CBO TESTIMONY

Statement of
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Director

The Budget and Economic Outlook: Fiscal Years 2005 to 2014

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

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CONGRESSIONAL BUDGET OFFICE
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WASHINGTON, D.C. 20515

Chairman Nussle, Congressman Spratt, and Members of the Committee, thank you for giving me this opportunity to present the Congressional Budget Office's (CBO's) budget and economic outlook for fiscal years 2005 to 2014. CBO projects that under current laws and policies, the federal government will incur a total budget deficit of $477 billion this year and $362 billion in 2005 *(see Table 1).* Such a deficit for this year would set a record in dollar terms, but at 4.2 percent of the nation's gross domestic product (GDP), it would represent a smaller share of the economy than the deficits of the mid-1980s and early 1990s. In the absence of further legislative changes, deficits would diminish after their peak in 2004, although outlays would continue to exceed revenues for most of the next 10 years. Deficits are projected to total $1.4 trillion for the five years after 2004 and $1.9 trillion for the 2005-2014 period.

By statute, CBO's baseline projections must estimate the future paths of federal revenues and spending under current laws and policies. The baseline is therefore not intended to be a prediction of future budgetary outcomes; instead, it is meant to serve as a neutral benchmark that lawmakers can use to measure the effects of proposed changes to taxes and spending.

New legislation can significantly affect the budget outlook. For example, laws enacted since CBO's previous baseline projections were published in August have increased spending by an estimated $681 billion (0.5 percent of GDP) between 2004 and 2013.[1] Much of that total stems from the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (Public Law 108-173). The outlays resulting from that law will steadily increase between 2006 and 2013, totaling nearly $400 billion over the 2004-2013 period (not including debt-service costs).

The baseline projections reflect CBO's forecast of robust economic growth for the next two years. By late 2003, stronger investment by businesses, a weaker dollar, and a rising stock market—augmented by expansionary monetary and fiscal policies—were spurring economic activity. CBO forecasts that real (inflation-adjusted) GDP will grow by 4.8 percent in calendar year 2004 and by 4.2 percent in 2005 and that the unemployment rate will fall to 5.8 percent in 2004 and 5.3 percent in 2005. Between 2006 and 2014, the annual rise in real GDP will average 2.7 percent, CBO projects.

Even if economic growth turns out to be greater than projected, however, significant long-term strains on the budget will start to intensify within the next decade as the baby-boom generation begins to reach retirement age. Federal outlays for the three largest retirement and health programs—Social Security, Medicare, and Medicaid—will consume a growing share of budgetary resources even under moderate assumptions about the programs' growth, rising from over 8 percent of GDP in 2004 to more than 14 percent in 2030. Such increasing demands on spending will exert pressure on the budget that economic growth alone is unlikely to alleviate.

The Budget Outlook

CBO projects that if current laws and policies remain unchanged, federal deficits will begin to decline after this year. In the ensuing years, under CBO's baseline, deficits drop as a percentage of GDP, from 4.2 percent in 2004 to 3.0 percent in 2005 and 1.7 percent in 2010. After 2011—if the tax cuts enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) expired as scheduled, growth in discretionary spending continued to be limited to the rate of inflation, and other policies stayed the same—the budget would essentially be in balance.

Over the 2004-2014 period, outlays are projected to grow at an average annual rate of 4.7 percent and to remain near 20 percent of GDP. That level would be slightly below the average share of the economy devoted to federal spending since 1962 *(see Figure 1).*

The constant share of outlays as a percentage of GDP, however, masks opposing trends in mandatory and discretionary spending. Under the assumption that no changes in policy take place, spending for entitlements and other mandatory programs is projected to grow by 5.5 percent a year—faster than the rate projected for the economy as a whole. Such growth is driven largely by spending for Medicare and Medicaid, which is projected to rise at average rates of 9.0 percent and 7.2 percent a year, respectively, from 2004 through 2014. Toward the end of that period, Social Security spending is also expected to grow faster than the economy as the baby-boom generation begins to retire.

1. That estimate includes the increased interest payments on federal debt attributable to legislative changes.

Table 1.

