HOUSE BUDGET COMMITTEE 110th Congress MAJORITY
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CBO Summer Budget Update

Key Points

Major challenges remain to put our fiscal house in order — Although any improvement is welcome news, the August forecast from the Congressional Budget Office (CBO) shows near-term deficits are still high. The Bush Administration has presided over the largest budget deterioration in American history. When the Administration took office in 2001, surpluses of $5.6 trillion were projected for the next ten-year period. Deficits of over $2 trillion are now anticipated for the same period. The President's answer is more of the same policies that caused our current deficit woes. The President is now seeking his fifth increase in the debt limit to finance continuing deficits. Much of this debt will be financed by foreign governments and investors, making our country more vulnerable to instability from abroad.

Uncertainty surrounds economic forecast — CBO's projections assume continued sound economic performance. However, there is significant risk associated with problems in the housing market and turbulence in financial markets. Only slight misses in the economic forecast can have significant impact on the government's fiscal position.

Long-terms fiscal trends are unsustainable — According to CBO, the nation faces substantial fiscal challenges over the long term, fueled in part by the retirement of the baby-boom population and rising health care costs. In reality, an even larger crisis is looming since the current revenue path assumes a steady increase in the number of taxpayers who will become subject to the alternative minimum tax. A permanent repair of the AMT could add as much as $1 trillion to the fiscal challenge over the next ten-year period.

Tax cuts make the picture worse — The large tax cuts enacted in 2001 and 2003 led to revenue losses totaling $165 billion in 2007, based on estimates from the time of enactment. These revenue losses exceed the size of the deficit for 2007, meaning that the budget would have been balanced in 2007 in the absence of the enacted tax cuts. This conclusion is supported by the data and analysis included in a July 20th letter from CBO to Chairman Spratt. Most of the tax cuts are scheduled to expire in 2011. Extension of some or all of the tax cuts, without corresponding offsets, will worsen the imbalance we face.

Debt continues to climb — Federal debt has exploded during this Administration, rising from $5.8 trillion in 2001 to an estimated $8.9 trillion at the end of 2007. This creates a very large burden on our economy at the worst possible time, just as the baby-boom population is reaching retirement age.

Democrats are Committed to Restoring Fiscal Balance

Balanced budget by 2012 — The 110th Congress has set putting our fiscal house in order as a top priority. Congress passed a budget resolution which reaches balance in 2012 and requires that important legislative priorities not increase the deficit.

Institution of tough new pay-as-you-go rule — One of the first acts of this Congress was to restore the pay-as-you-go principle for mandatory spending and revenues. Previous Congresses allowed pay-as-you-go to lapse and used the opportunity to enact major tax cuts and entitlement expansions without paying for them. This contributed to the shift of a $5.6 trillion surplus to over $2 billion in deficits over the same period. The House's new pay-as-you-go rule has worked. Important legislation has passed the House that provides high priority spending – including for farm programs, a modernized energy policy, and health care for children -- but does not pass along the cost to our children and grandchildren.

Discretionary programs subject to discipline — The budget resolution provides a fiscally responsible discretionary limit to the Appropriations Committee to allow adequate funding for important initiatives. The Appropriations Committee has lived within its means. All twelve bills have now passed the House. Most of the increased funding went toward security programs and was largely requested by the President.

CBO's Economic Forecast

Changes to the economic outlook are not all positive for the economy or for the typical American family — CBO explains the growth of income tax receipts over the past few years as a result of an increase in overall (aggregate) real incomes, an increase in income inequality, and unusually strong growth in corporate profits (which is nevertheless showing signs of slowing as are corporate tax revenues). Compared with its January projections, CBO's current economic forecast calls for slightly lower real economic growth over the next year (2008), significantly higher inflation for this year (2007), and higher interest rates over the entire 10-year outlook period.

Higher interest rates mean larger debt service costs — Interest on the debt is one of the fastest growing components of mandatory spending in the federal budget. In this August update, CBO has raised its forecast for long-term interest rates in 2007, 2008, and 2009, and raised its forecast for short-term interest rates throughout the ten-year forecast. This means that every dollar of deficit-financed tax cuts or spending will come with a higher additional cost of interest on that new debt.

Forecast may underestimate economic risk — The economic models used by CBO may not fully capture the risks posed by current financial turmoil and housing sector weakness. Should the credit crunch create broader macroeconomic problems, the resulting lower growth and higher interest rates could have a significant effect on the budget through lower receipts and higher interest-related outlays than the report projects.

Recent financial market turmoil just another symptom of excessive borrowing — In July and August, just before release of the CBO report, financial markets were shaken by worries about the "credit crunch" and in particular the fragile condition of the subprime mortgage market.

CBO's report on the economic outlook characterizes the recent movements in the values and interest rates associated with these risky assets as simply bringing the market values "back to more normal levels," as there had been an undervaluing of risk in these markets beforehand. The upward pressure on interest rates is occurring across all types of assets, not just private-market securities, as a symptom of our country's excessive demand for capital and lack of national saving.

Changes in CBO Projections Since March

On net, CBO's new projections show slight improvement — After adding supplemental spending approved since CBO's last official forecast, CBO now forecasts a deficit of $158 billion in 2007, which is $19 billion less than its earlier projections. Similarly, total economic and technical factors lead to improvements in the government's fiscal imbalance for the ten-year period 2008 through 2017.

Higher inflation is driving increase in receipts — CBO raised its forecast of nominal Gross Domestic Product (GDP) -- the value of goods and services produced in the economy -- to reflect higher inflation than it anticipated in the first half of 2007. This increase, along with adjustments in the relative shares of GDP for different types of income, pushed up CBO's 2007 receipt forecast by $20 billion. Although projected inflation rates beyond 2007 are similar to the March forecast, the higher starting point increases receipts throughout the projection period.

Much higher outlays in CBO's official baseline are largely artifact of baseline rules — Baseline concepts define discretionary spending at the current year level adjusted for inflation. As a result, the current baseline incorporates the full amount of emergency funding that was provided in 2007, largely for the wars in Iraq and Afghanistan, for every year through the period. Adjustment for the additional discretionary appropriations of $117 billion, enacted since the release of the March baseline, results in over $1 trillion in extra outlays over the ten-year budget horizon. The actual costs of military operations will depend on the future path of the wars.

Economic and technical factors boost outlays — In addition to enactment of the supplemental, revisions in economic assumptions and technical reestimates push outlays higher in most years in the budget horizon. Much of the increase is caused by higher inflation, which increases automatic cost-of-living adjustments as well as other inflation adjustments inherent in baseline rules. Partially offsetting these increases are reductions in debt service requirements resulting from higher revenues.