Committee for a Responsible Federal Budget

Analysis of CBO's August 2011 Baseline and Update of CRFB Realistic Baseline
August 24, 2011

Today, the Congressional Budget Office (CBO) released its Budget and Economic Update, under which current law debt is now projected to be on a declining path by mid-decade. According to CBO's projections, debt held by the public will rise from 67 percent of GDP in 2011 to a high of 73 percent in 2013, before falling to 61 percent by 2021.

As with past CBO baselines, however, current law projections are unlikely to materialize due to a number of unrealistic assumptions. In particular, CBO assumes that policymakers will discontinue their annual practice of passing AMT patches and doc fixes, continue to spend what we are today in Iraq and Afghanistan, and allow all of the 2001/2003/2010 tax cuts to expire as scheduled, and that the newly-appointed Joint Select Committee on Deficit Reduction (Super Committee) will identify $1.2 trillion in unspecified savings. In addition, CBO's new projections are based on economic assumptions from early July, which CBO now views as overly-optimistic.

Under our more realistic set of budgetary projections, which assumes that recently-enacted discretionary caps remain in place but does not include additional savings from the Joint Select Committee on Deficit Reduction (Super Committee), debt would rise to 74 percent of GDP in 2013 and over 81 percent by 2021. Even if the $1.2 trillion in Super Committee savings were to materialize, debt would still be on an upward path and would exceed 76 percent of GDP by 2021.

CBO's latest estimates do show an improvement from March, when our realistic assumptions put debt at 90 percent of GDP in 2021 instead of 81 percent. Still, these projections show that the specific policy changes in the recent debt deal did not go nearly far enough, and even if the Super Committee were to succeed in achieving $1.2 trillion (or $1.5 trillion) in savings, it would not be sufficient to stabilize the debt at a manageable level. We need to put in place a large-scale multi-year deficit reduction plan as quickly as possible, which means the Super Committee must aim to substantially exceed its mandate.

Revenues, Spending, Deficits, and Debt

Under CBO's current law projections, both revenue and outlays will continue to grow as a share of the economy over the long-term, though they will also begin to converge in a way that significantly reduces deficits.

As the economic recovery reduces spending on countercyclical programs and deficit reduction from the Budget Control Act begins to take effect, spending will temporarily fall from 23.8 percent of GDP in 2011 to 22.0 percent by 2015. However, the combination of rising interest rates, growing health care costs, and an aging population will put upward pressure on the budget in the second half of the decade. By 2021, spending is projected to rise to 22.7 percent of GDP, and would most certainly continue to grow thereafter. This is a substantial improvement from the March baseline – where outlays had been projected to grow to 23.9 percent of GDP by 2021.

CBO's projections also show revenue rising rapidly, not only because of the economic recovery but also due to the expiration of the 2001/2003/2010 tax cuts, the assumed discontinuation of AMT patches, and new revenue resulting from the Affordable Care Act. Were this revenue to materialize (we wouldn't bet on it), receipts would grow from 15.3 of GDP in 2011 to 19.0 percent in 2013, 20.2 percent in 2014, and 20.9 percent in 2021. These estimates are quite similar to those from March, although higher in the near-term mainly due to better-than-expected revenue collection.

Fig. 1: Budget Projections Under CBO's August and March Baselines (Percent of GDP)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Revenue											
CBO (August)	15.3%	16.8%	19.0%	20.2%	20.2%	20.1%	20.4%	20.5%	20.6%	20.7%	20.9%
CBO (March)	14.8%	16.3%	18.8%	19.9%	20.0%	20.0%	20.3%	20.4%	20.5%	20.6%	20.8%
Outlays											
CBO (August)	23.8%	23.0%	22.8%	22.4%	22.0%	22.2%	22.2%	22.1%	22.4%	22.6%	22.7%
CBO (March)	24.1%	23.2%	23.0%	22.9%	23.0%	23.3%	23.3%	23.2%	23.6%	23.7%	23.9%
Estimated Effect of the Super Committee											
CBO (August)	0.0%	0.0%	0.7%	0.7%	0.6%	0.6%	0.7%	0.7%	0.7%	0.7%	0.7%
CBO (March)	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Deficits											
CBO (August)	8.5%	6.2%	3.2%	1.6%	1.1%	1.5%	1.2%	1.0%	1.2%	1.2%	1.2%
CBO (March)	9.3%	6.9%	4.2%	3.0%	3.0%	3.3%	2.9%	2.8%	3.0%	3.1%	3.1%
Debt											
CBO (August)	67.3%	71.2%	72.8%	71.6%	68.7%	67.2%	65.8%	64.3%	63.1%	62.0%	61.0%
CBO (March)	68.9%	73.4%	75.1%	74.9%	74.5%	74.6%	74.7%	74.7%	75.0%	75.3%	75.6%

