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Baseline Budget Projections Under Alternative Assumptions

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Summary

The Congressional Budget Office (CBO) estimates a baseline budget based on simple rules prescribed by law. Statute requires CBO to project a baseline of revenues and outlays under current law over the next 10 years. Arguably, a "better guess" of the probable path of the federal budget under current policy might be achieved by modifying three assumptions in the CBO baseline. First, that discretionary spending will remain constant as a share of GDP rather than growing at the rate of inflation. Second, that recent tax reductions will be extended rather than allowed to expire. Third, that the alternative minimum tax (AMT) relief will be extended rather than allowing the AMT to "take back" the reductions in regular income tax. Modifying these baseline assumptions and accounting for the additional debt service required to finance these policies yield an estimate that the federal budget deficit is likely to be $5 trillion more over the FY2007 through FY2016 period than that shown by the baseline projection. The effects of the alternative assumptions grow over time: by 2016, the alternative baseline deficit is $861 billion, compared to an official baseline surplus of $67 billion.

This report will be updated periodically.

The Congressional Budget Office (CBO) produces baseline projections of the budget semi-annually so that policymakers have a common starting point from which to debate policy changes.[1] The purpose of the baseline is to project revenues and outlays under current law over the next 10 years. It does not include legislative changes even if Congress is actively considering them. The CBO defines the baseline projection as:

[1] For the latest baseline projection, see CBO, *The Budget and Economic Outlook: Fiscal Years 2007 to 2016*, Jan. 2006.

> a benchmark for measuring the budgetary effects of proposed changes in federal revenues or spending.... By statute, CBO's baseline projections must estimate the future paths of federal spending and revenues under current law and policies. The baseline is therefore not intended to be a prediction of future budgetary outcomes; instead, it is meant to serve as a neutral benchmark that lawmakers can use to measure the effects of proposed changes to spending and taxes. So for that reason and others, actual budgetary outcomes are almost certain to differ from CBO's baseline projections.[2]

The CBO baseline tends to be misunderstood and, hence, misused. Headlines such as "CBO predicts that the national debt will be paid off by 2008" or "Changes in the baseline projections prove policy change was unaffordable" are examples that reflect a misunderstanding of the baseline. As implied in the CBO quote, the baseline is not a "best guess" of future policy outcomes.

CBO baseline projections rarely provide a good indication of the realized path of federal spending and revenues. Critics have argued that using the CBO baseline as a predictor of future budgetary outcomes is inappropriate because several of the underlying assumptions or rules followed by CBO in making the budget baseline are not as realistic as they could be. Applying alternative assumptions to the baseline, they say, could significantly change the projected path of the federal budget. The CBO baseline treatment of discretionary spending, expiring tax provisions, and the alternative minimum tax (AMT) are three assumptions that have been cited as reasons not to use the baseline to forecast future budgetary outcomes.[3]

Discretionary Spending

Discretionary spending presents a special problem for budget estimates. Unlike entitlements, there are few legal determinants of its levels; instead, it is determined annually at the "discretion" of legislators. In its baseline projections, CBO is required to assume that overall discretionary spending will stay constant in inflation-adjusted terms. This has two implications. First, although discretionary spending is assumed to keep up with inflation, there is no adjustment for expected population growth. Under the baseline, therefore, future discretionary spending can buy the same amount of roads or military equipment or government services, but there will be fewer of them per person.

Second, since the economy, as measured by gross domestic product (GDP), is assumed to grow in real terms over the next 10 years, but real discretionary spending is assumed to remain constant, discretionary spending would fall as a percentage of GDP. This implies that as society becomes wealthier, it will not want to spend any of its additional wealth on government-provided discretionary goods and services. Although there are undoubtedly some government-provided goods and services on which people

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[2] CBO, *The Budget and Economic Outlook: Fiscal Years 2006 to 2015*, Jan. 2005. [http://www.cbo.gov/showdoc.cfm?index=6060&sequence=0]. Instructions for creating the baseline estimates are contained in the Budget Enforcement Act (BEA), as amended.

