



The Economic and Budgetary Effects of Discretionary Funding Caps as Specified in the Limit, Save, Grow Act of 2023

JULY | 2023

Summary

The Congressional Budget Office has analyzed the economic and budgetary effects of imposing caps on discretionary budget authority.¹ Specifically, the agency has estimated what the effects would be if the funding caps enacted in June 2023 had been those required under H.R. 2811, the Limit, Save, Grow Act of 2023 (LSGA), which was passed by the House of Representatives on April 26, 2023. CBO has previously published estimates indicating that, relative to the agency's February 2023 baseline budget projections, caps under the LSGA would reduce the primary deficit—that is, the total deficit minus net interest outlays—by \$3.2 trillion from 2024 to 2033.² In comparison, the caps that became law under the Fiscal Responsibility Act of 2023 (FRA, Public Law 118-5) would reduce CBO's projections of discretionary spending, and therefore the projected primary deficit, by \$1.3 trillion over that period.³

Those estimates were prepared according to long-standing practice, reflecting the assumption that the total output

1. Spending that is funded through or controlled by appropriations is generally classified as discretionary. Discretionary budget authority (or funding) is the authority provided in appropriation acts to undertake such spending.
2. For details, see Congressional Budget Office, letter to the Honorable Jodey Arrington providing an estimate of the budgetary effects of H.R. 2811, the Limit, Save, Grow Act of 2023 (April 25, 2023), www.cbo.gov/publication/59102. In addition to the discretionary funding caps that are the focus of this report, that legislation included various provisions that would have reduced the deficit by a total of \$4.8 trillion over the 2023–2033 period.
3. See Congressional Budget Office, letter to the Honorable Kevin McCarthy regarding CBO's estimate of the budgetary effects of H.R. 3746, the Fiscal Responsibility Act of 2023 (May 30, 2023), www.cbo.gov/publication/59225. (Those estimates were produced using CBO's May 2023 baseline.)

of the economy, measured in current-year dollars (that is, in terms of nominal gross domestic product, or GDP), would not change. As a result, total income would be unchanged. The dynamic analysis described in this report considers a broader set of effects. It takes into account the ways that reductions in discretionary spending would affect the total output of the economy and how the resulting macroeconomic changes would in turn affect federal revenues and spending.

Two Scenarios Under Discretionary Funding Caps

CBO examined two illustrative policy scenarios that are based on the caps that would have been imposed by the LSGA. In both scenarios, the caps would take effect in the first quarter of fiscal year 2024—that is, starting in October 2023—as specified in the legislation, and discretionary funding would be reduced by the same total amount.

For the first scenario, CBO assumed that all discretionary funding—both defense and nondefense—that would be constrained by the caps would be reduced by amounts that were proportional to their levels under current law. For the second scenario, CBO assumed that defense funding would not be affected and that all nondefense discretionary funding that would be constrained by the caps would be reduced by a greater proportion than in the first scenario. CBO distributed the reduction in nondefense funding across noninvestment government purchases, physical infrastructure and research and development (R&D), transfers and subsidies, and education in proportions equal to the shares of such funding in fiscal year 2022.⁴

4. Transfers to individuals include cash payments and in-kind services provided through federal, state, and local government-assistance programs.

The two scenarios are illustrative because actual allocations of discretionary funding would be determined by future legislation. Further, the economic and budgetary effects would depend on the mix of reductions in various funding categories that CBO analyzed. A different mix of funding would lead to different results.

Macroeconomic Effects

In the short term, the reductions in discretionary spending under both scenarios would result in lower levels of real GDP (that is, GDP adjusted to remove the effects of inflation), employment, interest rates, and inflation relative to CBO's baseline projections. In the long term, real GDP would be higher because smaller deficits would increase the amount of resources available for private investment and thus boost the stock of capital assets. That effect would be partially offset by reductions in funding for physical infrastructure, R&D, and education, which would reduce private-sector productivity growth and real GDP. That offset would be larger under the second scenario, in which defense funding would be unaffected by the caps.

In general, CBO's estimates of the macroeconomic effects of a fiscal policy are sensitive to the economic conditions that exist when the policy is implemented. For example, CBO estimates that fiscal policy has a larger impact on inflation when supply disruptions are greater and the labor market is tight (that is, when unemployment is low and job vacancies are plentiful). If funding caps had taken effect before October 2023, when supply chains were disrupted to a greater degree and labor market conditions were tight for a longer period of time, the effects of decreased government spending in reducing inflation would have been substantially larger.

