COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET

CBO's Long-Term Budget Outlook
September 17, 2013

Today, the Congressional Budget Office (CBO) released its updated Long-Term Budget Outlook – the first long-term projections to incorporate the impact of the fiscal cliff deal from early this year. The CBO analysis confirms that while our debt may be at bay for the next few years, the country remains on a dangerous long-term fiscal path.

Under CBO's Extended Baseline Scenario – which assumes policymakers abide by sequestration, allow various provisions to expire, and allow revenue to slowly grow indefinitely – debt will grow substantially in the coming decades.

Rising from a low of 68 percent of Gross Domestic Product (GDP) in 2018, debt is projected to exceed the size of the economy by 2038 and total about twice the size of the economy by 2075. Deficits will rise from 3.3 percent of GDP in 2023 to over 6 percent by 2035, 8 percent by 2050, and 13.5 percent by 2085.

Importantly, the debt situation would be far worse if policymakers cancelled sequestration or extended certain expiring provisions without any plan to replace those scheduled savings. Projected debt levels would also be worse if CBO incorporated the economic costs of higher debt into their projections.

Fig. 1: Fiscal Projections under CBO's Extended Baseline Scenario (% of GDP)

	2000	2013	2023	2035	2050	2085
Extended Baseline Scenario						
Spending	17.6%	20.8%	21.8%	25.5%	28.6%	37.7%
Revenue	19.9%	17.0%	18.5%	19.5%	20.8%	24.2%
Deficit	-2.3%*	3.9%	3.3%	6.1%	7.8%	13.5%
Debt	**34%**	**73%**	**71%**	**93%**	**129%**	**233%**

* Negatives denote surpluses.

Although lawmakers have made progress – with largely short-term savings such as sequestration – and health care cost growth has moderated, the long-term debt trajectory remains of great concern. Lawmakers have done nothing to slow the growth of entitlement programs over the coming decades as the baby boom population retires and health care costs continue to rise.

As the upcoming budget negotiations draw near, lawmakers should work toward a comprehensive plan, including entitlement and tax reform, to address the long-term debt situation and get our fiscal house in order.

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CBO's Long-Term Debt and Deficit Outlook

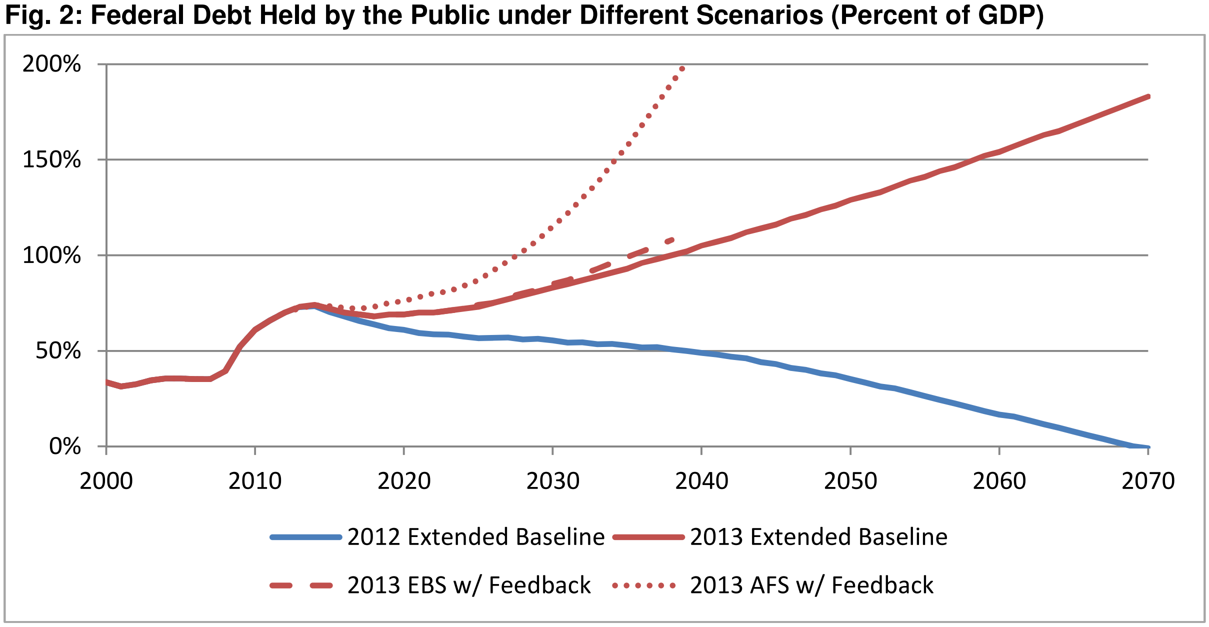
Encouragingly, CBO projects deficits and debt to decline over the next few years under current law – deficits from 3.9 percent of GDP in 2013 to a low of 2.1 percent in 2015 and debt from 73 percent of GDP to a low of 68 percent in 2018 (though those debt levels are roughly twice as large as those immediately before the economic crisis). But, after hitting these low points, both deficits and debt will rise substantially over the long term.

