CBO TESTIMONY

Statement of
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The Budget and Economic Outlook: Fiscal Years 2008 to 2018

before the
Committee on the Budget
U.S. House of Representatives

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The Budget and Economic Outlook: Fiscal Years 2008 to 2018

Chairman Spratt, Ranking Member Ryan, and Members of the Committee, thank you for giving me the opportunity to present the Congressional Budget Office's (CBO's) outlook for the budget and the economy in fiscal years 2008 to 2018.[1]

CBO projects that after three years of declining budget deficits, a slowing economy this year will contribute to an increase in the deficit. Under an assumption that current laws and policies do not change, CBO projects that the budget deficit will rise to 1.5 percent of gross domestic product (GDP) in 2008 from 1.2 percent in 2007 (see Table 1). Enactment of legislation to provide economic stimulus or additional funding for military operations in Iraq and Afghanistan could further increase the deficit for this year.

The state of the economy is particularly uncertain at the moment. The pace of economic growth slowed in 2007, and there are strong indications that it will slacken further in 2008. In CBO's view, the ongoing problems in the housing and financial markets and the high price of oil will curb spending by households and businesses this year and trim the growth of GDP. Although recent data suggest that the probability of a recession in 2008 has increased, CBO does not expect the slowdown in economic growth to be large enough to register as a recession.[2] Economic performance worse than that suggested in CBO's forecast could significantly decrease projected revenues and increase projected spending. Furthermore, policy changes intended to mitigate the economic slowdown would, by design, tend to increase the budget deficit in the short term.[3]

CBO expects the economy to rebound after 2008, as the negative effects of the turmoil in the housing and financial markets fade. Under the assumptions that govern CBO's baseline, the budget deficit will amount to 1.5 percent of GDP or less each year from 2009 to 2011. Subsequently, the budget will show a small surplus of 0.5 percent of GDP in 2012 and remain near that level each year through 2018 (the end of the current 10-year projection period).

The relatively sanguine outlook suggested by the 10-year baseline projections should not be interpreted as implying that the nation's underlying fiscal condition is sound, both because the United States continues to face severe long-term budgetary challenges and because many observers expect policy changes that would deviate from the current-law baseline over the next decade. Ongoing increases in health care costs, along with the aging of the population, are expected to put substantial pressure on the budget in coming decades; those trends are already evident in the current projection period. Economic growth alone will be insufficient to alleviate that pressure, as Medicare and Medicaid and, to a lesser extent, Social Security require ever greater resources under current law. A substantial reduction in the growth of spending, a significant increase in tax revenues relative to the size of the economy, or some combination of the two will be necessary to maintain the nation's long-term fiscal stability.[4]

1. For further details, see Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2008 to 2018* (January 2008).

2. The National Bureau of Economic Research, which by convention is responsible for dating the peaks and troughs of the business cycle, defines a recession as "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 wholesale-retail sales."

3. See Congressional Budget Office, *Options for Responding to Short-Term Economic Weakness* (January 2008).

4. For a detailed discussion of the long-term pressures facing the federal budget, see Congressional Budget Office, *The Long-Term Budget Outlook* (December 2007).

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	2,654	2,817	2,907	3,182	3,442	3,585	3,763	3,941	4,131	4,334	4,548	15,933	36,649
Total Outlays	2,731	2,873	3,015	3,148	3,299	3,355	3,524	3,666	3,824	4,037	4,183	4,325	16,341	36,376
Total Deficit (-) or Surplus	**-163**	**-219**	**-198**	**-241**	**-117**	**87**	**61**	**96**	**117**	**95**	**151**	**223**	**-408**	**274**
On-budget	-344	-414	-396	-450	-343	-151	-184	-154	-136	-160	-102	-27	-1,525	-2,104
Off-budget[a]	181	195	198	210	226	238	244	251	254	254	253	249	1,117	2,378
Debt Held by the Public at the End of the Year	5,035	5,232	5,443	5,698	5,827	5,751	5,701	5,613	5,503	5,414	5,269	5,050	n.a.	n.a.
							As a Percentage of Gross Domestic Product							
Total Revenues	18.8	18.7	19.0	18.6	19.3	19.9	19.9	20.0	20.0	20.1	20.2	20.3	19.4	19.8
Total Outlays	20.0	20.2	20.4	20.2	20.1	19.4	19.5	19.4	19.4	19.7	19.5	19.3	19.9	19.7
Total Deficit (-) or Surplus	**-1.2**	**-1.5**	**-1.3**	**-1.5**	**-0.7**	**0.5**	**0.3**	**0.5**	**0.6**	**0.5**	**0.7**	**1.0**	**-0.5**	**0.1**
Debt Held by the Public at the End of the Year	36.8	36.8	36.7	36.5	35.4	33.3	31.6	29.8	28.0	26.4	24.6	22.6	n.a.	n.a.
Memorandum:														
Gross Domestic Product (Billions of dollars)	13,670	14,201	14,812	15,600	16,445	17,256	18,043	18,856	19,685	20,540	21,426	22,355	82,156	185,018