[3] There are other issues surrounding the accuracy of baselines that are not included in this report, including the accuracy of economic projections and the treatment of unfunded liabilities. For a discussion of these issues, see CRS Report RL31414, *Baseline Budget Projections: A Discussion of Issues*, by Marc Labonte.

may not wish to spend their additional wealth, it is not obvious why this would be true of total discretionary spending, as implied by the baseline.

Does recent history suggest what growth rate is most realistic for discretionary spending? At least for non-defense discretionary spending, assuming spending would stay constant as a percentage of GDP is the only assumption that would not consistently underpredict spending levels historically. The baseline assumption that discretionary spending will stay constant in inflation-adjusted terms would reduce total discretionary spending as a share of GDP to its lowest level in the modern budget era.

Since 1962, non-defense discretionary spending has fluctuated between 3.2% and 5.6% of GDP, and has been increasing faster than GDP since 1999. Defense spending fell as a share of GDP after the cold war, but has been rising since 2001. If, as is likely based on historical standards, discretionary spending increases at the growth rate of GDP (in other words, stays constant as a percentage of GDP), then total federal outlays will be significantly higher than those levels contained in the baseline. CBO estimates that under this policy alternative, discretionary outlays will be $1.4 trillion larger than the baseline outlays over the FY2007 through FY2016 period, and the divergence grows over time. Absent other policy changes, higher discretionary spending would be deficit financed, which would increase future interest payments on the national debt by $234 billion over the next 10 years.

Extending Expiring Tax Provisions

On the revenue side there are also assumptions made in the baseline projection that arguably do not reflect what most observers consider to be current policy. For example, some federal tax provisions, especially many tax credits, have expiration dates. CBO is required to assume in its baseline projection that all tax measures (unless earmarked to a trust fund) will expire as scheduled, since that represents current policy according to the law. But most of these expiring provisions have proven very durable, having been routinely extended. Some examples of expiring tax provisions include credits or deductions for clean-fuel vehicles, qualified zone academy bonds, welfare-to-work, medical savings accounts, research and experimentation, and economic development empowerment zones.

In addition, the tax reductions contained in the Economic Growth and Tax Relief Reconciliation Act (EGTRRA, P.L. 107-16) and the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA, P.L. 108-27) are scheduled to expire after 2010.[4] (The reduction in taxes on capital gains and dividend income from JGTRRA is scheduled to expire after 2008.) However, it was not the intention of the tax cuts' authors that they be temporary, and there has been strong congressional and Administration support for making these tax cuts permanent or at least extending them. The CBO baseline projections do not include the revenue effects of extending or making these tax cuts permanent.

These omissions greatly inflate the revenue take of the government in the out years. CBO estimates that extending the EGTRRA and JGTRRA tax cuts — excluding an

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[4] See CRS Report RS21992, *Extending the 2001, 2003, and 2004 Tax Cuts*, by Gregg Esenwein.

extension of expiring alternative minimum tax reform — would reduce federal revenues by $1.6 trillion over the FY2007 through FY2016 period, mostly after 2010. Extending the expiring tax provisions, such as the deduction for medical savings accounts and welfare-to-work tax credit, would reduce federal revenues by another $406 billion over the same period. The total reduction of $2 trillion would also engender increased debt service expenditures of $324 billion. Hence, extending the expiring tax cuts and tax provisions would add $2.3 trillion to the deficit over the next 10 years.

The Alternative Minimum Tax

And this figure does not take into account the revenue loss associated with extending relief from the alternative minimum tax (AMT) for individuals that expired at the end of 2005.[5] The AMT was originally enacted in 1969 to make sure that certain high-income taxpayers were not able to escape their "fair share" of the federal income tax through the use of special deductions, exemptions, and credits.

However, because of the recent reductions in the regular income tax and the fact that the AMT is not indexed for inflation, there will be a significant increase in the number of middle to upper-middle income taxpayers affected by the AMT in the near future. In 1999, about 1 million taxpayers were affected by the AMT, but estimates indicate that by 2013, if the major tax reductions contained in the EGTRRA are made permanent, then 41 million taxpayers will be subject to the AMT.

