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The Budget for Fiscal Year 2007

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Summary

The President's fiscal year (FY) 2007 budget released in early February 2006 included proposals to make the 2001 and 2003 tax cuts permanent; slow the growth of Medicare spending; hold funding for non-defense, non-homeland security funding to little if any increase; and introduce, in FY2010, private accounts for Social Security. The budget also assumes that relief from the expanding coverage of the alternative minimum tax (AMT) will end after FY2007, and that there will be no supplemental funding for the war on terror after the $50 billion proposed for FY2007. Under these assumptions, and others, the deficit would shrink (in dollars) through FY2010 before rising slightly in FY2011. Whether these proposals will be implemented is unclear at this time. Any expansive deviations from the proposals, without offsetting actions, are likely to make the deficit larger than proposed in the President's budget.

The Congressional Budget Office's (CBO's) January 2006 budget report provided baseline estimates and projections through FY2016. The baseline, following required guidelines, assumes most current policies remain in place throughout its forecast period. This means that the 2001 and 2003 tax cuts expire in 2010 as current law states. The effect is a large tax increase beginning in FY2011 that shrinks the deficit and results in a small surplus in FY2012 (and through FY2016). CBO's baseline also assumes, as required, discretionary spending grows at the rate of inflation (a fairly slow rate of growth), supplemental funding approved in 2005 for the war on terror and hurricane relief is repeated annually, the AMT is in full effect after FY2005, and mandatory spending continues growing without legislative constraints.

CBO also estimated the cost of alternative policies that some would say are more likely to occur than some of the policies assumed in the baseline. The cost of extending or making permanent the tax cuts and maintaining AMT relief are enough to eliminate the possibility of reaching a surplus. Faster discretionary spending growth and growth rates closer to the historical rates would also make it more difficult to reduce the deficit and reach a surplus.

Over the longer term, the retirement of the baby boom generation will put enormous pressure on the federal budget and the economy. Neither the Administration nor CBO believe that current policies, particularly current federal policies for the elderly, can be sustained. Absent significant policy change, the effect of the growing numbers of recipients for federal programs will disrupt not only the programs themselves, but also the rest of the federal budget, the ability of the government to finance its obligations, and, possibly, the ability of the economy to support the expansion of government spending.

This report will be updated as events warrant.

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Background and Analysis

Presidents submit their budget proposals for the upcoming fiscal year (FY) early in each calendar year. The Bush Administration released its FY2007 budget (*The Budget of the U.S. Government, Fiscal Year 2007)* on February 6, 2006. The multiple volumes contain both general and specific descriptions of the Administration's policy proposals and expectations for the budget for FY2006 (still underway) through FY2011. It includes a section on long-term fiscal issues facing the nation and provides limited information on the revenue and mandatory spending changes after 2011. The full set of budget documents (*Budget, Appendix, Analytical Perspectives*, *Historical Tables*, among several other supplemental budget documents) 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 their 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 Congressional Budget Office (CBO) released its first budget report in this calendar year, the *Budget and Economic Outlook: Fiscal Years 2007-2016*, on January 27, 2006. The report contains CBO's baseline budget and economic estimates and projections for the next 10 fiscal years. The Administration released the President's FY2007 budget proposals, including information through FY2011,

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[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, which includes future changes in law, over the next 5 to 10 years. Their construction generally follows instructions provided in the Balanced Budget and Emergency Deficit Control Act of 1985 (DCA) and the Congressional Control and Impoundment Act of 1974.

on February 6, 2006. The numbers in the President's budget incorporate his proposed policy changes.

Budget Totals

Table 1 contains budget estimates for FY2007 from the CBO and the Administration (the Office of Management and Budget, OMB). Differences in totals can result from differing underlying economic, technical, and budget-estimating assumptions and techniques, as well as differences in policy assumptions. At the outset, the *policy*-generated dollar differences for an upcoming fiscal year may be relatively small compared to the budget as a whole. These small differences, however, may grow over time — sometimes substantially — producing widely divergent future budget paths. Budget estimates generally should be expected to change over time from those originally proposed or estimated by the President, CBO, or Congress.

Table 1. Budget Estimates for FY2007
(in billions of dollars)

	Receipts	Outlays	Deficit (-)/ Surplus
CBO, BEO Baseline, 1/06	$2,461	$2,732	$-270
OMB, Budget Proposals, 2/06	2,416	2,770	-354
OMB, Budget, CSB, 2/06	2,444	2,701	-257

BEO — The *Budget and Economic Outlook*, CBO.
CSB — The Administration's current services baseline.

Budget Estimates and Proposals

CBO's first budget report for FY2007, the *Budget and Economic Outlook: Fiscal Years 2007-2016* (January 2006), contained baseline and economic estimates and projections for FY2006 through FY2016. The report estimated an FY2007 baseline deficit of $270 billion (down from the estimated FY2006 baseline deficit of $337 billion). By FY2011, the CBO baseline deficit estimate had fallen to $114 billion. The next year, FY2012, the increased receipts from the expiration of the 2001 and 2003 tax cuts produce a small baseline surplus estimate of $38 billion. The small surplus estimates (never exceeding $75 billion, or 0.4% of GDP) persist through FY2016.