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.

CBO's baseline budget projections for the next 10 years are not a forecast of future outcomes; rather, they are based on the assumption that current laws and policies remain the same. The projections stem from long-standing procedures that were, until recently, specified in law, and they serve as a benchmark that lawmakers and others can use to assess the potential impact of future policy decisions.[5] Following those procedures generates deficits and surpluses in the baseline that are predicated on two key projections:

- That revenues will rise from 18.7 percent of GDP this year to almost 20 percent of GDP in 2012 and then remain near that historically high level through 2018. Much of the projected increase in revenues results from the growing impact of the alternative minimum tax (AMT) and, even more significantly, the expiration at the end of 2010 of various 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).

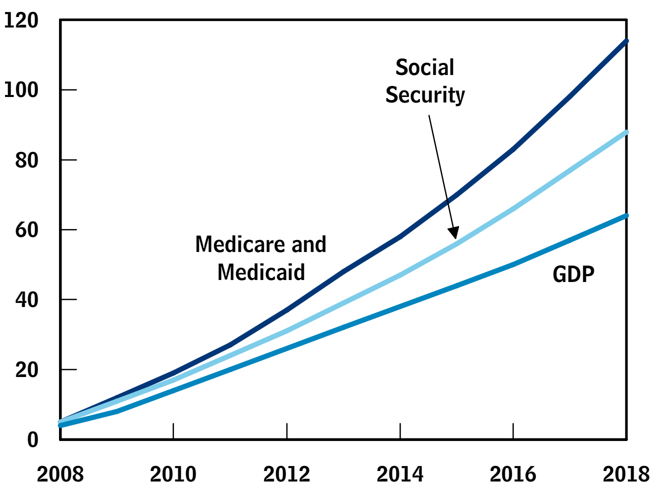
- That outlays for discretionary programs (those whose spending levels are set anew each year through appropriation acts) will decline from 7.6 percent of GDP last year to 6.1 percent by 2018—a lower percentage than any recorded in the past 40 years. Such a projection derives mainly from the assumption in the baseline that discretionary funding will grow at the rate of inflation, which is lower than the growth rate that CBO projects for nominal GDP. Implicit in the projection for discretionary spending is an assumption that no additional funding is provided for military

5. The Balanced Budget and Emergency Deficit Control Act of 1985, which established rules that have governed the calculation of CBO's baseline, expired on September 30, 2006. Nevertheless, CBO continues to prepare baselines according to the methodology prescribed in that law.

Figure 1.

Projected Growth of the U.S. Economy and Federal Spending for Major Mandatory Programs

(Cumulative nominal percentage growth from 2007 level)



Source: Congressional Budget Office.

operations in Iraq and Afghanistan in 2008 and that future appropriations for activities related to the war on terrorism remain equivalent, in real (inflation-adjusted) terms, to the $88 billion appropriated so far this year.

