

## What Is a Current-Law Economic Baseline?

The Congressional Budget Office (CBO) produces forecasts for the U.S. economy twice each year.<sup>1</sup> Unlike other forecasters, CBO is required to produce a very specific kind of forecast—called a current-law economic baseline—because CBO’s forecast must be consistent with the conventions of a baseline for the federal budget. In particular, CBO’s economic baseline assumes that future fiscal policy will evolve on the basis of current law.

The requirement that CBO’s economic baseline must embody current law can explain some of the differences between CBO’s and other forecasters’ predictions for the economy. Comparisons between CBO’s and other forecasts may be misleading if that distinction is overlooked. Differences resulting from policy assumptions are more likely to be apparent in specific aspects of the economic baseline, such as taxable income shares, than in the aggregate variables, such as the overall growth of gross domestic product (GDP).

### Defining a Current-Law Economic Baseline

CBO’s current-law economic baseline represents CBO’s best estimate of the path of the economy over a 10-year horizon based on the assumption that current legislation determining policy remains the same. Specifically, CBO refers to the first two years of the baseline as its economic forecast, as distinct from the subsequent eight years of economic projection. CBO is required to use certain rules to interpret current law over that horizon and then to assess the implications of current law for the economic forecast and projection.

For much federal spending—including the major expenditures for Social Security, Medicare, and Medicaid—the 10-year projection is based on the laws governing eligibility and benefits. Similarly, revenues reflect the tax code.

The way in which CBO translates that framework into 10-year paths for those budget outlays and for its revenue projections is governed by section 257 of the Balanced Budget and Emergency Deficit Control Act of 1985 (1985 Act) and by some conventions (see Table 1).

A significant share of federal spending, however, is governed by annual appropriations; thus, strictly speaking, the provisions of current law can be projected only for that year. Procedures for projecting expenditures beyond the one-year horizon of the current appropriation also are specified in section 257 of the 1985 Act.<sup>2</sup>

Current law is not the same as current policy. Indeed, some laws specify changes in policy over time. Current law, for example, implies that certain key tax rates will change over time.<sup>3</sup>

### How Do Fiscal Policy Assumptions Affect CBO’s Economic Outlook?

In addition to making a budget baseline interpretation of current law, CBO also assesses the implications of current law for economic variables such as output, prices, wages, profits, and interest rates. CBO’s treatment of the economic impact of policy over the first two years, in its forecast, differs conceptually and analytically from that over the remaining eight years, in its projection.

#### Fiscal Policy Effects over the Short-Term Horizon

Over the initial two years of the horizon, CBO allows the path of economic output to differ from the economy’s underlying potential. Hence, assumptions about fiscal policy may affect the level of economic activity by boosting or restraining aggregate demand. The actual impact of current fiscal policy on the economy will depend on

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1. CBO’s most recent forecast was published in Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2006 to 2015* (January 2005).

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2. 2 U.S.C. § 907.

3. Further details on how CBO assembles its current-law baseline are explained every year in *The Budget and Economic Outlook*.

