Economic Policy Program

Debt Reduction Task Force

The 12 Takeaways from CBO's 2012 Budget and Economic Outlook

Staff of the Bipartisan Policy Center | March 2012

BIPARTISAN POLICY CENTER

ABOUT BPC

Founded in 2007 by former Senate Majority Leaders Howard Baker, Tom Daschle, Bob Dole and George Mitchell, Bipartisan Policy Center (BPC) is a non-profit organization that drives principled solutions through rigorous analysis, reasoned negotiation and respectful dialogue. With projects in multiple issue areas, BPC combines politically balanced policymaking with strong, proactive advocacy and outreach.

DISCLAIMER

Introduction

The Congressional Budget Office (CBO) has released its 10-year budget and economic prospectus, "The Budget and Economic Outlook: Fiscal Years 2012 to 2022." This is CBO's annual report to Congress on the state of the U.S. economy and the federal budget, and it forms the starting point for the year's budget discussions.

The CBO projections are important both practically and politically – they form the baseline against which budgets will be judged, and set the scene for policymaking discussions. These 12 takeaways from the Outlook demonstrate that the U.S. faces persistent short- and long-term economic problems and that serious reform still is needed in order to strengthen the recovery and stabilize our debt.

The paper begins by examining the current economic conditions and then turns to the long-term debt trajectory.

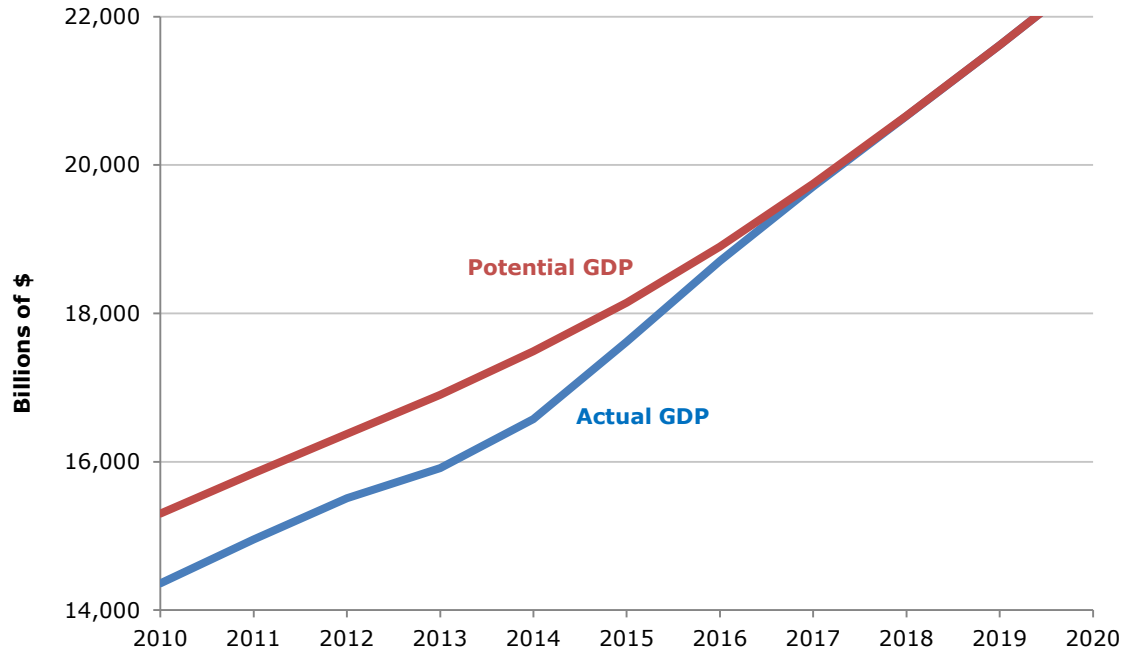
1. The economic recovery remains sluggish.

Modest economic growth in the fourth quarter of calendar year 2011 – real gross domestic product (GDP) rose by 2.8 percent – means the recovery is progressing, but slowly. CBO roughly projects this trend to continue, with 2.0 percent GDP growth forecast for 2012. This figure is fairly weak at a time when the economy is operating at well below its capability – a metric that economists term "potential GDP" (depicted in Figure 1).

The relatively tepid growth reflects the lingering consequences of the financial crisis and recession – a battered housing market, losses in private wealth, and immense personal debt all continue to depress consumer spending. Largely as a result of these poor economic conditions, inflation and interest rates are projected to remain low in the coming years.

The CBO report predicts that, on the economy's current trajectory, output will remain below its potential until 2018. Production below capacity for such an extended period was last seen during the Great Depression.

