A COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET PROJECT

USBUDGETWATCH

The Cost of "Current Policy"
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There is no denying it: the U.S. government is on an unsustainable fiscal path. The Congressional Budget Office's (CBO) recently projected a deficit of $1.4 trillion in 2010 and $7.1 trillion over the next 10 years. As a result, public debt will increase from about 40 percent of GDP in 2008 to more than 60 percent in 2010, 80 percent by the 2030s, and 300 percent by 2080.

As troubling as these numbers are, they may prove to be optimistic. These projections are based on CBO's "current law" baseline, which assumes that the path certain policies take will deviate from recent trends—either because they are supposed to under current law or because baseline conventions assume them to. In particular, there are four major assumptions are unlikely to materialize:

- The 2001/2003 tax cuts will all expire at the end of 2010;
- Policymakers will discontinue the routine "patching" of the Alternative Minimum Tax (AMT);
- Medicare payments to physician, which have been exempted from slated cuts since 2003, will decline by 21 percent in 2010;
- Discretionary spending will grow only with inflation over the next decade, thus declining as a percent of GDP.

Many policymakers who support extending these particular policies have advanced the notion that we should just "assume" current policies without attempting to offset the additional costs they would require.[1] This is an expensive proposition given the high cost of these policies. Policymakers should therefore consider carefully which current policies are important enough to extend, and how best to offset their costs.

Fig. 1: Bridge to "Current Policy" Baseline (billions)

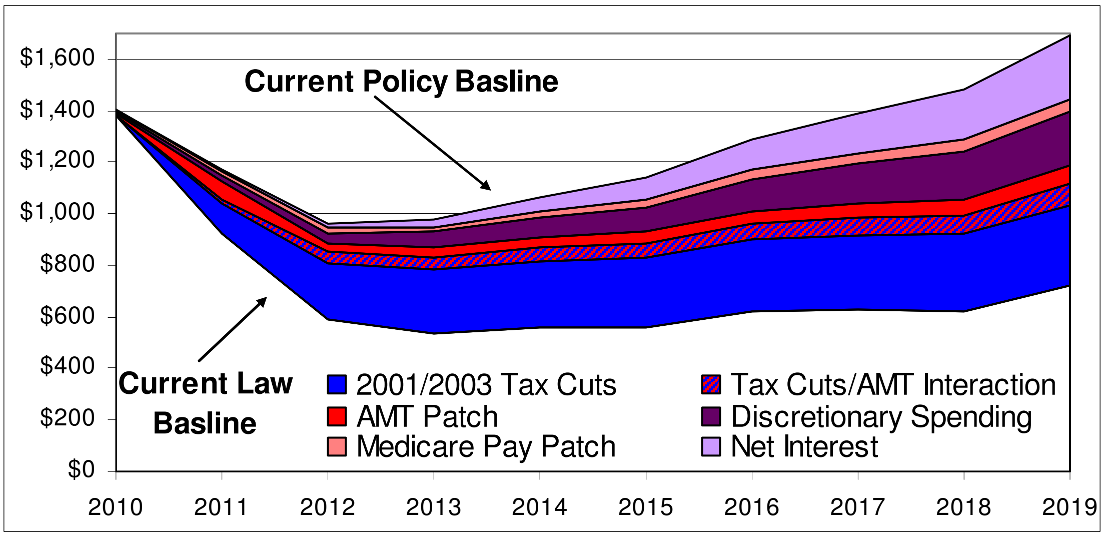
	2010-2014	2010-2019
Deficits under Current Law Baseline	**$3,988**	**$7,137**
2001/2003 Tax Cuts	+$849	+$2,296
AMT Patch	+$177	+$448
Medicare Pay Patch	+$87	+$285
Differences in Discretionary Spending	+$214	+$985
Interactions and Interest	+$263	+$1,425
Deficits under Current Policy Baseline	**$5,578**	**$12,576**

