THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2005–2014

TUESDAY, JANUARY 27, 2004

House of Representatives, Committee on the Budget, Washington, DC.

The committee met, pursuant to call, at 2:09 p.m., in room 210, Cannon House Office Building, Hon. Jim Nussle (chairman of the committee) presiding.

Members present: Representatives Nussle, Shays, Portman, Schrock, Brown, Wicker, Hulshof, Tancredo, Vitter, Bonner, Garrett, Diaz-Balart, Brown-Waite, Spratt, Moran, Moore, Neal,

DeLauro, Edwards, Scott, Thompson, Baird, and Emanuel.

Chairman NUSSLE. Good afternoon, the Budget Committee will come to order. Welcome everybody on the committee back for a new year and for a new budget season. We have invited the CBO Director Doug Holtz-Eakin here today to ensure that we have a clear understanding of our Nation's fiscal picture. We are here today to ensure that we have a very clear picture and understanding of our Nation's fiscal situation. It is critical for us to understand just what the bottom line is, so to speak, and so we have invited the Congressional Budget Office Director Doug Holtz-Eakin to provide us with that.

The resource that we use as a starting point is the report that was released just yesterday from the Congressional Budget Office, which gives their estimations of the budget and economic outlook

for the coming decade.

Director Holtz-Eakin is here not only to discuss with us the hard and fast numbers of this report but to explain just what all these numbers mean and to put them into some context; in other words, how did CBO arrive at these estimates and what are some of the key variables that could affect our economic and budgetary future.

And again to be clear, the purpose of today's hearing is not to guess what will be in the President's budget or to even for that matter begin writing our budget, but to get a solid understanding of where we are right now so that we can have a better idea of where we should go from here.

Next Monday the President will introduce his budget and we will begin a series of hearings, at which time it will be appropriate to discuss what should or for that matter what should not be in next

year's fiscal budget.

That said, let's get this process started by taking a look at what we have got. First, this report tells us in one very important respect that we are in a pretty similar situation or position as we were back in August when we received these projections. We have large deficits in the near term, \$477 billion in fiscal year 2004, and then \$362 billion in fiscal year 2005, with deficits declining over

the next decade according to this estimation.

This is really not a surprise. We have these deficits because we intentionally spent—and I say intentionally spent—at an extraordinary pace to react to extraordinary circumstances ranging from terrorist attacks and conflicts in Iraq and Afghanistan to an economic recession.

Now, does that mean these deficits are unimportant? Of course not. I have said that the spending driven deficits are an issue that we do need a get a handle on, we are going to get a handle on this information today because we are going to have a lot of serious discussion and have to make a whole lot of tough choices in the next few weeks to try and figure out where we need to go from here.

Before I turn this over to Director Holtz-Eakin for his explanation of the report, I would like to stress a couple of key points that I noticed in looking through the report. First, last year at this time we made it clear that we needed to invest in our economy to get it growing again. Those investments have clearly paid off. From GDP growth to retail sales we are seeing record highs; and most important, the economy has begun to create jobs again. Not as quickly as we would like, but it is moving in the right direction and faster than just about anybody predicted a year ago today.

In fact, to quote the report, "The economy should continue to

In fact, to quote the report, "The economy should continue to grow at a healthy rate over the next 2 years for a recovery appears to have taken hold." There should be no question that the economy has begun to recover and that the tax cuts that we installed are

working.

That said, I believe our starting point for the budget is really different in two cases. First, CBO's baseline assumes that Congress will raise taxes or that in fact the tax cuts will not be made permanent. This assumes that expiration of a whole range of tax relief provisions, including increasing the marriage penalty, reducing the child tax credit, resurrecting the death tax, increasing taxes on capital gains and stock dividends and increasing taxes on small businesses, for that matter increasing taxes on every American who pays income taxes, will occur.

That is not an assumption that anyone should make as we move forward. This will not happen as far as I am concerned in this budget or under our watch. In fact, I would be willing to wager that we might even have a few Democrats who might be willing to support it in that regard. So I think you can safely rule out that

part of the assumption.

Second, the baseline assumes that the \$87 billion of the Iraq supplemental that we spent last year will continue to be spent every year for the next decade. I think that also we can presume, barring extraordinary emergencies, that that will not also be the case.

So with that context and that understanding, we need to turn to the report and to get the wisdom of the Director of the Congressional Budget Office. Before we do that, let me turn it over to Mr. Spratt for any comments that he would like to make.

