CBO TESTIMONY

Statement of
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The Budget and Economic Outlook: Fiscal Years 2004-2013

before the
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Mr. Chairman, Senator Conrad, and Members of the Committee, I am pleased to be here today to discuss the Congressional Budget Office's (CBO's) baseline budget projections for 2003 through 2013. As it does each January, CBO has issued its outlook for the budget and the economy. The baseline budget projections that CBO provides incorporate the assumption that current laws and policies remain unchanged—thereby serving as a point of departure for measuring policy changes. The baseline also includes a variety of estimates and assumptions about how the economy will behave and government programs will operate. Such projections are always uncertain, but this year, the uncertainty is unusually pronounced.

Uncertainty in the Outlook

Before I discuss those projections, though, I would like to describe some of the uncertainty surrounding the baseline estimates. That uncertainty can be broken down into three main types: geopolitical, economic, and legislative. Unfortunately, many of the possible outcomes encompassed by that uncertainty are more likely to worsen than to improve the budget outlook.

Geopolitical Uncertainty

By far the biggest uncertainty is the potential instability in the international arena. A war with Iraq, for example, would require increased defense spending for supplies and other near-term needs as well as for the future replenishment of resources used in combat. Substantial resources might also be needed for reconstruction, occupation, and assistance to allies. In addition, such a war could have implications for oil prices (positive ones if the war went quickly and smoothly; negative ones if it took longer than expected and production was disrupted), which would ripple through the economy.

The ongoing threat of terrorism could also have budgetary implications. Shortly after the terrorist attacks of September 11, 2001, the Congress and the President enacted $40 billion in supplemental appropriations; another $25 billion was approved last summer. Concerns about homeland security and the implementation of measures to prevent future attacks will maintain the pressure to increase federal spending. And any additional terrorist attacks could threaten the economy's recovery.

Economic Uncertainty

Although uncertainty about the economy and about the effects of future legislation pales in comparison with the uncertainty surrounding geopolitical outcomes, both are clearly important and potentially very significant for the budget.

The economy continues to rebound from the recession of 2001. The future course of the recovery depends in large part on whether consumers will continue to provide the foundation for the economy's growth. Despite the three-year decline in the stock market, the household sector has been a source of strength throughout the recession and into the recovery. The growth of consumer spending is uncertain in the near term, however, because demand is weak in many other sectors of the economy. Spending by the business sector remains weak, as low corporate profits and excess capacity from overinvestment during the "bubble" years of the late 1990s have inhibited investment. Moreover, uncertainty about the strength of demand, and about the risks arising from terrorism and war, have led businesses to be particularly cautious in hiring. In addition, deteriorating state and local government finances have curtailed spending and may prompt some tax increases.

Nevertheless, some indications point to a brighter outlook for the economy as the year goes forward. Investors and consumers appear to have gained confidence in recent months, and the stock market has moved tentatively upward since its low in October. Spending by businesses on equipment and software, particularly on information technology, strengthened last year, and inventories may be reaching the point at which firms need to restock their shelves. Finally, the drop in the exchange value of the U.S. dollar sets the stage for stronger growth of exports.

Over the longer haul, the question of labor productivity looms large. From 1951 through 1973, the growth of gross domestic product (GDP) per worker—after adjusting for the business cycle—averaged about 2.2 percent a year. However, from 1974 through 1995, the growth of productivity slowed substantially, to a rate that was little more than half as fast. More recently, though, productivity growth picked up again, to about the same rate experienced during the high-growth period. That recent upturn has prompted CBO to remain upbeat about future productivity growth.

Legislative Uncertainty

CBO's baseline projections are intended to serve as a neutral benchmark against which to measure the effects of possible changes in tax and spending policies—they are not a forecast or prediction of future budgetary outcomes. Our projections are constructed according to both rules set forth in law and long-standing analytical practices and are designed to project federal revenues and spending under the assumption that current laws and policies remain unchanged. Thus, legislation enacted in the future by the Congress and the President will almost assuredly alter the bottom line.

