# THE CONGRESSIONAL BUDGET OFFICE'S BUDGET AND ECONOMIC OUTLOOK

### WEDNESDAY, JANUARY 23, 2008

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

The committee met, pursuant to call, at 10:04 a.m., in room 210, Cannon House Office Building, Hon. John M. Spratt Jr. [chairman

of the committee] presiding.

Present: Representatives Spratt, Edwards, Cooper, Schwartz, Becerra, Doggett, Blumenauer, Berry, Boyd, McGovern, Scott, Etheridge, Moore of Kansas, Bishop, Moore of Wisconsin, Ryan, Barrett, Hensarling, Lungren, Conaway, Campbell, Tiberi, Alexander and Smith.

Chairman SPRATT. Let me call the hearing to order and welcome

our witness this morning.

Dr. Orszag, as always, we are glad to have you and thank you for coming. Today you are here to lay out your latest forecast or outlook on the budget and economy released just this morning. We are pleased to have your perspective on recent developments in the economy and how these changes have affected the Federal budget and are likely to affect it further.

Given current discussions about economic stimulus proposals in your release on that subject last week, I expect that our members will have questions about the various roles that fiscal policy can play in firing up our faltering economy. Your budget and economic outlook offered some sobering projections on the short-term and long-term fronts. For the short-term, CBO's economic forecast has grown noticeably more pessimistic since last August, and a number of ominous economic signs have emerged since CBO finalized last month the forecast underlying today's report. Unemployment has spiked in 1 month from 4.7 to 5 percent. December retail sales, all important, actually fell by four-tenths of a percentage point from the prior month. And yesterday the Fed felt compelled to make an uncommon if not unprecedented cut of 75 basis points in the Fed funds rate.

Today's new economic forecast adds to the growing evidence that the country and that the economy has weakened and that we as policymakers must and should take action. Meanwhile, CBO shows the deficit for fiscal 2008 is larger than the deficit for fiscal 2007, and the '08 deficit is actually \$64 billion worse in this projection than in the projection you made last August. Over the long term, CBO's 10-year forecast is worse and relative to August by \$850 billion on an apples-to-apples basis.

Because yours is a baseline forecast, it does not include the full deficit impact of all of the administration's policies and the budget that they will send us in a few weeks. For example, your forecast does not include the roughly \$4 trillion impact on revenues which will be occasioned by the President's tax cut agenda or the full cost

of ongoing operations in Afghanistan and Iraq.

Under administration policies, the \$5.6 trillion surplus projected in 2001 has collapsed, vanished, been replaced by deficits which are nearly equal in amount and which have complicated our efforts, a response to the current slow down in the economy. Today's report provides the latest evidence that we should act and act now to strengthen the economy and that we should do so in a way that is mindful however of the long-term budget challenges, the structural deficits that we face unless we act and act seriously.

This report reminds us also that the President's budget policies, particularly his deficit financed tax cuts, have significantly increased the national debt and make it harder to address our long-

term challenges.

So, Dr. Orszag, we have a lot on our plate this morning, a lot to discuss with you, a lot of questions to ask. We look forward to your testimony, your answers to the questions that we will ask and follow. And before turning to you for your testimony, however, I want to recognize Mr. Ryan for any opening statement that he may wish to make.

Mr. Ryan.

Mr. RYAN. Thank you, Chairman Spratt.

And welcome back, Director Orszag.

Over the past few years, I think it is—we have almost come to expect good news when it comes to our near-term deficit projections at every one of these hearings we have had. We have seen dramatic declines in the deficit well below projections for each of the last 3 years. In fact, last year at this time we found ourselves on what many describe as a glide path to near-term balance as a result of our economy's performance. So it is no surprise that we began taking this trend for granted. We simply expected that our economy would keep cranking along, creating jobs, boosting revenues and driving down deficits.

But today I understand that Director Orszag is here to tell us otherwise. CBO is projecting the Federal deficit will increase this year largely as a result of the economic slow down and the drag it is going to place on revenue growth. For the past few weeks there have been broad discussions on how best to address the economic downturn. And there is bipartisan consensus that the Fed-

eral Government can and should respond.

