

CONGRESS OF THE UNITED STATES  
CONGRESSIONAL BUDGET OFFICE

# The Budget and Economic Outlook: An Update



AUGUST 2007





# **The Budget and Economic Outlook: An Update**

August 2007

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## Notes

Unless otherwise indicated, all years referred to in describing the economic outlook are calendar years; otherwise, the years are federal fiscal years (which run from October 1 to September 30).

Numbers in the text and tables may not add up to totals because of rounding.

Some of the figures use shaded vertical bars to indicate periods of recession. (A recession extends from the peak of a business cycle to its trough.)

Data from the Commerce Department's Bureau of Economic Analysis (BEA) on gross domestic product and the national income and product accounts are generally as of June 2007. BEA's revised estimates, released on July 27, 2007, were published too late to be incorporated into the Congressional Budget Office's (CBO's) current economic forecast. Consequently, in Chapter 2, tables incorporate the June 2007 data, but figures and discussions of recent events are consistent with the revised data. The revisions to the national income and product accounts are unlikely to have a major impact on the projections presented in this volume.

Supplemental data for this analysis are available on CBO's Web site ([www.cbo.gov](http://www.cbo.gov)).

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# Preface

**T**his volume is one of a series of reports on the state of the budget and the economy that the Congressional Budget Office (CBO) issues each year. It satisfies the requirement of section 202(e) of the Congressional Budget Act of 1974 for CBO to submit to the Committees on the Budget periodic reports about fiscal policy and to provide baseline projections of the federal budget. In accordance with CBO's mandate to provide impartial analysis, the report makes no recommendations.

The baseline spending projections were prepared by the staff of the agency's Budget Analysis Division under the supervision of Robert Sunshine (who has now become Deputy Director of CBO), Peter Fontaine, Janet Airis, Thomas Bradley, Kim Cawley, Paul Cullinan, Jeffrey Holland, and Sarah Jennings. The revenue estimates were prepared by the staff of the Tax Analysis Division under the supervision of Thomas Woodward, Frank Sammartino, Mark Booth, and David Weiner, with assistance from the Joint Committee on Taxation. (A detailed list of contributors to the revenue and spending projections appears in Appendix D.)

The economic outlook presented in Chapter 2 was prepared by the Macroeconomic Analysis Division under the direction of Robert Dennis, Kim Kowalewski, and John F. Peterson. Robert Arnold and Christopher Williams carried out the economic forecast and projections. David Brauer, Ufuk Demiroglu, Naomi Griffin, Juann Hung, Kim Kowalewski, Mark Lasky, Angelo Mascaro, John F. Peterson, Frank Russek, and Steven Weinberg contributed to the analysis. Eric Miller and Adam Weber provided research assistance.

CBO's Panel of Economic Advisers commented on an early version of the economic forecast underlying this report. Members of the panel are Richard Berner, Jared Bernstein, Michael Boskin, Martin Feldstein, Robert J. Gordon, Robert E. Hall, Lawrence Katz, Allan H. Meltzer, Laurence H. Meyer, William D. Nordhaus, Rudolph G. Penner, Adam S. Posen, James Poterba, Alice Rivlin, Nouriel Roubini, Diane C. Swonk, and Stephen P. Zeldes. Alan Auerbach, Robert Dugger, Karen Dynan, Douglas Elmendorf, and Brian Sack attended the panel's meeting as guests. Although CBO's outside advisers provided considerable assistance, they are not responsible for the contents of this report.

Jeffrey Holland wrote the summary. Barry Blom, with assistance from Barbara Edwards and Pamela Greene, wrote Chapter 1 (David Newman compiled Box 1-1). John F. Peterson, with assistance from Kim Kowalewski, authored Chapter 2. Ann Futrell and Eric Schatten, along with Mark Booth, wrote Appendix A. Amber Marcellino, with assistance from Pamela Greene, wrote Appendix B. Eric Miller and Adam Weber compiled Appendix C.

Christine Bogusz, Christian Howlett, Kate Kelly, Loretta Lettner, and John Skeen edited the report. Marion Curry, Denise Jordan-Williams, and Linda Lewis Harris assisted in its preparation. Maureen Costantino took the photograph for the cover and prepared the report for publication. Lenny Skutnik printed the initial copies, and Linda Schimmel handled the distribution. Simone Thomas prepared the electronic version for CBO's Web site: [www.cbo.gov](http://www.cbo.gov).

A handwritten signature in black ink, appearing to read "Peter R. Orszag". The signature is fluid and cursive, with the first name "Peter" and last name "Orszag" clearly distinguishable.

Peter R. Orszag  
Director

August 2007



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# Summary

**T**he Congressional Budget Office (CBO) estimates that the deficit for 2007 will be lower than it was in 2006, but the budget outlook for the long term remains daunting. This year's deficit is slightly smaller than the shortfall that CBO projected in March, when it last issued its projections of the federal budget, mostly because of higher-than-anticipated tax revenues. The long-term fiscal outlook continues to depend primarily on the future course of health care costs.

Economic growth slowed during the second half of 2006 and early 2007, and financial markets experienced significant turbulence during the summer of 2007. Although there is some risk that problems in the housing market and disruptions in financial markets may spread and impair economic growth, the most likely scenario is that economic performance will remain sound.

## The Budget Outlook from 2007 to 2017

CBO expects the 2007 deficit to total \$158 billion—a \$90 billion decline from the deficit recorded for 2006 (see Summary Table 1). Relative to the size of the economy, the deficit this year is expected to equal 1.2 percent of gross domestic product (GDP), down from 1.9 percent in 2006.

The deficit for 2007 is now expected to be \$19 billion lower than the amount that CBO estimated in March.<sup>1</sup> Higher-than-anticipated revenues, mostly from individual income taxes, improved the budget outlook for this year; they were partially offset by outlays from supple-

mental appropriations that were enacted after CBO prepared its March projections.<sup>2</sup> In particular, CBO expects revenues in 2007 to exceed its March estimate by \$35 billion, or 1.4 percent. At the same time, outlays this year are expected to be \$16 billion, or about 0.6 percent, higher than CBO's March estimate, primarily because of supplemental appropriations for military operations in Iraq and Afghanistan. That increase in spending has been partially offset by lower-than-anticipated outlays from earlier appropriations.

CBO has also updated its baseline budget projections for the coming decade. In accordance with long-standing procedures, CBO's projections assume that current laws and policies remain in place.<sup>3</sup> The baseline is therefore not intended to be a prediction of future budgetary outcomes; instead, it is meant to serve as a neutral benchmark that lawmakers can use to measure the effects of proposed changes to spending and revenues.

The general fiscal outlook for the coming decade remains about the same as what CBO projected in March. If the laws and policies currently in place did not change, the deficit for 2008 would fall slightly, to 1.1 percent of GDP, and then rise to about 1.5 percent of GDP for 2009 and 2010, CBO projects. In the years that follow, deficits would give way to small surpluses as a result of higher revenues associated with the scheduled expiration of tax provisions originally enacted in the Economic

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1. In March, CBO projected that the 2007 deficit would total \$177 billion if no changes to policy occurred and \$214 billion if the President's proposals were enacted. CBO's projections were published in Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2008* (March 2007).

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2. The supplemental appropriations proposed by the President were similar to those enacted in the U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act, 2007 (Public Law 110-28) on May 25, 2007. That law also provided additional funding for other purposes.

3. Exceptions exist for certain mandatory programs, primarily those established on or before the date that the Balanced Budget Act of 1997 was enacted, and for expiring excise taxes that are dedicated to trust funds.

**Summary Table 1.**

**CBO's Baseline Budget Outlook**

	Actual												Total,	Total,
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2008-	2008-
													2012	2017
<b>In Billions of Dollars</b>														
Total Revenues	2,407	2,577	2,771	2,855	2,950	3,225	3,477	3,619	3,798	3,981	4,173	4,378	15,278	35,228
Total Outlays	2,655	2,735	2,925	3,071	3,205	3,359	3,415	3,583	3,733	3,896	4,115	4,268	15,974	35,571
<b>Total Deficit (-) or Surplus</b>	<b>-248</b>	<b>-158</b>	<b>-155</b>	<b>-215</b>	<b>-255</b>	<b>-134</b>	<b>62</b>	<b>36</b>	<b>65</b>	<b>85</b>	<b>58</b>	<b>109</b>	<b>-696</b>	<b>-343</b>
On-budget	-434	-339	-353	-429	-484	-379	-193	-226	-202	-184	-211	-157	-1,839	-2,819
Off-budget <sup>a</sup>	186	181	198	214	229	245	255	262	267	269	269	266	1,142	2,476
Debt Held by the Public at the End of the Year	4,829	4,993	5,163	5,392	5,661	5,807	5,756	5,730	5,674	5,595	5,543	5,439	n.a.	n.a.
<b>As a Percentage of Gross Domestic Product</b>														
Total Revenues	18.4	18.8	19.2	18.9	18.6	19.4	20.0	19.9	20.0	20.1	20.2	20.3	19.2	19.7
Total Outlays	20.3	19.9	20.3	20.3	20.2	20.2	19.6	19.7	19.6	19.6	19.9	19.8	20.1	19.9
<b>Total Deficit (-) or Surplus</b>	<b>-1.9</b>	<b>-1.2</b>	<b>-1.1</b>	<b>-1.4</b>	<b>-1.6</b>	<b>-0.8</b>	<b>0.4</b>	<b>0.2</b>	<b>0.3</b>	<b>0.4</b>	<b>0.3</b>	<b>0.5</b>	<b>-0.9</b>	<b>-0.2</b>
Debt Held by the Public at the End of the Year	37.0	36.4	35.9	35.7	35.6	34.9	33.1	31.5	29.9	28.2	26.8	25.2	n.a.	n.a.
<b>Memorandum:</b>														
Gross Domestic Product (Billions of dollars)	13,065	13,721	14,401	15,120	15,881	16,640	17,399	18,190	19,005	19,842	20,704	21,599	79,440	178,779

Source: Congressional Budget Office.

Note: n.a. = not applicable.

a. Off-budget surpluses comprise surpluses in the Social Security trust funds as well as the net cash flow of the Postal Service.

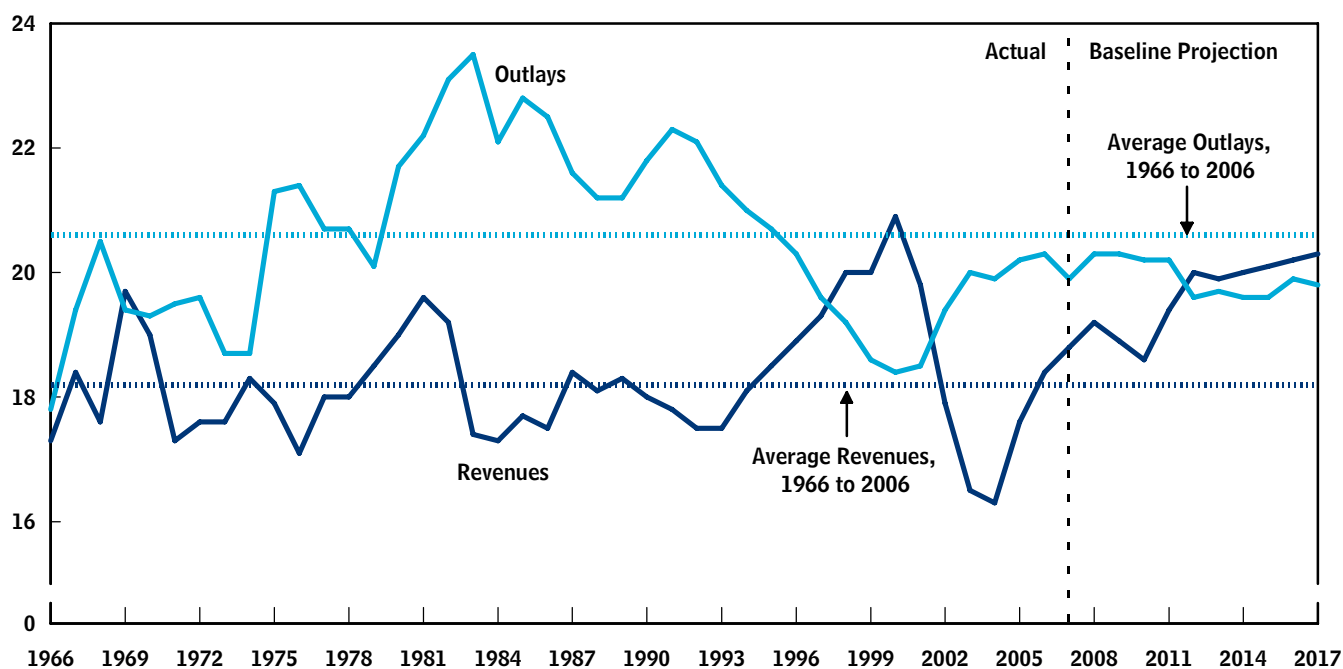
Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA).

Total outlays are projected to remain steady at roughly 20 percent of GDP over the next 10 years (see Summary Figure 1). Mandatory spending (excluding offsetting receipts) is estimated to grow 1.3 percentage points faster each year than nominal GDP does, but discretionary spending is assumed to increase at the rate of inflation and thus at slightly more than half the growth rate of GDP. (CBO projects that annual growth of nominal GDP will average 4.6 percent over the 2008–2017 period.)

Total revenues are projected to remain close to 19 percent of GDP through 2010—about their level in 2007—and then rise to more than 20 percent following the sched-

uled expiration of EGTRRA and JGTRRA. Individual income taxes account for the projected rise in revenues as a percentage of GDP over the next 10 years. Revenues from corporate income taxes are projected to peak this year at 2.7 percent of GDP (a level last reached in 1978) and then gradually diminish. Other sources of revenues, the largest of which is social insurance taxes, are estimated to remain stable as a share of GDP.

Since March, the bottom line in CBO's baseline over the next 10 years has worsened by an average of \$90 billion to \$100 billion per year. However, the changes do not indicate a substantive shift in the underlying budget outlook; rather, they result mostly from extrapolating into future years \$117 billion in supplemental appropriations enacted since March, in accordance with the rules governing the baseline. Indeed, in the absence of those supplemental appropriations, the underlying budgetary

**Summary Figure 1.****Total Revenues and Outlays as a Percentage of Gross Domestic Product, 1966 to 2017**

Source: Congressional Budget Office.

trends over the next 10 years are slightly improved. Changes in the economic outlook and other (technical) estimating revisions have decreased projected deficits by \$42 billion in 2008 and by amounts that grow from \$30 billion in 2009 to \$101 billion in 2017.

### The Long-Term Budget Outlook

Over the long term, the budget remains on an unsustainable path. Unless changes are made to current policies, growing demand for resources caused by rising health care costs and the nation's expanding elderly population will put increasing pressure on the budget. Federal spending on Medicare and Medicaid is expected to total 4.6 percent of GDP this year, and, without changes in law, such spending will rise to 5.9 percent of GDP in 2017—an increase of nearly 30 percent in just 10 years, CBO estimates (see Summary Figure 2). Over the same period, spending on Social Security will rise from 4.2 percent of GDP to 4.8 percent.

Beyond 2017, those trends are poised to accelerate. Over the past four decades, the costs per beneficiary under

Medicare and Medicaid have increased about 2.5 percentage points faster per year than has per capita GDP. If those costs continue to increase at that rate, federal spending on those two programs alone would rise from 4.6 percent of GDP this year to about 20 percent by 2050. Demographic changes in the programs can explain only about 2.5 percentage points of that increase, underscoring that the rate at which health care costs grow—not the aging of the population—is the key determinant of the nation's long-term fiscal outlook.<sup>4</sup>

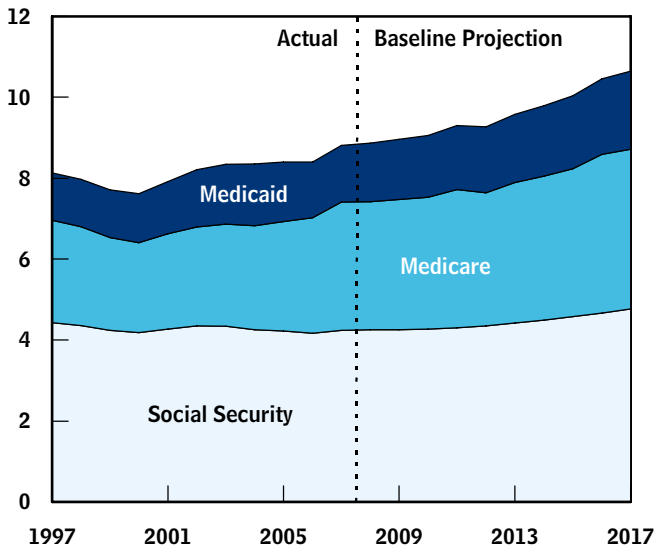
### The Economic Outlook

Although the economic outlook has been clouded by recent troubles in the housing market and turbulence in

4. See the statement of Peter R. Orszag, Director, Congressional Budget Office, *Health Care and the Budget: Issues and Challenges for Reform*, before the Senate Budget Committee (June 21, 2007). See also Congressional Budget Office, *The Long-Term Budget Outlook* (December 2005), *Updated Long-Term Projections for Social Security* (June 2006), and *The Outlook for Social Security* (June 2004).

**Summary Figure 2.**

**Spending on Social Security, Medicare, and Medicaid as a Percentage of Gross Domestic Product, 1997 to 2017**



Source: Congressional Budget Office.

financial markets, the most likely scenario is for the economy to return to solid growth by early 2008. According to CBO's projections, GDP will increase by 2.1 percent in real (inflation-adjusted) terms this calendar year and

by 2.9 percent in 2008 (see Summary Table 2). Employment growth, which slowed slightly in late 2006, is expected to continue to increase moderately, thereby keeping the unemployment rate near its current 4.6 percent through 2008.

Inflation, as measured by the year-to-year change in the consumer price index for all urban consumers (CPI-U), is projected to decline from 2.8 percent this year to 2.3 percent next year. Prices for food and energy, which increased during the first half of this year, are expected to moderate, keeping overall inflation lower than in the recent past. In addition, the underlying (or core) rate of consumer price inflation is expected to be relatively stable, averaging slightly above 2 percent over the next year and a half.

Economic projections for the near term, however, are subject to significant uncertainty, particularly about how problems experienced by home mortgage lenders will affect the broader availability of credit and the economy as a whole.

Over the 2009–2017 period, CBO projects that real growth will average 2.7 percent and inflation as measured by the CPI-U, 2.2 percent. The projected rate of real growth of GDP is lower in the latter half of that period because the growth of the labor force will slow when members of the baby-boom generation begin to retire.

**Summary Table 2.****CBO's Economic Projections for Calendar Years 2007 to 2017**

(Percentage change)

	Estimated 2006 <sup>a</sup>	Forecast		Projected Annual Average	
		2007	2008	2009–2012	2013–2017
Nominal GDP					
Billions of dollars	13,247	13,893	14,575	17,595 <sup>b</sup>	21,829 <sup>c</sup>
Percentage change	6.3	4.9	4.9	4.8	4.4
Real GDP	3.3	2.1	2.9	3.0	2.6
GDP Price Index	2.9	2.7	2.0	1.8	1.8
PCE Price Index	2.7	2.3	2.0	1.8	1.9
Core PCE Price Index <sup>d</sup>	2.2	2.0	1.9	1.9	1.8
Consumer Price Index <sup>e</sup>	3.2	2.8	2.3	2.2	2.2
Core Consumer Price Index <sup>f</sup>	2.5	2.6	2.2	2.3	2.2
Unemployment Rate (Percent)	4.6	4.5	4.7	4.8	4.8
Interest Rates (Percent)					
Three-month Treasury bills	4.7	4.8	4.8	4.7	4.7
Ten-year Treasury notes	4.8	4.9	5.2	5.2	5.2

Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

Notes: GDP = gross domestic product; PCE = personal consumer expenditures.

Percentage changes are measured from one year to the next.

Year-by-year economic projections for 2007 to 2017 appear in Appendix C.

- a. Values as of early July 2007, prior to the revisions to the national income and product accounts.
- b. Level in 2012.
- c. Level in 2017.
- d. The personal consumption expenditure chained price index excluding prices for food and energy.
- e. The consumer price index for all urban consumers.
- f. The consumer price index for all urban consumers excluding prices for food and energy.





## The Budget Outlook

**T**he nation's budget outlook for fiscal year 2007 has improved in the five months since the Congressional Budget Office (CBO) released its previous set of baseline projections, but prospects for the long term remain daunting. CBO now expects that the budget deficit for 2007 will total \$158 billion—\$19 billion lower than the estimate published in March and about \$90 billion less than the budget shortfall recorded last year (see Table 1-1).<sup>1</sup> Relative to the size of the economy, the 2007 deficit is expected to equal 1.2 percent of gross domestic product (GDP), down from 1.9 percent in 2006. Over the longer term, however, the federal budget continues to face substantial fiscal challenges, driven primarily by rising health care costs.<sup>2</sup>

The improvement in the 2007 budget outlook that has occurred since March is attributable primarily to higher-than-anticipated revenues—mostly from individual and corporate income taxes. CBO expects revenues in 2007 to exceed its March estimate by \$35 billion, or 1.4 percent. Outlays for this year are likely to be about \$16 billion (0.6 percent) more than CBO anticipated in March, largely because of supplemental appropriations enacted in May. (Outlays from the additional funding are partially

offset by slower-than-expected spending of previous appropriations.)

Despite the improved budgetary prospects for 2007, the outlook for the coming decade has not changed materially since March. If current laws and policies were to remain unaltered—the assumption that underlies CBO's baseline projections—the deficit would fall slightly, to 1.1 percent of GDP, in 2008 and then rise to about 1.5 percent of GDP in 2009 and 2010. In the years that follow, higher revenue levels associated with the scheduled expiration of tax provisions originally enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) are projected to shift the budget from deficits to small surpluses. For example, CBO projects a baseline surplus of 0.4 percent of GDP in 2012; nevertheless, based on past projection errors, CBO calculates that the probability of a deficit in that year is 45 percent (if no policy changes are enacted). Between 2012 and 2017, the projected surpluses range from 0.2 percent to 0.5 percent of GDP (see Figure 1-1). Many changes in policy—such as extending the tax provisions that are scheduled to expire or altering various payments under Medicare—could have a significant impact on projected budget outcomes.

The current baseline projections for the 2008–2017 period include both higher outlays and higher revenues than CBO estimated in March. Because the baseline shows the projected path of spending and revenues under current laws and policies, it assumes that all appropriations enacted for 2007, including supplemental appropriations, continue at their current level (adjusted for the effects of inflation) throughout the baseline period. Thus, CBO's updated spending projections include the extrapolation and inflation of \$117 billion in supplemental funding that was enacted in May, mainly for military

1. In March, CBO projected that the 2007 deficit would total \$177 billion if no changes to policy occurred and \$214 billion if changes proposed in the President's budget request for 2008 were enacted. (Supplemental appropriations similar to those proposed by the President and additional funding for other purposes were included in the U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act, 2007, or Public Law 110-28, which was enacted on May 25, 2007.) CBO's projections were published in Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2008* (March 2007).
2. Starting later this year, CBO will begin releasing its long-term budget outlook on an annual basis. That report will examine in more detail the impact of health care costs on the federal budget.

**Table 1-1.****Projected Deficits and Surpluses in CBO's Baseline**

(Billions of dollars)

	Actual												Total,	Total,
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2008-	2008-
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2012	2017
On-Budget Deficit	-434	-339	-353	-429	-484	-379	-193	-226	-202	-184	-211	-157	-1,839	-2,819
Off-Budget Surplus <sup>a</sup>	186	181	198	214	229	245	255	262	267	269	269	266	1,142	2,476
<b>Total Deficit (-) or Surplus</b>	<b>-248</b>	<b>-158</b>	<b>-155</b>	<b>-215</b>	<b>-255</b>	<b>-134</b>	<b>62</b>	<b>36</b>	<b>65</b>	<b>85</b>	<b>58</b>	<b>109</b>	<b>-696</b>	<b>-343</b>
<b>Memorandum:</b>														
Social Security Surplus	185	186	201	216	230	245	255	262	267	269	269	266	1,147	2,479
Total Deficit (-) or Surplus as a Percentage of GDP	-1.9	-1.2	-1.1	-1.4	-1.6	-0.8	0.4	0.2	0.3	0.4	0.3	0.5	-0.9	-0.2
Debt Held by the Public as a Percentage of GDP <sup>b</sup>	37.0	36.4	35.9	35.7	35.6	34.9	33.1	31.5	29.9	28.2	26.8	25.2	n.a.	n.a.
Probability of a Budget Deficit (Percent)	n.a.	92.0	77.0	77.0	77.0	62.0	45.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Source: Congressional Budget Office.

Note: GDP = gross domestic product; n.a. = not applicable.

a. Off-budget surpluses comprise surpluses in the Social Security trust funds as well as the net cash flow of the Postal Service.

b. Debt held at the end of the year.

operations in Iraq and Afghanistan.<sup>3</sup> Compared with its previous projections, CBO expects that revenues will grow more rapidly in 2007 and 2008 but at about the same rate for the remainder of the baseline period that it projected earlier. (See Appendix A for a detailed discussion of the changes to CBO's baseline projections since March.)

Federal debt held by the public is expected to total \$5.0 trillion at the end of this fiscal year, or 36.4 percent of GDP, a decline from last year's level of 37.0 percent. Under the assumptions incorporated in CBO's baseline, debt held by the public (as a share of GDP) continues to decline in each of the following three years, reaching 35.6 percent of GDP in 2010. It would decline more rapidly thereafter, as the budget shifts into surplus, with

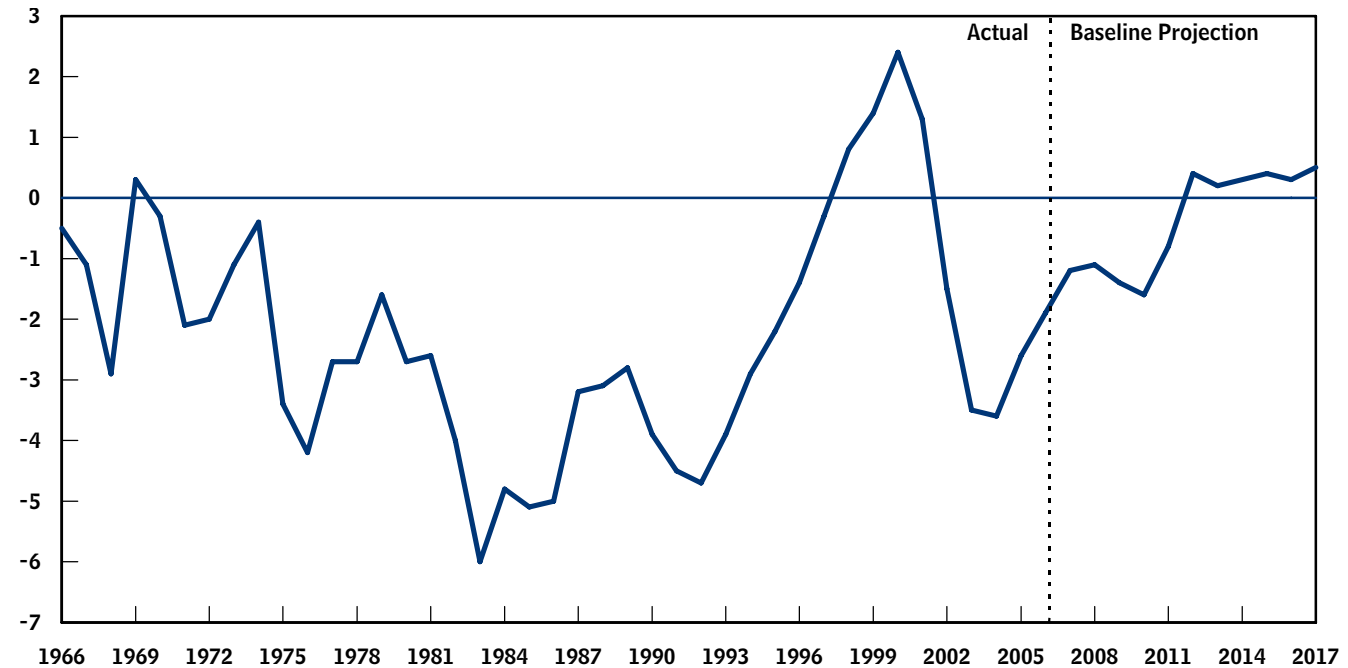
debt held by the public falling to 25.2 percent of GDP by the end of 2017.

