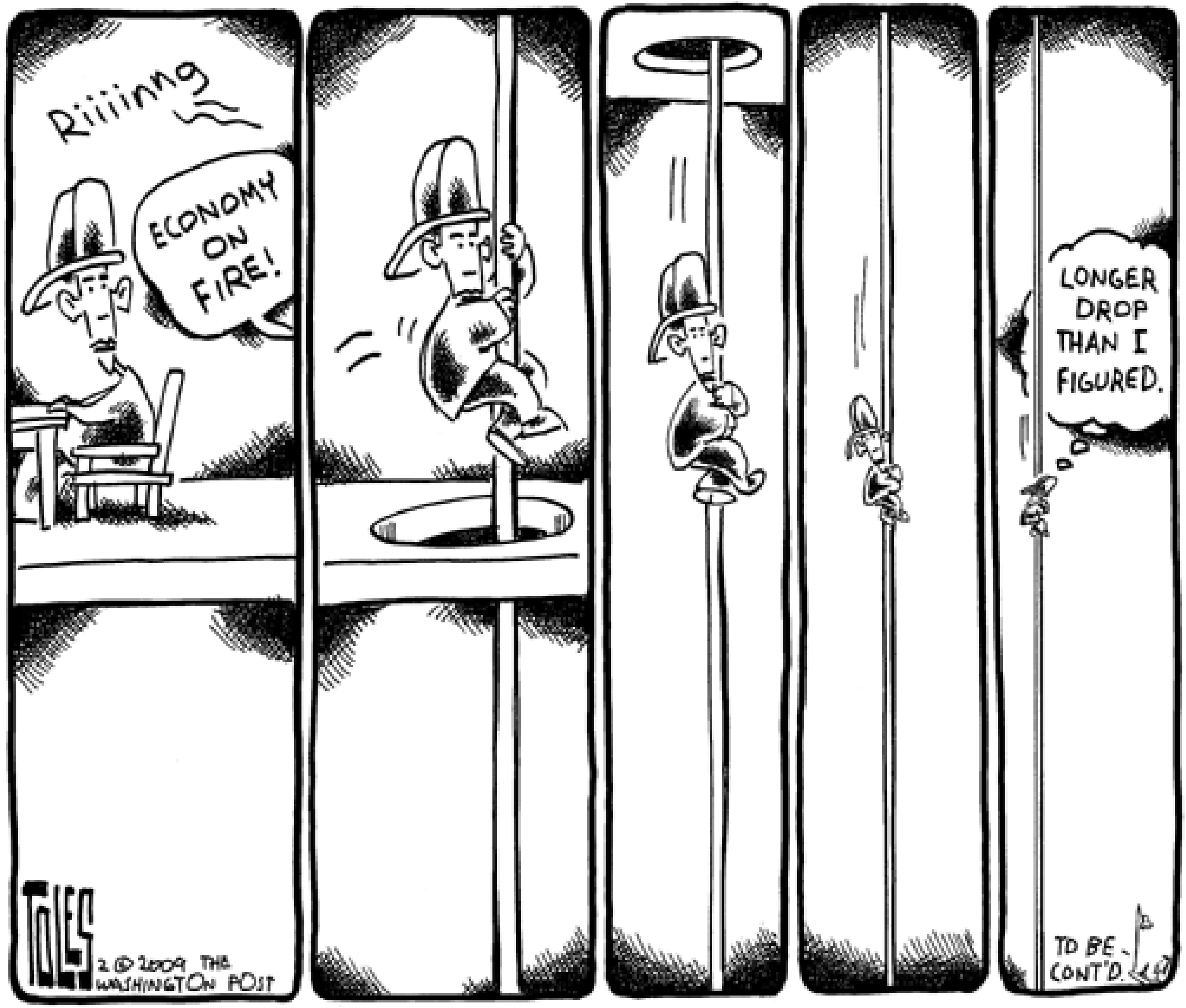
Riiiinng
ECONOMY ON FIRE!
LONGER DROP THAN I FIGURED.
TO BE CONT'D.
TOLES
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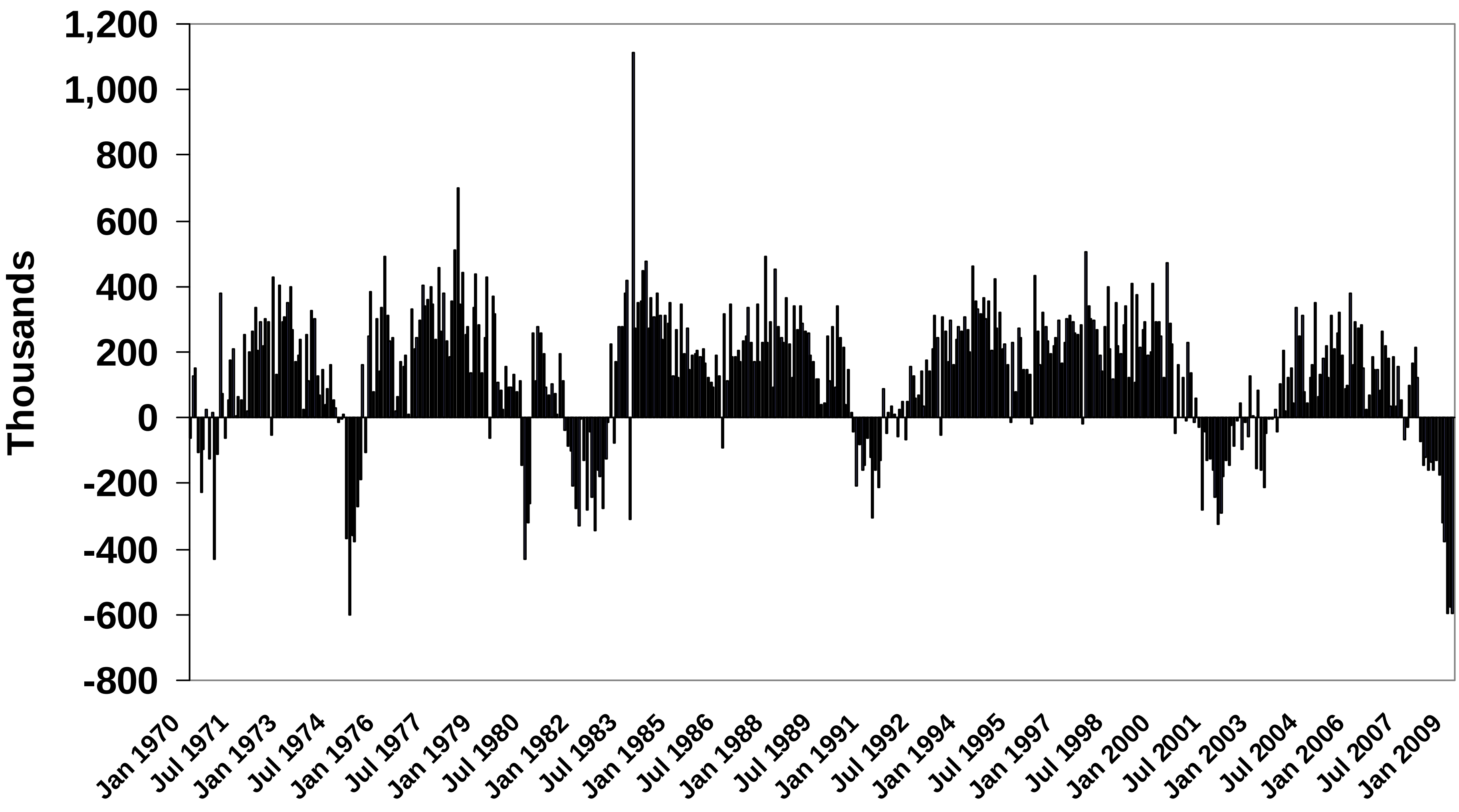
Monthly Change in Employment



