

THE CONCORD COALITION



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The President's Budget: A Bold Approach With Many Risks

I. Introduction

The budget outline submitted to Congress by President Obama on February 26, 2009 is a bold and ambitious proposal that could transform the policy agenda for years to come. On the plus side, it calls for significant deficit reduction, improves transparency, and reflects a commitment to paying for new initiatives. The downside risk is that many things have to go right for the plan to work. The economic assumptions are optimistic, as are the assumed savings from winding down the war in Iraq. There is also the political difficulty of enacting controversial offsets to pay for proposed spending increases and tax cuts. Even if it all works, deficits would remain at or above 3 percent of GDP by 2013 and beyond -- higher than the average over the past 40 years -- and the publicly held debt would approach 70 percent of GDP. Moreover, all of this assumes that health care reform can be enacted in a deficit-neutral manner and that presumed long-term savings from efficiencies will eventually materialize.

The defining feature of the budget is the sheer magnitude of the changes being proposed. It is already drawing comparisons to President Reagan's first budget in 1981. And yet, the first Reagan budget had just one central theme -- reduce taxes to grow the economy. By contrast, President Obama has chosen to tackle a host of thorny issues from health care, energy, defense, and education reform to taxes and income inequality. Alone, any one of these initiatives has the potential to tie the legislative process in knots.

A further complication is that many of the budget's main components are linked in an effort to control the net effect on the deficit. Maintaining this linkage is critical for fiscal responsibility. However, it will prove to be a formidable political hurdle because it challenges the free lunch mentality that has taken root in Washington. New initiatives, popular with many Congressional leaders, are paired with tax increases and spending cuts that are not as popular. If the carrots are taken without the sticks, a grim fiscal outlook will become even worse.

The current economic environment adds risks of its own. While the budget forecasts a strong and rapid recovery, the recession shows no signs of letting up. The unemployment rate has hit 8.1 percent, and gross domestic product (GDP) fell by 6.2 percent in the fourth quarter of 2008 -- a larger drop than had been expected. This increases the risk that the budget is based on overly optimistic growth assumptions despite passage of a \$787 billion fiscal stimulus bill. Moreover, the financial sector is still in peril, losses mount for automobile manufacturers, state and local budgets face large deficits, and the housing market is far from stabilized.

Table 1. Outline of the President's Budget

	Estimated 2009	2010	2011	2012	2013	2014
Budget Totals (dollars in billions)						
Receipts	2,186	2,381	2,713	3,081	3,323	3,500
Outlays	3,938	3,552	3,625	3,662	3,856	4,069
Deficit (-)/Surplus (+)	-1,752	-1,171	-912	-581	-533	-570
Budget Totals (percent of GDP)						
Receipts	15.4%	16.2%	17.5%	18.7%	19.0%	19.0%
Outlays	27.7%	24.1%	23.4%	22.2%	22.0%	22.1%
Deficit(-)/Surplus(+)	-12.3%	-8.0%	-5.9%	-3.5%	-3.0%	-3.1%
Gross Domestic Product (GDP)	14,240	14,729	15,500	16,470	17,498	18,386

Source: Table S-1 of February 2009 Budget (*A New Era of Responsibility: Renewing America's Promise*)

A final, and substantial risk posed by the president's ambitious agenda is that the nation's fiscal policy is already on an unsustainable track. Spending cuts and tax increases used to fund new initiatives in the budget would no longer be available to close the existing long-term gap -- a situation that would be exacerbated by more than \$3 trillion of exemptions from pay-as-you-go rules (PAYGO) granted in the budget for continuation of various existing policies.

For example, the budget's commitment to deficit-neutral health care reform and its identification of specific offsets to pay for reform, does not on its own reduce the ultimate fiscal challenge posed by rising health care costs. Ultimately the details of a reform plan will have to start bringing costs down -- not just keep them on a straight line of deficit neutrality. Investing in health care information technology, comparative effectiveness research, prevention, and care coordination as proposed in the budget may ultimately bring costs down, but there is no estimate of how these things would be translated into savings, how much would be saved, or when the savings would occur. Meanwhile, costs would continue to grow. Thus, it will be essential that as the details of reform legislation are negotiated they include a more specific strategy for producing long-term savings.

At a Fiscal Responsibility Summit held at the White House before the budget was released, President Obama acknowledged that more must be done than is recommended in the budget:

Now, I want to be very clear: while we are making important progress toward fiscal responsibility this year, in this budget -- this is just the beginning. In the coming years, we will be forced to make more tough choices and do much more to address our long-term challenges, from the rising cost of health care -- the most pressing fiscal challenge we face -- to the long-term solvency of Social Security.

Nothing in the budget directly alters the drift toward fiscal unsustainability, which is primarily driven by the projected growth of the three largest entitlement programs -- Medicare, Medicaid and Social Security. Under the budget, spending on these programs declines by just \$32 billion relative to baseline assumptions through 2019. As the president acknowledges, any effort to

permanently improve the fiscal outlook beyond the 10-year budget window will require more fundamentally addressing the structural causes of the long-term imbalance -- demographic changes and rising health care costs.

