Insight

Three Lessons from the CBO's Long-Term Budget Outlook

GORDON GRAY | JUNE 16, 2015

Today, the Congressional Budget Office (CBO) released the Long-Term Budget Outlook, the agency's projection for the nation's finances over the next 25 years and beyond. Compared to last year's projections, the 2015 numbers are largely similar. But three important lessons can be drawn from today's updates that underscore the significance of the nation's fiscal challenge. First, while the long-term debt outlook is largely unchanged from last year, one thing has changed: the passage of another year without a structural policy reform to address the debt. This tendency increasingly shifts a long-term challenge into a near-term crisis. Second, the biggest change in the nation's fiscal outlook from last year stems from a downward-revision of interest rates. This change belies the increasing share of the federal budget consumed by debt service. Lastly, today's report reiterates past work that the debt matters, and it matters for ordinary Americans – when debt crowds out other investment, the economy suffers.

Lesson 1: No Major Change but the Date

CBO projects that debt held by the public will exceed 100 percent of GDP by 2039, and will hit 103 percent of the economy in 25 years. This is largely unchanged from last year's projection, which estimated that the debt would be 106 percent of GDP by 2039.

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There were some revisions that altered the outlook slightly, but the rough magnitude and trajectory is the same, and given the uncertainty in long-term projections, the end points are quite similar. One key distinction from last year's projection is simply the passage of one more year. With the continued passage of time the "long-term" budget outlook becomes the near-tem budget outlook. Given the tepid economic growth projection, geopolitical risks, and already high debt levels, a year of inaction is irresponsible.

Lesson 2: Revisions Driven by Interest

While the nation's fiscal outlook is largely unchanged, the few changes reveal important trends in the federal budget; specifically, the rapid growth of debt service costs. CBO largely ascribes their downward revision of the debt to a reduction in the projection in interest rates. In 2014, CBO estimated that the average real interest rate on 10-year Treasuries would be 2.5 percent. Now, CBO projects this rate will average 2.3 percent, owing to evidence that market participants expect lower interest rates over this time period. The reduced interest rate corresponds to average interest rate on all federal debt of 2 percent, down from 2.2 percent last year. While not a sweeping reduction, this downward revision drives the reduction in the projected debt because interest is increasingly a major federal expenditure – and unlike even policy-stubborn mandatory spending, cannot be directly or effectively altered by policymakers.

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Indeed, interest expense will nearly triple over the next 25 years, squeezing other federal priorities. This is the consequence of the rapid accumulation of debt, the continued upward debt trajectory, and the projected normalization of interest rates. Despite the massive accumulation of the debt during the financials crisis, the cost of borrowing remained low given the low interest rate environment. As interest rates rise, albeit slowly, the cost of rolling over the nation's debt portfolio will increase. While the Treasury is taking steps to reduce this exposure by issuing longer-term securities, it will not wholly shield the budget from rising interest costs. These costs will only grow faster as the U.S. continues to add to the debt over the coming years.

Lesson 3: The Debt Matters

The national debt can sometimes appear as just an abstraction – an incomprehensively large number with an indirect effect on the economy. But the debt ultimately affects paychecks and the standard of living. As the federal government borrows more, it takes away resources that would otherwise be invested elsewhere, known as crowding out. This crowd out effect lowers the accumulation of capital and reduces the economic growth over time. Reduced economic growth ultimately harms incomes for working Americans. Moreover, CBO's projections don't normally take into account other important effects that fiscal policies can have on behavior and the size of the economy. Taking these elements into effect further alters the economic and fiscal outlook.[1]

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Ultimately, higher debt is associated with lower incomes, with American's risking $2,000 -$4,000 per person by 2040 if the nation's unsustainable deficits are not addressed.

[1] For a more detailed account of CBO's macroeconomic analysis as it relates to the long-term budget outlook, see chapter 6: https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/50250-LongTermBudgetOutlook.pdf#page=77