CRFB Analysis of CBO's January 2011 Baseline
January 26, 2011

The Congressional Budget Office (CBO) released its Budget and Economic Outlook today, showing the country is continuing to head down an unsustainable fiscal path. Under their baseline, debt held by the public will double from $9 trillion (62 percent of GDP) at the end of 2010 to over $18 trillion (77 percent of GDP) by 2021.

The United States cannot afford debt levels this high, particularly considering the rapid projected growth of Social Security, Medicare, and Medicaid expected to occur outside the ten-year budget window. Yet while these numbers are quite scary, they are actually optimistic. CBO's "current law" projections ignore several current practices by lawmakers, which tend to make deficits even worse. Under CRFB's Realistic Baseline, the debt would grow to over 90 percent of GDP by 2021.

In light of these alarming projections, and the few specifics in the President's State of the Union last night, it is critical that President Obama's budget contains a detailed proposal to bring the debt down, and that Congress and the White House take the initiative to work together to solve these problems.

In the analysis below, we discuss the new CBO baseline in detail, examining the updated deficit and debt projections, the future path for revenues and outlays, and CBO's most up to date economic assumptions. We also include our CRFB Realistic Baseline, which includes a number of existing policies that are slated to expire.

Among our major findings:

- Deficit projections over the coming decade have shown spectacular deterioration since August mainly due to the recently enacted tax cut and unemployment package and slightly worse economic growth and unemployment forecasts. The 2011-2020 deficit projections have grown by $1.4 trillion over the past six months, from a projected $6.2 trillion to a projected $7.7 trillion.

- Already at near-record levels, debt is projected to grow significantly over the next decade, reaching 77 percent of GDP under current law, and 92 percent of GDP if a number of current policies are continued. Such levels are likely to put America's credit rating at risk, and could lead to an economic crisis within the next few years.
- Under current law, spending will hover between 23 and 24 percent of GDP over the next decade, well above the historical average of about 21 percent.
- Under CBO's current law baseline, interest payments will rise from 1.5 percent of GDP this year to 3.3 percent of GDP by 2021 – tying a post-war record.

Deficits and Debt

CBO projects the deficit to rise from $1.3 trillion (8.9 percent of GDP) last year, to $1.5 trillion (9.8 percent of GDP) in FY2011, and fall back to $1.1 trillion (7.0 percent of GDP) in FY2012. After this year, the deficit will decline for a few years before stabilizing around $600 billion for another few years as increased revenues and reduced countercyclical spending from economic recovery measures, along with the expiration of the 2001/2003 tax cuts (extended through 2012 last year), improve deficits.

Toward the end of the decade, deficits will resume an upward path, climbing to $763 billion (3.3 percent of GDP) in 2021. And beyond the ten-year window, we expect deficits to rise even further. Over the next decade, CBO projects deficits to total nearly $7 trillion (averaging 3.6 percent of GDP).

These projections are much larger than those from August largely as a result of the $858 billion tax cut package passed in December, which not only extended the 2001/2003 tax cuts for the next two years, but also extended unemployment benefits for a year, instituted a temporary payroll tax holiday, reduced the estate tax, and made other temporary extensions. While most of the costs of this bill occur in 2011 and 2012, we estimate the added debt increases annual interest payments by about $50 billion a year.

Fig. 1: Baseline Deficit Projections

	Actual 2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Ten-Year*
January 2011													
Billions	$1,294	$1.480	$1,100	$704	$533	$551	$659	$617	$610	$696	$739	$763	$6,971
% of GDP	8.9%	9.8%	7.0%	4.3%	3.1%	3.0%	3.4%	3.1%	2.9%	3.2%	3.2%	3.2%	3.6%
August 2010													
Billions	$1,342	$1,066	$665	$525	$438	$507	$585	$579	$562	$634	$685	n/a	$6,246
% of GDP	9.1%	7.0%	4.2%	3.1%	2.5%	2.7%	3.0%	2.8%	2.6%	2.9%	3.0%	n/a	3.3%

