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THE PRESIDENT'S BUDGET FOR FISCAL YEAR 2010

THE GOOD, THE BAD, THE UGLY

27 February 2009

OVERVIEW

In his address to Congress, the President said that the answers to America's troubles "exist in our laboratories and our universities; in our fields and our factories; in the imaginations of our entrepreneurs and the pride of the hardest-working people on Earth." But his specific policies, and the hard reality of the numbers that constitute his budget, clash with the rhetoric.

His fiscal plan resorts to the tired and predictable notion that the central government is the first and best answer to the Nation's problems. It relies on the outdated and disproven belief that more spending, and larger and more intrusive government, can lead to greater prosperity. Worse, the elements of this plan will likely weaken the U.S. economy, and sap its prospects for sustained growth. The higher borrowing and taxes needed to finance the President's expansion of government will dampen incentives and crowd out opportunities for investment and growth.

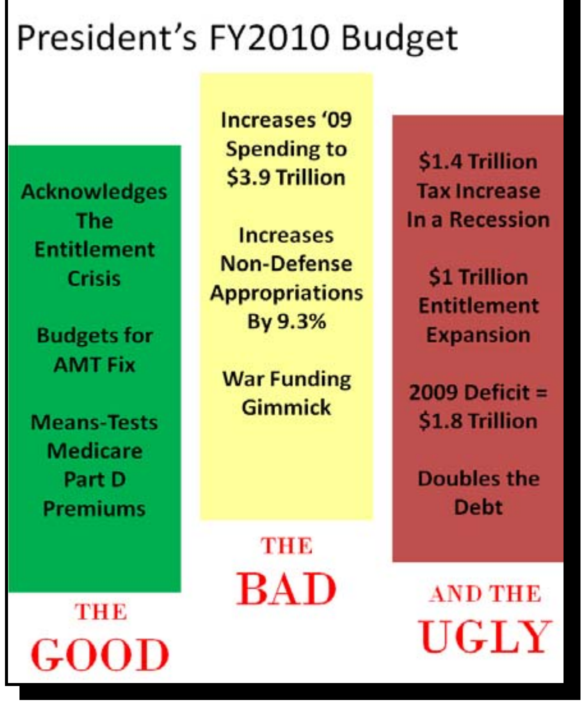
Taken as a whole, the President's budget is badly flawed, though it does offer at least a few virtues. One way to examine the budget is to assess it in the following terms:

- ***The Good***. The budget does have at least a few virtues. It highlights the critical need to address the unsustainable spending growth in the government's major entitlements. It proposes to fix the alternative minimum tax [AMT] and incorporates the budget impact in its out-year estimates. (It is not a complete AMT reform, because it only adjusts for inflation, and bracket creep will continue to push more taxpayers into this onerous tax code.) The budget also calls for relating Medicare Part D premiums to incomes; and it creates a reserve for emergencies – picking up a proposal from the House Budget Committee's fiscal year 2007 budget resolution.

- ***The Bad***. On the other hand, while promising *A New Era of Responsibility*, the President's budget nevertheless throws huge fistfulls of additional dollars at myriad Federal programs. It increases 2009 spending to $3.9 trillion, or 27 percent of gross domestic product [GDP] – the highest level of Federal spending as a share of the economy since World War II. His spending settles at 22.6 percent of GDP in 2019, nearly a full 2 percentage points higher than at any time in the previous administration despite the costs of 9/11, the war, and Hurricane Katrina. These figures include a net $1-trillion increase in entitlement spending over 10 years.

- ***The Ugly***. The budget's worst feature is its collection of heavy tax increases, imposed in the midst of an economic recession, weakening the prospects for sustained economic growth and job creation. These levies, totaling $1.4 trillion over 10 years, allegedly target "the wealthiest Americans," but in fact will hit small businesses and investors, precisely the people whose enterprise is needed to restore the economy. Most of these so-called wealthy taxpayers are small-business owners, who create 60 percent to 80 percent of the jobs in the U.S. The President's "cap-and-trade" proposal heaps at least a $646-billion tax increase on families' natural gas, electricity, home heating, and gasoline bills; and it will further erode job growth in the U.S. manufacturing sector, putting American companies at a further competitive disadvantage with China and other countries. The President needs these tax hikes to finance his additional spending and at the same time give the illusion that "cutting the deficit in half" results from real budgetary restraint – when in fact it would happen anyway if the President and Congress did nothing. Even *The New York Times* warned the President "will inevitably have to raise more taxes."

Figure 1



Yet even with all these tax increases, the President's spending continues to outpace revenue for the entire budget period. The 2009 budget deficit swells to $1.8 trillion, or 12.3 percent of GDP – more than twice the highest deficit level as a share of the economy since World War II. The President's red ink totals $1.2 trillion (8 percent of GDP) in 2010. While the President highlights his claim of "cutting the deficit in half" by 2013, his deficits begin climbing immediately after that, reaching $712 billion by 2019. The result is that the national debt *doubles* in the next 8 years. Like his tax increases, this debt soaks up resources needed for economic growth.

