CBO TESTIMONY

Statement of
June E. O'Neill
Director
Congressional Budget Office

on

*The Economic and Budget Outlook:
Fiscal Years 1998-2007*

before the
Committee on the Budget
United States Senate

January 28, 1997

NOTICE

This statement is not available for public release until it is delivered at 10:00 a.m. (EST), Tuesday, January 28, 1997.

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

Mr. Chairman, Senator Lautenberg, and Members of the Committee, I am pleased to appear before you today to present the Congressional Budget Office's (CBO's) current assessment of the economy and the budget. Our findings are detailed in CBO's annual report, *The Economic and Budget Outlook: Fiscal Years 1998-2007*, which we are releasing today in conjunction with this hearing. In this statement, I will briefly summarize our findings.

THE ECONOMIC OUTLOOK

CBO sees no clear signals that the end of the current economic expansion is imminent. Consequently, our new forecast assumes no significant changes in the course of the economy in the short term. The nation's gross domestic product adjusted for inflation (real GDP) is expected to grow at an average annual rate of 2.2 percent in 1997 and 1998, the same as it did over the past two years. Inflation and interest rates are also expected to remain close to current levels. CBO's forecast is extremely close to the *Blue Chip* consensus, which reflects an average of some 50 private-sector forecasts.

CBO's longer-term economic projections reflect an underlying trend of moderate growth and continuing low inflation. We do not attempt to predict

cyclical changes in the economy more than two years ahead, but our projections after that reflect the average historical probability of a boom or a recession in any year.

THE BASELINE BUDGET OUTLOOK

Under those economic assumptions, and assuming current budgetary policies continue, CBO projects that the federal deficit will rise modestly over the next decade. The deficit shrank to $107 billion in fiscal year 1996, the fourth straight year of decline. However, that decline is likely to come to a halt in 1997, when the deficit is estimated to rise to $124 billion.

In fact, if discretionary spending keeps pace with inflation (subject to the statutory cap in 1998), CBO projects that the deficit under current law will reach $188 billion in 2002—the year by which both the President and the Congress have pledged to balance the budget. By 2007, the deficit will climb to $278 billion. Even at 2.2 percent of GDP, however, that amount would still be smaller than any deficit from 1980 through 1995.

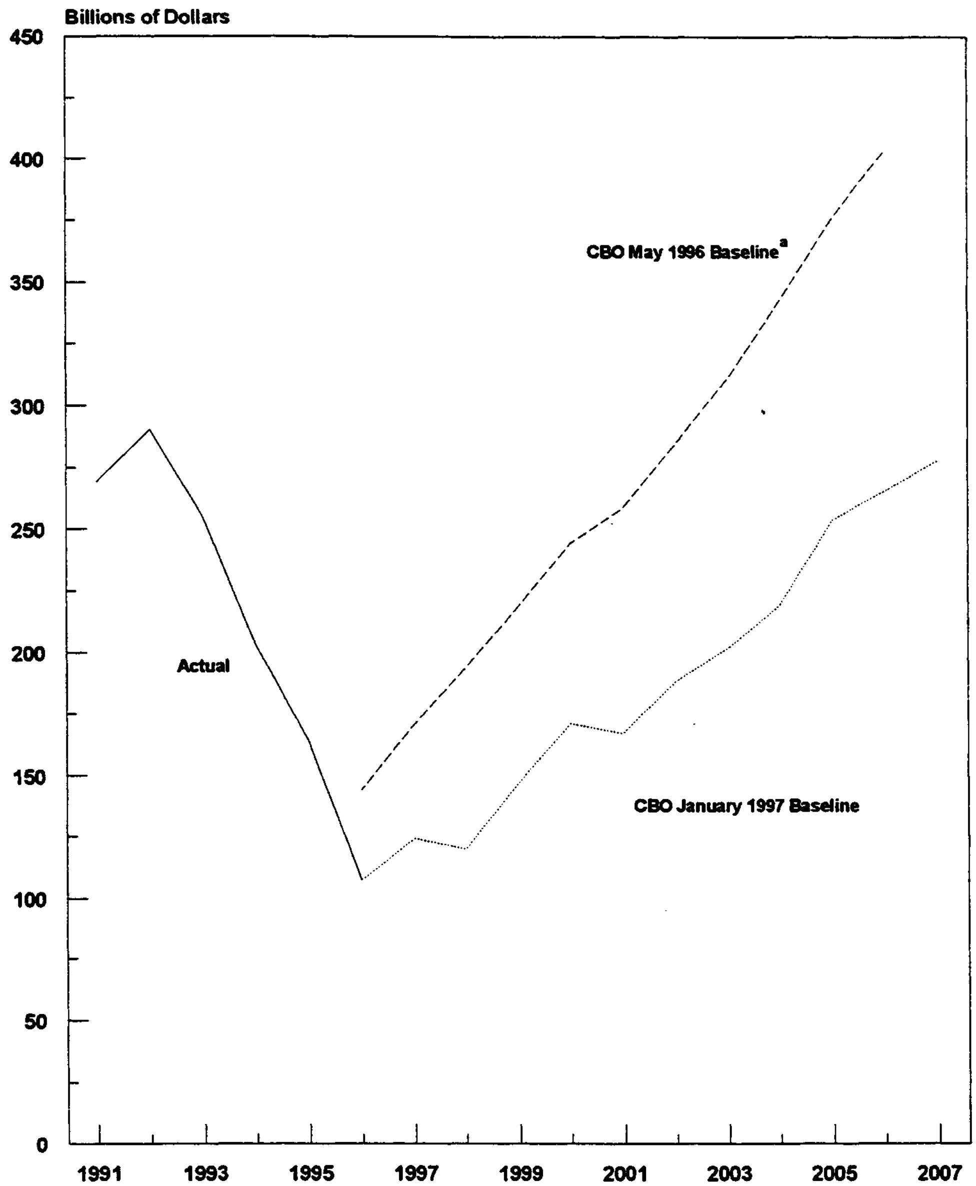
CBO's new projections of the deficit are one-third lower than last year's

