Committee for a Responsible Federal Budget

Analysis of CBO's Budget and Economic Projections and CRFB's Realistic Baseline
January 31, 2012

The Congressional Budget Office (CBO) released its updated budget and economic projections today, showing the appearance of a sustainable debt trajectory over the next ten years. However, these projections do not incorporate the costs of policies lawmakers are very likely to continue, nor do they show the long-term costs of an aging population and growing health care costs beyond the ten year window.

Among our major findings based on the report:

- Under current law, debt held by the public will grow from 67.7 percent of GDP ($10.1 trillion) in 2011 to 75.1 percent by 2013 ($11.9 trillion), but will then gradually fall to 62.0 percent ($15.3 trillion) by 2022.

- Due to the Super Committee's failure, current law includes across-the-board spending cuts beginning in 2013. Should policymakers waive this sequester, debt would end up at about 67 percent of GDP in 2022 instead of 62 percent. Under **CRFB's Realistic Baseline**, which also assumes lawmakers extend expiring tax cuts and doc fixes and draw down war spending, debt would rise to over **86 percent of GDP** by 2022.

- The latest current law projections are slightly worse than those made last August, with debt reaching 63 instead of 61 percent of GDP in 2021.

- Revenue projections average 20.4 percent of GDP under current law and 18.3 percent of GDP under CRFB's Realistic Baseline, compared to a historical average of about 18 percent. Spending averages 21.9 percent of GDP under current law and 22.8 percent of GDP under CRFB's Realistic Baseline, compared to a historical average of about 21 percent.

- Deficits average 1.5 percent of GDP each year under current law and 4.5 percent of GDP under CRFB's Realistic Baseline.

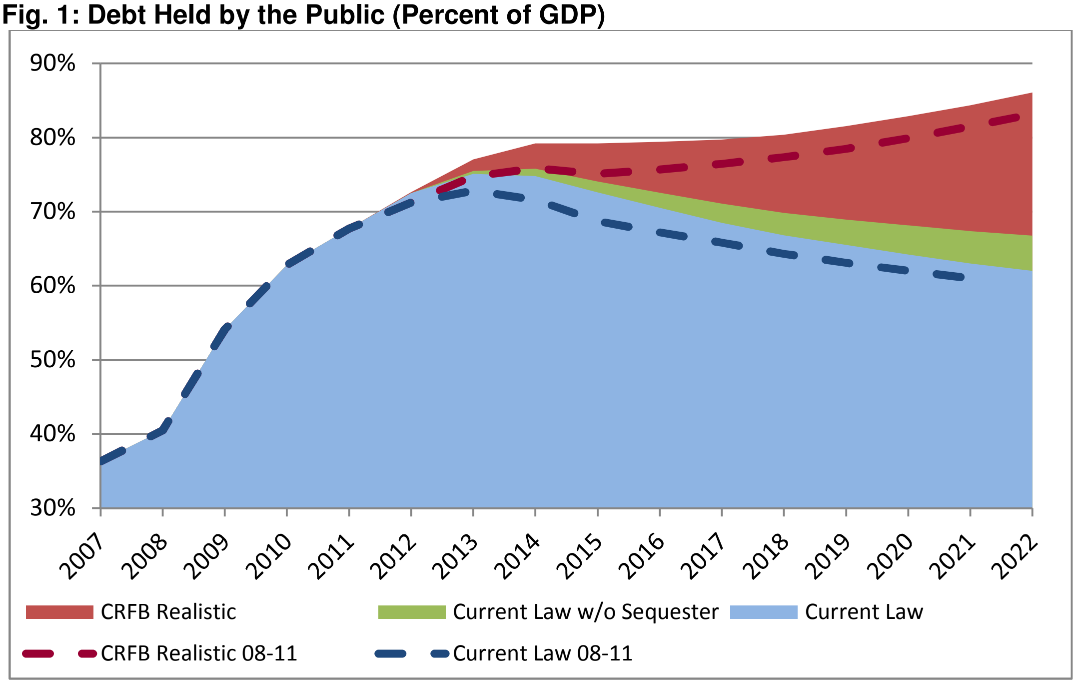
Deficits and Debt

CBO projects, under current law, that the deficit will decline substantially as the economy recovers, the Budget Control Act (BCA) sequester implements automatic spending reductions, and a number of temporary measures expire. Specifically, deficits will fall from 8.7 percent of GDP ($1.3 trillion) in 2011, to 7.0 percent of GDP ($1.1 trillion) in 2012, 3.7 percent of GDP ($585 billion) in 2013, and 1.4 percent of GDP ($339 billion) by 2022.

