Committee for a Responsible Federal Budget

Analysis of CBO's 2014 Budget and Economic Outlook
February 4, 2014

Today, the Congressional Budget Office (CBO) released its Budget and Economic Outlook, detailing its projections for the next ten years. The report shows that despite recent progress in enacting deficit reduction, debt will rise substantially over the next decade from its current post-World War II high.

Although deficits are projected to decline over the next couple of years, CBO expects only a brief period of relative stability. After remaining near current levels through 2017 – about twice the historical average – CBO projects debt as a share of GDP to grow rapidly as the population ages, health care costs continue to grow, and interest costs rise, even if policymakers abide by current law.

Our main findings from the report are:

- Debt is projected to remain at elevated levels and will grow from 72.1 percent of GDP in 2013 to 79.2 percent by 2024 – meaning debt will remain higher than any time since 1950.
- Debt levels are projected to roughly stabilize through 2017, but then will rise rapidly by an average of a percentage point of GDP a year through 2024.
- Deficits will total $7.9 trillion between 2015 and 2024, $1.2 trillion higher than CBO's previous estimate over the same period.
- Deficits will fall from $680 billion in 2013 (4.1 percent of GDP) to $478 billion in 2015 (2.6 percent of GDP) then rise to $1.07 trillion (4.0 percent) by 2024.
- Both spending and revenue rise after 2014; spending from 20.5 to 22.4 percent of GDP by 2024 and revenue from 17.5 to 18.4 percent. This compares to 40-year historical averages of 20.4 percent and 17.4 percent, respectively.
- CBO expects slower growth throughout most of the decade, along with a slower improvement in employment and labor force participation. This is the leading cause of worsening budget projections. CBO notes that elevated and rising debt levels will reduce investment and hold back economic growth.

CBO's latest projections show a fiscal situation that, despite recent deficit reduction efforts, remains far from solved. Their projections highlight the need to not only abide by strict pay-as-you-go (PAYGO) principles, but also pursue new tax and entitlement reforms to put the debt and economy on a sustainable path.

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Spending, Revenue, Deficits, and Debt

As the economy continues to recover, health care cost growth has slowed, and new spending reductions and tax increases are beginning to take effect, the gap between spending and revenue has narrowed since 2009. Unfortunately, that trend will reverse after 2015 and trillion-plus dollar deficits will return early next decade.

Since the record $1.4 trillion deficit in 2009 (9.8 percent of GDP), deficits have fallen to $680 billion in 2013 (4.1 percent of GDP), and CBO projects deficits to continue to fall to $514 billion (3.0 percent of GDP) in 2014 and a low of $478 billion (2.6 percent of GDP) in 2015. After that, deficits will rise rapidly, reaching $1.07 trillion (4.0 percent of GDP) in 2024.

These growing deficits will occur despite growing revenue levels, which are projected to rise from 16.7 percent of GDP in 2013 to 17.5 percent of GDP this year (roughly their historical average), and then grow to 18.4 percent of GDP by 2024. Driving the increase in federal revenues will largely be a recovering economy, in addition to new revenue measures put in place in the 2010 health care law and the 2013 fiscal cliff package.

Spending, meanwhile, is projected to rise from 20.5 percent of GDP this year (about the historical average) to 22.4 percent by 2024. This increase is driven primarily by spending on Social Security, Medicare, Medicaid, exchange subsidies from the Affordable Care Act, and especially interest costs. Spending on automatic stabilizers and defense and non-defense discretionary spending, meanwhile, are projected to fall as a share of GDP. (For more discussion and visualization of the spending drivers this decade, see CRFB's blog post: http://crfb.org/blogs/sources-spending-growth-cbos-baseline)

