THE HISTORY AND DRIVERS OF OUR NATION'S DEBT AND ITS THREATS

HEARING

BEFORE THE

JOINT SELECT COMMITTEE ON DEFICIT REDUCTION CONGRESS OF THE UNITED STATES

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

SEPTEMBER 13, 2011

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TUESDAY, SEPTEMBER 13, 2011

UNITED STATES CONGRESS,
JOINT SELECT COMMITTEE
ON DEFICIT REDUCTION,
Washington, DC.

The committee met, pursuant to call, at 10:33 a.m., in Room SH–216, Hart Senate Office Building, Hon. Patty Murray [co-chairman of the committee] presiding.

Present: Senator Murray, Representative Hensarling, Senator Baucus, Representative Becerra, Representative Camp, Representative Clyburn, Senator Kerry, Senator Kyl, Senator Portman, Senator Toomey, Representative Upton, and Representative Van Hollen.

OPENING STATEMENT OF HON. PATTY MURRAY, A U.S. SENATOR FROM WASHINGTON, CO-CHAIRMAN, JOINT SELECT COMMITTEE ON DEFICIT REDUCTION

Chairman MURRAY. Good morning. This hearing of the Joint Select Committee on Deficit Reduction will come to order.

As my co-chair, Representative Hensarling, mentioned at our meeting on Thursday, we have agreed to alternate chairing these hearings, with him chairing the hearings that are held on the House side, and I will be doing the ones here in the Senate.

I want to recognize and thank all of our fellow committee members for being here today, as well as our witness, Dr. Elmendorf, for joining us today.

And I want to thank all the members of the public who are here today as well. We appreciate your presence and ask that you help us maintain decorum by refraining from any displays of approval or disapproval during this hearing.

Before I start, I do want to announce that the joint select committee's Web site is now up and running. Members of the public can go to *http://www.deficitreduction.gov/*, where they can provide us input and ideas to this committee and where all public hearings will be streamed live, starting today.

Today, we are going to start off with brief opening statements from committee members—15 minutes for Democrats and 15 minutes from the Republican side. We will then hear from Dr. Elmendorf. And following his testimony, we will have some time for questions and answers.

The topic of today's hearing is "The History and Drivers of Our Nation's Debt and Its Threats." I think this is a fitting opening for us for the difficult work this committee has ahead of us. We are tasked with tackling a problem that wasn't created overnight and that didn't come about just in the last few years.

Our debt and deficit problems have a lengthy and complex history, and we will not be able to truly address them without a deep and honest understanding of the policies and circumstances that have led us to where we are today.

The challenges that we face are real, and our task will not be easy. But I am confident we can get it done because we have done it before.

Like a number of my fellow committee members, I was here back in the '90s, when we were facing serious deficits and a mounting public debt. I was proud to work with President Clinton and Republicans in Congress to balance the budget in a way that truly worked for the American people, a way that made smart cuts to Government spending that were desperately needed, included revenues, and continued to make the strong investments in healthcare, education, and infrastructure that helped lay down a strong foundation for economic growth.

The balanced and bipartisan work we did not only balanced the budget and it not only helped set our country up to create millions of new jobs, but it also put us on track to completely pay down our debt by 2012, which was a great accomplishment.

But as we all know, a lot has changed since then. For many reasons, our deficit and debt have exploded in the years since. Some of these reasons have to do with Government policies here at home, some with decisions made regarding our policies overseas, and others due to the financial and economic crisis that has devastated families and businesses here over the last few years.

I am looking forward to hearing more about the scope and drivers of our deficit and debt from Dr. Elmendorf today. And I am confident the members of this committee can help bring our Nation together once again around a balanced and bipartisan path to fiscal health and economic growth.

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

Chairman MURRAY. With that, I will call on my co-chair, Mr. Hensarling, for his opening statement.

OPENING STATEMENT OF HON. JEB HENSARLING, A U.S. REPRESENTATIVE FROM TEXAS, CO-CHAIRMAN, JOINT SELECT COMMITTEE ON DEFICIT REDUCTION

Co-Chair HENSARLING. Thank you, Madam Co-Chair.

The purpose of today's hearing is to really highlight the unsustainable nature of our Nation's debt. And I believe the term "unsustainable," frankly, is understated.

I certainly want to welcome Dr. Doug Elmendorf, head of the CBO, who, when I was a member of the Budget Committee, I have had an opportunity to work with, truly a professional in this town. Sir, I look forward to your testimony.

In the last organizational meeting we had, I mentioned the work by Professors Carmen Reinhart and Kenneth Rogoff, "This Time Is Different." Through their historical study of financial crisis, they indicated that letting debt rise above 90 percent of GDP was, frankly, a recipe for bad things to happen to a nation.

Well, this year, our Nation has raced past that tipping point. Our gross debt has now surpassed 100 percent of GDP. And I believe there are two crises in our Nation—not just the debt crisis, but the jobs crisis—and they are clearly connected. The explosive growth in our Nation's debt hampers our job creation today.

Last week, I quoted a small business person from the 5th District of Texas on the subject. Today, I want to quote from a few more, names you may be more familiar with.

Bernie Marcus, former chairman and CEO of Home Depot, which employs 255,000. "If we continue this kind of policy, we are dead in the water. If we don't lower spending and if we don't deal with paying down the debt, we are going to have to raise taxes. Even brain dead economists understand that when you raise taxes, you cost jobs."

Mike Jackson, CEO, AutoNation, 19,000 employees. "The best thing that this town could do to help this economic recovery become sustainable is to deal with the deficit and to see tax reform."

Jay Fishman, chairman and CEO of Travelers Insurance Company. "What is really weighing on their minds is not knowing how the coming explosion in Federal debt is going to affect their borrowing costs, liquidity, cost of doing business, and prices."

Finally, 2 or 3 months ago, the U.S. Chamber came out with a survey, their small business survey, 83 percent of respondents said that America's debt and deficit have a negative impact on their business.

So I would make the point, Madam Co-Chair, that a path to credible deficit reduction is a jobs program, and we should not be deterred in that mission. We have a spending-driven debt crisis. The deficit reduction will be a jobs plan.

And I look forward again to hearing the comments of our colleagues as we go about this important work and of the testimony of Dr. Elmendorf. And I yield back.

Thank you.

[The prepared statement of Co-Chair Hensarling appears in the appendix.]

Chairman MURRAY. We will now turn to our members, beginning with Representative Becerra.

OPENING STATEMENT OF HON. XAVIER BECERRA, A U.S. REPRESENTATIVE FROM CALIFORNIA

Representative BECERRA. I thank the two co-chairs and thank Dr. Elmendorf for being with us.

The creation of this Joint Select Committee on Deficit Reduction is the direct result of legislative policies and economic recessions that have hit us over the last 10 years and that have caused the Congressional Budget Office's 10-year estimated $5.6 trillion surplus in 2001 to turn into a more than $6 trillion deficit that we see today. So to know where to go with the work that we have to do, you have to know from where we came.

Today, we will hear about how we lost our way. What we will hear is that a select few in this country enjoyed the additional Government spending that occurred in those 10 years while the rest of Americans are being confronted with paying the tab.

In January 2001, CBO's assessment in its yearly Budget and Economic Outlook report was this, "The outlook for the Federal budget over the next decade continues to be bright. Assuming that current tax and spending policies are maintained, CBO projects that the mounting Federal revenues will continue to produce growing budget surpluses for the next 10 years."

But as we all know, current tax and spending policies were not maintained. Dr. Elmendorf, it is exactly these policies that induced the Federal deficit, which I want to explore in my questioning with you today.

Decisions were made to extinguish a $5.6 trillion surplus. The individual and groups who received the most benefits should be willing and ready to ante up, to meet their patriotic duty to contribute revenues and necessary spending decisions to heal this country's long-term fiscal situation.

We need to ask ourselves was it the senior citizen, the student, or the Wall Street banker who received the benefit of this spending binge? When we have our answer, we should ask the appropriate person or group to pay their fair share to right the wrong of running up the Government's debt.

I look forward to working with my colleagues to take the responsibility of improving job creation in this country and fixing the long-term deficits that we face by ensuring that those responsible for our deficits pay their fair share.

And with that, I yield back the balance of my time.

[The prepared statement of Representative Becerra appears in the appendix.]

Chairman MURRAY. Thank you very much.

Senator Kyl?

OPENING STATEMENT OF HON. JON KYL, A U.S. SENATOR FROM ARIZONA

Senator KYL. Thank you, Madam Chairman.

And welcome, Mr. Elmendorf.

The subject of the hearing today is "The History and Drivers of the Nation's Debt and Its Threats." Obviously, you need to know what the problem is before you can develop solutions.

One of the things we will hear is that entitlement spending is a key driver of our debt. And I think there is a consensus about that on both sides of the aisle. The concern I have is that some people fear that that means that the solution has to be a cut in benefits or a cut in payments to providers for programs like Medicare and Medicaid, for example, and I would like to focus very specifically on a potential alternative to that.

There may be very substantial savings that can be obtained from administrative efficiencies that would not involve cuts in these programs. That is one of the things that I will be talking to Dr. Elmendorf about today.

We hear a lot of talk about waste, fraud, and abuse. It is a trite phrase, but the reality is there is a significant amount of truth to it. And I think, especially with regard to Medicare and Medicaid, we have to find ways to achieve these administrative savings.

Let me just quote from one of the experts from Cato Institute, Mike Cannon. In a Forbes blog less than 2 months ago, he says, "Judging by official estimates, Medicare and Medicaid lose at least $87 billion per year to fraudulent and otherwise improper payments, and about 10.5 percent of Medicare spending and 8.4 percent of Medicaid spending was improper in 2009."

Others, like Harvard fraud expert Malcolm Sparrow, say actually that is low. He said loss rates due to fraud and abuse could be 10, 20, maybe even 30 percent in some segments.

Obviously, this is an important subject to address. And in order to do that, we may have to spend a little bit more money on the front end for people who can review the claims that are filed and so on, in order to make sure that they don't pay improper claims.

But at the end of the day, one of the reasons we haven't attacked this problem is that the CBO has had a very difficult time in scoring potential savings based upon potential approaches to the problem. And what I want to explore with Dr. Elmendorf today is how CBO can help our committee find ways to achieve administrative efficiencies, saving a lot of the money that we should not be spending, so that we do have the money to spend on the beneficiaries and the providers of important programs like Medicare and Medicaid.

Madam Chairman, Mr. Chairman, thank you.

Chairman MURRAY. Senator Baucus?

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

Senator BAUCUS. Thank you, Senator Murray.

I want to begin just by echoing what Senator Kyl said. I think there is a lot of fraud and waste in the Medicare and Medicaid, which we don't properly attack, and much of that is due to scoring requirements that we have to adhere to. And I would hope that we could somehow create a way to get beyond that. It is an excellent point, and I am glad that he made it.

One of our Founding Fathers, Patrick Henry, once said, "I know of no way of judging the future, but by the past." And today, we examine the past for lessons to improve our economic future—to reduce the deficit, create jobs, and create the certainty our country needs to thrive in the global economy.

The world is watching us. They are watching us closely. They are watching what we do and the next steps that we take as a country to confront our deficits. We can do this. We have already begun the process by cutting $900 billion. We have already done it. We have taken a first step.

And while the road ahead will not be easy, we have a duty, I think, to think even bigger, aim higher, ensure our country is on sound fiscal footing for the long term. We have a duty, I think, to ensure that we approach these cuts in a balanced way that creates jobs.

When I was home in Montana again last weekend, I heard over and over again, people said, "Max, let's get it done. Appreciate you being on that committee. Get it done. We need our country to get it done."

I know every member of this panel hears the same comments from their constituents when they are home, just as every Member of Congress does. And I urge us to listen to the wishes of our employers.

We are just the hired hands. We are just the employees. The people that we work for, the people that elect us or unelect us want us to get this done in a balanced, fair way.

Today, we review the sources of our problem. It is obvious that the factors that created our current deficit are the cost of two wars; long-term healthcare costs, which we began to tackle in health reform; a stagnant economy, which increased spending; and reduced Federal revenues, which are at historic lows.

Today, Federal revenues make up about 15 percent of GDP, compared to, for example, about 17 to 19 percent during the Reagan administration. A combination of factors created the deficit. It will take a combination of factors to resolve it. There is no silver bullet. So let's get together and get our work done.

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

Chairman MURRAY. Thank you very much.

Representative Upton?

OPENING STATEMENT OF HON. FRED UPTON, A U.S. REPRESENTATIVE FROM MICHIGAN

Representative UPTON. Well, thank you, Madam Chair.

And I intend to be brief. Chris Van Hollen reminded us last week that we had 77 days to get this thing done. That means we have about 72 days now, and we are going to leave some extra days, hopefully, for you, Dr. Elmendorf, to have your green eyeshade guys and women be able to put this package together for us to reach the goal.

Last week, I sat with Chairman Camp and Chairman Baucus—and Chairman Baucus, again, my folks in Michigan this last weekend assured me that they are rooting for us as well to get a solution to the problem that they all really do understand. And I know the three of us were on our feet when the President talked about entitlement reform, specifically Medicare and Medicaid. And I must say that I was disappointed that I did not see the President's written proposal come up like he did some others yesterday.

So I just want to say I am looking forward to working with all my colleagues here. I am going to submit my full statement for the record so that we can go back, so that we, in fact, all can go to work to get this thing done.

I yield back.

[The prepared statement of Representative Upton appears in the appendix.]

Chairman MURRAY. Thank you very much.

Representative Clyburn?

OPENING STATEMENT OF HON. JIM CLYBURN, A U.S. REPRESENTATIVE FROM SOUTH CAROLINA

Representative CLYBURN. Thank you very much, Madam Chair, Mr. Chairman.

Dr. Elmendorf, thank you for taking the time to talk with us today.

I think it is appropriate that today's hearing is entitled, "The History and Drivers of Our Nation's Debt and Its Threats." If we want to solve the related problems of debt and joblessness, we need to know how these problems arose. In 2000, we had a $236 billion surplus and had begun paying down our National debt. The economy was booming for all Americans, unemployment was at 4 percent, and the poverty rate dipped to its lowest level since 1979.

Instead of building on the policies that have served us so well, we embarked upon two wars, one of which was dubious at best. Using credit cards, we instituted two tax cuts, totaling $544 billion, which were tilted in favor of millionaires and billionaires. We created a new prescription drug benefit program, which CBO estimates will cost $967 billion over the next 10 years, and allowed mortgage lenders to gamble away the economic prosperity of millions of American families.

And then it was declared that deficits don't matter. This special committee was created because deficits and debt do matter. Now we find ourselves with painfully slow growth, unacceptably high unemployment, deficits as far as our eye can see, and a mounting long-term debt burden.

As we work together to achieve significant deficit reduction, it is important for us to remember how we got here. Many factors got us into this situation, and many factors are needed to get us out.

We must balance the budget with a balanced approach that includes job creation, revenue increases, and smart spending cuts. Shared sacrifice will be required. We cannot solve the problem on the backs of the most vulnerable in our society who did nothing to cause the problem.

I am willing to make tough compromises. I have said that if the distance between an opponent and me is five steps, I am willing to take three, as long as the opponent takes the other two.

Dr. Elmendorf, thank you again for being here, and I look forward to discussing these issues with you in the Q&A period.

Thank you, and I yield back.

[The prepared statement of Representative Clyburn appears in the appendix.]

Chairman MURRAY. Senator Portman?

OPENING STATEMENT OF HON. ROB PORTMAN, A U.S. SENATOR FROM OHIO

Senator PORTMAN. Thank you, Madam Chair.

And welcome to Director Elmendorf. As you all know, this committee is going to be relying heavily on you for your analysis and for your scoring. And to you and your colleagues behind you, I thank you in advance for the many hours that you will put in. Our success or failure will depend in large measure on your good work. So we need you and look forward to your responses to our many requests.

I listen to my colleagues' comments this morning, and I must say I am delighted that you are here today because we need to have a little objective analysis of how we got to where we are, and I know you will provide that. I hope you will also talk about the appropriate baseline for us to use to examine our proposals.

When measuring new proposals, the baseline questions help us determine "compared to what,"—whether it is a spending issue or revenue issue. And as you know, I have some concerns about the current law baseline because I don't think it is realistic. And I want you to address that today, if you could. Is the current-law or current-policy baseline more realistic? Or is there another one like the long-term extended baseline, alternative fiscal scenario? All these questions matter greatly in our work.

We have a $1.5 trillion task over the next 10 years. This, of course, is a huge challenge. But I would also like your analysis of how that compares to what you see as the real fiscal challenge over the next 10 years and the real economic challenge we face.

As many of the colleagues on the committee have mentioned this morning, obviously our economy is directly linked to what we do. And we will hear about this today from you. We will see how we got in this situation we are in, largely because of economic conditions. Just as in the late '90s because of the growing economy we were able to come to a unified balanced budget faster than anybody expected.

Using your data and the current policy baseline, as I look at $1.5 trillion, I think it is about 4 percent of projected spending over the next 10 years. So, in that sense, $1.5 trillion seems realistic. It is also, as I look at it, based on, again, your data and the current policies, less than 20 percent of the projected increase in the deficit over the next 10 years.

So $1.5 trillion seems to me to be something we should be doing at the very least. Again, I look forward to your insights on that and what is the most realistic baseline.

I hope you and your colleagues will also help us better understand the impacts of policy choices over the coming decades. As I look at your projections, it seems to me that deficit and debt levels would be devastating to our economy over the second, third, and fourth 10 years if we don't do something about the longer-term impact.

So while we could within this budget window find ways to get to $1.5 trillion, it will not be something that markets will react to well, in my view, unless we also are looking at long-term impacts. I would love to have your view there.

The long-term budget estimates are so unsustainable that your alternative budget scenario simply stops calculating the national debt after 2036 because it is so unsustainable. We will have crossed into totally unchartered territory.

Clearly, entitlement spending is driving those long-term deficits to impossible levels. I am interested in hearing what reforms you think can protect those in need, which we must do, while at the same time modernizing these programs and placing them on a sustainable path for future generations.

Again, thank you for being before us. And more importantly, thank you for all the hard work you will be doing with us over the next several weeks.

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

Chairman MURRAY. Thank you.
Senator Kerry?

OPENING STATEMENT OF HON. JOHN KERRY, A U.S. SENATOR FROM MASSACHUSETTS

Senator KERRY. Madam Chairwoman, thank you.

We all agree that we are facing an unsustainable financial future, and under the CBO's alternative fiscal scenario, the debt is going to reach 82 percent of GDP by 2021. That is higher than any year since 1948, and we all agree we can't let that happen.

But to avoid that dismal scenario, we are going to have to be pretty clear-eyed about the way that we got here and the forces that keep us on this dangerous trajectory. I think it is factual to say that this road began now more than a decade ago. Some would argue even longer.

But you have economic meltdown, two wars, rounds of the largest tax cuts in history that did not produce the jobs that were predicted, and then efforts to forestall larger economic collapse more recently. All of these contributed.

Demographic challenges loom large in the outyears, and it is more than just a spending problem, narrowly defined. And I think we do the dialogue a disservice by oversimplifying it because if it was a mere spending issue, it would be a lot easier to solve. But also because many tax expenditures are a form of spending in disguise.

Now while there may be partisan interpretations of how we got here, there is a bipartisan consensus not just about the urgency of action to dig us out of this mess, but about the approach that it requires. When I say bipartisan, three bipartisan groups that looked at the problem in recent months—Rivlin-Domenici, Simpson-Bowles, and the so-called Gang of Six—have all said—all, unanimously—that any real solution needs to be balanced with a mix of revenues and spending cuts and long-term reforms.

Now we benefit from their guideposts, and we also benefit from the cautionary lessons, important cautionary lessons of other countries. That means not fixating on austerity measures alone, particularly in the short term.

We have seen the damage that they have caused across Europe, and we can't put our own fragile economy in jeopardy by taking actions that will slow economic growth and decrease job creation. We need growth, not just revenue and not just cuts. And any economist worth their salt, any business person in America today will tell us creating jobs today helps reduce the deficit tomorrow.

Last week, the Committee for a Responsible Budget, a bipartisan organization including some of our country's leading experts on budget issues, including the co-chairs of the fiscal commission, recommended that this committee go big, go long, and go smart. I think Director Elmendorf's testimony today helps solidify the reality that we need to go big and reap savings of more than $1.5 trillion to address long-term deficits. We need to go long and address our long-term budget issues. And most importantly, we need to go smart and address the budget without preconceived dogmas or political agendas.

So I look forward to delving into these issues today with you, Dr. Elmendorf, and thank you for coming here to help us shape fair, balanced, thoughtful recommendations for this committee.

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

Chairman MURRAY. Representative Camp?

OPENING STATEMENT OF HON. DAVE CAMP, A U.S. REPRESENTATIVE FROM MICHIGAN

Representative CAMP. Thank you, Madam Chair.

There has been a lot of important things already said this morning. Our time is short today. Both in the committee and as Mr. Upton pointed out, our time is short in terms of trying to meet the responsibilities we have been given under the Budget Control Act.

So I look forward to hearing from Mr. Elmendorf. I think it is important that we just get down to business. So I will yield back the balance of my time.

Chairman MURRAY. Thank you.

Representative Van Hollen?

OPENING STATEMENT OF HON. CHRIS VAN HOLLEN, A U.S. REPRESENTATIVE FROM MARYLAND

Representative VAN HOLLEN. Thank you, Madam Chairman.

Yesterday, there were two important developments that relate to our work. First, the President submitted to the Congress a jobs plan that is fully paid for over 10 years. Every day that Americans are out of work is another day that the country is hurting and the deficit is growing.

The fastest and most effective way to reduce the deficit in the short term is to put Americans back to work. I hope this committee will address that reality in our work as we move forward.

Second, yesterday, as Senator Kerry mentioned, the co-chairs of the Bipartisan National Commission on Fiscal Responsibility, Alan Simpson and Erskine Bowles, called upon this committee to "go big," urging us to use this unique opportunity to develop a plan to reduce the deficit by about $4 trillion over 10 years, including the almost $1 trillion in savings from the Budget Control Act. They are right. I believe we should proposal a plan of that size.

The bipartisan Simpson-Bowles commission, the bipartisan Rivlin-Domenici commission, as well as the Gang of Six, have provided us with a framework of how to achieve that goal. What is clear in all of them is that we need a balanced approach to reduce the deficit, one that contains savings achieved from modernizing certain programs, as well as savings gained by simplifying and reforming the tax code in a way that generates revenue.

Addressing a problem of this magnitude requires shared responsibility in order to grow our economy and reduce the deficit. The testimony we will hear today from Mr. Elmendorf demonstrates why such a balanced approach is necessary. It vividly illustrates the policy choices driving our deficit are the significant cuts made to revenue, combined with increasing retirement and healthcare costs due to the retirement of the baby boomers.

Let's not duck those realities. Let's follow the advice of the three other bipartisan commissions and go big. I don't agree with every one of their proposals, but those three groups have provided this bipartisan group with a framework from which to start.

Time is short. The clock is ticking. I hope we will get to work and follow that balanced framework approach that has been set by, again, three other bipartisan groups that look to tackle the issues that this committee is asked to address.

Thank you, Madam Chairman.

[The prepared statement of Representative Van Hollen appears in the appendix.]

Chairman MURRAY. Thank you.

Senator Toomey?

OPENING STATEMENT OF HON. PAT TOOMEY, A U.S. SENATOR FROM PENNSYLVANIA

Senator TOOMEY. Thanks, Madam Chair.

And Dr. Elmendorf, thank you. I look forward to working with you as well.

Just a couple of points I wanted to stress. I think the point has been made, but I want to underscore that the problem that we face is, of course, much worse than what the current law baseline would seem to suggest. That is not a criticism. It is simply an observation.

The current law baseline is not meant to be a predictor of the future. If it were, it would be a really bad one, as we know.

In addition, some things have changed since you did that. The economy has gotten weaker. I would argue the sovereign debt crisis in Europe has gotten worse. So these things have aggravated the situation.

And then there is the fact that I think the risks are greater for downside surprises than upside surprises, if you will—things like the contingent liabilities that are lurking out there, which could come home to roost at any point in time.

The assumptions that you make about interest rates are not necessarily unreasonable. But if they are wrong, it is most likely that rates will be much higher rather than lower, significantly aggravating our problem. So I want to underscore that I think we should be striving to do every bit as much as we possibly can.

I hope that we will be able to dwell somewhat today on just how significant the big entitlement programs are the long-term drivers of this problem. And I hope we will be able to discuss what I see as a real danger in taking the approach that I think you might be advocating, although I am not entirely clear—the danger of delaying the spending cuts for fear that we will weaken a fragile economy.

On page 29 of your testimony, you do go through a list of the risks associated with delaying spending cuts now. I would argue that if we tolerate or aggravate the current deficit problem with the promise that we will work it all out in the future, that is a very, very dangerous direction to head in. And at the end of the day, there is no free lunch, and a Government spending expansion here is actually going to do more harm than good.

So, finally, the one point that I really want to underscore is just the importance of growth. If we can have policies that will encourage maximizing economic growth, all problems are easier to solve with a strong, growing economy. And I think that should guide our decisions.

With that, Madam Chair, I yield the balance of my time.

Chairman MURRAY. Thank you very much.

With that, we will turn to our witness for today. Dr. Douglas Elmendorf is the eighth Director of the Congressional Budget Office. His term began on January 22, 2009.

Before he came to CBO, Dr. Elmendorf was a senior fellow in the Economic Studies Program at Brookings Institution. As the Edward M. Bernstein Scholar, he served as co-editor of the Brookings Papers on Economic Activity and the Director of the Hamilton Project, an initiative to promote broadly shared economic growth.

He has served as an assistant professor at Harvard University, a principal analyst at the Congressional Budget Office, a senior economist at the White House Council of Economic Advisers, a Deputy Assistant Secretary for Economic Policy at the Treasury Department, and an Assistant Director of the Division of Research and Statistics at the Federal Reserve Board. In those positions, Dr. Elmendorf has gained a wide range of expertise on budget policy, Social Security, Medicare, national healthcare reform, financial markets, macroeconomic analysis and forecasting, and many other topics.

So I am very glad that he has agreed to join our committee here today. Dr. Elmendorf, thank you so much for taking the time and for helping us get through this. And we would look forward to your testimony.

STATEMENT OF DOUGLAS ELMENDORF, PH.D., DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Dr. ELMENDORF. Thank you, Senator Murray, Congressman Hensarling, and all the members of the committee.

I appreciate the invitation to talk with you today about the economic and budget outlook and about CBO's analysis of the fiscal policy choices facing this committee and the Congress.

The Federal Government is confronting significant and fundamental budgetary challenges. If current policies are continued in coming years, the aging of the population and rising costs for healthcare will push up Federal spending measured as a share of GDP well above the amount of revenue that the Federal Government has collected in the past. As a result, putting the Federal budget on a sustainable path will require significant changes in spending policies, significant changes in tax policies, or both.

Addressing that formidable challenge is complicated by the current weakness of the economy and the large numbers of unemployed workers, empty houses, and underused factories and offices. Changes that might be made to Federal spending and taxes could have a substantial impact on the pace of economic recovery during the next few years, as well as on the Nation's output and people's income over the longer term.

I will talk briefly about the outlook for the economy and the budget and then turn to some key considerations in making fiscal policy. The financial crisis and recession have cast a long shadow on the U.S. economy. Although output began to expand 2 years ago, the pace of recovery has been slow, and the economy remains in a severe slump.

CBO published its most recent economic forecast in August. That forecast was initially completed in early July and updated only to incorporate the effects of the Budget Control Act. In our view, incoming data and other developments since early July suggest that the economic recovery will continue, but at a weaker pace than we had anticipated.

With output growing at only a modest rate, CBO expects employment to expand very slowly, leaving the unemployment rate, as depicted by the dots in the figure, close to 9 percent through the end of next year. I should say all these figures are taken from the written testimony and nearly in the order in which they appear in the testimony.

As a result, we think that a large portion of the economic and human costs of this downturn remain ahead of us. The difference between output and our estimate of the potential level of output, shown by the gap between the lines in the figure, has cumulated so far to about $2.5 trillion. By the time output rises back to its potential, which will probably be several years from now, we expect that cumulative shortfall to be about twice as large as it is today, or $5 trillion.

Not only are the costs associated with this shortfall and output immense, they are also borne unevenly, falling disproportionately on people who lose their jobs, are displaced from their homes, or own businesses that fail.

I want to emphasize that the economic outlook is highly uncertain. Many developments could cause economic outcomes to differ substantially in one direction or the other from those we currently anticipate. If the recovery continues as expected and if tax and spending policies unfold as specified in current law, deficits will drop markedly as a share of GDP over the next few years.

Under CBO's baseline projections, shown by the dark blue portion of the bars in the figure, deficits fall to about 6 percent of GDP in 2012, about 3 percent in 2013, and smaller amounts for the rest of the decade. In that scenario, deficits over the decade total about $3.5 trillion.

But as a number of you have said, those baseline projections understate the budgetary challenges because changes in policy that will take effect under current law will produce a Federal tax system and spending for some Federal programs that differ sharply from the policies that many people have become accustomed to.

Specifically, CBO's baseline projections include the following policies specified in current law. First, certain provisions of the 2010 Tax Act, including extensions of lower rates and expanded credits and deductions enacted in 2001, 2003, and 2009, all expire at the end of next year.

Second, the 2-year extension of provisions designed to limit the reach of the alternative minimum tax, the extensions of emergency unemployment compensation, and the 1-year reduction in the payroll tax all expire at the end of this year.

Third, sharp reductions in Medicare's payment rates for physician services take effect at the end of this year.

Fourth, funding for discretionary spending declines over time in real terms in accordance with the caps established under the Budget Control Act.

And fifth, additional deficit reduction of more than $1 trillion will be implemented as required under the act.

Changing provisions of current law so as to maintain major policies that are in effect now would produce markedly different budget outcomes.