CBO's baseline budget projections are not intended to be a forecast of future budgetary outcomes; rather, they serve as a neutral benchmark that legislators and others can use to assess the potential effects of various policy decisions. Although CBO's baseline projections do not incorporate anticipated changes in policy, this chapter describes the budgetary implications over the next 10 years of some alternative policy assumptions. For example, CBO has constructed two possible scenarios for future spending related to military operations in Iraq and Afghanistan and other activities associated with the war on terrorism. Those scenarios incorporate differing assumptions about how rapidly troop levels might be reduced. Under both scenarios, outlays over the 10-year period would be significantly lower, relative to the baseline: In one scenario, outlays are reduced by roughly \$650 billion over the decade, and in the other scenario, the reduction in outlays is about \$1 trillion.

3. Lawmakers had already provided \$70 billion in funding for military operations in Iraq and Afghanistan and for other activities associated with the war on terrorism in September 2006; such spending was included in CBO's March baseline projections.

**Figure 1-1.****The Total Deficit or Surplus, 1966 to 2017**

(Percentage of gross domestic product)



Source: Congressional Budget Office.

By contrast, if all of the tax provisions that are set to expire over the next 10 years were extended and the alternative minimum tax (AMT) was indexed for inflation, revenues would be reduced by almost \$3.4 trillion over the next decade and the 10-year deficit would equal 2.4 percent of GDP rather than 0.2 percent. Debt held by the public would climb to 43.8 percent of GDP by the end of 2017 rather than 25.2 percent.

Over the long term, the budget is on an unsustainable path. Unless changes are made to current policies, the growing demand for resources caused primarily by rising health care costs and, to a lesser degree, by the nation's expanding elderly population will put increasing pressure on the budget. For instance, federal spending on Medicare and Medicaid is expected to total 4.6 percent of GDP this year. Without changes in law, such spending will rise to 5.9 percent of GDP in 2017—an increase of nearly 30 percent in just 10 years, CBO estimates. Over the same period, Social Security spending will rise from 4.2 percent of GDP to 4.8 percent. Those trends are poised to accelerate beyond 2017.<sup>4</sup>

**The Outlook for 2007**

In 2007, the federal deficit will fall for the third year in a row. If no further legislation is enacted that affects spending or revenues, the deficit will amount to \$158 billion, or 1.2 percent of GDP, CBO estimates, down from \$248 billion, or 1.9 percent of GDP, in 2006. Total revenues in 2007 are expected to increase by 7.1 percent, a significantly slower pace than that recorded in 2005 (14.5 percent) and in 2006 (11.8 percent) but still above the average rate of growth of 4.8 percent that occurred from 1995 to 2005 (see Table 1-2). Total outlays are projected to grow by 3.0 percent from last year's level, below the 7.4 percent increase observed in 2006 as well as the annual average increase of 5.0 percent recorded in the previous 10 years.

4. See the statement of Peter R. Orszag, Director, Congressional Budget Office, *Health Care and the Budget: Issues and Challenges for Reform*, before the Senate Budget Committee (June 21, 2007). See also Congressional Budget Office, *Updated Long-Term Projections for Social Security* (June 2006), *The Long-Term Budget Outlook* (December 2005), and *The Outlook for Social Security* (June 2004).

**Table 1-2.**

## Average Annual Growth Rates of Revenues and Outlays Since 1995 and as Projected in CBO's Baseline

(Percent)

	Actual		Estimated	Projected <sup>a</sup>	
	1995-2005	2005-2006	2006-2007	2007-2008	2008-2017
<b>Revenues</b>					
Individual Income Taxes	4.6	12.6	12.0	10.9	6.6
Corporate Income Taxes	5.9	27.2	6.2	2.0	0.9
Social Insurance Taxes	5.1	5.5	3.6	5.3	4.5
Other <sup>b</sup>	2.5	11.3	-4.7	7.4	5.9
<b>Total Revenues</b>	<b>4.8</b>	<b>11.8</b>	<b>7.1</b>	<b>7.5</b>	<b>5.2</b>
<b>Outlays</b>					
Mandatory	6.0	7.0	3.2	6.5	5.9
Social Security	4.5	4.9 <sup>c</sup>	6.9 <sup>c</sup>	5.3	5.9
Medicare	6.5	12.4	16.6	4.8	7.2
Medicaid	7.4	-0.6	6.4	8.5	8.0
Other <sup>d</sup>	7.5	9.5	-21.0	10.9	0.9
Discretionary	5.9	5.0	2.6	7.5	2.5
Defense	6.1	5.3	5.2	9.6	2.9
Nondefense	5.7	4.6	-0.2	5.1	1.9
Net Interest	-2.3	23.2	3.9	7.3	1.1
<b>Total Outlays</b>	<b>5.0</b>	<b>7.4</b>	<b>3.0</b>	<b>7.0</b>	<b>4.3</b>
Total Outlays Excluding Net Interest	6.0	6.2	2.9	6.9	4.6
<b>Memorandum:</b>					
Consumer Price Index	2.5	3.7	2.4	2.7	2.2
Nominal GDP	5.3	6.5	5.0	5.0	4.6
Discretionary Budget Authority	7.0	1.0	7.2	2.9	2.3
Defense	6.6	11.3	11.9	2.8	2.3
Nondefense <sup>e</sup>	7.4	-9.7	1.3	3.2	2.4

Source: Congressional Budget Office.

Notes: The growth rates in this table do not account for shifts in the timing of certain payments or receipts.

GDP = gross domestic product.

- Average annual growth rates of revenues and outlays as projected in CBO's baseline. When constructing its baseline, CBO uses the employment cost index for wages and salaries to inflate discretionary spending related to federal personnel and the GDP price index to adjust other discretionary spending.
- Includes excise taxes, estate and gift taxes, customs duties, and miscellaneous receipts.
- Reflects downward adjustments made by the Treasury Department to both Social Security outlays and tax revenues of \$6.2 billion in 2006 and \$1.3 billion in 2007 to correct a previous accounting error related to taxes withheld on Social Security benefits. Without those adjustments, the growth rates for 2006 and 2007 would have been 5.9 percent and 5.7 percent, respectively.
- Includes offsetting receipts (funds collected by government agencies from other government accounts or from the public in business-like or market-oriented transactions that are recorded as offsets to outlays).
- Includes funding provided through supplemental appropriations (as well as a rescission in 2006 of \$23 billion in budget authority originally provided to the Federal Emergency Management Agency in 2005). Excluding those factors would change the average annual growth rate for nondefense discretionary budget authority to 5.0 percent from 1995 through 2005, to 0.3 percent in 2006, and to 4.2 percent in 2007.

## Revenues

On the basis of tax collections recorded through July, CBO expects that total federal revenues will rise by \$170 billion in 2007 to \$2.6 trillion. As a share of GDP, revenues are expected to grow from 18.4 percent in 2006 to 18.8 percent this year.

This year's growth in receipts relative to GDP represents not only a continuation of the rebound from the trough experienced in 2003 and 2004, but also a change in the character of that growth. Until this year, the increase in corporate income tax receipts contributed disproportionately to the improvement in total revenues. By contrast, this year's growth has stemmed almost entirely from rising individual income taxes. CBO estimates that individual income tax receipts will increase from 8.0 percent of GDP in 2006 to 8.5 percent in 2007 (see Table 1-3), while corporate income taxes as a percentage of GDP will stay about the same.<sup>5</sup> It appears that the 2007 increase in individual income tax receipts is due partly to solid growth in wage and salary income and partly to rapid growth in nonwage income, but until detailed data are available, it is not possible to identify those causes precisely. For the most part, they appear to reflect underlying economic events that are unrelated to recent changes in fiscal policy.

Other sources of revenue are not expected to change much in 2007 relative to the size of the economy. CBO anticipates that revenues arising from social insurance and various other taxes in 2007 will decline slightly as a percentage of GDP. Much of the decline in revenues generated by those other taxes is attributable to the recent elimination of portions of the telephone excise tax and the issuance of related refunds.

**Individual Income and Social Insurance Taxes.** In combination, receipts for individual income and social insurance (payroll) taxes will increase this year by about \$156 billion, or 8.3 percent, CBO projects. Over three-

5. Employers remit a combined amount of withheld taxes to the Internal Revenue Service without specifying the breakdown between individual income and social insurance taxes. The Treasury estimates the division between the two sources of revenue when it receives withheld amounts. The estimates are revised when supporting information becomes available, sometimes months or as much as a few years later. As a result, some of the growth attributed to individual income taxes may later turn out to have been derived from social insurance receipts or vice versa.

fourths of that increase is attributable to individual income taxes, which CBO expects to grow to nearly \$1.2 trillion, an increase of 12 percent. By comparison, social insurance tax receipts rise more modestly—by 3.6 percent—to \$868 billion.

Most individual income and social insurance taxes are paid in two forms:

- As amounts that employers withhold from individuals' compensation and remit to the federal government on behalf of their employees; and
- As nonwithheld amounts that individuals pay directly, either in the form of quarterly estimated installments or when they file their yearly income tax returns.

CBO expects withheld receipts for individual income and payroll taxes to climb by \$111 billion, or 7 percent, in 2007. That increase, in both dollar and percentage terms, is slightly higher than the increase recorded in 2006. Over the past two years, aggregate wages and salaries (as measured in the national income and product accounts, or NIPAs) and withheld receipts have grown at their fastest annual pace since 2000. Substantial year-end bonuses in each of the past two years have contributed to the increases in both wage and salary income and withholding.

Nonwithheld receipts of income and payroll taxes are projected to rise by about \$56 billion, or 13 percent, this year. That rise would represent increases of about 12 percent in final payments remitted with tax returns and 14 percent in quarterly estimated payments. (Refunds are expected to rise by \$11 billion, or 6 percent.)

CBO's estimate of final payments—based on those recorded through July—indicates continued growth in calendar year 2006 in sources of income other than wages and salaries. Those sources include capital gains, noncorporate business income, interest, dividends, and retirement income. The specific sources of that growth should become clearer by the end of this calendar year when the Internal Revenue Service tabulates aggregate data from 2006 tax returns.

**Corporate Income Taxes.** Receipts from corporate income taxes will rise by over 6 percent in fiscal year 2007, CBO projects, to \$376 billion. That rise mostly

**Table 1-3.****CBO's Baseline Budget Projections**

	Actual 2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Total, 2008- 2012	Total, 2008- 2017
<b>In Billions of Dollars</b>														
<b>Revenues</b>														
Individual income taxes	1,044	1,169	1,297	1,340	1,406	1,611	1,754	1,857	1,957	2,066	2,182	2,306	7,407	17,775
Corporate income taxes	354	376	384	374	356	368	390	366	382	392	403	415	1,871	3,829
Social insurance taxes	838	868	914	958	1,005	1,053	1,102	1,152	1,203	1,255	1,308	1,362	5,033	11,314
Other	172	164	176	183	184	193	231	244	256	268	281	295	967	2,310
<b>Total</b>	<b>2,407</b>	<b>2,577</b>	<b>2,771</b>	<b>2,855</b>	<b>2,950</b>	<b>3,225</b>	<b>3,477</b>	<b>3,619</b>	<b>3,798</b>	<b>3,981</b>	<b>4,173</b>	<b>4,378</b>	<b>15,278</b>	<b>35,228</b>
On-budget	1,799	1,944	2,101	2,152	2,211	2,451	2,667	2,773	2,915	3,059	3,212	3,376	11,582	26,917
Off-budget	608	633	669	703	739	774	810	847	884	922	961	1,001	3,696	8,310
<b>Outlays</b>														
Mandatory spending	1,413	1,457	1,553	1,639	1,729	1,846	1,883	2,022	2,145	2,280	2,465	2,598	8,650	20,160
Discretionary spending	1,016	1,042	1,120	1,165	1,195	1,223	1,239	1,271	1,300	1,330	1,366	1,392	5,942	12,601
Net interest	227	235	253	267	281	290	292	290	289	286	284	278	1,383	2,810
<b>Total</b>	<b>2,655</b>	<b>2,735</b>	<b>2,925</b>	<b>3,071</b>	<b>3,205</b>	<b>3,359</b>	<b>3,415</b>	<b>3,583</b>	<b>3,733</b>	<b>3,896</b>	<b>4,115</b>	<b>4,268</b>	<b>15,974</b>	<b>35,571</b>
On-budget	2,233	2,283	2,454	2,581	2,695	2,830	2,860	2,999	3,117	3,243	3,423	3,533	13,421	29,736
Off-budget	422	452	471	489	509	529	555	584	617	653	692	736	2,553	5,834
<b>Deficit (-) or Surplus</b>	<b>-248</b>	<b>-158</b>	<b>-155</b>	<b>-215</b>	<b>-255</b>	<b>-134</b>	<b>62</b>	<b>36</b>	<b>65</b>	<b>85</b>	<b>58</b>	<b>109</b>	<b>-696</b>	<b>-343</b>
On-budget	-434	-339	-353	-429	-484	-379	-193	-226	-202	-184	-211	-157	-1,839	-2,819
Off-budget	186	181	198	214	229	245	255	262	267	269	269	266	1,142	2,476
Debt Held by the Public	4,829	4,993	5,163	5,392	5,661	5,807	5,756	5,730	5,674	5,595	5,543	5,439	n.a.	n.a.
<b>Memorandum:</b>														
Gross Domestic Product	13,065	13,721	14,401	15,120	15,881	16,640	17,399	18,190	19,005	19,842	20,704	21,599	79,440	178,779
<b>As a Percentage of Gross Domestic Product</b>														
<b>Revenues</b>														
Individual income taxes	8.0	8.5	9.0	8.9	8.9	9.7	10.1	10.2	10.3	10.4	10.5	10.7	9.3	9.9
Corporate income taxes	2.7	2.7	2.7	2.5	2.2	2.2	2.2	2.0	2.0	2.0	1.9	1.9	2.4	2.1
Social insurance taxes	6.4	6.3	6.3	6.3	6.3	6.3	6.3	6.3	6.3	6.3	6.3	6.3	6.3	6.3
Other	1.3	1.2	1.2	1.2	1.2	1.2	1.3	1.3	1.3	1.4	1.4	1.4	1.2	1.3
<b>Total</b>	<b>18.4</b>	<b>18.8</b>	<b>19.2</b>	<b>18.9</b>	<b>18.6</b>	<b>19.4</b>	<b>20.0</b>	<b>19.9</b>	<b>20.0</b>	<b>20.1</b>	<b>20.2</b>	<b>20.3</b>	<b>19.2</b>	<b>19.7</b>
On-budget	13.8	14.2	14.6	14.2	13.9	14.7	15.3	15.2	15.3	15.4	15.5	15.6	14.6	15.1
Off-budget	4.7	4.6	4.6	4.7	4.7	4.7	4.7	4.7	4.6	4.6	4.6	4.6	4.7	4.6
<b>Outlays</b>														
Mandatory spending	10.8	10.6	10.8	10.8	10.9	11.1	10.8	11.1	11.3	11.5	11.9	12.0	10.9	11.3
Discretionary spending	7.8	7.6	7.8	7.7	7.5	7.4	7.1	7.0	6.8	6.7	6.6	6.4	7.5	7.0
Net interest	1.7	1.7	1.8	1.8	1.8	1.7	1.7	1.6	1.5	1.4	1.4	1.3	1.7	1.6
<b>Total</b>	<b>20.3</b>	<b>19.9</b>	<b>20.3</b>	<b>20.3</b>	<b>20.2</b>	<b>20.2</b>	<b>19.6</b>	<b>19.7</b>	<b>19.6</b>	<b>19.6</b>	<b>19.9</b>	<b>19.8</b>	<b>20.1</b>	<b>19.9</b>
On-budget	17.1	16.6	17.0	17.1	17.0	17.0	16.4	16.5	16.4	16.3	16.5	16.4	16.9	16.6
Off-budget	3.2	3.3	3.3	3.2	3.2	3.2	3.2	3.2	3.2	3.3	3.3	3.4	3.2	3.3
<b>Deficit (-) or Surplus</b>	<b>-1.9</b>	<b>-1.2</b>	<b>-1.1</b>	<b>-1.4</b>	<b>-1.6</b>	<b>-0.8</b>	<b>0.4</b>	<b>0.2</b>	<b>0.3</b>	<b>0.4</b>	<b>0.3</b>	<b>0.5</b>	<b>-0.9</b>	<b>-0.2</b>
On-budget	-3.3	-2.5	-2.5	-2.8	-3.0	-2.3	-1.1	-1.2	-1.1	-0.9	-1.0	-0.7	-2.3	-1.6
Off-budget	1.4	1.3	1.4	1.4	1.4	1.5	1.5	1.4	1.4	1.4	1.3	1.2	1.4	1.4
Debt Held by the Public	37.0	36.4	35.9	35.7	35.6	34.9	33.1	31.5	29.9	28.2	26.8	25.2	n.a.	n.a.

Source: Congressional Budget Office.

Note: n.a. = not applicable.

reflects the growth in domestic corporate profits (as measured in the national income and product accounts), which are expected to increase by more than 4 percent. For both 2006 and 2007, corporate tax receipts as a share of GDP are at the highest level recorded since the late 1970s.

Growth in corporate income taxes has slowed markedly in 2007, however, following three years in which corporate receipts grew by an annual average of almost 40 percent. (Between 2003 and 2007, corporate tax revenue climbed from 1.2 percent of GDP to 2.7 percent, accounting for two-thirds of the overall increase in revenue as a share of GDP over that period.) That rate of growth has slowed progressively throughout this fiscal year (relative to the same period in the previous year), declining from 22 percent in the first quarter (October through December 2006) to 11 percent in the second and 4 percent in the third. That pattern mirrors the path of corporate profits, which peaked in the middle of calendar year 2006. CBO expects the trend to continue and anticipates that quarterly payments in September will show a further decline in the growth of corporate tax revenue (on a year-over-year basis).

### Outlays

CBO estimates that total federal outlays will grow by \$80 billion, or 3.0 percent, this year, reaching over \$2.7 trillion. Outlays will equal 19.9 percent of GDP in 2007—down from 20.3 percent last year.

Spending for mandatory programs is expected to account for more than half of the increase in federal outlays, rising by \$45 billion. Total federal outlays for Medicare and Medicaid are projected to increase, on net, by \$58 billion, while spending for Social Security is expected to rise by \$37 billion. Partially offsetting those increases are lower projected net outlays for other mandatory programs—including flood insurance and student loans—as well as substantial receipts generated by the auction of licenses for use of the electromagnetic spectrum.

Outlays for discretionary programs—whose funding is set anew each year through appropriation acts—are projected to increase by \$26 billion in 2007. The government's net interest costs will rise by \$9 billion in 2007, CBO estimates.<sup>6</sup>

**Mandatory Spending.** Outlays for mandatory programs are generally determined by eligibility rules and benefit

levels that are set in law rather than through the annual appropriation process. The growth of such spending is projected to moderate this year, declining to 3.2 percent; that is the slowest rate of growth recorded since 1997. Excluding net interest payments, mandatory spending will total nearly \$1.5 trillion this year—a figure that represents about 53 percent of total federal outlays for 2007—according to CBO's estimates.

Most of the relatively slow growth of mandatory outlays in 2007 results from factors that are unlikely to persist beyond the current fiscal year—in part because some programs had unusually high outlays in 2006. For example, the flood insurance program experienced a considerable increase in outlays in 2006 because of damage from Hurricane Katrina and other storms. Those claims have largely been paid and, as a result, outlays for the program are projected to drop by about \$16 billion in 2007, to \$0.4 billion. In addition, in 2006, several federal agencies revised previous estimates of subsidy costs for loans and loan guarantees that were issued in past years, which significantly boosted outlays in 2006. Revisions to previous estimates of such subsidy costs in 2007 were about \$16 billion lower than those that occurred in the previous year. Similarly, outlays for the subsidy cost of student loans rose sharply in 2006 as a result of substantial new loan consolidations. Because those costs are not expected to recur in 2007, the subsidy costs of student loans (recorded on a present-value basis) are projected to fall by \$14 billion. In addition, in 2007 the Federal Communications Commission auctioned licenses for use of the electromagnetic spectrum. That transaction brought in receipts—which are recorded as negative outlays—of \$14 billion this year. (Another large auction is planned for 2008.) Finally, the sharp rise in some commodity prices (especially for corn) is expected to reduce spending for agricultural subsidies by \$8 billion in 2007, CBO estimates.

Growth in the largest mandatory programs proceeded apace in 2007. Outlays for Social Security, for now the single biggest mandatory spending program, will rise by 6.9 percent this year, CBO estimates. However, that number reflects some accounting adjustments that the

6. The federal government's net interest payments on debt held by the public are offset by interest income on federal loans and investments on earnings from the National Railroad Retirement Investment Trust.

Treasury Department made for 2006 and 2007.<sup>7</sup> If those adjustments had not occurred, the growth rate for 2007 (as well as for 2006) would have been about 6 percent. Growth in spending on Social Security results from several factors: increases in the number of beneficiaries; increases in the average initial benefit (which is tied to wage growth); and the cost-of-living adjustment that occurs each January (which raised benefit payments this year by 3.3 percent).

Medicare outlays (excluding offsetting receipts from premiums and other sources) are expected to rise much faster than Social Security spending in 2007—by 16.6 percent—largely because 2007 is the first full fiscal year in which the new prescription drug program (Part D of Medicare) will be in effect and because of rapid growth in the Medicare Advantage component of the program. That percentage difference from 2006 outlays, however, overstates the growth in Medicare spending because it reflects shifts in the timing of certain payments.<sup>8</sup> Adjusted for those timing shifts, outlays for Medicare benefits will grow by 12.7 percent in 2007, CBO estimates. Medicare receipts (which partially offset gross Medicare spending) are projected to rise by nearly 32 percent this year, an increase that is primarily attributable to premiums associated with Part D. As a result, net Medicare outlays, adjusted for timing shifts, are estimated to increase by nearly 10 percent.

Federal spending for Medicaid will grow by 6.4 percent in 2007, CBO estimates. Rising caseloads, rate increases for health care providers, and increasing utilization of health care services in 2007 all contributed to that growth. The rate of growth would have been greater but for the fact that Medicaid spending in the first two quarters of fiscal year 2006 included the costs of covering prescription drugs for Medicaid enrollees who also qualified for Medicare; such spending was fully covered by Medicare in 2007.

**Discretionary Spending.** Outlays for discretionary programs are projected to constitute about 38 percent of

federal spending this year. They will rise from almost \$1.02 trillion in 2006 to just over \$1.04 trillion this year, CBO projects. That increase of 2.6 percent is significantly lower than both last year's rate of increase, 5.0 percent, and the 5.9 percent average annual increase recorded in recent years (see Table 1-2).

Roughly half of discretionary outlays are spent on national defense. CBO estimates that defense outlays will total \$547 billion in 2007—an increase of 5.2 percent from last year's level.<sup>9</sup> By contrast, defense outlays grew at an average annual rate of 10.5 percent from 2002 through 2006. Budget authority (the authorization to incur financial obligations that will result in outlays) for defense programs, however, is up by 11.9 percent this year, largely because funding for operations in Iraq and Afghanistan and for other activities related to the war on terrorism rose from \$116 billion in 2006 to \$165 billion in 2007.<sup>10</sup> Much of that budget authority for 2007 will be spent next year and thereafter. Excluding appropriations for military operations in Iraq and Afghanistan and for other activities related to the war on terrorism, budget authority for defense would be 3.9 percent higher in 2007 than it was last year. (For an overview of funding since 2001 for operations in Iraq and Afghanistan and other activities related to the war on terrorism, see Box 1-1.)

Nondefense discretionary outlays are expected to fall slightly this year relative to their level in 2006—from \$496 billion to \$495 billion. The decrease in outlays is largely attributable to a reduction in spending for disaster relief in response to Hurricane Katrina and other 2005 storms. A total of \$87 billion was provided for such purposes in 2005 and 2006; so far this year, an additional \$7 billion has been provided (some of the funding from previous years remains unspent). As a result, outlays by the Federal Emergency Management Agency for disaster relief are projected to fall by \$14 billion in 2007, to a total of \$10 billion. Budget authority for nondefense discretionary programs unrelated to hurricane relief has increased by more than \$16 billion, a rise of 3.8 percent. Among the largest increases in budget authority were

7. The Treasury adjusted both Social Security outlays and tax revenues down by \$6.2 billion in 2006 and shifted \$1.3 billion in 2007 from on-budget to off-budget to correct previous accounting errors related to taxes withheld from Social Security benefits.

8. A shift in certain payments from October to September 2005 and a legislated delay in payments at the end of 2006 have moved an estimated \$9 billion out of 2006 and \$4.7 billion into 2007.

9. Adjusted for a shift in the timing of payments to military personnel, the rate of growth for defense outlays in 2007 would be 6.0 percent.

10. Nondefense funding for operations in Iraq and Afghanistan and for other activities related to the war on terrorism totaled \$4 billion in 2006 and nearly \$6 billion in 2007.



those designated for hospital and medical care for veterans (\$4.8 billion), the Department of Homeland Security (\$4.4 billion), and housing assistance (\$2.2 billion).

**Net Interest.** Federal outlays for net interest payments will jump by 3.9 percent in 2007 to a total of \$235 billion, a figure that equals nearly 9 percent of total spending, CBO estimates. Almost all of this year's increase in net interest payments is attributable to rising short-term interest rates and the growth in the amount of federal debt held by the public.

## Baseline Budget Projections for 2008 Through 2017

Under the assumptions of the baseline, both outlays and revenues grow more rapidly in 2008 than they are expected to this year. Outlays are projected to rise by 7.0 percent, to \$2.9 trillion, and revenues by 7.5 percent, to \$2.8 trillion. At 20.3 percent of GDP and 19.2 percent of GDP, respectively, outlays and revenues would both be higher as a share of the economy this year than CBO projected in March (see Appendix A).

The budget deficit in CBO's baseline would drop slightly next year, to 1.1 percent of GDP, and then increase to roughly 1.5 percent of GDP over the next two years. After that, the expiration of various tax provisions causes the projected budget balance to move from a deficit of 0.8 percent of GDP in 2011 to small surpluses ranging between 0.2 percent and 0.5 percent of GDP through 2017.

### Outlays

In CBO's baseline, total outlays are projected to average roughly 20 percent of GDP over the next 10 years, slightly below the 20.6 percent average during the past 40 years. Under current law, mandatory spending is projected to grow more than a percentage point faster per year than nominal GDP. As a result, mandatory outlays would reach 12.0 percent of GDP by 2017, compared with 10.8 percent in 2008, CBO estimates. By contrast, discretionary spending in the baseline is assumed to grow at the rate of inflation (which is lower than the growth rate of GDP); consequently, projected discretionary outlays fall from 7.8 percent of GDP in 2008 to 6.4 percent in 2017. Spending on net interest is projected to remain steady as a percentage of GDP through 2010 and gradually fall thereafter as baseline deficits decline.

**Mandatory Spending.** Outlays for mandatory programs are expected to total almost \$1.6 trillion in 2008, with nearly 80 percent going for Medicare, Medicaid, and Social Security. CBO estimates that under current law, mandatory spending will grow at an average rate of 5.9 percent a year over the 2008–2017 period, reaching \$2.6 trillion by 2017 (see Table 1-4). Spending on federal health care programs is expected to exceed that average rate—growing by about 7 percent for Medicare and by about 8 percent for Medicaid—whereas outlays for most other mandatory programs are projected to grow more slowly.

In the absence of program changes, spending for Medicare will continue its strong growth, as caseloads increase and the costs of services rise. Partially restraining that growth is the formula for setting Medicare's payment rates for physicians—the sustainable growth rate formula—which, if left in place, would reduce those rates by about 10 percent in 2008 and by additional amounts for several years thereafter.<sup>11</sup> Despite those scheduled rate reductions, the annual rate of growth for Medicare spending is projected to accelerate, rising from about 6 percent in 2008 to nearly 9 percent by 2017.<sup>12</sup> CBO anticipates that outlays for Medicare benefits will rise from 3.2 percent of GDP (\$436 billion) in 2007 to 4.0 percent of GDP (\$854 billion) in 2017.

