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Testimony

**Statement of
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Director**

Confronting the Nation's Fiscal Policy Challenges

**before the
Joint Select Committee on Deficit Reduction
U.S. Congress**

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Senator Murray, Congressman Hensarling, and Members of the Committee, thank you for the invitation to testify about the outlook for the economy and the budget and about the Congressional Budget Office's (CBO's) analysis of the fiscal policy choices facing this Committee and the Congress.

Summary

The federal government is confronting significant and fundamental budgetary challenges. If current policies are continued in coming years, the aging of the population and the rising cost of health care will boost federal spending, as a share of the economy, well above the amount of revenues that the federal government has collected in the past. As a result, putting the federal budget on a sustainable path will require significant changes in spending policies, tax policies, or both. The task of addressing those formidable challenges is complicated by the weakness of the economy and the large numbers of unemployed workers, empty houses, and underused factories and offices. Changes that might be made to federal spending or tax policies could have a substantial impact on the pace of economic recovery during the next few years as well as on the nation's output and people's income over the longer term.

The Economic Outlook

The financial crisis and recession have cast a long shadow on the U.S. economy. Although output began to expand again two years ago, the pace of the recovery has been slow, and the economy remains in a severe slump. CBO expects that the economic recovery will continue but that output will stay well below the economy's potential output—an amount that corresponds to a high rate of use of labor and capital—for several years. CBO published its most recent economic forecast in August; that forecast was initially completed in early July and was updated in August only to reflect the policy changes enacted in the Budget Control Act. Incoming data and other developments since early July, as well as the latest *Blue Chip* consensus forecast, suggest that economic growth for the remainder of this year and next is likely to be weaker than the agency anticipated—with growth in the vicinity of 1½ percent this year and around 2½ percent next year.¹

With output growing at that modest rate, CBO expects employment to expand very slowly during the rest of this year and next year, leaving the unemployment rate close to 9 percent through the end of 2012. Weakness in the demand for goods and services is the principal restraint on hiring, but structural impediments in the labor market—such as a mismatch between the requirements of existing job openings and the characteristics of job seekers—appear to be hindering hiring as well.

If economic growth occurs at the slow pace that CBO anticipates, a large portion of the economic and human costs of the recession and slow recovery remains ahead. In

1. The *Blue Chip* consensus is the average of about 50 forecasts by private-sector economists.

mid-2011, according to the agency's estimates, the economy was only about halfway through the cumulative shortfall in output relative to its potential level that will result from the recession and the weak recovery. Between late 2007 and mid-2011, the cumulative difference between gross domestic product (GDP) and estimated potential GDP amounted to roughly \$2½ trillion; by the time the nation's output rises back to its potential level, probably several years from now, the cumulative shortfall is expected to equal about \$5 trillion. Not only are the costs associated with the output gap immense, but they are also borne unevenly, falling disproportionately on people who lose their jobs, who are displaced from their homes, or who own businesses that fail.

The economic outlook remains highly uncertain, however. The recent recession was unusual compared with previous ones in terms of its causes, depth, and duration. As a result, the recovery has had unusual features that have been hard to predict, and the path of the economy in coming years is also likely to be surprising in various ways. Many developments, such as changes in the degree to which households want to further reduce their debt burdens or the adoption of fiscal policies that differ from current law, could cause economic outcomes to differ substantially, in one direction or the other, from those CBO has projected.

The Budget Outlook

If the recovery continues as CBO expects, and if tax and spending policies unfold as specified in current law, deficits will drop markedly as a share of GDP over the next few years. Under CBO's baseline projections, which generally reflect the assumption that current law will not change, deficits fall to 6.2 percent of GDP in 2012 and to 3.2 percent in 2013, and then fluctuate within a range of 1.0 percent to 1.6 percent of GDP from 2014 through 2021. In that scenario, cumulative deficits over the coming decade will total \$3.5 trillion, and by 2021, debt held by the public will equal 61 percent of GDP—well above the annual average of 37 percent recorded between 1971 and 2010. (The weaker economy that CBO now anticipates for the remainder of this year and next would imply, all else being equal, a slightly larger federal deficit during that period.)

CBO's baseline projections incorporate the assumption that current law remains in place so they can serve as a benchmark for policymakers to use in considering possible changes to the law. But those baseline projections understate the budgetary challenges facing the federal government because changes in policy that will take effect under current law will produce a federal tax system and spending for some federal programs that differ noticeably from what people have become accustomed to. Specifically, CBO's baseline projections include the following policies specified in current law:

- Provisions of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Public Law 111-312, referred to in this testimony as the 2010 tax act) that reduced the payroll tax for one year and limited the reach of the

alternative minimum tax (AMT) for two years are set to expire on December 31, 2011.

- Several other key provisions of the 2010 tax act—including the extension of lower tax rates and expanded credits and deductions originally enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001, the Jobs and Growth Tax Relief Reconciliation Act of 2003, and the American Recovery and Reinvestment Act (ARRA, P.L. 111-5)—are set to expire on December 31, 2012.
- Medicare's payments for physicians' services are scheduled to be reduced by nearly 30 percent after December 31, 2011.
- Discretionary appropriations between 2012 and 2021 will be subject to statutory caps set in the Budget Control Act of 2011 (P.L. 112-25) that will reduce discretionary spending in real (inflation-adjusted) terms over time.
- Additional budgetary savings of more than \$1 trillion required by the Budget Control Act will occur as a result of legislation produced by this Committee or, if lawmakers fail to enact such legislation, by means of automatic cuts in spending that will then be triggered.

Changing provisions of current law so as to maintain major policies that are in effect now would produce markedly different budgetary outcomes. For example, if most of the provisions in the 2010 tax act were extended, if the AMT was indexed for inflation, and if Medicare's payment rates for physicians' services were held constant, then cumulative deficits over the coming decade would total \$8.5 trillion, and debt held by the public would reach 82 percent of GDP by the end of 2021, higher than in any year since 1948.

Beyond the coming decade, the fiscal outlook worsens, as the aging of the population and the rising costs of health care exert significant and increasing pressure on the budget under current law. When CBO issued its most recent long-term projections in June 2011, debt held by the public was projected to reach 84 percent of GDP in 2035 under an extension of current law. In those projections, rising federal spending relative to GDP kept debt high even though federal revenues reached significantly larger percentages of GDP than ever seen before in the United States. The agency also examined an alternative scenario in which the tax provisions enacted since 2001 that were extended most recently in 2010 were assumed to be extended, the reach of the AMT was assumed to be restrained to stay close to its historical extent, and tax law was assumed to evolve over the long term so that revenues remained near their historical average of 18 percent of GDP. CBO projected in June that, under that alternative scenario, revenues would increase much more slowly than spending, and debt held by the public would balloon to nearly 190 percent of GDP by 2035.

Although new long-term projections reflecting the latest 10-year projections would differ, the amounts of federal borrowing that would be required under those policy

assumptions clearly would be unsustainable. Interest payments on that debt would rise dramatically relative to the size of the tax base that would be available for generating revenues to cover those payments, consuming an ever-growing share of the federal budget. Even before the interest burden became unsupportable, a fiscal crisis could arise if participants in financial markets lost confidence in the government's ability to manage its budget and became unwilling to lend to the government at affordable rates. Thus, under current policies, the federal budget is quickly heading into territory that is unfamiliar to the United States and to most other developed countries as well.

Fiscal Policy Choices

The budgetary and economic challenges facing the nation present policymakers with difficult choices about fiscal policy. As this Committee considers its charge to recommend policies that would reduce future budget deficits, its key choices fall into three broad categories:

- How much deficit reduction should be accomplished?
- How quickly should deficit reduction be implemented?
- What forms should deficit reduction take?

The Magnitude of Deficit Reduction. There is no commonly agreed upon level of federal debt that is sustainable or optimal. Under CBO's current-law baseline, which incorporates \$1.2 trillion in expected deficit reduction related to this Committee's work, as well as significant increases in tax revenues relative to GDP, debt held by the public is projected to fall from 67 percent of GDP at the end of 2011 to 61 percent by 2021. However, stabilizing the debt at that level would leave it larger than in any year between 1953 and 2009.

Lawmakers might determine that debt should be reduced to amounts lower than those shown in CBO's baseline—in order to reduce the burden of debt on the economy, relieve some of the long-term pressures on the budget, diminish the risk of a fiscal crisis, and enhance the government's flexibility to respond to unanticipated developments. Accomplishing that objective would require larger amounts of deficit reduction. If, for example, this Committee chose to make recommendations that would lower debt held by the public in 2021 to 50 percent of GDP, roughly the level recorded in the mid-1990s, it would need to propose changes in policies—relative to those embodied in current law, which underlie CBO's baseline projections—that reduced deficits by a total of about \$3.8 trillion over the coming decade.

Furthermore, lawmakers might decide that some of the current policies that are scheduled to expire under current law should be continued. In that case, achieving a particular level of debt could require much larger amounts of deficit reduction through other changes in policy. For example, if most of the provisions in the 2010 tax act were extended, if the AMT was indexed for inflation, and if Medicare's payment rates for physicians' services were held constant, then reducing debt held by the

public in 2021 to the 61 percent of GDP projected under current law would require other changes in policy to reduce deficits over the next 10 years by a total of \$6.2 trillion, rather than the \$1.2 trillion in deficit reduction that this Committee would have to accomplish to avoid the automatic budget cuts required by the Budget Control Act.

The Timing of Deficit Reduction. Policymakers face difficult trade-offs in decisions about how quickly to implement policies to reduce budget deficits. On the one hand, cutting spending or increasing taxes slowly would lead to a greater accumulation of government debt and might raise doubts about whether the longer-term deficit reductions would ultimately take effect. On the other hand, implementing spending cuts or tax increases abruptly would give families, businesses, and state and local governments little time to plan and adjust. In addition, and particularly important given the current state of the economy, immediate spending cuts or tax increases would represent an added drag on the weak economic expansion.

However, credible steps to narrow budget deficits over the longer term would tend to boost output and employment in the next few years by holding down interest rates and by reducing uncertainty and enhancing business and consumer confidence. Therefore, the near-term economic effects of deficit reduction would depend on the balance between changes in spending and taxes that take effect quickly and those that take effect gradually. According to CBO's analysis, credible policy changes that would substantially reduce deficits later in the coming decade and over the long term—without immediate cuts in spending or increases in taxes—would both support the economic expansion in the next few years and strengthen the economy over the longer term.

There is no inherent contradiction between using fiscal policy to support the economy today, while the unemployment rate is high and many factories and offices are underused, and imposing fiscal restraint several years from now, when output and employment will probably be close to their potential. If policymakers wanted to achieve both a short-term economic boost and medium-term and long-term fiscal sustainability, a combination of policies would be required: changes in taxes and spending that would widen the deficit now but reduce it later in the decade. Such an approach would work best if the future policy changes were sufficiently specific and widely supported so that households, businesses, state and local governments, and participants in the financial markets believed that the future fiscal restraint would truly take effect.

The Composition of Deficit Reduction. As policymakers consider the composition of policy changes to be used to reduce budget deficits, many factors may play a role. The amount and composition of federal spending and revenues affect the total amount and types of output that are produced and consumed in the country, the distribution of those material resources among various segments of society, and people's well-being in a variety of ways.

In considering the challenge of putting fiscal policy on a sustainable path, many observers have wondered whether it is possible to return to policies regarding federal spending and revenues that, in earlier years, usually generated deficits that were small relative to GDP and kept the amount of debt held by the public to between about one-quarter and one-half of GDP. Unfortunately, however, the past combination of policies cannot be repeated when it comes to the federal budget: The aging of the population and rising costs for health care have changed the backdrop for federal budget policy in a fundamental way.

Under current law, spending on Social Security and the major health care programs—Medicare, Medicaid, the Children’s Health Insurance Program, and insurance subsidies to be provided through exchanges in coming years—is projected to be much higher than has historically been the case, reaching 12.2 percent of GDP in 2021, compared with 10.4 percent of GDP in 2011 and an average of 7.2 percent of GDP during the past 40 years. Most of that spending goes to benefits for people over age 65, with smaller shares for blind and disabled people and for nonelderly able-bodied people.

In contrast, under current law, all spending apart from that for Social Security, the major health care programs, and interest payments on the debt is projected to decline noticeably as a share of the economy. That broad collection of programs includes defense (the largest single piece), the Supplemental Nutrition Assistance Program (formerly known as Food Stamps), unemployment compensation, other income-security programs, veterans’ benefits, federal civilian and military retirement benefits, transportation, health research, education and training, and other programs. Such spending has averaged 11.5 percent of GDP during the past 40 years and totals 12.0 percent in 2011. Expected improvement in the economy and the caps on discretionary spending instituted in the Budget Control Act are projected to reduce such spending to 7.7 percent of GDP in 2021, the lowest level as a share of GDP in the past 40 years.

Thus, according to CBO’s projections under current law, even with the new constraints on discretionary spending, federal spending excluding net interest will grow to 19.9 percent of GDP in 2021—compared with the 40-year average of 18.6 percent. And the composition of that spending will be noticeably different from what the nation has experienced in recent decades: Spending for Social Security and the major health care programs will be much higher, and spending for all other federal programs and activities, except for net interest payments, will be much lower. Alternatively, if the laws governing Social Security and the major health care programs were unchanged, and all other programs were operated in line with their average relationship to the size of the economy during the past 40 years, total federal spending excluding net interest would be much higher in 2021—nearly 24 percent of GDP. That amount exceeds the 40-year average for revenues as a share of GDP by nearly 6 percentage points—even before interest payments on the debt have been included.

At the same time, the sharp increase in federal debt and a return to more-normal interest rates will boost the government's net interest costs. They are projected to reach 2.8 percent of GDP in 2021, compared with only 1.5 percent of GDP in 2011 and an average of 2.2 percent of GDP during the past 40 years.

What do those numbers imply about the choices that policymakers—and citizens—confront about future policies? Given the aging of the population and the rising costs for health care, attaining a sustainable budget for the federal government will require the United States to deviate from the policies of the past 40 years in at least one of the following ways:

- Raise federal revenues significantly above their average share of GDP;
- Make major changes to the sorts of benefits provided for Americans when they become older; or
- Substantially reduce the role of the rest of the federal government relative to the size of the economy.

The nation cannot continue to sustain the spending programs and policies of the past with the tax revenues it has been accustomed to paying. Citizens will either have to pay more for their government, accept less in government services and benefits, or both.

The Economic Outlook

The financial crisis and recession have cast a long shadow on the U.S. economy. Although total output began to expand again two years ago, the pace of the recovery in output and employment has been slow, and the economy remains in a severe slump. Some of the factors that appear to have contributed to economic weakness in the first half of this year—such as a reduction in consumers' purchasing power because of a rise in the price of crude oil—are projected to fade. Nevertheless, CBO expects that the economic recovery will continue to be slow and that real GDP will stay below the economy's potential—a level that corresponds to a high rate of use of labor and capital—for several years (see Figure 1).

