CHAPTER

1

The Budget Outlook

The Congressional Budget Office (CBO) projects that under current policies, the federal deficit will total $477 billion in fiscal year 2004 and then decline to $362 billion in 2005 *(see Table 1-1)*. Although that 2004 deficit would be a record in nominal dollars, it would represent a smaller share of the economy—4.2 percent of gross domestic product (GDP)—than the deficits recorded in the mid-1980s and early 1990s *(see Figure 1-1)*. For the 10 years from 2005 through 2014, CBO projects that current policies would produce a cumulative deficit of $1.9 trillion, or 1.3 percent of total GDP over that period.

Because those baseline projections are predicated on the assumption that present laws and policies remain unchanged, they are not intended to be a prediction of future budgetary outcomes. Rather, CBO's baseline provides a neutral benchmark that lawmakers can use to measure the effects of proposed changes to taxes and spending.

In the current baseline, total outlays are projected to grow at an average rate of 4.7 percent a year and remain near 20 percent of GDP through 2014 *(see Table 1-2)*. Within that total, spending for entitlements and other mandatory programs is projected to grow by 5.5 percent annually (faster than the economy as a whole). By contrast, discretionary spending is assumed to keep pace with inflation and wage growth, as the rules that govern the baseline require. Thus, discretionary spending is projected to increase by only 2.5 percent per year (about half the projected growth rate of the economy).

Table 1-1.

Projected Deficits and Surpluses in CBO's Baseline

(Billions of dollars)

	Actual 2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Total, 2005-2009	Total, 2005-2014
On-Budget Deficit	-536	-631	-535	-464	-477	-504	-507	-511	-421	-299	-294	-277	-2,487	-4,288
Off-Budget Surplus[a]	161	154	174	195	211	226	239	249	259	275	278	290	1,045	2,395
Total Deficit (-) or Surplus	-375	-477	-362	-269	-267	-278	-268	-261	-162	-24	-16	13	-1,443	-1,893
Memorandum:														
Social Security Surplus	156	152	172	192	208	223	235	245	255	270	273	284	1,030	2,357
Postal Service Outlays	-5	-3	-2	-3	-3	-3	-4	-4	-4	-5	-5	-5	-15	-38
Total Deficit (-) or Surplus as a Percentage of GDP	-3.5	-4.2	-3.0	-2.1	-2.0	-2.0	-1.8	-1.7	-1.0	-0.1	-0.1	0.1	-2.2	-1.3

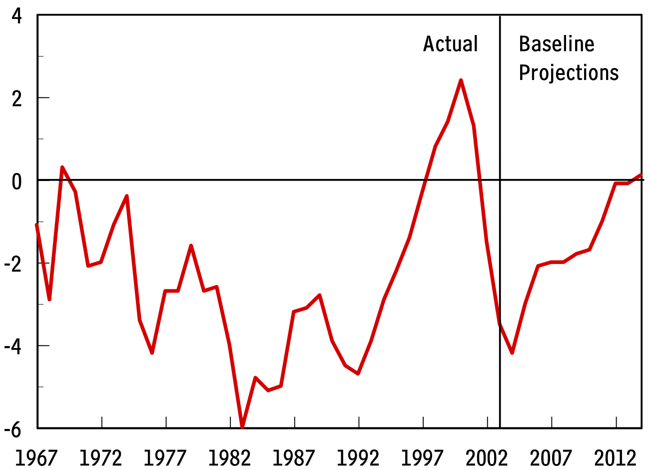
Source: Congressional Budget Office.

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

Figure 1-1.

The Total Deficit or Surplus as a Share of GDP, 1967 to 2014

(Percentage of GDP)



Source: Congressional Budget Office.

Revenues are projected to grow from 15.8 percent of GDP this year to 16.9 percent in 2005 as the economy continues to improve. From 2006 through 2010, they are expected to account for about 18 percent of GDP. After that, revenues are projected to rise as the major provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) expire. In CBO's baseline, revenues reach 20.1 percent of GDP in 2014.[1]

Federal debt held by the public will equal 38 percent of GDP at the end of this fiscal year, CBO projects. In the baseline, such debt stabilizes at about 40 percent of GDP through 2011, at which point the government's diminished need for borrowing causes debt held by the public to shrink as a share of GDP *(see Figure 1-2).*

Although the baseline projections cannot incorporate anticipated policy changes, this chapter shows the budgetary implications of some alternative policy assumptions over the next 10 years. For example, if the spending funded by the $87 billion supplemental appropriation law enacted in November 2003—mostly for military and reconstruction activities in Iraq—were not assumed to continue each year throughout the projection period, the projected 10-year deficit would shrink from $1.9 trillion to $785 billion. Debt held by the public at the end of 2014 would drop from 35 percent of GDP to 29 percent.

Alternatively, if all of the tax provisions that are set to expire over the next 10 years (except some related to the alternative minimum tax) were extended, the budget outlook for 2014 would change from a surplus of $13 billion to a deficit of $443 billion. Debt held by the public at the end of that year would climb to 48 percent of GDP, and the 10-year deficit would total $4.1 trillion.

Since August 2003, when CBO published its previous projections, revisions to the baseline have added nearly $1 trillion to the cumulative deficit for the 2004-2013 period (the 10 years covered by the earlier baseline).[2] About 70 percent of that increase, or $681 billion, comes from legislation enacted since August—primarily the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (Public Law 108-173), which is estimated to boost outlays by almost $400 billion over those 10 years.[3] Revisions that spring from changes in CBO's economic forecast account for another $171 billion of the rise in projected deficits from 2004 through 2013, with the bulk of that increase coming from reductions in CBO's forecast for various measures of inflation. Those reductions lower both projected revenues and spending, but because such changes largely offset each other, they produce only slightly greater deficits (or smaller surpluses). Other, technical revisions—mostly on the revenue side of the budget—boost the cumulative deficit for that 10-year period by a further $134 billion.

Over the longer term, the federal budget will face significant strains, which will begin within the current 10-year projection period and intensify as more of the baby-boom generation reaches retirement age.[4] The annual growth rate of Social Security spending is expected to rise from around 4.6 percent in 2004 to 6.3 percent by 2014. Medicare and Medicaid spending are both projected to increase by 8 percent to 9 percent a year toward the end

1. The expiration of EGTRRA is estimated to reduce economic growth slightly after 2010, an effect that is incorporated in CBO's economic projections (which are presented in *Chapter 2*).

2. The previous projections were published in Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2003).

3. The estimate for P.L. 108-173 excludes the cost of paying interest on any additional federal debt that results from the higher spending.

4. For an extensive discussion of the pressures facing the budget over the next 50 years, see Congressional Budget Office, *The Long-Term Budget Outlook* (December 2003).

Table 1-2.

CBO's Baseline Budget Projections

	Actual 2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Total, 2005-2009	Total, 2005-2014
In Billions of Dollars														
Revenues														
Individual income taxes	794	762	885	997	1,074	1,146	1,237	1,335	1,528	1,684	1,786	1,903	5,339	13,576
Corporate income taxes	132	161	224	264	273	275	276	278	287	297	307	320	1,312	2,801
Social insurance taxes	713	747	789	830	868	906	946	988	1,031	1,076	1,123	1,173	4,340	9,732
Other	144	147	151	164	170	178	185	184	190	215	224	234	848	1,895
Total	1,782	1,817	2,049	2,256	2,385	2,506	2,644	2,786	3,036	3,272	3,441	3,629	11,840	28,004
On-budget	1,258	1,273	1,477	1,655	1,756	1,847	1,954	2,065	2,283	2,486	2,620	2,771	8,688	20,913
Off-budget	524	545	572	601	629	659	690	721	753	786	821	858	3,152	7,091
Outlays														
Discretionary spending	826	896	936	955	972	998	1,021	1,045	1,075	1,091	1,122	1,149	4,882	10,363
Mandatory spending	1,179	1,242	1,295	1,350	1,424	1,504	1,591	1,687	1,796	1,872	2,000	2,129	7,165	16,647
Net interest	153	156	180	219	255	281	300	316	328	334	335	338	1,235	2,886
Total	2,158	2,294	2,411	2,525	2,652	2,783	2,912	3,047	3,198	3,296	3,457	3,616	13,282	29,897
On-budget	1,795	1,904	2,012	2,118	2,233	2,350	2,461	2,575	2,704	2,785	2,914	3,048	11,175	25,201
Off-budget	363	391	399	406	419	433	451	472	494	512	543	568	2,107	4,696
Deficit (-) or Surplus	-375	-477	-362	-269	-267	-278	-268	-261	-162	-24	-16	13	-1,443	-1,893
On-budget	-536	-631	-535	-464	-477	-504	-507	-511	-421	-299	-294	-277	-2,487	-4,288
Off-budget	161	154	174	195	211	226	239	249	259	275	278	290	1,045	2,395
Debt Held by the Public	3,914	4,393	4,771	5,055	5,338	5,630	5,912	6,185	6,356	6,388	6,409	6,399	n.a.	n.a.
Memorandum:														
Gross Domestic Product	10,829	11,469	12,091	12,682	13,236	13,862	14,519	15,187	15,862	16,562	17,301	18,070	66,389	149,371
As a Percentage of GDP														
Revenues														
Individual income taxes	7.3	6.6	7.3	7.9	8.1	8.3	8.5	8.8	9.6	10.2	10.3	10.5	8.0	9.1
Corporate income taxes	1.2	1.4	1.8	2.1	2.1	2.0	1.9	1.8	1.8	1.8	1.8	1.8	2.0	1.9
Social insurance taxes	6.6	6.5	6.5	6.5	6.6	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5
Other	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.2	1.2	1.3	1.3	1.3	1.3	1.3
Total	16.5	15.8	16.9	17.8	18.0	18.1	18.2	18.3	19.1	19.8	19.9	20.1	17.8	18.7
On-budget	11.6	11.1	12.2	13.0	13.3	13.3	13.5	13.6	14.4	15.0	15.1	15.3	13.1	14.0
Off-budget	4.8	4.7	4.7	4.7	4.8	4.8	4.8	4.7	4.7	4.7	4.7	4.7	4.7	4.7
Outlays														
Discretionary spending	7.6	7.8	7.7	7.5	7.3	7.2	7.0	6.9	6.8	6.6	6.5	6.4	7.4	6.9
Mandatory spending	10.9	10.8	10.7	10.6	10.8	10.9	11.0	11.1	11.3	11.3	11.6	11.8	10.8	11.1
Net interest	1.4	1.4	1.5	1.7	1.9	2.0	2.1	2.1	2.1	2.0	1.9	1.9	1.9	1.9
Total	19.9	20.0	19.9	19.9	20.0	20.1	20.1	20.1	20.2	19.9	20.0	20.0	20.0	20.0
On-budget	16.6	16.6	16.6	16.7	16.9	17.0	17.0	17.0	17.0	16.8	16.8	16.9	16.8	16.9
Off-budget	3.4	3.4	3.3	3.2	3.2	3.1	3.1	3.1	3.1	3.1	3.1	3.1	3.2	3.1
Deficit (-) or Surplus	-3.5	-4.2	-3.0	-2.1	-2.0	-2.0	-1.8	-1.7	-1.0	-0.1	-0.1	0.1	-2.2	-1.3
On-budget	-5.0	-5.5	-4.4	-3.7	-3.6	-3.6	-3.5	-3.4	-2.7	-1.8	-1.7	-1.5	-3.7	-2.9
Off-budget	1.5	1.3	1.4	1.5	1.6	1.6	1.6	1.6	1.6	1.7	1.6	1.6	1.6	1.6
Debt Held by the Public	36.1	38.3	39.5	39.9	40.3	40.6	40.7	40.7	40.1	38.6	37.0	35.4	n.a.	n.a.