Source: Congressional Budget Office and US Budget Watch Calculations

The Cost of Maintaining Current Policies

US Budget Watch has constructed its own "current policy" baseline by assuming select policies do not conform to current law (see http://crfb.org/blogs/understanding-current-policy for details).[2] Over the next decade, keeping certain policies in place would result in roughly $3 trillion less in revenues than is scheduled under law and close to $2.5 trillion more in spending, including interest. Complying with current policies without offsetting the costs would result in drastically larger deficits between 2010 and 2019 and would cause the ten-year deficit total to grow from an already dangerously high $7.1 trillion to $12.6 trillion. Debt held by the public would rise to over 90 percent of GDP by 2019, as opposed to 68 percent without those changes.

Fig. 2: Medium-Term Deficit Projections under Current Law and Current Policy (billions)



Source: Congressional Budget Office and US Budget Watch calculations

Since the president's budget largely continues current policies, it too would result in significantly higher spending and lower revenues than under current law. Revenues would be somewhat higher than under a pure current policy baseline—as a result of the 2001/2003 tax cuts expiring for income above $250,000. And spending would be a little lower due to the assumption of a more rapid phase-down of the Iraq war and lower

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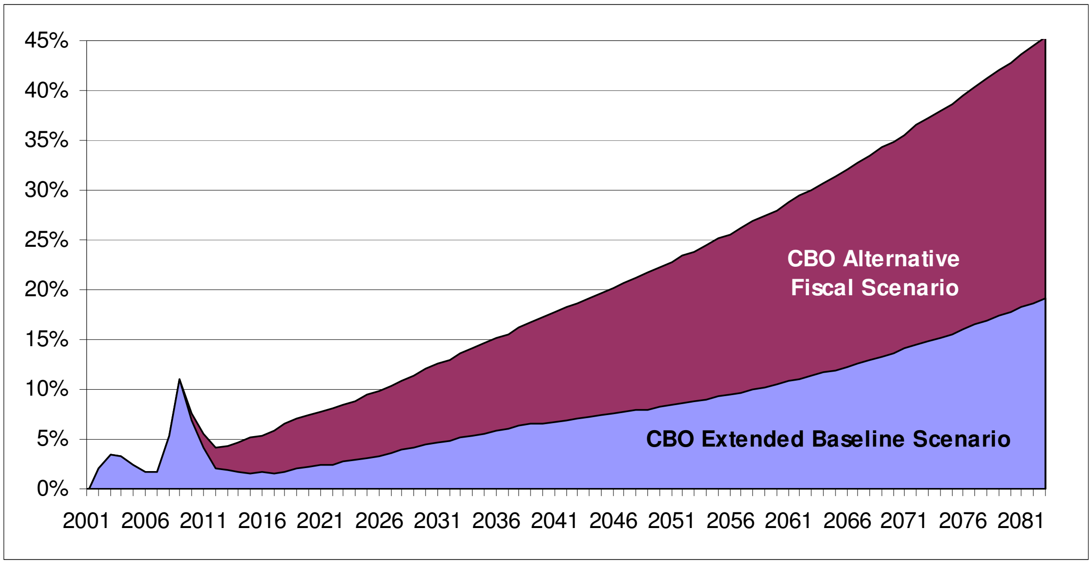
[1] The House of Representatives recently passed the *Statutory Pay*-As-*You-Go Act of 2009* which does just that.

[2] Note that a current policy baseline can be constructed a number of ways. The Office and Management and Budget, for example, estimates a ten year current policy deficit of $10.6 trillion mainly by assuming the 2001/2003 income tax cuts continue, the estate tax is frozen at 2009 levels, AMT patches are continued, Medicare physician payments are not cut, and Pell Grants will grow fast enough to support the eligibility standards set by the 2009 stimulus bill (http://www.whitehouse.gov/omb/assets/fy2010_msr/10msr.pdf). The Concord Coalition, meanwhile, projects a "plausible baseline" deficit of $14.4 trillion. Their baseline makes similar assumptions to ours, except that it does not assume physician payments are protected and it assumes a number of small and large temporary tax measures – especially from the 2009 stimulus bill – are renewed (http://www.concordcoalition.org/learn/budget/concord-coalition-plausible-baseline).

discretionary spending in the latter half of the decade. But the overall fiscal picture would be quite similar. Primarily due to the cost of renewing most of the 2001/2003 tax cuts, indexing the AMT, and allowing physician payments to grow, the president's own budget projects a 10-year deficit of more than $9.1 trillion. CBO would likely have estimated deficits closer to $10 trillion under the president's budget.

