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Economics Group

Special Commentary

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Federal Fiscal Policy Chartbook: What's the Baseline?

A Tough Operating Framework for Fiscal Policy

In the coming months, Congress and the administration will continue to work through a lengthy list of legislative items, including lifting the debt ceiling, funding the government, tackling a repeal and possible replacement for the Affordable Care Act (ACA) and attempting to pass major tax legislation. While the details and political likelihood of these proposals have yet to fully develop, one of the biggest challenges facing policymakers is the fiscal outlook under current law. This year's Budget and Economic Outlook published by the Congressional Budget Office (CBO) shows rising deficits and higher debt levels over the next 10 years.[1] As the fiscal policy debate continues to unfold, it is an open question whether more conservative members of Congress will agree to even greater deficit spending and debt if proposed budgetary offsets prove to be politically unpalatable. In our fiscal policy outlook, we review the current law baseline for federal spending and revenues to provide some context for the coming fiscal policy debates. In addition, we compare the assumptions employed by the CBO with our own economic forecast.

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Over the next 10 years, if current law remains unchanged, CBO expects federal revenues and outlays to average 18.1 percent of GDP and 22.0 percent of GDP, respectively. The result is a large and growing budget gap that climbs from 2.9 percent of GDP in federal fiscal year (FY) 2017 to 5.0 percent of GDP by FY 2027. The stock of debt, measured by the debt-to-GDP ratio, would climb roughly 12 percentage points from today's level to 88.9 percent of GDP in FY 2027.

The growth in annual deficits and by extension federal debt stems primarily from growing outlays for the major health care programs, Social Security and net interest expenses. These three components of the budget comprised about 56 percent of total federal spending in FY 2016 and, under CBO's baseline, would account for roughly 67 cents of every dollar spent by the federal government in FY 2027. Against this backdrop, Congress and the administration will face significant challenges fitting their policy ideas within the long-term fiscal outlook.

Figure 1

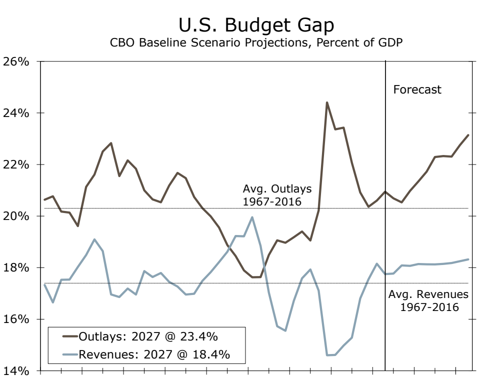
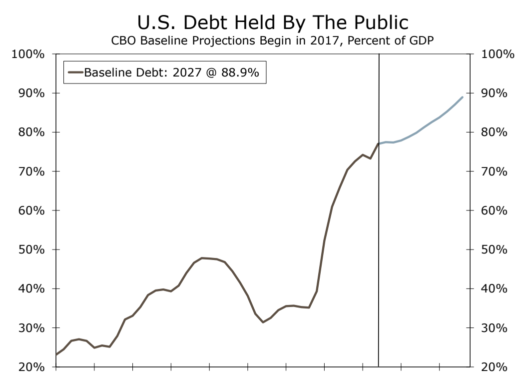


Figure 2



Source: Congressional Budget Office and Wells Fargo Securities

[1] **Congressional Budget Office. (2017).** ***The Budget and Economic Outlook: 2017 to 2027.***

We Expect Greater Deficits Relative to the Baseline

The current law baseline from the CBO serves as a key yardstick by which future policy actions will be measured.

The current law baseline from the CBO serves as a key yardstick by which future policy actions will be measured. With large and growing budget deficits under current law, enacting policy changes that do not make the fiscal outlook significantly worse remains the biggest challenge for policymakers.

Amid all of the debates over tax reform, ACA repeal, deregulation, immigration, trade and a slew of other policy areas, the discussion regarding the unsustainability of many entitlement programs and their adverse effect on the budget outlook has been drowned out. For example, the latest Trustees report on the state of the Social Security program shows that, without congressional intervention, the trust fund will be exhausted in 2034, resulting in an automatic 21 percent reduction in benefits.[2] Critically, the key drivers of federal debt growth in the years ahead are either programs the Trump administration has signaled some unwillingness to alter (such as Social Security and Medicare) or spending that policymakers can do little to change (net interest). Thus, financing these programs over the long-run translates into higher taxes, dramatically reduced spending on discretionary programs or greater deficit spending through debt issuance. The current baseline projections for the federal budget are a key hurdle as policy makers attempt to implement their policy wish list.

In our February *Monthly Economic Outlook*, we established a set of assumptions about the future path of federal fiscal policy. Among these assumptions were an increase in defense spending, the repeal and partial replacement of the Affordable Care Act and related taxes, individual income tax cuts and corporate tax cuts. At this time, we do not see a path for additional infrastructure spending, although some tax breaks for infrastructure projects are expected. With these assumptions, we see the federal budget deficit for the current 2017 fiscal year climbing to $650 billion or 3.4 percent of GDP compared to the CBO's estimate of $559 billion or 2.9 percent of GDP. For fiscal year 2018, we expect a federal budget deficit of $950 billion or 4.7 percent of GDP compared to the CBO's current law baseline of $487 billion or 2.4 percent of GDP.[3] In our outlook, we do not assume that the additional fiscal stimulus, mostly in the form of tax cuts, will be paid for through offsetting reforms, such as the border adjustment tax. Thus, our outlook entails much higher budget deficits relative to the CBO's outlook. The bottom line is that even under current law, the fiscal outlook remains on an unsustainable course, a path that will look much worse should fiscal policy actions result in even larger deficits in the years ahead.