Under the baseline assumptions, CBO increases discretionary spending at the rate of inflation, assumes that the 2001 and 2003 tax cuts fully expire after 2010 (as required under current law), and allows the recently lapsed alternative minimum tax (AMT) relief to remain lapsed. The effects of these assumptions raise receipts in the near-term and increase receipts by substantial amounts after FY2010 when most of the tax cuts from 2001 and 2003 expire under current law. The declining deficit and appearance of small surpluses over the 10 years in the CBO baseline are largely explained by the baseline construction rules that CBO must follow. The results likely understate the future size and persistence of the deficit, as CBO acknowledges in its report.

CBO's budget reports generally include estimates of the effect on the deficit (or surplus) of selected policies not included in the baseline estimates. These policy alternatives usually reflect policies under discussion or of high interest, such as making the tax cuts permanent, addressing the expanding coverage of the AMT, or assuming a rate of growth other than the inflation rate for discretionary spending. In CBO's January 2006 report, making the tax cuts permanent increases the five-year (FY2007-FY2011) cumulative deficit (including higher debt-service costs) by $372 billion, and by a cumulative $2.3 trillion over the 10-year period (FY2007-FY2016). CBO's estimate of the revenue loss from reforming the AMT produces a $317 billion five-year cumulative increase in the deficit and a $691 billion increase over 10 years. 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 an estimated $356 billion, and the 10-year cumulative deficit would increase by an estimated $1.6 trillion. Freezing discretionary appropriations at the FY2006 level would *reduce* the five-year cumulative deficit by $317 billion and the 10-year cumulative deficit by $1.4 trillion.

President Bush's FY2007 budget called for extending and making permanent most of the tax cuts adopted in 2001 and 2003, as well as extending other expiring tax provisions. The budget showed extending the 2001 and 2003 tax cuts would reduce receipts by an estimated $179 billion between FY2007 and FY2011, and by an estimated $1.4 trillion between FY2007 and FY2016 (these estimates do not include the resulting higher debt-service costs resulting from the change).[2] The Administration's total receipt proposals would reduce five-year receipts by $280 billion, and 10-year receipts by $1.7 trillion. Cumulative receipts over the 5- and 10-year periods total approximately $13,823 billion and $32,496 billion respectively, without the proposed changes.

The Administration's budget provided a limited amount of information for the years beyond FY2011. The budget did include estimates of the cumulative proposed revenue changes and proposed mandatory spending changes for the periods FY2007 through FY2011, and FY2007 through FY2016, but these projections contained no information for the individual years after FY2010. Nor were estimates provided for other components of the budget or for budget totals beyond FY2011.

Although not included in the budget documents (it was made available on February 9, 2006), the President proposed the elimination of, the reduction in, or the reform of approximately 141 discretionary programs. The Administration reports that these changes would produce an estimated $20 billion in budget authority (not

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[2] The changes are measured from OMB's current services estimates, its baseline, excluding the proposals assumed in its revenue baseline. OMB included the assumption that the tax cuts would be extended in its baseline. This produces a current services revenue estimate substantially smaller than CBO's baseline revenue estimate, particularly in the second half of the 10-year period.

outlay) savings in FY2007 compared to FY2006. How much these savings would affect the FY2007 deficit was left unclear.

The budget also proposed reductions (mostly in the rates of increase) in mandatory programs over the next five years. The proposed net savings total $71 billion over five years, but this is only a partial accounting of the President's mandatory proposals. The other proposals include user fee increases ($3 billion in savings), program "augmentations" ($9 billion in increases), Social Security personal accounts ($82 billion in increases in FY2010 and FY2011), the outlay effects of extending the tax cuts ($6 billion in increases), and other mandatory proposals ($1 billion in savings). The net effect increases mandatory outlays by $21 billion over five years. Over the same five years, cumulative mandatory spending, excluding the Administration's proposals, totals an estimated $8,385 billion. The Administration's $21 billion proposed increase raises mandatory spending 0.3% above its baseline estimates.

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.[3] Small changes in economic conditions, particularly the rate of GDP growth (from those assumed in the estimates) can produce large changes in the budget estimates. According to CBO, a persistent 0.1% increase in the real growth rate of real GDP would reduce the deficit (including interest costs) by $58 billion cumulatively over a five-year period and by $272 billion over the next 10 years. Reductions in the rate of GDP growth would increase the deficit by similar amounts over the same time periods. Policy changes that are likely, such as supplemental appropriations for operations in Iraq and Afghanistan, but are not included in CBO's baseline, can also change the budget outlook, both for the current budget year and for years in the future.

