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THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2013 TO 2023

HEARING

BEFORE THE

COMMITTEE ON FINANCE UNITED STATES SENATE

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CONTENTS

OPENING STATEMENTS

WITNESSES

ALPHABETICAL LISTING AND APPENDIX MATERIAL

COMMUNICATION

THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2013 TO 2023

TUESDAY, FEBRUARY 26, 2013

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:07 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Wyden, Schumer, Stabenow, Cantwell, Nelson, Menendez, Carper, Cardin, Brown, Bennet, Casey, Hatch, Grassley, Roberts, Enzi, Cornyn, Thune, Burr, Isakson, and Portman.

Also present: Democratic Staff: Amber Cottle, Staff Director; John Angell, Senior Advisor; and Mac Campbell, General Counsel. Republican Staff: Chris Campbell, Staff Director; and Aaron Taylor, Professional Staff Member.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will come to order.

President John F. Kennedy once said, "The solid ground of mutual confidence is a necessary partnership of government with all of the sectors of our society in the steady quest for economic progress."

In the close to 4 years since the end of the recession, steady progress has been made in our economic recovery, but a feeling of uncertainty nevertheless continues to spread across the Nation.

The dysfunction of our government is degrading confidence in our economy and creating uncertainty for families and businesses. It is preventing families from planning for the future, dragging down investment, and leaving businesses sitting on the sidelines and holding back our economy.

Like many members of the committee, I just returned from a week at home—in my case, Montana—talking with the people I work for. I heard from small business leaders in Billings, I met with law enforcement in Missoula and Bozeman, and I talked with the commander of Montana's Army National Guard based in Great Falls. As part of our traditional, what I call work day, I worked early shift at Wheat Montana Bakery in Three Forks. I started at 7 a.m. I cleaned tables, served coffee, and greeted the customers taking a break from their weekend travels.

At each stop in every corner of the State, I heard one thing over and over: the people we work for need certainty. It is time Washington started listening, they say. They are tired of being jerked around from one crisis to the next. They want us to work together and get our act together.

They make tough decisions every month to keep their budgets in the black, and they deserve a Congress and a President that can work together and do the same. In the coming days and weeks, we must confront a number of fiscal challenges facing our Nation.

Just 3 days from now on March 1st, across-the-board budget cuts, known as the sequester, will hit. Eighty-five billion dollars in Federal spending will be sliced from thousands of programs, including Medicare, rural development, and early education.

The repercussions will ripple through every sector of our economy. In Montana, more than 800 civilian employees at Malmstrom Air Force Base and the Army and Air National Guards will face up to a 20-percent reduction in pay. These are not just numbers, these are real people with bills to pay and families to care for.

Cuts to national parks hit home in our State, because 64,000 Montana jobs depend directly on outdoor recreation.

Nationwide, the Department of Justice's Office of Violence Against Women will lose $21 million. That means fewer grants to support the very critical work of the folks I met with in Missoula and in Billings—folks doing heroic work to help prevent violence against our mothers, sisters, and daughters. These are impressive people undertaking these programs, I can tell you. And cuts to the Community Oriented Policing Services (COPS) grants program could mean fewer police officers on the streets keeping our communities safe.

The uncertainty over how these and other cuts will play out is weighing heavily on businesses like Wheat Montana, and those I have met with in Billings. The nonpartisan Congressional Budget Office predicts the sequester cuts could slow economic recovery and result in another year of sluggish growth and high unemployment.

Yes, we need to cut our debt and get our fiscal house in order. We know there are some places to trim the fat. But we need to take a scalpel to waste and inefficiency, not allow a hatchet to hack into American jobs. We have a plan on the table to bridge the sequester and still cut $110 billion from our debt without putting working families and American jobs in jeopardy. The proposal is not perfect. I have concerns about cuts to programs family farmers rely on, but I understand the alternative of doing nothing could be far worse for agriculture and the rest of our economy.

That is why I secured a compromise that will extend the Supplemental Revenue Assistance Payments (SURE) program and give farmers a bridge between direct payments and the next farm bill. This includes livestock disaster assistance for ranchers recovering from the worst drought in decades. That too is important. So, while this plan is not exactly how I would have designed it on my own, I recognize that compromise is necessary to get something done.

My hope is that my colleagues will support this plan or offer their own to stop the sequester. We can then work together to prevent these indiscriminate cuts from causing lasting economic damage.

Our economy will be put to the test again in just weeks when the continuing resolution expires on March 27th. We face the threat of a government shut-down. On the horizon, the Federal borrowing limit will be reached in late May. That will require another extension of the debt ceiling.

This is no way to run a country. Congress has been lurching from one fiscal show-down to the next, leaving the Nation with uncertainty. The only way we will be able to get past these budget battles is by working together. It is a truism, but, like a lot of truisms, it is true. We can start right here in this committee. We need to take a balanced approach as we tackle these issues and work together to cut the debt.

Over the past 2 years, we have made real progress cutting deficits and the debt. In 2011, we passed $1.4 trillion in spending reductions. Last month, Congress passed legislation that reduced the deficit by another $600 billion.

Together, with interest savings, these actions will cut the deficit by $2.5 trillion over the next 10 years. Add to this the savings from winding down the wars in Iraq and Afghanistan, and our deficit reduction will reach almost $3.5 trillion over 10 years.

As the Nation's economy continues to recover, the long-term budgetary outlook has changed. CBO's forecasts for Medicare and Medicaid spending have dropped significantly. Current projections for the programs' costs through the end of the decade are $200 billion less than in March 2010.

CBO also forecasts decreasing deficits in a stable debt-to-GDP ratio over the next several years. It projects the 2013 budget deficit will be a full third lower than it was in 2010, and it will be cut in half by 2015. CBO notes that there will be a slight uptick at the end of the decade, so we must continue to attack the deficit head-on.

The unemployment rate is still unacceptably high. American families' budgets are being pinched: skyrocketing gas prices, rising food prices, and stagnant wage growth are making it harder for families to make ends meet. More must be done to strengthen our country's economy.

Today we will discuss how we can enact additional balanced savings to further reduce the deficit, give families and businesses certainty, and protect economic recovery. As we do that, I would like this committee to focus on three goals.

First, job creation. Twelve million people are actively looking for work but cannot find a job. An additional 8 million Americans are stuck working part-time, and they would like to work full-time. Job creation must be the top priority of the administration, this Congress, and this committee.

Second, we must simplify our tax code for America's families and businesses. It has been close to 30 years since the last major overhaul of America's tax code. In that time, our world has changed dramatically. Back then, China was our 18th-largest trading partner. China is now our 2nd-largest. Over the past 30 years, exports as a share of GDP have nearly doubled.

Our tax code is antiquated and acting as a brake on our economy, especially when compared with our overseas competitors. We need a pro-growth tax code that gives America's businesses the certainty they need to compete globally and plan and expand operations, instead of living and hoping for a continuation of temporary tax breaks.

Finally, we must make it a priority to return stability and confidence to our economy. We have to get off this roller coaster of a ride, going from one fiscal crisis to the next. We must give families and businesses certainty. We must agree on a balanced, comprehensive plan to cut the debt that includes both more revenue and spending cuts. The math will not work any other way.

A long-term, balanced plan will bridge the budget battles and make real progress solving our deficit problem. A balanced plan will also encourage businesses to invest and enable investors to return to the markets with confidence and, most importantly, put Americans back to work.

Expert witnesses are here today to help the committee examine the progress of America's economic recovery, as well as our economic outlook for the next decade. I look forward to hearing from each of you as you provide this committee with the necessary insight to take on the tough challenges ahead.

I also hope today this committee can complete its review of three individuals nominated to key administration posts. I urge the committee members, when we have a quorum, to support the nominations of William Schultz, to be General Counsel at the Department of Health and Human Services; Christopher Meade, to be the General Counsel at the Department of the Treasury; and Jack Lew, to be the Secretary of Treasury.

As we will discuss today, our Nation faces a number of great challenges. We need bright and dedicated individuals like these three nominees to work with us to find solutions.

So let us listen to the facts about our budget from our experts. Let us work together to make tough decisions and do the hard work and face the great responsibility before us. As President Kennedy understood, let us recognize that our economic progress in fact depends on the solid ground of mutual confidence. Let us embrace this opportunity to restore certainty and get America back on track.

[The prepared statement of Chairman Baucus appears in the appendix.]

The CHAIRMAN. Senator Hatch?

OPENING STATEMENT OF HON. ORRIN G. HATCH, A U.S. SENATOR FROM UTAH

Senator HATCH. Well, thank you, Mr. Chairman, for holding today's hearing. I want to welcome our witnesses and thank them for their willingness to appear here with us today.

This is an important hearing. Given that we are currently in the midst of a national debate over our country's fiscal future, it could not be more timely. Anyone who takes a careful look at our Federal finances should be very nervous. We have had 4 consecutive years with deficits above $1 trillion, and it looks like we are into the 5th now.

By the end of this fiscal year, CBO projects that the debt held by the public will reach the largest percentage of GDP since 1950. It only gets worse as time goes on. After a temporary lull in the growth of debt in 2018, CBO projects that the debt will rise for the remainder of the 10-year budget projection window, measuring 77 percent of GDP by the end of 2023.

Now, according to the CBO, “Along such a path, Federal debt held by the public will equal a greater percentage of GDP than in any year between 1951 and 2012 and will be far above the average of 39 percent over the 1973 to 2012 period. Moreover, it will be on an upward trend by the end of the decade. Debt that is high by historical standards, and heading higher, will have significant consequences for the budget and the economy.”

Now, these negative consequences of our growing national debt will include higher interest costs, lower national savings, more borrowing from abroad, less domestic investment, lower incomes, lesser abilities of policymakers to respond to unexpected challenges like natural disasters, and a greater likelihood of a fiscal crisis.

While some will try to argue that the coming debt crisis can be blamed on a lack of sufficient revenue, nothing could be further from the truth. With the tax increases included as part of a fiscal cliff package that passed on New Year’s Day, the Federal revenue as a share of our GDP is on a path to exceed the average of the last 40 years. So, despite some adamant claims to the contrary, it is clear that our government has a spending problem, not a revenue problem, and it is our problem.

Another common claim we have heard from the White House and from many here in Congress is that, over the last year and a half, we have already cut spending dramatically. This is also untrue. By any measure, spending has increased, and there is no use in kidding about it. It has increased significantly under this administration.

For starters, Federal outlays in fiscal year 2012 are well-above 2009 levels. Now, some have argued that it is not fair to hold the Obama administration entirely accountable for all of the outlays incurred during 2009, so for now let us consider fiscal year 2010. When you compare Federal outlays in fiscal year 2012 with those of fiscal year 2010, you see an increase in spending of over $82 billion. At the same time as the economy has sluggishly recovered, Federal revenues have increased. In fiscal year 2012, they were up by more than $286 billion compared to 2010.

So, between 2010 and 2012, the deficit went down by just over $204 billion, and literally no part of that reduction can be attributed to spending cuts; it is all due to high revenues. Despite these facts, the President continues to resist any real spending restraint and calls for even more tax hikes, even though he just raised taxes less than 2 months ago.

He also refuses to entertain serious structural changes to our entitlement programs, even though everyone agrees that entitlement spending is the main driver of our debts and our deficits. As far as I am concerned, any conversation about reducing our deficits that does not focus on shoring up and reforming our entitlement programs is a missed opportunity.

In the more immediate future, we face the indiscriminate spending reductions that are scheduled to begin on March 1st under the so-called sequester, which CBO says will reduce actual outlays in fiscal year 2013 by around $44 billion, or just over 1 percent of total Federal spending.

The debate over the sequester appears to be headed down the same path that all of our recent fiscal debates have followed, with the President and his allies here in Congress insisting that, in lieu of actually cutting spending, we raise taxes on the so-called "rich." Once again, none of the tax hike proposals we are hearing about was considered by this committee. Instead, they have been drafted somewhere else behind closed doors.

Today we will hear more about these and other fiscal challenges facing our Nation. In addition to discussions about our long-term budgetary problems, I expect we will hear recommendations about how to deal with short-term spending reductions scheduled under the sequester.

I assume we will also continue to hear grand claims of deficit reduction that measure progress using selective baselines and include only promises to reduce spending in the future. Once again, by any measure, spending has not been cut to date. We have promises for future cuts in spending, but nothing really has been realized.

I hope today's hearing will, among many other things, help us to get to the bottom of some of these claims and clarify for the American people how much Congress has actually done to reduce the deficit in recent years.

Now, Mr. Chairman, I want to thank you again for holding today's hearing, and I look forward to hearing from the witnesses. I will speak right now rather than later. I may reserve some rights to speak later, but I will speak right now on the Lew nomination.

In addition to the budget hearing, I also want to take a few minutes to comment on the committee's consideration of the nomination of Jack Lew to be Secretary of the Treasury. At the outset, let me say that I intend to vote today in favor of Mr. Lew's confirmation. I believe the President is owed a fair amount of deference in choosing people to work in his administration. Though I would have chosen a different person for this particular post, I intend to defer to President Obama with regard to the Lew nomination.

That said, I do have serious reservations regarding Mr. Lew. I like him personally very much. He certainly has a lot of experience in this town. But I have reservations regarding Mr. Lew that have not been assuaged through the committee's consideration of this appointment.

In the end, I hope that he will prove me wrong. For example, I strongly disagree with Mr. Lew on some significant policy issues, most notably his decision to backtrack from the administration's previous position on the need for entitlement reform and his belief in the need for higher taxes.

Ultimately, I hope we end up with the Jack Lew of the Clinton administration, not just another acolyte of the Obama White House. I hope we get a Treasury Secretary willing to work with the other side of the aisle to put our Nation first in order to confront the challenges facing us today. If Mr. Lew is that kind of Treasury Secretary, then I think we can work together to accomplish some great things for our great country.

But, if Mr. Lew is committed to playing the same partisan games that have gone on for the better part of the last 4 years, then we are going to have serious difficulties in getting anything done. I hope that will not be the case.

In addition, as my questions during the hearing demonstrated, I believe that Mr. Lew has been less than forthcoming about his time at Citigroup and NYU. Indeed, after extensive questioning, we still know very little about these areas of his record. This is problematic, and I plan to go into these concerns more fully when the nomination is debated on the floor.

Furthermore, I am deeply concerned about the general lack of responsiveness from the Obama administration to legitimate questions that I and other members of this committee have asked. Sometimes we get no answers at all, and that is entirely unacceptable, as I have said all too many times from this very spot.

Mr. Chairman, I expect the committee will report the Lew nomination today, and, once again, I intend to vote in favor of doing so. However, as I stated, I have significant concerns that I hope will be addressed by greater responsiveness and transparency from the administration. I hope you will continue to work with me to address these concerns, and I believe you will because of our relationship. I want to thank you, Mr. Chairman, for the work that you do.

The CHAIRMAN. Thank you, Senator.

[The prepared statement of Senator Hatch appears in the appendix.]

The CHAIRMAN. A quorum is present. I thank my colleagues for their attendance. We will now interrupt the hearing to conduct some business.

[Whereupon, at 10:26 a.m., the hearing was recessed, reconvening at 10:40 a.m.]

The CHAIRMAN. We will now resume the hearing.

I would like to now introduce our witnesses. Our first witness is Douglas Holtz-Eakin, former CBO Director and president of the American Action Forum; next, Bob Greenstein, who is president of the Center on Budget and Policy Priorities. Thank you both very much for coming.

We will start with you, Dr. Holtz-Eakin, then proceed to Mr. Greenstein. We ordinarily give 5 minutes. You might take a couple more if you want, but not many more. We have full attendance here, so do your best. Thank you.

STATEMENT OF DOUGLAS HOLTZ-EAKIN, Ph.D., PRESIDENT, THE AMERICAN ACTION FORUM, WASHINGTON, DC

Dr. HOLTZ-EAKIN. Well, thank you, Mr. Chairman, Ranking Member Hatch, and members of the committee, for the privilege of being here today to discuss the budget and economic outlook. I have really three points to make in my oral remarks. I did submit a written testimony for your reading.

The first is that we face a very sobering fiscal and economic picture in the United States. The second is that controlling the debt that we have and are projected to accumulate is consistent with better economic growth and job creation, not at odds with it, as is often portrayed. The third is that the current reliance on the sequester and the budgetary caps in the Budget Control Act is not as fruitful a strategy as a comprehensive tax and entitlement reform would be to deal with these problems, and I would like to elaborate on each briefly.

The first point is simply the sobering outlook presented in the most recent CBO budget and economic outlook. The outlook has the virtue of looking forward. It is starting from the point where we find ourselves and depicting what happens if the fiscal position is left on auto-pilot. If one looks at that, we start with a position of $16 trillion in gross Federal debt and would accumulate $7 trillion more in deficits over the next decade.

This would leave us in a situation where gross Federal debt would exceed GDP each and every year and end the decade in that position, a benchmark that I want to return to as an important one in its implications for economic growth.

The deficit and debt in the hands of the public, a more conventional measure, might decline briefly but will be rising both in absolute terms and as a percentage of GDP toward the end of the decade. This all occurs despite the recent efforts to close the deficit by raising $600 billion in new taxes at the turn of this year.

The economic outlook is no more promising, with subpar economic growth this year projected at 1.4 percent, and to me a more troubling aspect being the long-term growth rate marked down from 2.5 percent last year to 2.2 percent per year in the most recent economic outlook.

This is indeed a troubling projection for the United States over the next decade. Controlling the debt imbedded in this outlook is not at odds with robust economic growth and job creation. The result of research led by Carmen Reinhart, Ken Rogoff, and others shows that countries with the U.S.'s situation, situations where the gross debt exceeds 90 percent of GDP—and we are at 100 percent and will remain so in this outlook—those countries tend to grow more slowly, about a percentage point more slowly each year, than do comparable countries that are less burdened by debt.

That price that we are paying right now, the growth penalty, would translate into about a million jobs a year at this point in time—something desperately needed by Americans who are out of work—and lower incomes that could total as much as $10,000 per median family over the next decade or so.

So this is a situation which is harming the U.S., and it makes sense that high debt burdens inhibit economic growth, something I would be happy to elaborate on in the Q&A, because of the potential they raise for higher taxes and fiscal crises. So, being serious about controlling debt is a way to be serious about growing more rapidly.

But another lesson of the literature that has displayed the price you pay for high debt is that there are better and worse ways to deal with it. The playbook that has emerged is one in which the best approach to dealing with large debt and bad growth is one that keeps taxes low and reforms them to be more pro-growth.

I want to echo the call of the chairman for pro-growth tax reform. I know this committee has worked on this over the past year. I hope you get pro-growth tax reform over the finish line; it is desperately needed in the United States.

On the spending side, restraint must be displayed in order to control the level in growth and debt, but not all spending is created equal. It is important to preserve core functions of government—national security, basic research, infrastructure, education—and instead cut transfer programs.

In the United States, that means less reliance on things like the sequester and Budget Control Act discretionary caps and, instead, entitlement reform, which is the bulk of the spending in the Federal budget and is the place where the largest growth is projected over the next decade.

These reforms, I might point out, would also be a good idea in and of themselves. At the moment, the "plan" for Social Security is to keep it actuarily solvent on the government's books by cutting retirees' benefits 25 percent across the board 2 decades from now. That is not a particularly good way to run a retirement program.

Medicare at the moment is running a $300-billion-a-year cash flow deficit, the gap between premiums and payroll taxes and spending going out. We get 10,000 new beneficiaries every day. That is a program that is alone responsible for a quarter of all the Federal debt outstanding since 2001. Given its current State, it will fall under its own financial weight unless reformed.

Medicaid, similarly, has financial problems, and is a program where its beneficiaries end up in emergency rooms for ordinary care at twice the rate of the uninsured. So, these are programs that are hardly doing well at the moment and merit reforms on the basis of their services to beneficiaries. And reforms are what is needed to control the debt and the growth in debt and to grow more rapidly as a Nation. So I look forward to the conversation today. I would be happy to answer your questions and look forward to strategies which would improve our performance and lower the future debt. Thank you.

The CHAIRMAN. Thank you very much, Dr. Holtz-Eakin.

[The prepared statement of Dr. Holtz-Eakin appears in the appendix.]

The CHAIRMAN. Mr. Greenstein?

STATEMENT OF ROBERT GREENSTEIN, PRESIDENT, CENTER ON BUDGET AND POLICY PRIORITIES, WASHINGTON, DC

Mr. GREENSTEIN. Thank you. Let me start by partly agreeing, but partly disagreeing, with my colleague, Doug. I agree that we are on an unsustainable fiscal course and we need to act. On the other hand, I think the statement or the notion that we are already in a danger zone because gross debt exceeds 90 percent of GDP and that this is already costing jobs is not one most economists would agree with.

Most economists, and CBO, have long said that the best measure is the publicly held debt. That is the amount of debt we have to go and borrow in private credit markets. The difference between the publicly held debt and the gross debt, the additional debt, is that one part of the Federal Government owes another part because of the Social Security and Medicare trust funds. That is not money we go and borrow in private credit markets.

Reinhart and Rogoff did find a correlation between debt persistently being above 90 percent of GDP and slower growth, but those observations were based on European countries where what is called gross debt in those countries is essentially what we call publicly held debt here, because those countries do not have trust funds where one part of the government owes money to another.

Their gross debt is money you go and borrow in private credit markets, like our publicly held debt.

So the moral of the story, I think, is that the lesson we should derive from Reinhart and Rogoff is that the U.S. will be in a danger zone if our debt climbs to, and remains above, 90 percent of GDP—the publicly held debt. We are not there yet, but, if we do not take any action, over time we will end up there, and that will be a problem.

So where does this leave us? Based on the latest CBO projections, policymakers could stabilize the public debt as a share of the economy over the coming decade with $1.5 trillion in additional deficit reduction. That is the minimum policy, in my view, that policymakers should pursue.

To do that would require significant action that phases in as the economy recovers, and it would mean, if we stabilize the debt at about its current level—which is about 73 percent of GDP—for the coming decade with $1.5 trillion in deficit reduction, policymakers would then subsequently need to enact additional deficit reduction for the long term due to the aging of the population and rising health care costs, especially as we learn more about how to control the growth of health care costs throughout the U.S. health care system.

Now, let me add that a greater amount of deficit reduction would be desirable if policymakers can design it without doing harm in other areas, meaning deficit reduction really needs to be designed in a way that does not impede or slow the current economic recovery; does not jeopardize future productivity growth by providing inadequate resources for education, infrastructure, and basic research; does not increase poverty and inequality, which are already wider here than in most western nations; and does not increase the number of Americans who are uninsured or sacrifice health care quality.

In short, it is not just the quantity of deficit reduction that matters, it is the quality of the deficit reductions that are chosen that matters as well. This is particularly true in the health care area, where there are things we can and should do now, but where knowledge about effective ways to slow health care cost growth system-wide without risking the quality of care or jeopardizing access to needed care is not at the level that we need, and where such knowledge is likely to be significantly greater in a few years than it is now.

So let me note a few principles I would recommend for the design of deficit reduction. First, CBO says it will take at least 4 more years before the economy fully recovers. CBO's estimate that sequestration, for example, would lead to the loss of 750,000 jobs by the fourth quarter is an indication that we want to enact deficit reduction now, but you want to design it so it phases in as the economy recovers rather than taking a big whack out of the economy right now.

Number two, the Bowles-Simpson report made it a core principle that deficit reduction should not increase poverty or harm the disadvantaged, that it largely shield the programs for the disadvantaged from the cuts it recommended.

Bowles and Simpson, just last week, stated, "Broad-based entitlement reforms," which they recommend, "should either include protections for vulnerable populations or be coupled with changes designed to strengthen the safety net for those who rely on it the most." The Gang of 6 followed a similar course, and I would recommend that.

I would also note, as you think about these areas, some important new research quite relevant to this committee because of your jurisdiction with regards to the Earned Income Tax Credit. We have known for a long time from extensive research that it significantly increases work among single female parents, and the research suggests it had as large an effect in increasing work and reducing welfare receipt as the 1996 welfare law. The two actually reinforced each other.

The new research finds that the receipt of the EITC by families, particularly with young children, leads to improved test scores and educational attainment in school and increased earnings and employment in adulthood. I think this is quite important.

Finally, the last point in this big debate: taxes, spending, a mix? How should we do deficit reduction? I was struck by a *Wall Street Journal* column last week by Martin Feldstein. He observed, "Republicans want to reduce the deficit by cutting government spending. Democrats insist raising revenue must be part of the solution. Yet," Feldstein continues, "the distinction between spending cuts and revenue increases breaks down if one considers tax expenditures."

If I buy a solar panel for my house, the government pays me. But, instead of sending me a check, it gives me a tax credit or a tax deduction. I am hoping there might be a bipartisan process on the notion of focusing on spending, but spending in the tax code and spending in the outlay side of the budget as well.

Feldstein has written that tax expenditures are one of the first places policymakers should go to restrain spending. Douglas Elmendorf, in testimony earlier this month on the House side, said, "Many economists agree that tax expenditures are really best viewed as a form of government spending." Alan Greenspan summed it up when he said that "tax expenditures should be reviewed as tax entitlements and looked at along with spending entitlements."

Let me just close with an example to illustrate what I am trying to say. The example involves child care. So a parent with low or moderate income may be able to obtain a Federal subsidy to help defray child care costs, and it comes through a spending program on the spending side of the budget. But a parent higher on the income scale also gets government subsidies to reduce child care costs. Those are delivered through the tax code via a tax credit or an exclusion from income.

Now, there is a significant difference here. The main difference is the low- or moderate-income parent may fail to get a subsidy because the spending programs in question are capped. They only serve as many people as the funding allows. Only about 1 in 6 eligible low-income working families with children gets a Federal child care subsidy.

By contrast, the child care tax-based subsidies for middle- and upper-income households operate as open-ended entitlements. Everybody who has it and takes it on the tax return gets it and, unlike with the working poor families who get the child care spending subsidies, most of the higher-income families who get a child care subsidy through the tax code could afford child care without the subsidy anyway.

I bring this up just to make the point that spending occurs on both sides of the ledger, and it would not make sense, as you seek deficit reduction, to put tax code subsidies off-limits for deficit reduction while putting program-side subsidies on-limits. I would urge you to look at both.

Thank you.

The CHAIRMAN. Thank you both very much.

[The prepared statement of Mr. Greenstein appears in the appendix.]

The CHAIRMAN. I would like to focus a bit on health care, health care costs, Medicare. I think you, Dr. Holtz-Eakin, mentioned that 10,000 people turn 65 ever year.

Dr. HOLTZ-EAKIN. Every day.

The CHAIRMAN. Excuse me. Every day. Ten thousand people turn 65 every day. I saw somewhere that 60 percent of health care cost increases in Medicare and Medicaid are due to just demographics: more people. The other 40 percent are because health care costs are just going up. Could you focus a little more on how we can address short-term/mid-term health care costs in this country and what it means for Medicare and Medicaid?

I am going to ask you, Mr. Greenstein, to do the same thing. I would just like to focus on how we get control over health care costs in this country, because that is going to be one of the biggest challenges and most important efforts we can undertake.

Dr. HOLTZ-EAKIN. I think, obviously, this is a difficult area, and a broad one. Let me just say a couple of things. Number one, I think that delivery system reform and health care reform in the United States begin with entitlement reforms. It is the case that Medicare and Medicaid and new Affordable Care Act programs mean that the government is the majority payer of health care bills in the United States.

The way it pays bills matters a lot for practice patterns, so, if we do a better job in the entitlement programs, we will in fact enact broader health care reforms.

The CHAIRMAN. What would be some examples there of entitlement reform?

Dr. HOLTZ-EAKIN. So, first, stop doing the wrong thing. We know fee-for-service medicine leads to no emphasis on quality, an emphasis on quantity, and has been the source of a lot of bad practice of medicine in the United States. So, no fee-for-service, please.

The CHAIRMAN. Right. That is one.

Dr. HOLTZ-EAKIN. Number two, do not rely on provider cuts and other kinds of price controls, the SGRs, the living example of bad health care policy that comes back to haunt the Congress every year. Do not do it again. We saw most recently CMS, in the recent rule on Medicare Advantage, cutting payments that are just going to preclude services to beneficiaries, cause them to change their provider networks, and harm health care as a whole in the United States.

The CHAIRMAN. All right. That is two. Three?

Dr. HOLTZ-EAKIN. The other thing I would recommend is, put these programs on budgets. People make bad decisions with other people's money. It is a deep economic insight. Unlimited access to other people's money is a recipe for bad decisions, so let us put Medicare on a budget, let us put Medicaid on a budget, and say to the providers and the beneficiaries as a collective, here is your taxpayer money for the year, go do something of high quality and benefits with it. Stop giving them an unlimited draw on the U.S. Treasury to the tune of $300 billion a year and rising. None of that is going to promote good health care in the United States.

The CHAIRMAN. Mr. Greenstein?

Mr. GREENSTEIN. The big issue in Medicare and Medicaid—obviously, one part is demographics. Older people have higher average health care costs than younger people, and the population is aging. But the other is, it is not as though health care costs are rising more rapidly in Medicare or Medicaid than in private sector health care. They are rising system-wide. They have actually been rising a little more slowly of late in Medicare and Medicaid.

On the one hand, there has been a big slow-down in health care cost increases. If you compare the current CBO 10-year forecast to where CBO was, say, in August 2010 while Bowles-Simpson was meeting, the Medicare costs over the next 10 years are down $500 billion, and Medicaid, $200 billion.

Well, we hope some of that will endure. We do not know yet for sure. What that reduction in Medicare and Medicaid largely reflects is a slow-down in health care cost growth throughout the U.S. health care system. We need to find the ways to promote that.

Now, I think there are some reforms that can be looked at now in Medicare, ranging from more use, for example, of competitive bidding in purchasing medical equipment. There are still some over-payments in Medicare Advantage. We can get better prices for drugs. I think we can expand both the scope and the size of income-related premiums.

I think you can look at restructuring cost-sharing, catastrophic care, Medigap, that whole part of Medicare. If you do all of those things, you can get a few hundred billion dollars in savings over the next 10 years, but ultimately we are going to need more than that. To get significantly more than that, it really turns on changes in the overall U.S. health care system. If the current slow-down in cost growth proves to be enduring, we will be a significant part of the way there, and we need to build on that.

It is very important for us to learn in the years ahead from what has happened in the last few years to better understand why the cost growth has slowed, how can we build on that, to learn from various demonstration pilots now going on, some publicly funded, some entirely——

The CHAIRMAN. Do either of you disagree with what the other said, or do you both agree with what the other said?

Dr. HOLTZ-EAKIN. I think Bob said this, but I would emphasize it, that the recent slow-down in national health care cost growth is something you cannot rely on. I mean, this is a picture I would be happy to share which shows the history of these slow-downs. We have had them before. It happened in the 1990s when the budget got better. It went away. It has happened before. I would not count on that, particularly when we are about to expand coverage next year dramatically. When people are covered, they spend more, so I would expect this to reverse quickly, and I am nervous about relying on it.

The CHAIRMAN. My time is about up, Mr. Greenstein. Very quickly, very quickly.

Mr. GREENSTEIN. While I would not count on it as a guarantee, I do not expect it to reverse quickly. I have talked to health care experts: Bob Reischauer, Peter Orszag, Henry Aaron. All of them think there are growing signs that some of this slow-down is likely to endure. We cannot count on it, but we should look for that.

Where I disagree with Doug is, I do not think one can artificially put some cap on Medicare and Medicaid expenditures separate and apart from total health care expenditures, public and private sector, throughout the U.S. health care system.

The CHAIRMAN. All right. Thank you.

Senator Hatch?

Senator HATCH. Dr. Holtz-Eakin, your testimony says it would be sensible to reduce debt such that the ratio of gross debt-to-GDP is below the 90-percent threshold that economic research has identified as a threshold above which the debt is associated with about a 1-percent reduction in economic growth. Now, you offer an example of getting gross debt-to-GDP down to 85 percent, which you say would require around $4 trillion of additional promised debt reduction over 10 years.

Now, if we were to set a goal of $4 trillion in debt reduction over the next 10 years, and, if we hold spending at levels envisioned in CBO's most recent budget outlook, let me ask you three things. I will just read through the list, and then you can respond.

First, do you have any sense of what tax rates on upper-income earners, which would encompass many flow-through businesses, would be necessary to obtain the $4 trillion of debt reduction if we put tax hikes on the middle-class off-limits?

Second, how high would we have to set taxes on the middle class to facilitate the existing spending path if all taxes were raised?

Third, what might a more balanced way of doing things look like, in your mind, and do you think it ultimately has to involve entitlement reforms?

Dr. HOLTZ-EAKIN. Thank you, Senator. Four trillion dollars in tax increases is obviously an enormous impact on the economy. If you tried to pull that out of the top rates, you would have to have it exceed the 80-percent marginal rate. We can get you an exact number, but my guess is it is going to be north of 80 percent. It is extremely punitive.

Right now, if you look at taxpayers as a whole, the typical weighted average tax rate is something like 23, maybe 25 percent at tops. It would have to go close to 40 percent. Again, I can get you precise numbers. These are dramatic tax increases, a near doubling of all taxes.

Obviously, a more balanced approach is what would come out of the literature, which says that it is important to do tax reform so that you support economic growth, that tax reform would give you a more efficient tax code and might raise more revenue in the process, but the reliance would be on reforming the spending programs which, in the U.S., are these large entitlement programs.

As I mentioned in my opening statement, it is important to do those for economic growth reasons. It is important to do this for budgetary reasons, but I also think it is very important to do that on behalf of the beneficiaries. These programs are not going to serve them well and not survive to the next generation of seniors and low-income Americans.

Senator HATCH. Well, your fellow panelist argues that much of the leg work on deficit reduction has already taken place with the promises of future fiscal restraint embedded in the legislation enacted over the past several years.

Mr. Greenstein also argues, as I view it, that $1.5 trillion in additional deficit reduction would stabilize the debt-to-GDP ratio over the coming decade and that such stabilization would be the minimum appropriate budget policy.

Now, do you agree that, if we enacted legislation promising an additional $1.5 trillion in future deficit reduction, we would then have stabilized the debt-to-GDP ratio in the coming decade at a safe level, and do you agree that $1.5 trillion of added future promised deficit reduction would be sufficient to avoid substantial risks to the economy from our debt?

Dr. HOLTZ-EAKIN. I will spare the committee the geeks' fight over gross debt versus debt in the hands of the public. I use gross debt just because that is what the research used, and I wanted comparability. As I said, it indicates we are at too high a level, so reducing deficits by only $1.5 trillion in the next decade does not get us out of what I view as the danger zone. It might stabilize debt in the hands of the public, but it would stabilize it at a dangerously high level. There is no reason why one should cement, as a matter of objective, a policy that leaves us with subpar growth.

I believe we are growing poorly and that we can understand the reasons for that, and which leaves us constantly on the edge of the potential for a crisis. If you look at the recent budgetary travails of Congress and the administration, we are constantly in crisis. I think that is not a great future for the economy. If world capital markets decide to join the chorus of people who think we are, in large amount, on the edge of trouble, that would be a very troubling decade.

So I think a much more aggressive approach would take us out of the danger zone, would more than just stabilize debt at a high level, and would actually set the debt trajectory on a sensible level and relieve us of the poor economic performance and the threat of constant crisis.

Senator HATCH. My time is up, Mr. Chairman. I have some questions for Mr. Greenstein.

The CHAIRMAN. Thank you very much, Senator.

Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman. Mr. Chairman, I want to echo your comments with respect to health care costs. For our witnesses, in this week's *Congressional Quarterly*, the cover page says, "A Crisis in Plain Sight: As Washington Does Nothing, the Challenge of an Aging Population is Quickly Overwhelming the System."

That is why I would like to turn to Medicare to get a reaction from both of you. The longer I go on—and of course, the program has changed pretty dramatically since my Gray Panther days, and I think I have talked about this with both of you—the ball game to a great extent is those with multiple chronic conditions.

Seventy percent of Medicare costs go for those with three or more multiple chronic conditions, so, to a great extent, if we can find ways to ensure that those folks get quality care that is more affordable, we are going to go a long way toward fixing Medicare.

Now, I think there generally is bipartisan support for approaches that integrate services, that move away from this approach where someone who, say, has diabetes or pulmonary health issues just goes and gets services physician by physician and ends up without a care plan and eventually goes to the hospital emergency room. The Accountable Care Organizations go, certainly, in the right direction in this regard, but it seems to me that considerably more has to be done.

I would be interested in your views on this question of how we are going to deal with what I think is really the heart of an effective reform strategy with Medicare, and that is dealing with those with multiple chronic conditions. Either one of you can go first.

Mr. GREENSTEIN. I think you are absolutely right, Senator. This is just the sort of thing I had in mind when I said we do not have all the knowledge we need right now to write a piece of legislation that mandates how to do the care integration. We have more to learn. Some of the innovations going on in the private sector are hopeful.

As you know, there are individual examples of individual medical systems that do it better and save money. There also are a whole array of State-run demonstration projects that are starting up this year, particularly focusing on integrating care better for the dual-eligibles. We need to rigorously pursue these, and rigorously evaluate these, and try to set ourselves a goal that, as we learn how to do this in ways that both improve quality and save money, as you suggest, then we need to adopt them and implement them in Medicare and Medicaid.

Sadly, we do not have the silver bullet or know exactly how to do it yet, but, as you say, it is one of the most important things for us to learn and adopt as we find the answers.

Dr. HOLTZ-EAKIN. Again, it is a very important problem. The Medicare system was designed for an era of acute care as the primary medical expense. We now have chronic care as its leading problem, with multiple co-morbidities as the typical expensive Medicare patient. So moving the focus on that and integrated care is very important.

I would say a couple of things. Number one, I have started an organization called The Partnership for the Future of Medicare with Ken Thorpe, a bipartisan effort to guide reforms that are sustainable for Medicare. We have put out some "guard rails," do's and don'ts on Medicare reform, which I can provide to you and would be happy to.

One of the things going forward is, we need more options that provide the integrated care. We are concerned about the cuts to Medicare Advantage because it is an integrated platform. You may or may not like that. I do not want to get into a debate over Medicare Advantage, per se, but having less, not more, is a mistake. You need patient buy-in. You cannot simply litter the landscape with smart health innovations and expect the world to change. Patients have to buy in both personally and financially to get——

Senator WYDEN. Can I interrupt you on that point? Because Senator Portman is here, and he and I have introduced the first bill that essentially would reward those who stop smoking, lower their blood pressure, lower their cholesterol. It is really based on the work that was done at the Cleveland Clinic and Oregon Health Sciences Center. I gather that you feel that those kinds of behavioral changes, it is time that that would be part of the program.

Dr. HOLTZ-EAKIN. Yes. I do not know the specifics. I would be happy to look at it.

Senator WYDEN. Mr. Greenstein, are you all right with that? Because I think, and Senator Baucus might remember, that in the Affordable Care Act we began to start to integrate those preventive incentives. Senator Carper did some particularly good work on that, as I recall, for those under 65, but we have not begun to build that in in terms of those over 65. I think Oregon Health Sciences and the Cleveland Clinic kind of provide that model. I think it is time for those kind of behavioral changes, and I appreciate both of you being interested.

My time is up, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Grassley?

Senator GRASSLEY. I have a very general question at the end of a statement and some charts I am going to put up here. Obviously America faces no greater threat to our growth and prosperity than out-of-control national debt, $16 trillion today. As we move forward, we have to discuss spending. So I am trying to promote a thoughtful conversation that focuses upon where our Federal spending most calls for containment.

So, pay attention to the chart. This CBO chart details non-interest spending as a percentage of GDP. We already know the significant role health care spending plays in our budget. Over the next decade, the Federal Government will spend over $7 trillion on Medicare and $4.5 trillion on Medicaid. Together, these two programs account for one-fourth of the entire Federal Government spending over the next 10 years.

But look very closely at the even longer-term projections of our spending. According to CBO, the middle graph—pay attention—Social Security as a percentage of GDP will remain relatively stable over the next 25 years. The same for non-interest spending, the bottom graph. As a percentage of GDP, it will also remain relatively stable.

Now take a look at the top graph. Over the next 25 years, spending on health care entitlements will basically double as a percentage of GDP. So, unless we take a serious look at health care spending, we are not genuinely acting to reduce our country's debt. Now, 25 years may today seem like a long time, but we know, as we have looked at these problems over a couple decades, it is not a long time. We need to be talking about health care spending right now.

My question, and either or both can respond, is simple: do you think that we must take steps now to reduce the growth of our health care entitlements as a percentage of GDP over the next 25 years?

Dr. HOLTZ-EAKIN. Absolutely. There is no question that, for a long time, the long-term budget outlook has been driven by the mandatory spending, health spending in particular. You are not going to grow your way out of it. It has been clear for a long time you cannot tax your way out of it. This is about controlling spending.

Senator GRASSLEY. Mr. Greenstein?

Mr. GREENSTEIN. I think the key issue here is—and I think for years a number of experts from across the political spectrum have agreed on the following—over time we are not going to be able to sustain a rate of growth in Medicare and Medicaid costs per beneficiary that is substantially lower than the rate of growth of health care costs per beneficiary system-wide and in the private sector. They are all linked. Our big challenge is slowing the rate of growth of health care costs system-wide.

Now, Medicare is such a big player that it can help play a leading role. We have seen this in the past. As we learn ways to bring down costs to introduce efficiencies into Medicare, a lot of the private insurers pick it up because they want the efficiencies as well.

There are limits at the present time, I believe, to how much we can enact in Medicare now because of our lack of knowledge of some of the system-wide issues that we are learning about, and because Medicare is actually not a wildly generous benefit package.

If you look at seniors between one and two times the poverty line, $11,500 and $23,000 a year, they now spend 23 percent of their budgets, on average, on out-of-pocket health costs, even though they have Medicare. So, we have some constraints there.

Medicaid, I think, is a different issue. Medicaid pays providers very low rates. Medicaid, per beneficiary, costs 20 to 25 percent less than private insurance for the same beneficiaries. These are poor people. We cannot ask them to pay large amounts. I think in Medicaid our savings really are dependent on slowing the rate of growth system-wide, and I would not look for going in right now and making big cuts in Medicaid.

In Medicare, I think we should do those things that make sense now and really aggressively pursue all these demonstrations and private sector reforms and be prepared as we learn more to come back and continually make, over a number of years, a series of growing changes in Medicare.

Senator GRASSLEY. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator. I compliment you on your good staff over there. You were speaking with them. You had great staff work over there helping you out.

Senator GRASSLEY. Yes, I know. That is really nice of you.

The CHAIRMAN. Senator Stabenow?

Senator STABENOW. Thank you, Mr. Chairman. I was going to say the same thing. Next time you need a stick or something so you can do a more accurate job.

But welcome to both of you. Thank you very much for your input. If I could talk just—I would like to continue the discussion on health care costs, because clearly this is a challenge for us. We have tackled it as we have looked at health reform. We have actually begun to see health care costs slow, which is good. There is so much more that needs to be done.

We have seen Medicare Advantage premiums go down about 7 percent last year based on not providing over-payments, and we have seen a number of things begin to happen, but there is much, much more to do. The challenge in health care, as we all know, is that it is not optional.

I mean, as human beings, people are going to get sick. We cannot control when or where. The question is, how do we get care? What kind of care? How do we get care? How do we not use emergency rooms inappropriately but get preventative care?

So I would ask, Mr. Greenstein, specifically, there have been proposals that would cap spending through block-grants or other kinds of caps that really just shift costs from the Federal Government to States, ultimately to families.

Then we have what we are beginning, which is to provide expanded help under Medicaid which gets people out of emergency rooms and into a doctor's office. In Michigan, our Governor has supported expanding Medicaid because the recent estimates in Michigan show that we will save about $351 million over 10 years by getting people out of emergency rooms. All of us then will not be paying for it through higher rates.

Could you talk a little bit more about the differences in how we approach Medicaid and the impact of proposals to block-grant or cap Medicaid, what it would do to hospitals, communities, ultimately families?

Mr. GREENSTEIN. Yes. In Medicaid, as I noted a minute ago, the studies show that, on average, it costs already about 20 percent less per beneficiary relative to private insurance for adult, non-elderly, disabled beneficiaries, and about 27 percent less for children, primarily because Medicaid pays providers significantly lower rates.

So, if there is a big cost shift to States and they do not have enough funding, their choices are really, to cut the provider rates even more, limit eligibility, which would result in more people being uninsured, or have a benefit package that makes people under-insured rather than fully insured.

People talk about managed care. It should be noted that all but a handful of States already contract with private managed care companies to run their Medicaid programs for people other than the elderly and disabled. We hope that, over the next number of years, as a result of a series of demonstration projects now starting, State-run, federally supported—these are demonstration projects to try to find ways to improve the quality of care while saving money for the dual-eligibles, the people who get both, the elderly and disabled on both Medicare and Medicaid—if those pilots find successful ways to do that, then that ought to be an avenue for savings.

But we have to follow the Hippocratic Oath and do no harm. We do not know yet how to do it. In fact, when the super committee asked CBO about various proposals on the dual-eligibles, CBO's response was, it would not score them as saving money because we do not know yet how to do it to save money. But that is the kind of approach we should pursue.

Senator STABENOW. That is the kind of thing we should be doing.

Mr. GREENSTEIN. Rather than just arbitrarily limiting the money for States and then, if there is a flu epidemic, if there is a new disease—hopefully there will not be—like HIV–AIDS, or maybe there is a breakthrough on Alzheimer's or heart disease, and there is a new set of drugs that at least initially has higher costs but saves lives, you do not want to be in a situation where we are denying those to poor people, but higher-income people get them.

Senator STABENOW. Right.

Mr. GREENSTEIN. We do not want to be a country where health care is based on your income.

Senator STABENOW. Very quickly, if I might just ask, when we look at the $2.5 trillion that has already been put into place in deficit reduction and, if sequester is going to take effect, how much of the total deficit reduction since 2011 will be in cuts to services to middle-class families as opposed to asking those at the top to do a little bit more?

The CHAIRMAN. If you could keep your answer very short.

Senator STABENOW. Yes.

The CHAIRMAN. Time is over here.

Senator STABENOW. Yes.

Mr. GREENSTEIN. Well, simply on a spending versus tax basis, over the period from 2013 to—we are now moving into another 10-year period—we have about $1.5 trillion in cuts in discretionary programs, about $600 billion in revenues. If the sequestration goes into effect, we will have a total of about $2.5 trillion in spending cuts, not counting interest savings, to the $600 billion in revenues.

Obviously there will be impacts on many people. Spending programs on the spending side of the budget primarily benefit middle- and low-income people, who are the bulk of the population. Spending programs on the tax side of the budget—tax entitlements, tax expenditures, use what term you will—the data show, heavily benefit people in the upper part of the income scale.

The CHAIRMAN. Thank you very much.

Senator Thune?

Senator THUNE. Thank you, Mr. Chairman.

The CHAIRMAN. I might say, Mr. Greenstein, your point about dual-eligibles is one this committee feels very strongly about. Melanie Bella, who is heading the program on the pilots, has been before this committee a couple of times, and we are trying to focus very much and help her out with those pilots. Thank you.

Senator THUNE. Thank you, Mr. Chairman.

I would like to get Dr. Holtz-Eakin's reaction—maybe this has been discussed a little bit already—to Mr. Greenstein's statement in his opening statement about gross debt versus publicly held debt and the impact correlation between economic growth and indebtedness. Debt-to-GDP is the standard that is used. I have read the book "This Time Is Different." Reinhart and Rogoff make that correlation based upon a great deal of research of modern economies, primarily in Europe, as well as more ancient economies as well.

Mr. Greenstein drew a distinction between those and that the European example is different because they characterize their debt differently than we do in this country. It seems, to me at least, either way we have a big debt problem which I believe is impacting economic growth in this country. But would you care to just react to that, your thoughts with regard to the comparison there?

Dr. HOLTZ-EAKIN. Point number one, we have a lot of debt. The CBO outlook, which is a forward-looking document, says we are going to have around $7 trillion in deficit over the next 10 years. So, we are going to have more. So that is point one.

Point number two. It is not rocket science that this harms the economy. One option is, we do nothing and we run straight into what Erskine Bowles has characterized as the most predictable crisis in history. That cannot be a pro-growth policy to say we are going to run into a financial crisis. Or we could just raise taxes, as I did in that example for Senator Hatch.

If a businessman or anybody who is looking at a country that is going to double its tax rates over the next 10 years as its strategy for dealing with and avoiding a financial crisis, they are not going to expand, not going to hire, not going to locate in that economy. It is simply not sensible tax policy.

That leaves you with the reality that you have to control spending, and that is a reality that has been very hard for people to come to terms with. We have raised taxes, cut taxes, and reformed taxes in this country. We have never cut spending. It is visible this week how hard it is to cut even $85 billion in budget authority, which will turn into $44 billion in actual outlay reductions. This is trivial stuff compared to the problems we have.

In terms of gross debt versus debt in the hands of the public, I like debt in the hands of the public. I understand the economics of it. It is what I would choose. But when I talked with Ken Rogoff about his research and how I should think about it, he emphasized the only way to be correct in doing the comparisons is to use the gross debt measure.

The gross debt measure says we are over the danger line where you pay the price of slower growth and a higher probability of financial crisis. That is where we are, and the outlook says that is where we stay every year for 10 years.

I think it is a disservice to all the people whom these programs serve—the poor, the elderly, those who have health problems—to put them in an economy that is chronically growing too slowly and buffeted by the potential for crisis. That does not serve them well, so we need to actually do better on that front. Being sensible about entitlement reform is a way to do that.

Senator THUNE. Now, in coming back in on this correlation between debt and growth, this is the weakest economic recovery we have seen since World War II. We are growing roughly 2 percent, a little under. There has been some research done by the Republican staff of the Joint Economic Committee which suggests that, if you had economic growth that was equal to the average economic growth of the past 60 years since the beginning of this recovery, that you would have cut last year's deficit in half.

I guess I would like to get your reaction, both of you, to the idea that long-term economic growth rather than short-term stimulus measures ought to be our focus if we are really interested in improving our fiscal condition. Do you agree that, if we lowered rates across the board and, in tax reform, broadened the tax base, it would be an effective way to increase economic efficiency in long-term growth? First, long-term growth versus short-term stimulus; second, tax reform as a way to get long-term growth.

Dr. HOLTZ-EAKIN. Yes. Absolutely. There is a place for countercyclical policy. At the end of 2008, beginning of 2009, we were falling like a rock. I understand why it is necessary to step in. This recovery dates from June 2009. We are now closing in on the fourth year of poor economic growth. This is not a cyclical problem, this is a bad long-term trend growth problem. We need policies that improve the long-term trend growth, and that should be the focus, there is no doubt about it.

Tax reform is central to that. There is no doubt about the benefits of having a more efficient tax code so that we do not waste scarce resources on unproductive investments, on uncompetitive tax codes, that harm our most efficient global companies. There is a great place for that.

I think one of the lessons of the Bowles-Simpson Commission is, if you want a route to higher revenue, do not try to use a broken tax code; do the tax reform. So that should be central. This committee, I know, has done a lot of work on that. I think that is very important.

Mr. GREENSTEIN. Let me quickly note, I think the key finding of Reinhart and Rogoff is that financial crises, recessions resulting from financial crises, are deeper and have much slower, longer recoveries. This is the only recession we have had in decades that comes out of a big financial crisis. That is the key reason why the growth is so slow.

Second, yes, debt is a long-term problem. The idea that the current debt is reducing growth right now to me does not really compute, because the way debt slows growth over the long term is by competing for capital and pushing up interest rates, but interest rates—real interest rates—are close to zero now, so we are not seeing that effect right now.

I think the policy right now should be what Peter Orszag has referred to as the barbell. We actually should be doing more to stimulate the economy right now, like infrastructure, on a purely temporary basis, coupled with enacting deficit reduction that grows as the economy recovers and has the biggest impacts in future decades.

The CHAIRMAN. Thank you very much. I appreciate that. Thank you, Mr. Greenstein.

Senator Cardin?

Senator CARDIN. Thank you, Mr. Chairman.

Mr. Greenstein, I am going to follow up on the point that you were just talking about, that we have to do this deficit reduction plan in a way sensitive to economic growth. I was recently at the National Institutes of Health, talking to our workforce there. It is not just the direct impact of these cuts on the Federal workforce which has an impact on our economy—there is no question about that—but it is the related impact it has on those companies that depend on the basic research at NIH and the grants that are given, et cetera, and the impact of these cuts to our economy is very clear. We need more people working. When we cut those types of programs, we are just adding to the unemployed and adding to the difficulty of our economic recovery.

I also want to emphasize a point, Mr. Chairman, that you made. I met with small business leaders yesterday, and they said the same thing that your constituents in Montana told you, and that is: make a decision here. Get some predictability here. We would rather have a policy that we do not like but we know it is there than no policy at all. These short-term extensions are not helping us, and we need to deal with a game plan that we all agree on and implement for the future of our economy. I look forward to that type of a discussion.

But I think, Mr. Greenstein, the point that you made that we really need to look at the mandatory side—yes, the mandatory side includes the health care issues, and that has certainly been dominant. But it also includes the tax code and tax expenditures. I think you raise a very good point.

The people who are getting the benefits—you pointed out child care, but we could use housing, we could use health care, we could use so many different energy areas, where there are programs that people qualify for and are entitled to without any cap that we really have not evaluated.

I think of the work that was done before I got to Congress in the 1986 tax reform. That was an effort to try to evaluate the efficiencies of our tax code, and progress was made. But since 1986, there have been a lot of individual tax provisions that have been put in the tax code where their efficiency really is questioned. We do not have a process to evaluate the efficiencies of those tax expenditures. So, yes, we call it tax reform.

Can we not look at tax reform and, through that, help reduce the deficit through reducing the amount of tax expenditures and, I would say, encouraging economic growth? But do you have any advice for us as to how we can evaluate the programs in our tax expenditures versus the efficiency factors that we may have in other parts of the Federal spending code? Is there some material out there that could help us in trying to evaluate the efficiencies on the tax side?

Mr. GREENSTEIN. Well, of course this is compounded by the difficulty that some of the spending programs that are in the same area, and some of the tax expenditures, are under different committees. Nevertheless, given the central role of the Finance Committee, I do think it is something this committee could try to look at. It is interesting. I am unfortunately going to have to leave here in a few minutes, because I am moderating a Hamilton Project panel.

The panel I am moderating is a series of papers of people from both Republican and Democratic backgrounds, top analysts, looking at some specific tax expenditures and their economic efficiencies and inefficiencies and better ways to do it to both save money and increase efficiency, and make the tax incentives more effective at the same time. It is kind of analogous to what we talk about in health care. How do we deliver better quality for less cost?

I think these areas, in the area of housing, in the area of retirement savings, in the area of health expenditures, all warrant looking at. I also think there are a number of individual provisions that have crept in over the years that usually go below the radar.

Yes, there has been a lot of attention in recent years, say, to carried interest, but you also want to look at things like the like-kind exchange rules, valuation discounts, all of these things that tax attorneys and accountants have come up with that arguably reduce efficiency, lose a lot of money; they would not be affected by some kind of global limitation on deductions. They are really different. They are in their own area, but they really warrant looking at.

The last thing I would note is, when CBO and the Joint Tax Committee, several years ago, looked at the economic impacts of things like the tax cuts enacted in 2001, their assessment was that, while the rate cuts would improve growth, over the long run they were more likely to reduce growth than increase it because of the negative impact on the deficit.

My point being, yes, all else being equal, a broader base and a lower rate is positive for the economy. But the single-biggest threats to long-term economic growth are the deficit and debt issues we are talking about. On both the spending and the tax side, the single best thing we can do for the economy is find sensible, efficient ways to make changes that contribute to deficit reduction, both on the revenue side and on the spending side.

Senator CARDIN. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Bennet?

Senator BENNET. Thank you, Mr. Chairman. Thank you for holding this important hearing, and thank you for your testimony.

The columnist David Brooks has a piece today in which he observes that "the future has no lobby." The longer I am here, the more I think that is true. When I hear these numbers—$2.5 trillion in spending cuts on the discretionary side, the $600 billion in revenue on the revenue side—none of these pieces are being done together, all of them being done in these short-term deals, none of them addressing the main issue. It makes me think he is right about that.

If we do not do something about this, we are going to drastically fail to invest in the future of this country. I detected a difference in opinion at the beginning of the conversation about how urgent the problem is. I do not know the answer to that. But what I would suggest to both of you and to people who have been working, people of good will, on these issues, is, whether you think it is urgent or not, the longer we delay this, the harder it is going to be to solve.

We have to find a way to come together. There are enough moving parts here for us to actually do this in a meaningful way, to send the capital markets and our competitors around the world a message that we are serious about this. We have not done that. This Congress has not done that.

