The 2014 CBO Long-Term Budget Outlook
July 15, 2014

The Congressional Budget Office (CBO) today released its 2014 Long-Term Budget Outlook, detailing the budget picture for the next 75 years. The report shows debt rising as a share of the economy continuously after 2017, a trend that CBO describes as unsustainable over the long run.

Under the Extended Baseline Scenario (EBS), which assumes that policymakers allow temporary spending and tax provisions to expire and do not further increase deficits in the years ahead, debt held by the public will rise from 74 percent of Gross Domestic Product (GDP) in 2014 – a post-war record – to 108 percent by 2040, 147 percent by 2060, and 212 percent by 2085.

This dramatic rise in debt assumes policymakers act in a fiscally responsible manner. The Alternative Fiscal Scenario (AFS), which assumes that policymakers will increase spending and reduce taxes compared to current law, shows a steeper climb in debt – to 170 percent of GDP by 2040, and by our calculations to 330 percent by 2060, and 620 percent by 2085.

Fig. 1: Fiscal Projections under CBO's Long-Term Scenarios (% of GDP)

	2000	2014	2025	2040	2060	2085
Extended Baseline Scenario						
Spending	17.6%	20.4%	22.6%	26.0%	29.6%	35.5%
Revenue	19.9%	17.6%	18.4%	19.5%	21.3%	23.6%
Deficit	-2.3%	2.8%	4.2%	6.5%	8.3%	11.9%
Debt	**34%**	**74%**	**80%**	**108%**	**147%**	**212%**
Alternative Fiscal Scenario*						
Spending	17.6%	20.4%	23.6%	31.8%	42.0%	59.0%
Revenue	19.9%	17.4%	18.0%	18.0%	18.0%	18.0%
Deficit	-2.3%	3.0%	5.6%	13.8%	24.0%	41.0%
Debt	**34%**	**74%**	**89%**	**170%**	**330%**	**620%**

*2060 and 2085 numbers are rough CRFB extrapolations.

Despite legislation in recent years to raise revenue and reduce spending – particularly discretionary spending – the long-term debt situation remains far from solved. Health and retirement programs will continue to grow faster than the economy at a quicker pace than revenue growth, leading to growing deficits, rising interest costs, and ever-rising debt levels.

Policymakers should act quickly to put in place tax and entitlement reforms to put debt on a sustainable long-term path. The longer we wait to act, the more severe the consequences and the more painful the choices will be.

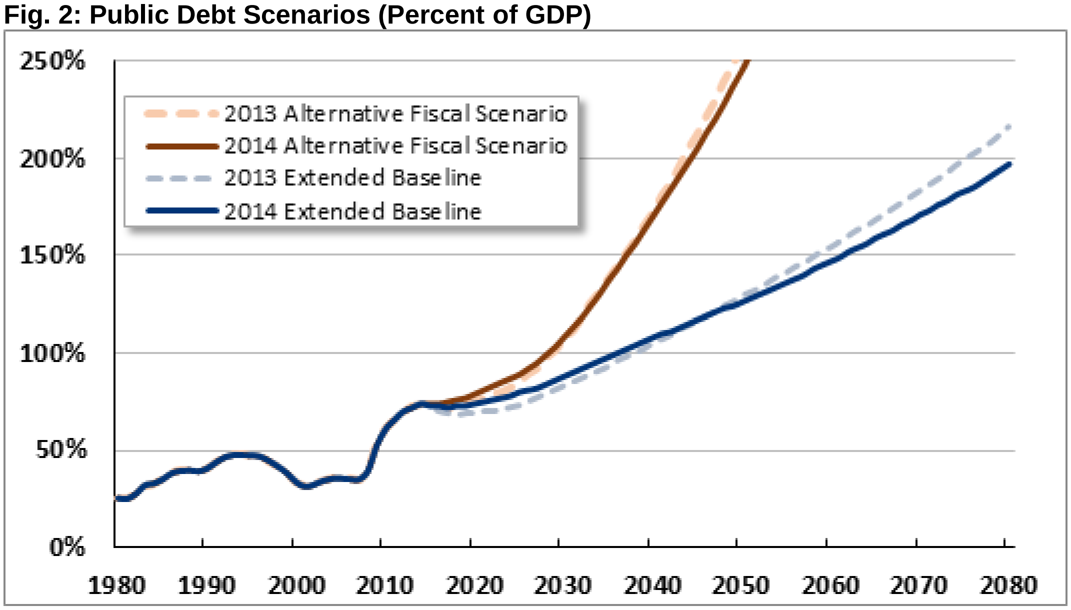
Long-Term Deficit and Debt Projections

Although deficits are projected to remain stable around 3 percent of GDP over the next several years, CBO projects a continuous increase in deficits over the long run. Under CBO's Extended Baseline Scenario, deficits will exceed 4 percent of GDP by 2025, grow to 6.5 percent by 2040, and approach 12 percent by 2085.

