CHAPTER 2: MACROECONOMIC OUTLOOK

The *Report* points out that relatively strong job growth has been particularly disconnected with slower GDP growth over the course of this recovery, and labor market "churn" has continued its long-run, declining trend. Yet whether this is due to greater job stability or workers' reduced ability to achieve wage gains by switching jobs remains to be seen. Despite presuming a relatively optimistic economic outlook going forward based upon a budget that presumes debt will at least "stabilize" over the next 10 years, the *Report* again fails to recognize the long-term impending debt crisis that, if left unaddressed, will hurt the U.S. economy, dampen wages, threaten our national security, and reduce the Federal Government's ability to respond to future challenges.

In the next decade, outlays on mandatory programs and interest payments on the debt will be the driving forces of increased spending, consuming 99 percent of all Federal revenues by 2026. Two of the primary trust funds used to provide certain Social Security and Medicare benefits will be exhausted by 2030 and 2026, respectively. It will cost over $5.9 trillion in additional spending to preserve scheduled Social Security benefits for 10 years after its insolvency date, and it will cost over $2.8 trillion to preserve Medicare services for an additional 10 years. Another key driver of mandatory outlays stems from the ACA, the costs of which have been grossly underestimated. The ACA essentially takes money from Medicare in order pay for the health law, and the JEC expects increased spending in the order of trillions will result from the ACA.

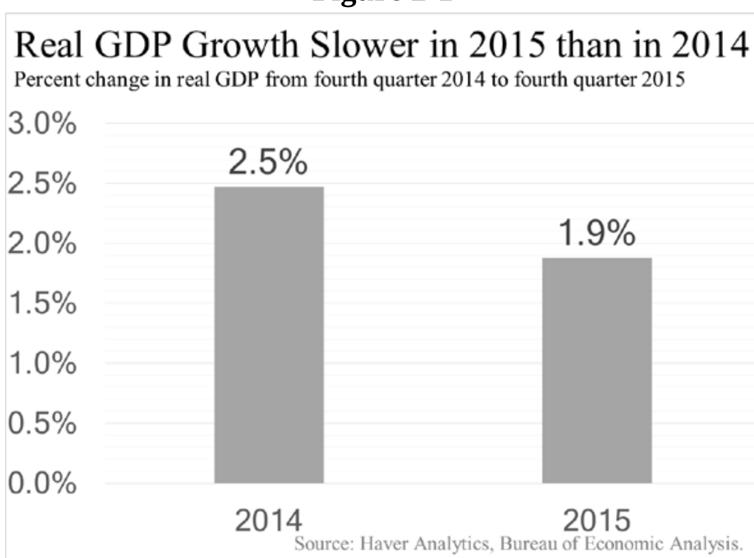
NEAR-TERM OUTLOOK

Gross Domestic Product

Economic growth continued at a relatively muted pace in 2015. After yet another slow start in the first quarter of 2015, GDP demonstrated tepid growth in the second quarter, a relatively strong third quarter, followed by deceleration in growth for the final quarter. Despite attaining average real GDP growth of only 2.1 percent over the course of the current recovery, President Obama's Fiscal Year 2017 Budget still assumes a relatively optimistic 2.4 percent average GDP growth over the next five years, ticking down to 2.3 percent average growth from 2022 through 2026.[1] By contrast, CBO expects a more conservative average rate of 2.1 percent over the next five years and 2.0 percent average growth from 2022 through 2026.[2] A smaller economy over the next decade would mean less revenue than the Obama Administration expects to meet ever-growing spending obligations. This comparison is limited by the fact that the CBO's economic assumptions are based on current law, and the President's budget is based on a variety of changes to current law and economic assumptions that differ from the CBO's analysis.

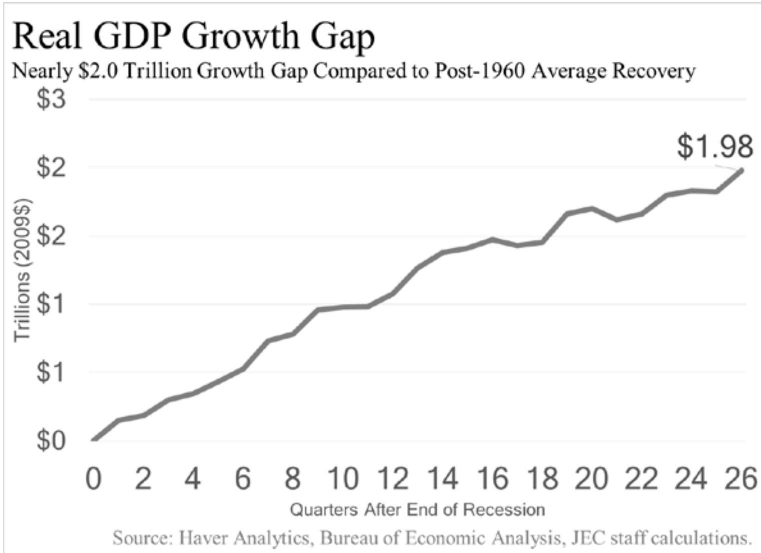
Real GDP growth in the fourth quarter of 2015 appears sluggish compared to earlier quarters in the year, though revised up to 1.0 percent. As measured from fourth quarter to fourth quarter, which is the preferred measurement used by CBO and the Federal Open Market Committee (FOMC), real GDP growth from the fourth quarter of 2014 to the fourth quarter of 2015 slowed to 1.9 percent (Figure 2-1).

Figure 2-1



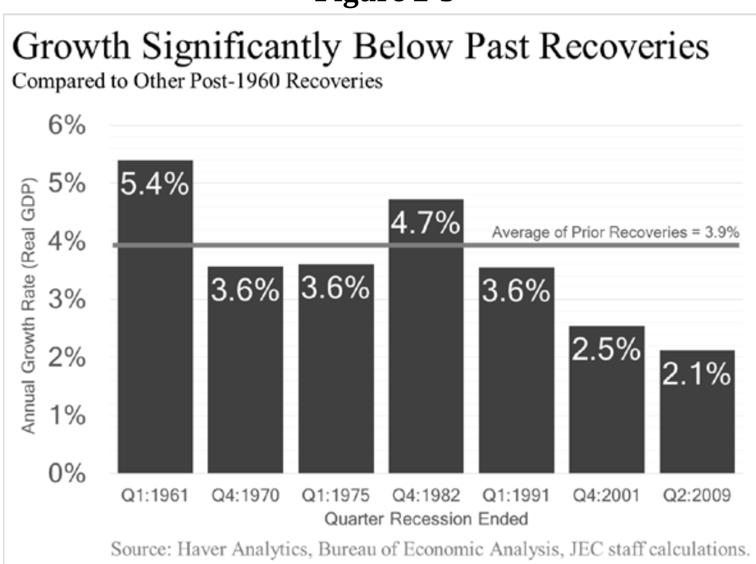
The economy continues to suffer from gaps in economic growth, private-sector jobs, and real income growth, lagging far behind the average post-1960 recovery. If real GDP had grown at the average rate of other post-1960 recoveries, real GDP would be nearly $2.0 trillion (2009 dollars) larger (see Figure 2-2).

Figure 2-2



The current recovery continues to rank last among post-1960 recoveries in terms of real economic growth. Since the recession ended in the second quarter of 2009, real GDP has grown at an average annual rate of 2.1 percent. In other post-1960 recoveries, real GDP expanded at an average annual rate of 3.9 percent during the comparable six-and-one-half year period (see Figure 2-3).