For example, and shown by the full bars in the figure, if most of the provisions of the 2010 Tax Act were extended, if AMT was indexed for inflation, and if Medicare's payment rates for physician services were held constant, then deficits over the coming decade would total $8.5 trillion, rather than the $3.5 trillion in the current law baseline. By 2021, debt held by the public would reach 82 percent of GDP, higher than in any year since 1948.

Yesterday, CBO released an analysis of the enforcement procedures of the Budget Control Act. As shown in the slide, we estimate that if no legislation originating from this committee is enacted, the following would occur over the next decade.

Reductions in the caps on discretionary appropriations for defense would cut outlays by about $450 billion. Reductions in the caps on discretionary appropriations for nondefense purposes would cut outlays by about $300 billion. And reductions in mandatory spending would yield net savings of about $140 billion. The total reduction deficits would be about $1.1 trillion.

The estimated reductions in mandatory spending are comparatively small because the law exempts a significant portion of such spending from the enforcement procedures. As a result, about 70 percent of the total savings would come from lower discretionary spending. Cuts in defense and nondefense spending of that magnitude would probably lead to reductions in the number of military and civilian employees and in the scale and scope of Federal programs.

Beyond the coming decade, as you know, the fiscal outlook worsens, as the aging of the population and rising costs for healthcare put significant and increasing pressure on the budget under current law. When CBO issued its most recent long-term outlook in June, debt held by the public was projected to reach 84 percent of GDP in 2035 under current law and about 190 percent of GDP under policies that more closely resemble the current policies.

Although new long-term projections would differ because we would incorporate the latest 10-year projections, the amount of Federal borrowing that would be necessary under current policies would be clearly unsustainable. In sum, the Federal budget is quickly heading into territory that is unfamiliar to the United States and to most other developed countries as well.

As this committee considers its charge to recommend policies that would reduce future budget deficits, its key choices fall into three broad categories listed in the slide. How much deficit reduction should be accomplished? How quickly should deficit reduction be implemented? What form should deficit reduction take? Let me take up these questions briefly in turn.

First, regarding the amount of deficit reduction, there is no commonly agreed upon level of Federal debt that is sustainable or optimal. Under CBO's current law baseline, debt held by the public is projected to fall from 67 percent of GDP this year to 61 percent in 2021. However, stabilizing the debt at that level would still leave it larger than in any year between 1953 and 2009.

Lawmakers might determine that debt should be reduced to amounts lower than those shown in CBO's baseline and closer to those we have experienced in the past. That would reduce the burden of debt on the economy, relieve some of the long-term pressures on the budget, diminish the risk of a fiscal crisis, and enhance the Government's flexibility to respond to unanticipated developments. Of course, it would also require larger amounts of deficit reduction.

Furthermore, lawmakers might decide that some of the current policies scheduled to expire under current law should be continued. In that case, achieving a particular level of debt could require much larger amounts of deficit reduction from other policies.

For example, if most of the provisions in the 2010 Tax Act were extended, the AMT was indexed for inflation, and Medicare's payment rates for physicians were held constant, then reducing debt in 2021 to the 61 percent of GDP projected under current law would require other changes in policies to reduce deficits over the next 10 years by a total of $6.2 trillion, rather than the $1.2 trillion needed from this committee to avoid automatic budget cuts.

In 2021 alone, the gap between Federal revenues and spending if those policies were continued and no other budgetary changes were made, as shown by the right pair of bars in the figure, is projected to be 4.7 percent of GDP. Putting debt on a downward trajectory relative to GDP in that year would require a much smaller deficit. Reaching that objective, declining debt relative to the GDP from that starting point would require a reduction in the deficit of about 2.5 percent of GDP, or $600 billion in that year alone.

Your second set of choices involves the timing of deficit reduction, which involves difficult tradeoffs summarized in the slide. On one hand, cutting spending or increasing taxes slowly would lead to a greater accumulation of Government debt and might raise doubts about whether the longer-term deficit reductions would ultimately take effect.

On the other hand, implementing spending cuts or tax increases abruptly would give families, businesses, and State and local governments little time to plan and adjust. In addition, and particularly important given the current state of the economy, immediate spending cuts or tax increases would represent an added drag on the weak economic expansion.

However, credible steps to narrow budget deficits over the longer term would support output and employment in the next few years by holding down interest rates and reducing uncertainty, thereby by enhancing confidence by businesses and consumers. Therefore, the near-term economic effects of deficit reduction would depend on the balance between changes in spending and taxes that take effect quickly and those that take effect slowly.

As shown in this next slide, credible policy changes that would substantially reduce deficits later in the coming decade and beyond without immediate spending cuts or tax increases would both support the economic expansion in the next few years and strengthen the economy over the longer term.

Moreover, there is no inherent contradiction between using fiscal policy to support the economy today while the unemployment rate is high and many factories and offices are underused and imposing fiscal restraint several years from now when output and employment will probably be close to their potential. If policymakers wanted to achieve both a short-term economic boost and longer-term fiscal sustainability, the combination of policies that would be most effective, according to our analysis, would be changes in taxes and spending that would widen the deficit today, but narrow it later in the decade.

Such an approach would work best if the future policy changes were sufficiently specific, enacted into law, and widely supported so that observers believe that the future restraint would truly take effect.

Your third set of choices involves the composition of deficit reduction. Federal spending and revenues affect the total amount and types of output that are produced, the distribution of that output among various segments of society, and people's well-being in a variety of ways.

In considering the challenge of putting fiscal policy on a sustainable path, many observers have wondered whether it is possible to return to previous policies regarding Federal spending and revenues. Unfortunately, the past combination of policies cannot be repeated when it comes to the Federal budget. The aging of the population and rising costs for healthcare have changed the backdrop for budget decisions in a fundamental way.

Under current law, spending on Social Security, Medicare, and other major healthcare programs, the darkest line in the figure, is projected to reach about 12 percent of GDP in 2021, compared with an average of about 7 percent during the past 40 years. That is an increase worth 5 percent of GDP. Most of that spending goes to benefits for people over age 65, with smaller shares for blind and disabled people and for nonelderly, able-bodied people.

In stark contrast, under current law, all spending apart from Social Security and the major healthcare programs and interest payments on the debt is projected to decline noticeably as a share of the economy. That broad collection of programs includes defense, the largest single piece; the Supplemental Nutrition Assistance Program, formerly known as food stamps; unemployment compensation; veterans benefits; Federal civilian and military retirement benefits; transportation; health research; education and training; and other programs.

That whole collection of programs has incurred spending averaging 11.5 percent of GDP during the past 40 years. With expected improvement in the economy and the new caps on discretionary spending, it falls in our projection by 2021 to less than 8 percent of GDP, the lowest share in more than 40 years, under current law and in our baseline projections.

Putting those pieces together and including interest payments, between 1971 and 2010, as shown by the left pair of bars in the figure, Federal spending averaged about 21 percent of GDP. But under current law for 2021, as shown by the right pair of bars, CBO projects it to grow to about 23 percent of GDP.

Alternatively, if the laws governing Social Security and the major healthcare programs were unchanged and all other programs were operated in line with their average relationship to the size of the economy during the past 40 years, Federal spending would be much higher in 2021, around 28 percent of GDP. That amount exceeds the 40-year average for revenues as a share of GDP by about 10 percentage points.

In conclusion, given the aging of the population and rising costs for healthcare, attaining a sustainable Federal budget will require the United States to deviate from the policies of the past 40 years in at least one of the following ways. Raise Federal revenues significantly above their average share of GDP, make major changes in the sorts of benefits provided for Americans when they become older, or substantially reduce the role of the rest of the Federal Government relative to the size of the economy.

My colleagues and I at CBO stand ready to provide the analysis and information that can help you in making these important choices.

Thank you. I am happy to take your questions.

[The prepared statement of Dr. Elmendorf appears in the appendix.]

Chairman MURRAY. Thank you very much, Dr. Elmendorf.

As we begin the work that has been outlined for us as a committee under the Budget Control Act, I think it is helpful for us to have a clear understanding of the scope of the problem, and you laid that out very clearly for us. I think we all agree this task is pretty enormous, and we have to come together around a balanced approach that addresses our fiscal situation, but also focuses on making sure that we remain competitive and looks at our long-term growth.

So I wanted to start by just asking you to expand a little bit on what you were just talking about and talk to us about what we should consider in weighing the tradeoffs between helping our economy in the short term to help create growth and not causing significant harm in the long term.

Dr. ELMENDORF. In our judgment, and this is consistent with a consensus of professional opinion, cuts in spending or increases in taxes at a moment when there are a lot of unused resources in the economy—unemployed workers, empty homes, unused factories and offices—and when monetary policy is finding it difficult to provide further support for economic activity because the Federal funds rate is already very close to zero, then under those conditions cuts in spending and increases in taxes will tend to slow the economic recovery. They will tend to reduce the levels of output and employment relative to what would otherwise be.

At the same time, and this is also quite consistent with a consensus professional opinion, over time, as our economy moves back toward potential output and those unused resources become used again, under those sorts of economic conditions, cuts in spending or increases in taxes that reduce outsize budget deficits are good for the economy, bolster output and incomes.

That may seem like a paradox, but it isn't really. It is just reflecting the view that the effect of Federal fiscal policy on the economy depends on economic conditions and on the stance and abilities of monetary policy.

And that is why, in our judgment, the analysis that we have done and presented to the Congress on a number of occasions over the past few years, to provide the greatest boost to economic activity now and over the medium run and long run, the combination of fiscal policies likely to be most effective would be policies that cut taxes or increase spending in the near term, but over the medium and longer term move in the opposite direction and cut spending or raise taxes.

Chairman MURRAY. Okay. Thank you.

Dr. Elmendorf, as you know, several bipartisan groups have released reports in the last 9 months with recommendations for reining in our deficit and spending and stemming the rise of Federal debt. All of them came with a balanced approach, and I am concerned that Congress has not yet included revenues or entitlements, as we have focused only so far on discretionary spending cuts and caps, when I think we need to be looking at balanced approaches.

Now some have made it clear that they want entitlements off the table. Others have made it clear they want revenues off the table. Unfortunately, that leaves only a relatively very small amount of discretionary and mandatory spending that Members so far have been willing to focus on.

Would you agree that while cuts and caps we instituted within the Budget Control Act can help somewhat with the long term, what we really need is a comprehensive approach that does address both revenue and mandatory programs?

Dr. ELMENDORF. So, Senator, as a matter of arithmetic, there are a lot of different paths to reducing budget deficits, and it is not CBO's role to make recommendations among those alternative paths. I think the crucial point, though, is that the more large pieces of the puzzle one takes off the table, then the greater the changes will need to be in the remaining pieces.

You can see this very clearly in this picture. In 2021, this pictures shows, under current law, revenues being about 21 percent of GDP. If one instead wants to——

Senator BAUCUS. Can you explain that? We can't see it.

Chairman MURRAY. It is hard to see.

Dr. ELMENDORF. I am sorry. So this is Figure 14 in the written testimony, if you have that in front of you? What the left-hand—I will explain it.

Senator BAUCUS. Exhibit 14?

Dr. ELMENDORF. Yes. Exhibit 14.

Senator BAUCUS. Thank you.

Dr. ELMENDORF. Figure 14 in the written testimony. The left-hand set of bars shows the averages over the last 40 years. The far left bar is revenues. Revenues have averaged about 18 percent of GDP. Then the right-hand bar shows the major pieces of spending. The bottom chunk is Social Security and major healthcare programs. This is——

Senator BAUCUS. Could you try a page?

Chairman MURRAY. Page 42.

Senator BAUCUS. Forty-two. Thank you.

Dr. ELMENDORF. The left-hand piece, as I said, is revenues. They have averaged 18 percent of GDP. The right-hand bar shows spending, Social Security, and the major healthcare programs—that is Medicare, Medicaid, now CHIP—in the future, including subsidies to be provided through insurance exchanges. In the past, that has averaged about 7 percent of GDP.

All other non-interest spending—that is other mandatory spending, it is defense spending, it is nondefense discretionary spending—has averaged 11.5 percent of GDP. And interest payments have averaged about 2.25 percent of GDP. With the deficit, that has been a little under 3 percent.

For 2021, under current law, revenues would rise to be about 21 percent of GDP. Social Security and the major healthcare programs would be 12, a little over 12 percent of GDP. That is 5 percent of GDP more than the average for the past 40 years, and that is the essence of the point that the aging of the population and rising costs for healthcare have changed the backdrop for the decisions that you and your colleagues make.

If those policies continue to operate—those programs continue to operate in the way they have operated in the past, they will be much more expensive than they have been in the past because there will be more people collecting benefits, and each person will be collecting more in benefits. And that is the crucial driver of the future budget trajectory relative to what we have seen in the past.

The other category, other non-interest spending, as you can see, is already much smaller in 2021 under current law and our projections than it has been historically. And that is a combination of improvement in the economy, which we think will reduce the number of people on food stamps, collecting unemployment insurance, and so on, but also discretionary spending caps that reduce both defense spending and nondefense discretionary spending in real terms and thus reduce them fairly sharply as shares of GDP.

Chairman MURRAY. Dr. Elmendorf, I am out of time.

Dr. ELMENDORF. Sorry.

Chairman MURRAY. And as chair, I am trying to keep everybody to that. But I appreciate that response and want to turn it over to my co-chair, Congressman Hensarling.

Co-Chair HENSARLING. Thank you, Madam Co-Chair.

And Dr. Elmendorf, maybe we will continue on this line of questioning. Is it possible to pull up your Figure 12 from your testimony, if somebody could help me with that?

Dr. ELMENDORF. Figure 12?

Co-Chair HENSARLING. Page 39 of your testimony. I believe it is entitled Figure 12.

Now as I understand it, this chart is a chart of historic and projected growth on Social Security, Medicare, other major healthcare programs. You wouldn't happen to have this chart plotted against growth in GDP, would you?

Dr. ELMENDORF. So these are shares of GDP. This is spending on these programs expressed as a percentage of GDP.

Co-Chair HENSARLING. Okay. But historic average, post World War II GDP has averaged what, roughly 3 percent annual economic growth?

Dr. ELMENDORF. I think that is about right, Congressman. I don't know for sure.

Co-Chair HENSARLING. Okay. On your Figure 14, again, Social Security and major healthcare programs have averaged 7.2 percent of GDP. Current law, going to 12.2 percent of GDP in just 10 years. So from 7.2 to 12.2, not quite double, but certainly that could be described as explosive growth, could it not?

Dr. ELMENDORF. Very rapid, Congressman. Yes.

Co-Chair HENSARLING. We won't parse terms. As I am looking at some of your CBO data just for the last 10 years, apparently Social Security has grown at an average of 5.8 percent, Medicare 9.1 percent, Medicaid 8.8 percent in the last decade. And again, we now have a revised GDP growth outlook coming out of your August revision of your baseline.

So, is it a fair assessment that we have Social Security, Medicare, other healthcare programs that are potentially growing two and three times the rate of growth in our economy?

Dr. ELMENDORF. They have grown much faster in the past, and our projections are for them to continue to outpace economic growth. Of course, the exact amount is uncertain, but the gap in the growth rates that we have seen historically has been very large, as you said.

Co-Chair HENSARLING. Now, Senator Toomey certainly in his comments talked about the current law baseline, and although an important exercise, it is certainly not dispositive to the task in front of us. But under a current law baseline, Medicare physicians are due to take essentially a 30 percent pay cut next year. Correct?

Dr. ELMENDORF. Yes. That is right.

Co-Chair HENSARLING. Does CBO—I believe recently you testified that CBO did not have a model to really impact—to show the impact of such a cut on healthcare delivery. Is that correct? Is CBO developing a model, or is that beyond the scope of what you do?

Dr. ELMENDORF. It is in the long-term plan, Congressman. We and others have raised concerns that the much slower growth projected for payments to physicians through Medicare relative to the private sector could affect the access to care or quality of care received by beneficiaries. But we do not have a model and are not about in the near term to have a model that would enable us to make any more specific predictions along those lines, I am afraid.

Co-Chair HENSARLING. Well, what I am trying to get at is clearly—and again, I quoted the President, who I don't often agree with, in our last organizational meeting, where he said, "The major driver of our long-term liabilities, everybody here knows, is Medicare and Medicaid and our healthcare spending. Nothing comes close." And I take it you would probably agree with that assessment as well, Dr. Elmendorf?

Dr. ELMENDORF. Yes. That is right.

Co-Chair HENSARLING. But I am also trying to get to the qualitative aspect of this, too, in our current systems, and you say CBO is developing a model. I know that CMS actuaries have said as essentially if that under the current baseline that, "Medicare beneficiaries would almost certainly face increasingly severe problems with access to care." That is the Medicare actuaries, August of 2010.

The Medicare trustees 2011 report, talking about the growing insolvency, "Beneficiary access to healthcare services would be rapidly curtailed."

The President's Administrator for Centers for Medicare and Medicaid Services has said, "The decision is not whether or not we will ration care. The decision is whether we will ration with our eyes open."

So, to some extent, Dr. Elmendorf, even though CBO doesn't have a model, we are looking at not just programs that are driving the insolvency of our country, but in many respects, left unreformed, is also shortchanging the beneficiaries as well. Would you agree with that assessment, or again, until you have your model, that is——

Dr. ELMENDORF. I think all I can say, Congressman, is that the extent of the pressure on providers of care to Medicare beneficiaries may depend a lot on the time horizon over which one looks. When the actuaries make projections for 75 years into the future, they have shown a picture that I have seen in testimonies about the relative payment rates to providers many, many decades into the future.

The sorts of changes that are in train for the coming decade might affect access to care or quality of the care, as I have said, but would be much less severe in those effects than if those same policies were left in place for the remainder of the 75-year period that the actuaries make projections for. So, but beyond that, we just don't have a way of trying to quantify for you the extent of the impact on beneficiaries.

Co-Chair HENSARLING. Apparently, the trustees in CMS do so far. In an attempt to lead by example and follow the lead of my co-chair, I see my time is now ended.

Thank you, Dr. Elmendorf.

Dr. ELMENDORF. Thank you.

Chairman MURRAY. Representative Becerra?

Representative BECERRA. Dr. Elmendorf, thank you very much for your testimony, and you focused quite a bit of your time on what is coming up, which, if we are not careful, could be pretty bad.

But we are dealing right now with a $14 trillion national debt plus—$14 trillion-plus national debt and fairly massive deficits today, and we have been charged to come up with savings from these current and past deficits of at least $1.5 trillion.

And so, let me ask that a few charts that I have, the first chart actually is a chart CBO's work done in 2001 that I would like to have raised. It is called "Changes in CBO's Baseline Projections of the Surplus Since January 2001," and what I would like to do on that chart, if we can get that up, is just point out what was being projected by your office back in 2001 and then analyze—and I think all my colleagues have copies of those charts with them—and analyze that.

Now it is very difficult to make out these tables and make much sense of them. But for those who can make out the lines, the numbers on those charts, the very top line, the total surplus as projected in January——

Senator BAUCUS. Xavier, could you tell us what page that is on?

Representative BECERRA. It should be a separate package that you got——

Senator BAUCUS. Oh, it is a handout.

Representative BECERRA. It is a separate handout. That is correct. It should be——

Dr. ELMENDORF. I think this is a table that CBO has published and posted on its Web site, but it is not included in the testimony that I brought today.

Representative BECERRA. That is correct. And I only will make a couple of points here since it is difficult to read all the numbers on the table. But the first one is that the top line there, total surpluses as projected in January 2001, projected that after—from 2001 to 2011, if you totaled it up, we have surpluses of $5.610 trillion.

And if you go down to the very bottom of the chart, towards the very bottom, to the line that says "Actual Surplus or Deficit," under the year 2002 column, by the year 2002, there was a negative 158, which means a deficit of $158 billion.

So that while the projections in 2001 were for record surpluses totaling over 10 or so years, $5.6 trillion, by the second year, by 2002, we were already beginning to run deficits, not surpluses. So we knew well in advance of the year 2011 that the Federal Government was beginning to run deficits—in fact, record deficits—that could ultimately harm our economy.

I have another chart that uses the data from the CBO that we just discussed and tries to put it in a little easier form to analyze. And the Pew Center did this chart, taking the data from the Congressional Budget Office to try to segment out where that change from surplus to deficit went. All those dollars that were spent, all the revenue through the tax code that was lost, where did it go?

And obviously, the biggest piece of the pie on the right, technical and economic, that is what I think you described earlier as shortfall in Nation's output. In other words, all the things that have caused us to have less output than we had expected, projected. The recession and so forth probably constitutes the biggest portion of that.

After that, the second biggest slice of the pie that drove our deficits, you can see, are the tax cuts in 2001 and 2002, the Bush tax cuts. Actually, you could put together our defense costs, which are here in the very bottom, "Operations in Iraq and Afghanistan" at 10 percent, and "Other Defense Spending," a little bit further up to the left, at 5 percent, and you have 15 percent of the pie due to defense spending, and so on.

And interestingly enough, increase in net interest, money we pay just on the interest we owe on that national debt, is one of the largest items as well. So nothing productive comes of making those payments.

I raise all that because as we talk about where we should target our solutions, we should know what has driven us most towards these large annual deficits that now give us this over $14 trillion national debt.

And the final chart that I wanted to raise because it also points out the actual discretionary spending part of the pie, which you spent some time on—not the tax expenditures, not the spending we do through the tax code, which is the largest portion, but through the allocations we make every year through the budgeting process, the appropriation process. Hard to tell again, unless you have a chart in your hand, but the largest item shows the change in spending from 2001 to 2010, the greatest percentage of that added spending in those 10 years was in the Department of Defense, much of it because of the war in Iraq and the war in Afghanistan. But fully two-thirds of the costs or the extra spending that was done from 2001 to now 2010 has come in spending done in the Department of Defense.

You could compare that to, say, the Veterans Department, Veterans Affairs Department. The share of the new spending over that 10-year period that went to veterans was about 5 percent. Education, you can see further down the list. The new spending beyond what was expected in 2001, it is about 1 percent.

And I think that is important to sort of gauge that. And as much as I hope we have a chance to get into some of this and talk about where we have to go, I think it is important to know where we are coming from. And so, I thank you for being here to help us gauge those responses into the future.

I yield back.

Chairman MURRAY. Senator Kyl?

Senator KYL. Thank you, Madam Chairman.

Rather than make a speech, which would probably have the effect of dividing us if I responded to my colleague, I would like to focus on areas where we might find agreement, going back to my opening statement, and to begin with a quotation from the President.

In March of last year, he said, and I quote, "It is estimated that improper payments cost taxpayers almost $100 billion last year alone. If we created a Department of Improper Payments, it would actually be one of the biggest departments in our Government."

Well, this committee can address the question of improper payments, but I think we are going to need CBO's help in order to do that. For 2010, GAO estimated total improper payments at over $125 billion. And according to its report, Medicare, Medicaid, and unemployment insurance ranked 1, 2, and 3 in total improper payments. Their figures were slightly below those I quoted earlier.

But the bottom line is that if you had $100 billion, as the President says, in overpayments each year, over a decade, that is $1 trillion. More than $1 trillion when you compound it. It is an area we need to address.

And since it doesn't involve cuts in benefits or fundamental reform of programs—which I happen to think we should do, but I am trying to stay on areas where we can reach bipartisan consensus here—we are going to need help in scoring how to approach this.

My first question I guess I should ask is do you agree, whether it is with these specific numbers or not, with the President's contention, let's just say, that at least there is a significant amount of inappropriate payment for some of the programs that I have mentioned?

Dr. ELMENDORF. So I agree with that. I have two quick comments. One is that there is a difference, of course, between improper payments and fraud. Fraud is a much narrower category involving certain legal issues.

Some improper payments are simply that people didn't put Social Security numbers into forms where they should have or so on. And if the forms were filled out properly, the payments might be still made.

So just people should understand that when they see some of these largest numbers for improper payments, that is a much broader set of situations than the sort of thing that we read of prosecutions regarding in the newspaper.

Second point to make, of course, is not just whether the improperness or the fraud is out there, but what policy levers the Government has to go after that. Of course, those programs are not trying to encourage improper payments or fraud. There is an active effort on the part of the Justice Department, as well as the part of the departments running these programs, to crack down on fraud. And you do see stories in the newspaper about prosecutions.

So the question that we can help the committee work on is what policy levers are available that can try to wring some of that money out of the system?

Senator KYL. Exactly so. And that is where we need your advice. And the comment about fraud is obviously correct. I think fraud is not the most significant part of these overpayments, but it is important.

One question is would we benefit in a cost-benefit analysis by devoting more resources to trying to root that out? We should deal with that. Another would deal with whether or not hiring additional people to check before the check goes out rather than audit after we find the problem would be beneficial.

The prompt payment requirements represent part of the challenge that we have here, as I understand it. So, now, is it true that CBO has—well, let me just ask, has CBO itself done an analysis of these numbers?

Dr. ELMENDORF. I don't have numbers comparable to the ones you quoted to use. But we do spend a fair amount of time working with Members of Congress, working with the people at CMS, and so on to think about ways that policies could be changed that would try to reduce the level of those payments.

And as you know, the Budget Control Act, in fact, included provisions for raising the caps in discretionary spending to cover some of those increased efforts that you described.

Senator KYL. Right.

Dr. ELMENDORF. And we included in our estimate of the effects of that act the savings that we thought would accrue in terms of reduced payments.

Senator KYL. Well, just to summarize, will you work with us to try to help us identify the potential policy that could result in, on a cost-benefit analysis, significant savings if we were to implement it?

Dr. ELMENDORF. Yes. We certainly will. But can I just also caution, I am not against our working with you on any issue that you want us to work with you on, but there is no evidence that suggests that this sort of effort can represent a large share of the $1.2 trillion or $1.5 trillion or the larger numbers that some of you have discussed as being the objective in savings for this committee.

Senator KYL. Well, the GAO, if the GAO report is right, if what the President said is right, if there is over $100 billion in just 1 year alone, then even if we get 25 percent of that, it is a significant amount of money. It is at least something that I think on a bipartisan basis we can agree on because it doesn't involve fundamental reform of the program, it seems to me.

Now there is a second area that I wanted raise here, too, and that is asset sales. There are a lot of different reports. CRS, for example, in 2009 said the Government held well over 10,000 unneeded buildings, spending $134 million just to maintain them. The President's budget assumed savings by selling property and so on.

One of the things we would also like to ask you to do, and I know you have scored the President's proposal, but that was a proposal that relied on incentives to sell property. If we simply mandated the sale of property, I think we would need your advice about how to structure that so that we would get the best return for the sales that we would want to accomplish.

Will you work with us on that potential area of—that is revenue rather than savings, but it all amounts to the same thing in terms of helping us with our problem.

Dr. ELMENDORF. Yes, Senator. Of course, we will work with you. I would caution again. We have done a fair amount of work. We have given testimony on this topic, and there is no evidence that the amount of savings that could be—or extra revenue that could be reaped by the Government through efforts in this direction could represent any substantial share of numbers that begin with "t" for trillion.

The Base Closure and Realignment effort has not yielded significant amounts of money for the Government in terms of selling the property. It saved money in terms of operating some of these facilities, but not much has been sold.

When one sees these numbers of thousands of Government properties not being used, many of them by number are shacks in the middle of nowhere that don't have market value. And the properties that have the most value—there has been some back and forth I have seen in the newspapers about property in Los Angeles—then the people who live around it are fighting very hard to prevent the Federal Government from selling it.

Not to discourage you from passing laws to the contrary. But what happens are the things that are most valuable is that the people who are there are using it or potentially using it or want the area to stay that way tend to push back very hard, and history suggests that very little money is actually reaped.

But we are certainly ready to work with you on policies in that direction.

Chairman MURRAY. Senator Baucus?

Senator BAUCUS. Thank you, Senator Murray.

Again, I want to follow up with Senator Kyl's questions. I think we should explore this much more vigorously than we have in the past, and I think you and I and others will try to work with you to try to find some solutions here.

On the version I have of your statement, it is page 5. You are talking about the timing of deficit reduction, and you state that according to analysis, essentially, credible policy changes that would substantially reduce deficits later in the coming decade for the longer term, the thought being spending, cuts in spending are efficient, would both support economic expansion in the next few years and the strength of the economy longer term.

My basic question is, could you give us some examples about how we could achieve both goals, namely jobs and deficit reduction? That is really one of the key questions here is how do we do this?

There are probably several ways. You mentioned that deficit reduction has to be, in the longer term, credible because we can't do something that is not credible. It has to work, but we have to find the balance. And I wondered if you could give us a couple examples in how we accomplish that?

Dr. ELMENDORF. Well, there are a number of possibilities, Senator. We released a report in January of 2010 that analyzed a set of alternative proposals for spurring job growth. We looked at increased transfer payments. We looked at cuts in all sorts of different types of taxes. We looked at other types of Government spending increases.

And I don't want to be appearing to steer the committee in any particular direction among those choices because the choices involve not just the effects on the economy—and we did estimate quantitatively the impact on output and employment. They also involve choices about what you want the Government to do, what sorts of activities it should be engaged in, what the role of the Government should be relative to the private sector.

So the set of choices in making stimulative policy, in addition to doing deficit reduction policy, are far beyond our technical role. I think the crucial points, though, are that cuts in taxes or increases in spending in the near term will spur output and employment in the near term. But just by themselves, they will reduce output and incomes later on because of the extra debt that is accumulated.

Senator BAUCUS. Right. I——

Dr. ELMENDORF. If one wants to also improve the medium and longer-term outlook for the economy, then one needs to have deficit reduction that offsets the extra costs in the near term and reduce the deficit further relative to the unsustainable path of current policies.

Senator BAUCUS. I appreciate that. In fact, I think I have your chart, your table, that is entitled "Estimated Effects of Policy Options on Output and Employment." And I applaud you for it because, according to that chart, you, for example, with respect to jobs as to cumulative effects on employment, in 2010, '11, '10 to '15, you have highs and lows that you rate. You know, this creates more jobs than that.