The Budget In Free-Fall

Joe Minarik
Committee for Economic Development
February 12, 2009

Questions for today:

- How much, and how quickly, has the federal budget picture changed?
- How realistic is the budget “baseline” today?
- What is the outlook for the public debt?

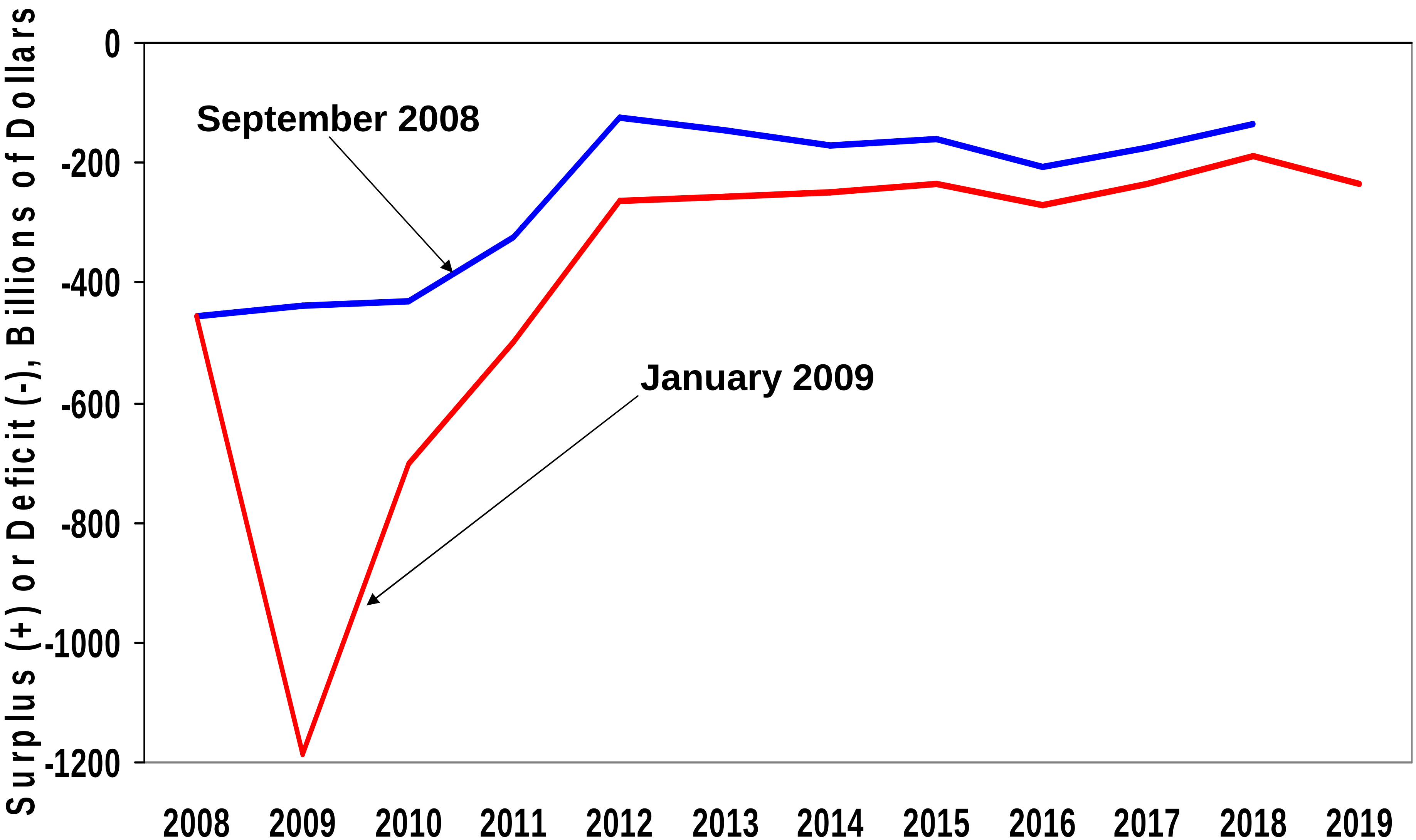
Quick, up-front conclusions:

- The budget has worsened enormously in the past six months.
- Huge anomalies make the current budget projections necessarily unhelpful and potentially misleading.
- Most current budget presentations make the deficit and debt outlook appear far less troubling than it really is.

Let’s start by looking at
the most common presentation
of the budget.

(We will talk about the limitations of
that presentation in just a moment.)

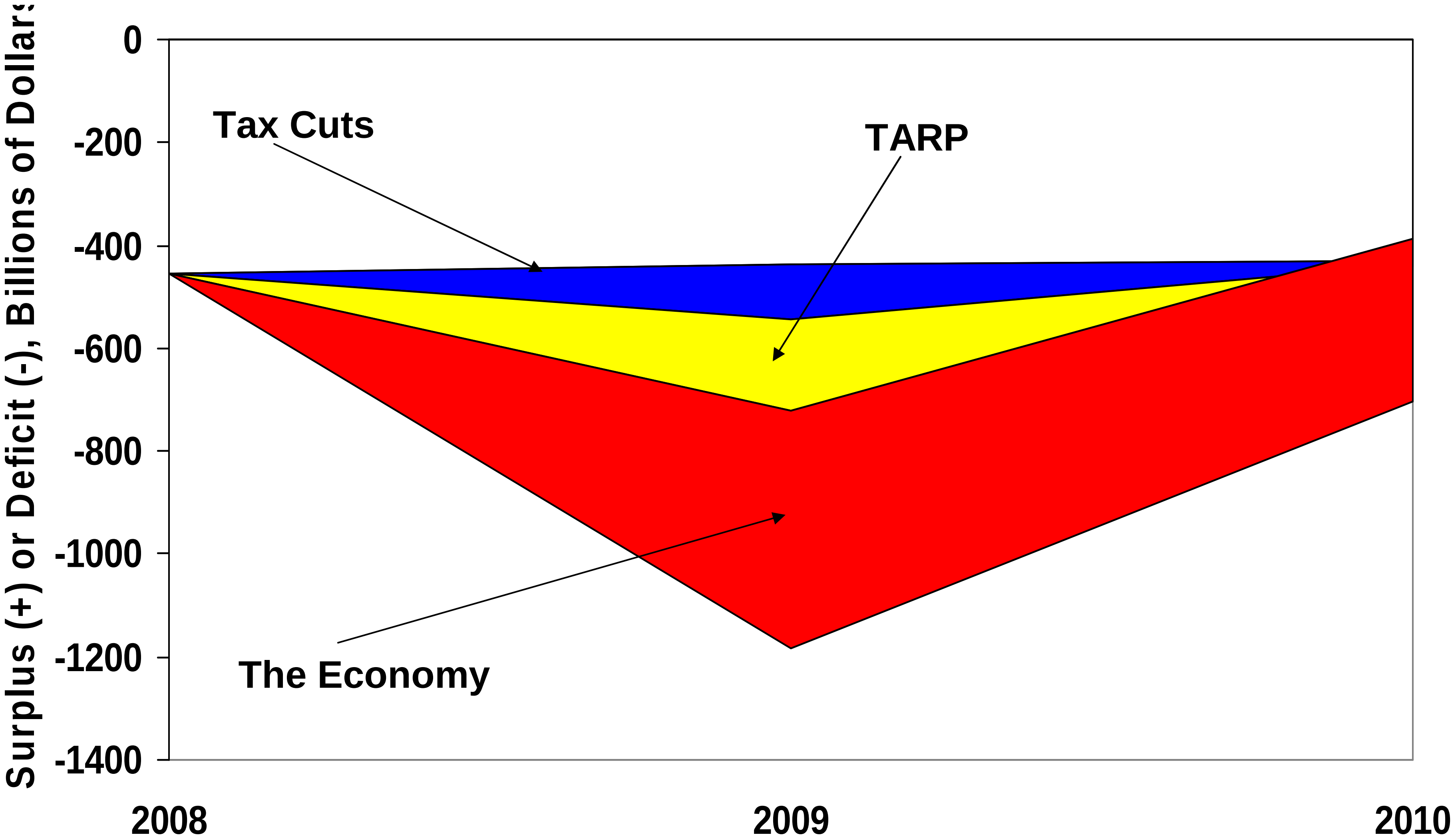
CBO's Baseline Budget Outlook



The budget outlook has tanked.