The President's (FY2007) budget includes a chapter in the *Analytical Perspectives* volume titled "Comparison of Actual to Estimated Totals." The chapter examines the causes of the changes from the initial budget estimates for FY2005 (February 2004) through the actual results for that year. OMB extends its analysis to find upper and lower bounds to the deficit or surplus estimates over a five-year period, based on data going back to FY1982. It found that the upper and lower bounds range over $1.1 trillion at the end of a five-year period. In other words, the Administration's deficit estimate for FY2011, $205 billion, could range from a surplus of approximately $300 billion to a deficit of approximately $700 billion (with a 90% chance of the budget balance falling between those two numbers). Even the

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[3] Some of the underlying components of budget estimates are known with some certainty. Demographics are one known component. In the next decade, the expected retirements in the baby boom generation will rapidly increase the spending for Medicare and Social Security as well as other federal activities benefitting 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.

Administration's deficit estimate for FY2007 has a 90% chance of being as small as $86 billion or as large as $622 billion.

Budget projections are dependent on the underlying assumptions about the direction of the economy, expected policy and policy changes, 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, particularly over longer periods.

Budget Action

Congressional committees have begun hearings on the President's FY2007 budget. The House and Senate Budget Committees are expected to begin their work on the FY2007 congressional budget resolution shortly.

Outlays

The Administration's FY2007 budget proposes $2,770 billion in outlays for FY2007, rising to $3,240 billion in FY2011, the last year shown in the President's budget. The proposals would boost funding for defense and homeland security spending, restrain or cut most other discretionary spending, and make modest growth-slowing changes to Medicare. In FY2010 and FY2011, it would raise spending by tens of billions of dollars to fund private accounts for Social Security. The Administration's proposals, which the budget assumes are adopted, would raise outlays by $61 billion (2.2%) above the Administration's revised FY2006 outlay estimate, and by 17.0% from FY2007 to FY2011.

Table 2. Outlays for FY2005-FY2011 and FY2016

(in billions of dollars)

	FY2005	FY2006	FY2007	FY2008	FY2009	FY2010	FY2011	FY2016
CBO Baseline, 1/05	*2,472* [a]	$2,649	$2,732	$2,857	$2,984	$3,105	$3,252	$4,046
President's FY06 Budget, 2/05		2,709	2,770	2,814	2,922	3,061	3,240	—
President's FY06 CSB, 2/05		2,669	2,701	2,798	2,925	3,050	3,210	—

a. Actual outlays for FY2005.
CSB — The Administration's current services baseline.

Measured against the Administration's FY2007 current services baseline outlay estimates, the proposed level of outlays grows by $69 billion (2.6%).[4] The difference between the current services baseline outlay estimate and proposed outlays for FY2007 indicates the "cost" of the Administration's proposed policies. The year-to-year change (the $61 billion increase) combines the "costs" of proposed policy changes for FY2007 with the relatively automatic growth in large parts of the budget from FY2006 to FY2007. These relatively automatic increases include cost-of-living adjustments in many federal programs, growth in populations eligible for program benefits, and inflation-driven costs of goods and services bought by the government.

From FY2006 to FY2007, the Administration's budget makes a number of assumptions, including the following: a $19 billion increase in undistributed offsetting receipts (that reduce outlays) from proposed sales of a portion of the radio spectrum; a reduction ($23 billion) in disaster and relief spending for hurricane relief efforts that the Administration expects to wind down in FY2007; a $22 billion reduction in federal education funding, mostly for support of higher education; substantial increases in outlays in net interest ($27 billion), as both the debt and interest rates rise; a rise in Social Security spending by an expected $31 billion; and a rise in Medicare spending by an expected $49 billion, including the Administration's proposals to slow its growth.

As shares of gross domestic product (GDP), the Administration's proposals reduce outlays from 20.8% of GDP in FY2006 to 20.1% of GDP in FY2007. By FY2011, the Administration projects that outlays will have fallen to 19.1% of GDP. CBO's January 2006 baseline estimates show outlays falling very slowly from 19.8% of GDP in FY2007 to 19.4% of GDP in FY2011 and, after falling slightly in the intervening years, returning to 19.4% of GDP in FY2016. Under a selection of CBO's alternative scenarios for spending — assuming there is a phase-down in activities in Iraq and Afghanistan over a number of years, that total discretionary spending increases at the rate of nominal GDP growth (rather than the rate of inflation), and including higher interest costs from the larger deficits and debt resulting from these changes (and from extending the tax cuts) — outlays would fall from 20.1% of GDP in FY2007 to 20.0% of GDP in FY2011 before rising to 21.2% of GDP in FY2016.

The President's budget indicates that Department of Defense (DOD) spending will increase by 6.9% from FY2006 to FY2007. This increase ($28 billion, from $411 billion to $439 billion) is based on *budget authority* (BA) for those two years and excludes enacted and proposed supplementals for the DOD. The President's budget shows outlays, the actual expenditures of the DOD, dropping from FY2006

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[4] The current services baseline estimates, like CBO's baseline estimates, are designed to provide "a neutral benchmark against which policy proposals can be measured." For outlays, the modified baseline used this year by OMB 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. These modifications reduced the reported current services baseline outlay estimate by approximately $45 billion in FY2007 and by $86 billion in FY2011.