Figure 3

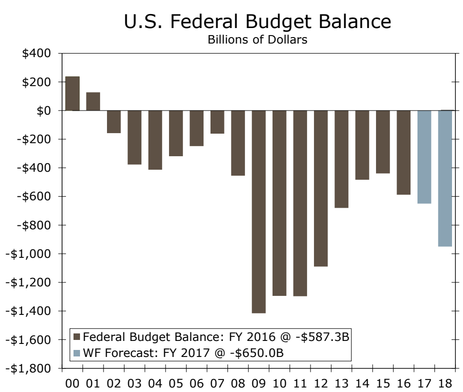
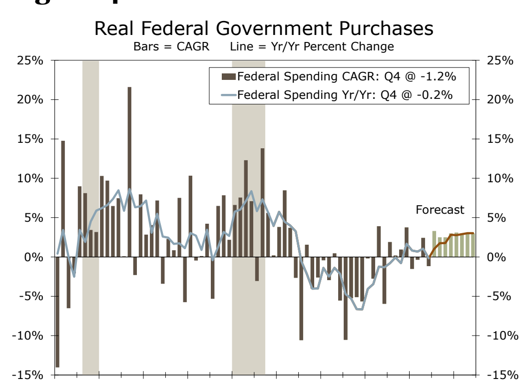


Figure 4

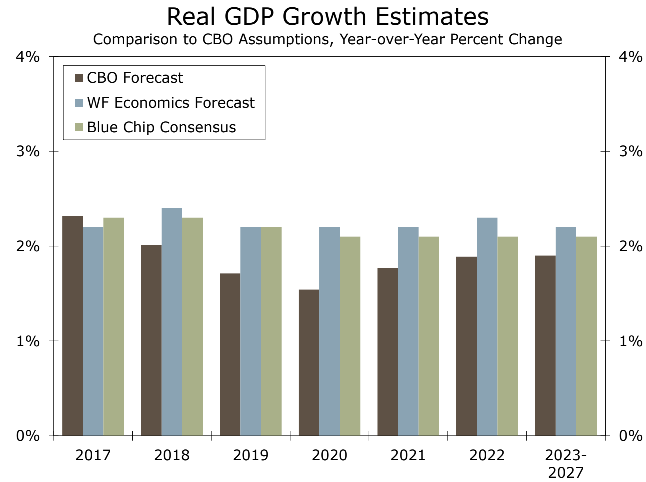


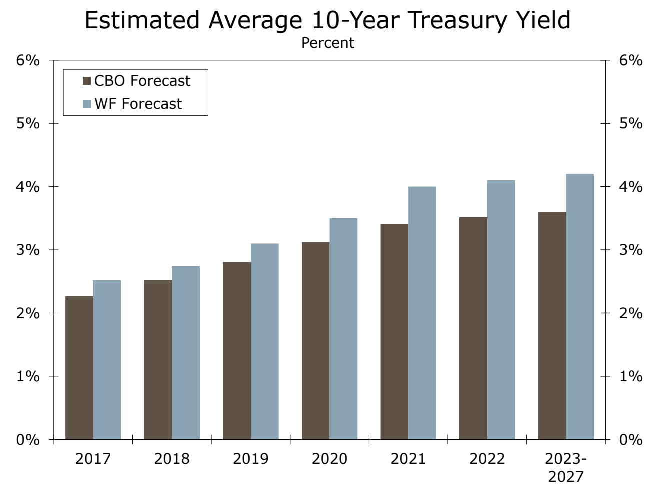
Source: U.S. Department of the Treasury, U.S. Department of Commerce and Wells Fargo Securities

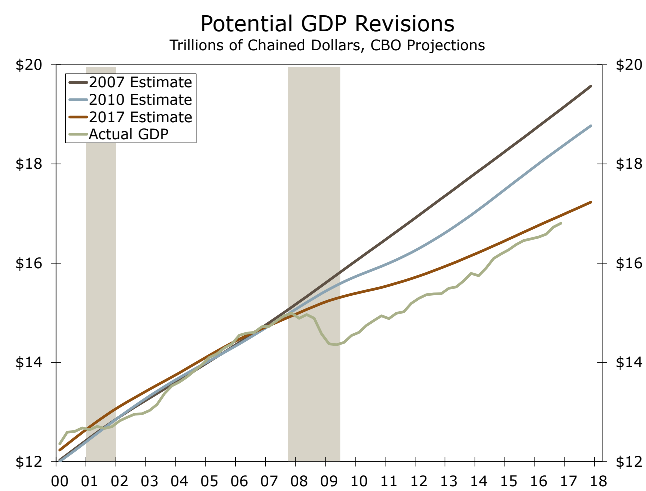
[2] The Board of Trustees, Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds. (2016). *The 2016 Annual Report of the Board of Trustees, Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds.*
[3] CBO's baseline assumptions assume that current law remains unchanged.

Economic Assumptions

- CBO's economic assumptions are key to understanding how its budget projections will develop over the next 10 years. As can be seen in the top graph, the CBO expects real GDP to grow 2.3 percent in 2017 and 2.0 percent in 2018. Beyond the near term, CBO estimates that real GDP growth will slow to 1.5 percent by 2020 before gradually returning to a 1.9 percent pace toward the end of their forecast horizon. It is important to note that the CBO does not attempt to forecast business cycles beyond a two-year window.
- Relative to our forecast and that of the Blue Chip Consensus, the CBO's estimates are nearly in agreement for this year. However, the CBO has a slower pace of real GDP growth over the remaining nine years.
- CBO estimates that the rate of potential GDP growth is 1.9 percent, which is above the 1.4 percent pace estimated for the 2008-2016 period. The key assumption behind this projected pick-up is that the potential productivity of the labor force will grow more quickly over the next several years. In prior years, CBO has repeatedly revised down its path of potential real GDP growth for a variety of reasons, including slower labor force and productivity growth. This year, CBO once again downgraded its assessment of potential GDP growth.
- CBO expects the Consumer Price Index to rise 2.4 and 2.3 percent in 2017 and 2018, respectively, and then average 2.4 percent in 2019 and beyond. The inflation outlook from the CBO closely matches that of both our economic outlook and the Blue Chip Consensus.
- With respect to interest rates, CBO expects the fed funds rate to end this year at 1.1 percent and end 2018 at 1.6 percent. While our forecast is in agreement for this year, we have one more fed funds rate hike built into our outlook for 2018 relative to the CBO's outlook.
- We estimate that the 10-year U.S. Treasury yield will average around 3.7 percent from 2019 through 2022 and 4.2 percent from 2023 to 2027 compared to the CBO's estimates of 3.2 percent and 3.6 percent over the same two periods. As we will see in the next section, these slight differences in rates can have dramatic implications for the fiscal policy outlook.