**Table 1.****Current Law and the Budget: The Rules Governing CBO's Baseline**

Budget Category	Baseline Procedure
<p><b><i>“Mandatory” Expenditures</i></b> Expenditures for which currently enacted laws govern outlays throughout the projection period, including those for the major entitlement programs such as Social Security, Medicare, Medicaid, and Food Stamps.</p> <p>In 2004, this category of spending amounted to \$1.2 trillion.</p>	<p>Under the 1985 Act, the Congressional Budget Office must project the baseline for mandatory expenditures by assuming that current laws will continue without change. Expiring provisions for most major programs are extended. (There are some exceptions: programs created since 1997 are not automatically extended.) Many of the laws governing those expenditures specify eligibility criteria for programs. CBO combines demographic and economic factors with the eligibility criteria to determine the baseline path for outlays for those programs.</p>
<p><b><i>“Discretionary” Expenditures</i></b> Expenditures governed by annual appropriations and specified by law only for the current year. Examples of spending that is projected under those baseline rules are defense, transportation, national parks, and law enforcement.</p> <p>In 2004, this category of spending amounted to \$0.9 trillion.</p>	<p>Under the 1985 Act, CBO must assume that the most recent year's budget authority is provided in each future year but adjusted using specific price indexes to offset projected inflation and to allow for factors such as the cost-of-living adjustments for federal workers.</p> <p>In addition, if the budgetary authority for the current year includes funds provided through supplementary appropriations, those funds also must be assumed to continue throughout the budget period, similarly adjusted for inflation.</p>
<p><b><i>Revenues</i></b> The major components of revenues are individual income taxes, corporate income taxes, and social insurance taxes.</p> <p>In 2004, revenues totaled \$1.9 trillion. The principal categories of revenues were individual income taxes, which accounted for about 43 percent of total revenues; corporate income taxes, about 10 percent; and social insurance taxes, about 39 percent.</p>	<p>CBO must project revenues under the assumption that current law will not change.</p> <p>In some cases, current tax law does not allow for any changes in tax provisions over time. An important instance is that the exemptions and brackets under the alternative minimum tax are not indexed for inflation under current law.</p> <p>In other cases, however, current law does imply changes in tax provisions over time. For example, under current law, major provisions of the tax code, such as the 10 percent income tax bracket, elevated levels of child tax credits, and the repeal of the estate tax, will expire at the end of 2010.</p> <p>By contrast with mandatory expenditures, most expiring tax provisions are not extended in the baseline. (Excise taxes dedicated to trust funds are an exception.)</p>
<p><b><i>Net Interest Payments</i></b> In 2004, net interest payments totaled \$160 billion.</p>	<p>CBO cumulates federal debt on the basis of its current-law projections of outlays and revenues. It combines projected stocks of debt with estimates of interest rates from the current-law economic baseline.</p>

Source: Congressional Budget Office.

Note: See CBO's January 2005 *Budget and Economic Outlook* for a discussion of the implementation of procedures outlined in this table, including some exceptions to the rules governing the expiration of provisions for mandatory spending and revenues.

such factors as the existence of spare capacity and the conduct of monetary policy. It also depends on private-sector expectations: if people do not expect that a policy change will be permanent, it will in many cases have a smaller effect on economic behavior than if they expect it to persist.

### **Fiscal Policy Effects over the Long-Term Horizon**

Over the final eight years of the 10-year horizon, CBO estimates the average path of the economy, with no attempt to anticipate business-cycle fluctuations in aggregate demand. In other words, beyond the first two years of the period, CBO assumes that fiscal policies affect the projection entirely through effects that are captured in its estimates of potential output. Those effects include the impacts of taxation on the supply of labor and capital and the impacts of public borrowing in dampening private investment.

CBO incorporates the effects of changing marginal tax rates on the supply of labor hours into its estimates of potential output. The path for labor hours begins with projections that explicitly reflect trends in demographics and participation but do not explicitly reflect tax law. In the event that current law implies notable changes in future marginal tax rates, CBO adjusts its projections of labor hours to reflect those changes using relationships drawn from the empirical literature.

CBO builds the effects of federal borrowing under current law directly into its projections of capital accumulation and potential economic output. To do that, CBO must first compute the effects of the federal deficits on national saving in its current-law baseline, which it does by applying rules that specify the offsetting shifts in private saving and foreign borrowing. Those rules are based on an examination of empirical studies.

### **Nonfiscal Aspects of Current Policy**

CBO also considers whether any other government policies embodied in current law, such as those affecting immigration or innovation, may appreciably affect the economic forecast and projection. The set of current policies that shapes the forecast and projection can therefore go beyond fiscal policy and the budget baseline.

## **How Do Current-Law Assumptions Make CBO's Economic Outlook Distinctive?**

The current-law assumptions about policy built into CBO's forecast and projection can differ from those used by other economic forecasts, which typically anticipate changes in the laws governing fiscal policy. If those forecasts assume an imminent change in fiscal policy, they may have stronger or weaker aggregate demand and economic growth in the near term than CBO's does; over a longer horizon, their different fiscal policy assumptions may explain different paths for national saving, capital accumulation, and growth. Although even quite large differences in policy may have only small implications for variables such as total economic output, different policy assumptions help explain some of the variation among economic forecasts.

### **Disparate Policy Assumptions May Explain Some Differences in Forecasts**

Some comparisons between CBO's economic baseline and the forecasts produced by others may be misleading if the current-law nature of CBO's economic outlook is not considered. That could be particularly true for forecasts of taxable income, where income may shift sharply between taxable and nontaxable categories, depending on the law. An informed comparison of forecasts may still be possible when the differences between the policy assumptions built into CBO's economic baseline and the alternatives are clear.

