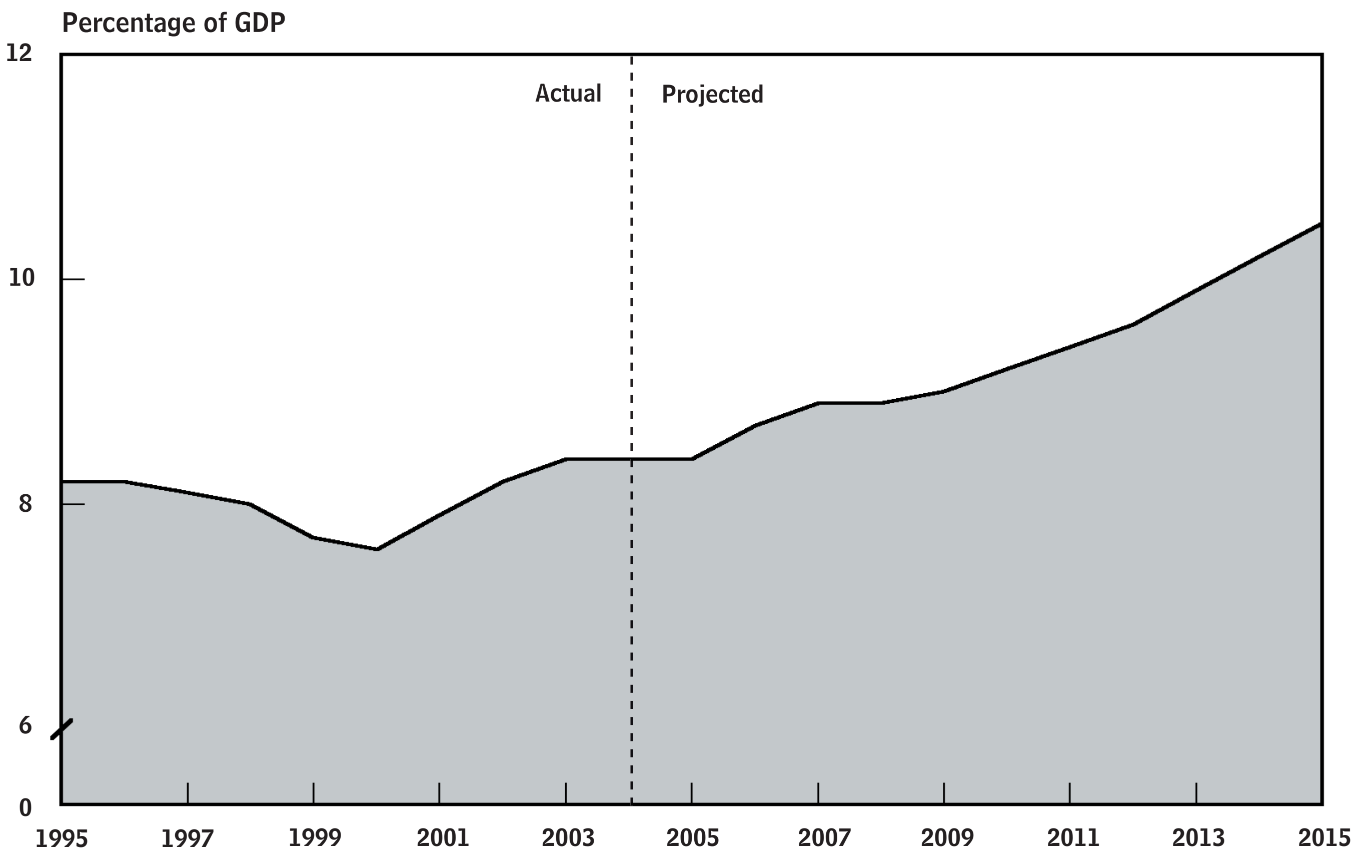
CONGRESS OF THE UNITED STATES
CONGRESSIONAL BUDGET OFFICE

The Budget and Economic Outlook: An Update

Spending on Social Security, Medicare, and Medicaid



AUGUST 2005

A CBO STUDY

The Budget and Economic Outlook: An Update

August 2005

The Congress of the United States ■ Congressional Budget Office

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 in Chapter 2 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 as of June 2005. As explained in Box 2-1 (on page 28), BEA's revised estimates, released on July 29, 2005, were published too late to be incorporated into the Congressional Budget Office's (CBO's) current economic forecast. Because CBO anticipated the key revision, the budget baseline presented here is essentially consistent with the revised data.

Preface

This 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 CBO's Budget Analysis Division under the supervision of Robert Sunshine, Peter Fontaine, Janet Airis, Tom Bradley, Kim Cawley, Paul Cullinan, Jeffrey Holland, and Jo Ann Vines. The revenue estimates were prepared by the staff of the Tax Analysis Division under the supervision of Thomas Woodward, Mark Booth, and David Weiner, with assistance from the Joint Committee on Taxation. The analysts who contributed to those spending and revenue projections are listed in Appendix C.

The economic outlook presented in Chapter 2 was prepared by the Macroeconomic Analysis Division (MAD) under the direction of Robert Dennis. John F. Peterson, Robert Arnold, and Christopher Williams carried out the economic forecast and projections. David Brauer, Menzie Chinn, Ufuk Demiroglu, Eva de Francisco, Douglas Hamilton, Juann Hung, Wendy Kiska, Kim Kowalewski, Mark Lasky, Angelo Mascaro, Shinichi Nishiyama, Benjamin Page, Frank Russek, Robert Shackleton, and Sven Sinclair—all of MAD—and Richard Farmer of the Microeconomic Studies Divison contributed to the analysis. Andrew Gisselquist, Brian Mathis, and Benjamin Umansky 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, Dan Crippen, Brad DeLong, Martin Feldstein, Robert J. Gordon, Robert E. Hall, Robert Glenn Hubbard, Ellen Hughes-Cromwick, Lawrence Katz, Catherine L. Mann, Allan H. Meltzer, Laurence H. Meyer, William D. Nordhaus, June E. O'Neill, Rudolph G. Penner, Robert Reischauer, and Alice Rivlin. Brad Setser and Edwin Truman 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, Mark Booth, Ann Futrell, and Christina Hawley Sadoti wrote Chapter 1, with assistance from Eric Schatten. Robert Arnold was the lead author for Chapter 2. Ellen Hays wrote Appendix A, and Andrew Gisselquist and Benjamin Umansky compiled Appendix B.

Christine Bogusz, Janey Cohen, Loretta Lettner, Leah Mazade, John Skeen, and Christian Spoor edited the report. Marion Curry, Linda Lewis Harris, and Denise Jordan-Williams assisted in its preparation. Maureen Costantino designed the cover and prepared the report for publication. Lenny Skutnik produced the printed copies, and Simone Thomas and Annette Kalicki prepared the electronic version for CBO's Web site (www.cbo.gov).

This is the final report to benefit from the contributions of departing Deputy Director Elizabeth M. Robinson. CBO thanks her for her service.

Douglas Holtz-Eakin
Director

August 2005

CONTENTS

Tables

Figures

Figures (Continued)

Boxes

Summary

The fiscal outlook for the coming decade has not changed much since the Congressional Budget Office (CBO) issued its previous baseline projections of the federal budget in March. Although the deficit for 2005 will be notably lower than CBO estimated then, the underlying projections of revenues and outlays for future years are similar to those presented five months ago.

The Budget Outlook

CBO now expects the 2005 deficit to total $331 billion—an $81 billion decline from the deficit recorded for 2004 (see Summary Table 1). Relative to the size of the economy, the deficit this year is expected to equal 2.7 percent of gross domestic product (GDP), down from 3.6 percent in 2004.

Revenues are likely to be $85 billion higher this year than CBO expected in March, primarily because of robust growth in corporate income tax payments. Outlays from supplemental appropriations offset about $33 billion of those higher revenues. (Such appropriations, mainly for military activities in Iraq and Afghanistan, were proposed earlier in the year but had not yet been enacted when CBO prepared its baseline in March and therefore were not included then.) In addition, outlays this year from other sources are expected to be about $18 billion larger than CBO anticipated in March.

Although the deficit for 2005 is lower than previously expected, the fiscal outlook for the coming decade remains about the same as what CBO described in March. If the laws and policies currently in place did not change, the deficit would shrink slightly over the next few years relative to the size of the economy, CBO projects, and then would decline more sharply after 2010, reflecting the tax increases scheduled to occur after provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) expire. By 2015, the baseline deficit would decline to 0.3 percent of GDP.

By statute, CBO's baseline must project the future paths of federal revenues and spending under current laws and policies.[1] 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 taxes and spending.

Total outlays are projected to remain steady at roughly 20 percent of GDP over the next 10 years. In CBO's baseline, mandatory spending grows nearly 1 percentage point faster each year than nominal GDP does, but discretionary spending is assumed to increase at the rate of inflation and thus at about half the growth rate of GDP. (CBO projects that annual growth in nominal GDP will average 4.9 percent over the 2006-2015 period.) Net interest spending is projected to increase, because of continued deficits and rising interest rates, from 1.5 percent of GDP in 2005 to 2.0 percent in 2010 and then decline slightly thereafter.

The path of federal revenues over the next 10 years is influenced by the scheduled expiration of numerous tax provisions enacted between 2001 and 2003. Total revenues are projected to remain close to their 2005 share of GDP (17.5 percent) through 2010. If the remaining tax provisions from EGTRRA and JGTRRA expire in December 2010 as scheduled, revenues will rise sharply, reaching 19.5 percent of GDP in 2015, the highest level since 2001.

Individual income taxes are responsible for all of 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 2.2 percent of GDP and then gradually diminish. Other sources of revenues, the

1. Exceptions exist for programs established on or before the date 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

(Billions of dollars)

	Actual 2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Total, 2006-2010	Total, 2006-2015
							In Billions of Dollars							
Total Revenues	1,880	2,142	2,280	2,396	2,526	2,675	2,817	3,075	3,312	3,481	3,660	3,848	12,695	30,071
Total Outlays	2,292	2,473	2,595	2,721	2,860	2,997	3,134	3,293	3,390	3,561	3,726	3,905	14,306	32,180
Total Deficit (-) or Surplus	**-412**	**-331**	**-314**	**-324**	**-335**	**-321**	**-317**	**-218**	**-78**	**-80**	**-66**	**-57**	**-1,612**	**-2,110**
On-budget	-567	-507	-503	-528	-554	-556	-564	-479	-347	-355	-344	-335	-2,706	-4,565
Off-budget[a]	155	176	189	203	219	234	248	261	269	275	278	279	1,094	2,456
Debt Held by the Public at the End of the Year	4,296	4,621	4,943	5,281	5,630	5,964	6,292	6,520	6,605	6,691	6,762	6,820	n.a.	n.a.
							As a Percentage of GDP							
Total Revenues	16.3	17.5	17.6	17.5	17.6	17.7	17.8	18.5	19.1	19.2	19.4	19.5	17.6	18.5
Total Outlays	19.8	20.2	20.0	19.9	19.9	19.8	19.8	19.9	19.6	19.7	19.7	19.8	19.9	19.8
Total Deficit	**-3.6**	**-2.7**	**-2.4**	**-2.4**	**-2.3**	**-2.1**	**-2.0**	**-1.3**	**-0.4**	**-0.4**	**-0.3**	**-0.3**	**-2.2**	**-1.3**
Debt Held by the Public at the End of the Year	37.2	37.7	38.1	38.7	39.2	39.5	39.7	39.3	38.1	37.0	35.8	34.6	n.a.	n.a.
Memorandum:														
Gross Domestic Product	11,554	12,271	12,967	13,655	14,372	15,106	15,836	16,578	17,331	18,105	18,903	19,729	71,937	162,582

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.

largest of which is social insurance taxes, are estimated to remain relatively stable as a share of GDP.

In CBO's current baseline, the deficit for 2006 is $16 billion higher than estimated in March; the cumulative deficit for the 2006-2015 period has risen by $1.1 trillion (see Summary Table 2). However, those changes do not indicate a significant shift in the budgetary outlook; rather, they result mostly from extrapolating into future years nearly $84 billion in supplemental appropriations enacted since March, as required under the rules governing the baseline. Changes in the economic outlook and other (technical) estimating revisions decrease projected deficits by only $89 billion over the 2006-2015 period, an average of $9 billion a year.

Significant strains on the budget will begin during the 10-year period of CBO's baseline and will intensify later as more of the baby-boom generation reaches retirement age (see Summary Figure 1). By CBO's estimates, a growing elderly population and rapidly rising health care costs will cause federal spending for Social Security, Medicare, and Medicaid to increase from more than 8 percent of GDP in 2005 to between 12 percent and 17 percent in 2030 and to between 13 percent and 28 percent in 2050.[2] Over the long term, then, growing resource demands for those programs will exert pressure on the budget that economic growth alone will not eliminate.

2. For a detailed discussion of the long-term pressures facing the federal budget, see Congressional Budget Office, *The Long-Term Budget Outlook* (December 2003), which CBO will update later this year, and *The Outlook for Social Security* (June 2004).

Summary Table 2.

Changes in CBO's Baseline Projections of the Deficit or Surplus Since March 2005

(Billions of dollars)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Total, 2006-2010	Total, 2006-2015
Total Deficit (-) or Surplus as Projected in March 2005	-365	-298	-268	-246	-219	-201	-95	57	69	99	122	-1,232	-980
Changes													
Legislative													
Revenues	*	*	-2	-2	-2	-2	-2	-2	-1	-1	-2	-9	-18
Outlays[a]	34	80	93	101	108	116	124	131	140	150	160	497	1,202
Subtotal, legislative	-34	-80	-94	-103	-110	-118	-126	-132	-142	-151	-162	-506	-1,219
Economic													
Revenues	28	21	11	8	10	13	14	15	14	13	13	62	132
Outlays[a]	3	*	*	5	8	10	12	13	15	16	19	23	97
Subtotal, economic	25	21	11	3	2	3	3	2	*	-3	-5	40	35
Technical													
Revenues	56	48	30	12	6	*	1	-5	-7	-9	-10	95	65
Outlays[a]	14	4	3	*	*	1	1	-1	*	1	2	8	10
Subtotal, technical	42	43	27	12	5	*	*	-4	-7	-10	-12	87	54
Total Effect on the Deficit or Surplus[b]	**33**	**-16**	**-56**	**-89**	**-103**	**-116**	**-123**	**-135**	**-149**	**-164**	**-179**	**-379**	**-1,130**
Total Deficit as Projected in August 2005	-331	-314	-324	-335	-321	-317	-218	-78	-80	-66	-57	-1,612	-2,110

Source: Congressional Budget Office.

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

a. Includes net interest payments.

b. Negative numbers indicate an increase in the deficit.

The Economic Outlook

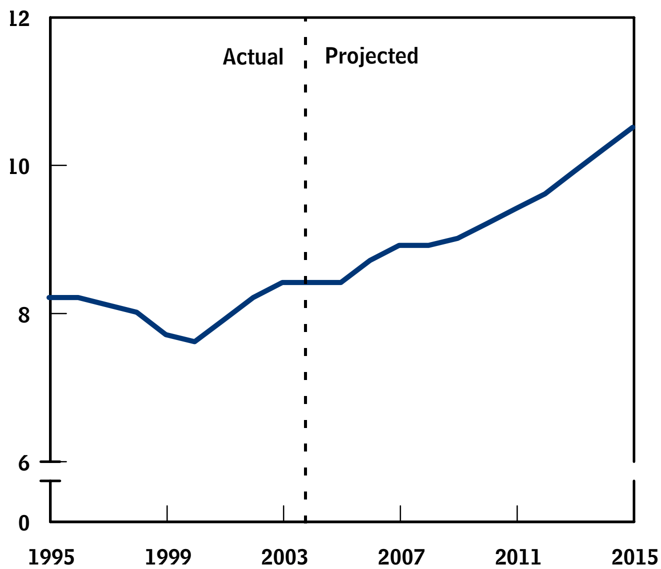
CBO forecasts that the U.S. economy will continue to expand at a healthy pace during the second half of 2005 and in 2006. Real (inflation-adjusted) GDP will grow by 3.7 percent in 2005, CBO estimates, and by 3.4 percent in calendar year 2006 (see Summary Table 3). Investment by businesses is likely to be the largest source of growth, with spending for equipment, software, and structures growing at a rate roughly double its post-World War II average. Strong expansion of domestic demand for goods and services will support a steady increase in the number of new jobs and, therefore, a rise in incomes. By contrast, gains in net exports over the next two years are expected to be weak, and the growth in demand for goods and services among the United States' trading partners is forecast to remain below its historical trend. As a result, CBO estimates that the speed at which the trade balance narrows will be slower than the agency anticipated in January, when it last described its outlook for the economy.

Growth of real GDP over the 2007-2015 period will average 2.9 percent annually, CBO projects, reflecting growth of 3.2 percent between 2007 and 2010, followed by a slower pace of 2.6 percent during the 2011-2015 period. That slowdown stems from a lower rate of growth of the labor force that coincides with the beginning of the

Summary Figure 1.

Spending on Social Security, Medicare, and Medicaid

(Percentage of GDP)



Source: Congressional Budget Office.

baby boomers' retirement. Compared with the corresponding projections in its January 2005 forecast, CBO's current projections for the growth of real GDP are generally slightly lower.

Unchanged since January are CBO's projections for the 2007-2015 period for inflation and unemployment. According to CBO's projections, inflation will average 2.2 percent per year as measured by the consumer price index for urban consumers and 1.8 percent as measured by the GDP price index (which measures inflation using a different array of goods and services). The rate of unemployment will average 5.2 percent, as will the natural rate of unemployment.[3]

By CBO's estimates, the rate on three-month Treasury bills will average 4.7 percent from 2007 through 2015, and the rate on 10-year Treasury notes, 5.4 percent. Those projections are, respectively, a tenth of a percentage point higher and a tenth lower than CBO's estimates last winter.

3. The natural rate of unemployment is the rate arising from sources apart from fluctuations in aggregate demand, such as unemployment associated with normal turnover or mismatches between the skills and location of available workers and vacant positions.

Summary Table 3.

CBO's Economic Projections for Calendar Years 2004 Through 2015

	Actual	Forecast		Projected Annual Average	
	2004	2005	2006	2007-2010	2011-2015
Nominal GDP (Billions of dollars)	11,735	12,450	13,137	16,023 [a]	19,946 [b]
Nominal GDP (Percentage change)	6.6	6.1	5.5	5.1	4.5
Real GDP (Percentage change)	4.4	3.7	3.4	3.2	2.6
GDP Price Index (Percentage change)	2.2	2.3	2.0	1.8	1.8
Consumer Price Index[c] (Percentage change)	2.7	3.1	2.5	2.2	2.2
Core Consumer Price Index[d] (Percentage change)	1.8	2.3	2.3	2.2	2.2
Unemployment Rate (Percent)	5.5	5.2	5.2	5.2	5.2
Three-Month Treasury Bill Rate (Percent)	1.4	3.0	3.7	4.6	4.7
Ten-Year Treasury Note Rate (Percent)	4.3	4.3	4.7	5.4	5.4

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

Note: Percentage changes are year over year.

a. Level in 2010.

b. Level in 2015.

c. The consumer price index for all urban consumers.

d. The consumer price index for urban consumers excluding food and energy prices.

CHAPTER

1

The Budget Outlook

The budget outlook for 2005 has improved noticeably in the five months since the Congressional Budget Office (CBO) produced its previous set of baseline projections, but the longer-term outlook has changed little.[1] In March, CBO anticipated a deficit of more than $390 billion for the current fiscal year, including proposed supplemental funding, primarily for military activities in Iraq and Afghanistan, that had not yet been enacted.[2]

CBO now estimates that the 2005 deficit will total $331 billion—$81 billion less than the deficit recorded for 2004 (see Table 1-1).[3] Relative to the size of the economy, this year's deficit is expected to equal 2.7 percent of gross domestic product (GDP), down from 3.6 percent last year. Revenues are likely to be $85 billion higher this year than CBO expected, primarily because of growth in corporate income tax payments. Outlays from sources other than supplemental appropriations will also be higher, though not by nearly as much.

Beyond 2005, the budget outlook remains about the same as described in March. If current laws and policies did not change—the assumption that, by law, underlies CBO's baseline projections—the deficit would shrink slightly over the next few years relative to the size of the economy and then decline more sharply after 2010. That decline reflects the tax increases scheduled to occur once provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) expire in 2010.[4] By 2015, the baseline deficit would equal just 0.3 percent of GDP (see Figure 1-1).

Under the assumptions of the baseline, federal debt held by the public would increase slightly relative to the size of the economy over the next few years, from 37.7 percent of GDP in 2005 to 39.7 percent in 2010. It would drop thereafter, falling to 34.6 percent of GDP by 2015.

The current baseline projects slightly higher revenues throughout the next 10 years, especially in 2006 and 2007, than CBO anticipated in March. Projected outlays (other than those for military operations in Iraq and Afghanistan) are also a bit higher. On average, however, the annual deficits projected for the 2006-2015 period (excluding the extrapolation of recent supplemental appropriations) are essentially unchanged.[5]

Although CBO's baseline does not incorporate possible policy changes, this report shows the budgetary implications over the next 10 years of some alternative policy assumptions. If military operations in Iraq and Afghani-

1. Those projections were published in Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2006* (March 2005).
2. The estimated baseline deficit for 2005 that CBO published in March was $365 billion. That estimate did not reflect outlays from most of the supplemental appropriations for 2005, which had not yet been enacted. Including such outlays would have brought the projected deficit to more than $390 billion.
3. The impact of recent legislation related to energy, veterans' health care, and the Central American Free Trade Agreement has been included in the current baseline, as has the impact on revenues of recent transportation legislation.
4. For revenues and mandatory spending, the Balanced Budget and Emergency Deficit Control Act of 1985 requires that the baseline assume that current laws continue without change. Exceptions exist for programs established on or before the date when the Balanced Budget Act of 1997 was enacted and for expiring excise taxes that are dedicated to trust funds.
5. Rules for the baseline that are specified in law require that discretionary appropriations be projected by assuming that current funding is continued each year in the future with adjustments for projected inflation. CBO's baseline projections therefore include an extrapolation of supplemental appropriations enacted in the current fiscal year ($11.5 billion provided in October, $82.1 billion provided in May, and $1.5 billion appropriated in August).

Table 1-1.

Projected Deficits and Surpluses in CBO's Baseline

(Billions of dollars)

	Actual 2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Total, 2006-2010	Total, 2006-2015
On-Budget Deficit	-567	-507	-503	-528	-554	-556	-564	-479	-347	-355	-344	-335	-2,706	-4,565
Off-Budget Surplus[a]	155	176	189	203	219	234	248	261	269	275	278	279	1,094	2,456
Total Deficit	**-412**	**-331**	**-314**	**-324**	**-335**	**-321**	**-317**	**-218**	**-78**	**-80**	**-66**	**-57**	**-1,612**	**-2,110**
Memorandum:														
Social Security Surplus	151	173	184	198	216	231	244	257	264	270	273	273	1,073	2,410
Postal Service Outlays	-4	-3	-5	-5	-4	-4	-4	-4	-5	-5	-5	-6	-21	-46
Total Deficit as a Percentage of GDP	-3.6	-2.7	-2.4	-2.4	-2.3	-2.1	-2.0	-1.3	-0.4	-0.4	-0.3	-0.3	-2.2	-1.3
Debt Held by the Public as a Percentage of GDP	37.2	37.7	38.1	38.7	39.2	39.5	39.7	39.3	38.1	37.0	35.8	34.6	n.a.	n.a.

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.

stan and other activities related to the war on terrorism were assumed to slow gradually for the next few years—rather than continuing at their current level, as the baseline implicitly assumes—the cumulative deficit projected for the 2006-2015 period would total 0.9 percent of GDP rather than 1.3 percent. Debt held by the public would drop to 31.0 percent of GDP by the end of 2015, instead of 34.6 percent. Similarly, if all of the tax provisions set to expire over the next 10 years (except the higher exemption amounts for the alternative minimum tax that expire at the end of 2005) were assumed to continue, the 10-year deficit would total 2.4 percent of GDP, and debt held by the public at the end of 2015 would climb to 44.0 percent of GDP.[6]

Over the longer term, the impact of demographic changes on current programs will put significant strains on the federal budget. Those strains will begin within the 10-year projection period, as the first baby boomers reach age 62 in 2008 and become eligible for early Social Security retirement benefits, and will intensify as members of that generation age. The number of people age 65 or older is expected to double over the next 30 years, while the number of adults under age 65 is projected to rise by less than 12 percent. In addition, health care costs have been growing more rapidly than the economy for many years (outstripping the annual growth of GDP by an average of more than 2.5 percentage points over the past four decades). So far, there is no evidence that those costs are likely to rise any less quickly in the future.

As a result, federal spending for Medicare is projected to increase substantially throughout the 2006-2015 period, with growth averaging about 9 percent in 2014 and 2015. Similarly, spending for Medicaid is expected to grow by more than 8 percent a year at the end of that period. The annual growth of Social Security spending is expected to accelerate from around 5.2 percent in 2006 to 6.5 percent in 2015. Under the assumptions of CBO's baseline, those three programs will together account for more than half of all federal spending by the end of the projection period, up from 42 percent this year.

