WebMemo
Published by The Heritage Foundation

No. 2057
September 10, 2008

New CBO Budget Baseline Shows Entitlements Driving Budget Deficits Higher

Brian Riedl

The Congressional Budget Office (CBO)'s new 10-year baseline shows steep Social Security, Medicare, and Medicaid spending costs driving the budget deficit upwards.

The published CBO baseline shows manageable 10-year budget estimates based on unrealistic assumptions that Congress requires the CBO to include in its baseline. Therefore, the CBO also provides a set of alternative budget assumptions that can be used to build a more realistic baseline. This realistic baseline shows that, while tax revenues should begin recovering next year, entitlement spending is projected to drive the budget deficit to $577 billion by 2013 and $969 billion by 2018. The best way to get the budget under control is by reforming Social Security, Medicare, and Medicaid and bringing down their 7 percent projected annual growth.

A Flawed Baseline. CBO's baseline projects $2.6 trillion more in federal debt over the next decade than had been projected in the March baseline. However, most of this higher debt figure results from a methodology quirk in the scoring of Iraq and Afghanistan spending rather than any actual policy change that would result in additional spending.[1] The substantive changes since March include higher inflation and interest rate assumptions that push spending slightly upward, as well as the inclusion of a new economic stimulus bill, a housing bailout, and veterans' entitlements.

Building a Better Baseline. In order to fix methodological problems like the one listed above, it is necessary to construct a more realistic baseline. Currently, Congress requires the CBO to include in its 10-year baseline the following unrealistic assumptions: that the Bush tax cuts and all other temporary tax cuts will expire, that the Alternative Minimum Tax (AMT) will not be annually adjusted for inflation, that non-war discretionary spending will grow no faster than inflation through 2018; and that the most recent Iraq and Afghanistan spending levels will continue (and grow) 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 adjusted for inflation annually;
- 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 2010.

Through 2018, the more realistic baseline projects that federal spending will increase by an average of 5.2 percent annually and revenues will increase by an average of 4.4 percent annually. The budget deficit would reach $407 billion in FY 2008,

This paper, in its entirety, can be found at:
www.heritage.org/Research/Economy/wm2057.cfm

Produced by the Thomas A. Roe Institute for Economic Policy Studies

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
(202) 546-4400 • heritage.org

$577 billion in FY 2013, and $969 billion in FY 2018 (see Table 1).

The updated budget numbers reveal short-term challenges caused by the slowing economy, followed by long-term challenges caused by escalating entitlement costs.

Current Budget and Spending Trends[2]

- Since 2001, federal spending has surged by 59 percent—6.8 percent per year on average. Had spending increases been limited to 37 percent—4.6 percent annually—the budget would already be in balance.
- Spending levels in 2008 are projected 8.3 percent above last year's level. Revenues are projected 0.8 percent below last year's level.
- Of the projected $247 billion rise in the budget deficit in 2008, $226 billion results from additional spending, and $21 billion results from decreased revenues.
- The "refundable" portion of the tax rebates is classified as spending (since it functions as a subsidy for those who paid little or no income taxes) and adds $38 billion in 2008 spending. Deposit insurance costs from failing banks and thrifts add $14 billion to 2008 spending, and rising unemployment insurance costs add $11 billion. Each of these is considered temporary.
- In 2009, spending is projected to reach 21.4 percent of GDP for the first time since 1993.
- Another temporary expense—the Fannie Mae and Freddie Mac bailout—adds $25 billion in projected costs over 2009 and 2010.
- The new college subsidies for veterans added $61 billion in projected spending over the next decade.

A More Realistic Budget Baseline
($billions)

Year	Revenues	Spending	Budget Deficit
2007	$2,568	$2,729	–$161
2008	2,547	2,955	–407
2009	2,613	3,146	–533
2010	2,767	3,268	–501
2011	2,896	3,439	–543
2012	3,052	3,544	–492
2013	3,171	3,748	–577
2014	3,293	3,952	–659
2015	3,450	4,173	–723
2016	3,604	4,446	–842
2017	3,764	4,668	–904
2018	3,933	4,902	–969

Source: Heritage Foundation calculations using Congressional Budget Office, "The Budget and Economic Outlook: An Update," September 2008, at *http://www.cbo.gov/ftpdocs/97xx/doc9706/09-08-Update.pdf.*

Table 1 • WM 2057 heritage.org

- Defense spending is currently 4.3 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 anytime during the Cold War.
- Balancing the budget by 2013 would require either limiting annual spending growth to 1.4 percent or raising annual revenue growth to 8.0 percent, or a combination of both.

