CBO TESTIMONY

Statement of
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Director

The Budget and Economic Outlook: Fiscal Years 2008 to 2017

before the
Committee on the Budget
United States Senate

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Chairman Conrad, Senator Gregg, 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 2008 to 2017.[1]

If current laws and policies remained the same, the budget deficit would equal roughly 1 percent of gross domestic product (GDP) each fiscal year from 2007 to 2010, the Congressional Budget Office (CBO) projects. Those deficits would be smaller than last year's budgetary shortfall, which equaled 1.9 percent of GDP (see Table 1). Under the assumptions that govern CBO's baseline projections, the budget would essentially be balanced in 2011 and then would show surpluses of about 1 percent of GDP each year through 2017 (the end of the current 10-year projection period).

The favorable outlook suggested by those 10-year projections, however, does not indicate a substantial change in the nation's long-term budgetary challenges. The aging of the population and continuing increases in health care costs are expected to put considerable pressure on the budget in coming decades. Economic growth alone is unlikely to be sufficient to alleviate that pressure as Medicare, Medicaid, and (to a lesser extent) Social Security require ever greater resources under current law. Either 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 spending and revenue changes will be necessary to promote the nation's long-term fiscal stability.[2]

1. See Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2008 to 2017* (January 2007).

2. For a detailed discussion of the long-term pressures facing the federal budget, see Congressional Budget Office, *The Long-Term Budget Outlook* (December 2005), *Updated Long-Term Projections for Social Security* (March 2005), and *The Outlook for Social Security* (June 2004).

CBO's baseline budget projections for the next 10 years, moreover, are not a forecast of future outcomes; rather, they are a benchmark that lawmakers and others can use to assess the potential impact of future policy decisions. The deficits and surpluses in the current baseline are predicated on two key projections (which stem from longstanding procedures that were, until recently, specified in law).[3]

- Revenues are projected to rise from 18.6 percent of GDP this year to almost 20 percent of GDP in 2012 and then remain near that historically high level through 2017. Much of that increase results from two aspects of current law that have been subject to recent policy changes: the growing impact of the alternative minimum tax (AMT) and, even more significantly, 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) and modified by subsequent legislation, which are scheduled to expire by December 31, 2010.

- Outlays for discretionary programs (activities whose spending levels are set anew each year through appropriation acts) are projected to decline from 7.8 percent of GDP last year to 5.8 percent of GDP by 2017—a lower percentage than any recorded in the past 45 years. That 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. The projection for discretionary spending

3. The Balanced Budget and Emergency Deficit Control Act of 1985, which established rules that govern 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.

Table 1.

CBO's Baseline Budget Outlook

	Actual 2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Total, 2008-2012	Total, 2008-2017
							In Billions of Dollars							
Total Revenues	2,407	2,542	2,720	2,809	2,901	3,167	3,404	3,550	3,717	3,896	4,084	4,284	15,001	34,531
Total Outlays	2,654	2,714	2,818	2,926	3,038	3,179	3,234	3,391	3,533	3,687	3,892	4,034	15,194	33,731
Total Deficit (-) or Surplus	**-248**	**-172**	**-98**	**-116**	**-137**	**-12**	**170**	**159**	**185**	**208**	**192**	**249**	**-194**	**800**
On-budget	-434	-357	-299	-332	-367	-258	-85	-101	-79	-57	-72	-10	-1,342	-1,662
Off-budget[a]	186	185	201	216	230	246	255	261	264	265	264	259	1,148	2,461
Debt Held by the Public at the End of the Year	4,829	4,995	5,104	5,232	5,380	5,403	5,242	5,089	4,912	4,709	4,521	4,274	n.a.	n.a.
							As a Percentage of Gross Domestic Product							
Total Revenues	18.4	18.6	19.0	18.7	18.4	19.2	19.8	19.8	19.8	19.9	20.0	20.1	19.1	19.5
Total Outlays	20.3	19.9	19.7	19.5	19.3	19.3	18.8	18.9	18.8	18.8	19.1	18.9	19.3	19.1
Total Deficit (-) or Surplus	**-1.9**	**-1.3**	**-0.7**	**-0.8**	**-0.9**	**-0.1**	**1.0**	**0.9**	**1.0**	**1.1**	**0.9**	**1.2**	**-0.2**	**0.5**
Debt Held by the Public at the End of the Year	37.0	36.6	35.7	34.8	34.2	32.8	30.5	28.3	26.2	24.0	22.1	20.1	n.a.	n.a.
Memorandum:														
Gross Domestic Product (Billions of dollars)	13,066	13,645	14,300	15,014	15,742	16,465	17,205	17,973	18,764	19,582	20,425	21,295	78,726	176,766

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.

implicitly assumes that no additional funding is provided for the war in Iraq in 2007 and that future appropriations for activities related to the war on terrorism remain equivalent, in real (inflation-adjusted) terms, to the $70 billion appropriated so far this year.

