Committee for a Responsible Federal Budget

CRFB Analysis of CBO's January 2010 Baseline
January 26, 2010

The Congressional Budget Office (CBO) released its Budget and Economic Outlook today, showing the country will continue on an unsustainable fiscal path. Under their baseline, debt held by the public will double in nominal terms from $7.5 trillion at the end of 2009 to $15.0 trillion by 2020. Relative to the economy, the debt will increase from 53 percent of GDP to 67 percent.

Yet as troubling as this scenario is, it is almost certainly optimistic. Budget projections in CBO's baseline are based on current law and not current policy, which means they assume a number of policies will deviate from recent trends.[1] If we assumed current policies were to continue as they have in the past, the debt would reach nearly 100 percent of GDP by 2020.

In the analysis below, we discuss the new CBO baseline in detail, including the new deficit and debt projections, the current law path of revenues and outlays, and CBO's newest economic assumptions. We have also constructed a more realistic "current policy baseline."

Our major findings include:

- The deficit will improve slightly in 2010, due to certain economic improvement and lower costs for support of the financial industry.
- While the deficit is projected to fall from recent highs in future years, the debt will continue to grow – hitting 67 percent of GDP in 2020.
- Under this baseline, nominal interest payments will more than triple, from $207 billion to $723 billion, between 2010 and 2020; and more than double as a share of GDP, from 1.4 percent to 3.2 percent.
- If tax cuts currently scheduled to expire were made permanent, the AMT was indexed for inflation, and annual appropriations kept pace with GDP, the deficit would remain large over the next decade, and debt held by the public would reach roughly 100 percent of GDP by 2020.
- CBO's current law projections are quite bad; but current policy numbers, based on the assumptions above, are devastating.

Deficits and Debt

For FY2010, the CBO projects the deficit will reach $1.35 trillion (9.2 percent of GDP), somewhat lower than last year's record of $1.41 trillion (9.9 percent of GDP), but still eye-poppingly large. Although reduced financial rescue payments are projected to bring down the deficit relative to last year, this is being offset by projected increases in stimulus spending – chiefly from the American Recovery and Reinvestment Act.

Over the next decade, the CBO projects cumulative deficits of just over $6 trillion, or an average annual deficit of 3.2 percent of GDP. Specifically, under their projections, the deficit will drop to 6.5 percent of GDP in 2011, 4.1 percent in 2012, and reach a low of almost exactly 2.6 percent in 2018, while rebounding to 3 percent in 2019 and 2020.

These projections are somewhat of an improvement from CBO's August baseline – by over $425 billion between 2010 and 2019. Driving the difference is higher assumptions for wages, salaries, and corporate profits, as well as lower assumed interest rates.

While the economic recovery is responsible for fueling much of the projected deficit abatement, it is also being driven heavily by several policy assumptions, in particular, the expiration of the 2001/2003 tax cuts at the end of 2010, which leads to significant growth in revenue. And slow discretionary spending growth helps keep outlays at bay.

Fig. 1: Baseline Deficit Projections

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Ten Year*
January 2010 Baseline													
Billions	$1,414	$1,349	$980	$650	$539	$475	$480	$521	$525	$542	$649	$687	$6,047
% of GDP	9.9%	9.20%	6.50%	4.10%	3.20%	2.70%	2.60%	2.70%	2.60%	2.60%	3.00%	3.00%	3.2%.
August 2009 Baseline													
Billions	$1,587	$1,381	$921	$590	$538	$558	$558	$620	$626	$622	$722	n/a	$7,137
% of GDP	11.2%	9.60%	6.10%	3.70%	3.20%	3.20%	3.10%	3.30%	3.20%	3.10%	3.40%	n/a	4.00%

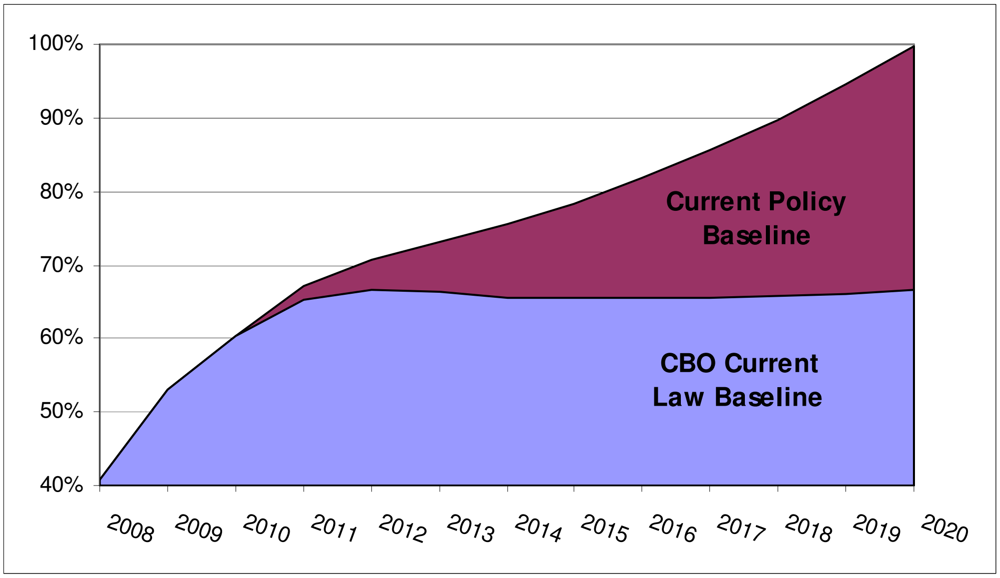
* Ten-year column reflects 2011-2020 for January baseline and 2010-2019 for August baseline.