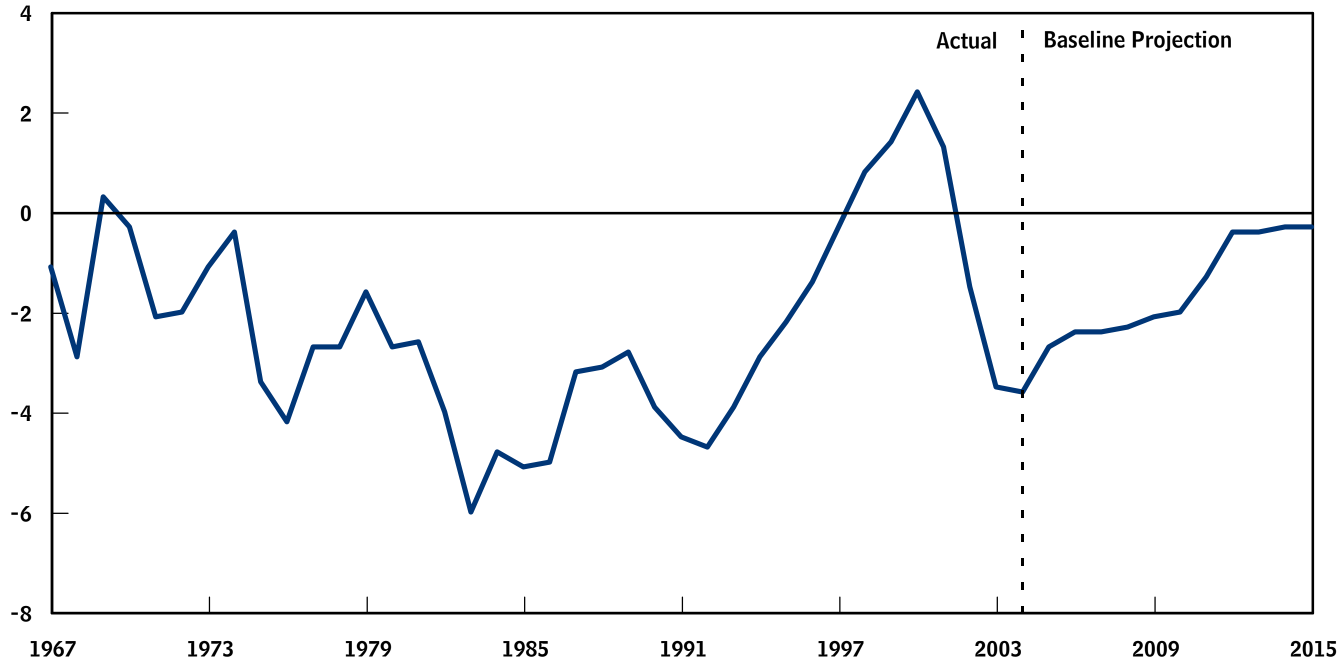
After 2015, as the percentage of the population age 65 or older continues to rise (from 14 percent in 2015 to 20 percent in 2030), spending on Social Security, Medicare,

6. CBO's baseline projections incorporate the effects that raising taxes has on the economy. By contrast, CBO's estimate of the budgetary effects of extending current tax rates does not include any macroeconomic effects (which are likely to be small relative to the size of the economy).

Figure 1-1.

The Total Deficit or Surplus as a Percentage of GDP

(Percent)



Source: Congressional Budget Office.

and Medicaid will claim an even larger share of total outlays, assuming that health care costs keep growing rapidly. In the long run, the increasing resources needed for such programs will exert pressure on the budget that is likely to make current fiscal policy unsustainable.[7]

The Outlook for 2005

If no further policy changes occur this year, the total federal budget deficit will shrink to $331 billion (2.7 percent of GDP) in 2005 from $412 billion (3.6 percent of GDP) in 2004, CBO estimates. Although outlays are projected to rise by 8 percent this year, revenues are expected to grow faster, by 14 percent.

Outlays

CBO expects total outlays to be $181 billion higher this year than in 2004, with mandatory spending accounting for about half of that growth (see Table 1-2). Mandatory outlays (which are generally governed by eligibility rules and benefit levels set forth in existing laws) are projected to increase by $92 billion, or 7.4 percent. Outlays for discretionary programs (the part of the budget whose spending levels are set each year in appropriation acts) are projected to rise by $68 billion, or 7.6 percent. Net interest (the government's interest payments on debt held by the public, offset by its interest income on federal loans and investments and earnings from the National Railroad Retirement Investment Trust) is expected to rise by $22 billion, or 13.6 percent, in 2005.

Mandatory Spending. CBO projects that mandatory spending (excluding offsetting receipts) will increase more quickly this year than in 2004: by 8 percent versus 5 percent. A major reason is that two of the three largest mandatory programs—Social Security and Medicare—will grow faster in 2005 than they did last year. Social Security spending is projected to rise by 5.5 percent this year (compared with 4.5 percent in 2004), primarily because of an increase in the annual cost-of-living adjustment. Federal spending for Medicare is expected to rise by 11.8 percent (versus 8.5 percent in 2004). However, part of that year-over-year increase occurs because the

7. For a detailed discussion of the long-term pressures facing the federal budget, see Congressional Budget Office, *The Long-Term Budget Outlook* (December 2003), which will be updated later this year, and *The Outlook for Social Security* (June 2004).

Table 1-2.

CBO's Baseline Budget Projections

	Actual 2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Total, 2006-2010	Total, 2006-2015
								In Billions of Dollars						
Revenues														
Individual income taxes	809	927	1,013	1,093	1,172	1,264	1,357	1,555	1,707	1,808	1,916	2,030	5,899	14,915
Corporate income taxes	189	269	258	245	245	253	257	264	273	282	293	304	1,257	2,673
Social insurance taxes	733	794	841	884	925	969	1,014	1,060	1,107	1,155	1,204	1,254	4,633	10,412
Other	148	153	169	174	183	190	189	197	226	235	248	260	905	2,071
Total	**1,880**	**2,142**	**2,280**	**2,396**	**2,526**	**2,675**	**2,817**	**3,075**	**3,312**	**3,481**	**3,660**	**3,848**	**12,695**	**30,071**
On-budget	1,345	1,566	1,670	1,753	1,849	1,966	2,075	2,298	2,501	2,635	2,778	2,930	9,312	22,456
Off-budget	535	576	611	643	676	709	743	776	811	846	881	918	3,382	7,615
Outlays														
Discretionary spending	894	962	991	1,008	1,032	1,052	1,075	1,104	1,120	1,151	1,179	1,207	5,159	10,920
Mandatory spending	1,237	1,329	1,396	1,476	1,557	1,650	1,743	1,857	1,928	2,064	2,196	2,343	7,821	18,210
Net interest	160	182	208	237	271	295	316	332	341	346	351	355	1,326	3,050
Total	**2,292**	**2,473**	**2,595**	**2,721**	**2,860**	**2,997**	**3,134**	**3,293**	**3,390**	**3,561**	**3,726**	**3,905**	**14,306**	**32,180**
On-budget	1,913	2,073	2,173	2,281	2,403	2,522	2,639	2,778	2,848	2,990	3,122	3,266	12,018	27,021
Off-budget	380	400	422	440	457	475	495	515	542	571	603	639	2,288	5,159
Deficit (-) or Surplus	**-412**	**-331**	**-314**	**-324**	**-335**	**-321**	**-317**	**-218**	**-78**	**-80**	**-66**	**-57**	**-1,612**	**-2,110**
On-budget	-567	-507	-503	-528	-554	-556	-564	-479	-347	-355	-344	-335	-2,706	-4,565
Off-budget	155	176	189	203	219	234	248	261	269	275	278	279	1,094	2,456
Debt Held by the Public	4,296	4,621	4,943	5,281	5,630	5,964	6,292	6,520	6,605	6,691	6,762	6,820	n.a.	n.a.
Memorandum:														
Gross Domestic Product	11,554	12,271	12,967	13,655	14,372	15,106	15,836	16,578	17,331	18,105	18,903	19,729	71,937	162,582
								As a Percentage of GDP						
Revenues														
Individual income taxes	7.0	7.6	7.8	8.0	8.2	8.4	8.6	9.4	9.8	10.0	10.1	10.3	8.2	9.2
Corporate income taxes	1.6	2.2	2.0	1.8	1.7	1.7	1.6	1.6	1.6	1.6	1.5	1.5	1.7	1.6
Social insurance taxes	6.3	6.5	6.5	6.5	6.4	6.4	6.4	6.4	6.4	6.4	6.4	6.4	6.4	6.4
Other	1.3	1.2	1.3	1.3	1.3	1.3	1.2	1.2	1.3	1.3	1.3	1.3	1.3	1.3
Total	**16.3**	**17.5**	**17.6**	**17.5**	**17.6**	**17.7**	**17.8**	**18.5**	**19.1**	**19.2**	**19.4**	**19.5**	**17.6**	**18.5**
On-budget	11.6	12.8	12.9	12.8	12.9	13.0	13.1	13.9	14.4	14.6	14.7	14.9	12.9	13.8
Off-budget	4.6	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7
Outlays														
Discretionary spending	7.7	7.8	7.6	7.4	7.2	7.0	6.8	6.7	6.5	6.4	6.2	6.1	7.2	6.7
Mandatory spending	10.7	10.8	10.8	10.8	10.8	10.9	11.0	11.2	11.1	11.4	11.6	11.9	10.9	11.2
Net interest	1.4	1.5	1.6	1.7	1.9	2.0	2.0	2.0	2.0	1.9	1.9	1.8	1.8	1.9
Total	**19.8**	**20.2**	**20.0**	**19.9**	**19.9**	**19.8**	**19.8**	**19.9**	**19.6**	**19.7**	**19.7**	**19.8**	**19.9**	**19.8**
On-budget	16.6	16.9	16.8	16.7	16.7	16.7	16.7	16.8	16.4	16.5	16.5	16.6	16.7	16.6
Off-budget	3.3	3.3	3.3	3.2	3.2	3.1	3.1	3.1	3.1	3.2	3.2	3.2	3.2	3.2
Deficit (-) or Surplus	**-3.6**	**-2.7**	**-2.4**	**-2.4**	**-2.3**	**-2.1**	**-2.0**	**-1.3**	**-0.4**	**-0.4**	**-0.3**	**-0.3**	**-2.2**	**-1.3**
On-budget	-4.9	-4.1	-3.9	-3.9	-3.9	-3.7	-3.6	-2.9	-2.0	-2.0	-1.8	-1.7	-3.8	-2.8
Off-budget	1.3	1.4	1.5	1.5	1.5	1.6	1.6	1.6	1.6	1.5	1.5	1.4	1.5	1.5
Debt Held by the Public	37.2	37.7	38.1	38.7	39.2	39.5	39.7	39.3	38.1	37.0	35.8	34.6	n.a.	n.a.

Source: Congressional Budget Office.

Note: n.a. = not applicable.

October 2005 payments to managed care providers will be made in September, shifting them from fiscal year 2006 to fiscal year 2005.[8] Adjusted for that shift in timing, Medicare outlays are projected to grow by 10.5 percent in 2005—the biggest increase since 1995.

Spending for the third-largest mandatory program, Medicaid, will grow more slowly this year than last year: by an estimated 4.5 percent compared with 9.7 percent in 2004. But that apparent slowdown reflects the fact that the federal government's share of program spending was temporarily increased from April 2003 to June 2004, a change not repeated in 2005. CBO estimates that the underlying growth rate of Medicaid outlays is over 8 percent.

Spending for other federal retirement and disability programs is expected to rise from $135 billion in 2004 to almost $148 billion in 2005, an increase of about 9 percent (see Table 1-3). Part of that rise reflects improved benefits for military retirees and higher enrollment in disability-compensation programs for veterans. In addition, the October 2005 payments to veterans receiving disability compensation and pension benefits will be made in September, shifting them into fiscal year 2005.

Outlays for various other mandatory programs will increase as well this year. In particular, farm price- and income-support payments administered by the Commodity Credit Corporation (CCC) are projected to jump from $9 billion last year to almost $18 billion this year. Near-record-high crop prices in 2004 caused the CCC to pay out relatively little in federal subsidies that year. However, crop prices have dropped significantly in 2005, leading to a sizable increase in federal spending. Outlays for the earned income and child tax credits are projected to rise from $42 billion in 2004 to $49 billion in 2005, mostly because the number of people claiming those credits continues to grow strongly and because outlays were reduced in 2004 by advance refunds paid in the summer of 2003. Spending for student loans will rise from $8 billion last year to almost $14 billion this year, CBO estimates, and Food Stamps outlays will grow from less than $29 billion in 2004 to almost $33 billion in 2005.

8. Such payments are ordinarily made on the first day of the month but are made a day or two earlier when the first of the month falls on a weekend.

Partly offsetting those increases is a significant decline in spending for unemployment insurance. Such spending is expected to fall to $33 billion this year from $43 billion last year and $55 billion in 2003, mainly because the labor market is improving and because a temporary increase in the availability of unemployment benefits expired in 2004.

Discretionary Spending. Outlays for national defense (including supplemental appropriations) will grow substantially in 2005, though more slowly than in recent years. Budget authority for defense programs increased by only 2.5 percent ($12 billion) in 2005, compared with 6.7 percent ($31 billion) last year and 26.1 percent ($94 billion) in 2003. As a result of those recent increases in appropriations, outlays for national defense will total $493 billion in 2005, CBO estimates, 8.6 percent more than last year (see Table 1-4 on page 8). By comparison, defense outlays grew by 12.1 percent in 2004 and 16.0 percent in 2003.

Funding provided for nondefense discretionary programs (including budget authority for discretionary activities other than defense and obligation limitations for certain transportation programs) rose by 1.3 percent in 2005, compared with 6.9 percent the previous year. Nevertheless, outlays for nondefense discretionary programs are expected to grow more quickly this year than last year: by 6.5 percent ($29 billion) versus 4.7 percent in 2004. That rise in the rate of growth results mostly from an increase in spending for emergency preparedness and response activities by the Department of Homeland Security (including spending derived from supplemental appropriations for disaster relief in 2004 and 2005), which is likely to grow by almost $6 billion this year. The rise also reflects funding provided in 2003 for relief and reconstruction activities in Iraq, which is now being spent in significant amounts. CBO expects such outlays to increase by about $5 billion in 2005.

Revenues

Federal revenues are projected to increase by about 14 percent, or $262 billion, this year—to a total of $2.1 trillion from $1.9 trillion in 2004 (see Table 1-2). Because that growth would far exceed the 6.2 percent growth expected for nominal GDP, revenues as a share of GDP are projected to rise for the first time since 2000 (when they reached a postwar high of 20.9 percent of GDP).

Table 1-3.

CBO's Baseline Projections of Mandatory Spending, Including Offsetting Receipts

(Billions of dollars)

	Actual 2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Total, 2006-2010	Total, 2006-2015
Social Security	492	519	546	574	602	634	670	709	753	801	852	907	3,026	7,047
Medicare[a]	297	332	385	437	462	491	527	574	606	665	722	785	2,301	5,653
Medicaid	176	184	192	203	221	239	260	282	305	330	357	387	1,115	2,775
Income Support Programs														
Unemployment compensation	43	33	34	37	40	42	44	46	48	51	53	55	197	450
Supplemental Security Income	34	39	37	35	41	42	44	50	43	49	50	52	199	443
Earned income and child tax credits	42	49	50	51	51	52	52	52	36	36	36	36	256	451
Food Stamps	29	33	33	33	33	33	34	35	36	37	38	39	165	349
Family support[b]	25	24	24	25	25	25	25	25	25	25	26	26	124	252
Child nutrition	12	13	13	14	15	15	16	17	17	18	19	19	73	162
Foster care and adoption assistance	6	6	7	7	8	8	8	9	9	9	10	10	38	84
Subtotal	191	198	199	203	212	217	222	232	214	224	231	237	1,053	2,191
Other Retirement and Disability														
Federal civilian[c]	60	64	67	70	74	77	80	83	86	90	93	96	368	816
Military	37	39	41	43	45	46	48	49	50	52	53	54	224	482
Veterans' benefits[d]	31	36	35	34	37	37	38	41	37	40	41	42	181	383
Other	6	8	8	8	9	9	10	11	11	11	9	9	45	96
Subtotal	135	148	152	156	164	170	176	184	184	192	196	202	817	1,776

Continued

CBO estimates that revenues will increase from 16.3 percent of GDP in 2004 to 17.5 percent this year—slightly below the postwar average of 17.9 percent.

Individual and corporate income taxes account for most of that increase. Both revenue sources are expected to rise by about 0.6 percentage points of GDP in 2005: individual income tax receipts from 7.0 percent to 7.6 percent, and corporate income tax receipts from 1.6 percent to 2.2 percent. In addition, social insurance (payroll) taxes are expected to generate slightly more revenue this year, 6.5 percent of GDP, and other receipts are projected to remain relatively stable at just over 1 percent of GDP.

Individual Income and Social Insurance Taxes. Receipts from individual income taxes are projected to grow by 14.6 percent between 2004 and 2005 (from $809 billion to $927 billion), and receipts from social insurance taxes are projected to increase by 8.2 percent (from $733 billion to $794 billion).

Those receipts mainly come in two forms: amounts of individual income, Social Security, and Medicare taxes that are withheld from employees' paychecks and sent by employers to the Internal Revenue Service (IRS) and amounts of those taxes that taxpayers pay directly to (or receive back from) the IRS.[9] Withheld receipts for income and payroll taxes combined are expected to grow by 6.4 percent ($89 billion) this year.[10] Such growth typ-

9. A small share of social insurance tax revenue also comes from unemployment insurance taxes and contributions to federal retirement programs other than Social Security.

10. Employers withhold both income and payroll taxes from paychecks and remit the combined amount to the IRS without being required to identify the components. The Treasury Department estimates the division between the two tax sources when it receives withheld amounts and corrects its estimates months later when certain data become available. Thus, when CBO analyzes recent data on collections of withheld taxes, it considers income and payroll taxes together to avoid using data for the components that may contain measurement errors.

Table 1-3.

Continued

	Actual 2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Total, 2006-2010	Total, 2006-2015
Other Programs														
Commodity Credit Corporation	9	18	18	16	14	14	13	13	12	12	12	12	75	136
TRICARE For Life	5	6	7	7	8	8	9	10	10	11	12	13	39	96
Student loans	8	14	6	7	8	8	8	8	9	9	9	9	37	81
Universal Service Fund	3	6	7	7	7	7	8	8	8	8	8	8	36	75
State Children's Health Insurance	5	5	5	5	5	5	5	5	5	5	5	5	26	52
Social services	5	5	5	5	5	5	5	5	5	5	5	5	24	49
Other	22	20	19	17	18	17	17	16	17	16	16	15	88	168
Subtotal	57	74	66	64	64	65	65	65	66	67	68	68	325	658
Offsetting Receipts														
Medicare premiums	-32	-38	-56	-63	-67	-71	-78	-85	-93	-102	-113	-125	-336	-855
Employers' share of employee retirement	-45	-46	-47	-49	-51	-53	-56	-58	-61	-63	-65	-67	-256	-571
Other	-32	-41	-40	-48	-49	-42	-43	-45	-46	-49	-51	-50	-223	-464
Subtotal	-110	-125	-143	-160	-167	-167	-177	-189	-200	-215	-230	-242	-815	-1,890
Total Mandatory Spending	**1,237**	**1,329**	**1,396**	**1,476**	**1,557**	**1,650**	**1,743**	**1,857**	**1,928**	**2,064**	**2,196**	**2,343**	**7,821**	**18,210**
Memorandum:														
Mandatory Spending Excluding Offsetting Receipts	1,347	1,454	1,540	1,636	1,724	1,816	1,920	2,046	2,128	2,278	2,426	2,585	8,636	20,100
Medicare Spending Net of Offsetting Receipts	265	295	329	373	395	420	449	488	513	563	609	660	1,966	4,798

Source: Congressional Budget Office.

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

a. Excludes offsetting receipts, which are shown on the facing page.

b. 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.

c. Includes Civil Service, Foreign Service, Coast Guard, and other, smaller retirement programs and annuitants' health benefits.

d. Includes veterans' compensation, pensions, and life insurance programs.

ically results from increases in total wage and salary income in the economy; that income is expected to increase by 7.2 percent this year.

Nonwithheld receipts of income and payroll taxes (net of refunds) will grow even more strongly this year, CBO estimates. Gross receipts are projected to be 28 percent ($79 billion) higher and refunds 4 percent ($7 billion) lower than in 2004. Most of the growth in net receipts has already occurred, coming in April and May after taxpayers filed their returns for tax year 2004.

Some of the year-over-year growth in nonwithheld receipts results from changes in tax law that caused a one-time reduction in receipts in 2004. JGTRRA lowered tax rates and made other changes that went into effect on January 1, 2003, but changes in withholding rates did not take effect until after the law was enacted in late May 2003. As a result, nonwithheld tax payments were reduced (and refunds boosted) when taxpayers filed their 2003 returns in the spring of 2004, CBO estimates. That effect did not recur this year.

Table 1-4.

CBO's Baseline Projections of Discretionary Spending and Homeland Security Spending

(Billions of dollars)

	Actual 2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Total, 2006-2010	Total, 2006-2015
						Total Discretionary Spending in CBO's Baseline								
Budget Authority														
Defense	486	498	512	523	536	549	562	575	589	604	618	634	2,681	5,701
Nondefense	421	427	436	446	456	469	478	489	500	512	524	536	2,286	4,848
Total	**907**	**925**	**947**	**970**	**992**	**1,018**	**1,040**	**1,064**	**1,089**	**1,116**	**1,143**	**1,170**	**4,967**	**10,549**
Outlays														
Defense	454	493	508	514	529	541	555	572	576	595	610	625	2,647	5,626
Nondefense	440	469	483	494	503	511	521	532	544	556	569	582	2,512	5,294
Total	**894**	**962**	**991**	**1,008**	**1,032**	**1,052**	**1,075**	**1,104**	**1,120**	**1,151**	**1,179**	**1,207**	**5,159**	**10,920**
						Discretionary Spending Classified as Homeland Security Spending[a]								
Budget Authority														
Defense	9	12	13	13	13	14	14	14	15	15	16	16	67	142
Nondefense[b]	27	31	29	30	30	33	32	33	33	34	35	36	155	326
Total	**36**	**43**	**42**	**43**	**44**	**47**	**46**	**47**	**48**	**49**	**51**	**52**	**221**	**469**
Outlays														
Defense	7	12	12	13	13	13	14	14	15	15	15	16	65	140
Nondefense	23	27	29	31	31	31	32	33	33	34	35	36	155	325
Total	**30**	**38**	**41**	**43**	**44**	**45**	**46**	**47**	**48**	**49**	**50**	**51**	**220**	**466**

Source: Congressional Budget Office.

Notes: 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.

Projected budget authority and outlays are the current (2005) levels adjusted for projected inflation using the inflators specified in the Balanced Budget and Emergency Deficit Control Act of 1985: the GDP deflator and the employment cost index for wages and salaries.

a. The amounts shown here reflect net spending for homeland security activities (about $3 billion to $4 billion in spending each year is offset by fees and other receipts). CBO's classification of homeland security spending is based on designations established by the Administration. Those designations are not limited to the activities of the Department of Homeland Security. In fact, some activities of the department (such as disaster relief) are not included in the definition, whereas nondepartmental activities (such as some defense-related programs and some funding for the National Institutes of Health) fall within the Administration's definition of homeland security. About half of all spending considered to be for homeland security is for activities outside the Department of Homeland Security.

b. The path of projected nondefense discretionary budget authority is affected by funding for Project BioShield, an initiative to expand the government's arsenal of counter-bioterrorism agents. The program has appropriations for 2004, 2005, and 2009; the budget authority projected for all other years is zero.

Strong growth in 2004 in personal income other than from wages and salaries probably also contributed to the growth this year of nonwithheld receipts, particularly of final payments with tax returns. CBO estimates that income from capital gains, investments in S corporations, activity in sole proprietorships and partnerships, and distributions from pensions and individual retirement accounts all rose more quickly than wage income in 2004. If taxpayers with such income did not make sufficient quarterly estimated payments to the Treasury in anticipation of their resulting tax liability, they would have been required to make up the difference when filing their tax returns earlier this year.

Corporate Income Taxes. CBO estimates that revenues from corporate income taxes will jump by 42 percent this year: to $269 billion from $189 billion in 2004. After a similar percentage rise last year, corporate receipts are expected to be more than double their 2003 level this year.

The strength of corporate receipts in fiscal year 2005 reflects activity in both calendar years 2004 and 2005. Receipts through April 2005 generally reflect economic activity in 2004, whereas receipts since then (mainly from quarterly estimated payments) mostly reflect firms' activity in 2005. Corporate tax payments from October through April of fiscal year 2005 were 48 percent higher than in the same period last year, and payments in June 2005 were 27 percent larger than in June 2004.

Corporations' book profits, as measured in the national income and product accounts (NIPAs), grew by about 13 percent in calendar year 2004—much less than the increase in corporate tax receipts. Growth in receipts can deviate from growth in profits for numerous reasons, but it is also possible that the NIPA numbers will be revised upward next year when the first tax-return data from 2004 become available.[11] Those data should allow CBO to better determine the sources of the strong growth in tax receipts from 2004 activity.

Recent changes in tax law have also played a role in this year's growth of corporate receipts. Most important, laws enacted in 2002 and 2003 gave firms additional first-year depreciation deductions of up to 50 percent of the amount of investment in equipment. Because those "partial-expensing" provisions permit greater up-front deductions for depreciation but do not increase the total amount that can be deducted over the life of the equipment, they delay tax liability but do not reduce it. The partial-expensing provisions expired at the end of calendar year 2004, resulting in additional tax liability in 2005 and 2006 and (to a lesser extent) for several years thereafter. Largely because of the expiration of partial expensing, CBO expects book profits to increase by 33 percent in calendar year 2005. Because of the difference between fiscal and calendar years and the normal delay in payment of corporate income taxes, CBO expects that some of the higher liability in 2005 will be paid in fiscal year 2006. Other recent tax-law changes, such as those in the American Jobs Creation Act of 2004, have had much smaller effects on corporate receipts in 2005.

