Center on Budget and Policy Priorities

820 First Street NE, Suite 510
Washington, DC 20002

Tel: 202-408-1080
Fax: 202-408-1056

center@cbpp.org
www.cbpp.org

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PRESIDENT OBAMA LARGELY INHERITED TODAY'S HUGE DEFICITS

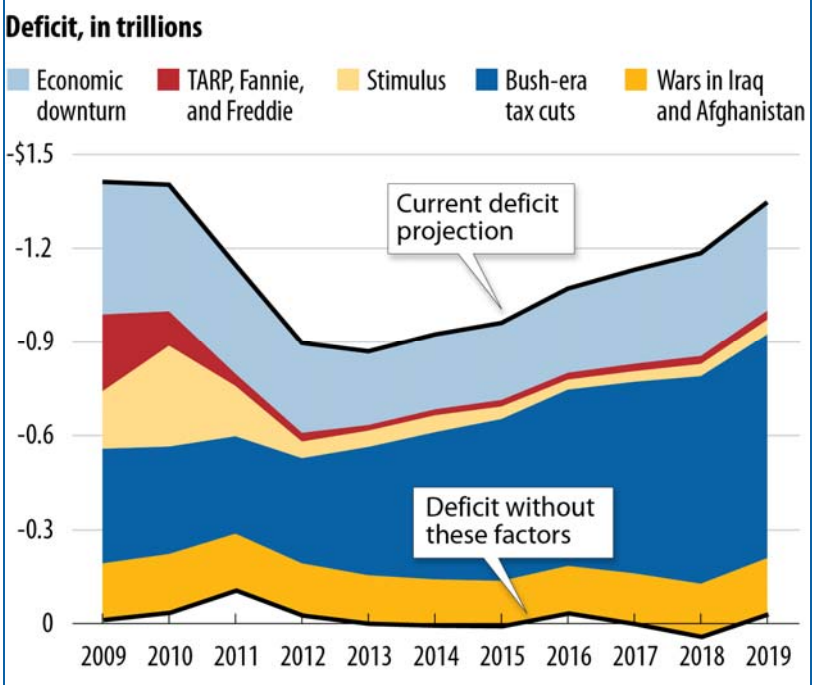
Economic Downturn, Financial Rescues, and Bush-Era Policies Drive the Numbers

Kathy A. Ruffing and James R. Horney

Some critics charge that the new policies pursued by President Obama and the 111th Congress generated the huge federal budget deficits that the nation now faces. In fact, the tax cuts enacted under President George W. Bush, the wars in Afghanistan and Iraq, and the economic downturn together explain virtually the *entire* deficit over the next ten years (see Figure 1).

The deficit for fiscal 2009 was $1.4 trillion and, at an estimated 10 percent of Gross Domestic Product (GDP), was the largest deficit relative to the size of the economy since the end of World War II. Under current policies, deficits will likely exceed $1 trillion in 2010 and 2011 and remain near that figure thereafter.

FIGURE 1:
Economic Downturn, Financial Rescues, and Legacy of Bush Policies Drive Record Deficits



Source: CBPP analysis based on Congressional Budget Office estimates.

The events and policies that have pushed deficits to astronomical levels in the near term, however, were largely outside the new Administration's control. If not for the tax cuts enacted during the Presidency of George W. Bush that Congress did not pay for, the cost of the wars in Iraq and Afghanistan that began during that period, and the effects of the worst economic slump since the Great Depression (including the cost of steps necessary to combat it), we would not be facing these huge deficits in the near term.

While President Obama inherited a bad fiscal legacy, that does not diminish his responsibility to propose policies to address our fiscal imbalance and put the weight of his office behind them. Although policymakers should not tighten fiscal policy in the near term while the economy remains fragile, they and the nation at large must come to grips with the nation's deficit problem. But we should all recognize how we got where we are today.

