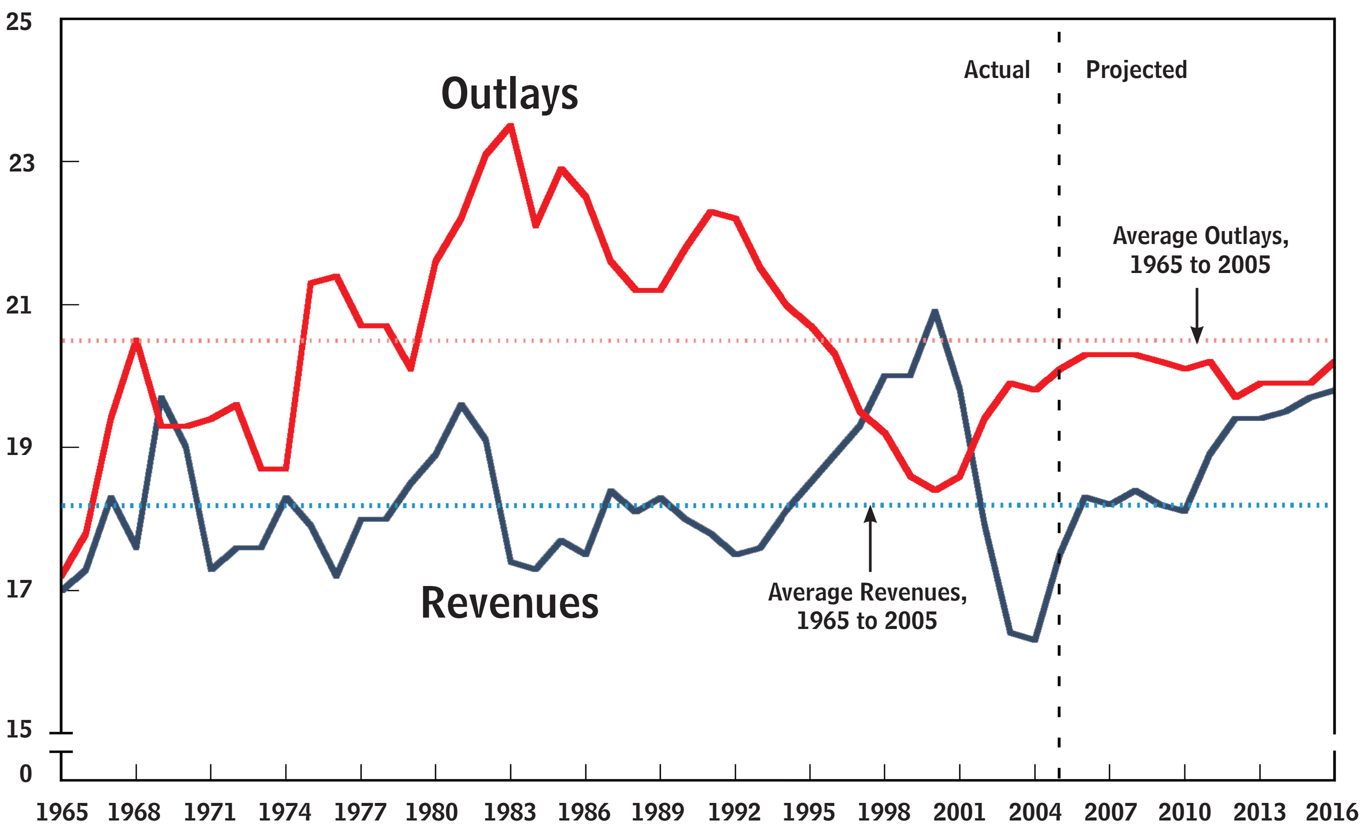
CONGRESS OF THE UNITED STATES
CONGRESSIONAL BUDGET OFFICE

The Budget and Economic Outlook: An Update

Total Outlays and Revenues as a Percentage of Gross Domestic Product



AUGUST 2006

Report Documentation Page

Form Approved
OMB No. 0704-0188

1. REPORT DATE **AUG 2006**	2. REPORT TYPE	3. DATES COVERED **00-08-2006 to 00-08-2006**

4. TITLE AND SUBTITLE **A CBO Study. The Budget and Economic Outlook: An Update**	5a. CONTRACT NUMBER 5b. GRANT NUMBER 5c. PROGRAM ELEMENT NUMBER
6. AUTHOR(S)	5d. PROJECT NUMBER 5e. TASK NUMBER 5f. WORK UNIT NUMBER
7. PERFORMING ORGANIZATION NAME(S) AND ADDRESS(ES) **Congressional Budget Office,Ford House Office Building 4th Floor,Second and D Streets, SW,Washington,DC,20515-6925**	8. PERFORMING ORGANIZATION REPORT NUMBER
9. SPONSORING/MONITORING AGENCY NAME(S) AND ADDRESS(ES)	10. SPONSOR/MONITOR'S ACRONYM(S) 11. SPONSOR/MONITOR'S REPORT NUMBER(S)

12. DISTRIBUTION/AVAILABILITY STATEMENT
Approved for public release; distribution unlimited

13. SUPPLEMENTARY NOTES
The original document contains color images.

14. ABSTRACT

15. SUBJECT TERMS

16. SECURITY CLASSIFICATION OF:			17. LIMITATION OF ABSTRACT	18. NUMBER OF PAGES	19a. NAME OF RESPONSIBLE PERSON
a. REPORT **unclassified**	b. ABSTRACT **unclassified**	c. THIS PAGE **unclassified**		**88**	

Standard Form 298 (Rev. 8-98)
Prescribed by ANSI Std Z39-18

Pub. No. 2822

A CBO STUDY

The Budget and Economic Outlook: An Update

August 2006

The Congress of the United States ■ Congressional Budget Office

Notes

Unless otherwise indicated, all years referred to in describing the economic outlook are calendar years; otherwise, the years are federal fiscal years (which run from October 1 to September 30).

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

In figures in Chapter 2, shaded vertical bars indicate periods of recession and a dashed vertical line separates actual and projected data. (A recession extends from the peak of a business cycle to its trough.)

Data from the Commerce Department's Bureau of Economic Analysis (BEA) on gross domestic product and the national income and product accounts are generally as of June 2006. As explained in Box 2-2, BEA's revised estimates, released on July 28, 2006, were published too late to be incorporated into the Congressional Budget Office's (CBO's) current economic forecast. Consequently, in Chapter 2, tables and figures that present the forecast incorporate the June 2006 data, but other figures and discussions of recent events are consistent with the revised data. Because CBO anticipated elements of the revision, the changes are unlikely to have a major impact on the projections presented in this volume.

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

Preface

This volume is one of a series of reports on the state of the budget and the economy that the Congressional Budget Office (CBO) issues each year. It satisfies the requirement of section 202(e) of the Congressional Budget Act of 1974 for CBO to submit to the Committees on the Budget periodic reports about fiscal policy and to provide baseline projections of the federal budget. In accordance with CBO's mandate to provide impartial analysis, the report makes no recommendations.

The baseline spending projections were prepared by the staff of CBO's Budget Analysis Division under the supervision of Robert Sunshine, Peter Fontaine, Janet Airis, Tom Bradley, Kim Cawley, Paul Cullinan, Jeffrey Holland, and Sarah Jennings. The revenue estimates were prepared by the staff of the Tax Analysis Division under the supervision of Thomas Woodward, Mark Booth, and David Weiner, with assistance from the Joint Committee on Taxation. The analysts who contributed to those spending and revenue projections are listed in Appendix D.

The economic outlook presented in Chapter 2 was prepared by the Macroeconomic Analysis Division (MAD) under the direction of Robert Dennis, Kim Kowalewski, and John F. Peterson. Robert Arnold, John F. Peterson, and Christopher Williams carried out the economic forecast and projections. David Brauer, Ufuk Demiroglu, Naomi Griffin, Douglas Hamilton, Juann Hung, Wendy Kiska, Kim Kowalewski, Mark Lasky, Angelo Mascaro, Frank Russek, Robert Shackleton, and Steven Weinberg—all of MAD—and Richard Farmer of the Microeconomic Studies Division contributed to the analysis. Andrew Gisselquist and Adam Weber provided research assistance.

CBO's Panel of Economic Advisers commented on an early version of the economic forecast underlying this report. Members of the panel are Martin Baily, Richard Berner, Dan Crippen, J. Bradford DeLong, Martin Feldstein, Robert J. Gordon, Robert E. Hall, Douglas Holtz-Eakin, Ellen Hughes-Cromwick, Lawrence Katz, Allan H. Meltzer, Laurence H. Meyer, William D. Nordhaus, June E. O'Neill, Rudolph G. Penner, James Poterba, Robert Reischauer, Alice Rivlin, Nouriel Roubini, and Diane C. Swonk. Douglas Duncan and Charles Steindel attended the panel's meeting as guests. Although CBO's outside advisers provided considerable assistance, they are not responsible for the contents of this report.

Jeffrey Holland wrote the summary. Barry Blom, Mark Booth, and Christina Hawley Anthony wrote Chapter 1, with assistance from David Newman and Eric Schatten. Frank Russek was the lead author for Chapter 2. Ann Futrell, along with Mark Booth and Pamela Greene, wrote Appendix A; Eric Schatten, with Pamela Greene, wrote Appendix B; and Andrew Gisselquist and Adam Weber compiled Appendix C.

Christine Bogusz, Christian Howlett, Loretta Lettner, Leah Mazade, and John Skeen edited the report. Marion Curry and Denise Jordan-Williams assisted in its preparation. Maureen Costantino designed the cover and prepared the report for publication. Lenny Skutnik printed the initial copies, and Simone Thomas prepared the electronic version for CBO's Web site (www.cbo.gov).

Donald B. Marron
Acting Director

August 2006

Contents

Tables

Figures

Boxes

Summary

The deficit for 2006 will be notably lower than the Congressional Budget Office (CBO) estimated in March, when it issued its previous projections of the federal budget. The broad fiscal outlook for the coming decade, however, has not changed materially since then. The underlying projections of outlays and revenues for future years are similar to those presented five months ago, with the exception that the current projections of spending from this year's appropriations are now higher—reflecting the extrapolation of recent supplemental funding primarily for the war in Iraq and hurricane relief.

The Budget Outlook

CBO now expects the 2006 deficit to total $260 billion—a $58 billion decline from the deficit recorded for 2005 (see Summary Table 1). Relative to the size of the economy, the deficit this year is expected to equal 2.0 percent of gross domestic product (GDP), down from 2.6 percent in 2005.

CBO's current estimate of the deficit for 2006 is $112 billion lower than the amount that it estimated when it analyzed the President's budgetary proposals in March.[1] Higher-than-anticipated revenues, mostly from individual and corporate income taxes, account for the bulk of that improvement. CBO now expects 2006 revenues to exceed its March estimate (including the President's proposals) by $99 billion, or about 4 percent. At the same time, outlays this year are expected to be $13 billion—or less than 0.5 percent—below CBO's March estimate (including the impact of proposed supplemental appropriations), primarily because of lower-than-anticipated spending on the government's major health care programs, Medicare and Medicaid.

CBO has also updated its baseline budget projections for the coming decade. By statute, those projections must assume that current laws and policies remain in place.[2] 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 revenues.

The general fiscal outlook for the coming decade remains about the same as what CBO projected in March. If the laws and policies currently in place did not change, the deficit would remain at around this year's level over the next few years relative to the size of the economy, CBO projects. After 2010, it would decline sharply, reflecting the rapid increase in tax revenues that would occur after provisions initially 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) expired. By 2016, the deficit would decline to 0.4 percent of GDP, according to CBO's baseline projections.

Total outlays are projected to remain relatively steady at roughly 20 percent of GDP over the next 10 years (see Summary Figure 1). Mandatory outlays are estimated to grow nearly 1.5 percentage points faster each year than nominal GDP does, but discretionary spending is assumed to increase at the rate of inflation and thus at about half the growth rate of GDP. (CBO projects that

1. In March, CBO projected that the 2006 deficit would total $371 billion if the President's proposals for supplemental funding and other policy changes were enacted and $336 billion assuming that those changes to policy did not occur. (Supplemental appropriations similar to those proposed by the President were later enacted.) See Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2007* (March 2006).

2. Exceptions exist for mandatory programs established on or before the date the Balanced Budget Act of 1997 was enacted and for expiring excise taxes that are dedicated to trust funds.

Summary Table 1.

CBO's Baseline Budget Outlook

	Actual 2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Total, 2007-2011	Total, 2007-2016
							In Billions of Dollars							
Total Revenues	2,154	2,403	2,515	2,672	2,775	2,890	3,156	3,398	3,555	3,733	3,922	4,118	14,007	32,733
Total Outlays	2,472	2,663	2,801	2,945	3,079	3,217	3,382	3,451	3,631	3,797	3,979	4,211	15,425	34,494
Total Deficit (-) or Surplus	**-318**	**-260**	**-286**	**-273**	**-304**	**-328**	**-227**	**-54**	**-76**	**-64**	**-56**	**-93**	**-1,418**	**-1,761**
On-budget	-493	-437	-471	-478	-526	-567	-481	-318	-346	-340	-333	-369	-2,522	-4,228
Off-budget[a]	175	177	185	204	221	239	254	264	270	275	277	276	1,104	2,466
Debt Held by the Public at the End of the Year	4,592	4,851	5,149	5,434	5,750	6,088	6,324	6,387	6,469	6,539	6,600	6,696	n.a.	n.a.
							As a Percentage of Gross Domestic Product							
Total Revenues	17.5	18.3	18.2	18.4	18.2	18.1	18.9	19.4	19.4	19.5	19.7	19.8	18.4	19.0
Total Outlays	20.1	20.3	20.3	20.3	20.2	20.1	20.2	19.7	19.9	19.9	19.9	20.2	20.2	20.1
Total Deficit	**-2.6**	**-2.0**	**-2.1**	**-1.9**	**-2.0**	**-2.0**	**-1.4**	**-0.3**	**-0.4**	**-0.3**	**-0.3**	**-0.4**	**-1.9**	**-1.0**
Debt Held by the Public at the End of the Year	37.4	37.0	37.3	37.5	37.7	38.1	37.8	36.5	35.4	34.2	33.1	32.2	n.a.	n.a.
Memorandum:														
Gross Domestic Product (Billions of dollars)	12,294	13,108	13,823	14,509	15,236	15,989	16,727	17,488	18,286	19,109	19,951	20,827	76,284	171,945

Source: Congressional Budget Office.

Note: 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.

annual growth of nominal GDP will average 4.7 percent over the 2007–2016 period.)

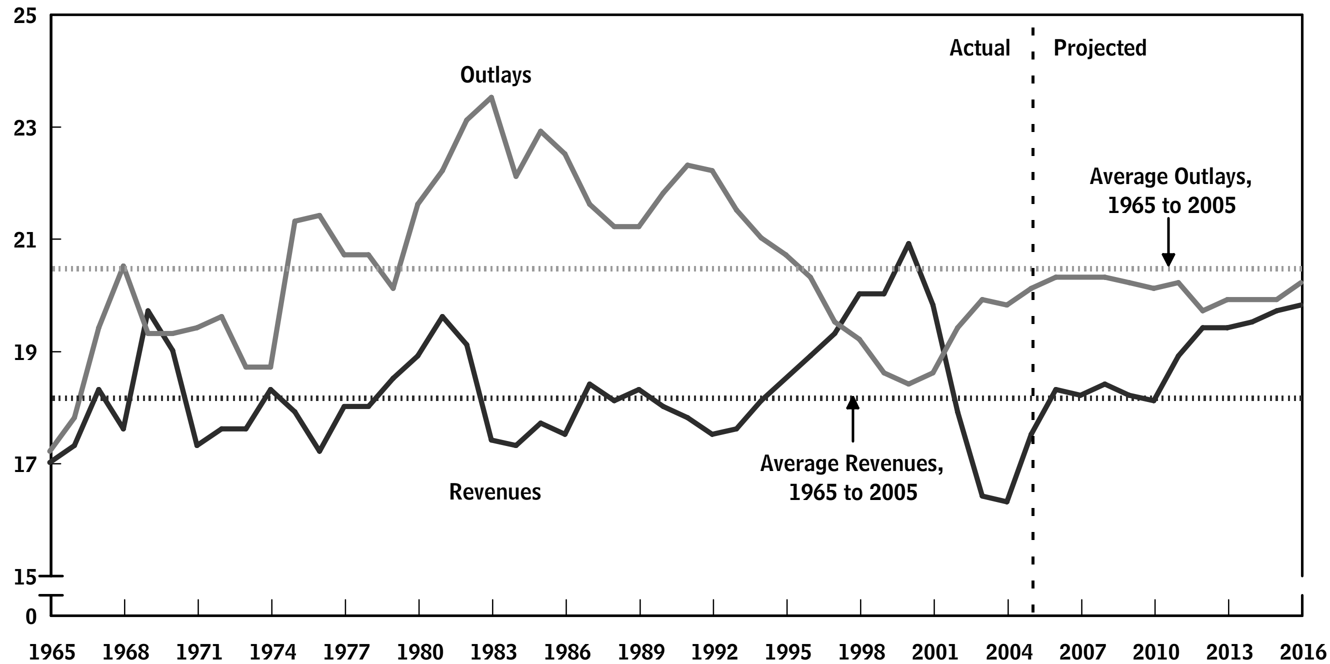
The path of federal revenues over the next 10 years is influenced by the scheduled expiration of numerous tax provisions originally enacted between 2001 and 2003. Through 2010, total revenues are projected to remain close to their 2006 level relative to the size of the economy: 18.3 percent of GDP. If the remaining tax provisions from EGTRRA and JGTRRA expire in December 2010 as scheduled, revenues will rise sharply, reaching 19.8 percent of GDP in 2016.

Individual income taxes account for the projected rise in revenues as a percentage of GDP over the next 10 years. Revenues from corporate income taxes are projected to peak this year at 2.6 percent of GDP (a level last reached in 1979) and then gradually diminish. Other sources of revenues, the largest of which is social insurance taxes, are estimated to remain relatively stable as a share of GDP.

The cumulative deficit for the 2007–2016 period in CBO's baseline has risen by $1.0 trillion since the agency's last set of baseline estimates (published in conjunction with its analysis of the President's budget). However, the changes do not indicate a significant shift in the budgetary outlook; rather, they result mostly from extrapolating into future years nearly $95 billion in supplemental appropriations enacted since March, as required under the rules governing the baseline. Changes in the economic outlook and other (technical) estimating revisions have decreased projected deficits by about $80 billion a year for 2007 and 2008, about $50 billion for 2009, and an average of $28 billion a year for 2010 through 2016.

Summary Figure 1.

Total Outlays and Revenues as a Percentage of Gross Domestic Product, 1965 to 2016



Source: Congressional Budget Office.

Spending on Social Security, Medicare, and Medicaid is projected to grow rapidly during the 10-year period covered by CBO's baseline (see Summary Figure 2); the resulting budgetary pressures will intensify in later years as the baby-boom generation ages and health care costs continue to rise. The percentage of the population age 65 or older will continue to increase (from 14 percent in 2016 to more than 19 percent in 2030). In addition, health care costs are likely to keep growing faster than GDP, as they have over the past four decades. As a result, spending for Social Security, Medicare, and Medicaid will exert pressures on the budget that economic growth alone is unlikely to alleviate. Consequently, substantial reductions in the projected growth of spending and perhaps a sizable increase in taxes as a share of the economy will probably be necessary to maintain fiscal stability in the coming decades.[3]

3. For a detailed discussion of the long-term pressures facing the federal budget, see Congressional Budget Office, *The Long-Term Budget Outlook* (December 2005) and *Updated Long-Term Projections for Social Security* (June 2006).

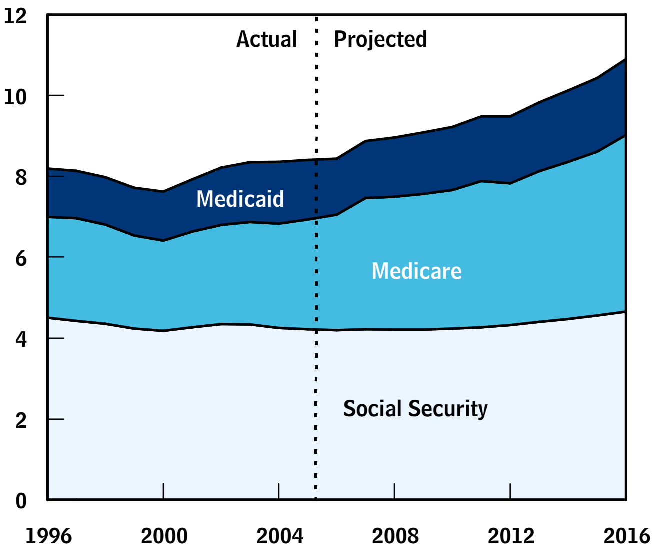
The Economic Outlook

Although the U.S. economy has been growing at a rapid rate since early 2003, its growth is likely to slow to a moderate, sustainable pace over the next year and a half. CBO forecasts that economic growth will diminish to an annual rate of 3 percent in real (inflation-adjusted) terms in the second half of this calendar year and then remain steady at that rate through 2007. Inflation in so-called core consumer prices (which exclude the more volatile prices of food and energy) will also moderate, CBO expects, dropping to 2 percent by the end of next year. CBO anticipates that the unemployment rate will average about 4¾ percent through 2007 and that the growth of productivity will be roughly 2 percent. Interest rates on Treasury securities will rise in the second half of this year, CBO forecasts, and then drop slightly during 2007.

Several major forces influence the economic outlook. Working to keep inflation under control, the Federal Reserve moved to a slightly restrictive stance in 2006, after having gradually removed the stimulus to short-term growth that it had maintained for several years. As a result, interest rates—especially those for short-term

Summary Figure 2.

Spending on Social Security, Medicare, and Medicaid as a Percentage of Gross Domestic Product, 1996 to 2016



Source: Congressional Budget Office.

securities—have increased. At the same time, energy prices have risen, largely as a result of developments in world markets for petroleum and petroleum products, and the housing market has begun a long-anticipated slowdown. Those factors are expected to restrain the growth of consumers' purchases of goods and services, as higher interest rates reduce borrowing by consumers, higher energy prices reduce households' real income, and the decline in the growth of house prices slows the rise in households' wealth.

The outlook for investment by businesses in new structures, equipment, and software (business fixed investment) is bright. Demand for goods and services from domestic and foreign customers is still solid, so after investing at low rates in 2002 and 2003, businesses are now seeking to add capacity. In addition, firms' profits are high, corporate debt is relatively low, and the cost of financing for investment is still favorable.

Over the next 10 years, economic growth is projected to slow, as the members of the baby-boom generation begin to leave the labor force. In CBO's estimation, average annual growth of real GDP will decline from 3 percent in 2008 through 2011 to 2.6 percent in 2012 through 2016 (see Summary Table 2). Both core and overall inflation, as measured by the growth of the price index for personal consumption expenditures, will average 2 percent over the 2008–2016 period, and the unemployment rate will average 5 percent. The average annual interest rate on three-month Treasury bills over the period will be about 4.5 percent, CBO projects; the rate on 10-year notes will average 5.2 percent.

Summary Table 2.

CBO's Economic Projections for Calendar Years 2006 to 2016

(Percentage change)

	Actual	Forecast		Projected Annual Average	
	2005[a]	2006	2007	2008 to 2011	2012 to 2016
Nominal GDP (Billions of dollars)	12,487	13,308	13,993	16,914 [b]	21,052 [c]
Nominal GDP	6.4	6.6	5.1	4.9	4.5
Real GDP	3.5	3.5	3.0	3.0	2.6
GDP Price Index	2.8	3.0	2.0	1.8	1.8
PCE Price Index[d]	2.8	3.0	2.4	2.0	2.0
Core PCE Price Index[e]	2.0	2.2	2.3	2.0	2.0
Consumer Price Index[f]	3.4	3.5	2.5	2.2	2.2
Core Consumer Price Index[g]	2.2	2.6	2.5	2.2	2.2
Unemployment Rate (Percent)	5.1	4.7	4.8	5.0	5.0
Three-Month Treasury Bill Rate (Percent)	3.1	4.8	5.0	4.5	4.4
Ten-Year Treasury Note Rate (Percent)	4.3	5.1	5.4	5.2	5.2

Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis (BEA); Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

Notes: GDP = gross domestic product.

Percentage changes are year over year.

a. Values are as of early July 2006, prior to revisions that BEA has since made to the national income and product accounts.

b. Level in 2011.

c. Level in 2016.

d. The personal consumption expenditure chained price index.

e. The personal consumption expenditure chained price index excluding prices for food and energy.

f. The consumer price index for all urban consumers.

g. The consumer price index excluding prices for food and energy.

CHAPTER

1

The Budget Outlook

The budget outlook for fiscal year 2006 has improved significantly in the five months since the Congressional Budget Office (CBO) released its previous set of baseline projections. CBO now expects this year's deficit to total $260 billion, or about $58 billion less than last year's budget shortfall (see Table 1-1). Relative to the size of the economy, the 2006 deficit is expected to equal 2.0 percent of gross domestic product (GDP), down from 2.6 percent in 2005. This year's shortfall is smaller than the average budgetary outcome recorded since 1965: a deficit of 2.3 percent of GDP.

CBO's current estimate of the 2006 deficit is $112 billion lower than the estimate it published in March, when it analyzed the President's budgetary proposals.[1] Higher-than-anticipated revenues—mostly from individual and corporate income taxes—account for the bulk of that change. CBO now expects 2006 revenues to exceed its March estimate (including the President's proposals) by $99 billion, or about 4 percent. At the same time, 2006 outlays are expected to fall short of CBO's March estimate (including proposed supplemental appropriations) by $13 billion, or less than 0.5 percent. The main reason is lower-than-anticipated spending on the government's major health care programs, Medicare and Medicaid.

Unlike the prospects for this year, the general budget outlook for the coming decade has not changed materially in the past five months. If current laws and policies continued unaltered—the assumption that, by law, guides CBO's baseline projections—the deficit would rise to 2.1 percent of GDP next year and then hover around 2 percent of GDP through 2010. At that point, it would decline sharply because of tax increases that are scheduled to occur when 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) expire.[2] Between 2012 and 2016, the deficit would range from 0.3 percent to 0.4 percent of GDP (see Figure 1-1).

The current baseline projections include both higher outlays and higher revenues over the 2007–2016 period than CBO estimated in March. Because the baseline is required to show the path of spending and revenues under current laws and policies, it assumes the continuation (and inflation) of all appropriations enacted for the current year, including supplemental appropriations. Thus, CBO's updated spending projections include the extrapolation and inflation of $95 billion in supplemental appropriations that were enacted in June, mainly for operations in Iraq and Afghanistan and hurricane relief.[3] Revenues grow more slowly in the current baseline than previously projected, but they start from a higher level in 2006. (The changes to CBO's baseline projections since March are described in detail in Appendix A.)

Federal debt held by the public is expected to total about $4.85 trillion at the end of this fiscal year, or 37.0 percent of GDP, a slight decline from last year's figure of 37.4 percent. Under the assumptions of CBO's baseline, however, federal debt would rise in each of the following four

1. In March, CBO projected that the 2006 deficit would total $371 billion if the President's proposals for supplemental funding and other policy changes were enacted and $336 billion if no policy changes occurred. (Supplemental appropriations similar to those proposed by the President were later enacted.) CBO's projections were published in Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2007* (March 2006).

2. The Tax Increase Prevention and Reconciliation Act of 2005 extended lower tax rates for long-term capital gains and qualified dividends through 2010. The lower rates were originally enacted through 2008 in JGTRRA.

3. In fiscal year 2006, lawmakers have enacted a total of $153 billion in funding for activities in Iraq and Afghanistan and supplemental appropriations for other purposes. About $59 billion of those funds were provided in December 2005 and thus were included in CBO's March baseline.

Table 1-1.

Projected Deficits and Surpluses in CBO's Baseline

(Billions of dollars)

	Actual 2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Total, 2007-2011	Total, 2007-2016
On-Budget Deficit	-493	-437	-471	-478	-526	-567	-481	-318	-346	-340	-333	-369	-2,522	-4,228
Off-Budget Surplus[a]	175	177	185	204	221	239	254	264	270	275	277	276	1,104	2,466
Total Deficit	**-318**	**-260**	**-286**	**-273**	**-304**	**-328**	**-227**	**-54**	**-76**	**-64**	**-56**	**-93**	**-1,418**	**-1,761**
Memorandum:														
Social Security Surplus	173	177	185	202	220	235	250	259	265	270	271	270	1,093	2,429
Postal Service Outlays	-2	*	*	-2	-1	-4	-4	-5	-5	-5	-5	-6	-11	-37
Total Deficit as a Percentage of GDP	-2.6	-2.0	-2.1	-1.9	-2.0	-2.0	-1.4	-0.3	-0.4	-0.3	-0.3	-0.4	-1.9	-1.0
Debt Held by the Public as a Percentage of GDP	37.4	37.0	37.3	37.5	37.7	38.1	37.8	36.5	35.4	34.2	33.1	32.2	n.a.	n.a.

