

## The Budget and Economic Outlook: An Update

**T**he Congressional Budget Office (CBO) estimates that the federal budget deficit for 2010 will exceed \$1.3 trillion—\$71 billion below last year’s total and \$27 billion lower than the amount that CBO projected in March 2010, when it issued its previous estimate.<sup>1</sup> Relative to the size of the economy, this year’s deficit is expected to be the second largest shortfall in the past 65 years: At 9.1 percent of gross domestic product (GDP), it is exceeded only by last year’s deficit of 9.9 percent of GDP. As was the case last year, this year’s deficit is attributable in large part to a combination of weak revenues and elevated spending associated with the economic downturn and the policies implemented in response to it.

This report presents CBO’s updated budget and economic projections spanning the 2010–2020 period. Those projections reflect the assumption that current laws affecting the budget will remain unchanged—and thus the projections serve as a neutral benchmark that lawmakers can use to assess the potential effects of policy decisions. As such, CBO assumes that tax reductions enacted earlier in this decade that are currently set to expire at the end of this year do so as scheduled; it also assumes that no new legislation aimed at keeping the alternative minimum tax (AMT) from affecting many more taxpayers is enacted. In addition, CBO assumes that the measures enacted in the past two years to provide fiscal stimulus to the weakened economy will expire as currently scheduled and that future annual appropriations will be kept constant in real (inflation-adjusted) terms. Under those assumptions, the federal budget deficit would decline substantially over the next two years—to 4.2 percent of GDP by 2012—and, consequently, the

budget would provide much less support to the economy than has been the case for the past two years.

According to CBO’s projections, the recovery from the economic downturn will continue at a modest pace during the next few years. Growth in the nation’s output since the middle of calendar year 2009 has been anemic in comparison with that of previous recoveries following deep recessions, and the unemployment rate has remained quite high, averaging 9.7 percent in the first half of this year. Such weak growth tends to occur in recoveries from recessions spurred by financial crises. The considerable number of vacant houses and underused factories and offices will be a continuing drag on residential construction and business investment, and slow income growth as well as lost wealth will weigh on consumer spending.

All of those forces, along with the waning of federal fiscal support, will tend to restrain spending by individuals and businesses—and, therefore, economic growth—during the recovery. CBO projects that the economy will grow by only 2.0 percent from the fourth quarter of 2010 to the fourth quarter of 2011; even with faster growth in subsequent years, the unemployment rate will not fall to around 5 percent until the end of 2014.

In CBO’s current-law projections, once the economy has recovered, the federal budget deficit amounts to between 2.5 percent and 3.0 percent of GDP from 2014 to 2020. Projected deficits total \$6.2 trillion for the 10 years starting in 2011, raising federal debt held by the public to more than 69 percent of GDP by 2020, almost double the 36 percent of GDP observed at the end of 2007.

Those projections, which are similar in many respects to the ones that CBO prepared in March, reflect assump-

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1. See Congressional Budget Office, *An Analysis of the President’s Budgetary Proposals for Fiscal Year 2011* (March 2010).

tions about revenues and spending that may significantly underestimate actual deficits. Because the projections presume no changes in current tax laws, they result in estimates of revenues that, as a percentage of GDP, would be quite high by historical standards. Because of the assumption that future annual appropriations are held constant in real terms, the projections yield estimates of discretionary spending relative to GDP that would be low by historical standards.

Of course, many other outcomes are possible. If, for example, the tax reductions enacted earlier in the decade were continued, the AMT was indexed for inflation, and future annual appropriations remained the share of GDP that they are this year, the deficit in 2020 would equal about 8 percent of GDP, and debt held by the public would total nearly 100 percent of GDP. A different fiscal policy would also yield different economic outcomes. For example, CBO estimates that under an alternative fiscal path similar to the one just mentioned, growth of real GDP in 2011 would be 0.6 to 1.7 percentage points higher than it is in the baseline forecast, and the unemployment rate at the end of 2011 would be 0.3 to 0.8 percentage points lower. However, later in the coming decade, real GDP would fall below the level in CBO's baseline because the larger budget deficits would reduce investment in productive capital.

