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Economics Group

Special Commentary

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2014 Federal Fiscal Policy Outlook Part I: More Clarity, Less Uncertainty, Better Economic Growth

This year marks a significant departure from the past few years on the fiscal policy front. For starters, there is more clarity around the federal budget since Congress is not relying on continuing resolutions to keep the government open. Second, the debt ceiling has been suspended until March 2015, providing financial markets and business decision makers with reduced uncertainty about the federal government meeting its debt obligations. This departure of federal fiscal policy moving from the perpetual fiscal cliff hangers is likely to help reinforce the ongoing acceleration in economic activity.

In the year ahead, we continue to expect the economy to expand at a 2.4 percent pace, while an improvement over 2013, we still believe this rate of growth will fall short of CBO's expectations.[1] Furthermore, federal revenues will continue to grow at a modest pace due to both stronger economic fundamentals and tax policy changes. The deficit will continue to decline over the next few years, before growing again in 2016. The short-term effects of the sequestration will put downward pressure on the federal deficit; however, the explosive growth in entitlement programs and the expectation that these programs will become insolvent will put upward pressure on deficits in later years and, in turn, drive up the debt to GDP ratio. The net result is that under current law, federal fiscal policy remains on a fiscally unsustainable path.

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A Comparison of Economic Assumptions for Budget Forecasting

One of the key factors affecting both the revenue and spending growth is the economic assumptions underpinning the fiscal outlook at the federal level. On the revenue side, employment and personal income growth play a key role in elevating federal revenues, while the overall rate of GDP growth often dictates the pace of federal spending, particularly during economic downturns, as can be seen in Figure 1. We begin with a comparison of the CBO's economic assumptions against our short- and long-run outlook over the next decade and highlight the similarities and differences in our outlooks.

Figure 2 shows the differences in CBO's real GDP assumptions compared to our outlook and the Blue Chip Consensus outlook. As can be seen, our forecast and that of the CBO's is roughly in line with one another for 2014. However, in 2015 and 2016, the CBO is expecting GDP growth of 3.3 percent and 3.4 percent respectively, much stronger than our outlook over the same period. Beyond 2016, our forecast is more optimistic than the CBO's through 2024.

The distribution of growth over the current 10-year window suggests that the growth assumption is one of the key factors affecting the reduction of near-term annual budget deficits. In addition, the near-term deficit reduction also results in reduced borrowing. Conversely, if GDP growth would be softer than currently estimated, i.e., closer to our forecast or that of the Blue Chip consensus, growth in the early years of the decade would mean slower revenue growth and faster debt accumulation. However, the stronger economic growth we are forecasting toward the end of the decade would mean that revenue growth would be somewhat faster than CBO is currently projecting over the 2017-2024 timeframe.

[1] **Congressional Budget Office. (2014). The Budget and Economic Outlook: 2014 to 2024.**

Figure 1

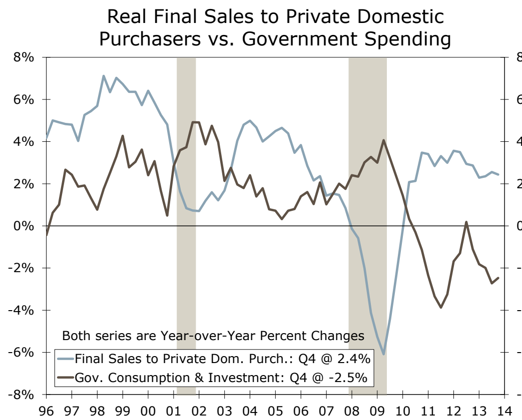
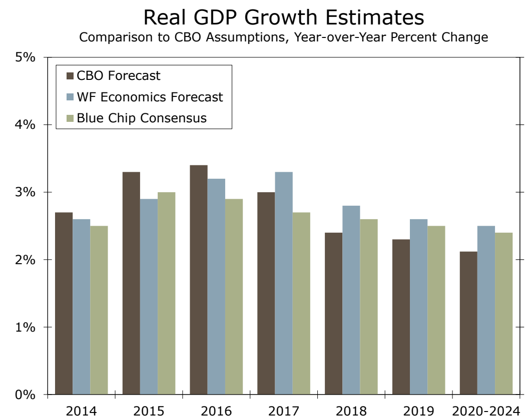


Figure 2



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

In comparison to our outlook, the CBO expects over the next two years that employment growth will be slower than we are projecting.

Beyond the overall GDP assumptions, the CBO also projects a number of other key economic variables, including labor market metrics, inflation and interest rates (Appendix). In comparison to our outlook, the CBO expects over the next two years that employment growth will be slower than we are projecting with a higher unemployment rate. CBO also expects somewhat slower inflation and very similar interest rates. Beginning in 2016 through 2019, the CBO expects a slower pace of inflation along with a lower interest rate environment. In the latter part of the decade, both inflation and interest rates are more or less in line with our outlook.