Figure 2-3



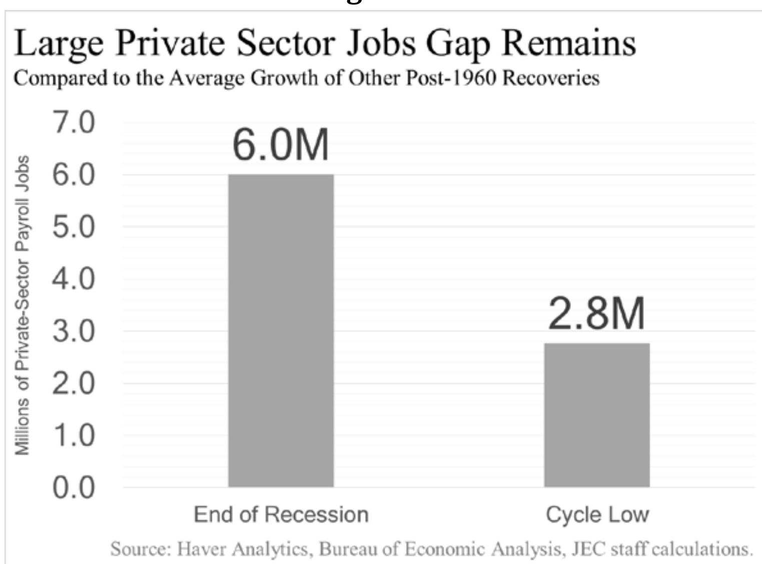
CBO projected in the January 2016 release of its *Budget and Economic Outlook* that real GDP will grow at a much slower rate during the 2015-2026 period—an average of 2.1 percent annually—than it did during the 1980s and 1990s, and slower than its previous August 2015 projection of 2.3 percent annually over the 2015-2025 period.[3] A growth of roughly 2 percent over the next decade and beyond is significantly lower than the average of nearly 3.4 percent growth enjoyed over the previous 50-year period prior to the recent recession, resulting in a smaller economy than previously anticipated going forward.

Labor Market

The *Report* highlights the last two years as the best job growth since 1999 and reiterates that the past year continues to post impressive job growth, adding 2.7 million jobs in 2015, bolstering the slightly stronger gains seen in 2014.[4] However, in today's economy, many people would like to work more hours, it takes longer for the unemployed to find a job, and wage growth remains tepid. The current economy is marked by slower economic growth, productivity and entrepreneurship.

The current recovery also suffers from a large and persistent private-sector jobs gap. Compared to the end of the recession in the second quarter of 2009, the private-sector jobs gap stands at 6.0 million compared with the average of other post-1960 recoveries (see Figure 2-4).

Figure 2-4



A recent Georgetown University Center on Education and the Workforce study found that the economy would have 6.4 million more nonfarm payroll jobs than it does today if the recession had never occurred, achieving more than 155 million payroll jobs in total based on pre-recession trends.[5]

For measuring progress on job gains, the Administration typically focuses on the period since February 2010, when private-sector payroll employment hit bottom, rather than the June 2009 end of the recession. Even on that more favorable basis, the private-sector jobs gap stands at 2.8 million compared to the average of other post-1960 recoveries. Over the last six months, the economy has added an average of 213,000 private-sector jobs per month. Even if that pace were to continue through the end of 2016, the private-sector jobs gap measured from the end of the recession would be 4.6 million compared with the average of other post-1960 recoveries.

As with the growth gap in real GDP, closing the private-sector jobs gap by the end of 2016 will require much more rapid job growth than the Obama recovery has delivered to date. To eliminate the 6.0 million private-sector jobs gap by the end of 2016, the economy will need to add 630,000 jobs each month over the next 11 months. That mark has not been achieved once during the current recovery.

CBO and other institutions have continued to revise GDP growth projections downward to account for demographic trends and for slower workforce growth in the years ahead, dulling expectations for stronger growth in the United States. Global growth has also slowed, and the trends in the United States and abroad kindled implications of the beginning of a "new normal" of slower economic growth. CBO's latest projections demonstrate muted expectations for nominal GDP growth over the next decade, revising nominal GDP down by approximately $5 trillion in 2025 compared to August projections.[6] In this projected slow-growth environment, it is estimated that standard of living growth will slow by half compared to previous growth rates over the past half-century.[7] Growth of real private nonresidential fixed investment has continued to steadily expand, but taxes, the ACA, and the ever-increasing accumulation of regulations continue to raise the after-tax cost of new investment.

Figure 2-5

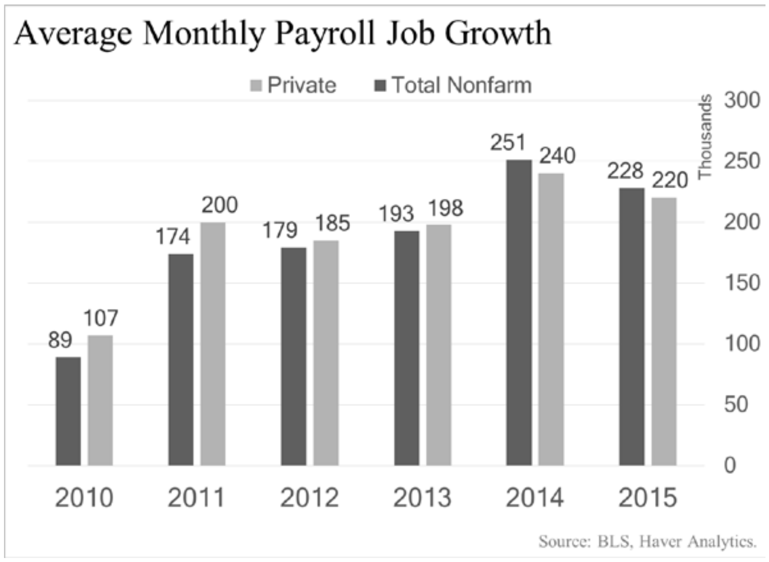
The relatively sluggish income growth over the course of the recovery has left many American households feeling bereft of the stronger gains seen in previous recoveries and on tighter budgets. Over the last six-and-one-half years, real disposable personal income per capita has increased 7.9 percent, or $2,834 (2009 dollars). In an average post-1960 recovery, the per capita increase would have been 15.6 percent or $5,582 (Figure 2-5). As aforementioned, median household income, at $53,657 in 2014, remains 6.5 percent below its recent 2007 peak of $57,357 (in 2014 dollars).[8]

Payroll Jobs

While jobless claims continued to trend downward over the year, nonfarm payroll growth averaged 228,000 and private-sector payrolls averaged 220,000 per month over the course of 2015 (Figure

2-6). The total recovery average is 155,000 for total nonfarm payrolls and 162,000 for private-sector job payrolls.

Figure 2-6



In addition, CBO projects nonfarm payroll employment to rise by an average of 196,000 jobs per month in 2016, slowing to less than 75,000 nonfarm payroll jobs added on average per month by 2026.[9]

Unemployment

The *Report* highlights the continued decline of the unemployment rate, decreasing to 4.9 percent in the latest estimate for January 2016. The unemployment rate continued to decline over the course of 2015 since its October 2009 peak of 10 percent, but long-term jobless workers still comprise more than a quarter of the unemployed. Long-term unemployed (unemployed 27 weeks and longer) fell from one-third to one-quarter of unemployed persons in the first six months of the year, and has hovered near that share for the final six months, still nearly double its 40-year historical pre-recession average of approximately 14 percent.

Recent research from the Federal Reserve Board finds that the prospects for the long-term unemployed remain relatively dim. St. Louis Federal Reserve Vice President Stephen Williamson suggests that the evidence points to the long-term unemployed lacking the necessary skills to attain a job, and that if history is a guide, many will drop out of the labor force altogether, as "[t]hey are unlikely to be hired under any conditions."[10] As it stands, the median and average duration of unemployment remains significantly elevated in the aftermath of the recent recession at a median 11 weeks and an average 29 weeks.

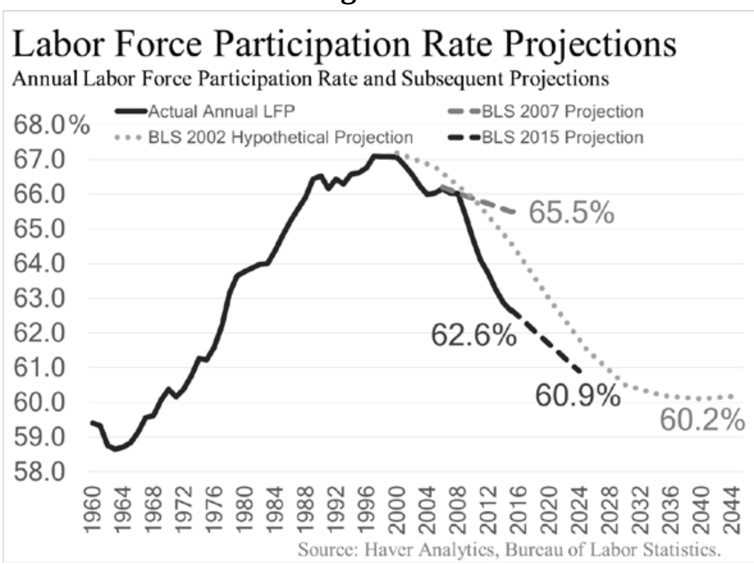
CBO estimates that if the unemployment rate returned to its natural rate and the labor force participation rate equaled its potential, there would have been 2.5 million more workers in the fourth quarter of 2015. CBO expects the unemployment rate to fall below its natural rate from