As a result of large and persistent deficits, the debt held by the public will continue its upward trend. In 2008, it stood at $5.8 trillion (41 percent of GDP). The CBO estimates debt will hit $8.8 trillion (60 percent of GDP) by the end of FY2010, $12.1 trillion (65

[1] The CBO "current law" baseline assumes that the 2001/2003 tax cuts will expire at the end of 2010, there will be no future "AMT patches" to prevent that tax from reaching into the middle class, Medicare physician payments will be allowed to drop by around 21 percent, and discretionary spending will grow with inflation – among other assumptions.

percent of GDP) by 2015, and $15 trillion (67 percent of GDP) by 2020. The debt is expected to grow further beyond the ten year window.

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



Source: Congressional Budget Office.

And again, these are based on current law assumptions. Debt would reach roughly 100 percent of GDP by 2020 if current policies were to continue.

Revenues and Spending

Driving the massive FY2010 deficit are revenues and spending levels which diverge significantly from historical levels. Revenues in 2010, for example, are expected to total only 14.9 percent of GDP (less than $2.2 trillion) – compared to 17.7 percent in FY2008 (itself a low-revenue year). Outlays, meanwhile, are projected to surpass 24.1 percent of GDP (over $3.5 trillion) – compared to 20.9 percent in FY2008.

These abnormal revenue and spending levels are mainly a result of depressed revenues and higher spending on automatic stabilizers (such as unemployment benefits) which occur automatically as a result of the economic crisis. Spending and tax cuts designed to stabilize the economy (which we track at http://www.stimulus.org) also are significant contributors. For example, the CBO expects that the American Recovery and Reinvestment Act, for example, will cost roughly $200 billion in 2010.

As the economy recovers and stimulus is withdrawn, outlays are expected to decline as a portion of the economy, to 22.3 percent of GDP in 2015. After that, however, CBO projects a slow but significant uptick in spending – to 23.3 percent by 2020 -- driven by growing mandatory spending and net interest costs. This is largely the result of continued growth of the Social Security, Medicare, and Medicaid programs. At the same time, though, interest payments are expected to double as a share of the economy between 2010 and 2020.

Relative to GDP, discretionary spending is projected to decline under the baseline. However, this is largely the result of a scoring convention in which regular discretionary appropriations are projected to grow with inflation. This is rarely the case, and, in fact, discretionary spending has grown faster than mandatory spending over the previous decade (see Controlling Discretionary Spending).

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

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Ten Year*
						January 2010 Baseline							
Revenues	**14.8%**	**14.9%**	**17.8%**	**18.8%**	**19.3%**	**19.7%**	**19.7%**	**19.8%**	**19.9%**	**20%**	**20.1%**	**20.2%**	**19.6%**
Outlays	**24.7%**	**24.1%**	**24.3%**	**23%**	**22.5%**	**22.4%**	**22.3%**	**22.6%**	**22.6%**	**22.6%**	**23.1%**	**23.3%**	**22.8%**
Mandatory	14.7%	13.3%	13.6%	12.6%	12.5%	12.4%	12.3%	12.6%	12.6%	12.7%	13.1%	13.3%	12.8%
Discretionary	8.7%	9.4%	9.1%	8.5%	8.1%	7.7%	7.5%	7.3%	7.1%	7.0%	6.9%	6.7%	7.5%
Net Interest	1.3%	1.4%	1.6%	1.8%	2.0%	2.2%	2.5%	2.7%	2.9%	3.0%	3.1%	3.2%	2.6%
Deficit	**9.9%**	**9.2%**	**6.5%**	**4.1%**	**3.2%**	**2.7%**	**2.6%**	**2.7%**	**2.6%**	**2.6%**	**3.0%**	**3.0%**	**3.2%**
						August 2009 Baseline							
Revenues	**14.9%**	**15.7%**	**18.1%**	**19.1%**	**19.4%**	**19.6%**	**19.9%**	**19.9%**	**20%**	**20.1%**	**20.2%**	**n/a**	**19.3%**
Outlays	**26.1%**	**25.2%**	**24.3%**	**22.8%**	**22.6%**	**22.9%**	**22.9%**	**23.2%**	**23.2%**	**23.2%**	**23.6%**	**n/a**	**23.4%**
Deficit	**11.2%**	**9.6%**	**6.1%**	**3.7%**	**3.2%**	**3.2%**	**3.1%**	**3.3%**	**3.2%**	**3.1%**	**3.4%**	**n/a**	**4.0%**

* Ten-year column reflects 2011-2020 for January baseline and 2010-2019 for August baseline.