As a result of these deficits, public debt will continue to accumulate. Already above its post-World War II record, CBO projects debt held by the public to grow from 74 percent of GDP in 2014 to 80 percent by 2025, 108 percent by 2040, 147 percent by 2060, and 212 percent by 2085. These debt levels would be unprecedented, and as CBO warns, "Beyond the next 25 years, the pressures caused by rising budget deficits and debt would become even greater unless laws governing taxes and spending were changed. With deficits as big as the ones that CBO projects, federal debt would be growing faster than GDP, a path that would ultimately be unsustainable."

These totals represent a modest deterioration from last year's projections over the first three decades, and a modest improvement thereafter.

Fig. 2: Public Debt Scenarios (Percent of GDP)



Importantly, CBO's Extended Baseline projection assumes a somewhat optimistic mix of policies. It assumes lawmakers make no further changes to sequestration (nor find ways to circumvent the discretionary caps), allow a 24 percent cut to Medicare physician payments next April, and fail to renew expired or expiring tax provisions. It also assumes that lawmakers allow revenue to climb to record high levels as a share of GDP, while non-health and non-Social Security spending to fall to record lows.

CBO also publishes an Alternative Fiscal Scenario (AFS), which represents a much more pessimistic fiscal outlook. It incorporates several policy assumptions that may be considered more realistic or more in line with what policymakers have done historically, though it also includes some assumptions which may be more pessimistic than what is likely to occur.

Specifically, the AFS assumes that policymakers will extend expiring tax provisions, prevent a 24 percent cut in Medicare physician payments in April of next year and freeze those payments going forward without paying for it, and repeal the sequester permanently. In addition, the scenario assumes that lawmakers will keep revenue constant as a share of GDP after 2024 and raise non-health and non-Social Security spending to its historical average.

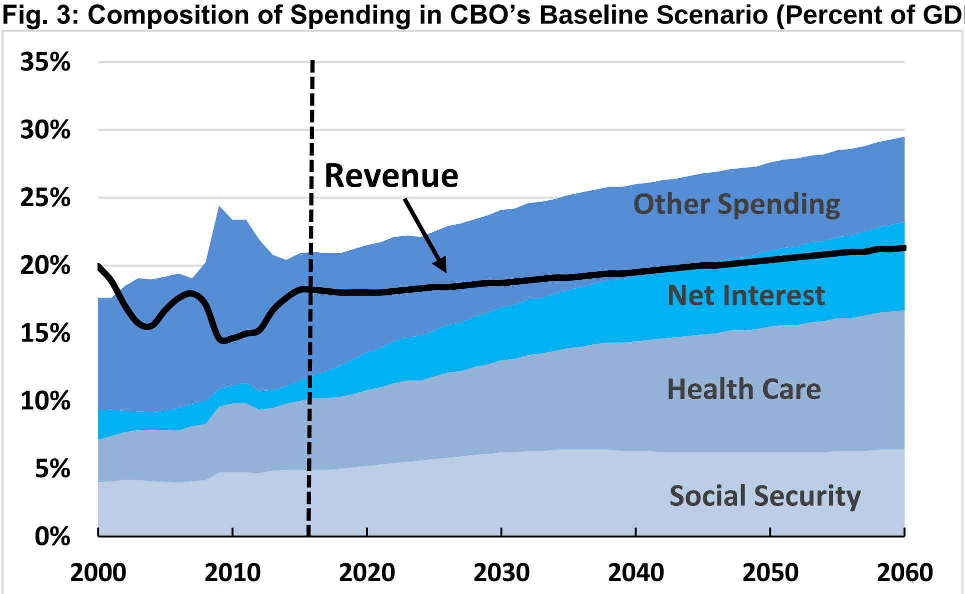
Under the AFS, CBO projects a much more rapid growth in debt levels. Specifically, debt would grow from 74 percent of GDP in 2014 to 170 percent by 2040 and would surpass 250 percent of GDP after 2050. By our estimates, the AFS would lead to debt levels of 620 percent of GDP by 2085.

Spending and Revenues

Over time, CBO projects spending will grow significantly, from more than 20 percent of GDP in 2014 to nearly 22.6 percent by 2025, 26.0 percent by 2040, nearly 29.6 percent by 2060, and nearly 35.5 percent by 2085. By comparison, spending has averaged about 20.5 percent of GDP over the past 40 years.

