Why the Markets Ignore CBO Forecasts

By Elizabeth MacDonald February 6, 2013

The Congressional Budget Office came out with its closely watched annual forecast of federal spending and revenues Tuesday, which underpins U.S. tax and regulatory policy. The CBO is the place elected officials run to because it is considered the main source for credible, non-partisan numbers.

The CBO said U.S. gross domestic product will be weak this year and the U.S. budget deficit would drop to $845 billion. It also said that the government would add a scary $7 trillion to the federal deficit over the next 10 years.

However, the stock market rallied anyway yesterday. Why? Because Wall Street analysts note to FOX Business that they understand the CBO has been consistently way off in its projections.

Economist Kevin Kliesen and economic adviser Daniel Thornton wrote last year in the Federal Reserve Bank of St. Louis Review (click here) that, surprisingly, “in 2000, after more than 40 years of nearly consecutive budget deficits, both the White House’s Office of Management and Budget and the CBO projected decade-long budget surpluses.”

Moreover, “both agencies projected that publicly held government debt (then totaling $3.5 trillion in 2000) would be completely eliminated by 2010,” the two economists wrote.

But rather than being wiped out as projected, “publicly held government debt increased to over $9 trillion by 2010,” the two note.

And it wasn’t because the financial collapse wrecked the CBO’s forecasts. “The failure of the projected surpluses to materialize was not the consequence of an unforeseen financial crisis,” they said. “Publicly held government debt had increased to over $5 trillion before the crisis.”

However, the CBO's initial rosy forecasts caused a blow-out in government spending—why should the government run a surplus?

The rosy estimates "naturally, caused economists and market participants to consider potential changes to market-making activity associated with the all-important Treasury securities market," the analysts noted, adding that in turn, "over the past few years, U.S. budget deficits have been at levels previously attained only during the Civil War and the two world wars," as well as the War of 1812.

The CBO misfired again, back in January 2001. Back then, CBO's baseline projections showed a cumulative surplus of $5.6 trillion for the 2002 to 2011 period. Instead, the government ran a cumulative deficit over the 10-year period of about $6.2 trillion, "a swing of $11.8 trillion from the January 2001 projections," notes Paul Caron, tax professor at Pepperdine University School of Law.

The CBO's economic growth forecasts have been off, too. For instance, it forecast back in 2011 that GDP growth for 2013 would be 3.4% and the jobless rate would be 6.4%.

It now says GDP growth for this year will be less than half of that number, 1.4%, and the jobless rate will be above 7.5%.

In fact, each of the CBO's "Outlook" forecasts in January 2012, 2011, 2010, and 2009, all forecast a robust recovery around the corner, just two years away.

The CBO in each of those forecasts since 2009 said that the U.S. "economy would grow by more than 3% two years out and maintain that growth for three to four years," says Salim Furth, PhD, a senior policy analyst at the Heritage Foundation.

But that hasn't happened either. Instead, "from 2010 to 2012, annual growth averaged 2.1 %," notes Furth, and GDP "hasn't grown by 2.5% in any year since the recession."

Despite the fact that the reality check has clearly bounced, the CBO now projects 3.4% GDP growth "in 2014 and an average of 3.6% a year from 2015 through 2018."

Kliesen and Thornton wrote in the St. Louis Fed Review that CBO forecasts are less predictive "than a random walk model," for example, mathematical models used on Wall Street to show haphazard picks of stocks perform better than managed portfolios. "Using CBO deficit projections over the period 1976-99, we found that the deficit projections beyond a year were unreliable," they added. "Importantly, we found that the projections were biased in the direction of under-projecting the size of the deficit or over-projecting the size of the surplus."

The concern over CBO numbers is heightened now because the White House and Congress are still battling over deep sequestration cuts in the fiscal cliff 2.0 negotiations. A Congressional "super committee" failed to lay out at least $1 trillion in spending cuts over 10 years as required under the Budget Control Act passed last summer (a "super committee," even though the government already has a debt commission, Congress, which has failed to do its day job, notes Senator Tom Coburn).

The problem is that the CBO is, by law, hamstrung largely because it can't include in its forecasts any of its own judgments about the decisions made by federal and monetary policymakers.

"Unlike private-sector forecasters," wrote the economists, the CBO cannot "anticipate future changes in fiscal or monetary policy." Instead, it must adhere to strict rules when scoring legislation. By law, it essentially must assume that existing Washington policies will stay the same and never change, the same policies "that govern outlays and receipts will prevail over the projection horizon," note the economists.

The CBO's hands are "tied by current laws," Philip Joyce, former CBO staffer and author of The Congressional Budget Office: Honest Numbers, Power, and Policymaking. Congress won't change the laws to let the CBO exercise its own judgment.

Which means the term "non-partisan CBO" is actually an oxymoron, because the CBO is merely serving up a reheated dish of numbers ordered up by the White House or Congress that are merely predictors of goals that these branches of government want to achieve.

The CBO, of course, knows its constraints, which is why it publishes its "alternate fiscal scenario," which gives it flexibility in making its own judgment calls.

The CBO also appears to be ratcheting down its expectations. "Since 2009, CBO's expectation of real GDP in 2019 has slid by 4%," Heritage's Furth says.

Despite that, the CBO has been heavily criticized for sticking hard and fast to the use of Keynesian multipliers, which say that if the government borrows and spends $10 billion, that adds $10 billion to GDP—never mind the cost of that spending, as well as the cost of government agencies and government workers.

The CBO also has been criticized for flawed assumptions that understate the amount of wealth the middle class owns and overstates the wealth of the top 1%.

"If your tax return shows no income from capital, then, according to the CBO, you own no capital," Alan Reynolds, a senior fellow with the Cato Institute and David Henderson, a research fellow with the Hoover Institution, have noted in The Wall Street Journal.

But they add: "Can the CBO spell IRA? A huge and growing portion of capital owners in the U.S. earns dividends, interest and capital gains that never show up on tax returns because it is tax-sheltered. And the middle class owns a much higher fraction of its wealth in tax-sheltered assets than does the top 1%," they note.

Moreover, the analysts note that "high-income taxpayers are not allowed to contribute to an IRA or tax-free Roth account, and their contributions to other accounts are tightly limited. As a result, about 95% of the top 1%'s assets are still potentially taxable. And that causes the CBO's method to show an increase in wealth of the top 1%."

Oddly, the CBO skews the 1% wealth higher because it "assigns corporate profits to households, and includes the taxable portion of capital gains" as well, skewing the 1% wealth higher, they note. CBO's allocation of most corporate profits to the top 1% implies an average income of $1,259,700, compared to an average income of $940,441 in the most similar Piketty and Saez series (which includes capital gains)," citing groundbreaking research by renowned economists Thomas Piketty and Emmanuel Saez.