Recession Caused Sharp Deterioration in the Budget Outlook

Whoever won the Presidency in 2008 faced a grim fiscal legacy, a fact already well known as the Presidential campaign got underway. The Congressional Budget Office (CBO) presented a sobering outlook in its 2008 summer update,[1] and during the autumn, the news got relentlessly worse. Fannie Mae and Freddie Mac, the two government-sponsored enterprises (GSEs) that became embroiled in the housing meltdown, failed in early September; two big financial firms — AIG and Lehman Brothers — collapsed soon thereafter; and others teetered. In December 2008, the National Bureau of Economic Research confirmed that the nation was in recession and pegged the starting date as December 2007. By the time CBO issued its new projections on January 7, 2009 — two weeks before Inauguration Day — it had already put the 2009 deficit at *well over $1 trillion*.[2]

The recession battered the budget, driving down tax revenues and swelling outlays for unemployment insurance, food stamps, and other safety-net programs.[3] Using CBO's August 2008 projections as a benchmark, we calculate that the changed economic outlook accounts for over $400 billion of the deficit in 2009 and slightly smaller amounts in subsequent years. Those effects persist; even in 2018, the deterioration in the economy since summer 2008 — including the extra debt-service costs — accounts for over $300 billion in extra deficits.

Financial Rescues, Stimulus Add to Deficits in Near Term

The government put Fannie Mae and Freddie Mac into conservatorship in September 2008.[4] In October, the Bush Administration and Congress enacted a rescue package to stabilize the larger financial system by creating the Troubled Assets Relief Program (TARP). Together, TARP and the GSEs accounted for $247 billion (including extra debt-service costs) of fiscal 2009's record deficit. They are expected to cost significant amounts again in 2010, but then fade quickly (see Figure 1).

In February 2009, the new Obama Administration and Congress enacted a $787 billion stimulus package – the American Recovery and Reinvestment Act (ARRA) – to arrest the economy's plunge.

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[1]Congressional Budget Office, *The Economic and Budget Outlook: An Update* (September 2008). Several organizations cautioned that CBO's projections made unrealistic assumptions about the expiration of the Bush tax cuts and about other policies; see, for example, the Concord Coalition, "Setting Expectations: Why Baselines Matter in the Presidential Campaign and for the Fiscal Future" (September 11, 2008); Cato Institute,"$1 Trillion Budget Deficit by 2017?" (September 11, 2008).

[2]Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2009 to 2019* (January 2009).

[3] At the same time, the recession pushed down inflation and interest rates, which generated some offsetting savings.

[4]That occurred on September 7, 2008—too late for inclusion in the CBO report issued just two days later.

Mainstream economists overwhelmingly argued that, to combat the recession, the federal government should loosen its purse strings temporarily to spur demand, with a mix of assistance to the unemployed, aid to strapped state and local governments, tax cuts, spending on infrastructure, and other measures. By design, this package adds to the deficit. By our reckoning, ARRA accounts for $1 trillion in deficits over the 2009-2019 period (including the associated debt service). ARRA's effects are highly concentrated in 2009 through 2011 and fade thereafter — delivering a boost to the economy during its most vulnerable period.[5]

Bush Tax Cuts, War Costs Do Lasting Harm to Budget Outlook

Some commentators blame recent legislation — the stimulus bill and the financial rescues — for today's record deficits. But those costs pale next to other policies enacted since 2001 that have swollen the deficit. They are less conspicuous now, because many were enacted years ago, and they have long since been absorbed into CBO's and other organizations' budget projections.

Just two policies dating from the Bush Administration — tax cuts and the wars in Iraq and Afghanistan — accounted for over $500 billion of the deficit in 2009 and *$7.1 trillion* in 2009 through 2019, including the associated debt-service costs.[6] These impacts easily dwarf the stimulus and financial rescues. Furthermore, unlike those temporary costs, these inherited policies (especially the tax cuts) do not fade away as the economy recovers (see Figure 1).

Without the economic downturn and the fiscal policies of the previous Administration, the budget would be roughly in balance over the next decade. That would put the nation on a much sounder footing to address the demographic challenges and the cost pressures in health care that darken the long-run fiscal outlook.[7]

President Obama's First Budget Proposes Responsible Steps

The key question is: where do we go from here? President Obama's first budget proposed to reduce anticipated deficits over the next ten years, chiefly by letting the Bush tax cuts expire on schedule for high-income taxpayers, closing certain tax loopholes and reforming the international tax system, keeping estate taxes at their 2009 parameters, and enacting health-reform and climate-change legislation on a deficit neutral basis. We estimate that enacting the President's proposals would reduce deficits by approximately $750 billion over the next ten years (see Figure 2). These proposals

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[5] CBO estimates that ARRA boosted the number of people employed in the United States by 600,000 to 1.6 million in the third quarter of 2009 and that real (inflation-adjusted) GDP was 1.2 percent to 3.2 percent higher than it would have been if ARRA had not been enacted. CBO and the Joint Committee on Taxation do not ascribe macroeconomic effects to individual pieces of legislation (a practice known as "dynamic scoring"), but it is reasonable to think that ARRA's beneficial effect on incomes and employment shrinks the law's true price tag. Congressional Budget Office, *Estimated Impact of the American Recovery and Reinvestment Act on Employment and Economic Output as of September 2009*, November 2009, p. 1.