- Just the ***increase*** in the CBO projected 2009 baseline deficit – from an already elevated point – is almost ***twice*** the ***level*** of the previous record deficit.
- What caused this collapse?

Sources of Worsening in the Budget



So the budget is collapsing in 2009 and 2010, but it looks to be getting better in later years. Whew.

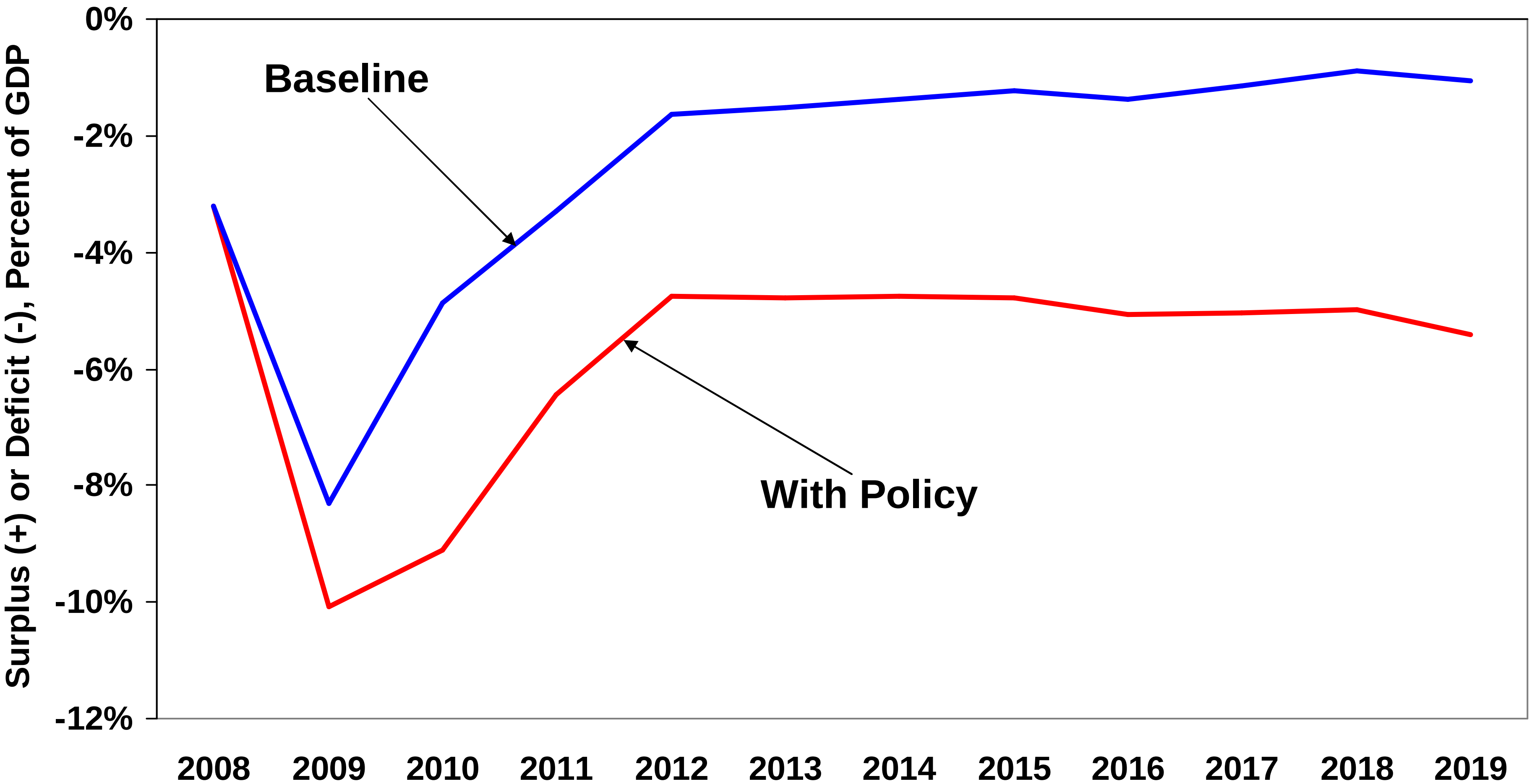
But wait, there's more…

This is a ***baseline*** budget projection. It assumes current ***law***.

