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Long-Term Budget Outlook Remains Challenging, But Recent Legislation Has Made It More Manageable

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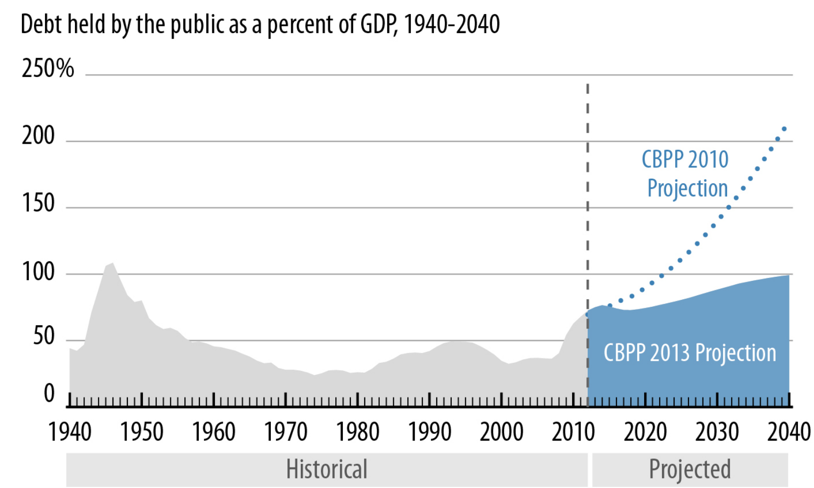
Summary

Despite marked improvement since our previous projections of 2010, the long-run budget outlook remains challenging and will ultimately present policymakers with difficult choices, according to CBPP's updated projections through 2040.

Figure 1
Debt-to-GDP Ratio



Source: Historical data from the Office of Management and Budget; projections from CBPP based on Congressional Budget Office, Joint Committee on Taxation, and Social Security and Medicare Trustees data.

Under current budget policies, the federal debt will edge down as a share of the economy in the middle of this decade but then resume a gradual rise. The projected ratio of debt to gross domestic product (GDP) — which was 73 percent at the end of fiscal year 2012 — will reach 78 percent in 2023 and 99 percent by 2040. (See Figure 1.)

Although the rising debt-to-GDP ratio remains a concern, we no longer project the debt to grow at an explosive rate, as many previous estimates (including ours) indicated and as many analysts and policymakers have taken as conventional wisdom about the long-term outlook. Since we issued our previous long-term projections in early 2010, the projected debt-to-GDP ratio in 2040 has shrunk by

[1] The authors acknowledge the extensive assistance of William Chen, Kelsey Merrick, and Joel Friedman.

half — from 218 percent of GDP to 99 percent.[2] The long-term "realistic baseline" of the Committee for a Responsible Federal Budget (CRFB), a nonpartisan fiscal watchdog, paints a similar picture, with a projected debt-to-GDP ratio of 108 percent in 2040.[3] (CRFB issued its projection before the Medicare and Social Security trustees released their 2013 reports, which slightly improve the outlook.) The Center for American Progress's recent long-term forecast is also similar.[4]

Our updated long-term projections are the product of several months of analysis and incorporate the recent Social Security and Medicare trustees' reports and the new budget baseline that the Congressional Budget Office (CBO) issued in May. Our new projections come at a time of renewed attention to fiscal policy challenges, with White House officials and some senators beginning to meet to seek paths forward on sequestration, the debt limit, and possibly broader budget issues.

Long-Term Outlook Has Improved Substantially Since 2010

Recent legislation and other factors have substantially improved the long-term budget outlook. Health reform (the 2010 Affordable Care Act, or ACA) and other developments have significantly slowed the projected growth of Medicare spending. The 2011 Budget Control Act (BCA) has sharply cut projected discretionary spending. And the American Taxpayer Relief Act (ATRA), enacted in January, and the ACA have increased tax revenues. Along with these policy changes, interest rates have remained unusually low and health care spending growth has slowed for reasons that go beyond the ACA's direct effects.