While there is plenty of room to debate the priorities, assumptions, and details, it cannot be said that the Obama administration has taken a timid approach in its first budget. It confronts a broad array of challenges and does not pretend that we can have something for nothing. For this, the administration deserves great credit. But the risks should not be minimized. By trying to do too much, too soon, the president's proposals may overload the legislative circuits and result in fewer real achievements than if a more targeted, but still ambitious, agenda were pursued.

II. The Fiscal Policy Goal

The budget projects a deficit of \$1.75 trillion (12.3 percent of GDP) in 2009 and a deficit of \$1.17 trillion (8 percent of GDP) in FY 2010. Both would easily exceed the post-World War II record deficit of 6 percent of GDP in 1983.

In just two years, from 2008 to 2010, debt held by the public would grow from 40.8 percent of GDP to 64.6 percent under the president's budget.¹ Given this astronomical rise in deficits and debt, it is imperative for the administration to show that it has a viable "exit strategy" to bring deficits back down to a more sustainable level. As the president noted in his budget message:

[W]e cannot lose sight of the long-term challenges that our country faces and that threaten our economic health -- specifically, the trillions of dollars of debt we inherited, the rising costs of health care, and the growing obligations of Social Security. Therefore, while our Budget will run deficits, we must begin the process of making the tough choices necessary to restore fiscal discipline.

The first step is to set a realistic fiscal policy goal. The budget does this by aiming to cut the deficit in half to \$533 billion by 2013, the end of the president's current term. As a percentage of GDP, this would more than cut the deficit in half, from 8 percent in 2010 to 3 percent in 2013. Establishing deficit reduction as a goal is a positive attribute of the budget because it provides a responsible framework and keeps pressure on policymakers, including the administration, to avoid actions that would jeopardize that goal -- whether through increased spending or lower revenues.

Cutting the deficit in half by 2013 is ambitious but achievable. It will require that the economy recovers as projected, that no further stimulus legislation is enacted, and that the stimulus provisions enacted in the American Recovery and Reinvestment Act of 2009 (ARRA) are allowed to expire, or continue with deficit-neutral offsets. It will also require that spending on the wars in Iraq and Afghanistan declines sharply from \$130 billion in 2010 to just \$50 billion by

¹ The budget also shows debt held by the public "net of financial assets," which subtracts the portion of the debt increase that has been used to acquire assets that might earn a return. Debt net of financial assets grows from 37.2 percent of GDP in 2008 to 54.8 percent of GDP in 2010.

2011 and beyond -- the placeholder amount in the budget for those years. Any change in these projected circumstances will challenge the administration's ability to achieve their proposed deficit reduction.

III. The Spending Path

Overall trend

Over the 10-year period covered by the budget (FY2010-2019), total outlays grow from \$3.5 trillion to \$5.1 trillion, but decline as a percentage of GDP from 24.1 percent to 22.6 percent. This trend represents a sustained upward shift. Outlays in 2008 were 21 percent of GDP, slightly above the 20.7 of GDP they have averaged over the past 25 years.

The immediate increase in outlays relative to the economy is quite large. It results from a combination of contracting growth in 2009 and a substantial increase in government spending aimed at mitigating that contraction. Some of the spending increase is attributable to "automatic stabilizers" such as unemployment compensation, food stamps and Medicaid. An even larger share comes from the \$787 billion stimulus bill signed into law. Continuing war costs are also a factor.

The administration projects that the economy will experience robust growth beyond 2009 and that spending from the stimulus bill and military operations in Iraq will wind down, causing the trend of outlays relative to GDP to decline over the 10-year window. As projected by the administration, real GDP growth will rise by 3.2 percent in 2010 and peak in 2012 at 4.6 percent. These growth assumptions are clearly on the optimistic side. Yet, even if they are accurate and the temporary spending increases fade as anticipated, the budget leaves spending on an upward trend from where it was before the current recession began.

Table 2. Spending in the President's Budget

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Outlays										
Mandatory	2,009	2,040	2,009	2,132	2,287	2,412	2,587	2,717	2,848	3,073
Discretionary	1,368	1,286	1,257	1,269	1,286	1,313	1,341	1,370	1,401	1,434
Percent of GDP										
Mandatory	13.6%	13.2%	12.2%	12.2%	12.4%	12.6%	12.9%	13.0%	13.0%	13.4%
Discretionary	9.3%	8.3%	7.6%	7.3%	7.0%	6.8%	6.7%	6.5%	6.4%	6.3%
GDP	14,729	15,500	16,470	17,498	18,386	19,205	20,060	20,952	21,884	22,858

Source: Tables S-4 and S-1 of February 2009 Budget (*A New Era of Responsibility: Renewing America's Promise*)

Discretionary spending (appropriations)

For discretionary appropriations, the president requests \$1.26 trillion for 2010 followed by a decrease of roughly 5 percent in 2011. This decrease reflects the assumed reduction in war costs from \$130 billion in 2010 to \$50 billion each year thereafter -- and also the decline of emergency stimulus spending.

