CBO TESTIMONY

Statement of
Dan L. Crippen
Director

The Budget and Economic Outlook: An Update

before the
Committee on the Budget
U.S. House of Representatives

September 5, 2001

This document is embargoed until 10:00 a.m. (EDT), Wednesday, September 5, 2001. The contents may not be published, transmitted, or otherwise communicated by any print, broadcast, or electronic media before that time.

CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

Mr. Chairman, Representative Spratt, and Members of the Committee, I am pleased to be here today to discuss the current outlook for the budget and the economy. Last week, the Congressional Budget Office (CBO) released *The Budget and Economic Outlook: An Update*, which I will summarize today.

Recently enacted legislation and the continued sluggish behavior of the U.S. economy have reduced the projected federal budget surpluses for fiscal year 2001 and future years. CBO projects that the total budget surplus in 2001 will be $153 billion—$122 billion lower than CBO estimated in May. About two-thirds of the decrease results from new legislation; one-third comes from a weaker economy and other factors. Despite that drop, if the $153 billion surplus materializes in 2001, it will equal 1.5 percent of gross domestic product (GDP), the second largest surplus as a share of the economy since 1951.

Because of the smaller total surplus, CBO now projects a small on-budget deficit for this year. (The on-budget accounts exclude the spending and revenues of Social Security and the Postal Service.) If current tax and spending policies are maintained and the economy performs as estimated, CBO projects small deficits or surpluses in on-budget accounts for the next four years; however, steadily increasing on-budget surpluses reemerge by the middle of the decade. The projected surpluses would allow all public debt that is available for redemption to be retired by 2010.

The Budget Outlook

For the five years from 2002 through 2006, CBO projects surpluses totaling $1.1 trillion, which come almost entirely from off-budget accounts (see Table 1). For the 10-year period through 2011, CBO estimates that under current policies, surpluses will total $3.4 trillion. Social Security makes up about three-quarters of that total. In 2010, the on-budget surplus reaches 1 percent of GDP, and the total surplus grows to 3 percent of GDP. Those estimates should be viewed cautiously, however, because future economic developments, technical estimating errors, and future legislative actions could produce substantial deviations—a point that CBO discussed in detail in its January report on the budget and economic outlook.

Total surpluses for the 2002-2011 period are $2.2 trillion less than CBO projected in May, when it last published its budget baseline (see Table 2). New legislation accounts for $1.8 trillion of that decrease, and changes in the economic forecast account for another $0.3 trillion; the remainder stems from other changes (technical ones not directly driven by new legislation or by changes in the components of CBO's economic forecast).

The Economic Growth and Tax Relief Reconciliation Act of 2001 (Public Law 107-16) is estimated to reduce revenues by $70 billion in 2001 and nearly $1.2 trillion over the 2002-2011 period. That law changed numerous tax provisions, including lowering income tax rates, establishing a 10 percent tax bracket, increasing tax credits for children, repealing the estate tax, lessening the so-called marriage penalty, raising the limits on contributions to retirement accounts, and enhancing education incentives. In addition, the law increases outlays for refundable tax credits by $4 billion in 2001 and $88 billion between 2002 and 2011.

Many of the provisions of P.L. 107-16, especially the ones with the greatest impact on the budget, phase in over time. Moreover, most of the provisions expire at the end of calendar year 2010. Extending all provisions through 2011 would reduce revenues by an additional $255 billion over the 2002-2011 period.

Other legislation will also increase projected outlays through 2011. Providing additional assistance to farmers will increase spending by $5.5 billion in 2001, and the 2001 Supplemental Appropriations Act is projected to boost spending by $83 billion from 2002 through 2011. Because legislative changes will leave less money available to reduce outstanding federal debt, interest payments will increase by $413 billion over the next 10 years, CBO estimates.

Lower projections of economic growth over the next few years, along with other revisions to the economic forecast, will diminish surpluses by $283 billion between 2002 and 2011, according to CBO's projections. (Those revisions reflect changes in the economic outlook since January, when CBO last updated its economic assumptions.) In addition, technical changes will reduce surpluses by $177 billion.

In the Administration's *Mid-Session Review*, the Office of Management and Budget's (OMB's) baseline budget projections are similar, though not identical, to those presented by CBO. For 2001, OMB estimates a small on-budget surplus, whereas CBO estimates a small on-budget deficit. In each year of the projection period, CBO's estimates are lower than OMB's—overall, CBO's figure for total surpluses from 2002 through 2011 is $445 billion less. Although that discrepancy may seem large, it results from differences of just 1.0 percent in total projected revenues for the period and 0.7 percent in total projected outlays.