Pressures to increase spending and reduce taxes could lead to a substantially worsened budgetary picture. For example, final appropriations for fiscal year 2003 could exceed the $751 billion that apparently has been agreed upon by the Republican leadership and the President, especially if supplemental appropriations were enacted later in the year. Other legislative action could also dim the outlook. Measures intended to stimulate the economy, fund military action and subsequent redevelopment in Iraq, extend expiring tax cuts, modify the alternative minimum tax, establish a prescription drug benefit for the elderly, or meet other pressing national needs could substantially increase projected deficits or reduce projected surpluses in the future.

The Budget Outlook

If current policies remained in place, the federal budget deficit would grow from $158 billion in 2002 to $199 billion in 2003, by CBO's projections (*see Table 1*). In nominal dollars, such a deficit would be the largest since 1994; however, at 1.9 percent of GDP, it would be well below the share of the economy that deficits accounted for in the 1980s through the mid-1990s.

Revenues in CBO's outlook are anticipated to resume their upward path in 2003 after falling in both 2001 and 2002. (The decrease in revenues from 2001 to 2002—nearly 7 percent—was the largest annual drop, in percentage terms, since 1946.) Total revenues are projected to grow to $1.9 trillion this year—about $68 billion (or 3.7 percent) above the amount recorded in 2002 but well below the $2.0 trillion that the government collected in the peak year of 2000. Much of that projected growth can be

Table 1.

The Budget Outlook Under CBO's Adjusted Baseline

(In billions of dollars)

	Actual 2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Total, 2004-2008	Total, 2004-2013
On-Budget	-317	-361	-319	-268	-228	-205	-185	-165	-145	-26	134	177	-1,206	-1,231
Off-Budget[a]	160	162	174	195	212	231	250	268	286	303	317	330	1,063	2,568
Total Surplus or Deficit (-)	**-158**	**-199**	**-145**	**-73**	**-16**	**26**	**65**	**103**	**140**	**277**	**451**	**508**	**-143**	**1,336**
Total Surplus or Deficit (-) as a Percentage of GDP	-1.5	-1.9	-1.3	-0.6	-0.1	0.2	0.5	0.7	0.9	1.7	2.7	2.8	-0.2[b]	0.9[b]
Debt Held by the Public at the End of the Year	3,540	3,766	3,927	4,013	4,045	4,034	3,983	3,894	3,766	3,501	3,062	2,565	n.a.	n.a.
Debt Held by the Public at the End of the Year as a Percentage of GDP	34.3	35.0	34.7	33.6	32.2	30.4	28.5	26.5	24.3	21.5	18.0	14.4	n.a.	n.a.

Source: Congressional Budget Office.

Notes: These projections incorporate the assumption that discretionary budget authority totals $751 billion for 2003 and grows with inflation thereafter.

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. As a percentage of cumulative GDP over the period.

traced to the improved economic prospects that CBO forecasts for 2003. At 17.9 percent of GDP, estimated revenues for this year are roughly at the average for the 1962-2002 period (*see Figure 1*).

Outlays are expected to grow to over $2.1 trillion this year—a rise of $110 billion (or 5.5 percent) from 2002 (*see Table 2*). Although net interest costs are falling (because of low interest rates), spending for all of the government's other programs and activities is projected to grow by 6.7 percent. That rate of increase is well below the 11 percent growth of noninterest spending in 2002—but still greater than the 3 percent average growth during most of the 1990s.