(see Figure 1). Four major factors account for that brighter budget outlook: lower estimates of the growth of spending for Medicare and Medicaid; the enactment of welfare reform legislation; higher projected revenues, particularly in the near term; and lower debt-service costs that result from lower deficits and a lower level of publicly held federal debt.

For any path of spending and revenues to be sustainable over the long run, the resulting federal debt must grow no faster than the economy. After peaking at more than 100 percent of GDP at the end of World War II, debt held by the public generally declined for the next 35 years (see Figure 2). It started climbing in the early 1980s but leveled off in recent years.

Under CBO's new baseline projections (again assuming that discretionary spending rises with inflation), federal debt held by the public would remain stable at just under 50 percent of GDP through 2007. However, the situation will start to deteriorate rapidly only a few years later with the retirement of the first of the baby boomers and the continued growth of per-person health care costs—as was discussed in last week's hearing on the long-term budget outlook.

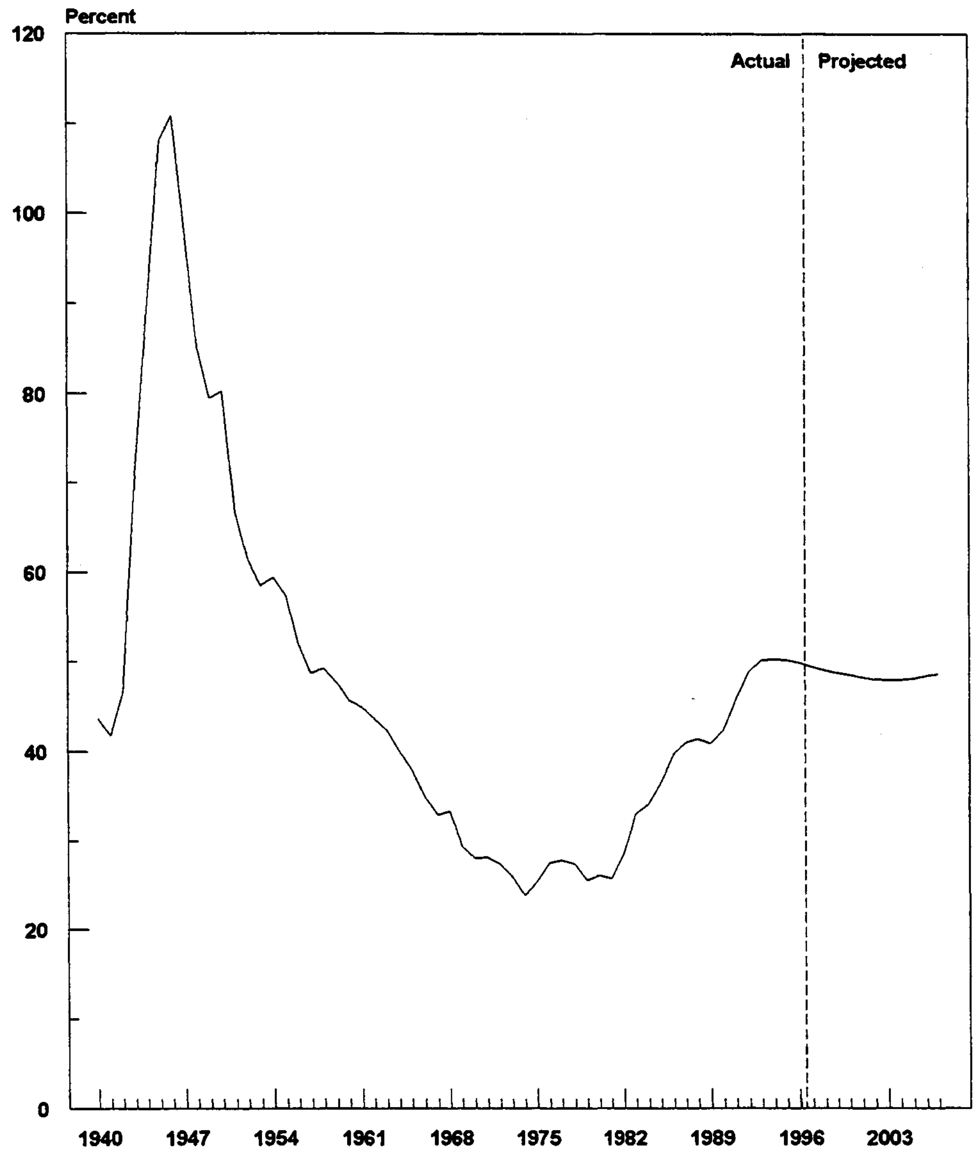
FIGURE 1. ACTUAL AND PROJECTED DEFICITS (By fiscal year)