The largest discretionary spending increase comes in 2012. The \$1.24 trillion request for that year represents a 3.2 percent increase from the previous year. Most of the increase comes from the phasing in of the president's new discretionary spending agenda which includes money for clean energy technologies and a National Infrastructure Bank. The president begins to fund the clean energy initiative with \$15 billion in 2012 (a total of \$45 billion through 2014), while the National Infrastructure Bank receives funding earlier -- beginning in 2010 -- and totals \$25 billion through 2014.

Despite these increases, spending in the outyears is relatively restrained. As a result, overall discretionary spending declines from 9.3 percent of GDP in 2010 to 7 percent in 2014 and 6.3 percent in 2019. This pattern is often seen in presidential budgets but rarely achieved.

Table 3. Defense and Non-defense Discretionary Spending

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Outlays										
Defense	673	614	604	609	618	631	644	659	674	689
Non-defense	695	672	653	661	668	682	697	711	727	745
Percent of GDP										
Defense	4.6%	4.0%	3.7%	3.5%	3.4%	3.3%	3.2%	3.1%	3.1%	3.0%
Non-defense	4.7%	4.3%	4.0%	3.8%	3.6%	3.6%	3.5%	3.4%	3.3%	3.3%

Source: Table S-4 of February 2009 Budget (*A New Era of Responsibility: Renewing America's Promise*)

Mandatory spending

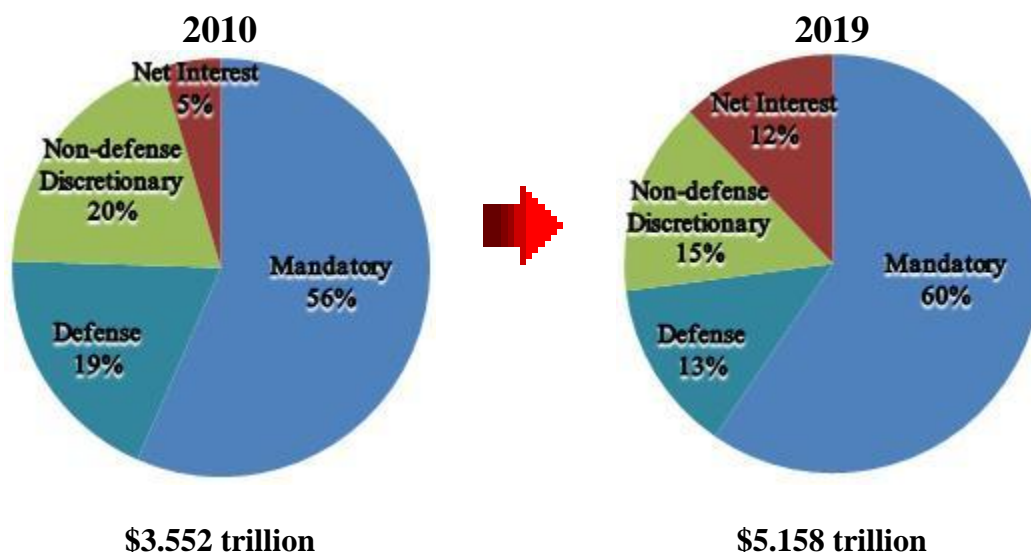
A more fundamental concern is the absence of substantial reforms concerning mandatory spending. Mandatory spending contains entitlement programs -- such as Medicare, Medicaid, and Social Security -- which expand each year automatically due to benefit formulas written into law. They are not subjected to any required review by Congress. As the population ages and health care costs grow faster than the economy, these programs will increasingly crowd out discretionary spending or put upward pressure on taxes. Over the coming decade, the president's budget projects an increase of \$1 trillion in mandatory spending. This equates to a growth of 5.3 percent per year.

However, the budget is not without policies aimed at producing savings on the mandatory side of the ledger. In an effort to promote efficiency, the president proposes a competitive bidding

process for Medicare Advantage, the bundling of Medicare payments covering hospital and post-acute settings, and promoting cost-effective purchasing and delivery of prescription drugs. Such proposals, as projected in the budget, would generate \$316 billion in savings over 10 years.

Yet, this money is dedicated to the president’s health reform reserve fund (discussed later) as a “down payment” on comprehensive reform. While the president deserves credit for acknowledging the nation’s unsustainable fiscal future, committing these savings to an expansion of his policy agenda does nothing to avoid the looming hard choices if no additional remedy is provided.

Chart 1. Composition of Spending Under the President’s Budget, 2010 and 2019



Net interest

The cost of financing our ballooning national debt becomes vividly apparent in the president’s budget as net interest payments escalate to \$622 billion in 2019 (totaling 12.1 percent of all spending). This is roughly two and a half times more than was paid in net interest last fiscal year.

