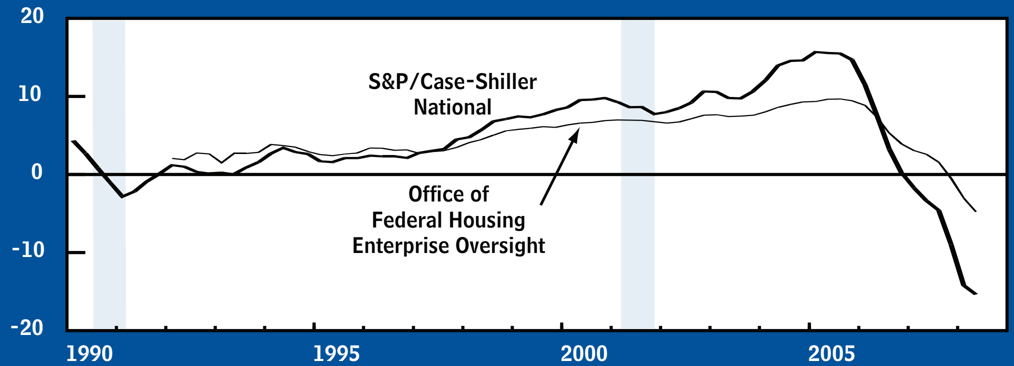
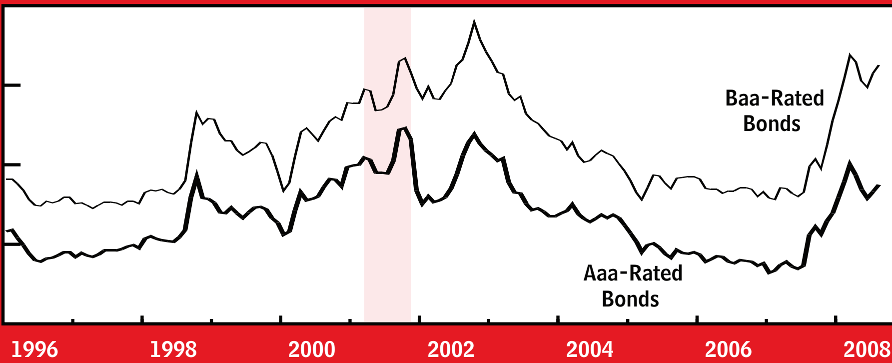
CONGRESS OF THE UNITED STATES
CONGRESSIONAL BUDGET OFFICE

The Budget and Economic Outlook: An Update

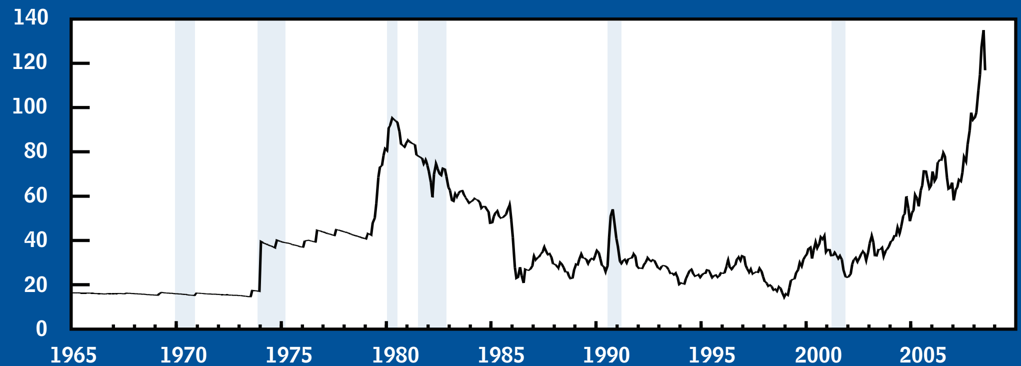
Indexes of House Prices
(Percentage change from previous year)



Risk Spreads Between Corporate Bonds and Treasury Notes
(Percentage points above rates on Treasury notes)



Inflation-Adjusted Price of Crude Oil
(Dollars per barrel)



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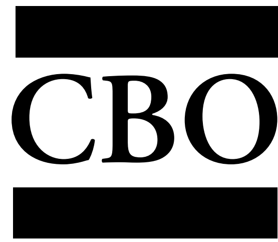


The Budget and Economic Outlook: An Update

September 2008

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; other 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.

Some of the figures use shaded vertical bars to indicate periods of recession. (A recession extends from the peak of a business cycle to its trough.)

The Congressional Budget Office's (CBO's) economic forecast incorporates the annual revisions to the national income and product accounts (maintained by the Commerce Department's Bureau of Economic Analysis) that were released on July 31, 2008.

Supplemental data for this analysis are available on CBO's Web site (www.cbo.gov).

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 the agency's Budget Analysis Division under the supervision of Peter Fontaine, Keith Fontenot, Theresa Gullo, Janet Airis, Tom Bradley, Kim Cawley, Jeffrey Holland, Sarah Jennings, Kate Massey, and Sam Papenfuss. The revenue estimates were prepared by the staff of the Tax Analysis Division under the supervision of Thomas Woodward, Frank Sammartino, Mark Booth, and David Weiner, with assistance from the Joint Committee on Taxation. (A detailed list of contributors to the revenue and spending projections appears in Appendix D.)

The economic outlook presented in Chapter 2 was prepared by the Macroeconomic Analysis Division under the direction of Robert Dennis, Kim Kowalewski, and John F. Peterson. Robert Arnold and Christopher Williams carried out the economic forecast and projections. David Brauer, Juan Contreras, Naomi Griffin, Juann Hung, Wendy Kiska, Mark Lasky, Angelo Mascaro, Damien Moore, Ben Page, John F. Peterson, Frank Russek, David Torregrosa, and Steven Weinberg contributed to the analysis. Eric Miller 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, Jared Bernstein, Michael Boskin, Douglas W. Elmendorf, Martin Feldstein, Robert J. Gordon, Robert E. Hall, Lawrence Katz, Allan H. Meltzer, Laurence H. Meyer, William D. Nordhaus, Rudolph G. Penner, Adam S. Posen, James Poterba, Alice Rivlin, Nouriel Roubini, Diane C. Swonk, and Stephen P. Zeldes. Jonathan Parker, Wesley Phoa, Gary Stern, and Peter Wallison 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.

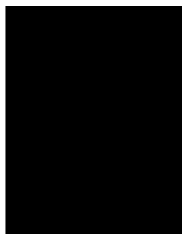
Jeffrey Holland wrote the summary. Christi Hawley Anthony, with assistance from Barbara Edwards and Pamela Greene, wrote Chapter 1 (David Newman compiled Box 1-1). Naomi Griffin, with assistance from Kim Kowalewski, authored Chapter 2. Amber Marcellino, along

with Mark Booth, wrote Appendix A. Eric Schatten, with assistance from Pamela Greene, wrote Appendix B. Eric Miller and Adam Weber compiled Appendix C.

Christine Bogusz, Leah Mazade, and John Skeen edited the report. Marion Curry, Denise Jordan-Williams, and Linda Lewis Harris assisted in its preparation. Maureen Costantino designed the cover and prepared the report for publication. Lenny Skutnik printed the initial copies, and Linda Schimmel handled the distribution. Simone Thomas prepared the electronic version for CBO's Web site: www.cbo.gov.

Peter R. Orszag
Director

September 2008



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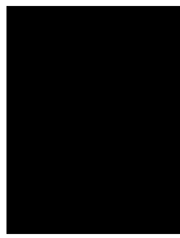


Summary

The Congressional Budget Office (CBO) estimates that the deficit for 2008 will be substantially higher than it was in 2007, rising from $161 billion last year to $407 billion this year. Furthermore, CBO's projections indicate that if current laws and policies remain in place, deficits for the next two years will remain above $400 billion, or about 3 percent of gross domestic product (GDP). Over the longer term, the fiscal outlook continues to depend mostly on the future course of health care costs as well as on the effects of a growing elderly population.

An unusual amount of turbulence has roiled the U.S. economy this year, weakening the near-term outlook since CBO's previous forecast in February.[1] The housing market remains depressed; conditions in the financial markets have remained fragile; and prices for energy and agricultural commodities have risen precipitously since last year. According to CBO's updated forecast, the economy is likely to experience at least several more months of very slow growth. Whether this period will ultimately be designated a recession or not is still uncertain, but the increase in the unemployment rate and the pace of economic growth are similar to conditions during previous periods of mild recession.[2]

Significant government action regarding Fannie Mae and Freddie Mac occurred as this report went to press. The estimates presented in this update were prepared before the specific details of that action were available.

1. Congressional Budget Office, "Update of CBO's Economic Forecast," letter to the Honorable Kent Conrad (February 15, 2008).

2. According to the National Bureau of Economic Research, a recession is "a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real [inflation-adjusted] GDP, real income, employment, industrial production, and manufacturing and wholesale-retail sales." See www.nber.org/cycles/jan08bcdc_memo.html.

The Budget Outlook from 2008 to 2018

CBO expects the deficit to rise from 1.2 percent of GDP in 2007 to 2.9 percent this year (see Summary Table 1). The significant expansion in the deficit is the result of a substantial increase in spending and a halt in the growth of tax revenues. In 2008, CBO estimates, federal spending will be 8.3 percent higher than in 2007; at the same time, total revenues will probably be less than they were in 2007.

On the basis of tax collections through July, CBO expects federal revenues to total $2.5 trillion this fiscal year, a decline of 0.8 percent from 2007. Revenues from all major sources have grown more slowly in 2008 than in 2007, but the drop from last year is largely the result of rebates provided in the Economic Stimulus Act of 2008 (Public Law 110-185), which was enacted in February. Excluding all of that law's direct effects on revenues—both the rebates and the provisions for business depreciation—CBO estimates that revenues would have increased by about 2.5 percent this year.

Outlays will rise by $226 billion this year, to nearly $3.0 trillion, CBO estimates, as a result of rapid growth in both discretionary and mandatory spending. In total, mandatory spending—driven by increases in many large programs, outlays resulting from the stimulus legislation, and a jump in expenditures to cover the insured deposits of insolvent financial institutions—will increase by $135 billion from the amount in 2007, a 9.3 percent rise. Outlays for discretionary programs—whose funding is set anew each year through appropriation acts—are anticipated to rise by $85 billion, or 8.1 percent, this year; the bulk of that increase stems from defense spending. The government's net interest costs will increase by $7 billion, or 2.9 percent, CBO estimates.

Summary Table 1.

CBO's Baseline Budget Outlook

	Actual 2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Total, 2009-2013	Total, 2009-2018
							In Billions of Dollars							
Total Revenues	2,568	2,548	2,720	2,881	3,178	3,451	3,619	3,770	3,958	4,145	4,341	4,546	15,848	36,606
Total Outlays	2,729	2,955	3,158	3,312	3,502	3,577	3,766	3,939	4,120	4,352	4,514	4,680	17,314	38,919
Total Deficit (-) or Surplus	**-161**	**-407**	**-438**	**-431**	**-325**	**-126**	**-147**	**-170**	**-162**	**-207**	**-174**	**-135**	**-1,466**	**-2,313**
On-budget	-342	-592	-611	-609	-520	-332	-357	-382	-374	-416	-378	-330	-2,429	-4,309
Off-budget[a]	181	184	173	179	195	206	210	212	212	209	204	196	964	1,996
Debt Held by the Public at the End of the Year	5,035	5,425	5,870	6,319	6,662	6,805	6,968	7,155	7,331	7,553	7,742	7,890	n.a.	n.a.
							As a Percentage of Gross Domestic Product							
Total Revenues	18.8	17.9	18.5	18.6	19.4	20.0	20.1	20.0	20.1	20.2	20.3	20.4	19.4	19.9
Total Outlays	20.0	20.8	21.5	21.4	21.4	20.7	20.9	20.9	21.0	21.3	21.2	21.0	21.1	21.1
Total Deficit	**-1.2**	**-2.9**	**-3.0**	**-2.8**	**-2.0**	**-0.7**	**-0.8**	**-0.9**	**-0.8**	**-1.0**	**-0.8**	**-0.6**	**-1.8**	**-1.3**
Debt Held by the Public at the End of the Year	36.9	38.2	39.9	40.8	40.6	39.4	38.6	38.0	37.3	36.9	36.3	35.5	n.a.	n.a.
Memorandum:														
Gross Domestic Product (Billions of dollars)	13,642	14,210	14,719	15,473	16,390	17,253	18,036	18,826	19,641	20,478	21,342	22,240	81,870	184,397

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.

Since March, CBO has increased its estimate of the deficit for 2008 by $51 billion, to $407 billion. That change is almost entirely the result of higher spending than projected in the March baseline. Much of that spending increase was expected, however, because it results from supplemental appropriations for military operations in Iraq and Afghanistan, which were pending at the time.[3] Added spending for deposit insurance and unemployment benefits also contributes to the increase in overall spending in 2008.

CBO has also updated its baseline budget projections for the coming decade. In accordance with long-standing procedures, CBO's projections assume that current laws and policies remain in place.[4] 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.

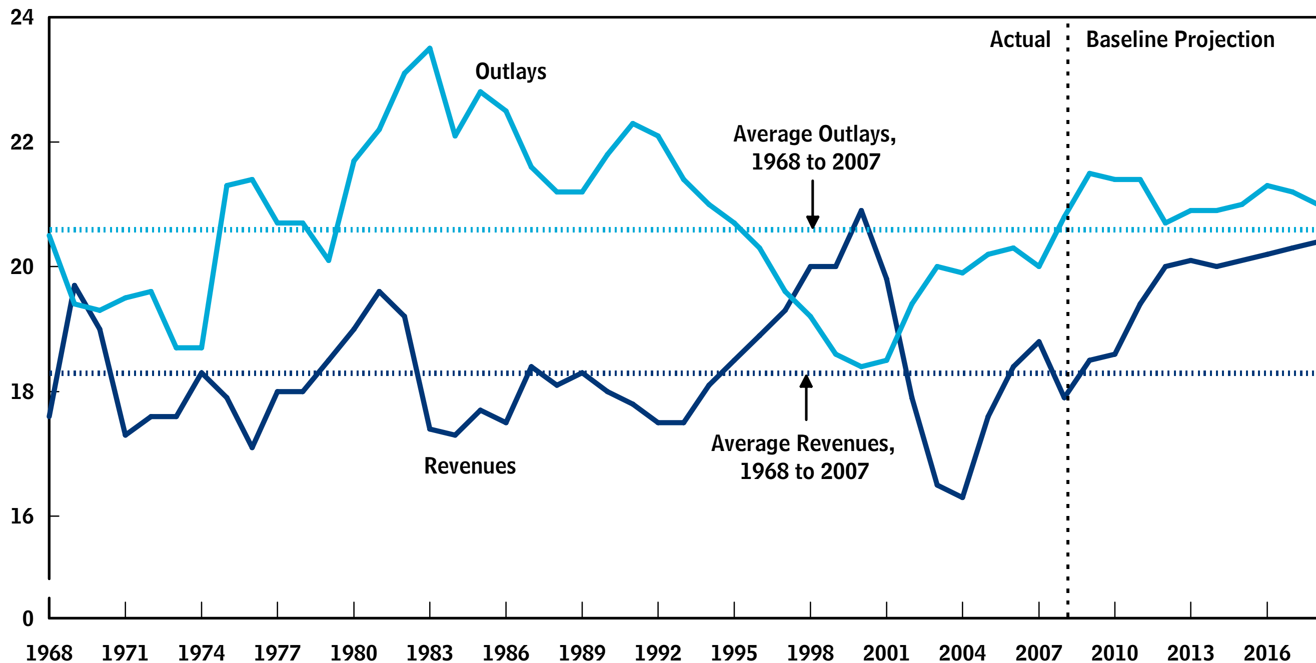
Over the next 10 years, total outlays are projected to remain steady at roughly 21 percent of GDP—higher than the average of 20.6 percent over the previous 40 years (see Summary Figure 1). Mandatory spending (excluding offsetting receipts) is estimated to grow

3. In *An Analysis of the President's Budgetary Proposals for Fiscal Year 2009* (March 2008), CBO estimated that the deficit would total $357 billion (under current policies at that time) and that the President's request for funding for ongoing operations in Iraq and Afghanistan would add $28 billion, for a prospective total of $385 billion.

4. Exceptions exist for certain mandatory programs, primarily those 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 Figure 1.

Total Revenues and Outlays as a Percentage of Gross Domestic Product, 1968 to 2018



Source: Congressional Budget Office.

1.2 percentage points faster each year than nominal GDP does, but, by convention, discretionary spending is assumed to increase at the rate of inflation and thus at about two-thirds the growth rate of GDP. (CBO projects that annual growth of nominal GDP will average 4.6 percent over the 2009–2018 period.)

Total revenues are projected to rise from 17.9 percent of GDP this year (almost 1 percentage point lower than their share last year) to about 18.5 percent for the next two years. Much of the growth next year results from the expiration of higher exemption amounts that have mitigated the effects of the alternative minimum tax and the end of most disbursements of tax rebates in 2008. Under current law, revenues would rise further, to 20.0 percent of GDP in 2012, following the scheduled expiration of tax provisions originally enacted in 2001 and 2003; they would reach 20.4 percent of GDP in 2018.

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 expected to fall from 2.7 percent of GDP last year to 2.2 percent this year and to gradually diminish thereafter. Other sources of revenues, the largest of which is social insurance taxes, are estimated to remain stable as a share of GDP.

Many policymakers and other analysts believe that at least some of the expiring tax provisions will be extended past their scheduled expirations. Nonetheless, if all tax provisions expired as specified under current law and if other policies remained the same (the assumptions underlying CBO's baseline projections), deficits would range between 0.6 percent and 1.0 percent of GDP for fiscal years 2012 through 2018.

Since March, the bottom line in CBO's baseline over the next 10 years has worsened by an average of nearly $260 billion per year. Some of that deterioration is due to the weakened economy, near-term inflation, and other economic variables; those factors increased projected deficits (or decreased projected surpluses) by about $85 billion a year. However, the larger component of the changes results from extrapolating into future years the supplemental appropriations enacted in June, in accordance with the rules governing the baseline. Those

extrapolations boost the cumulative deficit by nearly $1.2 trillion over the 2009–2018 period (excluding debt service). Other legislation enacted in recent months, including an act addressing problems in the housing market and the provision of an enhanced education benefit for veterans, have also contributed to the worsening budget outlook for the next 10 years.

The Long-Term Budget Outlook

Over the long term, the budget remains on an unsustainable path. Unless changes are made to current policies, growing demand for resources caused by rising health care costs and the nation's expanding elderly population will put increasing pressure on the budget. According to CBO's estimates, federal spending on Medicare and Medicaid is expected to total 4.6 percent of GDP this year, and, without changes in law, such spending will rise to 6.0 percent of GDP in 2018—an increase of 30 percent in just 10 years. Over the same period, spending on Social Security will rise from 4.3 percent of GDP to 5.0 percent.

Beyond 2018, those trends are poised to accelerate. Over the past four decades, per-beneficiary costs in the Medicare and Medicaid programs have increased about 2.5 percentage points faster per year than has per capita GDP. Even if that gap shrinks, CBO anticipates that outlays for those two health care programs combined could reach 12 percent of GDP by 2050. Without changes to federal fiscal policies, those rising costs would drive the amount of debt held by the public significantly higher than the 38 percent of GDP it represents today.[5] Over the long run, growing budget deficits and the resulting increases in federal debt would lead to slower economic growth. The difference in economic costs between acting to address the projected deficits (by either reducing spending or raising revenues) and failing to do so is generally much larger than the cost implications of pursuing one approach to deficit reduction rather than another.

5. See Congressional Budget Office, *The Long-Term Budget Outlook and Options for Slowing the Growth of Health Care Costs* (June 2008).

The Economic Outlook

The economic outlook this year has deteriorated as a result of the problems in the housing and financial markets, along with the high price of energy and agricultural commodities. Home prices and the number of construction projects continue to fall, and surging delinquencies and foreclosures on mortgage loans continue to destabilize financial markets. Rapid increases in the prices for energy and agricultural commodities in the first several months of the year reduced real (inflation-adjusted) income and spending on other goods and services. Real growth of GDP is projected to average below 1 percent (measured at an annual rate) from the last quarter of 2007 through the middle of 2009, before picking up during the second half of 2009. The growth of employment will probably remain weak through the middle of next year, keeping the unemployment rate above 6 percent in the near term. Inflation is expected to moderate later this year as energy and food prices ease back.

Specifically, CBO forecasts that, for calendar year 2008, GDP will grow by about 1.5 percent in real terms and, for 2009, 1.1 percent (see Summary Table 2). Inflation, as measured by the year-to-year change in the consumer price index for all urban consumers (CPI-U), is projected to remain high and average 4.7 percent for the year but to moderate in 2009, falling to an average of 3.1 percent. However, the underlying, or core, rate of consumer price inflation (which excludes the volatile energy and food prices) is expected to be relatively stable, averaging 2.4 percent over the next year and a half.

CBO also expects that as the economy recovers, interest rates on Treasury securities will rise next year from their current low levels. In CBO's forecast, the interest rate on 3-month Treasury bills averages 1.9 percent in 2008 and 2.7 percent in 2009; the rate on 10-year Treasury notes averages 3.9 percent in 2008 and 4.4 percent in 2009.

CBO's projections beyond that two-year horizon, for 2010 to 2018, indicate real growth averaging 2.8 percent and CPI-U inflation averaging 2.2 percent. By the agency's estimates, the unemployment rate will average 5.0 percent during the 2010–2018 period, while the interest rate on 3-month Treasury bills will average 4.6 percent and the rate on 10-year Treasury notes will average 5.4 percent.

Summary Table 2.

CBO's Economic Projections for Calendar Years 2008 to 2018

(Percentage change)

	Estimated	Forecast		Projected Annual Average	
	2007[a]	2008	2009	2010-2013	2014-2018
Nominal GDP					
Billions of dollars	13,808	14,334	14,873	18,231 [b]	22,470 [c]
Percentage change	4.8	3.8	3.8	5.2	4.3
Real GDP	2.0	1.5	1.1	3.3	2.4
GDP Price Index	2.7	2.3	2.6	1.9	1.9
PCE Price Index	2.6	3.9	3.1	1.9	1.9
Core PCE Price Index[d]	2.2	2.3	2.3	1.9	1.9
Consumer Price Index[e]	2.9	4.7	3.1	2.2	2.2
Core Consumer Price Index[f]	2.3	2.4	2.4	2.2	2.2
Unemployment Rate (Percent)	4.6	5.4	6.2	5.3	4.8
Interest Rates (Percent)					
Three-month Treasury bills	4.4	1.9	2.7	4.6	4.7
Ten-year Treasury notes	4.6	3.9	4.4	5.3	5.4

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

Notes: GDP = gross domestic product; PCE = personal consumption expenditure.

Percentage changes are measured from one year to the next.

Year-by-year economic projections for 2008 to 2018 appear in Appendix C.

a. Values as of August 22, 2008.

b. Level in 2013.

c. Level in 2018.

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

e. The consumer price index for all urban consumers.

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

CHAPTER

1

The Budget Outlook

The Congressional Budget Office (CBO) estimates that the federal budget deficit for this fiscal year will amount to $407 billion, or 2.9 percent of gross domestic product (GDP). That estimate of the 2008 deficit is about $20 billion higher than what CBO expected in March, after adding in the anticipated costs of funding for operations in Iraq and Afghanistan and other activities related to the war on terrorism.[1]

The federal fiscal situation has deteriorated markedly over the past year. The projected deficit for this year is more than twice as large as the deficit recorded for 2007, which was $161 billion, or 1.2 percent of GDP. Furthermore, CBO's projections indicate that if current laws remain in place, deficits for the next two years will stay above $400 billion, in the vicinity of 3 percent of GDP (see Table 1-1).

In CBO's baseline, projected deficits decline in 2011 and 2012 as the scheduled expiration of various tax provisions causes a rapid rise in estimated revenues. Many policymakers and other analysts believe that at least some of those tax provisions will be extended past their scheduled expirations. Nonetheless, if all tax provisions expired as specified under current law and if other policies remained the same (the assumptions underlying CBO's baseline projections), deficits would range, according to CBO's estimates, between 0.6 percent and 1.0 percent of GDP for fiscal years 2012 through 2018 (see Figure 1-1).

CBO's current baseline projections for the 10-year period from 2009 to 2018 appear significantly less favorable than those published in March, when CBO projected surpluses beginning in 2012 and a cumulative 10-year surplus of $0.3 trillion. Updated estimates for the 2009–2018 period now show deficits in each year and a cumulative 10-year deficit of $2.3 trillion. The bulk of that change results from the timing of appropriations for operations in Iraq and Afghanistan. Supplemental funding of $97 billion was appropriated for that purpose in June, and that amount is incorporated for each year in the updated projections (with adjustments for inflation). That change, by itself, adds about $1 trillion to projected spending over the 2009–2018 period (excluding debt-service costs). Revised economic assumptions also contribute significantly to the change in the budget outlook, adding about $850 billion to the aggregate deficit over that period. (See Appendix A for details on changes in CBO's baseline.)

Federal debt held by the public is expected to total $5.4 trillion at the end of this fiscal year, or 38.2 percent of GDP. Under CBO's baseline projections, debt held by the public (as a percentage of GDP) would rise next year and remain at roughly 40 percent of GDP through 2012, after which it would begin to decline slightly, falling to 35.5 percent of GDP by 2018.

Over the long term, the federal budget is on an unsustainable path. Without changes in current policies, the growing demand for resources—caused primarily by rising health care costs and, to a lesser degree, by the nation's expanding elderly population—will put increasing pressure on the budget. Federal spending for Medicare and Medicaid combined is expected to total 4.6 percent of GDP this year. Without changes in law, CBO estimates, such spending will rise to 6.0 percent of GDP in 2018—an increase of 30 percent in 10 years. Over the same period, Social Security spending will rise from 4.3 percent of GDP to 5.0 percent.

1. In *An Analysis of the President's Budgetary Proposals for Fiscal Year 2009* (March 2008), the Congressional Budget Office estimated that the deficit would total $357 billion (under current policies at that time) and that the President's request for funding for ongoing operations in Iraq and Afghanistan would add $28 billion, for a prospective total of $385 billion.

Table 1-1.

Projected Deficits and Surpluses in CBO's Baseline

(Billions of dollars)

	Actual 2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Total, 2009-2013	Total, 2009-2018
On-Budget Deficit	-342	-592	-611	-609	-520	-332	-357	-382	-374	-416	-378	-330	-2,429	-4,309
Off-Budget Surplus[a]	181	184	173	179	195	206	210	212	212	209	204	196	964	1,996
Total Deficit (-) or Surplus	**-161**	**-407**	**-438**	**-431**	**-325**	**-126**	**-147**	**-170**	**-162**	**-207**	**-174**	**-135**	**-1,466**	**-2,313**
Memorandum:														
Social Security Surplus	187	187	175	179	195	206	210	212	212	209	204	196	966	1,998
Total Deficit (-) or Surplus as a Percentage of GDP	-1.2	-2.9	-3.0	-2.8	-2.0	-0.7	-0.8	-0.9	-0.8	-1.0	-0.8	-0.6	-1.8	-1.3
Debt Held by the Public as a Percentage of GDP[b]	36.9	38.2	39.9	40.8	40.6	39.4	38.6	38.0	37.3	36.9	36.3	35.5	n.a.	n.a.
Probability of a Budget Deficit (Percent)	n.a.	100	98	92	81	61	61	c	c	c	c	c	n.a.	n.a.

Source: Congressional Budget Office.

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

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

b. Debt held at the end of the year.

c. Probabilities for years after 2013 cannot be calculated because of an insufficient history of past comparisons between projections and outcomes.

CBO's baseline projections are not intended to be a forecast of future budgetary outcomes; rather, they serve as a neutral benchmark that legislators and others can use to assess the potential effects of policy decisions. As such, CBO's baseline projections do not incorporate anticipated changes in policy. However, this chapter describes the budgetary implications of some alternative policy assumptions. For example, CBO has constructed two possible scenarios for future spending related to military operations in Iraq and Afghanistan and other activities associated with the war on terrorism. Those scenarios incorporate different assumptions about how rapidly troop levels might be reduced. Under both scenarios, outlays over the 10-year period would be significantly lower than those in CBO's baseline projections.

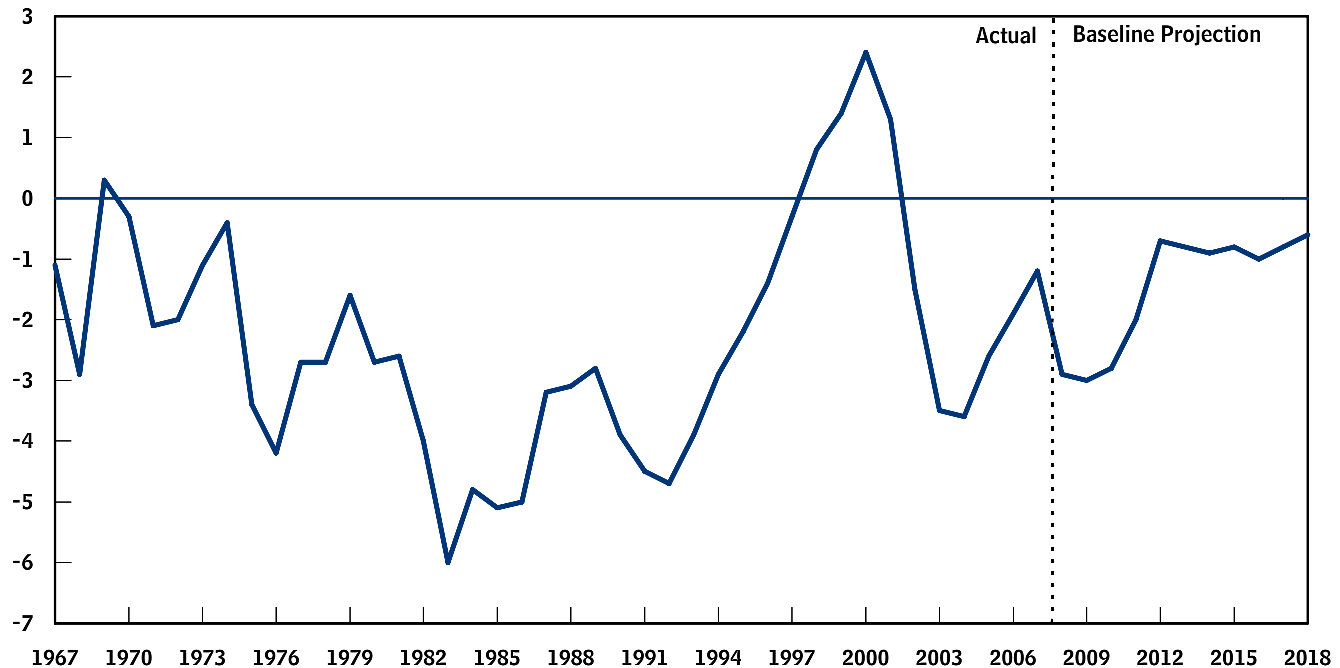
CBO also has estimated alternative projections for federal revenues under a scenario in which all of the tax provisions that are scheduled to expire over the next 10 years would be extended and the alternative minimum tax (AMT) would be indexed for inflation. According to estimates provided by the Joint Committee on Taxation, enacting those changes alone would add about $100 billion to the projected deficit for 2009, boosting that figure to more than $500 billion. Over the 2009–2018 period, those changes would increase projected deficits by about $4.2 trillion, even without taking into account any additional debt-service costs.