CBO Projects a Lower Path of Potential GDP Growth

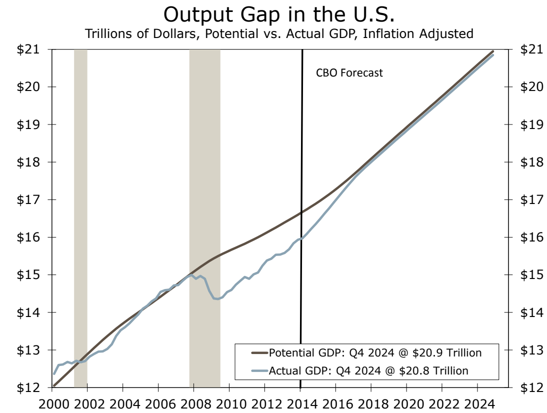
As part of the CBO's budget analysis, it also estimates the potential rate of GDP growth, or the maximum sustainable amount of real output the economy can produce. When actual output (GDP growth) rises above its potential level, then constraints on resources begin to result in inflation pressures. Conversely, when output falls below potential, some resources are going unutilized, and as in the current environment, inflation pressures usually do not emerge.[2] The gap between actual GDP growth and the estimated potential growth rate is known as the output gap.

CBO's estimates of potential output play an important role in determining projections of real GDP growth over the 10-year window for its Budget and Economic Outlook. As a matter of practice, CBO assumes that over its 10-year projection window that real GDP growth gradually returns back to the estimated potential level of GDP.[2] In other words, the CBO does not attempt to predict downturns in the business cycle. This assumption is critical because, should these downturns take place, a very different budget outlook story would unfold.

Since 2007, the CBO has downwardly revised its projections of potential GDP growth by a sizable 7.3 percent.[3] It cites four main factors for the downward revision. First, the cyclical impact from the recent recession accounts for approximately 1.8 percent of the total downward revision to CBO's potential GDP projections. The largest adjustment in its projection came from reassessments of economic trends that were in progress before the recession began (7.8 percent). The other two factors that the CBO citied as factors in its downgrade of potential GDP were revisions to historical GDP data (accounting for just 0.1 percent of the change) and the effects of changes in federal tax and spending policies, higher federal deficits, changes in the relative size of sectors of the economy.

[2] Congressional Budget Office. (2001). CBO's Method for Estimating Potential Output: An Update.
[3] The year 2007 is used since that was the last prerecession year in common with the current budget and economic outlook.

Figure 3



Source: Congressional Budget Office and Wells Fargo Securities, LLC

So why do we care that potential GDP has likely edged lower since the conclusion of the last recession? For starters, the fact that even with a lower projected level of potential GDP, actual GDP growth currently remains well below potential (Figure 3). The implication is that not only have the severe structural problems resulted in a permanent shift in the ability of the economy to grow, but current economic conditions dictate that there are a large number of resources (labor) that are going unutilized. By lowering its estimate of potential level of GDP, the CBO essentially makes it easier to close the output gap over the CBO's projection due to the fact that the output gap can close in the current environment of more modest GDP growth. The implication for revenues is that if the output gap does not close as expected by the CBO, revenues would grow slower than expected over the forecast horizon and, in turn, could lead to larger deficits than projected.[4]

Even with a lower projected level of potential GDP, actual GDP growth currently remains well below potential.

Projected Federal Revenues: Trending Above Historical Levels

Given the expected GDP growth environment under CBO's baseline economic assumptions, federal revenues as a share of GDP are expected to climb to roughly 18.2 percent of GDP by 2015, and more or less level off through 2024 (Figure 4). With the sizable rise in revenues as a share of GDP, over the near term, there are a couple of factors at play, cited by the CBO, helping to perpetuate the stronger pace of revenue growth as a share of the economy.[5] To begin with, there were a number of tax provisions that expired at the end of calendar year 2013 including the accelerated or "bonus" deprecation of investments in equipment which had the effect of reducing corporate tax liabilities.[6] These tax policy changes took place in January 2013, but the full effects will not be felt until the 2014 federal fiscal year.[7] In addition, new taxes, fees and fines related to the Affordable Care Act will also play a role in driving revenues higher as a share of GDP.

