



Testimony

The 2012 Long-Term Budget Outlook

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Chairman Ryan, Congressman Van Hollen, and Members of the Committee, thank you for inviting me to testify on the Congressional Budget Office's (CBO's) most recent analysis of the long-term outlook for the budget and the economy. My statement summarizes the report *The 2012 Long-Term Budget Outlook*, which CBO released yesterday.

In the past few years, the federal government has been recording the largest budget deficits since 1945, both in dollar terms and as a share of the economy. Consequently, the amount of federal debt held by the public has surged. At the end of 2008, that debt equaled 40 percent of the nation's annual economic output (gross domestic product, or GDP)—a little above the 40-year average of 38 percent. Since then, the figure has shot upward: By the end of this year, CBO projects, federal debt will exceed 70 percent of GDP—the highest percentage since shortly after World War II. The sharp rise in debt stems partly from lower tax revenues and higher federal spending caused by the severe economic downturn and from policies enacted during the past few years. However, the growing debt also reflects an imbalance between spending and revenues that predated the recession.

Whether that debt will continue to grow in coming decades will be affected not only by long-term demographic and economic trends but also by policymakers' decisions about taxes and spending. The aging of the baby-boom generation portends a significant and sustained increase in the share of the population receiving benefits from Social Security and Medicare, as well as long-term care services financed by Medicaid. Moreover, per capita spending for health care is likely to continue rising faster than spending per person on other goods and services for many years (although the magnitude of that gap is uncertain). Without significant changes in government policy, those factors will boost federal outlays relative to GDP well above their average of the past several decades—a conclusion that holds under any plausible assumptions about future trends in demographics, economic conditions, and health care costs.

According to CBO's projections, if current laws remained in place, spending on the major federal health care programs alone would grow from more than 5 percent of

GDP today to almost 10 percent in 2037 and would continue to increase thereafter.¹ Spending on Social Security is projected to rise much less sharply, from 5 percent of GDP today to more than 6 percent in 2030 and subsequent decades. Altogether, the aging of the population and the rising cost of health care would cause spending on the major health care programs and Social Security to grow from more than 10 percent of GDP today to almost 16 percent of GDP 25 years from now. That combined increase of more than 5 percentage points for such spending as a share of the economy is equivalent to about \$850 billion today. (By comparison, spending on *all* of the federal government's programs and activities, excluding net outlays for interest, has averaged about 18.5 percent of GDP over the past 40 years.) If lawmakers continued certain policies that have been in place for a number of years or modified some provisions of current law that might be difficult to sustain for a long period, the increase in spending on health care programs and Social Security would be even larger. Absent substantial increases in federal revenues, such growth in outlays would result in greater debt burdens than the United States has ever experienced.

Long-Term Scenarios

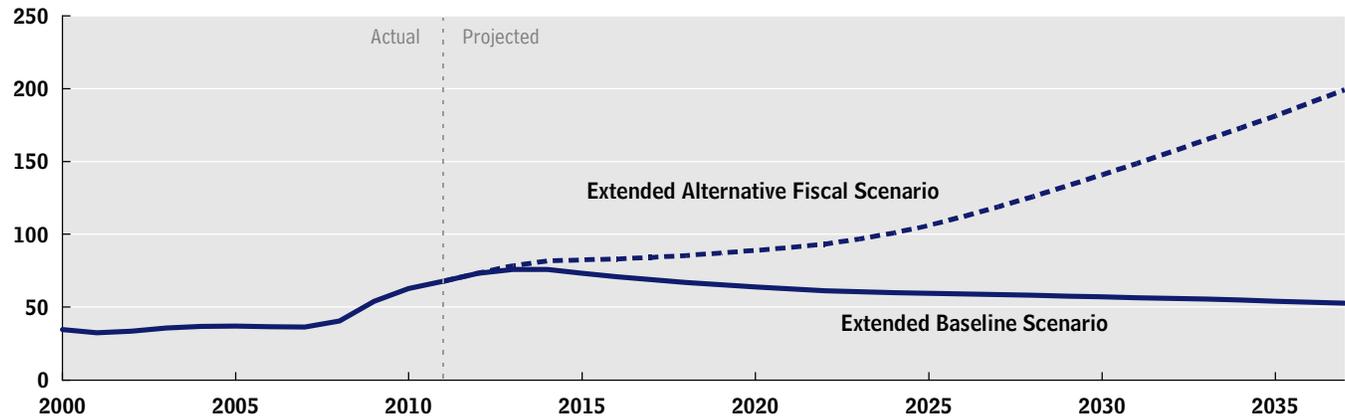
In this report, CBO presents the long-term budget outlook under two scenarios that embody different assumptions about future policies governing federal revenues and spending:

- The *extended baseline scenario*, which reflects the assumption that current laws generally remain unchanged; that assumption implies that lawmakers will allow changes that are scheduled under current law to occur, forgoing adjustments routinely made in the past that have boosted deficits.