Mr. Spratt. Thank you, Mr. Chairman. Dr. Holtz-Eakin, we welcome you back. As always, you have done an excellent job as the

Director of the Congressional Budget Office, and we welcome you today even though you are not exactly the bearer of good tidings. You have got some very sobering news for us about the budget.

Your projections show that deficits loom far into the future, that we are not going to grow out of them and somehow glide effort-lessly to the conclusion we all want, which is a balanced budget, and frankly I think they cast grave doubts on the Bush administration's claim that it will be able to cut the deficit in half over the next 5 years.

In particular, the first chart that I would like to call up here gives you a summary of the deficit for this year and the decline in that deficit over 3 short years. January 2001, CBO projected we would have a unified surplus of \$397 billion. Instead, we have a unified deficit this year of \$477 billion.

Next chart. This shows the cumulative surplus or deficit over the period of 10 years, a deterioration from \$5.6 trillion to 10-year estimated surplus between 2002 and 2011 and a cumulative deficit as CBO now sees it. That is a swing of about \$8.5 trillion in the wrong direction.

Next chart. And tax cuts add to the problem. We are not here to advocate the nonrenewal of the child tax credit or the expansion of the 10 percent bracket or the 15 percent bracket, but we are here to call attention to the fact that the whole agenda of the Bush administration is tax cuts if they are extended aggravate the bottom line significantly. They increased the January 2004 baseline. With the expansion of the tax credits, the cuts come out to \$4.150 trillion.

Next chart. This is the only budget surplus, excluding Social Security, which I think we should do and which Congress has dictated we should do in putting Social Security off budget. Back out Social Security, and you will see the debt accumulation between 2005–14. If you do the tax cuts, if you renew them all, we will be \$7.177 trillion. That is what we will add to our national debt over that period of time.

Next chart. Now, the Bush administration is apt to say in the face of forecasts like these this is why we need pro-growth policies. We couldn't agree more. We would love to grow out of it, but the truth of the matter is that CBO is assuming pretty robust growth, 4.8 percent for 2004, 4.2 percent for 2005, tapering off to 3 percent and then dropping slightly below 3 percent, but substantial robust growth for the next 10 years and particularly in the near term.

Next chart. If you look at pages 92 and 93, that is the only place where the small print is big enough to read, you will see that if you do extend the tax cuts, you will add \$2.3 trillion to the deficit over 2005, between 2005–14, that 10-year period of time.

All that is going to the bottom line. In 2001 when it appeared that we had a surplus of \$5.6 trillion, some may have felt that a tax cut of \$1.350 trillion was defensible, but now we know we don't have a surplus. We have a deficit, and the renewal of these tax cuts when they expire will add \$2.3 trillion to that deficit. There is no way around it.

Next chart. Now, it is also said by the Bush administration frequently we have got to rein in spending, and in that regard they mean discretionary spending, which is in the 13 different appro-

priation bills that we pass every year. But if you look where the increases in spending over and above current services have come over the last four fiscal years, you will see that the lion's share of it, 90-95 percent, has gone to defense, homeland security and our response to 9/11 for New York City and for the airlines relief. Ninety to 95 percent of it has gone there.

I would like to think we could rein in some of that, but I don't think we can. In truth, I think you will probably see when the budget comes up an increase in homeland security because there is a fairly common feeling that we are standing on thin ice and

barely funding that at an adequate level.

Next chart. So a couple quotations there that ended up. We have got a serious problem on our hands. I don't know whether we will get down to brass tacks in dealing with it this year or not but sooner or later we will have to deal with it.

One particular statement you made in the report today—a couple of them struck me, Dr. Holtz-Eakin. First of all, you noted that if we allowed the tax cuts to expire as scheduled and held discretionary spending to the rate of inflation, then the budget would balance itself over this period of time of 10 years. That is the way

I read your report.

On the other hand, you said if you renew all of the tax cuts that in 2014 we will have a deficit of \$484 billion. There on the eve of the retirement in big numbers of the baby boomers we will still have a huge deficit which will aggravate the problem of supporting the retirement programs that the baby boomers are looking forward to. That is the gravity of the situation we find ourselves into, and there is no way out of it except a budget plan that comes to grips with the different elements of it. It has got to include taxes, it has got to include spending, it has got to include all of these elements because this is a big intractable problem, it is not going away, and we can't grow out of it.

We will look forward to your testimony.

Chairman NUSSLE. Director Holtz-Eakin, thank you for coming back to the committee and for your work. Your entire report will be made a part of our record here today, and you may proceed as you wish to give us the details of the report. In addition, all members will have 7 days to enter statements for the record.