CBO published its most recent economic forecast in August.² The agency initially completed that forecast in early July, and it updated its projections in August to reflect the policy changes enacted in the Budget Control Act of 2011 but no other developments. The news since CBO completed that work suggests that economic growth for the remainder of this year and next is likely to be weaker than the agency anticipated—with growth in the vicinity of 1½ percent this calendar year (as measured by the change between the fourth quarter of 2010 and the fourth quarter of 2011) and around 2½ percent next year.³ (The latest *Blue Chip* consensus forecast for growth in

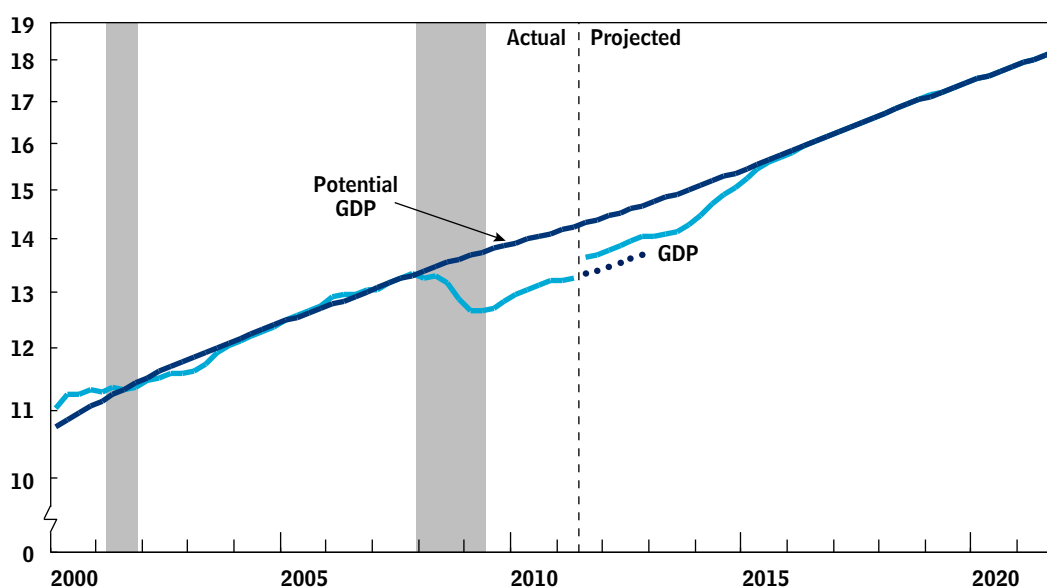
2. See Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2011).

3. Although real GDP grew at an average annual rate of 0.7 percent in the first half of this year, CBO anticipates it will grow at about 2.0 percent in the second half.

Figure 1.

Real Gross Domestic Product

(Trillions of 2005 dollars, logarithmic scale)



Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

Notes: Real gross domestic product (GDP) is the output of the economy adjusted to remove the effects of inflation. Potential GDP is CBO's estimate of the output that the economy would produce with a high rate of use of its labor and capital resources.

Data are quarterly. Actual data for GDP, which are plotted through the second quarter of 2011, incorporate the July 2011 revisions of the national income and product accounts. The projections of GDP indicated by the solid line are taken from Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2011). They are plotted through the fourth quarter of 2021 and are based on data issued before the revisions. The projections of GDP indicated by the dotted line incorporate the effects of the revisions and the news since early July, when the previous forecast was completed; they are plotted through the fourth quarter of 2012.

real GDP is 1.3 percent for 2011 and 2.5 percent for 2012.) Those estimates reflect CBO's expectation of continued strong growth in investment by businesses, modest increases in spending by consumers, gains in net exports (exports minus imports), and the beginning of a recovery in new-home construction. With weak economic growth anticipated for the next few years, CBO expects employment to expand very slowly, leaving the unemployment rate close to 9 percent through the end of 2012.

The economic outlook remains highly uncertain. The recent recession was unusual compared with previous ones in terms of its causes, depth, and duration. As a result, the recovery has had unusual features that have been hard to predict, and the path of the economy in coming years is also likely to be surprising in various ways. Many developments, such as changes in the degree to which households want to further reduce their debt burdens or the adoption of fiscal policies that differ from current

law, could cause economic outcomes to differ substantially, in one direction or the other, from those CBO has projected.

Recent Developments

The period since early July has seen significant financial and economic news that has led many forecasters to lower their projections of near-term growth. In the *Blue Chip* consensus forecast, the probability of a recession by the end of next year now stands at about one-third. Stock prices, as measured by the value of the Standard & Poor's 500 index, fell by more than 12 percent between early July and early September, returning to their level of late 2010. Interest rates on 10-year Treasury notes have dropped by almost a full percentage point since early July from already low levels—mainly because participants in financial markets have sought safer investments because of their concerns about a weaker U.S. economy and potential losses on the sovereign debt of some major euro-zone countries and because the Federal Reserve has signaled its intention to keep short-term interest rates low for an even longer period than many market participants may have expected.

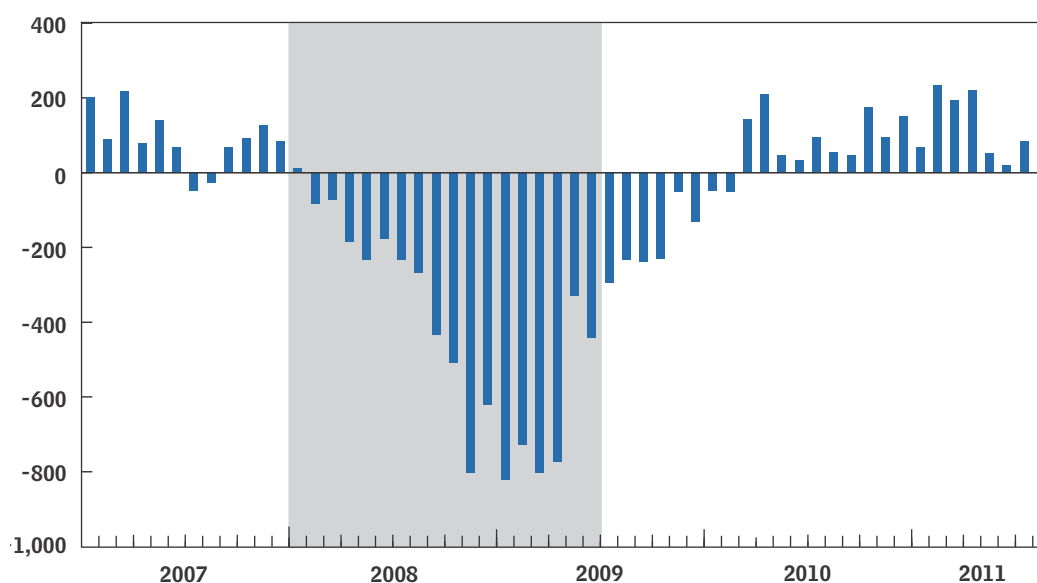
Moreover, employment growth has slowed in the past few months. The total number of jobs increased at an average monthly rate of about 180,000 in the first four months of this year, more than double its average pace in 2010 (see Figure 2). However, employment growth has ebbed again, averaging only 40,000 jobs per month from May through August. Likewise, the unemployment rate fell from 9.8 percent in November 2010 to 8.8 percent in March 2011, but in August, it was back up to 9.1 percent (see Figure 3). Probably reflecting the weak job market and developments such as the declines in stock prices, consumer confidence plunged recently; according to a survey by the University of Michigan, for example, it fell in August to levels last seen during the depths of the recession.

The annual revisions to the national income and product accounts (NIPAs) and the first estimate of GDP for the second quarter of 2011, issued by the Commerce Department in late July, showed that the economy was weaker from 2008 through the first half of 2011 than was previously thought. Real GDP grew at an average annual rate of 0.7 percent in the first half of this year—well below the previous estimate of 1.9 percent that CBO used in constructing its economic forecast in early July. In addition, the revisions indicated that the recession was considerably deeper than previously thought: The total decline in real GDP from its peak in the fourth quarter of 2007 to its trough in the second quarter of 2009 was revised downward from -4.1 percent to -5.1 percent. The figure for subsequent growth of real GDP from the trough of the recession in the second quarter of 2009 through the first quarter of 2011 was also revised downward slightly. With the revisions, real GDP for the first quarter of this year was 1.6 percent lower than previously estimated.

Figure 2.

Net Job Growth per Month

(Thousands of jobs)



Sources: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics.

Note: Data are monthly and are plotted through August 2011; in that most recent month, net job growth was zero. The data exclude temporary jobs associated with the 2010 census.

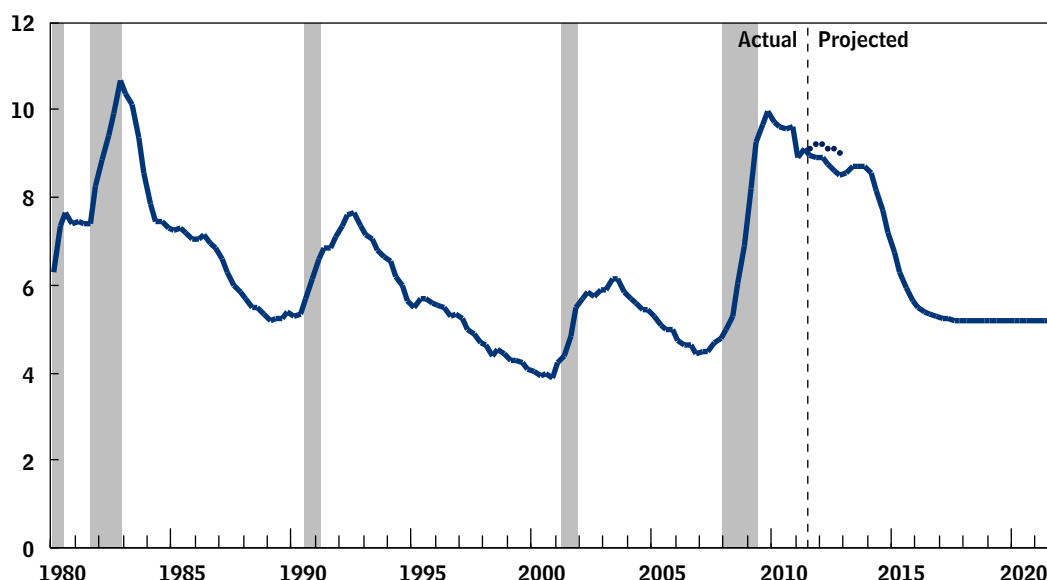
Prospects for world economic growth have also deteriorated since early July, which suggests a weaker outlook for U.S. exports. Recent data reveal that growth slowed in major foreign economies during the second quarter of 2011. The annualized growth of real GDP in the euro zone slowed to 0.6 percent in the second quarter from 3.4 percent in the previous quarter, as economic growth in Germany fell sharply. The outlook for growth in China is still bright, but prospects for other Asian economies that rely heavily on exports are softening, and Japan's economy contracted in the second quarter. In addition, the European sovereign debt crisis spread to Spain and Italy, increasing uncertainty and generating volatility in financial markets.

The news since early July has not been uniformly negative, though. Oil prices dropped in July and August from their recent highs. In the nonfinancial sector, the data released since early July point to stabilization in both homebuilding and house prices and to a recovery in vehicle sales and production after supply disruptions earlier in the year. In addition, consumer spending appears to have held up, at least through July. Moreover, the revisions to the NIPAs revealed that real gross domestic income, which some consider to be a more accurate indicator of current economic activity than real GDP, grew at a relatively healthy 2.2 percent pace during the first half of

Figure 3.

Unemployment Rate

(Percent)



Sources: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics.

Notes: 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.

Data are quarterly. Actual data are plotted through the second quarter of 2011. The projections indicated by the solid line are taken from Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2011) and are plotted through the fourth quarter of 2021. The projections indicated by the dotted line incorporate the effects of the news since early July when the previous forecast was completed; they are plotted through the fourth quarter of 2012.

2011, well above the 0.7 percent growth in real GDP.⁴

The Economic Outlook for 2011 and 2012

CBO expects the pace of economic recovery to pick up a little in the second half of this year but to remain modest for the next few years. Growth slowed and inflation increased in the first half of 2011, in part because of developments that are likely to be temporary, including jumps in energy and food prices and disruptions to the global supply chain caused by the earthquake and nuclear accident in Japan. As the effects of those developments fade, growth in the U.S. economy is likely to rebound a little, driven by continued strength in business investment, modest increases in consumer spending, and expansions in net exports and residential investment. Nevertheless, the pace of growth will probably be restrained for several more years by the lingering

4. For a review of evidence suggesting that real gross domestic income is a more accurate indicator of current economic activity than real GDP, see Jeremy J. Nalewaik, "The Income- and Expenditure-Side Estimates of U.S. Output Growth," *Brookings Papers on Economic Activity* (Spring 2010), pp. 71–106.

effects of the financial crisis and the recession—particularly their impact on households’ net worth and indebtedness, on access to credit for riskier borrowers, on the number of vacant homes, and on consumer and business confidence.

The growth in GDP that CBO now anticipates—about 1½ percent this year (as measured by the change between the fourth quarter of 2010 and the fourth quarter of 2011) and around 2½ percent next year—would be weaker than what CBO forecast in August, when it projected real GDP growth of 2.3 percent in 2011 and 2.7 percent in 2012. Other forecasters have also modified their expectations. For example, between early July and early September, the *Blue Chip* consensus forecast for real GDP growth in 2011 was marked down from 2.6 percent to 1.3 percent. For 2012, the *Blue Chip* forecast was lowered from 3.0 percent to 2.5 percent.

With modest growth in output, CBO expects employment to expand very slowly during the rest of this year and next year. Weakness in the demand for goods and services is the principal restraint on hiring, but structural impediments in the labor market—such as a mismatch between the requirements of existing job openings and the characteristics of job seekers (including their skills and geographic location)—appear to be hindering hiring as well. As a result, the unemployment rate is likely to be around 9.0 percent through the fourth quarter of next year. (In CBO’s August forecast, the unemployment rate fell to 8.5 percent by the fourth quarter of 2012.) Between early July and early September, the *Blue Chip* consensus similarly raised its forecast for the unemployment rate in the fourth quarter of 2012—from 8.1 percent to 8.7 percent.

Inflation increased markedly in the first half of 2011, spurred in large part by a sharp rise in oil prices, but CBO projects that it will diminish in the second half of the year and be low in 2012 (see Figure 4). The increase in oil prices since mid-2010 has been partly reversed, and trading in financial markets points to fairly stable prices for oil and other commodities in the next few years. In addition, the large amount of unused or underemployed resources in the economy will continue to hold down the growth of wages and prices.