But even while the President announced that we should act quickly to move an economic growth package, the exact contents of that package is obviously not yet resolved. As I noted last week, I believe there are several key principles we need to keep in mind. First, do no harm. I am concerned that in our rush to help we will talk ourselves into a quick feel-good hit today that will leave us with a bigger budgetary hangover tomorrow. Second, we need to get the fundamentals right. That means keeping tax rates low and spending under control both in the short and longer term. That is the best prudent recipe for real long-term economic growth. Third,

we need to understand that we simply cannot spend our way to prosperity. I am particularly concerned that Congress will be tempted to use the excuse of fiscal stimulus to push through a wish list of new spending, further worsening our budget outlook and our nation's economic future. In short, I believe that in addressing the current economic concerns, we have got to keep our focus on good

economic policy that lasts beyond the next few quarters.

On a final note and to be clear, this is in no way a criticism of the CBO. While the information we receive today is critical for drafting our budgets, we have got to recognize the limitations of something we call the baseline. The baseline concept, under which CBO formulates its projections, includes a built-in double standard favoring higher spending and higher taxes. In general, the baseline assumes that spending, even if scheduled to expire, goes on forever while tax relief is always temporary. As a result, extending the spending programs has no impact on baseline deficit while extending tax relief is shown as causing an increase in the deficit. Assuming revenues from the AMT or the expiration of the current tax relief in 2010 simply because they are baked into something called the baseline should not serve as an excuse to impose job-killing tax increases on our nation's economy.

To conclude, as we look at the current economic conditions as well as CBO's longer term forecast, we should pursue policy that maintain low tax rates; keeps spending under control; and works to address the long-term unsustainable growth in our major entitlement programs. Those are the things we should keep our eye on. And I appreciate the Chairman for his indulgence.

Chairman Spratt. Thank you, Mr. Ryan.

Dr. Orszag, the floor is yours. Before you begin, however, let me attend to a couple of housekeeping details. First let me say that your statement will be made in full part of the record so you can summarize it as you see fit. But I would encourage you, as I did earlier, to take your time and to walk us through this as carefully and deliberately as you see fit.

Secondly, I would ask unanimous consent that all members be allowed to submit an opening statement for the record at this point. There is no objection; so ordered.

[A letter submitted by Mr. McGovern follows:]

The Honorable Jim McGovern United States House of Representatives Washington, DC 20515

January 22, 2008

#### Dear Representative McGovern:

Rising unemployment, declining consumer spending, and contraction in housing values has caused many economists to conclude that federal economic stimulus is needed to reduce the severity of an economic downturn. The warning signs are sobering; if the federal government fails to respond, millions of Americans may pay with lost jobs or serious financial hardship. We urge Congress to act swiftly to enact a stimulus package that will work to increase consumer spending and employment. Evidence is strong from the most recent recession that the most effective federal policies provide quick infusions of funds to low- and moderate-income households and to state and local governments.

Federal Reserve Chair Ben Bernanke told the House Budget Committee that increased food stamp benefits and tax rebates reaching low-income people are effective ways to spur the economy. "There is good evidence that cash that goes to low and moderate income people is more likely to be spent in the near term." Those with higher incomes are far more likely to save funds they receive, which will not benefit the economy. Increased government spending on unemployment insurance and food stamps will quickly result in more consumer spending, fueling business income and employment. Targeting assistance to state and local governments is also effective stimulus. In the last recession, 37 states reduced their spending by \$13 billion, according to the Congressional Budget Office. Federal aid can allow states to spend on vital services such as Medicaid, child support enforcement, job training and employment services, school maintenance and repair, or home energy aid, all of which will lead to job growth and/or increased consumer spending.

A package built from the most effective forms of stimuli would provide the following:

Extend and improve Unemployment Insurance: Unemployment Insurance has been ranked as the single most effective stimulus measure, with studies showing each dollar of UI spending generating from \$1.73 (Zandi, Economy.com, 2004) to \$2.15 (Chimerine et al., U.S. Department of Labor, 1999). Because long-term unemployment is rising and more and more of the unemployed will exhaust the basic 26 weeks of benefits, Congress should enact a 20-week supplemental unemployment compensation program for those who have exhausted their basic benefits, with an additional 13 weeks in states with high unemployment, providing adequate funding to states to administer the program. Because UI benefits now average only \$285 a week, Congress should also increase weekly benefits by \$50. But extensions and increases will only help the minority of unemployed workers who qualify for UI. Only 38 percent of the unemployed now receive any unemployment compensation; the lowest-income workers are disproportionately excluded. To reach more of the unemployed, Congress should provide funding to states to improve their systems by counting more recent earnings, and by extending

eligibility to workers only available for part-time work and who leave jobs for compelling family reasons, as provided in the Unemployment Insurance Modernization Act (H.R. 2233; S. 1871).

