

INFORMED BUDGETEER

CBO SUMMER UPDATE

- On August 15th, the Congressional Budget Office (CBO) released its summer update, which included an updated baseline for fiscal year 2005, (which is about to end) and fiscal years 2006-15. The update reflects legislative, economic, and technical changes since CBO published its March baseline. It is worth noting that CBO's report was issued prior to Hurricane Katrina's devastation, so the effects of the \$10.5 billion supplemental and additional appropriations yet to be enacted, as well as the economic impact of Katrina, are not reflected in the baseline.
- Attentive budgeteers were not surprised by the contents of the report, as the Office of Management and Budget's (OMB) mid-session review and CBO's own monthly budget reviews foreshadowed the current year's higher-than-expected revenues and concurrent decline in deficit projections.
- CBO reduced its deficit projection for fiscal year 2005 from \$365 billion to \$331 billion. However, these estimates are not directly comparable because of the timing of the most recent supplemental war appropriations bill.
- For its statutory baseline, CBO is required to include an extension of all spending enacted in the current year, be it regular, supplemental, and/or emergency. When the March baseline was released, there had been no 2005 supplemental enacted yet for the war, so no supplemental spending was included in fiscal year 2005 or extended into the outyears. However, the supplemental was enacted well prior to CBO's summer update; therefore the spending for the war supplemental is now included in estimates of the 2005 deficit as well as in each year of the 10-year budget window (2006-15).
- An apples-to-apples deficit comparison would put the March deficit estimate at roughly \$400 billion (rather than \$365 billion). So the best picture of the decline in the deficit projection from the March estimate to the summer update is approximately \$70 billion.
- What has accounted for the declining deficit estimates? Total outlays are estimated to increase from 2004 to 2005 by 7.9 percent. Mandatory spending excluding offsetting receipts is expected to grow by 8 percent in 2005 (versus 5 percent in 2004). CBO cites faster growth in both Medicare and Social Security as primary sources of growth. In 2005, Medicare spending will grow at its fastest rate since 1995 – 10.5 percent (after adjusting for payments to managed care providers that will be shifted into 2006 because the first of October falls on a weekend).
- Even non-defense discretionary spending will grow more quickly in 2005 (6.5 percent) than in 2004 (4.7 percent), which CBO attributes to homeland security emergency preparedness and response activities and accelerating outlays from the Iraq Relief and Reconstruction Fund (which was appropriated in 2003 and is classified as non-defense – primarily international affairs – spending).
- The good news is on the revenue side of the equation. CBO projects 2005 revenues to be \$85 billion higher than projected in March. About one-third (\$28 billion) of the revision was due to CBO's new economic outlook, particularly higher projections of gross domestic product (GDP) and higher wages and salaries. Two-thirds (\$56 billion) of the revision was due to technical factors, primarily unanticipated strength in corporate income tax

collections. While CBO stresses that it will be several years before we know for sure why revenues have surged this year, CBO, contrary to OMB's mid-session review of the budget, believes that the revenue bump is only temporary.

Changes to 2005 deficit projections since March baseline	
(\$ in billions)	
March baseline deficit	-364.571
Revenue changes	84.507
Outlay changes	51.213
<i>Discretionary</i> ^{1/}	32.664
<i>Mandatory</i>	13.164
<i>Net interest</i>	5.385
Total change	33.294
August baseline deficit	-331.277

^{1/} Primarily outlays flowing from the 2005 war supplemental enacted in May.

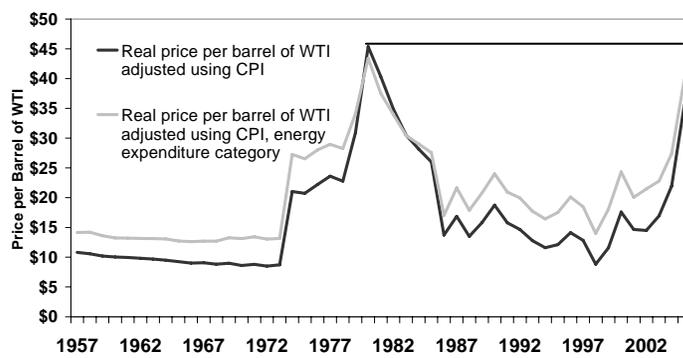
WHAT'S A "RECORD"?

