by William G. Gale and Peter R. Orszag

The President's 2005 Budget: First Impressions

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I. Introduction

On February 2, the Bush administration released its budget proposals for fiscal years 2005-2009. This article provides initial analysis of the budget, with the following main conclusions:

- The 2005 budget continues the administration's pattern of seeking large, regressive tax cuts, seemingly under any and all circumstances. The administration's continued insistence on long-term tax cuts not only fails to help resolve the nation's fiscal problems, but makes those problems worse. It is also contradictory to the approach taken by prior Republican and Democratic administrations alike when faced with unexpectedly adverse fiscal situations.
  - The principal tax proposal in the budget is to make almost all of the recently enacted tax cuts permanent. That policy would be expensive, regressive, and would ultimately prove harmful to economic growth. Furthermore, it would *not* resolve the fundamental source of fiscal uncertainty — how the fiscal gap will be closed — but rather exacerbate that uncertainty by making long-term deficits larger.
  - Another set of proposals, to greatly expand tax-favored saving accounts, would also be expensive in the long run and would be both regressive and unlikely to generate positive effects on national saving or economic growth.
- The administration proposes substantial increases in spending on defense and homeland security, and essentially a nominal freeze over five years for nondefense discretionary spending. Outside of defense, homeland security, and international affairs, the budget reduces real per capita discretionary spending by about 15 percent.
- On paper, the budget meets the administration's goal of cutting the deficit in half as a share of GDP by 2009. That is a meaningless victory, however. First, the same objective is achieved under the official baseline without any policy changes. Second, given its proposals to cut taxes and raise defense spending, the administration reaches the goal only because the budget omits several factors that should be included in any reasonable and responsible projection — including a fix for the alternative minimum tax and spending on the Iraq and Afghanistan wars after September 30 — and imposes heroic assumptions about the reductions possible in domestic discretionary spending outside homeland security. Third, the president proposes massive new tax cuts that would take place after 2009, thus swelling the deficit again. Fourth, cutting the deficit in half by 2009 is neither necessary nor sufficient to address the nation's long-term budget problems. The budget implicitly acknowledges this, noting that given the administration's policies, "long-term projections show the budget is on an unsustainable path."
- The president's proposals for budget reform aim to restrict spending increases, but place no constraints on tax cuts. Such an approach is unlikely to be effective, since it would encourage the shifting of spending programs to the tax side of the budget. Also, it fails to address the fact that the budget deficit has soared because revenues have plummeted, not because spending has exploded.
- The absence of a serious proposal to deal with the AMT is both striking and irresponsible. Under the president's budget proposals, there would be 30 million taxpayers on the AMT in 2009 and 44 million in 2014. Despite the fact that only a tenth as many face the AMT currently, the National Taxpayer Advocate has already declared the AMT to be the most important problem facing taxpayers. Although the AMT problem is the product of bipartisan neglect, the

Table 1
Revenue and Budget Costs of Tax Proposals in the 2005 Budget, $ billion

	2005-2009	2010-2014	2005-2014	2014
Panel 1: AMT Policy as in the Budget				
Extend 2001 and 2003 Tax Cuts[1]				
AMT Extension Through 2005	-23	0	-23	0
Extend Estate Tax Repeal	-9	-172	-180	-54
Extend Other Non-AMT Provisions of EGTRRA, JGTRRA	-139	-670	-810	-190
Total Revenue Change	-171	-842	-1,013	-243
Interest[2]	-20	-136	-156	-51
Subtotal	-191	-977	-1,169	-294
All Other Tax Proposals				
Revenue Change	-42	-185	-227	-43
Interest	-1	-36	-36	-12
Subtotal	-43	-221	-264	-55
All Tax Proposals				
Revenue Change	-213	-1,027	-1,240	-286
Interest	-21	-171	-192	-63
Total	-234	-1,198	-1,432	-349
Panel 2: Extending and Indexing the AMT				
Extend 2001 and 2003 Tax Cuts				
AMT Reform[3]	-164	-264	-428	-51
Extend Estate Tax Repeal	-9	-172	-180	-54
Extend Other Non-AMT Provisions of EGTRRA, JGTRRA	-180	-1,150	-1,330	-347
Total Revenue Change	-344	-1,414	-1,758	-398
Interest	-34	-255	-290	-90
Subtotal	-379	-1,669	-2,048	-487
All Tax Proposals Including AMT Reform				
Revenue Change	-386	-1,599	-1,986	-441
Interest	-34	-255	-290	-90
Total	-421	-1,855	-2,275	-530

