CONGRESS OF THE UNITED STATES
CONGRESSIONAL BUDGET OFFICE

An Analysis of the President's Budgetary Proposals for Fiscal Year 2008

MARCH 2007

Pub. No. 2908

CBO

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Notes

Unless otherwise indicated, the years referred to in this report are fiscal years.

Numbers in the text and tables may not add up to totals because of rounding.

Supplemental data for this analysis are available on the home page of the Congressional Budget Office's Web site (www.cbo.gov), under "Current Budget Projections."

Preface

This Congressional Budget Office (CBO) analysis of the President's budgetary proposals for fiscal year 2008—prepared at the request of the Senate Committee on Appropriations—was produced by the staffs of CBO's Budget Analysis, Macroeconomic Analysis, and Tax Analysis Divisions under the supervision of Robert Sunshine, Robert Dennis, and Thomas Woodward, respectively. CBO prepared the baseline revenue estimates and the estimates of selected revenue proposals; the Joint Committee on Taxation (JCT) prepared most of the estimates of the President's revenue proposals. The report expands on CBO's preliminary analysis, which was released on March 2, 2007, and incorporates updated estimates from JCT for the President's health insurance proposal.

Barry Blom of CBO's Projections Unit was the lead author for Chapter 1; Pamela Greene and John Peterson wrote major portions of the chapter. Robert Shackleton of the Macroeconomic Analysis Division wrote Chapter 2, Appendix B, and Appendix D. Benjamin Page coordinated the economic analysis in Chapter 2 under the supervision of Douglas Hamilton. Robert Arnold, Paul Burnham, Ufuk Demiroglu, Mark Lasky, Larry Ozanne, Frank Russek, Marika Santoro, Kurt Seibert, and Sven Sinclair carried out the modeling described in that chapter and in Appendix C.

Ann Futrell of the Projections Unit wrote Appendix A. David Weiner of the Tax Analysis Division wrote Appendix C, with contributions from David Auerbach, James Baumgardner, Stuart Hagen, and Kevin Perese. The contributors to the revenue and spending projections underlying this report are listed in Appendix E.

Christine Bogusz, Christian Howlett, and Loretta Lettner edited the report, with assistance from Kate Kelly. Maureen Costantino took the photograph for the cover and prepared the report for publication. Lenny Skutnik printed the initial copies, Linda Schimmel coordinated the print distribution, and Annette Kalicki and Simone Thomas prepared the electronic version for CBO's Web site (www.cbo.gov).

Peter R. Orszag
Director

March 2007

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CHAPTER

1

CBO's Estimates of the President's Budget for Fiscal Year 2008

At the request of the Senate Committee on Appropriations, the Congressional Budget Office (CBO) has analyzed the President's budget request for fiscal year 2008. The analysis is based on CBO's own economic assumptions and estimating techniques, and incorporates the Joint Committee on Taxation's (JCT's) estimates for provisions that affect the tax code. In addition, it incorporates updated estimates from JCT for the President's health insurance proposal. This report provides more detail and analysis about the President's budgetary proposals—and about CBO's updated baseline budget projections—than did the preliminary report that CBO released on March 2.

Overview of CBO's Estimates

If enacted, the proposals in the President's budget would add $37 billion to the deficit this year, reducing revenues by $9 billion and boosting outlays by $28 billion (mostly for military operations in Iraq and Afghanistan). As a result, the deficit in 2007 would total $214 billion, or 1.6 percent of gross domestic product (GDP), according to CBO's estimates (see Table 1-1). By comparison, the deficit in 2006 was $248 billion, or 1.9 percent of GDP.

Estimates for the 2008–2017 Period

In 2008, CBO estimates, the deficit under the President's budget would again total 1.6 percent of GDP (amounting to $226 billion in nominal dollars)—about twice the shortfall that CBO projects under current laws and policies. That difference is attributable largely to proposals from the Administration that affect defense spending and revenues. The President is requesting additional appropriations of nearly $100 billion in 2007 for military operations in Iraq and Afghanistan and for other activities related to the war on terrorism; much of that funding would be spent in 2008. The President also is seeking $145 billion for such activities next year. (CBO's baseline projection for 2008 includes an extrapolation of the $70 billion provided this year for those same purposes.) In addition, the President's budget proposes a one-year extension of the higher exemption levels that mitigate some of the effects of the alternative minimum tax (AMT).

The President's budget does not contain year-by-year estimates of spending and revenues after 2012. Instead, it provides a cumulative estimate through 2017 for each proposed change to laws that govern revenues and mandatory spending. For discretionary spending, the budget contains details only for 2007 and 2008; for 2009 through 2012, the Administration has provided aggregate funding totals for two categories of spending: that designated for the Department of Defense (DoD) and that designated for all other agencies. CBO incorporated those aggregate levels in its estimates and calculated discretionary outlays for the 2013–2017 period by projecting the amount of discretionary budget authority that the President recommended for 2012 and adjusting it for inflation.

From 2008 to 2012, the deficit as a percentage of GDP would decline steadily under the President's proposals, dropping from 1.4 percent in 2009 to a level approaching balance in 2012; the budget would remain close to balance through 2017, CBO estimates (see Figure 1-1). The cumulative deficit between 2008 and 2017 (the current 10-year projection period) would total $1.1 trillion, or 0.6 percent of GDP. Federal debt held by the public would decrease from 37 percent of GDP in 2009 to 29 percent of GDP in 2017. (Those results reflect the $50 billion budgeted by the President for military operations in Iraq and Afghanistan in 2009 but no further

Table 1-1.

Comparison of Projected Deficits and Surpluses in CBO's Estimate of the President's Budget and in CBO's March 2007 Baseline

(Billions of dollars)

	Actual 2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Total, 2008-2012	Total, 2008-2017
CBO's Estimate of the President's Budget for 2008														
On-Budget Deficit	-434	-400	-428	-424	-392	-390	-286	-319	-295	-270	-284	-219	-1,920	-3,309
Off-Budget Surplus[a]	186	186	202	209	223	241	255	245	231	218	215	210	1,130	2,248
Total Deficit (-) or Surplus	**-248**	**-214**	**-226**	**-215**	**-169**	**-149**	**-31**	**-74**	**-64**	**-53**	**-70**	**-10**	**-790**	**-1,060**
CBO's Baseline														
On-Budget Deficit	-434	-363	-315	-351	-388	-281	-102	-123	-104	-82	-104	-46	-1,438	-1,897
Off-Budget Surplus[a]	186	186	202	217	232	247	257	263	266	268	267	263	1,155	2,482
Total Deficit (-) or Surplus	**-248**	**-177**	**-113**	**-134**	**-157**	**-35**	**155**	**139**	**163**	**186**	**163**	**217**	**-283**	**586**
Difference (President's budget minus baseline)[b]														
On-Budget Deficit	0	-37	-113	-73	-3	-109	-184	-196	-191	-188	-181	-173	-482	-1,412
Off-Budget Surplus[a]	0	0	*	-8	-9	-6	-2	-17	-36	-51	-52	-54	-24	-234
Total Deficit (-) or Surplus	**0**	**-37**	**-113**	**-81**	**-12**	**-114**	**-186**	**-213**	**-227**	**-239**	**-233**	**-227**	**-507**	**-1,646**
Memorandum:														
Total Deficit (-) or Surplus as a Percentage of GDP														
CBO's estimate of the President's budget	-1.9	-1.6	-1.6	-1.4	-1.1	-0.9	-0.2	-0.4	-0.3	-0.3	-0.3	**	-1.0	-0.6
CBO's baseline	-1.9	-1.3	-0.8	-0.9	-1.0	-0.2	0.9	0.8	0.9	1.0	0.8	1.0	-0.4	0.3
Debt Held by the Public as a Percentage of GDP														
CBO's estimate of the President's budget	37.0	37.0	37.0	36.8	36.2	35.6	34.3	33.3	32.3	31.3	30.4	29.2	n.a.	n.a.
CBO's baseline	37.0	36.7	35.9	35.2	34.7	33.4	31.1	29.1	27.0	25.0	23.2	21.2	n.a.	n.a.
Probability of a Budget Deficit (Percent)														
CBO's estimate of the President's budget	n.a.	97	87	77	69	64	52	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
CBO's baseline	n.a.	94	72	68	68	53	38	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Source: Congressional Budget Office.

Note: * = between zero and $500 million; ** = between -0.05 percent and zero; GDP = gross domestic product; n.a. = not applicable.

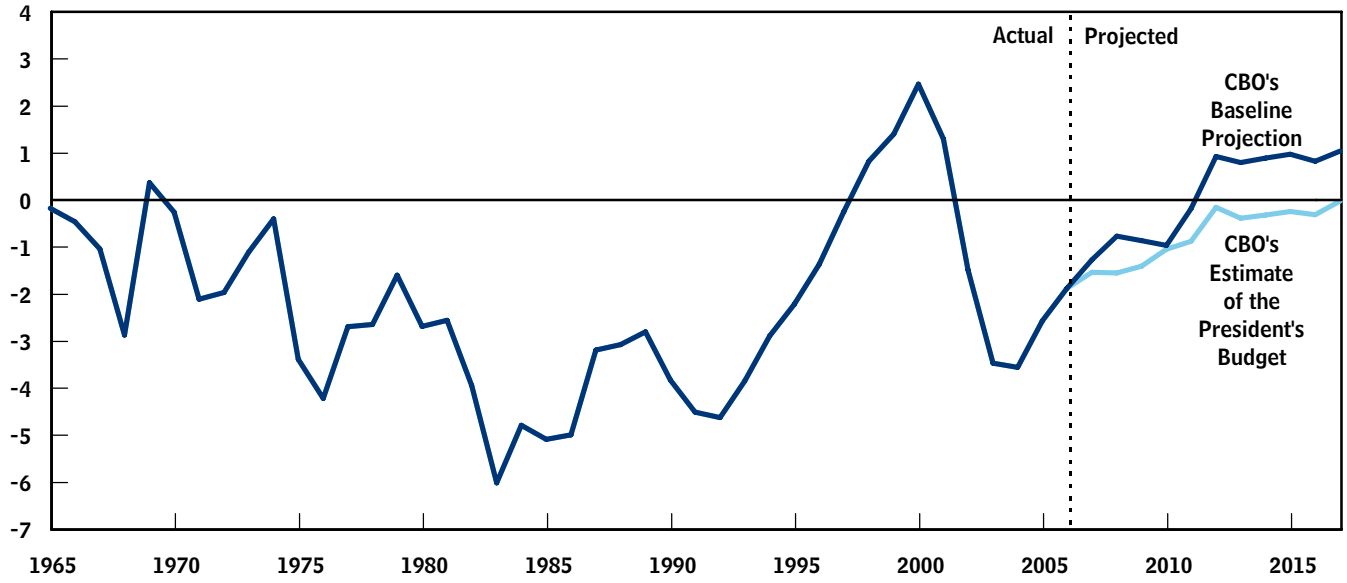
a. Off-budget surpluses comprise surpluses in the Social Security trust funds as well as the net cash flow of the Postal Service.

b. Negative numbers indicate an increase relative to the baseline deficit or a decrease relative to the baseline surplus.

Figure 1-1.

Total Deficit or Surplus, 1965 to 2017

(Percentage of gross domestic product)



Source: Congressional Budget Office.

funding for such operations thereafter. The results also reflect the fact that the Administration is not proposing any changes to the AMT beyond the one-year extension of the higher exemption levels.)

CBO has estimated a set of probabilities that the budget will be balanced under both its baseline projections (which assume the continuation of current laws and policies) and its evaluation of the President's proposals. On the basis of historical estimating experience, CBO calculates that, under baseline assumptions, there is roughly a 40 percent chance that the budget will be in deficit and a 60 percent chance that the budget will be balanced (or in surplus) in 2012. Assuming that the President's policies are enacted in their entirety and that no other legislation affecting spending or revenues is enacted in the next five years, the likelihood that the budget will be in deficit in 2012 is about equal to the likelihood that it will be in surplus.

According to CBO's estimates, if the President's proposals were enacted, total outlays as a share of GDP would measure 20.1 percent this year and 20.3 percent in 2008, slightly lower than their average of 20.6 percent over the last 40 years. Thereafter, total outlays would decline to about 19 percent of GDP for most of the next 10 years, CBO projects (see Table 1-2). Spending for mandatory programs would grow faster than nominal GDP through 2017—by an average of 6.2 percent annually, versus 4.5 percent for nominal GDP. By contrast, discretionary outlays would decline by $82 billion over the 2008–2012 period; as a percentage of GDP, they would fall from 7.9 percent to 6.1 percent.

Revenues as a percentage of GDP would total 18.6 percent this year and 18.7 percent in 2008 under the President's policies. That share would fall slightly—to 18.3 percent of GDP—in 2010 and 2011 but would gradually increase thereafter, reaching 19.2 percent of GDP by 2017. At that level, revenues would be about 1 percentage point above their average share of GDP over the past 40 years. Future growth in revenues as a percentage of GDP reflects a combination of factors: an increase in effective tax rates resulting from the progressive structure of the tax code combined with increases in real (inflation-adjusted) income; the withdrawal of tax-deferred retirement savings as workers with 401(k) plans and traditional individual retirement accounts begin to retire in increasing numbers; and the fact that the AMT is not indexed for inflation. According to estimates by JCT, the President's proposal on the taxation of health

Table 1-2.

CBO's Estimate of the President's Budget for 2008

	Actual 2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Total, 2008-2012	Total, 2008-2017
							In Billions of Dollars							
Revenues														
On-budget	1,799	1,895	2,010	2,093	2,148	2,239	2,367	2,463	2,598	2,743	2,897	3,062	10,858	24,621
Off-budget	608	638	669	695	729	767	807	847	889	932	976	1,022	3,666	8,333
Total	**2,407**	**2,533**	**2,679**	**2,787**	**2,877**	**3,007**	**3,174**	**3,310**	**3,487**	**3,675**	**3,873**	**4,084**	**14,524**	**32,954**
Outlays														
Mandatory spending	1,413	1,454	1,527	1,613	1,706	1,823	1,873	2,029	2,168	2,315	2,496	2,623	8,543	20,173
Discretionary spending	1,016	1,056	1,123	1,124	1,064	1,047	1,041	1,061	1,083	1,109	1,139	1,161	5,399	10,952
Net interest	227	236	256	265	276	285	291	295	300	305	308	310	1,372	2,890
Total	**2,655**	**2,747**	**2,905**	**3,002**	**3,046**	**3,156**	**3,205**	**3,384**	**3,552**	**3,728**	**3,943**	**4,094**	**15,314**	**34,014**
On-budget	2,233	2,296	2,439	2,517	2,540	2,629	2,654	2,782	2,893	3,013	3,181	3,281	12,778	27,929
Off-budget	422	451	467	485	506	526	552	602	658	714	762	813	2,536	6,085
Deficit (-) or Surplus	**-248**	**-214**	**-226**	**-215**	**-169**	**-149**	**-31**	**-74**	**-64**	**-53**	**-70**	**-10**	**-790**	**-1,060**
On-budget	-434	-400	-428	-424	-392	-390	-286	-319	-295	-270	-284	-219	-1,920	-3,309
Off-budget	186	186	202	209	223	241	255	245	231	218	215	210	1,130	2,248
Debt Held by the Public	4,829	5,048	5,286	5,518	5,703	5,866	5,909	5,994	6,067	6,126	6,201	6,214	n.a.	n.a.
Memorandum:														
Gross Domestic Product	13,065	13,645	14,300	15,014	15,742	16,465	17,205	17,973	18,764	19,582	20,425	21,295	78,726	176,766
							As a Percentage of Gross Domestic Product							
Revenues														
On-budget	13.8	13.9	14.1	13.9	13.6	13.6	13.8	13.7	13.8	14.0	14.2	14.4	13.8	13.9
Off-budget	4.7	4.7	4.7	4.6	4.6	4.7	4.7	4.7	4.7	4.8	4.8	4.8	4.7	4.7
Total	**18.4**	**18.6**	**18.7**	**18.6**	**18.3**	**18.3**	**18.4**	**18.4**	**18.6**	**18.8**	**19.0**	**19.2**	**18.4**	**18.6**
Outlays														
Mandatory spending	10.8	10.7	10.7	10.7	10.8	11.1	10.9	11.3	11.6	11.8	12.2	12.3	10.9	11.4
Discretionary spending	7.8	7.7	7.9	7.5	6.8	6.4	6.1	5.9	5.8	5.7	5.6	5.5	6.9	6.2
Net interest	1.7	1.7	1.8	1.8	1.8	1.7	1.7	1.6	1.6	1.6	1.5	1.5	1.7	1.6
Total	**20.3**	**20.1**	**20.3**	**20.0**	**19.3**	**19.2**	**18.6**	**18.8**	**18.9**	**19.0**	**19.3**	**19.2**	**19.5**	**19.2**
On-budget	17.1	16.8	17.1	16.8	16.1	16.0	15.4	15.5	15.4	15.4	15.6	15.4	16.2	15.8
Off-budget	3.2	3.3	3.3	3.2	3.2	3.2	3.2	3.4	3.5	3.6	3.7	3.8	3.2	3.4
Deficit (-) or Surplus	**-1.9**	**-1.6**	**-1.6**	**-1.4**	**-1.1**	**-0.9**	**-0.2**	**-0.4**	**-0.3**	**-0.3**	**-0.3**	*	**-1.0**	**-0.6**
On-budget	-3.3	-2.9	-3.0	-2.8	-2.5	-2.4	-1.7	-1.8	-1.6	-1.4	-1.4	-1.0	-2.4	-1.9
Off-budget	1.4	1.4	1.4	1.4	1.4	1.5	1.5	1.4	1.2	1.1	1.1	1.0	1.4	1.3
Debt Held by the Public	37.0	37.0	37.0	36.8	36.2	35.6	34.3	33.3	32.3	31.3	30.4	29.2	n.a.	n.a.

Source: Congressional Budget Office.

Note: n.a. = not applicable; * = between -0.05 percent and zero.

insurance would also contribute to the growth in revenues as a share of GDP.

The Impact of the President's Proposals on the Current Budget Outlook

CBO measures the potential budgetary effects of proposed policy changes relative to its baseline projections, which—in keeping with long-standing procedures—are constructed under the assumption that present laws and policies remain unchanged. Specifically, the baseline reflects the assumption that various tax provisions (including those affecting the AMT) will expire as scheduled, that most mandatory programs will continue to operate as they do under current law, and that all discretionary funding for the current year (including any supplemental appropriations) will grow at the rate of inflation in future years.

Relative to those baseline projections, the President's policies would increase the cumulative deficit by $507 billion over the 2008–2012 period, in CBO's estimation (see Table 1-3). Proposed changes to tax laws—such as extending the expiring provisions originally enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA)—would reduce revenues by an estimated $479 billion through 2012 compared with the baseline.[1] At the same time, outlays would be $28 billion higher under the President's proposals than they would be under current policies, CBO estimates. The proposed policy changes would increase discretionary outlays of the Department of Defense by $132 billion and net interest outlays by $61 billion, relative to the amounts in the baseline. They would reduce mandatory spending by $34 billion and other discretionary spending by $131 billion.

Over the 10-year budget window, the President's proposals would increase the cumulative deficit by $1.6 trillion. Under baseline assumptions, near-term deficits would be followed by surpluses in the vicinity of 1 percent of GDP starting in 2012, CBO projects. By contrast, under the President's policies, the budget would show a slight deficit (0.4 percent of GDP or less) beyond 2011. Between 2008 and 2017, the President's proposals would reduce revenues by almost $1.6 trillion (4.6 percent) from baseline levels, mainly by extending tax provisions that are scheduled to expire by 2011. Over that same period, proposals in the President's budget would increase mandatory spending by a total of $164 billion (0.8 percent) from baseline levels and decrease discretionary spending by $424 billion (3.7 percent), mostly for nondefense activities. The deficits that would result under the President's budget would require additional federal borrowing; debt-service costs on that borrowing would add another $323 billion to the cumulative deficit between 2008 and 2017. Overall, the President's policies would increase outlays over the 10-year period by $63 billion relative to CBO's baseline projection.

The Impact on the Economy

The estimates presented in this chapter are the result of an analysis that does not account for the potential impact of the President's budgetary proposals on the economy. Such an economic impact, however, could influence how the policy changes would affect spending and revenues. Therefore, CBO has also prepared a macroeconomic analysis of the President's budget, which is described in Chapter 2. That assessment uses various models to indicate the range of possible economic and budgetary effects of the President's proposals. On the basis of that analysis, CBO has concluded that if the President's proposals were enacted, the macroeconomic effects—and their resulting budgetary impact—would most likely be minor relative to the size of both the budget and the U.S. economy over the next 10 years.

Comparison with the Administration's Estimates

CBO's estimate of how the President's budget would affect the deficit in 2007 differs from the Administration's estimate by $30 billion (see Table 1-4). Whereas CBO anticipates a deficit of $214 billion, the Administration predicts a shortfall of $244 billion. CBO estimates that outlays would be $37 billion below the Administration's projection and that revenues would be $7 billion lower. Estimated outlays for the Defense Department and the Department of Homeland Security represent the largest differences in the two projections: CBO's estimates for those agencies are lower than the Administration's by $12 billion and $7 billion, respectively.

For 2008, the deficit estimates calculated by CBO and the Administration are only $13 billion apart. CBO calculates a deficit of $226 billion under the President's budget, whereas the Administration expects a deficit of

1. For proposals that would amend the Internal Revenue Code, CBO is generally required by law to use estimates provided by the Joint Committee on Taxation.

Table 1-3.

CBO's Estimate of the Effect of the President's Budget on Baseline Deficits or Surpluses

(Billions of dollars)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Total, 2008-2012	Total, 2008-2017
Total Deficit (-) or Surplus as Projected in CBO's March 2007 Baseline	-177	-113	-134	-157	-35	155	139	163	186	163	217	-283	586
Effect of the President's Proposals													
Revenues													
Extension of expiring EGTRRA and JGTRRA provisions													
General tax rates, child tax credit, and tax brackets[a]	0	0	0	0	-93	-150	-152	-154	-157	-160	-164	-243	-1,030
Estate and gift taxes	0	-2	-1	-3	-36	-60	-67	-74	-79	-85	-91	-102	-499
Tax rates on dividends and capital gains	0	*	1	-2	-17	-15	-33	-35	-37	-38	-41	-33	-216
Expensing for small businesses	0	0	0	-3	-5	-4	-3	-2	-1	-1	-1	-12	-19
Education, retirement, and other provisions	0	0	0	0	-1	-2	-2	-2	-3	-3	-3	-3	-15
Subtotal, proposed extensions	0	-2	*	-8	-152	-231	-257	-266	-277	-287	-299	-392	-1,779
Health insurance taxation and standard deduction[a]	0	0	-14	-6	7	22	39	57	78	101	127	8	411
Research and experimentation tax credit	0	-3	-5	-7	-8	-10	-11	-12	-13	-14	-15	-33	-99
Air transportation taxes	0	0	-7	-7	-7	-7	-8	-8	-9	-9	-9	-28	-71
AMT extension	-9	-37	0	0	0	0	0	0	0	0	0	-37	-37
Expansion of information reporting	0	*	1	1	2	2	2	3	3	3	3	5	19
Expansion of expensing for small businesses	0	-1	-2	-1	-1	-1	-1	*	*	*	*	-6	-8
Expansion of tax-free savings accounts	0	3	5	4	*	-5	-3	-1	-1	-2	-2	6	-3
Other proposals[a]	*	-1	-1	*	*	-1	-2	-2	-3	-3	-3	-2	-15
Total Effect on Revenues	**-9**	**-41**	**-22**	**-24**	**-160**	**-231**	**-241**	**-231**	**-222**	**-211**	**-200**	**-479**	**-1,583**
Outlays													
Mandatory													
Social Security individual accounts	0	0	0	0	1	1	21	44	62	68	73	2	270
Medicare	0	-4	-8	-11	-16	-20	-24	-28	-33	-40	-48	-58	-232
Earned income and child tax credits	0	*	*	10	10	24	24	24	24	24	24	44	164
Medicaid and SCHIP	*	-1	-2	-4	-4	-4	-4	-4	-5	-5	-5	-14	-37
Higher education	0	-5	*	1	1	3	4	4	4	4	4	*	19
Farm bill	0	1	1	1	2	2	2	1	1	*	-1	7	9
Other proposals	*	*	-3	-5	-3	-3	-3	-3	-3	-3	-3	-14	-30
Subtotal, mandatory	*	-9	-11	-8	-8	3	20	37	50	47	43	-34	164
Discretionary													
Department of Defense	26	77	80	16	-15	-25	-32	-35	-36	-37	-37	132	-44
Other	1	*	-18	-30	-38	-46	-47	-48	-49	-51	-53	-131	-380
Subtotal, discretionary	27	77	62	-14	-53	-71	-79	-83	-85	-88	-90	1	-424
Net interest	*	5	8	10	15	23	32	42	53	63	73	61	323
Total Effect on Outlays	**28**	**72**	**59**	**-12**	**-46**	**-45**	**-28**	**-4**	**17**	**22**	**27**	**28**	**63**
Total Impact on the Deficit or Surplus[b]	**-37**	**-113**	**-81**	**-12**	**-114**	**-186**	**-213**	**-227**	**-239**	**-233**	**-227**	**-507**	**-1,646**
Total Deficit Under the President's Proposals	-214	-226	-215	-169	-149	-31	-74	-64	-53	-70	-10	-790	-1,060

Sources: Congressional Budget Office; Joint Committee on Taxation.