Table 1: The Obama Budget

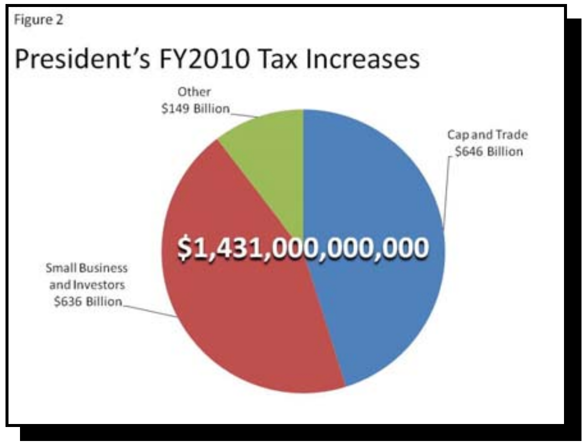
(dollars in billions)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Outlays	3,938	3,552	3,625	3,662	3,856	4,069	4,258	4,493	4,678	4,868	5,158
Revenue	2,186	2,381	2,713	3,081	3,323	3,500	3,675	3,856	4,042	4,234	4,446
Deficit	1,752	1,171	912	581	533	570	583	637	636	634	712
Deficit as % of GDP	12.3%	8.0%	5.9%	3.5%	3.0%	3.1%	3.0%	3.2%	3.0%	2.9%	3.1%

Source: Office of Management and Budget.

The discussion below details and analyzes President Obama's first budget submission to the Congress.

RAISING TAXES IN A RECESSION



Overall, the President's budget increases taxes by $1.4 trillion over 10 years, mainly through tax hikes on those earning more than $250,000 a year (which will include many small businesses), and a cap-and-trade tax on carbon emissions that will add to U.S. families' costs for natural gas, electricity, home heating, and gasoline.

Still, in contrast to the congressional Majority, the President's budget recognizes that keeping tax rates the same does not constitute to a new tax "cut." Specifically, his revenue baseline assumes the continuation of the 2001 and 2003 tax relief laws beyond their scheduled expiration in 2011. The administration baseline also assumes indexing the alternative minimum tax [AMT] for inflation. House Democrats adopted a pay-as-you-go rule that treated both of these extensions as new tax "cuts" requiring offsetting tax *increases.* Below is a description of the President's main tax proposals.

Tax Increases

- **Tax Hikes on "Upper-Income Individuals."** This provision raises $636.7 billion over 10 years. More than half that revenue ($339 billion) comes from reinstating the 36 percent and 39.6 percent tax brackets for taxpayers earning more than $250,000 (married) and $200,000 (single). The overwhelming majority of small businesses pay taxes at the top two individual rates, so this represents a de facto tax hike on the engine of job creation in the U.S. economy.

- **Limiting Key Deductions.** The budget also proposes to limit the mortgage-interest deduction for upper-income taxpayers. Households paying taxes at the top two income brackets (currently 33 percent and 35 percent) would only be able to take this deduction at the 28-percent rate instead, thereby lowering its tax value. It is a curious step at a time when the government also is trying to support a troubled housing market. The tax deduction for charitable giving would also be capped in a similar way for top-tier filers.

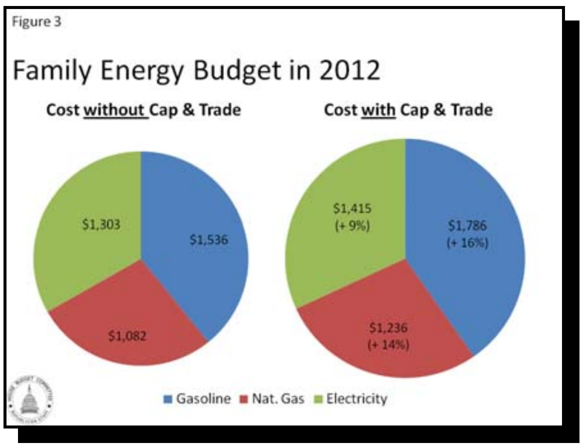
- **Exemptions and Deductions.** The budget reinstates the Personal Exemption Phaseout [PEP] and limitation on itemized deductions for those earning more than $250,000 (married) and $200,000 (single). This increases taxes by $179.8 billion over 10 years.

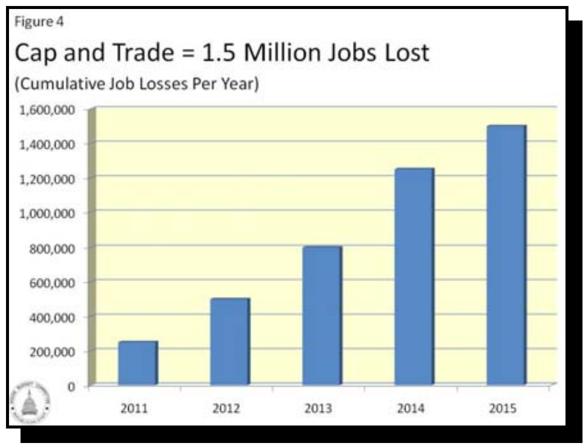
- **The Death Tax.** The estate tax, scheduled to be repealed next year, is resurrected in the President's budget, which maintains the provision at its 2009 parameters (i.e. top rate of 45 percent, estate exemption amount is $3.5 million). This onerous tax punishes families for building up savings to pass on to their heirs; and it imposes an especially heavy burden on small businesses and family farms.