The Entitlement Challenge

- Social Security, Medicare, and Medicaid costs are the most serious threat to reining in spending. Medicare spending has surged by 59 percent over the past five years. Over the next decade, the CBO projects that Medicaid will expand by 8 percent annually, Medicare by 7 percent annu-

1. CBO was required to project the latest Iraq War supplemental bill outward for the next decade, which added $1 trillion in projected new spending (and pushed projected 2018 supplemental spending to an unrealistic $219 billion). This new spending also caused much of the $672 billion hike in projected net interest spending over the next decade. When the timing of a bill's enactment can cause trillion-dollar swings in spending estimates, there is clearly a problem with the methodology that Congress is forcing CBO to use.
2. Past budget data comes from Office of Management and Budget, Budget of the United States Government: 2009 Historical Tables, at *www.whitehouse.gov/omb/budget/fy2009/hist.html* (September 9, 2008). Future projections were calculated by The Heritage Foundation using Congressional Budget Office, "The Budget and Economic Outlook: An Update," September 2008, at *http://www.cbo.gov/ftpdocs/97xx/doc9706/09-08-Update.pdf* (September 9, 2008).

ally, and Social Security by 6 percent annually. These programs will rise from 8.4 percent to 10.4 percent of GDP as the baby boomers begin to retire en masse—a process that already began with the first baby boomers collecting Social Security benefits on January 1.

- The Medicare drug entitlement is 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.
- It is highly unlikely that the budget will ever be balanced again until Social Security, Medicare, and Medicaid are reformed. To eliminate a budget deficit, spending must grow more slowly than revenues. But with these three spending programs soon to comprise half of the federal budget, their combined 7 percent annual growth is simply too great for revenue growth to keep up with, much less exceed, over the long-term.

Deficits and Public Debt

- The best way to measure budget deficits is as a percentage of GDP. Despite claims of "record deficits," the 2008 budget deficit of 2.9 percent of GDP is only the 13th largest budget deficit in the last 26 years. By comparison, the budget deficit peaked at 30.3 percent of GDP in 1943, during World War II. The post-war peak of 6.0 percent of GDP occurred in 1983.
- The public debt now stands at 38 percent of GDP, which is below the post-war average of 43 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.[3]
- Net interest spending is projected to rise over the next decade from $244 billion (1.7 percent of GDP) in 2008 to $597 billion (2.7 percent of GDP) in 2017. These higher net interest costs would result from increased debt levels, as well as interest rate increases that the CBO is projecting.

Taxes and Tax Policy

- After topping the historical average of 18.3 percent of GDP in 2007, tax revenues are projected to dip to 17.9 percent of GDP in 2008. The largest declines have occurred in corporate tax revenues, which are projected to drop by $55 billion (15 percent) this year.
- The economic stimulus package of tax rebates and business tax deductions trimmed projected revenues by approximately $80 billion in 2008 and $45 billion in 2009. After that, tax revenues are expected to rise up closer to the historical average.
- Inflation-adjusted tax revenues had surged by 25 percent between 2004 and 2007 (the largest three-year tax revenue surge since 1966–1969) before the 2008 decline. Revenues are projected to resume their annual increases beginning in 2009.

—Brian M. Riedl is Grover M. Hermann Fellow in Federal Budgetary Affairs in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.

3. Congressional Budget Office "The Long-Term Budget Outlook," December 2007, figure 1.2, at *www.cbo.gov/ftpdocs/88xx/doc8877/12-13-LTBO.pdf* (September 9, 2008), and supplemental data for Figure 1.2 at *www.cbo.gov/ftpdocs/88xx/doc8877/SupplementalData.xls* (September 9, 2008). This represents the alternative fiscal scenario.