



Congressional Budget Office

Testimony

**Statement of
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Director**

The Budget and Economic Outlook: Fiscal Years 2010 to 2020

**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 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 2010 through 2020. Those estimates were released on Tuesday in the report titled *The Budget and Economic Outlook: Fiscal Years 2010 to 2020*.

The Congressional Budget Office projects that if current laws and policies remained unchanged, the federal budget would show a deficit of about \$1.3 trillion for fiscal year 2010 (see Table 1). At 9.2 percent of gross domestic product (GDP), that deficit would be slightly smaller than the shortfall of 9.9 percent of GDP (\$1.4 trillion) posted in 2009. Last year's deficit was the largest as a share of GDP since the end of World War II, and the deficit expected for 2010 would be the second largest. Moreover, if legislation is enacted in the next several months that either boosts spending or reduces revenues, the 2010 deficit could equal or exceed last year's shortfall.

The large 2009 and 2010 deficits reflect a combination of factors: an imbalance between revenues and spending that predates the recession and turmoil in financial markets, sharply lower revenues and elevated spending associated with those economic conditions, and the costs of various federal policies implemented in response to those conditions.

The deep recession that began two years ago appears to have ended in mid-2009. Economic activity picked up during the second half of last year, with inflation-adjusted GDP and industrial production both showing gains. Still, GDP remains roughly 6½ percent below CBO's estimate of the output that could be produced if all labor and capital were fully employed (that difference is called the output gap), and the unemployment rate, at 10 percent, is twice what it was two years ago.

Economic growth in the next few years will probably be muted in the aftermath of the financial and economic turmoil. Experience in the United States and in other countries suggests that recovery from recessions triggered

by financial crises and large declines in asset prices tends to be protracted. Also, although aggressive action on the part of the Federal Reserve and the fiscal stimulus package enacted in early 2009 helped moderate the severity of the recession and shorten its duration, the support coming from those sources is expected to wane. Furthermore, spending by households is likely to be constrained by slow growth of income, lost wealth, and limits on their ability to borrow, and investment spending will be slowed by the large number of vacant homes and offices.

Under current law, the federal fiscal outlook beyond this year is daunting: Projected deficits average about \$600 billion per year over the 2011–2020 period. As a share of GDP, deficits drop markedly in the next few years but remain high—at 6.5 percent of GDP in 2011 and 4.1 percent in 2012, the first full fiscal year after certain tax provisions originally enacted in 2001, 2003, and 2009 are scheduled to expire. Thereafter, deficits are projected to range between 2.6 percent and 3.2 percent of GDP through 2020.

Those accumulating deficits will push federal debt held by the public to significantly higher levels. At the end of 2009, debt held by the public was \$7.5 trillion, or 53 percent of GDP; by the end of 2020, debt is projected to climb to \$15 trillion, or 67 percent of GDP. With such a large increase in debt, plus an expected increase in interest rates as the economic recovery strengthens, interest payments on the debt are poised to skyrocket. CBO projects that the government's annual spending on net interest will more than triple between 2010 and 2020 in nominal terms, from \$207 billion to \$723 billion, and will more than double as a share of GDP, from 1.4 percent to 3.2 percent (see Figure 1).

Moreover, CBO's baseline projections understate the budget deficits that would arise under many observers' interpretation of current policy, as opposed to current law. In particular, the projections assume that major provisions of the tax cuts enacted in 2001, 2003, and 2009 will expire as scheduled and that temporary changes that have kept the alternative minimum tax (AMT) from affecting many more taxpayers will not be extended. The

