COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET

BUDGET UPDATE
MAY 3, 2005

At the beginning of this year there were some indications that the era of "deficits don't matter" rhetoric was being replaced by a renewed concern about deficits, at least rhetorically. Unfortunately, the actions since then have shown no indication that policymakers have the stomach to match that rhetoric with actions.

The budget resolution conference agreement leads to higher deficits than current law in each of the next five years, with the costs of additional tax cuts and increased spending for defense and homeland security assumed in the resolution exceeding the savings called for in non-defense discretionary spending and mandatory spending programs. Meanwhile, the House didn't even wait for the budget resolution to pass to start passing tax cuts and Congress is moving forward with expensive highway and water infrastructure bills that are loaded with special projects.

Senate action on the budget resolution was particularly discouraging for advocates of fiscal responsibility. Amendments (supported by the Committee for a Responsible Federal Budget) to reinstate Paygo rules for all mandatory spending or revenue legislation that would increase the deficit and strike the reconciliation protections for tax cuts which would increase the deficit were defeated. Meanwhile, the Senate approved amendments nearly doubling the size of the tax cuts in the resolution and cutting in half the amount of mandatory savings called for in the resolution. The Senate also approved several smaller amendments providing for increases in discretionary spending on health care, education and veterans programs.

The fact that the House and Senate were able to agree on a budget resolution conference report is an important accomplishment, since Congress failed to adopt a budget resolution in two of the last three years. A failure to adopt a budget resolution again this year would have further undermined the credibility of the budget process.

The budget resolution conference agreement is closer to the President's budget than many observers, including the Committee, expected. The tax cut number in the budget resolution is large enough to accommodate most of the tax cuts proposed by the President and the budget adopts the discretionary spending limits proposed by the President for fiscal year 2006. The agreement calls for $30.5 billion in entitlement savings, $15 billion less than the President's budget would achieve under CBO scoring.

Despite this, the deficit would actually increase by $167 billion above current law over the next five years. The declining deficits in the conference report are purely a function of the improvements in the underlying near-term budget outlook. The domestic spending cuts in the resolution are more than offset by the increases above baseline for defense and new tax cuts. It is hard to justify sacrifices in entitlement programs as part of a budget that actually increases the deficit. We are concerned that making cuts in entitlement spending without achieving deficit reduction will make it even harder to reach agreement on a balanced deficit reduction plan in future years.

IMPACT OF BUDGET RESOLUTION CONFERENCE ON THE DEFICIT
(Deficit increases (+) or reductions (-) compared to CBO March baseline in billions of dollars)

	2005	2006	2007	2008	2009	2010	Total 2005-10
CBO Baseline Deficit	**365**	**298**	**268**	**246**	**219**	**210**	**1,606**
Tax Cuts	0.4	18	26	12	28	23	106
Defense Discretionary Spending	--	6	11	18	28	34	95
Iraq Supplemental[1]	32	62	24	8	3	2	133
Non-Defense Discretionary Spending	--	(4)	(18)	(30)	(40)	(48)	(139)
Total Mandatory Savings	0.2	(0.9)	(5)	(8)	(8)	(9)	(30)
Total Policy Change	33	81	38	0	11	0	164
Debt Service	0.3	3.1	7	8	9	10	36
Total Increase in Deficits	33	84	45	8	20	10	200
Resulting Deficit	**398**	**383**	**313**	**254**	**238**	**211**	**1,797**

1 Including reserve for additional war supplemental in fiscal year 2006
Note: Numbers may not add due to rounding

COMPARISON OF THE PRESIDENT'S BUDGET, THE HOUSE-PASSED BUDGET RESOLUTION, THE SENATE-PASSED BUDGET RESOLUTION & THE CONFERENCE AGREEMENT