Note: * = between -$500 million and $500 million; EGTRRA = Economic Growth and Tax Relief Reconciliation Act of 2001; JGTRRA = Jobs and Growth Tax Relief Reconciliation Act of 2003; AMT = alternative minimum tax; SCHIP = State Children's Health Insurance Program.

a. The estimates shown include the effect on revenues only; however, outlays for the refundable earned income and child tax credits are also affected. Estimates of those effects are included in the entry for earned income and child tax credits.

b. Negative numbers indicate an increase in the deficit or a decrease in the surplus.

Table 1-4.

Differences Between CBO's Estimate of the President's Budget and the Administration's Estimate, by Source

(Billions of dollars)

	2007	2008	2009	2010	2011	2012	Total, 2008-2012
				Administration's Estimate			
Deficit Under the President's Proposals	-244	-239	-187	-94	-54	61	-514
				Sources of Differences Between CBO and the Administration			
Revenue Differences							
Economic	-32	-64	-93	-118	-155	-189	-619
Technical							
Baseline	25	69	71	-2	24	35	196
Policy	*	12	11	42	34	21	120
Subtotal, technical	25	81	82	40	58	56	317
Total Revenue Differences	**-7**	**17**	**-11**	**-78**	**-97**	**-133**	**-302**
Outlay Differences							
Mandatory							
Economic	*	1	*	-3	-9	-10	-21
Technical							
Social Security individual accounts	-1	*	*	-1	*	-28	-29
Other	-10	-1	1	-2	3	-11	-10
Subtotal, technical	-11	-1	1	-3	3	-40	-39
Subtotal, mandatory	-11	*	1	-6	-6	-50	-61
Discretionary (Technical)	-23	9	26	8	3	2	48
Net interest							
Economic	*	-1	-1	5	15	23	42
Technical	-3	-5	-9	-11	-13	-17	-54
Subtotal, net interest	-3	-6	-10	-5	1	7	-13
Total Outlay Differences	**-37**	**4**	**17**	**-3**	**-2**	**-41**	**-26**
All Differences[a]	**30**	**13**	**-28**	**-74**	**-95**	**-92**	**-276**
				CBO's Estimate			
Deficit Under the President's Proposals	-214	-226	-215	-169	-149	-31	-790
Memorandum:							
Total Economic Differences[a]	-32	-64	-92	-120	-160	-203	-640
Total Technical Differences[a]	62	77	64	46	65	110	363

Sources: Congressional Budget Office; Joint Committee on Taxation.

Notes: Technical differences occur when CBO updates its annual baseline to reflect new information derived from the President's budget submission and from other sources. The Administration did not provide budget estimates beyond 2012.

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

a. Positive numbers denote that such differences cause CBO's estimate of the deficit to be lower than the Administration's estimate.

$239 billion. Thereafter, both CBO and the Administration estimate that the deficit will decline each year through 2012, but the Administration estimates larger declines in the deficit than CBO does and anticipates a surplus in 2012. As a result, for the 2008–2012 period, CBO's cumulative deficit projection of $790 billion is $276 billion higher than the Administration's. (The Administration did not provide budget estimates beyond 2012.)

Overall, CBO's estimates of outlays under the President's budget are smaller than those of the Administration—by a total of $26 billion for the 2008–2012 period. CBO projects that outlays will be $29 billion lower under the President's Social Security proposals over the five-year period, primarily because of differing expectations about when the first substantial outlays would be recorded in the budget if the President's proposal to add individual accounts to the Social Security program were to be implemented. (CBO shows those outlays beginning in 2013; the Administration expects them to begin in 2012.) Lower projected inflation and wages cause CBO's baseline projections of mandatory outlays between 2008 and 2012 to be lower than the Administration's by another $21 billion.

In total, CBO's projection of mandatory spending over the five years is $61 billion below that of the Administration. In addition, CBO estimates that net interest payments over that period will be about $13 billion lower than the Administration's estimate. (Most of that gap comes from differing assumptions about future interest rates and rates of inflation.) Partially offsetting those lower estimates, CBO's calculation of discretionary outlays under the President's budget during the 2008–2012 period exceeds the Administration's by $48 billion, primarily because CBO's estimate of outlays for DoD is $52 billion higher.[2]

CBO's and the Administration's projections of revenues under the President's budget are also very close through 2009 but then diverge by larger amounts thereafter. As a result, the Administration's estimate of revenues for the 2008–2012 period is $302 billion, or 2.1 percent, higher than CBO's projection. The difference mainly results because the Administration projects higher nominal GDP than CBO does. (Most of the difference in nominal GDP projections, in turn, reflects differences in inflation projections: CBO projects lower inflation than the Administration does.) Also contributing to the difference in revenue estimates is CBO's expectation that wages and salaries will make up a smaller share of GDP than the Administration anticipates.

CBO's Most Recent Baseline Budget Projections

In conjunction with its annual analysis of the President's budget, CBO typically updates its baseline projections to account for new information from that budget submission and other sources. (CBO refers to such changes as technical revisions.) The update also incorporates the effects of legislation enacted in the two months since the previous baseline was completed.[3]

All of the revisions to CBO's previous baseline that are attributable to legislation result from enactment of the Revised Continuing Appropriations Resolution, 2007 (Public Law 110-5). As of mid-February, funding for 2007 for departments other than Defense and Homeland Security had been provided through a series of short-term continuing resolutions; the appropriations that were provided for the rest of the year boosted discretionary appropriations by $7 billion relative to the amounts in the previous resolution. In addition, budgetary resources provided in the form of obligation limitations for certain transportation programs were raised by nearly $4 billion.[4] Extrapolating those amounts through 2017 increases projected discretionary outlays by $12 billion to $14 billion annually over the 2008–2017 period. In their entirety, the effects of that law have increased total outlay projections by $172 billion over those 10 years.

Technical changes to CBO's baseline have increased mandatory outlays by $72 billion and projected revenues by $6 billion over 10 years. The two largest technical changes are attributable to Medicare and Medicaid. CBO

2. CBO cannot identify reasons for the disparity because the Administration did not include detailed information for discretionary programs beyond 2008.

3. For the previous baseline, see Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2008 to 2017* (January 2007).

4. An obligation limitation is a provision of a law or legislation that restricts or reduces the availability of budget authority that would have become available under another law. Generally, when appropriation acts routinely place an obligation limitation on mandatory (or direct) spending, the limitation is treated as a discretionary resource, and the associated outlays are treated as discretionary.

has raised its estimate of outlays over the 2008–2017 period by $38 billion for Medicare and by $29 billion for Medicaid. The increase in Medicare outlays derives primarily from faster-than-anticipated growth in enrollment for the Medicare Advantage program, which is more expensive than traditional fee-for-service programs. The increase in projected Medicaid outlays is also primarily due to faster enrollment growth, specifically of children and low-income adults.

As a result of the various changes to its baseline, CBO now projects that if current tax and spending policies remained the same, the cumulative surplus for the 2008–2017 period would total $586 billion. That figure is $214 billion lower than CBO estimated in January. (For more information about recent revisions to CBO's baseline, see Appendix A.)

Policy Proposals That Affect Revenues

The President's budget proposes a number of changes to tax law that, in aggregate, would reduce revenues over the next decade relative to the amounts that would be collected under current law. Those proposals include the extension of a number of expiring tax provisions and a variety of new tax incentives. The most significant changes involve provisions originally enacted in EGTRRA and JGTRRA; other significant changes involve the AMT, the research and experimentation tax credit, the tax treatment of health insurance premiums and medical expenses, and the financing of the Airport and Airway Trust Fund.

Using the Joint Committee on Taxation's estimates of revenue provisions that affect the tax code, CBO estimates that, if they were enacted, the President's proposals as a whole would reduce revenues by $9 billion this year, by $41 billion in 2008, and by $1.6 trillion over the 2008–2017 period (see Table 1-3 on page 6). Those proposals would also increase mandatory outlays for refundable tax credits by $164 billion through 2017.[5]

Permanent Extension of Provisions in EGTRRA and JGTRRA

The Administration proposes to make permanent various provisions originally enacted in EGTRRA and JGTRRA that currently are set to expire at the end of 2010. Those provisions include changes in tax rates on income, capital gains, and dividends; relief from the so-called marriage penalty; an increase in the child tax credit; provisions related to education; and repeal of the estate tax. In total, this proposal would reduce revenues by $1.8 trillion and increase outlays by $91 billion through 2017, according to JCT's estimates.

Another provision originally enacted in JGTRRA altered the rules governing depreciation for small businesses. Specifically, it increased from $25,000 to $100,000 the amount of investment that such businesses could expense (that is, deduct from their taxable income immediately rather than over time). That change is currently scheduled to expire at the end of 2009. Extending this provision of JGTRRA would make the $100,000 limit permanent and index it for inflation, which would decrease revenues by about $19 billion over the 2008–2017 period. (The President is also proposing to raise the limit to $200,000 and index it for inflation. That change is discussed below.)

Changes to the Alternative Minimum Tax

The AMT exists alongside the regular income tax but includes a more limited set of exemptions, deductions, and tax credits than normally applies under the regular income tax. The taxpayer must calculate the amount owed under the AMT and the regular income tax and pay the higher of the two. The exemption amounts that taxpayers can use for the AMT calculation are set by law and are not indexed for inflation. EGTRRA and JGTRRA reduced income tax liabilities under the regular income tax through the end of 2010 but made adjustments to the AMT for a shorter period. As a result, unless the law is changed, a growing number of taxpayers will be subject to the AMT over time.

Since 2001, the law has been amended several times to temporarily raise the amount of income that is exempt from the alternative minimum tax. The AMT exemption reverted to pre-EGTRRA levels at the beginning of calendar year 2007, which will cause many more people to be liable for tax under the AMT. In addition, under current law, the AMT will restrict the use this year of some nonrefundable personal tax credits, such as the higher education credits and the child and dependent care credit.

The President's budget proposes to continue for one year (through the end of 2007) both the unrestricted use of

5. An income tax credit is refundable if the taxpayer receives a refund when the allowable credit exceeds the amount of income tax owed. Such refunds are recorded in the budget as outlays.

those personal tax credits under the AMT and the higher AMT exemption levels. JCT expects that most of the reduction in revenues from this provision will occur in fiscal year 2008 when taxpayers file their returns for tax year 2007. The proposal would decrease revenues by $37 billion in 2008.

Extension of the Research and Experimentation Tax Credit

Under current law, corporations can obtain a tax credit of 20 percent on certain research expenditures above a base amount. That credit is scheduled to expire on December 31, 2007, but the President proposes to make it permanent. According to JCT, the proposal would reduce revenues by a total of $99 billion over the next 10 years.

Expansion of Expensing for Small Businesses

The President proposes not only to make permanent the increased limit on the amount of investment that small businesses can expense, but also to further raise that limit to $200,000 (and index it for inflation). Those changes would decrease revenues by $8 billion over 10 years.

Provision of a Standard Income Tax Deduction for Taxpayers Who Purchase Health Insurance

Among the Administration's proposals is a plan to replace most current tax exclusions and deductions for health insurance premiums and out-of-pocket costs with a new standard deduction from income of $15,000 for married taxpayers and $7,500 for single taxpayers. All taxpayers not enrolled in Medicare who purchase qualifying insurance would be eligible for the deduction.

If the proposal took effect on January 1, 2009, it would increase revenues by $411 billion through 2017, JCT estimates. Of that amount, $57 billion would be counted as off-budget because of the proposal's effect on income subject to payroll taxes. In addition, through its impact on the earned income tax credit, the policy change would raise outlays by $77 billion over the 2008–2017 period. (See Appendix C for a more detailed discussion of the President's health insurance tax proposal.)

Expansion of Information Reporting

Under the Administration's proposals, additional information about potentially taxable transactions would need to be reported. Provisions of the proposal include the following:

- Businesses would be required to file an information return on certain payments to corporations.
- Brokers would be required to report the adjusted basis for certain types of securities sales; and the amount of information that brokers report about sales of tangible personal property, such as business equipment and vehicles, would be expanded.
- Certain banks would be required to report gross reimbursement payments to merchants from credit and debit card transactions.
- Penalties would be increased for those who did not comply with information-reporting requirements.

JCT estimates that the proposals to expand information reporting would increase revenues by almost $19 billion between 2008 and 2017.

Expansion of Tax-Free Savings Accounts

The tax code provides for a variety of tax-favored savings plans, which are used primarily for retirement savings but also for other purposes, such as education. The President proposes to unify many of those plans into two tax-favored vehicles for saving—retirement savings accounts (RSAs) and lifetime savings accounts (LSAs)—and to expand their scope.

Individuals would be allowed to contribute up to $5,000 a year to an RSA, with no income limits on participation. Those contributions would not be tax-deductible, but all earnings on the account would accumulate tax-free. Account holders could withdraw funds without facing taxes or penalties after they turned 58 years old or became disabled. (Upon an account holder's death, his or her heirs could also make tax- and penalty-free withdrawals.)

Accounts that are now held as Roth individual retirement accounts (IRAs) would automatically become RSAs under the President's plan. In addition, traditional IRAs could be converted into RSAs in the same way that they can now be converted into Roth IRAs. No further contributions to traditional IRAs would be allowed.

The same tax treatment and lack of income restrictions that applied to RSAs would apply to lifetime savings accounts as well, but annual contributions to LSAs would be limited to $2,000. (Individuals could contribute to both types of accounts in the same year.) Holders of

LSAs, unlike holders of RSAs, could make withdrawals at any age and for any purpose. Balances now held in Coverdell education savings accounts and qualified state tuition plans could be moved into LSAs.

On net, those proposals would reduce revenues by $3 billion over the 2008–2017 period. JCT projects a net increase in revenues during the first few years of that period as new contributions were directed away from current savings plans, which receive an immediate tax deduction, and toward the new plans, which would not. In addition, some taxpayers would convert their traditional IRAs to RSAs, generating more revenue in the early years. These temporary revenue gains, however, mask the underlying fiscal effect of the proposal: By expanding tax-preferred savings opportunities, the proposal would reduce revenue over time. Indeed, by the second half of the projection period, the proposals would result in a net reduction in revenues as the effect of untaxed withdrawals began to outweigh the effect of new contributions.

Modification of Financing of the Airport and Airway Trust Fund

Currently, excise taxes on airline tickets, domestic air freight transportation, and aviation fuel fund the Airport and Airway Trust Fund. Starting in 2009, the Administration proposes to stop collecting most taxes on air transportation. A tax on international arrivals and departures would continue, along with the aviation fuel tax, although the tax rates might change. Eliminating or changing these taxes would reduce revenues by $71 billion over the 2009–2017 period.

The Administration proposes replacing those taxes with various fees on commercial aviation that would help pay for the use of air traffic control services by that industry. Under the Administration's proposal, those fees would be recorded as offsets to discretionary spending by the Federal Aviation Administration, starting in 2009. (CBO assumes that the impact of those fees on discretionary spending is reflected in the aggregate funding levels specified in the President's budget for discretionary spending over the 2009–2012 period.)

Other Revenue Proposals

The President's budget also includes a number of other tax proposals, such as changing the treatment of incentives related to charitable giving, health care, education, the environment, and tax compliance. Together, those other proposals would reduce revenues by over $15 billion between 2008 and 2017 and decrease outlays for refundable tax credits by $4 billion over the same period.

Policy Proposals That Affect Mandatory Spending

If the proposals in the President's budget were enacted, they would reduce mandatory spending by $34 billion (0.4 percent) over the next five years, CBO estimates, but increase it by $164 billion over the 2008–2017 period (see Table 1-3 on page 6). Outlays would rise mostly for the Social Security program (for the proposed individual accounts), for refundable tax credits (primarily the earned income and child tax credits), for the Pell Grant program, and for the reauthorization of the farm bill. Those increases would be partly offset by lower spending for student loan programs, Medicare, and Medicaid, and by higher premium payments from Medicare beneficiaries.

Social Security

The President proposes to establish voluntary individual accounts for workers, which would replace some of the Social Security benefits provided under current law. For people who chose to participate, the government would deposit an amount equivalent to up to 4 percentage points of the current 12.4 percent tax on covered earnings into an individual account. The account holder would direct how the money should be invested within a limited number of investment options similar to those available under the Thrift Savings Plan for federal employees. When account holders eventually began to draw Social Security benefits, their defined benefit would be reduced according to a formula based on the amount deposited in their individual account.

Net outlays from establishing individual accounts would total $270 billion between 2011 and 2017, in CBO's estimation. The Administration projects much higher outlays—$637 billion over that period—chiefly because it estimates that two-thirds of eligible workers will participate, whereas CBO estimates that about one-third will sign up. In addition, CBO assumes that, initially, there will be a lag between the point at which the contributions are set aside and the point at which they are transferred to the individual accounts and recorded as outlays; therefore, CBO estimates that most outlays resulting from the establishment of individual accounts will first be recorded in 2013 (rather than in 2012, as estimated by the Administration).

The President's budget also includes three proposals that would modestly reduce outlays for Social Security benefits:

- Suspending benefits for 16- and 17-year-old children of retired, deceased, or disabled workers unless the children are in school (under current law, such benefits essentially continue through age 18 or for a slightly longer period if the recipients are still in secondary school);

- Requiring state and local governments to provide information about their annuitants in order to strengthen enforcement of two current provisions (the windfall elimination provision and the government pension offset) that reduce Social Security benefits for people who have pensions from employment that was not covered by Social Security; and

- Altering the way disability benefits are reduced when beneficiaries also receive workers' compensation for a work-related illness or injury.

In all, those three proposals would save more than $5 billion over the 2008–2017 period, CBO estimates. (Those savings are included under "other" mandatory outlay proposals in Table 1-3.)

Medicare

The President's budget contains various proposals to alter the Medicare program. The major components of the plan would reduce payment rates for a broad range of services covered by Hospital Insurance (Part A) and Supplementary Medical Insurance (Part B), shift some spending to private insurers, and increase premiums paid by certain beneficiaries. In CBO's estimation, those provisions would reduce net Medicare spending by $232 billion (or 4.3 percent) over the 2008–2017 period. (See Box 1-1 for a discussion of the long-term effects of the President's Medicare proposals.)

The proposal that would yield the largest estimated savings calls for a reduction in the annual updates to payment rates for most nonphysician services. Under current law, payment rates for most services increase each year with inflation. The proposal would permanently reduce those automatic annual updates for most nonphysician services by half of the expected gain in productivity, or 0.65 percentage points. (As a result, those payment rates would be about 6 percent lower in 2017 than is the case under current law.) In addition, the proposal would freeze payment rates in 2008 for services furnished by skilled nursing facilities and through 2012 for home health services. CBO estimates those provisions will reduce net Medicare spending by $133 billion over the 2008–2017 period.

Refundable Tax Credits

The Administration's tax proposals would add about $164 billion to mandatory outlays for the refundable portion of the earned income and child tax credits over the 2008–2017 period, JCT estimates. The change with the largest impact would make the 2001 expansion of the child tax credit permanent.[6] Continuation of that credit in its current form, combined with changes to tax brackets and tax rates that affect the earned income tax credit, would increase outlays by $91 billion through 2017. In addition, the Administration's proposals to change the way that health insurance premiums and health care expenses are taxed would raise outlays by about $77 billion over the next 10 years. Other proposals would reduce refundable tax credits by $4 billion.

Medicaid and SCHIP

Implementing the President's proposals for the State Children's Health Insurance Program (SCHIP) and Medicaid would increase spending for the former by $12 billion, CBO estimates, and lower spending for the latter by a total of $49 billion over the 2008–2017 period.

Under the President's proposals, SCHIP would be reauthorized for five years but several changes would be made to the program. The changes would include the following: Funding would be increased by $277 million in 2009 and by $1.5 billion for each year from 2010 to 2012; the time that states could use SCHIP funds would be shortened from three years to one year before those funds were reallocated to other states; and the Medicaid match rate would be applied to spending on all adults other than pregnant women and to spending on children and pregnant women with family income greater than 200 percent of the federal poverty level. Consistent with

6. Before enactment of EGTRRA, the maximum child tax credit per qualifying child was $500. The credit was refundable only for families with three or more qualifying children and had other limitations. EGTRRA increased the credit to $1,000 per child, with refundability not contingent on the number of qualifying children but limited to 15 percent of the amount of earned income in excess of $10,000 (indexed for inflation after 2001).

longstanding practice, CBO assumes in its estimate that funding for the program after 2012 would continue at the proposed 2012 level of $6.5 billion. (Under current law, the program has been funded at $5 billion per year.) CBO estimates that the proposal would increase SCHIP spending by $1 billion in 2007 and by $12 billion over the 2008–2017 period. By reducing the extent to which states could use Medicaid funds after exhausting their SCHIP funds, the proposal also would decrease Medicaid spending by $8 billion over the 2008–2017 period.

A total of 7.4 million people were enrolled in SCHIP at some point during 2006. Under the baseline funding level of $5 billion per year, CBO estimates that the program's enrollment would remain at 7.4 million in 2007 and then decline to 5.6 million by 2012. CBO estimates that, under the President's proposal, enrollment would reach 8.3 million people in 2007 and then fall to 6.7 million by 2012.

Further Medicaid savings would be realized by lowering the federal matching rate for certain services ($24 billion), by reducing spending on prescription drugs ($7 billion), and by reducing payments to states for administrative services ($4 billion). Additional savings of $4 billion would result from tightening eligibility for long-term-care services and increasing recoveries from estates of deceased beneficiaries. And, a policy to increase funding for the Supplemental Security Income program's disability reviews would lower Medicaid spending by an estimated $2 billion over the 10-year period.

Student Aid

The Administration proposes raising the maximum award under the Pell Grant program from the current level of $4,310 for academic year 2007–2008 to $4,600 for 2008–2009 and then by an additional $200 each succeeding year until the award reaches $5,400 in 2012–2013. CBO estimates that this proposal will increase mandatory outlays by nearly $47 billion between 2008 and 2017.[7]

The President also proposes numerous changes to the student loan programs. For the most part, those changes are designed to reduce the government's subsidy costs for guaranteed student loans by reducing federal payments to private lenders, increasing lender origination fees, and lowering the amount of the federal guarantee. In addition, the President proposes reducing the payments made to cover administrative costs of the guaranty agencies that oversee the guaranteed loan program on behalf of the federal government and accelerating the recall of the federal share of Perkins loan repayments. Changes that would raise the government's costs include a plan to increase borrowing levels for certain undergraduate students and to make the interest rates on parent and gradPLUS loans comparable across all programs. On net, those changes would reduce mandatory outlays by over $27 billion from 2008 to 2017, CBO estimates.

The President's Farm Bill Proposal

The President's budget includes an allowance of $5 billion over 10 years for legislation that would revise and extend expiring provisions of the Farm Security and Rural Investment Act of 2002. The Department of Agriculture subsequently announced details of the Administration's proposals (and estimated their total cost at $3 billion from 2008 to 2017). CBO estimates that the proposals, which would affect commodity, conservation, trade, rural development, nutrition and other programs, would increase spending by nearly $9 billion over the next 10 years, relative to CBO's baseline projections (which assume continuation of most current farm programs).

The proposals are intended to shift spending to programs that are not tied to current farm production. Under the proposals, lower loan rates would reduce spending for the commodity loan program (which compensates farmers for their current production if prices fall below a specified level) whereas higher payment rates would increase spending for the direct payment program (which provides fixed prices to farmers for a portion of their historical production). The countercyclical payment program, under which farmers receive payments on a portion of past production if national average prices fall below target prices, would be replaced by a countercyclical program under which farmers would receive payments if national average revenues were to fall below target revenues. (Producers could receive direct and countercyclical payments even if they did not produce a crop in the current year.) In addition, the President proposes to tighten payment limits, reduce spending for the sugar program, and extend dairy payments (under current law, those payments end in 2007).

7. The proposal would classify amounts necessary to fund a maximum grant of $4,050 as discretionary but funding for amounts above $4,050 as mandatory.

Box 1-1.

The Effect of the President's Proposals for Medicare on the Long-Term Outlook

The major components of the President's proposals for Medicare would reduce payment rates to health care providers for services covered by the Hospital Insurance (Part A) and Supplementary Medical Insurance (Part B) programs, shift some spending to private insurers, and increase premiums paid by certain beneficiaries. The Congressional Budget Office (CBO) estimates that those provisions would reduce net Medicare spending by $232 billion, or 0.1 percent of gross domestic product (GDP), over the 2008–2017 period.