So you give us a sense of what—for example, increasing the aid to the unemployed is very high in terms of its economic effect and helping people without jobs, but also with respect to the economy and GDP. So I appreciate that, and I will work with you to try to find ways to address that.

I would like to turn to another question, and that is I don't want to steal from my good friend Rob Portman. He can follow up a lot more. But it is sort of the baseline question. And you say that we can get to 61 percent of GDP in 2021 under current law. But I think most of us here in this room don't think that current law is very realistic. There are going to be changes, and you list some of the changes in your statement, namely, the tax cuts—2010 tax cuts, AMT indexed for inflation, Medicare payment rates, and so forth.

And if we were to assume that those provisions are going to be extended as something called the current policy, that instead of trying to get—instead of $1.2 trillion as to 61 percent of GDP in 2021, the figure I have is about $6.2 trillion.

Dr. ELMENDORF. Yes. That is right. The cost of extending those expiring provisions amounts to about—including the interest cost that would result, amounts to about $5 trillion over the coming decade. So the choice of the Congress about those policies is much larger an impact potentially than the stated target deficit reduction of this committee.

Senator BAUCUS. All right. So let's say we want to reduce the deficit by, what, 6.2—5 plus 1.2 is 6.2, let's say, for example.

Dr. ELMENDORF. Okay.

Senator BAUCUS. What would the composition of that reduction be if we reduce the deficit somewhat in parallel, in tandem with proportion to the causes of the additional $5 trillion? I guess it would just be——

Dr. ELMENDORF. Well, most of the extra $5 trillion under your scenario comes from a reduction in taxes. So if one wanted to offset that, that is what you are suggesting, then one would need to raise significant tax revenue through some other channel.

I mean, I think I understand the purpose for this hearing of talking about the history of debt and how we got here. And I think you are extending that a bit into the future, looking at what policy changes would get us to a certain place. But I think really the fundamental question for you is not how we got here, but where you want the country to go. What role do you and your colleagues want the Government to play in the economy and the society?

Senator BAUCUS. That is right.

Dr. ELMENDORF. And if you want a role that has benefit programs for older Americans like the ones we have had in the past and that operates the rest of the Government like the ones we have had in the past, then more tax revenue is needed than under current tax rates.

On the other hand, if one wants those tax rates, then one has to make very significant changes in spending programs for older Americans or other aspects of how the Federal Government does its business.

Senator BAUCUS. That is exactly right, and I don't want to take time here. But it is just really the question. Where do we want to go? And do we want to have AMT indexed, for example? Do we want to have SGR, the physicians payment rate? Do we want to increase taxes for middle-income Americans beginning 2013, or upper income, or not?

I mean, these are basic questions we are going to have to ask ourselves, and they all have consequences, really. And the consequences if we want to do all that is what we just agreed on. Namely, it is a $5 trillion addition to our job here. But in addition, we have what the President is going to have us do with his jobs plan.

Thank you.

Dr. ELMENDORF. Yes, Senator.

Chairman MURRAY. Representative Upton?

Representative UPTON. Well, thank you again, Dr. Elmendorf.

I want to underscore what our friend Mr. Kyl said about fraud and abuse. I mean, there is nothing more irritating to any of us here or certainly to our constituents, and any assistance that you could help us on that I know would be low-hanging fruit in a major way for us to include as part of the package.

Let me ask just an early question as to timing of this whole event. We are tasked to have a vote prior to November 23rd. What is the timing—I mean, other than as soon as possible. What is the realistic date that truly we have to have our documentation submitted to you?

I know sometimes a lot of our Members are frustrated trying to get a CBO score. I know that there is not a higher priority for you all to do this. But what is really the date that you are going to want the material so that we can complete the work by the statute?

Dr. ELMENDORF. As you know, Congressman, from your work on the Energy and Commerce Committee, in order to process——

Representative UPTON. Which would feed into the queue ahead of Ways and Means in terms of the committee——[Laughter.]

Dr. ELMENDORF. It is an iterative process in which we often see preliminary versions of ideas and offer some preliminary feedback. But if this committee intends to write legislation that would change entitlement programs in specific ways, that process usually takes weeks of drafting to make sure that the letters of the law that you are writing accomplish the policy objectives that you are setting out to accomplish.

And as part of that drafting process is our estimating ultimately the effects of the letter of the law as it is being written. So it will take us at least a few weeks.

I have a terrific set of colleagues who are incredibly talented and work unbelievably hard. But we need to do our jobs right, and that means not just pulling numbers out of the air. So we have said in discussions with some of the staff of the committee that, with all respect, your decisions really need to be mostly made by the beginning of November if you want to have real legislation and a cost estimate from CBO to go with that before you get to Thanksgiving.

Representative UPTON. Now I want to get a better understanding of some of the estimates of the cost impact to the Affordable Care Act. As we know, the bill increased taxes on some of our Nation's most innovative job creators, reduced Medicare spending significantly. The tax increases and Medicare cuts were traded to create three new entitlement programs, which have yet to take effect, and according to our staff's projections, which are based on your most recent baseline, those new entitlement programs will cost the Nation nearly $2 trillion over the first 10 years from '14 to 2023.

So, question one, have you all estimated the full 10-year costs for each of these entitlement programs, Medicaid, health coverage subsidies and the creation of the CLASS Act, for the '14 to '23 period when they are fully implemented?

Dr. ELMENDORF. No, Congressman. We have not.

Representative UPTON. Do you anticipate doing that at all?

Dr. ELMENDORF. No. As you know, we produced estimates for the 10-year period that was under consideration when the law was being considered, and then we provided a rougher sense of what we thought would happen in the second decade from that point in time.

As the time moves forward and the budget window moves out, we will ultimately end up with a 10-year budget window that will be from 2014 to 2023. But even then, it is not obvious that we will have an estimate of the effects of that legislation by itself.

Some pieces of that legislation create new institutions, new flows of money that didn't exist before, insurance exchanges and subsidies. And those lines of our cost estimate will, in some sense, become real flows of money at that point in time.

But much else of that legislation made changes in existing programs, in payments through Medicare and so on. And we will never know for sure what money actually is flowing differently because of that piece of legislation . We will see flow for certain purposes through certain accounts, but isolating the effects of that legislation won't really be possible.

The prescription drug benefit is one of the few pieces of legislation where we can look back at how we did. In a sense, that is because much of that legislation—not all, but much of it, the big part—created a whole new stream of money that would have been zero otherwise. So we can see the difference.

But for most legislation that the Congress passes, one can never really go back and tell. That is the risk of our table that we gave to Congressman Becerra and others. One can never really go back and tell what happened. And so, the healthcare legislation will be like that at some point.

Representative UPTON. Well, if there is a way that you would take the percentage of GDP and try to match that up with the outyears and look at 9, 10, 11, 12 years out? Is that a thought that you might take up?

Dr. ELMENDORF. Well, so we did. So we can talk with you further, Congressman. We did do an estimate as the net effect of the law, the share of GDP over the second 10 years. And we talked in our estimates at the time about some of the bigger pieces of the legislation, things that were growing rapidly or growing more slowly or so on.

That sort of calculation is not really possible to do on the level of little specific provisions. It is just too broad a brush we need to paint with at that horizon, given the uncertainty involved. But if there are other ways of looking at those pieces that would be helpful to you, we are happy to try to do that.

I think we made very clear—I hope nobody is confused about this—that legislation created significant new entitlements that raise Federal outlays. It also made other reductions in outlays and raised revenues in ways that on balance we think and still think reduce budget deficits. But that was a net effect of very large changes with different signs, and that increases the uncertainty surrounding those estimates of the net effects.

Representative UPTON. Thank you.

Chairman MURRAY. Thank you.

Representative Clyburn?

Representative CLYBURN. Thank you very much, Madam Chair. Dr. Elmendorf, since we have been sitting here, we received notice that the Nation's poverty rate has increased to 15.1 percent, up almost a full percentage point. Now back in, I think it was September 2010, in testimony before the Senate Budget Committee, you said this.

"Regarding structural changes, the end of the housing boom, and the recession have all induced a reshuffling of jobs among businesses, occupations, industries, and geographical areas. Those developments suggest that gains in employment in the next several years will rely more than usual on the creation of new jobs with different businesses in different industries and locations and requiring workers with different skills."

Do you still feel that to be true?

Dr. ELMENDORF. Yes, we do, Congressman. We think that much of the extra unemployment we are seeing now is what economists would call a cyclical response to a weakness in the demand for goods and services. But that some of the extra unemployment we see now is more what economists call a structural problem, which involves, importantly, the mismatches that we discussed in the passage you read, also relates to unemployment insurance benefits and other factors in the economy.

We made a rough attempt to quantify those pieces in our August update. But the upshot of that is to say that we think there is an important piece of current unemployment that relates to this kind of structural mismatch that would—makes it harder for those people to go back to work, because it is not so much going back as it is going on to something else.

Representative CLYBURN. Then that means then your view is there is not much that can be done in the short term to attack this?

Dr. ELMENDORF. I wouldn't quite say that. It is challenging. I mean, I think what I would say is that the cyclical part of the unemployment, that part that is responsive to the weakness in demand for goods and services, can be addressed through aggregate economic policies.

The people who are unemployed for structural reasons, in a sense, because of the sort of the thing that they knew how to do in the place that they live isn't being done there or anywhere anymore, that isn't amenable to broad macroeconomic policy. It might be responsive to certain types of more focused policies—training programs, for example.

I think the broad brush summary of training programs is that it is hard to make them work, but not impossible. I don't want to suggest that. But I think it is just a different sort of policy that would need to be considered in order to help some of those people find new jobs, to help other people create the jobs that those people would be able to do.

Representative CLYBURN. Well, just let me say, to be certain, I am just as concerned as my good friend Senator Kyl is about fraud and abuse. I want to cull that out of the system as well as we possibly can.

The problem I have, though, is that with these kinds of numbers and with what you have just laid out, it means that those in need are increasing rapidly. And the question then becomes if you look at the median family, household income declining 2.3 percent, that means that irrespective of what may be happening to people who may not be deserving of the assistance, there are increases occurring among the needy very rapidly, and we have not done anything to absorb that challenge.

Dr. ELMENDORF. Certainly right, Congressman, about the number of people who are hurting. One thing I would say is that the Federal budget automatically does some things for those people. Food stamp participation is up. A lot more money is flowing out that way. Unemployment insurance, even apart from extensions, will pay benefits to more people if more people are unemployed.

So some of the automatic features of entitlement programs end up helping those people, but I don't want to suggest that that has inoculated them against the overall problems that they face.

Representative CLYBURN. That means our burden of doing smart cuts is greater than what it may appear just looking at the numbers. It means we really need to look into all of these programs and see exactly where cuts ought to be made rather than just dealing with a number.

Thank you very much. I yield back.

Dr. ELMENDORF. Yes, Congressman.

Chairman MURRAY. Senator Portman?

Senator PORTMAN. Thanks, Madam Chair.

Building on what my colleague, Congressman Clyburn, just said and what Co-Chair Hensarling talked about earlier in terms of the impact of the deficit and debt on the economy, Dr. Elmendorf, have you got a reaction to the Rogoff and Reinhart study, which shows that once you are at 90 percent of gross debt, which we are already, that you have an impact on GDP, therefore on jobs, therefore on the kind of issues that Congressman Clyburn talked about?

Dr. ELMENDORF. So we are certainly familiar with that work, Senator. Carmen Reinhart is a member of our panel of economic advisers. We benefit from her expertise.

I think the thing to note about the study, first of all, as it was said, is that they are looking at gross debt. So those are larger numbers than the numbers that you will see from me. We focus on debt held by the public.

Senator PORTMAN. Right.

Dr. ELMENDORF. The other thing to say is that they divided the world into buckets in a sense, different levels of debt. That doesn't prove that there is some particular tipping point at 90 percent. It says that above—but their evidence shows that above that level, economies tend not to do well.

We just had an issue brief last year about the risk of a fiscal crisis, and in other things that we have written, that we don't think it is possible to identify a particular tipping point. But there is no doubt that as debt rises, risks of fiscal crises rise. The Federal Government loses the flexibility to respond to unexpected international developments or problems at home because of this looming debt.

And we are, as I said, moving into territory that is unfamiliar to most developed countries for most of the last half century.

Senator PORTMAN. In fact, in looking around the world, and there is a recent report by Alberto Alesina of Harvard University showing that the most successful and pro-growth test of reduction took place in countries that relied chiefly on austerity programs, spending cuts. And nations that relied more on tax increases were less successful in reducing the deficits and had slower economic growth.

Have you looked at some of these countries that have gone through the same process we are going through now, and what comment can you give us today on what we can learn from the experience of those countries? And maybe if you know about Professor Alesina's study?

Dr. ELMENDORF. So I do know Alberto's work. There have been a number of studies, as you know, looking at the international experience of countries that have faced fiscal crises and have undertaken austerity programs. The IMF looked at a very similar set of data to the work of Alberto and Silvia and came to a different conclusion, in fact. Their conclusion was that in countries that really set out to do fiscal austerity, the results tended to not be good in the short term.

I think the principal lesson of looking at countries like Greece and others is that it is a terrible situation to end up in, where one has to make drastic, abrupt changes in policy. But if you look at Greece or Ireland or the experience in the UK, which did not face such a crisis but has made a very determined pivot in its policy, those economies are not doing very well right now.

And I think leaders in those countries felt they had no alternative, given where they had gotten to, that they were at a point where people were not lending the governments money anymore or were about to stop lending them money, in the view of the governments. So they had to make drastic changes. But that is not a situation that we would like to find ourselves in as a country.

Senator PORTMAN. It appears as though we are heading there if you look at the current policy baseline and some of the more realistic assumptions that my colleague, Senator Baucus, talked about. If you look at your chart with regard to baselines, you say that we have about a $3.5 trillion deficit increase over the decade under the current law baseline, but under current policy that you have, you say it is about $8.5 trillion.

I would add tax extenders in there like the R&D tax credit and others, and possibly, you are up to about $9.3 trillion.

Dr. ELMENDORF. Yes.

Senator PORTMAN. So, again, the $1.5 trillion is a relatively small part of the problem. It is about 17.5 percent, by the way, of your $8.5 trillion number. So I do think that as we look at our work, we are going to need your help on looking at more realistic baselines. We are making very difficult choices on things like alternative minimum tax, SGR, and ending the UI extension and payroll tax and so on.

In terms of what drives that, your Figure 14, I think, is very instructive, which talks about the major healthcare programs. Earlier, there was discussion about President Obama's comments. "The major driver of our long-term liabilities," he said, "everybody here knows is Medicare and Medicaid and our healthcare spending. Nothing comes close."

Assuming you agree with that, which I assume you do?

Dr. ELMENDORF. Yes.

Senator PORTMAN. What do you think ought to be the primary focus of this committee?

Dr. ELMENDORF. Again, Senator, it is really not the place of me or CBO to offer recommendations about how to proceed. But there is no doubt that the aspect of the budget that is starkly different in the future relative to what we have experienced in the past 40 years is spending on programs for older Americans and spending on healthcare.

And the reasons those programs are so much more expensive in the future is partly due to changes in policy over time, but most importantly due to a greatly increased number of older Americans and higher cost for healthcare. As a matter of arithmetic, it is possible to raise taxes or carve away at the rest of the Government in a way that can support those programs in this form for some time, but there should be no illusion about the magnitude of the changes required in other policies to accommodate that.

If one really leaves those programs in place, then, in fact, under current law already the rest of the Government would be much smaller relative to the size of the economy in 2021 than it has been historically. And one would need to raise revenues substantially.

I mean, this is a 5 percent of GDP increase in the cost of Social Security and major healthcare programs in 2021, relative to the 40-year average. Five percent of GDP is a very big number, and that is why I think many people believe that there should be changes in that part of the budget.

Senator PORTMAN. So if the 22.7 percent of GDP is spending in that 2021 estimate under, again, current law and not even current policy, the major driver is Social Security and major healthcare programs. That is as compared to the historic average the last 50 years of about 20.8 percent.

Revenues there go from 18 percent historic average up to 20.9 percent. My understanding is even under current policy, revenues go up above the 18 percent level. So your $8.2 trillion——

Dr. ELMENDORF. A little bit.

Senator PORTMAN [continuing]. Or the $9.3 trillion, which is I think a more realistic estimate, also includes a slight increase in revenues, is that correct, as a percent of GDP?

Dr. ELMENDORF. I think a slight increase. Yes. That is right, Senator.

Senator PORTMAN. Twenty-two percent, I think, is the number.

Dr. ELMENDORF. I am not sure exactly. But, yes, a slight increase.

I would just add one fact here. The number of Americans over the age of 65 is going to rise by about one third in the coming decade. One third more beneficiaries of Social Security and Medicare a decade from now, roughly, than there are today. And on top of that, with higher healthcare costs per person, one can see why these programs in their current form are becoming much more expensive over time.

Senator PORTMAN. Thank you.

Chairman MURRAY. Senator Kerry?

Senator KERRY. Thank you, Madam Chairman.

Dr. Elmendorf, I want to try to move through a couple of things fairly quickly, if we can. You said a moment ago that the aspect of the budget that is starkly different is, I think you said, the number of older Americans and the cost of healthcare. Is that correct?

Dr. ELMENDORF. Yes. That is right.

Senator KERRY. And those are the two things that you said are starkly different about the aspect of the budget today?

Dr. ELMENDORF. Today, and in the future. Yes, even more so in the future.

Senator KERRY. But isn't it accurate that we have balanced the budget I think since World War II five times, and that each time we have balanced the budget, revenues have been somewhere between 19 and 21 plus percent of GDP? Is that accurate?

Dr. ELMENDORF. That sounds right, Senator. I have not checked exactly.

Senator KERRY. And assuming that is accurate, we are currently at 15 percent, 15.3 I think is your prediction for this year, of revenues to GDP. Correct?

Dr. ELMENDORF. Yes. That is right.

Senator KERRY. So isn't it fair to say that, in fact, there is an aspect about our budget today that is starkly different, which is the level of revenues relative to GDP. It is starkly different, isn't it?

Dr. ELMENDORF. Yes. That is right, Senator.

Senator KERRY. And it is starkly different in that it is well lower than the historical average of when we balanced the budget or not balanced the budget?

Dr. ELMENDORF. Yes. That is right.

Senator KERRY. So let me ask you, given that reality and given the reality that you and others—I think last year, the Committee on Fiscal Future of the United States, which was a joint effort of the National Academy of Sciences and the National Academy of Public Administration—developed four budget scenarios.

They had one budget scenario where you had nothing but cuts, another budget scenario where you had nothing but tax increase, and then two in between. The only way they could keep the revenues at the historical average and keep the spending at a decent level was basically with cuts. But that doesn't get you where you need to go in terms of some of this historical average and not winding up with major, major cuts in terms of the benefits of Medicare or Medicaid.

So if you want to avoid—you made the statement to us a moment ago that we have to make a decision about what we want to do. Most people have accepted that we don't want to have major reductions to—we have reforms, yes. We need to do a better job of making them fiscally sound. But I haven't heard anybody stand up on either side of the aisle and say there ought to be huge cuts in benefits.

If that is true, then aren't we forced into a situation where we look somewhere near the historical norm with respect to the revenue to GDP percentage?

Dr. ELMENDORF. So if one wants to leave spending on Social Security and the major healthcare programs roughly in line with what would happen under current law, then one needs to either further carve away at all the other functions of the Government, or one needs to raise revenues above their historical average share of GDP by a significant amount, or one could do combinations of those.

But there is no way to simultaneously let Social Security and the major healthcare programs grow the way they would under current policies or anything close to that and operate the rest of the Federal Government in line with its role in the economy over the past 40 years and keep revenues the same share of GDP they have been on average in the past 40 years. And the reason those things are inconsistent, even though they worked in the past 40 years, is because the number of people who will be older and the number who will be—and the amount they will be collecting in health benefits will be so much larger in the future than in the past.

Senator KERRY. Well, I happen to agree with that judgment that you have made, and I think it is a very important one with respect to how we approach this.

I also want to—we are going to obviously have some time here to discuss the healthcare piece, but isn't it true that, well, the Medicare excess cost growth, how does that compare to the excess cost growth in overall healthcare spending over the next decade?

I think in recent estimates that you found that Medicare in the excess cost growth was actually lower than the historical average now. Isn't that true?

Dr. ELMENDORF. Yes. So excess cost growth, meaning not necessarily excessive in the judgmental sense, but just faster growth in benefits per person than in the growth of GDP per person, that sort of excess cost growth in Medicare under current law is pretty close to zero for the coming decade. That would be a very sharp change from the experience of the past 40 years.

Senator KERRY. And what do——

Dr. ELMENDORF. In relation to the discussion we had earlier about payment rates to providers.

Senator KERRY. So what do we attribute that significant reduction in the Medicare cost growth rate?

Dr. ELMENDORF. So importantly, to features of the law, like the cuts in payment rates to physicians due to take effect the end of this year and like a number of the other cuts to provider payments enacted in last year's major health legislation.

Senator KERRY. So that has had a beneficial effect in terms of restraining growth in Medicare—in Medicare cost?

Dr. ELMENDORF. Yes. That is right.

Senator KERRY. Thank you. I will reserve my time at this point.

Chairman MURRAY. Representative Camp?

Representative CAMP. Well, thank you.

Director Elmendorf, I am sure you remember, as last year you testified before the President's National Commission on Fiscal Responsibility and Reform on a topic very similar to what you are covering today. It seems as if your presentation then said, then and now, that we need to get control of the automatic spending increases that have been built into the Government's budget. Is that a fair statement of your testimony then and now?

Dr. ELMENDORF. Well, again, I think we said that those pieces are growing very rapidly and that to accommodate that, as it stands, would require very large changes in other aspects of the money the Government spends or collects.

Representative CAMP. Those are the significant drivers of our current situation.

Dr. ELMENDORF. Yes.

Representative CAMP. So what programs in particular are at the core of CBO's projections for the long-term Government spending? And which programs are responsible for the largest increases in Government spending?

Dr. ELMENDORF. So if one looks at Figure 12 from the written testimony on page 39, and coming up on the screen for those with very good eyesight, one can see that this picture shows growth over the next decade in Social Security and in Medicare and in other major healthcare programs.

Representative CAMP. Do the other major healthcare programs include all of the Healthcare Act, long-term care and other Medicaid increases?

Dr. ELMENDORF. So the other major healthcare programs are Medicaid, the Children's Health Insurance Program, and subsidies through insurance exchanges, and some related smaller spending.

Representative CAMP. And the long-term care entitlement?

Dr. ELMENDORF. The long-term care entitlement, as you recall, actually raises money for the Government in the first decade of its life. And I don't know if that has been netted out here or not. I don't think so, actually, Congressman.

But one can see from this picture that the largest increase as a share of GDP over the coming decade among these three categories is the other major healthcare programs, followed by Social Security and Medicare.

Representative CAMP. All right.

Dr. ELMENDORF. And that is principally, I think, because of a great increase in the number of beneficiaries from the expansions enacted last year and continued sharp increases in costs for beneficiaries in those programs.

Representative CAMP. In your prepared testimony before the President's commission, you also included a chart, which—if we could pull that up now, and everyone has a copy of this chart at their desk in their packet—which showed real GDP per capita under different economic conditions. You will notice under the alternative fiscal scenario, the line stops between 2025 and 2030.

And you explained then that that line stops because economic growth collapses and that it simply can't handle debt loads that high. Is that an accurate statement of what you testified before the President's commission?

Dr. ELMENDORF. Yes. That is right. We have updated this picture in our long-term projections from this year. But similarly, Congressman, not at quite the same point, the amount of debt under this alternative scenario becomes so large that our models don't know what to do with it.

I don't think the economy would actually get that far at all because the people in the economy will be looking ahead and foreseeing what is happening. I think, in fact, much more serious problems will come sooner than we show in these pictures.

Representative CAMP. And I think you said that the Government debt has become so high that you don't know what to do with it because private investment ceases to function and the economy ceases to function under that scenario. Is that correct?

Dr. ELMENDORF. Ceases to function at some point. Again, I think that the freezing up would probably come sooner than we show in those pictures because of an anticipation of that problem.

Representative CAMP. And I think that analysis really does go along with what other analysts have said of the country's debt-to-GDP ratio when it exceeds 90 percent, and I am talking total debt to GDP ratio, that it reduces economic growth, as others have said in their time, by about 1 percent at that level.

Dr. ELMENDORF. Yes. I think the models that we are using here are consistent with a consensus approach to estimating this sort of issue.

Representative CAMP. And am I correct to say that our total debt-to-GDP ratio is over 90 percent at this time?

Dr. ELMENDORF. Yes. I think that is right, Congressman.

Representative CAMP. And what impact do you think these massive levels of debt relative to GDP have on the economy in general and specifically on the prospects for job creation?

Dr. ELMENDORF. Those levels of debt are a burden on the economy. They reduce our output and our incomes relative to what we would enjoy if we had done less borrowing and had done more saving.

Representative CAMP. This committee has been tasked under the Budget Control Act with finding $1.5 trillion in deficit reduction over a 10-year period. What is the size of the economy over the next 10 years?

Dr. ELMENDORF. So GDP today is about $15 trillion. We think it grows over the course of the coming 10 years. If you have done that calculation, Congressman, I would be happy to hear the number from you.

Representative CAMP. Well, just assuming over 10 years, $150 trillion, we are talking about 1 percent of our economy, are we not, in terms of rough numbers?

And the reason I want to point out this number is you mentioned the impact of us making decisions about spending that might have impacts on the economy, and I just want to put in perspective, over the next 10 years, these reductions in debt that we are asked to find over the next 10 years roughly represent about 1 percent of the economy. And I am talking very rough numbers.

Dr. ELMENDORF. So I think that sounds about right to me, Congressman. And I agree that the problem is very large by the standards of the incremental fiscal policy decisions that the Congress normally makes. But it should not be viewed as unsolvable. Changes in policy can put us on a different path.

Representative CAMP. And in terms of outlays, I think this amount over the next 10 years represents about 3 percent of our outlays, and as I think Senator Portman mentioned as well. And so, I think we need to put it in perspective that while I am not underplaying how difficult this might be, but in terms of impacting the economic trajectory of the United States economy, we are not over the next 10-year period in significant percentages of either economy or outlays. Most families and businesses have had to do with less than 3 percent, and I think it is something over a 10-year period, they have obviously had to do with less than that.

Dr. ELMENDORF. Yes.

Representative CAMP. And just lastly, I realize my time has expired. I do want to just ask you one quick thing.

We may come to agreement on impacts within the 10-year budget window, but we may have decisions that are outside of the 10-year budget window. And I just wanted to ask if you would be willing to work with us to find ways to measure the impact of policies outside the traditional budget window and if you would commit to helping us do that?

Dr. ELMENDORF. Yes. Absolutely, Congressman.

Representative CAMP. Thank you very much, and I yield back.

Chairman MURRAY. Representative Van Hollen?

Representative VAN HOLLEN. Thank you, Madam Chairman.

Let me just start, Dr. Elmendorf, by thanking you for your testimony and just say that—and this goes for Republicans and Democrats alike—we are all entitled to our own opinions, but not to our own facts. And the last time that our budget was balanced was back in the 2001, 2000 time period. And in fact, during that time, revenues as a percent of GDP was 20.6 percent in the year 2000 and 19.5 percent in the year 2001.

And the last time spending was 18 percent of GDP was about 1967, and it has risen since then largely because we, as a nation, decided to make sure that older Americans in their retirement had the health security they needed. So it is important to keep those facts in mind as we go forward.

Now you posed a very fundamental question to this committee, and let me ask you this. If we were to try and continue with current retirement and healthcare, security programs in the future, we would need significant changes to revenue beyond current law, would we not, in order to fund them and balance our budget, assuming we kept the rest of Government constant?

Dr. ELMENDORF. Yes. That is right, Congressman.

Representative VAN HOLLEN. And if we were to try to preserve those—let me ask you this. If we were to continue current revenue policy without any changes, it would require very deep cuts to those retirement and security programs, would it not, if we were to try and bring down the deficit?

Dr. ELMENDORF. If you also maintain the rest of the Government in accordance with its historical pattern, yes, Congressman.

Representative VAN HOLLEN. That is right. And as you pointed out in your testimony, in fact, over the next 10 years as a percent of GDP, that is going down, is it not?

Dr. ELMENDORF. Yes.

Representative VAN HOLLEN. Okay. So that is the fundamental question, and I think we recognize that we have to deal with the outyear issues. We have a demographic challenge. We have more and more people retiring. But as you just pointed out, if we want to avoid huge cuts to Medicare and to Social Security, we also have to deal with the revenue piece. In other words, we have to increase revenues beyond current policy if we want to avoid very deep cuts.

So I think it is important that we look at the revenue side of the equation right now, and you have presented that to us in your testimony. And I think it is time for this committee to get real and recognize that, yes, there are spending issues, especially in the outyears, but there is also a revenue issue.

Now, as you point out, under current law, the 10-year cumulative deficit is $3.4 trillion. Correct? Under current law.

Dr. ELMENDORF. I think it is a $3.5 trillion.

Representative VAN HOLLEN. Three and a half trillion dollars?

Dr. ELMENDORF. Yes.

Representative VAN HOLLEN. And as you point out on page 19 of your testimony, if we continue current tax policy and the current physician payments under Medicare, that will rise from $3.4 trillion to over $8.5 trillion. That is there in your testimony.

Dr. ELMENDORF. Yes.

Representative VAN HOLLEN. Now you mentioned those two factors together, but I think it is important to point out that of that over $5 trillion, that the huge bulk of it has to do with continuing current tax policy, does it not?

Dr. ELMENDORF. Yes.

Representative VAN HOLLEN. And in fact, by my calculation, you get just under $4 trillion on revenue. And if you add the debt service associated with that, you are talking about $4.5 trillion of your $5 trillion dealing with current revenue policy. Is that right?

Dr. ELMENDORF. Yes. That is right.

Representative VAN HOLLEN. So, just to be clear, if this committee were to adjourn today and the Congress were to adjourn for the next 10 years and go away, we would actually achieve greater deficit reduction than if we went, took the Simpson-Bowles advice and went big. Is that not right?