Even though net interest will fall this year due to very low interest rates, the trend will not continue over the extended outlook. The Treasury is currently benefiting from what amounts to a “teaser rate” on its borrowing needs. Once interest rates begin to rise, the consequences of taking on so much additional debt will be felt. As noted by the Congressional Budget Office:

Net interest costs are projected to change little from 2009 to 2010, as interest rates are expected to remain relatively low. However, such costs are projected to grow rapidly over the next several years as a result of extraordinarily large accumulations of debt over the 2008-2011 period and an anticipated rise in rates beginning in 2011.²

² Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2009-2019* (January 2009), p. 20.

The budget assumes that interest rates on 10-year Treasury notes will rise from 2.8 percent in 2009 to 4 percent next year and 5.2 percent by 2013 and beyond. This estimate, while reasonable, could prove to be optimistic if deficits remain higher than projected and lenders begin to sense that the government has no plan to bring them under control.

IV. The Revenue Path

A welcome sign of reality is an acknowledgment by the Obama administration that new sources of revenue will be needed to fund their new spending initiatives. However, this gesture of fiscal responsibility should be viewed with some caution.

President Obama's budget actually proposes a net decrease in revenues relative to current law. Under current law, the Bush tax cuts and relief from the Alternative Minimum Tax (AMT) expire over the next two years. If no action is taken, this would lead to a large influx of revenue. However, in the budget, the administration starts with a tax policy baseline that assumes these tax cuts continue permanently -- basically assuming an extension of current policy. They also add to their assumptions of current policy \$212 billion in tax cuts enacted as part of the economic recovery package (ARRA). Thus, they start from a "current policy baseline" that has substantially lower revenues than what current law would produce.

Next, the budget proposes \$1.6 trillion³ in new tax increases and \$940 billion in new tax cuts -- their policy changes from the current policy baseline. Evaluating whether the administration is ultimately lowering or raising taxes with these proposals depends on whether one starts from the current-law baseline or from the current policy baseline.

Relative to current policy (including extension of the Bush tax cuts and permanent AMT relief), the administration can claim it is proposing to increase revenues by \$696 billion, making revenues rise over time to 19 percent of GDP by 2013 and 19.5 percent of GDP by 2019. Compared with current law, however, under which revenues are 19.7 percent of GDP in 2013 and 20.2 percent in 2019 (according to CBO), the administration's tax policies *reduce* revenues by \$2.6 trillion.

Finally, the net effect of the president's budget proposals on revenue levels also depends on how tax increases to fund the deficit-neutral health reform reserve fund are counted. The fund is deficit-neutral but is not at all intended to be revenue-neutral or spending-neutral. The administration proposes a specific tax increase, a limit on itemized deductions which would raise \$318 billion through 2019, to partially fund the health reserve fund. However, in their budget tables, they do not show the reserve fund as having an impact on either revenue levels or spending levels because, they argue, how the fund will be allocated is yet to be specified, and how large the fund may need to grow is yet to be determined.

³ Not including the tax increase in the health care reserve fund.

This is problematic in that if the proposals going into the health reform reserve fund are passed, revenue levels will go up (as will spending levels). Just the one tax increase proposal now included in the reserve fund increases the 10-year revenue levels implied in the budget by \$318 billion. While this is a small addition over 10 years (0.9 percent of revenues), the omission of the health reform reserve fund means that the administration's budget is understating revenues under their proposals, and understating spending as well -- even as the administration is correct to emphasize the deficit neutrality of the reserve fund as a useful mechanism to encourage fiscal responsibility.

From an economic efficiency and growth perspective, the mix of tax cuts and tax increases proposed in the Obama budget may not be optimal. Relative to full extension of all of the Bush tax cuts, the choice to extend the middle-class tax cuts but not the high-income tax cuts is well motivated based on distributional concerns. But achieving a more progressive tax structure could be accomplished in more efficient ways if the debate were broadened to fundamental tax reform rather than being limited to the pros and cons of the various pieces of the Bush tax cuts.

Extending even the "middle-class" portions of the Bush tax cuts is costly; allowing some of the high-income tax cuts to expire as specified in the Obama budget saves just \$637 billion of the \$2.7 trillion cost of complete extension. Thus, more than \$2 trillion in continued Bush tax cuts (to extend all but the "high-income" portions) are contained in the Obama budget. In addition, the budget proposes \$770 billion in *new* tax cuts for households, primarily in the form of refundable tax credits. (The refundable portions of those tax credits, going to households who do not owe income taxes, account for 42 percent of the cost.) That refundability and the phaseouts with income allow the relief to be better targeted toward lower-income households, but they also add new layers of complexity to the personal income tax system.