Increase Food Stamp benefits: Food Stamp benefits average \$1 per meal for the 27 million current recipients, 87 percent of whom are living in households below the poverty line. An increase in benefits could be added to Food Stamp electronic debit cards rapidly. Like the current benefits, the temporary raises would be quickly spent and would at the same time prevent childhood ill health and developmental delays associated with inadequate nutrition. The Congressional Budget Office has rated a temporary increase in food stamp benefits highly for cost-effectiveness, short lag time, and relative certainty about the policy impact. Former Treasury Secretary Dr. Lawrence Summers reported to the Joint Economic Committee, "On the spending side the measures most likely to be effective are temporary increases in benefits perhaps for the long term unemployed and food stamp recipients."

Provide a temporary, refundable tax rebate to people who paid payroll or income taxes in 2007: Studies of the impact of the 2001 tax rebates confirmed that low-income, young, credit-constrained households spent more of their rebate checks. The Congressional Budget Office draws this conclusion: "Therefore, policies aimed at lower-income households tend to have greater stimulative effects." If the tax rebate does not broadly reach households that have paid payroll taxes but do not owe income tax, they will miss the households who need the income the most and whose spending will provide the most stimulus. The Economic Policy Institute has estimated that \$65 billion would fund rebates of at least \$350 per individuals or \$700 per married couples who paid payroll or income taxes in 2007. There are good arguments for phasing out the rebate at the upper ends of the income scale, and targeting as much as possible to the lowest-income people, including families with children, whose situation is most precarious.

Increase aid to state and local governments: According to the National Conference of State Legislatures, in mid-December 19 states were already projecting budget shortfalls for the coming FY 2009; 13 of these states estimated budget gaps totaling \$23 billion. The number of states in trouble is bound to grow as sales and property tax revenues shrink. If states are forced to cut services, benefits, or personnel, lay-offs and reduced expenditures will make the recession worse. Aid to state and local governments will prevent such ill effects. Helping states and counties to cover Medicaid costs will protect low-income families from loss of medical care at a time when rising joblessness and higher costs make them particularly vulnerable. Reversing child support enforcement cuts now starting to take effect will not only forestall lay-offs but will prevent the loss of billions of dollars in child support collections needed to help low-income families with children make ends meet. In addition, general flexible fiscal relief, similar to the package Congress enacted in 2003 would enable states and localities to quickly address their local varied circumstances.

Fund infrastructure repair or maintenance: The Economic Policy Institute has pointed to more than \$100 billion in needed repairs to U.S. public schools – well-defined projects that can be quickly implemented. EPI estimates that \$20 billion in such infrastructure repairs would create 280,000 jobs, and would of course be an investment in improving education. We believe that infrastructure investments in a stimulus package should be limited to projects that can be up and running within a year.

Increase home energy assistance: The Low Income Home Energy Assistance Program (LIHEAP) served only 15.6 percent of eligible households in FY 2007, providing assistance averaging \$305 per household for home heating or cooling. Between FY 2003 and FY 2007, LIHEAP funding increased by 10 percent, but heating costs rose 47 percent, with costs accelerating this year. We appreciate that Congress increased LIHEAP to nearly \$2.6 billion for FY 2008, but unmet need is still very great. Increased LIHEAP funding could be distributed quickly and would help families cope with huge increases in home energy costs.

Congressional leadership to craft an effective stimulus plan is urgently needed. Fortunately, the elements that provide the most economic gain will also serve to reduce hardship and to invest in education, health and job creation – all outcomes that will help in the short and long terms. We strongly urge Congress to enact a package with the elements outlined above, and to reject proposals for permanent tax breaks that provide little or no stimulus at great cost.

#### Sincerely,

ACORN

AFL-CIO

AFSCME

American Federation of Government Employees, AFL-CIO

American Friends Service Committee

American Network of Community Options and Resources

Americans for Democratic Action, Inc.

