



Issue brief

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CBO Update Casts Doubt on Campaign Rhetoric

With its August update of the Budget and Economic Outlook, the Congressional Budget Office (CBO) has thrown sand into the political gears of both parties as they hone their fiscal policy arguments for the November elections.

Based on CBO's analysis, permanent deficit-financed tax cuts are not as painless for the long-term health of the economy as many on both sides seem to assume and, contrary to some campaign rhetoric, there is no basis for concluding that health care reform "saved" Medicare for many years or that Social Security poses no budgetary challenge.

Moreover, the report cuts against the political winds by supporting claims that spending increases for economic stimulus, unemployment compensation and the Troubled Asset Relief Program (TARP) have provided support to the economy while not adding significantly to the long-term structural deficit.

On balance, CBO's August Update confirms that all policy options -- spending cuts and tax increases -- should remain on the table in addressing our nation's unsustainable structural deficit. Economic growth alone will not be enough to achieve a sustainable fiscal policy. Nor will trimming everyone's favorite target -- waste, fraud and abuse. Campaign rhetoric that suggests otherwise is not supported by CBO's nonpartisan analysis of the facts.

I. Stabilizing the debt: current law versus current policy

In assessing the campaign implications of CBO's August Update, the best place to start is with its bottom-line conclusion:

Unless policymakers restrain the growth of spending substantially, raise revenues significantly above their average percentage of GDP of the past 40 years, or adopt some combination of those two approaches, persistent budget deficits will cause federal debt to rise to unsupportable levels.¹

Federal spending has averaged about 21 percent of the gross domestic product (GDP) over the past 40 years while revenues have averaged about 18 percent over that time. The resulting deficits, about 3 percent of GDP, fall within a range that is considered sustainable because they do not cause the debt to grow faster than the economy.

¹ CBO, *The Budget and Economic Outlook: An Update*, August 2010, p. 27.

The problem is that spending -- primarily for automatic increases in health care and retirement benefits -- is projected to grow faster than revenues and the economy over the coming decades. This leads to a growing gap that must be filled by borrowing. If, as projected, the gap grows faster than the economy, then the debt will also grow faster than the economy. Eventually, the growing debt burden will become impossible to finance.

Candidates thus face some difficult choices that are not often acknowledged on the campaign trail but that will have to be confronted by whoever wins. The challenge is to craft a fiscal policy that initially stabilizes the debt-to-GDP ratio and facilitates a declining debt burden over time.

The CBO's "current law" baseline provides a general framework for how that might be accomplished. Following the baseline path of spending and revenues would reduce deficits to a more sustainable level over the next five years, although more would need to be done to maintain that favorable result.

Under the baseline, which assumes that no legislation increasing the deficit is enacted, revenues would rise from their current recession-induced level of 14.6 percent of GDP to 20.1 percent of GDP by 2015. Spending would fall from 23.8 percent of GDP to 22.8 percent. The resulting deficit, 2.7 percent of GDP, would temporarily stabilize the debt-to-GDP ratio and provide breathing room for more ambitious, and necessary, deficit reduction efforts.

While sticking to this baseline would require strong political will, it would not require new legislation. If Congress simply does nothing, the deficit will decline substantially as the economy recovers.

However, in assuming no new legislation the baseline assumes some tough choices that are not included in many campaign platforms. It assumes, for example, the expiration of all tax cuts that are set to expire, no further relief from the growing reach of the Alternative Minimum Tax (AMT), appropriations growing no faster than inflation, and a sharp decrease in Medicare physician reimbursements, as required by current law. It also assumes that Medicare cuts and tax increases enacted in this year's health care reform legislation are implemented on schedule to cover the cost of increased health insurance coverage.

If these baseline policy assumptions are deemed unwise or undesirable, an alternative would be to follow a strict "pay-as-you-go" (PAYGO) regime. This way, decisions to alter policy away from current law would not lead to higher deficits. The goal need not be to follow current law to the letter but simply to bend the spending and revenue lines closer together, in accordance with baseline levels.

If, on the other hand, Congress extends current policy (rather than current law) without regard to the deficit, the fiscal results would be dramatically worse.

