analysis of the President's Budgetary Proposals for Fiscal Year 2006*, March 2005) contained more details, an extended discussion of CBO's calculations, CBO's estimates of the President's proposals, and revised baseline estimates.

During the week of March 7, 2005, both the House and Senate Budget Committees adopted their respective versions of the budget resolution for FY2006 (H.Con.Res. 95; S.Con.Res. 18), on party-line votes. Both resolutions followed the general outline of the Administration's proposals: constraining discretionary spending; cutting the growth of some entitlement programs; and extending or making permanent various tax cuts, and some additional tax reduction. The House and Senate adopted their resolutions on March 17. The House, after defeating several substitutes, adopted the budget resolution as approved by the HBC. The Senate, after debate and a number of amendments, including increasing the size of the tax cut covered by the reconciliation instructions, reducing the mandatory spending cuts (from baseline estimates), and increasing the discretionary spending caps, adopted its budget resolution.

Resolving some of the differences between the House and Senate resolution became more difficult than initially hoped. By the end of April, the House and Senate leadership had reached an agreement on the FY2006 budget resolution. A conference committee reported (H.Rept. 109-62) the agreement on April 28, 2005, which was quickly (on the same day) adopted by the House and Senate. The House and Senate committees affected by the resolution's three sets of reconciliation instructions (reducing mandatory spending, reducing revenues, and raising the debt limit) are scheduled to report during September 2005. (In September, the congressional leadership pushed the reporting date for the reconciliation legislation into late October, responding to demands on Congress as it attempted to finish the FY2006 appropriations, responded to Hurricane Katrina, and the Senate held hearings on a new Chief Justice.)

By July 4, 2005, the House had passed all 11 of its regular appropriation bills for FY2006. The Senate had passed three of its twelve regular appropriation bills. The Senate continued considering its appropriation bills through the rest of the summer. At the end of July, two appropriations bills (Interior and the Legislative Branch) cleared Congress and were signed by the President.

In September, the Senate resumed its consideration of its remaining appropriation bills. By mid-September, the outlook for the timely adoption of the regular appropriations remained unclear. Speculation was widespread that at least one continuing resolution on appropriations (a CR) would be needed at the beginning of FY2006. The differences in the number, coverage, and amounts in the regular appropriation bills for the House and Senate seems to have complicated the already difficult process of adopting the annual appropriations.

During the last week of September, the Appropriation Committees indicated that a CR would be needed. The CR that emerged (P.L.109-77; H.J.Res. 68) would run through November 18, 2005, with funding levels varying by spending category. Congress passed, and the President signed, the CR on September 30, 2005.

By early November 2005, four regular appropriations had become law with the expectation that most of the rest would be adopted fairly shortly. Another CR became necessary as November 18th approached with two regular appropriations still not enacted. The second CR (P.L.109-105) cleared Congress on November 18 and ran through December 17.

The Senate adopted its first reconciliation bill (S. 1932, the Deficit Reduction Omnibus Reconciliation Act of 2005) on November 3, cutting mandatory spending from baseline estimates by approximately \$35 billion over five years. The House, after extensive tweaking by the House leadership, passed its spending reconciliation bill (H.R. 4241, the Deficit Reduction Act of 2005) on November 18, cutting mandatory spending by \$50 billion (from baseline levels) over five years.

A conference report (H.Rept.109-362) on the spending reduction reconciliation bill (S. 1932) was filed at 1 a.m. on December 19. At 6 a.m. that same morning, the House had passed the agreement. The Senate began considering the conference report on December 20. After upholding points of order against several sections of the legislation, the Senate passed the (modified) bill on December 21. The changes sent the bill back to the House for further action.

On November 18, the Senate passed a revenue reducing reconciliation bill (S. 2020, the Tax Relief Act of 2005). The bill would extend or make permanent existing tax cuts and reduce revenues from baseline levels by an estimated \$58 billion over five years. The House passed its five-year, \$56 billion revenue reducing reconciliation bill (H.R. 4297, the Tax Relief Extension Reconciliation Act of 2005) on December 8. Further action on the legislation is expected in early 2006.

The net effect of the spending and revenue reducing reconciliation bills would increase the cumulative five-year deficit by billions of dollars above the baseline estimates.

A third CR (P.L.109-128; December 18) became necessary as Congress continued to struggle to pass the final two appropriation bills. The third CR ran through December 31. As the Christmas holidays approached, Congress cleared, on December 21, the the final two regular appropriations for the President's consideration (he signed them). One of the two, the Defense appropriation bill, included selected rescissions totaling \$10 million and an across-the-board 1%

rescission in FY2006 discretionary budget authority, excluding discretionary authority available to the Department of Veterans Affairs and the administrative expenses related to Social Security.