CBO projects that revenues will also grow as a share of GDP, but from a lower starting point and not as quickly. Specifically, revenues will rise from 17.6 percent of GDP this year to 18.4 percent by 2025, 19.5 percent by 2040, 21.3 percent by 2060 and 23.6 percent by 2085. By comparison, revenue has averaged about 17.4 percent of GDP over the past 40 years.

Fig. 3: Composition of Spending in CBO's Baseline Scenario (Percent of GDP)



Under CBO's projections, the Social Security Disability Insurance fund will run dry in 2017, the Medicare Hospital Insurance Fund will be exhausted in 2030, and the Social Security Old-Age Fund will be exhausted by 2032. The growth in spending is due to a combination of population aging, growing health care costs, and higher debt leading to growing interest payments. Net federal health care spending, under CBO's projections, will grow from 4.8 percent of GDP in 2014 to 8.1 percent in 2040 and 13.4 percent by 2085. Social Security, meanwhile, will grow from 4.9 percent of GDP in 2014 to 6.3 percent by 2040 and 6.8 percent by 2085.

On a combined basis, the Social Security trust funds will run out of money in 2030, necessitating roughly a 25 percent across-the-board cut for all beneficiaries. Importantly, the long-term budget projections assume spending continues at scheduled levels after the trust fund exhaustion, essentially assuming that policymakers will transfer general revenue to fund the program.

On the revenue side, growth is almost entirely due to the effects of "real bracket creep," as individuals become richer and pay an increasing amount of taxes at higher income brackets because those brackets are indexed to prices, whereas people's incomes tend to grow faster. Other factors roughly net out against each other over the next quarter-century.

As this revenue fails to keep up with spending and interest rates rise to more typical levels, interest costs will soar. CBO projects interest payments will grow from 1.3 percent of GDP in 2014 to 4.8 percent in 2040, 6.5 percent in 2060, and 9.4 percent in 2085. Such increases would constitute a 160 percent increase in interest costs by 2025 as a share of the economy and a 270 percent increase by 2040 – an astronomical increase. Compounding interest costs will make it far harder to address the debt issue in the future than it would be starting today.

The Economic Effects of Growing Debt

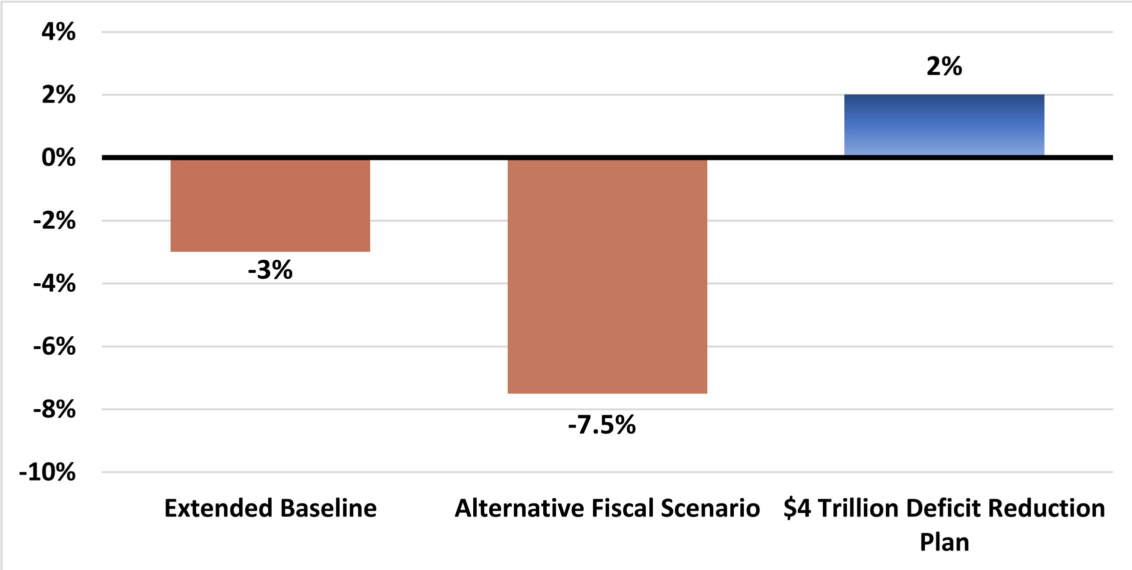
CBO's long-term economic projections are based on "benchmark" assumptions that the economy essentially operates in a stable situation. In reality, high and growing debt levels will hinder long-term economic growth.