[1]*The Budget of the U.S. Government, Fiscal Year 2005*. Department of the Treasury (2004). Includes refundable credits technically scored as outlays.
[2]Authors' calculations using January 2004 CBO debt service matrix.
[3]Authors' calculations using microsimulation model of Tax Policy Center. Under indexing of the AMT the number of taxpayers on the AMT is 6.5 million in 2014, compared with 3.6 million in 2005.

Bush administration bears special responsibility for dealing with the AMT because the tax cuts it has championed have made the problem far worse.

- At this stage, the fiscal legacy of the Bush administration seems clear. Its policies have made the medium- and long-term fiscal situation far worse. While policies that raised short-term deficits may have been justified in previous years as the necessary response to economic adversity, it was possible to stimulate the economy through alternative policies that likely would have been both less expensive and more effective than the paths chosen. Moreover, the administration continues to propose permanent new tax cuts, and perusal of the budget documents makes it clear that — three years into its term — the administration still has no plan to deal with medium- and long-term fiscal problems.

Section II provides a brief overview of the tax and spending proposals. Section III discusses the president's goal of cutting the deficit in half by 2009. Section IV examines the budget reform proposals. Section V provides a broader perspective on fiscal policy to date in the Bush administration.

II. The Budget: An Overview

A. Tax Proposals

The principal tax proposal in the administration's budget is to make most of the provisions of the 2001 and 2003 tax cuts permanent. The other major tax proposal is to greatly expand the scope and options for tax-preferred saving, especially by high-income households. The budget also contains the usual assort-

Table 2
Discretionary Spending Outlays, $ billion

	2004	2005	2006	2007	2008	2009	2005-9
Current services baseline							
Defense	452	439	417	421	433	443	2,153
Nondefense	457	471	468	475	481	490	2,385
Total	908	910	885	896	914	933	4,537
Budget							
Defense	452	448	435	446	466	486	2,280
Nondefense	457	466	458	459	457	457	2,296
Total	908	914	892	904	923	942	4,576
Change, budget relative to current services baseline							
Defense	–	9	17	25	33	43	127
Nondefense	–	(5)	(10)	(17)	(24)	(33)	(88)
Total	–	4	7	8	9	10	39

Sources: OMB (2004b, Table 24-1), OMB (2004c, Table 8.1). Note that the spending classifications are based on Budget Enforcement Act definitions. The budget summary tables in the main section of the budget use different classifications.

ment of measures — many of them off the shelf — for health care, charity, education, housing, environment, energy, simplification, pensions, tax compliance, tax administration, and extension of other expiring provisions. Notably, the only AMT proposal is a one-year extension of the current AMT exemption levels, and use of personal nonrefundable credits.

Table 1 shows the revenue and budget effects of the administration's proposals over the next five years and over the 2005-2014 period, as estimated by the administration. Several features of the tax cuts merit comment:

- Almost all of the revenue loss, in the 10-year budget window, is due to making the tax cuts permanent.
- More than 80 percent of the costs of that proposal would occur after 2009.
- Because the budget does not include a fix for the AMT, the figures in the top panel of Table 1 significantly understate the revenue loss under more reasonable scenarios. By 2010, for example, under current law the AMT would erase more than a third of the tax cut ostensibly provided by the 2001 tax legislation (Burman, Gale, and Rohaly, 2003).

The lower panel of Table 1 shows the effects of adding in a minimal AMT fix that extends the expiring provisions of the AMT (the exemption increase and the treatment of personal credits) and indexes the AMT for inflation starting in 2005. Under current law, the revenue loss from AMT reform would be $428 billion over 10 years. But the AMT reform also adds to the cost of making the tax cuts permanent, raising that figure to $1.33 trillion from $990 billion. The combined revenue loss from AMT reform and making the tax cuts permanent would be $1.76 trillion over the 10-year period.[1] The total budgetary costs (including interest payments) of the president's proposals, coupled with a minimal AMT fix, rise to almost $2.3 trillion.