As a result of these deficits, debt will rise from nearly 68 percent of GDP in 2011 to about 75 percent in 2013, but then decline substantially, falling to 63 percent in 2021 and 62 percent of GDP by 2022. By comparison, August's projections showed debt reaching 61 percent of GDP by 2021.

Without the sequester, deficits would be slightly higher at 4.1 percent of GDP ($651 billion) in 2013 and 1.9 percent ($478 billion) in 2022. Under this scenario, debt would reach a high of almost 76 percent of GDP in 2014 before falling to below 67 percent by 2022. Debt is substantially higher – rising to 86 percent of GDP by 2022 – under CRFB's Realistic Baseline (discussed below).

Fig. 1: Debt Held by the Public (Percent of GDP)



Revenues and Outlays

CBO's current law projections continue to show a gap between spending and revenues over the next decade.

Including the effects of the sequester, outlays are projected to fall from 24.1 percent of GDP in 2011 to 22.1 percent by 2014 and will remain at about 22 percent through 2021, before jumping to 22.4 percent in 2022. By comparison, spending has averaged 21 percent over the past 40 years, and CBO's August report projected average spending of closer to 22.4 percent of GDP over the coming decade.

The decline in spending from 2011 levels is due to a combination of forces. First, as the economy recovers and temporary stimulus measures continue to unwind, spending on countercyclical programs such as unemployment insurance will fall. In addition, the discretionary caps from the BCA will continue to tighten both security and non-security spending. On top of this, CBO's baseline assumes an across-the-board sequester will cut spending by enough to achieve most of the $1.2 trillion[1] deficit reduction goal that the Super Committee failed to achieve and that lawmakers will allow a 27 percent cut in Medicare physician payments to go into effect. And finally, the combination of these measures and the expiration of the 2001/2003/2010 tax cuts will put downward pressure on debt and therefore interest payments.

Pushing in the opposite direction, interest rates are projected to rise over the decade as the economy recovers; for example, the three-month Treasury bill rate will increase from about 0.1 percent in 2011 to 3.8 percent by 2022 and the ten-year Treasury note rate will increase from 2.8 percent in 2011 to 5.0 percent by 2022. These higher interest rates will more than offset the interest savings from a lower debt burden, increasing net interest costs overall. More significantly, the aging of the population (combined with health care cost growth) is putting upward pressure on entitlement spending – Social Security costs are projected to grow from 4.8 percent of GDP in 2011 to 5.5 percent by 2022 and Medicare costs are projected to grow from 3.7 percent of GDP in 2011 to 4.2 percent in 2022. And, finally, the health insurance coverage provisions of the 2010 health care reform law are expected to take hold beginning in 2014, increasing spending primarily for Medicaid and the new health insurance subsidies.

[1] While the Joint Select Committee on Deficit Reduction was charged with recommending at least $1.2 trillion of total deficit reduction *through 2021*, the sequester designed to enforce this mandate would save slightly less for a variety of reasons. Through 2021, CBO estimates the sequester would reduce total deficits by $1.03 trillion. Extrapolated to 2022, the sequester would save $1.171 trillion. For more explanation, see http://crfb.org/blogs/depth-look-trigger (note: numbers out of date).

On the tax side, current law revenues will rise substantially over the next few years and then continue to grow throughout the decade. Specifically, CBO projects revenue will rise from 15.4 percent of GDP in 2011 to 20.0 percent in 2014 and 21.0 percent in 2022. This would bring revenue to a post-World War II high and put the ten-year average (20.4 percent of GDP) to well above historical averages of about 18 percent of GDP.

