Congressional Budget Office

Testimony on the Budget and Economic Outlook: Fiscal Years 2012 to 2022

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Chairman Conrad, Senator Sessions, 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 outlook for the budget and the economy. My statement summarizes CBO's new economic forecast and baseline budget projections, which cover fiscal years 2012 to 2022. Those estimates were released two days ago in the report titled *The Budget and Economic Outlook: Fiscal Years 2012 to 2022*.

The federal budget deficit—although starting to shrink—remains very large by historical standards. How much and how quickly the deficit declines will depend in part on how well the economy does over the next few years. Probably more critical, though, will be the fiscal policy choices made by lawmakers as they face the substantial changes to tax and spending policies that are slated to take effect within the next year under current law.

The pace of the economic recovery has been slow since the recession ended in June 2009, and CBO expects that, under current laws governing taxes and spending, the economy will continue to grow at a sluggish pace over the next two years. That pace of growth partly reflects the dampening effect on economic activity from the higher tax rates and curbs on spending scheduled to occur this year and especially next. Although CBO projects that growth will pick up after 2013, the agency expects that the economy's output will remain below its potential until 2018 and that the unemployment rate will remain above 7 percent until 2015.

The Budget Outlook

As specified in law, and to provide a benchmark against which potential policy changes can be measured, CBO constructs its baseline estimates of federal revenues and spending under the assumption that current laws generally remain unchanged. On that basis, the federal budget will show a deficit of nearly $1.1 trillion in fiscal year 2012 (see Table 1). Measured as a share of gross domestic product (GDP), that shortfall will be 7.0 percent, which is nearly 2 percentage points below the deficit recorded last year but still higher than any deficit between 1947 and 2008. Over the next few years, projected deficits in CBO's baseline drop markedly, averaging 1.5 percent of GDP over the 2013–2022 period. With deficits small relative to the size of the economy, debt held by the public drops—from about 75 percent of GDP in 2013 to 62 percent in 2022, which is still higher than in any year between 1952 and 2009.

Much of the projected decline in the deficit occurs because, under current law, revenues will rise considerably as a share of GDP—from 16.3 percent in 2012 to 20.0 percent in 2014 and 21.0 percent in 2022. In particular, between 2012 and 2014, revenues in CBO's baseline shoot up by more than 30 percent, mostly because of the recent or scheduled expirations of tax provisions, such as those that lower income tax rates and limit the reach of the alternative minimum tax (AMT), and the imposition of new taxes, fees, and penalties that are scheduled to go into effect. Revenues continue to rise relative to GDP after 2014 largely because increases in taxpayers' real (inflation-adjusted) income are projected to push more of them into higher tax brackets and because more taxpayers become subject to the AMT.

As the economy expands in the next several years and as statutory caps constrain discretionary appropriations, federal spending in CBO's baseline projections declines modestly relative to GDP before turning up again because of increasing expenses generated by the aging of the population and rising costs for health care. Projected spending averages 21.9 percent of GDP over the 2013–2022 period, a percentage that is less than the 23.2 percent CBO estimates for 2012 but that is still elevated by historical standards. Spending resulting from the American Recovery and Reinvestment Act and outlays for unemployment compensation and other benefits that tend to increase during economic downturns will continue to ebb over the next few years. Caps on discretionary spending and other procedures established in the recently enacted Budget Control Act also will hold down growth in federal spending. In the baseline, discretionary spending is projected to decline to 5.6 percent of GDP in 2022—the lowest level in the past 50 years. Those constraining factors will be partially offset by increases in spending for mandatory programs, particularly Social Security, Medicare, Medicaid, and other federal health care programs: Mandatory spending is projected to climb from 13.3 percent of GDP in 2013 to 14.3 percent in 2022.

Although the projected deficits under current law are much smaller than those of the past few years, in CBO's baseline the federal budget remains out of balance throughout the decade. The resulting accumulation of

Table 1.