I would encourage both of you to think about how we could work together on this with a sense of urgency, simply because matters will only get worse if we do not do it. I wonder if you have a reaction to that before I have a health care question.

Dr. HOLTZ-EAKIN. I am beside myself with urgency. I think this is a big problem. I think it is a tremendous disservice to the next generation. I mean, we can fight about the fairness of raising one person's taxes, cutting somebody's spending program, whatever it may be. All of them pale in comparison to the fundamental immorality of what we are doing to the next generation. That is point one.

Number two, the way the budget is structured makes that worse. We are letting the legacy programs of the past, the mandatory spending programs, crowd out our ability to do discretionary spending, which is all about the future. So we are building a trap to really do a disservice to the next generation.

The third, and the reason I think it is so urgent, is, with all due respect, nothing has been done yet.

When people talk about $1.2 trillion in discretionary spending cuts, those are basically the caps in the out-years which are promises—"honest," "really"—that like never before we are not going to spit the bit and we are really going to spend less. It has not happened. Nothing has happened on the spending side. So, yes, I think it is really urgent, because right now this town is in a frenzy, and there is $85 billion, and it is not even——

Senator BENNET. Well, you do not have to say "with all due respect" to me. I think what we have engaged in is the lowest common denominator partisan politics. It is putting our children in an incredibly precarious position.

Dr. HOLTZ-EAKIN. Yes.

Mr. GREENSTEIN. I agree on the urgency front. I think we need to distinguish a few things. Sometimes people think urgency means we need to start putting the cuts into effect this moment, even though the unemployment rate is close to 8 percent. I know that is not what you mean or what I mean. Urgent, in terms of reaching a deal and enacting it now, but designing it so the cuts phase in as the economy recovers.

I think an argument for going sooner rather than later is—for example, we saw in the presidential campaign, neither party wanted to talk a lot about changes that would affect current beneficiaries in Social Security and Medicare.

When the 1983 Greenspan Commission legislation was enacted, it raised the Social Security retirement age starting in 2000, 17 years down the road. So anything we enact in some programs is probably not going to start for a while and phase in slowly, which adds to your point of, do it sooner rather than later.

The last point, though, is, I actually think it is counterproductive when people say, well, within 2 years the financial markets will implode. Then, when they do not, that leads people who think it is not urgent to say, see? So we are seeing a lot of quotes now of Simpson and Bowles having said 2 years ago, we only have 2 years. I think it was a mistake for Erskine and Alan to say that. You do not need to say that to say we have a mid-term and a long-term problem and we should act now.

Senator BENNET. That is my point. Actually, I do think if we were able, tomorrow, to say we have reached a broad-based bipartisan agreement that is balanced on the revenue side and on the spending side, that we would be shocked at how fast the $2 trillion that is sitting on balance sheets in this country would actually be invested in this country's future.

But my point is, you do not need to agree with that to agree that acting now is going to be much easier than acting later, and certainly much easier than acting on the back end of an economic crisis, if that is what we have.

Dr. HOLTZ-EAKIN. If I could say, briefly: the reason why entitlement reform is so important is, think of Social Security. It is a system that merits getting fixed for the reasons that I mentioned at the outset. If we were to fix it, it would have no near-term austerity effects whatsoever. It would take 10 years for anything to show up. It would send a signal to international capital markets that we can take on an important part of our spending problem, doing entitlement reform, some things that have been traditionally the third rail of politics. Why not do that?

The CHAIRMAN. Senator Roberts?

Senator BENNET. Thank you.

Senator ROBERTS. Well, thank you, Mr. Chairman.

I see here that the CBO is estimating an $845-billion budget deficit, and I would add, only if current law is not changed. Now, the President asked for 43 new programs in his State of the Union address. That current law base line does not include the tax extenders passed by this committee, the doc fix, likely other spending. You could have another Sandy. We certainly hope that is not the case, but we will have forest fires, we will have a drought in Montana and Kansas. I do not know about the gentleman from Utah.

The CHAIRMAN. Excuse me. I understand Mr. Greenstein has to leave now to chair that panel. Thank you very much, Mr. Greenstein. You have a few minutes?

Mr. GREENSTEIN. I have a few more minutes.

The CHAIRMAN. You can answer Senator Roberts' question.

Senator ROBERTS. Well, I have not asked a question yet, that is the problem. [Laughter.]

You have SSI climbing to 1 out of 15 Americans, you have food stamps doing the same thing. I do not see where the $845 billion is an accurate number, if current law is not changed, and it is going to be changed. This assumes also we are going to have the sequester. We just had some very good remarks by my distinguished predecessor.

I hope we can get that done, but the chances of that happening are—I do not know. We are talking about $85 billion, "b," that is bravo. You are indicating that the first step we ought to take is $1.5 trillion, "t," for tough. I do not know if we are going to get that done.

I also wonder about the CBO prediction that the Federal tax revenue will increase by 25 percent. This is based on the prediction for economic growth. Well now, if you have the Affordable Care Act out there and small businesses trying to figure out how they can work around it, businesses with 50 employees, so having people going down to 48, changing employees from business to business, and the part-time employees and a lot of people who have just given up in regards to looking for work, plus the official 7.9 percent unemployment, you are looking at 12, 13, 14 percent in regards to real unemployment.

Then, if we do not reach an accord on the sequester or even the $1.5 trillion, which I wish we could do, or 2.5—I do not know. I just think that these estimates—that is a glass half-full. I am sort of a glass half-empty guy. I do not know if you want to comment on that, either one of you.

Mr. GREENSTEIN. Well, my only comment is, on the one hand, when you talk about all these numbers, the $85 billion, as Doug has noted, is a small percentage.

It is a small percentage of the total. On the other hand, the CBO estimate is that the sequestration, by the 4th quarter of this year, will take six-tenths of a point off GDP and result in 750,000 fewer jobs than we would otherwise have.

Senator ROBERTS. Well, I know that. Listen, I serve on a lot of committees, and everybody else here does. So the people who understand that who serve on the committee—and I am semi-senior, so I am somebody—they come in, and everybody has pressed the hot-button.

The commandant of the Marine Corps. I am the senior Marine in the Congress. My God, my God, look what is happening to the Marine Corps! That was a pretty dumb thing we did. I think it was done on purpose to really single out the military, but we ought to do it when every agency comes in and then makes their own discretionary cuts so that this loss that you are talking about would not occur, or at least it would be less devastating.

So, everybody is talking about that. My Lord, we had the Secretary of Agriculture saying we were going to cut off all the meat inspectors, shut down the packing plants. Every cowboy in Kansas has been in touch with me saying, "What in the hell am I going to do with my cow herd?" They have already been devastated by a drought.

So I do not know what that answer is, but rest assured I know that all the hot-buttons have been pushed. Let me push mine. I said in regards to the nomination of Mr. Lew, who is already approved, the sub-regulatory guidance documents—bulletins, guidances, posting on the website, FAQs, so on and so forth—everything that goes out from the Federal Government, and more particularly I am talking about Medicare, is in regard to the sub-regulatory guidance. Who knows about these things?

My question to you, since we have people leaving and not paying any attention, basically, is there some way you can estimate regulatory costs? I will promise the chairman I will not go into my regulatory rant, but there has to be some cost to all the regulations, because what we are doing in terms of Medicare, over 50 percent of the doctors are not serving Medicare patients, and our hospitals, our community hospitals, are hanging on by a thread.

The rural health care delivery system is threatened. Every provider I know out there is hanging on by a thread, very worried about the fact that they are guilty as opposed to innocent, being fined, so on and so forth. There has to be a cost to the regulatory process. That affects every manufacturer, every business, every segment of our economy.

Do you have any comment on how on earth we would measure that?

Dr. HOLTZ-EAKIN. Yes. At the American Action Forum that I run, we have a section devoted to regulatory issues, and we total up the regulatory costs. They are $500 billion in new regulatory costs since 2008. We keep track of the Affordable Care Act, we keep track of Dodd-Frank, we keep track agency by agency, the EPA. I could not do justice to our efforts to measure regulatory costs and look at impacts in the economy in this brief time, but I would be happy to sit down with you, and I would be happy to bring those numbers to your attention.

Senator ROBERTS. Thank you.

The CHAIRMAN. Thank you, Senator.

Senator Portman?

Senator PORTMAN. Thank you, Mr. Chairman. Thank you and Senator Hatch for having this hearing. It has been fascinating. I have so many questions and so little time. I was going to give Bob the chance to respond to some of these. But Doug, it is great to have you here, and I appreciate what you said.

Senator Roberts just talked about growth, really. Senator Bennet talked about the $2 trillion on the balance sheets. I think one thing I was going to ask Bob about is, I think that is not part of the Rogoff and Reinhart study in a sense, because I think we have an unusual situation now in this country.

I spoke to the CEO of a major company in the last week and a business round table of small business folks, and they all said the same thing, which is, they are not taking that capital off the sidelines and investing it. Even though the earnings are good, the employment is bad. A lot of it does relate to the uncertainty over the debt and deficit.

You talked about tax reform. I appreciate Bob's support of that, and the chairman and ranking member have both been way out front on pro-growth tax reform that broadens the base and lowers the rates. There is $1.8 trillion locked up overseas alone. So, that is another huge opportunity for us to give the economy a shot in the arm.

I have a question for you that relates to the CBO report you talked about, and it was sobering. I think that is a good way to put it. A lot of it is because of the low economic growth because of the debt and deficit. But in a sense, as I look at it, I think what they are saying is that entitlement costs and the resulting higher interest on the debt accounts for 100 percent of our rising long-term deficits.

So, in other words, discretionary spending as a percent of GDP actually goes down, and tax revenue actually goes up from the historic level, about 18 percent, to over 19 percent. So you could say, I think—tell me if I am wrong—that 100 percent of our rising long-term debt is due to entitlement costs, to three entitlement programs—very important but unsustainable—and interest on the debt. Is that accurate?

Dr. HOLTZ-EAKIN. Yes. It is the fundamental problem of the Federal budget.

Senator PORTMAN. And let me ask you something else with regard to what is going to happen in the future. As I look at that report, discretionary spending, which is about 27 percent of the budget 10 years from now, goes up about 10 percent in nominal dollars. The entitlements, as I look at it, go up about 100 percent. They go from $1.5 trillion to $2.9 trillion.

So, instead of up 10 percent in the discretionary entitlements, Medicare, Medicaid, and Social Security alone go up 100 percent. They become almost 50 percent of the budget. Other entitlements go up about 39 percent. Interest goes up, by the way, 284 percent.

The question I was going to ask Bob was, is he taking into account those interest payments which are going to be so substantial, that go up 284 percent, along with this entitlement increase? Again, it is 100 percent of the problem.

Dr. HOLTZ-EAKIN. It is not quite fair, since Bob is not here. But I mean, we have looked pretty carefully at strategies like $1.5 trillion. I understand Bob does not want to touch a lot of things. We have had this discussion, and I get it.

But waiting is dangerous, and not touching things is dangerous, in part because that kind of an estimate is a hair-trigger estimate that needs the growth. If we do not get growth, we fall way short, and the debt does not stabilize. It relies on low interest rates.

If we get anything like a more rapid normalization, or God forbid an above-average normalization of borrowing costs, again, those stabilization trajectories fall apart quickly. So I think the prudent thing to do is to be more aggressive, and that is one of the reasons I went with the strategy I did.

Senator PORTMAN. Doug, let me ask you quickly, if I could, about Medicare Advantage. Over a third of the seniors in Ohio rely on it. The administration has come out with some new rulemakings with regard to reimbursement in Medicare Advantage. Talk to us a little about that. Is this going to push more folks into Medicare fee-for-service as you talked about earlier and the problems associated with that? Richard Foster, a recently retired actuary, has talked about this. What are your thoughts on it? What should we be doing on Medicare Advantage?

Dr. HOLTZ-EAKIN. Well, number one, I think an 8-percent year-over-year cut is a sharp cut. It will unambiguously reduce plan offerings in Medicare Advantage. I do not see any way around that. That means people currently in Medicare Advantage will have to leave their provider network. It is never good to change providers, and that often interrupts episodes of care in a detrimental way. It will move people from an integrated plan to fee-for-service, which is the opposite of what we need to be doing as a broader health care strategy.

It is typical of what has been a strategy of trying to impose provider cuts—whether they are MA plans, hospitals, doctors, or whatever it might be—as a strategy for controlling the budget costs that ultimately does nothing to improve the quality which we need and backfires in terms of really getting the spending problem under control, because fee-for-service is worse than almost every other alternative.

Senator PORTMAN. I asked about Medicare Advantage and, generally, about Part D as well, because I think that, per the chairman's good question about health care, it is a critical issue. If it is not solved, we cannot solve this bigger problem. In some respects, right before us there is an example, which is Part D and the cost estimates which were in the $600-plus billion range from Richard Foster and other actuaries, $400-plus billion from CBO, that ended up coming in below that.

Dr. HOLTZ-EAKIN. And mine was?

Senator PORTMAN. Well, I am not sure.

Dr. HOLTZ-EAKIN. Three hundred ninety-five billion dollars, roughly.

Senator PORTMAN. Yes. I am not sure if you were responsible for that estimate. But my point is, we have an opportunity here to look at a competitive model where you have the private sector working, competing for the business of seniors. Do you think that is something we should be looking to for the future?

Dr. HOLTZ-EAKIN. I think Part D is our most successful entitlement program. I remember working with the chairman a lot on it. We should try to make all of our entitlements look more like Part D and not the reverse, that is for sure.

Senator PORTMAN. All right. Thank you, Doug.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Carper?

Senator CARPER. Thanks, Mr. Chairman.

Dr. Holtz-Eakin, how are you doing? Do you think if your parents had known you were going to be testifying before all these congressional committees for all these years, that they would still have hyphenated your name and made it so hard for guys like me to pronounce?

Dr. HOLTZ-EAKIN. You have opened an enormous can of worms, because they did not, and they will never forgive me because I did. [Laughter.]

Senator CARPER. Well, we are glad you are here.

Dr. HOLTZ-EAKIN. Thank you.

Senator CARPER. I have been urging our chairman and ranking member to do what they have done so many times in the past, and that is to provide real leadership for us on this committee, and for this committee to provide real leadership for the Senate and for the Congress and for the country, to figure out how we get better health care results for less money. We have been talking about that today. I just spoke about that on the floor, and spoke on behalf of the nomination of Chuck Hagel a few minutes ago.

One of the things I said on the floor was, we spend more money for defense as a Nation than I think the next five or six, maybe seven nations combined. If we cannot find ways to provide for our defense and maybe at the same time save some money, shame on us. We also spend, as you know, way more money for health care than any other advanced nation in the world. I think the next closest nation is Norway, and they spend 52 percent or so less than we do, and they get better results, and they cover everybody.

You have given us a lot of good advice in the past. Where do you think the sweet spot lies for Medicare reform that is actually going to be likely to give us better results for less money? If you will, just think of a bunch of concentric circles, where they overlap. The edges where they overlap are where Democrats and Republicans can find agreement and actually pass something that does provide better health care results for less money. You have spoken to some of it, but just give us a couple of highlights and headlines, please.

Dr. HOLTZ-EAKIN. Just as a brief aside, on the defense front, one of the things that is poorly appreciated is that a big part of the defense budget is a health care problem and a pension problem. It has all the same problems the budget as a whole does, but smaller. I think reform of the defense health programs is just as important in many cases as Medicare and often gets forgotten.

Senator CARPER. That is a good point. Thank you.

Dr. HOLTZ-EAKIN. That is really, really important.

On Medicare, Medicare's problem is that it has Part A that pays hospitals, B pays some doctors, C pays some insurance companies, D pays drug companies. There is no beneficiary to be found in there anywhere. It is not coordinated, it is not integrated. It rewards volume, and you have to move away from that.

So there have been some suggestions which are sensible first steps on integrating the Part A and B co-pays and deductibles to turn them into a more sensible insurance policy, such as reforms of Medigap so that we do not have seniors completely insulated from the health care decisions that are made either by them or on their behalf.

So, these are not rocket science. These are sensible first steps. There is now, I think, a bipartisan recognition that practice patterns driven by legal liabilities ought to be taken out of the system so we have practice patterns driven by medical decisions, and a sensible tort reform would be a good thing that has not yet been accomplished.

So not everything has to be radical and new. I think there are some very sensible steps that can be taken and should be taken. I guess my biggest concern about the discussions that go on often in health care is that Republicans and Democrats agree more about delivery system reform than anything else. They agree on the diagnosis of lack of coordination, lack of prevention, too much acute care, not enough chronic disease. You go through the list, they are there.

Then they say, let us go study it and have a demonstration. My personal view is that the road to health care failure is paved with demonstrations. We have had demonstrations and pilots for decades in Medicare, and they do not turn into the program itself. We need to be more aggressive about making actual changes in the program and not going to do more demonstrations, because the baby boom is now retiring, the debt is very high. We have given up our cushion and our lead time, and we have to move more quickly.

Senator CARPER. All right.

Among the drivers in health care that have been just raised with me, literally in the last week, with folks whom I met with mostly in Delaware, number one is obesity. We are eating ourselves to death and at the same time just choking our Medicare program and our budget.

Number two is care for folks who have dementia. I used to think, before I became Governor—actually, before I became a Congressman, I used to think that we spent most of our money in Medicaid for poor families, mostly single women and children. That is not true. We spend most of our money in Medicaid, as you know, for folks who are old, elderly, and a lot of them have dementia. We spend a ton of money for dementia, trying to figure out, how do we get someplace? I just met with the leadership of Johnson and Johnson earlier this week to see what they are doing, what they suggest. But number one, obesity, number two, dementia.

A third one—and Bill Frist, God bless him, our former majority leader here, a collegue from Tennessee, has raised his voice of late and said it is about time for us to again look in a humane and caring way about end-of-life care. For us to continue to ignore that, I think we do it at our own peril. But those are at least three of the things that have been raised to me as items that we ought to focus on.

Do you want to just respond to any of those three?

Dr. HOLTZ-EAKIN. I do not have a lot to say about obesity. I think it has been widely recognized. On the dementia, this is an example of a genuinely very hard problem that has been left unaddressed, which is how we finance long-term care in the United States. I mean, the problem is simple. There will be rising demands for aides for daily living assistance, and, as the population ages, there will be diminishing supplies because most of it is done by daughters and wives.

Most of them are now working in a way that they did not in the past, and it is just not going to hang together. We do not have a good solution. So, I am here to tell you we do not have a good solution. I wish I did, but it is going to be a very large deal. It ought to be integrated with the delivery of medical services, probably in a home setting. So, that is a great challenge. I think there is no question about that.

Senator CARPER. All right.

Am I out of time, Mr. Chairman?

The CHAIRMAN. Take whatever time you want.

Senator CARPER. Thanks a lot.

Could you just, as a compassionate person, give us a word on end-of-life care? It is a really tough issue for everybody.

Dr. HOLTZ-EAKIN. That is enormously hard. One of the reasons that I have favored health care reforms that put the dollars closer to the beneficiary and the family is this issue, because, in my view, the American public is simply not going to let an insurance company make these decisions. They are not going to let the government make these decisions. In the end, the only place that is ethically well-suited for this decision is with the beneficiary and their family. They ought to have the monies close to where the decisionmaking is going to be made.

Having said that, they are not socially or intellectually equipped to make these decisions at this point. This is at odds with the way we have done business. We need to change it so that it is less at odds, to educate the people who are in fact going to be relied upon to make these decisions, inform them about their options more carefully. That is going to take a long time. That is not a 2013, 2014, 2015 initiative, it is a change in the way we think about this problem. It is very important.

Senator CARPER. All right.

Mr. Chairman, I just want to say to you and to Senator Hatch, this has been a terrific hearing. This is terrific and so timely, so timely, as we face the sequestration issues at the end of this week and try to figure out how, by the end of the fiscal year, we can actually put in place a comprehensive balanced deficit plan. This is just very helpful, and I thank you and both of our witnesses for their testimony.

The CHAIRMAN. Thank you, Senator, very much.

Dr. Holtz-Eakin, I wonder if you could help me a little bit here. The big problem in Washington is it is dysfunctional. It cannot get together, it is partisan. Neither side trusts the other, especially on economic matters. We have Bowles-Simpson who had a stab at it, Gangs of 6, Gangs of 8, lots of gangs. Bowles-Simpson was bipartisan at one level.

But I am wondering—and maybe it is not going to work, but you are a very good economist—if you could give some thought to maybe putting a couple or 4 economists together, two definitely ones whom Republicans listen to more than others, two whom Democrats will listen to more than others, and the four would get together with a plan. It is just an idea. We have to keep trying. We need to keep working on different ideas. On the surface that might sound a little stale because they are just four economists. On the other hand——

Dr. HOLTZ-EAKIN. A desperate appeal to economists to save the Nation is unusual, I will say. [Laughter.]

The CHAIRMAN. Right. Right. But if you have two on each side whom each side tends to listen to, that might work. Anyway, I urge you to think about it.

Dr. HOLTZ-EAKIN. Thank you.

The CHAIRMAN. And maybe if there are three others you can think of that you could team up with.

I have no further questions. Actually I do, but I do not have time.

Senator HATCH. Mr. Chairman, one of the witnesses raised the topic of tax expenditures. There is a lot of discussion about those expenditures that I think sometimes can confuse issues.

Now, to listen to some, you would think that policies that incentivize desirable behavior, like charitable giving and retirement savings, are somehow akin to potentially wasteful government spending and they should be removed or scaled back to shave down deficits so Federal outlays do not have to be cut. Well, I do not agree with that.

Now, I delivered a series of floor speeches in the summer of 2011 which discussed myths about tax expenditures, and I would ask that they be placed in the record at this point.

The CHAIRMAN. Thank you.

[The information appears in the appendix on p. 155.]

The CHAIRMAN. We have a little bit of a dilemma here. There is a roll call vote. We have one more witness. It would be my thought—the other witness is Doug Elmendorf—that Doug, you could come back at a later date. Otherwise, I do not want to be rude. It does not give you the justice that you deserve when we are running off to a vote. I am not sure how many can come back after the vote, frankly. So I would just suggest that you come back at a later date.

Dr. ELMENDORF. Whatever suits you is fine.

The CHAIRMAN. Well, I would just say at a later date to give the committee a better opportunity to ask you a lot of questions.

Senator HATCH. I know it is hard to concede that point, Doug, but we sure would like to have you back when we have enough time to really ask you all the questions that we would like to ask.

The CHAIRMAN. All right. Thanks, everybody. Thanks to all members, and thanks to the witnesses.

The committee is adjourned.

[Whereupon, at 12:05 p.m., the hearing was adjourned.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Hearing Statement of Senator Max Baucus (D-Mont.)
On Advancing the Economic Recovery and the Outlook of the Nation's Fiscal Future
As prepared for delivery

President John F. Kennedy once said, "The solid ground of mutual confidence is the necessary partnership of government with all of the sectors of our society in the steady quest for economic progress."

In the close to four years since the end of the recession, steady progress has been made in our economic recovery. But a feeling of uncertainty nonetheless continues to spread across our nation today.

And the dysfunction of our government is degrading confidence in our economy and creating uncertainty for families and businesses. It's preventing families from planning for the future. It's dragging down investment, leaving businesses sitting on the sidelines and holding back our economy.

Like many members of the committee, I just returned from a week at home in Montana talking with the people I work for. I heard from small business leaders in Billings. I met with law enforcement in Missoula and Bozeman. I talked with the Commander of Montana's Army National Guard, based in Great Falls.

And, as part of a tradition I call "work days," I worked the early shift at Wheat Montana Bakery in Three Forks. Starting at 7 a.m., I cleaned tables, served coffee and greeted customers taking a break from their weekend travels.

At each stop, from every corner of the state, I heard one thing over and over: the people we work for need certainty. It's time Washington started listening. They are tired of being jerked around from one crisis to the next.

They make tough decisions every month to keep their budgets in the black. They deserve a Congress – and a President – that can work together and do the same.

In the coming days and weeks we must confront a number of fiscal challenges facing our nation.

Just three days from now, on March 1, across the board budget cuts known as the sequester will hit.

Eighty five billion dollars in federal spending will be sliced from thousands of programs, including Medicare, rural development and early education. The repercussions will ripple through every sector of our economy.

In Montana, more than 800 civilian employees at Malmstrom Air Force Base and the Army and Air National Guards will face up to a 20 percent reduction in pay. These aren't just numbers, these are real people with bills to pay and families to care for.

Cuts to national parks hit home in our state. Because 64,000 Montana jobs depend directly on outdoor recreation.

Nationwide, the Department of Justice's Office of Violence Against Women will lose $21 million. That means fewer grants to support the critical work of folks I met with in Missoula and Billings – folks doing heroic work to help prevent violence against our mothers, sisters and daughters. These are impressive people undertaking these programs.

Cuts to the COPS grants program could mean fewer police officers on the streets keeping our communities safe.

The uncertainty over how these and other cuts will play out is weighing heavy on businesses like Wheat Montana and those I met with in Billings.

The nonpartisan Congressional Budget Office predicts the sequester cuts could slow the economic recovery and result in another year of sluggish growth and high unemployment.

Yes, we need to cut our debt and get our fiscal house in order. We know there are some places to trim the fat.

But we need to take a scalpel to waste and inefficiency, not allow a hatchet to hack into American jobs.

We have a plan on the table to bridge the sequester and still cut $110 billion from our debt without putting working families and American jobs in jeopardy.

This proposal is not perfect. I have concerns about cuts to programs family farmers rely on. But I understand the alternative of doing nothing could be far worse for agriculture and the rest of our economy.

That's why I secured a compromise that will extend the SURE program and give farmers a bridge between direct payments and the next farm bill.

And I worked to include livestock disaster assistance for ranchers recovering from the worst drought in decades. That, too, is important. So while this plan is not exactly how I would have designed it on my own, I recognize that compromise is necessary to get something done.

My hope is that my colleagues will support this plan or offer their own proposal to stop the sequester. We can then work together to prevent these indiscriminate cuts from causing lasting economic damage.

Our economy will be put to the test again in just weeks when the continuing resolution expires on March 27. We face the threat of a government shutdown.

And on the horizon, the federal borrowing limit will be reached in late May. That will require another extension of the debt ceiling.

This is no way to run a country. Congress has been lurching from one fiscal showdown to the next, leaving the nation with uncertainty. The only way we'll be able to get past these budget battles is by working together. And we can start right here on this Committee.

We need to take a balanced approach as we tackle these issues and work together to cut the debt.

Over the past two years, we have made real progress cutting deficits and debt. In 2011, we passed $1.4 trillion in spending reductions. And last month, Congress passed legislation that reduced the deficit by another $600 billion.

Together, with interest savings, these actions will cut the deficit by $2.5 trillion over the next ten years. Add to this the savings from winding down the wars in Iraq and Afghanistan and our deficit reduction will reach almost $3.5 trillion over ten years.

And as the nation's economy continues to recover, the long-term budgetary outlook has changed. CBO's forecasts for Medicare and Medicaid spending have dropped significantly. Current projections for the programs' costs through the end of the decade are $200 billion less than in March 2010.

CBO also forecasts decreasing deficits and a stable debt-to-GDP ratio over the next several years. It projects the 2013 budget deficit will be a full third lower than it was in 2010, and it will be cut in half by 2015. CBO notes there will be a slight uptick at the end of the decade, so we must continue to attack the deficit head on.

While progress has been made, the job is certainly not done.

The unemployment rate is still unacceptably high. American families' budgets are being pinched. Skyrocketing gas prices, rising food prices and stagnant wage growth are making it harder for families to make ends meet. More must be done to strengthen the American economy.

Today we will discuss how we can enact additional balanced savings to further reduce the deficit, give families and businesses certainty, and protect the economic recovery.

As we do that I want this Committee to focus on three key goals.

First, job creation. Twelve million people are actively looking for work but can't find a job. An additional 8 million Americans are stuck working part-time when they would like full-time work. Job creation must be the top priority of the Administration, this Congress and this Committee.

Second, we must simplify our tax code for America's families and businesses. It has been close to 30 years since the last major overhaul of America's tax code. In that time, our world has changed dramatically.

Back then, China was our 18th largest trading partner. Now China is our second largest. And over the past 30 years, exports as a share of our GDP have nearly doubled. Our tax code is now antiquated and acting as a brake on our economy, especially when compared with our overseas competitors.

We need a pro-growth tax code that gives America's businesses the certainty they need to compete globally and plan and expand operations, instead of leaving them hoping for a continuation of temporary tax breaks.

Finally, we must make it a priority to return stability and confidence to our economy. We have to get off this roller coaster of a ride. Going from one fiscal crisis to the next is undermining our economy.

To give families and businesses certainty, we must agree on a balanced, comprehensive plan to cut the debt that includes both revenue and spending cuts. The math will not work any other way.

A long-term balanced plan will bridge the budget battles and make real progress solving our deficit problem. A balanced plan will also encourage businesses to invest, enable investors to return to the markets with confidence, and, most importantly, put Americans back to work in a growing economy.

Three experts are here today to help the Committee examine the progress of America's economic recovery as well as our economic outlook over the next decade. I look forward to hearing from each of you as you provide this Committee with the necessary insight to take on the tough challenges ahead of us.

I also hope today this Committee can complete its review of three individuals nominated to key Administration posts. I urge Committee members to support the nominations of William Schultz to be the General Counsel at the Department of Health and Human Services, Christopher Meade to be the General Counsel at the Department of Treasury, and Jack Lew to be the Secretary of Treasury.

As we will discuss today, our nation faces a number of great challenges. We need bright, talented and dedicated individuals – like these three nominees – to work with us to find solutions and ensure a better future for America.

So let us listen to the facts about our budget from these experts with us today. Then let's work together to make the tough decisions. Let us do the hard work and face the great responsibility before us. As President Kennedy understood, let us recognize that our economic progress depends on the solid ground of mutual confidence. Let us embrace this opportunity to restore certainty and get America back on track.

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Congressional Budget Office

Testimony

The Budget and Economic Outlook: Fiscal Years 2013 to 2023

Douglas W. Elmendorf
Director

Before the
Committee on Finance
United States Senate

February 26, 2013

This document is embargoed until it is delivered at 10:00 a.m. (EST) on Tuesday, February 26, 2013. The contents may not be published, transmitted, or otherwise communicated by any print, broadcast, or electronic media before that time.

CONGRESS OF THE UNITED STATES

Chairman Baucus, Senator Hatch, and Members of the Committee, thank you for inviting me to testify on the Congressional Budget Office's (CBO's) most recent analysis of the outlook for the budget and the economy. My statement summarizes CBO's new economic forecast and baseline budget projections, which cover fiscal years 2013 to 2023. Those estimates were released earlier in the month in the report titled *The Budget and Economic Outlook: Fiscal Years 2013 to 2023*.

Economic growth will remain slow this year, CBO anticipates, as gradual improvement in many of the forces that drive the economy is offset by the effects of budgetary changes that are scheduled to occur under current law. After this year, economic growth will speed up, CBO projects, causing the unemployment rate to decline and inflation and interest rates to eventually rise from their current low levels. Nevertheless, the unemployment rate is expected to remain above 7½ percent through next year; if that happens, 2014 will be the sixth consecutive year with unemployment exceeding 7½ percent of the labor force—the longest such period in the past 70 years.

If the current laws that govern federal taxes and spending do not change, the budget deficit will shrink this year to $845 billion, or 5.3 percent of gross domestic product (GDP), its smallest size since 2008. In CBO's baseline projections, deficits continue to shrink over the next few years, falling to 2.4 percent of GDP by 2015. Deficits are projected to increase later in the coming decade, however, because of the pressures of an aging population, rising health care costs, an expansion of federal subsidies for health insurance, and growing interest payments on federal debt. As a result, federal debt held by the public is projected to remain historically high relative to the size of the economy for the next decade. By 2023, if current laws remain in place, debt will equal 77 percent of GDP and be on an upward path, CBO projects (see Figure 1).

Such high and rising debt would have serious negative consequences: When interest rates rose to more normal levels, federal spending on interest payments would increase substantially. Moreover, because federal borrowing reduces national saving, the capital stock would be smaller and total wages would be lower than they would be if the debt was reduced. In addition, lawmakers would have less flexibility than they might ordinarily to use tax and spending policies to respond to unexpected challenges. Finally, such a large debt would increase the risk of a fiscal crisis, during which investors would lose so much confidence in the government's ability to manage its budget that the government would be unable to borrow at affordable rates.

Under Current Law, Federal Debt Will Stay at Historically High Levels Relative to GDP

The federal budget deficit, which shrank as a percentage of GDP for the third year in a row in 2012, will fall again in 2013, if current laws remain the same. At an estimated $845 billion, the 2013 imbalance would be the first deficit in five years below $1 trillion; and at 5.3 percent of GDP, it would be only about half as large, relative to the size of the economy, as the deficit was in 2009. Nevertheless, if the laws that govern taxes and spending do not change, federal debt held by the public will reach 76 percent of GDP by the end of this fiscal year, the largest percentage since 1950.

With revenues expected to rise more rapidly than spending in the next few years under current law, the deficit is projected to dip as low as 2.4 percent of GDP by 2015 (see Table 1). In later years, however, projected deficits rise steadily, reaching almost 4 percent of GDP in 2023. For the 2014–2023 period, deficits in CBO's baseline projections total $7.0 trillion. With such deficits, federal debt would remain above 73 percent of GDP—far higher than the 39 percent average seen over the past four decades. (As recently as the end of 2007, federal debt equaled just 36 percent of GDP.) Moreover, debt would be increasing relative to the size of the economy in the second half of the decade.

Those projections are not CBO's predictions of future outcomes. As specified in law, CBO's baseline projections are constructed under the assumption that current laws generally remain unchanged, so that they can serve as a benchmark against which potential changes in law can be measured.

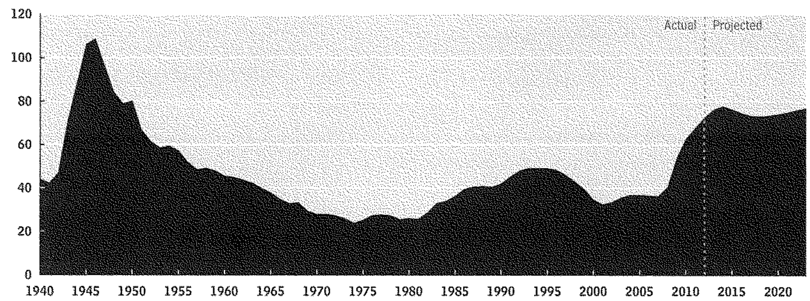
Revenues

Federal revenues will increase by roughly 25 percent between 2013 and 2015 under current law, CBO projects. That increase is expected to result from a rise in income because of the growing economy, from policy changes that are scheduled to take effect during that

Figure 1.

Federal Debt Held by the Public

(Percentage of gross domestic product)



Source: Congressional Budget Office.

period, and from policy changes that have already taken effect but whose full impact on revenues will not be felt until after this year (such as the recent increase in tax rates on income above certain thresholds).

As a result of those factors, revenues are projected to grow from 15.8 percent of GDP in 2012 to 19.1 percent of GDP in 2015—compared with an average of 17.9 percent of GDP over the past 40 years. Under current law, revenues will remain at roughly 19 percent of GDP from 2015 through 2023, CBO estimates.

Outlays

In CBO's baseline projections, federal spending rises over the next few years in dollar terms but falls relative to the size of the economy. During those years, the growth of spending will be restrained both by the strengthening economy (as spending for programs such as unemployment compensation drops) and by provisions of the Budget Control Act of 2011 (Public Law 112-25). Although outlays are projected to decline from 22.8 percent of GDP in 2012 to 21.5 percent by 2017, they will still exceed their 40-year average of 21.0 percent. (Outlays peaked at 25.2 percent of GDP in 2009 but have fallen relative to GDP in the past few years.)

After 2017, if current laws remain in place, outlays will start growing again as a percentage of GDP. The aging of the population, increasing health care costs, and a significant expansion of eligibility for federal subsidies for health insurance will substantially boost spending for Social Security and for major health care programs relative to the size of the economy. At the same time, rising interest rates will significantly increase the government's debt-service costs. In CBO's baseline, outlays reach about 23 percent of GDP in 2023 and are on an upward trajectory.

Changes from CBO's Previous Projections

The deficits projected in CBO's current baseline are significantly larger than the ones in CBO's baseline of August 2012. At that time, CBO projected deficits totaling $2.3 trillion for the 2013–2022 period; in the current baseline, the total deficit for that period has risen by $4.6 trillion. That increase stems chiefly from the enactment of the American Taxpayer Relief Act of 2012 (P.L. 112-240), which made changes to tax and spending laws that will boost deficits by a total of $4.0 trillion (excluding debt-service costs) between 2013 and 2022, according to estimates by CBO and the staff of the Joint Committee on Taxation. CBO's updated baseline also takes into account other legislative actions since August, as well as a new economic forecast and some technical revisions to its projections.

Table 1.

CBO's Baseline Budget Projections

	Actual, 2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	Total 2014-2018	Total 2014-2023
							In Billions of Dollars							
Revenues	2,449	2,708	3,003	3,373	3,591	3,765	3,937	4,101	4,279	4,496	4,734	4,961	17,669	40,241
Outlays	3,538	3,553	3,618	3,803	4,067	4,300	4,542	4,811	5,078	5,350	5,691	5,939	20,330	47,199
Deficit (-) or Surplus	**-1,089**	**-845**	**-616**	**-430**	**-476**	**-535**	**-605**	**-710**	**-798**	**-854**	**-957**	**-978**	**-2,661**	**-6,958**
On-budget	-1,151	-872	-630	-433	-476	-533	-598	-693	-763	-799	-878	-872	-2,670	-6,675
Off-budget[a]	62	27	14	3	*	-2	-6	-17	-35	-55	-79	-106	9	-283
Debt Held by the Public at the End of the Year	11,280	12,229	12,937	13,462	14,025	14,642	15,316	16,092	16,957	17,876	18,902	19,944	n.a.	n.a.
							As a Percentage of Gross Domestic Product							
Revenues	15.8	16.9	18.0	19.1	19.1	18.9	18.8	18.7	18.7	18.9	19.0	19.1	18.8	18.9
Outlays	22.8	22.2	21.7	21.6	21.6	21.5	21.7	22.0	22.2	22.4	22.9	22.9	21.6	22.1
Deficit	**-7.0**	**-5.3**	**-3.7**	**-2.4**	**-2.5**	**-2.7**	**-2.9**	**-3.2**	**-3.5**	**-3.6**	**-3.8**	**-3.8**	**-2.8**	**-3.3**
Debt Held by the Public at the End of the Year	72.5	76.3	77.7	76.3	74.6	73.4	73.1	73.5	74.2	75.0	76.0	77.0	n.a.	n.a.

Source: Congressional Budget Office.

Note: * = between -$500 million and zero; n.a. = not applicable.

a. Off-budget surpluses or deficits comprise surpluses or deficits in the Social Security trust funds and the net cash flow of the Postal Service.

Looming Policy Decisions May Have a Substantial Effect on the Budget Outlook

Current law leaves many key budget issues unresolved, and this year, lawmakers will face three significant budgetary deadlines:

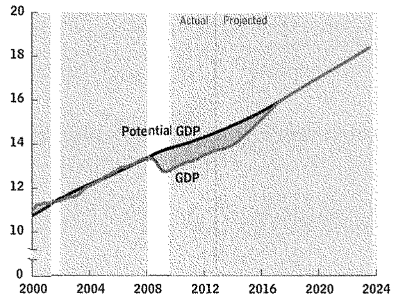
- Automatic reductions in spending are scheduled to be implemented at the beginning of March; when that happens, funding for many government activities will be reduced by 5 percent or more.
- The continuing resolution that currently provides operational funding for much of the government will expire in late March. If no additional appropriations are provided by then, nonessential functions of the government will have to cease operations.
- A statutory limit on federal debt, which was temporarily removed, will take effect again in mid-May. The Treasury will be able to continue borrowing for a short time after that by using what are known as extraordinary measures. But to avoid a default on the government's obligations, the debt limit will need to be adjusted before those measures are exhausted later in the year.

Budgetary outcomes will also be affected by decisions about whether to continue certain policies that have been in effect in recent years. Such policies could be continued, for example, by extending some tax provisions that are scheduled to expire (and that have routinely been extended in the past) or by preventing the 25 percent cut in Medicare's payment rates for physicians that is due to occur in 2014. If, for instance, lawmakers eliminated the automatic spending cuts scheduled to take effect in March (but left in place the original caps on discretionary funding set by the Budget Control Act), prevented the sharp reduction in Medicare's payment rates for physicians, and extended the tax provisions that are scheduled to expire at the end of calendar year 2013 (or, in some

Figure 2.

GDP and Potential GDP

(Trillions of 2005 dollars)



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

Notes: Potential gross domestic product (GDP) is CBO's estimate of the maximum sustainable level of output of the economy.

Data are quarterly. Actual data are plotted through the third quarter of 2012. Projections are plotted through the fourth quarter of 2023.

cases, in later years), budget deficits would be substantially larger over the coming decade than in CBO's baseline projections. With those changes, and no offsetting reductions in deficits, debt held by the public would rise to 87 percent of GDP by the end of 2023 rather than to 77 percent.

In addition to those decisions, lawmakers will continue to face the longer-term budgetary issues posed by the substantial federal debt and by the implications of rising health care costs and the aging of the population.

Economic Growth Is Likely to Be Slow in 2013 and Pick Up in Later Years

The U.S. economy expanded modestly in calendar year 2012, continuing the slow recovery seen since the recession ended in mid-2009. Although economic growth is expected to remain slow again this year, CBO anticipates that underlying factors in the economy will spur a more rapid expansion beginning next year.

Even so, under the fiscal policies embodied in current law, output is expected to remain below its potential (or maximum sustainable) level until 2017. By CBO's estimates, in the fourth quarter of 2012, real (inflation-adjusted) GDP was about 5½ percent below its potential level. That gap was only modestly smaller than the gap between actual and potential GDP that existed at the end of the recession (see Figure 2) because the growth of output since then has been only slightly greater than the growth of potential output. With such a large gap between actual and potential GDP persisting for so long, CBO projects that the total loss of output, relative to the economy's potential, between 2007 and 2017 will be equivalent to nearly half of the output that the United States produced last year.

The Economic Outlook for 2013

CBO expects that economic activity will expand slowly this year, with real GDP growing by just 1.4 percent (see Table 2). That slow growth reflects a combination of ongoing improvement in underlying economic factors and fiscal tightening that has already begun or is scheduled to occur—including the expiration of a 2 percentage-point cut in the Social Security payroll tax, an increase in tax rates on income above certain thresholds, and scheduled automatic reductions in federal spending. That subdued economic growth will limit businesses' need to hire additional workers, thereby causing the unemployment rate to stay near 8 percent this year, CBO projects. The rate of inflation and interest rates are projected to remain low.

The Economic Outlook for 2014 to 2018

After the economy adjusts this year to the fiscal tightening inherent in current law, underlying economic factors will lead to more rapid growth, CBO projects—3.4 percent in 2014 and an average of 3.6 percent a year from 2015 through 2018. In particular, CBO expects that the effects of the housing and financial crisis will continue to fade and that an upswing in housing construction (though from a very low level), rising real estate and stock prices, and increasing availability of credit will help to spur a virtuous cycle of faster growth in employment, income, consumer spending, and business investment over the next few years.

Nevertheless, under current law, CBO expects the unemployment rate to remain high—above 7½ percent through 2014—before falling to 5½ percent at the end of 2017. The rate of inflation is projected to rise slowly after

Table 2.

CBO's Economic Projections for Calendar Years 2012 to 2023

	Estimated, 2012	Forecast 2013	Forecast 2014	Projected Annual Average 2015–2018	Projected Annual Average 2019–2023
	Fourth Quarter to Fourth Quarter (Percentage change)				
Real Gross Domestic Product	1.9	1.4	3.4	3.6	2.2
Inflation					
PCE price index	1.5	1.3	1.8	1.9	2.0
Core PCE price index[a]	1.5	1.5	1.9	2.0	2.0
Consumer price index[b]	1.9 [c]	1.5	2.0	2.2	2.3
Core consumer price index[a]	1.9 [c]	1.8	2.0	2.2	2.3
	Fourth Quarter Level (Percent)				
Unemployment Rate	7.8 [c]	8.0	7.6	5.5 [d]	5.2 [e]
	Calendar Year Average (Percent)				
Interest Rates					
Three-month Treasury bills	0.1 [c]	0.1	0.2	2.2	4.0
Ten-year Treasury notes	1.8 [c]	2.1	2.7	4.5	5.2

Source: Congressional Budget Office. (Actual values for 2012 are from Department of Labor, Bureau of Labor Statistics; Federal Reserve.)

Notes: The numbers shown here do not reflect the values for GDP and related series released by the Commerce Department's Bureau of Economic Analysis on January 30.

PCE = personal consumption expenditures.

a. Excludes prices for food and energy.

b. The consumer price index for all urban consumers.

c. Actual value for 2012.

d. Value for 2018.

e. Value for 2023.

this year: CBO estimates that the annual increase in the price index for personal consumption expenditures will reach about 2 percent in 2015. The interest rate on 3-month Treasury bills—which has hovered near zero for the past several years—is expected to climb to 4 percent by the end of 2017, and the rate on 10-year Treasury notes is projected to rise from 2.1 percent in 2013 to 5.2 percent in 2017.

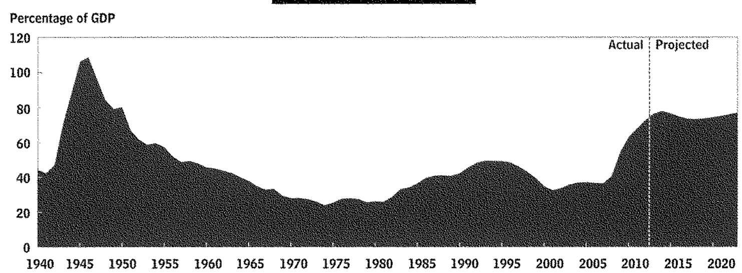
The Economic Outlook for 2019 to 2023

For the second half of the coming decade, CBO does not attempt to predict the cyclical ups and downs of the economy; rather, CBO assumes that GDP will stay at its maximum sustainable level. On that basis, CBO projects that both actual and potential real GDP will grow at an average rate of 2¼ percent a year between 2019 and 2023. That pace is much slower than the average growth rate of potential GDP since 1950. The main reason is that the growth of the labor force will slow down because of the retirement of the baby boomers and an end to the long-standing increase in women's participation in the labor force. CBO also projects that the unemployment rate will fall to 5.2 percent by 2023 and that inflation and interest rates will stay at about their 2018 levels throughout the 2019–2023 period.

CONGRESS OF THE UNITED STATES
CONGRESSIONAL BUDGET OFFICE

CBO

The Budget and Economic Outlook: Fiscal Years 2013 to 2023



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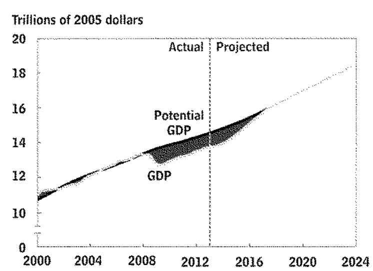
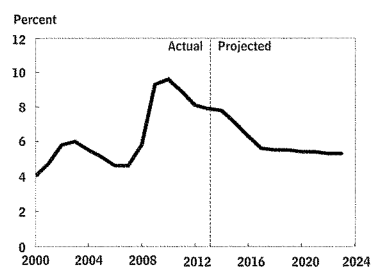


GDP and Potential GDP



Unemployment Rate

FEBRUARY 2013

Notes

Numbers in the text and tables may not add up to totals because of rounding.

Unless otherwise indicated, years referred to in describing the budget outlook are federal fiscal years (which run from October 1 to September 30) and years referred to in describing the economic outlook are calendar years.

The figures in Chapter 2 have white vertical bars that indicate the duration of recessions. (A recession extends from the peak of a business cycle to its trough.)

The economic forecast was completed in mid-January 2013, and the estimates of 2012 values shown in tables and figures in Chapter 2 and Appendix B are based on information available at that time.

Supplemental data for this analysis and the historical budget data that are usually included in this report are available on CBO's Web site (www.cbo.gov).

Pub. No. 4649

Contents

Summary

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Under Current Law, Federal Debt Will Stay at Historically High Levels Relative to GDP

The federal budget deficit, which shrank as a percentage of GDP for the third year in a row in 2012, will fall again in 2013, if current laws remain the same. At an estimated $845 billion, the 2013 imbalance would be the first deficit in five years below $1 trillion; and at 5.3 percent of GDP, it would be only about half as large, relative to the size of the economy, as the deficit was in 2009. Nevertheless, if the laws that govern taxes and spending do not change, federal debt held by the public will reach 76 percent of GDP by the end of this fiscal year, the largest percentage since 1950.

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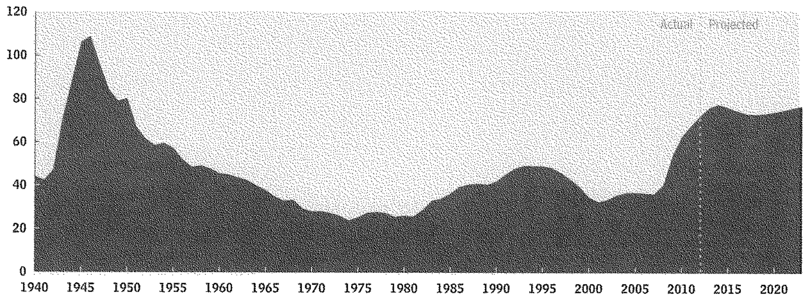
Summary Figure 1.

Federal Debt Held by the Public

(Percentage of gross domestic product)



Source: Congressional Budget Office.

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As a result of those factors, revenues are projected to grow from 15.8 percent of GDP in 2012 to 19.1 percent of GDP in 2015—compared with an average of 17.9 percent of GDP over the past 40 years. Under current law, revenues will remain at roughly 19 percent of GDP from 2015 through 2023, CBO estimates.

Outlays

In CBO's baseline projections, federal spending rises over the next few years in dollar terms but falls relative to the size of the economy. During those years, the growth of spending will be restrained both by the strengthening economy (as spending for programs such as unemployment compensation drops) and by provisions of the Budget Control Act of 2011 (Public Law 112-25). Although outlays are projected to decline from 22.8 percent of GDP in 2012 to 21.5 percent by 2017, they will still exceed their 40-year average of 21.0 percent. (Outlays peaked at 25.2 percent of GDP in 2009 but have fallen relative to GDP in the past few years.)

After 2017, if current laws remain in place, outlays will start growing again as a percentage of GDP. The aging of the population, increasing health care costs, and a significant expansion of eligibility for federal subsidies for health insurance will substantially boost spending for Social Security and for major health care programs relative to the size of the economy. At the same time, rising interest rates will significantly increase the government's debt-service costs. In CBO's baseline, outlays reach about 23 percent of GDP in 2023 and are on an upward trajectory.

Changes from CBO's Previous Projections

The deficits projected in CBO's current baseline are significantly larger than the ones in CBO's baseline of August 2012. At that time, CBO projected deficits totaling \$2.3 trillion for the 2013–2022 period; in the current baseline, the total deficit for that period has risen by \$4.6 trillion. That increase stems chiefly from the enactment of the American Taxpayer Relief Act of 2012 (P.L. 112-240), which made changes to tax and spending

Summary Table 1.

CBO's Baseline Budget Projections

	Actual, 2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	Total 2014-2018	Total 2014-2023
							In Billions of Dollars							
Revenues	2,449	2,708	3,003	3,373	3,591	3,765	3,937	4,101	4,279	4,496	4,734	4,961	17,669	40,241
Outlays	3,538	3,553	3,618	3,803	4,067	4,300	4,542	4,811	5,078	5,350	5,691	5,939	20,330	47,199
Deficit (-) or Surplus	**-1,089**	**-845**	**-616**	**-430**	**-476**	**-535**	**-605**	**-710**	**-798**	**-854**	**-957**	**-978**	**-2,661**	**-6,958**
On-budget	-1,151	-872	-630	-433	-476	-533	-598	-693	-763	-799	-878	-872	-2,670	-6,675
Off-budget[a]	62	27	14	3	*	-2	-6	-17	-35	-55	-79	-106	9	-283
Debt Held by the Public at the End of the Year	11,280	12,229	12,937	13,462	14,025	14,642	15,316	16,092	16,957	17,876	18,902	19,944	n.a.	n.a.
							As a Percentage of Gross Domestic Product							
Revenues	15.8	16.9	18.0	19.1	19.1	18.9	18.8	18.7	18.7	18.9	19.0	19.1	18.8	18.9
Outlays	22.8	22.2	21.7	21.6	21.6	21.5	21.7	22.0	22.2	22.4	22.9	22.9	21.6	22.1
Deficit	**-7.0**	**-5.3**	**-3.7**	**-2.4**	**-2.5**	**-2.7**	**-2.9**	**-3.2**	**-3.5**	**-3.6**	**-3.8**	**-3.8**	**-2.8**	**-3.3**
Debt Held by the Public at the End of the Year	72.5	76.3	77.7	76.3	74.6	73.4	73.1	73.5	74.2	75.0	76.0	77.0	n.a.	n.a.

Source: Congressional Budget Office.

Note: * = between -$500 million and zero; n.a. = not applicable.

a. Off-budget surpluses or deficits comprise surpluses or deficits in the Social Security trust funds and the net cash flow of the Postal Service.

laws that will boost deficits by a total of $4.0 trillion (excluding debt-service costs) between 2013 and 2022, according to estimates by CBO and the staff of the Joint Committee on Taxation. CBO's updated baseline also takes into account other legislative actions since August, as well as a new economic forecast and some technical revisions to its projections.

Looming Policy Decisions May Have a Substantial Effect on the Budget Outlook

Current law leaves many key budget issues unresolved, and this year, lawmakers will face three significant budgetary deadlines:

- Automatic reductions in spending are scheduled to be implemented at the beginning of March; when that happens, funding for many government activities will be reduced by 5 percent or more.

- The continuing resolution that currently provides operational funding for much of the government will expire in late March. If no additional appropriations are provided by then, nonessential functions of the government will have to cease operations.

- A statutory limit on federal debt, which was temporarily removed, will take effect again in mid-May. The Treasury will be able to continue borrowing for a short time after that by using what are known as extraordinary measures. But to avoid a default on the government's obligations, the debt limit will need to be adjusted before those measures are exhausted later in the year.

Budgetary outcomes will also be affected by decisions about whether to continue certain policies that have been in effect in recent years. Such policies could be continued, for example, by extending some tax provisions that are scheduled to expire (and that have routinely been extended in the past) or by preventing the 25 percent cut in Medicare's payment rates for physicians that is due to occur in 2014. If, for instance, lawmakers eliminated the automatic spending cuts scheduled to take effect in March (but left in place the original caps on discretionary funding set by the Budget Control Act), prevented the sharp reduction in Medicare's payment rates for physicians, and extended the tax provisions that are scheduled to expire at the end of calendar year 2013 (or, in some cases, in later years), budget deficits would be substantially larger over the coming decade than in CBO's baseline projections. With those changes, and no offsetting reductions in deficits, debt held by the public would rise to 87 percent of GDP by the end of 2023 rather than to 77 percent.

In addition to those decisions, lawmakers will continue to face the longer-term budgetary issues posed by the substantial federal debt and by the implications of rising health care costs and the aging of the population.

Economic Growth Is Likely to Be Slow in 2013 and Pick Up in Later Years

The U.S. economy expanded modestly in calendar year 2012, continuing the slow recovery seen since the recession ended in mid-2009. Although economic growth is expected to remain slow again this year, CBO anticipates that underlying factors in the economy will spur a more rapid expansion beginning next year.

Even so, under the fiscal policies embodied in current law, output is expected to remain below its potential (or maximum sustainable) level until 2017. By CBO's estimates, in the fourth quarter of 2012, real (inflation-adjusted) GDP was about 5½ percent below its potential level. That gap was only modestly smaller than the gap between actual and potential GDP that existed at the end of the recession (see Summary Figure 2) because the growth of output since then has been only slightly greater than the growth of potential output. With such a large gap between actual and potential GDP persisting for so long, CBO projects that the total loss of output, relative to the economy's potential, between 2007 and 2017 will be equivalent to nearly half of the output that the United States produced last year.