Policy choices that differed 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 almost $3 trillion lower over the next 10 years than CBO now projects. Similarly, if discretionary spending (other than for military operations in Iraq and Afghanistan) grew at the rate of nominal GDP over the next 10 years, total discretionary outlays during that period would be nearly $1.3 trillion higher than in the baseline. Combined, those policy changes—and associated debt-service costs—would produce a deficit of $328 billion (1.9 percent of GDP) in 2012 and a cumulative deficit over the 2008–2017 period of $4.2 trillion (2.4 percent of GDP).

Underlying CBO's baseline projections is a forecast that U.S. economic growth will slow in calendar year 2007 but pick up in 2008. Specifically, CBO anticipates that GDP will grow by 2.3 percent in real terms in 2007, a full percentage point less than the growth recorded last year. For 2008, CBO forecasts that GDP growth will rebound to

3.0 percent. Under the assumptions of the baseline, real GDP growth would continue at a similar rate in 2009 and 2010 and then slow to 2.7 percent in 2011 and 2012. For the rest of the projection period, average growth of real GDP is projected to decrease to 2.5 percent per year as increases in the size of the workforce continue to slow.

The Budget Outlook

CBO estimates that if today's laws and policies did not change, federal spending would total $2.7 trillion in 2007 and revenues would total $2.5 trillion, resulting in a budget deficit of $172 billion. The additional funding that is likely to be needed to finance military operations in Iraq and Afghanistan would put that deficit in the vicinity of $200 billion. Even so, this year's shortfall would be smaller than the 2006 deficit of $248 billion.

Baseline Projections for the 2008–2017 Period

Under current laws and policies, the deficit would drop further in 2008, to $98 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 $60 billion next year because of the scheduled expiration of the relief provided through tax year 2006. (In addition, telephone-tax refunds, which totaled $13 billion in 2007, are projected to drop by $10 billion in 2008.) On the spending side of the budget, outlays for operations in Iraq and Afghanistan and for relief and recovery from hurricane damage are about $14 billion lower in 2008 than in 2007 under the assumptions of the baseline.

The baseline deficit is projected to rise modestly over the following two years, 2009 and 2010, as outlays grow by about 3.8 percent annually and revenues increase by about 3.3 percent a year. That projected growth rate for revenues is lower than in recent years, mainly because corporate profits and capital gains realizations are expected to revert to levels that are 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 rate of Social Security spending is expected to increase from about 4.5 percent in 2008 to 6.5 percent by 2017.

In addition, because the cost of health care is likely to continue rising rapidly, spending for Medicare and Medicaid is projected to grow even faster—in the range of 7 percent to 8 percent annually. Total outlays for those two health care programs are projected to more than double by 2017, increasing by 124 percent, while nominal GDP is projected to grow only half as much, by 63 percent (see Figure 1). Consequently, under the assumptions of CBO's baseline, spending for Medicare, Medicaid, and Social Security will together equal nearly 11 percent of GDP in 2017, compared with a little less than 9 percent this year.

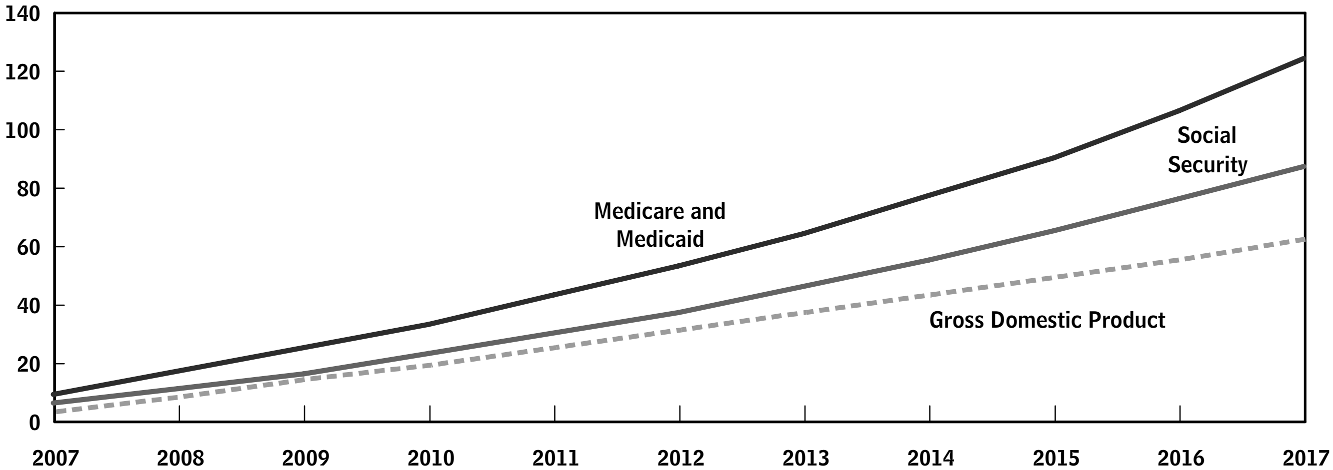
Revenues are projected to increase sharply after 2010 given the assumption that various tax provisions expire as scheduled. In the baseline, total revenues grow by 9.2 percent in 2011 and by 7.5 percent in 2012, thereby bringing the budget into surplus. Beyond 2012, revenues are projected to grow at about the same pace as outlays (by roughly 4.5 percent a year), keeping the budget in the black through 2017 under baseline assumptions.