When combined with the $1.2 trillion (about 0.7 percent of GDP per year) in additional savings from the Super Committee, CBO estimates that the gap between current law revenues and outlays will shrink substantially. Deficits, under their estimates, will fall from 8.5 percent of GDP in 2011 to 6.2 percent in 2012, 3.2 percent in 2013, and 1.6

percent in 2014. Deficits in the second half of the decade are projected to vary between 1.0 and 1.5 percent of GDP. By comparison, CBO's March projections had deficits closer to 3 percent of GDP in the second half of the decade.

As a result of these low deficits, CBO projects current law debt levels to fall quite significantly as a share of the economy. After rising from about 67 percent of GDP in 2011 to 73 percent in 2013, debt held by the public is projected to fall to 69 percent by 2015 and 61 percent by 2021. By comparison, CBO's March estimates projected debt would continue to rise, and reach 76 percent of GDP by 2021.

Understanding the Differences from March

CBO's latest current law projections represent a substantial improvement from their March outlook. By 2021, annual deficits are nearly 2 percent of GDP lower and debt held by the public is nearly 15 percent of GDP lower. In total, current law deficits between 2012 and 2021 are projected to be $3.25 trillion less now than they were in March ($3.5 trillion now vs. $6.7 trillion in March).

This $3.25 trillion in lower deficits is due to a number of factors – but results mainly from the policies included in the recently-enacted Budget Control Act (BCA). Specifically, the BCA included about $900 billion in deficit reduction coming mainly from discretionary caps (which future appropriators will have to meet through programmatic cuts), and requires a Super Committee to identify *at least* $1.2 trillion in further deficit reduction or else face automatic spending cuts. Together, these provisions account for $2.1 trillion of the $3.25 trillion difference in deficit projections from March.

Fig. 2: Bridge from CBO's March to August Baseline (Billions of Dollars)

	2012-2016	2012-2021
March Baseline Deficit	**-$3,459**	**-$6,737**
Direct Savings from Budget Control Act	$279	$895
Assumed Savings from Super Committee	$469	$1,200
Other Legislative Changes (Including Spending Cuts in the Continuing Resolution)	$42	$144
Lower Nominal Interest Rates	$373	$634
Other Economic and Technical Changes	$62	$378
August Baseline Deficit	**-$2,232**	**-$3,487**

The remaining differences come primarily from changes in CBO's economic and technical assumptions. Most significantly, CBO now projects nominal interest rates over the next decade to be an average of 0.4 percent lower for ten-year notes and 1.1 percent lower for three-month bills. This leads to about $630 billion less in net interest spending through 2021.

CBO also projects that *nominal* GDP will grow somewhat faster. Though in the near-term, CBO expects slower *real* economic growth, inflation is expected to be higher. By 2014, CBO assumes a relatively vibrant economic recovery and continues to assume faster economic growth than previously projected through 2019.

These adjustments, along with technical updates to their model (including higher than anticipated revenue collection), have resulted in an additional $380 billion improvement in the fiscal picture.

It should be noted, though, that much of the improvement in the fiscal situation since March may indeed be elusive. The $1.2 trillion in cuts from the Super Committee, for example, are by no means guaranteed and could be quite difficult to achieve.

Additionally, CBO generated its economic assumptions in early July and therefore did not incorporate the significant financial and economic developments since then (though they did incorporate the estimated economic effects of the Budget Control Act). Recent data has shown even slower than expected growth in the first half of this year along with revisions to earlier data showing we were in a deeper recession than previously thought. There has also been increased market volatility and growing concerns over the situation in Europe. As CBO explains, "Incorporating that recent news and economic data would have led CBO to temper its near-term forecast for economic growth."

