The Federal Budget Outlook:
A Post-Budget-Deal Update

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This paper provides a brief update to our most recent estimates of the 10-year and long-term federal budget outlook, published in July (Auerbach and Gale 2011), to account for the recent budget deal that President Obama signed into law on August 2, 2011 (Pub. L. No. 112-25).

The Outlook Through 2021

Highlights of the 10-year outlook are shown in Table 1 and Figures 1 and 2 (with supporting detail in the Appendix Table), and are as follows. The Congressional Budget Office (CBO 2011b) baseline budget projections, issued in March 2011 (and hence before the budget deal), show a cumulative deficit of $6.7 trillion from 2012-21, with deficits declining sharply from 9.3 percent of GDP in 2011 to 3 percent of GDP by 2014 and hovering around 3 percent of GDP through 2021. Federal debt would be 75.6 percent of GDP in 2021.

The measures contained in the budget deal would reduce the deficit in two phases. The Budget Control Act of 2011 first uses discretionary spending caps and program integrity initiatives to reduce the deficit by $917 billion over ten years (CBO 2011e). The legislation also establishes a bipartisan Joint Select Committee on Deficit Reduction to identify and recommend an additional $1.5 trillion in deficit savings by November 2011. Unless legislation from the Joint Select Committee is enacted and is projected to reduce deficits by at least $1.2 trillion over 10 years, the Budget Control Act specifies automatic spending cuts to achieve the difference between the required $1.2 trillion and any deficit savings on which Congress and the President can agree. Kogan (2011) illustrates how automatic sequestration would proceed if no deal is reached: Starting in January 2013, spending for both defense and nondefense programs would be cut by about $55 billion every year until 2021, and reduced interest payments would account for the remainder of the required savings.

With the budget deal (and including slight adjustments for final 2011 appropriation levels), we calculate an updated current law baseline, with the 10-year deficit falling to $4.46 trillion, and with deficits falling below 2 percent of GDP by 2014 and then falling to 1.6 percent by 2021. Debt would be 66.1 percent of GDP in 2021, somewhat lower than its current level.

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As is now well known, however, the CBO baseline (and, by extension, the updated current law baseline) is not intended to represent likely or probable outcomes. Rather, it essentially reports the implications of the assumption that Congress does nothing over the next 10 years. All major tax provisions currently scheduled to expire (other than excise taxes devoted to trust funds) are assumed to do so as scheduled. In particular, under the baseline assumptions: the Bush tax cuts expire; the alternative minimum tax grows to cover 41 million households by the end of the decade (Tax Policy Center 2010); payments to physicians under Medicare decline by about 28 percent in January 2012 and continue to decline in future years; and future military spending for Iraq and Afghanistan remains at current levels.

We report estimates of "extended policy" (or what is sometimes called "current policy") making the following adjustments: We assume that the Bush tax cuts for the income and estate taxes and the AMT provisions are extended permanently. It is worth highlighting that these tax cut extensions alone would increase the cumulative 10-year deficit by more than both parts of the recent budget deal combined reduce it. A variety of other tax provisions that have statutory expiration dates are routinely extended for a few years at a time as their expiration date approaches. We assume that all of these provisions will be extended.[2] In addition to assuming that the AMT provisions temporarily extended at the end of 2010 — including higher AMT exemption levels — are granted a continuance, we also assume indexation of the AMT exemption amount for inflation starting in 2012. (We do not, however, assume extension of the temporary payroll tax cuts, which are slated to expire at the end of 2011, given that these were explicitly adopted as a countercyclical measure.) We include the costs of freezing physician payment rates under Medicare at their 2011 levels. We assume that war-related defense spending will follow the policy outlined in CBO's alternative scenario in the budget. Such a policy calls for steep decreases in war-related defense funding after 2012 and results in a $1,134 billion reduction in defense spending relative to the CBO's defense baseline.