Source: Congressional Budget Office.

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

years, reaching 38.1 percent of GDP in 2010. With the tax increases scheduled to occur at the end of that calendar year, debt held by the public would decline thereafter, falling to 32.2 percent of GDP in 2016. (By comparison, debt held by the public has ranged from about 24 percent to nearly 50 percent of GDP since 1965, averaging just over 35 percent.)

As a neutral benchmark for assessing policy proposals, CBO's baseline does not incorporate possible policy changes that could alter the path of the federal budget. Lawmakers are certain to make decisions about discretionary spending that differ from the inflation-adjusted extrapolations that CBO is required to make. Other actions by the Congress and the President could cause mandatory spending or tax collections to be higher or lower than the baseline projections.

To illustrate some of the possible paths that the budget might take, this chapter describes the budgetary implications of various alternative policy assumptions. For example, if military operations in Iraq and Afghanistan and other activities related to the war on terrorism were assumed to slow gradually over the next few years—rather than continue at their current level, as the baseline implicitly assumes—and if no other supplemental funding was provided, the total projected deficit for the 2007–2016 period would equal 0.1 percent of GDP rather than 1.0 percent. Debt held by the public at the end of 2016 would drop to 25 percent of GDP rather than 32 percent.

In contrast, if all of the tax provisions that are set to expire over the next 10 years were assumed to continue (except the higher exemption amounts for the alternative minimum tax, which are scheduled to expire at the end of calendar year 2006), the 10-year deficit would total 2.3 percent of GDP, and debt held by the public would climb to 43 percent of GDP by the end of 2016.

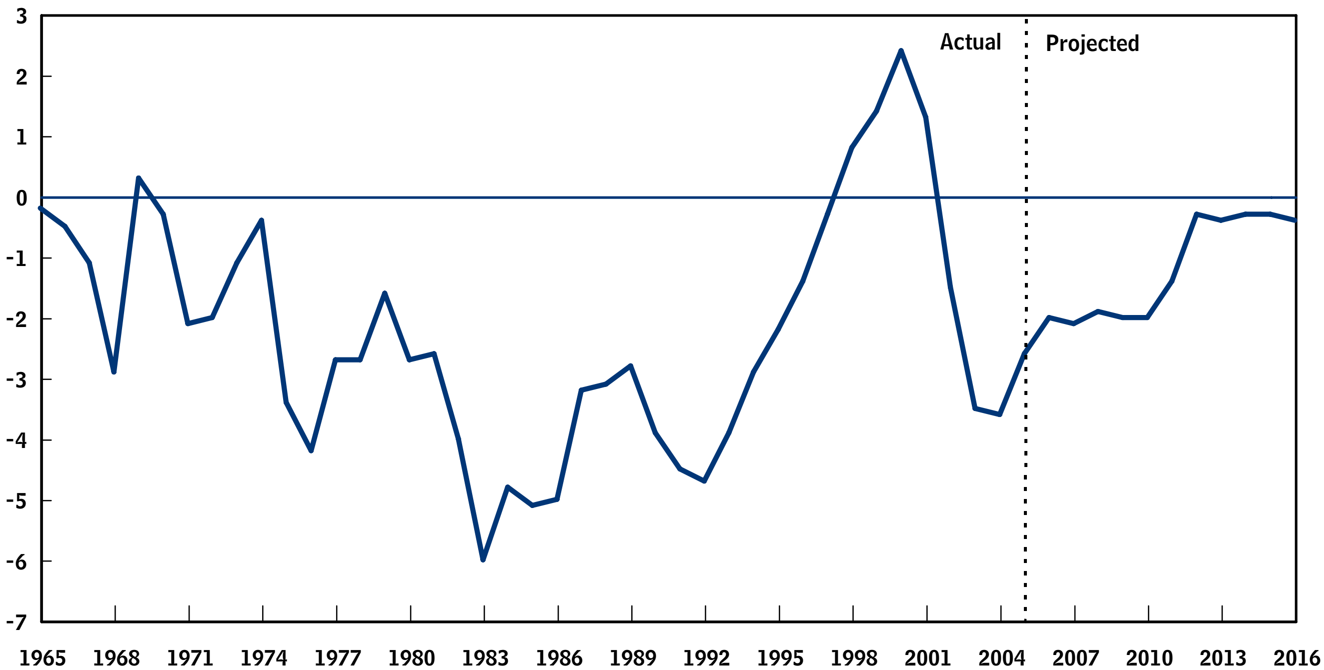
Throughout the 2007–2016 period and beyond, increased spending on the nation's elderly population is likely to put significant strains on the budget. Federal spending on the largest programs that serve elderly people—Social Security and Medicare—is expected to total 7 percent of GDP this year. Without changes in law, that figure will rise to 9 percent of GDP in 10 years, CBO estimates, as health care costs continue to grow and the elderly population increases.

The outlook is similar for the joint federal/state Medicaid program, which subsidizes health care coverage for low-income people. Federal spending for Medicaid is expected to rise rapidly in coming years because of increases

Figure 1-1.

The Total Deficit or Surplus as a Percentage of Gross Domestic Product, 1965 to 2016

(Percent)



Source: Congressional Budget Office.

in health care costs and in the number of elderly and disabled beneficiaries, many of whom require the long-term care that Medicaid subsidizes. CBO estimates that federal spending for Medicaid will grow from the current level of 1.4 percent of GDP to 1.9 percent by 2016.

Those trends are likely to continue beyond the 10-year projection period. The share of the U.S. population that is age 65 or older is expected to keep rising, from 14 percent in 2016 to more than 19 percent in 2030. In addition, health care costs are likely to continue to grow faster than GDP, as they have over the past 40 years. As a result, under current law, spending for Social Security, Medicare, and Medicaid will eventually exert such pressure on the budget as to make the current path of fiscal policy unsustainable.[4]

4. For a detailed discussion of the longer-term pressures facing the federal budget, see Congressional Budget Office, *The Long-Term Budget Outlook* (December 2005) and *Updated Long-Term Projections for Social Security* (June 2006).

The Outlook for 2006

If no further legislation is enacted that affects spending or revenues in 2006, the federal deficit will fall to $260 billion (2.0 percent of GDP) this year from $318 billion (2.6 percent of GDP) in 2005, CBO estimates. Total outlays are projected to grow by almost 8 percent from last year's level, but total revenues will grow faster: by nearly 12 percent. Although lower than the increases in 2005, those growth rates are well above the averages of recent years (see Table 1-2).

Revenues

On the basis of tax collections through July, CBO anticipates that federal revenues will rise sharply in 2006 for the second year in a row. After growing by 14.5 percent in 2005, total revenues are expected to increase by 11.6 percent—or $249 billion—this year to just over $2.4 trillion. Those percentage increases are the highest in the past 25 years. As a share of GDP, revenues are expected to rise from 17.5 percent in 2005 to 18.3 percent this year—slightly higher than the 18.2 percent average of the past four decades.

Table 1-2.

Average Annual Growth Rates of Revenues and Outlays Since 1994 and in CBO's Baseline

(Percent)

	Actual		Estimated	Projected[a]	
	1994-2004	2005	2006	2007	2007-2016
			Revenues		
Individual Income Taxes	4.1	14.6	14.3	7.8	7.5
Corporate Income Taxes	3.0	47.0	22.2	-1.0	0.3
Social Insurance Taxes	4.7	8.3	5.0	4.8	4.6
Other	2.7	3.8	10.2	-4.7	6.0
Total Revenues	**4.1**	**14.5**	**11.6**	**4.6**	**5.6**
			Outlays		
Mandatory	5.6	6.7	7.4	4.8	6.1
Social Security	4.5	5.5	5.9	6.0	5.8
Medicare	6.4	12.0	11.8	19.6	8.2
Medicaid	7.9	3.1	-0.1	7.4	8.1
Other[b]	5.5	5.3	9.7	-16.2	0.3
Discretionary	5.2	8.1	5.9	4.0	2.5
Defense	4.9	8.7	5.8	5.4	2.7
Nondefense	5.5	7.4	5.9	2.5	2.3
Net Interest	-2.3	14.8	19.7	13.1	3.3
Total Outlays	**4.6**	**7.8**	**7.7**	**5.2**	**4.6**
Total Outlays Excluding Net Interest	5.4	7.3	6.8	4.5	4.8
Memorandum:					
Consumer Price Index	2.4	3.3	3.7	2.7	2.2
Nominal Gross Domestic Product	5.2	6.5	6.6	5.5	4.7
Discretionary Budget Authority	5.9	8.7	0.9	5.5	2.3
Defense	6.4	2.9	11.4	2.8	2.4
Nondefense[c]	5.4	15.4	-9.9	8.9	2.3

Source: Congressional Budget Office.

Note: The growth rates in this table do not account for shifts in the timing of certain payments or receipts.

a. As specified by the Balanced Budget and Emergency Deficit Control Act of 1985, CBO's baseline uses the employment cost index for wages and salaries to inflate discretionary spending related to federal personnel and the price index for gross domestic product (formerly the GDP deflator) to adjust other discretionary spending.

b. Includes offsetting receipts.

c. Includes funding provided through supplemental appropriations (as well as a rescission in 2006 of $23 billion in budget authority originally provided in 2005 to the Federal Emergency Management Agency). Excluding those factors would change the growth rate for nondefense discretionary budget authority in 2006 to 0.2 percent and the rate in 2007 to 3.4 percent.

Receipts from individual income taxes account for most of the rise in revenues relative to GDP. Those receipts are projected to climb from 7.5 percent of GDP in 2005 to 8.1 percent this year (see Table 1-3). In addition, receipts from corporate income taxes are expected to grow strongly for the third consecutive year, increasing from 2.3 percent of GDP in 2005 to 2.6 percent in 2006, consistent with rising corporate profits.

Individual Income and Social Insurance Taxes. Together, receipts from individual income taxes and social insurance (payroll) taxes will increase this year by $172 billion, or 10 percent, CBO projects. Individual income taxes make up the bulk of that increase, jumping by more than 14 percent to nearly $1.1 trillion. Social insurance tax receipts are projected to rise more modestly: by 5 percent, to $834 billion.

Most individual income and social insurance taxes are paid in two forms:

- As amounts that employers withhold from paychecks and remit to the federal government on behalf of their employees;[5] and
- As nonwithheld amounts that individuals pay directly, either in quarterly estimated installments or when they file their income tax returns.[6]

Withheld receipts for individual income and payroll taxes are expected to climb by a total of $108 billion, or more than 7 percent, in 2006. That percentage increase would be the highest since 2000, when withheld taxes rose by 10 percent. The recent increase in withholding indicates that total wages and salaries in the economy are growing strongly, which is broadly consistent with recent income data from the national income and product accounts (NIPAs).

5. Employers remit a combined amount of withheld taxes to the Internal Revenue Service without specifying how much comes from income taxes and how much from payroll taxes. The Treasury Department estimates the division between the two sources of revenue when it receives withheld amounts. Months later, it corrects those estimates as new data become available. Thus, when CBO analyzes recent information about collections of withheld taxes, it considers income and payroll taxes together to avoid using Treasury estimates that may be adjusted later.

6. Many taxpayers also receive income tax refunds after filing returns that show that their amounts of withholding plus quarterly estimated payments exceeded their tax liability.

Nonwithheld receipts of income and payroll taxes are projected to rise by about $70 billion this year. That rise would represent increases of about 20 percent in both forms of nonwithheld receipts: final payments made with tax returns and quarterly estimated payments. (Refunds are expected to increase by $8 billion, or 4 percent.)

CBO's estimate for final payments is based on the payments made through July, which indicate strong growth in calendar year 2005 in sources of income other than wages and salaries. Those sources include capital gains, noncorporate business income, interest, dividends, and retirement income. The specific sources of that strength may become clearer by the end of this calendar year when aggregate data from 2005 tax returns are tabulated. In about a year, information will be available about the distribution of sources of income among different types of taxpayers in calendar year 2005, which affects the tax rate applied to that income.

Quarterly estimated payments made in fiscal year 2006 mainly represent people's expectations of their tax liability on economic activity in calendar year 2006. To some degree, taxpayers probably responded to higher nonwage income and final payments on their activity in 2005 by raising their subsequent estimated payments in 2006—in effect, assuming that those amounts of income and tax liability would persist.

Corporate Income Taxes. Receipts from corporate income taxes will rise by 22 percent in fiscal year 2006 to $340 billion, CBO projects. That rise reflects the growth of before-tax corporate profits (as measured in the NIPAs), which are expected to increase by about 30 percent this year. After three years of strong profits, corporate tax receipts as a share of GDP are at levels not seen since the late 1970s.

The growth rate of corporate receipts has slowed somewhat in recent months, however. Total receipts from October 2005 through March 2006 (which largely reflect economic activity from calendar year 2005) were about 30 percent higher than receipts in the same period a year earlier. Total receipts from April through June 2006 (which largely reflect economic activity in calendar year 2006) were 23 percent higher than a year ago. Receipts in the month of June were 19 percent higher than in June 2005. CBO expects additional slowing in the growth of quarterly corporate income tax payments due in September.

Table 1-3.

CBO's Baseline Budget Projections

	Actual 2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Total, 2007-2011	Total, 2007-2016
							In Billions of Dollars							
Revenues														
Individual income taxes	927	1,059	1,142	1,246	1,311	1,392	1,595	1,737	1,846	1,951	2,065	2,186	6,686	16,473
Corporate income taxes	278	340	337	332	317	304	312	326	314	324	334	345	1,602	3,244
Social insurance taxes	794	834	874	918	964	1,013	1,060	1,109	1,159	1,210	1,262	1,314	4,828	10,882
Other	154	170	162	176	183	181	188	225	236	247	262	273	890	2,134
Total	**2,154**	**2,403**	**2,515**	**2,672**	**2,775**	**2,890**	**3,156**	**3,398**	**3,555**	**3,733**	**3,922**	**4,118**	**14,007**	**32,733**
On-budget	1,576	1,798	1,878	2,001	2,068	2,146	2,377	2,583	2,704	2,845	2,996	3,153	10,471	24,751
Off-budget	577	605	637	671	707	744	779	815	851	888	926	965	3,536	7,982
Outlays														
Mandatory spending	1,320	1,418	1,486	1,569	1,659	1,759	1,882	1,926	2,071	2,204	2,351	2,543	8,355	19,449
Discretionary spending	968	1,025	1,065	1,106	1,138	1,164	1,192	1,209	1,241	1,269	1,299	1,335	5,666	12,018
Net interest	184	220	249	270	282	295	308	317	319	324	329	333	1,404	3,026
Total	**2,472**	**2,663**	**2,801**	**2,945**	**3,079**	**3,217**	**3,382**	**3,451**	**3,631**	**3,797**	**3,979**	**4,211**	**15,425**	**34,494**
On-budget	2,070	2,235	2,349	2,479	2,594	2,713	2,858	2,900	3,050	3,184	3,329	3,522	12,993	28,978
Off-budget	402	428	451	466	485	505	525	551	581	613	650	689	2,432	5,516
Deficit (-) or Surplus	**-318**	**-260**	**-286**	**-273**	**-304**	**-328**	**-227**	**-54**	**-76**	**-64**	**-56**	**-93**	**-1,418**	**-1,761**
On-budget	-493	-437	-471	-478	-526	-567	-481	-318	-346	-340	-333	-369	-2,522	-4,228
Off-budget	175	177	185	204	221	239	254	264	270	275	277	276	1,104	2,466
Debt Held by the Public	4,592	4,851	5,149	5,434	5,750	6,088	6,324	6,387	6,469	6,539	6,600	6,696	n.a.	n.a.
Memorandum:														
Gross Domestic Product	12,294	13,108	13,823	14,509	15,236	15,989	16,727	17,488	18,286	19,109	19,951	20,827	76,284	171,945
							As a Percentage of Gross Domestic Product							
Revenues														
Individual income taxes	7.5	8.1	8.3	8.6	8.6	8.7	9.5	9.9	10.1	10.2	10.3	10.5	8.8	9.6
Corporate income taxes	2.3	2.6	2.4	2.3	2.1	1.9	1.9	1.9	1.7	1.7	1.7	1.7	2.1	1.9
Social insurance taxes	6.5	6.4	6.3	6.3	6.3	6.3	6.3	6.3	6.3	6.3	6.3	6.3	6.3	6.3
Other	1.3	1.3	1.2	1.2	1.2	1.1	1.1	1.3	1.3	1.3	1.3	1.3	1.2	1.2
Total	**17.5**	**18.3**	**18.2**	**18.4**	**18.2**	**18.1**	**18.9**	**19.4**	**19.4**	**19.5**	**19.7**	**19.8**	**18.4**	**19.0**
On-budget	12.8	13.7	13.6	13.8	13.6	13.4	14.2	14.8	14.8	14.9	15.0	15.1	13.7	14.4
Off-budget	4.7	4.6	4.6	4.6	4.6	4.7	4.7	4.7	4.7	4.6	4.6	4.6	4.6	4.6
Outlays														
Mandatory spending	10.7	10.8	10.8	10.8	10.9	11.0	11.2	11.0	11.3	11.5	11.8	12.2	11.0	11.3
Discretionary spending	7.9	7.8	7.7	7.6	7.5	7.3	7.1	6.9	6.8	6.6	6.5	6.4	7.4	7.0
Net interest	1.5	1.7	1.8	1.9	1.9	1.8	1.8	1.8	1.7	1.7	1.6	1.6	1.8	1.8
Total	**20.1**	**20.3**	**20.3**	**20.3**	**20.2**	**20.1**	**20.2**	**19.7**	**19.9**	**19.9**	**19.9**	**20.2**	**20.2**	**20.1**
On-budget	16.8	17.0	17.0	17.1	17.0	17.0	17.1	16.6	16.7	16.7	16.7	16.9	17.0	16.9
Off-budget	3.3	3.3	3.3	3.2	3.2	3.2	3.1	3.1	3.2	3.2	3.3	3.3	3.2	3.2
Deficit (-) or Surplus	**-2.6**	**-2.0**	**-2.1**	**-1.9**	**-2.0**	**-2.0**	**-1.4**	**-0.3**	**-0.4**	**-0.3**	**-0.3**	**-0.4**	**-1.9**	**-1.0**
On-budget	-4.0	-3.3	-3.4	-3.3	-3.4	-3.5	-2.9	-1.8	-1.9	-1.8	-1.7	-1.8	-3.3	-2.5
Off-budget	1.4	1.4	1.3	1.4	1.5	1.5	1.5	1.5	1.5	1.4	1.4	1.3	1.4	1.4
Debt Held by the Public	37.4	37.0	37.3	37.5	37.7	38.1	37.8	36.5	35.4	34.2	33.1	32.2	n.a.	n.a.

Source: Congressional Budget Office.

Note: n.a. = not applicable.

That deceleration throughout 2006 stems in part from the dwindling effects of changes in tax law—mainly the expiration of partial-expensing provisions for businesses at the end of calendar year 2004. That expiration boosted corporations' profits and thus tax liabilities in tax year 2005, with part of the effect showing up in tax receipts in fiscal year 2006. In addition, growth in underlying corporate profits has probably slowed in recent months, although direct measures are not readily available.

Outlays

CBO estimates that total federal outlays will grow by $191 billion, or 7.7 percent, this year to almost $2.7 trillion. As a share of GDP, outlays will equal 20.3 percent in 2006—slightly higher than last year's figure of 20.1 percent of GDP but just below the 20.5 percent average since 1965.

Spending for mandatory programs is expected to account for more than half of the increase in federal outlays this year, rising by $98 billion. Outlays for discretionary programs are projected to increase by $57 billion. The government's net interest costs—the fastest growing major component of federal spending—will rise by $36 billion in 2006, CBO estimates.[7]

Mandatory Spending. Outlays for mandatory programs are generally determined by eligibility rules and benefit levels set in law rather than through the annual appropriation process. The growth of such spending is projected to speed up this year: to 7.4 percent from a 6.7 percent increase in 2005. CBO anticipates that mandatory spending will total just over $1.4 trillion for 2006.

Outlays for Social Security, the single biggest mandatory spending program, will rise by 5.9 percent this year, CBO estimates. Its growth results from an increasing number of recipients and from a relatively large cost-of-living adjustment (4.1 percent) in January, which raised benefit payments.

Medicare outlays are expected to rise twice as fast as Social Security spending in 2006—by 11.8 percent—largely because of the ramping up of the new prescription drug program. That percentage increase from 2005 outlays, however, understates the growth in Medicare spending. A shift in certain payments from October to September 2005 and a legislated delay in payments at the end of this fiscal year have moved an estimated $11.3 billion in Medicare outlays from fiscal year 2006 into 2005 and 2007. Adjusted for those timing shifts, outlays for Medicare benefits will jump by 16.7 percent in 2006.[8]

By contrast, federal spending for Medicaid will remain roughly flat this year, CBO estimates. One reason is that the new Medicare prescription drug program is now paying for some benefits that were previously funded by Medicaid.

Outlays for some smaller mandatory programs are expected to jump significantly in 2006. In particular, the federal government will spend a net $17 billion this year on the flood insurance program—up from $1 billion in 2005—because of damage from Hurricane Katrina and other storms. Outlays recorded for education programs (mostly student loans) are expected to rise from $15 billion last year to $28 billion this year, mainly because of revisions to previous estimates of subsidy costs for loans and loan guarantees issued in past years.

Spending on income security programs, including Supplemental Security Income (SSI) and unemployment compensation, is expected to grow modestly this year, by about 2 percent. Outlays for other federal retirement and disability programs will increase by 3 percent over last year's amounts, CBO estimates. However, those figures reflect shifts in the timing of SSI payments as well as veterans' disability compensation and pension benefits. Payments for October 2005 were made in the previous fiscal year (2005 instead of 2006) because October 1 fell on a weekend. A similar shift will occur this year. Adjusted for those shifts, outlays for income security programs would be 3 percent higher in 2006 than they were last year, and total spending for federal retirement and disability programs would be 5 percent higher.

Discretionary Spending. Outlays for discretionary programs—the part of the budget whose funding is set anew each year through appropriation acts—are likely to rise to just over $1 trillion this year from $968 billion in 2005. That increase of 5.9 percent is lower than last year's

7. "Net interest" refers to the government's interest payments on debt held by the public, offset by its interest income on federal loans and investments and by the earnings of the National Railroad Retirement Investment Trust.

8. Beneficiaries' premium payments and other types of Medicare receipts are also expected to rise sharply this year, by more than 28 percent. Net of those receipts, Medicare outlays (adjusted for shifts in the timing of payments) will grow by 15.1 percent this year to $335 billion, CBO estimates.

Box 1-1.

Funding for Activities in Iraq and the War on Terrorism

Since September 2001, the Congress and the President have provided a total of $432 billion in budget authority for military and diplomatic operations in Iraq, Afghanistan, and other regions in support of the war on terrorism (see the table at right). Over 90 percent of that total has been appropriated for activities that are categorized in the budget as national defense; the rest is for activities that are categorized as international affairs.

Funding for defense operations has totaled $381 billion thus far. Of that amount, nearly all has gone to the Department of Defense (DoD); funding for intelligence agencies and the Coast Guard accounts for less than 1 percent of that total. In addition, $12 billion was appropriated in fiscal years 2005 and 2006 combined to train and equip indigenous security forces in Iraq and Afghanistan. (Another $5 billion was provided for Iraqi security forces in 2004, but because it was appropriated to the State Department's Iraq Relief and Reconstruction Fund, it was classified as spending for international affairs.) With that $12 billion included, appropriations for defense-related activities in Iraq, Afghanistan, and the war on terrorism since September 2001 have totaled $393 billion.

Determining exactly how much of that budget authority has been spent is difficult. Reports by the Treasury Department do not distinguish between outlays from regular appropriations and outlays from supplemental appropriations, nor do they distinguish between spending for peacetime operations and spending associated with the war on terrorism.

Information from DoD indicates that the department has obligated almost all of the $277 billion in appropriations that it received before 2006 for operations in Iraq and Afghanistan and for antiterrorism activities. Reports from DoD suggest that through May 2006, it had probably obligated almost all of the $50 billion that was provided for those purposes in December 2005 as part of its 2006 appropriation act (Public Law 109-148). The Congressional Budget Office (CBO) cannot precisely estimate the amounts obligated to date because DoD has not furnished information about the obligation of funds appropriated for classified activities or for the restructuring of Army and Marine Corps units.

DoD reports that since the beginning of fiscal year 2005, it has obligated about $7 billion per month for Operations Iraqi Freedom, Enduring Freedom (in Afghanistan), and Noble Eagle (antiterrorism activities in the United States). Operation Iraqi Freedom has accounted for about 84 percent of the reported obligations, Operation Enduring Freedom for 14 percent, and Operation Noble Eagle for 2 percent.

In addition to funding for defense-related activities, the Congress and the President have appropriated just over $34 billion for diplomatic operations and foreign aid to Iraq, Afghanistan, and other countries assisting the United States in Iraq and in the war on terrorism. Including the $5 billion provided in 2004 to the State Department for Iraqi security forces, funding for activities related to international affairs has totaled $39 billion. About half of that total, or $21 billion, has been appropriated for the Iraq Relief and Reconstruction Fund, of which slightly more than 90 percent has been obligated. On the basis of information from the State Department, CBO estimates that most of the other $18 billion has also been obligated.

8.1 percent rise but higher than the 5.2 percent average annual increase of recent years (see Table 1-2 on page 4).

Roughly half of discretionary outlays are spent on national defense. CBO estimates that defense outlays will total $522 billion in 2006—an increase of 5.8 percent from last year. (Adjusted for a shift in the timing of military pay, the growth rate in 2006 would be 6.7 percent.) By comparison, defense outlays grew at an average annual rate of 12.7 percent from 2002 through 2005.

Budget authority for defense programs is up by 11.4 percent this year, largely because of $124 billion in additional appropriations for military operations in Iraq and

Box 1-1.

Continued

Estimated Appropriations Provided for Iraq and the War on Terrorism Since 2001
(Billions of dollars of budget authority)

	2001	2002	2003	2004	2005	2006	Total, 2001-2006
Defense Operations							
Iraq[a]	0	0	46	68	53	87	254
Other[b]	14	18	34	21	18	24	128
Subtotal	14	18	80	88	70	111	381
Indigenous Security Forces[c]							
Iraq	0	0	0	5	6	3	14
Afghanistan	0	0	0	0	1	2	3
Subtotal	0	0	0	5	7	5	17
Diplomatic Operations and Foreign Aid							
Iraq	0	0	3	15	1	3	22
Other	*	2	5	2	2	1	12
Subtotal	*	2	8	17	3	4	34
Total	**14**	**19**	**88**	**111**	**81**	**120**	**432**

Source: Congressional Budget Office.

Note: * = between zero and $500 million.

a. CBO estimated the appropriations provided for Operation Iraqi Freedom by allocating funds on the basis of obligations reported by the Department of Defense. For more information about funding for Operation Iraqi Freedom, see Congressional Budget Office, *Estimated Costs of U.S. Operations in Iraq Under Two Specified Scenarios* (July 13, 2006).

b. Includes Operation Enduring Freedom (in and around Afghanistan), Operation Noble Eagle (homeland security missions, such as combat air patrols, in the United States), the restructuring of Army and Marine Corps units, classified activities other than those funded by appropriations for the Iraq Freedom Fund, and other operations. (For 2005 and 2006, funding for Operation Noble Eagle has been intermingled with regular appropriations for the Department of Defense; that funding is not included in this table because it cannot be identified separately.)

c. Funding for indigenous security forces is used to train and equip local military and police units in Iraq and Afghanistan.

Afghanistan and other defense activities.[9] Much of that budget authority will be spent in coming years. Without those additional appropriations, budget authority for defense would be just 2.8 percent higher in 2006 than it was last year. (For an overview of funding for activities in Iraq and Afghanistan and the war on terrorism since 2001, see Box 1-1.)

Nondefense discretionary outlays are expected to increase from $474 billion in 2005 to $502 billion this year—a rise of 5.9 percent, down from last year's 7.4 percent growth. Most of this year's increase reflects spending on relief from Hurricane Katrina and other storms.[10] All other nondefense discretionary outlays, as a whole, are about equal to last year's level. Budget authority for non-

9. Appropriations related to Iraq and Afghanistan have totaled $116 billion for military operations and $4 billion for nondefense activities in 2006. In addition, supplemental appropriations have provided $8 billion for other defense programs this year.

10. A total of $87 billion in supplemental appropriations for hurricane relief has been provided over the past two years—$62 billion in 2005 and $48 billion in 2006. (About $23 billion of the 2005 appropriation was subsequently rescinded.)

defense programs (excluding supplemental appropriations of $78 billion for 2005 and $29 billion for 2006) is also nearly unchanged this year relative to last year's level: such funding has risen by just 0.2 percent.