	President's Budget[1]	House budget resolution	Senate budget resolution	Conference agreement
Deficits	$332 billion in 2006, declining to $246 billion in fiscal year 2010	$375 billion in 2006, declining to $210 billion in 2010	$368 billion in 2006, declining to $232 billion in 2010	$382 billion in 2006, declining to $211 billion in 2010
	Cumulative deficits of $1.336 trillion over five years, $104 billion higher than current law	Cumulative deficits of $1.359 trillion over five years, $127 billion higher than current law	Cumulative deficits of $1.45 trillion over five years, $217 billion higher than current law	Cumulative deficits of $1.399 over five years, $166 billion higher than current law
Total spending	$2.542 trillion in fy06	$2.553 billion in fy06	$2.560 billion in fy06	$2.562 trillion in fy06
	$13.783 trillion over five years	$13.850 trillion over five years	$13.931 trillion over five years	$13.877 trillion over five years
Entitlement savings[2]	$51 billion over five years	$67 billion over five years	$23 billion over five years ($17 billion from reconciliation)	$35 billion over five years
Discretionary spending budget authority budget authority for 2006[3]	$843 billion	$843 billion	$849 billion	$843 billion
Reductions in non-defense discretionary spending below CBO baseline	$134 billion over five years	$144 billion over five years	$135 billion below CBO baseline over five years	$139 billion over five years
Tax cuts over five years[4]	$125 billion	$105.7 billion ($45 billion reconciled)	$129 billion ($128 billion reconciled)	$105.7 billion ($70 billion reconciled)
Paygo rules	Paygo for mandatory spending, but not tax cuts	No paygo provision	Maintains existing Senate rule applying paygo for taxes and spending but exempts tax cuts in budget resolution	Maintains existing Senate rule applying paygo for taxes and spending but exempts tax cuts in budget resolution
Mandatory savings from agriculture and nutrition programs	$5.7 billion	$5.3 billion	$2.8 billion	$3 billion
ANWR	$2.5 billion	$1.4 billion	$2.4 billion	$2.7 billion
Medicaid savings	$9 billion under CBO re-estimate (CBO did not have enough information to estimate savings from all of the administration's proposals)	$15-$20 billion (depending on the amount of savings the Energy and Commerce Committee can achieve from other programs within its jurisdiction)	None	$10 billion
PBGC fees	$18 billion	$18.1 billion	$5.3 billion	$6.6 billion
Student loan savings	$4.5 billion	$3.4 billion	$3.4 billion	$7.1 billion
Mandatory savings from veterans programs	$2.5 billion	$800 million	None	None
Other entitlement savings	$5 billion in miscellaneous entitlement savings	$19 billion in unspecified savings from programs within the jurisdiction of the Ways and Means Committee	No savings comparable to the House resolution	$1 billion in unspecified savings from programs within the jurisdiction of the Ways and Means Committee

1 All numbers are from the CBO re-estimate of the President's budget
2 Excludes outlay effects of refundable tax credits
3 Excluding costs of operations in Iraq and Afghanistan
4 Includes outlays from refundable tax credits

Tax cuts

The budget resolution will allow Congress to pass tax cut legislation for the fifth year in a row. The budget allows tax cuts of $106 billion, $70 billion through reconciliation. The tax cut reconciliation instructions could accommodate an extension of major expiring tax provisions such as the capital gains and dividend tax cut and small business expensing, the research and experimentation tax credit, a one year extension of AMT relief and deductibility of state and local sales taxes.

The decision to set aside $36 billion for tax cuts outside of reconciliation will allow the Senate to move tax cut extensions that will have costs within the five year budget window, most notably the lower rates for capital gains and dividends and estate tax. The Byrd rule in the Senate prohibits the inclusion of provisions that would increase the budget deficit outside the budget window. Consequently, reconciliation legislation cannot extend tax cuts beyond 2010.

These restrictions would not apply to tax cut legislation moved through the regular legislative process. Although the budget process limits the amount of tax cuts within the budget window to the levels set forth in the budget resolution, there are no limits on the costs of tax cut or spending legislation beyond the budget window considered through the regular legislative process. As a result, the most expensive parts of the President's budgetary agenda, extension of the income tax rate reductions, marriage penalty relief, child tax credit and other provisions expiring in 2010 will effectively be exempted from any budgetary restraints.

