



Testimony

The Budget and Economic Outlook: 2017 to 2027

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Committee on the Budget
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Chairman Black, Ranking Member Yarmuth, and Members of the Committee, thank you for inviting me to testify about the Congressional Budget Office's most recent analysis of the outlook for the budget and the economy. My statement summarizes CBO's new baseline budget projections and economic forecast, which the agency released last week.¹

In fiscal year 2016, for the first time since 2009, the federal budget deficit increased in relation to the nation's economic output. CBO projects that over the next decade, if current laws remained generally unchanged, budget deficits would eventually follow an upward trajectory—the result of strong growth in spending for retirement and health care programs targeted to older people and rising interest payments on the government's debt, accompanied by only modest growth in revenue collections. Those accumulating deficits would drive debt held by the public from its already high level up to its highest percentage of gross domestic product (GDP) since shortly after World War II.

CBO's estimate of the deficit for 2017 has decreased since August 2016, when the agency issued its previous estimates, primarily because mandatory spending is expected to be lower than earlier anticipated.² However, the current projection for the cumulative deficit for the 2017–2026 period is about the same as that reported in August.

CBO's economic forecast—which underlies its budget projections—indicates that under current law, economic growth over the next two years would remain close to the modest rate observed since the end of the recession in 2009. Nevertheless, economic growth would continue to outpace growth in potential (maximum sustainable) GDP and thus continue to reduce the amount of underused resources, or slack, in the economy. The result would be increases in hiring, employment, and wages, along with upward pressure on inflation and interest rates. In the later part of the 10-year projection period, output growth would be constrained by a relatively slow increase in the nation's supply of labor.

1. Congressional Budget Office, *The Budget and Economic Outlook: 2017 to 2027* (January 2017), www.cbo.gov/publication/52370.

2. See Congressional Budget Office, *An Update to the Budget and Economic Outlook: 2016 to 2026* (August 2016), www.cbo.gov/publication/51908.

CBO's current economic projections differ from those it published in August because of revisions involving several factors that determine potential output. The agency now expects real (inflation-adjusted) GDP and real potential GDP in 2026 to be modestly lower than projected in August. It also expects interest rates to be lower in the first half of the projection period, but it projects a higher rate of labor force participation throughout the period than it reported in August.

CBO's budget and economic projections are predicated on the assumption that current laws generally remain in place. Budgetary and economic outcomes are difficult to project, however, and thus rather uncertain—even if there are no changes to the laws that govern federal taxes and spending. The agency strives to construct 10-year budget and economic projections that fall in the middle of the distribution of possible outcomes, given both the fiscal policy embodied in current law and the availability of economic and other data.

The Budget Deficit for 2017 Is Projected to Be Similar to Last Year's

CBO's baseline estimate of the 2017 deficit is \$559 billion, or 2.9 percent of GDP—less than the \$587 billion deficit posted in 2016 (see Table 1). Both totals, however, are affected by shifts in the timing of some payments. Outlays in 2016—and thus the deficit—were boosted by \$41 billion because certain payments that were to be made on October 1, 2016 (the first day of fiscal year 2017), were instead made in fiscal year 2016 because October 1 fell on a weekend.³

For 2017, the net effect of those timing shifts and similar shifts in spending from fiscal year 2018 into fiscal year 2017 is to increase outlays by \$4 billion. If not for those shifts, the deficit in 2016 would have been \$546 billion (3.0 percent of GDP), and the deficit projected for 2017 would be \$555 billion (2.9 percent of GDP).

If there are no further legislative changes, both revenues and outlays (adjusted to eliminate the timing shifts) are

3. October 1 will fall on a weekend again in 2017, 2022, and 2023. In such cases, certain payments due on October 1 are made at the end of September and thus are recorded in the previous fiscal year. Those shifts noticeably boosted projected spending and deficits in fiscal year 2016 and, in CBO's projections, increase them in 2022; the timing shifts reduce federal spending and deficits in fiscal years 2018 and 2024.