In The Concord Coalition's "plausible baseline," designed to demonstrate how sticking with current policies would alter CBO's baseline projections, revenues would remain slightly below 17 percent of GDP in 2015, while spending would remain around 24 percent of GDP. This projection assumes that current tax cuts are extended, including AMT relief, that discretionary

spending grows at the same rate as the economy, and that cuts to Medicare payments for doctors continue to be postponed.

In this scenario, which may seem more politically attractive than trying to meet CBO's baseline, deficits never get to a sustainable level. Instead, the deficit would grow to 7 percent of GDP by 2015 and top 9 percent of GDP by 2020. Ten-year deficits would more than double from CBO's baseline of \$6.2 trillion, to \$15.2 trillion over the next decade.

Even under the current law baseline, debt held by the public reaches 69 percent of GDP at the end of 2020, with \$778 billion spent on interest costs that year alone. However, under Concord's plausible assumptions, debt held by the public grows to 108 percent of GDP by 2020, rivaling the highest level since the height of WWII. Interest costs in that year alone would be over \$1 trillion -- larger than either defense spending or total non-defense discretionary spending.

As these comparisons make clear, big changes in current policies must be made. However, the state of the economy must also be considered. CBO cautions:

Making such changes while economic activity and employment remain well below their potential levels would probably slow the recovery. Nevertheless, the sooner that long-term changes to spending and revenues are agreed on, and the sooner they are carried out once the current economic weakness ends, the smaller will be the damage to the economy from growing federal debt.²

Candidates often overlook this subtlety regarding the timing of deficit-reduction efforts. The issue tends to be portrayed as immediate deficit reduction versus immediate economic stimulus. It need not, and should not, be such a blunt choice.

Given the continued sluggishness of the economy, it may be prudent to postpone the immediate implementation of deficit-reduction efforts. However, actions can be taken now that would phase in as the economy recovers. Indeed, having a specific plan in place to rein in deficits over time would likely enhance short-term stimulus efforts by demonstrating a confidence-building commitment to fiscal responsibility.

As CBO Director Douglas Elmendorf told the President's fiscal commission:

“There is no intrinsic contradiction between providing additional fiscal stimulus today, while the unemployment rate is high and many factories and offices are underused, and imposing fiscal restraint several years from now, when output and employment will probably be close to their potential.”³

² Ibid., p. 27.

³ Elmendorf, Testimony to Fiscal Commission on the Long-Term Budget Outlook, June 30, 2010.

II. Tax policy

The biggest hit to conventional campaign wisdom from the CBO report comes on the issue of tax policy. To a surprising degree, Democrats and Republicans alike have agreed that a broad range of tax cuts enacted in recent years should be made permanent without regard to the effect on the deficit. The main point of contention has been whether to exclude tax cuts for upper income households, defined as couples earning more than \$250,000 and individuals earning more than \$200,000 a year.

While not taking sides in this fairly narrow policy debate, the CBO's analysis suggests that it would not be prudent to permanently extend any of the tax cuts on a deficit-financed basis. According to CBO, deficit-financing a permanent extension of the tax cuts -- even excluding those for upper income households -- would have a positive effect on the economy through 2012 but a negative effect after 2012 "because the larger budget deficits would reduce or 'crowd out' investment in productive capital and result in a smaller capital stock."⁴

This is a more technical way of saying that tax cuts are not a free lunch.

The revenue loss alone from extending the full range of tax cuts enacted in 2001 and 2003 would be substantial. According to CBO, this policy would lower revenues by \$2.7 trillion over 10 years (2011-2020). Combining this with continued relief from the AMT would result in a 10-year revenue loss of \$3.9 trillion, which equals two percent of GDP over that time. In 2020, the final year of the projection period, the revenue loss would be 2.2 percent of GDP (\$517 billion).

Adding to the tab is the extra cost of servicing higher debt. According to CBO, deficit-financing a permanent extension of the tax cuts, and adjusting the AMT for inflation, would result in \$947 billion of added interest costs through 2020. Thus, the grand total for deficit-financing these policies would be \$4.8 trillion over the next 10 years.

Letting the tax cuts expire is often portrayed as a "tax increase," and indeed tax rates would go up from their current level if no extension is approved. But this tax increase was built into the tax cuts when they were enacted. It is thus current law. Any change in that law will have to be enacted by Congress and signed by the President. In other words, the key decision is whether to enact a tax cut (changing current law), not whether to enact a tax increase (doing nothing).