As spending falls, tax receipts are expected to rebound significantly. Between 2010 and 2020, revenues are expected to rise from 14.9 percent of GDP in 2010 to 17.8 percent in 2011 and 20.2 percent by 2020.

As we mentioned previously, two factors are largely responsible for this projected revenue growth – in roughly equal proportion. First, as the economy enters a clearer and more robust recovery path, and employment and wages begin to grow, the tax base is expected to expand. Second, the 2001/2003 tax cuts are scheduled to expire at the end of 2010, offering a significant revenue boost – in the vicinity of $2.6 trillion over the next decade. In all likelihood, however, Congress is likely to renew many of these tax cuts without any offsets.

Economic Projections

As we've suggested above, CBO's economic assumptions play a large role in its overall budget projections. For example, if GDP were to increase 0.1% slower per year, it would increase the deficit by nearly $300 billion over the next decade. Interest rates, inflation, unemployment, and wages and salaries as a percent of GDP also have significant budgetary impacts.

Under CBO's latest projections, real GDP growth will be 2.2 percent in 2010, compared to their August estimate of 1.7 percent. In 2011, however, GDP growth will only by 1.9 percent, compared to their previous estimates of 3.5 percent. Over the next decade, growth will average around 3 percent per year – the same as CBO's previous estimate.

Unemployment estimates, meanwhile, are higher than previously thought. Under CBO's latest assumptions, the rate will remain around 10 percent for 2010, and then decline steadily to 8 percent in 2012 and about 5 percent after 2015.

Finally, CBO's projects inflation to remain subdued – at about 2 percent over the coming decade. Such low inflation forecasts will most likely reduce some pressures to lower interest rates in the economy.

Fig. 4: Comparison of Economic Forecasts

								Annual Average	
	2009 Estimated	2010	2011	2012	2013	2014	2015	Five-Year	Ten-Year*
Inflation (Calendar year over calendar year)^									
CBO January 10	-0.2%	2.4%	1.3%	1.2%	1.1%	1.3%	1.7%	1.3%	1.5%
CBO August 09	-0.5%	1.7%	1.3%	1.0%	1.1%	1.5%	1.8%	1.3%	1.6%
OMB August 09	-0.7%	1.4%	1.5%	1.9%	2.0%	2.0%	2.0%	1.8%	1.9%
Average Blue Chip#	-0.4%	2.1%	2.0%						
Real GDP Growth (Calendar year over calendar year)									
CBO January 10	-2.5%	2.2%	1.9%	4.6%	4.8%	3.9%	2.9%	3.6%	3.0%
CBO August 09	-2.5%	1.7%	3.5%	5.0%	4.5%	3.0%	2.7%	3.5%	3.0%
OMB August 09	-2.8%	2.0%	3.8%	4.3%	4.3%	4.1%	3.6%	3.7%	3.3%
Average Blue Chip#	-2.5%	2.8%	3.1%						
Unemployment Rate (Annual averages, percent)									
CBO January 10	9.3%	10.1%	9.5%	8.0%	6.3%	5.3%	5.1%	6.8%	5.9%
CBO August 09	9.3%	10.2%	9.1%	7.2%	5.6%	4.9%	4.8%	7.4%	6.1%
OMB August 09	9.3%	9.8%	8.6%	7.7%	6.8%	5.9%	5.6%	7.8%	6.6%
Average Blue Chip#	9.3%	10.0%	9.2%						

* Ten-year column reflects 2011 through 2020 for January baseline and 2010-2019 for August baseline; ^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 2010.

Overall, CBO is slightly more pessimistic now than in previous estimates, and also slightly more pessimistic than either the Office of Management and Budget (OMB) or the recent Blue Chip consensus.