Outlays

The Administration's FY2006 budget proposed \$2,568 billion in outlays for FY2006, rising to \$3,028 billion in FY2010, the last year shown in the President's budget. The Administration's proposals, if adopted, would raise outlays by \$83 billion (3.6%) above the Administration's FY2005 outlay estimate and by 17.9% from FY2006 to FY2010. (Outlays are expected to grow by 8.2% between FY2004 and FY2005.) Measured against the Administration's FY2006 current services baseline outlay estimates, the proposed level of outlays grow by \$29 billion (1.1%). The difference between the current services baseline outlay estimate and proposed outlays for FY2006 indicates the "cost" of the Administration's proposed policies. The year-to-year change (the \$83 billion increase) combines the "costs" 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 cost of goods and services bought by the government.

Table 2. Outlays for FY2004-FY2010 and FY2015
(in billions of dollars)

	FY2004	FY2005	FY2006	FY2007	FY2008	FY2009	FY2010	FY2015
CBO Baseline, 1/05	\$2,292 ^a	\$2,425	\$2,507	\$2,618	\$2,743	\$2,869	\$2,996	\$3,706
President's FY06 Budget, 2/05		2,479	2,568	2,656	2,758	2,883	3,028	—
President's FY06 CSB, 2/05		2,443	2,539	2,650	2,770	2,897	3,048	—
CBO, Revised Baseline, 3/05		2,444	2,538	2,621	3,731	2,860	2,987	3,777
CBO, EPP 3/05		2,451	2,542	2,629	2,742	2,872	2,999	3,796
House FY06 Budget Resolution, 3/05		2,451	2,571	2,635	2,743	2,864	2,987	—
Senate Budg. Comm. Budg. Res., 3/05		2,455	2,559	2,651	2,755	2,874	2,999	—
Senate FY06 Budget Resolution 3/05		2,455	2,562	2,658	2,760	2,880	3,007	—
Conf. Rept. Budget Resolution 4/05		2,455	2,577	2,644	2,750	2,873	2,995	—
OMB MSR 7/13/05		2,472	2,613	2,661	2,750	2,888	3,063	—
CBO Update 8/15/05		2,473	2,595	2,721	2,860	2,997	3,134	3,905

a. Actual outlays for FY2004.

EPP — CBO's estimates of the President's proposals.

CSB — The Administration's current services baseline.

MSR — OMB's *Mid-Session Review*.

As it did in last year's budget, the Administration modified some of the underlying policy assumptions in creating its current services baseline estimates for

FY2006.⁴ The modifications had a relatively minor effect on the current services outlay estimates this year.

The President's budget did not include the estimated costs of ongoing action in Afghanistan or Iraq after the end of FY2005 (except for outlays flowing from the supplemental appropriation the Administration proposed for FY2005 — see below). Although unknown, the amount is unlikely to be zero. This implies that the Administration's initial outlay estimate for FY2006 (and for the following years) is smaller than actual outlays will be, even if the estimates for the remaining parts of the budget are accurate. A week after the budget became available, the Administration proposed, on February 14, 2005, an \$82 billion supplemental appropriation (budget authority) mostly for these costs. Approximately \$35 billion of this will become outlays in FY2005 and \$25 billion in FY2006, with the remaining being spent in following years. Although this produces some outlays for the war on terror in FY2006, the Administration is expected to request another supplemental (although when is unclear) specifically for FY2006.

As shares of gross domestic product (GDP), the Administration's proposals showed outlays falling from 19.9% of GDP in FY2006 to 19.0% of GDP in FY2010. CBO's estimate of the President's outlay proposals (March 2004) showed the shares falling from 19.7% of GDP in FY2006 to 19.0% of GDP in FY2010, before rising to 19.3% of GDP in FY2015. These outlays-as-shares-of-GDP are below both the average from FY1980 through FY2004 (21.0% of GDP) or the average from FY1990 through FY2004 (20.2% of GDP). CBO's *baseline* estimates showed outlays falling from 19.5% of GDP in FY2006 to 19.0% of GDP in FY2010 and sliding slightly to 18.9% of GDP in FY2015. Using two of CBO's alternative scenarios for spending

Discretionary and Mandatory Spending

The President's budget includes, in its glossary, the general definition of discretionary spending as "...budgetary resources ... provided in appropriation acts." Mandatory spending is defined as "... spending controlled by laws other than appropriations acts...."

Currently, discretionary spending produces 38% of total outlays (42% of total discretionary spending is for defense) and mandatory spending, including net interest, produces the other 62% (net interest is approximately 8% of total outlays).