Figure 1. The Output Gap: GDP to Remain Below Potential Until 2018



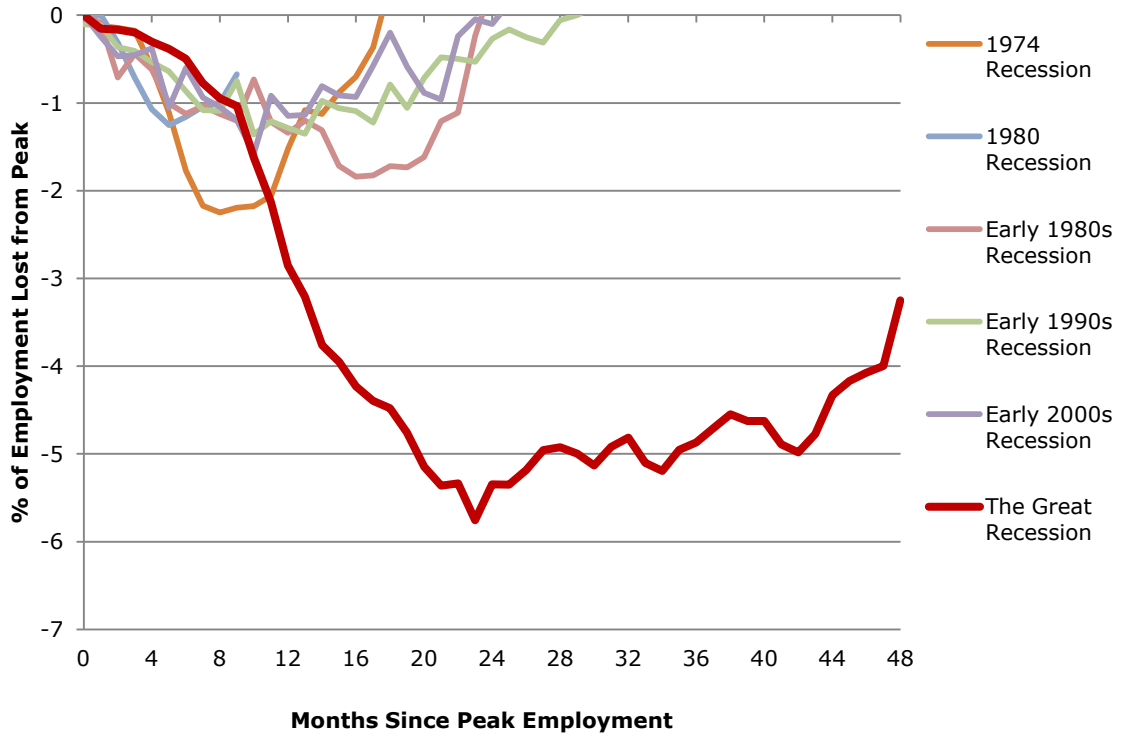
Source: Congressional Budget Office (January 2012)

2. Unemployment remains intractable, and CBO projects that gains will remain slow.

CBO does not forecast the unemployment rate to drop below eight percent this year. Alarmingly, alternative measures of joblessness that incorporate discouraged and part-time workers remain significantly higher, suggesting that many people either have stopped looking for work or settled for working fewer hours than desired. The labor market still has a tremendous amount of slack. Unemployment is not projected to return to near full employment – about 5.5 percent, by common consensus – until 2018.

The Great Recession therefore would be the longest period of persistent high unemployment in the U.S. since the Great Depression and could have significant consequences on output over time, depending on how firms and workers react. This type of elevated long-term unemployment carries great risks – such as a deteriorating skill set among the labor force that could damage long-term production in the economy.

Figure 2. And That's Why It's Called "The Great Recession…"



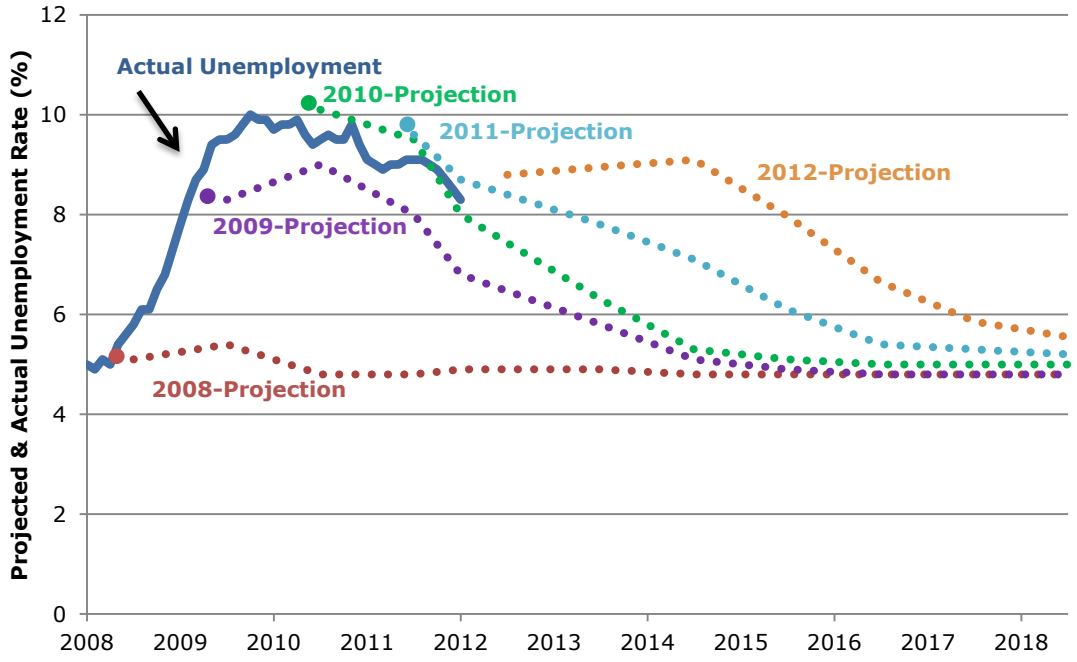
Sources: Federal Reserve Bank of St. Louis, FRED, Seasonally-Adjusted Nonfarm Employment

3. The "blue-chip consensus" projections for the unemployment rate originally overestimated the strength of the recovery, but recently appear to be erring on the pessimistic side.

Bottom line: these figures are difficult to predict. Carmen Reinhart and Ken Rogoff anticipated the extended economic stagnation in their recent work, "This Time Is Different." They describe how economic downturns caused by financial collapse do not produce typical, short-lived recessions. In these crisis situations, the economy often remains depressed for a long period of time, and recovery is elusive.

Initially, most forecasters did not adhere to the Reinhart and Rogoff findings in their predictions for the speed of the current recovery.[i] Adjusting to the fact that we were in a "different" situation has taken quite some time, and only recently have CBO's projections shown that unemployment will remain high for an extended period.

