CHAPTER

1

The Budget Outlook

The Congressional Budget Office (CBO) estimates that total federal spending and revenues will produce a deficit of $157 billion in fiscal year 2002 (which ends September 30). Under CBO's new baseline projections, which assume that current tax and spending policies remain unchanged, the federal government would run a slightly smaller deficit, $145 billion, in 2003 (*see Table 1-1*). After that, the budget outlook gradually improves through 2010, with projected deficits and surpluses that are relatively modest, both in dollar terms and as a percentage of the nation's gross domestic product (GDP). Projected surpluses rise sharply in 2011 and 2012 because the baseline assumes that the tax cuts enacted last year expire in 2010, as scheduled. As a result, more than 80 percent of the projected surplus for the 2003-2012 period accrues in the last two years.

Those baseline projections are not intended to be a forecast of future budgetary outcomes; they are simply meant to serve as a neutral benchmark that lawmakers can use to measure the effects of proposed changes in revenue and spending policies. The baseline is constructed according to rules set in law. CBO applies those rules—and its best judgment about how the economy and other factors would affect federal revenues and spending under existing laws and policies—to develop its projections of future surpluses or deficits.

In its previous baseline, published in March in *An Analysis of the President's Budgetary Proposals for Fiscal Year 2003*, CBO projected surpluses of $5 billion for 2002 and $6 billion for 2003 under the policies in effect at the end of February. On March 9, as that report was going to press, the President signed into law the so-called economic stimulus act (Public Law 107-147). At that time, CBO updated its baseline projections to incorporate the effects of that legislation, which it estimated would eliminate the projected surpluses and result in deficits of $46 billion in 2002 and $40 billion in 2003. Beyond 2003, surpluses were projected to rise steadily, reaching $653 billion by 2012. Although the updated deficit and surplus figures were included in that report (in Box 1 on page 2), the detailed supporting tables did not reflect the effects of the stimulus package. This report, therefore, compares CBO's new baseline projections with the ones that were presented in detail in the March report.

Since the end of February, the budget picture has shifted significantly: projected surpluses have declined sharply, and deficits are now envisioned through 2005. For the 2003-2007 period, the budget total has changed from a $489 billion surplus to a $229 billion deficit under current policies. For the 2003-2012 period, the total projected surplus has dropped from $2.4 trillion to $1.0 trillion. Roughly half of that $1.4 trillion decline over 10 years results from lower projections of revenues; the other half reflects increases in projected outlays.

Actual budgetary outcomes are virtually guaranteed to differ from CBO's baseline projections for two reasons. The first involves the rules under which CBO must construct its baseline. CBO does not predict future legislation—indeed, any attempt to incorporate future legislative changes in the baseline would undermine its usefulness as a way to measure the effects of such

Table 1-1.

The Budget Outlook Under Current Policies

(In billions of dollars)

	Actual 2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total, 2003-2007	Total, 2003-2012
On-Budget Surplus or Deficit (-)	-34	-314	-315	-299	-246	-209	-190	-173	-147	-122	4	185	-1,259	-1,513
Off-Budget Surplus[a]	161	157	170	188	207	224	242	262	280	299	319	337	1,031	2,527
Total Surplus or Deficit (-)	**127**	**-157**	**-145**	**-111**	**-39**	**15**	**52**	**88**	**133**	**177**	**323**	**522**	**-229**	**1,015**
Memorandum:														
Social Security Surplus	163	160	171	188	206	224	242	262	280	299	319	337	1,031	2,527
Postal Service Outlays	2	3	1	*	-1	0	0	0	0	0	0	0	*	*
Total Surplus or Deficit (-) as a Percentage of GDP	1.3	-1.5	-1.3	-1.0	-0.3	0.1	0.4	0.6	0.9	1.1	2.0	3.0	-0.4[b]	0.7[b]

Source: Congressional Budget Office.

Note: * = between zero and $500 million.

a. Off-budget surpluses comprise surpluses in the Social Security trust funds as well as the net cash flow of the Postal Service.

b. Cumulative surplus or deficit as a percentage of cumulative GDP over this period.

changes. However, future legislation will certainly alter the paths of federal spending and revenues. The second reason involves the uncertainty of forecasting. The U.S. economy and the federal budget are highly complex and are affected by many economic and technical factors that are difficult to predict.[1] In view of that uncertainty, the outlook for the budget can best be described not as a single row of numbers but as a range of possible outcomes around those numbers. That range widens as the projection extends: hence, 10-year projections are more uncertain than five-year projections.

The Outlook for 2002

The budget situation has changed dramatically over the past year. In 2001, the federal government recorded a surplus of $127 billion (1.3 percent of GDP). For this year, CBO projects a deficit of $157 billion (1.5 percent of GDP)—the first deficit since 1997 (*see Figure 1*). The swing from surplus to deficit was caused by a decline in revenues combined with sharp growth in spending.

1. For a more detailed discussion of the uncertainty in forecasting and the implications for budget projections, see Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2003-2012* (January 2002), Chapter 5.

Revenues are expected to fall in 2002 for the second year in a row. CBO projects this year's decrease at $131 billion, or 6.6 percent—the largest annual drop, in percentage terms, since 1946. Receipts from individual income taxes account for the bulk of the expected decline in revenues, falling by $127 billion, or about 13 percent. Those receipts were especially low during the recent tax-filing season. Taxpayers made much smaller final payments and received substantially greater refunds for tax year 2001 than they had the previous year. In contrast, revenues from social insurance taxes (such as payroll taxes for Social Security and Medicare) are expected to increase in 2002 by $8 billion, or slightly more than 1 percent. However, corporate tax receipts and other sources of revenue are projected to decline this year by about $12 billion, or 4 percent.

While revenues dwindle, outlays in 2002 are projected to rise by $153 billion, or 8 percent, from last year's level. CBO expects outlays for discretionary programs (the part of the budget whose spending levels are set anew each year in appropriation acts) to grow by $84 billion—or 13 percent—this year. Outlays for entitlements and other mandatory programs are projected to rise by $105 billion, or 10 percent. Those increases will be partly offset by a decline in the government's net interest payments of $36 billion, or 17 percent—a decline caused largely by the drop in interest rates over the past year. Excluding net interest on the public debt, spending will grow by about 11 percent in 2002, CBO estimates.

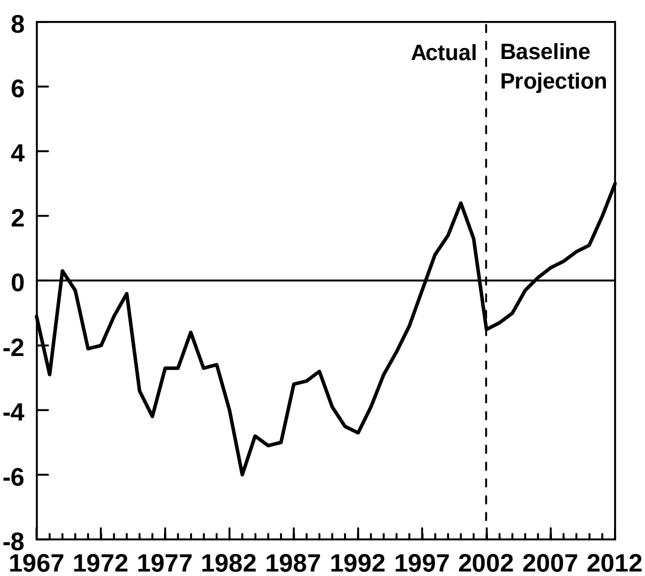
Lawmakers have significantly boosted defense appropriations, in part because of the war on terrorism. As a result, CBO projects that defense outlays will rise by $43 billion this year, from $306 billion to $349 billion. In addition, nondefense discretionary outlays—driven mostly by increases in spending for education, transportation, the administration of justice, health research, and public health programs—are projected to grow by nearly the same amount, from $343 billion last year to $384 billion in 2002.

On the mandatory side of the budget, Medicaid spending is expected to rise by $18 billion, or 14 percent, this year. That rapid increase may be attributable to rising costs for prescription drugs and greater enrollment in Medicaid because of the sluggish economy, the expansion of eligibility requirements in some states, and increased outreach efforts by states to recruit participants. (That spending increase is also reflected in state budgets, which have worsened significantly in the past year.) In addition, the weakened economy has caused a significant jump in applications for unemployment benefits. As a result, CBO anticipates that unemployment spending will nearly double in 2002—to $51 billion from $28 billion last year.