Fig. 3: Economic Projections

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Real GDP Growth											
CBO (August)	2.4%	2.6%	1.7%	4.4%	5.0%	3.2%	2.8%	2.5%	2.5%	2.3%	2.3%
CBO (January)	2.7%	3.1%	3.1%	3.5%	3.8%	3.0%	2.5%	2.4%	2.4%	2.4%	2.3%
OMB (February)	2.7%	3.6%	4.4%	4.3%	3.8%	3.3%	2.9%	2.6%	2.5%	2.5%	2.5%
Inflation (CPI)											
CBO (August)	2.9%	1.5%	1.3%	1.3%	1.8%	2.1%	2.3%	2.3%	2.3%	2.3%	2.3%
CBO (January)	1.6%	1.3%	1.6%	1.8%	2.0%	2.2%	2.4%	2.3%	2.3%	2.3%	2.3%
OMB (February)	1.3%	1.8%	1.9%	2.0%	2.0%	2.1%	2.1%	2.1%	2.1%	2.1%	2.1%
Unemployment Rate											
CBO (August)	8.9%	8.7%	8.7%	7.9%	6.1%	5.4%	5.2%	5.2%	5.2%	5.2%	5.2%
CBO (January)	9.4%	8.4%	7.6%	6.8%	5.9%	5.3%	5.3%	5.2%	5.2%	5.2%	5.2%
OMB (February)	9.3%	8.6%	7.5%	6.6%	5.9%	5.5%	5.3%	5.3%	5.3%	5.3%	5.3%
Interest Rates on 10-Year Treasury Notes											
CBO (August)	3.3%	3.2%	3.3%	3.8%	4.3%	4.9%	5.3%	5.3%	5.3%	5.3%	5.3%
CBO (January)	3.4%	3.8%	4.2%	4.6%	5.0%	5.3%	5.4%	5.4%	5.4%	5.4%	5.4%
OMB (February)	3.0%	3.6%	4.2%	4.6%	5.0%	5.2%	5.3%	5.3%	5.3%	5.3%	5.3%
Interest Rates on 3-Month Treasury Bills											
CBO (August)	0.1%	0.1%	0.2%	0.8%	1.9%	3.2%	4.0%	4.0%	4.0%	4.0%	4.0%
CBO (January)	0.3%	1.1%	2.5%	3.5%	4.0%	4.3%	4.4%	4.4%	4.4%	4.4%	4.4%
OMB (February)	0.2%	1.0%	2.6%	3.7%	4.0%	4.1%	4.1%	4.1%	4.1%	4.1%	4.1%

And finally, the lower projected interest rates come in part from the assumption that debt will be on a declining path as CBO projects under current law. Assuming lawmakers continue current practices, interest costs could rise substantially – by 0.4 or 0.5 percentage points by 2021 according to CBO.

CRFB's Updated Realistic Baseline

Though CBO projects the debt to be on a sustainable path over the course of the decade, these projections are based on a set of assumptions that are highly unlikely to materialize. To offer a better picture of where we are headed under current policy, we have updated our "CRFB Realistic Baseline."