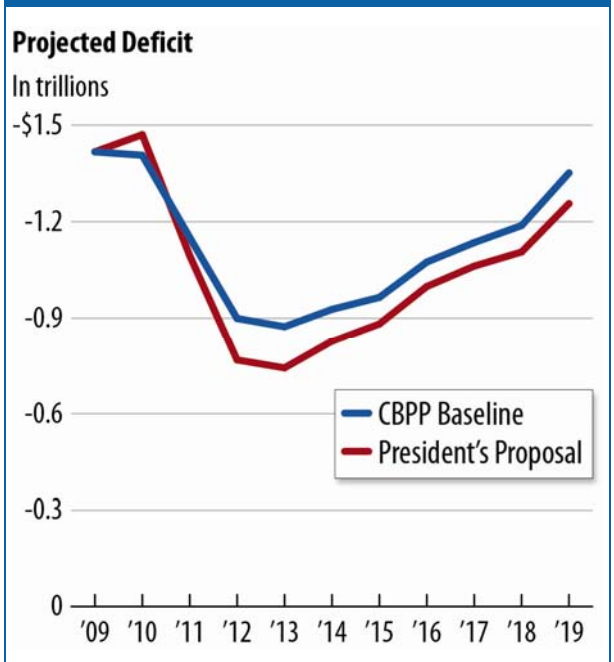
[6] As explained in the technical note at the end of the paper, this analysis assumes that expiring tax cuts will be extended and new funding will be provided for the wars in Iraq and Afghanistan.

[7] See Kris Cox, Kathy Ruffing, James R. Horney, and Paul N. Van de Water, "CBPP's Updated Long-Term Fiscal Deficit and Debt Projections" (Center on Budget and Policy Priorities, September 30, 2009).

represent a commendable first step, though they are hardly sufficient to address our long-term fiscal imbalance.

Like most fiscal analysts, we believe that the Administration and Congress will need to take considerably larger steps. First and foremost, they will need to restrain the growth of health care costs — especially as we gain more knowledge of how to accomplish that. Among other steps, they also will need to consider the extent to which additional revenues should contribute to deficit reduction.

FIGURE 2:
President Obama's Budget Would Reduce Deficits Over the Next Ten Years



Source: CBPP analysis based on Congressional Budget Office estimates.

Technical Note

Baseline projections depict the likely path of the federal budget if current policies remain unchanged. We base our estimates on CBO's latest ten-year projections, published in August 2009, with several adjustments to reflect what will happen if we continue current tax and spending policies.

Specifically, our baseline assumes that Congress will continue the 2001 and 2003 tax cuts that are scheduled to expire after 2010; that it will renew certain other so-called "tax extenders" such as the research and development tax credit; and that it will continue relief from the Alternative Minimum Tax (AMT). Our baseline also assumes that Congress will continue to defer scheduled cuts in payments for Medicare providers, as it routinely has in recent years, and instead provide doctors with a payment increase based on the Medicare Economic Index. We also account for a gradual phase-down of operations in Iraq and Afghanistan and unanticipated natural disasters. We detailed all of those adjustments in a September 2009 CBPP report.[8] Finally, we have adjusted those numbers to put outlays associated with Fannie Mae and Freddie Mac on a cash basis — as reported in the Monthly Treasury Statement (MTS), although CBO prefers a different budgetary treatment — and to incorporate the actual 2009 deficit published in the MTS.

We calculated major components of the deficits as follows:

- *Economic downturn* — This category includes all changes in the deficit that CBO labeled

[8]Kris Cox, Kathy Ruffing, James R. Horney, and Paul N. Van de Water, "CBPP's Updated Long-Term Fiscal Deficit and Debt Projections" (Center on Budget and Policy Priorities, September 30, 2009).