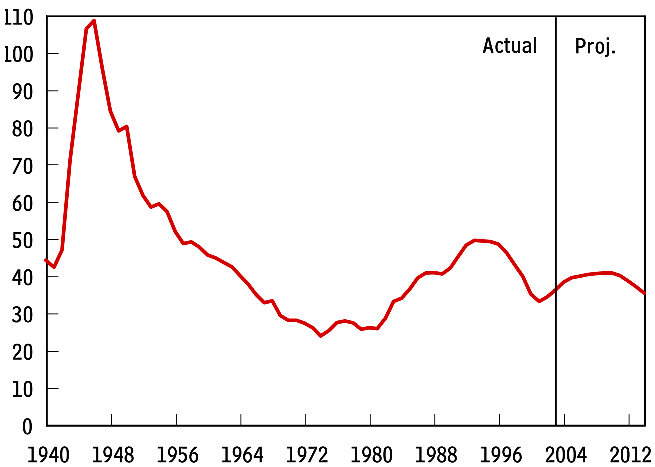
Source: Congressional Budget Office.

Note: n.a. = not applicable.

Figure 1-2.

Debt Held by the Public as a Share of GDP, 1940 to 2014

(Percentage of GDP)



Source: Congressional Budget Office.

of the projection period. Under baseline assumptions, those three entitlement programs together will account for nearly half of all federal outlays by 2014 (up from 40 percent this year).

After 2014, as the percentage of the population age 65 or older continues to increase (from 14 percent in 2014 to 19 percent in 2030), spending on those three programs will claim an even larger share of total outlays. Over the long term, increasing resource demands for major entitlement programs will exert pressure on the budget that economic growth alone is unlikely to alleviate.

A Review of 2003

The budget deficit more than doubled in 2003—growing to $375 billion from $158 billion in 2002. Although last year's deficit was smaller than those of the mid-1980s and early 1990s in relation to the size of the economy, it set a record in nominal dollar terms.

Outlays grew by over 7 percent ($147 billion) in 2003, to a total of almost $2.2 trillion. Excluding net interest, that growth rate was even higher: about 9 percent.[5] Outlays for defense rose by 16 percent ($56 billion) last year—with roughly half of that increase stemming from funds provided for the conflict in Iraq and continuing operations for the war on terrorism. Nondefense discretionary outlays grew by more than 9 percent ($35 billion). That rise was spread among numerous programs, with the largest increases found in transportation ($9 billion),[6] education ($8 billion), and health ($5 billion). In terms of mandatory programs, continued weakness in the job market and legislation that extended emergency benefits for the unemployed pushed up outlays for unemployment compensation by nearly 9 percent, to a record high of $55 billion. Spending on Medicaid also grew by almost 9 percent, reaching $161 billion. (For more information about recent and projected federal spending, see *Chapter 3*.)

While outlays continued to increase in 2003, revenues fell for the third consecutive year, by $71 billion. However, last year's decline (nearly 4 percent) was significantly smaller than the drop the year before (almost 7 percent). The decrease in revenues in 2003 stemmed mostly from weak income growth and changes in tax policies enacted since 2001.

Declines in two major revenue sources—taxes on individual and corporate income—exceeded the overall drop on a percentage basis. Revenues from individual income taxes were almost 8 percent lower in 2003 than in 2002, and corporate income tax receipts were nearly 11 percent lower. Receipts from social insurance (payroll) taxes, by contrast, grew by almost 2 percent. Other sources of revenue fell by roughly 1.5 percent. (Recent and projected revenues are described in more detail in *Chapter 4*.)

The Concept Behind CBO's Baseline Projections

The projections that make up CBO's baseline are not intended to be predictions of future budgetary outcomes but rather CBO's best judgment of how the economy and other factors would affect federal revenues and spending

5. Net interest comprises the government's interest payments on federal debt held by the public minus interest income that the government receives on loans and cash balances and earnings of the National Railroad Retirement Investment Trust.

6. That amount excludes the effects of a $2.75 billion intragovernmental transfer from the Federal Emergency Management Agency to the Department of Transportation.

under current laws and policies. CBO constructs its baseline according to rules set forth in law, mainly in the Balanced Budget and Emergency Deficit Control Act of 1985 and the Congressional Budget and Impoundment Control Act of 1974. (For further discussion of the federal budget process, *see Box 1-1 on page 8.*) In general, those laws instruct CBO and the Office of Management and Budget to project federal spending and revenues under current policies. Lawmakers can then use the baseline as a neutral benchmark against which to measure the effects of proposed changes in tax and spending policies.

For revenues and mandatory spending, the Deficit Control Act requires that the baseline be projected under the assumption that present laws continue without change.[7] In most cases, the laws that govern revenues and mandatory spending are permanent. The baseline projections reflect anticipated changes in the economy, demographics, and other relevant factors that affect the implementation of those laws.

The baseline rules differ for discretionary spending, which is governed by annual appropriation acts. The Deficit Control Act states that such spending should be projected by adjusting the current year's discretionary budget authority to reflect inflation—using specified indexes—and other factors (such as the cost of annualizing adjustments to federal pay). CBO's baseline for discretionary spending incorporates the omnibus appropriation act (H.R. 2673), which was signed by the President on January 23. That law covers appropriations for the Departments of Agriculture, Commerce, Justice, State, Labor, Health and Human Services, Education, Transportation, the Treasury, Veterans Affairs, and Housing and Urban Development, as well as for the District of Columbia, foreign operations, and a number of federal agencies.

7. Under the Deficit Control Act, baseline projections must assume that spending programs that are set to expire will continue if they have outlays of more than $50 million in the current year and were established at the same time as or before the enactment of the Balanced Budget Act of 1997. Programs established after that are not assumed in the baseline to continue automatically. Another requirement of the Deficit Control Act is that expiring excise taxes dedicated to a trust fund be extended at the current rates. However, the law does not provide for the extension of other expiring tax provisions, even if they have routinely been extended in the past.

Budget Projections Under Alternative Scenarios

Future legislation will undoubtedly alter the budget outlook in significant ways.[8] To illustrate the potential effects of different fiscal policies on the baseline, CBO has estimated the budgetary impact of some broad legislative options *(see Table 1-3).* The full impact of such options would also include their effect on debt-service costs (changes in projected interest payments resulting from changes in the government's projected borrowing needs).

The future path of discretionary spending has a significant impact on the budget outlook. As noted above, CBO's baseline inflates budget authority for discretionary programs from the level appropriated for the current year and thus projects total discretionary outlays of $10.4 trillion over the 2005-2014 period. For comparison, CBO estimated the budgetary impact of four alternative assumptions about future discretionary funding—two of which would worsen the budget outlook and two of which would improve it.

If current appropriations grow at the same rate as nominal GDP through 2014 instead of at the rate of inflation, total projected discretionary spending will be $1.4 trillion higher. If such appropriations rise by 6.9 percent a year—the average growth rate from 1999 through 2004 (excluding the $87 billion in supplemental appropriations for 2004)—discretionary spending will be $2.7 trillion greater over 10 years than the baseline projects.[9]

8. The budget is also sensitive to the state of the economy and to technical assumptions about the impact of tax and spending policies. Uncertainty about such factors is discussed in Appendix A. In addition, Appendix B illustrates the budgetary effects of some alternative economic assumptions.

9. In both of those scenarios, total budget authority for 2004—which includes supplemental appropriations, according to baseline conventions—is extended through 2014.