With these additions, the extended policy scenario shows a cumulative deficit of almost $9 trillion over the next decade, with annual deficits falling to 4 percent of GDP by 2018 but then rising to 4.6 percent by 2021. The debt/GDP ratio would rise to 85 percent by 2021. (By comparison, under the estimates we released prior to the budget deal (Auerbach and Gale 2011), the 10-year deficit was $11.9 trillion. The majority of the $2.9 trillion difference is due to the budget deal itself ($2.1 trillion), as well as the 2011 appropriations changes, the removal of our prior assumption that domestic discretionary spending would grow with inflation in the extended policy baseline, and associated net interest payments. The prior estimate projected an extended policy deficit of 6.5 percent of GDP in 2021, with a debt/GDP ratio of 97 percent.)

Four comments—one economic and two political—are important. First, all of these estimates rest on CBO's March 2011 projections for the overall economy, which assumes that the economy returns to full employment by the second half of 2016 and real GDP grows at an average rate of 2.4 percent thereafter (CBO 2011a). Second, cutting government purchases in a recession is unlikely to help the economy recover more quickly and could well weaken short-

[2] CBO (2011a) reports that the baseline includes $1,029 billion in outlays, not including debt service costs, for mandatory spending programs that are assumed to be extended beyond their expiration dates.

term growth.

Third, we assume that the supercommittee does not reach an agreement or the agreement is not enacted (this is sometimes referred to as the supercommittee "failing" but in this case that would be a misnomer since the automatic cuts would be triggered) and therefore that the additional $1.2 trillion reduction is achieved through automatic sequestration, as outlined by Kogan (2011). The supercommittee may reach an agreement and the resulting legislation may cut more than $1.2 trillion in additional deficit reduction. In this sense, our estimates are conservative. On the other hand, although the debt deal does not prohibit legislators from undertaking deficit-increasing activities outside of the deal, our projections do not include any such activities. Fourth, by projecting the effects of extending the Bush-era tax cuts and other tax adjustments outside of the budget deal, we are not taking a stance on whether it is advisable to exclude the tax cuts from the deal. In fact, we believe that a comprehensive deal should include consideration of all tax and spending items. Our analysis simply reports the effects of extending current tax and spending policies in addition to the automatic sequestration that would occur if Congress does not enact a proposal from the supercommittee.

Long-Term Outlook

Under the March 2011 CBO baseline, the debt-to-GDP ratio was expected to pass its 1946 high of 108.6 percent in 2032. This date gets pushed back nearly 10 years to 2041 after updating the March baseline to match current law. Under the extended policy baseline, however, the debt-to-GDP ratio will surpass 108.6 percent around 2026. All scenarios have one thing in common: the debt-to-GDP ratio continues to rise rapidly after surpassing its all-time record. This starkly contrasts with the sharp decline of debt-to-GDP immediately after 1946.

To examine long-term issues more formally, we estimate a long-term fiscal gap—the immediate and permanent increase in taxes or reduction in spending that would keep the long-term debt-to-GDP ratio at its current level (See Table 2). Using current-law assumptions for Medicare spending, as put forth by the Medicare trustees (2011), and depending on the time frame employed, the fiscal gap is estimated to be about 2 – 4 percent of GDP under the assumptions in the CBO baseline, about 1 – 3 percent of GDP under the updated current law baseline, and about 3 – 5 percent of GDP under current policy. However, the fiscal gap rises by 1-3 percent of GDP under each of these scenarios when substituting the Medicare outlay estimates put forth by the Medicare actuaries **(**CMS Office of the Actuary, 2011**)** and rises by an additional 1 percent when using assumptions employed by CBO (2011c). As a result, the gap is estimated to be 9 percent of GDP under our worst-case scenario. These estimates are in the range of 1.1 to 1.3 percent of GDP lower than our previous estimates (Auerbach and Gale 2011).

Conclusion

While the changes enacted in the recent budget deal moved the projected deficits in the right direction, the federal budget outlook is still unsustainable, primarily because of a rise in entitlement spending that is not accompanied by an increase in revenues. Health care reform is an important part of the long-term budget outlook, but even very substantial and sustained reform of health care will leave a significant fiscal gap.