In addition to following long-standing rules about the treatment of current laws and policies, CBO's baseline projections are based on assumptions about how the economy will perform in the future and how tax and spending policies will affect that performance. Because actual outcomes almost certainly will differ from CBO's projections, it is useful to view those projections as the midpoint within a range of potential outcomes. For example, even though CBO projects deficits for the next several years (under baseline assumptions), there is some

Figure 1-1.

The Total Deficit or Surplus

(Percentage of gross domestic product)



Source: Congressional Budget Office.

likelihood that, under those assumptions, the budget could show a surplus. For 2010, for example, CBO projects the probability of a deficit under current policies to be 92 percent, implying an 8 percent chance of a surplus (see Table 1-1).

The Outlook for 2008

CBO estimates that the deficit in 2008 will be more than twice as large as the shortfall in 2007, rising from $161 billion (or 1.2 percent of GDP) in 2007 to $407 billion in 2008, or about 2.9 percent of GDP. The significant expansion in the deficit is the result of a substantial increase in spending and a halt in revenue growth. In 2008, CBO estimates, federal spending will be 8.3 percent higher than it was in 2007; at the same time, total revenues will be less than they were in 2007 (see Table 1-2).

Revenues

On the basis of tax collections through July, CBO expects federal revenues to total $2.5 trillion this fiscal year (see Table 1-3), a decline of 0.8 percent from 2007. That drop is largely a result of rebates provided in the Economic Stimulus Act of 2008 (Public Law 110-185), which was enacted in February. Without those rebates, revenues would have increased by about 1.5 percent in 2008. If all of the direct effects on revenues of the Economic Stimulus Act—both the rebates and the business depreciation provisions—were excluded, revenues would have increased by about 2.5 percent this year, CBO estimates.

Revenues from all major sources have grown more slowly in 2008 than in 2007. Withholding of individual income and payroll taxes, the largest source of tax collections, is expected to grow by about 4 percent in 2008, after rising by nearly 7 percent in both 2006 and 2007.[2] That

2. In analyzing recent tax collections from withholding of individual income and payroll taxes, CBO focuses on the combined amount rather than separate amounts as reported by the Treasury Department in its *Monthly Treasury Statement of Receipts and Outlays of the United States Government*. Employers remit the combined amount of withheld taxes to the Internal Revenue Service without specifying the breakdown between individual income taxes and social insurance taxes. The Treasury estimates the division between the two sources at the end of each month, and the estimates are revised when supporting information becomes available (which may be as long as several years later). As a result, some of the receipts attributed to individual income taxes may later turn out to have been derived from social insurance taxes, or vice versa.

Table 1-2.

Average Annual Growth Rates of Revenues and Outlays Since 1997 and as Projected in CBO's Baseline

(Percent)

	Actual		Estimated	Projected[a]	
	1997-2006	2007	2008	2009	2010-2018
			Revenues		
Individual Income Taxes	4.7	11.5	-0.4	11.8	7.2
Corporate Income Taxes	7.5	4.6	-14.9	-0.1	3.2
Social Insurance Taxes	5.1	3.8	3.3	4.4	4.5
Other Revenues[b]	4.0	-3.9	6.2	-2.8	6.7
Total Revenues	**5.2**	**6.7**	**-0.8**	**6.8**	**5.9**
			Outlays		
Mandatory	6.0	2.8	9.3	9.0	5.4
Social Security	4.6	6.9	5.3	7.9	6.0
Medicare	6.9	16.7	4.1	9.3	6.7
Medicaid	7.0	5.5	6.2	9.7	8.1
Other mandatory outlays[c]	7.2	-22.5	30.4	10.4	-1.1
Discretionary	6.7	2.4	8.1	6.8	2.6
Defense	6.9	5.4	10.5	8.7	2.8
Nondefense	6.4	-0.7	5.5	4.5	2.3
Net Interest	-0.6	4.6	2.9	-7.0	6.4
Total Outlays	**5.5**	**2.8**	**8.3**	**6.9**	**4.5**
Total Outlays Excluding Net Interest	6.3	2.6	8.8	8.1	4.3
Memorandum:					
Consumer Price Index	2.6	2.3	4.5	3.8	2.2
Nominal GDP	5.4	4.9	4.2	3.6	4.7
Discretionary Budget Authority	7.2	6.8	7.8	4.1	2.3
Defense	7.7	11.8	10.5	2.2	2.4
Nondefense	6.6	0.5	4.2	6.7	2.3

Source: Congressional Budget Office.

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

GDP = gross domestic product.

a. When constructing its baseline, CBO uses the employment cost index for wages and salaries to inflate discretionary spending related to federal personnel and the GDP price index to adjust other discretionary spending.

b. Includes excise taxes, estate and gift taxes, customs duties, and miscellaneous receipts.

c. Includes offsetting receipts (funds collected by government agencies from other government accounts or from the public in businesslike or market-oriented transactions that are recorded as offsets to outlays).

Table 1-3.

CBO's Baseline Budget Projections

	Actual 2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Total, 2009-2013	Total, 2009-2018
							In Billions of Dollars							
Revenues														
Individual income taxes	1,163	1,159	1,296	1,395	1,608	1,754	1,867	1,965	2,074	2,187	2,306	2,432	7,920	18,883
Corporate income taxes	370	315	315	326	339	369	364	358	378	390	403	416	1,712	3,657
Social insurance taxes	870	898	938	990	1,046	1,101	1,148	1,193	1,240	1,289	1,340	1,393	5,223	11,679
Other revenues	165	175	170	171	185	227	240	254	266	278	291	304	994	2,388
Total Revenues	**2,568**	**2,548**	**2,720**	**2,881**	**3,178**	**3,451**	**3,619**	**3,770**	**3,958**	**4,145**	**4,341**	**4,546**	**15,848**	**36,606**
On-budget	1,933	1,891	2,032	2,159	2,416	2,649	2,782	2,898	3,050	3,200	3,358	3,524	12,038	28,069
Off-budget	635	657	687	722	762	802	837	872	907	944	982	1,022	3,810	8,537
Outlays														
Mandatory spending	1,451	1,586	1,729	1,789	1,897	1,931	2,073	2,201	2,336	2,518	2,642	2,770	9,420	21,886
Discretionary spending	1,041	1,125	1,202	1,258	1,297	1,318	1,353	1,385	1,417	1,456	1,485	1,514	6,427	13,685
Net interest	237	244	227	265	308	328	340	354	367	378	387	396	1,467	3,349
Total Outlays	**2,729**	**2,955**	**3,158**	**3,312**	**3,502**	**3,577**	**3,766**	**3,939**	**4,120**	**4,352**	**4,514**	**4,680**	**17,314**	**38,919**
On-budget	2,275	2,483	2,644	2,768	2,935	2,981	3,139	3,280	3,424	3,616	3,736	3,854	14,468	32,378
Off-budget	454	472	514	544	567	595	626	659	695	735	779	826	2,847	6,541
Deficit (-) or Surplus	**-161**	**-407**	**-438**	**-431**	**-325**	**-126**	**-147**	**-170**	**-162**	**-207**	**-174**	**-135**	**-1,466**	**-2,313**
On-budget	-342	-592	-611	-609	-520	-332	-357	-382	-374	-416	-378	-330	-2,429	-4,309
Off-budget	181	184	173	179	195	206	210	212	212	209	204	196	964	1,996
Debt Held by the Public	5,035	5,425	5,870	6,319	6,662	6,805	6,968	7,155	7,331	7,553	7,742	7,890	n.a.	n.a.
Memorandum:														
Gross Domestic Product	13,642	14,210	14,719	15,473	16,390	17,253	18,036	18,826	19,641	20,478	21,342	22,240	81,870	184,397
							As a Percentage of Gross Domestic Product							
Revenues														
Individual income taxes	8.5	8.2	8.8	9.0	9.8	10.2	10.4	10.4	10.6	10.7	10.8	10.9	9.7	10.2
Corporate income taxes	2.7	2.2	2.1	2.1	2.1	2.1	2.0	1.9	1.9	1.9	1.9	1.9	2.1	2.0
Social insurance taxes	6.4	6.3	6.4	6.4	6.4	6.4	6.4	6.3	6.3	6.3	6.3	6.3	6.4	6.3
Other revenues	1.2	1.2	1.2	1.1	1.1	1.3	1.3	1.3	1.4	1.4	1.4	1.4	1.2	1.3
Total Revenues	**18.8**	**17.9**	**18.5**	**18.6**	**19.4**	**20.0**	**20.1**	**20.0**	**20.1**	**20.2**	**20.3**	**20.4**	**19.4**	**19.9**
On-budget	14.2	13.3	13.8	14.0	14.7	15.4	15.4	15.4	15.5	15.6	15.7	15.8	14.7	15.2
Off-budget	4.7	4.6	4.7	4.7	4.7	4.6	4.6	4.6	4.6	4.6	4.6	4.6	4.7	4.6
Outlays														
Mandatory spending	10.6	11.2	11.7	11.6	11.6	11.2	11.5	11.7	11.9	12.3	12.4	12.5	11.5	11.9
Discretionary spending	7.6	7.9	8.2	8.1	7.9	7.6	7.5	7.4	7.2	7.1	7.0	6.8	7.9	7.4
Net interest	1.7	1.7	1.5	1.7	1.9	1.9	1.9	1.9	1.9	1.8	1.8	1.8	1.8	1.8
Total Outlays	**20.0**	**20.8**	**21.5**	**21.4**	**21.4**	**20.7**	**20.9**	**20.9**	**21.0**	**21.3**	**21.2**	**21.0**	**21.1**	**21.1**
On-budget	16.7	17.5	18.0	17.9	17.9	17.3	17.4	17.4	17.4	17.7	17.5	17.3	17.7	17.6
Off-budget	3.3	3.3	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.6	3.6	3.7	3.5	3.5
Deficit (-) or Surplus	**-1.2**	**-2.9**	**-3.0**	**-2.8**	**-2.0**	**-0.7**	**-0.8**	**-0.9**	**-0.8**	**-1.0**	**-0.8**	**-0.6**	**-1.8**	**-1.3**
On-budget	-2.5	-4.2	-4.2	-3.9	-3.2	-1.9	-2.0	-2.0	-1.9	-2.0	-1.8	-1.5	-3.0	-2.3
Off-budget	1.3	1.3	1.2	1.2	1.2	1.2	1.2	1.1	1.1	1.0	1.0	0.9	1.2	1.1
Debt Held by the Public	36.9	38.2	39.9	40.8	40.6	39.4	38.6	38.0	37.3	36.9	36.3	35.5	n.a.	n.a.

Source: Congressional Budget Office.

Note: n.a. = not applicable.

deceleration stems from slower growth of wages and salaries. (For a full discussion of the economic outlook, see Chapter 2.) Nonwithheld receipts of income and payroll taxes—mainly final payments made with tax return filings for 2007 and quarterly estimated payments of taxes in 2008—are expected to rise by about 5 percent this year, after increasing by roughly 13 percent last year. Corporate income tax receipts have begun to decline significantly after growing rapidly between 2003 and 2006. CBO expects receipts of corporate income taxes to end the year down by 15 percent, reflecting falling corporate profits and the impact of the recent changes in law that affect how businesses can depreciate investments made in 2008.

CBO expects that, as a share of GDP, federal revenues will total 17.9 percent in 2008, almost 1 percentage point lower than the 18.8 percent recorded in 2007. The decline relative to GDP is largely attributable to the drop in corporate receipts, which are expected to fall from 2.7 percent of GDP in 2007 to 2.2 percent this year, and in individual income tax receipts, which are expected to decline from 8.5 percent of GDP to 8.2 percent. CBO anticipates that other sources of revenue will remain more stable relative to GDP.

Individual Income and Social Insurance Taxes. In combination, receipts from individual income and social insurance taxes are expected to rise by 1.2 percent in 2008 and total $2.1 trillion. Although individual income taxes are anticipated to fall by 0.4 percent, social insurance taxes are estimated to rise by 3.3 percent.

The decline in receipts from individual income taxes stems largely from the effects of the rebates enacted in the Economic Stimulus Act. Those rebates reduce individual income tax receipts and increase outlays for refundable tax credits.[3] By the end of the fiscal year, almost $100 billion in rebates will have been disbursed, CBO expects, with roughly $60 billion of that amount representing revenue reductions. Without those rebates, CBO estimates, individual income tax receipts would have increased by about 5 percent in 2008. (That calculation does not incorporate the dynamic effects of the rebates on the economy and, therefore, on revenues.)

Payments of individual income and social insurance taxes are generally made in two forms:

- As amounts that employers withhold from their employees' paychecks and remit to the federal government on behalf of their employees; and
- As nonwithheld amounts that individuals pay directly, either in the form of quarterly estimated installments or as final payments made when they file their yearly income tax returns.

CBO expects withholding for combined income and payroll taxes to climb by about 4 percent in 2008. Those amounts grew more quickly at the beginning of the fiscal year (in the last quarter of calendar year 2007) and began to slow appreciably near the beginning of calendar year 2008, mainly because of slower growth in wages and salaries. CBO projects that wages and salaries, as measured in the national income and product accounts (NIPAs), will grow by 4.3 percent in 2008, down from 6 percent in the previous two years.

Nonwithheld receipts of income and payroll taxes are expected to climb by about 5 percent this year. Quarterly estimated payments and final payments are each projected to increase by about that same percentage. CBO expects that most of the revenue-reducing effects on individual income taxes of the enhanced depreciation rules enacted in the Economic Stimulus Act will occur in 2009. Those depreciation rules affect individual income tax receipts through their impact on depreciation claimed by noncorporate businesses, whose income is taxed at the individual level. Refunds of income taxes (excluding the rebates) are projected to grow by about 6 percent.

3. Such credits reduce a taxpayer's overall liability; if the credit exceeds that liability, the excess may be refunded to the taxpayer, in which case it is classified as an outlay in the federal budget. The 2008 rebates were calculated on the basis of information provided on tax returns filed for 2007. For many individuals, all or a portion of the rebate exceeded their 2007 tax liability. CBO estimates that about $38 billion in outlays will stem from rebates that are refunded to taxpayers in 2008. (Since CBO finalized its projections, more recent information indicates that an additional $5 billion will be classified as reductions in revenues and $5 billion less will be classified as increases in outlays; that information does not change the outlook for total rebates and thus has no effect on the deficit outlook.)

Corporate Income Taxes. CBO expects corporate income tax receipts to fall by 15 percent in 2008, to $315 billion. (Without the effects of the depreciation provisions enacted in the Economic Stimulus Act, CBO estimates, corporate receipts would have fallen by a smaller amount, roughly 9 percent.) That decline follows a rapid run-up over the 2003–2006 period, when receipts rose by an average of almost 40 percent annually.

Declining corporate profitability has reduced the amount of corporate income tax receipts. Economic profits, as measured in the NIPAs, are projected to fall by about 3 percent this year, and domestic economic profits are expected to drop by 11 percent. (The latter are a closer measure of the corporate tax base because they exclude profits earned abroad by U.S. corporations, on which they often pay little or no U.S. tax.) Neither of those measures of profit includes the effects of the recent changes to depreciation law.

Outlays

Outlays will rise by $226 billion this year, CBO estimates, to nearly $3.0 trillion—an increase of 8.3 percent. That amount of spending would equal about 20.8 percent of GDP, up from 20.0 percent last year. Spending for both mandatory and discretionary programs will contribute to the increase.

In total, CBO estimates, mandatory spending will increase by $135 billion from 2007 levels, a 9.3 percent rise. Outlays for discretionary programs—whose funding is set anew each year through appropriation acts—are anticipated to climb by $85 billion (or 8.1 percent) this year; the bulk of that increase stems from defense spending. The government's net interest costs will increase by $7 billion, CBO estimates.

Mandatory Spending. Outlays for mandatory programs generally are determined by eligibility rules and benefit levels that are set in law rather than established through the annual appropriation process. Excluding payments for net interest, mandatory spending will total $1.6 trillion in 2008, CBO estimates, about 54 percent of total federal outlays. The projected growth in such spending for 2008 (9.3 percent) is more than three times the rate experienced in 2007 and is more than 50 percent higher than the average annual rate of growth over the 1997–2006 period.

Unlike in recent years, when the growth in federal spending for Medicare and Medicaid drove the uptick in mandatory outlays, the growth this year is fueled by outlays for other mandatory programs. In particular, outlays for the refundable portion of the income tax rebates, at $38 billion, make up a sizable share of the projected $135 billion increase in mandatory spending. Other significant contributors are the Federal Deposit Insurance Corporation's (FDIC's) outlays for deposit insurance and payments for unemployment compensation, which CBO estimates will be substantially higher than in 2007, in part because of the availability of emergency extended unemployment compensation (see Table 1-4).[4]

With the number and size of failed financial institutions up sharply this year, CBO expects federal outlays for deposit insurance to rise by more than $15 billion. As of July 2008, the FDIC had spent about $18 billion to cover the insured deposits of insolvent institutions. CBO anticipates that recoveries from the sale of assets held by those banks and thrifts and receipts from insurance premiums will partially offset those outlays in 2008 and in future years.

Outlays also will be up significantly for programs that are designed to spend more when economic conditions deteriorate. CBO estimates that disbursements for unemployment compensation will rise by $11 billion this year—about one-third higher than they were in 2007. Projected outlays from the recently enacted emergency extended unemployment compensation program make up about 40 percent of that increase. In addition, CBO expects that rising caseloads and higher monthly benefits will cause spending for Food Stamps to jump by nearly 11 percent, or about $4 billion.

Growth in outlays for both Medicare and Social Security will slow this year compared with their growth last year, while federal spending for Medicaid will continue to expand at a strong pace. In 2007, spending for Medicare increased by nearly 17 percent from the previous year's level; this year, it will rise by about 4 percent, CBO estimates. In part, that slower growth is a result of legislative changes that shifted some spending out of 2006 and into 2007. Also, payments to plans for Part D (the prescrip-

4. The Supplemental Appropriations Act of 2008 (Public Law 110-252) provided up to 13 weeks of additional unemployment compensation for individuals who exhaust their regular benefits through March 2009.

Table 1-4.

CBO's Baseline Projections of Mandatory Spending

(Outlays, in billions of dollars)

	Actual 2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Total, 2009-2013	Total, 2009-2018
Social Security	581	612	661	701	738	781	827	877	930	987	1,048	1,114	3,708	8,664
Medicare[a]	436	454	496	522	569	570	634	685	737	822	855	889	2,790	6,779
Medicaid	191	202	222	240	259	280	304	329	355	384	415	449	1,304	3,237
Income Security														
Supplemental Security Income	36	41	44	46	53	46	52	53	55	62	59	55	241	525
Earned income and child tax credits	54	58	57	59	61	43	44	44	45	45	45	45	264	488
Unemployment compensation	33	44	56	51	44	43	45	48	50	52	54	56	240	498
Food Stamps	35	39	45	48	48	49	49	49	50	51	52	54	238	495
Family support[b]	24	25	25	25	25	25	25	25	25	25	25	26	124	250
Child nutrition	14	15	16	17	17	18	19	20	21	21	22	23	86	194
Foster care	7	7	7	7	7	8	8	8	8	9	9	9	37	80
Subtotal	202	228	251	252	255	231	241	248	254	265	267	268	1,230	2,531
Civilian and Military Retirement														
Federal civilian[c]	72	75	81	84	88	92	95	99	103	106	110	114	440	972
Military	44	46	50	51	53	54	55	57	58	59	61	62	263	560
Other	8	9	8	9	9	9	10	10	10	11	11	11	45	98
Subtotal	123	130	139	145	150	155	160	166	171	176	182	187	749	1,631
Veterans[d]														
Income security	36	41	43	45	49	45	49	50	52	57	55	53	231	499
Other	3	3	4	8	10	11	11	11	12	12	13	13	44	105
Subtotal	38	45	48	53	59	56	60	61	63	70	68	66	275	604

Continued

tion drug benefit) were reduced this year to correct for overpayments made in 2006. After adjusting for those changes, growth this year for Medicare spending will be about 6 percent, CBO estimates (and growth in 2007 would have been 12 percent, bolstered by the implementation of Part D for the full year).

Less dramatically, Social Security outlays will climb by 5.3 percent this year, compared with last year's 6.9 percent gain. That slowing is largely the result of a lower cost-of-living adjustment for 2008. (The 2007 growth rate for Social Security outlays also was affected by an accounting adjustment to that program in 2006; if that change were taken into account, growth in Social Security outlays would have been 5.8 percent last year.) Outlays for Medicaid are expected to be 6.2 percent higher than they were last year. That rate of growth is somewhat greater than the program experienced in 2007 (5.5 percent) but below the most recent 10-year average for that program (7.0 percent). In total, outlays for Medicare, Medicaid, and Social Security will exceed $1.25 trillion in 2008, CBO estimates, constituting about 40 percent of federal spending (not including offsetting receipts) and 8.9 percent of GDP.

Discretionary Spending. Outlays for discretionary programs are estimated to constitute 38 percent of total federal spending in 2008. The $1.1 trillion in discretionary outlays (up from $1.0 trillion in 2007) represents an increase of 8.1 percent from last year's level (see Table 1-5). The rate of growth in discretionary spending for 2008 is well above last year's 2.4 percent and higher

Table 1-4. **Continued**

CBO's Baseline Projections of Mandatory Spending

(Outlays, in billions of dollars)

	Actual 2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Total, 2009-2013	Total, 2009-2018
Other Programs														
Agriculture	12	14	18	16	17	17	18	16	15	15	15	15	86	161
TRICARE For Life	8	8	9	8	9	10	11	12	12	13	14	15	47	112
Student loans	7	4	1	3	5	5	3	3	3	3	3	3	16	30
Universal Service Fund	3	1	3	4	5	5	4	4	4	4	4	4	21	39
SCHIP	6	7	6	5	5	5	5	5	5	5	5	5	27	53
Social services	5	5	5	5	5	5	5	5	6	6	6	6	26	54
Refundable income tax rebates	0	38	6	0	0	0	0	0	0	0	0	0	6	6
GSE obligations[e]	0	0	20	5	0	0	0	0	0	0	0	0	25	25
Deposit insurance	-1	14	-4	-8	-8	-8	-6	-4	-4	-4	-4	-5	-35	-56
Other	18	23	41	37	33	33	32	30	32	33	38	39	175	348
Subtotal	57	116	102	76	71	72	72	71	72	73	79	82	394	771
Offsetting Receipts														
Medicare[f]	-65	-69	-75	-76	-79	-84	-90	-96	-102	-110	-118	-128	-403	-956
Employer's share of employee retirement	-48	-52	-54	-58	-60	-63	-65	-68	-71	-74	-77	-80	-301	-671
Other	-64	-81	-60	-65	-65	-67	-70	-72	-73	-75	-78	-78	-327	-703
Subtotal	-177	-201	-189	-199	-204	-213	-225	-236	-247	-259	-273	-285	-1,031	-2,330
Total Mandatory Spending	**1,451**	**1,586**	**1,729**	**1,789**	**1,897**	**1,931**	**2,073**	**2,201**	**2,336**	**2,518**	**2,642**	**2,770**	**9,420**	**21,886**
Memorandum:														
Mandatory Spending Excluding Offsetting Receipts	1,629	1,787	1,918	1,988	2,102	2,144	2,298	2,436	2,582	2,777	2,914	3,056	10,450	24,216
Medicare Spending Net of Offsetting Receipts	371	385	421	446	491	486	544	589	635	712	737	761	2,387	5,823

Source: Congressional Budget Office.

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

SCHIP = State Children's Health Insurance Program; GSE = government-sponsored enterprise.

a. Excludes offsetting receipts (funds collected by government agencies from other government accounts or from the public in businesslike or market-oriented transactions that are recorded as offsets to outlays).

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. Income security includes veterans' compensation, pensions, and life insurance programs. Other benefits are primarily education subsidies.

e. CBO's estimate of the expected value of the temporary authority granted to the Secretary of the Treasury to purchase any obligations of and securities issued by the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac).

f. 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 2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Total, 2009-2013	Total, 2009-2018
Budget Authority														
Defense	622	688	703	720	735	753	770	789	807	827	846	867	3,681	7,816
Nondefense	450	469	500	510	521	534	546	560	573	587	601	616	2,611	5,549
Total	**1,072**	**1,156**	**1,203**	**1,230**	**1,256**	**1,286**	**1,316**	**1,349**	**1,381**	**1,414**	**1,448**	**1,483**	**6,292**	**13,365**
Outlays														
Defense	548	605	658	696	723	732	755	773	792	816	831	845	3,565	7,621
Nondefense	493	520	543	562	574	585	598	612	625	640	655	669	2,863	6,063
Total	**1,041**	**1,125**	**1,202**	**1,258**	**1,297**	**1,318**	**1,353**	**1,385**	**1,417**	**1,456**	**1,485**	**1,514**	**6,427**	**13,685**

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.

Discretionary spending 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 replaced by the GDP price index) and the employment cost index for wages and salaries.

than the 6.7 percent average annual increase recorded in recent years.

More than half of discretionary outlays are spent on national defense. CBO estimates that defense outlays will total $605 billion in 2008—a gain of 10.5 percent from last year's level. (The increase drops to 9.7 percent when a shift in the timing of certain personnel payments from 2007 into 2006 is taken into account.) That rate of growth is the highest since 2004 and reflects a rapid run-up in budget authority (the authorization to incur financial obligations that will result in outlays) over the past three years; such authority has escalated by 11.2 percent a year, on average, since 2005 (see Figure 1-2).

Recent increases in defense spending have stemmed from higher funding for operations in Iraq and Afghanistan and for other activities related to the war on terrorism, as well as for defense activities not directly related to those conflicts. Funding for war-related operations continued to expand in 2008 (by about 9 percent). Budget authority for non-war-related defense programs rose even more than funding for the war in 2008—by roughly 11 percent. (For an overview of funding since 2001 for operations in Iraq and Afghanistan and other activities related to the war on terrorism, see Box 1-1.)

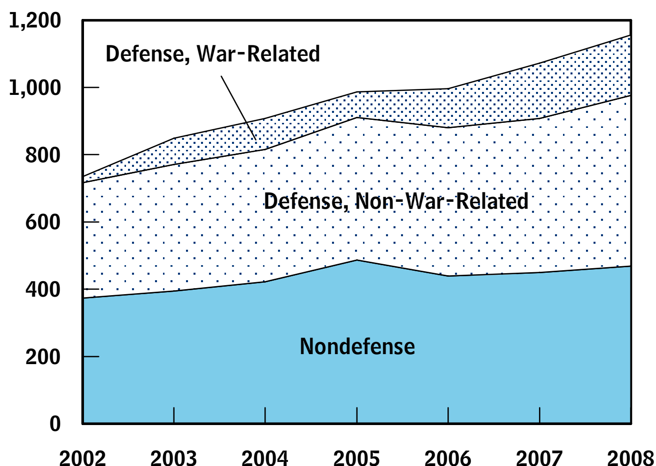
Nondefense discretionary outlays are expected to climb from $493 billion in 2007 to $520 billion this year, an increase of $27 billion, or 5.5 percent. That increase is spread widely throughout the budget. However, outlays in several areas are expected to grow substantially—in particular, for veterans' health benefits ($4.3 billion), transportation programs ($4.9 billion), and immigration, customs, and border enforcement ($2.1 billion). In the other direction, outlays for disaster relief are anticipated to be $2.2 billion lower than in 2007; outlays for community development and for relief and reconstruction efforts in Iraq are also likely to be lower, by nearly $2 billion each in 2008.

Net Interest. Federal outlays for net interest payments will grow by 2.9 percent this year to a total of $244 billion (or 1.7 percent of GDP). For 2008, federal payments for net interest will represent about 8 percent of all federal outlays. The increase in interest outlays results from higher inflation, an increase in the amount of federal debt, and more intragovernmental interest payments, effects that are mostly offset by lower short-term interest rates.

Figure 1-2.

Discretionary Budget Authority

(Billions of dollars)



Source: Congressional Budget Office.

Baseline Budget Projections for 2009 Through 2018

Under the assumptions underlying the baseline, the budget deficit would rise to $438 billion in 2009. Revenues would increase by 6.8 percent in 2009, rebounding from their slump this year. Outlay growth would slow moderately to 6.9 percent. As a percentage of GDP, both revenues and outlays would increase relative to their levels in 2008. Because growth in outlays is projected to outstrip growth in revenues, the deficit would increase.

At 3.0 percent of GDP, the deficit in 2009 would be slightly larger than it is estimated to be this year. Under current laws and policies, the deficit would fall to 2.8 percent of GDP in 2010, CBO projects, and drop further to 2.0 percent of GDP in 2011. Deficits would decline faster starting in 2012, when the full effects of the expiring tax provisions would be realized. By 2018, the federal deficit would represent about 0.6 percent of GDP under the assumptions of CBO's baseline projections.

Revenues

CBO projects that receipts will climb from 17.9 percent of GDP in 2008 to about 18.5 percent of GDP in 2009 and 2010. After 2010, projected revenues increase sharply with the expiration of 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). By 2012, revenues in CBO's baseline reach 20.0 percent of GDP. Because of the structure of the individual income tax, projected revenues continue to rise thereafter relative to the size of the economy, to 20.4 percent of GDP by 2018.