Association of Farmworker Opportunity Programs

Bread for the World

Campaign for America's Future

Center for Community Change

Child Welfare League of America

Coalition on Human Needs

Common Cause

Community Action Partnership

Easter Seals

Evangelical Lutheran Church in America

Families USA

Food Research & Action Center (FRAC)

Lutheran Services in America

National AIDS Housing Coalition

National Association for State Community Services Programs

National Association of County Behavioral Health and Development

National Association of Social Workers

National Benedictines For Peace

National Center for Law and Economic Justice

National Coalition for Asian Pacific American Community Development

National Community Action Foundation

National Council of Jewish Women

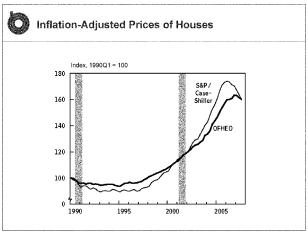
National Education Association National Head Start Association National Health Care for the Homeless Council National Immigrant Solidarity Network National Low Income Housing Coalition National Network of Abortion Funds National Poverty Engine National Priorities Project National Rehabilitation Association National Research Center for Women & Families National WIC Association National Women's Law Center NETWORK: A National Catholic Social Justice Lobby OMB Watch RESULTS Sargent Shriver National Center on Poverty Law The Arc of the U.S. The Children's Defense Fund The Corps Network The Workforce Alliance United Cerebral Palsy United for a Fair Economy USAction VOICES Wider Opportunities for Women Women's Committee of 100 YWCA USA

If you wish to be removed from this list, please call 1-800-915-2571 x 43200, or fax to (202) 223-2538

Dr. Orszag, thank you again for coming. We look forward to your testimony.

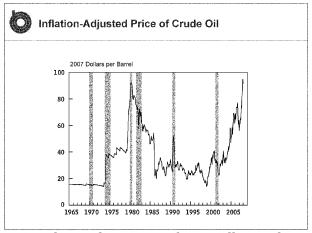
## STATEMENT OF PETER P. ORSZAG, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. Orszag. Mr. Spratt, Mr. Ryan, members of the committee, my testimony this morning will focus on the economic and budget outlook. First, the economy has been buffeted by several interlinked shocks, and the risk of recession is significantly elevated relative to normal economic conditions.



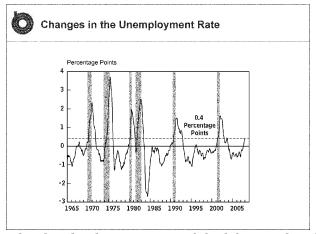
As my first chart shows, there was a dramatic run-up in housing prices during the first half of this decade, but housing prices have started to decline, and most forecasters expect further drops this year. The weakening of the housing sector directly affects the economy by reducing residential investment and indirectly affects the economy through reduced consumer spending as a result of lower housing wealth.

Moreover, problems in the housing markets and mortgage markets have spilled over into broader turmoil in financial markets which poses the risk of impeding the flow of credit essential to a modern economy.

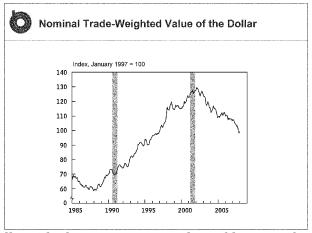


Energy prices have also risen substantially as the next chart shows. Although the effect of an increase in the price of oil on the macroeconomy today is smaller than it was in the 1970s and 1980s, the rise in oil prices is still an economic drag. The combination of these forces has not yet fully manifested, themselves; although the unemployment rate has ticked up. Indeed, as the next chart shows, the 3-month moving average unemployment rate has now risen 0.4 percentage points, almost a half a percentage point, above its level

relative to the same period last year, which as you can see from the graph has only and always occurred in periods associated with a recession, which are those dark bars in the graph. You can see that the only times that we have crossed that 0.4 percentage point horizontal line is during those dark bars, which are recessions.

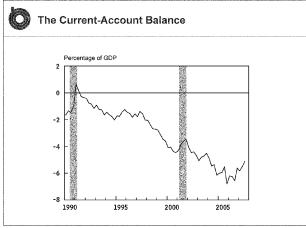


On the other hand, other measures of the labor market that have typically accompanied such a large increase in the unemployment rate at the onset of a recession have not behaved as they have in the past. For example, unemployment insurance claims typically spike up at the beginning of a recession, and they have not done so thus far in recent experience.



Especially with the most recent and notable action by the Federal Reserve yesterday, many professional forecasters are projecting continued, albeit sluggish, economic growth in 2008 rather than an outright recession. And one force leading to that conclusion has been net exports. Thus far, as the next chart shows, the depreciation of the dollar, which is a necessary part of the gradual adjustment of our current account deficit, has itself been gradual, and that has helped to stabilize and, along with growth abroad, even

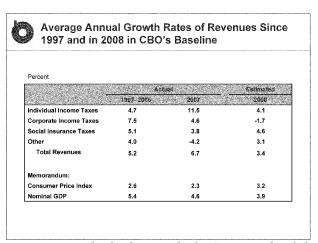
slightly improve the current account deficit, which is shown in the next chart. That force has—and rapid growth in real exports is helping to provide a cushion or a boost to the economy.



