The Budget and Economic Outlook: Fiscal Years 2011 Through 2021

The United States faces daunting economic and budgetary challenges. The economy has struggled to recover from the recent recession: The pace of growth in output has been anemic compared with that during most other recoveries and the unemployment rate has remained quite high. Federal budget deficits and debt have surged in the past two years, owing to a combination of the severe drop in economic activity, the costs of policies implemented in response to the financial and economic problems, and an imbalance between revenues and spending that predated the recession. Unfortunately, it is likely that a return to normal economic conditions will take years, and even after the economy has fully recovered, a return to sustainable budget conditions will require significant changes in tax and spending policies.

This morning CBO released its annual Budget and Economic Outlook. I will discuss the economic outlook first and then turn to the budget outlook.

CBO expects that production and employment will expand in the coming years but at only a moderate pace, leaving the economy well below its potential for some time. We project that real GDP will increase by about 3 percent this year and again next year, reflecting continued strong growth in business investment, improvements in both residential investment and net exports, and modest increases in consumer spending.

But we have a long way to go on the employment front. Payroll employment, which declined by 7.3 million during the recent recession, rose by only 70,000 jobs, on net, between June 2009 and December 2010. The recovery in employment has been slowed not only by the slow growth in output but also by structural changes in the labor market, such as a mismatch between the requirements of available jobs and the skills of job seekers. We estimate that the economy will add roughly 2.5 million jobs per year over the 2011–2016 period, similar to the average pace during the late 1990s. Even so, we expect that the unemployment rate will fall only to 9.2 percent in the fourth quarter of this year, and 8.2 percent in the fourth quarter of 2012. Only by 2016, in our forecast, does it reach 5.3 percent, close to our estimate of the natural rate of unemployment.

CBO projects that inflation will remain very low both this year and next, reflecting the large amount of unused resources in the economy, and will average no more than 2.0 percent a year between 2013 and 2016.

Economic developments, and the government’s responses to them, have—of course—had a big impact on the budget. We estimate that, if current laws remain unchanged, the budget deficit this year will be close to $1.5 trillion, or 9.8 percent of GDP. That would follow deficits of 10.0 percent of GDP last year and 8.9 percent in the previous year, the three largest deficits since 1945. As a result, debt held by the public will probably jump from 40 percent of GDP at the end of fiscal year 2008 to nearly 70 percent at the end of fiscal year 2011.

If current laws remain unchanged, as we assume for CBO’s baseline projections, budget deficits would drop markedly over the next few years as a share of output. Deficits would average 3.6 percent of GDP from 2012 through 2021, totaling nearly $7 trillion over that decade. As a result, the debt held by the public would keep rising, reaching 77 percent of GDP in 2021.

However, that projection is based on the assumption that tax and spending policies unfold as specified in current law. Consequently, it understates the budget deficits that would occur if many policies currently in place were continued, rather than allowed to expire as scheduled under current law. For example, suppose instead that three major aspects of current policy were continued during the coming decade:

- First, that the higher 2011 exemption amount for the alternative minimum tax (AMT) is extended and, along with the AMT tax brackets, is indexed for inflation,
- Second, that the other major provisions in the recently enacted tax legislation that affected individual income taxes and estate and gift taxes were extended, rather than allowed to expire in January 2013,
- And third, that Medicare’s payment rates for physicians’ services were held constant, rather than

dropping sharply as scheduled under current law.

All of those policies have recently been extended for one or two years. If they were extended permanently, deficits from 2012 through 2021 would average about 6 percent of GDP, rather than 3.6 percent, and cumulative deficits over the decade would be nearly $12 trillion. Debt held by the public in 2021 would rise to almost 100 percent of GDP, the highest level since 1946.

Beyond the 10-year projection period, further increases in federal debt relative to the nation's output almost certainly lie ahead if current policies remain in place. Spending on the government's major mandatory health care programs—Medicare, Medicaid, the Children's Health Insurance Program, and insurance subsidies to be provided through exchanges—along with Social Security will increase from roughly 10 percent of GDP in 2011 to about 16 percent over the next 25 years.

To prevent debt from becoming unsupportable, the Congress will have to substantially restrain the growth of spending, raise revenues significantly above their historical share of GDP, or pursue some combination of those two approaches. The longer the necessary adjustments are delayed, the greater will be the negative consequences of the mounting debt, the more uncertain individuals and businesses will be about future government policies, and the more drastic the ultimate policy changes will need to be. But changes of the magnitude that will ultimately be required could be disruptive. Therefore, Congress may wish to implement them gradually so as to avoid a sudden negative impact on the economy, particularly as it recovers from the severe recession, and so as to give families, businesses, and state and local governments time to plan and adjust. Allowing for such gradual implementation would mean that remedying the nation's fiscal imbalance would take longer and therefore that major policy changes would need to be enacted soon to limit the further increase in federal debt.

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