Net Interest

The government's net interest costs will reach $182 billion this year, CBO estimates, an increase of $22 billion from 2004. That rise reflects higher interest rates paid on Treasury bills, growth in the outstanding amount of federal debt held by the public, the effects of higher inflation on the Treasury's inflation-protected securities, and other factors.

Baseline Budget Projections for 2006 Through 2015

CBO projects that if current laws and policies remain the same, the annual budget deficit will drop to 2.4 percent of GDP in 2006 and then decline gradually, reaching 2.0 percent in 2010 (see Table 1-2 on page 4). After that, primarily as a result of increased revenues from the scheduled expiration of some provisions of EGTRRA, the baseline deficit drops considerably: to 0.3 percent of GDP in 2014 and 2015.

Because CBO's baseline projections must estimate the future paths of spending and revenues under current laws and policies (according to the provisions of the Balanced Budget and Emergency Deficit Control Act of 1985), the baseline is 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 taxes.

11. Such an upward revision would be in addition to those made in the July 2005 revisions to NIPA data, which raised the estimate of book profits for calendar year 2003 by $63 billion and for 2004 by $74 billion. Those revisions, which incorporated new information from 2003 tax returns and other sources, were in large part anticipated by CBO (see Box 2-1 on page 28).

Outlays

Under current laws and policies, total outlays are projected to remain steady at roughly 20 percent of GDP over the next 10 years. Mandatory spending grows approximately 1 percentage point faster each year in CBO's baseline than nominal GDP does, but discretionary spending is assumed to increase at the rate of inflation, which is about half of the rate that CBO projects for the growth of GDP. Net interest spending is projected to increase as a percentage of GDP through 2010 because of continued deficits and rising interest rates. After that, as baseline deficits shrink and debt held by the public declines as a share of the economy, net interest spending diminishes slightly as a percentage of GDP.

Mandatory Spending. Outlays for mandatory programs are generally determined by eligibility rules and benefit levels set in law rather than through the annual appropriation process. CBO estimates that under current law, those outlays will grow at an average rate of 6 percent a year through 2015. That growth is fueled primarily by spending for Social Security, Medicare, and Medicaid, which together account for more than three-quarters of mandatory outlays (see Table 1-3 on page 6).

Ten-year averages, however, do not fully reveal the long-term trends propelling the growth of outlays for those programs. As baby boomers begin to qualify for Social Security and Medicare in the second half of this decade, the underlying growth of spending for those programs will accelerate. For example, outlays for Social Security are projected to grow by about 5.2 percent in 2006, but that growth rate will rise to 6.5 percent by 2015. In the case of Medicare, the introduction of a prescription drug benefit in 2006 is projected to help boost that program's federal spending by 31 percent between 2005 and 2007. Medicare spending will continue growing at an average annual rate of 7.6 percent over the following eight years, CBO projects, driven by increases in enrollment and in utilization of medical services.

Spending for Medicaid, whose annual growth rate is projected to drop from roughly 10 percent in 2004 to less than 5 percent in 2005, is anticipated to increase by just 4 percent in 2006. The slowdown in growth in 2006 occurs because Medicaid will begin to realize substantial savings as Medicare assumes the cost of prescription drugs for people who are eligible for both programs. However, CBO projects that Medicaid's growth rate will return to previous levels and average 8.4 percent annually during the last eight years of the projection period.

Offsetting receipts—which mainly consist of premiums paid by Medicare beneficiaries and intragovernmental payments made by agencies to finance their employees' benefits—are expected to increase rapidly over the next few years: from $125 billion in 2005 to $160 billion in 2007, or by nearly 28 percent. Most of that projected increase stems from two factors. The first is the introduction of the Medicare prescription drug benefit next year. (Premiums paid by enrollees in the prescription drug program and amounts withheld from Medicaid payments to states and transferred to Medicare will be offsetting receipts.) The second is projected receipts from auctioning spectrum licenses in 2007 and 2008. In the second half of the projection period, offsetting receipts return to more-typical growth rates, ranging from 5.5 percent to 7.5 percent a year.

Relative to the size of the economy, overall mandatory outlays will rise from 10.8 percent of GDP in 2006 to 11.9 percent in 2015 under current law, CBO projects. Spending for Social Security, Medicare, and Medicaid combined is projected to grow from 8.7 percent of GDP in 2006 to 10.5 percent in 2015, at which point those three programs will account for more than half of all federal spending. Other mandatory programs, taken as a whole, are projected to decline as a share of GDP.

Discretionary Spending. According to the Deficit Control Act, CBO's baseline must assume that discretionary spending will continue at the level of the most recent appropriations (in this case, those for 2005), with annual increases based on two projected rates of inflation: the GDP deflator (which covers price changes for all of the goods and services that contribute to GDP) and the employment cost index for wages and salaries.

The base level of funding for 2005 was provided through three supplemental appropriation acts in addition to the regular appropriation acts. The 2005 Military Construction Appropriations and Emergency Hurricane Supplemental Appropriations Act, enacted in October 2004, provided $11.5 billion in budget authority, primarily for hurricane relief. The 2005 Emergency Supplemental Appropriations Act for Defense, the Global War on Terror, and Tsunami Relief, enacted in May, provided $82.1 billion in budget authority, mostly for military operations in Iraq and other activities associated with the war on terrorism. In August, the Congress provided an additional $1.5 billion in budget authority for veterans' health care.

All three supplemental appropriations (a total of $95.1 billion in budget authority) have been included in CBO's baseline and extrapolated through 2015, in accordance with the rules governing the baseline. As a result, discretionary outlays are projected to increase from $962 billion this year to $1.2 trillion in 2015—an average annual rate of 2.3 percent (see Table 1-4 on page 8). Relative to GDP, however, discretionary outlays fall from 7.8 percent in 2005 to 6.1 percent in 2015 under the assumptions of the baseline, CBO projects. (The budgetary effects of alternative assumptions about the growth of discretionary spending are discussed later in this chapter.)

The Administration has identified spending that it considers related to homeland security. Using the Administration's classification, net discretionary budget authority for homeland security is estimated to total about $43 billion this year: $12 billion for defense and $31 billion for nondefense programs.[12] The discretionary outlays resulting from that, as well as from prior years' budget authority, will total $38 billion this year, CBO estimates. (In addition, an average of less than $1 billion per year in net outlays for homeland security are classified as mandatory spending.) Over the 2006-2015 period, discretionary outlays for homeland security average slightly less than 0.3 percent of GDP in CBO's baseline.

Revenues

Under the assumptions of the baseline, total revenues as a share of GDP will rise slightly in 2006 (to 17.6 percent), remain virtually steady through 2008, and then rise each year thereafter (reaching 19.5 percent in 2015), CBO projects. Over the next three years, projected increases in individual income tax receipts as a percentage of GDP are largely offset by reductions in corporate income tax receipts. Beyond 2008, increases in individual income taxes dominate, and total revenues rise as a share of GDP. Over the 10-year projection period, receipts from corporate income taxes, social insurance taxes, and excise taxes all tend to decline relative to GDP.

Individual Income Taxes. Under the assumption that tax law remains the same (except for currently scheduled changes and expirations), CBO projects that receipts from individual income taxes will rise each year as a percentage of GDP, from 7.6 percent in 2005 to 10.3 percent in 2015. That increase results from several factors. First, scheduled changes in tax law—mainly those enacted in EGTRRA and JGTRRA—have the net effect of boosting individual income tax receipts as a percentage of GDP during the projection period. Exemption amounts for the alternative minimum tax (AMT) are set to decline in tax year 2006 from the amounts in place for tax years 2003 through 2005, causing projected receipts to rise in fiscal years 2006 and 2007. In 2009, tax rates on dividends and capital gains are scheduled to increase and thus boost receipts. Most important, a host of changes are scheduled to occur in 2011—statutory tax rates will rise, the amount of the child tax credit will decline, and tax brackets for joint filers will narrow, among other changes—which together will sharply increase individual income tax receipts.

Second, several characteristics inherent in the structure of the tax code cause effective tax rates (the ratio of taxes paid to adjusted gross income) to increase over time and lead federal revenues to grow more quickly than total income. The rise in effective tax rates stems in part from the phenomenon known as real bracket creep, in which the overall growth of real (inflation-adjusted) income causes more income to be taxed in higher tax brackets. In addition, the AMT, which is not indexed for inflation, will affect an increasing number of taxpayers and growing amounts of income in future years. Also, taxable distributions from tax-deferred retirement accounts, such as individual retirement accounts and 401(k) plans, are expected to grow more quickly than other income as the population ages.

Corporate Income Taxes. After rising sharply for the past two years, revenues from corporate income taxes are projected to decline gradually as a share of GDP over the projection period, from 2.2 percent this year to 1.5 percent in 2014 and 2015.

Increased contributions by corporations to defined-benefit pension plans play an important role in CBO's baseline projection of corporate tax receipts. At the end of 2005, provisions of law are scheduled to expire that have allowed firms to make smaller contributions to their underfunded plans, which means that they will have to contribute more (see Box 2-2 on page 32). Partly as a result, CBO projects that book profits, as measured in the

12. For more information about homeland security spending, see Congressional Budget Office, *Federal Funding for Homeland Security: An Update* (July 20, 2005).

NIPAs, will drop by about 11 percent in calendar 2006: from 10.5 percent of GDP this year to 8.8 percent. After 2006, firms will need to make up less of a shortfall in their defined-benefit plans, and the effect on profits will wane over the projection period, CBO estimates. Profits are projected to equal 8.2 percent to 8.5 percent of GDP between 2007 and 2015.

A second factor in CBO's projection of corporate tax revenues is its appraisal of why those revenues have increased to a greater extent than total corporate profits would indicate. In January, CBO projected that corporate tax receipts would grow by 14 percent this year; now, it estimates that they will grow by about 42 percent, exceeding the previous projection by about $53 billion. As noted above, receipts in fiscal year 2005 reflect economic activity in both calendar years 2004 and 2005. However, book profits grew by about 13 percent in 2004 and are projected to rise by 33 percent in 2005, both of which are lower rates than the anticipated growth of receipts in fiscal year 2005. Data on profit growth in 2004 and CBO's outlook for growth in 2005 have not changed much since January, so very little of the unexpected revenue can be attributed to changes in the economic projection.

The future path of corporate tax receipts depends on what is causing their current strength relative to profits. Those causes cannot be known until data from tax returns become available. (Such data for calendar year 2004 should begin to be available in about a year, and data for 2005 about a year after that.) Until those data are released, CBO must identify the probable sources of the additional receipts and must decide whether, on balance, they are likely to be temporary, permanent, or some combination of the two. The unexpected strength in projected receipts could come from four general sources: the recent history and near-term projections of book profits; the distribution of profits between profitable and unprofitable firms; recent changes in tax law; and differences between book profits and the profits on which firms calculate their tax liability (or the timing of the corresponding payment of that liability). On the basis of its analysis of those possible sources, CBO is treating most of the unexplained strength in receipts as temporary.

The Amount of Book Profits. CBO's projections of corporate tax receipts are based on historical values for book profits (as measured in the NIPAs) that are subject to later revision. In the absence of data from corporate tax returns, the current NIPA estimates of book profits in 2004 are generally based on data from financial statements, which can deviate from tax-return data in unexpected ways. One possible source of the unanticipated tax receipts, therefore, is that profits have actually been higher than current historical data indicate and that the NIPA measures of profits in 2004 will be revised upward in July 2006. Profits may also be higher this year than CBO now projects.

If book profits are higher as a percentage of GDP than currently believed, that most likely represents a temporary rather than a permanent shift in profits relative to GDP. In its economic projections, CBO assumes that the shares of national income that are allocated to labor and capital will, over time, move toward their postwar averages (see Chapter 2).

The Distribution of Book Profits. Higher corporate tax receipts may also have resulted from unexpected changes in the distribution of profits among firms. Only profitable corporations pay taxes, but the NIPA measure of book profits includes the profits of profitable firms (gross profits) net of the losses of unprofitable firms. If both gross profits and losses were greater than CBO expected for a given level of book profits, that could also explain stronger-than-anticipated corporate tax receipts.[13]

From 2000 through 2003, the ratio of gross profits to net profits was higher than CBO had expected on the basis of its modeling. More-recent data from financial statements suggest that the distribution of profits in 2004 may have been roughly in line with CBO's expectations. On the basis of experience since 2000, CBO has raised its 10-year projection of gross profits relative to net profits—in effect, making about one-quarter of this year's increase in corporate tax receipts permanent.

Legislative Changes. Recent changes in tax law have had important effects on corporate profits and receipts, but there is no evidence now that they have contributed to the unexpected growth of receipts this year. In January, CBO projected that receipts in fiscal year 2005 would be boosted by the lower depreciation deductions that re-

13. That effect is reduced to the degree that firms can carry their current losses backward to be netted against income in previous years and thus receive refunds of previous taxes paid. The "carryback" period is limited to two years, and many firms are unable to use their losses in that way. (Firms may also carry their losses forward up to 20 years to reduce taxable income.)

sulted from the expiration of partial-expensing provisions at the end of calendar year 2004. A one-year reduced rate of taxation applied to certain repatriated foreign-earned dividends was also expected to boost receipts modestly this year. If those effects have in fact contributed to the unanticipated receipts, they will be temporary.

Other Possible Explanations. Finally, profits as measured in the NIPAs differ in numerous ways from the profits on which corporations pay income taxes. Unexpected performance by factors excluded from the NIPA measure but included in the tax base (or vice versa) could also have contributed to the additional receipts in 2005. For example, corporations' capital gains could be larger than expected. In addition, corporations may have reduced their use of aggressive tax-minimizing strategies as a result of accounting abuses uncovered in recent years and subsequent legislation. Also, the timing of when corporations make their payments of tax liability could have played a role. On balance, however, CBO views those possible explanations for the recent strength of receipts as temporary.

Social Insurance and Other Taxes. Social insurance receipts are expected to grow slightly less quickly than GDP over the next 10 years. As a result, in CBO's baseline, those receipts decline from 6.5 percent of GDP in 2005 to 6.4 percent in 2008 and remain at that level through 2015. The small decline is caused partly by a slightly lower projection for total wages and salaries as a percentage of GDP and partly by projections of relatively slower growth in receipts from unemployment taxes, declines in the share of earnings below the taxable maximum for Social Security taxes, and decreases in revenues for other federal retirement programs.

Taken together, revenues from sources other than income or payroll taxes are projected to remain at about 1.3 percent of GDP throughout most of the projection period (despite dipping to about 1.2 percent in 2010 and 2011). Receipts from estate and gift taxes are projected to fall from 0.2 percent of GDP this year to 0.1 percent in 2010 and 2011 as the estate tax is reduced and then repealed in 2010 under EGTRRA. However, the estate tax is scheduled to be reinstated in 2011, and estate tax receipts are projected to rebound to 0.3 percent of GDP from 2012 through 2015. Earnings of the Federal Reserve System, which are largely generated from interest on its holdings of Treasury securities, are projected to increase gradually, from 0.2 percent of GDP this year 0.3 percent by 2010, mainly because CBO is projecting a rise in interest rates over the next several years.

Receipts from excise taxes are projected to decline very gradually over the next 10 years: from 0.6 percent of GDP this year to 0.5 percent from 2009 through 2015. Most excise taxes are assessed on the quantity of a good produced or consumed rather than on its price. Therefore, they are projected to grow more slowly than GDP, which includes price increases. Customs duties and other miscellaneous receipts are projected to be roughly stable relative to GDP over the next 10 years: customs duties at 0.2 percent of GDP and other miscellaneous receipts at 0.1 percent.

Net Interest

Under the assumptions of the baseline, interest costs—mainly on accumulated federal debt—will account for between 7 percent and 10 percent of annual outlays over the next decade, CBO estimates. Net interest costs reached a nadir in 2003, but they are projected to grow steadily over the next 10 years: from $208 billion in 2006 to $355 billion in 2015 (see Table 1-5). That rise reflects projected increases both in interest rates and in federal borrowing. Relative to GDP, however, net interest will peak at 2.0 percent from 2009 through 2012 and decline thereafter.

The baseline assumes that the statutory limit on federal borrowing is raised as necessary to cover projected deficits. That limit, which currently stands at $8.184 trillion, will be reached sometime between January and March 2006, CBO projects.

Uncertainty and Baseline Projections

Actual budgetary outcomes are highly sensitive to the performance of the economy and to the many ways in which tax and spending policies affect that performance. Uncertainty about the future of those factors translates into uncertainty about the outlook for the budget. Because of that uncertainty, it is informative to characterize the budget outlook not as a single row of numbers but as a range of possible outcomes centered around those numbers.

Using the difference between past CBO baselines and actual budgetary results as a guide, Figure 1-2 shows a range of possible outcomes for the total deficit or surplus

Table 1-5.

CBO's Baseline Projections of Federal Interest and Debt

(Billions of dollars)

	Actual 2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Total, 2006-2010	Total, 2006-2015
							Net Interest Outlays							
Interest on Public Debt (Gross interest)[a]	322	352	385	426	479	521	561	597	627	652	678	703	2,373	5,629
Interest Received by Trust Funds														
Social Security	-86	-93	-97	-104	-114	-126	-138	-152	-166	-180	-195	-210	-580	-1,483
Other trust funds[b]	-68	-69	-70	-73	-79	-83	-87	-91	-94	-98	-102	-105	-391	-880
Subtotal	-154	-162	-167	-177	-193	-209	-225	-242	-260	-279	-297	-315	-971	-2,364
Other Interest[c]	-4	-5	-10	-11	-14	-16	-19	-22	-24	-26	-29	-32	-70	-203
Other Investment Income[d]	-3	-3	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-6	-12
Total (Net interest)	**160**	**182**	**208**	**237**	**271**	**295**	**316**	**332**	**341**	**346**	**351**	**355**	**1,326**	**3,050**
							Federal Debt (At end of year)							
Debt Held by the Public	4,296	4,621	4,943	5,281	5,630	5,964	6,292	6,520	6,605	6,691	6,762	6,820	n.a.	n.a.
Debt Held by Government Accounts														
Social Security	1,635	1,808	1,993	2,191	2,407	2,637	2,881	3,138	3,402	3,672	3,945	4,218	n.a.	n.a.
Other government accounts[b]	1,424	1,515	1,615	1,713	1,818	1,927	2,041	2,154	2,283	2,408	2,534	2,661	n.a.	n.a.
Total	3,059	3,323	3,608	3,904	4,225	4,564	4,923	5,292	5,685	6,079	6,479	6,879	n.a.	n.a.
Gross Federal Debt	7,355	7,944	8,551	9,185	9,854	10,528	11,214	11,812	12,291	12,771	13,240	13,699	n.a.	n.a.
Debt Subject to Limit[e]	7,333	7,909	8,517	9,151	9,821	10,496	11,183	11,781	12,260	12,741	13,211	13,671	n.a.	n.a.
Memorandum:														
Debt Held by the Public as a Percentage of GDP	37.2	37.7	38.1	38.7	39.2	39.5	39.7	39.3	38.1	37.0	35.8	34.6	n.a.	n.a.

Source: Congressional Budget Office.

Note: n.a. = not applicable.

a. Excludes interest costs of 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.

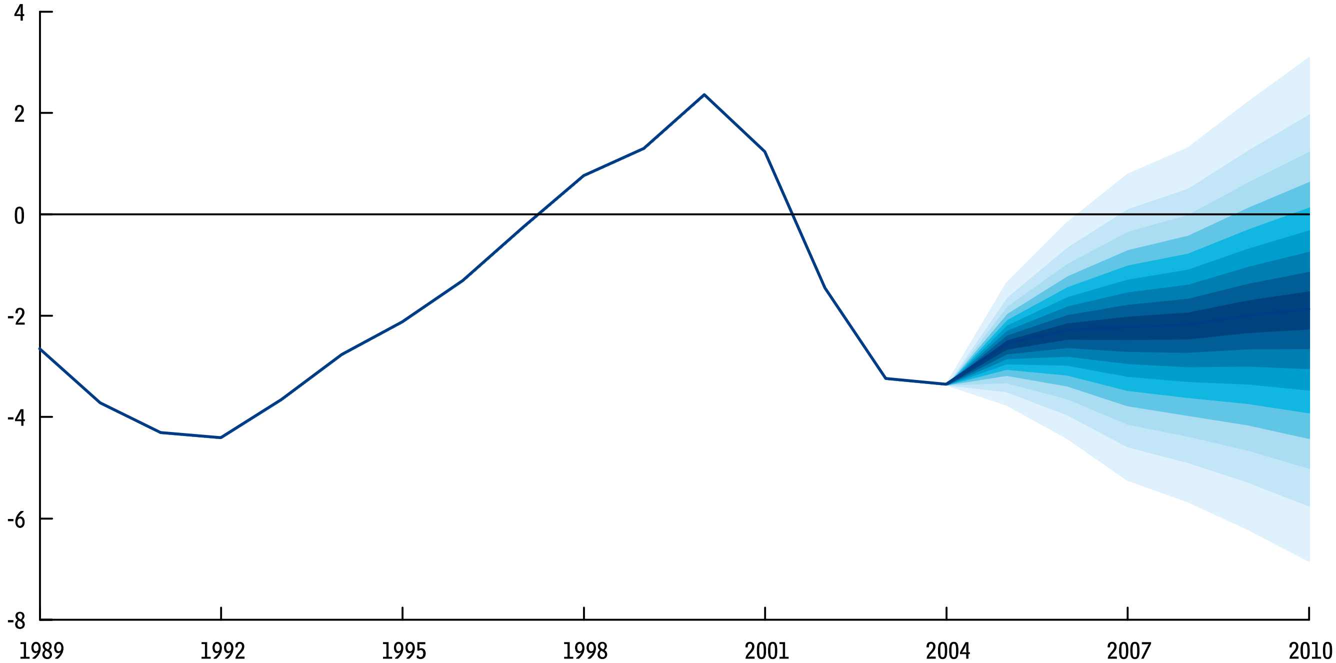
d. Earnings on private investments made by the National Railroad Retirement Investment Trust.

e. Differs from gross federal debt primarily because most debt issued by agencies other than the Treasury is excluded from the debt limit. The current debt limit is $8,184 billion.

Figure 1-2.

Uncertainty of CBO's Projections of the Budget Deficit or Surplus Under Current Policies

(Deficit or surplus as a percentage of GDP)



Source: Congressional Budget Office.

Notes: This figure, calculated on the basis of CBO's forecasting track record, shows the estimated likelihood of alternative projections of the budget deficit or surplus under current policies. The baseline projections described in this chapter 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 typically calculates the probability distribution underlying figures such as this one, see Congressional Budget Office, *The Uncertainty of Budget Projections: A Discussion of Data and Methods* (February 2005).

under current laws and policies. The current baseline projection of the deficit falls in the middle of the highest-probability area, shown as the darkest part of the figure. But nearby projections—other paths in the darkest part of the figure—have nearly the same probability of occurring as the baseline projection does.

Projections that are increasingly different from the baseline are shown in lighter areas, but they also have a significant probability of coming to pass. For example, CBO projects a baseline deficit for 2010 of 2.0 percent of GDP; however, under current law, there is roughly a 10 percent chance that the actual outcome that year will be a deficit greater than 5.9 percent of GDP. Alternatively, if policymakers leave current law unchanged, there is about a 25 percent chance that the budget will be in balance or show a surplus in 2010.

Budget Projections Under Alternative Scenarios

Policy developments will have a significant impact on the actual path of future budget deficits or surpluses. To illustrate the potential effects of possible legislative actions, CBO has estimated the budgetary impact of some broad alternative scenarios (see Table 1-6). Although the discussion below focuses on the direct effects of those scenarios on revenues and outlays, their full impact would include their effect on debt-service costs—that is, changes in projected interest payments resulting from changes in the

Table 1-6.

The Budgetary Effects of Selected Policy Alternatives Not Included in CBO's Baseline

(Billions of dollars)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Total, 2006-2010	Total, 2006-2015
Policy Alternatives That Primarily Affect Discretionary Spending for Activities in Iraq and Afghanistan													
Remove the Extension of Supplemental Appropriations from the Baseline After 2005[a]													
Total discretionary outlays	962	943	929	940	955	975	999	1,014	1,041	1,066	1,091	4,741	9,952
Effect on the deficit	0	49	79	92	98	101	105	107	110	113	115	418	968
Debt service	0	1	4	9	14	20	27	33	41	49	57	48	254
Assume Phasedown of Such Activities Instead of Extending 2005 Supplemental Appropriations[b]													
Total discretionary outlays	962	993	994	1,000	1,000	1,005	1,024	1,040	1,068	1,093	1,119	4,991	10,335
Effect on the deficit	0	-1	14	32	53	71	80	81	83	86	87	168	585
Debt service	0	*	*	1	4	7	11	16	21	27	32	13	120
Other Policy Alternatives That Affect Discretionary Spending													
Increase Discretionary Appropriations (Except supplementals) at the Growth Rate of Nominal GDP[c]													
Total discretionary outlays	962	1,006	1,047	1,099	1,148	1,201	1,259	1,305	1,366	1,425	1,486	5,501	12,341
Effect on the deficit	0	-15	-39	-67	-96	-125	-155	-184	-215	-246	-279	-341	-1,421
Debt service	0	*	-2	-4	-9	-15	-23	-33	-45	-59	-76	-30	-266
Freeze Total Discretionary Appropriations at the Level Provided for 2005													
Total discretionary outlays	962	975	971	973	969	967	969	962	965	964	963	4,854	9,677
Effect on the deficit	0	16	37	60	83	108	135	159	187	215	243	305	1,243
Debt service	0	*	2	4	8	14	21	29	40	52	66	28	235

Continued

government's projected borrowing needs (shown separately in Table 1-6).

