The Concord Coalition's Report on Fiscal Responsibility

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Lack of Action on Deficit Signals Undue Complacency

The budget deficit continues to ratchet upward, and there is no consensus on what, if anything, to do about it. At best, Washington policymakers seem content to tread water in the rising tide of red ink. At worst, they are cynically professing concern about the deficit while pursuing tax and spending policies they know will only dig the fiscal hole deeper. One thing is clear: specific plans to actually *reduce* the deficit are not on the agenda. Such complacency is not warranted.

Federal Reserve Board Governor Edward M. Gramlich summarized the challenge at a recent Concord Coalition forum where he admonished policymakers, "now that the recovery is well under way, it is important to concentrate on longer-run fiscal policy. Specifically, it is time to bring the budget deficits under control. Doing so will, of course, require action in the political arena."

Unfortunately, fiscal policy this year has featured wishful thinking and creative accounting rather than actions to control the deficit. The President's budget claims to cut the deficit in half over five years but omits the likely cost of ongoing military operations in Iraq and Afghanistan, assumes a freeze on non-security appropriations and pretends that relief from the growing alternative minimum tax (AMT) will be temporary. Moreover, its 5-year window ignores the 10-year revenue loss of making the President's tax cuts permanent.

In Congress, deficit reduction talk has produced actions that only make it more difficult to close the gap. A sensible proposal to reinstate "pay-as-you-go" rules (PAYGO) for both tax cuts and entitlement expansions was rejected. House appropriators rejected the idea of statutory spending caps. A bipartisan plan in the Senate to offset the revenue loss from extending three expiring "middle class" tax cuts was brushed aside, as was a similar proposal by the House Blue Dog Democrats. Efforts to offset the new spending and tax cuts in the transportation reauthorization bill, and the corporate tax bill have come up short—as demonstrated by the fact that $43 billion in identical offsets have been claimed for both bills. Negotiators on the defense authorization bill are considering plans to increase personnel, expand benefits and delay a new round of base closures.

Meanwhile, the appropriations process appears headed for its now routine debacle—a massive omnibus bill that simply delays inevitable hard choices on spending priorities.

The deficit cannot be dismissed as a self-correcting problem. Even assuming strong economic growth, plausible projections for the 10-year outlook show deficits of about $5 trillion. The longer-term outlook is worse. If policymakers want to get out of this hole, they are going to have to stop digging and start climbing. Deficits matter.

The Fiscal Responsibility Report Card

The Concord Coalition has graded Washington's performance on fiscal policy in three key time frames: the short-term (next 1-2 years), the medium-term (next 10 years), and the long-term (beyond the next 10 years). Each category is graded on a scale of A to F, with A signifying great improvement, and F signifying great harm. There is a necessary overlap in the consequences of policy decisions throughout the time frames. See pages 2-3 for an analysis of each category.

CATEGORY	GRADE
Overall: Progress toward fiscal responsibility.	D
Short-Term: Enacting measures that maintain fiscal responsibility over the next 1-2 years.	C-
Medium-Term: Enacting measures that are fiscally responsible over the next 10 years.	D
Long-Term: Enacting measures that deal with the entitlement financing gap and ensure fiscal sustainability.	F

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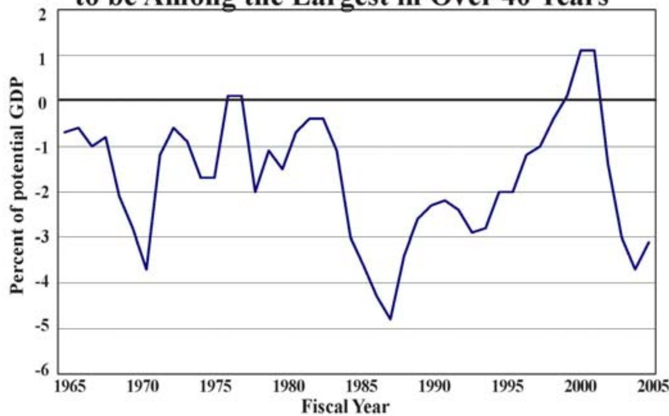


