# The CRFB Medium and Long-Term Baselines
## August 26, 2010

Last week, the Congressional Budget Office (CBO) released its updated Budget and Economic Outlook, which provides their latest baseline projections for the coming decade. Under current law, CBO estimates debt to rise from about 60 percent of GDP currently, to nearly 70 percent by 2020. However, this current law baseline assumes that a number of current policies scheduled to expire under current law will actually do so, a highly unlikely scenario. Absent policy change,  the debt is likely to grow far more quickly

CRFB's Realistic Baseline aims to offer a more probable fiscal outlook for both the medium- and long-term.

### CBO's Updated Baseline Projections

Under current law, CBO now expects the deficit to reach $1.34 trillion (9.1 percent of GDP) this year, as opposed to the $1.37 trillion (9.4 percent of GDP) projected in March. Though the deficit will be smaller this year than previously projected, larger than expected outlays for discretionary programs (mostly in defense), unemployment insurance, interest payments, and spending on mandatory programs will push cumulative deficits over the next ten years higher than was previously projected. Cumulative deficits over the coming decade are now expected to reach $6.25 trillion (3.3 percent of GDP), compared to the $5.99 trillion (3.2 percent of GDP) projected in March.

Over the coming decade, debt held by the public would grow from $9.03 trillion (61.6 percent of GDP) this year to $16.07 trillion (69.4 percent of GDP) by 2020 under CBO's current law projections. Debt will be larger each year over the coming decade than previously projected.

This year, revenues are expected to be 14.6 percent of GDP—near their post-war low. But over the coming decade, an improved economic outlook, increased revenues from provisions in the health care reform package, and baseline assumptions that AMT patches will end and the 2001/2003 tax cuts will fully expire at the end of this year will push baseline revenue projections up to an historical high of 21 percent by 2020 under current law—well above the 30-year average of about 18 percent. In CBO's long-term outlook, they project revenue to continue to rise beyond the ten year window, reaching 24.3 percent by 2040 and 29.9 percent by 2080.

Spending this year is now expected to be 23.8 percent of GDP. Over the next ten years, there will be a brief respite from the spending growth we have seen during the recession, but during the middle of the coming decade, spending will return to an upward path, and by the end of the ten-year period, spending is expected to reach 23.9 percent of GDP—much higher than the roughly 21 percent 30-year average. This short-term spending growth stems largely from the new health reform legislation as well as growth in Social Security and federal health programs due to the aging population. In its long-term projections, CBO expects spending to rise further due to growth in entitlement spending, largely coming from federal health spending (though this spending will be somewhat lower than it would have been absent reform). As a result, spending will reach 28.7 percent of GDP in 2040 and 30.2 percent of GDP by 2080.

## The CRFB Realistic Medium-Term Baseline

Along with updated baseline estimates last week of spending, revenues, deficits, and debt over the coming decade, CBO also released estimates for selected "policy alternatives" not included in the baseline. As mentioned above, actual spending and revenue levels are extremely likely to differ from those cited in current law projections, since they exclude several of lawmakers' current practices that are likely to be continued and end up making deficits even worse. The following current law assumptions are highly unlikely to materialize:

- The 2001/2003 tax cuts will fully expire at the end of this year;
- Lawmakers will stop "patching" the Alternative Minimum Tax (AMT) to keep it from hitting middle-income earners;
- Medicare physician payments will fall by about 30 percent over the next few years;
- Discretionary spending will grow in line with inflation over the next ten years, declining as a share of GDP;
- Spending on the wars in Iraq and Afghanistan will continue to grow with inflation, rather than decline as we withdraw troops from those countries.

On the revenue side, debate appears to be situated between renewing all the 2001/2003 tax cuts and renewing all the cuts for the roughly 97 percent of all taxpayers earning less than $250,000 a year – so it is highly unlikely that lawmakers will allow the cuts to expire altogether. AMT patches are even more likely to continue, as lawmakers have annually patched the AMT since 2001 in addition to several large prior adjustments.

The CRFB Baseline assumes that the 2001/2003 tax cuts will be extended for individuals making less than $200,000 and families making less than $250,000 per year—which is consistent with the exemptions in the 2009 PAYGO law—and that the AMT patches will continue. (Note: this does not reflect our preferred policies but just projections of what appears likely and thus useful in projecting future deficit and debt levels.)