Deficits will reach 6.1 percent of GDP in 2035, 7.8 percent in 2050, and 13.5 percent by 2085. Debt, meanwhile, will rise from its low of 68 percent of GDP in 2018 to 93 percent by 2035, 129 percent by 2050, and 233 percent by 2085. By comparison, last year's Extended Baseline showed our national debt being completely paid off by 2070.

The main driver of the difference is the fiscal cliff deal (the American Taxpayer Relief Act), which reduced the deficit relative to current policy baselines such as those used by CRFB, but increased it substantially relative to current law – by more than $4 trillion over ten years.

Importantly, CBO's projections assume no economic consequences from higher debt – which CBO believes would increase debt levels by 8 percent in 2038. They also assume sequestration remains in place, physicians receive a 24 percent payment cut next year from the Sustainable Growth Rate (SGR), various temporary tax breaks expire, and revenue continues to grow indefinitely as a share of the economy mainly as a result of "bracket creep." Absent these assumptions, debt levels could grow substantially higher. In one iteration of the "Alternative Fiscal Scenario" (which includes economic feedback effects), debt levels are projected to be more than 75 percent higher in 2038 than in CBO's Extended Baseline Scenario – though in fairness, both scenarios assume (hopefully unrealistically) that war and disaster spending continue at current levels.

Fig. 2: Federal Debt Held by the Public under Different Scenarios (Percent of GDP)