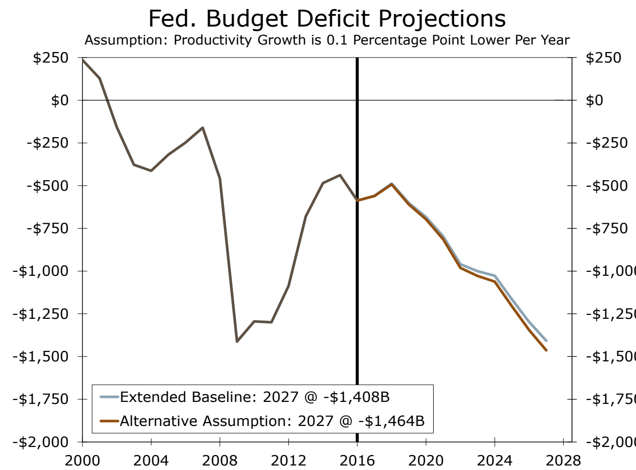


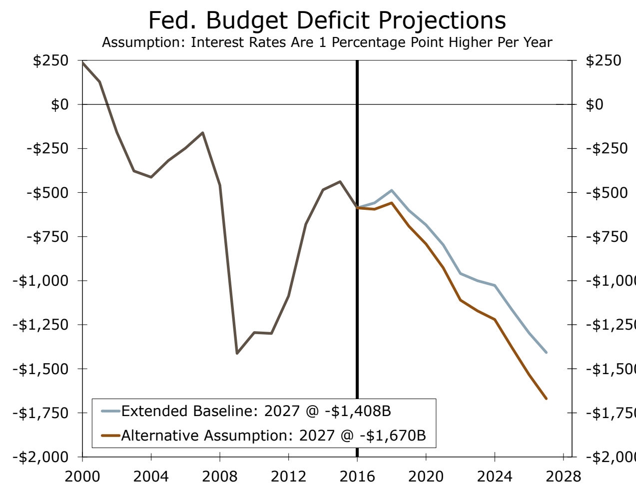


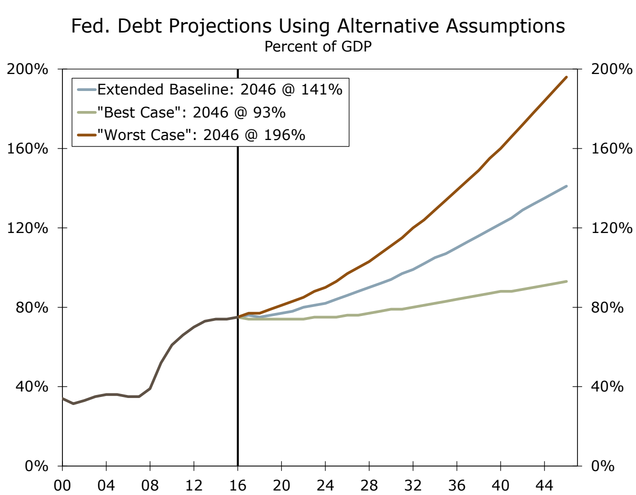
Source: Congressional Budget Office, U.S. Department of Commerce, Blue Chip and Wells Fargo Securities

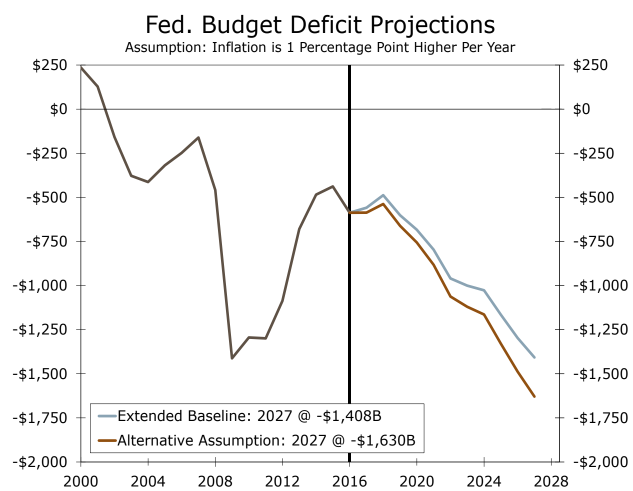
Alternative Economic Assumptions

- One of the more interesting aspects of the CBO's Budget and Economic Outlook is the sensitivity analysis around its economic assumptions. These alternative assumptions highlight the wide range of possible fiscal outcomes depending on differing economic inputs.
- If productivity growth is assumed to be 0.1 percentage point lower than the CBO baseline, real GDP growth would also be 0.1 percentage point lower each year. Under this scenario, taxable income would grow more slowly, resulting in a cumulative increase in the deficit of $273 billion from 2018 through 2027.
- Assuming inflation grows roughly at the rate CBO projects over the next ten years but interest rates are one percentage point higher per year, the net result would be a higher real interest rate. If real interest rates are one percentage point higher than the baseline projections, the cumulative impact on the federal deficit would be $1.6 trillion higher than the baseline estimates, mostly due to significantly higher net interest outlays.
- If actual inflation is one percentage point higher per year relative to the CBO's baseline assumption discussed above, the result would be an additional $1.2 trillion in additional deficit spending as revenues would increase by about 6 percent over the 10-year window, while outlays would be 7 percent higher than the baseline estimate.