Net Interest. Federal outlays for net interest payments will jump by 19.7 percent in 2006 to a total of $220 billion, CBO estimates. That growth rate—following on last year's 14.8 percent increase—represents a sharp reversal from the previous 10 years, when net interest payments averaged a decline of 2.3 percent per year.

About half of this year's increase results from rising short-term interest rates. Other key factors that add to projected interest spending are growth in the amount of federal debt held by the public and rising inflation (which boosts interest accruals on inflation-indexed Treasury securities).

Baseline Budget Projections for 2007 Through 2016

CBO projects that if current laws and policies remained the same, the annual budget deficit would increase next year to 2.1 percent of GDP and then return to roughly the current level of 2.0 percent of GDP until 2010. After that, scheduled tax increases cause the projected baseline deficit to drop sharply—to 1.4 percent of GDP in 2011 and 0.3 percent in 2012—and then remain between 0.3 percent and 0.4 percent of GDP through 2016.

Under the assumptions of the baseline, both outlays and revenues grow more slowly in 2007 than they are expected to do this year. Outlays rise by 5.2 percent to $2.8 trillion, and revenues grow by 4.6 percent to $2.5 trillion. Relative to the size of the economy, outlays equal 20.3 percent of GDP in 2007, and revenues equal 18.2 percent. Both of those percentages are higher than CBO estimated in March (see Appendix A).

Because the baseline charts the future path of spending and revenues under current laws and policies, it is not intended to be a prediction of future budgetary outcomes. Rather, the baseline serves as a neutral benchmark that lawmakers can use to measure the effects of proposed changes to spending and taxes.

Outlays

Under the assumptions of the baseline, total outlays are projected to average roughly 20 percent of GDP throughout the next 10 years. Mandatory spending—which is projected to grow more than a percentage point faster per year than nominal GDP—rises from 10.8 percent of GDP this year to 12.2 percent in 2016. The baseline assumes that discretionary spending grows at the rate of inflation (which is lower than the growth rate of GDP); thus, discretionary outlays fall from 7.8 percent of GDP this year to 6.4 percent in 2016. Spending on net interest is projected to increase as a percentage of GDP until 2008 because of continued deficits and because the Treasury will have to refinance maturing debt at interest rates that are projected to be higher than the rates at which the securities were initially issued. In later years of the 10-year projection period, net interest spending gradually falls as a percentage of GDP as annual deficits decline (primarily because of the tax increases that are scheduled to occur under current law).

Mandatory Spending. Outlays for mandatory programs are expected to total almost $1.5 trillion in 2007, with the vast majority going for Social Security, Medicare, and Medicaid. CBO estimates that under current law, mandatory spending will grow at an average rate of 6.1 percent a year over the 2007–2016 period, reaching $2.5 trillion by 2016 (see Table 1-4 on page 12). Spending on the largest federal health care programs is expected to grow faster than that average rate; spending on most other mandatory programs is projected to grow more slowly.

As members of the baby-boom generation start becoming eligible for early Social Security retirement benefits in 2008, the growth of Social Security will accelerate. The number of people receiving benefits will rise from 49 million this year to 61 million by 2016, CBO estimates. At that point, outlays for Social Security will total 4.7 percent of GDP (or $970 billion), compared with 4.2 percent of GDP ($582 billion) in 2007.

In the absence of program changes, spending for Medicare will continue its strong growth, as caseloads increase and the costs of services rise. Once the new prescription drug benefit is fully phased in next year, the annual growth of Medicare spending is projected to speed up from about 7.4 percent in the 2008–2010 period to nearly 9 percent by 2016. CBO projects that outlays for Medicare benefits will rise from 3.2 percent of GDP ($446 billion) in 2007 to 4.4 percent of GDP ($909 billion) in 2016.

Spending for the Medicaid program has not grown at all this year, in part because Medicare is beginning to assume the cost of prescription drugs for people who are eligible for both programs. However, CBO expects Medicaid outlays to rise steadily over the next 10 years, at an average rate of about 8 percent annually. By 2016, federal outlays for Medicaid will equal 1.9 percent of GDP ($392 billion), up from an estimated 1.4 percent of GDP ($195 billion) in 2007.

Under current law, spending for mandatory programs other than Social Security, Medicare, and Medicaid is projected to decline over the next 10 years relative to the size of the economy—from 3.1 percent of GDP (about $432 billion) to 2.6 percent ($534 billion). Some of those programs are projected to grow moderately (in nominal terms) and some to shrink. For example, payments for other retirement and disability programs will increase steadily over the 2007–2016 period, CBO projects, at an average rate of 3.8 percent a year. But outlays for the refundable portion of the earned income and child tax credits are projected to fall sharply in 2012, reflecting the expiration of various provisions of EGTRRA at the end of calendar year 2010. Flood insurance payments also are projected to be much lower than they have been this year, falling back to historical levels after recent increases related to Hurricane Katrina and other storms.

Offsetting receipts—certain types of payments from nonfederal entities to the federal government and from one federal agency to another—are reflected in the budget as negative outlays and thus as offsets to mandatory spending. The bulk of offsetting receipts are intragovernmental payments made by federal agencies to finance their employees' benefits and premiums paid by Medicare beneficiaries. Total Medicare premiums are expected to increase by about 30 percent in 2007, the first full fiscal year of enrollment in the Medicare prescription drug program.[11] As a whole, offsetting receipts will rise from about 1.2 percent of GDP ($169 billion) in 2007 to 1.3 percent of GDP ($263 billion) in 2016 under current law, CBO projects.

11. Both the premiums paid by enrollees in the Medicare drug program and the amounts withheld from federal Medicaid payments to states and transferred to Medicare are recorded as offsetting receipts.

Discretionary Spending. In CBO's latest baseline projections, total discretionary outlays increase at an average rate of 2.7 percent annually, from nearly $1.1 trillion next year to more than $1.3 trillion in 2016 (see Table 1-5 on page 14).[12] Relative to GDP, discretionary outlays fall from 7.7 percent in 2007 to 6.4 percent in 2016. (The budgetary effects of alternative assumptions about the growth of discretionary spending are discussed later in this chapter.)

CBO's projections of discretionary spending for the 2007–2016 period are based on the total amount of funding provided for 2006. That amount includes regular appropriations as well as supplemental appropriations that have been enacted at various times during the year. For example, in June, the 2006 Emergency Supplemental Appropriations Act for Defense, the Global War on Terror, and Hurricane Recovery provided $94.7 billion in budget authority, primarily for operations in Iraq and Afghanistan ($70.4 billion), hurricane relief ($20.0 billion), avian flu preparedness ($2.3 billion), and other activities ($2.0 billion). That budget authority, along with about $59 billion in net funding enacted in December, brings total appropriations for activities in Iraq and Afghanistan and supplemental funding for other purposes to $153 billion (net of rescissions) in 2006 (see Table 1-6 on page 15). That amount of additional funding is about the same as the $157 billion provided in 2005.

The magnitude of supplemental appropriations and the irregular pattern of funding for military operations in Iraq and Afghanistan have significant implications for CBO's projections of discretionary outlays. The amount of funding provided through supplemental appropriations—rather than as part of the regular appropriation process—has grown markedly in recent years. For example, supplemental funding for disaster relief averaged about $5 billion per year between 1994 and 2004 before shooting up to $62 billion in 2005 and $48 billion in 2006 in the wake of severe damage from Hurricane Katrina and other storms ($23 billion of the 2005 funding was later rescinded). Such supplemental appropriations

12. According to the Deficit Control Act, the baseline must assume that discretionary spending continues at the level of the most recent appropriations, with annual increases based on two projected rates of inflation: the GDP deflator, now known as the GDP price index (which covers price changes for all of the goods and services that contribute to gross domestic product), and the employment cost index for wages and salaries.

Table 1-4.

CBO's Baseline Projections of Mandatory Spending

(Outlays, in billions of dollars)

	Actual 2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Total, 2007-2011	Total, 2007-2016
Social Security	519	549	582	612	643	679	716	759	806	856	911	970	3,231	7,534
Medicare[a]	333	372	446	475	512	549	605	613	682	742	808	909	2,586	6,340
Medicaid	182	181	195	213	232	249	269	290	312	337	363	392	1,158	2,852
Income Support														
Supplemental Security Income	38	37	36	41	43	44	50	44	49	51	53	59	214	470
Earned income and child tax credits	49	52	53	54	55	54	54	37	37	37	38	38	271	458
Unemployment compensation	33	31	32	35	39	42	44	46	48	50	52	55	191	443
Food Stamps	33	35	35	35	36	37	37	38	39	40	41	42	179	379
Family support[b]	24	24	24	24	24	24	24	24	24	24	25	25	120	242
Child nutrition	13	14	14	15	16	16	17	18	18	19	20	21	78	174
Foster care	6	7	7	7	7	8	8	8	8	9	9	9	37	80
Subtotal	196	200	202	212	219	225	234	215	225	231	237	248	1,091	2,247
Other Retirement and Disability														
Federal civilian[c]	64	68	72	75	78	81	84	87	90	94	97	101	389	858
Military	39	41	44	46	47	49	50	51	53	54	56	57	235	507
Veterans[d]	36	36	35	39	40	41	45	40	44	45	46	51	199	424
Other	9	7	7	7	7	8	9	9	10	11	12	13	38	93
Subtotal	148	152	158	166	172	178	187	188	197	204	210	221	862	1,882

Continued

are extrapolated for each future year of the baseline, regardless of whether they are likely to continue at the current-year level throughout the projection period.

The timing of such additional funding can cause sharp swings in CBO's projections of total discretionary outlays over 10 years. For example, the current baseline extrapolates the $120 billion provided for military operations and other defense activities in Iraq and Afghanistan for 2006. However, only $50 billion of that total had been provided when CBO completed its previous baseline in March. As a result of such additional appropriations, CBO's projection of defense outlays over the 2007–2016 period is $721 billion higher now than it was in March. When CBO next updates its projections, in January 2007, it will do so on the basis of appropriations provided as of that date for fiscal year 2007.[13]

Net Interest. Under the assumptions of the baseline, net interest costs are one of the fastest growing components of the federal budget. They are projected to rise from $220 billion this year to $308 billion in 2011 (see Table 1-7 on page 16)—an average annual increase of 7 percent. After 2011, net interest rises more slowly, by about 1.6 percent a year, to $333 billion in 2016. About 80 percent of the total increase, or roughly $90 billion, reflects interest costs on the additional $1.8 trillion that the federal government is projected to borrow from the public (through sales of Treasury securities) between 2006 and 2016. Most of the rest of that increase occurs because the Treasury will need to refinance maturing notes and bonds with new issues that are likely to carry higher interest

13. Although CBO anticipates that significant funding will be necessary to continue operations in Iraq and Afghanistan, such funding will not be included in CBO's next baseline if it has not been provided by January. As a result, the January baseline could project much lower outlays for defense over the next 10 years than the current baseline does. (The next section of this chapter examines potential paths for budget projections that differ from the baseline.)

Table 1-4.

Continued

(Outlays, in billions of dollars)

	Actual 2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Total, 2007-2011	Total, 2007-2016
Other Programs														
Commodity Credit Corporation Fund	19	17	15	13	13	12	11	11	10	10	10	10	64	115
TRICARE For Life	6	7	8	8	9	10	10	11	12	13	14	15	46	112
Student loans	15	28	4	4	4	4	4	4	4	4	3	3	20	38
Universal Service Fund	6	7	7	8	8	8	9	9	9	9	9	9	40	85
State Children's Health Insurance	5	6	5	5	5	5	5	5	5	5	5	5	27	52
Social services	5	5	5	5	5	5	5	5	5	5	5	5	25	51
Flood insurance	1	17	3	0	0	0	0	0	0	0	0	0	3	3
Other	13	16	25	23	24	19	19	19	18	18	17	17	110	199
Subtotal	71	103	73	67	68	63	64	64	64	64	64	65	335	655
Offsetting Receipts														
Medicare[e]	-38	-49	-64	-71	-75	-79	-85	-91	-100	-111	-123	-138	-374	-936
Employer's share of employee retirement	-47	-48	-49	-51	-52	-54	-57	-59	-61	-63	-66	-69	-263	-581
Other	-43	-44	-56	-54	-59	-51	-51	-52	-55	-55	-54	-56	-271	-543
Subtotal	-128	-141	-169	-176	-186	-184	-193	-201	-216	-230	-243	-263	-908	-2,060
Total Mandatory Spending	**1,320**	**1,418**	**1,486**	**1,569**	**1,659**	**1,759**	**1,882**	**1,926**	**2,071**	**2,204**	**2,351**	**2,543**	**8,355**	**19,449**
Memorandum:														
Mandatory Spending Excluding Offsetting Receipts	1,448	1,559	1,655	1,745	1,845	1,943	2,075	2,128	2,286	2,434	2,594	2,806	9,263	21,510
Medicare Spending Net of Offsetting Receipts	295	323	382	405	437	469	520	522	583	631	685	771	2,213	5,404

Source: Congressional Budget Office.

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

a. Excludes offsetting receipts.

b. Includes Temporary Assistance for Needy Families and various programs that involve payments to states for child support enforcement and family support, child care entitlements, and research to benefit children.

c. Includes Civil Service, Foreign Service, Coast Guard, and other, smaller retirement programs as well as annuitants' health benefits.

d. Includes veterans' compensation, pensions, and life insurance programs.

e. Includes Medicare premiums and amounts paid by states from savings on Medicaid prescription drug costs.

Table 1-5.

CBO's Baseline Projections of Discretionary Spending

(Billions of dollars)

	Actual 2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Total, 2007-2011	Total, 2007-2016
Budget Authority														
Defense	500	557	572	585	599	613	627	642	657	673	689	705	2,996	6,361
Nondefense	487	439	478	489	502	512	524	536	549	561	575	588	2,505	5,313
Total	**987**	**995**	**1,050**	**1,074**	**1,101**	**1,125**	**1,151**	**1,178**	**1,205**	**1,234**	**1,263**	**1,293**	**5,501**	**11,675**
Outlays														
Defense	494	522	550	575	590	604	623	628	647	663	679	701	2,943	6,260
Nondefense	474	502	515	532	547	560	569	581	593	607	621	634	2,723	5,758
Total	**968**	**1,025**	**1,065**	**1,106**	**1,138**	**1,164**	**1,192**	**1,209**	**1,241**	**1,269**	**1,299**	**1,335**	**5,666**	**12,018**

Source: Congressional Budget Office.

Notes: Nondefense discretionary outlays are usually higher than budget authority because of spending from the Highway Trust Fund and the Airport and Airway Trust Fund, which is subject to obligation limitations set in appropriation acts. The budget authority for such programs is provided in authorizing legislation and is not considered discretionary.

Inflation in CBO's baseline is projected using the inflators specified in the Balanced Budget and Emergency Deficit Control Act of 1985: the gross domestic product deflator (now called the GDP price index) and the employment cost index for wages and salaries.

rates. Relative to GDP, net interest is projected to peak at 1.9 percent in 2008 and 2009 and then decline to 1.6 percent by 2016.

The baseline assumes that the statutory limit on federal borrowing is raised as necessary to cover projected deficits as well as debt issued to other federal government accounts. CBO estimates that federal debt will reach the current limit of $8.965 trillion sometime between the end of June and October 2007.[14]

Revenues

Under the assumptions governing the baseline, CBO projects that total revenues will remain near 18.2 percent of GDP (the average since 1965) for the next four years. Growth in individual income tax receipts relative to GDP is expected to be offset by reductions in corporate income tax receipts and (to a lesser extent) in receipts from estate and gift taxes and excise taxes. After 2010, projected revenues increase sharply with the expiration of provisions of EGTRRA, JGTRRA, and the Tax Increase Prevention and Reconciliation Act of 2005; by 2012, revenues reach 19.4 percent of GDP. Because of factors inherent in the structure of the individual income tax, total revenues continue to rise thereafter relative to GDP, equaling 19.8 percent by 2016.

Individual Income Taxes. If tax laws remain the same (except for currently scheduled changes and expirations), receipts from individual income taxes will rise in each of the next 10 years as a percentage of GDP—from 8.1 percent this year to 10.5 percent in 2016—CBO projects. That increase has two main causes.

First, various changes in tax rules that are now scheduled to occur would have the effect of boosting individual income tax receipts relative to GDP. The exemption amounts for the alternative minimum tax (AMT) are set to decline in 2007 from this year's level. That decline would greatly increase the number of taxpayers who are subject to the AMT starting in 2007—and thus increase receipts from the tax that year and, much more significantly, in 2008. In addition, a number of tax law changes originally enacted in EGTRRA and JGTRRA are sched-

14. Federal debt subject to that limit includes debt held by the public and debt held by government accounts (such as the Social Security trust funds and the Civil Service Retirement and Disability Fund). It does not include debt issued by the Federal Financing Bank and by agencies other than the Treasury.

Table 1-6.

Supplemental Appropriations and Funding for Operations in Iraq and Afghanistan Provided in 2006

(Billions of dollars)

	2006 Budget Authority
Funding for Military Operations and Other Defense Activities in Iraq and Afghanistan	
Enacted in December 2005[a]	50
Enacted in June 2006[b]	70
Subtotal	120
Funding for Hurricane Relief and Recovery	
Enacted in December 2005[a]	28
Enacted in December 2005[a]	-23 [c]
Enacted in June 2006[b]	20
Subtotal	25
Funding for Avian Flu Preparedness[a, b, d]	6
Other Supplemental Funding[a, b, d]	2
Total	**153**
Memorandum:	
Total Excluding the December 2005 Rescission	177

Source: Congressional Budget Office.

a. The Department of Defense, Emergency Supplemental Appropriations to Address Hurricanes in the Gulf of Mexico, and Pandemic Influenza Act, 2006 (Public Law 109-148), enacted on December 30, 2005.

b. The Emergency Supplemental Appropriations Act for Defense, the Global War on Terror, and Hurricane Recovery, 2006 (P.L. 109-234), enacted on June 15, 2006.

c. P.L. 109-148 rescinded $23 billion of the $62 billion initially provided in fiscal year 2005 to the Federal Emergency Management Agency.

d. "An act making supplemental appropriations for fiscal year 2006 for the Small Business Administration's disaster loans program, and for other purposes" (P.L. 109-174), enacted on February 18, 2006.

uled to expire at the end of December 2010, raising revenues sharply in 2011 and 2012. Those expirations would increase statutory tax rates on ordinary income, capital gains, and dividends; narrow the 15 percent tax bracket for people who file joint returns; and reduce the child tax credit, among other changes.

Second, several structural characteristics of the tax code cause effective tax rates—the amount of taxes paid as a percentage of personal income—to increase over time. One characteristic is the phenomenon known as "real bracket creep," in which the overall growth of real (inflation-adjusted) income causes more income to be taxed in higher tax brackets. In addition, as nominal income rises, a growing share of it is claimed by the AMT, whose structure is not indexed for inflation. Also, taxable distributions from tax-deferred retirement accounts, such as individual retirement accounts and 401(k) plans, are expected to grow more rapidly than other income as the population ages. Those various factors cause federal revenues to rise more quickly than total income in the economy.

CBO's projection of the increase in individual income tax receipts from those two causes is muted by an assumption about how long the current strength of such receipts will last. As noted above, the sources of this year's surge in individual income tax receipts will not be known until information from tax returns becomes available, starting this fall. In the absence of that information, CBO assumes that the "unexplained" receipts (those above the amount that can be explained by currently available data) will largely continue through 2007 and then gradually decline over the following several years. CBO assumes that in the longer term, taxable income will tend to return to its historical relationship to GDP.

Corporate Income Taxes. After rising sharply for the past three years, revenues from corporate income taxes are projected to decline gradually as a share of GDP over the next 10 years: from 2.6 percent in 2006 to 1.7 percent by 2013—a level similar to that seen in the early 1990s. That decline mainly results from CBO's forecast that corporate profits will grow more slowly than GDP after this year. Profits are projected to decrease from about 13 percent of GDP in 2006 to about 9 percent in 2016.

The recent growth in corporate tax receipts relative to GDP reflects profits' reaching new highs relative to the size of the economy. CBO expects that over the 2007–2016 period, both profits and receipts will return to levels more consistent with their historical relationship to GDP.

Social Insurance and Other Taxes. Receipts from social insurance (payroll) taxes are projected to remain relatively stable over the next decade at 6.3 percent of GDP. Total revenues from sources other than income and payroll

Table 1-7.

CBO's Baseline Projections of Federal Interest Outlays and Debt

(Billions of dollars)

	Actual 2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Total, 2007-2011	Total, 2007-2016
							Net Interest Outlays							
Interest on Treasury Debt Securities (Gross interest)[a]	352	404	444	479	508	536	566	592	612	636	659	682	2,533	5,714
Interest Received by Trust Funds														
Social Security	-92	-99	-107	-116	-127	-139	-151	-164	-178	-192	-206	-221	-640	-1,599
Other trust funds[b]	-69	-74	-77	-79	-82	-84	-86	-88	-90	-93	-94	-95	-407	-868
Subtotal	-161	-173	-184	-195	-209	-222	-237	-252	-268	-284	-300	-316	-1,047	-2,468
Other Interest[c]	-4	-8	-10	-13	-15	-17	-19	-21	-24	-26	-29	-32	-75	-208
Other Investment Income[d]	-3	-3	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-7	-13
Total (Net interest)	**184**	**220**	**249**	**270**	**282**	**295**	**308**	**317**	**319**	**324**	**329**	**333**	**1,404**	**3,026**
							Federal Debt (At end of year)							
Debt Held by the Public	4,592	4,851	5,149	5,434	5,750	6,088	6,324	6,387	6,469	6,539	6,600	6,696	n.a.	n.a.
Debt Held by Government Accounts														
Social Security	1,809	1,986	2,172	2,374	2,594	2,830	3,080	3,339	3,604	3,874	4,146	4,416	n.a.	n.a.
Other government accounts[b]	1,504	1,625	1,727	1,836	1,937	2,031	2,118	2,218	2,310	2,408	2,498	2,577	n.a.	n.a.
Total	3,313	3,611	3,899	4,210	4,531	4,861	5,198	5,557	5,915	6,282	6,644	6,993	n.a.	n.a.
Gross Federal Debt	7,905	8,463	9,048	9,644	10,281	10,949	11,522	11,944	12,383	12,821	13,244	13,689	n.a.	n.a.
Debt Subject to Limit[e]	7,871	8,429	9,015	9,612	10,249	10,918	11,492	11,914	12,354	12,793	13,217	13,663	n.a.	n.a.
Memorandum:														
Debt Held by the Public as a Percentage of GDP	37.4	37.0	37.3	37.5	37.7	38.1	37.8	36.5	35.4	34.2	33.1	32.2	n.a.	n.a.

Source: Congressional Budget Office.

Note: n.a. = not applicable; GDP = gross domestic product.

a. Excludes interest costs on debt issued by agencies other than the Treasury (primarily the Tennessee Valley Authority).

b. Mainly the Civil Service Retirement, Military Retirement, Medicare, and Unemployment Insurance Trust Funds.

c. Primarily interest on loans to the public.

d. Earnings on private investments by the National Railroad Retirement Investment Trust.

e. Differs from gross federal debt primarily because most debt issued by agencies other than the Treasury and the Federal Financing Bank is excluded from the debt limit.

taxes are projected to decline as a share of GDP in the first half of the 10-year projection period and then rebound to their current level. Those other revenues will drop from 1.3 percent of GDP this year to 1.2 percent next year, CBO projects, mainly because of a decline in telephone excise taxes.

In May, following successful legal challenges, the Internal Revenue Service terminated the tax on long-distance and wireless telephone services, effective in August. (The tax on local telephone service remains in force.) As a result, CBO expects gross telephone tax receipts to fall from $5 billion this year to $2 billion in 2007. In addition, the Internal Revenue Service will provide refunds to taxpayers for up to three years of past long-distance taxes. Those refunds are estimated to total about $9.5 billion in 2007 and $2 billion in 2008. CBO anticipates that over time, people and businesses will choose packages that bundle their local and long-distance telephone services, in which case the local component will not be subject to taxation. By 2011, CBO projects, less than $200 million per year will be collected from the telephone tax.

Under current law, receipts from estate and gift taxes are projected to remain at about 0.2 percent of GDP through 2009 and then decline to 0.1 percent of GDP as the estate tax is reduced and then repealed at the end of 2010 under EGTRRA. However, the estate tax is scheduled to be reinstated in 2011, which causes projected receipts to rebound to 0.3 percent of GDP in 2012 and 0.4 percent of GDP by 2016.

Revenues from customs duties, earnings of the Federal Reserve System, and other miscellaneous sources are projected to remain relatively stable as a percentage of GDP over the 2007–2016 period.

Budget Projections Under Alternative Scenarios

As noted above, future legislative actions will affect the budget outlook, causing deficits to be higher or lower than they are in CBO's current-law baseline projections. To illustrate the potential effects of some possible legislative actions, CBO has estimated the impact of various alternative scenarios on revenues and outlays as well as on the government's debt-service costs (see Table 1-8).

Different assumptions about spending for operations in Iraq and Afghanistan or about the growth rate of discretionary appropriations could produce very different estimates of the total deficit for the 2007–2016 period. For example, if the $177 billion in gross additional funding for those operations and in supplemental appropriations for other purposes enacted in 2006 was excluded from the amount of current appropriations extrapolated in future years, discretionary spending over the 2007–2016 period would be almost $1.8 trillion lower than in the baseline, and debt-service costs would be more than $400 billion smaller.

Alternatively, funding for operations in Iraq and Afghanistan and other aspects of the war on terrorism could be assumed to slow gradually if the number of troops involved in them declined instead of continuing at the current level for the next decade. For example, in 2007, the Department of Defense might slightly reduce the number of personnel deployed overseas in support of those operations from the present level of 220,000 to about 205,000. By 2011, that number could shrink to about 55,000 personnel and remain at that level for the rest of the projection period. That scenario, combined with not extrapolating other supplemental funding provided in 2006 (such as for hurricane relief), would reduce discretionary outlays over the 2007–2016 period by nearly $1.3 trillion relative to the baseline.

Alternative assumptions could also be made about overall discretionary appropriations. For example, if current appropriations (excluding supplementals and funding for activities in Iraq and Afghanistan) were assumed to grow at the same rate as nominal GDP through 2016 rather than at the rate of inflation, total projected discretionary spending would be $1.3 trillion higher over 10 years. In the other direction, if lawmakers opted not to increase appropriations each year to account for inflation, discretionary outlays would be $1.3 trillion lower over the 2007–2016 period.

The various tax provisions that are set to expire over the next 10 years (or that expired at the end of 2005) reduce revenues, on balance. Thus, if those provisions (except ones related to relief from the alternative minimum tax) were assumed to be extended rather than expiring as scheduled, projected revenues would be lower than in the baseline. If the expiring tax provisions originally enacted in EGTRRA and JGTRRA were extended, total revenues over the 2007–2016 period would be $1.5 trillion lower, CBO and the Joint Committee on Taxation (JCT) estimate. Extending other expiring tax provisions—includ-

Table 1-8.

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

(Billions of dollars)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Total, 2007-2011	Total, 2007-2016
				Policy Alternatives That Affect Discretionary Spending									
Remove the Extension of Certain Appropriations from the Baseline After 2006[a]													
Effect on the deficit	0	68	132	165	180	190	194	199	203	207	212	735	1,752
Debt service	0	2	7	14	23	33	43	54	66	79	92	78	413
Remove the Extension of Certain Appropriations and Include a Phasing Down of Military Operations in Iraq and Afghanistan[b]													
Effect on the deficit	0	13	42	85	125	151	161	168	173	178	182	416	1,280
Debt service	0	*	2	5	10	17	25	34	44	54	65	34	255
Increase Regular Discretionary Appropriations at the Growth Rate of Nominal GDP[c]													
Effect on the deficit	0	-14	-36	-61	-88	-115	-142	-171	-202	-233	-266	-313	-1,327
Debt service	0	*	-2	-4	-8	-13	-19	-28	-38	-50	-64	-26	-224
Freeze Total Discretionary Appropriations at the Level Provided for 2006													
Effect on the deficit	0	17	39	64	89	115	141	169	197	226	257	324	1,313
Debt service	0	*	2	4	8	13	20	28	38	50	63	28	227

Continued

ing the research and experimentation tax credit and the deductibility of state and local sales taxes, among several dozen others—would reduce revenues by $349 billion over the next 10 years.

Modifying the AMT, which many observers believe cannot be maintained in its current form, would also affect revenues. Because the AMT's exemption amount and brackets are not indexed for inflation, the tax will have a growing impact in coming years as more taxpayers become subject to it. If the AMT were indexed for inflation after 2006, federal revenues would be $513 billion lower over the next 10 years, according to CBO and JCT.

