

New CBO Report Shows the Aging of the Budget

I. Boomers' Retirement Clearly In View

The numbers in the new Congressional Budget Office (CBO) report, *The Budget and Economic Outlook: Fiscal Years 2006-2015*, provide a clear message: the long-term challenge isn't so long term any more. The oldest members of the post-World War II baby boom generation become eligible for early retirement in 2008, within the narrow five-year window that is now used by the Administration and the congressional budget committees. By 2015, the impact of the aging population is solidly embedded in CBO's economic assumptions and budget projections.

As the President begins his second term and the 109th Congress gets to work, the main question on deficit reduction is: "If not now, when?" When will elected officials act to address the gap between what they spend and how they pay for it over the short, medium, and long-term?

II. No Real Relief in Sight

There are no major surprises in CBO's new budget report. It shows a gradual improvement in the budget's outlook over the next decade. However, that improvement is misleading because under the rules imposed on it for developing baseline projections² CBO makes several unlikely assumptions: For example:

- The new baseline contains no new funding for Iraq, Afghanistan, and the Global War on Terrorism (GWT). The Administration has already announced that it will request another \$80 billion, and there is no reason to believe that more won't be requested later this year or in subsequent years.
- The projections assume that overall discretionary spending will only grow with inflation. Spending for those annually-appropriated programs has been growing at least twice as fast in recent years even when defense spending is excluded.
- The outlook assumes that tax cuts enacted between 2001 and 2004 will expire as scheduled between the 2006 and 2011. Most of those provisions were never intended to be temporary and were only enacted with sunset (expiration) dates to reduce their

² The CBO baseline is not a prediction or a value judgment about current law. It is CBO's estimate of how the economy and other factors would affect revenues and outlays assuming that current laws and policies remained the same. It thus serves as a neutral benchmark for measuring the impact of proposed legislation.

projected impact on revenue projections. The President and many congressional leaders have already announced their determination to extend those provisions permanently.

- The baseline assumes that measures to reduce the alternative minimum tax (AMT) liability of growing numbers of middle-income taxpayers will expire as scheduled at the end of calendar year 2005. CBO estimates that doing so would cause 19 million 2006 tax returns to be subject to the AMT, up from 4 million 2005 returns. Policy makers are likely to enact legislation to prevent that from happening, as they have in the past.

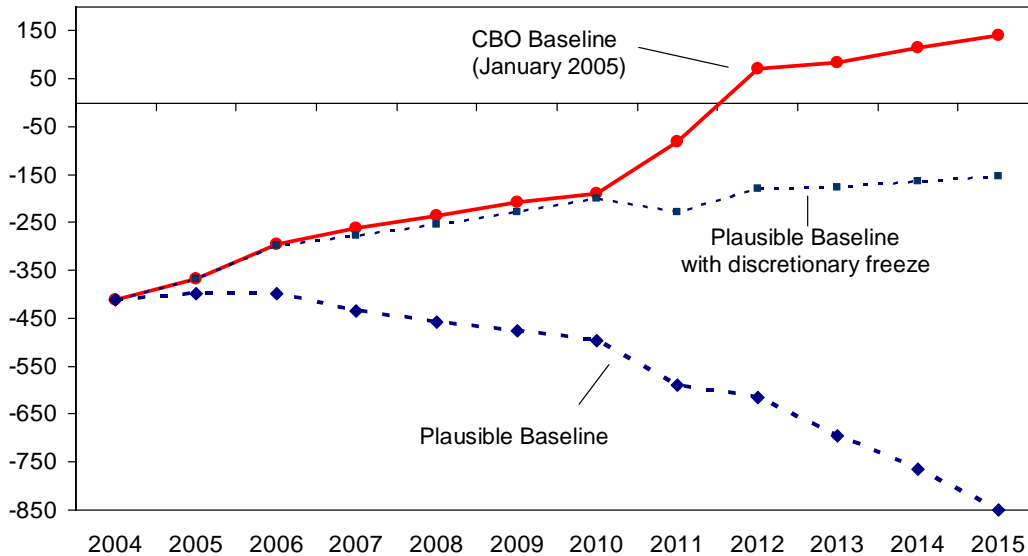
Table 1, which assumes a more plausible outlook for the budget under current policies, shows deficits accumulating to \$5.8 trillion over the next 10 years — \$5 trillion more than CBO projects in its January baseline.

