CBO TESTIMONY

Statement of
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The Budget and Economic Outlook: An Update

before the
Committee on the Budget
United States Senate

September 3, 2003

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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) update of its baseline budget projections for 2003 through 2013. CBO projects that the federal government will incur deficits of $401 billion in 2003 and $480 billion in 2004 under the assumption (mandated by statute) that current laws and policies remain the same (*see Table 1 on page 5*). Those deficits reflect the recent economic slowdown as well as legislation enacted over the past few years that has reduced revenues and rapidly increased spending for defense and many other programs. Although such deficits for this year and next year would be smaller than those of the mid-1980s relative to the size of the economy, they would reach record levels in nominal dollar terms.

The economy now seems poised for a more sustained recovery. CBO anticipates that gross domestic product (GDP) will rise by nearly 4 percent in calendar year 2004 after growing by less than 2 percent in the first half of this year. Signs of faster growth in consumer and business spending, rapid growth in federal purchases, tax cuts for businesses, and a slightly more accommodative monetary policy have improved the economic outlook for the rest of 2003 and for 2004.

Partly because of that economic growth, CBO's baseline projections show deficits that diminish and then give way to surpluses near the end of the 2004-2013 period—under the assumption that no policy changes occur. In particular, the baseline assumes that the major tax provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) will expire as scheduled in 2010. It also assumes (as required by the Balanced Budget and Emergency Deficit Control Act of 1985) that budget authority for discretionary programs will grow at the rate of inflation—which is projected to average 2.7 percent over the next 10 years. Furthermore, the baseline does not include possible policy changes such as the introduction of a prescription drug benefit for Medicare beneficiaries. Various combinations of possible actions could easily lead to a prolonged period of budget deficits, although other scenarios could be more favorable. In addition, economic and other factors that deviate from CBO's assumptions could affect the budget considerably—in either a positive or a negative direction.

Regardless of the precise course of the economy and future policy actions, significant long-term strains on spending will begin to intensify within the next decade as the baby-boom generation begins reaching retirement age. Driving those pressures on the budget will be growth in the largest retirement and health programs—Social Security, Medicare, and Medicaid. Federal spending on those three programs will consume a growing proportion of budgetary resources, rising as a share of the economy from 8 percent in 2002 to a projected level of nearly 14 percent in 2030.

The Budget Outlook

CBO projects that if current laws and policies remain unchanged, the recent surge in federal budget deficits will peak in 2004. In the ensuing years, under CBO's baseline, deficits decline steadily and give way to surpluses near the end of the 10-year projection period. Deficits are projected to total $1.4 trillion between 2004 and 2008; the following five years show a small net surplus of less than $50 billion.

Revenues have slid from a peak of 20.8 percent of GDP in 2000 to 16.5 percent this year and are anticipated to drop again next year, to 16.2 percent. From that point on, the trend reverses, as projected economic growth pushes revenues in the baseline up from 17.4 percent of GDP in 2005 to 18.7 percent in 2010. Under current laws and policies, revenues are projected to climb more rapidly thereafter because of the expiration of EGTRRA, reaching 20.5 percent of GDP in 2013.

Whereas revenues are expected to diminish in 2003, CBO anticipates that total outlays will rise—from 19.5 percent of GDP in 2002 to 20.2 percent this year. Under the assumptions of CBO's baseline, outlays are projected to peak at 20.5 percent of GDP in 2004 and then to begin a gradual decline as a share of the economy. By 2013, outlays are projected to account for 19.3 percent of GDP. That decline is mostly attributable to the baseline's treatment of discretionary spending, which is assumed to grow at the rate of inflation over the projection period (or at about half the rate of growth projected for the economy).

Since CBO last issued baseline projections in March, the budget outlook has worsened substantially. Half a year ago, CBO estimated that the deficit for 2003 would total $246 billion, the deficit for 2004 would decline slightly to $200 billion, and the cumulative total for the 2004-2013 period would be a surplus of $891 billion. Now, CBO's estimate for this year's deficit has risen by $155 billion and for next year's by $280 billion. For the 10- year period from 2004 through 2013, projected deficits have increased and projected surpluses have decreased by a total of nearly $2.3 trillion (*see Table 2 on page 6*).

Compared with the projections in the March baseline, revenues have declined by $122 billion for 2003 and by $878 billion for the 2004-2013 period. Changes resulting from legislation, mostly the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), account for the majority of the decline through 2005. After that, technical estimating changes explain most of the drop in projected revenues relative to those in the March baseline.

Outlays are $33 billion higher for 2003 than previously projected and a total of $1.4 trillion higher over the 10- year period, largely because of legislation enacted since March. Extending supplemental appropriations enacted in April and August over the 2004-2013 period, as required for CBO's baseline projections, accounts for $873 billion of that total, and additional debt-service costs resulting from both tax and spending legislation account for most of the rest.

The Economic Outlook

CBO's forecast for the next year and a half anticipates that the growth in overall demand for goods, services, and structures will pick up. The growth of consumer spending will remain modest because consumers are likely to save much of the money that they receive from the accelerated tax cuts under JGTRRA to rebuild their wealth. Businesses are likely to begin to restock, rather than draw down, their inventories and to increase their investments in structures and equipment. As a result, real (inflation-adjusted) GDP is expected to grow by 3.8 percent in calendar year 2004, up from 2.2 percent in 2003 (*see Table 3 on page 7*). CBO's forecast assumes that the rapid rise in the federal government's spending will contribute to growth for the next few quarters, but thereafter, under the assumptions in CBO's baseline, such growth will slow.