Table 1-3.

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

(Billions of dollars)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Total, 2005-2009	Total, 2005-2014
Policy Alternatives That Increase the Deficit or Reduce the Surplus[a]													
Extend Expiring Tax Provisions[b]													
Effect on the deficit or surplus													
EGTRRA and JGTRRA	-1	-14	-32	-35	-34	-40	-48	-175	-275	-285	-295	-155	-1,233
Partial expensing	3	-41	-71	-66	-58	-48	-40	-33	-28	-26	-28	-285	-440
Other	3	-1	-7	-12	-17	-19	-23	-25	-28	-31	-33	-56	-195
Total	6	-56	-110	-113	-108	-108	-110	-233	-331	-341	-356	-496	-1,868
Debt service	*	-1	-5	-11	-17	-24	-31	-41	-57	-77	-99	-57	-363
Reform the Alternative Minimum Tax[c]													
Effect on the deficit or surplus	0	-7	-21	-29	-39	-51	-62	-52	-31	-38	-45	-148	-376
Debt service	0	*	-1	-2	-4	-7	-10	-13	-16	-19	-22	-14	-93
Increase Discretionary Appropriations by the Growth Rate of Nominal GDP After 2004													
Effect on the deficit or surplus	0	-18	-44	-68	-93	-119	-147	-174	-202	-232	-264	-342	-1,360
Debt service	0	*	-2	-5	-9	-15	-23	-32	-43	-57	-72	-31	-258
Increase Discretionary Appropriations by 6.9 Percent a Year After 2004[d]													
Effect on the deficit or surplus	0	-25	-67	-114	-165	-219	-278	-343	-412	-488	-570	-590	-2,682
Debt service	0	*	-3	-7	-15	-26	-40	-58	-80	-107	-139	-51	-475

(Continued)

In the other direction, if the $87 billion in supplemental appropriations for 2004 are excluded from the amount extrapolated for future years, discretionary outlays will be $0.9 trillion lower over 10 years. If appropriations (including the supplemental) are frozen at the current level through 2014, with no adjustments for inflation, the effect will be even larger, reducing cumulative discretionary spending by $1.1 trillion.

For revenues, CBO's baseline projections rest on the assumption that current tax laws are not altered.[10] Therefore, CBO assumes that tax provisions that are scheduled to expire will actually do so. For example, the baseline envisions that major provisions of EGTRRA—such as the introduction of the 10 percent tax bracket, decreases in previously existing tax rates for individuals, 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 reduce receipts; thus, if those provisions are assumed to be extended, projected revenues are lower than the level in the baseline.[11] For example, if all expiring tax provisions were extended (except those related to the exemption amount for the alternative minimum tax), total revenues would be $1.9 trillion lower over the 2005-2014 period.[12]

10. The sole exception involves excise taxes dedicated to trust funds, which, under budget rules, are included in the revenue projections whether or not they are scheduled to expire.

11. In the years before 2011, the largest contributor to the cost of extending those provisions is depreciation deductions that businesses can take for qualifying investments (also known as partial expensing). Other contributors include the research and experimentation tax credit and two provisions of EGTRRA that were modified by the Jobs and Growth Tax Relief Reconciliation Act of 2003: the child tax credit and the 10 percent tax bracket.

12. Extending all expiring tax provisions would probably have a modest positive effect on economic growth, and thus on revenues, but such effects are not included in that estimate.

Table 1-3.

Continued

(Billions of dollars)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Total, 2005-2009	Total, 2005-2014
Policy Alternatives That Reduce the Deficit or Increase the Surplus													
Increase Discretionary Appropriations (Excluding supplemental appropriations for 2004) by the Rate of Inflation After 2004[e]													
Effect on the deficit or surplus	0	39	72	84	90	93	96	99	100	103	105	379	880
Debt service	0	1	3	8	13	18	24	30	37	44	51	42	227
Freeze Total Discretionary Appropriations at the 2004 Level ($876 billion)													
Effect on the deficit or surplus	0	15	30	48	70	94	119	146	170	198	226	257	1,117
Debt service	0	*	1	3	7	11	17	25	34	45	59	23	203
Memorandum:													
Total Deficit (-) or Surplus in CBO's January 2004 Baseline	-477	-362	-269	-267	-278	-268	-261	-162	-24	-16	13	-1,443	-1,893

Sources: Congressional Budget Office; Joint Committee on Taxation.

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

a. Negative amounts indicate an increase in the deficit or a reduction in the surplus.

b. This estimate does not include the effects of extending the increased exemption amount for the alternative minimum tax, which expires in 2004. See the policy alternative for the alternative minimum tax.

c. This alternative assumes that the exemption amount for the AMT, which was increased through 2004 in JGTRRA, is extended at its higher level and, together with the AMT tax brackets, is indexed for inflation after 2004. The estimates are shown relative to current law. 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 $173 billion (plus about $16 billion in debt-service costs) over the 2005-2014 period.

d. The 6.9 percent rate of growth is the historical average from 1999 through 2004, excluding $87 billion in supplemental appropriations for 2004 enacted in November. In this alternative, however, those supplemental appropriations are included in total budget authority for 2004 and are extended through 2014.

e. This alternative does not extend the $87 billion in supplemental appropriations enacted in November but includes the outlays resulting from them.

Another policy change that could affect revenues involves modifying the alternative minimum tax (AMT), a parallel income tax system that has fewer exemptions, deductions, and rates than the regular income tax. Unlike the regular tax, the AMT's exemption amount and brackets are not indexed for inflation. Consequently, its impact will grow in coming years as more taxpayers become subject to it (many of whom were not the intended target of the AMT when it was enacted). If the AMT was indexed for inflation after 2004, federal revenues would be $0.4 trillion lower over the next 10 years, according to CBO and the Joint Committee on Taxation.[13]

13. That estimate assumes that the exemption amount for the AMT (which was increased through 2004 in the Jobs and Growth Tax Relief Reconciliation Act of 2003) is extended at its higher level and, together with the AMT tax brackets, is indexed for inflation after 2004. In addition, if those changes to the AMT were enacted jointly with the extension of expiring tax provisions, an interaction effect would occur, causing revenues to decline by another $173 billion over 10 years.

Box 1-1.

Budget Enforcement Procedures: An Update

At the end of fiscal year 2002, the budget enforcement procedures that originated with the Budget Enforcement Act of 1990 (BEA) expired. Those procedures—annual limits on discretionary appropriations and the pay-as-you-go (PAYGO) requirement for new laws affecting mandatory spending or revenues—were devised as part of a broad agreement reached in 1990 to reduce and then eliminate budget deficits. Initially set to expire in 1995, the procedures were extended twice—in 1993 and 1997—as part of two subsequent budget agreements. The BEA procedures helped control the growth of spending and reduce deficits. Aided by a period of robust economic growth in the 1990s, they also contributed to producing a balanced budget by 1998.[1] Lawmakers are now confronted with the question of whether the BEA framework, or something comparable, should be resurrected.

In the absence of that framework, however, procedures that exist under permanent law provide a means for lawmakers to establish and enforce overall budgetary policies. The President submits an annual budgetary proposal to the Congress, which subsequently sets forth its own budgetary priorities in the form of a concurrent resolution. In general, the budget resolution is enforced through points of order—or procedural objections—that can prohibit the Congress from considering individual spending or revenue bills that are not consistent with the spending or revenue targets specified in the resolution. Budget resolutions may also contain other procedures to impose fiscal discipline. For example, recent resolutions have included broad restrictions on emergency spending and advance appropriations and have set separate discretionary spending limits and PAYGO requirements similar to the BEA procedures that expired in 2002. The points of order that enforce those and other requirements in the Congressional budget process may be waived or set aside, although in the Senate, waivers of major budget enforcement procedures require a three-fifths majority (60 votes) to be approved.

Nevertheless, some lawmakers and other observers assert that the current Congressional budget enforcement procedures are inadequate to control deficits. They argue that an additional framework such as the BEA is needed to strengthen fiscal discipline. However, experience under the BEA—and with the budget process in general—suggests that no procedures to control deficits or impose budgetary restraint will be effective in the absence of an overall political consensus to achieve those goals. Whether or not the BEA framework (or something like it) is renewed, political agreement on fiscal policy objectives is probably the largest single factor in ensuring that budget enforcement procedures and the budget process function smoothly.

1. For more details on the BEA procedures and their expiration, see Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2004-2013* (January 2003), Appendix A.

The Long-Term Outlook for the Budget

The aging of the baby-boom generation will cause a historic shift in the United States' fiscal position in the decades beyond CBO's projection period. Over the next 30 years, the number of people ages 65 and older will double, while the number of adults under age 65 will increase by less than 15 percent. In addition to those demographic changes, costs per enrollee in federal health care programs are likely to continue growing much faster than inflation. CBO projects that those pressures will cause federal spending for Social Security, Medicare, and Medicaid combined to increase (even under moderate growth assumptions) by more than two-thirds as a share of the economy—from more than 8 percent of GDP in 2004 to over 14 percent in 2030 and almost 18 percent in 2050.

Those budgetary pressures will ultimately require choices involving some combination of a substantial reduction in the growth of federal spending, an increase in taxation—

possibly to levels unprecedented in the United States—and a dramatic boost in federal borrowing. Responding to that looming situation sooner rather than later, however, can make a significant difference. In particular, policies that encourage economic growth can help by increasing the total amount of resources available for all uses. But economic growth alone is unlikely to bring the nation's longer-term fiscal position into balance—making reform of programs for the elderly or substantial tax increases (or both) necessary. Policymakers face difficult decisions about how best to accomplish that reform, but the sooner such decisions are made, the less disruptive the shifts in policy will be.