By sharp contrast with CBO's current-law baseline, the economic forecast that accompanies the President's budget is a policy forecast. That forecast assumes that the President's policy proposals will be enacted into law, and the accompanying budget documents spell out the details of the policy proposals. In its annual *Analysis of the President's Budgetary Proposals*, CBO reviews the contribution of policy assumptions to the differences between the Administration's forecast and CBO's economic baseline.

For some important forecasts, the differences in policy assumptions may be less clear-cut. For example, that ambiguity applies to the popular *Blue Chip* consensus forecast, which is formed as an average of many leading private economic forecasts. The policy assumptions of all the forecasts included in the sample are not stated, however. In such cases, any forecast comparison must include a caveat about the unknown differences in policy assumptions.

### Policy Assumptions Do Not Necessarily Compromise Forecasts for the Economy as a Whole

Although CBO's economic outlook is not intended to forecast what is most likely to happen, evidence suggests that its assumptions about current policy have not caused its economic forecast and projection to perform worse on average than other forecasts.<sup>4</sup> One reason for that finding is that even when policy differences are large, the differences implied for important economic variables may be much smaller. Large changes may not have a large immediate effect simply because fiscal policy effects often operate with a lag. Moreover, the impact of fiscal policy on the economy also depends on how the private sector reacts to the policy change. Finally, differing fiscal policy assumptions may not compromise forecasts because they may be offset by monetary policy assumptions; for example, the increase in demand spurred by higher government spending might be offset by higher interest rates.

### Current-Policy Assumptions Occasionally Can Make a Big Difference

Although it often may not have large quantitative implications, the current-law nature of CBO's economic forecast and projection matters in certain circumstances. The ways in which a current-law economic baseline may differ from a forecast of the most likely outcome can be illustrated usefully by three examples that are prominent features of CBO's January 2005 economic outlook: the expiration of tax laws by 2011; current law and the future requirements for funding defined-benefit pension plans; and the treatment of spending for Iraq and Afghanistan in the forecast.

#### The Rise in Taxes in 2011

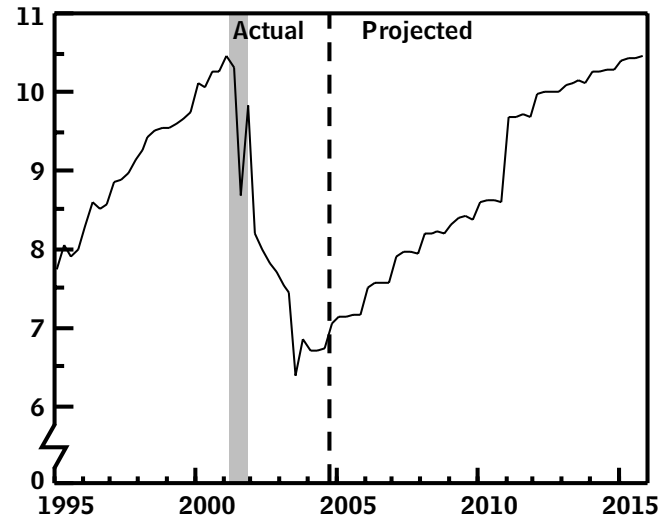
Under current law, taxes will rise as the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003 expire between 2005 and 2011. Many private forecasters do not expect that such a rise will happen, but CBO's current-law economic baseline has to assume that those tax increases will occur.

4. Congressional Budget Office, *CBO's Economic Forecasting Record* (September 2004).

**Figure 1.**

### Personal Taxes as a Share of Gross Domestic Product

(Percentage share of GDP)



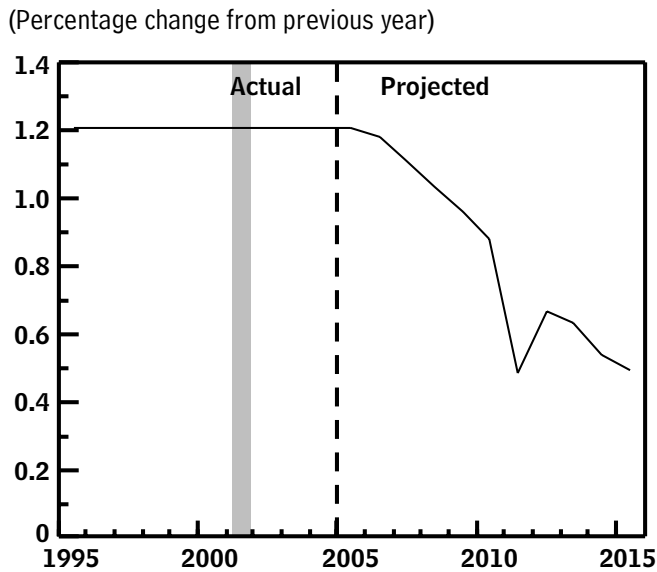
Source: Congressional Budget Office.