CBO's Baseline Budget Outlook

	Actual, 2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	Total 2013-2017	Total 2013-2022
							In Billions of Dollars							
Revenues	2,302	2,523	2,988	3,313	3,568	3,784	4,039	4,243	4,456	4,680	4,926	5,181	17,692	41,179
Outlays	3,598	3,601	3,573	3,658	3,836	4,086	4,259	4,439	4,714	4,960	5,205	5,520	19,413	44,251
Deficit (-) or Surplus	**-1,296**	**-1,079**	**-585**	**-345**	**-269**	**-302**	**-220**	**-196**	**-258**	**-280**	**-279**	**-339**	**-1,721**	**-3,072**
On-budget	-1,363	-1,130	-619	-363	-282	-318	-235	-206	-258	-265	-245	-283	-1,818	-3,074
Off-budget[a]	67	52	34	19	13	16	15	10	*	-16	-34	-55	97	2
Debt Held by the Public at the End of the Year	10,128	11,242	11,945	12,401	12,783	13,188	13,509	13,801	14,148	14,512	14,872	15,291	n.a.	n.a.
							As a Percentage of Gross Domestic Product							
Revenues	15.4	16.3	18.8	20.0	20.2	20.2	20.5	20.5	20.6	20.7	20.9	21.0	20.0	20.4
Outlays	24.1	23.2	22.5	22.1	21.8	21.8	21.6	21.5	21.8	21.9	22.0	22.4	21.9	21.9
Deficit	**-8.7**	**-7.0**	**-3.7**	**-2.1**	**-1.5**	**-1.6**	**-1.1**	**-0.9**	**-1.2**	**-1.2**	**-1.2**	**-1.4**	**-1.9**	**-1.5**
Debt Held by the Public at the End of the Year	67.7	72.5	75.1	74.8	72.6	70.5	68.5	66.8	65.5	64.2	63.0	62.0	n.a.	n.a.

Source: Congressional Budget Office.

Note: * = between -$500 million and zero; n.a. = not applicable.

a. Off-budget surpluses or deficits comprise surpluses or deficits in the Social Security trust funds and the net cash flow of the Postal Service.

debt, along with rising interest rates, drives up the cost of financing that debt; in CBO's projections, net interest costs grow significantly from 1.4 percent of GDP this year to 2.5 percent in 2022.

CBO's baseline projections are heavily influenced by changes in tax and spending policies that are embodied in current law—changes that in some cases represent a significant departure from recent policies. As a result, those projections show much higher revenues and lower outlays than would occur if the lower tax rates now in effect were extended and if provisions constraining future spending were not implemented. To illustrate the budgetary consequences of maintaining some tax and spending policies that have recently been in effect, CBO developed projections under an "alternative fiscal scenario." That scenario incorporates the following assumptions:

- Expiring tax provisions (other than the payroll tax reduction) are extended;
- The AMT is indexed for inflation after 2011;
- Medicare's payment rates for physicians' services are held constant at their current level (rather than dropping by 27 percent in March 2012 and more thereafter, as scheduled under current law); and
- The automatic spending reductions required by the Budget Control Act in the absence of legislation reported by the Joint Select Committee on Deficit Reduction do not take effect (thereby leaving in place the discretionary caps established by the act, which would otherwise be subject to those reductions).

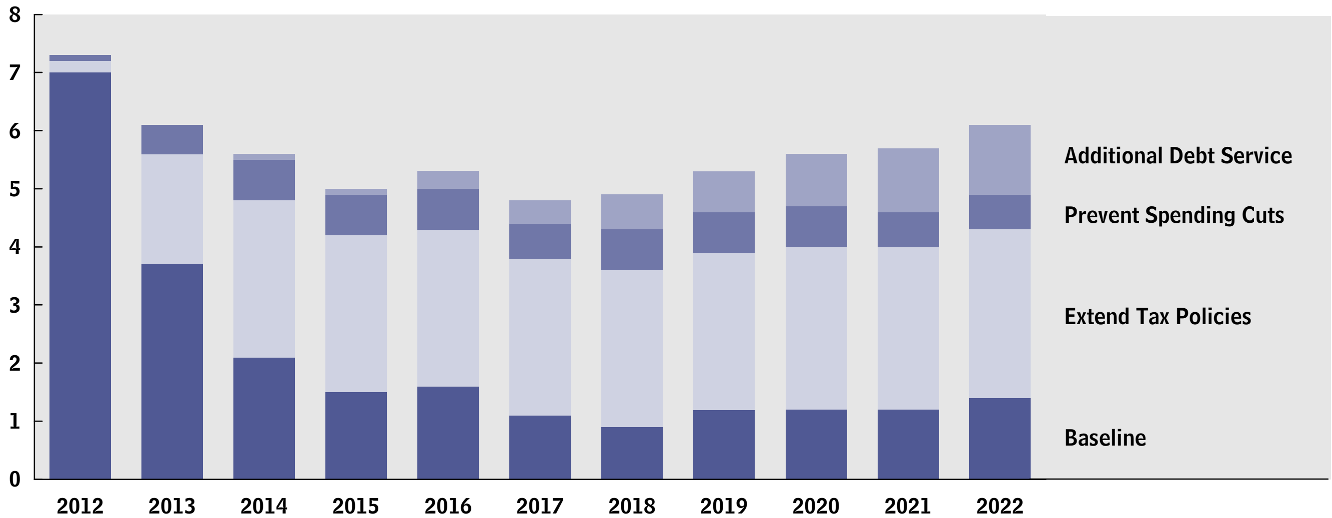
Under that alternative fiscal scenario, deficits over the 2013–2022 period would be much higher, averaging 5.4 percent of GDP, rather than the 1.5 percent reflected in CBO's baseline projections (see Figure 1). Debt held by the public would climb to 94 percent of GDP in 2022, the highest figure since just after World War II (see Figure 2).

