

CBO TESTIMONY

**Statement of
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Director**

The Budget and Economic Outlook: Fiscal Years 2006 to 2015

**before the
Committee on the Budget
United States Senate**

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Chairman Gregg, Senator Conrad, and Members of the Committee, I am pleased to be here today to discuss the Congressional Budget Office's (CBO's) report *The Budget and Economic Outlook: Fiscal Years 2006 to 2015*.

CBO projects that if current laws and policies remained the same, the federal government would run budget deficits of \$368 billion in 2005 and \$295 billion in 2006 (see Table 1). However, because of the statutory rules that govern such baseline projections, those estimates omit a significant amount of spending that will occur this year—and conceivably for some time in the future—for U.S. military operations in Iraq and Afghanistan and for other efforts in the war on terrorism.

Additional appropriations for such purposes are expected to add about \$30 billion to the deficit this year and possibly more next year. Thus, the 2005 deficit is likely to total around \$400 billion and the 2006 deficit well over \$300 billion. With that extra spending included, the deficit in 2005 would amount to about 3.3 percent of gross domestic product (GDP)—compared with last year's deficit of 3.6 percent of GDP.

The absence of further appropriations for activities in Iraq and Afghanistan also masks a deterioration in budget projections over the 10 years in CBO's baseline. Since September 2004, when CBO last made projections,¹ the cumulative deficit projected for the 2005-2014 period (the 10 years covered by the previous baseline) has declined from \$2.3 trillion to \$1.4 trillion. However, following rules set forth in law, CBO's September baseline extrapolated supplemental funding for 2004—provided mostly for activities in Iraq and Afghanistan—throughout the 10-year period, thereby increasing projected outlays by more than \$1.4 trillion (including the additional interest payments on federal debt). CBO's current baseline does not include appropriations for those activities because the funds have not been provided yet this year. If the baselines are made comparable by removing that extrapolation of supplemental funding from the preceding baseline, the outlook has actually become less favorable: the total deficit projected for the 2005-2014 period has grown by more than \$500 billion, or 0.3 percent of GDP (see Table 2). New legislation accounts for about three-quarters of that increase, most of it from recent laws that extend certain tax provisions and provide funding for disaster relief.

By statute, CBO's baseline projections must estimate the future paths of federal spending and revenues under current laws and policies. The baseline is therefore not intended to be a prediction of future budgetary outcomes; instead, it is meant to serve as a neutral benchmark that lawmakers can use to measure the effects of proposed changes to spending and taxes.

Underlying CBO's baseline projections is a forecast that the U.S. economy will continue to grow at a healthy pace in 2005 and 2006. Although real (inflation-adjusted) GDP grew rapidly during the past two years, output remained considerably below the economy's potential. Therefore, by CBO's expectations, GDP will grow at an average annual rate of about 3.8 percent in the next two years to close most of that gap, before slowing to a pace of 2.9 percent for the 2007-2015 period.

Over the longer term, the federal budget will be strained significantly by demographic changes that will begin within the current 10-year projection period and intensify as members of the baby-boom generation age. In particular, the rising cost of health care will contribute to the growth of programs for elderly and low-income beneficiaries. As a result, under current law, total federal spending for Social Security, Medicare, and Medicaid