Beyond the next two federal fiscal years, revenues are projected to remain above the 17.5 percent average share of GDP through at least 2024.[8] In addition, federal revenues are expected to again exceed the rate of growth in nominal GDP beginning in 2020 (Figure 5). The main reason, cited by CBO, for the above-average revenue collections anticipated through 2024 is related to "bracket creep," which occurs when total income grows faster than inflation-indexed tax brackets. In effect, as total incomes rise with stronger economic growth, more individuals become subject to higher rates of taxation by moving into higher tax brackets. Another less significant factor over the next 10 years that is expected to keep revenues above the long-run average is the expected taxation of

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[4] For a review of the growth outlook see Silvia, J.E. (2014). Growth: Defining Top Line Economic Opportunities as Fundamental Inputs to Decision Makers. Wells Fargo Economics Group.
[5] Congressional Budget Office. (2014). Budget and Economic Outlook: Fiscal Years 2014 to 2024.
[6] As of the date of this publication discussions are ongoing to determine if these expired provisions should be extended for the current fiscal year.
[7] The federal fiscal year begins in September of each year, thus federal fiscal year 2014 began in September 2013.
[8] The long-run average revenues as a share of GDP are a 40-year average calculated by the CBO.

income related to retirees withdrawing funds from their individual retirement accounts, such as 401(k) accounts. It is estimated that this "bracket creep" phenomena, combined with the increase in individual retirement account withdraws, will result in individual income taxes accounting for more than half of total federal revenues for the first time in history.

Figure 4

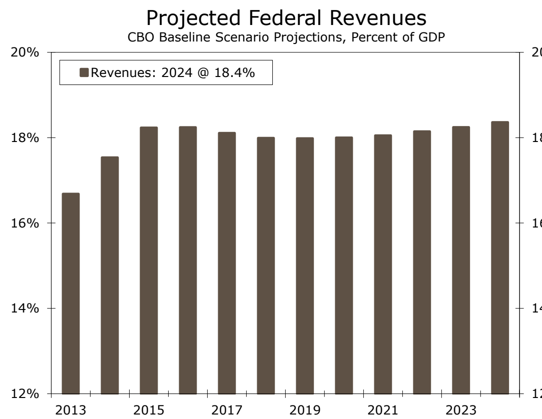
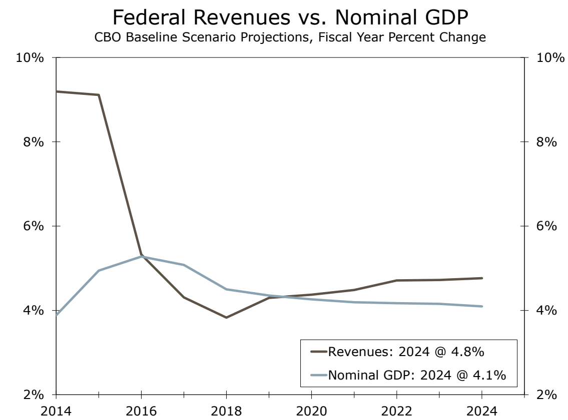


Figure 5



Source: Congressional Budget Office and Wells Fargo Securities, LLC

Sensitivity of Budget Projections to Economic Assumptions

Budget projections are sensitive to the economic environment over the projection window.

One of the often-overlooked factors in understanding federal budget projections over the next decade is how sensitive budget projections are to the economic environment over the projection window. In this section, we explore potential risks to the federal revenues should GDP growth come in just 0.1 percent below CBO's growth projections and what happens to revenues if interest rates are 1 percent higher per year than the CBO is currently estimating.

The CBO provides the basis for this sensitivity analysis in Appendix D of the Budget and Economic Outlook: 2014 to 2024. To begin, we examine the effects of GDP falling just 0.1 percent below the CBO's baseline estimate on the federal budget deficit. The results are displayed in Figure 6 below. In the near term, the impact on revenues is modest, however by 2024, the 0.1 percent slower pace of GDP growth each year results in the deficit increasing by $66 billion in 2024, the last year of the projection horizon. While the CBO does not include any major effects on outlays due to the slower pace of GDP growth, however, debt service costs increase, while revenues decline. The cumulative net effect is that over the 2014 to 2024 projection window, an additional $313 billion is added to the federal deficit. Given the magnitude of the effect on the deficit, it becomes quite clear how important the economic framework and growth estimates are to the overall budget outlook picture. For some context, historically, the average standard deviation over CBO's projections for GDP has been around 0.7 percent as opposed to the 0.1 percent decline displayed in Figure 6. Thus, if historical norms hold, the budget deficit over the next 10 years could be as much as seven times higher or lower than the baseline projections.

The effects of a 1 percent rise of all Treasury securities, however, are a bit more dramatic as can be seen in Figure 7. To begin with, the early years of the 10-year window are marked by sizable declines in revenues but only modest increases in interest and debt service outlays. In the latter years, outlays rise dramatically while revenues begin to slightly increase.[9] On net, the deficit would increase by a cumulative $1.5 trillion from 2014 to 2024 should interest rates rise by 1 percent.