Uncertainty and Baseline Projections

CBO's baseline budget projections are based not only on statutory rules about the treatment of current laws and policies but also on various assumptions about how the economy will perform in the future and how tax and spending policies affect that performance. Because actual outcomes will almost certainly differ from CBO's projections, it is useful to view those projections as a range of potential outcomes rather than as a single stream of numbers.

Figure 1-2 illustrates a range of possible outcomes for the total deficit under current laws and policies, using the dif-

Table 1-8.

Continued

(Billions of dollars)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Total, 2007-2011	Total, 2007-2016
						Policy Alternatives That Affect the Tax Code							
Extend EGTRRA and JGTRRA[d]													
Effect on the deficit	0	-3	-3	-3	-9	-145	-245	-269	-279	-289	-301	-164	-1,546
Debt service	0	*	*	*	-1	-4	-14	-26	-41	-56	-72	-6	-214
Extend Other Expiring Tax Provisions[d]													
Effect on the deficit	0	-16	-17	-22	-29	-34	-39	-43	-47	-50	-53	-117	-349
Debt service	0	*	-1	-2	-3	-5	-7	-9	-12	-15	-18	-12	-73
Reform the Alternative Minimum Tax[e]													
Effect on the deficit	0	-4	-65	-60	-71	-59	-35	-42	-50	-59	-68	-260	-513
Debt service	0	*	-2	-5	-8	-12	-14	-17	-20	-23	-27	-27	-128
Memorandum:													
Total Discretionary Outlays in CBO's Baseline	1,025	1,065	1,106	1,138	1,164	1,192	1,209	1,241	1,269	1,299	1,335	5,666	12,018
Total Deficit in CBO's Baseline	-260	-286	-273	-304	-328	-227	-54	-76	-64	-56	-93	-1,418	-1,761

Sources: Congressional Budget Office; Joint Committee on Taxation.

Notes: Positive amounts indicate a reduction in the deficit. "Debt service" refers to changes in interest payments on federal debt resulting from changes in the government's borrowing needs.

* = between -$500 million and $500 million; GDP = gross domestic product; EGTRRA = Economic Growth and Tax Relief Reconciliation Act of 2001; JGTRRA = Jobs and Growth Tax Relief Reconciliation Act of 2003.

a. This alternative does not extrapolate the $50 billion in funding for operations in Iraq and Afghanistan enacted as part of the Department of Defense appropriation act for 2006 or any supplemental appropriations provided during the year for activities in Iraq and Afghanistan, hurricane relief, or other purposes.

b. This alternative does not extrapolate the $50 billion in funding for operations in Iraq and Afghanistan enacted as part of the Department of Defense appropriation act for 2006 or any supplemental appropriations provided during the year for activities in Iraq and Afghanistan, hurricane relief, or other purposes. However, it assumes that an additional $110 billion in budget authority will be provided in 2007 to carry out operations in Iraq and Afghanistan, followed by $90 billion in 2008, $65 billion in 2009, $40 billion in 2010, and then about $30 billion a year from 2011 on (for a total of $483 billion over the 2007-2016 period).

c. This alternative assumes that the appropriations for operations in Iraq and Afghanistan and the supplemental appropriations for other purposes enacted during 2006 are projected according to statutory baseline rules (using specified measures of inflation).

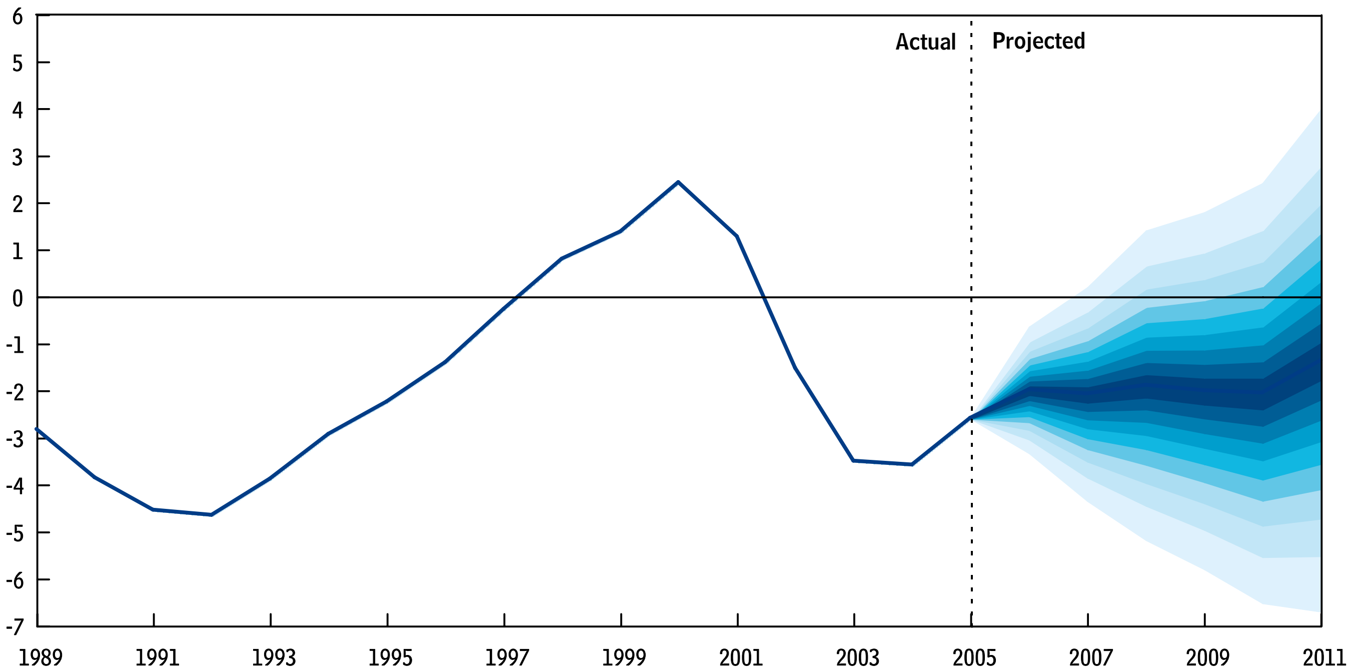
d. These estimates do not include the effects of extending the increased exemption amount or the treatment of personal credits in the alternative minimum tax, both of which expire at the end of 2006. The effects of such an extension are shown below.

e. This alternative assumes that the exemption amount for the alternative minimum tax (AMT), which was increased through 2006 in the Tax Increase Prevention and Reconciliation Act of 2005, is extended at its higher level and, together with the AMT tax brackets, is indexed for inflation after 2006. The treatment of personal credits against the AMT, which also expires at the end of 2006, is assumed to continue. The estimates shown are relative to current law. If this alternative was enacted jointly with the extension of both EGTRRA and JGTRRA, an interactive effect would occur that would make the combined reduction in revenues over the 2007-2016 period greater than the sum of the two separate estimates by about $388 billion (plus $49 billion in debt-service costs).

Figure 1-2.

Uncertainty of CBO's Projections of the Budget Deficit Under Current Policies

(Deficit or surplus as a percentage of gross domestic product)



Source: Congressional Budget Office.

Notes: This figure, calculated on the basis of CBO's forecasting track record, shows the estimated likelihood of alternative projections of the budget deficit or surplus under current policies. The baseline projections described in this chapter fall in the middle of the darkest area of the figure. Under the assumption that tax and spending policies will not change, the probability is 10 percent that actual deficits or surpluses will fall in the darkest area and 90 percent that they will fall within the whole shaded area.

Actual deficits or surpluses will be affected by legislation enacted in future years, including decisions about discretionary spending. The effects of future legislation are not reflected in this figure.

For an explanation of how CBO calculates the probability distribution underlying this figure, see Congressional Budget Office, *The Uncertainty of Budget Projections: A Discussion of Data and Methods* (March 2006).

ferences between past CBO baselines and actual budgetary results as a guide. The current baseline projection of the deficit falls in the middle of the highest-probability area, shown as the darkest part of the figure. Other possible paths for the deficit shown in that part of the figure, although different from the baseline projection, have nearly the same probability of occurring. Paths that fall in progressively lighter parts of Figure 1-2 are less likely to occur than CBO's current projection, but they still have a significant probability of coming to pass.

CBO's probability analysis indicates that future deficits could be significantly smaller or larger than the baseline projection. For example, CBO currently projects a deficit equal to 2.1 percent of GDP for 2007. But judging from past outcomes, there is an 80 percent chance that the actual deficit will be somewhere between 0.9 percent and 3.2 percent of GDP if current laws do not change. That range of probable variation is wider for later years.

CHAPTER

2

The Economic Outlook

Although the U.S. economy has been growing at a rapid rate since early 2003, growth is likely to slow to a moderate, sustainable pace over the next year and a half. The Congressional Budget Office forecasts that economic growth will diminish to an annual rate of 3 percent in the second half of this year and then remain steady through 2007. Inflation in so-called core consumer prices (which excludes the more volatile prices of food and energy) will also moderate, CBO expects, dropping to 2 percent by the end of next year. CBO anticipates that the unemployment rate will average about 4¾ percent through 2007, and productivity growth will be roughly 2 percent. Interest rates on Treasury securities are forecast to rise in the second half of this year and then drop slightly during 2007. (Table 2-1 presents CBO's current economic projections on a calendar year basis.)

Several major forces are driving the economic outlook. Working to keep inflation under control, the Federal Reserve moved to a slightly restrictive stance in 2006, after having gradually removed the stimulus to short-term growth that it had maintained for several years. As a result, interest rates, especially short-term rates, have increased. At the same time, energy prices have risen, largely as a result of developments in world markets for petroleum and its products, and the housing market has begun a long-anticipated slowdown.

Those factors are expected to slow the growth of consumers' purchases of goods and services. Higher interest rates reduce borrowing by consumers; higher energy prices reduce the real (inflation-adjusted) income of households; and the decline in the growth of house prices slows the rise in households' wealth. CBO expects that over the next year and a half, consumer spending will grow more slowly than in recent years.

The outlook for investment by businesses in new structures, equipment, and software (business fixed investment) is bright. Demand for goods and services from domestic and foreign customers is still solid, so after investing at low rates in 2002 and 2003, many businesses, including oil companies, now seek to add capacity to meet it. In addition, firms' profits are high, corporate debt is relatively low, and the cost of financing for investment is still favorable.

Over the next 10 years, economic growth is projected to slow, as members of the baby-boom generation begin to leave the labor force. In CBO's estimation, the average annual growth of real gross domestic product will decline from 3 percent in 2008 through 2011 to 2.6 percent in 2012 through 2016. Core and overall inflation, as measured by the growth of the chained price index for personal consumption expenditures (PCE), are both assumed to average 2.0 percent over the 2008–2016 period, and the unemployment rate is expected to average 5.0 percent. The average annual rate on three-month Treasury bills over the period will be about 4.5 percent, CBO projects; the rate on 10-year notes will average 5.2 percent.

Since January 2006, CBO has made three changes to the economic assumptions about the labor market that affect its projection of GDP over the next 10 years. First, CBO lowered its estimate of the natural rate of unemployment from 5.2 percent to 5.0 percent;[1] second, it lowered its estimates of the rate of labor force participation; and third, it raised its estimate of the rate of growth in average weekly hours worked in the nonfarm business sector. The first and third changes raise projections of future GDP, but they are more than offset by the second change. On balance, the changes reduce the projected level of real GDP by an average of 0.9 percent from 2008 to 2016. In 2016, real GDP is now expected to be about $133 billion lower than CBO projected last January, but because the

1. The natural rate of unemployment is the rate of unemployment arising from all sources except fluctuations in overall demand.

Table 2-1.

CBO's Economic Projections for Calendar Years 2006 to 2016

(Percentage change)

	Actual	Forecast		Projected Annual Average	
	2005[a]	2006	2007	2008 to 2011	2012 to 2016
			Year over Year		
Nominal GDP (Billions of dollars)	12,487	13,308	13,993	16,914[b]	21,052[c]
Nominal GDP	6.4	6.6	5.1	4.9	4.5
Real GDP	3.5	3.5	3.0	3.0	2.6
GDP Price Index	2.8	3.0	2.0	1.8	1.8
PCE Price Index[d]	2.8	3.0	2.4	2.0	2.0
Core PCE Price Index[e]	2.0	2.2	2.3	2.0	2.0
Consumer Price Index[f]	3.4	3.5	2.5	2.2	2.2
Core Consumer Price Index[g]	2.2	2.6	2.5	2.2	2.2
Unemployment Rate (Percent)	5.1	4.7	4.8	5.0	5.0
Three-Month Treasury Bill Rate (Percent)	3.1	4.8	5.0	4.5	4.4
Ten-Year Treasury Note Rate (Percent)	4.3	5.1	5.4	5.2	5.2
Tax Bases (Percentage of GDP)					
Corporate book profits	11.5	13.4	11.7	10.1	9.0
Wages and salaries	45.7	45.0	45.4	45.8	45.8
Tax Bases (Billions of dollars)					
Corporate book profits	1,438	1,781	1,641	1,587[b]	1,884[c]
Wages and salaries	5,712	5,994	6,354	7,771[b]	9,619[c]
			Fourth Quarter over Fourth Quarter		
Nominal GDP	6.4	6.3	5.0	4.8	4.5
Real GDP	3.2	3.6	3.1	3.0	2.6
GDP Price Index	3.1	2.6	1.9	1.8	1.8
PCE Price Index[d]	3.0	2.9	2.0	2.0	2.0
Core PCE Price Index[e]	2.0	2.5	2.1	2.0	2.0
Consumer Price Index[f]	3.7	3.2	2.2	2.2	2.2
Core Consumer Price Index[g]	2.1	2.9	2.3	2.2	2.2

Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

Notes: Year-by-year economic projections for 2006 to 2016 appear in Appendix C.

GDP = gross domestic product.

a. Values as of early July 2006, prior to the revisions to the national income and product accounts.

b. Level in 2011.

c. Level in 2016.

d. The personal consumption expenditure chained price index.

e. The personal consumption expenditure chained price index excluding prices for food and energy.

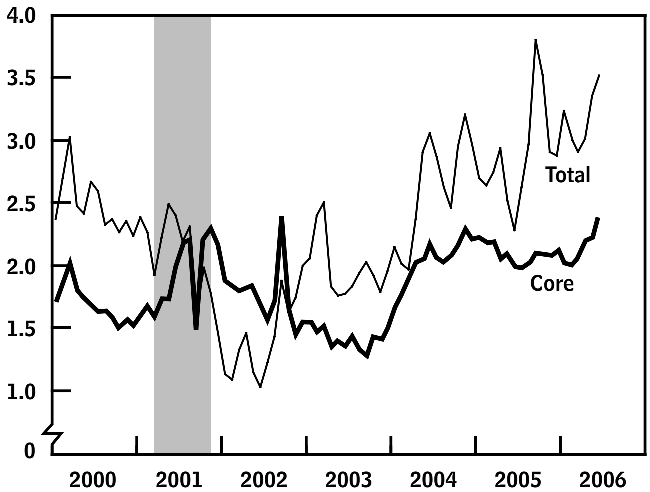
f. The consumer price index for all urban consumers.

g. The consumer price index excluding prices for food and energy.

Figure 2-1.

Total and Core Measures of the PCE Price Index

(Percentage change from previous year)



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

Notes: The total PCE price index is the personal consumption expenditure chained price index. The core PCE price index is the PCE price index excluding food and energy.

Data are monthly and are plotted through June 2006.

price level is now higher, the level of nominal GDP is only $12 billion lower than CBO's estimate from last January.[2]

Forecasts and projections by their very nature are uncertain, particularly in times of international conflict, and the actual course of the economy could be different from CBO's current outlook. Through the end of 2007, major economic developments that might result in a slower pace of growth than CBO anticipates are significantly higher energy prices; greater-than-expected inflation, which could trigger more monetary restraint by the Federal Reserve; a larger and much more widespread weakening in the growth of house prices; an unexpected slowing in economic growth among the United States' trading partners; or a major terrorist attack. Alternatively, the economy might grow more quickly than forecast if house prices and sales were stronger than expected, energy prices dropped significantly, or foreign economies expanded more than had been anticipated. Over the next 10 years, paths for productivity, labor force participation, and national saving that differ from CBO's projections could result in more or less growth than CBO anticipates.

2. See Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2007 to 2016* (January 2006).

Concerns About Higher Inflation

So far this year, overall consumer price inflation has remained higher than it has been in recent years, and core inflation has risen further above what many analysts believe is the Federal Reserve's "comfort zone" for price growth—that is, 1 percent to 2 percent (see Figure 2-1). That higher core inflation has raised concerns that monetary policy will be tightened more than had been expected, which might slow economic growth more sharply. That possibility will become more of a likelihood if households and businesses begin to think that inflation in the future will be higher than it has been. History has shown that when households and businesses raise their expectations, it can be especially difficult to moderate price growth without significantly slowing down economic growth—because workers and firms may seek higher wages and prices to try to protect their incomes from losing purchasing power.

Yet the evidence is mixed on the outlook for inflation. Although some indicators suggest that inflation could rise further, other indicators suggest that the recent rise may be largely temporary—provided that energy prices do not climb even higher. CBO's forecast incorporates the assumption that core inflation will ease over the next year and a half; however, inflation remains a major uncertainty in the economic outlook.

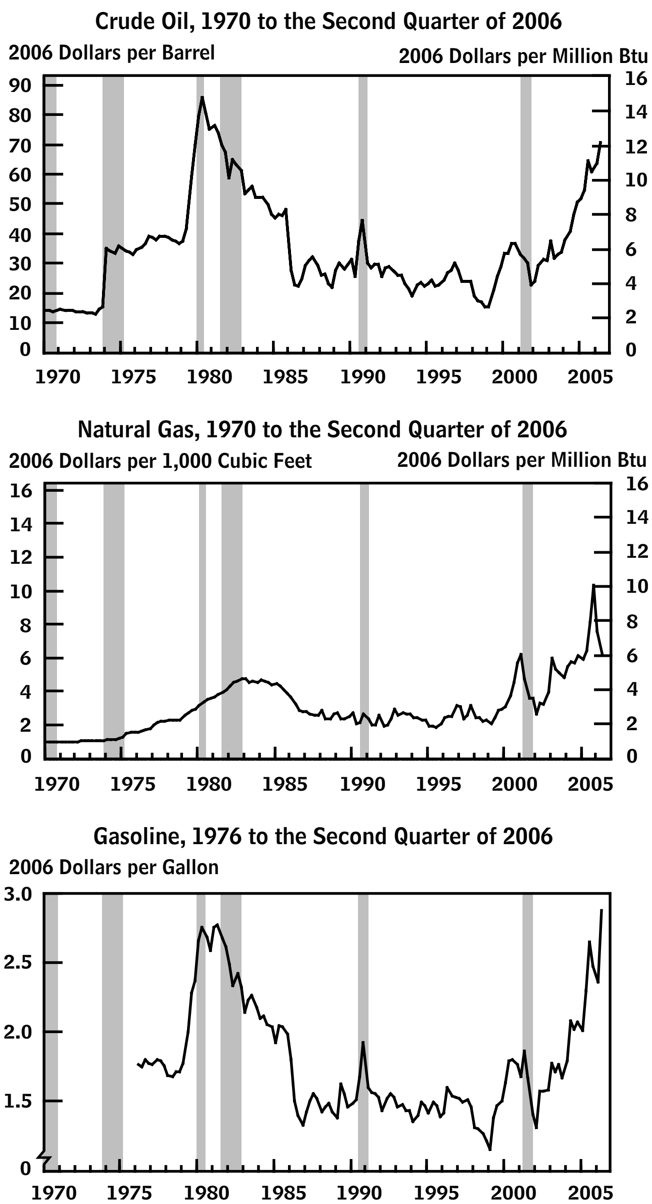
The Temporary Factor Pushing up Core Inflation in 2006

The jump in core inflation this year stemmed largely from a sizable increase in the measured cost of housing services—that is, rent rather than the price of houses.[3] After rising by 2.6 percent in 2005, the index of housing services rose by 3.4 percent in the first quarter of this year and by 5.0 percent in the second quarter.

3. A significant part of the overall housing services index is an estimate of the imputed rent for owner-occupied dwellings—essentially, what the owner could charge for renting the dwelling to someone else. In large part, that estimate is based on a survey of rents paid by people who live in apartments and other rental units.

Figure 2-2.

Crude Oil, Natural Gas, and Gasoline Prices



Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Energy, Energy Information Administration; Department of Labor, Bureau of Labor Statistics; *Wall Street Journal*.

Note: Crude oil prices are for West Texas Intermediate. Natural gas prices are wellhead prices, extended to 1970 using the producer price index for natural gas. (Btu are British thermal units.) Gasoline prices are average retail prices, including taxes, for regular unleaded. Series are converted to 2006 dollars using the GDP chained price index. For natural gas, the value for the second quarter of 2006 is estimated. All data are quarterly.

That increase will probably prove temporary, as have sharp jumps in the index in the past. One possible explanation for the recent rise is that in the estimate of imputed rental costs for homeowners, the cost of utilities is removed from the survey data on rents—a calculation that can make rental costs volatile when utility prices rise and fall. For example, natural gas prices rose rapidly in the second half of 2005 and then fell back equally sharply during the first half of 2006. If the changes in utility costs that those price changes produced were not reflected quickly in the rents in the survey, then subtracting utility costs from rents would temporarily push the rental cost index down, as gas prices rose, and then up, as gas prices fell. Such effects are likely to be transitory.

Key Determinants of the Inflation Outlook

Besides the reversal of temporarily faster growth in the price of housing services, the major determinants of the outlook for inflation are energy prices and the availability of productive resources (that is, labor and capital) relative to the growth of overall demand. The Federal Reserve's actions ultimately determine inflation by controlling the growth of demand for goods and services.

Energy Prices. Besides their direct impact on the level of prices through the cost of motor and heating fuels and electricity, energy prices affect the cost of other goods and services through the cost of the fuels used to produce and transport them and in some cases through the cost of industrial feedstocks (the raw materials required for industrial processes). In those ways, energy prices are an important determinant of core inflation as well as of overall inflation. The growth of energy prices may have raised core consumer inflation by about one-half of a percentage point in 2005 and, in CBO's estimation, will add a similar amount this year. Over the past two and a half years, rising energy prices have probably increased overall consumer inflation by nearly 1 percentage point (measured at an annual rate).[4]

Petroleum-based energy prices have been climbing over the past six months. Since the end of 2005, the price of crude oil (West Texas Intermediate) has risen by about $15 per barrel, reaching $74 in July 2006 (see Figure 2-2). That price hike stems from the strong world demand for oil and low level of investment in oil production when prices were much lower than they are now.

4. See Congressional Budget Office, *The Economic Effects of Recent Increases in Energy Prices* (July 2006).

Efforts by the petroleum industry to maintain higher-than-normal levels of inventories, perhaps in response to new uncertainty about supplies from the Middle East, may also be contributing to higher crude oil prices by limiting the available supply.

The rising cost of crude oil was part of the reason that the average retail price of regular gasoline increased during 2006, reaching $2.84 per gallon in the second quarter and $2.98 in July. Gasoline prices were also pushed up by the lingering effects of refineries' lost production following Hurricane Katrina, by federal regulatory changes that affected the production of gasoline, and by strong summer demand for gasoline and diesel fuel.

Although the price of natural gas has fallen sharply from its post-Katrina high, it remains historically elevated because of the upward trend in demand by households and electric utilities and temporarily reduced supplies as a result of the losses of gas production in the Gulf of Mexico.

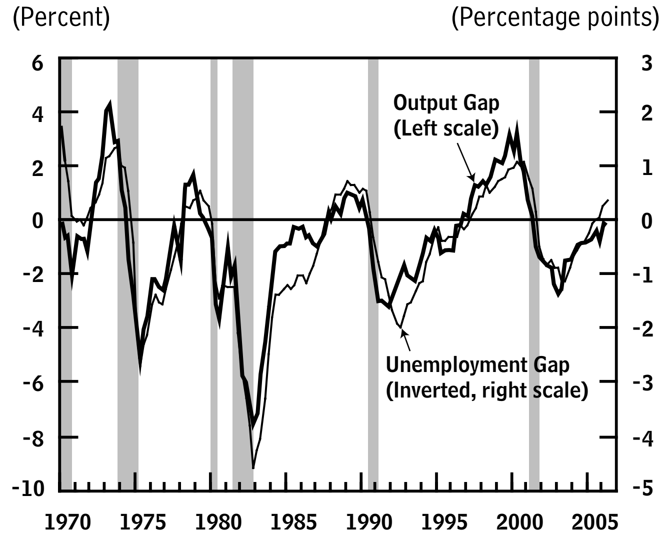
For the remainder of 2006 and 2007, CBO's current forecasts of prices for energy commodities generally reflect the prices in the futures market in mid-2006. Accordingly, prices for oil and gasoline in CBO's forecast remain near their current levels. Natural gas usage and prices, which are extremely sensitive to seasonal temperatures, were held down this year by the warm winter, resulting in higher-than-usual stocks during the summer. (The seasonally low price in July was $6.21 per 1,000 cubic feet.) In mid-2006, the futures market projected that prices would rise to an average of about $9 in 2007—an estimate that probably reflects the assumption that temperatures this winter will be closer to normal.[5] CBO assumes that after 2007, the prices of energy commodities will rise with general inflation, although considerable uncertainty surrounds that projection.

On the basis of the outlook for energy prices, CBO expects that energy costs will have little further effect on core inflation in 2007. That forecast reflects CBO's assumption that the effects of past increases in energy prices have largely been "passed through"—incorporated into the current prices of other goods and services.

5. Futures price contracts are for gas for delivery at the Henry Hub, a major interconnection point for natural gas pipelines. Prices at the wellhead (shown in Figure 2-2) average about 40 cents lower than those at the hub.

Figure 2-3.

Output and Unemployment Gaps



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

Notes: The output gap is the difference between actual GDP and potential GDP expressed as a percentage of potential GDP. (Potential GDP is the level of GDP that corresponds to a high level of resource—labor and capital—use.) The unemployment gap is the difference between the civilian unemployment rate and the natural rate of unemployment (the rate arising from all sources except fluctuations in overall demand).

Data are quarterly and are plotted through the second quarter of 2006.

Emerging Resource Constraints. Most estimates suggest that the economy has limited room to grow quickly without generating inflationary pressures. However, those estimates are uncertain, as are the effects of resource constraints on the extent of such pressures.

Several indicators provide mixed evidence about the degree of resource constraint in the labor market. The unemployment rate, at about 4¾ percent, has been somewhat below CBO's 5 percent estimate of the natural rate of unemployment, indicating some constraint on labor resources (see Figure 2-3); also, recent data show an acceleration in unit labor costs that could add to inflation. However, other data—from the employment cost index, usually thought to be more reliable—show no similar inflationary pressures. Moreover, the rate of unemployment has been below the estimated natural rate in some other periods, such as from 1997 to 2001, and at those times, core inflation was neither high nor rising.

Another common gauge of the degree of resource use —the difference, or gap, between GDP and potential GDP—suggests that the economy still has some, though not much, excess capacity. (Potential GDP is a benchmark measure that corresponds to a high rate of use of labor and capital.) Data for the manufacturing sector also indicate little underused productive capacity. (In June of this year, capacity utilization in manufacturing was essentially at its historical average of 81.2 percent.)

CBO's Forecast for Inflation

If oil prices remain at current levels and the recent increase in the growth rate of the price index for housing services proves transitory, growth of both core inflation and the overall PCE price index will decline to about 2 percent in 2007, CBO estimates. CBO expects some pressure from emerging constraints on resources that will partly offset the downward effect of assuming little further pass-through of higher energy prices.

The consumer price index for urban consumers (CPI-U), which affects CBO's projections of federal outlays, is expected to rise a little faster than the PCE price index, largely because of differences in weighting the price components. By 2007, inflation in the CPI-U in CBO's forecast slows to 2.5 percent, an estimate consistent with recent surveys of expectations about the future path of inflation. For several years, confidence in the policies of the Federal Reserve—confidence based on the fact that actual inflation has remained low—has kept people from expecting a rise in inflation. Those expectations are shared by professional forecasters, according to a survey of inflation forecasts collected by the Federal Reserve Bank of Philadelphia, which shows little if any increase in expected inflation in the next 10 years.

Nevertheless, the effects of the uncertainty that necessarily surrounds the inflation outlook, as discussed above, are apparent in the bond markets. On the basis of the yields on nominal and inflation-indexed Treasury securities, expectations about the five-year rate of CPI-U inflation five years down the road (currently, the rate of inflation for the 2012–2016 period) recently rose. In the past several years, that measure of inflation expectations had exhibited a downward trend, moving from a range of 2.75 percent to 3.25 percent (annual rate) in 2003 to between 2 percent and 2.25 percent for most of 2005. In the second quarter of 2006, however, the measure rose to between 2.5 percent and 2.75 percent.

