Summary

Each January, the Congressional Budget Office (CBO) issues its outlook for the budget and the economy to help the Congress prepare for the upcoming legislative year. The baseline budget projections that CBO provides are based on the assumption that current laws and policies remain unchanged as well as on various estimates and assumptions about how the economy will behave and government programs will operate. Such projections are always uncertain, but this year, the uncertainty seems to be magnified. As a result, estimates of budgetary outcomes should be interpreted cautiously.

Uncertainty in the Outlook

The uncertainty that surrounds the baseline can be broken down into three main types: economic, geopolitical, and legislative. Many of the possible outcomes encompassed by that uncertainty are more likely to worsen than to improve the budget outlook.

Economic Uncertainty

The economy continues to rebound from the recession of 2001. The future course of the recovery depends in large part on whether consumers will continue to provide the foundation for the economy's growth. Despite the three-year decline in the stock market, the household sector has been a source of strength throughout the recession and into the recovery. The growth of consumer spending is uncertain in the near term, however, because demand is weak in many other sectors of the economy. Spending by the business sector has not yet recovered, as weak corporate profits and excess capacity from overinvestment during the "bubble" years of the late 1990s have inhibited investment. Moreover, uncertainty about the strength of demand, and about the risks arising from terrorism and war, have led businesses to be particularly cautious in hiring. In addition, deteriorating state and local government finances have curtailed spending and may prompt some tax increases.

Nevertheless, some indications point to a brighter outlook for the economy as the year goes forward. Investors and consumers appear to have gained confidence in recent months, and the stock market has moved tentatively upward since its low in October. Spending by businesses on equipment and software, particularly on information technology, strengthened last year, and inventories may be reaching the point at which firms need to restock their shelves. Finally, the drop in the exchange value of the U.S. dollar sets the stage for stronger growth of exports.

Over the longer haul, the question of labor productivity looms large. From 1951 through 1973, the growth of gross domestic product (GDP) per worker—after adjusting for the business cycle—averaged about 2.2 percent a year. However, from 1974 through 1995, the growth of productivity slowed substantially, to a rate that was little more than half as fast. More recently, though, productivity growth picked up again, to about the same rate experienced during the high-growth period.

CBO's economic projections incorporate the assumption that the growth of GDP per worker will average 2 percent per year from 2003 through 2013. Productivity growth could turn out to be lower than that, however, as it was for nearly a quarter-century before the acceleration in the mid-1990s. Lower growth of productivity would reduce economic growth and worsen the budget's bottom line. Alternatively, productivity could rise more quickly than CBO has anticipated, mirroring the period of faster growth in the late 1990s. That outcome would reduce projected deficits or increase projected surpluses.

Summary Table 1.

The Budget Outlook Under CBO's Adjusted Baseline

(In billions of dollars)

	Actual 2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Total, 2004-2008	Total, 2004-2013
On-Budget	-317	-361	-319	-268	-228	-205	-185	-165	-145	-26	134	177	-1,206	-1,231
Off-Budget[a]	160	162	174	195	212	231	250	268	286	303	317	330	1,063	2,568
Total Surplus or Deficit (-)	**-158**	**-199**	**-145**	**-73**	**-16**	**26**	**65**	**103**	**140**	**277**	**451**	**508**	**-143**	**1,336**
Total Surplus or Deficit (-) as a Percentage of GDP	-1.5	-1.9	-1.3	-0.6	-0.1	0.2	0.5	0.7	0.9	1.7	2.7	2.8	-0.2[b]	0.9[b]
Debt Held by the Public at the End of the Year	3,540	3,766	3,927	4,013	4,045	4,034	3,983	3,894	3,766	3,501	3,062	2,565	n.a.	n.a.
Debt Held by the Public at the End of the Year as a Percentage of GDP	34.3	35.0	34.7	33.6	32.2	30.4	28.5	26.5	24.3	21.5	18.0	14.4	n.a.	n.a.

Source: Congressional Budget Office.

Notes: These projections incorporate the assumption that discretionary budget authority totals $751 billion for 2003 and grows with inflation thereafter.

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.
b. As a percentage of cumulative GDP over the period.

Geopolitical Uncertainty

Instability in the international arena could certainly have implications for the U.S. economy and the budget. War with Iraq, for example, would require increased defense spending for supplies and other near-term needs as well as for the future replenishment of resources used in combat. Substantial resources might also be needed for reconstruction, occupation, and assistance to allies. In addition, such a war could have implications for oil prices (positive ones if the war went quickly and smoothly; negative ones if it took longer than expected and production was disrupted), which would ripple through the economy.