($512 billion) to FY2007 ($505 billion), a 1.4% reduction in spending.[5] (Total outlays, not BA, and total revenues determine a year's surplus or deficit.) With the uncertainty surrounding the financing needs for the war on terror, FY2007 defense outlays seem likely to change. CBO's baseline estimates for defense spending (which include extending supplemental funding) increase BA (by 2.5%) and lower outlays (by less than 1%) between FY2006 and FY2007.[6]

Non-defense discretionary outlays in the President's budget grow by just under 1% ($5 billion) from FY2006 to FY2007, from $500 billion in FY2006 to $505 billion in FY2007. The President's budget shows non-defense discretionary BA falling by 4.2% ($18 billion) between those two years. Most of that change results from the boost in FY2006 spending from the Administration's proposed $18 billion hurricane relief supplemental. The Administration does not indicate a plan to repeat that funding in FY2007. Excluding that amount, non-defense discretionary BA, as a whole, barely changes from FY2006 to FY2007. CBO's baseline non-defense discretionary outlay estimates grow by less than 1% between FY2006 and FY2007, from $499 billion to $502 billion, similar to the change in the President's budget. The President's budget leaves unspecified his called for future year reductions in discretionary spending.

Mandatory spending, federal activities that generally do not need an annual appropriation, grows by 3.9% ($64 billion) from FY2006 to FY2007, including the Administration's proposed $1.7 billion in mandatory spending reductions for FY2007.[7] This raises mandatory spending, the largest category of federal spending, from $1,457 billion in FY2006 to $1,494 billion in FY2007. CBO's baseline estimates of mandatory spending show it rising from $1,432 billion in FY2006 to $1,488 billion in FY2007, a 3.9% increase.

The Administration proposes $36 billion in Medicare savings (from baseline levels) through FY2011, which would slow, slightly, the expected increase in Medicare spending. Medicare spending over the five years totals an estimated $2,207 billion. The Administration's proposed Medicare reduction amounts to a 1.6% cut from total Medicare baseline spending over the five years. The budget also includes in its mandatory proposals, personal accounts for Social Security (beginning in FY2010) that would increase spending by $82 billion over the two years, FY2010 and FY2011. The net effect of the Administration's mandatory proposals would increase spending by $21 billion over the five years, FY2007 through FY2011.[8]

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[5] These outlay numbers include both discretionary and mandatory outlays for the DOD. Mandatory spending for the DOD is less than $2 billion in both years.

[6] CBO's defense category matches the Budget Enforcement Act (BEA) defense category, a somewhat larger collection of defense related activities than is covered by the DOD alone.

[7] The Administration's reductions include increased user fee offsets as well as reductions in mandatory spending.

[8] The mandatory proposals would increase spending by an estimated $551 billion from FY2007 through FY2016, according to the budget documents.

The large deficits and rising interest rates are having an effect on the interest payments the government must make on its growing debt. Both the President's budget and CBO's baseline estimates show net interest rising by 12% from FY2006 to FY2007. Continued large deficits that rapidly increase the debt, combined with possibly rising interest rates, will continue to raise the government's annual interest payment. Net interest as a share of total outlays will have grown from 7.4% in FY2005 to an estimated 8.2% in FY2006, and to an estimated 8.9% of total outlays in FY2007.

Figure 1. The President's Proposed Outlays by Type, FY2000-FY2011

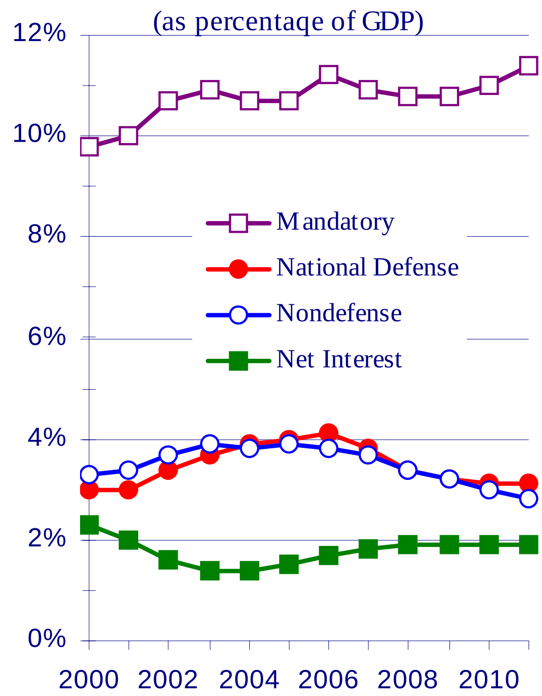


Figure 1 reflects the Administration's FY2007 budget proposals for spending by category. The data show actual outlays for defense, non-defense, mandatory, and net interest spending for the fiscal years 2000 through 2005 and the President's proposed spending for the fiscal years 2006 though 2011, all as percentages of GDP. The slide in defense and non-defense spending as a share of GDP after FY2006 occurs in both the Administration's proposed and current service baseline estimates and projections. The reductions depend on the Administration's assumptions that non-defense, non-homeland security discretionary spending falls by 1.6% annually (FY2007 through FY2011) and that there is no additional funding for the war on terror after the $50 billion proposed for FY2007 (which means that DOD outlays fall by 0.6% a year). The President proposed some reductions, from current service levels, in mandatory spending, but they have little effect in changing mandatory spending as a share of GDP. By FY2010 and FY2011, the President's proposed private accounts for Social Security raise mandatory spending as a percentage of GDP above the current services level. Mandatory spending grows at an annual rate of 5.2% in the President's budget.