Relative to the size of the economy, outlays are projected to range between 18.8 percent and 19.7 percent of GDP during the 2008–2017 period under the assumptions of CBO's baseline—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 5.9 percent a

Figure 1.

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

(Cumulative nominal percentage growth from 2006 level)



Source: Congressional Budget Office.

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 2.0 percent a year, on average, or less than half as fast as nominal GDP.

CBO projects that revenues will average 18.7 percent of GDP from 2008 to 2010 (close to the 18.6 percent level expected for this year) before jumping sharply in 2011 and 2012 with the expiration of tax provisions originally enacted in EGTRRA and JGTRRA. After that, revenues are projected to continue growing faster than the overall economy for three reasons: the progressive structure of the tax code combined with increases in total real income, withdrawals of retirement savings as the population ages, and the fact that the AMT is not indexed for inflation. Under the assumptions of the baseline, CBO projects that revenues will equal 20.1 percent of GDP by 2017—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 almost 37 percent of GDP at the end of this year. Thereafter, the baseline's projections of smaller annual deficits and emerging surpluses diminish the government's need for additional borrowing, causing debt held by the public to shrink to 20 percent of GDP by 2017.

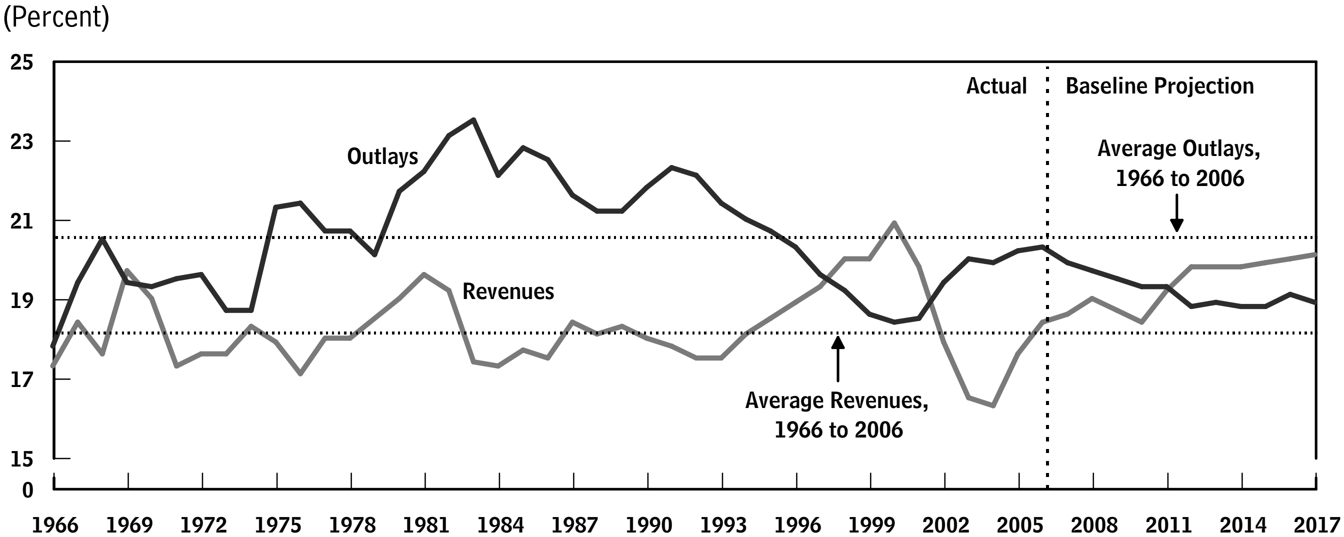
Changes in the Baseline Budget Outlook Since August

Although the long-term budgetary picture continues to be worrisome, the baseline outlook for the next 10 years has brightened in the five months since CBO issued its previous projections.[4]

4. Those projections were published in Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2006).

Figure 2.

Total Revenues and Outlays as a Percentage of Gross Domestic Product, 1966 to 2017



Source: Congressional Budget Office.