Individual Income Taxes. CBO projects that under current law, individual income tax receipts as a share of GDP will rise from 8.2 percent this year to 10.9 percent in 2018. The scheduled expiration of various current tax provisions causes projected revenues to increase in 2009 and 2010 and rise even more in 2011 and 2012. In addition, certain characteristics of the tax system cause revenues from individual income taxes to grow faster than GDP in most years. However, in some years, particularly 2009 and 2010, those factors are offset by projected slower growth in capital gains realizations and, to a lesser extent, by CBO's assumption that the portion of recent receipts that cannot be explained on the basis of current economic data will gradually disappear starting in 2010.

Various changes in tax rules that are scheduled to occur would boost individual income tax receipts relative to GDP over the next decade. The higher exemption amounts that have mitigated the effects of the alternative minimum tax expired at the end of 2007. CBO expects that, in the absence of future legislation, the resulting increase in tax liability in 2008 will be paid almost entirely in fiscal year 2009, raising receipts relative to GDP by about 0.5 percentage points. Disbursements of rebates will be completed in fiscal year 2008, providing another (slightly smaller) boost to revenues in 2009. Furthermore, a number of changes in tax law that were originally enacted in EGTRRA and JGTRRA are scheduled to expire at the end of December 2010, raising projected revenues sharply in 2011 and 2012. Those changes in law would, among other things, increase statutory tax rates on ordinary income, capital gains, and dividends; narrow the 15 percent tax bracket for people who file jointly; and reduce the child tax credit. Those expirations would boost income tax receipts by roughly 1.0 percentage point of GDP through 2018, CBO estimates.

In addition, several 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, wherein the overall growth of real (inflation-adjusted) income causes more income to be taxed in higher tax

Box 1-1.

Funding for Operations in Iraq and Afghanistan and for Other Activities Related to the War on Terrorism

Since September 2001, lawmakers have provided a total of $858 billion in budget authority for military and diplomatic operations in Iraq, Afghanistan, and other regions in support of the war on terrorism and for related veterans' benefits and services (see the table). Appropriations specifically designated for those activities, which averaged about $93 billion a year from 2003 through 2005, rose to $120 billion in 2006, to $171 billion in 2007, and to $186 billion in 2008. The Congress has appropriated $68 billion for war-related activities for the first part of 2009.

Funding to date for military operations and other defense activities related to the war totals $771 billion, most of which has gone to the Department of Defense (DoD). Lawmakers have also provided more than $38 billion to train and equip indigenous security forces in Iraq and Afghanistan.[1] A total of $810 billion has thus been appropriated since September 2001 for defense operations in Iraq and Afghanistan and for the war on terrorism.

In addition, $46 billion has been provided for diplomatic operations and foreign aid to Iraq, Afghanistan, and other countries that are assisting the United States in the war on terrorism. Of that amount, $16 billion was appropriated for the Iraq Relief and Reconstruction Fund.

DoD reports that in 2008, obligations for operations in Iraq and Afghanistan and for other activities related to the war on terrorism have averaged about $11 billion per month through June, the last month for which data are currently available. That rate is unchanged from the average monthly obligations in 2007. Because more than half of the funding for 2008 was provided at the end of June, however, the Congressional Budget Office (CBO) expects that monthly obligations will increase during the last quarter of this fiscal year.

Operation Iraqi Freedom accounts for approximately 82 percent of all reported obligations in 2008—down from 85 percent in 2007; Operation Enduring Freedom (which refers mainly to operations in and around Afghanistan) accounts for another 18 percent. Additional security missions that have taken place in the United States since the terrorist attacks of September 11, 2001—such as combat air patrols over Washington, D.C., and New York City (known as Operation Noble Eagle)—account for less than 1 percent.

Because most appropriations for operations in Iraq and Afghanistan and for other activities related to the war on terrorism appear in the same budget accounts that record appropriations for DoD's other functions, determining how much has actually been spent for those activities is difficult. However, CBO estimates that appropriations for defense operations in Iraq and Afghanistan and for the war on terrorism resulted in outlays of about $430 billion through fiscal year 2007 (with about $115 billion occurring in 2007). Of the funds appropriated for international affairs related to the war, about $30 billion was spent through 2007, CBO estimates. In total, outlays for operations in Iraq and Afghanistan amounted to about $120 billion last year. Outlays in 2008 (which also include outlays from prior years' appropriations) will total about $145 billion, in CBO's estimation.

1. The $38 billion includes $5 billion provided for Iraqi security forces in 2004 in an appropriation for the Department of State's Iraq Relief and Reconstruction Fund.

Continued

Box 1-1. Continued

Funding for Operations in Iraq and Afghanistan and for Other Activities Related to the War on Terrorism

Estimated Appropriations Provided to Date for U.S. Operations in Iraq and Afghanistan and for the War on Terrorism, 2001 to 2009

(Budget authority, in billions of dollars, by fiscal year)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	Total, 2001-2009
Military Operations and Other Defense Activities										
Iraq[a]	0	0	46	68	53	89	113	133	52	553
Other[b]	14	18	34	21	18	22	39	41	11	218
Subtotal	14	18	80	88	71	111	152	174	63	771
Indigenous Security Forces[c]										
Iraq	0	0	0	5	5	3	6	3	1	23
Afghanistan	0	0	0	0	1	2	7	3	2	15
Subtotal	0	0	0	5	7	5	13	6	3	38
Diplomatic Operations and Foreign Aid										
Iraq	0	0	3	15	1	3	3	2	1	28
Other	*	2	5	2	2	1	2	2	1	17
Subtotal	*	2	8	17	3	4	5	4	2	46
Veterans' Benefits and Services[d]										
Iraq	0	0	0	0	0	0	1	1	0	2
Other	0	0	0	0	0	0	*	*	0	1
Subtotal	0	0	0	0	0	0	1	2	0	2
Total Budget Authority	**14**	**19**	**88**	**111**	**81**	**120**	**171**	**186**	**68**	**858**

Source: Congressional Budget Office.

Note: * = between zero and $500 million.

a. CBO estimated the funding provided for Operation Iraqi Freedom by allocating funds on the basis of information in budget justification materials from the Department of Defense and in monthly reports on the agency's obligations.

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, efforts to permanently increase the size of the Army and Marine Corps, and other operations. (For 2005 through 2009, 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, which was appropriated in accounts for diplomatic operations and foreign aid (budget function 150) in 2004 and in accounts for defense (budget function 050) since 2005, is used to train and equip local military and police units in Iraq and Afghanistan.

d. Excludes about $3 billion in spending through 2008 for medical care, disability compensation, and survivors' benefits for veterans of operations in Iraq and Afghanistan and the war on terrorism. Those amounts, which were not explicitly appropriated for war-related expenses, are based on CBO's estimates of spending from regular appropriations for the Department of Veterans Affairs.

brackets. That factor is projected to push up receipts relative to GDP by about 0.5 percentage points over the next 10 years. Moreover, as nominal income rises, a growing share will be claimed by the AMT.[5] CBO estimates that without changes in law, the AMT will increase tax revenue relative to the size of the economy by about 0.4 percentage points between 2008 and 2018. 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. Taxation of those sources of retirement income is expected to cause revenues to rise relative to the size of the economy by about 0.4 percentage points over the 2009–2018 period.

CBO's projection of the increase in individual income tax receipts arising from those combined factors is held down by the expected slower growth in capital gains and by an assumption about how long unexplained factors boosting recent individual income tax receipts will last. Strong growth in capital gains realizations since 2002 has raised them to a level relative to GDP that is well above that implied by historical relationships, given the rate at which they are currently taxed. CBO estimates that capital gains realizations will decline relative to GDP except in 2010, when the imminent increase in the top tax rate on gains (from 15 percent to 20 percent) scheduled for 2011 will encourage taxpayers to speed up their sale of assets, to 2010. CBO projects that revenue from capital gains will fall relative to GDP by about 0.4 percentage points by 2018.

In addition, despite a recent slowing in revenue growth, total receipts over the past three years have risen faster than can be explained by current data. The particular sources of those unexplained receipts will not be known until information from 2006, 2007, and 2008 tax returns becomes available. In the absence of that information, CBO assumes that the unexplained portion will persist through 2009 and that such receipts will gradually decline over the following several years. Over the longer term, the relationship between taxable income and GDP will return to that seen in the most recently available tax return data, CBO expects. That assumption causes projected revenues to decrease as a share of GDP by about 0.3 percentage points.

Corporate Income Taxes. Revenues from corporate income taxes are projected to be near 2.1 percent of the economy through 2012, before declining to 1.9 percent of GDP thereafter, the same level that was seen, on average, between 1980 and 2007.

In recent years, corporate profits reached new highs relative to GDP; domestic economic profits peaked at 10.7 percent of GDP in 2006. CBO projects that domestic economic profits will be 8.4 percent of GDP in 2008 and fall to 7.7 percent by 2010, before returning to 8.3 percent of GDP after 2011, a level more consistent with their historical relationship to GDP.

Social Insurance and Other Taxes. Receipts from social insurance taxes are projected to grow at roughly the same rate as the economy over the next decade, primarily because wages and salaries are expected to remain relatively constant as a share of GDP during that period. As a result, social insurance taxes in CBO's baseline projections stay between 6.3 percent and 6.4 percent of GDP through 2018.

Total revenues from sources other than income and payroll taxes are expected to remain at about 1.1 percent of GDP through 2011 and then rise to 1.3 percent of GDP in 2012 and 1.4 percent of GDP by the end of the 10-year period.

The increase in other taxes as a share of GDP can be attributed to changes in the laws affecting estate and gift taxes. Under the provisions of current law, receipts from estate and gift taxes are anticipated 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, under EGTRRA, ultimately repealed for 2010. 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 to 0.4 percent of GDP by 2018.

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 2009–2018 period.

5. Like the regular income tax, the AMT extracts a greater proportion of overall income as real (inflation-adjusted) income rises. But unlike the regular income tax, the AMT is not indexed for inflation. So as incomes rise each year with the overall price level, a larger number of taxpayers find themselves subject to the alternative minimum tax.

Outlays

Under the assumptions governing the construction of CBO's baseline, total outlays are projected to average 21.1 percent of GDP over the next 10 years, compared with 20.0 percent in 2007 and 20.8 percent in 2008. Under current law, mandatory outlays are estimated to grow rapidly, outstripping growth in nominal GDP. In contrast, discretionary spending is projected to grow much more slowly, under the assumption that funding increases at the rate of inflation.

Mandatory Spending. Outlays for mandatory spending are projected to rise to about $1.7 trillion in 2009, 9.0 percent higher than the amount expected in 2008 (assuming no changes in current law). That year-over-year increase for 2009, which is similar to the increase expected this year, would be higher than the average rate of growth recorded over the past 10 years. Over the 2010–2018 period, CBO projects, those trends will moderate to some extent, with growth in mandatory spending averaging 5.4 percent under baseline assumptions.

Despite somewhat slower growth in Medicare spending in 2008, CBO projects that long-running trends of high growth in such spending will resume in 2009, with outlays for that program (not including offsetting receipts) rising by 9.3 percent. Over the 2010–2018 period, growth will average 6.7 percent a year, CBO projects, in line with the 6.9 percent growth experienced over the past decade. Under current law, and thus in the baseline, projected growth in Medicare spending is limited by a rate-setting system (the "sustainable growth rate") that controls the fees paid for physicians' services in Medicare. Under that system, CBO projects, those fees will be reduced by about 21 percent in 2010 and more thereafter. If legislation was enacted to override those reductions (as has happened in every year since 2003), spending on Medicare could be significantly greater than is projected in CBO's baseline.[6]

CBO expects Medicaid outlays to rise by 9.7 percent in 2009. Strong growth in spending for that program is expected to persist in the coming years, with increases averaging 8.1 percent annually through 2018. At that time, federal spending for Medicaid will reach $449 billion, or 2.0 percent of GDP, CBO estimates.

Outlays for Social Security are expected to grow faster over the coming decade than in previous years. Over the 1997–2006 period, such spending increased at a rate of 4.6 percent per year, on average. CBO estimates that outlays for Social Security will rise by 7.9 percent next year and by 6.0 percent per year from 2010 to 2018. The most significant factor underlying next year's anticipated increase in outlays is a higher cost-of-living adjustment. CBO expects that the adjustment in January 2009 will be 5.7 percent, nearly double the average of almost 3 percent paid out in each of the past five years. As inflation (the basis of the cost-of-living adjustment) moderates in subsequent years, CBO expects the rate of growth to diminish.

Another factor pushing up Social Security spending is the increase in caseloads. The oldest baby boomers began filing for Social Security benefits in calendar year 2008, and those caseload effects will be felt more fully in fiscal year 2009. Over the longer term, growth in caseloads will accelerate as more of the baby boomers collect benefits, with the number of beneficiaries rising from 51 million in 2009 to 64 million in 2018, CBO estimates.

Also contributing to the growth in mandatory spending over the next 10 years are greater outlays for veterans' benefits. Mandatory spending on veterans' benefits includes disability compensation, pensions, and life insurance programs, as well as readjustment benefits (which include education subsidies).[7] Together, those benefits will total $48 billion in 2009, CBO estimates. By 2018, CBO projects, they will total $66 billion. Although compensation and pension expenses are projected to grow at a rate of about 2.2 percent a year, on average, veterans' readjustment expenses will rise more rapidly. Outlays for those benefits will more than triple in coming years, CBO estimates, as provisions of the Post-9/11 Veterans Education Assistance Act of 2008 (enacted as part of Public Law 110-252) take effect. That legislation created a new education program for individuals with active-duty service since September 11, 2001. CBO projects that the cost of those benefits will rise from $4 billion in 2009 to $12 billion by 2018.

6. For example, if policymakers changed the way in which the costs of physicians' services were adjusted each year, by accounting for medical inflation (instead of using the sustainable growth rate), outlays would increase by $300 billion over the 2010—2018 period, CBO estimates.

7. The costs discussed in this section do not include veterans' health care benefits, which are discretionary.

Table 1-6.

Funding for Military Operations in Iraq and Afghanistan and for Other Activities Related to the War on Terrorism, 2008 and 2009

(Budget authority, in billions of dollars)

	2008	2009
Funding for Mine-Resistant Vehicles for Forces in Iraq and Afghanistan		
Enacted in September 2007[a]	5	0
Enacted in November 2007[b]	12	0
Funding for Military Operations in Iraq and Afghanistan and for Other Defense Activities Related to the War on Terrorism		
Bridge Funding Enacted in December 2007[c]	70	0
Enacted in June 2008[d]	93	0
Bridge Funding Enacted in June 2008 for 2009[d]	0	66
Funding for Nondefense Activities in Iraq and Afghanistan and for Other Activities Related to the War on Terrorism		
Enacted in December 2007[c]	2	0
Enacted in June 2008[d]	4	2
Total Budget Authority	**186**	**68**
Memorandum:		
Other Supplemental Funding Enacted in June 2008[d]	14	8

Source: Congressional Budget Office.

a. A joint resolution making continuing appropriations for the fiscal year 2008, and for other purposes (Public Law 110-92), enacted September 29, 2007.

b. Department of Defense Appropriations Act, 2008 (Public Law 110-116), enacted November 13, 2007.

c. Consolidated Appropriations Act, 2008 (Public Law 110-161), enacted December 26, 2007.

d. Supplemental Appropriations Act, 2008 (Public Law 110-252), enacted June 30, 2008.

Outlays for other mandatory programs are projected to grow more slowly—or, in some cases, decline—after showing large increases in 2008 and 2009. Growth in outlays for refundable tax credits, unemployment compensation, Food Stamps, and deposit insurance is likely to slow over the coming 10 years, compared with their rapid growth in the near term. Payments of the refundable portion of the tax rebates issued in 2008 will amount to $6 billion in 2009 and will not be a factor in future outlays under current law. CBO estimates that outlays for unemployment compensation will continue to rise in 2009 (by about 30 percent from their level in 2008). In CBO's baseline projections, they then fall in the following years as the unemployment rate drops and the provisions of Public Law 110-252 (which temporarily extends the number of weeks an individual can collect unemployment benefits) expire. In addition, outlays for Food Stamps are projected to grow by 17 percent next year. CBO estimates that the average monthly benefit will jump by 12 percent in 2009, mostly because of higher inflation, but also because caseloads are expected to rise significantly—by about 5 percent. Growth in spending for that program will moderate in the following years, CBO projects, rising at an annual rate of about 2 percent, on average.

For fiscal years 2009 to 2018, CBO projects that receipts collected by the FDIC will exceed the costs that the agency will incur in those years to cover insured deposits. Those receipts will come from the sale of assets acquired from failed financial institutions, from increased deposit insurance premiums charged to banks and thrift institutions, and from interest earned on the balances in the Deposit Insurance Fund. As a result, in contrast to the $14 billion in net outlays expected for 2008, CBO projects that the FDIC will show net receipts (that is, negative outlays) for the following 10 years.

CBO's baseline projections also include the estimated effects of recently enacted legislation that provides temporary authority to the Secretary of the Treasury to purchase any obligations and securities issued by the government-sponsored enterprises Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. Projected outlays for 2009 and 2010 reflect an expected-value estimate of $25 billion resulting from that provision.[8] That new authority expires on December 31, 2009.

8. For more information, see Congressional Budget Office, cost estimate for H.R. 3221, the Housing and Economic Recovery Act of 2008 (July 23, 2008); and Congressional Budget Office, "CBO's Estimate of the Cost of the Administration's Proposal to Authorize Federal Financial Assistance for the Government-Sponsored Enterprises for Housing," letter to the Honorable John M. Spratt Jr. (July 22, 2008).

Discretionary Spending. In CBO's latest baseline projections, total discretionary outlays grow at an average annual rate of 2.6 percent, rising from $1.2 trillion next year to $1.5 trillion in 2018.[9] Relative to GDP, discretionary outlays fall from 8.2 percent in 2009 to 6.8 percent in 2018. (The budgetary effects of alternative assumptions about the growth of discretionary spending are discussed later in this chapter.)

CBO's projections of discretionary spending through 2018 are based on the rules applied to baseline projections and reflect the most recent funding provided. That base level includes both regular and supplemental appropriations. The timing of such appropriations can cause sharp swings in CBO's projections of total discretionary outlays over 10 years. For example, in June, the Supplemental Appropriations Act of 2008 (Public Law 110-252) provided $111 billion in budget authority for 2008, mostly for operations in Iraq and Afghanistan and for other activities related to the war on terrorism. For 2009, the law also provided $68 billion in funding for such purposes and another $7.5 billion, primarily for disaster relief and for international programs (see Table 1-6). The 2008 supplemental funding and the appropriations for 2009 have been extrapolated to future years in CBO's baseline. Incorporating that supplemental funding into the baseline boosts CBO's projection of discretionary outlays over the 2009–2018 period by nearly $1.2 trillion over the amount projected in March.[10]

9. The rules used to project discretionary spending were set by statute in section 257 of the Balanced Budget and Emergency Deficit Control Act of 1985. Section 257 expired in September 2006, but CBO continues to follow the methodology prescribed in the law. As a result, the baseline assumes 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 (or GDP price index, which covers price changes for all of the goods and services that contribute to GDP) and the employment cost index for wages and salaries.

10. Since 2005, the Congress has provided in a separate title of an appropriation act some funding near the start of the fiscal year for activities in Iraq and Afghanistan. Such appropriations—frequently referred to as "bridge" funds—are intended to cover ongoing operations until further funding can be provided. In December 2007, lawmakers provided appropriations of $70 billion to continue operations for the first part of 2008. Similar appropriations for the first part of 2009 (a total of $66 billion) have already been provided as part of the supplemental appropriations law enacted in June; therefore, CBO's baseline includes an extrapolation of the more-recent funding in its projection of discretionary spending.

Net Interest and the Debt Limit. Under assumptions governing the baseline, net interest costs are estimated to fall in 2009 to $227 billion as a result of recent declines in short-term interest rates and projected lower inflation (see Table 1-7). For the following two years, rising short-term interest rates in CBO's economic forecast and growing federal debt raise projected outlays for net interest by an average of 17 percent per year. Growth then slows to an average annual rate of 4 percent as projected deficits decline with the expiration of the tax provisions enacted in EGTRRA and JGTRRA. Over the 2009–2018 period, outlays for net interest under CBO's baseline projections average 1.8 percent of GDP.

The baseline also includes the assumption 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 recently enacted limit of $10.615 trillion between November 2009 and March 2010.[11]

Budget Projections Under Alternative Scenarios

Future legislative actions will affect the budget outlook, causing deficits to be higher or lower than they are in CBO's baseline projections. For example, funding for operations in Iraq and Afghanistan and for other activities related to the war on terrorism is likely to follow a path different from the one in the baseline (which simply assumes the extrapolation and inflation of funding currently provided). Likewise, discretionary appropriations may grow at a higher or lower rate than the rate of inflation that is assumed in CBO's baseline. Future legislation could affect revenues as well—for example, by extending provisions of EGTRRA and JGTRRA and by modifying the AMT. The budgetary impact of those alternatives and their effect on the government's debt-service costs vary (see Table 1-8).

CBO's projections of discretionary spending for future years include the extrapolation of recent funding provided for operations in Iraq and Afghanistan and for other activities related to the war on terrorism. That extrapolation is derived from three sources: $17 billion in funding provided for 2008 for mine-resistant vehicles;

11. The statutory debt limit was raised on July 30, 2008, with enactment of the Housing and Economic Recovery Act of 2008. The previous debt limit was set at $9.815 trillion.

Table 1-7.

CBO's Baseline Projections of Federal Interest Outlays and Debt

(Billions of dollars)

	Actual 2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Total, 2009-2013	Total, 2009-2018
							Net Interest Outlays							
Interest on Treasury Debt Securities (Gross interest)[a]	430	452	434	482	540	578	607	639	669	695	720	745	2,641	6,109
Interest Received by Trust Funds														
Social Security	-106	-116	-120	-126	-134	-145	-157	-169	-182	-195	-208	-221	-681	-1,657
Other trust funds[b]	-72	-79	-75	-77	-80	-83	-86	-89	-89	-88	-87	-86	-401	-840
Subtotal	-178	-194	-195	-203	-214	-228	-242	-258	-271	-283	-295	-308	-1,082	-2,497
Other Interest[c]	-10	-14	-12	-14	-17	-20	-23	-26	-30	-33	-37	-40	-86	-252
Other Investment Income[d]	-5	*	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-6	-12
Total Net Interest Outlays	**237**	**244**	**227**	**265**	**308**	**328**	**340**	**354**	**367**	**378**	**387**	**396**	**1,467**	**3,349**
							Federal Debt[e]							
Debt Held by the Public	5,035	5,425	5,870	6,319	6,662	6,805	6,968	7,155	7,331	7,553	7,742	7,890	n.a.	n.a.
Debt Held by Government Accounts														
Social Security	2,180	2,367	2,542	2,721	2,916	3,122	3,332	3,545	3,757	3,966	4,170	4,365	n.a.	n.a.
Other government accounts[b]	1,735	1,806	1,866	1,940	2,019	2,133	2,232	2,320	2,400	2,458	2,526	2,612	n.a.	n.a.
Total	3,916	4,173	4,407	4,661	4,935	5,255	5,565	5,864	6,157	6,424	6,696	6,977	n.a.	n.a.
Total Gross Federal Debt	8,951	9,597	10,277	10,980	11,597	12,060	12,533	13,019	13,488	13,977	14,438	14,867	n.a.	n.a.
Total Federal Debt Subject to Limit[f]	8,921	9,568	10,247	10,951	11,568	12,031	12,504	12,990	13,459	13,948	14,409	14,838	n.a.	n.a.
Memorandum:														
Debt Held by the Public as a Percentage of GDP	36.9	38.2	39.9	40.8	40.6	39.4	38.6	38.0	37.3	36.9	36.3	35.5	n.a.	n.a.

Source: Congressional Budget Office.

Note: * = between -$500 million and zero; 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. Debt held at the end of the year.

f. 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.

supplemental appropriations of $97 billion ($93 billion for defense and $3.5 billion for nondefense activities) provided for 2008 in June; and initial funding for 2009 of $68 billion ($66 billion for defense and $2 billion for nondefense activities) that was also provided in June. All told, the baseline includes about $2 trillion in budget authority for operations in Iraq and Afghanistan and for other activities related to the war on terrorism over the 2009–2018 period.

However, the annual funding required for such activities may eventually be less than the amounts in the baseline if the number of deployed troops and the pace of operations diminish over time. Because of considerable uncertainty about those future operations, CBO had previously formulated two budget scenarios involving the deployment of U.S. forces to Iraq, Afghanistan, and elsewhere in support of the war on terrorism and has updated those scenarios here. (Many other outcomes—some costing more and some less—are also possible.) Under both scenarios, the number of active-duty, reserve, and National Guard personnel deployed in the war on terrorism average about 210,000 in fiscal year 2008. After 2008, force levels under the two scenarios are assumed to decline at different rates and to different sustained levels. The amount of spending for support of indigenous security forces in Iraq and Afghanistan, for diplomatic operations and foreign aid, and for veterans' benefits is the same under both scenarios.

Under the first scenario, troop levels would be rapidly reduced over a two-year period, with deployed forces declining to an average of roughly 170,000 in 2009 and 75,000 in 2010, until 30,000 military personnel remained overseas in support of the war on terrorism at the start of 2011. That number of deployed troops would be sustained through 2018, although not necessarily in Iraq and Afghanistan. Under such a scenario, discretionary outlays over the 2009–2018 period would be $1.3 trillion less than the amount recorded in the current baseline.

Under the second scenario, the number of troops would decline more gradually over a four-year period, dropping to an average of about 180,000 in 2009 and continuing to fall steadily in subsequent years, until 75,000 remained overseas in 2013 and each year thereafter. Under such a scenario, discretionary outlays for activities related to the war on terrorism would be less than the amount reflected in the baseline by almost $1 trillion over the 2009–2018 period.

Alternative assumptions also could be made about total discretionary appropriations. For example, if appropriations other than those for operations in Iraq and Afghanistan and for other activities related to the war on terrorism were assumed to grow through 2018 at the same rate as nominal GDP (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 $1.6 trillion lower through 2018.

The baseline reflects the assumption that the major provisions of EGTRRA and JGTRRA—such as the introduction of the 10 percent tax bracket, increases in the child tax credit, repeal of the estate tax, and lower rates on capital gains and dividends—will expire as scheduled at the end of 2010. Those tax provisions reduce revenues on net; thus, under a scenario in which they were extended, projected revenues would be lower than the amounts indicated in the current baseline. For example, if all expiring tax provisions (except those related to the amount of the exemption for the AMT) were extended, total revenues over the 2009–2018 period would be $2.9 trillion lower than in the current baseline projection.[12] That estimate reflects the fact that the effect of lowering the amount of taxpayers' regular tax liabilities would be partially offset by an increase in the number of taxpayers subject to the AMT.

Another change in policy that could affect revenues involves the modification of the AMT, which many observers believe cannot be maintained in its current form. Because the AMT's exemption amount and brackets are not indexed for inflation, the impact of the tax will grow in coming years as more taxpayers become subject to it. If the AMT was indexed for inflation after 2007 and no other changes were made to the tax code, federal revenues over the next 10 years would be $691 billion lower than the amount in the baseline, according to CBO and the Joint Committee on Taxation.

12. The estimate does not include any macroeconomic effects—unlike CBO's baseline projections, which incorporate the effects that the tax provisions' expiration would have on the economy. However, any macroeconomic effects are likely to be small relative to GDP.

Table 1-8.

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

(Billions of dollars)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Total, 2009-2013	Total, 2009-2018
Policy Alternatives That Affect Discretionary Spending													
Reduce the Number of Troops Deployed for Military Operations in Iraq and Afghanistan and for Other Operations Related to the War on Terrorism to 30,000 by 2011[a]													
Effect on the deficit or surplus[b]	0	12	52	105	137	156	168	173	178	181	185	462	1,346
Debt service	0	*	2	6	12	20	29	39	50	61	73	39	292
Reduce the Number of Troops Deployed for Military Operations in Iraq and Afghanistan and for Other Operations Related to the War on Terrorism to 75,000 by 2013[c]													
Effect on the deficit or surplus[b]	0	11	36	53	79	103	121	130	137	142	145	282	956
Debt service	0	*	1	4	7	12	18	25	33	42	51	24	194
Increase Discretionary Appropriations Other Than Those Related to Activities in Iraq and Afghanistan at the Growth Rate of Nominal GDP[d]													
Effect on the deficit or surplus[b]	0	-2	-19	-51	-86	-117	-147	-177	-207	-238	-271	-275	-1,315
Debt service	0	*	*	-2	-6	-11	-18	-27	-38	-51	-67	-20	-222
Freeze Total Discretionary Appropriations at the Level Provided for the Most Recent Year													
Effect on the deficit or surplus[b]	0	21	48	76	105	135	167	199	234	267	300	386	1,553
Debt service	0	*	2	5	10	17	25	35	48	63	80	34	286
Policy Alternatives That Affect the Tax Code													
Extend EGTRRA and JGTRRA[e]													
Effect on the deficit or surplus[b]	0	-3	-5	-148	-264	-294	-304	-316	-328	-342	-356	-713	-2,359
Debt service	0	*	*	-4	-14	-29	-46	-63	-82	-103	-126	-48	-468
Extend Other Expiring Tax Provisions[f]													
Effect on the deficit or surplus[b]	0	-21	-34	-47	-53	-58	-61	-63	-66	-69	-71	-213	-544
Debt service	0	*	-2	-4	-7	-10	-13	-17	-21	-25	-30	-22	-129
Index the AMT for Inflation[g]													
Effect on the deficit or surplus[b]	0	-82	-76	-70	-39	-46	-54	-64	-74	-86	-99	-313	-691
Debt service	0	-1	-5	-9	-13	-15	-19	-23	-27	-33	-39	-43	-184

Continued

Table 1-8. Continued

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

(Billions of dollars)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Total, 2009-2013	Total, 2009-2018
Memorandum:													
Interactive Effect of Extending EGTRRA and JGTRRA and of Indexing the AMT													
Effect on the deficit or surplus[b]	0	0	0	-17	-61	-68	-76	-83	-90	-97	-104	-146	-597
Debt service	0	0	0	*	-2	-6	-10	-14	-19	-25	-31	-9	-107
Total Discretionary Outlays in CBO's Baseline	1,125	1,202	1,258	1,297	1,318	1,353	1,385	1,417	1,456	1,485	1,514	6,427	13,685
Total Outlays in CBO's Baseline for Operations in Iraq and Afghanistan and for Other Activities Related to the War on Terrorism	146	173	185	191	193	198	203	207	212	215	219	939	1,994
Total Deficit in CBO's Baseline	-407	-438	-431	-325	-126	-147	-170	-162	-207	-174	-135	-1,466	-2,313

Sources: Congressional Budget Office; Joint Committee on Taxation.