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Table 1

Federal Budget Deficit and Debt
CBO March 2011 Baseline, Updated Current Law Baseline, and Extended Policy 2012-2021[1]

	Deficit		Debt in 2021
	$ billions	% of GDP	% of GDP
CBO March 2011 Baseline	**6,737**	**3.4**	**75.6**
Adjustments for final 2011 appropriations	-147	-0.1	
Adjustments for Budget Control Act of 2011	-917	-0.5	
Adjustments for Automatic Sequestration	-1,214	-0.6	
Updated Current Law Baseline	**4,459**	**2.3**	**66.1**
Adjustments for tax policy			
Extend income tax, estate tax, and AMT provisions	2,502	1.3	
Index AMT for inflation (includes interaction)	1,318	0.7	
Extend other expiring tax provisions	759	0.4	
Net interest	986	0.5	
Total adjustments for tax policy	5,565	2.8	
Adjustments for spending policy			
Adjust defense spending	-1,134	-0.6	
Freeze Medicare physician payment rates	249	0.1	
Net interest	-184	-0.1	
Total adjustments for spending policy	-1,068	-0.5	
Extended Policy	**8,956**	**4.6**	**85.0**

[1]See Appendix Table 1 for sources and notes.

Table 2
Fiscal Gaps

Baseline:	CBO Baseline			Updated Current Law Baseline			Extended Policy Baseline		
	Through 2035	Through 2085	Permanent	Through 2035	Through 2085	Permanent	Through 2035	Through 2085	Permanent
As a Percent of GDP	1.99	3.31	4.13	1.06	2.33	3.13	2.95	4.35	5.19
In Billions of Present-Value Dollars	6,334	24,969	57,805	3,371	17,585	43,865	9,401	32,815	72,737
w/ CMS actuary Medicare	2.34	4.95	6.91	1.41	3.97	5.91	3.30	5.99	7.97
	7,435	37,366	96,779	4,471	29,982	82,839	10,501	45,212	111,711
w/ CBO alternative scenario Medicare	2.28	5.31	7.93	1.35	4.33	6.94	3.25	6.35	9.00
	7,265	40,040	111,101	4,301	32,656	97,161	10,331	47,886	126,034

Source: Authors' calculations

Appendix Table

Federal Budget Deficit
CBO March 2011 Baseline, Updated Current Law Baseline, and Extended Policy 2012-2021[1, 2]

