Peter G. Peterson Foundation
Our America. Our Future.

Analysis of Congressional Budget Office's August 2012 Updateof the Budget and Economic Outlook

Aug 24, 2012

The nonpartisan Congressional Budget Office (CBO) has released a mid-year update to its projections of the nation's federal finances and economic health. The latest report emphasizes the fiscal challenges facing policymakers this year and the economic costs of failing to put fiscal policy on a sensible and sustainable course.

CBO warns about twin fiscal risks that policymakers must navigate. On one hand, if they fail to address the "fiscal cliff" at the end of this calendar year (the expiration of tax cuts and the imposition of automatic spending cuts under current law), the economy will probably slip back into recession. On the other, if lawmakers avoid the fiscal cliff by simply maintaining status-quo budget policies, within 10 years federal debt will climb to such high levels that it will undermine the growth of our economy.

The CBO report is an important reminder about the need to address the imbalance in current fiscal policies. What we need is a bipartisan solution to the nation's long-term fiscal problems that can be agreed upon now, and implemented gradually over time. Such a plan would give our economy a much-needed boost of confidence that would speed our recovery from recession and move our nation toward a more secure and prosperous future.

CBO'S BUDGET AND ECONOMIC OUTLOOK

The CBO projects that the federal government will close fiscal year 2012 (which ends in September) with a total deficit of $1.1 trillion, marking the fourth straight year of budget shortfalls in excess of one trillion dollars. Though still substantial, this is a slight drop from last year's deficit of $1.3 trillion, largely due to modest rises in tax collections, the winding down of stimulus spending, and decreases in military expenditures. Nonetheless, by the end of the year publicly-held federal debt will reach 73 percent of gross domestic product (GDP) — the highest level since shortly after World War II.

CBO's August 2012 budget projections
Percentage of GDP

	Actual 2011	2012	2013	2022	Total 2013-2022
Current Law Projections					
Revenue	15.4	15.7	18.4	21.4	20.6
Spending					
Mandatory	13.6	13.2	13.3	14.4	13.5
Discretionary	9.0	8.3	7.8	5.6	6.3
Net Interest	1.5	1.4	1.4	2.3	1.9
Total	24.1	22.9	22.4	22.3	21.7
Deficit	8.7	7.3	4.0	0.9	1.1
Debt Held by the Public	67.7	72.8	76.1	58.5	NA
Current Policy Projections					
Deficit	8.7	7.3	6.5	5.5	4.9
Debt held by the public	67.7	72.8	78.6	89.7	NA

SOURCE: Data from the Congressional Budget Office, *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022*, August 2012. Compiled by PGPF.

Current-Law Projections and the "Fiscal Cliff"

The fiscal outlook for 2013 depends critically on what lawmakers choose to do over the next several months. If current laws remain in place, the deficit next year will plummet by almost $500 billion compared to 2012. That decline would amount to more than 3 percent of GDP and stems largely from a set of policy changes built into current law that will sharply increase revenues and lower spending.

These sudden and drastic changes to our nation's fiscal policies, colloquially known as "the fiscal cliff," are the result of an assortment of laws that expire or go into effect in January of 2013:

- Expiration of significant tax provisions: At the end of the year, the tax cuts that were originally enacted in 2001, 2003, and 2009 and extended in 2010, will expire — along with a number of other tax provisions including rules that permit businesses to expense new investments. In addition, millions of additional taxpayers will be subject to the Alternative Minimum Tax (AMT) unless tax law is changed. Together, these changes would result in higher taxes for nearly all taxpayers. Because of those expiring tax provisions, CBO estimates that tax revenues will increase by about $290 billion in 2013, compared with 2012.

- Automatic spending cuts as part of the Budget Control Act (BCA) passed by Congress in 2011: The BCA stipulated that failure of the congressional "super committee" to agree upon a plan for long term deficit reduction totaling $1.2 trillion would result in sequestration—or, across-the-board cuts — in defense and nondefense programs in 2013. CBO projects that sequestration will reduce spending by $54 billion in 2013.

- Reduced Medicare payments to doctors: Unless waived, current law will reduce Medicare payments to physicians by 27 percent in January 2013 and by additional amounts in subsequent years. CBO projects this will reduce expenditures by $10 billion in 2013.

- Unemployment benefits and payroll taxes: An emergency extension of unemployment benefits and a 2 percentage point reduction in payroll taxes is set to expire at the end of the year. The expiration of these temporary changes will reduce benefit payments by $34 billion and raise revenues by $85 billion in 2013, compared to 2012.