According to CBO, simply accumulating the debt levels projected under current law would reduce the size of the economy by about 3 percent in the next quarter-century while increasing interest rates by about a third of a percentage point. Under the AFS, where debt reaches 163 percent of GDP by 2039, the size of the economy would fall by an *additional* 5 percent and interest rates would rise by an additional percentage point.

This weaker economic performance would also lead to a "feedback" effect that would further worsen the fiscal situation. For example, CBO's extended baseline would have debt of 111 percent of GDP in 2039 when economic effects are included, compared to 106 percent without those effects. Since CBO's AFS shows higher levels of debt that become more harmful to the economy, the upward swing in debt is even larger under those projections when economic feedback effects are incorporated – bringing debt up from 163 percent of GDP in 2039 to 183 percent.

Importantly, while CBO's projections show the negative consequences of rising debt, they also show the economic benefits of deficit reduction. Under an illustrative scenario with $4 trillion in non-interest deficit reduction over the next ten years, the economy in 2039 would be 5 percent larger than current law with economic feedback, interest rates would be about three-quarters of a point lower, and debt would fall to near its historical average.

Fig. 4: Percent Change in 2039 of Real GNP from CBO Benchmark



Conclusion

CBO's long-term outlook unequivocally shows that the budgetary status quo is not sustainable. Even with relatively optimistic assumptions, debt would be on a clear upward path as a share of GDP after the next few years and as far as the eye can see. Under CBO's Alternative Fiscal Scenario, which assumes continued fiscally irresponsible actions from lawmakers, the situation is far, far worse. Simply not digging our budget holes deeper will not be nearly good enough to solve the debt issue, though it would at least represent a start.

Rather, policymakers will have to make tough choices in reforming entitlements and the tax code to close the gap between spending and revenue. Although it will be difficult, acting sooner will make the adjustments less painful than waiting for debt to rise, particularly if doing nothing brings about some form of a fiscal crisis. As CBO explains, "The sooner significant deficit reduction was implemented, the smaller the government's accumulated debt would be, the smaller policy changes would need to be to achieve a particular long-term outcome, and the less uncertainty there would be about what policies would be adopted."

Policymakers may have lost focus on the importance of achieving a grand bargain to address the fiscal situation, but that does not mean our debt challenges have simply gone away.

Appendix: Assumptions in CBO's Scenarios

CBO's long-term numbers depend greatly on the policy and long-run assumptions they make. Because there is great uncertainty on both what policies lawmakers will follow and what will happen to spending and revenue over the long term, the agency publishes two baselines: the Extended Baseline Scenario, which extends their ten-year current law projections, and the Alternative Fiscal Scenario, which incorporates other assumptions such as the continuation of temporary policies.

Through 2024, the Extended Baseline Scenario largely assumes current law, which means that temporary provisions expire as scheduled and policies in place are allowed to occur. The sequestration remains in effect, Medicare physician payments are cut by 24 percent in April 2015 when the current "doc fix" expires, the temporary "tax extenders" that expired at the end of 2013 remain expired, the 2009 refundable tax credit expansions expire at the end of 2017, and war spending continues to grow with inflation.

Over the long term, CBO assumes that revenue grows as a percent of GDP due to natural features of the tax code like "real bracket creep," discretionary spending remains constant as a share of GDP, and non-health, non-Social Security mandatory spending gradually declines as a share of GDP. In addition, after 2024, health care spending grows as a percent of GDP initially consistent with the average of growth from 2022-2024, with growth slowly trending toward CBO's underlying cost growth assumptions (which are based on historical averages, adjusted for CBO's assumption that excess health care spending growth must slow gradually over time) by 2039.

By contrast, the Alternative Fiscal Scenario assumes that lawmakers repeal sequestration, enact a permanent unpaid-for doc fix, and extend the tax extenders and refundable credit expansions. Over the long term, the AFS assumes revenue remains constant as a share of GDP after 2024, and discretionary and other mandatory spending return to their historical share of GDP.

Fig. 5: Policy Assumptions under CBO's Extended Baseline and Alternative Fiscal Scenarios

	Extended Baseline Scenario	Alternative Fiscal Scenario
Sequestration	Remains in Effect	Repealed without offsets
Sustainable Growth Rate	24% pay cut in 2015	Payments frozen at 2014 levels
"Tax Extenders"	Remain expired	Reinstated permanently
Refundable Tax Credits	Expire as scheduled after 2017	Continued permanently
LT Revenue	Grows from "real bracket creep"	Frozen in 2024 at 18% of GDP
LT Discretionary Spending	Frozen after 2024 as share of GDP	Gradually increases to historical levels between 2024 and 2034
LT 'Other Mandatory'	Gradually falls as share of GDP	

LT = long term