[The information referred to follows:]

PREPARED STATEMENT OF HON. MARIO DIAZ-BALART, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA

Thank you, Mr. Chairman. Today's hearing marks the first in a series of hearings leading up to the debate over the fiscal year 2005 budget. It is important to not only review the current economic state, but also evaluate the projections for the next 10

Over the last 4 years, the U.S. economy has experienced significant hardship due to the 9/11 terrorist attacks, corporate accounting scandals and the wars in Iraq and Afghanistan. These events have greatly contributed to the sharp increase in spending and, ultimately, the current deficit levels.

Fortunately, the third quarter highlighted a strong recovery in the economy at-

tributed to the growth from the tax relief passed last year and the return of investor confidence. It is now our responsibility to create policies that will not only extend

this growth, but foster greater growth in the future.

It is clear that the major source of recent growth has been the tax relief passed by Congress and signed into law by the President last year. In fact, estimates show that the combined tax relief between 2001-04 amounts to nearly \$600 billion (or about 6 percent of gross domestic product). Additionally, 2.1 million more Americans would be out of jobs without the tax cuts and the unemployment rate would be around 7.5 percent rather than the current 5.7 percent.

As we enter a period of growth, I strongly believe that our economic path should be focused on adhering to the concept of fiscal discipline. We must—in every way possible—help Congress restrain spending and work on eliminating wasteful spending that is hamstringing the Federal Government and greatly burdening the American taxpayer.

I look forward to working with my colleagues on the Budget Committee to ensure that the fiscal year 2005 budget not only represents a restraint on spending, but also a clear path to economic recovery.

Thank you.

STATEMENT OF THE HON. DOUGLAS HOLTZ-EAKIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. HOLTZ-EAKIN. Thank you, Mr. Chairman, thank you, Congressman Spratt, members of the committee. I appreciate the chance to be here today to talk about the CBO provisions for the budgetary and fiscal and economic outlook for fiscal years 2005–14.

We have submitted our entire report for the record. There is a short extract of it that serves as a written testimony. I will provide an even shorter version in my oral remarks so that we can turn to any questions that you might have on the material.

Briefly, the facts are as follows. CBO projects that the Federal budget deficit will be \$477 billion in fiscal year 2004, will diminish to \$362 billion in 2005, \$269 billion in 2006, and then will steadily diminish thereafter until the budget reaches balance at the end of the budget window.

These deficits, while large in dollar terms—\$477 billion is the record in dollar terms—are 4.2 percent of GDP in 2004, dropping to 3 percent of GDP and 2.1 percent by 2006. So relative to the national income and the economy, these are not the largest deficits.

Over the 10-year budget window, as the slide shows, we have a cumulative deficit of \$1.9 trillion. Because the budget is largely in balance roughly after 2011, the 5-year total is the majority of that \$1.4 trillion.

A different way to look at the situation—a different fiscal barometer—is the cumulative effect of deficits or debt relative to GDP in the economy, and in these projections we see debt relative to GDP rising from about 38 percent at the beginning of the budget window and hitting between 40 and 41 percent, where it stays until after 2011 and then diminishes to about 45 percent.

Now, since the projections that we put out in August two things have happened. The first is that the economy has performed better than we projected it at that time. The third quarter is much stronger than we had expected. And indeed, we have altered our near-term economic assumptions accordingly and it may be the case in fact that the fourth quarter, which the data are not yet available, is stronger yet than what is included in the projections that you see before you today.

CBO's Baseline Budget Outlook						
	Actual 2003	2004	2005	2006	Total, 2005- 2009	Total, 2005- 2014
	In Billio	ns of Do	llars			
Total Revenues	1,782	1,817	2,049	2,256	11,840	28,004
Total Outlays	2,158	2,294	2,411	2,525	13,282	29,897
Total Deficit	-375	-477	-362	-269	-1,443	-1,893
	As a Perc	entage o	f GDP			
Total Deficit	-3.5	-4.2	-3.0	-2.1	-2.2	-1.3
Debt Held by the Public at						
the End of the Year	36.1	38.3	39.5	39.9	n.a.	n.a.

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Nevertheless, these economic growth rates will simply bring the cyclical recovery on more quickly and get us back to full employment. Our estimate of the capacity of the economy to produce has also been moved up since August. We have seen rapid productivity growth, and we have tried to adjust for that in our projections. And I can come back to that in a second.