In other words, we would get over $4 trillion over that 10-year period, even if we fixed the doctor, physician reimbursement piece, right?

Dr. ELMENDORF. So if—let me make sure I have this right. If you extended those expiring tax provisions——

Representative VAN HOLLEN. That is right.

Dr. ELMENDORF [continuing]. And indexed the AMT for inflation——

Representative VAN HOLLEN. Yes.

Dr. ELMENDORF [continuing]. Then that would add to deficits by $4.5 trillion or so. That would be larger than the amount of savings if this committee stayed——

Representative VAN HOLLEN. It is simple math, right? It would be more than the $4 trillion that a lot of people talked about, right?

Dr. ELMENDORF. Yes. That is right.

Representative VAN HOLLEN. Okay. So I think it is important, as we look at this challenge, to look at both sides of the equation there. And what we are talking about, just so we can translate this into what the American people have experienced, what we would be talking about is essentially going back to the same tax rates and tax policy that was in effect during the Clinton administration, a period of time when 20 million jobs were created and the economy booming.

Now I am not suggesting we go back to that particular tax policy, but if you look at Simpson-Bowles compared to current law, they provide about a $2 trillion tax cut compared to current law, as opposed to $4 trillion. If you look at Rivlin-Domenici, they propose about a $1 trillion tax cut compared to current law, approximation.

So if we are really going to address this challenge, let's recognize that if we don't deal with the revenue piece, as Dr. Elmendorf said, you are talking about dramatic cuts to health and retirement security for America's seniors. We have to take a balanced approach. That is why the other bipartisan groups took that kind of approach.

Thank you, Madam Chairman.

Chairman MURRAY. Senator Toomey?

Senator TOOMEY. Thank you, Madam Chairman.

Since my colleagues have raised this issue, I just want to touch on a couple of things that didn't quite make it into the conversation so far. Isn't it true that as recently as 2007 the current tax rate structure yielded revenue that was about 18.5 percent of GDP?

Dr. ELMENDORF. I think that is right, Senator. Yes. The current level, of course, is very low because the economy is very weak.

Senator TOOMEY. Exactly. And the main reason that total revenue as a percentage of GDP is so much lower than the historical levels is because we have an economy that is still effectively in a recession, very high unemployment, very weak, lack of growth. Isn't that right?

Dr. ELMENDORF. Yes. That is right.

Senator TOOMEY. And as recently as 2007, the deficit that we had that year was about, if I remember correctly, less than 1.5 percent of GDP, I believe. And if we could get to the point where we consistently had deficits of 1.5 percent of GDP, then our debt as a percentage of our economy would clearly be declining, and we would have, to a very large extent, solved this problem, if not completely.

Dr. ELMENDORF. Yes. That is right. If you could—yes. That is right.

Senator TOOMEY. To the level of the deficit that we had in 2007, with the current tax rates. Let me ask a couple of other questions, if I could?

You went through, and I don't think there is any dispute that excessive debt has all kinds of negative implications—we all acknowledge that—including the possibility that we get to the point where you have a financial crisis, an economic freezing up.

Isn't it true that it is essentially impossible to know precisely when you get to that point?

Dr. ELMENDORF. Absolutely.

Senator TOOMEY. So it is just not knowable?

Dr. ELMENDORF. I think it is just not knowable.

Senator TOOMEY. Right. Isn't there a danger that the magnitude of the debt is already impeding economic growth, having a chilling effect on investment and risk taking? Isn't that possible?

Dr. ELMENDORF. I think the level of debt is probably weighing on economic activity. All things equal, of course, we wish we had less.

Senator TOOMEY. Right.

Dr. ELMENDORF. I think the question is how to proceed from here.

Senator TOOMEY. I guess the point I want to make is given that it is probably already weighing on economic growth and given that we acknowledge that continuing down this path eventually leads to a full-blown crisis and we can't know when, that suggests to me that it is very dangerous to delay making meaningful reform. And while there is some concern that curbing the size of the deficit in the short run impedes economic growth, I would argue that it is already happening.

And if we—if the future promised reductions in the deficit either weren't credible or at some point became less credible, then we could discover we are already in that territory where the financial crisis could emerge. Isn't that a danger that we would run in delaying this?

Dr. ELMENDORF. I think there are disadvantages to delay, Senator, as we said in the written testimony and as I repeated here. Again, based on our analysis, which I think is consistent with a consensus of professional opinion, immediate increases in taxes or cuts in spending would slow the economic recovery. But that is not meant to imply that there aren't a variety of factors that can matter in different ways, not meant to imply that we are sure we have that right.

But that is, I think, the consensus of professional opinion.

Senator TOOMEY. It might be, but there certainly is an alternative point of view about that, especially with regard to the spending side.

Dr. ELMENDORF. Yes, Senator. That is right.

Senator TOOMEY. And even though you and I might disagree on this debate somewhat, I am sure you would agree that when it comes to its impact on economic growth, not all Government spending is equal.

Dr. ELMENDORF. That is absolutely right.

Senator TOOMEY. Spending in your models would generate more rather than less. Similarly, not all tax cuts are comparable, right?

Dr. ELMENDORF. Exactly.

Senator TOOMEY. Some encourage economic growth more than others?

Dr. ELMENDORF. Exactly.

Senator TOOMEY. And in fact, crudely speaking and broadly speaking, that spending and tax cuts, while they may arithmetically have the same impact on the deficit if you assume they have no other implications, in fact, they do have other implications?

Dr. ELMENDORF. That is right. And when we do economic modeling of the consequences of alternative fiscal policies, we try to capture that. We incorporate the level of marginal tax rates on labor and capital and those effects on work and on saving.

Senator TOOMEY. Right. And on page 33 of your testimony, you observe that lower marginal rates enhance the incentive to work and save and invest, and that has a pro-growth feedback on the economy.

One of the things we haven't discussed, but I would like your reflection on, is the possibility of a revenue-neutral tax reform that simplifies the code, broadens the base, and lowers marginal rates. Wouldn't that tend to enhance growth and, therefore, enhance revenue to the Government?

Dr. ELMENDORF. Yes. That is right, Senator. The magnitude of that effect, of course, depends on the specifics of the policies that would be enacted.

Senator TOOMEY. Right. And so, I wonder if you have a rule of thumb that you could share with us. For instance, for a given incremental increase in the rate of growth on average, what kind of impact does that have on the deficit over an extended period of time?

Dr. ELMENDORF. Well, so we offer our rules of thumb for that in the back of our annual Budget and Economic Outlooks. And the magnitude of that effect I will offer to you in one moment.

Senator TOOMEY. A figure that comes to mind, and maybe you could confirm or refute, is that a 0.1 percent of additional growth on average sustained over 10 years is roughly $300 billion in additional revenue? Is that about——

Dr. ELMENDORF. Yes. That is just right.

Senator TOOMEY. So a full percent, I mean, this may not be perfectly linear, but it certainly goes in the same direction?

Dr. ELMENDORF. Yes. It almost certainly isn't perfectly linear, and we offer these rules of thumb for small changes because we are just not sure what else might happen with very large——

Senator TOOMEY. The point is a small, sustained change in growth has a huge impact on the deficit or reducing the deficit. Would you agree with that?

Dr. ELMENDORF. Yes. That is right.

Senator TOOMEY. Thank you.

Thank you, Madam Chairman.

Chairman MURRAY. I thank you very much. And we have gotten through our first round here, and I appreciate everybody keeping it concise.

I am going to have to use the prerogative of my chair to make a small change at this time. The House is going to be having votes at approximately 1 p.m. There are 12 of us, and the time is very short. So unless somebody throws something at me, I am going to limit each of us to 2 minutes in the final round and would ask everybody to please keep it to that timeframe.

Dr. Elmendorf, let me just ask, as you have been talking about, in the long-term budget report from January, CBO included an analysis on the impact of lower than expected economic growth on the Federal budget. I wanted to ask you, what does CBO estimate is the impact on the deficit projections in the near term and over the next 10 years if GDP growth continues to weaken beyond what is reflected in the current estimates?

Dr. ELMENDORF. So, certainly, a weaker economy implies worse budget outcomes, primarily because tax revenues fall. Also because there is some extra spending in some of the entitlement programs that we talked about a moment ago.

We have not done quantitative estimates of budget outcomes for other particular scenarios beyond what is in these rules of thumb that we have offered in our volume in January. And the rules of thumb are rough because a lot of things can or may not rise and fall with the rest of the economy.

We have been surprised in the past few years at some of the outcomes of tax revenue even given the state of the economy. But there is no doubt that a weaker economy is worse for the budget and a stronger economy is a lot better for the budget. The challenge is how to move the economy, and it is not easy to move a $15 trillion economy.

Chairman MURRAY. Thank you.

I do have a question about sequestration. I am going to submit it for the record because I do think it is important. As hard as the choices we are looking at here, we need to understand the impact of that, and I appreciate the information you have put out on that.

But the significant impacts to sequestration I think need to be understood by our committee as well. So I will submit that for the record.

Dr. ELMENDORF. I will be happy to answer it, Senator.

Chairman MURRAY. And reserve my time and turn it over to Mr. Hensarling.

Co-Chair HENSARLING. Dr. Elmendorf, I think it was Senator Kerry who brought up that revenues today are roughly at 14 percent of GDP. Doesn't your latest budget estimate under a current policy baseline show that revenues go back to their historic norm of 18 percent of GDP in 2014?

Dr. ELMENDORF. Yes. That is right, Congressman. They are a little over 15 percent today, and the improvement in the economy and other underlying factors in the tax code we think will push that up to a little over 18 percent under current policy.

Co-Chair HENSARLING. Your alternative fiscal scenario, which is a current policy baseline, also shows spending going from a historic average of roughly 20.5 percent up to 34 percent of GDP. Is that correct?

Dr. ELMENDORF. That sounds about right, Congressman.

Co-Chair HENSARLING. So is it fair to say that with respect to revenues, one is episodic related to the lack of economic recovery, the other is structural. Is that a fair assessment?

Dr. ELMENDORF. Yes. Both factors are at work right now, Congressman, and——

Co-Chair HENSARLING. Let me continue on there. Those who have advocated or have brought up that historically when the budget has been balanced, taxes have gone beyond their historic norm of roughly 18 percent of GDP to closer to 20 percent of GDP. And again, this is your alternative fiscal scenario shows that spending by 2035 goes up to 33.9 percent, and the same alternative fiscal scenario shows that taxes already on a path to increase from 18 percent of GDP to 18.4.

So following the analysis of those who advocate that in order to achieve a balanced budget that revenues have to come up from what you say they are already rising, from 18.4 to, say, 20 percent of GDP, wouldn't the analysis also suggest under a balanced approach that spending has to decrease essentially 14 percentage points under your alternative fiscal scenario to reach its historic norm?

Dr. ELMENDORF. So, Congressman, I would rather not parse the meaning of the word "balance," given its role, apparent role in your discussions. But you are right that if revenues were at 20 percent of GDP, then balancing the budget, given the assumptions, it would require a reduction in spending.

Co-Chair HENSARLING. Thank you.

Chairman MURRAY. Representative Becerra?

Representative BECERRA. Dr. Elmendorf, I think I am going to start calling you "Sergeant Friday." You are here essentially giving us at least your best interpretation of the facts, and we appreciate that because you are not trying to give us opinion. You are not telling us whether in 5 years or 10 years we should reduce the benefits we give to seniors under Medicare or make a change to our defense and security needs.

You are simply telling us what the numbers show and leaving it to us as policymakers to come up with a good mix. And I appreciate that. I suspect your mother or father or your grandmother or grandfather are probably also pleased that you are just talking numbers and not saying what should be done to them with regard to Medicare or Social Security or anything else.

One quick point, with regard to the discussion of our long-term costs, you mentioned Medicare and Social Security and Medicaid. Medicare and Medicaid, because they deal with healthcare and healthcare costs, are in a different boat than Social Security, are they not, in terms of their long-term costs?

Dr. ELMENDORF. Yes. That is right. The increases in spending for those programs that we project under current law are a lot greater over time than for Social Security.

Representative BECERRA. And indeed, Social Security, by about 2028, 2030, starts to stabilize and stays pretty constant in terms of its cost to the Federal Government into the outyears, right?

Dr. ELMENDORF. Yes. Roughly so. After the baby boom generation has primarily retired, that line roughly levels out.

Representative BECERRA. And because you are dealing with facts, you are not here to tell us about how to make that fix to healthcare because the reality is that Medicare and Medicaid are simply reimbursement or financing systems. If we were to just cut benefits for a senior, that doesn't necessarily mean that their healthcare cost will drop. That shifts the cost more into the pocket of the senior to pay for that care if Medicare just reduces what it reimburses?

Dr. ELMENDORF. I think it depends on the policy, of course. But there are some policies that shift cost, and there may be some policies that reduce overall costs.

Representative BECERRA. Thanks, Sergeant Friday. Appreciate it.

Dr. ELMENDORF. Thank you, Congressman.

Chairman MURRAY. Senator Kyl?

Senator KYL. Thank you, Dr. Elmendorf.

Just one question in the interest of time here. While I know you agreed with Senator Toomey's observation that there is another point of view or other points of view, regarding your argument that cuts in spending now can harm economic growth or delay economic recovery, that is true of defense spending as much as other spending. Is that not correct?

Dr. ELMENDORF. It is true of potentially all types of spending. There may be differences across types, but I think that is a more subtle distinction.

Senator KYL. Yes. And here, with defense, for example, you have high unemployment of returning veterans to begin with. You have the reduction in end strength. You have more people potentially unemployed. You have people making radios and building ships and so on. And if those cuts, therefore, end up reducing the employment in those industries and the amount of money spent in those areas, obviously, it could delay economic recovery.

Dr. ELMENDORF. Yes. That is right, Senator.

Senator KYL. Thank you.

Chairman MURRAY. Senator Baucus?

Senator BAUCUS. Thank you, Madam Chairman.

I wondered, Dr. Elmendorf, if you could just again, we discussed a little bit of it already, what changes either let's say in tax policy will stimulate the economy most, if you could rank them somehow?

Dr. ELMENDORF. Well, as it turns out, in the table which you are looking, Senator, from our January 2010 report, we did consider the effects of a set of alternative tax cuts. We have not updated this table since that point. If we did, I think the numbers would be slightly different, but probably not fundamentally different.

Reductions in payroll taxes that we studied here were among the more powerful levers, followed by expensing of investment costs, and then followed below that by a little bit by broader reductions in income taxes. And the reason for that difference is principally that the money that is saved by employers or employees in payroll taxes we think translates into a fairly comparatively large amount of incremental spending. And also in the case of a cut to what employers pay amounts to at least a temporary discount on the cost of hiring workers.

Senator BAUCUS. Let me change subjects. If we have a revenue-neutral tax reform, corporate or individual, and the tax reform, let's say, on the individual side is dramatic, broaden the base, lowering the rate, et cetera, how much growth would result from a very simplified tax code along those lines?

Dr. ELMENDORF. A tax code with a broader base and lower rates would spur economic growth, but the magnitude is something we would have to take specific proposals from you back to our models and work hard on them for a while before we could hazard any sort of quantitative estimate.

Senator BAUCUS. Okay. Thank you.

Dr. ELMENDORF. Thank you, Senator.

Chairman MURRAY. Representative Upton?

Representative UPTON. Thank you.

I am concerned about the impact of the Affordable Care Act on job creation. Can you provide us a detailed explanation of the methodology used to calculate how many employers will actually drop their healthcare coverage for their employees?

Dr. ELMENDORF. I can provide a brief summary in the next minute and three-quarters, Congressman. We have a model of health insurance coverage in which employees and employers are trying to obtain coverage at low cost, but also giving weight to the quality of the coverage they receive.

In our analysis, the Affordable Care Act encourages some employers to provide insurance coverage who would not have otherwise because of the mandate for insurance coverage and some of the subsidies. On the other hand, it encourages other employers who would have offered coverage not to offer any more. And we think that latter effect outweighs the former, and we have a small reduction in employer-sponsored insurance coverage.

Our estimates are very consistent with the estimates of other people, with large-scale models like those at the Urban Institute. Obviously, there is a tremendous amount of uncertainty around those estimates, and there have been some surveys that have suggested there would be more employer dropping.

At this point, based on the things that we have seen since we did those estimates, we are comfortable those estimates make sense. But it is an issue where we have been asked to explore the sensitivity of the budgetary effects to alternative outcomes in terms of employer-sponsored insurance coverage, and we are working on those estimates now.

Representative UPTON. Could you actually provide us maybe a dial-up? I don't know what your percentage is. I thought it was like as low as 5 percent or less?

Dr. ELMENDORF. It is a small percentage. I am not exactly sure.

Representative UPTON. Yes. And I wonder if you could provide us an estimate, if it was maybe 10 or 20 percent?

Dr. ELMENDORF. So the challenge we have is that it matters a lot for budgetary cost who ends up with and without employer-sponsored health insurance coverage. So we can't really do just a scaling up in that sense. We have to understand in the model, and there are ways to change the assumptions in the model to give different answers. But we need to do that because that will affect the budgetary cost.

It is also not obvious that the budgetary cost is as large as it may seem at first. If people are not getting employer-sponsored coverage and move to the exchanges, they will pay—the Government will pay more for their coverage. On the other hand, the employers will have extra money that they were previously using to buy health insurance with. Most economists think that money will turn up as wages for workers. They will pay taxes on that.

If it doesn't, it will turn up as additional corporate profits, and they will pay tax on that. So the overall budgetary effects will depend on the combination of changes in exchange subsidies, in Medicaid costs, and in tax receipts. But we are working on that, Congressman.

Representative UPTON. Thank you.

Chairman MURRAY. Thank you.

Representative Clyburn?

Representative CLYBURN. Thank you, Madam Chair.

Dr. Elmendorf, let me look at revenue from a different perspective here. Is it fair to say that the decrease—or the increase in unemployment has decreased revenue going into the Federal coffers?

Dr. ELMENDORF. Yes. That is right, Congressman.

Representative CLYBURN. If we had a decrease in unemployment of just, say, 0.5 percent—from 9.1 to 8.6—what would be the level of revenue increase?

Dr. ELMENDORF. I can't do that in my head, Congressman. It would help, but I don't know. And it would help partly because we would pay less unemployment insurance benefits and partly because of people who are earning money would pay taxes on those earnings.

Representative CLYBURN. So it is a double whammy.

Dr. ELMENDORF. Both sides of the budget would be affected.

Representative CLYBURN. I would like to see some computer printout.

Dr. ELMENDORF. I will task my computer with that assignment, Congressman.

Representative CLYBURN. I appreciate it. Thank you.

Chairman MURRAY. Senator Portman?

Senator PORTMAN. I think Congressman Clyburn has just made a great point, which is the economy plays such a huge role here. And since this is a hearing about the history of how we got here, I have gone back and looked at your May 12, 2011, report, which talked about earlier 32 percent of the difference between a $5.6 trillion surplus projected and the $6.2 trillion deficit, which is an $11.8 trillion swing, 32 percent of that is because of the economy.

And about 33 percent of it is new spending. About a third of that spending is for global war on terror—Iraq, Afghanistan, and other spending on the war on terror. It is about 39 percent is due to new spending when you add the 6 percent that is the stimulus.

Fifteen percent is the Bush tax cut. By the way, over 70 percent of that went to those making less than $250,000 a year. And then the rest is interest and the AMT and the rebates in 2008.

So I think it is a great point that the economy is going to drive so much of this. And we talked about this earlier, but you said that you thought that increasing taxes at this point would have a negative impact, just as you thought that certain spending cuts would have a negative impact on economic growth and jobs.

But then, in response to Senator Baucus, you said that some tax reform, particularly lowering the rates, broadening the base, would have a positive economic impact. Can you briefly speak to that as it relates to the corporate tax code and the possibility also of lowering the rate to make the U.S. more competitive?

Dr. ELMENDORF. So I think that in terms of both the individual income tax and the corporate income tax, economists widely agree that lower tax rates and broader base would be good for the economy both because the lower rates would reduce the disincentive to worker to save and also because broadening the base itself can, if done in certain ways, reduce the incentives for misallocating capital resources.

Again, to actually estimate the effects on the economy, we or our colleagues at the staff of the Joint Committee on Taxation would need to have specific proposals and would need to spend some time trying to model those. It is a very complicated business, as you know, Senator.

Senator PORTMAN. How long would it take you?

Dr. ELMENDORF. I will not commit to that. Offhand, if we have proposals from you, we will work on them as fast as we possibly can. I will certainly promise you that.

Senator PORTMAN. And prioritize them, right?

Dr. ELMENDORF. We are giving very high priority to the work of this committee, Senator.

Senator PORTMAN. Thank you, Madam Chair.

Chairman MURRAY. Senator Kerry?

Senator KERRY. There is a big distinction, is there not, almost obvious, Dr. Elmendorf, if 98 percent of America was getting a tax cut and 2 percent, who happen to be the wealthiest people whose decisions are very different and whose impact on the economy is very different, there is a big difference in that versus sort of a blanket discussion of all of the tax cut versus none. Correct?

Dr. ELMENDORF. In terms of the economic effects, yes, Senator.

Senator KERRY. Yes.

Dr. ELMENDORF. We think that is right.

Senator KERRY. And I think that is part of the modeling that needs to be done here because I think that distinction will be very telling in a lot of ways.

What I want to ask is I think it would be helpful to all of us on the committee, I have great respect for the Rogoff-Reinhart analysis. In fact, I suggested we might get them in here, and I think it is an important one. But, and here is the "but," and I would like you to draw the distinction for us.

Your analyses and much of our discussion centers around the public debt. The public debt is 62 percent, I believe, of GDP. But we have had a number of references here to the gross debt, which obviously includes all of the trust funds and so forth, where there is a very different impact because of the full faith and credit of the United States and printing and so forth.

Help us understand how that distinction might play out in our deliberations, particularly with respect to the impact on interest rates. I think the public debt has far more impact on interest rates than on the economic judgments, does it not? So maybe you can just educate us a little bit on that distinction between them.

Dr. ELMENDORF. Yes, Senator. So CBO focuses on debt held by the public because we think that is a better measure of the impact of Federal borrowing on financial markets today than gross debt. Of course, any snapshot of what the Government owes at a point in time will be very incomplete without looking at where the fiscal trajectory is going, and that is why we always combine our reporting on current levels of debt held by the public with projections of revenues and spending. And certainly, financial markets are very attentive not just to the current amount of debt, but also to the amount of debt they would expect the Government to be trying to get them to buy in years ahead.

But our view is that debt held by the public, together with these projections for the future, offers you and your colleagues a fairly complete, by no means perfect, but a fairly complete picture of the Federal budget situation.

Gross debt, which, as you said, includes money, includes bonds held by various Government trust funds, we think does not really measure the amount of—does not measure the amount of debt that the private financial system has been asked to absorb today, nor is it a very good measure of what will happen in the future because for some programs, the amount of debt held in those trust funds is a lot less than the amount that they will need to pay benefits under current law. In other cases, the amount of debt held in the trust funds doesn't actually correspond to future spending. So we just don't think that is the most useful measure.

Now in the work that Carmen Reinhart and Ken Rogoff did, they viewed that as the best available measure for the set of countries over the period of time that they have done this analysis for. And I don't want to put words in their mouth, but we have discussed this issue with Carmen.

And, but I think in our case, because we do these very elaborate projections on a very detailed level of the budget, that combining those projections with debt held by the public gives you and your colleagues the best sense of where this country stands today.

Senator KERRY. Thank you.

Chairman MURRAY. And Representative Camp?

Representative CAMP. Thank you very much.

I just wanted to point out that as part of the fiscal commission, I researched how often Federal revenues exceeded 20 percent of GDP in the history of our country, and we found they have only done it three times since—in the history of our country—in 1944, in 1945, and 2000.

And in 2000, they were 20.6 percent of GDP revenues, and that was really largely due to the threefold increase in capital gains from $40 billion in 1999 to $12 billion—or $121 billion in 2000. So that was what drove that.

Is that and——

Dr. ELMENDORF. I think that is right, Congressman.

Representative CAMP. Thank you.

And in the 11 fiscal years since 1940, we have had surplus revenues for 4 of those years between 19 and 20 percent, and for 7 of those years, they were less than 19 percent of GDP.

So I have a letter that outlines all of this that I would like to submit for the record. And I just think it is important to point out that, again, during the 12 years in which the budget was in surplus, outlays never exceeded 19.4 percent of GDP, and I think it is important to keep those revenue levels in historical perspective.

Chairman MURRAY. Representative Van Hollen?

Representative VAN HOLLEN. Thank you, Madam Chairman.

I would again point out that the last time Federal spending was around 18 percent of GDP or lower was about 1967. We made a decision in this country to provide for health security for seniors. So we have really got to look at that period of time since then if we want to continue that commitment, including what years the budget was in balance, which was in 2000–2001 period.

Look, Dr. Elmendorf, I think you have made a very good point in your testimony. I know you are not making recommendations, but I think your testimony was clear that you can't address the deficit challenge without modernizing the health security programs, unless you have large increases in taxes above even current law. But unless you change current tax policy, you can't address the deficit situation without deep cuts in health security programs.

Now I just want to have a quick question. You mentioned that there are some tax policies that generate more economic activity, some that generate less. You mentioned the payroll tax holiday is one that generated relatively more than some of the others because more money in people's pockets.

Isn't it also true that with respect to spending programs, there are some that generate more activity than others in the economy and that investments in the area of infrastructure and education provide for economic growth? Isn't that also the case?

Dr. ELMENDORF. Yes. But just give me one moment to say that I want to be careful about the pieces of the budget. There are revenues. There is Social Security and the major healthcare programs on my chart, and there is the rest of the budget. And I don't think you disagree with this, Congressman.

But the thing that is not possible to do is to maintain Social Security and the major healthcare programs in their current state and maintain the rest of the Federal Government at the same share relative to the size of the economy it has been in the past and maintain revenues at their historical average share of GDP.

Representative VAN HOLLEN. Right.

Dr. ELMENDORF. One needs to move at least one. One could also choose to move any two or three of those as you choose. What is not possible, as a matter of arithmetic, given the aging of population and rising healthcare costs, is to have all three of those pieces look like they looked historically.

And different policies on the spending side do have different effects in economic growth, and they do at different horizons. So some policies might be more effective this year or next. Others might be more effective over longer periods of time, and we can try to provide that sort of information to you and others if you are interested in that.

Representative VAN HOLLEN. I appreciate that, Dr. Elmendorf. I am just making the point that both tax policies, as well as investment, spending policies, both can have positive economic impact. Is that right?

Dr. ELMENDORF. Yes. That is right.

Representative VAN HOLLEN. Thank you.

Chairman MURRAY. Senator Toomey?

Senator TOOMEY. Thanks, Madam Chairman.

Dr. Elmendorf, one of the challenges that we face is how we can address these challenges in a credible way, right? How, for instance, willing will future Congresses be to abide by spending caps or other kinds of reductions or disciplines that we might try to impose? And of course, we cannot tie the hands of future Congresses.

So I wonder if you might reflect on ways that we could maximize the chances that future—that spending restraints that we would hope to achieve would, in fact, come to pass, whether that would be through strengthening existing budget enforcement mechanisms, creating new ones, or other ways that we might do that.

Dr. ELMENDORF. I think, Senator, the most effective way to ensure that changes you discuss today actually become—take effect later is to enact those changes into law today. Enforcement procedures are only a backstop. Ultimately, the Congress will need to enact changes in the legislation governing certain programs or provisions to the tax code if it wants to make those changes.

And if specific changes are enacted into law this year, then I think there is a much greater chance that they will take effect when the time comes than if what is enacted into law this year is simply a set of objectives for total amounts of spending or total amounts of taxes or other sorts of benchmarks.

Senator TOOMEY. So structural reforms in a program are likely to have more enduring results than long-term caps designated. Would you agree with that?

Dr. ELMENDORF. Yes, I think that is right. And I think we have seen that historically. The original Gramm-Rudman legislation, Gramm-Rudman-Hollings, was cast aside because the overall target that it set for the deficit proved to be impossible to meet. Whereas the provisions of the early 1990s, the PAYGO provisions that tried to make it more difficult for the Congress to make deficits worse, seem, to most observers, to have been at least somewhat effective during the period when the Congress was very concerned about budget deficits.

So I think it is the important aspect of this for both the long-term effects and also for the shorter-term effects in terms of people believing the deficits will be smaller in the future comes from specificity in putting provisions into law today, even if they are timed to take effect, for various different reasons, at different points in the future.

Senator TOOMEY. Thank you.

Chairman MURRAY. Thank you very much.

I want to thank all of our committee members for being so accommodating. Dr. Elmendorf, certainly, for your input and your staff's input for today as well.

I want to remind all of our members that they have 3 business days to submit questions for the record, and I hope that the witness can respond quickly to that.

Dr. ELMENDORF. Yes, we will.

Chairman MURRAY. Great. Thank you.

And members should submit their questions by the close of business on Friday, September 16th.

[The information follows:]

Chairman MURRAY. Without objection, the joint committee stands now adjourned.

[Whereupon, at 1:10 p.m., the committee was adjourned.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Senator Max Baucus

Founding Father Patrick Henry once said, "I know no way of judging the future but by the past."

Today, we examine the past for lessons to improve our economic future to reduce the deficit, to create jobs that put Americans back to work and to regain the certainty our country needs to thrive in the global economy.

The world is closely watching what we do here and the next steps we take as a country to confront our deficits. We can do this. We've already begun the process by cutting $900 billion. We've already taken the first step.

And while the road ahead will not be easy, we have a duty to think even bigger and aim even higher to ensure our country is on sound fiscal footing for the long term. We have a duty to ensure that we approach these cuts in a balanced manner that creates jobs here at home.

I was back home in Montana again this weekend, and folks kept repeating the same thing: "Let's get it done." They want to see results. They want us to work together and find a balanced approach to cut our debt and create jobs, and I bet my colleagues hear the same thing when they go home as well. It's time to listen to these folks and work together to get our economy moving again.

