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Analysis of CBO's Updated Budget and Economic Forecast
August 27, 2014

Today, the Congressional Budget Office (CBO) released updated budget and economic projections for the coming decade, showing today's record-high debt levels continuing to rise over the next decade. The report focuses on a "current law" baseline, which assumes policymakers break with the current practice of deficit-financing extensions of various expired or expiring policies. Even under this somewhat optimistic scenario, CBO shows the following:

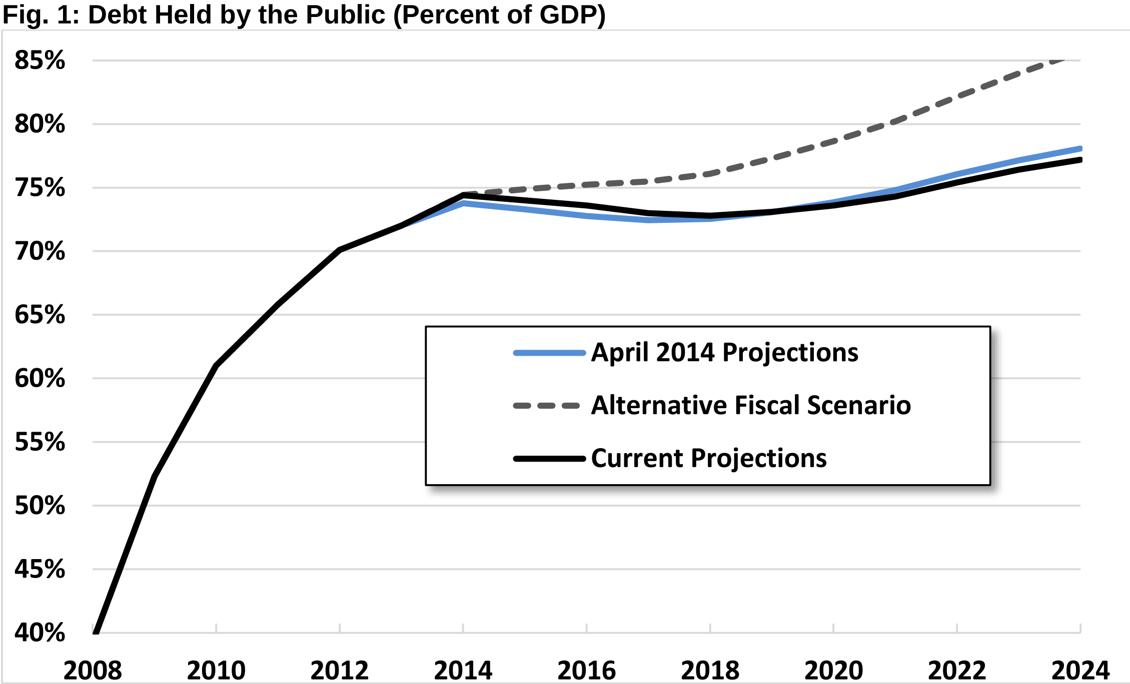
- In nominal dollars, deficits will grow from $506 billion in 2014 to $960 billion in 2024, and debt will grow from $12.8 trillion to $20.6 trillion.
- As a percent of GDP, debt will stabilize around its post-World War II record high of 74 percent through 2020, before rising to above 77 percent of GDP by 2024.
- Deficits will remain below 3 percent of GDP through 2018, but rise to 3.6 percent of GDP by 2024.
- Federal revenues will stabilize at about 18 percent of GDP, while spending will grow from 20.4 percent of GDP in 2014 to 21.8 percent in 2024.
- The fastest growing part of the budget is interest payments, which will rise from 1.3 to 3.0 percent of GDP by 2024. Spending on the major health and retirement programs will grow from 9.8 to 11.5 percent of GDP.
- Compared with prior estimates, CBO expects the economy to be somewhat weaker, mostly due to 2014 growth being 1.2 percentage points lower.
- Compared with prior projections, CBO expects the debt to be about $400 billion lower in 2024, reaching 77.2 percent of GDP rather than 78 percent.
- If extrapolated forward, we find CBO would project debt to exceed the size of the economy before 2040 and reach nearly 150 percent of GDP by 2060.

