COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET

Analysis of CBO's Updated Budget and Economic Outlook
August 22, 2012

Today, the Congressional Budget Office (CBO) released their updated budget and economic projections, highlighting the stark choice lawmakers face at year's end. Under CBO's current law scenario, the combination of sudden tax increases and spending cuts which comprise the "fiscal cliff" will cause the debt to fall to 58.5 percent by 2022, after peaking at 76.6 percent of GDP in 2014.

If Congress were to waive the fiscal cliff by extending all expiring tax cuts, repealing the so-called sequester, and extending other policies — as in CBO's Alternative Fiscal Scenario (AFS) — debt would rise from 72.8 percent of GDP this year to 82.5 percent in 2017 and 89.7 percent by 2022.

Our other major findings based on the report include:

- Under current law, CBO projects spending to fall from 22.9 percent of GDP this year to 21.2 percent by 2018 before rising to 22.3 percent by 2022. This compares to a historical average of about 21 percent. Meanwhile, CBO projects revenue to rise from 15.7 percent this year to 20.3 percent by 2015 and 21.4 percent by 2022. This compares to historical averages of about 18 percent of GDP.

- CBO's Alternative Fiscal Scenario projects spending to fall from 22.9 percent of GDP this year to 22.5 percent by 2015 and then rise to 24.1 percent by 2022. Meanwhile, CBO projects revenue to rise from 15.7 percent in 2012 to 17.8 percent by 2015 and 18.6 percent by 2022.

- Under current law, CBO projects the economy to go into recession and shrink by 3.9 percent during the first quarter of 2013 as a result of the fiscal cliff. This retraction is avoided in the AFS, but the accumulation of debt from continuing current policies would permanently slow economic growth and could lead to an eventual fiscal crisis.

CBO's latest projections make clear the need to replace the blunt and sudden fiscal cliff scheduled at year's end with a gradual and thoughtful debt reduction plan. Pursuing this strategy would be better for the economy in both the short and long-term.

Revenues, Spending, Deficits, and Debt

CBO's revised baseline projects that the federal government will run a deficit of 7.3 percent of GDP in 2012, slightly lower than the 7.6 percent deficit projected in its March baseline. Deficits will continue to drop to 4.0 percent in 2013, 2.4 percent in 2014, and 1 percent in 2016. Beyond 2016, deficits are projected to range from 0.4 to 0.9 percent per year.

In total, deficits are projected to equal $2.3 trillion (1.1 percent of GDP) between 2013 and 2022, compared to $2.9 trillion (1.4 percent of GDP) projected in March, 2012. The difference is largely due to lower projected health care spending as a result of the Supreme Court decision on the Affordable Care Act and slower growth of overall health costs, lower projected interest rates reducing interest on the debt, and higher projected revenue due to a larger corporate tax base.

As a result of these deficits, debt held by the public will continue to grow in nominal terms—from $11.3 trillion in 2012 to $14.5 trillion in 2022. Relative to the size of the economy, however, debt will peak in 2014 and then begin to decline—from 76.6 percent of GDP to 58.5 percent by 2022. These levels are about 3 percentage points lower than the 61.3 percent projected in the March baseline, and substantially lower than the current debt of 72.8 percent.

According to CBO's latest projections, revenue will continue to grow as a share of the economy over the next ten years, while spending will slightly decrease. As a result of the sequester and Sustainable Growth Rate formula going into effect at the beginning of 2013, spending is expected to fall from 22.9 percent of GDP in 2012 to 21.2 percent by 2018. However, CBO finds that it will begin to gradually increase again in the latter half of the decade, up to 22.3 percent by 2022, generally due to growing health care costs and the retirement of the baby boomers, but also portions of the sequester ceasing to be in effect.