Table 1. A More Plausible Budget Outlook
In billions of dollars

| | 2006 | 2015 | Total 2006-2010 | Total 2006-2015 |
|---|-------------|-------------|--------------------|--------------------|
| CBO Baseline Deficits (-)/ Surpluses (+) | -295 | 141 | -1,188 | -855 |
| <i>Adjustments:</i> | | | | |
| Phase-down funding for Iraq, Afghanistan and GWT | -70 | -28 | -285 | -418 |
| Discretionary spending grows at the rate of GDP growth | -15 | -283 | -347 | -1,437 |
| Extend expiring tax provisions | -5 | -342 | -143 | -1,616 |
| AMT reform | -12 | -117 | -187 | -642 |
| Debt service | <u>-3</u> | <u>-222</u> | <u>-114</u> | <u>-810</u> |
| Total adjustments | -105 | -991 | -1,076 | -4,922 |
| Plausible Deficits | -399 | -850 | -2,264 | -5,777 |
| As a percentage of GDP | -3.1 | -4.3 | n.a | n.a. |

If the appropriations (including defense, the war on terrorism and homeland security) were frozen over the next 10 years, instead of growing with inflation, projected deficits would improve by \$1.3 trillion (including lower debt service). However, if combined with the extension of tax cuts and continued AMT relief, the budget would still remain in deficit every year, totaling \$2.2 trillion over the next decade.

Figure 1. Baseline Deficit Projections
(Dollars in Billions)



SOURCE: Concord Coalition based upon Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2006-2015* (January 2005).

III. The Aging of the Budget

It is no secret that the aging population will affect the economy and the budget. CBO's new report states: "Over the longer term, the federal budget will be strained significantly by demographic changes that will begin within the current 10-year projection period and intensify as members of the baby-boom generation age."³ CBO has issued similar warnings for well over a decade—long before its 10-year projections began to incorporate those effects. Now the aging of the budget is visible in CBO's projections. The new baseline estimates that between 2004 and 2015 total federal spending for Social Security, Medicare, and Medicaid will increase by 25 percent—from 8 to 10 percent of GDP.⁴

CBO's projections reflect the changing demographic profile in the following ways:

- CBO projects that labor force participation will decline sharply over the next 10 years, slowing projected growth to 2.7 percent on average between 2011 and 2015 compared to the economy's long-run average of 3.5 percent growth since 1950.

³ Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2006-2015*, January 2005.

⁴ Although approximately 10 percent of Medicaid's beneficiaries are ages 65 and older, spending on their behalf represents about 26 percent of benefit costs.

- Spending for Social Security, Medicare (net of beneficiary premiums) and Medicaid more than doubles between 2004 and 2015, increasing from \$933 billion to over \$1.9 trillion. In 2015, CBO estimates that those programs will represent nearly 52 percent of total spending compared with 41 percent in 2004.
- Social Security cash surpluses (excluding federal interest payments) will peak in 2011 at \$117 billion. By 2015, that income declines to \$85 billion. In 2020, Social Security will no longer generate cash surpluses according to CBO.
- The new revenues estimates also reflect changes relating to aging baby boomers who are upping their retirement savings in tax-deferred accounts relative to CBO's previous assumptions. As a result, taxable income is lower as contributions to — and asset accumulation in — tax-deferred retirement accounts grows. The good news is that revenues should be higher in the future. As retirees withdraw funds from those accounts the amounts will be taxable. This does not, however, represent a “windfall” to the Treasury that will close the long-term budget gap. CBO's projections for this future revenue boost are incorporated into its long-term projections.

IV. That Was Then. This Is Now.

The start of a new presidential term and a new Congress is a good place to look at how the challenges for policy makers have changed with the fiscal landscape. Four years ago, the budget's future looked bright. Growing surpluses were projected throughout the baseline, totaling \$5.6 trillion over 10 years. That is not the case today. Table 2 compares the baseline projections issued in January 2001 for FY 2005 and FY 2010 with the new baseline projections for those same years. Despite the unrealistic assumptions underlying the latest baseline, that outlook has deteriorated by a considerable amount.

- Four years ago, CBO projected surpluses of \$433 billion in 2005 and \$796 billion in 2010. Today's baseline projects *deficits* of \$368 billion in 2005 and \$189 billion in 2010.
- Four years ago, because of those projected surpluses, some in Washington were concerned about the possibility that the government would retire all of its available, publicly-held debt. The 2001 baseline projected that debt held by the public in 2010 would fall to 5.5 percent of GDP; the new baseline projects that it will near 38 percent of GDP.
- Four years ago, the baseline figures for 2010 showed the federal government would take in \$51 billion more from earnings on uncommitted funds accumulated from surpluses than it would pay on remaining outstanding bonds.⁵ The 2005 baseline estimates that the government will pay \$303 billion in interest on borrowings. That's a swing of over \$350 billion in 2010.