Figure 3. The Difficulties of Projecting Unemployment



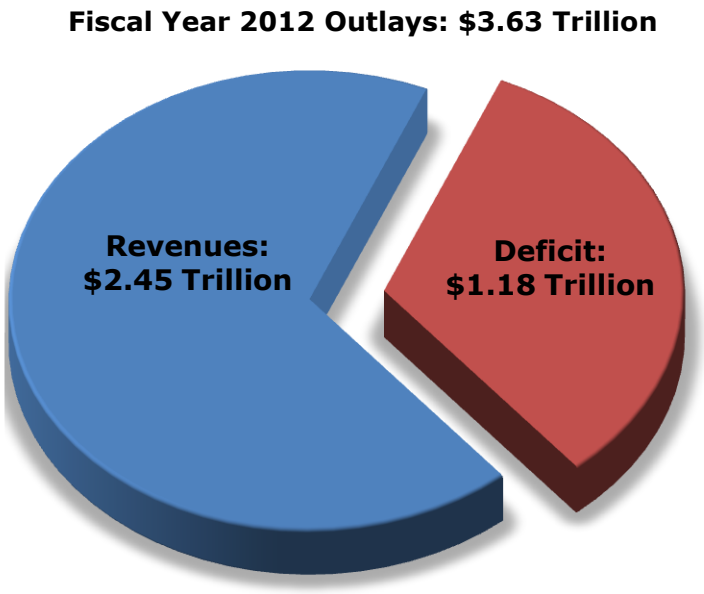
Note: CBO projections are of average unemployment levels for calendar years

Source: Congressional Budget Office (January 2012)

4. Our current budget deficit remains enormous.

The current U.S. budget deficit is $1.18 trillion, to be exact, or eight percent of GDP for FY 2012.

Figure 4. Nearly One-third of Our Spending is Borrowed



Source: Congressional Budget Office (January 2012)

5. Unrealistically, CBO's *current law* baseline shows deficits shrinking dramatically over the next few years.

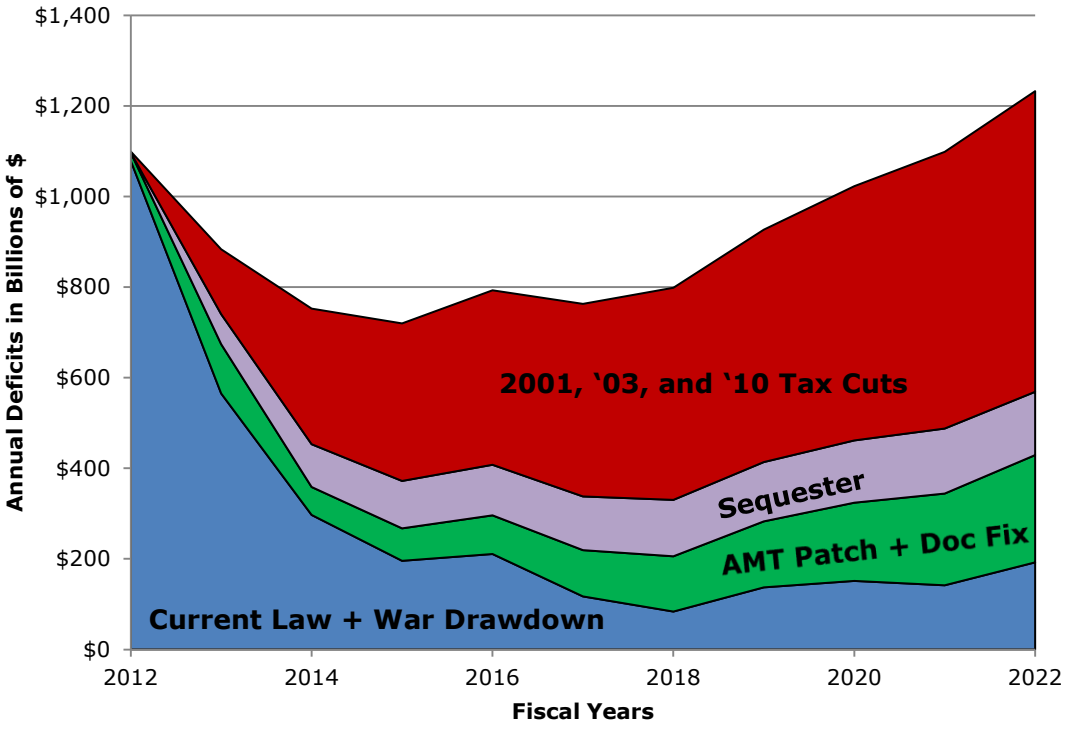
This projection contains many policy assumptions that are far from assured, including expiration of the 2001, 2003 and 2010 tax cuts, implementation of the Budget Control Act (BCA) sequester cuts, and failure to renew the alternative minimum tax (AMT) "patch" and the "doc fix." According to CBO, the current law baseline represents a "benchmark against which fiscal changes can be measured" and it should not be considered a serious forecast.

The implementation of these spending cuts and expiration of these tax cuts, paired with the winding down of the 2009 stimulus, would represent what CBO Director Douglas Elmendorf calls a "sharp fiscal contraction" – $400 billion in one year. According to the

report, the combination of drastic, immediate spending cuts and tax increases would reduce growth significantly in 2013, and could choke off the nascent recovery.