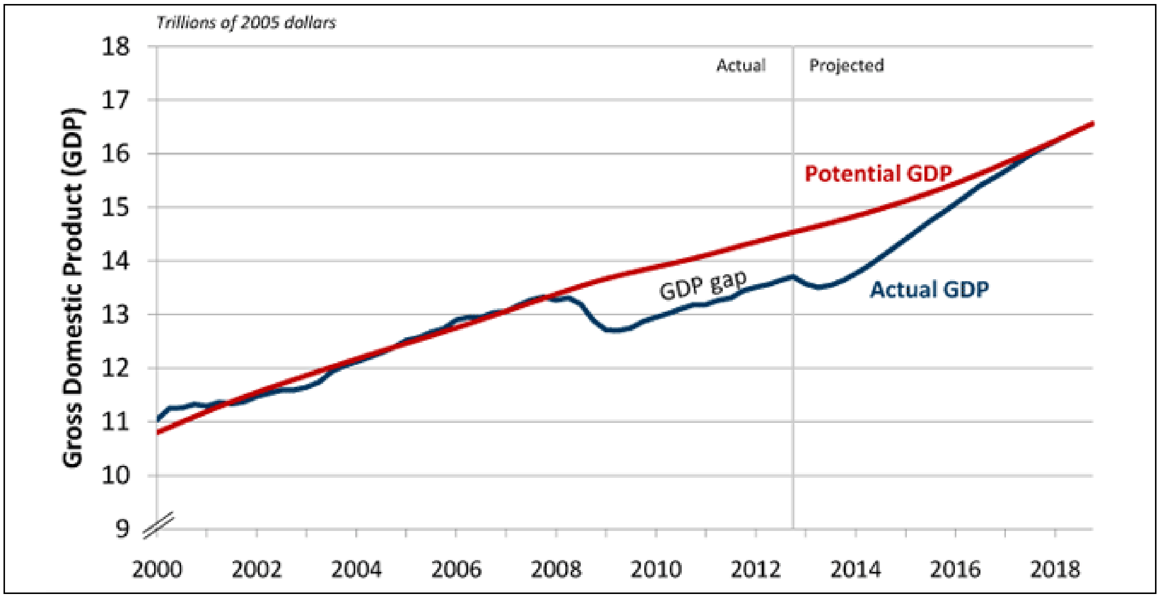
- New taxes enacted in the Affordable Care Act (ACA): The ACA increases tax rates on the earnings and investment income of high-income taxpayers, which will raise $18 billion of new revenues in 2013.

As a result of these and other changes, CBO projects that federal revenues will jump from 15.7 percent of GDP in 2012 to 18.4 percent in 2013 — an increase of almost 20 percent. At the same time, spending is projected to fall from 22.9 percent of GDP to 22.4 percent in 2013 — a 2 percent decline.

Although a reduction in the deficit can boost long-run economic growth when the economy is strong, a sharp and sudden cutback can damage a weak economy. Not surprisingly, CBO projects that the fiscal tightening projected under current law "will probably" lead to a recession in 2013, with real GDP declining at a 2.9 percent annual rate in the first half of next year. Although CBO projects that the economy would begin recovering in the second half of 2013, the unemployment rate would continue to climb to 9.1 percent by the fourth quarter of 2013.

Moreover, CBO warns that uncertainty about the fiscal outlook may have already begun to undermine consumer and business confidence. Investment in new plants and equipment during the second half of 2012 is expected to be "restrained by businesses' concern about possible changes in fiscal policies," and some households "will probably pull back on spending later in the year in response to rising concerns about the effects of future fiscal tightening." The outlook improves after 2013, but only after a painful and unnecessary transition. By 2018 the economy would finally begin to operate at full capacity again, with the unemployment rate falling to 5.3 percent.