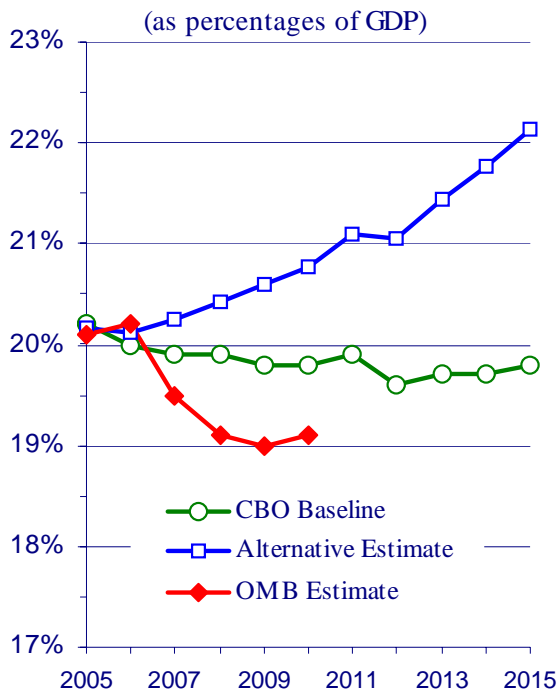
Discretionary spending is not completely discretionary and mandatory spending is not completely mandatory. All government activities require some discretionary spending to pay salaries and other operating expenses of the government. The laws underlying mandatory spending can be changed by Congress, altering the nature of the programs, how much they spend, and how they are funded.

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." For outlays, 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 (interest payment) changes resulting from these (and revenue related) modifications are included in the baseline.

— assuming the phase-down of activities in Iraq and Afghanistan over a number of years and that total discretionary spending increases at the rate of nominal GDP growth (rather than the rate of inflation), outlays as shares of GDP would rise from 20.1% of GDP in FY2006 to 21.0% of GDP in FY2015.

Figure 2 shows three possible paths for outlays from OMB’s and CBO’s mid-year budget reports through FY2010 and FY2015 as percentages of GDP (these numbers do not reflect the subsequent spending on hurricane recovery). CBO’s baseline varies little throughout the period, slowly declining as a share of GDP from FY2006 to FY2015. The Administration’s proposed level of outlays falls sharply after FY2006, in part the result of the Administration’s assumption of reductions in non-defense discretionary spending (the large amounts of expected spending for Hurricane Katrina recovery is likely to raise FY2006 outlays — and possibly in subsequent years — as a percentage of GDP above the levels shown in **Figure 2**).

Figure 2. Outlays, FY2005-FY2015



Both sets of estimates remain below the current (FY2005) level of outlays as a percentage of GDP. The third line, the alternative baseline based on CBO estimates, incorporates the assumption that discretionary spending will grow at the rate of nominal GDP growth, which is faster than the baseline assumption that it grows at the rate of inflation. The result is a rise in outlays as a percentage of GDP.⁵

The House and Senate budget resolutions (H.Con.Res. 95; S.Con.Res. 18) and the conference agreement held total outlay growth to less than 5% from FY2005 to FY2006. For the period FY2005 through FY2010, the resolutions showed outlays growing at a 3.8% to 4.1% annual rate. These outlay totals included, in the Allowances function, \$50 billion in budget authority and \$32 billion in outlays for FY2006 (that is expected to used for the global war on terror).⁶ No additional funding

⁵ The alternative estimate includes the associated higher interest payments resulting from larger deficits because of the higher spending. For consistency with the following two sections, the alternative estimate also includes the higher debt servicing costs associated with the alternative, and lower, receipt estimates shown in **Figure 3**.

⁶ The effect of the supplemental in FY2005 and the one allowed for in FY2006 boosts defense budget authority and outlays in those two years compared to the amounts in subsequent years through FY2010. The result is a peak in defense funding in FY2006 followed by reductions in defense funding. Excluding the additional funding in FY2005 and (continued...)

is assumed or provided for the war on terror in the budget resolutions for subsequent years.

The reduction proposed for discretionary spending (and non-defense discretionary spending in particular) in the budget resolution conference agreement differs markedly from the growth in mandatory spending and total outlays. Total outlays grow at an average annual rate of 3.8% between FY2006 and FY2010. Mandatory spending grows at an average annual rate of 6.1% (even with the reduction in mandatory spending proposed in the reconciliation instructions).⁷ Total discretionary spending over the period would actually fall at an average annual rate of 0.3%. Discretionary defense spending would grow at an average annual rate of 3.1%, even without assumptions about future spending for operations in Iraq and Afghanistan or the global war on terror. Since defense discretionary spending grows, non-defense discretionary spending must fall fairly rapidly for total discretionary spending to fall, and it does. Non-defense discretionary spending falls at an average annual rate of 3.5% from FY2006 to FY2010. The proposed reduction in non-defense discretionary spending would cut it both per capita and as a percentage of GDP.

The two resolutions and the conference agreement included reconciliation instructions to slow (barely) growth in mandatory spending between FY2006 and FY2010. The House instructions were for \$69 billion in savings while the Senate included \$17 billion in mandatory spending savings. The conference agreement included \$35 billion in mandatory savings for the FY2006 through FY2010 period.

The conference agreement also included a discretionary spending cap for the House of \$917 billion in outlays (\$843 billion in budget authority) for FY2006, similar to the discretionary spending levels included in the House and Senate versions of the budget resolution for FY2006. The cap did not include the \$50 billion allowance that is expected to become a defense supplemental appropriation sometime during the year.