Changes to the Budget Outlook Since August 2003

CBO's projection of the cumulative deficit for the 2004-2013 period has grown substantially since its August 2003 baseline *(see Table 1-4).* Revisions to that baseline have reduced the projected deficit for 2004 by $3 billion but increased the 10-year deficit by $986 billion.

CBO categorizes revisions to its baseline by their cause: recently enacted legislation, changes to the agency's outlook for the economy, and other factors that affect the budget (termed "technical" changes).[14] Legislation enacted since August accounts for more than two-thirds of the increase in the cumulative deficit for 2004 through 2013: $681 billion. Changes in the outlook for the economy have large, but mostly offsetting, effects on projected revenues and outlays—on net, they worsen the budget's bottom line by $171 billion. Technical changes add another $134 billion to the cumulative deficit.

Legislative Changes

Laws enacted in the past five months have increased projected deficits for the 2004-2013 period by a total of $681 billion (including $119 billion in additional debt-service costs attributable to that legislation). Virtually all of the increase has occurred on the spending side of the budget.

Discretionary Spending. Legislative changes to CBO's baseline for discretionary spending reflect budget authority for 2004 that is higher than the amounts assumed in the August baseline. Budget authority each year is set in 13 regular appropriation acts. In addition, budget authority for 2004 includes supplemental appropriations that were enacted in November 2003 for reconstruction efforts and ongoing military operations in Iraq and Afghanistan.

CBO estimates that appropriations to date for 2004 total $876 billion, about $4 billion more than the August baseline anticipated. That total reflects a transfer of more than $2 billion in budget authority for education from 2004 back to 2003 and rescissions for housing programs and the Iraqi Freedom Fund; those transfers and rescissions are not continued in the baseline. Extrapolating the remaining budget authority for 2004, CBO's projections of discretionary outlays have risen since the August baseline by $2 billion for 2004 and by a total of $124 billion for the 2004-2013 period.

Mandatory Spending. Legislation enacted since August has increased outlays for mandatory programs by a total of $442 billion between 2004 and 2013, CBO estimates. Most of that amount stems from the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (P.L. 108-173). That law is estimated to raise net outlays for Medicare by $535 billion, decrease spending for Medicaid by $138 billion, and reduce other health expenditures by $2 billion—for a combined effect of $395 billion over the 2004-2013 period.

Medicare and Medicaid. P.L. 108-173 will create a voluntary, federally subsidized benefit for outpatient prescription drugs under a new Part D of the Medicare program, with additional federal subsidies for drug coverage offered to some low-income Medicare beneficiaries. The law will also change the current Medicare+Choice program; expand and alter the payment structures for Medicare's fee-for-service benefits; increase the deductibles and modify the premiums paid by beneficiaries; and transfer to Medicare the obligation to pay certain costs that, under prior law, would have been paid by the Medicaid program. (For more details about the effects of the Medicare legislation, *see Box 1-2 on pages 12 and 13.*)

14. That categorization 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. However, if a new law proves to have different effects than CBO estimated initially, those differences will appear as technical changes (not legislative ones) in later revisions to the baseline. The distinction between economic and technical revisions is similarly imprecise. CBO classifies economic changes as ones that result directly from changes in the components of CBO's economic forecasts. Changes in other factors related to the performance of the economy—such as the amount of capital gains realizations—are classified as technical revisions.

Table 1-4.

Changes in CBO's Baseline Projections of the Deficit or Surplus Since August 2003

(Billions of dollars)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Total, 2004-2008	Total, 2004-2013
Total Deficit (-) or Surplus as Projected in August 2003	-480	-341	-225	-203	-197	-170	-145	-9	161	211	-1,445	-1,397
Changes to Revenue Projections												
Legislative	*	-1	*	*	*	*	*	*	*	*	-1	*
Economic	7	1	-15	-36	-55	-72	-89	-109	-132	-158	-98	-659
Technical	-15	-16	-4	1	-3	-7	-5	-20	-25	-35	-38	-130
Total Revenue Changes	-8	-15	-20	-36	-59	-79	-94	-129	-158	-193	-137	-790
Changes to Outlay Projections												
Legislative												
Discretionary												
Defense	*	-1	-2	-1	-1	-1	-1	*	*	*	-5	-8
Nondefense	2	10	13	15	15	15	15	16	16	16	53	132
Subtotal, discretionary	2	9	11	13	13	14	15	15	16	16	48	124
Mandatory												
Medicare and Medicaid	4	6	27	40	44	47	50	53	59	66	121	397
Military retirement	1	2	2	2	3	3	3	4	4	4	9	28
Tanker acquisition	*	1	2	2	2	2	2	2	2	1	7	18
Other	-2	*	1	1	*	*	*	*	*	*	-1	-1
Subtotal, mandatory	3	8	32	45	49	52	56	60	65	72	137	442
Net interest												
Debt service	*	*	2	5	8	12	16	20	25	31	15	119
Other	*	*	*	*	*	*	*	*	*	-1	-2	-4
Subtotal, net interest	*	*	1	4	8	11	15	20	25	30	13	115
Subtotal, legislative	5	17	45	62	70	78	86	95	106	118	199	681
Economic												
Discretionary	*	-1	-6	-11	-14	-17	-20	-22	-25	-28	-33	-144
Mandatory												
Social Security	*	-2	-5	-8	-10	-12	-15	-18	-21	-25	-24	-115
Other COLA programs	*	*	-2	-2	-3	-3	-4	-5	-5	-6	-30	-30
Medicare	*	*	-1	-2	-3	-4	-6	-8	-9	-12	-5	-43
Unemployment insurance	-7	-6	-6	-4	-3	-3	-3	-3	-3	-4	-25	-41
Other	-1	-1	-2	-2	-2	-3	-3	-4	-4	-5	-8	-27
Subtotal, mandatory	-7	-9	-14	-18	-21	-26	-31	-37	-43	-51	-69	-257

(Continued)

Table 1-4.

Continued

(Billions of dollars)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Total, 2004-2008	Total, 2004-2013
Changes to Outlay Projections												
Economic (Continued)												
Net interest												
Rate effect	*	-4	-2	-4	-9	-13	-14	-15	-16	-16	-19	-93
Debt service	*	-1	-1	-2	-2	-1	*	2	4	7	-6	6
Subtotal, net interest	*	-5	-3	-6	-11	-13	-14	-13	-12	-9	-25	-87
Subtotal, economic	-7	-15	-24	-34	-46	-56	-65	-73	-80	-88	-126	-488
Technical												
Discretionary	-5	-3	2	2	2	2	2	2	*	1	-3	3
Mandatory												
Medicaid	-2	-2	-2	-2	-2	-2	-2	-3	-3	-4	-9	-23
Medicare	3	2	*	1	1	-1	1	2	1	1	7	11
Farm programs (CCC)	-5	-3	-2	-1	*	*	*	1	1	1	-11	-8
Food Stamps	3	2	2	1	*	*	*	*	*	*	8	7
Spectrum receipts	0	8	3	-2	-3	0	0	0	0	0	6	6
Credit reestimates	5	0	0	0	0	0	0	0	0	0	5	5
Other	-9	-2	-1	*	-2	-2	-2	-4	-2	-2	-13	-26
Subtotal, mandatory	-4	6	*	-4	-6	-6	-3	-4	-4	-4	-7	-28
Net interest												
Debt service	-1	-1	*	*	1	1	2	3	5	7	*	18
Other	2	2	1	2	1	*	1	1	1	1	8	11
Subtotal, net interest	1	1	1	2	2	1	3	3	5	9	7	29
Subtotal, technical	-8	5	3	*	-2	-3	1	1	2	5	-3	4
Total Outlay Changes	**-11**	**6**	**23**	**28**	**22**	**19**	**22**	**24**	**27**	**35**	**69**	**196**
Total Impact on the Deficit or Surplus	**3**	**-21**	**-43**	**-64**	**-81**	**-98**	**-117**	**-153**	**-185**	**-227**	**-207**	**-986**
Total Deficit as Projected in January 2004	-477	-362	-269	-267	-278	-268	-261	-162	-24	-16	-1,652	-2,383
Memorandum:												
Total Legislative Changes	-5	-17	-45	-62	-70	-78	-86	-95	-106	-117	-200	-681
Total Economic Changes	14	17	9	-2	-10	-16	-24	-37	-52	-70	28	-171
Total Technical Changes	-7	-20	-7	1	-1	-4	-6	-21	-27	-40	-35	-134

Source: Congressional Budget Office.

Note: * = between -$500 million and $500 million; COLA = cost-of-living adjustment; CCC = Commodity Credit Corporation.

Box 1-2.

Effects of the New Medicare Law on Mandatory Spending

Enactment of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (Public Law 108-173) has increased the Congressional Budget Office's projection of mandatory spending over the 2004-2013 period by $395 billion. That increase reflects a projected $758 billion in new spending for Medicare over 10 years, partly offset by a reduction of $363 billion in outlays because of additional premium payments by Medicare beneficiaries, lower federal costs for Medicaid and other programs, and federal funding withheld from state Medicaid programs.

The Medicare Prescription Drug Program. Beginning in 2006, Medicare's new Part D will subsidize prescription drug coverage that is furnished in various ways: through private prescription drug plans available to all Medicare enrollees in a geographic area, through managed care plans that participate in the Medicare Advantage program, or through employer- or union-sponsored plans. Enrollees in the various plans will be charged premiums to pay for benefits not subsidized by Medicare.[1] The Part D program will provide additional federal subsidies to cover the costs of drugs for some low-income Medicare beneficiaries.