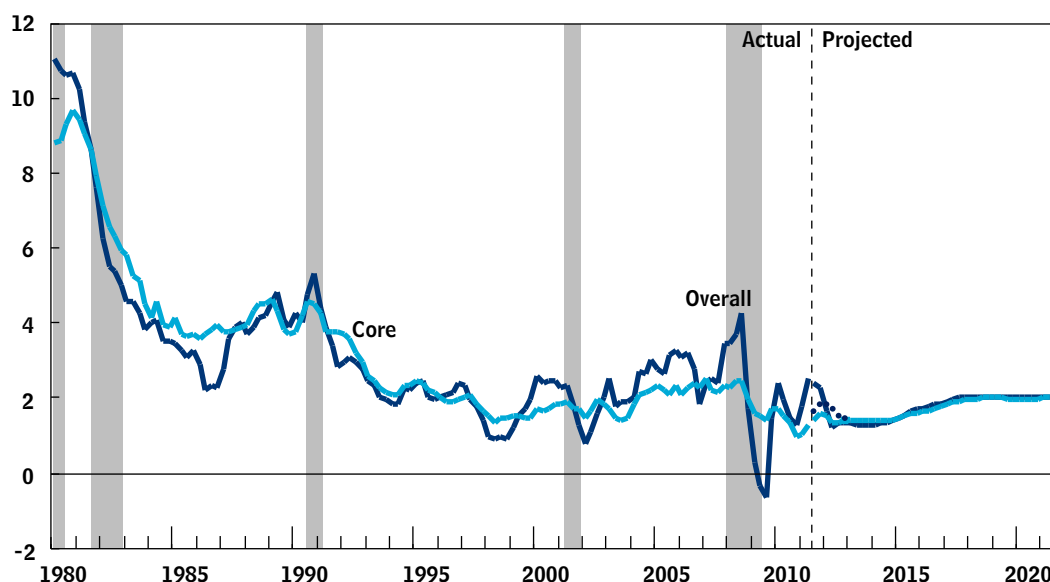
CBO now projects that the price index for personal consumption expenditures (PCE) will increase by about 2½ percent this year and by about 1½ percent next year (as measured by the change from the fourth quarter of the previous year). The “core” version of the PCE price index, which excludes prices for food and energy, is projected to rise by about 1¾ percent in 2011 and by about 1½ percent in 2012. The consumer price index for all urban consumers and its core version are expected to increase more rapidly than their PCE counterparts, especially in 2011. CBO now expects inflation in 2011, as measured by both the PCE price index and the consumer price index, to be higher than it forecast in August because gasoline prices have remained high and inflation in housing rents has been higher than projected; expected higher inflation in rents accounts for CBO’s higher inflation forecast in 2012.

With modest inflation and slow economic growth, interest rates are likely to remain quite low for the rest of 2011 and 2012. The interest rate on 3-month Treasury bills is likely to remain barely above zero, and as indicated by the financial markets, the rate on 10-year Treasury notes will probably average less than 3.0 percent.

Figure 4.

Inflation

(Percentage change in prices from previous year)



Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

Notes: The overall inflation rate is based on the price index for personal consumption expenditures; the core rate excludes prices for food and energy.

Data are quarterly. Actual data, which are plotted through the second quarter of 2011, incorporate the July 2011 revisions of the national income and product accounts. The projections indicated by the solid lines are taken from Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2011). They are plotted through the fourth quarter of 2021 and are based on data issued before the revisions. The projections indicated by the dotted line are for core inflation and incorporate the effects of the revisions and the news since early July, when the previous forecast was completed; they are plotted through the fourth quarter of 2012.

The Output Gap and Its Costs

Economic growth at the rates CBO anticipates would leave a very large and persistent gap between actual output and the agency's estimate of potential output—that is, a large amount of labor and capital resources would be unused for some time. In CBO's August baseline projections, the output gap is about 5 percent of potential GDP at the end of 2011 and does not close fully until the second half of the 2011–2021 projection period.⁵

As a result, a large portion of the economic and human costs of the recession and slow recovery remains ahead. In mid-2011, according to CBO's estimates, the economy was only about halfway through the cumulative shortfall in output relative to its

5. CBO has not prepared new estimates of the paths for potential GDP and the output gap since it published its previous estimates in August.

potential level that will result from the recession and the weak recovery. Between late 2007 and mid-2011, the cumulative difference between GDP and estimated potential GDP amounted to roughly \$2½ trillion; by the time the nation's output rises back to its potential level, the cumulative shortfall is expected to equal about \$5 trillion.

Not only are the costs associated with the output gap immense, but they are also borne unevenly. Those costs fall disproportionately on people who lose their jobs, who are displaced from their homes, or who own businesses that fail. In the first quarter of 2011, for example, the recession and weak recovery led to a shortfall of about 10 million jobs relative to the number that would have existed had the recession not occurred and had job growth matched the average rate in the previous business cycle. And the unemployment rate is projected to remain well above CBO's estimate of the natural rate of unemployment for several years.⁶ Even among workers who find a new job, experience suggests that many will end up with lower earnings, not only in the short term but for many years to come.⁷

Uncertainty in the Economic Outlook

Economic forecasts are always subject to a considerable degree of uncertainty, but the uncertainty surrounding the economic outlook is especially great because the present business cycle has been unusual in a variety of ways. CBO constructs its economic forecasts to lie in the middle of the distribution of possible future outcomes for the economy under an assumption that current law remains unchanged. Actual outcomes will undoubtedly differ from what CBO has projected in at least some respects. Key areas of uncertainty in the economic outlook include the following factors:

- The degree to which households want to further reduce their debt burdens,
- The pace at which firms hire and invest,
- The timing and magnitude of a recovery in house prices,
- The evolution in people's confidence about their future economic gains,
- Changes in stock prices and long-term interest rates,
- The resolution of concerns that some European governments may default on their debts, and
- The path of U.S. fiscal policy.

6. The natural rate of unemployment is the rate arising from all sources except cyclical fluctuations in the economywide demand for goods and services.

7. For an analysis of the cost of losing a job in an economic downturn, see Congressional Budget Office, *Losing a Job During a Recession*, Issue Brief (April 2010). For a discussion of other measures of weakness in the labor market, including the number of people who have recently been employed part time but want full-time work, see Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2011), pp. 47–48.

Different outcomes for those factors could combine to have quite divergent effects: from boosting the growth of the U.S. economy significantly to causing a new recession, or producing some result in between.

On the upside, the economy could grow considerably faster than CBO anticipates if the forces that have restrained the recovery fade more rapidly than the agency anticipates. The most important of those forces are the ones holding down consumer spending, including weak growth in employment and income as well as the loss of wealth from declines in house and stock prices. If wages and salaries grew faster than CBO projects—because of a shift in national income toward employee compensation and away from profits, for example—then they could support stronger consumer spending. If that faster growth in compensation was matched by gains in house prices and further easing of constraints on lending, then consumer spending could be buttressed by increased net worth and faster growth in consumer credit. Those conditions could in turn speed up the growth of employment and boost businesses' spending on facilities and equipment, potentially leading to a self-reinforcing cycle of increased spending, hiring, and income.

That favorable chain of events could be bolstered by renewed stability in financial markets or declines in the prices of oil and other commodities. In addition, foreign demand for U.S. goods and services could be greater than CBO expects if fears of negative financial repercussions from default on European sovereign debt proved to be exaggerated and if economic expansion in India, China, and other parts of the developing world ended up being stronger than expected.

However, outcomes that are considerably worse than CBO projects are also possible. The slowing of growth in U.S. output during the first half of 2011 might portend the onset of another recession. Although current economic indicators are not pointing to the kinds of imbalances that have preceded previous recessions, one possible path to a new recession would be a self-reinforcing downward spiral in which reduced hiring led to weaker growth of household income and diminished consumer and business confidence, which in turn led to lower spending by households and businesses and thus less need for workers and less hiring. Stock prices could continue to fall, reducing households' wealth and confidence. In addition, problems in housing and mortgage markets could persist longer than anticipated, which could push down house prices further, prolong problems in the financial system, and further restrain consumer spending and residential construction. Under those conditions, the income and confidence of businesses and households would decline further, and such a cycle of self-reinforcing adjustments could drive the economy into recession again.

Another possible catalyst for a recession is a worsening of the sovereign debt crisis in Europe, leading to more turmoil in international financial markets, potentially spilling over to U.S. financial markets, which have been fragile recently. If that occurred while policymakers in some developing countries were already slowing their economies to counteract inflationary pressures, economic activity worldwide could contract. The problems for the U.S. economy would be compounded if oil prices spiked because of further political unrest or military conflict in oil-producing states that threatened to disrupt the supply of oil. The problems would also be amplified if

concerns about large federal deficits and the high current level of federal debt restricted policymakers' ability to use fiscal policy to address the effects of an economic crisis.

The Budget Outlook

In part because of the weak economy and actions the government has taken in response, the budget deficit in fiscal year 2011 will total nearly \$1.3 trillion, CBO estimates.⁸ At 8.5 percent of GDP, this year's deficit will be the third-largest shortfall in the past 65 years, exceeded only by those in 2009 (at 10.0 percent) and 2010 (at 8.9 percent). As a result, at the end of the current fiscal year (September 30, 2011), debt held by the public will stand at an estimated 67 percent of GDP—the highest level since 1950 and up from 40 percent at the end of fiscal year 2008.

CBO's Budget Projections for 2012 to 2021

During the next several years and over the longer term, the nation faces profound challenges regarding the federal budget. The future paths of federal deficits and debt will depend crucially both on the strength of the economic recovery and on the tax and spending policies pursued by the federal government. In CBO's baseline estimates, which generally reflect the assumption that current law will not change, deficits drop markedly as a share of GDP over the next few years.⁹ Under current law, CBO projects, the deficit will fall to 6.2 percent of GDP in 2012 and to 3.2 percent in 2013, and then will fluctuate within a range of 1.0 percent to 1.6 percent of GDP from 2014 through 2021 (see Table 1). (The weaker economy that CBO now anticipates for the remainder of this year and next would imply, all else being equal, a slightly larger federal deficit during that period.) In that scenario, deficits will total \$3.5 trillion between 2012 and 2021, and by 2021, debt held by the public will equal 61 percent of GDP—well above the annual average of 37 percent recorded between 1971 and 2010.

However, the budgetary challenges facing the federal government are not fully reflected in CBO's baseline projections because current law provides for substantial changes to tax and spending policies in coming years. If those changes did not occur and current policies were continued instead, much larger deficits and much

8. Budget estimates are provided for fiscal years, which span the period of October 1 through September 30, while the economic outlook discussion presents information on a calendar year basis.

9. The budget projections discussed here are those that CBO reported in August 2011 and are based on the economic forecast that the agency issued at that time. For a more detailed discussion of those projections, see Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2011).

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

													Total	
	Actual, 2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012- 2016	2012- 2021
In Billions of Dollars														
Projection Excluding Effects of Provisions Related to the Joint Select Committee on Deficit Reduction														
Revenues	2,163	2,314	2,635	3,069	3,423	3,665	3,847	4,087	4,286	4,508	4,731	4,969	16,640	39,221
Outlays	3,456	3,597	3,609	3,692	3,803	3,988	4,249	4,449	4,635	4,913	5,161	5,409	19,340	43,908
Deficit	-1,294	-1,284	-973	-623	-380	-322	-402	-362	-349	-405	-430	-440	-2,701	-4,687
Effects of Provisions Related to the Joint Select Committee on Deficit Reduction ^a	0	0	0	113	115	118	124	132	139	146	154	161	469	1,200
Total Deficit	-1,294	-1,284	-973	-510	-265	-205	-278	-231	-211	-259	-277	-279	-2,232	-3,487
Debt Held by the Public at the End of the Year	9,019	10,164	11,153	11,773	12,148	12,463	12,840	13,169	13,473	13,820	14,181	14,541	n.a.	n.a.
As a Percentage of Gross Domestic Product														
Projection Excluding Effects of Provisions Related to the Joint Select Committee on Deficit Reduction														
Revenues	14.9	15.3	16.8	19.0	20.2	20.2	20.1	20.4	20.5	20.6	20.7	20.9	19.3	20.0
Outlays	23.8	23.8	23.0	22.8	22.4	22.0	22.2	22.2	22.1	22.4	22.6	22.7	22.5	22.4
Deficit	-8.9	-8.5	-6.2	-3.9	-2.2	-1.8	-2.1	-1.8	-1.7	-1.8	-1.9	-1.8	-3.1	-2.4
Effects of Provisions Related to the Joint Select Committee on Deficit Reduction ^a	0	0	0	0.7	0.7	0.6	0.6	0.7	0.7	0.7	0.7	0.7	0.5	0.6
Total Deficit	-8.9	-8.5	-6.2	-3.2	-1.6	-1.1	-1.5	-1.2	-1.0	-1.2	-1.2	-1.2	-2.6	-1.8
Debt Held by the Public at the End of the Year	62.1	67.3	71.2	72.8	71.6	68.7	67.2	65.8	64.3	63.1	62.0	61.0	n.a.	n.a.

Source: Congressional Budget Office.

Notes: The Budget Control Act of 2011 (Public Law 112-25) created the Joint Select Committee on Deficit Reduction to propose further deficit reduction totaling at least \$1.5 trillion over 10 years. The act also specified automatic procedures for reducing spending by as much as \$1.2 trillion if legislation originating with the new deficit reduction committee does not achieve savings of at least \$1.2 trillion. CBO has incorporated that amount of deficit reduction (which includes savings in debt-service costs) in its baseline but has no basis for allocating that amount between revenues and outlays. Policy changes were allocated evenly across the 2013–2021 period; the incremental increase in the annual effects results from the compounding of debt-service savings.

n.a. = not applicable.

a. Includes effects on debt service.

greater debt would result (see Figure 5). Specifically, current law includes the following features whose modification or elimination could significantly increase future deficits and debt:

- Provisions of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 that reduced the payroll tax for one year and limited the reach of the alternative minimum tax for two years are set to expire on December 31, 2011.
- Several other key provisions of the 2010 tax act—including the extension of lower tax rates and expanded credits and deductions originally enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001, the Jobs and Growth Tax Relief Reconciliation Act of 2003, and the American Recovery and Reinvestment Act are set to expire on December 31, 2012.
- Medicare’s payments for physicians’ services are scheduled to be reduced by nearly 30 percent after December 31, 2011.
- Discretionary appropriations between 2012 and 2021 will be subject to statutory caps set in the Budget Control Act of 2011. If adhered to, those caps will reduce discretionary outlays by about 5 percent in real terms over the 2012–2021 period relative to spending in 2011, CBO estimates.¹⁰
- Additional budgetary savings of more than \$1 trillion required by the Budget Control Act will occur as a result of legislation produced by this Committee or, if lawmakers fail to enact such legislation, by means of automatic cuts in spending that will then be triggered.

Under an assumption that those provisions of current law all remain in place, CBO projects that revenues will rise sharply—from 15.3 percent of GDP in 2011 to 20.2 percent in 2014 and to 20.9 percent by 2021. Outlays, by contrast, are projected to decrease as a percentage of GDP over the next few years, falling from 23.8 percent of GDP in 2011 to a low of 22.0 percent of GDP in 2015, before increasing again to 22.7 percent by 2021. (Those projections of revenues and outlays exclude the effects of changes that might occur as a result of provisions of the Budget Control Act related to the deficit reduction committee because CBO cannot predict what those changes might be.) By comparison, during the past 40 years, revenues have represented 18.0 percent of GDP, on average, and outlays have represented 20.8 percent.