Note: The standardized-budget measure removes the effects of the business cycle and other temporary factors. It shows CBO's estimate of the deficit or surplus assuming the economy operated at potential GDP. *Source: Congressional Budget Office, May 2004*

SHORT-TERM GRADE: C-MINUS

In the short-term, the most promising fiscal policy development may be that some politicians in both parties are beginning to recognize the danger of rising deficits and demanding offsets for the costs of new initiatives. It remains to be seen, however, whether this good intention will translate into actions that actually get the deficit under control.

By most projections, the deficit will peak this year and then decline in 2005 and 2006. Yet the desire of many policymakers to extend expiring tax cuts, with or without offsets, and the need to fund military operations abroad and security needs at home will likely keep the deficit at unusually high levels.

Earlier this year, the Congressional Budget Office (CBO) projected a fiscal year 2004 deficit of $477 billion—a record in dollar terms and tied for the third worst in over 40 years when adjusted for the business cycle and other temporary factors (see chart above). Since then, however, revenue growth has been stronger than expected and the actual deficit for 2004 will likely be closer to the $445 billion deficit that the Bush administration (OMB) now projects.

Does that mean that current policies are bringing the deficit down? No. For one thing, the deficit is going up, not down. It is true that when CBO issues its next forecast, the *projected* deficit will be lower than it was—just as the OMB's *projected* deficit has declined since February. What matters, however, is the bottom line and there can be no denying that a deficit of $445 billion, or close to it, is considerably larger than last year's deficit of $375 billion.

Policymakers bear direct responsibility for correcting this situation but they seem willing to let the economy do all the heavy lifting. It is a strategy with limited potential. While the economy can probably be counted on to produce a budgetary boost in the short-term, this alone will not be nearly enough to close the gap—particularly if policymakers use the proceeds of a growing economy to raise spending and cut taxes.

Meanwhile, not a single piece of legislation has been enacted this year that makes any hard choices designed to cut the deficit. It cannot be said, therefore, that fundamental progress has occurred even if the deficit projections change slightly for the better. Assisted by the growing economy and political gridlock, Washington policymakers get a polite C-minus on their short-term fiscal stewardship.

It is important to note, however, that this grade is better than last year's failing grade. One reason is that Congress and the President appear willing to hold the line on, or even cut, discretionary programs unrelated to national security. The potential savings are modest, however, because these programs account for less than 20 percent of total federal spending. Indeed policymakers would have to virtually eliminate these programs next year if they wanted to close the budget gap. Moreover, there is the very real threat of a lame duck Congressional session in which policymakers will turn to a large omnibus bill, encompassing all discretionary spending except defense. The past has shown that such legislation could include billions of last-minute spending increases under circumstances that can shield Congress from accountability.

Another short-term plus is that Congress is starting to push for a more complete and accurate accounting of the costs to fight the global war on terrorism. As this endeavor will last longer than the next six months, it is disingenuous for the Administration to only request funding in short-term increments. The CBO estimates that the war costs may increase by up to $35 billion over the amount requested so far by the administration for 2005. The Government Accountability Office (GAO) reports that the military has already gone through its supplemental funds for the war this year and will have to cannibalize other accounts causing a "bow wave" of deferred costs to hit the budget later on. Congress is right to put its foot down in insisting on more information and a longer-term perspective.