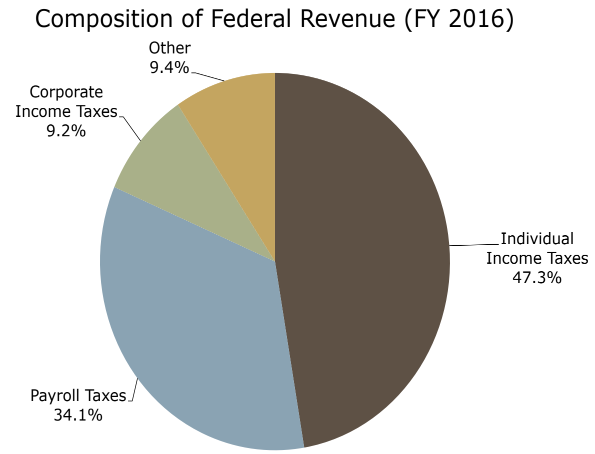


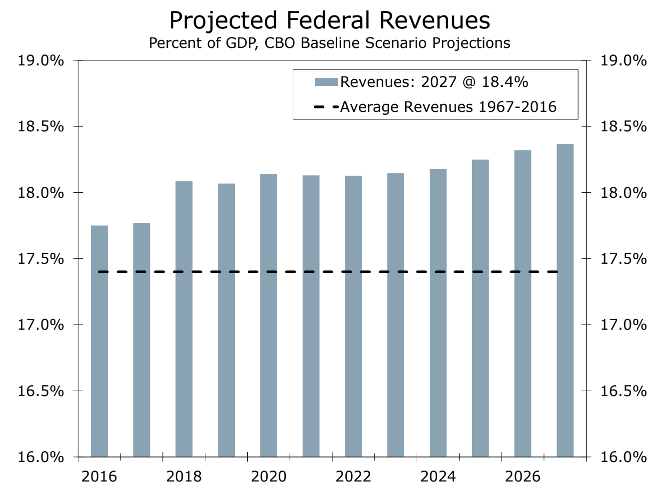


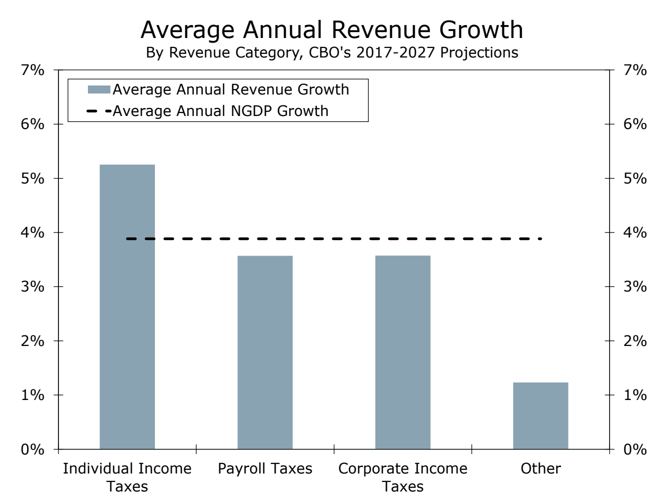
Source: Congressional Budget Office and Wells Fargo Securities

Federal Revenues

- Federal revenue growth has slowed significantly over the past couple years. Several factors have driven the slowdown, including lower capital gains realizations, weak corporate profits and one-off policy changes. Even with the sharp deceleration, federal revenues in fiscal year 2016 were 17.8 percent of GDP, 0.4 percentage points above the average over the past 50 years.
- The CBO expects that federal revenues as a share of GDP will remain above their long-run average over the next decade. Individual income taxes will drive much of the increase, primarily due to a phenomenon known as real bracket creep. The income limits for marginal tax rates are adjusted for inflation each year, but since income growth typically outpaces inflation, taxpayers are pushed into higher tax brackets over time due to real income growth. Faster income growth for high-earners is also expected to boost revenues as a result of higher effective tax rates for these workers, although a declining share of wages subject to the Social Security payroll tax would partially offset this dynamic.
- Tax expenditures have become a hot topic amid the tax reform debate. This term typically acts as a catchall for a slew of exclusions, deductions and credits throughout the tax code. Some of the largest include the exclusion for employer-contributions for health insurance, the deductions for state and local taxes and the mortgage interest deduction. Estimates from the Joint Committee on Taxation and the CBO suggest that tax expenditures will total 8 percent of GDP in 2017, or nearly half of all federal revenues for the year.
- On balance, federal revenue growth will likely rebound in the year ahead amid faster economic growth. However, despite above-average revenue collections, the debt and deficit outlook will continue to worsen as a result of projected spending that outpaces revenues.
- This dynamic will create a hurdle for policymakers as they weigh tax reform that achieves deficit-neutrality. Progressivity will likely also be a key issue in the tax reform debate; according to a study performed by the CBO, in 2013 the top quintile of earners paid 69 percent of all federal taxes. Given this, an outsized share of the benefits from an across the board tax cut would likely accrue to top earners, which could become a point of contention.



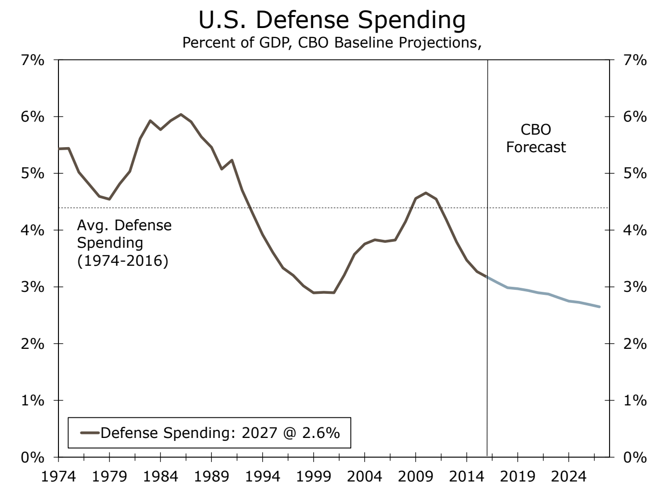


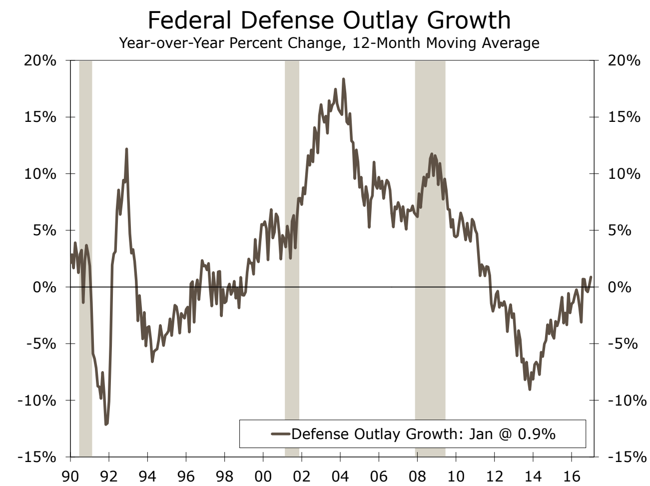


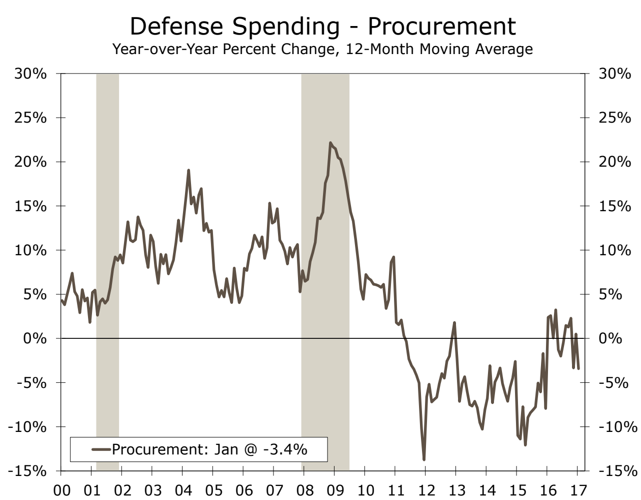
Source: Congressional Budget Office and Wells Fargo Securities