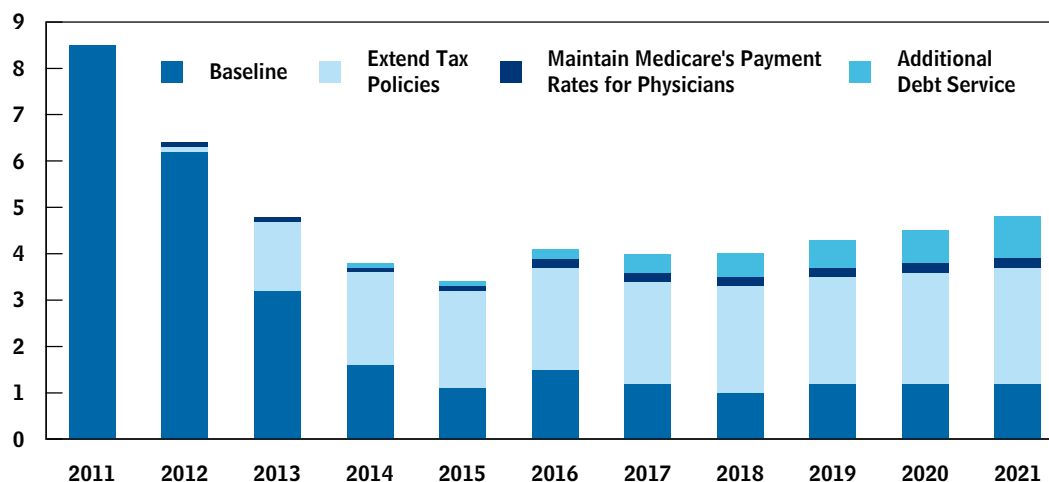
Changing provisions of current law so as to maintain major policies that are in effect now would produce markedly different budgetary outcomes. For example, if most of the provisions in the 2010 tax act were extended (rather than allowed to expire on

10. Outlays refer to spending to pay a federal obligation.

Figure 5.

Deficits in CBO's Baseline and Assuming a Continuation of Certain Policies

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Note: "Extend Tax Policies" reflects the following policy assumptions: Most of the provisions in the 2010 tax act that were originally enacted in 2001, 2003, 2009, and 2010 are extended (instead of being allowed to expire on December 31, 2012, as scheduled), and the alternative minimum tax is indexed for inflation. "Maintain Medicare's Payment Rates for Physicians" involves preventing the nearly 30 percent reduction in Medicare's payment rates for physicians' services that is scheduled to take effect at the end of 2011. "Additional Debt Service" is the amount of interest payments on the additional debt issued to the public that would result from the continuation of the specified policies.

December 31, 2012) and if the AMT was indexed for inflation, CBO projects that annual revenues would average 18 percent of GDP from 2012 through 2021, rather than the 20 percent shown in the baseline projections.¹¹ If Medicare's payment rates for physicians' services also were held constant, then deficits from 2012 through 2021 would average 4.3 percent of GDP, compared with the 1.8 percent in the baseline. With cumulative deficits during that decade of nearly \$8.5 trillion under such policies, debt held by the public would reach 82 percent of GDP by the end of 2021, higher than in any year since 1948 (see Figure 6).

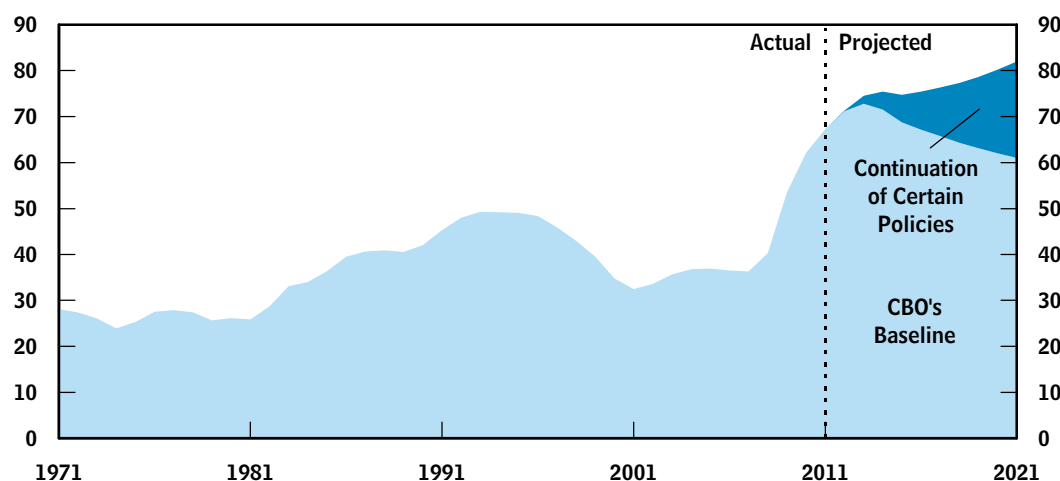
The projected deficits reflect the fact that, during the coming decade and over the long term, the aging of the population and rising costs of health care will exert

11. That alternative is based on an assumption that the lower tax rates, expanded credits, and higher deductions enacted in 2001, 2003, and 2009 and then extended through 2012 by the 2010 tax act are made permanent. It also reflects an assumption that the estate and gift tax rules for 2011 and 2012 (as established by the 2010 tax act) continue permanently beyond their currently scheduled expiration in 2012. Furthermore, it incorporates an assumption that the higher AMT exemption contained in the 2010 tax act does not expire at the end of 2011 and is indexed to inflation thereafter. Finally, it does not incorporate any changes in revenues that may result from the work of the deficit reduction committee.

Figure 6.

Federal Debt Held by the Public

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Note: The projected debt with the continuation of certain policies is based on several assumptions: first, that most of the provisions of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Public Law 111-312) that originally were enacted in 2001, 2003, 2009, and 2010 do not expire on December 31, 2012, but instead continue; second, that the alternative minimum tax is indexed for inflation after 2011; and third, that Medicare's payment rates for physicians are held constant at their 2011 level.

significant and increasing pressure on the budget. The number of people age 65 or older will increase by roughly one-third between 2011 and 2021, causing that segment of the U.S. population to climb from 13 percent to 17 percent of the total; beyond 2021, that share will rise further. In addition, the major health care legislation enacted in 2010 will increase the number of beneficiaries of federal health care programs, and CBO projects that the costs of those programs per beneficiary will continue rising (albeit at different rates because of differences in the laws that govern them). All told, outlays for Social Security, Medicare, and Medicaid—which will account for 44 percent of all federal noninterest spending in 2011—will continue to rise relative to GDP and to consume a growing share of the federal budget.

The Budget Control Act of 2011

CBO's current baseline projections show smaller deficits than the agency estimated earlier this year primarily because of the enactment of the Budget Control Act of 2011.¹² Provisions in that act:

12. Those earlier projections are shown in Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2012* (April 2011). For an analysis of the Budget Control Act of 2011, see Congressional Budget Office, *letter to the Honorable John A. Boehner and the Honorable Harry Reid estimating the impact on the deficit of the Budget Control Act of 2011* (August 1, 2011). The estimates discussed here do not include the effect of initiatives in the Budget Control Act to enhance "program integrity," which depend on future appropriations and will be incorporated into CBO's baseline if they are implemented in the future.

- Establish caps on discretionary funding through 2021;
- Allow certain amounts of additional spending for “program integrity” initiatives aimed at curtailing improper benefit payments;
- Change the Pell Grant and student loan programs;
- Require the House of Representatives and the Senate to vote on a joint resolution proposing a balanced budget amendment to the Constitution;
- Establish a procedure for increasing the debt limit by \$400 billion initially and procedures to raise the limit again in two additional steps, for a cumulative increase of between \$2.1 trillion and \$2.4 trillion;
- Reinstate and modify certain budget process rules;
- Create the Congressional Joint Select Committee on Deficit Reduction to propose further reductions that will amount to at least \$1.5 trillion in budgetary savings over 10 years; and
- Establish automatic procedures for reducing spending if legislation originating with the new deficit reduction committee does not achieve savings estimated to total at least \$1.2 trillion.

Discretionary Caps. The Budget Control Act imposes caps on appropriations of new discretionary budget authority that start at \$1,043 billion in 2012 and reach \$1,234 billion in 2021. For 2012 and 2013, separate caps for “security” and “non-security” budget authority will be in effect; from 2014 through 2021, only one cap will apply to total discretionary funding unless automatic spending reductions are triggered (as described below under “Enforcement Procedures”).¹³

The law allows for adjustments to the discretionary caps when appropriations are provided for certain purposes. Funding for the wars in Afghanistan and Iraq or similar activities (sometimes called overseas contingency operations) would lead to an increase in the caps, as would other funding designated as an emergency requirement. Furthermore, the law allows for an increase in the caps if additional budget authority is provided for program integrity initiatives aimed at reducing improper benefit payments in the Disability Insurance and Supplemental Security Income programs, Medicare, Medicaid, and the Children’s Health Insurance Program. Finally, the caps would be increased if appropriations were provided for disaster relief, but the adjustments would be limited on the basis of historical averages for such funding.

13. Budget authority (or “funding”) refers to the authority provided by law to incur financial obligations, which eventually result in outlays. For the purpose of enforcing the discretionary caps, the security category comprises discretionary appropriations for the Department of Defense, the Department of Homeland Security, the Department of Veterans Affairs, the National Nuclear Security Administration, the intelligence community management account (95-0401-0-1-054), and discretionary accounts in budget function 150 (international affairs). The nonsecurity category comprises all discretionary appropriations not included in the security category.

According to CBO's estimates, if appropriations in the next 10 years are equal to the caps on discretionary spending, implementing those caps will reduce budget deficits by \$756 billion between 2012 and 2021 (not counting the savings in interest payments that will result from lower outlays), compared with what would occur if discretionary budget authority was allowed to grow at the rate of inflation.

Overall Budgetary Impact of the Act. The law also made changes to education programs that will reduce mandatory outlays over the 2012–2021 period by \$5 billion. The savings in interest on the public debt because of the lower deficits resulting from those changes and the discretionary caps will come to \$134 billion, CBO estimates.¹⁴ In addition, CBO's estimate of the budgetary impact of the law, as well as the agency's August baseline projections, include further deficit reduction totaling \$1.2 trillion over the 10-year period stemming from legislation originating with the deficit reduction committee or the automatic reductions in spending that will occur in the absence of such legislation. (As discussed on the following page, CBO estimates that enforcement of the act, in the absence of any enacted legislation stemming from the committee's recommendations, would result in net savings of about \$1.1 trillion over the coming decade.) The composition of that additional deficit reduction over time and across budget categories will depend on the specific provisions of any legislation stemming from the committee's proposals and the extent of any automatic reductions that would be triggered. Overall, CBO's baseline projections incorporate \$2.1 trillion in deficit reduction over the 2012–2021 period stemming from the act.

Enforcement Procedures. If legislation originating from this Committee and estimated to produce at least \$1.2 trillion in deficit reduction (including an allowance for interest savings) is not enacted by January 15, 2012, automatic procedures for cutting both discretionary and mandatory spending would take effect.¹⁵ The magnitude of those cuts would depend on any shortfall in the estimated effects of such legislation relative to the \$1.2 trillion amount.

The automatic reductions—if triggered—would take the form of equal cuts (in dollar terms) in defense and nondefense spending starting in 2013. Those cuts would be achieved by lowering the caps on discretionary budget authority specified in the Budget Control Act and by automatically cancelling budgetary resources (a process known as sequestration) for some programs and activities financed by mandatory spending.¹⁶ The law exempts a significant portion of mandatory spending from sequestration,

14. That reduction in interest on the public debt is projected using CBO's August 2011 forecast for interest rates. Those rates are lower than ones forecast earlier in the year and used in Congressional Budget Office, [letter to the Honorable John A. Boehner and the Honorable Harry Reid estimating the impact on the deficit of the Budget Control Act of 2011](#).

15. Discretionary spending refers to outlays from budget authority that is provided and controlled by appropriation acts. Mandatory spending refers to outlays from budget authority provided by laws other than appropriation acts.

16. Budgetary resources consist of all sources of authority provided to federal agencies that permit them to incur financial obligations, including new budget authority, unobligated balances, direct spending authority, and obligation limitations.

however. The total savings attributed to the automatic procedures would include lower debt-service costs resulting from those cuts.

CBO has estimated the changes in discretionary and mandatory spending that would occur if the automatic enforcement mechanisms were triggered because no new deficit reduction legislation was enacted. CBO's analysis can only approximate the ultimate results; the Administration's Office of Management and Budget would be responsible for implementing any such automatic reductions on the basis of its own estimates. CBO estimates that, if no legislation originating from this Committee was enacted, the automatic enforcement process specified in the Budget Control Act would produce the following results between 2013 and 2021:

- Reductions ranging from 10.0 percent (in 2013) to 8.5 percent (in 2021) in the caps on new discretionary appropriations for defense programs, yielding total outlay savings of \$454 billion.
- Reductions ranging from 7.8 percent (in 2013) to 5.5 percent (in 2021) in the caps on new discretionary appropriations for nondefense programs, resulting in outlay savings of \$294 billion.
- Reductions ranging from 10.0 percent (in 2013) to 8.5 percent (in 2021) in mandatory budgetary resources for nonexempt defense programs, generating savings of about \$0.1 billion.
- Reductions of 2.0 percent each year in most Medicare spending because of the application of a special rule that applies to that program, producing savings of \$123 billion, and reductions ranging from 7.8 percent (in 2013) to 5.5 percent (in 2021) in mandatory budgetary resources for other nonexempt nondefense programs and activities, yielding savings of \$47 billion. Thus, savings in nondefense mandatory spending would total \$170 billion.
- About \$31 billion in outlays stemming from reductions in premiums for Part B of Medicare and other changes in spending that would result from the sequestration actions.
- An estimated reduction of \$169 billion in debt-service costs.

In all, those automatic cuts would produce net budgetary savings of about \$1.1 trillion over the 2013–2021 period, CBO estimates. That amount is lower than the \$1.2 trillion figure for deficit reduction in the Budget Control Act for three reasons. First, because of the lag in timing between appropriations and subsequent expenditures, part of the savings from the automatic cuts in budgetary resources would occur after 2021. Second, CBO expects that some reductions—particularly those related to Medicare—would have other effects that would boost net spending (by the \$31 billion mentioned above). Third, CBO estimates that the reduction in debt-service costs

would be lower than the amount of such savings stipulated in the Budget Control Act.¹⁷

The majority of the savings from the automatic spending reductions would stem from further cuts in discretionary spending (beyond those embodied in the new law's caps on discretionary budget authority). CBO expects that about 71 percent of the net savings from the automatic procedures would come from lowering the caps on discretionary appropriations, 13 percent would come from a net reduction in mandatory spending, and 16 percent would result from lower debt-service costs.

Of course, the Budget Control Act could produce outcomes that are very different from the figures outlined above. The Congress could enact legislation originating from this Committee that would produce \$1.2 trillion in savings through changes that differ significantly from the automatic reductions that would be required in the absence of such legislation. Or such legislation could yield some savings, but less than \$1.2 trillion, so the automatic procedures would have a smaller impact than CBO has estimated here. Alternatively, this Committee could recommend, and the Congress could enact, legislation saving significantly more than \$1.2 trillion. (The Budget Control Act states that the Committee's goal is to achieve at least \$1.5 trillion in savings over the 2012–2021 period.)¹⁸

The Long-Term Budget Outlook

Beyond the coming decade, the fiscal outlook worsens. When CBO issued its most recent long-term projections in June 2011, debt held by the public was projected to reach 76 percent of GDP in 2021 under current law.¹⁹ Beyond 2021, under an extension of current law that CBO labeled the “extended-baseline scenario,” debt was projected to rise to 84 percent of GDP in 2035. Because CBO's projections based on current law now show that debt held by the public will be declining relative to GDP after 2013 (to 61 percent in 2021), the long-term outlook under current law is a little brighter than it was earlier in the year. Even under the latest projections, however, debt would still be larger relative to GDP in 2021 than in any year between 1953 and 2009. Moreover, although long-term budget projections are highly uncertain, the aging of the population and rising costs for health care would almost certainly push federal spending up sharply relative to GDP after 2021 if current law remained in effect. Federal revenues also would continue to increase relative to GDP after 2021 under current law, reaching significantly higher percentages of GDP than ever seen

17. The Budget Control Act specifies that 18 percent of the \$1.2 trillion goal for deficit reduction be assumed to result from debt-service savings; that amount comes to \$216 billion. However, CBO estimates that the automatic spending reductions would produce debt-service savings of \$169 billion through 2021.