CBO's Baseline Budget Outlook

	Actual 2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Total, 2005-2009	Total, 2005-2014
						In Billions of Dollars								
Total Revenues	1,782	1,817	2,049	2,256	2,385	2,506	2,644	2,786	3,036	3,272	3,441	3,629	11,840	28,004
Total Outlays	2,158	2,294	2,411	2,525	2,652	2,783	2,912	3,047	3,198	3,296	3,457	3,616	13,282	29,897
Total Deficit (-) or Surplus	**-375**	**-477**	**-362**	**-269**	**-267**	**-278**	**-268**	**-261**	**-162**	**-24**	**-16**	**13**	**-1,443**	**-1,893**
On-Budget	-536	-631	-535	-464	-477	-504	-507	-511	-421	-299	-294	-277	-2,487	-4,288
Off-Budget[a]	161	154	174	195	211	226	239	249	259	275	278	290	1,045	2,395
Debt Held by the Public at the End of the Year	3,914	4,393	4,771	5,055	5,338	5,630	5,912	6,185	6,356	6,388	6,409	6,399	n.a.	n.a.
						As a Percentage of GDP								
Total Revenues	16.5	15.8	16.9	17.8	18.0	18.1	18.2	18.3	19.1	19.8	19.9	20.1	17.8	18.7
Total Outlays	19.9	20.0	19.9	19.9	20.0	20.1	20.1	20.1	20.2	19.9	20.0	20.0	20.0	20.0
Total Deficit (-) or Surplus	**-3.5**	**-4.2**	**-3.0**	**-2.1**	**-2.0**	**-2.0**	**-1.8**	**-1.7**	**-1.0**	**-0.1**	**-0.1**	**0.1**	**-2.2**	**-1.3**
Debt Held by the Public at the End of the Year	36.1	38.3	39.5	39.9	40.3	40.6	40.7	40.7	40.1	38.6	37.0	35.4	n.a.	n.a.

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 projects discretionary spending as specified in the Balanced Budget and Emergency Deficit Control Act of 1985 (using the GDP deflator and the Employment Cost Index for wages and salaries). The combined rate of growth of those factors is about half of that projected for nominal GDP. As a result, the baseline projection for discretionary outlays falls from 7.8 percent of GDP in 2004 to 6.4 percent in 2014. If instead such spending kept pace with the growth of GDP (and the other assumptions incorporated in the baseline remained the same), discretionary outlays would maintain a share of about 7.8 percent of GDP throughout the projection period and the deficit in 2014 would be $323 billion, or 1.8 percent of GDP (compared with a small surplus for 2014 under the baseline's assumptions).[2]

2. That projection includes an extrapolation of the $87 billion in supplemental appropriations for 2004 enacted in November 2003 to fund defense spending and reconstruction in Iraq and Afghanistan.

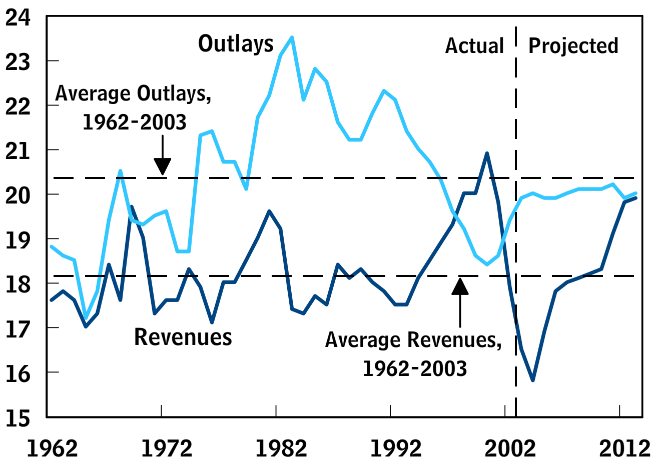
Revenues are projected to total 15.8 percent of GDP this year—about 2.5 percentage points below the average since 1962 (18.2 percent). As the economy continues to improve and certain tax provisions expire, revenues will increase to 16.9 percent of GDP in 2005, CBO projects. In 2006 through 2010, rising income and the expiration of more tax provisions will push revenues up to about 18 percent of GDP, by CBO's estimates. In the baseline, projected receipts rise more rapidly after the major provisions of EGTRRA expire at the end of 2010, reaching 20.1 percent of GDP in 2014. If those provisions—together with the expiring provisions of other tax laws—were instead extended and all of the other assumptions underlying the baseline were held constant, receipts would be 18.1 percent of GDP in 2014, and the deficit would total $443 billion, or 2.4 percent of GDP.

Debt held by the public (the most meaningful measure of federal debt in terms of its relationship to the economy) is anticipated to equal 38 percent of GDP at the end of this

Figure 1.

Total Revenues and Outlays as a Share of GDP, 1962 to 2014

(Percentage of GDP)



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

fiscal year. Under CBO's baseline, that debt will stabilize at around 40 percent of GDP through 2011, at which point the federal government's diminished need to borrow will reduce the growth of such debt.

Since CBO last issued its baseline (in the August 2003 *Budget and Economic Outlook: An Update*), the cumulative deficit over the 2004-2013 period has increased by nearly $1 trillion, or 0.7 percent of GDP *(see Table 2).* About 70 percent of that total results from new legislation, such as the Medicare law. Another $171 billion stems from economic factors—mainly the decline in CBO's forecast for inflation, which reduces estimates of both revenues and outlays (although the effect on revenues is moderately larger). Changes in projections of the unemployment rate, real GDP, and other variables also play a role. Technical revisions to CBO's baseline—mostly on the revenue side of the budget—account for another $134 billion of the addition to the cumulative deficit over the 2004-2013 period.

