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2005 Federal Budget Continues Fiscal Decline

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Deficit Projections

The President's 2005 Budget proposes a federal budget deficit for the current fiscal year of $521 billion, which is about 4.5 percent of the nation's gross domestic product (GDP). Without counting the Social Security surplus, the deficit in the current budget is $675 billion, or approximately 5.9 percent of GDP, and the second largest since World War II.[1]

While many questions have been raised about the accuracy of the budget's projections over the next decade – suggesting that they may understate the true size of the deficit[2] – even the numbers published in the budget present a gloomy vision for the federal budget situation over the next few years and beyond. During just the 2004-2009 period, the President's budget proposes adding $1.9 trillion to the national debt.[3] Over the next 10 years, the president is proposing a net $1.1 trillion in revenue reductions – most of which (87%) will occur after the 2005-2009 window included in the budget.[4] The proposals included in the budget would considerably worsen the deficit situation beyond the 2009 horizon.

This Tax and Budget Staff Note examines the impact of the President's budget on federal revenue and on the longer-term fiscal situation. The final section offers some of the implications of the recent fiscal decline.

Revenue Changes

What is the cause of these massive new deficits? An economic slowdown, and increased spending for national defense and national security are important contributors, but we must fist look to tax policy over the last few years.

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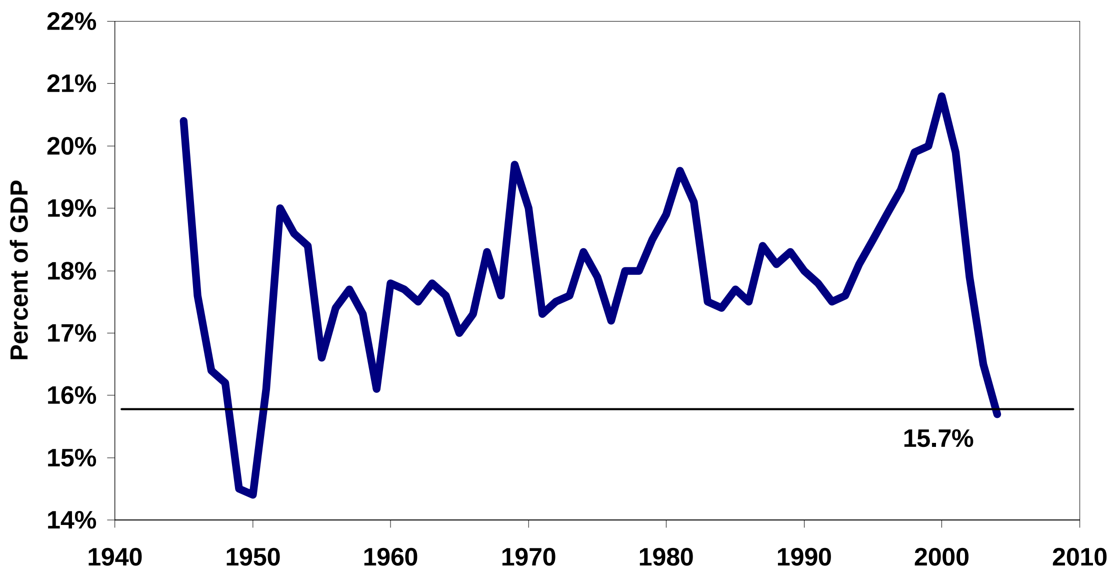
[1] Office of Management and Budget (OMB), The Budget for Fiscal Year 2005, Tables S12, S1, and author's calculations. The largest is 6 percent in 1983 during the presidency of Ronald Reagan.
[2] According to R. Kogan and R. Greenstein, *Analysis of the President's New Budget*, "The budget uses a series of stratagems to mask the magnitude of the deficits the nation faces . . . and to make it appear on paper as though the deficit will be cut in half. The budget omits approximately $160 billion in costs in 2009 (the fifth year) that the Administration itself favors and is expected to propose in future budgets," Center on Budget and Policy Priorities.
[3] 2005 Budget, Table S1.
[4] 2005 Budget, Analytical Perspectives, page 268.