Conversely, Figure 5 shows what deficits would look like, all else equal, if those policies were reversed:

Figure 5. Current Law Deficits Set to Decline Sharply, But Policies Could Change That

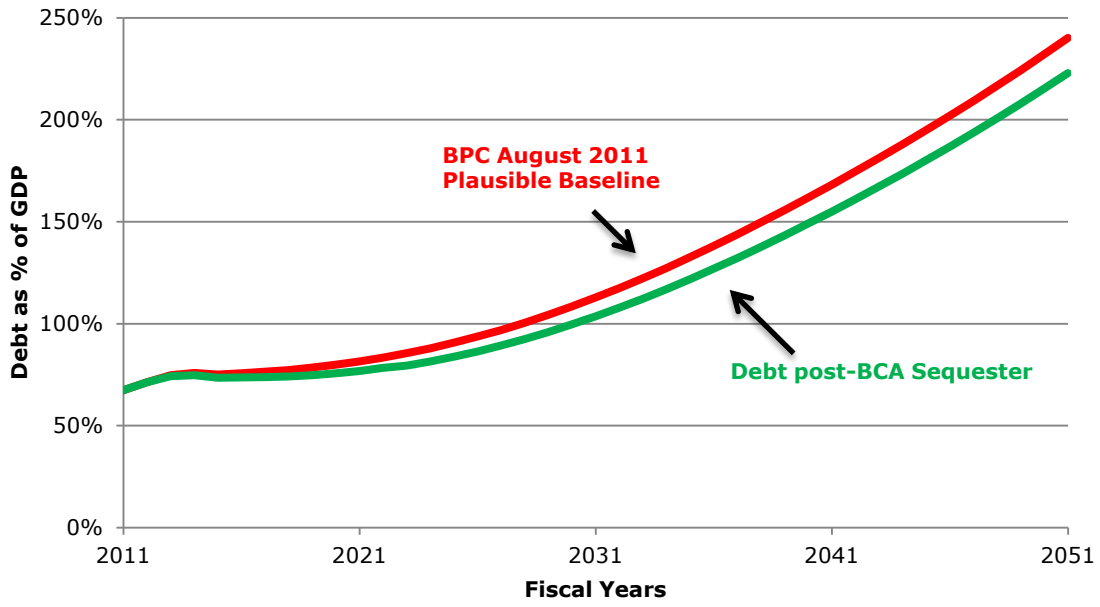


Source: Congressional Budget Office (January 2012)

6. The looming sequester would cut spending in the short- and medium-term, but does little to address the long-term debt situation.

The sequester is scheduled to cut over $1 trillion in spending over the next nine years.[ii] Beyond interest savings, the cuts will be evenly split between defense and non-defense programs that are not explicitly exempt. Figure 6 shows the sequester's effect on the debt trajectory and demonstrates that the cuts from the sequester produce a lot of pain for very little gain.

Figure 6. The Sequester Doesn't Control the Debt



Note: The Bipartisan Policy Center's (BPC) August 2011 Plausible Baseline assumes that the 2001, 2003, and 2010 tax cuts are extended permanently, Medicare physician payments are frozen (the "doc fix"), the AMT is indexed to inflation, and overseas combat operations wind down.

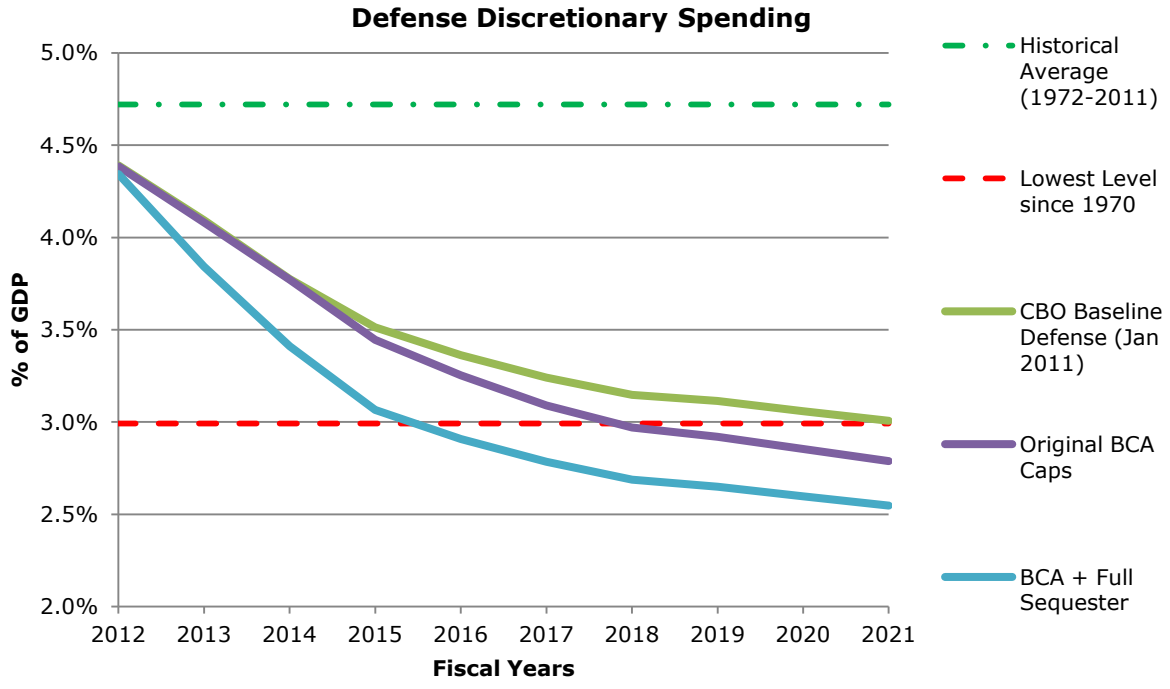
Sources: Congressional Budget Office; Bipartisan Policy Center projections

7. If the sequester takes effect as scheduled under current law, both defense and domestic (non-defense) discretionary spending will be reduced to their lowest levels in the last half century as a percentage of the economy.

The Budget Control Act of 2011 (BCA) already imposed caps on discretionary spending that would cut approximately $800 billion over the decade. The Department of Defense and other government agencies will require substantial reforms just to comply with the original BCA caps on spending. The sequester would cut roughly another $750 billion from these accounts over the same period, requiring reforms that many believe would be dangerous for defense and destructive to national investments.