With public debt accumulating on a compounding basis, extending current policies would create an even more dire long-run picture. CBO's Alternative Fiscal Scenario, which generally assumes current policy (although it has not been updated to reflect CBO's latest economic and technical assumptions), projects deficits will rise to 10 percent of GDP by 2027 (rather than 3.6 percent under current law), exceed 20 percent by 2045 (as opposed to 7 percent), and reach 42 percent by 2080 (rather than 18 percent).

Fig. 3: Long-Term Deficit Projections under Current Law and Current Policy (percent of GDP)



Source: Congressional Budget Office

This situation is economically impossible; at some point, U.S. debt would reach a level so high that creditors would stop lending us money. The question, though, is how the situation will be resolved. Will politicians confront the policy choices or delay them to the point where they will be forced upon us due to a fiscal crisis? The longer we wait to take on these issues, the worse they will get and the more painful it will be to change course.

In the coming months and years, policymakers will be faced with a number of difficult choices. Decisions over whether and how much to diverge from current law will have serious fiscal and economic implications. Below, we explore the four major policies where current policy will diverge considerably from CBO's current law baseline.

Renewing the 2001/2003 Tax Cuts

Under current law, the 2001 Economic Growth and Tax Relief Reconciliation Act (EGTRRA) and the 2003 Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) are set to expire at the end of 2010. These tax policies lowered marginal individual income tax rates, decreased tax rates on dividends and capital gains, expanded the child tax credit, reduced marriage penalties, and phased out the estate tax, among other provisions. Renewing all provisions of EGTRRA and JGTRRA would cost nearly $2.9 trillion over the next 10 years.[3] However, allowing them to revert to their pre-2001 levels would mean a significant jump in tax levels after 2010 for many individuals—on average $1,600 per person.

Fig. 4: Tax Policy under Select Scenarios (billions)

	Current Policy	Current Law	Cost of Current Policy 2010-2014	Cost of Current Policy 2010-2019
Income Tax Rates	Rates of 10%, 15%, 25%, 28%, 33%, 35% and elimination of Pease / PEP phase-out rules#	Rates of 15%, 28%, 31%, 36%, 39.6% and reinstatement of Pease / PEP phase-out rules	$376	$963
Child Tax Credit	$1,000 per child, non-refundable (except temporarily under ARRA stimulus bill)	$500 per child, not refundable for most families	$116	$305
Marriage Penalties	Penalties mitigated through larger standard deduction and 15% bracket for couples	Partial restoration of marriage penalties, as existed in pre-2001 law	$46	$110
Estate Tax	$3.5 million exemption and top rate of 45% in 2009; no tax in 2010	$1 million exemption and top rate of 55%	$163+	$502+
Dividends Tax Rates	Rates of 0% and 15%	Rates of 15%, 28%, 31%, 36%, and 39.6%	$115	$348
Capital Gains Tax Rates	Rates of 0% and 15%	Rates of 10% and 20%		
		Interaction with AMT Patch and Other Provisions:	$209	$659
		Total Deficit Impact:	**$1,025**	**$2,882**

Pease rules limit the value of total itemized deductions which can be taken by certain wealthier taxpayers and PEP rules phase out the personal exemption for higher earners.
+Cost of allowing estate tax repeal to remain permanent.
Source: Congressional Budget Office, Joint Committee on Taxation, Tax Policy Center, and US Budget Watch Calculations

[3] This number includes both lost revenues and increased outlays mainly from the refundable portion of certain tax credits. It also measures costs relative to a current law baseline, which assumes the estate tax is eliminated completely (as it would be in 2010, before returning in 2011).