1. The major health care programs consist of Medicare, Medicaid, the Children's Health Insurance Program, and health insurance subsidies that will be provided through the exchanges created by the Affordable Care Act, which comprises the Patient Protection and Affordable Care Act (Public Law 111-148) and the health care provisions of the Health Care and Education Reconciliation Act of 2010 (P.L. 111-152).

Figure 1.**Federal Debt Held by the Public Under CBO's Long-Term Budget Scenarios**

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Notes: The extended baseline scenario generally adheres closely to current law, following CBO's 10-year baseline budget projections through 2022 and then extending the baseline concept for the rest of the long-term projection period. The extended alternative fiscal scenario incorporates the assumptions that certain policies that have been in place for a number of years will be continued and that some provisions of law that might be difficult to sustain for a long period will be modified.

Debt does not reflect economic effects of the policies underlying the two scenarios.

- The *extended alternative fiscal scenario*, which incorporates the assumptions that certain policies that have been in place for a number of years will be continued and that some provisions of law that might be difficult to sustain for a long period will be modified, thus maintaining what some analysts might consider “current policies,” as opposed to current laws.²

Those scenarios span a wide range of possible policy choices, and neither represents a prediction by CBO of what policies will be in effect during the next several decades. Because budget projections of this type are inherently uncertain and become more so as they extend farther into the future, the report focuses on the next 25 years rather than a longer horizon.³

The Extended Baseline Scenario

Under the extended baseline scenario, debt would decline slowly from its high current levels relative to GDP.

2. The two scenarios are extensions of CBO's 10-year projections, as reported in Congressional Budget Office, *Updated Budget Projections: Fiscal Years 2012 to 2022* (March 2012).
3. Because considerable interest exists in the longer-term outlook, figures showing projections through 2087 and associated data are available on CBO's Web site (www.cbo.gov).

Federal debt held by the public would drift downward from an estimated 73 percent of GDP this year to 61 percent by 2022 and 53 percent by 2037 (see Figure 1). That outcome would be the result of two key sets of policy assumptions:

- Under current law, revenues would rise steadily relative to GDP because of the scheduled expiration of cuts in individual income taxes enacted since 2001 and most recently extended in 2010; the growing reach of the alternative minimum tax (AMT); the tax provisions of the Affordable Care Act; the way in which the tax system interacts with economic growth; demographic trends; and other factors. Revenues would reach 24 percent of GDP by 2037—much higher than has typically been seen in recent decades—and would grow to larger percentages thereafter.
- At the same time, under this scenario, government spending on everything other than the major health care programs, Social Security, and interest—activities such as national defense and a wide variety of domestic programs—would decline to the lowest percentage of GDP since before World War II.

That significant increase in revenues and decrease in the relative magnitude of other spending would more than offset the rise in spending on health care programs and Social Security.

The Extended Alternative Fiscal Scenario

The budget outlook is much bleaker under the extended alternative fiscal scenario because of the changes in law that are assumed to take place. The changes under this scenario would result in much lower revenues and higher outlays than would occur under the extended baseline scenario. In particular:

- Almost all expiring tax provisions are assumed to be extended through 2022. Specifically, for this scenario, CBO assumed that the cuts in individual income taxes enacted since 2001 and most recently extended in 2010, which are now scheduled to expire at the end of calendar year 2012, would be extended; relief from the AMT for many taxpayers, which expired at the end of 2011, would be extended; the 2012 parameters of the estate tax (adjusted for inflation) would continue to apply, preventing increases in rates and in the share of assets that is taxable; and all other expiring tax provisions (with the exception of the current reduction in the payroll tax rate for Social Security) would be extended.
- After 2022, revenues under this scenario are assumed to remain at their 2022 level of 18.5 percent of GDP, just above the average of the past 40 years.
- This scenario also incorporates assumptions that through 2022, lawmakers will act to prevent Medicare's payment rates for physicians from declining; that after 2022, lawmakers will not allow various restraints on the growth of Medicare costs and health insurance subsidies to exert their full effect; that the automatic reductions in spending required by the Budget Control Act will not occur (although the original caps on discretionary appropriations in that law are assumed to remain in place); and that, as a percentage of GDP, federal spending for activities other than Social Security, the major health care programs, and interest payments will return to its average level during the past two decades (rather than fall significantly below that level, as it does under the extended baseline scenario).