The Economic Outlook

CBO has revised its economic forecast to reflect the weakness in the U.S. economy during the first half of 2001. Although economic activity has slowed to a crawl, CBO believes that the economy will narrowly avoid recession and recover gradually next year. CBO now expects that the levels of both nominal and real (inflation-adjusted) GDP will be lower in 2001 and 2002 than it anticipated in January. CBO also has raised its estimates of the unemployment rate and long-term interest rates for the next few years and lowered its estimate of short-term interest rates.

CBO's current forecast assumes that growth of real GDP will average 1.7 percent this calendar year and 2.6 percent next year—for both years, those rates are about three-quarters of a percentage point lower than CBO estimated in January (see Table 3). CBO's projections do not incorporate the annual revisions to the national income and product accounts published by the Commerce Department's Bureau of Economic Analysis at the end of July, which were released after CBO's forecast was completed. Incorporating those revisions could move budget projections in either direction but probably not by very much.

Inflation, as measured by growth in the consumer price index for all urban consumers, is 0.4 percentage points higher for 2001 and 0.2 percentage points lower for 2002 than the estimates in the January forecast.

Short-term interest rates are projected to be lower in the next few years than CBO previously anticipated, but long-term rates are expected to be slightly higher. Interest rates on three-month Treasury bills are forecast to be about a full percentage point lower for both 2001 and 2002 than the levels estimated in January. However, the interest rate paid on 10-year Treasury notes is projected to be between 0.3 and 0.4 percentage points higher than previously anticipated.

CBO does not forecast fluctuations of the economy beyond two years. Instead, it extends historical patterns in the factors—increases in the labor force, rising productivity, and the rate of national saving—that underlie the growth of potential GDP. After incorporating those patterns, CBO makes economic projections that extend three to 10 years out.

For 2003 through 2011, CBO projects that growth of nominal GDP will average more than 5.2 percent a year and that growth of real GDP will average 3.2 percent—levels slightly above those estimated in January. According to CBO's projections, inflation in the 2003-2011 period will average 2.5 percent, which is similar to the rate that was anticipated last winter. Interest rates over the period will average 4.9 percent for three-month Treasury bills and 5.8 percent for 10-year Treasury notes, CBO projects—figures that are also similar to January's.

CBO's economic projections incorporate the effects of the recently enacted tax legislation. In the short run, the rebate of taxes payable on income earned in 2001 may help counter the economic slowdown by encouraging consumer spending. In the long run, the impact of the new tax law on GDP is uncertain, but any effect is likely to be small. Analysis of the law's economic effects is complicated by the sunset mechanism built into it, which establishes expiration dates for all of its provisions. People's expectations about the law's expiration in 2011 could affect their decisions about consumption, work, and saving over the next 10 years. For the purposes of its economic projections—but not for its budget calculations—CBO has ignored the expiration.

Like all forecasts, CBO's forecast is very uncertain, and economic activity could be significantly slower—or faster—than CBO currently expects. Indeed, economic indicators released since CBO's forecast suggest a weaker economy than assumed in July, though the nature of economic activity (weak business investment offset by moderate consumer spending and spending on residential structures) is close to CBO's last expectation. In light of additional weakness in construction spending and in the manufacturing sector, the latest estimate for the second quarter of this year indicates that output growth was only 0.2 percent, rather than the 0.7 percent first estimated. And indicators for July, the first month of the current quarter, suggest that growth may be less than CBO assumed because of much weaker business investment. Short-term interest rates in the current quarter are also likely to be lower than assumed in July because the Federal Reserve cut its intended federal funds interest rate another 25 basis points earlier this month.

Much of the uncertainty about medium-term growth involves the pace of investment in information technologies. The increase in the growth rate of overall productivity in the late 1990s resulted both from greater amounts of capital per worker, mainly in the information technology sector, and from more rapid growth in total factor productivity (reflecting both labor productivity and capital), probably in large part the result of innovative uses of information technologies throughout the economy. The question now is what the pace of investment in information technologies will be over the medium term and the extent to which those investments will lead to significant cost savings in other sectors of the economy.