2016 through early 2019, thus narrowing the employment shortfall, but the slack between the labor force participation rate and its potential rate is projected to fall but not completely disappear over the same time frame.[11]

Labor Force Participation and Employment-to-Population Ratio

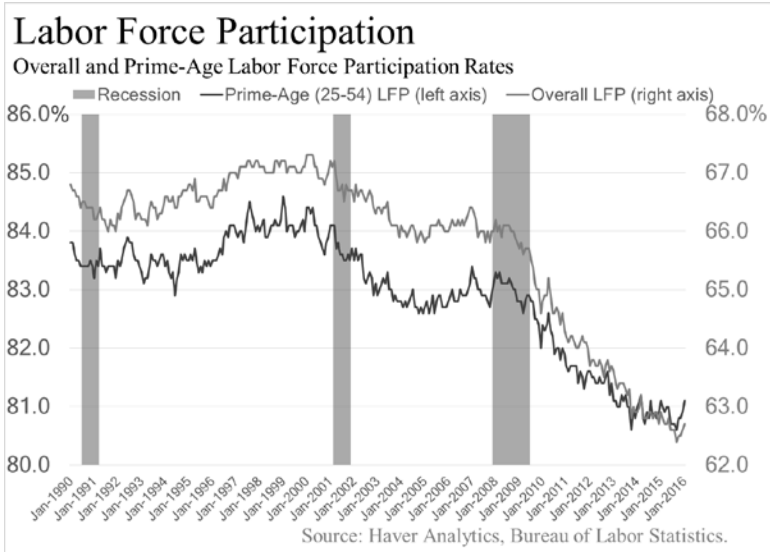
The labor force participation rate remains subdued, near a recovery low, and the share of part-time workers looking for full-time work remains elevated. The overall labor force participation rate continued to decline, as did the participation rate for prime-age workers (ages 25-54). The long-term trends continue to show steady declines overall and among prime-age workers, which slightly accelerated during the recession and through the recovery. While a decline in the overall participation rate was expected well in advance of the recession, the decline appeared sooner and at a faster rate than any previous predictions anticipated (Figure 2-7).[12]

Figure 2-7



After holding steady between 62.7 and 62.9 percent for more than a year between April 2014 and May 2015, the labor force participation rate hit a new recovery low of 62.6 percent in June 2015, and remained there for three consecutive months in total before falling to yet a new recovery low of 62.4 percent in September 2015. As of January 2016, the labor force participation rate remains near a recovery low at 62.7 percent, down 3.0 percentage points since the recovery started (Figure 2-8).

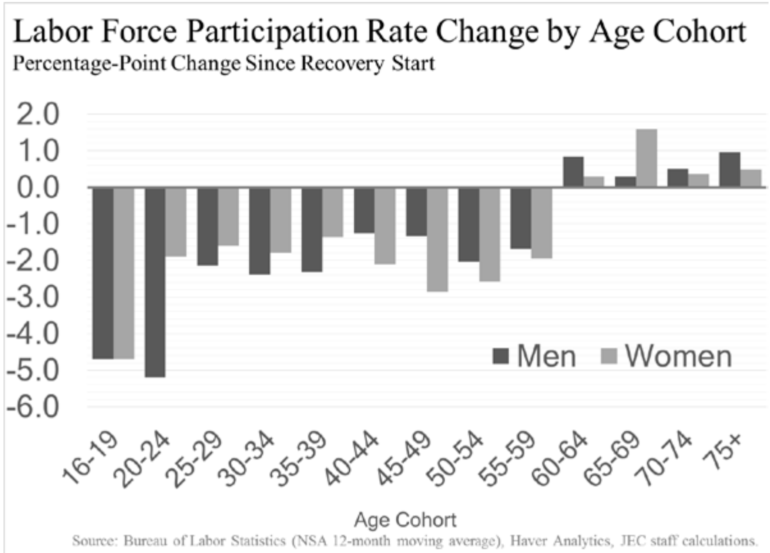
Figure 2-8



The workforce is also smaller among Americans in their prime working years. This is not just baby boomers aging out of the workforce; as mentioned in Chapter 1, at 81.1 percent, the participation rate for prime working age Americans remains 1.8 percentage points below its recovery start. As mentioned in last year's *Response*, prime-age workers have also seen their labor force participation in decline as a group since the early 2000s, and more rapidly over the course of the recession.[13] While the prime-age labor force participation rate has fallen 3.5 percentage points from its high in January 1999, the participation rate for workers age 55 and older has increased by 8.5 percentage points to 40.0 percent over the same time frame.

More recently, as shown in Figure 2-9, when broken down into five-year age cohorts, only workers age 60 and older have seen their participation increase since the start of the recovery. By comparison, workers age 59 and younger, particularly ages 16 to 19 and men ages 20 to 24, have seen their workforce participation decline significantly over the course of the recovery.

Figure 2-9



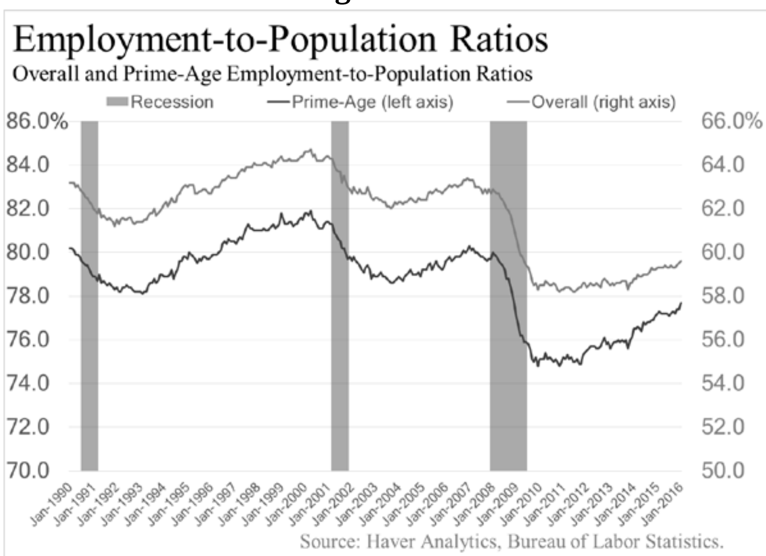
According to CBO, growth of the potential labor force is less than previous estimates. As was discussed at great length at the JEC hearing, "What Lower Labor Force Participation Rates Tell Us about Work Opportunities and Incentives," while many believe that America has entered a "new normal" characterized by lower economic growth and workforce participation, and subsequently requires policies that lessen negative consequences, it is perhaps too soon to claim that these trends are permanent features of the American economy. Manhattan Institute scholar Scott Winship stated in his written testimony, "Policies to help low-income individuals and families should not presume that the American job-creation machine is broken, or that our recent cyclical challenges portend a 'new normal' in the coming decades."[14]

In her testimony before the Committee, American Enterprise Institute scholar Aparna Mathur cited reduced job mobility, the decline in demand for "middle-skill" labor, and job quality among the reasons for the decline in workforce participation.[15] Winship testified that Federal disability benefits "increasingly serve as a shadow long-term unemployment program for able-bodied men who struggle to find work."[16] For Americans still in their prime-earning years, periods spent out of the labor force, underemployed, and jobless can have far-reaching implications for their well-being, including lower income, lower lifetime earnings, and less time to accumulate assets and financial security.

BLS, CBO, and the Social Security Administration (SSA) have known for some time that labor force participation would decline in the coming years as baby boomers retired. Yet none of these institutions predicted that the overall rate would fall this fast and this soon. Back in 2007, none of them could have predicted the lasting impact that the recent recession would have on the labor market, and the extent to which the recession introduced structural changes as well as cyclical ones remains a subject of debate today. As Mathur pointed out in her testimony, the fall in participation is troubling because participation is also declining among younger generations as well.