Figure 1-1.

Total Deficits and Surpluses as a Share of GDP, 1967-2012

(Percentage of GDP)



Source: Congressional Budget Office.

The Outlook for 2003 Through 2012

CBO projects that revenues will begin to rise again after 2002, going from 18.0 percent of GDP this year to 19.2 percent in 2010 (*see Table 1-2*). As a result, if current tax and spending policies are maintained, deficits are projected to diminish and surpluses are projected to emerge, reaching 1.1 percent of GDP by 2010. After that, projected surpluses spike upward as last year's tax cuts expire, rising to 3.0 percent of GDP by 2012. If those tax cuts, as well as other tax provisions scheduled to expire, were extended, the surplus in 2012 would be nearly 2 percentage points lower as a share of GDP than projected in the baseline (*see Box 1-1 on page 6 for more details*).

Under current laws and policies, total outlays as a share of GDP would decline gradually for the next 10 years—from 19.5 percent of GDP in 2002 to 17.5 percent in 2012. Although mandatory spending grows at about the same rate as GDP in the baseline, discretionary spending is assumed to grow at the rate of inflation and thus more slowly than GDP. Net interest spending is also projected to decline as a percentage of GDP once the budget shows a surplus again.

According to the Balanced Budget and Emergency Deficit Control Act of 1985, CBO's baseline must assume that discretionary spending will continue at the current level ($734 billion in budget authority for 2002), with annual increases for the projected rates of inflation—the GDP deflator and the employment cost index (ECI) for wages and salaries. Thus, the baseline assumes that discretionary budget authority will total $755 billion in

Table 1-2.

CBO's Baseline Budget Projections

	Actual 2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total, 2003-2007[a]	Total, 2003-2012[a]
In Billions of Dollars														
Revenues														
Individual income taxes	994	868	934	988	1,054	1,117	1,190	1,273	1,364	1,462	1,669	1,845	5,282	12,894
Corporate income taxes	151	146	147	165	214	236	248	259	268	279	292	306	1,009	2,414
Social insurance taxes	694	702	735	776	819	863	907	950	995	1,045	1,098	1,153	4,099	9,341
Other	152	144	147	155	158	166	168	175	182	178	184	217	794	1,730
Total	**1,991**	**1,860**	**1,962**	**2,083**	**2,244**	**2,381**	**2,513**	**2,658**	**2,809**	**2,965**	**3,243**	**3,521**	**11,184**	**26,379**
On-budget	1,484	1,345	1,422	1,516	1,649	1,756	1,855	1,966	2,081	2,199	2,438	2,675	8,198	19,556
Off-budget	508	515	540	567	595	626	658	692	728	766	805	846	2,986	6,823
Outlays														
Discretionary spending	649	733	782	803	827	845	864	889	912	936	965	983	4,121	8,807
Mandatory spending	1,008	1,113	1,161	1,200	1,248	1,309	1,386	1,471	1,560	1,657	1,771	1,853	6,305	14,616
Net interest	206	170	164	191	208	213	212	209	204	195	183	164	987	1,941
Total	**1,864**	**2,017**	**2,107**	**2,195**	**2,283**	**2,366**	**2,461**	**2,569**	**2,676**	**2,788**	**2,920**	**2,999**	**11,413**	**25,364**
On-budget	1,517	1,659	1,737	1,815	1,895	1,964	2,046	2,139	2,228	2,321	2,433	2,489	9,457	21,068
Off-budget	347	358	370	379	388	402	416	430	447	467	486	510	1,955	4,296
Surplus or Deficit (-)	**127**	**-157**	**-145**	**-111**	**-39**	**15**	**52**	**88**	**133**	**177**	**323**	**522**	**-229**	**1,015**
On-budget	-34	-314	-315	-299	-246	-209	-190	-173	-147	-122	4	185	-1,259	-1,513
Off-budget	161	157	170	188	207	224	242	262	280	299	319	337	1,031	2,527
Debt Held by the Public	3,320	3,504	3,676	3,805	3,862	3,865	3,829	3,757	3,639	3,476	3,167	2,658	n.a.	n.a.
Memorandum:														
Gross Domestic Product	10,032	10,324	10,773	11,343	11,927	12,562	13,239	13,953	14,699	15,476	16,288	17,140	59,844	137,399
As a Percentage of GDP														
Revenues														
Individual income taxes	9.9	8.4	8.7	8.7	8.8	8.9	9.0	9.1	9.3	9.4	10.2	10.8	8.8	9.4
Corporate income taxes	1.5	1.4	1.4	1.5	1.8	1.9	1.9	1.9	1.8	1.8	1.8	1.8	1.7	1.8
Social insurance taxes	6.9	6.8	6.8	6.8	6.9	6.9	6.8	6.8	6.8	6.8	6.7	6.7	6.9	6.8
Other	1.5	1.4	1.4	1.4	1.3	1.3	1.3	1.3	1.2	1.2	1.1	1.3	1.3	1.3
Total	**19.8**	**18.0**	**18.2**	**18.4**	**18.8**	**19.0**	**19.0**	**19.0**	**19.1**	**19.2**	**19.9**	**20.5**	**18.7**	**19.2**
On-budget	14.8	13.0	13.2	13.4	13.8	14.0	14.0	14.1	14.2	14.2	15.0	15.6	13.7	14.2
Off-budget	5.1	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	4.9	4.9	4.9	5.0	5.0
Outlays														
Discretionary spending	6.5	7.1	7.3	7.1	6.9	6.7	6.5	6.4	6.2	6.0	5.9	5.7	6.9	6.4
Mandatory spending	10.1	10.8	10.8	10.6	10.5	10.4	10.5	10.5	10.6	10.7	10.9	10.8	10.5	10.6
Net interest	2.1	1.7	1.5	1.7	1.7	1.7	1.6	1.5	1.4	1.3	1.1	1.0	1.6	1.4
Total	**18.6**	**19.5**	**19.6**	**19.3**	**19.1**	**18.8**	**18.6**	**18.4**	**18.2**	**18.0**	**17.9**	**17.5**	**19.1**	**18.5**
On-budget	15.1	16.1	16.1	16.0	15.9	15.6	15.5	15.3	15.2	15.0	14.9	14.5	15.8	15.3
Off-budget	3.5	3.5	3.4	3.3	3.3	3.2	3.1	3.1	3.0	3.0	3.0	3.0	3.3	3.1
Surplus or Deficit (-)	**1.3**	**-1.5**	**-1.3**	**-1.0**	**-0.3**	**0.1**	**0.4**	**0.6**	**0.9**	**1.1**	**2.0**	**3.0**	**-0.4**	**0.7**
On-budget	-0.3	-3.0	-2.9	-2.6	-2.1	-1.7	-1.4	-1.2	-1.0	-0.8	*	1.1	-2.1	-1.1
Off-budget	1.6	1.5	1.6	1.7	1.7	1.8	1.8	1.9	1.9	1.9	2.0	2.0	1.7	1.8
Debt Held by the Public	33.1	33.9	34.1	33.5	32.4	30.8	28.9	26.9	24.8	22.5	19.4	15.5	n.a.	n.a.

Source: Congressional Budget Office.

Notes: n.a. = not applicable; * = between zero and 0.05 percent of GDP.
For details about changes from CBO's previous baseline, see Table 1-6.

a. Numbers in the bottom half of the column are shown as a percentage of cumulative GDP over this period.

2003 and will rise by 2.4 percent to 2.8 percent a year thereafter.[2]

Although CBO's baseline for discretionary spending must follow the rules prescribed by the Deficit Control Act, alternative assumptions can illustrate how sensitive budget projections are to the growth rate of discretionary spending (*see Table 1-3 on page 8*). For example, assuming that such spending increases at the same rate as nominal GDP through 2012 (an average of 5.2 percent per year) would eliminate the cumulative 10-year surplus projected in CBO's baseline. Continuing the spending growth of recent years would worsen the budget outlook even more. Alternatively, if discretionary spending was frozen at the 2002 level with no increases for inflation, the projected 10-year surplus would be more than $1 trillion higher than in the baseline.