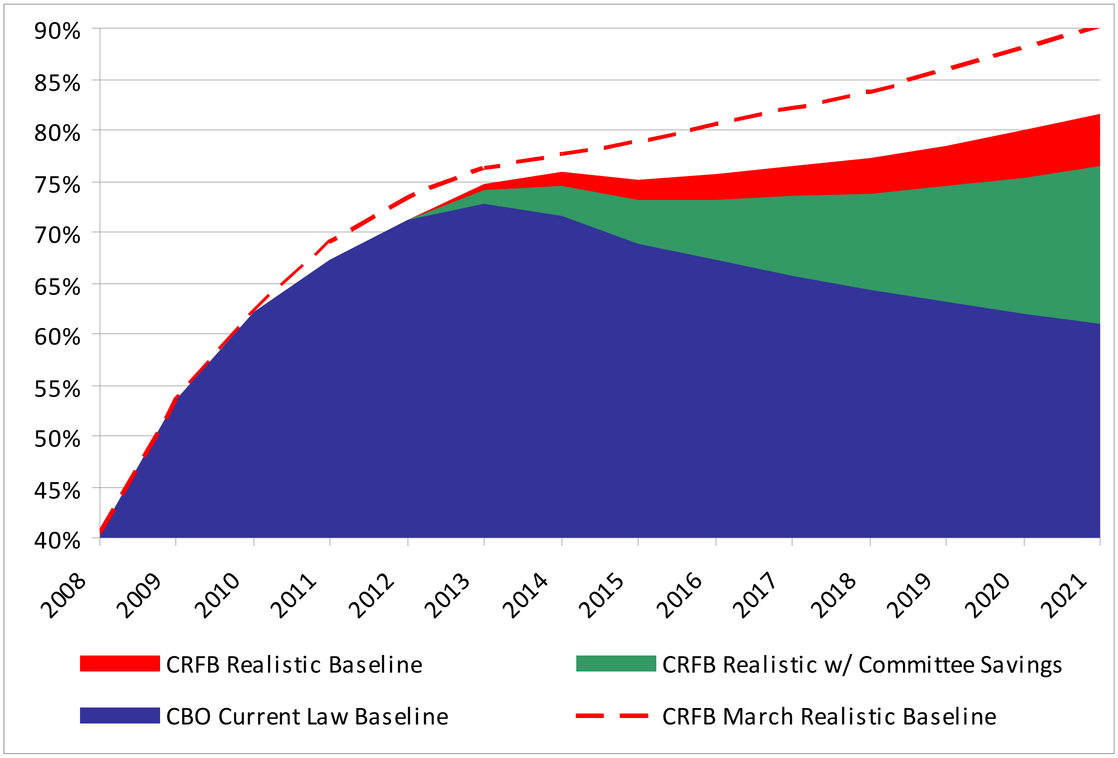
Using CBO's current law budget and economic projections, the CRFB Realistic Baseline first assumes that lawmakers will continue to extend all of the 2001/2003/2010 income and estate tax cuts as they did at the end of 2010. CRFB's baseline also assumes lawmakers will continue patching the Alternative Minimum Tax (AMT) to prevent it from hitting middle-income families and enacting doc fixes to avoid a 30 percent cut in Medicare payments to physicians. We also remove the $1.2 trillion in savings estimated to come from the Super Committee, which we believe would be more appropriate to include once specific policies have been identified and agreed to. And lastly, we incorporate savings from the drawdown of troops from Iraq and Afghanistan that is already in place.

Fig. 4: CRFB Realistic Baseline Projections

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Billions of Dollars										
Spending	$3,603	$3,660	$3,778	$3,948	$4,212	$4,428	$4,634	$4,935	$5,210	$5,487
Revenues	$2,624	$2,831	$3,114	$3,312	$3,465	$3,676	$3,844	$4,032	$4,218	$4,417
Deficits	-$978	-$829	-$664	-$635	-$747	-$752	-$791	-$903	-992	-$1,070
Debt	$11,158	$12,097	$12,870	$13,615	$14,461	$15,312	$16,197	$17,187	$18,263	$19,415
Percent of GDP										
Spending	23.0%	22.6%	22.3%	21.8%	22.0%	22.1%	22.1%	22.5%	22.8%	23.0%
Revenues	16.8%	17.5%	18.3%	18.3%	18.1%	18.4%	18.3%	18.4%	18.5%	18.5%
Deficits	-6.2%	-5.1%	-3.9%	-3.5%	-3.9%	-3.8%	-3.8%	-4.1%	-4.3%	-4.5%
Debt	71.2%	74.8%	75.8%	75.1%	75.7%	76.5%	77.3%	78.5%	79.9%	81.5%

Under these projections, outlays will fall from 23 percent of GDP in 2012 to 22 percent in 2016, before rising back to 23 percent by 2021. Revenues will recover to above 18 percent of GDP by 2014, in light of the economic recovery and other factors, but they will never eclipse 18.5 percent within the 10-year window. Because of the large disparity between taxes and spending, deficits will remain high, falling only to 3.5 percent of GDP by mid-decade, and rising up to 4.5 percent by 2021. Under this scenario, our debt will continue to grow, from 67 percent of GDP in 2011 to over 81 percent by 2021.

Fig. 5: CRFB Realistic Baseline Debt (Percent of GDP)



While these projections represent an improvement from March, they still result in a high and rapidly increasing debt path. This would still be true even if the Super Committee were to succeed in identifying $1.2 trillion in savings – in which case the debt would exceed 76 percent of GDP by 2021 and continue on an upward path thereafter.

Conclusion

The recently enacted spending caps have improved the country's fiscal outlook. If the Super Committee finds the savings it has been charged to, that will improve the outlook further. But neither scenario will be nearly enough to stabilize and reduce our debt.

The bottom line is clear: the Super Committee should find savings in excess of its mandate by passing a package two to three times as large that includes fundamental reforms to the nation's entitlement programs and tax system.