- **Capital Gains.** The President increases the capital gains tax rate from 15 percent to 20 percent for upper income taxpayers, raising taxes by $118.1 billion over 10 years.

- **Cap and Trade.** The budget proposes to begin capping carbon emissions beginning in 2012. This new policy would impose a $79-billion annual cost to the economy – or $646 billion over 10 years – by making carbon-based energy more expensive. According to a recent economic study, similar cap-and-trade policies would raise energy prices by an average of $516 per year for each household. When the costs of other energy intensive goods are included, households would need to spend an extra $1,100 on average under this new policy. The administration claims the burden of increased energy prices would be eased by returning most of the new revenue to taxpayers through the Make Work Pay tax credit. But the credit is not available to seniors and those who do not work. A conservative estimate also shows this proposal could lead to as many as 1.5 million job losses by 2015.

  It is important to note that Treasury routinely assumes excise taxes reduce incomes in the affected industry and for others throughout the economy, and offsets the revenue gain by 25 percent. Consequently, the $646 billion actually understates the impact of the cap-and-trade policy. The actual burden on consumers will be $860 billion.





- **Energy Taxes.** The budget signals a greater emphasis on alternative and renewable energy at the expense of the oil and natural gas industries. The budget repeals seven different tax provisions for oil and gas producers, including the manufacturing deduction and expensing of drilling costs, which would effectively raise taxes on the industry by $60 billion. The budget also levies an excise tax on certain offshore oil leases and increases the amortization period of energy reserves held by independent producers, costing the industry an additional $6.4 billion.

  In addition, the budget requests implementation of last summer's controversial "use it or lose it" leasing policy, which would add yet another $1.2 billion to domestic energy producers' costs. Altogether, the budget would make domestic energy $67.6 billion more expensive to produce than current policies. The result will be even greater U.S. dependence on foreign oil.

“Loophole Closers”

These provisions raise taxes by a total of $353 billion over 10 years.

- **Enforcement.** The largest item is “international enforcement, reform deferral, and other tax reform,” which raises $210 billion. The lion’s share of this revenue likely comes from an elimination or a severe restriction on the deferral of tax on overseas profits from U.S.-based multinational companies. This provision would undermine U.S. competitiveness by moving further toward a worldwide system of international taxation (most countries have territorial systems) and would likely lead to a rise in foreign takeovers of U.S.-based companies.

  The U.S. has experimented with this provision in the past. In the mid-1980s, tax deferral was eliminated for U.S.-based shipping companies. Several large U.S. shipping companies were subsequently taken over by foreign competitors to bypass the harmful effects of the new law and reap the tax benefits of being foreign-owned. These takeovers led to a loss of U.S.-headquartered jobs at these shipping companies and affected domestic jobs in industries tied to the shipping industry.

- **Carried Interest.** The budget would tax carried interest at private equity funds at the ordinary income rate instead of the capital gains rate (i.e. tax rate rises from current 15 percent to as much as 39.6 percent). This provision hampers the flow of private venture capital at precisely the time when we should be encouraging it.

Table 2: The President’s Net Tax Increase
(deficit impact in billions of dollars)[a]

	2010-19
Obama Net Tax Provisions (2010-19)	-50.0
Replace Aviation Excise Tax with an Equivalent Fee	-77.1
Include Climate Tax	-645.7
Include Health Reform Tax	-317.8
Include receipt Effect from Mandatory Proposals	-14.1
Include Outlay Effect of Tax Credits	-326.2
Total Tax Increase	**-1,430.8**

Source: Office of Management and Budget
[a] Negative numbers indicate an increase in taxes.

‘Tax Cuts’ for Families and Individuals

The budget advertizes these provisions as providing $770 billion in “tax cuts.” But due to the reliance on refundability – which extends the provisions even to those without tax liabilities – a significant portion is actually an outlay, a check sent to an individual rather than a reduction in taxes.

- **The Making Work Pay Credit.** The centerpiece is the extension of this provision, which started in the economic "stimulus" bill. The total budget impact is $537 billion over 10 years, of which $183 billion is outlays. On the effectiveness of this refundable credit, the non-partisan Tax Policy Center said: ". . . most of the lost revenue would go to taxpayers who receive no incentive to work more, and, in fact, the phaseout of the credit might induce some people with higher incomes to work less. On efficiency grounds, the money would probably be better spent reducing marginal tax rates overall or reducing the deficit."

- **EITC and the Child Tax Credit.** Both the earned income tax credit [EITC] and the Child Tax Credit are expanded. The budget impact totals $103.4 billion over 10 years, of which $102.7 billion is in the form of outlays.

