CBO TESTIMONY

Statement of
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on
The Economic and Budget Outlook: Fiscal Years 1997-2006

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Chairman Domenici, Senator Exon, and Members of the Committee, I am pleased to be with you this morning to review the state of the economy and the budget. Three weeks ago, the Congressional Budget Office (CBO) released *The Economic and Budget Outlook, Fiscal Years 1997-2006: A Preliminary Report*, which presents our current views. My testimony today summarizes that report and presents updated baseline budgetary projections that have been slightly revised to reflect the enactment since that report was issued of the farm bill, the spending and revenue provisions in the debt limit bill, and a new continuing resolution. It also summarizes CBO's analysis of the President's recent budget submission, as well as work that CBO has done on the long-term budgetary effects of the aging of the baby-boom population. Along with more detailed information on baseline projections, those analyses will be published in CBO's annual report to be released next month.

CBO projects that the deficit will decline for the fourth straight year in fiscal year 1996 and that the economy will continue to expand at a moderate rate. But if current policies for revenues and entitlements are not changed, and if discretionary appropriations keep pace with inflation, the deficit will begin to grow steadily in 1997. If discretionary spending is not adjusted for inflation, the deficit will level off in nominal terms at about $180 billion and shrink in relation to the size of the economy. Both the Congress and the President, however, have proposed changes in policies that would balance the budget by 2002.

The President presented a set of policy changes intended to eliminate the deficit in the budget he submitted in March. Under CBO's more cautious economic and technical assumptions, the basic policies outlined in the President's budget would bring down the deficit to about $80 billion by 2002 instead of producing the budget surplus that the Administration estimates. However, CBO estimates that additional, contingent policies proposed in the budget, which are to be carried out if deficits are higher than the Administration projects, would produce a small surplus in 2002.

Because CBO's regular current-policy projections extend only through 2006, they do not reflect a major event that will first begin to affect deficits about five years after 2006--namely, the aging of the baby-boom generation. Combined with anticipated continued growth in the per-person cost of Medicare, the increase in the number of beneficiaries of federal programs for the elderly and a slowing in the rate of growth of the labor force will put enormous pressure on the budget. If those pressures are not dealt with by reducing spending or increasing taxes, the mounting deficits could seriously erode future economic growth. Balancing the budget by 2002 will help alleviate the pressures, particularly if the deficit reduction package enacted includes measures that would slow the growth of entitlement spending. But the size of the future problem is so great that eliminating the deficit by 2002 would not alone ensure that future deficits remain at an acceptable level without additional changes in spending and taxes.

CBO projects that the deficit will fall to $144 billion in 1996, or 1.9 percent of gross domestic product (GDP). That figure is $28 billion lower than CBO predicted last winter in its report *The Economic and Budget Outlook: December 1995 Update.* The reduction in the estimated deficit stems largely from enacted appropriations. Those appropriations are expected to reduce discretionary spending by almost $20 billion from the statutory limit on discretionary outlays that CBO used as the basis for its December baseline projections.

CBO's current outlook for the deficit after 1996 is not very different from its December one. On average, the deficits projected for 1997 through 2005 in the comparable current baseline are lower than CBO's December projections by about 0.2 percent of GDP.

Estimates of the size of the deficit in 1997 and its course after that depend heavily on assumptions about economic conditions and the level of discretionary spending that annual appropriation legislation will provide. For the annual report this year, CBO has produced four different baseline projections of spending and revenues, which vary according to assumptions made about the course of the economy and the growth of discretionary spending. For all four of the baseline projections, CBO

assumes that current laws governing mandatory spending programs and revenues will not change.

Economic Assumptions

CBO has produced two sets of economic projections. The first set is the traditional one for the annual report, which assumes no change in current budgetary policies. Therefore, those economic projections are consistent with projections of the levels of spending, revenues, and deficits that will occur if budgetary policies do not in fact change.

A second set of projections incorporates the economic effects anticipated if the deficit is eliminated by 2002--a goal that both the Congress and the President have endorsed. CBO assumes that balancing the budget would lower interest rates and slightly increase economic growth. Consequently, federal interest payments would decrease and revenues would increase. As with CBO's economic forecast of last December, this set of projections was developed as an aid to policymakers considering plans to balance the budget by 2002. It does not represent an alternative projection of the course of the economy if no such plan is carried out.

