CBO’s Q&A aims to clarify impact of new budget legislation

By Editor Test *Mon, Jan 7, 2013*

The new law increases budget deficits relative to what would have happened if all the Bush-era tax cuts had been allowed to expire, but decreases budget deficits relative to what would have happened if all the Bush-era tax laws had been extended, the CBO explains.

In response to the large number of questions it has received from the public about the impact of the recently-enacted federal budget legislation, the Congressional Budget Office (CBO) has provided the following Q&A for guidance:

Does the legislation increase or decrease federal budget deficits?

That depends on what you compare the legislation with: Relative to what would have occurred under the laws previously in effect, this legislation will *increase* budget deficits in coming years. Relative to what would have occurred if most tax and spending policies that were in effect in 2012 were continued, this legislation will *reduce* budget deficits in coming years.

Like all of CBO’s cost estimates, our estimate for this legislation shows the effects of the legislation relative to current law at the time we did the estimate. Relative to the laws in place at the end of 2012, we estimate that this legislation will reduce revenues and increase spending by a total of nearly $4.0 trillion over the 2013-2022 period. (Also like all of CBO’s cost estimates, this estimate’s numbers for the effect of changes in the tax code—which represented the bulk of the bill—were produced by the staff of the Joint Committee on Taxation. They published the details of their tax revenue estimates separately.)

From that perspective, why will the legislation increase deficits? Mostly because, under the laws previously in place, numerous tax provisions originally enacted in 2001, 2003, and 2009 would have expired. As a result, in 2013 personal income tax rates would have gone up for people at all income levels, the alternative minimum tax (AMT) would have applied to many more people, estate and gift taxes would have risen, and a number of other revenue-increasing changes in tax law would have taken effect. This legislation will prevent those changes in law from occurring or reduce their scope; hence, relative to what would have happened without the legislation, it embodies substantial tax cuts. The legislation also will boost deficits by increasing spending, mostly for refundable tax credits and unemployment compensation.

That dramatic widening of the budget deficit will increase interest payments on the federal debt, an impact that is not included in CBO’s cost estimates. The additional debt service will cost about $600 billion. Thus, if we added the estimated cost of the legislation and the related debt service to our previous baseline budget projections (which followed current law at the time), we would show additional deficits between 2013 and 2022 of roughly $4.6 trillion.

Instead of comparing legislation with the *law* that was in effect at the end of 2012, one might also compare it with the tax and spending *policies* that were in effect in 2012 (or, in the case of the AMT, in 2011). Many of those policies were scheduled to expire at the end of December—but suppose instead they had been continued. If so, revenues would have been noticeably less than they would have been under the laws scheduled to be in effect in 2013 and beyond.

For example, CBO reported in its August *Update to the Budget and Economic Outlook* that extending certain income tax and estate and gift tax provisions scheduled to expire on December 31, 2012, and indexing the AMT for inflation would have boosted deficits by roughly $4.5 trillion during the 2013-2022 period through a combination of reduced revenues and increased outlays for refundable tax credits (see Table 1-5, page 19).

The extensions just enacted were less extensive than those assumed for that calculation, and hence the deficit increases as a result of the new legislation will be smaller than that: The cost of the comparable tax provisions in the legislation just enacted is estimated to be about $3.9 trillion over that decade.

Therefore, compared with an approach of extending the policies in CBO’s example, the legislation will have a smaller cost—probably in the range of $0.6 trillion to $0.7 trillion less. (Beyond those provisions, the legislation’s other changes to current policies were very small. CBO does not publish estimates for legislation relative to current policies, so we have not done a precise calculation of the savings compared with that benchmark.)

That reduction in deficits relative to extending those policies in effect in 2011 or 2012 would also garner savings in debt service compared with what debt service would have been if those policies had been extended. Including those savings, we would show deficits that are roughly $0.7 trillion to $0.8 trillion less over the coming decade than under a continuation of those policies.

How do the budgetary effects of the legislation compare with the deficits projected before it was enacted?