CBO's analysis suggests that those tax hikes in 2011 would have a noticeable quantitative impact. In CBO's January outlook, the growth of hours worked in the economy falls as those tax hikes occur. In addition, those tax hikes increase revenues and reduce the federal deficit, which over subsequent years raises the national saving rate and the share of economic output devoted to business investment. As personal taxes rise, the economic baseline assumes that private consumption spending falls as a share of output and that labor supply grows more slowly.<sup>5</sup>

An illustration of the implications of the current-law assumption for CBO's projection is provided by movements in the growth rate of labor hours during the 10 years of the projection horizon. As do most forecasters, CBO assumes that demographic developments imply an underlying decline in the growth rate of hours worked between 2005 and 2015. But the tax increases in 2011 under current law (see Figure 1) cause a sharp addi-

5. Note that because the expiration of the tax provisions occurs during the latter part of CBO's projection, CBO's forecast does not include any short-run effects on aggregate demand from the tax hikes built into current law.

**Figure 2.**  
**Projection of Potential Labor Force**



Source: Congressional Budget Office.

tional dip in the growth rate in 2011 and a permanent reduction in the level of labor hours thereafter (see Figure 2).

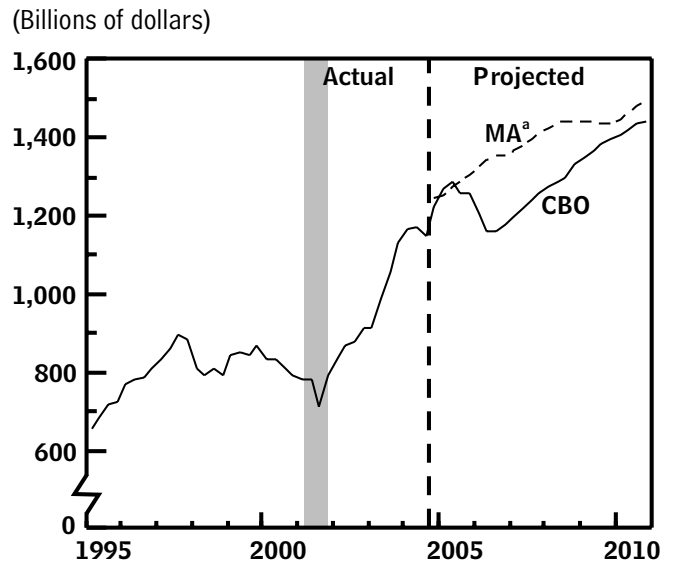
This example shows how major changes in future tax rates under current law can affect the economic baseline—in this particular case, through the growth of labor hours. If those tax hikes were not part of current law, CBO’s projection would be different.

**Current Law and the Future Requirements for Funding Defined-Benefit Pension Plans**

For 2004 and 2005, corporations were given temporary relief from previous legal requirements to make the full contributions to defined-benefit pension plans. The scheduled expiration of that relief raises such contributions and causes sharp reductions in corporate profits and the tax base during 2006.

When stock prices fell sharply between 2000 and 2002 and long-term interest rates declined, the defined-benefit pension plans at many U.S. corporations became underfunded relative to their legally required balances. To meet their obligations, corporations would have had to make large contributions to the plans, but temporary changes in the law eased the immediate burden.

**Figure 3.**  
**Corporate Profits**



Source: Congressional Budget Office and Macroeconomic Advisers.

a. MA = Macroeconomic Advisers.