Fig. 2: Revenues and Spending by Fiscal Year (Percent of GDP, Billions of Dollars)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	Ten-Year*
January 2012 Baseline													
Revenues	15.4%	16.3%	18.8%	20.0%	20.2%	20.2%	20.5%	20.5%	20.6%	20.7%	20.9%	21.0%	20.4%
Outlays^	24.1%	23.2%	22.5%	22.1%	21.8%	21.8%	21.6%	21.5%	21.8%	21.9%	22.0%	22.4%	21.9%
Deficit	**-8.7%**	**-7.0%**	**-3.7%**	**-2.1%**	**-1.5%**	**-1.6%**	**-1.1%**	**-0.9%**	**-1.2%**	**-1.2%**	**-1.2%**	**-1.4%**	**3.6%**
Debt	**67.7%**	**72.5%**	**75.1%**	**74.8%**	**72.6%**	**70.5%**	**68.5%**	**66.8%**	**65.5%**	**64.2%**	**63.0%**	**62.0%**	**n/a**
Deficit ($)	**-1,296**	**-1,079**	**-585**	**-345**	**-269**	**-302**	**-220**	**-196**	**-258**	**-280**	**-279**	**-339**	**-3,072**
Debt ($)	**10,128**	**11,242**	**11,945**	**12,401**	**12,783**	**13,188**	**13,509**	**13,801**	**14,148**	**14,512**	**14,872**	**15,291**	**n/a**
August 2011 Baseline													
Revenues	15.3%	16.8%	19.0%	20.2%	20.2%	20.1%	20.4%	20.5%	20.6%	20.7%	20.9%	n/a	20.0%
Outlays & JSC Savings^	23.8%	23.0%	22.1%	21.7%	21.3%	21.6%	21.6%	21.5%	21.8%	21.9%	22.0%	n/a	22.4%
Deficit	**-8.5%**	**-6.2%**	**-3.2%**	**-1.6%**	**-1.1%**	**-1.5%**	**-1.2%**	**-1.0%**	**-1.2%**	**-1.2%**	**-1.2%**	**n/a**	**-1.8%**
Debt	**67.3%**	**71.2%**	**72.8%**	**71.6%**	**68.7%**	**67.2%**	**65.8%**	**64.3%**	**63.1%**	**62.0%**	**61.0%**	**n/a**	**n/a**

* Ten-year column reflects 2013-2022 for January baseline and 2012-2021 for August baseline.

^ January figures include $1,033 billion of deficit reduction through 2021 and $1,172 billion through 2022 from the BCA sequester. By comparison, August figures assume $1.2 trillion of deficit reduction through 2012 as a result of potential recommendations from the Joint Select Committee on Deficit Reduction.

The reasons for this rapid increase in revenue are several. First, revenue collections will rise gradually as the economy continues to recover and earnings, profits, and employment go up. Second, the 2001/2003/2010 tax cuts are scheduled to expire at the end of calendar year 2012 and the AMT patch will remain expired, resulting in almost $4.6 trillion of revenue through 2022 relative to their continuation. The expiration of the AMT patch is particularly important because – due to the fact it is not indexed to inflation – the AMT generates increasing amounts of revenue over time. And finally, the 2010 health care reform law included a number of revenue-raising provisions which will phase in over the course of the decade.

Economic Projections

CBO's economic assumptions play a vital role in their budgetary projections because they influence spending and revenue estimates in a number of ways. For example, a stronger economy decreases spending on automatic stabilizers, such as unemployment insurance and food stamps, and increases revenue collection due to higher employment and wages.

CBO's latest current law economic projections show real GDP growth at 2.2 percent in calendar year 2012, below the 2.6 percent projected last August. The downward revision to growth for this year largely stems from "downward revisions to historical data on GDP and diminished near-term prospects for economic growth in other countries." In 2013, however, CBO projects real GDP growth of only 1 percent due to the large and abrupt spending cuts and tax increases set for 2013 under current law when the 2001/2003/2010 tax cuts expire and automatic spending cuts take effect. CBO expects economic growth to stabilize at about 2.5 percent annually near the end of the decade.