Notes: Positive amounts indicate a reduction in the deficit or an increase in the surplus. "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; AMT = alternative minimum tax.

a. This alternative does not extrapolate the $186 billion in funding for military operations in Iraq and Afghanistan for 2008 or the $68 billion already provided for 2009. Future funding for operations in Iraq, Afghanistan, or elsewhere would total $79 billion in 2009, $85 billion in 2010, $41 billion in 2011, and then about $34 billion a year from 2012 on (for a total of $440 billion over the 2009–2018 period).

b. Excluding debt service.

c. This alternative does not extrapolate the $186 billion in funding for military operations in Iraq and Afghanistan for 2008 or the $68 billion already provided for 2009. Future funding for operations in Iraq, Afghanistan, or elsewhere would total $83 billion in 2009, $137 billion in 2010, and then about $118 billion in 2011, $94 billion in 2012, $73 billion in 2013, and about $72 billion a year from 2014 on (for a total of $865 billion over the 2009–2018 period).

d. Under this alternative, appropriations for 2008 for activities in Iraq and Afghanistan are extrapolated according to baseline rules.

e. These estimates do not include the effects of extending the increased exemption amount or the treatment of personal credits for the AMT, provisions that expired at the end of 2007. The effects of that alternative are shown below.

f. These estimates include the effects of extending all other expiring provisions except the expiring provisions of the Economic Stimulus Act of 2008—specifically the rebate provisions and the depreciation provisions of the act, which were intended to provide temporary stimulus to the economy.

g. This alternative incorporates the assumption that the exemption amount for the AMT (which was increased through 2007 in the Tax Increase Prevention Act of 2007) is extended at its higher level and, together with the AMT tax brackets, is indexed for inflation after 2007. In addition, the treatment of personal credits against the AMT (which was also extended through the end of 2007 in that act) is assumed to be continued. If this alternative was enacted jointly with the extension of the expiring tax provisions, an interactive effect would occur after 2010 that would make the combined revenue loss over the 2011–2018 period greater than the sum of the two separate estimates (see the memorandum).

Because the number of taxpayers who are subject to the AMT will depend on whether the tax provisions originally enacted in 2001 and 2003 remain in effect, the combination of indexing the AMT for inflation and extending the expiring provisions would reduce revenues by more than the sum of the effects from each policy enacted alone. The interactive effect would lower revenues by an additional $597 billion between 2011 and 2018.

The Long-Term Budget Outlook

Beyond the 10-year window used by CBO in projecting estimates of the federal budget outlook, the nation faces significant fiscal challenges. In particular, the future rate of growth in health care spending will have a substantial impact on the budget's bottom line.

Together, outlays for Medicare and Medicaid (not including offsetting receipts) currently account for 22 percent of federal spending and about 4.6 percent of GDP. Spending for those programs is expected to rise at a rapid pace over the next 10 years, outstripping growth in GDP. By 2018, spending for those programs combined is projected to total about 6.0 percent of GDP. By 2050, it could reach 12 percent of GDP. Without changes to federal fiscal policy, those rising costs would drive the amount of debt held by the public significantly higher than the 38 percent of GDP it represents today.[13] Over the long run, growing budget deficits and the resulting increases in federal debt would lead to slower economic growth. The difference between the economic cost of acting to address the projected deficits (by either reducing spending or raising revenues) and failing to do so is generally much larger than the cost implications of pursuing one approach to deficit reduction rather than another.

13. Statement of Peter R. Orszag, Director, Congressional Budget Office, before the Senate Committee on Finance, *The Long-Term Budget Outlook and Options for Slowing the Growth of Health Care Costs* (June 17, 2008). In that testimony, CBO projected the deficit as a percentage of GDP under two scenarios. Under the extended-baseline scenario, federal debt held by the public would equal 50 percent of GDP by 2050. Under the alternative fiscal scenario, which incorporates some changes in policy that are widely expected to occur and that policymakers have regularly made in the past, debt held by the public would be more than 290 percent of GDP by 2050.

CHAPTER

2

The Economic Outlook

An unusual amount of turbulence has continued to beset the U.S. economy since the Congressional Budget Office prepared its previous forecast, which was released in February. As a result, the near-term outlook appears considerably less promising than it did then.[1] Since early 2008, the prices of houses and the rate of home construction have continued to fall, and delinquencies and foreclosures on mortgage loans have surged, threatening continued instability in financial markets. At the same time, prices for energy and agricultural commodities have been unexpectedly high. As a result, spending by consumers and businesses after accounting for inflation is likely to be weaker than CBO had expected earlier this year, in spite of strength in net exports and the short-term boost to the economy provided by increased federal spending and tax rebates.

According to CBO's updated forecast for the rest of 2008 and for 2009, the economy is about halfway through an extended period of very slow growth. The rise in gross domestic product is estimated to average about 1 percent (measured at an annual rate and adjusted for inflation) from the last quarter of 2007 through the middle of 2009, before picking up during the second half of 2009. The growth of employment will probably remain weak through the middle of next year, keeping the unemployment rate above 6 percent in the near term.

Whether or not that period of slow growth will ultimately be designated a recession is still uncertain. However, the increase in the unemployment rate and the pace of economic growth are similar to conditions during previous mild recessions.[2]

Specifically, CBO forecasts that GDP will grow by about 1.5 percent in real terms (after an adjustment for inflation) in 2008 and 1.1 percent in 2009 (see Table 2-1).[3] Inflation, as measured by the year-to-year change in the consumer price index for all urban consumers (CPI-U), is projected to average 4.7 percent this year but moderate to an average of 3.1 percent in 2009 in the wake of lower commodity prices. As the economy recovers, interest rates on Treasury securities are estimated to rise next year from their current low levels. In CBO's forecast, interest rates on 3-month Treasury bills average 1.9 percent in 2008 and 2.7 percent in 2009, and rates on 10-year Treasury notes average 3.9 percent in 2008 and 4.4 percent in 2009.

Beyond the forecast's two-year horizon, from 2010 to 2018, CBO projects real growth averaging 2.8 percent and CPI-U inflation averaging 2.2 percent. With very

1. For CBO's previous forecast, see Congressional Budget Office, "Update of CBO's Economic Forecast," letter to the Honorable Kent Conrad (February 15, 2008).

2. By convention, the National Bureau of Economic Research (NBER) is responsible for dating the peaks and troughs of the business cycle (a recession extends from the peak of a cycle to its trough). According to NBER's Business Cycle Dating Committee, a recession is a significant broad-based decline in economic activity that lasts more than a few months. To date a recession, the committee examines movements in economic indicators, including real GDP, employment, real personal income excluding transfers, and industrial production, as well as manufacturing, wholesale, and retail sales. For further discussion, see www.nber.org/cycles/jan08bcdc_memo.html.

3. CBO's economic outlook was completed in early July, before the release, on July 31, of the Bureau of Economic Analysis's (BEA's) annual revisions of the national income and product accounts. (Those revisions incorporate new sources of data, revisions to previously published data, and methodological changes.) Data from 2005 to the first quarter of 2008 were revised. For most of the NIPA data, including the growth rates of real GDP and various price indexes, BEA's revisions do not suggest the need for material changes in CBO's economic forecast. CBO will analyze the implications of the revisions more fully in its next outlook, to be published in January 2009, once data associated with the revisions (such as new information on capital stocks) become available. In the meantime, CBO has incorporated the revised history into the forecast presented in this update.

Table 2-1.

CBO's Economic Projections for Calendar Years 2008 to 2018

	Actual	Forecast		Projected Annual Average	
	2007[a]	2008	2009	2010-2013	2014-2018
			Year to Year (Percentage change)		
Nominal GDP (Billions of dollars)	13,808	14,334	14,873	18,231 [b]	22,470 [c]
Nominal GDP	4.8	3.8	3.8	5.2	4.3
Real GDP	2.0	1.5	1.1	3.3	2.4
GDP Price Index	2.7	2.3	2.6	1.9	1.9
PCE Price Index[d]	2.6	3.9	3.1	1.9	1.9
Core PCE Price Index[e]	2.2	2.3	2.3	1.9	1.9
Consumer Price Index[f]	2.9	4.7	3.1	2.2	2.2
Core Consumer Price Index[g]	2.3	2.4	2.4	2.2	2.2
			Calendar Year Average (Percent)		
Unemployment Rate	4.6	5.4	6.2	5.3	4.8
Three-Month Treasury Bill Rate	4.4	1.9	2.7	4.6	4.7
Ten-Year Treasury Note Rate	4.6	3.9	4.4	5.3	5.4
Tax Bases (Billions of dollars)					
Economic profits	1,642	1,605	1,586	1,995 [b]	2,505 [c]
Wages and salaries	6,362	6,616	6,882	8,376 [b]	10,238 [c]
Tax Bases (Percentage of GDP)					
Economic profits	11.9	11.2	10.7	10.8	11.1
Wages and salaries	46.1	46.2	46.3	46.1	45.7
			Fourth Quarter to Fourth Quarter (Percentage change)		
Nominal GDP	4.9	3.5	4.2	5.2	4.3
Real GDP	2.3	0.9	1.8	3.3	2.3
GDP Price Index	2.6	2.5	2.4	1.8	1.9
PCE Price Index[d]	3.5	4.0	2.5	1.9	1.9
Core PCE Price Index[e]	2.2	2.3	2.2	1.9	1.9
Consumer Price Index[f]	4.0	4.9	2.2	2.2	2.2
Core Consumer Price Index[g]	2.3	2.4	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: GDP = gross domestic product.

Economic projections for each year from 2008 to 2018 appear in Appendix C.

a. Values as of August 22, 2008.

b. Level in 2013.

c. Level in 2018.

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 for all urban consumers excluding prices for food and energy.

weak growth in real GDP likely for 2008 and the first half of 2009, real GDP will end 2009 considerably below the level at which the economy is fully using its resources—that is, below its estimated potential level. Consequently, CBO assumes that after 2009, real GDP will grow slightly faster than its potential rate, on average, thus closing that gap. Currently, CBO projects that potential GDP will grow by about 2.4 percent during the 2010–2018 period and that the unemployment rate will average 5.0 percent. Interest rates on 3-month Treasury bills will average 4.6 percent, CBO estimates, and rates on 10-year Treasury notes will average 5.4 percent.

Economic forecasts are always subject to a great deal of uncertainty, and CBO's current outlook is no exception. On the one hand, the unprecedented decline in activity in the housing market, the problems in the financial sector, and the high level of energy prices might mean that the current downturn will be deeper and more protracted than CBO expects and that inflation will be more severe. In addition to those risks, lingering weakness in the housing market could contribute to significantly more losses on mortgages and force lenders to markedly curtail the availability of credit, thereby delaying the economy's recovery. On the other hand, the economy might rebound sooner than CBO is forecasting if house prices stabilize and oil prices, which have already declined over the past month, are significantly lower than CBO anticipates.

Turbulence in the Economy

The economy remains fragile. A steep and continuing decline in the prices of houses has contributed to slower growth in consumer spending and a sharp falloff in residential construction. Rising delinquencies and foreclosures on mortgage loans have created large losses for some financial institutions and other holders of mortgage-backed securities, reducing their capital and hence their ability to support new lending. There has also been a general pullback from risky lending in the nation's mortgage and credit markets; banks have markedly tightened their standards for loans to reduce their exposure to the risk of further losses. In addition, high prices for petroleum and food have slowed economic activity by reducing the growth of real income.

Housing Markets

The weakened condition of the nation's housing markets continues to be a source of concern because of its effects on the stability of the financial system and the economic outlook. The amount of residential construction and the prices of houses continue to drop in response to an excessive inventory of unsold homes. The decline in house prices has shrunk household wealth and, in turn, cut the growth of consumer spending. The number of mortgage delinquencies and foreclosures has surged, as the fall in house prices and the tightening of lending standards diminish the ability of borrowers to sell or refinance their homes.

House Prices and Residential Construction. Housing prices have fallen this year (see Figure 2-1). One measure of such prices, the Standard & Poor's (S&P)/Case-Shiller national price index for single-family homes, declined over the year ending in the second quarter of 2008 by more than 15 percent. Similarly, a narrower S&P/Case-Shiller index that includes the prices of houses in just 10 cities and is reported monthly declined by 17 percent for the year ending in June. Another widely used index, the purchase-only price index compiled by the Office of Federal Housing Enterprise Oversight (OFHEO), fell by 4.8 percent for the year ending in June.[4]

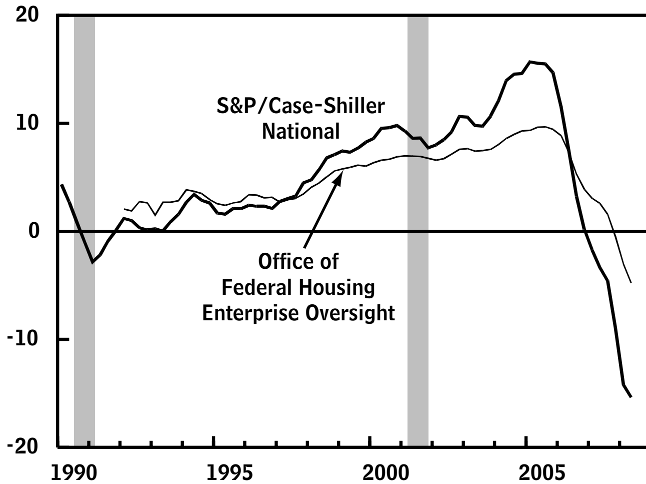
The pace of home construction—the number of housing starts—has plummeted since early 2006 as housing prices have dropped, mortgage lending has tightened, and vacant units have glutted the market (see Figure 2-2). The construction of housing units peaked in the first quarter of 2006 at more than 2 million (at an annual rate). By the second quarter of 2008, however, construction had fallen to about 1 million units, close to levels observed in past recessions. That decline in residential construction directly subtracted an average of 1 percentage point (measured at an annual rate) from the rate of growth of real GDP each quarter from early 2006 through the middle of this year.

4. The OFHEO measure covers only homes financed with conforming mortgages, which are low-risk loans up to a certain amount that are eligible to be purchased by Fannie Mae and Freddie Mac (formally, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, respectively). One reason for the discrepancy between the S&P/Case-Shiller and the OFHEO measures is that the latter omits houses that have been financed with higher-risk mortgages—the part of the mortgage market that has experienced the greatest turbulence over the past year.

Figure 2-1.

Indexes of House Prices

(Percentage change from previous year)



Sources: Congressional Budget Office; Office of Federal Housing Enterprise Oversight; Standard & Poor's, Fiserv, and MacroMarkets LLC.

Notes: The index shown for the Office of Federal Housing Enterprise Oversight is its purchase-only house price index.

Data are quarterly and are plotted through the second quarter of 2008.

A variety of indicators suggest that the pace of residential construction and the prices of houses will continue to decline:

- The ratio of unsold homes to monthly home sales remains above the levels observed in most past recessions;
- The number of building permits issued—a leading indicator for housing starts—fell precipitously in the first half of 2008 compared with the number issued in the second half of 2007;
- The vacancy rate for owner-occupied housing has risen since 2005 and has now reached a record high; and
- The housing market index published by the National Association of Home Builders and Wells Fargo was at an all-time low in August.

It is uncertain when the prices of houses and the pace of new housing starts will reverse their current declines. CBO assumed for its forecast that by the middle of 2009, house prices nationwide (calculated on the basis of the OFHEO purchase-only index) would fall by almost 10 percent from their levels in the second quarter of this year, resulting in a decline of approximately 15 percent from the peak of the index in the second quarter of 2007.[5] Such a fall in housing prices, the slow growth of household income because of the languishing economy, and an unusually large excess inventory of vacant units are all likely to delay any recovery in housing construction until at least the middle of 2009.

Mortgage Markets. Delinquency rates have increased for both prime and subprime borrowers, particularly those with adjustable-rate mortgages (ARMs).[6] The delinquency rate among subprime borrowers was 18.8 percent in the first quarter of this year, up from 17.3 percent in the fourth quarter of last year. The delinquency rate among borrowers with subprime ARMs was an even higher 22.1 percent in the first quarter, up from 20 percent in the fourth quarter. Delinquencies on prime loans rose by about 0.5 percentage points, to 3.7 percent in the first quarter, and delinquencies on prime ARMs climbed by about 1¼ percentage points, to 6.8 percent. Foreclosure rates have also continued upward this year: For example, 17.1 percent of subprime ARMs were in foreclosure in the first quarter, up from 13.4 percent in the fourth quarter of 2007.

The rates of delinquency and foreclosure are likely to increase in the near term as the economy remains fragile and the prices of houses continue to fall. However, various federal programs and other initiatives may blunt the pace of foreclosures (see Box 2-1).

Interest rates on mortgage loans have moved up this year and continue to signal a heightened aversion to risk on the part of lenders in the mortgage markets. For example, the interest rate on conforming fixed-rate 30-year mortgages—loans that can be purchased by Fannie Mae and Freddie Mac on the secondary mortgage market—has

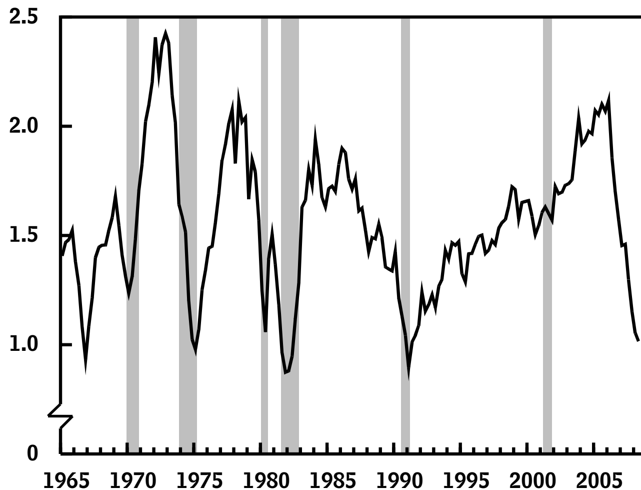
5. As of August 13, the futures market price for the composite 10-city S&P/Case-Shiller index indicated a decline of 12 percent between August 2008 and November 2009.

6. Subprime borrowers are those who have low credit ratings and a high risk of default, whereas prime borrowers are those whose credit ratings are solid. The distinguishing feature of ARMs is that their rates are subject to change when market interest rates rise or fall. (Rates are frequently tied to the rates that banks charge each other for short-term loans.)

Figure 2-2.

Housing Starts

(Millions, at an annual rate)



Sources: Congressional Budget Office; Department of Commerce, Bureau of the Census.

Note: Data are quarterly and are plotted through the second quarter of 2008.

risen this year, and the rate in July was greater than the average for all of last year (see Figure 2-3 on page 30). The interest rate on jumbo mortgages (mortgages that are larger than conforming loans) has increased even more—the "spread" (or difference) between the conforming rate and the rate for jumbo mortgages has widened since June 2007.[7]

Stricter standards for mortgage lending have dramatically reduced the availability of loans from private lenders, particularly for risky borrowers. Originations of subprime mortgages have come nearly to a standstill, mirroring the virtual disappearance of the securitization of those loans.[8] Indeed, the volume of securitized mortgage lending for Alt-A, subprime, and jumbo loans has continued to decline, reaching extremely low levels during the first few months of 2008.[9]

Financial Markets

Financial markets remain under stress. Although the federal government has taken a variety of steps to shore them up, the risk of significantly greater losses on loans remains. Concerns about such losses may curb lending to even creditworthy borrowers and delay the economy's recovery as a result.

Banks. Losses on loans and a pullback from risk continue to challenge the banking sector. Banks have written down large amounts of past and anticipated losses in the value of their assets (primarily from subprime loans and other credit that was extended to high-risk borrowers) and have suffered drops in the value of their stock. A key indicator of banks' wariness about current conditions is the spread between the three-month London interbank offered rate (or Libor)—the interest rate that major banks offer to other banks for such short-term loans—and the expected federal funds rate (see Figure 2-4 on page 31). That spread (which is often thought to be an indicator of credit and liquidity risk) has remained large in part because banks that have funds to lend fear further deterioration in the balance sheets of banks that need to borrow. Those worries have constrained interbank lending despite efforts by the Federal Reserve and foreign central banks to provide liquidity to the interbank market.

To reduce their risk of losses, many banks have significantly tightened their standards for lending. The Federal Reserve's July 2008 opinion survey of senior loan officers at banks around the country reports that most banks are tightening standards not only for residential mortgages and consumer loans but also for business loans, such as those for commercial real estate and commercial and industrial (C&I) loans (see Figure 2-5 on page 32). Those tighter standards are accompanied by larger spreads between, for example, interest rates on C&I loans and benchmark short-term rates—such as the target federal

7. The Economic Stimulus Act of 2008 (Public Law 110-185), which was enacted in February, temporarily increased the conforming loan limit—from $417,000 to $729,750—to cover some jumbo mortgages (and create a jumbo conforming limit) in high-cost areas to encourage lenders to continue to offer such loans to consumers who wished to refinance. The recently enacted Housing and Economic Recovery Act of 2008 (Public Law 110-289) permanently sets the jumbo conforming limit in high-cost areas at the lesser of 115 percent of the area's median house price or $625,500.

8. Securitization is the process by which such assets as student loans and mortgages are assembled into pools and the rights to the cash flows from the loans sold in the form of securities.

9. Alt-A mortgage loans, which share many of the same problems that afflict subprime mortgage loans, were often made on the basis of undocumented income.

CBO

Box 2-1.

Initiatives to Support Struggling Homeowners

The large number of delinquencies and foreclosures in the mortgage markets has prompted several initiatives by the federal government and the private sector to help homeowners who are having trouble making their mortgage payments. The Administration and the Congress have encouraged mortgage lenders to offer financial solutions to struggling homeowners to prevent further foreclosures. In addition, the federal government has broadened its role in the mortgage markets by increasing the mortgage loan guarantees it provides (by relaxing some eligibility requirements) and by expanding current programs for housing. Furthermore, policymakers have enacted broad legislation to address underlying problems in mortgage lending.

A Private-Sector Initiative

The HOPE NOW Alliance is a nongovernmental body composed of credit counselors, mortgage lenders and servicers, and investors that seeks to prevent foreclosures by helping homeowners who are finding it difficult to pay their mortgages. The HOPE NOW Alliance reports that its members "worked out" roughly 2.1 million loans between July 2007 and July 2008; the workouts comprised 1.4 million repayment plans (arrangements to catch up on missed payments) and about 700,000 loan modifications (changes in the original terms of the loan). In recent months, the new arrangements that the alliance has worked out for homeowners have been divided about equally between repayment plans and loan modifications.

About 60 percent of the loans that have been worked out to date have been subprime loans (loans made to borrowers who have low credit ratings and a high risk of default). Subprime loan repayment plans as a percentage of total workouts have declined since the program began, in late 2007. By contrast, the proportion of subprime loan modifications has increased.

Agency Initiatives

The Federal Housing Administration (FHA) provides insurance on mortgage loans made by FHA-approved lenders throughout the United States and its territories. To qualify for the insurance, loans must meet certain requirements established by the FHA (for example, loans must be for owner-occupied principal residences and meet statutory limits on loan amounts established by geographic area). The insurance protects lenders from losses if homeowners default on their mortgage loans, allowing the lenders to bear less risk and the borrowers to pay lower interest rates on their loans.

Recently, the FHA established FHASecure, a new program to help homeowners who have adjustable-rate mortgages (ARMs) that were not originated by FHA-approved lenders.[1] The program is designed to allow borrowers to refinance their loans and move into an FHA-insured mortgage. Initially, participation in the program was limited by strict eligibility requirements. However, policymakers expanded eligibility for the program in July 2008 (see the discussion below) to include homeowners who were experiencing temporary economic hardship or who were delinquent on their mortgages (up to three mortgage payments missed over the previous 12 months) because

1. Rates on ARMs are subject to change with market interest rates. (Rates are frequently tied to the rates that banks charge each other for short-term loans.) Many subprime ARMs are hybrid products in which rates are fixed for the first two or three years and then reset annually.

Continued

Box 2-1. **Continued**

Initiatives to Support Struggling Homeowners

of the large increase in their payments when their mortgage interest rate was reset. The expanded program operates with a risk-based premium structure to reach more borrowers affected by the volatility in the mortgage markets.[2]

Legislation

In July 2008, lawmakers enacted the Housing and Economic Recovery Act of 2008 (HERA), a broad piece of legislation that includes regulatory reform of the government-sponsored enterprises (GSEs) involving housing, measures to prevent foreclosures, and related changes to the tax code. Through December 2009, HERA authorizes the Department of the Treasury to purchase obligations and other securities directly from Fannie Mae, Freddie Mac, and the Federal Home Loan Banks—the housing GSEs. In addition, the law authorizes the new regulator of the GSEs, the Federal Housing Finance Agency, to adjust the limit on the size of conforming loans (mortgages eligible to be purchased on the secondary mortgage market by the housing GSEs) according to the annual index of house prices in high-cost areas. The agency can adjust the limit to 115 percent of an area's median house price or $625,500, whichever is smaller.

Other provisions of HERA are intended to reduce foreclosures. HERA establishes a three-year program, HOPE for Homeowners, within the FHA to guarantee up to $300 billion in new refinanced loans for borrowers who are unable to meet the terms of their current mortgages. The Congressional Budget Office estimates that 400,000 loans worth about $68 billion will be guaranteed under the program. In other foreclosure-prevention measures, HERA prohibits seller-financed down payments and establishes licensing and registration requirements for state-licensed mortgage brokers and mortgage originators.

2. The Housing and Economic Recovery Act of 2008 (Public Law 110-289) places a 12-month moratorium on the implementation of risk-based premiums effective October 1, 2008. However, the newly expanded FHASecure program has relied on risk-based premiums to maintain a negative or zero subsidy (that is, to operate within FHA's general appropriation and not require separate funding). To continue to operate, the program might require an appropriation.

funds rate that the Federal Reserve sets. (That spread increased from 1.9 percentage points in the third quarter of 2007 to 2.5 percentage points in the second quarter of 2008.)

At the same time, however, the large reduction in the federal funds rate over that same interval and the slowdown in the demand for loans have meant lower interest costs for firms that can still borrow from banks. The average interest rate on C&I loans from commercial banks fell from 6.9 percent in the fourth quarter of last year to 4.5 percent in the second quarter of this year.

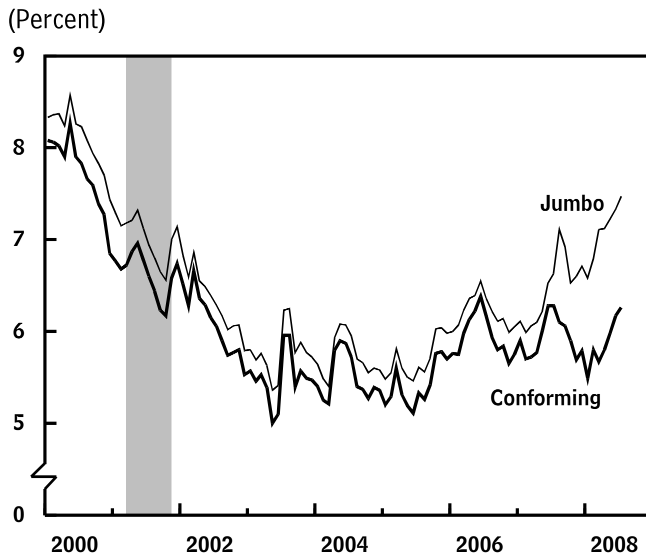
Tighter lending standards and the slowing economy have contributed to a noticeable decline in the growth of bank credit. However, with the exception of mortgages, lending from banks has not yet been severely curtailed. Moreover, lending through revolving home-equity loans, whose rates are linked to short-term interest rates, has grown rapidly this year—despite tightening loan standards and reports that existing lines of credit have been frozen for some homeowners.

So far, despite banks' loan losses, only a handful of commercial banks and thrift institutions have failed, although one of the closures was very large and many institutions are on the Federal Deposit Insurance Corporation's watch list. Between the beginning of this year and August, bank regulators closed down 10 banks. The closure of IndyMac—a California-based thrift and mortgage bank with roughly $32 billion in assets and large holdings of Alt-A mortgage loans—was one of the largest bank closures in U.S. history.

Figure 2-3.

Interest Rates on Mortgage Loans

(Percent)



Sources: Congressional Budget Office; Bankrate.com.

Notes: Conforming mortgage loans are those that can be purchased by Fannie Mae and Freddie Mac on the secondary loan market. Jumbo mortgage loans are all loans that are larger than conforming loans. (See also footnote 7.)

Date are monthly and are plotted through July 2008.

Even though the balance sheets of the vast majority of commercial banks, thrift institutions, and credit unions have so far remained relatively healthy, conditions could deteriorate severely or rapidly enough to cause a larger wave of failures.[10] Delinquency rates continue to rise in most sectors of lending. Whether banks and other lending institutions can sustain their current operations thus depends on the magnitude and duration of the economic slowdown. A continued lack of vigor in the economy would lead to more loan delinquencies, which would weaken banks' balance sheets and cause them to further curtail their lending to consumers and businesses.

Credit Markets. The pullback from risk has also affected the amount and cost of borrowing for corporations, mainly for firms that have a greater chance of default.

The number of new issuances of risky (speculative-grade) corporate bonds has fallen by about half in the first six months of this year as compared with the same period last year, whereas the number of issuances of lower-risk (investment-grade) bonds is about the same. The volume of buying and selling in the secondary market for securitized instruments has dwindled in response to greater aversion to risk in the financial markets. Less liquidity in the secondary market has tamped down demand among investors for new securitizations derived from financial institutions. The number of issuances of new asset-backed securities has fallen this year, particularly for securities backed by home-equity loans and lines of credit.

The Federal Reserve's monetary policy (discussed later) has pushed down interest rates on short-term borrowing this year. The rate on three-month Treasury bills fell from an average of 3.0 percent in December to 1.7 percent in August. Interest rates on commercial paper (a kind of loan that plays a key role in providing short-term credit to both financial and nonfinancial businesses) have also moved down. However, rates on lower-rated paper have not fallen as much as have rates on the highest-rated paper (because lower-rated paper has a greater risk of default and markets are already charging a higher amount to bear that risk).