CBO continues to show an unsustainable outlook for federal debt, even under current law. Under CBO's Alternative Fiscal Scenario, where Congress extends various expiring tax provisions, continues "doc fixes," and eliminates sequestration, debt would reach 85.7 percent of GDP in 2024 instead of 77.2 percent. Lawmakers will therefore need to strictly abide by pay-as-you-go rules *and* take steps to control the growth of entitlement spending, while enacting other tax and spending reforms to put debt on a downward path over the long run.

Budget Projections

As previous projections have shown, CBO expects the debt to remain relatively stable at its post-war record levels for the next few years, before beginning to rise again late in the budget window. Specifically, CBO projects debt will fall from 74.4 percent of GDP in 2014 to 72.8 percent by 2018, then increase to 77.2 percent by 2024. Similarly, deficits will fall to a low of 2.6 percent of GDP in 2015, and rise thereafter to 3.6 percent by 2024. In dollar terms, deficits and debt will both rise substantially, from $506 billion and $12.8 trillion, respectively, in 2014 to $960 billion and $20.6 trillion by 2024.

Fig. 1: Debt Held by the Public (Percent of GDP)



Rising deficits are driven by spending increasing faster than revenues. Total outlays will rise from 20.4 percent of GDP in 2014 to 21.8 percent in 2024. Much of this increase is due to the growth in entitlement programs resulting from health care cost growth, population aging, and the coverage expansion under the Affordable Care Act. Social Security will grow from 4.9 percent of GDP in 2014 to 5.6 percent by 2024. Meanwhile, federal health spending will grow from 4.9 percent of GDP to 5.9 percent by 2024. The fastest growing portion of the budget, however, is interest payments; they will rise precipitously as a result of rising interest rates and growing debt levels. Net interest costs are projected to *double* between 2014 and 2021 – increasing from 1.3 percent of GDP to 2.7 percent – and grow to 3 percent of GDP by 2024.

Revenue, meanwhile, will fail to keep up with spending as it stays largely constant as a percent of GDP over the 10-year window. CBO projects revenues to total 17.5 percent of GDP in 2014, 18.3 percent in 2015, 18.1 percent in 2020, and 18.2 percent in 2024. While individual income taxes will increase as a share of GDP over time – from 8.1 percent of GDP in 2014 to

9.4 percent by 2024 -- other sources of revenue will fall or stay flat as a share of GDP to largely offset that gain.

Importantly, the gap between spending and revenue would be much worse if Congress continues to extend a number of expired or expiring measures without annual offsets. For example, if they reinstate and continue expired and expiring tax provisions, enact an unpaid-for doc fix, and repeal sequestration, spending would rise to 22.7 percent of GDP, and revenue would be 17.9 percent of GDP by 2024, leaving a deficit of 4.8 percent of GDP and debt equal to 85.7 percent.