Business Tax Incentives

The budget provides $150 billion over 10 years in business tax relief. Key provisions are expansion of the net operating loss carryback and the elimination of capital gains taxation on small businesses.

A LARGER, MORE COSTLY FEDERAL GOVERNMENT

The President's budget will increase total spending to $3.9 trillion in 2009 – 27.7 percent of GDP – the highest Federal spending has been as a share of the economy since World War II. After 10 years, spending as a percentage of GDP would still be 22.6 percent of GDP, nearly a full 2 percentage points higher than any year during the Bush administration, despite the full costs of 9/11, the war, and Hurricane Katrina. Through the entire 10-year budget window, the President's spending remains at or above 22 percent of GDP, the longest sustained post-war period for that level of spending.

Discretionary Spending

The administration is requesting $1.133 trillion in discretionary budget authority [BA] for fiscal year 2010, an increase of 6.7 percent from its estimate of the fiscal year 2009 nonemergency level. The 2010 request includes $534 billion for the Department of Defense, a 4-percent increase, and $599 billion for nondefense programs, a 9.3-percent increase over the preceding fiscal year (excluding emergencies). For the outyears, the budget generally assumes fairly slow growth in discretionary BA for most, if not all, the major Federal agencies.

The budget also proposes $83 billion in fiscal year 2009 funding for the Global War on Terrorism, as well as $130 billion for war costs in fiscal year 2010. In the outyears, the request assumes a $50-billion placeholder in every year. Finally, the budget takes the peak year of Iraq war funding (fiscal year 2008), inflates this level, and adds $1.6 trillion in BA to the baseline for the Iraq war over the next 10 years. The budget then takes credit for the difference, claiming $1.5 trillion in outlay "savings" between this baseline and its actual war requests for fiscal year 2009 and beyond.

	2009	2010	$ Increase	% Increase
Defense	513.3	533.7	20.3	4.0%
Nondefense	548.2	599.1	50.8	9.3%
Total Base	1,061.6	1,132.8	71.2	6.7%

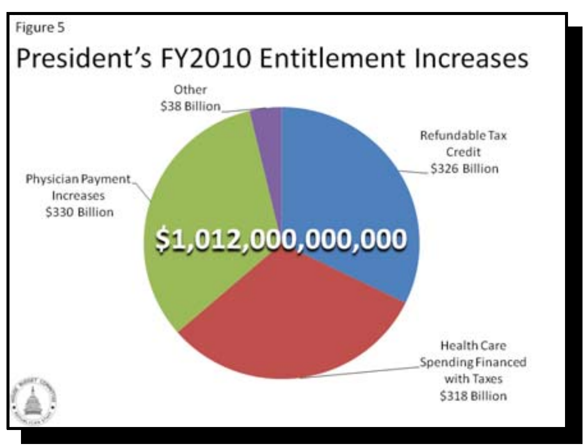
Source: Office of Management and Budget
Figures may not add due to rounding.

Notable discretionary spending increases in the budget include the following:

- The Environmental Protection Agency would receive a 35-percent increase in fiscal year 2010 budget authority after having received a 92-percent increase in 2009 in the "stimulus" bill.
- The State Department and other international agencies would receive a 41-percent increase in 2010.
- Housing would receive an 18-percent boost.
- Education funding would increase by 14 percent.
- Agriculture would receive an increase of 9 percent.

Entitlements

Despite the President's talk of the need to reform entitlements and become "fiscally responsible," his budget increases net entitlement spending over 10 years by $1 trillion. This consists of refundable tax credits ($326 billion); a Medicare physician payment increase ($330 billion); and $318 billion in tax increases toward a health care reserve fund that will finance entitlement spending increases.



The $634-billion health care reserve fund – described in further detail below – is said to be only a "down payment" on health care reform. The administration notes in the budget that $634 billion will "not be sufficient for comprehensive reform." and lists these additional entitlement expenditures as "TBD" – to be determined.

- **The Health Care Reserve Fund.** Half of the $634-billion "health reserve fund" is offset with $317 billion in tax increases. The other half is offset with $316 billion in reductions to the Medicare and Medicaid programs.

Of the $316 billion in Medicare and Medicaid reductions, more than half of the savings come from adding a "competitive bidding" requirement for Medicare Advantage plans. As this proposal reduces payments to Medicare Advantage plans by approximately the same amount of money ($176.6 billion) as past proposals for the program (such as reducing Medicare Advantage payments to 100 percent of fee-for-service Medicare payments), it can be expected to reduce coverage by approximately the same number of individuals as CBO has previously estimated – 6 million seniors.

In addition to the Medicare Advantage reductions, an additional $139 billion in savings is achieved from a variety of proposals, such as reductions in home health payments, changes to the Medicaid drug rebate program, bundling of Medicare hospital and post-acute care payments, and Food and Drug Administration approval of generic biologic drugs. Requiring the wealthiest seniors to pay more for their Medicare drug benefits is one proposal included that many Republicans have supported in the past, and has been included in the Republican budget substitute the past 2 years.