TABLE 1: Projected Deficits Under Current Policies and Selected Components											
By fiscal year, in billions of dollars; totals may not add due to rounding											
	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
CBPP September 2009 projection	1,587	1,407	1,156	907	886	933	969	1,078	1,138	1,191	1,355
Adjust budgetary treatment of Fannie and Freddie	-199	-1	-4	-8	-13	-5	-4	-3	-3	-3	-3
Adjust for actual 2009 deficit	29	0	0	0	0	0	0	0	0	0	0
Equals deficit under current policies	1,417	1,406	1,151	899	873	927	965	1,075	1,135	1,188	1,352
Selected components of deficit											
Economic downturn	427	408	353	291	239	244	251	274	305	333	N/A
TARP, Fannie, and Freddie	247	111	39	28	18	19	21	22	24	26	29
ARRA	184	323	161	53	52	54	40	32	34	39	47
Bush-era tax cuts	364	341	309	334	408	468	515	561	610	661	714
War costs	178	185	179	164	152	145	142	149	159	167	177

Note: Fannie=Fannie Mae; Freddie=Freddie Mac; TARP=Troubled Assets Relief Program; ARRA=American Recovery and Reinvestment Act. All estimates include the associated debt-service costs. N/A=not available.

"economic" in the three reports — in January, March, and August 2009[9] — that it has issued since September 2008, which total $1.6 trillion over the 2009-2018 period. It also includes the bulk of revenue changes that CBO called "technical." In the revenue area, so-called technical changes essentially refer to trends in collections that CBO's analysts cannot tie directly to published macroeconomic data. In fact, those data become available with a lag and are subject to major revision; weak revenues are often a tipoff that the economy is worse than the official statistics suggest. Furthermore, some key determinants of revenues — such as capital gains on stock-market transactions — are tied to the economy, but those influences are not captured by the standard macroeconomic indicators. Because the economic-versus-technical distinction is so arbitrary for revenues, we have ascribed most of CBO's large, downward "technical" reestimates to the economic downturn. We add the associated debt-service costs. The technical reestimates to revenues and the associated debt-service costs add $1.2 trillion and $0.4 trillion, respectively, to this category over the 2009-2018 period.[10]

- *TARP, Fannie, and Freddie* — The Treasury spent $245 billion for these entities in 2009 ($154

[9]Congressional Budget Office, *The Economic and Budget Outlook* (January 2009), *A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook* (March 2009), and *The Budget and Economic Outlook: An Update* (August 2009).

[10]Estimates are not available for 2019 because CBO's August 2008 projections ended in 2018. For Figure 1, CBPP arbitrarily assumed that this category amounted to $350 billion in 2019—a continuation of the previous few years' pattern.

billion for TARP and $91 billion for Fannie Mae and Freddie Mac, net of dividends received). Projections for 2010 through 2019 come from CBO's August 2009 baseline.[11] We computed the extra debt-service costs, which total $179 billion over the 2009-2019 period. (By 2013, virtually the entire cost shown in Table 1 represents debt-service costs.)

- *ARRA* — Budgetary effects of ARRA come from CBO's official estimate of February 13, 2009.[12] We removed the portion ascribed to indexing the AMT for another year.[13] Annual AMT "patches" have been a fixture since 2001, and ARRA just happened to provide the vehicle. The AMT provision accounted for $70 billion of ARRA's $787 billion "headline" cost, leaving a remaining $717 billion. We then added the associated debt-service costs, which amount to $302 billion over the 2009-2019 period.

- *Bush-era tax cuts* — Through 2011, the estimated impacts come from adding up past estimates of all changes in tax laws — chiefly the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), the 2008 stimulus package, and a series of annual AMT patches — enacted since 2001. Those estimates were based on the economic and technical assumptions used when CBO and the Joint Committee on Taxation (JCT) originally "scored" the legislation, but the numbers would not change materially using up-to-date assumptions. Most of the Bush tax cuts expire after December 2010 (partway through fiscal 2011). We added the cost of extending them, along with continuing AMT relief, from estimates prepared by CBO and JCT.[14] We did not assume extension of the temporary tax provisions enacted in ARRA. Together, the tax cuts account for $3.4 trillion of the deficits over the 2009-2019 period. Finally, we added the extra debt-service costs caused by the Bush-era tax cuts, amounting to $1.9 trillion over the period and an astonishing $350 billion in 2019 alone.

- *War costs* — Spending for operations in Iraq and Afghanistan and related activities cost $610 billion through fiscal 2008, according to CBO ($575 billion for the Department of Defense and $35 billion for international affairs).[15] We based estimates of costs in 2009 through 2019 on CBO's projections, adjusted for a phase-down to 75,000 troops; those costs come to $1.1 trillion.[16] We add the associated debt-service costs, which come to $715 billion over the 2009-2019 period and $121 billion in 2019 alone.