Because the growing costs of the government's health care programs will apply considerable pressure to the budget in the coming decades, it is useful to examine the long-term impact of proposed changes to those programs. In assessing the long-term budget outlook for Medicare, CBO projects the future path of such spending and the effect of the President's proposals using multiple scenarios.[1] In the high-cost scenario, spending per Medicare enrollee would grow 2.5 percentage points faster than per capita GDP between 2007 and 2050, approximately the average growth rate for overall U.S. health costs over the past few decades. In the intermediate scenario, such spending would grow 1 percentage point faster than per capita GDP, consistent with the assumptions used by the Medicare trustees.

Assessing the long-term impact of any proposed changes in payment rates is particularly difficult because the degree to which such proposals could be sustained for an extended time is unclear. Over the course of several decades, it would not be feasible for Medicare payment rates to differ substantially from private sector payment rates without limiting access or creating other problems. As a result, other changes in the health sector that slowed overall cost growth would be necessary in order to continue the proposed changes in payment policies for several decades while maintaining current levels of access to services among Medicare beneficiaries.

Nevertheless, to provide insight into the potential magnitude of the President's proposed changes in the event that they could be sustained for a long period, CBO has calculated their impact on net Medicare spending through 2050. In particular, the calculations assume that the proposed constraint on increases in payment rates for specified Medicare services would continue through 2050 without significant changes in providers' practices or their level of participation in the program and that increased premiums would not cause substantial reductions in beneficiaries' level of participation in Part B or the prescription drug program.

Those hypothetical calculations show that, under the high-cost scenario, the President's proposals to slow growth in Medicare spending and to increase Medicare premiums would reduce federal outlays for Medicare, net of premiums paid by beneficiaries, from about 9 percent of GDP to about 7 percent by 2050. Under the intermediate scenario, the potential effect of the proposals would be somewhat smaller—they would reduce the growth in net federal outlays by about 1.4 percent of GDP in 2050, relative to current law.

1. See Congressional Budget Office, *The Long-Term Budget Outlook* (December 2005). That report also includes a third scenario, which illustrates the level of spending that would occur if Medicare outlays grew only because of the aging of the population.

Box 1-1.

Continued

The Effect of the President's Proposals for Medicare on the Long-Term Outlook

	High-Cost Scenario	Intermediate-Cost Scenario
Medicare Outlays in 2050 (Percentage of GDP)		
Under the President's proposals	6.9	4.8
Under current law	8.9	6.3
Change	-2.0	-1.4
Medicare Outlays from 2007 to 2050 (Present value as a percentage of the present value of GDP)		
Under the President's proposals	6.7	4.7
Under current law	7.4	5.3
Change	-0.6	-0.5

Source: Congressional Budget Office.

Notes: GDP = gross domestic product.

Medicare outlays include receipts from premiums.

CBO estimates that net Medicare outlays in 2007 will equal 2.7 percent of GDP.

Those effects are much larger than would occur in earlier years because the proposed reductions in growth rates would compound over time. One way to summarize the effects over the entire period from 2007 to 2050 is to compare the present value of Medicare outlays with the present value of GDP.[2] The President's proposals would reduce that present value calculation from 7.4 percent of GDP to 6.7 percent of GDP under the high-cost scenario. Under the intermediate scenario, the present value of Medicare outlays as a percentage of GDP would drop from 5.3 percent to 4.7 percent. The effect of the proposals (amounting to about 0.5 percent of GDP) is generally consistent with the Administration's estimate.[3]

Those rough calculations are provided to indicate the potential long-run impact on Medicare's costs from proposed changes in the program's parameters. However, historical experience and the fact that Medicare has significant interactions with the rest of the health system suggest that, ultimately, slowing cost growth in the health sector as a whole will also be necessary to constrain the growth of costs for Medicare over a long period if broad access to medical services is to be maintained.

2. Present value is a single number that expresses a flow of current and future income (or payments) in terms of an equivalent lump sum received (or paid) today.

3. The Administration has published present-value figures through 2080 that are significantly higher than CBO's calculations primarily because of the effect of compounding over the additional 30 years.

Other provisions of the proposal would extend benefits to producers of specialty crops, livestock and forestry enterprises, and other agricultural and rural interests. The proposals also would reduce subsidies for crop insurance, expand access to Food Stamps among the elderly and working poor, and increase purchases of fruits and vegetables for nutrition assistance programs.

Other Mandatory Spending Proposals

If all other proposals that involve mandatory spending programs were enacted, they would, on net, decrease outlays by $30 billion over the 2008–2017 period, CBO estimates. Those proposals affect the following spending categories:

Pension Insurance. The President proposes raising the variable-rate insurance premiums that some companies pay to the federal Pension Benefit Guaranty Corporation (PBGC) on behalf of underfunded plans. Currently, the premium rate is set by statute at $9 per $1,000 of underfunding. Under the President's proposal, PBGC's board of directors would be given the authority to alter the premium rate; both CBO and the Administration assumed that the board would raise the rate to $14 per $1,000 of underfunding. The higher premiums would be used to offset some of PBGC's existing deficit and a portion of its anticipated deficits over the next 10 years. That change would increase collections and thus reduce outlays by $9 billion over the 2008–2017 period.[8]

ANWR Leasing. The President proposes leasing a portion of the coastal plain of the Arctic National Wildlife Refuge (ANWR) for the development of oil and natural gas. CBO anticipates that those leases would be offered in two phases (as specified in recent legislative proposals), with the first sale likely to occur in 2010 and the second in 2012. Proceeds to the federal government from bonuses and rents would total $6 billion between 2008 and 2017, CBO estimates. (Although the federal government would later receive income from royalties on production, nearly all of those payments would occur after 2017.) Under the President's proposal, half of the receipts from leasing would be paid to Alaska, resulting in net federal receipts of $3 billion over the projection period.[9]

Veterans' Benefits. The President has proposed several changes in the health care program of the Department of Veterans Affairs. First, the President proposes eliminating the practice of waiving copayments for doctors' visits from veterans with third-party insurance, beginning in 2008. The second proposal, which would also take effect in 2008, would increase pharmacy copayments from $8 to $15 for veterans without service-connected disabilities and incomes above a certain threshold. Third, the President proposes charging an enrollment fee for that same group of veterans, beginning in 2009; the annual fee would be $250, $500, or $750, depending on the level of family income. CBO estimates that, together, those proposals would generate additional receipts totaling nearly $5 billion over the 2008–2017 period. Those sums would be considered offsets to mandatory spending.

Other. Other policy changes proposed in the President's budget would affect mandatory spending in a number of areas. For example, the Administration has proposed reducing annual funding for the Social Services Block Grant program by $500 million starting in 2009, which would decrease outlays over the 10-year period by over $4 billion.[10] Proposed spending for Temporary Assistance for Needy Families would rise by nearly $3 billion over the 2008–2017 period, CBO estimates. That increase results mostly from proposals to continue an existing supplemental grant, to implement a change in work penalties, and to make the contingency fund available to states that opt into a new foster care block grant program and then experience an increase in their foster care caseload.

Policy Proposals That Affect Discretionary Spending

As of early March, lawmakers had enacted $951 billion in discretionary budget authority for 2007, including $70 billion for military operations in Iraq and Afghanistan. The Administration has requested another $103 billion in supplemental funding for 2007 (nearly $100 bil-

8. PBGC would also earn additional interest income as a result.

9. CBO's estimate of bonus bids is based on the U.S. Geological Survey's projections of the mean value of economically recoverable oil that could be produced from federal land in the refuge. It also relies on information from other federal agencies, the state of Alaska, and industry experts about how oil and gas companies perceive several key factors that affect the expected profitability of ANWR leases—in particular, companies' probable assumptions about long-term oil prices and required rates of return on such investments.

10. The reduction in 2008 would be classified as discretionary.

lion for military operations in Iraq and Afghanistan and for other activities related to the war on terrorism and over $3 billion for relief from hurricane damage). If that supplemental funding was enacted, total budget authority for 2007 would rise to $1,054 billion (see Table 1-5 and Table 1-6).

For 2008, the President proposes $1,078 billion in discretionary budget authority, CBO estimates—$646 billion for national defense and $432 billion for nondefense programs.[11] The defense request includes $142 billion for operations in Iraq and Afghanistan and other operations related to the war on terrorism.

If funding for activities in Iraq and Afghanistan and for relief from hurricane damage was excluded from the comparison, discretionary budget authority under the President's proposals would grow by 5.8 percent, or $51 billion, from 2007 to 2008. Appropriations for defense would increase by about 11.4 percent, and funding for homeland security activities would rise by 3.2 percent. Other appropriations would decrease overall by 0.3 percent.

As previously mentioned, the budget does not specify detailed appropriation amounts beyond 2008 but instead includes aggregate funding totals through 2012 for two categories of spending: that designated for the Department of Defense and that provided for all other agencies.[12] With funding for military operations in Iraq and Afghanistan and other activities related to the war on terrorism excluded, proposed funding for DoD would grow by $53 billion from 2008 to 2012—an average annual rate of growth of 2.6 percent (somewhat faster than the 2.2 percent rate of inflation that CBO projects for the period).

Discretionary funding provided for all other agencies would grow slightly from the level proposed for 2008—rising from $453 billion next year to $463 billion in 2012. Such a level in 2012 would represent a reduction of 6 percent in inflation-adjusted terms.

Defense Programs

CBO estimates that, relative to its baseline, the President's proposals will add $26 billion to defense outlays in 2007 and $77 billion in 2008. Most of those outlays stem from the request for another $94 billion in budget authority in 2007 and $142 billion in 2008 for military operations in Iraq and Afghanistan (in addition to the $70 billion already appropriated for this year).[13] If that $94 billion were appropriated, budget authority for defense would total $616 billion this year—10.7 percent more than the $557 billion provided for 2006. Defense outlays would reach 4.1 percent of GDP in 2007, up from 3.0 percent of GDP just six years ago.

Budget authority provided through emergency appropriations for DoD operations in Iraq and Afghanistan and the war on terrorism would total $164 billion in 2007, compared with $116 billion in 2006. Most of that growth would come from increases of more than $19 billion (26 percent) in funding for operations and maintenance and $26 billion (114 percent) for procurement. In total, emergency appropriations for Iraq, Afghanistan, and for the war on terrorism would constitute over 26 percent of budget authority for defense in 2007.

Operations and maintenance ($79 billion), procurement ($40 billion), and personnel ($17 billion) would receive the bulk of the $142 billion that the President has requested for military operations in Iraq and Afghanistan in 2008. The President's budget includes a much smaller amount of such funding in 2009 and no appropriations thereafter. As a result, budget authority for the Defense Department would fall from $561 billion in 2009 to $536 billion in 2012 under the President's policies (see Figure 1-2). Outlays for DoD would be a total of $132 billion above the amounts in CBO's baseline between 2008 and 2012. (In keeping with the rules that govern baseline projections, the baseline assumes that the $70 billion already appropriated this year will continue in each subsequent year through 2017, with adjustments for inflation.)

11. For a number of reasons—including differences in projections of offsetting collections, estimates for the defense health program, and other technical factors—the Administration's estimate of budget authority for 2008 is $2.7 billion lower than CBO's estimate.

12. The defense discretionary category in Table 1-5 and Table 1-6 also includes spending for atomic energy and other defense-related programs that are not administered by the Department of Defense. The Administration included its request for such funding for 2009 to 2012 in its "all other" category.

13. The President's request includes $10 billion in funding for 2007 and $4 billion for 2008 for programs outside of the Defense Department.

Table 1-5.

Proposed Changes in Discretionary Budget Authority in the President's Budget, 2006 to 2008

(Billions of dollars)

	Actual	Administration's Request		Percentage Change	
	2006	2007[a]	2008	2006-2007	2007-2008
Budget Authority					
Defense	557	616 [b]	646	10.7	4.8
Nondefense					
Homeland security[c]	29	31 [b]	32	6.0	3.1
Other	410	407 [b]	400	-0.7	-1.8
Subtotal, nondefense	439	438 [b]	432	-0.3	-1.4
Total	**996**	**1,054** [b]	**1,078**	**5.8**	**2.2**
Budget Authority, Excluding Funding for Activities in Iraq and Afghanistan and Disaster Relief[d]					
Defense	433	452	504	4.4	11.4
Nondefense					
Homeland security[c]	29	31	32	6.5	3.2
Other	389	398	397	2.4	-0.3
Subtotal, nondefense	418	429	429	2.6	*
Total	**851**	**881**	**932**	**3.6**	**5.8**

Source: Congressional Budget Office.

Notes: These numbers do not include obligation limitations for certain transportation programs.

* = between -0.05 percent and zero.

a. Includes the effects of the full-year continuing resolution (which had not been enacted at the time the President released his budget).

b. Includes the Administration's request for supplemental appropriations to fund military operations in Iraq and Afghanistan and for further hurricane relief and recovery.

c. CBO's classification of homeland security funding is based on designations established by the Administration. Those designations are not limited to the activities of the Department of Homeland Security. In fact, some of the department's activities (such as disaster relief) are not included in the Administration's definition of homeland security, whereas nondepartmental activities (such as some defense-related programs and some funding for the National Institutes of Health) fall within that definition. About 60 percent of all spending considered to be for homeland security is for activities outside the Department of Homeland Security.

d. In 2006, the Congress and the President provided $120 billion in funding for activities in Iraq and Afghanistan and for the war on terrorism and nearly $25 billion in supplemental appropriations in response to Hurricanes Katrina and Rita. Thus far in 2007, $70 billion in funding has been provided for operations in Iraq and Afghanistan. For 2007, the President's budget requests another $100 billion in supplemental funding for activities in Iraq and Afghanistan and for the war on terrorism, as well as $3 billion for hurricane relief and recovery. In addition, the President's budget requests $145 billion for 2008 for activities in Iraq and Afghanistan and for the war on terrorism.

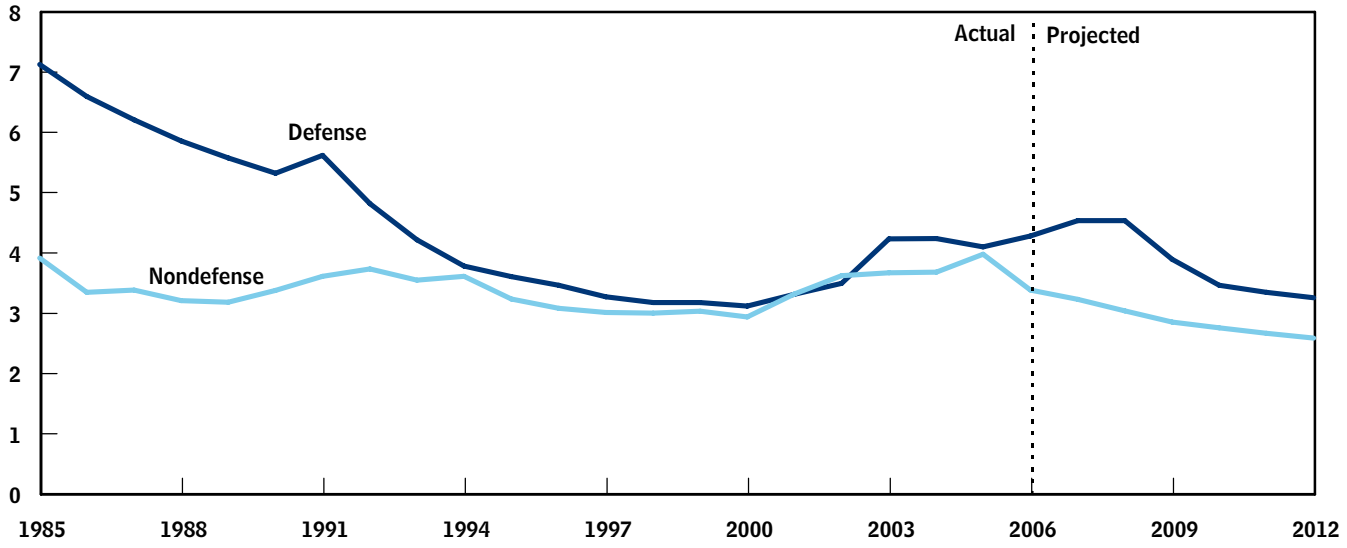
With funding for Iraq and Afghanistan and disaster relief excluded from the comparison, budget authority for defense grew by 4.4 percent, or $19 billion, from 2006 to 2007. Under the President's budget, it would rise by 11.4 percent, or $51 billion, in 2008.

Most major categories of nonemergency funding for DoD would receive increases in 2008. The largest percentage rise (100 percent, or $9.1 billion) would be for military construction, primarily to implement a new round of base closures. Procurement funding would increase by $20.4 billion (25.1 percent), in part for new equipment sought for the Administration's plan to permanently increase the number of personnel in the Army and Marine Corps.

Figure 1-2.

Discretionary Budget Authority in Recent Decades and Under Policies Proposed in the President's 2008 Budget

(Percentage of gross domestic product)



Source: Congressional Budget Office.

That increase, which must be approved by the Congress, would add 65,000 active-duty personnel to the Army and 27,000 to the Marine Corps, relative to the number of personnel serving prior to September 2001. The procurement increase would be used to purchase additional combat, tactical, and support vehicles for personnel already serving in the Army as well as for combat and other aircraft, including the Joint Strike Fighter.

Operation and maintenance activities would also receive a large boost (11.8 percent, or $17.6 billion), funding a wide variety of areas, such as depot maintenance, training, recruiting, transportation, and logistics and other support. The requested funds also would cover certain other costs associated with the planned increase in the number of Army and Marine Corps personnel.

Nondefense Discretionary Programs

Under the President's budget, funding for nondefense discretionary programs would reach $438 billion in 2007, an amount that includes a request for an additional $3.4 billion in supplemental appropriations for hurricane relief and recovery. For 2008, the Administration seeks to reduce budget authority for nondefense discretionary programs to $432 billion.

Excluding funding for activities in Iraq and Afghanistan and other activities related to the war on terrorism and funding for hurricane relief, total nondefense discretionary budget authority in 2008 under the President's budget would be about the same as that appropriated in 2007. Budget authority would rise for some activities and fall for others.

The largest funding decreases in dollar terms would be for education, training, employment and social services programs. That category of spending would face a reduction of $3.8 billion (4.8 percent), primarily for grants for social services, vocational education, higher education, employment, and training programs. Budget authority for community and regional development would decrease by $1.9 billion (14.7 percent); about half of that drop would occur in the community development fund.

Other areas of the budget would see their funding increase in 2008 under the President's proposals. Budget authority for international affairs programs would grow by $3.8 billion (11.5 percent), largely for the Millennium Challenge Corporation, economic support for other countries, and the global HIV/AIDS initiative. Veterans' benefits would receive an additional $3.1 billion (8.5 percent) in 2008, mainly to provide medical care to veterans

Table 1-6.

Discretionary Budget Authority Requested by the President for 2008 Compared with Funding for 2007, by Budget Function

(Billions of dollars)

	Funding for 2007			
	Regular Enacted	Emergency Enacted[a]	Supplemental Requested[a]	Total
Defense Discretionary	452.4	70.0	93.6	616.0
Nondefense Discretionary				
International affairs	32.7	*	6.0	38.7
General science, space, and technology	25.0	0	0	25.0
Energy	4.2	0	0	4.2
Natural resources and environment	30.4	0	0	30.4
Agriculture	5.8	0	0	5.8
Commerce and housing credit	2.7	0	0	2.7
Transportation	25.9	0.2	0	26.1
Community and regional development	13.0	0	3.4	16.4
Education, training, employment, and social services	80.3	0	0	80.3
Health	52.1	0	0	52.1
Medicare (Administrative costs)	4.8	0	0	4.8
Income security	49.5	0	0	49.5
Social Security (Administrative costs)	4.7	0	0	4.7
Veterans' benefits and services	36.5	0	0	36.5
Administration of justice	42.6	1.7	0.1	44.3
General government	16.1	0	*	16.1
Allowances for emergencies and other needs	0.8	0	0	0.8
Subtotal, nondefense discretionary	426.9	1.8	9.5	438.2
Total	**879.3**	**71.8**	**103.0**	**1,054.2**
Memorandum:				
Transportation Obligation Limitations[b]	51.1	0	0	51.1

Source: Congressional Budget Office.

Note: n.a. = not applicable; * = between -$50 million and $50 million.

a. Mostly for military operations in Iraq and Afghanistan and for hurricane relief.

b. Spending from the Highway Trust Fund and the Airport and Airway Trust Fund is controlled by obligation limitations. Budget authority for those programs is provided in authorizing legislation and is not considered discretionary.

Funding for 2008			Change in Regular Funding, 2007-2008	
Regular Requested	Supplemental Requested	Total	Billions of Dollars	Percent
503.8	141.8	645.7	51.4	11.4
36.5	3.3	39.8	3.8	11.5
27.3	0	27.3	2.4	9.5
4.3	0	4.3	0.2	3.7
28.8	0	28.8	-1.6	-5.3
5.8	0	5.8	*	0.4
3.4	0	3.4	0.7	26.5
23.3	*	23.3	-2.6	-10.2
11.0	-0.4	10.7	-1.9	-14.7
76.5	*	76.5	-3.8	-4.8
52.0	0	52.0	-0.1	-0.2
5.2	0	5.2	0.4	8.4
49.2	*	49.2	-0.3	-0.6
4.9	0	4.9	0.2	3.7
39.5	0	39.5	3.1	8.5
43.7	*	43.7	1.1	2.5
17.6	0	17.6	1.6	9.8
*	0	*	*	n.a.
429.0	3.0	432.0	2.9	0.5
932.8	**144.8**	**1,077.6**	**54.3**	**6.1**
51.6	0	51.6	0.5	1.0

and other beneficiaries. Funding for general science, space and technology would increase by $2.4 billion (9.5 percent), primarily for the National Aeronautics and Space Administration and energy programs.

Differences Between CBO's and the Administration's Budget Estimates

CBO's estimate of the deficit in 2007 under the President's budget ($214 billion) is $30 billion less than the Administration's estimate ($244 billion). The differences are smaller for 2008 and 2009 but larger for subsequent years. The cumulative five-year deficits and surpluses projected by CBO and the Administration differ by $276 billion—equivalent to 1.8 percent of projected outlays during that period. CBO's estimate of outlays over those five years is lower than the Administration's by $26 billion (0.2 percent), and its estimate of revenues is lower by $302 billion (2.1 percent).

Baseline Differences

In conjunction with the President's budget request, the Administration published a current-services baseline extending through 2012. In that baseline, the deficit declines each year through 2009; thereafter, the Administration projects an increasing surplus through 2012 (when it reaches $147 billion). CBO's baseline, by contrast, shows a growing deficit through 2010, followed by a sharp decline in the deficit in 2011 and a surplus in 2012 ($155 billion). The Administration's baseline shows a cumulative surplus of $143 billion over the 2008–2012 period, whereas CBO projects a $283 billion cumulative deficit for those five years (see Table 1-7).

There are significant conceptual differences between the two baselines, but because those differences largely offset one another, they do not significantly affect the gap between the baselines. CBO constructs its baseline as specified in the Balanced Budget and Emergency Deficit Control Act of 1985. (Although the provisions of the act that pertain to the baseline expired at the end of September 2006, CBO continues to follow that law's specifications in preparing its projections.) The Administration, however, has deviated from prior practices in three main ways. First, its current-services baseline assumes that the major tax-law changes enacted in EGTRRA and JGTRRA will be extended rather than allowed to expire as scheduled. From 2008 to 2012, that conceptual difference reduces the Administration's estimate of revenues by $374 billion. Second, the Administration has not extrapolated into future years the $72 billion in 2007 emergency funding that was appropriated in 2007 for operations in Iraq and Afghanistan ($70 billion) and for the Department of Homeland Security ($2 billion). Third, the Administration has adjusted the way it accounts for increases in pay when projecting discretionary spending.

With such conceptual differences excluded, the difference between the cumulative baseline deficits that CBO and the Administration project for the 2008–2012 period increases from $427 billion to $447 billion (or 2.9 percent of projected outlays). When presented on a comparable basis, the Administration's revenue estimates are $422 billion higher than CBO's, and its projection of outlays is $25 billion lower over the five-year period.

Most of the underlying discrepancy in baseline revenues results from differing economic assumptions, which are discussed in the next section. The Administration's assumptions result in higher projections of taxable income, thus leading to higher revenue estimates.

Excluding conceptual differences, CBO's projection of discretionary spending is still higher than the Administration's over the 2008–2012 period. About $20 billion of that difference is from defense spending projections; CBO also projects higher outlays than the Administration does for highway programs, veterans' medical services, and border security. In contrast, CBO projects lower total outlays for mandatory programs. Its estimates are lower than those outlined in the President's current-services baseline for Medicare (by $56 billion), veterans' benefits (by $32 billion), and Social Security (by $23 billion); they are higher for a few programs, including Medicaid (by $39 billion) and unemployment compensation (by $15 billion).