Table 4: The President's Entitlement Spending Increases
(deficit impact in billions of dollars)

	2010-19
Total Mandatory Initiatives and Savings (2010-19)	37.9
Outlay Effect of Tax Credits	326.2
Health Care Tax Spending	317.8
Medicare Physician Payments	329.6
Total	**1,011.5**

Source: Office of Management and Budget

- **Physician Payment.** The budget extends a physician payment increase that adds $330 billion to Medicare outlays over 10 years and increases Medicare's existing $36-trillion in unfunded obligations by $2 trillion. Because this payment increase is included in the President's baseline, it does not show up as a spending increase and is not subject to the pay-as-you-go requirement that this costly payment update be offset in the future. What this amounts to is increased deficit spending. While the details of this payment increase are not provided, an increase of about 1 percent each year can be expected, given the cost and past estimates of this proposal.

SCHIP. When the President signed into law the Democratic Majority's reauthorization of the State Children's Health Insurance Program [SCHIP], it included a funding cliff in new spending – meaning children would be put on the program initially only to be forced off or onto Medicaid when the new funding runs out after 5 years. As this is politically impossible, CBO estimated the true cost of the SCHIP expansion to be $115 billion over 10 years, instead of the advertised cost of $73 billion.

While the President argues it is disingenuous not to include a physician payment update in the baseline when it is politically considered an annual "must pass" item for Congress, he fails to recognize that it is also disingenuous not to show the full funding of the SCHIP program.

There are other entitlement expansions in the President's budget as well.

- **Pell Grants.** The budget permanently extends the "stimulus" bill's so-called "temporary" increase to the Pell Grant benefit, and indexes the benefit so that it automatically rises 1 percent ahead of the consumer price index [CPI] going forward. The budget also converts Pell Grants into an entitlement program by placing it in the mandatory spending category. This will cost taxpayers an additional $116.8 billion over 10 years.

- **Three More New Entitlement Programs.** The budget further expands government entitlements with the creation of three new mandatory programs. First, a new College Access and Completion Fund is created and funded for 5 years at a cost of $2.5 billion, after which time the program is ostensibly zeroed out. This is another misleading spending "cliff": it is highly unlikely that this program will end, and even if it does, it will not end abruptly.

  Second, the budget spends $8.6 billion to establish a new nursing home visitation program. Once this new entitlement starts, the budget estimates it will cost taxpayers $1.8 billion per year. Finally, an additional $4.3 billion is added to the entitlement spending category for an automatic increase in the Low Income Home Energy Assistance Program. The increase is intended to correspond with rising energy costs.

- **Student Loans.** To help offset these new expenses, the budget effectively eliminates the Federal Family Education Loan Program [FFEL] program, a student loan program that leverages private sector capitol, and is the largest source of student financial aid. In its place, the budget finances the entire Federal student loan program with U.S. treasury borrowing.

- **Troubled Assets Relief Program [TARP].** Also included in the President's mandatory spending proposals is a "placeholder for additional financial stabilization effort[s]" that could be used to purchase up to $750 billion in troubled assets from the banking sector. The budgeted amount of $250 billion actually represents the "subsidy," or net cost to the Federal Government after recoupment, although the up-front investment would be about three times that amount. The funding will be made available in addition to the $700 billion in TARP funds approved by Congress in September 2008.

- **Agriculture Programs.** The budget shifts Department of Agriculture funding away from farm subsidies and directs them toward food welfare programs. The most significant changes in farm subsidies include a reduction of direct payments to farmers making more than $500,000; a reduction in crop insurance premium assistance; and the elimination of payments for cotton storage.

- **Nutrition Programs.** The budget includes $9.8 billion to fund the reauthorization of the Child Nutrition and Women and Infant Children Programs, which provide assistance to low-income children. This comes on top of the $20 billion provided for nutrition programs in the "stimulus" bill. The budget also mentions the creation of a pilot program to increase the participation of low-income seniors in the Supplemental Nutrition Assistance Program (formerly known as food stamps), but does not provide a cost estimate for this provision.

- **Hope for Homeowners Program.** The Hope for Homeowners program began in 2008. The Department of Housing and Urban Development said: "400,000 borrowers in danger of losing their homes will be able to refinance into more affordable government-insured mortgages. Yet as of 3 February 2009, only 25 loans have been guaranteed under the Hope for Homeowners program. The President's budget proposes to increase funding for the program by $2.3 billion over 10 years.

THE PRESIDENT'S DEFICIT REDUCTION: LESS THAN MEETS THE EYE

The administration claims deficit "reduction" through two ploys. First, it claims the President "inherited" a deficit that he will "cut in half" by 2013, to $533 billion. Next, it claims to achieve $2 trillion in deficit reduction over 10 years. The first is remarkably unambitious. The second is only accomplished by manipulating the baseline to produce artificial savings.

"Cutting the Deficit in Half"

The deficit would fall by more than half *if the President did nothing* – according to the administration's own estimates. In short, the President's goal is worse than doing nothing.