Interest rates on long-term borrowing, by contrast, have not all fallen with short-term rates. Early this year, the rate on 10-year Treasury notes had dropped, but by June it had returned to its average of last December before falling again, through mid-August. The rate on Aaa-rated corporate bonds (investment-grade bonds with the highest credit rating) has changed very little this year, on net—at 5.6 percent in mid-August, it equals its average in both 2006 and 2007. Interest rates on lower-rated bonds, however, have moved noticeably higher. The rate on Baa-rated corporate bonds—bonds with the lowest investment-grade rating—has climbed this year from 6.7 percent last December to 7.2 percent in August.

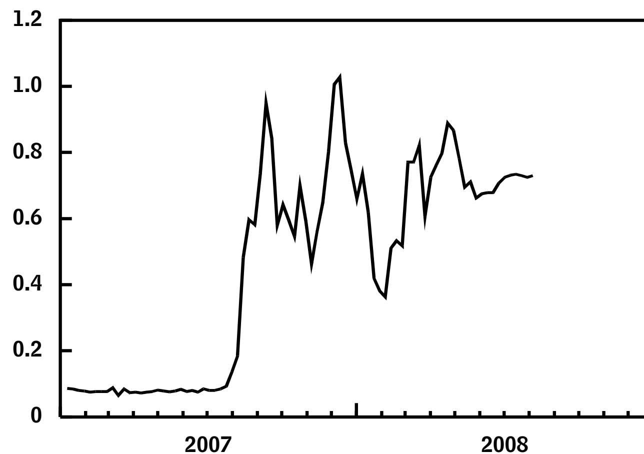
Interest rate spreads, at the same time, have grown as investors continue to avoid what they perceive as risky investments. The spreads between investment-grade corporate bonds (those rated from Aaa to Baa) and 10-year Treasury notes have neared or exceeded levels reached during the last economic downturn, in 2001 (see Figure 2-6). The spread between the rate on Caa-rated (below investment grade) corporate bonds and 10-year Treasury notes has also increased this year, although it is still less than what it was during the 2001 recession.

10. The potential support provided by the Housing and Economic Recovery Act of 2008 to Fannie Mae and Freddie Mac may help reduce the risk of losses on banks' portfolios of mortgage-backed securities that are guaranteed by the two firms.

Figure 2-4.

Spread on Three-Month Libor and Expected Federal Funds Rates

(Percentage points)



Sources: Congressional Budget Office; Bloomberg.

Notes: A spread is the difference between two interest rates. The three-month Libor (London interbank offered rate) is the interest rate major banks offer to other banks for those short-term loans. The expected federal funds rate is the three-month overnight index swap rate.

Data are weekly and are plotted through August 1, 2008.

Actions by the Federal Reserve. The Federal Reserve has continued to address the liquidity problems of the financial markets. It has used its traditional tools of monetary policy to lower short-term interest rates and expanded its "tool kit" to address the serious problems with liquidity outside of the commercial banking system that threaten the stability of the entire financial sector.

In an aggressive use of its traditional policy tools this year, the central bank lowered the target federal funds rate from 4.25 percent in December to 2.0 percent in April. Concurrently, it lowered the discount rate (the rate that banks pay for borrowing from the Federal Reserve) from 4.75 percent to 2.25 percent, reducing the spread between the target and the discount rate. Among other actions, it also increased the amount and the term of loans that it provides to depository institutions (such as commercial and savings banks) and continued to work with the European Central Bank and the Swiss National Bank to increase liquidity in the interbank loan market.

The Federal Reserve has also expanded the range of options it uses to address problems in the broader financial markets by creating facilities to lend to primary dealers.[11] The Primary Dealer Credit Facility (PDCF) provides overnight loans of funds, and the Term Securities Lending Facility (TSLF) lends U.S. Treasury securities held by the Federal Reserve for 28-day terms. All such lending must be secured with collateral. In the case of the PDCF, eligible collateral includes assets such as Treasury securities and riskier investment-grade debt. The range of eligible collateral for TSLF borrowing is broader and potentially riskier—it includes certain mortgage-backed and other asset-backed securities, among others.

Those new facilities have exposed taxpayers to potential losses on that collateral and raised questions about whether the central bank can continue to support the financial markets. Since last year, about 40 percent of the Federal Reserve's holdings of Treasury securities have been loaned out in exchange for other collateral. Losses could arise if a borrower defaulted on a loan at a time when the prices of the pledged collateral had fallen. The risk of a significant loss is somewhat reduced because the Federal Reserve typically lends less than the collateral's full value to protect itself against possible declines in those prices. Although the central bank has lent out a significant portion of its portfolio, it still holds a substantial amount—almost $500 billion worth—of Treasury securities.[12]

In addition, the Federal Reserve, in consultation with the Department of the Treasury, facilitated the purchase of the investment bank Bear Stearns by JPMorgan Chase, an investment and commercial bank. The Federal Reserve lent JPMorgan Chase $29 billion against a portfolio of $30 billion of Bear Stearns's less liquid assets. Many analysts believe that the central bank had to act to reduce the possibility that Bear Stearns's problems would spread to other financial institutions. That action, however, has

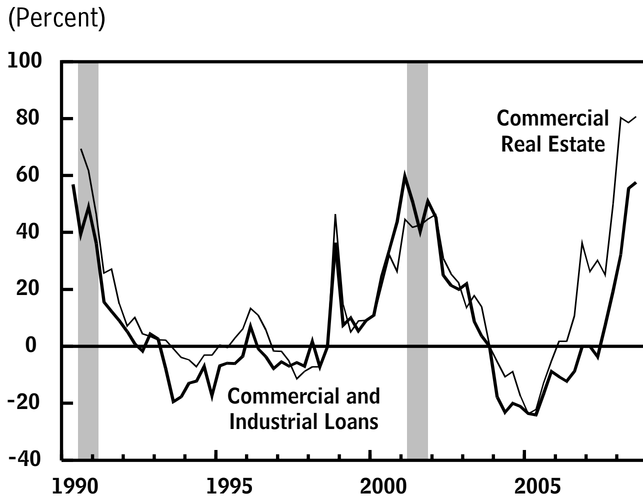
11. Primary dealers are firms that trade in U.S. government securities with the Federal Reserve System. There are currently 19 primary dealers.

12. Rather than the composition of its balance sheet, the primary limitation that the Federal Reserve faces in dealing with problems in the financial system is the need to keep inflation and expectations of price hikes in check.

Figure 2-5.

Tightening of Standards for Business Loans from Commercial Banks

(Percent)



Sources: Congressional Budget Office; Federal Reserve Board.

Notes: The figure shows the net percentage of bank respondents reporting tightening lending standards in the Federal Reserve Board's *Senior Loan Officer Opinion Survey on Bank Lending Practices*. The commercial and industrial loans measured are for loans to large and medium-sized firms.

Data are collected in January, April, July, and October. The final data point represents the July 2008 survey.

exposed taxpayers to possible losses.[13] Moreover, some people are concerned that the Federal Reserve's assistance to Bear Stearns has reinforced an expectation that large financial institutions that experience financial difficulties will receive help—creating a "too big to fail" policy for investment banks. Such a policy could increase future losses for taxpayers by giving financial institutions an incentive to expand with less concern about the risk they are taking on. (If the managers of such institutions believed that taxpayers would bear possible losses for taking on additional risk but that the stockholders and managers would benefit from possible higher returns, the managers might take on more risk than they otherwise would.)

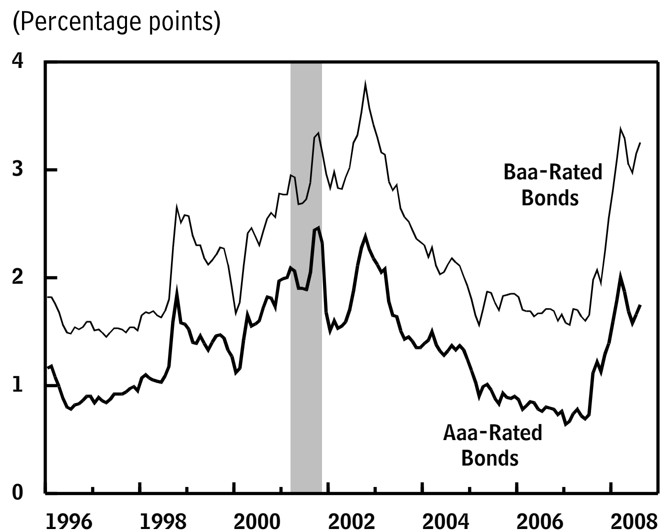
Other Government Actions. Recently, the federal government attempted to stabilize the financial markets in the face of renewed apprehension about the finances of Fannie Mae and Freddie Mac, two of the government-sponsored enterprises (GSEs) for housing. In July, investors feared that Fannie Mae and Freddie Mac, which own or guarantee roughly half of the nation's mortgages, would fail. To support the markets' confidence in the GSEs, policymakers included provisions in the Housing and Economic Recovery Act of 2008 that authorize the Treasury to temporarily purchase obligations and securities held by Fannie Mae and Freddie Mac and by the other housing GSE, the Federal Home Loan Banks (see Box 2-1 on page 28). Nevertheless, the stock prices of Fannie Mae and Freddie Mac fell in mid-August, suggesting that the market again feared that the federal government would be forced to take them over.

Legislation enacted earlier this year, the Ensuring Continued Access to Student Loans Act of 2008 (Public Law 110-227), may help alleviate some of the problems in the market for student loans. All lenders that make such loans, including those that participate exclusively in the

Figure 2-6.

Spreads on Corporate Bonds

(Percentage points)



Sources: Congressional Budget Office; Federal Reserve Board.

Notes: Spreads are measured by the difference between interest rates on corporate bonds and rates on 10-year Treasury notes.

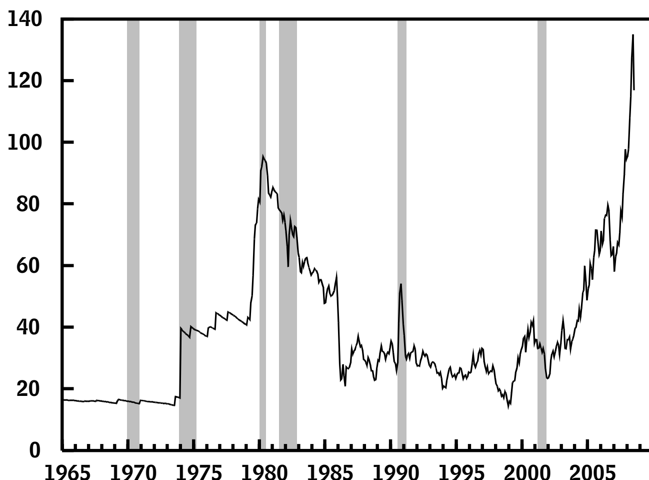
Data are monthly and are plotted through August 2008.

13. According to the agreement, JPMorgan Chase would be responsible for the first $1 billion in losses, and the Federal Reserve Bank of New York—and, ultimately, taxpayers—would absorb any losses that remained. Taxpayers would be involved because such losses would diminish the amount of the Federal Reserve's surplus that was turned over to the Treasury and recorded as federal revenues.

Figure 2-7.

Inflation-Adjusted Price of Crude Oil

(August 2008 dollars per barrel)



Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; *Wall Street Journal*.

Note: Data are monthly and are plotted through August 2008. The price is for West Texas Intermediate crude oil. Before 1982, it refers to the posted price; for later years, the spot price. The adjustment for inflation is based on the personal consumption expenditure chained price index.

Federal Family Education Loan (FFEL) program, have seen their borrowing costs increase dramatically as a result of the ongoing financial turmoil. The new law gives the Department of Education authority to temporarily purchase federally guaranteed loans originated by lenders in the FFEL program, effectively substituting federal funding for private money to help maintain the viability of new lending in the program. The law also helps increase the supply of student loans through the program's lender-of-last-resort provisions and boosts the limits on unsubsidized loans by $2,000 per year per student. By CBO's estimates, that expansion of the limit would increase the volume of unsubsidized loans by more than $1 billion in fiscal year 2008 and by nearly $7 billion by fiscal year 2018.

Energy and Food Prices

The high prices for petroleum and food seen over the past year have slowed economic growth. The high price of oil in particular has drained purchasing power from the economy. Faced with weak demand and higher costs for production and transportation, businesses have slowed the growth of jobs, wages, and investment in structures and equipment. The rise in prices for agricultural products has had a smaller impact on the economy than the rise in oil prices, but the increased cost of food has nonetheless constrained spending on nonfood items.

Increased demand relative to the supply worldwide of energy and food is the primary reason that the prices of those commodities have risen over the past year, but the upswing in the price of oil has boosted the price of food as well. Moreover, significant disruptions in the supply of food commodities in 2006 and 2007 have raised the prices of those items.

Inflation in both food and energy prices is likely to abate in the near term. The price of oil has fallen quite sharply since July, and reports of good harvests around the world suggest an easing of commodity food prices later this year. Furthermore, the slowing pace of worldwide economic growth foreseen by many analysts is likely to help lower prices for energy and food.

Oil Prices. The nominal price of petroleum—specifically, the price of West Texas Intermediate crude oil—roughly doubled over the 12 months between July 2007 and July 2008 (see Figure 2-7). Since then, however, the price of petroleum has fallen fairly rapidly, reaching $116 per barrel by late August. CBO's current forecast incorporates the assumption that the price of petroleum will average about $138 per barrel over the next year. That forecast was based on prices in the futures market for petroleum that were available in early July, when CBO completed its current forecast (see Box 2-2).

The primary factor in the upswing in prices is the rising demand for crude oil in rapidly developing countries, especially China and India and countries in the Middle East, combined with the comparatively slow growth of supplies. (The use of oil by industrialized countries actually declined in 2007.) Both the International Energy Agency and the United States' Energy Information Administration project that the global oil supply will—at best—grow modestly during the next two years. Higher prices for petroleum have not yet reduced demand in some developing countries.[14]

14. Energy subsidies provided by the governments of some developing countries may have prevented the surge in oil prices from damping down consumers' demand for oil in those nations. However, it is unclear how much of the increase in prices can be explained by such subsidies.

Box 2-2.

Forecasting Crude Oil Prices

The future course of the price of crude oil is a key factor affecting the outlook for inflation and economic growth. From mid-2003 to mid-2007, the price of crude oil more than doubled—and then, between June 2007 and June 2008, the price doubled again before easing back considerably in July and August. It is difficult to fully explain those movements in oil prices, but analysts generally believe that the factors behind the demand for and supply of oil have been the primary determinants.

Given the unpredictable nature of oil prices, the Congressional Budget Office (CBO) relies on prices from the futures market for crude oil to guide its forecasts. (The futures market for oil allows buyers and sellers to arrange transactions at an agreed-upon price for one month to eight years ahead.) Although no forecasting method has proved to be accurate in recent years, the futures market appears to incorporate the best available information.

Determinants of Oil Prices

At the most fundamental level, the forces that determine the price of oil are the same as for other goods—supply and demand. One important consideration is that the supply of oil and the quantity demanded respond very slowly to increases in prices. Because of technological limits on the production of oil, supply can adjust only slowly in the short run, particularly if there is little spare production capacity. The quantity demanded also responds slowly, in part because households and businesses are slow to change their energy-using habits. The gradual adjustments to price changes mean that relatively small shifts in supply or demand can have a large impact on the price of oil over short periods. Demand and supply respond to a greater extent over longer periods, when new sources of oil and substitutes for it are discovered and when households and businesses have more time to adjust their consumption of energy.

The sharp increase in the price of oil in recent years has resulted primarily from rapid world economic growth accompanied by only a modest increase in the global production of oil. By 2005, the growth of supply had begun to fall behind the growth of demand, and the gap between the two has widened ever since (see the figures).[1]

Some analysts believe that speculation in the futures market has also played a major role in the rise in oil prices. Speculators who trade in oil futures do not have a direct impact on supply and demand in the spot market (in which oil is traded for immediate delivery) because they do not add to the available supply of oil nor do they pull oil off the market by taking delivery and storing it. Because supply and demand respond only slowly to changing prices and because it takes some time for reliable information about supply and demand to become available, speculators may temporarily push prices above the market clearing price—that is, above the price that causes the quantity supplied to equal the quantity demanded. However, such a situation would be short-lived. Excess supplies would start building up if prices were above the market clearing price, and when such conditions became apparent, prices would fall.

1. For this analysis, CBO compared the available supply with its estimate of what the growth in the demand for oil would have been if prices had remained steady.

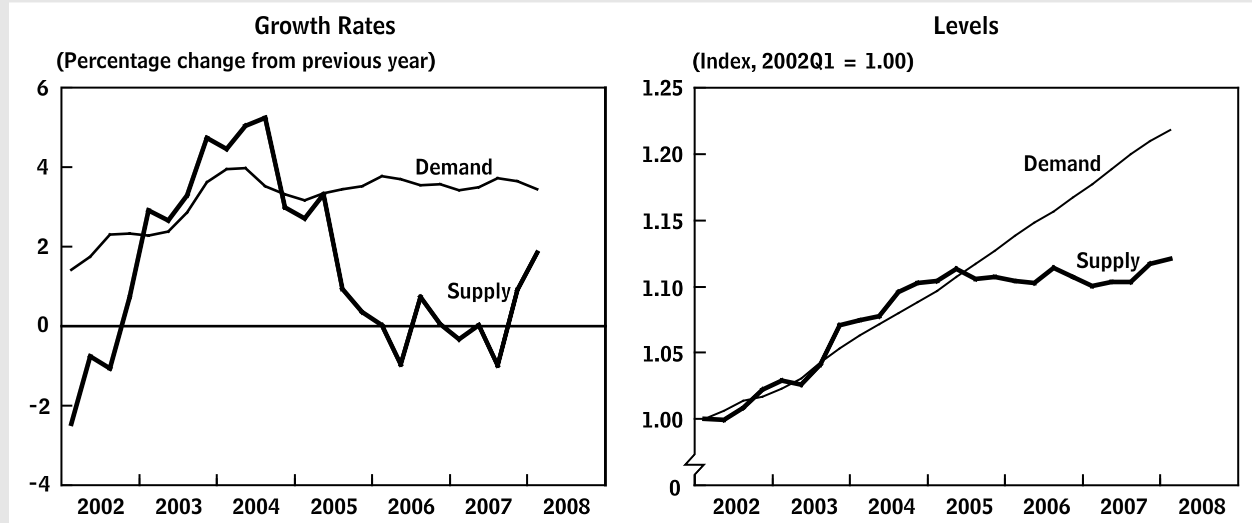
Continued

CBO

Box 2-2. **Continued**

Forecasting Crude Oil Prices

World Oil Demand and Supply



Sources: Congressional Budget Office; Department of Energy, Energy Information Administration; Federal Reserve Board.

Note: World oil demand is computed by using the growth of output from different regions of the world (weighted by their share of world oil consumption) and income elasticities of demand (the percentage increase in oil consumption relative to the percentage increase in gross domestic product).

Forecasting Oil Prices

The challenge of explaining the past ups and downs of oil prices makes predicting future prices even more difficult. Some analysts believe that prices will fall back to within the range of $50 to $70 per barrel; others foresee prices rising to $200 per barrel. That disparity reflects different views on the future course of the myriad factors that determine the demand for and supply of crude oil.

Prices from the futures markets provide a reasonable consensus forecast of future oil prices. Because participants in such markets stand to profit or lose from their decisions, they have a strong incentive to forecast prices as well as they can. Futures prices thus represent an aggregate of the various views about supply and demand in the market. For that reason, CBO has relied on the futures market in forecasting oil prices over the near term.

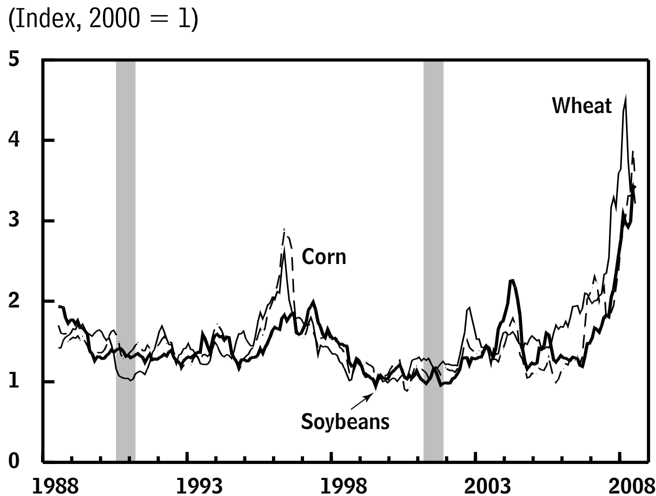
To a much lesser extent, other factors—such as geopolitical tensions, speculation, and the decline in the exchange value of the dollar—may have contributed to the dramatic rise in the dollar price of oil. Fears of disruptions in supply owing to political tensions in the Middle East, Africa, and South America, for example, may have encouraged producers to maintain larger inventories or to pump less oil. Some analysts also argue that speculative activity may have contributed to the upsurge and subsequent fall in the price of petroleum over the past year (see Box 2-2). Another factor is that the price of oil in most foreign currencies has risen less than it has in dollar terms because of the decline in the value of the dollar. Therefore, the global response of oil supply and demand has been dampened relative to the rise in the dollar price of oil.

Spending in the United States for petroleum imports rose significantly—by $177 billion, or about 1.2 percent of GDP—between the second quarter of 2007 and the

Figure 2-8.

Prices of Three Major Agricultural Commodities

(Index, 2000 = 1)



Sources: Congressional Budget Office; *Wall Street Journal*.

Note: Data are monthly and are plotted through July 2008.

second quarter of 2008. As a result, money that would have been spent primarily on domestic goods and services was channeled abroad, reducing, at least temporarily, the demand for U.S.-produced goods. That redirection of resources generally slowed the growth of employment here, although some of the increased expenditures for oil imports will come back to stimulate domestic production—either through other countries' purchases of more U.S. exports or as more investment in U.S. assets.

Over the longer term, however, high oil prices will force some consumers and producers to find alternative products or services to reduce their dependence on oil, easing some of the prices' negative impact on growth. Indeed, some consumers have already responded to the price hikes by driving less or by purchasing more fuel-efficient vehicles.

Food Prices. The prices of agricultural products have risen sharply over the past year. Prices for wheat, corn, and soybeans, in particular, set records recently (see Figure 2-8); prices for eggs and milk rose substantially in 2007 as well. High prices for animal feed have led meat producers to cull herds, preventing a short-run increase in meat prices but probably reducing supplies and boosting prices later this year. Similarly, the prices of dairy products are expected to climb further. Increases in prices for grain and soybeans have far outpaced increases in prices for other agricultural commodities.

The extent of the rise in agricultural prices was quite unexpected. As with oil, the steady surge in global demand has played a key role. In addition, the increase in energy prices seems to have been a factor in the higher retail food prices of the past two years. Higher prices for energy raised the costs of agricultural production and of retail food processing and distribution. Shocks to supplies as a result of poor weather (especially in the case of wheat) and rising demand for biofuel feedstocks (such as corn for ethanol production) also helped boost prices for agricultural commodities. Those shocks, coming at a time when international grain reserves were at historic lows, produced unexpectedly large increases in prices. Some speculative pressures may also have temporarily pushed up agricultural prices earlier this year.

Inflation in food prices is likely to ease by the end of this year as worldwide supply grows. In fact, prices for corn, wheat, and soybeans have already dropped. Futures markets also expect food prices to fall from recent peaks, although prices are expected to remain at historically high levels.

Net Exports and the Federal Government's Support of Growth

The relative strength of net exports and the stimulus provided by increased federal spending and tax rebates have partially offset the weakness elsewhere in the economy. In particular, the timeliness of the fiscal stimulus package enacted in February may have helped prevent a contraction of economic activity—consumer spending grew in the spring and early summer. CBO expects the strength in real net exports to continue to provide support for the growth of GDP in the near term, although under the assumptions embodied in CBO's baseline, the support from the federal government will ebb next year. (Chapter 1 presents CBO's updated baseline projections of federal spending.)

Net Exports

The relative economic strength of the United States' trading partners—in particular, the strength of emerging economies—and the substantial decline of the dollar over the past several years are likely to support the growth of real net exports in the near term. However, a significant slowdown in global economic growth in recent months has increased the downside risks to that forecast.

Economic Growth of the United States' Trading Partners. The momentum in the expansion of the world economy has slowed significantly since last year, and the economic outlook in foreign industrialized countries is particularly precarious. In emerging economies, growth has also pulled back from its previously rapid pace but remains faster than in industrialized countries. CBO expects that real GDP among the United States' major trading partners will grow more slowly but still faster, on average, than real GDP in the United States this year.

The pace of economic growth in foreign industrialized countries has been buffeted by several headwinds: the decline in those countries' purchasing power caused by higher prices for oil and food, tighter credit as a result of their exposure to subprime losses in U.S. financial markets, weaker housing markets, the appreciation of their currencies against the dollar, and the slowing U.S. economy. Even though the turmoil arising from the subprime mortgage problem has been less severe and the adverse effects on growth of higher energy prices likely to be more muted in those countries than in the United States, economic activity has slowed more in some foreign industrialized economies than it has here. That slower pace may be due in part to the less accommodative responses by policymakers in those countries and the greater rigidity of their labor markets.[15] Growth in those economies is likely to remain sluggish over the near term.

The outlook for emerging economies is better than the outlook for industrialized ones, even though the former are also showing signs of a significant slackening. Emerging economies in Asia are expected to post a solid rise in output in the near term, although the rate of increase will probably be more moderate than it was last year. Emerging economies in South America are also likely to weather the U.S. slowdown reasonably well—commodity exporters in particular have benefited from higher prices for their products. Nevertheless, inflation looms as a threat to growth in many emerging economies.

15. Instead of aggressively lowering interest rates, as the Federal Reserve did, the European Central Bank raised its policy interest rate (similar to the target federal funds rate) by a quarter of a percentage point in early July to combat inflationary pressures stemming from surging energy and food prices. In addition, none of those nations enacted a fiscal stimulus package similar in scope to the Economic Stimulus Act of 2008 in the United States.

The Exchange Value of the Dollar and the U.S. Current Account. The trade-weighted value of the dollar (the value relative to trading partners' currencies, with the weight of each country's currency equal to that country's share of U.S. trade) has been on a downward path since early 2002. From July 2007 through March 2008, the dollar fell at a noticeably faster rate than its average pace of decline since 2002. The dollar's rapid fall during that recent period was primarily a response to more aggressive easing of monetary policy in the United States than abroad and, to a lesser extent, the Chinese authorities' decision to allow the country's currency to appreciate more rapidly against the dollar than it had in the past.[16] Since March of this year, however, the trade-weighted value of the dollar has stayed relatively stable, as the dollar appreciated against some currencies and depreciated against others. The pause in the dollar's decline may in part reflect the views of investors about the future actions of the Federal Reserve (that it will make no further cuts in the federal funds rate) and of the European Central Bank (that the sharper-than-expected decline in economic growth in the countries that use the euro may force the bank to lower its interest rates soon).

In CBO's forecast, the exchange value of the dollar falls once the impact of short-term policy effects fades. The expected decline reflects the likelihood that foreign investors will be less willing to continue to add to their large dollar holdings at the same rate as they have in the past. Foreign investors have accumulated a sizable amount of dollar assets (for example, U.S. Treasury securities) in the past 15 years, a period of persistent U.S. current-account deficits.[17] Once those investors have accumulated enough such assets to carry out international transactions and meet their need for reserves, they are likely to slow their purchases of dollar assets.[18] In turn, the exchange value of the dollar will fall, and prices of U.S. assets will appreciate less than they would have if foreign investors had continued to accumulate dollar-denominated assets. Those outcomes will make domestic products relatively

16. China's currency, the renminbi, appreciated by about 11 percent against the dollar for the 12 months from July 2007 to July 2008. By comparison, the renminbi appreciated by 5 percent over the 12 months ending in July 2007.

17. The current-account balance of a country is a broad measure of its trade balance that includes goods, services, and unilateral current transfers.

18. For a detailed discussion, see Congressional Budget Office, *Will the U.S. Current Account Have a Hard or Soft Landing?* Issue Brief (June 11, 2007).

cheaper (compared with imports) and the growth of household wealth slower. U.S. residents as a result are likely to spend less on imported goods and to save more and spend less generally, thereby lowering the current-account deficit.

The U.S. current-account deficit as a share of GDP has followed a declining path since the end of 2005, although occasionally that decline has been interrupted by a surge in the price of imported oil. In CBO's forecast, the current-account deficit resumes its downward adjustment toward a more sustainable level as the value of oil imports stabilizes, domestic demand slows more than the demand for U.S. exports, and the value of the dollar declines.

The Fiscal Stimulus Package and Government Spending

The federal government is supporting growth in the short term through its tax and spending policies and through the automatic stabilizing effects of the federal budget. In February, policymakers enacted the Economic Stimulus Act of 2008. That law provided tax rebates of up to $600 for individual filers and up to $1,200 for couples, as well as $300 per qualified child under the age of 17. The stimulus package also included tax cuts for businesses (in the form of temporarily enhanced depreciation deductions). By mid-July, when the Treasury completed its major rounds of disbursements of the rebate checks, more than 90 percent of the roughly $100 billion in rebates that was expected to be distributed in this calendar year had been sent to qualifying individuals and families. CBO expects that the rebates will boost the rate of economic growth by almost 1½ percentage points (at an annual rate) during the second and third quarters of 2008. (CBO assumes that, on average, roughly 40 cents of each rebate dollar will be spent within six months.) By the last quarter of 2008, however, the rebates and the temporary boost to consumer demand they provide will have peaked, and the growth of household spending is likely to slow.

The federal government is also boosting short-term economic growth through such spending measures as an extension of unemployment benefits, which was enacted in June, and more generally through an increase in its purchases of goods and services. The contribution that those purchases make to growth is projected to shrink next year, however (under the assumptions embodied in CBO's baseline).

For 2008, CBO expects that real federal purchases will grow by 5 percent (compared with 2 percent in 2007) because of a faster pace of both defense and nondefense spending. That rate is projected to slow to 3 percent in 2009 because, under baseline assumptions, CBO projects that funding for defense programs in that year will grow only with inflation—a pace that would be well below the average annual increases witnessed thus far during the wars in Iraq and Afghanistan. (The outlook for the federal budget is discussed in detail in Chapter 1.)

In addition to the effects of tax and spending policies, the federal budget is supporting growth through the so-called automatic stabilizers, which derive from the impact of the economy on the federal budget deficit. As the economy slows, so does the growth in federal taxes, which helps cushion the slowdown in the growth of disposable income. Also, as the rate of unemployment goes up, so do benefit payments for unemployment insurance (even if policymakers do not extend unemployment benefits), which helps bolster consumer spending.