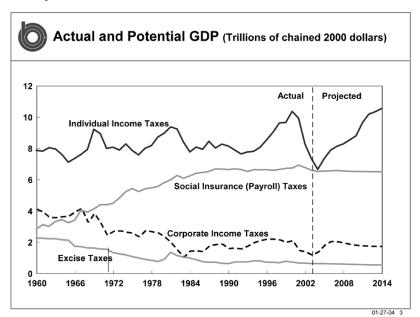
The second major innovation is legislative. Since August, over the 2004–13 budget window, the one we used last year, we have seen an increase of \$1 trillion in the cumulative deficit. That change comes from \$700 billion roughly—about \$680 billion more precisely—in legislation, largely the Medicare prescription drug bill but also concurrent receipts, the Air Force's Boeing tanker acquisition, appropriations and then roughly \$300 billion from economic and technical sources, roughly evenly divided. And I can talk about the details of that.

As has been noted, the CBO projections assume current law prevails over the baseline projection period. On the tax side, that assumes that tax law has the sunset of the 2001 and 2003 tax cuts as scheduled, and that is included on the outlay side. It also assumes that we have an ever-increasing reliance on the alternative minimum tax in the collection of our individual income tax receipts. So both of those are built into our baseline.

On the outlay side, the notable features is that we assume the current programs on the mandatory side, but we also for discretionary spending include all appropriations on the books, including the \$87 billion supplemental, and we inflate those only at the rate of inflation. So discretionary spending rises at 2.5 percent in these projections.

Now, what I thought I would do in conclusion is to touch briefly on those three topics and then take your questions—first the eco-

nomic forecast, then the pattern of receipts and then the pattern of outlays.

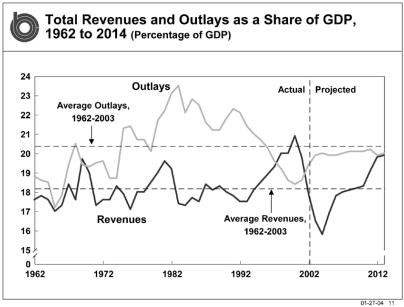


On the economy, we do expect a robust cyclical recovery, and if we can go to the next chart, the key features are represented in this graph of actual versus potential GDP. The actual course of the economy is the light blue line, and we anticipate that economic growth will be rapid over the next 2 years, at 4.8 percent, and 4.2 percent, and this will bring us back to potential and at the same time we will see the unemployment rate diminish as the economy comes closer to utilizing its capacity fully.

To the extent that the economy grows faster over that period than we projected, it will close that gap more quickly, but in the long run the capacity of the economy to produce and the long-run revenue potential that it will deliver is driven by the dark blue line, which is the potential GDP. And there the big news has been productivity in the U.S. economy.

As we detail in the report, we have experienced a recent period of very rapid productivity growth of origins not well understood, and in the interest of acknowledging the increased potential for production in the U.S. economy, we have raised the potential for GDP, but we haven't really changed its long-run growth rate. So we get a one-time increase in the level. That gives us more room to grow quickly and our projections assume that we will. They assume that we can grow quickly without large amounts of inflation, and our projections include a modest inflationary environment, both over the near term and over the long term where we have lowered our long term rate of inflation modestly.

As it turns out, the budgetary impact of these various changes is on balance a little bit negative. In the near term, the faster economic growth is a good piece of news from a budgetary point of view. Over the longer term, the combination of higher health costs lowers the fraction of compensation that comes in the form of taxable wages, and lower inflation on net has a modestly downward impact on the budget. And as a result, we get a net negative, which is really not quite substantial from our economic assumptions.



In the next slide, receipts are shown as the dark line at the bottom. The bottom dotted line is the historical average in the United States from 1962 forward, about 18 percent of GDP collected in revenues by the Federal Government. These projections have revenues rising rapidly at a rate of something in excess of 7 percent. The economy is growing, including inflation, growing at 4.7 percent. So we are seeing revenues rise faster than GDP in these projections.

As a result, revenues rise from 15.8 percent of GDP this year, which is a low number, the lowest number we have seen since the 1950s, to 20.1 percent in 2014. That growth in revenues comes from two sources. One source is the expiration of various tax provisions, first the partial expensing provision at the end of 2004, then the provisions in EGTRRA and JGTRRA, and with those we see the sunsets raising revenues. That contributes to about 2.3 percentage points or a little over half of that rise.