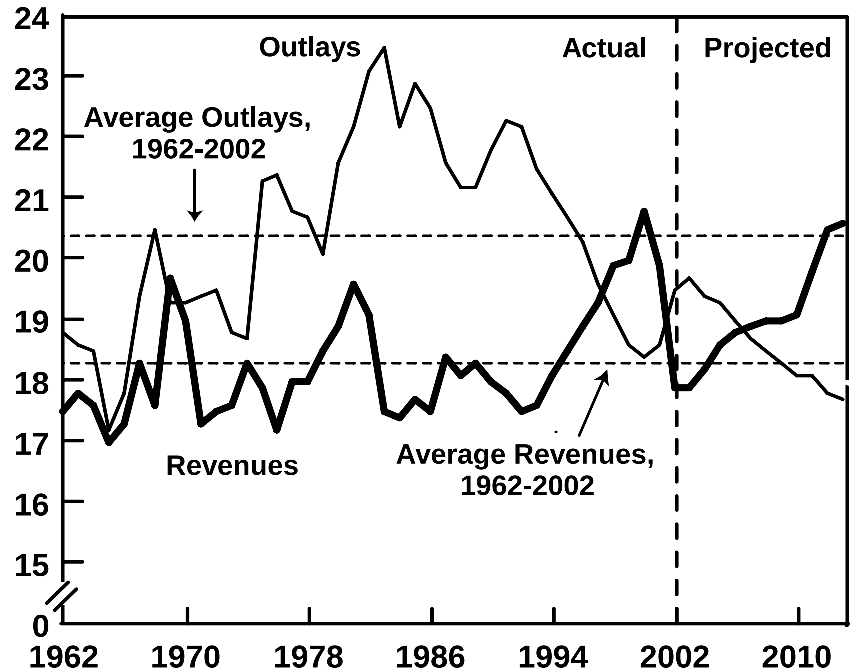
Fueling the rise in spending are boosts in discretionary outlays and continued growth of entitlements. Both defense discretionary spending (up by $28 billion from 2002) and nondefense discretionary spending (up by $30 billion) are expected to rise by nearly 8 percent this year. Those estimates are based on the assumption that discretionary budget authority for 2003 will total $751 billion. Both kinds of discretionary spending grew even faster in 2002 than the growth projected for 2003: defense outlays rose by 14 percent, and nondefense outlays, by 12.3 percent.

Spending for mandatory programs—which now consumes over half of all federal outlays—is estimated to increase in 2003 by $66 billion over its level in 2002. Social Security, Medicare, and Medicaid account for much of that jump. Total mandatory spending is projected to rise more slowly in 2003, at a rate of 6.0 percent, than it did in 2002—when it climbed by 9.6 percent. In particular, the rate of growth of Medicaid outlays is expected to drop from 13.2 percent in 2002 to 6.4 percent in 2003—

Figure 1.

Total Revenues and Outlays as a Share of GDP, 1962-2013

(Percentage of GDP)



Sources: Congressional Budget Office (projections); Office of Management and Budget (historical budget data).

Note: CBO's projections incorporate the assumption that discretionary budget authority totals $751 billion for 2003 and grows with inflation thereafter.

as a result of slower growth in enrollment, smaller increases in payment rates, and restrictions on certain types of spending.

Declining interest payments will offset some of the increases in discretionary and mandatory outlays. Despite a rise in debt held by the public, low interest rates in 2003 are projected to reduce net interest payments by $14 billion (or 8.1 percent).

CBO projects that the deficit will fall to $145 billion (1.3 percent of GDP) in 2004. Revenues are anticipated to climb to 18.2 percent of GDP as economic recovery progresses. Outlays as a share of the economy, however, are projected to fall from 19.7 percent of GDP in 2003 to 19.4 percent in 2004.

Over the full 10-year budget period (2004 through 2013), revenues under baseline assumptions are estimated to grow faster than outlays. CBO projects that revenues will grow at an average annual rate of 6.3 percent through 2010—increasing from 17.9 percent of GDP in 2003 to 19.1 percent in 2010. That increase occurs principally because of the tendency of the progressive U.S. tax system, as real income grows, to increase the proportion of income that it collects in taxes. After 2010, that tendency is exacerbated by the scheduled expiration of the tax cuts enacted in 2001.

Table 2.

Average Annual Rate of Growth in Outlays Under CBO's Adjusted Baseline

(In percent)

	Actual 2001-2002	Estimated 2002-2003	Projected[a] 2003-2013
Discretionary Spending	13.1	7.8	2.6
Defense	14.0	7.9	2.7
Nondefense	12.3	7.7	2.4
Mandatory Spending	9.6	6.0	5.4
Social Security	5.4	4.8	5.5
Medicare[b]	6.4	5.7	6.6
Medicaid	13.2	6.4	8.5
Other[b]	18.5	7.9	2.1
Net Interest	-17.1	-8.1	0.1
Total Outlays	7.9	5.5	4.1
Total Outlays Excluding Net Interest	11.0	6.7	4.4
Memorandum:			
Consumer Price Index	1.5	2.3	2.4
Nominal GDP	3.0	4.1	5.2
Discretionary Budget Authority	10.7	2.2	2.8
Defense	8.8	5.8	2.7
Nondefense	12.6	-1.3	2.8

Source: Congressional Budget Office.