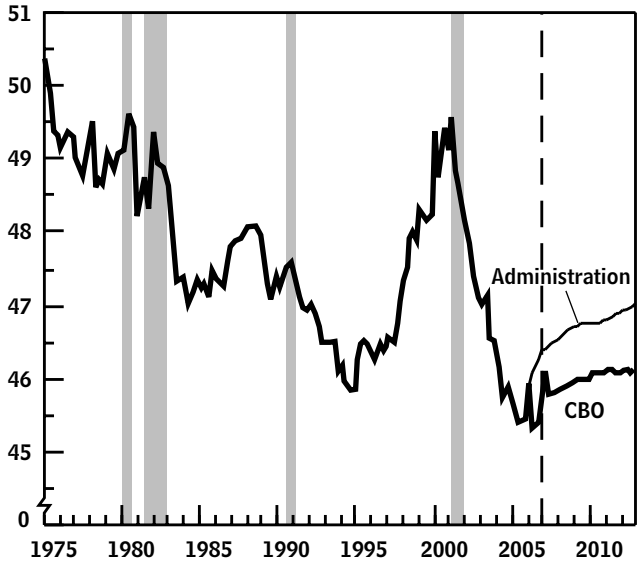
CBO's and the Administration's Economic Assumptions

The Administration's economic projections lead to more favorable budget projections than CBO's forecast does. The Administration's forecast indicates higher inflation, higher taxable incomes as a share of GDP, and slightly higher real GDP growth (see Table 1-8 and Table 1-9); as a result, its projections of revenues are also higher. Compared with CBO's economic outlook, the Administration's forecast decreases the projection of the cumulative deficit for the 2008–2012 period by $640 billion (including debt service).

Figure 1-3.

CBO's and the Administration's Forecasts of Wages and Salaries

(Percentage of gross domestic product)



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

According to CBO's estimates, revenue projections based on the Administration's economic forecast of wages and salaries, corporate profits, and other taxable incomes would be $619 billion greater over the 2008–2012 period than those that would result from CBO's economic outlook. The Administration's forecast for nominal GDP growth over that period is higher (largely because of higher inflation forecasts for this year and next), and its estimate of the share of wages and salaries in GDP is greater than CBO projects (see Figure 1-3). The difference in projections during the initial years of the projection period for the share of wages and salaries—a category of income that is extremely important for projecting revenues—stems in part from the timing of the forecasts.

The Administration had completed its forecast before the November 30, 2006, revision in the national income and product accounts, a revision that lowered the wage share for early 2006. CBO's forecast, which was completed later than the Administration's, incorporated that revision. The revision, however, was not a major factor in the difference in the latter years of the projection period because CBO and the Administration use different procedures to project the longer-run income shares.[14] The higher level of nominal GDP projected by the Administration coupled with the higher share of wages relative to GDP resulted in a projection of a much higher level of wages and salaries. That discrepancy accounts for most of the difference in the revenues implied by the two economic forecasts.

The forecasts also have different implications for outlays, but they are much smaller than for revenues. Because the Administration's inflation forecast is higher than CBO's, its economic outlook leads to slightly higher estimates of outlays.[15] The faster growth in the consumer price index results in projections of larger cost-of-living adjustments for Social Security and other indexed programs, and the faster growth in the GDP price index increases projections of discretionary spending.

Other differences between the two forecasts are smaller and have little effect on the respective budget projections. For example, the Administration's forecast for the unemployment rate is only slightly below that of CBO, and the two forecasts have similar outlooks for interest rates.

Total Outlay Differences

For 2007, CBO's estimate of outlays under the President's budget is $37 billion below the Administration's (see Table 1-4 on page 7). CBO's estimates of discretionary spending and mandatory outlays are less than the Administration's by $23 billion (2 percent of such outlays) and $11 billion (1 percent of outlays), respectively. CBO's estimate of net interest, which is $3 billion below the Administration's, mainly results from technical factors.

About $12 billion of the gap in discretionary outlays stems from different estimates for defense spending. Half of that amount is attributable to proposed supplemental appropriations for this year for operations in Iraq and Afghanistan—CBO expects that such spending will occur more slowly than does the Administration. The other half stems from a timing difference. CBO's estimates incorporate the effects of the recently enacted Revised Continuing Appropriations Resolution, 2007.

14. See Congressional Budget Office, *How CBO Forecasts Income* (August 2006).

15. The CBO forecast of inflation assumes that over the 2009–2012 period, the growth of the personal consumption price index will average about 2.0 percent—the upper end of the range in inflation that has been identified as acceptable by leading members of the Federal Reserve's Open Market Committee.

Table 1-7.

Comparison of CBO's March 2007 Baseline and OMB's February 2007 Current-Services Baseline

(Billions of dollars)

	2007	2008	2009	2010	2011	2012	Total, 2008-2012
			CBO's March 2007 Baseline				
Revenues	2,542	2,720	2,810	2,901	3,167	3,405	15,003
On-budget	1,905	2,051	2,107	2,164	2,395	2,597	11,313
Off-budget	638	669	703	738	773	808	3,690
Outlays							
Mandatory	1,454	1,536	1,625	1,714	1,832	1,870	8,576
Discretionary	1,029	1,046	1,062	1,078	1,100	1,112	5,398
Net interest	236	251	256	266	270	268	1,312
Total	2,719	2,833	2,944	3,058	3,202	3,250	15,286
On-budget	2,268	2,366	2,458	2,552	2,676	2,699	12,751
Off-budget	451	467	486	506	526	551	2,535
Deficit (-) or Surplus	-177	-113	-134	-157	-35	155	-283
On-budget	-363	-315	-351	-388	-281	-102	-1,438
Off-budget	186	202	217	232	247	257	1,155
			Administration's February 2007 Current-Services Baseline				
Revenues	2,550	2,714	2,831	3,008	3,151	3,348	15,051
On-budget	1,916	2,040	2,119	2,254	2,356	2,513	11,282
Off-budget	634	674	711	753	796	835	3,770
Outlays							
Mandatory	1,465	1,537	1,631	1,727	1,850	1,918	8,664
Discretionary	1,032	961	976	987	1,008	1,028	4,960
Net interest	238	254	258	259	258	255	1,284
Total	2,735	2,752	2,866	2,973	3,116	3,201	14,908
On-budget	2,284	2,290	2,380	2,464	2,583	2,642	12,359
Off-budget	451	462	486	509	533	559	2,549
Deficit (-) or Surplus	-185	-38	-35	34	35	147	143
On-budget	-368	-250	-261	-210	-228	-130	-1,077
Off-budget	183	212	225	244	263	277	1,221

Continued

That act provided less funding for certain defense programs outside of the Department of Defense than was assumed for 2007 in the President's budget.[16]

In the nondefense discretionary category, outlays for disaster relief and community development in 2007 are expected to be $4 billion less than the Administration's estimate, largely because CBO expects spending on relief and recovery from Hurricane Katrina to occur more slowly than the Administration does. Furthermore, CBO anticipates lower outlays for a number of other programs and activities, including diplomatic and consular programs administered by the State Department, flood

16. The President submitted his budget request to the Congress on February 5, 2007, prior to the enactment of Public Law 110-5. Therefore, the Administration could not include the effects of that legislation in its estimates.

Table 1-7.

Continued

(Billions of dollars)

	2007	2008	2009	2010	2011	2012	Total, 2008-2012
			Difference (CBO minus Administration)				
Revenues	-7	6	-21	-106	16	57	-48
On-budget	-11	11	-12	-91	39	85	31
Off-budget	3	-5	-9	-16	-23	-27	-80
Outlays							
Mandatory	-12	-1	-6	-13	-19	-48	-88
Discretionary	-2	85	86	91	92	84	438
Net interest	-2	-3	-2	7	13	13	28
Total	-16	81	78	84	86	49	378
On-budget	-16	77	78	88	93	57	392
Off-budget	*	4	*	-3	-7	-7	-14
Deficit or Surplus[a]	8	-75	-99	-191	-70	8	-427
On-budget	5	-66	-90	-179	-54	28	-360
Off-budget	4	-9	-8	-12	-16	-20	-66

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

Notes: OMB's baseline deviates from the concepts delineated in the Balanced Budget and Emergency Deficit Control Act of 1985 in two significant ways: It assumes that most tax provisions enacted in 2001 and 2003 will be extended rather than allowed to expire as scheduled, and it does not extrapolate supplemental appropriations provided for 2007 into future years.

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

a. Positive numbers denote that the Administration's deficit estimate is higher than CBO's, and negative numbers denote that the Administration's deficit estimate is lower than CBO's.

control and coastal emergencies activities of the Corps of Engineers, Project Bioshield, and several education programs.

Among mandatory programs, CBO's estimates of spending for Medicare, veterans' benefits, and certain programs for the administration of justice—such as customs and border protection, and assistance to crime victims—are each $2 billion less than those of the Administration. In addition, CBO estimates about $1 billion less in outlays for the Disability Insurance and Food Stamp programs.

For the 2008–2012 period, CBO estimates that total outlays under the President's budget would be $26 billion less than the Administration projects, a difference of about 0.2 percent of total outlays. The biggest difference occurs in 2012; the variance for the preceding four years is smaller. Over the five-year period, CBO estimates that mandatory outlays and net interest on the public debt will be lower than the Administration anticipates—by $61 billion and $13 billion, respectively. In contrast, CBO's estimate of discretionary outlays exceeds the Administration's forecast by $48 billion.

On the mandatory side, about $28 billion of the difference occurs because CBO anticipates that the first substantial outlays for the President's proposal to establish individual retirement accounts would begin in 2013, rather than in 2012 as shown in the Administration's budget. Another difference in the two estimates, $21 billion, results from differing economic assumptions, especially those that affect Social Security benefits. CBO's estimate of Social Security outlays between 2008 and 2012 is $20 billion less than the Administration's

Table 1-8.

Comparisons of CBO's, the Administration's, and Private-Sector Economic Projections for Calendar Years 2007 to 2012

	Actual	Forecast		Projected Annual Average,
	2006	2007	2008	2009-2012
Nominal GDP (Billions of dollars)				
CBO	13,245	13,805	14,472	17,395 [a]
Administration	13,245	13,946	14,711	18,003 [a]
March *Blue Chip*				
Top 10 average	13,245	13,933	14,741	18,366 [b]
Consensus	13,245	13,867	14,580	17,790 [b]
Bottom 10 average	13,245	13,801	14,436	17,281 [b]
Nominal GDP (Percentage change)				
CBO	6.3	4.3	4.8	4.7
Administration	6.3	5.3	5.5	5.2
March *Blue Chip*				
Top 10 average	6.3	5.2	5.8	5.6
Consensus	6.3	4.7	5.1	5.1
Bottom 10 average	6.3	4.2	4.6	4.6
Real GDP (Percentage change)				
CBO	3.3	2.3	3.0	2.9
Administration	3.3	2.7	3.0	3.0
March *Blue Chip*				
Top 10 average	3.3	2.8	3.4	3.3
Consensus	3.3	2.5	3.0	3.0
Bottom 10 average	3.3	2.2	2.6	2.6
GDP Price Index (Percentage change)				
CBO	2.9	1.9	1.8	1.8
Administration	2.9	2.5	2.4	2.1
March *Blue Chip*				
Top 10 average	2.9	2.5	2.5	2.5
Consensus	2.9	2.2	2.1	2.1
Bottom 10 average	2.9	1.8	1.7	1.8
Consumer Price Index (Percentage change)[c]				
CBO	3.2	1.9	2.3	2.2
Administration	3.2	2.1	2.6	2.4
March *Blue Chip*				
Top 10 average	3.2	2.4	2.8	2.6
Consensus	3.2	2.0	2.4	2.3
Bottom 10 average	3.2	1.6	2.0	1.9
Unemployment Rate (Percent)				
CBO	4.6	4.7	4.9	5.0
Administration	4.6	4.6	4.8	4.8
March *Blue Chip*				
Top 10 average	4.6	4.9	5.1	5.3
Consensus	4.6	4.7	4.8	4.8
Bottom 10 average	4.6	4.5	4.5	4.4

Continued

Table 1-8.

Continued

	Actual 2006	Forecast 2007	Forecast 2008	Projected Annual Average, 2009-2012
Three-Month Treasury Bill Rate (Percent)				
CBO	4.7	4.8	4.5	4.4
Administration	4.7	4.7	4.6	4.2
March *Blue Chip*				
Top 10 average	4.7	5.2	5.4	5.2
Consensus	4.7	5.0	4.9	4.7
Bottom 10 average	4.7	4.6	4.4	4.2
Ten-Year Treasury Note Rate (Percent)				
CBO	4.8	4.8	5.0	5.2
Administration	4.8	5.0	5.1	5.3
March *Blue Chip*				
Top 10 average	4.8	5.0	5.4	5.5
Consensus	4.8	4.8	5.0	5.2
Bottom 10 average	4.8	4.5	4.6	4.7

Sources: Congressional Budget Office; Office of Management and Budget; Randell E. Moore, ed., *Blue Chip Economic Indicators* (New York: Aspen Publishers, March 10, 2007); Department of Commerce, Bureau of Economic Analysis; Federal Reserve Board; Department of Labor, Bureau of Labor Statistics.

Notes: Percentage changes are year over year.

GDP = gross domestic product.

a. Level in 2012.

b. Calculated by CBO from growth rates published in the *Blue Chip* survey.

c. The consumer price index for all urban consumers.

projection, mostly because CBO assumes lower cost-of-living adjustments and lower wages.

CBO's estimate of Medicare outlays is also lower than the Administration's—by $48 billion (0.5 percent) over five years ($26 billion for Parts A and B and $22 billion for Part D, the new prescription drug program). Those differences result almost entirely from differing projections of spending under current law. CBO also anticipates less spending for veterans' disability compensation—a difference of $31 billion (or 15 percent) over the 2008–2012 period because of projected lower caseloads and smaller benefit payments. In contrast, CBO estimates higher spending for Medicaid—by about $33 billion (or 3 percent) over that period. CBO projects more savings from the President's proposals but higher baseline outlays than the Administration anticipates. In addition, CBO also projects $25 billion more in outlays for the earned income and child tax credits.

On the discretionary side, CBO's estimates of outlays are slightly higher—by less than 1 percent—in four of the five years and about 2 percent higher in 2009. That difference is partially explained by CBO's estimates of spending from both regular and supplemental appropriations, which will be less in 2007 and more in subsequent years than the Administration anticipates.

CBO's estimate of net interest payments over the 2008–2012 period is $13 billion lower than that of the Administration. Economic differences increase CBO's estimate of net interest by $42 billion over the Administration's estimate. CBO's projection of lower inflation and interest rates reduces its net interest estimate by $23 billion compared with that of the Administration over the five-year period; however, the effect on debt service of other economic differences in outlays and revenues raises the cumulative estimate by $65 billion. Technical differences in estimates of net interest by CBO

Table 1-9.

CBO's and the Administration's Projections of Tax Bases for Selected Calendar Years

	Estimated 2006	Forecast 2007	Forecast 2008	Projected 2012
	In Billions of Dollars			
Corporate Book Profits				
CBO	1,795	1,775	1,787	1,763
Administration	1,779	1,785	1,815	1,879
Wages and Salaries				
CBO	6,032	6,330	6,642	8,019
Administration	6,115	6,478	6,862	8,454
	As a Percentage of Gross Domestic Product			
Corporate Book Profits				
CBO	13.6	12.9	12.3	10.1
Administration	13.4	12.8	12.3	10.4
Wages and Salaries				
CBO	45.6	45.9	45.9	46.1
Administration	46.2	46.5	46.6	47.0

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

Note: The *Blue Chip* survey does not include projections of tax bases.

and the Administration total $54 billion between 2008 and 2012, largely as a result of debt service and other technical variations.

Total Revenue Differences

If the President's proposals were enacted, revenues would total $2.5 trillion this year, CBO estimates—$7 billion less than the Administration projects. For the 2008–2012 period, however, CBO's projection of $14.5 trillion in total revenues is lower than the Administration's by $302 billion, or 2.1 percent.[17]

As discussed above, differences in economic assumptions—CBO's lower projections for GDP, the share of GDP that comes from wages and salaries, and the amount of corporate profits—cause CBO's estimates of revenues under the President's budget to be $32 billion lower than the Administration's for 2007 and $619 billion less for the 2008–2012 period.

Some of the difference related to economic projections is offset by technical differences. In particular, CBO estimates a higher revenue yield from any given economic scenario mainly because it estimates a higher average tax rate on corporate profits. Such technical differences raise CBO's revenue projections, relative to those of the Administration, by $25 billion for 2007 and by $196 billion for the 2008–2012 period.

Additional technical differences result from varying estimates of the effects of the President's revenue proposals. CBO, using JCT's estimates for most revenue provisions, projects that if the President's proposals were enacted, they would reduce revenues by a total of about $479 billion between 2008 and 2012, which is $120 billion less than the Administration estimates.

That difference can largely be attributed to variations in the estimate of the proposed change in the treatment of health insurance premiums and medical expenses (for further details, see Appendix C). JCT estimates that the proposal would raise revenues by $8 billion between 2008 and 2012, whereas the Administration estimates that the proposal would reduce revenues by $121 billion. JCT also projects smaller revenue reductions for several other proposals as well. For instance, JCT estimates that the proposal to permanently extend lower tax rates for dividends and capital gains would reduce revenues by about $33 billion over the five-year period, $10 billion less than the Administration projects. Similarly, JCT estimates smaller revenue reductions from permanently extending the research and experimentation tax credit (a difference of $9 billion).

17. Revenue projections in CBO's baseline are below those in the Administration's current-services baseline by $7 billion in 2007 and $48 billion over the 2008–2012 period (see Table 1-7). Conceptual differences between the two baselines cause CBO's baseline revenues to be $374 billion higher than the Administration's current-services baseline revenues between 2008 and 2012. Almost all of that occurs in 2011 and 2012 as a result of the expiration of tax provisions originally enacted in 2001 and 2003 under EGTRRA and JGTRRA.

In a number of other cases, JCT's estimates of the President's revenue proposals indicate larger reductions in revenue than the Administration's estimates do. For example, extending those provisions of EGTRRA and JGTRRA that affect tax rates, the child tax credit, and income tax brackets would reduce revenues by almost $243 billion over the 2008–2012 period, according to JCT's calculations. That figure is almost $18 billion more than the Administration's estimate. Likewise, JCT estimates that permanently extending the EGTRRA estate and gift provisions would reduce revenues by more than $102 billion over the five-year period, $11 billion more than the Administration estimates.

CHAPTER

2

The Economy Under the President's Budget and Under CBO's Baseline Policy Assumptions

In addition to estimating the direct budgetary impact of the President's proposals (see Chapter 1), the Congressional Budget Office has analyzed how those policies would affect the economy as a whole. Several important provisions of his proposals would tend to have mutually offsetting effects on the economy: Those that would tend to reduce output would offset others that would tend to expand it, resulting in quite modest effects overall. In terms of direct budgetary effects—that is, excluding economic feedbacks—CBO estimates that the President's budgetary proposals would increase the cumulative deficit relative to its level under the current-law baseline by $507 billion, or about 0.6 percent of cumulative gross domestic product, from 2008 to 2012 and by $1,139 billion, or 1.2 percent of cumulative GDP, from 2013 to 2017.

CBO's estimates of the economic feedbacks associated with the President's proposals depend on a variety of specific assumptions. However, under any of the assumptions incorporated into this analysis, economic feedbacks would modify the budgetary impact of the proposals to only a minor extent: They could raise the proposals' impact on the cumulative deficit by $26 billion or reduce it by $11 billion from 2008 to 2012, and they could raise the proposals' impact on the cumulative deficit by $46 billion or reduce it by $68 billion from 2013 to 2017 (see Figure 2-1, Table 2-1, and Table 2-5).

How Federal Budget Policies Affect the Economy

Over the long run, the nation's potential to produce goods and services depends on the size and quality of both the labor force and the stock of productive capital (such as factories, vehicles, and computers) as well as on the level of technological know-how. Changes in those determinants of potential output—referred to by economists as "supply-side" changes—can have a lasting, sustainable impact on the economy's ability to supply goods and services.

In the short run, however, economic activity may deviate from its potential level in response to changes in aggregate demand, which can rise above or fall below the economy's sustainable ability to supply it. Such "demand-side" variations can push the employment of labor and the utilization of capital away from their long-term potential levels.[1] Unlike movements on the supply side of the economy, however, those changes generally balance out over time: Over the longer term, corrective forces usually tend to move the economy back toward the sustainable potential level determined by the supply side.

Economic developments on both the supply side and the demand side depend on the choices that millions of individuals make about what and how much to buy, how much to save and what assets to hold, and whether and how much to work. Such developments also depend on the choices that firms make about investment, employment, and production. The government plays important roles in establishing the legal, institutional, and regulatory framework within which the economy operates, including monetary policy, and in setting overall levels of government spending and taxation.

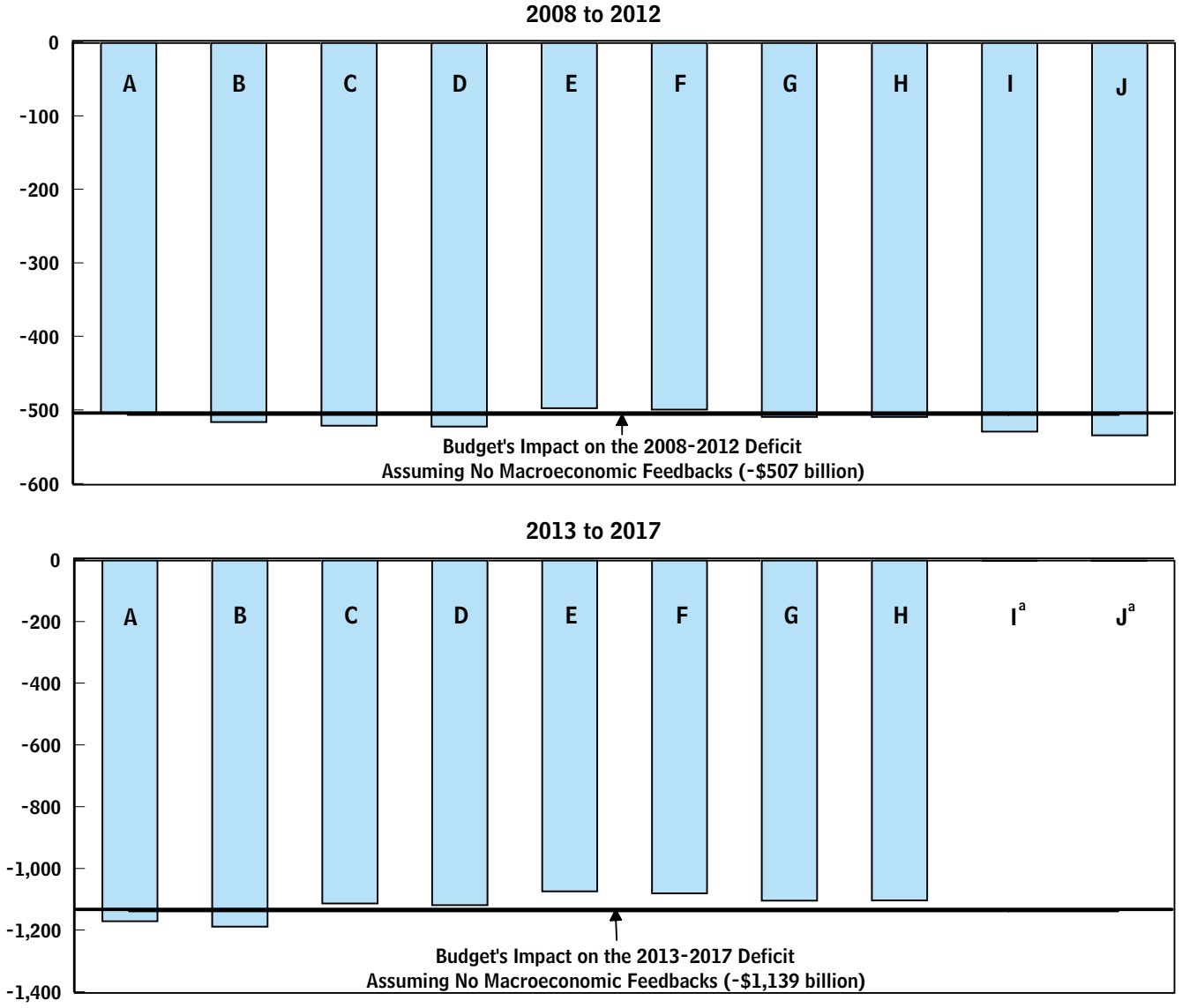
Budgetary policies can influence the economy through various channels, some of them affecting the supply side of the economy, some affecting the demand side, and some affecting both. Changes in the tax rates that people

1. Changes in supply-side factors such as energy prices, as well as other types of shocks, may also trigger temporary movements in the economy.

Figure 2-1.

CBO's Estimates, Using Various Models, of How the President's Budget Would Affect the Deficit After Accounting for Economic Effects

(Cumulative change from CBO's baseline, in billions of dollars)



Source: Congressional Budget Office.

