Center on Budget and Policy Priorities

820 First Street NE, Suite 510
Washington, DC 20002

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

center@cbpp.org
www.cbpp.org

Special Series: **Economic Recovery Watch**

Revised February 17, 2010

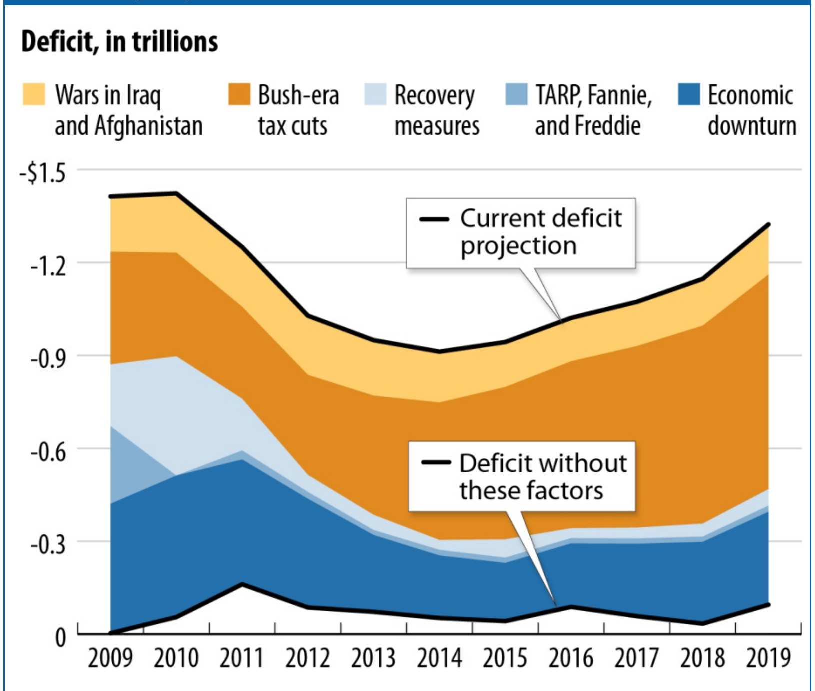
WHERE TODAY'S LARGE DEFICITS COME FROM

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

By Kathy A. Ruffing and James R. Horney

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

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



Source: CBPP analysis based on Congressional Budget Office estimates.

The deficit for fiscal 2009 was $1.4 trillion and, at 10 percent of Gross Domestic Product (GDP), was the largest deficit relative to the size of the economy since the end of World War II. If current policies are continued without changes, deficits will likely approach those figures in 2010 and remain near $1 trillion a year for the next decade.

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

While President Obama inherited a dismal fiscal legacy, that does not diminish his responsibility to propose policies to address our fiscal imbalance and put the weight of his office behind them. Although policymakers should not tighten fiscal policy in the near term while the economy remains fragile, they and the nation at large must come to grips with the nation's long-term deficit problem. But we should not mistake the causes of our predicament.

Recession Caused Sharp Deterioration in Budget Outlook

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

The recession battered the budget, driving down tax revenues and swelling outlays for unemployment insurance, food stamps, and other safety-net programs.[3] Using CBO's August 2008 projections as a benchmark, we calculate that the changed economic outlook accounts for over $400 billion of the deficit each year in 2009 through 2011 and slightly smaller amounts in subsequent years. Those effects persist; even in 2018, the deterioration in the economy since the summer of 2008 will account for over $250 billion in added deficits, much of it in the form of additional debt-service costs.

Financial Rescues, Stimulus Add to Deficits in Near Term

The government put Fannie Mae and Freddie Mac into conservatorship in September 2008.[4] In October of that year, the Bush Administration and Congress enacted a rescue package to stabilize the financial system by creating the Troubled Assets Relief Program (TARP). Together, TARP and the GSEs accounted for $245 billion (including extra debt-service costs) of fiscal 2009's record deficit. Their contribution then fades quickly (see Figure 1).

[1] Congressional Budget Office, *The Economic and Budget Outlook: An Update* (September 2008). As CBO itself acknowledged, its baseline employed some arguably unrealistic assumptions about the expiration of the Bush tax cuts and other policies; several other organizations pegged future deficits much higher than CBO's official estimates. See, for example, the Concord Coalition, "Setting Expectations: Why Baselines Matter in the Presidential Campaign and for the Fiscal Future" (September 11, 2008); Cato Institute, "$1 Trillion Budget Deficit by 2017?" (September 11, 2008).