Note: The projections incorporate the assumption that discretionary budget authority totals $751 billion for 2003 and grows with inflation thereafter.

a. As specified by the Deficit Control Act, CBO's baseline uses the employment cost index for wages and salaries to inflate discretionary spending related to federal personnel and the GDP deflator to adjust other spending.

b. Includes offsetting receipts.

In contrast to the rise in revenues relative to GDP, the growth of total outlays under baseline assumptions would remain below the pace of growth of the economy. Mandatory spending—led by Medicare and Medicaid—is expected to grow slightly faster than the economy (at an average annual rate of 5.4 percent, compared with projected growth in nominal GDP of 5.2 percent). But discretionary spending in CBO's projections is assumed to rise only by the rate of inflation (an assumption specified in the Balanced Budget and Emergency Deficit Control Act of 1985), or about half as fast as nominal GDP. And interest payments—with debt held by the public growing slowly in the near term and shrinking in later years—are estimated to decline from 1.5 percent of GDP in 2003 to 0.9 percent in 2013.

For the five years from 2004 through 2008, CBO projects that if current policies remained unchanged (and the economy followed the path of CBO's projections), deficits would diminish and surpluses would reappear, leaving the budget roughly balanced. Over the 2004-2008 period, the cumulative deficit would total $143 billion—or 0.2 percent of GDP, by CBO's estimates.

Table 3.

CBO's Economic Forecast for Calendar Years 2003 and 2004

	Estimated 2002	Forecast 2003	Forecast 2004
Nominal GDP (Percentage change)	3.6	4.2	5.4
Real GDP (Percentage change)	2.4	2.5	3.6
Consumer Price Index (Percentage change)[a]	1.6	2.3	2.2
Unemployment Rate (Percent)	5.8	5.9	5.7
Three-Month Treasury Bill Rate (Percent)	1.6	1.4	3.5
Ten-Year Treasury Note Rate (Percent)	4.6	4.4	5.2

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

a. The consumer price index for all urban consumers.

For the 10-year period from 2004 through 2013, the cumulative surplus is projected to total $1.3 trillion. But the last three years of the period are almost entirely responsible for that total. Projected surpluses from 2011 through 2013—the years after the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) is scheduled to expire—account for nearly 93 percent of the 10-year sum. (CBO estimates that if EGTRRA is not extended, revenues will climb to more than 20.5 percent of GDP—a level previously seen only during World War II and in 2000.) Through 2010, the baseline budget is projected to be close to balance, with annual deficits and surpluses generally running at 1 percent or less of GDP.

The Economic Outlook

CBO expects that the slow economic recovery will continue, with real (inflation-adjusted) GDP growing by 2.5 percent in calendar year 2003 and 3.6 percent in 2004 (*see Table 3*). That growth is comparable to the pace following the 1990-1991 recession. The unemployment rate is expected to stabilize in 2003 at 5.9 percent and then edge down to 5.7 percent in 2004. As the recovery achieves a firmer footing, CBO assumes that the Federal Reserve will gradually shift monetary policy from its current accommodative stance toward a more neutral one; consequently, both short- and long-term interest rates are expected to rise in late 2003 and during 2004. In CBO's current forecast, the consumer price index (CPI) remains below 2.5 percent for the next two years.

For the period from 2005 through 2013, CBO estimates that real GDP will grow at an average annual rate of 3.0 percent. CBO's projections for unemployment, interest rates, and inflation during that period are quite similar to the ones it published last August. Thus, CBO projects that the unemployment rate will decline to 5.2 percent (which equals its estimate of the nonaccelerating inflation rate of unemployment); the interest rate on three-month Treasury bills will reach 4.9 percent; the 10-year note rate will average 5.8 percent; and CPI inflation will average 2.5 percent annually.