Policy choices that differ from the assumptions in the baseline would produce different budgetary outcomes. For example, if lawmakers continued to provide relief from the AMT (as they have done on a short-term basis for the past several years) and if the provisions of EGTRRA and JGTRRA that are scheduled to expire were instead extended, total revenues would be $3.6 trillion lower over the next 10 years than CBO now projects. Similarly, if discretionary spending (other than that for military operations in Iraq and Afghanistan and other spending labeled as emergency) grew at the rate of nominal GDP over the next 10 years, total discretionary outlays during that period would be about $1.4 trillion higher than in the baseline. Combined, those policy changes—and associated debt-service costs—would produce a deficit of $402 billion (2.3 percent of GDP) in 2012 and a cumulative deficit of $5.7 trillion (3.1 percent of GDP) over the 2009–2018 period.

The Budget Outlook

CBO estimates that if today's laws and policies did not change, federal spending would total $2.9 trillion in 2008 and revenues would total $2.7 trillion, resulting in a budget deficit of $219 billion. That deficit could increase significantly if legislation is enacted to provide economic stimulus—as is currently under consideration. Furthermore, additional funding that is likely to be needed to finance military operations in Iraq and Afghanistan could add $30 billion to outlays this year.

Baseline Projections for the 2009–2018 Period

According to CBO's projections, under current laws and policies the deficit will drop slightly in 2009, to $198 billion. That decrease results primarily from two factors. On the revenue side of the budget, receipts from the AMT are estimated to increase by about $75 billion next year, largely because of the scheduled expiration of the relief provided through tax year 2007. On the spending side of the budget, outlays for military operations in Iraq and Afghanistan are about $10 billion lower in 2009 than in 2008 under the assumptions of the baseline.

The deficit is projected to rise modestly in 2010, as outlays grow by about 4.4 percent and revenues increase by about 3.2 percent. That projected growth rate for revenues is lower than in recent years, mainly because of a projected slowdown in corporate tax receipts (to a level that is more consistent with their historical relationship to GDP).

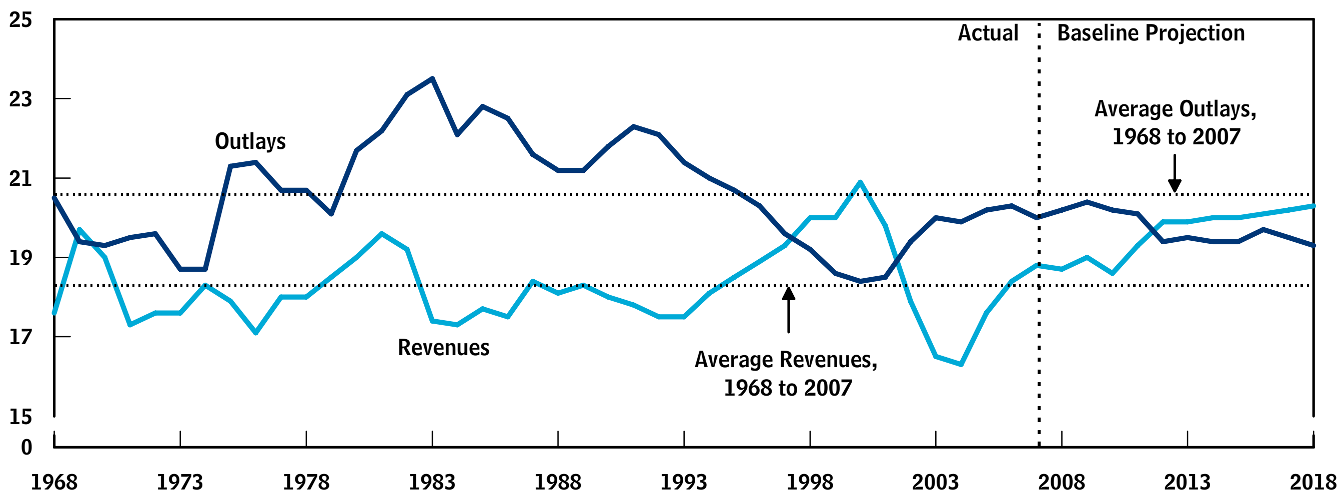
After 2010, spending related to the aging of the baby-boom generation will begin to raise the growth rate of total outlays. The baby boomers will start becoming eligible for Social Security retirement benefits in 2008, when the first members of that generation turn 62. As a result, the annual growth of Social Security spending is expected to accelerate from about 5.1 percent in 2008 to 6.4 percent by 2018.

