COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET

Analysis of the President's FY 2012 Budget
February 16, 2011

On Monday, the White House released its FY2012 budget. While the Administration is billing the budget as "a down payment" on more significant fiscal reforms, we are disappointed it didn't go further in reducing the deficit and identifying specific policy reforms.

The budget claims to stabilize the debt at 77 percent of GDP, but these claims rely on a number of charitable assumptions. Moreover, that level of debt is too high, and the debt would again soar in the next decade since the budget does not address the largest drivers of budgetary growth.

Under the President's budget, deficits are projected to total $7.2 trillion over the decade. This represents a significant improvement from the FY2011 budget proposal, where (according to the Mid-Session Review) deficits were projected to be $627 billion higher between 2012 and 2020. It also represents $1.1 trillion in non-security deficit reduction from the Administration's adjusted baseline.

The budget increases the deficit—yes, *increases* the deficit— by $1.7 trillion relative to current law. This is due primarily to the assumed extension of the Bush-Obama 2001/2003/2010 tax cuts for families earning below $250,000 a year and ongoing costs of patching the Alternative Minimum Tax (AMT).

In addition, the budget falls more than $100 billion short of the Administration's own fiscal target, of balancing the primary budget (the budget excluding interest) by 2015.

The budget also fails to adopt the President's Fiscal Commission's bipartisan recommendations as a starting point, and while it does include a few of the specifics recommended by the Commission, it does not take advantage of the political cover offered by using the Commission's recommendations to start a national conversation on comprehensive reforms.

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Overview

Under the President's budget, the deficit would be $1.1 trillion in FY2012. This $544 billion decrease from the prior year is largely due to the winding down of a number of stimulus measures and increased revenue collection from the strengthening economy.

The deficit and debt stabilize by mid-decade, after which both revenues and outlays continue to grow as a share of the economy. Due to the combination of economic recovery, the fading of tax-side stimulus measures, and a number of policy proposals (including allowing the upper-income tax cuts to expire at the end of 2012), revenues rise steadily from 14.4 percent of GDP in FY2011 to 17.9 percent by 2013, 19.1 percent by 2015, and 20.0 percent by 2021. Outlays, meanwhile, are projected to fall from 25.3 percent of GDP in FY2011 to 22.3 in FY2015 as stimulus and automatic stabilizers unwind and some of the President's spending cuts take effect. Beyond 2015, the combination of rising interest costs and growing entitlement spending put outlays on an upward path, reaching 23.1 percent of GDP by 2021.