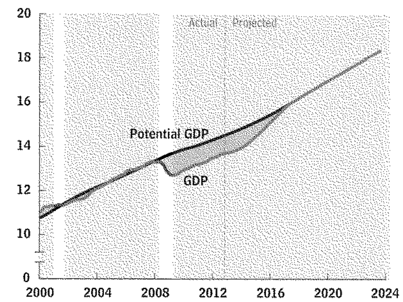
The Economic Outlook for 2013

CBO expects that economic activity will expand slowly this year, with real GDP growing by just 1.4 percent (see Summary Table 2). That slow growth reflects a combination of ongoing improvement in underlying economic factors and fiscal tightening that has already begun

Summary Figure 2.

GDP and Potential GDP

(Trillions of 2005 dollars)



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

Notes: Potential gross domestic product (GDP) is CBO's estimate of the maximum sustainable level of output of the economy.

Data are quarterly. Actual data are plotted through the third quarter of 2012. Projections are plotted through the fourth quarter of 2023.

or is scheduled to occur—including the expiration of a 2 percentage-point cut in the Social Security payroll tax, an increase in tax rates on income above certain thresholds, and scheduled automatic reductions in federal spending. That subdued economic growth will limit businesses' need to hire additional workers, thereby causing the unemployment rate to stay near 8 percent this year, CBO projects. The rate of inflation and interest rates are projected to remain low.

The Economic Outlook for 2014 to 2018

After the economy adjusts this year to the fiscal tightening inherent in current law, underlying economic factors will lead to more rapid growth, CBO projects—3.4 percent in 2014 and an average of 3.6 percent a year from 2015 through 2018. In particular, CBO expects that the effects of the housing and financial crisis will continue to fade and that an upswing in housing construction (though from a very low level), rising real estate and stock prices, and increasing availability of credit will help to spur a virtuous cycle of faster growth in employment, income, consumer spending, and business investment over the next few years.

Summary Table 2.

CBO's Economic Projections for Calendar Years 2012 to 2023

	Estimated, 2012	Forecast 2013	Forecast 2014	Projected Annual Average 2015–2018	Projected Annual Average 2019–2023
		Fourth Quarter to Fourth Quarter (Percentage change)			
Real Gross Domestic Product	1.9	1.4	3.4	3.6	2.2
Inflation					
PCE price index	1.5	1.3	1.8	1.9	2.0
Core PCE price index[a]	1.5	1.5	1.9	2.0	2.0
Consumer price index[b]	1.9 [c]	1.5	2.0	2.2	2.3
Core consumer price index[a]	1.9 [c]	1.8	2.0	2.2	2.3
		Fourth Quarter Level (Percent)			
Unemployment Rate	7.8 [c]	8.0	7.6	5.5 [d]	5.2 [e]
		Calendar Year Average (Percent)			
Interest Rates					
Three-month Treasury bills	0.1 [c]	0.1	0.2	2.2	4.0
Ten-year Treasury notes	1.8 [c]	2.1	2.7	4.5	5.2

Source: Congressional Budget Office. (Actual values for 2012 are from Department of Labor, Bureau of Labor Statistics; Federal Reserve.)

Notes: Economic projections for each year from 2012 to 2023 appear in Appendix B.

The numbers shown here do not reflect the values for GDP and related series released by the Commerce Department's Bureau of Economic Analysis on January 30.

PCE = personal consumption expenditures.

a. Excludes prices for food and energy.

b. The consumer price index for all urban consumers.

c. Actual value for 2012.

d. Value for 2018.

e. Value for 2023.

Nevertheless, under current law, CBO expects the unemployment rate to remain high—above 7½ percent through 2014—before falling to 5½ percent at the end of 2017. The rate of inflation is projected to rise slowly after this year: CBO estimates that the annual increase in the price index for personal consumption expenditures will reach about 2 percent in 2015. The interest rate on 3-month Treasury bills—which has hovered near zero for the past several years—is expected to climb to 4 percent by the end of 2017, and the rate on 10-year Treasury notes is projected to rise from 2.1 percent in 2013 to 5.2 percent in 2017.

The Economic Outlook for 2019 to 2023

For the second half of the coming decade, CBO does not attempt to predict the cyclical ups and downs of the economy; rather, CBO assumes that GDP will stay at its maximum sustainable level. On that basis, CBO projects that both actual and potential real GDP will grow at an average rate of 2¼ percent a year between 2019 and 2023. That pace is much slower than the average growth rate of potential GDP since 1950. The main reason is that the growth of the labor force will slow down because of the retirement of the baby boomers and an end to the long-standing increase in women's participation in the labor force. CBO also projects that the unemployment rate will fall to 5.2 percent by 2023 and that inflation and interest rates will stay at about their 2018 levels throughout the 2019–2023 period.

CHAPTER

1

The Budget Outlook

If current laws remain in place, the Congressional Budget Office (CBO) estimates, the federal budget deficit will total $845 billion in fiscal year 2013; this will be the first time since 2008 that the budget shortfall will be less than $1 trillion. At 5.3 percent of gross domestic product (GDP), that deficit will be well below the peak of 10.1 percent in 2009 but still larger than in all but one year between 1947 and 2008 (see Figure 1-1). As a result, debt held by the public is estimated to increase to 76 percent of GDP by the end of 2013, the largest ratio since 1950.

CBO constructs its baseline projections of federal revenues and spending under the assumption that current laws generally remain unchanged. Under that assumption, revenues are projected to rise as a share of GDP over the next few years—from nearly 16 percent in 2012 to 17 percent in 2013, 18 percent in 2014, and then about 19 percent from 2015 through 2023 (see Table 1-1). Outlays in the baseline drop from almost 23 percent of GDP in 2012 to 21.5 percent in 2017; they begin to rise again later in the decade, reaching 22.9 percent in 2023.

As a result, in CBO's baseline projections, annual deficits remain above their prerecession 40-year average (1968 to 2007) through 2023 relative to the size of the economy. They decline as a percentage of GDP for the next two years, to 3.7 percent in 2014 and 2.4 percent in 2015. But, beginning in 2016, deficits in the baseline start to increase again, reaching 3.8 percent of GDP at the end of the 10-year projection period.

Those accumulating deficits would boost debt held by the public to a peak of almost 78 percent of GDP by the end of 2014, CBO estimates. Relative to the nation's output, the debt would decline over the following few years but then start to climb again in the latter part of the projection period, reaching 77 percent of GDP at the end of 2023. (As recently as the end of 2007, the debt was equal to only 36 percent of GDP.)

Although relative stability in the debt as a share of GDP over the next 10 years would be a welcome development after its sharp upward surge during the past several years, the projected path of the federal budget remains a significant concern for several reasons.

First, under the current-law baseline, the projected debt is very high by historical standards. Throughout the 2013–2023 period, debt held by the public is projected to be significantly greater relative to GDP than at any time since just after World War II; at no time is it anticipated to fall below the percentage of GDP it represented in any year between 1951 and 2012. If the amount of debt held by the public remains so large, federal spending on interest payments will increase substantially when interest rates rise to more normal levels. Because federal borrowing generally reduces national saving, the stock of capital assets, such as equipment and structures, will be smaller and aggregate wages will be less than if the debt were lower. In addition, lawmakers will have less flexibility than they ordinarily might to use tax and spending policies to respond to unanticipated challenges. Moreover, such a large debt poses an increased risk of precipitating a fiscal crisis, during which investors would lose so much confidence in the government's ability to manage its budget that the government would be unable to borrow at affordable rates.[1]

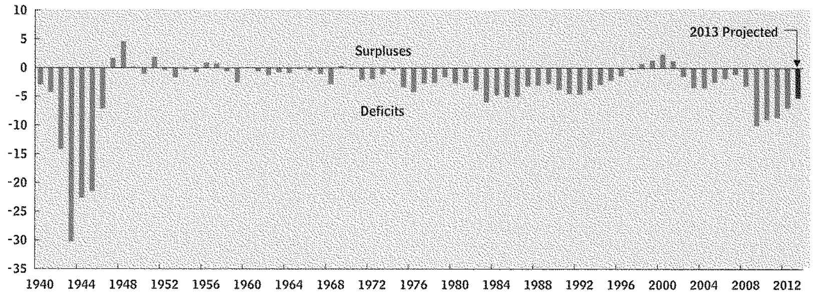
Second, deficits and the debt would be even larger if current laws were modified, as they have been in the past, to delay or undo certain scheduled changes in policy. CBO's baseline projections incorporate the assumption that the automatic spending reductions established by the Budget Control Act of 2011 (Public Law 112-25) will take effect at the beginning of March, that sharp reductions in Medicare's payment rates for physicians' services will occur at the beginning of January 2014, and that certain tax provisions that have regularly been extended but are

1. For a discussion of the consequences of elevated debt, see Congressional Budget Office, *Choices for Deficit Reduction* (November 2012), p.10, www.cbo.gov/publication/43692.

Figure 1-1.

Total Deficits or Surpluses

(Percentage of gross domestic product)



Source: Congressional Budget Office.

set to expire at the end of the calendar year (or, in some cases, in later years) will expire as scheduled. If those provisions of current law were removed, and if other changes in policies with offsetting effects on budget deficits were not enacted, budget deficits during the coming decade would be substantially larger than those shown in CBO's baseline projections. Specifically, under an alternative fiscal scenario, if those provisions of law were undone, debt held by the public would reach 87 percent of GDP at the end of 2023.

Third, deficits and the debt also might be larger than in CBO's baseline projections because holding discretionary spending within the limits required under current law might be difficult. Even if automatic spending reductions from the Budget Control Act were avoided, the original caps on discretionary budget authority established by that legislation would reduce such spending to an unusually small amount relative to the size of the economy. CBO projects that, with just those original caps in place, discretionary spending would equal 5.8 percent of GDP in 2023; by comparison, the lowest share for discretionary spending in any year since 1962 (the earliest year for which such data have been reported) was 6.2 percent in 1999. (Overall federal spending would be a larger share of GDP than its average during the past 40 years because of increased spending on Social Security, Medicare, Medicaid, health care subsidies for low-income people, and interest payments on the debt.) Because the allocation of discretionary spending is determined by annual appropriation acts, lawmakers have not yet decided which specific government services and benefits will be reduced or constrained to meet the specified limits.

Fourth, projections for the period covered in this report do not fully reflect long-term budgetary pressures, although upward pressure on the federal debt is evident in the later years of that period. Under current law, the aging of the population, the rising costs of health care, and the scheduled expansion in federal subsidies for health insurance will substantially boost federal spending on Social Security and the government's major health care programs, relative to GDP, for the next 10 years and for decades thereafter. Unless the laws governing those programs are changed—or the increased spending is accompanied by corresponding reductions in other spending, sufficiently higher tax revenues, or a combination of the two—debt will rise sharply relative to GDP after 2023.[2] Deciding now what policy changes to make to resolve that long-term imbalance would allow for gradual implementation, which would give households,

2. For a more detailed discussion of the long-term budget situation, see Congressional Budget Office, *The 2012 Long-Term Budget Outlook* (June 2012), www.cbo.gov/publication/43288. CBO has not yet updated its long-term projections to reflect the effects of the American Taxpayer Relief Act (P.L. 112-240) or other changes to its 10-year projections that have occurred since June 2012.

Table 1-1.

CBO's Baseline Budget Projections

	Actual, 2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	Total 2014-2018	Total 2014-2023
							In Billions of Dollars							
Revenues														
Individual income taxes	1,132	1,264	1,355	1,540	1,674	1,810	1,929	2,040	2,158	2,282	2,412	2,548	8,308	19,747
Social insurance taxes	845	953	1,021	1,068	1,129	1,195	1,256	1,314	1,372	1,433	1,498	1,565	5,670	12,852
Corporate income taxes	242	251	356	448	489	511	512	498	492	493	499	506	2,317	4,805
Other	229	241	270	317	299	249	239	249	258	288	326	342	1,374	2,837
Total	**2,449**	**2,708**	**3,003**	**3,373**	**3,591**	**3,765**	**3,937**	**4,101**	**4,279**	**4,496**	**4,734**	**4,961**	**17,669**	**40,241**
On-budget	1,880	2,038	2,271	2,607	2,779	2,904	3,029	3,149	3,285	3,457	3,651	3,832	13,589	30,963
Off-budget[a]	570	670	732	766	812	862	908	952	995	1,039	1,084	1,129	4,080	9,278
Outlays														
Mandatory	2,031	2,116	2,205	2,342	2,535	2,655	2,768	2,924	3,087	3,263	3,501	3,658	12,504	28,938
Discretionary	1,285	1,213	1,170	1,189	1,209	1,233	1,257	1,293	1,324	1,356	1,396	1,424	6,059	12,852
Net interest	223	224	243	272	323	412	517	593	667	730	795	857	1,767	5,410
Total	**3,538**	**3,553**	**3,618**	**3,803**	**4,067**	**4,300**	**4,542**	**4,811**	**5,078**	**5,350**	**5,691**	**5,939**	**20,330**	**47,199**
On-budget	3,031	2,910	2,901	3,039	3,255	3,437	3,627	3,842	4,048	4,256	4,529	4,704	16,259	37,637
Off-budget[a]	508	643	717	763	812	864	915	969	1,030	1,094	1,162	1,235	4,071	9,562
Deficit (-) or Surplus	**-1,089**	**-845**	**-616**	**-430**	**-476**	**-535**	**-605**	**-710**	**-798**	**-854**	**-957**	**-978**	**-2,661**	**-6,958**
On-budget	-1,151	-872	-630	-433	-476	-533	-598	-693	-763	-799	-878	-872	-2,670	-6,675
Off-budget[a]	62	27	14	3	*	-2	-6	-17	-35	-55	-79	-106	9	-283
Debt Held by the Public	11,280	12,229	12,937	13,462	14,025	14,642	15,316	16,092	16,957	17,876	18,902	19,944	n.a.	n.a.
Memorandum:														
Gross Domestic Product	15,549	16,034	16,646	17,632	18,792	19,959	20,943	21,890	22,854	23,842	24,858	25,910	93,972	213,326
							As a Percentage of Gross Domestic Product							
Revenues														
Individual income taxes	7.3	7.9	8.1	8.7	8.9	9.1	9.2	9.3	9.4	9.6	9.7	9.8	8.8	9.3
Social insurance taxes	5.4	5.9	6.1	6.1	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0
Corporate income taxes	1.6	1.6	2.1	2.5	2.6	2.6	2.4	2.3	2.2	2.1	2.0	2.0	2.5	2.3
Other	1.5	1.5	1.6	1.8	1.6	1.2	1.1	1.1	1.1	1.2	1.3	1.3	1.5	1.3
Total	**15.8**	**16.9**	**18.0**	**19.1**	**19.1**	**18.9**	**18.8**	**18.7**	**18.7**	**18.9**	**19.0**	**19.1**	**18.8**	**18.9**
On-budget	12.1	12.7	13.6	14.8	14.8	14.5	14.5	14.4	14.4	14.5	14.7	14.8	14.5	14.5
Off-budget[a]	3.7	4.2	4.4	4.3	4.3	4.3	4.3	4.3	4.4	4.4	4.4	4.4	4.3	4.3
Outlays														
Mandatory	13.1	13.2	13.2	13.3	13.5	13.3	13.2	13.4	13.5	13.7	14.1	14.1	13.3	13.6
Discretionary	8.3	7.6	7.0	6.7	6.4	6.2	6.0	5.9	5.8	5.7	5.6	5.5	6.4	6.0
Net interest	1.4	1.4	1.5	1.5	1.7	2.1	2.5	2.7	2.9	3.1	3.2	3.3	1.9	2.5
Total	**22.8**	**22.2**	**21.7**	**21.6**	**21.6**	**21.5**	**21.7**	**22.0**	**22.2**	**22.4**	**22.9**	**22.9**	**21.6**	**22.1**
On-budget	19.5	18.2	17.4	17.2	17.3	17.2	17.3	17.6	17.7	17.8	18.2	18.2	17.3	17.6
Off-budget[a]	3.3	4.0	4.3	4.3	4.3	4.3	4.4	4.4	4.5	4.6	4.7	4.8	4.3	4.5
Deficit (-) or Surplus	**-7.0**	**-5.3**	**-3.7**	**-2.4**	**-2.5**	**-2.7**	**-2.9**	**-3.2**	**-3.5**	**-3.6**	**-3.8**	**-3.8**	**-2.8**	**-3.3**
On-budget	-7.4	-5.4	-3.8	-2.5	-2.5	-2.7	-2.9	-3.2	-3.3	-3.3	-3.5	-3.4	-2.8	-3.1
Off-budget[a]	0.4	0.2	0.1	**	**	**	**	-0.1	-0.2	-0.2	-0.3	-0.4	**	-0.1
Debt Held by the Public	72.5	76.3	77.7	76.3	74.6	73.4	73.1	73.5	74.2	75.0	76.0	77.0	n.a.	n.a.

Source: Congressional Budget Office.

Note: * = between -$500 million and zero; n.a. = not applicable; ** = between -0.05 percent and 0.05 percent.

a. The revenues and outlays of the Social Security trust funds and the net cash flow of the Postal Service are classified as off-budget.

businesses, and state and local governments time to plan and adjust their behavior.

The baseline budget outlook has changed substantially from the projections that CBO published in August 2012.[3] At that time, deficits projected under current law totaled $2.3 trillion for the 2013–2022 period, or 1.1 percent of GDP. They are now $4.6 trillion larger. The majority of the increase in projected deficits stems from enactment of the American Taxpayer Relief Act of 2012 (P.L. 112-240) (see Box 1-1). Most of that effect results from reductions in revenues stemming from three types of changes:

- The permanent extension of lower tax rates for income below certain thresholds and other tax provisions originally enacted in 2001 and 2003,
- The permanent limit on the reach of the alternative minimum tax (AMT), and
- The temporary extension of other tax provisions that had expired at the end of 2011 or 2012.

The projections that make up CBO's baseline are not intended to be a forecast of budgetary outcomes. Rather, they are meant to provide a neutral benchmark that policymakers can use to assess the potential effects of policy decisions. Although CBO's baseline does not incorporate potential changes in law, this chapter shows how some alternatives would affect the budget over the next 10 years. For example, under CBO's baseline, funding for overseas contingency operations—that is, military operations and related activities in Afghanistan or other countries—is assumed to continue throughout the projection period at the level provided for 2013, with adjustments for inflation. Such funding has declined in recent years, however, so CBO has constructed a policy alternative reflecting that trend. Under that scenario, war-related funding would continue declining through 2015, rather than growing at the rate of inflation. As a result, the total deficit for the 2014–2023 period would be about $600 billion below the amounts projected in the baseline. In the other direction, if the automatic spending reductions put in place by the Budget Control Act did not take effect, deficits would be about $1 trillion higher over the projection period. (For more details, see "Alternative Assumptions About Fiscal Policy.")

Key Budgetary Decisions Facing Lawmakers in 2013

By changing some income tax rates and making permanent changes to the AMT, among other things, the American Taxpayer Relief Act has reduced the uncertainty surrounding federal fiscal policy. Nevertheless, many key budget issues remain unresolved.

Over the next few months, lawmakers will face three significant budgetary deadlines:

- Automatic spending reductions scheduled to be implemented at the beginning of March;
- The expiration in late March of a continuing resolution that provides operational funding for much of the federal government; and
- The statutory limit on federal debt, temporarily removed, which takes effect again in mid-May.

In addition, lawmakers still face the longer-term budget issues posed by the large current and projected federal debt and the implications of rising health care costs and the aging population.

Automatic Spending Reductions

The provisions of the Budget Control Act that established automatic procedures to restrain discretionary and mandatory spending are set to take effect on March 1; if fully implemented, they will reduce total funding in 2013 by $85 billion. (The American Taxpayer Relief Act delayed the reduction by two months and reduced it by $24 billion.) CBO estimates that, in 2013, discretionary funding (which is provided through annual appropriations) will decline by $71 billion and funding for mandatory programs (which is not subject to annual appropriations) will be reduced by $14 billion, as a result of those procedures. By CBO's estimate, budgetary resources for defense (other than spending for military personnel) will be cut by around 8 percent across the board, and nondefense funding that is subject to the automatic reductions will be cut by between 5 percent

3. For CBO's previous baseline budget projections, see Congressional Budget Office, *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022* (August 2012), www.cbo.gov/publication/43539.

and 6 percent (see Table 1-2 on page 14).[4] According to that estimate, discretionary outlays will drop by $35 billion and mandatory spending will be reduced by $9 billion this year as a direct result of those procedures; additional reductions in outlays attributable to the cuts in 2013 funding will occur in later years.[5] The deficit for 2013 will depend in part on whether those cuts are allowed to take place, are canceled (in whole or in part), or are replaced with other measures designed to reduce the deficit.

Continuing Resolution

Federal agencies are now operating under the Continuing Appropriations Resolution, 2013 (P.L. 112-175), which set discretionary funding for 2013 at an annual rate of $1.047 trillion, the sum of the caps established by the Budget Control Act (before the American Taxpayer Relief Act reduced the caps by $4 billion). That funding will expire on March 27, although following the rules in the Balanced Budget and Emergency Deficit Control Act of 1985, CBO's baseline incorporates the assumption that such funding will be extended at the current amount for the remainder of the fiscal year. If no additional appropriations are provided, nonessential functions of the government will cease operations after March 27. If final appropriations differ from those provided in the continuing resolution, CBO's projections of discretionary outlays will be affected for 2013 and future years.

Statutory Limit on Federal Debt

Until recently, the amount of debt that the Department of the Treasury could issue to the public and to other government accounts was capped at $16.394 trillion; that limit was reached at the end of December 2012. At that time, the Treasury began using what are known as extraordinary measures for managing cash and borrowing in order to continue funding the operations of the federal government. Lawmakers have recently suspended the limitation on borrowing through May 18, 2013, and on May 19, the existing debt limit will be raised by the amount of borrowing that occurred while the limitation was suspended (that is, from early February to May 18). If no further action is taken before May 19, the Treasury will once again resort to extraordinary measures to allow the government to continue operating normally. To avoid defaulting on the federal government's obligations, including possibly defaulting on the government's debt obligations, the debt ceiling will need to be adjusted before those extraordinary measures are exhausted later in the year.

Budgetary Outcomes in 2012 and the Outlook for 2013

In fiscal year 2012, the budget deficit totaled $1.1 trillion—$206 billion less than the shortfall recorded in 2011. As a percentage of GDP, the deficit declined from 8.7 percent in 2011 to 7.0 percent in 2012. Under current law, the budget shortfall will decline again in 2013, to $845 billion, or 5.3 percent of GDP, CBO estimates.

Revenues

Federal revenues increased by $147 billion (or 6 percent) in 2012, and they are projected to grow by $259 billion (or 11 percent) in 2013. If current laws remain the same, CBO estimates, revenues in 2013 will equal $2.7 trillion, or 16.9 percent of GDP, higher than the 15.8 percent of GDP recorded in 2012 and the highest percentage since 2008, although still below the average of about 18 percent of GDP over the past 40 years. The increase in revenues as a share of GDP expected for 2013 results largely from increases in payroll tax rates for all workers and individual income tax rates for upper incomes.

In 2012, receipts from corporate income taxes accounted for a large part of the increase in total revenues, rising by $61 billion (or 34 percent). Most of the gain resulted from changes in tax rules, notably a reduction between 2011 and 2012 in the portion of investments in equipment that businesses could deduct from their taxes in the year those investments were made. Receipts from individual income taxes rose by $41 billion (or 4 percent), and receipts from social insurance taxes rose by $27 billion (or 3 percent). Much of those gains resulted from increases in wages and salaries, which grew by about 3 percent last year. Receipts from other sources increased by $18 billion, mainly because of higher collections of estate and gift taxes and excise taxes.

4. The size of those automatic reductions will be determined by the Office of Management and Budget, which has not yet indicated what they will be. Most large nondefense programs (including, for example, Social Security, Medicaid, unemployment compensation, and veterans' benefits) are exempted from those cuts, and the reduction in Medicare is limited to 2 percent.

5. According to the rules for sequestration, reductions in Medicare will begin in the month after the sequestration order is issued, thereby delaying some of the effect on outlays until the following fiscal year. In addition, discretionary funding in subsequent years will be cut by roughly $90 billion annually as a result of the automatic reductions.

Box 1-1.

The American Taxpayer Relief Act of 2012

The American Taxpayer Relief Act of 2012 (Public Law 112-240), which was enacted in early January 2013, permanently extended some lower tax rates and other tax provisions that expired at the end of calendar year 2012, modified the alternative minimum tax (AMT) to permanently limit its reach, and temporarily extended other tax provisions. The law also extended emergency unemployment benefits, made changes in several health care programs, temporarily forestalled some provisions of the Budget Control Act of 2011 (P.L. 112-25), and extended agricultural subsidies.[1]

The Congressional Budget Office (CBO) and the staff of the Joint Committee on Taxation (JCT) estimate that, relative to laws in place at the end of 2012, enactment of the American Taxpayer Relief Act will add $4.0 trillion to federal deficits over the 2013–2022 period (see the table). Almost all of that amount—$3.9 trillion—will result from the extension of tax provisions. Other changes will increase deficits through 2022 by $42 billion. Major provisions of the law are discussed below.

Extensions of Tax Provisions

With some modifications that affect high-income taxpayers, the new law made permanent several tax provisions originally enacted in 2001 and 2003 that expired on December 31, 2012, including the following:

- Lower tax rates on ordinary income;
- An expanded 15 percent tax bracket and an increase in the standard deduction for married couples;
- The child tax credit of $1,000 per child;
- The 15 percent tax rate on long-term capital gains realizations and dividends; and
- The estate and gift tax rules in effect in 2012, with modifications.

At the end of 2012, tax rates on ordinary income were to rise from the lower rates in effect that year (10, 15, 25, 28, 33, and 35 percent) to the rates that had been in effect before 2001 (15, 28, 31, 36, and 39.6 percent). The new law permanently extended the lower rates, with the following exception: For single taxpayers whose income is above $400,000 and for married taxpayers filing jointly whose income is above $450,000, the new law sets the top tax rate at 39.6 percent, the same top rate that had been scheduled to take effect before the law was enacted.

The law permanently extended the increase in the child tax credit from $500 to $1,000 per child and provisions (also enacted in 2001) that made the credit refundable for more families. Before 2001, the credit was refundable only for families with three or more children. It also extended, through 2017, a lower earned income threshold for the refundability of the child tax credit, expansions to the earned income credit, and the American Opportunity Tax Credit—a refundable credit for postsecondary education expenses—all enacted in 2009.

Under prior law, the tax rate on capital gains was scheduled to rise to 20 percent and the tax rate on dividends was scheduled to equal the taxpayer's rate on other income. The new law kept the 15 percent limit on those rates for most taxpayers and raised the top rate on dividends and capital gains to 20 percent for high-income taxpayers. Separately, the law permanently extended the estate and gift tax rules in effect in 2012, although with a higher top tax rate of 40 percent. The law also increased the AMT's exemption amount (the higher amount had expired at the end of 2011) and indexed that amount (and other parameters of the tax) for inflation, beginning in 2013.

1. The budgetary effects of the law's provisions to extend federal agriculture programs and to prohibit Members of Congress from receiving cost-of-living adjustments in 2013 are not included in estimates shown here, either because those effects were already reflected in CBO's baseline projections or because the savings had been credited to previous legislation.

Continued

Box 1-1. Continued

The American Taxpayer Relief Act of 2012

Effects on the Deficit of the American Taxpayer Relief Act of 2012

(Billions of dollars)

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	Total 2013-2017	Total 2013-2022
Extensions of Tax Provisions	-280	-336	-313	-344	-375	-406	-417	-450	-485	-521	-1,648	-3,928
Unemployment Compensation	-22	-8	*	*	*	*	*	*	0	0	-30	-30
Medicare and Other Health Care Programs[a]	-13	-5	3	3	3	*	*	1	1	5	-8	-1
Other Provisions	-14	-5	-1	*	1	1	2	2	2	2	-20	-12
Total Change in the Deficit	**-329**	**-354**	**-311**	**-340**	**-371**	**-405**	**-416**	**-448**	**-482**	**-514**	**-1,706**	**-3,970**

Source: Congressional Budget Office.

Notes: Negative numbers indicate an increase in the deficit; positive numbers indicate a decrease in the deficit.

* = between -$500 million and zero.

a. The estimate shown in this table corrects an error in CBO's original cost estimate for the legislation, which showed a net cost of $1.7 billion, instead of the $1 billion net cost shown here, over the 2013–2022 period in the line labeled "Subtotal, Title VI, Estimated Outlays." See Congressional Budget Office, cost estimate for H.R. 8, the American Taxpayer Relief Act of 2012 (as passed by the Senate on January 1, 2013), www.cbo.gov/publication/43829.

Several tax provisions extended by the new law through calendar year 2013 had expired at the end of calendar year 2011. Some of those, including the research and experimentation tax credit, have routinely been extended in the past. The law also extended for one year a tax provision that allows businesses to immediately deduct 50 percent of new investments in equipment.

Changes to Other Provisions

The new law extended emergency unemployment compensation for a year, allowing certain people who have been unemployed for a long time to receive benefits through December 2013. That provision had an estimated cost of $30 billion.

The law prevented Medicare's payments to physicians from being cut by about 27 percent, as prior law would have required. Instead, through December 2013, payment rates will remain at amounts in effect in 2012. The law also postpones reductions in Medicare's payments for several other types of services, including ambulance services and speech, physical, and occupational therapy. The estimated $30 billion cost of those provisions was mostly offset by other changes to Medicare and other federal health care programs. The largest offsetting savings come from reductions in Medicare's payment rates for inpatient hospital and dialysis services and from a reduction in Medicaid's payments to states for hospitals that serve a disproportionate share of Medicaid patients and patients who have no health insurance.

The law also delayed and reduced the amount of the automatic spending reductions required by the Budget Control Act of 2011. Those reductions are now scheduled to take effect on March 1, rather than on January 1, and the amount of the reductions in budget authority was reduced by $24 billion. In addition, the law permits individuals to convert balances in tax-deferred 401(k) and similar employment-based retirement accounts into Roth accounts. Such conversions will result in taxes being paid earlier than they otherwise would be, increasing revenues by $12 billion through 2022, JCT estimates, but reducing revenues beyond 2022. Taken together, those provisions will increase deficits by an estimated $12 billion over fiscal years 2013 through 2022.

Table 1-2.

CBO's Estimates of Automatic Spending Reductions for 2013

	Reduction in Budgetary Resources (Billions of dollars)	Percentage Reduction
Defense		
Discretionary	42.7	7.9
Mandatory	*	7.8
Total	42.7	7.9
Nondefense		
Discretionary	28.7	5.3
Mandatory		
Medicare spending subject to 2 percent limit[a]	9.9	2.0
Other	4.0	5.8
Total	42.7	4.6

Source: Congressional Budget Office.

Notes: Budgetary resources subject to sequestration include new budget authority, unobligated balances for defense programs, and direct spending authority.

These estimates use CBO's baseline projections for 2013 as a basis for allocating the reductions among categories. However, the Office of Management and Budget will make the official calculations, using its own numbers; as a result, the actual percentage reductions could differ from those shown here by a few tenths of a percentage point in either direction.

* = between zero and $50 million.

a. The sequestration cannot exceed 2 percent for payments made for individual services covered under Medicare Part A (Hospital Insurance) and Part B (Medical Insurance) and monthly contractual payments for Part C (Medicare Advantage plans) and Part D (prescription drug benefit plans). According to the rules for sequestration, reductions in Medicare will begin in the month after the sequestration order is issued, thereby delaying some of the effect on outlays until the following fiscal year.

In 2013, CBO expects that revenues will increase at a faster pace, mostly as a result of robust increases in receipts from individual income and social insurance taxes. Receipts from individual income taxes are anticipated to rise by $131 billion (or 12 percent). Just under half of the increase is from changes in tax provisions, including increases in income tax rates and a new surtax on investment income, both affecting certain high-income taxpayers, beginning in January 2013. In addition, shifting of income—such as capital gains realizations from stock and other asset sales, wages and salaries, and dividends—mainly from calendar year 2013 into late 2012 in anticipation of those rate changes (and in anticipation of possible rate changes that did not ultimately occur) is expected to increase revenues in fiscal year 2013 and reduce them in 2014, when some of the taxes on that income would have been paid.[6] The other, slightly larger part of the expected gain in 2013 stems from increases in wages and salaries, capital gains realizations (apart from the effects of the changing tax rates), and retirement and other types of income.

Receipts from social insurance taxes in 2013 are expected to increase by $108 billion (or 13 percent), mainly because of the expiration of the 2 percentage-point reduction in the employee's portion of the Social Security payroll tax rate that was in effect in calendar years 2011 and 2012.

Corporate income tax receipts are estimated to rise by $9 billion (or 4 percent) in 2013 because of an increase in the average tax rate on domestic economic profits (the profits themselves are anticipated to be about the same as in 2012).

Outlays

In 2012, federal spending dropped by $60 billion (or 1.7 percent) from its 2011 mark to an amount slightly above $3.5 trillion. However, that decline occurred in part because about $30 billion in payments that ordinarily would have been made on October 1, 2011 (which fell on a weekend), were shifted into September 2011

6. The shifting of income will reduce revenues over time by moving the income into a year with lower tax rates. CBO estimates that the most significant shifting of revenues between those two years occurred for capital gains realizations; the revenue effects from shifts in wages and salaries occur largely within fiscal year 2013.

(and thus into the previous fiscal year). Had the shift not occurred, outlays in fiscal year 2012 would have been about the same as in fiscal year 2011. That result stands in marked contrast to most of the past decade; in 7 out of 10 years, federal outlays increased by more than 6 percent from the year before.

CBO estimates that outlays in 2013 will total $3.55 trillion, within 0.4 percent of outlays recorded in 2012. As a percentage of GDP, outlays will fall slightly, according to CBO's estimates, from 22.8 percent in 2012 to 22.2 percent—a share that is still larger than in any year between 1986 and 2008.

Mandatory Spending. Spending for mandatory programs changed little in 2012, increasing by just 0.5 percent, or $10 billion. Without the shift of about $27 billion in certain payments from 2012 into 2011, however, mandatory outlays would have risen by 3 percent, or $63 billion. (Mandatory outlays grew at an average annual rate of about 7 percent between 2002 and 2011.) Mandatory spending (adjusted for that shift of payments) is projected to increase by 3 percent again in 2013.

The Troubled Asset Relief Program. The largest change in mandatory spending in 2012 was for the Troubled Asset Relief Program (TARP). By law, the costs of investments made under that program are estimated as the present value of anticipated net outlays, calculated using a discount rate that incorporates market risk.[7] The estimates are adjusted annually to account for an updated valuation of the cash flows associated with the program. In 2012, the estimated costs of the program's transactions made in earlier years were revised upward by $21 billion. In addition, the TARP recorded $3 billion in new spending, primarily for mortgage assistance, thus pushing outlays for the program to about $25 billion in 2012. That total is $62 billion more than the outlays recorded for 2011, when a $58 billion downward revision of previous estimates and $21 billion in new spending caused the Treasury to record negative outlays of $37 billion for the program. This year, CBO anticipates, the net effect of the TARP will be to reduce the budget deficit by $13 billion, largely because the Treasury sold its shares of AIG stock at prices that were significantly higher than previously anticipated (see Table 1-3). That figure would be $38 billion less than the $25 billion net cost recorded for 2012.[8]

7. Present value is a single number that expresses a flow of current and future income (or payments) in terms of an equivalent lump sum received (or paid) today.

Social Security. Social Security outlays grew by $43 billion (or 6 percent) in fiscal year 2012, primarily because beneficiaries received a 3.6 percent cost-of-living adjustment in January 2012 (which applied to three-quarters of the fiscal year; there was no increase the previous year). In addition, the number of people receiving benefits grew by 2.5 percent. That cost-of-living adjustment also boosted benefits in the first quarter of fiscal year 2013; this January's cost-of-living adjustment was smaller (1.7 percent), as is the estimated increase in the number of beneficiaries (2.4 percent). All told, outlays are projected to increase by the same amount—$43 billion—in 2013 as they did in 2012.

Medicare. Net outlays for Medicare (excluding the effects of the shift in the timing of the first scheduled payments to health plans from fiscal year 2012 into fiscal year 2011) grew by 3 percent (or $16 billion) in 2012—a slower rate of growth than any recorded since 2000. Medicare's outlays will increase by 4 percent (or $21 billion) in 2013, CBO estimates. (Those amounts are net of receipts from premiums paid by the program's beneficiaries.)

Unemployment Compensation. The largest decline in spending in 2012 was for unemployment compensation. The number of people receiving first-time payments of regular unemployment benefits, which peaked in 2009 at 14.4 million, continued to fall in 2012, totaling 8.7 million. As a result, outlays for unemployment compensation dropped by $26 billion last year, to $93 billion. The decline is expected to continue—to $76 billion in 2013—as fewer of the long-term unemployed will be in states that qualify to provide the maximum number of weeks of emergency and extended unemployment benefits.[9]

8. CBO now estimates that the TARP will cost $22 billion (excluding administrative costs) over its lifetime.

9. Emergency unemployment benefits are currently available through December 2013. The maximum number of weeks that the long-term unemployed can receive benefits depends on the unemployment rate of the state in which they worked. Under current law, a state must have an unemployment rate at or above 9 percent in order to provide benefits for the maximum number of weeks under that program. The payment of extended benefits also requires a state's unemployment rate to be relatively high. For example, in order to provide extended benefits, a state's unemployment rate must not only exceed a certain threshold but it must be rising relative to recent unemployment rates in that state.

Table 1-3.

Mandatory Outlays Projected in CBO's Baseline

(Billions of dollars)

	Actual, 2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	Total 2014-2018	Total 2014-2023
Social Security														
Old-Age and Survivors Insurance	632	668	706	747	792	841	894	951	1,013	1,075	1,140	1,209	3,979	9,368
Disability Insurance	136	142	148	155	161	167	173	179	186	195	204	214	804	1,781
Subtotal	768	810	854	902	953	1,008	1,067	1,130	1,199	1,270	1,344	1,423	4,783	11,149
Health Care Programs														
Medicare[a]	551	592	605	627	680	706	741	811	867	928	1,024	1,079	3,360	8,070
Medicaid	251	265	297	331	372	399	422	449	476	505	536	572	1,821	4,360
Health insurance subsidies, exchanges, and related spending	*	1	21	42	74	95	106	111	115	122	128	134	339	949
MERHCF	9	9	9	10	10	11	12	13	13	14	15	16	52	124
Children's Health Insurance Program	9	9	13	14	8	6	6	6	6	6	6	6	47	75
Other	6	8	6	25	23	29	26	28	30	32	35	38	109	272
Subtotal[a]	825	885	951	1,049	1,168	1,246	1,314	1,417	1,508	1,608	1,744	1,845	5,727	13,850
Income Security														
Supplemental Nutrition Assistance Program	80	82	80	79	79	78	76	75	74	73	73	73	392	760
Supplemental Security Income	47	53	55	56	63	59	56	63	64	66	74	70	289	626
Unemployment compensation	93	76	53	46	43	42	43	46	50	53	57	59	227	492
Earned income and child tax credits	77	80	83	84	83	83	84	73	74	75	77	78	417	794
Family support[b]	24	25	25	25	25	25	25	25	25	25	25	25	123	248
Child nutrition	19	21	22	22	23	24	25	26	27	28	29	30	117	257
Foster care	7	7	7	7	7	7	7	8	8	8	8	8	36	76
Miscellaneous tax credits[c]	7	6	6	6	6	6	7	0	0	0	0	0	31	31
Subtotal	354	349	330	325	330	325	323	315	322	329	342	344	1,633	3,285
Federal Civilian and Military Retirement														
Civilian[d]	87	89	92	94	98	101	104	108	112	115	119	122	489	1,065
Military	49	54	56	57	63	61	58	64	66	68	75	72	294	638
Other	7	7	7	6	7	7	8	9	9	10	10	10	35	83
Subtotal	143	150	154	158	167	169	170	181	187	193	204	205	818	1,786
Veterans[e]														
Income security	56	65	70	72	81	78	74	82	83	84	92	86	375	801
Other	12	13	13	13	14	14	15	16	17	17	19	19	69	157
Subtotal	68	78	83	85	95	92	88	98	100	101	111	105	444	958
Other Programs														
Agriculture	12	23	15	16	16	16	15	16	16	16	16	16	78	158
Troubled Asset Relief Program	25	-13	3	2	1	1	*	*	*	*	0	0	7	7
Higher education	-19	-18	-22	-20	-12	-3	3	4	4	3	3	3	-54	-36
Deposit insurance	7	7	-9	-10	-11	-12	-13	-18	-18	-13	-14	-15	-54	-131
Other	57	47	56	54	56	56	54	54	53	53	60	60	277	558
Subtotal	82	48	43	42	51	58	60	56	55	60	66	65	254	556

Continued

Table 1-3. Continued

Mandatory Outlays Projected in CBO's Baseline

(Billions of dollars)

	Actual, 2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	Total 2014-2018	Total 2014-2023
Offsetting Receipts														
Medicare[f]	-85	-90	-96	-97	-102	-111	-121	-131	-139	-149	-162	-176	-527	-1,285
Federal share of federal employees' retirement														
Social Security	-16	-16	-16	-17	-18	-18	-19	-20	-21	-21	-22	-23	-88	-195
Military retirement	-22	-21	-21	-21	-22	-23	-24	-25	-26	-27	-28	-29	-111	-243
Civil service retirement and other	-30	-29	-30	-31	-32	-33	-34	-35	-37	-38	-40	-41	-159	-351
Subtotal	-67	-66	-67	-69	-71	-74	-77	-80	-83	-86	-89	-93	-358	-789
Receipts related to natural resources	-13	-15	-14	-14	-15	-14	-15	-19	-17	-18	-18	-18	-73	-164
MERHCF	-11	-9	-9	-9	-10	-10	-11	-12	-12	-13	-14	-14	-49	-114
Other	-33	-25	-23	-29	-32	-34	-30	-31	-31	-32	-27	-27	-148	-295
Subtotal	-209	-205	-209	-219	-230	-243	-255	-273	-282	-298	-310	-328	-1,154	-2,646
Total	**2,031**	**2,116**	**2,205**	**2,342**	**2,535**	**2,655**	**2,768**	**2,924**	**3,087**	**3,263**	**3,501**	**3,658**	**12,504**	**28,938**
Memorandum:														
Mandatory Spending Excluding Offsetting Receipts	2,240	2,321	2,414	2,560	2,765	2,897	3,022	3,197	3,369	3,561	3,812	3,986	13,659	31,584
Medicare Spending Net of Offsetting Receipts	466	502	509	529	578	596	620	680	728	779	862	903	2,833	6,785
Spending for Major Health Care Programs Net of Offsetting Receipts[g]	726	778	840	917	1,033	1,095	1,154	1,246	1,325	1,412	1,532	1,615	5,039	12,169

Source: Congressional Budget Office.

Notes: Data on spending for benefit programs in this table generally exclude administrative costs, which are discretionary.

* = between zero and $500 million; MERHCF = Department of Defense Medicare-Eligible Retiree Health Care Fund (including TRICARE for Life).

a. Excludes offsetting receipts from premium payments and from payments by states from savings on Medicaid's prescription drug costs.

b. Includes Temporary Assistance for Needy Families and various programs that involve payments to states for child support enforcement and family support, child care entitlements, and research to benefit children.

c. Includes outlays for the American Opportunity Tax Credit, the first-time homebuyer credit, and other tax credits.

d. Includes Civil Service, Foreign Service, Coast Guard, and other, smaller retirement programs as well as annuitants' health care benefits.

e. Income security includes veterans' compensation, pensions, and life insurance programs. Other benefits are primarily education subsidies.

f. Includes Medicare premiums and amounts paid by states from savings on Medicaid's prescription drug costs.

g. Includes Medicare (net of receipts from premiums), Medicaid, the Children's Health Insurance Program, and subsidies offered through new health insurance exchanges and related spending.

Medicaid. Medicaid spending also declined in 2012—by $24 billion (or 9 percent)—primarily because a temporary increase in the federal share of the program's costs expired in June 2011. That increase initially took effect in 2009 under the American Recovery and Reinvestment Act of 2009 (ARRA, P.L. 111-5) and was extended in modified form through June 2011; it was therefore not in place in fiscal year 2012. In 2013, Medicaid outlays will increase by $15 billion (or 6 percent), CBO estimates.

The Making Work Pay Tax Credit. This refundable tax credit (which expired at the end of December 2010) amounted to 6.2 percent of an eligible individual's earned income for tax years 2009 and 2010 (up to a maximum of $400 for individuals or $800 for joint filers). Because it was refundable, any portion that exceeded an individual's tax liability was paid to that person and recorded as an outlay in the budget. Because the credit expired, its associated outlays fell by $14 billion between fiscal year 2011 and fiscal year 2012.

Other Mandatory Spending. Spending for all other mandatory programs rose by $7 billion from 2011 to 2012 (after adjusting for the shift in certain payments). In 2013, other mandatory spending is anticipated to rise by about $35 billion (or 8 percent), in part because of an increase in spending for agriculture programs ($11 billion).

Discretionary Spending. In fiscal year 2012, total discretionary budget authority (that is, the authority provided in appropriation acts to incur financial obligations that will result in immediate or future outlays) dropped by $23 billion (or 2 percent). Discretionary outlays fell by $62 billion (or 5 percent) in 2012—only the fourth time since 1962 that such outlays have fallen. The decline was divided about equally between defense and nondefense outlays and stemmed mostly from the waning of spending from funds provided in ARRA and from a reduction in spending for military operations and related activities in Afghanistan and Iraq.

In 2013, discretionary budget authority is set to drop by another $58 billion (or 5 percent) to $1,140 billion. The automatic spending reductions put in place by the Budget Control Act will reduce funding by $71 billion, and on an annualized basis, funding for war-related activities, primarily in Afghanistan, will fall by $27 billion in 2013, CBO estimates. Partially offsetting those reductions is $50 billion in funding provided in response to Hurricane Sandy. Funding for all other discretionary programs is $10 billion lower than in the previous year. Total discretionary outlays will fall by $72 billion (or 6 percent) in the current year, CBO projects.

The caps on discretionary budget authority in place for 2013 apply to security and nonsecurity categories, rather than to defense and nondefense categories (which apply for the years between 2014 and 2021).[10] Currently, the amount of funding provided in 2013 for each category exceeds the amount allowed by the caps—by $6.8 billion for security and by $1.0 billion for nonsecurity, CBO estimates (see Table 1-4).

CBO's Baseline Budget Projections for 2014 to 2023

CBO constructs its baseline in accordance with provisions set forth in the Balanced Budget and Emergency Deficit Control Act of 1985 and the Congressional Budget and Impoundment Control Act of 1974. For the most part, those laws require that the baseline projections incorporate the assumption that current laws governing taxes and spending in future years are fully implemented.

Under those assumptions, CBO projects that the budget deficit will continue to shrink relative to the size of the economy—from 3.7 percent of GDP next year to a low of 2.4 percent by 2015. In dollar terms, the deficit is projected to fall roughly by half between 2013 and 2015. Beginning in 2016, the deficit is projected to increase again both in dollar terms and as a share of the economy, measuring 3.8 percent of GDP by 2023. For the 2014–2023 period, revenues and outlays alike are projected to be above their 40-year averages as a percentage of GDP (see Figure 1-2).

Under CBO's baseline projections, most of the decline in the deficit in the next two years is the result of a projected significant rise in revenues, which are estimated to increase by 25 percent between 2013 and 2015. As a share of GDP, revenues in the baseline rise from 16.9 percent in 2013 to 19.1 percent in 2015, resulting about equally from changes in tax rules and from other factors related mainly to the strengthening economy. CBO projects that revenues will remain at about 19 percent of GDP for the rest of the 10-year period.

In CBO's baseline, outlays initially decline slightly as a percentage of GDP, from 21.7 percent in 2014 to a low of 21.5 percent in 2017, and then follow an upward trend thereafter, reaching 22.9 percent by the end of the decade. Because of the aging of the population, rising

10. For fiscal year 2013, the security category comprises discretionary appropriations for the Departments of Defense, Homeland Security, and Veterans Affairs; the National Nuclear Security Administration; the intelligence community management account (Treasury account 95-0401-0-1-054); and discretionary accounts related to international affairs (budget function 150). The nonsecurity category comprises all other discretionary appropriations.

Table 1-4.

Limits on Discretionary Budget Authority for 2013

(Millions of dollars)

	Security[a]	Nonsecurity[a]	Total
Caps for 2013 in the Deficit Control Act[b]	684,000	359,000	1,043,000
Adjustments			
Overseas contingency operations[c]	99,941	0	99,941
Emergency[d]	7,015	34,627	41,642
Disaster relief[e]	11,779	0	11,779
Program integrity[f]	0	483	483
Total	118,735	35,110	153,845
Adjusted Caps for 2013	802,735	394,110	1,196,845
Budget Authority as Estimated by CBO When the Legislation Was Enacted[g]	809,572	395,133	1,204,705
Amount by Which Budget Authority Exceeds the Caps	6,837	1,023	7,860
Memorandum:			
Budget Authority in CBO's Baseline			
Excluding automatic spending reductions and reductions to meet the caps[g,h]	809,026	409,900	1,218,926
Automatic spending reductions[i]	-50,828	-20,522	-71,350
Reductions to meet the caps	-6,837	-1,023	-7,860
Total	751,361	388,355	1,139,716

Source: Congressional Budget Office.

a. For 2013, the security category comprises discretionary appropriations for the Departments of Defense, Homeland Security, and Veterans Affairs; the National Nuclear Security Administration; the intelligence community management account (Treasury account 95-0401-0-1-054); and discretionary accounts related to international affairs (budget function 150). The nonsecurity category comprises all other discretionary appropriations.

b. The Budget Control Act of 2011 amended the Balanced Budget and Emergency Deficit Control Act of 1985 to reinstate caps on discretionary budget authority. The American Taxpayer Relief Act of 2012 reduced the caps on security and nonsecurity funding for 2013 by $2 billion each (and reduced the caps on defense and nondefense funding for 2014 by $4 billion each). In addition, automatic procedures are slated to go into effect on March 1 to reduce discretionary funding in 2013 by another $71,350 million, CBO estimates.

c. This category consists of funding for war-related activities in Afghanistan or for similar activities.

d. This category consists mostly of funding for relief and recovery from Hurricane Sandy that was designated as an emergency requirement by the Congress. About $5 billion in funding related to Hurricane Sandy was declared disaster relief, and about $3 billion was not declared either as an emergency requirement or as disaster relief. Another $0.5 billion was provided for the Social Services Block Grant program and is classified as mandatory spending in CBO's baseline.

e. For the purposes of adjustments to the cap, disaster relief refers to activities carried out pursuant to section 102(2) of the Robert T. Stafford Disaster Relief and Emergency Assistance Act; such activities may result from a natural disaster that causes damage of sufficient severity to warrant federal assistance.

f. Program integrity initiatives identify and reduce overpayments in benefit programs, such as Disability Insurance, Supplemental Security Income, Medicare, Medicaid, and the Children's Health Insurance Program. For 2013, funding for program integrity initiatives thus far has been provided only for Disability Insurance and Supplemental Security Income.

g. Through March 27, 2013, federal agencies are operating under the Continuing Appropriations Resolution, 2013. The figures in this table are generally annualized totals based on the provisions of that law as modified by the American Taxpayer Relief Act of 2012 and the Disaster Relief Appropriations Act, 2013. The totals exclude the effects of the automatic spending reductions and reductions to meet this year's caps on discretionary budget authority.

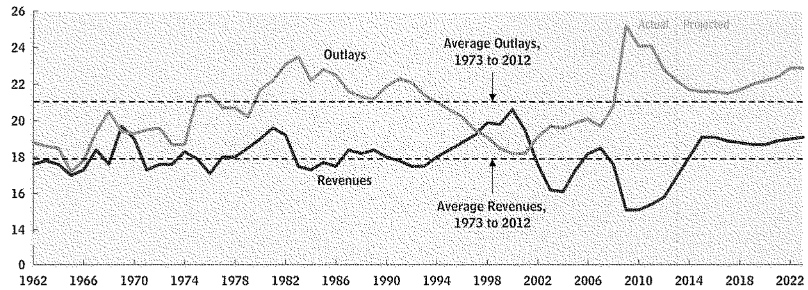
h. The amount of budget authority in CBO's baseline does not match the amount that CBO estimated when the continuing resolution was enacted, for two main reasons. First, nearly $20 billion in savings from changes to mandatory programs included in the resolution was credited against discretionary spending when the legislation was enacted; in CBO's baseline, those savings appear in their normal mandatory accounts. Second, current estimates of receipts of the Federal Housing Administration are about $4 billion higher than the amounts initially credited to the legislation.

i. As specified in the Budget Control Act, the automatic spending reductions will be allocated between defense and nondefense spending. For this table, CBO has apportioned those amounts to the security and nonsecurity categories.

Figure 1-2.

Total Revenues and Outlays

(Percentage of gross domestic product)



Source: Congressional Budget Office.

health care costs, and a significant expansion in eligibility for federal subsidies for health insurance, outlays for Social Security and the federal government's major health care programs are projected to rise substantially relative to the size of the economy over the next 10 years. In addition, growing debt and rising interest rates will boost net interest payments. Spending on all other programs—in the aggregate—is projected to decline relative to GDP between 2014 and 2023, primarily because of improving economic conditions and the spending limits in current law.

Revenues

CBO projects that, if current tax laws remain unchanged, revenues will rise relative to GDP over the next two years and then remain at about 19 percent of GDP through 2023. After 2015, increases in individual income tax receipts relative to GDP will roughly offset projected declines in corporate income tax receipts and declines in remittances from the Federal Reserve as a share of GDP.

Individual Income Taxes. CBO projects that, under current law, individual income tax receipts will rise from \$1.3 trillion this year to \$2.5 trillion in 2023—or from 7.9 percent to 9.8 percent of GDP. The projected increase in receipts relative to the economy in CBO's baseline reflects real (inflation-adjusted) bracket creep, the economic expansion, recent and scheduled changes in tax provisions, and other factors. In previous baselines, CBO had projected that those receipts would increase to a much higher percentage of GDP by the early part of the next decade, but the American Taxpayer Relief Act's permanent extension of most of the expiring income tax reductions has significantly reduced the amount of revenues anticipated under current law.

Real Bracket Creep. Increases in real income will push more income into higher tax brackets, which boosts revenues relative to GDP in CBO's projections by 0.9 percentage points over the next decade.[11]

Economic Recovery. CBO expects that the economic expansion and related factors will cause taxable incomes to rise faster than GDP, boosting individual income tax revenues as a share of GDP by about 0.4 percentage points over the next decade; most of that effect will occur by 2017. Certain components of taxable income—including wages and salaries, capital gains realizations, interest income, and proprietors' income—declined as a share of GDP over the past several years. CBO expects that, as the economy recovers, such income will rebound more quickly than the economy as a whole, increasing

11. Roughly three-quarters of that amount is a longer-term effect that results from increases in the potential output of the economy (that is, the maximum sustainable level of economic output), and the rest results from the return of output to its potential level over the next several years.

revenues as a percentage of GDP. (For more detail, see "Projections of Income" in Chapter 2.)

Changes in Tax Provisions. Several recent and scheduled changes in tax rules will, on net, increase individual income tax revenues as a share of GDP by 0.2 percentage points, CBO projects. Most significant are tax rates that apply to high-income individuals, which increased in January 2013 both because the American Taxpayer Relief Act did not extend the lower tax rates for those taxpayers and because a new surtax on investment income, enacted in the Affordable Care Act, takes effect in 2013.[12] In addition, for certain higher-income taxpayers, the American Taxpayer Relief Act reinstated limitations on the use of personal exemptions and itemized deductions. CBO expects that those changes will increase revenues as a percentage of GDP in fiscal year 2013 and will raise revenues even more, relative to GDP, in 2014, when they are first in effect for a full fiscal year. That impact persists through the next decade in CBO's baseline projections.

Other Factors. CBO estimates that other factors will increase individual income tax revenues, measured as a share of GDP, by 0.5 percentage points. Those factors include rapid growth in taxable distributions from tax-deferred retirement accounts (such as individual retirement accounts and 401(k) plans) as the population ages. CBO also expects that wages and salaries of higher-income taxpayers will grow faster than those of other taxpayers, boosting average tax rates.

Social Insurance Taxes. CBO expects that, under current law, receipts from social insurance taxes (which are dedicated to funding Medicare, Social Security, other retirement programs, and unemployment benefits) will edge up from 5.9 percent of GDP this year to 6.1 percent in 2014, and then remain at about 6.0 percent of GDP thereafter. The principal source of the initial increase in revenues relative to GDP is the expiration of the payroll tax cut that was in effect in calendar years 2011 and 2012. The employee's share of the tax was reduced by 2 percentage points (from 6.2 percent of wages to 4.2 percent) for those years, reducing receipts in fiscal years 2011 through 2013.