1. See Congressional Budget Office, *The Budget and Economic Outlook: An Update* (September 2004).

Table 1.**CBO's Baseline Budget Outlook**

	Actual 2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Total, 2006- 2010	Total, 2006- 2015
In Billions of Dollars														
Total Revenues	1,880	2,057	2,212	2,357	2,508	2,662	2,806	3,062	3,303	3,474	3,657	3,847	12,545	29,888
Total Outlays	<u>2,292</u>	<u>2,425</u>	<u>2,507</u>	<u>2,618</u>	<u>2,743</u>	<u>2,869</u>	<u>2,996</u>	<u>3,142</u>	<u>3,232</u>	<u>3,389</u>	<u>3,542</u>	<u>3,706</u>	<u>13,733</u>	<u>30,743</u>
Total Deficit (-) or Surplus	-412	-368	-295	-261	-235	-207	-189	-80	71	85	115	141	-1,188	-855
On-budget	-567	-541	-484	-471	-464	-453	-451	-357	-217	-212	-190	-169	-2,323	-3,469
Off-budget ^a	155	173	190	210	229	246	262	277	288	298	305	310	1,136	2,614
Debt Held by the Public at the End of the Year	4,296	4,665	4,971	5,246	5,494	5,716	5,919	6,012	5,955	5,884	5,784	5,658	n.a.	n.a.
As a Percentage of GDP														
Total Revenues	16.3	16.8	17.2	17.3	17.5	17.7	17.8	18.6	19.2	19.3	19.4	19.6	17.5	18.5
Total Outlays	<u>19.8</u>	<u>19.8</u>	<u>19.5</u>	<u>19.3</u>	<u>19.2</u>	<u>19.1</u>	<u>19.0</u>	<u>19.0</u>	<u>18.7</u>	<u>18.8</u>	<u>18.8</u>	<u>18.9</u>	<u>19.2</u>	<u>19.0</u>
Total Deficit (-) or Surplus	-3.6	-3.0	-2.3	-1.9	-1.6	-1.4	-1.2	-0.5	0.4	0.5	0.6	0.7	-1.7	-0.5
Debt Held by the Public at the End of the Year	37.2	38.1	38.6	38.6	38.4	38.0	37.6	36.5	34.5	32.6	30.7	28.8	n.a.	n.a.
Memorandum:														
Gross Domestic Product (Billions of dollars)	11,553	12,233	12,888	13,586	14,307	15,029	15,757	16,494	17,245	18,023	18,826	19,652	71,566	161,806

Source: Congressional Budget Office.

Note: 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.

is projected to grow by about 25 percent over the next 10 years relative to the size of the economy—from 8.4 percent of GDP in 2004 to 10.4 percent of GDP in 2015.

After 2015, if the growth of health care costs continues to exceed that of the economy, outlays for Social Security, Medicare, and Medicaid will claim an even larger share of federal spending as the percentage of the population age 65 or older continues to rise (from 14 percent in 2015 to 19 percent in 2030). Thus, over the long term, the increasing resources needed for such programs will exert pressure on the federal budget that will make current fiscal policy unsustainable.

The Budget Outlook

Under the assumption that current laws and policies remain unchanged, CBO projects that federal deficits will begin to decline this year. In CBO's baseline, deficits drop as a percentage of GDP, from the 3.6 percent recorded in 2004 to 1.2 percent in 2010. Beginning in 2012—if taxes increased as scheduled under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), discretionary spending continued to

Table 2.

Changes Since September 2004 in CBO's Estimate of the Cumulative Deficit for 2005 to 2014

(Billions of dollars)

	10-Year Total
September 2004	
Projected deficit	-2,294
Less the effect of extending supplemental appropriations for 2004	<u>1,433</u>
Adjusted projected deficit	-861
Other Changes to the Baseline Since September 2004	
Legislative	-371
Economic	41
Technical	<u>-173</u>
Total	-504
January 2005	
Projected deficit	-1,364

Source: Congressional Budget Office.

Note: According to rules set forth in law, CBO's September 2004 baseline extrapolated through 2014 supplemental appropriations of \$115 billion provided in 2004 (mostly for operations in Iraq and Afghanistan). CBO's January 2005 baseline does not include appropriations for those operations because the funds have not been provided yet this year. Hence, for the purpose of making a consistent comparison between the September 2004 and January 2005 baselines, this table removes the extension of such supplemental appropriations from the previous baseline. The 10-year totals include changes in projected debt-service costs (interest payments on federal debt) resulting from projected changes in the government's borrowing.

Negative numbers in this table represent deficits or increases to deficits.

In the current baseline, which covers 2006 through 2015, the cumulative deficit totals \$855 billion.

grow no faster than inflation, and other policies stayed the same—the budget would shift to small annual surpluses.