Federal revenue for fiscal year 2004 – at just 15.7 percent of gross domestic product – is projected to be at its lowest level since 1950 (see Figure1.); and federal individual income tax receipts for FY 2004, at 6.7 percent of GDP, will be at their lowest level since 1951.[5] **From 2000 to 2004, federal revenue as a share of GDP has declined by 5.2 percentage points – which is larger than the current deficit, which is at 4.5 percent of GDP for 2004.**[6]

Figure 1. Federal Revenue, 1945-2004



Source: Office of Management and Budget (OMB), 2005 Budget, Historical Tables, pg. 24

This reduction in federal revenue has created a long-term structural problem for the federal budget, since spending levels have not changed to the same degree. The "structural" deficit measures the size of the fiscal imbalance once we take out "cyclical" economic factors such as higher unemployment. According to the 2005 Budget, fiscal year 2004 will see a $483 billion structural deficit. In the following 5 years, the structural deficit will total $1.3 trillion (see figure 2.)[7]

Indeed, the structural deficit shows that 1) the current deficit is not a result of a weak economy, and 2) we are unlikely to grow our way out of massive deficits in the near term – the situation will not simply fade away over time.

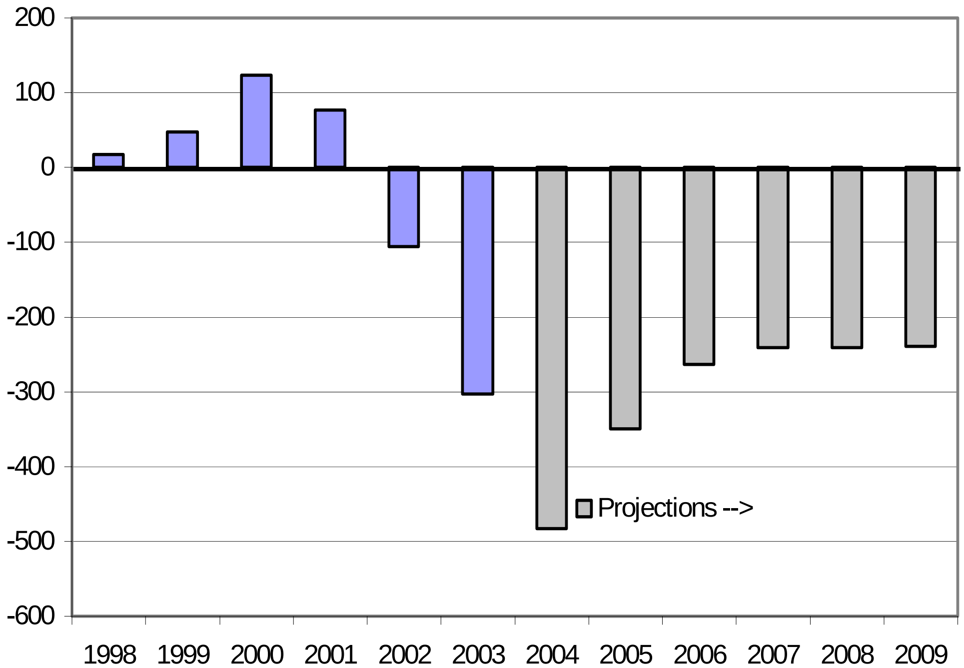
[5] 2005 Budget, Historical Tables, Table 2.3.

[6] For 2004, revenue is 15.7%, and for 2000, it was 20.9%. The reason the deficit revenue is larger than the decline in revenue is because there was a surplus in 2000. See Table 1.2, 2005 Budget, Historical Tables.

[7] See Table 11-5, 2005 Budget, Analytical Perspectives, page 178.

In addition, over the next 10 years, the president is proposing $1.1 trillion in revenue reductions – most of which (87%) will occur after the 2005-2009 window included in the budget.[8] These proposals, if passed, would considerably worsen the deficit situation beyond the 2009 horizon.

Figure 2. Structural Surplus (+) / Deficit (-), 1998-2009
($ Billions)



Source: 2005 Budget, Analytical Perspectives, Table 11-5.