Social insurance receipts will remain stable as a percentage of GDP after 2014, CBO projects, reflecting the offsetting effects of a projected increase in wages and salaries relative to GDP and a projected decrease in social insurance receipts relative to wages and salaries.

CBO expects that wages and salaries, which have declined as a share of GDP since 2009 as they have generally over the past few decades, will grow faster than the economy over the next 10 years, although remaining below their average share of GDP in recent decades. Social insurance receipts, however, are expected to decline relative to wages and salaries because a growing share of earnings is anticipated to be above the taxable maximum amount for Social Security payroll taxes. (That amount, currently $113,700, is indexed to the growth of average wages.) In addition, CBO expects receipts from unemployment insurance taxes, which include state unemployment taxes, to decline to more typical levels in coming years; those taxes have been higher than normal in recent years as states have raised their tax rates and tax bases to replenish unemployment insurance trust funds.

Corporate Income Taxes. Under current law, receipts from corporate income taxes will climb sharply relative to GDP over the next several years, CBO projects—from 1.6 percent this year to 2.5 percent in 2015 and 2.6 percent in 2016 and 2017—before declining to 2.0 percent of GDP by 2023, about the average of the past 40 years.

The average tax rate on domestic economic profits has been low by historical standards for the past several years. Temporary changes to the tax code, including provisions that allowed businesses to accelerate their deductions for equipment purchases, have contributed. CBO projects that the scheduled expiration under current law of those and certain other tax provisions, such as the research and experimentation tax credit, will raise corporate income tax receipts as a share of GDP by about 0.4 percentage points over the next two years. CBO expects that other factors contributing to the low average tax rate on domestic economic profits, such as deductions for bad debts (which have been high by historical standards), will gradually dissipate as the economy recovers, boosting revenues, measured as a share of GDP, by about 0.5 percentage points by 2015.

12. The Affordable Care Act comprises the Patient Protection and Affordable Care Act (P.L. 111-148) and the health care provisions of the Health Care and Education Reconciliation Act of 2010 (P.L. 111-152) and, in the case of this document, the effects of subsequent related judicial decisions, statutory changes, and administrative actions.

Between 2017 and 2022, corporate income tax receipts will decline by 0.6 percentage points of GDP, CBO projects, reducing those receipts to 2.0 percent of GDP in 2023. That decline stems largely from an expected drop in domestic economic profits relative to GDP, which in turn results from the rising burden of corporate interest payments, depreciation on the larger stock of business capital, and growth in the share of income going to labor.

Earnings of the Federal Reserve System. Income produced by the various activities of the Federal Reserve System, minus the costs of generating that income and the system's operations, is remitted to the Treasury and counted as revenue. Over the past several years, the Federal Reserve has more than tripled the size of its asset holdings through significant purchases of Treasury securities and mortgage-backed securities issued by Fannie Mae, Freddie Mac, and Ginnie Mae. Those actions caused remittances from the Federal Reserve to climb from 0.2 percent of GDP in 2009 to about 0.5 percent of GDP from 2010 through 2012, where they are expected to remain in 2013.

CBO expects those earnings to edge higher in 2014 and 2015, to about 0.6 percent of GDP, as the Federal Reserve further increases its holdings of Treasury and mortgage-backed securities. Beyond 2015, CBO expects remittances from the Federal Reserve to decline, falling to zero between 2018 and 2020.[13] That drop reflects expected sales of assets by the Federal Reserve as the economy grows to near its potential, which would generate capital losses as interest rates rise. Also expected is an increase in the federal funds rate, which would sharply boost the Federal Reserve's costs of paying interest on reserves of depository institutions.[14] The higher interest rates anticipated after 2015 would initially have a limited effect on earnings from the securities held by the central bank, because it would only gradually purchase new securities earning the higher yields.

In CBO's baseline projections, the Federal Reserve begins remittances to the Treasury again in 2021 that increase thereafter, growing to 0.2 percent of GDP by 2023, about the average in the decade from 2001 through 2010. CBO expects that several factors will contribute to the increase in remittances, including the end of asset sales and their associated losses, a reduction in interest payments on reserves as reserves fall back to more normal levels, and a gradual increase in the share of the portfolio consisting of higher-yielding securities as the portfolio begins to grow again.

Receipts from Other Sources. The federal government also collects revenues from excise taxes, estate and gift taxes, customs duties, and miscellaneous levies. CBO projects that receipts from those sources will rise from 1.0 percent of GDP in 2013 and 2014 to 1.2 percent of GDP in 2015, mainly as a result of new excise taxes and miscellaneous levies enacted in the Affordable Care Act. Revenues from other sources edge downward in CBO's projections to 1.1 percent of GDP after 2017, mostly because improved fuel efficiency of cars and trucks is expected to reduce receipts from excise taxes on motor fuels.

Outlays

The Deficit Control Act requires CBO's projections for most mandatory programs to be made in keeping with the assumption that current laws continue unchanged.[15] Thus, CBO's baseline projections for mandatory programs reflect the automatic enforcement procedures of the Budget Control Act and expected changes in the economy, demographics, and other factors. For discretionary spending, CBO's baseline incorporates the caps put in place by the Budget Control Act and accounts for further reductions in such spending that are scheduled to occur under the act's automatic enforcement procedures. On that basis, total outlays are projected to decline slightly relative to GDP between 2014 and 2017 and then to rise in most years through 2023—averaging 22.1 percent over the decade, slightly above the

13. The Federal Reserve's remittances would not drop below zero. Rather, the net losses that CBO projects for 2018 and 2019 would be carried forward and netted against future payments.

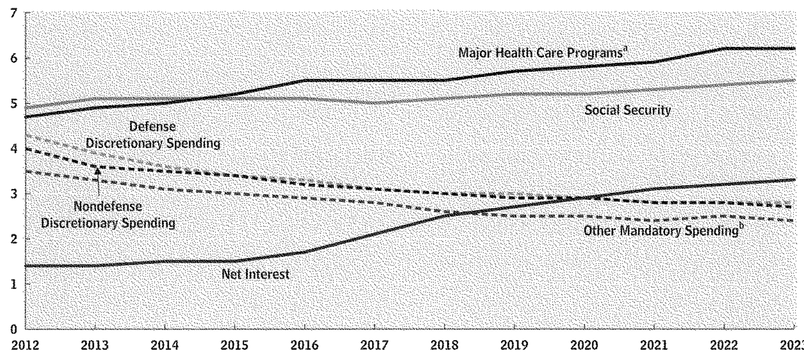
14. The federal funds rate is the interest rate that financial institutions charge each other for overnight loans of their monetary reserves.

15. The Deficit Control Act specifies some exceptions. For example, spending programs whose authorizations are set to expire are assumed to continue if they have outlays of more than $50 million in the current year and were established at or before the enactment of the Balanced Budget Act of 1997. Programs established after that law was enacted are not automatically assumed to continue but are considered individually in consultation with the budget committees.

Figure 1-3.

Projected Spending in Major Budget Categories

(Percentage of gross domestic product)



Source: Congressional Budget Office.

a. Includes Medicare (net of receipts from premiums), Medicaid, the Children's Health Insurance Program, and subsidies offered through new health insurance exchanges and related spending.

b. Other than mandatory spending for major health care programs and Social Security.

21.0 percent of GDP that has been the average for the past 40 years.[16]

In CBO's baseline, three major categories of spending are increasing relative to the size of the economy, particularly in the latter part of the 10-year period:

- Under current law, outlays for Social Security will total 5.1 percent of GDP this year and stay near that percentage for the next few years but reach 5.5 percent of GDP by 2023.
- Outlays for the major health care programs—Medicare (net of receipts from premiums), Medicaid, the Children's Health Insurance Program (CHIP), and subsidies offered through new health insurance exchanges and related spending—will soon be even greater than outlays for Social Security. Spending for major health care programs will be nearly 5 percent of GDP in 2013, and such spending is projected to grow rapidly when provisions of the Affordable Care Act are fully implemented by middecade, reaching 6.2 percent of GDP in 2023.
- Net interest is currently equal to 1.4 percent of GDP, but, in CBO's baseline, rising interest rates push that total to 3.3 percent of GDP in 2023.

By the end of the projection period, those three growing categories of spending will be the three largest in the budget (see Figure 1-3). Under current law, over the next 10 years, all other broad categories of spending—for defense and nondefense discretionary programs as well as for other mandatory programs—are projected to decline relative to GDP.

16. Under CBO's baseline, outlays are projected to remain steady at 22.9 percent of GDP in 2022 and 2023. That result is largely attributable to a shift in the timing of certain payments. Because both October 1, 2022, and October 1, 2023, fall on weekends, certain payments that are due on those days will instead be made at the end of September, thus shifting them into the previous fiscal year. Without that shift, under CBO's baseline, outlays would increase from 22.7 percent of GDP in 2022 to 22.9 percent in 2023.

Mandatory Spending. Between 2014 and 2020, mandatory spending (net of offsetting receipts, which reduce outlays) is projected to remain about the same as a share of the economy—between 13.2 percent and 13.5 percent. But, CBO projects, under current law, mandatory spending will accelerate in the final few years of the projection period, reaching 14.1 percent in 2022. Most of the government's mandatory spending consists of outlays for Social Security and the federal government's major health care programs. Those outlays are projected to grow from 10.2 percent in 2014 to 11.7 percent in 2023, accounting for about half of all federal spending by the end of the period.

Social Security and Medicare. Spending for Social Security and Medicare as a percentage of GDP is projected to remain roughly unchanged over the first half of the projection period but to grow more rapidly than the economy in the second half as the rate of growth in GDP declines slightly and as the rate of growth in Medicare spending picks up. Social Security outlays, which are estimated to account for almost one-fourth of the government's spending in 2014, are projected to remain near 5.0 percent of GDP in most years through 2018 and then climb in the following years to reach 5.5 percent of GDP in 2023. Medicare spending (net of receipts from premiums) in CBO's baseline remains around 3.0 percent of GDP through 2019 and then grows to 3.5 percent by 2023.

Medicaid and Other Health Care Programs. Under current law, federal outlays for Medicaid will rise steadily as a share of GDP over the next 10 years, from 1.8 percent in 2014 to 2.2 percent in 2023, by CBO's estimate. That rise is attributable in part to expected increases in the cost of Medicaid's benefits per beneficiary and in part to the fact that many states are expected to expand Medicaid coverage significantly, in keeping with provisions of the Affordable Care Act. In addition, spending on subsidies that will help people purchase health insurance through exchanges (which will become available starting in 2014 for individuals and families who meet income and other eligibility criteria), along with related spending, is projected to increase from 0.1 percent of GDP in 2014 to 0.5 percent 10 years from now.[17]

Other Mandatory Spending. In contrast, as the economy and the labor market gradually improve and as temporary measures that have provided additional assistance expire, spending on all mandatory programs other than Social Security and the major health care programs is projected to fall relative to GDP over the next 10 years, from 3.1 percent in 2014 to 2.4 percent in 2023. Spending for income support programs (such as unemployment compensation, the refundable portion of the earned income and child tax credits, and the Supplemental Nutrition Assistance Program) accounts for nearly all of that decline, gradually falling as a percentage of GDP from 2.0 percent in 2014 to 1.3 percent by 2023, CBO projects. Spending for the remaining mandatory programs is projected to remain near 1 percent of GDP.

Discretionary Spending. In CBO's baseline projections, most appropriations between 2014 and 2021 are assumed to be constrained by the caps and automatic spending reductions put in place by the Budget Control Act. For the final two years—2022 and 2023—discretionary funding covered by the caps is assumed to grow from the 2021 level at the rate of inflation, consistent with the statutory rules governing the baseline. Funding for war-related activities and for some other purposes is not constrained by the caps and is generally assumed to grow with inflation from the amount appropriated for 2013 (see Table 1-4 on page 19 for the amount of such adjustments).[18]

The components of CBO's projections of discretionary spending can be seen in Table 1-5, which shows what discretionary spending would be if appropriations grew at the rate of inflation and how those amounts are affected by the imposition of the caps and by the automatic spending reductions that are scheduled to reduce those caps. As a result of the caps and automatic reductions, projected spending in the baseline for the 2014–2023 period is about $1.5 trillion less than the amount that would be provided if appropriations grew at the rate of inflation after 2013.

Under the assumption that appropriations subject to the caps for 2013 and 2014 will be at the maximum amounts allowed under the Budget Control Act, discretionary

17. Subsidies for assistance with premiums will be given in the form of refundable tax credits, which are recorded as budget outlays to the extent that they exceed taxpayers' other liabilities and as reductions in revenues to the extent that they reduce people's tax payments. Some individuals and families will qualify for additional subsidies to reduce their out-of-pocket costs; those subsidies are classified entirely as outlays.

18. The caps also may be adjusted upward to allow additional spending for program integrity initiatives, which identify and reduce overpayments in certain benefit programs, as well as for some funding for emergencies and disaster relief.

budget authority will fall by $17 billion (or 1.5 percent) from 2013 to 2014, CBO estimates. That reduction reflects a full year's implementation of the automatic spending reductions in 2014, compared with the smaller reductions currently in effect for 2013 as a result of the American Taxpayer Relief Act.

After 2014, the resulting caps will limit growth in budget authority for most discretionary programs. Under the assumption that the maximum amounts allowed by the caps are appropriated (and that funding for war-related activities and emergencies grows at the rate of inflation), budget authority in the baseline grows by an average of 2.4 percent annually. Discretionary outlays are projected to grow more slowly—at an average rate of 2.2 percent per year from 2015 through 2023 (which is less than half of the projected growth rate of nominal GDP). Projected outlays during those years grow more slowly than budget authority because they also reflect, with a lag, the reductions in funding in years before 2014. With funding as assumed in the baseline, discretionary outlays would fall to 5.5 percent of GDP by 2023, more than 3 percentage points below their average from 1973 to 2012. Specifically, defense outlays in 2023 would equal 2.8 percent of GDP, compared with a 40-year average of 4.7 percent, and nondefense outlays in 2023 would equal 2.7 percent of GDP, compared with a 40-year average of 4.0 percent.

Net Interest. The increase in debt (in dollar terms), along with an anticipated substantial rise in interest rates as the economy strengthens, is expected to sharply boost interest payments on the debt. CBO projects that, under current law, the government's yearly net interest spending will double as a share of GDP—from 1.5 percent in 2014 to 3.3 percent in 2023, a percentage that has been exceeded only once in the past 50 years.

Federal Debt Held by the Public

Debt held by the public consists mostly of securities that the Treasury issues to raise cash to fund the federal government's activities and to pay off its maturing liabilities.[19] The amount the Treasury borrows by selling securities (net of the amount of maturing securities that it redeems) is influenced primarily by the annual budget deficit. However, several factors—collectively labeled other means of financing and not directly included in budget totals—also affect the government's need to borrow from the public. Among them are reductions (or increases) in the government's cash balance and in the cash flows associated with federal credit programs (such as those related to student loans and mortgage guarantees) because only the subsidy costs of those programs (calculated on a present-value basis) are reflected in the budget deficit.

CBO projects that Treasury borrowing will be $104 billion more than the projected budget deficit in fiscal year 2013, mainly to finance student loans. Each year from 2014 to 2023, borrowing by the Treasury is expected to exceed the amount of the deficit, mostly because of the need to provide financing for student loans and other credit programs. CBO projects that the government will need to borrow $76 billion more per year, on average, during that period than the budget deficits would suggest.

After accounting for all of the government's borrowing needs under current law, CBO projects that debt held by the public will increase from 73 percent of GDP at the end of fiscal year 2012 to 76 percent this year and 78 percent in 2014. Under the assumptions that govern CBO's baseline, debt will fall to a low of 73 percent in 2018 and then rise for the remainder of the projection period, measuring 77 percent of GDP at the end of 2023 (see Table 1-6 on page 28).

Along such a path, federal debt held by the public will equal a greater percentage of GDP than in any year between 1951 and 2012 and will be far above the average of 39 percent over the 1973–2012 period. Moreover, it will be on an upward trend by the end of the decade. Debt that is high by historical standards and heading higher will have significant consequences for the budget and the economy:

- The nation's net interest costs will be very high (after interest rates return to more normal levels) and rising. Higher costs for interest eventually will require the government to raise taxes, reduce benefits and services, or undertake some combination of those two actions.
- National saving will be held down, leading to more borrowing from abroad and less domestic investment, which in turn will decrease income in the United States relative to what it would be otherwise.

19. A small amount of debt held by the public is issued by other agencies, mainly the Tennessee Valley Authority.

Table 1-5.

Discretionary Spending Projected in CBO's Baseline

(Billions of dollars)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	Total, 2014-2023
						Budget Authority					
Defense											
Increase discretionary appropriations for 2013 subject to the caps at the rate of inflation[a]	569	584	600	617	635	653	671	689	n.a.	n.a.	n.a.
Reduction to meet the caps	-17	-18	-23	-27	-32	-37	-41	-45	n.a.	n.a.	n.a.
Caps established by the Budget Control Act	552	566	577	590	603	616	630	644	n.a.	n.a.	n.a.
Automatic spending reductions[b]	-55	-55	-55	-55	-55	-55	-55	-55	n.a.	n.a.	n.a.
Caps with automatic spending reductions[b]	497	511	522	535	548	561	575	589	n.a.	n.a.	n.a.
Adjustments to the caps											
War-related spending	90	92	94	96	99	101	103	105	n.a.	n.a.	n.a.
Emergency designation	*	*	*	*	*	*	*	*	n.a.	n.a.	n.a.
Subtotal, Adjustments	90	92	94	96	99	101	103	106	n.a.	n.a.	n.a.
Total, Defense[c]	**588**	**603**	**617**	**632**	**647**	**662**	**679**	**695**	**713**	**731**	**6,566**
Nondefense											
Increase discretionary appropriations for 2013 subject to the caps at the rate of inflation[a]	522	536	552	568	587	605	622	639	n.a.	n.a.	n.a.
Reduction to meet the caps	-16	-16	-22	-27	-34	-39	-44	-49	n.a.	n.a.	n.a.
Caps established by the Budget Control Act	506	520	530	541	553	566	578	590	n.a.	n.a.	n.a.
Automatic spending reductions[b]	-37	-37	-36	-36	-35	-34	-33	-32	n.a.	n.a.	n.a.
Caps with automatic spending reductions[b]	469	483	494	505	518	532	545	558	n.a.	n.a.	n.a.
Adjustments to the caps											
War-related spending	11	12	12	12	13	13	13	14	n.a.	n.a.	n.a.
Disaster relief[d]	12	12	11	9	9	9	10	10	n.a.	n.a.	n.a.
Emergency designation	42	43	44	44	45	46	47	48	n.a.	n.a.	n.a.
Program integrity	*	1	1	1	1	1	1	1	n.a.	n.a.	n.a.
Subtotal, Adjustments	66	67	67	66	68	69	71	73	n.a.	n.a.	n.a.
Total, Nondefense[c]	**535**	**550**	**560**	**571**	**586**	**600**	**616**	**631**	**647**	**663**	**5,960**
All Defense and Nondefense Budget Authority											
Increase discretionary appropriations for 2013 subject to the caps at the rate of inflation[a]	1,091	1,120	1,152	1,185	1,222	1,258	1,293	1,328	n.a.	n.a.	n.a.
Reduction to meet the caps	-33	-34	-45	-54	-66	-76	-85	-94	n.a.	n.a.	n.a.
Caps established by the Budget Control Act	1,058	1,086	1,107	1,131	1,156	1,182	1,208	1,234	n.a.	n.a.	n.a.
Automatic spending reductions[b]	-92	-91	-91	-91	-90	-89	-88	-87	n.a.	n.a.	n.a.
Caps with automatic spending reductions[b]	966	995	1,016	1,040	1,066	1,093	1,120	1,147	n.a.	n.a.	n.a.
Adjustments to the caps	156	159	161	163	167	170	174	178	n.a.	n.a.	n.a.
Total Discretionary Budget Authority[c]	**1,122**	**1,154**	**1,177**	**1,203**	**1,233**	**1,263**	**1,295**	**1,326**	**1,359**	**1,394**	**12,525**

Continued

- Policymakers' ability to use tax and spending policies to respond to unexpected challenges, such as economic downturns, natural disasters, or financial crises will be constrained. As a result, unexpected events could have worse effects on the economy and people's well-being than they would otherwise.
- The likelihood of a fiscal crisis will be higher. During such a crisis, investors would lose so much confidence in the government's ability to manage its budget that the government would be unable to borrow funds at affordable interest rates.

Table 1-5. Continued

Discretionary Spending Projected in CBO's Baseline

(Billions of dollars)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	Total, 2014-2023
						Outlays					
Defense											
Increase discretionary appropriations for 2013 subject to the caps at the rate of inflation[a]	577	577	593	604	615	637	655	673	n.a.	n.a.	n.a.
Reduction to meet the caps	-12	-15	-20	-24	-29	-34	-38	-42	n.a.	n.a.	n.a.
Outlays under the caps	565	562	573	579	586	603	617	630	n.a.	n.a.	n.a.
Automatic spending reductions[b]	-47	-52	-53	-54	-54	-54	-54	-54	n.a.	n.a.	n.a.
Outlays under the caps with automatic spending reductions[b]	518	510	520	525	532	549	563	576	n.a.	n.a.	n.a.
Adjustments to the caps											
War-related spending	75	86	92	94	96	98	101	103	n.a.	n.a.	n.a.
Emergency designation	*	*	*	*	*	*	*	*	n.a.	n.a.	n.a.
Subtotal, Adjustments	75	86	92	94	96	99	101	103	n.a.	n.a.	n.a.
Total, Defense[c]	**593**	**597**	**611**	**619**	**628**	**648**	**663**	**679**	**702**	**714**	**6,455**
Nondefense											
Increase discretionary appropriations for 2013 subject to the caps at the rate of inflation[a]	593	606	607	621	637	655	673	691	n.a.	n.a.	n.a.
Reduction to meet the caps	-9	-14	-19	-24	-31	-38	-43	-49	n.a.	n.a.	n.a.
Outlays under the caps	583	592	588	596	606	618	630	642	n.a.	n.a.	n.a.
Automatic spending reductions[b]	-29	-34	-35	-36	-35	-35	-34	-33	n.a.	n.a.	n.a.
Outlays under the caps with automatic spending reductions[b]	555	559	553	561	571	583	596	610	n.a.	n.a.	n.a.
Adjustments to the caps											
War-related spending	6	9	10	11	12	12	12	13	n.a.	n.a.	n.a.
Disaster relief[d]	6	8	9	10	10	10	10	10	n.a.	n.a.	n.a.
Emergency designation	9	17	25	32	37	40	42	44	n.a.	n.a.	n.a.
Program integrity	*	1	1	1	1	1	1	1	n.a.	n.a.	n.a.
Subtotal, Adjustments	22	34	45	54	59	62	65	67	n.a.	n.a.	n.a.
Total, Nondefense[c]	**577**	**593**	**597**	**614**	**630**	**645**	**661**	**677**	**693**	**710**	**6,397**
All Defense and Nondefense Outlays											
Increase discretionary appropriations for 2013 subject to the caps at the rate of inflation[a]	1,169	1,184	1,200	1,224	1,253	1,292	1,328	1,364	n.a.	n.a.	n.a.
Reduction to meet the caps	-21	-29	-39	-49	-60	-71	-81	-91	n.a.	n.a.	n.a.
Outlays under the caps	1,148	1,154	1,161	1,176	1,192	1,221	1,246	1,273	n.a.	n.a.	n.a.
Automatic spending reductions[b]	-75	-85	-89	-90	-90	-89	-88	-87	n.a.	n.a.	n.a.
Outlays under the caps with automatic spending reductions[b]	1,073	1,069	1,072	1,086	1,103	1,132	1,159	1,186	n.a.	n.a.	n.a.
Adjustments to the caps	97	120	136	148	155	161	166	170	n.a.	n.a.	n.a.
Total Discretionary Outlays[c]	**1,170**	**1,189**	**1,209**	**1,233**	**1,257**	**1,293**	**1,324**	**1,356**	**1,396**	**1,424**	**12,852**

Source: Congressional Budget Office.

Note: n.a. = not applicable; * = between zero and $500 million.

a. Funding for overseas contingency operations, emergencies, disaster relief, and certain program integrity initiatives (which identify and reduce overpayments in certain benefit programs) is not constrained by the statutory caps established by the Budget Control Act of 2011. Such caps were specified through 2021; CBO has extrapolated the totals for 2022 and 2023 on the basis of its projected rate of inflation.

b. Automatic spending reductions are slated to further reduce the caps for 2014 through 2021.

c. Because the caps on discretionary appropriations do not extend beyond 2021, CBO has extrapolated the totals for 2022 and 2023 on the basis of its projections of inflation.

d. Under the Balanced Budget and Emergency Deficit Control Act of 1985 (as amended), the limits on discretionary budget authority can be raised to reflect funding for disaster relief. However, the total increase in the cap in any year for that reason can be no more than the average funding for disaster relief over the previous 10 years (excluding the highest and lowest amounts) plus any amount by which the prior year's appropriation was below the maximum allowable cap adjustment for that year. In CBO's baseline, such funding exceeds the average, beginning in 2017; that adjustment is included in the totals shown for disaster relief.

Table 1-6.

Federal Debt Projected in CBO's Baseline

(Billions of dollars)

	Actual, 2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Debt Held by the Public at the Beginning of the Year	10,128	11,280	12,229	12,937	13,462	14,025	14,642	15,316	16,092	16,957	17,876	18,902
Changes in Debt Held by the Public												
Deficit	1,089	845	616	430	476	535	605	710	798	854	957	978
Other means of financing	62	104	93	95	87	82	69	66	66	65	69	64
Total	1,152	949	708	525	563	617	674	776	865	919	1,026	1,041
Debt Held by the Public at the End of the Year	11,280	12,229	12,937	13,462	14,025	14,642	15,316	16,092	16,957	17,876	18,902	19,944
Memorandum:												
Debt Held by the Public at the End of the Year (As a percentage of GDP)	72.5	76.3	77.7	76.3	74.6	73.4	73.1	73.5	74.2	75.0	76.0	77.0
Debt Held by the Public Excluding Financial Assets[a]												
In billions of dollars	10,392	11,243	11,833	12,241	12,695	13,211	13,794	14,482	15,259	16,091	17,024	17,977
As a percentage of GDP	66.8	70.1	71.1	69.4	67.6	66.2	65.9	66.2	66.8	67.5	68.5	69.4
Gross Federal Debt[b]	16,048	17,068	17,886	18,501	19,166	19,938	20,793	21,736	22,754	23,810	24,937	26,079
Debt Subject to Limit[c]	16,027	17,047	17,864	18,479	19,143	19,915	20,769	21,711	22,729	23,784	24,911	26,052

Source: Congressional Budget Office.

Note: GDP = gross domestic product.

a. Subtracts from debt held by the public the value of outstanding student loans and other credit transactions, financial assets (such as preferred stock) purchased from institutions participating in the Troubled Asset Relief Program, cash balances, and other financial instruments.

b. Comprises federal debt held by the public plus Treasury securities held by federal trust funds and other government accounts.

c. The amount of federal debt that is subject to the overall limit set in law. Debt subject to limit differs from gross federal debt because most debt issued by agencies other than the Treasury and the Federal Financing Bank is excluded from the debt limit. The debt limit was most recently set at $16.4 trillion but has recently been suspended through May 18, 2013.

Those consequences would be exacerbated if federal debt exceeded the amounts projected in CBO's baseline, as it would if certain deficit-reducing policies that are scheduled to take effect were instead reversed without being replaced by other policies with similar budgetary effects. Those consequences could be mitigated, however, if policies were enacted that reduced federal debt relative to GDP during the coming decade and beyond.

Other measures of the federal government's financial position are sometimes used. *Debt held by the public excluding financial assets* subtracts from debt the value of the government's financial assets, such as student loans. Under the assumptions for CBO's baseline, that measure will be smaller than debt held by the public alone but will vary roughly in line with it.

Gross federal debt consists of debt held by the public and debt issued to government accounts (for example, the Social Security trust funds). The latter type of debt does not directly affect the economy and has no net impact on the budget. Under current law, debt held by the public is expected to increase by more than 75 percent between 2012 and 2023, and debt held by government accounts is expected to rise by nearly 30 percent. As a result, gross federal debt is projected to reach $26.1 trillion at the end of 2023. A similar measure, ***debt subject to limit***, is the amount of debt that is subject to the statutory limit on federal borrowing; it includes virtually all gross federal debt. Under the assumptions that govern CBO's baseline, the agency projects that debt subject to limit will reach $26.1 trillion at the end of 2023.

Changes in CBO's Baseline Since August 2012

Since August 2012, when the agency completed its previous set of baseline projections, CBO has added $204 billion to its estimate of the deficit in 2013 and a total of $4.6 trillion to its baseline projection of the cumulative deficit from 2013 through 2022 (see Appendix A). Legislation enacted in the interim led CBO to boost projected deficits by $4.7 trillion through 2022 (including debt service); almost all of that increase stems from the enactment of the American Taxpayer Relief Act early in January. Also included in that amount is additional emergency spending. As mandated by law, the baseline incorporates the assumption that amounts equal to the $41 billion in emergency funding provided in the wake of Hurricane Sandy are appropriated each year with adjustments for inflation; that assumption added about $340 billion to outlays in the baseline. Revised economic projections increased the projection of the cumulative deficit by $141 billion, whereas other, technical changes reduced the projection of the cumulative deficit by $270 billion.

Uncertainty in Budget Projections

Even if federal laws remained unchanged for the next decade, actual budgetary outcomes would differ from CBO's baseline projections because of unanticipated changes in economic conditions and in a host of other factors that affect federal spending and revenues.

CBO's budgetary projections depend on the agency's economic projections for the coming decade, including forecasts for such variables as interest rates, inflation, and the growth of real GDP. Discrepancies between those forecasts and actual economic outcomes can result in significant differences between baseline budget projections and budgetary outcomes. For instance, CBO's baseline economic forecast anticipates that the interest rate on 3-month Treasury bills—which has hovered near zero for the past several years—will climb to 4 percent by the end of 2017; by that point, the rate on 10-year Treasury notes is also projected to rise from its current level of around 2 percent. If interest rates on all types of Treasury securities were 1 percentage point higher or lower each year from 2014 through 2023 and all other economic variables were unchanged, cumulative outlays projected for the 10-year period would be about $1.1 trillion higher or lower (excluding the additional costs of servicing the federal debt).

Uncertainty also surrounds myriad technical factors that can substantially affect CBO's baseline projections. For example, spending per enrollee for Medicare and Medicaid—which generally has grown faster than GDP—is very difficult to predict. If per capita costs in those programs rose 1 percentage point faster or slower per year than CBO has projected for the next decade, total outlays for Medicare (net of receipts from premiums) and Medicaid would be about $650 billion higher or lower for that period.

The impact of the Affordable Care Act is another source of great uncertainty. To estimate the effects of the act's broad changes to the nation's health care and health insurance systems, CBO and the staff of the Joint Committee on Taxation (JCT) have made projections concerning an array of technical, behavioral, and economic factors, some of which involve programs and institutions (such as the health insurance exchanges) that do not yet exist.

Projections of revenues also are quite sensitive to uncertainty about economic and technical factors. Revenues depend on total amounts of wages and salaries, corporate profits, and other income, all part of CBO's economic projections. For example, if the growth of real GDP and taxable incomes were 0.1 percentage point lower per year than in CBO's baseline projections, revenues would be lower than in the baseline projections by roughly $275 billion over the 2014–2023 period.

In addition, forecasting the amount of revenues that the government will collect from taxpayers for a given quantity of incomes included in the economic projections requires technical assumptions about the distribution of income and about many aspects of taxpayers' behavior. (Taxpayers' behavior, for example, determines the amount of deductions and credits people receive and how much income in the form of capital gains they realize from selling assets.) If CBO's judgments about such behavior and actual outcomes differ, the effect on revenues can be significant.

Even relatively small deviations can have a substantial impact on budget deficits. For example, if revenues projected for 2023 were too high by 5 percent (that is, if average annual growth during the coming decade was about 0.5 percentage points less than CBO estimates) and projected outlays for mandatory programs were too low by 5 percent, the deficit for that year would be about $430 billion greater than the $978 billion in CBO's baseline—or 5.4 percent of GDP, rather than 3.8 percent. Outcomes could differ in the other direction as well.

Alternative Assumptions About Fiscal Policy

CBO's baseline budget projections—which are constructed in accordance with provisions of law—are intended to show what would happen to federal spending, revenues, and deficits if current laws generally remained unchanged. Clearly, future legislation could lead to markedly different budget outcomes. Moreover, although the American Taxpayer Relief Act has reduced the number of changes to tax policies that are scheduled to take effect under current law, some significant changes to tax and spending policies alike are still set to occur. As a result, baseline projections constructed on the assumption that current laws will remain in place could differ markedly from the budgetary outcomes that would result if those laws were modified so that current policies were maintained instead.

To assist policymakers and analysts who may hold differing views about the most useful benchmark against which to consider possible changes to laws or policies, CBO has estimated the effects on budget projections of some alternative assumptions about future policies (see Table 1-7). The discussion below focuses on how those policy actions would directly affect revenues and outlays. Such changes also would influence projections of the costs of servicing the federal debt (shown separately in the table).

Military and Diplomatic Operations in Afghanistan and Other War-Related Activities

CBO's projections of discretionary spending for the next 10 years include outlays for military and diplomatic operations in Afghanistan and for other overseas contingency operations. The projections are based on budget authority provided for those purposes in 2012 and in prior years, the $100 billion in budget authority provided for 2013 (the annualized amount provided in the current continuing resolution), and the $1.1 trillion that is projected to be appropriated over the 2014–2022 period (under the assumption that this year's funding will be adjusted for anticipated inflation).

In coming years, the funding required for overseas contingency operations—in Afghanistan or other countries—may eventually be smaller than the amounts in the baseline if the number of deployed troops and the pace of operations diminish over time. Thus, CBO has formulated a budget scenario that assumes a reduction in the deployment of U.S. forces abroad for military actions and a concomitant reduction in diplomatic operations and foreign aid. Many other scenarios—some costing more and some less—also are possible.

In 2012, the number of U.S. active-duty, Reserve, and National Guard personnel deployed for war-related activities averaged about 115,000, according to CBO's estimates. Under the scenario presented here, the average number of military personnel deployed for war-related purposes would decline over three years: to 85,000 in 2013, 60,000 in 2014, and 45,000 in 2015 and thereafter. (Those numbers could represent various allocations of forces in different places around the world.) Under that scenario, and assuming that the related funding for diplomatic operations and foreign aid declines at a similar rate, discretionary outlays over the 2014–2023 period would be $582 billion less than the $1.1 trillion for overseas contingency operations included in the baseline.

Emergency Funding for Disaster Relief

Recently, lawmakers provided $50 billion in disaster relief in response to Hurricane Sandy. The portion of such funding declared an emergency requirement ($41 billion) is not constrained by the caps and, following the rules governing baseline projections, is assumed to be provided each year, with adjustments for inflation, in CBO's baseline.[20] If, however, such funding was not provided in future years, discretionary outlays would be $302 billion lower between 2014 and 2023 than in the baseline.

Other Discretionary Spending

Policymakers could vary discretionary funding in many ways from the amounts projected in the baseline. For example, if none of the constraints on discretionary funding were implemented and if appropriations grew each year through 2023 at the same rate as inflation after 2013, discretionary spending would be about

20. That act also contained $5 billion in funding designated as disaster funding (as defined in the Budget Control Act) and $3 billion that was not designated as emergency funding; both types of funding are extrapolated in CBO's baseline but are subject to constraints in future years.

$1.5 trillion higher for that period than it is in the baseline. If, by contrast, lawmakers kept appropriations constrained by the caps in 2013 at the same nominal level through 2023 (after accounting for the $71 billion reduction that will result from the automatic enforcement procedures set in the Budget Control Act), total discretionary outlays would be $829 billion lower for the period from 2014 through 2023. Under that scenario (sometimes called a freeze in regular appropriations), total discretionary spending would fall from 7.6 percent of GDP in fiscal year 2013 to 4.7 percent in 2023; by comparison, the lowest share for discretionary spending in any year since 1962 (the earliest year for which such data have been reported) was 6.2 percent in 1999.

Medicare's Payments to Physicians

Under current law, spending for Medicare is constrained by a rate-setting system—called the sustainable growth rate—that has existed for several years to control the fees physicians receive for their services. If the system is allowed to operate as currently structured, physicians' fees will be reduced by about 25 percent in January 2014 and will increase by small amounts in subsequent years, CBO projects. If, instead, lawmakers override those scheduled reductions—as they have every year since 2003—spending on Medicare might be greater than the amounts projected in CBO's baseline. For example, holding payment rates through 2023 at the levels they are now would raise outlays for Medicare (net of premiums paid by beneficiaries) by $14 billion in 2014 and about $138 billion (or about 2 percent) between 2014 and 2023.[21] The effect on Medicare (and on the deficit) of making such a change would depend on whether lawmakers offset the effects of the change, as they often have done in the past, with other changes to reduce deficits.

21. The estimated cost of holding payment rates constant is much lower relative to this baseline than was the case under previous CBO baselines, primarily because of lower spending for physicians' services in recent years. Under the sustainable growth rate, future payment updates depend on the difference between spending in prior years and spending targets established in law. Actual spending has been lower than projected—and lower than the spending targets inherent in the sustainable growth rate—for the past three years. Because actual spending has been lower than spending targets, CBO now estimates that payment rates will increase beginning in 2015. Those higher payment rates narrow the difference between growth under current law and a freeze at current levels, thereby reducing the estimated cost of restricting the payment rates.

Automatic Enforcement Procedures

The Budget Control Act put in place automatic procedures to reduce discretionary and mandatory spending that are now scheduled to take effect in March 2013 and continue through 2021. If fully implemented, those procedures will require equal reductions (in dollar terms) in defense and nondefense spending. For 2013, the reductions are to be achieved by automatically canceling, or sequestering, a portion of the budgetary resources for most discretionary programs as well as for some programs and activities that generate mandatory spending.[22] For the period from 2014 through 2021, the automatic procedures lower the caps on discretionary budget authority specified in the Budget Control Act and impose sequestration for some mandatory spending. If lawmakers chose to prevent those automatic cuts each year without making other changes that reduced spending by offsetting amounts, spending would be $42 billion higher in 2013 and $995 billion (or about 2 percent) higher over the 2014–2023 period than is projected in CBO's current baseline. Total discretionary outlays would be $869 billion (or 6.8 percent) higher, and mandatory outlays would be $126 billion (or 0.4 percent) higher.[23]

Revenues

Although the American Taxpayer Relief Act permanently extended several tax provisions that substantially affected revenues, a host of other tax provisions—many of which have been extended repeatedly—are still scheduled to expire over the next decade (see Box 1-1 on page 12). If all of those provisions were permanently extended, CBO and JCT estimate, revenues would be lower—and, although a much smaller effect, outlays for refundable tax credits would be higher—by a total of about $1.0 trillion over the 2014–2023 period. Most of those tax provisions are scheduled to expire at the end of 2013. They include a provision allowing businesses to immediately deduct 50 percent of new investments in equipment, which JCT

22. Budgetary resources subject to sequestration include new budget authority, unobligated balances for defense programs, and direct spending authority.

23. Because of interactions between the effects of different policy options, the estimated budgetary effects of this option cannot be added to the estimated budgetary effects of any of the alternatives that affect discretionary spending other than the one to reduce the number of troops deployed for overseas contingency operations.

Table 1-7.

Budgetary Effects of Selected Policy Alternatives Not Included in CBO's Baseline

(Billions of dollars)

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	Total 2014-2018	Total 2014-2023
Policy Alternatives That Affect Discretionary Outlays													
Reduce the Number of Troops Deployed for Overseas Contingency Operations to 45,000 by 2015[a]													
Effect on the deficit[b]	0	16	37	51	60	64	67	69	71	73	74	228	582
Debt service	0	*	*	2	4	8	11	15	19	23	28	14	111
Remove Extrapolation of Emergency Funding for Disaster Relief[c]													
Effect on the deficit[b]	0	2	9	18	26	33	38	41	43	45	47	88	302
Debt service	0	*	*	*	1	3	5	7	9	11	14	5	51
Increase Regular Discretionary Appropriations at the Rate of Inflation[d]													
Effect on the deficit[b]	-38	-97	-115	-128	-139	-150	-160	-169	-178	-186	-193	-628	-1,514
Debt service	*	-1	-2	-6	-13	-24	-31	-41	-51	-63	-74	-45	-306
Freeze Regular Discretionary Appropriations at the 2013 Amount[e]													
Effect on the deficit[b]	0	-12	*	19	41	63	88	115	141	171	203	110	829
Debt service	0	*	*	*	1	4	7	12	18	26	35	5	103
Policy Alternative That Affects Mandatory Outlays													
Maintain Medicare's Payment Rates for Physicians at the Current Rate[f]													
Effect on the deficit[b]	0	-14	-16	-13	-12	-12	-13	-14	-14	-15	-16	-67	-138
Debt service	0	*	*	-1	-1	-2	-3	-4	-5	-6	-7	-5	-29
Policy Alternative That Affects Both Discretionary and Mandatory Outlays													
Remove the Effect of the Automatic Enforcement Procedures Specified in the Budget Control Act[g]													
Effect on the deficit[b]	-42	-89	-99	-103	-104	-105	-104	-104	-104	-94	-89	-500	-995
Debt service	*	-1	-1	-5	-11	-19	-25	-31	-38	-45	-51	-38	-228

Continued

Sources: Congressional Budget Office; staff of the Joint Committee on Taxation.

Notes: Negative numbers indicate an increase in the deficit; positive numbers indicate a decrease in the deficit.

* = between -$500 million and $500 million.

a. For this alternative, CBO does not extrapolate the $100 billion in budget authority for military operations, diplomatic activities, and foreign aid in Afghanistan and other countries provided for 2013. Rather, the alternative incorporates the assumption that, as the number of troops falls to about 45,000 by 2015, funding for overseas contingency operations declines as well, to $70 billion in 2014, $51 billion in 2015, and then to an average of about $45 billion per year from 2016 on—for a total of $482 billion over the 2014–2023 period. [Note corrected on February 5, 2013, after initial release]

b. Excludes debt service.

c. For this alternative, CBO does not extrapolate the $41 billion in budget authority provided for relief and recovery from Hurricane Sandy that was designated as an emergency requirement in the Disaster Relief Appropriations Act, 2013. That act also provided $5 billion in funding designated as disaster funding (as defined in the Budget Control Act of 2011) and $3 billion that was not designated as emergency funding; both types of funding are extrapolated in CBO's baseline, subject to constraints set in the Budget Control Act.

d. These estimates reflect the assumption that appropriations will not be constrained by caps and other provisions of the Budget Control Act and will instead grow at the rate of inflation from their 2013 level. Discretionary funding related to federal personnel is inflated using the employment cost index for wages and salaries; other discretionary funding is adjusted using the gross domestic product price index.

Table 1-7. Continued

Budgetary Effects of Selected Policy Alternatives Not Included in CBO's Baseline

(Billions of dollars)

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	Total 2014-2018	Total 2014-2023
							Policy Alternative That Affects the Tax Code[h]						
Extend Expiring Tax Provisions[i]													
Effect on the deficit[b]	*	-58	-98	-89	-83	-81	-102	-103	-108	-114	-120	-408	-954
Debt service	*	*	-1	-4	-8	-15	-19	-25	-32	-38	-46	-28	-188
							Policy Alternative That Affects Spending and Revenues						
Changes in Deficits from the Alternative Fiscal Scenario[j]													
Effect on the deficit[b]	-42	-160	-212	-205	-199	-198	-219	-221	-226	-222	-225	-975	-2,088
Debt service	*	-2	-2	-10	-21	-36	-47	-60	-74	-89	-104	-71	-446
Memorandum:													
Outlays for Overseas Contingency Operations in CBO's Baseline	129	112	106	106	106	108	110	113	116	119	121	539	1,118
Deficit in CBO's Baseline	-845	-616	-430	-476	-535	-605	-710	-798	-854	-957	-978	-2,661	-6,958
Deficit Under the Alternative Fiscal Scenario	-887	-778	-644	-691	-755	-839	-976	-1,080	-1,154	-1,268	-1,307	-3,707	-9,492

e. This alternative reflects the assumption that appropriations for 2013 that are constrained by the caps, minus an estimated reduction of $71 billion resulting from the automatic enforcement procedures for this year, will total $978 billion. Such appropriations would generally be frozen at the 2013 level through 2023.

f. Medicare's current payment rates for physicians' services are scheduled to drop by 25 percent on January 1, 2014, and will increase by small amounts in subsequent years. In this alternative, payment rates are assumed to continue at their current level through 2023.

g. The Budget Control Act specified that if lawmakers did not enact legislation originating from the Joint Select Committee on Deficit Reduction that would reduce projected deficits by at least $1.2 trillion, automatic procedures would go into effect to reduce both discretionary and mandatory spending during the 2013–2021 period. Such automatic reductions in spending would take the form of equal cuts (in dollar terms) in funding for defense and nondefense programs in 2013 through 2021. The American Taxpayer Relief Act of 2012 subsequently reduced the amount of savings required in 2013 by $24 billion. For 2013, those reductions would be achieved by automatically canceling a portion of the budgetary resources (in an action known as sequestration) for most discretionary programs and for some programs and activities that generate mandatory spending. For the 2014–2021 period, the automatic procedures lower the caps on discretionary budget authority specified in the Budget Control Act and impose sequestration for some mandatory spending. The budgetary effects of this option cannot be combined with those of any of the alternatives that affect discretionary spending other than the one to reduce the number of troops deployed for overseas contingency operations.

h. The estimates are mainly from the staff of the Joint Committee on Taxation and are preliminary.

i. These estimates reflect the impact of extending about 75 provisions. Nearly all of those provisions have been extended previously; some, such as the research and experimentation tax credit, multiple times.

j. In *The Budget and Economic Outlook: Fiscal Years 2012 to 2022* (January 2012), www.cbo.gov/publication/42905, and the update to that report in August 2012, CBO presented an alternative fiscal scenario that incorporated the assumptions that all expiring tax provisions (other than the payroll tax reduction in effect in calendar years 2011 and 2012) were extended; the alternative minimum tax was indexed for inflation after 2011; Medicare's payment rates for physicians' services were held constant at the 2012 level; and the automatic spending reductions required by the Budget Control Act, which were set to take effect in January 2013, would not occur. The American Taxpayer Relief Act permanently extended many provisions slated to expire at the end of December 2012 and indexed the alternative minimum tax for inflation; therefore, the remaining components of the alternative fiscal scenario consist of holding constant the Medicare payment rates (which are now scheduled to fall in January 2014), undoing the automatic spending reductions (which were reduced by $24 billion and postponed until March 1, 2013), and extending certain tax provisions.

estimates accounts for about $0.3 trillion of the budgetary effects of extending all the provisions. The budgetary cost of extending all of the tax provisions increases starting in 2019, because the American Taxpayer Relief Act extended through 2017 certain provisions affecting refundable tax credits. Extending those provisions would increase outlays for refundable credits and reduce revenues by a total of about $140 billion over the 2018–2023 period, mostly starting in 2019 because payments for refundable credits are typically made a year after the applicable tax year.

An Alternative Fiscal Scenario

In recent years, CBO has presented an alternative fiscal scenario that illustrated the impact on projected deficits and debt of maintaining policies that were then in place but that were scheduled to change under then-current law. That scenario, as described by CBO in *The Budget and Economic Outlook: Fiscal Years 2012 to 2022* and in *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022*, incorporated the assumptions that all expiring tax provisions (other than the payroll tax reduction in effect in calendar years 2011 and 2012) were extended; the AMT was indexed for inflation after 2011; Medicare's payment rates for physicians' services were held constant at the 2012 level; and the automatic spending reductions required by the Budget Control Act, which were set to take effect in January 2013, would not occur.

The American Taxpayer Relief Act extended many of the provisions slated to expire at the end of December 2012 and indexed the AMT for inflation. As a result, many components of the alternative fiscal scenario (including many with the largest budgetary effects) have now been made permanent. One prominent component—the extension of the lower tax rates on the income of higher-income people originally enacted in 2001 and 2003—was not included in the legislation. The remaining components consist of holding constant Medicare's payment rates (now scheduled to be reduced in January 2014), undoing the automatic spending reductions (which were reduced by $24 billion and postponed until March 1, 2013), and extending certain expiring tax provisions.

If lawmakers were to make those changes to current law, and if other changes in policies with offsetting effects on budget deficits were not enacted, deficits and debt would be significantly higher than the amounts shown in CBO's current baseline. Relative to the baseline projections for 2014 to 2023, deficits would rise by a total of $2.5 trillion (including debt-service costs) to yield cumulative deficits of $9.5 trillion. Debt held by the public would reach 87 percent of GDP by the end of 2023, the largest share since 1947. Under that scenario, revenues from 2014 to 2023 would average 18.5 percent of GDP (slightly above their 40-year average of 17.9 percent), and outlays would average 22.9 percent (well above their 40-year average of 21.0 percent).

CHAPTER

2

The Economic Outlook

The Congressional Budget Office (CBO) expects that, under current laws governing taxes and spending, economic activity will expand slowly in 2013 but will increase more rapidly in 2014. As measured by the change from the fourth quarter of the previous year, real (inflation-adjusted) gross domestic product (GDP) is projected to increase by 1.4 percent this year and by 3.4 percent next year. With economic growth subdued until 2014, CBO forecasts that the unemployment rate will remain high—above 7½ percent through next year. If that occurs, 2014 will be the sixth consecutive year with unemployment exceeding 7½ percent of the labor force, the longest period of such high unemployment in the past 70 years. CBO projects that the high number of unemployed workers and the large amount of other unused resources in the economy will help to keep the rate of inflation (as measured by the price index for personal consumption expenditures, or PCE) below 2 percent during this year and next and that interest rates will stay quite low as well.

That pattern of slow growth in 2013 and then quickening growth in 2014 reflects a combination of a gradual improvement in underlying economic factors and the tightening of federal fiscal policy that is scheduled to occur this year. The effects of the housing and financial crisis will continue to fade, CBO expects: An upswing in housing construction (albeit from a very low level), rising real estate and stock prices, and increasing availability of credit will help to spur a virtuous cycle of faster growth in employment, income, consumer spending, and business investment over the next few years. However, the federal fiscal policy specified by current law will represent a drag on economic activity this year.

CBO estimates that economic growth in 2013 would be roughly 1½ percentage points faster than the agency now projects if not for the fiscal tightening. About 1¼ percentage points of that effect come from the automatic reductions in federal spending described in Chapter 1, the expiration of the cut in payroll tax rates, and the increase in tax rates on income above certain thresholds; the spending changes and the combined tax changes account for about equal portions. The remaining ¼ percentage point comes from other, smaller changes in spending and taxes. If policymakers modified the tax and spending policies in current law, their actions could have significant implications for economic growth. For instance, less fiscal tightening this year would lead to stronger growth in 2013 but, if not accompanied by sufficient additional tightening in later years, would also restrain real output and income in the middle of the decade and beyond owing to higher federal debt.[1]

Although CBO anticipates faster economic growth after this year, output is likely to remain below its potential (or maximum sustainable) level until 2017—almost a decade after the recession started in December 2007. CBO estimates that real GDP in the fourth quarter of 2012 was below its potential level by about 5½ percent; that gap is only modestly smaller than the gap (of about 7½ percent) that existed at the end of the recession in mid-2009 because growth in output since then has been only slightly faster, on average, than growth in potential output (see Figure 2-1). With such a large gap between actual and potential output persisting for so long, the cumulative loss of output relative to the economy's potential between 2007 and 2017 will be equivalent to nearly half of the output produced last year.

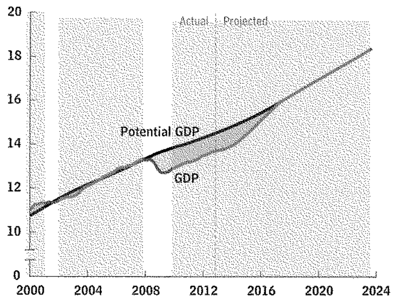
Consistent with the forecast that output will be growing rapidly enough between 2014 and 2017 to close the output gap, the unemployment rate is projected to fall from about 7½ percent at the end of 2014 to about 5½ percent at the end of 2017. The interest rate on three-month

1. An alternative fiscal scenario that incorporates one particular set of policies implying less fiscal tightening is detailed in Chapter 1. CBO has not quantified the economic effects of that scenario.

Figure 2-1.

GDP and Potential GDP

(Trillions of 2005 dollars)



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

Notes: Potential gross domestic product (GDP) is CBO's estimate of the maximum sustainable level of output of the economy.

Data are quarterly. Actual data are plotted through the third quarter of 2012. Projections are plotted through the fourth quarter of 2023.

Treasury bills is forecast to remain low through 2015 and then rise considerably through 2017 as the economy strengthens; the interest rate on 10-year Treasury notes is projected to rise steadily through 2017.

Beyond 2017, CBO's economic forecast is based on the assumption that real GDP will grow at the same rate as potential GDP, because the agency does not attempt to predict the timing or magnitude of fluctuations in the business cycle so far into the future. Under that assumption, the average growth of real GDP in CBO's projection is 2¼ percent a year during the 2019–2023 period; that pace is much slower than the average annual growth of 3¼ percent since 1950, primarily because of slower expected growth in the labor force from both the retirement of the baby-boom generation and an end to the long-standing increase in the labor force participation of women. In addition, the unemployment rate in CBO's projection falls to 5.2 percent by the end of 2023, and inflation holds steady at 2 percent between 2019 and 2023. The interest rate on three-month Treasury bills stabilizes at 4.0 percent in the 2019–2023 period, and the rate on 10-year Treasury notes stabilizes at 5.2 percent.

Since the end of the recession, the path of recovery has been difficult to predict, and outcomes in future years will no doubt hold surprises as well. Many developments apart from changes in the laws regarding federal taxes and spending—such as unanticipated changes in the pace of economic growth abroad—could cause economic outcomes to differ substantially from those CBO has projected.

CBO's current forecast of economic growth for 2013 differs significantly from the agency's August 2012 forecast. The American Taxpayer Relief Act of 2012 (Public Law 112-240) removed a significant amount of the fiscal tightening that had been scheduled to take effect in January 2013. (For a more detailed examination of that legislation, see Box 1-1 in Chapter 1.) As a result, CBO no longer projects that real GDP will decline this year.[2] However, CBO's current projection for the growth of real GDP in 2013 is still considerably below those of the *Blue Chip* consensus (which is based on roughly 50 private-sector forecasts) and the Federal Reserve's Federal Open Market Committee. Those differences probably stem in large part from differing assumptions about the federal government's future tax and spending policies.

The Economy in 2012

The economy expanded modestly in 2012, continuing the slow growth seen since the recession ended in June 2009, and the unemployment rate continued to decline.[3] Spending strengthened in some sectors—especially residential investment—but consumers spent cautiously and the advance of business investment moderated. Growth in consumer spending was probably held back by tepid growth in households' income, and growth in business investment was in turn limited by modest gains in consumer spending. In addition, spending was probably restrained by the anticipation of higher taxes and other consequences of fiscal tightening, as well as by uncertainty about the magnitude and composition of that tightening. Despite those negative effects of fiscal policy,

2. For a discussion of the fiscal tightening that was scheduled to occur in 2013, see Congressional Budget Office, *Economic Effects of Policies Contributing to Fiscal Tightening in 2013* (November 2012), www.cbo.gov/publication/43694.

3. For a discussion of the economic expansion since the end of the recession, see Congressional Budget Office, *What Accounts for the Slow Growth of the Economy After the Recession?* (November 2012), www.cbo.gov/publication/43707.

the demand for goods and services appeared to gain some momentum in 2012, which will support economic growth going forward. The labor market improved modestly in 2012, although it remains weak—primarily because overall demand for goods and services, and thus businesses' need to hire additional workers, has been growing slowly. In addition, inflation in consumer prices eased, and both short- and long-term interest rates stayed very low.

Economic Growth

On the basis of information available when CBO completed its economic projections in mid-January, the agency estimated that real GDP increased by 1.9 percent in 2012, as measured by the change from the fourth quarter of the previous year, compared with 2.0 percent in 2011. It turned out to be less.[4] Spending by consumers and businesses remained guarded, while residential investment continued to strengthen. In addition, purchases by federal, state, and local governments saw smaller declines than in 2011, and net exports increased slightly.