Under current law, GDP is projected to be below its potential level until 2018

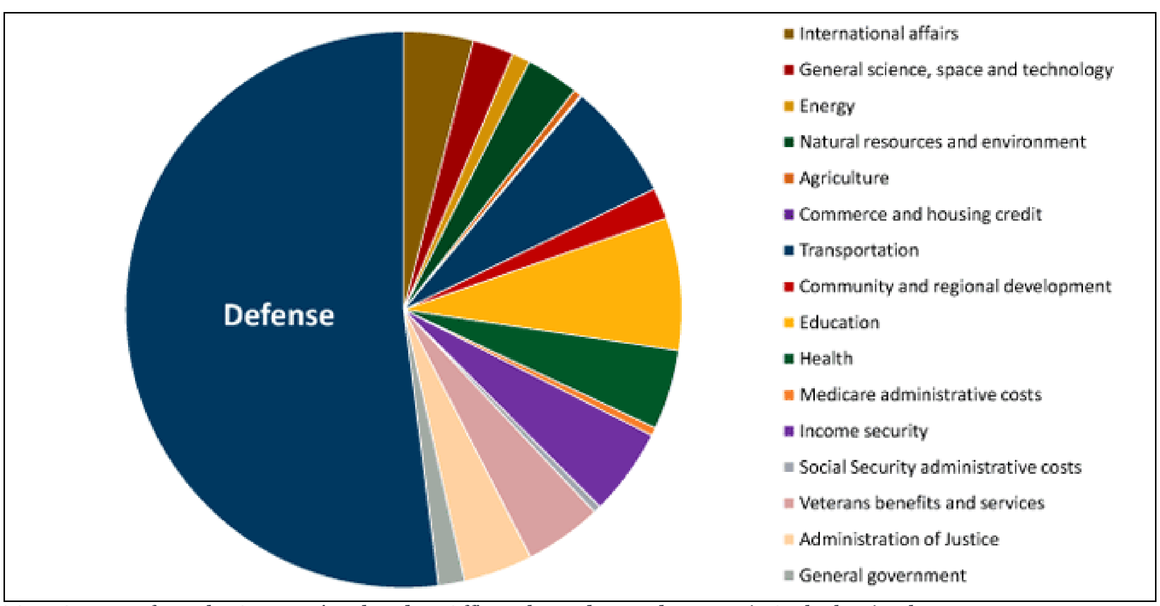


SOURCE: Data from the Congressional Budget Office, *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022*, August 2012. Compiled by PGPF.

The budget outlook also shows significant changes in the mix of government spending over the course of the next 10 years. Entitlement programs for the elderly will take up a growing share of the government's budget. Spending on Medicare, Medicaid, and Social Security will climb from 10.4 percent of GDP in 2011 to 12.2 percent of GDP in 2022 — a 17 percent rise. Those increases reflect not only the retirement of the baby-boom generation and the general aging of the population, but also the fact that health care costs, despite a recent slowdown, will continue to grow faster than the economy.

Over the same 10 year period, current law implies sharp reductions in discretionary spending. These programs represent more than one-third of the budget in 2012 and fund a wide range of activities including national defense, veterans' assistance, law enforcement and the court system, national parks, education, research and development, and investments in physical infrastructure.

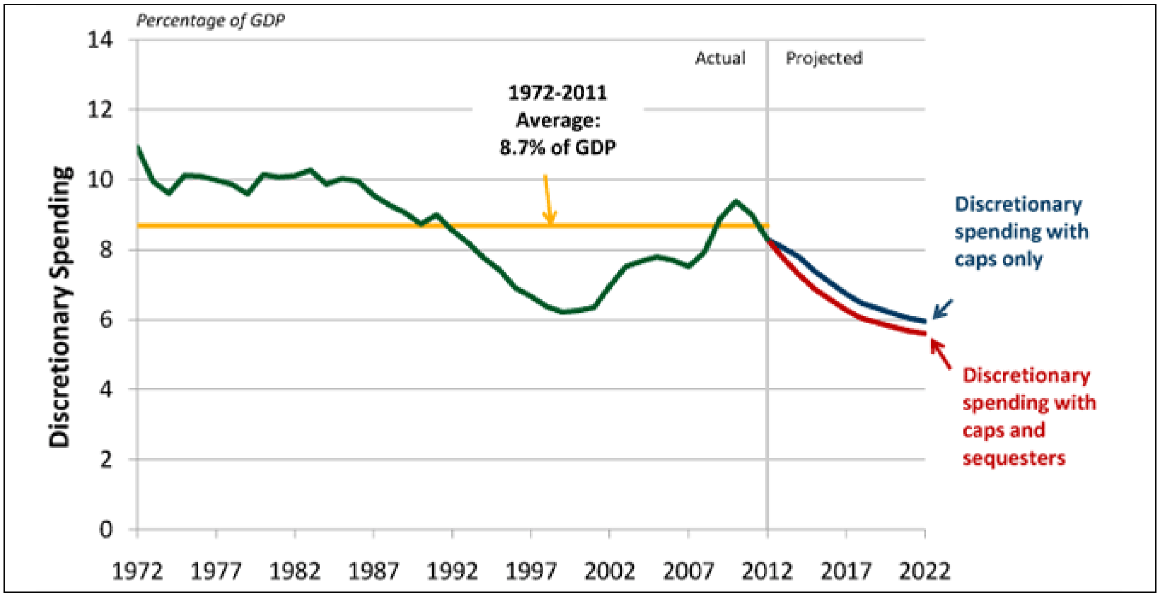
Discretionary spending funds a wide range of government programs