Three major policy uncertainties affect the fiscal outlook for the years immediately ahead: (1) whether sequestration will remain in effect after fiscal year 2013 and, if not, whether policymakers will replace it with measures that yield equivalent savings; (2) whether policymakers continue to block scheduled deep cuts in Medicare physician payments and, if so, whether they offset those costs; and (3) whether policymakers extend a group of largely corporate tax expenditures (the "tax extenders") that are scheduled to expire every year or two and, if so, whether they offset those costs.

For this long-term analysis, we have elected to pursue the most cautious course by assuming that policymakers will cancel sequestration and the scheduled Medicare physician cuts and extend the expiring tax provisions, all without offsetting the costs. (Here, we depart slightly from the standard ten-year baseline that we, CRFB, and some other groups use for budget analyses.[5]) Had we made different assumptions on these policy issues, our projected debt-to-GDP ratio in 2040 would be lower than 99 percent. For example, if we assumed that the tax extenders either will be allowed to expire or will be offset — as do the baselines that CRFB and we have traditionally used — the debt ratio in 2040 would be 91 percent.

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[2] Kathy Ruffing, Kris Cox, and James Horney, *The Right Target: Stabilize the Debt*, Center on Budget and Policy Priorities, January 12, 2010, http://www.cbpp.org/cms/index.cfm?fa=view&id=3049.

[3] Committee for a Responsible Federal Budget, *Our Debt Problems Are Still Far from Solved*, May 15, 2013, Figure 4.

[4] Michael Linden, *It's Time to Hit the Reset Button on the Fiscal Debate*, Center for American Progress, June 6, 2013, http://www.americanprogress.org/issues/budget/report/2013/06/06/65497/its-time-to-hit-the-reset-button-on-the-fiscal-debate/.

[5] Like our long-term baseline, the ten-year baseline that we and CRFB use assumes that sequestration will end after 2013 and the Medicare physician cuts will be cancelled, without offsets. However, that baseline assumes that the "tax extenders" either will expire as scheduled or that the costs of continuing these tax breaks will be offset.

Our new projection is more favorable than an oft-cited CBO projection of June 2012.[6] Although the ACA and BCA were in place by then, the near-term budget outlook has improved considerably for other reasons since CBO issued that projection 12 months ago, and those improvements affect the long-term outlook as well. More important, CBO's projection did not purport to represent current tax and spending policies.

In June 2012, CBO produced two long-run budget paths, and most observers have focused on the more pessimistic of the two. The more optimistic path, which CBO called the "extended baseline," strictly followed current law as it stood a year ago and, thus, assumed that policymakers would let all of the tax cuts enacted in 2001 and 2003 expire as scheduled after 2012. Most analysts viewed that assumption as highly unrealistic — correctly so, since President Obama and Congress made most of those tax cuts permanent as part of ATRA — and focused on CBO's more pessimistic path (the "alternative fiscal scenario") as the more realistic one.

That alternative fiscal scenario diverged from current policy in several significant ways. Besides assuming that *all* of the 2001-2003 tax cuts would be extended, it also assumed that the President and Congress would repeatedly cut taxes in the coming decades to keep revenues flat at 18.5 percent of GDP after 2022, by cancelling out the effects of real bracket creep and other provisions of tax law that would otherwise cause revenues to edge up gradually. On the spending side, this CBO scenario assumed that various cost-control provisions of health reform will *not* remain in effect after 2022. And it assumed that policymakers will restore federal spending for programs *outside* of Social Security and health entitlements to its average share of GDP over the previous two decades rather than allow the current downward trend to continue.

Due to these assumptions, which effectively undid much of the deficit reduction in the BCA and health reform, the debt in CBO's alternative fiscal scenario grew to 227 percent of GDP by 2040. Although this path was based on highly pessimistic fiscal assumptions of repeated future tax cuts and program expansions, despite the nation's fiscal problems, many commentators treated it as if it represented current budget policies.

Projections Reflect Likely Outcome of Continuing Current Budget Policies

Our long-run budget projections are neither a forecast nor an expression of desirable budgetary policy. Rather, they show what will likely happen if policymakers continue current laws and policies governing federal taxes and spending without changes (that is, without making changes either to constrain deficits or to cut taxes or expand programs without covering the cost).