Consumer Spending. Real spending on consumer goods and services—which represents about two-thirds of all spending in the economy—grew by an estimated 1.9 percent last year, about the same increase as in 2011. Consumer spending has recently been bolstered by gains in households' net worth, reflecting rising house prices, improvement in the stock market, and declines in mortgage debt. However, continued high unemployment has held down the growth of wages and salaries as well as consumers' confidence about future gains in income. Those factors, along with tight credit conditions for many households, have continued to restrain the growth of consumer spending. In addition, spending was probably held down last year by the anticipation of higher taxes and other effects of impending fiscal tightening, as well as by uncertainty about that tightening.

Business Investment. Real business fixed investment—in nonresidential structures, equipment, and software—grew much more slowly last year than in the preceding years: by an estimated 3.3 percent in 2012, following gains of 10.2 percent in 2011 and 7.7 percent in 2010. The slowdown in 2012 probably reflected businesses' response to the weak growth in demand for goods and services; it may also have reflected uncertainty and concern about the significant fiscal tightening that had been scheduled for early 2013. The growth of real investment in equipment and software slowed somewhat more than did the growth of real investment in nonresidential structures. That difference may reflect the fact that businesses can adjust their purchases of equipment and software more rapidly than their spending on structures.

Residential Investment. In 2012, residential investment grew rapidly as recovery in the housing market gained traction. Real residential investment rose by 15.4 percent last year, in CBO's estimation, up steeply from 3.9 percent in 2011—the first annual increase since 2005 (see Figure 2-2). Housing investment is still very low by historical standards, however, and the contribution of such investment to GDP growth remains small because the housing sector accounts for only a minor fraction of output. The recent expansion of housing construction is partly a response to the continued decline in the number of vacant housing units, following sharp increases in that number before and during the recession. Owing to the very low level of construction in recent years, the number of vacant housing units in excess of what would be expected under normal economic conditions fell to 1.2 million, or 0.9 percent of the total stock, in the third quarter of 2012, down from a peak of 2.9 million in the fourth quarter of 2008. Also bolstering housing construction was an improved outlook for house prices, which, in CBO's estimates, climbed by 5.3 percent from the fourth quarter of 2011 to the fourth quarter of 2012.

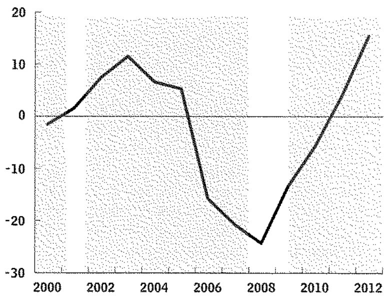
Governments' Purchases. Purchases by federal, state, and local governments (as measured by the Department of Commerce's national income and product accounts and adjusted to remove the effects of inflation) fell slightly in 2012 but by much less than in 2011. Purchases by the federal government edged down by 0.7 percent last year

4. This report was prepared before the release of data for the fourth quarter of 2012 by the Commerce Department's Bureau of Economic Analysis on January 30. According to that release, GDP grew more slowly in 2012 than CBO had estimated (1.5 percent instead of 1.9 percent) because GDP growth in the fourth quarter was well below CBO's estimate. However, growth in the fourth quarter was held down by several temporary developments, including large drops in defense spending and inventory investment, that are not expected to recur. Apart from those two developments, which reduced GDP growth in the fourth quarter by 2.6 percentage points, underlying momentum in the economy appears moderately strong, with gains in consumer spending, noninventory investment by businesses, and residential construction. Consequently, incorporating the fourth quarter data would have had only a small effect on CBO's projections.

Figure 2-2.

Real Residential Investment

(Percentage change)



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

Notes: Real residential investment consists of spending on residential construction, improvements to existing housing, mobile homes, and real estate brokers' commissions, adjusted to remove the effects of inflation.

Data are annual and are plotted through 2012. The value for 2012 reflects CBO's estimate for the fourth quarter. Percentage changes are measured between the fourth quarters of successive years.

(as measured on a fourth-quarter-to-fourth-quarter basis), according to CBO's estimates, after falling by 4.2 percent in 2011. For state and local governments, purchases fell by 0.9 percent in 2012, compared with decreases of 2.7 percent in 2011 and 3.6 percent in 2010. The smaller decline in 2012 primarily reflects improvements in state and local governments' finances from stronger growth in tax revenues.

Net Exports. International trade added a small amount to the growth of real GDP in 2012, in CBO's estimation. Although the growth rate of real exports decreased, partly in response to ongoing economic problems in the euro zone, that decrease was more than offset by a larger drop in the growth of real imports (because of a decline in oil imports). In addition, the exchange value of the dollar has increased moderately since mid-2011, reversing an overall downward trend since 2009 and making U.S. goods less price-competitive in foreign markets.

The Labor Market

The labor market experienced modest gains last year, but a substantial amount of slack remains in that market: According to CBO's estimates, employment in the fourth quarter of 2012 was more than 6½ million less than it would have been if the economy had been operating at its maximum sustainable level.

The unemployment rate fell from 8.7 percent in the last quarter of 2011 to 7.8 percent in the last quarter of 2012. About 0.2 percentage points of that decline can be attributed to real GDP growth that was slightly faster than the growth of potential GDP during 2011 and 2012. (A reduction in the gap between actual and potential GDP tends to reduce the unemployment rate, although that reduction usually occurs with some delay and is spread over several quarters.) Much of the remainder of that decline probably reflects an unwinding of the factors that caused the especially large increases in unemployment that occurred in 2008 and 2009, when firms reduced employment by more than would have been expected on the basis of the decline in GDP. Those factors include fears of an even deeper recession than actually occurred and the effects of restricted availability of credit.[5]

In CBO's view, about 1 percentage point of the net rise of 2.8 percentage points in the unemployment rate that occurred between December 2007 (the peak of the previous economic expansion) and December 2012 reflects structural factors—such as mismatches between employers and employees and the erosion of workers' skills—that are associated with the recession but that are not directly linked to current aggregate demand. Such structural factors have contributed to the historically high share of unemployment accounted for by the long-term unemployed, people who have been seeking work for more than 26 consecutive weeks.[6] That share has topped

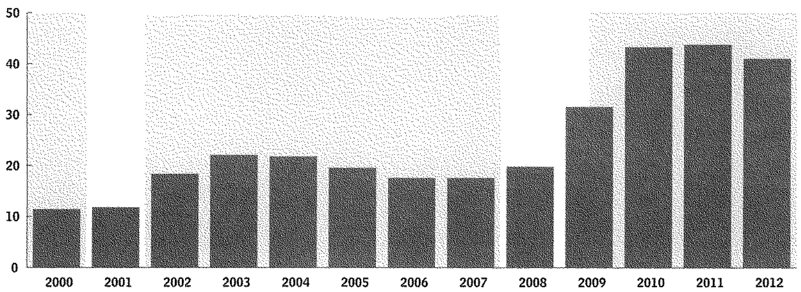
5. For additional discussion, see Ben S. Bernanke, "Recent Developments in the Labor Market" (address given at the National Association for Business Economics Annual Conference, Arlington, Va., March 26, 2012), www.federalreserve.gov/newsevents/speech/bernanke20120326a.htm.

6. For further discussion of structural unemployment and the weak labor market of the past few years, see Congressional Budget Office, *Understanding and Responding to Persistently High Unemployment* (February 2012), www.cbo.gov/publication/42989.

Figure 2-3.

Long-Term Unemployment

(Percent)



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

Notes: Data show the percentage of unemployed U.S. workers who have been unemployed for longer than 26 consecutive weeks.

Data are annual and are plotted through 2012.

40 percent for the past three years (see Figure 2-3), far higher than in any other three-year period since World War II. CBO expects that share to remain high for the next few years.

The unemployment rate during the past several years would have been even higher if participation in the labor force had not declined so much over that period. (The rate of participation in the labor force describes the share of the civilian noninstitutionalized population age 16 or older that is either working or actively seeking work.) Participation fell from 66.0 percent in 2007 to 63.7 percent in 2012, an unusually large decrease over such a short period. About 1.3 percentage points of that decrease reflects the movement of the baby-boom generation into retirement (the oldest members of that group turned 65 in 2011), and about 0.3 percentage points can be directly attributed to the elevated rate of unemployment. The factors contributing to the remaining 0.7 percentage points are unclear but may include an unusually large response to the protracted weakness in the labor market.

The growth of labor compensation (the combination of wages and benefits that workers receive) picked up a bit in 2012 but continued to be restrained by the weak demand for labor. Real labor compensation grew by 1.6 percent in 2012, in CBO's estimation, mostly from increases in the number of workers; real labor compensation per worker grew by only 0.2 percent. Because of the tepid growth of employment and wages in recent years, total real labor compensation at the end of 2012 was slightly below its value in late 2007, just before the start of the recent recession.

Inflation and Interest Rates

Inflation moderated in 2012, and interest rates remained low. By CBO's estimates, consumer prices, measured by the price index for personal consumption expenditures, increased by 1.5 percent last year (as measured on a fourth-quarter-to-fourth-quarter basis), compared with an increase of 2.5 percent in 2011. That moderation is largely attributable to smaller increases in prices for gasoline and food. The core PCE price index—which excludes food and energy prices—also increased by 1.5 percent in 2012, down a little from 1.7 percent in 2011.[7] Other measures, the consumer price index for all urban consumers (CPI-U) and its core version, increased by 1.9 percent last year. (Rates for the CPI-U differ from those for the PCE price index because of the methods used to calculate those indexes and the larger role of housing rents in the CPI-U.) Since the recession began in December 2007, overall inflation has averaged

7. According to the January 30 release of fourth quarter data by the Bureau of Economic Analysis, the PCE price index and the core PCE price index grew by 1.5 percent last year.

1.7 percent a year according to the PCE price index and 1.9 percent according to the CPI-U.

Interest rates remained low in 2012. Short-term interest rates were near zero, and longer-term rates declined to extremely low levels in the first half of 2012 and stayed unusually low thereafter. Those low rates reflect several factors:

- Investors' expectations that U.S. output will be below its potential for a few years;
- Investors' concerns about banking and fiscal problems in Europe; and
- Ongoing efforts by monetary policymakers to keep short- and long-term interest rates low, using the traditional and nontraditional policy actions employed since the recession.

That last factor includes the Federal Reserve's announcement in late 2012 that it intends to keep its target for the federal funds rate (the interest rate on overnight lending among banks that the Federal Reserve adjusts to conduct monetary policy) near zero until labor market conditions improve or inflation rises notably, and to continue purchasing long-term Treasury securities and mortgage-backed securities.[8]

The Economic Outlook for 2013 to 2018

CBO's economic outlook builds on the indications of a strengthening economy in 2012, but CBO expects that real GDP will grow slowly in 2013 because of fiscal tightening by the federal government that is scheduled to occur under current law. The agency's projections show the economy growing more strongly after this year and returning to its potential level in 2017. The anticipated improvement in the economy over the next few years reflects the fading effects of the housing and financial crisis, which have held down spending on housing, consumer goods and services, and business structures, equipment, and software. If some or all of the fiscal tightening scheduled to occur under current law was removed, the additional federal spending, lower tax revenues, or both would cause output to be greater and unemployment lower in the next few years than CBO projects. However, unless sufficient additional tightening was imposed later, output and income would be restrained in the middle of the coming decade and beyond by higher federal debt.

The Economic Outlook for 2013

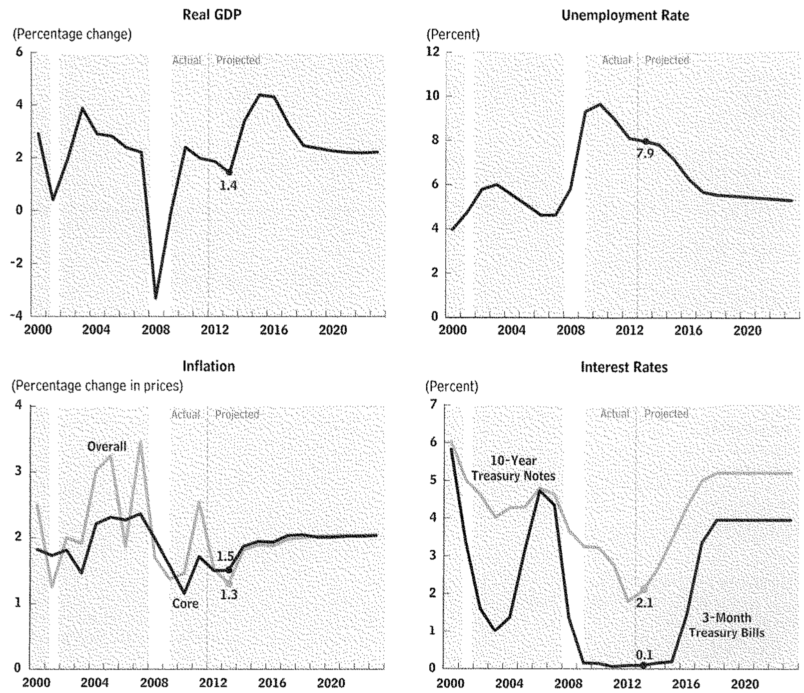
Under current law, real GDP will increase by 1.4 percent in 2013 after growing by an estimated 1.9 percent in 2012, CBO projects (see Figure 2-4 and Table 2-1). Consistent with that slow growth, the unemployment rate is expected to edge up from its 7.8 percent reading at the end of last year to 8.0 percent in the fourth quarter of this year. The rate of inflation (as measured by the PCE price index) is estimated to decline to 1.3 percent this year (compared with 1.5 percent in 2012), largely as a consequence of declining energy prices. In CBO's forecast, interest rates stay very low this year; the rate on 3-month Treasury bills hovers near zero, and the rate on 10-year Treasury notes remains under 2½ percent.

Economic growth is projected to slow in 2013 primarily because of federal fiscal tightening. Federal spending on goods and services drops significantly in CBO's projections, primarily as a result of the automatic spending reductions specified in current law. (Those reductions were slated to begin in January of this year but were delayed until March by the American Taxpayer Relief Act.) Changes in tax rules are also expected to curtail growth in 2013. The 2 percentage-point cut in the payroll tax that first went into effect in January 2011 expired in January 2013, as did some reductions in tax rates originally enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27). Those changes will reduce after-tax income for many people, which will constrain the growth of consumer spending. That slowdown, in turn, will restrain overall growth in output and employment this year.

8. For discussions of the Federal Reserve's nontraditional policy actions of the past few years and their effects on the economy, see Arvind Krishnamurthy and Annette Vissing-Jorgensen, *The Effects of Quantitative Easing on Interest Rates: Channels and Implications for Policy*, Working Paper 17555 (National Bureau of Economic Research, October 2011), www.nber.org/papers/w17555; and Brett W. Fawley and Christopher J. Neely, "Four Stories of Quantitative Easing," *Review*, Federal Reserve Bank of St. Louis, vol. 95, no. 1 (January/February 2013), pp. 51–88, http://research.stlouisfed.org/publications/review/13/01/Fawley.pdf.

Figure 2-4.

Actual Values and CBO's Projections of Key Economic Indicators



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

Notes: Real gross domestic product (GDP) is the output of the economy adjusted to remove the effects of inflation.

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.

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 annual and are plotted through 2023. Forecast values for 2013 are labeled.

For real GDP and inflation, actual data are plotted through 2011; the values for 2012 reflect CBO's estimates for the fourth quarter and do not incorporate data recently released by the Department of Commerce and the Department of Labor. Percentage changes are measured between the fourth quarters of successive years.

For the unemployment rate and interest rates, actual data are plotted through 2012.

Table 2-1.

CBO's Economic Projections for Calendar Years 2012 to 2023

	Estimated,	Forecast		Projected Annual Average	
	2012	2013	2014	2015–2018	2019–2023
	Fourth Quarter to Fourth Quarter (Percentage change)				
Gross Domestic Product					
Real	1.9	1.4	3.4	3.6	2.2
Nominal	3.7	2.9	5.3	5.7	4.3
Inflation					
PCE price index	1.5	1.3	1.8	1.9	2.0
Core PCE price index[a]	1.5	1.5	1.9	2.0	2.0
Consumer price index[b]	1.9 [c]	1.5	2.0	2.2	2.3
Core consumer price index[a]	1.9 [c]	1.8	2.0	2.2	2.3
GDP price index	1.8	1.5	1.9	2.1	2.0
Employment Cost Index[d]	1.9	2.2	3.3	4.0	3.6
	Fourth Quarter Level (Percent)				
Unemployment Rate	7.8 [c]	8.0	7.6	5.5 [e]	5.2 [f]
	Year to Year (Percentage change)				
Gross Domestic Product					
Real	2.3	1.4	2.6	3.7	2.3
Nominal	4.1	2.9	4.4	5.9	4.3
Inflation					
PCE price index	1.7	1.3	1.7	1.9	2.0
Core PCE price index[a]	1.7	1.3	1.8	2.0	2.0
Consumer price index[b]	2.1 [c]	1.6	1.9	2.2	2.3
Core consumer price index[a]	2.1 [c]	1.7	2.0	2.2	2.3
GDP price index	1.8	1.5	1.8	2.1	2.0
Employment Cost Index[d]	1.8	2.1	2.9	4.0	3.6
	Calendar Year Average				
Unemployment Rate (Percent)	8.1 [c]	7.9	7.8	6.1	5.4
Payroll Employment (Monthly change, in thousands)	157 [c]	105	182	171	75
Interest Rates (Percent)					
Three-month Treasury bills	0.1 [c]	0.1	0.2	2.2	4.0
Ten-year Treasury notes	1.8 [c]	2.1	2.7	4.5	5.2
Tax Bases (Percentage of GDP)					
Wages and salaries	44.1	43.5	43.9	44.2	44.9
Domestic economic profits	9.6	9.3	9.7	9.7	7.7

Source: Congressional Budget Office. (Actual values for 2012 are from Department of Labor, Bureau of Labor Statistics; Federal Reserve.)

Notes: Economic projections for each year from 2012 to 2023 appear in Appendix B.

The numbers shown here do not reflect the values for GDP and related series released by the Commerce Department's Bureau of Economic Analysis on January 30 and the values released by the Labor Department's Bureau of Labor Statistics for the employment cost index on January 31 and for payroll employment on February 1.

PCE = personal consumption expenditures; GDP = gross domestic product.

a. Excludes prices for food and energy.

b. The consumer price index for all urban consumers.

c. Actual value for 2012.

d. The employment cost index for wages and salaries of workers in private industry.

e. Value for 2018.

f. Value for 2023.

If all of the fiscal tightening still embodied in current law for 2013 was removed, growth in real GDP would be about 1½ percentage points higher this year than CBO currently projects.[9] About 1¼ percentage points of that effect comes from the automatic reductions in federal spending described in Chapter 1, the expiration of the cut in payroll tax rates, and the increase in marginal tax rates on higher income; the spending changes and the combined tax changes account for about equal portions. (The spending changes have a smaller budgetary impact than the tax changes, but they affect GDP by a larger amount per dollar of budgetary cost.) The remaining ¼ percentage point comes from other, smaller changes in spending and taxes. Even if all of the scheduled fiscal tightening in 2013 was removed, the economy would remain below its potential level and the unemployment rate would remain high for some time, CBO estimates.

Gathering strength in some sectors will keep the economy growing despite the impending fiscal tightening, CBO projects. For example, residential investment is expected to continue to improve, and increases in house prices and stock prices will boost households' wealth. CBO anticipates that consumer spending will grow moderately, increasing aggregate demand. As a result, business investment will rise, helping to spur additional hiring and further bolstering the wealth of households. Continued easing of credit conditions will also support spending by households and businesses.

The Economic Outlook for 2014 to 2018

The growth of real GDP will pick up considerably beginning in 2014, CBO projects, after economic activity adjusts to this year's fiscal tightening. In CBO's projections, economic growth is 3.4 percent in 2014 and averages 3.6 percent per year in 2015 through 2018 (see Table 2-1). That growth closes the gap between actual and potential GDP by 2017. As a result of that stronger economic growth, the unemployment rate in CBO's forecast falls from 8.0 percent in the fourth quarter of 2013 to 6.8 percent in the fourth quarter of 2015 and then declines gradually to 5.5 percent in the fourth quarter of 2018.

9. That estimate is informed by recent changes to law and CBO's previous analysis of the effects on GDP of fiscal tightening in 2013. See Congressional Budget Office, *Economic Effects of Policies Contributing to Fiscal Tightening in 2013* (November 2012), www.cbo.gov/publication/43694.

The quickening of economic growth in 2014 reflects CBO's projections of continued improvements in households' income and wealth and in credit markets. Consumer spending will be supported by faster growth in wages and salaries (a result of more robust employment growth) and by continued gains in household wealth, owing to persistent increases in house prices and stock prices. Stronger demand for goods and services by households, in turn, will encourage businesses to undertake investments in structures and equipment as well as to engage in further hiring. Greater availability of credit will also support consumer spending and business investment. In addition, CBO expects that increased spending by federal, state, and local governments will add a small amount to overall demand after 2013. In contrast, net exports are likely to decline for much of the 2014–2018 period while growth in the United States outpaces growth among its major trading partners.

From 2014 through 2018, CBO projects, the rate of inflation as measured by the PCE price index and its corresponding core index will rise slowly and then remain at 2 percent. CBO expects the CPI-U and its core version to increase a little more rapidly than their PCE counterparts.

As economic growth and financial markets improve domestically and abroad, CBO anticipates, short-term and long-term interest rates will rise. In CBO's forecast, monetary policymakers begin raising the federal funds rate in early 2016 and selling assets from the Federal Reserve's securities portfolio later in that year. In addition, CBO projects that as the effects of the financial crisis and recession fade, and as economies in Europe improve, demand for risk-free U.S. Treasury securities will decline to a more normal level as demand for other assets increases. Finally, an improvement in economic growth will raise the demand for credit, putting upward pressure on interest rates more broadly. All told, the interest rate on 3-month Treasury bills in CBO's projection climbs from 0.1 percent in the fourth quarter of 2013 to 4.0 percent in the fourth quarter of 2018 (see Figure 2-4). Over the same period, the rate on 10-year Treasury notes is projected to increase from 2.3 percent to 5.2 percent.

Some Uncertainties in the Economic Outlook

Economic forecasts are always uncertain, but the uncertainty surrounding CBO's forecast for the next several years is especially great because the current business cycle has been unusual in a variety of ways.[10] Following the agency's usual practice, CBO constructed its forecast to lie in the middle of the distribution of possible outcomes for the economy given the fiscal policies that are embodied in current law.

Even if no significant changes are made to fiscal policy, actual outcomes will undoubtedly differ from CBO's economic projections for various reasons. For example, the economy could grow considerably faster than CBO has forecast if exports are stronger as a result of more robust economic growth abroad than the agency has projected. Such an increase in exports could then speed the growth of employment and boost U.S. businesses' spending on structures, equipment, and software, potentially leading to a self-reinforcing cycle of increased spending, hiring, and income generation.

Outcomes that are worse than those in CBO's forecast also are possible, however. For instance, if spending by businesses failed to improve after 2013 (perhaps because of an increase in uncertainty or tightening in the availability of credit owing to disruptions in financial markets), then investment and hiring could remain weak. That outcome could trigger a downturn in consumer spending and stall the recovery in the housing market, which could, in turn, reinforce the weakness in investment and hiring by businesses.

The Economic Outlook for 2019 to 2023

For the second half of the coming decade, CBO does not attempt to predict cyclical ups and downs of the economy but assumes instead that real GDP will equal its maximum sustainable level. Thus, CBO's assessment of the outlook for output and income for 2019 to 2023 depends on projections of trends in the factors of production that underlie potential output: the size of the labor force, the stock of productive capital, and the productivity of those factors. CBO's projections of those trends reflect the negative effects of the recession of 2007–2009 and the ensuing slow recovery as well as the impact of fiscal policy under current law. The projections through 2023 further reflect the expectation that the Federal Reserve will keep inflation low and stable.

Potential Output

Potential GDP is projected to grow at an average annual rate of 2.3 percent between 2019 and 2023, substantially below the average rate since 1950 of 3.3 percent (see Table 2-2). That estimate is mainly a result of slower projected growth in the potential labor force (the labor force adjusted for variations caused by the business cycle). That growth is expected to decline from its 1.5 percent average annual rate since 1950 to a 0.5 percent average annual rate during the coming decade, mostly owing to the retirement of the baby-boom generation and an end to the long-standing increase in the labor force participation of women.[11] For the nonfarm business sector, which makes up the bulk of the economy, CBO also expects the growth of capital services (the flow of services available from the stock of capital assets, such as equipment and structures) to be slower over the coming decade than it has been, on average, since 1950, primarily reflecting the slower growth of the labor force but also greater federal borrowing as a share of GDP. Similarly, CBO anticipates that the growth of potential total factor productivity (the potential efficiency in producing goods and services—specifically, the average real output per unit of input from labor and capital services combined, adjusted for variations caused by the business cycle) will be slower as well.

CBO's projections for growth of all three factors that underlie potential output have been dampened by the recent recession and the ensuing slow recovery. In particular, CBO estimates the following:

- Persistent long-term unemployment will lead some workers to leave the workforce earlier than they would have otherwise and will erode the skills of other workers, making it harder for them to find work in the coming years;

10. For discussions of unusual features of the current business cycle, see, for example, Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2011 to 2021* (January 2011), pp. 28–36, www.cbo.gov/publication/21999, and *What Accounts for the Slow Growth of the Economy After the Recession?* (November 2012), www.cbo.gov/publication/43707.

11. With that pace of growth in the labor force and a steady unemployment rate, CBO projects that payroll employment will increase by 75,000 per month during the 2019–2023 period, also well below its historical average.

Table 2-2.

Key Assumptions in CBO's Projection of Potential GDP

(By calendar year, in percent)

	Average Annual Growth						Projected Average Annual Growth		
	1950-1973	1974-1981	1982-1990	1991-2001	2002-2012	Total, 1950-2012	2013-2018	2019-2023	Total, 2013-2023
Overall Economy									
Potential GDP	3.9	3.3	3.1	3.1	2.2	3.3	2.2	2.3	2.2
Potential Labor Force	1.6	2.5	1.6	1.3	0.8	1.5	0.6	0.5	0.5
Potential Labor Productivity[a]	2.3	0.8	1.5	1.8	1.4	1.7	1.6	1.8	1.7
Nonfarm Business Sector									
Potential GDP	4.0	3.6	3.2	3.5	2.5	3.5	2.6	2.6	2.6
Potential Hours Worked	1.4	2.4	1.6	1.2	0.5	1.3	0.5	0.5	0.5
Capital Services	3.8	4.3	4.1	4.7	2.3	3.8	3.3	3.3	3.3
Potential TFP	1.9	0.7	0.9	1.3	1.4	1.4	1.2	1.3	1.3
Potential TFP excluding adjustments	1.9	0.7	0.9	1.2	1.3	1.4	1.3	1.3	1.3
Adjustments to TFP (Percentage points)[b]	0	0	0	0.1	0.2	*	**	0	**
Contributions to the Growth of Potential GDP (Percentage points)									
Potential hours worked	0.9	1.7	1.1	0.8	0.3	0.9	0.3	0.4	0.3
Capital input	1.2	1.3	1.2	1.4	0.7	1.1	1.0	1.0	1.0
Potential TFP	1.9	0.7	0.9	1.3	1.4	1.4	1.2	1.3	1.3
Total Contributions	4.0	3.6	3.2	3.5	2.5	3.5	2.6	2.6	2.6
Potential Labor Productivity[c]	2.6	1.2	1.6	2.3	2.0	2.1	2.1	2.1	2.1

Source: Congressional Budget Office.

Notes: Potential GDP is the maximum sustainable level of output in the economy.

GDP = gross domestic product; TFP = total factor productivity; * = between zero and 0.05 percentage points; ** = between -0.05 percentage points and zero.

a. The ratio of potential GDP to the potential labor force.

b. The adjustments reflect CBO's estimates of the effect of the unusually rapid growth of TFP between 2001 and 2003 and the effect of the 2007–2009 recession on potential TFP.

c. The estimated trend in the ratio of potential GDP to potential hours worked in the nonfarm business sector.

- The cumulative effect of the projected rebound in investment over the next decade will not entirely make up for the investment lost during the recession; and

- Growth in total factor productivity has been held down as the recession and slow recovery have delayed the reallocation of workers to their most productive uses, slowed the rate at which workers gain new skills as technologies evolve, and lowered spending by businesses on research and development.

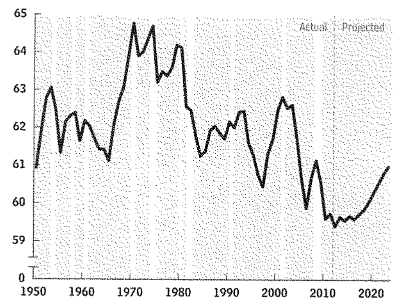
Combining those effects, CBO estimates that potential output will be about 1½ percent lower in 2023 than it would have been without the recession and slow recovery; each of the three factors accounts for about one-third of the reduction.[12]

12. For more discussion of those effects, see Congressional Budget Office, *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022* (August 2012), Box 2-2, www.cbo.gov/publication/43539.

Figure 2-5.

Labor Income

(Percentage of gross domestic income)



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

Notes: Labor income is defined as the sum of the compensation of employees and CBO's estimate of the labor share of proprietors' income. Gross domestic income is the sum of all income earned in the production of gross domestic product.

Data are annual. Actual data are plotted through 2011. The value for 2012 reflects CBO's estimate for the fourth quarter. Projections are plotted through 2023.

Unemployment, Inflation, and Interest Rates

In CBO's projections, the unemployment rate inches down from 5.5 percent at the end of 2018 to 5.2 percent by 2023. That decline matches the decline over that same period in the agency's estimate of the natural rate of unemployment (the rate arising from all sources except fluctuations in aggregate demand). CBO expects that the difficulty the long-term unemployed face in finding jobs—for example, because of the erosion of their skills or because of employers' perception that their absence from the job market is an indication of their quality as workers—will gradually diminish but not completely disappear by 2023; as a result, the natural rate of unemployment edges downward during the 2019–2023 period in CBO's projection.

Both inflation and core inflation as measured by the PCE price index are forecast to stay at 2.0 percent in the period from 2019 to 2023, in line with the Federal Reserve's announced target for inflation. (Average inflation as measured by the CPI-U is projected to be slightly higher.) CBO forecasts that the interest rates on 3-month Treasury bills and 10-year Treasury notes will average 4.0 percent and 5.2 percent, respectively, for the period. Those rates are consistent with the historical relationships among interest rates, inflation, federal borrowing, and the factors that underlie the growth of potential GDP. In particular, the rate on 10-year Treasury notes adjusted for inflation is projected to equal about 3 percent from 2019 to 2023, higher than its long-run historical average primarily because CBO forecasts a higher-than-average ratio of federal debt to GDP during that period.

Projections of Income

Economic activity and federal tax revenues depend not only on the amount of total income in the economy but also on how that income is divided among its constituent parts: wages and salaries, domestic economic profits, proprietors' income, interest and dividend income, and other categories. CBO forecasts various categories of income by projecting their shares of total gross domestic income (GDI). (In principle, GDI equals GDP because the costs of production are tracked as income; in practice, they differ because of difficulties in measuring both quantities.)

Labor income has fallen as a share of GDI during the economic recovery, continuing its previous downward trend (see Figure 2-5).[13] CBO estimates that labor's share averaged 59.4 percent in the fourth quarter of 2012, down from 61.0 percent in the second quarter of 2009 (at the end of the recession). Much of that weakness can be attributed to slower growth during the past few years in wages and salaries (the largest component of labor income) relative to growth in the other components of GDI. Historically, labor's share of income tends to decline early in recoveries and rise later. In CBO's projections, labor income grows faster than GDI over the next decade, bringing its share to 61.0 percent in 2023—still

13. CBO defines labor income as the sum of employees' compensation and a percentage of proprietors' income, where that percentage equals employees' compensation as a share of the difference between GDI and proprietors' income. In the past, CBO defined labor income as the sum of employees' compensation and 65 percent of proprietors' income, following the convention used most often in the economics literature. However, CBO recently reassessed its allocation of proprietors' income among the categories of labor and capital income in light of new research. See Congressional Budget Office, *The Taxation of Capital and Labor Through the Self-Employment Tax* (September 2012), pp. 16–17, www.cbo.gov/publication/43644.

below its average of about 61½ percent in recent decades. That increase stems from faster growth in real hourly labor compensation, which picks up during the first half of the projection period in response to stronger demand for labor and then remains strong during the latter years of the period, when it is assumed to match the growth of labor productivity and cause growth in labor income to exceed the growth of other types of income.

Domestic economic profits, CBO estimates, were 9.7 percent of GDI in 2012 and will decline slightly as a share of GDI in 2013 as the economy slows a bit.[14] CBO expects that profits' share will then rise through 2016 before falling again thereafter—to about 7.3 percent in 2023—because of the rising burden of corporate interest payments, depreciation on the larger stock of business capital, and growth in labor income.

Comparison with Other Economic Projections

CBO's current economic forecast differs in some important respects from the forecast it issued in August 2012. The forecast also differs in various ways from the *Blue Chip* consensus forecast published in January and from the Federal Reserve's forecasts presented at the December 2012 meeting of the Federal Open Market Committee.

CBO's current forecast for the growth of output in 2013 (1.4 percent) is significantly higher than its forecast from last August, when the agency projected that real GDP would decline by 0.5 percent (see Table 2-3). The August forecast was heavily influenced by the sharp fiscal tightening that had been scheduled to take effect in January 2013. However, the American Taxpayer Relief Act removed part of that fiscal tightening, boosting projected growth in real GDP in 2013 by between 1½ and 1¾ percentage points. That effect, along with better-than-expected news about the economy, led CBO to revise upward its projected growth rate for real GDP this year.

In contrast, CBO has revised downward its projection of the level of potential GDP in 2022, the last year of CBO's previous projections, by roughly 0.5 percent. That change primarily reflects data revisions that reduced historical estimates of capital services and, in turn, CBO's projection of those services. In addition, CBO estimates that greater federal borrowing under current law relative to the path in CBO's previous projections would reduce the size of the capital stock. That reduction would occur because, by CBO's estimates, federal borrowing would take up a larger share of the saving potentially available for private investment. Consistent with that greater federal borrowing and smaller capital stock, CBO raised its projection of the interest rate on 10-year Treasury notes in the latter part of the projection period to 5.2 percent from 5.0 percent in the previous projection.

CBO forecasts a weaker economy in the near term—with lower GDP growth in 2013 and a higher rate of unemployment over the next few years—than is forecast by the *Blue Chip* consensus or the Federal Reserve (see Table 2-4). Those differences in forecasts probably result from a variety of factors, including the economic data available when the forecasts were completed, the models used by the forecasters, and varying assumptions about future federal taxes and spending. In particular, a number of other forecasters report that they expect lawmakers to postpone some of the remaining near-term fiscal tightening, whereas CBO's forecast, based on current law, does not include such expectations.

14. Domestic economic profits are corporations' domestic profits adjusted to remove distortions in depreciation allowances caused by tax rules and to exclude the effects of inflation on the value of inventories. Domestic economic profits exclude certain income of U.S.-based multinational corporations that is derived from foreign sources, most of which does not generate corporate income tax receipts in the United States.

Table 2-3.

Comparison of CBO's Current and Previous Economic Projections for Calendar Years 2012 to 2022

	Estimated,	Forecast		Projected Annual Average	
	2012	2013	2014	2015–2018	2019–2022
	Fourth Quarter to Fourth Quarter (Percentage change)				
Real GDP					
February 2013	1.9	1.4	3.4	3.6	2.2
August 2012	2.1	-0.5	4.4	3.9	2.3
Nominal GDP					
February 2013	3.7	2.9	5.3	5.7	4.3
August 2012	3.9	0.8	6.0	5.9	4.4
PCE Price Index					
February 2013	1.5	1.3	1.8	1.9	2.0
August 2012	1.4	1.4	1.7	1.9	2.0
Consumer Price Index[a]					
February 2013	1.9 [b]	1.5	2.0	2.2	2.3
August 2012	1.3	1.6	1.9	2.2	2.3
GDP Price Index					
February 2013	1.8	1.5	1.9	2.1	2.0
August 2012	1.8	1.4	1.6	1.9	2.0
Employment Cost Index[c]					
February 2013	1.9	2.2	3.3	4.0	3.6
August 2012	2.6	2.4	3.4	4.4	3.7
Real Potential GDP					
February 2013	1.7	1.8	2.0	2.4	2.2
August 2012	1.7	1.6	1.9	2.4	2.3
	Calendar Year Average				
Unemployment Rate (Percent)					
February 2013	8.1 [b]	7.9	7.8	6.1	5.4
August 2012	8.2	8.8	8.7	6.5	5.4
Interest Rates (Percent)					
Three-month Treasury bills					
February 2013	0.1 [b]	0.1	0.2	2.2	4.0
August 2012	0.1	0.1	0.2	2.2	3.8
Ten-year Treasury notes					
February 2013	1.8 [b]	2.1	2.7	4.5	5.2
August 2012	1.8	1.8	2.4	4.0	5.0
Tax Bases (Percentage of GDP)					
Wages and salaries					
February 2013	44.1	43.5	43.9	44.2	44.9
August 2012	44.1	44.0	44.1	44.7	45.4
Domestic economic profits					
February 2013	9.6	9.3	9.7	9.7	7.9
August 2012	10.4	9.0	9.4	9.3	7.6

Source: Congressional Budget Office. (Actual values for 2012 are from Department of Labor, Bureau of Labor Statistics; Federal Reserve.)

Notes: Estimated values do not reflect the values for GDP and related series released by the Commerce Department's Bureau of Economic Analysis on January 30 and the values for the employment cost index released by the Labor Department's Bureau of Labor Statistics on January 31.

GDP = gross domestic product; PCE = personal consumption expenditures.

a. The consumer price index for all urban consumers.

b. Actual value for 2012.

c. The employment cost index for wages and salaries of workers in private industry.

Table 2-4.

Comparison of Economic Projections by CBO, the *Blue Chip* Consensus, and the Federal Reserve

(By calendar year)

	Estimated, 2012	2013	2014	2015	Longer Run[a]
		Fourth Quarter to Fourth Quarter (Percentage Change)			
Real GDP					
CBO	1.9	1.4	3.4	4.4	2.2
Blue Chip	1.9	2.2	2.8	n.a.	n.a.
Federal Reserve					
Range	1.6 to 2.0	2.0 to 3.2	2.8 to 4.0	2.5 to 4.2	2.2 to 3.0
Central tendency	1.7 to 1.8	2.3 to 3.0	3.0 to 3.5	3.0 to 3.7	2.3 to 2.5
PCE Price Index					
CBO	1.5	1.3	1.8	1.9	2.0
Federal Reserve					
Range	1.6 to 1.8	1.3 to 2.0	1.4 to 2.2	1.5 to 2.2	2.0
Central tendency	1.6 to 1.7	1.3 to 2.0	1.5 to 2.0	1.7 to 2.0	2.0
Core PCE Price Index[b]					
CBO	1.5	1.5	1.9	1.9	2.0
Federal Reserve					
Range	1.6 to 1.8	1.5 to 2.0	1.5 to 2.0	1.7 to 2.2	n.a.
Central tendency	1.6 to 1.7	1.6 to 1.9	1.6 to 2.0	1.8 to 2.0	n.a.
Consumer Price Index[c]					
CBO	1.9 [d]	1.5	2.0	2.1	2.3
Blue Chip	1.9	1.9	2.2	n.a.	n.a.
GDP Price Index					
CBO	1.8	1.5	1.9	2.1	2.0
Blue Chip	2.0	1.8	2.0	n.a.	n.a.

Continued

Table 2-4. Continued

Comparison of Economic Projections by CBO, the *Blue Chip* Consensus, and the Federal Reserve

(By calendar year)

	Estimated, 2012	2013	2014	2015	Longer Run[a]
			Fourth Quarter Level (Percent)		
Unemployment Rate					
CBO	7.8 [d]	8.0	7.6	6.8	5.2
Blue Chip	7.8 [d]	7.5	7.0	n.a.	n.a.
Federal Reserve					
Range	7.7 to 8.0	6.9 to 7.8	6.1 to 7.4	5.7 to 6.8	5.0 to 6.0
Central tendency	7.8 to 7.9	7.4 to 7.7	6.8 to 7.3	6.0 to 6.6	5.2 to 6.0
Interest Rates					
Three-month Treasury bills					
CBO	0.1 [d]	0.1	0.2	0.3	4.0
Blue Chip	0.1 [d]	0.1	0.3	n.a.	n.a.
Ten-year Treasury notes					
CBO	1.7 [d]	2.3	2.9	3.8	5.2
Blue Chip	1.7 [d]	2.2	2.7	n.a.	n.a.

Sources: Congressional Budget Office; Aspen Publishers, *Blue Chip Economic Indicators* (January 10, 2013); Board of Governors of the Federal Reserve System, "Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents, December 2012" (December 12, 2012), www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20121212.pdf; Department of Labor, Bureau of Labor Statistics; Federal Reserve.

Notes: The *Blue Chip* consensus is the average of about 50 forecasts by private-sector economists. The range of estimates from the Federal Reserve reflects the forecasts of the members of the Board of Governors and the presidents of the Federal Reserve Banks. The central tendency is that range without the three highest and three lowest projections.

The *Blue Chip* consensus does not provide forecasts of the PCE or core PCE price indexes. The Federal Reserve does not provide forecasts of the consumer price index, the GDP price index, or interest rates.

Estimated values for GDP and related series do not reflect the values for the fourth quarter of 2012 released by the Commerce Department's Bureau of Economic Analysis on January 30.

GDP = gross domestic product; n.a. = not applicable; PCE = personal consumption expenditures.

a. For CBO, values are for 2023. For the Federal Reserve, values represent assessments of the rate to which each variable would be expected to converge under appropriate monetary policy and in the absence of further shocks to the economy.

b. Excludes prices for food and energy.

c. The consumer price index for all urban consumers.

d. Actual value for 2012.

APPENDIX

A

Changes in CBO's Baseline Since August 2012

The Congressional Budget Office (CBO) anticipates that in the absence of further legislation affecting spending and revenues, the deficit for 2013 will be $845 billion, or $204 billion more than the agency projected in August, when it released its previous set of baseline budgetary projections (see Table A-1).[1] CBO now estimates that the cumulative deficit over the 2013–2022 period, under current law, will be $6.8 trillion, which is $4.6 trillion more than it projected in August. The enactment of legislation, most notably the American Taxpayer Relief Act of 2012 (Public Law 112-240), boosted the cumulative deficit by an estimated $4.7 trillion; together, changes in the economic outlook and other, technical, changes offset $129 billion of that increase. (For a description of the American Taxpayer Relief Act, see Box 1-1 in Chapter 1.)

For 2013, CBO estimates, revenues will be $204 billion less and outlays $1 billion lower than it had previously projected. Enactment of the American Taxpayer Relief Act will reduce revenues by an estimated $280 billion; that reduction is partially offset by increases in projected revenues because of economic and technical changes. The small drop in estimated outlays for the current year is the net result of nearly offsetting changes: reductions for technical reasons in CBO's estimates of both discretionary and mandatory spending ($58 billion), mostly offset by an estimated increase in mandatory outlays resulting from recent legislation ($41 billion), and other, smaller increases ($16 billion).

For the 2013–2022 period, the change in deficits is dominated by a projected reduction in individual income tax receipts stemming from provisions in the American Taxpayer Relief Act; by itself, that reduction results in a projected increase of $3.2 trillion in the cumulative deficit over the 10-year period (excluding added debt-service costs). In all, revenues for that period are now projected to be about 9 percent less and outlays are projected to be about 2 percent less than the amounts CBO projected in August 2012.

The changes in CBO's baseline include updates to the agency's projections of the budgetary effects of provisions in the Affordable Care Act that involve health insurance coverage.[2] Although several components of its estimates have changed since August, the difference in the net budgetary impact for the 2013–2022 period is less than $500 million.

Legislative Changes

Legislation enacted since the agency prepared its August baseline has had a substantial impact on CBO's estimates

1. Those projections were reported in Congressional Budget Office, *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022* (August 2012), www.cbo.gov/publication/43539.

   CBO constructs its baseline in accordance with provisions of the Balanced Budget and Emergency Deficit Control Act of 1985 and the Congressional Budget and Impoundment Control Act of 1974. To project revenues and mandatory spending, CBO assumes that current laws, with only a few exceptions, will remain unchanged. To project discretionary spending, CBO assumes that appropriations through 2021 will adhere to the caps and automatic spending reductions referenced in the Budget Control Act of 2011 (Public Law 112-25) and that appropriations for 2022 and 2023 will grow from the 2021 amount at the rate of inflation. The resulting baseline projections are not intended to be a prediction of future budgetary outcomes; rather, they serve as a benchmark that lawmakers can use to measure the potential effects of tax or spending proposals.

2. The Affordable Care Act comprises the Patient Protection and Affordable Care Act (P.L. 111-148) and the health care provisions of the Health Care and Education Reconciliation Act of 2010 (P.L. 111-152) and, in the case of this document, the effects of subsequent related judicial decisions, statutory changes, and administrative actions.

Table A-1.

Changes in CBO's Baseline Projections of the Deficit Since August 2012

(Billions of dollars)

											Total	
	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2013-2017	2013-2022
Deficit in CBO's August 2012 Baseline	**-641**	**-387**	**-213**	**-186**	**-123**	**-79**	**-130**	**-142**	**-144**	**-213**	**-1,549**	**-2,258**
						Legislative Changes						
Changes in Revenues												
Individual income taxes	-224	-258	-254	-277	-304	-330	-351	-379	-410	-443	-1,317	-3,232
Corporate income taxes	-55	-15	9	5	4	2	*	-1	-2	-2	-52	-54
Social insurance taxes	*	-1	-1	-1	-1	-1	-1	-1	-1	-1	-2	-5
Other	*	-25	-30	-33	-36	-39	-42	-45	-48	-51	-124	-348
All Changes in Revenues	**-280**	**-299**	**-275**	**-305**	**-337**	**-367**	**-393**	**-426**	**-461**	**-497**	**-1,495**	**-3,639**
Changes in Outlays												
Mandatory												
Refundable tax credits	0	36	37	37	37	37	23	23	23	23	148	277
Unemployment compensation	22	8	0	0	0	0	0	0	0	0	30	30
Medicare	13	4	-3	-3	-3	*	*	-1	-1	-1	8	5
Other	5	0	0	2	4	1	*	*	*	-4	11	7
Subtotal	41	48	34	36	38	38	22	22	22	18	197	319
Discretionary	9	-8	-7	-3	2	5	7	9	10	11	-8	35
Debt service	1	5	7	20	42	73	96	122	153	185	75	704
All Changes in Outlays	**50**	**45**	**34**	**52**	**82**	**116**	**126**	**153**	**185**	**213**	**264**	**1,057**
Total Legislative Changes[a]	**-330**	**-344**	**-309**	**-358**	**-419**	**-483**	**-519**	**-579**	**-645**	**-710**	**-1,760**	**-4,696**
						Economic Changes						
Changes in Revenues												
Individual income taxes	20	32	34	29	24	10	*	-3	-4	*	139	142
Corporate income taxes	-13	-1	-5	*	9	12	11	10	7	2	-11	31
Social insurance taxes	4	6	*	-5	-9	-15	-19	-20	-19	-16	-5	-94
Other	1	3	2	-1	1	3	1	1	1	1	5	11
All Changes in Revenues	**13**	**39**	**30**	**22**	**24**	**9**	**-7**	**-13**	**-15**	**-13**	**128**	**90**
Changes in Outlays												
Mandatory												
Student loans	2	3	4	5	6	5	3	2	2	2	21	35
Social Security	4	4	4	5	4	2	1	*	-1	-3	20	19
Other	-4	-5	*	1	1	2	2	2	*	-2	-9	-5
Subtotal	2	2	8	11	10	9	6	3	1	-2	32	50
Discretionary	-1	*	*	*	-1	-1	-2	-2	-2	-2	-1	-11
Net interest												
Debt service	*	*	*	-1	-1	-1	*	2	4	5	-3	7
Other	*	7	8	8	14	31	31	30	28	28	37	186
Subtotal	*	7	8	7	13	30	31	32	32	33	34	192
All Changes in Outlays	**1**	**8**	**16**	**19**	**22**	**38**	**35**	**33**	**31**	**29**	**65**	**231**
Total Economic Changes[a]	**12**	**31**	**15**	**4**	**2**	**-29**	**-42**	**-46**	**-46**	**-42**	**63**	**-141**

Continued

Table A-1. **Continued**

Changes in CBO's Baseline Projections of the Deficit Since August 2012

(Billions of dollars)

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	Total 2013-2017	Total 2013-2022
						Technical Changes						
Changes in Revenues												
Individual income taxes	43	38	40	37	21	15	3	-2	-8	-14	179	172
Corporate income taxes	21	10	4	2	8	10	11	10	10	10	44	95
Social insurance taxes	-9	-3	-5	-8	-13	-16	-17	-19	-21	-25	-38	-136
Other	8	10	37	26	-21	-42	-48	-61	-47	-22	60	-160
All Changes in Revenues	**63**	**55**	**76**	**57**	**-5**	**-33**	**-50**	**-72**	**-67**	**-51**	**245**	**-29**
Changes in Outlays												
Mandatory												
Medicaid	-2	-9	-11	-10	-16	-24	-31	-38	-44	-52	-48	-236
Medicare	-6	-9	-9	-9	-10	-11	-15	-18	-22	-29	-42	-137
Veterans' compensation and pensions	5	8	9	12	12	11	13	13	12	13	45	108
Fannie Mae and Freddie Mac	-29	*	*	*	-1	-1	-1	-2	-3	-6	-30	-44
Other	1	-8	-1	-3	5	8	4	2	1	4	-6	13
Subtotal	-31	-19	-11	-10	-10	-18	-30	-43	-56	-69	-81	-296
Discretionary	-27	-15	-3	-8	-4	1	2	2	2	2	-56	-47
Net interest												
Debt service	*	1	6	4	-7	-17	-18	-23	-22	-17	5	-92
Other	5	3	7	8	10	14	15	24	27	25	32	137
Subtotal	5	4	13	12	3	-2	-3	1	5	7	37	45
All Changes in Outlays	**-52**	**-30**	**-1**	**-7**	**-10**	**-19**	**-31**	**-40**	**-49**	**-60**	**-100**	**-298**
Total Technical Changes[a]	**114**	**84**	**78**	**64**	**5**	**-14**	**-20**	**-32**	**-19**	**8**	**345**	**269**
						All Changes						
Total Effect on the Deficit[a]	**-204**	**-229**	**-217**	**-290**	**-412**	**-526**	**-580**	**-656**	**-710**	**-744**	**-1,352**	**-4,568**
Deficit in CBO's February 2013 Baseline	**-845**	**-616**	**-430**	**-476**	**-535**	**-605**	**-710**	**-798**	**-854**	**-957**	**-2,901**	**-6,825**
Memorandum:												
Effects on the Deficit[a]												
Changes in revenues	-204	-206	-168	-226	-318	-391	-450	-511	-543	-561	-1,122	-3,577
Changes in outlays	1	-23	-49	-64	-94	-135	-130	-146	-167	-183	-230	-990

Source: Congressional Budget Office.

Note: * = between -$500 million and $500 million.

a. Negative numbers indicate an increase in the deficit; positive numbers indicate a decrease in the deficit.

of revenues and outlays. By itself, the American Taxpayer Relief Act boosted projected deficits by $4.0 trillion, excluding debt-service costs (see Box 1-1 in Chapter 1). As a result of that and other new laws, CBO has increased its estimate of the deficit by $331 billion for 2013 and by $4.7 trillion (including debt service) for the 2013–2022 period.

Changes to Projections of Revenues

Because of the American Taxpayer Relief Act (and other legislation that will have much smaller effects on the budget), CBO has significantly reduced its projections of revenues for the next decade. Specifically, the agency lowered its projections of revenues by $280 billion for 2013 and by an additional $3.4 trillion for the 2014–2022 period, which is in accord with estimates made by the staff of the Joint Committee on Taxation (JCT). (The act also will result in a $0.3 trillion increase in outlays for refundable tax credits, according to JCT's estimates.)

The act's most significant effects appear in receipts from individual income taxes: CBO reduced its projection for those revenues by $224 billion for 2013 and by $3.2 trillion for the 2013–2022 period. The law permanently extended several revenue-reducing provisions that had been set to expire on December 31, 2012. Most of those provisions were originally enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003 and were then extended for two years in December 2010. (The American Taxpayer Relief Act did not extend several expiring tax provisions that applied to the income of high-income taxpayers, however.) The law also will reduce revenues from individual income taxes because it permanently extended the higher exemption amounts for the alternative minimum tax, which had expired, and indexed them for inflation.

Furthermore, the American Taxpayer Relief Act modified laws concerning estate and gift taxes, extending most features that were in effect in 2012 but raising the top tax rate by 5 percentage points, to 40 percent. Because the top rate under prior law was scheduled to rise to 55 percent and the amount subject to taxes was scheduled to rise after 2012, CBO reduced its projections for revenues from estate and gift taxes by $348 billion for the next decade.

Legislation also caused CBO to lower its projection of revenues from corporate income taxes—by $54 billion for the 2013–2022 period; the largest change was for 2013. The effects stemmed mostly from a one-year extension of provisions that allow businesses to accelerate deductions for the cost of acquiring equipment and a two-year extension of a host of business tax credits and deductions.

Changes to Projections of Outlays

Since August, CBO has raised the amount it estimates for outlays in fiscal year 2013 by $51 billion because of legislative actions that are projected to boost mandatory outlays by $41 billion and discretionary outlays by $9 billion. For the 2013–2022 period, outlays are now projected to be higher by $1.0 trillion (or 2.4 percent), largely because of higher debt-service costs related to enacted legislation and increased outlays for refundable tax credits.

Mandatory Spending. CBO and JCT estimate that the American Taxpayer Relief Act will result in an increase of $309 billion in mandatory spending over the 2013–2022 period. (That total does not include the $24 billion cost of eliminating a portion of this year's automatic spending reductions; much of that effect is classified as discretionary spending in the baseline.) Most of that increase ($277 billion) is the result of additional payments for certain refundable tax credits (which are recorded in the budget as outlays). Among other provisions, the law also extended emergency unemployment compensation (which CBO estimates will boost outlays by $30 billion over the 2013–2014 period) and delayed by one year scheduled cuts in Medicare's payments to physicians (raising estimated outlays by $25 billion over the 10-year period); other changes to Medicare yielded estimated savings of $20 billion for that period.[3]

Discretionary Spending. Since August, CBO has increased its baseline projections of discretionary spending by $9 billion for 2013 and by $35 billion for the 2013–2022 period. Those increases arise mainly from the baseline's treatment of supplemental funding provided in response to Hurricane Sandy and of appropriations in 2013 for overseas contingency operations.

In January, the Disaster Relief Appropriations Act, 2013 (P.L. 113-2), provided about $50 billion in discretionary budget authority for relief and recovery from Hurricane Sandy. Most of that amount, $41 billion, was designated as emergency spending and has been extrapolated fully in CBO's baseline. The law also provided $5 billion in funding designated for disaster relief (as defined in the Budget Control Act) and $3 billion that was not designated either as emergency funding or for disaster relief; both amounts are extrapolated in CBO's baseline but are subject to constraints imposed by the Budget Control Act in future years. Overall, the additional funding for 2013 and the extrapolation of those supplemental appropriations added about $330 billion to CBO's projections of discretionary outlays for the 2013–2022 period.

As a result of the Continuing Appropriations Resolution, 2013 (P.L. 112-175), enacted in September 2012, funding for overseas contingency operations in 2013 is

3. Overall, CBO estimates that the American Taxpayer Relief Act will increase Medicare's outlays by $5 billion for the 2013–2022 period; taking account of the effects of provisions of the legislation related to other health care programs yields a net increase for the period of about $1 billion in outlays for such programs (including Medicare).

$27 billion less than the amount that had been projected in the previous baseline (that amount was equal to the 2012 appropriation, adjusted for inflation). Extrapolating that smaller amount of funding reduces the projection of outlays for the 2013–2022 period by $277 billion.

The American Taxpayer Relief Act also altered the automatic enforcement procedures established in the Budget Control Act that require reductions in 2013 for discretionary and mandatory funding. The law delayed the procedures' implementation by two months and decreased the amount of the reduction required for 2013 by a total of $24 billion, most of it in the category of discretionary spending. That change boosted CBO's baseline projection of discretionary outlays by $22 billion for the 2013–2022 period. (That increase was offset by certain other changes to revenues and spending that were made by the act.) Other changes stemming from the amount of funding provided in the continuing resolution reduce discretionary outlays in the baseline by about $40 billion between 2013 and 2022.