Fig. 2: Comparing the August 2014 and Previous CBO Budget Projections

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	Ten-Year*
REVENUES (Percent of GDP)												
Aug. 2014 Baseline	17.5%	18.3%	18.1%	18.1%	18.0%	18.0%	18.1%	18.1%	18.1%	18.2%	18.2%	18.1%
Apr. 2014 Baseline	17.6%	18.2%	18.2%	18.1%	18.0%	18.0%	18.0%	18.0%	18.1%	18.2%	18.3%	18.1%
Feb. 2014 Baseline	17.5%	18.2%	18.2%	18.1%	18.0%	18.0%	18.0%	18.1%	18.1%	18.2%	18.4%	18.1%
OUTLAYS (Percent of GDP)												
Aug. 2014 Baseline	20.4%	20.9%	21.0%	20.8%	20.7%	21.1%	21.3%	21.5%	21.9%	21.9%	21.8%	21.3%
Apr. 2014 Baseline	20.4%	20.8%	21.0%	20.9%	21.0%	21.3%	21.5%	21.7%	22.2%	22.1%	22.1%	21.5%
Feb. 2014 Baseline	20.5%	20.9%	21.1%	21.0%	21.1%	21.4%	21.7%	21.9%	22.3%	22.3%	22.4%	21.7%
DEFICITS (Percent of GDP)												
Aug. 2014 Baseline	2.9%	2.6%	2.9%	2.7%	2.7%	3.0%	3.3%	3.5%	3.8%	3.7%	3.6%	3.2%
Apr. 2014 Baseline	2.8%	2.6%	2.8%	2.9%	3.0%	3.3%	3.5%	3.7%	4.0%	3.9%	3.7%	3.4%
Feb. 2014 Baseline	3.0%	2.6%	2.8%	2.9%	3.1%	3.4%	3.7%	3.8%	4.2%	4.1%	4.0%	3.5%
DEBT (Percent of GDP)												
Aug. 2014 Baseline	74.4%	74.0%	73.6%	73.0%	72.8%	73.1%	73.6%	74.3%	75.4%	76.4%	77.2%	N/A
Apr. 2014 Baseline	73.8%	73.3%	72.8%	72.4%	72.5%	73.1%	73.8%	74.8%	76.1%	77.2%	78.1%	N/A
Feb. 2014 Baseline	73.6%	73.2%	72.6%	72.3%	72.6%	73.3%	74.2%	75.3%	76.8%	78.0%	79.2%	N/A
DEFICITS (in Billions of Dollars)												
Aug. 2014 Baseline	$506	$469	$556	$530	$560	$661	$737	$820	$946	$957	$960	$7,196
Apr. 2014 Baseline	$492	$469	$536	$576	$627	$722	$804	$878	$998	$1,005	$1,003	$7,618
Feb. 2014 Baseline	$514	$478	$539	$581	$655	$752	$836	$912	$1,031	$1,047	$1,074	$7,904
DEBT (in Trillions of Dollars)												
Aug. 2014 Baseline	$12.8	$13.3	$13.9	$14.5	$15.1	$15.9	$16.6	$17.5	$18.5	$19.5	$20.6	N/A
Apr. 2014 Baseline	$12.7	$13.3	$13.9	$14.5	$15.2	$16.0	$16.8	$17.8	$18.8	$19.9	$20.9	N/A
Feb. 2014 Baseline	$12.7	$13.3	$13.9	$14.5	$15.2	$16.0	$16.8	$17.9	$19.0	$20.1	$21.3	N/A

*Ten-year figures reflect 2015-2024 period.

The current ten-year outlook is slightly better than the one CBO produced in April, when debt was projected to reach 78.0 percent of GDP (instead of 77.2 percent) by 2024. This difference can be explained entirely by lower projected interest rates.

Economic Projections

CBO's latest report updates its economic projections for the first time since February. CBO revised down their near-term economic growth projections, as 2014 GDP numbers have come in below their estimates, growing at only an average annual rate of 0.9 percent in the first half of this year. The agency expects real economic growth to be stronger for the rest of this calendar year, bringing the rate of growth in 2014 up to 1.5 percent but still down from the 2.7 percent they previously expected. Beyond this year, CBO expects similar growth to what they projected in February but from a lower base. As a result of this change, GDP in 2024 is projected to be about $200 billion (0.8 percent) less than CBO previously anticipated.

While GDP has grown slower than expected, the unemployment rate has fallen significantly faster than CBO anticipated; CBO now expects unemployment to reach 5.9 percent by the end of 2014, compared to the 6.8 percent rate predicted in February. CBO also lowered their unemployment projections in the following few years, with the rate falling to 5.6 percent by the end of 2017. CBO ultimately expects the unemployment rate to stabilize at 5.5 percent.