The ongoing threat of terrorism is also likely to have budgetary implications. Shortly after the terrorist attacks of September 11, 2001, the Congress and the President enacted $40 billion in supplemental appropriations; another $25 billion was approved last summer. Concerns about homeland security and the implementation of measures to prevent future attacks will maintain the pressure to increase federal spending. And any additional terrorist attacks could threaten the economy's recovery.

Legislative Uncertainty

CBO's baseline projections are intended to serve as a neutral benchmark against which to measure the effects of possible changes in tax and spending policies—they are not a forecast or prediction of future budgetary outcomes. The projections are constructed according to both rules set forth in law and long-standing practices and are designed to project federal revenues and spending under the assumption that current laws and policies remain unchanged. Thus, legislation enacted by the Congress and the President is likely to alter the bottom line in the baseline.

Pressures to increase spending and reduce taxes could lead to a substantially worsened budgetary picture. For example, final appropriations for fiscal year 2003 could exceed the $751 billion that apparently has been agreed upon by the Republican leadership and the President, especially if supplemental appropriations were enacted later in the year. Other legislative action could also dim the outlook. Measures intended to stimulate the economy, fund military action and subsequent redevelopment in Iraq, extend expiring tax cuts, modify the alternative minimum tax, establish a prescription drug benefit for the elderly, or meet other pressing national needs could substantially increase projected deficits or reduce projected surpluses in the future.

The Budget Outlook

If current policies remained in place, the federal budget deficit would grow from $158 billion in 2002 to $199 billion in 2003, by CBO's projections (*see Summary Table 1*). In nominal dollars, such a deficit would be the largest since 1994; however, at 1.9 percent of GDP, it would be well below the share of the economy that deficits accounted for in the 1980s through the mid-1990s.

Revenues in CBO's outlook are anticipated to resume their upward path in 2003 after falling in both 2001 and 2002. (The decrease in revenues from 2001 to 2002—nearly 7 percent—was the largest annual drop, in percentage terms, since 1946.) Total revenues are projected to grow to $1.9 trillion this year—about $68 billion (or 3.7 percent) above the amount recorded in 2002 but well below the $2.0 trillion that the government collected in the peak year of 2000. Much of that projected growth can be traced to the improved economic prospects that CBO forecasts for 2003. At 17.9 percent of GDP, estimated revenues for this year are roughly at the average for the 1962-2002 period (*see Summary Figure 1*).

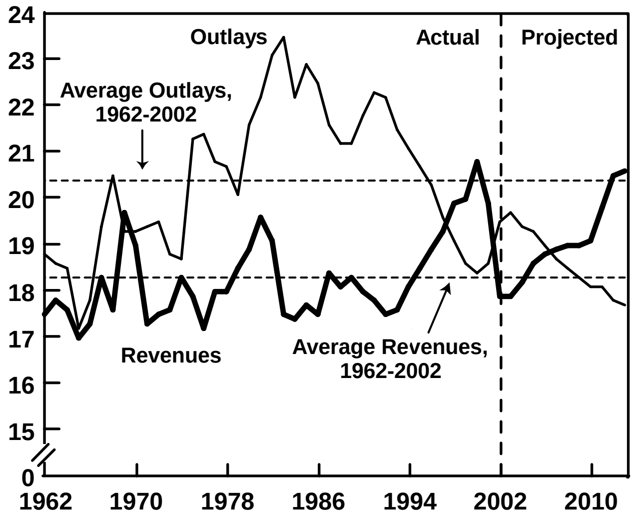
Outlays, by CBO's estimates, will grow to over $2.1 trillion this year, a rise of $110 billion (or 5.5 percent) from 2002. Although net interest costs are falling (because of low interest rates), spending for all of the government's other programs and activities is projected to grow by 6.7 percent. That rate of increase is well below the 11 percent growth of noninterest spending in 2002—but still greater than the 3 percent average growth during most of the 1990s.

Fueling the rise in spending are boosts in discretionary outlays and continued growth of entitlements. Both defense discretionary spending (up by $28 billion from 2002) and nondefense discretionary spending (up by $30 billion) are expected to rise by nearly 8 percent this year. Those estimates are based on the assumption that discretionary budget authority for 2003 will total $751 billion.[1] Both kinds of discretionary spending grew even faster in 2002 than the growth projected for 2003: defense outlays rose by 14 percent, and nondefense outlays, by 12.3 percent.