CBO estimates that in fiscal year 2008, those automatic stabilizers will increase the federal budget deficit by about half a percent of potential GDP, compared with an increase of roughly a quarter percent in 2007. In 2009, the automatic stabilizers will boost the deficit by more than 1 percent of potential GDP, CBO projects.

Spending by Households, Businesses, and State and Local Governments

The recent turbulence in the economy is likely to further dampen spending by households, businesses, and state and local governments. The growth of consumer spending, buoyed by tax rebates during the middle of this year, is forecast to slacken in the near term. Investment by businesses will also probably be sluggish: Companies will feel less need to add to existing capacity, and that reluctance is likely to reduce the growth of real GDP this year. In addition, a sustained fall in the revenues of state and local governments—an effect of the weak economy—is likely to force cutbacks in spending in that sector.

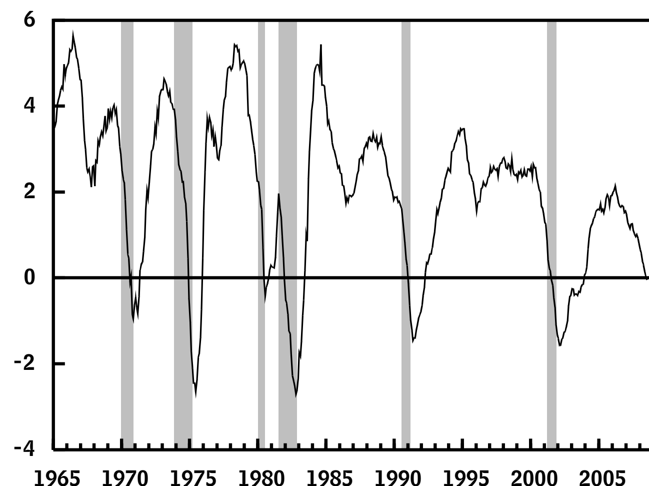
Household Spending

The outlook for growth in household spending has become less favorable since CBO's previous forecast. Employment this year has persistently contracted; as a result, the growth of household income has slowed and will probably decelerate more in the near term. Surveys show that consumer confidence has deteriorated to a level usually seen during a recession. The continued decline in

Figure 2-9.

Total Nonfarm Payroll Employment

(Percentage change from previous year)



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

Note: Data are monthly and are plotted through July 2008.

the prices of both houses and stocks has shrunk households' net wealth and will further depress spending. In addition, the high cost of energy is likely to reduce real income. Finally, more-stringent lending standards among banks will probably limit the availability of credit for consumers and further curb spending. CBO forecasts that real consumer spending, which was temporarily supported by tax rebates during the middle of this year, will decline later this year and early next year, before recovering during the second half of 2009.

Employment and Household Income. Employment has weakened significantly this year (see Figure 2-9). Current data show that the economy lost an average of 76,000 jobs per month through August, whereas it added an average of roughly 100,000 jobs monthly during the same period last year. With the decline in employment, the unemployment rate has been rising over the past year, climbing from an average of 4.5 percent during the first half of 2007 to 6.1 percent in August of this year.

Not only has the pace of job losses in construction and other housing-related industries quickened this year but losses have spread beyond economic sectors with ties to housing. Employment in residential construction continues to decline and has fallen by more than half a million jobs, or roughly 16 percent, since its peak in early 2006. Employment in nonresidential construction remained solid until late last year, but it has also been declining during 2008. The manufacturing sector continues to shed jobs, although the magnitude of the contraction during this downturn has been somewhat smaller than in previous slowdowns. Among service-providing industries, retail employment as well as employment in temporary-help services shrank significantly during the first half of this year.

CBO's forecast implies that employment will continue to contract for the rest of this year—with the economy losing an average of roughly 50,000 jobs per month during the second half of 2008—and will grow sluggishly for much of 2009. Although the number of layoffs has been small by comparison with the number seen in previous recessions, layoffs are likely to increase as economic activity remains slack and forces some employers to adjust the size of their workforce. The unemployment rate, according to CBO's forecast, will remain high during much of next year, averaging 6.2 percent in 2009.

The rate of growth of household income is likely to decline in the near term as the growth of hourly wages and the number of hours worked slow. Over the past year, the growth of hourly wages has declined, and CBO expects it to slow further throughout 2008 and in 2009, the result of the sluggish pace projected for economic growth. Some households might attempt to maintain their spending by borrowing against their future earnings or their houses, but with the tightening of lending standards, many households will probably be unable to do so. The near-term reduction that CBO foresees in the growth of household income is therefore likely to bring about a significant falloff in the growth of consumer spending.

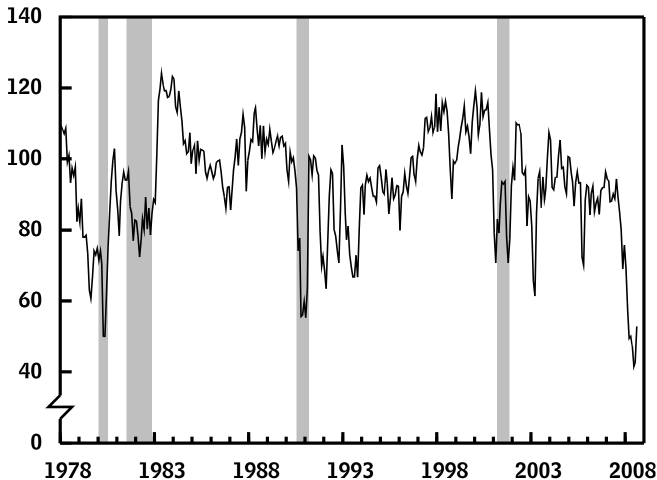
Consumer Expectations. Consumer expectations have fallen sharply since early 2007 and are now close to or below levels observed during past recessions (see Figure 2-10). Although expectations increased noticeably in August, possibly as a result of lower prices for gasoline, the growth of consumer spending is still likely to deteriorate as the effects of the tax rebates recede.

Household Wealth. Falling prices for houses and stocks have led to declines in households' net wealth, which shrank for the first time since 2002 during the final quarter of 2007 and continued to contract during the first quarter of 2008. The decline in wealth is likely to persist

Figure 2-10.

Index of Consumer Expectations

(Index, 1985 = 100)



Sources: Congressional Budget Office; Conference Board.

Note: Data are monthly and are plotted through August 2008.

as housing prices slide further and the weak economy further depresses stock prices. Less household wealth, in turn, will dampen consumer spending.

Business Spending

The drop in overall demand for goods and services has contributed to much of the deterioration—compared with CBO's prior forecast—in the outlook for business fixed investment (spending for structures, equipment, and software). A greater-than-expected contraction in employment during the first half of this year suggests less need for additional capital in the near future. In addition, profits from businesses' domestic operations have been squeezed by tepid domestic demand and higher costs for production-related materials and transportation. Lower stock prices and the pullback from risk in the credit markets are also likely to restrain businesses' spending in the near term. CBO forecasts that the growth of real business fixed investment will fall substantially during 2008, reaching its slowest rate during the second half of this year before recovering in 2009.

Although the growth of spending for nonresidential structures has remained strong, it has started to show some signs of faltering. (By contrast, investment in producers' durable equipment had already moderated during 2007.) The relative strength in spending for nonresidential structures was primarily a delayed response to faster growth in employment in prior years. Increased exploration and drilling for petroleum spurred by the soaring price of crude oil played a role as well. Nevertheless, a leading indicator for nonresidential construction—the architectural billings index of the American Institute of Architects—indicates sharply lower billings by architectural firms so far in 2008, which suggests a decline in real nonresidential construction (other than drilling) in the coming months. Tighter lending standards will also tend to depress construction activity in the near future.

State and Local Government Spending

The real growth of spending (that is, consumption plus investment) by state and local governments has measured less than 2 percent (at an annual rate) in each of the past four quarters, and that growth is projected to be even weaker during the rest of this year and next. Real compensation of employees grew by slightly more than 1 percent in the second quarter—the slowest pace since the last quarter of 2005. Although real investment grew by nearly 4 percent in the second quarter of this year, its growth did not offset a decline of nearly 7 percent in the first quarter.

The continued slowing of the growth of state and local governments' revenues in the near term will worsen their budget outlooks, CBO forecasts, and cause policymakers—despite some help from rainy-day reserves and selective increases in taxes and fees—to trim plans for spending as they cope with balanced-budget requirements. The sluggish economy, the drop in consumers' purchases of gas as a result of record prices, and the impact of the subprime mortgage problems will continue to curtail collections of income, sales, and property taxes. Fewer revenues are apt to lead in turn to less growth in spending on government personnel and purchases of goods and other services. Moreover, the effects of slower growth in revenues could be exacerbated by higher costs for debt servicing (because in order to borrow, state and local governments might have to raise the interest rates they pay on state and municipal debt).

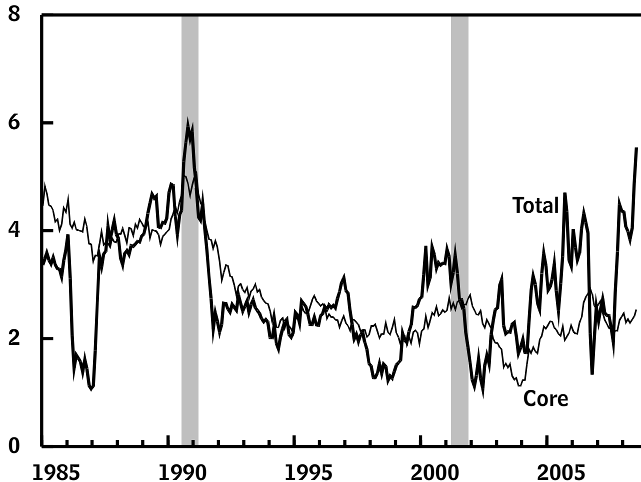
Inflation and Monetary Policy

Surging prices for food and energy have boosted overall consumer inflation this year, although core consumer inflation, which excludes those prices, has been relatively well contained. Increases in commodity prices plus increases in the prices of noncommodity imports over the past year have raised concerns that inflation will be

Figure 2-11.

Consumer Price Index

(Percentage change from previous year)



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

Notes: The core measure is the consumer price index for all urban consumers (CPI-U) excluding prices for food and energy. The figure uses the research series of the CPI-U, which, approximately, applies current methods of calculating the CPI-U to historical data.

Data are monthly and are plotted through July 2008.

persistently high in the near term. Yet the recent drop in the price of oil—should it persist—reduces both that risk and the chances that the Federal Reserve will raise interest rates more quickly than CBO anticipates to tamp down inflation. In CBO's view, overall inflation will ease in the near term as core inflation remains low, the growth of food prices slows, and prices for energy decline. With those conditions in place, the Federal Reserve will start raising its policy interest rate in 2009, CBO forecasts.

Commodity and Import Prices

In addition to commodity prices for energy and food, prices for other commodities (such as nonfood agricultural products, metals, and other industrial materials) have spiked over the past year. The breadth and size of those recent jumps were similar to those observed in the 1972–1975 period, which has kindled fears that inflation will be as stubbornly high in the near future as it was during the 1970s.

The prices of imported goods are also putting upward pressure on domestic inflation. As the exchange value of the dollar has fallen, the growth of import prices, even if commodities are excluded, has increased. Inflation in such prices is likely to remain high both this year and next because of the past decline in the dollar and because of a boost in inflation overseas.

The rapid increases in petroleum and food prices during the year ending in July and, to a lesser extent, the increase in the prices of imports have raised the overall rate of consumer price inflation this year (see Figure 2-11). With the price of crude oil doubling from the middle of 2007 to the middle of 2008, the consumer price index for energy rose by 29 percent during the year ending in July 2008. The prices that consumers paid for food over the same period rose by 6 percent; average rates of growth in food prices for 2006 and 2007 were 2.3 percent and 4 percent, respectively.

CBO does not expect the recent increase in prices for energy and commodities to lead to persistently high inflation. During the 1970s, large price hikes for commodities and imported goods triggered higher inflation (including core consumer price inflation, which excludes food and energy) by igniting a wage-price spiral, in which an initial price shock sets off higher wage growth, which in turn causes businesses to raise prices, and so on. But measures of current wages and salaries, such as the Bureau of Labor Statistics' employment cost index, have not yet provided evidence that higher prices for food and energy are boosting wages. Moreover, unlike in the 1970s, the Federal Reserve appears likely to use monetary policies to discourage such a spiral from taking hold. Another development arguing against a wage-price spiral is that the price of oil has recently begun to decline.

Core Inflation

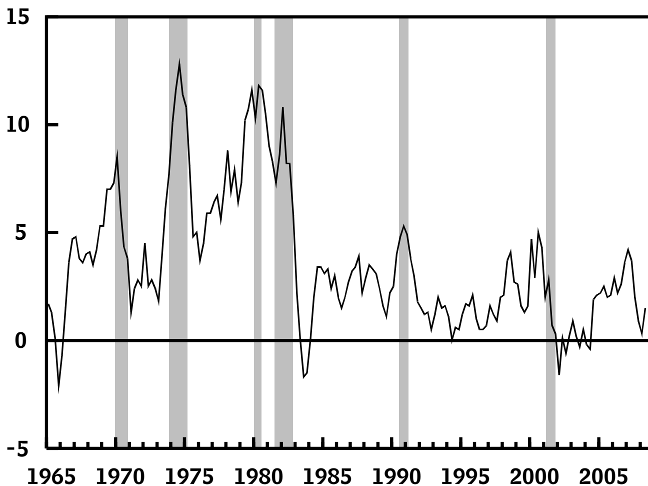
Core consumer price inflation has remained moderate this year despite the pressures generated by rising prices for commodities and imports. Moreover, several indicators, particularly those from the labor market, point to continued moderation in core inflation for the rest of this year:

- Unemployment has risen steadily over the past year, reaching 6.1 percent in August, and the growth of wages has slowed;
- The growth of unit labor costs has been modest over the past year (see Figure 2-12); and

Figure 2-12.

Unit Labor Costs

(Percentage change from previous year)



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

Notes: Unit labor costs are hourly costs for labor divided by output per hour.

Data are quarterly and are plotted through the second quarter of 2008.

- Capacity utilization in manufacturing is below the level associated in the past with higher inflation.[19]

Components of the consumer price index, such as housing, medical care, and apparel, also suggest that pressures on core inflation are relatively subdued. Housing rents, including the imputed rent for owner-occupied homes, are particularly important because they compose roughly a third of the overall CPI-U. Inflation in housing rents has continued to ease over the past year with the rise in vacancy rates for both traditional rental units and owner-occupied houses. Those high vacancy rates are likely to persist, and if they do, they will continue to curb inflation in housing rents. As for the smaller components of the CPI-U, inflation in the price of medical care has moderated, and even the rise in prices for apparel, a category heavily dominated by imports, has remained small so far this year.

19. Capacity utilization is the seasonally adjusted output of the nation's factories, mines, and electric and gas utilities expressed as a percentage of their capacity to produce output. (A facility's capacity is the greatest output it could produce if its capacity was fully utilized.)

Monetary Policy

Over the near term, the Federal Reserve will continue to try to alleviate the downturn in economic activity and at the same time keep the chances of persistently higher inflation small. In view of the outlook for weak growth of the economy in 2008 and 2009, as well as the expectation that core inflation will be relatively contained, CBO does not believe that the Federal Reserve will raise short-term interest rates significantly in 2008. But if the risk of higher core inflation increases, the Federal Reserve may boost its short-term policy interest rate (the federal funds rate) to lessen that risk.

As the downward pressures on the economy from the housing and financial sectors fade, however, the Federal Reserve is likely to raise the target federal funds rate throughout 2009 and 2010, in CBO's estimation, reversing much of the fall in the rate that has taken place over the past year. In CBO's forecast, the federal funds rate averages 2.3 percent this year and 2.8 percent in 2009. Interest rates on 3-month Treasury bills, which have fallen significantly since last summer, are expected to rise in the near future in concert with the increase in the federal funds rate. CBO projects that the rate on 3-month Treasury bills will average 1.9 percent in 2008 and 2.7 percent in 2009. Similarly, CBO expects that the rate on 10-year Treasury notes will climb from an average of 3.9 percent in 2008 to 4.4 percent in 2009.

Risks in the Economic Outlook

Economic growth has slowed substantially since mid-2007, and CBO believes that the economy is now about halfway through an extended period of sluggish growth. This period has not as yet been designated a recession; the National Bureau of Economic Research, or NBER (which by convention determines the starting and ending dates of recessions in the United States) usually waits for more data before making a formal determination, in part because revisions to economic data can sometimes be significant. However, the patterns of some of the key economic indicators that NBER examines (such as employment and real personal income excluding transfers from programs like Social Security) are similar to the patterns that have characterized mild recessions in the past, and many features of CBO's forecast—in particular, the anticipated rise in the unemployment rate—are similar to those observed in recent downturns.

Concerns remain that the economy's current challenges—the unprecedented decline in house prices, the problems in the financial markets, and the high price of oil—could cause this downturn to be deeper and more protracted than the last several recessions. Indeed, some analysts have argued that current conditions in the housing and financial markets are the worst since the Great Depression. They contend that the prices of homes will fall by much more, further weakening banks and reducing the credit available for loans, in turn forcing down house prices even more. In the view of some researchers, economic downturns that are associated with housing "busts" and shortages of credit tend to be deeper and longer than other recessions.[20] The economic outlook could deteriorate even more if many banks became insolvent or if the current financial crisis in the United States spreads more widely overseas and destabilizes global financial markets.

However, the economic outlook could also improve sooner than CBO is currently forecasting. During the past 25 years, the economy has been resilient in the face of adverse shocks; since 1983, it has experienced only two relatively mild recessions, and inflation has been much more contained than in earlier years. Some economists attribute that long period of relative stability to a number of developments—for example, less economic regulation, greater competition in labor and product markets (including globalization), and more-effective monetary policy. They argue that the economy has become more competitive and more flexible, able to respond to shocks because prices can adjust more quickly to reflect relative scarcities. (According to that view, scarce goods and services can be quickly redirected to their most valued uses, and a price shock's negative effect on output will be muted.)[21]

The current turbulence in the financial markets is testing that argument, but up to now, the economy has coped with the severe shocks of the past year relatively well. In particular, in a distinct contrast to events following the shocks of the 1970s, the lack of a steady surge in core inflation and unit labor costs, and the degree to which the consumption of petroleum products has declined, indicate an efficient response by businesses and households to skyrocketing oil prices. (For example, initial estimates indicate that the consumption of petroleum products during the second quarter of this year was about 4 percent lower than it was a year ago, even though real GDP was 1.8 percent higher. In contrast to responses to earlier oil price shocks, the reduction in the use of petroleum per unit of GDP has occurred without causing major disruptions.) Moreover, the apparent restraint in core inflation has given the Federal Reserve more latitude to try to mitigate the downturn in the economy. Also, some of the negative effects that the shortage of credit has had on businesses' investment spending may have been alleviated by the relatively healthy balance sheets of nonfinancial corporations.

CBO's Economic Projections Through 2018

CBO projects that real GDP will grow at an average annual rate of 2.7 percent during the 2010–2018 period—slightly faster than the estimated growth of potential GDP, which will average 2.4 percent during the same time. CBO's forecast of a very weak rate of growth for output during 2008 and 2009 leaves a substantial gap between real GDP and its potential level at the end of the latter year (see Figure 2-13). In CBO's projection, that gap is closed by faster growth during 2010, 2011, and 2012. CBO assumes that after 2012, output will grow, on average, at the same rate as potential GDP, keeping the output gap at an average of zero.

CBO expects that inflation, as measured by the CPI-U, will average 2.2 percent from 2013 to 2018 and that the rate of unemployment will average 4.8 percent, the same as CBO's estimate of the natural rate of unemployment.[22] CBO projects that rates on 3-month Treasury bills will average 4.6 percent during the period and rates on 10-year Treasury notes will average 5.4 percent.

To develop its projections for the medium term (that is, 2010 through 2018), CBO projects levels and rates of growth for the factors that underlie potential GDP, such as the growth of the labor force, of capital services (how much the stock of physical capital contributes to the flow of production), and of productivity. In doing so, CBO

20. Stijn Claessens, Ayhan Kose, and Marco Terrones, "What Happens During Recessions, Crunches, and Busts?" (paper presented at the American Enterprise Institute forum "Will the Global Economy Turn Down?" Washington, D.C., July 21, 2008).

21. See Congressional Budget Office, *The Economic Effects of Recent Increases in Energy Prices* (July 2006), Chapter 3.

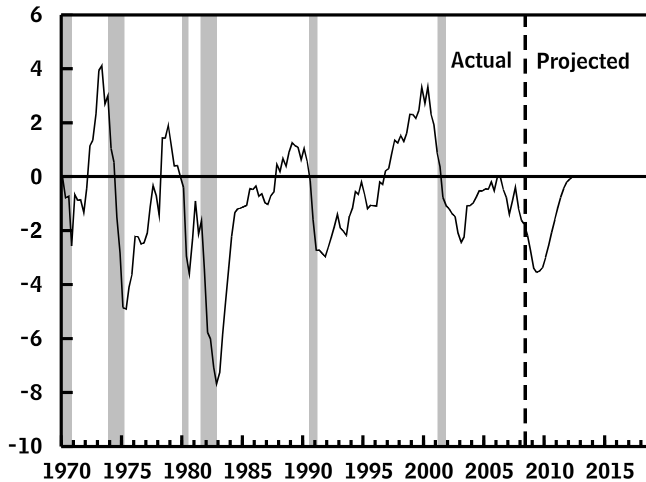
22. The natural rate of unemployment is the rate arising from all sources except fluctuations in aggregate demand.

CBO

Figure 2-13.

The GDP Gap

(Percentage of potential gross domestic product)



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

Notes: The GDP gap is the difference between real (inflation-adjusted) gross domestic product and its estimated potential level (which corresponds to a high level of resource—labor and capital—use).

Data are quarterly and are plotted through 2018.

takes into account the effect that current fiscal policy may have on those variables, but it does not attempt to forecast fluctuations in the business cycle beyond the next two years.

Potential Output

CBO projects that potential output will grow at an average annual rate of 2.4 percent during the 2008–2018 period, or about a tenth of a percentage point slower than the rate that CBO foresaw last February (see Table 2-2). Coming on top of a downward revision to CBO's estimate of potential GDP for 2007, CBO's revised projection for potential growth implies that the level of real GDP in 2018 will be roughly 2 percent lower than the level CBO expected last winter. About half of the revision to potential output stems from a slower pace of capital accumulation during the 2008–2018 period; however, part of the change arises from a downward revision to the estimates of potential hours worked during recent years that derives from CBO's revised interpretation of trends in the labor markets.

CBO's current projection for the rate of growth of investment by businesses is lower than its projection of last winter. Real fixed investment by businesses will grow at an average annual rate of 4.4 percent from 2008 through 2018, CBO estimates, down from the 4.6 percent pace projected in February. A weaker outlook for investment by businesses has two primary causes. First, the slower growth of employment projected for the entire 2008–2018 period implies that firms will need to spend less to adequately equip their workers with tools, machines, and other capital goods to maintain their current productivity. Second, in CBO's baseline, the federal deficit is larger during the 2008–2018 period than CBO anticipated last winter, which implies that national saving and investment by businesses will also be lower than they were in the February projection.[23]

CBO has also made a significant downward revision to its estimate of potential hours worked in the nonfarm business sector—the primary labor input underlying CBO's estimate of potential output—for the period since 2004 and in its projection for the 2008–2018 period. That revision is not the result of a change to CBO's outlook for the potential labor force, which is largely unaltered since the forecast last February. (In CBO's current projection, the potential labor force grows at an average annual rate of 0.7 percent during the 2008–2018 period.) Instead, the revision stems from a change in CBO's interpretation of trends in employment, particularly in the nonfarm business sector.

The growth of nonfarm employment has been much lower, on average, during the business-cycle expansion occurring since 2001 than would have been expected on the basis of past expansions. Employment in the nonfarm business sector did not grow relative to the labor force during the last recovery, as it did during the previous 20 years (see Figure 2-14). It is not entirely clear why that is the case—shifts of jobs to other sectors of the economy explain only part of the slower growth. It seems increasingly likely that nonfarm business employment will merely match the growth of the labor force in the future rather than grow more quickly, as it has since the 1970s.

One implication of that interpretation is that the experience of the late 1990s, when the share of the labor force employed in nonfarm businesses was very large, was

23. National saving equals total saving by all sectors of the economy: personal saving, business saving (corporate after-tax profits not paid as dividends), and government saving (budget surpluses). National saving represents all income not consumed, publicly or privately, during a given period.

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	1991-2001	2002-2007[a]	Total, 1950-2007[a]	2008-2013	2014-2018	Total, 2008-2018
Overall Economy									
Potential Output	3.9	3.2	3.1	3.1	2.7	3.4	2.5	2.4	2.4
Potential Labor Force	1.6	2.5	1.6	1.2	1.1	1.6	0.8	0.5	0.7
Potential Labor Force Productivity[b]	2.3	0.7	1.4	1.9	1.6	1.8	1.6	1.9	1.7
Nonfarm Business Sector									
Potential Output	4.0	3.6	3.3	3.5	3.0	3.6	2.8	2.8	2.8
Potential Hours Worked	1.4	2.3	1.7	1.1	1.0	1.5	0.7	0.4	0.6
Capital Input	3.8	4.2	4.1	4.6	2.5	3.9	2.9	3.5	3.2
Potential TFP	1.9	0.7	0.9	1.3	1.5	1.4	1.4	1.4	1.4
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	0.1	0.2	*	0.1	0.1	0.1
Price measurement[c]	0	0	0	0.1	0.1	*	0.1	0.1	0.1
Temporary adjustment[d]	0	0	0	*	*	*	0	0	0
Contributions to the Growth of Potential Output (Percentage points)									
Potential hours worked	1.0	1.6	1.2	0.8	0.7	1.0	0.5	0.3	0.4
Capital input	1.1	1.3	1.2	1.4	0.8	1.2	0.9	1.0	1.0
Potential TFP	1.9	0.7	0.9	1.3	1.5	1.4	1.4	1.4	1.4
Total Contributions	4.0	3.6	3.3	3.5	2.9	3.6	2.8	2.8	2.8
Potential Labor Productivity in the Nonfarm Business Sector[e]	2.6	1.3	1.6	2.4	1.9	2.1	2.1	2.3	2.2

Source: Congressional Budget Office.

Note: TFP = total factor productivity; * = between zero and 0.05 percent.

a. Values as of August 22, 2008.

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

c. An adjustment for a conceptual change in the official measure of the gross domestic product 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.

unusual and may not be repeated. Consequently, CBO is now placing less weight than before on the data from the late 1990s in estimating the level of potential employment in the nonfarm business sector. The net result is a lower level of potential employment during the 1990s and in the decade after 2000.

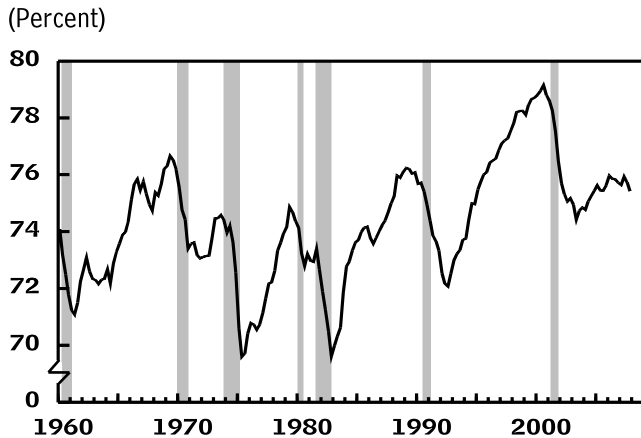
CBO projects that employment in the nonfarm business sector will grow at an average annual rate of 0.7 percent during the 2008–2018 period—that is, at the same pace as the potential labor force during that time. CBO projects that average weekly hours worked will decline very slightly during the period, so that hours worked in the nonfarm business sector will grow somewhat more slowly, at an average annual rate of 0.6 percent.

In CBO's projections, potential total factor productivity (TFP) grows by 1.4 percent per year, on average, virtually

Figure 2-14.

Nonfarm Business Employment as a Percentage of the Labor Force

(Percent)



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

Note: Data are quarterly and are plotted through the fourth quarter of 2007.

the same rate assumed for productivity growth in CBO's February forecast.[24] Although total factor productivity grew more slowly than potential TFP during the fourth quarter of 2007 and the first quarter of 2008, it is still very close to its estimated potential level. As a result, the addition of new data released since the previous forecast had little effect on CBO's estimate of potential TFP.

Inflation, Unemployment, and Interest Rates

CBO's outlook for inflation during the 2010–2018 period has also changed little since February. CBO projects that inflation, as measured by the CPI-U, will average 2.2 percent annually during the medium term, whereas growth in the personal consumption expenditure (PCE) and core PCE price indexes (the core measure excludes food and energy) will average 1.9 percent annually. (The PCE price index is an alternative to the consumer price index as a measure of inflation.) In general, CBO assumes that during the 2010–2018 period, inflation will be determined by monetary policy and that the Federal Reserve can, on average, maintain core inflation as measured by the PCE price index at just under 2 percent. The rate of unemployment is projected to average 4.8 percent during the latter years of the coming decade.

Compared with CBO's February estimates, its current projections of long-term interest rates are higher because federal borrowing to finance the deficit is estimated to be greater. Larger amounts of federal borrowing tend to lower the national saving rate, raise interest rates, and reduce investment. CBO's projection for interest rates on 3-month Treasury bills over the 2008–2018 period (4.6 percent, on average) is the same as it was in February, but its projection for rates on 10-year Treasury notes (5.4 percent, on average) is two-tenths of a percentage point higher. CBO projects interest rates for the medium term by adding expected inflation (as measured by the CPI-U) to its estimate of real interest rates.[25]

Projections of Income

CBO projects federal revenues (see Chapter 1) on the basis of various categories of income as measured in the national income and product accounts. The outlook for revenues is most directly affected by wages and salaries, domestic corporate profits, proprietors' income, and interest and dividend income. However, CBO makes numerous adjustments to the NIPA categories to estimate the income reported on tax forms for calculating tax liability.