By far the largest spending category in the budget is entitlements and other mandatory programs. Under current law, spending for that category would grow at an average annual rate of 5.2 percent through 2012. That growth is fueled by spending for Social Security, Medicare, and Medicaid, which together account for more than three-quarters of mandatory outlays (*see Table 1-4 on page 10*). Those three programs, which amounted to 8.0 percent of GDP last year, are projected to reach 9.1 percent of GDP in 2012.

Interest costs remain a sizable portion of the federal budget, even though they have been shrinking for several years. Debt held by the public is projected to increase for the next few years to pay for annual budget deficits. Nevertheless, net interest payments are projected to fall from $206 billion in 2001 to $170 billion this year and $164 billion in 2003 because of the recent decline in short-term interest rates (*see Table 1-5 on page 11*). After that, a projected rise in interest rates combined with continued federal borrowing pushes projected net interest spending back up—reaching about $213 billion in 2006 and 2007. For the rest of the 10-year period, net interest payments are projected to decline gradually, reflecting higher surpluses and the resulting lower levels of publicly held debt.

Recent Changes to the Budget Outlook

When CBO periodically revises its baseline projections, it divides the changes into three categories based on their cause: recently enacted legislation, changes to CBO's outlook for the economy, and other, so-called technical factors that affect the budget (*see Table 1-6 on page 12*).[3]

Revisions to CBO's March baseline have lowered revenue projections by a total of $678 billion for the 2003-2012 period, largely because of technical reestimates. Outlay projections for that period have risen by a total of $688 billion, mostly as a result of legislation enacted since February and the effects of all revisions on debt-service costs.

The Department of Commerce's Bureau of Economic Analysis recently released its annual revisions of the national income and product accounts (NIPAs). Those revisions are incorporated in CBO's new economic and budget projections. Among other changes, the bureau lowered its estimates of wages and salaries and of corporate book profits in calendar year 2001 by about $175

2. Discretionary budget authority for 2002 includes approximately $44 billion that was provided in two supplemental appropriation laws during the year. As required by baseline rules, that supplemental spending is extended through 2012 and also grows at the projected rates of inflation.

3. Those categorizations should be interpreted with caution. For example, legislative changes reflect CBO's best estimates of the future effects of laws enacted since the previous baseline; but if a new law proves to have different effects from the ones in CBO's initial estimate, those differences will appear as technical reestimates in later revisions to the baseline. The distinction between economic and technical reestimates is similarly imprecise. CBO classifies economic revisions as those resulting directly from changes in the components of CBO's economic forecast. Changes in other factors related to the performance of the economy—such as the level of capital gains realizations—are shown as technical reestimates. Despite those imperfections, classifying and tracking reestimates of revenues and spending as either legislative, economic, or technical is useful to evaluate the reasons for a changing budget outlook.

Box 1-1.

The Expiration of Revenue Provisions

The scheduled expiration of various revenue provisions has an important impact on the budget outlook for the next 10 years.[1] Three items in last year's tax-cut legislation, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), are scheduled to end on or before December 31, 2006. The rest—which represent the bulk of the law's budgetary cost—expire on December 31, 2010. In addition, the economic stimulus law enacted in March 2002 established several new tax cuts for businesses that, in most cases, end over the next three years. Many other provisions of the tax code, enacted before EGTRRA, are scheduled to expire over the next decade.

By law, the Congressional Budget Office's (CBO's) baseline budget projections must assume that almost all of the expiring tax provisions end as scheduled. (The only exception is for expiring excise taxes dedicated to trust funds.) An alternative measure of the long-term budgetary effects of current policy could assume that all of those expirations do not occur as scheduled but rather that the provisions are immediately and permanently extended. Under those assumptions, the Joint Committee on Taxation (JCT) and CBO estimate that federal revenues would be $956 billion lower during the 2003-2012 period than projected in CBO's baseline (*see the table at right*).

Over half ($553 billion) of the estimated decline in revenues from extending all expiring tax provisions would result from extending EGTRRA. About three-quarters of that cost would occur in 2011 and 2012, immediately after most of the provisions of the law are scheduled to expire, although some effects would occur earlier. Extending the changes that the law made to estate and gift taxes could reduce revenues as early as 2003, because if taxpayers knew that those changes would become permanent in 2011, some might postpone making taxable gifts that they would otherwise have made over the decade.

A more limited alternative measure would assume that all expiring tax provisions were extended except the ones created by the economic stimulus law, which were not intended to be permanent. (Those provisions include allowing businesses to take an additional first-year depreciation deduction, expanding the ability of unprofitable firms to receive refunds of past taxes paid, and targeting tax benefits to the area of New York City damaged on September 11, 2001.) If all but those expiring provisions were extended, JCT and CBO project, federal revenues would be $693 billion lower during the 2003-2012 period.

1. It can also be expected to affect the economy, but only some of those effects are reflected in the estimates presented here.

billion.[4] Those changes, however, did not significantly affect CBO's projections of revenues or outlays. CBO had already largely anticipated the income revisions on the basis of tax collections in 2001. In addition, those revisions did not cause CBO to alter its projections of overall economic growth, the primary determinant of revenue growth.

The Effects of Recent Legislation

Laws enacted since CBO completed its March baseline have reduced projected revenues and raised spending. Nearly $60 billion of the $162 billion increase in this year's projected deficit is attributable to legislation enacted since the end of February. A similar share—roughly 40 percent—of the decline in the cumulative surplus for the 2003-2012 period results from newly enacted legislation, mostly on the spending side of the budget.

Revenues. Altogether, recent legislation has caused CBO to lower its revenue projection for 2002 by $43 billion but to increase its projection for the following 10 years by a total of $7 billion. The most significant legislative change to revenues was the enactment of the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147), commonly called the economic stimulus package. That law provides temporary tax relief for businesses and

4. For more information about the NIPA revisions, see Box 2-4 in Chapter 2. For a comparison of the federal sector of the NIPAs with the federal budget, see Appendix A.

Box 1-1.

Continued

Effects on Revenues of Extending Expiring Tax Provisions (In billions of dollars)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total, 2003-2007	Total, 2003-2012
Provisions in the Economic Growth and Tax Relief Reconciliation Act of 2001												
Provisions expiring in 2010	-1	-1	-2	-2	-3	-3	-3	-4	-125	-228	-9	-371
Provisions expiring before 2010[a]	n.a.	n.a.	-3	-12	-18	-22	-27	-29	-33	-37	-33	-181
Subtotal	-1	-1	-5	-15	-20	-25	-29	-33	-157	-265	-43	-553
New Provisions in the Economic Stimulus Law[b]	-1	-6	-35	-43	-38	-34	-30	-28	-26	-25	-122	-264
Other Expiring Tax Provisions[c]	*	-1	-5	-9	-14	-18	-20	-22	-25	-27	-29	-140
Total Effect on Revenues	**-1**	**-8**	**-45**	**-67**	**-72**	**-77**	**-79**	**-83**	**-208**	**-317**	**-194**	**-956**
Memorandum:												
Total Effect on Revenues Excluding the Economic Stimulus Law	-1	-2	-10	-24	-34	-43	-49	-56	-182	-292	-72	-693

Sources: Congressional Budget Office; Joint Committee on Taxation.

Notes: n.a. = not applicable; * = between zero and $500 million.

These estimates assume that the expiring provisions are extended immediately rather than when they are about to expire. The provisions are assumed to be extended at the rates or levels existing at the time of expiration. In addition, the estimates include interactions between provisions, which are most significant in 2011 and 2012. The estimates do not include effects on debt-service costs.

a. Includes the increased exemption amount for the alternative minimum tax (expires in 2004), the deduction for qualified education expenses (expires in 2005), and the credit for individual retirement accounts and 401(k)-type plans (expires in 2006).

b. The Job Creation and Worker Assistance Act of 2002. New provisions in that law that are scheduled to expire include special depreciation-expensing allowances for certain property, a five-year carryback of net operating losses, and tax benefits for the area of New York City damaged in the September 11 terrorist attacks. These estimates do not include provisions in the law that had existed and been extended in previous years. The effects of extending those provisions yet again are included in the line for other expiring tax provisions.

c. Includes numerous provisions, such as the tax credit for research and experimentation.

extends unemployment benefits for individuals.[5] Most of the law's revenue provisions became effective immediately, or were retroactive to 2001, but are set to expire within the next three years.