Even if the fiscal policies specified by current law come to pass, budgetary challenges over the longer term remain—

Figure 1.

Deficits Projected in CBO's Baseline and Under an Alternative Fiscal Scenario

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Note: "Additional Debt Service" is the amount of interest payments on the additional debt issued to the public that would result from the policies in the alternative fiscal scenario. "Prevent Spending Cuts" involves holding Medicare's payment rates for physicians' services at their current level (rather than permitting them to drop, as scheduled under current law) and preventing the cuts to federal spending that will occur under the automatic enforcement procedures of the Budget Control Act of 2011 from taking effect (but leaving in place the original caps on discretionary appropriations in that legislation). "Extend Tax Policies" reflects the assumptions that expiring tax provisions (other than the payroll tax reduction) are instead extended and that the alternative minimum tax is indexed for inflation.

and the challenges will be much more acute if those policies do not remain in place. Under both CBO's baseline and its alternative fiscal scenario, the aging of the population and rising costs for health care will push spending for Social Security, Medicare, Medicaid, and other federal health care programs considerably higher as a percentage of GDP. If that rising level of spending is coupled with revenues that are held close to the average share of GDP that they have represented for the past 40 years (rather than being allowed to increase, as under current law), the resulting deficits will increase federal debt to unsupportable levels. To prevent that outcome, policymakers will have to substantially restrain the growth of spending for those programs, raise revenues above their historical share of GDP, or pursue some combination of those two approaches.

The Economic Outlook

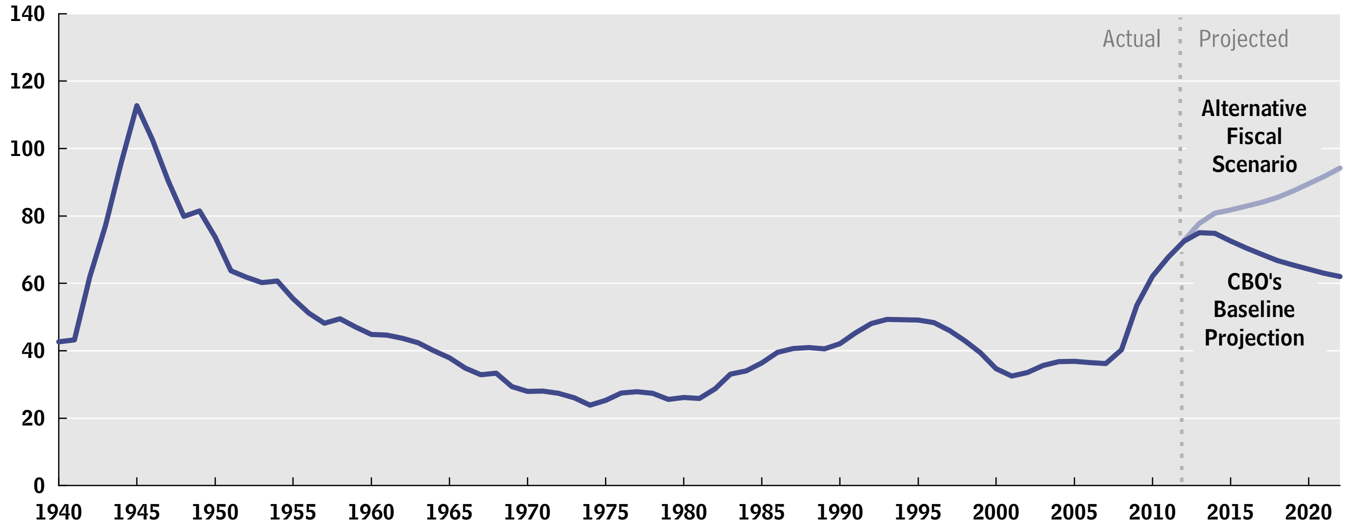
The continued slow recovery that CBO projects for the next two years reflects the lingering effects of the financial crisis and the recession, as well as the fiscal restraint that will arise under current law. According to CBO's projections, real GDP will grow by 2.0 percent this year (as measured by the change from the fourth quarter of the previous calendar year) and by 1.1 percent next year (see Table 2). CBO expects economic activity to quicken after 2013 but real GDP to remain below the economy's potential until 2018. As of late 2011, according to the agency's projections, the economy was only about halfway through the cumulative shortfall in total output that will result from the recession and its aftermath.

