COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET — U.S. Budget Watch

More on the President's FY2010 Budget Blueprint
March 9, 2009

In our previous release (President Obama's FY2010 Budget), we discussed the broad fiscal impact of the FY2010 Budget Blueprint. We commended the President for having a specific fiscal goal, honestly budgeting for expected costs, and for providing offsets for many of the new policies he supports. However, we expressed strong concern that the budget included items in the baseline (such as AMT patches, Medicare patches, and the renewal of the 2001 and 2003 tax cuts), as a way to avoid paying for them—a policy that would make the already dire fiscal picture even worse. This release takes a more in-depth look at some of the most important items and trends in the budget.

Main Points:

- If the economy is growing as strongly as the Administration is projecting, a more aggressive deficit goal would be appropriate. But if OMB's economic assumptions prove to be overly optimistic, it is likely that large deficits will need to persist. Any short-term deficit goal should remain flexible.

- We find it troubling that President Obama's budget introduces large new spending programs and tax cuts (and renews existing tax cuts and spending), before finding ways to close the fiscal gap. We would prefer to see the proposed revenue raisers and spending reductions used to improve the current fiscal picture. At the very minimum, it is critical that the Administration insist that Congress abide by the principle they set forth that all new initiatives should be fully offset. We worry that Congress will attempt to pass many of the spending initiatives and tax cuts without the offsets.

- We are disappointed that the budget largely fails to address the long-term. The health care savings in the budget are a commendable first step, but relatively small in size and used entirely to pay for new health care spending – at least through 2019. More aggressive efforts to slow health care cost growth will be needed, as will additional measures to reduce and/or finance the growth in entitlement spending.

Deficit & the Debt

President Obama's budget would significantly increase spending over the short- and long-term, while keeping taxes low (and in fact cutting them further) in the short-term before increasing them somewhat. The Administration's policies would reduce the ten-year deficit by $2 trillion compared to the Administration's policy baseline (which assumes the 2001/2003 tax cuts are renewed, the AMT received annual patches, physicians payments continue to grow in Medicare, and high levels of spending on the wars in Iraq and Afghanistan continue), but would increase it by at least $4.5 trillion from a standard current-law baseline. Baselines aside, the budget would require nearly $7 trillion in borrowing over ten years – with deficits decreasing through 2013, before remaining roughly steady at 3% of GDP.

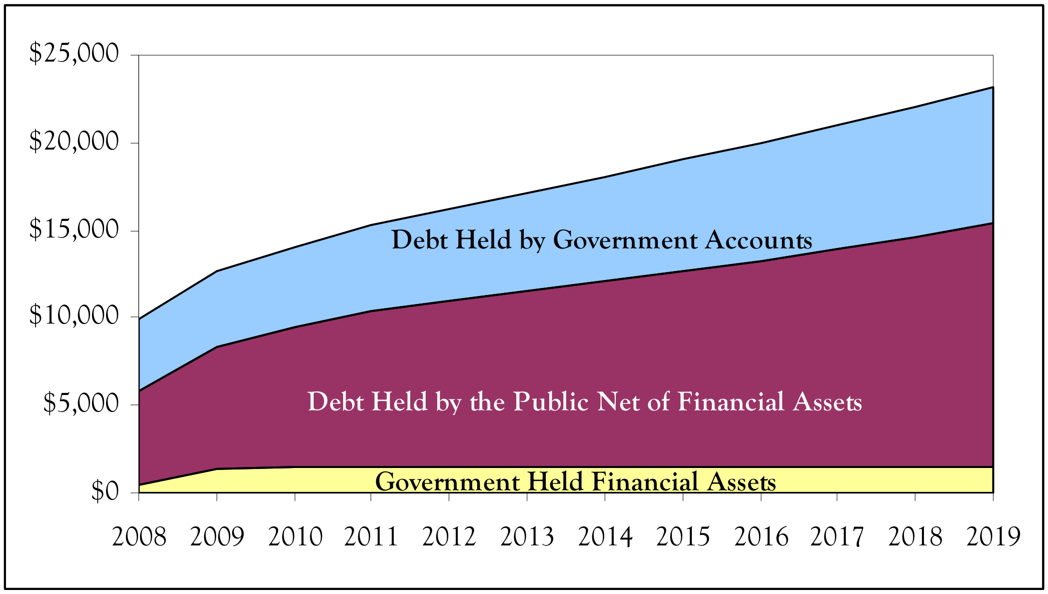
Fig. 1: Ten Year Budget Projections (billions and percent of GDP)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2010-2019
Revenue	$2,186	$2,381	$2,713	$3,081	$3,323	$3,500	$3,675	$3,856	$4,042	$4,234	$4,446	**$35,250**
Outlays	$3,938	$3,552	$3,625	$3,662	$3,856	$4,069	$4,258	$4,493	$4,678	$4,868	$5,158	**$42,219**
Deficit	**-1,752**	**-$1,171**	**-$912**	**-$581**	**-$533**	**-$569**	**-$583**	**-$637**	**-$636**	**-$634**	**-$712**	**-$6,969**
Revenue	15.4%	16.2%	17.5%	18.7%	19.0%	19.0%	19.1%	19.2%	19.3%	19.3%	19.5%	**18.7%**
Outlays	27.7%	24.1%	23.4%	22.2%	22.0%	22.1%	22.2%	22.4%	22.3%	22.2%	22.6%	**22.6%**
Deficit	**-12.3%**	**-8.0%**	**-5.9%**	**-3.5%**	**-3.0%**	**-3.1%**	**-3.1%**	**-3.2%**	**-3.0%**	**-2.9%**	**-3.1%**	**-3.9%**