[9] The movement in revenues is tied primarily to remittances of the Federal Reserve to the Treasury which are accounted as revenues.

Figure 6

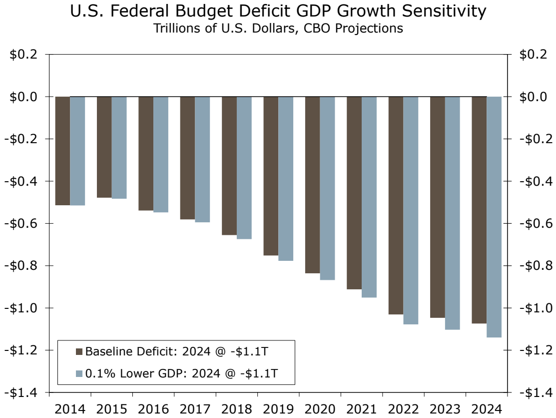
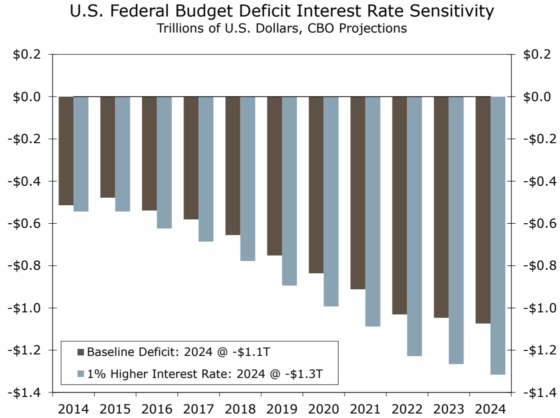


Figure 7



Source: Congressional Budget Office and Wells Fargo Securities, LLC

Conclusion

In comparing the CBO's economic assumptions with both our outlook and the Blue Chip consensus, we discovered that in the early years of the CBO's 10-year projection window, both our forecast and that of the Blue Chip consensus are lower than the CBO's. However, in the latter years of the projection window, our outlook and the Blue Chip consensus is more optimistic than the CBO's. Another key factor in the CBO's economic outlook, the rate of potential GDP growth, has been downgraded by CBO due to structural effects of the last recession. The revision to potential GDP growth by the CBO has affected its budget projections as well. Based on the revision to potential GDP growth and the projected rate of real GDP growth, revenues are estimated to grow faster than the rate of nominal GDP for most of the CBO's current 10-year projection window. By 2024, revenues as a share of nominal GDP are estimated to be far above the historical average. Finally, we noted that the CBO's projections are highly sensitive to deviations from the CBO's economic assumptions putting rather sizable upside and downside risk to the budget outlook. In Part II of our annual budget series, we will focus on the outlook for federal spending and the deficit.

Appendix

Wells Fargo U.S. Economic Forecast vs. CBO Baseline Forecast

All values are Yr/Yr Percent Change Except as Noted	2014		2015		2016-2019		2020-2024	
	Wells Fargo Securities	Congressional Budget Office	Wells Fargo Securities	Congressional Budget Office	Wells Fargo Securities	Congressional Budget Office	Wells Fargo Securities	Congressional Budget Office
Gross Domestic Product								
Real GDP	2.6	2.7	2.9	3.3	3.0	2.8	2.5	2.1
Nominal GDP	4.2	4.2	5.0	5.1	5.5	4.7	4.9	4.2
Labor Market								
Unemployment Rate (Average)	6.7	6.8	6.3	6.5	*	5.9	*	5.6
Employment (Average Monthly Change, in Ths.)	196	164	204	160	*	258	*	270
Inflation								
PCE Price Index	1.6	1.3	2.2	1.7	*	1.9	*	2.0
Consumer Price Index	1.8	1.7	2.1	2.0	2.6	2.3	2.5	2.4
Core Consumer Price Index	1.9	1.8	2.1	2.1	*	2.3	*	2.3
Employment Cost Index	2.3	2.3	2.6	3.0	*	3.8	*	3.7
3-Month T-Bill (Average)	0.13	0.20	0.50	0.40	3.60	3.10	4.10	3.70
10-Year Treasury Note (Average)	3.10	3.10	3.50	3.70	5.00	4.80	5.00	5.00

*A Forecast is not available
Source: Congressional Budget Office and Wells Fargo Securities, LLC
Wells Fargo Economic Forecasts for 2014 and 2015 as of January 31, 2014, Long-Range Forecast as of December 2013 Blue Chip Financial Forecast Submission

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