Similarly, CBO expects Medicaid outlays to rise steadily over the next 10 years, at an average annual rate of about 8 percent. By 2017, under current law, federal outlays for Medicaid will equal 1.9 percent of GDP (\$417 billion), up from a projected 1.4 percent of GDP (\$192 billion) in 2007, CBO estimates.

As members of the baby-boom generation start becoming eligible for Social Security benefits in 2008, the growth of spending under that program will accelerate. The number of people receiving benefits will rise from 50 million in 2008 to 62 million by 2017, CBO estimates. At that point, outlays for Social Security are expected to total 4.8 percent of GDP, compared with 4.3 percent in 2008.

11. For more details on the sustainable growth rate formula, see Congressional Budget Office, *The Sustainable Growth Rate Formula for Setting Medicare's Physician Payment Rates* (September 7, 2006).

12. Growth rates for 2008 and 2017 have been adjusted to exclude certain shifts in the timing of payments to managed care providers.

**Box 1-1.****Funding for Operations in Iraq and Afghanistan and for Other Activities Related to the War on Terrorism**

Since September 2001, the Congress and the President have provided a total of \$602 billion in budget authority for military and diplomatic operations in Iraq, Afghanistan, and other regions in support of the war on terrorism and for related veterans' benefits and services (see the table on the facing page). In addition, although not explicitly appropriated for that purpose, an estimated \$2 billion has been spent by the Department of Veterans Affairs for costs related to the war.<sup>1</sup>

Specific appropriations, which averaged about \$93 billion a year from 2003 through 2005, have risen to \$120 billion in 2006 and \$170 billion in 2007. According to estimates by the Congressional Budget Office (CBO), about \$533 billion of the appropriated sums has been allocated for U.S. military operations and other activities carried out by the Department of Defense (DoD). Lawmakers have also provided approximately \$30 billion to train and equip indigenous security forces in Iraq and Afghanistan. Including that \$30 billion in funding, a total of \$563 billion has been appropriated since September 2001 for defense-related activities in Iraq and Afghanistan and for the war on terrorism. In addition, \$39 billion has been provided for reconstruction and relief efforts, diplomatic and consular operations, embassy construction, economic support, and foreign aid.

1. For a more extensive discussion, see the statement of Robert A. Sunshine, Assistant Director for Budget Analysis, Congressional Budget Office, *Estimated Costs of U.S. Operations in Iraq and Afghanistan and of Other Activities Related to the War on Terrorism*, before the House Budget Committee (July 31, 2007).

DoD reports that it has obligated almost \$11 billion per month thus far in 2007 for operations in Iraq and Afghanistan and for other activities related to the war on terrorism—an increase of nearly \$3 billion compared with average monthly obligations in 2006. Operation Iraqi Freedom accounted for approximately 85 percent of all reported obligations; Operation Enduring Freedom (which refers mainly to operations in and around Afghanistan) accounted for another 15 percent. Additional security missions that have taken place in the United States since the terrorist attacks of September 11, 2001—such as combat air patrols over Washington, D.C., and New York City (known as Operation Noble Eagle)—accounted for less than 1 percent.

Because most appropriations for operations in Iraq and Afghanistan and for other activities related to the war on terrorism appear in the same budget accounts that record appropriations for other DoD activities, determining how much has actually been spent for those activities is difficult. However, CBO estimates that appropriations for military operations in Iraq and for the war on terrorism resulted in outlays of about \$315 billion through fiscal year 2006 (with about \$95 billion occurring in 2006). CBO projects outlays of roughly \$115 billion for war-related defense activities in 2007, an average of between \$9 billion and \$10 billion a month. Of the funds appropriated for international affairs activities related to the war, CBO estimates that close to \$25 billion has been spent through 2006 and that another \$5 billion will be spent in 2007.

Assuming that current laws and policies continue unchanged, spending for mandatory programs other than Medicare, Medicaid, and Social Security is projected to decline over the next 10 years relative to the size of the economy—from 3.2 percent of GDP (\$457 billion) to 2.6 percent (\$561 billion). Some programs are projected to grow moderately and some to decline. For example,

outlays for unemployment benefits are expected to grow at an average rate of 4.9 percent a year over the baseline period (mostly stemming from projections of a larger workforce, a rising unemployment rate, and a higher average benefit). In addition, spending for veterans' programs (primarily for veterans' disability compensation and pensions) is projected to grow at a rate of about

**Box 1-1.****Continued**

**Estimated Appropriations Provided for U.S. Operations in  
Iraq and Afghanistan and for the War on Terrorism, 2001 to 2007**

(Budget authority in billions of dollars, by fiscal year)

	2001	2002	2003	2004	2005	2006	2007	Total, 2001-2007
<b>Military Operations and Other Defense Activities</b>								
Iraq <sup>a</sup>	0	0	46	68	53	89	113	368
Other <sup>b</sup>	<u>14</u>	<u>18</u>	<u>34</u>	<u>21</u>	<u>18</u>	<u>22</u>	<u>39</u>	<u>165</u>
Subtotal	14	18	80	88	70	111	152	533
<b>Indigenous Security Forces<sup>c</sup></b>								
Iraq	0	0	0	5	6	3	6	19
Afghanistan	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>1</u>	<u>2</u>	<u>7</u>	<u>11</u>
Subtotal	0	0	0	5	7	5	13	30
<b>Diplomatic Operations and Foreign Aid</b>								
Iraq	0	0	3	15	1	3	3	25
Other	<u>*</u>	<u>2</u>	<u>5</u>	<u>2</u>	<u>2</u>	<u>1</u>	<u>2</u>	<u>14</u>
Subtotal	*	2	8	17	3	4	5	39
<b>Veterans' Benefits and Services<sup>d</sup></b>								
Iraq	0	0	0	0	0	0	1	1
Other	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>*</u>	<u>*</u>
Subtotal	0	0	0	0	0	0	1	1
<b>Total</b>	<b>14</b>	<b>19</b>	<b>88</b>	<b>111</b>	<b>81</b>	<b>120</b>	<b>170</b>	<b>602</b>

Source: Congressional Budget Office.

Notes: Numbers may not add to totals because of rounding.

\* = between zero and \$500 million.

- CBO estimated the appropriations provided for Operation Iraqi Freedom by allocating funds on the basis of information in budget justification materials and on obligations reported by the Department of Defense.
- Includes Operation Enduring Freedom (in and around Afghanistan); Operation Noble Eagle (homeland security missions, such as combat air patrols, conducted in the United States); the restructuring of Army and Marine Corps units; classified activities other than those funded by appropriations for the Iraq Freedom Fund; efforts to permanently increase the size of the Army and Marine Corps; and other operations. (For fiscal years 2005 through 2007, funding for Operation Noble Eagle has been intermingled with regular appropriations for the Department of Defense; that funding is not included in this table because it cannot be identified separately.)
- Funding for indigenous security forces is used to train and equip local military and police units in Iraq and Afghanistan.
- Excludes almost \$2 billion in estimated spending for medical care, disability compensation, and survivors' benefits for veterans of operations in Iraq and Afghanistan and the war on terrorism. Those amounts are based on CBO's estimates of spending from ongoing programs of the Department of Veterans Affairs and were not explicitly appropriated for war-related expenses.

**Table 1-4.****CBO's Baseline Projections of Mandatory Spending**

(Outlays, in billions of dollars)

	Actual												Total, 2008-	Total, 2008-
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2012	2017
Social Security	544	581	612	643	678	715	757	804	854	908	966	1,029	3,405	7,966
Medicare <sup>a</sup>	374	436	456	488	518	570	572	633	677	726	812	854	2,604	6,306
Medicaid	181	192	209	225	243	263	284	306	331	357	386	417	1,223	3,020
Income Support														
Supplemental Security Income	37	36	41	43	45	51	44	50	51	53	60	56	224	495
Earned income and child tax credits	52	54	56	56	57	57	39	40	40	40	40	40	265	466
Unemployment compensation	31	32	36	38	41	43	45	47	49	51	53	55	203	457
Food Stamps	35	35	37	37	38	38	39	41	42	43	44	46	189	405
Family support <sup>b</sup>	24	24	24	24	24	24	24	24	25	25	25	25	121	245
Child nutrition	14	14	15	16	16	17	18	18	19	20	21	22	81	181
Foster care	6	7	7	7	7	8	8	8	8	9	9	9	37	81
Subtotal	199	202	216	222	228	238	217	228	234	241	252	254	1,121	2,329
Other Retirement and Disability														
Federal civilian <sup>c</sup>	68	88	75	77	81	84	87	90	94	97	100	104	403	888
Military	41	44	46	48	49	50	52	53	54	55	57	58	244	522
Veterans <sup>d</sup>	36	36	40	41	42	46	42	46	47	49	54	52	210	458
Other	5	9	8	8	8	9	9	9	10	10	10	10	42	91
Subtotal	149	177	169	173	180	189	189	198	205	211	221	225	900	1,959

Continued

4 percent per year. By contrast, projected outlays for the refundable portion of the earned income and child tax credits fall sharply in 2012, reflecting the scheduled expiration of various provisions of EGTRRA at the end of calendar year 2010.

Offsetting receipts—certain payments from private entities to the federal government and from one federal agency to another—are reflected in the budget as negative outlays and thus as offsets to mandatory spending. Most of the offsetting receipts are premiums paid by Medicare beneficiaries and the receipts of intragovernmental payments made by federal agencies to finance their employees' benefits. Offsetting receipts will remain stable over the 10-year period, CBO projects, measuring 1.3 percent of GDP in 2008 (\$181 billion) and 1.2 percent each year thereafter.

**Discretionary Spending.** In CBO's latest baseline projections, total discretionary outlays increase at an average rate of 2.5 percent annually, from over \$1.1 trillion next year to almost \$1.4 trillion in 2017 (see Table 1-5).<sup>13</sup> Relative to GDP, discretionary outlays fall from 7.8 percent in 2008 to 6.4 percent in 2017. (The budgetary effects of alternative assumptions about the growth of discretionary spending are discussed later in this chapter.)

13. The rules used to project discretionary spending were set by statute in section 257 of the Balanced Budget and Emergency Deficit Control Act of 1985. Section 257 expired in September 2006, but CBO continues to follow the methodology prescribed in the law. As a result, the baseline assumes that discretionary spending continues at the level of the most recent appropriations, with annual increases based on two projected rates of inflation: the GDP deflator (or GDP price index), which covers price changes for all of the goods and services that contribute to GDP, and the employment cost index for wages and salaries. When CBO next updates its projections, in January 2008, it will do so on the basis of appropriations provided as of that date for fiscal year 2008.

**Table 1-4.****Continued**

(Outlays, in billions of dollars)

	Actual												Total,	Total,
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2008-	2008-
													2012	2017
Other Programs														
Commodity Credit Corporation Fund	18	10	11	8	8	8	8	8	9	9	9	10	44	89
TRICARE For Life	7	8	8	9	9	10	10	11	12	13	14	15	46	111
Student loans	34	7	4	5	5	6	6	5	5	5	5	5	26	53
Universal Service Fund	7	7	8	8	9	9	9	9	9	9	10	10	43	91
SCHIP	5	6	5	5	6	6	6	6	5	5	5	5	27	54
Social services	5	5	5	5	5	5	5	5	5	5	5	5	25	52
Flood insurance	17	*	1	1	1	*	0	0	0	0	0	0	3	3
Other	13	22	29	28	27	25	25	25	25	24	25	32	135	266
Subtotal	106	66	72	70	70	68	69	69	71	71	74	83	349	718
Offsetting Receipts														
Medicare <sup>e</sup>	-49	-64	-67	-71	-76	-81	-86	-92	-98	-105	-114	-124	-381	-915
Employer's share of employee retirement	-47	-48	-51	-53	-55	-58	-60	-63	-66	-68	-71	-81	-277	-626
Other	-44	-84	-64	-58	-57	-58	-59	-61	-62	-60	-62	-58	-295	-598
Subtotal	-141	-196	-181	-182	-188	-196	-205	-216	-226	-234	-248	-263	-953	-2,139
<b>Total Mandatory Spending</b>	<b>1,413</b>	<b>1,457</b>	<b>1,553</b>	<b>1,639</b>	<b>1,729</b>	<b>1,846</b>	<b>1,883</b>	<b>2,022</b>	<b>2,145</b>	<b>2,280</b>	<b>2,465</b>	<b>2,598</b>	<b>8,650</b>	<b>20,160</b>
<b>Memorandum:</b>														
Mandatory Spending Excluding Offsetting Receipts	1,553	1,654	1,734	1,821	1,917	2,042	2,088	2,238	2,371	2,514	2,713	2,861	9,602	22,299
Medicare Spending Net of Offsetting Receipts	325	371	390	416	442	489	486	541	578	621	698	730	2,223	5,391

Source: Congressional Budget Office.

Notes: \* = between zero and \$500 million.

Spending for the benefit programs shown above generally excludes administrative costs, which are discretionary.

SCHIP = State Children's Health Insurance Program.

- Excludes offsetting receipts (funds collected by government agencies from other government accounts or from the public in business-like or market-oriented transactions that are recorded as offsets to outlays).
- Includes Temporary Assistance for Needy Families and various programs that involve payments to states for child support enforcement and family support, child care entitlements, and research to benefit children.
- Includes Civil Service, Foreign Service, Coast Guard, and other, smaller retirement programs as well as annuitants' health benefits.
- Includes veterans' compensation, pensions, and life insurance programs.
- Includes Medicare premiums and amounts paid by states from savings on Medicaid prescription drug costs.

**Table 1-5.****CBO's Baseline Projections of Discretionary Spending**

(Billions of dollars)

	Actual 2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Total, 2008- 2012	Total, 2008- 2017
<b>Budget Authority</b>														
Defense	557	623	640	654	669	685	701	716	733	750	768	786	3,348	7,102
Nondefense	440	446	460	472	481	492	504	516	528	541	554	567	2,410	5,115
<b>Total</b>	<b>996</b>	<b>1,068</b>	<b>1,099</b>	<b>1,126</b>	<b>1,150</b>	<b>1,177</b>	<b>1,205</b>	<b>1,233</b>	<b>1,261</b>	<b>1,291</b>	<b>1,322</b>	<b>1,353</b>	<b>5,758</b>	<b>12,217</b>
<b>Outlays</b>														
Defense	520	547	599	634	656	678	684	704	721	738	761	773	3,251	6,948
Nondefense	496	495	521	531	539	546	555	567	579	592	605	619	2,691	5,653
<b>Total</b>	<b>1,016</b>	<b>1,042</b>	<b>1,120</b>	<b>1,165</b>	<b>1,195</b>	<b>1,223</b>	<b>1,239</b>	<b>1,271</b>	<b>1,300</b>	<b>1,330</b>	<b>1,366</b>	<b>1,392</b>	<b>5,942</b>	<b>12,601</b>

Source: Congressional Budget Office.

Notes: Nondefense discretionary outlays are usually higher than budget authority because of spending from the Highway Trust Fund and the Airport and Airway Trust Fund, which is subject to obligation limitations set in appropriation acts. The budget authority for such programs is provided in authorizing legislation and is not considered discretionary.

Inflation in CBO's baseline is projected using the inflators specified in the Balanced Budget and Emergency Deficit Control Act of 1985: the gross domestic product deflator (now known as the GDP price index) and the employment cost index for wages and salaries.

CBO's projections of discretionary spending over the 2008–2017 period are based on the total amount of funding provided for 2007. That base level includes regular appropriations as well as supplemental appropriations that have been enacted during the year. Specifically, in May, the U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act, 2007 (Public Law 110-28) provided \$117 billion in budget authority for the following: operations in Iraq and Afghanistan and other activities related to the war on terrorism (\$100 billion); hurricane relief (\$7 billion); and other purposes (\$10 billion, more than half of which is for base realignment and closure and military personnel). In addition, \$70 billion in funding for military operations in Iraq and Afghanistan and for other activities related to the war on terrorism was provided in September 2006 (see Table 1-6).

The timing of such appropriations can cause sharp swings in CBO's projections of total discretionary outlays over 10 years. For example, the current baseline extrapolates \$170 billion in funding provided in 2007 for military operations in Iraq and Afghanistan and for other activities related to the war on terrorism. Since only \$70 billion of that total had been provided when CBO completed its previous baseline in March, CBO's projection of discre-

tionary outlays over the 2008–2017 period is now more than \$1 trillion higher than it was in March.

**Net Interest.** Under the assumptions governing the baseline, net interest costs are projected to rise from \$253 billion in 2008 to a peak of \$292 billion in 2012 (see Table 1-7)—an average annual increase of 3.7 percent. After 2012, net interest slowly falls—by an average rate of 1.0 percent a year—to \$278 billion in 2017. Relative to GDP, net interest is projected to remain steady at 1.8 percent through 2010 and then slowly fall to 1.3 percent by 2017.

The baseline further assumes that the statutory limit on federal borrowing is raised as necessary to cover projected deficits as well as debt issued to other federal government accounts. CBO estimates that federal debt will reach the current limit of \$8.965 trillion sometime during the last calendar quarter of 2007.<sup>14</sup>

14. Federal debt subject to that limit includes debt held by the public and debt held by government accounts (such as the Social Security trust funds and the Civil Service Retirement and Disability Fund). It does not include debt issued by the Federal Financing Bank and by agencies other than the Treasury. At the end of 2007, CBO expects, debt held by the public will total \$5.0 trillion and debt held by government accounts will equal \$3.9 trillion.

**Table 1-6.**

## Supplemental Appropriations and Funding for Military Operations in Iraq and Afghanistan and for Other Activities Related to the War on Terrorism, 2007

(Billions of dollars)

	2007 Budget Authority
Funding for Military Operations in Iraq and Afghanistan and for Other Activities Related to the War on Terrorism	
Enacted in September 2006 <sup>a</sup>	70
Enacted in May 2007 <sup>b</sup>	100
Subtotal	170
Funding for Hurricane Relief and Recovery	
Enacted in May 2007 <sup>b</sup>	7
Other Supplemental Funding <sup>b</sup>	10
<b>Total</b>	<b>187</b>

Source: Congressional Budget Office.

- a. Department of Defense Appropriations Act, 2007 (Public Law 109-289), enacted on September 29, 2006.
- b. U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act, 2007 (P.L. 110-28), enacted on May 25, 2007.

### Revenues

Assuming no changes in tax law, CBO projects that total revenues will range between 18.6 percent and 19.2 percent of GDP through 2010, above the average of 18.2 percent recorded between 1966 and 2006. CBO projects that, as a percentage of GDP, growth in individual income tax receipts will be offset by reductions in corporate income tax receipts and (to a lesser extent) by lower receipts from estate and gift taxes and excise taxes. After 2010, projected revenues increase sharply with the expiration of provisions of EGTRRA, JGTRRA, and the Tax Increase Prevention and Reconciliation Act of 2005.<sup>15</sup> By 2012, baseline revenues reach 20 percent of GDP. Because of factors inherent in the structure of the individual income tax (including the structure of the alternative minimum tax), total revenues thereafter rise

relative to the size of the economy, to 20.3 percent of GDP by 2017.<sup>16</sup>

**Individual Income Taxes.** CBO projects that individual income tax receipts as a share of GDP will rise from 8.5 percent this year to 10.7 percent in 2017. Relative to the size of the economy, they are expected to rise in 2008, stabilize through 2010, and increase every year thereafter. Scheduled tax law changes cause CBO's revenue projections to increase in 2008 and rise to a greater extent in 2011 and 2012. In addition, certain characteristics of the tax system push the growth in revenues from individual income taxes above that of GDP in most years. However, in some years, particularly 2009 and 2010, those factors are offset by projected slower growth in capital gains realizations and CBO's assumption that the unexplained recent strength in receipts will begin to decline gradually starting in 2009 and continue over the following several years.

Various changes in tax rules that are now scheduled to occur would boost individual income tax receipts relative to GDP. The higher exemption amounts that have mitigated the effects of the AMT expired at the end of 2006. CBO expects that, absent future legislation, the resulting increase in tax liability in 2007 will be paid almost entirely in fiscal year 2008, boosting receipts relative to GDP by about 0.4 percentage points. Furthermore, a number of tax law changes originally enacted in EGTRRA and JGTRRA are scheduled to expire at the end of December 2010, raising projected revenues sharply in 2011 and 2012. Relative to extension of the provisions, the expirations would increase statutory tax rates on ordinary income, capital gains, and dividends; narrow the 15 percent tax bracket for people who file joint returns; and reduce the child tax credit, among other changes. Those expirations would boost income tax receipts by roughly 1.2 percentage points of GDP through 2017, CBO estimates.

15. The Tax Increase Prevention and Reconciliation Act extended lower tax rates for long-term capital gains and qualified dividends—rates that were originally enacted in JGTRRA—through 2010.

16. Like the rate structure of the regular income tax, the AMT extracts a greater proportion of overall income as real (inflation-adjusted) income rises. But unlike the regular income tax, the AMT is not indexed for inflation. So as incomes rise each year with the overall price level, a larger number of taxpayers find themselves subject to the alternative tax.

**Table 1-7.****CBO's Baseline Projections of Federal Interest Outlays and Debt**

(Billions of dollars)

	Actual 2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Total, 2008- 2012	Total, 2008- 2017
<b>Net Interest Outlays</b>														
Interest on Treasury Debt Securities (Gross interest) <sup>a</sup>	406	430	457	486	516	542	562	578	597	614	631	645	2,562	5,628
Interest Received by Trust Funds														
Social Security	-98	-108	-116	-125	-136	-149	-161	-175	-189	-203	-217	-232	-687	-1,703
Other trust funds <sup>b</sup>	-72	-73	-73	-75	-77	-79	-82	-84	-87	-89	-91	-92	-386	-828
Subtotal	-169	-181	-188	-201	-214	-228	-243	-258	-275	-292	-308	-324	-1,073	-2,531
Other Interest <sup>c</sup>	-7	-10	-14	-17	-20	-22	-25	-28	-31	-34	-38	-42	-98	-271
Other Investment Income <sup>d</sup>	-3	-5	-2	-2	-2	-2	-2	-2	-2	-1	-1	-1	-8	-15
<b>Total (Net interest)</b>	<b>227</b>	<b>235</b>	<b>253</b>	<b>267</b>	<b>281</b>	<b>290</b>	<b>292</b>	<b>290</b>	<b>289</b>	<b>286</b>	<b>284</b>	<b>278</b>	<b>1,383</b>	<b>2,810</b>
<b>Federal Debt<sup>e</sup></b>														
Debt Held by the Public	4,829	4,993	5,163	5,392	5,661	5,807	5,756	5,730	5,674	5,595	5,543	5,439	n.a.	n.a.
Debt Held by Government Accounts														
Social Security	1,994	2,180	2,381	2,597	2,828	3,072	3,328	3,590	3,856	4,126	4,394	4,660	n.a.	n.a.
Other government accounts <sup>b</sup>	1,628	1,725	1,820	1,916	2,012	2,102	2,218	2,326	2,439	2,557	2,659	2,771	n.a.	n.a.
Total	3,622	3,906	4,201	4,513	4,840	5,175	5,546	5,916	6,296	6,682	7,054	7,431	n.a.	n.a.
Gross Federal Debt	8,451	8,899	9,364	9,905	10,501	10,982	11,301	11,645	11,970	12,278	12,597	12,870	n.a.	n.a.
Debt Subject to Limit <sup>f</sup>	8,420	8,868	9,334	9,875	10,472	10,954	11,273	11,618	11,943	12,251	12,570	12,844	n.a.	n.a.
<b>Memorandum:</b>														
Debt Held by the Public as a Percentage of GDP	37.0	36.4	35.9	35.7	35.6	34.9	33.1	31.5	29.9	28.2	26.8	25.2	n.a.	n.a.

Source: Congressional Budget Office.

Note: n.a. = not applicable; GDP = gross domestic product.

- a. Excludes interest costs on debt issued by agencies other than the Treasury (primarily the Tennessee Valley Authority).
- b. Mainly the Civil Service Retirement, Military Retirement, Medicare, and Unemployment Insurance Trust Funds.
- c. Primarily interest on loans to the public.
- d. Earnings on private investments by the National Railroad Retirement Investment Trust.
- e. Debt held at the end of the year.
- f. Differs from gross federal debt primarily because most debt issued by agencies other than the Treasury and the Federal Financing Bank is excluded from the debt limit.



In addition, several characteristics of the tax code cause effective tax rates—the amount of taxes paid as a percentage of personal income—to increase over time. One characteristic is the phenomenon known as real bracket creep, wherein the overall growth of real (inflation-adjusted) income causes more income to be taxed in higher tax brackets. That factor is projected to increase receipts relative to GDP by about 0.6 percentage points over the next 10 years. Moreover, as nominal income rises, a growing share will be claimed by the AMT, which is not indexed for inflation. CBO estimates that, without changes in law, the AMT will increase tax revenue relative to the size of the economy by about 0.3 percentage points between 2007 and 2017. Also, taxable distributions from tax-deferred retirement accounts, such as individual retirement accounts and 401(k) plans, are expected to grow more rapidly than other income as the population ages. Taxation of those sources of retirement income is expected to cause revenues to rise, relative to the size of the economy, by about 0.4 percentage points over the projection period.

CBO's projection of the increase in individual income tax receipts arising from those combined factors is attenuated by projected slower growth in capital gains and by an assumption about how long the current strength of individual income tax receipts will last. Strong growth in capital gains realizations since 2002 has pushed them to a level that is well above that implied by their historical relationship to GDP and the rate at which they are taxed. CBO assumes that capital gains realizations will rise more slowly than GDP except in 2010, when the increase in tax rates on gains—scheduled for 2011—will encourage taxpayers to speed up the sale of assets into 2010. By 2017, capital gains realizations are projected to return to nearly 3.4 percent of GDP, CBO's estimate of the equilibrium given the maximum tax rate on capital gains of 20 percent, which is scheduled to be in effect after 2010. Under those assumptions, revenues are projected to decline relative to GDP by about 0.4 percentage points; half of that drop (absent the effects of scheduled law changes) occurs over the 2009–2011 period.

In addition, overall receipts over the past two years have grown faster than can be explained by current data. The sources of those receipts will not be known until information from 2006 and 2007 tax returns becomes available. In the absence of that information, CBO assumes that

the sources of those receipts will persist through 2008 and then gradually decline over the following several years. Over the longer term, CBO expects, the relationship between taxable income and GDP will return to that seen in the most recently available tax return data. That assumption causes projected revenues to decline as a share of GDP by about 0.3 percentage points.

**Corporate Income Taxes.** After rising sharply for the past four years, revenues from corporate income taxes are projected to decline gradually relative to the size of the economy over the next 10 years: from 2.7 percent in 2007 to 1.9 percent by 2017. The recent growth in corporate tax receipts relative to the size of the economy reflects profits' reaching new highs relative to GDP. CBO expects that over the projection period, both profits and receipts will return to levels more consistent with their historical relationship to GDP. Domestic corporate profits peaked in the middle of 2006, and CBO expects that profits will continue to grow more slowly than GDP after this year. Domestic profits are projected to decrease from about 11.5 percent of GDP in 2007 to about 8.4 percent in 2017, causing a decline in revenues relative to GDP.

**Social Insurance and Other Taxes.** Receipts from social insurance taxes are projected to grow at roughly the same rate as the economy over the next decade, primarily because wages and salaries are projected to remain at a relatively constant share of GDP during that period. As a result, social insurance taxes remain stable at 6.3 percent of GDP through 2017.

Total revenues from sources other than income and payroll taxes are expected to remain at about 1.2 percent of GDP in the first half of the 10-year projection period and then rise slowly to 1.4 percent of GDP by 2017.

The increase in other taxes as a share of GDP can be attributed to changes in the law affecting estate and gift taxes. Under the provisions of current law, receipts from estate and gift taxes are projected to remain at about 0.2 percent of GDP through 2009 and then decline to 0.1 percent of GDP as the estate tax is reduced and, under EGTRRA, ultimately repealed at the end of 2010. However, the estate tax is scheduled to be reinstated in 2011, which causes projected receipts to rebound to 0.3 percent of GDP in 2012 and to 0.4 percent of GDP by the end of the 10-year period.

Revenues from customs duties, earnings of the Federal Reserve System, and other miscellaneous sources are projected to remain relatively stable as a percentage of GDP over the 2008–2017 period.

