Congressional Budget Office

Testimony

Statement of
Douglas W. Elmendorf
Director

CBO's 2011 Long-Term Budget Outlook

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

June 23, 2011

This document is embargoed until it is delivered at 10:00 a.m. (EDT) on Thursday, June 23, 2011. The contents may not be published, transmitted, or otherwise communicated by any print, broadcast, or electronic media before that time.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

Chairman Ryan, Congressman Van Hollen, and Members of the Committee, thank you for inviting me to testify today about the Congressional Budget Office's (CBO's) *2011 Long-Term Budget Outlook*, which the agency released yesterday.[1]

Recently, the federal government has been recording budget deficits that are the largest as a share of the economy since 1945. Consequently, the amount of federal debt held by the public has surged. At the end of 2008, that debt equaled 40 percent of the nation's annual economic output (a little above the 40-year average of 37 percent). Since then, the figure has shot upward: By the end of this year, CBO projects, federal debt will reach roughly 70 percent of gross domestic product (GDP)—the highest percentage since shortly after World War II. The sharp rise in debt stems partly from lower tax revenues and higher federal spending related to the recent severe recession. However, the growing debt also reflects an imbalance between spending and revenues that predated the recession.

As the economy continues to recover and the policies adopted to counteract the recession phase out, budget deficits will probably decline markedly in the next few years. But the budget outlook, for both the coming decade and beyond, is daunting. The retirement of the baby-boom generation portends a significant and sustained increase in the share of the population receiving benefits from Social Security, Medicare, and Medicaid. Moreover, per capita spending for health care is likely to continue rising faster than spending per person on other goods and services for many years (although the magnitude of that gap is very uncertain). Without significant changes in government policy, those factors will boost federal outlays sharply relative to GDP in coming decades under any plausible assumptions about future trends in the economy, demographics, and health care costs.

According to CBO's projections, if current laws remained in place, spending on the major mandatory health care programs alone would grow from less than 6 percent of GDP today to about 9 percent in 2035 and would continue to increase thereafter.[2] Spending on Social Security is projected to rise much less sharply, from less than 5 percent of GDP today to about 6 percent in 2030, and then to stabilize at roughly that level. Altogether, the aging of the population and the rising cost of health care would cause spending on the major mandatory health care programs and Social Security to grow from roughly 10 percent of GDP today to about 15 percent of GDP 25 years from now. (By comparison, spending on *all* of the federal government's programs and activities, excluding interest payments on debt, has averaged about 18.5 percent of GDP over the past 40 years.) That combined increase of roughly 5 percentage points for such spending as a share of the economy is equivalent to about

1. See Congressional Budget Office, *CBO's 2011 Long-Term Budget Outlook* (June 2011).

2. Mandatory programs are programs that do not require annual appropriations by the Congress; the major mandatory health care programs consist of Medicare, Medicaid, the Children's Health Insurance Program, and health insurance subsidies that will be provided through the exchanges established by the March 2010 health care legislation.

$750 billion today. If lawmakers ultimately modified some provisions of current law that might be difficult to sustain for a long period, that increase would be even larger.

Long-Term Scenarios

In its report released yesterday, CBO presents the long-term budget outlook under two scenarios that embody different assumptions about future policies governing federal revenues and spending. Neither of those scenarios represents a prediction by CBO of what policies will be in effect during the next several decades, and the policies adopted in coming years will surely differ from those assumed for the scenarios. Moreover, even if the assumed policies were adopted, their economic and budgetary consequences would undoubtedly differ from those projected in the report because outcomes also depend on economic conditions, demographic trends, and other factors that are difficult to predict. The report focuses on the next 25 years rather than a longer horizon, because budget projections grow increasingly uncertain as they extend farther into the future.[3]

The Extended-Baseline Scenario

One long-term budget scenario used in CBO's analysis, the *extended-baseline scenario,* adheres closely to current law. Under this scenario, the expiration of the tax cuts enacted since 2001 and most recently extended in 2010, the growing reach of the alternative minimum tax, the tax provisions of the recent health care legislation, and the way in which the tax system interacts with economic growth would result in steadily higher revenues relative to GDP. Revenues would reach 23 percent of GDP by 2035—much higher than has typically been seen in recent decades—and would grow to larger percentages thereafter. At the same time, under this scenario, government spending on everything other than the major mandatory health care programs, Social Security, and interest on federal debt—activities such as national defense and a wide variety of domestic programs—would decline to the lowest percentage of GDP since before World War II.

That significant increase in revenues and decrease in the relative magnitude of other spending would offset much—though not all—of the rise in spending on health care programs and Social Security. As a result, debt would increase slowly from its already high levels relative to GDP, as would the required interest payments on that debt. Federal debt held by the public would grow from an estimated 69 percent of GDP this year to 84 percent by 2035 (see Figure 1). With both debt and interest rates rising over time, interest payments, which absorb federal resources that could otherwise be used to pay for government services, would climb to 4 percent of GDP (or one-sixth of federal revenues) by 2035, compared with about 1 percent now.