Today we review the sources of the problem. A number of factors created our current deficit: the cost of two wars; long-term health care costs, which we began to tackle in health reform; a stagnant economy which increased spending; and reduced federal revenues, which are at historic lows.

Today, federal revenues make up only 15 percent of GDP, compared, for example, to 17 to 19 percent during the Reagan Administration. A combination of factors created the deficit; and it will take balance to solve it. There is no silver bullet to fix this problem.

So let us listen to the wisdom of the folks back home who want us to work together to craft a balanced solution, let us look to the past for lessons -- not blame -- and let us focus on creating jobs and improving our economy for the future.

Representative Xavier Becerra

Opening Statement

"I thank the two co-chairs and thank Dr. Elmendorf for being with us.

The creation of this joint select committee on deficit reduction is the direct result of legislative policies and economic recessions that have hit us over the last ten years and that have caused the Congressional Budget Office's (CBO) $5.6 trillion surplus in 2001 to turn into a more than $6 trillion deficit that we see today.

So to know where to go with the work that we have to do, you have to know from where we came. Today we will hear about how we lost our way.

What we will hear is that a select few in this country enjoyed the additional government spending that occurred in those ten years while the rest of Americans are being confronted with paying the tab.

In January 2001 CBO's assessment in its yearly budget and economic outlook report was this: 'the outlook for the federal budget over the next decade continues to be bright. Assuming that current tax and spending policies are maintained, the CBO projects that the mounting revenues will continue to produce growing budget surpluses for the next ten years.' But as we all know, current tax and spending policies were not maintained.

Dr. Elmendorf, it is exactly these policies that induce the federal deficit which I want to explore in my questioning with you today. Decisions were made to extinguish a $5.6 trillion surplus.

The individuals and groups who received the most benefits should be willing and ready to ante up to meet their patriotic duty, to contribute revenue and necessary spending decisions to heal this country's long-term fiscal situation.

We need to ask ourselves: was it the senior citizen, the student, or the Wall Street banker who received the benefit of this spending binge?

When we have our answer we should ask the appropriate person or group to pay their fair share to right the wrong of running up the government's debt.

I look forward to working with my colleagues to take the responsibility of improving job creation in this country and fixing the long term deficits that we face to ensure that those responsible for our deficits pay their fair share."

Representative James Clyburn

Opening Statement

WASHINGTON, DC—Assistant Democratic Leader James E. Clyburn today released the following statement on the Joint Select Committee on Deficit Reduction's hearing with Dr. Douglas Elmendorf, Director of the Congressional Budget Office. Below is Clyburn's statement as prepared for delivery:

"Thank you, Madam Chairwoman and Mr. Chairman, and Dr. Elmendorf, thank you for taking the time to talk with us today.

"I think it is appropriate that today's hearing is entitled 'The History and Drivers of our Nation's Debt and Its Threats.' If we want to solve the related problems of debt and joblessness, we need to know how these problems arose.

"In 2000, we had a $236 billion surplus and had begun paying down our national debt. The economy was booming for all Americans, unemployment was at 4 percent, and the poverty rate dipped to its lowest level since 1979. Instead of building on the policies that had served us so well, we embarked upon two wars, one of which was dubious at best. Using credit cards, we instituted two tax cuts totaling $1.8 trillion which were tilted in favor of millionaires and billionaires, we created a new prescription drug benefit program which CBO estimates will cost $967 billion over the next ten years, and we allowed mortgage lenders to gamble away the economic prosperity of millions of Americans. And then it was declared that 'deficits don't matter.' This special committee was created because deficits and debt do matter.

"Now we find ourselves with painfully slow growth, unacceptably high unemployment, deficits as far as the eye can see, and a mounting long term debt burden.

"As we work together to achieve significant deficit reduction, it is important to remember how we got here. Many factors got us into this situation, and many factors are needed to get us out. We must balance the budget with a balanced approach that includes job creation, revenue increases, and smart spending cuts. Shared sacrifice will be required. We cannot solve the problem on the backs of the most vulnerable in our society, who have had nothing to do with causing it.

"I am willing to make tough compromises. I have said that if the distance between an opponent and me is five steps, I am willing to take three as long as the other side takes the other two.

"Dr. Elmendorf, thank you again for being here, and I look forward to discussing these issues with you in the question and answer period."

Congressional Budget Office

Testimony

Statement of
Douglas W. Elmendorf
Director

Confronting the Nation's Fiscal Policy Challenges

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

September 13, 2011

This document is embargoed until it is delivered at 10:30 a.m. (EDT) on Tuesday, September 13, 2011. The contents may not be published, transmitted, or otherwise communicated by any print, broadcast, or electronic media before that time.

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

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

Summary

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

The Economic Outlook

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

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

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

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

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

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

The Budget Outlook

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

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

- Provisions of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Public Law 111-312, referred to in this testimony as the 2010 tax act) that reduced the payroll tax for one year and limited the reach of the alternative minimum tax (AMT) for two years are set to expire on December 31, 2011.

- Several other key provisions of the 2010 tax act—including the extension of lower tax rates and expanded credits and deductions originally enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001, the Jobs and Growth Tax Relief Reconciliation Act of 2003, and the American Recovery and Reinvestment Act (ARRA, P.L. 111-5)—are set to expire on December 31, 2012.

- Medicare's payments for physicians' services are scheduled to be reduced by nearly 30 percent after December 31, 2011.

- Discretionary appropriations between 2012 and 2021 will be subject to statutory caps set in the Budget Control Act of 2011 (P.L. 112-25) that will reduce discretionary spending in real (inflation-adjusted) terms over time.

- Additional budgetary savings of more than $1 trillion required by the Budget Control Act will occur as a result of legislation produced by this Committee or, if lawmakers fail to enact such legislation, by means of automatic cuts in spending that will then be triggered.

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

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

Although new long-term projections reflecting the latest 10-year projections would differ, the amounts of federal borrowing that would be required under those policy assumptions clearly would be unsustainable. Interest payments on that debt would rise dramatically relative to the size of the tax base that would be available for generating revenues to cover those payments, consuming an ever-growing share of the federal budget. Even before the interest burden became unsupportable, a fiscal crisis could arise if participants in financial markets lost confidence in the government's ability to manage its budget and became unwilling to lend to the government at affordable rates. Thus, under current policies, the federal budget is quickly heading into territory that is unfamiliar to the United States and to most other developed countries as well.

Fiscal Policy Choices

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

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

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

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

Furthermore, lawmakers might decide that some of the current policies that are scheduled to expire under current law should be continued. In that case, achieving a particular level of debt could require much larger amounts of deficit reduction through other changes in policy. For example, if most of the provisions in the 2010 tax act were extended, if the AMT was indexed for inflation, and if Medicare's payment rates for physicians' services were held constant, then reducing debt held by the public in 2021 to the 61 percent of GDP projected under current law would require other changes in policy to reduce deficits over the next 10 years by a total of $6.2 trillion, rather than the $1.2 trillion in deficit reduction that this Committee would have to accomplish to avoid the automatic budget cuts required by the Budget Control Act.

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

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

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

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

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

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

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

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

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

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

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

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

The Economic Outlook

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

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

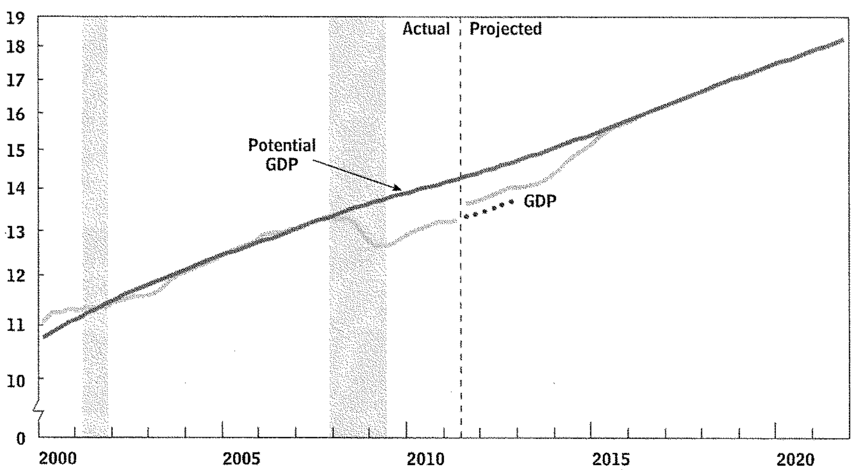
2. See Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2011).

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

Figure 1.

Real Gross Domestic Product

(Trillions of 2005 dollars, logarithmic scale)



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

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

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

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

The economic outlook remains highly uncertain. The recent recession was unusual compared with previous ones in terms of its causes, depth, and duration. As a result, the recovery has had unusual features that have been hard to predict, and the path of

the economy in coming years is also likely to be surprising in various ways. Many developments, such as changes in the degree to which households want to further reduce their debt burdens or the adoption of fiscal policies that differ from current law, could cause economic outcomes to differ substantially, in one direction or the other, from those CBO has projected.

Recent Developments

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

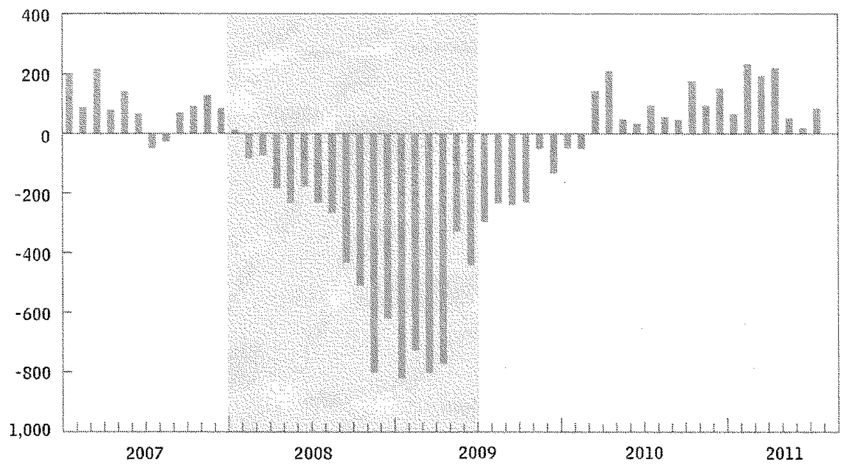
Moreover, employment growth has slowed in the past few months. The total number of jobs increased at an average monthly rate of about 180,000 in the first four months of this year, more than double its average pace in 2010 (see Figure 2). However, employment growth has ebbed again, averaging only 40,000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

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

Figure 2.

Net Job Growth per Month

(Thousands of jobs)



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

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

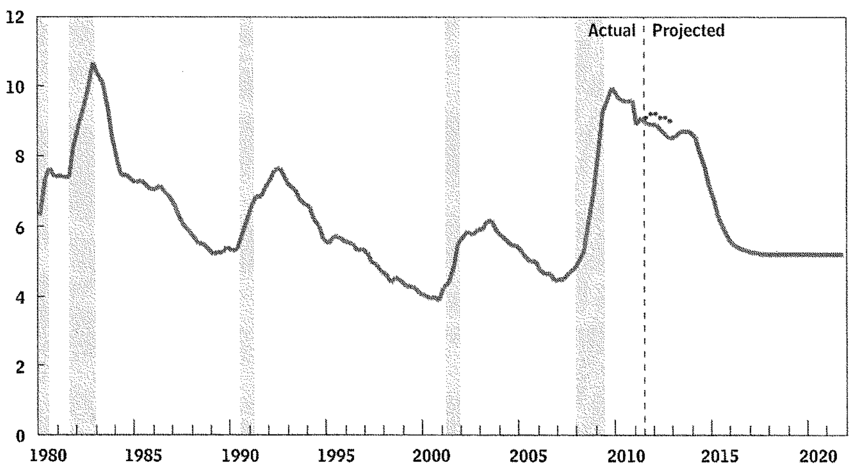
Prospects for world economic growth have also deteriorated since early July, which suggests a weaker outlook for U.S. exports. Recent data reveal that growth slowed in major foreign economies during the second quarter of 2011. The annualized growth of real GDP in the euro zone slowed to 0.6 percent in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

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

Figure 3.

Unemployment Rate

(Percent)



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

Notes: The unemployment rate is a measure of the number of jobless people who are available for work and are actively seeking jobs, expressed as a percentage of the labor force.

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

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

The Economic Outlook for 2011 and 2012

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

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

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

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

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

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

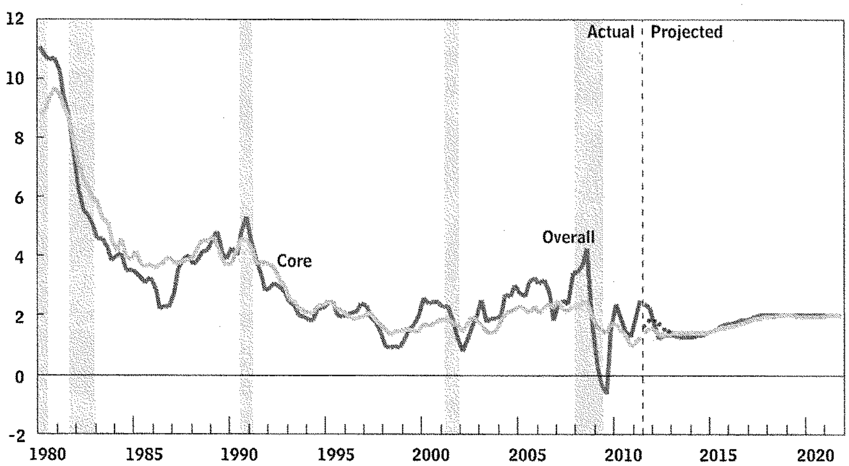
CBO now projects that the price index for personal consumption expenditures (PCE) will increase by about 2½ percent this year and by about 1½ percent next year (as measured by the change from the fourth quarter of the previous year). The "core" version of the PCE price index, which excludes prices for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

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

Figure 4.

Inflation

(Percentage change in prices from previous year)



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

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

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

The Output Gap and Its Costs

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

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

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

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

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

Uncertainty in the Economic Outlook

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

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

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

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

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

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

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

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

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

The Budget Outlook

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

CBO's Budget Projections for 2012 to 2021

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

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

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

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

Table 1.

CBO's Baseline Budget Outlook

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

Source: Congressional Budget Office.

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

n.a. = not applicable.

a. Includes effects on debt service.

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

- Provisions of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 that reduced the payroll tax for one year and limited the reach of the alternative minimum tax for two years are set to expire on December 31, 2011.

- Several other key provisions of the 2010 tax act—including the extension of lower tax rates and expanded credits and deductions originally enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001, the Jobs and Growth Tax Relief Reconciliation Act of 2003, and the American Recovery and Reinvestment Act are set to expire on December 31, 2012.

- Medicare's payments for physicians' services are scheduled to be reduced by nearly 30 percent after December 31, 2011.

- Discretionary appropriations between 2012 and 2021 will be subject to statutory caps set in the Budget Control Act of 2011. If adhered to, those caps will reduce discretionary outlays by about 5 percent in real terms over the 2012–2021 period relative to spending in 2011, CBO estimates.[10]

- Additional budgetary savings of more than $1 trillion required by the Budget Control Act will occur as a result of legislation produced by this Committee or, if lawmakers fail to enact such legislation, by means of automatic cuts in spending that will then be triggered.

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

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

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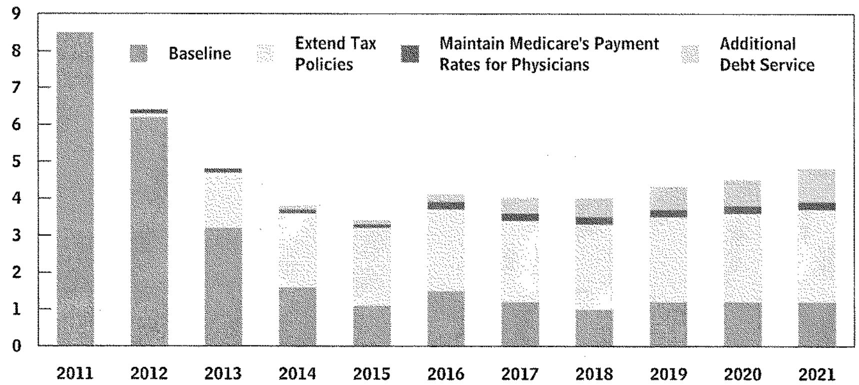
10. Outlays refer to spending to pay a federal obligation.

Figure 5.

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

(Percentage of gross domestic product)



Source: Congressional Budget Office.

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

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

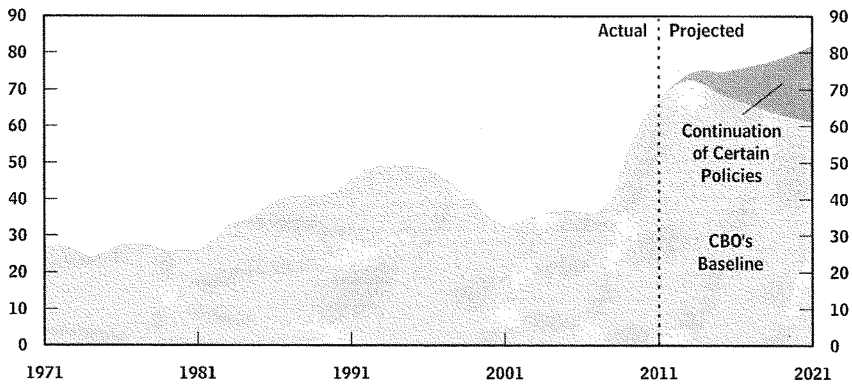
The projected deficits reflect the fact that, during the coming decade and over the long term, the aging of the population and rising costs of health care will exert

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

Figure 6.

Federal Debt Held by the Public

(Percentage of gross domestic product)



Source: Congressional Budget Office.

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

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

The Budget Control Act of 2011

CBO's current baseline projections show smaller deficits than the agency estimated earlier this year primarily because of the enactment of the Budget Control Act of 2011.[12] Provisions in that act:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

- Reductions ranging from 10.0 percent (in 2013) to 8.5 percent (in 2021) in the caps on new discretionary appropriations for defense programs, yielding total outlay savings of $454 billion.

- Reductions ranging from 7.8 percent (in 2013) to 5.5 percent (in 2021) in the caps on new discretionary appropriations for nondefense programs, resulting in outlay savings of $294 billion.

- Reductions ranging from 10.0 percent (in 2013) to 8.5 percent (in 2021) in mandatory budgetary resources for nonexempt defense programs, generating savings of about $0.1 billion.

- Reductions of 2.0 percent each year in most Medicare spending because of the application of a special rule that applies to that program, producing savings of $123 billion, and reductions ranging from 7.8 percent (in 2013) to 5.5 percent (in 2021) in mandatory budgetary resources for other nonexempt nondefense programs and activities, yielding savings of $47 billion. Thus, savings in nondefense mandatory spending would total $170 billion.

- About $31 billion in outlays stemming from reductions in premiums for Part B of Medicare and other changes in spending that would result from the sequestration actions.

- An estimated reduction of $169 billion in debt-service costs.

In all, those automatic cuts would produce net budgetary savings of about $1.1 trillion over the 2013–2021 period, CBO estimates. That amount is lower than the $1.2 trillion figure for deficit reduction in the Budget Control Act for three reasons. First, because of the lag in timing between appropriations and subsequent expenditures, part of the savings from the automatic cuts in budgetary resources would occur after 2021. Second, CBO expects that some reductions—particularly those related to Medicare—would have other effects that would boost net spending (by the $31 billion mentioned above). Third, CBO estimates that the reduction in debt-service costs would be lower than the amount of such savings stipulated in the Budget Control Act.[17]

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

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

The Long-Term Budget Outlook

Beyond the coming decade, the fiscal outlook worsens. When CBO issued its most recent long-term projections in June 2011, debt held by the public was projected to reach 76 percent of GDP in 2021 under current law.[19] Beyond 2021, under an extension of current law that CBO labeled the "extended-baseline scenario," debt was projected to rise to 84 percent of GDP in 2035. Because CBO's projections based on current law now show that debt held by the public will be declining relative to GDP after 2013 (to 61 percent in 2021), the long-term outlook under current law is a little brighter than it was earlier in the year. Even under the latest projections, however, debt would still be larger relative to GDP in 2021 than in any year between 1953 and 2009. Moreover, although long-term budget projections are highly uncertain, the aging of the population and rising costs for health care would almost certainly push federal spending up sharply relative to GDP after 2021 if current law remained in effect. Federal revenues also would continue to increase relative to GDP after 2021 under current law, reaching significantly higher percentages of GDP than ever seen before in the United States. CBO has not updated its long-term projections to reflect

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

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

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

its new 10-year baseline, and the net effect that those trends in outlays and revenues would have on budget deficits beyond 2021 is not clear.

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

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

Fiscal Policy Choices

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

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

The Magnitude of Deficit Reduction

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

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

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

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

For example, if most of the provisions in the 2010 tax act were extended, if the AMT was indexed for inflation, and if Medicare's payment rates for physicians' services were held constant, then in the absence of other policy changes, deficits over the next 10 years would total $8.5 trillion—compared with $3.5 trillion in the baseline—and debt held by the public would reach 82 percent of GDP in 2021, well above both the current level and the projected level in 2021 under current law. If lawmakers decided to change the law in order to extend those policies, then reducing debt held by the public in 2021 to the 61 percent of GDP projected under current law would require other changes in policy that reduced deficits over the next 10 years by $5 trillion in addition to the $1.2 trillion in deficit reduction that this Committee would have to accomplish to avoid the automatic budget cuts required by the Budget Control Act. If this Committee aimed to achieve that goal through its own recommendations, it would need to propose changes in policies that reduced deficits (apart from the effects of extending those existing policies) by a total of about $6.2 trillion (including interest savings) over the coming decade. To lower debt held by the public to the 50 per-

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

cent of GDP seen in the mid-1990s would require significantly larger reductions in deficits.

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

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

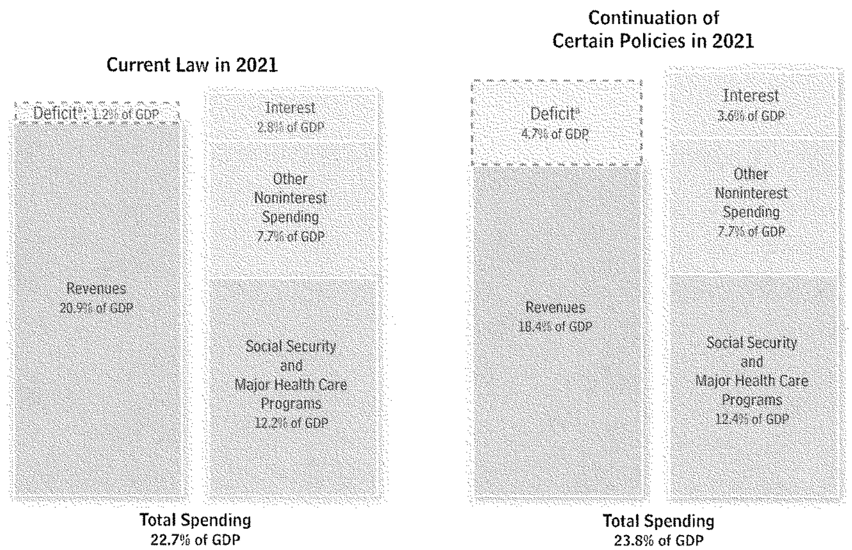
The Timing of Deficit Reduction

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

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

Figure 7.

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



Source: Congressional Budget Office.

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

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

GDP = gross domestic product.

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

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

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

- Higher levels of debt imply higher interest payments on that debt, which would eventually require either higher taxes or a reduction in government benefits and services.

- Rising debt would increasingly restrict policymakers' ability to use tax and spending policies to respond to unexpected challenges, such as economic downturns, financial turmoil, or international crises. As a result, the effects of such developments on the economy and people's well-being could be worse.

- Growing debt also would increase the probability of a sudden fiscal crisis, during which investors would lose confidence in the government's ability to manage its budget and the government would thereby lose its ability to borrow at affordable rates. Such a crisis would confront policymakers with extremely difficult choices. To restore investors' confidence, policymakers would probably need to enact spending cuts or tax increases more drastic and painful than those that would have been necessary had the adjustments come sooner.

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

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21. CBO estimated the magnitude of those effects for the paths of federal debt presented in *CBO's 2011 Long-Term Budget Outlook*. CBO estimated that under the extended-baseline scenario in that report, real gross national product (GNP) would be reduced slightly by 2025 and by as much as 2 percent by 2035, compared with what it would be under the stable economic environment underlying most of the projections in that report. In addition, CBO estimated that under the alternative fiscal scenario in that report, real GNP would be 2 percent to 6 percent lower in 2025, and 7 percent to 18 percent lower in 2035, than under a stable economic environment. (GNP differs from GDP primarily by including the capital income that residents earn from investments abroad and excluding the capital income that nonresidents earn from domestic investment. In the context of analyzing the impact of growing deficits and debt, GNP is a better measure because projected budget deficits would be partly financed by inflows of capital from other countries.)

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

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

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

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

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

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

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

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

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

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

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

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

A recent analysis by CBO provides a rough indication of the magnitude of the economic effects of reducing deficits along a hypothetical time path under current economic conditions.[24] In that analysis, the agency estimated the short-term and longer-term effects of reducing the primary deficit (the budget deficit excluding net interest) by $100 billion in 2012 and by amounts increasing gradually to $300 billion by 2021 (without any particular changes in spending or revenues specified). According to the agency's estimates, that illustrative plan would decrease real gross national product (GNP) in 2012, 2013, and 2014 by amounts ranging from roughly 0.1 percent to 0.6 percent depending on the year and the assumptions used.[25] However, the increases in national saving and investment that would result from smaller deficits were estimated to increase real GNP by roughly 0.4 percent to 1.4 percent from 2019 through 2021.[26]

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

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

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

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

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

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

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

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

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

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

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

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

The Composition of Deficit Reduction

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

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

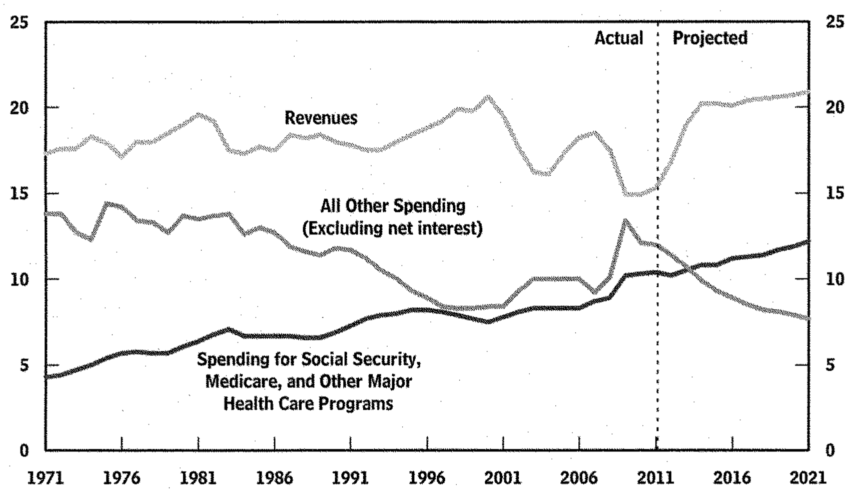
Looking for historical reference points is natural. However, the past combination of policies cannot be repeated when it comes to the federal budget: The aging of the population and rising costs for health care have changed the backdrop for federal

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

Figure 8.

Revenues and Spending, Excluding Interest

(Percentage of gross domestic product)



Source: Congressional Budget Office.

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

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

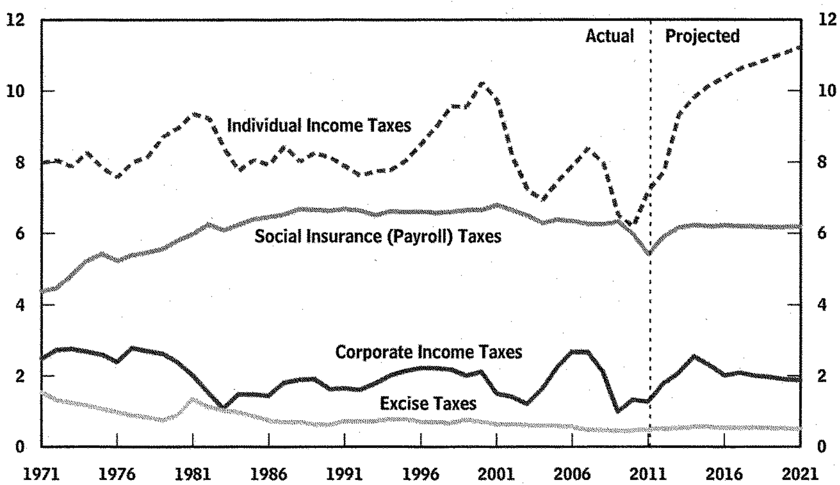
Federal Revenues. Revenues have averaged 18.0 percent of GDP during the past 40 years (see Figure 8). They have varied substantially around that level but show no clear trend. Under current law, revenues equal 15.3 percent of GDP in 2011 and will rise to about 21 percent of GDP in 2021; if, instead,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

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

Figure 9.

Revenues by Source

(Percentage of gross domestic product)



Source: Congressional Budget Office.