If the decision is to enact a tax cut, then the secondary decision is whether to mitigate the effect on the deficit by raising other revenues or cutting spending by a commensurate amount. When Congress enacted a new pay-as-you-go law (PAYGO) earlier this year, it exempted the extension of tax cuts for families earning less than \$250,000 and individuals earning less than \$200,000 a

⁴ CBO, *The Budget and Economic Outlook: An Update*, August 2010, p. 36.

year. This exemption makes it easier to extend the bulk of the tax cuts, but it does not change the economic consequences of deficit-financing such a policy decision.

More bad news for certain campaign ideas is that allowing current law to take effect does not result in “new money” that can be used as an offset for new spending or tax cuts. The revenue from the expiring tax cuts is already assumed in the baseline because it is current law. Using it as an “offset” would simply be another way of increasing the deficit.

Congress and the President should carefully weigh these factors before determining how the expiration of the tax cuts should be dealt with. On the one hand, extension of the tax cuts would provide some support to the still-fragile economic recovery, particularly when it comes to middle- and lower-income households that would be more likely to spend the money. On the other hand, in the short term there are probably more effective forms of deficit-financed stimulus than even the “middle-class” portions of the expiring tax cuts. Over the longer term, large, chronic deficits become more harmful than helpful. As the CBO observed in its report:

Although running deficits during or shortly after a recession generally hastens economic recovery, persistent deficits and ever-growing debt would have several negative consequences for the United States. National saving and investment would be lower than they would be otherwise, reducing output, wages and incomes in the long-run.⁵

This suggests that the best policy would be to phase in the expiration of all the tax cuts so as not to harm the short-term economic recovery, while still limiting the long-term impact on the deficit. Alternatively, the tax cuts, or some portion of them, could be temporarily extended for a year or two while offsets are found (perhaps in the context of more fundamental tax reform) so that the revenue loss from any further extension would not add to the growing national debt.

In any event, CBO’s analysis refutes the notion that broad-based tax cuts pay for themselves, or come anywhere close to doing so.

As for the economic effect, CBO estimates that even if all the tax cuts were allowed to expire as scheduled at the end of this year, the negative effect on the economy would be short-lived. Real GDP growth would be lower in 2011 and 2012 -- an obvious political liability -- but would improve beyond then relative to a scenario in which the tax cuts were extended on a deficit-financed basis.

The tax policy dilemma now playing out on the campaign trail is thus a familiar one. Short-sighted policies may meet with immediate approval and temporary gains, but at a cost to long-term objectives.

⁵ Ibid., p. 27.

III. Spending policy

The options are no more politically comforting on the spending side of the budget, where the biggest problems come from the most popular programs.

When thinking about realistic spending reductions as a means of controlling the deficit, it is important to consider the magnitude of various categories within the budget and to distinguish between short-term and long-term trends. Some policies that add to the deficit in the short term have little lasting effect and thus present less of a problem for the long-term budget outlook. Other policies that may seem “affordable” in the near term have substantial long-term effects that are not fully captured by focusing only on the next few years.

For example, while last year’s large economic stimulus bill and the 2008 TARP program have been cited by many as “out of control” spending and thus, presumably, a major source of rising deficits, CBO’s report makes clear that these policies contribute very little to the dire budget outlook in the years ahead.

It is true, of course, that in the short term stimulus spending and TARP have added to the huge deficits. According to CBO, the spending and revenue effects of the 2009 fiscal stimulus bill will contribute \$392 billion of the \$1.3 trillion deficit in 2010. The TARP, however, which added \$151 billion to the deficit in 2009, will produce a net positive inflow of \$106 billion in 2010. In total, these items will constitute about 20 percent of the deficit this year.

Looking ahead, which is more important for purposes of addressing the deficit problem, the costs of these two initiatives will quickly fade. In CBO’s baseline, stimulus spending represents 13 percent of next year’s deficit and nine percent of the 2012 deficit. Beyond then, the effects on the deficit are minor -- a total of \$87 billion from 2013 through 2019. And, as noted, the net effect of the TARP has turned *positive* as the loans made under this program are repaid with interest. Thus, whatever one thinks of the stimulus bill or TARP as economic policy, they contribute very little to the deficit outlook.