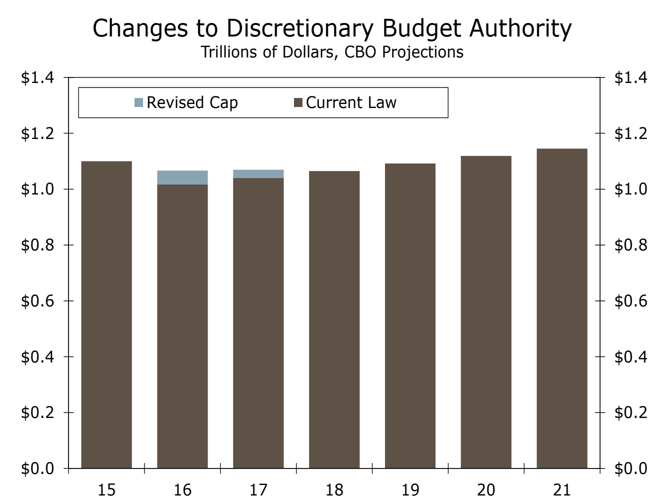
Discretionary Spending–Defense

- With the winding down of the wars in Iraq and Afghanistan and the budget caps imposed by the Budget Control Act (BCA) of 2011, defense spending as a share of GDP has declined from a peak in 2010 of 4.7 percent to 3.2 percent in fiscal year 2016.
- Defense outlays rose 0.1 percent in fiscal year 2016, the first increase since 2011. That said, the slight increase was related to the timing of military compensation rather than an appropriated increase in defense spending.
- Under the Budget Control Act, across the board budget cuts were enacted for both defense and nondefense discretionary programs through 2021. The cuts to both defense and non-defense programs were mitigated through FY 2017 under the Bipartisan Budget Act of 2015.
- Federal defense cuts under the BCA are scheduled to resume in fiscal year 2018 which, without changes from Congress, will result in a cut to defense spending subject to the budget caps of $2 billion in the next fiscal year.
- One category that is exempt from the BCA is overseas contingency operations (OCO) funding, typically war related activities. CBO expects OCO funding to rise roughly in line with the rate of assumed inflation over the coming years, which results in a higher budget authority level and by extension, higher outlays.





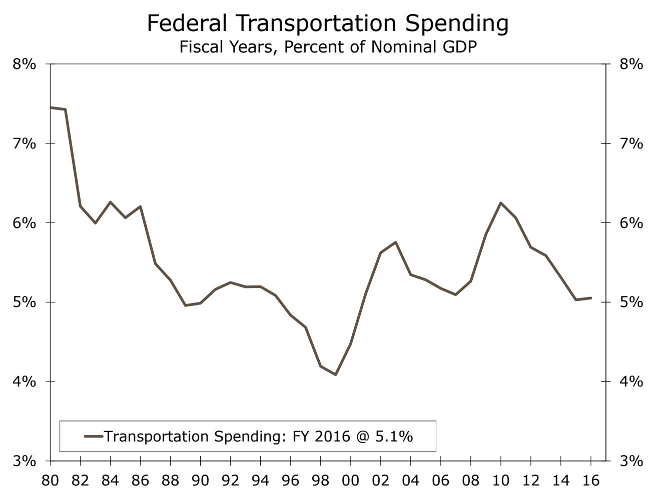


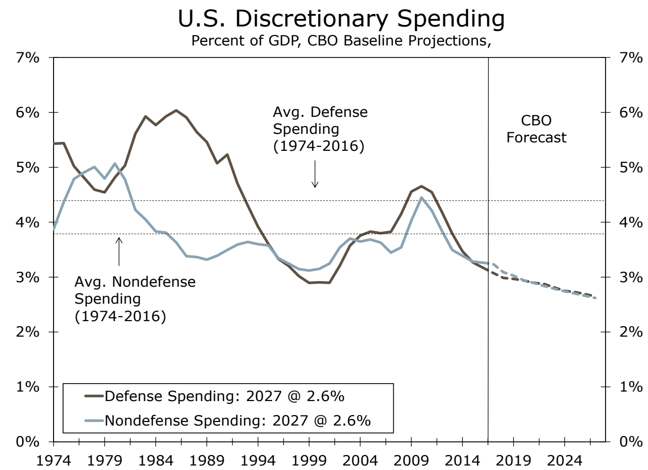


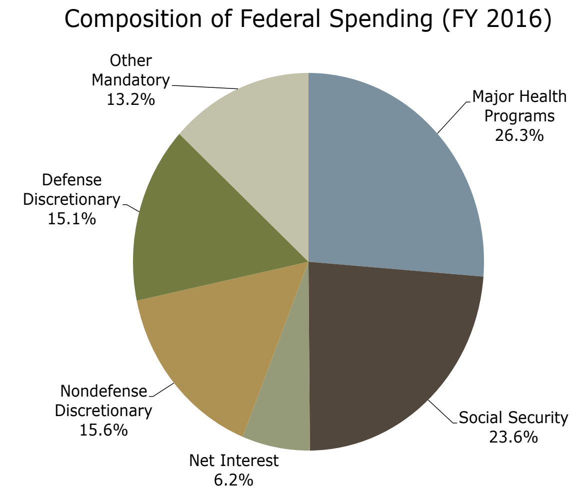
Source: Congressional Budget Office, U.S. Department of the Treasury and Wells Fargo Securities