This analysis is based on the economic forecast that CBO finalized in early December 2022; that forecast underlies the agency's February 2023 baseline budget projections, which were used in this analysis. In CBO's forecast, the economy slowed in the first half of 2023, signaled by a modest decline in GDP, an increase in the unemployment rate, and a gradual decline in inflation. If the analysis described in this report had accounted for the faster economic growth and lower unemployment in the last quarter of 2022 and the first quarter of 2023 than CBO forecast, the effects of the reduction in government spending in reducing inflation would also have been larger. (Unless this report indicates otherwise, all years referred to in describing economic projections are calendar years. Years referred to in describing budget projections are federal fiscal years, which run from

October 1 to September 30 and are designated by the calendar year in which they end.)

Budgetary Effects

In both of CBO's illustrative scenarios, the macroeconomic changes would primarily affect the budget through reductions in interest rates. Those macroeconomic changes would reduce the deficit from 2024 to 2033 by \$242 billion in the first scenario and by \$222 billion in the second scenario.

In terms of total budgetary effects, including those stemming from macroeconomic changes, debt as a percentage of GDP in both scenarios would be 10 percentage points lower in 2033 than in CBO's February 2023 baseline. All told, deficits as a percentage of GDP would be an average of 0.9 percentage points below their values in CBO's February 2023 baseline, with a difference of 1.2 percentage points by 2033. About a tenth of the reductions in deficits and debt would stem from macroeconomic changes.

Caps on Discretionary Funding as Specified in the Limit, Save, Grow Act

The caps on discretionary budget authority that CBO analyzed, as specified in the LSGA, would have taken effect in October 2023.⁵ According to CBO's analysis, discretionary funding under those caps would be \$1.7 trillion in 2024, compared with \$1.8 trillion in 2022 and 2023, and would grow by about 1 percent per year thereafter.⁶

CBO estimates that, relative to its baseline projections in February 2023, the LSGA's discretionary funding caps—if they had been enacted instead of the FRA's caps—would have reduced total deficits over the 2024–2033 period by \$3.6 trillion, before accounting for the budgetary effects that would arise from changes in the economy. That deficit reduction reflects a decrease of \$3.2 trillion in primary deficits and \$0.4 trillion in net interest costs—amounting to 18 percent of the projected

5. The LSGA contained other provisions that are not analyzed in this report, such as changing energy taxation by repealing certain tax provisions of the 2022 reconciliation act (Public Law 117-169).
6. Discretionary spending encompasses an array of federal activities, including most defense spending and many nondefense activities, such as elementary and secondary education, housing assistance, the administration of justice, highway programs, and international affairs. It does not include entitlement programs such as Social Security and Medicare, which are categorized as mandatory spending.

deficit over that period. CBO used that estimate to underpin its analyses of the macroeconomic effects of the caps.

In the two scenarios that CBO analyzed, discretionary funding that would be constrained by the caps would be reduced by an amount that was proportional to the levels projected in CBO's baseline. In the first scenario, funding for defense, which accounted for approximately 45 percent of discretionary funding in 2022, would be reduced along with nondefense funding. In the second scenario, funding for defense would remain at baseline levels, and all the reductions needed to meet the same total reduction in discretionary budget authority required in the first scenario would be made in nondefense funding. (Ultimately, the actual spending mix would be determined by future appropriation legislation.)

The agency divided nondefense funding into four broad categories of spending that affect the economy through different avenues. The amount allocated to each category was estimated on the basis of an analysis of appropriations for 2022. Those categories are as follows:

- **Noninvestment government purchases of goods and services**, which accounted for approximately 27 percent of nondefense funding;⁷
- **Physical infrastructure and R&D**, which accounted for 27 percent of nondefense funding;
- **Transfers and subsidies** to individuals and state and local governments for purposes other than education, including cash payments and in-kind services provided through federal, state, and local government-assistance programs, which accounted for 27 percent of nondefense funding; and
- **Education**, which accounted for 18 percent of nondefense funding.

That mix of funding reductions represents one of many possible combinations of reductions that would satisfy the LSGA's caps. If the actual changes in discretionary funding relative to the baseline reflected a different distribution, then the economic effects would be different from those reported here.

7. Noninvestment government purchases of goods and services include spending for most federal employees' salaries and benefits, contracted services, and procurement.

Macroeconomic Effects of Discretionary Funding Caps

In the short term, total demand for goods and services in the economy—that is, aggregate demand—would be less in both scenarios under the LSGA's caps than in CBO's forecast because of reduced government spending. (Aggregate demand includes consumer spending, business investment, residential investment, government spending, and net exports.) As a result, levels of output, employment, interest rates, and inflation would be lower than they are in CBO's economic forecast. Estimates of the effects are sensitive to economic conditions, such as the tightness of the labor market and disruptions to supply chains. In the long term, output would rise because of increased private investment, and interest rates would remain lower than in CBO's forecast because of smaller deficits.

Short-Term Economic Effects

The short-term effects on the economy would be similar under both scenarios, though the effects on economic outcomes would be slightly smaller if only nondefense funding was reduced. That would occur because more of the reduction in funding would come from reduced transfers to state and local governments, which generally have a smaller effect on aggregate demand than direct government purchases do, in CBO's assessment.