The economic outlook has not changed significantly since December. CBO continues to believe that the U.S. economy is fundamentally sound and estimates that the chances of a major downturn in the next two years are not high. CBO does not attempt to forecast cyclical economic patterns beyond two years. Hence, economic projections for 1997 through 2006 represent CBO's estimates of the average economic performance over the period, based on an assessment of the fundamental factors affecting the economy.

Under the current-policy economic assumptions, CBO projects that the economy, as measured by real GDP, will grow at slightly below its noninflationary potential rate of growth over the next three years. After that, CBO assumes that the economy will on average grow at the potential rate--estimated by CBO to be 2.1 percent a year (see Table 1 on page 23). The unemployment rate is expected to average 6 percent over the 1997-2006 period, 0.4 percentage points above the rate for the first quarter of 1996. The projected level is also slightly above CBO's estimate of the nonaccelerating inflation rate of unemployment (NAIRU) because the average unemployment rate has historically been slightly higher than the NAIRU. Inflation, as measured by the consumer price index, will climb slightly over the next two years but will average a moderate rate of about 3 percent a year during the 1997-2006 period. CBO forecasts little change in long-term and short-term interest rates over the next two years. Similarly, it projects that the average level of interest rates for 1998 through 2006 will be close to current levels.

If instead of assuming that current budgetary policies continue, CBO assumes that the budget will be balanced by 2002, projected interest rates would be 110 basis points (1.1 percentage points) lower by 2002, and real growth would be 0.1 percentage point a year higher (see Table 2). The economic projections that assume a balanced budget are quite similar to CBO's December 1995 projections, which also assumed a balanced budget by 2002.

Assumptions About Discretionary Spending

As with the economic variables, CBO has made two different assumptions about the path of discretionary spending. Such spending is uncertain under current law because it is governed by annual appropriations instead of permanent law. The starting point for both sets of projections is the level of appropriations enacted for 1996 (assuming the amount of spending that would result from extending the current continuing resolution for a full year).

In the first set of projections, discretionary spending is assumed to grow at the rate of inflation up to the statutory caps imposed on it through 1998. CBO projects that 1996 appropriations from the Violent Crime Reduction Trust Fund (VCRTF) adjusted for inflation will be below the limit set on that spending in both 1997 and 1998. Consequently, the caps would not affect VCRTF spending.

However, although inflated general-purpose discretionary spending (all discretionary spending other than VCRTF spending) will be below its cap in 1997, it will exceed the cap in 1998. Therefore, CBO assumes that general-purpose discretionary spending will equal the cap in 1998 and will grow from that level at the rate of inflation in 1999 through 2006.

In the second set of projections, discretionary funding remains frozen at the dollar level provided in the 1996 appropriation bills in all years through 2006. In that case, the caps never become constraining.

Baseline Budget Projections

The combination of two alternative assumptions about the economy and two assumptions about discretionary spending produces four different sets of deficit projections (see Table 3).

Under current-policy economic assumptions, the projected deficit will grow steadily, both in nominal terms and as a percentage of GDP, if discretionary spending is at the cap level adjusted for inflation. If discretionary spending policy is to freeze appropriations at the 1996 dollar amount, deficits will level off at around $180 billion a year and decrease as a percentage of GDP. Even at the relatively low levels of

inflation that CBO assumes over the next 10 years, such a freeze would cut the purchasing power of discretionary appropriations by about 25 percent by 2006.

Under the balanced budget economic assumptions, the deficit will grow in both nominal terms and as a percentage of GDP if discretionary spending equals the cap in 1998 and keeps up with inflation after that. However, it will climb more slowly than under the current-policy economic assumptions. The deficit is held down by the so-called fiscal dividend--reductions in payments for interest on the debt and increases in revenues that flow from the lower interest rates and slightly faster economic growth under the economic assumptions that assume a balanced budget. If debt-service savings that stem from the lower deficits are included, the fiscal dividend would lower the deficit by $75 billion in 2002.[1]

If discretionary spending is frozen, the deficit will rise in 1997 and 1998 but then begin to decline. Although the freeze would not produce a balanced budget by 2002 (the deficit would be $106 billion), it would go a long way toward achieving the policy savings that are needed to reach budgetary balance and produce the economic benefits that this baseline assumes. That outcome is not surprising. Freezing discretionary appropriations at the 1996 level produces discretionary

1. The fiscal dividend described in CBO's report *The Economic and Budget Outlook: December 1995 Update* did not include debt-service savings resulting from the fiscal dividend itself. In addition, the interest component of that fiscal dividend was calculated on the stock of debt that would result if a balanced budget was achieved, not on the higher stock of debt implied by a continuation of current budgetary policies.

outlays in 2002 close to the level assumed by the Congress in the budget resolution for 1996. Under its December economic assumptions, CBO estimated that, given the level of discretionary spending assumed in the budget resolution, the approximately $100 billion in net deficit reduction in 2002 resulting from changes in entitlement and revenue policies proposed in H.R. 2491, the Balanced Budget Act, would eliminate the deficit in 2002.