Figure 2. Outlays, FY2000-FY2016

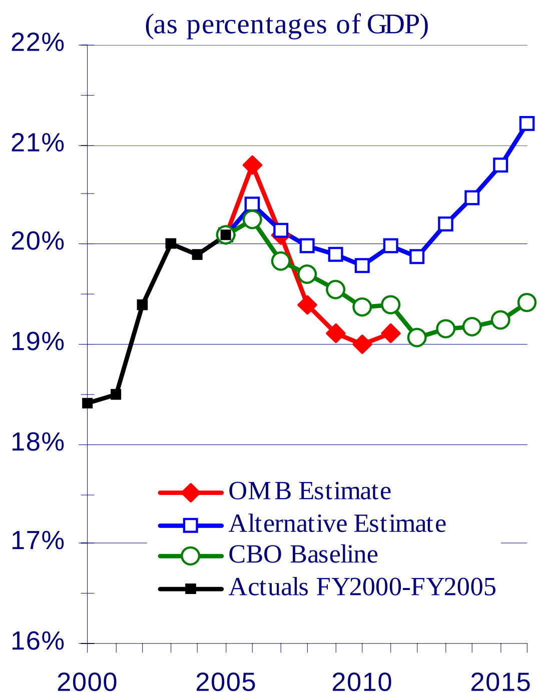


Figure 2 shows three possible paths for outlays as percentages of

GDP through FY2016: the CBO baseline, the President's proposal (OMB estimate), and the alternative estimate derived from CBO data. CBO's baseline falls as a share of GDP through FY2012 before beginning to rise. The President's proposed outlays fall sharply after FY2006, in part the result of the Administration's assumption of reductions in discretionary spending before a rise in FY2011. Both estimates remain below estimated outlays as a percentage of GDP in FY2006. The third line, the alternative estimate, is based on CBO's selected policy alternatives not included in the baseline. This incorporates several assumptions. One, that discretionary spending grows at the rate of nominal GDP growth (a higher rate of growth than used in the baseline). Two, that instead of annually repeating the recent supplementals for the war on terror and hurricane relief, funding for the military activities in Iraq and Afghanistan are phased down over several years and hurricane relief ends after FY2006. Three, that, because of larger deficits and debt, the government's interest costs are larger than in the baseline. And four, that, as in the baseline, mandatory spending is expected to grow faster than GDP. The lower outlays resulting from the change in the assumption about repeating the supplementals is overwhelmed by the higher outlays resulting from the faster rate of discretionary spending and additional interest costs. Outlays under the alternative estimate fall as a percentage of GDP in the near future (from 20.1% of GDP in FY2007 to 19.9% of GDP in FY2012) before rising fairly rapidly after FY2012 (from 19.9% of GDP in FY2012 to 21.2% of GDP in FY2016).

Receipts

Receipts are expected to rise by 5.7% from FY2006 to FY2007 under the Administration's FY2007 budget proposal, including the effect of extending the alternative minimum tax (AMT) relief through FY2007. Over the five years forecast in the President's budget, revenues would rise from $2,416 billion in FY2007 to $3,035 billion in FY2011, a 25.6% increase.

Table 3. Receipts for FY2005-FY2011 and FY2016

(in billions of dollars)

	FY2005	FY2006	FY2007	FY2008	FY2009	FY2010	FY2011	FY2016
CBO Baseline, 1/05	*$2,154*[a]	$2,312	$2,461	$2,598	$2,743	$2,883	$3,138	$4,113
President's FY06 Budget, 2/05		2,285	2,416	2,590	2,714	2,878	3,035	—
President's FY06 CSB 2/05		2,301	2,444	2,597	2,729	2,901	3,064	—

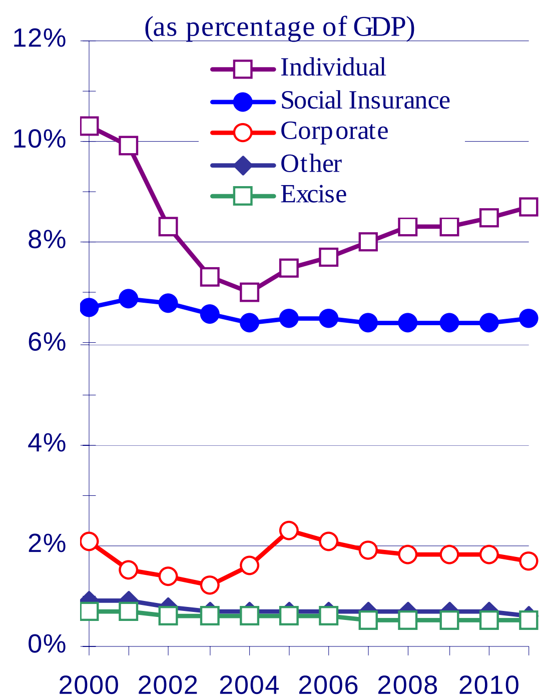
a. Actual receipts for FY2005.
CSB — The Administration's current services baseline.