Uncertainty of Budget Projections

As discussed earlier, significant uncertainty surrounds CBO's baseline projections, partly by design—CBO's baseline does not take into account potential legislative changes—and partly because of the impossibility of accurately forecasting future geopolitical outcomes.

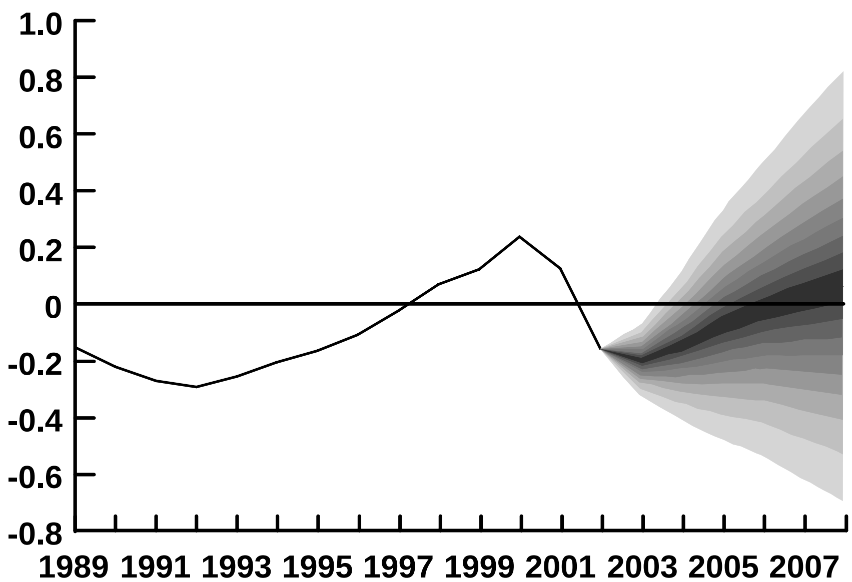
In addition, much uncertainty stems from the fact that the U.S. economy and the federal budget are highly complex and are affected by many economic and technical factors that are difficult to foresee. That uncertainty can best be illustrated by a fan of probabilities surrounding the year-by-year point estimates presented in this testimony (*see Figure 2*). Not surprisingly, the range of possible outcomes widens as the projection period extends. The fan chart makes clear that outcomes quite different from those in our baseline have a significant likelihood of occurring.

We can also use the fan chart methodology to examine whether CBO's projections have been consistently biased in one direction or the other (*see Figure 3*). As the figure shows, CBO's misestimates

Figure 2.

Uncertainty of CBO's Projections of the Total Budget Surplus Under Current Policies

(In trillions of dollars)



Source: Congressional Budget Office.

Note: Calculated on the basis of CBO's track record, this figure shows the estimated likelihood of alternative projections of the surplus under current policies. CBO's projections fall in the middle of the darkest area. Under the assumption that tax and spending policies do not change, the probability is 10 percent that actual surpluses or deficits will fall in the darkest area and 90 percent that they will fall within the whole shaded area.

