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CBO CONFIRMS DECLINE IN 2007 DEFICIT – BUT HIGHER SPENDING THREATENS THE TREND

THE BUDGET AND ECONOMIC OUTLOOK: AN UPDATE

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SUMMARY

The Congressional Budget Office [CBO] today estimated the current year's budget deficit would shrink to $158 billion, $19 billion smaller than CBO's baseline deficit projection in March, and $90 billion less than the fiscal year 2006 deficit. The figure does not, however, account for spending increases passed by the House that would, if enacted, increase deficit spending in fiscal year 2008 and thereafter.

The deficit reduction has resulted from faster-than-expected increases in Federal tax revenue, a product of continued economic growth and job creation during the first half of 2007. CBO – along with the administration's Office of Management and Budget, and the Blue Chip forecasters – estimates an improvement of economic growth from 2.1 percent in 2007 to 2.9 percent in 2008.

While short-term revenue growth improves the deficit picture in 2007, CBO notes somewhat ominously that "the budget deficit for the long term remains daunting."

Table 1: CBO Baseline Budget Estimates
(By fiscal year in billions of dollars)

	2007	2008	2009	2010	2011	2012
Outlays[a]	2,735	2,925	3,071	3,205	3,359	3,415
Revenue[b]	2,577	2,771	2,855	2,950	3,225	3,477
Deficit (-)[a,b]	-158	-155	-215	-255	-134	62
Deficit as a % of GDP[a,b]	-1.2	-1.1	-1.4	-1.6	-0.8	0.4

[a] CBO's baseline spending estimates for future years assume the continuation of supplemental and emergency spending amounts, even though these were enacted as temporary spending measures. The figures do not account for spending increases passed by the House this year.
[b] Revenue estimates for 2011 and thereafter assume automatic tax increases resulting from the scheduled expiration of 2001 and 2003 tax relief provisions.
Source: Congressional Budget Office.

The figures – CBO's updated "baseline" estimates – reflect the estimated costs of policies as written in current law, without change. In this way they differ from the administration's estimates, released in July, which anticipate enactment or continuation of the President's

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recommended policies. CBO's deficit figure – $47 billion smaller than the administration's – also assumes the continuation each year of temporary emergency supplemental spending; no further congressional efforts to restrain spending growth; and no changes in tax laws, including the scheduled expiration of tax relief provisions enacted in 2001 and 2003.

KEY POINTS

- **The Budget Deficit.** The deficit for the current year – fiscal year 2007, which ends on 30 September – is estimated at $158 billion, or 1.2 percent of gross domestic product [GDP]. The 40-year average is 2.4 percent. As noted, this is $19 billion less than the $177-billion baseline deficit CBO projected in March, and $90 billion lower than the 2006 deficit of $248 billion.

  The deficit is projected to remain at roughly 1.5 percent of GDP through 2010, and then move toward surplus in 2012 and beyond, even if Congress continued funding levels (such as those for operations in Iraq and Afghanistan) as adopted this year. The projection does not, however, account for other spending increases already passed by the House that also will increase the deficit (see further discussion below).

  CBO's estimates for 2011 and thereafter also assume automatic tax increases resulting from the expiration of the 2001 and 2003 tax relief provisions. These tax increases, if allowed to occur, would total more than $150 billion in 2011 and more than $250 billion in 2012; and the magnitude of the tax increases would continue growing thereafter.

- **Revenue.** In that regard, tax revenue already is growing at faster-than-historical rates, without tax increases. As has been the case in recent years, the deficit decline in 2007 is almost entirely attributable to a significant increase in tax revenue, which is $35 billion higher than CBO estimated in March. After growing by 14.5 percent in 2005 and 11.8 percent last year, receipts this year are expected to increase by about 7.1 percent, reaching a total of about $2.6 trillion. The long-term average for revenue growth, without changes in tax laws, is about 5.5 percent. CBO attributes much of this increase to rising individual income taxes, which are estimated to increase by about 12 percent compared with 2006 – apparently the result of solid growth in wage and salary income, and growth in non-wage income. Corporate income taxes are projected to increase by 6.2 percent.