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

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

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

In February 2009, the new Obama Administration and Congress enacted a major package — the American Recovery and Reinvestment Act (ARRA) — to arrest the economy's plunge. Mainstream economists overwhelmingly argued that, to combat the recession, the federal government should loosen its purse strings temporarily to spur demand, with a mix of assistance to the unemployed, aid to strapped state and local governments, tax cuts, spending on infrastructure, and other measures. By design, this package added to the deficit. In the fall of 2009, policymakers enacted several smaller measures to spur recovery and aid the unemployed. By our reckoning, the combination of ARRA and these other measures account for $1.1 trillion in deficits over the 2009-2019 period (including the associated debt service). Their effects are highly concentrated in 2009 through 2011 and fade thereafter, delivering a boost to the economy during its most vulnerable period.[5]

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

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

Just two policies dating from the Bush Administration — tax cuts and the wars in Iraq and Afghanistan — accounted for over $500 billion of the deficit in 2009 and will account for almost *$7 trillion* in deficits in 2009 through 2019, including the associated debt-service costs.[6] (The prescription drug benefit enacted in 2003 accounts for further substantial increases in deficits and debt, which we are unable to quantify due to data limitations.) These impacts easily dwarf the stimulus and financial rescues. Furthermore, unlike those temporary costs, these inherited policies (especially the tax cuts and the drug benefit) do not fade away as the economy recovers (see Figure 1).

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

---

[5] CBO estimates that ARRA boosted the number of people employed in the United States by 600,000 to 1.6 million in the third quarter of 2009 and that real (inflation-adjusted) GDP was 1.2 percent to 3.2 percent higher than it would have been if ARRA had not been enacted. Under CBO's latest projections, ARRA's impact on real GDP will peak in the first half of 2010. CBO and the Joint Committee on Taxation do not ascribe macroeconomic effects to individual pieces of legislation (a practice known as "dynamic scoring"), but it is reasonable to think that ARRA's beneficial effect on incomes and employment shrinks the law's true price tag. Congressional Budget Office, *Estimated Impact of the American Recovery and Reinvestment Act on Employment and Economic Output as of September 2009*, November 2009, p. 1, and *The Economic and Budget Outlook: Fiscal Years 2010 to 2020*, January 2010, p. 30.

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

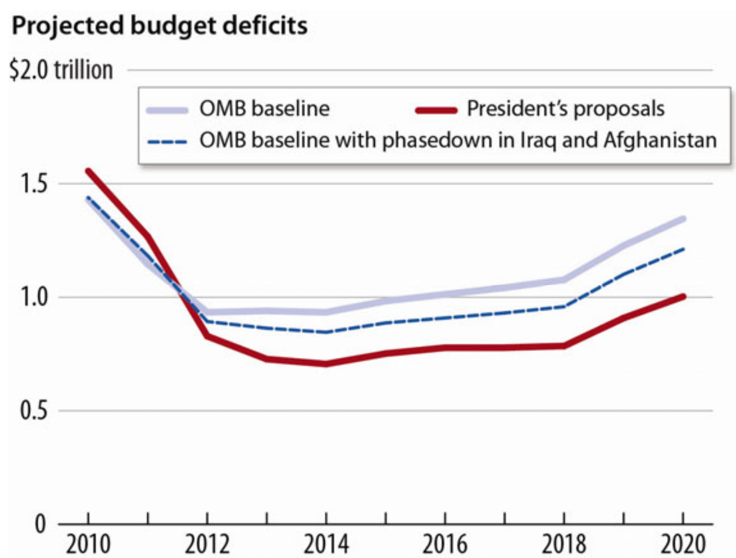
[7] See Kathy Ruffing, Kris Cox, and James Horney, "The Right Target: Stabilize the Federal Debt," Center on Budget and Policy Priorities, January 12, 2010.

The Effect of President Obama's Budget

The key question is: where do we go from here? President Obama's 2011 budget proposes to reduce anticipated deficits over the next ten years, chiefly by letting the Bush tax cuts expire on schedule for high-income taxpayers, closing certain tax loopholes and reforming the international tax system, keeping estate taxes at their 2009 parameters, enacting health care reform along the lines of the Senate- and House-passed bills, and freezing (in aggregate) most appropriations for non-security domestic programs for the next three years. The President also backs another round of temporary recovery measures that would boost the deficit in 2010 through 2012, a proposal that is appropriate in size and well targeted.[8]

According to the Administration's own estimates, its budget would reduce deficits by $2.1 trillion over the 2011-2019 period — or (more appropriately) by $1.2 trillion, when using a baseline that (like CBPP's) assumes a gradual phasedown of operations in Iraq and Afghanistan and does not count future reductions in costs there as lowering the deficit. (See Figure 2.) The Congressional Budget Office and the Joint Committee on Taxation are currently sifting through President Obama's budget proposals, and we await the results of that analysis. Although the Administration and CBO figures will certainly not match exactly — for a variety of economic, technical, and conceptual reasons — it is clear that, using a reasonable benchmark, the President's budget proposals would reduce future deficits by a significant amount.[9]

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



Source: Office of Management and Budget.