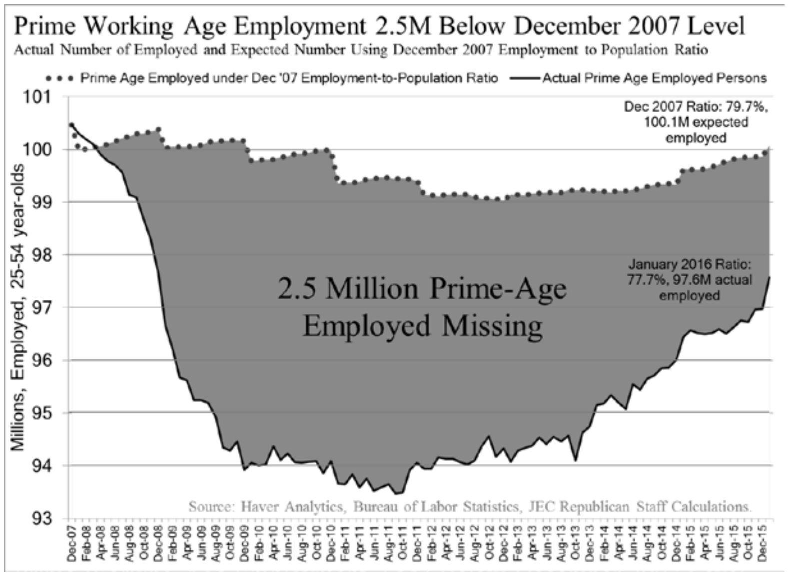
The employment-to-population ratio remained relatively unchanged over the course of 2015. The overall employment-to-population ratio is 0.2 above the recovery start level, but it is still 3.1 percentage points below its pre-recession level. For prime-age workers, the employment-to-population ratio is up 0.3 percentage point since the recovery's start, but remains 2.0 percentage points below its pre-recession level. Though the employment-to-population ratio has continued to show an upward trend, the January 2016 rate of 59.6 percent still remains well below the pre-recession level of 62.9 percent (see Figure 2-10). Despite recent gains in the ratio, it would appear that the return to the pre-recession peak in the employment-to-population ratio will not occur in the near term.

Figure 2-10



Over the course of the recession and part of the recovery, the number of Americans between the ages of 25 and 54 actually fell by roughly a million, before beginning to recover again starting around the beginning of 2013. Despite this interesting demographic turn of events, using the employment-to-population ratio nonetheless shows the ratio of the population, regardless of its size, which is working.

Figure 2-11

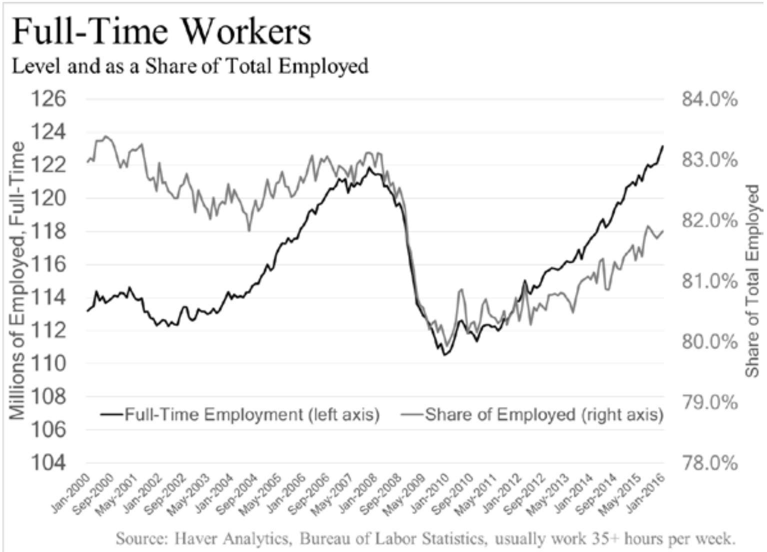


As shown in Figure 2-11, even accounting for changes in the prime-age worker population, there would be approximately 2.5 million more prime-age workers employed if the employment-to-population ratio for prime-age workers was the same rate as it was in December 2007, when the recession began.

Full-time and Part-time Employment

For the first time since the recession began, full-time employment achieved its pre-recession level briefly in August 2015, and subsequently regained and surpassed that level in October 2015 and beyond. Nearly eight years later, it now stands at 123,141,000 in January 2016. As a share of total employed, however, full-time employment remains more than a percentage point below its pre-recession share of employed as part-time employment continues to gain. Part-time jobs jumped during the recession and remain elevated by more than 2 million compared to pre-recession levels. As a share of the employed, part-time work is up 1.3 percentage points compared to its pre-recession level.

Figure 2-12



The share of those working part-time for economic reasons has fallen considerably over the past year, yet still remains elevated above its pre-recession average, and as noted in the *Report* still contributes to the elevated U-6 unemployment rate of 9.9 percent, also frequently termed the "real" unemployment rate given that it captures a broader array of labor underutilization data.

The Effects of the Affordable Care Act *on Labor*

The *Response* to last year's *Report* outlined numerous negative effects of the ACA on the supply of labor. The ACA continues to cast a long-term shadow over the labor market. As aforementioned, CBO's most recent projections indicate that the ACA will reduce the labor supply by 0.86 percent by 2025, translating to 2 million fewer full-time equivalent workers in the labor force than if the ACA had never become law.[17] This projected labor supply reduction is due to various disincentives to work created by provisions of the ACA designed to subsidize health insurance coverage, mandate the purchase or provision of health insurance coverage, and raise revenue through different taxes and penalties.

Half of the total labor supply reduction projected by CBO (0.43 percent) is attributable to the health insurance premium and cost-sharing subsidies available through the ACA marketplace.[18] Premium subsidies are available to individuals with incomes between 100 and 400 percent of the Federal Poverty Level (FPL) who lack access to employer-sponsored health insurance. Because premium subsidies on the marketplace decrease as income rises, the result is an increased effective marginal tax on work.[19] This disincentive to work is compounded for individuals with incomes between 100 and 250 percent of FPL who obtain health coverage through the marketplace because the effective marginal tax on work is more pronounced as a result of the sharp phase-out "cliffs" built into the ACA's cost-sharing subsidy formula.

Subsidized health coverage is also available to individuals with incomes below 138 percent of FPL in states that have either expanded traditional Medicaid as originally envisioned by the ACA or in states that have expanded coverage through an alternative model incorporating waivers from Medicaid's rules. Because state Medicaid programs generally provide more heavily subsidized coverage in comparison to subsidies gained through the ACA marketplace, individuals whose incomes rise above the Medicaid eligibility threshold are therefore subject to a subsidy cliff and increased effective marginal tax on work. Individuals with incomes just above the eligibility threshold also have an incentive to work less in order to land on the more advantageous side of the Medicaid eligibility threshold, thereby gaining access to lower-cost health insurance.

However, the exact design of Medicaid programs vary by state, largely depending on whether the program is viewed as more of a temporary bridge to self-sufficiency as opposed to a permanent entitlement. For example, Indiana's alternative to traditional Medicaid, Healthy Indiana Plan, mitigates the subsidy cliff by requiring personal health account contributions from all enrollees who choose the more robust "HIP Plus" plan and from all enrollees with incomes above the poverty line. The required contribution amount, 2 percent of income, in fact matches exactly the ACA exchange premium cap for individuals up to 138 percent FPL.[20] Other Indiana reforms, such as a 6-month "lock-out" period for non-payment and the absence of retroactive coverage, replicate standard policies found in the private insurance market as well as the ACA marketplace. Indiana's plan also incorporates a "Gateway to Work" referral program to help participants develop and hone marketable skills and matches them with prospective employers, thereby enhancing the participant's prospects for upward mobility.

The ACA imposes new taxes on individual income that will reduce the incentives to work, save, and invest, thereby reducing employment. Wages and self-employment income over $200,000 (single) or $250,000 (married) are now subject to an additional 0.9 percent Medicare payroll tax. Investment income, such as rent, interest, dividends, and capital gains, for this same group of earners is subject to an additional 3.8 percent tax. According to a Tax Foundation study, these taxes will reduce the number of full-time equivalent jobs by 0.3 percent.[21]

Small and medium-sized employers with 50 or more full-time equivalent employees are mandated to offer health insurance coverage or face a tax, prorated monthly, per each full-time employee over the first 30 employees. The tax is indexed each calendar year to the premium growth rate, and in 2016 the annual tax rises to $2,160. Larger employers offering health insurance could face $3,240 tax in 2016 for each full-time employee receiving a subsidy to purchase health insurance coverage through the marketplace. The employer mandate creates an incentive for employers to hire less full-time employees and shift some existing full-time employees to part-time employment. Employers may also choose instead to reduce wages as an offset to the cost of the tax. However, in light of the relatively recent imposition of this tax, it remains to be seen how exactly employers will alter their structure and compensation to manage its full costs.