The Administration's *Mid-Session Review* (MSR; OMB; July 13, 2005) increased the FY2006 outlay estimates by \$46 billion over the President's outlay estimates in the FY2006 budget in February. Most of the increase (\$37 billion) came from additional war funding; the rest was a combination of small policy changes and the effect of technical and economic revisions on outlays. The inclusion of the Administration's proposed Social Security policy changes (the proposed personal or private accounts) raised the new outlay estimates above the Administration's previous estimates, beginning in FY2009. As has been the Administration's practice, the MSR did not include any estimates for future costs for the operations in Iraq and

⁶ (...continued)

FY2006, defense spending would grow slowly throughout the five-year period.

⁷ Between FY2006 and FY2010, the budget resolution shows cumulative mandatory spending totaling \$9.068 trillion. The \$34 billion five-year reduction in mandatory spending in the reconciliation instructions is 0.37% (a little over one third of one percent) of cumulative mandatory spending over the period.

Afghanistan. Such costs, which are likely to occur in future years, will raise outlays in those years above the levels shown in the MSR.

CBO's mid-year Update (August 2005) revised FY2006 outlays upward by \$84 billion, most of which reflected the adoption of the defense supplemental earlier in 2005. Because the baseline rules require CBO to assume the repetition of the supplemental each year in its forecast, outlays in all the years were larger than in the March 2005 CBO baseline estimates. CBO estimates using alternative assumption that reduce funding for Iraq and Afghanistan and the war on terror over a period of time, produced 10-year cumulative outlay estimates that were \$705 billion smaller (including interest savings) than the cumulative 10-year baseline estimates.

Congress passed a continuing resolution on appropriations (P.L.109-77; H.J.Res. 68; CR) at the end of the fiscal year, September 30, 2005. The CR funds governmental activities through November 18, 2005, that are not already funded by permanent authority or by an FY2006 regular appropriation. The CR would fund most activities at the lower of the House- or Senate-passed appropriation, or the FY2005 current rate of spending. A second CR (P.L.109-105), lasting through December 17, was adopted as the first one expired. Two of the regular appropriations remained unfinished. Congress is expected to attempt to complete its appropriation efforts early in December.

Both the House and Senate passed spending reduction reconciliation bills (H.R. 4241 and S. 1932 respectively) in November. They would reduce spending, from baseline levels, on a selection of mandatory spending programs by between \$35 billion and \$50 billion over five years. The reductions would be approximately \$5.5 billion in FY2006. The bills included spending increases as well as spending reductions and differed substantially from each other. The conference report (H.Rept. 109-362; December 19) would reduce mandatory spending by approximately \$40 billion over five years.

Receipts

The Administration's FY2006 budget proposed extending and making permanent many of the tax cuts adopted in the first term that otherwise would expire (as required by law), mostly in 2010. The change, incorporated in the Administration's receipt proposals, produced relatively little change from the Administration's baseline estimates. Much of the budgetary effect of making the tax cuts permanent would not occur until after FY2010, the last year shown in the budget. The Administration estimated that making the cuts permanent would reduce receipts by \$53 billion between FY2006 and FY2010 and by \$1.0 trillion between FY2011 and FY2015. CBO's estimate of these proposals put the cost at \$143 billion for the FY2006 through FY2010 period and \$1.5 trillion for the FY2011 through FY2015 period.⁸

⁸ These amounts from CBO do not include the outlay effects (usually interest costs associated with larger deficits) of the extensions.

Under the initial request, receipts would grow from an estimated \$2,178 billion in FY2006 to \$2,821 billion in FY2010. The increases continue the dollar growth in receipts that began in FY2004, following three years of dollar declines in receipts (FY2001 through FY2003). Receipts reached their highest level (since World War II) both in dollars (\$2,025 billion) and as a percentage of GDP (20.9% of GDP) in FY2000. By FY2003, receipts had fallen for three years in a row in both dollars (to \$1,782 billion) and as a percentage of GDP (to 16.4%), with that share of GDP being lower than in any year since FY1955. Receipts grew to \$1,880 billion, but fell to 16.3% of GDP in FY2004. The Administration estimated receipts of \$2,053 billion (16.8% of GDP) in FY2005, exceeding FY2000 receipts in dollars, and \$2,178 billion (16.9% of GDP — still below recent averages) in 2006 (later estimates raised these amounts).