While the economic impact of current law policies would reduce growth in the short-term, CBO notes that they would likely increase the size of the economy over the longer-term as lower deficits and debt reduce the "crowding out" of private investment. Under CBO's alternative fiscal scenario, however, which makes a number of assumptions about which policies lawmakers would continue or waive, deficits and debt would be significantly larger this decade. The impact of the alternative scenario would increase real GDP growth in 2012 and 2013 but "would tend to become more negative [beyond 2022], as the projected impact of the alternative fiscal scenario on deficits, and therefore, investments, rose."

These projections underscore the importance of announcing a debt reduction plan now which would phase in savings over the medium and longer-term. Under such an approach, policymakers could mitigate the short-term impacts of debt reduction by giving the economy time to recover and creating certainty about the future, while bringing down deficits and debt later in the decade to promote private investment and economic growth. Additionally, focusing on reforms that by themselves encourage economic growth could make a debt reduction package even stronger.

Fig. 3: Comparison of Economic Forecasts

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	Ten-Year*
Inflation (Calendar Year over Calendar Year)													
CBO January 12	3.1%	1.7%	1.5%	1.5%	1.7%	2.0%	2.2%	2.3%	2.3%	2.3%	2.3%	2.3%	2.0%
CBO August 11	2.9%	1.5%	1.3%	1.3%	1.8%	2.1%	2.3%	2.3%	2.3%	2.3%	2.3%	N/A	2.0%
OMB August 11	2.8%	1.8%	1.9%	2.0%	2.0%	2.1%	2.1%	2.1%	2.1%	2.1%	2.1%	N/A	2.0%
Average Blue Chip#		2.0%	2.2%	N/A									
Real GDP Growth (Calendar Year over Calendar Year)													
CBO January 12	1.7%	2.2%	1.0%	3.6%	4.9%	4.2%	3.3%	2.8%	2.6%	2.5%	2.4%	2.4%	2.9%
CBO August 11	2.4%	2.6%	1.7%	4.4%	5.0%	3.2%	2.8%	2.5%	2.5%	2.3%	2.3%	N/A	2.9%
OMB August 11	2.6%	3.3%	3.7%	4.0%	3.9%	3.7%	3.2%	2.7%	2.5%	2.5%	2.5%	N/A	3.2%
Average Blue Chip#		2.3%	2.8%	N/A									
Unemployment Rate (Annual Average, Percent)													
CBO January 12	9.0%	8.8%	9.1%	8.7%	7.4%	6.3%	5.7%	5.5%	5.5%	5.4%	5.4%	5.3%	6.7%
CBO August 11	8.9%	8.7%	8.7%	7.9%	6.1%	5.4%	5.2%	5.2%	5.2%	5.2%	5.2%	N/A	6.5%
OMB August 11	8.8%	8.3%	7.7%	6.9%	6.3%	5.7%	5.3%	5.2%	5.2%	5.2%	5.2%	N/A	6.4%
Average Blue Chip#		8.5%	8.0%	N/A									

* Ten-year column reflects 2013-2022 for January baseline and 2012-2021 for August projections.

\# Reflects Blue Chip consensus estimates as of January 2012.

CBO has also revised its unemployment and inflation projections, forecasting that unemployment will actually *rise* from an average of 8.8 percent this year to 9.1 percent next year, before stabilizing at about 5.4 percent later in the decade. Inflation, on the other hand, is expected to remain subdued at or below 1.7 percent through 2015, gradually rising to about 2.3 percent per year by 2018.

Compared to economic projections from OMB and private forecasters in the Blue Chip Consensus, CBO expects lower economic growth and inflation in the short-term and higher unemployment, although these projections are perhaps a result of different fiscal policy assumptions.

The CRFB Realistic Baseline

While the debt projections under CBO's current law baseline show the debt to be on a stable and downward path this decade, these projections rely on Congress to allow a number of provisions to expire and an across-the-board spending sequester to go into effect. As CRFB explained earlier in a press release, "*While we are highly supportive of actions to reduce the debt, there are smart ways and there are mindless ways to proceed.*" CBO's dismal economic projections for 2013 highlight the consequences of reducing the deficit through large, blunt, and immediate changes as opposed to gradual, thoughtful, and pro-growth reforms.