  Revenue also continues to grow as a share of the economy, rising from 18.4 percent in 2006 to 18.8 percent this year. Both figures are higher than the average of Federal tax revenue over the past 40 years, 18.2 percent of GDP.

- **Spending.** CBO estimates total spending for 2007 at $2.7 trillion, and has increased outlay estimates for the year by $16 billion above its March estimate. The effect is due principally to higher costs for operations in Afghanistan and Iraq, as well as higher interest rates. CBO estimates $1.5 trillion in mandatory outlays for the year, $1.0 trillion in discretionary outlays, and $235 billion in net interest.

  As previously noted, CBO's spending estimates for future years assume the continuation each year of supplemental and emergency amounts, even though these were enacted as

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temporary spending measures. On the other hand, the future-year figures do not account for various spending increases passed by the House that could threaten the improvement in the deficit. Among these House-passed spending measures are the following:

- An increase of $48 billion in annually appropriated spending in fiscal year 2008 above CBO's "baseline" estimate. The CBO baseline assumes this spending level increases by the rate of inflation.

- A $28-billion net increase over the next 5 years for the House-passed reauthorization of the State Children's Health Insurance Program.

- A net increase of $3.5 billion over the next 5 years for the House-passed Farm Bill reauthorization.

For the longer term, CBO warns that spending for Medicare and Medicaid "will be the primary determinant of the nation's long-term fiscal balance." If these programs continue to grow at their current rate, Federal spending on just these two programs will be at 20 percent of GDP in 2050.

- **The Economy and Jobs.** Economic growth moderated in the latter half of 2006 and the start of 2007, due in part to the drag from housing. But GDP growth is generally expected to rebound over the near term, from 2.1 percent this year to just under 3.0 percent in 2008, according to CBO (see Table 2 on the next page). Meanwhile, the unemployment rate is expected to remain close to 4.6 percent through the end of next year, which is low by historical standards.

CBO's economic estimates, tallied in early July, do not capture any potential impact from the recent turbulence in financial markets. They also do not account for the economic impact of potential tax increases, such as the tobacco tax increase recently passed by the House.

Principal details of CBO's economic projection are the following:

- *GDP*. CBO estimates annual growth in real (inflation-adjusted) GDP of 2.1 percent in 2007, and 2.9 percent in 2008.

- *Jobs.* The unemployment rate is estimated at 4.5 percent for this year and 4.7 percent next year.

- *Inflation*. Inflation, as measured by the consumer price index [CPI], advanced by more than 3.0 percent in 2006; but CBO expects food and energy prices to ease from their recent high levels, leading to a moderation in overall inflation. The CPI is expected to increase by 2.8 percent this year, easing further to 2.3 percent in 2008.

- *Interest Rates*. CBO estimates the rate on 3-month Treasury bills to be constant at 4.8 percent this year and next. The rate on 10-year Treasury notes is projected to rise from 4.9 percent this year to 5.2 percent in 2008.

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Table 2: CBO's Economic Forecast and Projection
(calendar year over calendar year)

	Actual	Forecast		Projected Annual Average	
	2006	2007	2008	2009-12	2013-17
Nominal GDP (billions of dollars)	13,247	13,893	14,575	17,595[a]	21,829[b]
Real GDP (percent change)	3.3	2.1	2.9	3.0	2.6
Consumer Price Index (percent change)	3.2	2.8	2.3	2.2	2.2
Unemployment Rate (percent)	4.6	4.5	4.7	4.8	4.8
Ten-Year Treasury Note (percent)	4.8	4.9	5.2	5.2	5.2
Three-Month Treasury Bill (percent)	4.7	4.8	4.8	4.7	4.7

[a] Level in 2012.
[b] Level in 2017.
Source: Congressional Budget Office.