Table 1.

CBO's Baseline Budget Projections

	Actual,												Total	
	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2018-2022	2018-2027
In Billions of Dollars														
Revenues	3,267	3,404	3,604	3,733	3,878	4,019	4,176	4,346	4,527	4,724	4,931	5,140	19,410	43,078
Outlays	3,854	3,963	4,091	4,334	4,562	4,816	5,135	5,346	5,554	5,890	6,228	6,548	22,938	52,504
Deficit	-587	-559	-487	-601	-684	-797	-959	-1,000	-1,027	-1,165	-1,297	-1,408	-3,528	-9,426
Debt Held by the Public at the End of the Year	14,168	14,838	15,416	16,092	16,845	17,704	18,721	19,776	20,858	22,078	23,430	24,893	n.a.	n.a.
As a Percentage of Gross Domestic Product														
Revenues	17.8	17.8	18.1	18.1	18.1	18.1	18.1	18.1	18.2	18.2	18.3	18.4	18.1	18.2
Outlays	20.9	20.7	20.5	21.0	21.3	21.7	22.3	22.3	22.3	22.8	23.1	23.4	21.4	22.2
Deficit	-3.2	-2.9	-2.4	-2.9	-3.2	-3.6	-4.2	-4.2	-4.1	-4.5	-4.8	-5.0	-3.3	-4.0
Debt Held by the Public at the End of the Year	77.0	77.5	77.4	77.9	78.8	79.9	81.3	82.6	83.8	85.3	87.0	88.9	n.a.	n.a.

Source: Congressional Budget Office.

n.a. = not applicable.

projected to rise by about 4 percent this year. Higher receipts from individual income taxes would be responsible for much of the projected revenue increase, and net interest payments would be the fastest-growing component of the increase in spending.

Outlays (if not for the timing shifts) and revenues would both rise at about the same rate as GDP, CBO estimates, so they would be roughly the same relative to the size of the economy in 2016 and 2017: 20.7 percent for outlays and 17.8 percent for revenues. Debt held by the public is projected to rise slightly relative to GDP.

Growing Deficits Through 2027 Are Projected to Drive Up Federal Debt

In CBO's baseline projections, budget deficits remain below 3.0 percent of GDP through 2019. But subsequently, continued growth in spending—particularly for Social Security, Medicare, and net interest—would outstrip growth in revenues, resulting in larger deficits and increasing debt. By 2027, the deficit would reach 5.0 percent of GDP—\$1.4 trillion.

Revenues

If current laws generally remained unchanged, revenues would rise from 17.8 percent of GDP in 2017 to

18.4 percent by 2027. They have averaged 17.4 percent of GDP over the past 50 years.

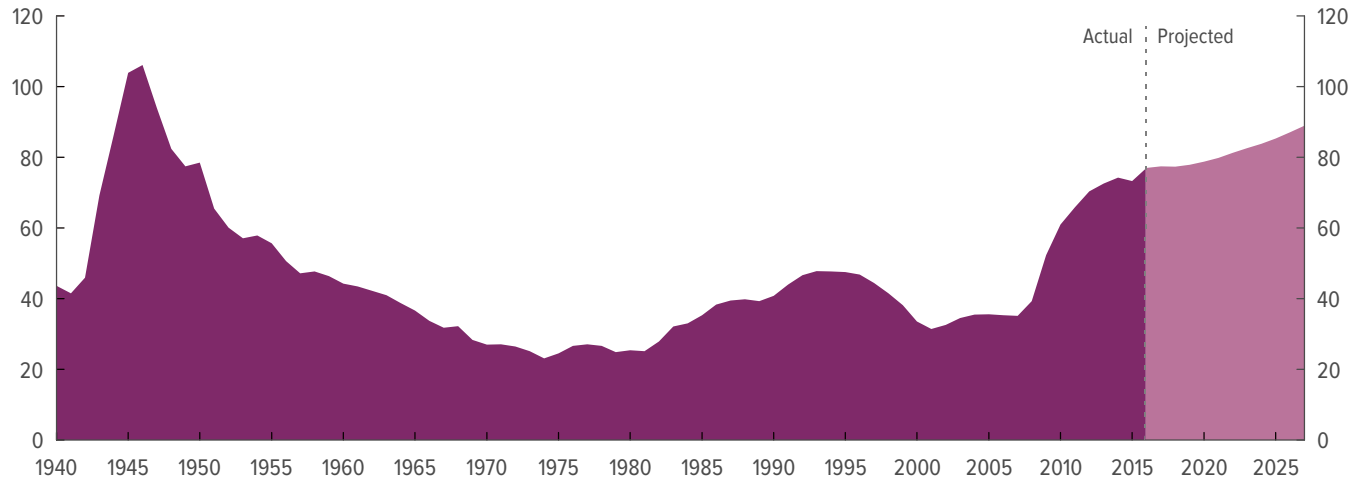
Only revenues from individual income taxes would grow faster than the economy over the course of the decade. CBO's baseline includes the following projections:

- Receipts from individual income taxes increase by a total of 1.1 percentage points of GDP over the 10-year period as a result of several factors, including real bracket creep (the process by which, as income rises faster than prices, an ever-larger proportion of income becomes subject to higher tax rates), rising distributions from tax-deferred retirement accounts, and an increase in the share of wages and salaries earned by higher-income taxpayers.
- Remittances from the Federal Reserve, which have been unusually high since 2010, drop by 0.2 percentage points of GDP to return to more typical amounts.
- Payroll tax receipts decline by 0.1 percentage point of GDP, primarily because of the expected increase in the share of wages going to higher-income taxpayers.
- Corporate income tax receipts as a share of GDP also fall by 0.1 percentage point between 2017 and 2027.

Figure 1.

Federal Debt Held by the Public

Percentage of Gross Domestic Product



Source: Congressional Budget Office.

Outlays

In CBO's projections, outlays remain near 21 percent of GDP for the next few years, which is higher than their average of 20.3 percent over the past 50 years. Later in the coming decade, the growth in outlays would exceed growth in the economy, and, by 2027, outlays would rise to 23.4 percent of GDP. That increase reflects significant growth in mandatory spending and interest payments, which is offset somewhat by a decline in discretionary spending as a share of GDP. More specifically, CBO's baseline includes the following projections:

- Outlays for mandatory programs increase as a share of GDP by 2.4 percentage points from 2017 to 2027—mainly because of the aging of the population and rising per capita health care costs. Social Security and Medicare account for nearly all of that increase.
- Because of rising interest rates and, to a lesser extent, growing federal debt held by the public, the government's interest payments on that debt rise sharply over the next 10 years—nearly tripling in nominal terms and almost doubling relative to GDP.
- Discretionary spending drops from 6.3 percent of GDP in 2017 to 5.3 percent in 2027—a smaller percentage relative to the size of the economy than in any year since 1962 (the first year for which comparable data are available).

Debt Held by the Public

As deficits accumulate in CBO's baseline, debt held by the public rises from 77 percent of GDP (\$15 trillion) at the end of 2017 to 89 percent of GDP (\$25 trillion) by 2027. At that level, debt held by the public would be the largest since 1947 and more than twice the average over the past five decades in relation to GDP (see Figure 1).

Beyond the 10-year period, if current laws remained in place, the pressures that contributed to rising deficits during the baseline period would accelerate and push debt up even more sharply. Three decades from now, for instance, debt held by the public is projected to be nearly twice as high, relative to GDP, as it is this year—and a higher percentage than any previously recorded.

Such high and rising debt would have serious negative consequences for the budget and the nation:

- Federal spending on interest payments would increase substantially as a result of increases in interest rates, such as those projected to occur over the next few years.
- Because federal borrowing reduces total saving in the economy over time, the nation's capital stock would ultimately be smaller, and productivity and total wages would be lower.