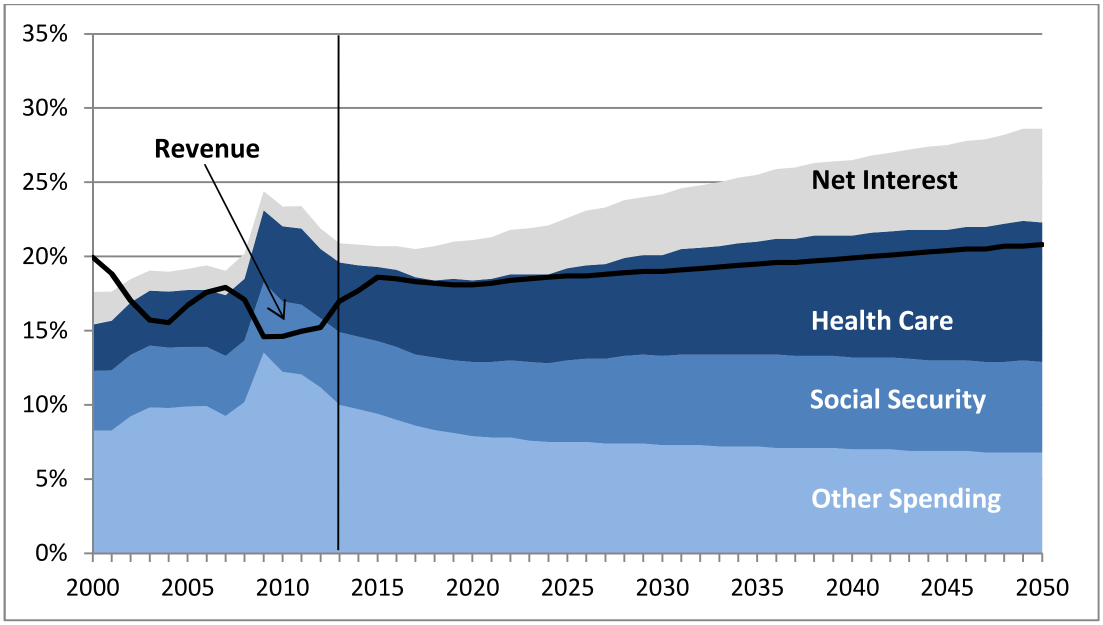
Source: CBO Long-Term Budget Outlook

Spending and Revenues

Continually rising deficits over the long-term are driven by a significant increase in spending on entitlement programs and interest payments on the debt and revenues from an inefficient and outdated tax code that will fail to keep pace. Under the Extended Baseline Scenario, federal spending is projected to increase from 20.8 percent of GDP in 2013 to 21.8 percent in 2023, 25.5 percent in 2035, 28.6 percent by 2050, and 37.7 percent by 2085. This growth in spending stands out even more when compared to a historical average of 20.4 percent of GDP for spending over the past forty years.

Beyond rising interest costs, the projected increase in spending is driven largely by the growth of federal health programs – including Medicare, Medicaid, and ACA insurance exchange subsidies – as well as the rising cost of Social Security benefits. This growth is fueled by an aging population and rising health care costs.

Fig. 3: Annual Spending by Category in CBO's Extended Baseline Scenario (Percent of GDP)

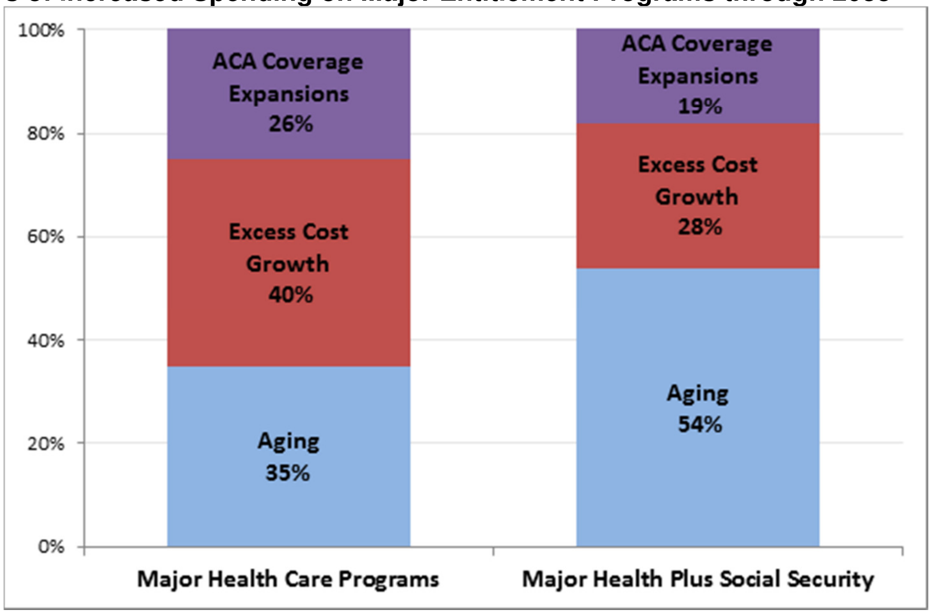


Source: CBO Long-Term Budget Outlook

Federal health spending alone is projected to grow from the 3.1 percent of GDP in 2000 and 4.7 percent today to 7.6 percent by 2035, 9.4 percent by 2050, and 13.5 percent by 2085. This rapid growth is still projected to occur despite the fact that health care cost increases have slowed in recent years, as CBO believes that a portion of the slowdown is temporary and lower future growth projections will be offset by increased life expectancy projections. As a result, federal health spending is projected to grow by 3.5 percentage points of GDP from 2023-2050 – the same as it was in CBO's 2012 report.

Importantly, even if the recent health care slowdown did continue in full, much of the growth in entitlement programs over the next couple of decades is driven by demographics rather than health costs. In fact, the retirement of the baby-boom population and growing life expectancy are projected to account for 54 percent of the growth of major federal entitlement programs by 2038 and more than a third of health care programs – the remainder is attributed to a combination of excess health care cost growth and ACA's coverage expansions.

Fig. 4: Drivers of Increased Spending on Major Entitlement Programs through 2038



Source: CBO Long-Term Budget Outlook

The Social Security program is particularly affected by this demographic shift, which will cause spending on the program to rise from 4.9 percent today to as high as 6.2 percent by 2035; compared to a historical average of 4.2 percent. This assumes general fund transfers into the Social Security trust fund; otherwise, benefits would have to be cut by 23 percent when the trust fund is exhausted in 2031.