We base the first ten years of our long-run projection on CBO's May 2013 current-law baseline, with certain adjustments that policy analysts typically make to reflect current policies. Some of these adjustments *increase* deficits relative to the CBO baseline — for instance, we assume that sequestration, which is scheduled to run through 2021, does not continue after 2013; that scheduled cuts in Medicare physician payments do not take effect; and that certain tax cuts do not expire. We make other, commonsense adjustments that result in *lower* deficits — for instance, we assume a phase-down in war funding in accordance with current Administration and congressional policy and assume that the unusually high disaster funding in 2013 associated with Hurricane Sandy does not continue year after year (as CBO is required to assume in its baseline). In total, the adjustments

[6] Congressional Budget Office, *The Long-Term Budget Outlook*, June 2012.

result in deficits that are somewhat *higher* than those in CBO's current-law baseline. We adopt CBO's underlying economic and technical estimating assumptions.

After 2023, we assume that:

- Revenues will edge up gradually as a share of GDP, largely reflecting increases in real income that gradually move taxpayers into higher marginal tax brackets.
- Social Security, Medicare, and other health entitlements will grow in response to increases in enrollment and will pay the full benefits specified in law (except, as noted, we assume that the scheduled reduction in Medicare physician payment rates does *not* take effect).
- All other program spending — primarily discretionary, or annually appropriated, spending — will keep pace with inflation plus population growth, thereby maintaining the same level of real services per person.
- Interest costs will be shaped by the projected size of the debt and the level of interest rates, using CBO's interest-rate projections.

Under these assumptions, total federal outlays (including interest payments) grow from 21.5 percent of GDP in 2013 to 22.9 percent in 2023 and 25.2 percent in 2040. *Primary* outlays — outlays other than interest payments — fall from 20.2 percent of GDP today to 19.3 percent in the early 2020s and then rise again to 20.6 percent by 2040, slightly above today's level. Medicare, Medicaid, and other mandatory health programs more than account for the growth in primary outlays from the early 2020s to 2040. Social Security also rises as a share of GDP, but much more modestly. Outlays for other programs decline; much of that reduction comes in the first decade, as the economy recovers and spending consequently falls for programs like unemployment insurance, and as the BCA caps on discretionary funding continue to tighten (relative to GDP). Revenues grow substantially for the next few years, reflecting an economy recovering from the deep recession, and creep up slowly thereafter, reaching 20.6 percent of GDP in 2040 — close to the level in the final Clinton years, the last time the federal budget was in surplus.

Since budget projections are highly uncertain, particularly for the long run, we also prepared two illustrative alternative paths — one with more pessimistic assumptions, the other with more optimistic assumptions.

In our optimistic path, the debt plateaus at about 80 percent of GDP in the late 2030s. This path assumes that policymakers replace sequestration for 2014 through 2021 with measures that yield equal policy savings over the next ten years and somewhat greater savings beyond that. This path also assumes slower growth in Medicare costs.

In our pessimistic path, the debt ratio rises more rapidly and reaches 120 percent of GDP by 2040. This path assumes higher rates of spending after 2023 for all programs except Social Security. These assumptions do not reflect the full range of uncertainty. Another severe recession or a catastrophic disaster, for example, could cause the debt to shoot up rapidly.

Difficult Policy Changes Still Needed to Ensure Long-Term Stability

Although the long-term budget problem appears significantly more manageable than in previous projections, policymakers still face difficult choices to put the budget on a more sustainable path for the long term. We have long maintained that stabilizing the debt-to-GDP ratio over the coming decade (with deficit reduction measures phased in *after* the economy has recovered more fully) is a minimum appropriate budget course.[7] Deficits are not a problem when the economy is operating well below its potential, as it has been since 2008. But a persistently rising debt-to-GDP ratio in good times and bad alike reflects an unsustainable budget policy that ultimately poses threats to financial stability and long-term growth.[8] That's why the debt ratio should not rise when the economy is at or near full employment. In addition, a falling debt-to-GDP ratio would give policymakers more flexibility to address future economic or financial crises.