Fig. 1: Budget Projections Under CBO's August and March 2012 Baselines (Percent of GDP)

Fiscal Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2013-2022
REVENUES												
CBO (August)	15.7%	18.4%	19.6%	20.3%	20.6%	20.7%	20.8%	20.9%	21.1%	21.2%	21.4%	20.6%
CBO (March)	15.8%	18.7%	19.8%	20.4%	20.5%	20.6%	20.7%	20.7%	20.9%	21.0%	21.2%	20.5%
OUTLAYS												
CBO (August)	22.9%	22.4%	21.9%	21.5%	21.6%	21.4%	21.2%	21.5%	21.7%	21.8%	22.3%	21.7%
CBO (March)	23.4%	22.5%	22.1%	21.8%	21.9%	21.7%	21.5%	21.8%	21.9%	22.0%	22.4%	22.0%
DEFICITS												
CBO (August)	7.3%	4.0%	2.4%	1.2%	1.0%	0.6%	0.4%	0.6%	0.6%	0.6%	0.9%	1.1%
CBO (March)	7.6%	3.8%	2.3%	1.5%	1.4%	1.0%	0.8%	1.0%	1.0%	1.0%	1.2%	1.4%
DEBT												
CBO (August)	72.8%	76.1%	76.6%	73.8%	70.8%	67.9%	65.2%	63.2%	61.4%	59.8%	58.5%	n/a
CBO (March)	73.2%	75.8%	75.8%	73.3%	70.9%	68.8%	66.9%	65.3%	63.9%	62.4%	61.3%	n/a

On the revenue side, CBO projects receipts will increase from 15.7 percent of GDP in 2012 to 18.4 percent in 2013, reaching 21.4 percent by 2022. This forecast assumes the full expiration of the 2001/2003/2010 tax cuts and the Alternative Minimum Tax hitting millions more taxpayers than it does now, a scenario that is unlikely to occur.

Economic Projections

In constructing its budgetary projections, CBO first must make various economic assumptions with regards to GDP growth, inflation, the unemployment rate, and interest rates. These assumptions directly impact revenue and spending projections in a number of ways.

Due to the "fiscal cliff" expected to occur at years' end, CBO projects a steep contraction in the first two quarters of 2013, with real GDP declining at an annualized rate of 3.9 percent and 1.9 percent in the first and second quarters respectively. Growth will be modest for the rest of the year, not enough to offset the contraction at the beginning of the year. As a result, growth is -0.3 percent for the year.

Not surprisingly, unemployment also will rise as a result of the fiscal cliff. It will increase from 8.2 percent at the end of 2012 to 8.7 percent by midway through 2013. It will rise further to 9.1 percent by the end of 2013 before beginning to decline starting in 2014.

Fig. 2: Economic Projections

Calendar Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Real GDP Growth											
CBO (August)	2.1%	-0.3%	3.1%	4.8%	4.5%	3.8%	3.1%	2.6%	2.4%	2.2%	2.3%
CBO (January)	2.2%	1.0%	3.6%	4.9%	4.2%	3.3%	2.8%	2.6%	2.5%	2.4%	2.4%
OMB (July)	2.3%	2.7%	3.5%	4.1%	4.0%	3.8%	3.2%	2.7%	2.5%	2.5%	2.5%
Blue Chip	1.8%	2.5%	N/A								
Federal Reserve	2.1%	2.5%	3.3%	N/A							
Inflation (CPI)											
CBO (August)	1.8%	1.4%	1.8%	2.0%	2.2%	2.3%	2.3%	2.3%	2.3%	2.3%	2.3%
CBO (January)	1.7%	1.5%	1.5%	1.7%	2.0%	2.2%	2.3%	2.3%	2.3%	2.3%	2.3%
OMB (July)	2.1%	1.9%	2.0%	2.0%	2.1%	2.2%	2.2%	2.2%	2.2%	2.2%	2.2%
Blue Chip	1.7%	2.1%	N/A								
Federal Reserve*	1.5%	1.8%	1.8%	N/A							
Unemployment Rate											
CBO (August)	8.2%	8.8%	8.7%	7.7%	6.7%	5.9%	5.5%	5.5%	5.4%	5.4%	5.3%
CBO (January)	8.8%	9.1%	8.7%	7.4%	6.3%	5.7%	5.5%	5.5%	5.4%	5.4%	5.3%
OMB (July)	8.0%	7.7%	7.3%	6.7%	6.2%	5.7%	5.4%	5.4%	5.4%	5.4%	5.4%
Blue Chip	8.1%	7.7%	N/A								
Federal Reserve	8.1%	7.8%	7.3%	N/A							
Interest Rates on 10-Year Treasury Notes											
CBO (August)	1.8%	1.8%	2.4%	3.0%	3.8%	4.5%	4.9%	5.0%	5.0%	5.0%	5.0%
CBO (January)	2.3%	2.5%	2.9%	3.5%	4.1%	4.6%	4.8%	5.0%	5.0%	5.0%	5.0%
OMB (July)	2.0%	2.7%	3.5%	4.1%	4.5%	4.9%	5.0%	5.1%	5.1%	5.1%	5.1%
Blue Chip	1.8%	2.5%	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).

