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Questions Raised by the CBO Report

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As expected, the Congressional Budget Office (CBO) *Budget and Economic Outlook* released today continued the pattern of predicting a strong recovery just two years away.[1] Although CBO's economic approach is typical among forecasters and historically unbiased, the economy's persistent failure to launch as predicted raises questions. Are current conditions of persistent slow growth and high unemployment principally the result of bad luck, uncertain global economic conditions, or bad policy?

The Case of the Missing Recovery. Like most macroeconomic forecasts, CBO uses a hybrid approach. It uses current economic conditions and changes to make short-term predictions but ties medium-term growth to an estimate of "potential" gross domestic product (GDP). Potential GDP is an estimate of how much the economy could produce if labor and capital were used at typical intensity and efficiency. Economic history suggests that national output can deviate from potential GDP, but the further it deviates, the faster it tends to spring back.

In the 2013 forecast, CBO predicts that the next two years will continue the mediocre, below-potential growth of the past three years. After that, its framework dictates that actual GDP must spring back toward potential GDP. Since we are far below potential, that means three years (2015–2017) of rapid growth.

Sound familiar? If so, you probably read the CBO's *Outlook* in January 2012—or the one in 2011, 2010, or 2009. Each year the *Outlook* embodies the spring-back theory of recessions, with a robust recovery beginning two years away. As Chart 1 exhibits, the boom is always just around the corner—but has not arrived as predicted in the past few years. From 2010 to 2012, annual growth averaged 2.1 percent, which is not enough to diminish the gap between actual and potential GDP.

CBO is not alone in having predicted a recovery. Taking the economic fundamentals into consideration, many public and private forecasters predicted a robust recovery back in 2010, but reality has fallen short of these expectations. Why? Three types of explanation are possible:

1. Economic forecasts are never perfect. Bad luck in the form of natural disasters, large failed investments, or socio-cultural upheaval can depress growth in hard-to-predict ways. But it is hard to find examples in the past three years that could have had such strong, persistent negative effects.

2. Economic factors such as private and public debt overhang, Europe's depression, economic uncertainty, or pessimistic financial markets can all slow growth and have certainly contributed to the slow recovery. But these elements are usually taken into account by forecasters. They may explain why the forecast does not predict even stronger growth, but unless the problems are getting progressively worse over time, they do not explain why the economy continues to underperform.

3. The past five years have been a clinic in bad policymaking. Washington has made large,

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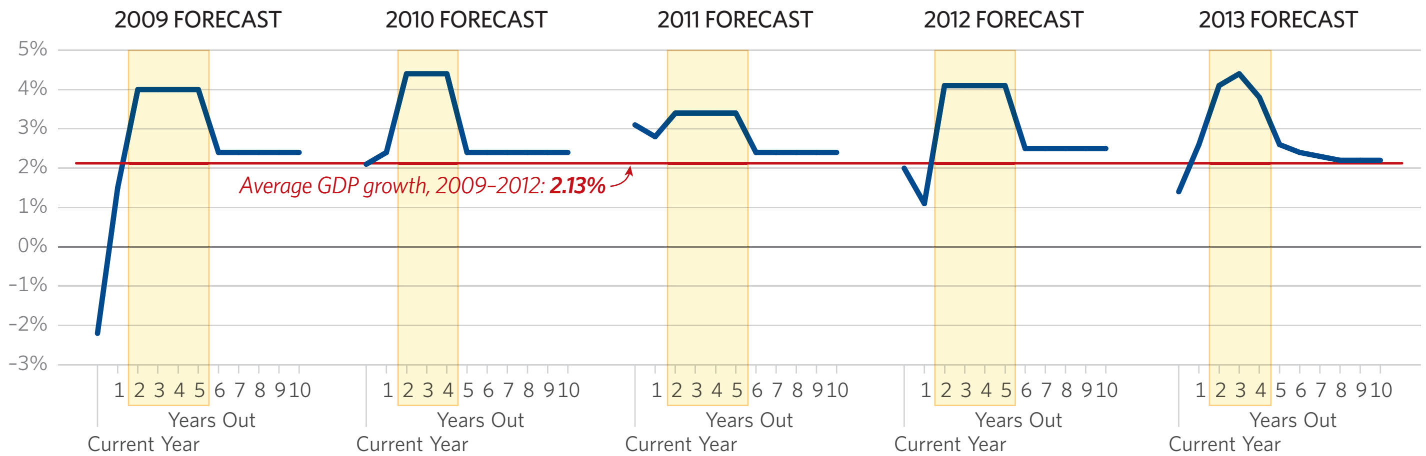
CHART 1

The Sun'll Come Out ... Tomorrow

According to the Congressional Budget Office, economic recovery is always two years away. In each of its forecasts since 2009, the CBO projected that the economy would grow by more than 3 percent two years out and maintain that growth for three to four years, as shown in the highlighted areas ( ). In reality, GDP hasn't grown by 2.5 percent in any year since the recession.



Sources: Congressional Budget Office, *Budget and Economic Outlook*, 2009–2013, and Center for Data Analysis calculations.