As noted above, CBO's baseline inflates budget authority for discretionary programs—including supplemental appropriations—from the 2005 level and thus projects total discretionary outlays of $10.9 trillion for the 2006-2015 period. Different assumptions about spending for operations in Iraq and Afghanistan or about the growth rate of regular discretionary appropriations would produce a different total. For example, if the $95 billion in supplemental appropriations enacted in 2005 (primarily for military operations in Iraq and Afghanistan and the war on terrorism) was excluded from the amount extrapolated for future years, total discretionary outlays over the next 10 years would be $968 billion lower than in the baseline.

Alternatively, activities associated with the war on terrorism (including operations in Iraq and Afghanistan) could be assumed to slow gradually instead of continuing at their current level through 2015. Such a slowdown might involve keeping the number of U.S. troops involved in operations in Iraq or other aspects of the war on terrorism at about the 2004 and 2005 level through fiscal year 2006 and then gradually reducing it over several years. For example, the Department of Defense might continue

Table 1-6.

Continued

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Total, 2006-2010	Total, 2006-2015
					Policy Alternatives That Affect the Tax Code								
Extend Expiring Tax Provisions[d]													
Effect on the deficit													
EGTRRA and JGTRRA	0	-2	-4	-10	-22	-17	-155	-260	-270	-284	-295	-54	-1,318
Other	0	-2	-11	-18	-23	-29	-36	-41	-45	-50	-53	-83	-308
Total	0	-4	-14	-29	-45	-46	-191	-301	-315	-333	-349	-138	-1,626
Debt service	0	*	-1	-2	-4	-6	-13	-26	-43	-62	-83	-12	-238
Reform the Alternative Minimum Tax[e]													
Effect on the deficit	0	-12	-34	-41	-50	-60	-50	-27	-33	-40	-47	-198	-395
Debt service	0	*	-1	-3	-6	-9	-12	-15	-17	-20	-23	-20	-109
Memorandum:													
Total Discretionary Outlays in CBO's Baseline	962	991	1,008	1,032	1,052	1,075	1,104	1,120	1,151	1,179	1,207	5,159	10,920
Total Deficit in CBO's Baseline	-331	-314	-324	-335	-321	-317	-218	-78	-80	-66	-57	-1,612	-2,110

Sources: Congressional Budget Office; Joint Committee on Taxation.

Notes: * = between -$500 million and $500 million; EGTRRA = Economic Growth and Tax Relief Reconciliation Act of 2001; JGTRRA = Jobs and Growth Tax Relief Reconciliation Act of 2003.

Positive numbers indicate a reduction in the projected deficit. "Debt service" refers to changes in interest payments on federal debt resulting from changes in the government's borrowing needs.

a. This alternative does not extrapolate the $95 billion in supplemental appropriations enacted during fiscal year 2005 ($11.5 billion in October, $82.1 billion in May, and $1.5 billion in August) into future years.

b. This alternative does not extend the $95 billion in supplemental appropriations enacted during 2005; however, it assumes that about $85 billion in budget authority will be needed in 2006 to maintain activities related to Iraq, Afghanistan, and the war on terrorism. Such budget authority is projected to decline to $65 billion in 2007, $50 billion in 2008, $35 billion in 2009, and about $25 billion per year thereafter (a total of $393 billion over the 10-year period).

c. This alternative assumes that the supplemental appropriations enacted during 2005 are projected at baseline levels (that is, increased at the rate of inflation).

d. This alternative does not include the effects of extending the increased exemption amount for the alternative minimum tax (AMT), which expires in 2005. The effects of that alternative are shown separately.

e. This alternative assumes that the exemption amount for the AMT (which was increased through December 2005 in the Working Families Tax Relief Act of 2004) is extended at its higher level and, together with the AMT tax brackets, is indexed for inflation after 2005. If this alternative was enacted jointly with the extension of expiring tax provisions, an interactive effect would occur that would make the combined revenue loss greater than the sum of the two separate estimates by about $247 billion (plus $24 billion in debt-service costs) over the 2006–2015 period.

to deploy about 200,000 active-duty, Reserve, and National Guard personnel overseas to support those operations through 2006, but over the longer term, U.S. involvement would shrink to about four brigades (40,000 troops) and domestic military operations for homeland security would diminish. That scenario would increase baseline discretionary outlays by about $1 billion in 2006 but reduce them by about $585 billion over the 2006-2015 period. Under that scenario, funding for operations related to the war on terrorism would ultimately drop to less than $30 billion annually. Many other outcomes—some costing more and some costing less—are also possible for those operations.

In addition, alternative assumptions could be made about discretionary spending as a whole. For example, if current appropriations (other than supplementals) were assumed to grow at the same rate as nominal GDP through 2015 instead of at the rate of inflation, total projected discretionary spending would be $1.4 trillion higher over 10 years. In the other direction, if lawmakers did not increase appropriations after 2005 to account for inflation, discretionary outlays would be $1.2 trillion lower over the 2006-2015 period.

As described above, three mandatory programs—Social Security, Medicare, and Medicaid—dominate federal spending. Outlays for those programs are projected to double from $1 trillion (excluding offsetting receipts) this year to $2 trillion in 2015. Legislation could affect those large programs in significant ways. For example, the Administration is advocating broad changes to Social Security, including allowing workers to divert part of their tax payments into private investments. Likewise, changes in the laws that set payment rates, eligibility, and other criteria for Medicare and Medicaid are proposed and considered every year. Further changes to any of those programs could significantly affect outlays over the next 10 years.

For revenues, CBO's baseline projections rest on the assumption that current tax laws do not change. Consequently, the baseline envisions that major provisions of EGTRRA (such as the introduction of the 10 percent tax bracket, increases in the child tax credit, and the repeal of the estate tax) will expire as scheduled at the end of 2010. On balance, the tax provisions that are set to expire during the projection period reduce revenues; thus, if they were assumed to be extended, projected revenues would be lower than in the baseline.[14] If all expiring tax provisions except those related to the exemption amount for the alternative minimum tax were extended, total revenues over the 2006-2015 period would be $1.6 trillion lower, CBO and the Joint Committee on Taxation (JCT) estimate.

Another policy change that would affect revenues involves modifying the AMT, which many observers believe cannot be maintained in its current form. The AMT's exemption amount and brackets are not indexed for inflation, which means that 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 2005, federal revenues would be $395 billion lower over the next 10 years, according to JCT and CBO.

Changes in the Budget Outlook Since March

Compared with its previous baseline projections, which were published in March, CBO has reduced its estimate of the deficit for 2005 by $33 billion (from $365 billion to $331 billion).[15] Significantly higher revenues have been partially offset by higher spending from supplemental appropriations provided in May, mostly for military operations in Iraq and Afghanistan.

CBO's current baseline has increased the projected deficit for 2006 by $16 billion and the cumulative deficit for the 10-year projection period by $1.1 trillion (see Table 1-7 on page 20). However, those changes do not indicate a significant shift in the budget outlook; rather, they result mainly from extrapolating nearly $84 billion in supplemental appropriations enacted since March.

When CBO periodically updates its 10-year baseline projections, it generally divides the changes into three categories according to their source: recently enacted legislation, changes to CBO's outlook for the economy, and

14. In the years before 2011, the largest sources of revenue reductions from extending those provisions would be continuation of the research and experimentation tax credit and the current tax rates on dividends and capital gains.

15. The $365 billion estimate did not reflect outlays from most of the supplemental appropriations for 2005, which had not yet been enacted. Including such outlays would have brought the projected deficit in the March baseline to more than $390 billion.

other, so-called technical factors that affect the budget.[16] Legislative changes have increased the 2005 deficit by $34 billion, CBO estimates, and worsened the baseline budget outlook for the 2006-2015 period by roughly $1.2 trillion (almost entirely reflecting the extrapolation of recent supplemental appropriations). Together, changes in economic assumptions and technical estimating revisions have reduced the 2005 deficit by $67 billion, more than offsetting the effects of recent legislation. For the 2006-2015 period, however, economic and technical changes have reduced projected deficits by a total of only $89 billion, or an average of $9 billion a year.

CBO now estimates that revenues will be $85 billion higher this year and $179 billion (0.6 percent) higher over the 2006-2015 period than projected in March. Changes to the economic outlook have increased projected revenues by $28 billion in 2005 and $132 billion over the 10-year period. Technical changes have also raised revenue projections, by $56 billion in 2005 and $65 billion from 2006 through 2015. Recently enacted laws are projected to reduce revenues by $18 billion over the 2006-2015 period.

Outlays in the current baseline are $51 billion higher for 2005 and $1.3 trillion (4.2 percent) higher for the following 10 years (including debt-service costs) than in CBO's March projections. Nearly all of that increase stems from newly enacted legislation—principally, from extrapolating 2005 supplemental appropriations for military operations in Iraq and Afghanistan. Changes in CBO's economic assumptions have boosted the 10-year outlay projection by $97 billion (0.3 percent), generally for programs sensitive to changes in inflation (such as benefit programs subject to cost-of-living adjustments). Technical changes have had a relatively minor impact on projected spending through 2015.

16. The categorization of revisions should be interpreted with caution. For example, legislative changes represent CBO's best estimates of the future effects of laws enacted since the previous baseline. If a new law proves to have different effects from the ones in CBO's initial estimate, the differences will appear as technical reestimates in later revisions to the baseline. The distinction between economic and technical revisions is similarly imprecise. CBO classifies economic changes as those resulting directly from changes in the components of CBO's economic forecast (interest rates, inflation, GDP growth, and so on). Changes in other factors related to the performance of the economy (such as the amount of capital gains realizations) are shown as technical revisions.

The Effects of Recent Legislation

Laws enacted in the past five months have increased this year's deficit by $34 billion and the cumulative deficit for the 2006-2015 period by more than $1.2 trillion, under the assumptions of the baseline. Virtually all of that 10-year change comes from revisions to the projections of outlays.

Mandatory Spending. On the whole, legislation enacted since March has made little difference to the outlook for mandatory programs, lowering mandatory spending over the projection period by a total of less than $500 million.[17] The Energy Policy Act of 2005 is expected to increase payments to states for conservation and restoration of coastal resources, efforts to enhance the reliability of electricity-transmission systems, and other programs related to energy research and development. CBO estimates that the law will also result in savings in farm income-support programs because it will boost demand for ethanol and other renewable fuels.

Other new laws will increase mandatory spending slightly over the 2006-2015 period. The Dominican Republic–Central America–United States Free Trade Agreement Implementation Act (Public Law 109-53), known as CAFTA-DR, will lead to a very small rise in payments to sugar producers over that period. The extension of the Temporary Assistance to Needy Families program (P.L. 109-19) is expected to increase outlays for that program, as well as for Medicaid and other programs, from 2006 through 2009. In addition, the Bankruptcy Abuse Prevention and Consumer Protection Act (P.L. 109-8) is expected to raise spending for federal judicial activities through 2015.

Discretionary Spending. Recent laws have added $33 billion to discretionary outlays this year—mostly additional spending for military activities in Iraq and Afghanistan. Under the rules governing the baseline, CBO assumes that appropriations will continue in the future at the current level, adjusted for the projected rate of inflation.

17. The current baseline does not incorporate new spending resulting from the Safe, Accountable, Flexible, and Efficient Transportation Equity Act—A Legacy for Users. At the time the baseline was finalized, CBO had not completed its estimate of the new law's effects on mandatory spending. However, those effects are not expected to have a significant impact on the budget outlook. Most spending authorized by the transportation law will be determined by future appropriation acts. CBO has incorporated the effects of the law into its revenue projections.

Table 1-7.

Changes in CBO's Baseline Projections of the Deficit or Surplus Since March 2005

(Billions of dollars)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Total, 2006-2010	Total, 2006-2015
Total Deficit (-) or Surplus as Projected in March 2005	-365	-298	-268	-246	-219	-201	-95	57	69	99	122	-1,232	-980
Changes to Revenue Projections													
Legislative	*	*	-2	-2	-2	-2	-2	-2	-1	-1	-2	-9	-18
Economic	28	21	11	8	10	13	14	15	14	13	13	62	132
Technical	56	48	30	12	6	*	1	-5	-7	-9	-10	95	65
Total Revenue Changes	**85**	**68**	**39**	**18**	**13**	**10**	**13**	**9**	**6**	**3**	**1**	**148**	**179**
Changes to Outlay Projections													
Legislative													
Discretionary													
Defense	32	69	77	80	82	84	86	86	89	91	93	392	836
Nondefense	2	7	8	8	8	8	8	8	9	9	9	39	82
Subtotal, discretionary	33	76	85	88	90	92	94	95	97	100	102	431	919
Mandatory	*	1	*	*	*	*	*	*	*	*	*	2	*
Net interest (Debt service)	*	3	7	12	18	24	30	37	43	51	59	64	283
Subtotal, legislative	**34**	**80**	**93**	**101**	**108**	**116**	**124**	**131**	**140**	**150**	**160**	**497**	**1,202**
Economic													
Discretionary	*	1	3	3	4	4	4	4	4	4	4	16	36
Mandatory													
Social Security	0	4	7	8	9	9	10	10	11	12	13	37	94
Medicare	0	1	3	2	2	2	3	4	4	5	6	11	34
Other	-1	-3	-2	-1	-1	-1	-1	-1	-1	-2	-2	-8	-15
Subtotal, mandatory	-1	2	8	10	10	10	12	13	14	16	18	40	113
Net interest													
Debt service	*	-1	-2	-3	-3	-3	-3	-3	-3	-3	-3	-12	-29
Rate effect/inflation	4	-2	-9	-5	-3	-2	-1	*	*	*	*	-21	-23
Subtotal, net interest	4	-3	-12	-8	-6	-5	-4	-3	-4	-4	-3	-33	-52
Subtotal, economic	**3**	*****	*****	**5**	**8**	**10**	**12**	**13**	**15**	**16**	**19**	**23**	**97**

Continued

Therefore, CBO projects that legislative changes since March will increase discretionary spending by a total of $919 billion over the 2006-2015 period.

Defense. The 2005 Emergency Supplemental Appropriations Act for Defense, the Global War on Terror, and Tsunami Relief (P.L. 109-13) provided $76 billion to the Department of Defense (DoD), primarily to cover costs associated with operations in Iraq and Afghanistan. CBO estimates that DoD will spend about $32 billion of that budget authority in 2005, with more than half of it ($17 billion) going for military pay. Other day-to-day operating expenses—such as for transportation, base support, and maintenance and repair of equipment—account for most of the rest of the $32 billion. Including the supplemental appropriations for 2005 and extrapolating them into future years increase projected defense outlays by $836 billion over the 2006-2015 period.

Table 1-7.

Continued

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Total, 2006-2010	Total, 2006-2015
Technical													
Discretionary	-1	-1	-1	*	-1	-1	-1	*	*	*	*	-4	-4
Mandatory													
Medicare[a]	5	1	3	2	3	3	3	3	4	4	4	12	30
Medicaid	1	1	1	1	*	*	0	0	0	0	0	3	3
Earned income and child tax credits	2	3	4	4	4	4	4	2	2	2	2	18	30
Other	6	3	3	1	2	2	2	2	2	3	3	11	23
Subtotal, mandatory	14	9	11	8	9	9	9	7	8	9	9	44	86
Net interest													
Debt service	*	-3	-5	-6	-7	-7	-7	-7	-7	-6	-6	-27	-60
Other	2	*	-2	-2	-1	-1	*	-1	-1	-1	-1	-6	-11
Subtotal, net interest	1	-3	-7	-8	-7	-7	-7	-8	-8	-8	-7	-33	-71
Subtotal, technical	**14**	**4**	**3**	*****	*****	**1**	**1**	**-1**	*****	**1**	**2**	**8**	**10**
Total Outlay Changes	**51**	**84**	**95**	**106**	**116**	**126**	**136**	**144**	**155**	**167**	**180**	**527**	**1,309**
Total Impact on the Deficit or Surplus[b]	**33**	**-16**	**-56**	**-89**	**-103**	**-116**	**-123**	**-135**	**-149**	**-164**	**-179**	**-379**	**-1,130**
Total Deficit as Projected in August 2005	-331	-314	-324	-335	-321	-317	-218	-78	-80	-66	-57	-1,612	-2,110
Memorandum:													
Total Legislative Changes	-34	-80	-94	-103	-110	-118	-126	-132	-142	-151	-162	-506	-1,219
Total Economic Changes	25	21	11	3	2	3	3	2	*	-3	-5	40	35
Total Technical Changes	42	43	27	12	5	*	*	-4	-7	-10	-12	87	54

Source: Congressional Budget Office.

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

a. Includes offsetting receipts.

b. Negative numbers indicate an increase in the projected deficit.

Nondefense. P.L. 109-13 also provided $6 billion in budget authority for nondefense activities—largely for recovery and reconstruction related to the December tsunami and for other international assistance. Under the assumptions of the baseline, that additional funding raises nondefense discretionary outlays by $64 billion over the 10-year projection period, CBO estimates.

In addition, CBO's baseline includes the effects of a $1.5 billion supplemental appropriation provided recently to cover the rising costs of health care for veterans. Although that funding is available on enactment, CBO assumes that most of it will be spent in 2006, since little time remains in the current fiscal year. Extrapolating that funding over the 10-year projection period increases nondefense discretionary outlays by roughly $18 billion.

Revenues. Legislation enacted since March has had a much smaller impact on CBO's revenue projections than have revised economic assumptions and technical factors (which are described below). CBO and the Joint Committee on Taxation estimate that recently enacted laws will increase revenues by $80 million this year but reduce them by nearly $500 million in 2006 and $18 billion over the 2006-2015 period.

Almost all of those changes come from three pieces of legislation that the Congress passed just before the August recess: the Energy Policy Act, CAFTA-DR, and the Safe, Accountable, Flexible, and Efficient Transportation Equity Act—A Legacy for Users (SAFETEA-LU). The energy law creates or expands credits for energy-efficient technologies, alternative motor vehicles and fuels, and renewable electricity, nuclear power, clean coal, and other types of fuel. It also mandates the increased use of ethanol-blended motor fuels, which are taxed at a lower rate than gasoline. CBO and JCT estimate that the law will add $40 million to revenues in 2005 but lower revenues by $588 million in 2006 and $12.3 billion over the next 10 years.

Tariff reductions included in CAFTA-DR will reduce revenues by $15 million between 2006 and 2008 and by $4.4 billion between 2009 and 2015, CBO estimates. The revenue effects begin mainly after 2008 because most imports from the affected countries currently enter the United States duty-free as a result of the Caribbean Basin Initiative, which is scheduled to expire in 2008.

SAFETEA-LU, which reauthorizes highway programs, includes provisions to repeal taxes on producers and marketers of alcoholic beverages that are based on the number of locations they operate and to modify the tax treatment of kerosene fuel for aviation in order to reduce fraud. Altogether, SAFETEA-LU's provisions are estimated to decrease revenues by $1.1 billion over the 2006-2015 period. The law also extends gasoline and other taxes that finance the Highway Trust Fund for six years beyond their September 30, 2005, expiration. However, those extensions are estimated to have no budgetary effect relative to CBO's baseline, because by law the baseline is required to assume that excise taxes dedicated to trust funds do not expire.

Net Interest. In all, legislation enacted in the past five months will increase the cumulative deficit for the 2006-2015 period by $936 billion under the assumptions of CBO's baseline. That increase adds another $283 billion to projected debt-service costs over those 10 years (for a total legislative impact of more than $1.2 trillion).

The Effects of Economic Changes

Changes to the economic outlook have had little net effect on the budgetary picture for the next decade. Since January, when CBO last updated its economic projections, such changes have trimmed $25 billion off the deficit for 2005 and $35 billion off the cumulative deficit for the 2006-2015 period (with most of that change occurring in 2006 and 2007). Mainly because of higher projections of nominal GDP and wages throughout the 10-year period, CBO has increased its revenue projections by $28 billion for this year and by $132 billion for the 2006-2015 period. Much of that increase is offset by higher outlay projections, the result of an increase in projected inflation over the next few years. (CBO's new economic forecast and projections are discussed in Chapter 2.)

Mandatory Spending. Revisions to CBO's economic forecast since January have added $113 billion (0.6 percent) to projected mandatory outlays for the 2006-2015 period. The bulk of those revisions are reflected in the two largest mandatory programs, Social Security and Medicare. Higher projected inflation—as measured by the consumer price index for urban wage earners—has boosted the anticipated cost-of-living adjustment for Social Security by 1.1 percentage points in 2006 and by 0.3 percentage points in 2007, thus raising projected payments to beneficiaries each year. Those adjustments, coupled with higher growth in Social Security's national average wage index (which increases future benefit payments), have boosted projected outlays for Social Security by $94 billion over the 2006-2015 period. Increases in Medicare's payment rates, based on updated projections of inflation, have raised projected outlays for that program by a total of $34 billion from the March baseline.

Other economic changes to mandatory spending are dominated by rising energy prices, which increase mineral royalties to the government from onshore and offshore leases by a total of $26 billion over the 2006-2015 period.[18] Those receipts are displayed in the budget as negative outlays. They more than offset increases in spending for benefit programs (such as civil service retirement, military retirement, and veterans' compensation) that, like Social Security, are affected by increases in cost-of-living adjustments.

Discretionary Spending. By law, CBO must project discretionary budget authority using two measures of inflation: the GDP deflator and the employment cost index for wages and salaries. CBO's forecast of the GDP defla-

18. Higher energy prices affect the federal budget in many ways. Some effects, such as increased royalty receipts from oil and gas leases, are directly reflected in budgetary accounts. Indirect effects, such as the impact of energy prices on agencies' operating costs and on inflationary measures such as the consumer price index, are spread throughout the budget.

tor has risen for 2006 and 2007, but its projection of growth in the employment cost index for wages and salaries during those years has declined. The combined effect of those changes is a $36 billion increase in projected discretionary outlays over the 2006-2015 period.

Revenues. As a result of its new economic forecast, CBO has increased its projection of revenues by $28 billion for 2005 and $132 billion for 2006 through 2015. Those increases largely reflect higher projections of GDP and wage and salary disbursements, which affect receipts from individual income and social insurance taxes. Since January, CBO has raised its estimate of wages and salaries by $84 billion for 2005 and by smaller amounts for later years, for a total increase of $512 billion (0.7 percent) over the 2006-2015 period. Those changes have led CBO to increase its projection of individual income and social insurance tax receipts by $26 billion for 2005 and $139 billion for the 10-year projection period.

Other changes to revenue projections because of the updated economic outlook are relatively minor. Lower projections of profits result in smaller projected receipts from corporate income taxes, and lower projected growth of real GDP and higher oil prices reduce projected excise tax receipts. In the other direction, higher projections for imports and interest rates increase projected receipts from customs duties and Federal Reserve earnings, respectively. All told, such changes increase revenues by $2 billion in 2005 and lower them by a total of $7 billion from 2006 through 2015.

Net Interest. Economic revisions to projections of net interest spending have two parts: the effects of changes in projected interest rates and inflation, and the effects of additional (or reduced) debt service. In 2005, short-term interest rates and inflation have increased faster than CBO had expected and thus have boosted interest paid on Treasury bills and inflation-protected securities by about $4 billion. However, for 2006 and 2007, CBO's current forecast of three-month and 10-year interest rates is lower than the January forecast by an average of 0.25 percentage points and 0.5 percentage points, respectively. As a result, projected interest outlays are $21 billion lower for the 2006-2010 period. In addition, CBO projects that debt-service savings associated with economic changes to revenue and outlay projections total $29 billion over the 10-year period.

The Effects of Technical Changes

Technical changes represent all other revisions to the baseline that are not directly attributable to newly enacted laws or to changes in the economic outlook. Buoyed by upward revisions to revenue estimates in the near term, such changes have reduced the projected deficit by $42 billion in 2005 and by $87 billion from 2006 through 2009. Beginning in 2010, however, technical changes are projected to have the opposite effect, slightly increasing deficits through the rest of the projection period. Overall, technical changes have reduced the baseline deficit for the entire 10-year period by $54 billion.

Mandatory Spending. Technical adjustments have raised CBO's estimate of mandatory outlays for each year from 2005 through 2015, adding $14 billion for this year and $86 billion (0.5 percent) for the 2006-2015 period.

About one-third of those technical revisions involve Medicare spending. Outlays for that program are turning out to be higher in 2005 than anticipated. In addition, recent announcements by the Centers for Medicare & Medicaid Services indicate that payment rates for Medicare Advantage plans and for skilled nursing services will be higher than CBO assumed in its March baseline. Likewise, the Medicare Boards of Trustees have indicated that premiums for Part B of Medicare for the next few years will be higher than CBO estimated. Those premiums are considered offsetting receipts (negative outlays) in the federal budget. As a result of all of those developments, CBO has raised its estimates of Medicare outlays by $5 billion for this year and $30 billion (0.6 percent) for the 2006-2015 period.

The other major health care program, Medicaid, has also experienced higher-than-expected growth so far this year. Consequently, CBO has added $1 billion to its projection of Medicaid outlays for 2005 and $3 billion for the 2006-2015 period.

CBO has also made technical adjustments to reflect increased numbers of people claiming the earned income and child tax credits. Estimates of outlays for the refundable portion of those credits have risen by $2 billion for 2005 and by $30 billion for the following 10 years.

Technical revisions for all other mandatory programs increase projected outlays by $6 billion this year and by $23 billion over the 2006-2015 period. Those changes include an added $2 billion in Social Security outlays in

2005 and $11 billion thereafter, primarily reflecting a small increase in the projected number of beneficiaries. In addition, CBO has raised its estimate of outlays for the student loan program in 2005 by $4 billion on the basis of spending so far this year.