Economic Changes

CBO's latest economic forecast incorporates updated projections of gross domestic product, the unemployment rate, interest rates, inflation, and other economic variables that affect federal outlays and revenues (see Chapter 2). Those updates have led CBO to trim its projection of the deficit for 2013 by $12 billion and to increase its projection of the cumulative deficit for the 2013–2022 period by $141 billion, mostly because of the increased cost of interest on the debt.

Changes to Projections of Revenues

Revisions to CBO's economic forecast caused the agency to increase its projections of revenues by $13 billion for 2013 and by $90 billion (or 0.2 percent) for the 2013–2022 period. Compared with the projections released in August, revenues are now expected to be $138 billion greater for the first part of the projection period, from 2013 to 2018, but $47 billion lower for the 2019–2022 period.

For the first half of the period, CBO increased its projections of personal income—including wages and salaries, interest income, and proprietors' income—in part because of the enactment of the American Taxpayer Relief Act and its removal of much of the fiscal tightening scheduled under prior law. All else being equal, those changes in income imply higher revenues from individual income taxes and social insurance taxes. The effects on social insurance revenues were largely offset, however, by an estimated reduction in receipts from state unemployment taxes (which are counted as federal revenues); CBO expects that larger balances in state unemployment trust funds will lead states to reduce their unemployment taxes.

CBO projects lower wages and salaries for the second half of the period, which would also reduce the amounts it anticipates in revenues from individual income and social insurance taxes. But the agency's estimates of receipts from individual income taxes have changed little since August because reductions in wages and salaries have been offset by increases in interest income and proprietors' income. CBO increased the amount it projects for receipts from corporate income taxes to reflect an anticipated increase in domestic corporate profits.

Changes to Projections of Outlays

Revisions to CBO's economic forecast have prompted the agency to increase its estimates of outlays (including debt service), boosting them by $1 billion for the current year and by $231 billion (or 0.5 percent) for the 2013–2022 period. The change for the 10-year period is mostly the result of higher projected interest rates.

Net Interest. Economic revisions to CBO's projections of spending for net interest have two components: the effects of changes in the agency's projections of interest rates and inflation and the effects on the government's borrowing that result from the impact of economic changes on revenues and noninterest outlays. Overall, CBO projects that changes in the economic forecast will result in outlays for net interest over the 2013–2022 period that are $192 billion higher than the amount it estimated in August. Almost all of that change stems from CBO's updated projections of interest rates and inflation, which in turn have resulted in estimates of net interest that are $186 billion higher than they were in August. CBO now expects higher interest rates for most securities throughout the 2013–2022 period. Upward revisions to interest rates for securities with a maturity of less than one year range from 1 basis point to 45 basis points for that period.[4] For securities with a maturity of two years or more, upward revisions range from 1 basis point to 58 basis points for the same period.

4. A basis point is one one-hundredth of a percentage point. For example, the difference between interest rates of 1.0 percent and 1.5 percent is 50 basis points.

Mandatory Spending. Updates to its economic forecast caused CBO to raise its estimates of mandatory outlays for the current year by $2 billion and for the 2013–2022 period by $50 billion.

Student Loans. Consistent with the procedures set forth in the Federal Credit Reform Act of 1990, annual outlays for the student loan program represent the costs of the subsidies provided by the government. Those costs are measured as the present value of the future cash flows associated with new federal loans disbursed each year, calculated using the Department of the Treasury's borrowing rates to discount those cash flows.[5] In updating its economic forecast, CBO raised its estimate of those rates for the 2013–2022 period. With higher discount rates, the estimated present value of future cash flows associated with student loans decreases (that is, such cash flows are discounted more). Because those future cash flows will be income to the government (in the form of loan repayments, interest payments, and default recoveries), CBO now anticipates that net outlays for student loans over the 2013–2022 period will be $35 billion higher than it projected in August. (On balance, CBO estimates that the student loan program produces net negative subsidies under the Federal Credit Reform Act's present-value methodology; the revised, higher discount rates produce lower estimates of net negative subsidies.)

Social Security. Because of changes in the economic forecast, CBO increased by $19 billion the amount it projects that the government will spend for Social Security over the 2013–2022 period. The cost-of-living adjustment of 1.7 percent that Social Security beneficiaries received in January 2013 is 0.6 percentage points higher than CBO anticipated in August. Projected cost-of-living adjustments for the 2014–2022 period are only slightly different from the amounts in the August forecast. Those changes boost the agency's estimates of benefit payments for the period by $39 billion. In contrast, revisions to CBO's projections of the growth in wages and salaries (which affect initial benefits) result in estimates of benefit amounts that are lower by about $20 billion between 2013 and 2022.

5. Present value is a single number that expresses a flow of current and future income (or payments) in terms of an equivalent lump sum received (or paid) today.

Technical Changes

Technical updates to CBO's estimates of revenues and outlays—that is, revisions that do not stem from legislation or changes in economic assumptions—have resulted in a net decrease of $115 billion in the estimated deficit for 2013 and a net decrease of $270 billion in the cumulative deficit for 2013 through 2022.

Changes to Projections of Outlays

As a result of technical revisions to CBO's projections, the agency has reduced its estimate of spending by $52 billion for 2013 and by $299 billion (or 0.7 percent) for the 2013–2022 period. CBO made nearly equal reductions in its estimates of discretionary and mandatory spending for the current year; in contrast, for the 2013–2022 period, most of the revision is in projections of outlays for mandatory programs (most notably for Medicaid, Medicare, and veterans' programs).

Mandatory Spending. Technical revisions related to mandatory programs have reduced the amounts projected for spending in the current year by $31 billion, primarily because of an increase in estimated receipts related to the Treasury's transactions with Fannie Mae and Freddie Mac. For the 2013–2022 period as a whole, technical adjustments, largely related to Medicaid and Medicare, reduce the net amount projected for mandatory spending by $297 billion.

Medicaid and Medicare. In recent years, health care spending has grown much more slowly both nationally and for federal programs than historical rates would have indicated. (For example, in 2012, federal spending for Medicare and Medicaid was about 5 percent below the amount that CBO had projected in March 2010.) In response to that slowdown, over the past several years, CBO has made a series of downward technical adjustments to its projections of spending for Medicaid and Medicare. From the March 2010 baseline to the current baseline, such technical revisions have lowered estimates of federal spending for the two programs in 2020 by about $200 billion—by $126 billion for Medicare and by $78 billion for Medicaid, or by roughly 15 percent for each program.

Spending projections also have been affected by legislative action—most notably as a result of the Affordable Care Act—and by updated economic forecasts. From 2010 to the present, those other types of revisions boosted the estimates of outlays for Medicare and Medicaid in 2020 by $72 billion, or about 5 percent. (The Affordable Care Act also created new subsidies for some people to purchase health insurance through exchanges, adding $115 billion to the estimate for federal outlays for health care programs in 2020, according to CBO's current projections.)

For the 2013–2022 period, technical changes to estimates for the Medicaid program have reduced projections for spending by $236 billion (or 5.5 percent) relative to CBO's estimates in August 2012. (Changes to estimates of Medicaid outlays related to legislation or economic factors amounted only to $3 billion.) The revisions reflect both lower anticipated enrollment in Medicaid and lower expected costs per person. CBO now estimates that enrollment in 2022, for example, will be about 84 million, compared with the 85 million it projected last August. Although CBO projects that more people will enroll in Medicaid for the first time because of the Affordable Care Act's expansion of the program, the agency's projection of the number of people who would have been covered by Medicaid in the absence of that act has declined by a greater amount. Lower estimated Medicaid enrollment among those other groups is, in part, the result of improvements in CBO's methods for forecasting the number of people with insurance. More people are now expected to have insurance through other sources (primarily employers), resulting in lower projected enrollment in Medicaid. In addition, fewer people are now expected to enroll in the Supplemental Security Income program, and because people who are enrolled in that program automatically qualify for Medicaid, that change in turn reduces the projected number of Medicaid enrollees.

CBO's current baseline also shows lower spending per person in the Medicaid program than was shown in August, primarily because of adjustments to account for the slowed growth in Medicaid spending. The agency also anticipates that per-person costs will be lower than it anticipated in August because a larger share of the people who will be covered under the Medicaid program will be children and healthier adults, whose medical costs tend to be lower than those of less healthy adults. Because of those and other factors, CBO now estimates that Medicaid's spending per person in 2020 will be about 6 percent lower than it projected in August. (For a discussion, see "Baseline Changes Related to Insurance Coverage Under the Affordable Care Act.")

For Medicare, CBO has reduced its 10-year projections of outlays for Medicare by $137 billion (or 2 percent) for technical reasons, mostly because of updated data on actual spending for 2012, the third consecutive year in which spending was significantly lower than CBO had projected. In past baselines, CBO had begun to reflect the slowing growth in spending for Medicare's Part A (Hospital Insurance) and Part B (Medical Insurance); the largest downward revision in the current baseline is for spending for Medicare's Part D (prescription drugs).[6]

Veterans' Compensation and Pensions. CBO increased its baseline projection for veterans' disability benefits and compensation by $108 billion (or 16 percent) over the 2013–2022 period to reflect substantial recent growth in average benefit payments (the average benefit increased by 8 percent in 2012) and in the number of people added to the disability compensation rolls (there was a 4 percent increase in 2012).

Fannie Mae and Freddie Mac. CBO considers the activities of Fannie Mae and Freddie Mac to be governmental, and therefore it considers the subsidy costs of new activity by the two entities to be federal outlays. The Administration, in contrast, considers the two entities to be outside the federal government for budgetary purposes and records cash transactions between the Treasury and Fannie Mae and Freddie Mac as federal outlays or receipts (in CBO's view, those are intragovernmental transactions).

To provide CBO's best estimate of what the Treasury will ultimately report as the federal deficit for 2013, its current baseline includes an estimate of those net cash transactions for fiscal year 2013. That figure is $29 billion lower than CBO's August estimate, mostly reflecting a shift to a cash-basis estimate for the current year (following the Administration's budgetary treatment for the year in progress) along with an administrative change (agreed to by the Federal Housing Finance Agency and the Treasury Department) that now requires the two entities to convey their quarterly profits to the Treasury rather than paying dividends on outstanding senior preferred stock. CBO's August 2012 baseline showed an estimated subsidy cost (outlays) of about $13 billion for

6. Since 2009, spending for Part A and Part B has risen by an average of 2.9 percent per year, compared with average annual growth of 8.4 percent from 2002 to 2009. (That comparison excludes spending for Part D because the growth rates for fiscal years 2006 and 2007 were affected by the program's establishment in 2006.)

the activities of Fannie Mae and Freddie Mac in 2013; in the current baseline, CBO shows cash receipts—that is, negative outlays—of $17 billion (on the basis of Fannie Mae and Freddie Mac's most recent quarterly financial releases).

For 2014 through 2022, CBO's baseline follows the agency's customary approach of showing the projected subsidy costs of credit assistance offered by Fannie Mae and Freddie Mac. Those estimates are calculated on a fair-value basis, reflecting the market risk associated with the two housing entities. For the nine-year period, CBO now estimates that those subsidies will cost the government $35 billion, about $15 billion less than it projected in August. Most of the reduction is the result of an increase in the average fees for new loans and guarantees that Fannie Mae and Freddie Mac implemented at the end of 2012.

Discretionary Spending. Technical adjustments to CBO's projections for several discretionary programs have resulted in a net decrease of $27 billion in outlays estimated for 2013. The largest reductions—which are generally based on slower-than-expected spending—include those in CBO's estimates for the discretionary portion of spending for Pell grants and for certain categories of military spending (mainly operations and maintenance, procurement, and construction).

Changes to projections of discretionary outlays between 2013 and 2022 yield a net decrease of $47 billion (or 0.1 percent), primarily reflecting CBO's expectation that appropriations will be spent at a slightly slower rate, particularly in 2013 and 2014.

Net Interest. As a result of technical updates, CBO's estimates of outlays for net interest have increased by $5 billion for 2013 and by $45 billion for the 2013–2022 period. The increase for the coming decade is mainly attributable to changes in CBO's estimates of the mix of securities that the Treasury will issue, offset partially by a $92 billion reduction in debt service stemming from technical changes in other areas of the budget.

To cover the increase in projected deficits relative to those in the August baseline, CBO expects the Treasury to boost borrowing in longer-term and inflation-protected securities, which require higher interest rates than those for nominal securities of shorter maturity. That effect increased projections of interest outlays by about $100 billion for the 2013–2022 period. The remaining $37 billion increase stems from higher expected interest outlays for government securities associated with the Thrift Savings Plan for federal employees and from lower projected interest receipts from the financing accounts associated with the government's credit programs.[7]

Changes to Projections of Revenues

Relative to its August projections, CBO increased its revenue estimates for technical reasons by $63 billion (or 2 percent) for 2013 and by $188 billion (or 2 percent) for the 2014–2016 period. But it has reduced its projections of revenues for the 2017–2022 period by $280 billion (or 1 percent).

Over the 2013–2016 period, increases in revenues from individual income taxes and remittances from the Federal Reserve to the Treasury accounted for most of the technical revisions. CBO increased its projection of receipts from individual income taxes by $158 billion relative to its August projection because of larger collections in fiscal year 2012 than the agency had expected in August and because of improvements in CBO's modeling of payments that are made with tax returns. Neither factor affects CBO's forecasts for revenues beyond the next few years.

CBO also increased the amount it projects will be made in remittances from the Federal Reserve for the 2013–2016 period. The change reflects larger expected purchases of securities by the central bank, but it also is a result of new modeling that indicates that recent actions by the Federal Reserve to increase the average maturity of its portfolio of Treasury securities will initially result in higher earnings than previously expected. Those remittances are now projected to average about $95 billion per year during that period.

Over the 2017–2022 period, decreases in projected revenues from social insurance taxes and remittances from the Federal Reserve account for most of the technical revisions. CBO reduced its estimate of receipts from

7. The Thrift Savings Plan is a retirement savings program for civil service employees and members of the uniformed services. Like private-sector 401(k) plans, the Thrift Savings Plan offers federal employees an opportunity to invest in funds that hold different sorts of financial assets, including domestic and foreign stocks, and U.S. government securities, which are nonmarketable Treasury securities issued specifically for the program. Those securities have short maturities but earn a long-term interest rate equal to the weighted average market yield on outstanding marketable Treasury securities with four or more years to maturity.

social insurance taxes throughout the 10-year projection period—and by larger amounts later in the period—mostly because recent tax returns show a smaller amount of wages covered by Social Security than CBO estimated, and the agency expects that pattern to persist in coming years. For the period as a whole, those reductions amounted to about 1 percent of the receipts previously projected from those taxes.

CBO reduced its projections of remittances from the Federal Reserve for the second half of the 10-year period, for several reasons. The most significant is that the central bank is now expected to acquire more securities in the short term; the Federal Reserve is expected to shrink the size of its portfolio later in the decade by selling assets, and because interest rates are projected to be higher at that point, those sales will involve capital losses. CBO also now anticipates that the average yield on the Federal Reserve's portfolio will be lower in the second part of the decade because the central bank has locked in today's relatively low interest rates by shifting its portfolio to longer-term securities.

Baseline Changes Related to Insurance Coverage Under the Affordable Care Act

In conjunction with JCT, CBO has updated its August 2012 estimate of the budgetary impact of the provisions of the Affordable Care Act that are related to health insurance coverage (see Table A-2).[8] Although several components of the estimate have changed, the difference in the net budgetary impact for the 2013–2022 period is less than $500 million. The new estimate reflects recent legislative, regulatory, and administrative actions along with economic and technical changes made since the previous estimate was published.[9]

In August, CBO and JCT projected the net cost of the act's provisions that concern health insurance at $1,165 billion for the 2013–2022 period; that amount remains essentially unchanged. For the 2013–2023 period covered by the current projections (one year beyond the previous ones), the estimated cost of those coverage provisions is $1,329 billion.[10] The most important changes to CBO's estimates include the following:

- Lower marginal tax rates under the American Taxpayer Relief Act reduce the tax benefit associated with employment-based health insurance and will lead to a greater reduction in such coverage and higher enrollment in insurance exchanges than previously estimated by CBO and JCT.
- The Department of Health and Human Services has indicated that, to receive full funding from the federal government for the costs of newly eligible beneficiaries through 2016, states must expand eligibility for Medicaid to the levels specified in the act. Relative to previous projections, that guidance results in a small increase in the estimate of the number of people who will be enrolled in Medicaid and a small reduction in the estimate of the number who will be covered through the exchanges.
- CBO and JCT have slightly reduced their estimates of the rates at which people will enroll in the insurance exchanges or Medicaid as the expansion of coverage is implemented—a process that had already been anticipated to occur gradually. That change reflects the agencies' judgment about a combination of factors, including the readiness of exchanges to provide a broad array of new insurance options, the ability of state Medicaid programs to absorb new beneficiaries, and people's responses to the availability of the new coverage. As a result, revised estimates for 2014 and 2015 reflect more people with employment-based coverage and more who will be uninsured than in the previous projections. CBO and JCT project that those factors will wane in importance over the following two years. In the current projection, the number of people gaining coverage through the exchanges rises from 7 million in 2014 to 24 million

8. Details of the current estimate are posted along with this report on CBO's Web site, www.cbo.gov/publication/43900.

9. The current budget baseline does not incorporate the effects of regulations and guidance issued in late December 2012 and January 2013 by the Department of the Treasury and the Department of Health and Human Services.

10. Those sums, which include effects on both revenues and outlays, do not reflect the total budgetary impact of the legislation. The law included many other provisions that, on net, will reduce budget deficits; on balance, CBO and JCT have estimated that the legislation as a whole will reduce deficits over a 10-year period. CBO and JCT have not updated their estimates of the total budgetary impact of the Affordable Care Act. For CBO and JCT's most recent estimate of the budgetary impact of repealing the act, see Congressional Budget Office, letter to the Honorable John Boehner providing an estimate for H.R. 6079, the Repeal of Obamacare Act (July 24, 2012), www.cbo.gov/publication/43471.

Table A-2.

Comparison of CBO's Estimates of the Effects of Insurance Coverage Provisions in the Affordable Care Act

	August 2012 Baseline	February 2013 Baseline	Difference
	Changes in Insurance Coverage in 2022 (Millions of nonelderly people, by calendar year)		
Medicaid and CHIP	11	12	1
Employment-Based[a]	-4	-7	-4
Nongroup and Other[b]	-3	-4	-1
Insurance Exchanges	25	26	*
Uninsured[c]	-30	-27	4
	10-Year Effects on the Federal Deficit, Fiscal Years 2013 to 2022[d,e] (Billions of dollars)		
Medicaid and CHIP Outlays	643	550	-93
Exchange Subsidies and Related Spending[f]	1,015	1,047	32
Small-Employer Tax Credits[g]	22	23	1
Gross Cost of Coverage Provisions	1,680	1,620	-60
Penalty Payments by Uninsured Individuals	-55	-45	11
Penalty Payments by Employers[g]	-117	-130	-13
Excise Tax on High-Premium Insurance Plans[g]	-111	-102	9
Other Effects on Tax Revenues and Outlays[h]	-231	-178	53
Net Cost of Coverage Provisions	1,165	1,165	**

Sources: Congressional Budget Office; staff of the Joint Committee on Taxation.

Notes: The Affordable Care Act comprises the Patient Protection and Affordable Care Act and the health care provisions of the Health Care and Education Reconciliation Act of 2010 and, in the case of this document, the effects of subsequent related judicial decisions, statutory changes, and administrative actions.

CHIP = Children's Health Insurance Program; * = between zero and 500,000 people; ** = between zero and $500 million.

a. The change in employment-based coverage is the net result of projected increases in and losses of offers of health insurance from employers and projected changes in enrollment by workers and their families.

b. The effects are almost entirely for nongroup coverage; "other" includes Medicare.

c. The count of uninsured people includes unauthorized immigrants as well as people who are eligible for but not enrolled in Medicaid.

d. Excludes effects on the deficit of other provisions of the act that are not related to coverage, which in the aggregate reduce deficits. Also excludes federal administrative costs subject to appropriation. CBO has previously estimated that the Internal Revenue Service will need to spend between $5 billion and $10 billion over 10 years to implement the Affordable Care Act and that the Department of Health and Human Services and other federal agencies also will have to spend $5 billion to $10 billion over that period. In addition, the Affordable Care Act included explicit authorizations for spending on a variety of grant and other programs; that funding is also subject to future appropriation action.

e. Negative numbers indicate a decrease in the deficit; positive numbers indicate an increase in the deficit.

f. Includes spending for high-risk pools, premium review activities, loans to consumer-operated and -oriented plans, and grants to states for the establishment of exchanges.

g. These effects on the deficit include the associated effects of changes in taxable compensation on revenues.

h. The effects are almost entirely on revenues.

in 2016, and the number gaining coverage through Medicaid rises from 8 million in 2014 to 11 million in 2016.

- CBO and JCT have revised their projections of insurance coverage in the absence of the act. In later years, that revision shows a larger number of people with employment-based coverage and a smaller number without insurance, compared with earlier projections.

- CBO has refined its projections of people's income so that slightly more tax filers and their dependents are now expected to have income that will qualify them for subsidies through the exchanges and for enrollment in Medicaid, resulting in a larger reduction in employment-based coverage in response to changes made by the act than previously had been estimated.

- CBO has revised its analysis of the health status of newly eligible Medicaid enrollees; they now are expected to be healthier and therefore to require less costly care than CBO had previously projected.

Lower Projected Costs for Medicaid and the Children's Health Insurance Program

On net, CBO and JCT project that the Affordable Care Act will increase the number of people enrolled in Medicaid by 12 million in 2022, rather than by the 11 million estimated in August 2012. Despite the difference, the costs for Medicaid and the Children's Health Insurance Program are projected to be $93 billion (or 14 percent) below the earlier projection for the 2013–2022 period, for several reasons: the revised assessment of the health status of newly eligible enrollees, reductions in the projected cost of Medicaid's benefits generally in response to the recent slowdown in the growth of Medicaid's spending, and a revised projection that boosts the proportion of children (whose health care generally costs less than that for adults) among the people expected to enroll in Medicaid as a result of the act.

Higher Enrollment in and Subsidies for Coverage Through Exchanges

CBO and JCT's estimate of the costs of subsidies for insurance obtained through the exchanges and for related spending over the 2013–2022 period is now $32 billion (or about 3 percent) higher than it was in August, mostly because of higher projected enrollment in the exchanges. Lower marginal tax rates under the American Taxpayer Relief Act will reduce the relative attractiveness of employment-based insurance for low-income workers and for their employers. CBO and JCT anticipate that the change in tax law will increase the number of people who shift out of employment-based coverage as a result of the Affordable Care Act by 2 million to 3 million people, many of whom are expected to obtain insurance through the exchanges. Several other technical changes decreased projected enrollment in the exchanges. All told, CBO and JCT now project that 26 million people will be enrolled in the insurance exchanges in 2022, about 500,000 more than estimated in the August 2012 report.

Fewer People with Employment-Based Coverage

In 2022, by CBO and JCT's estimate, 7 million fewer people will have employment-based health insurance as a result of the Affordable Care Act; in August, that figure was estimated to be about 4 million people. The revision is the net effect of several considerations, with the largest factor being the reduction in marginal tax rates, which reduces the tax benefits associated with health insurance provided by employers. The increased movement out of employment-based coverage also reflects revisions to CBO's projections of income over time and higher projections of employment-based coverage in the absence of the Affordable Care Act.

Reductions in employment-based health insurance coverage boost federal tax revenues because they increase the proportion of compensation received by workers that is taxable. (That effect is included in Table A-2 in the line labeled "Other Effects on Tax Revenues and Outlays.") Although a greater reduction in the number of people with employment-based coverage is expected, the projected increase in revenues from changes in the taxability of compensation is now $53 billion less for the 2013–2022 period than was projected in August because of the lower tax rates enacted in the American Taxpayer Relief Act and because of other technical changes.

CBO and JCT have raised their estimate of revenues that will come from penalties paid by employers, by $13 billion for the 2013–2022 period, because fewer businesses are now expected to offer insurance coverage than had been estimated in August. Penalties arising from the individual mandate are projected to be $11 billion lower than expected in August because, on the basis of revised income projections, more people who remain uninsured are expected either to be exempt from the penalty or to pay a smaller penalty based on a flat rate instead of one based on a percentage of income.

APPENDIX

B

CBO's Economic Projections for 2013 to 2023

The tables in this appendix expand on the information in Chapter 2 by showing the Congressional Budget Office's (CBO's) economic projections for each year from 2013 to 2023 (by calendar year in Table B-1 and by fiscal year in Table B-2). CBO does not forecast cyclical fluctuations in its projections for years after 2018. Instead, the projected values shown in the tables for 2019 to 2023 reflect CBO's assessment of the effect of economic and demographic trends in the medium term but do not reflect an attempt to forecast the frequency or size of fluctuations in the business cycle.

Table B-1.

CBO's Economic Projections, by Calendar Year

	Estimated, 2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
					Year to Year (Percentage change)							
Real GDP	2.3	1.4	2.6	4.1	4.4	3.8	2.6	2.4	2.3	2.2	2.2	2.2
Nominal GDP	4.1	2.9	4.4	6.2	6.6	6.0	4.7	4.5	4.4	4.3	4.3	4.2
PCE Price Index	1.7	1.3	1.7	1.9	1.9	1.9	2.0	2.0	2.0	2.0	2.0	2.0
Core PCE Price Index[a]	1.7	1.3	1.8	1.9	1.9	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Consumer Price Index[b]	2.1 [c]	1.6	1.9	2.1	2.1	2.2	2.3	2.3	2.3	2.3	2.3	2.3
Core Consumer Price Index[a]	2.1 [c]	1.7	2.0	2.1	2.2	2.3	2.3	2.3	2.3	2.3	2.3	2.3
GDP Price Index	1.8	1.5	1.8	2.0	2.1	2.1	2.1	2.0	2.1	2.0	2.0	2.0
Employment Cost Index[d]	1.8	2.1	2.9	3.9	4.0	4.2	4.0	3.8	3.7	3.6	3.6	3.5
					Calendar Year Average							
Unemployment Rate (Percent)	8.1 [c]	7.9	7.8	7.1	6.3	5.6	5.5	5.5	5.4	5.4	5.3	5.3
Payroll Employment (Monthly change, in thousands)	157 [c]	105	182	222	220	153	88	86	82	80	66	62
Interest Rates (Percent)												
Three-month Treasury bills	0.1 [c]	0.1	0.2	0.2	1.5	3.4	4.0	4.0	4.0	4.0	4.0	4.0
Ten-year Treasury notes	1.8 [c]	2.1	2.7	3.5	4.3	5.0	5.2	5.2	5.2	5.2	5.2	5.2
Tax Bases (Percentage of GDP)												
Wages and salaries	44.1	43.5	43.9	44.0	44.1	44.2	44.5	44.6	44.8	44.9	45.1	45.2
Domestic economic profits	9.6	9.3	9.7	9.9	10.2	9.8	9.0	8.4	8.0	7.7	7.5	7.2
Tax Bases (Billions of dollars)												
Wages and salaries	6,916	7,029	7,397	7,876	8,410	8,946	9,414	9,872	10,343	10,827	11,326	11,835
Domestic economic profits	1,509	1,506	1,629	1,782	1,944	1,973	1,913	1,863	1,847	1,858	1,876	1,893
Nominal GDP (Billions of dollars)	15,692	16,149	16,863	17,913	19,087	20,224	21,178	22,129	23,099	24,093	25,117	26,180

Source: Congressional Budget Office. (Actual values for 2012 are from Department of Labor, Bureau of Labor Statistics; Federal Reserve.)

Notes: The numbers shown here do not reflect the values for GDP and related series released by the Commerce Department's Bureau of Economic Analysis on January 30 and the values released by the Labor Department's Bureau of Labor Statistics for the employment cost index on January 31 and for payroll employment on February 1.

GDP = gross domestic product; PCE = personal consumption expenditures.

a. Excludes prices for food and energy.

b. The consumer price index for all urban consumers.

c. Actual value for 2012.

d. The employment cost index for wages and salaries of workers in private industry.

Table B-2.

CBO's Economic Projections, by Fiscal Year

	Actual, 2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
	Year to Year (Percentage change)											
Real GDP	2.3	1.5	2.1	3.9	4.4	4.0	2.8	2.4	2.3	2.2	2.2	2.2
Nominal GDP	4.2	3.1	3.8	5.9	6.6	6.2	4.9	4.5	4.4	4.3	4.3	4.2
PCE Price Index	2.0	1.3	1.5	1.9	1.9	1.9	2.0	2.0	2.0	2.0	2.0	2.0
Core PCE Price Index[a]	1.8	1.3	1.7	1.9	1.9	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Consumer Price Index[b]	2.4	1.7	1.7	2.1	2.1	2.2	2.3	2.3	2.3	2.3	2.3	2.3
Core Consumer Price Index[a]	2.2	1.7	1.9	2.1	2.1	2.2	2.3	2.3	2.3	2.3	2.3	2.3
GDP Price Index	1.8	1.5	1.7	2.0	2.1	2.1	2.1	2.1	2.0	2.1	2.0	2.0
Employment Cost Index[c]	1.8	2.0	2.6	3.7	4.0	4.1	4.1	3.9	3.7	3.6	3.6	3.6
	Fiscal Year Average											
Unemployment Rate (Percent)	8.3	7.9	7.9	7.3	6.5	5.7	5.5	5.5	5.4	5.4	5.3	5.3
Payroll Employment (Monthly change, in thousands)	157	110	156	224	223	183	91	84	84	80	70	63
Interest Rates (Percent)												
Three-month Treasury bills	0.1	0.1	0.1	0.2	1.0	2.9	4.0	4.0	4.0	4.0	4.0	4.0
Ten-year Treasury notes	1.9	1.9	2.5	3.2	4.1	4.9	5.2	5.2	5.2	5.2	5.2	5.2
Tax Bases (Percentage of GDP)												
Wages and salaries	43.8	43.7	43.9	43.9	44.0	44.2	44.4	44.6	44.7	44.9	45.1	45.2
Domestic economic profits	9.7	9.4	9.5	9.9	10.2	9.9	9.2	8.6	8.1	7.8	7.5	7.3
Tax Bases (Billions of dollars)												
Wages and salaries	6,812	7,014	7,300	7,748	8,274	8,818	9,300	9,757	10,224	10,704	11,201	11,707
Domestic economic profits	1,506	1,503	1,589	1,742	1,913	1,978	1,929	1,873	1,847	1,854	1,871	1,890
Nominal GDP (Billions of dollars)	15,549	16,034	16,646	17,632	18,792	19,959	20,943	21,890	22,854	23,842	24,858	25,910

Source: Congressional Budget Office. (Actual values for 2012 are from Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve.)

Note: GDP = gross domestic product; PCE = personal consumption expenditures.

a. Excludes prices for food and energy.

b. The consumer price index for all urban consumers.

c. The employment cost index for wages and salaries of workers in private industry.

List of Tables and Figures

Tables

Figures

About This Document

This volume is one of a series of reports on the state of the budget and the economy that the Congressional Budget Office (CBO) issues each year. It satisfies the requirement of section 202(e) of the Congressional Budget Act of 1974 for CBO to submit to the Committees on the Budget periodic reports about fiscal policy and to provide baseline projections of the federal budget. This year, though, the report is considerably shorter than it has been in the past because of the limited time available since enactment of the American Taxpayer Relief Act of 2012 early in January. In keeping with CBO's mandate to provide objective, impartial analysis, this report makes no recommendations.

CBO's Panel of Economic Advisers commented on an early version of the economic forecast underlying this report. Members of the panel are Raj Chetty, Menzie D. Chinn, Dan L. Crippen, Steven J. Davis, Robert E. Hall, Jan Hatzius, Simon Johnson, Charles I. Jones, Anil Kashyap, Lawrence Katz, Donald Kohn, June O'Neill, Rudolph G. Penner, Adam S. Posen, James Poterba, Joel Prakken, Carmen M. Reinhart, Alice Rivlin, Robert Shimer, Matthew Slaughter, and Stephen P. Zeldes. Nicholas Bloom and Mickey Levy attended the panel's meeting as guests. Although CBO's outside advisers provided considerable assistance, they are not responsible for the contents of this report.

The CBO staff members who contributed to this report—by preparing the economic, revenue, and spending projections; writing the report; editing and publishing it; compiling the supplemental materials posted along with it on CBO's Web site (www.cbo.gov); and providing other support—are listed on the following pages.

Douglas W. Elmendorf

Douglas W. Elmendorf
Director

February 2013

Economic Projections

The economic projections were prepared by the Macroeconomic Analysis Division, with contributions from analysts in other divisions. That work was supervised by Wendy Edelberg, Kim Kowalewski, Robert Arnold, Benjamin Page, and William Randolph (formerly of CBO).

Bruce Arnold	Net exports, exchange rates
Alexander Arnon	Model and data management
David Brauer	Inflation, labor markets
Stephanie Burns	Housing sector, research assistance
Thais Canedo	Research assistance
Gabriel Ehrlich	Interest rates, monetary policy, energy prices, house prices
Ronald Gecan	Energy prices
Jonathan Huntley	Medium-term analysis of fiscal policy
Mark Lasky	Business investment, housing
Felix Reichling	Short-term analysis of fiscal policy
Frank Russek	Federal, state, and local government spending and revenues
Robert Shackleton	Potential output, productivity
Christopher Williams	Consumer spending, incomes

Revenue Projections

The revenue projections were prepared by the Tax Analysis Division, supervised by Frank Sammartino, David Weiner, Mark Booth, and Janet Holtzblatt. In addition, the staff of the Joint Committee on Taxation provided valuable assistance.

Paul Burnham	Retirement income
Barbara Edwards	Federal Reserve System earnings, customs duties, miscellaneous receipts
Jennifer Gravelle	Depreciation, international taxation
Pamela Greene	Corporate income taxes, estate and gift taxes
Ed Harris	Individual income taxes, social insurance taxes, tax modeling
Shannon Mok	Estate and gift taxes
Larry Ozanne	Capital gains realizations, excise taxes
Kevin Perese	Tax modeling
Kurt Seibert	Social insurance taxes, refundable tax credits, depreciation, tax modeling
Joshua Shakin	Individual income taxes
Logan Timmerhoff	Excise taxes

Spending Projections

The spending estimates were prepared by the Budget Analysis Division, with contributions from analysts in other divisions; that work was supervised by Peter Fontaine, Theresa Gullo, Holly Harvey, Janet Airis, Tom Bradley, Kim Cawley, Jean Hearne, Jeffrey Holland, Sarah Jennings, and Sam Papenfuss of the Budget Analysis Division, as well as by Jessica Banthin of the Health, Retirement, and Long-Term Analysis Division and Damien Moore of the Financial Analysis Division.

Defense, International Affairs, and Veterans' Affairs

Kent Christensen	Defense (projections, working capital funds, procurement, scorekeeping)
Sunita D'Monte	International affairs
Ann Futrell	Veterans' health care
Raymond Hall	Defense (research and development, stockpile sales, atomic energy, other programs)
William Ma	Veterans' readjustment benefits, reservists' education benefits, defense (operation and maintenance)
David Newman	Defense (military construction and family housing, military activities in Afghanistan), veterans' housing
Dawn Sauter Regan	Defense (military personnel)
Matthew Schmit	Military retirement, military health care
Jason Wheelock	Defense (other programs, operation and maintenance, compensation for radiation exposure, compensation for energy employees' occupational illness)
Dwayne Wright	Veterans' compensation and pensions

Health

Kirstin Blom	Medicaid, Children's Health Insurance Program
Stephanie Cameron	Medicare, Public Health Service
Julia Christensen	Food and Drug Administration, prescription drugs
Anna Cook	Prescription drugs
Stuart Hagen	Health insurance coverage
Lori Housman	Medicare
Paul Jacobs	Health insurance coverage
Paul Masi	Medicare
Sarah Masi	Health insurance exchanges, other programs
Jamease Miles	Medicare, Public Health Service
Alexandra Minicozzi	Health insurance coverage
Julia Mitchell	Federal Employees Health Benefits program

Health (Continued)	
Andrea Noda	Medicaid prescription drugs, long-term care, Public Health Service
Romain Parsad	Health insurance coverage
Allison Percy	Health insurance coverage
Lisa Ramirez-Branum	Medicaid, health insurance coverage, Public Health Service
Lara Robillard	Medicare
Robert Stewart	Medicaid, Children's Health Insurance Program, Indian Health Service
Ellen Werble	Health insurance coverage, other programs
Rebecca Yip	Medicare Part D, prescription drugs
Christopher Zogby	Health insurance coverage
Income Security and Education	
Christina Hawley Anthony	Unemployment insurance, training programs, Administration on Aging, Smithsonian, arts and humanities
Chad Chirico	Housing assistance, Fannie Mae and Freddie Mac, Troubled Asset Relief Program, Pension Benefit Guaranty Corporation
Sheila Dacey	Old-Age and Survivors Insurance, Social Security trust funds, Pension Benefit Guaranty Corporation
Kathleen FitzGerald	Supplemental Nutrition Assistance Program and other nutrition programs
Justin Humphrey	Elementary and secondary education, Pell grants, student loans
Deborah Kalcevic	Student loans, higher education
Jonathan Morancy	Temporary Assistance for Needy Families, Child Support Enforcement, foster care, Social Services Block Grant, child care programs, Children and Families Services, Low Income Home Energy Assistance Program
David Rafferty	Disability Insurance, Supplemental Security Income, refugee assistance
Emily Stern	Child nutrition and other nutrition programs
Natural and Physical Resources	
Megan Carroll	Energy, air transportation
Mark Grabowicz	Administration of justice, Postal Service
Kathleen Gramp	Energy, Outer Continental Shelf receipts, spectrum auction receipts
Gregory Hitz	Agriculture

Natural and Physical Resources (Continued)	
Daniel Hoople	Community and regional development, Federal Emergency Management Agency, deposit insurance
David Hull	Agriculture
Jeff LaFave	Conservation and land management, other natural resources
James Langley	Agriculture
Susanne Mehlman	Pollution control and abatement, Federal Housing Administration and other housing credit programs
Matthew Pickford	General government, legislative branch
Sarah Puro	Highways, Amtrak, water transportation
Aurora Swanson	Water resources, Fannie Mae and Freddie Mac
Martin von Gnechten	Administration of justice, science and space exploration, Bureau of Indian Affairs, recreation
Susan Willie	Mass transit, commerce, Small Business Administration, Universal Service Fund
Other Areas and Functions	
Janet Airis	Legislative branch appropriation bills
Shane Beaulieu	Computer support
Edward Blau	Authorization bills
Barry Blom	Federal pay, monthly Treasury data
Jared Brewster	Interest on the public debt
Joanna Capps	Appropriation bills (Labor–Health and Human Services, State–Foreign operations)
Mary Froehlich	Computer support
Avi Lerner	Troubled Asset Relief Program, automatic budget enforcement and sequestration, other interest
Amber Marcellino	Federal civilian retirement, historical data
Virginia Myers	Appropriation bills (Commerce–Justice, financial services, general government)
Mitchell Remy	Fannie Mae and Freddie Mac
Mark Sanford	Appropriation bills (Agriculture, Defense)
Esther Steinbock	Appropriation bills (Transportation–Housing and Urban Development, military construction and veterans' affairs, energy and water development)
Santiago Vallinas	Various federal retirement programs, national income and product accounts, federal pay
Patrice Watson	Database system administrator
Adam Wilson	Appropriation bills (Homeland Security, Interior)

Writing

Christina Hawley Anthony wrote the summary. Barry Blom wrote Chapter 1, with assistance from Mark Booth, and Christina Hawley Anthony wrote Box 1-1. Charles Whalen wrote Chapter 2. Amber Marcellino wrote Appendix A, with assistance from Mark Booth and Jessica Banthin. Alexander Arnon compiled Appendix B.

Editing and Publishing

The editing and publishing of the report were handled by CBO's editing and publishing group, supervised by John Skeen, and the agency's Web team, supervised by Deborah Kilroe.

Christine Bogusz, Christian Howlett, Kate Kelly, and Jeanine Rees edited the report, with assistance from Loretta Lettner and Sherry Snyder. Maureen Costantino and Jeanine Rees prepared the report for publication.

Alexander Arnon and Logan Timmerhoff compiled the supplemental data posted with the report on CBO's Web site. Jeanine Rees and Simone Thomas coordinated the presentation of those data.

Questions for the Record
"The Budget and Economic Outlook: Fiscal Years 2013 to 2023"
Questions for Dr. Douglas Elmendorf
Hearing Date: February 26, 2013

Questions from Senator Ron Wyden

Question 1(a): What are some of the least economically efficient and/or justifiable tax expenditures? What economic effects—positive or negative—would you expect from their repeal? How would each of you propose we maximize any positive or mitigate any negative effects?

Answer:

The staff of the Joint Committee on Taxation identifies over 250 provisions of the individual and corporate income tax systems that it includes in its list of tax expenditures.[1] Of that number, the 10 largest income tax expenditures (show in the tables below) account for most of the total cost.

CBO has prepared separate analyses of a number of major tax expenditures (see for example: *Refundable Tax Credits, Options for Taxing U.S. Multinational Corporations, Taxation of Owner-Occupied and Rental Housing: Working Paper 2012-14, Federal Support for State and Local Governments Through the Tax Code, Options for Changing the Tax Treatment of Charitable Giving, Tax Arbitrage by Colleges and Universities, Testimony on the Taxation of Carried Interest, The Tax Treatment of Employment-Based Health Insurance, Tax Policy for Pensions and Other Retirement Saving*) but has not done a systematic comparison of the economic efficiency of those provisions nor a complete investigation of the economic effects of their repeal. Nonetheless, some general conclusions apply.

Tax expenditures are generally designed to further societal goals. For example, the tax expenditures for health insurance costs, pension contributions, and mortgage interest payments may help to promote a healthier population, adequate financial resources for retirement and greater national saving, and stable communities of homeowners. However, tax expenditures have a broad range of effects that do not always further those goals.

First, tax expenditures may lead to an inefficient allocation of economic resources by encouraging more consumption of goods and services receiving preferential treatment; they also may subsidize activity that would have taken place without the tax incentives. For example, the tax expenditures mentioned above may prompt people to be less cost-conscious in their use of health care services than they would in the absence of the tax expenditure for health insurance costs; to reallocate existing savings from accounts that are not tax-preferred to retirement accounts, rather than add to their savings; and to purchase more expensive homes, investing too much in housing and too little elsewhere relative to what they would do if all investments were treated equally.

[1] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2012-2017* (JCS-1-13), February 1, 2013.

Second, by providing benefits to specific activities, entities, or groups of people, tax expenditures increase the size and scope of federal involvement in the economy. Indeed, adding tax expenditures to conventional federal outlays makes the federal government appear notably larger relative to GDP.

Third, tax expenditures reduce the amount of revenue that is collected for any given set of statutory tax rates—and thereby require higher rates to collect any chosen amount of revenue. All else being equal, those higher tax rates lessen people's incentives to work and save and therefore decrease output and income. At the same time, some tax expenditures more directly raise output and income. For example, the preferential rate on capital gains and dividends raises the after-tax return on some forms of saving, which tends to increase saving and boost future output. As another example, the increase in take-home pay arising from the earned income tax credit appears to encourage work effort by some people.

Fourth, tax expenditures have mixed effects on the societal goal of limiting the complexity of the tax code. On the one hand, most tax expenditures, such as itemized deductions and tax credits, require that taxpayers keep additional records and make additional calculations, increasing the complexity of the tax code. On the other hand, some exclusions from taxable income simplify the tax code by eliminating recordkeeping requirements and the need for certain calculations. For example, in the absence of the exclusion for capital gains on assets transferred at death, taxpayers would need to calculate the appreciation in the value of their assets since their original purchase—a calculation that would require records of the purchase of assets acquired by deceased benefactors, perhaps many decades earlier.

Fifth, tax expenditures affect the distribution of the tax burden in ways that may not always be recognized, both among people at different income levels and among people who have similar income but differ in other ways. For example, the deduction for nonbusiness state and local taxes tends to benefit higher-income taxpayers more than low- and moderate-income taxpayers because higher-income taxpayers are more likely to itemize their deductions and because, generally, the higher a taxpayer's income, the higher is his or her marginal tax rate and thus the larger is the reduction in federal taxes for each additional dollar of state and local taxes paid. The deduction for state and local taxes also benefits taxpayers living in high-tax states more than taxpayers with similar income who live in low-tax states.

Limiting or eliminating tax expenditures would have different economic impacts on specific sectors of the economy. For example, limiting the deduction for charitable contributions in a way that reduces the marginal incentive for giving would reduce the amount of funding available to charities (though in aggregate, contributions account for a small portion of their funding). Likewise, limiting the deduction for mortgage interest on owner-occupied housing would depress home prices to some degree, which might be undesirable at a time when housing markets are still weak and in the process of recovery.

Lawmakers could choose to offset some of those impacts, either for a transitional period or permanently, through policies that avoided some of the undesirable effects of the current tax expenditures. Using tax credits in place of exclusions or deductions would avoid some of the distributional outcomes of current tax expenditures—that is, higher-income households receive a larger subsidy for each deductible dollar. Thus, some proposals would replace the deductions for mortgage interest and charitable contributions or the exclusion of tax-exempt interest with tax credits.

Another approach, in the case of charitable contributions, would be to limit the deduction for contributions by disallowing the tax deduction for contributions that were less than a specified minimum amount. Such a policy would continue to provide incentives for charitable giving of contributions above the limit but would reduce the cost of the federal subsidy. The floor could either be a fixed dollar amount or a percentage of a taxpayer's income. Although there would be some reduction in giving for contributions below the limit, CBO has found that with either type of floor, the reduction in charitable giving would be less than the reduction in the cost of the tax expenditure.

Another option for mitigating the negative effects of repealing tax expenditures would be to use some or all of the additional revenues to finance other tax or spending policies that would offset some or all of the impact of repeal on the economy as a whole or on certain sectors or categories of people (see the response to the following question).

Finally, even if limiting or eliminating certain tax expenditures would lead to a more efficient allocation of resources over time, abrupt changes could have adverse short-term effects. For example, limiting or eliminating the mortgage interest deduction without a gradual transition could depress home prices at a time when housing markets are weak and in the process of recovery.

Ten Largest Corporate Tax Expenditures, 2013 (billions of dollars)	
Deferral of active income of controlled foreign corporations	42.4
Depreciation of equipment in excess of the alternative depreciation system	13.9
Deduction for income attributable to domestic production activities	10.1
Exclusion of interest on public purpose state and local government bonds	9.3
Deferral of gain on non-dealer installment sales	7.0
Credit for increasing research activities (Code section 41)	6.8
Credit for low-income housing	6.1
Deferral of active financing income	5.9
Expensing of research and experimental expenditures	5.3
Deferral of gain on like-kind exchanges	4.9

Ten Largest Individual Tax Expenditures, 2013 (billions of dollars)	
Reduced rates of tax on dividends and long-term capital gains	160.8
Exclusion of employers' contributions for health care, health insurance premiums, and long-term care insurance premiums	131.7
Net exclusion of pension contributions and earnings	101.2
Deduction of nonbusiness state and local government income taxes, sales taxes, personal property taxes, and taxes on real property	77.3
Deduction for mortgage interest on owner-occupied residences	69.7
Exclusion of Medicare benefits	67.0
Earned income credit	60.9
Credit for children under age 17	57.3
Exclusion of capital gains at death	42.8
Deduction for charitable contributions	39.0

<u>Question 1(b)</u>: In a similar vein, there is a great debate among Republicans and Democrats as to what we should do with any additional revenue generated by rolling back or reducing tax expenditures, also commonly referred to as closing loopholes. On the one hand, some would have us use any additional revenue to buy down marginal tax rates, while, on the other, some would have us use any resulting revenue for deficit reduction and/or other investments. Weighing in on that debate, Martin Sullivan, a widely read commentator on tax policy, has suggested that perhaps the best solution would be to devote half of any resulting revenue to reducing rates and half to reducing the deficit. Do you feel that Sullivan has the ratio about right? Or would you suggest a different allocation of any resulting revenue and why?

<u>Answer</u>:

The Congressional Budget Office does not make policy recommendations, so we cannot make judgments about how lawmakers should use the additional revenues that would be generated by reducing tax expenditures.

In a recent publication (*Choices for Deficit Reduction*, November 2012), CBO identified several criteria that might be used in evaluating federal budget plans. That analysis focused on the following factors, all of which could be considered in assessing how best to apply such revenues:

- How big would the government be?
- How would the government's resources be allocated among various priorities?
- How much deficits would be reduced in the next 10 years and beyond?
- What would the economic impact be in the short term as well as in the medium and long term?
- Who would bear the burden of proposed changes in tax and spending policies?

In addition to those broader factors, there are some specific issues to consider concerning the economic impact and the distributional consequences of limiting or eliminating specific tax expenditures, and how those effects might be addressed by other changes in tax or spending policies. Those impacts would depend very much upon which tax provisions were modified and the way in which they were changed

For example, limiting or eliminating tax expenditures would affect incentives to work and save. A sometimes overlooked effect of limiting or eliminating certain tax expenditures is that that doing so would raise effective marginal tax rates on labor and capital. Some of that effect would occur directly. For example, limiting or eliminating the deduction for state and local income taxes would raise the combined federal and state marginal tax rate on both labor and capital income for taxpayers claiming the deduction. Restricting or eliminating other tax expenditures, such as the preferential tax rates for dividends and realized capital gains or the deduction for mortgage interest, would directly raise the effective marginal tax rate on capital income. Although limiting or eliminating preferential rates for certain types of investments would have the economic benefit of reducing the disparity in effective marginal tax rates across all investments, it would nonetheless raise the overall marginal tax rate. Other effects would occur indirectly. For example, restricting the amount of deductions that taxpayers can claim would increase taxable income, pushing more income into higher tax brackets and raising marginal tax rates on additional earnings and investment. Lawmakers could choose to offset these increases in effective marginal rates with a uniform reduction in statutory tax rates.

In addition, limiting or eliminating tax expenditures would have differing effects on households depending upon the amount and sources of their income and how they choose to spend it. For example, tax expenditures for the earned income tax credit and child tax credit largely go to low- and moderate-income families with children, while tax expenditures for most major itemized deductions tend to go to families at the higher end of the income scale. Lawmakers could choose to offset some of the impact on lower-income families through alternative tax or spending policies (for example, by boosting spending on means-tested programs), but those policies might not function more efficiently in reaching the intended families than the tax expenditures they would replace.

<u>Question 2</u>: Inadequate revenues in the Highway Trust Fund have denied state transportation departments the long-term stability to carry out much-needed investments in critical infrastructure projects. Given the difficulty of finding new revenues and the need to get our fiscal house in order, do you think there's a strong case to be made for federal tax-credit bonding for transportation and infrastructure projects as an alternative to direct spending? Can you provide your thoughts on the relative economic merits of this approach to infrastructure financing in a time of scarce budget resources?

<u>Answer</u>:

Federal financial support for public spending on transportation and other infrastructure currently includes both spending programs (for example, grants made to states from the Highway Trust Fund) as well as tax preferences for bonds issued to finance infrastructure investment by state and local governments and, in some cases, the private sector. Tax preferences, including tax exemptions and tax credits, provide a federal subsidy for infrastructure spending by lowering the cost of borrowing money to finance infrastructure projects. Providing such tax preferences has both advantages and disadvantages. Tax preferences for debt financing have the advantage of leaving to the discretion of state and local governments, which may have a better understanding of infrastructure needs in their jurisdictions, decisions about how much to borrow and spend, what types of projects to undertake, and the burden—net of the federal financing subsidy—of paying for them. But offering a tax preference for infrastructure financing also has drawbacks compared with federal spending; most notably, tax preferences mask the true scope of the federal government's activities. That is because the tax preferences, though a commitment of federal resources, are reflected in the budget as a reduction in revenues, rather than as spending. As a result, the revenue forgone through tax preferences is outside the control of the annual appropriation process. Moreover, the federal government can make explicit decisions about how much of its limited resources it wants to spend on a particular type of activity, but when tax preferences are provided, those decisions are made by others in most cases.

The primary type of federal tax preference for state and local borrowing is the exclusion from federal income tax of interest payments on bonds. However, for several reasons, among tax-preferred bonds, traditional tax-exempt bonds are considered an inefficient means of providing a federal subsidy and thus are inherently less efficient than tax-credit bonds. First, not all of the federal revenue loss from the tax exclusion translates into lower borrowing costs for issuers. Second, the subsidy rate is not under the control of the federal government but depends instead on conditions in taxable and tax-exempt debt markets. Tax credit bonds can address both types of inefficiency. In particular, borrowers that issue tax credit bonds receive all of the federal revenues forgone through the tax credit. Moreover, the federal government can set the subsidy rate according to the types of projects to be financed and the benefits expected from them at the national level. (For more information, see Congressional Budget Office, *Subsidizing Infrastructure Investment with Tax-Preferred Bonds* (October 2009), http://www.cbo.gov/publication/22059.)

In spite of their advantages in theory, most tax-credit bond programs have in practice not been particularly well received by financial markets. There are a number of reasons for that, including the limited size and temporary nature of the programs and the absence of rules for separating tax credits from the associated bonds and reselling them (which could make such bonds advantageous to investors whose income tax liability does not allow them immediately to claim the full value of the credit). Additionally, there is a potential disincentive for individuals to purchase tax-credit bonds because bond holders must complete additional paperwork to claim the tax credit (in contrast, tax-exempt bond holders are asked—but not required—to report interest income from tax-exempt bonds when filing their federal income taxes). Because the market for tax credit bonds has tended to be fairly limited, those bonds are not very liquid. As a consequence, issuers have to pay a premium to sell their bonds, and that cost offsets some of the federal subsidy provided through the tax credit.

An exception to the typically tepid reception for tax-credit bonds was the response of bond buyers to the Build America Bond (BAB) program, under which $181 billion of bonds were issued in 2009 and 2010. However, in contrast to earlier tax-credit bond programs, all of the BABs that were issued were "direct-pay" bonds, which entitled the issuer to a claim a subsidy payment from the Secretary of the Treasury against interest costs (which were fully taxable). Because issuers received the full federal subsidy—set at a rate that varied somewhat by purpose of issuance—direct-pay BABs shared the efficiency-enhancing properties attributed to traditional tax-credit bonds. Additionally, because subsidy payments are counted as outlays, the federal financial support provided to bond issuers through direct-pay BABs is more readily assessed than would have been the case under traditional tax-credit bonds. (Issuers also responded to the larger federal financing subsidy offered by BABs compared to conventional tax-exempt debt.) As suggested above, the direct-pay subsidy also proved much more marketable than a tax credit. Indeed, when the direct-pay option was subsequently applied to other types of tax-credit bonds (Qualified School Construction Bonds), issuance of those bonds rose dramatically.

Questions from Senator Robert P. Casey, Jr.

With rising gas prices and an uncertain fiscal future, there are a number of indications consumers are pulling back. The Congressional Budget Office's February 5th report cites the expiration of the payroll tax cut as a drag on consumer spending and therefore on the economy. To that point, the Wall Street Journal reported this week that Wal-Mart and other retailers are making adjustments to their projections in response to consumers' decreased spending power. Can you quantify the drag on the economy? Should Congress pursue policies to reverse this impact?

Answer:

CBO estimates that economic growth in 2013 is being held down by federal fiscal tightening. That tightening is mostly a result of two developments: the automatic spending reductions that are now occurring (the sequestration) and the expiration of certain tax policies, which has led to an increase in tax revenue. The most significant source of the increase in tax revenue is the expiration of the 2-percentage-point payroll tax cut, which resulted in an increase in payroll tax rates. In addition, tax rates on income above certain thresholds increased. Those changes have reduced after-tax income for many people, which will constrain the growth of consumer spending and thus restrain overall growth in output and employment this year.

In the absence of that fiscal tightening, real GDP would grow about 1¼ percentage points faster between the fourth quarter of 2012 and the fourth quarter of 2013, CBO estimates. The automatic spending cuts and the expiration of those tax provisions, including the expiration of the payroll tax cuts, account for about equal portions of that 1¼-percentage-point effect. The spending changes have a smaller budgetary impact than the tax changes, but they affect GDP by a larger amount per dollar of budgetary cost. (Other, smaller changes in spending and taxes will diminish growth by another ¼ percentage point, CBO estimates.)