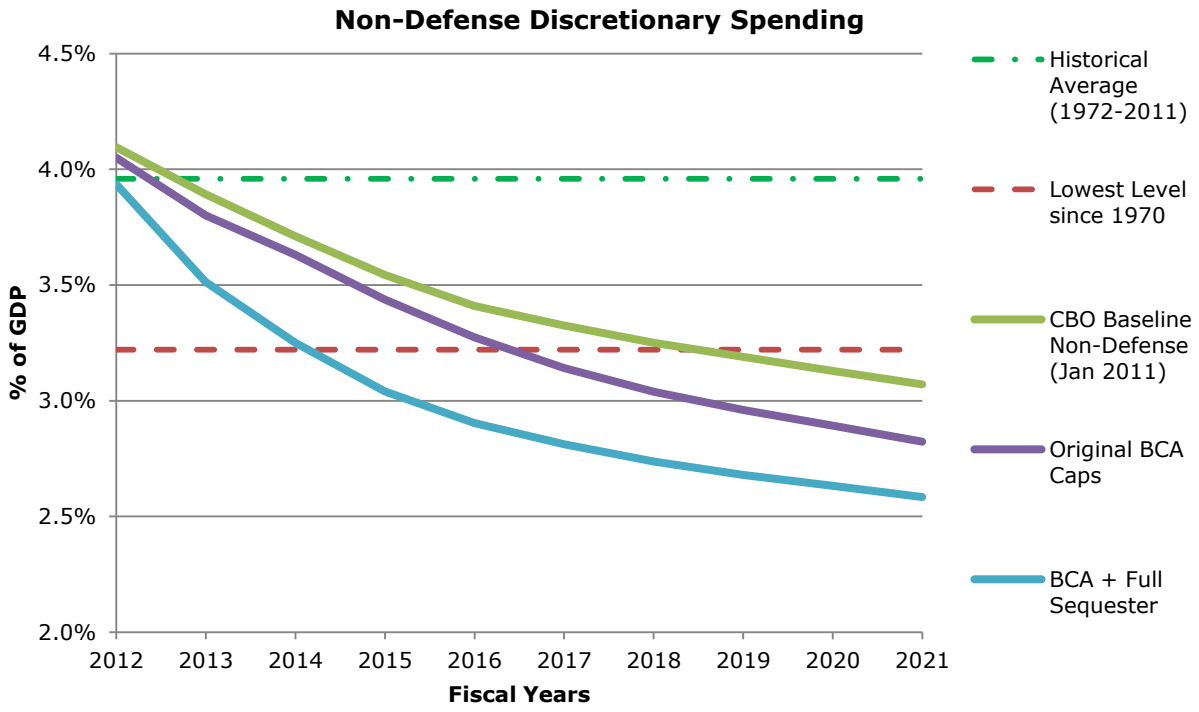
When combined, these cuts will reduce FY 2013 discretionary budget authority by approximately 15 percent from CBO's January 2011 baseline, indiscriminately slashing both defense and non-defense discretionary spending.

Figure 7a. Defense Spending Would Be Cut Again from Unprecedented Low



Source: Congressional Budget Office

Figure 7b. Domestic Discretionary Spending Would Be Cut to the Bone



Source: Congressional Budget Office

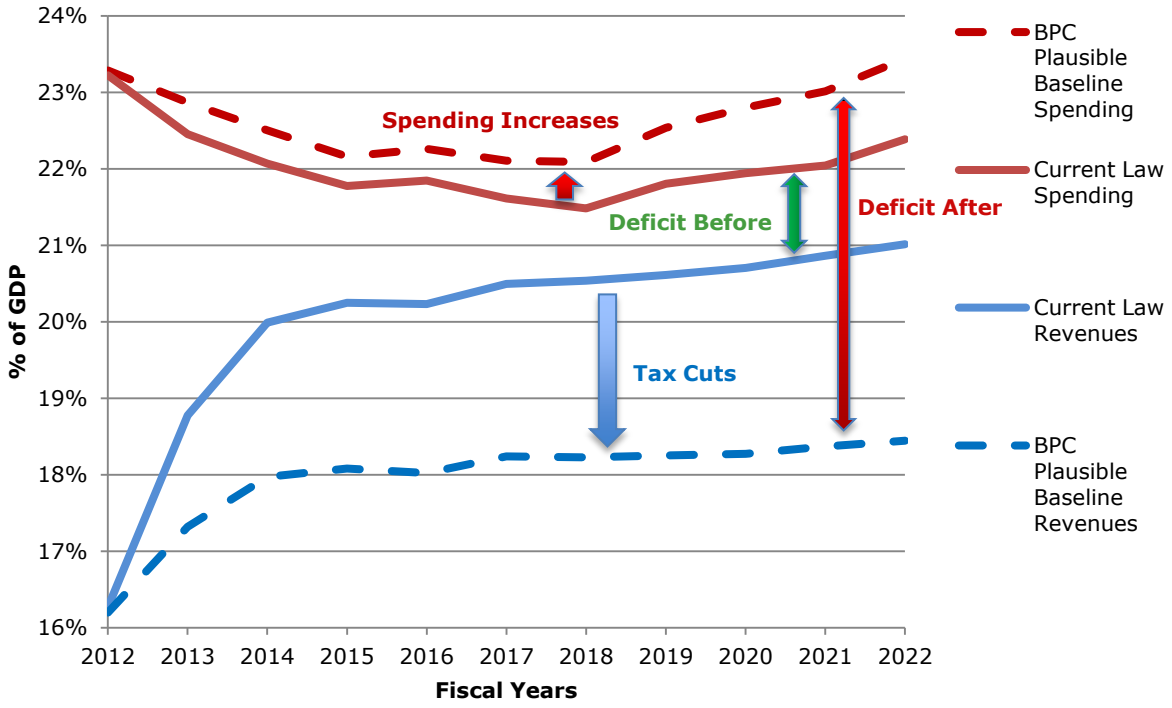
8. Under what many would consider to be CBO's "more realistic" scenario, deficits will remain close to or above $1 trillion in each of the next 10 years.