Real GDP. When discretionary funding decreases, aggregate demand generally falls as overall spending declines. In both scenarios, real GDP would be 0.5 percent lower in calendar year 2024 than in CBO's forecast and would remain below CBO's baseline projection through 2027 (see Table 1).

Employment. The reductions in real GDP would correspond to reductions in employment. In 2024, employment would be lower by 0.5 million workers in the first scenario and by 0.4 million workers in the second scenario, relative to CBO's forecast. Employment would remain below the level in CBO's forecast through 2027 in both scenarios.

Interest Rates. Responding to the reduction in aggregate demand from reduced discretionary spending, the Federal Reserve would pursue easier monetary policy in the short term than it would have undertaken without the reduced spending, in CBO's assessment. As a result, interest rates would be lower than those in CBO's baseline projection. Relative to CBO's forecast, the interest

Table 1.

Macroeconomic Effects of Discretionary Caps as Specified in the Limit, Save, Grow Act of 2023 in Relation to CBO's February 2023 Baseline Forecast

| | 2024 | 2025 | 2026 | 2027 | 2028 | 2029 | 2030 | 2031 | 2032 | 2033 |
|--|-------|-------|-------|-------|------|------|------|------|------|------|
| Scenario 1: All Discretionary Funding Reduced | | | | | | | | | | |
| Real GDP (Percent) | -0.5 | -0.3 | -0.2 | * | ** | 0.1 | 0.1 | 0.1 | 0.2 | 0.2 |
| Employment (Millions of people) | -0.5 | -0.4 | -0.2 | -0.1 | 0 | 0 | 0 | 0 | 0 | 0 |
| Ten-Year Treasury Notes (Percentage points) | -0.2 | -0.2 | -0.1 | * | * | * | * | * | -0.1 | -0.1 |
| CPI-U Inflation (Percentage points) | -0.06 | -0.08 | -0.05 | -0.02 | 0 | 0 | 0 | 0 | 0 | 0 |
| Scenario 2: Only Nondefense Discretionary Funding Reduced | | | | | | | | | | |
| Real GDP (Percent) | -0.5 | -0.3 | -0.2 | -0.1 | ** | ** | 0.1 | 0.1 | 0.1 | 0.1 |
| Employment (Millions of people) | -0.4 | -0.4 | -0.2 | -0.1 | 0 | 0 | 0 | 0 | 0 | 0 |
| Ten-Year Treasury Notes (Percentage points) | -0.2 | -0.2 | -0.1 | * | * | * | * | * | -0.1 | -0.1 |
| CPI-U Inflation (Percentage points) | -0.05 | -0.07 | -0.05 | -0.02 | 0 | 0 | 0 | 0 | 0 | 0 |

Data source: Congressional Budget Office. See www.cbo.gov/publication/59173#data.

Real values are nominal values that have been adjusted to remove the effects of inflation.

CPI-U = consumer price index for all urban consumers; GDP = gross domestic product; * = between -0.05 and zero; ** = between zero and 0.05.

rate for 10-year Treasury notes would be 0.2 percentage points lower in 2024 in both scenarios and would remain lower for at least a few years thereafter.

Inflation. The reduction in aggregate demand from reduced government spending would reduce the annual rate of inflation by less than 0.1 percentage point in the first few years of the policy's implementation. (For details about the effects of discretionary funding caps on inflation, see Box 1.)

Long-Term Economic Effects

In the long term, the deficit reduction resulting from reduced discretionary funding under the LSGA's caps would increase the amount of resources available for private investment, which would boost real GDP. The increase in private investment and smaller deficits would reduce interest rates relative to CBO's forecast. Employment and inflation would be unaffected by the reduction in discretionary funding in the long term, in CBO's assessment. Additionally, reductions in funding for physical infrastructure, R&D, and education would reduce long-term productivity growth.

Real GDP. CBO estimates that, starting in calendar year 2028, real GDP would rise above its forecast in both scenarios. By 2033, real GDP would be 0.2 percent higher in the first scenario and 0.1 percent higher in the second scenario. The long-term rise in real GDP would be driven primarily by increases in resources available for

private investment resulting from the reduction in deficits relative to CBO's baseline; that effect would continue beyond the 10-year projection period considered in this analysis. By contrast, the reduction in spending for physical infrastructure, R&D, and education would result in decreased productivity growth relative to CBO's baseline projections, offsetting a portion of that growth. That offsetting effect would be larger in the second scenario, in which only nondefense funding would be reduced.

Employment. Reductions in discretionary funding would not affect employment in the long term because, in CBO's assessment, average employment in the long term is primarily determined by demographic trends and factors that affect the amount of labor supplied and not by aggregate demand. Employment would return to the levels in CBO's baseline forecast by 2028, the agency estimates.