In our August *Update* we projected that, under the laws in effect at the time, budget deficits from 2013 through 2022 would total $2.3 trillion. This legislation will boost deficits over that period by an estimated $4.6 trillion (including debt service costs). CBO’s next budget projections will incorporate the effects of the legislation, as well as technical revisions and the effects of a revised economic forecast.

Also in August, CBO published projections under an *alternative fiscal scenario* that embodied the assumption that many policies that were in effect or had recently been in effect would be continued. For that scenario, we projected budget deficits over the coming decade of $10.0 trillion. (Our August *Update* presented a description of the policies included in that scenario and our estimate of their budgetary effects on pages 21 to 23.) Compared with the assumptions underlying that scenario, the new legislation will produce deficits that are smaller—but only by $0.7 trillion to $0.8 trillion.

What effect will the legislation have on the economy this year?

We and many other forecasters had warned that, if all of the fiscal tightening that was scheduled to occur at the end of 2012 had actually occurred, the economy probably would have fallen into a recession. Thus, our economic projections under current law last August showed a drop in real gross domestic product

(GDP) of ½ percent in 2013 (as measured by the change from the fourth quarter of 2012 to the fourth quarter of 2013).

In a November report, we estimated the economic effects of eliminating various components of the scheduled fiscal tightening. The legislation just enacted by the Congress removes or modifies several of those components:

- The extension of expiring tax provisions in the legislation is fairly close for 2013 to the policies that we included in that report under "extend most expiring tax provisions—except for the lower rates on income above certain thresholds—and index the AMT for inflation." Accordingly, based on the estimate in that report, that part of the recent legislation will probably increase GDP growth in 2013 by about 1¼ percentage points, compared with what would have happened if no legislation had been enacted at the beginning of January.
- The legislation also extended emergency unemployment benefits, eliminated for one year the scheduled reductions in Medicare's payment rates for physicians, and trimmed the automatic reductions in defense and nondefense spending specified in the Budget Control Act of 2011. Although none of those policies is analyzed separately in our November report, certain variations and combinations of those policies were analyzed in that report. Based on those estimates, those parts of the recent legislation will probably increase GDP growth in 2013 by about ½ percentage point.

Taking those figures together, the legislation will probably increase GDP growth in 2013 by about 1½ to 1¾ percentage points relative to what would have happened under prior law. Because CBO's August forecast showed GDP for 2013 declining by ½ percent under that prior law, the change in law *by itself* would raise that forecast to an increase of 1 percent or more. However, CBO's next economic forecast will not necessarily match that number because other information about the economy has become available since we set our economic forecast for the August Update last summer. One of the factors influencing our next forecast will be the fiscal tightening that is still scheduled to occur under current law: Although the recent legislation reduced the magnitude of fiscal tightening by 1½ to 1¾ percentage points relative to prior law, our November report identified other components of tightening that are still in place and that we estimated will damp GDP growth in 2013 by roughly 1¼ percentage point.

What effect will the legislation have on the economy over the longer term?

Although we expect that the legislation just enacted by the Congress will lead to higher output and income in 2013 we also expect that it will lead to *lower* output and income later in the decade than would have occurred under prior law.

The legislation lowers tax rates for many people—thereby boosting output—but it also expands budget deficits—which will reduce national saving and lower the stock of productive capital, thereby reducing output relative to what would have occurred under prior law. CBO has not estimated the longer-term economic effects of the legislation itself, but we previously estimated the economic effects of the aforementioned alternative fiscal scenario, which embodied the assumption that many policies that were in effect or had recently been in effect would be continued.

Under that scenario, as described on page 37 of our Update, we estimated that real gross national product (GNP) would be 1.7 percent lower in 2022 than would have been the case under prior law. (GNP is a better measure for analyzing the impact of growing debt on income because prospective budget deficits would be financed partly by inflows of capital from other countries that would lead to a future flow of income to those countries—income that is deducted from GDP in calculating GNP.) The longer-term economic impact of this legislation will probably be less negative than that scenario.