Economist Casey Mulligan, Professor of Economics at the University of Chicago, estimates that the ACA's explicit and implicit taxes will affect nearly half of the working population, reducing average wages by $1,000 per year, or about four percent for low-income families and nearly two percent for higher-income families.[22] Mulligan also estimates that, by 2017, the ACA's labor effects will translate to roughly three percent less in weekly employment, three percent fewer total hours worked, two percent less in labor income, and two percent less GDP compared to the economy in absence of the ACA.[23] CBO notes that, when factoring in labor supply elasticities, it will take some time for workers to fully adjust to the harmful incentive structures created by the ACA, meaning that the overall impact of the ACA on the supply of labor will become progressively worse as time goes by.[24] This also means that it is not too late for Congress to step in and prevent the bulk of the labor market damage projected to occur as a result of the ACA's existence.

Housing Market

The weak recovery of the past seven years has been barely apparent to middle-class families, whose income growth remains muted, and to retirees, whose retirement savings earn little interest as a result of years of low rates driven by Federal Reserve policies. One of the few financial benefits they have seen is an increase in the value of their home. The residential real estate market has achieved steady gains since the recession, and American households' balance sheets show higher equity.

The *Report* finds that the housing market's recovery is well underway,[25] and net housing wealth is nearing 2008 levels.[26] However, the Administration has not taken advantage of improving market conditions to push for reforms that could strengthen the government-sponsored housing enterprises, Fannie Mae and Freddie Mac. As a result, Federal Housing Finance Agency Chairman Watt is warning that taxpayers may again be asked to bail out Fannie Mae, as they did in 2008.[27] The Administration should take immediate action to improve underwriting, discourage lending criteria that is leading to higher default risk in an improving market, and protect the taxpayer.

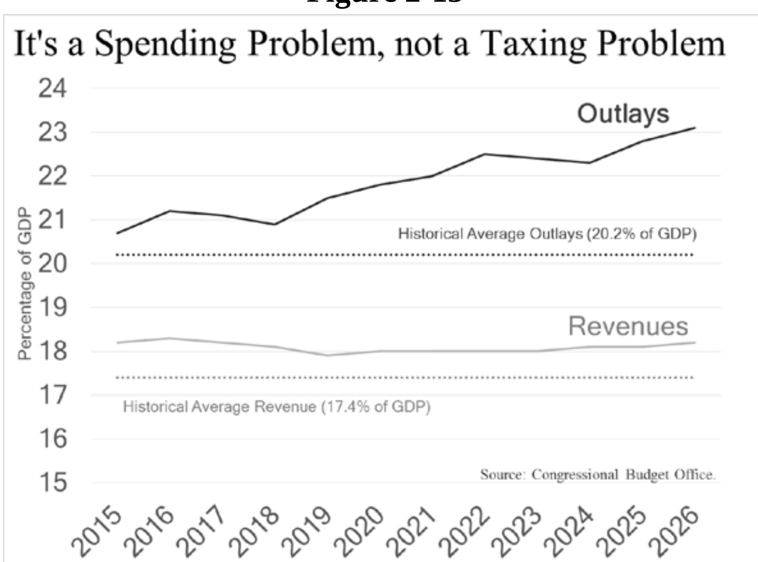
However, several variables present risks to continued residential real estate market gains. First, the mortgage market remains dominated by Federal agencies,[28] offering consumers a limited range of mortgage options and "one-size-fits-all" approval criteria that freeze out would-be homeowners.[29] Second, Federal lending is returning to the low-down-payment programs that contributed to the real estate bubble of a decade ago, and contributed to a financial crisis that wiped out the equity many homeowners believed they had.[30] Third, as aforementioned, graduating millennials have started careers in a weak job market; this slow start in their independent adult lives means they delay marriage and purchases of their first homes.[31] Federal policy should take action to mitigate these risks and encourage a thriving private-market economy that rewards work and innovation, supports families, and provides a backstop against imprudent borrowing and lending. Furthermore, if Americans adjust to a "new normal" lifestyle supported by the two percent real GDP growth rate characterized by the current recovery, fewer may ever achieve sufficient income and savings to move up from their "starter home," leaving "move-up" homeowners in a market that has fewer buyers than sellers.[32]

Fiscal Policy

The *Report* repeats the claim President Obama touted in his State of the Union address that the Federal budget deficit has been cut "by almost three-quarters."[33] While technically correct, the *Report's* lack of context misrepresents the issue. It is misleading to emphasize deficit reduction without also noting that the President's starting point for such a comparison was one of the most expensive years in U.S. history. Due to the coupling of a weak economy and a large growth in Federal spending from the stimulus, Federal outlays reached 24.4 percent of GDP in fiscal year 2009—the President's starting point. Since 1930, only three other years have had higher outlays than this starting point: 1943-1945.[34]

According to CBO and the President's Office of Management and Budget (OMB), Federal deficits are actually expected to increase in fiscal year 2016 from the previous year.[35] Deficits are projected to continue to rise, even though revenues are expected to be higher than historical averages. The historical average of Federal outlays over the past 50 years is 20.2 percent of GDP, while revenues average 17.4 percent of GDP during the same time.[36] As shown in Figure 2-13, revenues are expected to hover around 18 percent of GDP through 2026, whereas outlays will continue to climb above the historical average and will hit 23.1 percent of GDP in 2026.

Figure 2-13



Under President Obama, outlays have averaged over 22 percent of GDP.[37] The OMB even expects deficits to be higher than CBO's calculations, with OMB estimating a $616 billion deficit in 2016,[38] compared to CBO's $543 billion.[39] Such trends make the President's blanket-claim of reduced deficits all the more dubious, particularly when he and this *Report* fail to mention the burgeoning growth of gross and publicly held Federal debt.

The President's Fiscal Year 2017 Budget, however, seeks to remove the previously-established budget caps in favor of additional spending, offset by increased taxes. The President's budget would increase Federal spending by $2.5 trillion and raise taxes by $3.4 trillion over the next 10 years. Even with this additional $3.4 trillion in proposed taxes, the President's budget never balances and would result in $24.7 trillion in debt—an increase of 30 percent—by 2027.[40]

The day President Obama was first sworn into office, the total Federal debt held by the public stood at $10.6 trillion.[41] Due to a rapid expansion of Federal spending, the debt now tops $19 trillion.[42] In fact, President Obama managed to add more to the Federal debt in his first 7 years of office than during the combined 16 years Presidents Bill Clinton and George W. Bush held office.[43]

Monetary Policy

In December 2015 the FOMC of the Federal Reserve (Fed) ended seven years of holding the Federal funds rate at the zero bound. The Fed raised the target Federal funds rate to a modest 1/4 percent, and maintained this level at the January 2016 FOMC meeting.[44] Federal Reserve Chair Janet Yellen has stressed that the rate increase trajectory will be slow and gradual, though recent data signals that trajectory may be even slower. Important though this rate hike was, the Fed remains nowhere close to a normalized monetary policy, evidenced by several factors. These include the Fed's elevated balance sheet—which can be the fuel for inflation—and the FOMC's policy of reinvesting, rather than unwinding, principal from its holdings in agency mortgage-backed securities.

It is troubling that the Fed has not found a way to normalize monetary policy in the years following the 2008 financial crisis. Certainly, the Fed is not alone among its global central banking peers, and perhaps it should even be commended for resisting the temptation to engage in further quantitative easing, like the European Central Bank, or the move to negative interest rates, like the Bank of Japan. Nonetheless, the current policy has pushed many, including those on fixed incomes, into equities and other investments that may not be appropriate for their age and circumstances. Equity prices have surged in this loose monetary policy environment, but the recent market volatility, owing partially to developments in the energy sector and China, demonstrates that such investments are not without risk.

