THE BASELINE

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The Long-term Budget Outlook is Grim, but Gaps in CBO's Baseline Reveal Even Worse Deficits

Key Facts:

- CBO's long-term budget outlook sees entitlement spending rising to over 17 percent of GDP in thirty years - approaching total outlays seen in 2000 and 2001. Fast growing annual deficits will push the federal debt load to 144 percent of GDP in 2049.
- CBO may be underestimating economic expansion and productivity growth to some extent, but its current-law assumptions mask deficits by underestimating outlays and counting on receipts that may never materialize.
- The enormity of the impending crisis on the horizon should encourage a course correction to reduce overspending and craft a sustainable balanced budget.

Introduction

The Congressional Budget Office (CBO) released a report on the long-term fiscal imbalance of the federal budget and the threat posed to the economy from the projected massive deficits. Normally, CBO's budget projections look out over a decade, with assumptions that spending and revenues will generally continue over the period as set under current law. This becomes the budgetary baseline against which policy proposals are scored. This new report extends those same assumptions in the baseline over the next thirty years.

But gaps in CBO's analysis reveal an even more gruesome budget outlook, with billions in unrealistic assumptions that mask additional red ink. According to CBO, spending and revenues are on track to increase federal debt from 78 percent of GDP this year to 144 percent by 2049. Unfortunately, shortcomings built into the statutory baseline tend to short change the true scale of the budgetary imbalance we'll face if we continue on the current fiscal path. The enormity of the impending crisis on the horizon should encourage a course correction to reduce overspending and craft a sustainable balanced budget.

CBO's Findings

CBO's updated ten-year outlook estimates that for the current Fiscal Year, spending will exceed revenues by $896 billion, bringing the amount of federal debt held by the public to $16.6 trillion, or 78 percent of GDP ($21.3 trillion). If outlays and taxes under current law are kept in place without change, the debt load will continue to balloon, surpassing the record level reached after World War II (106 percent in 1946), and will reach 144 percent of GDP by 2049.

Tax receipts will steadily rise over the three decades of the projection as a share of GDP, from 16.5 percent this year and averaging 19.2 percent of GDP in the third decade of the long-term outlook. While discretionary spending will shrink as a share of the economy, *total spending* will outpace revenues because of enormous increases in entitlement costs.

Due to an aging population, the number of people enrolled in Social Security will grow by over one-half, from 64 million this year to 97 million in 2049. Medicare will also grow significantly, while facing much higher costs per person. In fact, according to CBO, rising health care costs per person "accounts for about two thirds of the increase in spending, measured as a share of GDP, for the major health care programs between 2019 and 2049." This will lead to an expansion of entitlement spending from 12.7 percent of GDP in FY 2019 to 17.1 percent on average over the third decade. By comparison, that would equal total federal outlays as a share of the economy for 1966, exceed the levels for nine post-World War II years, and come close to matching total outlays in 2000 and 2001 under budgets signed by President Clinton (17.7 percent in each year).

CBO is statutorily required to assume that these programs will continue to pay benefits as scheduled under current law without taking into account the dwindling reserves available in their dedicated trust funds. Medicare's Federal Hospital Insurance Trust Fund will run out by 2026. The Social Security's combined trust funds will start running a shortfall next year for the first time since 1982 and will be unable to pay full benefits starting in 2035. It currently has a long-term actuarial deficit of 4.6 percent of taxable payroll. That amount represents the immediate hike in taxes or reduction in scheduled benefits that would be necessary to maintain the trust fund balances through 2093.

Financing the debt will also grow more expensive in absolute terms and consume a greater share of the budget. Net interest payments on federal debt will rise from 1.8 percent of GDP in 2019 to average 4.9 percent over the third decade of the extended baseline.

CBO warns of the risks posed by the massive deficits on the fiscal horizon. Unaddressed, the accumulating debt load would weaken economic output over time. Rising interest costs on the federal debt would "increase interest payments to foreign debt holders, reducing the income of U.S. households." Federal debt also crowds out "private investment in productive capital goods, which could have negative impacts on productivity and wages and the supply of labor." Rising debt levels would increase the costs of financing new debt as concerns rise about the country's credit rating and confidence in the U.S. dollar sinks. Over time, debt levels and the rising costs of financing new debt would impose fiscal restraints on the ability of policymakers to respond to emergencies.

CBO's Assumptions that Underestimate Long-term Deficits

There are several assumptions in the statutory baseline that understate the scale of the problem if the United States continues down the current path. CBO is required to build its baseline using assumptions based on current law. This methodology leads to some significant gaps in the data, underestimating outlays and counting on tax revenues and offsetting receipts that may never materialize.

- **Discretionary spending caps are counted under current law**: Projections of discretionary spending are based on the most recent appropriations and incorporate the assumption that they will be extended and grow at the rate of inflation. The reality, however, is that these caps are likely to be exceeded. The current-law baseline still includes Budget Control Act's spending caps for the next two years even though Congress and the President are working on a FY2020 budget deal that will significantly boost spending, and that previous years' limits were overridden. This means that the official baseline is lower than it will likely be by *$2 trillion* over the next decade.

- **Tax cuts expire under current law**: The official baseline assumes that the individual income tax cuts enacted in the Tax Cuts and Jobs Act (TCJA) will expire as scheduled under law after 2025. Under the budgetary rules used to pass the TCJA in the Senate, Republicans had to set the individual income tax to expire. This was done with full awareness of the history of previous income taxes enacted with similar expiration dates: lawmakers extended the reductions to prevent a massive tax hike from hitting filers. In CBO's projection, the expired individual income tax provisions boost tax revenues by an annual average of 0.8 percent of GDP from 2026 through 2049. By way of comparison, this would amount to $170 billion this year, or 10 percent of total individual income taxes collected.