More to the point, though, policymakers have not allowed these types of changes to current policy to happen in the past and are not likely to do so in the future.

CRFB makes several adjustments to CBO's current law baseline projections to reflect a more realistic budget trajectory. These projections, however, are in no way a recommendation for future policies, but one possible combination of policies that could occur if we do not act to put forward a comprehensive plan. In particular, the CRFB Realistic Baseline assumes:

- The 2001/2003/2010 income and estate tax cuts will be extended before they expire at the end of December 2012.
- The Alternative Minimum Tax (AMT) will be "patched" for 2012 and beyond to prevent it from hitting millions of upper-middle and middle income taxpayers.
- Congress will enact a permanent "doc fix" to prevent a 27 percent reduction in Medicare physician payments under the Sustainable Growth Rate (SGR) formula.
- Spending on the wars in Iraq and Afghanistan will continue to decline until the U.S. has only 45,000 troops in overseas contingency operations by 2015.

- The sequester from the Budget Control Act, in response to the failure of the Super Committee, will not be allowed to go into effect for calendar years 2013 through 2021, and instead will be waived in each of those years.

Taken together, these changes would add $5.9 trillion to the deficit through 2022, including nearly $900 billion of interest costs.

CRFB's Realistic Baseline projections do not incorporate potential costs of extending the payroll tax holiday and unemployment benefits through the rest of the year because we assume these changes will be fully offset over the ten-year window. Deficit-financing these extensions could add nearly $200 billion more to the debt by 2022.

Fig. 4: Bridge to CRFB Realistic Baseline (Billions of Dollars)

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	Ten-Year
Current Law Deficit	**-$585**	**-$345**	**-$269**	**-$302**	**-$220**	**-$196**	**-$258**	**-$280**	**-$279**	**-$339**	**-$3,072**
Extend 2001/2003/2010 Tax Cuts and AMT Patch	-$232	-$334	-$382	-$413	-$445	-$477	-$511	-$549	-$589	-$633	-$4,564
Continue "Doc Fixes"	-$19	-$21	-$23	-$26	-$29	-$32	-$36	-$40	-$43	-$47	-$316
Reduce Troops in Iraq and Afghanistan	$20	$48	$72	$87	$94	$98	$102	$104	$106	$108	$838
Waive the Sequester	-$66	-$93	-$101	-$104	-$106	-$106	-$105	-$105	-$105	-$94	-$984
Net Interest	-$1	-$5	-$16	-$34	-$57	-$85	-$119	-$153	-$189	-$229	-$889
Realistic Baseline Deficit	**-$883**	**-$750**	**-$719**	**-$792**	**-$763**	**-$798**	**-$927**	**-$1,023**	**-$1,099**	**-$1,234**	**-$8,988**
Deficit as % of GDP	*-5.5%*	*-4.5%*	*-4.1%*	*-4.2%*	*-3.9%*	*-3.9%*	*-4.3%*	*-4.5%*	*-4.7%*	*-5.0%*	*-4.5%*
Debt as % of GDP	*77%*	*79%*	*79%*	*79%*	*80%*	*80%*	*82%*	*83%*	*84%*	*86%*	N/A

Under the CRFB Realistic Baseline, deficits will average 4.5 percent of GDP over the decade, rising to 5.0 percent by 2022. As a result, debt would increase from roughly 68 percent of GDP in 2011 to over 86 percent by 2022.

Though an improvement from estimates prior to the enactment of the Budget Control Act, these levels are unacceptably high over the next ten years – especially given their propensity to grow over the long-term.

Conclusion

This latest CRFB Realistic Baseline paints a clear picture of what policymakers are facing – a mountain of rising debt. Current law projections may appear to be sustainable, but this sustainability would be achieved through unwise and unrealistic changes to the budget – changes that Congress has not allowed to occur in the past. Lawmakers must act soon to put in place a fiscal plan that stabilizes and reduces the debt trajectory as a share of the economy – one that relies on smart spending and revenue decisions and not blunt, across-the-board cuts.