The most important factor in determining whether the President's deficit goal of $533 billion in FY2013 is appropriate will be how well the economy is performing. If the economy remains weak, it would be premature to make deficit reduction a primary goal since aggressively pursuing contractionary policies could hinder a fragile recovery. If rather than deficit reduction, we need to continue deficit spending to help bring on a sustained recovery, they should come from automatic stabilizers, intentional stimulus measures, and policies with highly stimulative "bang for the buck."

However, if the economy is performing well (the Administration assumes real GDP growth of 3.2% in 2010, 4% in 2011, 4.6% in 2012, and 4.2% 2013), a half trillion dollar deficit goal is insufficient. In that case, the large increase in national debt, and in particular, in the debt held by the public, is likely to crowd out private investment and therefore reduce long-term economic growth. At the same time, ever-growing interest payments threaten the government's ability to deal with either normal or emergency policy challenges, especially as entitlement growth begins crowding out the remaining non-interest portion of the budget.

Fig. 2: Federal Debt (billions)



Once the economy is growing strongly enough to accommodate significant deficit reduction efforts, the trend should be continued deficit reduction until the budget is on a sustainable path. While the Administration has promised sustainability as a fiscal goal, deficits would continue to grow in dollar terms, and would fluctuate as a share of GDP, after the low point in FY2013 under the proposed budget. Just as we believed it was irresponsible to pass large tax cuts in 2001 and 2003 prior to dealing with the country's long-term fiscal imbalances—at which time the short term deficit projections were far better than those we face today—we think it is irresponsible to pursue policies that would further cut taxes or expand government spending before addressing both the immediate and longer-term budget imbalances.

Discretionary Spending

President Obama's FY2010 discretionary request, excluding stimulus and emergency spending (mainly for Iraq and Afghanistan), is 7.7% higher than the estimated budget authority for FY2009. Looking only at non-defense discretionary spending, this growth would increase to 11.2%.

Fig. 3: Discretionary Spending Budget Authority (billions)

Spending Category	FY2009 (estimated)	FY2010 (requested)	Percent Change
Defense Discretionary (Excluding Overseas Operations)	$513	$534	+4.1%
Non-Defense Discretionary (Excluding Stimulus Costs)	$539	$599	+11.2%
Total Non-Stimulus Spending	**$1,052**	**$1,133**	**+7.7%**

Note: Numbers exclude Pell Grants for both years, since the administration proposes designating them as mandatory spending. FY2009 numbers are adjusted for CHIMP Savers.