## Budget Projections Under Alternative Scenarios

Future legislative actions will affect the budget outlook, causing deficits to be higher or lower than they are in CBO's current-law baseline projections. To illustrate the potential effects of some possible legislative actions, CBO has estimated the impact of various alternative scenarios on outlays and revenues as well as on the government's debt-service costs (see Table 1-8).

The annual funding required for operations in Iraq and Afghanistan and for other activities related to the war on terrorism may eventually be less than the amounts in the baseline if the number of deployed troops and the pace of operations diminish over time. Because of considerable uncertainty about those future operations, CBO has formulated two budget scenarios involving the deployment of U.S. forces to Iraq, Afghanistan, and elsewhere in support of the war on terrorism. (Many other outcomes—some costing more and some less—are also possible.) Under both scenarios, the number of active-duty, reserve, and National Guard personnel deployed in the war on terrorism would average about 210,000 in fiscal years 2007 and 2008. That figure reflects the recently implemented plan to increase the number of troops in Iraq and assumes that the Department of Defense will sustain current personnel levels until June 2008. After 2008, force levels under the two scenarios are assumed to decline at different rates and to different sustained levels. The level of spending for support of indigenous security forces in Iraq and Afghanistan and for diplomatic operations and foreign aid is the same under both scenarios.

Under the first scenario, troop levels would be rapidly reduced over a two-year period, with deployed forces declining to an average of roughly 100,000 in 2009 and to 30,000 military personnel overseas in support of the war on terrorism at the start of 2010. That number of deployed troops would be sustained through 2017, although not necessarily in Iraq and Afghanistan. Under such a scenario, discretionary outlays over the 2008–2017 period would be \$1.1 trillion less than the amount recorded in the current baseline.

Under the second scenario, the number of troops would decline more gradually over a six-year period, dropping to an average of about 175,000 in 2009 and continuing to fall steadily in subsequent years until 75,000 remained overseas in 2013 and each year thereafter. Under such a scenario, discretionary outlays for activities related to the war on terrorism would be less than the amount reflected in the baseline by \$647 billion over the 2008–2017 period.

Alternative assumptions could also be made about overall discretionary appropriations. For example, if regular appropriations were assumed to grow through 2017 at the same rate as nominal GDP, rather than at the rate of inflation, total projected discretionary spending would be \$1.3 trillion higher over 10 years.<sup>17</sup> In the other direction, if lawmakers opted not to increase appropriations each year to account for inflation, discretionary outlays would be \$1.4 trillion lower over the 2008–2017 period.

The baseline assumes that major provisions of EGTRRA and JGTRRA—such as the introduction of the 10 percent tax bracket, increases in the child tax credit, repeal of the estate tax, and lower rates on capital gains and dividends—will expire as scheduled at the end of 2010. On balance, the tax provisions that are set to expire during the 10-year projection period reduce revenues; thus, under a scenario in which they were extended, projected revenues would be lower than the amounts indicated in the current baseline. For example, if all expiring tax provisions (except those related to the amount of the exemption for the AMT) were extended, total revenues over the 2008–2017 period would be \$2.3 trillion lower than in the current baseline projection.<sup>18</sup> That estimate reflects the fact that the effect of lowering the amount of taxpayers' regular tax liabilities would be partially offset by an increase in the number of taxpayers subject to the AMT.

Another change in policy that could affect revenues involves the modification of the AMT, which many observers believe cannot be maintained in its current form. Because the AMT's exemption amount and brack-

17. Funding declared to be an emergency requirement was assumed to grow at the baseline rates of inflation.

18. That estimate does not include any macroeconomic effects—unlike CBO's baseline projections, which incorporate the effects that the tax provisions' expiration would have on the economy. However, such effects are likely to be small relative to GDP.

ets are not indexed for inflation, the impact of the tax will grow in coming years as more taxpayers become subject to it. If the AMT was indexed for inflation after 2006 and no other changes were made to the tax code, federal revenues over the next 10 years would be \$621 billion lower than the amount in the baseline, according to CBO and the Joint Committee on Taxation.

Because the number of taxpayers who are subject to the AMT will depend on whether the tax provisions originally enacted in 2001 and 2003 remain in effect, the combination of indexing the AMT for inflation and extending the expiring provisions would reduce revenues by more than the sum of the effects from each policy enacted alone. That interactive effect would lower revenues by an additional \$456 billion between 2011 and 2017.

Combining certain policy alternatives could significantly worsen the budget outlook. For example, if all expiring tax provisions were extended, the AMT was indexed for inflation, regular discretionary appropriations grew at the same rate as nominal GDP, and all other programs operated as assumed in the baseline, the budget would show a deficit equal to 4.4 percent of GDP in 2017. Alternatively, if all other assumptions remained as in the baseline but the number of troops deployed for operations related to the war on terrorism declined to 30,000 by 2010, the projected surplus in 2017 would equal 1.5 percent of GDP.

## Uncertainty and Baseline Projections

CBO's budget projections are based not only on long-standing rules about the treatment of current laws and policies but also on various assumptions about how the economy will perform in the future and how tax and spending policies will affect that performance. Because actual outcomes will almost certainly differ from CBO's projections, it is useful to view those projections as a range of potential outcomes rather than as a single stream of numbers.

Figure 1-2 illustrates a range of possible outcomes for the total deficit or surplus under current laws and policies, using the differences between past CBO baselines and actual budgetary results as a guide. The current baseline projection of the deficit falls in the middle of the highest-probability area, shown as the darkest part of the figure. Other possible paths for the deficit shown in that part of

the figure, although different from the baseline projection, have nearly the same probability of occurring. Paths that fall in progressively lighter parts of the shaded area of the figure are less likely to occur than CBO's current projection, but they still have a significant probability of coming to pass. For example, there is a 50 percent chance that under baseline assumptions, the budget will record a surplus of 0.4 percent of GDP or more in 2012. Even with no changes in policy, there is almost a 40 percent chance that the budget will record a deficit of 0.5 percent of GDP or more in that year.

## The Long-Term Budget Outlook

Despite some improvement in the short-term budget picture, the nation faces substantial fiscal challenges over the long term. In particular, the rates of growth in health care spending will significantly affect the federal budget. Attaining fiscal stability in the coming decades will almost certainly require some combination of reductions in the growth of spending and increases in taxes as a share of the economy.

The future rates of growth for the government's major health care programs—Medicare and Medicaid—will be the primary determinant of the nation's long-term fiscal balance. They are also a primary source of budgetary uncertainty. Over the past four decades, per-beneficiary costs under Medicare and Medicaid have increased about 2.5 percentage points faster per year than has per capita GDP. Should those costs continue to increase at that rate, federal spending on those two programs alone would rise from 4.6 percent of GDP in 2007 to about 20 percent by 2050 (see Figure 1-3). That percentage represents about the same share of the economy that the entire federal budget does today. Even if health care costs grow 2.0 percentage points above per capita GDP—a rate consistent with that experienced in Medicare and Medicaid over the past 15 years—the share of GDP absorbed by the two major health care programs would reach 17 percent of the economy by the middle of the century. (At a rate of growth of 1.0 percent above per capita GDP, the share of those programs would be about 11 percent of GDP by 2050.)

However, if the costs to the federal government of the two health care programs grew at the same rate as income—an assumption that isolates just the effects of demographic changes on the programs—the growth in

**Table 1-8.****The Budgetary Effects of Selected Policy Alternatives Not Included in CBO's Baseline**

(Billions of dollars)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Total, 2008- 2012	Total, 2008- 2017
<b>Policy Alternatives That Affect Discretionary Spending</b>													
Reduce the Number of Troops Deployed for Military Operations in Iraq and Afghanistan and for Other Operations Related to the War on Terrorism to 30,000 by 2010 <sup>a</sup>													
Effect on the deficit or surplus <sup>b</sup>	0	-3	10	65	106	130	139	146	151	156	158	308	1,057
Debt service	0	*	*	2	6	12	19	27	36	45	55	20	203
Reduce the Number of Troops Deployed for Military Operations in Iraq and Afghanistan and for Other Operations Related to the War on Terrorism to 75,000 by 2013 <sup>c</sup>													
Effect on the deficit or surplus <sup>b</sup>	0	-3	-1	18	39	55	83	104	113	119	121	108	647
Debt service	0	*	*	*	2	4	8	13	18	25	32	6	101
Increase Regular Discretionary Appropriations at the Rate of Growth of Nominal GDP <sup>d</sup>													
Effect on the deficit or surplus <sup>b</sup>	0	-12	-33	-59	-87	-114	-142	-172	-202	-233	-265	-305	-1,319
Debt service	0	*	-1	-4	-7	-13	-20	-28	-39	-51	-66	-26	-230
Freeze Total Discretionary Appropriations at the Level Provided for 2007													
Effect on the deficit or surplus <sup>b</sup>	0	20	43	68	95	121	150	178	208	240	270	346	1,392
Debt service	0	*	2	5	9	15	22	31	42	55	70	31	252
<b>Policy Alternatives That Affect the Tax Code</b>													
Extend EGTRRA and JGTRRA <sup>e</sup>													
Effect on the deficit or surplus <sup>b</sup>	0	-2	-2	-6	-151	-249	-274	-283	-293	-303	-316	-410	-1,879
Debt service	0	*	*	*	-4	-14	-28	-43	-59	-76	-95	-19	-319
Extend Other Expiring Tax Provisions													
Effect on the deficit or surplus <sup>b</sup>	0	-13	-20	-28	-36	-43	-48	-52	-57	-61	-66	-140	-424
Debt service	0	*	-1	-2	-4	-6	-9	-12	-15	-18	-22	-14	-90
Index the AMT for Inflation <sup>f</sup>													
Effect on the deficit or surplus <sup>b</sup>	0	-69	-60	-70	-60	-38	-46	-54	-63	-74	-87	-298	-621
Debt service	0	-2	-5	-8	-12	-15	-18	-21	-25	-29	-35	-42	-170

Continued

**Table 1-8.****Continued**

(Billions of dollars)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Total, 2008- 2012	Total, 2008- 2017
<b>Memorandum:</b>													
Interactive Effect of Extending EGTRRA and JGTRRA and of Indexing the AMT													
Effect on the deficit or surplus <sup>b</sup>	0	0	0	0	-22	-57	-63	-69	-76	-82	-88	-78	-456
Debt service	0	0	0	0	-1	-2	-6	-9	-13	-18	-23	-3	-71
Total Discretionary Outlays in CBO's Baseline	1,042	1,120	1,165	1,195	1,223	1,239	1,271	1,300	1,330	1,366	1,392	5,942	12,601
Total Outlays in CBO's Baseline for Military Operations in Iraq and Afghanistan and for Other Activities Related to the War on Terrorism	121	146	165	174	181	183	188	191	195	200	203	849	1,825
Total Deficit (-) or Surplus in CBO's Baseline	-158	-155	-215	-255	-134	62	36	65	85	58	109	-696	-343

Sources: Congressional Budget Office; Joint Committee on Taxation.

Notes: \* = between -\$500 million and \$500 million.

Positive amounts indicate a reduction in the deficit or an increase in the surplus. "Debt service" refers to changes in interest payments on federal debt resulting from changes in the government's borrowing needs.

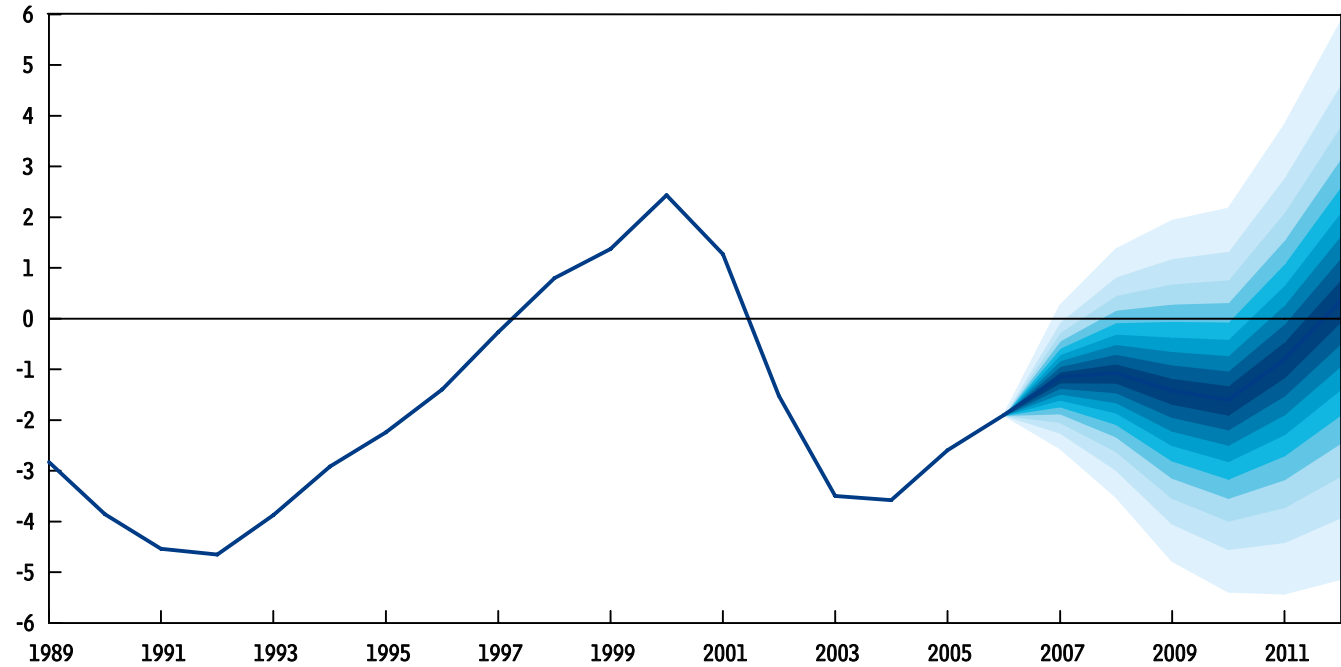
AMT = alternative minimum tax; EGTRRA = Economic Growth and Tax Relief Reconciliation Act of 2001; GDP = gross domestic product; JGTRRA = Jobs and Growth Tax Relief Reconciliation Act of 2003.

- This alternative does not extrapolate to future years the \$170 billion in funding provided for 2007 for military operations in Iraq and Afghanistan and for other activities related to the war on terrorism. Under this scenario, funding for those activities would total \$178 billion in 2008, \$119 billion in 2009, \$61 billion in 2010, and about \$45 billion in 2011 and each year thereafter (for a total of \$669 billion over the 2008–2017 period).
- Excluding debt service.
- This alternative does not extrapolate to future years the \$170 billion in funding provided for 2007 for military operations in Iraq and Afghanistan and for other activities related to the war on terrorism. Under this scenario, funding for those activities would total \$178 billion in 2008, \$156 billion in 2009, \$143 billion in 2010, \$127 billion in 2011, \$102 billion in 2012, and about \$80 billion in 2013 and each year thereafter (for a total of \$1.1 trillion over the 2008–2017 period).
- Under this alternative, appropriations for operations in Iraq and Afghanistan and other activities related to the war on terrorism (as well as other emergency appropriations) are extrapolated to future years according to baseline rules.
- These estimates do not include the effects of extending the increased exemption amount or the treatment of personal credits for the AMT that expired at the end of 2006. The effects of that alternative are shown below.
- This alternative incorporates the assumption that the exemption amount for the AMT (which was increased through 2006 in the Tax Increase Prevention and Reconciliation Act of 2005, or TIPRA) is extended at its higher level and, together with the AMT tax brackets, is indexed for inflation after 2006. In addition, the treatment of personal credits against the AMT (which was extended through the end of 2006 in TIPRA) is assumed to be extended. If this alternative was enacted jointly with the extension of the expiring tax provisions, an interactive effect would occur after 2010 that would make the combined revenue loss over the 2011–2017 period greater than the sum of the two separate estimates (see the memorandum).

**Figure 1-2.**

## Uncertainty of CBO’s Baseline Projections of the Budget Deficit or Surplus Under Current Policies

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Notes: This figure, calculated on the basis of CBO’s track record in forecasting, shows the estimated likelihood of alternative projections of the budget deficit or surplus under current policies. The baseline projections described in Chapter 1 fall in the middle of the darkest area of the figure. Under the assumption that tax and spending policies will not change, the probability is 10 percent that actual deficits or surpluses will fall in the darkest area and 90 percent that they will fall within the whole shaded area.

Actual deficits or surpluses will be affected by legislation enacted in future years, including decisions about discretionary spending. The effects of future legislation are not reflected in this figure.

For an explanation of how CBO calculates the probability distribution underlying this figure, see Congressional Budget Office, *The Uncertainty of Budget Projections: A Discussion of Data and Methods* (March 2007).

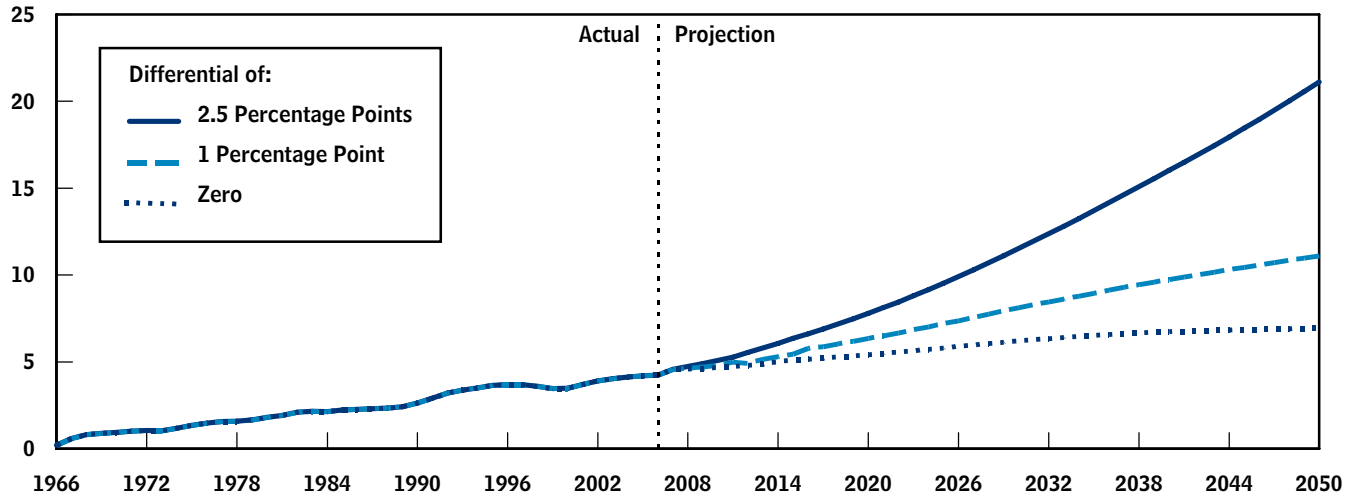
spending by 2050 would be much smaller, rising to only about 7 percent of GDP. That observation underscores the fact that the rate at which health care costs grow compared to per capita income—rather than the aging of the population—is the key determinant in the nation’s long-term fiscal outlook.

The aging of the population does have some impact on the budget, though, particularly as that demographic shift affects Social Security. CBO projects that under current law, Social Security spending will rise from its current level of 4.2 percent of GDP in 2007 to 6.4 percent of GDP in 2050, an increase of 50 percent.

**Figure 1-3.**

## Total Federal Spending for Medicare and Medicaid Under Different Assumptions About the Health Cost Growth Differential

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Note: The health cost growth differential refers to the number of percentage points by which the growth of annual health care spending per beneficiary is assumed to exceed the growth of nominal gross domestic product per capita, after an adjustment for the growth and aging of the Medicare and Medicaid populations.

If tax revenues as a share of GDP remain at historical levels (about 18.2 percent of GDP), additional spending for Medicare, Medicaid, and Social Security will eventually cause future budget deficits to become unsustainable. Even if revenues follow the path projected under current law and rise to about 24 percent of GDP by 2050, budgetary pressures would increase significantly.<sup>19</sup> As a result, substantial reductions in the projected growth of

spending, a sizable increase in taxes as a percentage of the economy, or some combination of changes in policies for spending and revenues is likely to be necessary to achieve fiscal stability in the coming decades. Such policy changes would certainly have some effect on the economy, but those effects would probably be less than the costs of allowing deficits to grow to unsustainable levels.<sup>20</sup>

19. For more information on revenue scenarios, see Congressional Budget Office, *The Long-Term Budget Outlook* (December 2005).

20. See Congressional Budget Office, Letter to the Honorable Judd Gregg, *Financing Projected Spending in the Long Run* (July 9, 2007).





## The Economic Outlook

**A**lthough the economic outlook has been clouded by recent problems in the housing market and disruptions in financial markets, the most likely scenario is that economic performance will remain sound. In particular, the Congressional Budget Office projects that gross domestic product will increase by 2.1 percent after inflation (in “real” terms) this year and by 2.9 percent next year (see Table 2-1). Employment growth, which slowed slightly in late 2006, is projected to continue to post moderate gains, keeping the unemployment rate near its current 4.6 percent through 2008. Inflation, as measured by the year-to-year change in the consumer price index for all urban consumers (CPI-U), is projected to decline from 2.8 percent this year to 2.3 percent next year. Rates of inflation for food and energy prices, which increased during the first half of this year, are expected to moderate, keeping overall inflation lower than in the recent past. In addition, the underlying (or core) rate of consumer price inflation is expected to be relatively stable, averaging slightly above 2 percent over the next year and a half. The interest rate on 3-month Treasury bills averages 4.8 percent in 2007 and 2008 in CBO’s forecast, and the interest rate on 10-year Treasury notes increases from an average of 4.9 percent in 2007 to 5.2 percent in 2008.

CBO’s projections beyond the two-year horizon, for 2009 to 2017, indicate real growth averaging 2.7 percent and CPI-U inflation averaging 2.2 percent. The projected rate of real GDP growth is lower in the latter half of the projection period because the growth of the labor force will slow as members of the baby-boom generation begin to retire. The unemployment rate averages 4.8 percent after 2008, while the interest rate on 3-month Treasury bills averages 4.7 percent and that on 10-year Treasury notes averages 5.2 percent.

Those projections are subject to many uncertainties. One important risk is how the growing defaults and losses on home mortgages will affect the availability of credit for all

borrowers. CBO’s forecast assumes that the problems in mortgage markets will lead to stricter lending standards and higher costs for mortgage borrowing and will continue to depress the housing sector; however, in CBO’s estimation, the most likely scenario is that those problems will not seriously interfere with the cost or availability of business and consumer credit for borrowers with good credit ratings. It is possible, though, that borrowing costs for businesses and consumers could rise significantly. Another important uncertainty is the extent of the problems in the housing market, which affect not only housing construction and sales but also consumer spending through the value of housing wealth. Although CBO expects that the housing sector will begin to recover by the middle of next year, the recent turmoil in financial markets could stall that recovery. Finally, economic activity abroad could be stronger or weaker than CBO anticipates, resulting in more or fewer exports of goods and services than CBO expects.

### The Pause in Growth

After growing at an average rate of 3½ percent from early 2003 to the middle of 2006, real GDP increased by only 1¼ percent during the second half of 2006 and the first quarter of this year. The major causes of the slowdown were a steady increase in short-term interest rates since mid-2004 and a large decline in housing construction. Rising prices for commodities—particularly oil—also dampened growth.

### The Rise in Interest Rates and the Decline in Housing Construction

In an effort to make interest rates consistent with a combination of steady growth and low inflation, the Federal Reserve pushed up the federal funds rate, a short-term interest rate that it manages, from 1 percent in mid-2004 to 5¼ percent in mid-2006, where it remains today (see Figure 2-1). A continuation of the low interest rates seen

**Table 2-1.****CBO's Economic Projections for Calendar Years 2007 to 2017**

	Actual 2006 <sup>a</sup>	Forecast		Projected Annual Average	
		2007	2008	2009 to 2012	2013 to 2017
<b>Year to Year (Percentage change)</b>					
Nominal GDP (Billions of dollars)	13,247	13,893	14,575	17,595 <sup>b</sup>	21,829 <sup>c</sup>
Nominal GDP	6.3	4.9	4.9	4.8	4.4
Real GDP	3.3	2.1	2.9	3.0	2.6
GDP Price Index	2.9	2.7	2.0	1.8	1.8
PCE Price Index	2.7	2.3	2.0	1.8	1.9
Core PCE Price Index <sup>d</sup>	2.2	2.0	1.9	1.9	1.8
Consumer Price Index <sup>e</sup>	3.2	2.8	2.3	2.2	2.2
Core Consumer Price Index <sup>f</sup>	2.5	2.6	2.2	2.3	2.2
<b>Calendar Year Average (Percent)</b>					
Unemployment Rate	4.6	4.5	4.7	4.8	4.8
Three-Month Treasury Bill Rate	4.7	4.8	4.8	4.7	4.7
Ten-Year Treasury Note Rate	4.8	4.9	5.2	5.2	5.2
Tax Bases (Billions of dollars)					
Corporate book profits	1,811	1,880	1,897	1,995 <sup>b</sup>	2,352 <sup>c</sup>
Wages and salaries	6,031	6,383	6,703	8,104 <sup>b</sup>	10,016 <sup>c</sup>
Tax Bases (Percentage of GDP)					
Corporate book profits	13.7	13.5	13.0	11.9	10.9
Wages and salaries	45.5	45.9	46.0	46.0	46.0
<b>Fourth Quarter to Fourth Quarter (Percentage change)</b>					
Nominal GDP	5.7	5.1	4.9	4.8	4.4
Real GDP	3.1	2.2	3.0	2.9	2.5
GDP Price Index	2.5	2.8	1.8	1.8	1.8
PCE Price Index	1.9	2.7	1.9	1.8	1.9
Core PCE Price Index <sup>d</sup>	2.2	1.9	1.9	1.9	1.8
Consumer Price Index <sup>e</sup>	1.9	3.6	2.1	2.2	2.2
Core Consumer Price Index <sup>f</sup>	2.7	2.6	2.1	2.3	2.2

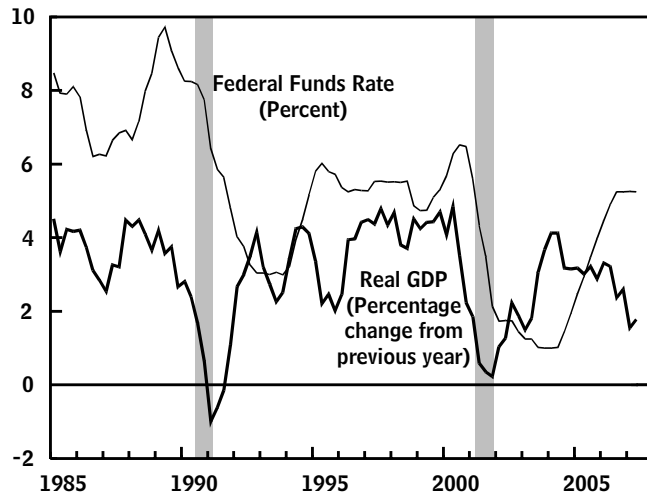
Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

Notes: GDP = gross domestic product; PCE = personal consumption expenditures.

Economic projections for each year from 2007 to 2017 appear in Appendix C.

- a. Values as of early July 2007, prior to the revisions to the national income and product accounts.
- b. Level in 2012.
- c. Level in 2017.
- d. The personal consumption expenditure chained price index excluding prices for food and energy.
- e. The consumer price index for all urban consumers.
- f. The consumer price index for all urban consumers excluding prices for food and energy.

**Figure 2-1.**  
**Real GDP and the Federal Funds Rate**



Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Federal Reserve Board.

Notes: GDP = gross domestic product.

Data are quarterly and are plotted through the second quarter of 2007.

in 2003 and 2004 would ultimately have caused the demand for goods and services to outpace the economy’s ability to produce, resulting in inflationary pressures.

An increase in interest rates initially inhibits growth in sectors of the economy that most depend on financing—consumer durable goods (such as motor vehicles) and both residential and business investment. Spending on consumer durable goods and business investment was moderately dampened by the recent rise in short-term interest rates. The housing sector, which had been in a boom since 2003 and was most vulnerable to the interest rate hike, declined sharply in 2006 and continued to weaken this year (see Figure 2-2).