SOURCES: Congressional Budget Office and *Budget of the United States Government, Fiscal Year 1997: Historical Tables.*

a. From *The Economic and Budget Outlook: Fiscal Years 1997-2006.*

FIGURE 2. DEBT HELD BY THE PUBLIC AS A PERCENTAGE OF GDP (By fiscal year)



SOURCE: Congressional Budget Office.

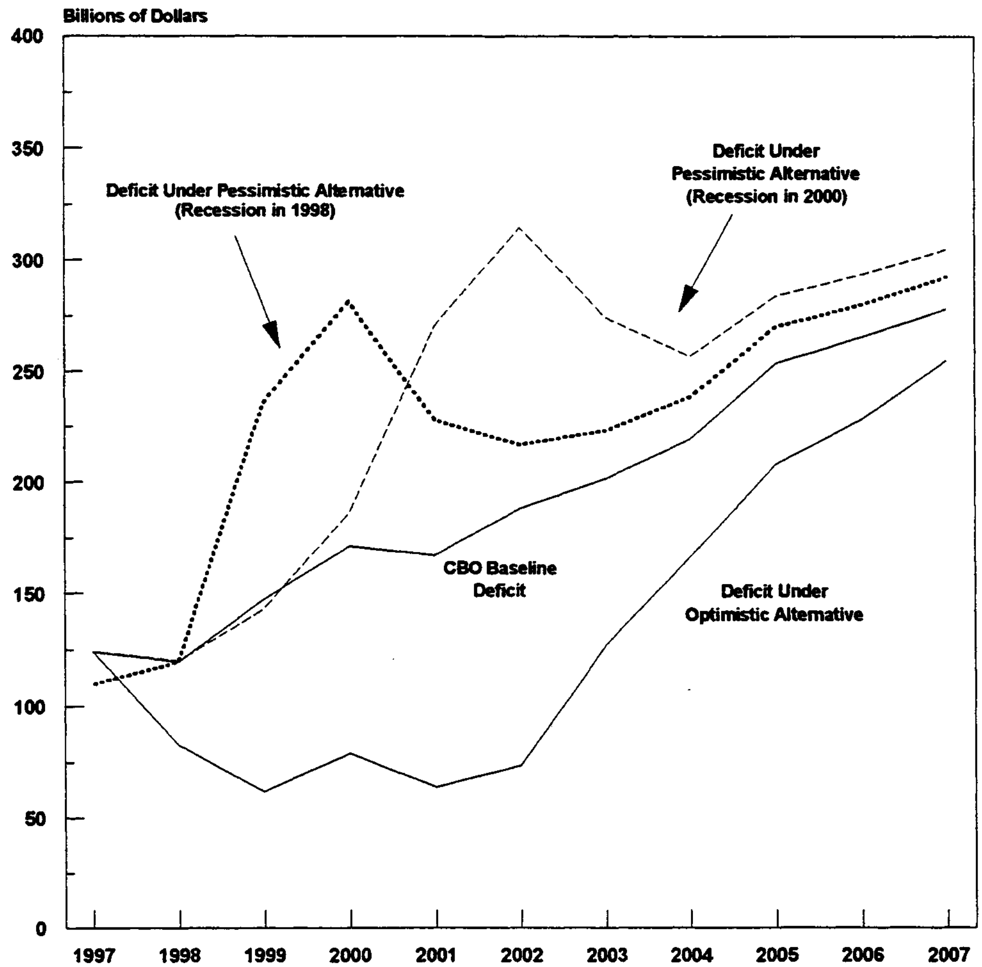
THE UNCERTAINTY IN CBO'S BUDGET PROJECTIONS