As transitional measures, P.L. 108-173 also established a drug discount card for certain low-income beneficiaries (which will cover up to $600 in prescription drugs per year) and appropriated $1.5 billion for 2004 and 2005 to pay the administrative costs of setting up the drug benefit. Gross Medicare spending for the prescription drug program is expected to total $47 billion in 2006, when the program is fully implemented, and rise to $153 billion in 2014. By that time, CBO estimates, Part D will account for 22 percent of all Medicare spending (not including offsets from premium payments).

Net Medicare outlays for the Part D drug program will total about $640 billion through 2013, CBO estimates—$771 billion in payments to prescription drug plans offset by $131 billion in premium receipts *(see the table at right).* Of that $640 billion cost, $552 billion is estimated to come from the general fund of the Treasury. The other $88 billion will come from withholding part of the government's payments to state Medicaid programs and instead crediting them to the Part D account in Medicare's Supplementary Medical Insurance Trust Fund. (The new law is projected to save states $115 billion over the 2006-2013 period by shifting responsibility for the prescription drug benefits of millions of people who are eligible for both Medicaid and Medicare, so-called dual eligibles, from the joint federal/state Medicaid program to the federal Medicare program. However, the law requires that some of those savings—$88 billion, in CBO's estimate—be transferred to Part D.)

Other Changes in Medicare and Medicaid. P.L. 108-173 will also affect spending for benefits under Parts A (Hospital Insurance) and B (Supplementary Medical Insurance) of Medicare. It will increase payments to managed care plans by an estimated $14 billion through 2013, of which $10 billion will be used to encourage preferred provider organizations to offer services on a regional basis. In addition, the law will increase Medicare payments to rural providers in the fee-for-service sector by about $21 billion.

Other provisions of the law that affect fee-for-service providers will reduce Medicare's payments by $28 billion, CBO estimates—largely through lower payment rates for durable medical equipment, drugs covered under Part B, and services furnished by home health agencies, ambulatory surgical centers, and clinical laboratories. P.L. 108-173 will also shift about $21 billion in spending: some to beneficiaries

1. Beneficiaries will pay those premiums either by having them withheld from their Social Security benefit checks (as is generally done with premiums for Part B of Medicare) or by arranging to pay the plans directly. The discussion above assumes that all participants in the drug benefit—except those enrolled in an employer- or union-sponsored plan—choose to have premiums withheld from their Social Security benefits. To the extent that participants opted to pay plans directly, federal spending for benefits and premium collections would be reduced equally, producing no effect on the net cost of the prescription drug benefit.

Box 1-2

Continued

through a rise in the Part B deductible and some to third-party insurers subject to secondary-payer requirements. Finally, it will increase the Part B premiums collected from beneficiaries by $3 billion over the 2004-2013 period. (That figure reflects a $13 billion increase in premiums paid by Medicare beneficiaries with relatively high income and a $10 billion reduction in premiums paid by all beneficiaries that results from lower Part B costs.)

P.L. 108-173 will also affect federal spending for Medicaid—reducing outlays by $138 billion over 10 years, CBO estimates. Transferring responsibility for the prescription drug benefits of dual eligibles to Medicare will save the federal government an estimated $152 billion in Medicaid spending through 2013. Those savings will be partly offset by an additional $14 billion in Medicaid outlays resulting from the new law—largely, higher spending for administration, increased payments to hospitals serving a disproportionate share of Medicaid beneficiaries, and additional spending on benefits for Medicare beneficiaries who will enroll in Medicaid as a result of applying for the low-income subsidy under the Medicare prescription drug program.

Finally, the Medicare law will reduce mandatory spending for the Federal Employees Health Benefits program and other federal programs that pay for prescription drugs by an estimated $2 billion over the 2006-2013 period.

Effects of the Part D Prescription Drug Benefit and Other Provisions of P.L. 108-173 on Mandatory Spending, 2004 to 2013

(Billions of dollars)

	Part D Provisions[a]	Other Provisions	Total
Medicare			
Part D prescription drug benefit	771	n.a.	771
Payments to managed care plans	n.a.	14	14
Payments to rural providers in fee-for-service sector	n.a.	21	21
Other fee-for-service provisions	n.a.	-28	-28
Spending shifted to beneficiaries	n.a.	-12	-12
Spending shifted to secondary payers	n.a.	-9	-9
Gross Mandatory Outlays for Medicare	771	-14	758
Premium receipts	-131	-3	-134
Transfer of funds withheld from state Medicaid programs	-88	n.a.	-88
Net Mandatory Outlays for Medicare	552	-17	535
Medicaid	-142	3	-138
Other Programs	-2	n.a.	-2
Total Mandatory Spending	**409**	**-14**	**395**

Source: Congressional Budget Office.

Note: n.a. = not applicable.

a. Includes mandatory spending for administration of Part D (in title X of P.L. 108-173) and interactions with the Hatch-Waxman Act and importation provisions in title XI; excludes the interaction of Part D with Medicare spending for benefits under Parts A and B (which is included in "Other fee-for-service provisions"). Those factors account for the difference between the $409 billion for Part D shown above and CBO's $410 billion estimate for title I of H.R. 1.

CBO estimates that the new law will increase net Medicare outlays by $3 billion this year and by $535 billion through 2013. Most of the law's effect on outlays will occur after 2005 because the prescription drug benefit will not be implemented until 2006. The enactment of P.L. 108-173 will also alter Medicaid spending—reducing federal outlays for the joint federal/state program by $138 billion over 10 years, CBO estimates.

Other Programs. The National Defense Authorization Act for 2004 (P.L. 108-136) expands benefits for disabled retirees of the military and other uniformed services whose degree of disability has been rated as 50 percent or higher by the Department of Veterans Affairs (VA). Under prior law, retired veterans could not receive both full retirement annuities and disability compensation from the VA. Beginning in 2014, those retirees will be able to concurrently receive full retirement annuities and veterans' disability benefits; until then, they will receive an increasing portion of their retirement annuities. That legislation also expands the combat-related special compensation program to include retired reservists and to cover all degrees of disability. (In addition, it transfers the obligation for that and another special compensation program for retirees from the military personnel accounts to the Department of Defense's Military Retirement Fund.) Taken together, those provisions will increase spending for military retirement programs by $1 billion in 2004 and $28 billion over the 2004-2013 period, CBO estimates.

P.L. 108-136 also authorized the Air Force to acquire up to 100 KC-767 tankers for aerial refueling through a hybrid acquisition strategy in which the Air Force would lease no more than 20 tankers and purchase as many as 80 additional ones. CBO determined that such transactions, if executed under financing arrangements previously agreed to by the Air Force and Boeing, would obligate the government to acquire the aircraft in advance of the necessary appropriations. Thus, CBO estimates that the legislation provides direct spending authority for tanker acquisition that could result in outlays of $18 billion over the 2004-2013 period.[15]

15. See Congressional Budget Office, *Estimate of Direct Spending and Revenue Effects for H.R. 1588, the National Defense Authorization Act for Fiscal Year 2004* (November 25, 2003) and *Letter to the Honorable Don Nickles regarding the Air Force's plan to acquire 100 Boeing tanker aircraft* (August 26, 2003).

Revenues. Recently enacted laws have had only a minor effect on CBO's revenue projections. Those laws—particularly the Military Family Tax Relief Act of 2003 (P.L. 108-121) and the Medicare legislation—are estimated to reduce revenues by a total of less than $500 million over the 2004-2013 period.

Net Interest. Almost all of the changes since August to CBO's projections of net interest outlays stem from the effects of recently enacted legislation on cumulative deficits. Because that legislation has increased projected deficits or decreased projected surpluses between 2004 and 2013 by $562 billion, debt-service costs will be $119 billion higher during that period, CBO estimates. Thus, the total impact of legislative actions since August is to increase spending by an estimated $681 billion through 2013.

Economic Changes

CBO's underlying assessment of the U.S. economy has not changed much since August. However, CBO has lowered its projections for the consumer price index (CPI), the GDP price index, and other measures of inflation. The current projection for the annual increase in the CPI is 0.7 percentage points lower for 2005 than the August projection, 0.5 percentage points lower for 2006, and 0.3 percentage points lower each year from 2007 through 2013. CBO made similar changes for the GDP price index.

Such changes in the outlook for inflation are responsible for the bulk of the economic revisions to CBO's baseline since August, although changes to the unemployment rate and other effects on interest rates also play a role. Together, those changes reduce projected revenues over the 2004-2013 period by $659 billion *(see Table 1-4).* They also reduce projected outlays, but to a lesser extent: by $488 billion. As a result, the economic revisions increase the projected 10-year deficit by $171 billion. (For more details about how inflation interacts with various components of the federal budget, *see Box 1-3.*)

Discretionary Spending. CBO is required to project future discretionary budget authority using a mix of two economic variables: the GDP price deflator and the employment cost index for wages and salaries. Both measures are now anticipated to be lower than CBO projected last August. Because of those reductions, CBO's projections of discretionary outlays are $144 billion lower over the 2004-2013 period than they would otherwise be.

Box 1-3.

How Inflation Affects the Federal Budget

Both the federal government's revenues and spending are sensitive to increases in the general level of prices, although the effects on the two sides of the budget mostly offset each other. In some cases, components of the budget are keyed directly to measures of inflation, such as the consumer price index; in other cases, the impact of inflation is felt through other measures, such as nominal wages, that affect tax collections or benefit payments. Over the next 10 years, the effects of inflation on revenues are slightly greater than the effects on outlays.[1]

On the revenue side, slower growth in prices results in slower growth in nominal wages, which translates directly into lower amounts of income taxes and payroll taxes withheld from people's paychecks. (The opposite is true for faster growth in prices.) Tax brackets for the individual income tax are indexed for inflation, but the adjustments lag behind actual price increases by more than a year, on average. In addition, lower corporate profits from slower growth in prices quickly reduce receipts from firms' quarterly estimated tax payments.