The main provision of the law lets businesses take an additional first-year depreciation deduction of 30 percent of the value of qualified property purchased between September 11, 2001, and September 11, 2004. That change allows businesses to accelerate depreciation into the year a property is placed in service and then take smaller depreciation deductions in later years. In addition, the law temporarily expands the ability of unprofitable corporations to receive refunds of taxes they paid in the past, as well as extending some expiring tax provisions. In total, CBO and the Joint Committee on Taxation estimate that the law will reduce revenues by $114 billion between 2002 and 2005 but increase revenues by $85 billion over the 2006-2012 period. Over the entire 11 years, therefore, P.L. 107-147 is estimated to decrease revenues by a total of $30 billion.

Enactment of the Trade Act of 2002 (P.L. 107-210) has reduced projected revenues through 2012 by another $6 billion. About half of that reduction stems from a tax credit for health insurance costs that is being offered to workers who lose their jobs because of expanded trade.

5. For more information about the economic stimulus law, see Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2003* (March 2002), Box 1.

Table 1-3.

CBO's Projections of Discretionary Spending Under Alternative Assumptions

(In billions of dollars)

	Actual 2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total, 2003-2007	Total, 2003-2012
Baseline (Discretionary Spending Grows at the Rate of Inflation After 2002)[a]														
Budget Authority														
Defense	332	361	369	378	387	398	408	419	430	442	454	466	1,939	4,151
Nondefense	332	373	386	395	405	416	427	438	449	461	474	487	2,029	4,338
Total	**664**	**734**	**755**	**773**	**792**	**813**	**835**	**857**	**880**	**903**	**928**	**953**	**3,968**	**8,489**
Outlays														
Defense[b]	306	349	368	376	387	393	399	413	424	436	452	456	1,922	4,103
Nondefense	343	384	414	428	440	452	465	476	488	500	514	527	2,198	4,703
Total	**649**	**733**	**782**	**803**	**827**	**845**	**864**	**889**	**912**	**936**	**965**	**983**	**4,121**	**8,807**
Discretionary Spending Grows at the Rate of Nominal GDP After 2002														
Budget Authority														
Defense	332	361	377	388	397	408	419	430	441	453	465	478	1,989	4,257
Nondefense	332	373	390	419	452	486	523	563	605	648	695	742	2,271	5,524
Total	**664**	**734**	**767**	**807**	**849**	**894**	**943**	**993**	**1,046**	**1,102**	**1,160**	**1,220**	**4,260**	**9,781**
Outlays														
Defense[b]	306	349	374	385	396	403	410	424	435	447	463	467	1,967	4,203
Nondefense	343	384	416	442	475	509	546	584	625	667	713	760	2,387	5,735
Total	**649**	**733**	**789**	**827**	**871**	**911**	**955**	**1,008**	**1,060**	**1,114**	**1,175**	**1,227**	**4,354**	**9,938**
Discretionary Spending Grows at the Average Annual Rate Recorded from 1998 Through 2002 (8.5 percent)														
Budget Authority														
Defense	332	361	392	425	461	500	543	589	639	693	752	816	2,320	5,808
Nondefense	332	373	405	440	477	518	562	609	661	717	778	844	2,401	6,012
Total	**664**	**734**	**797**	**864**	**938**	**1,018**	**1,104**	**1,198**	**1,300**	**1,410**	**1,530**	**1,660**	**4,721**	**11,820**
Outlays														
Defense[b]	306	349	384	412	448	481	518	566	614	666	727	780	2,244	5,597
Nondefense	343	384	424	457	493	532	575	621	669	723	781	843	2,481	6,118
Total	**649**	**733**	**807**	**869**	**941**	**1,014**	**1,094**	**1,187**	**1,284**	**1,389**	**1,507**	**1,623**	**4,725**	**11,715**
Discretionary Spending, Excluding Supplemental Appropriations for 2002, Grows at the Rate of Inflation After 2002[a,c]														
Budget Authority														
Defense	332	361	351	360	369	379	389	399	410	421	433	445	1,848	3,956
Nondefense	332	373	357	366	375	385	395	405	416	427	439	451	1,877	4,016
Total	**664**	**734**	**708**	**725**	**744**	**763**	**784**	**805**	**826**	**848**	**872**	**896**	**3,725**	**7,972**
Outlays														
Defense[b]	306	349	356	360	369	374	380	394	404	415	431	434	1,839	3,917
Nondefense	343	384	404	411	418	426	436	446	457	468	481	494	2,095	4,441
Total	**649**	**733**	**760**	**770**	**787**	**800**	**817**	**839**	**861**	**884**	**911**	**928**	**3,934**	**8,358**

(Continued)

Table 1-3.

Continued

(In billions of dollars)

	Actual 2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total, 2003-2007	Total, 2003-2012
Discretionary Spending Is Frozen at the Level Enacted for 2002														
Budget Authority														
Defense	332	361	361	361	361	361	361	361	361	361	361	361	1,804	3,609
Nondefense	332	373	376	375	375	375	375	375	375	375	375	375	1,877	3,752
Total	**664**	**734**	**737**	**736**	**736**	**736**	**736**	**736**	**736**	**736**	**736**	**736**	**3,681**	**7,361**
Outlays														
Defense[b]	306	349	363	362	364	360	357	360	360	360	363	357	1,806	3,606
Nondefense	343	384	408	416	419	421	423	417	417	416	416	416	2,087	4,169
Total	**649**	**733**	**771**	**778**	**783**	**781**	**780**	**777**	**777**	**776**	**779**	**773**	**3,893**	**7,775**
Memorandum:														
Debt-Service Cost on Differences from Baseline														
Growth at rate of nominal GDP	n.a.	n.a.	*	1	3	6	11	17	25	36	48	63	21	209
Growth at 8.5 percent	n.a.	n.a.	*	3	8	16	28	44	65	91	123	162	55	539
Growth excluding supplementals	n.a.	n.a.	*	-2	-4	-7	-10	-13	-16	-20	-24	-28	-22	-123
Frozen at the 2002 level	n.a.	n.a.	*	-1	-3	-6	-11	-17	-24	-34	-45	-58	-21	-199

Source: Congressional Budget Office.

Notes: n.a. = not applicable; * = between -$500 million and $500 million.

In CBO's projections, discretionary outlays are generally higher than budget authority because of spending from the Highway Trust Fund and the Airport and Airways Trust Fund, which is subject to obligation limitations in appropriation acts. The budget authority for such programs is provided in authorizing legislation and is not considered discretionary. Another reason why outlays exceed budget authority is that they include spending from appropriations provided in previous years.

a. Using the inflators specified in the Deficit Control Act (the GDP deflator and the employment cost index for wages and salaries).

b. When October 1 (the beginning of the fiscal year) falls on a weekend, certain federal payments due to be made on that date are shifted into September. Consequently, military personnel who are normally paid twice a month will be paid 25 times in 2005 and 2011 and 23 times in 2007 and 2012.

c. The Department of Defense and Emergency Supplemental Appropriations Act for Recovery from and Response to Terrorist Attacks on the United States, Fiscal Year 2002 (P.L. 107-117) and the 2002 Supplemental Appropriations Act for Further Recovery From and Response to Terrorist Attacks on the United States (P.L. 107-206) provided $44 billion of supplemental budget authority for 2002. This scenario does not extend those emergency appropriations beyond 2002 but includes the outlays resulting from them.

Outlays. CBO projects that outlays will be $16 billion higher in 2002 and $534 billion higher over 10 years because of laws enacted since the previous baseline. Five pieces of legislation account for the majority of those spending increases.

The 2002 Supplemental Appropriations Act for Further Recovery From and Response to Terrorist Attacks on the United States (P.L. 107-206) provides $24 billion in additional discretionary budget authority for 2002.[6] Over half of that funding, $13.3 billion in budget au-

6. P.L. 107-206 also included $5.1 billion in budget authority that the Congress declared contingent emergency funding. To activate that funding, the President also had to declare those appropriations as emergency requirements and accept the entire amount of the contingency. (Otherwise, none of the funding would have become available.) On August 13, the Administration announced that it would not declare those appropriations as emergency requirements, thus eliminating the $5.1 billion in budget authority.

Table 1-4.