CBO's baseline projections represent its estimate of the most likely outcome for the economy and the budget. Yet a wide range of alternative outcomes is possible. In fact, because the U.S. economy and the federal budget are so large and complicated, there is little chance that either one will precisely follow the course projected by CBO. Moreover, the likely deviations from the CBO projections are generally larger the farther the projections extend into the future.

To illustrate how deviations from the baseline economic assumptions could affect the projected deficit, CBO developed a set of alternative economic scenarios that incorporate cyclical swings in the economy. In the optimistic alternative, the economy experiences a boom that mimics the experience of the late 1960s, although its fluctuation is only half as large as occurred then. If the boom extended through 2002, the projected deficit in that year would be more than $100 billion lower than in CBO's baseline (see Figure 3).

Under the pessimistic alternatives, the economy experiences a downturn roughly the size of the 1990 recession. If the economy entered the recession

FIGURE 3. DEFICITS UNDER ALTERNATIVE CYCLICAL PROJECTIONS OF THE ECONOMY (By fiscal year)



SOURCE: Congressional Budget Office.

in the second half of 1998, it would probably recover fully by 2002. Under that scenario, CBO projects the deficit would be only about $30 billion higher in 2002 than in the baseline. If instead the recession began late in 2000, the maximum effect on the budget would be felt in 2002, when the projected deficit would be more than $100 billion higher than in the baseline.

Departures from the economic assumptions, of course, are not the only reason that CBO's projections could be off the mark. Changes in how fast spending grows for programs such as Medicare or Medicaid, or unexpected events such as a savings and loan crisis, could significantly alter the budget. Indeed, the likelihood that the budget will veer off its plotted course should make policymakers wary of staking too much on the accuracy of any projections of what the deficit will be in a particular year in the future.