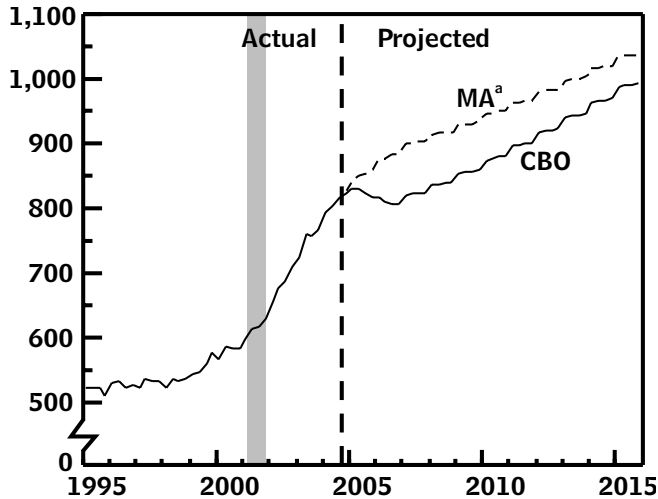
In January 2005, CBO projected that contributions for defined-benefit plans during 2005 would more than double under current law, to about \$300 billion, because of the expiration of the temporary relief measures that were included in the Job Creation and Worker Assistance Act of 2002 and in the Pension Funding Equity Act of 2004.<sup>6</sup> Such a rise in contributions to defined-benefit plans would not occur in any forecast that assumed that the temporary pension measures would be made permanent or that otherwise failed to take account of the more onerous requirements that are implied for 2006 under current law.

CBO assumes that required catch-up contributions to defined-benefit pension plans do not reflect compensation for current workers but instead are a belated realization of previously incurred labor costs. Hence, those costs operate to reduce profits, rather than offset wages or other forms of labor compensation (see Figure 3). By contrast, one leading commercial provider of economic

6. CBO’s forecasts of defined-benefit pensions are discussed at greater length in Appendix D of *The Budget and Economic Outlook: Fiscal Years 2006 to 2015*.

**Figure 4.****Federal Consumption and Investment**

(Billions of dollars)



Source: Congressional Budget Office and Macroeconomic Advisers.

a. MA = Macroeconomic Advisers.

forecasts, Macroeconomic Advisers, assumes some change in the law to temporarily extend pension relief, as well as some offset of wages.

This example illustrates that the current-law assumption can have large implications for certain economic variables. In this case, the current-law assumption that explicitly temporary provisions governing defined-benefit pensions will be allowed to lapse has significant implications for CBO's projection of the corporate tax base and, hence, of revenues.

**The Treatment of Spending for Iraq and Afghanistan**

At the time that CBO prepared its January 2005 forecast and projection, the Administration announced that it would request a supplemental appropriation for fiscal year 2005 to cover the cost of military operations in Iraq and Afghanistan, but no supplemental appropriation had yet been passed into law. Under statutory procedures for

its baseline, CBO could not include that spending in its forecast for federal outlays in 2005 or extend it into subsequent years following the baseline rules for discretionary spending. By contrast with most private forecasts, CBO's January budget baseline did not include such spending, nor could the economic forecast and projection reflect the impacts of such spending. The 10-year projection for federal consumption and investment in the January 2005 forecast by Macroeconomic Advisers exceeded the corresponding 10-year projection in CBO's January outlook by more than 7 percent (see Figure 4).

The inclusion in the budget baseline of spending from supplemental appropriations that the Congress considered for 2005 would carry large implications for total federal outlays and 10-year cumulative federal deficits. It would also have identifiable effects on the current-law economic baseline. By excluding such spending, the current-law economic baseline has weaker economic growth in 2005 and 2006 but slightly stronger growth on average over the 10-year horizon than if the baseline had included an estimate of that spending. Specifically, near-term GDP growth may have been roughly 0.5 percentage points weaker for 2005, but over the 10-year horizon, growth would be modestly (under 0.1 percentage points) faster. That example shows how high-profile and large differences between current-law fiscal policy and the fiscal policies built into other forecasts may affect CBO's economic outlook.

**Related CBO Publications:** In addition to the publications listed in footnotes 1 and 4 of this brief, see *The Budget and Economic Outlook: An Update* (August 2003), p. 44, and (August 2001), p. 34; and *The Budget and Economic Outlook* (January 2003), p. 26, for accounts of how CBO has incorporated fiscal policy changes into its economic outlook.

This issue brief was prepared by Christopher Williams. It and other publications by CBO are available at the agency's Web site ([www.cbo.gov](http://www.cbo.gov)).