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New CBO Budget Baseline Shows Entitlement Spending Imperiling Deficit Reduction Goals

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The Congressional Budget Office (CBO) released its annual ten-year budget baseline today. The CBO provided two different baselines: one incorporating realistic assumptions and one with the unrealistic assumptions required by law. The realistic baseline shows that, while tax revenues continue to rise, entitlement spending is projected to drive the budget deficit to $367 billion by 2012 and $704 billion by 2017. Reforming Social Security, Medicare, and Medicaid is the only way to get the budget under control.

Building the Baseline

Overall, the CBO projects a budget deficit of $172 billion in 2007. The deficit then gradually decreases before reaching a surplus of $170 billion in 2012. However, the CBO estimates do not paint a realistic budget picture, because they are required by law to assume:

1. All of the Bush tax cuts will expire, as well as all other temporary tax cuts;
2. The threshold for the Alternative Minimum Tax (AMT) will not be adjusted annually for inflation;
3. Current spending levels in Iraq and Afghanistan will continue; and
4. Non-war discretionary spending will expand just 1.9 percent per year through 2017.

The CBO includes alternative budget estimates that can be used to construct a more realistic baseline. The projections used in this paper adjust the CBO's baseline to assume:

1. All expiring tax cuts will be extended, and the AMT will be annually adjusted for inflation;
2. Spending on Iraq and Afghanistan will grow at the midpoint between the CBO's "slow drawdown" and "fast drawdown" scenarios; and
3. Other discretionary spending will expand 4 percent per year beginning in FY 2008.

Even a baseline incorporating these assumptions likely understates spending. The baseline assumes that farm subsidies will be halved and several antipoverty programs will expand no faster than the inflation rate. Additionally, this baseline assumes that there will be no additional terrorist attacks, natural disasters, or new entitlement programs.

General Budget Trends

- Through 2017, the adjusted projections show 4.8 percent growth per year in federal spending, exceeding the 4.1 percent annual growth in revenue. GDP is projected to increase by 4.5 percent annually.
- Since 2001, federal spending has surged 42 percent—7.3 percent per year, on average. Had spending increases been limited to 29 percent—

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Table 1 WM 1329

Adjusted CBO Budget Baseline ($billions)

FY	Revenue	Spending	Budget Deficit
2006	$2,407	$2,654	-$248
2007	2,530	2,739	-209
2008	2,648	2,890	-242
2009	2,732	3,013	-281
2010	2,796	3,129	-333
2011	2,899	3,291	-392
2012	3,033	3,400	-367
2013	3,136	3,586	-450
2014	3,272	3,772	-500
2015	3,424	3,982	-558
2016	3,580	4,239	-659
2017	3,745	4,449	-704

Source: Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2008 to 2017," January 2007.

5.2 percent annually—the budget would already be in balance.

- In 2006, spending increased by $182 billion, or 7.4 percent. The budget deficit dipped by $71 billion only because tax revenues leaped by $253 billion—12 percent.
- President Bush has pledged to balance the budget without tax increases by 2012. That means spending, which is projected at $2,739 billion in 2007, would be limited in 2012 to the revenue projection of $3,033 billion. Reaching that target means total spending between 2007 and 2012 could grow by no more than $294 billion. Total spending could rise no more than 2 percent annually.

Entitlement Spending

- The spending trends for Social Security, Medicare, and Medicaid present major obstacles to balancing the budget by 2012. Balancing the budget without tax increases requires lawmakers to limit 2012 federal spending to $294 billion above the 2007 level. However, spending on Social Security, Medicare, and Medicaid is projected to increase by $367 billion during that period. Thus, if lawmakers refuse to address these three entitlements, the rest of the budget would have to be reduced by $71 billion by 2012.
- Over the next decade, Medicare and Medicaid costs will surge by nearly 8 percent per year, and Social Security costs by 6 percent annually. These programs will rise from 8.5 percent to 10.7 percent of GDP as the baby boomers begin to retire.
- Medicare spending (including offsetting receipts) expanded 12 percent in 2006 and will grow 13 percent more in 2007. Combined Medicare and Medicaid spending now exceeds Social Security spending.
- The Medicare drug entitlement is now projected to cost $822 billion through 2017. It will cost $60 billion per year by 2012 and $119 billion per year by 2017. Its annual expense will continue to increase thereafter.

Deficits and Public Debt

- The public debt now stands at 37 percent of GDP, which is below the post-war average of 44 percent of GDP and lower than every year during the 1990s. By historical standards, the public debt is small. The much larger threat is the trillions in future costs associated with Social Security, Medicare, and Medicaid.
- As the budget deficit increases over the next decade, so will net interest spending—from $227 billion (1.9 percent of GDP) in 2006 to $446 billion (3.3 percent of GDP) in 2017.

Taxes and Tax Policy

- Tax revenues in 2006 amounted to 18.4 percent of GDP— above the 40-year average of 18.3 percent. Revenues are projected to reach 18.5 percent of GDP in 2007 and 2008, assuming tax extenders and AMT relief.
- Tax revenues continue to expand strongly. Following growth rates of 15 percent and 12 percent in 2005 and 2006, these projections show healthy 5 percent revenue growth in 2007 and 2008, even after adjusting for all tax extenders and AMT relief.
- The actual 2006 tax revenues of $2,407 billion were $47 billion more than the amount the CBO projected *before* the 2003 tax cuts.

- Capital gains revenues continue their rapid rise. Following the 2003 capital gains tax cuts, the CBO projected that revenues would rise from the current $50 billion to $68 billion in 2006. Instead, 2006 revenues came in at $103 billion—double the 2003 level and the second-highest level ever. The capital gains tax cuts have more than paid for themselves.
- Allowing the Bush tax cuts to expire would not be sufficient to balance the budget by 2012. Furthermore, while the CBO projects that allowing the Bush tax cuts to expire would increase revenues by 1.5 percent of GDP, these projections unrealistically assume that steep tax rate hikes would not affect productivity and economic growth. Nearly all economists would reject that assumption. In reality, the revenue increases would be much smaller than the CBO's projection, as high tax rates discourage working, saving, investing, and other productive activities.

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