A more fundamental reform of the income tax system would involve reducing or eliminating inefficient and/or unfair tax expenditures -- filling in the "holes" in the current tax base. With the total value of tax expenditures approaching \$1 trillion (nearly as much as all of discretionary spending), reducing such tax preferences has the potential to raise a lot of revenue. Moreover, the largest federal tax expenditure is the exclusion for employer-provided health benefits, which costs around \$250 billion a year. Limiting the value of this exclusion could raise significant revenue, be done in a progressive manner, and would be consistent with health care reform goals -- and would thus be a natural candidate for the health reform reserve fund. CBO has looked at one option for capping the exclusion that would raise about \$450 billion over 10 years, far more than the \$318 billion the Obama administration proposes to raise for the health reform reserve fund through the limit on itemized deductions.

While the administration deserves credit for proposing revenue increases to at least partially offset the cost of new initiatives, the political reality is that the specific revenue proposals have already encountered resistance from members of both parties in Congress. The revenue increases

Table 4. Revenue Changes Proposed in the President’s Budget, 2010-2019

	Revenue Effect 2010-2019
TAX CUTS ADDED BY ADMINISTRATION IN THEIR POLICY-EXTENDED BASELINE	
<i>(current tax cuts relative to current-law baseline)</i>	
- Extended AMT relief	-\$575.9 billion
- Extend 2001 and 2003 tax cuts (but maintain estate tax at 2009 law)	-\$2,681.3 billion
- Tax cuts in recovery act (ARRA) -- passed but not yet in CBO current-law baseline	-\$211.8 billion ⁴
TOTAL, tax cuts added to current-law baseline:	-\$3,469.0 billion
<i>minus recovery act tax cuts (not yet enacted but assumed in policy baseline):</i>	-\$3,257.2 billion
TAX INCREASES PROPOSED BY ADMINISTRATION IN THEIR FY2010 BUDGET	
<i>(new tax increases relative to current-policy extended baseline)</i>	
- Limit on itemized deductions (dedicated to health reform reserve fund)	\$317.8 billion
- Climate revenues (carbon permit auctions dedicated to climate policy and Making Work Pay credit)	\$645.7 billion
- Expiration of upper-income tax provisions (dedicated to deficit reduction)	\$636.7 billion
- Revenue raisers and loophole closers (mostly corporate base broadeners)	\$353.5 billion
TOTAL, tax increases proposed:	\$1,953.7 billion
<i>minus itemized deduction (health reserve fund) provision:</i>	\$1,635.9 billion
TAX CUTS PROPOSED BY ADMINISTRATION IN THEIR FY2010 BUDGET	
<i>(new tax cuts relative to current-policy extended baseline)</i>	
- Provide Making Work Pay Tax Credit	-\$536.7 billion
- Expand Earned Income Tax Credit	-\$32.9 billion
- Expand refundability of the Child Tax Credit	-\$70.5 billion
- Expand saver’s credit and automatic enrollment in IRA and 401(k)s	-\$55.2 billion
- Provide American Opportunity Tax Credit	-\$74.9 billion
- Make research and experimentation tax credit permanent	-\$74.5 billion
- Additional tax cuts for businesses	-\$74.8 billion
- Continue remaining expiring tax provisions through calendar year 2010	-\$20.7 billion
TOTAL, new tax cuts proposed:	-\$940.2 billion
Net Tax Increase Relative to Current Policy Extended:	\$1,013.5 billion
<i>minus itemized deduction (health reserve fund) provision:</i>	\$695.7 billion
Net Tax Decrease (-) Relative to Current Law:	-\$2,243.7 billion
<i>minus itemized deduction (health reserve fund) provision:</i>	-\$2,561.5 billion

Source: Tables S-2 and S-5 of February 2009 Budget (*A New Era of Responsibility: Renewing America’s Promise*), and CBO cost estimate of H.R. 1, the American Recovery and Reinvestment Act of 2009 (Public Law 111-5)

⁴ Includes 2009 costs.

can be sorted into three categories, with about a third of the increases coming from each, and each with their own political problems.

Nearly a third of the added revenue (\$637 billion, or 32.6 percent) comes from the expiration of the high-end Bush tax cuts. This debate will just be a replay of the highly partisan arguments that took place during the Bush administration over the “largest tax increase in American history.”

Another third of the revenue increase (\$646 billion, or 33 percent) comes from auction proceeds from a carbon permits “cap-and-trade” policy. Whatever its merits from an environmental and economic standpoint, this will be attacked as a tax that will burden all Americans -- despite the administration’s pairing it with a middle-class tax cut (the Making Work Pay credit) designed to help neutralize its distributional effects.

The remaining third of the budget’s proposed revenue increase (\$672 billion, or 34.4 percent) comes from reduction of tax expenditures: the corporate base broadeners (or “loophole closers”) which will be resisted by the corporations who currently benefit from such preferences; and the limit on itemized deductions for high-income households used to partially fund the health reform reserve fund, which has already met resistance from Democrats and Republicans alike.