Beyond the 10-year budget window, the nation will face daunting long-term fiscal challenges posed by the aging of the population and rising costs for health care. Continued large deficits and the resulting increases in federal debt over time would reduce long-term economic growth. Putting the nation on a sustainable fiscal course will require policymakers to restrain the growth of spending substantially, raise revenues significantly above their average percentage of GDP of the past 40 years, or adopt some combination of those approaches.

## The Budget Outlook

Fiscal year 2010 will mark a change in the recent trends that have prevailed for both revenues and outlays. After falling sharply during the recession, revenues are projected to increase (in nominal dollars) for the first time in three years, rising by \$38 billion, or about 2 percent. Outlays, which have grown rapidly in recent years because of the recession, the turmoil in financial markets, and policies enacted in response to those events, are expected to decline by about 1 percent.

On the basis of tax collections through July 2010, CBO expects federal revenues to total \$2.1 trillion this fiscal year, or about 14.6 percent of GDP (see Summary Table 1). Gains in receipts in recent months indicate that federal revenues are beginning to recover from the recession. In the period from October to December 2009, revenues were about 10 percent lower than in the same quarter a year earlier. But from January to July 2010, revenues were about 6 percent greater than in the comparable period of 2009.

Outlays are expected to total \$3.5 trillion this year, or nearly 24 percent of GDP—a level slightly lower than the 25 percent share recorded last year but still much higher than the average level of roughly 21 percent of GDP over the past 40 years (see Summary Figure 1). Spending has dropped sharply this year for certain programs related to the federal government's response to the turmoil in the housing and financial markets. For activities other than those programs, overall spending will rise by 10 percent in 2010, CBO estimates.

Over the next few years, federal budget deficits would decline markedly as a share of GDP if the current-law assumptions about fiscal policy in CBO's baseline came to pass. Under those assumptions, the deficit would drop to 7.0 percent of GDP in 2011 and 4.2 percent in 2012 and then would reach a low of 2.5 percent of GDP in 2014. For the rest of the 10-year projection period, deficits would range between 2.6 percent and 3.0 percent of GDP, close to the average of 2.6 percent of GDP experienced over the past 40 years.

In CBO's baseline, total revenues climb sharply in the next few years, from 14.6 percent of GDP in 2010 to 17.5 percent in 2011 and 18.7 percent in 2012. That increase is attributable in part to the scheduled expiration of tax provisions originally enacted in 2001, 2003, and 2009 (including temporary relief from the AMT, which expired at the end of December 2009) and in part to the anticipated economic recovery. Revenues will also be boosted by provisions of the recently enacted health care legislation (the Patient Protection and Affordable Care Act, as amended by the Health Care and Education Reconciliation Act of 2010), which are estimated to increase receipts by growing amounts over the next few years, reaching 0.6 percent of GDP by 2020. In addition, the structure of the individual income tax will gradually raise receipts over time. Together, all of those factors push federal revenues in CBO's baseline to 21.0 percent of GDP