In the other direction, the estimate of spending by the Commodity Credit Corporation this year has declined by $3 billion (although the agency's overall spending in 2005 is still significantly higher than it was in 2004).

Discretionary Spending. Technical revisions to projections of discretionary spending largely offset one another and therefore have little impact on the projected deficit. For example, spending on defense programs is about $3 billion lower than expected this year, but that decline is offset by spending on disaster-relief activities and on relief and reconstruction in Iraq, which is estimated to be $3 billion higher in 2005 than previously projected. For the 2006-2015 period, technical adjustments reduce projected discretionary outlays by just $4 billion.

Revenues. CBO has increased its revenue projections by $56 billion for 2005, $48 billion for 2006, and a total of $48 billion for 2007 through 2011 for reasons other than the new economic outlook or recent laws. For years after 2011, such technical factors have led CBO to reduce its projections of revenues by $31 billion.

The main factor behind the increases through 2011 is the recent unanticipated strength in tax collections, especially from the corporate income tax. CBO now expects that when all revenues for 2005 are tabulated, corporate tax receipts will exceed its March projection by $53 billion. Only $1 billion of that difference can be attributed to the revised economic outlook.

As explained above, the sources of the current strength in corporate tax receipts will not be known until information from tax returns becomes available in future years, but CBO anticipates that most of that strength will be temporary. However, CBO has raised its projection of corporate receipts over the 2006-2015 period to reflect new estimates of the distribution of profits between profitable and unprofitable firms. Those technical reestimates—which add $177 billion to baseline revenues over the 2006-2015 period—decline from $52 billion for 2005 to an average of $14 billion per year between 2009 and 2015.

Technical revisions add about $10 billion to projections of individual income tax receipts for this year and subtract $106 billion for the following 10 years. CBO sees the 2005 increase as temporary and generally phases it out over the next five years in the baseline. In addition, CBO has made some technical changes to its modeling of distributions from pensions and individual retirement accounts (IRAs), reducing the anticipated rate of return on assets in those tax-deferred accounts to make it more consistent with overall rates of return in the economic projections. That change, plus some other minor revisions to pension and IRA distributions, have caused CBO to lower its projections of revenues from retirement-account income by amounts growing to almost $20 billion in 2015, or slightly more than $90 billion over the 10-year projection period.

Technical reestimates to other sources of tax revenues are smaller. CBO has reduced its projections of excise tax receipts by $19 billion for the 2006-2015 period, mainly to reflect lower anticipated receipts from motor fuel and telecommunications taxes. Projections of social insurance tax receipts have been lowered by $14 billion for the same period to reflect new modeling. Projections of customs duties have been raised by $19 billion for the 10-year period to reflect higher recent collections and an anticipated higher average duty rate.

Net Interest. Technical revisions lower projected outlays for net interest by a total of $71 billion over the 2006-2015 period. Those revisions are mostly attributable to lower debt-service costs, which reflect technical changes to revenue and outlay projections that, taken together, improve the budget outlook through 2008.

CHAPTER

2

The Economic Outlook

The Congressional Budget Office forecasts that the U.S. economy will continue to expand at a healthy pace during the second half of 2005 and in 2006. Real (inflation-adjusted) gross domestic product will grow by 3.7 percent in 2005, CBO estimates, and by 3.4 percent in 2006 (see Table 2-1). CBO anticipates that investment by businesses will be the largest source of growth, with spending for equipment, software, and structures growing at a rate roughly double its post-World War II average. Strong growth of domestic demand for goods and services will support a solid rate of job creation and therefore a rise in incomes. By contrast, CBO expects that over the forecast period (2005 and 2006), growth of demand for goods and services among the United States' trading partners will remain below its historical trend.

The rate of unemployment will change little over the next two years, in CBO's estimation, averaging 5.2 percent during the 2005-2006 period (and thereafter). CBO expects that inflation will be slightly higher in 2005 than it was in 2004, largely because of higher energy prices. As measured by the consumer price index for urban consumers (CPI-U), inflation will average 3.1 percent in 2005, CBO forecasts, as compared with 2.7 percent in 2004. However, CBO expects that in 2006, the rise in energy prices will ease and CPI-U inflation in turn will dip, to 2.5 percent. Over the following nine years (2007 through 2015), CPI-U inflation will average 2.2 percent, CBO projects. Core inflation (a measure of underlying inflation that excludes prices for food and energy) will also ease, slipping from an average annual rate of 2.3 percent during 2005 and 2006 to 2.2 percent during the 2007-2015 period.

Interest rates will rise over the next two years, CBO estimates, as the Federal Reserve continues to raise its target for the federal funds rate (the interest rate that financial institutions charge each other for overnight loans of their monetary reserves). The interest rate on three-month Treasury bills is forecast to average 3.0 percent in 2005 and 3.7 percent in 2006; during the 2007-2015 period, it will average 4.7 percent. The rate on 10-year Treasury notes is also projected to rise but by less: in CBO's estimation, it will average 4.3 percent in 2005, 4.7 percent in 2006, and 5.4 percent over the medium term.

Growth of real GDP over the 2007-2015 period will average 2.9 percent annually, CBO projects. From 2007 to 2010, growth will average 3.2 percent, followed by a slower pace of 2.6 percent during the 2011-2015 period. The slowdown stems from a lower rate of labor force growth that coincides with the beginning of the retirement of the baby boomers.

One key to understanding the recent performance of the U.S. economy is the influence of foreign economic developments. The past two years have been unusual in a number of ways: long-term interest rates and underlying core inflation have been much lower than might have been expected, given the strong growth of demand; the rate of housing construction and the level of housing prices have been higher than forecast; the growth of employment has been less than expected; and the trade balance did not improve as analysts had anticipated. Many of those anomalies appear to be related to the willingness of foreign investors and governments to purchase dollar-denominated assets, which in turn is related to the high levels of foreign saving relative to foreign investment. Although the unique characteristics of this expansion cannot all be attributed to that single cause, it is apparent that foreign economic developments in recent years have had a notable influence on the U.S. economy.

As always, the accuracy of CBO's outlook is vulnerable to risks arising from a number of factors. Among them are

Table 2-1.

CBO's Economic Projections for Calendar Years 2005 Through 2015

	Actual	Forecast		Projected Annual Average	
	2004	2005	2006	2007 to 2010	2011 to 2015
Nominal GDP (Billions of dollars)	11,735	12,450	13,137	16,023 [a]	19,946 [b]
Nominal GDP (Percentage change)	6.6	6.1	5.5	5.1	4.5
Real GDP (Percentage change)	4.4	3.7	3.4	3.2	2.6
GDP Price Index (Percentage change)	2.2	2.3	2.0	1.8	1.8
Consumer Price Index[c] (Percentage change)	2.7	3.1	2.5	2.2	2.2
Core Consumer Price Index[d] (Percentage change)	1.8	2.3	2.3	2.2	2.2
Unemployment Rate (Percent)	5.5	5.2	5.2	5.2	5.2
Three-Month Treasury Bill Rate (Percent)	1.4	3.0	3.7	4.6	4.7
Ten-Year Treasury Note Rate (Percent)	4.3	4.3	4.7	5.4	5.4
Tax Bases (Percentage of GDP)					
Corporate book profits	8.4	10.5	8.8	8.4	8.3
Wages and salaries	45.8	46.2	46.1	46.0	45.9
Tax Bases (Billions of dollars)					
Corporate book profits	985	1,308	1,158	1,334 [a]	1,655 [b]
Wages and salaries	5,373	5,749	6,055	7,367 [a]	9,132 [b]

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

Note: Percentage changes are year over year.

a. Level in 2010.

b. Level in 2015.

c. The consumer price index for all urban consumers.

d. The consumer price index excluding prices for food and energy.

the risks that surround the economy's response to terrorism, developments in Iraq and Afghanistan, and other events around the world. In addition, many risks derive from the present international economic environment. Changes in production or demand in other countries, for example, could affect the demand for U.S. exports as well as the level of commodity prices, including prices for energy. Moreover, some analysts are concerned that continued financing of the large deficit in the U.S. current account will require a lower exchange value of the dollar, higher domestic interest rates, or both.[1] Investors may decide to reduce the share of dollar-denominated assets in their portfolios; if their desire to hold dollars abates suddenly and substantially, the result could be a disruptive drop in the dollar's value and a rise in interest rates in the United States. That rise in turn could slow consumer spending, business investment, and activity in the housing market, thereby dampening the growth of GDP.

The Outlook for 2005 and 2006

In CBO's estimation, the economy will continue to grow at a solid rate during the remainder of 2005 and through

1. The current account is a broad measure of U.S. transactions with the rest of the world. It includes not only the trade balance but also net investment income and net unilateral transfers, which are international payments that are not made in exchange for goods or services.

2006. Overall demand will keep climbing, and businesses are likely to respond by boosting their capital purchases and their hiring. International trade will be a drag on the growth of GDP, CBO estimates, and weak demand among the United States' trading partners is expected to contribute to a widening of the trade deficit through the end of 2006. At the same time, inflation will moderate, and interest rates will gradually rise.

The Business Sector

Among the many decisions made by businesses, decisions about investment spending for equipment, software, structures, and inventories directly affect the growth of demand in the economy. Although such investment makes up a small share of GDP (roughly 11 percent in recent years), historically, that share has been quite volatile. Therefore, it disproportionately affects changes in GDP growth.

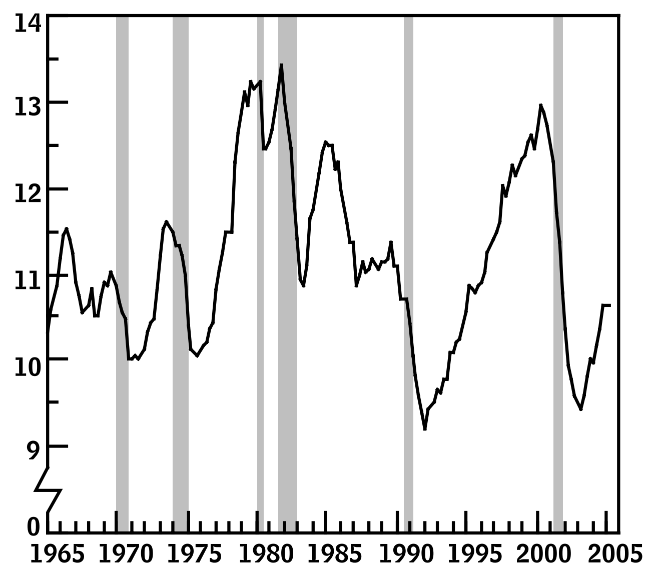
CBO forecasts that investment by businesses will continue to play a major role in sustaining economic growth during the 2005-2006 period. Recent revisions to the federal government's official economic data—specifically, the national income and product accounts—have lowered estimates of demand growth slightly over the past two years (see Box 2-1). Nevertheless, estimates of the growth of real final sales are still strong, and that growth has outstripped businesses' ability to meet that demand solely through increased productivity, as they did in 2002 and early 2003. As a result, firms are likely to expand their capacity by investing in equipment, software, and structures (business fixed investment) and by hiring more workers.

Business fixed investment has been robust during the past two years: since the first quarter of 2003, real business fixed investment has expanded at an average annual rate of nearly 11 percent—a pace that far exceeds such investment's long-run average and is about the same as the average rate of growth during the investment boom of the late 1990s. In particular, real spending for equipment and software has been quite vigorous, climbing at an average annual rate of more than 13 percent since the beginning of 2003. Despite that rapid growth, however, real fixed investment spending by businesses in mid-2004 had only just reached the level it had attained prior to the 2001 recession. And nominal investment, when measured as a share of potential GDP, was well below the level it had attained before the business-cycle peak in 2001 (see Figure 2-1).[2] As a result, CBO estimates that during the remainder of 2005 and through 2006, the pace of growth of business fixed investment will remain rapid.

Figure 2-1.

Business Fixed Investment

(Percentage of potential GDP)



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

Several developments support the view that businesses' investment spending will continue to rise at a healthy rate. First, new orders for nondefense capital goods have been quite strong in recent months, which suggests that firms will continue to invest during the remainder of 2005 and in 2006 to meet demand. Second, according to surveys by the Business Roundtable and the Conference Board, business executives remain confident about their economic prospects in the coming months. Third, the healthy level of business fixed investment has not kept the rate of capacity utilization in manufacturing from rising (from less than 73 percent at the end of 2001 to 78 percent in the second quarter of 2005), signaling that further growth of business investment is likely. (Rising rates of capacity utilization suggest that several manufacturing industries have worked off the overcapacity that developed in the wake of the late 1990s investment boom.)

2. Potential GDP is the level of real gross domestic product that corresponds to a high level of resource (labor and capital) use.

Box 2-1.

The Recent Revisions to the National Income and Product Accounts

The Commerce Department's Bureau of Economic Analysis (BEA) is the federal agency responsible for maintaining the national income and product accounts (NIPAs), a key element of the nation's official economic data. BEA regularly updates the NIPAs, and it released its latest revised estimates of gross domestic product (GDP) as well as other data on July 29, 2005.[1] (The revisions affected data for 2002 through the first quarter of 2005.) Those changes came too late to be incorporated in the Congressional Budget Office's (CBO's) current economic forecast; however, CBO's preliminary assessment indicates that the revised data would have had little effect on the major aspects of its forecast or, in turn, on its baseline budget projections.

BEA now estimates that growth of real (inflation-adjusted) GDP for the years 2002 through 2004 was 2.8 percent, down from its previous estimate of 3.1 percent. The primary reasons for that reduction are lower estimates for business fixed investment (including a downward revision to spending for computers and communications equipment) and a reduction in personal consumption expenditures for services (primarily housing services). Because of the slower growth of real GDP, growth of labor productivity in the nonfarm business sector (which is calculated by the Bureau of Labor Statistics) was revised downward for all three years. Productivity growth for 2004 is now estimated to be 3.4 percent instead of the previously published figure of 4.0 percent.

BEA revised upward (from 1.9 percent to 2.1 percent) its estimate for growth of the GDP price index over the 2002-2004 period. That revision occurred primarily because of higher estimates of changes in the prices of commercial and residential structures and in personal consumption expenditures for services.

For some categories of income, BEA's revisions were significant, but the effects of its revisions to the data for taxable labor income were small. BEA altered its estimates of labor compensation for all three years

1. BEA will publish details of the July 29 revisions in the August edition of *Survey of Current Business,* available at www.bea.gov.

A fourth factor underlying CBO's forecast of strong levels of business fixed investment is that today's financial conditions are favorable for firms that seek to invest. Both corporate profits and retained earnings (the portion of profits not paid to shareholders as dividends) have been at high levels since the end of the recession (see Figure 2-2); that strength has permitted businesses to finance their investments with their own funds. And profits may have been even more robust during the past few quarters than current estimates show. Corporate income tax receipts ran ahead of expectations during late 2004 and the first half of 2005 (see Chapter 1); that unanticipated rise suggests that the NIPAs may be revised in July 2006 to show an even bigger hike in profits in 2004 than they now record. In addition, gains in the stock market since early in 2003 suggest that the cost of equity financing has declined (so it is easier for firms to pay for investment by issuing stock). Moreover, because long-term interest rates have remained low, the cost of firms' borrowing has not increased.

CBO expects that those conditions will allow business fixed investment to continue to grow at a healthy rate in 2005 and 2006. In CBO's forecast, real spending for producers' durable equipment and software rises at an average annual rate of 12 percent in those years, a pace that roughly equals the average rate during the late 1990s. In addition, businesses' spending for nonresidential structures is expected to grow at an average annual rate of more than 3 percent, which is faster than the long-run average pace for that type of spending.

Despite the signs that businesses' spending for investment will continue to rise rapidly in 2005 and 2006, the precise path of those expenditures depends on many factors.

Box 2-1.

Continued

(in 2004, for example, by $37 billion). That upward revision stemmed mostly from new estimates of the employer's share of the cost of employees' health care coverage, which are excluded from the tax base. BEA's revised estimate for wages and salaries constituted a small upward change; for proprietors' income, the data were revised downward.

The revised data for profits are more consistent with the recent strength in corporate tax receipts. Economic profits for 2004 were revised downward, by $20 billion, but book profits (the measure that approximates the tax base) were revised upward, by $74 billion.[2] The revision in book profits stems from BEA's reduction of its estimates of the amount of depreciation that corporations claimed in 2004 in response to changes in tax law in 2002 and 2003.

2. Economic profits are the profits of corporations, adjusted to incorporate more-accurate depreciation allowances than those specified in the tax rules and to exclude the effect of inflation on the value of inventories. Economic profits are a better measure of profits from current production than are book profits, which are calculated using book (or tax) depreciation and standard accounting conventions for inventories.

Reducing depreciation deductions caused book profits to increase even though economic profits were revised downward. CBO had anticipated much of the upward revision to book profits from that source; thus, its projections of corporate tax receipts for its forecast were generally consistent with the revised data.

The revisions to the NIPAs may affect CBO's outlook slightly when complete information on them—including the revisions to capital stocks—is available and CBO has had time to analyze their implications. For example, the trend growth in potential GDP may be revised downward marginally because of the downward revision to productivity growth in recent years. However, to date, there is no information to indicate that the revisions will significantly change CBO's view of the economy or its projections. Similarly, CBO's baseline budget projections are little affected by the revisions—wage and salary disbursements, the primary income category for CBO's revenue forecasting, were virtually unchanged, and the projections anticipated the revised estimate of book profits.

If, for example, the growth of productivity picked up, firms might be able to meet more of the expected future increases in demand with existing capacity and thus would not need to boost investment by as much as CBO has envisioned. Alternatively, other components of demand (such as consumer or government spending) could grow more or less vigorously than CBO has forecast, which could lead to a correspondingly stronger or weaker course for business investment.

The Household Sector

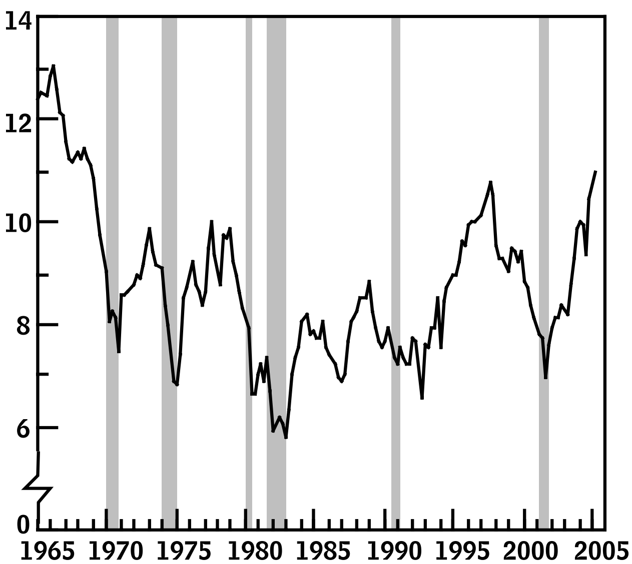
During the first half of 2005, real consumer spending continued to grow at a solid average annual rate of 3.4 percent, or very close to its average rate since 1960 of 3.6 percent. Growth of real residential investment was also substantial, rising during the first two quarters of 2005 at a rate well above its long-run average. Several fundamental elements—in particular, the rate of growth of incomes and households' current state of financial health—suggest that spending by the household sector will continue to bolster the expansion of GDP during the next two years. Nevertheless, rising interest rates are likely to cause some consumers to moderate their spending and may also help cool the pace of housing construction, an outcome that many observers are anticipating. Real consumer spending during the 2005-2006 period will rise at an average annual pace of 3.4 percent, CBO forecasts, whereas growth of real housing investment will decline during the remainder of that span.

The primary risk to the accuracy of CBO's outlook for healthy consumer spending is slowing growth of employment and incomes, which could weaken the outlook markedly. But there are other potential risks as well. One would be a further increase in the price of oil, which

Figure 2-2.

Corporate Economic Profits

(Percentage of potential GDP)



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

Note: Economic profits are taxable profits adjusted to remove distortions in depreciation allowances caused by tax rules and to exclude the effect of inflation on the value of inventories.

could boost consumers' energy costs more than CBO has forecast and displace a modest amount of spending for other goods and services. A second would be a decline in the prices of houses, which could result in a lower level of household wealth and lead consumers to curtail their spending. Indeed, any effort on the part of consumers to build up their wealth and raise their saving rate, even in the absence of a softening of housing prices, would slow consumer spending, relative to CBO's forecast.

Employment and Incomes. After a slow start during the recovery from the 2001 recession, hiring picked up in 2004: the economy added more than 2 million jobs, as measured by the Bureau of Labor Statistics' payroll survey (see Figure 2-3). That pace continued in early 2005—gains in the number of jobs averaged about 190,000 per month during the first half of the year—and CBO forecasts that employment will continue to expand at a solid rate through the end of 2006.

The upturn in employment growth over the past two years is reflected in the unemployment rate, which declined from 6.1 percent in mid-2003 to 5.4 percent at the end of 2004 and 5.0 percent in July 2005. That rate is slightly below CBO's estimate of the natural rate of unemployment, a situation that typically would imply a fairly tight labor market.[3] However, the unemployment rate may understate the current degree of slack in the market because the rate of labor force participation—the share of the civilian population aged 16 and older who are either employed or looking for work—has been declining since 2000. It is unclear how much of that drop in participation results from business-cycle factors and how much reflects changes in the underlying trends of labor force participation. CBO believes that a steady pace of job creation during the next two years will induce a rebound in labor force participation rates. However, if the participation rate does not bounce back, the unemployment rate could drop even further.

The gains in employment of the past two years are mirrored in the growth of labor compensation. Real labor compensation—which is measured in the NIPAs as wages and salaries plus fringe benefits—rose by more than 4 percent (measured as an annual rate) during 2004 and the first half of 2005. Because other indicators, such as the employment cost index, suggest that labor compensation grew at a modest pace during late 2004 and early 2005, it seems likely that part of the recent increase seen in the NIPA measure stems from onetime payments, such as bonuses and realizations of stock options. CBO forecasts that the rate of growth of labor compensation will ease slightly during the second half of 2005 before rising quickly in 2006, when current law requires employers to increase, by a significant amount, their contributions to their defined-benefit pension plans (see Box 2-2).

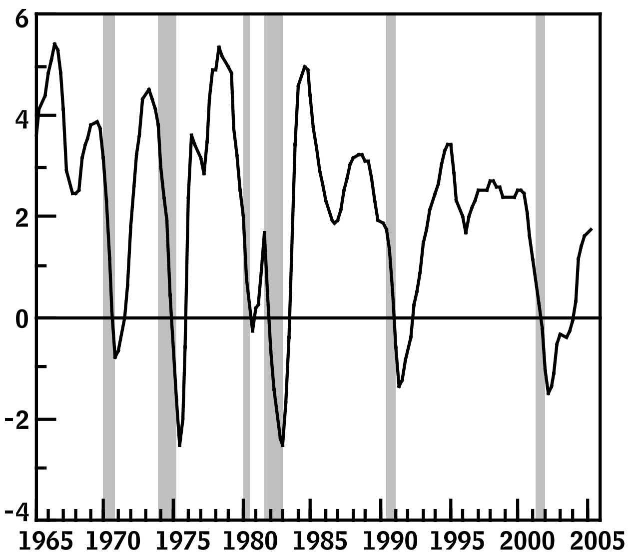
Consumers' energy costs surged during 2004 and early 2005, spurred by increases in the prices of oil and natural gas. (For example, the price of West Texas Intermediate crude oil rose from $32 per barrel at the end of 2003 to $56 per barrel in mid-2005.) Those increases raised energy expenditures for consumers in mid-2005 to almost $500 billion (measured at an annual rate), compared with expenditures of less than $400 billion during 2003. CBO

3. The natural rate of unemployment is the rate arising from sources apart from fluctuations in aggregate demand, such as unemployment associated with normal turnover or mismatches between the skills and location of available workers and vacant positions.

Figure 2-3.

Nonfarm Payroll Employment

(Percentage change from previous year)



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

forecasts that the cost of oil will fall slightly by the end of 2006—although it is not expected to decline by as much as CBO anticipated last January.

Households' Financial Health. The financial condition of the household sector is generally strong and is not expected to noticeably restrain consumers' spending. Early in 2005, gains in the value of homes raised households' wealth, despite a flat stock market and a personal saving rate that continued to hover at a very low level. That increased wealth, CBO forecasts, will continue to support growth in spending by consumers.

CBO's outlook is bolstered by various indicators of financial stress, which do not suggest that consumers will retrench during the remainder of 2005 and in 2006. Delinquency rates on all types of consumer loans (including credit card balances and real estate loans) have been declining since the end of the 2001 recession. Moreover, households' financial obligations, including debt-service payments, auto lease payments, rent payments, homeowner's insurance premiums, and property taxes, are slightly lower as a share of disposable personal income than they were in late 2001, largely because interest rates, especially mortgage rates, have been unusually low.

Housing. The housing sector has been a key source of strength for the economy over the past few years. Since the middle of 2003, residential investment has grown at an average annual rate of nearly 10 percent (which is well above its long-run rate of growth) and during that same period has contributed roughly 0.5 percentage points to the annual growth of real GDP. However, CBO expects that the housing market will cool somewhat during the next year and a half—housing starts in late 2006 will be more than 10 percent below their current levels, CBO estimates. That pullback will come as interest rates rise along with the transition of monetary policy toward a more neutral stance.