As mentioned above, the *current law* baseline incorporates a host of assumptions that most outside observers find unlikely to occur, such as expiration of the large tax cuts and full implementation of the BCA sequester. In his February 2012 testimony before the House and Senate Budget Committees, Director Elmendorf elaborated on this subject:

> *"As the last few years have gone on, and more and more aspects of the budget have either been enacted or extended on a temporary basis, we felt that the current law baseline provides a less and less useful guide to what the current stance of fiscal policy is."*[iii]

CBO has constructed an alternative fiscal scenario (AFS) to roughly simulate the future budget situation if Congress continues to extend certain tax cuts and obviate particular spending cuts. This budget path is drastically different from the one under current law.[iv] The policy assumptions in the AFS are projected to produce deficits totaling $11 trillion for the coming decade, versus $3 trillion using current law.

Figure 8. The Consequences of Tax Cuts and Lifting the Sequester



Source: Congressional Budget Office (January 2012)

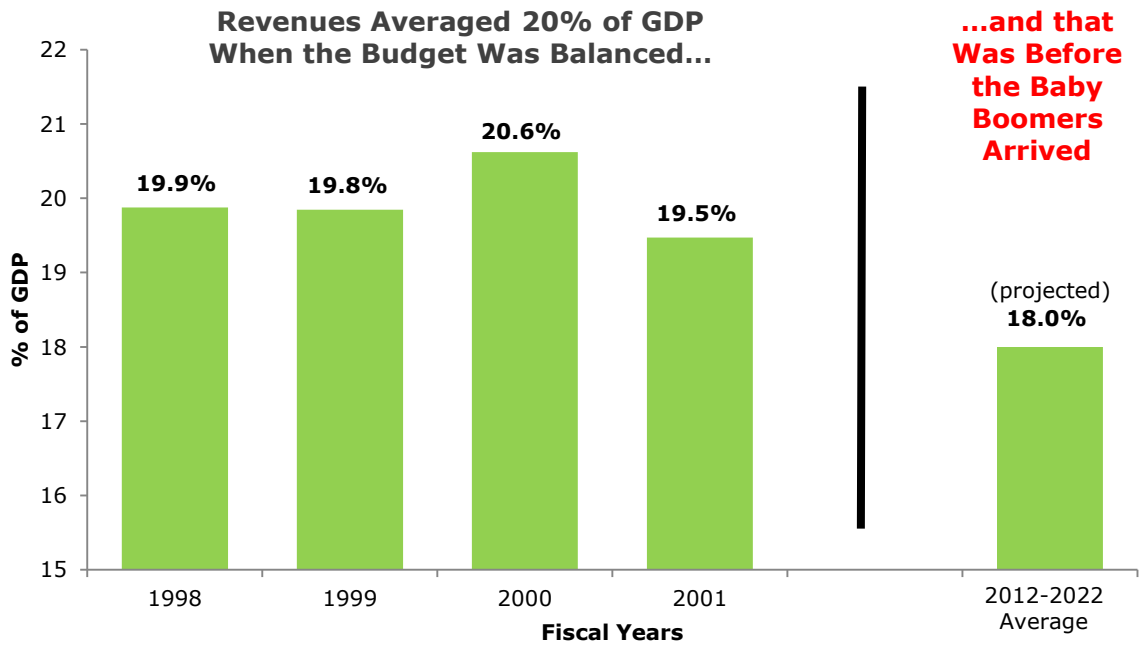
9. Within the decade – if current policies stay in place – revenues will return to their historical levels, but not beyond.

Even if the 2001, 2003 and 2010 tax cuts are extended, as they are in the AFS, revenues are projected to rise from 16.1 percent of GDP in 2012 to 18.0 percent in 2017, and then remain roughly at that level for the balance of the decade. This approximates the average U.S. revenue level in the modern era.

In times of better fiscal health, such receipts might have been sufficient, but the coming decades do not fit the bill. First, our public debt is already at 72 percent of GDP – higher than it has been in over half a century – and is projected to increase further. Second, a wave of baby boomers are beginning to descend on the entitlement programs, and supporting them in retirement will require additional spending even if significant reforms are made to control costs. Between these two trends, we will not be able to collect revenues at "normal" levels if we want to have a sustainable budget and a functioning economy.

The four balanced budgets in recent times have come at revenue levels between 19.5 and 20.6 percent of GDP. We will need to at least enter that range if we hope to stabilize the debt, particularly with the demographic tidal wave that inevitably will add a heavy burden to the federal budget.

Figure 9. Revenue Under Current Policies Simply Will Not Be Enough



Source: Congressional Budget Office alternative fiscal scenario (January 2012)

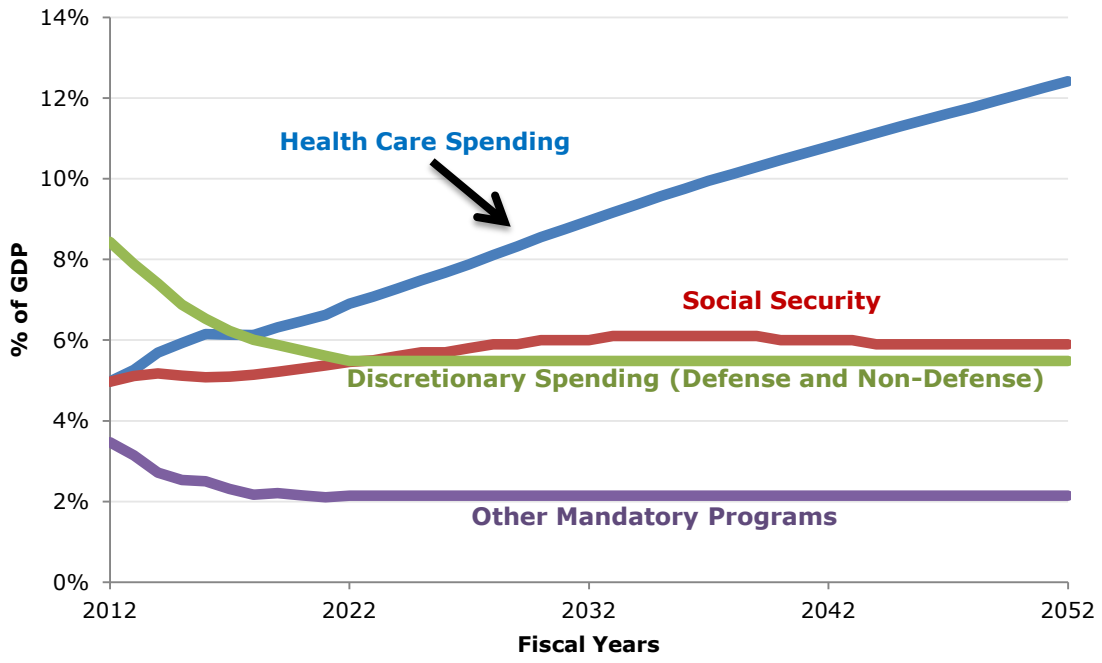
10. Health care spending remains the primary long-term driver of U.S. debt.