More important, because the cost of health care is likely to continue rising rapidly, spending for Medicare and Medicaid is anticipated to grow even faster—generally in the range of 7 percent to 8 percent annually. Total outlays for those two health care programs are projected to more than double during the baseline period, increasing by 114 percent, while GDP is projected to grow somewhat more than half as fast, by 64 percent (see Figure 1). Under the assumptions underlying CBO's baseline, spending for Medicare and Medicaid will rise to

Figure 2.

Total Revenues and Outlays as a Percentage of Gross Domestic Product

(Percent)



Source: Congressional Budget Office.

5.9 percent of GDP in 2018, compared with about 4.6 percent this year, and spending for Social Security will rise to 4.9 percent of GDP from 4.3 percent this year.

Revenues are projected to increase sharply after 2010 under the assumption that various tax provisions expire as scheduled. In the baseline, total revenues grow by 9.4 percent in 2011 and by 8.2 percent in 2012, thereby bringing the budget into surplus. Beyond 2012, revenues are projected to grow at roughly the same pace as outlays (between 4 percent and 5 percent a year), keeping the budget in the black through 2018.

Outlays over the 2009–2018 period are projected to range between 19.3 percent and 20.4 percent of GDP under the assumptions of the baseline—somewhat lower than the 20.6 percent average of the past 40 years (see Figure 2). Mandatory spending (funding determined by laws other than annual appropriation acts) is projected to grow by nearly 6 percent a year over that period, which is faster than the economy as a whole. By contrast, discretionary appropriations are assumed simply to keep pace with inflation and, to a lesser extent, with the growth of wages. Thus, discretionary outlays are projected to increase by about 2.2 percent a year, on average, or less than half as fast as nominal GDP.

In CBO's projections, revenues average 18.8 percent of GDP in 2009 and 2010 (close to the 18.7 percent level expected for this year) before the sharp jump in 2011 and 2012 with the expiration of tax provisions originally enacted in EGTRRA and JGTRRA. After that, revenues continue growing faster than the overall economy for three reasons: increases in total real income combined with the progressive structure of the tax code, the increasing reach of the AMT, and taxable withdrawals of retirement savings as the population ages. Under the assumptions used for the baseline, CBO projects that revenues will equal 20.3 percent of GDP by 2018—a level reached only once since World War II.

Federal government debt that is held by the public (mainly in the form of Treasury securities sold directly in the capital markets) is expected to equal about 37 percent of GDP at the end of this year. Thereafter, the baseline's projections of short-term deficits followed by emerging surpluses diminish the government's need for additional borrowing, causing debt held by the public to shrink to 22.6 percent of GDP by 2018.

Changes in the Baseline Budget Outlook Since August

The budget outlook for 2008 has deteriorated somewhat since CBO issued its previous projections in August, but the pattern of deficits and surpluses in the outlook for the

Table 2.

CBO's Economic Projections for Calendar Years 2008 to 2018

(Percentage change)

	Estimated	Forecast		Projected Annual Average	
	2007	2008	2009	2010-2013	2014-2018
Nominal GDP					
Billions of dollars	13,828	14,330	14,997	18,243 [a]	22,593 [b]
Percentage change	4.8	3.6	4.7	5.0	4.4
Real GDP	2.2	1.7	2.8	3.1	2.5
GDP Price Index	2.5	1.9	1.8	1.9	1.9
PCE Price Index[c]	2.5	2.6	1.8	1.9	1.9
Core PCE Price Index[d]	2.1	1.9	1.9	1.9	1.9
Consumer Price Index[e]	2.8	2.9	2.3	2.2	2.2
Core Consumer Price Index[f]	2.3	2.2	2.2	2.2	2.2
Unemployment Rate (Percent)	4.6	5.1	5.4	4.9	4.8
Interest Rates (Percent)					
Three-month Treasury bills	4.4	3.2	4.2	4.6	4.7
Ten-year Treasury notes	4.6	4.2	4.9	5.2	5.2

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; PCE = personal consumption expenditure.

Percentage changes are measured from one year to the next.

a. Level in 2013.

b. Level in 2018.

c. The personal consumption expenditure chained price index.