On the outlay side, three main connections exist between federal spending and inflation. First, many entitlement programs automatically adjust benefit levels each year to reflect price increases. Social Security, federal employee retirement programs, Supplemental Security Income, veterans' pensions, Food Stamps, and child nutrition programs, among others, are adjusted (with a lag) for changes in the consumer price index or one of its components. Many Medicare reimbursement rates are also adjusted annually for inflation. Second, to the extent that the benefit payments that participants in retirement and disability programs initially receive are related to wages, changes in nominal wages will be reflected in future outlays for those programs. Third, future spending for discretionary programs is projected on the basis of assumed rates of wage and price growth, and actual appropriations are often affected by the perception of how allocated resources keep pace with inflation.

Inflation also has an impact on net interest because it is one component of nominal long-term interest rates (the other being a real, or inflation-adjusted, rate of return). For example, if real rates of return remain constant but the inflation rate drops, interest rates will decline and new federal borrowing will incur lower interest costs.

1. For an illustration of how altering projections of inflation affects budget totals, see *Appendix B*.

Mandatory Spending. For many mandatory programs, spending is linked to economic indicators. Changes in CBO's economic outlook decrease projected mandatory spending by $7 billion for 2004 and $257 billion for the 2004-2013 period, mostly because of the decline in projected inflation rates.

The largest economic revision involves the Social Security program. By 2013, cost-of-living adjustments (COLAs), which affect payments to beneficiaries already on the rolls, and nominal wages, which affect new recipients' initial benefits, are both projected to be about 3 percent lower than in CBO's August baseline. As a result, projected outlays for Social Security are also about 3 percent lower in 2013—and $115 billion lower over the entire 2004-2013 period. Projected outlays for other mandatory programs that use COLAs have been reduced by a total of $30 billion over that 10-year period. Those programs include civil service retirement, military retirement, Supplemental Security Income, and some veterans' benefits.

Projected Medicare spending has risen slightly in 2004 and 2005 as a result of CBO's outlook for faster growth of GDP (because expenditure targets for physicians' services are linked to projected GDP growth). After 2005, lower projected inflation begins to offset such spending increases (because payment rates for most services are raised each year to reflect changes in the prices of inputs for those services). As a result, CBO now projects Medicare spending to be lower by $43 billion over 10 years.

Downward revisions to CBO's forecast of the unemployment rate and labor force participation have reduced projected outlays for unemployment compensation by $7 billion for 2004 and $41 billion for the 2004-2013 period. Specifically, CBO has lowered its projections of the unemployment rate in fiscal years 2004 through 2006 by 0.4 to 0.5 percentage points, and the 2007 and 2008 rates by smaller amounts. CBO has also reduced its estimate of the size of the labor force throughout the projection period. The combination of a lower unemployment rate and smaller labor force shrinks CBO's estimate of the number of people drawing unemployment insurance during the 2004-2013 period by about 4 percent. In addition, because CBO has reduced its assumptions for wage growth, average unemployment benefits are projected to be lower.

Revenues. Most of the total decline in CBO's revenue projections since August is attributable to economic changes. Economic reestimates of revenues are slightly positive in 2004 and 2005 but then turn negative and grow steadily through 2013.

The bulk of the change in projected revenues results from CBO's lower outlook for inflation, which generates smaller projected income growth and therefore less tax revenue—roughly $700 billion less over the 2004-2013 period. That reduction is slightly offset, however, by two other effects of the new economic outlook, which together increase projected revenues by about $40 billion over those 10 years. First, CBO has raised its projections for real economic growth in the next two years and for real GDP through 2013. Those revisions result in higher projected revenues from individual and corporate income taxes and payroll taxes. Second, CBO has lowered its projection for the share of GDP earned in the form of wages and salaries (the type of income in CBO's projections that has the highest marginal tax rate). That change reduces projected revenues from individual income and payroll taxes. The two effects nearly offset each other over the 10-year projection period, with the real-growth effect dominating slightly in the early and middle part of the period and the income-share effect dominating slightly in the later part of the period.

Net Interest. Changes to CBO's forecast for interest rates have lowered projected outlays for net interest by $93 billion over 10 years. In the current forecast, interest rates on three-month Treasury bills are 0.3 percentage points lower in 2004 and 0.4 percentage points lower in 2005 than they were in the August forecast. However, CBO's current projections for interest rates on two-year Treasury notes in the near term are higher than they were last summer. As a result, the changes to net interest spending attributable to the new forecast for interest rates are relatively small through 2007. For the years that follow, projected interest rates on three-month bills and 10-year notes have declined by 0.3 percentage points, reducing projected net interest payments by as much as $16 billion a year.

In addition to that rate effect, changes in CBO's economic forecast reduce projected deficits in the near term and thereby decrease estimates of the government's borrowing needs. However, the situation reverses later in the projection period. As a result, additional debt-service costs attributable to economic changes net to just $6 billion over the 2004-2013 period.

Technical Changes

Technical changes represent revisions to the baseline that cannot be ascribed either to recent laws or to changes in CBO's economic forecast. As a whole, technical changes worsen the baseline budget outlook by $7 billion in 2004 and by a total of $134 billion through 2013, largely because of revisions to the revenue projections.

Discretionary Spending. CBO has made small technical adjustments that lower projected discretionary spending by $5 billion this year and $3 billion in 2005 and that increase it thereafter—for a total increase of $3 billion over the 2004-2013 period. Those technical revisions affect nearly all areas of the budget. The largest revision for 2004 and 2005 involves slower projected spending by the Department of Homeland Security's Office for Domestic Preparedness (estimated outlays were reduced by $2 billion for 2004 and $1 billion for 2005).

Mandatory Spending. Overall, technical changes to mandatory programs have a relatively small effect on the budget—amounting to no more than $6 billion in any one year and reducing projected outlays by a total of $28 billion through 2013.

CBO lowered its projections for Medicaid spending over the 2004-2013 period by $23 billion, largely because of lower-than-anticipated spending in 2003. With Medicare, by contrast, new information about the mix of program spending in 2003 has prompted CBO to raise its outlay projections for that period by $11 billion.

Projected outlays by the Commodity Credit Corporation for farm price and income-support payments over the 2004-2013 period have been reduced by $8 billion since the August baseline. Most of the reduction affects the first few years of that period and stems from new information about program participants and the current favorable market for many crops. The Department of Agriculture recently released data from the initial enrollment for benefits under the Farm Security and Rural Investment Act of 2002. Producers reported payment yields and acreage bases that were lower than expected for several major crops. In addition, prices of most major crops are higher than CBO anticipated last summer. Those higher prices result from lower-than-expected production and strong overseas demand for U.S. crops. The federal payments associated with a given year's crop production can span several fiscal years, and the effects of tight supplies and higher prices can last for several years. Consequently, CBO now expects lower federal payments to agricultural producers for the next few years.

Spending for the Food Stamp program is projected to be $7 billion higher during the 2004-2013 period than CBO estimated in August. That change reflects increases in CBO's projections of program participation and of the average benefit over the next few years.

Licenses to use the electromagnetic spectrum are now expected to bring in lower auction receipts through 2013 than previously anticipated. That change increases net federal outlays by an estimated $6 billion over the period. It reflects the likelihood that less spectrum will be auctioned before the Federal Communications Commission's authority to do so expires (at the end of 2007) and a judgment, based on recent trends in the telecommunications industry, that the proceeds from scheduled auctions will be somewhat lower than projected earlier.

Technical reestimates of mandatory spending in 2004 also reflect a net increase in the estimated subsidy cost (the projected net present value of government losses on outstanding loans and guarantees) for a number of federal credit programs. The budget includes the cost of federal programs that guarantee loans made by private financial institutions and the cost of direct federal loans to individuals or businesses. Accurately projecting loan repayments, defaults, and changes in interest rates over the life of a credit program is difficult; as a result, each year, federal agencies revise their estimates of subsidy costs for loans and guarantees that were made in previous years. On the basis of preliminary information from the Administration, CBO has raised its estimate of outlays in 2004 by almost $5 billion to reflect such changes.

The remaining technical changes to projected mandatory spending result from reestimates for a variety of programs, including small reductions in estimated outlays for TRICARE for Life, the Federal Employees Health Benefits program, the Postal Service, and Social Security.

Revenues. CBO has reduced its revenue projections for the 2004-2013 period by $130 billion because of technical factors—specifically, the revenue yield expected from a given amount of income in the economic projections. The downward changes to revenues equal or exceed $15 billion a year for the first two and the last three years of the projection period; they are relatively small for 2006 through 2010. Those changes generally reflect new modeling and information from recent tax collections.

The downward reestimates for 2004 and 2005 are largely based on recent tax revenues and revised estimates of the effects of the past few years' tax cuts. Corporate receipts in recent months have been weaker than analysts had expected given the strong surge in profits indicated by the national income and product accounts. In addition, CBO has revised its estimates of when and to what degree certain provisions of the Jobs and Growth Tax Relief Reconciliation Act of 2003 will reduce revenues.

More than 60 percent of CBO's total technical changes to revenue projections affect the 2011-2013 period. The latest information (from 2001 tax returns) indicates that more of the recent shortfall in revenues is likely to be permanent, rather than temporary, than CBO assumed in its August baseline. That information affects every year through 2013 but is especially apparent in the last three years, when offsetting effects are smaller.