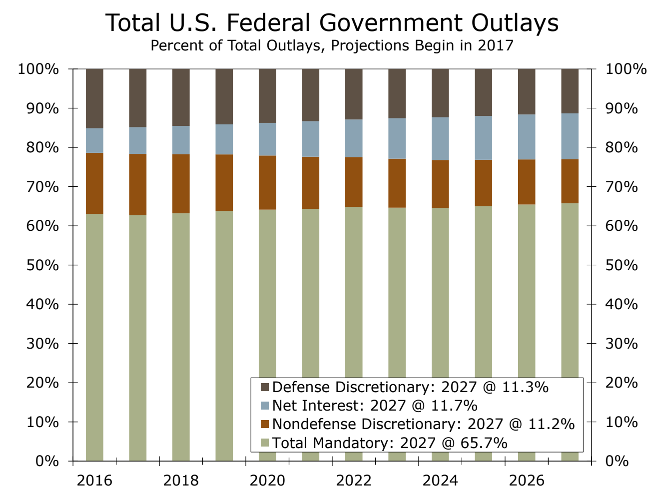
Discretionary Spending–Nondefense

- Nondefense discretionary spending includes a wide range of federal programs including research, education, infrastructure spending, environmental protection, federal employment and many other government operations not falling into the category of defense spending.
- In federal fiscal year 2016, nondefense discretionary spending rose 3 percent, or $15 billion, mostly as a result of a lower negative subsidy rate for mortgage guarantees by the Federal Housing Administration. As a share of GDP, nondefense discretionary spending was 3.3 percent, unchanged from fiscal year 2015.
- The Budget Control Act of 2011 also established a scheduled set of cuts for nondefense discretionary spending through 2021. Given that the Bipartisan Budget Act of 2015 is expiring beginning October 1 of this year, nondefense discretionary spending subject to the budget caps is expected to decline by $3 billion if current law remains unchanged.
- Transportation spending as a share of GDP has been declining since 2010 when it peaked at 6.2 percent. However, following the passage of the FAST act in 2015, transportation spending as a share of GDP began to grow slightly in fiscal year 2016, rising to 5.1 percent of GDP.
- Overall, CBO projects that nondefense discretionary spending will continue to decline as a share of the economy through the end of its estimation window of 2027.





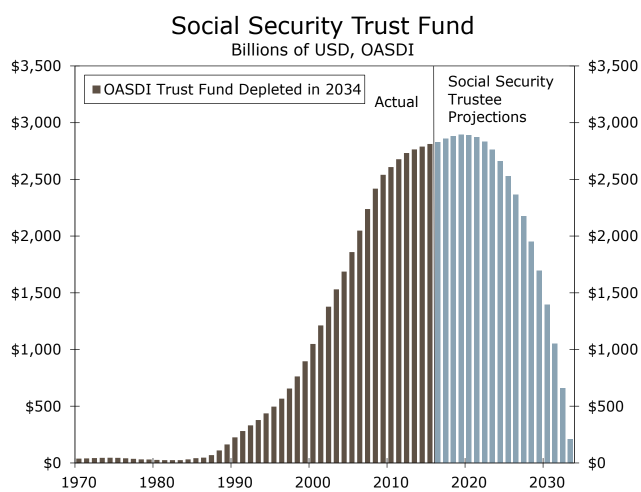


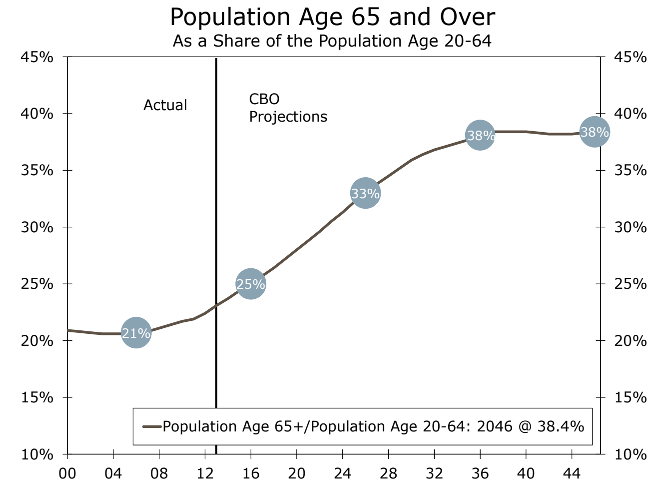


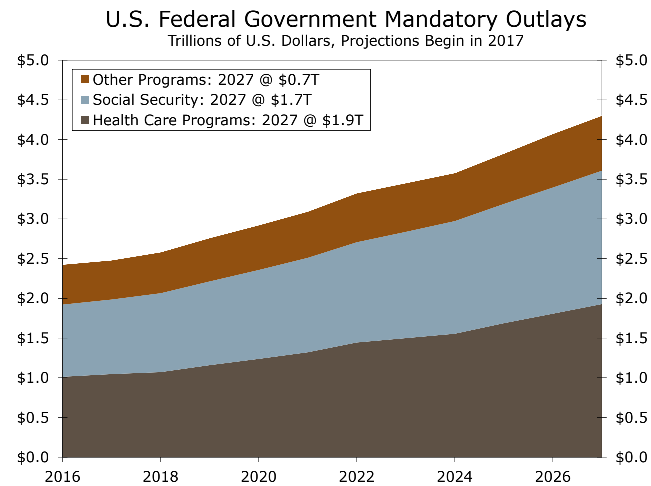
Source: Congressional Budget Office, U.S. Department of the Treasury and Wells Fargo Securities