Interest Rates. In the long term, increased private investment resulting from smaller deficits and decreased productivity from reductions in federal funding for physical infrastructure, R&D, and education would contribute to decreases in the return on capital and interest rates. The interest rate on 10-year Treasury notes would be about 0.1 percentage point lower in 2033 in both scenarios than in CBO's forecast; the effect would be slightly larger in the second scenario, in which only nondefense funding would be reduced.

Box 1.

Effects of Discretionary Funding Caps on Inflation

In the Congressional Budget Office's assessment, the effects of changes in fiscal policy depend critically on economic conditions that exist when the policy is in effect. Such conditions include the extent of disruptions in supply chains, the amount of tightness in the labor market, and the response of monetary policy. For instance, in the forecast CBO completed in December 2022 (which underlies the baseline budget projections used in this report), supply chains would function normally and the unemployment rate would average 5.1 percent in the first three months of calendar year 2024. Under those economic conditions, if the caps on discretionary funding as specified in the Limit, Save, Grow Act of 2023 (LSGA) were in effect from 2024 to 2033, the response of inflation to the resulting changes in fiscal policy would be relatively small.

To demonstrate those effects, CBO examined two illustrative policy scenarios. In the first scenario, the effect on inflation in calendar year 2024 would be a reduction of 0.06 percentage points, and in the second scenario, the effect would be a reduction of 0.05 percentage points.

Sensitivity Analysis

To indicate the sensitivity of the analysis to economic conditions, CBO also examined what the effects on inflation would have been if reductions in discretionary funding equal in size to those under the LSGA's caps had been made starting in the fourth quarter of calendar year 2021 and in the fourth quarter of calendar year 2022. (Those reductions were applied proportionally to defense and nondefense funding—the first scenario in this report.) In addition, CBO examined the effects on inflation if the agency used actual economic conditions from December 2022 through June 2023 and from its updated forecast for calendar years 2023 to 2025 (which will be published on July 26, 2023).

Effects on Inflation Under the Economic Conditions in 2021

In the fourth quarter of calendar year 2021, supply-chain disruptions reached their peak according to the Global Supply

Chain Pressure Index published by the Federal Reserve Bank of New York. In the following four quarters, the unemployment rate was below 4.0 percent. If the reductions in discretionary funding specified in the LSGA had started in the fourth quarter of calendar year 2021, the effect on inflation would have been amplified by the supply-chain disruptions and the tightness in the labor market. The reduction in inflation would have been about seven times larger during the first calendar year after the policy's implementation than CBO estimates would occur if the reductions in discretionary funding were to start in the fourth quarter of calendar year 2023.

Effects on Inflation Under the Economic Conditions in 2022

In the fourth quarter of calendar year 2022, the pressure on supply chains was about one-fourth of what it was a year earlier. The unemployment rate in that quarter was 3.6 percent. If the reductions in discretionary funding specified in the LSGA had started in that quarter, the reduction in inflation would have been about twice as large during the first calendar year after the policy's implementation than CBO estimates would occur if the reductions in discretionary funding were to start in the fourth quarter of calendar year 2023.

Effects on Inflation in CBO's Updated Summer 2023 Forecast

If the reductions in discretionary funding started in the fourth quarter of calendar year 2023 and the analysis used actual economic conditions from December 2022 through June 2023, along with CBO's updated forecast for 2023 to 2025, the effect on inflation would be amplified by more tightness in the labor market than CBO projected in December 2022. The reduction in inflation would be about one-sixth larger during calendar year 2024 than CBO estimates would occur using its December 2022 economic forecast.

Inflation. Although the reduction in aggregate demand would initially lower inflation in the short term, monetary policy would fully offset that effect in the long term, in CBO's assessment. As it does in CBO's forecast, inflation would return to the Federal Reserve's long-term inflation target of 2 percent after 2025, CBO estimates.

Budgetary Effects of Macroeconomic Changes Under Discretionary Funding Caps

In total, over the 2024–2033 period, changes in the economy resulting from the LSGA's caps on discretionary funding would increase revenues, decrease outlays, and reduce deficits and debt relative to CBO's

Table 2.