Mandatory spending reductions

For the first time since the 1997 Balanced Budget Agreement, the budget resolution conference report contains reconciliation instructions to reduce mandatory spending. Although the real challenge remains when Congress has to agree on policies to achieve these savings, it is encouraging that this budget recognizes that budgeting involves sacrifices and not just promising more goodies. While reconciliation bills containing spending cuts and revenue increases for deficit reduction were a nearly annual occurrence in the 1980s and early 1990s, nearly half of the current Members of Congress have never voted on a reconciliation bill that cuts spending.

The budget contains reconciliation instructions to achieve savings in mandatory spending programs of $1.5 billion in 2006 and $35 billion over five years. The budget calls for savings in agriculture and nutrition programs, student loans, Medicaid, oil drilling in ANWR and increases fees paid by businesses to the Pension Benefit Guarantee Corporation, among other areas. The largest source of savings and consequently most controversial items in the conference agreement are Medicaid and increased PBGC fees.

The House budget resolution contained instructions requiring the Ways and Means Committee to achieve savings of $18.7 billion without any indication of where those savings would be achieved other than assurances that none of the savings would come from Medicare. Other major programs within the jurisdiction of the

Ways and Means Committee include the EITC, Trade Adjustment Assistance, Unemployment Compensation, the TANF (welfare) and child care block grants and Supplemental Security Income. Although the budget negotiators initially agreed to instruct the Ways and Means and Finance Committees to achieve $5 billion in unspecified savings in these programs, those instructions were dropped after facing resistance from Senators. In addition, the conference report did not include the savings in veterans programs that were in the President's budget and the House-passed budget resolution.

Although the budget resolution sets out instructions for the amount of savings that must be achieved, the real challenge comes when the committees try to find policies to achieve the required savings. Each authorizing committee must set priorities and make tradeoffs for programs within its jurisdiction. The authorizing committees are not bound by the policy assumptions in the budget resolution, so the actual policy changes made in reconciliation could be very different than the resolution assumes. For example, the Finance Committee could reduce Medicaid spending less than the resolution assumes by making reductions in Medicare or other programs within its jurisdiction. There may be efforts within the Agriculture Committees to limit the reduction in farm programs by making greater reductions in nutrition programs. Similarly, there could be pressure to achieve greater savings in student loans or other programs within the jurisdiction of the House Education and Workforce Committee and Senate HELP Committee to limit the amount PBGC fees need to be increased to meet the reconciliation instructions.

Drafting legislative language that CBO estimates will achieve the required savings is much more difficult than assuming those savings in a budget resolution. This is particularly true with regard to the Medicaid savings called for in the budget. This was made evident when CBO analyzed the proposed Medicaid changes contained in the President's budget and estimated lower savings than the administration, in part because CBO did not have enough information about several provisions to determine whether they would succeed in reducing spending. Although the President's budget called for Medicaid savings of $12 billion over five years and $45 billion over ten years, more than enough to meet the reconciliation target, CBO estimated that those policies would only achieve $9 billion in savings over five years and $27 billion over ten years.

Prior to the vote on the conference report there were reports that the Governors had agreed on a package of Medicaid reforms that would achieve more than $8 billion in savings, but the governors quickly clarified that the reported agreement was just a discussion draft that had not been approved. Even if the policies contained in the discussion draft were endorsed by the governors, it is not clear whether those policies would actually achieve the amount of savings claimed.

Reconciliation

Budget reconciliation legislation has special procedural protections intended to help Congress take actions that are responsible but politically difficult, not politically popular actions that are fiscally irresponsible. When the budget went into surplus, Congress began to use reconciliation protections to make it easier to cut taxes and make projected budgets worse, the exact opposite of the way reconciliation was intended to be used. This was a bad precedent to set in a period of surpluses, and is even worse now that the budget is back into deficit.

On a more positive note, the conference report followed the Senate position calling for consideration of spending cut reconciliation legislation before tax cut reconciliation. That is the approach that was taken in implementing the 1997 Balanced Budget Agreement, the previous time that Congress considered both a spending cut and tax cut reconciliation bill. Requiring Congress to eat its spinach by passing the spending cuts before getting to the dessert of tax cuts is a positive step, although the budget still allows a large helping of dessert and only a modest portion of vegetables.