SOURCE: Data from the Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2013 to 2022*, January 2012. Compiled by PGPF.

CBO projects that under current law, discretionary spending will decline from 9.0 percent of GDP in 2011 to 5.6 percent of GDP in 2022. At that level, discretionary spending will be lower than it has been in any year for the past 50 years. Discretionary spending will not keep up with inflation, so real resources available for these programs will be reduced by 17 percent in 2022.

Discretionary spending is projected to go well below historical levels under current law



SOURCE: Data from the Congressional Budget Office, *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022*, August 2012; and *The Budget and Economic Outlook: Fiscal Years 2013 to 2022*, January 2012. Compiled by PGPF.

Current-Policy Projections

Many observers expect that lawmakers will intervene to avoid the sudden and sizeable changes to our fiscal policies set to take place in 2013. For this reason, CBO produces a second set of economic projections under the assumption that our nation's policies remain largely unchanged. This alternative fiscal scenario assumes that expiring tax cuts are extended, the Alternative Minimum Tax is indexed for inflation, payments to physicians under Medicare are not cut, and the automatic spending cuts from the Budget Control Act are not imposed.

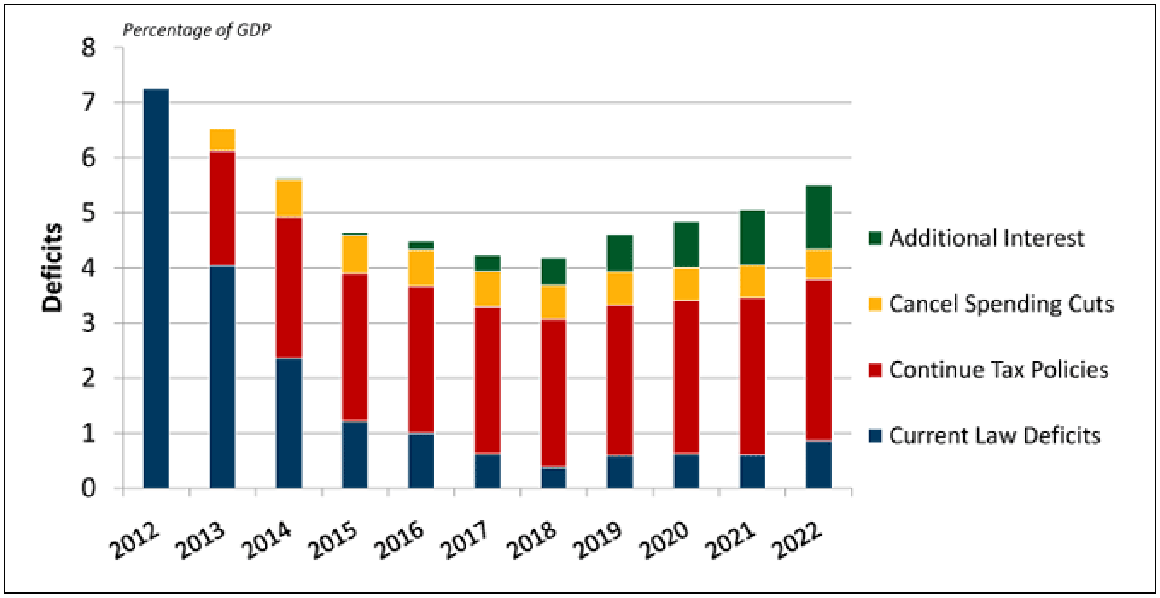
Comparison of CBO's current law and current policy scenarios
Billions of dollars