Fig. 1: Comparing the February 2014 and May 2013 CBO Budget Projections

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	Ten-Year
REVENUES (Percent of GDP)													
Feb 2014 Baseline	16.7%	17.5%	18.2%	18.2%	18.1%	18.0%	18.0%	18.0%	18.1%	18.1%	18.2%	18.4%	18.1%
May 2013 Baseline	17.0%	17.7%	18.6%	18.5%	18.3%	18.2%	18.1%	18.1%	18.2%	18.4%	18.5%	N/A	18.3%
OUTLAYS (Percent of GDP)													
Feb 2014 Baseline	20.8%	20.5%	20.9%	21.1%	21.0%	21.1%	21.4%	21.7%	21.9%	22.3%	22.3%	22.4%	21.7%
May 2013 Baseline	20.8%	20.9%	20.7%	20.8%	20.6%	20.7%	21.0%	21.2%	21.4%	21.8%	21.8%	N/A	21.1%
DEFICITS (Percent of GDP)													
Feb 2014 Baseline	4.1%	3.0%	2.6%	2.8%	2.9%	3.1%	3.4%	3.7%	3.8%	4.2%	4.1%	4.0%	3.5%
May 2013 Baseline	3.9%	3.3%	2.1%	2.2%	2.3%	2.5%	2.9%	3.1%	3.2%	3.5%	3.3%	N/A	2.9%
DEBT (Percent of GDP)													
Feb 2014 Baseline	72.1%	73.6%	73.2%	72.6%	72.3%	72.6%	73.3%	74.2%	75.3%	76.8%	78.0%	79.2%	N/A
May 2013 Baseline	72.5%	73.6%	72.1%	70.3%	68.8%	68.4%	68.6%	69.0%	69.6%	70.4%	71.1%	N/A	N/A
DEFICITS (in Billions of Dollars)													
Feb 2014 Baseline	680	514	478	539	581	655	752	836	912	1,031	1,047	1,074	7,904
May 2013 Baseline	642	560	378	432	482	542	648	733	782	889	895	N/A	6,340
DEBT (in Billions of Dollars)													
Feb 2014 Baseline	11,982	12,717	13,263	13,861	14,507	15,218	16,028	16,925	17,899	19,001	20,115	21,260	N/A
May 2013 Baseline	12,036	12,685	13,156	13,666	14,223	14,827	15,537	16,330	17,168	18,118	19,070	N/A	N/A

Note: Ten-year figures reflect 2014-2023 period for May 2013 baseline and 2015-2024 for February 2014 baseline.

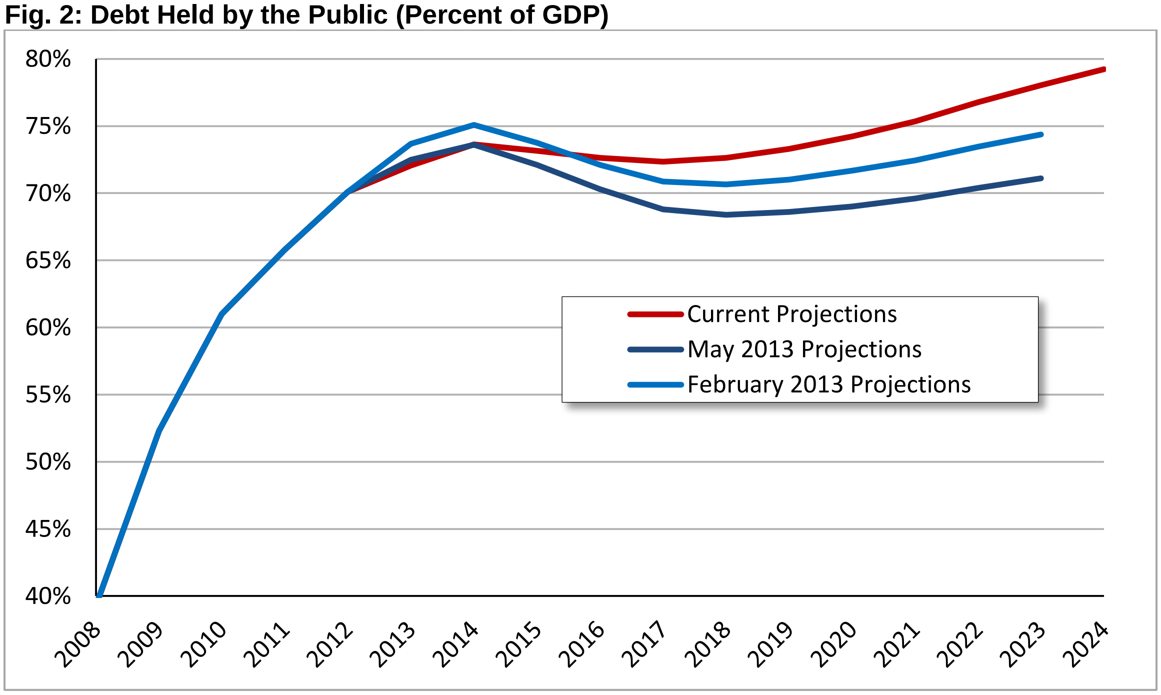
CBO's latest projections are notably different than their previous baseline issued in May 2013. In that baseline, spending, revenue, and deficits were projected to average 21.1 percent, 18.3

percent, and 2.9 percent of GDP, respectively, over the next ten years, compared to 21.7 percent, 18.1 percent, and 3.5 percent in the latest projections. The majority of the changes in projections are a result of updated economic forecasts for growth, inflation, and the labor force, which are discussed in more detail in subsequent sections.