Notes: The estimates in the panels above reflect the supply-side effects of the President's proposals on the economy but exclude demand-side economic impacts, as explained in the text. A negative change indicates an increase in the cumulative deficit relative to CBO's baseline.

CBO's analysis used the following models (which are described in the text): (A) "textbook" high model, (B) "textbook" low model, (C) closed-economy life-cycle model with lower government spending after 2017, (D) closed-economy life-cycle model with higher taxes after 2017, (E) open-economy life-cycle model with lower government spending after 2017, (F) open-economy life-cycle model with higher taxes after 2017, (G) infinite-horizon model with lower government consumption after 2017, (H) infinite-horizon model with higher taxes after 2017, (I) Macroeconomic Advisers' model, and (J) Global Insight's model.

a. Because this model is designed primarily to capture business-cycle developments, which are hard to predict beyond a few years, CBO did not compute an estimate for the 2013–2017 period.

Table 2-1.

CBO's Estimates of How the President's Budget Would Affect the Deficit After Accounting for Economic Effects

(Cumulative change from CBO's baseline, in billions of dollars)

	2008 to 2012	2013 to 2017
Growth Models		
Without Forward-Looking Behavior		
Textbook Model		
High (Hours worked respond strongly to tax-rate changes)	-503	-1,168
Low (Hours worked respond weakly to tax-rate changes)	-515	-1,185
With Forward-Looking Behavior		
Closed-Economy Life-Cycle Model		
Government spending adjusted after 2017	-520	-1,110
Taxes adjusted after 2017	-521	-1,115
Open-Economy Life-Cycle Model		
Government spending adjusted after 2017	-496	-1,071
Taxes adjusted after 2017	-498	-1,077
Infinite-Horizon Model		
Government spending adjusted after 2017	-508	-1,101
Taxes adjusted after 2017	-508	-1,100
Macroeconometric Models		
Supply-Side Contribution		
Macroeconomic Advisers' Model	-528	n.a.
Global Insight's Model	-533	n.a.
Supply-Side and Demand-Side Contributions		
Macroeconomic Advisers' Model	-519	n.a.
Global Insight's Model	-497	n.a.
Memorandum:		
CBO's Estimate of the Budgetary Effects of the President's Proposals Under Baseline Economic Assumptions	-507	-1,139

Source: Congressional Budget Office.

Notes: A negative number indicates an increase in the cumulative deficit relative to CBO's baseline.

The "textbook" growth model is an enhanced version of a model developed by Robert Solow. The life-cycle growth model, developed by CBO, is an overlapping-generations general-equilibrium model. The infinite-horizon growth model is an enhanced version of a model first developed by Frank Ramsey. The models by Macroeconomic Advisers and Global Insight, which are available commercially, are designed to forecast short-term economic developments. The various models reflect a wide range of assumptions about the extent to which people are forward-looking in their behavior: In the textbook model and those by Macroeconomic Advisers and Global Insight, people have the least foresight, whereas in the infinite-horizon model, people's foresight is perfect and extends infinitely to include a full consideration of effects on descendants.

In models with forward-looking behavior, CBO had to make assumptions about how the President's budget would be financed after 2017. CBO chose two alternatives—adjusting government purchases of goods and services and transfer payments or adjusting marginal tax rates.

n.a. = not applicable.

face can affect their willingness to work and save, potentially influencing the short-run level of demand but also changing the sustainable long-run levels of labor supply and capital. Similarly, changes both in government spending for goods and services and in government transfers can affect the overall level of demand in the short run and may also increase or reduce the resources available for private investment, affecting the long-term level of the capital stock. (CBO's macroeconomic analysis distinguishes between government transfers to persons and government purchases of goods and services, but most of CBO's models do not differentiate more finely among various types of government spending in terms of their impact on long-term economic performance. In reality, however, the economic effects of different types of government spending vary.) The economic effects of changes in both revenue and spending policies depend on how those changes are financed. In the short run, reductions in tax rates or increases in spending can be financed by larger budget deficits. Over the long term, however, the fiscal impact of changes in spending or revenues must ultimately be offset through other policy changes; those offsetting policy changes can significantly influence the long-term economic impact of the initial change in spending or revenues.

Supply-Side Effects

The supply-side effects of the President's budgetary proposals can include influences on the quantity and quality of the labor force, the size and composition of the capital stock, and technological progress. Changes in any or all of those factors can alter potential output.

The Quantity and Quality of the Labor Force. Potential output is strongly influenced by the overall quantity and quality of labor in the economy. A sustained, long-term increase in the total number of hours worked raises the economy's potential to generate output. CBO's analysis focused on channels through which the President's proposals could affect the quantity of labor—that is, the number of hours of labor supplied. Potential output could also be affected by improvements in workers' levels of education, training, experience, and on-the-job effort, which raise the quality of each hour worked. However, because any such effects would not be very large over the 2008-2017 budget period, CBO did not incorporate them in this analysis.

The President's proposals could affect the quantity of labor through two channels. First, several of the President's proposed policies would *change people's after-tax income* but would not significantly alter the marginal tax rates on income resulting from labor.[2] (For some people, for example, the extension of the child tax credit would raise their after-tax income but would not affect their marginal tax rates.) In the absence of a change in marginal rates, a rise in after-tax income tends to reduce the number of hours of labor supplied because people can maintain their standard of living with less work; conversely, a decline in income tends to increase hours supplied.

Second, some provisions would *change after-tax income and also would change after-tax compensation for each additional hour of work*. (For example, the extension of the marginal tax rates on income enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 would increase both. In contrast, other provisions, such as the President's health proposal, would reduce them for many people in most years.) Provisions that raise both after-tax income and incremental after-tax compensation (as well as provisions that reduce both) have opposing effects on people's incentives. In the case of the extension of EGTRRA, for example, workers would earn more for each extra hour of labor they supplied, which would tend to encourage them to work longer hours, but they could also maintain their current levels of after-tax income by working fewer hours, which would tend to discourage work. Studies generally have found that, on balance, those opposing incentives largely offset each other, but that the former (the substitution effect) slightly outweighs the latter (the income effect). As a consequence, reductions in marginal tax rates will tend to increase modestly the hours of labor that workers supply, primarily because those reductions will draw secondary earners (for example, the spouse of a household's primary breadwinner) into the labor force.[3] Conversely, increases in marginal tax rates will modestly decrease hours worked.

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2. The marginal tax rate is the rate on an additional dollar of income.

3. See Congressional Budget Office, *Labor Supply and Taxes* (January 1996). Since that report was published, CBO has slightly reduced its estimated total wage elasticity and substitution elasticity for secondary earners, on the basis of evidence that their responsiveness has declined over time as their participation in the labor force has grown. See Francine D. Blau and Lawrence M. Kahn, "Changes in the Labor Supply Behavior of Married Women: 1980-2000," Discussion Paper No. 2180 (Bonn, Germany: Institute for the Study of Labor, June 2006), forthcoming in the *Journal of Labor Economics*.

Table 2-2.

CBO's Estimates of Effective Federal Marginal Tax Rates on Labor Income

(Percent)

Calendar Year	Tax Rate Under Current Law	Tax Rate Under the President's Budget	Difference	
			Percentage Points	Percent
2007	30.3	29.4	-0.9	-2.9
2008	30.6	30.6	0	0
2009	30.9	32.1	1.2	4.0
2010	31.1	32.4	1.3	4.0
2011	32.9	32.7	-0.1	-0.4
2012	33.0	33.1	*	0.1
2013	33.3	33.4	0.1	0.4
2014	33.4	33.7	0.2	0.7
2015	33.6	34.0	0.4	1.2
2016	33.8	34.3	0.4	1.3
2017	34.0	34.6	0.6	1.8

Source: Congressional Budget Office.

Notes: The effective federal marginal tax rate on labor income is the share of the last dollar of earnings in the economy that is taken by federal individual income taxes and payroll taxes.

* = between zero and 0.05 percentage points.

CBO estimates that the President's policies would lower the marginal tax rate on labor by about 3 percent in 2007, compared with its baseline level, largely as a result of the proposal to extend for one year an increase in the exemptions allowed under the alternative minimum tax (see Table 2-2).[4] The President's policies would leave the marginal rate nearly unchanged in 2008; but after 2008, two sets of proposals would have large, opposing effects on marginal tax rates. The proposed changes in the taxation of health insurance would raise the marginal rate on labor by 4 percent in 2009 and by even more in succeeding years (see Appendix C). However, proposals that would make a number of provisions associated with the 2001 and 2003 tax legislation permanent would reduce the marginal rate by 4.5 percent in 2011 and by somewhat less in the following years (because the AMT would offset an increasing share of the marginal rate reductions over time). Together, those sets of proposals would raise effective marginal federal tax rates on labor income by 4 percent in 2009 and 2010, reduce it by about 0.4 percent in 2011, and gradually raise it thereafter, by about 0.1 percent in 2012, to stand at nearly 2 percent by 2017.

Taking into account the effects described above, CBO estimates that the President's budgetary proposals would probably raise the number of hours people worked in 2007 but have a negligible effect on that measure in 2008. In 2009 and 2010, higher marginal tax rates from the health proposal would tend to discourage people from working. After 2010, however, changes in marginal tax rates might lead workers either to increase or decrease their work effort modestly and would tend to have a fairly minor impact, on average, on the number of hours supplied over the entire 2011–2017 period, compared with the rates in CBO's baseline policy assumptions.

The Size and Composition of the Capital Stock. The President's budgetary policies would influence the size of the capital stock owned by Americans primarily by affecting national saving. National saving comprises private saving minus the budget deficit; an increase in private saving raises national saving, whereas an increase in the budget

4. CBO's estimates of current-law effective marginal tax rates on labor income are about 2.5 percentage points higher than they were last year, primarily because CBO has lowered its estimate of the portion of any increment in labor compensation that workers would choose to receive in tax-exempt health insurance payments. That change, which is not related to the President's budgetary proposals, increases the portion of incremental labor compensation subject to tax, raising effective marginal tax rates under current law.

deficit reduces it. An overall decline in national saving reduces the capital stock owned by Americans over time, either through a decrease in domestic investment or an increase in borrowing from abroad, or both.

According to CBO's estimates, the President's proposals would increase the federal deficit relative to its level in the agency's baseline in every year from 2007 to 2017. However, almost half of the increase in the deficit would result from two proposals that, in CBO's judgment, would have little effect on national saving. First, the establishment of individual accounts in Social Security would raise private saving while increasing the budget deficit; the net effect on national saving would thus be much smaller than the increase in the deficit itself. (The net effect of that proposal on national saving depends on the reaction of households to the funds deposited into individual accounts as well as the impact of the deposits on federal budget policy.) Second, the increase in incomes resulting from the extension of the repeal of the estate tax would nearly all be saved, almost entirely offsetting the resulting decline in government revenues. Taking into account all of the President's proposals, the higher deficits, by themselves, would have a modest negative effect on national saving.

In addition to their effect on the deficit, several of the President's tax proposals might encourage greater private saving by lowering the effective marginal tax rates on capital income and thus raising the after-tax rate of return on savings. Through that channel, the tax proposals would influence private saving in two opposing ways, just as lowering marginal tax rates on labor income would have opposing effects on the supply of labor: Higher after-tax returns would tend to increase saving and thus reduce current consumer spending; but they would also increase the value of existing assets, making households wealthier and thus tending to encourage spending. On balance, the combined effect on spending of higher after-tax returns can be either positive or negative. CBO included in its analysis a range of plausible assumptions about how households might respond to changes in the after-tax rate of return on savings. At one end of the range, some of CBO's models assumed that the rate would have little or no effect on how households allocate their income between consumer spending and saving; at the other end, other models assumed that increasing the rate of return would boost saving and reduce spending significantly.

The provisions of the President's budget that could affect the after-tax rate of return on capital include extending EGTRRA's marginal income tax rates, extending the cuts in tax rates on dividends and capital gains enacted in the Jobs and Growth Tax Relief Reconciliation Act of 2003, and expanding tax-free savings accounts. (Appendix B provides greater detail on the potential economic effects of the President's proposals for dividend and capital gains taxation, tax-free savings accounts, the estate tax, and individual accounts in Social Security. Appendix C provides greater detail about the proposal to change the tax treatment of health benefits.) CBO summarized the effects of those provisions on the rate of return on savings by estimating the aggregate impact they would have on effective marginal tax rates on capital income, compared with its baseline estimates of those rates under current-law policies (see Table 2-3).[5] According to CBO's estimates, effective marginal federal tax rates on capital income during the 2011–2017 period would be about 15 percent lower under the President's proposals than under the policies assumed in CBO's baseline.[6]

Taking into account the effects discussed above, CBO estimates that the policies in the President's proposed budget would lead to modest declines, on average, in the capital stock over the 2008–2017 period, compared with the policies in its baseline.

Some policies proposed in the President's budget would not only affect the level of the capital stock but would change the mix of different types of capital within that stock—a shift that could also affect potential output. Among the relevant policies in the President's budget, the proposal to extend the lower tax rates on corporate dividends and capital gains would probably have the biggest effect on the composition of the capital stock because the proposal would reduce taxes on personal income received from the corporate sector, thus encouraging some capital to shift from the noncorporate to the corporate sector. Currently, some corporate income is taxed once at the level of the firm (through the corporate income tax) and

5. Both sets of estimates yield effective tax rates that are below all but the lowest statutory marginal rates, because some capital income (for example, the interest that flows into tax-free savings accounts or pension funds, as well as rental income from owner-occupied housing) is not taxed.

6. For a description of CBO's method for estimating effective tax rates, see Congressional Budget Office, *Computing Effective Tax Rates on Capital Income* (December 2006).

Table 2-3.

CBO's Estimates of Effective Federal Marginal Tax Rates on Capital Income

(Percent)

Calendar Year	Tax Rate Under Current Law	Tax Rate Under the President's Budget	Difference	
			Percentage Points	Percent
2007	14.2	14.4	0.2	1.6
2008	14.1	14.1	0	0
2009	14.0	14.1	0.1	0.4
2010	13.9	13.9	0.1	0.4
2011	16.2	13.8	-2.4	-14.9
2012	16.1	13.7	-2.4	-14.9
2013	16.1	13.7	-2.4	-15.0
2014	16.0	13.6	-2.4	-15.1
2015	16.0	13.6	-2.4	-15.0
2016	16.0	13.6	-2.4	-15.0
2017	15.9	13.5	-2.3	-14.8

Source: Congressional Budget Office.

Note: The effective federal marginal tax rate on income from capital is the share of the last dollar of such income that is taken by taxes—specifically, federal individual income and corporate income taxes.

again at the personal level (through the individual income tax on dividends and capital gains). (Not all corporate income is taxed in this fashion—some corporate income is effectively not taxed at the firm level, and some corporate income is not taxed at the personal level.) That tax treatment distorts the way that capital is allocated in the economy because it discourages investment in the corporate sector relative to investment in the housing and noncorporate business sectors. As a result, less capital may be held in the corporate sector than is optimal for the economy's efficient operation. Extending lower tax rates on dividends and capital gains would reduce that distortion, tending to enhance economic output.

Extending the current tax rates on dividends and capital gains would also diminish a distortion that would come into effect under the baseline's assumption that the tax rates will rise again after 2010. The taxation of dividends and capital gains may encourage greater corporate reliance on debt to finance investment than would otherwise be the case. Because firms may deduct interest payments on debt they owe (such as the bonds they have issued) from any taxable income, they can lower their tax payments by borrowing rather than issuing stock to finance their investments. The net result is that the interest payments are taxed only once, at the personal level. If the current tax rates expire as projected in the baseline, the tax treatment of interest payments on debt may influence firms' decisions about financing and lead to a less efficient allocation of resources.

Technological Progress. New and improved technical processes and products are the source of most long-term growth in productivity, and the President's budgetary proposals could affect the economy by influencing the rate of technological progress. Researchers, however, understand little about how taxation and spending policies affect technological innovation. Therefore, CBO for the most part has not incorporated in its analysis effects on technological progress arising from the President's proposals.[7]

Demand-Side Effects

By increasing the deficit, the President's budgetary proposals would also increase after-tax income, thus tending to encourage higher consumer spending and enhance the total demand for goods and services. Increases in demand may cause firms to temporarily gear up production and

7. CBO used two commercial macroeconometric models to estimate the demand-related effects of the President's proposals. In one of those models, created by Global Insight, potential GDP responds positively to spending for research and development—which in turn would be stimulated by the proposal to extend tax credits for such activities.

hire more workers; decreases in demand may have the opposite effects. From a demand-side perspective, budgetary policies that raise private and public consumption might increase the pace of the economy's current expansion. Nevertheless, demand-side effects are relatively fleeting: They can only temporarily raise or lower output beyond what it would otherwise be because stabilizing economic forces tend to move output back toward its sustainable potential level. Moreover, policies that increase demand by raising government consumption or private consumer spending are likely to lower national income in the long run because such policies may tend eventually to reduce the size of the capital stock owned by Americans and therefore reduce aggregate income.

The Models and Their Results

CBO used five different economic models to estimate the economic effects of the President's budgetary proposals relative to the policy assumptions in CBO's baseline. The models, which fall into two broad categories, focus on somewhat different aspects of the economy and reflect distinct ways of thinking about it. Three models provide estimates of supply-side effects only; the other two are commercial macroeconometric models that emphasize the business-cycle aspects of the economy and are designed primarily to analyze demand-side effects, although they incorporate some supply-side influences as well. Each type of model represents individuals' economic decisions—in particular, the degree to which individuals anticipate future developments—in an idealized way that does not capture all aspects of actual behavior. Even so, results from such models are likely to provide a reasonable range of estimates of individuals' responses to changes in policy. (Figure 2-2 presents, year by year, the impact of the President's proposals on some of the key inputs for CBO's various models—effective tax rates on labor and capital and the size of the deficit.)

Supply-Side Effects

CBO used three growth models to analyze the supply-side effects of the President's proposals from 2007 through 2017.[8] The models—a "textbook" growth model, a life-cycle growth model, and an infinite-horizon growth model—differ mainly in their assumptions about how far into the future people look in making plans (see Appendix D). The textbook growth model assumes, in effect, that people do not explicitly take into account expected future policies when making their current plans—that is, the model incorporates no forward-looking behavior. Moreover, the model does not account for the influence on investment of changes in marginal tax rates on capital income.

In contrast, the life-cycle model incorporates the assumption that people make lifelong plans for working and saving but do not consider events that might occur after they die. The infinite-horizon model differs yet again, assuming, in effect, that people behave as if they will live forever—or, equivalently, that they care about the well-being of their descendants as well as their own. Moreover, the latter two models assume that people know with certainty how the government will resolve its long-term budget imbalance, whether it be through higher tax rates, lower spending and transfer payments, or some combination of the two.

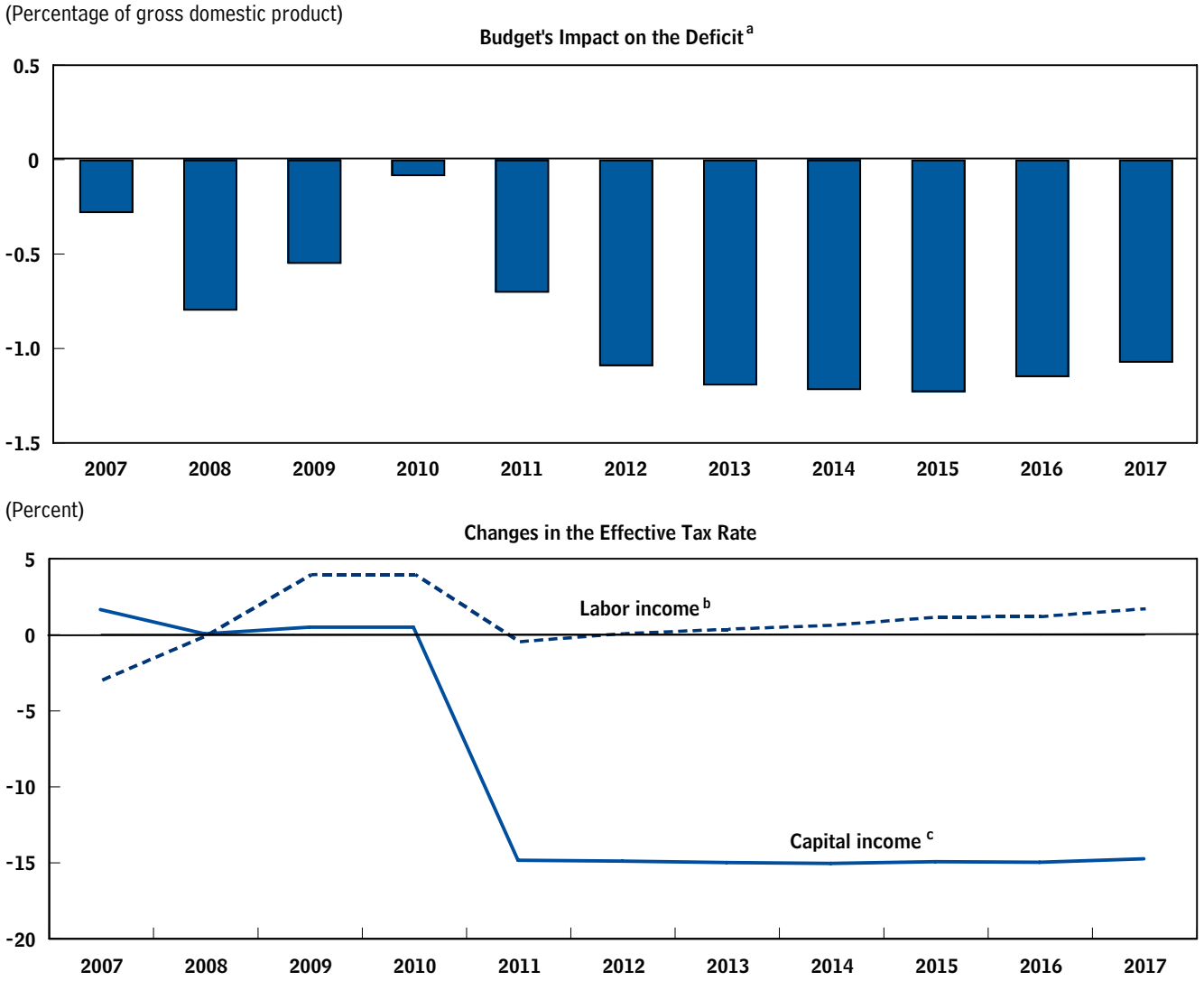
CBO used the textbook growth model to estimate effects under two different assumptions about how much people will adjust their work hours in response to changes in marginal tax rates: a "low" assumption, under which workers respond very little, and a "high" assumption, under which their response is on the high side of the consensus range of empirical estimates.[9] CBO found that under both assumptions, the President's proposals would reduce gross national product (GNP) by 0.1 percent, on

8. Growth models are often referred to as supply-side models. They assume that the labor market is always in equilibrium—that is, that fiscal policy does not shift unemployment from its natural rate. CBO presents effects for the 2008–2012 and 2013–2017 periods because the main purpose of this discussion is to illustrate how economic feedbacks could affect the budget numbers presented in Chapter 1 for those periods. Its models showed positive supply-side effects on output in 2007. The positive effects stemmed mainly from reduced tax rates on labor income as a result of the proposal to extend for one year the increase in the exemptions allowed under the alternative minimum tax. The positive effects in 2007 are reflected in calculations of revenues, government debt, and interest costs for 2008 and beyond.

9. Based on data from a large sample of taxpayers, CBO's estimates account for the effects on labor supply of changes in both marginal tax rates and after-tax income under the President's proposals and incorporate a larger response to changes in marginal tax rates among secondary earners than among primary earners.

Figure 2-2.

Effects of the President's Budget on the Deficit and on the Effective Tax Rates on Capital Income and Labor Income



Source: Congressional Budget Office.

Note: Effects on the deficit are by fiscal year; impacts on effective tax rates are by calendar year.

a. The bars represent the effects of the President's proposals on the budget balance under CBO's baseline economic assumptions. A negative change indicates an increase in the annual deficit relative to CBO's baseline.

b. Changes in the effective federal marginal tax rate on income from labor (the share of the last dollar of such income taken by federal individual income and payroll taxes).

c. Changes in the effective federal marginal tax rate on income from capital (the share of the last dollar of such income taken by federal individual income and corporate income taxes).

average, over the 2008–2012 period.[10] Over the 2013–2017 period, the proposals would reduce GNP by about 0.3 percent under the high assumption and by about 0.4 percent under the low assumption (see Table 2-4).

The results of the life-cycle and infinite-horizon growth models differ from those of the textbook growth model, for several reasons. Unlike the textbook growth model, the other two models are built on the assumption that individuals adjust their decisions about work, consumer spending, and saving both in response to changes in marginal tax rates and after-tax rates of return and in anticipation of expected future changes in policy.