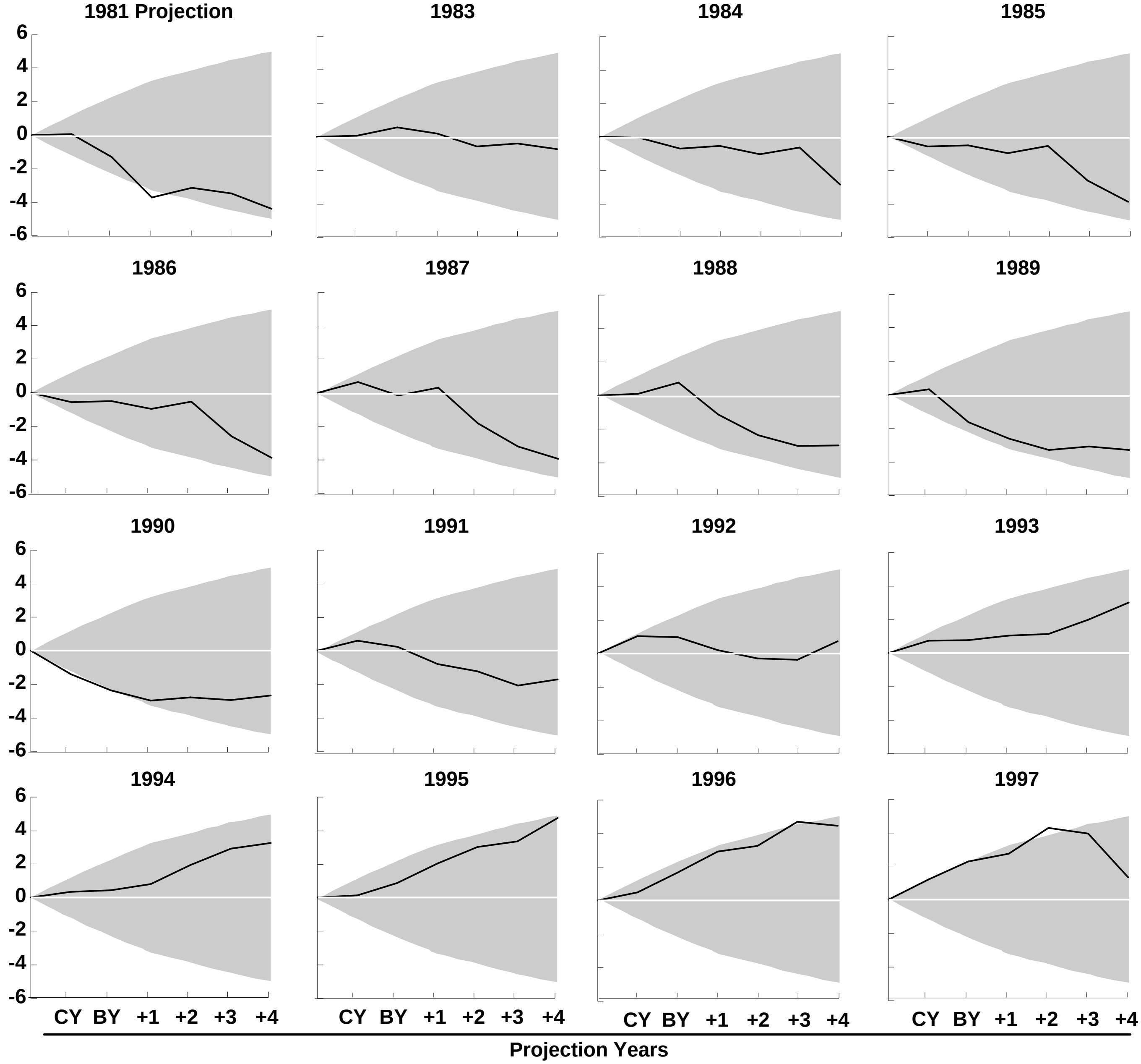
Actual surpluses or deficits will of course be affected by legislation enacted during the next 10 years, including decisions about discretionary spending. The effects of future legislation are not included in this figure.

For an explanation of how CBO calculates the probability distribution, see *Uncertainties in Projecting Budget Surpluses: A Discussion of Data and Methods* (February 2002), available at www.cbo.gov; an update of that publication will appear shortly.

Figure 3.

Misestimates in CBO's Projections Made from 1981 to 1997

(Percentage of GDP)



Source: Congressional Budget Office.

Notes: CY = current year; BY = budget year.

This figure shows misestimates in CBO's projections of the primary surplus—the total surplus excluding net interest—made at different times. Plotted points that lie below the center line reflect instances in which CBO overestimated the primary surplus, while points above the center line reflect underestimates. In each panel, the shaded cone indicates the estimated 90 percent confidence band; that is, there was a 90 percent chance that CBO's projection would be within the shaded area. CBO estimated that confidence band on the basis of its track record since 1981 (excluding 1982, because of insufficient data).

The figure excludes the effects of legislation enacted after the projections were made.

of the budget's bottom line do not appear to be systematically biased: sometimes the projections were too high and at other times too low. For example, the five-year budget calculations made between 1993 and 1997 tended to be too pessimistic, while most of those made earlier tended to be optimistic. Not enough time has elapsed since our more recent projections for us to be able to comment on their accuracy.