Moreover, the CBO report credits these policies with having helped, at least temporarily, to stabilize the economy. Given the remaining economic sluggishness, the argument that “things could have been worse” is not very compelling but it is supported by CBO’s analysis.

A less apparent but very significant factor driving up deficits in recent years has been the effect of “automatic stabilizers,” which CBO describes as “automatic changes in revenues and outlays that are driven by the business cycle.”⁶ During times of recession, revenues fall with incomes and outlays increase for support programs such as unemployment compensation, Medicaid and

⁶ CBO, *The Effects of Automatic Stabilizers on the Federal Budget*, May 2010, Appendix.

food stamps. Most of the deficit increase from these factors can be attributed to falling revenues.

According to CBO, “Those automatic reductions in revenues and increases in outlays help to bolster the economy, but they also temporarily increase the deficit. The opposite occurs when there are upturns in the business cycle; that is, automatic stabilizers tend to shrink as the economy moves toward its potential output.”⁷

This pattern can be seen in CBO’s estimates of the effect that automatic stabilizers have had in recent years. In a May 2010 report, CBO estimated the following increases in the deficit attributable to automatic stabilizers:

Cost of Automatic Stabilizers in Billions of Dollars, 2007 to 2014⁸

Fiscal Year	2007	2008	2009	2010	2011	2012	2013	2014
Automatic Stabilizers	0	-47	-282	-351	-403	-331	-163	-29

For purposes of assessing campaign rhetoric, the significance of this is that automatic stabilizers have contributed even more to the deficit than deliberate policy actions designed to combat the recession. Moreover, both the automatic stabilizers and the deliberate policy actions will fade substantially in the coming years as the economy recovers.

Whether additional stimulus would be a good idea is a different question. As with extending the expiring tax cuts, the decision requires a balance between short-term support for the economy and the long-term effect of higher deficits. At some point, the stimulative effect gives way to the negative effect. Exactly when that happens is impossible to predict. It would be prudent, therefore, to either pair future short-term stimulus initiatives with efforts to tackle the long-term fiscal challenge, or to pair policies that support economic growth with reductions in spending or tax breaks that do little to support the economy. In short, the twin objectives of supporting the economy while not increasing the deficit may be combined to help produce a more efficient and effective government.

Campaign rhetoric is not accurate in suggesting a zero sum game between efforts to improve the economy and efforts to reduce the deficit. If properly designed, fiscal stimulus need not have an adverse impact on economic growth over the long term, and long-term discipline need not have an adverse impact on economic activity in the short term. We don’t need to sacrifice one to achieve the other, but we need to be clear about the trade-offs.

Much more significant for the future budgetary outlook is the growing cost of three very popular and important programs -- Social Security, Medicare and Medicaid. These three programs

⁷ Ibid., p.1.

⁸ Ibid., Table 1.

account for 41 percent of the budget. And it is these programs that are projected to grow the fastest in the coming years as the baby boom generation moves into retirement. The dynamics driving up their expenditures comes from the combination of more beneficiaries and rising health care costs.

Moreover, as “entitlement” programs they will grow automatically and without the restraint of PAYGO, which only applies to new legislation.

According to CBO, the average annual growth rate of Social Security between 2012 and 2020 will be 5.7 percent. Medicare growth will average 5.8 percent annually over that time and Medicaid will average 7.8 percent. By contrast, defense spending (20 percent of today’s budget) is projected to grow by 2.2 percent annually, and non-defense appropriations (19 percent of today’s budget) are projected to grow by just 1.1 percent annually.

The role of war costs

An important spending trend often cited in campaign rhetoric is the cost of the wars in Iraq and Afghanistan, which CBO estimates will total about \$170 billion in 2010. Unlike the stimulus bill and TARP, war spending is likely to persist for several more years. In fact, CBO assumes that war costs will remain at the same level, adjusted for inflation, over the next 10 years. This may overstate likely spending on the wars but even so, CBO projects that overall defense spending will decline as a share of GDP from 4.8 percent in 2011 to 3.8 percent by 2020. This would still be higher than pre-war levels, which dipped to three percent of GDP in 2000. However, the trend would be headed down.

So while the cost of war has certainly added to the deficit in recent years, it too is not a major factor in the long-term structural deficit. That does not mean that defense should be “off the table” for purposes of reducing the deficit. It simply means that ending the wars -- even if that could be done quickly -- or reducing defense spending in general would not be enough to bring the deficit down to a sustainable level.