Budgetary Effects of Caps on Discretionary Funding as Specified in the Limit, Save, Grow Act of 2023

Billions of Dollars

| | 2024 | 2025 | 2026 | 2027 | 2028 | 2029 | 2030 | 2031 | 2032 | 2033 | Total | |
|---|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|---------------|
| | | | | | | | | | | | 2024–2027 | 2024–2033 |
| Budgetary Effects Without Macroeconomic Feedback^b | | | | | | | | | | | | |
| Effects on the Primary Deficit ^a | -129 | -202 | -244 | -280 | -314 | -343 | -373 | -404 | -436 | -469 | -854 | -3,194 |
| Effects on Net Interest Costs | -1 | -7 | -13 | -21 | -30 | -40 | -52 | -64 | -78 | -94 | -43 | -401 |
| Effects on the Deficit | -130 | -209 | -257 | -301 | -344 | -383 | -425 | -469 | -514 | -563 | -897 | -3,595 |
| Scenario 1: All Discretionary Funding Reduced | | | | | | | | | | | | |
| Effects of Macroeconomic Feedback | | | | | | | | | | | | |
| Effects on the Primary Deficit ^a | 16 | 18 | 11 | -22 | 4 | 2 | 0 | -2 | -5 | -9 | 23 | 13 |
| Effects on Net Interest Costs | -12 | -25 | -30 | -28 | -26 | -24 | -24 | -26 | -28 | -32 | -95 | -255 |
| Effects on the Deficit | 5 | -7 | -18 | -51 | -21 | -22 | -24 | -28 | -33 | -41 | -72 | -242 |
| Effects With Macroeconomic Feedback | | | | | | | | | | | | |
| Effects on the Primary Deficit ^a | -113 | -184 | -233 | -302 | -310 | -341 | -373 | -406 | -441 | -478 | -831 | -3,180 |
| Effects on Net Interest Costs | -13 | -32 | -43 | -49 | -56 | -64 | -76 | -90 | -106 | -125 | -138 | -656 |
| Effects on the Deficit | -126 | -216 | -276 | -352 | -366 | -405 | -449 | -497 | -548 | -604 | -969 | -3,836 |
| Scenario 2: Only Nondefense Discretionary Funding Reduced | | | | | | | | | | | | |
| Effects of Macroeconomic Feedback | | | | | | | | | | | | |
| Effects on the Primary Deficit ^a | 16 | 17 | 11 | -21 | 5 | 4 | 3 | 2 | -1 | -4 | 23 | 33 |
| Effects on Net Interest Costs | -11 | -25 | -29 | -28 | -25 | -24 | -25 | -27 | -29 | -33 | -93 | -255 |
| Effects on the Deficit | 4 | -7 | -18 | -49 | -20 | -20 | -22 | -25 | -30 | -37 | -69 | -222 |
| Effects With Macroeconomic Feedback | | | | | | | | | | | | |
| Effects on the Primary Deficit ^a | -113 | -184 | -233 | -301 | -309 | -339 | -370 | -403 | -437 | -473 | -831 | -3,161 |
| Effects on Net Interest Costs | -13 | -32 | -42 | -49 | -55 | -64 | -76 | -91 | -107 | -127 | -135 | -656 |
| Effects on the Deficit | -126 | -216 | -275 | -349 | -364 | -403 | -446 | -494 | -544 | -600 | -966 | -3,817 |

Data source: Congressional Budget Office. See www.cbo.gov/publication/59173#data.

Macroeconomic feedback refers to the ways in which the act would affect the budget by changing the economy.

Negative numbers indicate a reduction in the deficit, and positive numbers indicate an increase in the deficit.

a. The primary deficit is the total deficit excluding net outlays for interest.

b. The budgetary effects without macroeconomic feedback reflect CBO's baseline economic projections and were included in Congressional Budget Office, letter to the Honorable Jodey Arrington providing an estimate of the budgetary effects of the Limit, Save, Grow Act of 2023 (April 25, 2023), www.cbo.gov/publication/59102.

February 2023 baseline budget projections. Most of the deficit reduction stemming from macroeconomic changes would be attributable to a reduction in net interest costs. From 2024 to 2033, those macroeconomic changes would reduce total deficits by an estimated \$242 billion in the first scenario, in which all discretionary funding would be reduced proportionally (see Table 2). In the second scenario, in which only non-defense funding would be reduced, macroeconomic changes would lower total deficits by \$222 billion during that period.

Effects on the Primary Deficit

Although the lower discretionary spending resulting from the caps would reduce primary deficits—by a total of \$3.2 trillion over 10 years—the resulting macroeconomic changes would increase those deficits slightly—by an estimated \$13 billion in the first scenario and by \$33 billion in the second one.

Changes in the economy would increase the primary deficit during the first several years of the 2024–2033 period because the fall in real GDP would reduce

revenues; at the same time, the rise in the unemployment rate, among other macroeconomic changes, would increase mandatory spending. (Mandatory spending includes outlays for the following major programs: Social Security, Medicare, Medicaid, unemployment insurance, the Supplemental Nutrition Assistance Program, refundable tax credits, child nutrition programs, and other indexed entitlements. Such spending is generally governed by statutory criteria and is not normally constrained by the annual appropriation process.) In the long term, the rise in real GDP would boost revenues, leading to reductions in the primary deficit toward the end of the 10-year period.