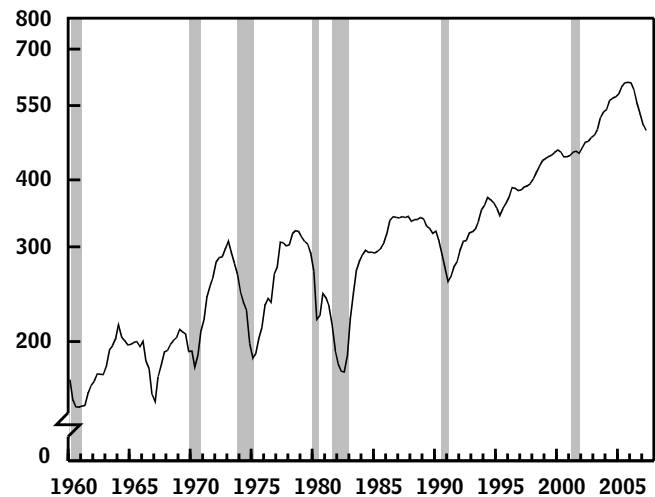
Changes in interest rates were an important factor in the recent boom-and-bust cycle in housing sales and construction. Low mortgage rates initially spurred demand for houses in 2003 as rates for 30-year conventional mortgages, which had averaged 7.6 percent from 1995 through 2000, dropped to 5.8 percent in 2003 and gen-

erally remained below 6 percent until the fourth quarter of 2005. Those low mortgage rates—along with a generally strong economy and an increase in the use of nontraditional financing arrangements (such as adjustable-rate mortgages with repayment options, known as option ARMs)—boosted the demand for homes and ultimately bid up prices. Housing prices and construction both grew rapidly from the middle of 2003 to early 2006. That price appreciation may have further fuelled demand by causing some buyers to have unrealistically high expectations for future prices, particularly for houses in areas where employment and income growth were relatively strong.

In early 2006, home sales and construction began to falter, and housing price appreciation slowed as the combination of increased mortgage rates and high house prices reduced the affordability of buying a house. By mid-2007, housing construction activity was 32 percent lower than it had been in early 2006 and housing prices were

**Figure 2-2.**  
**Real Private Residential Investment**

(Billions of chained 2000 dollars, log scale)

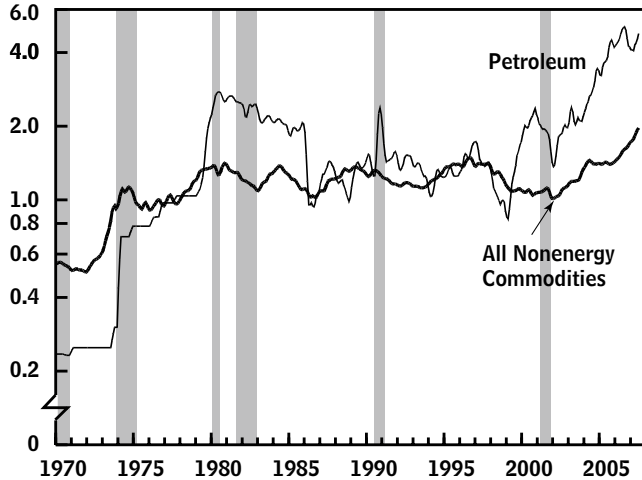


Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

Note: Data are quarterly and are plotted through the second quarter of 2007.

**Figure 2-3.**  
**Commodity Prices**

(Index, 1977 = 1.0, log scale)



Sources: Congressional Budget Office; Commodity Research Bureau; *Wall Street Journal*.

Note: Data are three-month moving averages and are plotted through July 2007. Petroleum prices are for West Texas intermediate. Before 1982, they refer to the posted price; for later years, they refer to the spot price.

about 2.8 percent lower.<sup>1</sup> The direct effect of the fall in residential investment reduced real GDP growth in the second half of 2006 and the first quarter of 2007 by more than a percentage point.

The rise in interest rates and the decline in housing activity also slowed the growth in demand for durable goods, which in turn curbed the growth of manufacturing output and inventory accumulation. Motor vehicle sales were lower in 2006 than in 2004 and 2005, and businesses' demand for equipment stagnated. With the slower growth in demand for goods, aggregate weekly hours worked in manufacturing declined, after having been on an upward trend from the middle of 2005 to the middle of 2006.

1. The information on housing prices comes from the S&P/Case-Shiller home price index. That index measures growth in the prices of existing single-family homes (excluding condominiums and cooperatives) by tracking repeat sales of properties in 20 metropolitan areas. That method reduces distortions resulting from changes over time in the type, size, or other physical characteristics of homes sold, which affect some other measures of housing prices.

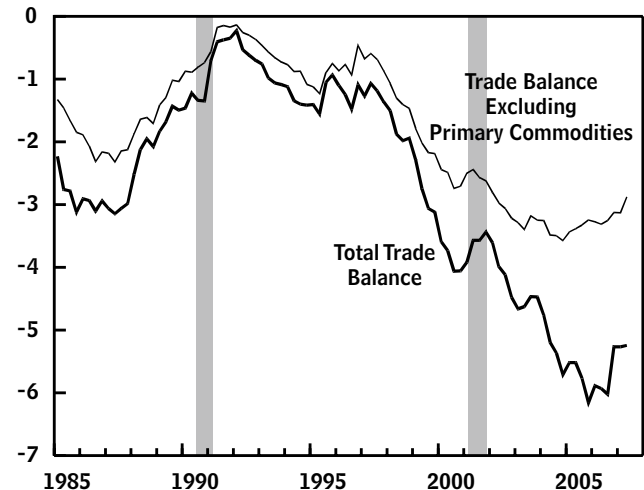
**The Increase in Commodity Prices**

Consumer energy and food prices have jumped in recent years because of higher prices for commodities, and the general rise in those prices appears to have also played a role in the slowdown in growth last year. The price of West Texas intermediate crude oil climbed from \$29.76 a barrel in December 2003 to a peak of \$73.77 a barrel in July 2006; oil prices then dropped during the second half of 2006 but rose close to their previous peak in July of this year. Prices have increased recently for many other commodities as well. During 2006 and through the first half of 2007, the prices of virtually all commodities—foodstuffs, metals, and many other raw industrial materials—rose rapidly (see Figure 2-3).

The rise in commodity prices has pushed up some consumer prices. For example, gasoline prices and food prices are directly influenced by the prices for oil and agricultural products. Higher prices for those goods hurt consumers' real incomes in the first half of 2007, possibly

**Figure 2-4.**  
**The Total Trade Balance and the Balance Excluding Primary Commodities**

(Percentage of gross domestic product)



Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

Note: Primary commodities are industrial supplies and materials, including petroleum, and food, feed, and beverages. Data are quarterly and are plotted through the second quarter of 2007.

contributing to the second quarter's weak growth of inflation-adjusted consumer spending. If price hikes indeed curbed spending in the spring, it appears that consumers were less willing or able to cushion the effect of price increases on their spending than they were as energy prices rose over the previous three years.

Whatever their impact on consumer spending, the sharp increases in commodity prices appear to have affected real growth in domestic output in the short run by diverting demand abroad. The dollar value of U.S. imports of commodities far exceeds the dollar value of U.S. exports, so a sudden increase in commodity prices, particularly for petroleum, causes the nominal trade deficit to rise in the short term. That increase temporarily siphons spending power out of the United States. A major factor in the increase in the overall trade deficit in recent years has been the increase in the trade deficit for primary commodities (see Figure 2-4). Although it is an oversimplification to look at a single component of the trade deficit in isolation, the increase in commodity prices reduced real spending power between 2004 and early 2006 and probably contributed to the pause in growth last year.

### Projected Rebound in GDP Growth

Real GDP grew by 2 percent in the first half of 2007, and despite further declines in the housing sector and the turbulence in financial markets, the most likely scenario is for growth on the order of 2½ percent for the second half of the year. A moderate rebound in business fixed investment as well as solid growth in exports and, in the near term, in government spending for goods and services should offset the drag from the housing sector and keep the anticipated slowdown in consumer spending mild.

### Continued Weakness in Housing

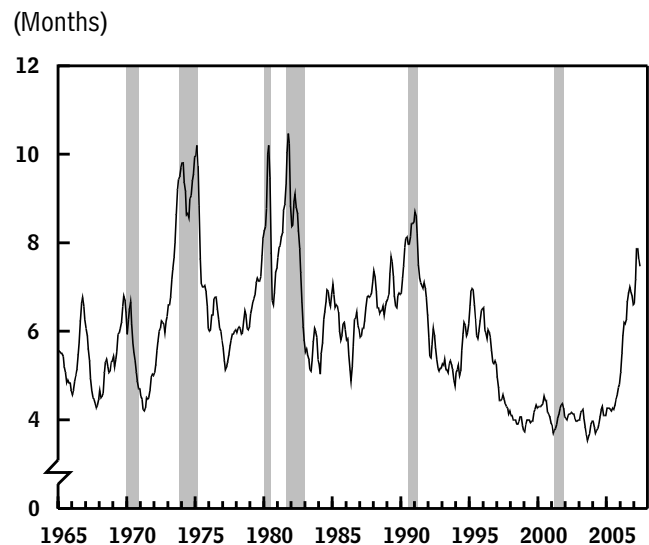
Although the housing sector slowed the growth of the overall economy significantly for the past year and a half—directly through the reduction in construction and sales, and indirectly through the slowing in the growth of housing wealth and the problems in mortgage markets—the most likely scenario for the rest of this year and in 2008 is that the combined effects of the housing sector on the economy will temper growth only slightly. CBO anticipates that housing construction will continue to contract for the rest of this year, but at a rate that is slower than the drop of the past year and a half. There is a significant risk, however, that the problems in mortgage markets will delay the recovery of the housing sector.

**Construction and Sales.** The large inventory of unsold new homes is likely to further depress housing construction in the near term. The number of months' supply of new single-family homes at current sales rates, a commonly used measure of excess inventory and a short-run leading indicator for housing construction, rose quickly in recent months and is higher than it has been since 1991 (see Figure 2-5). Continued weakness in confidence among home builders also indicates near-term weakness in construction. If sales remain low, builders will continue to postpone new construction to reduce their inventories of unsold homes.

Stricter lending terms and standards for mortgage loans in the wake of greater delinquencies and foreclosures are also likely to restrain the housing market in the coming year. For example, the interest rate on fixed-rate first mortgages, as reported by the Federal Home Loan Mortgage Corporation, was 6.7 percent in July, up from an

**Figure 2-5.**

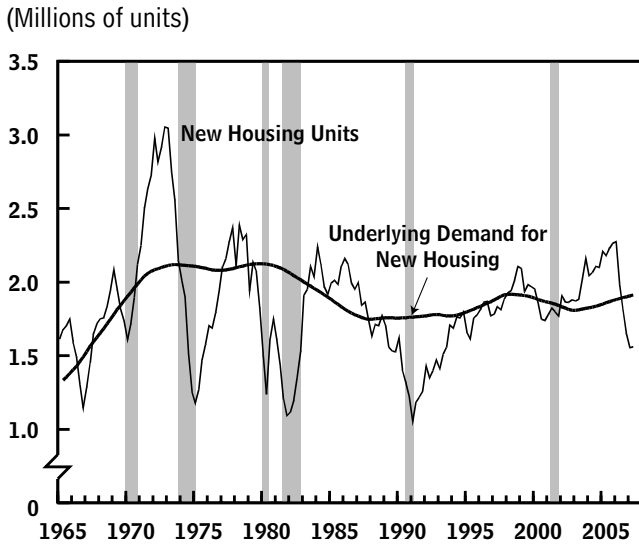
### Months' Supply of New Single-Family Homes for Sale



Sources: Congressional Budget Office; Department of Commerce, Bureau of the Census; Department of Housing and Urban Development.

Note: Months' supply is the number of months it would take to sell the supply of unsold new single-family homes at the current sales rate. Data are three-month moving averages and are plotted through June 2007.

**Figure 2-6.**  
**New Housing Units and the Underlying Demand for New Housing**



Sources: Congressional Budget Office based on data from Global Insight; Department of Commerce, Bureau of the Census.

Note: New housing units are the total number of housing starts (single-family and multifamily) plus mobile home shipments. The underlying demand for new housing is based on the growth in the number of households and the depreciation of the housing stock. Data are quarterly and are plotted through the second quarter of 2007.

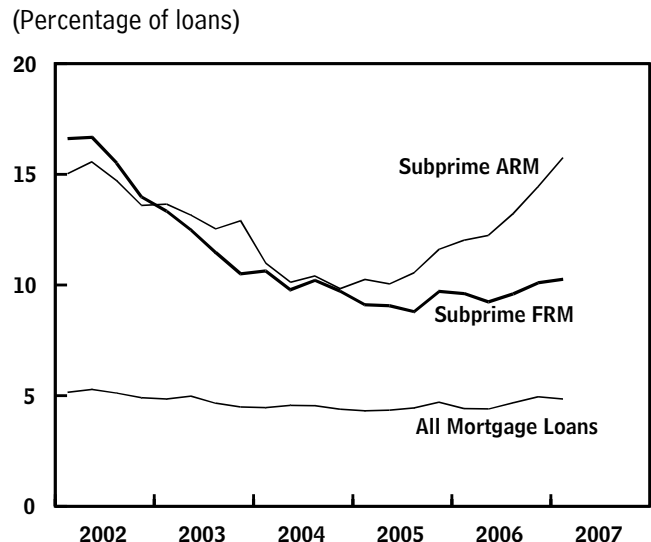
average of 6.2 percent in the first quarter of this year. The Federal Reserve also has found that many commercial banks have tightened standards on mortgage loans this year, particularly for subprime and nontraditional mortgages.

CBO’s forecast assumes that the housing sector will begin to strengthen in 2008, in part because of ongoing moderate gains in employment and household income. That economic environment will support stronger growth in housing sales and new-home construction. In addition, an indicator of the underlying demand for new housing—a rough measure of the need for housing units based on the growth in the number of households and an estimate of the need for replacement housing due to depreciation of the housing stock—suggests that housing starts are currently below underlying demand (see Figure 2-6). Although that measure cannot predict when housing starts will return to the level of underlying demand, it indicates a tendency toward recovery over the next few years.

**Problems in Mortgage Markets.** Many of the recent problems in mortgage markets have come from subprime mortgages, particularly subprime ARMs. Subprime mortgage loans generally are made to borrowers who have poor credit histories, make unusually small down payments (or finance their down payment with a second mortgage), or are not required to provide the usual documentation about their creditworthiness to their lenders. The share of subprime mortgages rose rapidly after 2002, and more than 20 percent of total home mortgage originations (in dollar terms) in the past two years were for subprime loans. By the end of 2006, the outstanding value of subprime mortgages totaled an estimated \$1.2 trillion and accounted for about 12 percent of all home mortgages. Many of the subprime loans made in recent years are ARMs that have very low initial interest rates, known as “teaser rates,” that reset to higher rates after one or more years.

Delinquencies and foreclosures on subprime loans have risen rapidly, particularly for subprime ARMs. In the first quarter of 2007, almost 16 percent of subprime ARM

**Figure 2-7.**  
**Mortgage Delinquencies**

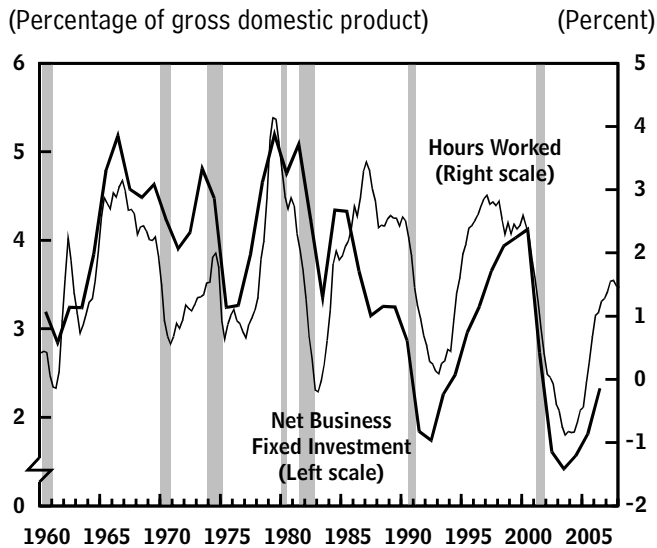


Sources: Congressional Budget Office; Mortgage Bankers Association.

Notes: ARM = adjustable-rate mortgage; FRM = fixed-rate mortgage.

Data are quarterly and are plotted through the first quarter of 2007.

**Figure 2-8.**  
**Net Business Fixed Investment and**  
**Hours Worked**



Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics.

Note: The measure of hours worked is quarterly data plotted as the average annual growth rate over the previous four years. The series includes a forecast through the end of 2007. Net business fixed investment is annual data plotted through 2006.

loans were delinquent, up from a recent low of 10 percent in the second quarter of 2005 (see Figure 2-7). The share of subprime ARMs entering foreclosure increased from an average of 1.5 percent in 2004 and 2005 to 3.2 percent in the first quarter of 2007.

Delinquencies and foreclosures will rise in coming years as interest rates reset on both prime and subprime ARMs, but those problems are likely to be manageable, in CBO's view. As borrowers pay higher rates on ARMs, their household spending on goods and services will be affected. The increase in mortgage payments by those borrowers may be on the order of \$40 billion a year for the next few years.<sup>2</sup> That amount, although substantial, is small relative to the almost \$10 trillion in current consumer spending.

2. See Christopher L. Cagan, *Mortgage Payment Reset: The Issue and the Impact* (Santa Ana, Calif.: First American CoreLogic, March 19, 2007).

Higher rates of foreclosure may further depress housing prices, undermining efforts to refinance, pushing more homes into foreclosure, and slowing consumer spending by reducing the growth of household wealth. CBO anticipates that such a development would put downward pressure on housing prices, delaying the recovery of the housing sector, but the effect on consumer spending is not expected to be significant.

### Moderate Rebound in Business Fixed Investment

In the absence of broad problems in credit markets, real business fixed investment is forecast to grow faster than GDP over the next two years. Investment in business structures, which is still recovering from the recession of 2001, is likely to continue its recent pattern of rapid growth during the second half of 2007. Growth in the other major category of investment, equipment and software, will also support GDP in the near term. The recent turbulence in financial markets, however, could dampen business fixed investment by raising firms' borrowing costs and fostering greater uncertainty about the business climate in the near term.

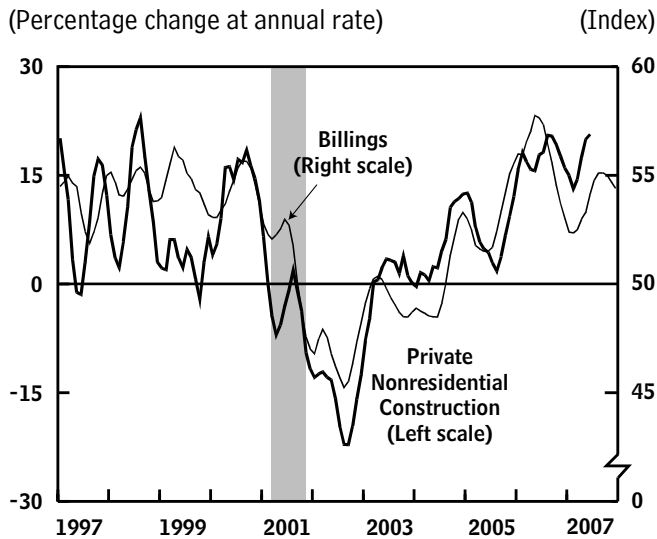
Investment spending by businesses on equipment and software was surprisingly weak in late 2006 and early 2007. Economists had generally expected that investment spending would continue to outpace growth in the economy overall and help dampen the effects of the housing downturn, but investment spending showed virtually no growth during the last quarter of 2006 and the first quarter of 2007.

However, the historical relationship between hours worked and business investment suggests future growth in investment spending. Businesses satisfy growing demand for their output by adding to their capital stock (through investment spending), by increasing hours worked (largely through overtime and hiring more workers), and, if possible, by increasing their total productivity. They can change labor hours more quickly than they can change their stock of plant and equipment, so growth in hours worked is generally a leading indicator of net investment.<sup>3</sup> Given the growth in hours worked over the past four years, it appears that business fixed investment has room to increase (see Figure 2-8). That historical relationship did not seem to hold true during the recent pause in investment, however. One explanation may be

3. Net investment is gross investment minus depreciation, which is the wearing out and obsolescence of capital.

**Figure 2-9.**

## The AIA Architecture Billings Index and Private Nonresidential Construction



Sources: Congressional Budget Office; American Institute of Architects (AIA); Department of Commerce, Bureau of the Census.

Note: The AIA Architecture Billings Index, which indicates future construction activity, is converted to a five-month moving average for the period ending six months earlier. Any score above 50 indicates an increase in billings. Private nonresidential construction is the growth over the previous six months at an annual rate. Both the converted AIA index and the construction series are smoothed using a three-month moving average and include data through June 2007.

that firms have been able to manage well with a lower amount of equipment and structures relative to output than the patterns of the past would suggest.

CBO's forecast assumes that firms will not be able to continue to make such extraordinary gains in the productivity of capital in the future. If they can, then investment spending may be lower than CBO anticipates. However, an alternative explanation of recent experience is that firms, seeing a mild slackening in the growth of sales for their goods and services, simply postponed needed investment spending in order to better determine how long the period of weaker demand growth would last. If that explanation is correct, investment spending might be stronger than in CBO's forecast.

**Equipment and Software.** Real investment in producers' durable equipment and software (PDE) increased at a

2.3 percent annual rate in the second quarter of 2007. Nominal orders for nondefense capital equipment excluding aircraft, a leading indicator of investment in PDE, rose at about an 11 percent annual rate in the second quarter, pointing to further gains in such investment in the second half of this year. The recovery in business investment coincides with a mild recovery in manufacturing that is implied by the Institute of Supply Management's PMI index for manufacturing. That index averaged 54.9 over the past four months, up from its average of 50.9 for the previous six months.

**Structures.** Because of the usual long lags in starting and completing new projects, investment in structures began to recover from the recession of 2001 much later than investment in equipment and software, and, for the same reason, it is likely to remain solid over the next two years. The fall in vacancy rates for commercial buildings since early 2004, which has continued despite strong growth in construction since late 2005, implies further growth. The American Institute of Architects' "work on the boards" survey of architectural firms—a useful leading indicator of growth in nominal business fixed investment in structures—is consistent with that assessment. Readings have been fairly strong in recent months (see Figure 2-9), indicating continued healthy growth of nonresidential construction through the rest of this year.

### Continued Strong Growth in Exports

In CBO's estimation, foreign economic activity will continue to support growth in the United States over the next few years. Real GDP growth among the United States' major trading partners is forecast to remain above 4 percent for some time—significantly higher than growth in the United States. Average growth during the 2007–2008 period is expected to be about 5 percent for 15 Asian Pacific countries, about 4½ percent for Latin America, and about 2½ percent for Western Europe and Canada.

The continued growth abroad over the past year in the wake of the slowdown in growth in the United States suggests that other countries' economic growth is becoming less dependent on exporting to the United States. An increasing proportion of foreign output is used to satisfy demand for goods and services within those countries and for exports to countries other than the United States. Such a shift, from a dependence on demand in the United States to demand abroad, will stem the increase in



the trade and current-account deficits of the United States.

CBO also expects that a continued decline in the exchange value of the U.S. dollar will help to reduce the nation's large current-account deficit. As of July 2007, the dollar was at a 26-year low against the British pound and at its lowest value against the euro since that currency's creation in 1999. Some of the recent weakness in the dollar stems from rising interest rates in Europe, but the dollar has been on a downward trend since 2002. CBO's forecast assumes that the trade-weighted value of the dollar will decline at roughly a 2 percent to 3 percent annual rate throughout the 10-year projection period. That rate is slightly slower than the decline of the past five years, which averaged about 3½ percent per year.

The combination of more rapid growth in demand abroad than in the United States and the continuing fall in the value of the dollar will ultimately cause the trade deficit to decline as a share of GDP. Exports grew faster than imports over the past six quarters, and despite this summer's turbulence in global financial markets, CBO expects that trend to continue.

### **Acceleration of Government Spending on Goods and Services**

Federal spending on goods and services will give a lift to demand for the rest of this year and next year, primarily as a result of additional discretionary outlays. Spending by state and local governments is expected to be solid as well, helped by continued strength in revenues, which has exceeded expectations recently.

As discussed in Chapter 1, enactment in May of supplemental appropriations for 2007 added \$100 billion in budget authority for operations in Iraq and Afghanistan and for other activities related to the war on terrorism. Another \$17 billion in appropriations for hurricane relief and other programs were also included in that legislation. About one-quarter of those supplemental appropriations will probably be spent this year, with the rest to be spent next year or beyond. Additionally, in accordance with the rules used to construct its baseline budget projections, CBO assumes that such appropriations will continue in future years, adjusted for projected rates of inflation.

For the state and local sector, purchases of goods and services are expected to register growth of about 2 percent this year, slightly above last year's pace. That growth is

significantly stronger than in the 2003–2005 period, when purchases rose by less than half a percentage point per year, on average. Most states continue to experience solid growth in revenues. Although a number of states are using the unexpected revenues to reduce tax rates, and a few are planning to use the revenues to shore up pension plans and fund other postretirement benefits, many states are planning to increase spending on salaries, education, and capital expenditures. For some localities, however, slower growth of property taxes in the wake of a weaker housing market could crimp spending.

### **Modest Growth in Consumer Spending**

Consumer spending is expected to grow somewhat slower during the next year and a half than it did in the previous five years. In the past, consumer spending was supported by gains in household employment and income, increases in housing wealth, and, during 2003 and 2004, by unusually low interest rates. Because those factors will not provide as much support in the future, CBO expects real consumer spending to slow from the 3½ percent pace of the past five years to about 2¾ percent over the next two years.

**Employment and Household Income.** The growth of both payroll employment and household income will be slower this year than in 2006. Employment growth has gradually shifted downward, falling from a pace of about 2 percent early last year to about 1.4 percent for the first half of 2007. The financial activities and business services sectors experienced the greatest slowing in employment growth, and that slowing was only partially offset by faster growth in the state and local sector and the education and health services sector. Surprisingly, residential construction employment in the official statistics has not yet weakened significantly in spite of the decline in housing construction. CBO anticipates that employment as a whole will grow by slightly more than 1 percent, on average, through the end of 2008.

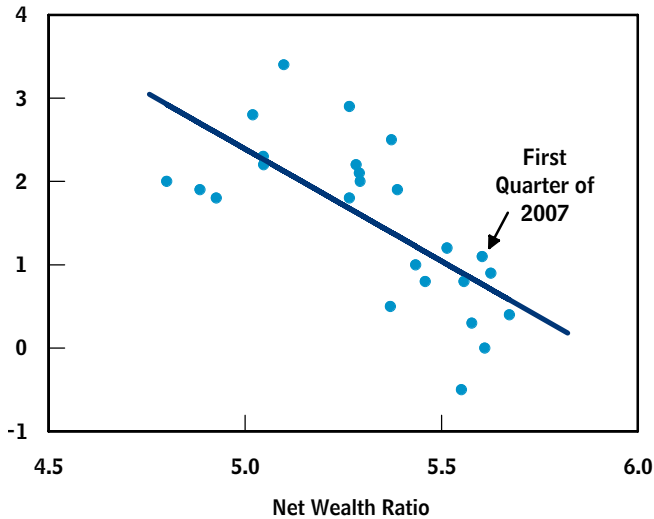
The growth of household income will be slower this year than it was last year, largely because growth in wage and salary income will ease slightly. A decline in the growth of hours worked will slow income growth substantially, but that slowdown will be partially offset by faster growth of hourly wage rates.

**Financial Condition of Households.** The financial condition of households appears to have deteriorated last year, as indicators of financial distress edged up. In addition to

**Figure 2-10.**

## The Personal Saving Rate and the Net Wealth Ratio, 2001 to 2007

(Saving rate in percentage points)



Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Federal Reserve Board.

Notes: The net wealth ratio equals the net wealth of households divided by disposable personal income.

