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**AN ALTERNATE BASELINE
FEBRUARY 4, 2008**

As the Committee noted in an earlier release, ([CRFB CBO Statement](#)) the Congressional Budget Office (CBO) currently projects that—after three consecutive years of decline—the deficit will increase to \$219 billion in fiscal year 2008. The CBO baseline also shows the budget returning to surplus in 2012.

CBO projections reflect current law, which does not reflect many likely budget scenarios. Accordingly, this budget update calculates an alternate baseline that incorporates alternate budget scenarios. This baseline does not necessarily reflect the policy path that is likely to occur—the next Administration will most likely enact major changes. But the numbers in this baseline help paint a realistic picture of the current short-term fiscal picture.

We find that the deficit is likely to hover between 2.5 and 3 percent of GDP over the next few years before growing steadily over the second five years of the 2009 – 2018 projection period. Under this scenario, debt as a share of GDP will reach levels not seen in the prior 40 years, and will continue to increase beyond the projection period as the costs of providing health care to the nation's poor and elderly continue to grow faster than the economy as a whole.

Alternate Baseline Assumptions

- **Defense projections** - In recent years, CBO's baseline spending assumptions have oscillated between August and January with the level of appropriations provided for the Iraq War. In January, when only a portion of the full year cost of military operations has been enacted, the spending baseline is lower than it is in August when the full-year costs have been funded. CBO estimates that increasing the baseline assumption of Iraq War funding to the 2007 level of about \$170 billion (up from the \$88 billion in the January baseline) would increase cumulative spending by more than \$850 billion for 2008 through 2017. CBO also provides two scenarios to simulate the eventual reduction of US troop levels in Iraq. One assumes that troops are reduced to 30,000 in 2010, and the other assumes that troops are reduced to 75,000 by 2013. Counting the current

205,000 troop strength and \$170 billion annual cost as the high scenario, the 75,000 troops by 2013 would be a mid-range scenario. These computations use a mid-range scenario for Iraq War funding (reducing troops to 75,000 by 2013), which increases baseline spending by \$150 billion over 2008-2018, plus \$106 billion in interest costs.

- **Discretionary spending** – Although the standard baseline assumes discretionary spending will grow at the rate of inflation, this has rarely been the case. Instead, we assume discretionary spending will grow at the rate of nominal GDP. This assumption increases discretionary spending by \$1.4 trillion over 10 years, in addition to adding \$243 billion in higher interest payments.
- **Economic stimulus** - In recognition that a stimulus package is likely to be passed, we assume a package of around \$150 billion structured like the version that was agreed to between the White House and the House of Representatives.
- **Alternative Minimum Tax** – We assume that there will continue to be one-year Alternative Minimum Tax patches, and that they will not be offset. This assumption is consistent with recent experience. According to the CBO report, continuing the current policy of indexing the AMT exemption amount threshold will reduce revenues by \$730 billion over 2008-2018, and higher interest spending will add \$189 billion over that period.
- **Making the tax cuts permanent** – In this baseline, we assume that the 2001 and 2003 tax cuts will not be allowed to expire. While it strikes us as likely that some provisions of the 2001 and 2003 tax cuts will be continued while others are allowed to expire, the data CBO provided for this kind of analysis only permits the package to be included or excluded in its entirety. Assuming that the tax cuts continue will reduce revenues by \$2.3 trillion over 10 years, plus an additional \$598 billion for the interaction that comes from assuming lower regular tax liability along with indexed AMT exemption amounts. Debt service on these items total \$550 billion.

Effect on the Budget Totals

The attached table shows the effect of these assumptions on revenues, spending, and the deficit. As illustrated in the table, under these assumptions the deficit for 2008 will increase from the \$219 billion in CBO's baseline to \$404 billion.

Although the deficit would drop to \$368 billion in 2009, it would increase again up to \$552 billion in 2013 with some variation in 2011 and 2012 caused by the way that the extension of the tax cuts affects the timing of cash flows. After 2013 we expect steady growth in the deficit, which will reach \$869 billion in 2018 under these assumptions. Over the full 10 years of the projections, the deficit would average 3.2 percent of GDP, which would be higher than either of the preceding 10 year periods.

Persistent deficits at fairly large levels will cause the debt held by the public to balloon. While debt as a share of GDP has declined over the past two years, under the assumptions of this analysis, that progress will be reversed and debt as a share of GDP will increase every year. By 2017, in fact, it would reach 50 percent of the nation's output, and would surpass the highest level recorded in the last 40 years (49.4 percent of GDP in 1993, when the nation was emerging from recession).