**Summary Table 1.****CBO's Baseline Budget Outlook**

	Actual												Total, 2011-	Total, 2011-
	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2015	2020
<b>In Billions of Dollars</b>														
Total Revenues	2,105	2,143	2,648	2,953	3,236	3,561	3,743	3,975	4,201	4,421	4,640	4,856	16,140	38,234
Total Outlays	3,518	3,485	3,714	3,618	3,760	4,000	4,250	4,560	4,780	4,983	5,274	5,541	19,342	44,480
<b>Total Deficit (-) or Surplus</b>	<b>-1,413</b>	<b>-1,342</b>	<b>-1,066</b>	<b>-665</b>	<b>-525</b>	<b>-438</b>	<b>-507</b>	<b>-585</b>	<b>-579</b>	<b>-562</b>	<b>-634</b>	<b>-685</b>	<b>-3,202</b>	<b>-6,246</b>
On-budget	-1,550	-1,419	-1,154	-766	-639	-569	-650	-732	-727	-711	-777	-817	-3,778	-7,542
Off-budget <sup>a</sup>	137	77	88	101	114	131	143	148	148	149	143	132	576	1,296
Debt Held by the Public at the End of the Year	7,545	9,031	10,007	10,790	11,422	11,950	12,544	13,214	13,885	14,546	15,281	16,073	n.a.	n.a.
<b>As a Percentage of Gross Domestic Product</b>														
Total Revenues	14.8	14.6	17.5	18.7	19.4	20.1	20.1	20.4	20.6	20.8	20.9	21.0	19.2	20.1
Total Outlays	24.7	23.8	24.5	23.0	22.5	22.5	22.8	23.4	23.4	23.4	23.8	23.9	23.0	23.3
<b>Total Deficit</b>	<b>-9.9</b>	<b>-9.1</b>	<b>-7.0</b>	<b>-4.2</b>	<b>-3.1</b>	<b>-2.5</b>	<b>-2.7</b>	<b>-3.0</b>	<b>-2.8</b>	<b>-2.6</b>	<b>-2.9</b>	<b>-3.0</b>	<b>-3.8</b>	<b>-3.3</b>
Debt Held by the Public at the End of the Year	53.0	61.6	66.1	68.5	68.4	67.3	67.3	67.7	68.1	68.3	68.8	69.4	n.a.	n.a.
<b>Memorandum:</b>														
Gross Domestic Product (Billions of dollars)	14,230	14,666	15,148	15,764	16,705	17,760	18,630	19,508	20,398	21,293	22,205	23,154	84,008	190,567

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.

by 2020, compared with an average level of about 18 percent of GDP over the past 40 years.

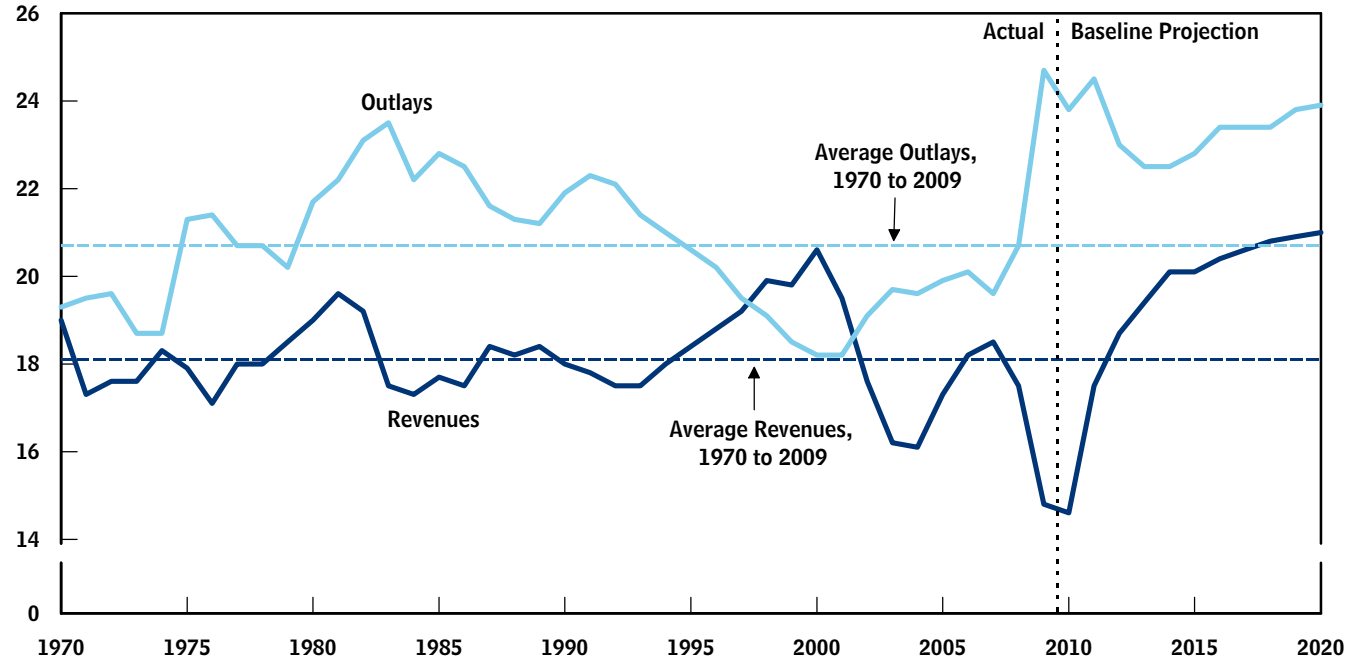
In 2011, federal outlays in CBO's baseline total \$3.7 trillion (24.5 percent of GDP), almost \$230 billion more than the amount anticipated for this year. Much of that increase stems from temporary factors that have held down outlays this year. Net outlays in 2010 for the Troubled Asset Relief Program were reduced by an adjustment to the outlays recorded for the previous year, and premiums paid by banks for deposit insurance were unusually high this year; neither factor is expected to recur next year. Furthermore, because October 1, 2011, falls on a weekend, some benefit payments will shift from fiscal year 2012 into 2011. In the other direction, outlays related to Fannie Mae and Freddie Mac are projected to decline significantly in 2011. With all of those factors excluded, total outlays would be only about \$80 billion more than the projection for this year.