The data are measured from the first quarter of 2001 through the first quarter of 2007.

the rise in delinquencies for subprime loans discussed previously, delinquency rates for a number of other types of debt increased during 2006 and the first half of 2007. For example, the delinquency rate at commercial banks for credit card debt and other consumer loans has risen, although it has yet to reach the levels that prevailed during the late 1990s. The delinquency rate on residential real estate loans (mortgage loans and home-equity lines of credit) at commercial banks has climbed sharply, however, and is close to levels seen in the last recession. As a consequence, commercial banks appear to be tightening standards on consumer and mortgage loans. In the absence of a sudden and unexpected downturn in employment or household income growth, however, the financial condition of households is strong enough to support continued growth in consumer spending, in CBO's view.

**Wealth and the Personal Saving Rate.** Household spending is affected not only by year-to-year growth in household income but also by changes in wealth. Increases in

wealth, whether from financial market gains or housing price appreciation, generally push up spending on consumer goods and services.<sup>4</sup> The exact relationship between changes in wealth and spending is difficult to determine, however, because it is affected by a number of intangible factors: the extent to which households may view wealth gains as temporary or permanent; whether the gains are in pension or other retirement funds that households may not factor into their spending decisions; the state of households' confidence about employment or income; and shifts in the timing between wealth changes and spending changes. Because of such uncertainties, analysts give a range of estimates of the wealth effect.

Assuming a lag of about a year, CBO estimates that the run-up in housing wealth between 2003 and the end of 2005 added somewhere between  $\frac{1}{4}$  percent and  $\frac{3}{4}$  percent per year, on average, to the growth of household spending for 2004 through 2006. In contrast, housing wealth is forecast to subtract about one-third of a percentage point from consumer spending in 2007 and 2008 because housing price growth was slower during 2006 and because CBO expects housing wealth to fall by about 1 percent this year and next.

Although some analysts believe that households will curtail their spending in the future in an effort to rebuild their savings, such restraint may not occur. The personal saving rate, which has been trending downward for many years, was 1.1 percent in the first quarter of 2007 and 0.6 percent in the second. The saving rate tends to fall when the net wealth ratio rises, but the rate in recent quarters has been close to what one would expect given households' wealth (see Figure 2-10). Consequently, there is little reason to expect that consumers believe they need to rebuild their savings. The saving rate is more likely to just stabilize, as the drop in housing wealth this year and next year will tend to dampen consumer spending slightly, moderating the downward trend in the saving rate.

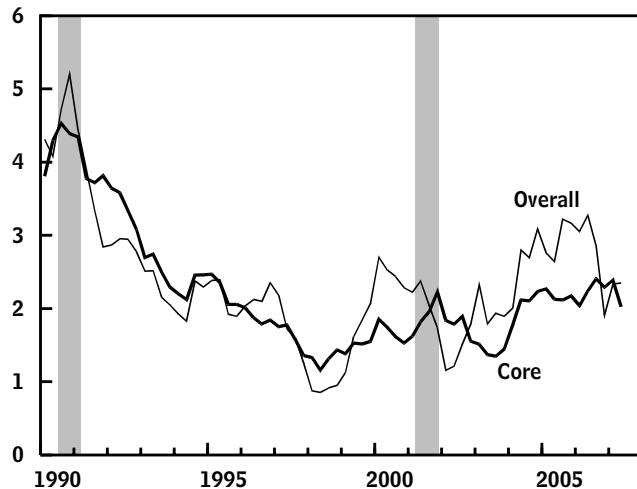
## The Stability of Core Inflation

The overall growth in consumer prices has oscillated with the ups and downs of energy and food prices over the past several years, but the core personal consumption expendi-

4. See Congressional Budget Office, *Housing Wealth and Consumer Spending* (January 2007).

**Figure 2-11.**  
**The Overall and Core PCE Price Indexes**

(Percentage change from previous year)



Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

Note: The overall PCE price index is the personal consumption expenditure chained price index. The core index excludes prices for food and energy. Data are quarterly and are plotted through the second quarter of 2007.

ture (PCE) price index, which excludes volatile energy and food prices, has been relatively steady (see Figure 2-11). Core inflation is generally, but not universally, considered to be a better guide to future inflation than the overall inflation rate. CBO's forecast assumes that core consumer price inflation will remain close to its current rate of 2 percent. The Federal Reserve and many private forecasters are concerned about upward pressures on inflation from several factors—a possible acceleration in labor costs, the sharp increase in prices for many commodities, and higher prices for imported goods—but it still appears that there is sufficient productive capacity in the United States and abroad to dampen any short-term inflationary pressures that may arise.

The increases in prices for commodities and imports are generally less of a concern than a rise in labor costs, for two reasons. First, commodity prices tend to plateau or fall, rather than continue to climb rapidly, after sharp increases. Second, commodities constitute a relatively small share of the costs of production for consumer goods and services, so increases in commodity prices do not have a pervasive or persistent effect on inflation unless

market structures and monetary policy exacerbate the initial price shock. Increases in labor costs, in contrast, might be both widespread and persistent. If so, the Federal Reserve could still manage to control inflation, but it might have to slow economic growth considerably to do so. Like other forecasters, and in line with the expectations of the financial markets, CBO considers the risk of a significant rise in core inflation and a subsequent slowdown in growth to be small.

### Commodity Prices

Although some analysts believe that the rapid rise over the past six months in prices for various commodities portends higher core inflation, the CBO forecast discounts that risk. The rise in agricultural and energy prices pushed consumer food and gasoline inflation higher earlier this year, but it appears that nonfood, nonenergy inflation will be little affected by the commodity price surge, and the effects of higher commodity prices on overall inflation will be temporary.

Prices for agricultural products climbed rapidly at the end of last year and during the first half of this year. Poor weather in parts of the United States and in other agricultural-exporting countries, combined with an increase in the use of corn for ethanol production, helped to drive prices up. Consumer prices for food rose at an annual rate of 5.2 percent during the first half of this year. Such a steep increase in food prices causes households to have a heightened awareness of inflation, but it has very little effect on the underlying rate of price change. Costs of processing, transportation, and retailing are much more significant contributors to the final cost of food than are the costs of raw materials. In addition, agricultural prices will probably decline as supplies increase in response to the higher prices. Finally, agricultural prices, unlike energy prices, do not affect the cost of production of a wide variety of other goods and services. Therefore, it is unlikely that the recent increase in agricultural prices will affect core inflation.

Petroleum prices, in contrast, have a greater potential to spur core inflation, according to many analysts. Energy use is pervasive in the economy—spending on petroleum alone is equal to about 3 percent of GDP—and it appears that energy prices will remain high. The near-term supply and demand responses to the higher prices are not sufficient to cause prices to fall significantly (although a sharp slowing of overall world growth would weaken oil prices). CBO expects that petroleum prices, despite jumping to

about \$77 a barrel in July, will be in the range of \$62 to \$70 a barrel over the next two years (using the benchmark measure of oil prices from the Brent field). The Energy Information Agency, most private-sector forecasters, and the futures market also anticipate that prices will remain in that range.

As pervasive an effect as energy prices have on the economy, they are still not likely to have a significant impact on core inflation in the near future. If Brent petroleum prices fall back to about \$70 a barrel during the rest of this year, the average price for all of 2007 will not be much higher than the \$65 a barrel average price of last year. In addition, the core rate of inflation changed little when petroleum prices grew rapidly from 2004 to 2006, and the effect of energy prices on core inflation will continue to be small, in CBO's estimation.<sup>5</sup>

Gasoline prices rose much more in 2007 than petroleum prices, but they may ease this winter even if oil prices remain near current levels. The refinery margin—the spread between the cost of petroleum for refiners and the price they charge for gasoline at the wholesale level—rose by more than \$20 a barrel (or about 50 cents a gallon) over the first six months of this year. A number of unexpected refinery outages in the United States, combined with little excess refining capacity abroad, limited the stockpiling of gasoline inventories ahead of the summer driving season this year, and the combination of those supply and demand pressures drove up the refinery margin. Those pressures have started to abate. As a result, the national average price for gasoline, which was \$2.97 per gallon in July, is projected to drop back to the \$2.60–\$2.75 a gallon range this winter.

### The Decline in the Dollar and U.S. Inflation

Although the decline in the value of the dollar will put some upward pressure on price growth, CBO's forecast assumes that the effect will be small. A continuous drop in the value of the dollar tends to increase inflation both by raising the prices of imported goods and by reducing the competitive pressure on U.S. producers to keep price increases low. As the value of the dollar relative to a foreign currency falls, foreign producers must either raise their prices in dollar terms; find ways to reduce costs (for example, by boosting productivity); or let profits, in

terms of their own currency, fall. Studies have found that about half or perhaps even less of the change in the value of the dollar is reflected in changes in prices for imported goods.<sup>6</sup> As the dollar has fallen over the past five years, foreign exporters, anxious to avoid losing market share in the United States, have been trying to keep the dollar prices of their goods from increasing too rapidly. Consequently, import prices generally have not increased nearly as much as the dollar has fallen. So far, profits of foreign producers do not appear to have weakened significantly, possibly because foreign producers have been able to lower their costs of production. Thus, it seems likely that foreign producers could continue to limit the rise in the dollar prices of their goods in the face of a persistent decline in the value of the dollar.

The effect of changes in the value of the dollar on overall consumer price inflation in the United States is even smaller than the effect on import prices. The link between prices for imported products and the prices that U.S. consumers pay is diluted, primarily because imported goods make up only a small percentage of all consumer goods and services. In addition, imported goods go through several intermediary stages (such as warehousing, transportation, and retailing) before being sold to the consumer. Since those intermediary costs are domestic, they are little affected by a decline in the value of the dollar. To be sure, a drop in the dollar generally reduces the threat of competitive pressure on U.S. producers and therefore may result in higher inflation regardless of the direct effect on import prices. Foreign competition may have helped keep inflationary pressures low in the United States, particularly during periods of dollar appreciation, by encouraging productivity growth and dampening wage pressures. Even so, studies have found that the CPI-U inflation rate is only affected slightly by changes in the value of the dollar. Estimates range from a negligible effect to about 10 percent of the change in the value of the dollar.<sup>7</sup>

5. See Congressional Budget Office, *The Economic Effects of Recent Increases in Energy Prices* (July 2006).

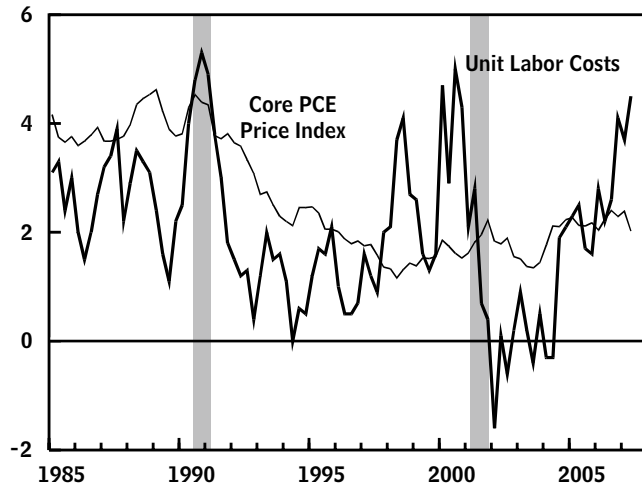
6. See, for example, José Campa and Linda Goldberg, "Exchange Rate Pass-Through into Import Prices," *Review of Economics and Statistics*, vol. 87, no. 4 (November 2005), pp. 679–690.

7. José Campa and Linda Goldberg, *Distribution Margins, Imported Inputs, and the Sensitivity of the CPI to Exchange Rates*, Working Paper No. 12121 (Cambridge, Mass.: National Bureau of Economic Research, March 2006); and Thomas Helbling, Florence Jaumotte, and Martin Sommer, "How Has Globalization Affected Inflation?" Chapter 3 in *World Economic Outlook* (Washington, D.C.: International Monetary Fund, April 2006).

**Figure 2-12.**

## The Core PCE Price Index and Unit Labor Costs

(Percentage change from previous year)



Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics.

Note: The core PCE price index is the personal consumption expenditure chained price index excluding prices for food and energy. Data are quarterly and are plotted through the second quarter of 2007.

On average, the value of the dollar fell by 2.1 percent against the currencies of the United States' major trading partners last year, and CBO expects declines of between 2 percent and 3 percent in 2007 and 2008. Declines of that magnitude imply that the pressures for higher inflation from the drop in the dollar will not be large enough to seriously interfere with the Federal Reserve's ability to contain inflation.

### Possible Resource Constraints and Unit Labor Costs

The possibility that demand pressures are pushing up against potentially widespread constraints on output growth has also raised concerns about higher inflation, but it appears that such pressures are not imminent. Currently, the only evidence for general constraints on production is in the labor market. The unemployment rate is low compared with CBO's estimate of the level that indicates labor market tightness, and the growth rates of some labor compensation measures and unit labor costs have picked up over the past year (see Figure 2-12).

Although the growth of labor costs per unit of output (labor costs per hour divided by output per hour) appears to suggest higher inflation in the near term, the growth of unit labor costs is likely to moderate in the near future. A significant part of the increase in unit labor costs last year stemmed from unusually large bonuses and the exercising of stock options, which pushed up aggregate compensation growth. Such extraordinary compensation probably does not have a major impact on inflation because it is not widespread and because affected firms may not consider such payments part of their cost structure when they make pricing decisions. Also, the slowing of the economy at the end of last year and early this year resulted in a slowing of productivity growth, which slightly increased the growth of unit labor costs. However, if the economy picks up as expected, productivity growth should recover to about 2¼ percent per year. CBO assumes that hourly compensation growth will be near 4¼ percent, resulting in a moderate growth of unit labor costs, about 2 percent, over the near term.

Even if unit labor costs increase by more than CBO anticipates, firms may choose to let profits fall somewhat before raising prices. Although profits per unit of output are small relative to labor and other production costs, profits have been high in recent years, and they may provide a cushion to absorb higher growth of unit labor costs in the short run.

The degree to which the manufacturing sector may be pushing up against output constraints, measured as the capacity utilization rate for manufacturing, indicates that capacity in that sector is not strained enough to increase inflation. After rising to 80.9 percent in August 2006, capacity utilization eased back to about 80 percent during the recent slowdown. In general, the capacity utilization rate has to reach at least 83 percent before it exerts an upward push on inflation.

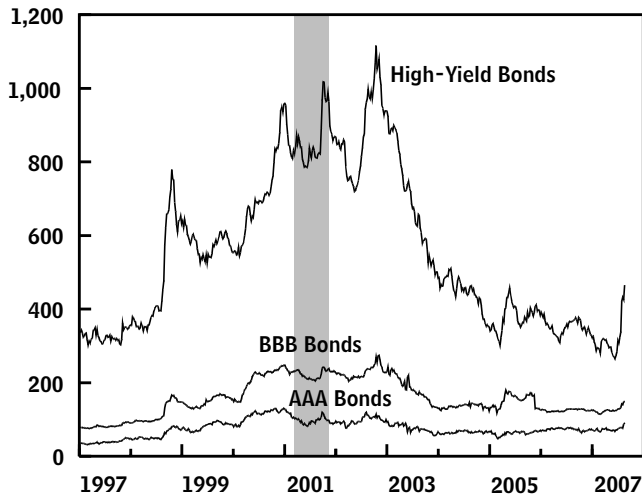
### Financial Markets and Monetary Policy

Turmoil in some segments of credit markets and sharp declines in the stock market this summer have raised concerns that a significant drop in the availability of credit—and, consequently, a slowing of economic activity—may be developing. Acknowledging that risk, the Federal Reserve took several actions to provide liquidity to financial markets and signaled its readiness to take additional action if the turmoil in financial markets slows economic activity.

**Figure 2-13.**

## The Yield Spread Between Corporate Bonds of Various Ratings and the 10-Year Treasury Note

(Basis points)



Sources: Congressional Budget Office; Bloomberg.

Note: Data are weekly and are plotted through August 17, 2007.

### Financial Markets

The problems in mortgage markets initially upset financial markets in the spring of this year, when major problems in the subprime market first surfaced. Markets were further roiled in July and August following the failure of several hedge funds that had invested heavily in subprime securities and the arrival of other news on the depth of the problems in mortgage markets. Because of a lack of clear information about who holds those subprime investments in their portfolios, investors often do not know who has exposure to the losses in the subprime market. That confusion has led to a repricing of risk in general, which has affected valuations and interest rates on a wide variety of investments—prices of risky assets fell, whereas prices of Treasury securities rose.

The repricing of risk was greatest for the riskiest assets. One indication of the repricing is the change in the differences, or spreads, between interest rates on corporate bonds and the rate on 10-year Treasury notes. To date, the increase in spreads on riskier bonds (those with lower credit ratings) has been substantial and greater than the increases on less risky bonds (see Figure 2-13). Much of

the recent increase, though, simply brings the spreads of risky assets back to more normal levels. That is, investors appear to have been underpricing risk for some time, and the jump in the riskiest rates in recent months brings them up to levels that are still low relative to more serious episodes of credit restraint, such as those in the fall of 1998 (when the Long-Term Capital Management hedge fund failed) and at the end of 2000 (when the stock market started to fall).

The most dramatic repricing of risk occurred in the market for assets collateralized by subprime mortgages. Investment houses issue mortgage-backed securities (MBSs) to investors with the payment of interest and principal tied to the payments made by subprime borrowers. Securities with various levels, or “tranches,” of risk are created from the MBSs. Investors holding the safest tranche (AAA) stand first in line to receive payments from subprime borrowers (and receive a correspondingly lower return). They are the last to absorb losses. Investors holding the riskiest tranche (BBB-) stand last in line to receive payments (but receive a correspondingly higher return) and are the first to absorb losses. As of mid-August, the prices of the riskiest tranches of mortgages issued in 2006 and early 2007 had fallen to 40 cents or less on the dollar but were above 90 cents on the dollar for the safest tranche. Prices of tranches based on mortgages issued earlier, in the last half of 2005, ranged from 60 cents for the BBB- tranche to almost 97 cents for the AAA tranche, indicating that the worst losses seem to apply to originations made in 2006 and early 2007.

If the investors who bought the riskiest tranches knew of the risk they were accepting, then the pain of defaults will fall primarily on those who had accepted, and presumably can bear, the loss. In that case, the extent of contagion from mortgage markets to other financial markets would be limited. But the novelty of those subprime-backed securities, the uncertainty about how severely losses in the value of those assets will affect financial intermediaries such as banks, and the possibility that at least some investors were not fully aware of the risk they were assuming makes it difficult to forecast how large an effect the problems in mortgage markets ultimately will have on financial markets and credit availability in general. Those concerns pose a major uncertainty for the economic outlook and consequently for the conduct of monetary policy.

### Monetary Policy

The Federal Reserve has provided liquidity in a deliberate manner to financial markets through mid-August. It first provided temporary liquidity to the overnight money market in early August after banks unexpectedly pulled back from lending in response to fears of losses related to subprime-backed securities. On August 17, after problems developed in the market for commercial paper (short-term business loans), the Federal Reserve lowered its discount rate—the interest rate it charges on loans to banks—by 50 basis points, to 5.75 percent. It also extended the usual term for such lending from overnight to as long as 30 days. On the same day, the Federal Open Market Committee (FOMC)—the group in the Federal Reserve that sets monetary policy—announced that it believes that the turmoil in financial markets has “appreciably” increased the risks of slower growth and that it “is prepared to act as needed to mitigate the adverse effects on the economy.”

That announcement solidified the financial markets’ expectation that the FOMC will reduce its policy interest rate, the federal funds rate. In the wake of the growing turmoil in financial markets earlier this summer, financial markets began to anticipate that the Federal Reserve would ease monetary policy before the end of this year. After the August 17 action, markets expected the FOMC to lower its target for the federal funds rate by 50 basis points by the fall and by a total of 100 basis points by the spring of 2008. Those expectations are not reflected in CBO’s forecast, which was completed earlier.

CBO’s forecast through 2008 assumes that the Federal Reserve will restore order to financial markets and thus avert a significant slowing in the growth of the economy. The interest rate on 3-month Treasury bills, which fell markedly as investors sought safe investments, is expected to rise in response to more orderly conditions in financial markets and average 4.8 percent through 2008. The interest rate on 10-year Treasury notes, which also fell with the flight to safe assets, is projected to rise to 5.2 percent next year. Rates on private-market securities also are projected to move higher to reflect more normal compensation for the risk of default.

### The Outlook Through 2017

Growth of real GDP will average 2.7 percent annually during the 2007–2017 period, CBO estimates, about the same as the growth of potential GDP (the level of output

that corresponds to a high level of resource use). Inflation as measured by the overall PCE price index will average 1.9 percent annually through 2017, CBO projects; as measured by the more commonly used CPI-U, inflation will average 2.3 percent. The rate of unemployment averages 4.8 percent in CBO’s outlook, the same as its estimate of the natural rate of unemployment (the rate that would prevail, on average, in the absence of cyclical fluctuations). The interest rate on 3-month Treasury bills averages 4.7 percent, and the rate on 10-year Treasury notes, 5.2 percent.

### Potential Output

Potential output grows at an average annual rate of 2.7 percent during the 2007–2017 period in CBO’s projection (see Table 2-2). That estimate, which is very similar to what CBO projected in January, results from roughly offsetting changes in several variables that underlie the projection for potential output, including growth of the potential labor force (the level of the labor force that corresponds to the natural rate of unemployment), business investment (which affects the growth of capital services), and total factor productivity (TFP).<sup>8</sup>

CBO’s projection for the growth of the potential labor force—0.7 percent per year, on average, through 2017—has been revised slightly upward since January. That revision arose largely because of an increase in the projected size of the civilian population and because CBO lowered its estimate of the natural rate of unemployment.<sup>9</sup> The new projection implies that the potential labor force in 2017 will be nearly a million people larger than CBO assumed in January.

CBO’s projection for the civilian population, including the level of net migration into and out of the United States, is similar to projections made by the Social

8. CBO’s forecast and its estimates of potential GDP were completed before the July 27, 2007, revision of the national income and product accounts. That revision reduced official estimates of the average annual growth rate of real GDP from 2004 to the first quarter of 2007 by 0.3 percentage points. Historical estimates of labor productivity growth were similarly affected. Further revisions are likely in the data for the capital stock and the labor force.

9. All else being equal, a lower estimate of the natural rate of unemployment implies that the gap between the labor force and the potential labor force is larger than was previously estimated. Because the actual labor force is unaffected by the change, the reestimate of the natural rate implies a larger potential labor force.

**Table 2-2.****Key Assumptions in CBO's Projection of Potential Output**

(By calendar year, in percent)

	Average Annual Growth						Projected Average Annual Growth		
	1950-1973	1974-1981	1982-1990	1991-2001	2002-2006 <sup>a</sup>	Total, 1950-2006 <sup>a</sup>	2007-2012	2013-2017	Total, 2007-2017
<b>Overall Economy</b>									
Potential Output	3.9	3.2	3.1	3.1	2.8	3.4	2.7	2.6	2.7
Potential Labor Force	1.6	2.5	1.6	1.2	1.1	1.6	0.9	0.5	0.7
Potential Labor Force Productivity <sup>b</sup>	2.3	0.7	1.4	1.9	1.7	1.8	1.9	2.0	1.9
<b>Nonfarm Business Sector</b>									
Potential Output	4.0	3.6	3.3	3.6	3.1	3.7	3.1	3.0	3.0
Potential Hours Worked	1.4	2.3	1.7	1.1	1.1	1.5	0.9	0.6	0.8
Capital Input	3.8	4.2	4.1	4.6	2.4	3.9	3.4	3.7	3.5
Potential TFP	1.9	0.7	0.8	1.4	1.6	1.4	1.4	1.4	1.4
Potential TFP excluding adjustments	1.9	0.7	0.9	1.3	1.3	1.4	1.3	1.3	1.3
TFP adjustments	0	0	0	0.1	0.3	*	0.1	0.1	0.1
Price measurement <sup>c</sup>	0	0	0	0.1	0.1	*	0.1	0.1	0.1
Temporary adjustment <sup>d</sup>	0	0	0	*	0.1	*	0	0	0
Contributions to the Growth of Potential Output (Percentage points)									
Potential hours worked	0.9	1.6	1.2	0.8	0.8	1.0	0.6	0.4	0.5
Capital input	1.1	1.3	1.2	1.4	0.7	1.2	1.0	1.1	1.0
Potential TFP	1.9	0.7	0.8	1.4	1.6	1.4	1.4	1.4	1.4
Total Contributions	4.0	3.6	3.3	3.5	3.0	3.6	3.1	3.0	3.0
Potential Labor Productivity in the Nonfarm Business Sector <sup>e</sup>	2.6	1.3	1.5	2.4	2.0	2.2	2.2	2.4	2.3

Source: Congressional Budget Office.

Note: TFP = total factor productivity; \* = between zero and 0.05 percent.

- a. Values as of early July 2007, prior to the revisions to the national income and product accounts.
- b. The ratio of potential output to the potential labor force.
- c. An adjustment for a conceptual change in the official measure of the gross domestic product chained price index.
- d. An adjustment for the unusually rapid growth of TFP between 2001 and 2003.
- e. The estimated trend in the ratio of output to hours worked in the nonfarm business sector.

Security Administration. The SSA revised its projection of the civilian population slightly upward in part because of a reestimate of the level of immigration for recent years. Like the SSA, CBO assumes that there will be net legal immigration of about 600,000 people per year over the next decade. But CBO's estimate of the average net number of unauthorized immigrants—at 500,000 per year—is larger than SSA's projection of slightly less than 400,000 per year between now and 2017. CBO's projec-

tions of net migration assume that current policies continue. Significantly increased enforcement efforts, such as those recently announced by the Administration, could result in somewhat lower net flows of unauthorized immigrants than CBO projects.

CBO has revised its estimate for the natural rate of unemployment downward by two-tenths of a percentage point since January. The lower estimate of the natural rate is



based largely on recent work suggesting that the labor market has been operating more efficiently—better matching jobs and job seekers—in recent years than in the 1970s or 1980s.<sup>10</sup> Exactly why the market is more efficient is unclear; potential explanations include the expansion of the temporary-help industry, more job searching via the Internet, and better matches between the attributes of job seekers and those desired by employers.

The lower estimate of the natural rate of unemployment raises, by a small amount, the primary labor input underlying CBO's estimates of potential output (potential hours worked in the nonfarm business sector) and potential TFP during recent history and in the projection period. CBO expects that potential hours worked will grow at an average annual rate of 0.8 percent through 2017, slightly higher than the rate assumed in January. Similarly, potential TFP is anticipated to grow by 1.4 percent annually, on average, through 2017, which is slightly faster than last January's projection.

In contrast, the projection for capital accumulation has been revised downward since CBO's winter forecast. CBO's index of capital services is projected to grow at an average annual rate of 3.5 percent during the projection period, about two-tenths of a percentage point slower than what was assumed in January. A lower level of business investment accounts for the dimmer outlook for growth in capital services.

### **Inflation, Unemployment, and Interest Rates**

CBO's outlook for inflation over the next 10 years is very similar to January's projection. CBO assumes that the Federal Reserve's monetary policy will be able to maintain, on average, a rate of core inflation for the PCE price index that is slightly below 2 percent. Core and overall inflation as measured by that index are both projected to average 1.9 percent during the next decade, down about one-tenth of a percentage point from last winter's projection. Core and overall CPI-U inflation are projected to average about 2.3 percent annually. The rate of unemployment is expected to average 4.8 percent through 2017.

10. See David Brauer, *The Natural Rate of Unemployment*, Congressional Budget Office Working Paper 2007-06 (April 2007).

The rate on 3-month Treasury bills averages 4.7 percent during the 2007–2017 period in CBO's outlook, and the rate on 10-year Treasury notes averages 5.2 percent. CBO projects interest rates over the medium term by adding expected CPI-U inflation to its projections for real interest rates. The real interest rates on 3-month Treasury bills and 10-year Treasury notes are projected to average 2.4 percent and 2.9 percent, respectively, through 2017.

### **Projections of Income**

CBO's economic projections of various income categories as measured in the national income and product accounts are the basis for its projections of federal revenues. The outlook for revenues is most directly affected by projections of wages and salaries, corporate profits, proprietors' income, interest income, and dividend income. The NIPA measures of those income categories are used to project the corresponding incomes reported on tax forms for calculating tax liabilities. (See Chapter 1 for details of CBO's outlook for revenues.)