On the other side of the ledger, revenues will fail to keep up with spending growth. As a result of the recovery and various pieces of legislation, revenue will grow from 17 percent of GDP in 2013 to 18.5 percent in 2023 under current law. After 2023, revenues will continue to grow due to "real bracket creep" and the excise tax on high-cost health plans, reaching 19.5 percent of GDP by 2035, 20.8 percent by in 2050, and over 23 percent by 2075.

As a result of the continued gap between spending and revenue, debt will build up and interest costs will grow drastically. In the near term, interest rates will rise to more normal levels as the economy recovers, pushing up interest costs from 1.3 percent of GDP in 2013 to 3.1 percent in 2023. After that, the rising debt burden will cause interest spending to increase to 4.5 percent of GDP by 2035, 6.3 percent by 2050, and 11.4 percent by 2085. The longer the fiscal imbalance goes unaddressed, the longer interest on the debt will compound and the larger interest payments will grow. (See CRFB's recent analysis on interest costs and associated risks: http://crfb.org/document/report-interest-rate-risk-and-us-debt)

Long-Term Economic Outlook

Over the long-term, CBO extrapolates its economic projections this decade to create a "benchmark" for future years, but does not incorporate the "feedback effects" (also known as "dynamic effects") of the particular policy changes or overall debt levels. However, because many economic variables can affect government debt levels, and vice versa, CBO has also published data on how their long-term projections could change when debt levels affect economic variables. *The results reaffirm the existing body of research that elevated and rising debt levels can hold back long-term economic growth.*

Under the Extended Baseline Scenario, CBO projects that the inflation-adjusted (real) economy will grow by about 2.2 percent annually after 2023, inflation (as measured by the consumer price index) will average about 2.5 percent each year, and the real interest rate on ten year bonds will average 3.0.

As CBO explains, *"the fiscal policies of the extended baseline tend to worsen the economic outlook…and incorporating feedback effects of those economic changes on the budget worsens the budget outlook as well."* Slower economic growth rates that accompany greater debt levels are largely explained by the "crowding out" effect, whereby increased government borrowing — and, thus, higher interest rates on government debt — reduces the amount of investment in more productive private ventures. With less investment, economic growth would be considerably slower.

Incorporating these feedback effects into their extended baseline scenario would reduce average real GNP growth through 2038 from 2.3 percent to 2.1 percent, would reduce total GNP by 4.2 percent, and would increase the debt by 8 percent – from 100 percent of GDP to 108 percent. Under CBO's more pessimistic "Alternative Fiscal Scenario," GNP growth would be 0.5 points worse than their benchmark, GNP levels would be 11 percent lower, and the debt would total 190 percent of GDP.

Fig. 5: Economic Feedback Effects of Illustrative Budget Scenarios in 2038

	Real GNP per Person`	Real Interest Rate on 10-year bond	Percent Change in GNP	25-Year Average GNP Growth	Debt as a % of GDP
Extended Baseline without Feedback Effects	*$75,700*	*3.0%*	*n/a*	*2.3%*	*100%*
Extended Baseline with Feedback Effects	$72,500	3.5%	-4.2%	2.1%	108%
Alternative Fiscal Scenario* with Feedback Effects	$67,500	4.5%	-10.8%	1.8%	190%

*Assumes roughly $2 trillion in higher deficits through 2023, largely from canceling the sequestration, freezing Medicare physician payments and extended various expiring tax measures.
`2013 dollars
^Assumes the reduction is to non-interest deficits. Total deficit reduction with related interest savings would be larger.

CBO also estimates economic effects of packages that would reduce the deficit by $2 trillion and $4 trillion of generic savings. These packages increase economic growth over the long-term due to a smaller federal deficit and a decreased crowding out effect. A $2 trillion deficit reduction package would keep our debt near today's levels, at 69 percent of GDP. A $4 trillion deficit reduction package would reduce debt to 31 percent of GDP, a level last seen in 2001.