Congress can also be complimented for its renewed interest in budget enforcement rules intended to help rein in the deficit. While such rules will not balance the budget on their own they can help reluctant lawmakers to "do the right thing." To be effective, however, there must be a consensus about what the rules are supposed to accom-

plish and the political will to stick with them. That crucial part of the equation is still missing

MEDIUM TERM GRADE: D

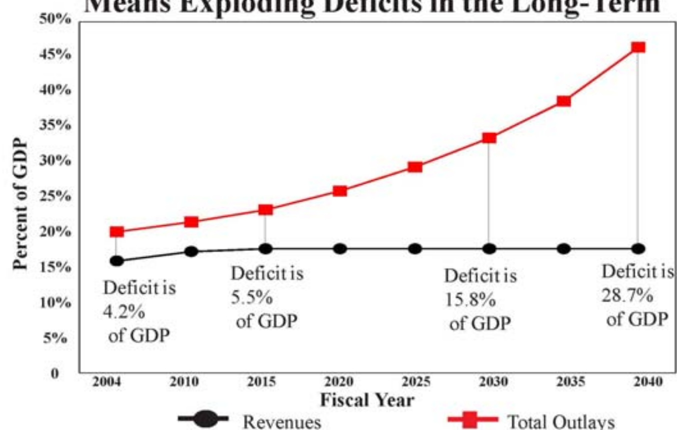
The ten-year outlook remains as worrisome as ever. Absent a change of course, deficits totaling $5 trillion are likely under plausible assumptions. Most problematic in this bleak picture are expiration dates, or "sunsets," embedded in the tax cuts passed over the last three years. While the official 2005-2014 revenue loss of $1 trillion is a significantly large amount, the actual cost of the tax cuts explodes to around two-and-a-half times that when not hidden by sunset gimmickry. The cost is even larger if one assumes Congress will be forced to fix the AMT. Even a partial fix will cost over $500 billion.

No consensus has developed over how the sunsets should be dealt with. When Congress reconvenes in September, it will try again to reach agreement on extending three popular "middle class" tax cuts that expire this year. Earlier talks broke down over whether to extend them for two years or five years and whether to find offsets for the revenue loss. Whatever Congress decides in this regard, the revenue loss *will* be offset. The only question is whether the offset will be in the form of more borrowing, rather than spending cuts, or revenue increases elsewhere in the budget.

Circumstances have changed dramatically since 2001. The tax cuts can no longer be justified as “refunding a surplus” and whatever short-term stimulus the tax cuts provided has already helped the economy grow out of the recession. The country now faces endless deficit spending that, if left unchecked, will reduce national savings and private sector investment, potentially suppressing future economic growth.

An added complexity is that Congress is considering another large tax bill, this one masquerading as an international tax system reform. In reality, the corporate tax bill is a boondoggle of special-interest corporate welfare with costs hidden by unrealistic sunsets. The House version officially costs $35 billion, however, the non-sunset cost hovers around $200 billion. By infusing this bill with budget gimmickry, instead of workable revenue neutrality, policymakers have made it incredibly difficult to control vote-buying through special interest fiscal giveaways and have reduced a necessary bill to Congressional pork-barreling at its worst.

Policymakers are also considering an expensive 6-year reauthorization of the TEA-21 transportation spending bill. While the proposals from the Senate, House and President have provisions for raising some revenue to offset increased spending, each would add from $12 to $32 billion to the federal



Assumes that discretionary spending grows with the economy after 2004, and that all expiring tax provisions are extended through 2014. After 2014, revenue is held constant as a share of GDP (17.7 percent). *Source: GAO, March 2004*

budget deficit, according to the Senate Budget Committee. However, a fiscally responsible solution is not impossible. If the revenue proposals from the Senate bill were combined with the restrained spending the President has proposed, the bill would not add to the deficit. Unfortunately, the overall environment in Washington these days makes such a compromise the least likely outcome.

The debate about the middle class tax cuts, the corporate tax bill, and the transportation bill is laudable in one sense. There are supporters of each who admit that offsets and deficit neutrality are worthy goals. The problem is that proponents of all three bills use some of the same offsets. This is a game of musical chairs: once one is passed, the others’ costs will immediately jump. Worse yet, the negotiations necessary to find more offsets might prove to be so difficult that Congress will avoid offsets altogether. A responsible strategy would be to first use the package of offsets for the middle class tax cuts that are already in place, before enacting wholly new tax cuts or expanding transportation programs without raising fuel taxes. While spending on war has historically been unpredictable and deficit financed, there is no excuse for deficit financing transportation’s planned multi-year projects, especially at a time when the fiscal situation has deteriorated.