Accuracy of CBO's Estimating Methodology

Over time, CBO has constantly changed (and, one hopes, improved) its estimating methodology to achieve greater accuracy in its projections. In looking at recent criticisms of our methods, we undertook some calculations to shed light on the issue of whether our baseline economic projections sufficiently accounted for the supply-side effects of changes in tax law. Thus, the small fan charts also show that increasing the assumed response of labor supply and investment to changes in taxes (and their "feedback effects" on the budget) would generally not have improved budget estimates made during periods in which the tax system was undergoing significant change. For example, adding revenues to the baseline projections of the primary surplus (the surplus excluding interest costs) for the mid-1980s to reflect larger supply-side effects in those baselines from the Economic Recovery Tax Act of 1981 would generally have increased rather than reduced the forecasts' inaccuracies. Similarly, assuming larger supply-side effects from the Omnibus Budget and Reconciliation Act of 1993 than those incorporated into subsequent baselines would have reduced the level of estimated revenues and magnified the inaccuracies in projecting the budget balance in subsequent years. We continue to pursue improved accuracy and will seek additional input from outside experts on a variety of methodological issues.

Context for the Future

Given the uncertainty surrounding CBO's outlook and the current pressures on the budget, I thought it might be useful to say something about how our projections might be used in considering fiscal policy.

First, several factors argue for focusing on the longer term. Just past the 10-year baseline period loom significant long-term strains on the budget that intensify as the baby-boom generation ages. The number of people of retirement age will surge by about 80 percent over the next 30 years—increasing costs for federal benefit programs—while the number of workers whose taxes help pay for those benefits is expected to grow by only 15 percent. In addition to the demographic situation, the costs per enrollee in federal health care programs are likely to grow much faster than inflation. As a result, the amount that the government spends on its major health and retirement programs (Medicare, Medicaid, and Social Security) is projected to consume a substantial portion of what the government now spends on the entire budget. Although the current baseline shows a brighter situation a few years out, that picture is bound to change, and the policy choices made now serve the nation's fiscal health best if they avoid making the long-term situation worse.

Today, with security and economic concerns paramount, that long-term perspective may seem elusive. The current debate seems to focus on the desirable levels of taxes and spending and, correspondingly, the appropriate size of government. However, the way in which those questions are resolved will inevitably influence the long-term budget situation. The illustration of historical revenues and outlays and CBO's baseline projections for the next 10 years can help depict two contrasting viewpoints about how those questions should be answered (*see Figure 1 on page 4*).

Many policymakers advocate a more limited sized government. Proponents of that view seek lower taxes and lower levels of spending. CBO's estimates indicate that total revenues are now close to their historical level (around 18 percent of GDP). However, revenues as a share of GDP are projected to creep up to more than 19 percent in 2010 under current policies. If the tax cuts enacted in 2001 expire in 2010 as scheduled, total revenues in 2013 are projected to reach 20.6 percent of GDP—over 2 percentage points above the average from 1962 through 2002.

Other policymakers see a more expansive role for government. They believe that the country has significant unmet needs whose costs cannot be offset elsewhere with spending cuts and that therefore require higher levels of taxation. CBO's baseline does not include funding for such unmet needs; if it did, spending as a percentage of GDP would move toward higher levels than those depicted in the figure—levels closer to the historical average. Boosting spending further to pay for education, homeland security, a prescription drug program for the elderly, or other needs (not to mention a possible war with Iraq) may well require a level of revenues above the historical average. Without a hike in revenues, and without the ability to offset such spending in other parts of the budget, large deficits would return.

So, the outstanding question for the Congress as it creates budgets for 2004 and future years is not how the aforementioned figure looks today but how it should look in the future. While some people may feel that there is an obvious, clear path to a higher standard of living for all Americans, the public policy choices that must be made along the way are not as clear. But whatever decisions are made, it is critical to avoid a prolonged and unsustainable mismatch between taxes and spending. Cut taxes—but limit spending as well. Alternatively, boost spending—but increase revenues to the levels necessary to support that spending. In that context, CBO's baseline projections can be used to gauge the degree of latitude that the Congress has to adjust priorities while preserving a budget that balances long-term economic growth and fiscal responsibility with current needs.