As spending from the American Recovery and Reinvestment Act of 2009 tails off and as the anticipated economic recovery allows payments for unemployment compensation and other benefits that automatically rise during recessions to continue returning toward more typical levels, outlays are projected to decline to 23.0 percent of GDP in 2012 and then to fall a bit further before rising eventually to 23.9 percent by 2020. Relative to GDP, mandatory spending is projected to rise (outlays for Medicare, Medicaid, and Social Security contribute significantly to that increase), and discretionary outlays are projected to fall. From 2012 through 2020, outlays in CBO's baseline average 23.2 percent of GDP—2.5 percentage points higher than the average over the past 40 years.

The federal government's spending on interest is determined largely by the stock of debt and prevailing interest

**Summary Figure 1.****Total Revenues and Outlays**

(Percentage of gross domestic product)



Source: Congressional Budget Office.

rates. The amount of federal debt held by the public has skyrocketed in the past two years: from 40 percent of GDP at the end of 2008 to nearly 62 percent at the end of this year, CBO estimates. Interest rates, however, have fallen to historically low levels, so despite the higher levels of debt, interest costs have not yet increased significantly.

Interest rates are expected to rise noticeably in the next few years, though, and under the assumptions of CBO's baseline, debt held by the public is projected to exceed 69 percent of GDP by the end of 2020. As a result, over the next decade, the government's annual net spending for interest is projected to more than double as a share of GDP, increasing from 1.5 percent in 2011 to 3.4 percent by 2020 (see Summary Figure 2). Over the 10-year projection period, such spending grows at an average rate of 15 percent a year.