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impactful policies that have negative incentive effects on the private economy, including overhauling the welfare eligibility rules, rewriting the bankruptcy rules for General Motors, pointless tax rebates, harmful tax increases, regulatory uncertainty, sequestration uncertainty, "Cash for Clunkers," the "Cornhusker Kickback," blocking the Keystone XL pipeline, funding railroad boondoggles in the desert, Obamacare, and Dodd–Frank. Although these incentives can be found in economic theory and data, neither the incentives nor their effects are easy to capture in an economic forecast.

The Future Ain't What It Used to Be. Another interesting question raised by the *Outlook* is how much potential GDP has changed as a result of the Great Recession and subsequent policies. Since 2009, CBO's expectation of real GDP in 2019 has slid by 4 percent.

In the 2013 *Outlook*, CBO justified lowering its estimates of future potential GDP. Following work by Manmohan Kumar and Jaejoon Woo,[2] among others, CBO concludes that the U.S. has reached a level of debt at which growth will probably be harmed.[3] Likewise, it expects the financial crisis to cast a long shadow on investment and skill acquisition, following research by Carmen Reinhart, Kenneth Rogoff,[4] and others. In 2010, CBO concluded that the Affordable Care Act would reduce labor supply by about half a percent, lowering potential output.[5] Higher taxes also lower potential output,

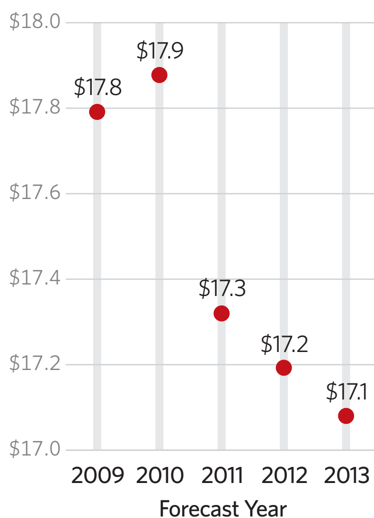
1. Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2013–2023*, February 2013, http://cbo.gov/sites/default/files/cbofiles/attachments/43907_Outlook_2012-2-5.pdf (accessed February 5, 2013).
2. Manmohan S. Kumar and Jaejoon Woo, "Public Debt and Growth," International Monetary Fund, July 2010, http://www.imf.org/external/pubs/ft/wp/2010/wp10174.pdf (accessed February 5, 2013).
3. Congressional Budget Office, *The Budget and Economic Outlook*, p. 35.
4. Carmen M. Reinhart and Kenneth S. Rogoff, "The Aftermath of Financial Crises," *American Economic Review*, Vol. 99, No. 2 (May 2009).
5. Congressional Budget Office, *The Budget and Economic Outlook: An Update*, August 2010, Box 2-1, pp. 48–49, http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/117xx/doc11705/08-18-update.pdf (accessed February 5, 2013).

CHART 2

Eroding Expectations

In 2009, the Congressional Budget Office projected GDP in 2019 to be $17.8 trillion. In the years that followed, CBO's predictions about the 2019 economy have grown gloomier.

CBO PREDICTIONS OF GDP IN 2019, IN TRILLIONS OF DOLLARS



Sources: Congressional Budget Office, *Budget and Economic Outlook*, 2009–2013, and Center for Data Analysis calculations.

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but most regulations and executive decisions are difficult to model in a potential output framework.

As the economy limps through its fourth year of "recovery," CBO has further diminished its expectations for the long-term potential of the economy. This can be seen in Chart 2, where the forecast for 2019 GDP has fallen each year since 2010.

By explicity discussing potential GDP, the CBO raises a very important question: How will policies affect long-term growth? Where CBO is constrained to consider potential output within the existing policy framework, policymakers and other economists have an even more important task: to consider the economy's potential unconstrained by current law. Can the labor supply loss due to Obamacare easily be undone? Or once they leave the labor force, will those who gave up working never come back? What if (as is probably the case) the incentive effects of Obamacare are even more deleterious than CBO's cautious 2010 estimate?

Bad Policies at Work. The release of the *Budget and Economic Outlook* gives economists, policymakers, and observers a framework to raise questions about the health and future of the American economy. Beyond the truism that the economy is in a nasty slump, data and theory indicate that the economy is worse than one would expect based on economic factors alone.

The policies of the past five years have systematically harmed the economy in both the short run and the long run. Policies aimed at the unemployed have decreased their rewards from work.[6] Policies in the business sector attenuate the pressure to innovate and adapt, allow established firms to reap profits without improving their products, and shrink the overall "pie" in order to serve a bigger slice to those favored by government.[7] Policies on taxation have twice increased tax rates on capital, discouraging investment and lowering GDP.

As discouraging as the new CBO *Outlook* is, reality will probably be worse unless federal policies improve.

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6. Casey Mulligan, *The Redistribution Recession: How Labor Market Distortions Contracted the Economy* (Oxford: Oxford University Press, 2012).
7. Salim Furth, "Why the Slow Economic Recovery?," Heritage Foundation *Issue Brief* No. 3746, October 3, 2012, http://www.heritage.org/research/reports/2012/10/why-the-slow-economic-recovery.