Fig. 1: Ten-Year Projections from OMB

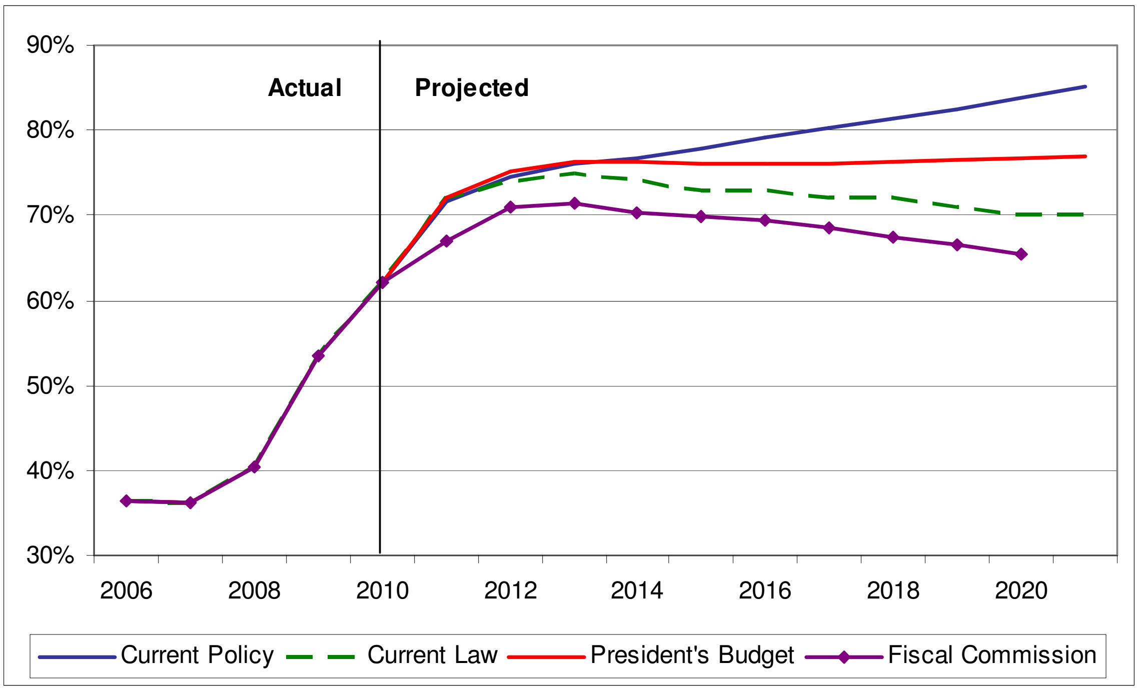
Fiscal Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Ten-Year*
Receipts (GDP)												
2012 Budget	14.4%	16.6%	17.9%	18.7%	19.1%	19.3%	19.5%	19.6%	19.8%	19.9%	20.0%	19.0%
Mid-Session	15.8%	17.4%	18.1%	19.0%	18.8%	19.2%	19.4%	19.6%	19.7%	19.8%	N/A	18.7%
Current Law	14.4%	16.7%	18.7%	20.0%	20.0%	20.1%	20.5%	20.7%	21.0%	21.1%	21.3%	20.0%
Adjusted Baseline	14.4%	16.5%	17.7%	18.6%	18.5%	18.6%	19.0%	19.2%	19.4%	19.4%	19.6%	18.7%
Outlays (GDP)												
2012 Budget	25.3%	23.6%	22.5%	22.4%	22.3%	22.6%	22.5%	22.5%	22.8%	23.0%	23.1%	22.7%
Mid-Session	25.1%	23.0%	22.4%	22.8%	22.8%	22.9%	22.8%	23.0%	23.3%	23.5%	N/A	23.2%
Current Law	25.0%	23.3%	22.6%	22.6%	22.6%	22.8%	22.7%	22.7%	22.9%	23.1%	23.3%	22.9%
Adjusted Baseline	25.0%	23.4%	22.7%	22.9%	23.0%	23.3%	23.3%	23.3%	23.6%	23.8%	24.1%	23.3%
Deficit (GDP)												
2012 Budget	10.9%	7.0%	4.6%	3.6%	3.2%	3.3%	3.0%	2.9%	3.0%	3.1%	3.1%	3.7%
Mid-Session	9.2%	5.6%	4.3%	3.8%	4.0%	3.8%	3.4%	3.4%	3.6%	3.8%	N/A	4.5%
Current Law	10.6%	6.6%	3.8%	2.6%	2.6%	2.8%	2.2%	1.9%	1.9%	2.0%	2.0%	2.8%
Adjusted Baseline	10.6%	6.9%	5.1%	4.3%	4.5%	4.7%	4.3%	4.1%	4.2%	4.4%	4.5%	4.7%
Deficit (Billions)												
2012 Budget	$1,645	$1,101	$768	$645	$607	$649	$627	$619	$681	$735	$774	$7,205
Mid-Session	$1,416	$911	$736	$698	$762	$758	$721	$749	$822	$900	N/A	$8,474
Current Law	$1,593	$1,036	$643	$463	$496	$552	$460	$417	$438	$472	$488	$5,465
Adjusted Baseline	$1,597	$1,090	$846	$770	$841	$938	$890	$891	$960	$1,045	$1,116	$9,387

* Ten-year column refers to 2012-2021, except for the Mid-Session Review which refers to 2011-2020.

With both outlays *and* revenues on the rise, deficits stabilize by 2015 at just above 3 percent of GDP. Though this is more than $100 billion short of the Administration's previously-stated goal of primary balance, it represents a roughly $150 billion (0.8 percent of GDP) improvement over last year's budget (as measured by the MSR).