- Lawmakers would have less flexibility to use tax and spending policies to respond to unexpected challenges.
- The likelihood of a fiscal crisis in the United States would increase. There would be a greater risk that investors would become unwilling to finance the government's borrowing unless they were compensated with very high interest rates; if that happened, interest rates on federal debt would rise suddenly and sharply.

The Projected Deficit for 2017 Is Smaller Than CBO's August 2016 Estimate, but the Cumulative Deficit Is Largely Unchanged

The deficit that CBO now projects for 2017 is \$35 billion less than the amount the agency estimated in August. Revenues and outlays alike are expected to be lower: revenues by \$17 billion, mostly as a result of lower receipts from individual income taxes, and outlays by \$52 billion, mostly because of reductions in mandatory spending.

For the 2017–2026 period, CBO now projects a cumulative deficit that is just \$6 billion (or less than 0.1 percent) larger than it projected in August, and the total remains at \$8.6 trillion for that period. By 2026, debt held by the public is projected to total \$23 trillion, about the same as in the August projections.

CBO Expects Moderate Economic Growth to Continue

According to CBO's current baseline projections, continued economic expansion over the next two years will virtually eliminate slack in the economy, thus putting upward pressure on inflation and interest rates. After that, the economy is expected to grow a bit more slowly. The projections for later years do not reflect predictions about business-cycle fluctuations or possible changes in fiscal policy; rather, they are based primarily on projected trends of underlying factors, such as productivity, growth in the labor force and in the number of hours worked, inflation, and interest rates.

Economic Growth

CBO estimates that, in real terms, GDP will expand at an average annual pace of 2.1 percent from the fourth quarter of 2016 to the fourth quarter of 2018, after having risen at an annual rate of 1.8 percent last year (see Figure 2). Most of the growth in output during the coming years will be driven by consumer spending, business

investment, and residential construction, CBO anticipates.

According to CBO's projections, actual and potential GDP alike will expand at an average annual rate of 1.9 percent during the second half of the 10-year period. CBO estimates that the growth of potential output over that period will be faster than it has been since the 2007–2009 recession, mainly because the productivity of the labor force is projected to rise, returning closer to its average of the preceding two decades. However, that rate of output growth represents a significant slowdown from the average over the 1980s, 1990s, and early 2000s, mainly because of the slower growth projected for the nation's supply of labor, which is largely attributable to the ongoing retirement of baby boomers and the relatively stable labor force participation rate among working-age women. (The labor force participation rate is the percentage of people in the civilian noninstitutionalized population who are at least 16 years old and are either working or seeking work.)

The Labor Market

The shortfall between actual and potential employment, CBO's primary measure of slack in the labor market, was about 1.6 million people at the end of 2016.⁴ That shortfall is projected to disappear in 2018 as the result of two developments. First, the strengthening economy is expected to slow the downward trend in the rate of labor force participation as the increase in employers' demand for labor continues to draw workers back into the labor force. Second, increases in hiring will lower the unemployment rate, which is projected to reach 4.4 percent by the end of 2018. As slack in the labor market dissipates over the next two years, hourly wages are expected to rise.