Table 1.
CBO's Baseline Budget Outlook

	Actual 2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Total, 2011- 2015	Total, 2011- 2020
In Billions of Dollars														
Total Revenues	2,105	2,175	2,670	2,964	3,218	3,465	3,625	3,814	3,996	4,170	4,352	4,563	15,941	36,836
Total Outlays	<u>3,518</u>	<u>3,524</u>	<u>3,650</u>	<u>3,613</u>	<u>3,756</u>	<u>3,940</u>	<u>4,105</u>	<u>4,335</u>	<u>4,521</u>	<u>4,712</u>	<u>5,000</u>	<u>5,250</u>	<u>19,065</u>	<u>42,883</u>
Total Deficit (-) or Surplus	-1,414	-1,349	-980	-650	-539	-475	-480	-521	-525	-542	-649	-687	-3,124	-6,047
On-budget	-1,551	-1,434	-1,076	-757	-659	-608	-619	-659	-659	-669	-765	-793	-3,719	-7,263
Off-budget ^a	137	86	96	108	120	133	139	138	134	127	116	107	595	1,216
Debt Held by the Public at the End of the Year	7,544	8,797	9,785	10,479	11,056	11,556	12,055	12,595	13,133	13,678	14,329	15,027	n.a.	n.a.
As a Percentage of Gross Domestic Product														
Total Revenues	14.8	14.9	17.8	18.8	19.3	19.7	19.7	19.8	19.9	20.0	20.1	20.2	19.1	19.6
Total Outlays	<u>24.7</u>	<u>24.1</u>	<u>24.3</u>	<u>23.0</u>	<u>22.5</u>	<u>22.4</u>	<u>22.3</u>	<u>22.6</u>	<u>22.6</u>	<u>22.6</u>	<u>23.1</u>	<u>23.3</u>	<u>22.9</u>	<u>22.8</u>
Total Deficit	-9.9	-9.2	-6.5	-4.1	-3.2	-2.7	-2.6	-2.7	-2.6	-2.6	-3.0	-3.0	-3.7	-3.2
Debt Held by the Public at the End of the Year	53.0	60.3	65.3	66.6	66.3	65.6	65.4	65.5	65.5	65.7	66.1	66.7	n.a.	n.a.
Memorandum:														
Gross Domestic Product (Billions of dollars)	14,236	14,595	14,992	15,730	16,676	17,606	18,421	19,223	20,036	20,823	21,667	22,544	83,425	187,719

Source: Congressional Budget Office.

Note: n.a. = not applicable.

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

baseline projections also assume that annual appropriations rise only with inflation, which would leave discretionary spending very low relative to GDP by historical standards. If the tax cuts were made permanent, the AMT was indexed for inflation, and annual appropriations kept pace with GDP, the deficit in 2020 would be nearly the same, historically large, share of GDP that it is today, and debt held by the public would equal nearly 100 percent of GDP.

The Budget Outlook

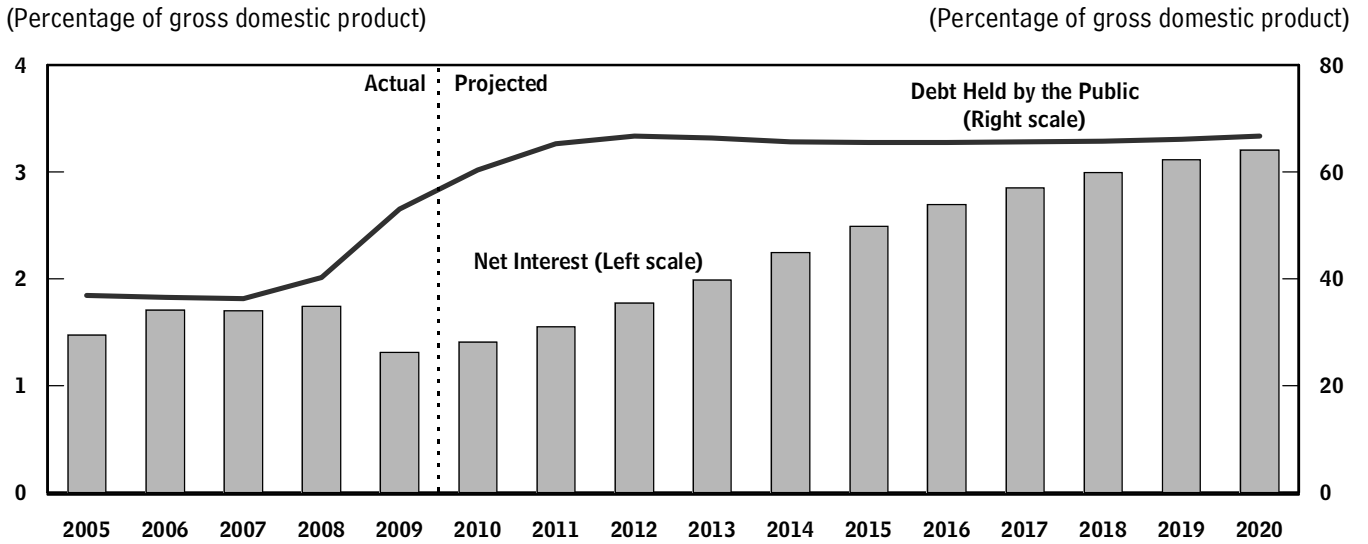
In 2010, under an assumption that no legislative changes occur, CBO estimates that federal spending will total \$3.5 trillion and revenues will total \$2.2 trillion. The resulting deficit of about \$1.3 trillion would be just \$65 billion less than last year's shortfall and more than three times the size of the deficit recorded in 2008. Total outlays are projected to increase by just \$5 billion, while