Uncertainties abound, however, in considering the outlook for housing. Some analysts believe that the construction of new homes will slacken to a greater extent than CBO has anticipated. They point out that speculative motives appear to have driven a substantial proportion of recent purchases of houses, that investment in housing currently accounts for an unusually large share of GDP, and that housing prices—especially in many metropolitan areas—are high relative to the general level of prices (see Figure 2-4 on page 34). According to such analysts, even a moderate rise in mortgage rates will lead to a substantial decline in speculative buying over the next two years. Inflation in housing prices nationwide will slow substantially, they further maintain, and prices will actually fall in some regions of the country. In addition, those factors may lead to disproportionate rates of default on more-risky mortgage loans.

By contrast, other analysts argue that housing construction will not contract over the next two years, even if the growth of prices slows, because the general economic outlook calls for a steady rise in households' incomes and because mortgage rates, though rising, will still be quite low. Those analysts believe that housing starts can remain near their current levels as long as households' incomes experience no large negative shock.

Imports, Exports, and the Exchange Value of the Dollar

CBO's current outlook for the contribution of international trade to GDP growth is less favorable than its outlook in January. CBO anticipates that during the two-year forecast period, the trade deficit will continue to widen. At the end of 2006, it will be about $100 billion larger than CBO forecast last winter. That outlook reflects the impact of the higher energy prices of the past

Box 2-2.

Employers' Contributions to Defined-Benefit Pension Plans

According to the national income and product accounts (NIPAs), employers' contributions to defined-benefit pension plans have substantially increased in recent years, more than doubling from 2001 ($36.0 billion) to 2002 ($77.2 billion) and then jumping again in 2003 ($102.8 billion). That growth in contributions occurred because many plans had become underfunded, in some cases by substantial amounts. (Being underfunded means that the value of the plans' assets is currently insufficient to meet the plans' projected liabilities—the pensions owed to current workers and retirees and their survivors.) The plans' underfunding contrasted with their circumstances during the late 1990s, when many plans were well funded because of the boom in the stock market. In that instance, not only were firms not required to contribute to defined-benefit plans but they were discouraged from doing so by limits on the tax deductibility of contributions to overfunded plans. When stock prices declined between 2000 and 2002, the value of the plans' assets fell, and many of them abruptly became underfunded.

A pension plan's projected liabilities depend on the stream of payments that it expects to make, after its rules and actuarial assumptions about mortality are taken into account. A further, critical element is the interest rate, or discount rate, used to compute the present value—the value in today's dollars—of future payments. The lower the discount rate, the higher the value of future payments in today's dollars. Under the Employment Retirement Income Security Act of 1974, which sets minimum standards for the funding of pension plans in private industry, the discount rate must be no more than 105 percent of a weighted average of interest rates on 30-year Treasury securities over the previous four-year period. The 2000-2002 decline in stock prices coincided with a sharp fall in long-term interest rates—which exacerbated plans' emerging underfunding.

Policymakers granted firms some temporary relief from falling interest rates with the enactment of the Job Creation and Worker Assistance Act of 2002 (JCWAA) and the Pension Funding Equity Act of 2004. JCWAA allowed plans to set a discount rate equal to 120 percent of the weighted-average 30-year Treasury rate in 2002 and 2003; the pension funding act stipulated that for 2004 and 2005, the maximum applicable rate would be a weighted average of rates on amounts "conservatively invested in long-term corporate bonds." As a result, the maximum applicable rate for most plans was 6.65 percent in 2003, 6.55 percent in 2004, and 6.10 percent in 2005. (Without the legislation, it would have been about 5.8 percent in 2003, about 5.6 percent in 2004, and 5.5 percent in 2005.) One consequence of that temporary relief is that the value of the assets of defined-benefit pension plans is now further out of line with the value of their liabilities than it would otherwise have been—which means that future contributions will probably have to be larger.

The Congressional Budget Office (CBO) estimates that contributions in 2004 to private defined-benefit plans totaled about $125 billion. That figure is about $50 billion higher than CBO's January 2005 estimate of such contributions and roughly $30 billion below what contributions would have been without the temporary relief provided by the Pension Funding Equity Act. For 2005, those contributions will edge up to $129 billion, CBO projects, despite last year's larger-than-expected total, reflecting the decline in the maximum interest rate applicable to most plans. Under current law, contributions in 2006 are projected to surge by more than two-and-a-half

Box 2-2.

Continued

times, to about $335 billion, as the temporary relief measures expire and the maximum applicable interest rate falls—to about 5.2 percent, CBO estimates (on the basis of its interest rate forecast). For 2007, the level of contributions will remain elevated, at $319 billion. But as those years' contributions diminish the funding gap and the maximum applicable interest rate moves toward its estimated long-run average of 6.1 percent, contributions will fall, in CBO's estimation, to about $250 billion for 2008, about $230 billion for 2009, and roughly $200 billion annually through 2015.

The required catch-up contributions, however, could be either larger or smaller than CBO is forecasting, for several reasons:

- CBO's estimates reflect the best available information about the current funding status of defined-benefit plans, but complete and accurate data on past contributions and current funding become available only after a lag of several years. Thus, if the current level of underfunding has been overstated, the estimated level of required contributions will be too high (and vice versa).

- Actual contributions will be affected by the performance of the stock market. Several years of rising stock prices could increase the value of plans' assets by enough to eliminate the underfunding in many plans. Conversely, falling stock prices over the next several years could drive some of the most distressed plans into default, shifting the burden of payments from the plans' sponsors to the federal Pension Benefit Guaranty Corporation. (A weak stock market would probably also substantially increase the contributions required for defined-benefit plans that remained in existence.) Although CBO does not attempt to forecast stock prices, it does take their variability into account in projecting defined-benefit contributions (in part because bigger ups and downs in stock prices raise the probability that any given defined-benefit plan will go into default).

- CBO assumed in its forecast that existing plans would continue to operate unless they were forced to default. However, some sponsors might choose instead to "freeze" their plans so that no further liabilities were accrued.

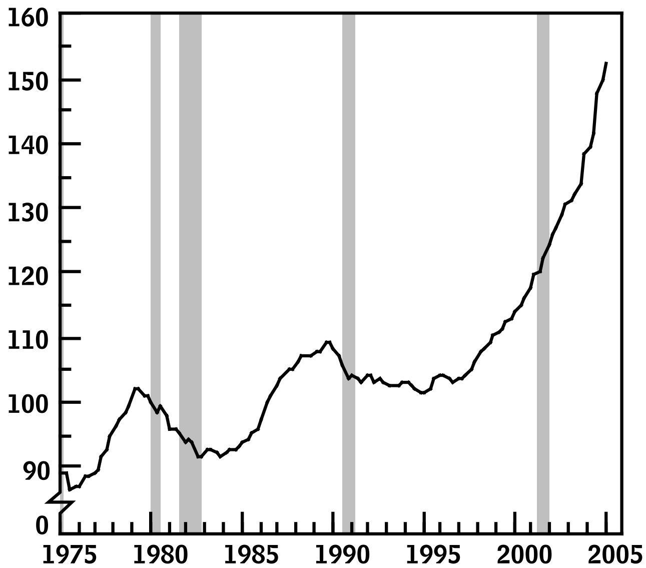
- CBO's estimates of required contributions might be too high or too low if the future path of interest rates differed significantly from CBO's forecast.

CBO's current estimate of contributions to defined-benefit plans differs from its January estimate in several respects. First, the level of contributions that CBO is now projecting for 2005 is about $15 billion lower than the level in its previous forecast (because of the larger-than-anticipated actual contributions in 2004, which slightly reduced the year-end gap between plans' assets and liabilities). Second, because the projected maximum applicable interest rate has been reduced since CBO prepared its previous estimates, projected contributions are now higher by about $35 billion for 2006, $70 billion for 2007, and $50 billion for 2008. Those estimates reflect both lower yields on10-year Treasury notes and a smaller assumed "spread" (or difference) between the yields on 10-year and 30-year Treasury securities. By 2015, estimated contributions in CBO's current forecast are about $100 billion higher per year than they were in its January forecast. Most of that difference is attributable to improvements in CBO's methods for estimating the probability of a plan's default.

Figure 2-4.

Price Index for Existing Homes

(Index, 1980Q1 = 100)



Sources: Congressional Budget Office; Office of Federal Housing Enterprise Oversight; Department of Labor, Bureau of Labor Statistics.

Note: The price index for existing homes is the house price index of the Office of Federal Housing Enterprise Oversight divided by the research series of the consumer price index for all urban consumers.

year and a half and CBO's view that the fundamental factors underlying the increase in the trade deficit—including the weak growth of demand among the United States' trading partners and the demand for dollar assets by foreign investors—will dissipate only slowly.

Economic Conditions Abroad. Since CBO's forecast last winter, economic conditions abroad have deteriorated slightly, and although the overseas economic recovery is expected to continue, it appears to have slowed. *Consensus Forecasts*, a survey of financial and economic forecasters, reports that since January, private forecasters have downgraded their outlook for economic growth during 2005 among countries that use the euro, cutting their estimates from an average of 1.7 percent to 1.3 percent.[4] For 2006, forecasts have been cut from 2.0 percent to 1.7 percent. Growth among the Asian economies in 2005 and 2006 is expected to slow to about 3 percent, on average (down from 4.2 percent in 2004), according to *Consensus Forecasts*. Japan is expected to continue to struggle with sagging demand—although growth picked up slightly during the first half of 2005—as well as with deflation and slow expansion of incomes.[5] Among major emerging economies in Asia (such as those of China and Malaysia), analysts expect growth to slow from its fast pace in 2004 to more sustainable rates in 2005 and 2006. The economies of several Central and South American countries (including Mexico's, Brazil's, and Argentina's) grew rapidly in 2004. However, they are expected to grow more slowly in 2005 and 2006 because interest rates in those countries have risen during the first half of 2005 to counter inflationary pressures.

China's economy has continued to expand rapidly: output has risen by more than 9 percent (measured as an annual rate) over the past six months, despite its government's attempt to restrain investment spending. Most private forecasters predict that economic growth in China will remain strong in the near term (2005 and 2006), averaging about 8 percent annually. That robust outlook is unlikely to be affected by China's recent announcement that it will no longer peg its currency, the yuan, strictly to the dollar and will thus allow market forces to play a larger, though still limited, role in determining the yuan's exchange value.

The Current Account and the Exchange Value of the Dollar. During the first half of 2005, the exchange value of the dollar, which had been declining since 2002, rose, and the current-account deficit continued to mount, at midyear reaching $800 billion, or about 6½ percent of GDP (see Figures 2-5 and 2-6). CBO estimates that the value of the dollar will resume its decline during the next year and a half. However, it does not expect that drop to offset the effect on the current account of stronger growth in the United States relative to growth abroad. Thus, in CBO's estimation, the current-account deficit will remain above $800 billion in 2005 and will top $850 billion in 2006.

A deficit in the current account implies that the amount of capital flowing into the United States exceeds the amount of capital flowing out of it; it is therefore a mea-

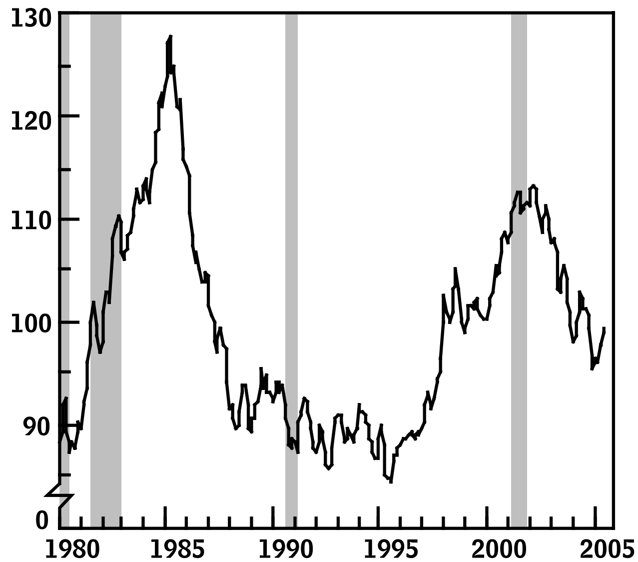
4. Consensus Economics, Inc., *Consensus Forecasts: A Digest of International Forecasts* (London: Consensus Economics, Inc., July 11, 2005).

5. Deflation is a drop in prices so broadly based that general indexes of prices, such as the consumer price index, register continuing declines.

Figure 2-5.

Real Trade-Weighted Value of the Dollar

(Index, March 1973 = 100)



Sources: Congressional Budget Office; Federal Reserve Board.

Note: The real trade-weighted exchange value of the U.S. dollar is a weighted average of the foreign exchange values of the dollar against the currencies of a large group of major U.S. trading partners, adjusted for relative inflation rates.

sure of the growth of the United States' net foreign liabilities. Persistent current-account deficits since the early 1990s have led to a sizable increase in such liabilities—which stood at $2.5 trillion at the end of 2004—prompting concerns about an abrupt fall in the demand for dollar-denominated assets and, in turn, in the exchange value of the dollar.

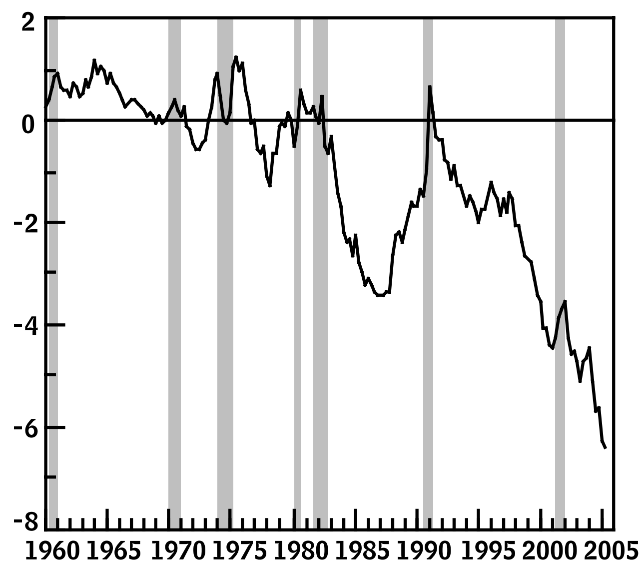
CBO expects that over the near term, the dollar will decline at a moderate pace rather than fall sharply—a view based on four reasons. First, investments in the United States are expected to be more attractive than those available in other industrialized countries, primarily because the outlook for U.S. economic growth is brighter. Second, countries that export goods and services to the United States will have an incentive to curb the decline in the dollar's value because it may hamper their sales in U.S. markets and lower the value of their holdings of foreign exchange, which are primarily dollars. Third, a decline in the dollar will be partly self-limiting. Most foreign assets owned by U.S. citizens, firms, and governments are denominated in the relevant local currency, but almost all of the United States' liabilities to foreigners are denominated in dollars. As a result, when the dollar declines, the foreign-currency value of those net liabilities to foreigners tends to shrink, thus relieving some of the pressure for further depreciation. Fourth, because the dollar's depreciation makes U.S. goods cheaper abroad, it tends to boost U.S. exports and economic growth and thus improve the outlook for the current-account deficit.

International Developments and Their Influence on the Domestic Economy. Some of the unusual aspects of the U.S. economy's recent performance (including low inflation, low long-term interest rates, and a stronger-than-expected exchange value of the dollar) may stem from the influence that foreign economic developments have on the United States. Robust demand for dollar-denominated assets in particular has buoyed the exchange value of the dollar since the end of the 2001 recession, preventing it from declining as much as might be expected, given the size of the U.S. current-account deficit. In addition, the demand among foreign investors for dollar assets has promoted lower interest rates in the United States, which

Figure 2-6.

The Current-Account Balance

(Percentage of GDP)



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

Note: The current account indicates, on balance, how much the United States borrows each year from the rest of the world.

have supported domestic demand and aided the boom in residential investment.

The vigorous growth of U.S. demand for goods and services has obvious benefits for the nation's trading partners, providing them with markets abroad for their goods at a time when demand at home is weak. Indeed, the United States has bolstered growth in the world economy at a time when few other countries could do so, thus helping in recent years to avert a possible global slowdown. However, U.S. demand for foreign goods has also resulted in larger current-account deficits.

Why dollars have been in such great demand abroad is not fully understood, but a number of interrelated developments have encouraged the growth of saving relative to investment in the rest of the world at the same time that investment relative to saving has expanded in the United States. (That shift in positions has led to capital flows into the United States that are the counterpart of the increasing current-account deficit.) Those developments include the desire by many governments after the currency crises of the late 1990s to maintain large foreign exchange balances in dollars; persistently slow growth in domestic demand in a number of foreign economies; consumer spending growth in China that lags behind the rapid expansion of production and incomes; and, more recently, the sharp increase in the price of oil. (See Box 2-3 for more discussion of global saving, investment, and capital flows.)

Economic activity in the rest of the world may also have affected the U.S. economy through competitive pressures and commodity prices. With few exceptions, domestic demand has been growing slowly in economies around the world during the past few years. At the same time, though, production has been growing rapidly in many countries, as firms in those nations focused on increasing output for export. That added production of low-priced goods for export—particularly goods from Asian countries—may have spurred increases in productivity among U.S. manufacturers and dampened inflationary pressures in the United States. It has also stimulated demand for raw materials, which in turn has contributed to the recent strength in the demand for petroleum.

Monetary Policy and Financial Market Conditions

During the next two years, the Federal Reserve will continue to move away from the accommodative stance that it maintained from 2001 until the middle of 2004, CBO forecasts, and will continue to raise its target for the federal funds rate, its primary policy instrument. CBO expects the central bank to increase the target rate at a measured pace until it reaches a neutral level that will support sustainable growth yet maintain low inflation. Private forecasters' estimates of that neutral level vary with their interpretation of underlying economic conditions but generally range between 4 percent and 5 percent. As of this writing, the target federal funds rate stands at 3.5 percent (compared with 1 percent in mid-2004); by early next year, financial market participants expect the rate to reach 4 percent.

Despite the increases that have occurred in the target rate, conditions in the financial markets still favor the growth of demand, according to an index of monetary and financial conditions compiled by the consulting firm Macroeconomic Advisers (see Figure 2-7). The index shows that financial conditions are supporting demand through low rates of interest on loans to businesses and households, high levels of household wealth, and the expectation of further declines in the exchange value of the dollar. Monetary policy is expected to avert a sharp reversal of those favorable financial conditions by continuing—as CBO's forecast assumes—the measured pace of increases in the target federal funds rate.

In CBO's estimation, the rate on three-month Treasury bills will mirror the ascent of the target rate during the near term. The rate on three-month bills, which stood at 2.5 percent early in 2005, is projected to average 3 percent for 2005 and 3.7 percent for 2006.

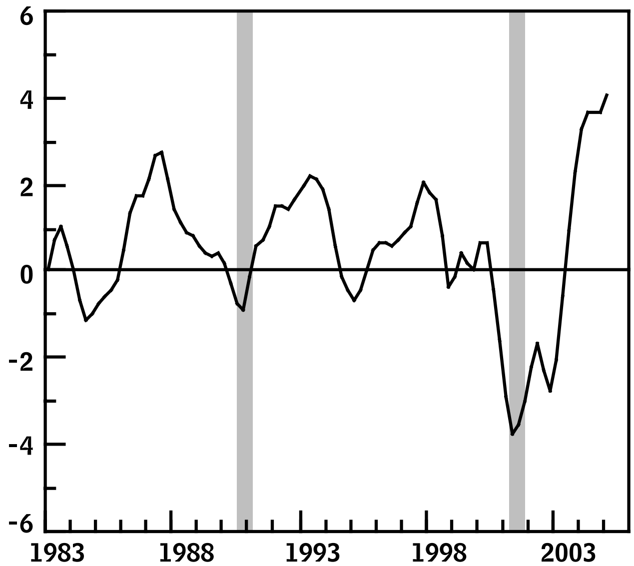
The rate on 10-year Treasury notes will also rise, in CBO's estimation. The rate stood at 4.2 percent early this year; CBO expects it to average 4.3 percent for all of 2005 and 4.7 percent for 2006. CBO's estimates of the rate for 2005 and 2006 are about 0.5 and 0.7 percentage points lower, respectively, than its estimates last January.

Long-term rates have remained surprisingly low in recent months despite an increase in short-term rates (see Box 2-4 on page 40). Although the reasons for that stability are not completely understood, strong foreign demand for dollar-denominated assets has certainly helped keep rates low. As a result, CBO's forecast for long-term rates is subject to an unusual degree of uncertainty: a shift in the preferences of foreign investors could cause interest rates to differ markedly from CBO's estimates.

Figure 2-7.

Index of Monetary and Financial Conditions

(Percentage points of GDP growth)



Sources: Congressional Budget Office; Macroeconomic Advisers, LLC.

Note: This index indicates the contributions of financial markets to the rate of growth of real (inflation-adjusted) GDP. It draws on statistical relationships between real GDP and financial variables such as interest rates, exchange rates, and equity values. When the index is positive, overall conditions in the financial markets are conducive to the growth of real GDP. When it is negative, overall financial market conditions are a drag on growth.

Government Spending

The growth of real consumption plus spending for investment by all levels of government combined has slowed in each of the past two years, and CBO expects it to remain at roughly 2 percent for 2005 (essentially the same pace as in 2004). Continued slow growth of purchases of goods and services by state and local governments are the main reason for the persistent sluggishness in public spending. By contrast, federal consumption plus investment will remain solid in 2005, CBO estimates, buoyed by the supplemental appropriations for activities in Iraq and Afghanistan, which had not been enacted when CBO prepared its winter forecast.

CBO's procedures for projecting discretionary spending in its baseline call for extrapolating the growth of budget authority at the projected rate of inflation. CBO forecasts that under those procedures, real federal spending will show essentially no growth in calendar year 2006. By contrast, the rate of growth of real consumption plus investment spending by states and localities will rise—but not by enough to offset the slowdown in federal spending, in CBO's estimation. As state and local revenues continue to pick up, those governments are likely to boost their purchases modestly; however, a portion of the increased revenues will probably be devoted to higher spending for benefit programs, such as Medicaid, rather than to direct purchases of goods and services.

Inflation

Consumer price inflation advanced more quickly during the first half of 2005 than CBO and many other analysts had anticipated, largely because energy prices remained high but also because core inflation (which excludes food and energy prices) grew faster than analysts had expected. Despite those developments, however, CBO does not believe that the recent increases in prices will persist. Thus, according to CBO's forecast, oil prices will ease and, helped by excess productive capacity worldwide, will cause inflation to moderate in 2006 and thereafter. Growth in the consumer price index, in CBO's estimation, will equal 3.1 percent between the fourth quarter of 2004 and the fourth quarter of 2005 and 2.1 percent during 2006.

Energy and Food Prices. The price of oil early in 2005 remained higher than analysts expected, as robust economic growth, especially in China and North America, spurred a rising global demand for oil. The price of West Texas Intermediate crude oil, for example, climbed to about $48 per barrel in late 2004 and then rose further, by mid-2005, to $56 per barrel (see Figure 2-8 on page 42). Growth of the world's oil supply was constrained by production capacity among members of the Organization of the Petroleum Exporting Countries (OPEC) and the dampening of private incentives to develop oil reserves in Russia. CBO anticipates that oil prices will stop rising during 2005 and 2006, as new investment in Saudi Arabia and oil from new sources outside of OPEC raise the global supply. However, CBO no longer forecasts, as it did last winter, that oil prices will

Box 2-3.

Global Saving and Investment

During the past decade in the United States, a fall in the rate of saving and a rise in the rate of investment produced a dramatic decline in the current-account balance, from a deficit of 1.6 percent of gross domestic product (GDP) in 1996 to a record deficit of over 6 percent early this year.[1] Such a large decline in the balance that summarizes the United States' transactions with the rest of the world would not have been possible without the willingness of foreigners to finance that deficit by buying U.S. dollar-denominated assets. The financing provided by all advanced economies (excluding the United States'), as measured by their collective current-account balance, rose from $82 billion a year, on average, during the 1990-1996 period to $338 billion in 2004 (see the table at the right). Developing countries as a group also provided a significant share of financing, as their collective current-account balance rose from an average annual deficit of $87 billion during the 1990-1996 period to a surplus of $247 billion last year.

The sources of the financing for the U.S. current-account deficit arose from different developments in different regions of the world. In the other advanced economies, both the saving and investment rates fell, with the rate of investment falling by more than the rate of saving (see the table on the next page).

- In the Eurozone (comprising countries that use the euro as their currency), weak economic activity depressed investment between 2000 and 2005.

- In Japan, the recession that began in 1992 turned into a prolonged period of stagnation, further weakening investment in that country over the past decade.

1. The saving rate is national saving as a percentage of GDP; the investment rate is business fixed investment plus inventories as a percentage of GDP.

The Current-Account Balance in Selected Countries and Areas

(Billions of dollars)

	Average, 1990-1996	2004	Change
United States	-79.0	-665.9	-586.9
Other Advanced Economies	81.6	338.1	256.6
Eurozone	4.7 [a]	35.6	30.9
Japan	94.9	171.8	76.9
Newly industrialized Asian economies	10.7	89.6	78.9
Other	-28.7	41.1	69.8
Emerging/Developing Economies	-86.5	246.6	333.1
Middle East	-15.4	112.5	127.9
Developing Asia	-24.1	103.3	127.4
China	5.2	70.0	64.8
Other	-47.0	30.8	77.8

Sources: Congressional Budget Office; International Monetary Fund; Organization for Economic Cooperation and Development; China's National Bureau of Statistics.

Note: The categories in which the various economies are grouped come from the International Monetary Fund, *World Economic Outlook: Globalization and External Imbalance* (Washington, D.C.: International Monetary Fund, April 2005).

a. Data for the Eurozone begin in 1991, so the average is for 1991 to 1996.