Table 3. Receipts for FY2004-FY2010 and FY2015
(in billions of dollars)

	FY2004	FY2005	FY2006	FY2007	FY2008	FY2009	FY2010	FY2015
CBO Baseline, 1/05	\$1,880 ^a	\$2,057	\$2,212	\$2,357	\$2,508	\$2,662	\$2,806	\$3,847
President's FY06 Budget, 2/05		2,053	2,178	2,344	2,507	2,650	2,821	—
President's FY06 CSB 2/05		2,053	2,178	2,347	2,518	2,668	2,841	—
CBO, Revised Baseline, 3/05		2,057	2,213	2,357	2,508	2,662	2,807	3,847
CBO, EPP 3/05		2,057	2,210	2,350	2,492	2,625	2,770	3,540
House, FY06 Budget Resolution, 3/05		2,057	2,195	2,331	2,496	2,635	2,784	—
Senate Budg. Comm. Budg. Res., 3/05		2,057	2,197	2,352	2,496	2,638	2,792	—
Senate, FY06 Budget Resolution 3/05		2,057	2,193	2,343	2,483	2,623	2,775	—
Conf. Agree. Budget Resolution 4/05		2,057	2,195	2,331	2,496	2,635	2,784	—
OMB MSR 7/13/05		2,140	2,273	2,428	2,588	2,727	2,893	—
CBO Update 8/15/05		2,142	2,280	2,396	2,526	2,675	2,817	3,848

a. Actual receipts for FY2004.

EPP — CBO's estimates of the President's proposals.

CSB — The Administration's current services baseline.

MSR — OMB's *Mid-Session Review*.

Update — CBO's *The Budget and Economic Outlook: an Update*.

The Administration's proposals did not include extending the current relief from the alternative minimum tax (AMT) after the end of FY2005. Without a further extension, a growing number of middle-class taxpayers will find themselves subject to the AMT.⁹ CBO estimated (January 2005) that providing extended or permanent AMT relief would reduce receipts by \$198 billion between FY2006 and FY2010 and by \$395 billion between FY2006 and FY2015. Without some adjustment to the

⁹ For discussions of the AMT issue, see CRS Report RL30149, *The Alternative Minimum Tax for Individuals*; and CRS Report RS22100, *The Alternative Minimum Tax for Individuals: Legislative Initiatives and Their Revenue Effects*, both by Gregg A. Esenwein.

AMT, it will recapture much of the tax reduction provided in the 2001 and 2003 tax cuts.¹⁰

The CBO baseline and OMB's proposed and baseline estimates are fairly similar from FY2006 through FY2010. Under both baselines, receipts rise from 16.8% of GDP in FY2005 to between 17.8% (CBO) and 17.7% of GDP (OMB) in FY2010. CBO's baseline, which assumed the scheduled expiration of the tax cuts, extended the projections through FY2015. In the CBO baseline, receipts rise rapidly after FY2010 (the year the tax cuts expire) and reach 19.6% of GDP in FY2015.

Using CBO's January 2005 estimates of alternative revenue policies — to extend the tax cuts and to reform the alternative minimum tax (AMT) — results in a much slower growth in receipts in dollars and as shares of GDP.¹¹ Receipts still rise as a percentage of GDP, but much more slowly than in the President's proposal or CBO's baseline. By FY2010, the alternative receipts have risen to \$2,727 billion and 17.3% of GDP. By FY2015, the alternative estimated receipts rise to \$3,508 billion and 17.9% of GDP.

CBO's March 2005 estimates of the President's revenue proposals (using CBO's underlying assumptions and budget model) produced numbers similar to those in the President's budget (a bit larger in the early years and a bit smaller in the later years of the FY2006 to FY2010 period).

The House and Senate budget resolutions followed the lead of the President's budget and included tax cuts or other tax changes for the period FY2006 through FY2010. The resolutions did not address the expiration of the tax cuts in 2010. The House resolution included \$106 billion in revenue reductions over five years, \$45 billion of which were included in reconciliation instructions. The Senate, in amending the resolution as presented by the Senate Budget Committee, increased the five-year revenue reduction to \$129 billion (from \$70 billion), all of which was to be included within reconciliation instructions.

The conference agreement on the budget resolution included five-year revenue reductions of almost \$106 billion, \$70 billion of which fell under reconciliation instructions. The FY2006 \$11 billion tax reduction under reconciliation (in the budget resolutions) would not be large enough (by an estimated \$5 billion) to accommodate all of the tax breaks that expire that year. Among those tax breaks expiring is the relief from the Alternative Minimum Tax (AMT) for many (and growing) middle-class taxpayers. The House Ways and Means Committee and the Senate Finance Committees will determine what is included and excluded from the tax cut reconciliation bill that each Chamber will initially consider. Whether a

¹⁰ See CRS Report RS21817, *The Alternative Minimum Tax (AMT): Income Entry Points and "Take Back" Effects*, by Gregg A. Esenwein, for more information on the interaction of the AMT and the tax cuts.

¹¹ CBO indicates that combining the reform of the AMT and the tax extenders produces an interactive effect that makes the combined loss greater than the sum of the two estimates separately.

separate tax cut bill, continuing or extending other expiring tax cuts, will be introduced is uncertain.