These numbers are significant in both real and nominal terms, especially given the low levels of economic growth and inflation being projected by the President's budget. On the other hand, they exclude the costs of overseas operations and other emergencies, which are projected to fall considerably over the next year. If these costs were taken into consideration, the administration predicts discretionary spending would grow by roughly 3%.

Mandatory Spending

In the President's budget, mandatory spending is slated to increase dramatically over the next decade, from $1.6 trillion in 2008 to over $3 trillion by 2019. Combined with interest payments on the debt, mandatory spending will grow from 62% of spending in 2008 to 70% in 2019. Most of this increase is already scheduled under current law or projected based upon current policy. However, a portion of this increase comes from the refundable portion of new tax credits (discussed in the tax section), as well as direct spending changes.

Included on the mandatory side of the President's budget is billions of dollars in both new spending and new savings. Among the major spending initiatives included are increased spending for child nutrition, a large expansion of Pell Grants (which are also moved from the discretionary side of the budget to the mandatory side), new funding for welfare, home heating, and home nursing programs, and increased spending on Trade Adjustment Assistance and Unemployment Insurance.

Over a five-year period, President Obama's budget fully offsets this new spending, largely from reducing farm subsidies, reforming student loan programs, and enhancing "program integrity" to reduce improper payments. Beyond the five year window, however, the President's new mandatory proposals begin to cost more than his new cuts and fees save – resulting in a $31 billion net increase in mandatory spending over ten years.[1] It should be noted that these numbers include nearly $50 billion in savings from program integrity initiatives that likely would not be scoreable for the purpose of budget enforcement. Furthermore, they do not include the refundable portion of tax credits, which are scored as outlays under standard budget procedures. These tax credit outlays are almost twice as big as the gross increase in mandatory spending, reflecting the preference of the Administration to use the tax code as a vehicle for many of its policy priorities.

[1] This increase excludes the costs of the refundable portions of proposed tax credits. It includes offsets raised from user fees, as well as changes in revenue which occur as a result of mandatory savings initiatives.

Fig. 4: Mandatory Spending and Savings by Category 2010 - 2019 (billions)

Measure	2010-2014	2010-2019
Child Nutrition	$4.9	$9.9
Defense Spending	$2.0	$5.4
Pell Grants	$41.8	$116.8
College Access	$2.1	$2.5
TANF, LIHEAP, & Home Nursing Visitation	$5.3	$15.8
Housing Assistance	$3.2	$3.3
Trade Adjustment and Unemployment Reform	$12.0	$23.6
Costs	**$71.2**	**$177.2**
Risk Insurance and Contracting Reform	-$0.9	-$2.2
Making VA DI Payments Discretionary	-$0.5	-$1.3
Spectrum Auctions	-$0.6	-$1.6
Increased Postal Contributions	-$4.2	-$9.5
Increase Return from Minerals on Federal Lands	-$1.8	-$3.1
Program Integrity Initiatives	-$29.8	-$51.4
Repeal Oil Exploration Program	-$0.2	-$0.3
Reform Student Loans	-$27.4	-$54.0
Cut Farm Subsidies	-$6.2	-$16.0
Savings	**-$71.6**	**-$139.3**
User Fees	**-$3.3**	**-$7.2**
Net Costs	**-$3.6**	**$30.7**
Increase in Outlays from Tax Expenditures	*$117*	*$326*

Tax Measures in the Budget

President Obama's budget includes a number of changes to the tax code with considerable economic, distributional, and fiscal consequences. Taken as a whole, the President's budget makes the tax code far more progressive than it currently is, both by allowing the 2001 and 2003 tax cuts to expire for wealthier individuals[2] and by creating or expanding a number of "refundable" tax credits that are targeted toward lower earners – including those who do not pay income taxes.

The centerpiece of the President's tax proposal is a plan to permanently renew the $400 per person "Making Work Pay" tax credit established in the recent stimulus package. The tax cut would cost roughly $65 billion a year and would be offset with revenues from auctioning carbon permits from a cap-and-trade system. In addition, the President would expand the EITC, expand the refundability of the Child Tax Credit, create an

[2] This excludes the proposed tax expenditure limits meant to finance heath care reform, which would make the tax code even more progressive.