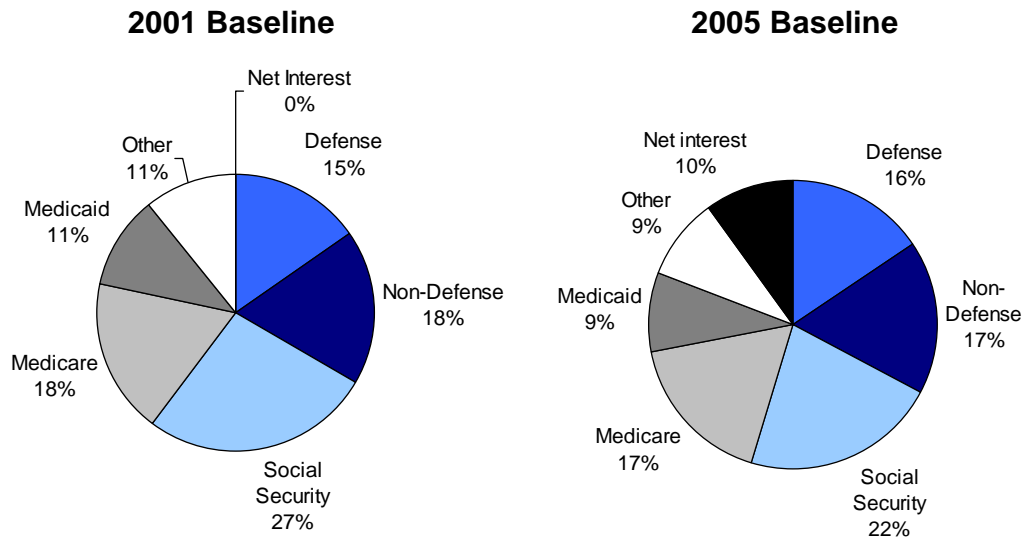
⁵ At the time, amounts of projected surpluses exceeded amounts of debt maturing and available for redemption. CBO made no assumption about how those “excess” funds would be used, but assumed that they would be invested and earn interest at the prevailing Treasury rate.

The changed outlook results from many factors, some of an economic or technical nature that were obviously beyond policy makers' control. However, *nearly 60 percent of the changes in the CBO budget outlook for the 2002 through 2011 period stems from legislative decisions.* Those decisions included funding provided for homeland security and the wars in Iraq and Afghanistan, as well as major tax cuts and the new Medicare prescription drug benefit.

While the conditions and events of the last several years may provide some rationalization for where the budget is today, that erosion makes it even more difficult to address already difficult policy choices such as Social Security reform. For example, funding Social Security private accounts with budget surpluses or using the Social Security surplus to pay down the debt are no longer viable options.

In 2001, policy makers anticipated a declining debt and debt servicing costs. Under the new baseline, the public debt will continue to rise through 2011. As a result, 10 percent of the budget—\$303 billion—will be used to pay interest costs in 2010, squeezing other spending (see figure 2).

Figure 2. CBO Projections for 2010: January 2001 v. January 2005



**Table 2. Comparison of CBO's January 2001 and 2005 Baseline Projections
for FY 2005 and FY 2010**

| | Outlook for FY 2005 | | | Outlook for FY 2010 | | |
|----------------------------------|---------------------|----------|------------|---------------------|----------|------------|
| | Jan 2001 | Jan 2005 | Difference | Jan 2001 | Jan 2005 | Difference |
| Revenues | | | | | | |
| In billions of dollars | 2,570 | 2,057 | -513 | 3,271 | 2,806 | -465 |
| Percent of GDP | 20.3 | 16.8 | -3.5 | 20.3 | 17.8 | -2.5 |
| Outlays | | | | | | |
| In billions of dollars | 2,137 | 2,425 | 288 | 2,475 | 2,996 | 521 |
| Percent of GDP | 16.9 | 19.8 | 2.9 | 15.4 | 19.0 | 3.6 |
| Surplus (+) / Deficit (-) | | | | | | |
| In billions of dollars | 433 | -368 | -801 | 796 | -189 | -985 |
| Percent of GDP | 3.4 | -3.0 | -6.4 | 4.9 | -1.2 | -6.1 |
| Debt held by the public | | | | | | |
| In billions of dollars | 1,714 | 4,665 | 2,951 | 878 | 5,919 | 5,041 |
| Percent of GDP | 13.5 | 38.1 | 24.6 | 5.5 | 37.6 | 32.1 |
| Gross domestic product (GDP) | 12,656 | 12,233 | -423 | 16,109 | 15,757 | -352 |
| Selected Program Outlays | | | | | | |
| Defense discretionary | | | | | | |
| In billions of dollars | 344 | 464 | 120 | 388 | 468 | 80 |
| Percent of GDP | 2.7 | 3.8 | 1.1 | 2.4 | 3.0 | 0.6 |
| Non-defense discretionary | | | | | | |
| In billions of dollars | 407 | 466 | 59 | 456 | 511 | 55 |
| Percent of GDP | 3.2 | 3.8 | 0.6 | 2.8 | 3.2 | 0.4 |
| Social Security | | | | | | |
| In billions of dollars | 523 | 517 | -6 | 679 | 659 | -20 |
| Percent of GDP | 4.1 | 4.2 | 0.1 | 4.2 | 4.2 | 0.0 |
| Medicare | | | | | | |
| In billions of dollars | 317 | 325 | 8 | 456 | 520 | 64 |
| Percent of GDP | 2.5 | 2.7 | 0.2 | 2.8 | 3.3 | 0.5 |
| Medicaid | | | | | | |
| In billions of dollars | 180 | 186 | 6 | 271 | 262 | -9 |
| Percent of GDP | 1.4 | 1.5 | 0.1 | 1.7 | 1.7 | 0.0 |
| Net Interest | | | | | | |
| In billions of dollars | 116 | 178 | 62 | -51 | 303 | 354 |
| Percent of GDP | 0.9 | 1.5 | 0.5 | -0.3 | 1.9 | 2.2 |