Like most fiscal analysts, we believe that the Administration and Congress will need to take considerably larger steps. The President himself acknowledges that his proposals do not fully put the budget on a sustainable footing and is establishing a bipartisan fiscal commission to recommend

[8] Kris Cox, "President's Budget Requests $266 Billion to Support Economic Recovery," Center on Budget and Policy Priorities, February 5, 2010.

[9] It will be important, when gauging the President's proposed deficit reduction measures, to express them relative to a baseline that more accurately reflects current policies. CBO is likely to state that the President's proposals would *increase* future deficits, but as explained in the technical note at the end of this paper, that is because — by law — the CBO baseline assumes that a number of current policies that policymakers are very likely to extend will be allowed to expire as scheduled under current law.

more substantial deficit reductions. First and foremost, policymakers will need to restrain the growth of health care costs — especially as we gain more knowledge of how to accomplish that. Among other steps, they also will need to consider the extent to which additional revenues should contribute to deficit reduction.

Technical Note

Baseline projections depict the likely path of the federal budget if current policies remain unchanged. We base our estimates on CBO's latest ten-year projections, published in January 2010, with several adjustments to reflect what will happen if we continue current tax and spending policies.

Specifically, our baseline includes the budgetary effects of continuing the 2001 and 2003 tax cuts that are scheduled to expire after 2010, renewing certain other so-called "tax extenders" such as the research and development tax credit, and continuing relief from the Alternative Minimum Tax (AMT). Our baseline also assumes the effects of continuing to defer scheduled cuts in payments for Medicare providers, as has routinely occurred in recent years, and instead providing doctors with a payment increase based on the Medicare Economic Index. We also account for a gradual phase-down of operations in Iraq and Afghanistan and unanticipated natural disasters. In all cases except for natural disasters (for which we adopted an assumption from the Administration's 2011 budget), we based our adjustments on estimates published by CBO. Finally, we have adjusted these numbers to put outlays associated with Fannie Mae and Freddie Mac on a cash basis — as reported in the budget and in the Monthly Treasury Statement (MTS), although CBO prefers a different budgetary treatment.

We calculated major components of the deficits as follows:

> *Economic downturn* — This category includes all changes in the deficit that CBO labeled "economic" in the four reports — in January, March, and August 2009 and January 2010[10] — that it has issued since September 2008, which total $1 trillion over the 2009-2018 period. It also includes the bulk of revenue changes that CBO classified as "technical." In the revenue area, so-called technical changes essentially refer to trends in collections that CBO's analysts cannot tie directly to published macroeconomic data. In fact, those data become available with a lag and are subject to major revision; weak revenues are often a tipoff that the economy is worse than the official statistics suggest. Furthermore, some key determinants of revenues — such as capital gains on stock-market transactions — are tied to the economy, but those influences are not captured by the standard macroeconomic indicators. Because the economic-versus-technical distinction is so arbitrary for revenues, we have ascribed most of CBO's large, downward "technical" reestimates to the economic downturn. We add the associated debt-service costs. The technical reestimates to revenues and the associated debt-service costs add $1.5 trillion and $0.4 trillion, respectively, to this category over the 2009-2018 period.

[10] Congressional Budget Office, *The Economic and Budget Outlook* (January 2009), *A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook* (March 2009), *The Budget and Economic Outlook: An Update* (August 2009), and *The Economic and Budget Outlook* (January 2010).