Finally, for all the revenue increases proposed, spending growth keeps pace and the long-term deficit outlook is not improved. This is best demonstrated by looking at the second five years of the budget when short-term volatility has played out. Between 2014 and 2019, revenues grow by 0.5 percent of GDP (from 19 percent to 19.5 percent) but spending *also* grows by 0.5 percent of GDP (from 22.1 to 22.6 percent). Thus, the deficit fails to narrow, even assuming that all of the tax increases proposed in the budget are passed.

Whether the politics of Washington will allow the Obama administration and Congress to move beyond vague talk about “fiscal responsibility” to agreement on specific proposals to actually reduce the structural deficit remains to be seen. The danger is that Congress will not go along with any of the tax offsets designed to help pay for the spending increases, and that even the spending that is presented as conditional on the revenue offsets will be enacted. If that happens, the notion of fiscal responsibility will turn out to be only an opening bid from the Obama administration that in the end may actually result in larger, not smaller, deficits.

V. Significance of the Health Care Reserve Fund

The budget presents one of its largest proposals, health care reform, as a “reserve fund.” This mechanism is used to identify \$316 billion of Medicare and Medicaid savings plus \$318 billion of new revenues “dedicated towards financing reforms to our health care system.” The details of health care reform will be negotiated in the coming months with Congress, but the budget makes clear that the reserve fund amount “is not sufficient to fully fund comprehensive reform.” Benefit expansion and additional savings are labeled as “yet to be determined.”

The main significance of the health care reserve fund is not so much its size or the specifics of its policy proposals -- these are only intended to be markers -- but that it imposes a deficit neutral-

framework for health reform over the 10-year budget window. Deficit neutrality is an extremely important commitment, and a minimum requirement for fiscal responsibility. However, given that health care spending in the budget is already on an unsustainable path, deficit-neutrality is not a sufficient long-term fiscal goal for health care reform.

The commitments that have already been made are unsustainable. Simply adding more, even deficit-neutral ones, would not change that fact.

Furthermore, there is a substantial risk that Congress will enact politically popular new commitments without offsets or solid proposals to achieve cost control. Maintaining a commitment to both during the coming debate over reform will be essential to achieving President Obama's short-term deficit reduction goals and will be a crucial test for the administration's dedication to long-term budget sustainability.

The administration is already facing pressure from members of Congress and outside groups to jettison even the goal of deficit neutrality.⁵ Some object to the specific offsets suggested in the budget. One offset would be a limit in the rate at which itemized deductions can reduce tax liability, to 28 percent, which would reduce the tax benefit to upper-income households who fall in marginal tax rate brackets above 28 percent. The other offset specified is actually a collection of Medicare cuts that primarily come from recommendations by the non-partisan Medicare Payment Advisory Commission (MedPAC). The answer to those who specifically criticize these offsets should be to find others of similar size—not to drop the effort altogether.

Another objection to paying for health care reform is that finding offsets is politically difficult and has the potential to upset any fragile bargain between the multitude of coalitions involved in the reform discussion—either the bi-partisan groups of legislators writing the legislation, or the cross-cutting alliances of business, labor, and health care industry groups that have gathered together to work for reform. The problem with this argument is that these groups believe now is the time for health care reform because their business models require reform, or because the country's economic growth is being impeded by health care costs, or because they object to the large number of Americans without health insurance. If now is such an important time for health care reform and it is such a high priority, these groups should support paying for the effort by recognizing items in the budget or tax code that are of lower priority, instead of loading the burden on future generations.

Furthermore, if a coalition makes it through the incredibly difficult process of producing health care legislation with enough votes to pass through Congress, it is hard to believe that it would break up over what appears to be much more incremental changes to the tax code or Medicare payments.

⁵ Letter to Budget Chairmen and Ranking members Senators Conrad and Gregg, Representatives Spratt and Ryan (March 9, 2009).

Unfortunately, the fact that these groups are already attempting to duck relatively minimal hard choices before the details of legislation have been put to paper does not bode well for the ultimate reform process. Real and necessary health care reform will require hard choices in order to constrain costs and provide better and more accessible care. If these groups cannot accept that reality, it is hard to see any positive movement on comprehensive reform.

A third and more seductive objection to paying for health care reform is that it will pay for itself at some point beyond the 10-year budget window by bringing efficiencies that will lower overall health care costs for the government and everyone else. The problems with this argument are specificity of savings and timing. From a specificity standpoint, in order for the “paying for itself” logic to work, the details of the reform plan are crucial in that they would have to include major attempts at cost control that involve a degree of certainty in their payoff. From a timing standpoint, the plan would need to start lowering costs quite rapidly in order for the increase in indebtedness to not swamp the ship-of-state before we achieve any savings.

While the Obama budget provides details of where partial funding for the 10-year start-up costs could come from to pay for reform, the budget does not specify the details of a reform plan. The big goals are only identified as “constraining costs, expanding access and improving quality.”