"American Opportunity Tax Credit" to help pay for college, create new incentives and institutions for retirement savings, make permanent the R&D tax credit, and cut or extend certain other taxes.

To pay for these new tax cuts, President Obama would close a number of corporate and individual tax loopholes, and increase tax enforcement. Separately, the administration would allow the 2001 and 2003 tax cuts to expire – and tax capital gains and dividends at a 20% rate – for family income over $250,000 a year (or individual income over $200,000 a year). The Administration has said this money would be "dedicated to deficit reduction."

Compared to the Administration's baseline, these provisions (including revenue from the cap-and-trade system) would increase revenue by almost $700 billion over ten years. However, included in their baseline is the renewal of *all* of the 2001 and 2003 tax cuts, as well as continued annual patches of the AMT – neither of which would occur under present law. Compared to a standard present-law baseline, the President's budget would *reduce* revenue by nearly $2.6 trillion (although some of this reduction would come from the refundable portion of tax credits, which would be counted as outlays under standard budgeting procedure).

Fig. 5: Tax Changes in the Budget (billions)

Measure	2010-2014	2010-2019
Making Work Pay Tax Credit	-$203.5	-$536.7
Other Individual Tax Cuts	-$75.1	-$233.4
Corporate Tax Cuts	-$61.6	-$149.4
Continuation of Certain Provisions through End of 2010	-$17.1	-$20.7
New Tax Cuts	**-$357.3**	**-$940.2**
Tax Carried Interest as Ordinary Income	$14.8	$23.9
Repeal LIFO Accounting Rules	$17.8	$61.1
International Enforcement and Other Tax Reform	$70.0	$210.0
Eliminate Tax Preferences for Oil and Gas Companies	$12.7	$31.5
Close Other Tax Loopholes	$10.4	$27.0
Allow 2001 and 2003 Tax Cuts to Expire for Higher Earners	$204.0	$636.7
Cap-and-Trade Revenue	$237.5	$645.7
New Tax Increases	**$567.1**	**$1,635.9**
Net Revenue Increase from Budget Baseline	**$209.9**	**$695.7**
Annual AMT Patches	-$205.6	-$575.9
Renewal of All 2001/2003 Tax Cuts	-$953.0	-$2,681.3
Net Revenue Increase from Current-Law Baseline	**-$948.8**	**-$2,561.5**

Health Care in the Budget

While many details remain unavailable, President Obama has set aside some money to finance his health care reform plan in a "reserve fund." Measures to finance this fund would raise $49 billion in 2012, $96 billion in 2019, and $624 billion over ten years. This money would be insufficient to finance the plan on which President Obama campaigned – which his campaign estimated would cost roughly $115 billion a year and the Lewin Group priced at $1.8 trillion over ten years.[3] However, the President's budget commits to budget-neutral health care reform, suggesting that any further spending will be paid for with additional offsets.

The $634 billion dedicated to health care reform come both from new revenue ($318 billion) and from reduced spending on Medicare and Medicaid ($316 billion). The expected revenue comes from a proposal to limit the tax rate at which an itemized deduction can be taken to 28%. Of the expected Medicare and Medicaid savings, the largest chunk comes from reducing spending on Medicare Advantage – the private alternative to Medicare. Other savings come from means-testing Medicare Part-D (through progressive premiums), from implementing a number of payment reforms designed to make health care delivery more efficient, and from addition measures.

Fig. 6: Health Care Savings in the Budget (billions)