Projected debt-to-GDP ratios should be reduced through carefully designed policies that strengthen (rather than weaken) the slow economic recovery and job creation in the near term, while putting in place fair and balanced deficit reduction that grows in size over time. (Job creation is essential; it has little chance of passing either house of Congress, however, unless it is part of a broader fiscal policy package.) Replacing sequestration with a more sensible set of savings measures that end the immediate austerity which sequestration is imposing and replace it with larger savings later in the decade could *both* benefit the economy in the short term *and* produce somewhat lower debt ratios in the long term. That echoes the recent recommendations of the International Monetary Fund, which called the automatic spending cuts "indiscriminate" and instead urged U.S. lawmakers to "[repeal] the sequester and [adopt] a more balanced and gradual pace of fiscal consolidation in the short term; expeditiously [raise] the debt ceiling to avoid a severe shock to the U.S. and the global economy; and [implement] a comprehensive and back-loaded set of measures to restore long-run fiscal sustainability."[9]

Based on CBO's February 2013 projections, CBPP previously estimated that $1.5 trillion in additional deficit reduction (including interest savings) would stabilize the debt at 73 percent of GDP over the coming decade (relative to a baseline that, as noted, makes a different assumption about certain expiring tax cuts).[10] Because CBO's May baseline projections reduced projected deficits by more than $800 billion through 2023, the deficit reduction required to stabilize the debt will now be somewhat less. In a future paper, we will analyze how various deficit-reduction paths, including paths that combine some near-term, temporary measures to accelerate job creation with permanent deficit-reduction measures that kick in after the economy has fully recovered, would affect the debt-to-GDP ratio.

Even if the President and Congress agreed on enough deficit reduction to stabilize the debt over the coming decade, the debt-to-GDP ratio would still very likely rise somewhat for a number of

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[7] Ruffing, Cox, and Horney.

[8] Chad Stone, *From a Deficit to a Surplus and Back Again*, *U.S. News*, April 25, 2013, http://www.usnews.com/opinion/blogs/economic-intelligence/2013/04/25/debt-economic-growth-relationship.

[9] International Monetary Fund, *Concluding Statement of the 2013 Article IV Mission to The United States of America*, June 14, 2013, http://www.imf.org/external/np/ms/2013/061413.htm.

[10] Richard Kogan, *$1.5 Trillion in Deficit Savings Would Stabilize the Debt Over the Coming Decade*, Center on Budget and Policy Priorities, February 11, 2013, http://www.cbpp.org/cms/index.cfm?fa=view&id=3900.

years after 2023 (before slowing down) and remain well above the level of the previous 60 years. In particular, the aging of America's population and projected increases in per-capita health care costs will continue to put considerable pressure on federal health and retirement programs and on the budget as a whole. Stabilizing the debt ratio over the coming decade — while not sufficient to solve our long-term fiscal problems — would give policymakers time to identify, by later in the decade, further steps needed to keep the debt ratio from rising again in future decades and make more progress on these long-run budget challenges.

As we have written, going further and enacting more significant deficit reduction now that puts the debt ratio on a modest downward path after the economy has recovered would bring additional advantages (see box below) — if policymakers can achieve it without slowing the recovery, shortchanging important investments for the future, increasing poverty and inequality, or sacrificing health care quality. Unfortunately, this seems a tall order in the current political environment.[11]

There are major unknowns in the health care arena, and policymakers should approach this area with appropriate caution. The growth of both public and private health costs has slowed appreciably in the past few years, but experts do not agree on how much of this slowdown is likely to continue over the long term. As our pessimistic and optimistic paths demonstrate, the answer affects the size of the long-term fiscal problem and the magnitude of the measures that will be needed to further slow health-care cost growth (beyond modest steps that can be taken now). More fundamentally, we currently lack needed information on *how* to slow health cost growth substantially without reducing health care quality or impeding access to necessary care. Demonstration projects and other experiments to find ways to do so are now starting and should generate important lessons. By later in the decade, we will know more about what works and what doesn't, and whether we can build upon and spread the changes already starting to occur to slow health cost growth.

[11] Kogan, *$1.5 Trillion in Deficit Savings Would Stabilize the Debt*, p. 4.