CBO projects the NIPA income categories as shares of output, or GDP.<sup>11</sup> At the broadest level, GDP can be divided into a share for labor income, a share for domestic capital income, and a share that reflects taxes on production and imports. The labor share has averaged 62.3 percent over the postwar period. Labor income consists of the total compensation that employers pay their employees—that is, the sum of wages and salaries and supplemental benefits (the employer's share of health and other insurance premiums and the employer's contribution to pension funds)—and the employer's share of payroll taxes (for Social Security and Medicare). Nonqualifying stock options (the most common type of stock options), a component of executive pay, are included in the wage and salary component of labor income when they are exercised. In addition, CBO assumes that 65 percent of proprietors' income is part of labor's share of GDP. Capital income consists of domestic corporate profits, depreciation charges, interest and transfer payments made by domestic businesses, rental income, and the remaining 35 percent of proprietors' income.

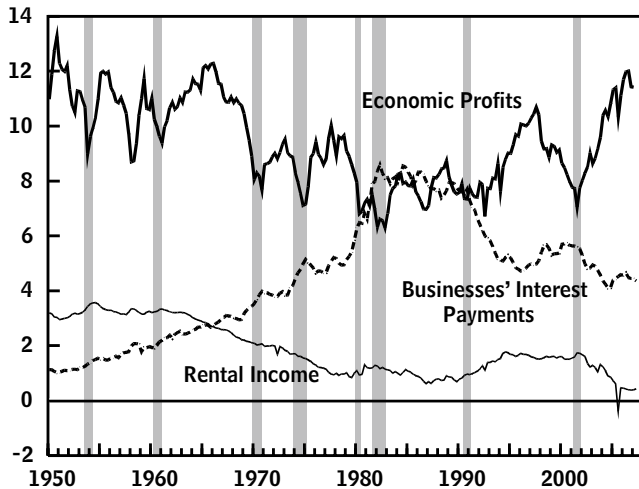
Recent NIPA data indicate that labor's share of GDP over the four quarters ending in the second quarter of 2007

11. See Congressional Budget Office, *How CBO Forecasts Income* (August 2006).

**Figure 2-14.**

## Selected Components of Capital Income

(Percentage of gross domestic product)



Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

Note: Data are quarterly. Economic profits are plotted through the first quarter of 2007; the other components are plotted through the second quarter of 2007.

averaged about 61.7 percent—about half a percentage point lower than the long-term average but closer to that average than in 2005 or 2006. Because labor markets are relatively tight and aggregate wages have been trending upward recently, CBO forecasts that the wage and salary component of labor income will grow marginally faster than nominal GDP over the next few years. Supplements to wages and salaries (pension contributions, health insurance premiums, and so forth) are expected to grow slightly faster than GDP for most of the projection period. Combined, those projections cause labor's share of output to converge with its long-run average by the end of the 10-year period.

Economic profits have grown rapidly in recent years, but two other forms of income from capital, net interest payments by businesses and rental income, have fallen as shares of GDP (see Figure 2-14). Businesses' interest payments have been trending downward since the 1980s, roughly mimicking the decline in corporate bond rates, but CBO anticipates that the decline will end in a few years and then interest payments will turn up modestly.

Rental income has fallen because the costs of owning a property—including interest expenses, depreciation, taxes, maintenance, and closing costs—have increased much faster since 2000 than gross rents. Rising property values have led to greater mortgage activity and property taxes, and depreciation has increased because it is measured at current cost and because construction costs have grown more rapidly than rents. CBO anticipates that rental income will decline slightly as a percentage of GDP in the next few years and then stabilize. Economic profits are forecast to grow over the next decade but at a slower rate than nominal GDP, so their share of GDP declines slightly, falling below 11 percent by 2017.

## Changes in the Economic Outlook Since January 2007

Compared with its January projections, CBO's current projections show slightly slower real growth in the near term, significantly higher inflation for 2007, and a greater share of GDP for profits. Real growth in the first quarter of 2007 was weaker than CBO anticipated last January, so the forecast for year-over-year GDP growth in 2007 was lowered slightly, to 2.1 percent (see Table 2-3). Growth over the 10-year period was revised upward slightly, however, because of the increase in the estimate of the potential labor force discussed previously.

CPI-U inflation was significantly higher than expected early this year because of the unanticipated increase in food and energy prices, so the projected growth of the consumer price index for this year is higher. The forecast for CPI-U growth after this year is identical to that in the January forecast.

The outlook for long-term interest rates is moderately higher for 2007, 2008, and 2009 than it was last January but the same thereafter. Short-term interest rates, in contrast, are projected to be slightly higher throughout most of the 10-year projection period. Over the past six months, but before the market turmoil in July and August, the *Blue Chip* consensus forecast and the futures market indicated that short-term rates will be higher than had been previously indicated. It appears that financial market participants anticipated a smaller term premium—the difference between short-term rates and long-term rates—than they had before, and CBO has built that change in attitude into its forecast.

**Table 2-3.****CBO's Current and Previous Economic Projections for Calendar Years 2007 to 2017**

	Actual 2006 <sup>a</sup>	Forecast		Projected Annual Average	
		2007	2008	2009 to 2012	2013 to 2017
Nominal GDP (Billions of dollars)					
August 2007	13,247	13,893	14,575	17,595 <sup>b</sup>	21,829 <sup>c</sup>
January 2007	13,235	13,805	14,472	17,395 <sup>b</sup>	21,519 <sup>c</sup>
Nominal GDP (Percentage change)					
August 2007	6.3	4.9	4.9	4.8	4.4
January 2007	6.3	4.3	4.8	4.7	4.3
Real GDP (Percentage change)					
August 2007	3.3	2.1	2.9	3.0	2.6
January 2007	3.3	2.3	3.0	2.9	2.5
GDP Price Index (Percentage change)					
August 2007	2.9	2.7	2.0	1.8	1.8
January 2007	2.9	1.9	1.8	1.8	1.8
Consumer Price Index <sup>d</sup> (Percentage change)					
August 2007	3.2	2.8	2.3	2.2	2.2
January 2007	3.4	1.9	2.3	2.2	2.2
Unemployment Rate (Percent)					
August 2007	4.6	4.5	4.7	4.8	4.8
January 2007	4.6	4.7	4.9	5.0	5.0
Three-Month Treasury Bill Rate (Percent)					
August 2007	4.7	4.8	4.8	4.7	4.7
January 2007	4.7	4.8	4.5	4.4	4.4
Ten-Year Treasury Note Rate (Percent)					
August 2007	4.8	4.9	5.2	5.2	5.2
January 2007	4.8	4.8	5.0	5.2	5.2
Tax Bases (Billions of dollars)					
Corporate book profits					
August 2007	1,811	1,880	1,897	1,995 <sup>b</sup>	2,352 <sup>c</sup>
January 2007	1,795	1,775	1,787	1,763 <sup>b</sup>	2,126 <sup>c</sup>
Wages and salaries					
August 2007	6,031	6,383	6,703	8,104 <sup>b</sup>	10,016 <sup>c</sup>
January 2007	6,032	6,330	6,642	8,019 <sup>b</sup>	9,860 <sup>c</sup>
Tax Bases (Percentage of GDP)					
Corporate book profits					
August 2007	13.7	13.5	13.0	11.9	10.9
January 2007	13.6	12.9	12.3	10.8	9.9
Wages and salaries					
August 2007	45.5	45.9	46.0	46.0	46.0
January 2007	45.6	45.9	45.9	46.1	46.0
<b>Memorandum:</b>					
Real Potential GDP (Percentage change)					
August 2007	2.8	2.8	2.8	2.7	2.6
January 2007	2.7	2.8	2.8	2.7	2.5

Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

Note: GDP = gross domestic product; percentage changes are measured from one year to the next.

- a. Values as of early July 2007, prior to the revisions to the national income and product accounts.
- b. Level in 2012.
- c. Level in 2017.
- d. The consumer price index for all urban consumers.

**Table 2-4.**

### Comparison of Economic Forecasts by CBO, the Administration, and the *Blue Chip* Consensus for Calendar Years 2007 to 2012

	Actual 2006 <sup>a</sup>	Forecast		Projected Annual Average, 2009 to 2012
		2007	2008	
<b>Fourth Quarter to Fourth Quarter (Percentage Change)</b>				
Nominal GDP				
CBO	5.7	5.1	4.9	4.8
Administration	5.7	5.2	5.4	5.1
<i>Blue Chip</i> consensus	5.4	5.1	5.2	n.a.
Real GDP				
CBO	3.1	2.2	3.0	2.9
Administration	3.1	2.3	3.1	3.0
<i>Blue Chip</i> consensus	2.6	2.3	2.9	n.a.
GDP Price Index				
CBO	2.5	2.8	1.8	1.8
Administration	2.5	2.8	2.2	2.0
<i>Blue Chip</i> consensus	2.7	2.7	2.2	n.a.
Consumer Price Index <sup>b</sup>				
CBO	1.9	3.6	2.1	2.2
Administration	1.9	3.2	2.5	2.3
<i>Blue Chip</i> consensus	2.0	3.5	2.4	n.a.
<b>Calendar Year Average (Percent)</b>				
Unemployment Rate				
CBO	4.6	4.5	4.7	4.8
Administration	4.6	4.5	4.7	4.8
<i>Blue Chip</i> consensus	4.6	4.6	4.7	n.a.
Three-Month Treasury Bill Rate				
CBO	4.7	4.8	4.8	4.7
Administration	4.7	4.8	4.6	4.2
<i>Blue Chip</i> consensus	4.7	4.9	4.9	n.a.
Ten-Year Treasury Note Rate				
CBO	4.8	4.9	5.2	5.2
Administration	4.8	4.8	5.0	5.2
<i>Blue Chip</i> consensus	4.8	4.9	5.2	n.a.

Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board; Council of Economic Advisers, Department of the Treasury, and Office of Management and Budget, "Administration Economic Forecast" (joint press release, June 6, 2007); Aspen Publishers, Inc., *Blue Chip Economic Indicators* (August 10, 2007).

Notes: The *Blue Chip* consensus is the average of about 50 forecasts by private-sector economists. The latest *Blue Chip* consensus does not extend past 2008.

GDP = gross domestic product; n.a. = not applicable.

a. Values for CBO and the Administration do not incorporate the July 2007 revisions to the national income and product accounts. Values for the *Blue Chip* consensus do incorporate those revisions, but they are probably not fully incorporated in the *Blue Chip* projections for 2007 and 2008.

b. The consumer price index for all urban consumers.

**Table 2-5.**

## Comparison of Economic Forecasts by the Federal Reserve and CBO for Calendar Years 2007 and 2008

	Federal Reserve		CBO
	Range	Central Tendency	
<b>2007</b>			
<i>Fourth Quarter to Fourth Quarter (Percentage change)</i>			
Nominal GDP	4.5 to 5.5	4.5 to 5.0	5.1
Real GDP	2.0 to 2.75	2.25 to 2.5	2.2
Core PCE Price Index <sup>a</sup>	2.0 to 2.25	2.0 to 2.25	1.9
<i>Average Level, Fourth Quarter (Percent)</i>			
Unemployment Rate	4.5 to 4.75	4.5 to 4.75	4.6
<b>2008</b>			
<i>Fourth Quarter to Fourth Quarter (Percentage change)</i>			
Nominal GDP	4.5 to 5.5	4.75 to 5.0	4.9
Real GDP	2.5 to 3.0	2.5 to 2.75	3.0
Core PCE Price Index <sup>a</sup>	1.75 to 2.0	1.75 to 2.0	1.9
<i>Average Level, Fourth Quarter (Percent)</i>			
Unemployment Rate	4.5 to 5.0	About 4.75	4.7

Sources: Congressional Budget Office; Federal Reserve Board of Governors, *Monetary Policy Report to the Congress* (July 18, 2007).

Notes: GDP = gross domestic product; PCE = personal consumption expenditures.

The range of estimates from the Federal Reserve reflects all views of the members of the Federal Open Market Committee. The central tendency reflects the most common views of the committee's members.

a. The PCE chained price index excluding prices for food and energy.

On balance, changes in the economic outlook since January have slightly reduced projected deficits and increased projected surpluses.<sup>12</sup> That improvement in the budget outlook is largely attributable to two changes: the higher-than-expected growth in inflation during the first half of this year, and the projection of greater profits relative to GDP throughout the 10-year period. The higher inflation rate raised the levels of nominal GDP and taxable incomes, boosting projections of revenues. It also affected projections of outlays, but to a smaller extent.

CBO's revenue projections are also higher than they were last January because the profit share of GDP is higher. More of the capital income share of GDP is assumed to be in the form of profits because CBO lowered its projec-

tions for some other categories of domestic capital income, particularly net interest payments by businesses. It now appears that the decline in the share of those interest payments will continue longer than previous forecasts had assumed. Consumption of fixed capital (depreciation) relative to GDP is also lower, because the projections of investment, specifically short-lived investment in producers' durable equipment, are lower than in January.

### Comparison with Other Forecasts

CBO's economic forecast for the next two years is similar to those of the Administration, the *Blue Chip* consensus of about 50 private-sector economists, and the Federal Reserve (see Tables 2-4 and 2-5). The Administration's forecast, which was released in June and which extends to 2012, indicates slightly stronger GDP growth and higher CPI-U inflation, on average, through 2012 than does CBO's forecast. The Administration's forecast for the

12. Those changes to the budget projections reflect not only changes to the economic forecast but also new laws and various technical factors. See Appendix A for more details.

unemployment rate is the same as CBO's, but its interest rate forecasts are lower. CBO assumes that book profits will account for a larger share of GDP (11.3 percent) in 2012 than the Administration does (10.9 percent) and that wages and salaries will account for a smaller share (46.1 percent, versus the Administration's 46.7 percent).

The August 10 *Blue Chip* consensus forecast, which covers only 2007 and 2008, has virtually the same rates as CBO for GDP growth, unemployment, and interest rates, but higher inflation in 2008. (The August *Blue Chip* consensus is based on forecasts largely prepared in July.) The *Blue Chip* forecast does not include wages and

salaries or book profits. The *Blue Chip* does forecast economic profits, however, and its estimate of average annual growth of 4.1 percent for that measure for 2007 and 2008 is similar to CBO's forecast.

The Federal Reserve presented its projections for GDP, core PCE inflation, and unemployment in its semiannual monetary policy report to the Congress in July. The report provides a "range" and a "central tendency" forecast for those variables. The Federal Reserve's range for core inflation this year, at 2.0 to 2.25 percent, is higher than CBO's forecast of 1.9 percent. Otherwise, the two forecasts are very similar.

## Changes in CBO's Baseline Since March 2007

**C**ompared with its previous baseline budget projections, which were published in March, the Congressional Budget Office (CBO) has reduced its estimate of the 2007 deficit from \$177 billion to \$158 billion (see Table A-1).<sup>1</sup> That decrease primarily reflects higher-than-expected revenues, partly offset by a rise in projected spending because of supplemental appropriations enacted in May. In addition, outlays from some previously enacted appropriations have been lower this year than anticipated.

For the succeeding 10 years, by contrast, recent changes to CBO's baseline have worsened the budget's bottom line by a total of \$928 billion—turning a projected surplus of \$586 billion for the 2008–2017 period (under current laws and policies) into a projected deficit of \$343 billion. Most of that change does not represent a substantive revision to the 10-year budget outlook, however. Rather, it results mainly from assuming that \$117 billion in recently enacted supplemental appropriations will be repeated (with increases for inflation) in later years, in accordance with long-standing rules that govern how CBO produces baseline projections.

When CBO updates its baseline, it divides the changes into three categories according to their source: newly enacted legislation, changes in CBO's economic forecast, and other, so-called technical factors that affect the budget.<sup>2</sup> New laws have added \$29 billion to the estimated deficit for 2007 and have increased projected deficits (or decreased projected surpluses) for the following 10 years by nearly \$1.6 trillion, mostly because of the extrapola-

tion of recent supplemental appropriations. Conversely, economic and technical revisions to the baseline—which in this instance are more reflective of the underlying budget outlook—have reduced the estimated 2007 deficit by \$48 billion and bolstered the cumulative bottom line over the 2008–2017 period by \$625 billion.

### The Effects of Recent Legislation

In budgetary terms, the most significant new law since March is the U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act, 2007 (Public Law 110-28), enacted in May. Supplemental funding provided in that law has had a substantial effect on CBO's 10-year projections of discretionary outlays. P.L. 110-28 and other recent laws have had a much smaller impact on projected mandatory spending and revenues, raising mandatory spending over the 2008–2017 period by \$5 billion and raising projected revenues over that period by less than \$100 million.

### Discretionary Spending

Recently enacted legislation has added \$117 billion in discretionary budget authority and an estimated \$28 billion in discretionary outlays to this year's budget totals—mostly from supplemental appropriations provided for military operations in Iraq and Afghanistan. In accordance with the rules used to construct the baseline, CBO

1. In *An Analysis of the President's Budgetary Proposals for Fiscal Year 2008* (March 2007), CBO estimated that the 2007 deficit would total \$177 billion under current law and \$214 billion if the President's proposals were enacted (including supplemental appropriations for operations in Iraq and Afghanistan and funding for relief from hurricane damage). This appendix compares CBO's latest baseline projections with the current-law estimates from March.

2. The categorization of such changes should be viewed with caution. For example, legislative changes represent CBO's best estimates of the future effects of laws enacted since the previous baseline was prepared. If a new law proves to have effects different from the effects that CBO initially estimated, the difference will appear as a technical change in later versions of the baseline. The distinction between economic and technical changes is similarly imprecise. CBO classifies economic changes as those resulting directly from changes in the components of its economic forecast (interest rates, inflation, the growth of gross domestic product, and so on). Changes in other factors related to the economy (such as capital gains realizations) are shown as technical adjustments.

**Table A-1.****Changes in CBO's Baseline Projections of the Deficit or Surplus Since March 2007**

(Billions of dollars)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Total, 2008- 2012	Total, 2008- 2017
Total Deficit (-) or Surplus as Projected in March 2007	-177	-113	-134	-157	-35	155	139	163	186	163	217	-283	586
Changes to Revenue Projections													
Legislative	*	*	*	-4	-2	7	-4	1	1	1	1	*	*
Economic	20	29	32	42	50	56	63	70	76	79	85	209	582
Technical	15	22	14	11	10	9	9	9	8	9	8	66	109
<b>Total Revenue Changes</b>	<b>35</b>	<b>51</b>	<b>46</b>	<b>49</b>	<b>58</b>	<b>72</b>	<b>69</b>	<b>80</b>	<b>85</b>	<b>89</b>	<b>93</b>	<b>275</b>	<b>691</b>
Changes to Outlay Projections													
Legislative													
Mandatory outlays	*	3	*	*	*	*	*	*	*	*	*	4	5
Discretionary outlays													
Defense	26	67	90	100	105	106	109	111	114	117	118	468	1,037
Nondefense	2	10	13	16	18	19	19	20	20	21	21	76	176
Subtotal, discretionary	28	76	103	116	123	125	128	131	134	137	139	544	1,214
Net interest outlays (Debt service)	*	3	8	14	21	28	35	43	52	61	70	74	335
<b>Subtotal, legislative</b>	<b>29</b>	<b>83</b>	<b>112</b>	<b>130</b>	<b>143</b>	<b>153</b>	<b>164</b>	<b>174</b>	<b>186</b>	<b>198</b>	<b>210</b>	<b>621</b>	<b>1,553</b>
Economic													
Mandatory outlays													
Social Security	0	4	5	5	5	5	5	5	6	6	6	25	54
Unemployment compensation	-1	-1	-2	-2	-2	-2	-2	-2	-2	-3	-3	-9	-21
Medicare	0	1	1	1	1	1	2	2	2	2	2	5	14
Student loans	1	1	1	1	1	1	1	1	1	1	1	6	12
Other	-1	1	1	2	3	2	3	3	3	3	3	9	24
Subtotal, mandatory	*	6	6	8	9	8	9	9	9	10	10	37	83
Discretionary outlays	0	2	2	3	3	3	3	3	3	3	4	13	29
Net interest outlays													
Debt service	*	-1	-2	-3	-5	-7	-9	-12	-16	-19	-24	-19	-100
Rate effect/inflation	5	*	6	7	7	6	5	5	4	3	2	26	45
Subtotal, net interest	5	-1	4	3	2	-1	-4	-8	-12	-16	-21	7	-55
<b>Subtotal, economic</b>	<b>4</b>	<b>6</b>	<b>12</b>	<b>14</b>	<b>13</b>	<b>11</b>	<b>8</b>	<b>4</b>	<b>*</b>	<b>-3</b>	<b>-8</b>	<b>56</b>	<b>57</b>

Continued

assumes that those appropriations will continue in future years at the current level, adjusted for anticipated inflation. As a result, legislative changes have increased the total discretionary outlays projected for the 2008–2017 period by \$1.2 trillion—or about 11 percent—from the previous baseline projections.

The bulk of that increase involves defense spending. P.L. 110-28 provides the Department of Defense (DoD) with \$95 billion in budget authority to cover the costs of operations in Iraq and Afghanistan and other activities related to the war on terrorism. DoD has also received roughly \$5 billion in supplemental appropriations to



**Table A-1.****Continued**

(Billions of dollars)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Total, 2008- 2012	Total, 2008- 2017
Changes to Outlay Projections (Continued)													
Technical													
Mandatory outlays													
Medicare	6	5	5	4	4	4	5	5	5	5	6	21	47
Unemployment compensation	1	1	1	1	1	1	1	1	1	1	1	5	10
Other	-3	3	2	2	*	*	-1	*	*	*	*	7	7
Subtotal, mandatory	4	8	8	7	5	5	5	5	6	6	8	33	64
Discretionary outlays													
	-15	-4	-3	-2	-2	-1	-1	-1	-1	-1	-1	-13	-17
Net interest outlays													
Debt service	*	-2	-3	-3	-3	-4	-4	-5	-5	-5	-6	-15	-39
Other	-5	1	1	1	1	1	1	*	-1	-1	-2	6	3
Subtotal, net interest	-6	*	-1	-2	-2	-3	-4	-5	-6	-6	-8	-9	-36
<b>Subtotal, technical</b>	<b>-17</b>	<b>3</b>	<b>3</b>	<b>3</b>	<b>1</b>	<b>1</b>	<b>1</b>	<b>*</b>	<b>*</b>	<b>-1</b>	<b>-1</b>	<b>11</b>	<b>10</b>
<b>Total Outlay Changes</b>	<b>16</b>	<b>92</b>	<b>127</b>	<b>147</b>	<b>157</b>	<b>165</b>	<b>172</b>	<b>178</b>	<b>186</b>	<b>194</b>	<b>201</b>	<b>688</b>	<b>1,619</b>
<b>Total Impact on the Deficit or Surplus<sup>a</sup></b>	<b>19</b>	<b>-41</b>	<b>-82</b>	<b>-98</b>	<b>-99</b>	<b>-93</b>	<b>-103</b>	<b>-98</b>	<b>-101</b>	<b>-105</b>	<b>-108</b>	<b>-413</b>	<b>-928</b>
Total Deficit (-) or Surplus as Projected in August 2007	-158	-155	-215	-255	-134	62	36	65	85	58	109	-696	-343
<b>Memorandum:</b>													
Total Legislative Changes <sup>a</sup>	-29	-83	-112	-134	-146	-146	-168	-173	-185	-197	-209	-621	-1,553
Total Economic Changes <sup>a</sup>	16	23	20	28	37	46	56	66	76	83	93	152	525
Total Technical Changes <sup>a</sup>	32	19	11	8	10	8	9	9	8	10	9	55	99

Source: Congressional Budget Office.

Note: \* = between -\$500 million and \$500 million.

a. Negative numbers indicate an increase in the deficit or a decrease in the surplus.

cover costs associated with planned military base closures and other expenses. CBO estimates that DoD will spend about \$26 billion of the added funding in 2007. Extrapolating the \$100 billion in supplemental appropriations through 2017 boosts projected defense outlays over 10 years by \$1 trillion.

P.L. 110-28 also contains \$18 billion in appropriations for nondefense discretionary programs—the largest portions for relief and recovery from hurricane damage (\$7 billion) and for international assistance programs (\$6 billion), such as the Economic Support Fund and the State Department's diplomatic and consular operations.<sup>3</sup>

Extrapolating that additional funding adds \$176 billion to projected nondefense discretionary outlays between 2008 and 2017.

### Mandatory Spending

Recent legislative changes to mandatory programs have been relatively small, raising projected spending over the 2008–2017 period by about \$5 billion. P.L. 110-28 includes funding for certain agriculture programs, such as

- Of the funds provided for international assistance programs, \$5 billion is for activities in Iraq, Afghanistan, and elsewhere that are related to the war on terrorism.

disaster relief for crop producers and livestock owners, which increases projected outlays in the near term. The law also extends payments under the Milk Income Loss Contract program through the end of fiscal year 2007, which (consistent with past baseline practices) led CBO to assume their extension through the following 10 years. In addition, the Implementing Recommendations of the 9/11 Commission Act of 2007 (P.L. 110-53) authorizes the Transportation Security Administration to collect fees from airline passengers and use them to improve security measures at airports.

### Net Interest

Under the rules that govern baseline projections, legislation enacted since March is estimated to increase projected deficits or reduce projected surpluses over the 2008–2017 period by \$1.2 trillion. The resulting increase in federal borrowing is projected to add \$335 billion to the government's debt-service costs over that period (for a total legislative impact on the baseline of nearly \$1.6 trillion).

### Revenues

On net, legislation enacted since March has had little impact on the outlook for revenues. CBO and the Joint Committee on Taxation estimate that recently enacted laws will lower revenues by \$191 million in 2007 and raise them by about \$73 million over the 2008–2017 period. Those amounts are the result of various provisions that are expected to decrease revenues by about \$5 billion between 2008 and 2017, offset by other provisions that are estimated to increase revenues by roughly the same amount over 10 years.

Most of the provisions that affect revenues are contained in P.L. 110-28. Provisions that are expected to reduce revenues include extending the work opportunity tax credit through 2011; allowing individual and corporate taxpayers to claim both that credit and the credit for Social Security and Medicare taxes paid on tips (the 45(B) credit) against the alternative minimum tax; and increasing the amount of investment between 2007 and 2010 that businesses can deduct immediately. Revenue-raising provisions include increasing the age of children whose unearned income is taxed as if it were their parent's, and extending the time during which the Internal Revenue Service (IRS) can charge taxpayers interest and penalties on deficiencies in their tax payments (if the IRS has not notified them of those deficiencies) from 18 months to 36 months. Another provision of P.L. 110-28

requires large corporations to pay a greater share of their estimated income taxes between July and September 2012; that change will shift revenues from fiscal year 2013 into 2012.

## The Effects of Economic Changes

As a result of changes to its economic forecast, CBO has raised its projections of both revenues and spending for the 2008–2017 period. (CBO's current economic outlook is described in Chapter 2.) Revenue projections have risen because of higher estimates for nominal gross domestic product (GDP), wages, and corporate profits. That increase is partly offset by higher spending projections, which result from a rise in the rates of inflation anticipated for the near term. On net, economic revisions to the baseline have cut \$16 billion from the 2007 deficit and improved the cumulative budget outlook for the following 10 years by \$525 billion.

### Revenues

As a result of updates to its economic forecast, CBO has raised its revenue estimates by \$20 billion for 2007 and by steadily increasing amounts thereafter. Over the 2008–2017 period, those increases total \$582 billion—or about 1.7 percent more than the previous baseline levels.

The revenue increases mainly reflect changes in the outlook for several types of income: higher wages, salaries, and corporate profits, partially offset by lower personal interest income. Those revisions to income projections in turn stem from changes to CBO's forecast for nominal GDP and for profits as a share of GDP:

- Higher inflation in the first half of 2007 has prompted CBO to raise its forecast for nominal GDP and taxable income. In the case of income, that increase persists throughout the 10-year projection period because the level of income from which the projection starts is higher, while projected inflation after the first half of this year remains similar to the rates used in CBO's previous baseline. CBO has also slightly raised its projection of growth in the labor force, which produces small increases in the outlook for nominal GDP after 2008.
- The share of GDP that is projected to be earned as corporate profits has also grown. That increase flows from CBO's assumption that some other categories of capital income—especially interest payments by U.S.

businesses—will account for smaller shares of GDP than previously projected. Net business interest payments have declined as a percentage of GDP since 2000; CBO now expects that the decline will not be reversed over the next 10 years, as previous forecasts had assumed. People receive much of their interest income in nontaxable or tax-deferred forms, such as in individual retirement accounts (IRAs) and 401(k) accounts, so assuming that less income will be earned as personal interest income and more as corporate profits, which are taxable, raises estimates of tax revenues.