The forward-looking characteristics of the life-cycle and infinite-horizon growth models require CBO to make assumptions about what people believe will happen in the future, both in CBO's baseline and under the President's proposed policies, not only during the 10-year projection period but into the indefinite future as well. For its analysis, CBO assumed that people believe that the budgetary policies being assessed—those of the President or of CBO's baseline—will be maintained over the entire 10-year projection period. (In reality, people may well believe that the policies might change at some point during that time.)

For the years beyond 2017, however, matters are complicated by the fact that the policies reflected in both CBO's baseline and the President's proposals are unsustainable in the long run, owing to projected increases in spending for health and retirement programs.[11] For the purposes of its analysis, CBO assumed that people expect the fiscal imbalances projected under current-law policies to be resolved over the long run. It then made explicit assumptions about the manner in which changes in deficits or surpluses under the President's budgetary policies, relative to those in the baseline, would eventually be financed in the future.

The life-cycle and infinite-horizon models each generated two sets of estimates based on different assumptions about that financing. Under one assumption, people believe that the proposals will be financed by gradually adjusting government spending for goods and services and for transfer payments (as shares of GNP) over the 2018–2027 period. Under the other assumption, people believe that the proposals will be financed by gradually adjusting marginal tax rates on income over the same period.

Depending on which assumption about financing is used and whether the economy is considered to be open or closed to flows of foreign capital, both models project that the President's proposals will have little impact on GNP over the 2008–2012 period—roughly a decline between 0.1 percent and 0.2 percent. Over the 2013–2017 period, the two models project that the President's proposals will raise GNP by between zero and 0.2 percent, depending on assumptions.

The supply-side effects of the President's proposed policy changes would feed back to the budget but would tend to have very modest effects (see Tables 2-1 and 2-5). Under the assumptions incorporated into its baseline, CBO projects that the President's proposals will expand the cumulative deficit over the 2008–2012 period by $507 billion, ignoring economic feedbacks, but those feedbacks could add as much as $26 billion to that total or subtract as much as $11 billion from it, depending on which set of assumptions is incorporated into the analysis. (That range includes supply-side effects from all five models.) For the 2013–2017 period, the President's budgetary policies are projected to boost the cumulative deficit by $1,139 billion, ignoring economic feedbacks, but those feedbacks could add up to $46 billion to that increase or subtract as much as $68 billion from it. No single number is likely to provide an accurate measure of the feedback, but the numbers presented here illustrate the range of its likely magnitude.

Demand-Side Effects

Because demand-side economic developments become increasingly hard to estimate the farther projections extend into the future, CBO analyzed demand-side effects of the President's budgetary proposals only for the

10. In presenting the economic effects of the President's budgetary proposals, CBO uses gross national product as its measure of output rather than the more commonly cited gross domestic product. Changes in GNP exclude foreigners' earnings on investments in the domestic economy but include domestic residents' earnings overseas and are therefore a better measure of the proposals' effects on domestic residents' income than changes in GDP in an open economy like that of the United States. The budget calculations presented in Table 2-5 reflect the fact that tax treaties and other factors result in some foreign income being effectively untaxed.

11. See Congressional Budget Office, *The Long-Term Budget Outlook* (December 2005).

Table 2-4.

CBO's Estimates of How the President's Budget Would Affect Real Gross National Product

(Average percentage difference from CBO's baseline, by calendar year)

	2008 to 2012	2013 to 2017
Growth Models		
Without Forward-Looking Behavior		
Textbook Model		
High (Hours worked respond strongly to tax-rate changes)	-0.1	-0.3
Low (Hours worked respond weakly to tax-rate changes)	-0.1	-0.4
With Forward-Looking Behavior		
Closed-Economy Life-Cycle Model		
Government spending adjusted after 2017	-0.2	*
Taxes adjusted after 2017	-0.2	*
Open-Economy Life-Cycle Model		
Government spending adjusted after 2017	-0.1	0.2
Taxes adjusted after 2017	-0.1	0.2
Infinite-Horizon Model		
Government spending adjusted after 2017	-0.1	0.1
Taxes adjusted after 2017	-0.1	0.1
Macroeconometric Models		
Supply-Side Contribution		
Macroeconomic Advisers' Model	-0.2	n.a.
Global Insight's Model	-0.2	n.a.
Supply-Side and Demand-Side Contributions		
Macroeconomic Advisers' Model	0.1	n.a.
Global Insight's Model	*	n.a.

Source: Congressional Budget Office.

Notes: The "textbook" growth model is an enhanced version of a model developed by Robert Solow. The life-cycle growth model, developed by CBO, is an overlapping-generations general-equilibrium model. The infinite-horizon growth model is an enhanced version of a model first developed by Frank Ramsey. The models by Macroeconomic Advisers and Global Insight, which are available commercially, are designed to forecast short-term economic developments. The various models reflect a wide range of assumptions about the extent to which people are forward-looking in their behavior: In the textbook model and those by Macroeconomic Advisers and Global Insight, people have the least foresight, whereas in the infinite-horizon model, people's foresight is perfect and extends infinitely to include a full consideration of effects on descendants.

In models with forward-looking behavior, CBO had to make assumptions about how the President's budget would be financed after 2017. CBO chose two alternatives—adjusting government purchases of goods and services and transfer payments or adjusting marginal tax rates.

* = between -0.05 and 0.05 percent; n.a. = not applicable

Table 2-5.

The Budgetary Implications of the Macroeconomic Effects

(Cumulative change from CBO's estimate of the President's budget, in billions of dollars)

	2008 to 2012	2013 to 2017
Growth Models		
Without Forward-Looking Behavior		
Textbook Model		
High (Hours worked respond strongly to tax-rate changes)	4	-29
Low (Hours worked respond weakly to tax-rate changes)	-9	-46
With Forward-Looking Behavior		
Closed-Economy Life-Cycle Model		
Government spending adjusted after 2017	-14	28
Taxes adjusted after 2017	-15	24
Open-Economy Life-Cycle Model		
Government spending adjusted after 2017	11	68
Taxes adjusted after 2017	9	62
Infinite-Horizon Model		
Government spending adjusted after 2017	-1	37
Taxes adjusted after 2017	-1	39
Macroeconometric Models		
Supply-Side Contribution		
Macroeconomic Advisers' Model	-22	n.a.
Global Insight's Model	-26	n.a.
Supply-Side and Demand-Side Contributions		
Macroeconomic Advisers' Model	-12	n.a.
Global Insight's Model	10	n.a.

Source: Congressional Budget Office.

Notes: Numbers in this table reflect the effects on the cumulative deficit (relative to CBO's baseline) of the economic impacts shown in Table 2-4. (Negative numbers indicate an increase in the deficit; positive numbers, a reduction.) They do not include the estimated cost of the President's budgetary proposals under CBO's baseline economic assumptions. The total impact of the proposals on the cumulative deficit, including both those direct costs and the secondary effects shown above, appear in Table 2-1.

The "textbook" growth model is an enhanced version of a model developed by Robert Solow. The life-cycle growth model, developed by CBO, is an overlapping-generations general-equilibrium model. The infinite-horizon growth model is an enhanced version of a model first developed by Frank Ramsey. The models by Macroeconomic Advisers and Global Insight, which are available commercially, are designed to forecast short-term economic developments. The various models reflect a wide range of assumptions about the extent to which people are forward-looking in their behavior: In the textbook model and those by Macroeconomic Advisers and Global Insight, people have the least foresight, whereas in the infinite-horizon model, people's foresight is perfect and extends infinitely to include a full consideration of effects on descendants.

In models with forward-looking behavior, CBO had to make assumptions about how the President's budget would be financed after 2017. CBO chose two alternatives—adjusting government purchases of goods and services and transfer payments or adjusting marginal tax rates.

n.a. = not applicable.

first five years of the 2008–2017 period. To do so, it used macroeconometric forecasting models created by two private forecasting firms—Macroeconomic Advisers and Global Insight. The design of each of those models includes an embedded growth model, but each concentrates primarily on demand-side economic effects.

As with the textbook growth model, CBO adjusted Macroeconomic Advisers' and Global Insight's models to incorporate its own estimates of how workers would adjust their hours worked in response to the changes in marginal tax rates on labor income implied by the President's proposals.

Like the textbook growth model, Macroeconomic Advisers' and Global Insight's models are not forward-looking—people, as the models represent them, do not behave as though they have specific expectations about future policies or economic developments. However, the models do represent individuals as responding to some economic changes in the same way that they have responded in the past, regardless of the source of those changes. For example, people are assumed to react to the tax proposals in the President's budget that would change marginal income tax rates and after-tax labor income in roughly the same way as they did, on average, when after-tax wages and income changed in the past.

The lack of forward-looking behavior in the macroeconometric models implies that specific policy changes that are scheduled to occur in the future will not affect current behavior unless special adjustments are made to mimic such behavior.[12] For example, the President's proposals would reduce taxes throughout the projection period, compared with the levels in CBO's baseline. Those lower taxes would increase the amount of after-tax income that people expected in the future, which might cause them to boost their spending today (as the forward-looking models imply). In the macroeconometric models, however, those changes in taxes affect consumer spending only when they occur.

CBO explored the relative magnitude of demand- and supply-side effects of the proposed policies by manipulating monetary policy responses in the models. For one set of scenarios, CBO assumed that the Federal Reserve would respond to economic developments as it has in the past. For a second set, CBO assumed that the Federal Reserve would respond in such a way as to hold the unemployment rate at the level projected in CBO's baseline. The second approach produced an estimate of the implications of the proposals for potential (noncyclical) GNP—in other words, the supply-side effects. Subtracting the second set of results from the first provides an estimate of the demand-side effects of the proposed policies.

Incorporating CBO's estimate of effects on labor supply, Macroeconomic Advisers' model predicted that the demand- and supply-side effects of the President's proposed policies would increase GNP by 0.1 percent, on average, between 2008 and 2012 (see Table 2-4 on page 41). Global Insight's model forecast virtually no effect. The models also projected similar, small negative supply-side effects under the President's budgetary policies, with output estimated as 0.2 percent lower over the 2008–2012 period using either model. The similarity of those results reflects in part the common assumption about effects on labor supply.

Both models indicate that the proposals' projected economic impacts would feed back to the budget and affect the size of the projected deficit. According to the projections from Macroeconomic Advisers' model, feedback effects on the supply side could add $22 billion to the $507 billion increase in the cumulative deficit projected for the 2008–2012 period under the CBO baseline's economic assumptions (see Table 2-5). By the estimates of Global Insight's model, the supply-side feedbacks of the President's proposals over the same period could add $26 billion to the deficit.

Including both demand- and supply-side effects, the two models estimate different feedbacks on the budget. In Global Insight's model, the proposals would decrease the cumulative deficit by $10 billion over the 2008–2012 period. In contrast, Macroeconomic Advisers' model predicts that the deficit will increase by $12 billion from 2008 to 2012. In that model, positive demand-side stimulus would raise the inflation rate by much more than in Global Insight's model. Monetary authorities would respond by raising interest rates, thus increasing federal outlays for net interest. Those higher outlays would offset a greater portion of the positive impacts of higher GNP on the budget than in Global Insight's model.

12. One such adjustment is that stock prices are assumed to incorporate the effects of extending lower rates on income earned from capital gains and dividends immediately, even though the extension would not affect tax rates until after 2010.

APPENDIX

A

Changes in CBO's Baseline Since January 2007

In conjunction with its annual analysis of the President's budgetary proposals, the Congressional Budget Office (CBO) typically updates its baseline budget projections, which show the paths of federal spending and revenues over the next 10 years under current laws and policies (see Table A-1). The updated baseline reflects new information gleaned from various sources—including the President's budget—and legislation enacted since January, when CBO completed its previous baseline projections.[1] (Because CBO has not updated its overall economic assumptions since January, none of the revisions to the baseline reflect changes to those assumptions.)

CBO constructs its baseline in accordance with the provisions set forth in the Balanced Budget and Emergency Deficit Control Act of 1985 and the Congressional Budget and Impoundment Control Act of 1974. (Although the provisions of the Deficit Control Act that pertain to the baseline expired at the end of September 2006, CBO continues to follow that law's specifications in preparing its baseline.) To project revenues and mandatory spending, CBO assumes that current laws continue unchanged in the future, with only a few exceptions.[2] That approach includes the assumption that various tax-law changes enacted since 2001 will expire as scheduled by 2011, causing a rise in revenues thereafter. To project discretionary spending, CBO adjusts the current year's budget authority for inflation and certain other factors specified in law. The resulting baseline projections are not intended to be a prediction of future budgetary outcomes. Rather, they serve as a benchmark that lawmakers can use to measure the effects of spending or revenue proposals, such as those in the President's budget.

Since January, CBO has increased its estimate of the deficit that would result in 2007 under current law by $5 billion, to $177 billion. Likewise, it has lowered its projection of the cumulative surplus for the 2008–2017 period by $214 billion—from $800 billion to $586 billion (see Table A-2). Most of those changes affect the outlay side of the budget; they stem from extrapolating the appropriations enacted in the Revised Continuing Appropriations Resolution, 2007 (Public Law 110-5), and from so-called technical changes (revisions attributable to factors other than new laws or changes in CBO's economic forecast). CBO has made only negligible revisions to its revenue estimates for the 10-year projection period, increasing them by 0.02 percent, or a total of $6 billion.

Changes to Outlay Projections

CBO has added $5 billion to its outlay projection for 2007 and a total of $220 billion (0.7 percent) to the outlay projections for the 2008–2017 period. More than three-quarters of that increase—$172 billion over the 10-year period (including debt-service costs)—results from the enactment of appropriations for the remainder of this year. Technical changes to the baseline have increased projected outlays between 2008 and 2017 by another $48 billion.

1. Those projections were published in Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2008 to 2017* (January 2007).

2. For example, the Deficit Control Act directed that spending programs whose authorizations are set to expire be assumed to continue if they have outlays of more than $50 million in the current year and were established on or before the enactment of the Balanced Budget Act of 1997. Expiring programs established after that law was enacted are not automatically assumed to continue. The Deficit Control Act also required CBO to assume that expiring excise taxes that are dedicated to trust funds will be extended at their current rates. The law did not provide for the extension of other expiring tax provisions, even if they have routinely been extended in the past.

Table A-1.

CBO's Baseline Budget Projections

	Actual 2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Total, 2008-2012	Total, 2008-2017
							In Billions of Dollars							
Revenues														
Individual income taxes	1,044	1,144	1,259	1,311	1,380	1,584	1,730	1,830	1,928	2,036	2,149	2,269	7,263	17,473
Corporate income taxes	354	368	374	360	336	339	349	333	340	349	360	373	1,758	3,513
Social insurance taxes	838	875	914	958	1,004	1,052	1,100	1,149	1,198	1,249	1,301	1,354	5,029	11,281
Other	172	155	173	181	181	192	226	239	251	263	275	289	954	2,270
Total	**2,407**	**2,542**	**2,720**	**2,810**	**2,901**	**3,167**	**3,405**	**3,551**	**3,718**	**3,896**	**4,085**	**4,284**	**15,003**	**34,537**
On-budget	1,799	1,905	2,051	2,107	2,164	2,395	2,597	2,707	2,838	2,979	3,130	3,290	11,313	26,258
Off-budget	608	638	669	703	738	773	808	844	880	917	955	994	3,690	8,279
Outlays														
Mandatory spending	1,413	1,454	1,536	1,625	1,714	1,832	1,870	2,009	2,131	2,264	2,449	2,580	8,576	20,009
Discretionary spending	1,016	1,029	1,046	1,062	1,078	1,100	1,112	1,140	1,166	1,194	1,227	1,250	5,398	11,376
Net interest	227	236	251	256	266	270	268	263	258	252	246	237	1,312	2,567
Total	**2,655**	**2,719**	**2,833**	**2,944**	**3,058**	**3,202**	**3,250**	**3,411**	**3,555**	**3,710**	**3,921**	**4,067**	**15,286**	**33,951**
On-budget	2,233	2,268	2,366	2,458	2,552	2,676	2,699	2,830	2,942	3,062	3,233	3,336	12,751	28,154
Off-budget	422	451	467	486	506	526	551	581	613	649	688	731	2,535	5,797
Deficit (-) or Surplus	**-248**	**-177**	**-113**	**-134**	**-157**	**-35**	**155**	**139**	**163**	**186**	**163**	**217**	**-283**	**586**
On-budget	-434	-363	-315	-351	-388	-281	-102	-123	-104	-82	-104	-46	-1,438	-1,897
Off-budget	186	186	202	217	232	247	257	263	266	268	267	263	1,155	2,482
Debt Held by the Public	4,829	5,010	5,137	5,285	5,455	5,502	5,358	5,229	5,075	4,895	4,737	4,525	n.a.	n.a.
Memorandum:														
Gross Domestic Product	13,065	13,645	14,300	15,014	15,742	16,465	17,205	17,973	18,764	19,582	20,425	21,295	78,726	176,766
							As a Percentage of Gross Domestic Product							
Revenues														
Individual income taxes	8.0	8.4	8.8	8.7	8.8	9.6	10.1	10.2	10.3	10.4	10.5	10.7	9.2	9.9
Corporate income taxes	2.7	2.7	2.6	2.4	2.1	2.1	2.0	1.9	1.8	1.8	1.8	1.8	2.2	2.0
Social insurance taxes	6.4	6.4	6.4	6.4	6.4	6.4	6.4	6.4	6.4	6.4	6.4	6.4	6.4	6.4
Other	1.3	1.1	1.2	1.2	1.2	1.2	1.3	1.3	1.3	1.3	1.3	1.4	1.2	1.3
Total	**18.4**	**18.6**	**19.0**	**18.7**	**18.4**	**19.2**	**19.8**	**19.8**	**19.8**	**19.9**	**20.0**	**20.1**	**19.1**	**19.5**
On-budget	13.8	14.0	14.3	14.0	13.7	14.5	15.1	15.1	15.1	15.2	15.3	15.5	14.4	14.9
Off-budget	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7
Outlays														
Mandatory spending	10.8	10.7	10.7	10.8	10.9	11.1	10.9	11.2	11.4	11.6	12.0	12.1	10.9	11.3
Discretionary spending	7.8	7.5	7.3	7.1	6.8	6.7	6.5	6.3	6.2	6.1	6.0	5.9	6.9	6.4
Net interest	1.7	1.7	1.8	1.7	1.7	1.6	1.6	1.5	1.4	1.3	1.2	1.1	1.7	1.5
Total	**20.3**	**19.9**	**19.8**	**19.6**	**19.4**	**19.4**	**18.9**	**19.0**	**18.9**	**18.9**	**19.2**	**19.1**	**19.4**	**19.2**
On-budget	17.1	16.6	16.5	16.4	16.2	16.3	15.7	15.7	15.7	15.6	15.8	15.7	16.2	15.9
Off-budget	3.2	3.3	3.3	3.2	3.2	3.2	3.2	3.2	3.3	3.3	3.4	3.4	3.2	3.3
Deficit (-) or Surplus	**-1.9**	**-1.3**	**-0.8**	**-0.9**	**-1.0**	**-0.2**	**0.9**	**0.8**	**0.9**	**1.0**	**0.8**	**1.0**	**-0.4**	**0.3**
On-budget	-3.3	-2.7	-2.2	-2.3	-2.5	-1.7	-0.6	-0.7	-0.6	-0.4	-0.5	-0.2	-1.8	-1.1
Off-budget	1.4	1.4	1.4	1.4	1.5	1.5	1.5	1.5	1.4	1.4	1.3	1.2	1.5	1.4
Debt Held by the Public	37.0	36.7	35.9	35.2	34.7	33.4	31.1	29.1	27.0	25.0	23.2	21.2	n.a.	n.a.

Source: Congressional Budget Office.

Note: n.a. = not applicable.

Table A-2.

Changes in CBO's Baseline Projections of the Deficit or Surplus Since January 2007

(Billions of dollars)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Total, 2008-2012	Total, 2008-2017
Total Deficit (-) or Surplus as Projected in January 2007	-172	-98	-116	-137	-12	170	159	185	208	192	249	-194	800
Changes to Revenue Projections (Technical)	*	*	*	**1**	**1**	**1**	**1**	**1**	**1**	**1**	**1**	**2**	**6**
Changes to Outlay Projections													
Legislative													
Mandatory	*	*	*	*	*	*	*	*	*	*	0	*	*
Discretionary													
Defense	1	2	2	2	3	3	3	3	3	3	3	11	26
Nondefense	7	11	11	10	10	10	10	11	11	11	11	52	106
Subtotal, discretionary	8	13	13	13	12	13	13	13	14	14	14	63	132
Net interest (Debt service)	*	1	1	2	3	3	4	5	6	7	8	10	40
Subtotal, legislative	**8**	**13**	**14**	**15**	**15**	**16**	**17**	**18**	**20**	**21**	**22**	**74**	**172**
Technical													
Mandatory													
Medicare[a]	-2	1	4	5	7	2	4	4	3	5	3	19	38
Medicaid	*	*	1	1	1	2	3	4	5	6	7	5	29
Social Security	-1	-1	-1	-1	-1	-1	-2	-2	-2	-3	-3	-6	-17
Veterans' compensation	1	1	1	1	1	1	2	2	2	3	3	5	17
Other	1	2	*	1	2	*	1	*	-1	-1	2	5	6
Subtotal, mandatory	-2	3	5	6	11	4	7	8	7	10	12	29	72
Discretionary	-3	-1	-1	-2	-2	-1	-2	-2	-2	-2	-2	-7	-17
Net interest													
Debt service	*	*	1	1	1	1	2	2	2	2	3	5	15
Other	1	*	-1	1	-3	-5	-4	-3	-3	-2	-2	-8	-22
Subtotal, net interest	1	*	*	2	-1	-3	-2	-2	-1	*	1	-3	-7
Subtotal, technical	**-4**	**2**	**3**	**6**	**8**	*	**3**	**4**	**3**	**8**	**11**	**19**	**48**
Total Outlay Changes	**5**	**15**	**18**	**20**	**23**	**16**	**21**	**23**	**23**	**29**	**33**	**92**	**220**
Total Impact on the Deficit or Surplus[b]	**-5**	**-15**	**-17**	**-20**	**-22**	**-15**	**-20**	**-22**	**-22**	**-28**	**-32**	**-90**	**-214**
Total Deficit (-) or Surplus as Projected in March 2007	-177	-113	-134	-157	-35	155	139	163	186	163	217	-283	586
Memorandum:													
Total Legislative Changes[b]	-8	-13	-14	-15	-15	-16	-17	-18	-20	-21	-22	-74	-172
Total Technical Changes[b]	4	-2	-3	-5	-7	1	-3	-3	-3	-7	-10	-16	-42

Source: Congressional Budget Office.

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

a. Includes offsetting receipts.

b. Negative numbers indicate an increase in the deficit or decrease in the surplus.

Legislative Changes

Through mid-February, funding for 2007 for departments other than the Departments of Defense (DoD) and Homeland Security had been provided through a series of short-term continuing resolutions. Appropriations for the rest of the year, which were enacted on February 15, boosted discretionary budget authority for 2007 by $7 billion over the amount in the previous resolution. In addition, budgetary resources provided in the form of obligation limitations for certain transportation programs were increased by nearly $4 billion. Extrapolating those amounts through 2017—in accordance with the rules used to construct CBO's baseline—raises projected discretionary outlays by $12 billion to $14 billion per year over the 2008–2017 period.

That higher projected spending raises CBO's projections of the federal government's borrowing needs, thereby boosting projected debt-service costs over 10 years by $40 billion.

Technical Changes

CBO has made relatively small technical changes to its outlay projections, reducing them by $4 billion for 2007 and increasing them by $48 billion for the 2008–2017 period. The largest changes involve higher spending projections for Medicare, Medicaid, and veterans' compensation, partly offset by lower spending projections for Social Security and discretionary programs (mostly for DoD).

Medicare. Since publishing the January baseline, CBO has reduced its estimate of Medicare spending in 2007 by $2 billion. However, it has raised its Medicare projections for the following 10 years by a total of $38 billion, or 0.7 percent.

The change for 2007 is the net result of a $2.6 billion reduction in projected net spending for Hospital Insurance (Part A of Medicare) and Supplementary Medical Insurance (Part B) and a $0.6 billion increase in projected net spending for the prescription drug benefit (Part D). Information on spending for Parts A and B through mid-February suggests that the slower rate of growth in spending that occurred in 2006 appears to be continuing and that receipts from Medicare beneficiaries' premium payments for Part B have been unexpectedly high. In the other direction, the program's payments to prescription drug plans under Part D grew slightly more in January (the first month of the new benefit year) than CBO had anticipated.

The change for the 2008–2017 period is concentrated in Parts A and B and results largely from rapid growth in enrollment in the private fee-for-service (PFFS) component of the Medicare Advantage program.[3] Medicare generally pays much more for enrollees in PFFS plans than it would if those beneficiaries remained in the traditional fee-for-service program. (The additional cost varies by area but can be 40 percent or more.) During 2006, enrollment in PFFS plans soared from about 200,000 to almost 900,000. Another 500,000 people enrolled in those plans in January 2007. CBO now projects that enrollment in PFFS plans will total about 5 million by 2017 and that those plans will account for roughly one-third of enrollment in the Medicare Advantage program. (Currently, about 18 percent of Medicare beneficiaries are enrolled in Medicare Advantage plans; CBO expects that share to grow to 26 percent by 2017.)