18. For further details, see Congressional Budget Office, *Estimated Impact of Automatic Budget Enforcement Procedures Specified in the Budget Control Act* (September 2011).

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

before in the United States. CBO has not updated its long-term projections to reflect its new 10-year baseline, and the net effect that those trends in outlays and revenues would have on budget deficits beyond 2021 is not clear.

Under certain policy assumptions other than those underlying CBO's baseline, the budget outlook is much bleaker—both for the next 10 years and over the longer term. In CBO's long-term projections issued in June, the agency also examined an “alternative fiscal scenario,” which incorporated 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. Specifically, the tax provisions enacted since 2001 that were extended most recently in 2010 were assumed to be extended, the reach of the AMT was assumed to be restrained to stay close to its historical extent, and tax law was assumed to evolve over the long term so that revenues remained near their historical average of 18 percent of GDP. CBO projected in June that, under the alternative fiscal scenario, revenues would increase much more slowly than spending, and debt held by the public would balloon to nearly 190 percent of GDP by 2035.

Although new long-term projections reflecting the latest 10-year projections would differ, the amounts of federal borrowing that would be required under those policy assumptions clearly would be unsustainable. Moreover, the projections of federal debt that CBO highlighted in June for the alternative fiscal scenario do not include the harmful effects of rising debt on economic growth and interest rates. If those effects were taken into account, projected debt would increase even more rapidly. Thus, under current policies, the federal budget is quickly heading into territory that is unfamiliar to the United States and to most other developed countries as well.

Fiscal Policy Choices

The budgetary and economic challenges facing the nation present policymakers with difficult choices about fiscal policy. As this Committee considers its charge to recommend policies that would reduce future budget deficits, its key choices fall into three broad categories:

- How much deficit reduction should be accomplished?
- How quickly should deficit reduction be implemented?
- What forms should deficit reduction take?

The Magnitude of Deficit Reduction

There is no commonly agreed upon level of federal debt that is sustainable or optimal. At a minimum, federal debt cannot continually increase as a share of the economy because the interest payments on that debt would then continually grow relative to the size of the tax base that would be available for generating revenues to cover those payments and all of the other activities of the government. Even before the interest burden became unsupportable, a fiscal crisis could arise if participants in financial markets lost confidence in the government's ability to manage its budget and became unwilling to lend to the government at affordable rates.²⁰

Under CBO's current-law baseline, which incorporates \$1.2 trillion in expected deficit reduction related to this Committee's work, debt held by the public falls from 67 percent of GDP at the end of 2011 to 61 percent by 2021. However, stabilizing the debt at that level relative to GDP would leave it larger than in any year from 1953 through 2009. Moreover, an aging population and rising health care costs will exert significant and increasing pressure on the budget in the years beyond 2021.

Lawmakers might determine that debt should be reduced to amounts lower than those shown in CBO's baseline—in order to reduce the burden of debt on the economy, relieve some of the long-term pressures on the budget, diminish the risk of a fiscal crisis, and enhance the government's flexibility to respond to unanticipated developments. Accomplishing that objective would require larger amounts of deficit reduction. For example, to lower debt held by the public in 2021 to 50 percent of GDP, roughly the same level recorded in the mid-1990s, budget deficits during the next decade would need to be about \$2.6 trillion lower than in CBO's baseline. If this Committee aimed to achieve that goal through its own recommendations, it would need to propose changes in policies that would reduce deficits by a total of about \$3.8 trillion (including interest savings) over the coming decade.

Furthermore, the current laws that underlie CBO's baseline projections provide for significant changes to tax and spending policies in coming years. Lawmakers might decide that some of those current policies should be continued. In that case, achieving a particular level of debt could require much larger amounts of deficit reduction through other changes in policy.

For example, if most of the provisions in the 2010 tax act were extended, if the AMT was indexed for inflation, and if Medicare's payment rates for physicians' services were held constant, then in the absence of other policy changes, deficits over the next 10 years would total \$8.5 trillion—compared with \$3.5 trillion in the baseline—and debt held by the public would reach 82 percent of GDP in 2021, well above both the current level and the projected level in 2021 under current law. If lawmakers decided to change the law in order to extend those policies, then reducing debt held by the public in 2021 to the 61 percent of GDP projected under current law would require other changes in policy that reduced deficits over the next 10 years by \$5 trillion in

20. See Congressional Budget Office, *Federal Debt and the Risk of a Fiscal Crisis*, Issue Brief (July 2010).

addition to the \$1.2 trillion in deficit reduction that this Committee would have to accomplish to avoid the automatic budget cuts required by the Budget Control Act. If this Committee aimed to achieve that goal through its own recommendations, it would need to propose changes in policies that reduced deficits (apart from the effects of extending those existing policies) by a total of about \$6.2 trillion (including interest savings) over the coming decade. To lower debt held by the public to the 50 percent of GDP seen in the mid-1990s would require significantly larger reductions in deficits.

In 2021 alone, the gap between federal revenues and spending if those policies were continued and no other budgetary changes were made would be \$1.1 trillion, or 4.7 percent of GDP, CBO projects (see Figure 7). Given CBO's forecast of economic growth and interest rates in that year, the deficit would need to be less than 2.2 percent of GDP to put debt on a downward trajectory relative to GDP. Relative to the benchmark of continuing those policies, reaching that objective would require a reduction in the deficit of roughly 2.5 percent of GDP, or about \$600 billion in that year.

An additional consideration is that lawmakers might determine that current economic conditions call for new policies that would increase deficits in the next few years. If such policies were enacted, then reducing debt held by the public to a particular level in 2021 would require even greater deficit reduction in later years.

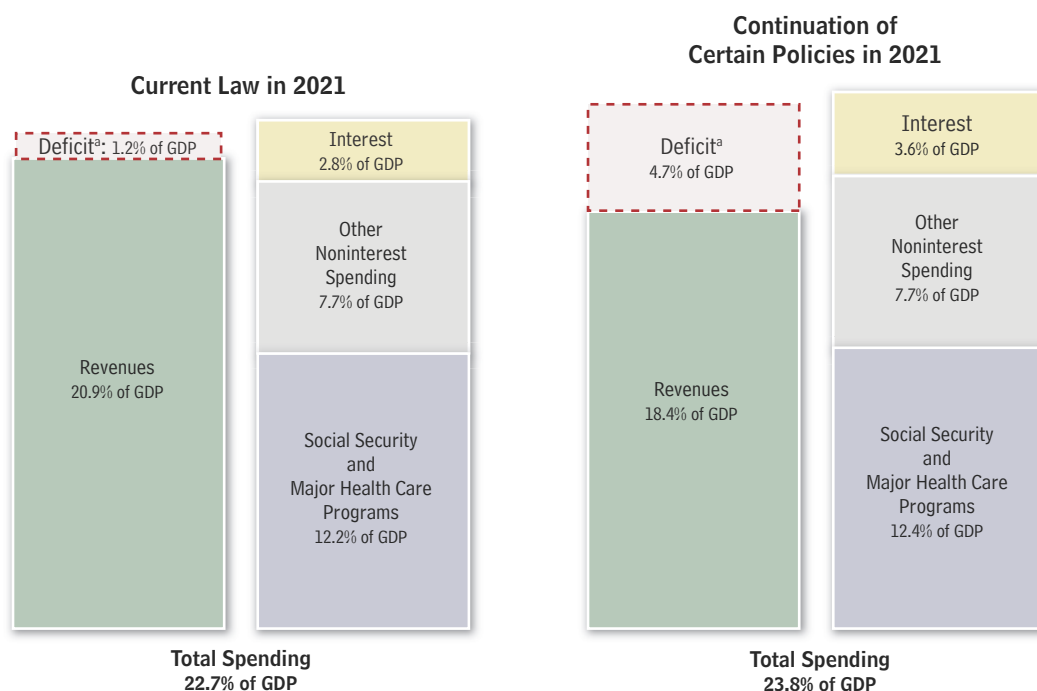
The Timing of Deficit Reduction

Policymakers face difficult trade-offs in decisions about how quickly to implement policies to reduce budget deficits, as the impacts on people and the economy depend crucially on the timing of the changes. In confronting those trade-offs, policymakers could consider the relative disadvantages of reducing deficits slowly or quickly, the economic effects of deficit reduction achieved on alternative time paths, and ways to reconcile near-term and longer-term economic objectives.

Although there are trade-offs in choosing the timing of policy changes to reduce future deficits, such trade-offs do not apply to the timing of decisions about the changes. Rather, there are important benefits and few apparent costs to deciding now what policy actions will be taken to resolve the longer-term budgetary imbalance. Enacting policy changes soon would allow for implementing them gradually while still limiting further increases in federal debt and the corresponding negative consequences. Moreover, the enactment of credible policy changes that reduce deficits in the future would probably increase economic activity in the near term by boosting confidence and holding down interest rates.

Figure 7.

Federal Revenues and Spending in 2021 Under CBO's Baseline or with a Continuation of Certain Policies



Source: Congressional Budget Office.

Notes: The projection with the continuation of certain policies is based on several assumptions: first, that most of the provisions of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 that originally were enacted in 2001, 2003, 2009, and 2010 do not expire on December 31, 2012, but instead continue; second, that the alternative minimum tax is indexed for inflation after 2011; and third, that Medicare's payment rates for physicians are held constant at their 2011 level. Continuing the tax provisions would also increase outlays for refundable tax credits; however, the effect on outlays is shown in the revenue portion of the bar.

Major health care programs include Medicare, Medicaid, the Children's Health Insurance Program, and exchange subsidies and related spending.

GDP = gross domestic product.

- a. In this figure, the deficit does not equal total spending minus revenues in 2021 because it has been reduced by incorporating effects of provisions related to the Joint Select Committee on Deficit Reduction. The Budget Control Act of 2011 (Public Law 112-25) created that committee to propose further deficit reduction totaling at least \$1.5 trillion over 10 years. The act also specified automatic procedures for reducing spending by as much as \$1.2 trillion if legislation originating with the new deficit reduction committee does not achieve savings of at least \$1.2 trillion. CBO has incorporated that amount of deficit reduction in its baseline (including an amount equal to 0.7 percent of GDP in 2021, which includes savings in debt-service costs) but has no basis for allocating that amount between revenues and outlays. Accordingly, outlay and revenue projections included here exclude the effects of those provisions; the deficit projection, however, includes the effects.

Disadvantages of Reducing Deficits Slowly. On the one hand, reducing deficits slowly would have some negative consequences. First, implementing spending cuts or tax increases gradually, rather than abruptly, would lead to a greater accumulation of government debt, which would have a number of costs:

- Rising debt would cause a growing portion of people's savings to go to purchase government debt rather than to finance investments in productive capital such as factories and computers. Specifically, larger federal deficits imply, all else being equal, lower national saving; that lower saving reduces the capital stock owned by U.S. citizens over time through a decrease in domestic investment, an increase in net borrowing from abroad, or both. That crowding out of investment in productive capital would lead to lower output and incomes than would otherwise occur.²¹
- 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, financial turmoil, or international crises. As a result, the effects of such developments on the economy and people's well-being could be worse.
- 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.

Second, gradual spending cuts or tax increases might reduce the credibility of the intended deficit reduction. Households, businesses, state and local governments, and financial market participants might be skeptical that unpleasant policy changes that were announced but deferred well into the future would ever take effect. Instead,

21. CBO estimated the magnitude of those effects for the paths of federal debt presented in *CBO's 2011 Long-Term Budget Outlook*. CBO estimated that under the extended-baseline scenario in that report, real 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 underlying most of the projections in that report. In addition, CBO estimated that under the alternative fiscal scenario in that report, 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. (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.)

those observers might expect that those changes would be altered before they occurred. Such expectations might be reinforced by recent experience, in which the expiration of provisions that restrain individual income tax revenues were extended, the expanding reach of the AMT under existing law was checked, and looming cuts in Medicare's payments to physicians under existing law were avoided. In each of those policy areas, lawmakers have acted to extend existing policies rather than to follow current law.

Lessening the credibility of future deficit reduction would diminish the favorable effects of such policy changes in the near term. If there is widespread belief that cuts in spending or increases in taxes were going to happen in the future, that expectation would help to hold down current medium-term and long-term interest rates. Those lower interest rates would tend to increase spending and investing by households and businesses, other things being equal. However, if people did not believe that promised changes in policy would actually take effect, those advantages would be diminished or lost. In order to increase the credibility of future deficit reduction, policymakers could enact specific policy changes into law and show that those changes had fairly widespread support.

Disadvantages of Reducing Deficits Quickly. On the other hand, reducing deficits quickly would have some negative consequences as well. First, implementing spending cuts or tax increases abruptly would give families, businesses, and state and local governments little time to plan and adjust. Deficit reduction inevitably involves some combination of scaling back government benefits, shrinking government contracts or payrolls, reducing grants to state and local governments, or raising tax collections. The households, businesses, and other levels of government that would be affected by such changes would need to adjust their own spending habits, work behavior, investment and hiring decisions, or tax policies—perhaps in significant ways. Therefore, they would benefit from advance notice so they would have some flexibility in how and when they can alter their behavior.

Older generations would have particular difficulty adapting to immediate spending cuts or tax increases because their opportunity to adjust their work or saving is more limited.²² As a result, a common feature of proposals to change programs that affect older Americans—including Social Security, Medicare, and Medicaid—is to limit the impact of such changes on people who are currently over certain ages. (Of course, limiting the impact of policy changes on the current elderly would reduce the amount of savings that could be achieved in the near term and might, for a given amount of cumulative deficit reduction, increase the extent of the policy changes that would be imposed later on current young people.) Moreover, the ability of many households, firms, and state and local governments to adjust to cutbacks in federal spending or

22. See Congressional Budget Office, *Economic Impacts of Waiting to Resolve the Long-Term Budget Imbalance*, Issue Brief (December 2010).

increases in federal taxes may be more limited now than at other times because of the strained financial circumstances in which many find themselves.

Second, and particularly important given the current state of the economy, immediate spending cuts or tax increases would represent an added drag on the weak economic expansion. When the economy has substantial unemployment, as well as unused factories, offices, and equipment, reductions in aggregate demand (the total purchases of a country's output of goods and services by consumers, businesses, governments, and foreigners) generally widen the gap between the economy's actual level of output and its potential (a level that corresponds to a high rate of use of labor and capital). Decreasing federal spending or increasing federal taxes now would tend to reduce aggregate demand and thereby lead to less output and employment in the next few years.

For example, cutting federal purchases of goods and services subtracts from the demand for goods and services directly, and reducing federal transfers to people (such as unemployment insurance payments or Social Security benefits) or to states and localities (such as support for secondary education) tends to decrease the amount of goods and services purchased by the recipients. Similarly, raising tax collections tends to decrease the spending of the people paying those taxes.