With deficits at around 3 percent of GDP, the President's budget is projected to stabilize the debt through the decade, albeit at a very high level. Debt would grow from an estimated 72 percent of GDP by the end of 2011 to just over 75 percent of GDP in 2012, and then settle between 76 percent and 77 percent in the subsequent years. (By 2021 the debt would reach 85 percent of GDP under the adjusted baseline, and 70 percent under current law. The Fiscal Commission recommendations would have reduced the debt to below 65 percent of GDP.)

Fig. 2: Debt Held by the Public under Various Projections (Percent of GDP)



Baseline Assumptions

Like all budgets, the Administration compares their budget to a baseline in order to determine how much deficit reduction they have accomplished. Though baselines are useful for comparison purposes, they can be incredibly confusing and misleading as well.

The President's budget begins with a measurement of *current law* baseline, which interestingly shows deficits far lower than the equivalent estimates produced by the Congressional Budget Office (CBO). Due to their more optimistic economic and technical assumptions, OMB's current law deficit projections are about $1.5 trillion lower than CBO's over ten years.

As a result, the Administration begins with a deficit that is 0.4 percent of GDP, or $55 billion lower than CBO in 2015, and 1.2 percent, or $275 billion in 2021. This makes the task of deficit and debt reduction appear easier, though it isn't clear this will pan out in reality.

Fig. 3: Budget Enforcement Act Deficits According to OMB and CBO

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Ten-Year
Deficit (Billions)											
OMB	$1,036	$643	$463	$496	$552	$460	$417	$438	$472	$488	$5,465
CBO	$1,100	$704	$533	$551	$659	$617	$610	$696	$739	$763	$6,971
Deficit (Percent of GDP)											
OMB	6.6%	3.8%	2.6%	2.6%	2.8%	2.2%	1.9%	1.9%	2.0%	2.0%	2.8%
CBO	7.0%	4.3%	3.1%	3.0%	3.4%	3.1%	2.9%	3.2%	3.2%	3.2%	3.6%
Debt (Billions)											
OMB	$11,724	$12,494	$13,082	$13,701	$14,357	$14,911	$15,414	$15,927	$16,470	$17,037	N/A
CBO	$11,598	$12,386	$12,996	$13,625	$14,358	$15,064	$15,767	$16,557	$17,392	$18,253	N/A
Debt (Percent of GDP)											
OMB	74%	75%	74%	73%	73%	72%	72%	71%	70%	70%	N/A
CBO	74%	76%	75%	75%	75%	75%	75%	76%	76%	77%	N/A

The President's budget uses this as a starting point to generate an "adjusted baseline", which assumes the permanent extension of the 2001/2003/2010 tax cuts for families earning below $250,000 a year, continued patches of the Alternative Minimum Tax (AMT), and adjustments for Pell Grants and disaster funding.

In total, these baseline adjustments would cost $3.9 trillion over ten years and explode the deficit in 2021 – from 2 percent of GDP to 4.5 percent. The White House has always relied on these adjusted baselines (and it has in the past been standard practice to do so), but this year's has two major differences.

First, past budgets have assumed the extension of *all* the 2001/2003 tax cuts (and let the upper-income cuts expire as a policy proposal), rather than only continuing the cuts for income below $250,000 a year.

The second difference is that this year's baseline *does not* assume continued "doc fixes," which have been passed every year since 2003**.** Instead, its calls for a permanent fully-offset fix to the SGR – which CRFB very strongly supports. Unfortunately, they only identify enough savings (over 10 years) to offset the cost of the first two years, and then assume unspecified offsets will cover the costs through the remainder of the decade.