Deficit ($ billions)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012-2021
CBO March 2011 Baseline [3]	**1,399**	**1,081**	**692**	**513**	**538**	**635**	**590**	**585**	**665**	**710**	**729**	**6,737**
as percent of nominal GDP	**9.3**	**6.9**	**4.2**	**3.0**	**3.0**	**3.3**	**2.9**	**2.8**	**3.0**	**3.1**	**3.1**	**3.4**
Adjustments for final 2011 appropriations [4]												
Discretionary spending	3	-2	-8	-11	-12	-13	-14	-15	-15	-16	-16	-122
Subtotal	3	-2	-8	-11	-12	-13	-14	-15	-15	-16	-16	-122
Net interest[5]	0	0	0	0	-1	-2	-2	-3	-4	-5	-6	-25
Total adjustments for final 2011 appropriatio	3	-2	-8	-11	-13	-15	-16	-18	-19	-21	-22	-147
as percent of nominal GDP	0.0	0.0	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Adjustments for Budget Control Act of 2011[6]												
Discretionary spending: Caps	0	-25	-47	-59	-67	-74	-81	-89	-97	-104	-112	-756
Discretionary spending: Program integrity	0	1	1	1	1	2	2	2	2	2	2	15
Mandatory spending: Program integrity	0	0	0	-1	-1	-1	-2	-2	-2	-3	-3	-16
Mandatory spending: Pell grants	0	4	8	5	0	0	0	0	0	0	0	17
Mandatory spending: Other education	0	-1	-2	-2	-2	-2	-2	-2	-2	-2	-3	-22
Subtotal	0	-21	-41	-56	-69	-76	-84	-91	-100	-108	-116	-761
Net interest	0	0	-1	-3	-6	-10	-15	-20	-26	-33	-40	-156
Total adjustments for Budget Control Act of	0	-21	-42	-59	-75	-87	-99	-112	-126	-141	-156	-917
as percent of nominal GDP	0.0	-0.1	-0.3	-0.3	-0.4	-0.5	-0.5	-0.5	-0.6	-0.6	-0.7	-0.5
Adjustments for Automatic Sequestration[7]												
Defense reductions	0	0	-55	-55	-55	-55	-55	-55	-55	-55	-55	-492
Nondefense reductions	0	0	-55	-55	-55	-55	-55	-55	-55	-55	-55	-492
Subtotal	0	0	-109	-109	-109	-109	-109	-109	-109	-109	-109	-984
Net interest[5]	0	0	-2	-6	-11	-17	-24	-31	-38	-46	-54	-230
Total adjustments for Automatic Sequestrati	0	0	-111	-115	-120	-127	-133	-140	-148	-155	-163	-1214
as percent of nominal GDP	0.0	0.0	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-0.6
Updated Current Law Baseline	**1,402**	**1,057**	**530**	**328**	**329**	**407**	**342**	**314**	**372**	**392**	**387**	**4,459**
as percent of nominal GDP	**9.3**	**6.7**	**3.2**	**1.9**	**1.8**	**2.1**	**1.7**	**1.5**	**1.7**	**1.7**	**1.6**	**2.3**
Adjustments for tax policy												
Extend income tax, estate tax, and AMT provisions	0	2	118	245	276	287	297	306	314	323	333	2,502
Index AMT for inflation (includes interaction)	0	9	105	99	110	123	138	154	173	192	213	1,318
Index AMT for inflation	0	9	94	46	51	56	63	70	80	90	102	661
Interaction effect of indexing AMT	0	0	11	53	59	67	75	84	93	102	111	657
Extend other expiring tax provisions	0	12	77	113	100	87	80	75	72	71	73	759
Subtotal	0	24	300	457	486	498	515	534	559	587	619	4,579
Net interest	0	0	6	20	42	69	99	132	167	205	246	986
Total adjustments for tax policy	0	24	306	478	529	567	614	666	726	791	865	5,565
as percent of nominal GDP	0.0	0.2	1.9	2.8	2.9	3.0	3.1	3.2	3.3	3.5	3.6	2.8
Adjustments for spending policy												
Adjust defense spending	0	-21	-54	-87	-113	-129	-137	-142	-147	-150	-153	-1,134
Freeze Medicare physician payment rates	0	12	19	19	21	24	25	28	31	34	36	249
Subtotal	0	-9	-35	-68	-92	-106	-112	-114	-115	-116	-117	-885
Net interest	0	0	-1	-3	-7	-12	-18	-25	-32	-39	-47	-184
Total adjustments for spending policy	0	-9	-36	-70	-98	-118	-130	-139	-147	-156	-164	-1,068
as percent of nominal GDP	0.0	-0.1	-0.2	-0.4	-0.5	-0.6	-0.7	-0.7	-0.7	-0.7	-0.7	-0.5
Extended Policy Baseline	**1,402**	**1,072**	**800**	**735**	**760**	**856**	**826**	**841**	**950**	**1,028**	**1,088**	**8,956**
as a percent of nominal GDP	**9.3**	**6.8**	**4.9**	**4.3**	**4.2**	**4.5**	**4.1**	**4.0**	**4.3**	**4.5**	**4.6**	**4.6**
GDP	15,034	15,693	16,400	17,258	18,195	19,141	20,033	20,935	21,856	22,817	23,810	196,138

[1]Columns may not sum to total due to rounding.
[2]Unless otherwise noted, the source of these estimates is CBO (2011) "The Budget and Economic Outlook: Fiscal Years 2011 to 2021."
[3]CBO (April 2011) "An Analysis of the President's Budgetary Proposals for the Fiscal Year 2012," Table 1-6.
[4]CBO (May 2011) "Extrapolation of Full-Year Appropriations for 2011."
[5]Authors' calculations.
[6]CBO (August 2011) "CBO Analysis of August 1 Budget Control Act," Table 3.
[7]Kogan, Richard (2011) "How the Potential Accros-the-Board Cuts in the Debt Limit Deal Would Occur," Center on Budget and Policy Priorities.