The economic perspectives of OMB and CBO are generally quite similar, but the differences in those outlooks still account for a large part of the difference between the two agencies' budget projections. The Administration's current economic projections anticipate stronger near-term growth than CBO's projections do, with a sharp improvement in economic conditions by the end of this year. As a result, corporate profits in the Administration's forecast return to recent levels almost immediately, and the unemployment rate remains below 5 percent (see Table 4). By contrast, in CBO's forecast, profits remain weak in the near term, and the unemployment rate rises to 5.2 percent by the end of 2002. After 2002, the Administration's projections of nominal GDP and of tax bases (such as corporate profits and wages and salaries) remain slightly stronger than CBO's. Throughout most of the period, the Administration anticipates significantly lower interest rates on Treasury securities than CBO does, although the implications of that difference for the budget are limited at a time when publicly held debt is being paid down.

Table 1.
CBO's Baseline Budget Projections (By fiscal year)

	Actual 2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Total, 2002-2011
						In Billions of Dollars							
Revenues													
Individual income taxes	1,004	1,015	1,039	1,079	1,123	1,175	1,223	1,286	1,360	1,440	1,528	1,717	12,970
Corporate income taxes	207	149	210	195	215	247	253	265	278	292	307	321	2,584
Social insurance taxes	653	694	727	761	794	838	880	923	967	1,016	1,066	1,119	9,092
Other	161	152	158	160	175	178	187	189	196	204	203	185	1,833
Total	2,025	2,011	2,134	2,196	2,307	2,438	2,543	2,663	2,801	2,952	3,103	3,341	26,479
On-budget	1,545	1,503	1,602	1,638	1,723	1,822	1,897	1,985	2,089	2,204	2,319	2,518	19,795
Off-budget	481	507	532	558	584	616	647	679	712	748	785	823	6,684
Outlays													
Discretionary spending	615	647	689	717	737	759	774	789	812	833	853	878	7,842
Mandatory spending	1,032	1,092	1,181	1,243	1,313	1,387	1,454	1,531	1,625	1,724	1,831	1,961	15,249
Offsetting receipts	-81	-89	-92	-109	-112	-107	-112	-119	-125	-132	-139	-148	-1,196
Net interest	223	207	179	174	168	155	139	121	101	78	58	50	1,223
Proceeds earned on the balance of uncommitted funds[a]	0	0	0	0	0	0	0	0	0	0	-7	-29	-36
Total	1,789	1,858	1,958	2,024	2,106	2,194	2,254	2,323	2,413	2,502	2,596	2,713	23,083
On-budget	1,458	1,512	1,600	1,656	1,726	1,802	1,850	1,906	1,983	2,057	2,134	2,235	18,948
Off-budget	331	346	358	369	380	392	405	417	430	445	462	478	4,135
Surplus or Deficit (-)	236	153	176	172	201	244	289	340	389	450	507	628	3,397
On-budget	87	-9	2	-18	-3	21	47	78	106	147	184	283	847
Off-budget	150	162	174	190	204	224	242	262	283	303	323	345	2,549

SOURCE: Congressional Budget Office.

a. "Uncommitted funds" is CBO's term for the surpluses that remain each year after paying down publicly held debt available for redemption. CBO assumes that those funds, which accumulate from one year to the next, earn proceeds at a rate equal to the average interest rate projected for Treasury bills and notes.

Table 2.
Changes in CBO's Projections of the Surplus Since May 2001 (By fiscal year, in billions of dollars)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Total, 2002-2006	Total, 2002-2011
Total Surplus as Projected in May 2001	275	304	353	400	437	508	578	641	718	806	883	2,002	5,629
Changes													
Legislative													
Tax act[a]	-74	-38	-91	-108	-107	-135	-152	-160	-168	-187	-130	-479	-1,275
Other[b]	-7	-10	-8	-7	-8	-8	-8	-8	-8	-9	-9	-41	-83
Debt service[c]	*	-4	-9	-16	-23	-31	-41	-53	-65	-79	-92	-84	-413
Subtotal	-81	-52	-107	-131	-138	-174	-201	-221	-241	-274	-230	-603	-1,771
Economic	-25	-48	-54	-50	-40	-31	-23	-16	-9	-6	-5	-224	-283
Technical[d]	-16	-27	-20	-18	-15	-13	-13	-16	-17	-18	-19	-93	-177
Total	-122	-128	-182	-198	-192	-219	-238	-253	-268	-299	-254	-920	-2,232
Total Surplus as Projected in August 2001	153	176	172	201	244	289	340	389	450	507	628	1,082	3,397

SOURCE: Congressional Budget Office.