- In the newly industrialized Asian economies (those of Taiwan, Hong Kong, South Korea and Singapore), the investment rate dropped even more sharply than in Japan and the Eurozone. That drop may be partly a cooling from their unsustainably strong investment growth in the early 1990s and partly a result of a shift of their investment funds to China in search of better opportunities for profits.

Box 2-3.

Continued

By contrast, for the emerging or developing economies taken as a whole, the rates of saving and investment rose, but the saving rate rose by a greater amount.

- In the Middle East, the rate of saving rose sharply with the rise in oil revenues, especially with the increase in oil prices after 2001, whereas the investment rate barely changed. (Saving rates in other oil-exporting nations in the emerging and developing world, notably Russia, Nigeria, and Venezuela, also rose relative to investment.)

- In countries affected by the series of financial crises in the late 1990s and early 2000s—the Asian crisis of 1997-1998, Russia's debt default in 1998, the Brazilian real crisis of 1999, and the Argentinian peso crisis of 2002—saving rates also rose. Those countries may have been unable to avoid or dampen the severity of those crises because they did not hold enough foreign exchange reserves to fend off the attacks on their currencies. Consequently, those and other emerging and developing countries (such as China) have adopted economic policies to shift their current-account balances toward greater surpluses in an attempt to accumulate reserves and reduce their exposure to the risk of crisis.

- For China, globalization and a shift from a state-oriented economy to a more market-oriented one may also have spurred increases in the rates of investment and saving. Chinese businesses and foreign firms have boosted their investment in an attempt to capitalize on the country's fast-growing economy. Furthermore, facing underdeveloped financial markets, Chinese businesses have retained their growing revenues to finance further investment, while Chinese workers also have increased their saving.

Saving and Investment in Selected Countries and Areas

(Percentage of GDP)

	Average, 1990-1996	2004	Change
World			
Saving	22.9	24.9	2.0
Investment	24.0	24.6	0.6
United States			
Saving	15.6	13.6	-2.0
Investment	18.1	19.6	1.5
Other Advanced Economies			
Saving	23.7	22.7	-1.0
Investment	23.6	21.3	-2.3
Eurozone			
Saving	21.4 [a]	20.9	-0.5
Investment	21.3 [a]	20.2	-1.1
Japan			
Saving	32.4	27.6	-4.8
Investment	30.2	23.9	-6.3
Newly industrialized Asian economies			
Saving	34.1	31.3	-2.8
Investment	32.6	24.9	-7.7
Emerging/Developing Economies			
Saving	25.2	31.5	6.3
Investment	27.5	29.2	1.7
Middle East			
Saving	22.4	32.0	9.6
Investment	25.8	25.4	-0.4
Developing Asia			
Saving	30.7	38.2	7.5
Investment	32.8	35.5	2.7
China			
Saving	40.6	46.4	5.8
Investment	38.8	43.9	5.1

Sources: Congressional Budget Office; International Monetary Fund; Organization for Economic Cooperation and Development; China's National Bureau of Statistics.

a. Data for the Eurozone begin in 1991, so the average is for 1991 to 1996.

Box 2-4.

The Spread Between Long-Term and Short-Term Interest Rates

Between mid-2004 and August 2005, the Federal Reserve boosted its target for the federal funds rate (the interest rate that financial institutions charge each other for overnight loans of their monetary reserves) from 1 percent to 3.5 percent in 10 carefully prepared steps that for the most part market participants were able to anticipate. Further increases are widely expected over the balance of 2005.

Under such circumstances, the rate on 10-year Treasury notes would typically increase as well. Economic analysis indicates that the long-term rate should in part reflect the average of the current short-term rate and the sequence of short-term rates expected to prevail over the 10-year span of the long-term note. The other component of the long-term rate is a risk premium. Holders of long-term Treasury notes cannot rule out the possibility that inflation might be higher than they expect—which would result in an unanticipated loss of purchasing power from the stream of interest payments that the notes provide and the principal that is returned when the note matures. To cover that risky contingency, the long-term rate would be expected to include an extra margin above the average of current and expected short-term rates. Instead, between mid-2004 and August 2005, the rate on 10-year Treasury notes failed to rise as sharply as in past instances of increases in the federal funds rate.

What accounts for that surprising relationship of long-term rates to actual and expected increases in short-term rates? Analysts have offered a number of explanations, and the factors they have suggested may all have played some role. One such factor may be that market participants expected U.S. economic growth to slow as a result of higher oil prices, which are siphoning off demand and sending it abroad. Typically, long-term rates fall relative to short-term rates when the economy is expected to weaken. But the low long-term rates have been a global phenomenon, which suggests that other influences besides oil prices are operating.

A second factor may be the growing need of pension funds to add more long-term, investment-grade securities (such as Treasury notes) to their stock of assets to shore up underfunded plans. Pension funds

retreat to their pre-2004 values. Nevertheless, the halt in the ascent of prices will be enough to considerably slow inflation in consumer energy prices during the remainder of 2005 and in 2006.

After surging in 2004, inflation in food prices moderated in early 2005 and is expected to decline during the remainder of this year and throughout 2006. Prices for food and beverages, as measured by the CPI-U, climbed by 3.4 percent in 2004, largely because of an unexpected spike in the price of beef. CBO forecasts that food prices will grow by a modest 2.5 percent in 2005 and by 2.4 percent in 2006.

Core Inflation. Core inflation stepped up slightly in early 2005, rising at an annual rate of 2.3 percent during the first half of this year, compared with 2.1 percent in 2004. Most of the hike in core inflation can be traced to a jump in growth of the CPI-U for core commodities—itself the result of a sharp increase in used car prices as well as higher prices for new vehicles, apparel, and household furnishings (see Figure 2-9 on page 42). Some of those categories appear to be rebounding from unusually small price rises during the 2002-2004 period; if that is indeed the case, those categories are unlikely to push up core inflation further. Apparently, however, the spike in energy prices since 2003 has temporarily fed into the core rate's upturn, although it is difficult to calculate the impact with precision. CBO estimates that faster energy price inflation has contributed more than a quarter of a percentage point to growth in the core CPI-U during the first half of 2005.

In CBO's forecast, the core CPI-U grows by 2.4 percent during 2005 (measured fourth quarter over fourth quar-

Box 2-4.

Continued

may have turned to the government's 10-year notes because the financial markets in recent years have downgraded bonds from companies such as Ford and General Motors, and as a result, the supply of investment-grade securities has shrunk. (Some analysts maintain that this effect can be no more than a very small part of the explanation.)

A third factor is the large purchases of Treasury securities by the central banks of other nations. Yet according to Federal Reserve Chairman Greenspan, "given the depth of the market for long-term Treasury instruments, the Federal Reserve Board staff estimates that the effect of foreign official purchases has been modest. Furthermore, such purchases seem an implausible explanation of why yields on long-term *non*-U.S. sovereign debt instruments are so low."[1]

A fourth factor in the decline of long-term rates in the face of an expected path of higher short-term rates could be the addition of China, India, and countries of the former Soviet Union to the global marketplace. That development has had several important effects: it has increased the world's productive capacity, supplied new saving, contributed to low inflation, and reduced inflation risk premiums—thus helping narrow the spread between long-term and short-term interest rates. However, whether that development has affected interest rates only in the past year and not earlier is an open question.

In the Congressional Budget Office's (CBO's) view, some of those factors are likely to persist during the next 10 years. Consequently, CBO's medium-term projection incorporates a spread between the three-month Treasury bill rate and the 10-year Treasury note rate of 0.7 percentage points, on average, during the 2007-2015 period—which is about two-tenths of a percentage point smaller than the spread in last winter's forecast.

1. Alan Greenspan, "Remarks by Chairman Alan Greenspan [at] the International Monetary Conference, Beijing, People's Republic of China" (June 6, 2005), available at www.federalreserve.gov/boarddocs/speeches/2005/20050606/default.htm.

ter) and then climbs by 2.2 percent in 2006. The slowing of core inflation reflected in that second estimate is based on CBO's view that excess capacity apparently exists both in the United States and abroad. For the United States, CBO's estimates imply a sizable output gap (the difference between GDP and potential GDP) during the first half of 2005. Hence, there is room for the growth of real GDP to outpace that of potential GDP before the nation's productive capacity begins to feel some strain.

The Economic Outlook Through 2015

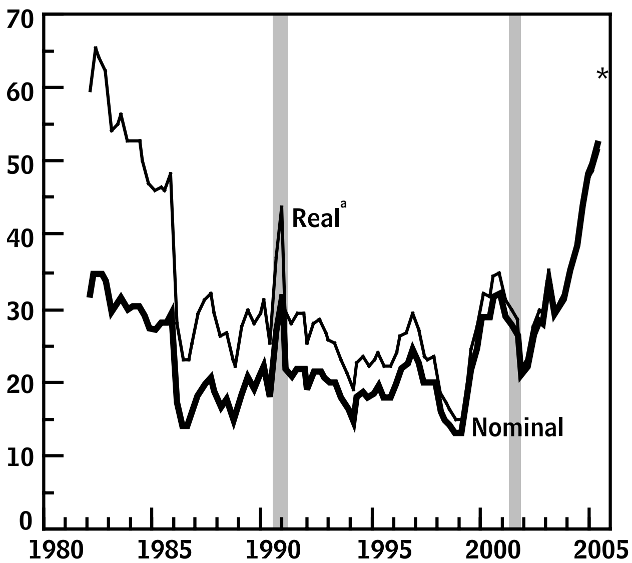
CBO projects that over the medium term (2007 through 2015), growth of real GDP will average 2.9 percent, a pace just slightly faster than the average annual rate of growth it projects for potential GDP (2.8 percent). In CBO's forecast for real GDP during 2005 and 2006, the gap that exists between actual and potential output does not completely close; rather, at the end of 2006, actual GDP is slightly lower than potential GDP. Hence, real GDP is projected to grow a bit faster than potential during the medium term to bring the gap between actual and potential output back to zero. CBO's current projections for the growth of real and potential GDP are both slightly below the corresponding projections in its January 2005 forecast.

Unchanged since last winter are CBO's medium-term projections for inflation and unemployment. Inflation, CBO projects, will average 2.2 percent annually as measured by the CPI-U and 1.8 percent as measured by the GDP price index (which measures inflation by using a different array of goods and services). The rate of unemployment will average 5.2 percent, in CBO's estimation, which is the same as its forecast of the natural rate of unemployment.

Figure 2-8.

The Price of Crude Oil

(Dollars per barrel)



Sources: Congressional Budget Office; Department of Energy, Energy Information Administration; Department of Labor, Bureau of Labor Statistics.

Note: Prices are for West Texas Intermediate crude oil. The asterisk denotes the nominal price on August 5, 2005.

a. Real prices, which are expressed in 2004 dollars, were computed using the research series of the consumer price index.

CBO estimates that during the 2007-2015 period, the rate on three-month Treasury bills will average 4.7 percent and the rate on 10-year Treasury notes, 5.4 percent. For the three-month rate, CBO's projection is a tenth of a percentage point higher than last winter's estimate; for the 10-year rate, its projection is a tenth of a percentage point lower.

In developing its medium-term projections, CBO considers the factors that underlie estimates of potential GDP, such as growth of the labor force, of capital services (the productive services provided by the economy's capital stock), and of productivity. In doing so, CBO takes into account the potential effects of current fiscal policy on those factors, but it does not attempt to forecast business-cycle fluctuations beyond the next two years.

Potential Output

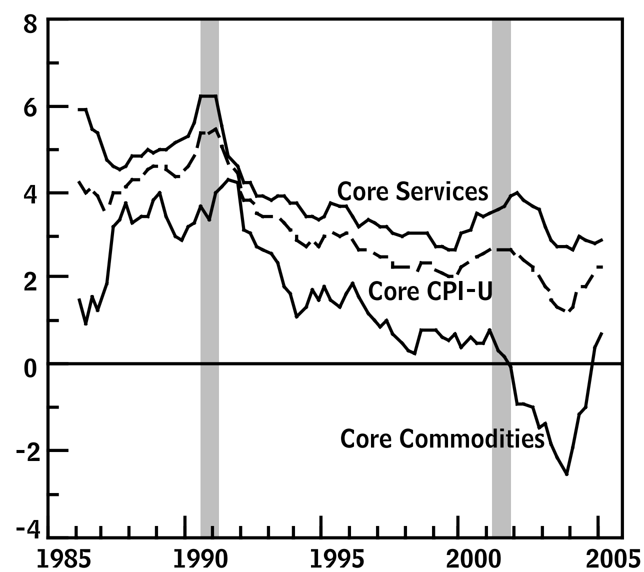
CBO estimates that during the 2005-2015 period, potential output will grow at an average annual rate of 2.9 percent (see Table 2-2). That rate of growth matches CBO's January estimate; however, the current projection incorporates small changes in the expected paths of some underlying variables that largely offset one another. In particular, CBO's estimate of the labor input (hours worked) reflects slower growth than that in last winter's projection, whereas CBO's current projections for the growth of capital services and total factor productivity, by comparison with January's, have been revised upward.

CBO projects that growth of the potential labor force will average 0.8 percent annually during the 2005-2015 period, down slightly from last winter's estimate. That revision is based on new data in the sample used to estimate the historical trend in that factor and on CBO's reassessment of trends in labor force participation rates. Until now, CBO had assumed that the very low rates of labor force participation since the 2001 recession were largely a cyclical phenomenon and that those rates would recover as the demand for labor picked up. But despite a more robust labor market since mid-2003, the participation rate has not markedly risen. Hence, CBO's current projection relative to last January's includes a smaller rebound in

Figure 2-9.

Core Consumer Price Index

(Percentage change from previous year)



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

Note: The core consumer price index excludes food and energy prices.

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	1991-1995	1996-2004	Total, 1950-2004	2005-2010	2011-2015	Total, 2005-2015
					Overall Economy				
Potential Output	3.9	3.3	3.0	2.7	3.4	3.5	3.1	2.6	2.9
Potential Labor Force	1.6	2.5	1.6	1.2	1.2	1.6	1.0	0.5	0.8
Potential Labor Force Productivity[a]	2.3	0.8	1.4	1.5	2.2	1.8	2.1	2.1	2.1
					Nonfarm Business Sector				
Potential Output	4.0	3.6	3.1	3.1	3.9	3.7	3.5	3.0	3.3
Potential Hours Worked	1.4	2.4	1.5	1.3	1.3	1.5	1.1	0.6	0.8
Capital Input	3.8	4.3	4.1	2.7	4.6	3.9	4.5	3.6	4.1
Potential Total Factor Productivity	1.9	0.7	0.9	1.3	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	*	0.3	*	0.1	0.1	0.1
Price measurement[b]	0	0	0	*	0.1	*	0.1	0.1	0.1
Temporarily faster growth[c]	0	0	0	0	0.2	*	0	0	0
Contributions to Growth of Potential Output (Percentage points)									
Potential hours worked	1.0	1.7	1.0	0.9	0.9	1.1	0.7	0.4	0.6
Capital input	1.1	1.3	1.2	0.8	1.4	1.2	1.4	1.1	1.2
Potential TFP	1.9	0.7	0.9	1.3	1.6	1.4	1.4	1.4	1.4
Total Contributions	4.0	3.7	3.1	3.0	3.9	3.7	3.6	2.9	3.3
Memorandum:									
Potential Labor Productivity[d]	2.6	1.2	1.7	1.8	2.6	2.2	2.4	2.4	2.4

Source: Congressional Budget Office.

Note: * = between zero and 0.05 percent.

a. The ratio of potential GDP to the potential labor force.

b. An adjustment for a conceptual change in the official measure of the GDP price index.

c. An adjustment for the unusually rapid growth between 2001 and 2003.

d. The estimated trend in the ratio of output to hours worked in the nonfarm business sector.

participation rates, particularly for women ages 25 to 54, and slower growth of the potential labor force (that is, the labor force adjusted for business-cycle effects).

CBO's projection for the growth of capital services during the 2005-2015 period is now nearly one-tenth of a percentage point faster than it was in January. CBO made that change largely because revisions in the data underlying its estimate have indicated that the weighting scheme used for different types of capital should give more prominence to faster-growing components of the capital stock (especially communications equipment) both in recent history and in CBO's projection of their future growth. In addition, as a result of adding new data for late 2004 and early 2005, CBO has revised its projection for the rate of growth of potential total factor productivity—growth is now estimated to be a shade faster than it was in last winter's projection.

Inflation, Unemployment, and Interest Rates

CBO's outlook for inflation and unemployment during the 2007-2015 period has not changed since January. Inflation as measured by the CPI-U is expected to average 2.2 percent over the medium term, and growth of the GDP price index is projected to average 1.8 percent. CBO projects that the unemployment rate will average 5.2 percent between 2006 and 2015.

CBO projects interest rates over the medium term by adding its projection for CPI-U inflation to its projections for real interest rates. Its current estimate of interest rates during the 2007-2015 period differs slightly from its projection last January as a result of its reevaluation of both the level of real long-term rates over the medium term and the spread between long- and short-term rates. Over the 2007-2015 period, the interest rate on 10-year Treasury notes will be 5.4 percent, CBO estimates, a figure that consists of an inflation projection of 2.2 percent (unchanged since January) and a real rate of 3.2 percent (which is 0.1 percentage points lower than January's estimate). That lower real rate reflects CBO's revised projection for some of the components that determine the return to capital, including a modestly lower assumption about the rate of depreciation relative to the one CBO used for last January's estimate.[6]

The rate on three-month Treasury bills (4.7 percent) in CBO's current medium-term projection is 0.1 percentage point higher than its estimate last January. CBO raised the rate to narrow the projected spread between long- and short-term interest rates and thus to better align its projection with the difference between those rates in recent years. Observers have attributed that historical narrowing of the spread to structural factors, including the possibility that investors have increased confidence in the ability of the Federal Reserve to keep inflation low during the medium term. If that explanation is correct, then the demand by investors for government securities could shift away from short-term bills and toward longer-term notes. (The more uncertain investors are about future inflation, the more they tend to hold short-term bills to guard against an unexpected loss of purchasing power.)

An additional structural factor that may be moderating markets' expectations about inflation is the integration of China, India, and the economies of the former Soviet Union into world markets. That expansion of global economic linkages has increased the world's productive capacity and boosted global saving. In turn, by lessening worries about inflation, those developments have probably reduced the risk premium on the returns that investors have required to protect themselves against inflation.

Incomes

The portions of CBO's economic forecast that most directly affect its outlook for revenues are the projections for various categories of income—specifically, book profits, wages and salaries, proprietors' income, and personal interest and dividend income.[7] For example, CBO's estimates of revenues from Social Security taxes, which are levied on wages and salaries, are based largely on its estimates of wages and salaries. In fact, because wages are also the major determinant of future personal income tax revenues, CBO's projection for wages and salaries is the forecast's single most important element for estimating revenues.

CBO's estimate of wages and salaries over the medium term is based on the assumption that the GDP share of labor compensation will move toward its post-World War II average. Broadly speaking, GDP can be divided into a share that goes to labor and a share that goes to capital. Labor's share includes wages and salaries, payments made on behalf of workers by employers (such as their share of health insurance premiums, contributions to pension funds, and payments for Social Security and Medicare), and about 70 percent of proprietors' income.[8] The rest of GDP is attributed to capital. Although the two shares have varied over the postwar period, labor's share has averaged 63 percent of GDP and capital's, 37 percent (see Figure 2-10). Under the assumption that labor compensation overall will maintain its postwar aver-

6. For more details, see Angelo Mascaro, *Using the Natural Rate Concept to Assess the Consistency of Projections Ten Years Ahead for Real Interest Rates and Inflation,* Technical Paper No. 2004-5 (March 2004), available at www.cbo.gov.

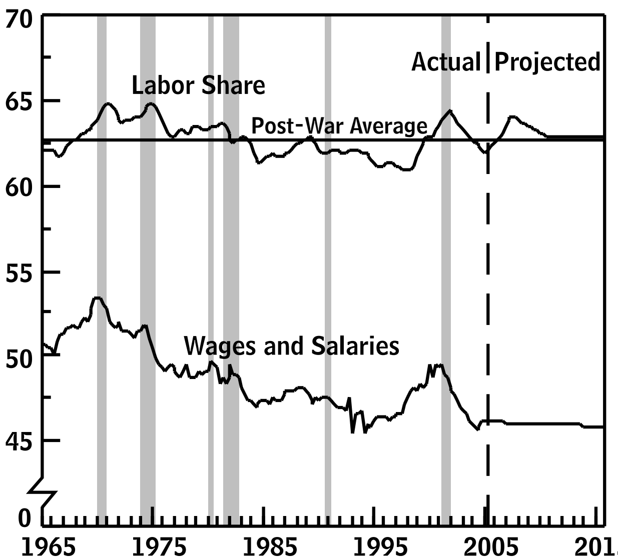
7. Proprietors' income includes the income of self-employed workers and income from partnerships.

8. The fraction of proprietors' income that should be considered labor income—as opposed to the part that is a return to capital (the depreciation, rent, interest payments, and profits that can be attributed to the fixed assets that proprietors use)—is not clear, but a figure of 70 percent is generally accepted.

Figure 2-10.

Labor Income and Wages and Salaries

(Percentage of GDP)



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

age share of GDP, CBO forecasts a slight decline over the medium term in the share of compensation accounted for by wages and salaries. That estimated decline is consistent with the stability of labor's overall GDP share over the period because employers' payments for pensions and health insurance premiums are assumed to rise slightly relative to GDP during those years.

A component of that increase during the medium term is a near-term surge that CBO expects in employers' payments for defined-benefit pensions (see Box 2-2 on page 32). That surge will temporarily raise the share of income going to labor. Because many defined-benefit plans are underfunded (that is, their obligations exceed their present assets and expected future income), current law implies that employers will have to make large contributions in 2006. Those contributions will reduce employers' profits. Policymakers have provided firms with temporary relief from some of their funding requirements, but those provisions expire at the end of this year. Although the law may change and the large jump in contributions may not occur, CBO's forecast for profits relies on an assumption that current laws and policies remain in place.[9] Consequently, CBO estimates that as a result of employers' required contributions to defined-benefit plans, profits measured as a share of GDP will fall in 2006 and remain lower in 2007 and subsequent years than would otherwise be the case.

Nevertheless, CBO does not project that profits as a share of GDP will be extraordinarily low after 2007; in CBO's estimation, profits will average 8.3 percent of GDP during the 2008-2015 period, a share slightly larger than their average of the past 30 years. One reason that CBO projects relatively high profits for the medium term is that firms' interest payments, which reduce profits, are expected to be low relative to payments in the past—largely because interest rates are low relative to those of the past 30 years.

Changes in the Economic Outlook Since January

CBO's current outlook for the economy differs slightly from its January 2005 outlook (see Table 2-3). For example, in CBO's current forecast, growth of real GDP is slightly lower for 2005 and 2006 by comparison with January's estimates; thereafter, it is about the same in both projections, averaging 2.9 percent between 2006 and 2015. CBO's estimate of the unemployment rate is also largely unchanged since last January.

The biggest difference between the current forecast and last January's is in the near-term outlook for inflation. Prices for energy-related goods and services rose more rapidly during the first half of 2005 than CBO had anticipated, and CBO no longer assumes that oil prices will be significantly lower in 2006. As a result, it has raised its forecast for consumer price inflation by 0.6 percentage points, on average, for 2005 and 2006. Its forecast for growth in the GDP price index has been revised by a slightly smaller amount, 0.5 percentage points for 2005 and 2006.

CBO's current outlook for interest rates also differs from last January's, especially during the medium term. CBO now projects that the rate on three-month Treasury bills will average 4.7 percent during the 2007-2015 period, or about a tenth of a percentage point higher than it projected in January; the rate on 10-year Treasury notes will

9. For a general description of the use of that assumption in CBO's economic forecast, see Congressional Budget Office, *What Is a Current-Law Economic Baseline?* (June 2, 2005).

Table 2-3.

CBO's Current and Previous Economic Projections for Calendar Years 2004 Through 2015

	Actual	Forecast		Projected Annual Average	
	2004	2005	2006	2007 to 2010	2011 to 2015
Nominal GDP (Billions of dollars)					
August 2005	11,735	12,450	13,137	16,023 [a]	19,946 [b]
January 2005	11,730	12,396	13,059	15,940 [a]	19,861 [b]
Nominal GDP (Percentage change)					
August 2005	6.6	6.1	5.5	5.1	4.5
January 2005	6.6	5.7	5.3	5.1	4.5
Real GDP (Percentage change)					
August 2005	4.4	3.7	3.4	3.2	2.6
January 2005	4.4	3.8	3.7	3.3	2.7
GDP Price Index (Percentage change)					
August 2005	2.2	2.3	2.0	1.8	1.8
January 2005	2.1	1.8	1.5	1.8	1.8
Consumer Price Index[c] (Percentage change)					
August 2005	2.7	3.1	2.5	2.2	2.2
January 2005	2.7	2.4	1.9	2.2	2.2
Unemployment Rate (Percent)					
August 2005	5.5	5.2	5.2	5.2	5.2
January 2005	5.5	5.2	5.2	5.2	5.2
Three-Month Treasury Bill Rate (Percent)					
August 2005	1.4	3.0	3.7	4.6	4.7
January 2005	1.4	2.8	4.0	4.6	4.6
Ten-Year Treasury Note Rate (Percent)					
August 2005	4.3	4.3	4.7	5.4	5.4
January 2005	4.3	4.8	5.4	5.5	5.5
Tax Bases (Billions of dollars)					
Corporate book profits					
August 2005	985	1,308	1,158	1,334 [a]	1,655 [b]
January 2005	984	1,331	1,222	1,349 [a]	1,635 [b]
Wages and salaries					
August 2005	5,373	5,749	6,055	7,367 [a]	9,132 [b]
January 2005	5,346	5,665	5,979	7,317 [a]	9,096 [b]
Tax Bases (Percentage of GDP)					
Corporate book profits					
August 2005	8.4	10.5	8.8	8.4	8.3
January 2005	8.4	10.7	9.4	8.7	8.3
Wages and salaries					
August 2005	45.8	46.2	46.1	46.0	45.9
January 2005	45.6	45.7	45.8	45.9	45.9
Memorandum:					
Real Potential GDP (Percentage change)					
August 2005	3.1	3.2	3.3	3.1	2.6
January 2005	3.2	3.2	3.3	3.1	2.7

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

a. Level in 2010.

b. Level in 2015.

c. The consumer price index for all urban consumers.

average 5.4 percent during the period, or a tenth of a percentage point lower than in the previous forecast. The implied narrowing of the spread between the two rates reflects the view that investors will shift their focus away from short-term debt and toward interest-bearing assets with longer maturities.