	10-Year Total: 2013-2022
Current law deficits	**2,258**
• Medicare "doc fix"	245
• Extend 2001/2003/2010 tax cuts*	4,532
• Extend other expiring tax provisions	890
• No automatic spending cuts as required by the Budget Control Act	972
• Debt service	1,078
Subtotal: changes	7,717
Current policy deficits	**9,975**

SOURCE: Data from the Congressional Budget Office, *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022*, August 2012. Compiled by PGPF.
*Includes indexing the AMT for inflation

Under this "current policy" scenario, budget deficits would persist at a substantially higher level over the next ten years. Deficits in 2013 would exceed $1 trillion and would average 5 percent of GDP in subsequent years — well above the deficits of 1 percent of GDP under current law. From 2013 to 2022, cumulative deficits will reach almost $10 trillion, well above the $2.3 trillion deficit total under current law.

Extending current tax laws has a significant impact on future deficits

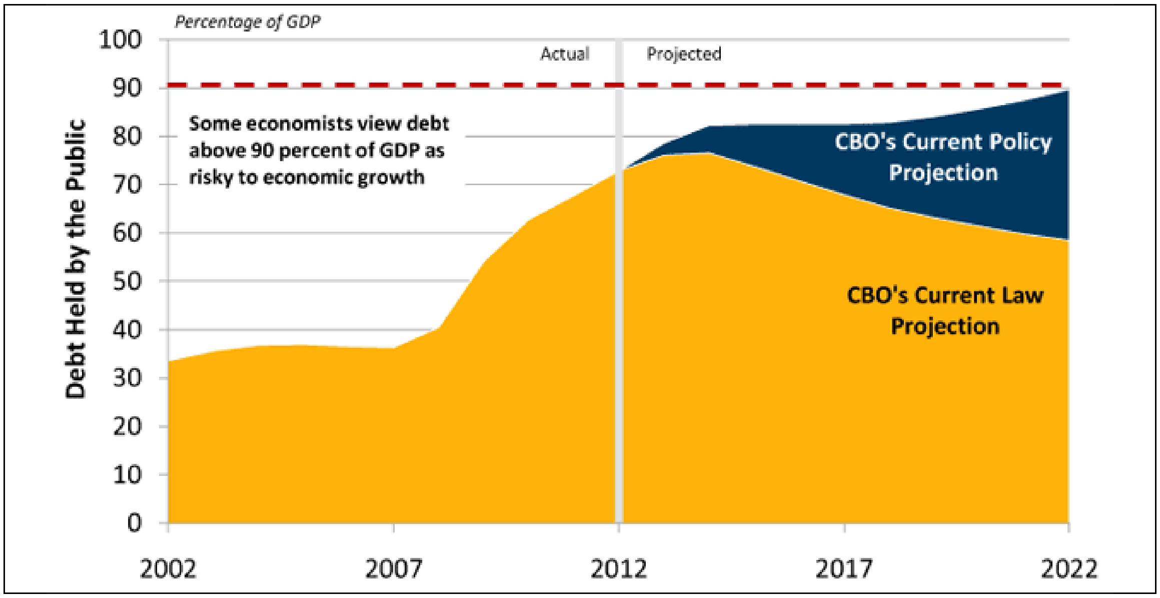


SOURCE: Data from the Congressional Budget Office, *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022*, August 2012. Compiled by PGPF.

Most of difference between the two scenarios stems from changes in revenues. CBO estimates that extending all of the tax cuts set to expire and indexing the AMT for inflation will add approximately $4.6 trillion to the non-interest (or primary) deficit over the next 10 years. By contrast, extending the Medicare "Doc Fix" would prevent cuts to physician payments, but it would add only $245 billion to accumulated primary deficits. Overriding the automatic spending cuts mandated by the Budget Control Act would add an additional $972 billion to accumulated primary deficits. In other words, extending current tax policies raises the primary deficit almost four times more than the combined effect of extending the Doc Fix and overriding BCA's automatic spending cuts.

The outlook for federal debt would be significantly worse under the current policy scenario. Over the next 10 years, federal debt would climb from 68 percent of GDP in 2011 to 90 percent in 2022 — a level of debt that history suggests can slow economic growth. By contrast, debt would decline to 58 percent of GDP under current law.

Under current policy, federal debt is projected to approach 90 percent of GDP by the end of the decade



SOURCE: Data from the Congressional Budget Office, *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022*, August 2012. Compiled by PGPF.