The remainder comes from other sources. It comes from the fact that real growth in the economy raises real incomes and moves people into higher tax brackets. That is one source of revenue growth. It comes from the presumption in these projections that we will see capital gains realizations return to closer to their normal relationship with the economy, and we will get more capital gains tax receipts as a result.

During this period as well, we will begin to see the retirement of the baby boom population and with that will come the cashout of tax preferred savings accounts like IRAs and 401(k)s. That will contribute as well to receipts into the Federal coffers.

And finally, as I mentioned earlier, the alternative minimum tax will become increasingly important both as a revenue source and in the number of taxpayers that it affects. We have a discussion in chapter 4 of the report pointing out that under our baseline projections the number of individuals affected, the number of taxpayers affected by the AMT, rises from about \$3 million to close to \$30 million at the peak. Depending on how things proceed, those receipts could become as important as 7 percent or so of individual income tax receipts.

On the outlay side, the light blue line at the top, we assume that current law will deliver a growth in mandatory spending that is about 5.5 percent a year over the budget window. That is going to increase largely because of the effects of Social Security, Medicare, and Medicaid to the point where in the last year, 2014, the growth rate will be 6.5 percent. And that is the beginning of a long-run interaction between rising health care costs in the U.S. economy and an aging population that will lead Social Security, Medicare and Medicaid, the latter two programs in particular, to demand an increasing fraction of budgetary resources, or indeed national income, on the current track.

On the discretionary side, as I mentioned earlier, we include the \$87 billion supplemental increased at the rate of inflation. If one were to remove that \$87 billion for each of the 10 years and the inflation and the debt service associated with it, it would lower the baseline projected deficit by \$1.1 trillion over this 10-year period; so the inclusion following baseline rules contributes \$1.1 trillion in these projections. And as well, I would note that the assumption of growth at 2.5 percent is at odds with past growth rates, which have been much higher, and we present in the report as a result some broad brush alternatives that would lead to different budgetary outcomes.

I think the fair message of the report is that it anticipates cyclical recovery. It gets the economy back to potential. It is an economy that grows at a relatively rapid rate, and our productivity growth assumptions are laid out in the report. As a result, policy choices will matter for where we actually end up.

The Budgetary Effects of Policy Alternatives Not Included in CBO's Baseline (Billions of dollars) Total. Total. 2005-2009 2014 Policy Alternatives That Increase the Deficit or Reduce the Surplus **Extend Expiring Tax Provisions** -2.230 Reform the Alternative Minimum Tax -161 -469 Increase Discretionary Appropriations by the Growth Rate of Nominal GDP After 2004 -1,618 Increase Discretionary Appropriations by 6.9 Percent a Year After 2004 -641 -3.157 Policy Alternatives That Reduce the Deficit or Increase the Surplus Increase Discretionary Appropriations (Excluding Supplemental 421 Appropriations for 2004) by the Rate of Inflation After 2004 1.108 280 1,320 Freeze Total Discretionary Appropriations at the 2004 Level (\$876 billion) Total Deficit in CBO's January 2004 Baseline -1,443 -1,893

And in the final slide and in the report, we sketch the ones that stand out in most discussions. The impact of expiring tax provisions is laid out in considerable detail in a table in chapter 4. This includes not only the provisions of EGTRRA and JGTRRA but all expiring tax provisions. We include an impact of the reform of the alternative minimum tax. Here reform should be taken as a loose, stylized reform in which we index the alternative minimum tax for inflation so that no one ends up paying the AMT unless he is really rich. The effects of inflation alone don't put you on AMT. And the consequences there, about \$4.5 billion over 10 years, are shown.

Finally, some outlay projections for discretionary spending that are both faster and slower than the baseline. At the top increasing discretionary spending at its historical rate would have a consequence of about \$3.2 trillion over the 10-year budget window, whereas removing the effect of the supplemental, as I mentioned, would be worth \$1.1 trillion, or an absolute freeze would reduce the 10-year budget deficit by \$1.3 trillion.

Those I think make clear that the range of budgetary outcomes is considerable from the perspective of policy decisions that the Congress and the administration might make, and we also try to display in Appendix A the range of budgetary outcomes that might come from simple uncertainty over the future path of the economy and the technical assumptions associated with it.

So with that I would close. These are our baseline projections constructed according to the standard procedures. We have also displayed the economic uncertainty and some of the policy uncertainty that surrounds them, and I will be happy to go through it in any way that you might desire and look forward to your questions

[The prepared statement of Douglas Holtz-Eakin follows:]