CBO projects that the debt will not only remain at elevated levels indefinitely but will also rise as a share of the economy over the course of the decade, despite an improving economy and despite the spending cuts and tax increases enacted in recent years. After remaining somewhat stable through 2017 – at levels higher than any time since the aftermath of World War II – debt will rise rapidly from just above 72 percent of GDP to more than 79 percent by 2024. By comparison, debt was projected to reach 71 percent of GDP in 2023 under CBO's previous projections.

In fact, changes in the projections from the May 2013 baseline to this baseline are twice as large as those made between the February 2013 and May 2013 baseline - only in the opposite and debt-increasing direction.

Fig. 2: Debt Held by the Public (Percent of GDP)



Source: Congressional Budget Office
Note: CBO projections have been adjusted for new GDP accounting changes.

These projections also assume lawmakers follow current law. Debt would exceed 85 percent of GDP by 2024 if lawmakers were extend various expiring provisions and reverse cuts put in place by the sequester without offsets.

Box 1: War Spending in CBO's Baseline

By convention, CBO's baseline projections assume that uncapped discretionary spending grows with inflation. While discretionary spending caps do apply to base defense and non-defense spending, there is no cap on war spending, or Overseas Contingency Operations (OCO). Therefore, CBO assumes that war spending grows with inflation from the FY 2014 level of $92 billion. As a result, total budget authority over the 2015-2024 equals $1.0 trillion.

The assumption of continually increasing war spending is a technical quirk in CBO's baseline since the Obama Administration has planned a drawdown for many years; all combat troops are supposed to exit Afghanistan by the end of the year. This divergence presents an opportunity for lawmakers to set caps on war spending to reflect the drawdown. CBO shows that an option to draw troops overseas down to 30,000 by 2017 would reduce spending below the baseline projections by $572 billion over ten years.

However, setting caps would not represent real savings since it would simply be reflecting a policy that has already been in place for years. As CBO itself said in discussing the issue two years ago, war savings "might simply reflect policy decisions that have already been made and that would be realized even without such funding constraints." Furthermore, lawmakers did not intend for war spending to continue forever, so letting temporary spending lapse that was never paid for in the first place does not represent real savings.

Some have proposed using war "savings" to offset real costs, such as a permanent Sustainable Growth Rate formula replacement for Medicare or to increase veterans' benefits. As CRFB has pointed out, drawing down war spending cannot offset costs since the savings have essentially already been planned in the Administration's plans.

Changes in Budget Projections

CBO's budget projections have changed dramatically from those made last year. Overall, deficits are now expected to be about $1.2 trillion higher through 2024 and $1 trillion higher through 2023. That $1 trillion would be $1.4 trillion when accounting for the fact that CBO's previous deficit estimates included about $425 billion of spending from assuming (by convention) one-time disaster spending related to Hurricane Sandy was continued annually.

Legislation over the past year only slightly changed the net deficit. The combination of the Bipartisan Budget Act, the Pathway for SGR Reform Act, the Bipartisan Student Loan Certainty Act, and other minor legislative changes (as well as extrapolations of discretionary spending levels) increased deficits by about $95 billion in the first five years, but decreased them by $55 billion in the second five, increasing net 10-year deficits by roughly $40 billion.

The main driver of CBO's significantly increased deficit projections is a much slower estimate of economic growth over the next ten years. Weaker growth forecasts lowered estimated income, resulting in $1.4 trillion less in income and payroll tax revenue through 2023.

On the other side of the ledger, CBO estimates that slower growth will lower non-interest outlays by $256 billion through 2023, $221 billion of which arises from lower Medicare and Medicaid spending. The higher deficits as a result of these changes will also increase associated debt service costs. In addition, slightly lower projected interest rates and inflation are expected to reduce CBO's estimates of interest on the debt by $109 billion. On net, the new economic projections account for about $1.2 trillion in increased deficits through 2023.

The remaining changes are a result of technical changes, primarily to CBO's revenue projections and how they estimate receipts to the Treasury from Fannie Mae and Freddie Mac, on net resulting in higher projected deficits than in last year's report. Revenue is now expected to be almost $200 billion lower through 2023 as a result of technical changes, almost entirely concentrated in the next three years. Receipts from Fannie and Freddie are expected to total $88 billion this year, but other smaller technical changes, however, roughly cancel out the effects of Fannie and Freddie receipts on outlays.