Finally, by the criteria used by the administration in the past, the budget proposes several tax *increases.* Those include not indexing the AMT for inflation, allowing the AMT exemption to fall back to its 2001 level after 2005, and not extending the saver's credit (which provides a matching tax credit for contributions to 401(k)s and IRAs made by moderate-income households) beyond 2006.

B. Spending Proposals

The basic thrust of the spending initiatives in the budget is simple: substantial increases in defense and homeland security and significant reductions in domestic discretionary spending. Table 2 shows the changes relative to the current services baseline. By 2009, defense outlays would be $43 billion — or almost 10 percent — above the current services baseline. The reduction in defense outlays between 2004 and 2006 is more apparent than real, since the administration's budget does not include funding for ongoing operations in Iraq and elsewhere (which are reflected in the 2004 figures). Administration officials have indicated that funding would be provided in a supplemental request that is not reflected in the budget.

Nondefense outlays under the budget are constant in nominal terms through 2005 to 2009, which implies reductions after inflation is taken into account. Indeed, by 2009, those outlays are $33 billion *below* the current services baseline, a reduction of 7 percent. On a real per capita basis, the reduction is more than 10 percent.

The "nondefense" spending category, furthermore, includes international affairs and components of homeland security spending. Kogan and Kamin (2004) calculate that for domestic spending outside homeland security, the budget proposes a funding cut of 11 percent in inflation-adjusted terms and a 15 percent reduction on a real per capita basis over the next five years.

As discussed below, the budget proposes spending caps at the levels proposed in the budget. Those spending caps, if enacted, would require severe reductions in domestic spending outside homeland security. Also,

[1]The revenue estimates, assuming an AMT adjustment, differ somewhat from those presented in Table 2 of Orszag (2004) for two reasons. First, the components of the revenue provisions included differ slightly. Second, the revenue estimates in Orszag (2004) are based on adjustments to CBO projections; the revenue estimates shown here are based on adjustments to administration projections.

Table 3
Alternative Deficit Projections

	2004	2005	2006	2007	2008	2009
Current services budget	527	360	253	229	218	211
Administration budget	521	364	268	241	239	237
CBO baseline	477	362	269	267	278	268

Source: CBO (2004), OMB (2004a, supplemental tables, S-15, 2004c)

the spending caps would apply to *all* discretionary spending. If anything, however, the defense outlays are likely to be understated in the out-years, relative to the costs of the administration's defense policies. As a result, the required reduction in domestic spending would be even more substantial.

III. Cutting the Deficit in Half Over Five Years

The administration has claimed for months that it would propose a budget that cut the deficit in half over five years. The 2005 budget meets that goal, but the proper response, for several reasons, is "so what?"

A. Current Services Baseline

As shown in Table 3, the administration's goal of cutting the deficit in half by 2009 is achieved under its current services baseline (that is, before any new policy changes are considered). According to administration documents, the current services budget is a "policy-neutral benchmark against which the President's Budget and other budget proposals can be compared to see the magnitude of the proposed changes" (OMB 2004b, page 357). Notably, the current services budget provides reductions in the deficit from 2004 to 2009 that are *greater than* those proposed in the administration's budget. That is, under the current services baseline, the budget was already on course to cut the deficit by more than half over the next five years.

Table 3 also shows the CBO budget baseline projections, another policy benchmark for the status quo. The administration's budget does slightly better at reducing the deficit than the CBO baseline, but that is entirely due to two reasons, neither of which has anything to do with the administration's new proposals. First, the administration forecasts a 2004 budget deficit that is $44 billion higher than the CBO's (and the difference cannot be explained by legislative proposals as shown by the current services budget). A higher deficit in 2004 makes it easier to cut the deficit in half by 2009. Second, OMB's estimate of GDP in 2009 is more than $200 billion larger than the CBO's. If taxes rise by roughly 20 percent of an increase in GDP, that translates into an extra $40 billion in 2009, just from the difference in GDP assumptions. This more than explains the $31 billion difference between the CBO baseline and the administration's budget in 2009.