The extent to which deficit reduction lessens demand depends on the details of the policies enacted and on the economic situation.²³ For example, when the Federal Reserve's ability to lower short-term interest rates is constrained because those rates are already near zero, as they are currently, the short-run effects of changes in government spending and taxes on output tend to be larger than usual. Nevertheless, changes in government spending and taxes usually affect demand only temporarily: They raise or lower output relative to potential only for a while because, over time, stabilizing forces in the economy (such as the responses of prices and interest rates and actions by the Federal Reserve) tend to move output back toward its potential.

Quantifying the Economic Effects of Deficit Reduction. Although cuts in government spending or increases in taxes in the next few years would, by themselves, reduce output and employment during that period, credible steps to narrow budget deficits over the longer term would tend to boost output and employment in the next few years by holding down interest rates and by reducing uncertainty and enhancing business and consumer confidence. Therefore, the near-term economic effects of deficit reduction would depend on the balance between changes in spending and taxes that take effect quickly and those that take effect gradually. According to CBO's analysis, credible policy changes that would substantially reduce deficits later in the coming decade and over the long term—without immediate cuts in spending or increases in taxes—

23. See Congressional Budget Office, *Estimated Impact of the American Recovery and Reinvestment Act on Employment and Economic Output from March 2011 Through June 2011* (August 2011) and Statement of Douglas W. Elmendorf, Director, Congressional Budget Office, before the Senate Committee on the Budget, *The Economic Outlook and Fiscal Policy Choices* (September 28, 2010).

would both support the economic expansion in the next few years and strengthen the economy over the longer term.

A recent analysis by CBO provides a rough indication of the magnitude of the economic effects of reducing deficits along a hypothetical time path under current economic conditions.²⁴ In that analysis, the agency estimated the short-term and longer-term effects of reducing the primary deficit (the budget deficit excluding net interest) by \$100 billion in 2012 and by amounts increasing gradually to \$300 billion by 2021 (without any particular changes in spending or revenues specified). According to the agency's estimates, that illustrative plan would decrease real gross national product (GNP) in 2012, 2013, and 2014 by amounts ranging from roughly 0.1 percent to 0.6 percent depending on the year and the assumptions used.²⁵ However, the increases in national saving and investment that would result from smaller deficits were estimated to increase real GNP by roughly 0.4 percent to 1.4 percent from 2019 through 2021.²⁶

A different policy that had the same amount of cumulative reduction in primary deficits but that reduced deficits more slowly than the policy analyzed would have more favorable macroeconomic effects in the next few years. However, that alternative policy would have less favorable effects later in the decade because the total budgetary impact of slower deficit reduction would be smaller—a result of the policy's smaller impact on interest and the slower reduction in debt relative to what would otherwise occur, causing the savings in interest costs to compound more slowly. Those differences in macroeconomic effects later in the decade could be offset by undertaking slightly more cumulative reduction in primary deficits.

The economic effects of policies that reduce budget deficits sharply given current economic conditions can be seen by comparing CBO's baseline economic projections under current law with economic projections under a different set of policies. Under current law, most of the provisions in the 2010 tax act expire at the end of 2011 or 2012, the reach of the AMT expands greatly at the end of 2011, and Medicare's payment rates for physicians' services fall sharply at the end of 2011; those policies help

24. See Congressional Budget Office, *The Macroeconomic and Budgetary Effects of an Illustrative Policy for Reducing the Federal Budget Deficit* (July 2011).

25. CBO's analysis considered a range of possible short-term effects on output. The medium-sized response reflected the assumption that each one-dollar reduction in the deficit would cause economic output to decline by a dollar in the short term, excluding the effects from changes in interest rates. At one end of the range, each one-dollar cut in the deficit was assumed to cause cumulative economic output to decline by \$0.60 over several quarters. At the opposite end of the range, each one-dollar cut in the deficit was assumed to cause economic output to decline by a cumulative \$1.40. The dollar-for-dollar response lies within the ranges of estimated effects on economic output for many policies examined in CBO's analysis of the macroeconomic effects of ARRA.

26. To illustrate a range of possible effects, CBO assumed that each dollar of deficit reduction would increase domestic investment by 20, 36, or 50 cents (reflecting different assumptions about the effects of deficits on both national saving and net borrowing from abroad).

to reduce deficits sharply, but CBO also expects them to reduce economic growth in the near term. Suppose, instead, that most of the cuts in individual income taxes and estate and gift taxes now scheduled to expire in 2012 or 2013 are extended through 2021, limits to the reach of the AMT that are set to expire at the end of 2011 are also continued through 2021, and Medicare's payment rates for physicians are maintained at their 2011 levels. Under those alternative assumptions, CBO estimates that real GDP in 2013 would be between 0.6 percent and 2.3 percent more than projected under current law.²⁷ Higher real GDP would result in a lower unemployment rate and somewhat higher interest rates over the next few years than would occur with the smaller deficits projected in the baseline.

However, unless other policy changes were enacted, real GDP would be higher in CBO's baseline projections by later in the decade than under that set of alternative policies. The lower marginal tax rates under those policies would increase people's incentives to work and save, but the significantly larger budget deficits would crowd out private investment in productive capital. By the end of 2021, as the effect of larger budget deficits outweighed that of lower tax rates, real GDP would be between 0.3 percent and 1.9 percent smaller than it would be under current law, CBO estimates. Without other policy changes, the budget would be on an unsustainable path under those policies, and the negative effects on output and incomes would rise further after 2021.

Reconciling Near-Term and Longer-Term Objectives. Some policymakers and analysts have advocated near-term reductions in taxes or increases in federal spending to increase output and employment in the next few years. Such policies might or might not worsen the medium-term and long-term fiscal outlook depending on whether other changes in policy were enacted at the same time and on what those other changes were. However, there is no inherent contradiction between using fiscal policy to support the economy today, while the unemployment rate is high and many factories and offices are underused, and imposing fiscal restraint several years from now, when output and employment will probably be close to their potential.²⁸ What would such an approach mean in practice?

27. See Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2011), Table 2-2. To reflect the high degree of uncertainty that accompanies estimates of the economic impact of fiscal policy, CBO used a range of assumptions about the extent to which changes in taxes and government spending affect the demand for goods and services, budget deficits affect private investment, and changes in marginal tax rates on labor income affect the labor supply. For more information about CBO's assumptions, see Congressional Budget Office, *The Macroeconomic and Budgetary Effects of an Illustrative Policy for Reducing the Federal Budget Deficit*.

28. For further discussion, see Congressional Budget Office, *Policies for Increasing Economic Growth and Employment in 2010 and 2011* (January 2010) and Statement of Douglas W. Elmendorf, Director, Congressional Budget Office, before the Senate Committee on the Budget, *The Economic Outlook and Fiscal Policy Choices*.

If taxes were cut permanently or government spending was increased permanently, and no other changes were made to fiscal policy, the economy would suffer in the medium term and long term. Indeed, if people believed that policy changes that increased near-term deficits presaged larger budget deficits in the medium term and long term, and thus that the federal budget outlook had become even bleaker, the economy could be hurt in the near term by a faltering of business and consumer confidence and an increase in interest rates. Moreover, even if tax cuts or spending increases were temporary, the additional debt accumulated during that temporary period would weigh on the budget and the economy over time.

Therefore, if policymakers wanted to achieve both a short-term economic boost and medium-term and long-term fiscal sustainability, a combination of policies would be required: changes in taxes and spending that would widen the deficit now but reduce it later in the decade. Such an approach would work best if the future policy changes were sufficiently specific and widely supported so that households, businesses, state and local governments, and participants in financial markets believed that the future fiscal restraint would truly take effect.

The Composition of Deficit Reduction

As policymakers consider the composition of policy changes to be used to reduce budget deficits, many factors may play a role. The most fundamental question is what role the government should play in the U.S. economy and society. The amount and composition of federal spending and revenues affect the total amount and types of output that are produced and consumed in the country, the distribution of those material resources among various segments of society, and people's well-being in a variety of ways.²⁹ In particular, policymakers may be influenced by the historical patterns of spending and revenues and by the economic impacts of alternative spending and tax policies.

Projected Spending and Revenues in Historical Context. In considering the challenge of putting fiscal policy on a sustainable path, many observers have wondered whether it is possible to return to policies regarding federal spending and revenues that, in earlier years, usually generated deficits that were small relative to GDP and kept the amount of debt held by the public to between about one-quarter and one-half of GDP.

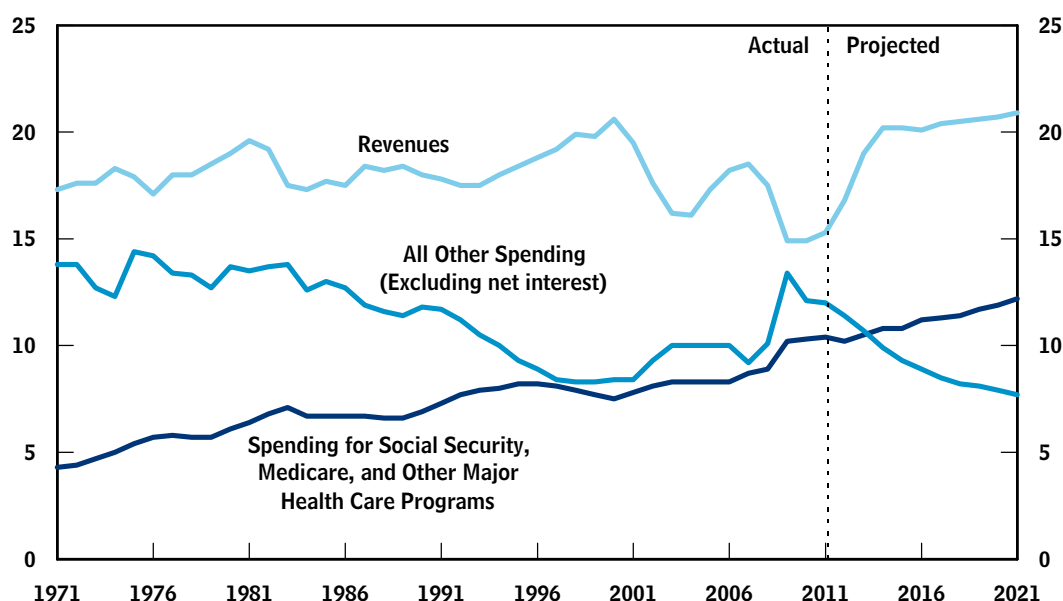
Looking for historical reference points is natural. However, the past combination of policies cannot be repeated when it comes to the federal budget: The aging of the population and rising costs for health care have changed the backdrop for federal

29. For numerous options for changing tax and spending policies, and estimates of their potential budgetary impacts, see Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options* (March 2011).

Figure 8.

Revenues and Spending, Excluding Interest

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Note: Other major health care programs include Medicaid, the Children's Health Insurance Program, and exchanges subsidies and related spending.

budget policy in a fundamental way. To see this point most clearly, it is useful to consider the historical experience and CBO's projections for three broad categories of the budget: revenues; spending for Social Security, Medicare, and other major health care programs; and all other spending excluding interest payments.

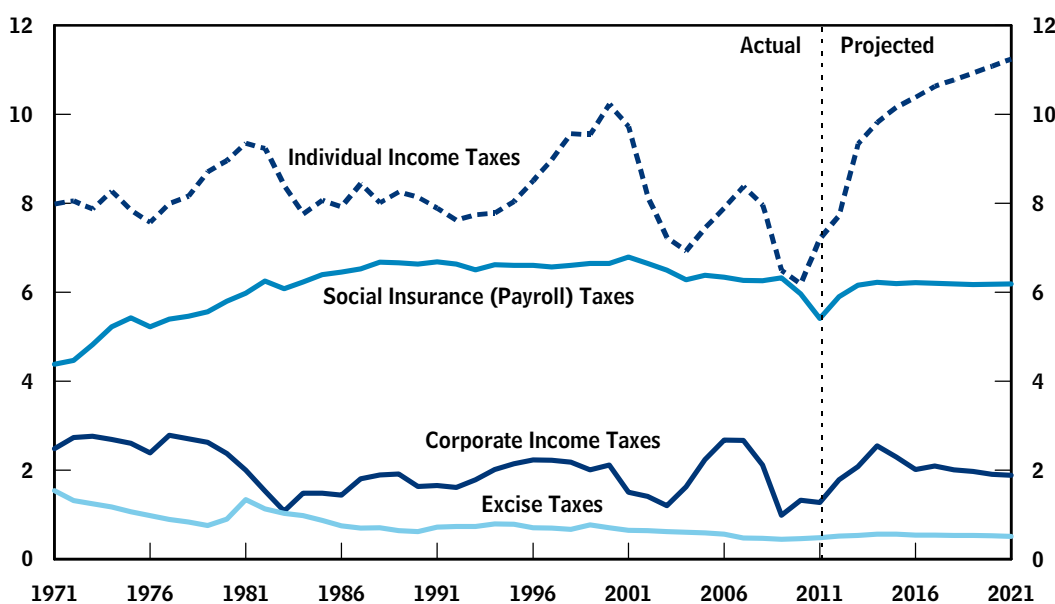
Federal Revenues. Revenues have averaged 18.0 percent of GDP during the past 40 years (see Figure 8). They have varied substantially around that level but show no clear trend. Under current law, revenues equal 15.3 percent of GDP in 2011 and will rise to about 21 percent of GDP in 2021; if, instead, all of the tax provisions that are scheduled to expire under current law were extended, revenues in 2021 would be close to their historical average of 18 percent.

Individual income tax receipts account for most of the projected increase in federal revenues over the coming decade, largely because of scheduled changes in tax law and features of the tax system that cause revenues to rise faster than income over time, as well as projected increases in receipts that reflect an expected rebound in taxable

Figure 9.

Revenues by Source

(Percentage of gross domestic product)



Source: Congressional Budget Office.

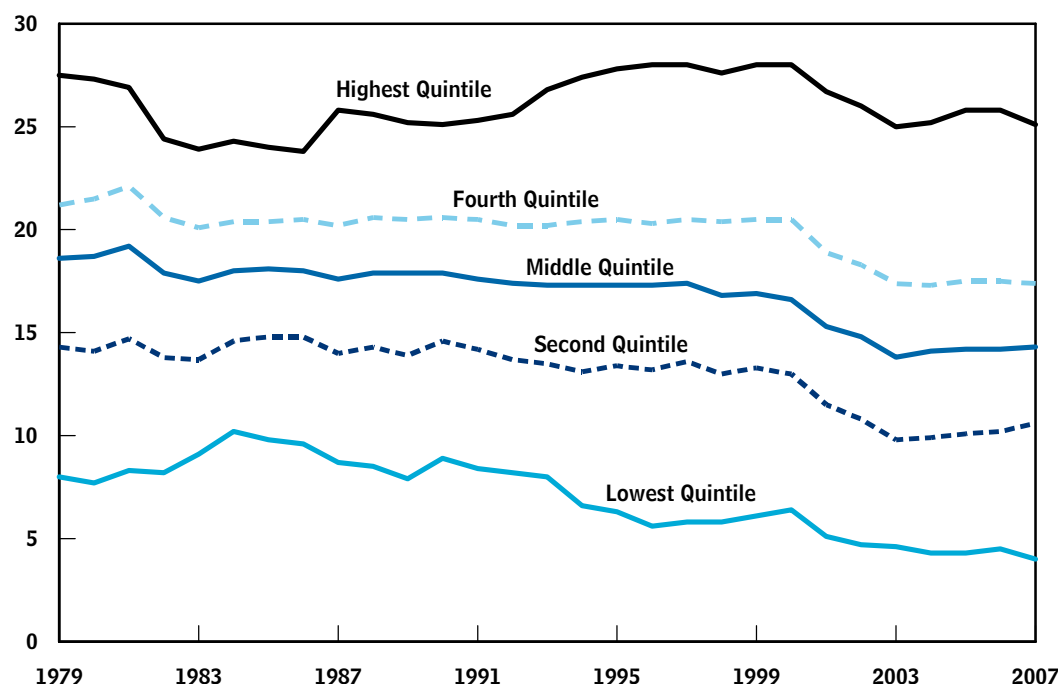
income and some other effects of the economic recovery (see Figure 9). As a result, individual income tax receipts increase steadily in CBO’s baseline, from 7.2 percent of GDP in 2011 to 11.2 percent in 2021. By comparison, such receipts stood at 8.0 percent in 1971. Receipts from both social insurance and corporate income taxes are projected to increase modestly relative to GDP over the next 10 years, remaining in the vicinity of their 40-year averages, CBO projects.