Policymakers will soon need to decide which tax cuts to renew and which to allow to sunset as planned. Under President Obama's plan, the tax cuts for couples making under $250,000 per year (and for individuals making under $200,000) would be preserved. Additionally, the estate tax would be frozen at 2009 levels, and a new 20 percent dividends and capital gains tax rate would be created for income above $250,000 a year ($200,000 for individuals). This set of policies would raise more than allowing all cuts to expire but, according to the Administration's own estimates, would still cost around $2.1 trillion over the next decade, relative to current law.

Patching the AMT

In addition to addressing the 2001/2003 tax cuts expiring under current law, policymakers will need to decide how to address the growth of the Alternative Minimum Tax. The AMT is a secondary tax system originally intended to capture higher-earning taxpayers whose tax liabilities were below a preset threshold. Although it was designed to affect only the wealthiest taxpayers, the AMT is scheduled to hit an increasingly large number of upper-middle- and middle-income earners because it was never indexed to inflation.

Fig. 5: Projected Percent of Taxpayers Subject to AMT in 2019 by Income

Income	Current Law	Current Policy *without* AMT Patches	Current Policy *with* AMT Patches
Under $50,000	4%	4%	0%
$50,000 to $100,000	36%	47%	1%
$100,000 to $200,000	66%	91%	4%
Over $200,000	72%	92%	55%
Total	**30%**	**39%**	**5%**

Source: Tax Policy Center and US Budget Watch Calculations

In past years, Congress has taken action annually to prevent the AMT from hitting the middle-class by passing temporary "patches," which adjust the tax for inflation. The latest patch, enacted as part of the recent stimulus bill, kept as many as 26 million taxpayers from paying the AMT. That number is expected to increase in future years.

Patching the AMT is expensive and projected to cost roughly $450 billion over the next 10 years.[4] Without offsets through spending cuts or tax increases, indexing or continually patching the AMT would considerably increase the national debt.

Fig. 6: The Projected Cost of Patching and Eliminating the AMT Over the Next Decade (billions)

	2010	2011	2012	2013	2014	2010-2014	2010-2019
Index AMT Patch for Inflation	$7	$69	$31	$34	$37	$177	$448
Eliminate AMT	$11	$108	$45	$49	$53	$266	$626

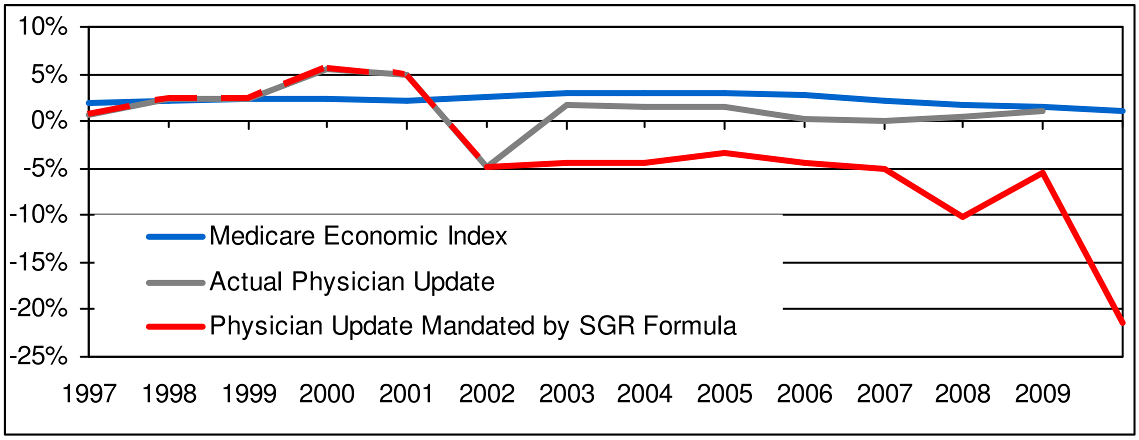
Source: Congressional Budget Office

[4] This does not account for some interaction with the income tax cuts, which are accounted for in the cost of renewing those cuts.