Fig. 3: CBO's Legislative, Economic, and Technical Changes from May Projections

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2014-2023
CBO May Deficits	**$560**	**$378**	**$432**	**$482**	**$542**	**$648**	**$733**	**$782**	**$889**	**$895**	**$6,340**
Legislative Changes	**$48**	**$34**	**$15**	**$1**	**$2**	**-$4**	**-$3**	**-$2**	**-$18**	**-$30**	**$41**
Student Loan Bill	$10	$10	$2	-$3	-$4	-$5	-$5	-$5	-$5	-$5	-$9
BBA/SGR Fix	$27	$22	$5	-$2	-$3	-$5	-$6	-$6	-$21	-$34	-$23
Other Changes	$10	$1	$6	$3	$5	$3	$5	$5	$5	$6	$50
Interest	$0	$1	$2	$2	$3	$3	$3	$3	$3	$2	$23
Economic Changes	**-$87**	**-$33**	**$47**	**$111**	**$143**	**$158**	**$179**	**$203**	**$222**	**$242**	**$1,186**
Revenue	-$77	-$16	$66	$136	$168	$187	$209	$231	$249	$262	$1,415
Medicare/Medicaid	-$3	-$12	-$20	-$24	-$19	-$23	-$25	-$28	-$33	-$33	-$221
Other Spending	-$5	-$8	-$9	-$5	-$5	-$4	-$3	-$1	$0	$1	-$36
Debt Service	-$1	-$1	-$1	$1	$6	$12	$18	$26	$34	$44	$136
Changes in Interest Rates	-$1	$4	$11	$5	-$8	-$14	-$20	-$25	-$29	-$31	-$109
Technical Changes	**-$3**	**$112**	**$69**	**$21**	**$11**	**-$1**	**-$17**	**-$8**	**$5**	**$11**	**$200**
Revenue	$91	$110	$59	$13	$6	-$16	-$32	-$25	-$7	-$3	$196
Fannie/Freddie	-$88	-$1	-$1	$0	$0	-$1	$0	$0	-$1	$0	-$92
EITC	$3	$4	$5	$5	$5	$4	$4	$4	$3	$3	$39
Other Spending	-$6	-$2	$3	$4	$3	$11	$14	$15	$14	$15	$70
Interest	-$3	$1	$2	-$1	-$1	$0	-$2	-$2	-$4	-$4	-$13
Sandy Funding Adjustment	**-$3**	**-$13**	**-$24**	**-$34**	**-$43**	**-$51**	**-$57**	**-$62**	**-$67**	**-$72**	**-$424**
Remove Funding	-$3	-$13	-$23	-$32	-$39	-$45	-$49	-$52	-$54	-$56	-$365
Interest	$0	$0	-$1	-$2	-$4	-$6	-$8	-$10	-$13	-$16	-$58
Total Changes	**-$46**	**$100**	**$107**	**$99**	**$113**	**$104**	**$103**	**$130**	**$143**	**$151**	**$1,004**
CBO February Deficits	**$514**	**$478**	**$539**	**$581**	**$655**	**$752**	**$836**	**$912**	**$1,031**	**$1,047**	**$7,344**

Note: Positives/negatives reflect increases/decreases in deficits, respectively. Numbers may not add due to rounding.
*Legislation refers to the Bipartisan Budget Act and the Pathway for SGR Reform Act from December 2013.

Economic Projections

Many notable economic developments have taken place since last winter, when CBO last released a set of economic projections. Among those changes have been some upward revisions to recent GDP growth and a faster decline in the unemployment rate on the positive side, but also declining labor force participation and downward revisions to potential GDP growth on the concerning side. CBO's economic projections greatly impact its budget projections, as federal revenues and spending noticeably rise and fall in the wake of changes in projected incomes, employment, inflation, and many other factors.

Incorporating all recent developments, CBO has made significant downward revisions to their projections of the performance of the economy in future years, but expects slightly stronger growth in the near-term. Inflation-adjusted economic growth in 2014 is projected to be 2.7 percent, slightly higher than the 2.6 percent they estimated last February. Economic growth will accelerate to almost 3.5 percent in the next few years until the economy reaches potential output, at which point it will grow at the potential growth rate of between 2.0 and 2.2 percent.