**The Economic Outlook**

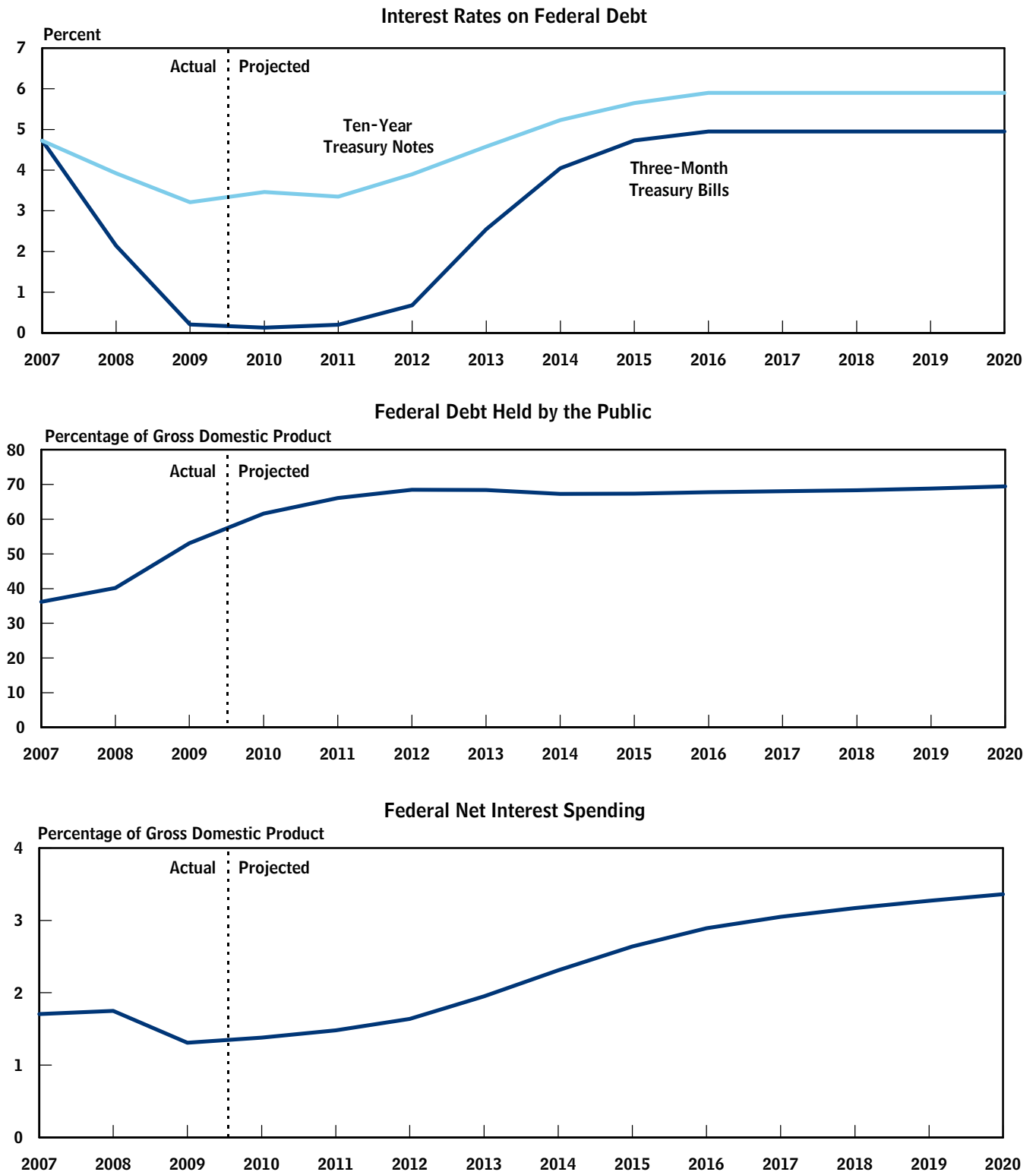
The pace of growth after the recent recession is likely to be slower than usual as the economy recovers from the effects of the financial crisis and as the support to economic activity provided by fiscal policy diminishes. In

the past, many recoveries from deep recessions have been quite robust. After deferring purchases during a slump (especially for expensive goods like homes, automobiles, and capital equipment), households and businesses typically boost their spending quickly as economic prospects improve. However, international experience suggests that recoveries from recessions that were spurred by financial crises tend to be slower than average—perhaps because the losses in wealth and damage to the financial system that occur during such crises weigh on spending for a number of years. Following such a crisis, it takes time for consumers to rebuild their wealth, for financial institutions to restore their capital bases, and for nonfinancial firms to regain the confidence required to invest in new plant and equipment; all of those forces tend to restrain spending. In addition, under current law, both the waning of fiscal stimulus and the scheduled increases in taxes will temporarily subtract from growth, especially in 2011.

In CBO's projections, real GDP increases by 2.8 percent between the fourth quarter of calendar year 2009 and the fourth quarter of 2010 and by 2.0 percent in 2011 (see Summary Table 2). Such rates of growth are well below

**Summary Figure 2.**

**Net Interest and Its Determinants in CBO's Baseline**



Source: Congressional Budget Office.