Of course, the full amount of the savings from the fiscal dividend would result only if the budget was in fact balanced. Therefore, a baseline that reflects the economic improvements from balancing the budget but has large deficits resulting from projections of revenues and spending under current policies is internally inconsistent. Such a baseline, however, is a useful tool because it indicates the amount of direct savings from policy changes that is needed to balance the budget. Section 203 of the third continuing resolution (Public Law 104-56) directed CBO to produce a baseline in December on just such a basis to aid discussions between the Congress and the Administration on balancing the budget. The current projections based on balanced budget economic assumptions should be useful to the Budget Committees in putting together a budget resolution plan to balance the budget. CBO also used them to analyze the President's March 19 budget submission, which does balance the budget by 2002. In addition, CBO can compare the projections with the December baseline.

Changes Since December

CBO's current baseline budget projections using balanced budget economic assumptions and capped discretionary spending (with inflation after 1998) do not differ much from its December baseline projections, which used the same concepts. The currently projected deficit for 1996 is $28 billion lower than the December projection. However, about two-thirds of that change results from actions on 1996 appropriation bills that the December baseline did not reflect (see Table 4). The reductions in the deficit in the years after 1996 are smaller, by amounts ranging from $8 billion in 1998 to $29 billion in 2005. Aside from the effects of the enacted 1996 appropriations on the 1996 and 1997 deficits, relatively little change comes from enacted legislation, since few bills affecting direct spending or revenues have been signed into law since December.

Much of the change in estimated deficits for 1998 through 2005 stems from reductions in projected discretionary spending. The reductions largely reflect an adjustment to the cap that the Office of Management and Budget (OMB) made under the provisions of the Balanced Budget and Emergency Deficit Control Act of 1985 to reflect the Administration's estimate of the measure of inflation used in the cap adjustments. That estimate was lower than a year earlier. Projected spending for a number of mandatory programs (particularly Medicare and Medicaid) is also down, as are interest costs.

Lower projected revenues, however, partially offset those reductions. The drop in revenues results in part from the expiration at the end of calendar year 1995 of the airline ticket tax, which CBO estimates will cost the government $5 billion in 1996 and $10 billion by 2005. Under baseline rules, excise taxes dedicated to a trust fund that are scheduled to expire during the projection period are extended in the baseline; however, those taxes are excluded from the baseline if they have already expired before the baseline is released. Thus, those taxes were included in the December baseline but are excluded from the current revenue projections.

The 1997 deficit is affected by a substantial increase in the estimate of the proceeds from ongoing auctions by the Federal Communications Commission of licenses to use parts of the electromagnetic spectrum. The reestimate reflects both a revised estimate of the likely bids in the auctions and a decision by OMB and CBO to record installment payments for the licenses under credit reform procedures on a net present-value basis when a license is issued.

One source of significant change in both mandatory spending and revenue projections--though not shown in Table 4 because it has no net effect on the deficit--is the Telecommunications Act of 1996 (P.L. 104-104), which calls for expanding a fund to provide universal telephone service. Although the receipts and expenditures of the fund do not pass through the government, they clearly would not exist except for action taken by the federal government and thus are ultimately under

the control of the government. OMB and CBO therefore concluded that the transactions of the fund should be recorded as revenues and outlays in the budget. Those transactions include both those provided for by law before the Telecommunications Act was enacted as well as new transactions resulting from the act. Because the projected revenues equal the projected outlays in every year, including those transactions in the budget does not affect the deficit.

Additional Details of the Projections

The major sources of revenues, the major categories of spending, and the deficit under CBO's new baseline projections with current-policy economic assumptions and capped inflated discretionary spending are shown in Table 5. More detailed baseline projections of major mandatory spending programs are shown in Table 6.