Non-defense appropriations

Non-defense appropriations show a similar pattern of declining growth in CBO’s projections. In 2010 this category, which includes much of the stimulus spending, will reach 4.5 percent of GDP. Assuming, however, that the stimulus spends out and other appropriations grow no faster than is needed to keep pace with inflation, non-defense programs would shrink to 3.2 percent of GDP by 2020. Limiting non-defense appropriations to that level would require a commitment to fiscal responsibility that has rarely occurred. Congress has not kept such spending to 3.2 percent of GDP since 1999, and that was the one time it had occurred since 1962.

While this low-growth projection for non-defense appropriations may prove to be an optimistic assumption, there is little reason to believe that this spending category will outpace GDP growth over time. It is not driven by the same cost-growth factors that drive the growth of Social Security, Medicare and Medicaid (i.e., more beneficiaries and higher health care costs). Keeping spending in this area down to the CBO baseline levels, or below, will be important in the years ahead and that will not be easy as the population grows and the demand for services increases. Tough choices will have to be made in prioritizing and weeding out programs that are no longer needed or inefficient. There should be no free pass here, but it is also important to recognize that these annually appropriated programs, unlike Social Security, Medicare and Medicaid, do not present a *structural* deficit problem.

The real spending issue

Does all this mean that there is no spending problem? No. It does mean, however, that campaign debates over the stimulus bill, war spending and TARP shed very little light on the steps policymakers must take now to rein in future deficits. The main problem is that even when the economy improves, the stimulus actions end and the war winds down, the budget will remain on an unsustainable path. That is the real spending problem and the driving force is the projected cost growth of the three largest and most popular entitlement programs -- Social Security, Medicare and Medicaid.

Together, these three programs will expand spending by 1.2 percent of GDP through 2020 and by 5.6 percent in 2035. This, along with new mandatory spending for health care insurance subsidies, will put far more upward pressure on the budget than any conceivable increase in defense or non-defense appropriations. Moreover, this projection assumes that the cost control provisions of the health care reform bill, some of which will take effect several years from now, are implemented on schedule. If not, CBO warns in an alternative scenario that Medicare and Medicaid would cost an additional 1.2 percent of GDP by 2035. For purposes of comparison, adding another six percent or so to this year's budget would increase the deficit by almost \$900 billion.

Claims sometimes made in the campaign context that Medicare has been "saved" for several years by this year's health care bill or that Social Security is on solid fiscal ground through the late 2030's rest on intergovernmental trust fund accounting, not on the programs' growing budgetary cost.

The distinction is important because positive trust fund balances merely record how much one branch of the government owes to another. In the end, the taxpayers must pay all trust fund claims.

For example, some argue that there is no reason to reform Social Security now because the program's trust fund can pay full benefits until 2037. This is true as far as it goes, but it overlooks the fact that the trust funds are simply a claim on future general revenues. Coming up with the cash to satisfy those claims -- and keep the trust fund "solvent" through 2037 -- will place a growing strain on the budget and still leave the trust funds insufficient to pay more than 78 percent of promised benefits beyond 2037. In a sign of things to come, Social Security will pay out more than it takes in this year. It will be the first such "cash deficit" since 1983. While small cash surpluses may briefly reappear, the Social Security trustees project that cash deficits will become permanent in 2015.

Similarly, as a matter of trust fund accounting, Medicare's finances have indeed improved. The new health care law reduces future non-physician Medicare provider reimbursements and adds dedicated revenue through a 0.9 payroll tax increase for individuals earning more than \$200,000 and for married couples earning more than \$250,000. The cost savings and added revenues were credited to the Medicare Part A trust fund, thus substantially improving its balance. In addition, CBO's baseline projections continue to assume that a roughly 30 percent cut in physician payments over the next three years will be implemented as scheduled under current law.

However, in its report, CBO appropriately focuses on total Medicare expenditures and not its trust fund balance. For one thing, the Part A trust fund is only a part of the Medicare program. Thus, its balance is not necessarily indicative of the program's overall fiscal position. More fundamentally, it is the total cost of the program that will determine its effect on the budget and the economy. In that regard, CBO notes that although the health care reform legislation lowered projected Medicare costs by a substantial amount (\$555 billion over 10 years), the program will still grow faster than the economy. Even if all of the cost control mechanisms in the new law work as planned, CBO projects that Medicare will grow by 2.3 percent of GDP over the next 25 years. Meanwhile, the Medicare savings from the health care reform are largely devoted to new spending for Medicaid and insurance subsidies, not to improving the overall federal budget outlook.