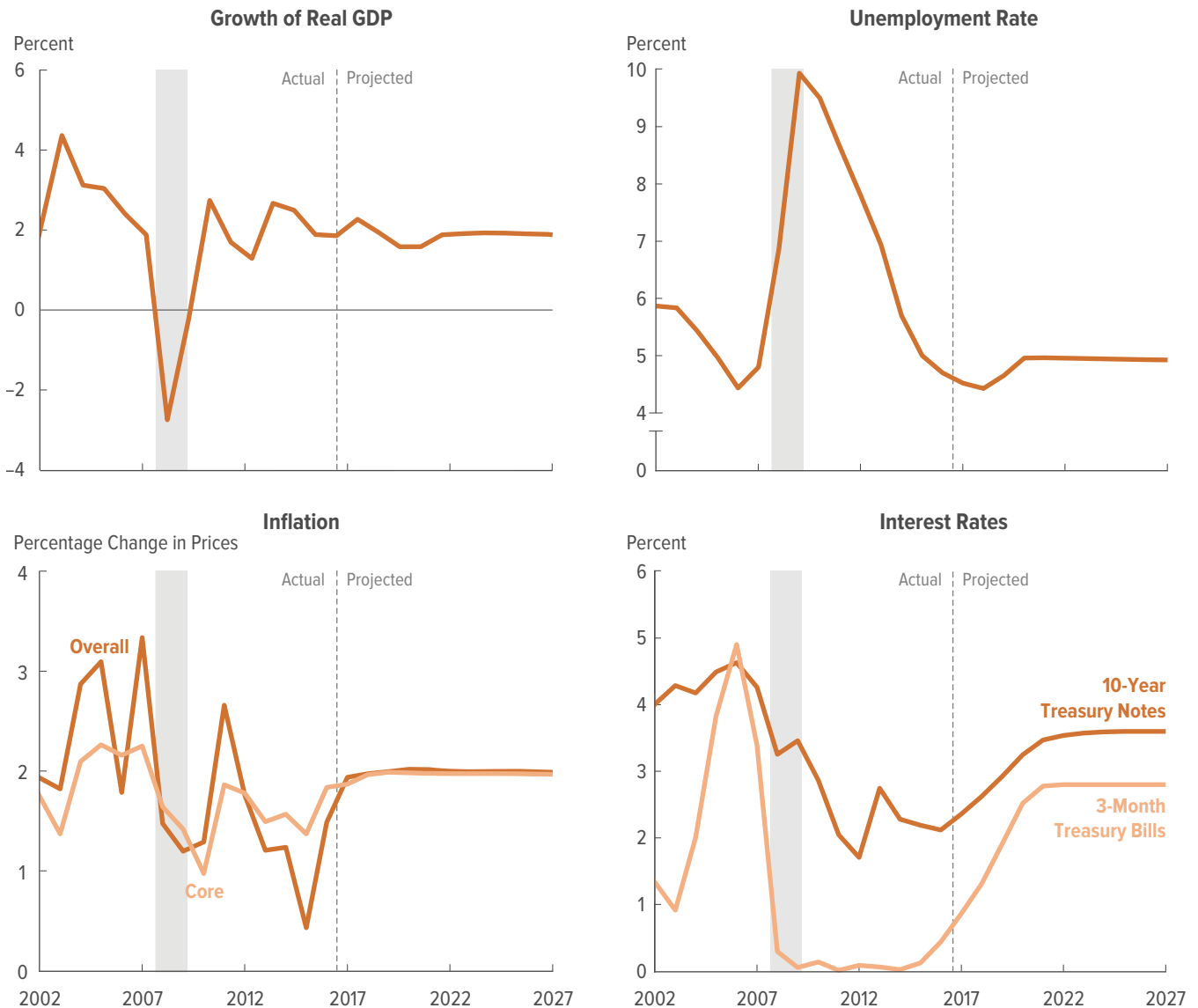
Over the next five years, the monthly increase in nonfarm payroll employment, which is estimated to average 160,000 jobs in the first half of 2017, is projected to settle down to an average of 64,000 jobs. That slower pace of job growth primarily reflects relatively slow growth in the labor force, which is affected by the ongoing retirement of the baby boomers. In CBO's projections, the

4. Potential employment is the number of people employed when unemployment is at its natural rate—the rate that arises from all sources except fluctuations in aggregate demand—and when labor force participation is at its potential rate. (Aggregate demand is the overall demand for goods and services in the economy.)

Figure 2.

Actual Values and CBO’s Projections of Key Economic Indicators

CBO projects that economic activity will expand at a pace this year and next that will lower the unemployment rate and place upward pressure on inflation and interest rates.



Source: Congressional Budget Office, using data from the Bureau of Economic Analysis, the Bureau of Labor Statistics, and the Federal Reserve.