SOURCE: Concord Coalition based upon CBO's *The Budget and Economic Outlook: Fiscal Years 2002-2011*, January 2001, and *The Budget and Economic Outlook: Fiscal Years 2006-2015*, January 2005.

V. Important Questions for the 109th Congress and 43rd President

The President and congressional leaders have pledged to cut the deficit in half by 2009. If they were willing to adopt as specific policy the assumptions that CBO must use to develop its baseline, (i.e., no more war spending, no further AMT relief, no tax cut extensions and appropriations growing no faster than inflation) *and* if CBO's economic and technical assumptions prove accurate, they could fulfill their promise. In 2004, the deficit was \$412 billion (3.6 percent of GDP). In 2009, CBO's baseline projects a deficit of \$207 billion (1.4 percent of GDP). Unfortunately none of those "ifs" are likely to hold.

The question is whether political leaders will assert the discipline necessary to put the budget on a fiscally responsible path. Relative to four years ago, budget options today are narrower. Four years are gone, shortening the time available to design and implement solutions to longer-term problems.

The renewed focus on Social Security reform is a step in the right direction. However, it is not the only fiscal challenge that confronts our nation. As CBO's new projections emphasize, spending growth for Social Security will average 5.6 percent annually over the next 10 years while Medicare will average 9 percent annual growth and Medicaid will grow by almost 8 percent a year. Those projections underscore the importance of adopting a comprehensive approach to fiscal policy decisions. No federal program exists in a vacuum. Ultimately, it is the government's total spending commitment that must be paid for, either with taxes or debt. Given that Social Security is but one part of the larger budget problem, solutions designed to "save" Social Security that ignore the larger context may commit the country to a course that further limits flexibility and makes addressing other needs much more difficult.

Active campaigning is already underway to win public support for or against proposals to reform Social Security. So far, the claims and counterclaims provide little information about — and much distraction from — the basic issue. That is that overall fiscal policies are unsustainable. The status of the accounting device known as the Social Security trust fund is essentially irrelevant to the central question of how the federal government will operate in the coming decades. The creation of personal accounts and diverting funds to them instead of to the trust fund will not help and could even make budget problems worse.

Simply put, the budget's long-term future cannot be solved by wishful thinking. Federal spending is projected to rise faster than the revenues, leading to growing deficits and debt that threaten the economy's long-term growth potential and future standards of living. The CBO report states, "Together, the growing resource demands of Social Security, Medicare, and Medicaid will exert pressure on the budget *that economic growth alone is unlikely to alleviate.* (Emphasis added.) Consequently, policy makers face choices that involve reducing the growth of federal spending, increasing taxation, boosting federal borrowing, or some combination of those approaches."

As the comparison of budget outlooks from 2001 and 2005 shows, economic conditions and budget projections can change quickly. However, today's policy choices are constrained by a legacy of deficits and debt resulting from past decisions. Unless policy makers change direction they will add to that dubious legacy and pass it on to younger generations.

The President unveils his budget for FY 2006 on February 7th. The legislative timetable calls for a congressional budget resolution to be finished by April 15. Those documents will reveal answers to the question of whether elected officials are ready and willing to tackle the tough questions:

- What are our national priorities?
- How should responsibilities for those objectives be divided between the public and private sectors?
- Who should benefit; and
- Who should pay?

Stay tuned.