Figure 1. Alternative Deficit Projections, 2011-2021

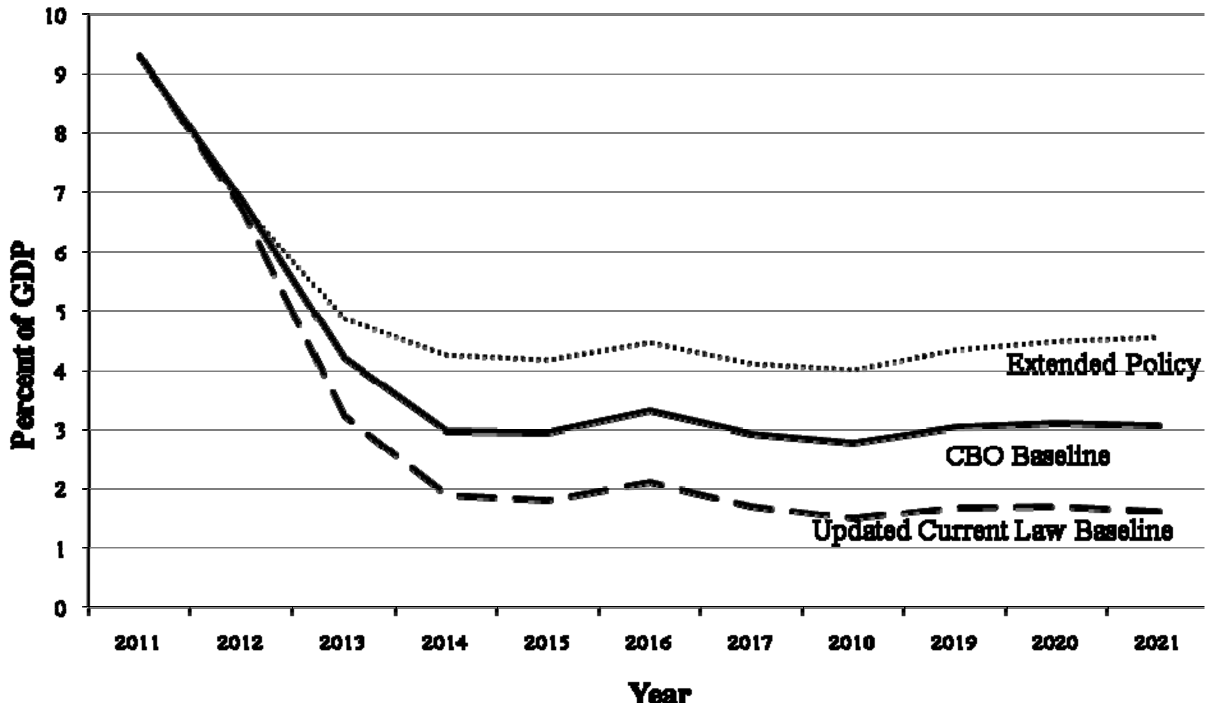

Figure 2. Alternative Debt Projections, 2011-2021

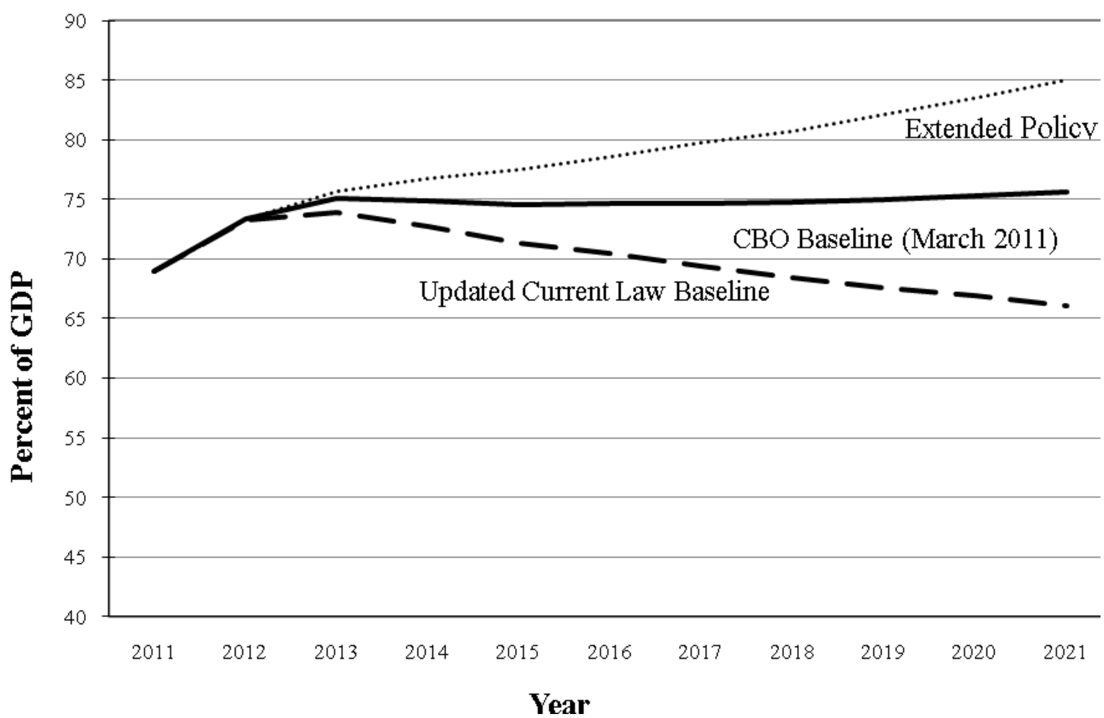