The specifics of the funding provided under the caps would be determined by future appropriation acts. Those specifics might, in turn, have important budgetary effects that are not accounted for in this report. Discretionary funding is needed to administer most federal programs, and reductions in discretionary funding could, in turn, alter mandatory spending and revenues.⁸ For example, if people faced additional challenges and delays in receiving disability benefits because of reductions in discretionary funding for administration of the program, then spending for those benefits would be lower than projected in CBO's baseline. Alternatively, some reductions in discretionary spending could result in increases in mandatory spending.

Changes to discretionary funding can also affect revenues. If, for example, regular discretionary appropriations to the Internal Revenue Service (IRS) were reduced as a result of the caps, CBO anticipates that revenues would be lower than projected in its baseline. That baseline reflects the assessment that the voluntary compliance rate—that is, the share of taxes owed that are paid voluntarily and on time—is unlikely to change much in the next 10 years under CBO's baseline projections of IRS funding. If funding for the IRS was reduced,

CBO expects that less revenue would be collected from enforcement activities.

In addition, a large reduction in IRS funding would increase the risk of a decline in the voluntary compliance rate. Such a decline could result from reductions in customer service, as taxpayers who wanted to comply with tax laws struggled to understand their liability, or from reductions in enforcement, which could change the likelihood of penalties for noncompliance. A reduction in voluntary compliance could have large budgetary effects. The IRS projects that the voluntary compliance rate was about 85 percent over the 2017–2019 period. In CBO's assessment, a one-percentage-point reduction in the voluntary compliance rate would increase the primary deficit by about \$700 billion over the 2024–2033 period.

Effects on Net Interest Costs

Decreases in net interest costs under the caps would more than offset the increase in mandatory spending that would occur because of macroeconomic changes. Changes in net interest costs would reduce the total deficit from 2024 to 2033 by \$255 billion in both scenarios relative to the amounts in CBO's baseline projections, the agency estimates. The decrease in net interest costs would be attributable primarily to the decreases in interest rates throughout the 10-year period relative to those in CBO's forecast.

Effects on Deficits and Debt

Under the caps, the increase in revenues and decrease in outlays stemming from macroeconomic changes would reduce the annual deficit, measured as a percentage of GDP, over the 2024–2033 period by an average of 0.1 percentage point, with minimal difference between the two scenarios. As a result of those macroeconomic changes, the deficit in 2024 would increase slightly, and deficits in subsequent years would decrease.

Including those changes, the caps would reduce projected budget deficits by \$3.8 trillion over the 10-year period—an average of 0.9 percentage points of GDP each year, with a reduction of 1.2 percentage points in 2033. As a result, by 2033, federal debt as a percentage of GDP would be 10 percentage points lower than in CBO's February 2023 baseline projection in both scenarios (see Table 3). About a tenth of the reductions in deficits and debt would stem from macroeconomic changes.

8. Although some mandatory spending and revenues are sensitive to discretionary funding levels, under Congressional scorekeeping guidelines, cost estimates for appropriation legislation reflect baseline levels of mandatory spending and revenues unless that legislation modifies the authorizing statutes that govern those programs or taxes. The effects on mandatory spending and revenues that stem from changes in the amounts appropriated for administrative or enforcement costs, for example, would be reflected in CBO's subsequent baseline projections.

Table 3.

Total Effects on Deficits and Debt of Discretionary Funding Caps as Specified in the Limit, Save, Grow Act of 2023

Percentage of GDP

| | 2024 | 2025 | 2026 | 2027 | 2028 | 2029 | 2030 | 2031 | 2032 | 2033 |
|--|------|------|------|------|------|------|------|------|------|------|
| Scenario 1: All Discretionary Funding Reduced | | | | | | | | | | |
| Decrease (-) in the Primary Deficit ^a | -0.4 | -0.6 | -0.8 | -1.0 | -1.0 | -1.0 | -1.1 | -1.1 | -1.2 | -1.2 |
| Decrease (-) in Net Interest Costs | * | -0.1 | -0.1 | -0.2 | -0.2 | -0.2 | -0.2 | -0.2 | -0.3 | -0.3 |
| Decrease (-) in the Total Deficit | -0.4 | -0.7 | -0.9 | -1.1 | -1.1 | -1.2 | -1.3 | -1.4 | -1.4 | -1.5 |
| Change in Federal Debt Held by the Public | ** | -1 | -2 | -3 | -4 | -5 | -6 | -7 | -9 | -10 |
| Scenario 2: Only Nondefense Discretionary Funding Reduced | | | | | | | | | | |
| Decrease (-) in the Primary Deficit ^a | -0.4 | -0.6 | -0.8 | -1.0 | -0.9 | -1.0 | -1.1 | -1.1 | -1.2 | -1.2 |
| Decrease (-) in Net Interest Costs | * | -0.1 | -0.1 | -0.1 | -0.2 | -0.2 | -0.2 | -0.2 | -0.3 | -0.3 |
| Decrease (-) in the Total Deficit | -0.4 | -0.7 | -0.9 | -1.1 | -1.1 | -1.2 | -1.3 | -1.3 | -1.4 | -1.5 |
| Change in Federal Debt Held by the Public | ** | -1 | -2 | -3 | -4 | -5 | -6 | -7 | -8 | -10 |
| Memorandum: | | | | | | | | | | |
| Deficit in CBO's February 2023 Baseline | -6.1 | -6.1 | -5.7 | -5.5 | -5.6 | -5.8 | -6.0 | -6.3 | -6.5 | -6.9 |
| Federal Debt Held by the Public in CBO's February 2023 Baseline | 100 | 102 | 103 | 104 | 107 | 108 | 110 | 112 | 115 | 118 |