The projections continue to incorporate CBO's expectation that the economy will in average remain modestly below potential over the long-run (CBO estimates that the natural rate of unemployment is 5.2 percent in 2024), a development they first forecasted in February

Fig. 3 CBO's Economic Projections

Calendar Year	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	Ten-Year
Real GDP Growth												
CBO (August 2014)	1.5%	3.2%	3.5%	3.0%	2.4%	2.3%	2.3%	2.2%	2.1%	2.1%	2.0%	2.5%
CBO (February 2014)	2.7%	3.3%	3.4%	3.0%	2.4%	2.3%	2.2%	2.2%	2.1%	2.1%	2.0%	2.5%
OMB (July 2014)	2.4%	3.5%	3.3%	2.8%	2.5%	2.4%	2.4%	2.3%	2.3%	2.3%	2.3%	2.6%
Blue Chip	1.9%	2.9%	N/A									
Federal Reserve	2.2%	3.1%	2.8%	N/A								
Inflation (CPI)												
CBO (August 2014)	2.0%	2.2%	2.0%	2.1%	2.2%	2.3%	2.4%	2.4%	2.4%	2.4%	2.4%	2.3%
CBO (February 2014)	1.7%	2.0%	2.1%	2.2%	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%	2.3%
OMB (July 2014)	1.8%	2.0%	2.1%	2.2%	2.3%	2.3%	2.3%	2.3%	2.3%	2.3%	2.3%	2.2%
Blue Chip	2.3%	2.1%	N/A									
Federal Reserve*	1.6%	1.8%	1.8%	N/A								
Unemployment Rate												
CBO (August 2014)	6.2%	5.9%	5.8%	5.7%	5.6%	5.6%	5.6%	5.6%	5.6%	5.6%	5.5%	5.6%
CBO (February 2014)	6.8%	6.5%	6.1%	5.9%	5.8%	5.7%	5.7%	5.6%	5.6%	5.5%	5.5%	5.8%
OMB (July 2014)	6.3%	5.7%	5.5%	5.4%	5.4%	5.4%	5.4%	5.4%	5.4%	5.4%	5.4%	5.4%
Blue Chip	6.0%	5.5%	N/A									
Federal Reserve	6.1%	5.6%	5.3%	N/A								
Interest Rates on 10-Year Treasury Notes												
CBO (August 2014)	2.8%	3.3%	3.8%	4.2%	4.6%	4.7%	4.7%	4.7%	4.7%	4.7%	4.7%	4.4%
CBO (February 2014)	3.1%	3.7%	4.3%	4.8%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	4.8%
OMB (July 2014)	2.8%	3.3%	3.7%	4.1%	4.3%	4.5%	4.6%	4.8%	4.8%	4.8%	4.8%	4.4%
Blue Chip	2.9%	3.7%	N/A									

*Federal Reserve numbers reflect Personal Consumption Expenditures (PCE) index, which is on average 0.2 to 0.3 percentage points lower than the Consumer Price Index (CPI).

The most significant change in CBO's economic projections relates to interest rates, which are now predicted to be somewhat lower in both the short term and longer term than CBO projected in February. The ten-year Treasury rate is expected to be 2.8 percent in 2014 instead of 3.1 percent due to lower observed rates so far this year, but is also now expected to stabilize at 4.7 percent rather than 5.0 percent in the longer run. Similarly, the three-month T-bill rate is expected to ultimately reach 3.5 percent, as compared to 3.7 percent in previous projections.

These lower interest rates alone reduce CBO's ten-year deficit projections by $465 billion.

Changes in Budget Outlook

Over 2014-2024, CBO now expects deficits to be $408 billion lower than predicted in April. The largest change results from reduced interest spending. In total, interest payments are projected to be nearly $620 billion lower from 2014-2024, driven largely by the economic revisions described above. In other words, lower interest payments explains roughly 150 percent of the revisions in deficit and debt projections.