The Economic Outlook

CBO's forecast for the next two calendar years anticipates continued robust growth in overall demand. Stronger business investment will lead the way as firms spend more than they have spent in the past few years on their fixed assets (such as buildings and equipment) and switch from drawing down inventories to restocking their shelves. The rapid growth of productivity over the past three years has contributed to the economy's capacity to expand quickly without boosting inflation significantly. Indeed, the unexpected strength of productivity during 2003 has caused CBO to raise its expectation for potential GDP (the level of GDP consistent with a high rate of resource use) and, in turn, for GDP. CBO expects real GDP to expand by 4.8 percent in calendar year 2004 and 4.2 percent in 2005 and then to grow at an average annual rate of 2.7 percent from 2006 to 2014 *(see Table 3).*

The unemployment rate is forecast to fall from 6.0 percent in 2003 to 5.8 percent in 2004 and 5.3 percent in 2005, reflecting the expected closing of the gap between GDP and potential GDP. After briefly dipping to 5.0 percent in 2006, the unemployment rate will average 5.2 percent from 2007 through 2014, according to CBO's projections.

In CBO's estimates, inflation and nominal interest rates will remain low by historical standards from 2004 to 2014, even though interest rates will rise from current levels. The consumer price index for all urban consumers (CPI-U) will fall from 2.3 percent in 2003 to 1.6 percent in 2004 and then gradually rise to average 2.2 percent from 2006 to 2014. Since its previous forecast in August, CBO has reduced the projected rate of CPI-U growth by 0.7 percentage points for 2005 and by about 0.3 percentage points annually beyond 2006. That outlook reflects CBO's view that the Federal Reserve will act to maintain the underlying rate of CPI-U inflation at between 2.0 percent and 2.5 percent, on average.

The interest rate on three-month Treasury bills for calendar year 2003 was just 1.0 percent. The rate for such bills will remain very low for 2004, CBO anticipates, but will increase to 3.0 percent in 2005. By CBO's projections, the rate will reach 4.6 percent in 2007 and remain at that level through 2014. The yield on 10-year Treasury notes will rise from an average 4.0 percent in 2003 to 4.6 percent in 2004, 5.4 percent in 2005, and 5.5 percent from 2006 through 2014, CBO projects.

Table 2.

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

(Billions of dollars)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Total, 2004-2008	Total, 2004-2013
Total Deficit (-) or Surplus as Projected in August 2003	-480	-341	-225	-203	-197	-170	-145	-9	161	211	-1,445	-1,397
Changes												
Legislative												
Revenues	*	-1	*	*	*	*	*	*	*	*	-1	*
Outlays[a]	5	17	45	62	70	78	86	95	106	118	199	681
Subtotal, legislative	-5	-17	-45	-62	-70	-78	-86	-95	-106	-117	-200	-681
Economic												
Revenues	7	1	-15	-36	-55	-72	-89	-109	-132	-158	-98	-659
Outlays[a]	-7	-15	-24	-34	-46	-56	-65	-73	-80	-88	-126	-488
Subtotal, economic	14	17	9	-2	-10	-16	-24	-37	-52	-70	28	-171
Technical												
Revenues	-15	-16	-4	1	-3	-7	-5	-20	-25	-35	-38	-130
Outlays[a]	-8	5	3	*	-2	-3	1	1	2	5	-3	4
Subtotal, technical	-7	-20	-7	1	-1	-4	-6	-21	-27	-40	-35	-134
Total Effect on the Deficit or Surplus[b]	3	-21	-43	-64	-81	-98	-117	-153	-185	-227	-207	-986
Total Deficit as Projected in January 2004	-477	-362	-269	-267	-278	-268	-261	-162	-24	-16	-1,652	-2,383

Source: Congressional Budget Office.

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

a. Includes net interest payments.

b. Negative numbers represent an increase in the deficit or a decrease in the surplus.

Table 3.

CBO's Economic Projections for Calendar Years 2004 Through 2014

	Estimated 2003	Forecast 2004	Forecast 2005	Projected Annual Average, 2006-2014
Nominal GDP (Billions of dollars)	10,980	11,629	12,243	18,266[a]
Nominal GDP (Percentage change)	4.8	5.9	5.3	4.5
Real GDP (Percentage change)	3.2	4.8	4.2	2.7
GDP Price Index (Percentage change)	1.6	1.1	1.1	1.8
Consumer Price Index[b] (Percentage change)	2.3	1.6	1.7	2.2
Unemployment Rate (Percent)	6.0	5.8	5.3	5.2
Three-Month Treasury Bill Rate (Percent)	1.0	1.3	3.0	4.5
Ten-Year Treasury Note Rate (Percent)	4.0	4.6	5.4	5.5

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 2014.

b. The consumer price index for all urban consumers.