The Administration's proposal to extend and make permanent many of the tax cuts adopted in the Administration's first term has little effect on FY2007 revenues. Much of this proposal's budgetary effect would occur after FY2010. (Because the Administration incorporated the effect of making the tax cuts permanent in both its proposed and current services baseline estimates, there is no upward bump in receipts in FY2010 or FY2011. CBO's baseline, which assumes the tax cuts expire, shows a larger increase in receipts between FY2010 and FY2011 than in earlier years. See **Table 3**.) The Administration estimates that making the 2001 and 2003 tax cuts permanent would reduce receipts by $179 billion between FY2007 and FY2011 and by $1.4 trillion between FY2007 and FY2016. The effect of these extensions and the Administration's other proposals for receipts would reduce receipts by $280 billion in the first five years and by $1,667 billion over 10 years. CBO's January 2006 budget report estimated that extending the expiring provisions of the major tax cuts in 2001 and 2003 would reduce revenues by an estimated $346 billion over the first five years and by $1,606 billion over 10 years. Extending *all* the tax cuts that expire over the 10-year period would reduce revenues (from CBO baseline levels) by $582 billion in the first five years and by $2,644 billion over the full 10 years of the forecast.[9]

The estimated reductions in revenues from extending tax cuts do not reduce year-to-year revenues. The Administration projects that receipts will rise from $2,285 billion in FY2006, to $2,416 billion in FY2007, and to $3,035 billion in FY2011 (including the effect of the Administration's proposals). CBO's baseline estimates show revenues increasing from an estimated $2,312 billion in FY2006, to $2,461 billion in FY2007, to $3,138 billion in FY2011, and to $4,113 billion in FY2016.

Figure 3 shows the President's budget's proposed receipts, by type, for the fiscal years 2000 through 2011. Actual receipts are shown through FY2005, and the Administration's proposed amounts are shown for FY2006 through FY2011, all as percentages of GDP. Under the Administration's proposals, excise and other receipts remain below 1% of GDP. Corporate income taxes, after rising through FY2005, decline slowly and steadily as a share of GDP under the Administration's projection. Social Insurance receipts remain fairly steady throughout the period shown. Individual income taxes, having fallen over 1.5% of GDP between FY2000 and FY2004, regain some of their lost share under the Administration's proposals, but remain well below their FY2000 level.

Figure 3. The President's Proposed Receipts by Source, FY2000-FY2011

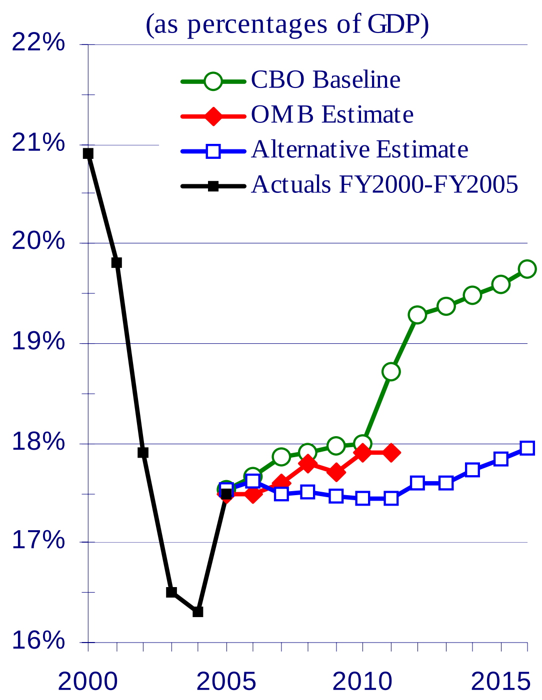


[9] These amounts from CBO do not include the outlay effects (usually interest costs associated with larger deficits and debt) of the extensions.

The Administration's proposals include extending the current relief from the alternative minimum tax (AMT) for fiscal years 2006 and 2007. Without further extensions of or a permanent fix to the AMT, a growing number of middle-class taxpayers will find themselves subject to the AMT.[10] CBO estimates (January 2006) that providing annual AMT relief would reduce receipts by $236 billion between FY2007 and FY2011, and by $437 billion between FY2007 and FY2016. Without some adjustment to the AMT, it will eventually recapture much of the tax reduction provided in the 2001 and 2003 tax cuts.[11]

As shares of GDP, total receipts remain below their average of 18.2% (between FY1965 and FY2005) throughout the period covered in the Administration's budget. The Administration shows receipts rising slowly from 17.6% of GDP in FY2007 to 17.9% of GDP in FY2011. CBO's baseline estimates are larger, rising from 17.9% of GDP in FY2007 to 18.7% of GDP in FY2011. By FY2016, CBO's baseline revenue forecast reaches 19.7% of GDP.[12]

Figure 4. Receipts, FY2000-FY2016



Modifying CBO's baseline revenue estimates and projections by using its alternative policy estimates produces much slower growth in receipts, both in dollars and as shares of GDP, than in CBO's baseline.[13] And while receipts still rise as a percentage of GDP, they do so much more slowly than in the President's proposal or CBO's baseline. By FY2011, the alternative estimates of receipts would rise to $2,925 billion, or 17.4% of GDP. By FY2016, the alternative estimated receipts rise to $3,740 billion, or 17.9% of GDP. This is $400 billion and 2% of GDP below the baseline projections for FY2016.