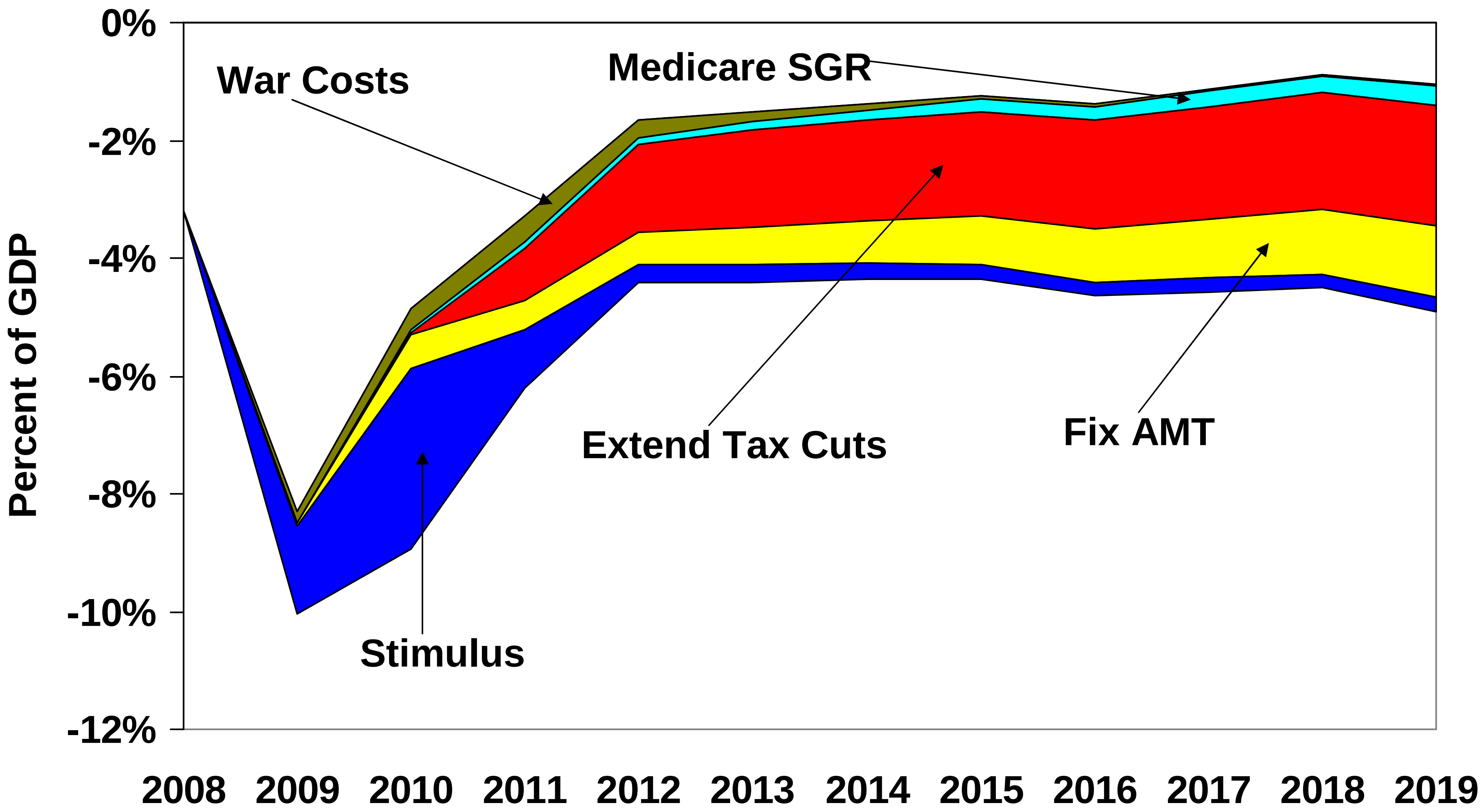
- All tax cuts scheduled to expire under current law go away.
- The alternative minimum tax, which has been postponed for years, takes effect.
- The “sustainable growth rate” restraint under Medicare, which has been postponed since 2003, takes effect.
- War costs continue at the as-yet less-than-half-funded levels of 2009.
- And ***no stimulus package***.

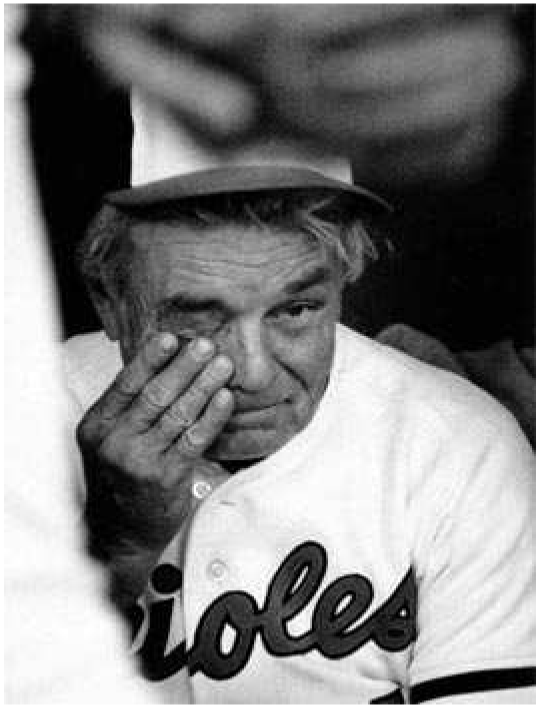
So what would the picture look like if we eliminated those unrealistic assumptions?

CBO Budget Outlook With Possible Policy Changes, Percents of GDP



What Are the Major Causes?





