CBO projects bleak long-term fiscal picture, warns of third-quarter default risk

The latest annual projections from the nonpartisan Congressional Budget Office (CBO) assessing the state of the US budget and economy for the next decade show a continuing large and growing mismatch between federal revenues and spending even as the agency sees certain economic factors returning to more normal levels in the coming years.

Meanwhile, a separate CBO report released this week projects that, absent congressional action to raise or suspend the statutory debt limit, the federal government could be at risk of default during the third calendar quarter of this year when the agency anticipates the Treasury Department's ability to use so-called "extraordinary measures" will expire.

Revenue, spending projections

CBO's *Budget and Economic Outlook: 2023 to 2033*, which was released on February 15, represents the agency's first full accounting of the federal fiscal and economic forecast after enactment of the Chips and Science Act (P.L. 117-167) and the Inflation Reduction Act of 2022 (P.L. 117-169), both of which had significant tax titles and were signed into law in August of 2022. CBO's penultimate budgetary projections had been released during May of 2022. (For prior coverage, see *Tax News & Views*, Vol. 23, No. 19, May 27, 2022.)
URL: https://www.cbo.gov/publication/58946
URL: https://www.congress.gov/117/plaws/publ167/PLAW-117publ167.pdf
URL: https://www.congress.gov/117/plaws/publ169/PLAW-117publ169.pdf
URL: https://dhub.blob.core.windows.net/dhub/Newsletters/Tax/2022/TNV/220527_1.html

The latest report predicts budget deficits will average 6.1 percent of gross domestic product (GDP) over the next decade—more than two-thirds higher than the average 3.6 percent of GDP deficit registered over the past 50 years.

Although deficits have declined recently as the economy has recovered from the COVID-19 pandemic, that trend appears to be coming to a close. Relative to the prior fiscal year, CBO projects the deficit in fiscal 2023 (which runs through September 30 of this year) will increase slightly to $1.4 trillion. By the end of the 10-year budget window—in 2033—the agency expects the annual deficit will be more than double this year's, or almost $2.9 trillion.

Revenues and spending: CBO sees federal revenues falling from 19.6 percent of GDP last year to 18.3 percent in the current fiscal year. According to CBO, much of that decline is due to a sharp reduction in capital gains taxes expected on tax returns filed for tax year 2022. Over the course of the next 10 years, CBO projects revenues will fall by roughly another percentage point through 2025, but then recover as major components of the Tax Cuts and Jobs Act of 2017 (TCJA, P.L. 115-97) are scheduled to expire. After that time, the agency expects receipts will hover within a relatively narrow band and average 18.0 percent of GDP over the full budget window, a bit north of the 17.4 percent of GDP average over the past five decades.
URL: https://www.congress.gov/115/plaws/publ97/PLAW-115publ97.pdf

As for corporate revenues in particular, CBO actually foresees a decline as a share of the economy over the next decade—a dynamic the agency attributes in part to the scaling-up of the Inflation Reduction Act's clean energy tax package, as well as declining returns from that law's new 15 percent minimum tax on the adjusted financial statement income of certain large corporations.

"The new [book minimum] tax, which goes into effect in 2023, will boost receipts in 2023, but the increase attributable to that tax is smaller in subsequent years in CBO's projections because firms will offset the minimum tax by using credits for tax liability in prior years that exceeded the minimum," the report states.

Meanwhile, on the spending side of the ledger, outlays—which have fallen sharply from their pandemic-era highs—are expected to resume their steady climb due to pre-existing demographic trends that are projected to increase the ranks of Social Security and Medicare beneficiaries and thus push up spending within those programs. By 2033, outlays would exceed 25 percent of the economy.

Over the past 50 years, spending has averaged about 21 percent of GDP.

Inflation, interest rates, GDP: On the economic front, CBO forecasts that currently elevated levels of inflation will fall from 8.0 percent (actual) in 2022 to about 4.8 percent—as measured by growth in the Consumer Price Index—in 2023. By next year and for the remainder of budget window, CBO sees inflation returning to a more normal Federal Reserve-targeted level of about 2 percent.