- **Affordable Care Act "Cadillac tax"**: Current law also includes scheduled tax hikes whose start date has been regularly pushed back. The Affordable Care Act included a "Cadillac tax" on certain employer-provided health insurance plans with high premiums, originally scheduled to take effect in 2018. This tax has already been delayed twice and remains in legislative limbo. In the extended baseline however, CBO assumes that the tax would take effect that the receipts from this tax would amount to 0.7 percent of GDP by 2049, despite questions about the tax being implemented at all and without regard to dynamic impacts that would limit its ability to generate revenue.

- **Bracket creep**: CBO notes that the largest source of revenue increases in the extended baseline would result from bracket creep, whereby many filers are pushed into higher tax brackets as income grows faster than inflation: "If current laws generally remain unchanged, real bracket creep would continue to gradually push up taxes in relation to income over the next three decades." By 2049, with no change, bracket creep would increase revenues as a share of GDP by 1.5 percent. This assumption assumes that lawmakers take no effort to address these hidden tax hikes or that taxpayers do not plan accordingly to minimize, where possible, their total tax liability.

- **Interest payments**: In CBO's long-term projection, interest payments are set to rise from 1.8 percent of GDP this year ($382 billion) to 5.7 percent of GDP in 2049. All the factors above (plus other smaller ones not listed such as the inclusion in the official baseline $385 million in annual nuclear waste management fees that haven't collected since 2014) would exacerbate annual deficits, thus boosting the cost of debt interest payments. However, there is another reason that interest costs could be higher than projected: CBO assumes lower interest rates over the period than the historical average. Interest rates on a 10-year Treasury notes are projected to rise from 2.9 percent at the end of 2018 to 4.6 percent in 2049, which CBO notes is "1.3 percentage points below the 5.8 percent average

> recorded over the 1990-2007 period." All else being equal, if the government's net interest costs were 1 percent higher in each year than in the extended baseline, CBO projects that net interest costs would amount to about 10 percent of GDP in 2049 – consuming half of tax receipts.

Silver Linings

While many assumptions built into CBO's projection are unwisely optimistic, there are some components of their analysis that understate positive trends. The agency's assumptions regarding the economy and productivity are pessimistic relative to recent history. Due to a number of factors related to projections about aging and the size of the labor force, CBO sees lower growth over the period of the extended baseline compared to recent historical averages. From 1969 through 2018, the economy grew at an average rate of 2.8 percent. Over the next three decades, CBO's model projects an average rate of 1.9 percent per year. Growth that turns out to be higher than CBO expects would improve the overall budget projection by increasing labor force participation, reduce welfare assistance payments (including "refundable" credits), and boost tax receipts.

The slower growth seen in CBO's model is in part also the result of lower annual labor productivity growth of 1.5 percent per year compared to 1.7 percent per year seen since 1950. CBO notes their model's sensitivity to different assumptions about productivity growth. If nonfarm productivity grows 0.5 percent faster than projected, publicly-held federal debt would amount to just 106 percent of GDP instead of 144 percent in 2049. On the other hand, a 0.5 percent swing downward would accelerate debt levels to 185 percent.

It would not be the first time that CBO's GDP forecasts have been off the mark, especially in periods following passage of tax relief. Alan Reynolds of the Cato Institute highlighted CBO's record on underestimating economic growth:

> CBO systematically *underestimated* growth of real GDP after the Reagan tax rate reductions were phased in during 1983–84 and 1988–90 (TRA86), and again after the capital gains tax was slashed from 28% to 20% in 1997. Conversely, the CBO *overestimated* GDP growth after Bush 41 raised tax rates in 1990, after Obama raised tax rates in 2013, and during the high-tax bracket creep years of 1976–82. The CBO appears to suffer from a pro-tax estimating bias – assuming higher tax rates do no harm, and lower tax rates do no good.

The Uncertainty in the Forecast

Naturally, there is a significant degree of uncertainty in any projection of the federal budget: natural disasters, unexpected changes in the economy, or international affairs can quickly change the direction of fiscal decisions. This is especially so the farther out a projection looks. The newest long-term outlook is based on a model with four components "to integrate demographic and economic changes": a demographic model, a microsimulation model to project year-to-year changes in economic outcomes for a sample of the population, a budget model, and a model of economic growth.

CBO illustrated uncertainty in last year's long-term outlook by running two alternative projections with changes in the key factors. This year's report used a more sophisticated method to quantify the uncertainty in the model by estimating a distribution of budgetary outcomes, running simulations with different values for the main economic and demographic variables. This model also included an increased number of variables than last year.

In its assessment, the agency states that there "is about a two-thirds chance that federal debt would be between 71 percent and 175 percent of GDP in 2039." The figures used for the extended baseline represent the “middle two-thirds of the range of possible outcomes.” CBO also provided details on the sensitivity of a few of the major factors that were used to generate the long-term outlook. Small changes in the course of certain key variables could lead to widely different outcomes. These data points provide areas where policymakers could focus to improve the long-term budgetary outlook, as noted above, increasing productivity and boosting real GDP growth would help improve the long-term budget view.

Conclusion

While it is a Herculean task to project economic and budget outcomes three decades into the future, there are reasons to believe that CBO’s estimate of the problem significantly understates the scale. While the agency may be underestimating economic expansion and productivity growth to some extent, other gaps in its analysis underestimate just how much red ink is in our future. Their report should serve as a stark reminder of the need to reform spending programs as soon as possible. This is especially necessary for the major entitlements which are the largest sources of budgetary growth.

The sooner that politicians implement meaningful reforms, the greater the long-term budgetary benefits will be. Kicking the can down the road just means that the steps that are needed to rectify will be even more costly.

About the Author

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