Summary Figure 1.

Total Revenues and Outlays as a Share of GDP, 1962-2013

(Percentage of GDP)



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

Note: CBO's projections incorporate the assumption that discretionary budget authority totals $751 billion for 2003 and grows with inflation thereafter.

Spending for mandatory programs—which now consumes over half of all federal outlays—is estimated to increase in 2003 by $66 billion over its level in 2002. Social Security, Medicare, and Medicaid account for much of that jump. Total mandatory spending is projected to rise more slowly in 2003, at a rate of 6.0 per-

1. Programs funded by 11 of the 13 regular appropriation bills are currently governed by a continuing resolution that, for the most part, provides funding authority at the 2002 level. However, the apparent agreement by the President and the Republican leadership would put total appropriations for 2003 in those 13 bills at about $751 billion. Pending enactment of the regular appropriations, CBO has used that figure as the basis for projecting discretionary spending.

Summary Table 2.

CBO's Economic Forecast for Calendar Years 2003 and 2004

	Estimated 2002	Forecast 2003	Forecast 2004
Nominal GDP (Percentage change)	3.6	4.2	5.4
Real GDP (Percentage change)	2.4	2.5	3.6
Consumer Price Index (Percentage change)[a]	1.6	2.3	2.2
Unemployment Rate (Percent)	5.8	5.9	5.7
Three-Month Treasury Bill Rate (Percent)	1.6	1.4	3.5
Ten-Year Treasury Note Rate (Percent)	4.6	4.4	5.2

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

a. The consumer price index for all urban consumers.

cent, than it did in 2002—when it climbed by 9.6 percent. In particular, the rate of growth of Medicaid outlays is expected to drop from 13.2 percent in 2002 to 6.4 percent in 2003 as a result of slower growth in enrollment, smaller increases in payment rates, and restrictions on certain types of spending.

Declining interest payments will offset some of the increases in discretionary and mandatory outlays, CBO estimates. Despite a rise in debt held by the public, low interest rates in 2003 are projected to reduce net interest payments by $14 billion (or 8.1 percent).

As the 10-year budget period (2004 through 2013) progresses, revenues are estimated to grow more quickly than outlays under baseline assumptions. CBO projects that revenues will grow by an average annual rate of 6.3 percent through 2010—increasing from 17.9 percent of GDP in 2003 to 19.1 percent in 2010. That increase occurs principally because of the tendency of the tax system, as income grows, to increase the proportion of income that it collects in taxes. After 2010, that tendency is exacerbated by the scheduled expiration of the tax cuts enacted in 2001 in the Economic Growth and Tax Relief Reconciliation Act (EGTRRA).

In contrast to the rise in revenues relative to GDP, the growth of total outlays under baseline assumptions does not keep pace with the growth of the economy. Mandatory spending—led by Medicare and Medicaid—is expected to grow slightly faster than the economy (at an average annual rate of 5.4 percent, compared with projected growth in nominal GDP of 5.2 percent). But discretionary spending in CBO's projections rises only by the rate of inflation (as specified in the Balanced Budget and Emergency Deficit Control Act of 1985), or about half as fast as nominal GDP. And interest payments—with debt held by the public growing slowly in the near term and shrinking in later years—are estimated to decline from 1.5 percent of GDP in 2003 to 0.9 percent in 2013.

For the five years from 2004 through 2008, CBO projects that if current policies remained unchanged (and the economy followed the path of CBO's projections), deficits would diminish and surpluses would reappear, leaving the budget roughly balanced. Over the 2004-2008 period, the cumulative deficit would total $143 billion, or 0.2 percent of GDP, by CBO's estimates.

For the 10-year period from 2004 through 2013, the cumulative surplus is projected to total $1.3 trillion. But the last three years of the period are almost entirely responsible for that total. Projected surpluses from 2011 through 2013—the years after EGTRRA is scheduled to expire—account for nearly 93 percent of the 10-year sum. (CBO estimates that if EGTRRA is not extended, revenues will climb to more than 20.5 percent of GDP—a level previously seen only during World War II and in 2000.) Through 2010, the budget is projected to be close to balance; annual deficits and surpluses generally total 1 percent or less of GDP.