The economic outlook is also significantly different under the current policy scenario. CBO projects that because the fiscal cliff would be avoided, the economy would grow by 1.7 percent in 2013, instead of contracting at a -0.5 percent rate as CBO projects it would under current law. Similarly, the unemployment rate would also be lower for the first few years if current policies are maintained, falling to 8 percent at the end of 2013 instead of climbing to 9.1 percent as projected under current law.

However, rapidly rising debts would begin to undermine economic growth during the 10-year period. CBO's report states, "The persistence of large budget deficits and rapidly escalating federal debt would hinder national saving and investment, thus reducing GDP and income relative to the levels that would occur with smaller deficits." As a result, CBO projects that debt will reduce the level of real GDP by 0.4 percent in 2022 and lower real gross national product (GNP) by 1.7 percent. Although GNP is a less familiar measure than GDP, it is a better measure of the effects of debt on the real incomes available to U.S. residents for consumption because it subtracts the interest costs of U.S. borrowings from foreigners.

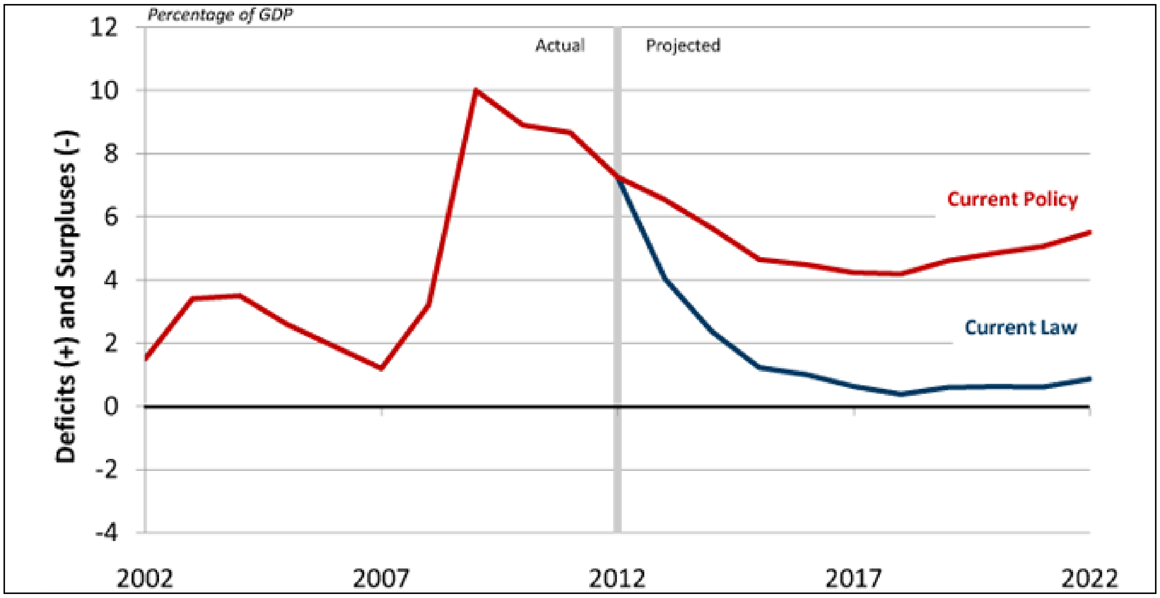
CONCLUSION

Although 10-year budget projections are never accurate predictions of the future — and CBO emphasizes the unusually large degree of uncertainty in its latest set of estimates — CBO's report paints a stark picture of the fiscal challenges our nation faces. If maintained over the next 10 years, current laws will drastically reshape our nation’s fiscal policy, significantly altering current policies on both taxation and expenditures. Such sudden and substantial near-term changes would jeopardize an already fragile economic recovery, increase unemployment, and likely send the nation back into recession next year.

On the other hand, if current policies are maintained all the way through 2022, our national debt will escalate to 90 percent of GDP and undermine economic growth. The CBO states that such a policy "would lead to a level of federal debt that would be unsustainable from both a budgetary and an economic perspective." Indeed many economists have previously stated that 90 percent is the point where our debt will begin to seriously burden the nation's economy.

The CBO's report highlights the need for an alternative, reasoned approach for addressing our nation's long-term fiscal challenges without recklessly endangering our fragile economic recovery. Our leaders must chart a prudent course between the extremes, crafting sensible long-term reforms now with policies that go into place once the economy is on more sound footing.

The federal deficit as a percentage of GDP, 2002-2022



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