CHARTS PRESENTED
AT THE HEARING

CBO's Baseline Budget Outlook

	Actual 2003	2004	2005	2006	Total, 2005-2009	Total, 2005-2014
In Billions of Dollars						
Total Revenues	1,782	1,817	2,049	2,256	11,840	28,004
Total Outlays	2,158	2,294	2,411	2,525	13,282	29,897
Total Deficit	-375	-477	-362	-269	-1,443	-1,893
As a Percentage of GDP						
Total Deficit	-3.5	-4.2	-3.0	-2.1	-2.2	-1.3
Debt Held by the Public at the End of the Year	36.1	38.3	39.5	39.9	n.a.	n.a.

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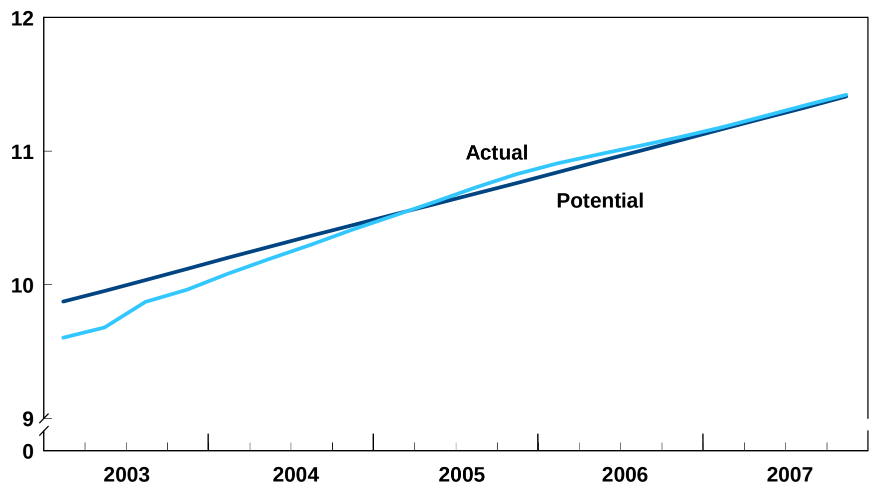
Actual and Potential GDP (Trillions of chained 2000 dollars)



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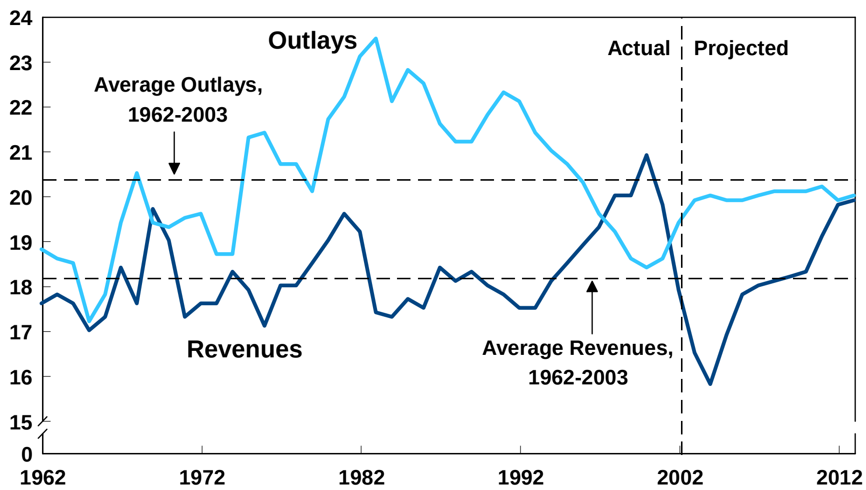
Total Revenues and Outlays as a Share of GDP, 1962 to 2014 (Percentage of GDP)



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The Budgetary Effects of Policy Alternatives Not Included in CBO's Baseline (Billions of dollars)

	Total, 2005-2009	Total, 2005-2014
Policy Alternatives That Increase the Deficit or Reduce the Surplus		
Extend Expiring Tax Provisions	-553	-2,230
Reform the Alternative Minimum Tax	-161	-469
Increase Discretionary Appropriations by the Growth Rate of Nominal GDP After 2004	-374	-1,618
Increase Discretionary Appropriations by 6.9 Percent a Year After 2004	-641	-3,157
Policy Alternatives That Reduce the Deficit or Increase the Surplus		
Increase Discretionary Appropriations (Excluding Supplemental Appropriations for 2004) by the Rate of Inflation After 2004	421	1,108
Freeze Total Discretionary Appropriations at the 2004 Level ($876 billion)	280	1,320
Memorandum:		
Total Deficit in CBO's January 2004 Baseline	-1,443	-1,893

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