Measure	2010-2014	2010-2019
Institute Competitive Bidding for Medicare Advantage	$46.8	$176.6
Increase Premiums for High-Income Enrollees Medicare Part D	$2.4	$8.1
Reallocate Medicare and Medicaid Improvement Funds	$5.8	$23.9
Encourage Hospitals to Reduce Readmissions Rates	$2.5	$8.4
Create Hospital Quality Incentive Payments	$3.0	$12.1
Bundle Certain Medicare Payments	$1.0	$17.8
Reform Payments for Medical Imaging	$0.1	$0.3
Ensure Accurate Medicare Payments	$0.7	$2.0
Promote Cost-Effective Purchase of Medicaid Prescription Drugs	$8.2	$19.6
Promote Increased Use of Generic Medications	$0.0	$9.2
Expand Family Planning Under Medicaid	$0.0	$0.2
Ensure Appropriate Medicaid Payments	$0.2	$0.6
Improve Medicare Home Health Payments	$13.2	$37.1
Medicare and Medicaid Savings	**$83.7**	**$316.0**
Limit the Tax Rate for Deductions to 28%	**$110.8**	**$317.8**
Total Funding Available for Health Reform	**$194.6**	**$633.8**
Cost of Additional Expected Medicare Physician Payments Relative to Current-Law Baseline	*-$147.1*	*-$329.6*

[3] Lewin Group, http://www.lewin.com/content/Files/The_Lewin_Group_McCain-Obama_Health_Reform_Analysis_Revised_10-15-08.pdf.

Economic Assumptions

Given the considerable uncertainty regarding the future economic climate, the economic assumptions used in the budget are extremely important. In addition to suggesting different policy prescriptions, these assumptions have a large effect on deficit projections. Higher economic growth and lower unemployment, for example, lead to more tax revenue and lower spending on automatic stabilizers such as unemployment benefits and food stamps.

The administration's GDP growth assumptions seem to be in line with what CBO would project, after accounting for the effects of the stimulus.[4] They are also consistent with, and perhaps on the pessimistic side of what is being projected by the members of the Federal Reserve Board of Governors Bank Presidents. At the same time, the President's budget is far more optimistic than the private sector projections. The Administration expects to see a small (but significant) drop in real GDP this year (-1.2%), followed by high growth rates of 3.2%, 4%, and 4.6% over the next three years. Private sector forecasters are projecting GDP to decline by closer to 2% this year, and expect growth rates of between 2% and 3% in subsequent years.[5]

Fig. 7: Projections of GDP Growth

	2008*	2009	2010	2011	2012	2013
2010 Budget	+1.3%	-1.2%	+3.2%	+4.0%	+4.6%	+4.2%
CBO (High)*	+1.3%	+1.6%	+4.9%	+5.4%	+4.9%	+4.4%
CBO (Low)*	+1.3%	-0.8%	+2.6%	+4.6%	+4.5%	+4.1%
Blue Chip#	+1.3%	-1.9%	+2.1%	+2.9%	+2.9%	+2.8%
Survey Professional Forecasters	+1.3%	-2.0%	+2.2%			
NABE Panel	+1.3%	-1.9%	+2.4%			
Federal Reserve Governors and Presidents+		-2.5% to +0.2%	+1.5% to +4.5%	+2.3% to +5.5%		

*CBO numbers approximated by CRFB based on *annual* baseline estimates and *fourth quarter* estimates of stimulus impact. Actual CBO projections would likely differ somewhat.
#The Blue Chip longer-run forecast is from their October long-run extension survey, not their February near-term survey. Some have argued that they therefore fail to account for an economic uptick often seen after periods of recession.
+Represents range of forecasts made by Federal Reserve Governors and Bank Presidents. Projections measured from fourth quarter to fourth quarter.

4 CRFB adjusts the economic assumptions from CBO's January baseline to account for their estimates on the impact of the recently passed stimulus bill (see http://www.cbo.gov/doc.cfm?index=10008 and http://www.cbo.gov/doc.cfm?index=9958). Since the latter is based upon fourth quarter rather than annual average estimates, our numbers might differ modestly from CBO's actual revised projections, which will be issued in two weeks. In a recent blog entry, OMB Director Peter Orszag argued that this provides a better "apples-to-apples" comparison between CBO's and OMB's economic assumptions, since it accounts for the stimulus (http://www.whitehouse.gov/omb/blog/09/02/28/EconomicforecastsandtheBudgetConsistencywithCBO/).

5 From 2011 through 2013, the Administration's GDP forecasts are at least 1.4 to 1.7 percentage points above the Blue Chip average, but the comparison may be limited by the fact that the Blue Chip extension beyond the next two years is taken from its October 2008 publication.