IMPLICATIONS FOR BUDGET PLANS

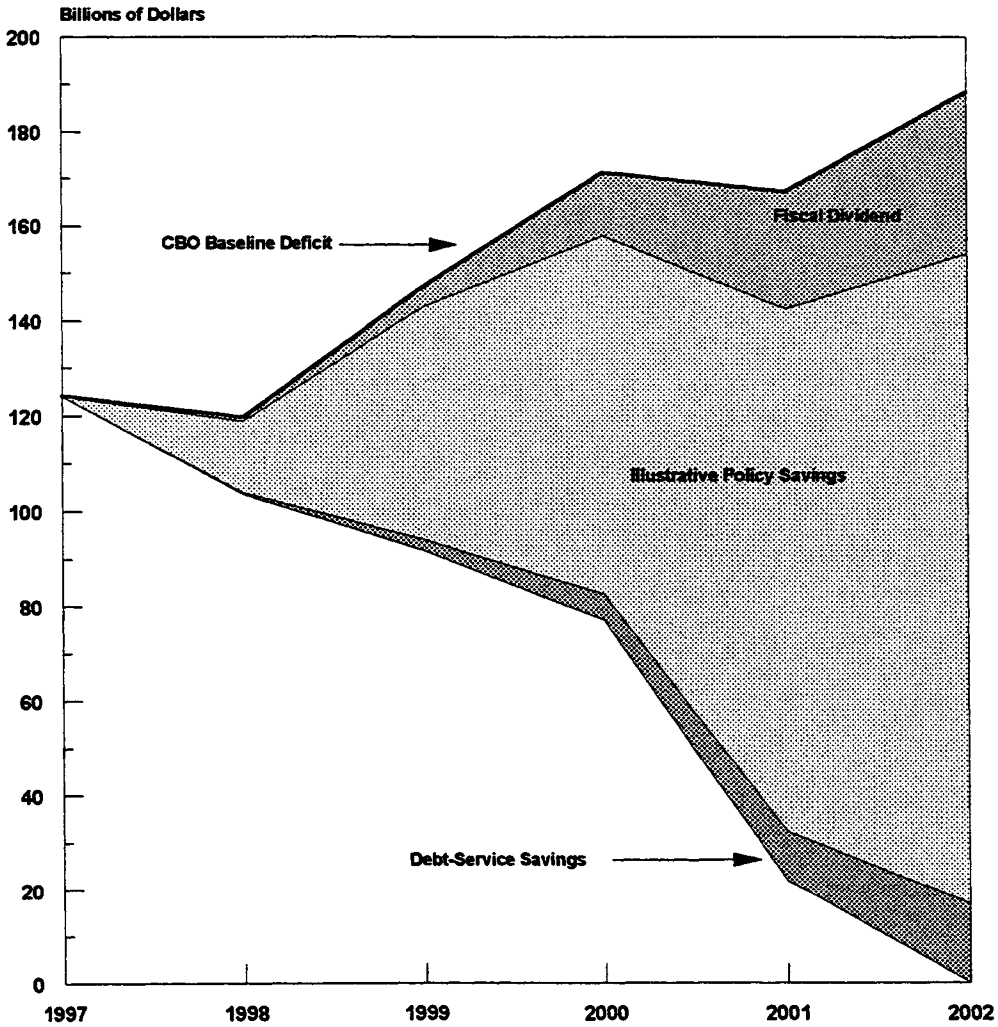
What are some of the implications of CBO's analysis for the Congress as it attempts to hammer out a plan for the budget?

First, although CBO projects that the deficit will reach $188 billion in 2002 under current policies, policymakers need only produce $154 billion in policy savings in 2002 to balance the budget. The reason is that balancing the budget will induce favorable changes in the economy, slightly altering interest rates, economic growth, and the share of GDP represented by corporate profits. While those changes are likely to be small, they nonetheless have an important effect on the budget. The estimated $34 billion in increased revenues and reduced spending resulting from those economic changes—the so-called fiscal dividend—can appropriately be factored into plans to balance the budget (see Figure 4).

The fiscal dividend is smaller than CBO estimated last year because CBO's baseline deficits are substantially lower. Therefore, eliminating the deficit would not entail such a large reduction in federal borrowing and debt. In effect, part of last year's estimate of the fiscal dividend has already been achieved and is incorporated into the revised baseline projections.

Second, despite the encouraging reduction in the baseline deficits, balancing the budget by 2002 may not be easier this year than last—largely because the time frame is shorter. Subtracting the fiscal dividend from CBO's

FIGURE 4. THE FISCAL DIVIDEND AND AN ILLUSTRATIVE PATH TO A BALANCED BUDGET (By fiscal year)



SOURCE: Congressional Budget Office.

baseline projection for 2002 yields a deficit of $154 billion, which is the amount of savings that must be achieved in that year to balance the budget. Last year's budget resolution anticipated virtually the same amount of savings in the fifth year (2001).

Third, wringing savings out of discretionary programs is becoming harder and harder. The Congressional budget resolution for fiscal year 1997 assumed that the Congress would cut discretionary appropriations in real terms. In fact, however, the Congress appropriated $10 billion more in budget authority than the resolution assumed. As a result, even if discretionary appropriations were frozen at the 1997 enacted level, outlays in 1998 would be $4 billion higher than the discretionary cap allows and $20 billion higher than last year's budget resolution assumed. Under a freeze at the level of the 1998 cap, discretionary outlays would be worth 14 percent less than the 1997 amount by 2002 and 26 percent less by 2007. Thus, achieving the discretionary savings anticipated in 1998 and future years will be tough going.

CONCLUSION

I would like to conclude on a cautionary note. First, although the baseline projections represent CBO's estimate of the most likely budgetary outcomes, the actual course of the deficit could easily be less favorable. Second, because the current baseline projections run only through 2007, they do not show the detrimental budgetary effects of the retirement of the baby-boom generation and the continuing growth in per-person health care costs after 2007.

Both of those cautions highlight the need to make a major effort to reduce the deficit in the near term. Taking action now would contribute to assuring budgetary stability in the next century, particularly if the policy changes adopted deal with the problems associated with federal health care and other retirement benefits. Doing so would make the additional policy changes required in the future much less painful.