- First, the President claims he "inherited" this year's deficit. Using the administration's own numbers, the deficit with which the President started is $1.2 trillion. That figure would fall naturally to $101 billion by 2013 under spending laws that were in place on Inauguration Day. Moreover, the deficit would still fall by more than half even if the alternative minimum tax [AMT] relief and the full provisions of 2001 and 2003 were extended.

- Additional spending enacted by the President and Congress – principally the economic "stimulus" bill, plus the President's new proposals, combine to increase the fiscal year 2009 deficit to $1.8 trillion. This is not an "inherited" deficit. His own actions and proposals have widened this year's deficit by $540 billion – a deficit *increase* larger than any *total* deficit in the Nation's history.

Manipulating the Baseline to Achieve Deficit Savings

The Budget Enforcement Act [BEA] establishes the guidelines for making budget projections, known as a "baseline." CBO makes projections based on the BEA, and this is the baseline congressional Democrats used to measure the impact of President Bush's budgets and other budget proposals.

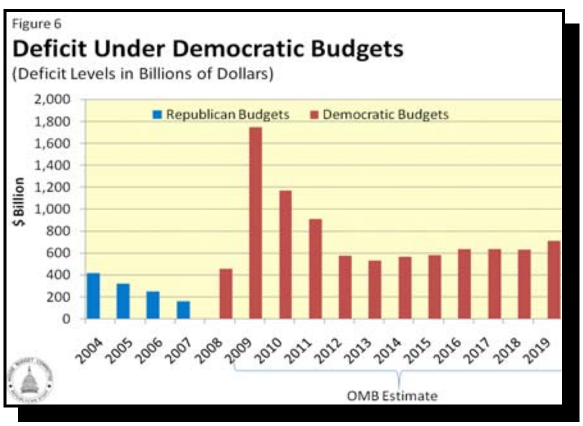
According to the current administration, using the BEA baseline for laws in place when President Obama took office results in deficits totaling $1.6 trillion over 10 years (fiscal years 2010-19). Using the administration's estimates, the President's budget would increase these deficits by total of $5.3 trillion over the 10 years, to $7 trillion over this 10 year period, a $5.3 trillion increase in the deficit.

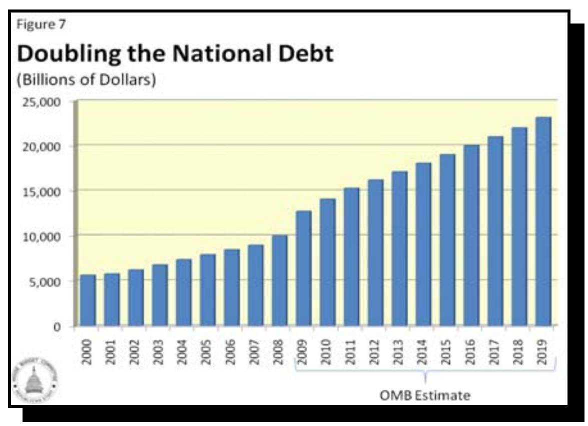
The President can show deficit "reduction" over this period only by applying several adjustments to the deficit baseline, artificially raising total deficits to $9 trillion. Among these is the addition of $2.1 trillion on the assumption that the "surge" in Iraq will continue for the next 10 years, even though the Bush administration had already begun winding down the war effort in Iraq. In other words, only by artificially inflating the baseline is the Obama administration able to show its budget reducing the deficit.

RECORD DEFICITS AND DEBT

While claiming he "inherited" a deficit of $1.2 trillion this year, the President and Democratic Congress have already widened this fiscal gap by $540 billion, according to the Office of Management and Budget – an amount greater than the deficit in any year in the country's history and nearly triple the amount of the entire deficit produced in the last year when Republicans controlled Congress.

This staggering deficit increase results from the economic "stimulus" bill, expanded funding for the Troubled Assets Relief Program, doubling the bailout of Fannie Mae and Freddie Mac, and an omnibus appropriations bill that will drive this year's total discretionary spending above $1 trillion. Thus, this year's budget deficit swells to $1.8 trillion, or 12.3 percent of GDP – more than twice the highest deficit level as a share of the economy since World War II. The President's red ink totals $1.2 trillion (8 percent of GDP) in 2010, and $912 billion (5.9 percent of GDP) in 2011. They hit the low point of $533 billion in 2013, the year he picked for his cut-the-deficit-in-half goal. Deficits then begin growing again, reaching $712 billion by the end of the decade.



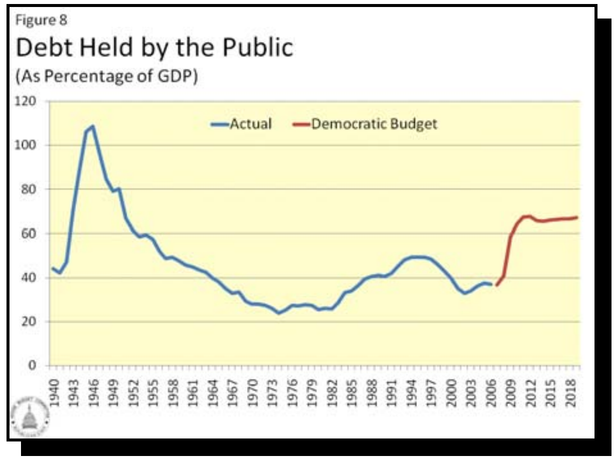


Like the President's tax increases, these deficits soak up the very economic resources needed for private-sector investment to sustained growth in the U.S. economy. They work precisely against any claims of "jump-starting" the economy. They also add to an already growing debt that threatens to overwhelm future generations.