**Fig. 1: Bridge to CRFB Realistic Baseline**

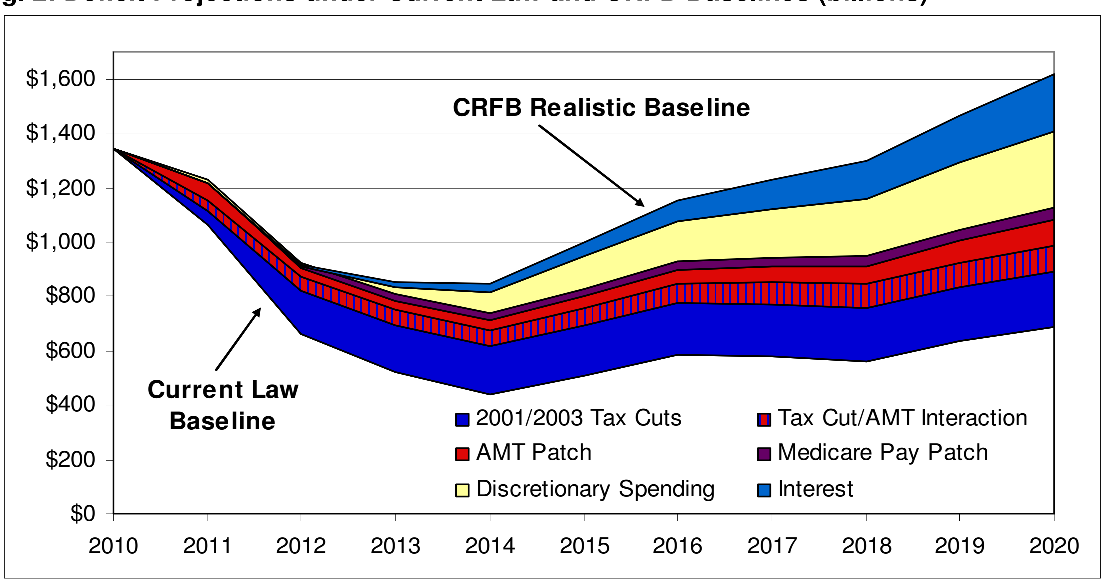
| | 2011-2020 (Billions) | 2011-2020 (Percent of GDP) |
|---|---|---|
| ***Current Law Deficits*** | ***$6,246*** | ***3.3%*** |
| Extend 2001/2003 Tax Cuts for All but Top Earners | $1,727 | 0.9% |
| Index AMT to Inflation | $583 | 0.3% |
| Interaction between Tax Cuts and AMT | $683 | 0.4% |
| Medicare Payment Patch | $276 | 0.1% |
| Faster Discretionary Spending Growth | $1,273 | 0.7% |
| Reduce Troops in Iraq/Afghanistan | -$914 | -0.5% |
| Interest | $810 | 0.4% |
| ***CRFB Realistic Baseline Deficits*** | ***$10,683*** | ***5.6%*** |

Source: Congressional Budget Office and CRFB calculations.

On the spending side, it is also unlikely that lawmakers will allow an abrupt cut to Medicare physician payments, since they have enacted annual "doc fixes" to waive this requirement since 2003 – and in fact they replaced a 21 percent scheduled cut with a 2.2 percent increase earlier this year. We assume that physician payments will be frozen over the next decade, in place of the significant cuts scheduled over the same period.

Discretionary spending growth is more of a wild card. On the one hand, spending on Iraq and Afghanistan will in all likelihood fall in coming years, and there appears to be an effort this year to hold down the growth in regular discretionary spending as well. At the same time, discretionary spending has tended to grow with or close to overall economic growth – especially on the defense side. In our baseline, we assume the number of troops deployed in Iraq and Afghanistan will fall from about 145,000 today to 60,000 by 2015, and regular appropriations will be frozen in nominal terms this year, but allowed to grow with GDP thereafter.

**Fig. 2: Deficit Projections under Current Law and CRFB Baselines (billions)**



More realistic projections show significantly higher deficits and debt for the coming decade than the current law baseline. By 2020 debt would reach 89 percent of GDP, far above the current law projection of 69 percent. These projections should serve as a stark warning that if lawmakers continue a "business as usual" budget path, deficits and debt will reach significantly higher levels.