CBO does not anticipate a quick reduction in the unemployment rate from its current level. Typically, the unemployment rate falls when the growth of real GDP exceeds the growth of potential GDP (the highest level of production that can persist for a substantial period without raising inflation). But even though the GDP growth that CBO is forecasting exceeds its estimate of potential GDP, CBO expects that the unemployment rate will average 6.2 percent for calendar years 2003 and 2004. In part, the sustained high rate of unemployment reflects caution on the part of employers, who—if they follow recent patterns—are not likely to resume hiring immediately as demand begins to grow. In part, it also reflects the likelihood that people who have been discouraged in their job searches by the economic weakness of the past few years are now likely to resume them—and be tallied among the unemployed.

The near-term outlook is subject to a number of risks. Foreign economic growth and foreign demand for U.S. goods may deviate from the assumptions in CBO's forecast. The residual effects of certain economic developments in recent years—the large reduction in households' equity wealth, the fall in the personal saving rate, businesses' productive capacity that remains underused, and the increased dependence on foreign financing—may also continue to dampen growth more than CBO assumes. However, favorable economic fundamentals—such as low inflation and rapid growth of productivity—may set the stage for another long period of robust growth.

Between 2005 and 2008, the growth of real GDP is projected to average 3.3 percent, and between 2009 and 2013, 2.7 percent. In CBO's projections, the growth of real GDP slows as the gap closes between GDP and its potential; once that gap has been eliminated, real GDP grows at the same rate as potential GDP.

CBO expects that inflation, as measured by the consumer price index for all urban consumers, will average 2.5 percent from 2005 through 2013, while the rate of unemployment will average 5.3 percent. The projection for the rate on three-month Treasury bills averages 4.6 percent during the 2005-2013 period and that for 10-year Treasury notes, 5.8 percent. All of those projections are virtually identical to the ones published by CBO last January.

Table 1.

Projected Deficits and Surpluses in CBO's 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 Deficit (-)	-317	-562	-644	-520	-425	-421	-434	-426	-417	-298	-143	-105	-2,444	-3,833
Off-Budget Surplus[a]	160	162	164	179	199	219	237	255	273	289	304	317	999	2,436
Total Deficit (-) or Surplus	**-158**	**-401**	**-480**	**-341**	**-225**	**-203**	**-197**	**-170**	**-145**	**-9**	**161**	**211**	**-1,445**	**-1,397**

Source: Congressional Budget Office.

a. Off-budget surpluses comprise surpluses in the Social Security trust funds as well as the net cash flow of the Postal Service.

Table 2.

Changes in CBO's Baseline Projections of the Deficit or Surplus Since March 2003

(In billions of dollars)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Total, 2004-2008	Total, 2004-2013
Total Deficit (-) or Surplus as Projected in March 2003	-246	-200	-123	-57	-9	27	61	96	231	405	459	-362	891
Changes													
Legislative													
Revenues	-53	-135	-77	-20	-13	-17	-11	-4	4	2	2	-263	-270
Outlays	46	92	101	105	117	129	140	150	162	172	184	544	1,352
Subtotal	-99	-227	-178	-126	-130	-146	-151	-155	-158	-169	-183	-808	-1,622
Economic													
Revenues	-16	-13	-12	-12	-15	-17	-19	-23	-20	-12	-8	-70	-151
Outlays	*	-12	-31	-34	-25	-16	-16	-17	-20	-24	-28	-118	-223
Subtotal	-16	-1	18	21	10	*	-3	-6	*	11	21	48	72
Technical													
Revenues	-53	-51	-51	-51	-55	-50	-45	-41	-39	-40	-34	-258	-457
Outlays	-13	1	6	12	19	27	33	39	44	47	51	66	280
Subtotal	-40	-51	-58	-64	-74	-77	-78	-80	-82	-87	-86	-324	-737
Total Impact on the Deficit or Surplus	**-155**	**-280**	**-218**	**-168**	**-194**	**-223**	**-232**	**-240**	**-240**	**-245**	**-248**	**-1,083**	**-2,287**
Total Deficit (-) or Surplus as Projected in August 2003	-401	-480	-341	-225	-203	-197	-170	-145	-9	161	211	-1,445	-1,397
Memorandum:													
Legislative Changes to Discretionary Outlays													
Defense	27	54	62	65	66	68	70	72	74	75	77	315	683
Nondefense	6	14	17	18	19	19	20	20	21	21	22	87	190
Total	33	68	79	83	85	87	90	92	95	96	99	402	873

Source: Congressional Budget Office.

Note: * = between -$500 million and $500 million.

Table 3.

CBO's Current and Previous Economic Projections for Calendar Years 2003 Through 2013

	Forecast		Projected Annual Average	
	2003	2004	2005-2008	2009-2013
Nominal GDP (Billions of dollars)				
August	10,836	11,406	14,098[a]	17,943[b]
January	10,880	11,465	14,154[a]	18,066[b]
Nominal GDP (Percentage change)				
August	3.7	5.3	5.4	4.9
January	4.2	5.4	5.4	5.0
Real GDP (Percentage change)				
August	2.2	3.8	3.3	2.7
January	2.5	3.6	3.2	2.7
GDP Price Index (Percentage change)				
August	1.5	1.4	2.1	2.2
January	1.6	1.7	2.1	2.2
Consumer Price Index[c] (Percentage change)				
August	2.3	1.9	2.5	2.5
January	2.3	2.2	2.5	2.5
Unemployment Rate (Percent)				
August	6.2	6.2	5.4	5.2
January	5.9	5.7	5.3	5.2
Three-Month Treasury Bill Rate (Percent)				
August	1.0	1.7	4.2	4.9
January	1.4	3.5	4.9	4.9
Ten-Year Treasury Note Rate (Percent)				
August	4.0	4.6	5.7	5.8
January	4.4	5.2	5.8	5.8

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

Note: Percentage changes are year over year.

a. Level in 2008.

b. Level in 2013.

c. The consumer price index for all urban consumers.