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

(In billions of dollars)

	Actual 2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total, 2003-2007	Total, 2003-2012
Means-Tested Programs														
Medicaid	129	147	155	166	180	196	213	232	253	276	301	329	911	2,302
State Children's Health Insurance	4	4	4	5	5	5	5	5	5	5	5	5	24	50
Food Stamps	19	22	24	24	25	25	26	27	28	29	29	30	124	267
Supplemental Security Income	27	31	32	33	37	36	35	39	41	43	48	43	173	386
Family Support[a]	25	26	26	26	26	26	26	26	26	26	26	26	129	258
Veterans' Pensions	3	3	3	3	4	3	3	3	3	3	4	4	16	34
Child Nutrition	10	10	11	11	11	12	12	13	13	14	14	15	57	126
Earned Income and Child Tax Credits	27	34	35	35	35	39	39	39	40	41	44	31	183	378
Student Loans	-2	4	4	5	5	5	5	6	6	6	6	6	24	52
Foster Care	6	6	7	7	7	8	8	8	9	9	9	10	36	81
Total, Means-Tested	**248**	**286**	**300**	**315**	**335**	**354**	**372**	**398**	**423**	**451**	**487**	**499**	**1,677**	**3,934**
Non-Means-Tested Programs														
Social Security	429	452	474	494	516	542	571	602	637	675	717	762	2,596	5,989
Medicare	238	253	263	273	292	306	331	357	384	412	446	474	1,465	3,538
Subtotal	667	705	737	767	807	848	902	958	1,021	1,088	1,163	1,236	4,061	9,527
Other Retirement and Disability														
Federal civilian[b]	53	56	59	62	65	68	71	75	78	82	86	90	326	737
Military	34	35	36	37	38	39	40	41	42	43	44	44	189	402
Other	5	6	6	6	6	6	6	6	6	7	7	7	30	63
Subtotal	93	97	101	105	109	113	118	122	126	132	136	141	545	1,202
Unemployment Compensation	28	51	50	43	39	40	42	44	45	47	49	51	214	450
Other Programs														
Veterans' benefits[c]	20	25	28	29	32	31	30	33	34	35	38	34	150	324
Department of Defense health care	0	0	6	7	7	8	8	9	10	10	11	12	36	89
Commodity Credit Corporation Fund	22	15	19	18	17	15	14	12	11	11	10	10	84	137
Social services	5	5	5	5	5	5	5	5	5	5	5	5	24	48
Universal Service Fund	5	5	6	6	6	6	6	7	7	7	7	7	31	65
Other	13	16	12	11	10	11	11	12	13	14	14	15	56	123
Subtotal	65	66	75	75	78	77	75	77	79	81	86	83	380	787
Total, Non-Means-Tested	**853**	**918**	**964**	**990**	**1,033**	**1,078**	**1,136**	**1,201**	**1,271**	**1,348**	**1,434**	**1,512**	**5,201**	**11,966**
Offsetting Receipts														
Offsetting Receipts	**-93**	**-91**	**-103**	**-104**	**-120**	**-123**	**-123**	**-128**	**-134**	**-142**	**-150**	**-158**	**-572**	**-1,284**
Total														
Mandatory Spending	**1,008**	**1,113**	**1,161**	**1,200**	**1,248**	**1,309**	**1,386**	**1,471**	**1,560**	**1,657**	**1,771**	**1,853**	**6,305**	**14,616**
Memorandum:														
Mandatory Spending Excluding Offsetting Receipts	1,101	1,205	1,264	1,305	1,368	1,432	1,509	1,599	1,694	1,798	1,921	2,011	6,877	15,900

Source: Congressional Budget Office.

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

a. 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.

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

c. Includes veterans' compensation, readjustment benefits, life insurance, and housing programs.

Table 1-5.

CBO's Baseline Projections of Federal Interest and Debt

(In billions of dollars)

	Actual 2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total, 2003-2007	Total, 2003-2012
Net Interest Outlays														
Interest on the Public Debt (Gross interest)[a]	360	331	326	367	402	425	443	461	478	493	506	513	1,963	4,415
Interest Received by Trust Funds														
Social Security	-69	-77	-85	-93	-104	-116	-129	-143	-158	-175	-192	-211	-526	-1,404
Other trust funds[b]	-75	-75	-68	-71	-75	-79	-84	-88	-93	-98	-103	-109	-377	-868
Subtotal	-144	-153	-153	-164	-179	-195	-212	-231	-251	-273	-295	-319	-903	-2,272
Other Interest[c]	-9	-8	-9	-12	-15	-16	-18	-20	-22	-25	-27	-30	-70	-195
Other Investment Income[d]	0	*	*	-1	-1	-1	-1	-1	-1	-1	-1	-1	-3	-7
Total (Net interest)	206	170	164	191	208	213	212	209	204	195	183	164	987	1,941
Federal Debt (At end of year)														
Debt Held by the Public	3,320	3,504	3,676	3,805	3,862	3,865	3,829	3,757	3,639	3,476	3,167	2,658	n.a.	n.a.
Debt Held by Government Accounts														
Social Security	1,170	1,330	1,500	1,688	1,894	2,118	2,360	2,622	2,902	3,201	3,520	3,857	n.a.	n.a.
Other government accounts[b]	1,280	1,324	1,384	1,479	1,590	1,713	1,842	1,976	2,113	2,255	2,403	2,563	n.a.	n.a.
Total	2,450	2,654	2,884	3,167	3,484	3,830	4,202	4,598	5,015	5,457	5,924	6,419	n.a.	n.a.
Gross Federal Debt	5,770	6,157	6,560	6,972	7,346	7,695	8,031	8,354	8,654	8,933	9,090	9,077	n.a.	n.a.
Debt Subject to Limit[e]	5,733	6,120	6,528	6,944	7,324	7,673	8,010	8,333	8,633	8,913	9,070	9,058	n.a.	n.a.
Federal Debt as a Percentage of GDP														
Debt Held by the Public	33.1	33.9	34.1	33.5	32.4	30.8	28.9	26.9	24.8	22.5	19.4	15.5	n.a.	n.a.

Source: Congressional Budget Office.

Note: * = between -$500 million and zero; n.a. = not applicable.

a. Excludes interest costs of debt issued by agencies other than the Treasury (primarily the Tennessee Valley Authority).
b. Principally Civil Service Retirement, Military Retirement, Medicare, and Unemployment Insurance.
c. Primarily interest on loans to the public.
d. Earnings on private investments by the Railroad Retirement Board.
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 $6,400 billion.

thority, goes to the Department of Defense (DoD) to prosecute the war against terrorism and support other defense operations. Major recipients of the law's non-defense funding include the Transportation Security Administration, the Federal Emergency Management Agency, foreign aid programs, and federal transit grants.

CBO estimates that about $6 billion of the funding provided by P.L. 107-206 will be spent in 2002; the rest will be spent over the next few years. Of the $6 billion that will be spent this year, about $5 billion stems from appropriations to DoD.

Under the rules of the Deficit Control Act, CBO's baseline projections must assume that annual appropriations for discretionary programs continue at the current level, with increases each year for the projected rates of inflation. As a result, enactment of P.L. 107-206 causes discretionary outlays in CBO's baseline to increase by a total of $268 billion from 2003 through 2012.

Table 1-6.