These numbers quantify the economic costs of high debt, which places a drag on economic growth. In contrast, a comprehensive debt reduction plan would not only bring our debt burden to safer and more sustainable levels, but can substantially strengthen the economy in future decades. CBO used a generic deficit reduction package, but specific pro-growth reforms which encourage work and investment can have further economic benefits. (See CRFB's blog post for more discussion: http://crfb.org/blogs/its-about-how-and-when-not-just-how-much).

Conclusion

While the recovering economy, slowing of health care cost growth, and implementation of various deficit reduction measures have helped to put the debt on a safer path for the next few years, the long-term fiscal outlook remains quite troubling.

Even if lawmakers choose to keep policies like sequestration in place, debt will still rise to unprecedented and potentially dangerous levels. As CBO explains:

> *At some point, investors would begin to doubt the government's willingness or ability to pay U.S. debt obligations, making it more difficult or more expensive for the government to borrow money. Moreover, even before that point was reached, the high and rising amount of debt that CBO projects under the extended baseline would have significant negative consequences for both the economy and the federal budget.*

The best way to prevent these consequences is through a comprehensive plan including serious reforms to entitlements and the tax code sufficient to put the debt on a clear downward path relative to the economy.

As lawmakers turn their focus to short-term budget issues such as the expiration of the FY 2013 continuing resolution, the debt ceiling, and the ongoing sequestration, lawmakers should use that opportunity to begin addressing our long-term fiscal issues and relieve the debt burden being left to future generations.

Appendix: Assumptions in CBO's Extended Baseline Scenario

CBO's long-term projections are highly dependent on the assumptions made about the future actions of lawmakers – in addition to how the economy responds to higher or lower levels of debt and other policy differences. CBO's long-term outlook is based on what it refers to as its "Extended Baseline Scenario," which is based on its short-term current law baseline.

Through 2023, the Extended Baseline Scenario assumes current law generally continues as scheduled, with all uncapped discretionary costs growing with inflation. This means that sequestration is continued, annual war spending continues to grow from current levels, Medicare physician payments are cut by about a quarter as called for by the Sustainable Growth Rate (SGR) formula, certain refundable tax credits are allowed to expire in 2018, and other temporary tax provisions expire as scheduled.

Beyond 2023, CBO generally assumes the continuation of current law – with revenue and spending continuing to grow as the population ages, health care costs rise, and "bracket creep" pushes an increasing number of taxpayers into higher brackets. However, for health care costs, CBO assumes cost controls enacted under the ACA continue to be effective through 2029, they assume discretionary costs will continue to grow at the rate of GDP growth, and they assume non-health non-Social Security mandatory spending will gradually decline as a share of GDP.

By comparison, CBO's Alternative Fiscal Scenario (AFS) assumes sequestration is cancelled for future years, lawmakers continue to enact Medicare "doc fixes," and about three quarters of expiring tax provisions are continued – adding $2.4 trillion to deficits over the next ten years. Over the long term, the AFS assumes revenue and non-entitlement spending returns to historical levels as a share of GDP and the cost controls from the ACA are generally ineffective.

Fig. 6: Policy Assumptions under CBO's Extended Baseline and Alternative Fiscal Scenarios

<table>
<tr><th></th><th>Extended Baseline Scenario</th><th>Alternative Fiscal Scenario</th></tr>
<tr><td>Sequestration</td><td>Remains in Effect</td><td>Repealed without offsets</td></tr>
<tr><td>Sustainable Growth Rate</td><td>24% pay cut in 2014</td><td>Payments frozen at 2013 levels</td></tr>
<tr><td>"Tax Extenders"</td><td>Expire as scheduled</td><td rowspan="2">Three quarters of expiring provisions continued</td></tr>
<tr><td>Refundable Tax Credits</td><td>Expire as scheduled after 2017</td></tr>
<tr><td>Long-Term Revenue</td><td>Grows from "real bracket creep"</td><td>Frozen at 2023 at 18.1% of GDP</td></tr>
<tr><td>Long-Term Health Care*</td><td>ACA cost controls assumed to be in effect through 2029; Subsidies grow at current law rates</td><td>ACA cost controls assumed to be in effect through 2023; Subsidies grow faster than current law</td></tr>
<tr><td>Long-Term Non-Health, Non-Retirement Spending</td><td>Discretionary frozen as a share of GDP; other mandatory falls.</td><td>Increase to historical levels by 2028 and beyond</td></tr>
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*ACA refers to Affordable Care Act.