Updating Physician Payments

Current law also diverges from recent policy decisions regarding physician payments in the Medicare system. Since 1997, payment rates have been scheduled to update through the so-called "Sustainable Growth Rate" (SGR).

Fig. 7: Historical Growth Rate of Perspective and Actual Medicare Indices



Source: Congressional Budget Office, Health and Human Services

Because the SGR often grows significantly slower than health-care costs, this formula has called for reducing physician payment rates every year since 2002. With the exception of that year, however, politicians have not allowed for such a reduction to occur, and instead have instituted ad hoc payment freezes or increases. As a result, actual physician payments have grown much faster than planned under current law. These adjustments, though, have been made through temporary patches, which pull payments further away from the current law trend each year. As a result, the size of scheduled cuts tends to increase each year. Beginning in 2010, for example, a 21 percent cut is scheduled to go into effect (followed up by additional cuts in subsequent years).

Fig. 8: Select Options to Reform the Sustainable Growth Rate (billions)

SGR Reform Options	2010	2011	2012	2013	2014	2010-2014	2010-2019
Update Payments with Medicare Economic Index	$8	$14	$18	$25	$31	$96	$344
Freeze Payments at 2010 Levels	$7	$17	$22	$18	$23	$87	$285
Gradually Reduce Payments to Reach SGR Levels	$7	$11	$11	$12	$13	$53	$106
Reset SGR Targets at 2008 Spending Level	$8	$13	$15	$19	$20	$75	$202

Source: Congressional Budget Office

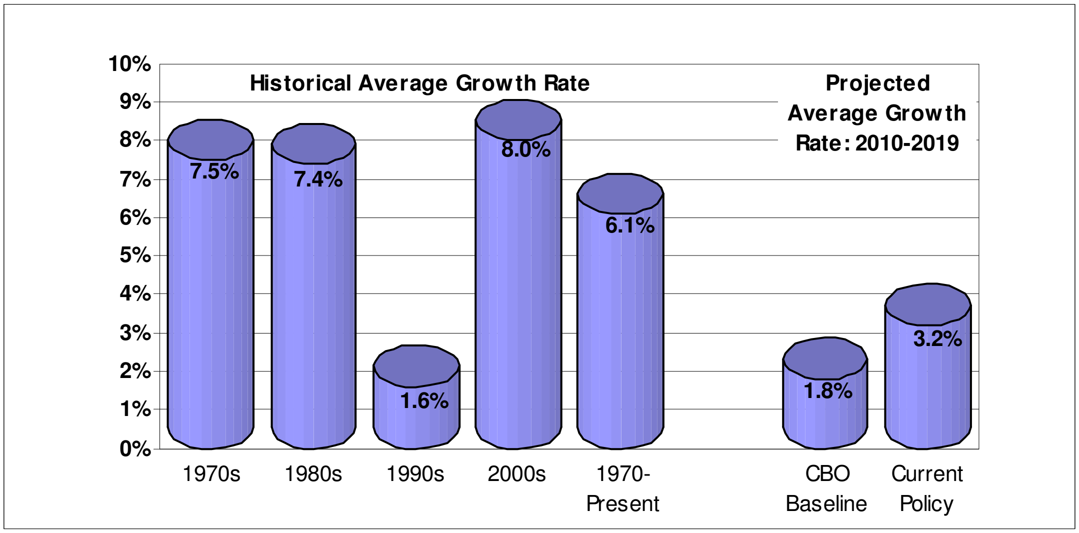
Although few policymakers are willing to allow these cuts to occur, they disagree over how to reform the payment system. Some argue that payments should be frozen at current levels, or that the SGR should remain in place but be "reset" to begin this year. Others have suggested that physician payments should be indexed to the Medicare Economic Index, or some other measure of inflation. And still others believe we should gradually move back toward payment levels intended under the current SGR rules.