Changes in CBO's Baseline Projections of the Surplus Since March 2002

(In billions of dollars)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total, 2003-2007	Total, 2003-2012
Total Surplus as Projected in March 2002	5	6	61	111	135	175	213	263	309	454	653	489	2,380
Changes to Revenue Projections													
Legislative	-43	-40	-30	-4	15	16	16	13	10	7	4	-43	7
Economic	*	-22	-35	-32	-20	-10	1	10	20	31	41	-119	-16
Technical	-104	-61	-61	-62	-61	-62	-66	-72	-74	-74	-75	-307	-668
Total Revenue Changes	**-146**	**-124**	**-126**	**-98**	**-66**	**-56**	**-50**	**-49**	**-45**	**-36**	**-30**	**-469**	**-678**
Changes to Outlay Projections													
Legislative													
Discretionary	6	23	23	25	26	27	28	28	29	30	30	123	268
Mandatory													
Farm bill	2	8	10	10	10	9	8	8	8	7	7	48	86
Trade act	*	*	1	1	1	1	1	1	1	1	1	3	6
Stimulus package	8	4	*	*	*	*	*	*	*	*	*	4	3
Spectrum auctions	0	3	*	1	-2	-2	0	0	0	0	0	-1	-1
Debt service	*	3	8	12	14	16	18	21	23	26	29	54	171
Other	*	*	*	*	*	*	*	*	*	*	*	*	*
Subtotal, mandatory	10	18	19	23	23	24	27	29	31	34	37	107	265
Subtotal, legislative	16	40	42	48	49	51	55	58	60	64	67	230	534
Economic													
Discretionary	*	-2	-4	-5	-4	-4	-3	-3	-2	-1	1	-19	-28
Mandatory													
Social Security	0	-1	-3	-4	-5	-6	-7	-8	-10	-11	-12	-18	-66
Unemployment insurance	-5	-4	*	-1	*	*	*	*	*	*	*	-5	-6
Net interest	1	-15	-12	-5	-1	*	*	*	*	*	*	-33	-34
Debt service	*	*	*	1	2	2	2	1	-1	-3	-5	5	-1
Other	*	-1	-1	-1	-1	-1	-1	-1	*	*	1	-4	-6
Subtotal, mandatory	-4	-21	-15	-9	-5	-6	-7	-9	-11	-14	-17	-55	-113
Subtotal, economic	-5	-23	-19	-13	-9	-10	-11	-12	-14	-14	-16	-74	-141
Technical													
Discretionary	-4	1	*	1	1	1	1	1	1	1	1	3	9
Mandatory													
Medicare	5	2	-1	-2	-3	-4	-5	-6	-7	-8	-10	-8	-43
Debt service	1	10	15	14	16	21	29	36	41	48	55	77	286
Other	3	-3	9	5	1	8	5	5	5	5	4	20	43
Subtotal, mandatory	8	10	24	17	14	25	30	35	39	44	49	90	286
Subtotal, technical	4	11	24	18	15	26	31	36	40	45	50	93	295
Total Outlay Changes	**16**	**28**	**47**	**52**	**54**	**68**	**75**	**81**	**87**	**95**	**102**	**249**	**688**
Total Impact on the Surplus	**-162**	**-151**	**-173**	**-150**	**-120**	**-123**	**-124**	**-130**	**-132**	**-131**	**-131**	**-718**	**-1,366**
Total Surplus or Deficit (-) as Projected in August 2002	-157	-145	-111	-39	15	52	88	133	177	323	522	-229	1,015
Memorandum:													
Total Legislative Changes	-59	-80	-71	-53	-34	-35	-39	-44	-51	-57	-63	-273	-527
Total Economic Changes	5	1	-16	-18	-11	*	12	22	33	45	57	-45	125
Total Technical Changes	-108	-72	-85	-79	-76	-88	-97	-108	-114	-119	-125	-400	-964

Source: Congressional Budget Office.

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

The new farm law—the Farm Security and Rural Investment Act of 2002 (P.L. 107-171)—will increase mandatory outlays by about $2 billion this year and $86 billion over the 2003-2012 period, CBO estimates. The law amends and extends major programs of the Department of Agriculture that deal with farm income support, land conservation, food assistance, trade promotion, rural development, research, forestry, and energy.[7]

The Trade Act of 2002 establishes procedures under which trade agreements are considered by the Congress on a parliamentary fast track, which bans amendments and allows only an up-or-down vote. The law also extends cash benefits and training to new categories of workers displaced because of imports, expands the length of unemployment coverage, and provides a refundable tax credit covering 65 percent of the cost of health insurance (55 percent for people receiving payments from the Pension Benefit Guaranty Corporation). CBO estimates that the law will add about $1 billion a year to outlays from 2004 through 2012.

The Job Creation and Worker Assistance Act will raise outlays by $8 billion in 2002 and $4 billion in 2003, CBO estimates, mostly for temporary emergency assistance to people whose regular unemployment benefits have run out. The law grants long-term unemployed workers up to 13 weeks of emergency compensation regardless of their state's unemployment rate. In some states with especially high unemployment rates, those workers could receive an additional 13 weeks of benefits.

The 2002 Auction Reform Act (P.L. 107-195) repealed most of the statutory deadlines for the Federal Communications Commission to auction licenses for use of the electromagnetic spectrum. Although the law is expected to have little net effect over the 2003-2012 period (increasing offsetting receipts by less than $1 billion), CBO estimates that it will change the timing and amount of offsetting receipts likely to be collected over the next five years. Relative to the March baseline, auction proceeds are now projected to be lower during the 2003-2005 period but higher in 2006 and 2007.

In all, the legislation enacted since CBO's previous baseline will reduce projected surpluses by $59 billion this year and by a total of $356 billion over the 2003-2012 period (excluding effects on debt service). Those changes will necessitate more government borrowing throughout the 10-year period, so outstanding debt will be higher than it otherwise would have been. As a result, CBO estimates, added interest payments on federal debt because of the recent legislative changes will be small in 2002 but will total $171 billion over the 2003-2012 period—bringing the total impact of legislation enacted since the end of February to $527 billion over those 10 years.

The Effects of Economic Changes

Changes in the economy since March have prompted CBO to revise its economic outlook, lowering its forecast for inflation, unemployment, and short-term interest rates and raising its projection for growth of nominal income (income not adjusted for inflation) after 2005. (For a detailed discussion of CBO's new economic forecast, see Chapter 2.) Those changes affect projections of both revenues and outlays. Unlike legislative and technical changes, economic revisions to the baseline brighten the budget picture—reducing this year's deficit by $5 billion and increasing the projected surplus for the 2003-2012 period by $125 billion (*see Table 1-6)*.

Revenues. Changes in the economic outlook have a negligible effect on the revenue projection for 2002 and decrease projected revenues for the 2003-2012 period by $16 billion. That relatively small reduction over 10 years, however, includes more-substantial changes in certain years.

The new economic forecast implies lower revenues from 2003 through 2007 than CBO projected last March but higher revenues beginning in 2008. Slower projected growth of nominal income in 2003 through 2005 reduces revenue projections for those years: by $22 billion, $35 billion, and $32 billion, respectively. Thereafter, nominal income is projected to grow faster than previously anticipated. As a result, the revenue reductions

7. For most programs, the law covers fiscal years 2002 through 2007. For many of those programs, however, the baseline includes costs through 2012, as required by the Deficit Control Act.

shrink for 2006 and 2007 and, by 2008, give way to increases in projected revenues, which grow to $41 billion by 2012.

Outlays. Changes in the outlook for such economic variables as inflation, unemployment, and interest rates lower CBO's 10-year spending projection by $141 billion. One-fifth of that decrease involves discretionary spending; most of the effect is on mandatory programs.

For projecting discretionary spending, the Deficit Control Act specifies the measures of inflation to be used: the GDP deflator and the ECI for wages and salaries. Thus, projections of discretionary spending are highly sensitive to assumptions about the future values of those measures. CBO's current projections for the GDP deflator are slightly lower each year than they were in March. In addition, its projections for the growth rate of the ECI are 0.9 percentage points lower for 2003 and 0.2 percentage points lower for 2004; after that, the ECI is projected to grow slightly faster than in the previous forecast. Those changes in projected inflation rates reduce discretionary outlays in the new baseline by $2 billion to $5 billion per year through 2010 and by lesser amounts thereafter—for a total reduction of $28 billion over 10 years.

Unlike discretionary spending, mandatory outlays in CBO's baseline are determined by provisions of permanent law enacted up to the time the projection is made. Changes in CBO's economic forecast reduce projections of mandatory spending by a total of $113 billion for the 2003-2012 period. Social Security and unemployment insurance are the two mandatory programs most affected by the revised economic forecast.

CBO's projection for Social Security spending over the 2003-2012 period is $66 billion lower than in the March baseline (out of a total projected cost for the program of nearly $6 trillion over those 10 years). The largest factor contributing to the change is a decrease in CBO's forecast for the growth of wages, which reduces the projected growth of Social Security benefits for future recipients. In addition, lower projections for inflation reduce CBO's estimates of the cost-of-living adjustment (COLA) made to Social Security benefits each year. Compared with those in the March baseline, COLAs are now expected to be smaller in 2003 and 2004, decreasing total Social Security payments by an estimated $1.4 billion in 2003 and $2.2 billion in 2004.

Other, much smaller income-security programs receive mandated cost-of-living adjustments and are similarly affected by CBO's revised forecast for inflation. They include Railroad, Civil Service, and Military Retirement; Supplemental Security Income; and veterans' compensation and pensions.