Data source: Congressional Budget Office. See www.cbo.gov/publication/59173#data.

The denominator of the estimates for Scenarios 1 and 2 is CBO's forecast of GDP, which was published in February 2023.

The changes are relative to CBO's February 2023 baseline.

GDP = gross domestic product; * = between -0.05 and zero; ** = between zero and 0.1.

a. The primary deficit is the total deficit excluding net outlays for interest.

Basis for the Estimates

For this analysis, CBO used a suite of models to estimate the economic effects stemming from reduced discretionary funding and the resulting budgetary effects. Those models are designed to estimate both the short- and long-term effects of alternative fiscal policies under a set of specified economic conditions and the budgetary effects caused by macroeconomic changes.⁹

Short-Term Macroeconomic Analysis

In the short term, the reduction in discretionary funding under the LSGA's caps would translate over time into reduced federal outlays and aggregate demand. Dollar for

dollar, reductions in government spending on purchases directly affect aggregate demand, whereas the effect on aggregate demand from reductions in transfers and subsidies depends in part on how households and businesses respond to such reductions. Households and businesses adjust their spending in response to changes in transfers and subsidies. That change in consumption is reflected in the change in aggregate demand.

For this analysis, CBO estimated that for every dollar in reduced federal spending on transfers and subsidies, household and business spending would decline by 70 cents. That estimate reflects the fact that the reductions in federal spending would mostly affect households in the bottom third of the income distribution.

In CBO's estimation, the effect on inflation following a reduction in aggregate demand depends on the economic conditions that exist when the policy is implemented. When supply constraints are severe and labor markets

9. For overviews of that approach to economic analysis, see Mark Lasky, *The Congressional Budget Office's Small-Scale Policy Model*, Working Paper 2022-08 (Congressional Budget Office, September 2022), www.cbo.gov/publication/57254; and Congressional Budget Office, *How CBO Analyzes the Effects of Changes in Federal Fiscal Policies on the Economy* (November 2014), www.cbo.gov/publication/49494.

are tight, the effect of reduced aggregate demand on inflation is larger than it would be when supply is less constrained and the labor market is less tight (see Box 1 on page 5).¹⁰

Long-Term Macroeconomic Analysis

Reductions in the deficit affect investment and output over the longer term by increasing the amount of funding available for private investment. In CBO's estimation, for every dollar of deficit reduction, private investment increases by 33 cents.¹¹

For this analysis, CBO assumed that a portion of the reduction in discretionary funding under the LSGA would include reductions in funding for physical infrastructure and R&D. In CBO's assessment, spending for infrastructure and R&D increases productivity and output. Specifically, CBO estimates that a one-dollar reduction in infrastructure capital decreases real potential (maximum sustainable) GDP by 9.2 cents, on average, after accounting for depreciation. All else being equal, reductions in funding for infrastructure and R&D under discretionary funding caps would depress output, in CBO's estimation.

The long-term macroeconomic effects of reductions in funding for education could occur with long delays (as could the effects of changes in funding for R&D), especially for elementary and early childhood education. Moreover, the productivity returns to education funding are potentially different from those for physical infrastructure and R&D. CBO estimates that, under the caps, the reduction in federal spending for postsecondary education would slightly reduce aggregate productivity and output between calendar years 2026 and 2033 and would slightly reduce labor income from calendar year 2026 to 2033 relative to the amounts in the agency's economic forecast. Decreases in funding for education would continue to decrease output beyond the first 10 years.

Federal funding for physical infrastructure and education often involves grants to state and local governments. CBO estimates that a dollar reduction of federal spending on physical infrastructure would decrease realized investment spending by 87 cents; the remaining 13 cents would be offset by an increase in investment spending by state and local governments. For education funding, CBO estimates that the state and local offset would be 12 cents on the dollar. The size of those offsets under the caps would depend on the amount of the reduction in infrastructure and education funding.