**Fig. 3: Baseline and CRFB Projections for Deficits and Debt (percent of GDP)**

| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Baseline Deficit** | 9.1% | 7.0% | 4.2% | 3.1% | 2.5% | 2.7% | 3.0% | 2.8% | 2.6% | 2.9% | 3.0% |
| **CRFB Realistic Deficit** | **9.1%** | **8.0%** | **5.8%** | **4.9%** | **4.4%** | **4.8%** | **5.3%** | **5.4%** | **5.4%** | **5.9%** | **6.3%** |
| **Baseline Debt** | 62% | 66% | 69% | 68% | 67% | 67% | 68% | 68% | 68% | 69% | 69% |
| **CRFB Realistic Debt** | **62%** | **67%** | **71%** | **73%** | **73%** | **75%** | **77%** | **80%** | **82%** | **85%** | **89%** |

Source: Congressional Budget Office and CRFB calculations.

## The CRFB Realistic Long-Term Baseline

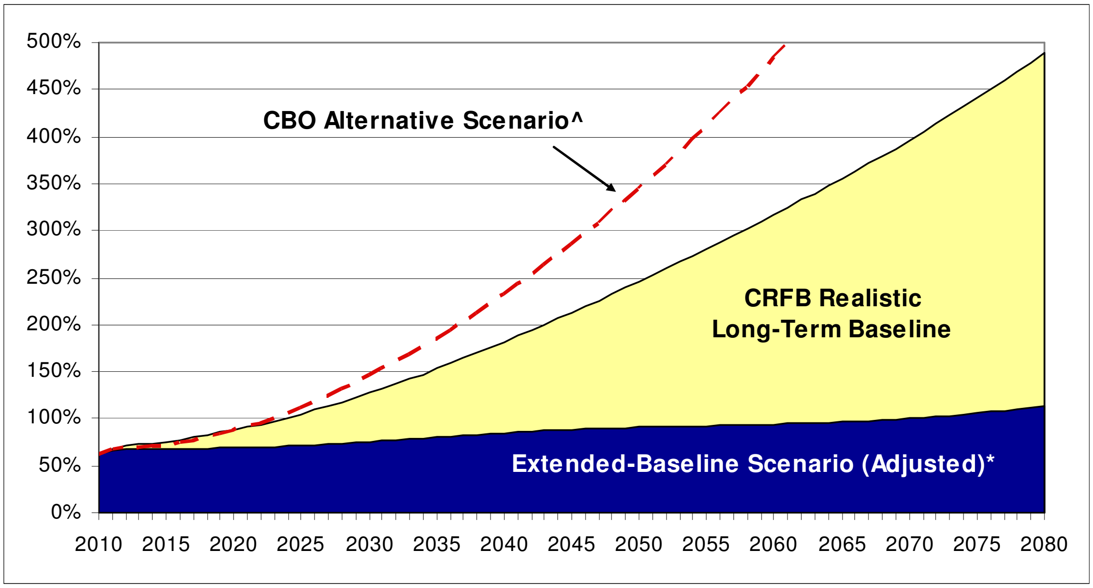
While many of the current practices included in our realistic medium-term projections also affect the long-term, several longer-term assumptions also have to be made to show the most likely long-term path of deficits and debt.

Beyond 2020, we assume that revenues will grow slowly as a percent of GDP. Though we assume the 2001/2003 tax cuts will stay in place for income below $250,000 per year and AMT patches will continue indefinitely, wage growth will slowly bump earners into higher income tax brackets. This "real bracket creep" occurs even though the bracket thresholds are indexed to inflation, since wages grow faster than prices. In addition, we assume that the excise tax on high-cost insurance plans—enacted in health reform—will continue to generate a growing amount of revenue – 3 percent of GDP by 2080.

On the spending side, we make many of the same long-term assumptions as CBO does – that Social Security will continue to pay scheduled benefits, that federal health spending will continue to grow faster than GDP, that other government spending will growth with the economy, and that interest costs will accrue as the debt rises.

The impact of health care reform poses very difficult questions for health spending projections (some of which we have discussed at http://crfb.org/document/effect-health-reform-long-term). Both CBO and the Medicare actuaries have affirmed that cuts in the growth of Medicare provider payments will ultimately lead to an unsustainably large gap between public and private health care payment rates, making it increasingly likely that lawmakers will choose to override these scheduled cuts at some point. Though it is hard to know when this would occur, we assume health reform would no longer slow cost growth after 2030, resuming its historical growth trends at that point (from a lower base).