Reversing the fiscal tightening in 2013 would boost the economy in the short run. However, other things equal, reversing the fiscal tightening would also increase federal debt, which eventually would crowd out capital investment and reduce output and incomes, CBO estimates. To illustrate such effects, CBO analyzed some illustrative budget paths in its report *Macroeconomic Effects of Alternative Budget Paths (February 2013)*. Relative to projections under current law, CBO estimated that policies that led to larger deficits throughout the coming decade by raising spending or cutting taxes would boost GNP from 2014 to 2016—reflecting the short-term impact of tax and spending policies on the demand for goods and services. But sustained higher deficits would lead to lower GNP beginning in 2017—reflecting the impact of deficits on national saving and domestic investment.

Question from Senator Chuck Grassley

In 2003, during the consideration of the Medicare Modernization Act, CBO developed a measure referred to as the cost reduction factor (CRF). The CRF was the factor CBO applied to the Part D scoring depending on how aggressive the competitive model was and for other factors. Is it plausible for CBO to develop a similar tool in 2013 to consider potential Medicare-Medicaid restructuring proposals? While not to oversimplify the

complex task you are charged with, scoring cuts to providers and increases in beneficiary liability are easier than considering structural change. That said, if Members of Congress wanted to explore the ability to bend the growth curve through programmatic restructuring, CBO modeling will be critical. Considering risk-bearing, competitive models that consider populations and service packages differently than is contemplated under statute today is quite complex. Your ability to provide guidance will be essential to any conversation that tries to examine Medicare and Medicaid through a fresh perspective.

Answer:

In both its published reports and its analysis of legislation, the CBO focuses on identifying and describing the key levers that the agency believes would affect budgetary outcomes and explaining the magnitude and direction of those effects. Towards that end, CBO's analysts strive to develop whatever tools and techniques are necessary to estimate the budgetary effects of possible new policies. For example, CBO is currently engaged in developing its modeling capacity in the areas of Medicare restructuring and supply-side responses and is carefully following reforms that states are undertaking to provide care to people through both Medicare and Medicaid.

In its analysis of restructuring proposals, it is unlikely that CBO would be able to provide a "cost reduction factor" in the same way as was done during consideration of legislation to create the Medicare Part D program because the issues are more complex and consist of more dimensions or factors than was the case with Part D. Nonetheless, as it assesses proposed legislation in the health area, CBO will endeavor to fully account for the effects of competition, changes in people's incentives to use or provide medical services, and any other structural changes that might be contemplated.

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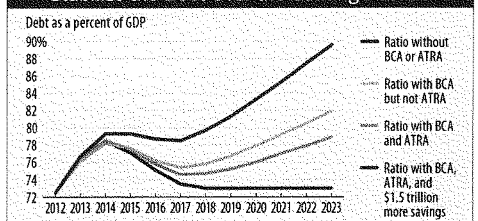
Testimony of Robert Greenstein

President, Center on Budget and Policy Priorities
Before the Senate Committee on Finance
February 26, 2013

Mr. Chairman and distinguished members of the Finance Committee, I appreciate the invitation to testify here today. As we all know, the nation faces fiscal and economic challenges, and we will have to make some tough decisions to put the budget on a more sustainable fiscal course and to do so without hindering a still-too-weak economic recovery.

Earlier this month, we issued an analysis which finds (based on the new Congressional Budget Office projections, with several adjustments that analysts commonly make to reflect the cost of continuing current policies[1]) that policymakers could stabilize the public debt as a share of the economy over the coming decade with $1.5 trillion in additional deficit reduction.

$1.5 Trillion in Additional Deficit Reduction Would Stabilize the Debt Over the Coming Decade



Notes: BCA stands for the Budget Control Act, enacted in August 2011; ATRA stands for the American Taxpayer Relief Act, enacted in January 2013.

Source: Center on Budget and Policy Priorities based on Congressional Budget Office and Joint Committee on Taxation data.

[1] In calculating that another $1.5 trillion in deficit savings would stabilize the debt over the latter years of the decade at 73 percent of GDP, we start with the budget baseline that CBO has just released. We use CBO's economic assumptions and make certain adjustments to its policy projections, which are identical to the adjustments that organizations such as the Committee for a Responsible Federal Budget also make. We freeze Medicare reimbursement rates for physicians at current levels, rather than assuming they will be slashed deeply. We phase down war funding over the next few years to a lower level, as policymakers are on course to do, rather than assuming that current levels of war costs continue (and rise with inflation) through 2023. We assume disaster funding will revert to the ten-year historical average level, as allowed by the Budget Control Act, rather than grow with inflation from the unusually high levels resulting from Hurricane Sandy. We assume that the scheduled sequestration cuts do *not* occur in 2013 or in the 2014-2021 period. We also assume that policymakers will continue certain improvements in refundable tax credits that they have just extended for five years. At the same time, we follow the CBO baseline in assuming that policymakers either will not continue a series of tax provisions often referred to as the "tax extenders," which expire at the end of 2013, or will offset the costs of continuing those "extenders" they do maintain.

Policymakers could achieve these savings with $1.3 trillion in policy savings (that is, spending cuts and revenue increases), which would generate about $200 billion in savings in interest payments. The $1.5 trillion in total savings would stabilize the debt at 73 percent of gross domestic product (GDP) over the latter part of the decade. (Stabilizing the debt at a somewhat lower level of GDP would require a larger amount of deficit reduction; stabilizing at a somewhat higher level of GDP would require a lesser amount of deficit reduction.)

The fact that $1.5 trillion in deficit savings, rather than a much larger amount, would stabilize the debt over the coming decade at about the 2012 debt-to-GDP ratio of 73 percent of GDP is due primarily to two factors. First, Congress and the President have enacted significant deficit reduction over the two-plus years since the Bowles-Simpson report and Rivlin-Domenici task force made major deficit reduction proposals; over this period, policymakers have enacted nearly $1.5 trillion in spending cuts for appropriated programs (relative to the CBO baseline in use at the time of the Bowles-Simpson and Rivlin-Domenici reports), mainly through the annual caps enacted in the 2011 Budget Control Act and nearly $600 billion in revenue increases in the American Taxpayer Relief Act (ATRA). Including the related savings in interest payments, policymakers have achieved about $2.35 trillion in deficit reduction so far. (Other analysts, like those at the Committee for Responsible Federal Budget, use the same $2.35 trillion savings estimate.) These savings are for the ten-year budget window of 2013-2022. Over the new budget window of *2014-2023*, the same policies are estimated to produce savings of $2.75 trillion, as Table 1 indicates.

Table 1
Deficit Reduction to Stabilize the Debt
Cumulative totals, 2014-2023, in billions

	Policy savings	Interest savings	Total deficit reduction
Discretionary savings from cuts in 2011 funding and caps imposed by the BCA	1,576	336	1,912
Savings from the ATRA	732	117	850
Further savings to stabilize debt at 73% of GDP	1,327	202	1,529
TOTAL	**3,636**	**655**	**4,290**

Notes: BCA stands for the Budget Control Act, August 2011; ATRA stands for the American Taxpayer Relief Act, January 2013; all savings measured relative to current policy (see Appendix I)

Source: Center on Budget and Policy Priorities based on Congressional Budget Office and Joint Committee on Taxation data.

The other factor is that CBO's economic and technical projections have improved over the past few years. Not counting the reductions in discretionary funding and the savings from ATRA, the new projections reduce estimated deficits under current policies by about $750 billion over the coming decade, relative to CBO's forecast of last March. Relative to CBO's August 2010 forecast, which the Bowles-Simpson and Rivlin-Domenici panels relied upon for their reports, the new CBO economic and technical projections reduce estimated deficits by about $1.3 trillion.

Is Stabilizing the Debt the Right Target?

Stabilizing the debt-to-GDP ratio over the coming decade — so the debt grows no faster than the economy — is the minimum appropriate budget policy. Stabilizing the debt at 73 percent of GDP would require shrinking annual deficits to below 3 percent of GDP.

Stabilizing the debt ratio for the decade ahead would require that policymakers subsequently enact additional deficit reduction for the long term. In ensuing decades, the aging of the population and increases in per-capita health care costs (which are likely to rise faster than per-capita GDP) will raise costs for health and retirement programs, returning the budget to a path where debt is increasing as a share of the economy.

Some call for greater deficit reduction now in order to achieve a declining debt ratio, citing these long-term trends. Enacting larger deficit reduction now would require deeper program cuts, larger tax increases, or both. Enacting a larger amount of deficit reduction now would be desirable *if* policymakers can secure it without doing harm in other areas — that is, if policymakers can achieve it through policies that: do *not* impede the economic recovery or jeopardize future productivity growth by providing inadequate resources for areas like education, infrastructure, and basic research; don't increase poverty and inequality, which already are higher here than in many other Western nations, or raise the number of Americans who are uninsured; and don't sacrifice health care quality or increase overall U.S. health care costs.

This brings me to a related point. It is not just the *quantity* of deficit reduction that matters; the *quality* of the deficit reduction measures chosen matters as well.

This is particularly true in the health care area — where knowledge about effective ways to slow health care cost growth without risking the quality of care or jeopardizing access to needed care remains limited at the present time, with policy remedies still elusive, and where such knowledge is likely to be greater in coming years due to changes underway in the health care sector and various research and demonstration projects.

Policymakers can enact measures now, as part of a balanced deficit-reduction package, that would achieve significant Medicare savings (a few hundred billion dollars over ten years) without jeopardizing the quality of care or access to care. Rushing now to enact cuts much deeper than that in federal health spending, however, could result in measures that largely shift costs to states, individuals, and private employers and harm some of the most vulnerable members of society, while *failing* to address the underlying causes of the unsustainable growth in costs across the U.S. health care system. Indeed, analysts have found that some proposals to enact large cuts now in Medicare or other health programs would actually increase total U.S. health care costs, not a desirable outcome.

Stabilizing the debt for the coming decade would give policymakers time to figure out how to take the further steps that will be needed to slow the growth of health care costs throughout the U.S. health care system without impairing the quality of care. Stabilizing the debt during the decade ahead won't permanently solve our fiscal problems, but it would represent a significant accomplishment.

Designing Deficit Reduction

Given the continued weakness in the U.S. economy, with the unemployment rate still close to 8 percent and CBO projecting it will take four more years before the economy recovers fully, deficit reduction needs to be designed very carefully to avoid making the recovery even slower. Deficit reduction should be phased in over coming years. In fact, policymakers really should couple some *temporary* fiscal measures to accelerate growth and job creation now with *permanent* deficit reduction measures.

As noted, the design of permanent deficit reduction measures matters. As I've indicated, we recommend that deficit reduction be secured through well-designed, balanced policies that don't impede the economic recovery, jeopardize future productivity growth, increase poverty and inequality, or sacrifice access to health care or health care quality. For the remainder of my testimony, let me discuss a few issues related to deficit-reduction design: 1) its immediate effect on the economy; 2) how it affects the disadvantaged; 3) some issues related to health care and elderly individuals; and 4) the debate over revenue increases versus spending cuts.

1. Implementing or Replacing Sequestration and the Effect on the Economy

We all know that the impending automatic, across-the-board cuts, which affect both defense and non-defense programs, represent unsound policy. The point I want to make here is that replacement savings, which I hope policymakers will be able to agree upon, should be enacted now but be designed so that the budget cuts and/or revenue increases involved largely or entirely take effect after the economy has more fully recovered. As the economy's poor performance in the 4th quarter of 2012 indicates, it would be injurious to growth and jobs to institute either sequestration or alternative savings measures right now. This is reflected in CBO's estimate that by the fourth quarter of this year, sequestration would cut 0.6 percentage points off of GDP growth and cost 750,000 jobs.

2. Protecting the Disadvantaged

The Bowles-Simpson report made it a core principle that deficit reduction should *not* increase poverty or harm the disadvantaged. It largely shielded core programs for the disadvantaged from the cuts it recommended. And in the revised plan they released last week, Erskine Bowles and Alan Simpson reiterated that principle and said "Broad-based entitlement reforms should either include protections for vulnerable populations or be coupled with changes designed to strengthen the safety net for those who rely on it the most." Bowles and Simpson have also called for revenue increases to be designed so they maintain or improve the progressivity of the tax code.

These principles and design features also are reflected in the plan presented in July 2011 by the Senate's bipartisan "Gang of Six." These principles have been highlighted as well by a group of Christian leaders that ranges from the Catholic Bishops' Conference and the Episcopal Church to the Salvation Army and the National Association of Evangelicals, which has issued a call for policymakers to safeguard the poor in deficit reduction and draw a "circle of protection" around programs targeted on them.

Our current system of supports for low-income families and individuals surely isn't perfect. But it does a great deal of good for tens of millions of our less fortunate fellow citizens. Using a measure of poverty that many analysts favor because it *counts* rather than *ignores* major benefits like food stamps and refundable tax credits — the Census Bureau's Supplemental Poverty Measure — we see that the poverty rate would have been 29 percent in 2011 without government assistance. Yet it stood at about 16 percent when those benefits were counted. The safety net cuts U.S. poverty nearly in half, compared to what it would otherwise be.

One can also look at the Census data on how many people individual programs lift out of poverty. In 2010, for example, the Earned Income Tax Credit (EITC) and the Child Tax Credit (CTC) lifted about 9 million people in low-income working families above the poverty line, including nearly 5 million children. (SNAP, formerly called the Food Stamp Program, lifted about 4 million out of poverty.)

Some argue that in the absence of safety net programs, some people might have worked more. But the impact of the safety net on poverty — including its effect on work — has been extensively studied. In a recent comprehensive review and synthesis of the research literature, some of the field's leading scholars examined the impact of means-tested programs on the amount that people work and found the programs' overall impact on work to be small. They also found that, after taking behavioral effects into account, the safety net lowers the U.S. poverty rate by approximately 14 percentage points. In other words, *one of every seven Americans — more than 40 million people — would be poor without the safety net but is above the poverty line because of it.*[2]

Refundable tax credits, which this Committee has jurisdiction over, are of particular note. A strong body of research finds that the Earned Income Tax Credit not only reduces poverty but also increases work substantially, especially among single mothers.[3] The research indicates that the expansions of the EITC in the 1990s had as large or larger an effect in inducing more single mothers to go to work as the changes in the 1996 welfare law. (The EITC and the welfare changes reinforced each other in this respect.) The research similarly finds that the EITC likely contributed as much to the decline in cash welfare receipt among female-headed families as did time limits and other welfare reforms.[4]

In addition, in the past few years, a growing body of research has found that the EITC and related types of assistance can have sizeable positive long-term effects on children such as improvements in educational success, health status, and future labor-market outcomes. The research finds that programs that supplement the earnings of low-income working families, like the EITC and the low-income component of the Child Tax Credit, boost children's school achievement and are associated with increased work and earnings in adulthood. Economists Raj Chetty and John N. Friedman of Harvard University and Jonah Rockoff of Columbia University analyzed school data for grades 3-8 from a large urban school district and found that additional income from the EITC and CTC led to significant increases in students' test scores.[5] Economists Gordon B. Dahl of the University of California, San Diego and Lance Lochner of the University of Western Ontario similarly found, after

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[2] Yonatan Ben-Shalom, Robert A. Moffitt, and John Karl Scholz "An Assessment of the Effectiveness of Anti-Poverty Programs in the United States," NBER Working Paper 17042, May 2011.

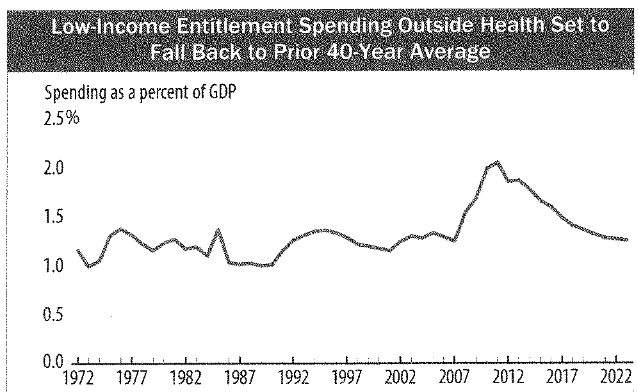
[3] Stacy Dickert, Scott Houser, and John Karl Scholz, "The Earned Income Tax Credit and Transfer Programs: A Study of Labor Market and Program Participation," Tax Policy and the Economy, Vol. 9, MIT Press, 1995. V. Joseph Holt, Charles H. Mullin, and John Karl Scholz, "Examining the Effect of the Earned Income Tax Credit on the Labor Market Participation of Families on Welfare," NBER Working Paper No. 11968, January 2006.

[4] Jeffrey Grogger, "The Effects of Time Limits, the EITC, and Other Policy Changes on Welfare Use, Work, and Income among Female-Head Families," *Review of Economics and Statistics*, May 2003. In separate study using different data, Grogger reaches similar conclusions. Jeffrey Grogger, "Welfare Transitions in the 1990s: the Economy, Welfare Policy, and the EITC," NBER Working Paper No. 9472, January 2003, http://www.nber.org/papers/w9472.pdf.

[5] Chetty, Friedman, and Rockoff 2011.

Costs of Means-Tested Programs Other Than Health Care Will Decline Over the Coming Decade, and Fall Back to Historical Average, as a Share of GDP

Historical data on government spending and the new CBO projections enable us to examine cost trends for means-tested programs outside health care. The data are illuminating. In fiscal year 2011, total federal expenditures for means-tested entitlement (or mandatory) programs outside health care equaled 2.0 percent of GDP, which was about 50 percent higher than the average for the prior 40 years. But the recent increases were driven largely by the economic downturn and temporary program expansions under the Recovery Act. The CBO projections show that total expenditures for means-tested entitlements outside health care will decline steadily as a share of the economy as the economy recovers, and will fall to 1.3 percent of GDP by 2020 and thereafter. (These figures include outlays for refundable tax credits.)



Sources: CBPP estimates based on OMB and CBO data.

In other words, by 2020, means-tested entitlement expenditures outside health care, measured as a share of GDP, will return to their prior 40-year average. And these figures do not include low-income *discretionary* programs, which are virtually certain to decline as a share of GDP under the Budget Control Act caps. (Total non-defense discretionary spending will fall under the BCA caps to its lowest level, as a share of GDP, since 1962, so a decline in low-income discretionary programs is virtually inevitable.) As a result, *total* expenditures on low-income (or means-tested) programs outside health care, including both mandatory and discretionary programs, are expected to decline over the coming decade to a level below their average over the prior 40-year period.

Costs for health care programs, in contrast, *are* rising as a share of GDP. But this is a reflection, especially in the case of Medicaid, of rising health care cuts throughout the U.S. health care system and the aging of the Medicaid beneficiary population. Medicaid already is lean, providing health coverage at a significantly lower cost than private insurance. The data show it costs about 27 percent less per child and 20 percent less per non-elderly adult than private coverage. Most budget proposals that would secure more than a modest amount of Medicaid savings would do by shifting costs to states. If that occurs, however, state policymakers are likely to cut benefits and provider payments and hence reduce patients' access to care. In recent years, as states faced severe recession-induced budget crunches, many scoured Medicaid for savings and imposed painful cuts, including eliminating dental or vision care for various beneficiaries, restricting personal care for some people who are frail or disabled, and restricting access to nursing homes and other long-term services. States also cut provider payments, which already are well below what private insurance and Medicare pay.

studying nearly two decades of data on mothers and their children, that additional income from the EITC significantly raises students' math and reading test scores.[6]

The research suggests that the beneficial effects of the EITC and CTC follow children into adulthood. Harvard's Chetty and his co-authors report evidence that test score gains can lead to significant improvements in students' later earnings and employment rates when they become adults.[7] Their findings are consistent with other research that followed poor children from early childhood into their adult years and found that significant increases in the incomes of these children's families are associated with some enduring beneficial effects. The researchers found that each additional $3,000 in annual income in early childhood, whether from earnings or government assistance, was associated with more hours of work and an additional 17 percent in annual earnings in young adulthood.[8]

One final point related to refundable tax credits bears noting. The minimum wage has been allowed to erode over recent decades and is now more than 20 percent lower, after adjusting for inflation, than in the late 1960s. For this and other reasons, relating in part to globalization of the economy, wages for low-paid jobs in the United States have fallen. Partly in response, policymakers have expanded refundable tax credits for low-income working families with children, principally the EITC. These credits offset part of the wage decline for low-income working parents with children. Any consideration of the increases in federal costs in recent decades for refundable tax credits and other supports for low-income working families should be put in the context of what has happened to these workers' wages.

3. Health Care Costs and an Aging Population Pose Longer-Term Challenge

The aging of the population and projected increases in per-capita health care costs, which are likely to rise faster than per-capita GDP, will put pressure on federal health and retirement programs, and on the budget in the decades ahead.

At the present time, there are major unknowns in the health area. The growth of both public and private health costs has slowed appreciably in the past few years. Spending for Medicare grew by

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6 Gordon Dahl and Lance Lochner, "The Impact Of Family Income On Child Achievement: Evidence From The Earned Income Tax Credit," *American Economic Review* (2012), 1927-1956, http://www.aeaweb.org/articles.php?doi=10.1257/aer.102.5.1927.

Building on Dahl and Lochner's research methods, economists Alexander M. Gelber of the Wharton School of Business and Matthew C. Weinzierl of the Harvard Business School conclude that the income boost that low-income families with children receive from the EITC helps the tax system raise revenue more effectively. In essence, they conclude, when low-income families with young children receive additional income, their children perform better in school, which increases the opportunities that their children will have to succeed. Alexander M. Gelber and Matthew C. Weinzierl, "Equalizing Outcomes vs. Equalizing Opportunities: Optimal Taxation When Children's Abilities Depend On Parents' Resources," NBER Working Paper No. 18332, August 2012, http://www.nber.org/papers/w18332.

7 Raj Chetty, John N. Friedman, Nathaniel Hilger, Emmanuel Saez, Diane Whitmore Schanzenbach, and Danny Yagan, "How Does Your Kindergarten Classroom Affect Your Earnings? Evidence from Project Star," *The Quarterly Journal of Economics* (2011), http://qje.oxfordjournals.org/content/126/4/1593.abstract.

8 Greg J. Duncan, Kathleen M. Ziol-Guest, and Ariel Kalil, "Early-Childhood Poverty and Adult Attainment, Behavior, and Health," *Child Development* (January/February 2010), pp. 306-325.) The $3,000 figure is in 2005 dollars, equivalent to approximately $3,530 in 2012.

In Designing Medicare Changes, Policymakers Should Consider Effects On Beneficiaries with Modest Incomes

When designing changes in Medicare, and in Social Security as well, policymakers should consider the circumstances of beneficiaries with very modest incomes. People sometimes think of affluent seniors playing golf and receiving benefits from these programs. To be sure, some beneficiaries are affluent and can afford to pay somewhat higher Medicare premiums or receive somewhat less from Social Security. However, half of all Social Security and Medicare beneficiaries have income (including their spouse's income) of less than about $25,000 a year.

It's often also assumed that people who are elderly or disabled face little in the way of out-of-pocket health costs because they are covered by Medicare (or jointly by Medicare *and* Medicaid, Medigap, or other supplemental insurance). Yet data from the Kaiser Family Foundation show that while U.S. households who are *not* receiving Medicare spend an average of *5 percent* of their budgets on out-of-pocket health costs, Medicare households as a whole spend an average of *15 percent* of their budgets on such costs. And, near-poor Medicare beneficiaries — those with incomes between 100 percent and 200 percent of the poverty line — or between $11,500 and $23,000 for an elderly or disabled individual — spend an average of *23 percent* of their modest incomes on out-of-pocket health costs.

Changes affecting Medicare and Social Security beneficiaries should therefore be designed carefully to avoid causing hardship or impeding access to needed health care among people with modest incomes. The Social Security checks that beneficiaries receive equal their Social Security benefits *minus* their Medicare premiums, which are deducted from the checks. The premiums increase with health care costs, which tend to rise faster than general inflation, which erodes the purchasing power of Social Security checks over time.

The nation would not be well served if, for example, elderly widows trying to live on $15,000 a year in Social Security are unable to afford to see a doctor because we have set their Medicare deductible too high and they can't afford to pay it out of their Social Security check. These are the types of matters that will require considerable attention to detail in the design of deficit reduction measures.

only 3.2 percent in fiscal year 2012, CBO has reported,[9] compared to an average of 6.7 percent a year from 2007 through 2011. Moreover, Medicare spending *per beneficiary* rose only 0.4 percent in 2012.

CBO's latest projections of Medicare spending over the 2011-2020 period under current policy are more than *$500 billion below* the projections CBO made just two years ago, a significant improvement.

Experts do not yet know whether this slowdown is ongoing, at least in part — and will generate more savings than CBO has projected for future years and decades, as a growing number of experts now believe likely — or is strictly temporary. The answer will affect the magnitude of the nation's long-term fiscal problem and the scope of the future changes that will be needed to further slow health care cost growth.

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[9] This figure subtracts premiums paid by beneficiaries and corrects for shifts in the timing of payments. Congressional Budget Office, *Monthly Budget Review, Fiscal Year 2012,* October 5, 2012, http://www.cbo.gov/sites/default/files/cbofiles/attachments/2012_09_MBR.pdf.

Most important, we currently lack needed information on how to slow health cost growth appreciably without reducing health care quality or impeding access to necessary care. Demonstration projects and other experiments to find ways to do so are starting, some of them government-funded and others entirely private-sector efforts. By later in the decade, we should have substantially more knowledge of what works and what doesn't, and whether substantial changes are already occurring in health care delivery that are slowing cost growth and can be built upon and spread. Taking major policy action in this area — beyond the few hundred billion dollars in potential Medicare savings referred to earlier — *before* we have the necessary knowledge and experience could produce problematic results — it could fail to restrain health care cost growth, compromise health care quality, or harm substantial numbers of sick or otherwise vulnerable individuals. This isn't an argument for taking no action, but rather for acting now to stabilize the debt for the coming decade, knowing that we'll need to come back and do more for the longer run. Stabilizing the debt would buy us time to find answers to these very important health care questions.

4. Taxes or Spending?

Some policymakers argue that all further deficit reduction should come from spending cuts. Others argue it should come from a mix of spending cuts and revenue increases.

Can this difference be overcome? Martin Feldstein, former chief economic adviser to President Reagan, has written that there is a great deal of government spending that is embedded in the tax code. Feldstein suggests that deficit reduction could be achieved through reductions both in *spending in the tax code* and in *spending on the outlay side of the budget.*

Writing in the *Wall Street Journal* last week, Feldstein observed: "Republicans want to reduce the deficit by cutting government spending while Democrats insist that raising revenue must be part of the solution. Yet the distinction between spending cuts and revenue increases breaks down if one considers tax expenditures. Here are some examples. If I buy a solar panel for my house, a hybrid car, or an energy-efficient refrigerator, the government pays me. But instead of sending me a check, it gives me a tax credit or a tax deduction. There are dozens of such examples that increase the annual budget deficit by billions of dollars. Congress should review these tax expenditures and eliminate those that the country cannot afford."

Feldstein wrote earlier that tax expenditures are the single largest source of wasteful and low-priority spending in the federal budget and one of the first places policymakers should go to restrain spending.

CBO director Douglas Elmendorf made a similar analytic point earlier this month at the House Budget Committee. In response to a question, Elmendorf explained:

> "And I think that many economists agree that [tax expenditures] are really best viewed as a form of government spending because they are directed at particular people or entities or designed to subsidize particular activities, very much analogous to the way that government spending is often directed at particular people or entities or designed to subsidize particular activities.

> So it is essentially a large component of spending by the federal government even though it is recorded essentially as lost revenue on the revenue side of the budget."

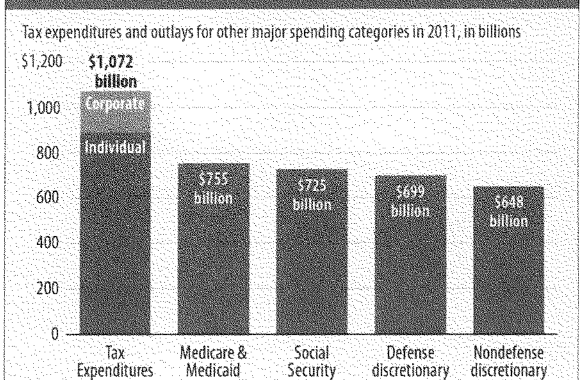
Alan Greenspan, as well, has made this point. He has referred to tax expenditures as "tax entitlements" and said they should be looked at along with spending entitlements.

That policymakers should look together at tax and spending entitlements can be illustrated by examining the subsidies that the federal government provides for child care costs. A parent with low or moderate income may be able to obtain a subsidy to help defray child care costs, with the subsidy being provided through a government *spending* program. A parent higher on the income scale also can receive a government subsidy that reduces her child care costs, but this parent's subsidy is delivered *through the tax code*, via a tax credit or an exclusion from income.

The two types of subsidies differ in their availability to eligible families. The low- or moderate-income parent may fail to get any subsidy to help with her child care costs, because the spending programs that provide these subsides are *not* open ended; they can serve only as many people as their capped funding allows, and only about one in six eligible low-income working families with children receives such a subsidy. By contrast, the child care tax-based subsidies for higher-income households are *guaranteed*; the child care tax subsidies operate as open-ended entitlements, and they are available to families up the income scale. *All* higher-income households that qualify can receive the tax subsidy, despite the fact that they — unlike many of the working-poor families — would generally be able to afford child care without the subsidy.

It would not be sound policy for policymakers to put the tax-code subsidies off limits for deficit reduction while making the program subsidies a target for deficit reduction, because one type of subsidy is delivered through a "spending" program and the other is delivered through the tax code.

Cost of Tax Expenditures and Other Parts of the Budget



Notes: Tax expenditure estimates do not account for interaction effects; estimate does not include outlays.
Source: Office of Management and Budget, Historical Tables 8.5 and 8.7 and Analytical Perspectives Table 17-2.

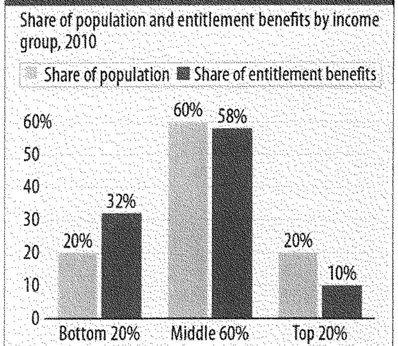
This isn't a small matter. The federal income tax code includes about $1.1 trillion a year in tax expenditures. As Mr. Elmendorf noted in House Budget Committee testimony earlier this month, the cost of tax expenditures exceeds the cost of Medicare (which was $480 billion in 2011), Social Security ($725 billion) and defense ($699 billion). In fact, it substantially exceeds the cost of Medicare and Medicaid combined ($755 billion). It also far exceeds the total spending on of non-defense discretionary programs, which stood at $648 billion in 2011.

It's also worth noting that tax expenditures and spending entitlements do differ in an important respect — how they distribute their benefits. With spending entitlements, the middle class receives a share of the benefits that is roughly proportionate to its share of the population: in 2010, the middle 60 percent of the population received 58 percent of the entitlement benefits. The bottom 20 percent received 32 percent of the benefits, while the top 20 percent received 10 percent of the benefits.[10]

With tax entitlements, however, the situation is different. The Urban Institute-Brookings Institution Tax Policy Center has estimated that for tax year 2011, the top fifth of the population received 66 percent of all individual tax-expenditure benefits, with the top 1 percent of households receiving 24 percent of those benefits. The middle 60 percent of the population received just a little over 31 percent of the benefits. The bottom 20 percent of the population received 2.8 percent of the benefits.

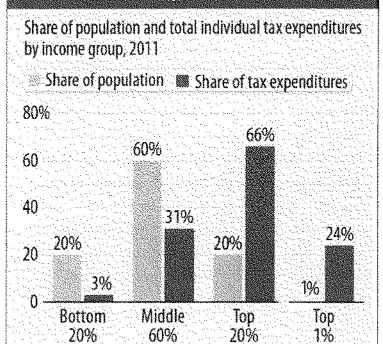
If policymakers want to achieve deficit reduction that doesn't further widen inequality or overly burden middle- and low-income households, and if they want to achieve deficit reduction in an economically efficient way, they will need to look at spending throughout the entire budget — in the tax code as well as on the outlay side of the ledger.

Middle-Income Households Receive a Proportionate Share of Entitlement Benefits



Source: CBPP analysis of data from Office of Management and Budget, U.S. Departments of Agriculture, Health and Human Services, and Labor, and the U.S. Census Bureau.

High-Income Households Receive Disproportionate Share of Tax Expenditures



Note: The bottom 20% means the 20% of tax units with the lowest incomes; the same is true for the other income categories.
Source: Tax Policy Center.

[10] Spending entitlement figures include the outlay components of the Earned Income Tax Credit and the Child Tax Credit. See Arloc Sherman, Robert Greenstein, and Kathy Ruffing, "Contrary to 'Entitlement Society' Rhetoric, Over Nine-Tenths of Entitlement Benefits Go to Elderly, Disabled, or Working Households," Center on Budget and Policy Priorities, February 10, 2012, http://www.cbpp.org/cms/?fa=view&id=3677.

Questions for the Record
"The Budget and Economic Outlook: Fiscal Years 2013 to 2023"
Questions for Mr. Robert Greenstein
Hearing Date: February 26, 2013

Questions from Ranking Member Orrin G. Hatch

1. I hear conflicting claims about promised future deficit reduction, along with conflicting claims about how much of the promises involve spending cuts relative to tax hikes. Deficit reduction numbers I have seen range from the just above $ 2 trillion to over $3.6 trillion, and ratios of cuts to tax hikes I have seen are all over the map. Your testimony says that we have achieved $2.35 trillion in deficit reduction so far, if interest payments are included, or $2.75 trillion if you move the budget window by a year. I have two questions:

   a. First, can you explain to me the wide range of numbers being thrown around regarding how much "we have achieved" in deficit reduction and the wide ranges of claimed ratios of spending cuts to tax hikes?

   Answer: I can explain the figures the Center on Budget and Policy Priorities uses, and would note that the Committee for a Responsible Federal Budget accounts for deficit reduction the same way we do and has published an identical estimate. But I would not attempt to explain figures used by others.

   The Center measures the cumulative change in projected deficits during a budget window that spans ten years. My testimony first referred to the 2013-2022 budget window, then to the 2014-2023 budget window. The latter encompasses the coming fiscal year – 2014 – for which new congressional and presidential budgets are formulated, as well as the subsequent nine years.

   In our methodology, we count spending cuts and revenue increases as those changes in policy caused by the enactment of new legislation; natural increases or decreases in costs or changes in estimates caused by factors outside the control of Congress are not part of the calculation. We estimate that policy savings over the 2013-2022 period reflects nearly $1.5 trillion in spending cuts to appropriated programs, mainly through the caps on discretionary funding imposed in the 2011 Budget Control Act, and another $565 billion in savings from the American Taxpayer Relief Act. (These figures do not count either war savings or the sequestration.) With the savings in interest on the debt these two actions generate (because deficits and thus debt will be lower than if they did not happen), the cumulative deficit reduction over the 2013-2022 window is $2.35 trillion.

   When we project the $2.35 trillion savings forward into the new budget window, covering 2014-2023, the total deficit reduction (including interest) rises to $2.75 trillion. The non-interest savings over that period are 70 percent budget cuts and 30 percent revenue increases.

   For a more technical discussion of our assumptions, you may wish to refer to two Center analyses: "$1.5 Trillion in Deficit Savings Would Stabilize the Debt Over the Coming Decade" by Richard Kogan, Robert Greenstein, and Joel Friedman, February 11, 2012; and

"Congress Has Cut Discretionary Funding By $1.5 Trillion Over Ten Years," by Richard Kogan, revised November 8, 2011.

b. And, second, how much in terms of actual federal spending cuts have been realized—that is, cuts we have banked—relative to fiscal year 2009 when the President took office, or fiscal year 2010 if you don't want to hold the President entirely responsible for 2009 spending?

Answer: The estimate of $2.75 trillion for the period 2014-2023 is entirely prospective; that amount of deficit reduction will be achieved as long as Congress continues to adhere to the discretionary caps enacted in the Budget Control Act of 2011 and as long as Congress does not reverse the revenue and other changes enacted in the American Taxpayer Relief Act.

In addition to the $2.75 trillion over 2014-2023, enacted funding for appropriated programs was lower in fiscal years 2011, 2012, and 2013 than CBO's 2010 projection for those years, reflecting funding cuts totaling about $230 billion over those three years. Moreover, this figure does not include the 2013 sequestration currently in effect.

2. CBO identifies that federal outlays as a share of GDP have averaged 21.0 percent over the past 40 years, but are projected to remain above the average in their projection period, after having peaked at over 25.0 percent of GDP in 2009. Many people argue that, given demographics and the resulting increases in entitlement beneficiaries in future years, spending as a share of GDP will have to rise in coming decades. I wonder if you agree and, if you do, precisely how much above the long-run average do you believe should be the federal-spending share of GDP, on average, over the next 10 years?

Answer: I do agree that, because Social Security, Medicare, and Medicaid currently constitute almost half of all non-interest federal program costs, and because these programs will grow faster than the economy as whole over the next two decades as the baby boom generation retires, they will inevitably put upward pressure on the federal budget. This is one key reason that I do not regard historical averages as useful policy guides for the future; what may have sufficed when we had relatively few retirees will not suffice when we have more.

In addition to the growth of these three programs as a percent of GDP, interest costs will rise as interest rates return to more normal levels. But partly offsetting these two upward pressures will be reductions in spending in other programs relative to GDP, as the economy recovers and as war costs wind down, for example. All in all, total outlays are likely to remain above the historical average, but below the 2009-2011 recession peak, in every year over the next ten years.

We last published long-term budget projections in 2010, and are currently in the process of revising those projections to take into account legislation that has been enacted and changes in underlying economic and technical assumptions. Our estimates will rely on longer-term projections by the Social Security and Medicare actuaries and by CBO with respect to Medicaid. Our preliminary findings show that the long-term outlook is more favorable than what we had previously published.

3. I believe that you advocated for higher taxes as part of the resolution of the fiscal cliff and seemed to have no reservations about raising taxes before the economy has more fully recovered. And I see, in your written testimony, that you hope that sequestration is replaced with other policies, but argue that those other policies to reduce future deficits be designed to "largely or entirely take effect after the economy has more fully recovered."

   Did you think that it was premature to have raised taxes on New Year's Day, before the economy has more fully recovered? And, if you think that the tax hike earlier this year was not problematic in an economy that has not fully recovered, why would it suddenly now be problematic to engage in fiscal restraint?

   Answer: We have advocated for a balanced approach to long-term deficit reduction that includes not just spending measures but also policies that increase revenues. In general we have recommended that deficit reduction be phased in on the grounds that too much deficit-reduction too soon in a slack economy reduces aggregate demand and is therefore a drag on the economic recovery.

   However, different policies have a different effect on aggregate demand – that is, they have a different "bang-for-the-buck." At one extreme, programs that put money in the hands of people who will spend it quickly, such as food stamps or unemployment insurance, have a high bang-for-the-buck. So cutting these programs reduces aggregate demand significantly—by many estimates, by more than a dollar for each dollar of budget savings. At the other extreme, increasing top marginal tax rates or lowering the exemption for the estate tax have a low bang-for-the-buck, because spending by very high-income or wealthy taxpayers is much less sensitive to changes in after-tax income. We supported raising upper-income tax rates in the fiscal cliff deal because, for these low bang-for-the-buck policies, the benefits from locking in budget savings far outweigh any minor change in aggregate demand in the short term.

4. You note in your written testimony that the minimum wage has been allowed to erode because of inflation, and I presume that you support the President's idea of indexing the minimum wage to inflation. If you do not agree, then I would be interested to learn that. If you do agree, I wonder whether you would also support indexing the threshold level of public works projects after which Davis-Bacon wage requirements apply—a threshold whose value has significantly been eroded by inflation over time—and, if not, why not?

   Answer: The Davis-Bacon Act is not a policy that we work on or have studied, and we therefore do not have a response.

5. The President laid out a list of what he would like done in his recent State of the Union Speech, including things like creating a network of 3D printing manufacturing hubs, setting up a "fix-it-first" program to hire people to work on infrastructure, somehow facilitating more mortgage refinancing by federal means, providing preschool availability to every child in America, and more. He said that "nothing I'm proposing tonight should increase our deficit by a single dime." The President also claimed that we have reduced the deficit by more than $2.5 trillion and are more than halfway towards a goal of $4 trillion, meaning that he wants $1.5 trillion more in deficit reduction.

If we got the President's desired $4 trillion of promised future deficit reduction and instituted his list of desires, which must include additional federal funding, it seems to me that some combination of the following two things has to happen. One, spending on some things other than the President's latest wish list would have to be cut. And, two, taxes would have to go up.

Do you agree that satisfying the President's desire for more spending along with his desire for more promised future deficit reduction would have to involve either other spending cuts or more tax hikes or both? And, do you think it would be feasible to enact $1.5 trillion of additional promised future deficit reduction, raise spending on some of the President's new proposals, and not cut any other spending while at the same time not adding a dime to deficits and not raising taxes on the middle class?

Answer: I agree that addressing the nation's many fiscal challenges will require a combination of spending cuts and revenue increases. Definitions of the "middle class" are often subjective, but I also agree that it is implausible to assume that the nation can rely solely on the extremely wealthy to produce all of the deficit reduction needed to put the budget on a more sustainable path.

Since I testified before the Finance Committee, the President has released his fiscal year 2014 budget. As you suggest, he relies on a combination of spending cuts and revenue increases to offset the cost of his proposed initiatives, which in total are deficit neutral. In addition, the President's budget includes a deficit-reduction package that reflects his final offer to Speaker Boehner during their budget negotiations at the end of last year. That package also includes both revenue increases and spending reductions.

I also support a balanced approach to deficit reduction, believing that our longer-term fiscal challenges cannot be addressed only by changes to one side of the budget or the other. Rather, it will require changes to both revenues and spending programs. Further, it is essential for revenues to be part of a deficit-reduction package if policymakers are to adhere to the important principle (endorsed in the deficit-reduction plan by fiscal commission co-chairs Erskine Bowles and Alan Simpson) that policy changes to reduce the deficit should be crafted in a way to ensure they do not increase poverty or inequality.

Questions from Senator Ron Wyden

1) As you are undoubtedly aware, almost 27 years ago, when President Reagan and Congressional Democrats enacted Tax Reform, it was a big boost to the economy. More than six million new jobs were created in just the two years after the 1986 reform – something that's urgently needed today. I don't claim that every one of those jobs was the direct result of tax reform but it certainly helped.

   Since that time, especially in recent years, there have been dozens of calls from members of Congress, Administrations, outside task forces and commissions, and economists of every stripe for comprehensive tax reform. In the same vein, the Obama Administration has acknowledged the need for comprehensive reform with the release of two reports—one in August 2010 and one just less than a year ago. And, in his inaugural address last month, the President made clear the need to "revamp our tax code."

   However, despite such repeated calls for comprehensive reform, the reality appears more like lip service than commitment. Our current system is terribly inefficient, hopelessly complex and not by any measure the kind of pro-growth policy our country needs.

   Since 2001, Congress has passed almost 140 laws amending the tax code in one way or the other, and with each such adjustment, the revenue regime the country now has becomes even more byzantine, counterproductive and uneconomical. It has now gotten to the point that almost as much, if not more, money is spent through the tax code as it brings in, so it's getting harder and harder even to call it a revenue code at all.

   Individuals and businesses need confidence and certainty, and irregular short-term extensions of major parts of the tax code offer neither.

   In Dr. Greenstein's testimony, he notes that deficit reduction can be achieved through reductions both in spending in the tax code and in spending on the outlay side of the budget, and he cites the esteemed Martin Feldstein in support of this proposition.

   In the *Wall Street Journal* last week, Dr. Feldstein wrote: "Republicans want to reduce the deficit by cutting government spending while Democrats insist that raising revenue must be part of the solution. Yet the distinction between spending cuts and revenue increases breaks down if one considers tax expenditures. Here are some examples. If I buy a solar panel for my house, a hybrid car, or an energy-efficient refrigerator, the government pays me. But instead of sending me a check, it gives me a tax credit or a tax deduction. There are dozens of such examples that increase the annual budget deficit by billions of dollars. Congress should review these tax expenditures and eliminate those that the country cannot afford."

   Feldstein has also written that "tax expenditures are the single largest source of wasteful and low-priority spending in the federal budget and one of the first places policymakers should go to restrain spending."

   Dr. Elmendorf, in testimony before the House Budget Committee, made a similar point when he stated that tax expenditures "are really best viewed as a form of government spending because they are directed at particular people or entities or designed to subsidize particular activities," almost precisely analogous to other government spending.

Alan Greenspan has suggested that tax expenditures represent just as great a threat to a sustainable budget path as any other spending, including entitlements.

a. With that background, what, in your respective views, are some of the least economically efficient and/or justifiable tax expenditures? What economic effects—positive or negative—would you expect from their repeal? How would each of you propose we maximize any positive or mitigate any negative effects?

Answer: There are two areas of tax expenditures that should be the focus of reform: the large individual tax deductions and exclusions; and specific loopholes in the tax code which allow wealthy individuals to avoid or defer taxation, or pay tax at a lower rate.

First, roughly 70 percent of each year's spending on individual tax expenditures results from deductions, exemptions, or exclusions. The value of these tax breaks increases as household income rises — the higher one's tax bracket, the greater the tax benefit for each dollar that is deducted, exempted, or excluded. As a result, these tax expenditures provide their largest subsidies to high-income people, even though those are the individuals least likely to need a financial incentive to engage in the activities that these tax policies are generally designed to promote, such as buying a home, sending a child to college, or saving for retirement. Meanwhile, middle-class families receive considerably smaller tax-expenditure benefits for engaging in these activities. In this regard, these tax expenditures are "upside down," which makes them less efficient, as well as less equitable.

Consider how the deduction for home mortgage interest affects two households' decisions to buy a home. An investment banker making $675,000 who has a $1 million mortgage and pays $40,000 in mortgage interest each year receives a housing subsidy of about $14,000 annually from the mortgage interest deduction. By contrast, a middle-class family led by a nurse making $60,000, and paying $10,000 a year in mortgage interest on a more modest home, receives a housing subsidy worth $1,500 annually. Not only does the mortgage interest deduction provide the high-income banker with a larger total subsidy (in dollar terms) than the nurse, but the subsidy also represents a greater share of the banker's mortgage interest expenses. In fact, the proportion of the banker's mortgage interest expense covered by the subsidy is more than twice as large as the percentage subsidy that the nurse receives.

The most economically efficient policy response would be to turn these deductions and exclusions into single-rate, refundable tax credits. The Bipartisan Policy Center, for example, used this approach for its proposed reform of the mortgage interest deduction. Such a policy shift would address the problems highlighted in my banker/nurse example, and improve both equity and economic efficiency. This would be an ideal template for reform. To the extent that political constraints and other factors limit the reach of the policy change, movement in this direction could still prove beneficial. For example, the Obama Administration's proposal to limit to 28 percent the benefit from a range of deductions and exclusions would improve upon their current upside-down structure, even though it may fall short of ideal policy.

As far as possible negative consequences to avoid, the Committee would need to give due consideration to transition issues and near-term weakness in the economy.

Second, while converting deductions or exclusions to credits or imposing an across-the-board limitation can address many issues, some tax expenditures are embedded in the tax code in a way that would make it difficult or impossible to apply such approaches. These types of tax breaks should be addressed directly, with carefully designed policies.

In particular, policymakers should examine tax breaks that enable various people with high incomes to avoid substantial amounts of tax on that income (and do so without creating incentives for desirable activities such as homeownership or charitable giving). Former Treasury Secretary Lawrence Summers wrote recently that policymakers "should be able to come together around the idea that it should not be possible to accumulate and transfer large fortunes while avoiding taxation almost entirely. Yet this is all too possible today." For many of these tax breaks, it would make sense to restructure or eliminate them independently. Some examples of these tax breaks include carried interest, like-kind exchanges, and valuation adjustments. Closing each of these loopholes would have economic efficiency gains.

For a more detailed discussion of these issues, I would recommend this Center analysis: "Tax Expenditure Reform: An Essential Ingredient of Needed Deficit Reduction," by Chuck Marr, Chye-Ching Huang, and Joel Friedman, February 27, 2013.

b. In a similar vein, there is a great debate among Republicans and Democrats as to what we should do with any additional revenue generated by rolling back or reducing tax expenditures, also commonly referred to as closing loopholes. On the one hand, some would have us use any additional revenue to buy down marginal tax rates, while, on the other, some would have us use any resulting revenue for deficit reduction and/or other investments. Weighing in on that debate, Martin Sullivan, a widely read commentator on tax policy, has suggested that perhaps the best solution would be to devote half of any resulting revenue to reducing rates and half to reducing the deficit. Do you feel that Sullivan has the ratio about right? Or would you suggest a different allocation of any resulting revenue and why?

Answer: I do not support the idea of splitting the revenue generated by reforming tax expenditures evenly between deficit reduction and lower rates, but rather believe it is essential that deficit reduction be the top priority. I believe it would be a serious mistake for the Committee to put cutting tax rates ahead or even on the same level as deficit reduction when setting its priorities for tax reform. In the context of long-term budget deficits, burgeoning inequality, and the political difficulty of cutting tax expenditures, cutting rates – and particularly the top rate – would be very expensive, would aggravate inequality, and would not provide as much long-term economic benefit of deficit reduction.

Curbing tax expenditures is difficult politically, and tax reform will likely exhaust the achievable savings in that area. Thus, once tax reform is enacted, opportunities for significant revenue-raising will likely be gone for many years. If policymakers use tax expenditure savings to pay for lower tax rates – particularly in the context of revenue-neutral reform – then they will have squandered the opportunity to raise the significant additional revenue needed for deficit reduction. Further, if revenue-neutral tax reform takes revenues for deficit reduction off the table, I believe it will likely dim prospects for agreement on future deficit reduction. I think it will be very difficult for policymakers to build support for cutting popular entitlement programs such as Social Security and Medicare in the name of deficit reduction in the *absence* of additional revenue from curbing unproductive or low-priority tax breaks that is also dedicated to reducing the deficit.

2) In his State of the Union, the President discussed the need for investment in transportation and infrastructure. That means roads, bridges, rail, ports, and inland waterways. You simply cannot have a big league economy with a little league transportation system. In the Senate, there is widespread consensus that highways, roads, transit systems, and bridges must be fortified. Furthermore, transportation projects put people to work, which the construction industry and the country need.

But the big challenge, in my view – the outstanding issue – is how America will pay for improving our transportation system, especially given the budget outlook. Fortunately, there is a proven way to generate tens of billions of dollars of additional funds for transportation on top of what is raised by the gas tax. The idea is based on Build America Bonds, which for years had widespread bipartisan support and were tremendously successful.

My proposal would be to authorize Transportation Regional Infrastructure Project bonds, or "TRIP bonds", which I first proposed in legislation last Congress. Under the legislation, TRIP bonds would provide up to $1 billion in tax credit bonds for each state to use for transportation and infrastructure projects of the state's choosing.

In a time when we are trying to get our fiscal house in order, "TRIP bonds" use federal tax credit bonding to leverage private dollars for investment in infrastructure. This decreases the federal government's share of the cost, while still investing in critical infrastructure that's the gateway to the United States' big league economy.

Soon, I will reintroduce the TRIP legislation, and I hope it garners the same bipartisan support it did last Congress. It's my hope that we can use TRIPs to grow our national investment in transportation and infrastructure in a fiscally responsible and economically efficient manner.

Inadequate revenues in the Highway Trust Fund have denied state transportation departments the long-term stability to carry out much-needed investments in critical infrastructure projects. Given the difficulty of finding new revenues and the need to get our fiscal house in order, do you think there's a strong case to be made for federal tax-credit bonding for transportation and infrastructure projects as an alternative to direct spending? Can each of you provide your thoughts on the relative economic merits of this approach to infrastructure financing in a time of scarce budget resources?

Answer: We have not studied the TRIP legislation. But, in general, economists find that well-designed tax credit bonds are able to subsidize state and local infrastructure financing more efficiently than the traditional approach of making the bond interest tax-free to investors, while also encouraging more investors to buy them (because they are attractive to investors with no tax liability, such as pension funds).

From Senator Robert Menendez

1) As you already know, the Ryan budget sought to cut all discretionary spending as a share of the total economy to 3.5 percent of GDP, while somehow still protecting defense spending. Assuming defense spending remains level in real terms, budget experts have estimated that under the Republican budget most of the rest of the federal government outside of health care, Social Security, and defense would cease to exist.

   If you compare the cuts to the non-defense side of discretionary spending from sequestration to the cuts that would be necessary for the Ryan budget to work, is sequestration that much harsher? Would the real world impact on air travel, our schools, food inspection and any number of other important services face any more serious deterioration over the long-term from sequestration than they would if the Ryan budget actually became law?

   Answer: The recent House-passed budget resolution for fiscal year 2014 cuts nondefense discretionary spending significantly below sequestration. The non-defense discretionary caps enacted in the Budget Control Act of 2011 would reduce funding for these programs to the lowest level on record as a share of GDP. Relative to these levels, sequestration would further reduce funding for non-defense discretionary programs by about $350 billion over the 10-year period 2014-2023. In contrast, the House-passed budget resolution calls for that funding to be cut below the caps by almost $1.1 trillion. In short, sequestration would cut funding below the levels already imposed by the tight caps set in the Budget Control Act, and the cuts required under the Ryan budget would be three times as deep as sequestration.

2) The Congressional Budget Office wrote in their latest report on the budget and economic outlook: "Persistent long-term unemployment will lead some workers to leave the workforce earlier than they would have otherwise and will erode the skills of other workers, making it harder for them to find work in the coming years." Compounding this problem is evidence which shows many employers discriminating against the long-term unemployed, perpetuating a vicious cycle. The longer a worker is unemployed the less attractive they are as a job candidate and the longer they remain unemployed.

   How difficult do you believe the crisis of long-term unemployment is today and what, in your view, are some of the most effective steps we can take to tackle the problem?

   Answer: The problem of long-term unemployment is very serious. The percentage of the unemployed who are long-term (unemployed 27 weeks or longer) jumped over the course of the recession and has remained high – around 40 percent – since the end of the recession, a figure that is significantly higher than the highest level reached in any previous recession since the end of World War II (26 percent in June 1983).

   Stimulus policies that increase the demand for goods and services are critical to reducing long-term unemployment by creating more job opportunities. Evidence suggests that employers discount the value of applicants who have been unemployed for long periods. A healthier job market reduces that effect. As the economy improves, it still may be necessary to devote special effort to assisting the long-term unemployed in their job search and helping them rebuild their skills through retraining programs.

3) In my view, expanding opportunities for workers to advance their skills and their value is a critical one when we're thinking about how to help shore up the economic fortunes of the middle class. Estimates show the economy is going to be short 5 million trained workers by 2018. Every state in the country is confronted with this shortage and in my opinion, we shouldn't shy away from any opportunity to address the issue.

   Do you agree that there is an increasing challenge for America to produce more skilled workers and do you believe there should be a federal role in meeting that challenge? If so, what do you believe would be some of the most effective policy measures Congress should consider?

   Answer: Over the years, improvements in the average skill levels of our workforce have been one of the most important contributors to increased productivity and a rising standard of living. We do face challenges ahead making sure that our workforce has appropriate levels of education and training. That means continuing the federal commitment to higher education through Pell Grants and other policies that help people pursue higher education, but it also will likely require an increased commitment to policies that produce an educated workforce at all levels of educational achievement.

   These investments in our workforce are largely funded through annual appropriations in the nondefense discretionary part of the budget. This budget category includes other programs, such as basic research and infrastructure, that can also make an important contribution to increasing our future productivity. Yet funding for nondefense discretionary programs is projected to fall to historically low levels under the caps imposed by the Budget Control Act, and would be cut even further if sequestration were to remain in effect. We are very concerned about these cuts, and their potential to harm the nation's ability to meet important economic challenges, including those that you have raised concerning boosting the skill levels of our workforce.

Questions from Senator Robert P. Casey, Jr.

1. Your testimony rightly acknowledges the positive long-term impact of the Child Tax Credit and the Earned Income Tax Credit on children and working families, including boosting children's school achievement and future earnings as an adult.

   Can you speak to the impact of the EITC on school performance specifically? In recent years, we have worked to expand these tools. What are the impacts of these improvements? Specifically, how have they created economic ladders of opportunity?

   Answer: There is exciting new research that concludes that the extra income from the EITC and the child tax credit improves the educational outcomes of young children in low-income families.

   When researchers analyzed ten anti-poverty and welfare-to-work experiments, they found a consistent pattern of better school results for low-income children in programs that provided more income. Each $1,000 increase (in 2001 dollars) in annual income — the equivalent of a full CTC for one child — for two to five years led to modest but statistically significant increases in young children's school performance on a number of measures, including test scores. While not specifically analyzing the EITC's impact, the researchers noted that their results have important implications for income-boosting policies like the EITC "that link increases in income to increases in employment."