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.

following 10 years is about the same.[6] At $219 billion, the deficit projected for 2008 is $64 billion higher than what CBO estimated in August. Because the August projections already reflected some expected slowing of the economy in 2008, most of that difference stems from legislation that extended relief to individuals from the AMT for one year.

For the 2009–2017 period, the baseline's bottom line has improved slightly, compared with CBO's projections in August. In the current baseline, projected revenues are lower, mostly as a result of lower estimates of corporate profits. Projected outlays are also lower, primarily because of the use of partial-year funding for military operations in Iraq and Afghanistan; this baseline extrapolates the $88 billion appropriated thus far for 2008, whereas the August baseline extended the entire funding provided for 2007 (about $170 billion). With the effect of partial-year funding excluded, the current baseline would show an increase in the cumulative deficit for 2008 through 2017 of more than $850 billion (0.5 percent of GDP).

The Economic Outlook

Underlying CBO's baseline projections is a forecast that U.S. economic growth will slow in calendar year 2008 but pick up in 2009. Specifically, CBO anticipates that GDP will grow by 1.7 percent in real terms for 2008 as a whole, about half a percentage point less than the

6. Those projections were published in Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2007).

but pick up in 2009. Specifically, CBO anticipates that GDP will grow by 1.7 percent in real terms for 2008 as a whole, about half a percentage point less than the growth recorded last year. For 2009, CBO forecasts that GDP growth will rebound to 2.8 percent (see Table 2).

Problems in the housing and financial markets, along with high oil prices, triggered much of the recent slowdown. Between mid-2006 and the end of 2007, residential investment (which includes the construction of new housing units, improvements to existing units, and brokers' commissions) declined, but the drop was largely offset by growth in both consumer spending and business fixed investment (businesses' spending on structures, equipment, and software). Those two sectors are unlikely to provide as much support to economic growth this year. Residential investment is expected to continue to decline through much of 2008; in addition, the growth of consumer spending, sustained thus far by solid growth in people's real income as well as by their borrowing and use of savings, is likely to fall off, curtailed by a drop in housing wealth (home equity), increased costs for borrowing, the high price of oil, and slower growth of real income. The resulting weak domestic demand for goods and services in turn is expected to slow the growth of business fixed investment, which is likely to further diminish the pace of overall economic growth this year.

In contrast, the relative economic strength of the United States' major trading partners—in particular, developing countries with emerging market economies—when combined with the dollar's decline will partially offset the sluggishness in domestic demand expected in 2008 and support U.S. economic growth by stimulating exports. Emerging economies have become increasingly less dependent on demand in the United States to fuel their expansions and, as a result, have become less vulnerable to slowdowns in U.S. economic growth. Moreover, the pace of the decline begun in 2002 in the value of the dollar relative to the currencies of major trading partners—which helps make U.S. exports less expensive—has quickened. Those developments, accompanied by less domestic demand for imports, are likely to reduce the U.S. current-account deficit (broadly, the summary measure of the United States' trade with the rest of the world).

Inflation (as measured by the year-to-year change in the price index for personal consumption expenditures) is likely to be about the same this year as last year; in 2009, CBO forecasts, the rate will fall, to 1.8 percent, as inflation in energy and food prices eases. The unemployment rate, which was 4.6 percent last year, will average 5.1 percent in 2008 and reach 5.3 percent by the end of the year, CBO estimates. Interest rates on Treasury securities are expected to remain low this year and to increase in 2009 as the economy works through and emerges from its current difficulties. In CBO's forecast, the rate on 3-month Treasury bills averages 3.2 percent in 2008 and moves higher, to 4.2 percent, in 2009. Similarly, the rate on 10-year Treasury notes moves from an average of 4.2 percent in 2008 to 4.9 percent in 2009.

For 2010 to 2018, CBO projects that real growth will average 2.7 percent and the personal consumption expenditure price index, 1.9 percent. CBO also projects that in the latter years of the projection period, the unemployment rate will average 4.8 percent and that the interest rates on 3-month Treasury bills and 10-year Treasury notes will average 4.7 percent and 5.2 percent, respectively.