The budget would increase the national debt by $2.7 trillion this year, to $12.7 trillion, requiring another increase in the debt limit, which was just increased to $12.1 trillion in the "stimulus" bill. The budget doubles the national debt in 8 years. Democrats frequently criticize President Bush's record on the debt, which rose by $4.9 trillion during his tenure. Under President Obama's budget, the debt is projected to increase by $5.6 trillion in just 3 years.

The debt held by the public is effectively the amount Treasury needs to borrow in private markets. It will increase by $2.6 trillion this year, and it will double in 6 years.

According to Treasury, foreigners currently hold more than 50 percent of U.S. debt; but it cannot be taken for granted that they will continue to hold this current debt, much less the huge increases the Obama administration will need to borrow. Debt held by the public will reach 58.7 percent of GDP this year, and eventually will rise to 67 percent of GDP.



The last time debt exceeded 50 percent of GDP was in 1956 – the middle of the birth of the baby boom generation – and the debt was declining steeply at the time. Today, the debt is climbing rapidly, and 80 million baby boomers are beginning to leave the taxpaying workforce to collect Medicare and Social Security benefits.

GIMMICKS

Having boasted about "honest" budgeting, and exiling gimmickry, the President's budget nevertheless has a few noteworthy exceptions.

- The budget adjusts the baseline by taking the budget authority of $187 billion from 2008 – the peak year of spending for operations in Iraq and Afghanistan – and inflating that level through 2019, adding $2.1 trillion over 10 years. The budget then assumes $83 billion in 2009 as the second supplemental, $130 billion in 2010, and $50 billion thereafter. By artificially inflating the baseline from the 2008 level, the President then claims $1.4 trillion in savings by budgeting at the reduced level.

  In other words, the President claims savings from spending that was never going to happen from a war that is winding down from its peak in 2008.

- The recently enacted State Children's Health Insurance Program bill has a funding cliff in 2014: it assumes the program grows by an average of 23.7 percent through 2014, and then abruptly stops. The budget does not assume extended funding for this program.

- The President's budget notes that the $634 billion health reserve fund that "is not sufficient to fully fund comprehensive reform" and then identifies additional spending and savings as "TBD," to be determined. In critiques of previous budgets, this has been known as a "magic asterisk."

- The College Access and Completion program is funded through 2015 and then sunsets.

THE ECONOMY

The heavy borrowing and taxing required by this budget undermine the ostensible benefits of the President's economic "stimulus" and "investments." This taxing and borrowing absorbs the very resources from private-sector investment, which is key to sustaining economic growth.

Compared to the consensus private sector economic forecast, the President's budget relies on an assumption that the economy will contract less sharply in 2009; that it will rebound more briskly in 2010; and that it will continue a stronger path of GDP growth for the next 3 years. For instance, the budget expects GDP to contract by 1.2 percent this year, compared to the private sector consensus of a larger 1.9-percent decline and the Congressional Budget Office's [CBO] expectation of a 2.2-percent fall.

The administration also forecasts that GDP will bounce back sharply to 3.2 percent in 2010, well above the private sector forecast of a moderate 2.1 percent, and more than *double* CBO's estimate of 1.5 percent. Looking farther out, the private sector Blue Chip consensus sees economic growth remaining under 3.0 percent for the next 5 years. In sharp contrast, the administration's forecast predicts that total GDP growth will exceed 4 percent from 2011 through 2013, which would be the strongest multiyear pace of GDP growth since the boom of the late 1990s.

Economic forecasting is always a difficult exercise and there are many divergent opinions about future developments. But it is important to note that the differences between the administration's economic forecast and the private sector consensus are large. These economic assumptions are critical in forecasting the near-term trajectory of the budget. For instance, slower-than-expected GDP growth would imply lower tax receipts, and therefore higher deficits than the path contained in the President's budget.

Expected inflation is also lower in the President's budget than the private consensus. For instance, in 2011 and 2012, the administration sees a mild inflation rate, slightly under 2.0, percent, while the Blue Chip consensus predicts higher inflation in the 2.5-percent range for this period. The key takeaway from the administration's economic forecast is that the rebound will be quick and will transition into a benign period of brisk growth coupled with low inflation. That is certainly the ideal economic scenario, but substantial risks to this type of forecast abound.