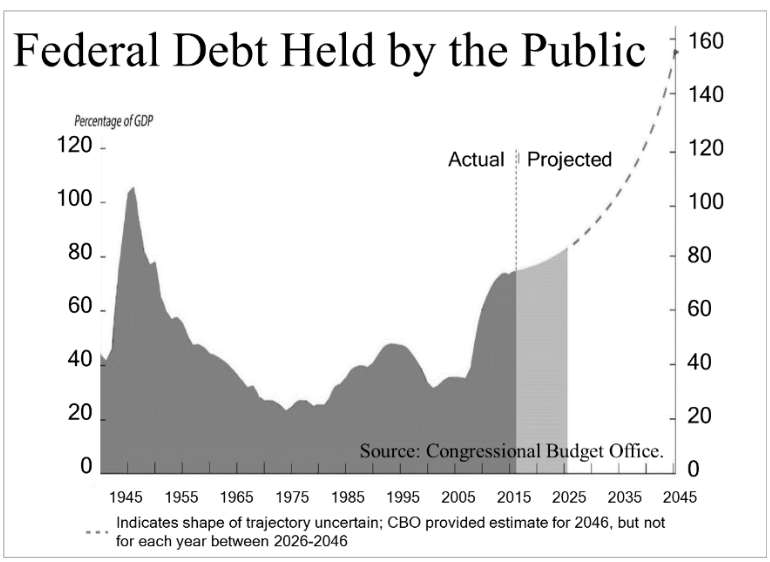
Moreover, when the economy is flying "low-and-slow" as it has throughout this weak economic recovery, the effect of external economic shocks can be much more dramatic. Absent a normalized monetary policy, the Federal Reserve has no playbook with tested scenarios to which it can turn. Rather, it must learn as it goes in an environment where not much separates appropriate boldness from rash hubris, leading to national fiscal peril. Such is the case when the ordinary tools of monetary policy have been exhausted and not reset.

Meanwhile the effects of Administration policies—with respect to the national debt and deficits, having one of the highest corporate tax rates in the world, and an ever increasing regulatory burden such as that imposed by the ACA—weigh on the national economy and hinder our global competitiveness. In response, the Fed has directed monetary policy on a course to try and achieve what monetary policy simply cannot achieve. The Fed would do well to return its monetary focus to the one thing that it can achieve—stable prices over the long term—and leave removal of fiscal and regulatory obstacles to long-term economic growth and job creation to their rightful domain, the Congress and the Administration.

LONG-TERM OUTLOOK

Once again, in this year's *Report*, as in last year's, there is little to no discussion regarding the dangers of the nation's increasing debt burden, despite the fact that CBO expects deficits to begin rising again in 2016, one year sooner than projected in the *Budget and Economic Outlook* released in August 2015. In fact, CBO projects trillion-dollar deficits will return in 2022, three years earlier than previously projected, with deficit growth projected to outpace economic growth by 2019.[45] As aforementioned, debt is expected to reach levels never before seen in the United States, with debt held by the public rising to 155 percent of GDP within the next 30 years under current law (Figure 2-14).[46]

Figure 2-14



The Risk of High and Rising Debt

The accumulation of such staggering levels of debt are nothing short of reckless, and this *Report* does a serious disservice by downplaying the impacts of such egregiously high levels of debt. The consequences of the United States' unmanageable debt include reduced private capital in the economy, lower productivity and wages, and higher interest rates—discussions of which are noticeably absent in the *Report*.

Ironically, the *Report* notes the global economic harm that has resulted from high levels of debt in *other* countries, yet the *Report* and the Administration fail to extend its analysis to the destructive consequences of the U.S. Federal Government's debt. The *Report* rightfully mentions that high levels of debt in major advanced economies—except the United States—has decreased demand and private investment in those countries, resulting in "persistently disappointing world growth over the last half-decade,"[47] while not acknowledging that the United States is following suit. Instead, the *Report* claims that long-term debt will stabilize under the President's proposed budget, but relies on dramatic tax increases and unrealistic economic conditions to achieve such debt stabilization.

For example, the *Report* emphasizes the "dangers [that] have materialized in Japan" as a result of unsustainable debt levels, an aging population, and fewer workers to support pensions. The end result is a stagnant economy that is expected to persist in the coming years. The *Report* also emphasizes the increased challenges Japan faces in attempts to manage government debt and finance future government commitments—all of which are having global reverberations that "are now coming to the forefront of the global economy."[48]

Interestingly, the *Report* omits the obvious similarities that the United States will soon have to grapple with. The number of Americans age 65 or older is already more than twice what it was only 50 years ago, and as the baby boomer generation continues to retire, the number of Americans over 65 is expected increase by more than 30 percent in the next decade.[49] Similar to Japan, the aging population equates to increased Federal spending for this population's pensions, Social Security and Medicare benefits. Also like Japan, the labor force participation rate in the United States has been on a continual decline in recent years and that trend is expected to continue for at least the next decade.[50] Even though the United States will be in an eerily similar situation to that currently facing Japan—with remarkably high debt, an aging population and declining labor force participation—the *Report* does not provide a shred of concern for impending consequences to the U.S. economy and financial burden being placed on younger generations.

The Congressional Research Service (CRS) has also concluded that increased Federal debt dampens economic growth and burdens future generations:

> *The current consensus view among economists is that the source of the burden associated with the national debt is the government budget deficit that gives rise to the debt. In a fully employed economy, the deficit "crowds out" private sector spending, especially spending on capital goods. Thus, a smaller private capital stock and a lower level of output are passed along to future generations and it is this lower level of output that is the burden of the national debt. And, it is a burden that is largely shifted forwarded [sic] to future generations. Thus, according to the consensus view, the burden of a national debt is borne by future generations.*[51]

The average share of the Federal debt for children born in 2016 is over $58,800 and that burden is expected to rise to nearly $84,000 by the time they are 10 years old.[52] Forcing children to pay the price—both financially and economically—for our spending is the worst kind of intergenerational theft.

Beyond the "crowding out" effect of the Federal deficits and debt, increased debt would make it riskier to invest in the United States. This would deter investors from financing the Federal Government's continued deficit spending, unless they receive substantially higher interest rates from the government. CBO estimates that interest payments on the debt will account for about 13 percent of Federal outlays in 2026, more than double the 2016 expectations of 6 percent.[53] Diverting potentially even more money than CBO currently anticipates just to pay for the interest on the Federal debt, let alone address the principle, will further contribute to the decline in private capital and economic growth.

Simply put, debt prevents the economy from reaching its full potential. The *Report* names employment and economic growth as key goals in the coming years. However, the "crowding out" effect of increased Federal outlays makes it virtually impossible to achieve these goals without reducing our debt burden.

Perhaps the most glaring omission in this *Report*, especially during this period of geopolitical unrest, is the lack of discussion concerning debt's adverse effects on national security. High levels of debt increase the likelihood of a fiscal crisis in the United States, as lawmakers will have less flexibility to respond to unexpected challenges—whether they be military or fiscal.[54]

Former Chairman of the Joint Chiefs of Staff U.S. Navy Admiral Michael Mullen rightfully stressed this, stating, "The most significant threat to our national security is our debt," in large part because the United States must have a strong economy in order to provide the resources necessary to defend its citizens. Adm. Mullen went on to say, "That's why it's so important that the economy move in the right direction, because the strength and the support and the resources that our military uses are directly related to the health of our economy over time."[55] When Adm. Mullen made those remarks, our debt was $13 trillion, so it stands to reason that it is an even larger security threat today.[56]

The U.S. debt has historically risen during war times, but it has typically been paid down shortly thereafter.[57] The *Report* reiterates the President's repeated calls for increased spending and deficits, reversing the historical trends of cutting spending after military drawdowns in order to reduce the debt. As has previously been noted, increased debt weakens economic growth. Without a vibrant economy, the United States risks losing its unparalleled creditworthiness, thereby making it more difficult to finance the resources necessary to protect the country.

To prevent the looming debt explosion, we must address the key causes of increased spending: interest payments on the debt and mandatory spending.[58] As aforementioned, by 2026, interest on the debt and mandatory spending programs will consume nearly 99 percent of all Federal revenues.[59]

Reducing our debt naturally becomes more difficult as levels increase, primarily due to higher interest costs associated with the greater risk of sovereign default. Within only 10 years, the nominal interest payments alone on the debt held by the public will have nearly quadrupled, costing taxpayers $830 billion in 2026.[60] Net interest payments, which are the third-largest driver of increased spending—behind only Social Security and mandatory health care programs—can only truly be addressed by paying down debt and restructuring programs so that the United States borrows less.