Figure 3. Receipts, FY2005-FY2015

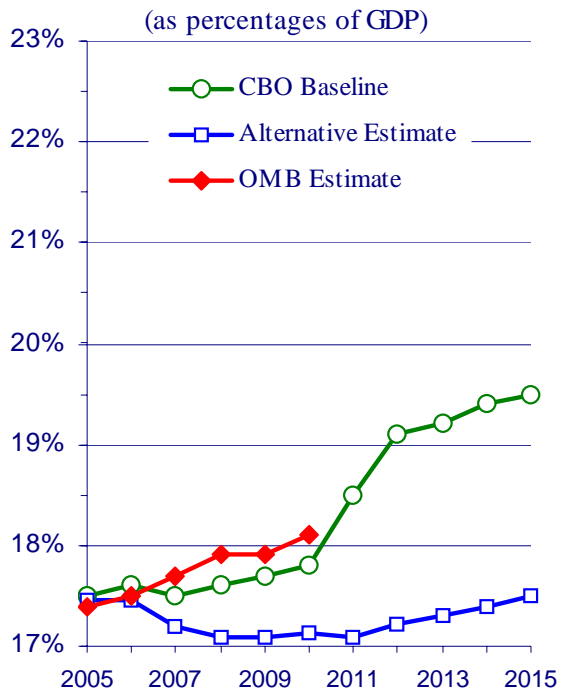


Figure 3 uses data from the OMB and CBO 2005 mid-year budget reports. It shows receipts as percentages of GDP for fiscal years 2003 through 2015 (projected). The two lines following similar paths through FY2010 are CBO's baseline estimate and the OMB's MSR. Both show revenues growing slowly as percentages of GDP through FY2010.

CBO's baseline assumes tax increases after 2010, with the currently scheduled expiration of the 2001 and 2003 tax cuts. This assumption raises receipts rapidly as a percentage of GDP in the first half of the second decade of the 21st century. The alternative estimate used CBO's August 2005 alternative scenarios that assume the tax cuts are

extended and that the AMT relief is adjusted annually. This alternative outlook for receipts shows them remaining between 17.0% and 17.5% of GDP throughout the FY2005 to FY2015 period.¹²

The MSR showed revenues rising from less than 17% of GDP to over 18% of GDP in FY2010. CBO's baseline rises to just below 18% of GDP in FY2010 to almost 19.5% of GDP in FY2015. The CBO baseline in **Figure 3** reflects the growth in revenues after FY2010 if the tax cuts are allowed to expire.

The MSR (July 2005) indicated that the unforeseen increase in receipts in 2005 would persist through FY2010. The Administration attributed the higher revenues to stronger economic growth, which the Administration claimed resulted in large part from its tax cut policies. The stronger economic growth is not reflected in the economic data included in the MSR. The MSR and the President's February FY2006 Budget contain the same rate of economic growth for FY2005 (and the MSR contains a marginally lower rate of GDP growth for FY2006). Future receipts may also be smaller than the MSR indicates if Congress and the President continue adjusting the Alternative Minimum Tax (AMT) to provide relief to middle-class taxpayers.

CBO's mid-year report (the Update, August 2005) showed a large increase in receipts for both FY2005 and FY2006 with smaller increases in several subsequent

¹² By FY2015, CBO's baseline and the alternative estimate are approximately 2% of GDP or \$400 billion apart.

years, compared to its March 2005 baseline estimates. CBO attributed most of the increased receipts to higher than expected income taxes (both individual and corporate). CBO indicated that the increases were likely the result of temporary tax law changes that have expired. CBO attributed some of the more persistent increased receipts to changes in its expected economic conditions. CBO does not expect the increased receipts to affect the budget's long-term imbalance. Better analysis of the changes in receipts will appear in the future as more detailed data on the receipts becomes available.

The effect of summer's hurricanes on federal revenues is uncertain. Although a short-term reduction in collections is possible, the rebuilding that is expected may replace some of the loss over time.

The tax reduction reconciliation bills under consideration (in early December) in Congress would reduce FY2006 revenues by between \$6 billion and \$11 billion and by between \$56 billion and \$60 billion over five years. Congress is expected to consider the legislation when it returns in early 2006.

Deficits (and Surpluses)

Deficits and surpluses are the residuals left after Congress and the President set policies for spending and receipts. Surpluses, in which receipts are greater than outlays, reduce federal debt held by the public, which can lead to lower net interest payments (among other effects). Deficits, in which outlays exceed receipts, increase government debt held by the public, generally 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.

The President's FY2006 budget proposals had estimates of the FY2006 deficit falling to \$390 billion (3.0% of GDP) from an FY2005 deficit of \$427 billion (3.5% of GDP). The deficit would fall to an estimated \$207 billion (1.3% of GDP) in FY2010. The President's budget indicated that its policies, if adopted, would halve the deficit as a percentage of GDP by the end of FY2010. This goal would likely not be reached if additional AMT relief is implemented, additional defense supplementals are adopted, or non-defense discretionary spending grows rather than falls after FY2006.