Risks to the Assumptions

- **Medicare** - The spending projections assume that the 10 percent reduction in physician reimbursements scheduled for July 2008 and subsequent years will take effect. Even with those reductions in reimbursement rates, Medicare is still projected to grow at a rate of 6.8 percent. Implicit in these computations, therefore, is the assumption that offsets will be found for the annual "doc fix." In testimony before the House Budget Committee, the CBO Director stated that eliminating the reduction in physician payments would increase the deficit by \$250 billion.
- **Taxes** - The revenue projections assume that the routine tax extenders (such as the credit for Research and Experimentation or the deduction for state and local sales taxes) will be offset. Failure to offset these routine tax extenders will increase the deficit by another \$247 billion over 2008-2018.
- **Economy** - Finally, there is the strong possibility that the economic outlook is softer than assumed by CBO. In its report, the agency indicated that it expected the federal funds rate to be reduced to 3.5 percent by the middle of 2008, and to stay at that rate throughout the year. Given that the rate is already at 3.0 due to two rate cuts since the publication of the CBO report, these assumptions are clearly already outdated. These aggressive reductions suggest the economy may be weaker than CBO was assuming. While CBO does not forecast a recession, they point out that if a recession does arise, the cyclical component of the recession likely would increase the deficit by between 1.1 and 1.6 percent of GDP.

This Alternate Baseline shows that Congress' habit of extending current policies one year at a time can paint a misleading picture to budget-watchers. While short-term extensions may cause the baseline outlook to look relatively benign, it obscures the undeniable conclusion that current policy is unsustainable.

SEE TABLE ON NEXT PAGE

Alternative Baseline (Billions)

	<u>A 2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>	<u>2016</u>	<u>2017</u>	<u>2018</u>	<u>2013</u>	<u>2018</u>
<u>REVENUES</u>														
CBO Baseline	2,568	2,654	2,817	2,907	3,182	3,442	3,585	3,763	3,941	4,131	4,334	4,548	15,933	36,649
AMT Patch		-6	-75	-76	-71	-42	-49	-58	-68	-80	-94	-110	-313	-724
Continue 2001 and 2003 Tax Cuts		0	-3	-6	-147	-254	-281	-292	-304	-316	-329	-344	-692	-2,277
Interaction		0	0	0	-18	-61	-69	-76	-83	-90	-97	-105	-148	-598
Stimulus (HR 5120 as passed)		-114	-11	12	9	8	6	4	2	1	1	1	23	32
Alternate Baseline	2,568	2,535	2,728	2,837	2,954	3,093	3,191	3,340	3,489	3,647	3,814	3,989	14,802	33,082
<u>SPENDING</u>														
CBO Baseline	2,731	2,873	3,015	3,148	3,299	3,355	3,524	3,666	3,824	4,037	4,183	4,325	16,341	36,376
Additional Iraq War Funds		30	58	59	51	29	13	-4	-17	-21	-24	-25	210	120
Appropriations grow at rate of nominal GDP		0	9	33	64	95	125	154	184	214	246	280	324	1,403
Stimulus (HR 5120 as passed)		32	3	0	0	0	0	0	0	0	0	0	3	3
Debt Service		3	11	19	33	54	82	113	147	186	230	279	198	1,153
Alternate Baseline	2,731	2,939	3,096	3,259	3,445	3,534	3,743	3,929	4,138	4,416	4,636	4,859	17,076	39,054
CBO Deficit	-163	-219	-198	-241	-117	87	61	96	117	95	151	223	-408	274
Percent of GDP (%)	-1.2	-1.5	-1.3	-1.5	-0.7	0.5	0.3	0.5	0.6	0.5	0.7	1	-0.5	0.1
Alternate Deficit	-163	-404	-368	-422	-492	-441	-552	-589	-649	-769	-821	-869	-2,274	-5,972
Percent of GDP (%)	-1.2	-2.8	-2.5	-2.7	-3	-2.6	-3.1	-3.1	-3.3	-3.7	-3.8	-3.9	-2.8	-3.2
CBO Baseline Debt Held by the Public	5,035	5,232	5,443	5,698	5,827	5,751	5,701	5,613	5,503	5,414	5,269	5,050	n.a.	n.a.
Percent of GDP (%)	36.8	36.8	36.7	36.5	35.4	33.3	31.6	29.8	28	26.4	24.6	22.6	n.a.	n.a.
Alternative Debt Held by the Public	5,035	5,417	5,798	6,234	6,738	7,190	7,752	8,350	9,006	9,781	10,608	11,481	n.a.	n.a.
Percent of GDP (%)	36.8	38.1	39.1	40	41	41.7	43	44.3	45.8	47.6	49.5	51.4	n.a.	n.a.
<u>Memorandum:</u>														
Gross Domestic Product	13,670	14,201	14,812	15,600	16,445	17,256	18,043	18,856	19,685	20,540	21,426	22,355	82,156	185,018

Source: CRFB calculations based on Congressional Budget Office and Joint Committee on Taxation data.