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[11]Recent news stories suggest that future TARP outlays may be less than expected. See, for example, Jackie Calmes, "U.S. Forecasts Smaller Loss From Bailout of Banks," *New York Times*, December 6, 2009, page A-1. CBO will issue new budget projections in January 2010.

[12]See Congressional Budget Office, cost estimate for H.R. 1, American Recovery and Reinvestment Act of 2009 (February 13, 2009, online at www.cbo.gov) and Joint Committee on Taxation, "Estimated Budget Effects Of The Revenue Provisions Contained In The Conference Agreement For H.R. 1, The 'American Recovery And Reinvestment Tax Act Of 2009'" (February 12, 2009, online at www.jct.gov).

[13] That one-year fix — made necessary by the interaction of the AMT and the 2001 and 2003 tax cuts — instead is combined with the "Bush-era tax cuts," below.

[14]CBO August 2009, "The Budgetary Effects of Selected Policy Alternatives Not Included in CBO's Baseline" (Table 1-7) and unpublished backup from CBO.

[15]CBO August 2009, "Funding for Operations in Iraq and Afghanistan and Other Related Activities" (Box 1-3).

[16]CBO August 2009, Table 1-7.

What About the Medicare Prescription Drug Benefit?

One of the major domestic initiatives of the Bush Administration was the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (known informally as the Medicare Modernization Act, or MMA). The MMA created a new prescription-drug benefit in Medicare, known as Medicare Part D. This legislation was only partly paid for, and it added significantly to the deficit that President Obama inherited. Why is it absent from this analysis?

The Congressional Budget Office initially estimated that the MMA would add to the deficit by $395 billion over its first decade, spanning the years between 2004 and 2013. (Medicare's chief actuary pegged the net cost significantly higher — at $534 billion over that period.) CBO's estimate consisted of $552 billion in net spending — new benefits, partially offset by premiums and by receipts from the states — for the new Medicare drug benefit itself, minus $157 billion in savings in Medicaid and other federal programs.

Part D outlays are coming in lower than CBO and the Medicare actuary expected, but it is not possible to update the original price tag for the entire MMA. CBO now expects the net cost of Medicare Part D over that initial 2004-2013 period to be about $355 billion (as compared to the original $552 billion figure). But, it is not possible to tell whether the savings in Medicaid and other programs have deviated from CBO's original estimate of $157 billion; while Part D is a new, identifiable account in the federal budget, those other effects represent relatively small changes in large, ongoing programs.

In short, we did not include the costs of the prescription-drug program in this analysis because we could not estimate those costs with the same confidence that we could estimate costs, based on CBO analyses, for other Bush-era policies — namely, the tax cuts and the wars in Iraq and Afghanistan. Over the 2009-2019 period that is this paper's focus, CBO now expects net outlays for Part D to total nearly $800 billion, but some fraction of that will be offset by savings in Medicaid and other programs that we are not able to estimate. Nevertheless, it is clear that, as noted above, enactment of the prescription-drug program added materially to the deficit that the current administration inherited.

Conspicuously missing from this list is the Medicare prescription-drug program that Congress enacted in 2003. That new program has also added significantly to deficits through 2019, but data limitations leave us unable to quantify its net budgetary effects (see the box on page 7).

CBO analyzed President Obama's budget proposals in June 2009,[17] but did not revise those estimates with the rest of its projections in August. We therefore produced such a series, by taking CBO's June 2009 numbers, updating them for the economic and technical changes in CBO's August 2009 baseline, removing the $250 billion requested for additional financial stabilization (a proposal that the President dropped in his midsession review), and — for comparability with the baseline — putting Fannie Mae and Freddie Mac on a cash basis. Using that approach, we estimate that President Obama's proposals would lead to deficits of about $10.2 trillion over the 2010-2019 period, which is about $750 billion *below* the baseline. For various reasons, CBPP believes that estimate is conservative, but the conclusion is clear: the President's budget would *reduce* deficits compared with a continuation of current policies.[18]

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[17] Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2010* (June 2009).

[18] For an earlier version of this analysis, see Kathy Ruffing and Paul N. Van de Water, "Obama Budget Reduces Deficit by $900 Billion Compared to Current Budget Policies" (Center on Budget and Policy Priorities, March 31, 2009).