This is the fundamental challenge of the coming decades, stemming from the rising cost of providing health care and the aging of the population.

Even with savings from the Affordable Care Act (ACA), health care costs per capita are projected to continue growing significantly faster than the economy; this is an unsustainable course. Additionally, with the retirement of the baby boomers, Medicare will face a flood of new beneficiaries over the next few decades. The number of Americans aged 65 or older is expected to increase by one-third by 2022.

These facts combine to produce one of the most compelling displays of the nation's fiscal problems. Health care spending is the only part of the budget that is projected to grow relative to the size of the economy – from 5 percent of GDP this year to 12.4 percent of GDP by 2052. Curbing this line is a necessity for any viable debt reduction package.

Figure 10. Health Care Costs are the Primary Driver of the Debt



Sources: Congressional Budget Office's Alternative Fiscal Scenario (January 2012), additionally assuming that troops overseas decline to 45,000 by 2015; Bipartisan Policy Center extrapolations

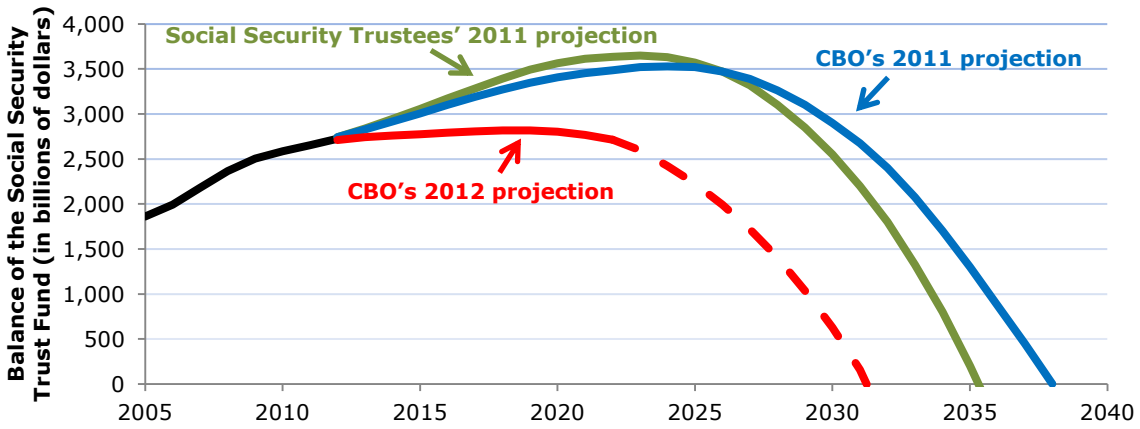
11. The outlook for Social Security has worsened substantially.

It should come as no surprise that Social Security requires reforms in order to remain solvent. This has been confirmed by reports of both the president's fiscal commission and the Bipartisan Policy Center's Domenici-Rivlin Task Force. Additionally, many people may be unaware that CBO's latest projections for the Social Security Trust Fund are even more severe than they were as recently as 2011.

Reforms were made during the 1980s, including the gradual increase in the full retirement age from 65 to 67, to prepare the program for the retirement of the Baby Boom generation. This resulted in a buildup of the Trust Fund over the ensuing decades, so that it could be drawn down to pay benefits as the baby boomers progressed through retirement, thereby maintaining the underlying solvency of the program. Unfortunately, those reforms now appear to have been insufficient.

As of 2011, the Social Security Trustees projected that the Trust Fund would be exhausted by 2036, and would at that point no longer have sufficient funds to pay out full benefits to beneficiaries on the strength of payroll taxes. The data in this year's CBO report appear much worse, however, indicating that the Trust Fund could be bankrupt within two decades.

Figure 11. Without Reform, Time is Running Short for Social Security



Note: The Congressional Budget Office's (CBO) 2012 projections only extend for ten years. The dotted line represents the Bipartisan Policy Center's rough extrapolation of those projections. The same goes for CBO's 2011 projections, except that CBO provided an exhaustion date for the Trust Fund (2038). The Trustees' projections are taken from their "intermediate" estimates.