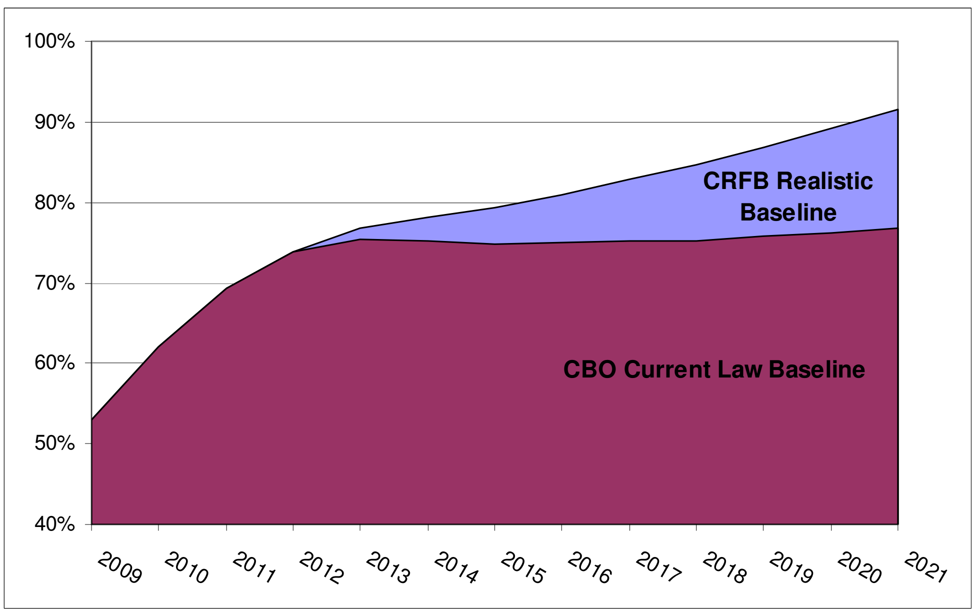
*Ten-year column reflects 2012-2021 for January baseline and 2011-2020 for August baseline.

In addition, updated projections of slower economic growth from 2012-2014 and higher unemployment have increased projected deficits over the 2011-2020 period by over $570 billion. Deficit estimates over the 2011-2020 period are now over $1.4 billion higher than projected in August.

Resulting from the relentless and burgeoning deficits from the past decade, debt held by the public has continued its upward climb. In 2010, debt held by the public reached over $9 trillion (62 percent of GDP). The CBO estimates that deficits will push debt up to $10.4 trillion (69 percent of GDP) at the end of this year, to $11.6 trillion (74 percent of GDP) by 2012, and to over $18 trillion (77 percent of GDP) by 2021. Using more realistic, current policy assumptions, the situation is far worse.

Note that these numbers are well above the internationally accepted threshold of debt at 60 percent of GDP, which is also the level that has been targeted by a number of outside groups concerned with the fiscal situation, including the Peterson-Pew Commission on Budget Reform.

Fig. 2: Debt Held by the Public (Percent of GDP)



Revenues and Outlays

Deficits result from divergent outlay and revenue levels, a trend that will continue unabated if we do not change course. Outlays in FY2011 are projected to be 24 percent of GDP, and remain between 23 and 24 percent over the next decade. Though that would be below last year's levels (25 percent of GDP), it is significantly greater than the historical average of around 21 percent.

Revenues, meanwhile, are projected to rise from a record low of 14.8 percent of GDP in 2011 to a record high of 20.8 percent of GDP in 2021. The low revenues this year are due to a combination of a still-weak economy and a variety of tax cut measures (such as a payroll tax holiday) designed to jumpstart economic growth. Revenue levels are projected to rise significantly as the economy recovers, the 2001/2003 tax cuts and AMT patches expire (as they are scheduled to do under current law), and real bracket creep leads to further revenue growth. Despite this high revenue level, though, even higher levels of spending will ensure that deficits persist.

Fig. 3: Revenues and Spending by Fiscal Year (Percent of GDP)

	2010	2011	2012	2013	2014	2015	2016	Five-Year*	Ten-Year*
					January 2011 Baseline				
Revenues	14.9%	14.8%	16.3%	18.8%	19.9%	20.1%	20.0%	19.1%	19.9%
Outlays	23.8%	24.7%	23.3%	23.1%	23.0%	23.1%	23.5%	23.2%	23.5%
Mandatory	*13.2%*	*14.0%*	*13.0%*	*12.8%*	*12.8%*	*12.9%*	*13.3%*	*13.0%*	*13.3%*
Discretionary	*9.3%*	*9.1%*	*8.6%*	*8.3%*	*8.0%*	*7.7%*	*7.4%*	*8.0%*	*7.4%*
Net Interest	*1.4%*	*1.5%*	*1.7%*	*2.0%*	*2.3%*	*2.5%*	*2.8%*	*2.3%*	*2.8%*
Deficit	8.9%	9.8%	7.0%	4.3%	3.1%	3.0%	3.4%	4.1%	3.6%
					August 2010 Baseline				
Revenues	14.6%	17.5%	18.7%	19.4%	20.1%	20.1%	20.4%	n/a	20.1%
Outlays	23.8%	24.5%	23.0%	22.5%	22.5%	22.8%	23.4%	n/a	23.3%
Deficit	9.1%	7.0%	4.2%	3.1%	2.5%	2.7%	3.0%	n/a	3.3%

* Ten-year column reflects 2012-2021 for January baseline and 2011-2020 for August baseline

Economic Projections

CBO's economic assumptions play a vital role in their future budgetary projections since they influence spending and revenues in a numbers of ways.