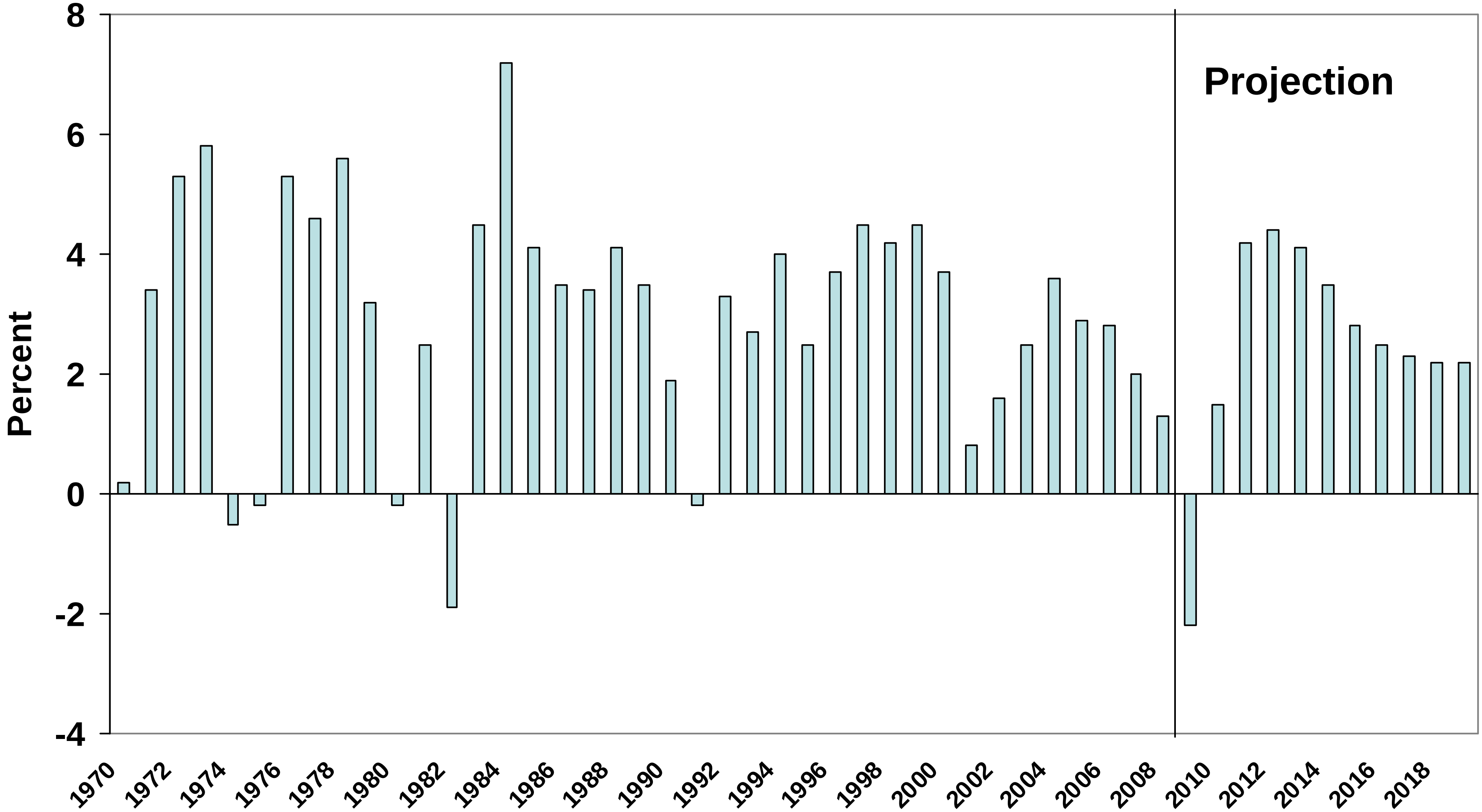
Earl Weaver to the budget:

"Are you gonna get any better,
or is this it?"

Remaining Budget Downsides

- CBO says that it assumes a slow economic recovery. But will the economy recover as ***well*** as CBO anticipates?

Annual Change in Real GDP



Remaining Budget Downsides, Continued

- New federal government guarantees: money-market funds, sharing of losses in recent bank transactions, acceptance of securities of questionable value as collateral
- Pre-existing federal government guarantees: Pension Benefit Guaranty Corporation, deposit insurance
- TARP-Two?

“If we make it, it’s half a bottle of beer for each.”

The problem with running continuing big deficits is that they pile up debt.

- A larger debt increases debt service costs.
- Higher debt service costs increase the deficit.
- A larger deficit increases the debt…

A rising debt is dangerous

- In the long run, rising deficits and debt-service costs drain the pool of available savings, crowding out investment and thereby reducing economic growth.
- At some point, a rising national debt load could frighten both domestic and foreign investors, causing them to “run for the exits” on the nation’s paper, public and private.

“A man drink like that and he don’t eat, he is going to die!”