Comparison of Forecasts

CBO's economic forecast is, broadly speaking, quite similar to those of the Administration and the *Blue Chip* consensus, which is an average of the forecasts of about 50 private-sector forecasters (see Table 2-4). CBO's estimates of real growth in 2005 and 2006, for example, are within a tenth of a percentage point of the Administration's and the *Blue Chip*'s forecasts for that period; in addition, CBO and the private consensus foresee a slowing of growth in 2006. The three forecasts for the unemployment rate over the near term are almost identical.

Nevertheless, there are some differences, notably in the forecasts for inflation and short-term interest rates. CBO predicts slightly higher inflation for 2005 than the other forecasters do, but its estimate for 2006 is lower than theirs. For 2005, its forecast for growth in the CPI-U is two-tenths of a percentage point above the Administration's and about a tenth of a percentage point higher than that of the *Blue Chip* consensus. For 2006, however, CBO's forecast for CPI-U inflation is 0.3 percentage points below the Administration's and 0.4 percentage points below the *Blue Chip*'s. CBO's outlook for short-term interest rates is below that of the consensus for 2005 and 2006, equal to that of the Administration for 2005, and above that of the Administration for 2006.

For the medium term (in this case, the 2007-2010 period that the Administration's projections cover), CBO's and the Administration's outlooks are similar. (There is no recent *Blue Chip* consensus survey of medium-term projections.) In both forecasts, the growth of real GDP averages 3.2 percent; however, the Administration forecasts higher inflation than CBO expects as well as a slightly lower rate of unemployment. The two projections for long-term interest rates are identical: both expect the rate on 10-year notes to average 5.4 percent from 2007 through 2010. However, forecasts of short-term interest rates are the exception—CBO projects a significantly higher rate on three-month Treasury bills during that period than the rate the Administration anticipates.

Table 2-4.

Comparison of CBO, *Blue Chip*, and Administration Forecasts for Calendar Years 2004 Through 2010

	Actual	Forecast		Projected Annual Average,
	2004	2005	2006	2007 to 2010
	Fourth Quarter to Fourth Quarter (Percentage Change)			
Nominal GDP				
Blue Chip consensus	6.4	6.1	5.4	n.a.
CBO	6.4	6.0	5.3	5.0
Administration	6.4	5.9	5.5	5.4
Real GDP				
Blue Chip consensus	3.9	3.6	3.2	n.a.
CBO	3.9	3.5	3.4	3.2
Administration	3.9	3.4	3.4	3.2
GDP Price Index				
Blue Chip consensus	2.4	2.4	2.1	n.a.
CBO	2.4	2.3	1.8	1.8
Administration	2.4	2.3	2.1	2.1
Consumer Price Index[a]				
Blue Chip consensus	3.4	2.9	2.3	n.a.
CBO	3.4	3.1	2.1	2.2
Administration	3.4	2.9	2.4	2.4
	Calendar Year Average			
Unemployment Rate (Percent)				
Blue Chip consensus	5.5	5.1	5.0	n.a.
CBO	5.5	5.2	5.2	5.2
Administration	5.5	5.2	5.1	5.0
Three-Month Treasury Bill Rate (Percent)				
Blue Chip consensus	1.4	3.2	4.1	n.a.
CBO	1.4	3.0	3.7	4.6
Administration	1.4	3.0	3.4	3.7
Ten-Year Treasury Note Rate (Percent)				
Blue Chip consensus	4.3	4.3	4.9	n.a.
CBO	4.3	4.3	4.7	5.4
Administration	4.3	4.3	4.8	5.4

Sources: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board; Aspen Publishers, Inc., *Blue Chip Economic Indicators* (August 10, 2005); Office of Management and Budget, *Mid-Session Review: Fiscal Year 2006* (July 13, 2005).

Note: n.a. = not applicable.

a. The consumer price index for all urban consumers.

APPENDIX

A

Comparison of CBO's and OMB's Baselines

The Administration's Office of Management and Budget (OMB) published its annual *Mid-Session Review* of the President's budget on July 13, 2005. In that report, OMB updated its baseline (and policy) budget projections and its economic assumptions through 2010. This appendix compares OMB's baseline projections—also referred to as its "current-services" baseline projections—with those of the Congressional Budget Office (CBO).

In the past, OMB and CBO constructed their baselines using similar concepts derived from the Balanced Budget and Emergency Deficit Control Act of 1985. Consequently, discrepancies between the agencies' estimates were attributable to differences in their respective technical and economic assumptions. This year, however, some differences between CBO's and OMB's baselines result from differing conceptual approaches and a difference in when the estimates were prepared.

The Administration has deviated from the statutory baseline concepts in two significant areas. First, OMB's current-services baseline assumes that most major provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) will be extended, although under statutory baseline rules they should be assumed to expire as scheduled. The bulk of those tax provisions are slated to expire at the end of December 2010—just beyond the five-year time horizon discussed in this appendix—but some of them expire prior to that.

Second, the Administration has not assumed future-year appropriations equal to the inflated value of supplemental appropriations enacted in October 2004 ($11.5 billion for disaster relief, primarily in response to hurricane damage) and in May 2005 ($82.1 billion, primarily for military activities in Iraq and Afghanistan). Another $1.5 billion in supplemental funding was enacted for veterans' medical programs after OMB published its current-services baseline in July and is likewise not included in OMB's projections.

In addition to those relatively large conceptual adjustments, OMB made two small changes in the way it accounts for increases in pay and administrative expenses when projecting discretionary spending, which results in lower spending relative to CBO's estimates. Finally, because OMB's estimates were prepared earlier than CBO's, OMB's baseline estimates do not include the effects of legislation enacted since mid-July—such as the Energy Policy Act of 2005 and the Dominican Republic-Central America-United States Free Trade Agreement Implementation Act.

For 2005, CBO anticipates a deficit of $331 billion—the same as OMB's current-services estimate for the year.[1] For each of the following five years, the gap between CBO's estimate of the deficit and that of OMB grows progressively larger. In total, CBO's projection of the deficit is $1.6 trillion for the 2006-2010 period, as compared with OMB's current-services projection of under $1.0 trillion (see Table A-1).

Most of the divergence stems from the differing conceptual approaches. If OMB had followed the conventions specified in the Deficit Control Act (and had known about subsequent legislation), CBO estimates that the gap would shrink to roughly $210 billion, occurring

1. This is slightly lower than the $333 billion deficit the Administration projected assuming enactment of supplemental funding for veterans' health care, student loan reforms (which have not been enacted), and a few other proposals.

Table A-1.

Comparison of CBO's August 2005 Baseline and OMB's July 2005 Current-Services Baseline

(Billions of dollars)

	2005	2006	2007	2008	2009	2010	Total, 2006-2010
				CBO's August 2005 Baseline			
Revenues	2,142	2,280	2,396	2,526	2,675	2,817	12,695
On-budget	1,566	1,670	1,753	1,849	1,966	2,075	9,312
Off-budget	576	611	643	676	709	743	3,382
Outlays							
Discretionary	962	991	1,008	1,032	1,052	1,075	5,159
Mandatory	1,329	1,396	1,476	1,557	1,650	1,743	7,821
Net interest	182	208	237	271	295	316	1,326
Total	2,473	2,595	2,721	2,860	2,997	3,134	14,306
On-budget	2,073	2,173	2,281	2,403	2,522	2,639	12,018
Off-budget	400	422	440	457	475	495	2,288
Surplus or Deficit (-)	-331	-314	-324	-335	-321	-317	-1,612
On-budget	-507	-503	-528	-554	-556	-564	-2,706
Off-budget	176	189	203	219	234	248	1,094
				OMB's July 2005 Current-Services Baseline			
Revenues	2,140	2,273	2,429	2,598	2,744	2,914	12,958
On-budget	1,564	1,651	1,781	1,913	2,023	2,150	9,519
Off-budget	576	622	648	685	721	763	3,439
Outlays							
Discretionary	960	945	940	947	964	987	4,783
Mandatory	1,329	1,422	1,500	1,575	1,658	1,766	7,921
Net interest	183	204	226	245	262	278	1,215
Total	2,471	2,571	2,666	2,767	2,884	3,031	13,919
On-budget	2,071	2,148	2,226	2,311	2,408	2,533	11,626
Off-budget	400	424	440	456	476	498	2,293
Surplus or Deficit (-)	-331	-299	-237	-169	-140	-117	-961
On-budget	-507	-497	-445	-398	-385	-382	-2,107
Off-budget	176	198	208	229	246	265	1,146

Continued

largely in fiscal years 2008-2010.[2] Adjusted for the conceptual and timing differences described above, CBO's revenue projections are lower than OMB's—by about $300 billion, or 2.3 percent—but CBO's projected outlays are also slightly lower—by roughly $90 billion, or 0.6 percent—over the five-year period.

Outlays

CBO expects total outlays in 2005 to be $2 billion higher than OMB's current-services projections, with the largest differences attributable to defense spending, Medicare, and Medicaid. For the 2006-2010 period, CBO projects

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

Table A-1.

Continued

	2005	2006	2007	2008	2009	2010	Total, 2006-2010
			Difference (CBO's Baseline Minus OMB's)				
Revenues	2	8	-33	-72	-69	-96	-263
On-budget	2	19	-29	-64	-57	-76	-207
Off-budget	*	-11	-4	-9	-12	-20	-57
Outlays							
Discretionary	3	46	68	85	88	88	376
Mandatory	*	-26	-25	-17	-8	-23	-99
Net interest	-1	4	11	25	32	38	110
Total	2	23	54	94	113	103	387
On-budget	2	25	54	93	114	106	392
Off-budget	*	-2	*	1	-1	-3	-5
Surplus or Deficit (-)[a]	*	-16	-87	-166	-182	-200	-650
On-budget	*	-7	-83	-156	-171	-182	-599
Off-budget	*	-9	-5	-10	-11	-18	-52

Sources: Congressional Budget Office; Office of Management and Budget.

Notes: OMB's baseline deviates from the concepts delineated in the Balanced Budget and Emergency Deficit Control Act of 1985 in two significant ways: it assumes that most tax provisions enacted in 2001 and 2003 will be extended, and it does not extrapolate supplemental appropriations provided for 2005 into future years. Also, CBO's baseline includes the effects of recent legislation, such as the Energy Policy Act of 2005 and the Dominican Republic-Central America-United States Free Trade Agreement Implementation Act, which were enacted after OMB's baseline had been published.

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

a. Negative numbers denote that the Administration's deficit estimate is lower than CBO's.

$387 billion more in total outlays than OMB does in its current-services baseline. Conceptual (and timing) differences boost CBO's estimate of outlays over OMB's by about $480 billion over the five-year period; underlying economic and technical assumptions cause CBO's outlay projections to be roughly $90 billion lower than OMB's current-services estimates. Such underlying differences mostly stem from estimates of mandatory spending—chiefly for the Medicare program.

Mandatory Spending

In total, CBO's estimate for mandatory outlays in 2005 is very close to OMB's. Although CBO estimates $4 billion in higher outlays for Medicare, that difference is mostly offset by estimates of lower outlays for Medicaid ($2 billion lower than OMB's estimates) and civil service retirement programs and the Commodity Credit Corporation—each $1 billion lower than OMB anticipates for 2005.

Over the 2006-2010 period, CBO projects about $99 billion (or 1.3 percent) less in mandatory outlays than OMB does. The bulk of that difference ($72 billion) is related to Medicare spending and results from OMB's higher estimates of spending for the prescription drug benefit and Medicare Advantage programs. OMB also projects higher spending for veterans' and civil service retirement programs and Social Security—driven by higher projected cost-of-living adjustments. Those differences are partly offset by OMB's larger estimates of future receipts from auctions of portions of the electromagnetic spectrum, which reduce net outlays.

Discretionary Spending

CBO estimates that outlays for defense in 2005 will total about $493 billion—slightly higher than OMB's estimate of $490 billion. For the 2006-2010 period, CBO's projections for defense outlays exceed OMB's by $336 billion. Much of that difference results from the fact that OMB does not include and inflate in future years $77.3 billion in supplemental funding provided in October 2004 and May 2005 for defense programs, which adds $355 billion to CBO's baseline outlays for the five-year period. Excluding the extrapolated supplemental spending, CBO's defense discretionary outlays are slightly lower than OMB's—mostly because the Administration assumes higher inflation over the five-year period.

For nondefense discretionary spending, CBO's 2005 estimate of $469 billion is identical to OMB's total. For the 2006-2010 period, CBO projects that nondefense discretionary outlays will exceed OMB's estimate by $40 billion under baseline assumptions. Again, much of that difference stems from supplemental budget authority ($17.8 billion in nondefense discretionary budget authority) that CBO extrapolates in its baseline, thereby adding $63 billion in outlays over the five-year period. Excluding the extension of the supplemental funding from CBO's numbers, the Administration's higher inflation projection causes OMB's estimate of nondefense outlays to be slightly higher than CBO's.

Net Interest

CBO's and OMB's estimates for net interest in 2005 are very close, reflecting the fact that the 2005 deficit estimates are the same. For the 2006-2010 period, however, CBO's estimate of net interest exceeds OMB's by $110 billion. The Administration's shorter-term interest rates are lower than those in CBO's economic projection, which accounts for about $71 billion of the difference. CBO projects higher baseline deficits than OMB does, accounting for another $48 billion of the difference. Technical differences reduce the gap by about $10 billion.

Revenues

CBO projects revenues that are higher than OMB's current-services baseline by $2 billion in 2005 and $8 billion in 2006—relatively small differences. Over the 2006-2010 period, however, CBO's revenue estimates are a net $263 billion lower than OMB's—$303 billion lower for economic and technical reasons, $9 billion lower because CBO incorporated later-enacted legislation, and about $49 billion higher for conceptual reasons.

Differences in the two agencies' economic projections, especially for wage and salary disbursements, explain most of the economic and technical differences. First, CBO and OMB assume about the same growth in real gross domestic product (GDP), but CBO anticipates slightly slower increases in prices. As a result, CBO projects lower levels of nominal GDP growth and corresponding taxable incomes, especially wage and salary disbursements.

That difference in the two agencies' projections for wage and salary disbursements is accentuated by CBO's assumption that a lower share of GDP will accrue to wages and salaries than OMB assumes. CBO anticipates that the wage and salary share of GDP will decline slightly from 46.2 percent in calendar year 2005 to 46.0 percent by 2010, whereas OMB anticipates that the share will rise to 47.0 percent by 2010. In total, CBO projects that wages and salaries will be lower than OMB projects over the 2006-2010 period by about $750 billion, which reduces CBO's estimate of individual income and social insurance revenues relative to OMB's estimate.

Legislation enacted after the Administration published its current-services baseline lowers CBO's baseline revenue estimates relative to OMB's estimates. The Energy Policy Act of 2005 and the Dominican Republic-Central America-United States Free Trade Agreement Implementation Act together lower revenues by roughly $9 billion over the 2006-2010 period.

The conceptual differences derive from OMB's inclusion of the effects of making permanent certain elements of the tax provisions enacted in 2001 and 2003. Most of the effects occur in 2008 and beyond, when the Administration's proposals would extend the expiring tax cuts on dividends, capital gains, and immediate deduction ("expensing") of certain investments by small businesses. CBO and the Joint Committee on Taxation estimate that extending those elements of the tax laws would reduce revenues by about $49 billion over the 2006-2010 period.

APPENDIX

B

CBO's Economic Projections for 2005 Through 2015

Year-by-year economic projections for 2005 to 2015 are shown in the accompanying tables (by calendar year in Table B-1 and by fiscal year in Table B-2). The Congressional Budget Office did not try to explicitly incorporate cyclical fluctuations into its projections for years after 2006. Instead, the projected values shown in the tables for 2007 through 2015 reflect CBO's assessment of average values for that period—which take into account the potential ups and downs of the business cycle.

Table B-1.

CBO's Year-by-Year Forecast and Projections for Calendar Years 2005 Through 2015

	Actual	Forecast		Projected								
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Nominal GDP (Billions of dollars)	11,735	12,450	13,137	13,832	14,556	15,290	16,023	16,768	17,527	18,306	19,112	19,946
Nominal GDP (Percentage change)	6.6	6.1	5.5	5.3	5.2	5.0	4.8	4.6	4.5	4.4	4.4	4.4
Real GDP (Percentage change)	4.4	3.7	3.4	3.4	3.4	3.2	2.9	2.8	2.7	2.6	2.6	2.5
GDP Price Index (Percentage change)	2.2	2.3	2.0	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8
Consumer Price Index[a] (Percentage change)	2.7	3.1	2.5	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Core Consumer Price Index[b] (Percentage change)	1.8	2.3	2.3	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Employment Cost Index[c] (Percentage change)	2.5	2.5	3.1	3.2	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3
Unemployment Rate (Percent)	5.5	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2
Three-Month Treasury Bill Rate (Percent)	1.4	3.0	3.7	4.4	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7
Ten-Year Treasury Note Rate (Percent)	4.3	4.3	4.7	5.3	5.4	5.4	5.4	5.4	5.4	5.4	5.4	5.4
Tax Bases (Billions of dollars)												
Corporate book profits	985	1,308	1,158	1,181	1,217	1,277	1,334	1,389	1,448	1,510	1,579	1,655
Wages and salaries	5,373	5,749	6,055	6,366	6,698	7,033	7,367	7,705	8,047	8,398	8,759	9,132
Tax Bases (Percentage of GDP)												
Corporate book profits	8.4	10.5	8.8	8.5	8.4	8.3	8.3	8.3	8.3	8.2	8.3	8.3
Wages and salaries	45.8	46.2	46.1	46.0	46.0	46.0	46.0	46.0	45.9	45.9	45.8	45.8

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

Note: Percentage change is year over year.

a. The consumer price index for all urban consumers.

b. The consumer price index for all urban consumers, excluding food and energy prices.

c. The employment cost index for wages and salaries only, private-industry workers.

Table B-2.

CBO's Year-by-Year Forecast and Projections for Fiscal Years 2005 Through 2015

	Actual	Forecast		Projected								
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Nominal GDP (Billions of dollars)	11,554	12,271	12,967	13,655	14,373	15,108	15,839	16,581	17,335	18,109	18,908	19,734
Nominal GDP (Percentage change)	6.6	6.2	5.7	5.3	5.3	5.1	4.8	4.7	4.5	4.5	4.4	4.4
Real GDP (Percentage change)	4.6	3.8	3.5	3.4	3.4	3.3	3.0	2.8	2.7	2.6	2.6	2.5
GDP Price Index (Percentage change)	2.0	2.3	2.1	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8
Consumer Price Index[a] (Percentage change)	2.3	3.2	2.7	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Core Consumer Price Index[b] (Percentage change)	1.5	2.3	2.3	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Employment Cost Index[c] (Percentage change)	2.7	2.4	3.0	3.2	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3
Unemployment Rate (Percent)	5.6	5.3	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2
Three-Month Treasury Bill Rate (Percent)	1.1	2.7	3.6	4.2	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7
Ten-Year Treasury Note Rate (Percent)	4.3	4.2	4.6	5.2	5.4	5.4	5.4	5.4	5.4	5.4	5.4	5.4
Tax Bases (Billions of dollars)												
Corporate book profits	962	1,250	1,190	1,172	1,203	1,262	1,322	1,374	1,433	1,495	1,562	1,634
Wages and salaries	5,286	5,668	5,980	6,286	6,614	6,950	7,283	7,620	7,961	8,309	8,667	9,037
Tax Bases (Percentage of GDP)												
Corporate book profits	8.3	10.2	9.2	8.6	8.4	8.4	8.3	8.3	8.3	8.3	8.3	8.3
Wages and salaries	45.8	46.2	46.1	46.0	46.0	46.0	46.0	46.0	45.9	45.9	45.8	45.8

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

Note: Percentage change is year over year.

a. The consumer price index for all urban consumers.

b. The consumer price index for all urban consumers, excluding food and energy prices.

c. The employment cost index for wages and salaries only, private-industry workers.

APPENDIX

C

Contributors to the Revenue and Spending Projections

The following Congressional Budget Office analysts prepared the revenue and spending projections in this report:

Revenue Projections

Annabelle Bartsch	Customs duties, miscellaneous receipts
Mark Booth	Individual income taxes
Paul Burnham	Retirement income
Barbara Edwards	Social insurance taxes, Federal Reserve System earnings
Pamela Greene	Corporate income taxes, estate and gift taxes
Laura Hanlon	Excise taxes
Ed Harris	Individual income taxes
Larry Ozanne	Capital gains realizations
Monisha Primlani	Individual income taxes
Emily Schlect	Customs duties, miscellaneous receipts
Kurt Seibert	Earned income tax credit
David Weiner	Individual income taxes

Spending Projections

Defense, International Affairs, and Veterans' Affairs

Jo Ann Vines	Unit Chief
Kent Christensen	Defense
Sunita D'Monte	International affairs (conduct of foreign affairs and information-exchange activities), veterans' housing
Raymond Hall	Defense (Navy weapons, missile defenses, stockpile sales, atomic energy defense)
Sarah Jennings	Military retirement, veterans' education
David Newman	Defense (infrastructure and procurement, military activities in Iraq and Afghanistan and for the war on terrorism)

Sam Papenfuss	International affairs (development, security, international financial institutions)
Michelle Patterson	Veterans' health care, military health care
Matthew Schmit	Defense (military personnel, military activities in Iraq and Afghanistan and for the war on terrorism)
Jason Wheelock	Defense (other programs), intelligence programs, radiation exposure compensation, Department of Energy employees' occupational illness compensation
Dwayne Wright	Veterans' compensation and pensions

Health

Tom Bradley	Unit Chief
Julia Christensen	Federal Employees Health Benefits program, Public Health Service
Jeanne De Sa	Medicaid, State Children's Health Insurance Program
Geoffrey Gerhardt	Medicare
Tim Gronniger	Medicare
Eric Rollins	Medicaid, State Children's Health Insurance Program
Shinobu Suzuki	Medicare
Christopher Topoleski	Medicare, Public Health Service
Camile Williams	Medicare, Public Health Service

Human Resources

Paul Cullinan	Unit Chief
Chad Chirico	Housing assistance, education
Sheila Dacey	Child Support Enforcement, Temporary Assistance for Needy Families, Social Services Block Grant program, child care programs
Kathleen FitzGerald	Food Stamps and nutrition programs, child and family services
Geoffrey Gerhardt	Federal civilian retirement, Pension Benefit Guaranty Corporation, Supplemental Security Income, Railroad Retirement
Justin Humphrey	Elementary and secondary education, Pell grants
Deborah Kalcevic	Education
Matthew Kapuscinski	Low Income Home Energy Assistance Program, refugee assistance
Chad Newcomb	Social Security
Kathy Ruffing	Social Security
Christina Hawley Sadoti	Unemployment insurance, training programs, Administration on Aging, foster care, Smithsonian, arts and humanities, report coordinator

Natural and Physical Resources

Kim Cawley	Unit Chief
Megan Carroll	Conservation and land management, air transportation

Lisa Cash Driskill	Energy, Outer Continental Shelf receipts
Mark Grabowicz	Justice, Postal Service
Kathleen Gramp	Spectrum-auction receipts, energy, deposit insurance
Greg Hitz	Agriculture
David Hull	Agriculture
James Langley	Agriculture
Susanne Mehlman	Pollution control and abatement, Federal Housing Administration and other housing credit programs
Julie Middleton	Water resources, Federal Emergency Management Agency
Rachel Milberg	Highways, Amtrak, mass transit
Matthew Pickford	General government
Deborah Reis	Recreation, water transportation, community development, other natural resources, legislative branch, conservation and land management
Gregory Waring	Justice, regional development
Michael Waters	Science and space exploration, Bureau of Indian Affairs
Melissa Zimmerman	Commerce, Small Business Administration, Universal Service Fund

Other

Janet Airis	Unit Chief, Scorekeeping
Jeffrey Holland	Unit Chief, Projections
Edward Blau	Authorization bills
Barry Blom	National income and product accounts, monthly Treasury data, report coordinator
Joanna Capps	Appropriation bills (Interior and the environment, Agriculture)
Kenneth Farris	Computer support
Mary Froehlich	Computer support
Ann Futrell	Other interest, report coordinator
Ellen Hays	Federal pay, report coordinator
Virginia Myers	Appropriation bills (Commerce-State-Justice, energy and water)
Jennifer Reynolds	Appropriation bills (Defense, foreign relations)
Eric Schatten	Interest on the public debt, report coordinator
Robert Sempsey	Appropriation bills (Labor-HHS, Homeland Security)
Phan Siris	Computer support
Esther Steinbock	Appropriation bills (Transportation-Treasury-HUD, military quality of life and veterans' affairs, District of Columbia)
Patrice Watson	Database system administrator