TABLE 1											
Projected Deficits Under Current Policies and Selected Components (By fiscal year, in billions of dollars; details may not add to totals due to rounding)											
	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Projected Deficits Under Current Policies											
CBO baseline	1,413	1,349	980	650	539	475	480	521	525	542	649
Do not extend emergencies[a]	0	0	-69	-110	-126	-133	-136	-139	-142	-144	-147
Tax law extensions[b]	0	11	141	249	280	299	315	326	338	349	363
AMT relief	0	7	82	75	83	92	103	115	129	144	162
Adjust Iraq and Afghanistan[c]	0	8	89	130	123	96	70	54	46	43	43
Cancel physician-fee cuts	0	6	14	18	25	31	38	46	51	55	60
Additional debt-service	0	0	3	10	25	50	71	98	125	157	191
Disaster relief	0	1	3	4	4	5	5	5	5	5	5
Adjust treatment of Fannie and Freddie[d]	0	14	8	2	-3	-3	-3	-3	-3	-3	-3
Total adjustments	0	47	271	378	411	437	462	501	549	606	673
CBPP baseline	1,413	1,396	1,251	1,028	950	912	942	1,022	1,074	1,148	1,322
Selected Components											
Economic downturn	418	457	403	351	248	202	188	205	234	264	#N/A
TARP, Fannie, and Freddie	245	-28	29	22	16	18	17	17	17	17	19
Economic recovery measures	200	385	167	55	49	32	59	32	35	42	53
Bush-era tax cuts	364	335	297	323	385	444	492	539	586	639	693
War costs	178	191	193	191	179	164	145	140	143	151	162
Source: CBPP calculations based on data from the Congressional Budget Office and the Office of Management and Budget.											
a. In its standard baseline, CBO assumes that all emergency spending enacted for 2010 is extended. CBPP removes the extension of emergencies.											
b. These include the 2001 and 2003 tax cuts (EGTRRA and JGTRRA) as well as the regular "tax extenders." Expiring tax provisions originating in the American Recovery and Reinvestment Act (ARRA), however, are not assumed to be extended.											
c. These amounts include expected spending on the wars in Iraq and Afghanistan outside of the base defense budget, assuming that troops deployed in those two theatres decrease to 60,000 by 2015.											
d. This adjustment removes the estimated subsidy cost of federal intervention in Fannie and Freddie — the measure employed by CBO (consistent with the budgetary treatment of other credit activities) — and substitutes the cash-flow measure used by the Administration.											
Note: CBO=Congressional Budget Office, AMT=Alternative Minimum Tax, Fannie and Freddie=Fannie Mae and Freddie Mac, TARP=Troubled Assets Relief Program.											

Combined, the factors that we ascribe to the economic downturn account for nearly $3 trillion in extra deficits in 2009 through 2018.[11]

- *TARP, Fannie, and Freddie* — The Treasury spent $243 billion for these entities in 2009 ($152 billion for TARP and $91 billion for Fannie Mae and Freddie Mac, net of dividends received). Projections for 2010 through 2019 come from CBO's January 2010 baseline. We computed the extra debt-service costs, which total $112 billion over the 2009-2019 period. (By 2014, virtually the entire cost shown in Table 1 represents debt-service costs.)

- *Recovery measures* — When ARRA was passed, it bore a "headline" cost of $787 billion as officially estimated by CBO.[12] In January 2010, CBO revised that figure to $862 billion, chiefly

[11] Estimates are not available for 2019 because CBO's August 2008 projections ended in 2018. For Figure 1, CBPP arbitrarily assumed that this category amounted to $300 billion in 2019 — a continuation of the previous few years' pattern.

[12] See Congressional Budget Office, cost estimate for H.R. 1, American Recovery and Reinvestment Act of 2009 (February 13, 2009, online at www.cbo.gov) and Joint Committee on Taxation, "Estimated Budget Effects Of The

to reflect higher costs than initially expected for ARRA's provisions governing unemployment insurance and the Supplemental Nutrition Assistance Program (commonly known as food stamps) — primarily as a result of economic conditions — and for Build America Bonds.[13] We removed the portion of ARRA costs ascribed to indexing the AMT for another year.[14] Annual AMT "patches" have been a fixture since 2001, and ARRA just happened to provide the vehicle. The AMT provision accounted for $70 billion of ARRA's $862 billion cost, leaving $792 billion. CBPP then added the cost of several smaller, discrete recovery measures that were enacted in the fall of 2009, totaling $58 billion in 2010 (but just $14 billion over the 2010-2019 period).[15] We then added the associated debt-service costs, which amount to $304 billion over the 2009-2019 period.

- *Bush-era tax cuts* — Through 2011, the estimated impacts come from adding up past estimates of various changes in tax laws — chiefly the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), the 2008 stimulus package, and a series of annual AMT patches — enacted since 2001. Those estimates were based on the economic and technical assumptions used when CBO and the Joint Committee on Taxation (JCT) originally "scored" the legislation, but the numbers would not change materially using up-to-date assumptions. Most of the Bush tax cuts are scheduled to expire after December 2010 (partway through fiscal 2011). We added the cost of extending them, along with continuing AMT relief, from estimates prepared by CBO and JCT.[16] (We did not assume extension of the temporary tax provisions enacted in ARRA.) Together, the tax cuts account for $1.7 trillion in extra deficits in 2001 through 2008, and $3.4 trillion over the 2009-2019 period. Finally, we added the extra debt-service costs caused by the Bush-era tax cuts, amounting to more than $200 billion through 2008 and another $1.7 trillion over the 2009-2019 period — and $330 billion in 2019 alone.