Medicaid. Revisions to CBO's outlook for the Medicaid program have increased projected federal spending for Medicaid by $29 billion (or less than 1 percent) over the 2008–2017 period. Because the percentage of the population with private-sector health insurance is expected to keep declining, CBO has raised its projection of the number of children and low-income adults who will enroll in Medicaid, boosting projected spending by $40 billion over 10 years. Partially offsetting that change is a decrease of $15 billion through 2017 in the estimated growth of Medicaid spending for prescription drugs. Other, smaller adjustments have increased projected Medicaid spending over that period by $4 billion.

Social Security. The most recent information about Social Security recipients has led CBO to lower its spending projections slightly. The changes include reducing the average monthly and initial (retroactive) retirement-benefit payments expected in Social Security's Old-Age and Survivors Insurance program. For the Disability Insurance program, reduced projections of retroactive benefit payments are offset by increased projections of

3. A private fee-for-service plan is a Medicare Advantage health plan that—unlike other Medicare Advantage plans—generally neither establishes a network of providers nor requires that enrollees use such a network. Beneficiaries can see any provider who is eligible to receive payment from Medicare and who agrees to accept payment from the PFFS plan.

caseloads. The net effect of those changes is to decrease spending by an average of roughly $2 billion per year over the 2008–2017 period, for a total drop of $17 billion, or 0.2 percent.

Veterans' Compensation. CBO now projects that spending for veterans' disability compensation will be about $17 billion higher between 2008 and 2017 than it anticipated in January. Recent data from the Department of Veterans Affairs about average monthly benefit payments for veterans suggest that monthly benefits for new recipients of disability compensation will be higher than previously projected.

Other Mandatory Programs. Technical changes to the spending projections for other mandatory programs have been relatively small; on net, they increase mandatory outlays by $6 billion over the 2008–2017 period. In the largest such change, CBO has added $7 billion to its 10-year projection of outlays for the Pension Benefit Guaranty Corporation because it anticipates lower income from premiums and interest and smaller transfers from nonbudgetary funds (all of which are recorded in the budget as negative outlays), partly offset by lower payments to pension recipients. In the other direction, CBO has reduced its estimate of outlays for international affairs programs by a total of $4 billion over 10 years (primarily because of adjustments in the estimated earnings of the Exchange Stabilization Fund). Other, smaller changes have added a net $3 billion to total projected mandatory spending over the 2008–2017 period.

Discretionary Programs. Technical changes since January have had a smaller effect on CBO's baseline projections of discretionary spending than on its projections of mandatory spending. Those adjustments decrease discretionary outlays by $3 billion in 2007 and by $17 billion over the 2008–2017 period. The biggest change for 2007 was a reduction of $4 billion to reflect slower-than-expected growth in spending by DoD—especially in the category of operations and maintenance, which funds many of the department's day-to-day activities.

The $17 billion reduction for the 2008–2017 period reflects a $21 billion decrease in projected outlays for defense programs and a $4 billion increase in projected spending for nondefense discretionary programs. The revisions to projections of defense spending are mostly attributable to new actuarial information from DoD that shows lower contribution rates for 2008 for the military's TRICARE For Life Trust Fund. That change has led CBO to pare $14 billion from its projection of spending for future health care benefits from the TRICARE For Life program.

Net Interest. In all, technical changes to projections of net interest spending have reduced projected outlays over the next 10 years by $7 billion. That reduction is the net result of two countervailing changes. On one hand, CBO has lowered its projections of net interest costs for the 2008–2017 period by $22 billion, in large part because of revisions to certain intragovernmental interest payments and adjustments in the estimated balances of financing accounts for federal credit programs (which affect federal borrowing needs). On the other hand, increases in projected deficits (or decreases in projected surpluses) resulting from other technical changes to the baseline have added $15 billion to projected debt-service costs between 2008 and 2017.

Changes to Revenue Projections

The revisions to CBO's revenue projections since January are all considered technical and reflect higher projections of revenues from miscellaneous fees and fines (such as receipts of the Department of Justice's Assets Forfeiture Fund). The changes have little effect on projected revenues in 2007 and 2008 but add $500 million to $700 million each year thereafter.

APPENDIX

B

The Potential Economic Effects of Selected Proposals in the President's 2008 Budget

Considerable uncertainty surrounds the potential economic impact of five of the President's budgetary proposals for 2008—those that would extend beyond 2010 the lower tax rates on dividends and capital gains, expand the availability of tax-free savings accounts, extend the repeal of the estate tax, establish individual accounts as part of Social Security, and change the tax treatment of health insurance. This appendix discusses the factors that the Congressional Budget Office (CBO) considered and methods it used in assessing the impact of the first four of those proposals. Appendix C discusses the health proposal, and Chapter 2 presents the analysis of the overall economic effects of all of the proposals.

Extend the Lower Tax Rates on Dividends and Capital Gains

Enactment of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) reduced tax rates applicable to dividends and capital gains through 2008. Those rates comprise a bottom bracket of 5 percent and a top bracket of 15 percent; in 2008, the bottom bracket is slated to drop to zero. The Tax Increase Prevention and Reconciliation Act of 2006 extended the zero and 15 percent rates through 2010. Before JGTRRA was enacted, dividends were subject to the same tax rates as ordinary income—ranging from 10 percent to 35 percent—and most capital gains were subject to rates of 8 percent, 10 percent, or 20 percent (depending on a filer's income tax bracket and on how long the asset was held).

The President, in his 2008 budget, has proposed making the rates of zero and 15 percent permanent. Many types of productive capital are sufficiently long-lived that investments in them today will continue to earn returns long after JGTRRA's rate changes are scheduled to expire. Permanently extending those rates would enhance firms' incentive to invest in long-lived capital stock by increasing the expected returns.

Reduced rates on capital gains and dividends lower the overall taxation of corporate profits, some of which are taxed twice: once under the corporate income tax and again when people receive dividends and realize capital gains—brought about by a firm's reinvestment of its profits—on sales of stock. Lowering the tax rates that individuals face on the two types of income would reduce the total rate of taxation.

In addition to decreasing tax rates on corporate income, JGTRRA reduced taxes on some income that is currently taxed only once. A substantial portion of taxable capital gains arises from investments whose earnings are not subject to the corporate income tax, such as gains on real estate held by individuals. The lower capital gains tax rate reduced the level of taxation on those investments as well.

One effect of extending the tax rates on dividends and capital gains involves the cost of financing for businesses. Lower tax rates on capital gains and dividends could lower the cost of financing, because businesses could pay investors less before taxes to yield the same after-tax return. But how much the cost of capital might fall is unclear. Some analysts argue that only the decrease in taxes on capital gains will act to reduce that cost. Others hold that both the decrease in taxes on dividends and the

decrease in taxes on capital gains will reduce the cost of capital.[1]

A related difference of views among analysts involves how much the value of firms' stock might rise if the lower rates of taxation were extended permanently. (Share values rise because the decrease in taxes increases the after-tax return to shareholders, making the investments more valuable to them.) The view of corporate finance that predicts a relatively large increase in those values predicts a relatively small decrease in the cost of capital, and vice versa.

In the absence of a clear consensus about which view is correct, CBO has adopted middle-ground estimates of the effects of the President's proposal on the cost of capital for firms and on share values.

Higher values for shares of stock raise the net wealth of shareholders, encouraging more spending on goods and services—the so-called wealth effect. Through that channel, the President's proposal would boost overall demand in the short run. But to the extent that it enhanced demand by raising consumer spending in the short run, it would tend to reduce national saving and national income in the long run.

The enactment of JGTRRA has provided an opportunity to examine how changes in dividend taxes affect a firm's value. Some researchers have found evidence that reductions in dividend taxes raised stock prices, although it is uncertain whether those changes will be permanent or temporary.[2] Other researchers have found no measurable effects on the value of the total U.S. stock market, but their work does not rule out the possibility of a modest positive effect. [3]

Extending the lower rates on capital gains and dividends is also likely to lessen the disadvantage that the corporate sector now faces in the competition for capital. For example, although some income from the corporate sector is taxed twice under current law, income from unincorporated businesses is taxed only once (at the personal level), and income from owner-occupied housing—that is, the value of the housing "services" consumed by the owner—is not taxed at all at the federal level. That disparity in tax treatment may lead to lower investment in the corporate sector than is optimal for economic output. Lowering the taxes that firms face would allow them to attract additional capital from the housing and small-business sectors and may thus improve the economy's efficiency. Such a shift in investment might, however, conflict with other policy goals, such as support for owners' occupancy of homes or for unincorporated businesses.

The proposal to extend the lower rates on dividends and capital gains might affect firms' financial behavior in two ways: They might choose to finance more investment by issuing stock (equity financing) rather than debt, and they might decide to pay out more in dividends and retain fewer earnings. Currently, firms may deduct the interest they pay on debt from their taxable income, so those payments are taxed only once, at the personal level. (That is, the individual who receives the payment pays the tax.) But if a firm finances a project by issuing stock, some of the returns on the investment that the project generates are taxed at both the corporate and personal levels. The President's proposal would narrow that disparity in tax treatment.

1. Although economists do not agree on how the taxation of dividends affects the economy, two competing views prevail. Under the first (or "traditional") view, reducing the tax on dividends lowers the cost of capital and increases investment. In the short run, stock prices rise under this view because expected after-tax returns to investors increase. But the additional investment drives the pretax return to capital back down over time, so the impact on stock prices is temporary. Under the second (or "new" view), reducing the tax on dividends permanently raises the value of a firm and therefore its stock price but leaves unaffected both the cost of capital and investment by the firm. For an overview of those issues, see Alan Auerbach, "Taxation and Corporate Financial Policy," in Alan Auerbach and Martin Feldstein, eds., *Handbook of Public Economics*, vol. 3 (Amsterdam: North-Holland, 2003); and George R. Zodrow, "On the 'Traditional' and 'New' Views of Dividend Taxation," *National Tax Journal*, vol. 44, no. 4, part 2 (December 1991), pp. 497–509; and Roger Gordon and Martin Dietz, "Dividends and Taxes," Working Paper No. 12292 (Cambridge, Mass.: National Bureau of Economic Research, June 2006).

2. Alan J. Auerbach and Kevin A. Hassett, "The 2003 Dividend Tax Cuts and the Value of the Firm: An Event Study," in A. Auerbach, J. Hines, and J. Slemrod, eds., *Taxing Corporate Income in the 21st Century* (Cambridge: England, Cambridge University Press, 2007), pp. 93–126; Alan J. Auerbach and Kevin A. Hassett, "Dividend Taxes and Firm Valuation: New Evidence," *American Economic Review*, vol. 96, no. 2 (May 2006), pp. 119–123.

3. Gene Amromin, Paul Harrison, and Steven Sharpe, *How Did the 2003 Dividend Tax Cut Affect Stock Prices?* Working Paper 2006–17 (Chicago: Federal Reserve Bank of Chicago, October 2006).

The evidence amassed so far is consistent with the view that dividend taxation affects firms' payout policies, at least in the short run. The reduction in dividend taxation in 2003, for instance, has been followed by a significant increase in dividends issued by firms, although it is uncertain whether that increase will be permanent and whether the tax cut caused firms to increase their total payout to shareholders or simply to substitute dividends for share repurchases.[4] In addition, the factors explaining why some firms increased dividend payouts more than others are still being explored; the evidence to date suggests that the response to the tax reduction appeared to be greater among firms whose top executives held relatively large amounts of company stock (and relatively small amounts of unexercised stock options) and among firms whose ownership was dominated by taxable institutions.

The proposed reduction in the future taxation of dividends and capital gains would also interact with some of the President's other proposals and with current law. For instance, the President's proposal to boost the amount that people may deposit in tax-free savings accounts (discussed below) would increase the share of personal assets held in such accounts—duplicating some of the effect that the proposal to extend the tax rates on dividends and capital gains would have on the cost of capital and its allocation among sectors of the economy. However, the expanded accounts would partly mitigate the impact that the dividend/capital gains proposal would have in bolstering equity financing because the interest earned on assets in the accounts would not be taxed at either the personal or the corporate level. Also contributing to that lessening of the proposal's impact on equity financing would be the combined effect of the two policies in increasing the proportion of interest-bearing assets in tax-free accounts: Investors' incentive to hold stocks in such accounts would be weakened if their returns already faced lower tax rates.

CBO incorporated the effects of the dividend/capital gains proposal in its analysis in two ways. For the two macroeconometric forecasting models (from Macroeconomic Advisers and Global Insight), CBO estimated the proposal's effect on the cost of capital in different sectors of the economy and on the value of stock shares under the assumption that both investors and businesses are forward-looking. It then incorporated those estimates in the models and projected the ultimate effect on the economy.

For the growth models (the "textbook" growth model, life-cycle growth model, and infinite-horizon growth model), CBO incorporated an estimate of the proposal's overall effect on the cost of capital. Those models, however, have no mechanism to account for the effect of reallocating capital. CBO therefore reviewed research on how reallocation might influence output, determined a midrange estimate, and added that amount to the models' underlying estimates of the effect on output. The procedure phased in an increase in gross national product over the 2008–2017 period that reached 0.07 percent in 2017.

Expand Tax-Free Savings Accounts

The President's 2008 budget includes a proposal that is designed to both consolidate and expand the current system of tax-free savings accounts for retirement and other purposes, such as education. Two new kinds of accounts would be created: retirement savings accounts (RSAs) and lifetime savings accounts (LSAs). The RSA would function in some ways like a Roth individual retirement account (IRA)—that is, taxes would not be deferred on contributions, as they are for contributions to traditional IRAs, but the interest that the accounts earned would accrue tax-free. In contrast to Roth IRAs, however, RSAs would be available to all workers (and their spouses) regardless of income. In addition, the President's proposal would eliminate further tax deferrals for IRA contributions.

Like the RSAs, the proposed lifetime savings accounts would face tax treatment similar to that governing Roth IRAs. However, unlike Roth IRAs or RSAs, LSAs would be open to everyone, regardless of age, income, or employment status, and participants could withdraw

4. Raj Chetty and Emmanuel Saez, "The Effects of the 2003 Dividend Tax Cut on Corporate Behavior: Interpreting the Evidence," *American Economic Review*, vol. 96, no. 2 (May 2006), pp. 124–129; Raj Chetty and Emmanuel Saez, "Dividend Taxes and Corporate Behavior: Evidence from the 2003 Dividend Tax Cut," *Quarterly Journal of Economics,* vol. 120, no. 3 (2005), pp. 791–833; Jeffrey Brown, Nellie Liang, and Scott Weisbenner, "Executive Financial Incentives and Payout Policy: Firm Responses to the 2003 Dividend Tax Cut," Working Paper No. 11002 (Cambridge, Mass.: National Bureau of Economic Research, 2004); and Jennifer Blouin, Jana Raedy, and Douglas Shackelford, "Did Dividends Increase Immediately After the 2003 Reduction in Tax Rates?" Working Paper No. 10301 (Cambridge, Mass.: National Bureau of Economic Research, February 2004).

funds at any time for any reason. Taxpayers could also use LSAs to consolidate other savings plans, including Coverdell education savings accounts and qualified state tuition plans.

In CBO's estimation, the new savings accounts that the President has proposed would have little effect on the economy, on average, over the 2008–2017 period. Most taxpayers would save similar amounts in one of the new accounts as they would have saved in one of their present tax-free accounts. Furthermore, a possible outcome of implementing the new accounts is that people who currently have assets in taxable accounts will reduce their tax liability by selling those assets and putting the proceeds into the new accounts; similarly, over time some people may contribute less to taxable savings accounts because they contributed to the tax-preferred ones instead. To the extent that such shifting of assets occurred, total private saving would be unaffected but the budget deficit would be larger, so the net effect on national saving would be negative (because the change in private saving would fail to offset the increase in the budget deficit). Most new private saving would involve small amounts set aside by taxpayers with few taxable assets to shift.

Beyond 2017, the effects of the proposal might be greater than those just described (because increasing numbers of taxpayers would run out of assets that could be shifted). For those later years, CBO estimates, the proposal would have a modestly positive impact on private saving.

Extend the Estate Tax's Repeal

The President's proposal to extend the repeal of the estate tax beyond the end of calendar year 2010 (the repeal's scheduled expiration date) could have varying effects on consumer spending and saving, depending on people's motives for leaving bequests. Consensus is lacking, however, about which motives predominate and how estate taxes affect consumer spending. A lower estate tax makes it cheaper for people to leave money to their heirs, which could encourage people to reduce their spending to leave larger bequests. But a lower estate tax also means that people can make the same after-tax bequest and spend more at the same time. Furthermore, to the extent that a lower estate tax increased the size of bequests after taxes, potential recipients might increase their spending as well. Some opponents of the estate tax argue that it has a particularly negative effect on the creation of new small businesses, but CBO has found little evidence to support that contention.[5]

CBO's estimates of the effects of the President's proposal incorporated the assumption that extending the repeal of the estate tax would increase consumer spending slightly, on balance—by about 5 cents for each dollar of tax savings. That assumption implies that the extension of the repeal will reduce the capital stock, but by an amount too small to affect the estimates presented in Chapter 2 of this report. Alternative assumptions that CBO considered—for example, that the positive effect on consumer spending from increasing after-tax income would be balanced by the incentive effects of lower tax rates, resulting in no net impact on that spending—would have yielded similar results.

Establish Individual Accounts in Social Security

The President's budget includes a proposal that would allow workers to redirect a portion of their payroll tax payments from the Social Security trust funds to individual accounts and invest the contributions to such accounts in various financial assets. In CBO's estimation, the proposal would result in budgetary outlays of $270 billion from 2011 to 2017; however, it would have no appreciable effect on the economy during that period because it would not change people's expected lifetime income (once the expected returns of the assets in the accounts were adjusted for the risk they carry) and would not alter people's take-home pay. In addition, the accounts would not significantly affect the investment capital available in the economy, because the additional government borrowing to finance the accounts would be roughly offset by the increase in investable funds in the accounts.

Under the proposal, workers could redirect payroll taxes to individual accounts, but their contributions to the accounts would ultimately be offset by reductions in their traditional Social Security benefits, which would be calculated using hypothetical accounts. In addition to tracking the actual balances in an individual account, the Social Security Administration would follow a hypothetical account that held the same amount of contributions

5. See Congressional Budget Office, *Effects of the Federal Estate Tax on Farms and Small Businesses* (July 2005).

and that grew at a specified real (inflation-adjusted) rate of 2.6 percent per year. When a person claimed traditional Social Security benefits, those benefits would be reduced in such a way that the actuarial value of the reduction over the person's remaining lifetime would equal the amount in the hypothetical account—regardless of how much was actually in the person's individual account.

CBO derived the rate of growth for the notional account from projections by the trustees of the Social Security system. In their estimation, Treasury bonds over the long run will earn an average real return of 2.9 percent, and the individual accounts, if enacted, will incur annual administrative expenses equal to 0.3 percent of assets—for a net real return of 2.6 percent. Because that rate equals the rate of return on the notional account that would be used to calculate the reduction in benefits, diverting payroll taxes to an individual account and investing entirely in government bonds is projected to leave a person's total benefits (including the account assets) unchanged. If, however, the average rate of return on government bonds turns out to be higher or lower than that projected 2.9 percent, the total benefits of a person who chose to divert some payroll taxes to an individual account and invest in Treasury bonds will also be correspondingly higher or lower.

On average, greater returns would be expected from investing the contributions to an individual account in other assets, such as corporate bonds or equities. However, those investments would also be riskier than government bonds. The prices of various assets and their expected returns are determined by the preferences and judgments of financial market participants, who attempt to balance the risks of various assets against their extra expected returns. Therefore, despite the fact that an individual account holding assets such as stocks (with an expected return higher than 2.6 percent) would yield expected lifetime Social Security benefits whose value was greater than it would be under the traditional system, that higher anticipated income would not be expected to change the account holder's behavior (by, for example, inducing him or her to increase spending now) because the higher expected return would be balanced by additional risk. Shifting some payroll taxes to an individual account would also be unlikely to affect the consumption patterns of people who spend all of their income because it would not alter their take-home pay.[6]

6. See Congressional Budget Office, *Evaluating Benefit Guarantees in Social Security* (March 2006).

APPENDIX

C

The President's Proposal for a Standard Tax Deduction for Health Insurance

In his 2008 budget request, the President proposes to replace virtually all of the current tax preferences for health insurance with a new standard deduction for any taxpayer who buys a qualifying health insurance plan. The Joint Committee on Taxation (JCT) estimates that the proposal would increase federal revenues by a net $411 billion over the next 10 years (as well as raising outlays for refundable tax credits by $77 billion over that period). The reason for the significant net revenue increase in JCT's estimates is that the large revenue gain from eliminating current tax advantages for health spending would outweigh the large revenue loss from the new standard health deduction. The proposal would also raise effective marginal tax rates on labor income (the rate that applies to the last dollar of earnings) and would lead to a slight reduction in economic output between 2008 and 2017, according to economic modeling by the Congressional Budget Office (CBO). In addition, the plan would reduce the number of uninsured people by about 6.8 million, CBO estimates.

The current tax exclusion for the costs of employment-based health insurance tends to cause more health spending to occur through that type of insurance—and more spending on health in general—than would otherwise be the case. The President's proposal would eliminate the distortion toward employment-based insurance by replacing the exclusion with a standard tax deduction for the purchase of a qualifying health plan regardless of its cost or source (that is, whether the policy was obtained through an employer, union, or professional association or in the individual "nongroup market.")[1] Thus, the proposal would set employment-based health insurance on a par with individually purchased insurance. Moreover, once taxpayers had purchased a plan qualifying for the standard health deduction, they would no longer have a tax incentive to spend additional income on health insurance rather than on other goods. The change in incentives for purchasing insurance would be likely to have a variety of important effects, especially over time. This analysis focuses on the proposal's impact on the budget, marginal tax rates on labor, economic output, and the number of people with health insurance. It does not examine other potential effects, such as on economic efficiency or health outcomes.

Description of the Proposal

Under current law, employers' payments for employment-based health insurance (and most payments by employees) are excluded from taxable income for calculating income and payroll taxes, whereas the income that individuals use to buy non-employment-based health insurance is generally subject to taxation. Current law offers employees another tax advantage as well: Their spending from employer-sponsored flexible spending accounts and health savings accounts is exempt from both individual income and payroll taxes. Self-employed individuals are allowed to take an income tax deduction for health insurance payments. Finally, people who itemize deductions on their tax returns can deduct medical expenses that exceed 7.5 percent of their adjusted gross income.

The Administration's proposal would replace most of those tax exclusions and deductions with a standard health deduction for taxpayers not enrolled in Medicare who purchased qualifying insurance. The standard deduction would be allowed for calculating federal income and payroll taxes.

1. For simplicity, this appendix uses the term "nongroup market" to mean people who purchase health insurance through the traditional nongroup market as well as those who buy insurance as part of a group not associated with employment.

To qualify for the deduction, a health insurance plan would have to meet certain minimum requirements, including a specific limit on out-of-pocket expenses, reasonable caps on annual or lifetime benefits, rules about the types of care covered, and guaranteed renewability.[2] Nearly all current health plans would be expected to qualify, although some policies sold in the individual insurance market might not meet those standards.

The President's proposal contains the following provisions:

- All contributions by employers and employees for health insurance would be included in employees' taxable income.
- Employees would no longer be able to use flexible spending accounts to pay for the costs of health insurance and health care. However, health savings accounts would continue to exist.
- Self-employed people would not be allowed to deduct health insurance payments for income tax purposes.
- Taxpayers who bought qualifying health plans—whether through their employer or on their own—would receive a deduction against their earnings (for income and payroll tax purposes) of $15,000 for family coverage and $7,500 for single coverage. Those amounts would be indexed to rise with inflation each year, as measured by the change in the consumer price index (CPI). Taxpayers enrolled in Medicare would not be eligible for the standard health deduction.
- The itemized deduction for medical expenses that exceed 7.5 percent of adjusted gross income would be eliminated, except for taxpayers enrolled in Medicare.
- For taxpayers with qualifying children, the rate at which the earned income tax credit (EITC) phases out as earnings rise would be lowered to 15 percent from the current range of 15.98 percent to 21.06 percent. That change would reduce the potential loss in the EITC that some low-income workers would experience when health insurance premiums were counted as taxable earnings.