In explaining changes, CBO generally divides them between legislative, economic, and technical.

Fig. 4: CBO's Legislative, Economic, and Technical Changes from April Projections

	2014-2019	2014-2024
CBO April Deficits	**$3,421 billion**	**$8,110 billion**
Legislative Changes	**-$4 billion**	**$4 billion**
Highway Funding	-$19 billion	-$10 billion
VA Relief	$13 billion	$10 billion
Supplemental Appropriation	$1 billion	$3 billion
Economic Changes	**-$6 billion**	**-$56 billion**
Revenue	$207 billion	$514 billion
Interest	-$205 billion	-$465 billion
Medicare	-$11 billion	-$49 billion
Medicaid	-$12 billion	-$41 billion
Other Spending	$12 billion	-$8 billion
Debt Service	$2 billion	-$7 billion
Technical Changes	**-$128 billion**	**-$355 billion**
Revenue	-$36 billion	-$153 billion
Interest	-$51 billion	-$89 billion
Medicare	-$19 billion	-$20 billion
Refundable Credits	-$6 billion	-$25 billion
Other Spending	-$9 billion	-$15 billion
Debt Service	-$8 billion	-$53 billion
Total Changes	**-$139 billion**	**-$408 billion**
CBO August Deficits	**$3,283 billion**	**$7,702 billion**

Note: Positives/negatives reflect increases/decreases in deficits. Numbers may not add due to rounding

Legislative changes slightly added to deficits by $4 billion cumulatively through 2024. The Highway Trust Fund patch will reduce the debt by $10 billion, although the deficit reduction technically only offsets the general revenue transfer and partially consists of a gimmick that will produce no savings over the long term. Overtaking this deficit reduction is the $10 billion net cost of the Veterans Affairs (VA) bill, which provides funding for veterans to receive care from non-VA providers and for improvements to the VA itself, and a $225 million supplemental appropriation to Israel, which adds $3 billion through 2024 due to the cost being extrapolated to future years.

CBO's adjusted economic projections had large but largely offsetting effects on the deficits. On the one hand, lower GDP projections led CBO to reduce its revenue projections by over $500 billion. On the other hand, lower interest rates led them to revise down their outlay projections by almost as much. On net, after also accounting for other spending changes, economic changed reduced deficits by $56 billion over the decade.

Finally, CBO revised down 2014-2024 deficits by $355 billion due to technical changes, which consist of changes to program-specific data and forecasting methodologies, largely due to a methodological improvement in how the agency estimates interest paid on Treasury inflation-protected securities and higher income tax receipts.

Conclusion

CBO's latest projections continue to paint a picture of unsustainable federal finances – namely, increasing deficits and debt later this decade and beyond. Under CBO's current law projections, debt would remain at post-World War II record highs throughout the decade, and rise from as low as 72.8 percent of GDP in 2018 to 77.2 percent by 2024.

Even these numbers likely understate the case, since they assume Congress will fully offset (on an annual basis) expired and expiring tax provisions, doc fixes, sequester relief, or any other policy changes they pursue. Assuming this does not fully occur, as under CBO's Alternative Scenario, debt could reach almost 86 percent of GDP by 2024, and would grow even more rapidly and unsustainably over the long term.

These figures highlight the importance of strictly abiding by PAYGO rules in order to avoid making the debt situation worse. At the same time, they show that PAYGO alone is not enough to put the debt on a sustainable long-term path. Doing so will require reducing spending, raising revenue, reforming entitlements, or likely some combination of the three.

CBO's projections show that the economic recovery and various deficit reduction measures enacted in recent years will stabilize the fiscal situation over the next few years, but that those measures have failed to address the drivers of long-term debt: health care cost growth and population aging. In fact, fully 85 percent of the growth in spending over the next decade is due to the growth of Social Security, federal health spending, and interest on the debt. Failing to address these drivers, in combination with other tax and spending adjustments, would be detrimental to the budget and the overall economy.