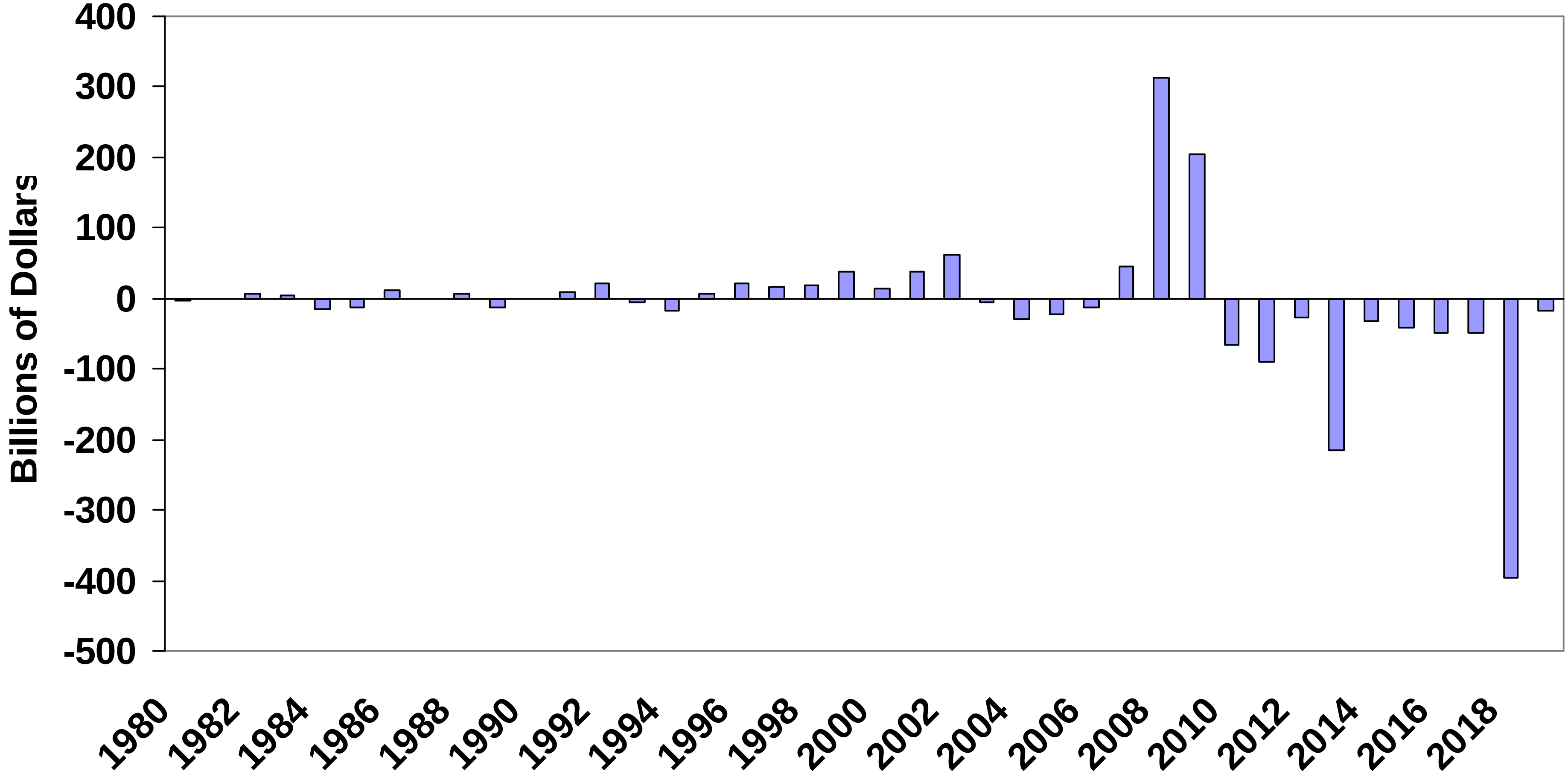
“When?”

A rising debt is unfair to future generations, who will have to pay higher taxes to service that debt.

So, what are the implications of this budget deficit outlook for the public debt?

The implications are dire – but the deficit presentations do not show the outlook accurately.