Health Care Reform

Campaign rhetoric about the broader budgetary implications of the new health care law also deserves scrutiny. Based on CBO's analysis, the law is neither the cost-control and deficit-reduction bonanza portrayed by supporters, nor the fiscally irresponsible calamity portrayed by detractors. Not surprisingly, the least popular elements of the bill, and thus the most politically vulnerable, are the ones that do the most to help control costs.

The health care law is an enormously complex piece of legislation and CBO cautions that its cost estimates are "subject to considerable uncertainty." With that caveat, CBO estimates that the law

will increase spending by \$485 billion over the 10-year budget window (2011-2020) and increase revenues by \$643 billion. This results in a net deficit reduction of \$158 billion.

That hardly represents dramatic deficit reduction; in fact it is only around two percent of projected deficits. Even in the legislation's second decade, when reform is fully phased in, deficit reduction is minimal given large projected deficits. Furthermore, even that small deficit reduction requires policymakers to follow through on the politically difficult cost controls embedded in the legislation, such as cuts to certain parts of Medicare and a new tax on high-cost insurance plans to be implemented in 2018. These projections highlight the need to continually revisit reform and build in more cost controls.

Still, the fact that the legislation was "paid for" represents an improvement over the addition of a Medicare prescription drug benefit in 2003, which was entirely deficit-financed.

In campaign debate, one can legitimately argue that the law will end up costing more than anticipated or that some of the proposed savings will fail to materialize. However, the surest way to guarantee exploding deficits would be to leave in place popular insurance reforms and repeal the politically difficult choices that have been made to pay for them. Therefore, attacking Medicare cuts or the insurance tax, the individual insurance mandate, or the legislation's Medicare commission (Independent Payment Advisory Board or IPAB), represents an attack on the only items recognized by the CBO as actually decreasing health care costs.

Popular insurance reforms, such as eliminating denial of coverage due to pre-existing conditions, cannot be maintained without a mandate that everyone buys insurance. Without a mandate, guaranteed coverage would trigger a so-called "death spiral" for insurance plans. The uninsured could wait until they need medical care to sign up for insurance, pushing up the cost for everyone else. As costs go up, more people would drop out of the "risk pool," pushing premiums even higher for those remaining.

Additionally, most health care experts agree that transforming our health care system into one that rewards quality health care as opposed to one that pays for quantity, is crucial to slowing system-wide health care inflation. Having an independent commission made up of health care experts to guide this transition in Medicare, with savings targets and the ability to enact changes on an expedited basis, is an important way to speed up this transformation, and in the process speed up efforts to achieve fiscal sustainability. That is the IPAB's potential.

For those concerned that the new legislation is deficient in cost control -- and The Concord Coalition is among this group -- the best approach is to find ways of beefing it up rather than promising the public that we can really have something for nothing. While recent analysis from the Medicare trustees has shown the legislation has improved the long-term outlook for

Medicare, those numbers overstate the case and show there is much more work to be done. The aging of the population and rapid growth of health care costs, which are so devastating to the sustainability of Medicare, Medicaid, and the federal budget, will not wait for politicians to bicker about past health care battles before deciding to tackle the issue again.

IV. Conclusion

The CBO's August Update is not normally viewed as a document with great import for the country's broad political discussion. This year, however, with the amount of attention on the campaign trail being given to the economy and federal budget deficits, lessons from the report should be widely considered.

Those lessons help us understand that the current discussion on efforts to improve the economy, on deficits, on taxes, on Medicare and Social Security, and on other federal spending is incomplete at best and often misleading. Furthermore, as election day gets closer, campaign rhetoric tends to get more dramatic and hyperbolic.

The danger is a rhetorical death spiral that all but eliminates the possibility of responsible policymaking both in the short term, before the election, and in the long term -- as politicians draw lines in the sand or promise "free-lunch" solutions. The way to prevent this is to use resources such as CBO's non-partisan report, to provoke politicians of both parties into debating fiscal issues on more transparent and substantive ground.