**Summary Table 2.****CBO's Economic Projections for Calendar Years 2010 to 2020**

	Forecast		Projected Annual Average	
	2010	2011	2012-2014	2015-2020
<b>Calendar Year Average</b>				
Nominal GDP				
Billions of dollars	14,804	15,262	17,987 <sup>a</sup>	23,398 <sup>b</sup>
Percentage change	3.8	3.1	5.6	4.5
Unemployment Rate (Percent)	9.5	9.0	6.7	5.0
Interest Rates (Percent)				
Three-month Treasury bill rate	0.2	0.2	2.8	4.9
Ten-year Treasury note rate	3.4	3.5	4.7	5.9
<b>Fourth Quarter to Fourth Quarter (Percentage change)</b>				
Real GDP	2.8	2.0	4.1	2.4
GDP Price Index	1.0	1.0	1.6	2.0
PCE Price Index	0.9	1.1	1.6	2.0
Core PCE Price Index <sup>c</sup>	0.9	1.1	1.5	2.0
Consumer Price Index <sup>d</sup>	0.8	1.2	1.8	2.3

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

Notes: The dollar values for nominal GDP do not incorporate the July 2010 revisions of the national income and product accounts.

Economic projections for each year from 2010 to 2020 are in Appendix C of this report.

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

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

historical norms for a recovery from a severe recession; for example, following the deep recession of 1981 and 1982, real GDP surged by nearly 8 percent in 1983 and by roughly 6 percent in 1984. In CBO's forecast, the growth of real GDP picks up after 2011, averaging 4.1 percent annually from 2012 through 2014 and closing the gap between GDP and its potential level (the amount of production that corresponds to a high use of labor and capital) by the end of 2014.

The modest growth in output projected for the next few years points to sluggish growth in employment during the remainder of this year and next. Consequently, CBO projects that the unemployment rate will decline slowly, falling to 9.3 percent at the end of 2010 and 8.8 percent at the end of 2011. After that, the growth in employment will accelerate, and the unemployment rate will decline more rapidly, reaching 5.1 percent at the end of 2014.

Inflation in the prices of consumer goods and services (calculated using the price index for personal consumption expenditures, or PCE) is projected to be about 1 percent in 2010 and 2011, when measured on a fourth-quarter-to-fourth-quarter basis. Core inflation, which excludes the prices of food and energy, is also projected to be about 1 percent this year and next. CBO projects that inflation will pick up moderately thereafter but remain below 2.0 percent from 2012 through 2014.

Interest rates in CBO's projections remain very low through the end of 2011 and then rise gradually as the recovery continues. The Federal Reserve is unlikely to raise its target for the federal funds rate (the interest rate at which depository institutions lend reserves to each other overnight) from its near-zero level while the recovery remains subdued and inflation stays low. As a result, the interest rate on 3-month Treasury bills will average

0.2 percent in 2010 and 2011, CBO projects. However, given CBO's outlook that the economy will strengthen and inflation will increase somewhat between 2012 and 2014, the projected 3-month Treasury bill rate averages 2.8 percent in those years. In the projections, the interest rate on 10-year Treasury notes, which is influenced by investors' expectations about monetary policy and other factors, edges up from an average of 3.4 percent in 2010 to 3.5 percent in 2011 and then rises to an average of 4.7 percent over the 2012–2014 period.

Beyond 2014, CBO projects, growth in real GDP will match the growth of potential GDP at 2.4 percent. In the agency's projections, the unemployment rate averages 5.0 percent from 2015 through 2020, and inflation (as

measured by the PCE price index) averages 2.0 percent. During that period, the interest rates on 3-month Treasury bills and 10-year Treasury notes average 4.9 percent and 5.9 percent, respectively.

Economic forecasts are always subject to considerable uncertainty. The uncertainty regarding CBO's current forecast is especially large, both because forecasting the path of the economy near turning points in the business cycle is always difficult and because the current business cycle has been unusual in a variety of ways. Many developments could lead to outcomes that differ substantially, in one direction or the other, from those CBO has projected.