Two additional perspectives on the evolution of the federal tax system during the past several decades are provided by changes in the burden of taxes on households at different points in the distribution of income and by changes in tax rates that affect the after-tax return to additional work or saving.³⁰ Households generally bear the economic cost, or burden, of the taxes that they pay directly, such as individual income taxes (including taxes paid on dividends, interest, and capital gains) and employees’ share of payroll taxes. Households also bear the burden of the taxes paid by businesses; in particular, in CBO’s judgment (and that of most economists), employers’ share of payroll taxes is passed on to employees in the form of lower wages. One measure of the tax burden is the average tax rate—that is, the taxes paid as a share of income.

30. For additional information on these topics, see Statement of Douglas W. Elmendorf, Director, Congressional Budget Office, before the Senate Committee on Finance, *Trends in Federal Tax Revenues and Rates* (December 2, 2010); and Congressional Budget Office, *An Analysis of the President’s Budgetary Proposals for Fiscal Year 2012*.

Figure 10.

Average Federal Tax Rates, by Income Quintile, 1979 to 2007



Source: Congressional Budget Office.

Note: For information on the calculation of average tax rates, the ranking of households, and the allocation of taxes, see Congressional Budget Office, *Average Federal Tax Rates in 2007* (June 2010).

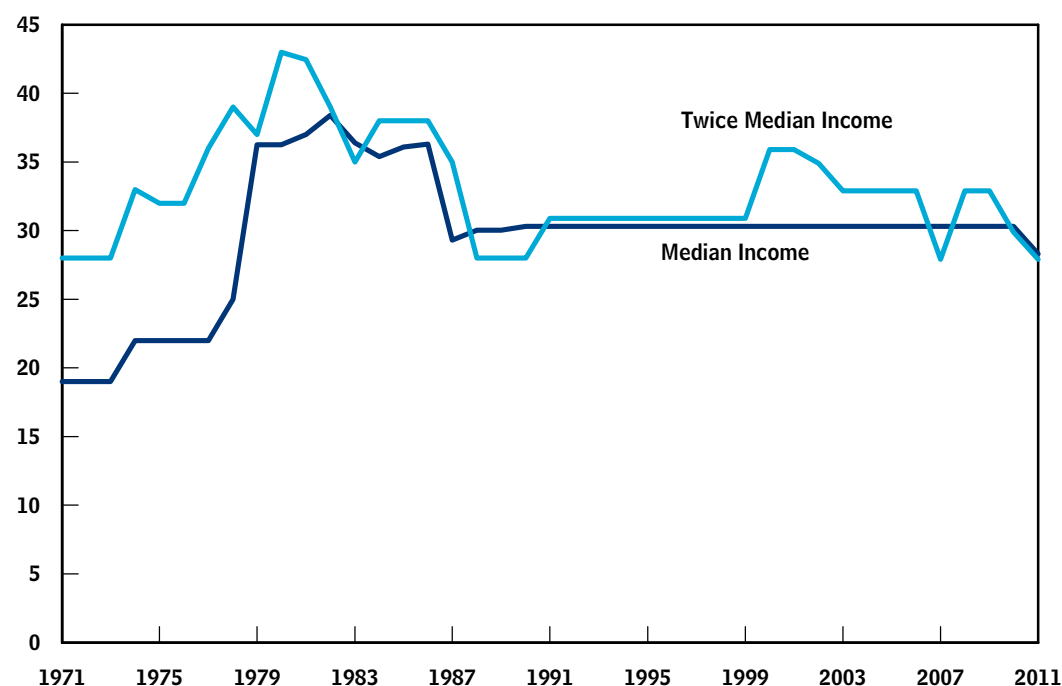
Federal taxes are progressive: Average federal tax rates generally rise with income. In 2007 (the most recent year for which data are available), households in the bottom fifth, or quintile, of the income distribution (with average income of \$18,400, under a broad definition of income) paid about 4 percent of their income in federal taxes, while the middle quintile, with average income of \$64,500, paid 14 percent, and the highest quintile, with average income of \$264,700, paid 25 percent (see Figure 10). Between 1979 and 2007, average tax rates declined, on balance, for households in each quintile of the income distribution.

One measure of the effect of taxes on the returns from working and saving is the marginal tax rate—the tax paid per dollar of extra earnings or dollar of extra income from savings. For a representative family of four with median income, the marginal tax rate on earnings (combining the rates for both federal income and payroll taxes) 40 years ago was around 20 percent (see Figure 11). That rate climbed over the next 10 years as a result of rising payroll tax rates and inflation-driven increases in nominal incomes, which pushed median-income families into higher tax brackets. Following a reduction in income tax rates in 1986, the marginal tax rate for a representative

Figure 11.

Marginal Tax Rates (Income and Payroll) on Earnings for a Family of Four with a Single Earner, 1971 to 2011

(Percent)



Sources: Department of the Treasury, Office of Tax Analysis; Congressional Budget Office.

median-income family has remained at about 30 percent (the rate is 2 percentage points lower in 2011 with the temporary reduction in the payroll tax rate). The marginal tax rate on income from savings has also fallen, on balance, over the past 40 years owing to reductions in statutory tax rates on overall taxable income as well as separate reductions in the tax rates that apply to income from capital gains and dividends.

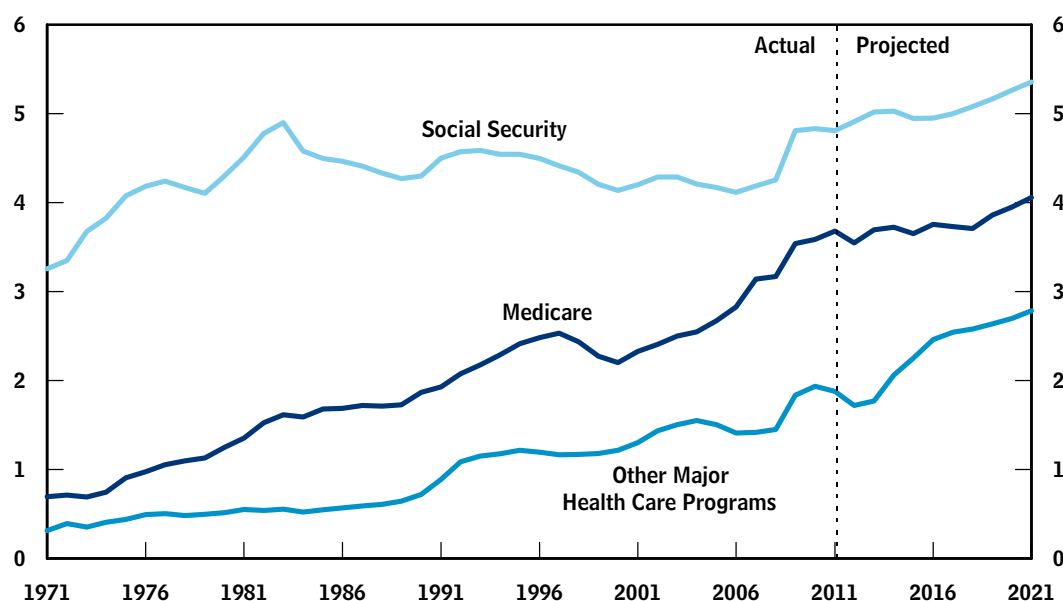
Social Security and Major Health Care Programs. Spending on Social Security and the major health care programs—Medicare, Medicaid, the Children’s Health Insurance Program, and insurance subsidies to be provided through exchanges in coming years—will be 12.2 percent of GDP in 2021, according to CBO’s projections based on current law. Such spending equals 10.4 percent of GDP in 2011 and represented an average of 7.2 percent of GDP during the past 40 years. The marked increases in such spending experienced during the past 40 years and projected for the next 10 years reflect the aging of the population, rising costs for health care, and changes in federal programs.

Spending for Social Security, which totaled 3.3 percent of GDP in 1971, will equal 4.8 percent in 2011 and is projected to continue growing over the next 10 years,

Figure 12.

Spending for Social Security, Medicare, and Other Major Health Care Programs

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Note: Other major health care programs include Medicaid, the Children's Health Insurance Program, and exchange subsidies and related spending.

reaching 5.4 percent in 2021 (see Figure 12). Medicare spending (excluding offsetting receipts) is projected to grow even faster, relative to the overall economy, from 0.7 percent of GDP in 1971 to 3.7 percent in 2011 and 4.1 percent in 2021. CBO projects that spending for other major health care programs will rise from 1.7 percent of GDP in 2012 to 2.8 percent in 2021; by comparison, Medicaid spending represented 0.3 percent of GDP in 1971.

Most of the spending for Social Security and the major health care programs goes to benefits for people over age 65, with smaller shares for blind and disabled people and for nonelderly able-bodied people. Specifically, CBO estimates that more than four-fifths of Social Security spending in 2021 will go to benefits for retired workers and their dependents and survivors, with the remaining less than one-fifth going to benefits for disabled workers and their spouses and children. In addition, even with the significant expansion of federal support for health care for lower-income people enacted in last year's legislation, CBO projects that about half of spending for the major health care programs in 2021 will go to people over age 65, with another quarter going to the blind and disabled, and the remaining quarter going to able-bodied nonelderly people.

Other Federal Spending. All spending apart from that for Social Security, the major health care programs, and interest payments on the debt has averaged 11.5 percent of GDP during the past 40 years and equals 12.0 percent in 2011. That broad category includes some mandatory spending as well as all of defense and nondefense discretionary spending. That mandatory spending includes various income security programs, retirement benefits, and other outlays. Defense spending is by far the largest single piece of the broad category, and nondefense discretionary spending includes transportation, health research, education and training, and other programs. Given the assumptions that govern CBO's baseline projections, spending for all of these programs together is projected to equal 7.7 percent of GDP in 2021, the lowest as a share of GDP in the past 40 years.

The mandatory spending in that category is spending apart from that on Social Security and the major health care programs—specifically, outlays for the Supplemental Nutrition Assistance Program (formerly known as Food Stamps), unemployment compensation, some veterans' benefits, federal civilian and military retirement benefits, and other programs (including offsetting receipts). Such spending averaged 2.7 percent of GDP during the past 40 years and totals 3.0 percent in 2011 (see Figure 13). Expected improvement in the economy and other factors reduces that spending to 1.6 percent of GDP by 2021 in CBO's baseline projections.

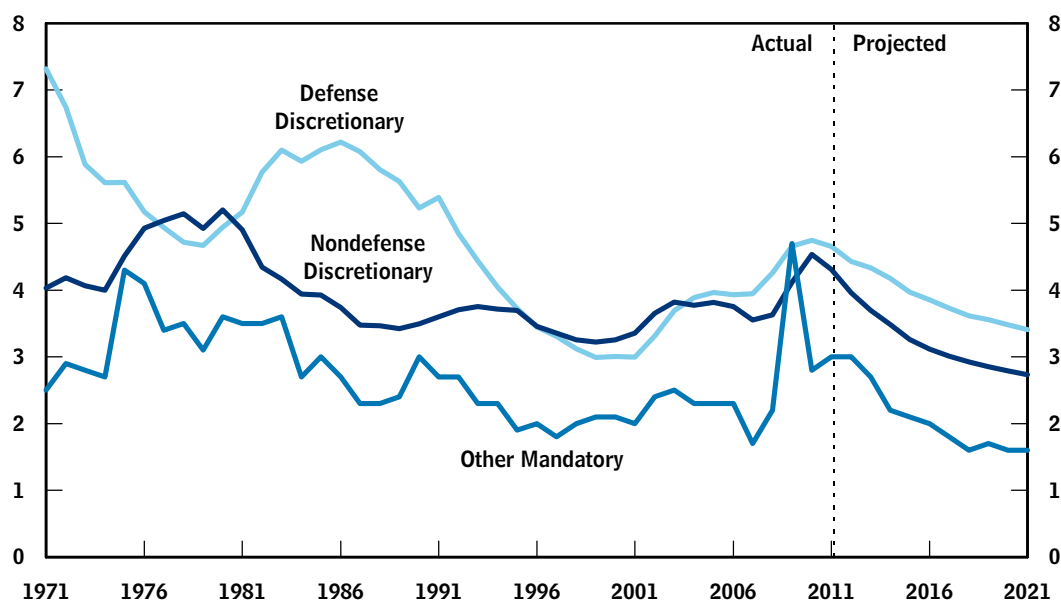
Discretionary spending, which stood at 11.3 percent of GDP in 1971, will total 9.0 percent in 2011. As a result of the caps put in place by the Budget Control Act (and apart from any further reduction in caps triggered by the enforcement provisions of the act), such spending will fall sharply relative to the size of the economy over the next 10 years, reaching 6.1 percent in 2021, CBO projects. That reduction in discretionary spending could be achieved by many different combinations of defense and nondefense appropriations. For example, if defense and nondefense appropriations (excluding war-related funding) were reduced proportionately, relative to the funding that would be necessary to keep pace with inflation, defense spending would total 3.4 percent of GDP in 2021 while nondefense spending would equal 2.7 percent, CBO estimates. By comparison, in 1971, defense and nondefense spending totaled 7.3 percent and 4.0 percent of GDP. Many other combinations of defense and nondefense funding are possible under the caps.

Implications for Future Budget Policy. Combining the various components of spending, total federal spending excluding net interest will represent 19.9 percent of GDP in 2021, according to CBO's projections under current law, a bit above the 40-year average of 18.6 percent (see Figure 14). And the composition of that spending will be noticeably different from what the nation has experienced in recent decades: Spending for Social Security and the major health care programs will be much higher, and spending for all other federal programs and activities, except for net interest payments, will be much lower. Alternatively, if the laws governing Social Security and the major health care programs were unchanged, and all other programs were operated in line with their average relationship to the size of the economy during the past

Figure 13.

Other Federal Spending, by Category

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Notes: Other federal spending includes discretionary spending (both defense and nondefense) and mandatory spending besides that for Social Security and Medicare and other major health care programs (as shown in Figure 12) as well as interest payments on debt held by the public.