Both growth and unemployment will improve beyond 2013. Real growth is projected to be 3 percent in 2014 and near 5 percent in 2015 and 2016 before settling into a steady state of around 2.5 percent by 2019. Unemployment will decline steadily to 6.7 percent by 2016 and will settle in at around 5.5 percent by 2018.

Compared to their previous projections, CBO is generally more pessimistic in the near term because the fiscal cliff is now more severe due to the fact that the payroll tax cut, unemployment insurance extension, and doc fix are projected to expire at the end of the year. However, they do have lower projected unemployment than previously projected for January, 2012.

Compared to other forecasters, CBO is more pessimistic since other forecasters generally assume that the fiscal cliff will be mostly averted. As a result, other forecasters project modest growth and a decline in the unemployment rate, rather than the economic contraction in CBO's projections.

CBO's Alternative Fiscal Scenario

While CBO's baseline scenario provides useful information on where the country is headed if Congress follows the law as it is written, Congress is very likely to deviate from current law in a number of ways. For this reason, CBO constructs a second and in many ways more realistic scenario based on what would happen if policymakers continued to extend current policies.

CBO's Alternative Fiscal Scenario (AFS) assumes the extension of all the 2001/2003/2010 tax cuts, continued enactment of patches to the AMT to prevent it from hitting middle-income earners, continued doc fixes to avoid the scheduled 27 percent cut in Medicare physician payments, the repeal of the automatic sequester, and the extension of various temporary "tax extenders."

Fig. 3: Alternative Fiscal Scenario Projections

Fiscal Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2013-2022
REVENUES												
CBO (August)	15.7%	16.3%	17.2%	17.8%	18.1%	18.3%	18.3%	18.4%	18.5%	18.5%	18.6%	18.1%
CBO (March)	15.7%	16.7%	17.3%	17.9%	18.1%	18.2%	18.2%	18.2%	18.3%	18.4%	18.5%	18.0%
OUTLAYS												
CBO (August)	22.9%	22.8%	22.9%	22.5%	22.6%	22.5%	22.5%	23.0%	23.3%	23.6%	24.1%	23.0%
CBO (March)	23.4%	23.0%	23.1%	22.9%	23.1%	22.9%	22.9%	23.3%	23.6%	23.9%	24.3%	23.4%
DEFICITS												
CBO (August)	7.3%	6.5%	5.6%	4.6%	4.5%	4.2%	4.2%	4.6%	4.8%	5.1%	5.5%	4.9%
CBO (March)	7.7%	6.3%	5.8%	5.0%	5.0%	4.8%	4.7%	5.1%	5.3%	5.5%	5.9%	5.3%
DEBT												
CBO (August)	72.8%	78.6%	82.3%	82.5%	82.5%	82.5%	82.9%	84.1%	85.7%	87.5%	89.7%	n/a
CBO (March)	73.3%	78.4%	81.7%	82.4%	83.1%	84.1%	85.4%	87.1%	88.9%	90.9%	93.2%	n/a