Considerable slack remains in the labor market, mainly as a consequence of continued weakness in demand for goods and services. In CBO's forecast, the unemployment rate remains above 8 percent both this year and next. As economic growth picks up after 2013, the unemployment rate will gradually decline, but it will still be around 7 percent at the end of calendar year 2015, before dropping to near 5½ percent by the end of 2017 and 5¼ percent by the end of 2022.

Figure 2.

Federal Debt Held by the Public Projected in CBO's Baseline and Under an Alternative Fiscal Scenario

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Note: The alternative fiscal scenario incorporates the assumptions that all expiring tax provisions (other than the payroll tax reduction), including those that expired at the end of December 2011, are instead extended; that the alternative minimum tax is indexed for inflation after 2011 (starting at the 2011 exemption amount); that Medicare's payment rates for physicians' services are held constant at their current level; and that the automatic enforcement procedures specified by the Budget Control Act of 2011 do not take effect. The budgetary effects under the alternative fiscal scenario also include the incremental interest costs associated with projected additional borrowing.

While the economy continues to recover during the next few years, inflation and interest rates will remain low. In CBO's forecast, the price index for personal consumption expenditures (PCE) increases by just 1.2 percent in 2012 and 1.3 percent in 2013, and rates on 10-year Treasury notes average 2.3 percent in 2012 and 2.5 percent in 2013. As the economy's output approaches its potential later in the decade, inflation and interest rates will rise to more normal levels. In CBO's projections for the 2018–2022 period, the annual change in the PCE price index averages 2.0 percent per year, and interest rates on 10-year Treasury notes average 5.0 percent.

Many developments could cause economic outcomes to differ substantially, in one direction or another, from those that CBO has projected. For example, the economy could grow considerably faster than the agency has forecast if the forces that have restrained the recovery fade more rapidly than anticipated. Alternatively, a significant worsening of the banking and fiscal problems in Europe could lead to further turmoil in international financial markets that could spill over to those in the United States and greatly weaken the economy here.

Furthermore, changes in fiscal policy that diverge from the path assumed in CBO's baseline also could have a significant impact on economic growth. Under CBO's alternative fiscal scenario, real GDP would be noticeably higher in the next few years than it is in CBO's baseline economic forecast. Over time, however, real GDP under that scenario would fall increasingly below the level in CBO's baseline projections because the larger budget deficits would reduce private investment in productive capital.

Table 2.

CBO's Economic Projections for Calendar Years 2012 to 2022

	Estimated,	Forecast		Projected Annual Average	
	2011	2012	2013	2014-2017	2018-2022
		Fourth Quarter to Fourth Quarter (Percentage change)			
Real GDP	1.6	2.0	1.1	4.1	2.5
Inflation					
PCE price index	2.6	1.2	1.3	1.7	2.0
Core PCE price index[a]	1.8	1.2	1.4	1.6	2.0
Consumer price index[b]	3.3 [c]	1.4	1.5	1.9	2.3
Core consumer price index[a]	2.2 [c]	1.4	1.6	1.9	2.2
		Fourth-Quarter Level (Percent)			
Unemployment Rate	8.7 [c]	8.9	9.2	5.6 [d]	5.3 [e]
		Calendar Year Average (Percent)			
Interest Rates					
Three-month Treasury bills	0.1 [c]	0.1	0.1	2.0	3.7
Ten-year Treasury notes	2.8 [c]	2.3	2.5	3.8	5.0

Source: Congressional Budget Office.

Note: GDP = gross domestic product; PCE = personal consumption expenditures.

a. Excludes prices for food and energy.

b. The consumer price index for all urban consumers.

c. Actual value for 2011.

d. Value for 2017.

e. Value for 2022.