Budgetary outcomes have improved for each year from 2007 to 2016 (the period covered by the previous projections), from a reduction of $114 billion in the deficit for 2007 to a swing of $285 billion in the bottom line for 2016 (from a deficit of $93 billion to a surplus of $192 billion). In all, those reductions represent a difference of about 1.2 percent of GDP over 10 years.

Those changes overstate the fundamental improvement in the underlying budget outlook, however. Roughly half of the total change stems from the baseline's treatment of previous supplemental appropriations for disaster relief and the irregular pattern of funding for military operations in Iraq and Afghanistan. Consequently, more than half of the improved bottom line is unrelated to changes in the underlying budgetary and economic environment.

Much of the remaining change to the current baseline comes from lower projected spending for Medicare. Total outlays for that program over the 2007–2016 period are nearly 8 percent lower in this baseline than in CBO's August projections. That reduction is largely attributable to new estimates of per capita costs for all Medicare benefits, but it also reflects lower projections of the number of enrollees in the prescription drug benefit program. Those recent changes, however, do not significantly alter the upward trajectory of Medicare spending in the long term.

The Economic Outlook

The Federal Reserve's shift in monetary policy over the past two and a half years and the recent decline in housing construction are expected to restrain economic growth this year, but the economy is likely to post solid gains next year. CBO forecasts that GDP will grow by 2.3 percent in real terms in calendar year 2007 but by 3.0 percent in 2008 (see Table 2).

Gains in employment, which remained solid in 2006 despite a slowdown in economic growth during the second half of the year, are expected to lessen in 2007. That change may cause unemploy-

Table 2.

CBO's Economic Projections for Calendar Years 2007 to 2017

(Percentage change)

	Estimated	Forecast		Projected Annual Average	
	2006	2007	2008	2009-2012	2013-2017
Nominal GDP					
Billions of dollars	13,235	13,805	14,472	17,395 [a]	21,519 [b]
Percentage change	6.3	4.3	4.8	4.7	4.3
Real GDP	3.3	2.3	3.0	2.9	2.5
GDP Price Index	2.9	1.9	1.8	1.8	1.8
PCE Price Index[c]	2.8	1.7	1.9	2.0	2.0
Core PCE Price Index[d]	2.3	2.1	1.9	2.0	2.0
Consumer Price Index[e]	3.4	1.9	2.3	2.2	2.2
Core Consumer Price Index[f]	2.6	2.6	2.3	2.2	2.2
Unemployment Rate (Percent)	4.6	4.7	4.9	5.0	5.0
Interest Rates (Percent)					
Three-month Treasury bills	4.7	4.8	4.5	4.4	4.4
Ten-year Treasury notes	4.8	4.8	5.0	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.

Percentage changes are measured from one year to the next.

a. Level in 2012.

b. Level in 2017.

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.

ment to edge up from the 4.6 percent rate recorded for 2006. As housing construction stabilizes, however, economic growth and employment should start to recover by the middle of 2007.

Last year, robust investment by businesses and solid growth in exports helped the U.S. economy absorb the decline in housing construction. Investment and exports are expected to continue to support the economy in 2007. For many years, businesses' capital stock (the plant, equipment, and software they use for production) grew more slowly than overall demand for U.S. goods and services; as a result, despite the recent growth of investment, the nation's capital stock is still low relative to the level of demand. Investment should therefore continue to increase, even if the growth of demand slows. Similarly, export growth is likely to remain strong because increases in demand for U.S. products overseas are durable enough to withstand a slight slowdown in U.S. demand for other countries' exports.

In the absence of any adverse price shocks to the economy, the core rate of inflation—which excludes prices for food and energy—is expected to ease slightly this year. Overall inflation (as measured by the year-to-year change in the price index for personal consumption expenditures) will fall from last year's rate of 2.8 percent to 1.7 percent in 2007 because of a large drop in prices for motor fuels near the end of last year. The core rate of inflation, however, is expected to decline less rapidly during 2007.

CBO anticipates that the interest rate on three-month Treasury bills will drop slightly this year from the 4.9 percent rate seen at the end of 2006. Further declines are expected during 2008, when that rate will average 4.5 percent. CBO's forecast assumes that long-term interest rates will edge up as short-term interest rates decline. The rate on 10-year Treasury notes, for example, is forecast to rise from 4.8 percent this year to 5.0 percent in 2008.

Beyond the two-year horizon, CBO projects that economic growth (as measured by increases in real GDP) will average 2.7 percent a year from 2009 to 2017. As members of the baby-boom generation begin to retire, the growth of the labor force is expected to slow, pushing down the rate of real GDP growth during the second half of that period. Projected rates of inflation, unemployment, and growth of labor productivity average 2.0 percent, 5.0 percent, and 2.2 percent, respectively, after 2008. Interest rates are projected to average 4.4 percent for three-month Treasury bills and 5.2 percent for 10-year Treasury notes.