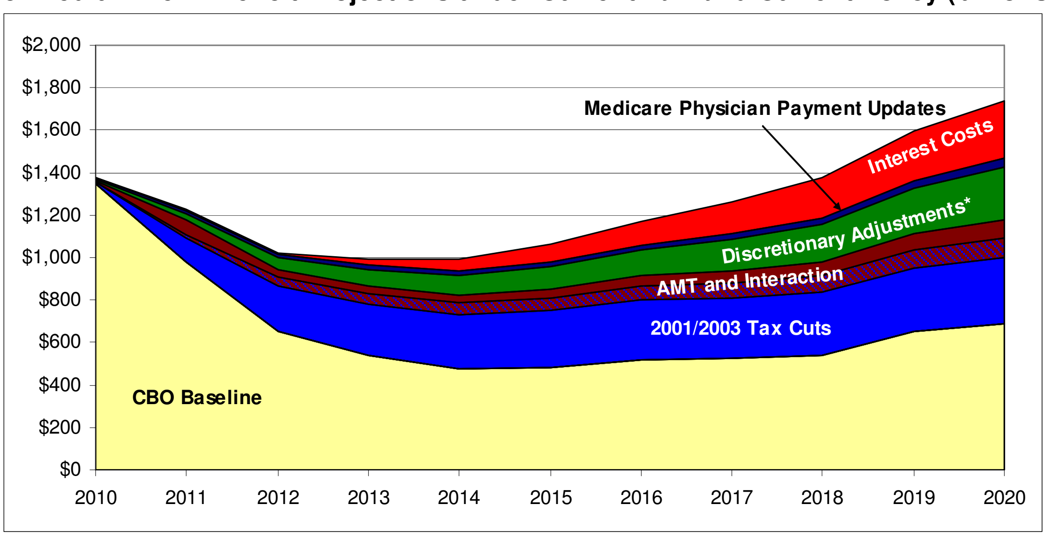
A Realistic Baseline

As we have explained above, the CBO baseline is in many ways unrealistic. By law and convention, their projections reflect the budgetary impacts of the laws as currently written, disregarding current and likely policy trends. As a result, CBO's baseline numbers will almost certainly prove to be optimistic. Reflecting current law and budget conventions, baseline estimates assume:

- The 2001/2003 tax cuts will expire as scheduled at the end of 2010;
- Policymakers will discontinue the routine "patching' of the Alternative Minimum Tax (AMT), requiring millions of American to begin paying the tax;
- Medicare payments to physicians will decline by 21 percent this March, and continue to fall thereafter;
- Discretionary spending – including funding for the war in Iraq and Afghanistan – will grow in-line with inflation

Understanding that these assumptions are unrealistic, the CBO provides cost estimates for a number of alternative policies. From these, CRFB has constructed a "current policy baseline" below.

Fig. 5: Medium-Term Deficit Projections under Current Law and Current Policy (billions)



* Discretionary adjustments shows costs of setting regular discretionary appropriations at the rate of growth of nominal GDP along with war adjustment costs of reducing the number of troops deployed abroad to 60,000 by 2015.

Under our baseline, the 2001/2003 tax cuts are made permanent, AMT patches continue, cuts to Medicare physician payments are avoided, and regular discretionary spending grows with the economy. Additionally, we assume that the number of troops stationed abroad will decrease to 60,000 by 2015.

Under our current policy baseline, future deficits are much larger and grow at a faster rate than under CBO's baseline. Between 2011 and 2020, cumulative deficits are more than *twice* as large - $12.4 trillion as opposed to $6 trillion. And instead declining to below 3 percent of GDP, deficits bottom out at 5.6 percent in 2014, before growing to 7.7 percent – $1.7 trillion – in 2020.

By our calculations, under this current policy baseline, debt held by the public will reach 100 percent of GDP in 2020. And beyond the ten year window, without changes, the situation would get far worse.

Conclusion

CBO's budget projections are quite troubling, to say the least. Although large near-term deficits do not in themselves pose a threat to economic growth (and to the contrary, can strengthen it), the CBO shows that deficits will persist even after the economy has recovered. As a result, by the end of the decade, debt is expected to reach about 68 percent of GDP, a level that would be nearly 30 percent of GDP higher than the debt level at the end of 2008. And the continued growth of Social Security, Medicare, Medicaid, and interest costs mean that it will grow further beyond the budget window.

Yet these projections are wildly optimistic, since they are based on current law. If policymakers were to continue to support current policies, the debt would reach around 100 percent by 2020. At that level, the prospects for a debt crisis – or else a slow erosion of our standard of living – are quite significant.

Policymakers must, therefore, take affirmative steps to bring the debt under control. Given the fragile state of the economy, aggressive debt reduction would be risky in the short-term. Instead, policymakers must devise and enact a credible plan which stabilizes the debt at a low enough level to allow for future fiscal stability and reassure credit markets, once the economy recovers. (The Peterson-Pew Commission on Budget Reform has recommended a debt target of 60 percent of GDP. see http://www.budgetreform.org.) If credible, the announcement of this plan alone could strengthen the economy and mitigate the costs of borrowing in the short-term.