COLAs are not the only federal payments affected by the economy; payments of unemployment compensation are linked to the unemployment rate. CBO has lowered its forecast of the unemployment rate for 2002 from 6.0 percent to 5.8 percent and raised its forecast of the unemployment rate for 2004 from 5.4 percent to 5.6 percent. (The rates projected for 2003 and the years beyond 2004 are the same as in CBO's previous forecast.) On net, those revisions reduce projected payments of unemployment benefits by $5 billion this year, by $4 billion in 2003, and by small amounts thereafter.

Lower projections for short-term interest rates drive projected net interest payments below the levels in the March baseline. CBO has reduced its forecast of the interest rate on three-month Treasury bills in 2003 from 4.0 percent to 2.4 percent. The forecast for next year's rate on 10-year Treasury notes has decreased by a much smaller amount, from 5.3 percent to 5.2 percent. Those changes reduce the projection for federal net interest costs by $15 billion for 2003 and $12 billion for 2004. (By middecade, CBO's projections for interest rates return to their previous long-term level—4.9 percent for three-month bills and 5.8 percent for 10-year notes.)

Overall, revisions to CBO's economic forecast lower projected revenues by $16 billion over the decade but reduce outlays by $140 billion (excluding debt service), thus raising projected surpluses. However, because those revisions reduce surpluses in the near term and increase them in later years, the net impact on debt service over the 10-year period is very small.

The Effects of Technical Changes

Technical changes represent all other modifications to the baseline not directly related to enacted legislation or to revisions in the variables in CBO's economic forecast. About $108 billion of the $162 billion drop in 2002 is driven by technical changes, almost all of them to the revenue projections (*see Table 1-6)*. For the succeeding 10 years, technical reestimates lower the total projected surplus by $964 billion, of which close to 70 percent represents changes in revenue projections.

Revenues. Nearly all of the cumulative change to CBO's revenue projections since March involves technical revisions. Those changes reduce projected revenues by $104 billion this year and by $668 billion over the 2003-2012 period. The revisions are largely prompted by recent information on total tax collections.

So far this year, receipts from both individual and corporate income taxes have been lower than CBO projected in March. Total income appears to be growing at the expected rate, although from a lower base, so revisions to CBO's revenue projection for this year cannot be classified as economic reestimates. Instead, the sharp downward revision for 2002 that is not attributable to recent legislation—just over $100 billion—represents technical reestimates. Information about the sources of individual income responsible for this year's weakness in tax receipts will not become available until later in the year.

Although detailed data are lacking, CBO believes that some of the decline in both individual and corporate income tax receipts this year is likely to prove temporary. An analysis of individual tax receipts suggests that taxpayers paid an unusually large percentage of their 2001 tax liabilities in withholding and estimated payments, meaning that less was paid in 2002 when taxpayers filed their returns.[8] One reason is that taxpayers may have set their 2001 withholding and estimated payments at a level consistent with the higher bonuses and capital gains realizations they experienced in previous years. Thus, by year's end, their payments proved to be too high when bonuses and capital gains turned out to be smaller than in previous years. In addition, to the extent that weakness in earnings occurred unevenly throughout the year, taxpayers may have paid withholding at a higher marginal rate than would have been the case if their earnings had been steady during the year. In either case, tax receipts would have been lower in 2001 and higher in 2002 had that unusual payment pattern not occurred.

Part of CBO's downward technical reestimate to projected individual receipts for 2002—roughly $25 billion—reflects that phenomenon. CBO expects withholding and estimated tax payments to return to a more normal pattern for tax years 2002 and beyond, making that $25 billion of weakness in this year's receipts temporary. In addition, about $10 billion of CBO's $30 billion downward technical reestimate to 2002 corporate receipts is considered a one-time event, resulting from recent court cases and from the tax cuts in the economic stimulus law. As a result, the downward technical reestimate to revenues for 2003 is smaller than the one for this year ($61 billion versus $104 billion).

Some of the decline in receipts in 2002 probably represents unexpectedly weak realizations of capital gains in calendar year 2001. Capital gains realizations are not part of national income or GDP, but individuals and corporations must pay taxes on them. Consequently, capital gains realizations can grow more rapidly or fall more precipitously than national income, resulting in changes in revenue that are proportionally greater or smaller than changes in overall economic activity. CBO's analysis indicates that rapid growth of capital gains realizations from 1995 to 1999 explained about 30 percent of the increase in individual income tax receipts as a share of GDP during those years, so capital gains realizations may be playing a major role in the decrease in receipts this year as well. Information about the amount of capital gains realizations for 2001 reported on tax returns will not be available until later this year.

Despite their volatility, capital gains are not big enough to plausibly explain all of the weakness in receipts this year. In its January and March 2002 baselines, CBO projected liabilities of $100 billion from capital gains

8. For more information about changes in revenues since 2001, see Congressional Budget Office, *Where Did the Revenues Go?* CBO Revenue and Tax Policy Brief (August 13, 2002).

Table 1-7.

Comparison of CBO's August 2002 Baseline and OMB's July 2002 Current-Services Estimates

(In billions of dollars)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total, 2003-2007	Total, 2003-2012
CBO's August 2002 Baseline													
Revenues	1,860	1,962	2,083	2,244	2,381	2,513	2,658	2,809	2,965	3,243	3,521	11,184	26,379
On-budget	1,345	1,422	1,516	1,649	1,756	1,855	1,966	2,081	2,199	2,438	2,675	8,198	19,556
Off-budget	515	540	567	595	626	658	692	728	766	805	846	2,986	6,823
Outlays													
Discretionary	733	782	803	827	845	864	889	912	936	965	983	4,121	8,807
Mandatory	1,113	1,161	1,200	1,248	1,309	1,386	1,471	1,560	1,657	1,771	1,853	6,305	14,616
Net interest	170	164	191	208	213	212	209	204	195	183	164	987	1,941
Total	2,017	2,107	2,195	2,283	2,366	2,461	2,569	2,676	2,788	2,920	2,999	11,413	25,364
On-budget	1,659	1,737	1,815	1,895	1,964	2,046	2,139	2,228	2,321	2,433	2,489	9,457	21,068
Off-budget	358	370	379	388	402	416	430	447	467	486	510	1,955	4,296
Surplus or Deficit (-)	**-157**	**-145**	**-111**	**-39**	**15**	**52**	**88**	**133**	**177**	**323**	**522**	**-229**	**1,015**
On-budget	-314	-315	-299	-246	-209	-190	-173	-147	-122	4	185	-1,259	-1,513
Off-budget	157	170	188	207	224	242	262	280	299	319	337	1,031	2,527
OMB's July 2002 Current-Services Estimates													
Revenues	1,868	2,035	2,180	2,369	2,475	2,595	2,727	2,865	3,011	3,256	3,505	11,653	27,017
On-budget	1,353	1,495	1,611	1,761	1,837	1,924	2,025	2,129	2,235	2,441	2,652	8,628	20,110
Off-budget	515	540	569	608	638	670	703	736	776	815	852	3,025	6,907
Outlays													
Discretionary	733	759	783	802	817	833	855	875	896	921	936	3,995	8,477
Mandatory	1,114	1,168	1,203	1,258	1,320	1,388	1,471	1,557	1,652	1,761	1,832	6,336	14,609
Net interest	171	179	193	192	187	180	171	159	146	130	107	931	1,644
Total	2,018	2,106	2,179	2,253	2,324	2,401	2,496	2,591	2,694	2,812	2,875	11,262	24,730
On-budget	1,661	1,739	1,799	1,863	1,923	1,985	2,065	2,141	2,222	2,319	2,357	9,309	20,413
Off-budget	358	367	380	389	401	415	431	450	472	493	518	1,953	4,317
Surplus or Deficit (-)	**-150**	**-71**	**1**	**117**	**151**	**194**	**231**	**273**	**317**	**444**	**630**	**392**	**2,286**
On-budget	-308	-244	-187	-102	-86	-61	-41	-12	13	122	296	-681	-303
Off-budget	157	173	189	219	237	255	272	286	304	322	334	1,072	2,590

(Continued)

realizations in tax year 2001. Those projections already incorporated a 20 percent drop in realizations from the 2000 level, largely because of the fall in the stock market. Analysts now know that the distribution of capital gains from mutual funds fell steeply in 2001—reportedly by about 80 percent. However, total gains realizations differ from mutual fund gains. Although stocks are the principal component of mutual funds, they account for only half of taxable capital gains, with the rest coming from other capital assets, such as real estate. Consequently, total gains probably fell less than gains from mutual funds did.

