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Economic Watch
US

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Economic Analysis

US
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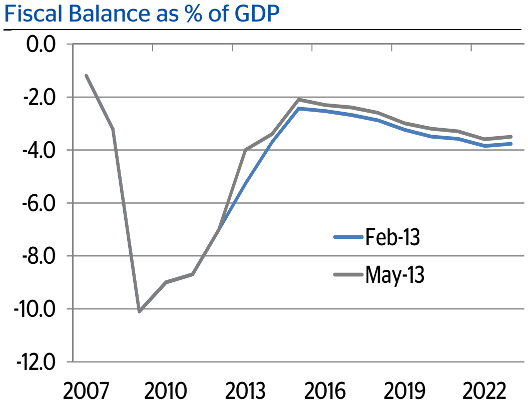
CBO Releases Updated Budget Projections
Significant Improvements in Deficit Outlook for 2013 and Beyond

- **Fiscal deficit estimated to be 4.0% of GDP in 2013 vs. prior estimate of 5.3%**
- **Sequestration accounts for biggest change, reducing outlays through 2023**
- **Another summer of increasing political uncertainty lies ahead**

This week the Congressional Budget Office (CBO) released updated budget projections for fiscal years 2013-2023. The previous report was released in February, just a month before Congress officially approved the $85bn worth of automatic spending cuts to be implemented for FY2013. The CBO is usually quite optimistic when it comes to fiscal projections, so it is not surprising that the updated report shows a brighter picture for the government's budget balance, particularly in the near-term. For 2013, revenues are expected to be nearly 4% more than previously estimated in February, while outlays are projected to be 2.8% lower. Ultimately, the CBO estimates that the fiscal deficit will approach 4.0% of GDP this year, compared to February's estimate of 5.3%. This is a significant improvement compared to previous estimates and also compared to our baseline forecast which calls for a deficit of 5.4% of GDP in 2013. Our projections are a bit more aligned with the CBO's for 2014 and 2015 at 3.8% and 2.6% of GDP, respectively.

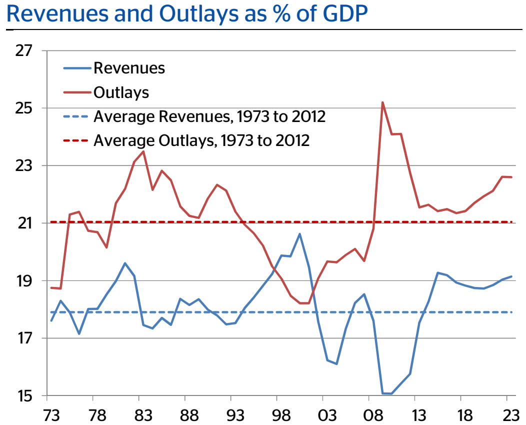
These updated projections, based on recent changes to both the political and financial spheres, are divided between outlays and revenues. In terms of outlays, the CBO has revised its projections based on the decline in spending for both mandatory and discretionary programs. A significant portion of the decline in outlays comes from an adjustment in the payments from Fannie Mae and Freddie Mac, which are expected to make quarterly payments to the Treasury. Directly related to net worth, these payments are categorized as offsetting receipts and the CBO estimates that they will provide an additional $95bn in offsetting pressure, decreasing the budget deficit in 2013. For the longer term 2014-2023, reductions come from three mandatory programs (social security, Medicare and Medicaid) and net interest costs. Projected to reduce outlays over the remaining 9-year period by $522bn, the CBO points toward the recent sequestration as the source of their revised projections due to the across the board budget cuts. Both nondiscretionary and discretionary spending is expected to decline due to the budget cuts but the CBO warns that their estimate could increase if political action is taken to prevent some of the expected spending reductions.

Chart 1
Fiscal Balance as % of GDP



Source: CBO & BBVA Research

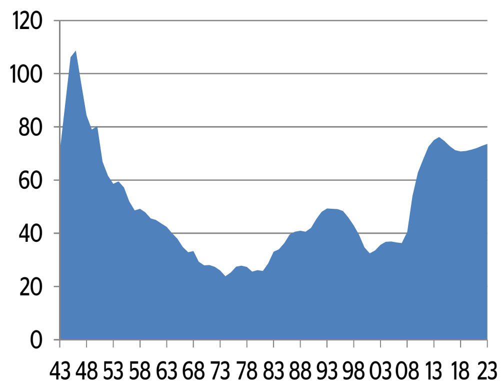
Chart 2
Revenues and Outlays as % of GDP



Source: CBO & BBVA Research

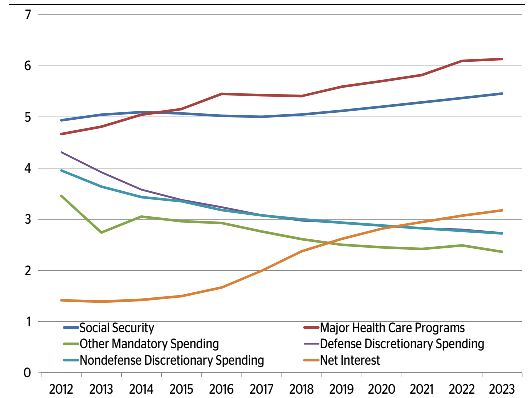
On the revenues side, the CBO revised its estimate upward for tax revenues as a percent of GDP for 2012-2015 due to the recent rise in income tax and its effects on taxable income. As of January 2013, the 2% payroll tax cut expired, prompting taxpayers to realize income in 2013 in anticipation of the higher tax rate. The CBO estimates that this shift in realized income onto 2012 taxes will increase revenues as a percent of GDP from 15.8% to the newly projected 17.5%. This increase also happens in 2013 and the CBO estimates it will likely happen until 2016 when the rate stabilizes at 19% through 2023. As suggested by the CBO in reference to outlays, the situation is subject to the administration's policy actions throughout the period. If President Obama were to implement a tax cut that reversed some or all of the gains in revenue, it stands to reason that the current projections would no longer be accurate and have to be estimated lower.

Chart 3
Federal Debt Held by the Public as % of GDP



Source: CBO & BBVA Research

Chart 4
Government Spending as % of GDP



Source: CBO & BBVA Research

Bottom line: A Never-ending Story…

Overall, the CBO's revised projections do not affect the mid to long run view of fiscal policy. Short term effects are predominantly based on the status quo prevailing over the next half decade which the CBO cautions is possible but far from guaranteed. Considering that the current budget negotiations are scheduled for debate by the end of September, there could be policy meant to curb or increase certain outlays. However, given the lack of progressive negotiation concerning the sequestration and payroll tax increase, the status quo is likely to remain permanent. If policy were to prevail that would partially or completely avoid the spending cuts set for the next decade then, as the CBO states, the budget deficit would enlarge as outlays increase across in line with whatever the policy dictates. Furthermore, the debt ceiling suspension expires May 19th, but the Treasury Department can manage to pay off debts until the end of the fiscal year – but what comes next? On par with the past year of political uncertainty, we can most likely expect the coming months to incite reoccurring political fissures that result in a "kick the can down the road" outcome.