revenues are projected to rise by \$70 billion. The deficit for this year is on track to be about as large as last year's because an expected decline in federal aid to the financial sector will be offset by increases in other outlays, particularly spending from last year's stimulus legislation and outlays for income support programs, health care programs, Social Security, and net interest. At the same time, revenues are projected to increase only modestly primarily because of the slow pace of economic recovery forecast by CBO and the lagged effect of the recession on tax receipts.

In 2011, according to CBO's baseline projections, the deficit falls to \$980 billion, or 6.5 percent of GDP, as the economy improves, certain tax provisions expire as scheduled, and spending related to the economic downturn abates. Revenues are projected to rise by about \$500 billion, an increase of 23 percent, while outlays are projected to increase by \$126 billion, or 4 percent.

Figure 1.

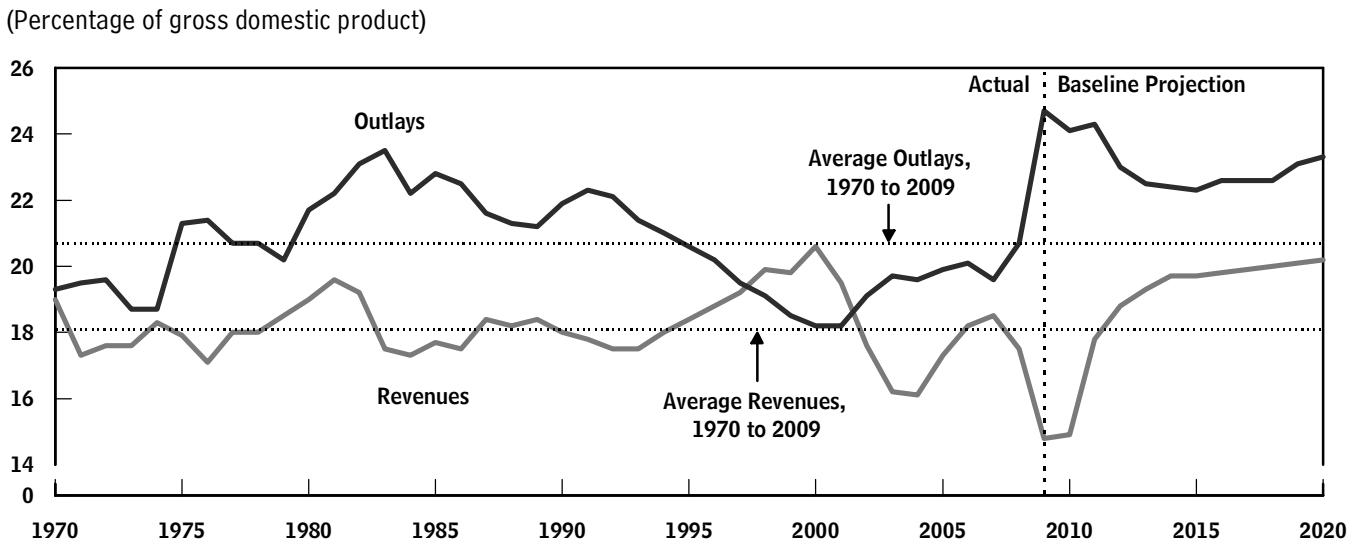
Debt Held by the Public and Net Interest