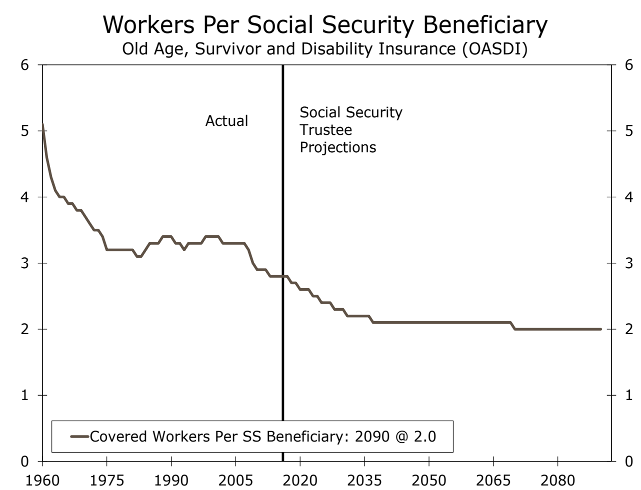
Social Security

- The aging of the population presents a significant challenge for the long-run sustainability of Social Security. The population age 65 and over as a share of those age 20-64 is expected to rise from about 25 percent today to 38 percent by 2046. This in turn has led to a declining number of workers per Social Security beneficiary.
- Contrary to some popular belief, the Social Security Trust Fund remains intact and ended FY 2016 with about $2.8 trillion in assets. However, the cash flow for the program (defined here as tax revenues coming in minus outlays going out) has been negative since 2010. As the aging of the population continues, the Trust Fund will continue to dwindle as reserves are utilized to meet promised benefits. Without any congressional action, the Social Security Trustees project that the Trust Fund will run dry in 2034, at which point a 21 percent cut in benefits would occur to bring spending in line with dedicated revenues.
- The economic implications of Social Security's solvency are in large part a result of the program's size and scope. About 60 million people received benefits from Social Security in 2015, and 61 percent of aged beneficiaries received at least half of their income from Social Security in 2014.
- Some combination of tax increases, benefit cuts or deficit spending will be needed to fully meet scheduled benefits over the ensuing decades. The sooner policymakers act, the less draconian policy will have to be to achieve long-run sustainability.





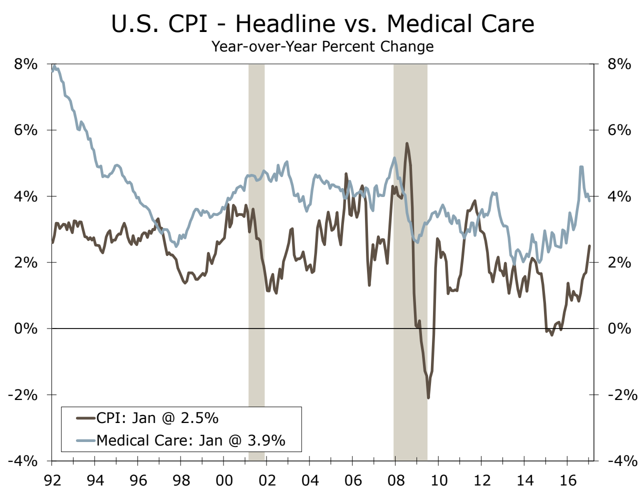


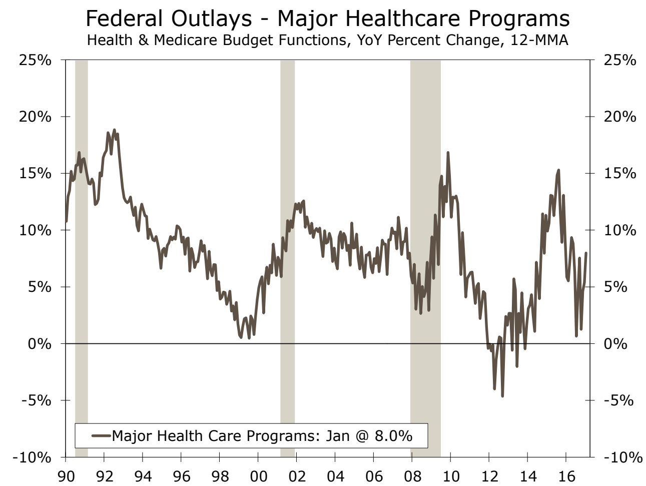


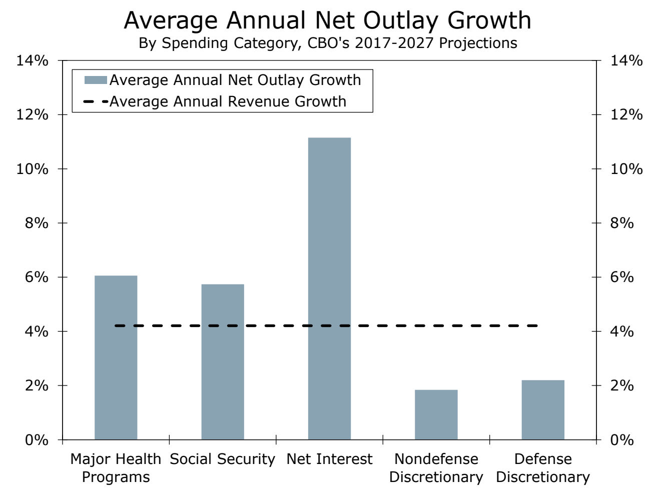
Source: Congressional Budget Office, Social Security Administration and Wells Fargo Securities

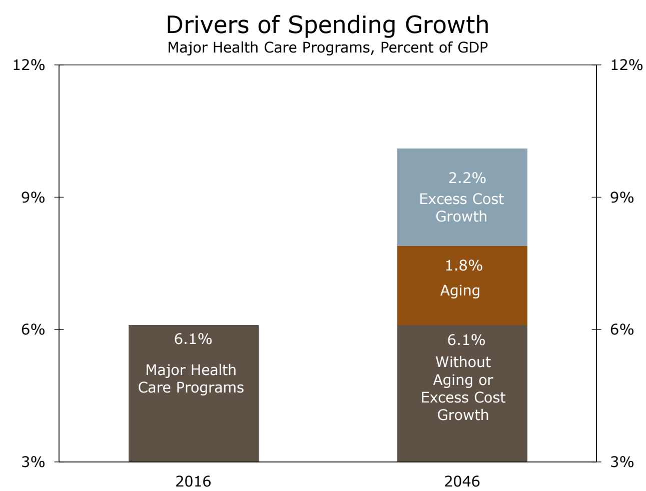
Major Health Care Programs

- The major federal health care programs include Medicare, Medicaid, the Children's Health Insurance Program and subsidies for purchasing health insurance under the Affordable Care Act. These programs accounted for roughly a quarter of federal spending in FY 2016. Of these programs, Medicare comprises the biggest slice: net of offsetting receipts, Medicare spending was $588 billion in FY 2016, about the same amount the federal government spent on national defense.
- Medicare (and to an extent Medicaid, which also provides some health coverage to the elderly) face a dual-threat on the sustainability front. The aging of the population will create fiscal strain for these programs similar to the problems facing Social Security. However, rising medical care costs are also expected to create fiscal headaches. Spending per enrollee in Medicare is projected to increase at an average annual rate of 4.3 percent over the next decade.
- In the years ahead, spending on the major health programs will likely outpace federal revenue growth and be one of the main drivers of the growth in the deficit. The CBO anticipates that Medicare spending alone will account for 22 percent of the total increase in outlays between 2017 and 2027. As a share of GDP, the CBO projects that spending on these programs net of offsetting receipts will increase from 5.5 percent in FY 2016 to 6.9 percent in FY 2027.