- Many have incorrectly stated that the federal deficit of \$412 billion in 2004 was a record. And for the past year, many media outlets regularly recounted that oil and/or gas prices "set a new record today."
- Yet despite the constant effort to hype these numerical events by claiming each one is a "record," the mantra of repetition of such claims does not make them true. But getting people to understand why is unbelievably difficult.
- So let's look to the simplicity and truthfulness of children for analytical guidance. Let's say in playing a jumping game that one child did a jump of two feet that was measured with a bona fide yardstick meeting the specifications of the National Institute of Standards and Technology, official keeper of weights and measures.
- Then let's say another child does a jump and brings out another stick. The piece of wood objectively looks to be exactly the same as the official yardstick used to measure the jump of the first child. But a careful examination of the tic marks and numerals written on to the stick seem to indicate that the stick measures not three feet, but four! And when that unofficial stick is used to measure the jump of child #2, whose jump looked pretty much the same as the jump of child #1, lo and behold, the second child is announced as having jumped 2.6 feet. The second child is therefore announced as the "winner", or, in other words, as setting a record jump between the two children.
- But child number one, thinking something is fishy, compares the unofficial stick to the official yardstick, easily observing that the tic marks and numerals on the second stick do not measure in the same units (official, NIST-approved, inches and feet) and, with justification, cries out, "That's not fair!"
- Remember the Olympics, where new records are set every four years? Athletic budgeteers (no, that's not an oxymoron) will remember that officials there are very careful to measure

Olympians' performance in the same units and under similar conditions, so that Olympic records mean something over time. For example, sometimes if the wind speed at a track event is faster than a certain threshold, times or distances that appeared to set a record because they were faster or further do not get that recognition because they do not compare to the conditions that existed when previous record times and distances were achieved.

- The bottom line: measured units have to mean the same thing over time before they can be used to measure a record. Dollars do not mean the same thing over time, as \$1 could purchase a lot 30 or 130 years ago, but now \$1 purchases much less. One dollar does not mean the same thing each and every year because of the effects of inflation. In contrast, the meaning of an inch or a pound does not change every year because of inflation.
- That is why good analysts adjust nominal dollars (the way prices are usually reported and compared) into constant (aka, inflation-adjusted or "real") dollars before making any comparison of prices for goods and services over time.
- Some observers who are aware of this distinction between nominal and constant dollars attempt to insulate themselves from analytical criticism by saying things such as, "While not a record in constant dollars, the new levels do set a record in nominal dollars." But there is no such thing as a "record in nominal dollars."
- Simply declaring something a record does not make it a true record when the units being compared mean different things (purchasing power) for the different events (in these cases, the prices of oil or gas or the deficit) in different years. Saying that the (nominal) price of \$2.50 for a pound of X today sets a record because it is higher than the last highest price of \$2.00 for a pound of X 20 years ago, is like saying the price for a pound of X today is 2.50 zornks, and that sets a record because the last numerical high for a pound of X was 2.00 quonks 20 years ago. A dollar 20 years ago is just as different from a dollar today as a zornk is different from a quonk.
- Have oil and gas prices reached record levels? No doubt they are high and that the economy may be feeling their pinch, and that they have been approaching true record levels for the past year, especially in the past week. But the graphs below show that the average annual prices in certain years before 2005 still exceeded the average price for a barrel of oil or a gallon of gas last week. (the value reflected for the 2005 entry in each graph is last week's average nationwide price).

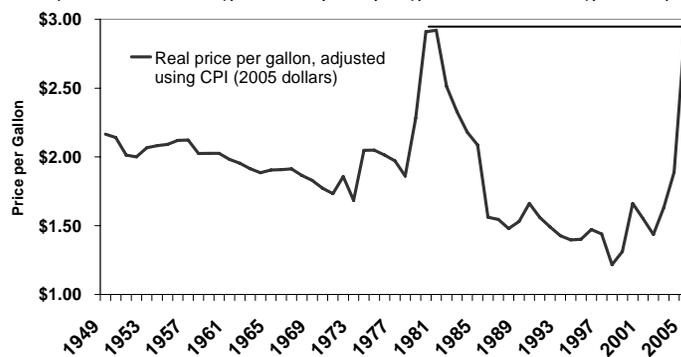
Latest Oil Prices Below True Record Level



Source: Wall Street Journal, SBC Calculations

Gasoline Prices Not Quite a Record Level

(nationwide average annual price per gallon retail motor gasoline)



Source: Energy Information Administration, DOE; 2005 nominal price of \$2.87/gal. reflects nationwide average last week

- Back to the case of the budget deficit -- if the 2004 deficit was not a record, was it high? The answer depends on what you want to compare it to – deficits in the past (adjusted to constant dollars) or deficits related to the size of the economy? The Historical Tables (pp. 25-26) of the President's 2006 Budget show previous deficits (back to 1930) that were higher either way than the \$412 billion recorded for 2004.
- Talking about records only when records are truly set would reduce society's "record-fatigue" and enable people to take more notice when a real record is set.