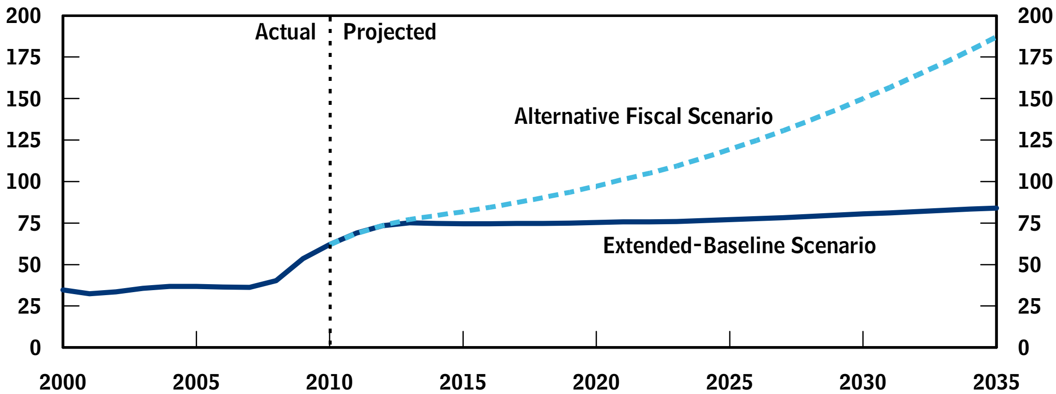
---

3. Because considerable interest exists in the longer-term outlook, figures showing projections through 2085 are presented in Appendix B of *CBO's 2011 Long-Term Budget Outlook*, and associated data are available on CBO's Web site (www.cbo.gov).

Figure 1.

Federal Debt Held by the Public Under CBO's Long-Term Budget Scenarios

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Note: The extended-baseline scenario adheres closely to current law, following CBO's 10-year baseline budget projections through 2021 and then extending the baseline concept for the rest of the long-term projection period. The alternative fiscal scenario incorporates several changes to current law that are widely expected to occur or that would modify some provisions that might be difficult to sustain for a long period.

The Alternative Fiscal Scenario

The budget outlook is much bleaker under the *alternative fiscal scenario*, which incorporates several changes to current law that are widely expected to occur or that would modify some provisions of law that might be difficult to sustain for a long period. Most important are the assumptions about revenues: that the tax cuts enacted since 2001 and extended most recently in 2010 will be extended; that the reach of the alternative minimum tax will be restrained to stay close to its historical extent; and that over the longer run, tax law will evolve further so that revenues remain near their historical average of 18 percent of GDP. This scenario also incorporates assumptions that Medicare's payment rates for physicians will remain at current levels (rather than declining by about a third, as under current law) and that some policies enacted in the March 2010 health care legislation to restrain growth in federal health care spending will not continue in effect after 2021. In addition, the alternative scenario includes an assumption that spending on activities other than the major mandatory health care programs, Social Security, and interest on the debt will not fall quite as low as under the extended-baseline scenario, although it will still fall to its lowest level (relative to GDP) since before World War II.

Under those policies, federal debt would grow much more rapidly than under the extended-baseline scenario. With significantly lower revenues and higher outlays, debt held by the public would exceed 100 percent of GDP by 2021. After that, the growing imbalance between revenues and spending, combined with spiraling interest payments, would swiftly push debt to higher and higher levels. Debt as a share of GDP would exceed its historical peak of 109 percent by 2023 and would approach 190 percent in 2035 (see Figure 1).

Many budget analysts believe that the alternative fiscal scenario presents a more realistic picture of the nation's underlying fiscal policies than the extended-baseline scenario does. The explosive path of federal debt under the alternative fiscal scenario underscores the need for large and rapid policy changes to put the nation on a sustainable fiscal course.

The Impact of Growing Deficits and Debt

CBO's projections in most of the *2011 Long-Term Budget Outlook* understate the severity of the long-term budget problem because they do not incorporate the negative effects that additional federal debt would have on the economy, nor do they include the impact of higher tax rates on people's incentives to work and save. In particular, large budget deficits and growing debt would reduce national saving, leading to higher interest rates, more borrowing from abroad, and less domestic investment —which in turn would lower income growth in the United States. Taking those effects into account, CBO estimates that under the extended-baseline scenario, real (inflation-adjusted) gross national product (GNP) would be reduced slightly by 2025 and by as much as 2 percent by 2035, compared with what it would be under the stable economic environment that underlies most of the projections in the report released yesterday.[4] Under the alternative fiscal scenario, real GNP would be 2 percent to 6 percent lower in 2025, and 7 percent to 18 percent lower in 2035, than under a stable economic environment.

Rising levels of debt also would have other negative consequences that are not incorporated in those estimated effects on output:

- Higher levels of debt imply higher interest payments on that debt, which would eventually require either higher taxes or a reduction in government benefits and services.

- Rising debt would increasingly restrict policymakers' ability to use tax and spending policies to respond to unexpected challenges, such as economic downturns or financial crises. As a result, the effects of such developments on the economy and people's well-being could be worse.

4. GNP differs from GDP primarily by including the capital income that residents earn from investments abroad and excluding the capital income that nonresidents earn from domestic investment. In the context of analyzing the impact of growing deficits and debt, GNP is a better measure because projected budget deficits would be partly financed by inflows of capital from other countries.

- Growing debt also would increase the probability of a sudden fiscal crisis, during which investors would lose confidence in the government's ability to manage its budget and the government would thereby lose its ability to borrow at affordable rates. Such a crisis would confront policymakers with extremely difficult choices. To restore investors' confidence, policymakers would probably need to enact spending cuts or tax increases more drastic and painful than those that would have been necessary had the adjustments come sooner.

To keep deficits and debt from climbing to unsustainable levels, policymakers will need to increase revenues substantially as a percentage of GDP, decrease spending significantly from projected levels, or adopt some combination of those two approaches. Making such changes while economic activity and employment remain well below their potential levels would probably slow the economic recovery. However, the sooner that medium- and long-term changes to tax and spending policies are agreed on, and the sooner they are carried out once the economy recovers, the smaller will be the damage to the economy from growing federal debt. Earlier action would permit smaller or more gradual changes and would give people more time to adjust to them, but it would require more sacrifices sooner from current older workers and retirees for the benefit of younger workers and future generations.