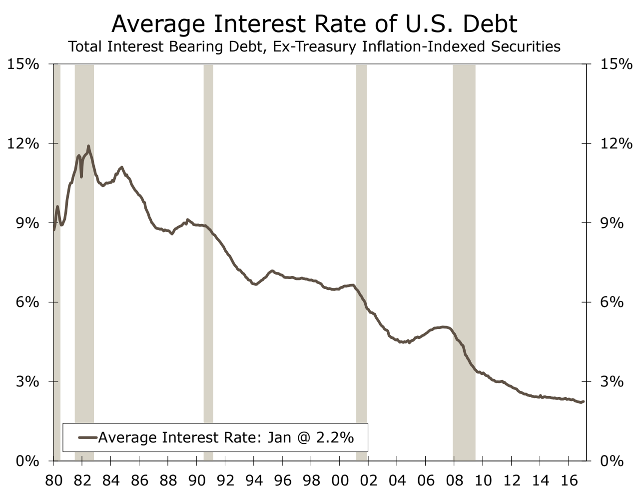


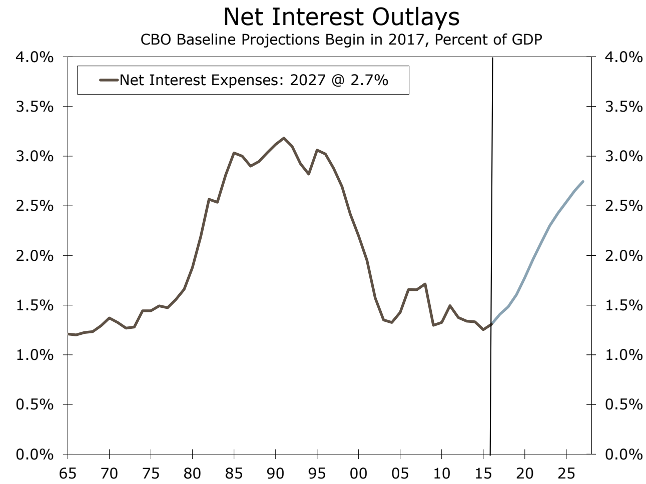


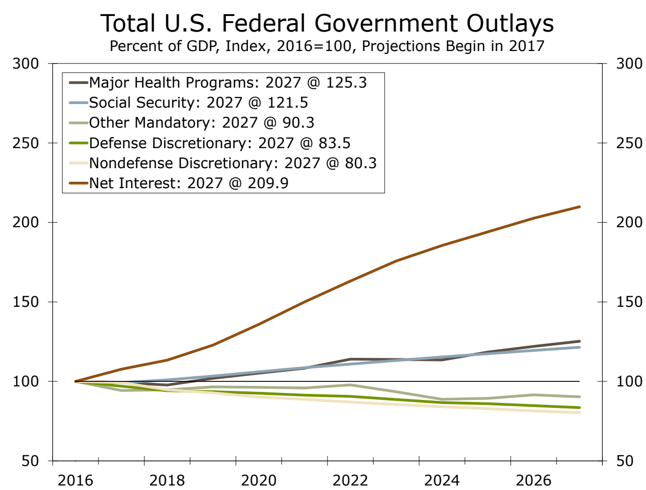
Source: CBO, U.S. Dept. of the Treasury, U.S. Dept. of Labor and Wells Fargo Securities

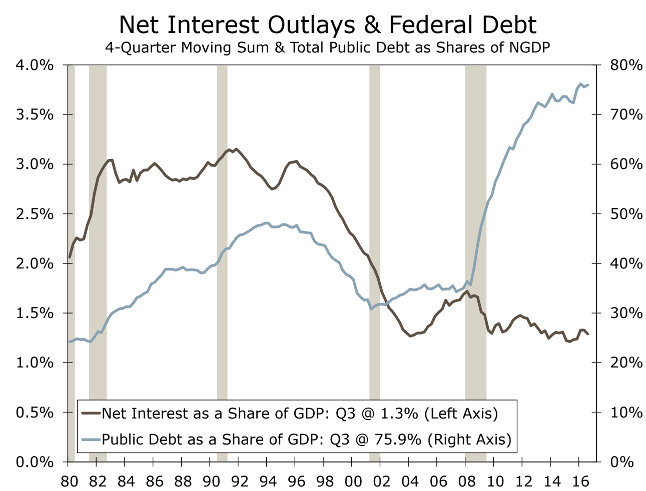
Net Interest Spending

- Net interest spending is projected to be the fastest growing segment of the federal budget over the next decade. Like the major health care programs, there are two key factors driving net interest spending higher. A rising stock of debt, coupled with rising interest rates, will generate significant budgetary pressure. Net interest expenses are expected to rise from 1.3 percent of GDP in FY 2016 to 2.7 percent of GDP by FY 2027.
- Despite a doubling in debt held by the public as a share of GDP, the federal government's net interest costs have remained relatively tame. Historically low interest rates have kept a lid on net interest spending.
- Under the CBO's baseline, both debt and interest rates will continue to climb. The debt-to-GDP ratio is estimated to rise from 77 percent today to 88.9 percent over the next 10 years.
- CBO's baseline scenario assumes the yield on the 10-year will rise from 2.2 percent in FY 2017 to its equilibrium value of 3.6 percent by FY 2023. In this scenario, interest spending would consume 12 cents of every federal dollar spent in FY 2027 compared to 6 cents today.
- Forecasting the path of interest rates over the next decade is one of the biggest challenges and most important assumptions when considering the long-run fiscal baseline. Over a long period of time, the federal budget is highly sensitive to changes in interest rates.









Source: Congressional Budget Office, U.S. Department of the Treasury and Wells Fargo Securities

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