Source: Congressional Budget Office.

Figure 2.

Total Revenues and Outlays



Source: Congressional Budget Office.

Looking beyond 2011, CBO's baseline projections show outlays remaining between 22.3 percent and 23.3 percent of GDP (compared with 24.1 percent in 2010) (see Figure 2 on page 3). Continued economic growth will allow payments for unemployment compensation and other benefit programs to subside, and discretionary spending is assumed to increase slowly. However, the retirement of more members of the baby-boom generation and rising health care spending per person will cause outlays for Medicare, Medicaid, and Social Security to continue to grow fairly rapidly.

The baseline projections show revenues rising to 20.2 percent of GDP by 2020 (compared with 14.9 percent in 2010), with most of the increase stemming from individual income tax receipts. Almost half of the increase in those receipts relative to the size of the economy can be attributed to the expiration of provisions originally enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001, the Jobs and Growth Tax Relief Reconciliation Act of 2003, and the American Recovery and Reinvestment Act (ARRA), as well as other expiring tax provisions; the remainder is due to the economic recovery and structural features of the individual income tax system.

The Economic Outlook

Severe economic downturns often sow the seeds of robust recoveries. During a slump in economic activity, consumers defer purchases, especially for housing and durable goods, and businesses postpone capital spending and try to cut inventories. Once demand in the economy picks up, the disparity between the desired and actual stocks of capital assets and consumer durable goods widens quickly, and spending by consumers and businesses can accelerate rapidly. Although CBO expects that the current recovery will be spurred by that dynamic, in all likelihood, the recovery will also be dampened by a number of factors. Those factors include the continuing fragility of some financial markets and institutions; declining support from fiscal policy as the effects of ARRA wane and tax rates increase because of the scheduled expiration of key tax provisions; and slow wage and employment growth, as well as a large excess of vacant houses.

In CBO's forecast, real GDP increases by 2.1 percent between the fourth quarter of 2009 and the fourth quarter of 2010 and by 2.4 percent in 2011 (see Table 2). Given CBO's estimate of growth in potential output,

those GDP growth rates will narrow the difference between actual output and potential output (the output gap) only slightly. Growth of real GDP will accelerate after 2011, spurred by stronger business investment and residential construction. For 2012 through 2014, CBO projects that real GDP will increase by an average of 4.4 percent per year, which would close the output gap completely by the end of 2014.

Even though economic activity began to increase again during the second half of 2009, the unemployment rate continued to rise, finishing the year at 10.0 percent. Hiring usually lags behind output during the initial stages of a recovery because firms tend to increase output first by boosting productivity and by raising the number of hours that existing employees work; adding employees tends to occur later. CBO expects that the unemployment rate will average slightly above 10 percent in the first half of 2010 and then turn downward in the second half of the year (see Figure 3). As the economy expands further, the rate of unemployment is projected to continue declining until, in 2016, it reaches 5 percent, which is equal to CBO's estimate of the rate of unemployment consistent with the usual rate of job turnover in U.S. labor markets.

Reflecting the large amount of slack in the economy, inflation will decrease further from its already low level in 2009, CBO forecasts. The core price index for personal consumption expenditures (that is, the PCE price index excluding the prices of food and energy) will rise by about 1 percent (on a fourth-quarter-to-fourth-quarter basis) in 2010 and by 0.9 percent in 2011. The overall PCE price index will rise by 1.4 percent in 2010 and 1.1 percent in 2011.