CBO's latest projections show real GDP growth at 2.7 percent in 2011. This is higher than their August estimate of 2.1 percent. However, the economy in 2012 is expected to grow at a slower pace than CBO last projected. The better growth this year is due to the increased investment activity and the December tax deal. For much of the ten year window, though, growth is now expected to be slower.

Unemployment continues to fall under CBO's projections – which is welcome news. However, CBO's estimate has unemployment higher than their previous estimate. CBO projects that unemployment will drop to 9.4 percent in 2011, continue to fall to 5.3 in 2016, and stabilize at 5.2 percent for the remainder of the ten-year window.

Lastly, inflation under CBO's latest projection continues to be low, although it is projected to be higher than CBO said in August. CBO projects inflation to be 1.7 percent this year, up by 0.1 percent from August. Additionally, inflation is projected to be 1.6

percent in 2012, which is 0.6 percent higher than in August. Beyond 2015, inflation is expected to stabilize at 2.3 percent as it did in the August projections.

Overall, CBO is slightly less optimistic than it was before, less than the Office of Management and Budget (OMB) was in its Mid-Session Review, and also less optimistic than the latest Blue Chip forecast. As a result of these new economic assumptions, the deficit is $570 billion larger, between 2011 and 2020, than it would be using CBO's August assumptions.

Fig. 4: Comparison of Economic Forecasts

	2010 Estimated	2011	2012	2013	2014	2015	2016	Five-year+	Ten-year*
Inflation (Calendar year over calendar year)^									
CBO January 11	1.7%	1.6%	1.3%	1.6%	1.8%	2.0%	2.2%	1.8%	2.0%
CBO August 10	1.6%	1.0%	1.4%	1.7%	1.9%	2.3%	2.3%	1.7%	2.0%
OMB August 10	1.6%	1.3%	1.8%	1.9%	2.0%	2.0%	2.1%	1.8%	1.95%
Average Blue Chip#	1.6%	1.7%	1.9%						
Real GDP Growth (Calendar year over calendar year)									
CBO January 11	2.8%	2.7%	3.1%	3.1%	3.5%	3.8%	3.0%	3.3%	2.9%
CBO August 10	3.0%	2.1%	3.4%	4.7%	4.2%	2.7%	2.5%	3.4%	2.9%
OMB August 10	3.2%	3.6%	4.2%	4.2%	4.0%	3.6%	3.2%	3.9%	3.3%
Average Blue Chip#	2.8%	3.1%	3.2%						
Unemployment Rate (Annual averages, percent)									
CBO January 11	9.6%	9.4%	8.4%	7.6%	6.8%	5.9%	5.3%	6.8%	6.0%
CBO August 10	9.5%	9.0%	8.1%	6.6%	5.3%	5.0%	5.0%	6.8%	5.9%
OMB August 10	9.7%	9.0%	8.1%	7.1%	6.2%	5.7%	5.3%	7.2%	6.2%
Average Blue Chip#	9.6%	9.4%	8.7%						

+ Five-year column reflects 2012-2016 for January baseline and 2011-2015 for August projections.
* Ten-year column reflects 2012-2021 for January baseline and 2011-2020 for August projections.
^ Inflation measured from calendar year over calendar year change in Consumer Price Index, All Urban Consumers (CPI-U).
# Reflects Blue Chip consensus estimate as of January 2011.

The CRFB Realistic Baseline

Though the debt path outlined in CBO's baseline is troublesome, it is actually wildly optimistic. CBO is required to design their baseline off of current law, and as a result assumes the expiration of a number of policies which are quite likely to continue. Budget conventions also require them to assume discretionary spending continues to grow out the rate of inflation, regardless of the most likely outcome.

In particular, the CBO Baseline assumes:

- The 2001/2003 tax cuts and all of the tax cuts in the recently passed tax deal will expire at the end of 2012, despite the fact that nearly all politicians have called for the extension of at least a large portion, if not all, of them.