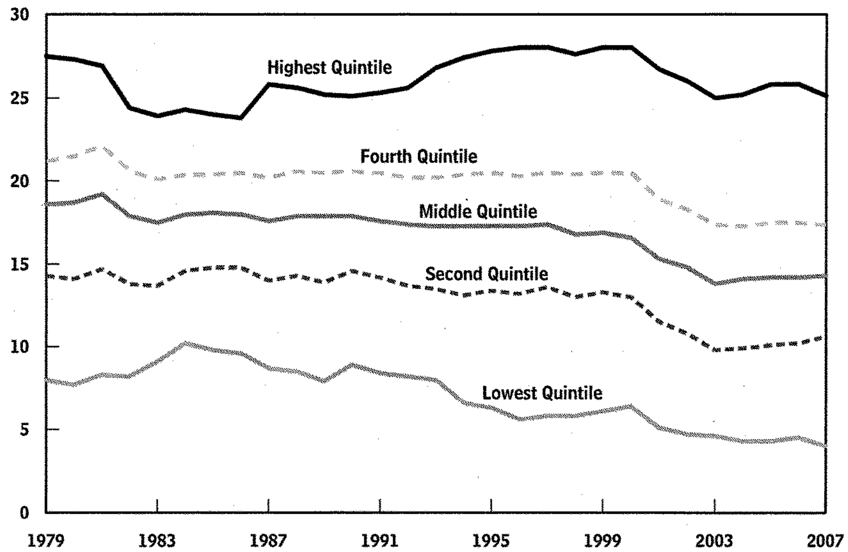
income and some other effects of the economic recovery (see Figure 9). As a result, individual income tax receipts increase steadily in CBO's baseline, from 7.2 percent of GDP in 2011 to 11.2 percent in 2021. By comparison, such receipts stood at 8.0 percent in 1971. Receipts from both social insurance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

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

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

Figure 10.

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



Source: Congressional Budget Office.

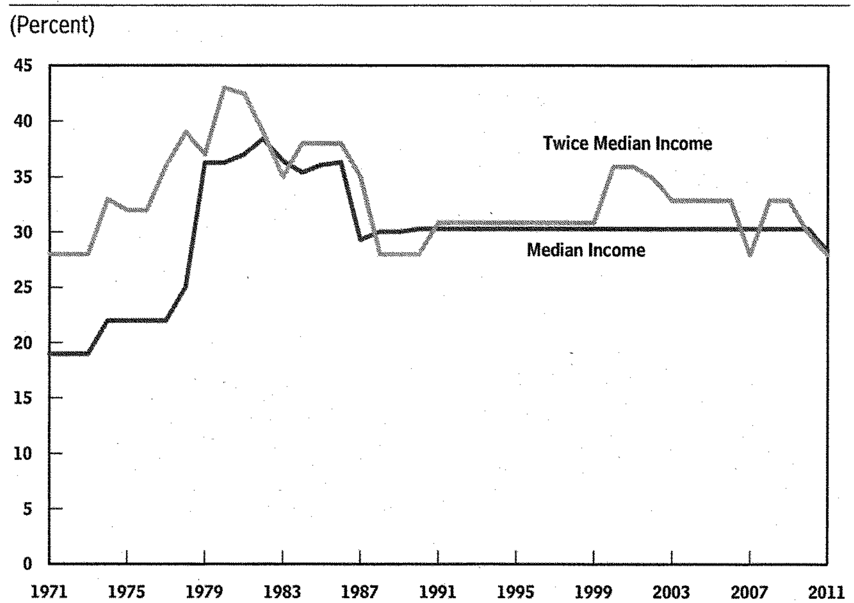
Note: For information on the calculation of average tax rates, the ranking of households, and the allocation of taxes, see Congressional Budget Office, *Average Federal Tax Rates in 2007* (June 2010).

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

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

Figure 11.

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



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

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

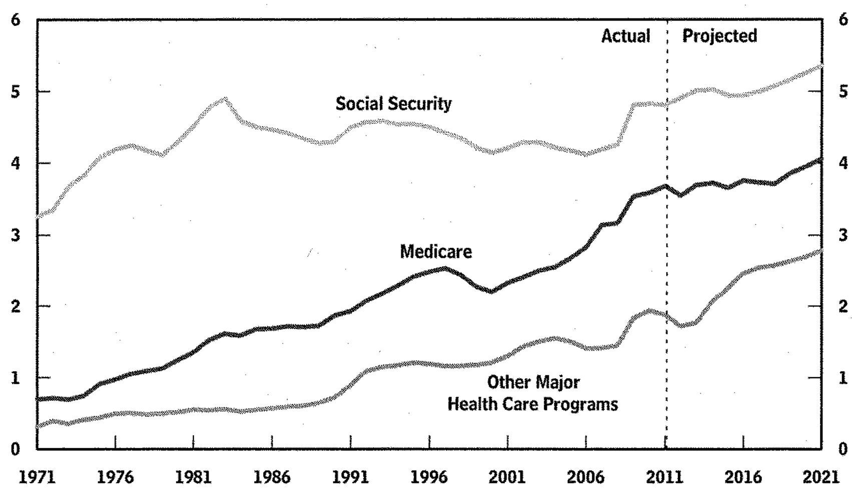
Social Security and Major Health Care Programs. Spending on Social Security and the major health care programs—Medicare, Medicaid, the Children's Health Insurance Program, and insurance subsidies to be provided through exchanges in coming years—will be 12.2 percent of GDP in 2021, according to CBO's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

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

Figure 12.

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

(Percentage of gross domestic product)



Source: Congressional Budget Office.

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

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

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

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

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

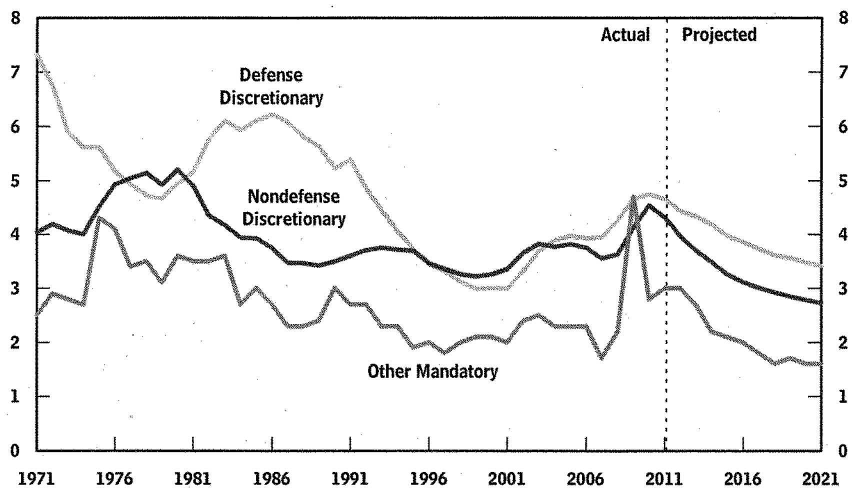
Discretionary spending, which stood at 11.3 percent of GDP in 1971, will total 9.0 percent in 2011. As a result of the caps put in place by the Budget Control Act (and apart from any further reduction in caps triggered by the enforcement provisions of the act), such spending will fall sharply relative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

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

Figure 13.

Other Federal Spending, by Category

(Percentage of gross domestic product)



Source: Congressional Budget Office.

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

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

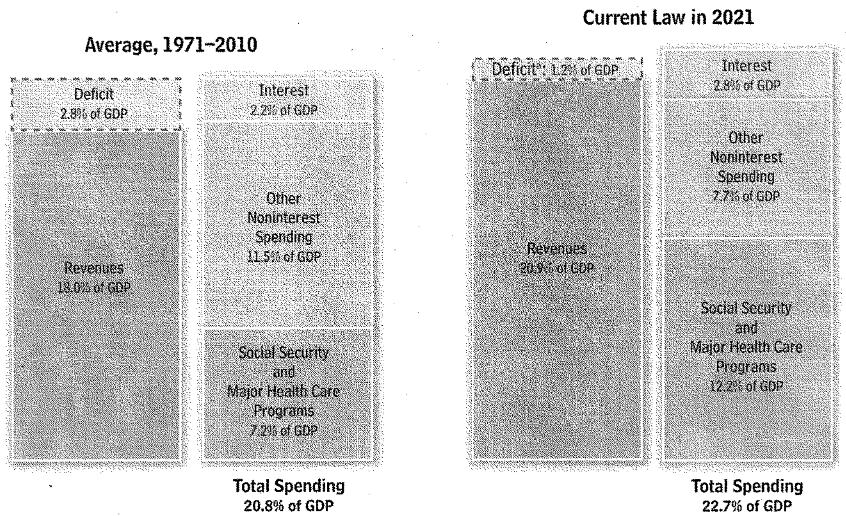
40 years, total federal spending would be projected to be much higher in 2021—nearly 24 percent of GDP. That amount exceeds the 40-year average for revenues as a share of GDP by nearly 6 percentage points—even before interest payments on the debt have been included.

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

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

Figure 14.

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



Source: Congressional Budget Office.

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

GDP = gross domestic product.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

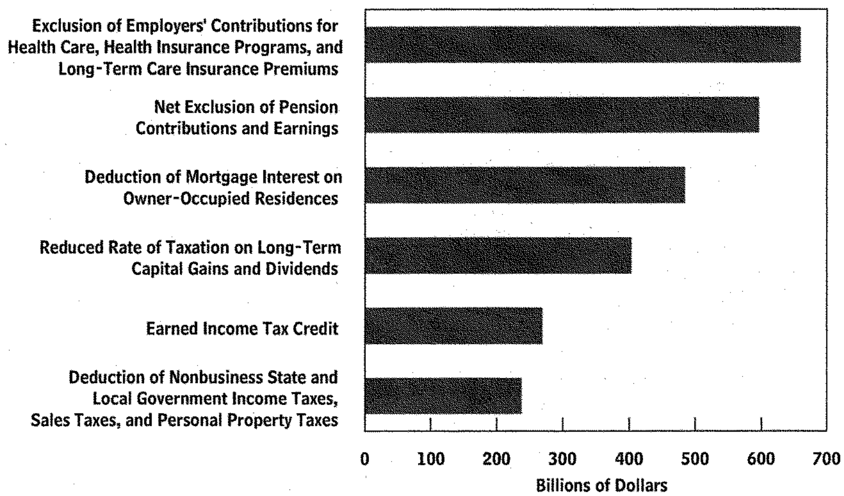
encourage additional work. For many people, the opposing incentives from increasing marginal tax rates largely offset each other, although most economists conclude that, on average, the negative effects of lower after-tax earnings for each additional hour worked slightly outweigh the positive effects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

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

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

Figure 15.

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



Source: Joint Committee on Taxation.

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

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

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

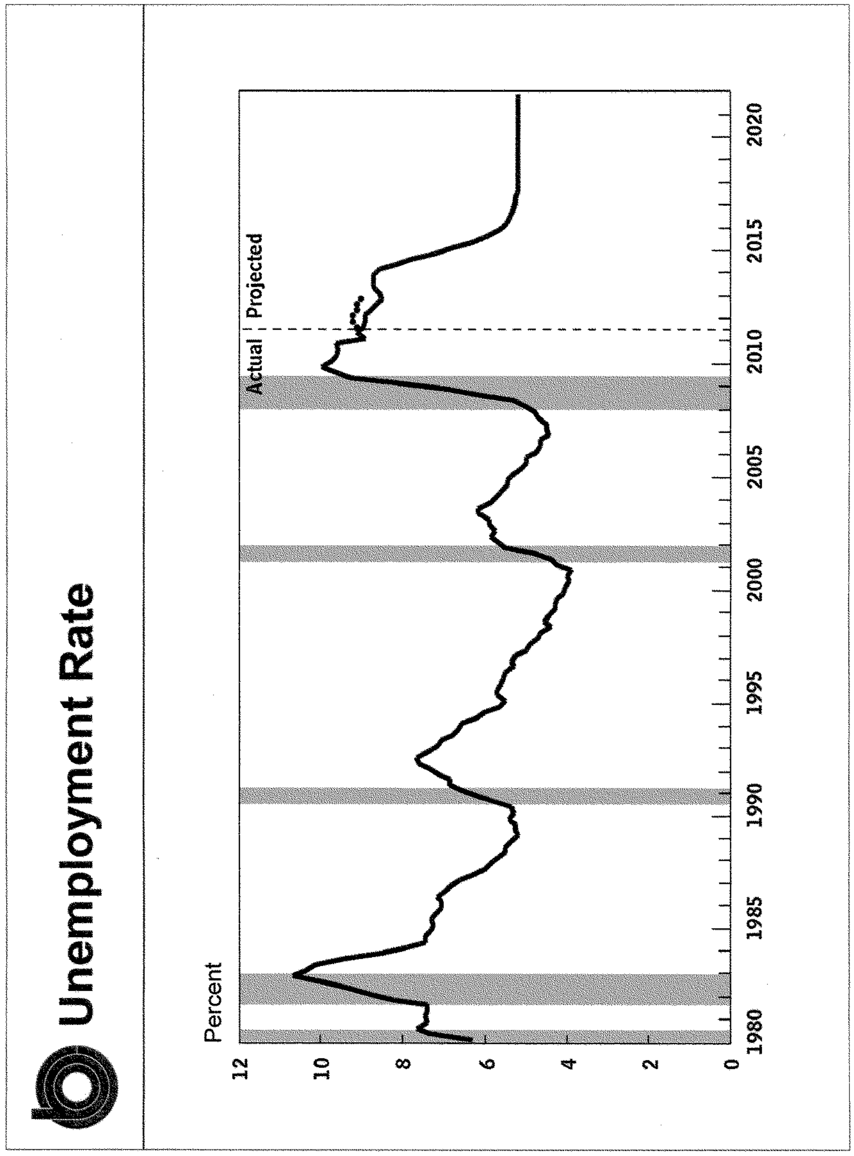
On a more fundamental level, the government provides a crucial role in maintaining the legal and institutional framework within which the economy operates. Government spending on the justice system, for example, supports the smooth functioning of the economy by protecting private property rights and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

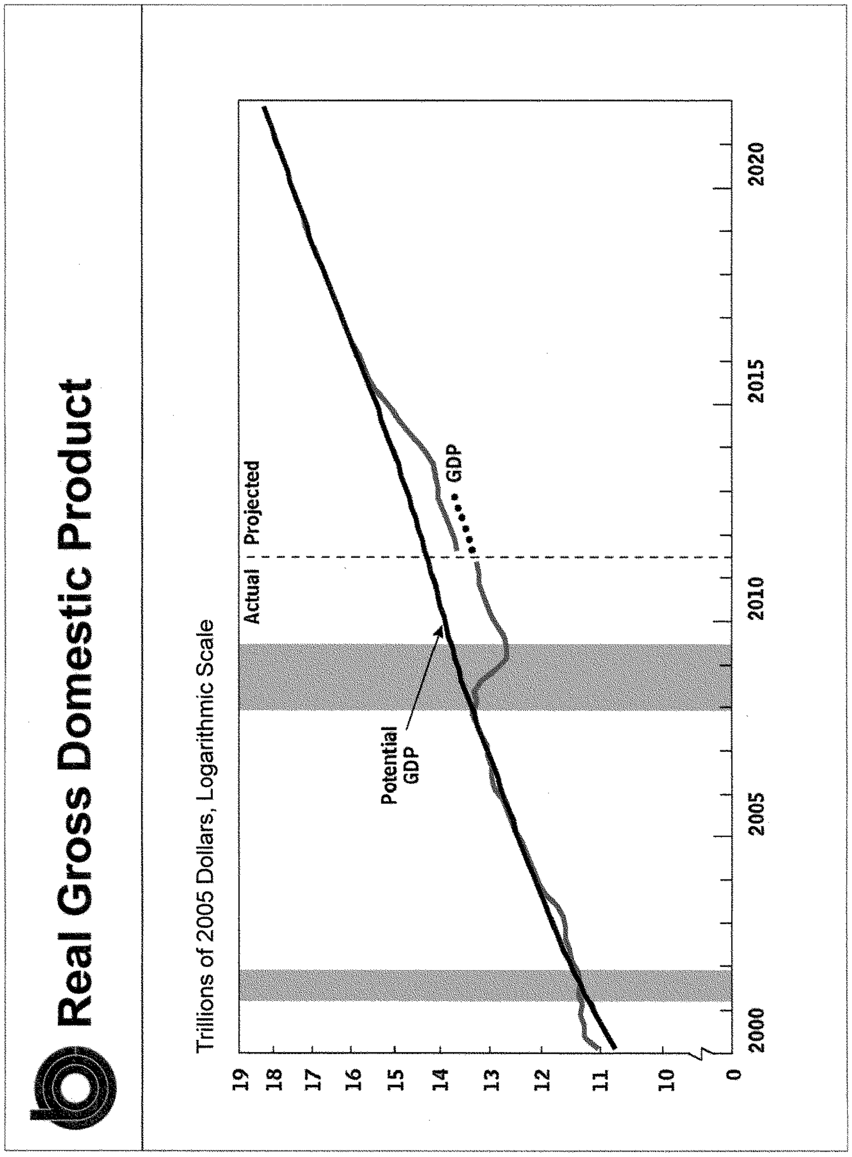
Congressional Budget Office

Confronting the Nation's Fiscal Policy Challenges

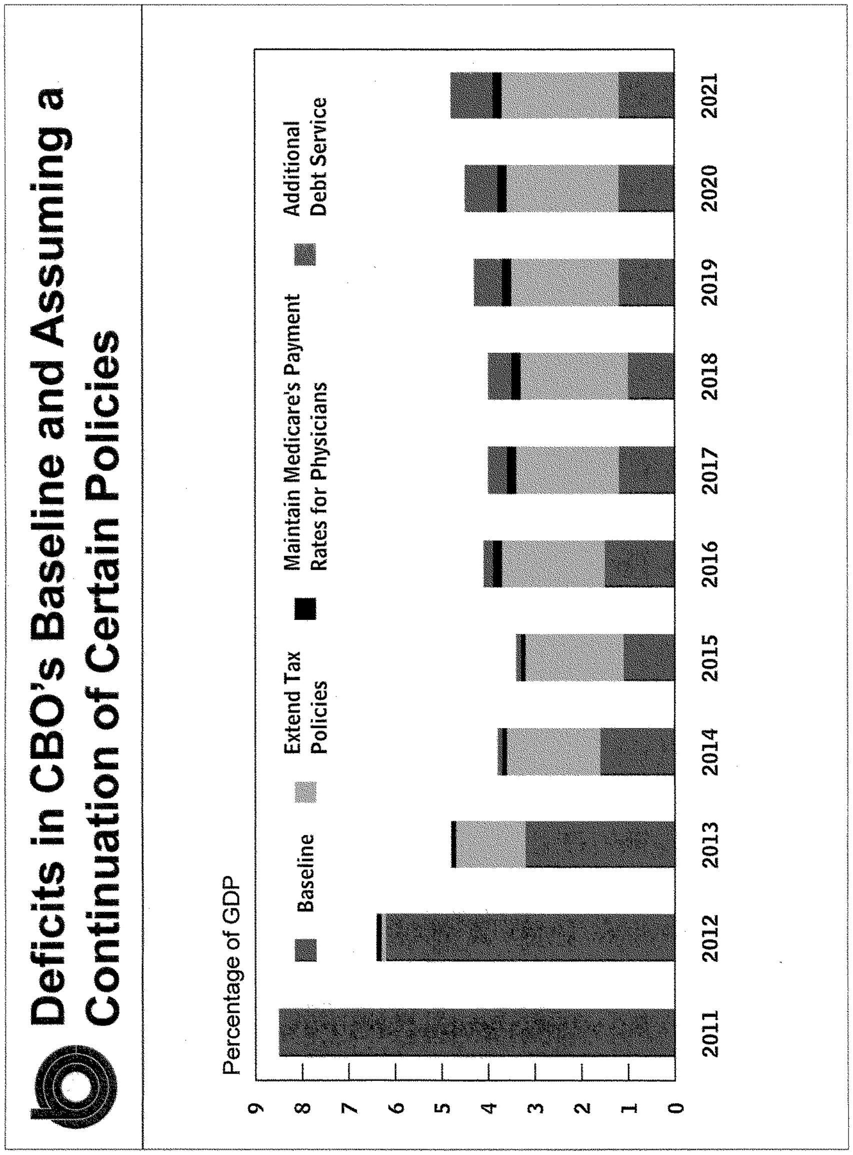
September 13, 2011

Douglas W. Elmendorf
Director


Unemployment Rate
Percent
12
10
8
6
4
2
0
1980
1985
1990
1995
2000
2005
2010
2015
2020
Actual
Projected



Real Gross Domestic Product
Trillions of 2005 Dollars, Logarithmic Scale
Actual
Projected
Potential GDP
GDP
19
18
17
16
15
14
13
12
11
10
0
2000
2005
2010
2015
2020


Deficits in CBO's Baseline and Assuming a Continuation of Certain Policies
Percentage of GDP
Baseline
Extend Tax Policies
Maintain Medicare's Payment Rates for Physicians
Additional Debt Service
0
1
2
3
4
5
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8
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2011
2012
2013
2014
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2018
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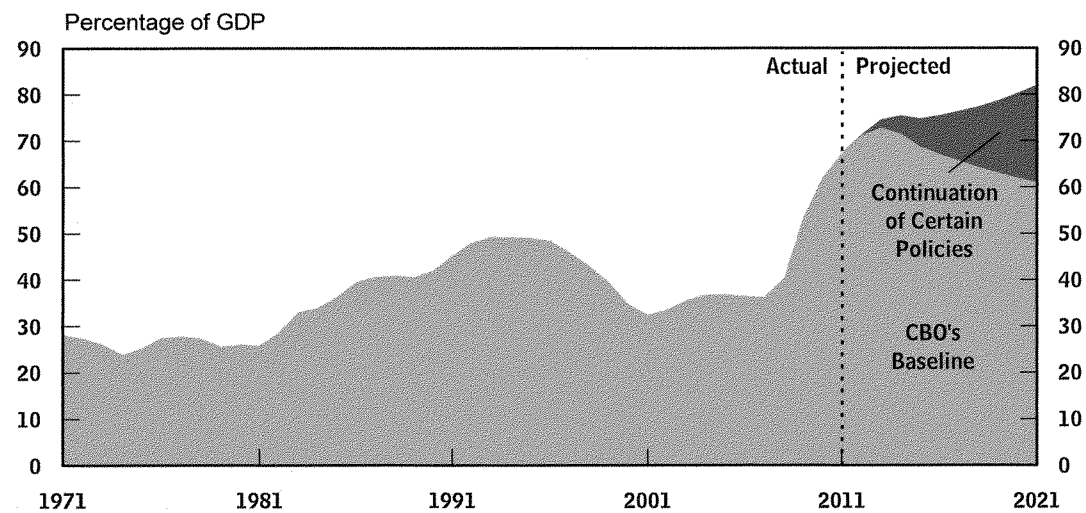
2020
2021

Federal Debt Held by the Public



Enforcement Procedures of the Budget Control Act

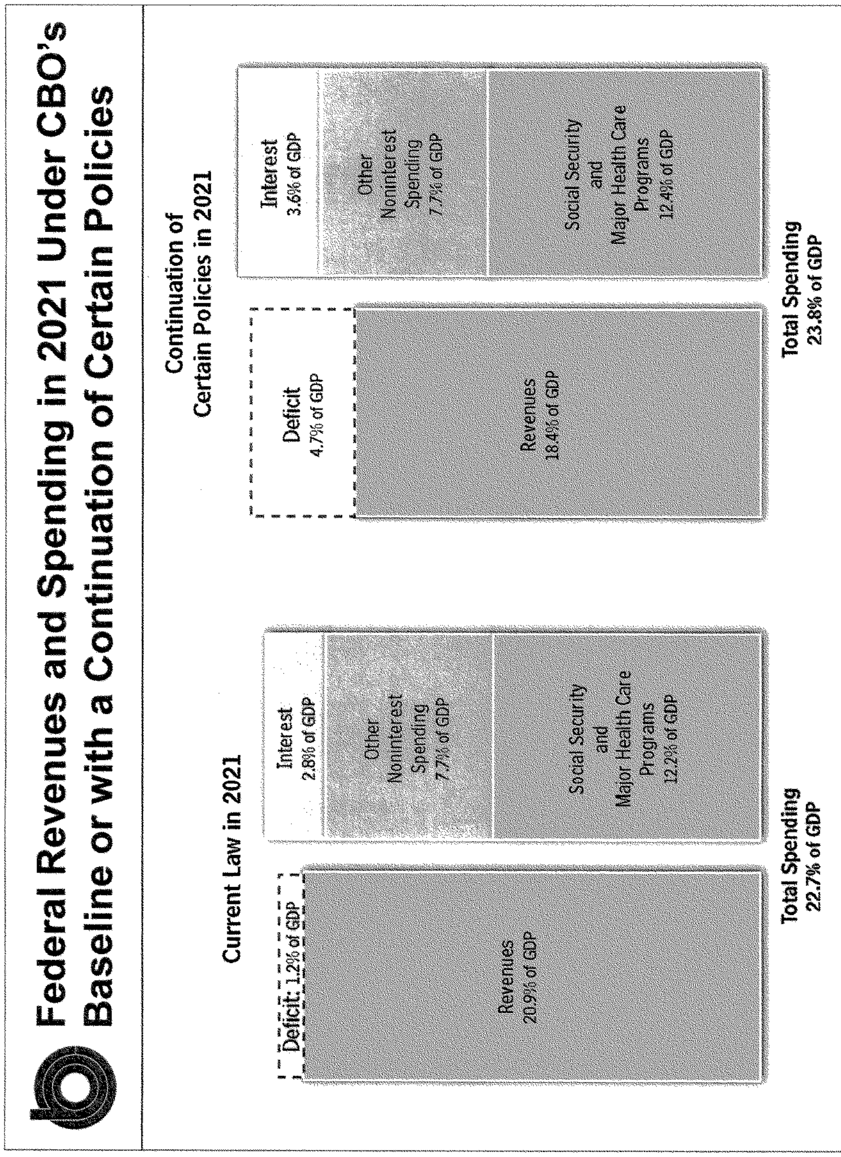
If no legislation originating from this Committee was enacted, the following would occur over the coming decade:

- Reductions in the caps on discretionary appropriations for defense would cut outlays by about $450 billion.
- Reductions in the caps on discretionary appropriations for nondefense purposes would cut outlays by about $300 billion.
- Reductions in mandatory spending would yield net savings of about $140 billion.
- Debt-service costs would decline by about $170 billion.

The total reduction in deficits would be about $1.1 trillion.

Fiscal Policy Choices

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

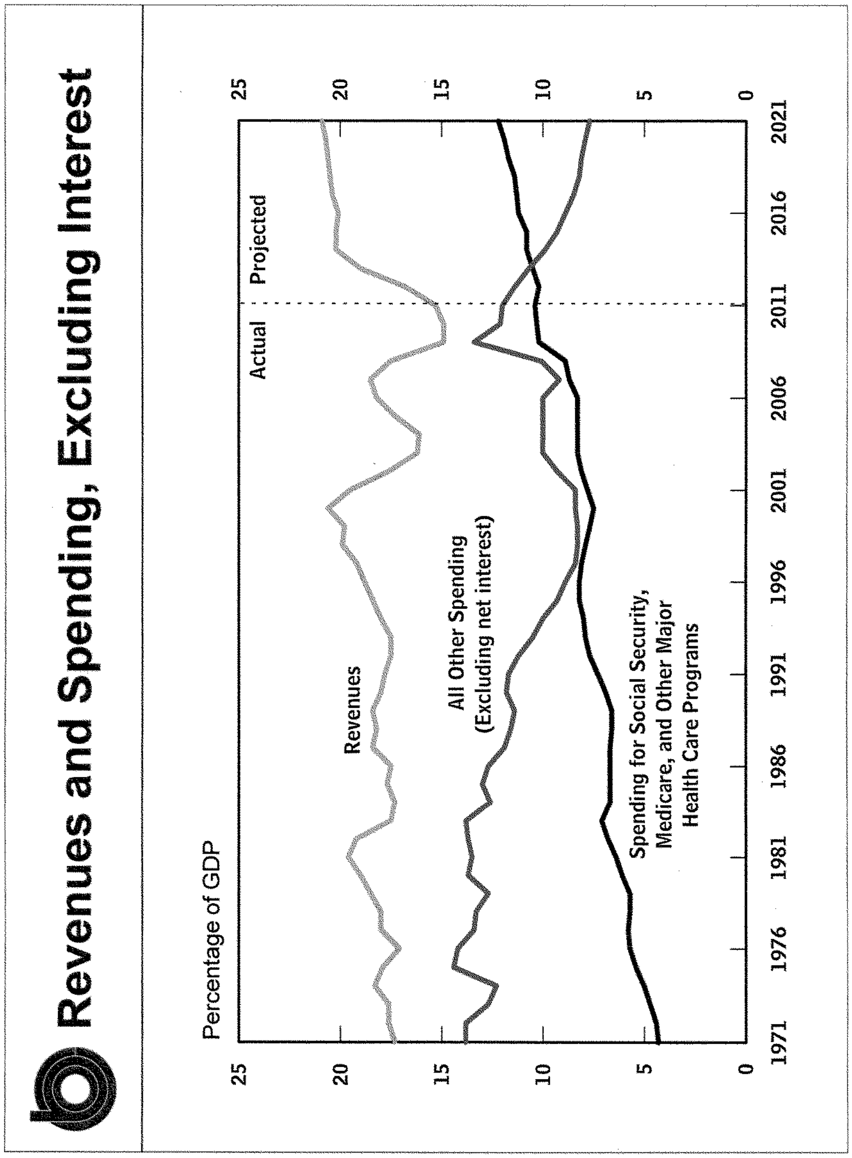

Federal Revenues and Spending in 2021 Under CBO's Baseline or with a Continuation of Certain Policies
Current Law in 2021
Deficit: 1.2% of GDP
Revenues 20.9% of GDP
Interest 2.8% of GDP
Other Noninterest Spending 7.7% of GDP
Social Security and Major Health Care Programs 12.2% of GDP
Total Spending 22.7% of GDP
Continuation of Certain Policies in 2021
Deficit 4.7% of GDP
Revenues 18.4% of GDP
Interest 3.6% of GDP
Other Noninterest Spending 7.7% of GDP
Social Security and Major Health Care Programs 12.4% of GDP
Total Spending 23.8% of GDP

Trade-offs in the Timing of Deficit Reduction

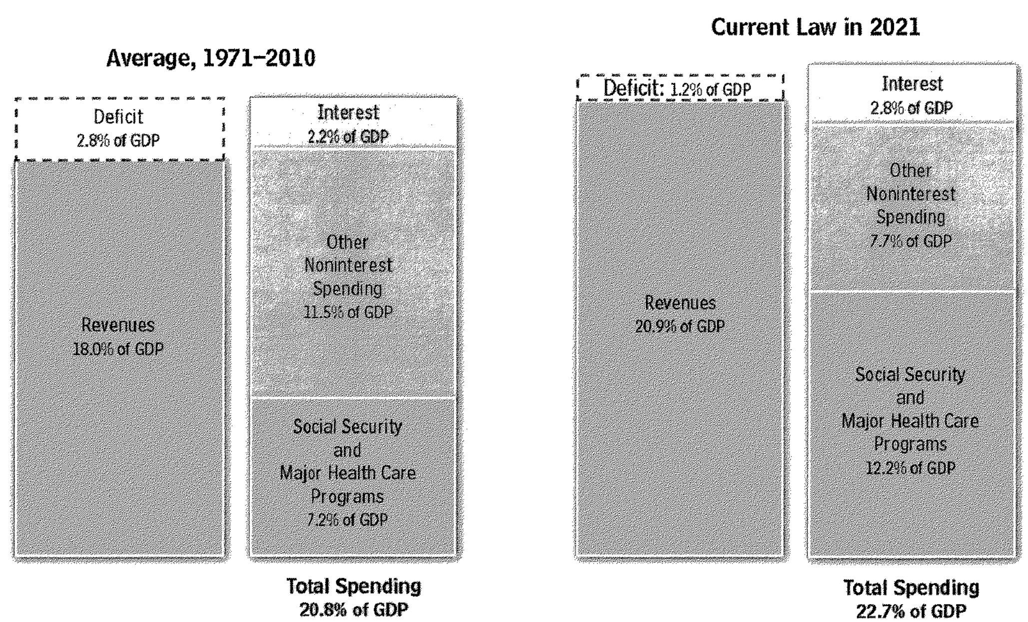
- Cutting spending or increasing taxes slowly would lead to a greater accumulation of government debt and might raise doubts about whether the longer-term deficit reductions would ultimately take effect.
- Implementing spending cuts or tax increases abruptly would give little time to plan and adjust. In addition, and particularly important given the current state of the economy, immediate spending cuts or tax increases would represent an added drag on the weak economic expansion.