Most of these options would cost billions or tens of billions of dollars a year, suggesting that significant savings elsewhere (or considerable deficits) will be necessary to prevent current-law payment cuts.

Discretionary Spending Growth

Though not technically "current law," the CBO baseline makes assumptions regarding the growth of discretionary spending that are probably unrealistically low. As a matter of convention, CBO assumes that discretionary spending (including supplemental spending for overseas operations) will grow roughly with inflation. In reality, the discretionary spending level is set annually by Congress, and absent any caps it can grow at any rate. Historically, the growth rate has been much higher than inflation—often closer to the pace of GDP growth.

Figure 9: Nominal Average Annual Growth of Discretionary Spending



Source: Congressional Budget Office and US Budget Watch Calculations

While the baseline assumes average annual growth of around 1.8 percent per year, actual discretionary spending has grown by an average of 6.1 percent since 1970. And while some of this disparity is due to differences in inflation, it does suggest that holding discretionary spending to baseline numbers could be difficult.

Figure 10: Discretionary Spending Projections (billions)

	2010	2011	2012	2013	2014	2010-2014	2010-2019
CBO Baseline	**$1,378**	**$1,370**	**$1,343**	**$1,347**	**$1,358**	**$6,796**	**13,929**
Increase Regular Spending with GDP	*+$8*	*+$33*	*+$74*	*+$120*	*+$159*	+$394	*+$1698*
Phase Down Iraq Spending	*-$1*	*-$7*	*-$29*	*-$59*	*-$83*	-$179	*-$713*
Current Policy Baseline	**$1,385**	**$1,396**	**$1,388**	**$1,408**	**$1,434**	**$7,011**	**$14,914**

Source: Congressional Budget Office and US Budget Watch Calculations

At the same time, the cost of continuing the current policy of annually increasing discretionary spending is quite high. If regular discretionary spending is allowed to grow with GDP as opposed to inflation, it would add $1.7 trillion to the deficit over the next ten years (excluding interest). Even after assuming a gradual phase-down in spending for the war in Iraq, discretionary spending would still be $1 trillion higher than in CBO's baseline.

In the past, politicians have been able to limit discretionary growth through enforceable spending caps. The Budget Enforcement Act of 1990, for example, put successful caps in place that were reaffirmed in 1993 and 1997. As a result, nominal discretionary spending growth was held to around 1.6 percent per year in the 1990s. Without similar caps, however, it seems unlikely discretionary spending will be held to the lower levels anticipated in the CBO baseline.

Conclusion

Ultimately, few observers believe this president or Congress will allow tax and spending policies to play out as intended under current law. The political costs of allowing all the 2001/2003 tax cuts to expire, discontinuing AMT patches, permitting a 21 percent cut in physician payments, and holding down discretionary spending would be quite high.

But the longer-term economic costs of continuing current policies, without considerable spending cuts and/or new sources of revenue, are far higher. The baseline, itself, is already unsustainable over the medium- and long-term. Allowing the debt to grow as it is projected to under current policy, though, would thrust the nation into dangerous and unprecedented territory.

The mounting debt under such a scenario would likely crowd out private investment to a significant degree, resulting in stunted economic growth. At the same time, it would ensure that government interest payments would consume a large and rising share of the budget, leaving little room for anything else. And, at some point, our rising debt would make continued borrowing prohibitive, as our lenders and investors cease their large-scale purchasing of U.S. Treasury bonds. If it came to this, the result would likely be a serious fiscal and economic crisis, followed by steep and perhaps crippling tax increases and spending cuts.

Policymakers must therefore consider carefully which provisions of current policy are most important to them, and which are simply unaffordable. And they should find ways to pay for the policies they do choose to continue. Otherwise, in only a few years, none of the policies will be affordable.