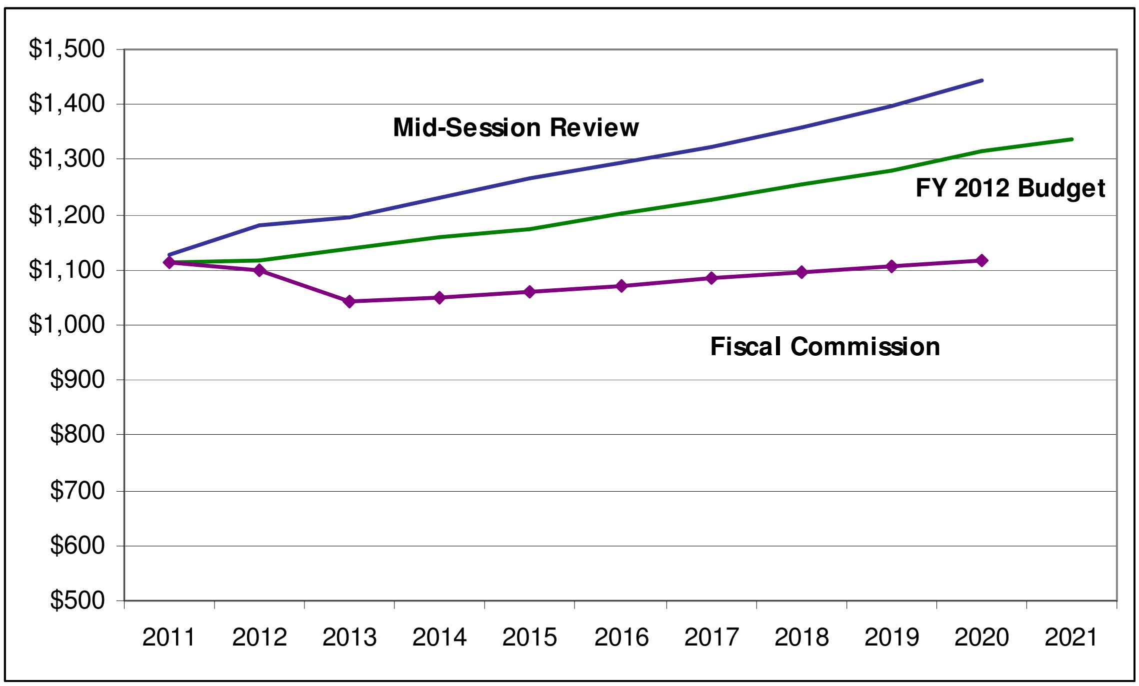
In previous budgets, the Administration has assumed the full cost of doc fixes, explaining that this would bring "new levels of honesty…making good-faith estimates about what costs we would incur; and it accounts for items that under the old rules could have been left out, making it appear that we had billions more to spend than we really do." By assuming but not identifying offsets for the doc fix, this year, this budget seems to abandon the "new levels of honesty" of the previous two years.

Discretionary Spending

Encouragingly, the budget makes real inroads on controlling the growth of discretionary spending by extending last year's three-year non-security spending freeze for another two years, saving $400 billion over a decade in the process.

The budget also begins making progress on controlling security spending, cutting $78 billion (over 5 years) off of last year's request and keeping defense spending growth in line with inflation – as opposed to allowing 1 percent real growth.

Fig. 4: Discretionary Spending Projections from OMB (Budget Authority, Billions)



The President's suggestions on discretionary restraint are positive steps. As a result of his proposals, base discretionary spending is projected to total $1,315 billion in 2020, compared to $1,442 billion under the previous budget.

That said, the White House certainly could have gone further by suggesting nominal cuts for both defense and domestic discretionary spending. Furthermore, statutory caps should be adopted as part of freezes or cuts for discretionary spending.

Mandatory and Tax Policy Proposals

Though much of the deficit reduction in the budget comes from the discretionary side of the ledger, the President's Budget also reduces mandatory spending and increases revenue collection. Relative to the Administration's baseline, the budget reduces net mandatory spending by over $80 billion (excluding the effect of refundable tax credits), generates $375 billion in new revenue, and calls for an additional $87 billion in *net* deficit reduction from the transportations trust fund.

As in previous years, though, the President also proposes a number of tax and spending measures which would increase the deficit. On the spending side, his budget calls for a permanent fix to the SGR ("doc fix"), a continuation of the Pell Grants extension from the stimulus, additional funding for low income families, broadband and wireless development, and a large increase in transportation spending. On the tax side, the President has proposed an extension of the American Opportunity Tax Credit, the Research and Experimentation Credit, and preferential rates for capital gains and dividends (though at 20 percent instead of 15 percent), along with additional tax cuts.