Improving quality and expanding access are important goals for health care reform and represent the “sweeteners” in the ultimate momentum driving reform. If accomplished by themselves, however, these goals would only lead to higher health care spending in the future. Insuring all Americans would cut down on expensive emergency care and increase usage of preventative care, but the net costs to the system would still increase. As such, there is an even greater imperative that this expansion of coverage be paid for, because unlike an investment -- which one could argue leads to lower costs down the road and “pays for itself”-- the same cannot be said of a permanent new insurance initiative. And while research shows that spending more on health care does not necessarily improve health outcomes, it does not follow that reform only focused on better quality would lower costs. That is why these sweeteners need to be paired with the more difficult choices to constrain costs--the first goal stated by the administration. This is where tough choices have to be made and where the administration will have to be forceful in order to produce a fiscally responsible outcome.

The specifics of the plan, then, are crucial in determining the true cost of the reform effort not only over 10 years, but over the long term. At this point, however, it is impossible to say what those specifics will be.

Over the long term, the administration is heavily banking on health care IT, comparative effectiveness research, prevention, and care coordination to ultimately bring costs down. The budget increases spending on these initiatives, but there is no estimate of how much money would be saved over time or when the savings would occur. More details will be forthcoming, but so far the administration has not laid out a strategy for translating comparative effectiveness and IT into savings. It is not enough to simply gather information, although that is a necessary first step. The information gathered must be put to use in altering coverage or payment decisions for things that are found to confer little benefit. Provider practices and patient expectations must

change, and Medicare must have the tools it now lacks to enforce standards. Right now, the explanation on how to get from here to there is missing. There is clearly a potential for savings but there is also great difficulty in realizing those savings.

Yet, we know the problem of demographically-driven cost growth is certain as opposed to the more speculative savings from reducing per-beneficiary growth. That is why paying for reform now is imperative. If we do not start accumulating savings now, the resulting rate of cost growth could destroy the budget before long-term savings arrive.

VI. Improving Transparency

The budget takes many steps to improve transparency of the president's proposals. These measures provide a more realistic evaluation of the president's agenda moving forward.

In recent years, official budgets employed a number of scoring tactics that understated likely expenses and overstated likely revenue. It grew increasingly difficult to know where the budget was headed, even in the short term, by looking at official documents. There were several areas in the budget where this was particularly clear, such as the treatment of AMT relief. Even though Congress routinely enacted annual patches to prevent additional taxpayers from exposure, previous budgets operated under the assumption that there would be a revenue windfall from allowing AMT revenues to grow without patches. By ignoring action on the AMT, billions of dollars in additional revenue were forecast which illustrated a deceptively smaller deficit.

The wars in Iraq and Afghanistan received similar treatment. Since these operations were funded through emergency supplemental bills each year, the costs of operations were zeroed out in budget outyears. This enabled the budget to show far lower outlays than reasonable expectations might have otherwise dictated.

The president's budget has taken steps to address these concerns. The 10-year costs of both AMT relief and funding for overseas operations are explicitly spelled out in this budget. Some have expressed legitimate concerns regarding the manner in which this was done -- the administration built the costs of AMT relief into the current policy baseline it established and committed only a \$50 billion placeholder for operations in Iraq and Afghanistan for 2011 and beyond. However, by including these proposals in the budget and attaching an actual price tag to them, the public is encouraged to consider the costs of continuing such policies which provides for an elevated discourse.

Another improvement is the assumption of costs for natural disasters and other emergencies. Although the timing of such events is by definition unpredictable, these unfortunate events do frequently occur and require relief and reconstruction funds from the federal government. Instead of pretending that these expenditures will never be needed, as budgets have traditionally done, the administration assumes \$11 billion for emergencies in 2010 growing to \$30 billion in 2019. This assumption is not a request for a "rainy day fund" that Congress could tap into for dubious "emergencies." It is simply a recognition that such sums are likely to be spent and thus helps to provide a more realistic baseline.

In addition, the budget includes further efforts related to the current financial crisis. The budget acknowledges the overall costs stemming from the Troubled Assets Relief Program (TARP) passed last year, and also includes a placeholder of \$250 billion in FY2009 for additional action that may be needed to address the frozen credit markets. While this is funding the president may hope to avoid using, it is to his credit that such a contingency has been included in the budget.

Finally, the budget provides an extended window to consider the policies put forward under the president's outline. Recent presidential budgets have utilized a five-year outlook. President Obama has instead provided a 10-year baseline -- identical to what is used by the Congressional Budget Office. This extended outlook provides a more comprehensive vision of where the president's policies would lead.