Over the 2005-2015 period, outlays are projected to grow at an average annual rate of 4.3 percent and to gradually diminish from 19.8 percent of GDP this year to 18.9 percent in 2015 (see Figure 1). That downward drift of total outlays as a percentage of GDP is driven by the treatment of discretionary spending under rules set forth in law. CBO projects growth in discretionary spending as specified in the Balanced Budget and Emergency Deficit Control Act of 1985 (using the GDP deflator and the employment cost index for wages and salaries). The combined rate of growth of those factors is about half of that projected for nominal GDP. As a result, CBO's baseline projection for discretionary outlays falls from 7.6 percent of GDP in 2005 to 5.6 percent in 2015. Including future costs for activities in Iraq and Afghanistan (and for other such activities) would probably not affect that trend significantly.

Mandatory spending continues to account for a rising share of federal outlays; such spending is projected to grow from 54 percent of total outlays in 2004 to 62 percent in 2015 (see Figure 2). Under the assumption that no changes in policy take place, spending for mandatory programs is projected to grow by 5.7 percent a year—faster than the rate projected for the economy as a whole. Such growth is driven largely by outlays for Medicare and Medicaid, which are projected to rise at average annual rates of 9.0 percent and 7.8 percent, respectively, through 2015. By the middle of the projection period, Social Security spending is also expected to grow faster than the economy, as the baby-boom generation begins to collect benefits.

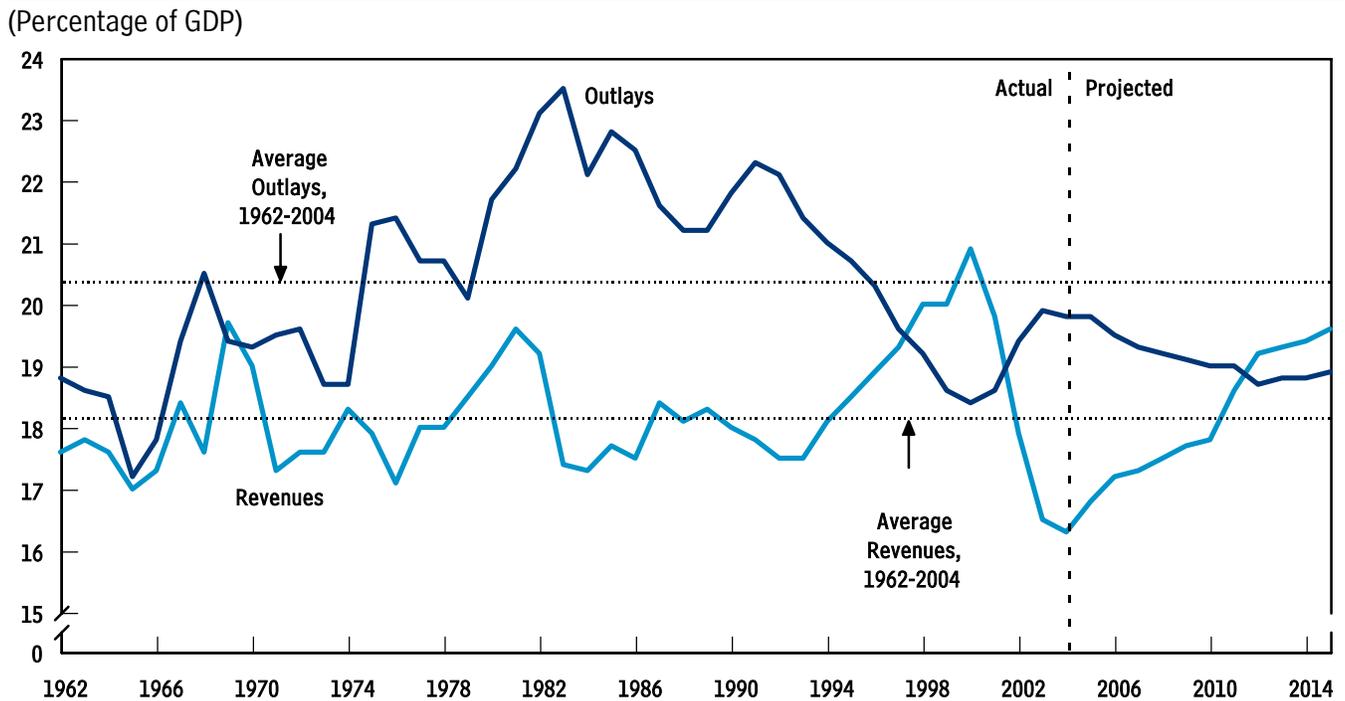
Revenues are projected to total 16.8 percent of GDP this year—nearly 1.5 percentage points below the average since 1962 (18.2 percent). Over the coming decade, revenues are expected to continue increasing, growing faster than GDP in every year of the projection period. That ascent is driven by the structure of the tax system, which causes revenues to claim a higher fraction of income in taxes every year as income grows. In addition, a large boost in revenues occurs in CBO's baseline after the major provisions of EGTRRA expire at the end of 2010. By 2015, such receipts are projected to reach 19.6 percent of GDP.