B. Gimmicks and Ploys

The second reason that ostensibly cutting the projected deficit in half by 2009 is a pyrrhic victory is that the administration achieves that outcome only with a variety of budget gimmicks, omissions, and untenable assumptions.

One major ploy is to claim to substantially reduce domestic spending outside of homeland security over the next five years. Virtually no one believes those cuts are plausible.[2] Adding to the sense of incredulity is the fact that the budget raises spending on several programs in 2005 and then proposes future cuts starting in 2006. If the cutting were intended seriously, it could begin in 2005 (Greenstein, 2004).

The second major ploy is to omit costs that any responsible projection would include. That includes the continuing costs of war in Iraq and Afghanistan, which the administration has already indicated it will ask for in a supplemental request (that is, outside of the budget). It also includes ignoring the AMT. Under the administration's budget, 30 million people face the AMT in 2009 and 44 million in 2014, compared to just 3 million today. The Center on Budget and Policy Priorities estimates that there are about $160 billion in those omitted costs. (Greenstein, 2004). Extending the expiring AMT provisions and indexing the AMT for inflation, which would represent a minimal fix, would cost $71 billion in revenue and debt service costs in 2009 alone.

C. Does Not Address the Long-Term Problem

The third reason that cutting the deficit in half by 2009 is not an interesting or helpful goal is that it does nothing to resolve the longer-term budget problems facing the country. Indeed, the budget itself indicates that under the administration's policies, and even with favorable productivity growth over time, the budget is "unsustainable" (OMB 2004b, page 191). Figure 1 shows that explicitly, in a graph taken directly from the budget. The figure shows the administration's own estimates of the long-term consequences of its budget and shows clearly that deficits are slated to rise inexorably for the foreseeable future, once we get past the next few years.

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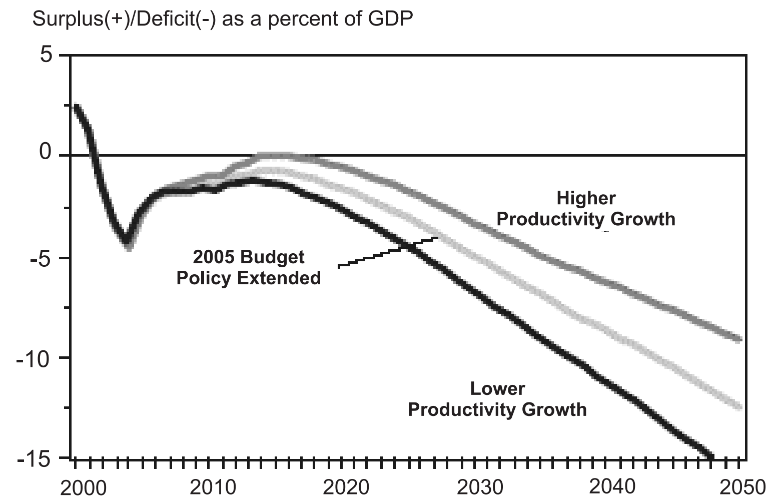
[2] This especially includes conservative commentators. Chris Edwards at the Cato Institute is quoted as saying, "They have a reasonable number in the first year, but then there are really low or no increases after that. . . . The problem is that Bush doesn't really have a plan for that happening. It's phony." (Andrews, 2004). Bruce Bartlett of the National Center for Policy Analysis said, "I don't think you'll find anybody in any party who takes seriously the administration's promise to hold down spending. The president has never made small government a major element of his philosophy." (Bumiller, 2004).

IV. Budget Reform

The administration has proposed new budget rules to replace the ones that expired in 2002 (and that have been only ineffectively and partially replaced since then). The old budget rules put a cap on discretionary spending and required that changes to mandatory spending and revenues be offset by other changes to mandatory spending or revenues. The rules proposed by the Bush administration create a new cap on discretionary spending, and require that mandatory spending changes be self-financing, but place no limit on tax cuts.

The administration's proposed rules are misguided for several reasons. First, fiscal discipline requires restraint on both sides of the budget, as the experience of the past few years seems to indicate. When taxes were cut dramatically in 2001, advocates of the tax cuts argued that the lower revenues would help restrain government spending. If anything, the opposite seems to have occurred. That is, once the deficit grew significantly, lawmakers saw no incentives to hold back on spending or new tax cuts. Experiences in 1990 and 1993 also show that successful budget reform requires discipline on both the spending and the tax side.