Under those policies, federal debt would grow rapidly from its already high level, exceeding 90 percent of GDP in 2022. After that, the growing imbalance between revenues and spending, combined with spiraling interest payments, would swiftly push debt to higher and higher levels. Debt as a share of GDP would exceed its historical peak of 109 percent by 2026, and it would approach 200 percent in 2037.

Many budget analysts believe that the extended alternative fiscal scenario is more representative of the fiscal policies that are now (or have recently been) in effect than is the extended baseline scenario. The explosive path of federal debt under the alternative scenario underscores the need for large and timely policy changes to put the federal government on a sustainable fiscal course.

The Impact of Growing Deficits and Debt

In fact, the projections discussed above understate the severity of the long-term budget problem under the extended alternative fiscal scenario because they do not incorporate the negative effects that additional federal debt would have on the economy. In particular, large budget deficits and growing debt would reduce national saving, leading to higher interest rates, more borrowing from abroad, and less domestic investment—which in turn would lower the growth of incomes in the United States. Taking those effects into account, CBO estimates that gross national product (GNP) would be lower under the extended alternative fiscal scenario than it would be if debt remained at the 61 percent of GDP it would reach in 2022 under the extended baseline scenario.⁴ The reduction in GNP would lie in a broad range around 4 percent in 2027 and in a broad range around 13 percent in 2037. (Under the extended baseline scenario, GNP would be nearly identical to what it would be if the nation's debt burden remained constant.)

Rising levels of debt would have other negative consequences beyond those estimated effects on output:

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4. GNP differs from GDP primarily by including the capital income that residents earn from investments abroad and excluding the capital income that nonresidents earn from domestic investment. In the context of analyzing the impact of growing deficits and debt, GNP is a better measure because projected budget deficits would be partly financed by inflows of capital from other countries.

- Greater debt would result in higher interest payments on that debt, which would eventually require higher taxes, a reduction in government benefits and services, or some combination of the two.
- Rising debt would increasingly restrict policymakers' ability to use tax and spending policies to respond to unexpected challenges, such as economic downturns or financial crises. As a result, the effects of such developments on the economy and people's well-being could be worse.
- Growing debt also would increase the probability of a sudden fiscal crisis, during which investors would lose confidence in the government's ability to manage its budget and the government would thereby lose its ability to borrow at affordable rates. Such a crisis would confront policymakers with extremely difficult choices. To restore investors' confidence, policymakers would probably need to enact spending cuts or tax increases more drastic and painful than those that would have been necessary had the adjustments come sooner.

The aging of the U.S. population and the rising costs for health care mean that the combination of budget policies that worked in the past cannot be maintained in the future. To keep deficits and debt from climbing to unsustainable levels, as they will if the set of current policies is continued, policymakers will need to increase revenues substantially above historical levels as a percentage of GDP, decrease spending significantly from projected lev-

els, or adopt some combination of those two approaches. In fact, the current laws that underlie CBO's baseline projections provide for significant changes of those kinds in coming years. As projected under the extended baseline scenario, revenues would reach the historically high level of 24 percent of GDP in 2037, and spending for programs other than the major health care programs and Social Security would reach the lowest level relative to GDP since before World War II. Of course, many other approaches to constraining future deficits are possible as well.

Policymakers face difficult trade-offs in deciding how quickly to implement policies to reduce budget deficits. On the one hand, cutting spending or increasing taxes slowly would lead to a greater accumulation of government debt and might raise doubts about whether longer-term deficit reduction would ultimately take effect. On the other hand, abruptly implementing spending cuts or tax increases would give families, businesses, and state and local governments little time to plan and adjust, and would require more sacrifices sooner from current older workers and retirees for the benefit of younger workers and future generations. In addition, immediate spending cuts or tax increases would represent an added drag on the weak economic expansion.⁵

5. For discussion of the trade-offs policymakers face in deciding how quickly to implement policies to reduce budget deficits, see Congressional Budget Office, *Economic Effects of Reducing the Fiscal Restraint That Is Scheduled to Occur in 2013* (May 2012).