Two policies, in particular, could reverse the desired trends of growth and inflation painted by the President's budget. The administration's tax hikes increases will further constrain growth during a vulnerable time. Meanwhile, the Federal Reserve has taken extraordinary actions to increase much-needed liquidity in the financial system, bolstering the money supply. As the economy recovers, however, special attention must be given to ensure that Fed policies do not lead to stronger-than-expected inflation. There is at least some risk that the Fed is unable to unwind its myriad lending facilities and begin raising interest rates at the critical juncture when the economy starts to recover. Any missteps in monetary policy could lead to higher inflation. Weak growth coupled with high levels of inflation could lead back to Carter-era stagflation.

The economic scenarios contained in the Treasury Department's "stress test" of banks give a sense of the severity of the downside risks in the current economic forecast. Their economic scenarios range from "moderate" to more onerous. The moderate, or expected, scenario simulates a 2-percent fall in GDP this year, which is almost *double* the decline outlined in the administration's budget assumptions for 2009 (i.e. 1.2 percent). The "extreme" Treasury scenario is much more severe, testing the banks' reaction to a 3.3-percent contraction for 2009.

Table 5: Comparison of Economic Assumptions
(Calendar Years)

	Projections						Average
	2009	2010	2011	2012	2013	2014	2009-14
	Percent Change						
Real Gross Domestic Product							
Administration Budget	-1.2	3.2	4.0	4.6	4.2	2.9	3.0
CBO January	-2.2	1.5	4.2	4.4	4.1	3.5	2.6
Blue Chip Consensus (February)	-1.9	2.1	2.9	2.9	2.8	2.7	2.0
GDP Price Index							
Administration February Budget	1.2	1.1	1.5	1.7	1.8	1.8	1.5
CBO January	1.8	0.9	1.0	1.7	1.8	1.8	1.5
Blue Chip Consensus (February)	1.0	1.3	1.9	2.2	2.2	2.2	1.8
Consumer Price Index							
Administration February Budget	-0.6	1.6	1.8	2.0	2.1	2.1	1.5
CBO January	0.1	1.7	1.8	2.0	2.2	2.2	1.7
Blue Chip Consensus (February)	-0.8	1.8	2.4	2.5	2.4	2.5	1.8
	Annual Average, Percent						
Unemployment Rate							
Administration February Budget	8.1	7.9	7.1	6.0	5.2	5.0	6.6
CBO January	8.3	9.0	8.0	6.8	5.8	5.1	7.2
Blue Chip Consensus (February)	8.3	8.7	5.8	5.5	5.3	5.2	6.5
3-Month Treasury Bill Rate							
Administration February Budget	0.2	1.6	3.4	3.9	4.0	4.0	2.9
CBO January	0.2	0.6	2.1	4.0	4.7	4.7	2.7
Blue Chip Consensus (February)	0.3	1.1	4.2	4.3	4.4	4.4	3.1
10-Year Treasury Note Rate							
Administration February Budget	2.8	4.0	4.8	5.1	5.2	5.2	4.5
CBO January	3.0	3.2	3.6	4.7	5.4	5.4	4.2
Blue Chip Consensus (February)	2.8	3.6	5.1	5.2	5.3	5.2	4.5

Sources: Office of Management and Budget, Congressional Budget Office, Blue Chip Economic Indicators.

PAY-AS-YOU-GO

The President's budget proposes to return to a pay-as-you-go [pay-go] budget enforcement from the 1990s, but the proposal is vague: it states only that "the President and his economic team look forward to working with the Congress to develop budget enforcement rules." While the proposal does say pay-go would be set in statute, there are no specifics – only that a new system would be "based" on the expired pay-go system.

The budget refers to the pay-go enforcement procedures established by the Budget Enforcement Act [BEA] of 1990, which expired in 2002, whereby increases in mandatory spending, or reductions in revenue, had to be offset by corresponding decreases in spending or increases in revenue. If at the end of the year this has not been done, an across-the-board reduction in spending (a "sequester") occurs. From 1991 through the end of fiscal year 2002, no sequester of mandatory spending ever occurred, even though net increases in mandatory spending and revenue reduction did occur.

Statutory pay-go is different from the current rules in the Democratic Congress, which are enforced through procedural points of order. These can and have been easily waived or gamed.

The President's budget proposal appears to contain a built-in loophole for certain spending. The test under pay-go is whether a fiscal year's enacted legislation worsens the deficit. Under the BEA, projected deficits (the baseline) are estimated under specific procedures. But under this budget, certain spending is built in to the baseline. Legislation like higher Medicare physician payments ($329.6 billion over 10 years) and continued Transitional Medical Assistance and Qualified Individuals programs ($16.9 billion over 10 years) are exempt from the pay-go rule. The increased spending would be built into the baseline.

The budget is notable for what it does not say: there is no mention of statutory caps on annually appropriated funds, or whether mandatory spending would be allowed to be placed in such bills and escape pay-go (as is the case in the House Rule). It does not specify how to control spending designated as an emergency when it clearly is not. While amounts for emergencies are laudably placed within the budget, there is no mention of a mechanism to enforce an emergency standard.

The budget does propose changing the budgetary treatment of transportation programs to show both budget authority and outlays as discretionary.