Annual economic growth (adjusted for inflation) is projected to fall to only 0.1 percent this year (down from 1.0 percent in 2022), but then bounce back to 2.5 percent in 2024 and average 1.8 percent over the last five years of the budget window. Inherent in these projections is an assumption that the Federal Reserve's current campaign to raise the Federal Funds Rate will result in a so-called "soft landing" that blunts annual price growth without triggering a recession.

Debt service costs: Those short-term interest rate increases, however, will also serve to push up longer-term rates as well as the government's debt service costs. According to CBO, the average rate on 10-year Treasury bonds will rise from about 3.0 percent in 2022 to 3.9 percent this year, a level that CBO sees persisting for the next decade. As a result, interest payments on the national debt are projected to average 3.1 percent of GDP over the next decade, up from a 2.6 percent of GDP average in last year's report and 1.9 percent of GDP in the year before. In nominal terms, the agency expects the government will incur $1.4 trillion in debt service costs in 2033 alone—roughly 14 percent of total projected spending that year.

Publicly held debt: In its January 2020 long-term outlook (published before the pandemic), CBO had projected that debt held by the public—that is, federal debt not held in intragovernmental accounts such as Social Security and Medicare Trust funds—would not reach 100 percent of GDP until the early 2030s.

This week's analysis, however, shows that dubious milestone will be reached next year, and that publicly held debt will climb to 118.2 percent of the economy by the end of the 10-year budget window. (Actually, debt briefly crossed the 100 percent threshold by the end of fiscal year 2020, but then fell again as pandemic-related pressures began to wane).

'Current law' caveat

It is important to note that, by law, CBO is generally required to make its projections on the basis of "current law," or laws as they are currently in effect. (One exception is excise taxes dedicated to trust funds—for example, highway taxes—which are assumed to be continued beyond any scheduled expiration).

That means this week's analysis does not account for the budget impact of any potential spending reduction package that congressional Republicans are currently demanding as a condition of raising or suspending the statutory debt limit later this year. Those negotiations remain in their nascency and many Democratic lawmakers, for their part, continue to insist that the debt limit should be lifted unconditionally on a "clean" basis and that any deficit reduction talks should be broader in scope—that is, they should include revenue increases—and be pursued on a separate legislative track.

On the flip side, also inherent in CBO's projections is an assumption that the temporary tax provisions scheduled to expire over the budget window—including nearly all of the individual tax changes and the passthrough deduction under section 199A that were enacted in the Tax Cuts and Jobs Act and are set to lapse after 2025—will not be renewed, and revenues will be higher as a result. That assumption similarly applies to certain other TCJA provisions—affecting bonus depreciation, the business interest deduction limitation under section 163(j), the timing of research expenditure deductions, and the minimum tax on US multinationals known as the global intangible low-taxed income regime—that, if left untouched by lawmakers, will have (or, in some cases, such as research amortization, are already having) the effect of raising revenue under current law. (A list of all the temporary tax provisions that expired in 2022 or are scheduled to expire through 2034 is available from the Joint Committee on Taxation staff.)
URL: https://www.jct.gov/publications/2023/jcx-1-23/

Thus, if additional deficit-increasing legislation is enacted into law, or if temporary tax provisions are instead made permanent or otherwise extended beyond their scheduled expiration, future deficits may be higher than this week's CBO projections, while passage of a deficit-reducing fiscal package could have the opposite effect.

Debt limit could be exceeded between July and September

In a separate report, *Federal Debt and the Statutory Limit, February 2023*, which was also released on February 15, CBO estimates that the so-called "extraordinary measures" that Treasury has utilized multiple times in recent years to stave off a potential default on federally issued debt—and has been using again since January 19 when the debt limit was last reached—could be exhausted during the third calendar quarter of this year.
URL: https://www.cbo.gov/publication/58906

"The Congressional Budget Office projects that, if the debt limit remains unchanged, the government's ability to borrow using extraordinary measures will be exhausted between July and September 2023," the report states.

The report also cautions that its projections are subject to considerable uncertainty since they rely on estimates of the amount and timing of federal receipts and outlays that may change depending on the path of the economy and other factors.

“. . . [I]f capital gains realizations in 2022 were smaller or if US income growth slowed by more in early calendar year 2023 than CBO projected—the extraordinary measures could be exhausted sooner and the Treasury could run out of funds before July,” the agency writes.

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