- *War costs* — Spending for operations in Iraq and Afghanistan and related activities cost $610 billion through fiscal 2008, according to CBO ($575 billion for the Department of Defense and $35 billion for international affairs), and another $160 billion in 2009.[17] We based estimates of costs in 2010 through 2019 on CBO's projections, adjusted for a phase-down to 60,000 troops; those costs come to $1 trillion.[18] We add the associated debt-service costs, which came to $64 billion through 2008 and will total another $683 billion over the 2009-2019 period ($119 billion in 2019 alone).

Revenue Provisions Contained In The Conference Agreement For H.R. 1, The 'American Recovery And Reinvestment Tax Act Of 2009'" (February 12, 2009, online at www.jct.gov).

13 See Appendix A, "The American Recovery and Reinvestment Act of 2009" in CBO January 2010.

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

15 Specifically, these reflect measures to extend the homebuyers' credit, allow businesses to carry back certain operating losses, extend and expand the tax credit for continuation of health insurance coverage for workers who lose their jobs, and lengthen the duration of the temporary program for emergency unemployment compensation by 20 weeks. See Appendix B, "Changes in CBO's Baseline Since August 2009" in CBO January 2010.

16 CBO January 2010, "The Budgetary Effects of Selected Policy Alternatives Not Included in CBO's Baseline" (Table 1-5) and unpublished backup from CBO.

17 CBO January 2010, "Funding for Operations in Iraq and Afghanistan and Other Related Activities" (Box 1-1).

18 CBO January 2010, Table 1-5.

What About the Medicare Prescription Drug Benefit?

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

The Congressional Budget Office initially estimated that the MMA would add to the deficit by $395 billion over its first decade, spanning the years between 2004 and 2013. (Medicare's chief actuary pegged the net cost significantly higher — at $534 billion over that period.) CBO's estimate consisted of $552 billion in net spending — new benefits, partially offset by premiums and by receipts from the states — for the new Medicare drug benefit itself, minus $157 billion in savings in Medicaid and other federal programs. Although that "headline" estimate spanned ten years, costs were negligible in the first two years, because the new benefit took effect in January 2006.

Part D outlays are coming in somewhat lower than CBO and the Medicare actuary expected, but it is not possible to update the original price tag for the entire MMA. CBO now expects the net cost of Medicare Part D over that initial 2004-2013 period to be about $370 billion (as compared to the original $552 billion figure). But, it is not possible to tell whether the savings in Medicaid and other programs have deviated from CBO's original estimate of $157 billion. While Part D is a new, identifiable account in the federal budget, those other effects represent relatively small changes in large, ongoing programs.

In short, we did not include the costs of the prescription-drug program in this analysis because we could not estimate those net costs with the same confidence that we could estimate costs, based on CBO analyses, for other Bush-era policies — namely, the tax cuts and the wars in Iraq and Afghanistan. Over the 2009-2019 period that is this paper's focus, CBO now expects net outlays for Part D to total approximately $840 billion (over $120 billion in 2019 alone), but some fraction of that will be offset by savings in Medicaid and other programs that we are not able to estimate. Nevertheless, it is clear that, as noted above, enactment of the prescription-drug program added materially to the deficit that the current administration inherited.

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

The Administration's Office of Management and Budget (OMB) — using its own economic and technical assumptions — projects baseline deficits under current policies of $10.6 trillion in 2010 through 2020. OMB judges that the President's proposals would reduce those deficits by $2.1 trillion, of which $0.9 billion comes from phasing down operations in Iraq and Afghanistan (similar to the policy that is already assumed in CBPP's baseline) and $1.2 trillion from other tax and spending proposals.[19] It is not yet possible to put the Administration's and CBO's projections on a fully comparable footing. Like other budget-watchers, CBPP awaits CBO's analysis of the President's latest budgetary proposals, which is expected to be published in March 2010.

[19] See Office of Management and Budget, Summary Table S-2, "Effect of Budget Proposals on Projected Deficits," in *Budget of the United States Government, Fiscal Year 2011* (February 2010).