Achieving the Administration's deficit reduction proposals would require, over five years, strict limits on the growth in domestic discretionary spending, a modest reduction (from baseline estimates) in some entitlements, slowing defense spending growth, and letting AMT relief to lapse after 2005. The proposals included some revenue-reducing tax cuts, increasing other changes needed to reduce the deficit.¹³

¹³ The Administration's current services baseline estimate, which assumes current policy, had smaller deficits in each year through FY2009 (and the same sized deficit in FY2010)
(continued...)

An inability to hold to these spending and revenue levels, a task that may prove difficult, would result in larger deficits than those expected in the President's budget.

Table 4. Surpluses/Deficits(-) for FY2004-FY2010 and FY2015
(in billions of dollars)

	FY2004	FY2005	FY2006	FY2007	FY2008	FY2009	FY2010	FY2015
CBO Baseline, 1/05	\$-412 ^a	\$-368	\$-295	\$-261	\$-235	\$-207	\$-189	\$141
President's FY06 Budget, 2/05		-427	-390	-312	-251	-233	-207	—
President's FY06 CSB 2/05		-390	-361	-303	-251	-229	-207	—
CBO Revised Baseline 3/05		-365	-298	-268	-246	-219	-201	122
CBO EPP 3/05		-394	-332	-278	-250	-246	-229	-256
House FY06 Budget Resolution, 3/05		-394	-376	-304	-247	-229	-203	—
Senate Budg. Comm. Budg. Res., 3/05		-397	-361	-299	-258	-236	-208	—
Senate, FY06 Budget Resolution, 3/05		-397	-368	-315	-277	-257	-232	—
Conf. Agree. Budget Resolution 4/05		-398	-383	-313	-254	-238	-211	—
OMB MSR 7/13/05		-333	-341	-233	-162	-162	-170	—
CBO Update 8/15/05		-331	-314	-324	-335	-321	-317	-57

a. Actual deficit for FY2004.

EPP — CBO's estimates of the President's proposals.

CSB — The Administration's current services baseline.

MSR — OMB's *Mid-Session Review*.

Update — CBO's *The Budget and Economic Outlook: An Update*.

CBO's March 2005 estimates of the President's proposals put the FY2005 deficit at \$394 billion (3.2% of GDP) and the FY2006 deficit at \$332 billion (2.6% of GDP). Both are below the deficits for those years proposed in the budget. CBO's reestimated deficits are below the Administration's deficits through FY2008 and larger than the Administration's deficit estimates in FY2009 and FY2010. CBO extended its projections of the President's policies through FY2015 (the President's budget estimates ended with FY2010).

The House and Senate budget resolutions, in following the Administration's lead, showed declining deficits throughout the five years covered by the resolution. The conference agreement on the resolution followed the same pattern. The differences among these deficit estimates were slight (see Table 4). The conference agreement set a FY2006 deficit of \$383 billion (3.0% of GDP) falling to \$211 billion (1.1% of GDP) in FY2010.

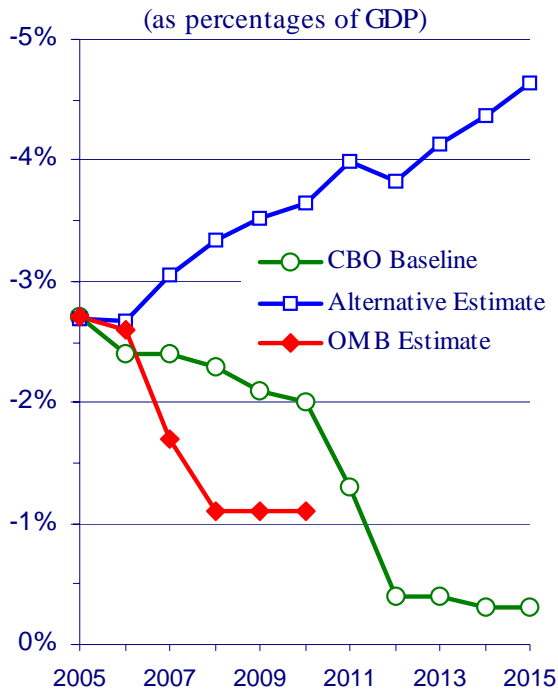
Figure 4 shows deficit estimates as shares of GDP for FY2005 through FY2015 based on data from the OMB's and CBO's mid-year (July and August 2005

¹³ (...continued)

than the President's proposed budget. The cumulative five-year deficit would be smaller without the President's proposed policy changes than with them.

respectively) budget reports.¹⁴ The CBO baseline deficit estimate in August 2005 included assuming the expiration of the 2001 and 2003 tax cuts in 2010, no future adjustments to lessen the expanding coverage of the AMT, adjusting non-defense

Figure 4. Deficits, FY2005-FY2015



discretionary spending for inflation, and an annual repetition of the 2005 funding supplemental for the military activities in Iraq and Afghanistan. The result, particularly after FY2010, is a rapid fall in the deficit as a share of GDP, but which does not reach surplus by FY2015.