Longer-term view

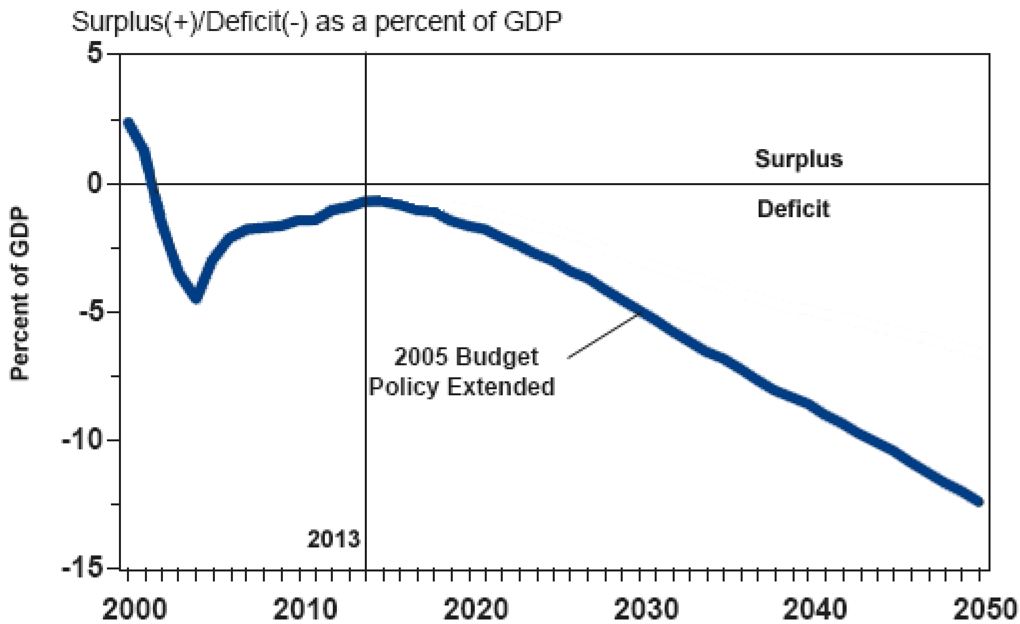
When compared to these short-term deficit projections, the longer-term situation under proposed policy is even worse. Figure 3 shows the budget situation over the next 50 years - from 2000 to 2050 if current budget policy is extended.

This figure, which is derived from a chart in the 2005 budget, vividly demonstrates that current tax and budget policy are not sustainable, and that current massive deficits are merely difficult times before an even sharper deterioration. As the baby-boom generation reaches retirement age, the deficit will dramatically worsen under current policy.

In addition, there are additional tax policies supported by the administration – such as a permanent adjustment to the Alternative Minimum Tax – that would increase the size of these deficits even further.

[8] 2005 Budget, Analytical Perspectives, page 268.

Figure 3. Surplus / Deficit, 2000 – 2050



Source: Derived from Chart 12-5, OMB, 2005 Budget, Analytical Perspectives, page 194

Interpretation

Budget deficits can harm longer-term economic growth by reducing public savings, increasing interest rates, and lowering total investment. In times of economic hardship a temporary deficit might be desirable. However, in the context of the current economic and budgetary situation, we know that the current deficit is not temporary, and is a symptom of overall irresponsible tax and budget policy.

Overall, the current budget proposes a tax policy that is:

1. Irresponsible, because it shifts trillions of dollars of the tax burden to future generations, and away from those that can best afford to pay.
2. Reckless, because it threatens our ability to respond to future crises and challenges, and harms the economy in the long run.
3. A lost opportunity, because is does not deal with longer-term issues such as the viability of Social Security or Medicare.

First, by greatly increasing the size of the federal debt, the budget shifts the responsibility for paying taxes from current to future generations and the young. In addition, while this note has focused on the overall level of revenue, there are also concerns with the well-documented changes in the distribution of the tax burden across taxpayers.[9] While lower income taxpayers have received little or no reduction in their tax payments, upper income individuals have seen their tax bill greatly reduced in recent years.

Second, the federal government was better able to adjust to the shocks of 9-11 and the conflicts afterwards because of the sound fiscal situation – and budget surpluses – that existed in 2001 and the preceding years. The Federal Reserve was better able to conduct aggressive monetary policy, and the government was better able to meet national and military challenges as a result of the surplus. Beyond the conventional economic cost of running a large and persistent deficit, current policy is reckless since it leaves the federal government less able to conduct counter-cyclical fiscal policy or to address future national crises.

Finally, the deterioration of the budget situation leaves us less able to address looming budgetary challenges. With the baby-boom generation nearing retirement, great strains will be placed on our national retirement system as outlays for Social Security and Medicare will soon begin to skyrocket. With massive persistent deficits, we are less able to meet the challenges of the coming decades.

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[9] For estimates, see the analyses by the Tax Policy Center. For example, removing the income tax sunsets in 2001-2003 tax laws would give those with incomes above $1million an average tax break in excess of $100,000.

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