Just past the 10-year baseline period, however, loom significant long-term strains on the budget that intensify as the baby-boom generation ages. The number of people of retirement age will surge by about 80 percent over the next 30 years—increasing costs for federal benefit programs—while the number of workers whose taxes help pay for those benefits is expected to grow by only 15 percent. In addition to the demographic situation, the costs per enrollee in federal health care programs are likely to grow much faster than inflation. As a result, the amount that the government spends on its major health and retirement programs (Medicare, Medicaid, and Social Security) is projected to consume a substantial portion of what the government now spends on the entire budget.

The Economic Outlook

CBO expects that the slow economic recovery will continue, with real (inflation-adjusted) GDP growing by 2.5 percent in calendar year 2003 and 3.6 percent in 2004 (*see Summary Table 2*). That growth is comparable to the pace following the 1990-1991 recession. The unemployment rate is expected to stabilize in 2003 at 5.9 percent and then edge down to 5.7 percent in 2004. As the recovery achieves a firmer footing, CBO assumes that the Federal Reserve will gradually shift monetary policy from its current accommodative stance toward a more neutral one; consequently, both short- and long-term interest rates are expected to rise in late 2003 and during 2004. In CBO's current forecast, inflation in the consumer price index (CPI) remains below 2.5 percent for the next two years.

For the period from 2005 through 2013, CBO estimates that real GDP will grow at an average annual rate of 3.0 percent. CBO's projections for unemployment, interest rates, and inflation during that period are quite similar to the ones it published last August. Thus, CBO projects that the unemployment rate will decline to 5.2 percent (which equals CBO's estimate of the nonaccelerating inflation rate of unemployment); the interest rate on three-month Treasury bills will reach 4.9 percent; the 10-year note rate will average 5.8 percent; and CPI inflation will average 2.5 percent annually.

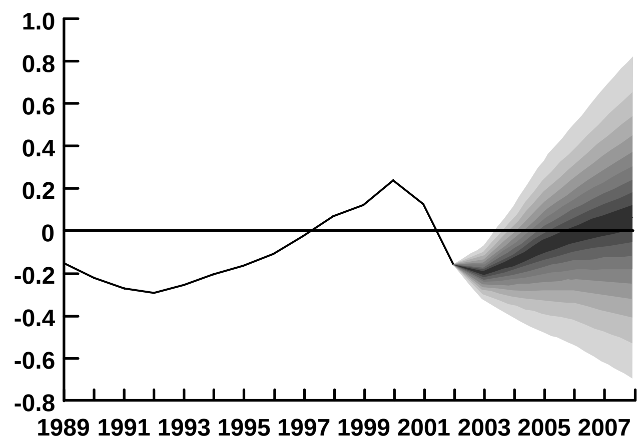
Uncertainty and Budget Projections

As discussed earlier, significant uncertainty surrounds CBO's baseline projections, some of which is intentionally not factored into the estimates. For example, CBO does not predict future legislative changes—indeed, any attempt to incorporate those actions would undermine the usefulness of the baseline as a benchmark.

Summary Figure 2.

Uncertainty of CBO's Projections of the Total Budget Surplus Under Current Policies

(In trillions of dollars)



Source: Congressional Budget Office.

Note: Calculated on the basis of CBO's forecasting track record, this figure shows the estimated likelihood of alternative projections of the total budget surplus under current policies. CBO's projections described in Chapter 1 fall in the middle of the darkest area. Under the assumption that tax and spending policies do not change, the probability is 10 percent that actual deficits or surpluses will fall in the darkest area and 90 percent that they will fall within the whole shaded area.

Actual surpluses or deficits will of course be affected by legislation enacted during the next 10 years, including decisions about discretionary spending. The effects of future legislation are not included in this figure.

For an explanation of how CBO calculates the probability distribution, see *Uncertainties in Projecting Budget Surpluses: A Discussion of Data and Methods* (February 2002), available at www.cbo.gov; an update of that publication will appear shortly.

Much uncertainty also stems from the fact, however, that the U.S. economy and the federal budget are highly complex and are affected by many economic and technical factors that are difficult to foresee. CBO's baseline projections represent the midrange of possible outcomes, calculated on the basis of past and current trends and the assumption that current policies do not change. But actual budgetary outcomes will almost certainly differ from CBO's baseline projections.

In view of that sort of uncertainty, the outlook for the budget can best be described as a fan of probabilities surrounding the point estimates presented in this report (*see Summary Figure 2 on page xix*). Not surprisingly, those probabilities widen as the projection period extends. As the fan chart makes clear, outcomes quite different from those in CBO's baseline have a significant likelihood of coming to pass.