The Outlook for Real Growth in 2006 and 2007

CBO based its economic forecast for 2006 and 2007 on its best judgments about short-term developments in the economy, including its assessment of how the business cycle is likely to affect that outlook. (By contrast, in its projections for later years, CBO mainly considered economic and demographic trends rather than attempting to forecast the timing and magnitude of future business cycles.)

The Business Sector

CBO assumes that investment by businesses (which accounts for about 11 percent of GDP, on average) will continue to propel economic growth in the second half of this year and in 2007. The growth of demand over the past few years, firms' currently high profits, and favorable conditions in the debt and equity markets will encourage businesses to make additional investments. Inventory accumulation by businesses is expected to increase by more than half of its relatively slow pace in 2005—a slowdown that in part reflected reductions in retail stocks of motor vehicles.

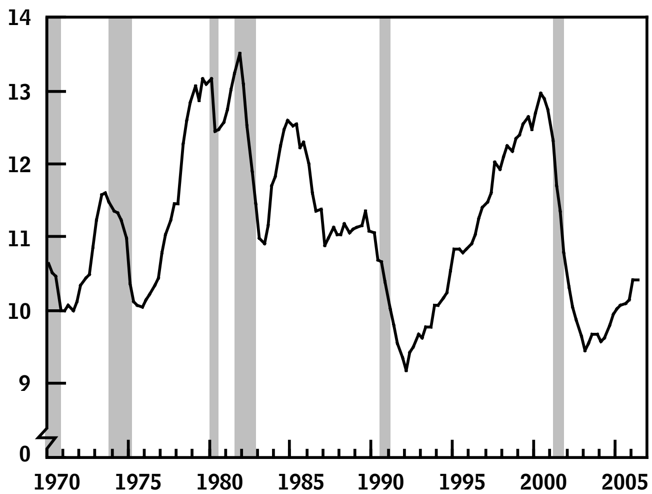
Business Fixed Investment. The outlook for investment by businesses in structures, equipment, and software remains strong. Since 2003, demand for goods and services has grown faster than productivity; as a result, firms need to add capacity to keep pace with sales. As of mid-2006, investment had not yet risen to a level at which the growth of the capital stock was keeping pace with the growth of demand for goods and services. Investment was also below its historical share of potential GDP (see Figure 2-4).

Although business fixed investment slowed in the second quarter of 2006, indicators of capacity utilization point to healthy growth during the rest of this year and in 2007. First, capacity utilization in manufacturing rose from 78.7 percent in June 2005 to 81.1 percent in June 2006, indicating that at recent rates of investment, growth in demand was still outpacing growth in supply. Second, semiannual surveys by the Institute for Supply Management show that the operating rate for nonmanufacturing firms rose from 86.9 percent to 88.4 percent between April 2005 and April 2006. Third, CB Richard Ellis, a private real estate research firm, reports that the vacancy

Figure 2-4.

Business Fixed Investment

(Percentage of potential gross domestic product)



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

Note: Data are quarterly and are plotted through the second quarter of 2006.

rate for office space during the second quarter of 2006 fell to its lowest level since 2001. And finally, Reis Inc., another such firm, notes that in the first quarter of 2006, the national office vacancy rate posted the largest quarterly drop in at least seven years—and then fell again in the second quarter. In addition, high oil and gas prices will continue to spur investment in exploration and wells.

Economic profits, at more than 12 percent of GDP in the first quarter, are at their highest level in 40 years and significantly above the post-World War II average of 9.4 percent of GDP.[6] Even though the level of profits might decline for several reasons (higher required contributions by firms to employee pension plans under the Employee Retirement Income Security Act and increases in wages, depreciation, and interest costs), economic profits should be ample to fund much of the increase in business investment that CBO forecasts.[7]

6. Economic profits are adjusted to remove distortions in depreciation allowances caused by tax rules and to exclude the effect of inflation on the value of inventories. They are considered a better measure of profits from current production than are the so-called book profits reported by corporations for tax purposes.

7. CBO assumes that under current law, contributions to defined-benefit pension plans will rise significantly in 2007.

A relatively low cost of funds also supports CBO's current outlook for business investment. In recent years, corporations' liabilities have dropped significantly relative to their assets, and at 45.1 percent in the first quarter, that ratio was the lowest in roughly two decades, indicating strong financial positions. The risk premium (the extra cost for private-sector borrowing, measured relative to the rates on government securities) has fallen consistently since 2002. The real cost of corporate borrowing, which reflects those factors, is expected to remain near its current level, which is close to the average for the post-World War II period. Similarly, there has been little increase in the real cost of raising funds through the equity markets.

Inventories. Inventory accumulation depends not only on techniques of inventory management, which have improved over time, but also on unexpected variations in sales. CBO assumes that inventory accumulation through 2007 will average between $30 billion and $40 billion annually (in 2006 dollars) after averaging $20 billion in 2005. If advances in management are significantly slower this year and next than they have been in recent years—as was the case, on average, between 1970 and 2000—inventory accumulation could be somewhat larger.

The Household Sector

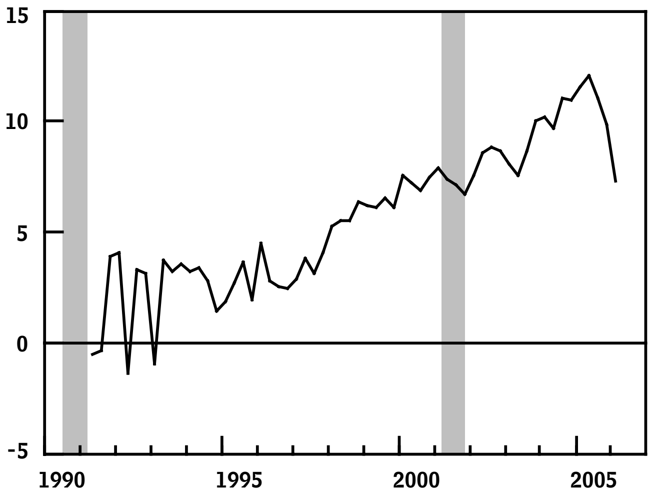
Real spending by households is likely to grow more slowly than output through 2007. CBO estimates that spending for consumer goods and services will grow at a modestly slower pace in light of continued high energy prices, less robust growth of households' net wealth (because of the cooling market for housing), and higher interest rates on consumer and mortgage loans. Residential investment is expected to fall in response to the significant drop over the past year and a half in the ability of households to afford a new home as well as the less optimistic outlook for gains from the appreciation of real estate. Although job growth is likely to be somewhat slower than it has been over the past several years, the growth of wages and salaries will remain strong this year, CBO forecasts, supporting households' spending.

Consumer Spending. The growth of consumer spending for goods and services has been erratic during recent quarters, but overall, its pace appears to have slowed. The growth of consumer purchases, measured as the percentage change from a year ago, stayed within a range of roughly 3½ percent to 4 percent for most of 2004 and

Figure 2-5.

Prices of Houses

(Percentage change at an annual rate)



Sources: Congressional Budget Office; Office of Federal Housing Enterprise Oversight.

Notes: The measure of house prices in this figure is the house price purchase-only index published by OFHEO. The index (which is based on transactions involving conforming, conventional mortgages purchased or securitized by Fannie Mae or Freddie Mac) measures average price changes in repeat sales of the same single-family properties.

Data are quarterly and are plotted from 1991 through the first quarter of 2006.

2005 but fell to only 3 percent to 3½ percent during the first half of 2006. That slowdown was primarily due to weak spending in two areas: energy goods and services (because of the relatively mild winter weather and possibly some conservation stemming from higher energy prices) and motor vehicles and parts (because of fewer purchases of light trucks such as sport-utility vehicles, presumably a response in part to high prices for gasoline). Excluding energy and motor vehicles and parts, however, the course of consumer spending has changed very little this year.

The outlook through 2007 is for a modest further slowdown in the growth of consumer spending. Continued high prices for energy are likely to lower the amount of energy demanded by consumers and further shift sales of vehicles away from light trucks. The growth of all other consumer spending is likely to slow because of lower real income and the slower growth of households' wealth as a result of the cooling housing market. According to the seasonally adjusted purchase-price index of the Office of Federal Housing Enterprise Oversight, house prices grew at an annual rate of 7.3 percent in the first quarter of 2006, down from 11.2 percent for all of last year and the slowest rate of increase since that for the last quarter of 2001 (6.7 percent), which coincided with the end of the last recession (see Figure 2-5). In addition, the growth rates (measured on a year-over-year basis) of both the median and average prices of new homes continue to slow.

Another factor in the slowing growth of consumer spending is a slight increase in interest rates on consumer and mortgage loans, which raises the cost of borrowing and lessens the attractiveness of cashing out equity from homes through the mortgage market.

Labor Markets. The labor market remains healthy, supporting a moderate outlook for the growth of households' spending. Although the rate of growth of nonfarm employment, as measured by the establishment survey conducted by the Bureau of Labor Statistics (BLS), dropped from 1.7 percent in the first quarter of 2006 to 1.2 percent in the second, the rate as measured by BLS's household survey was higher, averaging 2.1 percent in the first half of the year.[8] Moreover, weekly initial claims for unemployment insurance have averaged about 315,000 over the past several months, a rate consistent with continued economic expansion. CBO's forecast of job growth (as measured in the establishment survey) averages 1.4 percent in the second half of 2006 and 1.3 percent in 2007.

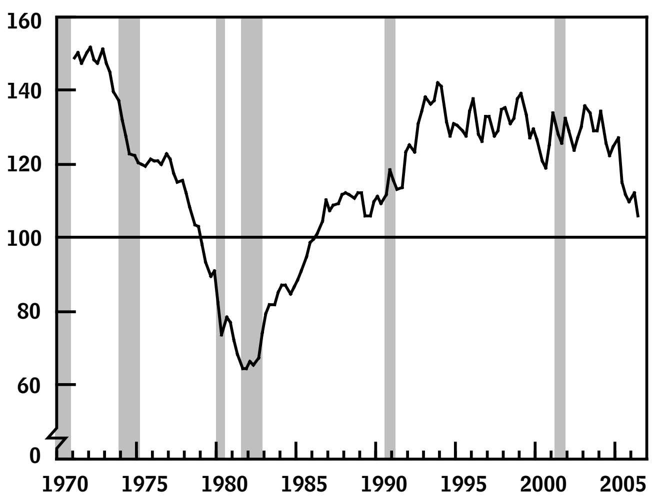
The growth of total wages and salaries strengthened in the first half of this year, and CBO expects that stronger pace to continue. Nominal income from wages and salaries is expected to grow by roughly 6 percent this year and next. In its forecast of wage and salary growth, CBO assumes that average hourly earnings (of production and nonsupervisory workers) will continue to grow by between 3 percent and 3½ percent. Growth of wages and salaries will support consumer spending and contribute to some rise in the personal saving rate.

8. The household survey measure is derived from the Current Population Survey (CPS), a monthly survey of households conducted by the Bureau of the Census for BLS. It provides a comprehensive body of data on the labor force, employment, unemployment, and individuals not in the labor force. The growth rate in the CPS measure is adjusted for a break in the underlying population estimate between December 2005 and January 2006.

Figure 2-6.

Housing Affordability Index

(Index)



Sources: Congressional Budget Office; National Association of Realtors.

Notes: A housing affordability index value of 100 means that a family with the median income has exactly enough income, with a down payment of 20 percent, to qualify for a mortgage on a median-priced single-family home. An index above 100 signifies that a family earning the median income has more than enough income to qualify for a mortgage loan on a median-priced home.

Data are quarterly and are plotted from 1971 through the second quarter of 2006.

Housing. For the past two years, the housing market has experienced unusually rapid growth in the price of homes, facilitated by low mortgage rates and—in some regions in recent years—possibly high expectations of gains from appreciation. Now, though, the housing market has lost some of its upward momentum. The growth of home sales has moderated as potential buyers have found home ownership less affordable in the face of rising house prices and mortgage interest rates and what appear to be less promising gains from appreciation (see Figure 2-6). In June, monthly sales of new plus existing single-family homes were nearly 9 percent lower than at the same time last year. Slowing demand has led to sharply increasing numbers of new and existing homes on the market, especially on the East and West Coasts. As housing inventories have accumulated across the nation, builders have reduced the number of housing starts. (Since January, starts of single-family homes have declined in most months, and in June of this year, the number of homes begun was 14 percent below the number begun in June 2005.) Housing starts are expected to decline through 2007 to help work off the excess inventory.

Under the assumption that mortgage interest rates will be modestly higher and the growth of income and employment will be moderate, housing construction and sales are likely to continue to decline further, and the growth of home prices is likely to slow through the end of 2007. CBO expects that real residential investment will fall, on average, by about 6 percent this year and next, measured on a fourth-quarter-over-fourth-quarter basis.

Uncertainty About the Household Sector. The primary factors that could cause spending by households to be faster or slower than CBO has projected are the paths of energy prices, households' net worth (including house values), mortgage interest rates, and personal saving. Consumer spending could falter if energy prices rose significantly, reducing real disposable income and possibly boosting core inflation—which might prompt a further tightening of monetary policy. Under that scenario, the housing market might decline further, an outcome that would adversely affect households' net worth, especially if it led to a significant decline in house prices nationwide. Higher mortgage interest rates might lead to significantly more defaults on adjustable-rate mortgages whose terms are due to be adjusted in the upcoming year and whose loan balances may consequently grow to exceed the value of the homes, particularly if house prices fall markedly. By contrast, consumer spending could be stronger than CBO projects if wage growth is faster, energy prices drop significantly below current levels, or the housing market heats up again.

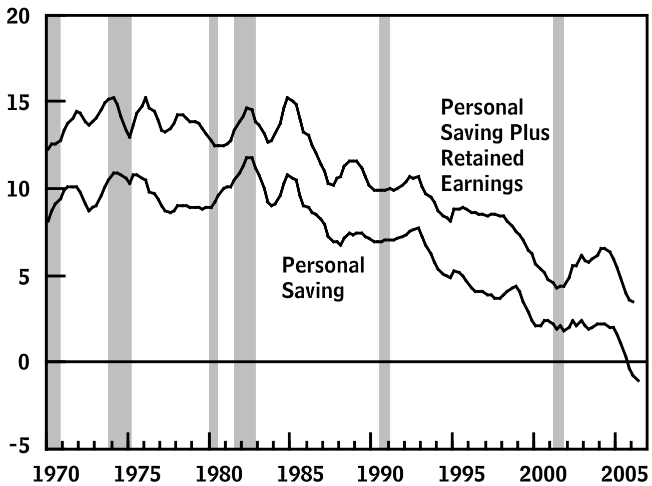
A greater desire on the part of households to raise their personal net worth could also slow the growth of consumer spending. For more than a year, the personal saving rate, as measured in the national income and product accounts, has been negative, indicating that, on average, consumers have been spending more than their disposable income.[9] Given the uncertainty that surrounds

9. Disposable income is income that individuals receive (including transfer payments) minus the taxes and fees they pay to governments. In the NIPAs, personal saving equals disposable income minus outlays by consumers. Thus, it does not include saving in the form of capital gains on real estate and other assets.

Figure 2-7.

Personal Saving Plus Firms' Retained Earnings

(Percentage of disposable personal income)



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

Notes: The value for retained earnings (firms' undistributed profits) for the second quarter of 2006 was unavailable at the time of publication. Disposable personal income is the income that individuals receive, including transfer payments, minus the taxes and fees they pay to governments.

Data were smoothed using a four-quarter moving average and are plotted through the second quarter of 2006.

the future course of inflation, interest rates, and the housing market, households might increase their saving for precautionary purposes. CBO has incorporated a small rise in personal saving in its forecast, but consumers could decide to save much more.

Alternatively, favorable economic developments, such as a rebound in the housing market, could result in less saving of disposable income. Households might also decide not to increase their saving if they are stockholders and view increases in stock values—such as those stemming from corporations' retained earnings (undistributed profits)—as part of their personal saving. Including retained earnings in an adjusted, broader measure of personal saving produces a much higher measure of saving by households, although it is still only about a third of its postwar average of 11.6 percent of disposable personal income (see Figure 2-7).

The Government Sector

Government purchases of goods and services are not expected to grow as fast as the economy, reflecting CBO's assessment that the growth of demand on the part of states and localities will continue at roughly recent rates and the assumption (based on the conventions of CBO's projections for the federal budget—see Chapter 1) that the pace of federal purchases will slow a bit in the near term. The growth of federal consumption plus investment spending (as measured in the NIPAs) has varied widely in recent quarters but on average has slowed economic growth in the first half of 2006. Similarly, the growth of purchases by state and local governments has been slower than output growth thus far this year, even though it accelerated from the very slow pace prevailing in the past few years as a result of tighter budgetary constraints.

Supplemental appropriations for defense and other activities enacted in June, which are extrapolated into future years at a specified rate of inflation under CBO's baseline procedures, have boosted CBO's current-law projection for federal purchases, compared with the projection in CBO's January 2006 budget outlook.[10] The supplemental legislation included $70 billion for activities in Iraq and Afghanistan, mainly for compensation, fuel, materials, and equipment. It also included another $24 billion, mostly related to recovery from Hurricane Katrina.

The growth of purchases by state and local governments is expected to remain faster than its weak pace in recent years but slower than the growth of the economy. That stronger trend in spending, however, could be tempered if the growth of revenues slowed. In addition, purchases could be slowed if state and local governments decided to address their unfunded pension liabilities, which recent estimates put in the neighborhood of $250 billion to $350 billion. (Those figures can be compared with estimated total state and local revenues in the first half of 2006 of roughly $1.8 trillion, measured at an annual rate and on a NIPA basis.)[11] However, the potential budget-

10. See Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2007–2016*, and *What Is a Current-Law Economic Baseline?* (June 2005).

11. See Wilshire Associates Inc., *2006 Wilshire Report on State Retirement Systems: Funding Levels and Asset Allocation* (March 2006). The Public Fund Survey of the National Association of State Retirement Administrators reports similar estimates.

ary problems posed by unfunded pensions and other retiree benefits (such as health insurance) are not expected to greatly influence overall state and local budget decisions in the 2006–2007 period.[12]

The International Sector

The U.S. trade deficit increased during the first half of 2006 and is expected to grow throughout the rest of this year. CBO anticipates that in 2007, the trade deficit will decline slightly, as foreign economies continue to rebound, the dollar continues its downward adjustment, and oil prices remain near current levels. Faster growth of exports will help account for that expected narrowing, but slower growth of imports is likely to play a larger role. Over the 2008–2016 period, the trade deficit and the current-account deficit are both expected to decline gradually relative to GDP.

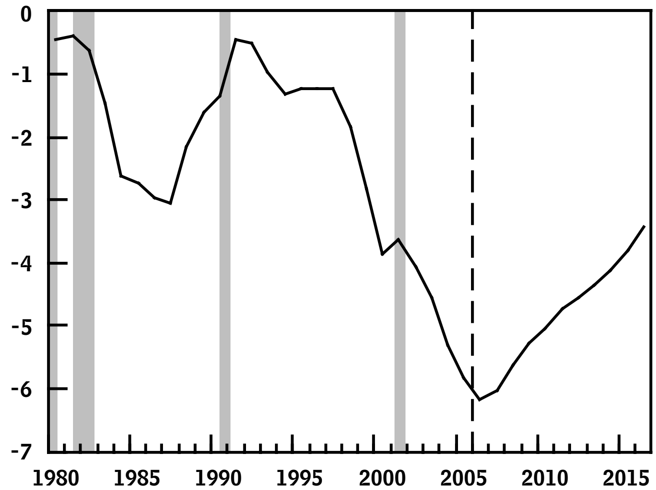
Trade Deficit. In the first half of 2006, the nominal trade deficit (exports minus imports) averaged about $775 billion, or 5.9 percent of GDP—a level approximately $95 billion higher than in the first half of 2005. Higher oil prices contributed to those record deficits by increasing the amount spent on oil imports; higher prices may also have added to the trade deficit indirectly by lowering interest rates and stalling the dollar's depreciation.[13]

In real terms, exports have grown significantly faster than imports throughout most of the past year and a half, reversing a trend of many years. After rising by 6.7 percent over the four quarters of last year, real exports grew at an average annual rate of 8.5 percent in the first half of 2006 (mainly in the first quarter), with most of that strength concentrated in goods. Real imports grew by 5.2 percent over the four quarters of 2005 and at an average annual

Figure 2-8.

The U.S. Trade Deficit

(Percentage of gross domestic product)



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

Note: Data are annual and are plotted through 2016.

rate of 4.5 percent in the first half of this year (also mainly in the first quarter). The growth of real imports of capital goods has been especially vigorous this year; by contrast, the level of real imports of petroleum and petroleum products has fallen. CBO expects some weakening next year (compared with the first half of this year) in the growth of real demand for imports as a result of continued high oil prices, the depreciating dollar, and the slowdown in consumer spending more generally. By contrast, CBO expects stronger growth of real exports as a result of improving economic activity abroad and the dollar's depreciation.

CBO does not anticipate any significant reduction in the trade deficit in coming years, although as GDP grows, the deficit will begin to fall as a share of output (see Figure 2-8). Because the level of imports is about one and a half times that of exports, exports must grow one and a half times as fast as imports simply to keep the trade deficit from growing. Because mounting U.S. liabilities will eventually lead to declines in net international investment income, the current-account deficit is projected to continue to grow slightly in dollar terms and to narrow by somewhat less than the trade deficit as a percentage of GDP. CBO projects that the current-account deficit, which was $835 billion in the first quarter of 2006, will

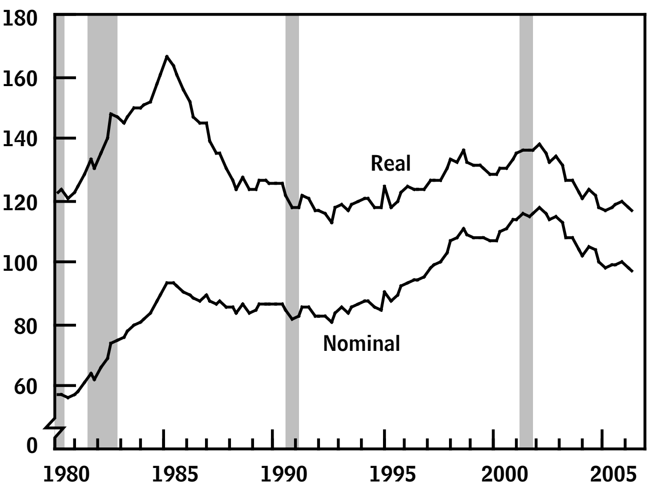
12. Recent changes in accounting procedures recommended by the Governmental Accounting Standards Board (GASB) call on states and localities to more explicitly account for unfunded liabilities for health insurance and other postemployment benefits. The GASB guidelines will be fully phased in for fiscal years that begin after December 2008. See GASB Statement No. 43 (April 2004) and No. 45 (June 2004).

13. The surge in oil prices from roughly $35 per barrel in the beginning of 2004 to about $74 per barrel in the middle of 2006 has effectively increased saving in the rest of the world, boosting purchases of U.S. assets and providing extra liquidity to U.S. financial markets. Thus, oil price hikes may have indirectly contributed to the widening of the trade deficit by interrupting the depreciation of the dollar and the rise of long-term interest rates.

Figure 2-9.

The Trade-Weighted Value of the U.S. Dollar

(Index)



Sources: Congressional Budget Office; Federal Reserve Board.

Notes: The trade-weighted value of the U.S. dollar is a weighted average of the foreign exchange values of the dollar against the currencies of a large group of the United States' major trading partners. The index weights, which change over time, are based on a country's share of U.S. imports and exports. The real trade-weighted value is adjusted for changes in relative prices.

Data are quarterly and are plotted through the second quarter of 2006.

stay between $900 billion and $1 trillion a year through 2016 and, correspondingly, that foreign investors will continue to lend sums of that magnitude to the United States.

Exchange Value of the Dollar. CBO expects the dollar, measured on a trade-weighted basis, to continue its downward adjustment, depreciating by 1 percent to 3 percent per year (in nominal terms) as a result of the large U.S. current-account deficit and the corresponding growth in the United States' international liabilities. The dollar had been depreciating for nearly three years, since early in 2002; then, during most of 2005, the downward adjustment stalled, in large part because of short-term factors that have either faded or begun to fade.[14] So far this year, the dollar has depreciated by about 3 percent (see Figure 2-9). That adjustment has occurred not only in relation to currencies against which the dollar has been dropping for several years (such as the euro and the Japanese yen) but also in relation to the currencies of Asian countries other than Japan, including China, Korea, and Singapore, against which the dollar has depreciated relatively little for many years.

Economic Growth Outside the United States. The economies of the United States' trading partners grew rapidly in the second half of last year, despite the negative effects of higher oil prices. Strong growth in China and a resumption of growth in Japan combined with continuing economic robustness in Canada, in newly industrialized countries, and in other emerging economies. In the first half of this year, China's economy continued its rapid expansion, led by investment and net exports. Real GDP in China grew by 10.9 percent from the first half of 2005 to the first half of 2006, following growth of 9.9 percent from 2004 to 2005. Japan's economy (real GDP) grew by 3.1 percent in the first quarter of this year (measured as an annual rate), following solid 4.0 percent growth in 2005. Among economies whose currency is the euro, signs of revival are also evident: growth of real GDP rose to a 2.4 percent annual rate in the first quarter of this year (after growth of 1.7 percent in 2005) and is expected to exceed 2 percent for the year overall.

The acceleration in economic growth abroad has prompted many central banks, especially the European Central Bank and the Bank of Japan, to tighten their monetary policies to contain inflationary pressures. More-restrictive financial conditions coupled with high oil prices suggest that the growth of foreign economies may moderate somewhat. Nevertheless, CBO expects that solid domestic demand for goods and services in other countries will spur economic growth in those nations. Such growth will continue to be robust—with rates of roughly 4 percent this year and next—and exceed the rate of expansion of the U.S. economy, on average, over the next 10 years.

Monetary Policy and Financial Market Conditions

Because of higher inflation in recent months, it currently appears that monetary policy will maintain a slightly re-

14. Those factors include a very accommodative monetary policy in Japan while U.S. monetary policy was moving toward restraint; the sharp rise in oil-exporting countries' revenues, which such nations tend to invest in dollar assets; and the increase in the repatriation of overseas profits prompted by the American Jobs Creation Act of 2004, which boosted the demand for dollar assets during its roughly one-year duration.

strictive stance this year and next. The federal funds rate is now likely to remain above the so-called neutral rate of 4 percent to 5 percent—a range that many analysts believe roughly balances the goals of sustainable growth and low inflation in the current financial environment. As a result, other interest rates have risen, and the spread, or difference, between rates on short-term and long-term securities has widened. Despite the increase in interest rates, however, overall financial conditions are still contributing to the growth of demand in the economy.

Monetary Policy. CBO's outlook for a slightly restrictive monetary policy reflects its view that the Federal Reserve intends to keep core inflation at an acceptably low level as well as maintain what are currently low expectations of future inflation. The central bank increased its target for the federal funds rate to 5.25 percent in June and then, in August, paused in its rate hikes—the first time the target has not been raised in 17 meetings of the Federal Open Market Committee (the group within the Federal Reserve System that determines the stance of monetary policy). In early August, the consensus among the approximately 50 forecasters surveyed for the *Blue Chip* economic indicators was that one further 25-basis-point increase might be possible, taking the federal funds target to 5.5 percent by the end of 2006. (A basis point is one-hundredth of a percentage point.) CBO shares that view but does not expect the federal funds rate to persist at a higher level unless inflation increases further. If core inflation subsides next year, as CBO forecasts, the target for the federal funds rate is likely to move down toward the neutral range.

Interest Rates. The rate on three-month Treasury bills, which was nearly 5 percent in July, is expected to climb to 5.2 percent by year's end and then recede to 5.0 percent by the end of 2007, a path that reflects CBO's expectations about monetary policy. The rate on 10-year Treasury notes—5.1 percent in July—is expected to reach 5.5 percent by the end of this year and remain elevated, at 5.4 percent, through 2007. Those estimates imply that the spread between the rates on Treasury notes and bills will stay near its mid-2006 level of 40 basis points through 2007.

Borrowing terms in the private sector are somewhat less favorable now than they were earlier in the year. Since April, the rate on Aaa corporate bonds has been above 5.8 percent, compared with last December's level of 5.4 percent. Similarly, the rate on Baa corporate bonds has risen, moving from 6.3 percent in December to 6.8 percent in July, and rates on 30-year conventional mortgages have also climbed from about 6.3 percent to 6.8 percent. At the same time, interest-rate spreads between Treasury and private securities have fallen slightly this year. If, instead, those spreads had widened to a significant degree, resulting in yet higher rates in the private sector, private credit would have become more costly, thus tending to slow economic activity even more. In addition, a widening of the spreads would have suggested an increased risk of default. Analysts expect default rates on corporate bonds and bank loans to rise during the next year or so but not beyond levels that financial institutions can be expected to absorb without significant effects on their profits.