Fig. 4: CBO's Economic Projections

Calendar Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	Ten - Year
Real GDP Growth													
CBO (February 2014)	1.7%	2.7%	3.3%	3.4%	3.0%	2.4%	2.3%	2.2%	2.2%	2.1%	2.1%	2.0%	2.5%
CBO (February 2013)	1.4%	2.6%	4.1%	4.4%	3.8%	2.6%	2.4%	2.3%	2.2%	2.2%	2.2%	N/A	2.9%
OMB (July 2013)	2.4%	3.4%	3.5%	3.5%	3.5%	2.6%	2.4%	2.4%	2.3%	2.3%	2.3%	N/A	2.8%
Blue Chip	2.4%	2.8%	3.0%	N/A									
Federal Reserve	2.3%	3.0%	3.2%	2.9%	N/A								
Inflation (CPI)													
CBO (February 2014)	1.5%	1.7%	2.0%	2.1%	2.2%	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%	2.3%
CBO (February 2013)	1.6%	1.9%	2.1%	2.1%	2.2%	2.3%	2.3%	2.3%	2.3%	2.3%	2.3%	N/A	2.2%
OMB (July 2013)	1.4%	1.9%	2.2%	2.2%	2.2%	2.2%	2.2%	2.2%	2.2%	2.2%	2.2%	N/A	2.2%
Blue Chip	1.2%	1.9%	2.1%	N/A									
Federal Reserve*	1.0%	1.5%	1.8%	1.9%	N/A								
Unemployment Rate													
CBO (February 2014)	7.4%	6.8%	6.5%	6.1%	5.9%	5.8%	5.7%	5.7%	5.6%	5.6%	5.5%	5.5%	5.8%
CBO (February 2013)	7.9%	7.8%	7.1%	6.3%	5.6%	5.5%	5.5%	5.4%	5.4%	5.3%	5.3%	N/A	5.9%
OMB (July 2013)	7.5%	7.0%	6.5%	6.0%	5.6%	5.4%	5.4%	5.4%	5.4%	5.4%	5.4%	N/A	5.8%
Blue Chip	7.0%	6.6%	6.1%	N/A									
Federal Reserve	7.0%	6.5%	5.9%	5.6%	N/A								
Interest Rates on 10-Year Treasury Notes													
CBO (February 2014)	2.3%	3.1%	3.7%	4.3%	4.8%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	4.8%
CBO (February 2013)	2.1%	2.7%	3.5%	4.3%	5.0%	5.2%	5.2%	5.2%	5.2%	5.2%	5.2%	N/A	4.7%
OMB (July 2013)	2.1%	2.6%	3.2%	3.7%	4.1%	4.4%	4.6%	4.8%	5.0%	5.0%	5.0%	N/A	4.2%
Blue Chip	2.7%	3.4%	3.9%	N/A									

*Federal Reserve numbers reflect Personal Consumption Expenditures (PCE) index, which is on average 0.2 to 0.3 percentage points lower than the Consumer Price Index (CPI).

Although CBO still projects that the economy will largely recover to its potential output by late 2017 or 2018, economic growth is now forecast to be slower than previously thought and labor force participation is not projected to recover as fast as the rest of the economy. According to CBO, overall economic output will be lower this decade as a result of slower productivity growth (due to reassessed historical trends), reduced investments as a result of higher debt levels, a slower improvement in the unemployment rate, and a slower improvement in labor force participation. Labor force participation will continue to suffer as a result of lasting effects of the recession on long-term unemployment, an aging population, and the impact of the 2010 health care law. CBO also expects that output will fall slightly short of its potential in later years even after the economy recovers.

With regards to the unemployment rate, CBO projects a 6.8 percent rate in 2014, compared to 7.8 percent in the previous estimate. However, CBO projects that the unemployment rate will ultimately decline to 5.5 percent, as opposed to 5.3 percent in prior projections.

Interest rates, which are currently extraordinarily low by historical standards, will continue to rise as the economy recovers and as the stock of debt continues to rise later this decade – but are now expected to be lower than in last year's forecast. Interest rates on three-month and ten-year Treasury securities would rise from 0.2 and 3.1 percent, respectively, in 2014 to 3.7 and 5.0 percent by 2018. These rates are somewhat lower than previous estimates of 4.0 percent and 5.2 percent, respectively.

Conclusion

CBO's new budget estimates are further evidence that our deficit problems are far from solved and highlight the importance of putting the debt on a clear downward path, rather than settling for projections of stability. Budget forecasts are by their very nature estimates, and, as today's report shows, changes in economic or technical assumptions can result in a much bleaker fiscal picture.

CBO's report also demonstrates that economic growth and deficit reduction are intrinsically linked. With debt scheduled to balloon from only 72 percent of economic output in 2017 to above 79 percent by 2024, the ideal fiscal plan would work to simultaneously lower debt levels and raise economic output.

Building on recent bipartisan success in agreeing to reform certain spending programs and enact all twelve appropriation bills, we encourage Congress and the President to work toward comprehensive tax reform and structural entitlement reforms designed to put the debt on a clear downward path relative to the economy. At a minimum, policymakers should adhere to strict pay-as-you-go (PAYGO) rules to prevent the record-high debt projections from worsening further.