BUDGET PROJECTIONS UNDER THE PRESIDENT'S POLICIES

The President submitted a budget in March that is intended to eliminate the deficit by 2002. To help ensure that the goal is achieved, the budget included two sets of policies: one that the Administration estimates will balance the budget if the Administration's economic and technical assumptions are accurate, and contingent

policies that would have to be carried out if the Administration's assumptions prove too optimistic and additional deficit reduction is required to balance the budget.

Using its economic projections that assume a balanced budget, CBO estimates that the basic policies proposed in the President's budget would lower the deficit substantially below CBO's baseline projections but that the deficit would still total $81 billion in 2002 (see Table 7). The budget would achieve deficit reductions with proposals that hold the growth of discretionary appropriations below the rate of inflation, cut the growth of Medicare and Medicaid below current-law projections, reduce projected spending for welfare programs, and limit other mandatory spending. It also proposes to shrink the deficit through sales of government assets and the auctioning of additional portions of the electromagnetic spectrum. The savings would be partially offset by a net reduction in revenues resulting from a combination of tax cuts and increases.

CBO's estimates of the deficits under the President's basic policies are higher than those of the Administration largely because CBO's baseline projections of the deficit are higher than the Administration's. The Administration's economic assumptions do not differ that much from CBO's economic projections under a balanced budget. The Administration assumes a slightly higher rate of real growth, and the projections differ in a number of other details. But, however slight, those differences do produce noticeably different deficit projections. The largest difference

is in the estimates of revenues: CBO projects current-policy revenues that are $73 billion lower under its balanced budget economic assumptions than under the Administration's economic forecast. CBO also assumes that Medicaid and some other mandatory programs will grow more rapidly under current policy than does the Administration. In addition, CBO estimates that a number of the President's proposed policy changes will reduce the deficit less than the Administration assumes. For instance, the Administration assumes that the proposed changes in the Medicaid program will cut spending by $27 billion in 2002. CBO estimates that the proposal will save $22 billion.

The package of contingent policies outlined in the President's budget would further reduce deficits, producing a surplus of $3 billion in 2002. Those policies call for the sunset of proposed tax-relief provisions after 2000, additional savings from further restraining Medicare costs, deeper cuts in discretionary spending, and new fees on television broadcasters to offset any shortfall in anticipated receipts from the proposed auction of the right to use the electromagnetic spectrum.

The aging of Americans born between 1946 and 1964 will dramatically affect the federal budget in the coming century. Because the first members of that baby-boom generation will turn 65 in 2011, those effects are not reflected in CBO's projections of spending and revenues through 2006. In the decades after 2010, however, the demographic shift will push up the deficit rapidly if no changes are made in entitlement benefits for the elderly or in taxes on the working population. Because escalating deficits would reduce investment, increase interest rates, and eventually choke off economic growth, such a path is not sustainable. Although the problem must ultimately be dealt with, it will be less painful to deal with it sooner rather than later.

Demographic Changes

The trustees of the Social Security Old-Age and Survivors and Disability Insurance (OASDI) Trust Funds estimate that the number of citizens 65 or older in 2030 will be more than double the number in 1990, while the number of working-age Americans (20 to 64 years old) will increase only about 25 percent (see Table 8). As a result, the number of retirees to be supported per worker will jump sharply.

The increase in the number of the elderly after 2010 will drive up the costs of Social Security. It will also put pressure on Medicare, which provides basic health care coverage for most people 65 and over, and Medicaid, which provides long-term care and some other assistance for the poor elderly. At the same time, revenues will grow more slowly because the growth in the number of workers will slow.

Budgetary and Economic Assumptions

The concept of a current-policy baseline is somewhat ambiguous even for the 10-year projections of spending and outlays described earlier. Over a much longer period, the approach used in those projections would produce misleading results. For instance, freezing discretionary spending at the 1996 dollar level over the next 10 years is one possible interpretation of current policy in CBO's 10-year projections, even though that level of spending would purchase only about three-fourths as much in 2006 as in 1996. But if such a freeze were continued for another 40 years, even at the relatively low inflation rate of 3 percent, discretionary appropriations would cover less than one-fourth of the cost of the armed forces, law enforcement officials, highway construction, and other goods and services that are being provided in 1996 although the population would be significantly larger.