CBO's forecast anticipates slower growth in 2010 and 2011 than does the forecast of the *Blue Chip* consensus (reflecting the views of about 50 private-sector economists). Most private forecasters probably assume that the Congress will not allow previous tax cuts to expire as scheduled. If CBO assumed, in contrast with the assumption of its baseline, that all of the expiring tax provisions were extended beyond 2010, the agency's forecast of the level of real GDP at the end of 2011 would be in line with the forecast of the *Blue Chip* consensus (although real GDP in later years would be diminished relative to the baseline projection by the greater accumulation of government debt). CBO's forecast for inflation is roughly in line with that of the *Blue Chip* consensus in 2010 but significantly lower in 2011.

Table 2.**CBO's Economic Projections for Calendar Years 2009 to 2020**

	Estimated	Forecast		Projected Annual Average	
	2009	2010	2011	2012–2014	2015–2020
Fourth Quarter to Fourth Quarter (Percentage change)					
Real GDP	-0.4	2.1	2.4	4.4	2.4
GDP Price Index	0.9	1.0	0.9	1.2	1.7
PCE Price Index	1.4	1.4	1.1	1.2	1.8
Core PCE Price Index ^a	1.5	1.0	0.9	1.1	1.7
Consumer Price Index ^b	1.7	1.6	1.1	1.3	1.9
Core Consumer Price Index ^a	2.0	1.1	0.9	1.2	1.9
Calendar Year Average					
Nominal GDP					
Billions of dollars	14,253	14,706	15,116	17,816 ^c	22,770 ^d
Percentage change	-1.3	3.2	2.8	5.6	4.2
Unemployment Rate (Percent)	9.3	10.1	9.5	6.5	5.0
Interest Rates (Percent)					
Three-Month Treasury bill rate	0.1	0.2	0.7	2.9	4.6
Ten-Year Treasury note rate	3.2	3.6	3.9	4.5	5.5

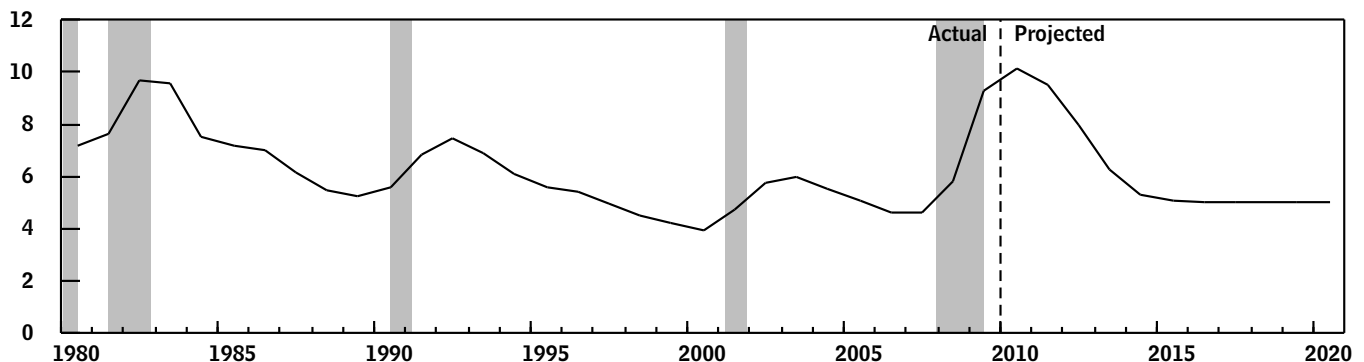
Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

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

- a. Excludes prices for food and energy.
- b. The consumer price index for all urban consumers.
- c. Level in 2014.
- d. Level in 2020.

Figure 3.**Unemployment Rate**

(Percent)



Source: Congressional Budget Office.

Note: The shaded bars indicate the duration of recessions.