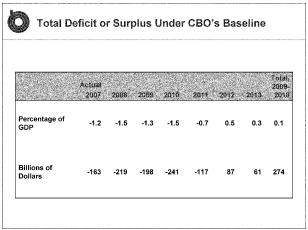
The bottom-line is that the risk of recession is substantially elevated, but CBO expects, along with most professional forecasters, a period of unusually weak growth rather than outright recession. In particular, CBO expects growth for the year as a whole of under 2 percent, as the next chart shows, and a rise in the unemployment rate to an average of 5.1 percent during 2008.

CBO's Economic Projections for Calendar Years 2008 to 2018  Percentage Change				
2007	2008	2009	2010-2013	2014-2018
13,828	14,330	14,997	18,243	22,593
4.8	3.6	4.7	5.0	4.4
2.2	1.7	2.8	3.1	2.5
2.5	2.6	1.8	1.9	1.9
4.6	5.1	5.4	4.9	4.8
	8 Estimated 2007 13,828 4.8 2.2 2.5	8 Februated Fore 2007 2008 13,828 14,330 4.8 3.6 2.2 1.7 2.5 2.6	8 Formated Forecast 2007 2008 2009 13,828 14,330 14,997 4.8 3.6 4.7 2.2 1.7 2.8 2.5 2.6 1.8	8  Festmated Forecast Projected Air 2007 2098 2909 2910-2913  13,828 14,330 14,997 18,243  4.8 3.6 4.7 5.0  2.2 1.7 2.8 3.1  2.5 2.6 1.8 1.9

A reflection of this general slowing in economic activity can be seen in job growth. In 2005, job growth averaged 220,000 per month. It fell in half last year to an average of 110,000 per month. CBO projects that during the first half of 2008, it will fall in half yet again to an average of 55,000 per month during the first half of this year.

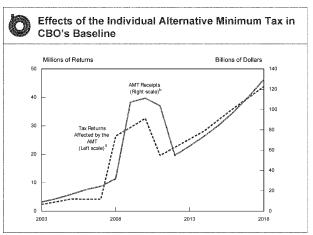


Let me now turn to the budget outlook. As a result of the slowing economy, we have already seen some slowing of revenue growth, as the next chart shows, especially in corporate income taxes. And CBO expects some further slowing this year. Indeed we expect corporate income taxes to decline in nominal terms this fiscal year relative to last year. We now have information for corporate tax receipts during January and project that again in January we will have a year-over-year decline in corporate tax receipts—the seventh month in a row in which that occurred. This is particularly notable because a lot of the fiscal improvement between 2003 and 2006/7 occurred because of a very sharp rise in corporate income tax revenue.



Our baseline suggests that after 3 years of declining deficits, a slowing economy will boost the deficit to \$219 billion this year, as the next chart shows, which amounts to 1.5 percent of GDP or 1.5 percent of the economy, which is up from 1.2 percent last year. If policymakers fund the additional appropriations for Iraq and Afghanistan that the administration has requested, that deficit would rise to—this year to about \$250 billion. And if policymakers adopt-

ed some fiscal stimulus measures, the deficit this year could rise significantly above that. And indeed, at least from the perspective of short-term stimulus, that would be one of the objectives of providing such stimulus. Thereafter, under our baseline, which assumes a growing impact of the alternative minimum tax and the expiration of the 2001 and 2003 tax legislation, the budget moves towards balance in 2012.



However, as both Mr. Spratt and Mr. Ryan have already noted, that baseline is often viewed as being unrealistic because policy changes that are widely viewed as likely to occur are not incorporated into it. In particular, for example, the baseline assumes no further relief from the alternative minimum tax and, therefore, that the number of taxpayers on the alternative minimum tax will rise from 4 million last year to 26 million this year and continue rising thereafter as you can see on the chart. If, instead of making that assumption, you assumed relief from the AMT was continued, you assume that the 2001 and 2003 tax legislation is continued past its official expiration in 2010, that you adopt one of the scenarios we have put together for the future war-global war on terrorism and you assume that discretionary spending keeps pace with economic growth and not just inflation, the next chart shows you that you get a much different path for the projected deficit than what the baseline shows. And indeed, under that scenario, the cumulative deficit, instead of being a surplus of \$274 billion between 2009 and 2018 under our baseline, would show a deficit of \$6.3 trillion or about 3.5 percent of GDP.