Effects on the Federal Budget

If the President's proposal took effect in 2009, it would reduce revenues by almost $14 billion in that fiscal year and by $6 billion the following year but would raise revenues by growing amounts thereafter, according to JCT (see Table C-1). Over the current 10-year budget window (2008–2017), the proposal would increase revenues by a total of about $411 billion. Some of that increase would come from higher Social Security payroll taxes. With the additional revenues to the Social Security trust funds excluded, on-budget revenues would rise by $354 billion. JCT estimates that the proposal would also boost outlays for refundable tax credits by $77 billion over the 2008–2017 period. Therefore, the proposal would have a net budgetary effect of $334 billion over 10 years.[3]

Repealing the current tax preferences for employment-based health insurance and other health benefits would have a net positive budgetary effect of $3.6 trillion over the 10-year budget window, while creating the standard health deduction would have a negative effect of $3.2 trillion over that period. Thus, eliminating the current tax preferences would produce more revenues than would be lost by creating the new deduction. The additional revenues collected under the proposal would rise over time because the revenue gain from the repeal would grow at a faster rate than the revenue loss from the deduction. That pattern results from the fact that the deduction would be indexed to increases in the CPI, whereas under current law, health insurance premiums (which influence the size of the current tax exclusions) are assumed to grow more quickly than the CPI.

Beyond 2017, the revenues collected under the proposal would continue to rise, but they would be partly offset by growing outlays for Social Security benefits. The proposal would affect spending for Social Security to the extent that changes in taxable wages altered the covered wages used to calculate Social Security benefits. Through 2017, any effect on Social Security outlays would be quite small, and the cumulative impact on those outlays could

2. The limits on out-of-pocket costs would be based on the standards that apply to health savings account plans; currently, those limits cannot exceed $5,500 for individuals and $11,000 for family policies (amounts that are indexed to increase with overall inflation). Other requirements for the new deduction would be established by the Treasury Department through regulation. Those rules would not preempt states' minimum standards for health insurance coverage.

3. That "net budgetary effect"—as is generally the case when CBO analyzes specific proposals—excludes any associated changes in debt-service costs.

Table C-1.

Budgetary Effects of the President's Health Proposal

(Billions of dollars)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Total, 2008-2017
Revenues											
On-budget	0	-6	3	12	22	34	48	63	80	98	354
Off-budget	0	-8	-9	-5	-1	4	10	15	22	29	57
Total	0	-14	-6	7	22	39	57	78	101	127	411
Outlays	0	0	10	10	10	10	10	9	9	9	77
Net Budgetary Effect[a]	0	-14	-17	-4	12	29	48	69	93	118	334
Memorandum:											
The Treasury's Estimate of the Proposal's Net Budgetary Effect[a]	0	-32	-44	-36	-25	-11	4	20	36	54	-33

Sources: Joint Committee on Taxation; Department of the Treasury.

a. Negative numbers indicate an increase in the deficit or a decrease in the surplus, whereas positive numbers indicate a decline in the deficit or a rise in the surplus.

be either positive or negative. Over a longer period, however, the proposal would have the effect of raising taxable wages—and hence outlays for Social Security benefits—by increasingly significant amounts.

Compared with JCT's estimates, which envision a significant revenue increase from the President's proposal over the next decade, the Treasury Department's estimates suggest more modest effects. In particular, the Treasury estimates that the proposal would have a net budgetary cost of $33 billion over the 2008–2017 period (see Table C-1). JCT estimates negative net budgetary effects in the proposal's first three years, after which its estimates turn positive, whereas the Treasury predicts negative effects for the first five years. For 2017, the Treasury estimates that the proposal would reduce the deficit or increase the surplus by $54 billion, compared with JCT's estimate of $118 billion.

Effects on Marginal Tax Rates on Labor

The rate at which someone's last dollar of income from labor is taxed influences the amount of labor supplied to the economy. Increases in marginal tax rates reduce the return from working and therefore tend to reduce the amount of labor supplied to the economy, at least to some degree. CBO estimates that the President's proposed changes in the tax deductibility of health insurance would increase effective marginal tax rates on labor. That effect arises from the fact that when people consider the benefits of working additional hours, they think about what they can buy with the additional income earned. To the extent that they wanted to purchase more health insurance with their higher income, the President's proposal would raise marginal tax rates because it would increase the cost of buying additional insurance from the additional income earned.

In the near term, workers have little flexibility to alter the amount they spend on health insurance: In most cases, insurance is offered in a fixed amount by their employer. Over time, however, as their income rises, employees can demand more-expensive health insurance plans. That longer-run connection between changes in income and desired increases in health insurance spending underlies CBO's conclusion that the President's health proposal would raise effective marginal tax rates on labor.

That rise can be illustrated by considering how workers would spend the money earned from another hour of work. To understand how taxes interact with health spending, assume that workers can instantaneously adjust the amount spent on employment-based health insurance. If the workers would devote some of their additional earnings to health insurance premiums, they would enjoy a tax savings under the current tax treatment of such spending. However, the same workers considering an additional hour of work under the President's health

Table C-2.

CBO's Estimates of Effective Federal Marginal Tax Rates on Labor Income Under the President's Proposals

Calendar Year	Tax Rates Under the President's Budget (Percent)		Change Attributable to the Health Proposal (Percentage points)
	Without Health Proposal	With Health Proposal	
2007	29.4	29.4	0
2008	30.6	30.6	0
2009	30.9	32.1	1.2
2010	31.1	32.4	1.3
2011	31.4	32.7	1.4
2012	31.6	33.1	1.5
2013	31.9	33.4	1.5
2014	32.1	33.7	1.6
2015	32.3	34.0	1.7
2016	32.6	34.3	1.7
2017	32.8	34.6	1.8

Source: Congressional Budget Office.

Note: The effective federal marginal tax rate on labor income is the share of the last dollar of earnings in the economy that is taken by federal individual income taxes and payroll taxes.

proposal would no longer enjoy the tax savings from their extra spending on health insurance. As long as they would spend some of their additional earnings from increased work on employment-based health insurance, the after-tax benefit from working an extra hour would be lower under the President's proposal. That reduction in the after-tax benefit from working an extra hour is similar to an increase in tax rates; therefore, CBO incorporated an increase in rates into its estimates of effective marginal tax rates on labor under the President's proposal.

CBO analyzed the impact of that proposal on marginal tax rates not only for people considering changing how many hours they work but also for individuals entering or leaving the labor force. For those individuals, marginal tax rates could either rise or fall under the proposal. The outcome would depend on several factors, including the number of people who had tax-deductible insurance through another family member, the availability of jobs that provided insurance, and the value of the new standard health deduction relative to the value of insurance. Another factor could also affect marginal tax rates: To the extent that the new deduction exceeded the amount that would be included in taxable income from the removal of current tax preferences, a taxpayer's taxable income might be reduced and the taxpayer might fall into a lower marginal tax bracket. Conversely, to the extent that the deduction was smaller than the rise in taxable income from the elimination of current preferences, a taxpayer might move into a higher marginal tax bracket.

The impact of the President's health proposal on marginal tax rates on earnings can be seen by comparing effective marginal rates under the full set of proposals in the President's budget with rates calculated excluding the health proposal (see Table C-2). Beginning in 2009, when the health proposal would take effect, economy-wide marginal tax rates on labor under the President's budget would be 1.2 percentage points higher as a result of the health proposal. That difference would grow to 1.8 percentage points by 2017. Those increases represent a rise of 4 percent to 5 percent from the rates under the rest of the President's budgetary proposals.

CBO's estimates depend on assumptions about the amount that would be spent on additional health insurance from additional income earned. CBO assumed that for the average person, health spending grows at half the rate at which income grows (an elasticity of 0.5).[4] Deductible health spending is projected to make up roughly 10 percent of total compensation during the 2008–2017 period. Given those assumptions, under current law, 5 cents of each additional dollar earned would be spent on health insurance and would not be subject to income and payroll taxes. The current tax exclusion thus makes marginal tax rates on labor about 5 percent lower than they would be otherwise, which amounts to a reduction of about 1.5 percentage points, given that rates without the health proposal average roughly 30 percent. Eliminating that exclusion as part of the health proposal would therefore raise marginal tax rates on labor by about 1.5 percentage points. The increase would be less than that initially, CBO estimates, because many workers

4. The amount of additional health insurance that people desire when their income rises is uncertain. CBO's assumed elasticity of 0.5 falls in the middle of estimates by other researchers (which range from near zero to almost 1). To the extent that the actual response was lower than CBO assumed, the increase in marginal rates from the President's health proposal would be lower than estimated here. To the extent that the actual response was higher, the increase in marginal tax rates would be greater.

would be shifted to lower marginal tax brackets in the first years of the proposal, when the value of the standard health deduction would exceed the value of insurance. The reverse would be true in later years, when the value of insurance would tend to be greater than the value of the deduction.[5]

A rise in marginal tax rates is normally associated with an increase in the total taxes paid by workers. The increase in taxes—and accompanying reduction in after-tax income—by itself causes people to work more in an attempt to maintain the same standard of living. That "income effect" usually offsets, to some extent, people's tendency to work less when marginal tax rates rise because the prospect of lower after-tax compensation from another hour of labor makes work less attractive relative to other uses of a person's time.

Except for the first two years, JCT estimates that the total taxes paid would increase under the President's health proposal. The income effect from the reduced after-tax income would cause people to work more, thus offsetting some of the effect of higher marginal tax rates on labor. However, the total taxes paid would not rise as much as marginal rates would, because the total revenues gained from repealing the current tax exclusion would largely be reduced by the new standard health deduction. The income effect, which is linked to the change in the total taxes paid, would therefore be smaller as well.

Effects on Gross National Product

The proposal to change the tax treatment of health insurance premiums would reduce economic output slightly from what it would be under the President's budget without that proposal. By raising effective marginal tax rates on labor income, the health proposal would decrease the supply of labor somewhat. At the same time, however, the additional tax revenues collected under the proposal would reduce the government's need to borrow funds. Less federal borrowing would raise national saving, which in turn would increase future economic output. (The proposal might also affect private saving by changing effective marginal tax rates on capital. Those rates would be largely unaffected, however, because the change in the effective price of additional health insurance spending would occur in all years and therefore would not alter the trade-off between current and future consumption, which matters for calculating effective marginal tax rates on capital.)[6]

To illustrate how the health proposal fits into CBO's estimates of the effects of the President's budget on economic output, CBO used some of its growth models to estimate the macroeconomic impact from adding that proposal to the other policy changes in the President's budget. (For more information about CBO's models and the impact of all of the President's proposals, see Chapter 2 and Appendix D.) Depending on assumptions about workers' responsiveness to tax changes, how the government ultimately finances deficits, and whether the economy is open or closed to flows of foreign capital, CBO estimates that the health proposal would reduce real (inflation-adjusted) gross national product (GNP) by a total of zero to 0.3 percent in the five years from 2008 to 2012 and by zero to 0.5 percent over the following five years.

Although the health proposal is projected to reduce GNP modestly, it would also have the beneficial effect of lessening the overall tax incentive to shift additional spending to health insurance from other goods and services (beyond the spending on a qualifying health plan). To the extent that the existing incentive distorts households' spending patterns, the proposal might reallocate total spending in the economy in a way that could tend to improve overall well-being or economic efficiency but that GNP would not reflect.

Effects on the Number of People with Health Insurance

In addition to its budgetary and economic effects, the President's health proposal would reduce the number of

5. In estimating the economic impact of the President's health proposal using various models (as described later in this appendix), CBO phased in the increase in marginal tax rates on labor for the models that do not assume forward-looking behavior (the textbook growth model, Global Insight's model, and Macroeconomic Advisers' model). In those models, taxpayers might not recognize the policy change right away, and even when they did recognize it, they might not be able to alter their purchase of health insurance quickly. As a result, they would not experience an immediate increase in marginal tax rates under the President's proposal. (In the forward-looking models, there would be no lags in recognizing or adjusting to the policy change.)

6. Although taxing additional health spending under the proposal would have no effect on effective marginal tax rates on capital, the proposal would move some people into different tax brackets. That movement would have a small net effect on the overall marginal tax rate on capital, changing it by less than 0.1 percentage point in any year through 2017.

uninsured people in the United States, CBO estimates. Under current law, an average of about 51 million people are expected to lack health insurance on any given day in 2010.[7] Assuming that individuals and firms had fully adjusted to the new policy by then, CBO estimates that under the President's proposal, the number of people without health insurance would be about 6.8 million smaller. (Because the proposal represents a significant departure from the current tax treatment of health insurance, its estimated effects on coverage are highly uncertain. The numbers described here represent CBO's best estimates of the effects, but significant uncertainty surrounds them.)

The overall reduction in the number of uninsured individuals reflects many channels of change in the health insurance market. Of people who would otherwise be uninsured in 2010, for example, approximately 7 million would become insured in the nongroup market under the proposal, CBO estimates, and about 1.3 million would obtain employment-based coverage. At the same time, about 1.5 million people who would have employment-based coverage under current law would become uninsured under the proposal, and about 6.3 million would switch from employment-based to nongroup coverage.

The amount of the proposed tax deduction would represent a subsidy of about 70 percent of the health insurance premiums for the average person who became newly insured through the nongroup market. That subsidy rate would vary among individuals and households depending on their taxable income, the type and comprehensiveness of the insurance they bought, such factors as their age and health status (which could affect their quoted premiums), the number of individuals covered under their policy, and the cost of health care in their region.

Compared with people who would be uninsured in 2010 under current law, those gaining insurance coverage under the President's proposal would have higher income, on average. The reason is that the value of the new deduction would be greater at higher marginal tax rates, which are associated with higher income. Nonetheless, the majority of newly insured people would come from lower-middle- and middle-income households, mostly because the uninsured population as a group has relatively low income compared with the population as a whole. The uninsured people who would acquire insurance coverage under the proposal would also have better health status, on average, than the uninsured population at large. The reason is that premiums in the nongroup market are generally lower for people with lower expected health costs, so the proposed deduction would represent a larger percentage subsidy of premiums for people with lower expected costs.

Replacing the tax exclusion for employment-based health plans with a deduction that could be used in either the employment-based or nongroup market would make employment-based plans less attractive relative to nongroup plans than they are now.[8] As a result, the number of people insured through employment-based plans would decline by more than 6 million, CBO estimates. Although some of the people losing coverage in the employment-based market would become uninsured, the bulk of them would be insured through the nongroup market instead.

Despite the change in tax treatment, the vast majority of privately insured individuals would remain in the employment-based market rather than the nongroup market, CBO estimates, because the former has significantly lower administrative costs and advantages in forming insurance pools with more predictable costs. Nevertheless, the number of people obtaining coverage through the nongroup market would increase significantly, mainly as a result of newly insured individuals and those who would switch from employment-based coverage to nongroup coverage.

Moving from the current system—in which the tax exclusion creates a bigger tax subsidy for larger health insurance expenditures—to a fixed deduction independent of the comprehensiveness of a health plan would cause people to buy plans with less generous benefits, on average. CBO estimates that the extent of that benefit reduction—combining both the effects of people purchasing employment-based plans with less generous benefits and a shift in coverage toward the nongroup market (where coverage is typically less generous)—would amount to roughly 15 percent in 2010.

7. For a discussion of different ways to measure the uninsured, see Congressional Budget Office, *How Many People Lack Health Insurance and for How Long?* (May 2003).

8. Under current law, self-employed people can take an income tax deduction for health insurance premiums even though they often purchase insurance through the traditional nongroup market.

APPENDIX

D

The Models Used to Analyze the Supply-Side Macroeconomic Effects of the President's Budgetary Proposals

The Congressional Budget Office (CBO) used three models to estimate the supply-side effects of the President's budgetary proposals from 2008 to 2017: a "textbook" growth model, a life-cycle growth model, and an infinite-horizon growth model. (Estimates generated by those models are presented in Chapter 2.)

The Textbook Growth Model

The textbook growth model is an enhanced version of a model developed by Robert Solow, a pioneer in the theory of growth accounting. The textbook growth model incorporates the assumption that economic output is determined by the number of hours of labor supplied by workers, the size and composition of the capital stock (for example, factories and information systems), and total factor productivity—which represents the state of technological know-how. The model is not forward-looking; the people that it represents base their decisions about working and saving entirely on current economic conditions. In particular, they do not respond to expected future changes in government policy. Nor does the model incorporate effects from demand-side variations in the economy. Rather, it assumes that output is always at its potential (or sustainable) level.

The estimates that CBO developed using the textbook growth model incorporate the effects that changes in marginal tax rates on labor income specified in the President's proposals would have on the number of hours worked. (CBO calculated those tax-rate effects separately.) Changes in marginal tax rates on capital, however, have no direct effect on private-sector saving in the model.

The President's budgetary proposals would increase federal deficits over the 10-year budget window, but as described in Chapter 2, almost half of the increase in the deficit would result from two proposals that, in CBO's judgment, would have little effect on national saving (that is, private saving minus the government deficit). Nevertheless, under the assumptions of the textbook growth model, all of the President's proposals, taken together, would modestly reduce national saving relative to its level in CBO's baseline and would thus tend to crowd out investment.

In deriving those effects on saving and investment, the textbook growth model makes specific assumptions about how changes in deficits affect national saving and about how changes in national saving affect investment. In the model, the negative effects of deficits are partially offset by an increase in private saving. That increase could result from a number of possible responses by households, including a response to higher interest rates or anticipation of potential future tax increases associated with the larger budget deficits under the President's proposals. In addition, the effect of a decline in national saving on the capital stock could be offset by increased borrowing from abroad. However, those capital inflows would require payments of interest and profits to foreigners. As a result, the net effect on the total income of U.S. residents of the increase in the capital stock and the increase in borrowing from abroad would be small.

The textbook growth model accounts for those tendencies by including two assumptions, each based on past relationships. First, the model assumes that every dollar of deficit leads people to increase their private saving by 40 cents and thus reduces national saving by only

60 cents. Second, the model assumes that every decline of $1 in the level of national saving leads to a 40 cent increase in the amount of foreign capital invested in the United States. Together, those assumptions imply that a $1 increase in the budget deficit results in a 40 cent increase in private saving, a 24 cent increase in capital inflows (24 cents equals 60 cents times 0.4), and a 36 cent decline in domestic investment.

The Life-Cycle and Infinite-Horizon Growth Models

The other models that CBO used in its supply-side analysis—the life-cycle and infinite-horizon growth models—are similar to the textbook growth model in ignoring demand-side effects but differ from it in several other fundamental ways. The life-cycle and infinite-horizon models assume that people decide how much to work and save in order to make themselves as well off as possible over their lifetime. Their behavior is calibrated so that such macroeconomic variables as the total amount of labor supplied and the size of the capital stock (relative to output) match the levels of those variables in the U.S. economy. In the life-cycle and infinite-horizon models, people's spending changes by a relatively large amount in response to changes in the after-tax rate of return on their saving.

The life-cycle and infinite-horizon models are designed to take into account the fact that people make decisions on the basis not only of information about the present but also of their expectations about future developments. In any given year, the President's proposals can affect government spending and revenues over the 10-year projection period, and any deficits or surpluses that accumulate over that period can affect budgetary decisions in later years. People's expectations about those future developments—correct or not—can affect their behavior long before the developments materialize. Analysts disagree, however, on the extent to which expectations influence people's economic decisions, the time horizon over which people plan, or the future policy shifts they actually expect. CBO therefore analyzed the President's proposals using a wide range of assumptions about the extent of people's foresight and the expectations they might have about future policies. That approach yields a range of plausible estimates about how those proposals could affect economic growth.

The households in the life-cycle and infinite-horizon models are assumed to have "rational" or "model-consistent" expectations—that is, they are forward-looking, have information about future developments, and alter their behavior accordingly. They are assumed to have foresight about future developments of the economy as a whole and about future policies—the other end of the range of possibilities from the assumption of no foresight used in the textbook growth model. Most people's foresight actually falls somewhere between those two extremes, but in using those two somewhat dramatic assumptions, CBO has tried to encompass as broad a range of possible responses to the President's budgetary proposals as is feasible.

Although households in the life-cycle and infinite-horizon models are fully knowledgeable about broad future developments, they face unforeseeable fluctuations in income against which they cannot buy insurance. Faced with those income uncertainties, households hold some additional, "precautionary" savings to buffer against potential drops in income. Because that saving motive is not affected as strongly by changes in tax rates as some other motives are, simulated households' saving behavior may not respond as strongly to policy changes as it would in models that do not include the precautionary motive. That, in turn, may make the model's simulations somewhat more realistic than simulations from models whose households are assumed to have perfect information about their future income.

Because people's behavior as represented in the life-cycle and infinite-horizon models depends in part on future policies, the use of those models requires analysts to make assumptions about budgetary policies beyond 2017 (the end of the period covered by CBO's current 10-year baseline projections). Policies that increase deficits during the projection period would yield greater debt payments, requiring higher taxes or lower spending than would have been the case under CBO's baseline assumptions. Policies that reduce deficits would require the opposite.

Assumptions about how and when to finance the increased deficits can influence the estimated economic effects of the President's proposed policies over the 2008–2017 period. That impact stems from the fact that in the models, people anticipate the offsetting policies and plan accordingly. In its analysis, CBO used two different assumptions about how the budget would be stabilized after 2017: Either marginal tax rates would be adjusted,

or government spending would be adjusted. (Spending adjustments are assumed to be spread roughly equally across government purchases of goods and services—which the models assume do not substitute for private spending—and transfer payments.) In either case, those adjustments are assumed to be phased in over 10 years, from 2017 to 2026.

The life-cycle and infinite-horizon models differ in what they assume about how far ahead people look in making their plans. The life-cycle model is calibrated so that the probability of death at a given age matches current U.S. mortality rates, and people are assumed to take account of the impact of future economic or policy changes only for themselves and not for their children. In the infinite-horizon model, people behave as though they expect to live forever—behavior that is effectively equivalent to acting as though the well-being of their descendants is also important to them. Although the possibility that such an assumption reflects actual behavior cannot be ruled out, there is some evidence against it.

The difference in the models' time horizons has an important effect on the resulting estimates. Although people in both models anticipate future changes in policy under the President's budgetary proposals, older generations in the life-cycle model know that they may retire or die before policy changes occur. Consequently, anticipation of future policy changes tends to have a smaller effect on people's current behavior in the life-cycle model than in the infinite-horizon model.

Another characteristic that affects the models' estimates is the degree to which the domestic economy is open to the flow of foreign capital. That characteristic is important because it determines both how easily domestic investment can be financed by sources other than domestic saving and the degree to which budgetary policies can affect wage and interest rates. CBO used two different assumptions in the life-cycle model about how open the economy is to flows of capital to and from other countries. One assumption is that the economy is completely closed—no capital can flow into or out of the United States. The other assumption is that the economy is completely open and cannot affect world interest rates—in the models, capital flows freely into and out of the country to keep the domestic interest rate equal to a constant world rate. The U.S. economy effectively operates somewhere between those two extremes because even though it is relatively open to investment, it is so large that it can influence world interest rates. By using two different assumptions, CBO obtained a range of results that bounds the likely effect of the modeled policy changes.

APPENDIX

E

Contributors to the Revenue and Spending Projections

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

Revenue Projections

Mark Booth	Individual income taxes
Paul Burnham	Retirement income
Barbara Edwards	Social insurance taxes, Federal Reserve System earnings
Seth Giertz	Health and education taxation
Pamela Greene	Corporate income taxes, estate and gift taxes, excise taxes
Ed Harris	Individual income taxes
Andrew Langan	Excise taxes
Larry Ozanne	Capital gains realizations
Kevin Perese	Tax modeling, health insurance
Kristy Piccinini	State and local taxes, tax-exempt bonds
William Randolph	International and corporate income taxes
Emily Schlect	Customs duties, miscellaneous receipts
Kurt Seibert	Earned income tax credit, depreciation
David Weiner	Individual income taxes

Spending Projections

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Sunita D'Monte	International affairs (conduct of foreign affairs and information-exchange activities), veterans' housing
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Sheila Dacey	Old-Age and Survivors Insurance, Social Security trust funds
Kathleen FitzGerald	Food Stamps and nutrition programs
Justin Humphrey	Elementary and secondary education, Pell grants, student loans
Deborah Kalcevic	Student loans, higher education
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Daniel Hoople	Science and space exploration, Bureau of Indian Affairs, justice, community and regional development
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Julie Middleton	Water resources, Federal Emergency Management Agency, other natural resources
Matthew Pickford	General government, highways, Amtrak, mass transit
Deborah Reis	Recreation, water transportation, legislative branch, conservation and land management
Susan Willie	Commerce, Small Business Administration, Universal Service Fund

Other

Janet Airis	Unit Chief, Scorekeeping; legislative branch appropriation bill
Jeffrey Holland	Unit Chief, Projections
Edward Blau	Authorization bills
Barry Blom	Federal pay, monthly Treasury data, report coordinator
Joanna Capps	Appropriation bills (Interior and the environment, Labor–Health and Human Services)
Kenneth Farris	Computer support
Mary Froehlich	Computer support
Ann Futrell	Other interest, report coordinator
Virginia Myers	Appropriation bills (Commerce–Justice, financial services, general government)
Jennifer Reynolds	Appropriation bills (Agriculture, foreign relations)
Mark Sanford	Appropriation bills (Defense, Homeland Security)
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Luis Serna	National income and product accounts, report coordinator
Phan Siris	Computer support
Esther Steinbock	Appropriation bills (Transportation–Housing and Urban Development, military construction and veterans' affairs, energy and water)
Patrice Watson	Database system administrator