Sources: CBO Budget and Economic Outlook (2011 & 2012), CBO 2011 Long-Term Projections for Social Security, Social Security Trustees Report

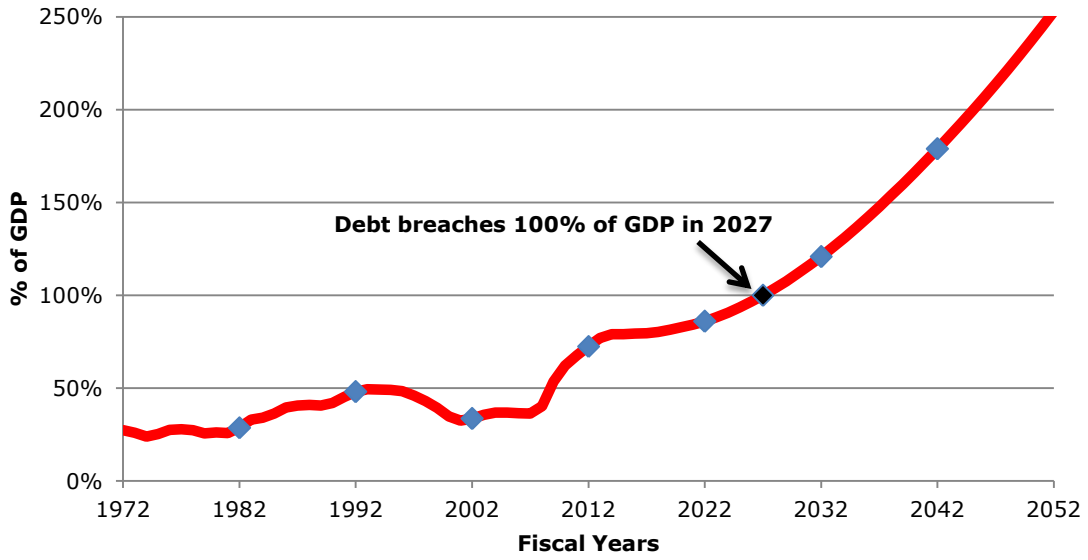
12. On its current path, public debt will exceed the size of our economy by 2027 and continue to explode thereafter.

There are consequences and risks to carrying such a large national debt. At some point, it will begin to crowd out private investment and retard economic growth. Moreover, at these debt levels, policymakers will have significantly less flexibility to respond to national emergencies or changing economic conditions.

Director Elmendorf has stated that "there is no plausible economic outcome under which [this policy path] would lead to a sustainable budget." In other words, the U.S. cannot grow its way out of this problem. Congress and the president will have to make the tough decisions to bring down our debt burden.

Demonstrating just how large our fiscal gap is, the federal government would need savings of over $750 billion in the year 2022 to have debt steady relative to GDP at that point.[v] Debt held by the public is on track to equal roughly $21 trillion, or 86 percent of GDP, by the end of the projection window in 2022.[vi] This would be by far the highest level since World War II, and a dangerous position for the country, particularly with no end in sight.

Figure 12. Absent Reforms, Debt Held by the Public is Set to Skyrocket in the Coming Decades



Note: Unlike current law, the Bipartisan Policy Center's Plausible Baseline assumes that the 2001, 2003, and 2010 tax cuts are extended, the AMT is indexed to inflation, Medicare's physician payment rates are maintained at their current rate (the "doc fix"), the looming sequester from the Budget Control Act of 2011 is lifted, and troops stationed overseas decline to 45,000 by 2015

Sources: Congressional Budget Office (January 2012) and Bipartisan Policy Center extrapolations

Conclusions

All told, there is little new information provided by CBO. The economy is growing, but slowly, and it will take quite some time to pick up the slack in the labor market. Spending will continue to rise (in part, due to the inevitable retirement of the baby boomers), revenues will fail to keep pace and, consequently, the deficit and debt will continue to grow. Because of the difficult position the country is in – due to rising deficits, a weak economy and a changing workforce – the time is ripe for serious, thoughtful reforms to our national commitments. As Director Elmendorf has stated, the ideal fiscal policy would enact legislation now that both widens deficits in the near term, and closes them in later years:

> *"Very sharp imposition of fiscal restraint… under the current economic conditions, in particular, will tend to hold back the economy. At the same time, letting debt skyrocket… will ultimately be very, very damaging to the economy and unsupportable. So, one can both provide short-term support and put the economy on a… sustainable medium-term to long-term path. There is no intrinsic contradiction, but to do that requires that fiscal restraint take effect slowly and amount to* ***very large changes*** *by the end of the decade [emphasis added]."*

The U.S. has a long-run debt problem that policymakers need to start addressing now, in tandem with our immediate economic problems. Growth, health care cost restraint, and tax reform are three critical components to a formula for economic strength. Waiting to decide what policy changes we will make only has downsides, chiefly, greater uncertainty and a growing debt burden.

Endnotes

[i] Based on economic data released since CBO completed its latest projections, some commentators (e.g., former Director of the Tax Policy Center Dr. Len Burman - http://www.forbes.com/sites/leonardburman/2012/02/09/the-economic-forecasts-are-wrong-which-is-probably-good-news/) now believe that the economy may perform stronger than previously indicated. In fact, in Figure 3, CBO's 2010 projections closely match recent unemployment data.

[ii] You can find more information on the sequester in detailed blogs from the BPC at the following links:
http://www.bipartisanpolicy.org/blog/2011/11/bca-sequester
http://www.bipartisanpolicy.org/blog/2012/01/2013-sequester-may-not-be-what-you-think
http://www.bipartisanpolicy.org/blog/2012/01/three-reasons-why-12-trillion-isn%E2%80%99t-really-12-trillion

[iii] References come from Director Elmendorf's February 2012 testimony before the House and Senate Budget Committees. Some of the direct quotes are oral remarks from those hearings, and cannot be found in the text of his prepared statement.

[iv] Unlike current law, the AFS assumes that the 2001, 2003 and 2010 tax cuts are extended, the AMT is indexed to inflation, Medicare's physician payment rates are maintained at their current rate (the "doc fix"), and the looming sequester from the BCA is lifted. BPC's "plausible" baseline incorporates all of these assumptions, and also that troops stationed overseas decline to 45,000 by 2015.

[v] $750 billion of savings in a particular year is gigantic. For reference, the sequester saved $1 trillion *over 10 years*, but only approximately $100 billion in *each* year. The in-year 2022 savings to stabilize the debt would have to be substantially larger.

[vi] This projection uses BPC's "plausible" baseline, which is based on the AFS and incorporates the additional assumption that the U.S. will gradually draw down its troops that are engaged in overseas combat operations.