To counteract the effects of the AMT, Congress increased the AMT basic exemption and allowed certain personal tax credits to offset AMT tax liability. However, to minimize the revenue loss, these changes have been enacted for one or two years at a time and expired at the end of 2005. Allowing the AMT exemption increase to expire at the end of 2005 means that, in the out years, the AMT will "take back" much of the regular income tax relief provided by extending the other expiring provisions.[6]

Because the revenue estimates of extending the other expiring tax provisions are based on the AMT exemption increase expiring after 2005, the out year revenue estimates of these extensions include the AMT take back effect. As a result, they significantly understate the actual cost of providing the full amount of projected reductions in the regular income tax. If the increase in the AMT exemption is not extended throughout the forecast period, then the number of taxpayers subject to the AMT will increase dramatically.

If Congress decides to provide taxpayers with the full amount of regular income tax relief from the expiring tax provisions, the AMT would need to be "held harmless." This means that the AMT would not be allowed to "take back" the tax reductions provided by the extensions of the other expiring middle class tax relief provisions. To hold the AMT harmless would require, at the least, that the AMT exemption increase be extended over the same time period as the other middle-class tax reductions (i.e., through the 10-year baseline projection period, FY2007 through FY2016).

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[5] See CRS Report RL30149, *The Alternative Minimum Tax for Individuals*, by Gregg Esenwein.

[6] See CRS Report RS21817, *The Alternative Minimum Tax (AMT): Income-Entry Points and "Take Back" Effects*, by Gregg Esenwein.

CBO estimates that extending and indexing the higher AMT exemption, which expired at the end of 2005, so that it does not take back the reductions in the regular income tax, would reduce revenues by $865 billion over the FY2007 through FY2016 period (assuming extension of the other tax reductions). In addition, debt servicing costs would add $182 billion in additional interest costs to the deficit.

Effects of Alternative Assumptions on the Baseline

CBO estimates a baseline based on simple rules prescribed by law. Arguably, a "better guess" of the probable path of the federal budget under current policy might be achieved by modifying three assumptions in the CBO baseline. First, that discretionary spending will remain constant as a share of GDP rather than growing at the rate of inflation. Second, that recent tax reductions will be extended rather than allowed to expire. Third, that the AMT relief will be extended rather than allowing the AMT to "take back" the reductions in regular income tax.

The table below shows the effects of these probable policy initiatives on the federal budget deficit over the 10-year budget projection period. Modifying these baseline assumptions and accounting for the additional debt service required to finance these policies means that the federal budget deficit is likely to be $5 trillion higher over the next 10 years than that shown by the baseline projection. The effects of the alternative assumptions grow over time: by 2016, the alternative baseline deficit would be $895 billion, compared to an official baseline surplus of $67 billion. Rather than return to surplus as in the official baseline, the deficit would get bigger each year if alternative assumptions are made.

CBO's baseline projection is a benchmark and it does not — and is not intended to — predict the probable path of the federal budget. Therefore, critics say, a projection that includes alternative assumptions that are likely to occur can provide a better starting point for policymakers weighing the budgetary effect of different options.

Effects of Alternative Policy Options on Path of the Federal Budget

(billions of dollars)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Total 2007-2016
CBO baseline surplus/deficit	-270	-259	-241	-222	-114	38	40	57	73	67	-832
Discretionary Appropriations constant as % of GDP[a]	-15	-38	-64	-92	-121	-149	-178	-207	-238	-271	-1,372
Extend EGTRRA/ JGTRRA	-4	-9	-20	-18	-154	-257	-270	-282	-290	-301	-1,606
Other tax extenders	-15	-22	-28	-34	-41	-45	-49	-53	-57	-61	-406
Extend AMT[b]	-46	-48	-58	-70	-88	-94	-101	-108	-118	-130	-865
Debt Service	-2	-8	-14	-24	-42	-67	-95	-125	-161	-199	-740
Total Modifications[a]	-82	-125	-184	-238	-446	-612	-693	-775	-864	-962	-4,989
Modified baseline surplus/deficit	-352	-384	-425	-460	-560	-574	-653	-718	-791	-895	-5,821

Source: CRS calculations based on CBO data

Notes: See text for details.
a. Supplemental spending is excluded from the constant share of GDP assumption.
b. For the purposes of this table, the cost of extending the AMT tax relief includes the interactive effects when the AMT relief and the other tax cuts are extended jointly.