Real GDP is the output of the economy adjusted to remove the effects of inflation. The unemployment rate is a measure of the number of jobless people who are available for work and are actively seeking jobs, expressed as a percentage of the labor force. The overall inflation rate is based on the price index for personal consumption expenditures; the core rate excludes prices for food and energy.

For real GDP growth and inflation, percentage changes are measured from the fourth quarter of one calendar year to the fourth quarter of the next. For the unemployment and interest rates, data are fourth-quarter values.

GDP = gross domestic product.

unemployment rate averages 4.9 percent over the later part of the projection period.

Inflation

CBO expects prices to rise at a modest pace over the next few years. The agency anticipates that the diminishing slack in the economy and higher oil prices will put upward pressure on prices for goods and services. That pressure will be somewhat alleviated by the effects of a strong dollar in relation to other currencies, which will reduce the cost of imported goods. In CBO's projections, the rate of inflation, as measured by the price index for personal consumption expenditures, rises to 1.9 percent in 2017 and to 2.0 percent in 2018. It remains, on average, at the Federal Reserve's longer-run goal of 2 percent throughout the rest of the coming decade.

Interest Rates

As the slack in the economy continues to diminish, the Federal Reserve will continue to reduce its support of economic growth, in CBO's view. Thus, the federal funds rate—the interest rate that financial institutions charge one another for overnight loans of their monetary reserves—is expected to rise gradually over the next few years, reaching 1.1 percent in the fourth quarter of 2017, 1.6 percent in the fourth quarter of 2018, and 3.1 percent in the later part of the projection period. Interest rates on short-term Treasury securities are expected to follow a similar pattern.

A projected rise in longer-term rates reflects the anticipated increase in short-term rates and an expected increase in the term premium from historically low levels. (The term premium is paid to bondholders as compensation for the extra risk associated with longer-term securities.) In CBO's estimation, the term premium has remained low because of heightened concern about global economic growth and increased demand for longer-term Treasury securities as a hedge against possible economic adversity. CBO projects that the interest rate on 10-year Treasury notes will rise from 2.1 percent in the fourth quarter of 2016 to 3.6 percent in the later part of the projection period.

Although CBO projects that interest rates will rise above those currently in effect, they are projected to remain low by historical standards, for several reasons: slower growth in the labor force, slightly slower growth in productivity, and only partial dissipation of the factors that have

increased the demand for Treasury securities and held down the term premium.

Real GDP Is Projected to Be Modestly Lower Than CBO Estimated in August

CBO's current economic projections differ somewhat from those the agency made in August 2016. Most significantly, potential and actual real GDP are expected to grow more slowly. As a result, those measures are 0.8 percent lower than CBO previously projected for 2026 (the last year in the previous projection period). CBO's projection of economic output is lower because of improvements in the agency's analytical methods and because of data that became available between early July and early December 2016. Nominal GDP is expected to be a little lower, on average, over the decade.

Other changes are relatively small. CBO now estimates that over the next decade, more people will be working than it estimated in August. That change results from an upward revision to the projected labor force participation rate, which is partially offset by a downward revision in the projected size of the population. Also, interest rates are expected to be lower in the first half of the decade than they were in the August projections. The slower rise in interest rates that CBO now projects stems partly from an anticipated slowing in the pace of rate increases by the Federal Reserve.

This testimony reiterates the summary of *The Budget and Economic Outlook: 2017 to 2027*, which is one in a series of reports on the state of the budget and the economy that CBO issues each year. The report satisfies the requirement of section 202(e) of the Congressional Budget Act of 1974 for CBO to submit to the Committees on the Budget periodic reports about fiscal policy and to provide baseline projections of the federal budget. In accordance with CBO's mandate to provide objective, impartial analysis, neither that report nor this testimony makes any recommendations. Both publications are available on CBO's website, at www.cbo.gov/publication/52370 and www.cbo.gov/publication/52390, respectively.



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