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[10] 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.

[11] 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.

[12] The CBO baseline incorporates the assumption of a substantial tax increase after FY2010 when the large 2001 and 2003 tax cuts expire under current law.

[13] 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.

Figure 4 uses data from the early 2006 OMB and CBO budget reports. It shows receipts as percentages of GDP for fiscal years 2000 through 2016 (projected). Actual receipts are shown for fiscal years 2000 through 2005. CBO's baseline and the Administration's proposed receipts follow similar paths through FY2010. CBO's baseline receipt estimates are slightly larger as shares of GDP than those of the Administration. The CBO baseline does not assume the FY2006 and FY2007 AMT relief that is included in the Administration estimate. The similarity in the paths ends in FY2011 when the Administration assumes the permanency of the 2001 and 2003 tax cuts and CBO does not. Both show revenues growing slowly as percentages of GDP through FY2010. CBO shows a big jump in receipts in FY2011, as its assumptions include the tax increases resulting from the expiration of the 2001 and 2003 tax cuts. OMB assumes that the tax cuts are made permanent. The alternative estimates keep receipts between 17.5% and 17.9% of GDP throughout the 10-year period.

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. The government had its last surplus in FY2001 ($128 billion and 1.3% of GDP).

The President's budget proposed a FY2007 deficit of $354 billion (2.6% of GDP). The Administration's budget shows the deficit shrinking in dollars and as a share of GDP through FY2010 before rising slightly in FY2011. Without policy changes, the deficit is likely to begin rising in subsequent years as the baby boom generation retires in large numbers and raises the demand for federal spending on the elderly, even as revenues remain below historical levels.

Table 4. Surpluses/Deficits(-) for FY2005-FY2011 and FY2016

(in billions of dollars)

	FY2005	FY2006	FY2007	FY2008	FY2009	FY2010	FY2011	FY2016
CBO Baseline, 1/05	*$-318* [a]	$-337	$-270	$-259	$-241	$-222	$-114	$67
President's FY06 Budget, 2/05		-423	-354	-223	-208	-183	-205	—
President's FY06 CSB 2/05		-367	-257	-201	-196	-149	-146	—

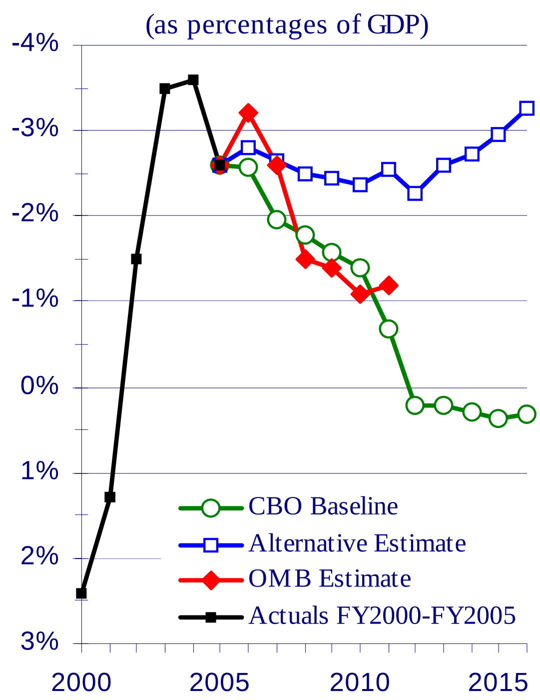
a. Actual deficit for FY2005.
CSB — The Administration's current services baseline.

The Administration asserts that the FY2007 budget will further the President's oft-repeated goal of cutting the deficit in half by FY2009. To achieve this goal, the Administration reaches back to its February 2004 deficit estimate for FY2004 (4.5%

of GDP) as the starting point, and the time when it first articulated this goal.[14] The FY2007 budget shows the deficit falling below 2% of GDP by FY2008 and to 1.4% of GDP in FY2009. The goal may be difficult to reach if Congress does not fully adopt the Administration's proposals, if additional AMT relief is implemented beyond FY2007, if additional defense supplementals (or regular funding) for the war on terror are adopted beyond the ones included in the budget, or if any number of budget-related events occur over the next several years that raise outlays or reduce receipts.

Achieving the Administration's deficit reduction goals would require, during the next five years, strict limits on the growth in domestic discretionary spending (if not actual reductions), a slowing in the growth rate of some entitlements, and letting AMT relief lapse after 2007. Some of the President's proposals would increase spending or reduce receipts, requiring larger spending reductions in other areas of the budget, since the Administration has steadfastly opposed any tax increases to reduce the deficit.[15] Holding to these spending and revenue levels may prove difficult. Higher than proposed spending or lower than proposed revenues, would result in deficits larger than those expected in the President's budget.

