CBO's Take on the Economic Outlook

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Eakinomics: CBO's Take on the Economic Outlook

The Congressional Budget Office (CBO) yesterday released an overview of its latest economic projections (cleverly titled "An Overview of the Economic Outlook: 2021 to 2031"). AAF's Gordon Gray takes a close look in his latest piece; here are a few highlights.

First, taken as a whole, CBO has upgraded the outlook noticeably. Shown below are the current projection for real gross domestic product (GDP) in orange and the previous projection (done in July 2020) in blue. As one can see, the current projection shows uniformly higher levels of output and income.

This reflects two different kinds of changes. The first is acknowledging the reality that the economy recovered much more quickly in 2020 than CBO had anticipated. (This change is mirrored in the unemployment rate, which CBO had pegged for 10.5 percent in the 4th quarter of 2020 and turned out to be 6.8 percent.)

The second is that the projection better reflects the ability of the private sector to recover. To see this, note that the third, green-gray, line is CBO's estimate of potential GDP – the amount of GDP generated when the economy is at full employment. In the 2020 projection, the economy never reaches its potential – an incredibly pessimistic viewpoint. In the current projection, the economy returns to potential in 2025 or so. That is still fairly slow, but nothing like the previous outlook.

The second aspect of the projection is how it fits into the current debate over the president's proposed $1.9 trillion stimulus package. Recall that the "theory" of stimulus is that when the economy is below full employment, government stimulus – tax cuts, checks, spending – will boost spending. This will, in turn, necessitate hiring back the laid off to meet those spending demands, which will begin a virtuous cycle of additional income to workers, more spending, and more hiring. Notice that because of the virtuous cycle, $1 of stimulus is expected to have (much) more than a $1 impact – the so-called "multiplier effect."

That's the theory – it just has nothing to do with the current policy debate.

Attentive readers will recall from the figure that currently the economy is below full employment – GDP is below potential GDP, and the difference between the two is called the "output gap." In the theory, above, stimulus plus the multiplier effects is supposed to close the output gap. According to the CBO estimates, the output gap is a bit above $650 billion. According to the administration and Hill Democrats, a stimulus of $1.9 trillion – three times the size of the output gap – is needed to get the economy back to pre-pandemic shape. Those are some pretty unimpressive multipliers! Essentially, the case being made is that every $1 of spending in the proposal will kill off $0.67 cents of existing economic activity. That's not stimulus; that's economic slaughter.

The new CBO economic projections are a realistic assessment of the state of the economy and its natural capacity for recovery. They are launched into a debate, however, that is devoid of all realism.