At the broadest level, GDP can be roughly divided into labor income and domestic capital income.[26]

Labor Income

CBO's measure of the labor share of GDP consists of the total compensation that employers pay their employees—that is, the sum of wages and salaries and supplemental benefits—and 65 percent of proprietors' income. Supplements include employers' payments for health and other insurance premiums, employers' contributions for pension funds, and the employer's share of payroll taxes (for Social Security and Medicare). During the 1950–2007 period, CBO's measure of the labor share averaged

24. Total factor productivity is average real output per unit of combined labor and capital services.

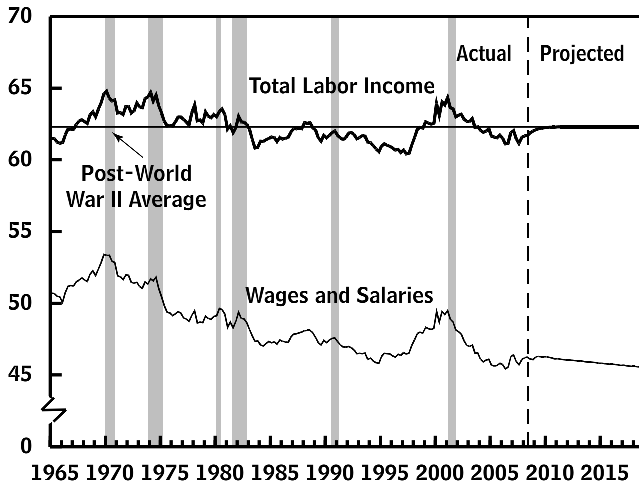
25. The projected real 10-year rate is determined by the rate of national saving, among other factors. For more information, see Congressional Budget Office, *How CBO Projects the Real Rate of Interest on 10-Year Treasury Notes* (December 2007).

26. For more details on CBO's projection methods, see Congressional Budget Office, *How CBO Forecasts Income* (August 2006).

Figure 2-15.

Total Labor Income and Wages and Salaries

(Percentage of gross domestic product)



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

Note: Data are quarterly and are plotted through 2018.

62.3 percent of GDP, and CBO assumes that during the 2008–2018 period, the labor share of output will gravitate toward that average.

Over the four quarters ending in the second quarter of 2008, the labor share of GDP averaged 61.5 percent, or 0.8 percentage points below the long-term average (see Figure 2-15). CBO anticipates a rise in the labor share during the short run, for several reasons:

- The share of compensation ordinarily increases temporarily in a slowing economy because the growth of compensation usually does not fall as fast as the growth of GDP;
- Low interest rates will boost net proprietors' income, much of which is labor income; and
- Firms may have to make some catch-up contributions to defined-benefit pension funds because of lower stock prices. Those contributions will come out of profits because they are not related to benefits for current workers.

CBO expects that during the 2010–2018 period, the share will return to its long-run average.

Supplements to wages—in particular, employers' payments for health insurance premiums—are projected to grow faster than GDP, so the wage and salary share of GDP declines slightly from 2010 to 2018 in CBO's projection. The rate of decline, however, is slower than the trend over the past 40 years.

Domestic Capital Income

The share of GDP attributable to domestic capital income generally moves in the opposite direction from the labor share, and it falls slightly in the near term in CBO's projection. Capital income consists of domestic corporate profits, depreciation charges, interest and transfer payments made by domestic businesses, rental income, and the remaining share (35 percent) of proprietors' income. CBO forecasts that the profits component within the capital share will be small in 2009 and 2010 when compared with that in recent years but profits will increase as the general economic recovery projected for the second half of 2009 takes hold.

As a share of GDP, interest payments by businesses are projected to remain relatively small. Mortgage payments by homeowners are included in that category, and the current low level of housing-related activity, combined with the expectation that housing and the financing of mortgages will recover only slowly, damps down CBO's projection of business interest payments.

Changes in the Outlook Since February 2008

Compared with its February estimates, CBO's current forecast indicates a much less favorable outlook, particularly over the next two years. The forecast now indicates weaker growth, significantly higher inflation and unemployment, and slightly higher interest rates for 2008 and 2009. On average, for the entire projection period (2008 to 2018), the forecast suggests slower growth and higher long-term interest rates (see Table 2-3).

By far the single largest negative surprise since February has been the rise in energy prices. That spurt in prices had a sizable effect on measures of inflation and the growth of real GDP. The increase in consumer energy prices alone accounted for roughly 60 percent of the 4.7 percent rate of growth in the CPI-U (measured on an annual basis) during the first half of this year. The rise in energy prices was also a major factor in CBO's downward revision to its forecast for growth, because the surge in

Table 2-3.

CBO's Current and Previous Economic Projections for Calendar Years 2008 to 2018

	Actual	Forecast		Projected Annual Average	
	2007[a]	2008	2009	2010-2013	2014-2018
Nominal GDP (Billions of dollars)					
September 2008	13,808	14,334	14,873	18,231 [b]	22,470 [c]
February 2008	13,843	14,358	14,946	18,278 [b]	22,625 [c]
Nominal GDP (Percentage change)					
September 2008	4.8	3.8	3.8	5.2	4.3
February 2008	4.9	3.7	4.1	5.2	4.4
Real GDP (Percentage change)					
September 2008	2.0	1.5	1.1	3.3	2.4
February 2008	2.2	1.9	2.3	3.2	2.5
GDP Price Index (Percentage change)					
September 2008	2.7	2.3	2.6	1.9	1.9
February 2008	2.7	1.8	1.7	1.9	1.9
Consumer Price Index[d] (Percentage change)					
September 2008	2.9	4.7	3.1	2.2	2.2
February 2008	2.9	2.8	1.9	2.1	2.2
Unemployment Rate (Percent)					
September 2008	4.6	5.4	6.2	5.3	4.8
February 2008	4.6	5.2	5.5	4.9	4.8
Three-Month Treasury Bill Rate (Percent)					
September 2008	4.4	1.9	2.7	4.6	4.7
February 2008	4.4	2.1	2.4	4.6	4.7
Ten-Year Treasury Note Rate (Percent)					
September 2008	4.6	3.9	4.4	5.3	5.4
February 2008	4.6	3.6	3.8	5.1	5.2
Tax Bases (Billions of dollars)					
Economic profits					
September 2008	1,642	1,605	1,586	1,995 [b]	2,505 [c]
February 2008	1,601	1,588	1,588	1,831 [b]	2,310 [c]
Wages and salaries					
September 2008	6,362	6,616	6,882	8,376 [b]	10,238 [c]
February 2008	6,367	6,651	6,936	8,421 [b]	10,364 [c]
Tax Bases (Percentage of GDP)					
Economic profits					
September 2008	11.9	11.2	10.7	10.8	11.1
February 2008	11.6	11.1	10.6	10.2	10.0
Wages and salaries					
September 2008	46.1	46.2	46.3	46.1	45.7
February 2008	46.0	46.3	46.4	46.2	45.9
Memorandum:					
Real Potential GDP (Percentage change)					
September 2008	2.7	2.6	2.5	2.4	2.4
February 2008	2.8	2.8	2.7	2.6	2.5

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

Note: GDP = gross domestic product; percentage changes are measured from one year to the next.

a. Values as of August 22, 2008.

b. Level in 2013.

c. Level in 2018.

d. The consumer price index for all urban consumers.

spending for imports of petroleum and oil-related products undercut spending for domestically produced goods and services.

The changes that CBO has made in some of its other assumptions about prices have been less significant. Prices for food also rose somewhat more than CBO anticipated in February, but they have had a much smaller effect on inflation and growth than energy prices have had. Moreover, the growth of the core consumer price index was a surprise in the other direction: The index grew slightly more slowly than CBO foresaw in its February forecast.

Other developments during the first half of this year that worsened the near-term outlook for growth (other than the rise in energy prices) included slower housing sales, a weakening in businesses' investments in structures and equipment, and a decline in the growth of employment (which diminishes future spending by households).

Changes in economic conditions since February have resulted, on balance, in a worse outlook for the federal budget because CBO's new forecast leads to both a reduction in CBO's projections of revenues and an increase in its projections of spending. The more-rapid-than-expected growth in inflation in 2008 and 2009 has increased CBO's projections of spending for programs such as Social Security and Medicare. In addition, the net effect of higher prices and lower real output in the new forecast is a slightly lower projection for nominal GDP after 2008, which results in lower estimated revenues. Changes in the composition of income have a similar effect. (The specific revisions to the budget outlook that can be attributed to changes in the economic forecast are described in more detail in Appendix A.)

How CBO's Forecast Compares with Those of Other Forecasters

Compared with the estimates of other forecasters, CBO's estimate of real economic growth in the near term is generally weaker (see Table 2-4).[27] CBO's estimates of the growth of real GDP in 2008 and 2009 are slightly more pessimistic than those of the current *Blue Chip* consensus forecast;[28] however, its forecast of unemployment rates is very similar to that of the consensus, being only slightly lower in 2008 and slightly higher in 2009. The Administration's forecast for the growth of real GDP—published on July 28—is stronger than CBO's, especially for 2009. The Administration foresees a slightly lower unemployment rate for 2008 and a much lower rate for 2009, which is consistent with its forecast of faster growth of real GDP. CBO foresees real growth of GDP that is at the lower end of the range of estimates of the Federal Reserve's Federal Open Market Committee (FOMC) for 2008 and 2009 but higher for 2010 (see Table 2-5).[29] In contrast, its forecast for the unemployment rate is at or above the high end of the Federal Reserve's range throughout the 2008–2010 period.

Compared with the *Blue Chip*'s and the Administration's forecasts, CBO's near-term estimate of inflation is generally higher for 2008 but similar for 2009. Compared with the view of the *Blue Chip* consensus, CBO expects higher inflation (on the basis of the consumer price index) in 2008 but slightly lower inflation in 2009. The Administration's forecast for CPI-U inflation is much lower than CBO's for 2008 but is the same as CBO's for 2009. CBO's forecasts for both overall and core inflation are all within the Federal Reserve's ranges and within its central tendency for 2008. CBO's forecasts of interest rates on short- and long-term Treasury securities are similar to the *Blue Chip*'s and the Administration's forecasts for 2008 and 2009. (The Federal Reserve does not publish its interest-rate forecasts.)

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27. For full details of those other forecasts, see Aspen Publishers, Inc., *Blue Chip Economic Indicators* (New York: Aspen Publishers, Inc., August 10, 2008); Office of Management and Budget, *Mid-Session Review, Fiscal Year 2009* (July 28, 2008); and Federal Reserve Board, "Summary of Economic Projections for the Meeting of June 24–25, 2008" (July 15, 2008).

28. The *Blue Chip* consensus forecast is based on a survey of 50 private-sector forecasters.

29. Four times a year, the Federal Reserve's Federal Open Market Committee compiles the forecasts prepared by members of the Board of Governors of the Federal Reserve System and the presidents of the Federal Reserve banks. Those forecasts are then released in conjunction with the publication of the minutes for the FOMC meetings held in late January, April, June, and October. Table 2-5 compares CBO's forecast with the projections prepared for the committee's meeting in June 2008. (The next time the projections will be released will be in November, after the committee's October meeting.)

Table 2-4.

Comparison of Economic Forecasts by CBO, the Administration, and the *Blue Chip* Consensus for Calendar Years 2008 to 2013

	Actual 2007[a]	Forecast 2008	Forecast 2009	Projected Annual Average, 2010 to 2013
	Fourth Quarter to Fourth Quarter (Percentage Change)			
Nominal GDP				
CBO	4.9	3.5	4.2	5.2
Administration	5.1	3.5	5.1	5.3
Blue Chip consensus	5.0	3.5	4.3	n.a.
Real GDP				
CBO	2.3	0.9	1.8	3.3
Administration	2.5	1.2	2.9	3.2
Blue Chip consensus	2.3	1.1	2.1	n.a.
GDP Price Index				
CBO	2.6	2.5	2.4	1.8
Administration	2.6	2.3	2.1	2.0
Blue Chip consensus	2.6	2.3	2.2	n.a.
Consumer Price Index[b]				
CBO	4.0	4.9	2.2	2.2
Administration	4.0	3.1	2.2	2.3
Blue Chip consensus	4.0	4.4	2.3	n.a.
	Calendar Year Average (Percent)			
Unemployment Rate				
CBO	4.6	5.4	6.2	5.3
Administration	4.6	5.3	5.6	5.0
Blue Chip consensus	4.6	5.5	6.1	n.a.
Three-Month Treasury Bill Rate				
CBO	4.4	1.9	2.7	4.6
Administration	4.4	1.9	2.8	4.0
Blue Chip consensus	4.4	1.9	2.5	n.a.
Ten-Year Treasury Note Rate				
CBO	4.6	3.9	4.4	5.3
Administration	4.6	4.0	4.6	5.2
Blue Chip consensus	4.6	3.9	4.5	n.a.

Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board; Office of Management and Budget, *Mid-Session Review, Fiscal Year 2009* (July 28, 2008); Aspen Publishers, Inc., *Blue Chip Economic Indicators* (New York: Aspen Publishers, Inc., August 10, 2008).

Notes: The *Blue Chip* consensus is the average of about 50 forecasts by private-sector economists. The latest *Blue Chip* consensus does not extend past 2009.

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

a. Values for CBO incorporate the July 2008 revisions to the national income and product accounts, whereas values for the Administration do not. Historical values for the *Blue Chip* consensus incorporate the revisions but probably not fully.

b. The consumer price index for all urban consumers.

Table 2-5.

Comparison of Economic Forecasts by the Federal Reserve and CBO for Calendar Years 2008, 2009, and 2010

	Federal Reserve		
	Range	Central Tendency	CBO
2008			
Fourth Quarter to Fourth Quarter (Percentage change)			
Real GDP	0.9 to 1.8	1.0 to 1.6	0.9
PCE Price Index[a]	3.4 to 4.6	3.8 to 4.2	4.0
Core PCE Price Index[b]	2.0 to 2.5	2.2 to 2.4	2.3
Average Level, Fourth Quarter (Percent)			
Civilian Unemployment Rate	5.5 to 5.8	5.5 to 5.7	5.9
2009			
Fourth Quarter to Fourth Quarter (Percentage change)			
Real GDP	1.9 to 3.0	2.0 to 2.8	1.8
PCE Price Index[a]	1.7 to 3.0	2.0 to 2.3	2.5
Core PCE Price Index[b]	1.8 to 2.3	2.0 to 2.2	2.2
Average Level, Fourth Quarter (Percent)			
Civilian Unemployment Rate	5.2 to 6.1	5.3 to 5.8	6.3
2010			
Fourth Quarter to Fourth Quarter (Percentage change)			
Real GDP	2.0 to 3.5	2.5 to 3.0	4.2
PCE Price Index[a]	1.6 to 2.1	1.8 to 2.0	1.8
Core PCE Price Index[b]	1.5 to 2.0	1.8 to 2.0	2.0
Average Level, Fourth Quarter (Percent)			
Civilian Unemployment Rate	5.0 to 5.8	5.0 to 5.6	5.8

Sources: Congressional Budget Office; Federal Reserve Board, "Summary of Economic Projections for the Meeting of June 24–25, 2008" (July 15, 2008).

Notes: GDP = gross domestic product.

The range of estimates from the Federal Reserve reflects all views of the members of the Federal Open Market Committee. The central tendency reflects the most common views of the committee's members.

a. The personal consumption expenditure chained price index.

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

APPENDIX

A

Changes in CBO's Baseline Since March 2008

The Congressional Budget Office (CBO) updates its baseline budget projections each summer to illustrate the paths of federal spending and revenues over the next 10 years under current laws and policies (see Table A-1). The updated baseline reflects a revised economic forecast by CBO and the effects of legislation enacted since March, when CBO completed its previous baseline projections.[1] In addition, CBO has updated some projections for technical reasons, reflecting new information from various sources about programs' operations.

CBO constructs its baseline in accordance with the provisions set forth in the Balanced Budget and Emergency Deficit Control Act of 1985 and the Congressional Budget and Impoundment Control Act of 1974. (Although the provisions of the Deficit Control Act that pertain to the baseline expired at the end of September 2006, the agency continues to follow that law's specifications in preparing its baseline.) To project revenues and mandatory spending, CBO assumes that current laws continue unchanged in the future, with only a few exceptions.[2]

That approach includes the assumption that various changes in tax law enacted since 2001 expire as scheduled, by the end of December 2010, causing a rise in revenues thereafter. To project discretionary spending, CBO adjusts appropriations for the most recent year for inflation and for certain other factors, as the Deficit Control Act specified. The resulting baseline projections are not intended to be a prediction of future budgetary outcomes. Rather, they serve as a benchmark that lawmakers can use to measure the effects of spending or revenue proposals.

Since March, CBO has increased its current-law estimate of the deficit for 2008 by $51 billion, to $407 billion. That change is almost entirely the result of higher spending than projected in the March baseline. Much of that increase was expected, however, because it results from supplemental appropriations for military operations in Iraq and Afghanistan, which were pending at the time. Added expenditures for deposit insurance and unemployment benefits also contributes to the anticipated increase in spending in 2008.

The net impact that CBO's updates have had on its projection of the deficit or surplus from 2009 through 2018 has been substantial. In March, CBO projected a cumulative surplus of $270 billion over the period; the current baseline now shows a cumulative deficit of $2.3 trillion. Nearly two-thirds of that change stems from the timing of supplemental appropriations, most of which were related to military operations in Iraq and Afghanistan. In June, supplemental appropriations of $111 billion were made for 2008; the law also provided $76 billion in

1. Those projections were published in Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2009* (March 2008).

2. The Deficit Control Act specified that mandatory spending programs whose authorizations are set to expire should be assumed to continue if they have outlays of more than $50 million in the current year and were established on or before the date when the Balanced Budget Act of 1997 was enacted. (Programs established after that date are not automatically assumed to continue.) The Deficit Control Act also specified that expiring excise taxes whose revenues are dedicated to trust funds should be assumed to be extended at their current rates. (The law did not provide for the extension of other expiring tax provisions, even if they had been routinely extended in the past.)

Table A-1.

Changes in CBO's Baseline Projections of the Deficit or Surplus Since March 2008

(Billions of dollars)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Total, 2009-2013	Total, 2009-2018
Total Deficit (-) or Surplus as Projected in March 2008	-357	-207	-213	-93	105	70	90	104	79	134	202	-339	270
Changes to Revenue Projections													
Legislative	-1	-11	5	5	-1	18	-7	3	3	3	3	16	22
Economic	-4	-14	-29	-25	-15	-3	-2	-1	-4	-11	-20	-85	-124
Technical	7	-49	-11	-3	4	5	8	8	7	7	8	-55	-17
Total Changes to Revenues	**1**	**-73**	**-35**	**-23**	**-12**	**19**	**-1**	**10**	**6**	**0**	**-10**	**-124**	**-118**
Changes to Outlay Projections													
Legislative													
Mandatory outlays													
Veterans benefits and services	*	*	4	6	7	7	7	7	8	8	8	23	61
Housing Act	*	26	8	1	1	1	1	1	1	1	1	37	41
Unemployment benefits	5	8	0	0	0	0	0	*	*	*	*	8	7
Other	2	11	6	1	-4	-5	1	3	*	-5	-5	9	3
Subtotal, mandatory	7	45	17	8	4	3	9	10	8	4	5	76	112
Discretionary outlays													
Defense	29	64	85	96	98	102	104	107	110	111	113	446	991
Nondefense	2	9	14	17	19	20	21	22	22	23	23	79	191
Subtotal, discretionary	30	73	99	113	117	122	126	129	132	134	137	524	1,182
Net interest outlays (Debt service)	*	3	9	16	23	30	38	47	56	66	76	81	364
Subtotal, legislative	**37**	**121**	**125**	**136**	**144**	**156**	**173**	**186**	**197**	**204**	**217**	**681**	**1,658**
Economic													
Mandatory outlays													
Social Security	0	13	20	22	23	23	24	23	23	23	23	102	218
Other COLA programs	0	4	6	7	7	7	8	8	8	8	8	32	72
Oil and gas receipts	-2	-6	-7	-8	-8	-9	-9	-9	-10	-10	-11	-38	-88
Medicare	0	2	3	4	4	5	5	5	6	6	6	18	46
Food Stamps	*	3	4	4	4	3	3	4	4	4	4	18	36
Earned income tax credit	0	*	*	2	3	3	3	3	3	3	4	8	25
Unemployment benefits	*	2	6	5	*	*	*	*	*	*	*	13	14
Other	*	2	2	2	2	2	2	2	2	2	3	9	19
Subtotal, mandatory	-2	19	34	38	35	35	36	36	37	37	36	161	342
Discretionary outlays	0	5	11	12	12	12	13	13	13	13	13	52	118
Net interest outlays													
Debt service	*	1	4	9	13	17	21	25	29	34	39	44	192
Rate effect/inflation	12	8	5	12	7	8	7	7	7	8	8	39	76
Subtotal, net interest	12	9	9	20	20	25	28	32	36	42	47	83	268
Subtotal, economic	**10**	**33**	**53**	**70**	**67**	**72**	**77**	**81**	**86**	**92**	**96**	**295**	**728**

Continued

Table A-1. Continued

Changes in CBO's Baseline Projections of the Deficit or Surplus Since March 2008

(Billions of dollars)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Total, 2009-2013	Total, 2009-2018
Changes to Outlay Projections (Continued)													
Technical													
Mandatory outlays													
Deposit insurance	17	-1	-4	-5	-4	-2	*	*	*	*	*	-16	-15
Social Security	*	1	1	1	2	2	2	3	3	3	3	7	21
Agriculture programs	-2	1	1	2	5	3	1	*	*	*	*	12	13
Other	-11	*	1	1	1	1	2	1	*	1	1	3	7
Subtotal, mandatory	4	1	-2	-1	4	4	5	3	3	4	5	6	26
Discretionary outlays	3	2	2	2	1	1	1	1	1	1	1	8	14
Net interest outlays													
Debt service	*	1	2	3	3	3	4	4	4	4	4	12	32
Other	-2	*	1	-1	-1	*	1	1	1	2	3	*	7
Subtotal, net interest	-2	1	4	2	3	3	4	5	5	6	8	12	40
Subtotal, technical	**5**	**4**	**4**	**2**	**7**	**8**	**10**	**9**	**9**	**11**	**13**	**26**	**79**
Total Changes to Outlays	**52**	**158**	**182**	**208**	**218**	**236**	**259**	**276**	**292**	**307**	**327**	**1,003**	**2,465**
Total Impact on the Deficit or Surplus[a]	**-51**	**-231**	**-217**	**-231**	**-231**	**-216**	**-260**	**-266**	**-286**	**-307**	**-336**	**-1,127**	**-2,583**
Total Deficit as Projected in September 2008	-407	-438	-431	-325	-126	-147	-170	-162	-207	-174	-135	-1,466	-2,313
Memorandum:													
Total Legislative Changes[a]	-38	-131	-120	-131	-145	-138	-179	-183	-193	-201	-214	-666	-1,635
Total Economic Changes[a]	-15	-47	-82	-95	-82	-75	-79	-82	-91	-103	-116	-380	-852
Total Technical Changes[a]	2	-53	-15	-5	-4	-3	-2	-1	-2	-4	-6	-81	-96

Source: Congressional Budget Office.

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

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

funding for 2009. Extrapolating those amounts throughout the 10-year period added $1.2 trillion to the cumulative deficit.[3] Additional interest costs resulting from that spending added another $0.4 trillion.

Updated economic assumptions have also substantially worsened the budget outlook—by an average of $85 billion a year through 2018. Much of that decline stems from projections of a near-term jump in inflation and a weaker economy. In particular:

- CBO has increased its projections of inflation, as measured by both the consumer price index (CPI) and the gross domestic product (GDP) deflator; most of the rise occurs in 2008 and 2009, reflecting the recent increases in inflation stemming from rapidly rising energy and food prices. The forecast rate of inflation beyond 2009 has changed little.

3. Since 2005, the Congress has provided in a separate title of an appropriation act some funding near the start of the fiscal year for operations in Iraq and Afghanistan. Such appropriations—frequently referred to as "bridge" funds—are intended to cover ongoing operations until further funding can be provided. In December 2007, the Congress and the President enacted appropriations of $70 billion to continue operations for the first part of 2008. As part of the supplemental appropriations enacted in June, they have already provided $66 billion for such military operations during early 2009; the baseline extends that more recent appropriation.

- CBO has reduced its projection of real (inflation-adjusted) GDP by 1.7 percent, on average, over the 2008–2018 period. At the beginning of the period, that reduction reflects a weaker economic outlook. By the end of the period, the reduction in real GDP reflects decreases in factors determining potential GDP, specifically slower capital accumulation (from reduced business investment) and lower growth in the potential number of hours worked (see Chapter 2 for more detail).

Other, technical, changes (ones not directly related to changes in law or in the economic outlook) have a smaller impact—an increase in the aggregate deficit of $96 billion over the 10-year projection period.

Changes to Projections of Outlays

Since March, CBO has added $52 billion to its estimate of outlays for 2008. That total reflects an increase of $37 billion in estimated outlays due to legislative action, augmented by economic changes totaling $10 billion and technical changes totaling $5 billion. For the 2009–2018 period, total projected outlays are up by $2.5 trillion, mostly from extrapolating supplemental appropriations.

Legislative Changes

Several pieces of legislation have been enacted since CBO's last baseline in March, leading to additional projected outlays totaling $1.7 trillion (including debt service) over the 2009–2018 period. Legislation has produced the largest changes to estimates of the deficit in all years of the projection, largely as a result of extrapolating recent supplemental funding, mostly for operations in Iraq and Afghanistan, through the end of the period.

Supplemental Appropriations. Enactment of the Supplemental Appropriations Act of 2008, Public Law 110-252, increased both discretionary and mandatory spending. The bulk of the budgetary effects derive from discretionary outlays to support military operations in Iraq and Afghanistan (for military pay, operating costs, the procurement and repair of hardware, and other activities). That law provided an additional $93 billion for such operations in 2008 and appropriated $66 billion for 2009. As a result of the legislation, which also provided $7 billion for 2008 defense programs not directly related to Iraq and Afghanistan, CBO added about $29 billion to its estimate of outlays for 2008 and extrapolated the funding throughout the projection period, resulting in an increase of nearly $1 trillion in defense outlays from 2009 to 2018.

For certain nondefense discretionary programs, P.L. 110-252 provided $10 billion in 2008 and an additional $10 billion for 2009. More than half of that funding is for reconstruction projects related to Hurricane Katrina. Extrapolating the funding for nondefense programs generates an additional $191 billion in projected outlays over the 2009–2018 period.

P.L. 110-252 also made changes to mandatory programs—those providing veterans' education, unemployment, and Medicaid benefits—that are estimated to increase projected outlays by a total of $71 billion over 10 years:

- The Post-9/11 GI Bill included in P.L. 110-252 will create a new education program for individuals with active-duty service since September 11, 2001, effective on August 1, 2009. The new program is intended to completely cover the cost of an undergraduate degree at a public institution (including tuition, housing, books, and supplies) for qualifying service members. Effective August 1, 2008, the law also increased the benefits under existing education programs and greatly expanded a program allowing certain service members to transfer unused education benefits to their spouse and children. The new education benefits are expected to increase direct spending by $61 billion over the 2009–2018 period.

- P.L. 110-252 provided up to 13 weeks of additional unemployment compensation for individuals who exhaust their regular benefits, increasing projected outlays by $13 billion through 2009. Under that law, those benefits are available to individuals who exhaust their regular benefits before March 31, 2009.

- The law also placed moratoriums on certain administrative actions governing the Medicaid program, including actions that would have affected payments for services furnished by public providers for graduate medical education, for school-based administration and transportation services, and for rehabilitation and targeted case-management services. In addition, the law added a requirement that all states verify the assets of applicants for Medicaid's coverage of long-term care. On net, those changes lead to lower estimated outlays, a decrease of $3 billion from 2009 through 2018.

Housing Legislation. The Housing and Economic Recovery Act of 2008, P.L. 110-289, made a number of changes in federal housing policy that affect mandatory spending. The law provides temporary authority to the Secretary of the Treasury to purchase obligations and securities issued by the government-sponsored enterprises (GSEs) Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. It also requires Fannie Mae and Freddie Mac to pay to the federal government a portion of the value of new mortgages they purchase or securitize to be used for a housing trust fund and a new mortgage guarantee program. Additionally, it provided funds for state grants to purchase and rehabilitate foreclosed and abandoned homes.

CBO estimates that the additional outlays resulting from the enactment of P.L. 110-289 will total $26 billion in 2009 and $41 billion over the 2009–2018 period. Included in those figures is $25 billion in outlays for 2009 and 2010 resulting from the provision granting the Secretary of the Treasury the authority to provide financial support to the GSEs. That amount is a probability-weighted estimate, reflecting a wide range of possible outcomes.[4]

Other Legislation. The enactment of the Food, Conservation, and Energy Act of 2008 (P.L. 110-246, commonly referred to as the farm bill) is estimated to increase mandatory outlays by $3 billion over the 2009–2018 period. Provisions in the law that link disaster assistance to participation in the crop insurance program increase costs through 2011; a shift in the timing of payments beginning in 2012 and other provisions are expected to reduce some costs in subsequent years.

The Medicare Improvements for Patients and Providers Act (MIPPA, P.L. 110-275) canceled a reduction in Medicare's payment rates for physicians' services that went into effect on July 1, 2008, and extended other expiring provisions governing the Medicare program. It also increased payment rates for physicians' services for 2009, expanded eligibility for benefits for low-income people, and reduced payments to private insurance plans that provide services under Medicare. MIPPA also affects the Medicaid program in several ways: The law extended several expiring provisions, delayed implementation of new payment limits on drugs available from multiple sources, and allowed expansion of county-operated managed care plans for Medicaid beneficiaries in California. For 2009, MIPPA is estimated to increase Medicare spending by $7 billion and Medicaid spending by nearly $1 billion. Over the 2009–2018 period, it is estimated to decrease Medicare spending by $9 billion and to increase Medicaid spending by $8 billion, relative to CBO's March projections.

Net Interest. Legislation enacted since March is estimated to increase projected deficits over the 2009–2018 period by $1.3 trillion. The resulting increase in federal borrowing is projected to add $364 billion to the government's debt-service costs over that period.

Economic Changes

As part of its updated economic forecast, CBO modified its projections of the unemployment rate, interest rates, and prices used to estimate outlays. Such revisions have caused the agency to increase its estimate of outlays by $10 billion for 2008 and by a total of $728 billion over the 2009–2018 period. An increase in the estimate of inflation accounts for much of the change in projected spending that results from economic factors, particularly because it leads to higher projected cost-of-living adjustments (COLAs) for many programs.