Mandatory Spending Programs Drive Debt

Similar to interest payments, mandatory programs run on auto-pilot and, unlike discretionary programs, are not subject to the annual appropriations process. This status has enabled them to grow to 69 percent of all spending, or 14.7 percent of GDP, on track to rise to 78 percent within 10 years—16 times higher than the level in 1966.[61]

Social Security and major health care entitlement programs—including Medicare, Medicaid, Children's Health Insurance Program, and the ACA—are unquestionably the two primary drivers of increased Federal outlays. In fact, Social Security and Medicare alone will account for nearly half of all increased spending over the coming decade.[62] Rather than confronting these mandatory program, this *Report* doubles-down on President Obama's failed tax-and-spend policies that have only exacerbated the impending debt crisis.

Without taking serious action, the two primary trust funds associated with Social Security and Medicare are all projected to be exhausted by 2030[63] and 2026,[64] respectively. This means that by the time a current 50-year old becomes eligible for retirement at age 65 (and full retirement by age 67), the trust funds used towards paying for traditional Medicare and Social Security retirement benefits will be exhausted. Put starkly, the government will be unable to keep its promise to seniors.

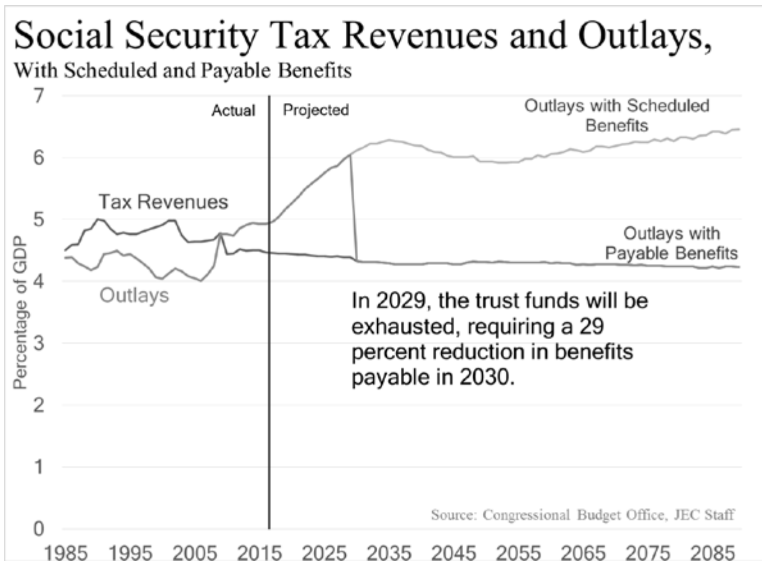
Since 2010, the annual outlays for Social Security—including Social Security Disability Insurance (SSDI) and Old-Age and Survivors Insurance (OASI)—have exceeded non-interest revenues. This funding gap has continued since and without any changes, the combined outlays for OASI and SSDI will exceed revenues by nearly 30 percent in 2025.[65]

One of the most significant pieces of legislation impacting the Social Security trust funds in recent years is the *Balanced Budget Act of 2015*. This law extended the life of SSDI, which was expected to hit insolvency by 2017, but it was done at the expense of OASI. Rather than fixing the majority of the underlying causes pushing SSDI and OASI towards insolvency, the law extended the life of SSDI by four years by cutting the life expectancy of OASI by a year. CBO now estimates that the SSDI trust fund will be exhausted in fiscal year 2021, followed by the OASI trust fund's exhaustion in 2030. When measured together, the trust funds will now be exhausted by 2029.[66]

Though the *Report* attempts to downplay the upcoming Social Security crisis, all 500 economic simulations run by CBO found that Social Security outlays will exceed or be equal to revenues by

2030.[67] When the trust funds are exhausted, the Social Security Administration will be forced to shift from the current system of "scheduled benefits" to "payable benefits," in which Social Security benefits would be reduced so that annual outlays would not exceed annual revenues.[68] As a result, without changes, Social Security benefits would be cut by nearly one-third beginning in 2030. This funding shortfall is expected to persist through the end of CBO's projections in 2089.[69] The JEC estimates that it will cost over $5.9 trillion just to maintain scheduled benefits through 2040 and about $12.2 trillion[70] to maintain benefits through 2050 (Figure 2-15).[71]

Figure 2-15



Major health care entitlement programs are the other key drivers of Federal spending and debt. The ACA is one of the primary reasons for the recent spikes in spending for mandatory health care entitlement programs. In 2015, major health care entitlement programs accounted for 40 percent of all gross mandatory spending, or approximately $1 trillion. Outlays for these programs are expected to double, costing $2 trillion in 2026.[72] In addition, the *Report* indicates that "health care price growth remained at low levels,"[73] yet it is health care price inflation that is buoying core inflation, and has increased sharply over the past two years.[74]

Medicare outlays will encompass $1.3 trillion of the $2 trillion in total outlays in 2026 for mandatory health care entitlement programs,[75] the same year in which CBO expects the Medicare Hospital Insurance (HI) trust fund to be exhausted.[76] Even after accounting for offsetting receipts, the HI trust fund is expected to run deficits every year through the next decade, except in 2018, until the fund is exhausted in 2026.[77]

The Medicare Trustees have a slightly more optimistic outlook, estimating that the HI trust fund will not be exhausted until 2030. After the fund is exhausted, the Trustees expect that Medicare revenues will only be sufficient to pay for 86 percent of the HI costs.[78] However, there is no provision of the *Social Security Act* outlining what would happen when the HI trust fund becomes insolvent. Additional legislation would need to be enacted to provide the necessary funding to cover the costs of HI services.[79]

The JEC estimates that it will cost approximately $7.7 trillion to make up for the HI shortfall through 2045.[80] The *Report* does not account for the increased outlays in such a scenario and it fails to provide a framework for response, much less a preemptive plan. Yet, the likelihood of such an event happening and having a large financial impact is high.

In fact, the Centers for Medicare and Medicaid Services (CMS) Actuary and the Medicare Trustees warn that the underlying law used for their estimates assumes much rosier economic growth than is likely to occur. In its most recent findings, the Trustees stressed that the current assumptions that funding will remain available until 2030 "assumes a substantial long-term reduction in per capita health expenditure growth rates relative to historical experience," and that "current-law projections indicate that Medicare still faces a substantial financial shortfall that will need to be addressed with further legislation."[81]

Medicaid is in similarly poor financial shape, most recently because of the expansion of the program resulting from the ACA. Outlays have been higher than was previously estimated, and CBO actually increased its cost estimates for the program between its August 2015 projection and its January 2016 projection. CBO noted that the actual enrollment numbers for Medicaid were so much higher than expected that the increase in Medicaid outlays was one of the "most significant adjustments" in projected spending since its August 2015 projection,[82] accounting for an additional $187 billion in outlays than previously expected.[83] Medicaid outlays increased by $48 billion, or 16 percent, between 2014 and 2015. This is on par with the enrollment increase of 55 percent between 2014 and 2015. The increase in enrollment and outlays is particularly substantial when the increase between 2013 and 2014 already witnessed sharp spending increases of $36 billion, or 14 percent, which was the largest annual increase in spending.[84]

CBO projects Medicaid costs will continue to grow at these elevated rates, increasing by another $31 billion in 2016.[85] About two-thirds of the increased growth of Medicaid "resulted from enrollment of people who were newly eligible because of the ACA," according to CBO.[86] Beginning in 2017, Federal outlays for Medicaid are expected to grow more slowly, but only because the Federal Government's share of the costs associated with ACA-eligible enrollees will decline.[87] The growing aggregate financial burden increasingly will be borne by the states, allowing the Federal Government to erroneously claim fiscal discipline at the expense of states' finances.

This is yet another reason why the Federal Government must give states the flexibility to administer Medicaid in a fashion that works best for them. Medicaid was established as a state-administered program, yet Federal Medicaid rules and mandates have created a one-size-fits-all system that does not work for all states and makes it challenging for states to develop ways to reduce costs and improve health outcomes.[88] Even the Medicaid demonstration waiver process is bureaucratically cumbersome and time consuming. The potential for state-level innovation was first recognized under President Harry S. Truman, whose 1949 Commission on the Organization of the Executive Branch developed the concept, stating that "a system of grants should be established based upon broad categories—such as highways, education, public assistance, and public health—as contrasted with the present system of extensive fragmentation."[89] Rather than unleashing the potential of Medicaid block grants, the *Report* entirely ignores the consequences of traditional Medicaid's rigidity for enrollees and states.