Net Interest. The small technical changes to CBO's projections of net interest costs mostly reflect new information about the composition and amount of federal debt. Such changes total $11 billion over the 2004-2013 period.

In total, revisions to the baseline projections that are attributable to technical changes increase the cumulative deficit by $116 billion (excluding debt service) over that 10-year period. CBO estimates that the additional debt-service costs resulting from technical revisions would add $18 billion to interest payments over that period, for a total technical change of $134 billion.

The Outlook for Federal Debt

The federal government's debt falls into two main categories: debt that is held by the public (in the form of marketable and nonmarketable Treasury securities) and debt that is held by government accounts. Debt held by the public is the most meaningful measure of debt in terms of its relationship to the economy; it represents debt that the Treasury issues to raise cash in order to fund the operations of the federal government and pay off its maturing liabilities. Debt held by government accounts consists of securities issued by the Treasury to various federal agencies. Those intragovernmental IOUs are used as an accounting device to track cash flows relating to specific federal programs (such as Social Security).

Debt Held by the Public

When federal revenues are insufficient to finance spending, the Department of the Treasury raises money by selling securities in the capital markets to buyers such as foreign investors (governments, businesses, and individuals), pension funds, mutual funds, state and local governments, commercial banks, insurance companies, and individuals. Of those groups, foreign investors are currently the largest owners of federal debt issued to the public; they hold $1.5 trillion, or more than one-third of the roughly $4 trillion that is now outstanding.

Among foreign investors, those of Japan, China, and the United Kingdom are the largest holders of Treasury securities.[16] The Japanese alone hold about $500 billion in such securities, more than $100 billion of which were bought in 2003—over 25 percent of the size of the 2003 deficit. In all, foreign holdings increased by $260 billion last year. Foreign investors will be important lenders in the future as long as they continue to accumulate dollars and use those funds to buy Treasury securities.

State and local governments and mutual funds are also relatively large investors in Treasury securities. Those governments hold $319 billion in debt held by the public, and mutual funds hold $299 billion.[17]

Debt held by the public fluctuates according to changes in the government's borrowing needs. It reached nearly 50 percent of GDP in 1993, but by 2001, that share had fallen to about 33 percent *(see Figure 1-2 on page 4)*. Over the past two years, debt held by the public has crept up to 36 percent of GDP. If current policies do not change, it will grow to almost 41 percent of GDP by 2008 before falling to 35 percent by 2014 *(see Table 1-5).*

The Composition of Debt Held by the Public. More than 88 percent of publicly held debt consists of marketable securities—Treasury bills, notes, bonds, and inflation-indexed issues. The rest comprises nonmarketable securities, such as savings bonds and state and local government securities, which are nonnegotiable, nontransferable debt instruments issued to specific investors.[18]

The Treasury sells marketable securities in regularly scheduled auctions, whose size varies along with fluctuations in the government's cash flow. (The Treasury also sells cash-management bills periodically to cover shortfalls in cash balances.) In 2003, the Treasury significantly altered its auction schedule because of larger and more volatile borrowing requirements: it introduced a three-year note, which is issued on a quarterly basis, and increased the frequency with which it auctions five-year, 10-year, and inflation-indexed notes.[19] Those changes should enable the Treasury to respond to its large near-term financing requirements. However, increased issuance of notes may boost the average maturity of debt held by the public.

Why Changes in Debt Held by the Public Do Not Equal the Size of Surpluses and Deficits. In most years, the amount that the Treasury borrows or redeems approximates the total budget deficit or surplus. However, a number of factors—which are broadly labeled "other means of financing"—also affect the government's need to borrow money from the public. CBO projects that

16. See Department of the Treasury, *Major Foreign Holdings of Treasury Securities* (January 16, 2004), available at www.ustreas.gov/tic/mfh.txt. That information should be viewed as approximate because the Treasury's data indicate the location where a purchase was made but not necessarily the location of the owner's residence.

17. Department of the Treasury, Financial Management Service, *Treasury Bulletin* (December 2003).

18. State and local government securities are time deposits that the Treasury sells to the issuers of state and local government tax-exempt debt to help them comply with the arbitrage restrictions in the Internal Revenue Code.

19. Five-year notes are now sold monthly instead of quarterly; 10-year notes are sold eight times a year rather than four times a year; and inflation-indexed notes are sold quarterly rather than three times a year.

Table 1-5.

CBO's Baseline Projections of Federal Debt

(Billions of dollars)

	Actual 2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Debt Held by the Public at the Beginning of the Year	3,540	3,914	4,393	4,771	5,055	5,338	5,630	5,912	6,185	6,356	6,388	6,409
Changes to Debt Held by the Public												
Surplus (-) or deficit	375	477	362	269	267	278	268	261	162	24	16	-13
Other means of financing	-2	3	16	16	16	15	14	12	10	8	5	2
Total	373	480	377	285	282	292	282	273	171	32	21	-10
Debt Held by the Public at the End of the Year	3,914	4,393	4,771	5,055	5,338	5,630	5,912	6,185	6,356	6,388	6,409	6,399
Debt Held by Government Accounts												
Social Security	1,484	1,636	1,807	2,000	2,207	2,430	2,666	2,911	3,166	3,436	3,709	3,993
Other government accounts[a]	1,362	1,430	1,519	1,627	1,733	1,840	1,949	2,063	2,179	2,303	2,427	2,552
Total	2,846	3,066	3,326	3,626	3,940	4,270	4,615	4,974	5,345	5,739	6,136	6,545
Gross Federal Debt	6,760	7,459	8,097	8,681	9,278	9,900	10,527	11,159	11,701	12,127	12,546	12,944
Debt Subject to Limit[b]	6,738	7,437	8,075	8,659	9,255	9,877	10,503	11,135	11,677	12,102	12,520	12,918
Memorandum:												
Debt Held by the Public at the End of the Year as a Percentage of GDP	36.1	38.3	39.5	39.9	40.3	40.6	40.7	40.7	40.1	38.6	37.0	35.4

Source: Congressional Budget Office.

a. Mainly the Civil Service Retirement, Military Retirement, Medicare, Unemployment Insurance, and Airport and Airway Trust Funds.

b. Differs from gross federal debt primarily because it excludes most debt issued by agencies other than the Treasury. The current debt limit is $7,384 billion.

debt held by the public will increase by more than the cumulative deficit over the 2004-2014 period because other means of financing activities will raise the Treasury's borrowing needs *(see Table 1-5).*

In most years, the largest type of other means of financing is the capitalization of financing accounts used for federal credit programs. Direct student loans, rural housing programs, loans by the Small Business Administration, and other credit programs require the government to disburse money in anticipation of repayment at a later date. Those initial outlays are not counted in the budget, which reflects only the estimated subsidy costs of such programs. From 2004 through 2014, the amount of loans being disbursed will typically be larger than the amount of repayments and interest collected. Thus, the government's annual borrowing needs will be $3 billion to $15 billion greater than the annual budget deficit or surplus would indicate.

In July 2003, the Treasury announced plans to eliminate a program in which interest-free cash balances were held at banks as compensation for their financial services. The withdrawal of those balances throughout the year returned $28 billion to the Treasury, reducing its borrowing needs by that amount. Under the omnibus appropriation act, the Treasury will pay banks directly for their services. Since July, it has compensated banks with interest payments from depositary compensation securities (currently about $20 billion outstanding). CBO's baseline assumes that the Treasury will withdraw those securities, decreasing debt held by the public by $20 billion.

Debt Held by Government Accounts

Besides selling securities to the public, the Treasury has issued more than $2.8 trillion in securities to various accounts of the federal government. All of the major trust funds and many other government funds invest in special, nonmarketable Treasury securities known as the government account series. (Trust funds are described in more detail at the end of this chapter.) Those transactions are intragovernmental and have no direct effect on the economy. The securities represent credits to the various government accounts and are redeemed when benefit payments and other expenses arise. In the meantime, the Treasury assigns interest earnings to the funds holding those securities; such payments have no net effect on the budget.

The largest balances of such debt are in the Social Security trust funds (almost $1.5 trillion at the end of 2003) and the retirement funds for federal civilian employees ($602 billion). If current policies continue, the balance of the Social Security trust funds will rise to $4 trillion by 2014, CBO projects, and the balance of all government accounts will climb to $6.5 trillion *(see Table 1-5).*