VII. PAYGO Issues: Paying for New Initiatives but Giving a Pass to Current Policies

The budget includes a strong endorsement of the PAYGO principle in which tax cuts and new mandatory spending must be offset with corresponding tax increases or mandatory spending cuts:

Moving forward, we need to return to pay-as-you-go budgeting that we had in the 1990s for all non-emergency measures. The President and his economic team look forward to working with the Congress to develop budget enforcement rules that are based on the tools that helped create the surpluses of a decade ago, including statutory pay-as-you-go rules.⁶

Strengthening PAYGO, and adhering to it, would be a valuable step in the right direction. The president has promised to fully offset each new agenda item he puts forth: including a comprehensive health care plan and the Making Work Pay tax credit. As it pertains to these two initiatives, the president's desire to comply with PAYGO rules sends an optimistic signal that all new policy prescriptions will be subjected to these rules. Lacking such commitment was a large part of the degradation of fiscal responsibility during the previous years.

Yet, there is a glaring inconsistency in the president's application of PAYGO. Expiring policies under current law which the president wishes to extend are assumed into his baseline without the offsets that are required under PAYGO rules. At the same time, expiring policies he is not in favor of extending are treated as new money and dedicated to deficit reduction. This exempts trillions of dollars in spending and tax cuts from current PAYGO rules.

The president and his spokesmen have often claimed that the budget contains \$2 trillion of savings. The impression is left that this accomplishment comes from a careful scrubbing of the budget to root out waste, inefficiency and fraud. However, most of the deficit reduction in the president's budget outline results from allowing a portion of the 2001 and 2003 tax cuts to expire on schedule, reducing troop levels in Iraq and assuming a rapid economic recovery.

⁶ *A New Era of Responsibility: Renewing America's Promise* (February 2009), p. 36.

Relative to current law, President Obama is not proposing to fully fund the legislative cost of his new initiatives, and his budget does not reduce the deficit from where it would otherwise be. The \$2 trillion in net “deficit reduction” is achieved only relative to a “policy-extended” baseline.

Table 5. The President’s Claim to Savings

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2010-2019
BEA Baseline	-651	-459	-194	-101	-84	-53	-71	-30	+23	+6	-\$1,614
ACHIEVING THE \$2 Trillion In Savings											
Current Policy	-1,178	-1,033	-758	-734	-791	-811	-878	-893	-906	-1,002	-8,983
Obama Budget	-1,171	-912	-581	-533	-570	-583	-637	-636	-634	-712	-6,969
Savings	+7	+121	+176	+201	+221	+228	+241	+256	+272	+290	+2,014

Source: Tables S-2 and S-3 of February 2009 Budget (*A New Era of Responsibility: Renewing America’s Promise*)

The vast majority of changes described by the administration as “deficit reduction” come from two primary sources: the drawdown of troops in Iraq and Afghanistan and increased taxes on those families earning more than \$250,000 (allowing tax cuts for upper-income households to expire on schedule in 2011). The increased taxes account for \$637 billion over 10 years, while the changes in overseas operations provide \$1.49 trillion. The \$2 trillion in total deficit reduction relative to the *policy-extended* baseline includes \$311 billion in reduced interest payments (debt service).

The proposed savings from Iraq and Afghanistan may rely on optimistic assumptions regarding the speed in which they can be realized, but the accounting method used to show these savings is also worth noting. The president assumes operations continue at 2008 funding levels and then indexes that number to inflation for each year over the following decade. For the purposes of the president’s official budget request, a \$50 billion placeholder is used for each year (aside from 2010 in which the administration requests \$130 billion). The savings are then identified by calculating the difference between what the administration proposes spending on the overseas operations and that which is assumed in the current policy baseline. This explains how the administration can claim simultaneous spending increases, tax cuts and deficit reduction.

It would take an act of Congress and President Obama’s signature to extend any of the 2001 or 2003 tax cuts after 2011 or provide additional relief for the AMT after 2009. Enforcing PAYGO on these agenda items would keep the long-term outlook from getting worse and also force an explicit acknowledgement of the obvious -- someone always pays for increases in entitlement spending and tax cuts, even when deficit financed -- if not within the five to 10-year budget window, then in the future through higher taxes or reduced federal programs, benefits and services.

VIII. Conclusion

It is difficult to imagine a more difficult environment in which to prepare a budget for the federal government. Near-term economic factors pull in the direction of large deficits. Yet, pre-existing long-term factors require a firm commitment to fiscal discipline. President Obama deserves credit for producing an initial budget outline that does not duck this dilemma and does not pretend that there are easy answers to it.

If anything, the budget may attempt to fix too many problems at once and risks collapsing under its own weight. This prospect will be tested once the legislative process gets underway. Given the fragility and tremendous uncertainty facing our economy right now, the president will need to remain flexible in pursuing his fiscal policy agenda so that taxpayer dollars are used as effectively as possible.

Barring a further deterioration in the economy, the president's commitment to bringing the deficit down substantially from its record setting level should be adopted by Congress in its Fiscal Year 2010 budget resolution. Moreover, legislative actions that affect the long-term outlook must go beyond PAYGO to produce real savings. President Obama must play a critical role in getting Congress to work cooperatively and responsibly on a budget that encourages mutual *sacrifice* from both parties over the business-as-usual mutual *excesses* — where everyone gets everything and no one needs to pay for any of it.