Near-Term Economic Effects of Deficit Reduction

- Credible policy changes that would substantially reduce deficits later in the coming decade and beyond—without immediate spending cuts or tax increases—would both support the economic expansion in the next few years and strengthen the economy over the longer term.
- There is no inherent contradiction between using fiscal policy to support the economy today, while the unemployment rate is high and many factories and offices are underused, and imposing fiscal restraint several years from now, when output and employment will probably be close to their potential.


Revenues and Spending, Excluding Interest
Percentage of GDP
Revenues
All Other Spending
(Excluding net interest)
Spending for Social Security,
Medicare, and Other Major
Health Care Programs
Actual
Projected
25
20
15
10
5
0
1971
1976
1981
1986
1991
1996
2001
2006
2011
2016
2021

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



Conclusion

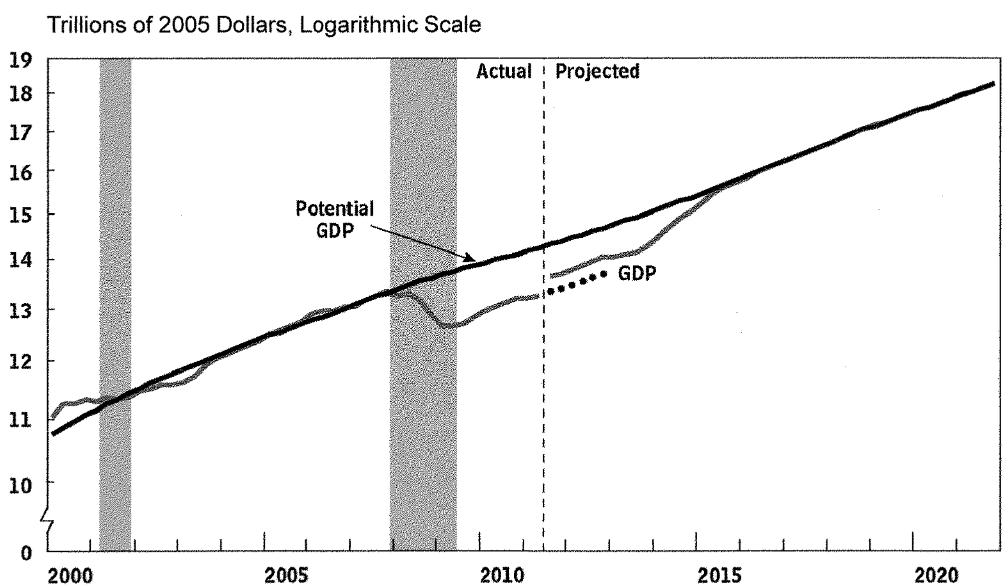
Given the aging of the population and rising costs for health care, attaining a sustainable federal budget will require the United States to deviate from the policies of the past 40 years in at least one of the following ways:

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

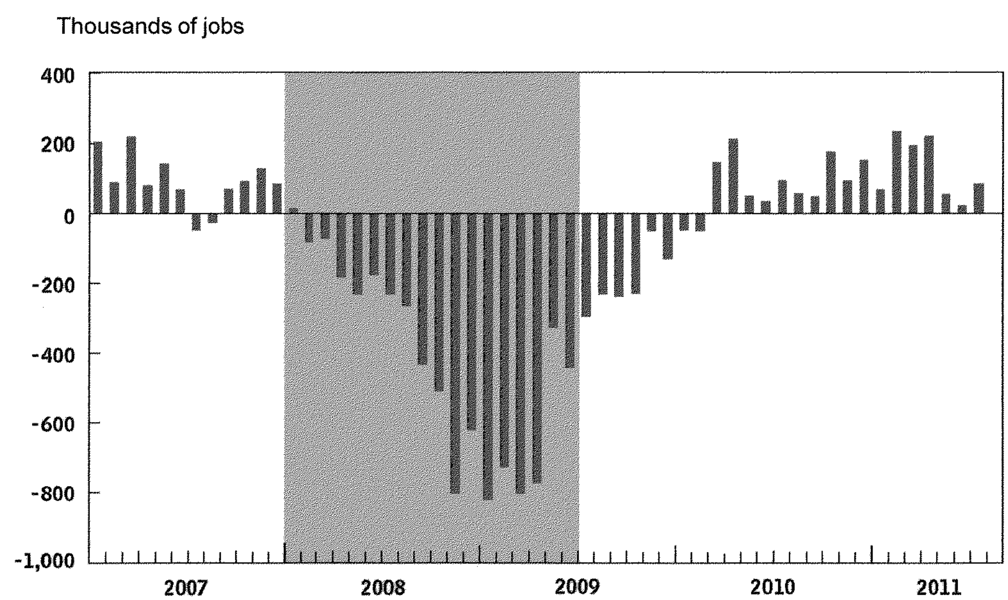
Congressional Budget Office

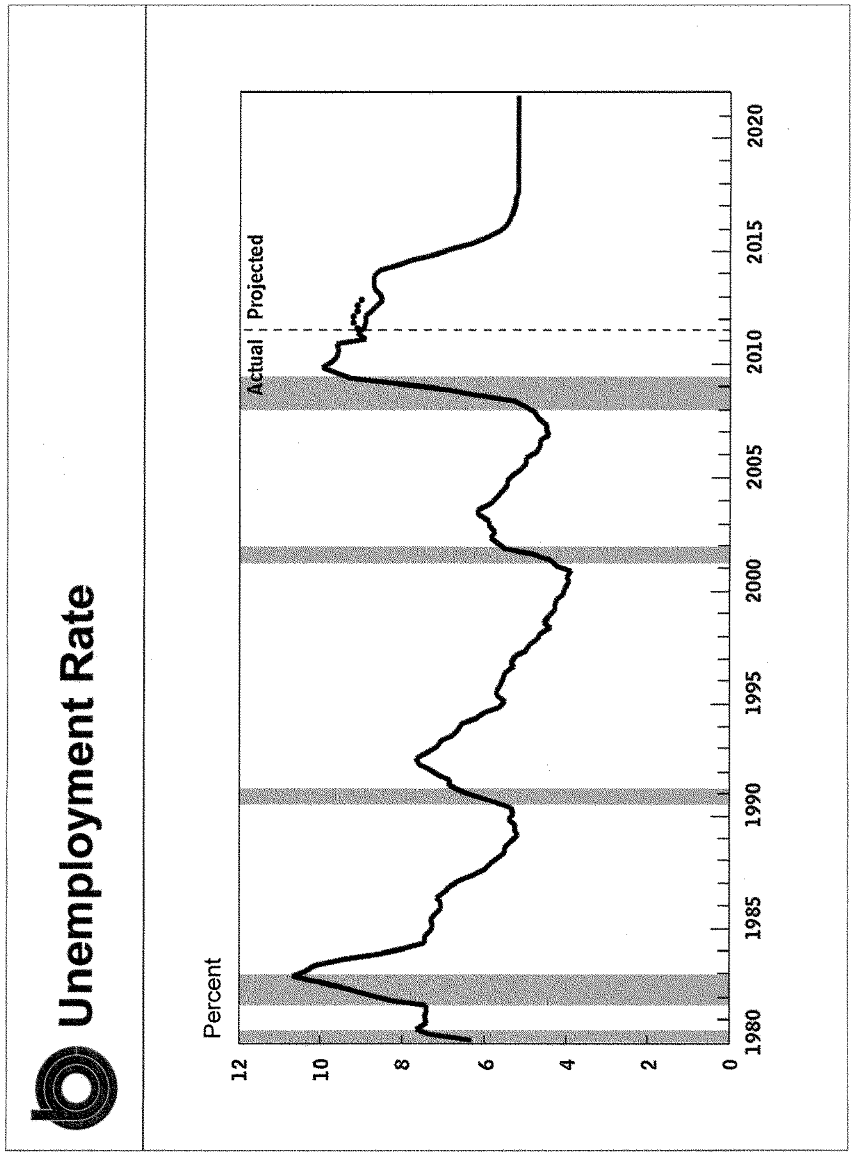
Full Set of Figures from the Written Testimony

Real Gross Domestic Product



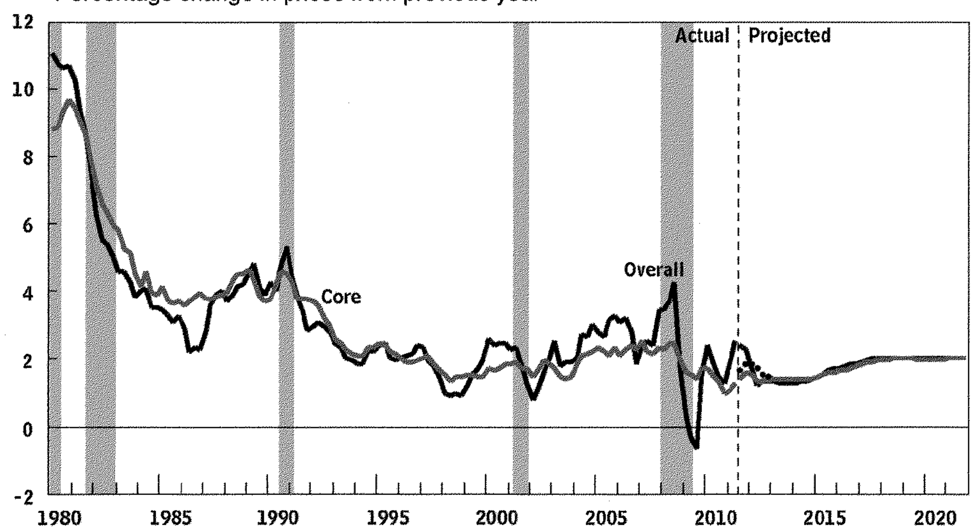
Net Job Growth per Month



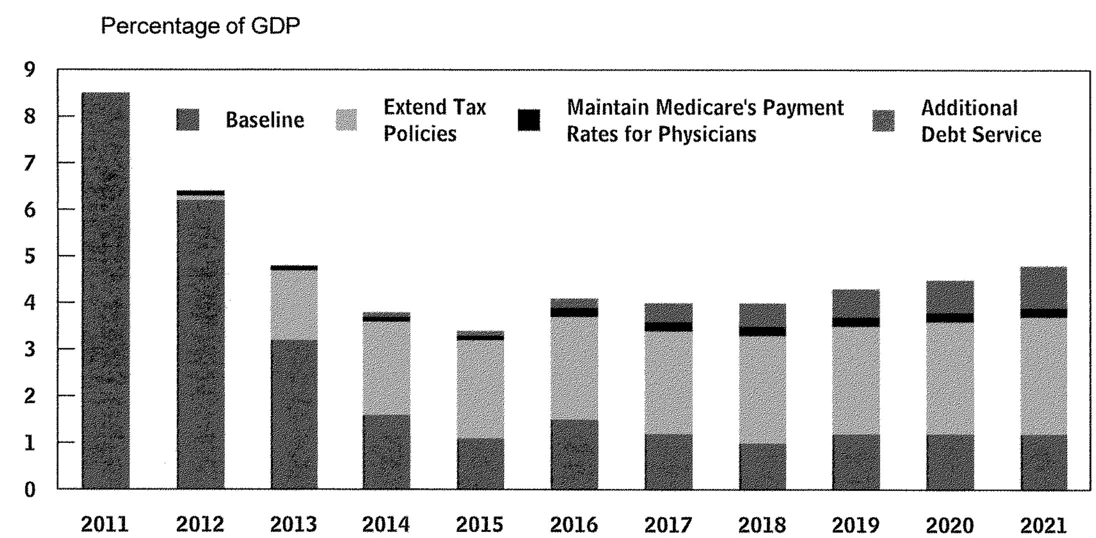

Unemployment Rate
Percent
12
10
8
6
4
2
0
1980
1985
1990
1995
2000
2005
2010
2015
2020
Actual
Projected

Inflation

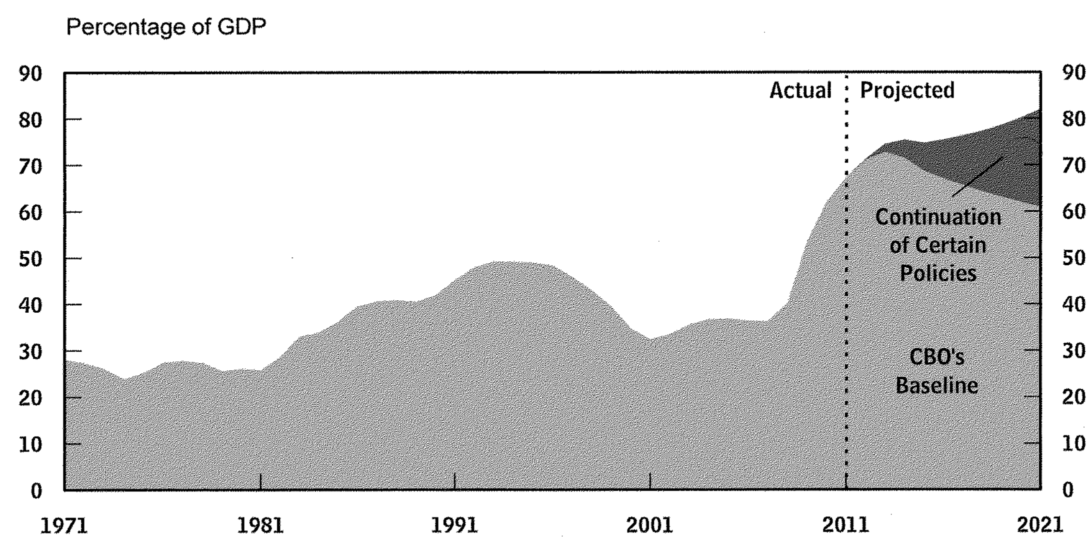
Percentage change in prices from previous year



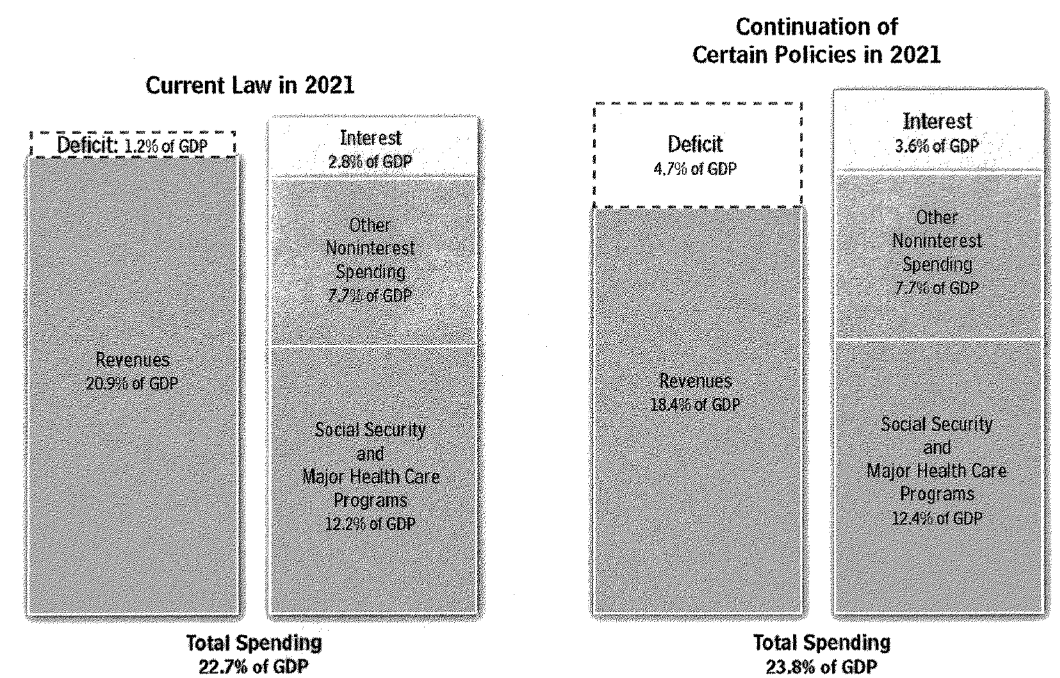
Deficits in CBO's Baseline and Assuming a Continuation of Certain Policies

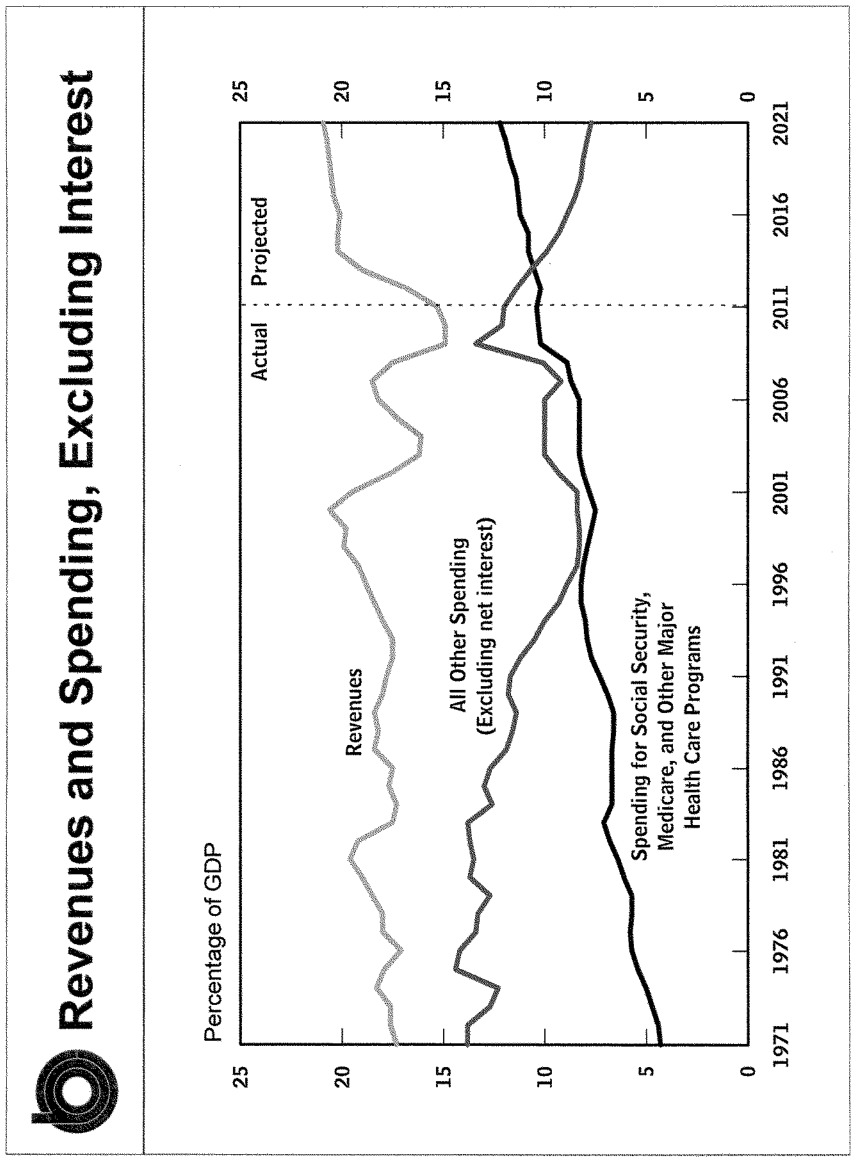


Federal Debt Held by the Public



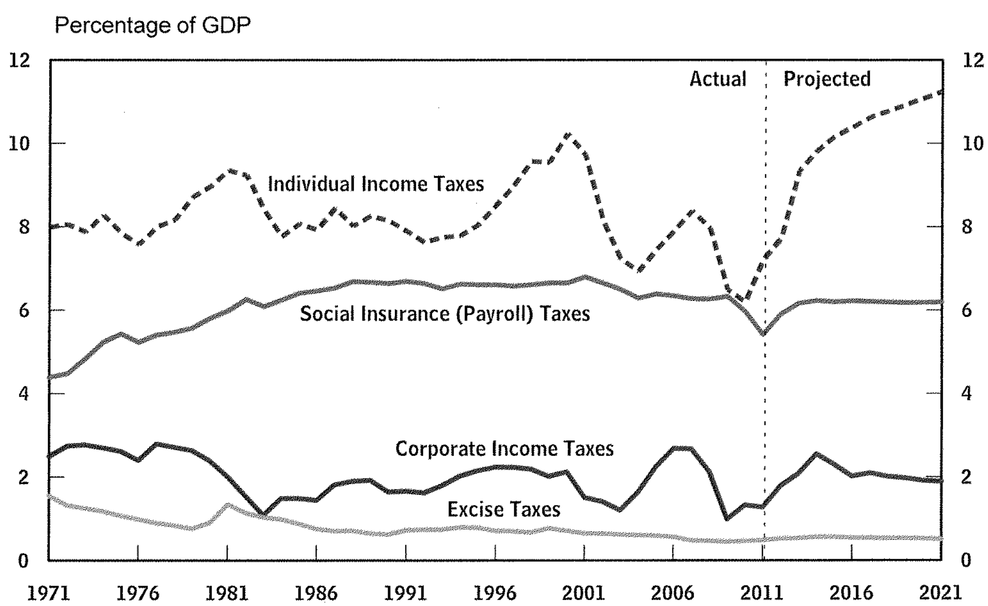
Federal Revenues and Spending in 2021 Under CBO's Baseline or with a Continuation of Certain Policies



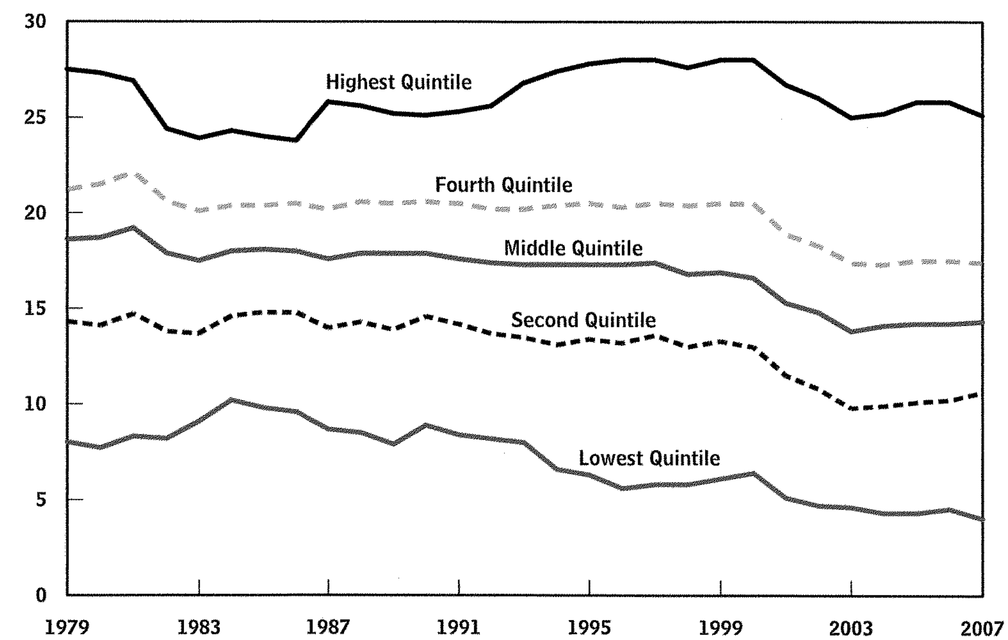


Revenues and Spending, Excluding Interest
Percentage of GDP
25
20
15
10
5
0
1971
1976
1981
1986
1991
1996
2001
2006
2011
2016
2021
Actual
Projected
Revenues
All Other Spending
(Excluding net interest)
Spending for Social Security,
Medicare, and Other Major
Health Care Programs

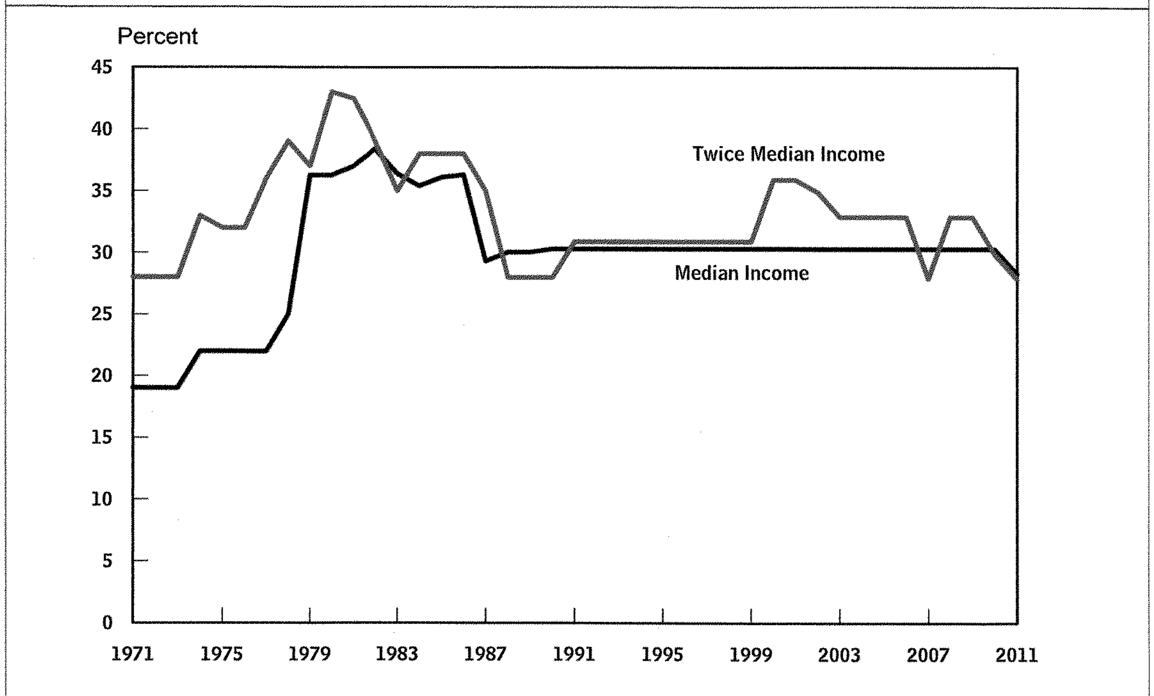
Revenues by Source



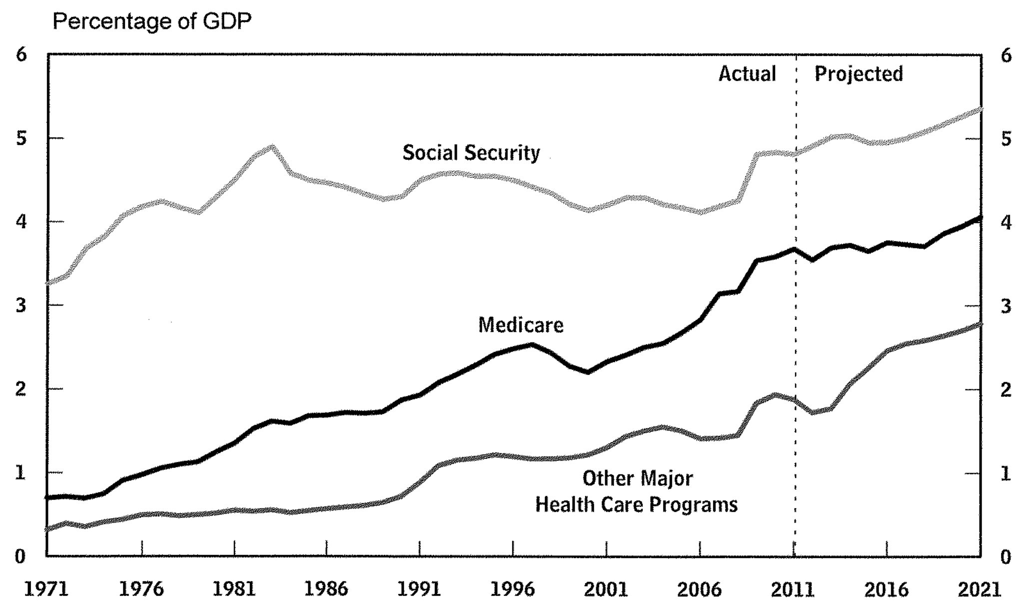
Average Federal Tax Rates, by Income Quintile,1979 to 2007