Social Security. CBO's revised economic forecast raises the estimated COLAs that Social Security beneficiaries will receive by 2.8 percentage points for 2009 (to 5.7 percent) and by 0.3 percentage points for 2010 and for 2011—a change that contributes heavily to a $13 billion increase in benefit payments for 2009 and an average increase of about $23 billion annually thereafter. As a result, estimated spending for Social Security has increased by $218 billion over the 2009–2018 period.

Other Programs with COLAs. Projections for several other programs are also significantly affected by CBO's updated forecast of COLAs. For 2009 to 2018, that change along with other smaller adjustments to the economic forecast raises projected outlays by $41 billion for retirement benefits for military and civil service retirees, by $16 billion for Supplemental Security Income benefits, and by $15 billion for disability compensation and pension benefits for veterans. On net, those changes have added $72 billion in outlays over the baseline period.

4. P.L. 110-289 also affects federal revenues. For additional information, see Congressional Budget Office, cost estimate for H.R. 3221, the Housing and Economic Recovery Act of 2008 (July 23, 2008); and Congressional Budget Office, "CBO's Estimate of the Cost of the Administration's Proposal to Authorize Federal Financial Assistance for the Government-Sponsored Enterprises for Housing," letter to the Honorable John M. Spratt Jr. (July 22, 2008).

Oil and Gas Receipts. CBO's revised economic forecast anticipates that prices of oil and natural gas will be significantly higher than the amounts projected in March. Consequently, the agency has increased its estimates of offsetting receipts from royalties paid on oil and gas leases on federal land (net of payments to states) and the Outer Continental Shelf by a total of $88 billion over the 2009–2018 period.

Medicare. Payment rates for most services in the fee-for-service sector of Medicare (including hospital care and services furnished by physicians, home health agencies, and skilled nursing facilities) are subject to automatic updates based on changes in prices in those settings. CBO's higher projections of inflation for 2008 through 2011 raise its estimates of Medicare spending by a total of $46 billion through 2018.

Food Stamps. Higher food prices have led to significantly higher benefits for the Food Stamp program, compared with the amount in CBO's prior baseline. The maximum Food Stamp benefit is set each June as the cost to feed a family of four, as determined by the Department of Agriculture. In March, CBO projected that the June 2008 figure would be 4 percent higher than that in the prior year; however, the actual amount was 8.5 percent higher. In the baseline, adjustments to account for that difference and other changes lead to additional outlays totaling $36 billion over the 2009–2018 period.

Earned Income Tax Credit. Changes to CBO's estimates of inflation and employment have led the agency to boost its estimate of outlays for the earned income tax credit by $25 billion. In its baseline, higher projections of eligible earnings (which are indexed to inflation) lead to increased outlays for the program; however, lower projections of employment result in fewer individuals qualifying for the tax credit, which slightly tempers the effect of inflation.

Unemployment Benefits. Updates to CBO's economic forecast have increased projected outlays for unemployment compensation by $14 billion over the 2009–2018 period. Most of that change is estimated to occur in 2010 and 2011—for those years, CBO has raised its projection of the unemployment rate by 1.0 and 0.7 percentage points (to 6.2 percent and 5.5 percent), respectively.

Discretionary Outlays. CBO has increased its estimate of the growth in the GDP price index for 2009 by 1.1 percentage points and made some smaller changes to the estimates for later years. That index is one of the factors that CBO uses to inflate discretionary spending into future years; changes in such factors increase the agency's projection of discretionary outlays from 2009 through 2018 by $118 billion.

Net Interest. CBO has raised its projection of net interest outlays in 2008 by $12 billion as a result of economic factors. Most of that revision reflects an increase in the consumer price index (not seasonally adjusted), which the agency now expects to grow by 4.4 percent this year, up from a forecast of 3.3 percent growth in March 2008. That change raises estimated interest costs on inflation-protected securities, which are keyed to the index.

For the 2009–2018 period, CBO has increased its estimate of net interest outlays by $268 billion as the result of economic factors. Projections of higher spending and lower tax revenues resulting from economic factors boost projected federal debt and add $192 billion to debt-service costs in the baseline. Also, an increase in projected interest rates—in almost every year through 2018, CBO has raised its forecast of the rate for 10-year Treasury notes by 20 basis points (or 0.2 percentage points)—adds $76 billion.

Technical Changes

Technical changes have had little effect on CBO's new baseline projections. For 2008, such revisions produce a net increase of $5 billion in outlays. The largest change for this year is a significant increase in outlays for deposit insurance as a result of recent bank failures. That increase is partially offset by decreases in estimated outlays for other programs. For the 2009–2018 period, technical changes increase projected outlays by $79 billion.

Deposit Insurance. CBO has adjusted its baseline projections for deposit insurance to reflect an increase in the number of recent and anticipated failures of federally insured banks and thrift institutions. Such failures increase federal spending when the Federal Deposit Insurance Corporation (FDIC) makes payments to cover insured deposits but reduce outlays in future years as the FDIC liquidates the assets held by those institutions and raises insurance premiums to cover any losses. On the basis of the costs incurred by the FDIC through July, CBO has raised its estimate of net outlays for 2008 by nearly $17 billion and lowered its estimate for the 2010–2013 period by a similar amount.

Social Security. Mostly as a result of increased projections of the U.S. population and participation rates in the Old-Age and Survivors Insurance portion of the Social Security program, CBO estimates that outlays for the program for the 2009–2018 period will be $21 billion higher than what it projected in March.

Agriculture Programs. For 2008, CBO has reduced its estimate of outlays for agriculture programs to align with lower-than-expected claims in crop insurance and agriculture disaster programs. For 2009 to 2018, the agency has increased that estimate largely because of higher projections of crop prices. Such higher prices reduce the estimated cost of traditional agriculture programs, which compensate producers for low prices; however, they raise the expected cost of crop insurance and other revenue-protection programs. The estimated cost of such programs has increased because the higher crop prices expected initially are anticipated to decline in subsequent years. Estimated costs for federal crop insurance also have increased because, other things being equal, the higher the value of the crops, the higher the costs to insure them. In total, projected spending for agriculture programs has increased by $13 billion over the 2009–2018 period.

Discretionary Programs. Upward and downward adjustments in several areas of the budget have resulted in net increases in CBO's estimates of discretionary outlays totaling $3 billion for 2008 and $14 billion for the 2009–2018 period.

Net Interest. For 2008, CBO's current estimate of net interest spending is $2 billion lower than the amount the agency estimated in March. That decrease mainly stems from lower intragovernmental interest payments and a reduction in the expected earnings of the Railroad Retirement Investment Trust Fund. For the next 10 years, technical changes to projections of spending for net interest have boosted projected outlays by $40 billion. About $32 billion of that increase stems from debt-service costs as a result of other technical changes to the baseline.

Changes to Projections of Revenues

In CBO's baseline, revisions since March increase anticipated revenues in 2008 by $1 billion and decrease projected revenues over the next decade by $118 billion, mostly because of changes to the agency's economic forecast.

Legislative Changes

On net, legislation enacted since March is expected to reduce revenues by about $1 billion in 2008 and $11 billion in 2009 and then generally increase revenues by between $3 billion and $5 billion a year thereafter through 2018—except from 2012 to 2014, when legislated shifts in payments of estimated corporate taxes (discussed below) change that pattern. Over the 2009–2018 period, recently enacted legislation is expected to increase revenues by about $22 billion.

The most significant legislative impact on revenues stems from the enactment of the Housing and Economic Recovery Act of 2008. That law will raise an estimated $18 billion in additional revenues over the 2009–2018 period. The provision with the largest immediate effect provides a tax credit of up to $7,500 to individuals who purchase a home from April 8, 2008, through June 2009 and who have not owned a home for at least the past three years. The credit is refundable and is repaid in higher taxes over a 15-year period or, in general, immediately upon the sale of the home, without interest.[5] The Joint Committee on Taxation (JCT) estimates that the provision will reduce revenues by almost $10 billion in 2009 (and increase outlays for refundable credits by about $4 billion in that year) but then will increase revenues by about $9 billion over the 2010–2018 period.

Several other provisions in P.L. 110-289 are estimated to raise revenues. One provision requires credit card companies and other processors of third-party payments to report to the Internal Revenue Service information on certain types of transactions by merchants, starting in 2011; according to JCT's estimates, that change will increase revenues by almost $10 billion over the 2011–2018 period. The legislation will also delay for two years the implementation of a provision enacted in 2004 that reduces corporate income taxes by allowing firms to allocate more of their worldwide interest expenses to U.S. income. That change in P.L. 110-289 will raise revenues by about $8 billion over the 2009–2012 period, JCT estimates. In addition, the legislation imposes new fees on Fannie Mae and Freddie Mac, which CBO estimates will increase revenues by about $7 billion over the next 10 years.

5. A tax credit reduces a taxpayer's overall tax liability. If the credit is refundable and the amount of the credit exceeds that liability, then the excess is refunded to the taxpayer. In that case, the excess is classified as an outlay in the federal budget.

Among other recently enacted legislation with effects on revenues, the Supplemental Appropriations Act of 2008 included additional benefits for unemployment insurance, which CBO estimates will result in states' increasing unemployment taxes by about $3 billion to replenish their trust funds; those receipts are included in the federal budget as revenues. Also, a variety of provisions in the Food, Conservation, and Energy Act of 2008 will affect revenues, including a reduction of the tax subsidy for ethanol-blended motor fuels, which, by JCT's estimates, will increase revenues by about $1 billion through 2011.

Several enacted laws shifted corporate income tax payments between fiscal years by accelerating in certain years and decelerating in others the payment of quarterly estimated taxes. On net, according to JCT's estimates, those changes will reduce receipts by about $5 billion in 2012, increase them by $15 billion in 2013, and reduce them by $10 billion in 2014.

Economic Changes

As a result of changes to its economic forecast since March, CBO has lowered its projection of revenues over the 2009–2018 period by $124 billion (or 0.3 percent of the March revenue projection). The reductions are largest from 2009 to 2012, accounting for over half of that total change. The updated outlook for revenues broadly follows the new, somewhat lower, projected path of nominal GDP.

Shifts in the projected composition of income have contributed less to the changed outlook for revenues. CBO has lowered its near-term projection of personal interest income to reflect lower mortgage interest payments by homeowners, a share of which passes through in taxable form to individuals who receive interest on their investments. In addition, CBO has changed slightly its projection of the mix of capital income, reducing business interest payments and depreciation and raising the more highly taxed corporate profits. That change caused CBO to reduce its projection of revenues in later years of the period by less than the amount indicated by the reductions in projected GDP alone.

Technical Changes

CBO has made several adjustments to its March revenue projection to reflect technical factors, lowering its estimate for 2009 by $49 billion and making small overall changes in its estimates for other years. The irregular pattern stems from a combination of factors that offset one another in most years but largely reinforce one another in 2009.

- CBO expects that roughly $20 billion of the reduction in revenues from the depreciation provisions of the Economic Stimulus Act of 2008 (P.L. 110-185) that it had previously anticipated would occur in 2008 will instead be realized in 2009.[6] The agency now expects that roughly half of the up-front revenue losses will occur in 2008, and the other half in 2009.
- In addition, CBO estimates that the rebates issued this year to individuals from the enactment of P.L. 110-185 will be about $10 billion, or roughly 10 percent, less than expected, both boosting revenues and lowering outlays for refundable credits. About half of that difference, CBO projects, will be made up in 2009 when taxpayers file their returns for 2008.
- Overall, tax revenues in 2008 are running relatively close to CBO's March projection. Because the revenue losses from the stimulus legislation are smaller than anticipated, that outcome means that other factors are causing revenues to run below expectations. Those lower-than-anticipated revenues are not explained by the latest economic indicators. They are concentrated in withholding of income and payroll taxes and in receipts from corporate income taxes. CBO has therefore lowered its estimates of revenues by about $20 billion in 2008 and by progressively smaller amounts over the following few years.

6. Provisions in the law allow corporate and noncorporate businesses to immediately expense (deduct from taxable income) half of their investment in equipment undertaken in 2008 and to depreciate over a period of years the remainder of the investment following the normal tax rules. The provisions result in reduced receipts up front and higher receipts later, when fewer depreciation deductions may be taken.

- In the baseline, small upward adjustments to revenues from 2012 to 2018 reflect the net effect of a variety of factors, the most significant of which stems from partial information now available from individual income tax returns for 2006. Those tax returns indicate that taxable incomes were higher than expected relative to comparable measures in the national income and product accounts (which are maintained by the Department of Commerce's Bureau of Economic Analysis)—a pattern that CBO projects will persist over the coming decade.

APPENDIX

B

A Comparison of CBO's and OMB's Baselines

Like the Congressional Budget Office (CBO), the Administration's Office of Management and Budget (OMB) updates its baseline budget projections and economic assumptions each summer. This appendix compares OMB's latest baseline projections—the July "current-services" baseline—with those produced by CBO.[1] (Unlike CBO's 10-year projections, OMB's current-services baseline runs only through 2013.)

For 2008, CBO anticipates a deficit of $407 billion—$18 billion higher than OMB's estimate of $389 billion. CBO expects $13 billion more in outlays and $6 billion less in revenues than OMB does (see Table B-1).

For the following five years, CBO estimates a cumulative deficit of $1.47 trillion, which exceeds by $777 billion OMB's projection of $689 billion. Part of that difference stems from different conceptual approaches to the treatment of appropriations designated as emergency requirements and expiring tax provisions (see Box B-1). If OMB followed the estimating conventions specified in the Balanced Budget and Emergency Deficit Control Act of 1985, as CBO does, the gap between the two agencies' projections of the five-year deficit would be roughly $500 billion—or 3 percent of total outlays. Adjusted to account for the conceptual differences, CBO's revenue projections would be nearly $390 billion lower than OMB's, and its outlay projections would be about $110 billion higher than OMB's (including debt service).

1. OMB's most recent update was published in Office of Management and Budget, *Fiscal Year 2009 Mid-Session Review: Budget of the U.S. Government* (July 28, 2008). See Table S-11 for OMB's current-services baseline.

Revenues

CBO's current-law estimate of 2008 revenues is just $6 billion less than OMB's. That gap between the baselines increases to $40 billion in 2009 and $66 billion in 2010. Thereafter, CBO's estimates are higher than OMB's, by amounts ranging from $55 billion in 2011 to $151 billion in 2013.

For the 2009–2013 period as a whole, CBO's projection of total revenues is above OMB's by $229 billion. The disparity results from offsetting factors:

- Conceptual differences cause CBO's five-year revenue projection to be higher than OMB's by $616 billion, with $600 billion of that difference occurring after 2010. OMB's baseline includes the effects of permanently extending certain tax provisions originally enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003, whereas CBO's baseline assumes that those provisions expire in December 2010, as currently scheduled. Adjusted for those conceptual differences, CBO's estimate of revenues under current law is nearly $390 billion (or about 2 percent) below OMB's estimate for the 2009–2013 period.

Table B-1.

Comparison of CBO's September 2008 Baseline and OMB's July 2008 Current-Services Baseline

(Billions of dollars)

	2008	2009	2010	2011	2012	2013	Total, 2009-2013
				CBO's September 2008 Baseline			
Revenues	2,548	2,720	2,881	3,178	3,451	3,619	15,848
On-budget	1,891	2,032	2,159	2,416	2,649	2,782	12,038
Off-budget	657	687	722	762	802	837	3,810
Outlays							
Mandatory	1,586	1,729	1,789	1,897	1,931	2,073	9,420
Discretionary	1,125	1,202	1,258	1,297	1,318	1,353	6,427
Net interest	244	227	265	308	328	340	1,467
Total	2,955	3,158	3,312	3,502	3,577	3,766	17,314
On-budget	2,483	2,644	2,768	2,935	2,981	3,139	14,468
Off-budget	472	514	544	567	595	626	2,847
Deficit (-) or Surplus	**-407**	**-438**	**-431**	**-325**	**-126**	**-147**	**-1,466**
On-budget	-592	-611	-609	-520	-332	-357	-2,429
Off-budget	184	173	179	195	206	210	964
				OMB's July 2008 Current-Services Baseline			
Revenues	2,553	2,760	2,947	3,123	3,322	3,467	15,619
On-budget	1,896	2,076	2,216	2,350	2,512	2,619	11,773
Off-budget	657	684	730	773	810	849	3,846
Outlays							
Mandatory	1,580	1,695	1,777	1,887	1,932	2,079	9,370
Discretionary	1,130	1,203	1,092	1,082	1,094	1,117	5,589
Net interest	232	226	255	280	291	297	1,350
Total	2,942	3,125	3,125	3,249	3,316	3,493	16,309
On-budget	2,470	2,623	2,595	2,692	2,730	2,873	13,513
Off-budget	473	502	530	557	587	620	2,795
Deficit (-) or Surplus	**-389**	**-365**	**-178**	**-126**	**6**	**-26**	**-689**
On-budget	-573	-547	-378	-343	-218	-255	-1,740
Off-budget	184	182	201	217	223	229	1,051

Continued

Table B-1. Continued

Comparison of CBO's September 2008 Baseline and OMB's July 2008 Current-Services Baseline

(Billions of dollars)

	2008	2009	2010	2011	2012	2013	Total, 2009-2013
			Difference (CBO's Baseline Minus OMB's)				
Revenues	-6	-40	-66	55	129	151	229
On-budget	-6	-44	-57	66	137	164	265
Off-budget	0	3	-8	-11	-8	-12	-36
Outlays							
Mandatory	6	34	12	10	*	-6	50
Discretionary	-5	-2	166	215	224	236	839
Net interest	12	1	10	28	37	42	117
Total	13	33	187	253	260	272	1,006
On-budget	13	21	173	243	252	266	955
Off-budget	*	12	14	11	9	6	51
Deficit or Surplus[a]	**-18**	**-73**	**-253**	**-199**	**-131**	**-121**	**-777**
On-budget	-19	-65	-231	-177	-115	-102	-689
Off-budget	*	-8	-22	-22	-17	-18	-87

Sources: Congressional Budget Office (CBO) and 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 appropriations designated as emergency funding into future years, and it assumes that most tax provisions enacted in 2001 and 2003 will be extended rather than expire as currently scheduled.

* = 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 the opposite.

- Variations arising from economic and technical factors offset $400 billion of CBO's higher five-year revenue projections. The two agencies' projections are based on different economic forecasts.[2] CBO projects lower levels of nominal gross domestic product (GDP) and taxable income—especially wages and salaries, which it expects to be 1.7 percent lower than OMB does over the 2009–2013 period. Relative to OMB's estimates, lower wage and salary income translates into lower revenues from individual income taxes and social insurance (payroll) taxes. That factor accounts for most of the economic differences between the two agencies' five-year revenue projections. CBO's projections also imply lower effective tax rates on corporate profits and personal income than OMB's do.

- Differences attributable to legislation raise CBO's revenue projections by about $14 billion relative to OMB's. The deviation primarily results from CBO's including the estimated revenue effects of the Housing and Economic Recovery Act of 2008 (Public Law 110-289), which became law after the Administration published its baseline (see Appendix A).

Outlays

The largest difference between CBO's and OMB's estimates of federal spending in 2008 is for net interest. CBO's estimate is higher by $12 billion, or 5 percent, mainly because CBO estimates higher inflation for this year, which increases the cost of Treasury inflation-protected securities. Differences in the two agencies'

2. For details of CBO's updated economic projections of various income categories as measured in the national income and product accounts (maintained by the Department of Commerce's Bureau of Economic Analysis), see Chapter 2.

Box B-1.

Conceptual Differences Between CBO's and OMB's Baselines

As it has done for many years, the Congressional Budget Office (CBO) constructs its baseline budget projections using methods specified in the Balanced Budget and Emergency Deficit Control Act of 1985.[1] Those methods included projecting discretionary spending by starting with the total funding provided for the most recent year—including supplemental appropriations—and extrapolating that amount into future years, with increases for expected inflation. The Deficit Control Act also stipulated that, in general, "laws providing or creating direct spending or receipts are assumed to operate in the manner specified in those laws." Following that stricture, CBO assumes that tax provisions that are due to expire during the projection period will end as scheduled.

The Office of Management and Budget's (OMB's) latest current-services baseline deviates from that framework in two significant ways:

- In projecting discretionary spending, it does not extrapolate funding provided in 2008 and 2009 that was deemed an emergency requirement. For example, it excludes projections of funding for military operations in Iraq and Afghanistan and other activities related to the war on terrorism (which totaled $186 billion for 2008), as well as other funding (which totaled $29 billion for 2008). Mainly because of that difference, OMB's projection of total discretionary outlays over the 2009–2013 period is about $839 billion lower than CBO's.
- OMB's baseline assumes that most of the major provisions initially enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003—which are slated to expire by the end of December 2010—will be extended. That difference causes OMB to project $616 billion less in revenues between 2009 and 2013 than CBO does. Most of that disparity occurs after 2010. The difference also causes OMB's estimate of the refundable portion of the earned income and child tax credits to be $28 billion more than CBO's estimate.

In addition, OMB made two small conceptual adjustments to its baseline that relate to the way it accounts for increases in pay and administrative expenses when projecting discretionary spending. Those adjustments reduce projected outlays by $13 billion relative to CBO's estimate over the 2009–2013 period.

1. Although the provisions of the Deficit Control Act that pertain to the baseline expired at the end of September 2006, CBO continues to follow that law's specifications in preparing its baseline projections.

estimates of discretionary spending and mandatory spending largely offset each other: CBO projects discretionary outlays that are lower (by $5 billion) and mandatory outlays that are higher (by $6 billion).

For the 2009–2013 period, CBO projects $1.0 trillion more in total outlays than OMB does. Conceptual differences (discussed in Box B-1) account for nearly $900 billion of that amount. Also, including the estimated effects of the Housing and Economic Recovery Act of 2008 adds $37 billion to CBO's baseline over the five years. Differences arising from economic and technical factors add another $74 billion.

Discretionary Spending

By far the biggest gap between CBO's baseline and OMB's current-services baseline for the 2009–2013 period is in discretionary spending, mainly for defense. That difference is largely attributable to the agencies' divergent treatment of supplemental appropriations.

Defense outlays for 2008 in CBO's baseline are $3 billion higher than OMB's estimate. For the 2009–2013 period,

CBO's projections of defense outlays exceed the Administration's by a total of almost $700 billion. Most of that difference results from the varying treatment of funding for military operations in Iraq and Afghanistan.

Nondefense outlays for 2008 in CBO's baseline are $8 billion less than OMB's estimate. Most of that difference stems from lower outlays for ground transportation programs ($2 billion less), spending related to international activities ($2 billion less), and funding for elementary and secondary education ($1 billion less). As with defense spending, CBO projects higher nondefense discretionary outlays over the 2009–2013 period than the Administration does; in this case, the difference is $141 billion. That difference reflects $27 billion in emergency funding and supplemental budget authority for 2008 and 2009 that is not extrapolated in OMB's current-services baseline. With such variations in approach excluded, CBO's projection of nondefense discretionary outlays between 2009 and 2013 would be roughly $30 billion, or 1 percent, higher than the Administration's.

Mandatory Spending

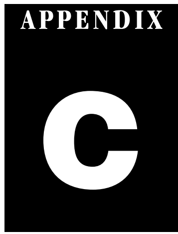
CBO anticipates that spending on mandatory programs this year will be $6 billion higher than OMB estimates. CBO projects higher spending for deposit insurance ($12 billion more) and Medicare ($5 billion more).[3] In the other direction, OMB projects higher spending for student loans ($3 billion more) and Medicaid ($2 billion more).

CBO's projection of total mandatory outlays over the 2009–2013 period is also slightly higher than OMB's estimate; the two differ by $50 billion, or 0.5 percent of such outlays. In particular, CBO's projections of spending are higher for Medicare (by $42 billion), Medicaid (by $36 billion), and Social Security (by $33 billion). Incorporating the effects of the Housing and Economic Recovery Act of 2008 adds $37 billion in mandatory spending to CBO's baseline, most of which stems from providing the Secretary of the Treasury authority to purchase obligations issued by government-sponsored enterprises involved in the mortgage market. Conversely, OMB's spending projections exceed CBO's for some mandatory programs, such as ones for veterans' benefits (by $27 billion) and deposit insurance (by $15 billion, mostly as a result of differences in the anticipated timing of bank failures). The two agencies also differ in their five-year projections of the refundable portion of the earned income and child tax credits, primarily because of a conceptual difference: OMB's assumed extension of expiring tax provisions causes its estimate to exceed CBO's by $28 billion.

Net Interest

CBO's estimate of net interest outlays in 2008 is higher than OMB's by $12 billion; for the 2009–2013 period, CBO's projection of those outlays exceeds OMB's by $117 billion. The effects of conceptual differences on revenues and spending account for about $39 billion of that amount, and the rest is attributable to differences in assumptions—about federal borrowing (reflecting roughly $50 billion), interest rates and inflation ($13 billion), and other factors ($15 billion).

3. Coming a number of weeks after OMB's baseline, CBO's baseline incorporates more recent information regarding this year's payments to cover insured deposits at failed banks and thrifts. However, both CBO and OMB project roughly the same net cost for deposit insurance over the 2008–2013 period.



CBO's Economic Projections for 2008 to 2018

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 2008 to 2018 (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 2009. Instead, the projected values shown in the tables for 2010 to 2018 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 2008 to 2018

	Actual	Forecast		Projected								
	2007[a]	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Nominal GDP (Billions of dollars)	13,808	14,334	14,873	15,696	16,618	17,451	18,231	19,028	19,847	20,691	21,563	22,470
Nominal GDP (Percentage change)	4.8	3.8	3.8	5.5	5.9	5.0	4.5	4.4	4.3	4.2	4.2	4.2
Real GDP (Percentage change)	2.0	1.5	1.1	3.6	4.1	3.1	2.5	2.4	2.4	2.3	2.3	2.3
GDP Price Index (Percentage change)	2.7	2.3	2.6	1.9	1.7	1.9	1.9	1.9	1.9	1.9	1.9	1.9
PCE Price Index[b] (Percentage change)	2.6	3.9	3.1	2.0	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9
Core PCE Price Index[c] (Percentage change)	2.2	2.3	2.3	2.1	1.9	1.9	1.8	1.9	1.9	1.9	1.9	1.9
Consumer Price Index[d] (Percentage change)	2.9	4.7	3.1	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)	2.3	2.4	2.4	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Employment Cost Index[f] (Percentage change)	3.4	3.1	2.7	2.9	3.2	3.3	3.3	3.3	3.3	3.3	3.3	3.3
Unemployment Rate (Percent)	4.6	5.4	6.2	6.1	5.3	4.9	4.8	4.8	4.8	4.8	4.8	4.8
Three-Month Treasury Bill Rate (Percent)	4.4	1.9	2.7	4.4	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7
Ten-Year Treasury Note Rate (Percent)	4.6	3.9	4.4	5.1	5.4	5.4	5.4	5.4	5.4	5.4	5.4	5.4
Tax Bases (Billions of dollars)												
Economic profits	1,642	1,605	1,586	1,663	1,793	1,905	1,995	2,090	2,190	2,295	2,397	2,505
Wages and salaries	6,362	6,616	6,882	7,286	7,623	8,030	8,376	8,727	9,087	9,458	9,841	10,238
Tax Bases (Percentage of GDP)												
Economic profits	11.9	11.2	10.7	10.6	10.8	10.9	10.9	11.0	11.0	11.1	11.1	11.1
Wages and salaries	46.1	46.2	46.3	46.4	45.9	46.0	45.9	45.9	45.8	45.7	45.6	45.6

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

Note: GDP = gross domestic product; percentage changes are measured from one year to the next.

a. Values as of August 22, 2008.

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 prices for food and energy.

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 2008 to 2018

	Actual	Forecast		Projected								
	2007[a]	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Nominal GDP (Billions of dollars)	13,642	14,210	14,719	15,473	16,390	17,253	18,036	18,826	19,641	20,478	21,342	22,240
Nominal GDP (Percentage change)	4.9	4.2	3.6	5.1	5.9	5.3	4.5	4.4	4.3	4.3	4.2	4.2
Real GDP (Percentage change)	2.1	1.9	0.8	3.0	4.2	3.3	2.5	2.4	2.4	2.3	2.3	2.3
GDP Price Index (Percentage change)	2.7	2.3	2.7	2.1	1.7	1.9	1.9	1.9	1.9	1.9	1.9	1.9
PCE Price Index[b] (Percentage change)	2.2	3.7	3.4	2.2	1.8	1.9	1.9	1.9	1.9	1.9	1.9	1.9
Core PCE Price Index[c] (Percentage change)	2.2	2.2	2.3	2.1	1.9	1.9	1.8	1.8	1.9	1.9	1.9	1.9
Consumer Price Index[d] (Percentage change)	2.3	4.5	3.8	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)	2.4	2.4	2.4	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Employment Cost Index[f] (Percentage change)	3.4	3.2	2.8	2.8	3.1	3.3	3.3	3.3	3.3	3.3	3.3	3.3
Unemployment Rate (Percent)	4.5	5.2	6.1	6.2	5.5	4.9	4.8	4.8	4.8	4.8	4.8	4.8
Three-Month Treasury Bill Rate (Percent)	4.7	2.2	2.3	4.1	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7
Ten-Year Treasury Note Rate (Percent)	4.7	4.0	4.3	4.9	5.3	5.4	5.4	5.4	5.4	5.4	5.4	5.4
Tax Bases (Billions of dollars)												
Economic profits	1,651	1,599	1,597	1,633	1,761	1,880	1,972	2,066	2,165	2,268	2,371	2,478
Wages and salaries	6,286	6,560	6,804	7,154	7,556	7,941	8,290	8,638	8,996	9,364	9,744	10,137
Tax Bases (Percentage of GDP)												
Economic profits	12.1	11.3	10.8	10.6	10.7	10.9	10.9	11.0	11.0	11.1	11.1	11.1
Wages and salaries	46.1	46.2	46.2	46.2	46.1	46.0	46.0	45.9	45.8	45.7	45.7	45.6

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

Note: GDP = gross domestic product; percentage changes are measured from one year to the next.

a. Values as of August 22, 2008.

b. The personal consumption expenditure chained price index.

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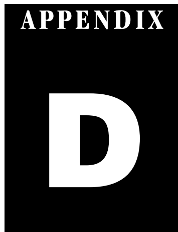

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The following Congressional Budget Office analysts prepared the revenue and spending projections in this report:

Revenue Projections

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