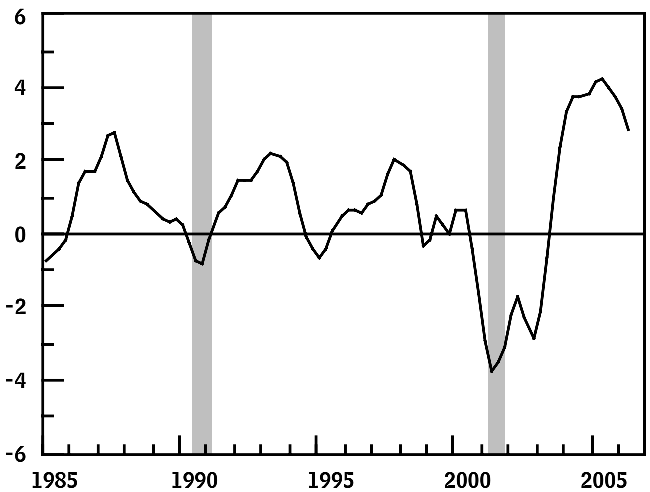
Financial Conditions. Monetary and financial conditions are still conducive to growth, but they are becoming less so. According to an index constructed by Macroeconomic Advisors, LLC, the contribution of financial variables (such as interest rates, real exchange rates, and households' wealth) to the growth of real GDP fell from 3.8 percent in the fourth quarter of 2005 to 2.9 percent in the second quarter of 2006, a level indicating that overall financial conditions were making the smallest contribution to the growth of real GDP since the last quarter of 2003 (see Figure 2-10). During the first half of 2006, two components of that index—the federal funds rate and the corporate bond rate—were dampening growth; by contrast, two other components—households' wealth and the depreciation of the dollar—were contributing significantly to growth. Conditions in the financial markets are expected to slow economic growth through 2007 as the effects of restrictive monetary policy spread across credit markets and the rate of growth of households' wealth declines.

Uncertainty and Risks. Although monetary and financial conditions currently do not seem to pose a significant risk to the growth of GDP, some aspects of world financial markets may increase the possibility that economic growth will slow. In recent months, for example, those markets have experienced correlated movements; most notably, stock markets in many countries dropped sharply—by roughly 5 percent in May—and in general have not yet fully rebounded. Synchronous movements of that sort mean that a weakening in stock markets in the United States is reinforced by a weakening in international stock markets. Such movements thus raise the

Figure 2-10.

Index of Monetary and Financial Conditions

(Percentage points of GDP growth)



Sources: Congressional Budget Office; Macroeconomic Advisers, LLC.

Notes: This index estimates how much financial conditions contribute to the growth rate of real, or inflation-adjusted, GDP (gross domestic product). It draws on statistical relationships between real GDP and financial variables such as interest rates, exchange rates, and stock market values. When the index is positive, overall conditions in financial markets are conducive to the growth of real GDP; when the index is negative, overall financial market conditions are a drag on growth.

Data are quarterly and are plotted through the second quarter of 2006.

possibility that U.S. economic growth will be affected by large and abrupt downturns in equity markets.

The growth of global hedge funds could pose another risk to worldwide financial markets. Hedge funds can increase the efficiency of global financial markets, but the risks associated with large, overly leveraged funds became a focus of concern when the Federal Reserve in 1998 helped in the private sector's restructuring of the hedge fund Long Term Capital Management. The ongoing attention to such risks since then by the Federal Reserve and other key participants in financial markets here and abroad has led to various steps to broadly improve risk management and monitoring.[15] As a result, despite the growth in the number and complexity of hedge funds, the markets appear thus far to be capable of weathering financial turbulence (such as the large decline in stock prices in May). At the same time, the markets' ever-growing complexity implies that concerns about the risks associated with global hedge funds will continue.

The Outlook Through 2016

CBO projects that real GDP will grow at an average annual rate of 2.8 percent during the 2008–2016 period, or at the same pace as that of potential GDP. (Those rates are very similar to the estimates that CBO published in January 2006.) Inflation as measured by the growth of the PCE index will average 2.0 percent during the period, CBO estimates, and CPI-U inflation, 2.2 percent. Unemployment will average 5.0 percent, identical to CBO's estimate of the natural rate of unemployment. Over the period, the rate on three-month Treasury bills will average 4.5 percent (4.4 percent after 2009), and the rate on 10-year Treasury notes will average 5.2 percent.

To develop its estimates for 2008 to 2016, CBO projects paths for the factors that underlie potential GDP, such as the growth of the labor force (a variable that determines total hours worked), capital services (the productive services provided by the economy's capital stock), and total factor productivity (TFP).[16] In doing so, CBO takes into account the effect that current fiscal policy may have on those variables, but it does not attempt to forecast business-cycle fluctuations beyond the next two years.

15. For additional discussion, see "Remarks by Chairman Ben S. Bernanke: Hedge Funds and Systemic Risk," May 16, 2006, available at www.federalreserve.gov/boarddocs/speeches/2006/200605162/default.htm.

16. Total factor productivity is average real output per unit of combined labor and capital services. The growth of total factor productivity is defined as the growth of real GDP that is not explained by the growth of labor and capital.

Table 2-2.

Key Assumptions in CBO's Projection of Potential Output

(By calendar year, in percent)

	Average Annual Growth						Projected Average Annual Growth		
	1950–1973	1974–1981	1982–1990	1991–1995	1996–2005[a]	Total, 1950–2005[a]	2006–2011	2012–2016	Total, 2006–2016
					Overall Economy				
Potential Output	3.9	3.2	3.1	2.6	3.3	3.4	3.0	2.6	2.8
Potential Labor Force	1.6	2.5	1.6	1.2	1.2	1.6	0.9	0.5	0.7
Potential Labor Force Productivity[b]	2.3	0.7	1.5	1.4	2.1	1.8	2.1	2.1	2.1
					Nonfarm Business Sector				
Potential Output	4.0	3.6	3.3	3.0	3.7	3.7	3.4	3.0	3.2
Potential Hours Worked	1.4	2.3	1.7	1.2	1.1	1.5	1.0	0.7	0.8
Capital Input	3.7	4.2	3.9	2.7	4.4	3.8	4.3	3.7	4.0
Potential TFP	1.9	0.7	0.9	1.4	1.6	1.5	1.5	1.5	1.5
Potential TFP excluding adjustments	1.9	0.7	0.9	1.3	1.3	1.4	1.3	1.3	1.3
TFP adjustments	0	0	0	*	0.2	*	0.1	0.1	0.1
Price measurement[c]	0	0	0	*	0.1	*	0.1	0.1	0.1
Temporary adjustment[d]	0	0	0	0	0.1	*	0	0	0
Contributions to the Growth of Potential Output (Percentage points)									
Potential hours worked	0.9	1.6	1.2	0.8	0.8	1.0	0.7	0.5	0.6
Capital input	1.1	1.3	1.2	0.8	1.3	1.2	1.3	1.1	1.2
Potential TFP	1.9	0.7	0.9	1.4	1.6	1.5	1.5	1.5	1.5
Total Contributions	4.0	3.6	3.3	3.0	3.7	3.7	3.4	3.0	3.2
Memorandum:									
Potential Labor Productivity in the Nonfarm Business Sector[e]	2.6	1.3	1.6	1.8	2.6	2.2	2.4	2.3	2.4

Source: Congressional Budget Office.

Note: TFP = total factor productivity; GDP = gross domestic product; * = between zero and 0.05 percent.

a. Values as of early July 2006, prior to the revisions to the national income and product accounts.

b. The ratio of potential output to the potential labor force.

c. An adjustment for a conceptual change in the official measure of the GDP chained price index.

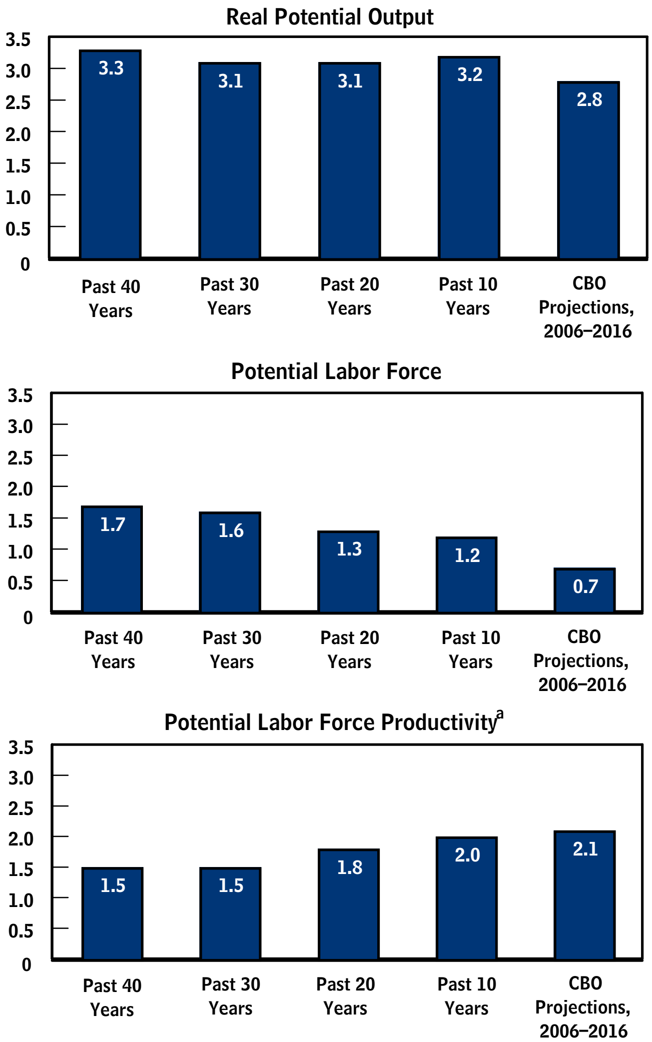
d. An adjustment for the unusually rapid growth of TFP between 2001 and 2003.

e. The estimated trend in the ratio of output to hours worked in the nonfarm business sector.

Figure 2-11.

Real Potential Output, Potential Labor Force, and Potential Labor Force Productivity

(Average annual growth rate)



Source: Congressional Budget Office.

Note: Growth rates are rounded.

a. Potential labor force productivity is the ratio of real potential GDP (the level of inflation-adjusted gross domestic product that corresponds to a high level of resource—labor and capital—use) to the potential labor force (the labor force adjusted for movements in the business cycle).

Potential Output

Growth of potential output (potential GDP) will average 2.8 percent during the years from 2006 to 2016, CBO projects (see Table 2-2 on page 35). Over the course of that period, the growth of potential GDP slows, averaging 3 percent annually from 2006 to 2011 and then subsiding to 2.6 percent, on average, from 2012 to 2016. The slowdown arises largely because of declining growth in the potential labor force.

The projected rate of growth of potential output is lower than its average pace of 3.3 percent over the past 40 years (see Figure 2-11). The drop is due to slower growth in the potential labor force, which expands at a rate 1.0 percentage point slower than its 40-year average of 1.7 percent. By contrast, the capital stock and TFP are projected to grow at rates that are closer to their long-run averages, implying a larger-than-average increase in capital per worker. As a result, potential labor force productivity (or potential GDP per potential labor force member) grows more quickly over the 10 years of CBO's projection than it has in most of the postwar period.

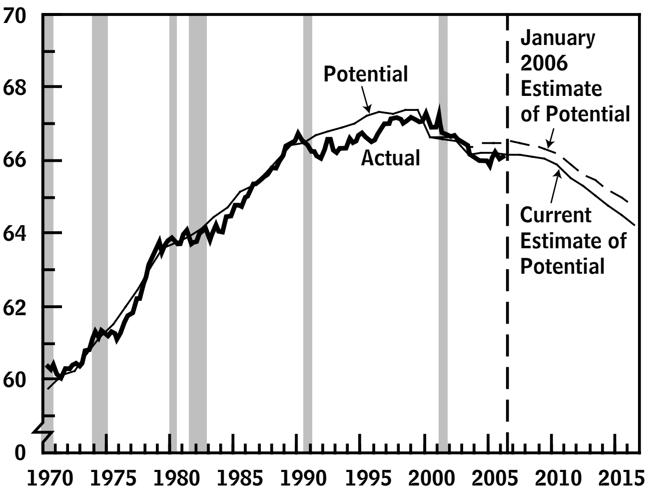
Labor Force and Hours Worked. CBO projects that the potential labor force will grow at an average annual pace of 0.7 percent during the 2006–2016 projection period, a rate slightly lower than that projected last January and considerably below the average rate of growth during the past several decades. The decrease stems largely from demographic forces, as more and more of the large cohort of workers born during the postwar baby boom retire. The drop also stems from the expected effects that the expiration of several tax provisions will have on the supply of labor. When those provisions (contained in the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003) expire at the end of 2010, the marginal tax rate on labor (the rate on the last dollar of income) will rise, decreasing people's incentives to work and somewhat reducing the potential labor supply.

Compared with its estimates of last January, CBO has made three changes that together have resulted in a downward revision to potential hours worked for both 2005 and the 2006–2016 period (see Box 2-1).

Figure 2-12.

Actual and Potential Labor Force Participation

(Percent)



Sources: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics.

Notes: The potential labor force participation rate is the rate consistent with full employment.

For the actual participation rate, data are quarterly and are plotted through the second quarter of 2006. For potential participation rates, data are annual and are plotted through 2016.

- First, CBO has lowered its estimate of the rate of labor force participation—and hence its view of what the labor force would be if the economy was operating at its potential—both for 2005 and through 2016 (see Figure 2-12). Much of the decline in participation that has occurred in recent years—particularly for younger workers and women ages 25 to 54—appears to be more permanent than transitory. That change has the effect of reducing potential output throughout the years of CBO's outlook.

- Second, CBO has lowered its estimate of the natural rate of unemployment (the rate that would prevail, on average, in the absence of cyclical fluctuations) from 5.2 percent to 5.0 percent. That change raises potential output throughout the projection period but not by enough to fully offset the effect of a lower potential level of the labor force.

- Third, CBO has incorporated in its forecast the assumption that average hours per worker per week will decline more slowly than they have in recent years. Although that change does not affect the current level of potential output, it does increase potential output slightly by 2016.

Capital Services. Capital services will grow during the projection period, in CBO's estimation, at an average annual rate of 4.0 percent, which is slightly below the pace of 4.1 percent that CBO projected in January. The estimate has been reduced, even though the level of business investment in CBO's current projections is higher and investment grows faster during the 2006–2016 period than CBO had projected in January. The difference stems from a change in the composition of investment relative to what CBO had assumed last winter. Specifically, CBO's current projection incorporates the assumption that business investment will shift toward assets that provide slightly lower levels of capital services per year (such as nonresidential structures) and away from assets that provide relatively higher levels of services (such as producers' durable equipment and software).

Total Factor Productivity. Potential total factor productivity (potential TFP) is expected to rise at an average annual rate of 1.5 percent during the 2006–2016 period, up slightly compared with CBO's January projection. The upward revision in the projected growth rate results in part from new data and in part from CBO's downward revision to the natural rate of unemployment (which is used to calculate potential TFP). A lower estimate of the natural rate, all else being equal, implies that potential GDP is higher relative to actual GDP than was previously thought—and that in turn implies a higher value for potential TFP than had previously been estimated.

Inflation, Unemployment, and Interest Rates

For the most part, CBO's outlook for inflation during the 2008–2016 period has not changed much since January. Core and overall inflation as measured by the PCE price index are both projected to average 2.0 percent over the period, an outlook based on the assumption that the Federal Reserve will manage to keep inflation in check. Overall CPI-U inflation will average 2.2 percent, CBO projects, and the growth of the GDP price index will average 1.8 percent. The unemployment rate is expected to average 5 percent.

Box 2-1.

Changes in CBO's Assumptions About the Labor Market

Over the past five years, the growth of the labor force, employment, and hours worked in the nonfarm business sector has continued to be slower than the growth expected on the basis of past business cycles. As a consequence, the Congressional Budget Office (CBO) has changed its projections of those variables.

The Labor Force

Since the end of the 2001 recession, the growth of the labor force has consistently fallen short of expectations. Until now, CBO had assumed that the decline in the labor force participation rate—from 67.1 percent in 2000 to a low of 65.8 percent in the first quarter of 2005 and an average of 66.1 percent during the first half of 2006—was largely a cyclical phenomenon; consequently, CBO expected that participation would rebound significantly, as would the labor force.[1] But that rebound has failed to materialize. In particular, the participation rate of women ages 25 to 54 has dropped, reversing a long upward trend, and participation rates have fallen sharply for teens and dropped for young adults (see the figure to the right). CBO now believes that a large portion of the decline in participation is permanent rather than cyclical—that is, the overall participation rate is unlikely to regain much of the ground that it has lost.[2]

In its current forecast, CBO has reduced its estimate of the potential participation rate for 2005—the rate consistent with full employment—to 66.2 percent, only slightly higher than the actual participation rate during the first half of 2006 (see Figure 2-12 on page 37). CBO's current revision to participation rates follows a series of smaller revisions since 2004.[5]

For 2016, the lower potential participation rate in CBO's current projection reduces the level of the projected labor force by a million people (to 161.7 million) compared with last January's projection; that drop corresponds to a reduction—from 64.7 percent to 64.2 percent—in the potential participation rate for that year. (The decline in the rate between 2005 and 2016 mainly reflects the retirement of more and more baby boomers, an element of CBO's labor force projections that has not changed significantly since 2004.)

1. See Congressional Budget Office, *CBO's Projections of the Labor Force* (September 2004).

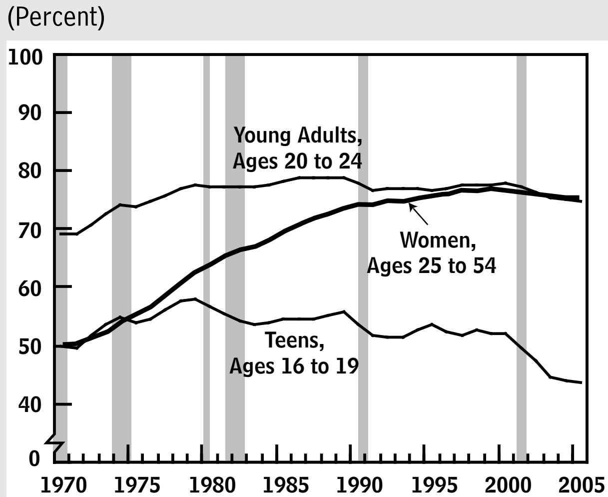
2. Economists at the Federal Reserve Board have reached a similar conclusion. They also suggest that the cyclical component reflects exceptional strength during the late 1990s at least as much as it reflects the 2001 recession and subsequent period of slow growth. See Stephanie Aaronson and others, *The Recent Decline in the Labor Force Participation Rate and Its Implications for Potential Labor Supply*, Brookings Papers on Economic Activity (Washington, D.C.: Brookings Institution, forthcoming).

3. In CBO's January forecast, the potential participation rate was 66.5 percent. See Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2007 to 2016* (January 2006).

Box 2-1.

Continued

Labor Force Participation Rates, Selected Groups



Sources: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics.

Note: All data are annual.

The Natural Rate of Unemployment

CBO's lower estimate of the natural rate of unemployment is directly related to the downward revision in its estimate of the potential labor force and reflects the lower participation rates since 2000 for teens and young adults. The teenage unemployment rate stood at 16.6 percent in 2005; if the teen participation rate had not fallen but remained at its 2000 level, the overall unemployment rate would have been 0.1 percentage point higher than it actually was.[4] The declining participation rate among 20- to 24-year-olds and the increase in the share of the labor force composed of people ages 55 and older (who have below-average unemployment rates) have also reduced the natural rate by an additional 0.1 percentage point since the late 1990s. However, the projected composition of the labor force over the next 10 years implies no further drop from the 2005 level.

Average Weekly Hours

A third revision affecting CBO's assumptions about the labor market involves the length of the workweek. CBO's January forecast incorporated the assumption that the downward trend in average weekly hours per worker in the nonfarm business sector would continue at the same rate throughout the projection period. In the current projection, by contrast, that downward trend slows to less than half its pace of the past 20 years. The change reflects CBO's view that the downward trend is largely attributable to a shift in the composition of employment by industry—specifically, the rapid decline that has occurred in the share of employment accounted for by manufacturing. (The workweek for production workers in manufacturing averaged 41.1 hours during the first half of 2006, compared with 33.8 hours for all production and nonsupervisory workers in the private sector.)[5] The change CBO has made in its assumptions reflects its view that the pace of compositional change will slow and manufacturing employment will rebound somewhat in response to firms' strong investment spending and a depreciating dollar.

4. CBO assumed for that estimate that the declining teen participation rate affected neither the teen unemployment rate nor the labor force status of adults.

5. During the 1970s and early 1980s, by contrast, the decline in average weekly hours largely reflected the increasing share of part-time work that accompanied the rapid rise in women's labor force participation over that period. However, the percentage of workers employed part time has not increased further over the past two decades.

The rate on three-month Treasury bills will average about 4.5 percent during the 2008–2016 period, in CBO's estimation, and the rate on 10-year Treasury notes will average 5.2 percent. To project nominal interest rates in that period, CBO added expected inflation (its projection of the CPI-U) to its estimates of real interest rates. The real interest rate on three-month Treasury bills is projected to average 2.3 percent during the 2008–2016 period and the real rate on 10-year Treasury notes, 3 percent.[17]

CBO's current projection of the real long-term rate is the same as the estimate it published in January; however, its current projection of the real short-term rate over the next 10 years is 0.1 percentage point higher—because projected rates are higher from 2006 through 2009. During the 2010–2016 period, real short-term rates average 2.2 percent, identical to the rate that CBO projected in January.

Projections of Income

CBO's economic projections are the basis for its projections of federal revenues. Most directly affecting the outlook for revenues are projections of the various categories of national income as measured in the NIPAs: specifically, wages and salaries, corporate profits, proprietors' income, interest income, and dividend income.[18] Although those categories do not precisely correspond to the income concepts reported on tax forms for calculating tax liabilities, projections of them provide an important starting place for CBO's estimates of federal revenues.

CBO projects the components of national income as shares of output, or GDP. At the broadest level, GDP can be divided into a share for labor income, a share for capital income, and a share that reflects taxes on production and imports. Those shares have been fairly stable during the postwar period, averaging 62.3 percent for labor, 29.9 percent for capital, and 7.8 percent for taxes.

Labor income consists of the total compensation that employers pay their employees—that is, the sum of wages and salaries and supplemental benefits (the employer's share of health and other insurance premiums and employers' contributions to pension funds)—and the employer's share of payroll taxes (Social Security and Medicare). In addition, CBO assumes that about 65 percent of proprietors' income is part of labor's share of GDP. Capital income consists of domestic corporate profits, depreciation charges, interest and transfer payments made by domestic businesses, rental income, and the remaining 35 percent of proprietors' income.

Recent NIPA data indicate that labor's share of GDP during the last half of 2005 and the first half of 2006—about 61.4 percent of GDP—was low relative to its historical average; however, CBO anticipates that that share will rise during the rest of this year. CBO projects that in subsequent years, labor's share of income will gradually revert to its historical average (see Figure 2-13).

Wages and salaries is the single most important category of income for projecting revenues, making up the largest part of the income base that is used to project individual income taxes and to estimate payroll taxes (including contributions by employers and employees). Estimates from the NIPAs indicate that the wage and salary share of GDP was smaller in late 2005 and early 2006 than it had been during the past decade. However, CBO anticipates that over the next two years, the labor market will be tight enough to put upward pressure on wages and salaries and their share of GDP is likely to rebound.

CBO projects faster growth of benefits than of GDP over the next 10 years. In the short term, that increase comes from payments to pension plans: firms must make additional contributions to their underfunded defined-benefit pension plans. For the most part, businesses will not pay the required contributions for 2006 until 2007—resulting in a jump in those payments next year. Beyond 2007, the growth of benefits is mainly attributable to the growth of employers' contributions for health insurance.

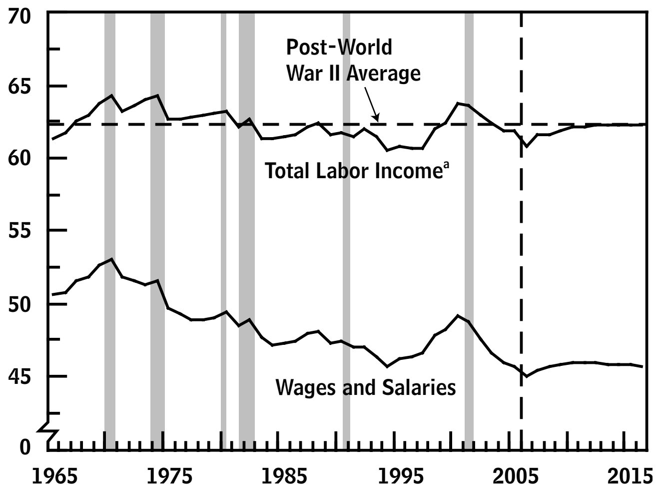
17. The estimates of real rates are based on two economic assumptions. First, the real long-term rate on Treasury securities is assumed to converge to the real return to nonfinancial capital assets (structures, equipment, and software) after an adjustment for the risk of default inherent in financial claims on private assets. Second, the real short-term rate on bills is assumed to converge to a lower level. The difference between long- and short-term rates reflects, among other things, the fact that interest rates on long-term bonds include a premium for the uncertainty that surrounds future interest rates. In its economic projections for the next 10 years, CBO incorporates the assumption that the spread between the rates increases from 40 basis points in 2007 to 80 basis points, which is much lower than the average of 140 basis points for the post-World War II period as a whole.

18. See Congressional Budget Office, *How CBO Forecasts Income* (forthcoming).

Figure 2-13.

Labor Income

(Percentage of gross domestic product)



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

Note: Data are annual and are plotted through 2016.

a. The total compensation that employers pay their employees, including benefits, the employer's share of payroll taxes, and some proprietors' income.

Capital's share of GDP will move inversely with that of labor, declining rather quickly during the next few years and then trending down more slowly. Corporate economic profits, which account for roughly a third of capital's GDP share, are forecast to fall even more than the overall share will. During the next two years, businesses' interest payments, which reduce profits, are likely to climb, as interest rates continue to rise and corporate debt increases. After 2007, profits will fall as a share of GDP, in CBO's estimation, mainly because of a steady increase in costs for depreciation. Such costs have generally been declining since the 2001 recession because investment was at a low ebb from 2001 until mid-2003 and the corporate capital stock thus grew slowly. However, in CBO's current projection, depreciation costs increase relative to GDP because of faster growth in investment and in the capital stock.

The basis for projecting corporate tax liabilities is not economic profits but book profits. Book profits more closely track the profits that firms report under Internal Revenue Service (IRS) rules for depreciation, inventory valuation, and the like. By contrast, economic profits use economic principles for depreciation and inventory valuation rather than IRS rules. Book profits have deviated sharply from economic profits in recent years because the IRS rules for depreciation were temporarily changed under the partial-expensing provisions of the Job Creation and Worker Assistance Act of 2002 and JGTRRA, which permitted much larger depreciation charges than economic estimates of depreciation implied. CBO projects that over the next 10 years, book profits will gradually decline relative to economic profits.

Changes in the Outlook Since January 2006

Changes to CBO's economic forecast since January have increased both projected revenues and projected outlays for the 2006–2016 period—but revenues have been boosted to a greater degree than outlays have. Thus, the changes to CBO's economic outlook have reduced its projections of the budget deficit. CBO's current projections do not include the effects of the late-July revisions to the NIPAs (see Box 2-2).

In response to current developments, CBO has slightly reduced its estimate of the growth of real GDP over the next five years (see Table 2-3 on page 45). As a result, the level of real GDP throughout the 2006–2016 period is lower than that projected in January. At the same time, however, the rate of growth in the GDP price index has been raised for 2006 and 2007 (as have forecasts of other inflation measures). The net effect of those two changes is to decrease the level of nominal GDP by about $206 billion from 2008 to 2016, or about 0.1 percent of cumulative GDP for that period. In the short term, nominal GDP is higher than CBO had projected last January.

By itself, the downward revision to nominal GDP after 2007 would slightly reduce projected revenues, whereas the upward revisions for 2006 and 2007 would slightly raise them. However, CBO has substantially increased its projection of corporate profits relative to GDP for the years 2006 to 2011, and especially in the early years of that period, because data from the NIPAs indicated that profits for the first quarter of 2006 were much stronger than CBO had projected in January. (In part, profits were stronger because large payments by corporations to their defined-benefit pension plans that had been incorporated into CBO's projections did not appear in the NIPA numbers.) In response to the information from the NIPAs and the estimated effects of H.R. 4, the Pension Protection Act of 2006, CBO has raised its estimate of cumulative

Box 2-2.

