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Notes on the New 10-Year CBO Budget Baseline

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The Congressional Budget Office (CBO) recently released its annual 10-year budget baseline. However, Congress requires the CBO to include unrealistic assumptions in its baseline. Therefore, the CBO also provides a set of alternative budget assumptions that can be used to build a more realistic baseline. A realistic baseline shows that while tax revenues continue to rise, entitlement spending is projected to drive the budget deficit to $390 billion by fiscal year (FY) 2012 and $788 billion by FY 2018. The best way to get the budget under control is by reforming Social Security, Medicare, and Medicaid.

Building a Baseline. Congress requires the Congressional Budget Office (CBO) to include in its 10-year baseline the following unrealistic assumptions: The Bush tax cuts and all other temporary tax cuts will expire; the Alternative Minimum Tax (AMT) will not be annually adjusted for inflation; and non-war discretionary spending will grow no faster than inflation through 2018.

The projections used in this paper adjust the CBO's baseline with the following assumptions:

- All expiring tax cuts will be extended, and the AMT will be annually adjusted for inflation;
- Spending on Iraq and Afghanistan will grow at the midpoint between CBO's "slow drawdown" and "fast drawdown" scenarios; and
- Other discretionary spending will expand by 4 percent per year beginning in FY 2009.

Through 2018, the more realistic baseline projects that federal spending will increase by an average of 5.0 percent annually and revenues will increase by an average of 4.1 percent annually. The budget deficit would reach $263 billion in FY 2008, $390 billion in FY 2012, and $788 billion in FY 2018.

This excludes any stimulus package, which would likely add approximately $150 billion to the FY 2008 budget deficit but would have a minimal effect on subsequent years' budget deficits.

General Budget and Spending Trends[1]

- Since 2001, federal spending has surged by 47 percent—6.6 percent per year, on average. Had spending increases been limited to 38 percent—5.5 percent annually—the budget would already be in balance.
- In 2007, spending increased by $75 billion, or 2.8 percent. The budget deficit dipped by $86 billion because tax revenues leaped by $161 billion, or 6.7 percent.
- Social Security, Medicare, and Medicaid costs are the most serious threat to reining in spending. Medicare spending has surged by 51 per-

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cent over the past four years. Over the next decade, the CBO projects, Medicaid will expand by 8 percent annually, Medicare by 7 percent annually, and Social Security by 6 percent annually. These programs will rise from 8.8 percent to 10.8 percent of GDP as the Baby Boomers begin to retire en masse—a process which began with the first Baby Boomers collecting Social Security benefits on January 1.

- The Medicare drug entitlement is now projected to cost $783 billion over the next decade. It will cost $56 billion per year by 2012 and $112 billion per year by 2018. Its annual expense will continue to increase thereafter.
- Defense spending is currently 4.0 percent GDP, up from 3.0 percent when President Bush took office. However, it remains well below the 40-year average of 5.1 percent of GDP, and lower than it had been at any time during the Cold War.

Deficits and Public Debt

- At 1.2 percent of GDP, the 2007 budget deficit was lower than in 25 of the past 30 years.
- 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.
- The much-larger threat is the trillions in future costs associated with Social Security, Medicare, and Medicaid, which the CBO projects could push the federal public debt to nearly 300 percent of GDP by 2050, and over 850 percent of GDP by 2082.[2]
- Even if the stimulus package pushes the 2008 budget deficit to $400 billion, it would still come to only 2.8 percent of GDP—slightly above the 40-year average of 2.4 percent of GDP. By comparison, the highest budget deficit ever measured was 30.3 percent of GDP in 1943, during World War II. The post-war peak of 6.0 percent of GDP occurred in 1983.
- As the budget deficit increases over the next decade, so will net interest spending—from $238 billion (1.7 percent of GDP) in 2006 to $506 billion (2.3 percent of GDP) in 2017.

Taxes and Tax Policy

- By historical standards, Americans are now overtaxed. Total 2007 tax revenues (18.8 percent of GDP) and individual income tax revenues (8.5 percent of GDP) are well above their historical averages, and even above their averages in the 1990s.[3] Concerns that the Bush tax cuts would lead to a long-term shortfall of government revenues have proven false.
- Over the past three years, tax revenues have increased by 15 percent, 12 percent, and 7 percent, respectively. The inflation-adjusted 2004–2007 revenue surge of 25 percent represents the largest three-year tax revenue surge since 1966–1969.
- 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 $73 billion in 2007. Instead, 2007 revenues came in at $122 billion—more than double the 2003 level and the second-highest level ever. The capital gains tax cuts have more than paid for themselves.[4]

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1. Past budget data come from Office of Management and Budget, "Budget of the United States Government: 2009 Historical Tables," at *www.whitehouse.gov/omb/budget/fy2009/hist.html*. Future projections were calculated by The Heritage Foundation using Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2008 to 2018," January 2008, at *www.cbo.gov/ftpdocs/89xx/doc8917/Frontmatter.1.3.shtml.*
2. Congressional Budget Office "The Long-Term Budget Outlook," December 2007, Figure 1.2, at *www.cbo.gov/ftpdocs/88xx/doc8877/12-13-LTBO.pdf*, and supplemental data for Figure 1.2 at *www.cbo.gov/ftpdocs/88xx/doc8877/SupplementalData.xls*. This represents the alternative fiscal scenario.
3. Office of Management and Budget, "Budget of the United States Government: 2009 Historical Tables," Table 2.3, located at *www.whitehouse.gov/omb/budget/fy2009/hist.html*. The 20-, 40-, and 60-year historical averages range from 17.9 percent to 18.4 percent of GDP for total tax revenues, and from 8 to 8.4 percent of GDP for individual income tax revenues. During the 1990s, the figures were 18.6 percent and 8.4 percent of GDP, respectively.

- Tax revenues in 2007 came in at $63 billion above the level projected even *before* the 2003 tax cuts. In other words, tax revenues are now *above* their pre-tax cut baseline.[5]

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4. Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2004-2013," January 2003, Table 3.5, at *www.cbo.gov/ftpdoc.cfm?index=4032&type=0*. Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2008 to 2018," January 2008, Table 4.3, at *www.cbo.gov/ftpdocs/89xx/doc8917/Chapter4.8.1.shtml#1069855.*
5. Following the 2003 tax cuts, the Congressional Budget Office (CBO) lowered its 2007 revenue projections from $2,504 billion to $2,421 billion. Final 2007 tax revenues were $2,567 billion. See Congressional Budget Office, "An Analysis of the President's Budgetary Proposals for Fiscal Year 2004," March 2003, at *www.cbo.gov/showdoc.cfm?index=4129&sequence=0#pt3*, and Congressional Budget Office, "The Budget and Economic Outlook: An Update," August 2003, at *www.cbo.gov/ftpdoc.cfm?index=4493&type=0&sequence=2*