Gross Federal Debt and Debt Subject to Limit

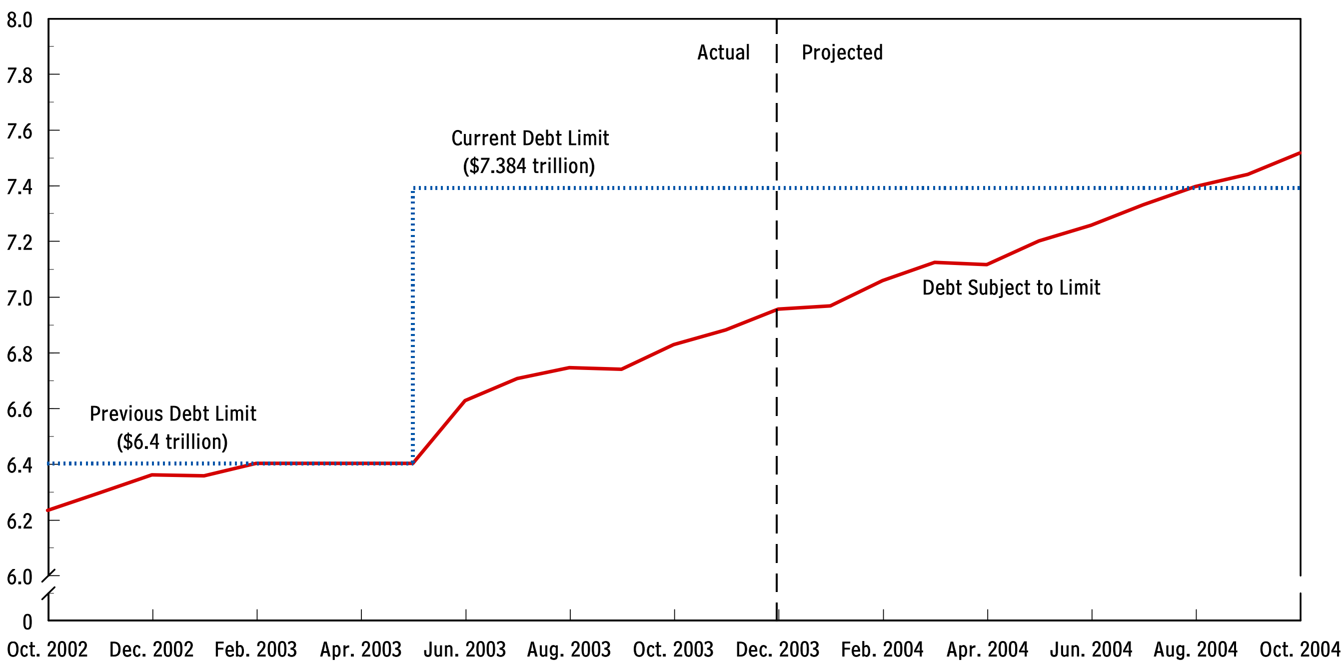
Gross federal debt and its companion measure, debt subject to limit, comprise debt issued to government accounts as well as debt held by the public. The future path of gross federal debt is determined by the sum of those components. CBO projects that gross federal debt will increase in every year of the projection period and reach $12.9 trillion in 2014. That amount is roughly 90 percent greater than the 2003 total of $6.8 trillion. Most of that increase reflects debt held by government accounts.

The Treasury's authority to issue debt is restricted by a statutory ceiling. Although it covers debt held by the public and by government accounts, that ceiling does not apply to debt issued by agencies other than the Treasury (such as the $26 billion of debt issued by the Tennessee Valley Authority). The current debt limit, which was set in May 2003 by P.L. 108-24, is $7.384 trillion. CBO estimates that under current policies, that limit will be reached this year sometime between July and September *(see Figure 1-3).*

Figure 1-3.

Debt Subject to Limit, October 2002 to October 2004

(Trillions of dollars)



Source: Congressional Budget Office.

Table 1-6.

CBO's Baseline Projections of Trust Fund Surpluses

(Billions of dollars)

	Actual 2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Social Security	156	152	172	192	208	223	235	245	255	270	273	284
Medicare												
Hospital Insurance (Part A)	22	19	18	24	22	22	22	21	17	20	14	9
Supplementary Medical Insurance (Part B)	-14	-6	*	5	3	1	2	2	1	2	1	-1
Subtotal, Medicare	8	12	17	28	25	24	23	22	19	21	15	8
Military Retirement	10	6	6	6	6	6	6	6	7	7	8	7
Civilian Retirement[a]	28	35	35	36	36	36	37	37	38	39	39	40
Unemployment	-20	-7	4	9	9	6	5	5	5	5	6	7
Highway and Mass Transit	-5	-5	-4	-3	-3	-3	-2	-2	-2	-2	-1	-1
Airport and Airway	*	-1	*	*	1	1	1	2	2	3	3	4
Other[b]	-24	5	4	4	4	4	4	4	5	5	5	5
Total Trust Fund Surplus	**151**	**198**	**235**	**272**	**285**	**297**	**309**	**320**	**328**	**348**	**347**	**355**
Intragovernmental Transfers to Trust Funds[c]	350	369	399	464	514	551	589	630	673	730	779	837
Net Budgetary Impact of Trust Fund Programs	**-198**	**-171**	**-164**	**-192**	**-229**	**-254**	**-280**	**-310**	**-345**	**-382**	**-431**	**-482**

Source: Congressional Budget Office.

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

a. Includes Civil Service Retirement, Foreign Service Retirement, and several smaller retirement trust funds.

b. Primarily trust funds for Railroad Retirement, federal employees' health and life insurance, Superfund, and various veterans' insurance programs.

c. Includes interest paid to trust funds, payments from the general fund to the Supplementary Medical Insurance program, the employer's share of employee retirement, lump-sum payments to the Civil Service and Military Retirement Trust Funds, taxes on Social Security benefits, and smaller miscellaneous payments.

At that time, if a higher debt limit has not been enacted, the Treasury will have to use accounting measures to remain under the ceiling so it can continue to raise cash to pay for government activities. Those measures—most of which have been used in past debt-limit impasses—could include suspending the issuance of certain securities held in the Thrift Savings Plan, postponing the issuance of state and local government series securities, delaying the issuance of securities to the Civil Service Retirement Trust Fund, and withdrawing federal securities from the Exchange Stabilization Fund. In the most recent impasses, such steps enabled the Treasury to remain below the debt limit for more than three months.

Trust Funds and the Budget

The federal budget includes more than 150 trust funds, although fewer than a dozen account for the vast share of trust fund dollars. Among the largest are the two Social Security trust funds (the Old-Age and Survivors Insurance Trust Fund and the Disability Insurance Trust Fund) and those dedicated to civil service retirement, Hospital Insurance (Part A of Medicare), and military retirement *(see Table 1-6).* Trust funds have no particular economic significance. They do not hold separate cash balances; instead, they function primarily as accounting mechanisms to track receipts and spending for programs that have specific taxes or other revenues earmarked for their use.

When a trust fund receives payroll taxes or other income that is not currently needed to pay benefits, the Treasury credits the fund and uses the excess cash for other government purposes. As a result, the government borrows less from the public than it would in the absence of those excess funds. The process is reversed when revenues for a trust fund program fall short of its expenses. In that case, the government raises the necessary cash by borrowing more than it otherwise would.

Including the cash receipts and expenditures of trust funds in the budget totals along with other federal programs is necessary to assess how federal activities affect the economy and capital markets. Thus, CBO, the Office of Management and Budget, and other fiscal analysts focus on the total deficit or surplus.

In CBO's current baseline, trust funds as a whole are projected to run a surplus of $198 billion in 2004. That balance is somewhat misleading, however, because trust funds receive much of their income in the form of transfers from other parts of the budget.[20] Such intragovernmental transfers reallocate costs from one part of the budget to another; they do not change the total deficit or the government's borrowing needs. Consequently, they have no effect on the economy or on the government's future ability to sustain spending at the levels indicated by current policies.

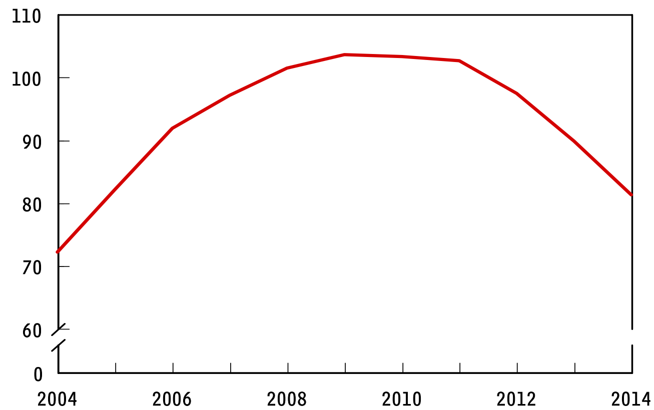
For 2004, those intragovernmental transfers are estimated to total $369 billion. The largest of them involve interest credited to trust funds on their government securities ($154 billion in CBO's projections), transfers of federal funds to Medicare for Supplementary Medical Insurance ($95 billion), contributions by government agencies to retirement funds for their current and former employees ($42 billion), and payments from the general fund to Social Security ($13 billion). When intragovernmental transfers are excluded and only income from sources outside the government is counted, the trust funds as a whole are projected to run deficits throughout the projection period, growing from $171 billion in 2004 to $482 billion in 2014.

20. See Congressional Budget Office, *The Impact of Trust Fund Programs on Federal Budget Surpluses and Deficits,* Long-Range Fiscal Policy Brief No. 5 (November 4, 2002), and *The Impact of Social Security and Medicare on the Federal Budget,* Long-Range Fiscal Policy Brief No. 6 (November 14, 2002).

Figure 1-4.

Social Security Trust Fund Surplus (Excluding interest)

(Billions of dollars)



Source: Congressional Budget Office.

Although the budgetary impact of the aging of the baby-boom generation will not be completely realized during the 2004-2014 period, CBO's current projections provide initial indications of the coming budgetary pressures. Charting the differences over the next 10 years between projected receipts and outlays for the Social Security trust funds (excluding intragovernmental interest payments) illustrates those pressures. Receipts are projected to exceed expenditures throughout the period, but under current policies, the amount by which they do so will decline from over $100 billion between 2008 and 2011 to about $81 billion in 2014 *(see Figure 1-4).* At that point, outlays will be growing by more than 6 percent per year, but non-interest receipts will be growing by less than 5 percent. Thus, in CBO's baseline projections, the capacity of the Social Security trust funds to offset some of the net deficit in the rest of the budget—as they now do—will begin to dwindle during the coming decade. Shortly thereafter, Social Security is projected to begin adding to deficits or reducing surpluses.