Figure 5. Surpluses or Deficits, FY2000-FY2016



CBO's baseline estimates and projections show the deficit steadily falling in dollars and as a percentage of GDP through FY2011, after which small surpluses appear over the remaining years of the forecast. The requirements and assumptions that CBO must follow in producing the baseline estimates accounts for almost all of this improvement in the deficit/surplus outlook. Under a selection of alternative policies not included in the baseline (in CBO's January 2006 budget report), that may more accurately indicate the future path of fiscal policy, the deficit does not shrink and become a surplus. Instead, it grows throughout the 10-

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[14] The actual deficit for FY2005 was 2.6% of GDP. Since 2002, the Administration has consistently overestimated the size of the current or the next year's deficit in each year's budget.

[15] The Administration's current services baseline estimate, which assumes current policy, has smaller deficits throughout the five-year period than the deficits in the President's proposed budget. The cumulative five-year deficit would be smaller without the President's proposed policy changes than with them.

year period in dollars and share of GDP (see the CBO-based alternative estimate in **Figure 5**).

Figure 5 shows deficit estimates as shares of GDP for FY2000 through FY2016. The actual amounts for the surpluses and deficits are shown for FY2000 through FY2005. Subsequent years are based on data from the CBO's January 2006 and OMB's February 2006 budget reports.[16] The CBO baseline deficit estimate assumes the expiration of the 2001 and 2003 tax cuts in 2010, no future adjustments to lessen the expanding coverage of the AMT, the adjustment of discretionary spending for inflation, and an annual repetition of the 2005 funding supplemental for the military activities in Iraq and Afghanistan and hurricane relief efforts. The result of these baseline assumptions, as percentages of GDP, is growing receipts, falling outlays, and a rapid fall in the deficit as a share of GDP, reaching a surplus in FY2012. The President's budget assumes additional spending for defense in FY2006 and FY2007, additional hurricane relief in FY2006, very tight controls on domestic discretionary spending, a slight slowing in the growth of Medicare, and the creation of personal accounts for Social Security in FY2010 and FY2011. The effect of the proposals produces the upward spike in the deficit in FY2006, followed by a fall in the deficit through FY2010.

The alternative estimate in **Figure 5** used selected estimates of alternative policies estimated 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, after the upward bump in FY2006, slowly fall through FY2012. At that point, deficits begin growing fairly rapidly as revenues fall (as a percentage of GDP) and outlays continue growing (as a percentage of GDP).

The Longer Run

Both OMB and CBO agree that over a longer time period, one beginning in the next decade and lasting for decades, demographic pressure will so badly distort current policies as to make them unsustainable. The future, under current policies, will lead to growing and persistent deficits. A CBO report on *The Long-Term Budget Outlook* (December 2005) states

> Over the next half-century, the United States will confront the challenge of conducting its fiscal policy in the face of the retirement of the baby-boom generation.... Under current policies, the aging of the population is likely to combine with rapidly rising health care costs to create an ever-growing demand for resources to finance federal spending for mandatory programs, such as Medicare, Medicaid, and Social Security.... [A]ttaining fiscal stability in the coming decades will probably require substantial reductions in the projected

[16] Note that in the chart, growing deficits move upward; shrinking deficits or growing surpluses move downward.

> growth of spending and perhaps also a sizable increase in taxes as a share of the economy.[17]

The Administration indicated similar concerns about the outlook for the budget over the long term in the President's FY2007 budget (February 2006).

> ...the long-term picture presents a major challenge due to the expected growth in spending for major entitlement programs. In only two years, the leading edge of the baby boom generation will become eligible for early retirement under Social Security. In 5 years, these retirees will be eligible for Medicare. The budgetary effects ... will be muted at first. But if we do not take action soon to reform both Social Security and Medicare, the coming demographic bulge will drive Federal spending to unprecedented levels and threaten the Nation's future prosperity.
>
> No plausible amount of cuts to discretionary programs or tax increases can help us avert this major fiscal challenge.... By 2070, if we do not reform entitlement programs to slow their growth, the rate of taxation on the overall economy would need to be more than doubled....[18]

The short-term budget outlook can change when it is buffeted by all types of unexpected events, such as the hurricanes last year or deteriorating economic conditions. The long-term budget outlook, although susceptible to these types of events, will largely be determined by the interplay of current policy and demographics. The retirement of the baby boom generation, rapidly expanding the population eligible for federal programs serving the elderly, will put enormous pressure on the federal budget. Without policy changes, these programs could overwhelm the rest of the budget. Not only will the programs themselves be stressed, but their growth would be likely to impede the government's ability to meet its obligations and the ability of the economy to provide the resources needed.

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[17] CBO, *The Long-Term Budget Outlook*, Dec., 2005, p.1.

[18] OMB, *Budget of the United States Government for Fiscal Year 2007*, Feb. 2006, p.18.

For Additional Reading

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