Debt held by the public (the most meaningful measure of federal debt in terms of its relationship to the economy) is anticipated to equal 38.1 percent of GDP at the end of this fiscal year. In CBO's baseline, that debt stabilizes at around its current level of GDP through 2010, at which point the federal government's diminished need to borrow reduces the growth of such debt.

Since September, when CBO issued its previous baseline, changes unrelated to the treatment of spending for activities in Iraq and Afghanistan have increased the cumulative deficit projected for 2005 to 2014 by more than \$500 billion. Among the legislation that contributed to that increase was the Working Families Tax Relief Act of 2004. That law extended several tax provisions, including the 10 percent tax bracket, relief from the marriage penalty, and the increase in the child tax credit—thereby adding \$146 billion to the 10-year deficit (excluding debt-service costs). In addition, supplemental appropriations for 2005 provide \$11.5 billion in disaster relief for hurricane victims; extrapolating that budget authority through 2014 (following rules for the baseline) adds \$94 billion to discretionary spending. Revisions to the baseline caused by changes in CBO's economic forecast were fairly small, reducing the projected 10-year deficit by \$41 billion. Other, so-called technical revisions to the baseline—mostly involving revenues—increased that cumulative deficit by \$173 billion.

Figure 1.

Total Revenues and Outlays as a Percentage of GDP, 1962 to 2015



Source: Congressional Budget Office.

The Economic Outlook

According to CBO's forecast, in 2005 and 2006, the U.S. economy continues to grow at a healthy pace. Although investment by businesses is not expected to grow as rapidly as in 2004, such spending will probably still lead the economy's continuing expansion. Moreover, the caution that has characterized firms' decisions over the past three years appears to be dissipating, and businesses seem to be having greater difficulty meeting increases in demand with their current workforce; as a result, hiring should accelerate. Growth of productivity, which has been exceptionally strong since 2001, is expected to slow relative to its rate in the recent past but to continue at a pace similar to the long-run average. Thus, CBO expects that real GDP will grow by 3.8 percent in calendar year 2005 and 3.7 percent in 2006, before slowing to a pace of 2.9 percent for the 2007-2015 period (see Table 3).