Recent Revisions to the National Income and Product Accounts

Each July, the Department of Commerce's Bureau of Economic Analysis (BEA) releases a revised set of national income and product accounts (NIPAs). Typically, the revisions cover the previous three years and reflect new sources of data, changes to previously published data, and methodological changes. BEA released its latest revised estimates of gross domestic product (GDP) and other data on July 28, 2006.[1] (The revisions affected data for 2003 through the first quarter of 2006.) Those changes came too late to be incorporated in the Congressional Budget Office's (CBO's) current economic forecast, but CBO's preliminary assessment indicates that the revised data are unlikely to have a major impact on the broad outlines of its economic and budget projections.

In general, those revised data show that the rate of economic growth during the past three years has been lower and inflation slightly higher than was previously thought. Growth of real (inflation-adjusted) GDP for the years 2003 through 2005 is now estimated to average 3.2 percent annually, down from the previously estimated 3.5 percent. The primary reasons for that reduction are lower estimates of business fixed investment (especially for spending on equipment and software) and a reduction in personal consumption expenditures for nondurable goods (particularly food but also energy). Investment in residential structures was revised slightly upward.

As a result of the revisions, average annual growth of the GDP price index was faster (2.7 percent instead of 2.5 percent) during the 2003–2005 period than had previously been reported. That change occurred primarily because of higher estimates of growth in the prices of residential structures and in government consumption and investment expenditures. Measures of core inflation (excluding food and energy) were also revised upward to a slight degree. Growth in the core price index for personal consumption expenditures is now estimated to average 1.8 percent during the 2003–2005 period, up about 0.1 percentage point compared with the estimate before the revision.

BEA substantially revised several categories of income, but on balance, the effects of its changes to the data for taxable components of income were relatively small. For example, it lowered the estimate of labor compensation in the NIPAs by $37 billion for

1. BEA will publish details of the July 28 revisions in the August 2006 edition of *Survey of Current Business*, available at www.bea.gov.

corporate profits for the 2006–2010 period by roughly $640 billion, relative to its January estimate.[19] For 2011 to 2016, CBO has reduced profits by $171 billion compared with January's estimate because of lower nominal GDP and corporate profits' slightly smaller share of output.

At the same time, wages and salaries for the first half of 2006 were lower than CBO had projected in January. As a result, CBO has reduced the estimated level of wages and salaries throughout the 10-year period by about $26 billion per year, compared with its estimates last winter.

Changes in CBO's projections of inflation, unemployment, and interest rates all affect its projections of budget outlays. CBO has raised its projection of inflation in the CPI-U price index for this year and next to a significant degree, and that change will increase outlays for various programs, including cost-of-living adjustments for federal retirement programs (which are indexed for inflation). In addition, CBO has boosted its forecast of interest rates slightly, on average, from 2006 to 2009, thus adding somewhat to federal interest costs. By contrast with those

19. Among its other provisions, the Pension Protection Act of 2006 (at the time of this writing, awaiting signature by the President) extends from five years to seven (or more) the time sponsors of underfunded defined-benefit plans may take to make the required catch-up contributions to their pension funds.

Box 2-2.

Continued

2004 and $83 billion for 2005. However, much of that revision was caused by changes to the estimate of employer-provided health care and pension benefits, which are excluded from the tax base. BEA's revision to wages and salaries was smaller, with upward changes of less than $3 billion for 2003 and 2004, a downward change of $47 billion for 2005, but little change for the first half of 2006. Moreover, the new pattern of year-to-year growth in wages and salaries conforms better to the pattern in tax withholding data for the past year and a half.

Similarly, BEA's revised data for corporate profits are more consistent with the strength in corporate tax receipts observed during 2004 and 2005. Economic profits were revised upward (by $21 billion) for 2004 and then downward by about the same amount for 2005.[2] However, book profits (the measure that more closely tracks income that is taxed) were revised upward by $85 billion for 2004 and $80 billion for 2005. The revision in book profits stems from a sharp reduction in BEA's estimate of the amount of depreciation that corporations claimed in 2004 and 2005 in response to changes in tax law in 2002 and 2003. (A smaller estimate of corporate depreciation deductions raises book profits because depreciation is deducted from income for tax purposes.)

The revisions to the NIPAs may affect CBO's outlook slightly when complete information on them—including the revisions to capital stocks—is available and CBO has analyzed their implications. For example, the trend growth in CBO's estimate of potential GDP may be revised downward because of BEA's downward revision to output growth in recent years. However, it is unclear at present whether the revisions would significantly change CBO's view of the economy or its projections. Similarly, the revisions would not significantly affect CBO's baseline budget projections. Wage and salary disbursements, the primary income category for CBO's revenue forecasting, were revised only modestly, and the projections anticipated a substantial share of the revised estimates of book profits.

2. Economic profits are the profits of corporations, adjusted to incorporate more-accurate depreciation allowances than those specified in the tax rules and to exclude the effect of inflation on the value of inventories. Economic profits are a better measure of profits from current production than are book profits, which are calculated using book (or tax) depreciation and standard accounting conventions for inventories.

changes, CBO has lowered its projection of the unemployment rate by about 0.2 percentage points throughout the 2006–2016 period, and that modification reduces outlays, mainly for unemployment insurance.

Comparison with Other Forecasts

CBO's economic forecast differs in some ways from those of the Administration and the *Blue Chip* consensus of about 50 private-sector forecasters (see Table 2-4 on page 46). In general, however, those differences are not large.

CBO's forecast for 2006 and 2007 does not differ for the most part from the Administration's or the *Blue Chip*'s. CBO expects less real growth than the Administration does in 2007, measured on a fourth-quarter-to-fourth-quarter basis, but higher growth than the *Blue Chip* consensus expects in both 2006 and 2007. CBO's forecast of inflation, as measured by the growth in the GDP price index, is lower than both the Administration's and the *Blue Chip*'s for both years. Although CBO expects more consumer price inflation in 2006 than the Administration does, its forecast of inflation in the CPI-U for 2007 is lower. CBO anticipates a slightly lower rate of unemployment than that forecast by the Administration for 2006 and a rate slightly lower than the *Blue Chip*'s for 2007. Three-month Treasury bill rates for 2006 are slightly less in CBO's than in the *Blue Chip*'s forecast; for 2007, rates are higher in CBO's forecast than in the

Administration's. CBO's estimate of the rate for 10-year Treasury notes is slightly higher than the Administration's for 2006; for 2007, CBO's forecast is the highest.

For the 2008–2011 period, CBO projects less real growth and less inflation but a slightly higher rate of unemployment than the Administration does. (The *Blue Chip*'s estimates do not extend past 2007.) In addition, CBO projects a lower interest rate than the Administration does for 10-year Treasury notes but the identical rate for three-month Treasury bills.

Table 2-3.

CBO's Current and Previous Economic Projections for Calendar Years 2006 to 2016

	Actual	Forecast		Projected Annual Average	
	2005[a]	2006	2007	2008 to 2011	2012 to 2016
Nominal GDP (Billions of dollars)					
August 2006	12,487	13,308	13,993	16,914[b]	21,052[c]
January 2006	12,494	13,262	13,959	16,954[b]	21,064[c]
Nominal GDP (Percentage change)					
August 2006	6.4	6.6	5.1	4.9	4.5
January 2006	6.5	6.1	5.3	5.0	4.4
Real GDP (Percentage change)					
August 2006	3.5	3.5	3.0	3.0	2.6
January 2006	3.6	3.6	3.4	3.1	2.6
GDP Price Index (Percentage change)					
August 2006	2.8	3.0	2.0	1.8	1.8
January 2006	2.7	2.4	1.8	1.8	1.8
Consumer Price Index[d] (Percentage change)					
August 2006	3.4	3.5	2.5	2.2	2.2
January 2006	3.4	2.8	2.2	2.2	2.2
Unemployment Rate (Percent)					
August 2006	5.1	4.7	4.8	5.0	5.0
January 2006	5.1	5.0	5.0	5.2	5.2
Three-Month Treasury Bill Rate (Percent)					
August 2006	3.1	4.8	5.0	4.5	4.4
January 2006	3.2	4.5	4.5	4.4	4.4
Ten-Year Treasury Note Rate (Percent)					
August 2006	4.3	5.1	5.4	5.2	5.2
January 2006	4.3	5.1	5.2	5.2	5.2
Tax Bases (Billions of dollars)					
Corporate book profits					
August 2006	1,438	1,781	1,641	1,587[b]	1,884[c]
January 2006	1,434	1,451	1,438	1,555[b]	1,901[c]
Wages and salaries					
August 2006	5,712	5,994	6,354	7,771[b]	9,619[c]
January 2006	5,723	6,050	6,383	7,785[b]	9,647[c]
Tax Bases (Percentage of GDP)					
Corporate book profits					
August 2006	11.5	13.4	11.7	10.1	9.0
January 2006	11.5	10.9	10.3	9.4	9.0
Wages and salaries					
August 2006	45.7	45.0	45.4	45.8	45.8
January 2006	45.8	45.6	45.7	45.9	45.8
Memorandum:					
Real Potential GDP (Percentage change)					
August 2006	2.9	3.1	3.2	3.0	2.6
January 2006	3.0	3.2	3.2	3.0	2.6

Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

Note: Percentage changes are year over year; GDP = gross domestic product.

a. Values as of early July 2006, prior to the revisions to the national income and product accounts.

b. Level in 2011.

c. Level in 2016.

d. The consumer price index for all urban consumers.

Table 2-4.

Comparison of CBO, Administration, and *Blue Chip* Forecasts for Calendar Years 2006 to 2011

	Actual 2005[a]	Forecast 2006	Forecast 2007	Projected Annual Average, 2008 to 2011
	Fourth Quarter to Fourth Quarter (Percentage Change)			
Nominal GDP				
CBO	6.4	6.3	5.0	4.8
Administration	6.4	6.6	5.7	5.3
Blue Chip consensus	6.4	6.3	5.2	n.a.
Real GDP				
CBO	3.2	3.6	3.1	3.0
Administration	3.2	3.6	3.3	3.1
Blue Chip consensus	3.1	3.3	2.8	n.a.
GDP Price Index				
CBO	3.1	2.6	1.9	1.8
Administration	3.1	2.9	2.3	2.1
Blue Chip consensus	3.1	2.9	2.3	n.a.
Consumer Price Index[b]				
CBO	3.7	3.2	2.2	2.2
Administration	3.7	3.0	2.4	2.5
Blue Chip consensus	3.7	3.2	2.5	n.a.
	Calendar Year Average (Percent)			
Unemployment Rate				
CBO	5.1	4.7	4.8	5.0
Administration	5.1	4.8	4.8	4.9
Blue Chip consensus	5.1	4.7	4.9	n.a.
Three-Month Treasury Bill Rate				
CBO	3.1	4.8	5.0	4.5
Administration	3.2	4.8	4.7	4.5
Blue Chip consensus	3.2	4.9	5.0	n.a.
Ten-Year Treasury Note Rate				
CBO	4.3	5.1	5.4	5.2
Administration	4.3	5.0	5.2	5.5
Blue Chip consensus	4.3	5.0	5.2	n.a.

Source: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board; Council of Economic Advisers, Department of the Treasury, and Office of Management and Budget, "Administration Economic Forecast" (joint press release, July 11, 2006); Aspen Publishers, Inc., *Blue Chip Economic Indicators* (August 10, 2006).

Notes: The *Blue Chip* consensus is the average of about 50 individual *Blue Chip* forecasts. The latest *Blue Chip* consensus does not extend past 2007.

GDP = gross domestic product; n.a. = not applicable.

a. Values for CBO and the Administration do not incorporate the July 2006 revisions to the national income and product accounts. Values for the *Blue Chip* consensus do incorporate those revisions, but they are probably not fully incorporated in the *Blue Chip* projections.

b. The consumer price index for all urban consumers.

APPENDIX

A

Changes in CBO's Baseline Since March 2006

In the five months since the Congressional Budget Office (CBO) published its previous baseline budget projections, its estimate of the deficit for fiscal year 2006 has declined significantly.[1] That decrease results mainly from higher-than-anticipated revenues this year. On the outlay side of the budget, spending for some programs in 2006 will be lower than previously estimated, but those changes are more than offset by spending from supplemental appropriations enacted in June.

The cumulative deficit that CBO is projecting for the 2007–2016 period has increased by $1 trillion since March (see Table A-1). That change does not represent a significant revision to the budget outlook, however. Rather, it results from extrapolating nearly $95 billion in recently enacted supplemental appropriations, as required by the statutory rules that govern the baseline. CBO's view of the underlying budget and economic outlook for the next decade has not changed materially in recent months.

When CBO updates its 10-year baseline projections, it divides the changes into three categories according to their cause:

- Enacted legislation,
- Changes to CBO's economic outlook, and
- Other, so-called technical factors that affect the budget.[2]

Legislative changes have added about $30 billion to this year's estimated deficit and $1.4 trillion to the total deficit projected for the 2007–2016 period (mostly because of the extrapolation of recent supplemental appropriations). Economic and technical changes to the baseline—which are more reflective of the underlying budget outlook—have reduced the estimated 2006 deficit by $107 billion and the total 10-year deficit by $411 billion.

The Effects of Recent Legislation

Supplemental funding enacted in the past five months has had a major impact on CBO's 10-year projections of discretionary outlays. Other laws enacted since March have had a small effect on projected outlays, but they have reduced projected revenues for the 2007–2016 period by $145 billion.

Discretionary Spending

Recent laws have added an estimated $95 billion in discretionary budget authority and $25 billion in discretionary outlays to this year's budget totals—mostly from additional appropriations provided for military opera-

1. In *An Analysis of the President's Budgetary Proposals for Fiscal Year 2007* (March 2006), CBO estimated that the 2006 deficit would total $336 billion under current law and $371 billion if the President's proposals (including supplemental appropriations for operations in Iraq and Afghanistan and funding for hurricane relief) were enacted. This appendix compares CBO's latest baseline budget projections with the current-law estimates from March. (The comparisons at the beginning of Chapter 1 relate to the March estimates that included the President's budgetary proposals.)

2. The categorization of such changes should be interpreted with caution. For example, legislative changes represent CBO's best estimates of the future effects of laws enacted since the previous baseline was prepared. If a new law proves to have different effects than CBO initially estimated, the difference will appear as a technical change in later versions of the baseline. The distinction between economic and technical changes is similarly imprecise. CBO classifies economic adjustments as those resulting directly from changes in the components of its economic projections (interest rates, inflation, the growth of gross domestic product, and so on). Changes in other factors related to the economy (such as the size of capital gains realizations) are shown as technical adjustments.

Table A-1.

Changes in CBO's Baseline Projections of the Deficit or Surplus Since March 2006

(Billions of dollars)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Total, 2007-2011	Total, 2007-2016
Total Deficit (-) or Surplus as Projected in March 2006	-336	-265	-250	-224	-216	-117	58	53	74	91	70	-1,072	-726
Changes to Revenue Projections													
Legislative	-4	-32	-7	-21	-16	-7	-6	-12	-13	-14	-16	-84	-145
Economic	18	35	33	26	20	17	14	12	13	13	12	130	196
Technical	77	51	48	27	3	7	11	8	8	10	7	135	180
Total Revenue Changes	**90**	**53**	**74**	**32**	**7**	**17**	**19**	**9**	**8**	**9**	**4**	**182**	**231**
Changes to Outlay Projections													
Legislative													
Mandatory outlays													
Pension Protection Act	0	*	*	*	-1	-1	-1	-1	-1	-1	-1	-2	-5
Other	*	2	*	*	*	*	*	*	*	*	*	2	2
Subtotal, mandatory	*	2	*	*	-1	-1	-1	-1	-1	-1	-1	*	-3
Discretionary outlays													
Defense	22	51	65	69	72	74	75	77	78	80	82	331	721
Nondefense	4	14	21	26	29	29	29	30	30	31	32	119	271
Subtotal, discretionary	25	65	86	96	101	102	104	106	108	110	113	450	992
Net interest outlays (Debt service)	*	4	9	15	20	26	33	40	47	55	63	75	313
Subtotal, legislative	**26**	**72**	**95**	**110**	**120**	**128**	**136**	**145**	**155**	**165**	**176**	**525**	**1,301**
Economic													
Mandatory outlays													
Social Security	0	4	5	5	5	5	5	6	6	6	7	26	57
Other	-2	*	1	2	1	1	1	*	-1	-1	-1	6	3
Subtotal, mandatory	-2	5	6	7	7	7	6	5	5	6	6	31	60
Discretionary outlays	*	2	3	3	3	4	4	4	4	4	4	16	36
Net interest outlays													
Debt service	*	-1	-2	-3	-3	-3	-4	-4	-4	-5	-5	-13	-34
Rate effect/inflation	4	9	11	8	4	3	2	1	1	1	1	36	41
Subtotal, net interest	4	8	9	6	1	*	-2	-3	-3	-4	-4	23	8
Subtotal, economic	**3**	**15**	**18**	**16**	**11**	**10**	**8**	**6**	**6**	**6**	**7**	**70**	**104**

Continued

Table A-1.

Continued

(Billions of dollars)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Total, 2007-2011	Total, 2007-2016
Changes to Outlay Projections (Continued)													
Technical													
Mandatory outlays													
Medicaid	-8	-4	-2	-1	-1	-1	-1	-1	*	*	*	-9	-12
Student loans	8	*	*	*	*	*	*	*	*	*	*	*	*
Other	-9	*	-4	-2	*	1	1	1	2	3	2	-3	6
Subtotal, mandatory	-10	-4	-6	-3	*	1	*	1	2	2	2	-13	-6
Discretionary outlays	-3	-1	*	*	*	*	*	*	*	*	*	-1	-1
Net interest outlays													
Debt service	-1	-6	-9	-12	-13	-14	-15	-16	-17	-18	-19	-54	-137
Other	-1	*	-1	*	*	*	1	1	1	1	1	-1	5
Subtotal, net interest	-2	-7	-10	-12	-13	-13	-13	-15	-15	-17	-18	-54	-132
Subtotal, technical	**-14**	**-12**	**-16**	**-14**	**-13**	**-12**	**-13**	**-14**	**-14**	**-14**	**-16**	**-68**	**-139**
Total Outlay Changes	**14**	**75**	**96**	**112**	**118**	**126**	**130**	**138**	**147**	**156**	**167**	**527**	**1,266**
Total Impact on the Deficit or Surplus[a]	**76**	**-21**	**-23**	**-80**	**-112**	**-110**	**-111**	**-129**	**-139**	**-147**	**-163**	**-346**	**-1,035**
Total Deficit as Projected in August 2006	-260	-286	-273	-304	-328	-227	-54	-76	-64	-56	-93	-1,418	-1,761
Memorandum:[a]													
Total Legislative Changes	-30	-104	-102	-131	-137	-135	-142	-157	-168	-179	-192	-609	-1,446
Total Economic Changes	16	20	15	10	8	6	6	6	7	7	6	60	92
Total Technical Changes	91	62	64	41	16	20	24	22	22	24	23	203	319

Source: Congressional Budget Office.

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

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

tions and other defense activities in Iraq and Afghanistan. As required by the rules set forth in the Balanced Budget and Emergency Deficit Control Act of 1985, CBO's baseline assumes that those appropriations will continue in future years at the current level, adjusted for projected rates of inflation. As a result, legislative changes since March have increased the total discretionary outlays projected for the 2007–2016 period by $992 billion.

Defense. In June, the Emergency Supplemental Appropriations Act for Defense, the Global War on Terror, and Hurricane Recovery, 2006 (Public Law 109-234), provided $66 billion in budget authority to the Department of Defense (DoD) to cover the costs of operations in Iraq and Afghanistan. (DoD also received supplemental appropriations of roughly $2 billion for activities related to hurricane relief and border security.) CBO estimates that the department will spend about $22 billion of that funding in 2006—with half of the outlays going for military pay. Most of the rest of those outlays are expected to cover other day-to-day operating expenses, such as costs associated with transportation, base support, and maintenance and repair of equipment. Extrapolating the recent 2006 supplemental appropriations through 2016 increases projected defense outlays over 10 years by $721 billion.

Nondefense. P.L. 109-234 also provided $26 billion in appropriations for nondefense programs—mainly for relief and recovery from hurricane damage ($19 billion); State Department activities and foreign assistance programs, primarily for Iraq ($4 billion); and avian flu research, preparedness, and response ($2 billion). Extrapolating that additional funding raises projected nondefense discretionary outlays by $271 billion between 2007 and 2016.

Mandatory Spending

Recent legislative changes to mandatory programs have been modest—reducing projected spending over the 2007–2016 period by just $3 billion. That reduction mostly comes from higher projected collections of offsetting receipts as a result of the Pension Protection Act of 2006 (H.R. 4). Those additional receipts are partly offset by slightly higher projected spending as a result of the National Flood Insurance Program Enhanced Borrowing Authority Act of 2006 (P.L. 109-208).

The Pension Protection Act is expected to reduce net outlays by a total of $5 billion over the 10-year projection period. Most of the law's impact on spending will stem from changes in the premiums that companies pay to the Pension Benefit Guaranty Corporation (PBGC). The act alters funding requirements for defined-benefit pension plans; increases the amount of plans' underfunding on which firms pay premiums to the PBGC; and permanently extends the special premium paid by sponsors of plans that are terminated on an involuntary or distressed basis. (That premium had been scheduled to expire in December 2010.)

P.L. 109-208 increases the Federal Emergency Management Agency's borrowing authority by $2.275 billion to cover flood insurance claims resulting from Hurricanes Katrina, Rita, and Wilma in 2005. CBO expects that the additional outlays will occur in 2007.

Revenues

Legislation enacted since March has had a modest impact on CBO's revenue projections. CBO and the Joint Committee on Taxation (JCT) estimate that recently enacted laws will lower revenues by $4 billion this year, $32 billion in 2007, and $145 billion over the 2007–2016 period.

Almost all of those changes result from the Tax Increase Prevention and Reconciliation Act of 2005, or TIPRA (P.L. 109-222), which was enacted in May 2006, and the Pension Protection Act of 2006. TIPRA makes a number of changes to tax law, including:

- Extending the 15 percent and zero tax rates for long-term capital gains and qualified dividends through December 31, 2010;[3]
- Increasing the amount of income exempt from the individual alternative minimum tax and allowing certain nonrefundable credits to be claimed under the tax through December 31, 2006;
- Extending some tax provisions that affect controlled foreign corporations through the end of 2008;[4]
- Raising from 14 to 18 the age of children whose investment income (currently in excess of $1,700) can be taxed at their parents' tax rate;
- Removing the income limitation for converting traditional individual retirement accounts (IRAs) to Roth IRAs after 2009 and allowing taxpayers who convert their IRAs to Roth IRAs in 2010 to pay the resulting tax liability in equal installments in 2011 and 2012;
- Indexing for inflation the amount of foreign-earned income that U.S. citizens can exclude from U.S. taxes, starting in 2006;
- Capping the reimbursed expenses for foreign housing that can be excluded from taxable income, also starting in 2006;
- Requiring 3 percent withholding on certain payments for property and services made in 2011 or later by the federal government and by state and local governments; and
- Altering the timing of some estimated corporate tax payments in certain years.

Together, TIPRA's provisions will reduce revenues by $4 billion this year, $33 billion in 2007, and $72 billion

3. Those rates depend on taxpayers' tax brackets and amount of realized capital gains.
4. A controlled foreign corporation is a foreign company in which 50 percent or more of the stock is owned by those U.S. shareholders who individually own at least 10 percent of the company's stock.

over the 2007–2016 period, according to estimates by JCT.[5]

Besides changing the funding requirements for defined-benefit pension plans, the Pension Protection Act makes permanent the higher contribution limits for IRAs and employment-based retirement plans that were scheduled to expire at the end of 2010. It also extends a tax credit for contributions to certain retirement savings accounts that was set to expire at the end of 2006. JCT estimates that the law will increase revenues by $0.5 billion in 2007 but reduce them by a total of $73 billion over the 2007–2016 period.

Net Interest

Overall, legislation enacted since March has increased the projected deficit for the 2007–2016 period by $1.1 trillion. The additional federal borrowing needed to finance that increase in the deficit is projected to add $313 billion to the government's debt-service costs over the 10-year period (for a total legislative impact of $1.4 trillion).

The Effects of Economic Changes

CBO has raised its projections of both spending and revenues over the next 10 years because of changes to its economic outlook. Those increases largely offset each other, resulting in a relatively small effect on the baseline deficits or surpluses projected in March. On net, economic revisions cut $16 billion from the deficit estimated for this year and $92 billion from the total deficit for the 2007–2016 period.

Mandatory Spending

Changes to CBO's projections of inflation, wages, unemployment, and other economic variables affect the outlook for various mandatory programs. Such changes have reduced CBO's estimate of mandatory outlays in 2006 by $2 billion but have raised baseline projections of mandatory spending from 2007 through 2016 by $60 billion.

Most of those changes involve the largest mandatory program, Social Security. Inflation (as measured by the consumer price index for urban wage earners) has been significantly higher in 2006 than CBO expected. Because of that increase, CBO has added 1.0 percentage point to its estimate of the cost-of-living adjustment that will be made to Social Security benefits in 2007, which in turn raises projected payments to beneficiaries each year. In addition, higher estimates of growth in Social Security's national average wage index raise projected benefit payments for future recipients. Together, those changes have boosted outlay projections for Social Security over the 2007–2016 period by $57 billion.

Other economic changes to projections of mandatory spending result from upward and downward revisions that mostly offset each other and thus have a relatively small net effect—increasing outlays over the 10-year projection period by $3 billion. Higher estimates of inflation are the largest factor. They raise projected spending over the 2007–2016 period for programs such as civil service and military retirement (by $10 billion), the earned income and child tax credits (by $8 billion), and Supplemental Security Income (by $4 billion).

CBO is now projecting that the unemployment rate will be roughly 0.2 percentage points lower each year through 2016 than it previously projected. Mainly as a result of that change, estimated outlays for unemployment compensation have declined by $1 billion for this year and by $21 billion for the following 10 years.

Discretionary Spending

By law, CBO must project discretionary budget authority using two measures of inflation: the gross domestic product (GDP) deflator (now called the GDP price index) and the employment cost index for wages and salaries. In CBO's current economic forecast, the growth rates of both measures have risen for 2007 (by 0.4 percentage points for the GDP price index and by 0.1 percentage point for the employment cost index). Together, those increases add $36 billion to projected discretionary outlays over the 2007–2016 period. Beyond 2007, CBO's estimates of the growth rate of the two measures of inflation are unchanged.

Revenues

Changes to the economic outlook have caused CBO to raise its revenue projections by $18 billion for this year and by $196 billion for the subsequent 10 years. Those increases are largest for 2007 and 2008 ($35 billion and $33 billion) and smaller for later years of the projection period (between $12 billion and $14 billion after 2011). The increases reflect higher projections of corporate and

5. JCT based those estimates on CBO's January 2006 baseline. They differ from the amounts that JCT estimated when TIPRA was under consideration, which were based on the January 2005 baseline.

individual income tax receipts, partly offset by lower projections of revenues from social insurance taxes.

Recent quarterly data suggest that corporations' book profits (called profits before tax in the national income and product accounts) will be $330 billion higher in calendar year 2006 than previously projected. That outlook for stronger profits has caused CBO to raise its estimates of future profits by steadily smaller amounts over the projection period. (The increase is smaller for each succeeding year because CBO expects profits, which are now at a historically high level relative to GDP, to gradually return close to the levels that it projected in January, when CBO previously updated its economic projections.) In all, CBO has increased its projection of corporate receipts over the 2007–2016 period by about $130 billion in response to the changed economic forecast.

CBO's forecast for various types of personal income, especially interest income, has also risen. That increase adds about $86 billion to projected individual income tax receipts between 2007 and 2016, almost three-quarters of it in the second half of the 10-year period.

Although CBO's projection for personal income has increased, on net, its projection for wages and salaries (the most highly taxed form of income) has decreased slightly: by 0.3 percent over the 2007–2016 period. As a result, receipts from social insurance taxes—which are largely assessed on wage and salary disbursements—are about $23 billion smaller over that period than in the previous baseline projections.

Net Interest

Economic revisions to projections of net interest spending have two parts: the effects of changes in the outlook for interest rates and inflation, and changes in debt-service costs that result from the impact of all other economic changes on the baseline deficits or surpluses. The first factor has increased projected net interest outlays, and the second factor has lowered them—for a net increase of $8 billion over 10 years.

Higher inflation this year than CBO expected has boosted the amount of interest that the Treasury will pay on inflation-protected securities in 2006 by about $4 billion. Further, CBO's forecast for three-month and 10-year interest rates in 2007 and 2008 has risen by an average of about 0.5 and 0.2 percentage points, respectively. Because of those higher rates, projected interest outlays are $36 billion higher over the 2007–2011 period (and another $6 billion higher between 2012 and 2016). In the other direction, economic changes to the baseline have, on net, reduced the projected 10-year deficit, so they have lowered projected debt-service costs over that period by $34 billion, CBO estimates.