When constructing its baseline, CBO assumes that discretionary appropriations will adhere to the statutory caps recently enacted into law by the Budget Control Act of 2011 (Public Law 112-25). Because the caps do not constrain appropriations for military operations in Afghanistan and Iraq (or for similar activities), such outlays are assumed to equal \$159 billion (the amount provided for 2011), adjusted in future years for inflation. In this figure, all other funding is assumed to be reduced proportionately, relative to the funding that would be necessary to keep pace with inflation, in order to keep total discretionary funding within the caps on appropriations other than those for war-related purposes.

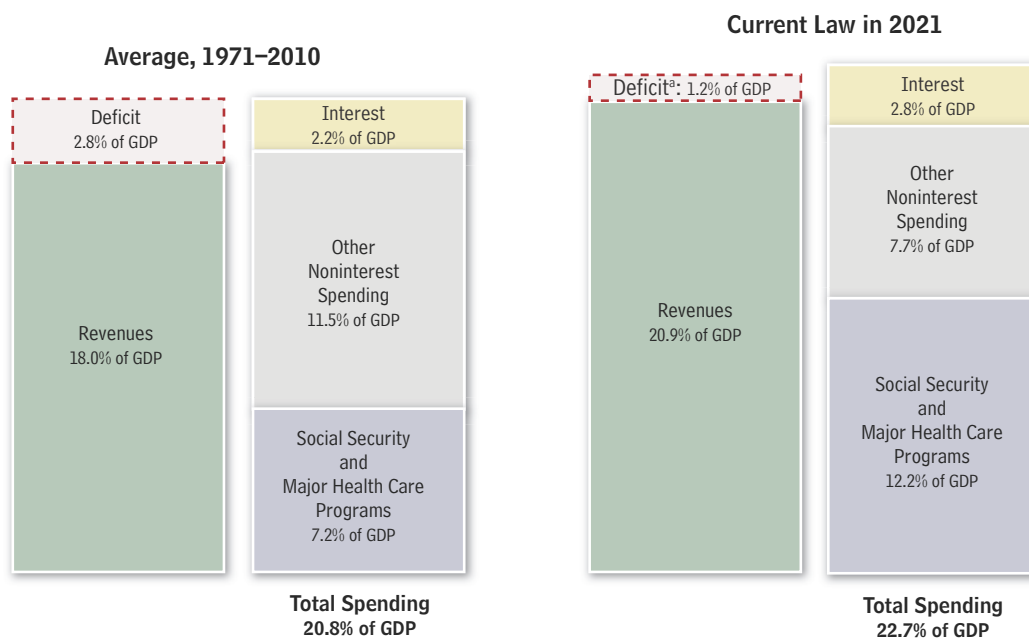
40 years, total federal spending would be projected to be much higher in 2021—nearly 24 percent of GDP. That amount exceeds the 40-year average for revenues as a share of GDP by nearly 6 percentage points—even before interest payments on the debt have been included.

At the same time, the sharp increase in federal debt and a return to more-normal interest rates will boost the government's net interest costs. They are projected to reach 2.8 percent of GDP in 2021, compared with only 1.5 percent of GDP in 2011 and an average of 2.2 percent of GDP during the past 40 years.

What do those numbers imply about the choices that policymakers—and citizens—confront about future policies? Given the aging of the population and the rising costs

Figure 14.

Federal Revenues and Spending Historically and in 2021 Under CBO's Baseline



Source: Congressional Budget Office.

Notes: Major health care programs include Medicare, Medicaid, the Children's Health Insurance Program, and exchange subsidies and related spending.

GDP = gross domestic product.

- a. In this figure, the deficit does not equal total spending minus revenue in 2021 because it has been reduced by incorporating effects of provisions related to the Joint Select Committee on Deficit Reduction. The Budget Control Act of 2011 (Public Law 112-25) created that committee to propose further deficit reduction totaling at least \$1.5 trillion over 10 years. The act also specified automatic procedures for reducing spending by as much as \$1.2 trillion if legislation originating with the new deficit reduction committee does not achieve savings of at least \$1.2 trillion. CBO has incorporated that amount of deficit reduction in its baseline (including an amount equal to 0.7 percent of GDP in 2021, which includes savings in debt-service costs) but has no basis for allocating that amount between revenues and outlays. Accordingly, outlay and revenue projections included here exclude the effects of those provisions; the deficit projection, however, includes the effects.

for health care, attaining a sustainable budget for the federal government will require the United States to deviate from the policies of the past 40 years in at least one of the following ways:

- Raise federal revenues significantly above their average share of GDP;
- Make major changes to the sorts of benefits provided for Americans when they become older; or

- Substantially reduce the role of the rest of the federal government—that is, defense, the Supplemental Nutrition Assistance Program, unemployment compensation, support for blind and disabled people, other income-security programs, health care programs for people under age 65, veterans’ benefits, federal civilian and military retirement benefits, transportation, health research, education and training, and other programs—relative to the size of the economy.

Economic Effects of the Composition of Deficit Reduction. The effects of deficit reduction on the economy would depend not just on the timing of changes in federal spending and taxes, as discussed earlier, but also on the composition of those changes.

In the near term, with a large amount of unused resources in the U.S. economy and short-term interest rates near zero, the principal channel through which policy changes will affect output and employment is through their impact on the economy’s overall demand for goods and services. Changes in different types of federal spending and different types of federal taxes could have very different impacts on demand, as CBO has estimated previously.³¹ Policies that would generally reduce near-term output and employment the most per dollar of budgetary savings are those that are implemented relatively quickly; have the largest effect on people whose consumption tends to be restricted by their income; or withdraw a time-limited incentive for households, businesses, or state and local governments to increase their spending.

In the medium term and long term, the principal channel through which policy changes would affect output and employment is through their impact on the economy’s potential output. Over the long run, the nation’s potential to produce goods and services depends on the size and quality of its labor force, on the stock of productive capital (such as factories, vehicles, and computers), and on the efficiency with which labor and capital are used to produce goods and services. The nation’s capital stock depends both on public saving (the surpluses, if any, of state and local governments and the federal government) and on private saving (by households and businesses). Efficiency depends on such factors such as production technology, the way businesses are organized, and the regulatory environment. Thus, the federal government’s tax and spending policies affect potential output by altering the size and quality of the labor force, the amount of public and private saving, and the efficiency with which labor and capital are combined.

Smaller federal deficits owing to any combination of spending and tax policies imply greater public saving and, other effects aside, national saving. An overall increase in national saving expands the capital stock owned by U.S. citizens over time through an increase in domestic investment, a decrease in net borrowing from abroad, or both. However, changes in spending or tax policies can have other significant effects on potential output depending on the specific nature of those changes.

31. See Congressional Budget Office, *Policies for Increasing Economic Growth and Employment in 2010 and 2011* and Statement of Douglas W. Elmendorf, Director, Congressional Budget Office, before the Senate Committee on the Budget, *The Economic Outlook and Fiscal Policy Choices*.

The Economic Impact of Increases in Federal Tax Revenues. Changes in tax policy can affect the incentives for individuals and businesses to save and invest. Increasing effective marginal tax rates on capital income (income derived from wealth, such as stock dividends, realized capital gains, or the owner's profits from a business) would reduce the after-tax rate of return on saving and therefore affect the amount of saving that people chose to do.³² Specifically, a reduction in the after-tax return on saving would influence private saving in two opposing ways: Lower after-tax returns would tend to decrease saving, but they also would reduce the value of existing assets, making households poorer and thus tending to encourage saving. On balance, the combined effect on saving of lower after-tax returns can be positive or negative, and researchers generally conclude that the effect is small. CBO, in its analyses, projects that increases in marginal tax rates on capital income reduce saving by a small amount.³³

Changes in corporate tax rules can affect the effective marginal tax rates on investments in different forms of physical capital (equipment, software, and structures) and in research and development related to new types of goods and services and methods of production. They can also affect the organization of production: Because the corporate income tax does not apply to all businesses (for example, it exempts partnerships, sole proprietorships, and corporations with a limited number of shareholders), changes in corporate tax rules can affect how businesses are organized, which can affect the efficiency of the allocation of resources. In addition, corporate tax rules can affect multinational corporations' decisions about where to invest. A country with a relatively high corporate tax rate stands to lose investment to lower-tax countries, and less investment may reduce the amount of capital available to workers and thus reduce wages. Even if the location of investment does not change, the tax base of a country with a relatively high corporate tax rate may erode because businesses can reduce their taxes by recharacterizing where their income is earned to place relatively more of it in low-tax countries.

Changes in tax policy can also affect the incentives for individuals to work or for individuals and firms to invest in the education and skills of the workforce. Increasing effective marginal tax rates on labor income would reduce the after-tax return on work and therefore affect the amount of work that people chose to do. As with a reduction in the after-tax return on saving, a reduction in after-tax earnings would influence labor supply in two opposing ways: Lower after-tax earnings would tend to decrease working because workers would receive less for each extra hour of labor they supplied, but lower after-tax earnings also would reduce workers' earnings for any given amount of work, making it difficult to sustain a certain standard of living and thus tending to

32. The effective marginal tax rate on capital income is the rate that would apply to the return on additional investment. That rate is averaged across all the businesses, people, and institutions that would receive that investment income (and that could face different tax rates).

33. Reductions in saving can, in turn, affect labor supply. A smaller capital stock would lead to lower pretax wage rates, which would weaken people's incentives to work.

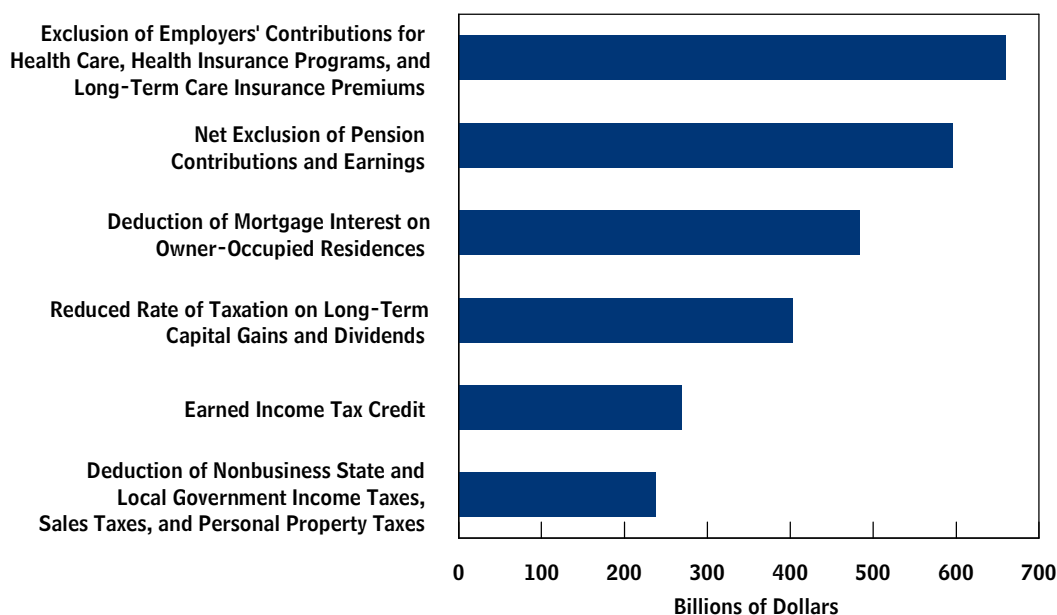
encourage additional work. For many people, the opposing incentives from increasing marginal tax rates largely offset each other, although most economists conclude that, on average, the negative effects of lower after-tax earnings for each additional hour worked slightly outweigh the positive effects of lower after-tax earnings from current working hours. Responses to changes in tax rates can also vary among family members, with secondary earners (for example, the spouse of a household's primary breadwinner) generally responding to a greater extent than primary earners. CBO, in its analyses, projects that increases in marginal tax rates on labor income decrease modestly the hours of labor that workers supply.

Rather than, or in addition to, changes to tax rates, changes in tax policy could involve revisions to other aspects of the tax code. A variety of exclusions, deductions, and exemptions in both the federal individual and corporate income taxes cause the individual and corporate income tax bases—the amount of income subject to taxation—to be significantly smaller than the income reported on tax returns. The most comprehensive measure of income reported on individual income tax returns is gross income—and even that measure omits certain types of personal income that taxpayers are allowed to exclude from reporting. Gross income totaled \$8.4 trillion in 2008, but once the allowable deductions and exemptions were subtracted, total income subject to tax (taxable income) was \$5.7 trillion—or 67 percent of gross income. In addition to the exclusions, deductions, and exemptions, both the individual and the corporate income tax allow for tax credits that reduce the final tax directly paid by households and businesses. All else being equal, those provisions of tax law reduce tax receipts by hundreds of billions of dollars each year; as a result, tax rates must be higher to collect the same amount of revenues that would be collected in the absence of those provisions.

Income tax exclusions, deductions, exemptions, and credits generally fall into three broad categories: those that modify taxable income to exclude the costs of earning that income, such as an employee's deduction for work-related expenses; those that subsidize or promote certain uses of income that are deemed worthy, such as the deduction for charitable contributions; and those that provide tax relief on the basis of certain income or demographic characteristics, such as the earned income tax credit for lower-income working families and the child tax credit for families with children. Some of those tax provisions are termed "tax expenditures" because they are similar in some ways to government spending. Like spending programs, tax expenditures provide financial assistance to particular activities, entities, or groups of people. They are more similar to entitlement programs than to discretionary spending because they are not subject to annual appropriations and any person or entity that meets the requirements can receive the benefits.

Figure 15.

Cumulative Budgetary Effect of Major Income Tax Expenditures, 2010 to 2014



Source: Joint Committee on Taxation.

Raising tax revenues by reducing tax expenditures would, for many existing expenditures, enhance the allocation of resources and therefore be good for the economy. According to estimates by the staff of the Joint Committee on Taxation, the three largest tax expenditures in the individual income tax law are those providing preferential treatment for employment-based health insurance, retirement savings, and home ownership (see Figure 15). Each of those tax expenditures may help achieve certain societal goals: a healthier population, adequate financial resources for retirement, and stable communities of homeowners. But uncapped tax expenditures may also encourage overconsumption of the favored good or subsidize activity that would have taken place without the tax incentives. For example, those three income tax expenditures may prompt people to consume more health services than are necessary, reallocate existing savings from accounts that are not tax-preferred to retirement accounts, and acquire mortgages and purchase homes beyond their needs.

The Economic Impact of Reductions in Federal Spending. Changes in government spending can affect potential output as well. Some types of spending, such as funding for improvements to roads and highways, may add to the economy's potential output in much the same way that private capital investment does. Other government programs, such as funding for grants to increase access to college education, may raise long-term productivity by enhancing people's skills. Reducing spending in those areas might reduce potential output.

Even among types of federal spending that contribute to potential output, the effects of different policies can vary greatly. For example, spending for basic research and education may affect output only after a number of years, but once those investments begin to boost output, they may pay off over more years than would the average investment in physical capital (in economic terms, they may have a low rate of depreciation). Moreover, even within a specific program, how those funds are allocated also matters a great deal. Although some specific government investments in a particular category may be as productive as private investment, other projects probably fall short of that benchmark.

On a more fundamental level, the government provides a crucial role in maintaining the legal and institutional framework within which the economy operates. Government spending on the justice system, for example, supports the smooth functioning of the economy by protecting private property rights and enforcing contracts. Cutbacks in such spending could diminish potential output.