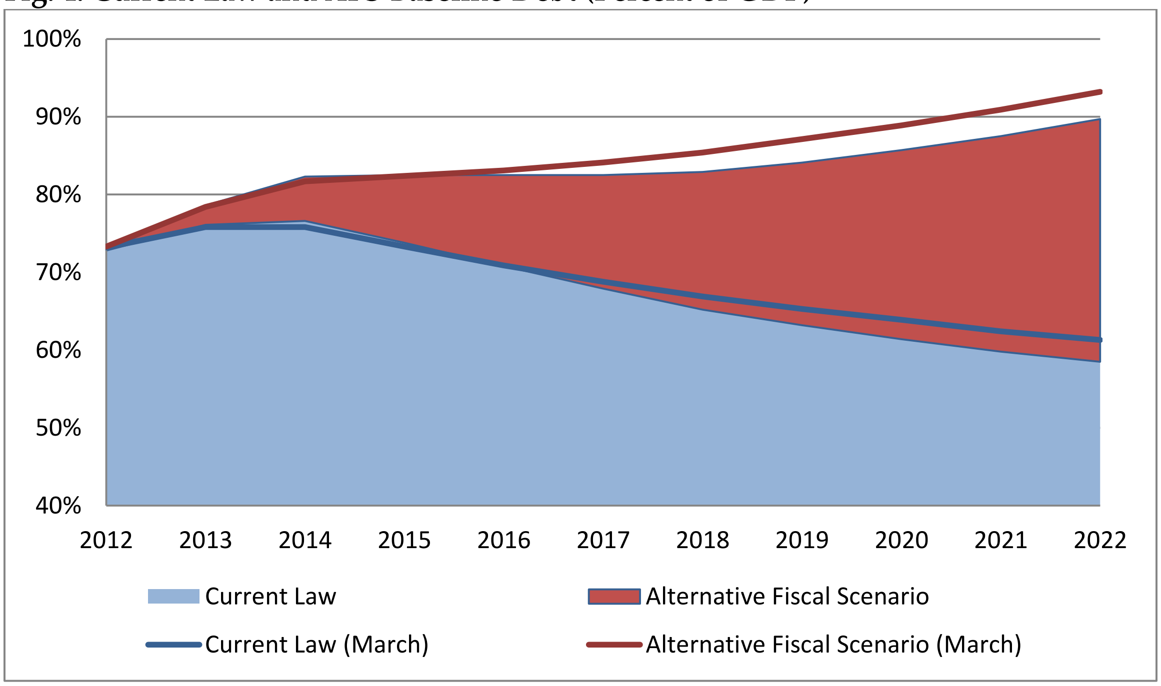
Under the AFS, CBO projects spending will decline from 22.9 percent of GDP in 2012 to 22.5 percent of GDP in 2015, before rising again to 24.1 percent by 2022. This compares to 2022 levels of 22.3 percent in their current law scenario.

Revenue under the AFS are projected to increase from 15.7 percent of GDP in 2012 to 17.8 percent by 2015 and 18.6 percent by 2022 as a result of the economic recovery, real bracket creep, and new taxes enacted as part of the Affordable Care Act. This is compared to 2022 revenue levels of 21.4 percent in their current law scenario.

As a result of the large divergence between revenue and spending, deficits will remain relatively high over the next ten years, only reaching a low of 4.2 percent by 2017 before rising to 5.5 percent by 2022. Meanwhile, debt as a share of the economy will continue to grow from 72.8 percent in 2012 to nearly 90 percent in 2022.

Under this scenario, CBO projects the economy would grow about 2.2 percent faster in 2013 since waiving the fiscal cliff policies would avert a double-dip recession. However, by 2022 annual growth would be about 0.2 percent slower each year and interest rates 0.4 percent higher. Eventually, this scenario would result in more debt than the markets could bear, leading either to the enactment of future austerity measures, a fiscal crisis, or both.

Fig. 4: Current Law and AFS Baseline Debt (Percent of GDP)



Conclusion

CBO's latest baseline shows a similar outlook as its earlier report this year. The country's debt trajectory would be put on a sustainable path in CBO's current law scenario, but only by throwing the economy into a double-dip recession and relying on many blunt and sudden policies which could inhibit long-term growth and would fail to address the real drivers of the debt.

If we continued current policies by waiving the components of the fiscal cliff—as in CBO's Alternative Fiscal Scenario–we would avoid a recession in 2013, but at the cost of dramatically rising debt, permanently slower growth, and the risk of an eventual fiscal crisis.

The next several months present a challenge for lawmakers, but also offer an opportunity for them to work together on a sensible plan to both avoid the fiscal cliff while also controlling the debt. It is critical they move swiftly to enact a comprehensive plan to set our nation on a sustainable fiscal track. The strength of the American economy and standard of living will suffer if they do not.