**Fig. 4: Long-Term Debt under Current Law and Current Policy (percent of GDP)**




Source: Congressional Budget Office and CRFB calculations.
*CBO's Extended-Baseline Scenario adjusted by CRFB to include recently updated medium-term budget projections.
^CBO's Alternative Fiscal Scenario as presented in the June Long-Term Budget Outlook.

In many ways, our baseline resembles CBO's Alternative Fiscal Scenario (AFS) published within its long-term budget outlook. The AFS, though, is now based on an out-of-date current law baseline. In addition, it assumes that revenues will remain at a constant share of the economy (at 19.3 percent) after 2020 and that the cost controls in health reform will no longer be at all effective after 2020. We believe that, given projected deficits, the fiscal pressures would be too great to enact a new tax cut – which would be necessary to simply counteract the effects of real bracket creep. We also believe it unlikely that Congress would waive the provider payment update cuts altogether, prevent IPAB (the "Medicare commission") from making any changes, *and* increase the growth rate of exchange subsidies all by 2020 – though we do worry these actions may eventually occur.

Our baseline shows the deficit growing from 6 percent of GDP in 2020, to almost 14 percent by 2040, and to over 30 percent by 2080. And whereas debt remains below 100 percent of GDP until 2070 under the current law baseline, we project it would exceed 100 percent of GDP in the early 2020s, grow to 200 percent in 2043, and reach 488 percent by 2080 under out more realistic assumptions. No economy could possibly sustain debt levels at these heights.

**Fig. 5: Long-Term Baseline and CRFB Projections of Deficits and Debt (percent of GDP)**

| | 2020 | 2030 | 2040 | 2050 | 2060 | 2070 | 2080 |
|---|---|---|---|---|---|---|---|
| Baseline Revenues* | 21.0% | 22.6% | 24.6% | 26.4% | 27.9% | 29.2% | 30.3% |
| Baseline Outlays* | 23.9% | 26.8% | 29.1% | 30.8% | 32.4% | 34.5% | 36.9% |
| Baseline Deficit* | 3.0% | 4.2% | 4.5% | 4.3% | 4.5% | 5.2% | 6.6% |
| **Baseline Debt*** | **69%** | **76%** | **85%** | **91%** | **94%** | **100%** | **114%** |
| CRFB Realistic Revenues | 19.4% | 20.0% | 20.9% | 22.0% | 23.3% | 24.5% | 25.8% |
| CRFB Realistic Outlays | 25.7% | 30.1% | 34.6% | 39.2% | 44.1% | 50.0% | 56.1% |
| CRFB Realistic Deficit | 6.3% | 10.1% | 13.7% | 17.2% | 20.8% | 25.5% | 30.3% |
| **CRFB Realistic Debt** | **89%** | **127%** | **182%** | **246%** | **317%** | **396%** | **488%** |

Source: Congressional Budget Office and CRFB calculations.
*Long-term baseline figures derived by CRFB from using CBO's medium-term August projections to update their long-term projections released in June.

Under realistic assumptions, both revenues and spending are on track to surpass historical norms by a significant amount. Revenues under our realistic baseline would rise from about 19 percent of GDP in 2020, to 21 percent in 2040, and to 26 percent by 2080—well beyond a 30-year historical average of about 18 percent. Federal spending, meanwhile, would explode, rising from about 26 percent of GDP in 2020, to 34 percent by 2040, and 56 percent by 2080. Such levels are significantly higher than a 30-year average of about 21 percent. The imbalance between projected spending and revenues would drastically increase our borrowing needs, thereby pushing up interest payments on the debt. By 2020 interest payments would reach 4 percent of GDP before rising to almost 9 percent by 2040 and 24 percent by 2080.

## Conclusion

Making predictions about the future has become increasingly difficult with so many laws in place which policymakers actually have little intention of following. Unfortunately, almost all of these policy preferences make the deficit and debt much worse than it is already slated to be.

While the political costs of following current law or offsetting the costs of extending existing policies may be large, they would be dwarfed by the economic costs of an exploding national debt. Government borrowing needs would make interest payments consume an inordinate portion of the budget while crowding out more productive private investment, thereby inhibiting strong economic growth. At some point, a fiscal crisis would ensue as creditors would not be willing to provide the needed funds to cover such large imbalances.

To avoid such an outcome, lawmakers must choose to continue only the policies most important for the country. Then, lawmakers should pay for the policies they choose to keep.