### **Mandatory Spending**

Updates to CBO's estimates of inflation, unemployment, and other economic variables affect the outlook for various mandatory programs. Such changes have increased baseline projections of mandatory spending for the 2008–2017 period by \$83 billion.

**Social Security.** Inflation (as measured by the consumer price index for urban wage earners) has been much higher in 2007 than CBO expected. As a result, CBO has added 1.0 percentage point to its estimate of the cost-of-living adjustment that will be made to Social Security benefits in 2008, which raises projected payments to beneficiaries each year thereafter. In addition, CBO's estimates of growth in Social Security's national average wage index are generally higher than they were in March, which boosts projected benefit payments beginning in 2009. Together, those changes have increased outlay projections for Social Security by \$54 billion (or 1 percent) through 2017.

**Unemployment Compensation.** CBO has lowered its projections of the unemployment rate by an average of 0.2 percentage points per year through 2017. Benefit payments from the Unemployment Trust Fund are linked to that rate, so CBO's estimates of unemployment benefits have also declined, by a total of \$21 billion for the 2008–2017 period.

**Medicare.** Inflation has a direct impact on health care costs. In particular, payment rates for most services in the fee-for-service sector of Medicare (including hospital care and services furnished by physicians, home health agencies, and skilled nursing facilities) are subject to automatic updates based on changes in input prices in those settings. Thus, CBO's new, higher inflation projections

for 2007 and 2008 raise its estimates of Medicare spending by a total of \$14 billion through 2017.

**Student Loans.** Changes in the outlook for short-term interest rates have boosted projected subsidy costs for student loans each year through 2017. CBO has raised its projections of three-month interest rates—the rates on which federal payments to lenders are based—by an average of about 0.25 percentage points per year after 2007. As a result, outlay projections for student loan programs over the 2008–2017 period have increased by a total of about \$12 billion.

**Other Mandatory Programs.** Projections for other benefit programs—such as Food Stamps, civil service and military retirement, and veterans' compensation and pensions—have also risen. Like Social Security, those programs will see a larger cost-of-living adjustment in 2008 than CBO projected in March. Such changes are the main drivers of the \$24 billion net increase in projected outlays for other mandatory programs between 2008 and 2017.

### **Discretionary Spending**

CBO projects discretionary budget authority using two measures of inflation: the GDP price index (which covers changes in prices for all goods and services that contribute to GDP) and the employment cost index (which covers changes in wages and salaries). CBO expects both of those measures to be slightly higher in 2008 than previously anticipated. As a result, it has increased its 10-year projections of discretionary outlays by a total of \$29 billion for economic reasons.

### **Net Interest**

Economic revisions to projections of net interest spending have two parts: the effects of changes in the outlook for interest rates and inflation, and changes in debt-service costs that result from the impact of all other economic changes on the baseline projections. Since March, the first factor has raised projections of net interest outlays, and the second factor has lowered them—for a net decrease of \$55 billion (or 2 percent) over 10 years.

Because of higher-than-expected inflation this year, CBO has boosted its estimate of the amount of interest that the Treasury will pay on inflation-protected securities in 2007 by about \$4 billion. In addition, higher three-month interest rates in CBO's economic outlook have added \$45 billion to projected interest outlays over the

2008–2017 period. In the other direction, economic changes to CBO’s baseline have, on net, improved the cumulative 10-year budget outlook, reducing projected debt-service costs by roughly \$100 billion.

## The Effects of Technical Changes

Technical changes represent all revisions to the baseline that are not directly attributable to new laws or updated economic assumptions. Such changes have lowered this year’s projected deficit by \$32 billion and improved the 10-year budget outlook by \$99 billion.

### Revenues

Various technical factors have led CBO to increase its revenue projections by \$15 billion for 2007 and by \$109 billion (less than 0.5 percent) for the following 10 years. The technical changes are largest in 2008, at \$22 billion; after that, they decline steadily to \$9 billion in 2012 and remain near that level for the rest of the projection period.

The most significant technical changes to revenue projections involve capital gains realizations and distributions from pensions and IRAs, all of which affect receipts from individual income taxes:

- Newly available data from tax returns show that capital gains realizations were higher in calendar year 2005 than preliminary tax data had suggested. For that reason—and because the stock market was stronger in the first half of 2007 than previously expected—CBO has raised its estimates of capital gains realizations for 2007 and beyond. The effect of that change on projected tax receipts is largest in 2008 and tapers off in later years because CBO expects capital gains to revert to their longer-term equilibrium level relative to GDP.
- New data from 2005 tax returns also show greater-than-expected amounts of tax-deferred distributions from pensions and IRAs. In addition, data from the Federal Reserve’s flow-of-funds accounts suggest that amounts in tax-deferred accounts were higher at the end of calendar year 2006 than CBO had anticipated. Such information implies that retirement income is higher now than CBO estimated in March. Because the projection of retirement income grows from a higher base, the effect on tax revenues becomes larger over time, boosting projected receipts of individual income taxes by increasing amounts through 2017.

Other technical changes play a less prominent role in the overall revenue projections but have significant effects on particular sources of tax revenues in specific years. The most noteworthy of those changes stems from recent information on refunds of telephone excise taxes. After successful court challenges to their validity, the IRS terminated part of those taxes last year and authorized that individuals and businesses receive refunds for the taxes they had paid in the three previous years. In March, CBO predicted that about \$13 billion in refunds would be paid in 2007. However, it now appears that less than half that amount will be disbursed. When filing income tax returns this year, fewer taxpayers than expected chose to calculate their actual taxes paid, instead opting for the automatic “safe harbor” amount that could be obtained without any documentation. Also, the IRS reports that a large share of qualifying taxpayers did not claim any refund for those taxes.

### Mandatory Spending

Technical adjustments have boosted CBO’s estimates of outlays for mandatory programs in each year through 2017. Those adjustments have added \$4 billion to projected mandatory spending this year and \$64 billion (less than 0.5 percent) over the 2008–2017 period.

**Medicare.** Because of unexpectedly high spending through mid-July, CBO has raised its estimate of Medicare outlays in 2007 by \$6 billion. About \$1 billion of that increase reflects a timing shift: CBO had anticipated that prescription drug plans—which had lower-than-expected costs in 2006—would refund about \$1 billion to the Medicare program in 2007. CBO now believes that those payments will be made in 2008. The other \$5 billion reflects higher-than-expected spending for Medicare benefits thus far in 2007 and an improvement in how CBO accounts for recoveries of overpayments to providers. Those factors affect CBO’s expectations of future spending and account for most of the \$47 billion increase in projected Medicare outlays over the 2008–2017 period.

**Unemployment Compensation.** Average unemployment insurance benefits have been higher than anticipated this year, and CBO now expects that such payments will continue to be higher over the next 10 years than it estimated in March. As a result, CBO has added \$10 billion to its projection of spending for unemployment compensation over the 2008–2017 period.

**Other Mandatory Programs.** As a whole, technical changes to projections for other mandatory programs reduce spending in 2007 by \$3 billion and increase spending over the following decade by a total of \$7 billion. The largest changes involve projected spending for the National Flood Insurance Program, the Rural Utilities Service, and the Strategic Petroleum Reserve.

### **Discretionary Spending**

Technical revisions to the baseline since March have lowered projections of discretionary outlays by \$15 billion (about 1.5 percent) for 2007 and by \$17 billion (0.1 percent) for the 2008–2017 period. The biggest change for 2007 is a reduction of \$10 billion in estimated defense discretionary spending. That reduction reflects slower-than-expected spending by DoD, especially for operations and maintenance (which funds many of the department's day-to-day activities) and for procurement. CBO has also reduced outlay projections by \$6 billion for 2008 and \$2 billion for 2009 to reflect recent spending patterns in those two categories of DoD's budget.

For nondefense discretionary programs, the largest technical changes relate to Community Development Block Grants for states affected by the 2005 Gulf Coast hurricanes. Compared with its March baseline, CBO now projects more spending for that program in the near term

(another \$5 billion in 2007 and \$1 billion in 2008) and less spending in later years.

Other technical revisions have trimmed \$10 billion from CBO's estimate of nondefense discretionary outlays in 2007. The largest changes are a \$3 billion reduction in estimated spending for international affairs programs (mostly for activities related to international economic support and embassy security, construction, and maintenance); a \$2 billion decrease in estimated spending for highway and transit programs; and a \$2 billion reduction in estimated spending for Justice Department activities and various programs related to homeland security, including those of the Drug Enforcement Agency, U.S. Customs and Border Protection, and the Federal Bureau of Investigation. The remaining technical changes have decreased CBO's estimate of nondefense discretionary outlays in 2007 by an additional \$2 billion.

### **Net Interest**

In all, technical revisions have lowered CBO's projections of net interest outlays over the next 10 years by \$36 billion. Most of that decrease stems from lower projected debt-service costs because technical changes have increased projected revenues (mainly from corporate and individual income taxes). Other, smaller changes to projections of net interest spending reflect revisions to CBO's estimates of intragovernmental interest payments.



## A Comparison of CBO's and OMB's Baselines

**L**ike the Congressional Budget Office (CBO), the Administration's Office of Management and Budget (OMB) updates its baseline budget projections and economic assumptions each summer.<sup>1</sup> This appendix compares OMB's latest baseline projections—the July “current-services” baseline—with those produced by CBO. (Unlike CBO's 10-year projections, OMB's current-services baseline runs only through 2012.)

For 2007, CBO anticipates a deficit of \$158 billion—\$47 billion less than OMB's estimate of \$205 billion. Both agencies expect about the same amount of revenues to come in this year, but CBO anticipates \$44 billion less in outlays than OMB does (see Table B-1).

For the next five years, CBO's estimate of the cumulative baseline deficit exceeds OMB's estimate by \$488 billion (a total deficit of \$696 billion versus \$208 billion). Most of that difference stems from differing conceptual approaches to the treatment of supplemental appropriations and expiring tax provisions (see Box B-1 on page 58). CBO estimates that if OMB followed the estimating conventions specified in the Balanced Budget and Emergency Deficit Control Act of 1985, the gap between the two agencies' five-year deficit projections would nearly disappear. Adjusted for conceptual differences, CBO's revenue projections for the 2008–2012 period would be \$140 billion lower than OMB's, and its outlay projections would be \$128 billion lower than OMB's. The net result would be a difference in deficit projections of only \$12 billion, or 0.1 percent of total outlays, over five years.

### Outlays

The largest differences between CBO's and OMB's estimates of federal spending in 2007 are for discretionary

programs. Differences in the two agencies' estimates of mandatory spending and net interest outlays for 2007 are modest. For the 2008–2012 period, CBO projects \$726 billion more in total outlays than OMB does—conceptual differences cause CBO's estimate of total outlays to exceed OMB's by \$854 billion, but differences in underlying economic and technical assumptions reduce that disparity by \$128 billion.

### Discretionary Spending

By far the biggest gap between CBO's baseline projections and OMB's current-services baseline involves discretionary spending, mainly for defense. After 2007, that difference is largely attributable to the agencies' differing treatment of supplemental appropriations, as described in Box B-1.

Outlays for defense will total \$547 billion this year, CBO estimates—\$12 billion less than OMB's estimate. For the 2008–2012 period, CBO's projections of defense outlays exceed OMB's by a total of \$731 billion. Most of that difference results from the varying treatment of funding for military operations in Iraq and Afghanistan, appropriations for other activities associated with the war on terrorism, and other supplemental funding. The \$170 billion provided for such defense activities in 2007 is not extrapolated into future years in OMB's current-services baseline. Doing so would add an estimated \$717 billion to OMB's projection of defense discretionary outlays through 2012.<sup>2</sup> With those and other conceptual differences excluded, CBO's projection of defense discretionary spending over the 2008–2012 period would be \$4 billion higher than OMB's—a difference of only 0.2 percent.

1. OMB's most recent update was published in Office of Management and Budget, *Fiscal Year 2008 Mid-Session Review: Budget of the U.S. Government* (July 11, 2007).

2. OMB has not published complete details on the impact of its conceptual adjustments to the baseline. For discretionary spending, CBO used its own calculations to estimate the effect of such differences.

**Table B-1.**

## Comparison of CBO's August 2007 Baseline and OMB's July 2007 Current-Services Baseline

(Billions of dollars)

	2007	2008	2009	2010	2011	2012	Total, 2008- 2012
<b>CBO's August 2007 Baseline</b>							
Revenues	2,577	2,771	2,855	2,950	3,225	3,477	15,278
On-budget	1,944	2,101	2,152	2,211	2,451	2,667	11,582
Off-budget	633	669	703	739	774	810	3,696
Outlays							
Mandatory	1,457	1,553	1,639	1,729	1,846	1,883	8,650
Discretionary	1,042	1,120	1,165	1,195	1,223	1,239	5,942
Net interest	235	253	267	281	290	292	1,383
Total	2,735	2,925	3,071	3,205	3,359	3,415	15,974
On-budget	2,283	2,454	2,581	2,695	2,830	2,860	13,421
Off-budget	452	471	489	509	529	555	2,553
Deficit (-) or Surplus	-158	-155	-215	-255	-134	62	-696
On-budget	-339	-353	-429	-484	-379	-193	-1,839
Off-budget	181	198	214	229	245	255	1,142
<b>OMB's July 2007 Current-Services Baseline</b>							
Revenues	2,574	2,722	2,830	3,005	3,143	3,340	15,040
On-budget	1,941	2,054	2,124	2,257	2,351	2,509	11,294
Off-budget	633	669	706	749	792	832	3,746
Outlays							
Mandatory	1,471	1,556	1,651	1,745	1,871	1,932	8,756
Discretionary	1,072	1,028	1,020	1,028	1,039	1,057	5,172
Net interest	235	253	262	266	269	271	1,321
Total	2,779	2,837	2,934	3,039	3,179	3,259	15,248
On-budget	2,326	2,370	2,446	2,527	2,641	2,696	12,680
Off-budget	453	467	488	512	537	563	2,568
Deficit (-) or Surplus	-205	-115	-104	-34	-36	81	-208
On-budget	-385	-316	-322	-270	-291	-188	-1,387
Off-budget	180	202	218	236	255	268	1,178

Continued

Nondefense discretionary outlays will total \$495 billion in 2007, CBO estimates—\$18 billion less than OMB's estimate. Most of that difference comes from estimates for international assistance programs (which differ by \$6 billion) and for activities of the Department of Transportation (\$2 billion) and the Department of Homeland Security (\$2 billion). As with defense spending, CBO projects higher nondefense discretionary spending over

the 2008–2012 period than the Administration does; in this case, the difference is \$39 billion. That difference reflects about \$19 billion in emergency funding for 2007 that is not extrapolated in OMB's current-services baseline. With such variations in approach excluded, CBO's total projection of nondefense discretionary outlays over five years would be lower than the Administration's by \$35 billion, or 1.3 percent.



**Table B-1.****Continued**

(Billions of dollars)

	2007	2008	2009	2010	2011	2012	Total, 2008- 2012
<b>Difference (CBO's Baseline Minus OMB's)</b>							
Revenues	3	48	26	-55	82	137	238
On-budget	3	48	28	-46	100	158	289
Off-budget	0	1	-3	-10	-18	-21	-51
Outlays							
Mandatory	-14	-4	-12	-16	-25	-49	-106
Discretionary	-30	92	144	167	184	182	770
Net interest	*	*	5	15	21	22	62
Total	-44	88	137	166	180	155	726
On-budget	-42	85	136	168	188	164	741
Off-budget	-1	4	1	-3	-8	-9	-15
Deficit or Surplus <sup>a</sup>	47	-40	-111	-221	-98	-18	-488
On-budget	46	-37	-107	-214	-88	-6	-452
Off-budget	1	-3	-4	-7	-9	-13	-36

Sources: Congressional Budget Office (CBO) and Office of Management and Budget (OMB).

Notes: OMB's current-services baseline deviates from the concepts delineated in the Balanced Budget and Emergency Deficit Control Act of 1985 in two significant ways: It does not extrapolate supplemental appropriations provided for 2007 into future years, and it assumes that most tax provisions enacted in 2001 and 2003 will be extended rather than expire as currently scheduled.

\* = between -\$500 million and zero.

a. Positive numbers denote that the Administration's deficit estimate is higher than CBO's, and negative numbers denote the opposite.

**Mandatory Spending**

CBO anticipates that mandatory programs will spend \$14 billion less this year than the Administration estimates. The largest differences involve spending for Medicaid (\$5 billion) and the National Flood Insurance Program (\$3 billion).

CBO's projection of total mandatory outlays over the 2008–2012 period is lower than OMB's by \$106 billion, or 1.2 percent. In particular, CBO projects less spending than OMB does for Medicare (by \$65 billion), veterans' programs (\$34 billion), and Social Security (\$12 billion). Conversely, CBO's spending projections exceed the Administration's for some mandatory programs, such as unemployment insurance (by \$14 billion) and Medicaid (\$11 billion). The two agencies also differ in their five-year projections of the refundable portion of the earned income and child tax credits, primarily because of a

conceptual difference: OMB's assumed extension of expiring tax provisions causes its estimate to exceed CBO's by about \$15 billion in 2012.

**Net Interest**

The two agencies' estimates of net interest outlays in 2007 are nearly identical. For the 2008–2012 period, however, CBO's projection of those outlays exceeds OMB's by \$62 billion. Conceptual differences push CBO's projection \$68 billion above OMB's total, but differences in assumed interest rates, inflation, and other factors offset \$6 billion of that amount.

**Revenues**

Just \$3 billion separates CBO's and OMB's estimates of revenues in 2007. That gap is larger over the next five years, ranging from \$48 billion in 2008 to \$137 billion

**Box B-1.****Conceptual Differences Between CBO's and OMB's Baselines**

As it has done for many years, the Congressional Budget Office (CBO) constructs its baseline budget projections using methods specified in the Balanced Budget and Emergency Deficit Control Act of 1985.<sup>1</sup> Those methods include projecting discretionary spending by starting with the total funding provided for the current year—including supplemental appropriations—and extrapolating that amount into future years, with increases for expected inflation. The Deficit Control Act also stipulates that, in general, “laws providing or creating direct spending or receipts are assumed to operate in the manner specified in those laws.” Following that stricture, CBO assumes that tax provisions that are due to expire during the projection period will end as scheduled (except those involving excise taxes dedicated to trust funds).

The Office of Management and Budget's (OMB's) latest current-services baseline deviates from that framework in two significant ways:

- In projecting discretionary spending, OMB does not extrapolate and inflate all of the discretionary funding provided in 2007. It excludes further funding for U.S. operations in Iraq and Afghanistan and other activities related to the war on terrorism (which totaled \$170 billion this year), certain Department of Homeland Security spending for border control (\$1.8 billion), additional funding for relief and recovery from Hurricane Katrina and other hurricanes (\$7.4 billion), and other supplemental appropriations (\$9.7 billion). Mainly because of that difference, OMB's projection of total discretionary outlays over the 2008–2012 period is \$770 billion lower than CBO's.
- OMB's baseline assumes that most major provisions initially enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003—which are due to expire by the end of December 2010—will be extended. That difference causes OMB to project \$378 billion less in revenues between 2008 and 2012 than CBO does. Most of that disparity occurs in 2011 and 2012.

In addition, OMB made two small conceptual adjustments to its baseline that relate to the way it accounts for increases in pay and administrative expenses when projecting discretionary spending. Those adjustments result in lower levels of spending relative to CBO's estimates.

1. Although the provisions of the Deficit Control Act that pertain to the baseline expired at the end of September 2006, CBO continues to follow that law's specifications in preparing its baseline projections.

in 2012. For all but one of those years (2010), CBO projects higher revenues than the Administration does.

For the 2008–2012 period as a whole, CBO's estimate of total revenues exceeds OMB's by \$238 billion, of which \$219 billion occurs in 2011 and 2012. That disparity has two main causes:

- Economic and technical factors push CBO's five-year revenue projections below OMB's by \$140 billion (or 0.9 percent). In particular, the two agencies' projec-

tions are based on differing economic forecasts, especially for wage and salary income.<sup>3</sup> CBO assumes slightly lower growth in real (inflation-adjusted) gross domestic product (GDP) and lower inflation than the Administration does. As a result, CBO projects lower levels of nominal GDP and taxable income—especially wages and salaries, which it expects to be 1.7 percent lower than OMB does over the 2008–

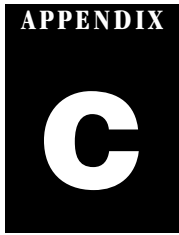
3. For details of CBO's updated economic forecast, see Chapter 2.

2012 period. Smaller wage and salary income translates into lower revenues from individual income taxes and social insurance (payroll) taxes relative to OMB's estimates. That factor accounts for about three-quarters of the economic differences between the two agencies' five-year revenue projections, with the effects particularly evident after 2009.

- Conceptual differences more than offset the impact of economic and technical differences. OMB's baseline

includes the effects of permanently extending certain elements of the tax provisions initially enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003, whereas CBO's baseline assumes that those provisions expire in 2010 as currently scheduled. OMB estimates that making those provisions permanent would reduce revenues by about \$378 billion between 2008 and 2012, mostly after 2010.





## **CBO's Economic Projections for 2007 to 2017**

**T**he tables in this appendix expand on the information in Chapter 2 by showing the Congressional Budget Office's (CBO's) year-by-year economic projections for 2007 to 2017 (by calendar year in Table C-1 and by fiscal year in Table C-2). CBO does not forecast cyclical fluctuations in its projections for years after 2008. Instead, the

projected values shown in the tables for 2009 through 2017 reflect CBO's assessment of average values for that period. That assessment takes into account economic and demographic trends but does not attempt to forecast the frequency and size of ups and downs in the business cycle.

**Table C-1.****CBO's Year-by-Year Forecast and Projections for Calendar Years 2007 to 2017**

	Actual 2006 <sup>a</sup>	Forecast		Projected								
		2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Nominal GDP (Billions of dollars)	13,247	13,893	14,575	15,306	16,073	16,827	17,595	18,390	19,213	20,054	20,925	21,829
Nominal GDP (Percentage change)	6.3	4.9	4.9	5.0	5.0	4.7	4.6	4.5	4.5	4.4	4.3	4.3
Real GDP (Percentage change)	3.3	2.1	2.9	3.2	3.2	2.8	2.7	2.7	2.6	2.5	2.5	2.5
GDP Price Index (Percentage change)	2.9	2.7	2.0	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8
PCE Price Index <sup>b</sup> (Percentage change)	2.7	2.3	2.0	1.8	1.8	1.9	1.9	1.9	1.9	1.9	1.9	1.9
Core PCE Price Index <sup>c</sup> (Percentage change)	2.2	2.0	1.9	1.8	1.8	1.8	1.9	1.9	1.9	1.8	1.8	1.9
Consumer Price Index <sup>d</sup> (Percentage change)	3.2	2.8	2.3	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Core Consumer Price Index <sup>e</sup> (Percentage change)	2.5	2.6	2.2	2.3	2.4	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Employment Cost Index <sup>f</sup> (Percentage change)	2.9	3.5	3.4	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3
Unemployment Rate (Percent)	4.6	4.5	4.7	4.8	4.8	4.8	4.8	4.8	4.8	4.8	4.8	4.8
Three-Month Treasury Bill Rate (Percent)	4.7	4.8	4.8	4.8	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7
Ten-Year Treasury Note Rate (Percent)	4.8	4.9	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2
Tax Bases (Billions of dollars)												
Corporate book profits	1,811	1,880	1,897	1,907	1,929	1,962	1,995	2,044	2,111	2,185	2,268	2,352
Wages and salaries	6,031	6,383	6,703	7,046	7,399	7,748	8,104	8,470	8,844	9,222	9,612	10,016
Tax Bases (Percentage of GDP)												
Corporate book profits	13.7	13.5	13.0	12.5	12.0	11.7	11.3	11.1	11.0	10.9	10.8	10.8
Wages and salaries	45.5	45.9	46.0	46.0	46.0	46.0	46.1	46.1	46.0	46.0	45.9	45.9

Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

Note: GDP = gross domestic product; percentage changes are measured from one year to the next.

- a. Values as of early July 2007, prior to the revisions to the national income and product accounts.
- b. The personal consumption expenditure chained price index.
- c. The personal consumption expenditure chained price index excluding prices for food and energy.
- d. The consumer price index for all urban consumers.
- e. The consumer price index for all urban consumers excluding prices for food and energy.
- f. The employment cost index for wages and salaries of workers in private industry.

**Table C-2.****CBO's Year-by-Year Forecast and Projections for Fiscal Years 2007 to 2017**

	Actual 2006 <sup>a</sup>	Forecast		Projected								
		2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Nominal GDP (Billions of dollars)	13,065	13,721	14,401	15,120	15,881	16,640	17,399	18,190	19,005	19,842	20,704	21,599
Nominal GDP (Percentage change)	6.5	5.0	5.0	5.0	5.0	4.8	4.6	4.5	4.5	4.4	4.3	4.3
Real GDP (Percentage change)	3.3	2.3	2.7	3.1	3.2	2.9	2.7	2.7	2.6	2.6	2.5	2.5
GDP Price Index (Percentage change)	3.1	2.7	2.2	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8
PCE Price Index <sup>b</sup> (Percentage change)	3.1	2.1	2.2	1.8	1.8	1.9	1.9	1.9	1.9	1.9	1.9	1.9
Core PCE Price Index <sup>c</sup> (Percentage change)	2.2	2.1	1.9	1.9	1.8	1.8	1.9	1.9	1.9	1.8	1.8	1.9
Consumer Price Index <sup>d</sup> (Percentage change)	3.7	2.4	2.7	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Core Consumer Price Index <sup>e</sup> (Percentage change)	2.4	2.6	2.3	2.3	2.4	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Employment Cost Index <sup>f</sup> (Percentage change)	2.7	3.4	3.5	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3
Unemployment Rate (Percent)	4.8	4.5	4.7	4.7	4.8	4.8	4.8	4.8	4.8	4.8	4.8	4.8
Three-Month Treasury Bill Rate (Percent)	4.5	4.9	4.8	4.8	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7
Ten-Year Treasury Note Rate (Percent)	4.8	4.8	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2
Tax Bases (Billions of dollars)												
Corporate book profits	1,751	1,868	1,890	1,906	1,922	1,954	1,986	2,031	2,092	2,167	2,247	2,331
Wages and salaries	5,941	6,295	6,620	6,959	7,311	7,662	8,013	8,378	8,750	9,127	9,513	9,914
Tax Bases (Percentage of GDP)												
Corporate book profits	13.4	13.6	13.1	12.6	12.1	11.7	11.4	11.2	11.0	10.9	10.9	10.8
Wages and salaries	45.5	45.9	46.0	46.0	46.0	46.0	46.1	46.1	46.0	46.0	45.9	45.9

Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

Note: GDP = gross domestic product; percentage changes are measured from one year to the next.

- a. Values as of early July 2007, prior to the revisions to the national income and product accounts.
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- d. The consumer price index for all urban consumers.
- e. The consumer price index for all urban consumers excluding prices for food and energy.
- f. The employment cost index for wages and salaries of workers in private industry.





# Contributors to the Revenue and Spending Projections

**T**he following Congressional Budget Office analysts prepared the revenue and spending projections in this report:

## Revenue Projections

Mark Booth	Individual income taxes
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Pamela Greene	Corporate income taxes, estate and gift taxes
Ed Harris	Individual income taxes
Andrew Langan	Excise taxes
Larry Ozanne	Capital gains realizations
Kevin Perese	Tax modeling
Kristy Piccinini	Capital gains realizations
Anna Rakhman	Capital gains realizations
Emily Schlect	Customs duties, miscellaneous receipts
Kurt Seibert	Earned income tax credit, depreciation
David Weiner	Individual income taxes

## Spending Projections

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Jeffrey Holland	Unit Chief, Projections
Edward Blau	Authorization bills
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Joanna Capps	Appropriation bills (Interior and the environment, Labor–Health and Human Services)
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Mary Froehlich	Computer support
Ann Futrell	Other interest, report coordinator
Amber Marcellino	Other interest, report coordinator
Virginia Myers	Appropriation bills (Commerce–Justice, financial services, general government)
Jennifer Reynolds	Appropriation bills (Agriculture, foreign relations)
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Eric Schatten	Interest on the public debt, report coordinator
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