The unemployment assumptions used by the Administration also appear to be near the middle of the range of CBO's post-stimulus estimates. At the same time, their numbers are more optimistic, overall, than the members of the Federal Reserve Board of Governors and Bank Presidents or than most recent private sector forecasts or forecast averages.

Fig. 8: Projections of Unemployment Rates

	2008	2009	2010	2011	2012	2013
2010 Budget	5.8%	8.1%	7.9%	7.1%	6.0%	5.2%
CBO (High)*		8.5%	8.1%	7.2%	6.3%	5.4%
CBO (Low)*		7.8%	6.8%	6.6%	6.0%	5.3%
Blue Chip#	5.8%	8.3%	8.7%	5.8%	5.5%	5.3%
Survey of Professional Forecasters		8.4%	8.8%			
Federal Reserve Governors and Presidents+		8.0% to 9.2%	7.0% to 9.2%	5.5% to 8.0%		

*Projections for fourth quarter.
#The Blue Chip longer-run forecast is from their October long-run extension survey, not their February near-term survey. Some have argued that they therefore fail to account for an economic uptick often seen after periods of recession
+Represents range of forecasts made by Federal Reserve Governors and Bank Presidents. Projections for fourth quarter.

All of these forecasts – including from the President's budget – were made before the recent downward revision of fourth quarter GDP. With the economy contracting at a 6.2% annualized rate in the fourth quarter (revised from 3.8%), we should expect considerably weaker-than-expected growth for 2009. This will further increase deficits beyond existing projections.

Given the extreme uncertainty in making economic projections in this environment, the degree to which the Administration's deficit projections rely on economic performance, and the new (mostly bad) economic news that has come out since the budget was released, we encourage the Administration to update their economic projections for the release of their full budget in April.

* * *

Economic conditions and fiscal policy are inextricably linked—now more than ever. While our focus tends to be on fiscal policy and responsible budgeting, we would certainly point to stabilizing the economy as the single most immediate, important objective. We are gravely concerned about short- and long-term deficits, the growing debt, and the negative consequences they can have on the economy and standards of living. However, we would counsel against adopting overly aggressive short-term fiscal goals that could destabilize the recovery once it begins. If the economy grows as the Administration is projecting, the fiscal goal of cutting the deficit in half over four years is not particularly aggressive—particularly given the starting point. But because we believe it is likely the economy will not perform as well as projected, we recommend the

Administration and Congress to remain flexible about whatever fiscal goal they adopt, tying it to overall economic performance.

We are disappointed there is not more focus on reducing long-term deficits in the budget. Given that contractionary tax increases and spending reductions should not be enacted during an economic downturn, this may be the perfect political moment to make some of the tough choices necessary to close the longer term fiscal gap by phasing in policy changes in over a number of years. Whether we proceed by working on the most relevant issues –health care cost control, Social Security and taxes – in a piecemeal fashion or comprehensively as part of a grand bargain, focusing on closing the long-term fiscal gap could both help reassure financial markets in a way that would benefit any economic recovery while also addressing the long-term fiscal issues the President has courageously promised to tackle.

Finally, there are a number of specific policies that we believe should be back on the table for consideration:

- Given the huge fiscal gap and the political resistance demonstrated by both parties to significantly reducing government spending, we don't believe it will be possible to limit future revenue increases to only families earning over $250,000 a year. The economic crisis, the fiscal challenges, and the notion of shared sacrifice set the stage for rethinking tax policies.

- The proposed offsets in the "Health Reform Reserve Fund" will not be sufficient to pay for any of the health care plans being seriously considered. More aggressively tackling health care cost growth will be necessary. Additionally, capping or eliminating the tax exclusion for employer-provided health care is a logical source of additional revenues that should be considered.

- Finally, as many experts have pointed out, growing health care costs pose the single largest threat to the budget. That said, it appears unlikely that controlling health care costs will ultimately generate enough savings to single-handedly close the fiscal gap. This point is reinforced in the budget as all health care savings projected during the budget window are plowed back into new health care spending. It will therefore be necessary to consider other policies to help close the fiscal gap, including Social Security, tax reform, and other budgetary savings.