NOTE: * = less than $500 million.

a. The Economic Growth and Tax Relief Reconciliation Act of 2001 will reduce revenues by $1,186 billion and increase outlays by $88 billion between 2002 and 2011.

b. Mostly the 2001 Supplemental Appropriations Act, along with recent legislation that provides additional funds in 2001 for agricultural producers.

c. Reflects only the change in debt-service costs resulting from legislative actions. Other effects on debt-service costs are included under economic and technical changes.

d. Changes not directly driven by new legislation or by changes in the components of CBO's economic forecast.

Table 3.
CBO's Current and Previous Economic Projections for Calendar Years 2001 Through 2011

	Forecast		Projected Annual Average	
	2001	2002	2003-2006	2007-2011
Nominal GDP (Billions of dollars)				
August 2001	10,366	10,876	13,355[a]	17,145[b]
January 2001	10,446	11,029	13,439[a]	17,132[b]
Nominal GDP (Percentage change)				
August 2001	4.0	4.9	5.3	5.1
January 2001	4.7	5.6	5.1	5.0
Real GDP (Percentage change)				
August 2001	1.7	2.6	3.2	3.2
January 2001	2.4	3.4	3.1	3.1
GDP Price Index (Percentage change)				
August 2001	2.3	2.3	2.0	1.9
January 2001	2.3	2.1	1.9	1.9
Consumer Price Index[c] (Percentage change)				
August 2001	3.2	2.6	2.5	2.5
January 2001	2.8	2.8	2.6	2.5
Unemployment Rate (Percent)				
August 2001	4.6	5.2	5.2	5.2
January 2001	4.4	4.5	4.7	5.2
Three-Month Treasury Bill Rate (Percent)				
August 2001	3.9	3.8	4.9	4.9
January 2001	4.8	4.9	4.9	4.9
Ten-Year Treasury Note Rate (Percent)				
August 2001	5.3	5.6	5.8	5.8
January 2001	4.9	5.3	5.6	5.8

SOURCE: Congressional Budget Office.

NOTES: The August 2001 values for GDP and its components are based on data from the Bureau of Economic Analysis' national income and product accounts before the annual revision in July. Incorporating those revisions, which occurred after CBO had completed its forecast, could move budget projections in either direction but probably not by very much.

Percentage changes are year over year.

a. Level of GDP in 2006.

b. Level of GDP in 2011.

c. The consumer price index for all urban consumers.

Table 4.
Comparison of CBO's and the Administration's Economic Projections for Calendar Years 2001 Through 2011

	Forecast		Projected Annual Average	
	2001	2002	2003-2006	2007-2011
Nominal GDP (Billions of dollars)				
CBO	10,366	10,876	13,355[a]	17,145[b]
Administration	10,364	10,937	13,553[a]	17,488[b]
Nominal GDP (Percentage change)				
CBO	4.0	4.9	5.3	5.1
Administration	4.0	5.5	5.5	5.2
Real GDP (Percentage change)				
CBO	1.7	2.6	3.2	3.2
Administration	1.7	3.2	3.3	3.1
GDP Price Index (Percentage change)				
CBO	2.3	2.3	2.0	1.9
Administration	2.3	2.2	2.1	2.1
Consumer Price Index[c] (Percentage change)				
CBO	3.2	2.6	2.5	2.5
Administration	3.3	2.7	2.5	2.5
Unemployment Rate (Percent)				
CBO	4.6	5.2	5.2	5.2
Administration	4.6	4.8	4.6	4.6
Three-Month Treasury Bill Rate (Percent)				
CBO	3.9	3.8	4.9	4.9
Administration	3.8	3.9	4.3	4.3
Ten-Year Treasury Note Rate (Percent)				
CBO	5.3	5.6	5.8	5.8
Administration	5.2	5.2	5.2	5.2
Tax Bases (Percentage of GDP)				
Corporate book profits				
CBO	7.9	7.5	8.0	8.1
Administration	7.7	8.9	8.9	8.0
Wages and salaries				
CBO	48.6	48.9	48.4	48.1
Administration	48.1	48.2	48.6	48.1

SOURCES: Congressional Budget Office; Office of Management and Budget.

NOTES: CBO's values for GDP and its components are based on data from the national income and product accounts before the July 2001 revision.

Percentage changes are year over year.

a. Level of GDP in 2006.

b. Level of GDP in 2011.

c. The consumer price index for all urban consumers.