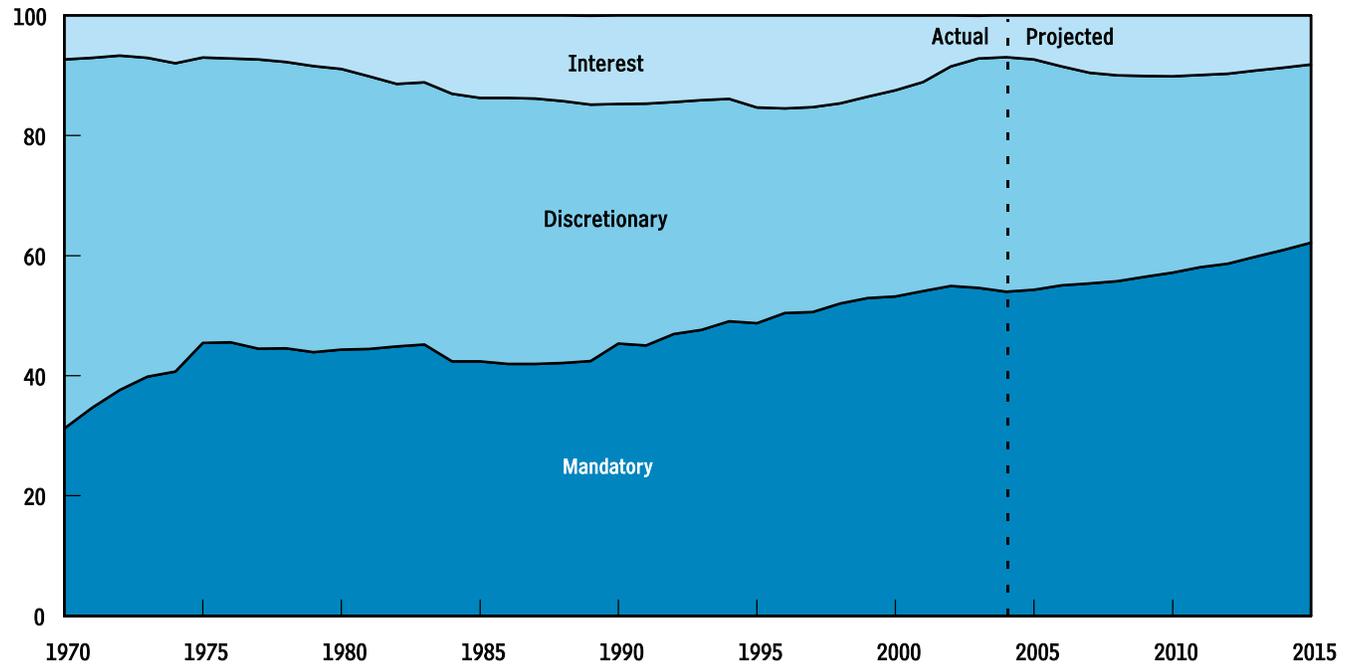
The rate of unemployment is forecast to decline from 5.4 percent at the end of 2004 to 5.2 percent in 2005 and 2006. During the 2007-2015 period, the rate of unemployment is expected to average 5.2 percent.

According to CBO's forecast, inflation is lower in 2005 and 2006 than in 2004. A surge in energy prices, along with an acceleration in the cost of shelter and in used car prices, caused a spike in inflation in 2004, as measured by the consumer price index for all urban consumers. That increase is not expected to feed into core inflation (inflation excluding changes in prices for food and energy). CBO projects that consumer prices will rise by 2.4 percent in 2005 and 1.9 percent in 2006; during the 2007-2015 period, CBO anticipates growth averaging 2.2 percent.

Figure 2.

Type of Spending as a Share of Total Outlays, 1970 to 2015

(Percent)



Source: Congressional Budget Office.

Interest rates are expected to move upward during the next two years, as the economy grows and the Federal Reserve continues to move toward a more neutral monetary policy. CBO forecasts that the three-month Treasury bill rate will rise to about 2.8 percent in 2005 and 4 percent in 2006; thereafter, it will average 4.6 percent, which is relatively low by historical standards. In the forecast, the rise in the rate for the 10-year Treasury note is somewhat smaller; it averages 4.8 percent in 2005 and 5.4 percent in 2006, then inches up to average 5.5 percent from 2007 to 2015.

Table 3.**CBO's Economic Projections for Calendar Years 2005 to 2015**

	Estimated 2004	Forecast		Projected Annual Average	
		2005	2006	2007-2010 ^a	2011-2015 ^b
Nominal GDP (Billions of dollars)	11,730	12,396	13,059	15,940 ^a	19,861 ^b
Nominal GDP (Percentage change)	6.6	5.7	5.3	5.1	4.5
Real GDP (Percentage change)	4.4	3.8	3.7	3.3	2.7
GDP Price Index (Percentage change)	2.1	1.8	1.5	1.8	1.8
Consumer Price Index ^c (Percentage change)	2.7	2.4	1.9	2.2	2.2
Unemployment Rate (Percent)	5.5	5.2	5.2	5.2	5.2
Three-Month Treasury Bill Rate (Percent)	1.4	2.8	4.0	4.6	4.6
Ten-Year Treasury Note Rate (Percent)	4.3	4.8	5.4	5.5	5.5

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

Note: Percentage changes are year over year.

a. Level in 2010.

b. Level in 2015.

c. The consumer price index for all urban consumers.