Figure 3. Alternative Projections of Revenues and Non-Interest Outlays, 2011-2085

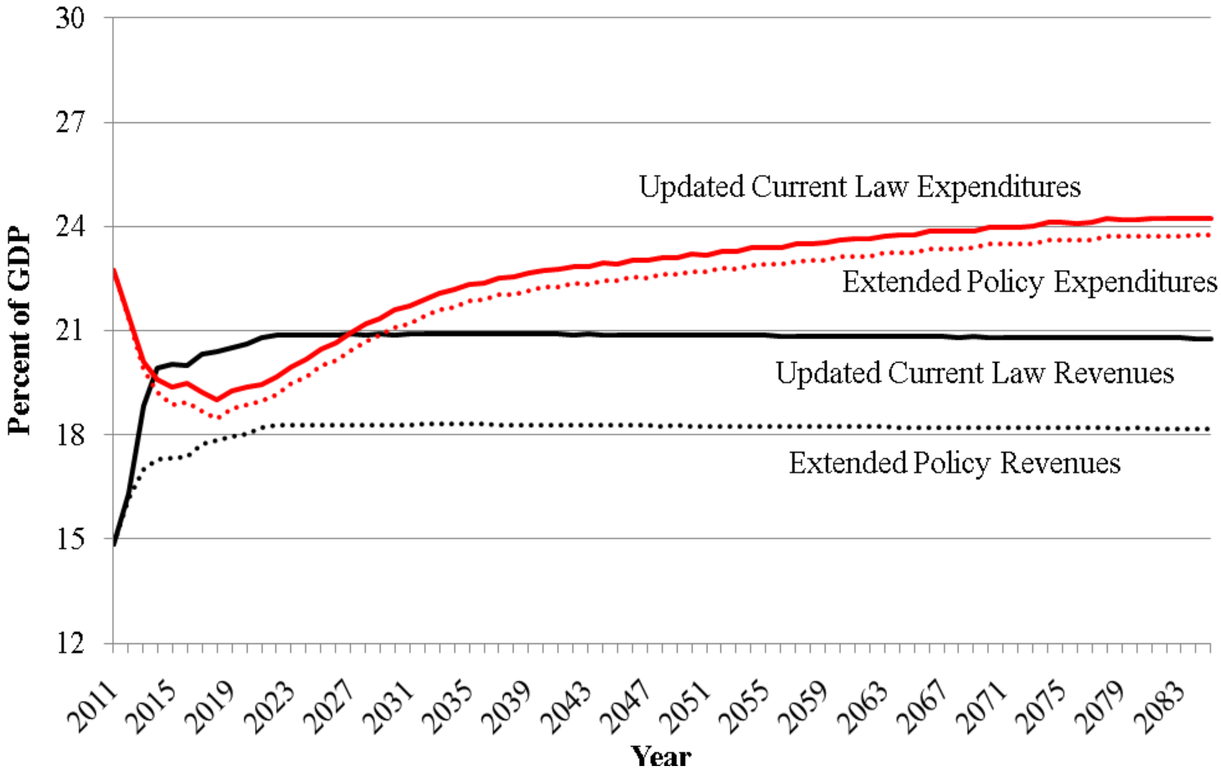

Figure 4. Alternative Projections of the National Debt, 2011-2085