Budgetary Analysis

Using the macroeconomic effects discussed above as inputs, CBO used its incomes model to forecast a larger set of income and interest rate variables required for its budgetary analysis.¹² The incomes model takes a small number of variables as inputs, including the following: production variables, such as GDP and private investment; employment variables, such as wages and salaries and the unemployment rate; price indexes, such as the GDP price index and the consumer price index; and interest rates, such as the federal funds rate, the 3-month Treasury bill rate, and the 10-year Treasury note rate. The model generates a larger number of variables as outputs that are largely subcomponents of national income, including the following: proprietors' income and labor compensation; total nonwage personal income and net interest payments; current transfer payments and corporate profits; consumption of fixed capital and capital income; and interest rates on Treasury securities with durations of 1, 3, 5, and 30 years.

10. See U. Devrim Demirel and Matthew Wilson, *Effects of Fiscal Policy on Inflation: Implications of Supply Disruptions and Economic Slack*, Working Paper 2023-05 (Congressional Budget Office, April 2023), www.cbo.gov/publication/59056. See also Gauti B. Eggertsson and Don Kohn, "The Inflation Surge of the 2020s: The Role of Monetary Policy," paper presented at the conference on *The Fed: Lessons Learned From the Past Three Years* (Brookings Institution, May 23, 2023), <https://tinyurl.com/4vrsmc93>; Pierpaolo Benigno and Gauti B. Eggertsson, *It's Baaack: The Surge in Inflation in the 2020s and the Return of the Non-Linear Phillips Curve*, Working Paper 31197 (National Bureau of Economic Research, April 2023), www.nber.org/papers/w31197; Peter Hooper, Frederic S. Mishkin, and Amir Sufi, "Prospects for Inflation in a High Pressure Economy: Is the Phillips Curve Dead or Is It Just Hibernating?" *Research in Economics*, vol. 74, no. 1 (March 2020), pp. 26–62, <https://doi.org/10.1016/j.rie.2019.11.004>; Alexander Doser and others, *Inflation Expectations and Nonlinearities in the Phillips Curve*, Working Paper 17-11 (Federal Reserve Bank of Boston, October 2017), <https://tinyurl.com/2k6dp6um>; Laurence M. Ball, Daniel Leigh, and Prachi Mishra, *Understanding U.S. Inflation During the COVID Era*, Working Paper 30613 (National Bureau of Economic Research, October 2022), www.nber.org/papers/w30613; and Joseph E. Gagnon and Christopher G. Collins, *Low Inflation Bends the Phillips Curve*, Working Paper 19-6 (Peterson Institute for International Economics, April 2019), <https://tinyurl.com/42e6ww52>.

11. See Jonathan Huntley, *The Long-Run Effects of Federal Budget Deficits on National Saving and Private Domestic Investment*, Working Paper 2014-02 (Congressional Budget Office, February 2014), www.cbo.gov/publication/45140.

12. See Congressional Budget Office, "Assessing the Budgetary Implications of Economic Uncertainty With CBO's Incomes Model and Budgetary Feedback Model" (January 2023), www.cbo.gov/publication/58885.

CBO used its budgetary feedback model to estimate how changes in the economy stemming from the funding reductions under the caps would affect budgetary outcomes.¹³ CBO used that model to project the following major sources of revenues: receipts from individual income taxes, payroll taxes, corporate income taxes, Federal Reserve remittances, customs duties, estate and gift taxes, and excise taxes. CBO also used the model to project outlays for mandatory, discretionary, and net interest spending.

13. See Nathaniel Frentz, Jaeger Nelson, Dan Ready, and John Seliski, *A Simplified Model of How Macroeconomic Changes Affect the Federal Budget*, Working Paper 2020-01 (Congressional Budget Office, January 2020), www.cbo.gov/publication/55884.

This report was prepared at the request of the Chairman of the Senate Committee on the Budget. In keeping with the Congressional Budget Office's mandate to provide objective, impartial analysis, the report makes no recommendations.

Jaeger Nelson and Matthew Wilson wrote the report with guidance from Devrim Demirel and Richard DeKaser. Nabeel Alsalam, Elizabeth Ash, Aaron Betz, Sheila Campbell, William J. Carrington (formerly of CBO), Junghoon Lee, Brooks Pierce, Dan Ready, and Chad Shirley contributed to the analysis. Christi Hawley Anthony, Joseph Kile, John McClelland, and Julie Topoleski provided useful comments. Grace Berry fact-checked the report. Participants at the June 2023 meeting of CBO's Panel of Economic Advisers also commented on the analytical approach; that assistance implies no responsibility for the final product, which rests solely with CBO.

Mark Doms, Jeffrey Kling, and Robert Sunshine reviewed the report. Loretta Lettner edited it, and Casey Labrack formatted the tables, with assistance from Jorge Salazar, and prepared the text for publication. The report is available on CBO's website at www.cbo.gov/publication/59173.

CBO seeks feedback to make its work as useful as possible. Please send any comments to communications@cbo.gov.



Phillip L. Swagel
Director