To offset these policies (and reduce the deficit some), the President's budget would enact a number of useful mandatory spending cuts, including ending in-school interest subsidies for graduate student loans, auctioning off broadband licenses, increasing various user fees, reforming the Pension Benefit Guarantee Corporations (PBGC), and reducing fraud. The budget also raises significant new revenue, including from reducing/eliminating various corporate tax expenditures, increasing the unemployment payroll tax, imposing a bank tax, and reducing the tax gap.

In a welcomed move, the budget also offsets a two-year doc fix through a number of Medicare and Medicaid cuts, including reducing Medicaid gaming and prescription drug reforms, and a three-year AMT patch by limiting the value of itemized deductions to 28 percent for higher earners – though the offsets occur over ten years.

Unfortunately, some of the largest areas of deficit reduction are assumed rather than real. After two years, the budget assumes doc fixes will be fully offset – on a same year basis – without identifying any policies to achieve this. Meanwhile, the President calls for existing and expanded transportation spending to be paid for through "bipartisan financing," but never identifies where this financing would come from (our estimate is that a 25 cent gas tax increase would more or less do the trick).

Together, these policies are responsible for a whopping $780 billion of the deficit reduction in the President's budget (including interest), and $130 billion in 2021. That means that without assuming these policies, the deficit would be about half a percent of GDP higher in the final year. Even if the lack of "bipartisan financing" results in no expansion of transportation funding (current levels are maintained), the deficit would be nearly $500 billion higher absent the unspecified savings, including $85 billion in 2021.

Fig. 5: Effects of Tax and Spending Proposals on the Deficit (Billions)

	5-year	10-year
BEA Baseline	**$3,189**	**$5,465**
Extend 2001/2003/2010 Tax Cuts for Income below $250,000	$588	$1,520
Continue AMT Patches	$512	$1,550
Adjustments for Pell Grants and Disaster Funding	$100	$210
Net Interest	$97	$642
Adjusted Baseline	**$4,486**	**$9,387**
Tax Proposals		
Extend the American Opportunity Tax Credit	$34	$94
Tax Capital Gains and Dividends at 20% for High Earners	$45	$124
Extend Research & Experimentation Credit	$42	$106
Other Tax Cuts for Individuals and Businesses	$44	$73
Limit Itemized Deductions to Pay for 3-year AMT Patch	-$114	-$321
Financial and Energy Taxes	-$45	-$100
Reform U.S. international tax system	-$65	-$129
Reduce Tax Gap	-$20	-$77
Reform Unemployment Taxes	-$33	-$61
Other Tax Changes	-$39	-$84
Sub-Total, Tax Changes	**-$151**	**-$375**
Spending Proposals		
Enact Doc Fixes	$144	$370
Specified Health Spending Reductions	-$17	-$62
Unspecified Measures to Offset Doc Fixes	-$90	-$315
Reduce Fraud and Abuse (Program Integrity Measures)	-$22	-$69
Other Mandatory Changes	-$26	-$6
Enact 5-Year Non-Security Freeze	-$153	-$406
Increase Certain Non-Defense Security Spending	$104	$188
Assume $50 Billion Plug for War Spending	-$443	-$1,090
Increase Transportation Spending	$114	$241
Sub-Total, Spending	**-$389**	**-$1,149**
Unspecified Measures to Fully Finance Transportation Spending	**-$140**	**-$328**
Net Interest Savings	**-$38**	**-$331**
Total Deficit	**$3,769**	**$7,205**

On top of these unfortunate punts, the President's budget fails to truly take on the largest and fastest growing spending programs. Absent from the budget is any Social Security reform proposals, and any significant efforts to control federal health care spending (though the health measures in the budget are certainly positive ones). The President also misses an opportunity to propose comprehensive tax reform, which – as the Fiscal Commission showed – could substantially increase revenues even while reducing tax rates in a way that promotes economic growth.

Economic Assumptions

The Administration's economic assumptions play a vital role in their budget accomplishments. Revenue levels, in particular, are influenced heavily by economic projections – since a larger and wealthier workforce is expected to pay more in taxes.

The economic projections in the budget show significantly higher growth over the next few years than what is projected by CBO or the Blue Chip Consensus. The White House assumes a substantial economic rebound, bringing GDP growth to 4.4 percent in 2013 – an expectation which is not shared either by CBO or the Blue Chip Consensus.