   Other researchers analyzed data for grades 3-8 from a large urban school district and the corresponding U.S. tax records for families in the district. Even under conservative assumptions, they found, additional income from the EITC and CTC leads to significant increases in students' test scores. Likewise, researchers who studied nearly two decades of data on mothers and their children concluded that additional income from the EITC raises the combined math and reading test scores of students by similarly large magnitudes.

   Gordon Berlin, the president of MDRC — one of the nation's leading research organizations that is known for its rigorous evaluation of anti-poverty and welfare-to-work programs — summarized the results this way:

   > [There is] a remarkably strong body of research — much of it based on large-scale, well-implemented, experimental research designs — showing that supplementing the earnings of parents helps raise families out of poverty and improves the school performance of young children. This point is so important — and to many so surprising — that I want to state it again: We have reliable evidence involving thousands of families in multiple studies demonstrating that "making work pay" causes improvements in young children's school performance.

   We discuss these finding in more detail in a report titled: "Earned Income Tax Credit Promotes Work, Encourages Children's Success at School, Research Finds," by Chuck Marr, Jimmy Charite, and Chye-Ching Huang, revised April 9, 2013.

2. In your testimony you state "Policymakers can enact measures now, as part of a balanced deficit-reduction package, that would achieve significant Medicare savings (a few hundred billion dollars over ten years) without jeopardizing the quality of care or access to care."

   What specific changes would you suggest we make to strengthen Medicare while also protecting it for millions of older citizens and people with disabilities?

   Answer: The Medicare proposals in the Administration's fiscal year 2014 budget would save $371 billion over the first ten years and $1 trillion in the second ten years, according to the Office of Management and Budget. These proposals all merit serious consideration and illustrate the kinds of changes that can be made without raising Medicare's age of eligibility or removing its guaranteed benefit.

   More than three-quarters of the budget's Medicare savings over the first ten years stem from changing payments to providers. The largest single proposal would secure the same low prices for drugs prescribed to low-income Medicare beneficiaries that *Medicaid* pays for those drugs. Other provider proposals in the budget include refining payment mechanisms for post-acute care, reducing overpayments to Medicare Advantage plans, and changing payments for clinical laboratory services.

   The budget also includes earlier Administration proposals for further structural changes in Medicare. The budget would increase the income-related premiums paid by upper-income beneficiaries and gradually expand those premiums to cover a larger fraction of beneficiaries. It would also increase cost-sharing for *new* beneficiaries by raising the deductible for physician services, introducing co-payments for certain home health care services, and introducing a premium surcharge for those who purchase Medigap supplement plans that provide near-first-dollar coverage (which encourages greater utilization of health care services). Finally, the budget would strengthen the Independent Payment Advisory Board and lower Medicare's target spending growth rate per beneficiary, now set at the rate of GDP growth per capita plus 1 percentage point, to GDP growth per capita plus 0.5 percentage points.

STATEMENT OF HON. ORRIN G. HATCH, RANKING MEMBER
U.S. SENATE COMMITTEE ON FINANCE HEARING OF FEBRUARY 26, 2013
THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2013 TO 2023

WASHINGTON – U.S. Senator Orrin Hatch (R-Utah), Ranking Member of the Committee on Finance, delivered the following opening statement at a committee hearing examining the nation's budget and economic outlook for fiscal years 2013 to 2023:

Thank you, Mr. Chairman, for holding today's hearing. I want to welcome all of our witnesses and thank them for their willingness to appear here today.

This is an important hearing and, given that we are currently in the midst of a national debate over our country's fiscal future, it couldn't be more timely.

Anyone who takes a careful look at our federal finances should be very nervous. We have had four consecutive years with deficits above $1 trillion. By the end of this fiscal year, CBO projects that the debt held by the public will reach the largest percentage of GDP since 1950.

And, it only gets worse as time goes on.

After a temporary lull in the growth of debt in 2018, CBO projects that the debt will rise for the remainder of the 10-year budget projection window, measuring 77 percent of GDP by the end of 2023.

According to CBO:

> *"Along such a path, federal debt held by the public will equal a greater percentage of GDP than in any year between 1951 and 2012 and will be far above the average of 39 percent over the 1973-2012 period. Moreover, it will be on an upward trend by the end of the decade. Debt that is high by historical standards and heading higher will have significant consequences for the budget and the economy..."*

Those negative consequences of our growing national debt will include: higher interest costs, lower national savings, more borrowing from abroad, less domestic investment, lower incomes, lesser abilities of policymakers to respond to unexpected challenges like natural disasters, and a greater likelihood of a fiscal crisis.

While some will try to argue that the coming debt crisis can be blamed on a lack of sufficient revenue, nothing could be further from the truth.

With the tax increases included as part of the fiscal cliff package that passed on New Year's Day, federal revenue as a share of our GDP is on a path to exceed the average of the last 40 years.

So, despite some adamant claims to the contrary, it's clear that our government has a spending problem, not a revenue problem.

Another common claim we've heard from the White House and from many here in Congress is that, over the last year and a half, we've already cut spending dramatically.

This is also untrue. By any measure, spending has increased significantly under this administration.

For starters, federal outlays in Fiscal Year 2012 were well above 2009 levels.

Now, some have argued that it's not fair hold the Obama Administration entirely accountable for all of the outlays incurred during 2009. So, for now, let's consider Fiscal Year 2010.

When you compare federal outlays in Fiscal Year 2012 with those of Fiscal Year 2010, you see an increase in spending of over $82 billion.

At the same time, as the economy has sluggishly recovered, federal revenues have increased. In Fiscal Year 2012, they were up by more than $286 billion compared to 2010.

So, between 2010 and 2012 the deficit went down by just over $204 billion. And, literally no part of that reduction can be attributed spending cuts; it's all due to higher revenues.

Despite these facts, the President continues to resist any real spending restraint and calls for even more tax hikes, even though he just raised taxes less than two months ago. He also refuses to entertain serious, structural changes to our entitlement programs, even though everyone agrees that entitlement spending is the main driver of our debts and deficits.

As far as I'm concerned, any conversation about reducing our deficits that doesn't focus on shoring up and reforming our entitlement programs is a missed opportunity.

In the more immediate future, we face the indiscriminate spending reductions that are scheduled to begin on March 1 under the so-called sequester, which CBO says will reduce actual outlays in FY 2013 by around $44 billion, or just over one percent of total federal spending.

The debate over the sequester appears to be headed down the same path that all of our recent fiscal debates have followed, with the President and his allies here in Congress insisting that, in lieu of actually cutting spending, we raise taxes on the so-called rich.

And, once again, none of the tax hike proposals we're hearing about were considered by this Committee. Instead, they have been drafted somewhere else behind closed doors.

Today, we will hear more about these and other fiscal challenges facing our nation. In addition to discussions about our long-term budgetary problems, I expect we'll hear recommendations about how to deal with short-term spending reductions scheduled under the sequester.

I assume that we'll also continue to hear grand claims of deficit reduction that measure progress using selective baselines and include only promises to reduce spending in the future. Once again, by any measure, spending has not been cut to date. We have promises for future cuts in spending, but nothing has been realized.

I hope today's hearing will, among many other things, help us get to the bottom of some of these claims and clarify for the American people how much Congress has actually done to reduce the deficit in recent years.

Mr. Chairman, thank you again for holding today's hearing, and I look forward to hearing from our witnesses on both of today's panels.

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SUBMITTED BY SENATOR HATCH

July 26, 2011

Fact Sheet: Who Benefits From Tax Expenditures?

In much of the coverage of tax expenditures, it has been taken as an article of faith that they disproportionately benefit wealthy taxpayers. But, data show tax expenditures tend to skew towards middle class Americans or those below the Obama Administration's definition of the rich – that is singles with adjusted gross incomes over $200,000 per year and married couples with incomes over $250,000 per year.

According to the Joint Committee on Taxation, taxpayers with income over $200,000 bear 64% of the tax burden while taxpayers earning under $200,000 bear 36%. The following summarizes the percentage of tax expenditures that go to these taxpayers:

Mortgage Interest Itemized Deduction: 30% of the benefit of the mortgage interest tax expenditure goes to taxpayers over $200,000. Taxpayers with income below $200,000 receive 70% of the benefit, while shouldering 36% of the tax burden. By a ratio of almost 2 to 1, taxpayers under $200,000 benefit from it.

Earned Income Credit: It is a refundable credit. That means taxpayers receive it whether they pay income tax or not. Because the earned income credit is refundable, the so-called rich taxpayers do not benefit from it, but 100% of the benefits go to those earning under $200,000.

Child Tax Credit: This is by definition, limited to lower and middle income taxpayers. Again, none of it goes to higher income taxpayers.

State and Local Taxes: This one splits down the middle – 50% of this broad-based deduction goes to middle income families and 50% to top earners.

Charitable Itemized Deductions: Of all of the tax expenditures listed, at 55% this one distributes in the highest proportion to taxpayers above $200,000 in income. But keep in mind, overall, taxpayers with income over $200,000 bear 64% of the tax burden. This means, proportionately, the charitable deduction benefits taxpayers under the $200,000 level more than taxpayers above the $200,000 level.

Tax-Free Portion of Social Security Benefits: Just 2% of that favorable tax treatment of Social Security goes to seniors with incomes over $200,000.

Real Property Taxes: While some may say that only those with villas are taking the property tax deduction, 80% of the real property tax benefit goes to taxpayers under $200,000.

Education Credit: Here again, 100% of these benefits go to taxpayers earning under $200,000.
Medical Itemized Deduction: 89% of this tax benefit goes to taxpayers earning less than $200,000.

Dependent child care credit: This is a modest tax credit that working moms and dads can tap. Like the child tax credit, it mainly is used by middle income families. 96% of the benefits of this credit go to families earning less than $200,000.

Student Loan Interest Deduction: This tax benefit is income limited. All of the benefit goes to taxpayers earning less than $200,000.

Source: Joint Committee on Taxation Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014, December 15th, 2010, http://www.jct.gov/publications.html?func=startdown&id=3718.

July 14, 2011

Fact Sheet: What Are the Top 10 Largest Tax Expenditures?

Tax expenditures are incentives that were intentionally included in the tax code by Congress to realize certain policy goals. They are neither spending nor "loopholes" for millionaires, yachts or corporate jets.

Given their reach and impact on so many middle-class families, reducing them as a means of accomplishing fundamental tax reform shows the challenge ahead. Achieving a significant tax overhaul requires a basic understanding of what tax expenditures are in order to have a fair and constructive debate to make the tax code more efficient and less burdensome.

So, what are the top 10 largest tax expenditures?
(NOTE – these are not only the largest tax expenditures, but they also benefit individuals.)

1. Exclusion for Employer-Provided Health Insurance.
Representing 13 percent of tax expenditures, it's the single largest tax expenditure. To do away with this would threaten access to health care for families and individuals that have health insurance through their employers.

2. Home Mortgage Interest Deduction.
Having helped millions of Americans achieve home ownership, this expenditure accounts for 9 percent of all tax expenditures.

3. Preferential Rates for Dividends & Capital Gains.
Take away this tax expenditure which accounts for 8 percent of tax expenditures, and the rate on dividends will almost triple in less than 18 months, and the rate on capital gains will go up 59%, also in less than 18 months. This will discourage investment in stocks and bonds.

4. Exclusion of Medicare Benefits.
Accounting for 7 percent of tax expenditures, its elimination would increase taxes seniors' Medicare benefits.

5. Pre-Tax Treatment of Defined Benefit Pension Plan Contributions.
This is a tax benefit that reduces the cost for those workers who save for retirement. It represents 6 percent of tax expenditures.

6. Earned Income Tax Credit.
Designed for low-income people, the Earned Income Tax Credit accounts for five percent of all tax expenditures.

7. Deduction for State and Local Taxes.
This deduction would hit high-tax states hardest, driving up the marginal rate of taxpayers who take this deduction by as much as 35 percent. It represents 5 percent of all tax expenditures.

8. Pre-Tax Treatment for Contributions to a 401(k).
At four percent of tax expenditures, this is a significant incentive to families and individuals to save for retirement.

9. Exclusion of Capital Gains at Death.
If this one goes, death would be taxed twice. First, the decedent's estate might get hit with the death tax. Then the decedent's heirs would be subject to tax again on the gain embedded in any inherited asset, should they decide to sell it. This accounts for four percent of tax expenditures.

10. Deductions for Charitable Contributions.
This is the tax benefit for donations to charities other than education and health care institutions, including donations to religious institutions. This charitable deduction represents four percent of tax expenditures.

Source: Joint Committee on Taxation, "Estimates Of Federal Tax Expenditures For Fiscal Years 2010-2014," December 21, 2010, http://www.jct.gov/publications.html?func=startdown&id=3717.

July 12, 2011

Debunking the Myths of So-Called Tax Expenditures

Some in Washington have claimed that eliminating tax expenditures is the same as getting rid of wasteful spending or closing unwanted loopholes. The reality is somewhat different. Middle-class families would hardly agree that incentives to save for college and retirement or to buy a home are loopholes. Here's a closer look at the myths of tax expenditures:

MYTH: Tax Expenditures Are Spending.

FACT: The federal government cannot spend money that it never touched and never possessed. Tax expenditures let taxpayers keep more of their own money. And only by the public consent is the government permitted to take some of it in taxation to pay for certain public goods. When tax hike proponents say we are giving businesses and individuals all this money in tax expenditures, they are incorrectly assuming that the government has that money to give in the first place, when in fact it does not. To the contrary, the government never touches the money that a taxpayer keeps due to benefitting from a tax expenditure, whereas with spending, the government actually collects money from taxpayers and then spends it.

Another difference between tax expenditures and spending is that reducing or eliminating a tax expenditure without an offsetting tax cut to reach a revenue neutral level will cause the size of the federal government to grow, while reducing or eliminating spending causes the size of the federal government to shrink.

MYTH: Tax Expenditures are Loopholes.

FACT: This is deliberately inaccurate. A loophole is something that Congress did not intend and would generally shut down, at least going forward, once it learned of the loophole. Tax expenditures, by contrast, were generally placed by Congress into the tax code deliberately. For example, the largest tax expenditure is the exclusion for employer-provided health insurance and benefits. The second-largest: the home mortgage interest deduction.

Whether you agree with a particular tax expenditure or not, an honest debate requires recognition that tax expenditures were designed by Congress with economic or social goals in mind and are not inadvertent loopholes.

July 11, 2011

Hatch: Raising Taxes By Cutting Tax Expenditures For Deficit Reduction is "Dog That Won't Hunt"

WASHINGTON – In a speech on the Senate floor today, U.S. Senator Orrin Hatch (R-Utah), Ranking Member of the Senate Finance Committee (R-Utah), slammed the Obama Administration's decision to raise taxes by cutting tax expenditures to achieve deficit reduction, will be a "bull's eye on the backs of middle class American families." This speech is the third in a series Hatch has delivered on so-called tax expenditures.

Following are excerpts from Hatch's speech:

<u>On Why Tax Hikes "On the Rich" Won't Restore Fiscal Order:</u>
"Tax increases on the wealthy will not get our nation to fiscal balance. Even if we let the Bush tax breaks expire for the top income bracket, the total amount raised over ten years would be $615 billion. Yet our deficit this year alone is $1.5 trillion. And this is why the issue of tax expenditures is critical. Democrats talk about tax expenditures as though they are the holy grail of deficit reduction. Just close these loopholes, and happy days are here again. I am not going to let them get away with this. Cutting back tax expenditures is a convenient way for Democrats to tax middle class taxpaying families and small businesses without having to say they are raising their tax rates."

<u>On the "Lion's Share of Tax Expenditures":</u>
"The lion's share of tax expenditures go to that part of the middle class that is already shouldering much of the nation's tax burden. Most tax expenditures are either income limited or of limited value to wealthy taxpayers. Likewise, low income families don't pay income tax. They receive tax expenditures that are designed for the non-taxpaying population. So, who is left? The answer is the taxpayers who are not rich by the President's definition. The answer is middle class families."

<u>On Current Deficit Reduction Negotiations:</u>
"Contrary to the President's vague assertions, the left wing base that he is depending on for his reelection, refuses to any meaningful structural reforms to the spending programs that are bankrupting the country. That means that the only serious deficit reduction option available to Democrats is massive tax increases on the middle class. Democrats won't acknowledge the inevitable tax increases that their agenda assumes, and Republicans won't give the President any cover in this drive to 'spread the wealth around.' That is what is holding up this process."

<u>On Why Cut Backs in Tax Expenditures Will Not Achieve Real Deficit Reduction:</u>
"Instead, he [President Obama] and his party sit around and spread the myth that simply getting rid of tax expenditures and loopholes will fix our problem. We have two reasons to worry about that wrong-headed approach. One, to the extent deficit reduction energies are diverted to cutting back tax expenditures, pressure is taken off the root cause of the deficit and debt problem. That is, pressure that should be brought to bear on out-of-control spending programs, is released. Two, the productive sectors of the economy – workers, small business owners, and investors – are burdened with yet more in federal taxes. For many reasons, cutbacks in tax expenditures are a deficit reduction dog that won't hunt."

Economic Implications of the Budget and Economic Outlook: Fiscal Years 2013 to 2023

Testimony presented to the
U.S. Senate
Committee on Finance

Douglas Holtz-Eakin, President*
American Action Forum

February 26, 2013

*The views expressed here are my own and do not represent the position of the American Action Forum. I thank Gordon Gray for tremendous assistance in preparing this testimony.

Introduction

Chairman Baucus, Ranking Member Hatch and members of the Committee, I am pleased to have the opportunity to appear today. In this testimony, I wish to make three basic points:

- The level and projected growth of federal debt is a drag on current U.S. economic growth and a threat to future prosperity,
- The scale of debt reduction required dwarfs the impending sequester and associated discretionary caps in the Budget Control Act, and
- A superior strategy for debt control and economic growth is to pair entitlement reform with pro-growth tax reform.

I will pursue each in additional detail.

The Economic Consequences of Federal Debt

Earlier this month, the Congressional Budget Office (CBO) released its Budget and Economic Outlook for 2013-2023. This release is particularly significant in light of recent events.

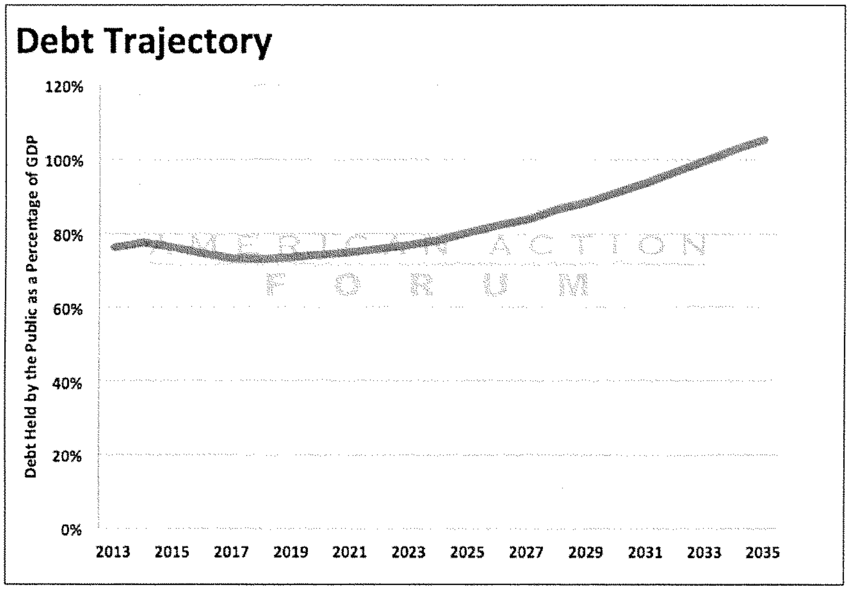
For the first time in over ten years, the current-law baseline offers a fairly reasonable projection of the nation's current budget policy over the next decade. With the enactment of the so-called "fiscal cliff" tax deal, current tax law is relatively stable – that is, largely free of scheduled expirations that are regularly overturned. On the spending side, the discretionary caps under the Budget Control Act of 2011 (BCA) give a realistic pathway for annual appropriations. Mandatory spending is, of course, guided by current law with the overall result that current law provides a good depiction of current budgetary intent over the next decade.

One would hope that outlook would reveal that existing deficit reduction measures (the BCA and the tax increases embedded in the American Taxpayer Relief Act (ATRA)) have improved the federal government's finances. Unfortunately, CBO's baseline confirms that the nation, despite claims to the contrary, remains on a damaging debt pathway.

The Debt Trajectory (2013-2035)

Under current law debt held by the public – measured as a fraction of Gross Domestic Product (GDP) – will temporarily shrink during the ten-year budget window. Some will suggest that the absence of immediate and additional severe debt accumulation in the near-term provides the nation the freedom to forgo meaningful debt reduction. This ignores the fact that the debt outlook is but a temporary reprieve, as the debt burden begins to rise toward the end of the budget window. A conservative medium-term projection reveals that the debt held by the public will continue to spiral upward and reach 105 percent of GDP by 2035 (see Figure 1).[1]

Figure 1:



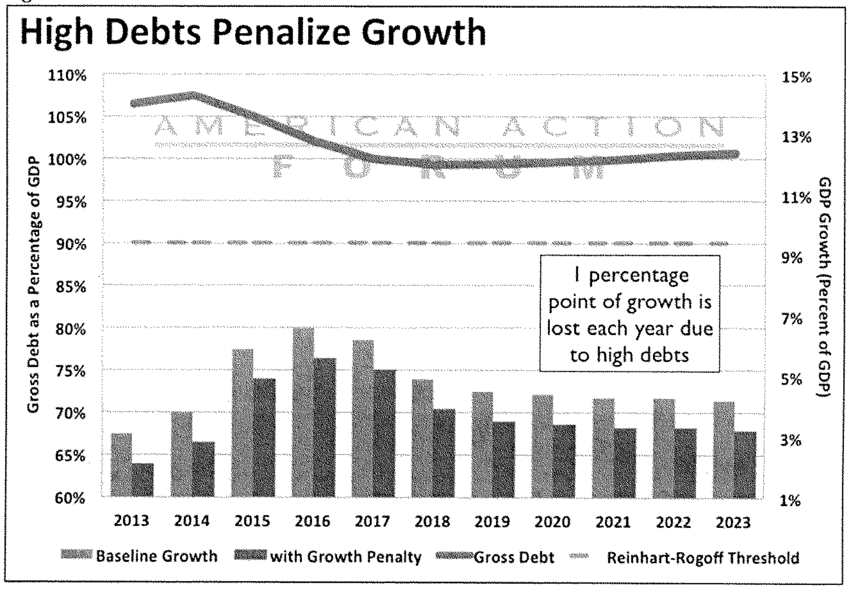
Federal Debt is a Drag on the Economy
It is often asserted that the economic downside to excessive federal debt is a distant threat; indeed, that it is even more economically damaging to address the debt explosion than to accommodate it. This reasoning is 180 degrees from reality, as the U.S. is already paying an economic price for the excessive federal debt.

Research of Carmen Reinhart and Kenneth Rogoff – based on a careful empirical analysis of 44 countries over the past two centuries – indicates that when gross government debt (as a percent of GDP) exceeds 90 percent, median growth is roughly 1 percentage point lower annually than for comparable countries with lower debt burdens.[2]

[1] AAF calculations. Details available upon request.
[2] http://www.economics.harvard.edu/faculty/rogoff/files/Growth_in_Time_Debt.pdf

Gross federal debt already exceeds 100 percent of U.S. GDP, and under current law gross debt will remain above 90 percent over the entire 2013-2023 period.[3] Applying the research rule of thumb indicates that the U.S. is right now paying a persistent growth penalty of 1 percentage point per year (see Figure 2). Accordingly, debt reduction is no mere arithmetic exercise – it is an economic imperative. Continued high levels of indebtedness will slow annual economic growth, and therefore slow job creation and wage growth.

Figure 2:

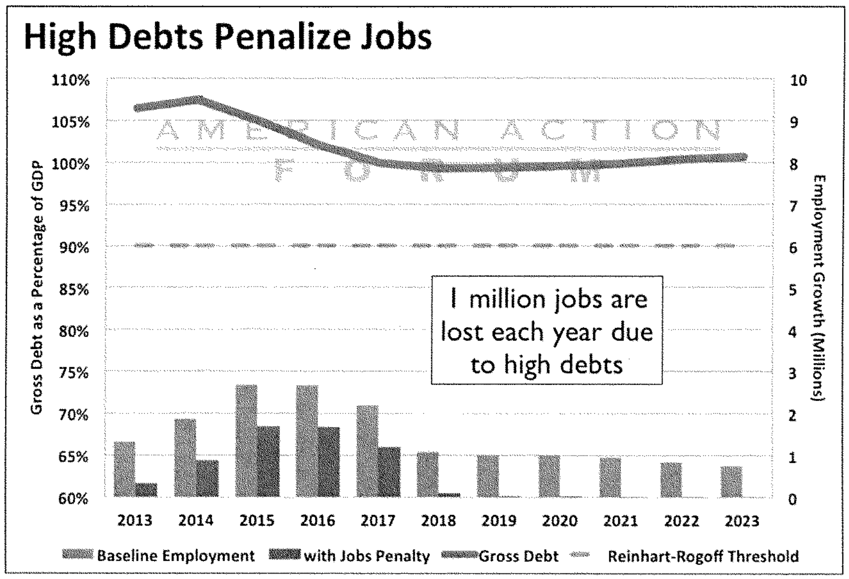


The administration has estimated that one percentage point in growth translates into approximately 1 million jobs created.[4] Accordingly, over the period in the CBO baseline, a persistent 1 percentage point growth penalty should translate into an annual penalty of 1 million jobs forgone – or 11 million jobs over 2013-2023 (see Figure 3).

[3] Gross federal debt is larger than the debt in the hands of the public. I focus on it in what follows to permit comparisons with the published research.

[4] http://www.politico.com/pdf/PPM116_obamadoc.pdf

Figure 3:



Slower job creation is only one metric of the price the U.S. is paying for not addressing the federal debt load. Over 2013-2023, CBO estimates growth of wages and salaries to average about 5 percent. Median household income was $50,054 in 2011.[5] Under CBO's projections, this should exceed $86,000 by 2023. Assuming a growth penalty of 1 percent, however, indicates that this income growth would be penalized by as much as $9,390 by 2035 under current law (see Figure 4).

The Mechanisms of Slower Growth

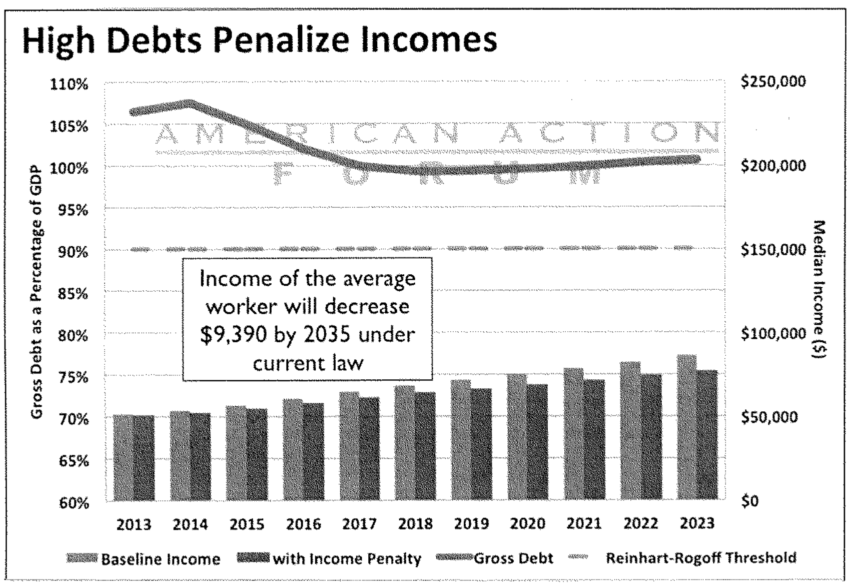
One question that arises is the mechanism by which the deleterious growth effects occur. This is far from mysterious. In the worse case, a nation might be unwilling to undertake the tax and spending changes needed to stabilize its debt. A conscious strategy to sail straight toward a financial crisis would alarm small firms, large firms, and investors alike. Their unwillingness to hire, expand, and start new firms would immediately hamper growth.

Alternatively, the strategy might be dominated by an unwillingness to control spending and instead a commitment to dramatic tax increases as the means of

[5] http://www.census.gov/prod/2012pubs/p60-243.pdf

reducing deficits and debt. The deleterious growth effects of anticipated sharply lower returns to work, saving and investment will become immediately apparent. These estimated penalties to growth, employment, and income penalties from high debt include the budgetary impacts of higher tax rates, lower discretionary spending, and the sequester enacted in recent years. The obvious conclusion is that additional deficit reduction is needed to avoid debt-driven economic stagnation. There exist, however, important disagreements over just how much further deficit and debt reduction should be pursued.

Figure 4:

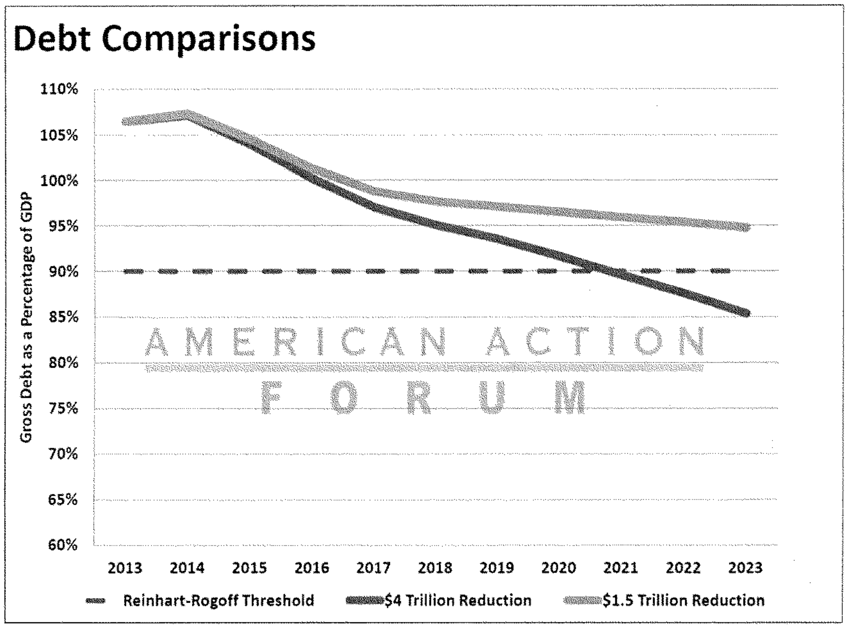


Targets for Debt Reduction

What is the right target for debt reduction? Many recent discussions on additional debt reduction have focused on "stabilizing" the debt as a share of GDP. That would be a sensible goal if it is stabilized at a level that is manageable and does not pose risks to the economy. Unfortunately, as noted above, the debt is currently above those levels. Stabilizing at or near the current levels of debt is a commitment to a future of slower growth and impending financial crisis.

A more sensible would be to reduce the debt to below the empirically observed threshold of 90 percent of gross debt as a share of GDP, thereby reducing the risk of financial crisis and stagnant growth. For example, choosing a gross debt-to-GDP ratio of 85 percent would require approximately $4 trillion in additional deficit reduction over ten years (see figure 5).

Figure 5



In addition to maintaining the current anti-growth effects of high debt, any plan to merely stabilize the debt within ten years would contribute to a failure to restrain debt accumulation over the medium and long-term. The stability promised by a more modest ($1.5 trillion in 10 years) deficit reduction plan would persist for only a single year beyond the ten-year budget window. Thereafter, the debt would grow as a share of the economy to 87 percent by 2035 (see Figure 6).

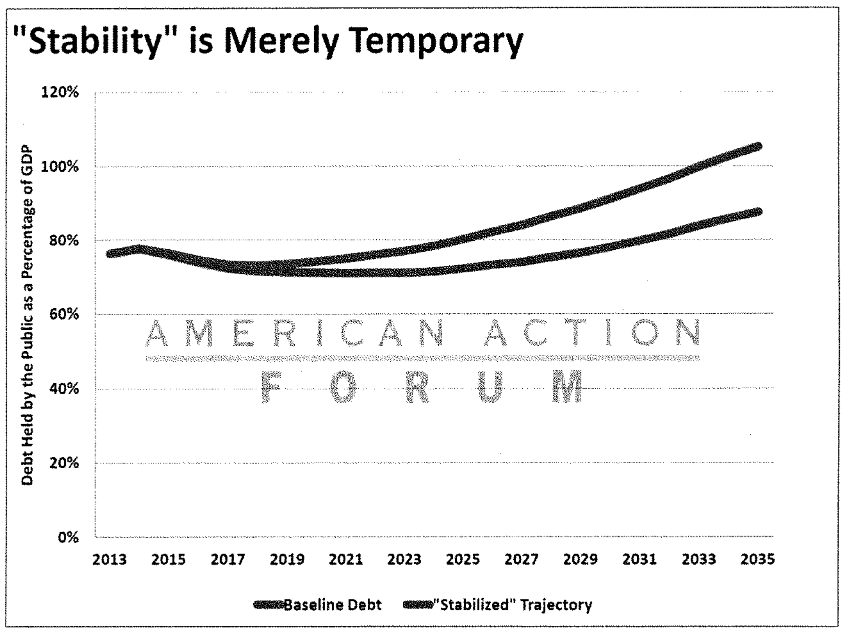
This is significant from a risk-management perspective. The longer that debt is preserved at high levels, the longer the risk remains that the United States would be vulnerable to a fiscal crisis.

Risk Management Issues and Debt Projections

The economic projections underlying the CBO baseline assume real GDP growth of 2.7 percent and 10-year interest rates of 4.4 percent over the next ten years. Plans to stabilize the debt-to-GDP using this projection are vulnerable to downside risks that would worsen the nation's debt outlook, and contribute to the well-understood mechanics of a fiscal spiral.

Slower growth or higher interest payments would be followed by higher debt, slower-yet growth, higher-yet interest rates and so on. Moreover, preserving debt held by the public at above 70 percent of GDP (or 100 percent in gross terms) leaves no cushion to absorb other adverse geopolitical or natural events. It assumes on can take comfort in the razor-thin margins embedded in necessarily- inexact projections.

Figure 6



Importantly, even a "stable" deficit reduction plan for the next 10 years does not contain the growth of the debt beyond the ten-year window.

Sequestration: A bad idea whose time has come
Of lesser consequence than the broader fiscal outlook, but perhaps greater immediacy, is the pending sequester. The automatic enforcement mechanism of the failed "Super-Committee's" goal $1.2 trillion in deficit reduction is an admittedly blunt budgetary policy that is a poor substitute for meaningful reform, but is preferable to no spending reduction at all.

First, there is a need to demonstrate that spending will actually be controlled. CBO estimated that the discretionary spending caps in the BCA would reduce spending by $756 billion over ten years, exclusive of debt service.[6] However, these are promised benefits – they contain no programmatic changes that would guarantee lasting deficit reduction. Will these really occur?

Indeed, this past year has already seen Congress and the Executive branch willing to exceed the statutory caps for security spending, and supplement expenditures for Hurricane Sandy will increase budget authority by over $50 billion in FY 2013.[7] This increase nearly matches the entirety of the funding reduction of $62 billion in FY2013 attributable to the discretionary caps imposed by the BCA, as estimated by CBO. I point this out only to emphasize that promised deficit reduction in the absence of programmatic change is ephemeral. CBO has echoed this sentiment, noting that "holding discretionary spending within the limits required under current law might be difficult...the original caps on discretionary budget authority established by that legislation would reduce such spending to an unusually small amount relative to the size of the economy."

Sequestration will reduce the deficit modestly this year. Going forward, the mechanics of this automatic enforcement mechanism – essentially tighter discretionary caps married to a mandatory sequester – may only worsen the challenge of maintaining the discretionary caps. However, in the near term, the sequester will reduce outlays by $44 billion this year.

A second issue is the impact on government services. These impacts are real and we are beginning to hear about potential service disruption. To the extent practicable, agencies should be allowed to mitigate service disruption through prioritization, but some diminution of federal services should be expected. The potential disruption to federal agencies is not insignificant, but also not insurmountable.

The final issue is the impact on economic growth. Obviously, I believe it is imperative to control the debt and that this will have beneficial impacts. At the same time, the near-term impacts of the sequester are far less consequential than many have portrayed. The sequester is an $85 billion (roughly $44 billion in actual outlays) cut in a $3.6 trillion annual budget in a $16 trillion economy. That is a slice representing one half of one percent of the pie. Economic calamity will not ensue.

The economy is growing at about $630 billion per year. For the sequester to wipe out economic growth – as some rhetoric suggests – it would have to create roughly 7 times its size in economic impact, which far exceeds any realistic estimate of the size of economic multipliers.

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[6] http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/123xx/doc12357/budgetcontrolactaug1.pdf
[7] http://www.cbo.gov/sites/default/files/cbofiles/attachments/SummaryDRApropAct2013-HR152-PassedHouse.pdf

Thus, a more realistic estimate predicts more modest near-term effects. I don't dispute that, all else being equal, a reduction in federal expenditures now will not have *some* impact in the economy. Rather, it is important to recognize the need for some near term reduction in current spending to the benefit of future economic growth that is risked by higher debt.

Better Strategies for Debt and Growth

As noted above, the nation faces a significant debt challenge, and existing measures to address it, though necessary, are inadequate. Removing the sequester would avoid some near-term discomfort, but the fiscal challenge confronting the United States is daunting and failure to address it in a credible way would likely generate negative economic effects. The CBO noted "eliminating or reducing the fiscal restraint scheduled to occur next year without imposing comparable restraint in future years would reduce output and income in the longer run relative to what would occur if the scheduled fiscal restraint remained in place." It is therefore necessary to pair any mitigation of near-term fiscal tightening with meaningful budget restraint in future years.

The essence of a better strategy is to pair the entitlement reform with tax reform, thereby controlling the underlying source of debt explosion and supporting the most rapid pace of economic growth possible. As an example, the American Action Forum has formulated *Balanced,* a plan to navigate these duel challenges. *Balanced* reflects the principle that the United States is served best by a contained, efficient government focused on core national security and domestic activities, including a durable social safety net. It is guided by the lesson of history that the best approach to simultaneous poor growth and explosive debt is to keep taxes low, reform taxes to be more pro-growth, preserve core functions of government, and focus on transfer programs - entitlement programs in the United States - as the route to controlling debt.

Balanced includes several key priorities that reflect the right balance of near-term growth considerations and longer term debt challenges.

Fundamental Tax Reform

While the "fiscal cliff" tax deal established some degree of permanence to the tax code, it did little to otherwise improve it. Rather, it locked in higher rates and a narrower base than is optimal. Looking past the current tax code, there is wide agreement that the U.S. corporate tax is an international outlier and in need of reform. The end-of-year tax agreement left this outlier untouched.

Balanced incorporates a fundamental tax reform that would move the U.S. to a progressive consumed-income tax code. This plan would be pro-growth and not penalize savings and investment. Research suggests that implementing a progressive consumed-income tax consistent with AAF's tax plan would improve long-run economic growth by over 6 percent.[8]

Reprioritize the Sequester in Favor of Entitlement Reform
The sequester has been widely acknowledged as poor policy – a failed "stick" to induce more substantive reforms that the "Super-Committee" ultimately failed to deliver. *Balanced* would reprioritize sequestration with more lasting, mandatory savings through programmatic reforms.

Balanced takes on the budgetary challenge by reforming the projected growth in mandatory spending programs, specifically health and retirement entitlements. Accordingly, major reforms focus on these areas of the federal budget. Future social security benefits are reformed to reflect price, rather than wage growth, while a premium support model is phased into Medicare for future retirees. Medicaid is reformed to reflect cost efficiencies achievable through competitive bidding.

Balanced includes additional reforms to other major areas of spending. The plan keeps discretionary spending slightly above current law. However, the plan includes a repeal of the overreaching and broken Affordable Care Act.

Taken together, these changes would set forth a credible and gradual improvement in the U.S. fiscal position. The American Action Forum plan achieves balance in 2031, with debt to GDP of 60.2. Over the long term, the AAF plan pays down the debt by 48 percent going from 77.6 percent of GDP at the end of FY2013 to 40.1 by 2037. These are far better budgetary outcomes than those contemplated in either current law or modest deficit reduction plans, but through the right policy choices – fundamental tax reform paired with entitlement reform – are eminently achievable and would leave future generations with a higher standard of living, rather than a legacy of debt and poor economic growth.

Obviously, I have a preference for the proposals developed at AAF. However, more important than the particulars are a strategy that shifts the focus of spending control to the needed entitlement reforms and shifts the debate on taxes away from harmful higher marginal tax rates in favor of pro-growth tax reform.

Thank you for the opportunity to appear today. I look forward to answering your questions.

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[8] David Altig, Alan J. Auerbach, Laurence J. Kotlikoff, Kent A. Smetters, and Jan Walliser, "Simulating Fundamental Tax Reform in the United States," American Economic Review, 91(3), June 2001, pp. 574-595.

Questions for the Record
"The Budget and Economic Outlook: Fiscal Years 2013 to 2023"
Questions for Dr. Douglas Holtz-Eakin
Hearing Date: February 26, 2013

Questions from Senator Ron Wyden

1) As you are undoubtedly aware, almost 27 years ago, when President Reagan and Congressional Democrats enacted Tax Reform, it was a big boost to the economy. More than six million new jobs were created in just the two years after the 1986 reform – something that's urgently needed today. I don't claim that every one of those jobs was the direct result of tax reform but it certainly helped.

   Since that time, especially in recent years, there have been dozens of calls from members of Congress, Administrations, outside task forces and commissions, and economists of every stripe for comprehensive tax reform. In the same vein, the Obama Administration has acknowledged the need for comprehensive reform with the release of two reports—one in August 2010 and one just less than a year ago. And, in his inaugural address last month, the President made clear the need to "revamp our tax code."

   However, despite such repeated calls for comprehensive reform, the reality appears more like lip service than commitment. Our current system is terribly inefficient, hopelessly complex and not by any measure the kind of pro-growth policy our country needs.

   Since 2001, Congress has passed almost 140 laws amending the tax code in one way or the other, and with each such adjustment, the revenue regime the country now has becomes even more byzantine, counterproductive and uneconomical. It has now gotten to the point that almost as much, if not more, money is spent through the tax code as it brings in, so it's getting harder and harder even to call it a revenue code at all.

   Individuals and businesses need confidence and certainty, and irregular short-term extensions of major parts of the tax code offer neither.

   In Dr. Greenstein's testimony, he notes that deficit reduction can be achieved through reductions both in spending in the tax code and in spending on the outlay side of the budget, and he cites the esteemed Martin Feldstein in support of this proposition.

   In the *Wall Street Journal* last week, Dr. Feldstein wrote: "Republicans want to reduce the deficit by cutting government spending while Democrats insist that raising revenue must be part of the solution. Yet the distinction between spending cuts and revenue increases breaks down if one considers tax expenditures. Here are some examples. If I buy a solar panel for my house, a hybrid car, or an energy-efficient refrigerator, the government pays me. But instead of sending me a check, it gives me a tax credit or a tax deduction. There are dozens of such examples that increase the annual budget deficit by billions of dollars. Congress should review these tax expenditures and eliminate those that the country cannot afford."

Feldstein has also written that "tax expenditures are the single largest source of wasteful and low-priority spending in the federal budget and one of the first places policymakers should go to restrain spending."

Dr. Elmendorf, in testimony before the House Budget Committee, made a similar point when he stated that tax expenditures "are really best viewed as a form of government spending because they are directed at particular people or entities or designed to subsidize particular activities," almost precisely analogous to other government spending.

Alan Greenspan has suggested that tax expenditures represent just as great a threat to a sustainable budget path as any other spending, including entitlements.

a. With that background, what, in your respective views, are some of the least economically efficient and/or justifiable tax expenditures? What economic effects—positive or negative—would you expect from their repeal? How would each of you propose we maximize any positive or mitigate any negative effects?

   The fundamental problem facing the United States is poor growth. Since growth ultimately derives from decisions to forego current consumption in favor of investments in capital, skills, and technologies, tax policy can support better growth by not discriminating against investment, or by not subsidizing consumption. Tax expenditures should be evaluated from this perspective. Those that subsidize consumption (e.g., the tax exclusion for employers sponsored health insurance) should be pared back.

b. In a similar vein, there is a great debate among Republicans and Democrats as to what we should do with any additional revenue generated by rolling back or reducing tax expenditures, also commonly referred to as closing loopholes. On the one hand, some would have us use any additional revenue to buy down marginal tax rates, while, on the other, some would have us use any resulting revenue for deficit reduction and/or other investments. Weighing in on that debate, Martin Sullivan, a widely read commentator on tax policy, has suggested that perhaps the best solution would be to devote half of any resulting revenue to reducing rates and half to reducing the deficit. Do you feel that Sullivan has the ratio about right? Or would you suggest a different allocation of any resulting revenue and why?

   The greatest tax reform need is to lower the U.S. corporation income tax rate to an internationally-competitive level; say, 25 percent. Good tax policy requires that businesses be taxed the same, regardless of their legal form. In practice, that means that the pass-through entities taxed under the individual income tax should face a 25 percent rate as well. To the extent that base-broadening meets this objective and still generates additional revenue, that revenue should be devoted to deficit reduction.

2) In his State of the Union, the President discussed the need for investment in transportation and infrastructure. That means roads, bridges, rail, ports, and inland waterways. You simply cannot have a big league economy with a little league transportation system. In the Senate, there is widespread consensus that highways, roads, transit systems, and bridges must

be fortified. Furthermore, transportation projects put people to work, which the construction industry and the country need.

But the big challenge, in my view – the outstanding issue – is how America will pay for improving our transportation system, especially given the budget outlook. Fortunately, there is a proven way to generate tens of billions of dollars of additional funds for transportation on top of what is raised by the gas tax. The idea is based on Build America Bonds, which for years had widespread bipartisan support and were tremendously successful.

My proposal would be to authorize Transportation Regional Infrastructure Project bonds, or "TRIP bonds", which I first proposed in legislation last Congress. Under the legislation, TRIP bonds would provide up to $1 billion in tax credit bonds for each state to use for transportation and infrastructure projects of the state's choosing.

In a time when we are trying to get our fiscal house in order, "TRIP bonds" use federal tax credit bonding to leverage private dollars for investment in infrastructure. This decreases the federal government's share of the cost, while still investing in critical infrastructure that's the gateway to the United States' big league economy.

Soon, I will reintroduce the TRIP legislation, and I hope it garners the same bipartisan support it did last Congress. It's my hope that we can use TRIPs to grow our national investment in transportation and infrastructure in a fiscally responsible and economically efficient manner.

Inadequate revenues in the Highway Trust Fund have denied state transportation departments the long-term stability to carry out much-needed investments in critical infrastructure projects. Given the difficulty of finding new revenues and the need to get our fiscal house in order, do you think there's a strong case to be made for federal tax-credit bonding for transportation and infrastructure projects as an alternative to direct spending? Can each of you provide your thoughts on the relative economic merits of this approach to infrastructure financing in a time of scarce budget resources?

I have supported TRIP bonds – implemented in a deficit-neutral fashion -- as a means of financing the U.S. infrastructure needs. See http://americanactionforum.org/topic/trip-bonds-and-national-infrastructure-needs .

From Senator Robert Menendez

1) As you already know, the Ryan budget sought to cut all discretionary spending as a share of the total economy to 3.5 percent of GDP, while somehow still protecting defense spending. Assuming defense spending remains level in real terms, budget experts have estimated that under the Republican budget most of the rest of the federal government outside of health care, Social Security, and defense would cease to exist.

   If you compare the cuts to the non-defense side of discretionary spending from sequestration to the cuts that would be necessary for the Ryan budget to work, is sequestration that much harsher? Would the real world impact on air travel, our schools, food inspection and any number of other important services face any more serious deterioration over the long-term from sequestration than they would if the Ryan budget actually became law?

   Both sequestration and the House budget resolution overly rely on disciplined non-defense discretionary spending to meet budget targets over the next decade. An important difference is that any budget approach provides flexibility that is not available in the across the board cuts sequestration uses in 2013 and 2014.

2) The Congressional Budget Office wrote in their latest report on the budget and economic outlook: "Persistent long-term unemployment will lead some workers to leave the workforce earlier than they would have otherwise and will erode the skills of other workers, making it harder for them to find work in the coming years." Compounding this problem is evidence which shows many employers discriminating against the long-term unemployed, perpetuating a vicious cycle. The longer a worker is unemployed the less attractive they are as a job candidate and the longer they remain unemployed.

   How difficult do you believe the crisis of long-term unemployment is today and what, in your view, are some of the most effective steps we can take to tackle the problem?

   I believe that this is a significant problem that merits a strategic response. At the macroeconomic level, better policies (tax reform, entitlement reform, immigration reform) that raise the trend rate of economic growth in the U.S. are essential. For too many years, the focus has been on discretionary "stimulus" approaches that neither suit the problem (poor sustained growth) nor have a track record of success. At the microeconomic level, it is time for the federal government to consolidate the disparate training programs strewn across agencies into a single, effective lifelong learning program for adult workers.

3) In my view, expanding opportunities for workers to advance their skills and their value is a critical one when we're thinking about how to help shore up the economic fortunes of the middle class. Estimates show the economy is going to be short 5 million trained workers by 2018. Every state in the country is confronted with this shortage and in my opinion, we shouldn't shy away from any opportunity to address the issue.

   Do you agree that there is an increasing challenge for America to produce more skilled workers and do you believe there should be a federal role in meeting that challenge? If so, what do you believe would be some of the most effective policy measures Congress should consider?

America's global competitive success and the concerns over a widening income distribution can only be addressed through better education policies. In general, the U.S. education sector is characterized by an absence of competition and open-ended federal subsidies, a combination that has produced a "product" of uneven quality and high cost. K-12 education should focus on enhancing choice and accountability in every feasible way – magnet, charter, and other schools. Higher education reform should begin with targeting federal subsidies (Pell grants and student loans) more effectively.

COMMUNICATION

Comments for the Record
to the
United States Senate
Committee on Finance
The Budget and Economic Outlook: Fiscal Years 2013 to 2023
Tuesday, February 26, 2013, 10:00 AM

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Chairman Baucus and Minority Leader Hatch, thank you for the opportunity to provide comments for the record on this topic. As always, we are available to more fully brief members and staff regarding our comments or to answer any questions.

We expect that Dr. Elmendorf will bring you his best assumptions, as is his duty as Director of the CBO. Meanwhile, Dr. Holtz-Eaken will likely continue to call for the need to cut entitlements while Mr. Greenstein will defend them.

At the Center for Fiscal Equity, we continue to offer a fresh approach that will help control spending, improve the performance of entitlement programs and lead to the paying down, if not paying off, of the national debt. In today's comments, we will highlight how our four part plan of reform accomplishes this – especially if taken to its fullest extent. Our plan is as follows:

- A Value Added Tax (VAT) to fund domestic military spending and domestic discretionary spending with a rate between 10% and 13%, which makes sure very American pays something.
- A VAT-like Net Business Receipts Tax (NBRT), which is essentially a subtraction VAT with additional tax expenditures for family support, health care and the private delivery of governmental services, to fund entitlement spending and replace income tax filing for most people (including people who file without paying), the corporate income tax, business tax filing through individual income taxes and the employer contribution to OASI, all payroll taxes for hospital insurance, disability insurance, unemployment insurance and survivors under age 60.
- Employee contributions to Old Age and Survivors Insurance (OASI) with a lower income cap, which allows for lower payment levels to wealthier retirees without making bend points more progressive. The floor of contributions could also occur where the Earned Income Tax Credit occurs now, because employer contributions will be funded equally (regardless of individual wage).
- Personal income surtaxes on joint and widowed filers with net annual incomes of $100,000 and single filers earning $50,000 per year to fund net interest payments, debt retirement, regional deficits and overseas and strategic military spending and other international spending, with graduated rates between 5% and 25% in either 5% or 10% increments. Heirs would also pay taxes on distributions from estates, but not the assets themselves, with distributions from sales to a qualified ESOP continuing to be exempt.

Using these tools, we can gain control over our budgetary and economic policy, rather than have it happen too us as the CBO projections seem to indicate.

The debate for many years now centers on discretionary spending. Indeed, the current sequester takes place solely in that sphere because it is most controllable. Both parties hold on to the dream that the budget could be controlled if wasteful pork-barrel spending were limited. At the Center, we agree, although providing such control would require a constitutional amendment, as a Value Added Tax qualifies as excise taxes for constitutional purposes. Our proposal would be to segregate discretionary non-strategic military and civil spending into regional pools and have them be fully funded by a regional VAT. If a region wanted more spending, it would raise its tax rate. If it wanted less spending, spending cuts would occur. On the occasion that a region is facing dire economic circumstances and fiscal policy appears to be the answer, it would be allowed to run a deficit – but only then. This puts the power to determine the size of government back in the hands of the people, especially if the VAT is receipt visible.

Net Business Receipts Taxes (NBRT) are similar to a VAT, except that they allow employer offsets for providing social goals. If employer contributions to Social Security were to include personal retirement accounts (which should only hold insured employer voting stock rather than funds for the Wall Street Casino), they would be an offset to this tax. Otherwise, they would be offset from the VAT. This tax would also include offsets for health care funded by the employer as well as an enhanced, consolidated and refundable Child Tax Credit, as the Center has explained in multiple comments over the past two years. If the Affordable Care Act collapses the private insurance system, however, and no offsets are allowed, then the VAT rather than the NBRT would fund any single-payer system. The NBRT could also be regionally set (falling under the same constitutional change allowing regional VATs) and could include deficit spending to develop regions which face human capital deficits.

Individual OASI taxes can be reduced, with more of the burden put on employers and consumers – who in reality pay the tax anyway, especially if the employer tax is shifted to a consumption tax. The goal of such a change would be to reduce or eliminate bend points in the benefit system, with progressivity provided on the employer side while allowing employees an incentive to demand higher wages to build their retirement savings. The OASI taxes would need no adjustment to solve the Social Security funding program, as the easier fix would be to increase NBRT obligations instead. Because the NBRT and/or VAT have no income cap, increasing these taxes will not hurt American workers or jobs as much as a change to the payroll tax or benefit formulas surely would.

As to the income surtax, we would urge that inheritance tax changes recently enacted in the *American Tax Relief Act* be modified so that inheriting an asset is not a taxable event, but liquidating it becomes one above the same floor as the income tax. We urge you to respect equality among the living rather than among the dead.

The recent CBO report, which will undoubtedly be discussed, shows that the major driver for our deficit is the funding of net interest on the debt, especially internationally. The Center commented upon this instance to the House Ways and Means Committee on February 14th on this topic regarding tax reform and charitable contributions. We stated, regarding Net Interest, that:

> This explosion essentially fuels the growth of the growth of the Dollar as the world's currency. Essentially, this means that we pay our expenses with taxation (even without adopting the Center for Fiscal Equity Plan) while we roll over our debt without repaying it. This seems like a wonderful way for American consumers to continue to live like imperial Rome, however it cannot last.
>
> There are two possible ends to this gravy train. The first is the internationalization of the Dollar, the Federal Reserve and our entire political system into a world currency or government and its concurrent loss of national sovereignty or the eventual creation of rival currencies, like a tradable Yuan or a consolidated European Debt and Income Tax to back its currency. In the prior case, all nations which use the Dollar will contribute to an expanded income tax to repay or finance the interest on the global debt. In the second case, the American taxpayer will be required to pay the debt back – and because raising taxes on all but the wealthy will hurt the economy, it will be the wealthy and their children who will bear the burden of much higher tax levies.
>
> In order to avert either crisis, there are two possibilities. The first is the elimination of deductions, including the Charitable Deduction itemized on personal income taxes – especially for the wealthy. If the charitable sector, from the caring community to the arts, industrial and education sectors, convince wealthier taxpayers to fight for this deduction, then the only alternative is higher rates than would otherwise occur, possibly including a much more graduated tax system.

Luckily, the *American Tax Relief Act* may provide a solution to some of these problems. In our studies on the relationship between tax policy, the federal capital markets and economic growth, which we shared with this committee on February 7, 2012, we showed that in Democratic regimes which raise taxes on the wealthy, the relationship between reducing the deficit and economic growth changes slope because more is taken out of the savings sector and added to the spending sector. If *ATRA* impacts over the next decade duplicate the Clinton years, much of the net interest problem will solve itself. If we have learned our lesson from the 2000s, we shall not make the same mistake again.

Thank you again for the opportunity to present our comments. We are always available to discuss them further with members, staff and the general public.

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