The Effects of Technical Changes

Technical changes comprise other revisions to the baseline that are not directly attributable to newly enacted laws or to changes in CBO's economic forecast. Most of the technical revisions since March relate to revenue projections and the resulting impact on debt-service costs. Those revisions have increased projected revenues and slightly decreased projected outlays—for net reductions of $91 billion in this year's estimated deficit and $319 billion in the deficits projected for the 2007–2016 period.

Revenues

CBO has raised its revenue projections by $77 billion for 2006 and $180 billion for the following 10 years because of various technical factors—the most important of which is higher-than-expected receipts from individual income taxes this year. About 70 percent ($125 billion) of the total technical change to revenues over the 2007–2016 period involves the projections for 2007 through 2009.

Collections of individual and corporate income taxes so far this year have been substantially higher than CBO estimated in March. CBO now expects individual income tax receipts to grow by more than 14 percent in 2006 to almost $1.1 trillion and corporate receipts to grow by 22 percent to $340 billion. Those totals are $56 billion and $38 billion higher, respectively, than CBO projected in March.

As explained in Chapter 1, the underlying sources of the recent strength in individual income tax receipts will not be known until information from tax returns becomes available in the future. However, that strength has been observed in final payments made with tax returns (which reflect economic activity in 2005); withholding on wages and salaries earned in recent months; and quarterly payments based on taxpayers' expected income for 2006.

Without enough information available to explain the recent strength in individual income tax receipts, CBO assumes that the amount of receipts above what can be explained by recent economic data will largely continue through 2007 and then gradually decline over the following several years. CBO assumes that taxable income will eventually tend to return to its historical relationship to GDP.

Total technical changes to revenue projections are smaller for 2007 ($51 billion) than for 2006 in part because of anticipated reductions in net receipts from the telephone excise tax. After the Internal Revenue Service eliminated most of that tax in response to legal challenges, CBO reduced its projection of receipts from the tax by about $12 billion for 2007 (including refunds of about $9 billion to be paid that year) and by $5 billion to $6 billion per year for 2008 to 2016—for a total reduction of $59 billion over the 10-year period.

Other changes to CBO's revenue models and forecasting methods—especially to those involving receipts from income taxes and estate and gift taxes—have also contributed to the latest technical revisions:

- This year's corporate income tax receipts are higher than can be explained by currently available data on corporate profits. As it did with individual income taxes, CBO assumes that some of that unexplained strength will persist in the near term.
- CBO has raised its projections of individual income tax receipts through 2016 to reflect new projections of the difference between the amount of receipts that the Treasury collects and the amount that is reported on tax returns (the starting point for CBO's estimates).[6]
- CBO has increased its projections of receipts from estate and gift taxes, mainly after 2011, to reflect more-recent information about the distribution of wealth in the U.S. population.

Mandatory Spending

Recent technical revisions have had a modest effect on the outlook for mandatory spending. On net, such changes have trimmed $10 billion from CBO's estimate of mandatory spending for 2006 and a total of just $6 billion from the projections for the 2007–2016 period. The biggest changes involve the Medicaid program and student loans.

On the basis of outlays so far this year and an analysis of spending in individual states, CBO has lowered its estimates of federal Medicaid outlays by $8 billion for 2006 and by $12 billion for the 2007–2016 period. CBO now expects that Medicaid will spend slightly less this year ($181.5 billion) than it did in 2005 ($181.7 billion). That lack of growth partly reflects the fact that the new Medicare prescription drug program is paying for some benefits that were previously covered by Medicaid.

Information from the Administration's *Mid-Session Review* has led CBO to add about $8 billion to its estimate of outlays for student loans in 2006. About a third of that increase occurs because the Administration is planning a further budget adjustment (called a credit subsidy reestimate) to account for higher-than-expected subsidy costs for outstanding student loans. Much of the remaining difference results from the Administration's budgetary treatment of consolidation loans, which differs significantly from that of CBO. The Administration treats a consolidated loan as a new loan, which generally raises loan subsidy costs, whereas CBO (as specified by law) treats consolidation as one of the terms of the original loan. Because the Treasury Department will report outlays using the Administration's treatment, that difference will substantially increase the loan subsidy costs reported in 2006.

Other technical changes reduce estimates of mandatory spending this year by $9 billion. The largest of those changes is a net reduction of $3 billion in estimated Medicare spending, based on actual outlays so far this year. CBO's estimate of spending for Parts A and B of Medicare has declined by roughly $7 billion, whereas its estimate of spending for the Part D prescription drug program has grown by about $4 billion (largely because of higher-than-expected enrollment and lower-than-expected premium payments). Among those other changes, CBO has increased its estimate of receipts from sales of military equipment to foreign governments and its estimate of collections from outstanding loans for international assistance programs. Together, those increases in offsetting receipts reduce the mandatory outlays projected for 2006 by roughly $2 billion.

6. One reason for that difference is that some lower-income workers who do not owe income taxes have tax withheld from their paychecks but do not file tax returns to receive refunds.

Discretionary Spending

Technical changes to CBO's baseline projections for discretionary programs have been minimal since March. Together, those changes have lowered projected outlays by $3 billion for this year and by a total of just $1 billion for the 2007–2016 period.

Net Interest

Technical changes have reduced CBO's projections of net interest outlays over the next 10 years by $132 billion. Most of that reduction stems from lower projected debt-service costs because technical changes have increased projected revenues (mainly from corporate and individual income taxes) and lowered projected outlays (mostly for Medicaid). Other, smaller changes to projections of net interest spending reflect revisions to CBO's projections of intragovernmental interest payments and of the borrowing needs of federal loan programs.

APPENDIX

B

A Comparison of CBO's and OMB's Baselines

The Administration's Office of Management and Budget (OMB) published its annual *Mid-Session Review* of the President's budget on July 11, 2006.[1] In that report, OMB updated its baseline and policy projections and its economic assumptions through 2011. This appendix compares OMB's baseline projections—which that agency labels its "current-services" baseline—with those prepared by the Congressional Budget Office (CBO).[2]

For fiscal year 2006, CBO anticipates a deficit of $260 billion, $31 billion less than OMB's current-services estimate of $290 billion.[3] Both agencies expect about the same amount of revenues for the year, but CBO anticipates that outlays will be $31 billion less than OMB estimates.

Comparing the two baselines for subsequent years is not straightforward, however, because they are conceptually different. In the past, OMB and CBO constructed their baselines using similar concepts derived from the Balanced Budget and Emergency Deficit Control Act of 1985. Consequently, discrepancies between the agencies' estimates were attributable primarily to differences in their respective technical and economic assumptions. But, this year's projections reflect the continuation of a recent pattern in which OMB has deviated from the conceptual framework specified in the Deficit Control Act.

1. Office of Management and Budget, *Fiscal Year 2007 Mid-Session Review: Budget of the U.S. Government* (July 11, 2006).

2. This appendix analyzes the differences between CBO's and OMB's baseline projections over the next five years. A 10-year analysis was not possible because OMB's baseline ends in 2011.

3. OMB's $290 billion baseline deficit is slightly lower than the $296 billion deficit that it estimated assuming the enactment of additional funding for the National Flood Insurance Program, an extension of the research and experimentation tax credit, and a few other proposals.

The Administration has not followed the statutory baseline rules in two significant areas. First, it has not extrapolated and inflated all of the discretionary funding provided in 2006. Its current-services baseline excludes further funding for U.S. activities in Iraq and Afghanistan, which has totaled $120 billion this year. It also does not extrapolate supplemental budget authority provided for hurricane relief and recovery ($48 billion), avian flu preparedness ($6 billion), and other programs ($2 billion). By contrast, CBO's baseline follows the specifications of the Deficit Control Act and assumes that all appropriations for 2006 are continued in future years, with adjustments for inflation. As a result of differing treatments of supplemental appropriations, CBO's projection of discretionary outlays is $735 billion higher than that of the Administration over the 2007–2011 period.

Second, OMB's current-services baseline assumes that most major provisions initially 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) will be extended, although, under statutory baseline rules, they should be assumed to expire as scheduled.[4] Most of those tax provisions are slated to expire at the end of December 2010, thereby causing CBO's estimates of revenues to exceed OMB's by $157 billion between 2007 and 2011. Most of that disparity occurs in 2011.

In addition to those conceptual adjustments, OMB made two small changes in the way it accounts for increases in pay and administrative expenses when projecting discretionary spending. Those changes result in lower levels of

4. The Tax Increase Prevention and Reconciliation Act of 2005 extended lower tax rates for long-term capital gains and qualified dividends through 2010. Those lower rates were originally enacted through 2008 in JGTRRA.

Table B-1.

A Comparison of CBO's August 2006 Baseline and OMB's July 2006 Current-Services Baseline

(Billions of dollars)

	2006	2007	2008	2009	2010	2011	Total, 2007-2011
				CBO's August 2006 Baseline			
Revenues	2,403	2,515	2,672	2,775	2,890	3,156	14,007
On-budget	1,798	1,878	2,001	2,068	2,146	2,377	10,471
Off-budget	605	637	671	707	744	779	3,536
Outlays							
Mandatory	1,418	1,486	1,569	1,659	1,759	1,882	8,355
Discretionary	1,025	1,065	1,106	1,138	1,164	1,192	5,666
Net interest	220	249	270	282	295	308	1,404
Total	2,663	2,801	2,945	3,079	3,217	3,382	15,425
On-budget	2,235	2,349	2,479	2,594	2,713	2,858	12,993
Off-budget	428	451	466	485	505	525	2,432
Deficit (-) or Surplus	-260	-286	-273	-304	-328	-227	-1,418
On-budget	-437	-471	-478	-526	-567	-481	-2,522
Off-budget	177	185	204	221	239	254	1,104
				OMB's July 2006 Current-Services Baseline			
Revenues	2,403	2,470	2,673	2,791	2,955	3,129	14,018
On-budget	1,798	1,841	2,000	2,081	2,202	2,330	10,454
Off-budget	605	629	673	710	753	799	3,564
Outlays							
Mandatory	1,439	1,482	1,566	1,664	1,761	1,884	8,358
Discretionary	1,035	1,006	966	975	991	1,016	4,955
Net interest	219	247	264	275	284	290	1,360
Total	2,693	2,736	2,796	2,914	3,036	3,191	14,673
On-budget	2,265	2,287	2,332	2,431	2,532	2,664	12,245
Off-budget	428	449	464	483	505	527	2,428
Deficit (-) or Surplus	-290	-266	-123	-122	-81	-62	-654
On-budget	-468	-446	-332	-349	-330	-333	-1,791
Off-budget	177	181	209	227	249	271	1,137

Continued

Table B-1.

Continued

	2006	2007	2008	2009	2010	2011	Total, 2007-2011
			Difference (CBO's Baseline Minus OMB's)				
Revenues	*	45	-1	-16	-66	27	-11
On-budget	*	38	1	-13	-56	46	17
Off-budget	0	7	-2	-3	-10	-20	-28
Outlays							
Mandatory	-21	4	3	-5	-3	-3	-3
Discretionary	-11	59	140	163	173	176	711
Net interest	1	2	6	8	11	18	45
Total	-31	65	149	165	181	191	752
On-budget	-30	62	147	163	181	194	748
Off-budget	*	3	2	2	*	-3	5
Deficit (-) or Surplus[a]	31	-20	-150	-182	-247	-165	-763
On-budget	31	-25	-145	-176	-237	-148	-731
Off-budget	*	5	-5	-5	-10	-17	-32

Sources: Congressional Budget Office (CBO) and the Office of Management and Budget (OMB).

Notes: OMB's current-services baseline deviates from the concepts delineated in the Balanced Budget and Emergency Deficit Control Act of 1985 in two significant ways: it does not extrapolate supplemental appropriations provided for 2006 into future years, and it assumes that most tax provisions enacted in 2001 and 2003 will be extended.

* = 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.

spending relative to CBO's estimates. Finally, because OMB's estimates were prepared earlier than CBO's, OMB's baseline estimates do not include most of the effects of legislation enacted since early July (primarily the Pension Protection Act of 2006).[5]

Over the next five years, CBO's estimate of baseline deficits exceeds OMB's projection. In total, CBO's projection of baseline deficits for the 2007–2011 period—$1.4 trillion—is twice as large as OMB's figure of $0.7 trillion (see Table B-1).

Most of that discrepancy stems from the differing conceptual approaches applied to supplemental appropriations and expiring tax provisions. CBO estimates that if OMB were to follow the conventions specified in the Deficit Control Act (and could account for recent legislation) the gap would shrink from $763 billion to $94 billion.[6] Adjusted for the conceptual differences and recent legislation described above, CBO's revenue projections would be lower than OMB's by $163 billion, or 1.2 percent of total revenues. CBO's estimate of outlays would also be lower than OMB's, differing by just $70 billion over the five-year period.

5. OMB's current-services baseline does include the effects of those provisions of the Pension Protection Act of 2006 (PPA) that extend some retirement provisions initially enacted in EGTRRA. Those components of PPA include permanently extending higher contribution limits for individual retirement accounts and employment-based retirement plans that were scheduled to expire at the end of 2010.

6. OMB has not published complete details on the impact of its conceptual adjustments to the baseline. CBO used its own calculations to estimate the effect of such differences.

Outlays

CBO expects total outlays in 2006 to be $31 billion lower than OMB's current-services estimate, with the largest differences attributable to spending for defense, Medicare, and Medicaid. For the 2007–2011 period, CBO projects $752 billion more in total outlays than OMB does in its current-services baseline. Conceptual differences and recent legislation boost CBO's estimate of outlays over OMB's by about $822 billion. However, underlying economic and technical assumptions cause CBO's outlay projections to be $70 billion lower than OMB's current-services estimates.

Mandatory Spending

CBO anticipates that mandatory outlays in 2006 will be $21 billion lower than the amount reported by the Administration. The largest differences are found in estimates of spending on Medicare ($7 billion) and Medicaid ($3 billion). Most of the remaining gap stems from differences in estimates in several areas, including unemployment compensation, the Universal Service Fund, the National Flood Insurance Program, and liquidating accounts for credit programs.[7]

For the 2007–2011 period, CBO projects only $3 billion less in mandatory outlays than OMB does. CBO projects higher outlays for Medicaid ($36 billion) and Medicare ($8 billion) and fewer receipts from auctions of portions of the electromagnetic spectrum ($11 billion). However, those estimates are more than offset by OMB's higher projections of spending on veterans' programs ($23 billion), student loans ($14 billion), Social Security ($4 billion), and a number of other programs.

Discretionary Spending

CBO estimates that outlays for defense in 2006 will total $522 billion—$10 billion less than OMB's estimate of $532 billion. For the 2007–2011 period, CBO's projections for defense outlays exceed OMB's by $538 billion. Much of that difference results from the fact that OMB does not assume future-year appropriations equal to the inflated value of the $124 billion in funding provided in fiscal year 2006 for military operations in Iraq and Afghanistan and other supplemental funding.[8] Extrapolating that funding adds $547 billion to CBO's baseline for defense outlays over the five-year period. Excluding such funding, CBO's projection of defense discretionary outlays would be similar to that of the Administration, differing by only $9 billion (less than 1 percent) between 2007 and 2011.

For nondefense discretionary spending, CBO's 2006 estimate of $502 billion is nearly identical to OMB's total of $503 billion. For the 2007–2011 period, CBO projects that nondefense discretionary outlays will exceed OMB's estimate by $173 billion under baseline assumptions. Again, most of that difference stems from the supplemental budget authority of about $53 billion that CBO extrapolates in its baseline, thereby adding $189 billion in outlays over the five-year period.[9] Excluding the extension of supplemental funding from CBO's numbers, the Administration's projections of nondefense discretionary outlays would be $16 billion higher than CBO's, which represents a difference of less than 1 percent.

Net Interest

CBO's estimate of net interest in 2006 is $1 billion higher than OMB's, partly reflecting minor technical differences in the estimate of interest receipts from federal loan programs. For the 2007–2011 period, CBO's projection of net interest outlays exceeds OMB's by $45 billion. Conceptual differences cause CBO's estimate of interest to be $75 billion above OMB's total; differences in assumed interest rates, inflation, and other factors offset $30 billion of that amount.

Revenues

CBO's estimate of revenues for 2006 is almost the same as OMB's current-services estimate. Over the following five years, differences in projected revenues between the two agencies fluctuate. For 2007, CBO's projection of revenues is $45 billion higher than OMB's—nearly 2 percent of the total. For 2010, OMB's projection is $66 billion greater than CBO's. In 2011, the sign reverses

7. Liquidating accounts record the cash flows of federal credit programs for loans and loan guarantees provided prior to 1992. They are sometimes referred to as pre-credit reform loans and guarantees.

8. Appropriations related to activities in Iraq and Afghanistan totaled $116 billion for military operations and $4 billion for nondefense programs. Other supplemental appropriations provided $8 billion in budget authority for defense programs.

9. Policymakers also rescinded $23 billion from previous appropriations provided to the Federal Emergency Management Agency, but that rescission is not extended into the future in CBO's baseline.

again as CBO's projection exceeds that of OMB by $27 billion.

Over the five-year period from 2007 to 2011, CBO's estimate of total revenues is almost identical to OMB's, although there are some offsetting differences underlying the $11 billion gap. CBO's estimate is $163 billion (or 1.2 percent) lower for economic and technical reasons and $5 billion lower because of recent legislation. Conceptual differences, however, boost CBO's estimate by $157 billion (or 1.1 percent).

Differing economic projections, especially for wage and salary disbursements, explain some of the disparities between the agencies' estimates for the 2007–2011 period. First, CBO assumes slightly lower growth in real (inflation-adjusted) gross domestic product (GDP) and slower increases in prices. As a result, CBO projects lower levels of nominal GDP and corresponding taxable incomes, especially wage and salary disbursements. (For CBO's updated economic forecast, see Chapter 2.) In total, CBO projects that wages and salaries will be lower than OMB does over the 2007–2011 period by about $596 billion (or 1.7 percent), which reduces CBO's estimate of individual income and social insurance revenues relative to OMB's estimate. The effects of those differing economic and technical assumptions are particularly evident in 2011, accounting for a $114 billion difference in revenues. Over half of that amount, or $66 billion, is attributable to differing wage and salary assumptions, and the remaining $48 billion is the result of other differences in the economic forecasts and miscellaneous technical differences.

The conceptual differences derive from OMB's inclusion of the effects of making permanent certain elements of the tax provisions initially enacted under EGTRRA and JGTRRA. The effects are particularly evident in 2011, when the Administration's estimate includes an extension of the provisions scheduled to expire in December 2010. CBO and the Joint Committee on Taxation estimate that extending those elements of the tax laws would reduce revenues by about $157 billion between 2007 and 2011; a large portion of that reduction would take place in 2011.

Legislation enacted after the Administration published its current-services baseline reduces CBO's baseline revenue estimates relative to OMB's estimates. The Pension Protection Act of 2006 lowers revenues by roughly $8 billion over the 2007–2011 period; however, $3 billion of that total stems from provisions that were assumed in the Administration's current-services baseline.

APPENDIX

C

CBO's Economic Projections for 2006 to 2016

The tables in this appendix expand on the information in Chapter 2 by showing the Congressional Budget Office's (CBO's) year-by-year economic projections for 2006 to 2016 (by calendar year in Table C-1 and by fiscal year in Table C-2). CBO does not forecast cyclical fluctuations in its projections for years after 2007. Instead, the projected values shown in the tables for 2008 through 2016 reflect CBO's assessment of average values for that period. That assessment takes into account economic and demographic trends but does not attempt to forecast the frequency and size of ups and downs in the business cycle.

Table C-1.

CBO's Year-by-Year Forecast and Projections for Calendar Years 2006 to 2016

	Actual	Forecast		Projected								
	2005[a]	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Nominal GDP (Billions of dollars)	12,487	13,308	13,993	14,685	15,425	16,174	16,914	17,684	18,491	19,317	20,167	21,052
Nominal GDP (Percentage change)	6.4	6.6	5.1	4.9	5.0	4.9	4.6	4.6	4.6	4.5	4.4	4.4
Real GDP (Percentage change)	3.5	3.5	3.0	3.1	3.2	3.0	2.8	2.7	2.7	2.6	2.5	2.5
GDP Price Index (Percentage change)	2.8	3.0	2.0	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8
PCE Price Index[b] (Percentage change)	2.8	3.0	2.4	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Core PCE Price Index[c] (Percentage change)	2.0	2.2	2.3	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Consumer Price Index[d] (Percentage change)	3.4	3.5	2.5	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Core Consumer Price Index[e] (Percentage change)	2.2	2.6	2.5	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Employment Cost Index[f] (Percentage change)	2.5	2.9	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3
Unemployment Rate (Percent)	5.1	4.7	4.8	4.9	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Three-Month Treasury Bill Rate (Percent)	3.1	4.8	5.0	4.8	4.5	4.4	4.4	4.4	4.4	4.4	4.4	4.4
Ten-Year Treasury Note Rate (Percent)	4.3	5.1	5.4	5.3	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2
Tax Bases (Billions of dollars)												
Corporate book profits	1,438	1,781	1,641	1,624	1,580	1,573	1,587	1,621	1,675	1,736	1,806	1,884
Wages and salaries	5,712	5,994	6,354	6,706	7,069	7,430	7,771	8,117	8,478	8,847	9,226	9,619
Tax Bases (Percentage of GDP)												
Corporate book profits	11.5	13.4	11.7	11.1	10.2	9.7	9.4	9.2	9.1	9.0	9.0	8.9
Wages and salaries	45.7	45.0	45.4	45.7	45.8	45.9	45.9	45.9	45.8	45.8	45.7	45.7

Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

Note: Percentage change is year over year; GDP = gross domestic product.

a. Values as of early July 2006, prior to the revisions to the national income and product accounts.

b. The personal consumption expenditure chained price index.

c. The personal consumption expenditure chained price index excluding prices for food and energy.

d. The consumer price index for all urban consumers.

e. The consumer price index for all urban consumers excluding food and energy prices.

f. The employment cost index for wages and salaries of workers in private industry.

Table C-2.

CBO's Year-by-Year Forecast and Projections for Fiscal Years 2006 to 2016

	Actual	Forecast		Projected								
	2005[a]	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Nominal GDP (Billions of dollars)	12,294	13,108	13,823	14,509	15,236	15,989	16,727	17,488	18,286	19,109	19,951	20,827
Nominal GDP (Percentage change)	6.5	6.6	5.5	5.0	5.0	4.9	4.6	4.5	4.6	4.5	4.4	4.4
Real GDP (Percentage change)	3.7	3.4	3.2	3.1	3.1	3.1	2.8	2.7	2.7	2.6	2.6	2.5
GDP Price Index (Percentage change)	2.7	3.1	2.2	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8
PCE Price Index[b] (Percentage change)	2.8	3.1	2.6	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Core PCE Price Index[c] (Percentage change)	2.1	2.1	2.4	2.1	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Consumer Price Index[d] (Percentage change)	3.3	3.7	2.8	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Core Consumer Price Index[e] (Percentage change)	2.2	2.4	2.7	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Employment Cost Index[f] (Percentage change)	2.5	2.7	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3
Unemployment Rate (Percent)	5.2	4.8	4.7	4.9	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Three-Month Treasury Bill Rate (Percent)	2.7	4.5	5.1	4.9	4.6	4.4	4.4	4.4	4.4	4.4	4.4	4.4
Ten-Year Treasury Note Rate (Percent)	4.2	4.9	5.4	5.3	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2
Tax Bases (Billions of dollars)												
Corporate book profits	1,327	1,733	1,671	1,632	1,586	1,576	1,580	1,611	1,661	1,720	1,788	1,863
Wages and salaries	5,657	5,909	6,265	6,618	6,977	7,341	7,687	8,029	8,386	8,754	9,130	9,519
Tax Bases (Percentage of GDP)												
Corporate book profits	10.8	13.2	12.1	11.2	10.4	9.9	9.4	9.2	9.1	9.0	9.0	8.9
Wages and salaries	46.0	45.1	45.3	45.6	45.8	45.9	46.0	45.9	45.9	45.8	45.8	45.7

Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

Note: Percentage change is year over year; GDP = gross domestic product.

a. Values as of early July 2006, prior to the revisions to the national income and product accounts.

b. The personal consumption expenditure chained price index.

c. The personal consumption expenditure chained price index excluding prices for food and energy.

d. The consumer price index for all urban consumers.

e. The consumer price index for all urban consumers excluding food and energy prices.

f. The employment cost index for wages and salaries of workers in private industry.

APPENDIX

D

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
Pamela Greene	Corporate income taxes, estate and gift taxes, excise taxes
Laura Hanlon	Excise taxes
Ed Harris	Individual income taxes
Andrew Langan	Excise taxes
Larry Ozanne	Capital gains realizations
Kevin Perese	Tax modeling
Monisha Primlani	Individual income taxes
Emily Schlect	Customs duties, miscellaneous receipts
Kurt Seibert	Earned income tax credit and depreciation
David Weiner	Individual income taxes

Spending Projections

Defense, International Affairs, and Veterans' Affairs

Sarah Jennings	Unit Chief
Kent Christensen	Defense
Sunita D'Monte	International affairs (conduct of foreign affairs and information-exchange activities), veterans' housing
Raymond Hall	Defense (stockpile sales, atomic energy defense)
David Newman	Defense (military construction and family housing, military activities in Iraq and Afghanistan and for the war on terrorism)
Sam Papenfuss	International affairs (development, security, international financial institutions)

Michelle Patterson	Veterans' health care, military health care
Matthew Schmit	Defense (military personnel, military activities in Iraq and Afghanistan and for the war on terrorism)
Michael Waters	Military retirement, veterans' education
Jason Wheelock	Defense (other programs), radiation exposure compensation, energy employees' occupational illness compensation
Mark Whitaker	Energy employees' occupational illness compensation
Dwayne Wright	Veterans' compensation and pensions

Health

Tom Bradley	Unit Chief
Julia Christensen	Federal Employees Health Benefits program, Public Health Service
Jeanne De Sa	Medicaid, State Children's Health Insurance Program
Sarah Evans	Medicare, Public Health Service
Geoffrey Gerhardt	Medicare
Tim Gronniger	Medicare, Public Health Service
Eric Rollins	Medicaid, State Children's Health Insurance Program, Medicare
Shinobu Suzuki	Medicare
Camile Williams	Medicare, Public Health Service

Human Resources

Paul Cullinan	Unit Chief
Christina Hawley Anthony	Unemployment insurance, training programs, Administration on Aging, foster care, Smithsonian, arts and humanities, report coordinator
Chad Chirico	Housing assistance, education
Sheila Dacey	Old-Age and Survivors Insurance, Social Security
Kathleen FitzGerald	Food Stamps and nutrition programs
Justin Humphrey	Elementary and secondary education, Pell grants
Deborah Kalcevic	Student loans, higher education
Matthew Kapuscinski	Low Income Home Energy Assistance Program, refugee assistance
Craig Meklir	Federal civilian retirement, Pension Benefit Guaranty Corporation, Railroad Retirement
Jonathan Morancy	Child Support Enforcement, Temporary Assistance for Needy Families, Social Services Block Grant program, child care programs, child and family services
David Rafferty	Disability Insurance, Supplemental Security Income

Natural and Physical Resources

Kim Cawley	Unit Chief
Megan Carroll	Energy, conservation and land management, air transportation
Mark Grabowicz	Justice, Postal Service
Kathleen Gramp	Spectrum-auction receipts, energy, deposit insurance, Outer Continental Shelf receipts
Greg Hitz	Agriculture
Daniel Hoople	Science and space exploration, Bureau of Indian Affairs, justice, community and regional development
David Hull	Agriculture
James Langley	Agriculture
Susanne Mehlman	Pollution control and abatement, Federal Housing Administration and other housing credit programs
Julie Middleton	Water resources, Federal Emergency Management Agency, other natural resources
Matthew Pickford	General government
Deborah Reis	Recreation, water transportation, legislative branch, conservation and land management
Gregory Waring	Justice, community and regional development, highways, Amtrak, mass transit
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	National income and product accounts, federal pay, monthly Treasury data, report coordinator
Joanna Capps	Appropriation bills (Interior and the environment, Labor-HHS)
Kenneth Farris	Computer support
Mary Froehlich	Computer support
Ann Futrell	Other interest, report coordinator
Virginia Myers	Appropriation bills (Commerce-State-Justice, energy and water)
Jennifer Reynolds	Appropriation bills (Agriculture, foreign relations)
Mark Sanford	Appropriation bills (Defense, Homeland Security)
Eric Schatten	Interest on the public debt, report coordinator
Luis Serna	National income and product accounts, report coordinator
Phan Siris	Computer support
Esther Steinbock	Appropriation bills (Transportation-Treasury-HUD, military quality of life and veterans' affairs, District of Columbia)
Patrice Watson	Database system administrator

CONGRESS OF THE UNITED STATES
CONGRESSIONAL BUDGET OFFICE
WASHINGTON, DC 20515

INSIDE MAIL