Beyond 2002, CBO's March forecast reflected a further gradual decline in capital gains realizations, anticipating that they would revert to their long-term relationship with GDP. Since CBO has not changed its view of that long-term relationship, a decline in revenues because of lower capital gains realizations in the short run will diminish over the course of the projection period.

Table 1-7.

Continued

(In billions of dollars)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total, 2003-2007	Total, 2003-2012
						Difference (CBO minus OMB)							
Revenues	-8	-72	-97	-126	-93	-81	-70	-56	-46	-13	16	-469	-638
On-budget	-8	-72	-95	-112	-81	-69	-59	-48	-36	-3	22	-430	-554
Off-budget	*	*	-2	-13	-12	-12	-11	-8	-10	-10	-6	-39	-84
Outlays													
Discretionary	-1	23	20	24	28	31	35	37	40	44	47	126	329
Mandatory	*	-7	-3	-9	-11	-2	*	3	5	10	21	-32	7
Net interest	-1	-15	-2	16	25	32	38	44	49	54	56	56	298
Total	-2	2	16	31	43	61	73	84	94	108	124	151	634
On-budget	-2	-2	17	32	42	60	74	87	99	115	133	148	655
Off-budget	*	3	-1	-1	1	*	-1	-3	-5	-7	-9	3	-21
Surplus or Deficit	**-7**	**-74**	**-113**	**-156**	**-136**	**-142**	**-143**	**-140**	**-140**	**-121**	**-108**	**-620**	**-1,272**
On-budget	-6	-71	-112	-144	-123	-129	-133	-135	-135	-118	-111	-578	-1,209
Off-budget	*	-3	-1	-12	-13	-13	-10	-5	-5	-3	3	-42	-63

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

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

Other factors may help explain this year's drop in revenues and may also affect revenues in the future. It is possible that the income reported by individual and corporate taxpayers on their tax returns for 2001 and the income earned during the first half of this year may turn out to be lower than what is currently reflected in the national income and product accounts (despite the recent revisions to those accounts). That difference could explain part of the unexpected weakness in revenues in 2002. In addition, if income grows at the same pace as in CBO's forecast but starts from a lower level, it will produce a similar decline in receipts in future years.

A full understanding of the weakness in this year's receipts requires data from tax returns, which are not processed until after the receipts are counted. Many individual returns—especially those of high-income taxpayers, who pay much of the revenue—are not filed until later in the year because of filing extensions. A complete picture of the income on which people pay taxes, therefore, is often not available for more than a year after the tax year ends. Nevertheless, given the likelihood that a large part of the revenue weakness in 2002 will turn out to be from sources that CBO considers permanent, CBO has reduced its revenue projections for technical reasons by $60 billion to $75 billion each year from 2003 through 2012.

Outlays. The single largest technical revision to projected outlays—an upward reestimate of $286 billion over 10 years—reflects additional debt-service costs, mostly stemming from the technical changes that reduce projected revenues. Other technical revisions to CBO's spending projections largely offset each other, leaving a net reestimate of a similar amount ($295 billion for the 2003-2012 period).

For discretionary spending, the largest technical changes apply to the current fiscal year. Those revisions, which chiefly reflect new information about spending so far this year, decrease projected discretionary outlays by nearly $4 billion in 2002. For the 2003-2012 period, other technical adjustments raise projected discretionary spending by a total of $9 billion.

Although the revisions for 2002 affect nearly all budget functions, the largest involves defense outlays, which are now projected to be about $4 billion lower than CBO previously estimated (excluding additional spending from the supplemental appropriations). This year, spending has grown more slowly than anticipated for a number of defense programs—primarily military medical care and other operation and maintenance activities. Outlays for defense procurement and military pay have been higher than expected, but those increases are partly offset by lower-than-expected spending for research programs and military construction.

In the mandatory category, CBO has increased its estimate of Medicare outlays this year by $4.5 billion because of higher-than-anticipated spending since February. For the following 10 years, however, CBO has reduced its projections of Medicare spending by a total of $43 billion. Specifically, it has lowered the spending projections for home health care and skilled nursing facilities because of updated analyses of the relationship between the use of post-acute-care services and the incidence of disabilities and hospitalizations among Medicare enrollees. That reduction is partly offset by a net increase in CBO's projection for physician payments over 10 years, which reflects a recently announced change in the method for adjusting components of the Medicare economic index for increases in productivity. Over the 2003-2012 period, such revisions to Medicare are offset by projected increases in spending for other mandatory programs.

CBO's Baseline Compared with OMB's Current-Services Estimates

The Administration's Office of Management and Budget (OMB) published its annual *Mid-Session Review* of the President's budget on July 15. In that report, OMB updated its baseline budget projections (also known as current-services estimates) and its economic assumptions for 2003 through 2012. Because its estimates were prepared before CBO's, they do not reflect the precipitous drop in the stock market, the Bureau of Economic Analysis's revisions of economic data for the past three years, or the recently enacted supplemental appropriation law, P.L. 107-206.

The two agencies' baseline budget projections are similar for this year but diverge, sometimes significantly, for the succeeding 10 years (*see Table 1-7 on page 16)*. Both OMB and CBO estimate a deficit for 2002—OMB projects a figure of $150 billion, close to CBO's estimate of $157 billion. (Almost all of the difference is attributable to the supplemental appropriation law.) After that, OMB projects a deficit of $71 billion for 2003 and a tiny surplus ($1 billion) for 2004, whereas CBO's baseline projections do not show a surplus until 2006. For the 10-year period, OMB projects a cumulative surplus of $2.3 trillion, compared with CBO's projection of $1.0 trillion.

Revenues over the 2003-2012 period are $638 billion higher in OMB's baseline than in CBO's, a difference of 2.4 percent. The bulk of the difference—all but roughly $50 billion—results from differences in the two agencies' economic projections. In particular, CBO projects slower growth of GDP and its major income component, wage and salary disbursements, through 2005.

On the spending side, CBO projects $634 billion more in outlays over 10 years than the Administration does, a difference of 2.6 percent. However, enactment of P.L. 107-206 between the time that OMB prepared its current-services estimates and CBO produced its new baseline accounts for much of the difference in projections of discretionary spending. Adjusted for that law, CBO's projection of discretionary outlays is not much higher than OMB's over the 2003-2012 period.

For mandatory spending programs, CBO projects $7 billion more in outlays over 10 years than the Administration does, or just 0.05 percent. However, that small difference masks some larger variation for specific programs. For example, CBO is projecting $121 billion more in spending for Medicare over the 10-year period than the Administration estimates; but its projection of spending for Medicaid over 10 years is $85 billion lower than the Administration's.

The combination of lower revenues and higher spending in CBO's baseline produces larger projections of federal debt. That difference is the main reason that projected net interest costs over the 2003-2012 period are $298 billion higher in CBO's baseline than in OMB's.

The Long-Term Outlook

Although the budget outlook has deteriorated since March, CBO still projects that surpluses would return within the next several years if current policies remained the same. The outlook for the economy over the coming decade is favorable—with real economic growth of more than 3 percent a year, on average, declining unemployment, and stable prices.

The longer term, however, remains problematic. Without changes to federal programs for the elderly, the aging of the baby-boom generation will cause a historic change in the United States' fiscal position. The demographics are inexorable: the number of people of retirement age will nearly double over the next 30 years (from 36 million to almost 69 million), while the number of workers will grow by only 15 percent. Little can be done to change that phenomenon. All of those future retirees are alive today, as are most of the people who will be working then. Only a change in immigration policy can drastically alter the U.S. workforce over the next 30 years. In addition to those demographic factors, costs per enrollee in federal health care programs are likely to grow much faster than inflation.

As a result, the amount that the government spends on its major health and retirement programs (Medicare, Medicaid, and Social Security) is projected to consume a substantial portion of what the government now spends on the entire budget. Consequently, either taxes on the next generation of workers will need to rise dramatically, spending on other federal programs will have to be cut severely, or federal borrowing will soar (although capital may be scarce because other countries are likely to face similar or even worse budget problems because of their own demographic changes).

Beyond 2030, those pressures will intensify as longevity continues to increase and health costs continue to grow. Simply weathering the baby-boom surge would not be enough to restore federal fiscal policy to its recent norms. Only reforming programs for the elderly before the baby boomers retire and enacting policies to enhance economic growth could mitigate the demands on future generations.