

August 24, 2011

CBO Deficit Update: How Big Is Big?

CBO released its new budget deficit estimates this morning.

- Relative to its March report, CBO lowered its deficit estimate for FY2011 (which ends September 30) by \$116 billion to \$1.284 trillion (8.5% of GDP). This was mostly due to individual income taxes coming in faster than expected (not spending cuts). The debt-to-GDP ratio will rise to 67.3% in September.
- For FY12, CBO lowered the baseline deficit forecast by \$108 billion to \$973 billion (6.2% of GDP). However, this is based on very rosy economic assumptions and \$36 billion in extra tax receipts from letting the AMT patch, R&D credit and other must-pass extenders expire in December. The FY12 deficit estimate takes into account \$21 billion in savings from lower discretionary spending agreed to in the continuing resolution and the debt limit increase plus the assumption of an extra \$80 billion in larger-than-expected tax receipts during FY12 (note 4:1 ratio between revenue increases and spending cuts). The debt-to-GDP ratio rises to 71.2% in September 2012 (we expect it to grow to 75%).
- CBO's 2012 economic projections are rosy. It looks like they were done before the deep downward revision to the first quarter came out in July or the extended soft patch came into view. CBO assumes GDP growth of 2.3% in calendar 2011. This implies 3.75% growth in the second half of 2011. CBO then has 2.7% growth in 2012, yet has interest rates stay at near zero with inflation falling below 2%. While CBO is considered non-partisan, this set of deficit estimates looks way too low for 2012, an election year.

We expect very loose fiscal policy to continue.

- As we've warned throughout the year, there's been no progress on fiscal restraint yet and little progress is likely under the current rules. We were disappointed that Congress didn't use the debt limit increase to put realistic procedural restraints on spending growth – deficit reduction committees and sequesters haven't worked in the past and probably won't this time.
- In factoring in this year's Congressional battles over the continuing resolution in April and the debt ceiling increase in August, CBO found very little spending restraint. It shows that **legislation since the March CBO baseline increased FY11 spending by \$3 billion and reduced spending by only \$21 billion in FY12** (mostly from the discretionary spending freeze). The remainder of the projected savings from the two

agreements mostly kicks in starting in FY13. It is based on the assumption that Congress will decide to continue the current restraint on discretionary spending and that either the super committee will cut spending (not many cuts expected) or that Congress will allow the sequester process to cut spending according to the sequester rules (which is unlikely because it hits defense and Medicare spending but not Medicaid or certain other carve-outs.)

- The next opportunities for fiscal restraint are: 1) the roll-over of the continuing resolution on October 1; the Administration will threaten a government shutdown again unless business-as-usual proceeds; the House will probably want to avoid a shutdown, getting minor spending cuts; 2) the super-committee output in November; CBO doesn't assume any cuts through the super committee process; we think there may be a few cuts, leaving the rest of the \$1.2 trillion ten-year goal to the sequester and tax increase showdown after the 2012 election; 3) the 2012 election; 4) the 2013 debt limit increase.

CBO's ten-year deficit outlook is not very useful because the baseline includes rosy economic forecasts and highly unlikely tax assumptions. For example, the baseline assumes that the alternative minimum tax stops being indexed in December 2011 raising an extra \$809 billion over 10 years. We've argued that the Congressional Budget Committees should specify a different baseline to CBO more in keeping with likely policy – this would help immensely with tax reform because CBO wouldn't score extensions of current tax system as revenue losers the way they do now.

- In the 10-year baseline, CBO expects the debt-to-GDP ratio to fall to 61% in 2021 from an expected 67.3% in September. Debt held by the public, approaching \$10.2T reaches \$14.5T in 2021 (was \$18.0T in the March baseline). CBO assumes 10-year deficits are cut to \$3.5T from the \$6.7T accumulated deficits in the March baseline. Included in this improvement, it counts \$1.1T in 10-year savings from the CR and debt limit agreements; \$1.2T in savings from the sequester that is scheduled for 2013 unless Congress changes it; and \$700 billion from a deficit-favorable improvement in interest rates.
- CBO provides an alternative scenario in which more reasonable assumptions are made on taxes, yielding a debt-to-GDP ratio of 82% in 2021. In this scenario, debt held by the public reaches \$19.5 trillion in 2021. We think this is still decidedly optimistic because it includes rosy assumptions about the economy, spending restraint and tax receipts. More likely is that the debt-to-GDP ratio is on track toward 85% in 2016 and 100% in 2021.
- Regarding the Fed, CBO notes on page 67 of its report that most of the Fed's portfolio is invested in longer-term securities that are expected to be held to maturity. In CBO's baseline, the Fed's growing profits help offset the reduced revenues CBO expects from slower growth in 2012-2015.

Notes: This email and attachment are confidential and intended solely for the use of the individual to whom they are addressed. Encima Global LLC does not accept liability for the content, or for the consequences of any actions taken on the basis of the information provided. The information is not necessarily complete, and we make no warranty as to its accuracy.