Policymakers get a D for their medium-term actions. Perhaps their most notable recent accomplishment is that they have not done anything as irresponsible as simultaneously passing a prescription drug benefit while enacting another large tax cut, as in 2003. There have also been some small victories. Attempts to convert certain veterans programs and special education funding from discretionary to mandatory spending have been turned aside for now. The problem is not that these programs are unworthy—but that turning them into an entitlement shields them from any fiscal scrutiny.

LONG-TERM GRADE: F

Washington has been consumed this year with reports of intelligence failures leading up to the September 11 attacks and the war in Iraq. Many have concluded that the official agencies entrusted with giving policymakers timely warnings about developing problems failed in that mission. No such charge can be leveled against those who are entrusted to provide warnings about our fiscal future. Here, the warnings have been timely, loud and clear. Any "intelligence failure" rests squarely with policymakers who hear the warnings and choose to ignore them.

From the Social Security and Medicare Trustees to Federal Reserve Chairman Alan Greenspan to the GAO, CBO, and OMB, those in charge of the programs and those who analyze the programs have consistently informed policymakers that Social Security and Medicare promise far more in future benefits than they can afford to deliver. The multi-trillion dollar long-term shortfalls are well documented and well known. There is no shortage of "actionable intelligence" on this subject. For example, U.S. Comptroller General David Walker has warned, "Absent reform, the nation will ultimately have to choose between persistent, escalating budget deficits, significant tax increases, and/or dramatic budget cuts...Taken together, Social Security, Medicare, and Medicaid represent an unsustainable burden on future generations."

Similarly, the Congressional Budget Office cautioned in a recent report, "If taxation is restricted to the levels that prevailed in the past, the growth of entitlement spending will have to substantially reduced. Restricting the growth of outlays for defense, education, transportation, and other discretionary programs would not be enough to ensure fiscal sustainability. Likewise, economic growth alone is unlikely to bring the nation's long-term fiscal position into balance. Moreover, issuing ever-larger amounts of debt or dramatically raising tax rates could significantly reduce growth."

In spite of these clear warnings, Washington policymakers have chosen to avoid taking any action to rein in the long-term cost of Social Security and Medicare. With the baby boom generation poised to retire in a few short years, Washington has rallied around the "Do Nothing Plan" for Social Security, added to the long-term liabilities of Medicare, and set off on a fiscal path that is likely to add trillions to our National Debt over the next ten years. This is a "hat trick" of thoroughly irresponsible fiscal policy, and earns an F.

FISCAL FACTS

YEAR OVER YEAR COMPARISON OF OMB'S MID-SESSION REVIEW

Deficit Projection in Billions of Dollars

	2004	2005	2006	2007	2008	2009
July 2004	-445	-331	-261	-233	-228	-229
July 2003	-475	-304	-238	-213	-226	--
Difference	30	-27	-23	-20	-2	--

Receipts, Outlays, and Deficits as a Percentage of GDP

Receipts	2004	2005	2006	2007	2008	2009
July 2004	16.2%	17.1%	17.3%	17.5%	17.6%	17.6%
July 2003	16.0%	17.2%	17.8%	18.1%	18.1%	--

Outlays	2004	2005	2006	2007	2008	2009
July 2004	20.1%	19.8%	19.4%	19.3%	19.2%	19.1%
July 2003	20.2%	19.8%	19.8%	19.8%	19.8%	--

Deficits	2004	2005	2006	2007	2008	2009
July 2004	-3.8%	-2.7%	-2.0%	-1.7%	-1.6%	-1.5%
July 2003	-4.2%	-2.6%	-1.9%	-1.6%	-1.7%	--