Therefore, CBO did not attempt to extend its regular budgetary projections beyond 2006. For Social Security, Medicare, and federal retirement programs, CBO simply adopted the long-term projections made by trustees of those programs (or the Office of Personnel Management and the Department of Defense in the case of federal retirement) and adjusted for any differences between CBO's economic assumptions and those of the trustees. Various broad national income and product account (NIPA) categories of other spending were assumed to grow according to simple rules applied to each category. For instance, transfer payments (other than those included in the trustees' projections) were assumed to grow with demographic demands, labor productivity, and inflation. In the case of discretionary spending, CBO used two alternative assumptions. In one scenario, expenditures grow at the same rate as the economy. In the other, they increase at the rate of inflation. CBO assumes that revenues will remain a stable share of economic income, except for an adjustment for the growth in interest income on the federal debt and Medicare Supplementary Medical Insurance premiums, which are treated as revenues in NIPA accounting.

Similarly, in order to assess the effect of long-run budget policies, CBO had to make assumptions about fundamental forces in the economy over the coming decades. Reflecting the anticipated slowing in the growth of the labor force, CBO's base cases assume that annual growth in the total hours of work will drop from 1.2 percent in 1995 to almost nothing in 2025. Assuming further that total factor

productivity continues to grow at the average rate since 1947, annual growth of real GDP is projected to slip from 2.1 percent in 2005 to 1.2 percent in 2025 before any effects that increasing deficits will have on growth are factored in.

Long-Term Budget Projections

Because of the great uncertainty about both the budgetary and economic assumptions, CBO looked at several different scenarios and tested the sensitivity of its results to changes in the assumptions. Under an array of plausible scenarios, the deficit would grow as a percentage of GDP after about 2010. The level of the deficit in relation to the size of the economy would depend on the specific assumptions about growth in spending and revenues and on assumptions about population growth, increases in productivity, and the effects of mounting deficits on the economy.

Even without assuming any economic feedback effects from increasing deficits, one seemingly plausible path of revenues and spending (with discretionary spending growing at the rate of the economy after 2006) would produce a deficit that equals 12 percent of GDP by 2025 and debt held by the public equal to 135 percent of GDP (see Table 9). The deficit has reached levels that high only during World War II, and the debt has never been that large. The path of spending and revenues in this scenario clearly cannot be sustained because the debt-to-GDP ratio spirals out

of control after 2025. Interest payments would consume an ever larger share of federal spending.

For a path of spending and revenues to be sustainable, the resulting debt must grow no faster than the economy. One measure of the size of the problem presented by burgeoning deficits is the increase in revenues (or reduction in spending) needed to keep the debt as a percentage of GDP from exceeding its current level for the foreseeable future. Assuming that discretionary spending grows at the rate of the economy, CBO estimates that increasing revenues by an amount equal to 5 percent of GDP would achieve that goal. Since revenues in the scenario equal 20 percent of GDP, that amount would represent about a 25 percent hike in revenues. If discretionary spending is assumed to grow only at the rate of inflation after 2006, a revenue increase equal to about 3 percent of GDP (or 15 percent of revenues) would keep the debt as a percentage of GDP at or below its current level.

Other assumptions about the growth of spending produce lower projected deficits and debt. However, taking economic feedbacks into account will produce projected deficits that are significantly higher, reaching about 20 percent of GDP by 2025, assuming that discretionary spending grows with the economy. These projections are much worse because they assume that burgeoning deficits will crowd out capital, which pushes up interest rates and slows the growth of the economy. As a result, the federal tax base is weaker and federal interest costs are higher. Although

the precise path of deficits and debt as a percentage of GDP depends on the particular assumptions about demographics, productivity, and the growth of discretionary spending, the projected deficits and debt in all of the scenarios that assume the economic feedbacks and no change in policy eventually soar to levels that are clearly not sustainable.

Those results reinforce the conclusions of other analysts that the aging of the baby-boom population will eventually force policymakers to make difficult decisions about paring entitlement benefits or other spending or increasing taxes. CBO's analysis also shows that making those changes now will yield considerable benefits. For example, cutting deficits now trims future debt and interest payments on the debt, thereby reducing the programmatic cuts that would be needed later to cut deficits to the desired levels. In addition, if policies involving retirement age or benefit levels are changed, current workers should have a chance to plan for their retirement with those changes in mind. Regardless of what policy changes are made, the economic benefits of achieving a long-term, sustainable budget policy would be quite large. For example, permanently balancing the budget could raise real incomes in the United States by 10 percent to 15 percent by 2025 and by larger percentages in years thereafter.