Figure 1
Long-Term Budget Outlook Under Administration Budget Policies



Source: OMB (*2004b*, Chart 12-5).

Second, the rules would encourage lawmakers to convert spending programs to tax cuts. That incentive would only accelerate the trend of disguising spending changes as revenue provisions — thereby creating what Alan Greenspan has called "tax entitlements." Those tax entitlements are every bit as damaging to long-run fiscal prospects as spending entitlements, but are also typically much more regressive.

Third, the rules ignore the fundamental point that the budget problems that exist today are the result of a precipitous decline in revenues, not an explosive growth in spending. Of the increase in the budget deficit as a share of GDP between 2000 and 2004, more than three-quarters is due to a decline in revenue (and half of that due to legislation) and less than one-quarter to spending. Moreover, much of the increase in spending is due to defense, homeland security, and the rebuilding of New York City after the terrorist attacks. Well under 10 percent of the increase is due to increases in domestic discretionary spending (Gale and Orszag, 2004).

Fourth, under the proposed rules, one could not use increased tax receipts to fund current or new programs. For example, an effort to close tax shelters could be used only to cut other taxes, not to finance changes in spending programs.

Finally, the administration justifies the need for budget rules by arguing that "legislation tends to be considered in isolation and not in the context of the entire budget" (OMB 2004a, page 42). If anything, that statement applies with even more force to tax cuts than to spending initiatives. In 2001, for example, the president proposed a tax cut two months before submitting a budget.

In short, the proposed rules are counterproductive and unbalanced. A much better approach would be to reinstate the previous rules. That would prevent the removal of existing sunsets unless they were paid for. It would also be beneficial to create new budget rules to score proposals at their long-term cost regardless of whether the proposals officially sunset.

V. Concluding Comments

With the submission of President Bush's fourth budget, an overall summary of his policies emerges that is both clear and troubling. The budget outlook has deteriorated dramatically since January 2001, and largely because of legislation. The official CBO budget baseline for 2002-2011 has deteriorated by $8.5 trillion over the past three years. That represents 6.5 percent of GDP over the period.

In fairness to the administration, some of that deterioration is due to economic and technical considerations beyond anyone's control. That is not the whole story, though. More than 60 percent of the deterioration in the outlook is due to tax and spending changes, with about 45 percent of the legislated changes due to the administration's tax cuts (Gale and Orszag, 2004).

While the administration makes strident claims about its concern for fiscal responsibility, its actions prove otherwise. In his 2003 State of the Union address, the president famously declared that he would not pass burdens on to future generations. In the ensuing year, the CBO baseline projection for 2004-2013 deteriorated by $3.7 trillion, of which $2.6 trillion was due to legislation. Moreover, this year, the president once again has proposed large, permanent tax cuts.

In short, passing the burden on to future generations is precisely what the administration is doing, in two different ways. First, it refuses to address the medium- and long-term budget problems facing the country. That is, the administration has put forth no serious plan to deal with the nation's underlying fiscal problems. Second, the administration has made the problem worse at every turn — encouraging tax cuts and spending increases.

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The bottom line is that the nation has a serious fiscal problem and the administration is standing idly by at best, and fueling the fire at worst. Last year we referred to this neglect as "Faith Based Budgeting" (Gale and Orszag, 2003). The appellation still stands. The policy stands in sharp contrast to the behavior of previous Republican and Democratic presidents and Congresses. Ronald Reagan raised income taxes in 1982 and 1984 when it became clear that tax cuts, recessions, and defense spending were creating unsustainable deficits. A bipartisan agreement in 1990 and a Democratic effort in 1993 also raised taxes, restrained spending, and imposed stringent budget rules when it was necessary.

The administration remains committed to making the long-term budget problem worse through unaffordable tax cuts, but the time has come to start moving in the opposite direction. *Restoring Fiscal Sanity*, a new Brookings publication edited by Alice Rivlin and Isabel Sawhill, presents three different paths for reaching balance in the unified budget by 2014 under realistic projections and by coupling spending reductions with tax increases.

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