- The Alterative Minimum Tax (AMT) will not be "patched" after 2012, despite the fact that Congress has always enacted such patches to prevent the tax from hitting millions of upper-middle and middle income Americans.
- Medicare payments to physicians will decline by 28 percent in January 2012 under the Sustainable Growth Rate (SGR) formula, despite the fact that Congress has delayed and averted similar (but smaller) cuts every year since 2003.
- Spending on the wars in Iraq and Afghanistan will continue at the rate of inflation, despite a strategy in place to withdraw troops from those regions.

CBO is aware of the lack of realism in their baseline, and so they include several cost estimates for selected alternative policies based on lawmakers' current practices. Using these estimates, CRFB has constructed a more realistic baseline that captures what is more likely to occur over the next ten years.

Fig. 5: Deficits under Current Law and CRFB Realistic Baseline Projections (Billions)

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Ten-Year
Current Law Deficits	$1,100	$704	$533	$551	$659	$617	$610	$696	$739	$763	$6,971
Extend Expiring Tax Cuts	$2	$118	$245	$276	$287	$297	$306	$314	$323	$333	$2,501
Continue to Patch AMT	$9	$94	$46	$51	$56	$63	$70	$80	$90	$102	$661
Interaction	$1	$11	$53	$59	$67	$75	$84	$93	$102	$111	$656
Continue "Doc Fixes"	$12	$19	$19	$21	$24	$25	$28	$31	$34	$36	$249
Reduce Troops in Iraq and Afghanistan	-$21	-$54	-$87	-$113	-$129	-$137	-$142	-$147	-$150	-$153	-$1,133
Net Interest	*	$4	$12	$25	$42	$60	$81	$103	$129	$155	$611
CRFB Realistic Baseline Deficits	$1,103	$896	$821	$870	$1,006	$1,000	$1,037	$1,170	$1,267	$1,347	$10,516
CRFB Realistic Baseline Deficits as % of GDP	*7.0%*	*5.5%*	*4.8%*	*4.8%*	*5.3%*	*5.0%*	*5.0%*	*5.4%*	*5.6%*	*5.7%*	*5.4%*
CRFB Realistic Baseline Debt as % of GDP	*73.9%*	*76.7%*	*78.1%*	*79.3%*	*81.0%*	*82.8%*	*84.7%*	*86.9%*	*89.2%*	*91.5%*	*N/A*

Under our baseline, we assume all provisions from the 2001/2003 tax cuts extended last year will be continued permanently (note that deficits would be smaller if the upper-income tax cuts were allowed to expire after 2012), AMT patches will continue, and Medicare physician payment rates will be frozen rather than allowed to fall 28 percent next January. We also assume that the number of troops stationed in Iraq, Afghanistan, and elsewhere will drop from 215,000 in 2010 to 45,000 by 2015. Given the broadening support for discretionary spending controls, we *do* take CBO's base discretionary estimates as is – with spending growing at the rate of inflation. However, if discretionary spending were to instead grow with GDP, it would add an additional $2.1

trillion to the debt over the next decade. On the other hand, a ten-year discretionary freeze (on defense and non-defense) would reduce the debt by over $1.6 trillion over the next decade.

Under our more realistic baseline, deficits in the future are significantly larger than what CBO is projecting under their current law baseline -- $10.5 trillion over the next decade instead of $7.0 trillion. By the end of the decade, deficits would rise to 5.7 percent of GDP (instead of 3.2 percent), and debt would grow to 91.5 percent of GDP (instead of 76.7 percent).

Conclusion

The latest CBO projections show a fiscal picture even more dire than what was projected several months ago. While large deficits may be warranted in the short-term to buttress the economy, they pose a serious threat to our economic wellbeing down the road. By 2021, our debt is projected to grow to larger than three quarters of the economy under current law, and could reach 90 percent or higher under a more realistic set of assumptions. Such levels are unsustainable and put us at great risk of a fiscal crisis. As CBO Director Doug Elmendorf explained today, "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."

We need a comprehensive plan to reduce and control all parts of the discretionary budget, bring federal health care spending in check, put Social Security on a sustainable path, and reform the tax code in a way that encourages growth and raises revenue at the same time.

In his State of the Union address last night, President Obama took a first step by proposing a five-year domestic discretionary freeze and by expressing willingness to address the remaining challenges outlined above. Now, the President must work with Congress to develop a bipartisan plan equal to the magnitude of the problem. Enacting legislation now can allow changes to be phased in slowly so as not to disrupt the recovery, and provide a positive "announcement effect" for businesses and investors.

As Director Elmendorf explained, "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."

For the sake of our economy and posterity, the time for leadership is now.