The OMB July 2005 estimates show the deficit falling quickly from FY2006 to FY2008, to just over 1% of GDP, and remaining at that level through FY2010, the end year of the Administration's estimates. The Administration's proposal to make the tax cuts permanent has little effect on the deficit estimates until after FY2010. The Administration's policies would likely result in increases in the deficit as a percentage of GDP in the years after FY2010.

The alternative baseline in **Figure 4** used selected estimates of alternative policies created by CBO (that reflect faster discretionary spending growth, extending the expiring tax cuts, retaining relief from the AMT, and incorporating increased debt servicing costs). Under these assumptions, the deficit estimates begin rising after FY2006 and approach 5% of GDP by FY2015.

The Administration's *Mid-Session Review* (MSR, July 2005) included smaller deficit estimates for each year in the five-year forecast (compared to the President's FY2006 February budget). Most of the improvement came from higher than previously expected receipts. A small amount came from smaller than expected interest payments resulting from the slower growth in federal debt (because of the smaller deficits).

The CBO August 2005 budget report, *The Budget and Economic Outlook: An Update*, like the OMB MSR, expected substantial reductions in the deficit in both FY2005 and FY2006, mostly because of the higher than expected receipts collected in 2005. CBO did not expect the deficit shrinkage to persist in the future or have much, if any, effect on the long-term budget outlook.

¹⁴ Note that in the chart, larger deficits are towards the top and smaller deficit are towards the bottom.

The hurricanes that caused extensive damage along the Gulf Coast changed the budget outlook for FY2006 (after the release of the OMB and CBO mid-year reports). The higher spending expected, along with reduced receipts, is likely to add many tens, if not hundreds of billions of dollars to the deficit in FY2006 and possibly in subsequent years. At this time (early October 2005), no official estimates of the costs, both spending and receipts, to the government of the hurricanes are available.

The Longer Run

Over a longer time period, one beginning in the next decade and lasting for decades into future, CBO indicates (in its January 2005 budget documents) that it expects, under existing policies and assumptions, that demographic pressures will produce large and persistent deficits. CBO states

In the decades beyond CBO's projection period, the aging of the baby-boom generation, combined with rising health care costs, will cause a historic shift in the United States' fiscal situation....

Driven by rising health care costs, spending for Medicare and Medicaid is increasing faster than can be explained by the growth of enrollment and general inflation alone. If excess cost growth continued to average 2.5 percentage points in the future, federal spending for Medicare and Medicaid would rise from 4.2 percent of GDP today to about 11.5 percent of GDP in 2030....

Outlays for Social Security as a share of GDP are projected to grow by more than 40 percent in the next three decades under current law: from about 4.2 percent of GDP to more than 6 percent....

Together, the growing resource demands of Social Security, Medicare, and Medicaid will exert pressure on the budget that economic growth alone is unlikely to alleviate. Consequently, policymakers face choices that involve reducing the growth of federal spending, increasing taxation, boosting federal borrowing, or some combination of those approaches.¹⁵

The Administration indicated similar concerns about the outlook for the budget over the long term but tied much of its discussion to the President's proposed reforms to Social Security. Less was said about Medicare and Medicaid.

The short-term budget outlook can change when it is buffeted by economic or policy changes. The long-term budget outlook is expected to be dominated by the expansion of the population eligible for Social Security, Medicare, Medicaid, and other programs for the elderly as the baby boom generation begins retiring in large numbers. The steady price increases experienced by the health programs, if unchanged, could begin to dominate future budget debates. 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, spending increases, and

¹⁵ CBO, *The Budget and Economic Outlook: Fiscal Years 2006-2015*, Jan. 2004, pp. 10-11.

policy changes of the last few years have not produced the difficult fiscal future, but they appear to have made an already difficult situation 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 generally have on the economy. The worse-than-previously-expected economic conditions that lasted from 2001 into 2003, played a minor role, directly and indirectly, in the deterioration of the budget outlook over those years. CBO expects continued economic growth during calendar years 2005 and 2006, which should result in higher revenues and lower spending than would occur if the economy were to grow at a slower rate. Because there is no way of predicting the timing of economic ups and downs, especially as estimates run into the future, CBO projects that GDP will grow at a rate close to potential GDP for the period 2007 through 2015.¹⁶

Under governmental policies that are in fiscal balance, a return to normal economic growth (growth close to that 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 under current policies experiences a shrinking deficit, but does not move into surplus throughout the forecast period. Under CBO's alternative policies, the deficit grows as a percentage of GDP; it does not shrink or disappear during a period of expected normal economic growth. This result implies that the budget, particularly if using the alternative assumptions, has a basic fiscal imbalance that cannot be eliminated by economic growth. To produce a balanced budget or one in surplus requires spending reductions or tax increases.

¹⁶ Potential GDP represents an estimate of what GDP would be if both labor and capital were as fully employed as is possible.

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