Ways and Means Chairman Bill Thomas raised the intriguing possibility that he might attempt to achieve mandatory savings greater than the budget resolution requires. In a press conference the day after the budget resolution passed, Thomas told reporters "The numbers in the budget are minimums, not maximums. And the number in the tax reductions are maximums, not minimums. And I think you'll find in dealing with minimums and maximums, the House wants to make a far bolder statement than the budget act legislation looks like right now." Other House Committees may also consider mandatory savings greater than required by the budget resolution. Passing a reconciliation bill with mandatory savings greater than the budget requires could give the House a stronger negotiating position going into a reconciliation conference with the Senate.

<u>Discretionary spending</u>

The budget generally follows the President's overall funding levels for domestic discretionary program. Total discretionary spending for 2006 would be $843 billion – a 2.1% increase over 2005. The conference agreement dropped increases in total discretionary spending in fiscal year 2006 added by Senate amendments increasing funding for education, health care, veterans and other discretionary programs.

After 2006 the budget calls for modest increases for homeland security programs and essentially freezing all other domestic discretionary programs through 2010. This would result in savings of $216 billion below the CBO baseline over five years. Put another way, domestic discretionary spending over the next five years would be $216 billion lower than necessary to keep pace with inflation.

The budget fully funds the President's level of defense funding for 2006 through 2010, including the costs of the $81.9 billion Iraq supplemental the President requested. It also contains a reserve fund of $50 billion for ongoing military operations for 2006 which was not included in the President's budget. It does not include any costs for military operations after 2006.

We are somewhat concerned that the budget resolution could repeat the mistakes of the late 1990s when Congress and the administration set unrealistic budget limits and then disregarded them. The conference report relies heavily on large, unspecified saving in discretionary spending after FY2006 to achieve its deficit targets. A responsible budget sets limits and enforces those limits. If Congress is unwilling to live within the constraints it sets for itself and actual spending is much higher than the limits, the credibility of the budget process will be further damaged.

Budget enforcement

The budget includes several budget enforcement provisions which would apply to the Senate. It establishes discretionary spending limits at the levels contained in the resolution for 2006 through 2008. The budget ostensibly retains paygo rules in the Senate for taxes as well as spending, but all tax cuts assumed in the budget resolution would be exempt. Both the discretionary spending limits and paygo exemption would apply to subsequent budget resolutions. The budget would also establish a new 60 vote point of order against legislation that would increase mandatory spending by $5 billion or more in any of the four 10-year periods from 2015 through 2055. This point of order would not apply to tax cuts that would substantially increase the deficit in future years.

The rule for the budget resolution conference report codified the agreement reached with conservative Republicans in the House to establish a new point of order against spending bills which exceed budget limits. The point of order would apply after the House has considered the bill and voted on amendments. This is intended to address the issue of spending bills which were within budget limits when they came to the floor being loaded down with amendments which would cause the legislation to exceed budget limits. This point of order does not apply to conference reports, where spending above budget limits is often added.

Conclusion

Despite the renewed talk about fiscal restraint, the budget resolution conference agreement allows deficits to continue as far as the eye can see and actually makes the deficit hole deeper. The fact that Congress is willing to go forward with modest savings in mandatory spending is a positive development, but proposing savings in a budget resolution is not the same as actually enacting policy changes. The proposed savings in mandatory spending programs and cuts in discretionary programs have created considerable controversy without achieving any deficit reduction, and it is uncertain at best whether the discretionary spending cuts will be achieved in the outyears. This could actually make it harder to reach agreement on a deficit reduction package in the future because spending cuts that could have been included as part of a balanced deficit reduction package will no longer be available.

We need to develop a specific and realistic plan to put the country on a sustainable fiscal path. Congress should consider holding a Budget Summit, where everything including, defense, discretionary spending, entitlement programs, and taxes are on the table. The Committee is growing increasingly concerned that if Congress and the President fail to act, financial markets will force our hand.