Fig. 6: Comparison of Economic Projections (Calendar Years)

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Ten-Year Average
Real Economic Growth											
FY 2012 Budget	3.6%	4.4%	4.3%	3.8%	3.3%	2.9%	2.6%	2.5%	2.5%	2.5%	3.2%
Mid-Session Review	4.2%	4.2%	4.0%	3.6%	3.2%	2.8%	2.5%	2.5%	2.5%	n/a	3.3%
CBO Outlook	3.1%	3.1%	3.5%	3.8%	3.0%	2.5%	2.4%	2.4%	2.4%	2.3%	2.9%
Blue Chip Consensus	3.3%	3.0%	2.8%	2.7%	2.6%	2.5%	2.5%	2.5%	2.5%	2.4%	2.7%
Inflation (CPI-U)											
FY 2012 Budget	1.8%	1.9%	2.0%	2.0%	2.1%	2.1%	2.1%	2.1%	2.1%	2.1%	2.0%
Mid-Session Review	1.8%	1.9%	2.0%	2.0%	2.1%	2.1%	2.1%	2.1%	2.1%	n/a	2.0%
CBO Outlook	1.3%	1.6%	1.8%	2.0%	2.2%	2.4%	2.3%	2.3%	2.3%	2.3%	2.1%
Blue Chip Consensus	1.9%	2.2%	2.2%	2.2%	2.2%	2.3%	2.3%	2.3%	2.3%	2.3%	2.2%
Unemployment											
FY 2012 Budget	8.6%	7.5%	6.6%	5.9%	5.5%	5.3%	5.3%	5.3%	5.3%	5.3%	6.1%
Mid-Session Review	8.1%	7.1%	6.3%	5.7%	5.3%	5.2%	5.2%	5.2%	5.2%	n/a	6.2%
CBO Outlook	8.4%	7.6%	6.8%	5.9%	5.3%	5.3%	5.2%	5.2%	5.2%	5.2%	6.0%
Blue Chip Consensus	8.4%	7.7%	7.1%	6.6%	6.2%	-- average 5.9% --					6.6%
Gross Domestic Product (Fiscal years, trillions)											
FY 2012 Budget	$15.8	$16.8	$17.8	$18.8	$19.8	$20.8	$21.7	$22.6	$23.6	$24.6	n/a
Mid-Session Review	$16.2	$17.1	$18.1	$19.1	$20.1	$21.1	$22.0	$22.9	$23.9	n/a	n/a
CBO Outlook	$15.7	$16.4	$17.3	$18.2	$19.1	$20.0	$20.9	$21.9	$22.8	$23.8	n/a

On average, over ten years, OMB projects real GDP growth of more than 3.2 percent per year, compared to less than 2.9 percent for CBO. If one were to apply CBO's "rules of thumb" for the effects of economic growth, they would find that this difference corresponds to a deficit level about $265 billion lower in 2021 alone. Not surprisingly, OMB's current law baseline projects 2021 deficits $275 billion[1] lower than CBO.

Combined with a higher GDP – which increases the denominator of the deficit-to-GDP ratio – this lower baseline deficit substantially improves the 2021 deficit to the tune of 1.2 percent of GDP. Our concern is that the Administration's generous economic projections may be masking a substantial debt increase embedded in the President's budget proposal, and make the fiscal challenges ahead seem artificially small.

Conclusion

Overall, the President's budget offers too little at a time when so much is needed. Rather than taking advantage of the political opportunity created by the Fiscal Commission to address defense, entitlements, and tax reform, this budget shirks away from making the hard choices and instead focuses in on non-security discretionary spending.

To the extent it is projected to stabilize the debt, it does so only through optimistic economic assumptions and hundreds of billions of dollars in claimed but unspecified deficit reduction.

There is no substitute for strong leadership from the White House on an issue as serious as our fiscal challenges. Yet, there can be a way through this mess. The White House must work with lawmakers this year to enact a budget and fiscal plan that goes further than what they propose here. The country needs a credible plan to get us out of the enormous fiscal hole we've dug for ourselves.

[1] Note that this is the net effect of a number of different economic and technical assumptions, though economic growth likely makes up the lion's share of the difference.