The ACA Compounds Long-Term Fiscal Issues

The subsidies for individuals to purchase insurance is the most expensive provision of ACA, accounting for over 70 percent, or $27 billion, of ACA-related spending in 2015. The cost of these subsidies is projected to jump to $39 billion in 2016, consuming the majority of the $56 billion in ACA-related outlays. By 2026, outlays for ACA subsidies are expected to hit $93 billion annually.[90]

The costs associated with the ACA are particularly concerning when the number of enrollees in exchanges is substantially lower than initial projections. In 2014, CBO and CMS estimated that 13 million—18.6 million people would be enrolled through the exchanges in 2015, and that 21 million—24.8 million people would be exchange enrollees by 2016.[91] In reality, CBO found that only 9.5 million people were enrolled through the exchanges in 2015 and only 8 million of those people received subsidies to purchase health insurance on the exchanges.[92]

After the open enrollment period for 2016 coverage, 12.7 million individuals were enrolled in a plan through the exchanges.[93] However, previous years have shown that a number of individuals do not remain enrolled through the duration of the year.[94] That is why, by the end of 2016, the Department of Health and Human Services (HHS) expects that 2.7 million consumers will have dropped their coverage, leaving only 10 million consumers enrolled through the exchanges.[95]

These poor projections resulted in a $2.5 billion aggregate loss for insurers within the individual marketplace in 2014.[96] This $2.5 billion loss comes after calculating for the risk corridor, meaning the $2.5 billion is only a portion of the insurers' losses. Brian Blase with the Mercatus Center estimates that the actual losses, without adjustments for the risk corridor, are closer to $4 billion within the individual market in 2014.[97]

The high cost of coverage is the predominant reason why millions of people are actively choosing not to enroll in health insurance, particularly those that are relatively young and healthy.[98] Researchers have found that healthy individuals who do not qualify for large premium subsidies are consistently worse off if they buy insurance than they are by remaining uninsured,[99] even after considering the penalty in 2016 is the greater of $695 or 2.5 percent of household income.[100]

However, the ACA was constructed such that, without these healthy enrollees, insurance risk, premiums, and the risk of program deficits would all rise. This is exacerbated by the fact that people with preexisting conditions cannot be denied coverage under the ACA nor be subject to higher premiums because of their health. The end result is a much sicker risk pool within the exchanges, since the insurance is most attractive to the sick people that need the coverage which, in turn, leads to a much more expensive population to insure.

To make up these losses, the average cost of health insurance premiums is increasing across the country, which only compounds the already massive functional and financial problems with the ACA. It is also why President Obama's repeated promises that the average family will save $2,500 annually after the ACA's enactment have proven false.[101] Premiums for plans offered on the exchange continued to increase, on average, each year since their implementation. According to CMS, the average rate increase for the 37 states using the Federal HealthCare.gov exchange was 7.5 percent in 2016.[102] However, the amount by which a premium changed from 2015 to 2016 varied widely, depending on the consumer's age, health status, and location. For example, the Kaiser Family Foundation's analysis of 2016 premium changes in the ACA marketplaces found that the national average premium increase was just over 10 percent, or about $300 per month, for a 40-year old non-smoker earning $30,000 annually.[103]

Even insurers that were given $2.4 billion in Federal support to create the Consumer Operated and Oriented Plans (CO-OPs) were incapable of financially sustaining the CO-OPs due to the magnitude of problems that have arisen as a result of the ACA. The Administration originally provided funding for 24 CO-OPs, one of which failed before open enrollment even began, creating 23 CO-OPs across 23 states. The likelihood of these CO-OPs failing was clear from the beginning—even HHS initial estimates stated that about one-third of all loans would not be repaid, which is roughly $792 billion not including any forgone interest.[104] Yet, the Administration never established criteria to determine whether a CO-OP was viable or sustainable,[105] further increasing the risk to the Federal Government. As a result of the ACA's failure, 21 of the CO-OPs reported net losses in 2014.[106] Another was forcibly taken over by the Iowa State Insurance Commissioner because of financial instability and was ultimately liquidated.[107]

As of 2016, over half of the 23 CO-OPs have failed and many of the others are suffering financially.[108] The cost of these failing CO-OPs will be borne by the taxpayers, based upon the Administration's initial assumptions. Unlike HHS's estimates that one-third of the CO-OP loans will not be repaid,[109] the JEC estimates it is the more likely scenario that HHS's high-cost estimate of less than 50 percent, or about $1.2 billion, of the CO-OPs loans will be repaid.[110]

Higher insurance premiums lead to higher Federal subsidies, which in turn increases Federal deficits. The *Report* and President Obama ignore the fact that as health insurance premiums outpace GDP growth, the annual cost to the Federal Government will also increase accordingly. ACA subsidies are tied to the recipients' income: families with incomes between 100 and 133 percent of the FPL receive subsidies to ensure they do not pay more than two percent of their annual income in premiums and a family between 300 and 400 percent of the FPL does not pay more than 9.5 percent of their income in premiums.[111] Over the next 10 years, the annual cost of health insurance premiums are expected to outpace per capita income by two percentage points.[112]

This is just one of the reasons why the true costs of the ACA are not yet reflective in the current ACA outlays.

Beyond the ACA outlays, the productivity adjustment factor is the single largest non-revenue, cost-saving provision within the ACA and is specifically indexed to produce outcomes that merely appear to save money, rather than reflect the true costs. Similar mechanisms have been used in previous legislation, as discussed in this chapter, but Congress later passed legislation to prevent the automatic cuts from going into effect. If history repeats itself and the automatic productivity adjustment cuts from the ACA are averted, then the ACA could end up costing trillions more than expected. Furthermore, the ACA productivity "savings" are nothing but a budget gimmick, achieved by cutting funding for Medicare, undermining the ACA's core mission of providing health care for all.

The law requires Medicare payment rates to be updated based upon a "productivity adjustment factor." This productivity factor is a measure of output per worker across the entire economy, not specifically within the health care industry. While there may be changes in the level of additional goods and services individual workers can produce across the economy, it fails to capture the actual cost of care for Medicare beneficiaries. Under the ACA, as the productivity factor increases across the economy, Medicare payments to providers decrease by the same percentage.[113]

This productivity factor assumes that Medicare services will achieve the exact same productivity improvement as the rest of the economy, regardless of whether such levels of productivity are actually plausible. The productivity factor and other ad hoc reductions took effect for Medicare payments to hospitals in 2012 and the adjustment will continue to be used to update payments each year going forward.[114]

CBO found that this Medicare cut will reduce costs by about $196 billion over 10 years, whereas the CMS Actuaries predict savings of $205.3 billion.[115] However, CBO has expressed concerns that the ACA's Medicare cuts are unlikely and may be "difficult to sustain over a long period of time," in part because the ACA assumes that "Medicare spending would increase significantly more slowly during the next two decades than it has increased during the past two decades…" Further, CBO noted that past attempts to reduce Medicare provider costs by simply cutting their payments has proven ineffective.[116]

Similar indexing measures were included in the 1997 *Balanced Budget Act* (BBA) to reduce Medicare payments to physicians through what became known as the Sustainable Growth Rate (SGR). Rather than tying the payments to the cost of the services, the payments were indexed to grow no faster than GDP.[117] When the BBA was enacted, the SGR was projected to save $11.7 billion over 10 years.[118]

Because the indexing provisions in the BBA were not in sync with the actual cost of care, Congress subsequently passed legislation—which became known as "doc fixes"—to prevent the automatic Medicare reductions.[119] These subsequent fixes cost $170 billion from 2003 through 2015, until subsequent legislation was enacted to fully repeal the SGR. CBO projected that the full repeal of the SGR will increase deficits by $175 billion, compared to the current baseline that assumed a 21 percent cut in Medicare payments to physicians beginning in April 2015.[120]

In the end, rather than saving $11.7 billion within 10 years, the United States spent $345 billion in the long-run fixing the SGR problem. In March 2010, CBO estimated the productivity factor alone would reduce Medicare spending by $196 billion over 10 years.[121] Should Congress and the President suspend or repeal the productivity factor provisions of the ACA, which is plausible given the history of the SGR, then the budgetary effects of the ACA will result in a worse financial outcome for the United States than the *Report* indicates.

It is astounding that the *Report* again fails to provide a single plan of action to address these key areas of spending. This failure only increases the magnitude of the country's ticking debt bomb, and it will only make future actions to address the debt more painful.

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