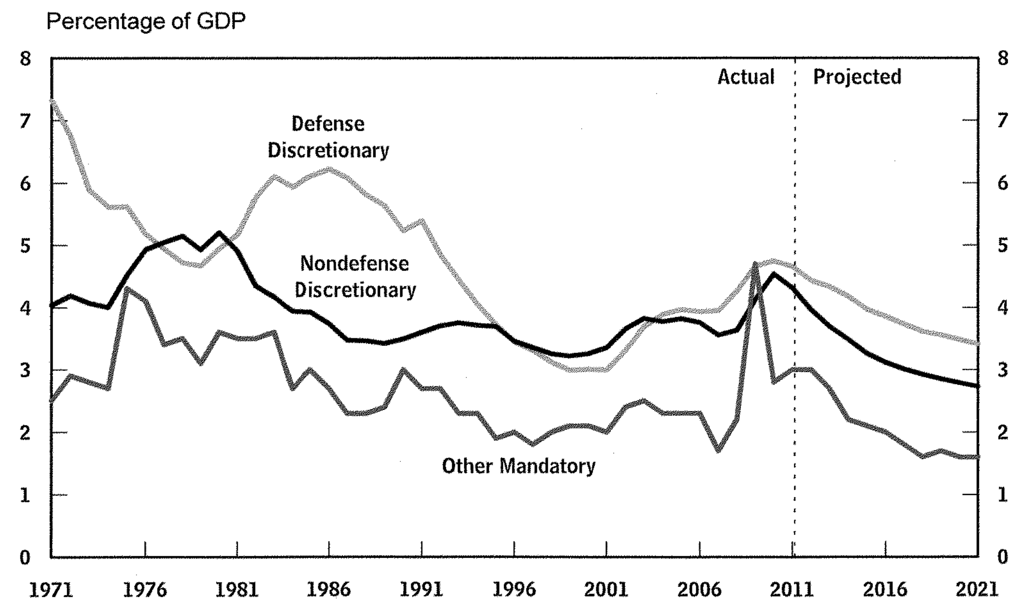
Marginal Tax Rates (Income and Payroll) on Earnings for a Family of Four with a Single Earner, 1971 to 2011



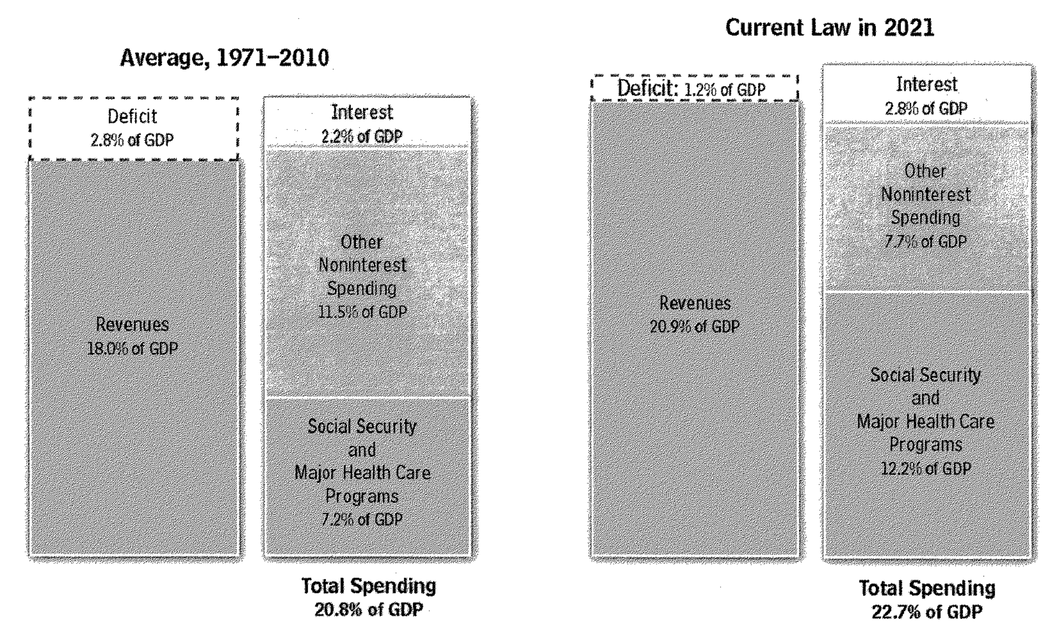
Spending for Social Security, Medicare, and Other Major Health Care Programs

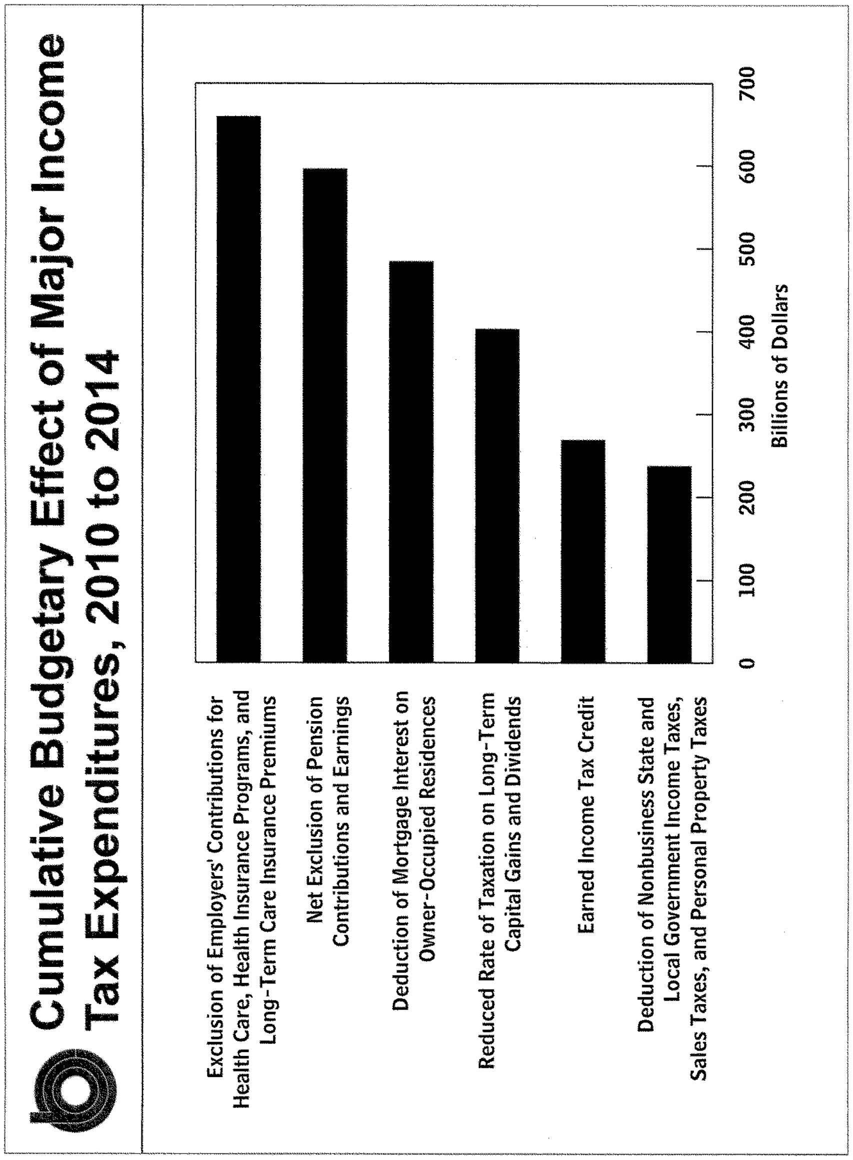


Other Federal Spending, by Category



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





Cumulative Budgetary Effect of Major Income Tax Expenditures, 2010 to 2014
Exclusion of Employers' Contributions for Health Care, Health Insurance Programs, and Long-Term Care Insurance Premiums
Net Exclusion of Pension Contributions and Earnings
Deduction of Mortgage Interest on Owner-Occupied Residences
Reduced Rate of Taxation on Long-Term Capital Gains and Dividends
Earned Income Tax Credit
Deduction of Nonbusiness State and Local Government Income Taxes, Sales Taxes, and Personal Property Taxes
0
100
200
300
400
500
600
700
Billions of Dollars

Questions for the Record
CONGRESSIONAL BUDGET OFFICE

Question from Senator Kerry:

As we discussed, the last five times there have been surpluses, revenues have ranged between 19.5 percent and 20.6 percent of GDP. All five of these surpluses occurred since 1969. The budget has been in surplus 12 times since 1940. Seven of the surpluses occurred between 1947 and 1960; in those surplus years, revenues ranged as a share of GDP from 14.5 percent to 17.8 percent. Those surpluses were achieved in years that pre-date the creation of Medicare and Medicaid. Does the historical data since 1969 more closely reflect the commitments of our modern government?

Answer:

The federal government is currently confronting significant and fundamental budgetary challenges that differ in nature and magnitude from those it has faced in previous periods: With our aging population and rising costs for health care, the combination of budget policies that has worked in the past cannot be maintained in the future.

It is certainly true that historical data since 1969 provide somewhat more-relevant information about current government spending commitments than data for much-earlier years, but even the past 40 years of history are not necessarily a good predictor of the future: It is clear that if current policies are continued in the coming years, the aging of the population and the rising costs of health care will boost federal spending, as a share of the economy, well above both the amounts spent in earlier years and the average revenues (as a share of the economy) that the federal government has collected in the past. For example, if the laws governing Social Security and the major health care programs were unchanged, and all other programs were operated in line with their average relationship to the size of the economy during the past 40 years, total federal spending would be projected to be much higher in 2021—nearly 24 percent of GDP—than it has been in recent decades. That amount exceeds the 40-year average for revenues as a share of GDP by nearly 6 percentage points—even before interest payments on the debt have been included.

Thus, the nation cannot continue to sustain the spending programs and policies of the past with the tax revenues it has been accustomed to paying. Given the aging of the population and rising costs for health care, attaining a sustainable federal budget will require the United States to deviate from the policies of the past 40 years in at least one of the following ways:

- Raise federal revenues significantly above their past average share of GDP;

- Make major changes to the sorts of benefits provided for Americans when they become older; or
- Substantially reduce the role of the rest of the federal government relative to the size of the economy.

Question from Senator Baucus:

Much of the hearing focused on historical levels of spending and revenue. But as you explained in your testimony, "The aging of the population and rising costs for health care have changed the backdrop for federal budget policy in a fundamental way." Given these fundamental changes, how would a return to historical levels of spending for Social Security and health programs translate to cuts in currently scheduled benefits in 2021?

Answer:

Social Security, Medicare, and Medicaid have been expanded and modified many times since their inception; as a result, comparisons with spending levels of the past would reflect such programmatic changes, as well as the aging of the population and changes in the cost of health care. In 2000, for example, spending for those three programs amounted to 7.5 percent of gross domestic product (GDP). In CBO's current-law baseline, spending for those three programs is projected to total nearly 12 percent of projected GDP in 2021. To get back down to the 2000 level (as a share of GDP) in 2021 would require reductions, relative to current law, of more than one-third.

The underlying demographic and economic trends, by themselves, would necessitate significant cuts just to return 2021 outlays for those programs to the share of GDP they were in 2011. Spending for Social Security, Medicare, and Medicaid, in total, amounted to a little more than 10 percent of GDP in that year. If policies were changed so that those three programs maintained their current level of spending relative to GDP, outlays in 2021 would be about 12.5 percent—about $350 billion—lower than projected in CBO's most recent current-law projections.

Question from Senator Baucus:

Can you describe where our current level of defense spending stands in historical terms? For instance, how does our current defense spending compare with spending during the Korean War, the Vietnam War, the Reagan Administration, and the Cold War average?

If the sequester were triggered, how would defense spending compare with spending during the Korean War, the Vietnam War, the Reagan Administration, and the Cold War average?

Answer:

There are a number of different ways to compare spending at different points in time. The following are comparisons of spending over time on the military activities of the Department of Defense (DoD) as a share of gross domestic product (GDP) and in constant 2011 dollars (that is, adjusted for inflation).

Spending by DoD as a Share of GDP
Spending by the Department of Defense on military activities amounted to about 4.5 percent of GDP in 2011, slightly lower than the 4.6 percent share in 2010. Although high by recent standards (that 4.6 percent share in 2010 was higher than in any year since 1992), that level of spending is not at all high by historical standards. Prior to the 1990s, DoD's spending in the post-World War II era ranged from a high of almost 12 percent of GDP in 1953 (during the Korean War) to a low of 4.6 percent in 1978. As a share of GDP, DoD's spending on military activities averaged:

- 9.6 percent during the Korean War (1950-1953);
- 7.3 percent during the Vietnam War (1965-1973);
- 5.8 percent during the Reagan Administration (1981-1989); and
- 6.7 percent during the Cold War (1946-1991; data begin in 1948)

If reductions in the annual caps on discretionary funding are triggered for the 2013-2021 period as specified in the Budget Control Act (specifically, if legislation emanating from the Joint Select Committee on Deficit Reduction to lower deficits over the 2012-2021 period is not enacted), CBO estimates that DoD's spending as a share of GDP would average 3.3 percent over that period and fall to a low of 3.0 percent by 2021. For this estimate, CBO assumed that funding each year for overseas contingency operations (OCO—such as the operations in Afghanistan) would equal the annualized level in the current continuing resolution for 2012 (that is, $119 billion) adjusted for inflation. Under that scenario, such spending would account for roughly 21 percent of DoD's spending, on average, over the 2013-2021 period, meaning that non-OCO spending by DoD would fall to about 2.4 percent of GDP by 2021 if defense spending is subject to such caps on new non-OCO funding.

Spending by DoD in Constant 2011 Dollars
DoD's spending for 2011 amounted to $678 billion, an all-time high. In constant 2011 dollars (calculated using the GDP chain-type price index), past peak levels of spending were about $300 billion during the Korean War, $400 billion during the Vietnam War,

and $480 billion in 1989 (a figure that was not reached again until 2004). In 2011 dollars, annual spending by DoD on military activities averaged about:

- $240 billion during the Korean War;
- $340 billion during the Vietnam War;
- $445 billion during the Reagan Administration; and
- $310 billion during the Cold War (data begin in 1948).

If reductions in the annual caps on discretionary funding specified in the Budget Control Act are triggered, CBO projects that DoD's outlays would average $590 billion, in 2011 dollars, over the 2013-2021 period—including an average of $121 billion of annual OCO spending (assuming that OCO funding in each year is equal to the annualized amount in the current continuing resolution for 2012, adjusted for inflation). Even without any OCO spending, those amounts would exceed average spending, in 2011 dollars, during the previous periods shown above.

(Note: DoD spending accounts for over 95 percent of total spending in the defense budget function. Most of the remaining 5 percent of spending in that budget function is for atomic energy activities carried out by the Department of Energy. CBO does not have long-term historical data for that part of defense spending.)

Representative Jeb Hensarling

Opening Statement

The purpose of today's hearing is to highlight the unsustainable nature of our nation's debt and I believe the term "unsustainable," frankly, is understated. I certainly want to welcome Dr. Doug Elmendorf, director of the CBO, who when I was a member of the budget committee, I had an opportunity to work with, truly a professional in this town. Sir, I look forward to your testimony.

In the last organization meeting we had, I mentioned the work by Professors Carmen Reinhart and Kenneth Rogoth, This Time is Different. Through their historical study of financial crises, they indicated that letting debt rise above 90% of GDP was frankly a recipe for bad things to happen to a nation. Well, this year our nation has raced past that tipping point. Our gross debt has now surpassed 100% of GDP. And I believe there are two crises facing our nation, not just a debt crisis, but a jobs crisis, and they are clearly connected. The explosive growth in our nation's debt hampers our job creation today.

Last week I quoted a small business person from the 5th District of Texas on the subject; today I want to quote from a few more—names you may be more familiar with.

Bernie Marcus, former chairman and CEO of Home Depot, which employs 255,000: "If we continue this kind of policy we are dead in the water. If we don't lower spending, if we don't deal with paying down the debt, we are going to have to raise taxes. Even brain-dead economists understand that when you raise taxes you cost jobs."

Mike Jackson, CEO AutoNation, 19,000 employees: "The best thing this town could do to help this economic recovery become sustainable is to deal with the deficit and to see tax reform."

Jay Fishman, Chairman and CEO of Traveler's insurance company: "What is really weighing on their minds is not knowing how the coming explosion in federal debt is going to affect their borrowing costs, liquidity, cost of doing business, and prices."

Finally, two or three months ago the U.S. Chamber came out with their small business survey; 83% of their respondents said that America's debt and deficit have a negative impact on their businesses.

So I would make the point, Madam Co-chair, that a path to credible deficit reduction is a jobs program, and we should not be deterred in that mission. We have a spending driven debt crisis. The deficit reduction will be a jobs plan, and I look forward again to hearing the comments of our colleagues as we go about this important work, and of the testimony of Dr. Elmendorf.

Senator John Kerry

Opening Statement - Hearing on "The History and Drivers of our National Debt"

"We all agree that we're facing an unsustainable financial future. Under CBO's alternative fiscal scenario, debt will reach 82 percent of GDP by 2021, higher than any year since 1948. We all agree we can't let that happen.

"But to avoid that dismal scenario, we have to be clear-eyed about the way we got here and the forces keeping us on that dangerous trajectory. This road began now more than a decade ago. Economic meltdown, two wars, rounds of the largest tax cuts in history, and efforts to forestall larger economic collapse contributed. Demographic challenges loom large in the out years. It is more than just a "spending problem" narrowly defined, and we do the dialogue a disservice by oversimplifying it: both because if it was a mere spending issue, it'd be a lot easier to solve – but also because many tax expenditures are a form of spending in disguise.

"But while there may be partisan interpretations of how we got here, there is bi-partisan consensus not just about the urgency of action to dig us out of this mess, but about the approach it requires. Three bipartisan groups looked at this problem in recent months – Rivlin/Domenci, Simpson/Bowles, and the so-called Gang of 6 – and they've all said that any real solution needs to be balanced with a mix of revenues and spending cuts and long term reforms.

"We benefit from their guideposts, and we also benefit from the cautionary lessons of other countries. That means not fixating on austerity measures alone, particularly in the short term.. We've seen the damage they've caused across Europe, and we can't put our own fragile economy in jeopardy by taking actions that will slow economic growth and decrease job creation. We need growth, not just revenue, and not just cuts. In a recent speech, IMF managing Director Lagarde warned Europe about "drastic upfront belt tightening" and recommended that the United States "strike the right balance between reducing public debt and sustaining the recovery—especially by making a serious dent in long-term unemployment" That's the path we need to take – because any economist will tell you, creating jobs today helps reduce the deficit tomorrow.

"Last week, the Committee for a Responsible Budget, a bipartisan organization which includes some of our country's leading experts on budget issues, including the co-chairs of the Fiscal Commission, recommended that this Committee "go big, go long, and go smart.

"Director Elmendorf's testimony today helps solidify the reality that we need to "go big" and reach savings of more than $1.5 trillion to address long-term deficits. We need to "go long" and address our long-term budget issues. And most importantly of all we need to "go smart" and address the budget without preconceived dogmas or political agendas. So I look forward to delving more deeply into these issues today, and helping us shape recommendations for this Committee and this Congress to adopt.

Thank you."

Senator Patty Murray

Opening Statement

This hearing of the Joint Select Committee on Deficit Reduction will now come to order.

"As my co-chair Representative Hensarling mentioned at our meeting on Thursday, we have agreed to alternate chairing these hearings, with him chairing those held on the House side, and me the ones here in the Senate.

"I want to recognize all of my fellow committee members, as well as our witness, Dr. Elmendorf, for joining us.

"And I want to thank the members of the public here today—we appreciate your presence, and ask that you help us maintain decorum by refraining from any displays of approval or disapproval during the hearing.

"Before I start, I want to announce that the Joint Select Committee's website is now up and running.

"Members of the public can go to deficitreduction.gov where they can provide input and ideas to the Committee, and where all public hearings will be streamed live starting today.

"Today we are going to start off with brief opening statements from committee members—fifteen minutes for the Democrats, and then fifteen minutes for the Republicans.

"We will then hear from Dr. Elmendorf, and following his testimony we will have some time for questions and answers.

"The topic of today's hearing is "The History and Drivers of Our Nation's Debt and Its Threats.

"I think this is a fitting opening for the difficult work this Committee has ahead of us.

"We are tasked with tackling a problem that wasn't created overnight. That didn't come about just in the last few years. Our debt and deficit problems have a lengthy and complex history.

"And we will not be able to truly address them without a deep and honest understanding of the policies and circumstances that have led to where we are today.

"The challenges we face are real, and our task will not be easy—but I am confident we can get it done, because we've done it before.

"Like a number of my fellow committee members, I was here back in the '90s when we were facing serious deficits and a mounting public debt.

"And I was proud to work with President Clinton and Republicans in Congress to balance the budget in a way that truly worked for the American people.

"A way that made the smart cuts to government spending that were desperately needed, included revenues, and continued to make the strong investments in health care, education, and infrastructure that helped lay down a strong foundation for economic growth.

"The balanced and bipartisan work we did not only balanced the budget, and it not only helped set our country up to create millions of new jobs, but it also put us on track to completely pay down our debt by 2012—which was truly a great accomplishment.

"As we all know, a lot has changed since then. For many reasons, our deficit and debt have exploded in the years since. Some of these reasons have to do with government policies here at home, some with decisions made regarding our policies overseas—and others due to the financial and economic crisis that has devastated families and businesses here over the last few years.

"I am looking forward to hearing more about the scope and drivers of our deficit and debt from Dr. Elmendorf today.

"And I am confident the members of this Committee can help bring our nation together once again around a balanced and bipartisan path to fiscal health and economic growth."

Senator Rob Portman

WASHINGTON, D.C. – U.S. Senator Rob Portman (R-Ohio) a member of the Joint Select Committee on Deficit Reduction, today made the following opening remarks, as delivered, during the Committee's hearing on "The History and Drivers of Our Nation's Debt and Its Threats."

Thank you, Madame Chair. And welcome Director Elmendorf. As you all know, this Committee is going to be relying heavily on your analysis and for your scoring. And to you and your colleagues behind you, I thank you in advance for the many hours you will put in. Our success or failure will depend in large measure on your good work, so we need you and look forward to your responses to our many requests.

I listened to my colleagues' comments this morning and I must say I'm delighted you're here today because we need to have a little objective analysis of how we got to where we are and I know you'll provide that. I hope you'll also talk a little about the appropriate baseline for us to use to look at our proposals. It's always going to be compared to what? Whether it's a spending issue or a revenue issue. And as you know, I have some concerns about the current law baseline because I don't think it's realistic. And I want you to address that today if you could. Is that closer to realistic or is the current policy baseline or is there another one like the long term extended baseline, alternative fiscal scenario – all these are going to matter greatly in our work.

We have a $1.5 trillion-dollar task over the next ten years. This of course is a huge challenge but I'd also like your analysis of how that compares to what you see as the real fiscal challenge over the next ten years and the real economic challenge we face. As many of the colleagues on the committee have mentioned this morning, obviously our economy is directly linked to what we do. And we hear about this today from you as we'll see how we got in the situation we're in, largely because of economic conditions. Just as in the late 90's because of the growing economy we were able to come to a unified balanced budget faster than anyone expected.

Using your data and the current policy baseline, as I look at $1.5 trillion I think it's about 4 percent of projected spending over the next 10 years. So in that sense it seems like it's something realistic. It's also as I look at it, based on again your data, and the current policies, less than 20 percent of the projected increase in the deficit over the next 10 years. So 1.5 seems to me to be something we should be doing at the very least. Again I look forward to your insights on that and what is the most realistic baseline.

I hope you and your colleagues will also help us better understand the impacts of policy choices over the coming decades. As I look at your projections, it seems to me that deficit and debt levels would be devastating to our economy over the second, third and fourth 10 years if we don't do something about the longer term impact. So while we could, within this budget window, find ways to 1.5, it will not be something that markets will react to well in my view unless we're also looking at long term impacts. And we'd love to have your view there.

The long-term budget estimates are so unsustainable, that your alternative budget scenario simply stops calculating the national debt after 2036, because it is so unsustainable. We will have crossed into totally unchartered territory.

Clearly, entitlement spending is driving these long-term deficits to impossible levels. I'm interested in hearing what reforms you think can protect those in need, which we must do while at the same time modernizing these programs and placing them on a sustainable path for future generations.

Again, thank you for being before us and more importantly, thank you for all the hard work you'll be doing with us over the next several weeks.

Representative Fred Upton

I'd like to begin by thanking Mr. Elmendorf for joining us today to examine the history and drivers of our nation's debt and the threat this debt poses to our long-term economic health and stability.

So why are we here? Why was this committee created? In my view, it is ultimately a question of jobs. We need jobs to get our economy growing. We need jobs to improve the fiscal outlook and bring in more revenues because more folks are working.

We hear from job creators all the time who tell us the long-term debt burden and uncertainty about spending and entitlements are keeping them from investing and growing. When I am home in Michigan, where families have faced double-digit unemployment for 32 straight months, people are crying out for an economy they can count on, and that begins by getting our fiscal house in order.

Our nation's fiscal future is on an unsustainable path. If job creators lack confidence in our *economic policy*, that means they lack confidence in our *economy*. And that lack of confidence means they're not hiring.

Deficit reduction is a pro-growth strategy. Reducing our deficit by cutting spending and reforming entitlements will help restore that confidence. And that is why we are here.

We need to look at the spending side of the ledger, and especially at the health care spending and entitlements that continue to grow at an unsustainable rate. I expect we will hear from Mr. Elmendorf this morning about the unique challenges when it comes to both containing health care spending and accurately estimating the impact of policy changes on such spending. The combination of an aging population and ever-rising health care costs means that health care is going to consume more and more of our budget each year.

Left unchecked, this would force us to choose among several unacceptable options. The massive tax increases that would be required to pay for these costs would send our economy into a permanent downward spiral, which would only worsen our long-term fiscal outlook. Dramatically reducing benefits becomes more likely as time passes without action. The only remaining choice would be to disinvest in other national priorities as health care consumes nearly every dollar we take in. None of these are welcome choices.

So what do we do about it?

That is the question the JSC was created to answer. And the solutions are not a mystery. We need to reform entitlements and begin to tackle the rising cost of health care. We need to shrink the size of government so we are living within our means. We need to enact policies that spur investment and economic growth.

With passage of the health care law, Congress dramatically expanded the entitlement state and made an already-unsustainable fiscal challenge significantly worse. I can point to three new entitlements in that law – premium/cost-sharing subsidies, an unprecedented expansion of Medicaid, and the unsustainable CLASS program – three programs that are not benefitting a single American today, yet they will cost trillions in the long-term.

President Obama promised Medicare and Medicaid reform in his address to Congress last week. While I am disappointed we have not yet received his entitlement reform or deficit reduction proposals, I am eager to see them so they can be viewed alongside his proposals for new spending. I'm also eager for Mr. Elmendorf to score the entirety of the president's plan, so we know what he is asking to spend and how he proposes to pay for this spending. But as we review the existing Medicare and Medicaid programs, we should also look to potential changes in the new entitlements when we weigh the difficult choices about what we can afford.

As the president said, we need entitlement reform – I have consistently argued we need to address the rising cost of health care if we want these programs to serve future generations and not simply bankrupt them. I look forward to hearing Mr. Elmendorf's thoughts on our fiscal picture as a whole, and particularly his views on the role of entitlement spending and where we are headed.

Representative Chris Van Hollen

"Yesterday there were two important developments that relate to our work.

"First, the President submitted to Congress a jobs plan that is fully paid-for over 10 years. Every day that Americans are out of work, the country is hurting and the deficit is growing. The fastest, most effective way to reduce the deficit is to put Americans back to work. We must address that reality in our work and include job creation as part of our effort.

"Second, the co-chairs of the bipartisan National Commission on Fiscal Responsibility and Reform, Alan Simpson and Erskine Bowles, called upon our Committee to 'go big' – urging us to use this unique opportunity to develop a plan to reduce the deficit by over $4 trillion over 10 years, including the almost $1 trillion in savings from the Budget Control Act. They are right. We should propose a plan of that size.

"The bipartisan Simpson-Bowles Commission and the bipartisan Rivlin-Domenici Commission, as well as the Gang of Six, have provided a framework for how to achieve that goal. What is clear in all of their work is that a balanced approach is required to reduce the deficit – one that contains savings achieved from modernizing certain programs as well as savings gained by simplifying and reforming the tax code in a way that generates revenue. Addressing a problem of this magnitude requires shared responsibility in order to grow the economy and reduce the deficit.

"The testimony we will hear today from Mr. Elmendorf demonstrates why such a balanced approach is necessary. It vividly illustrates that the policy choices driving our deficit are the significant cuts made to revenues combined with increasing retirement and health security costs due to the retirement of the baby bombers.

"Let's not duck those realities. Let's follow the advice of Simpson-Bowles, Rivlin-Domenici, and the Gang of Six: 'go big." I don't agree with every one of their proposals, but those bipartisan groups have provided this bipartisan group with a framework from which to start."