Difference Between Budget Deficit and Amount of Increase in Debt in CBO Baseline

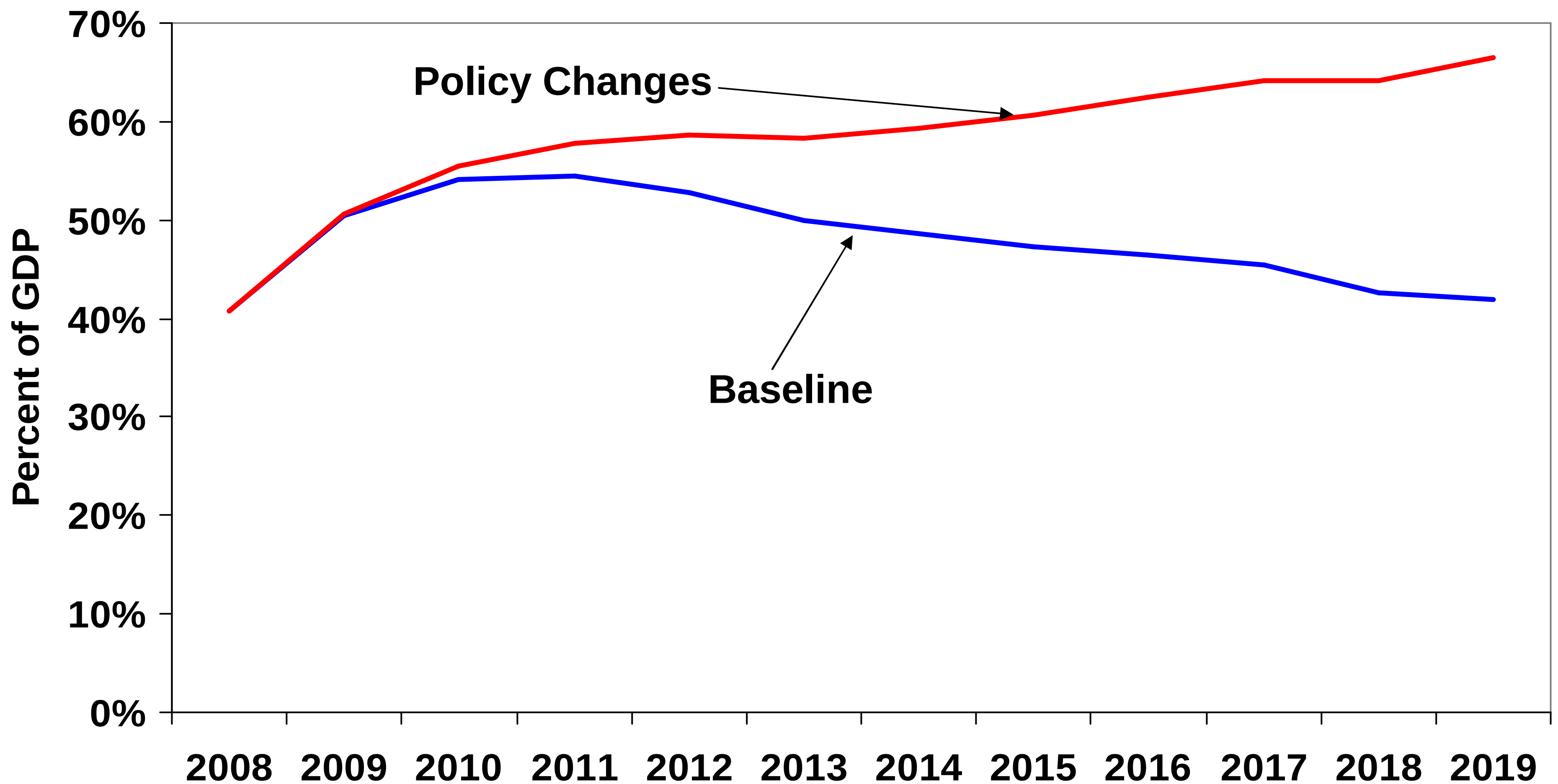


Beyond the quirks of the budget baseline, we have anomalies in the rules for the deficit and debt.

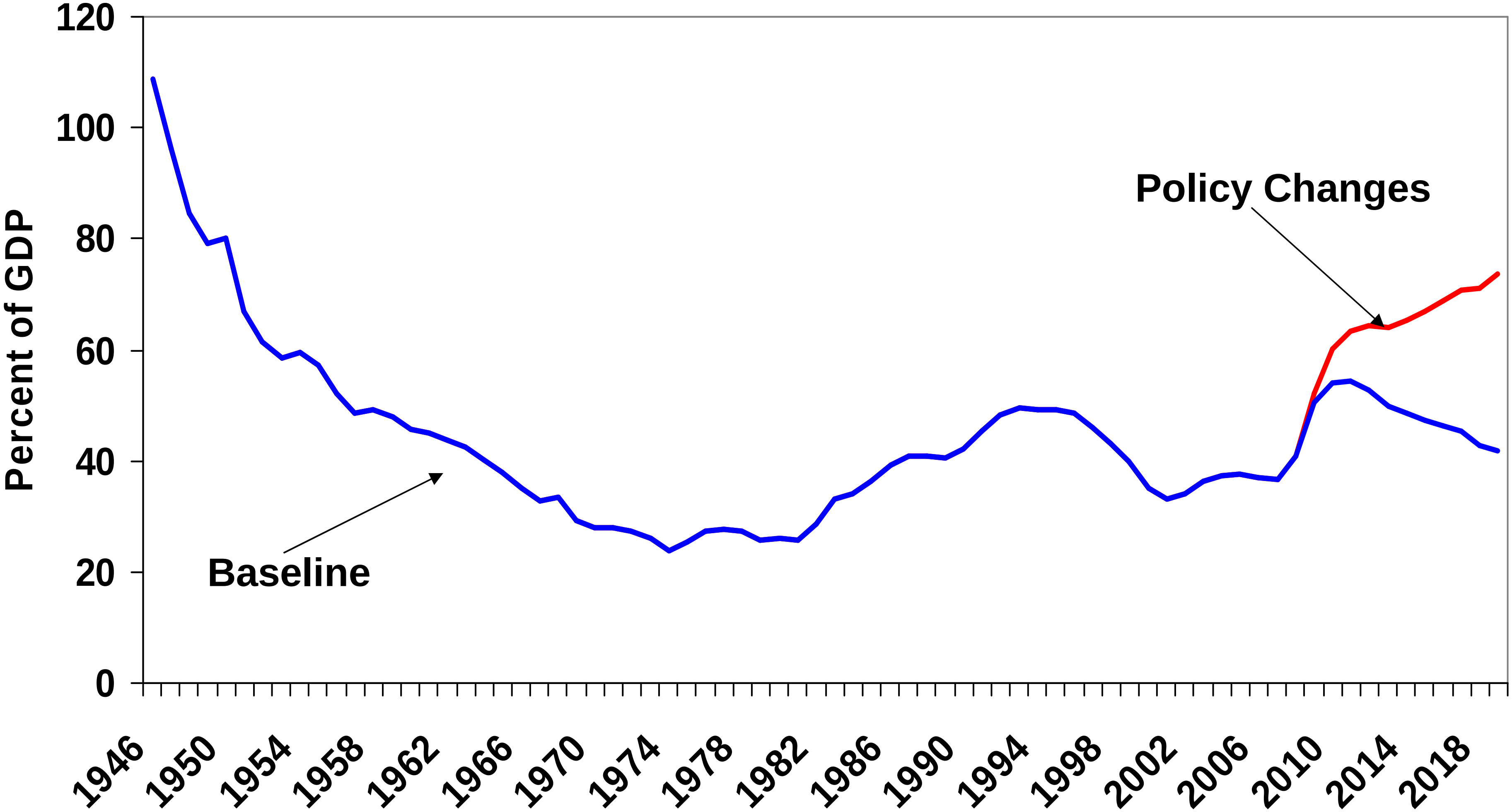
- Programs like the TARP are scored for the budget on a present-value basis, including the effect of expected losses.
- So while the Treasury must borrow $700 billion to execute the TARP, the deficit shows only the estimated net loss.
- Later repayments that meet initial estimates reduce the debt, but not the deficit.

So with all of those caveats, where are we likely to be on the public debt?

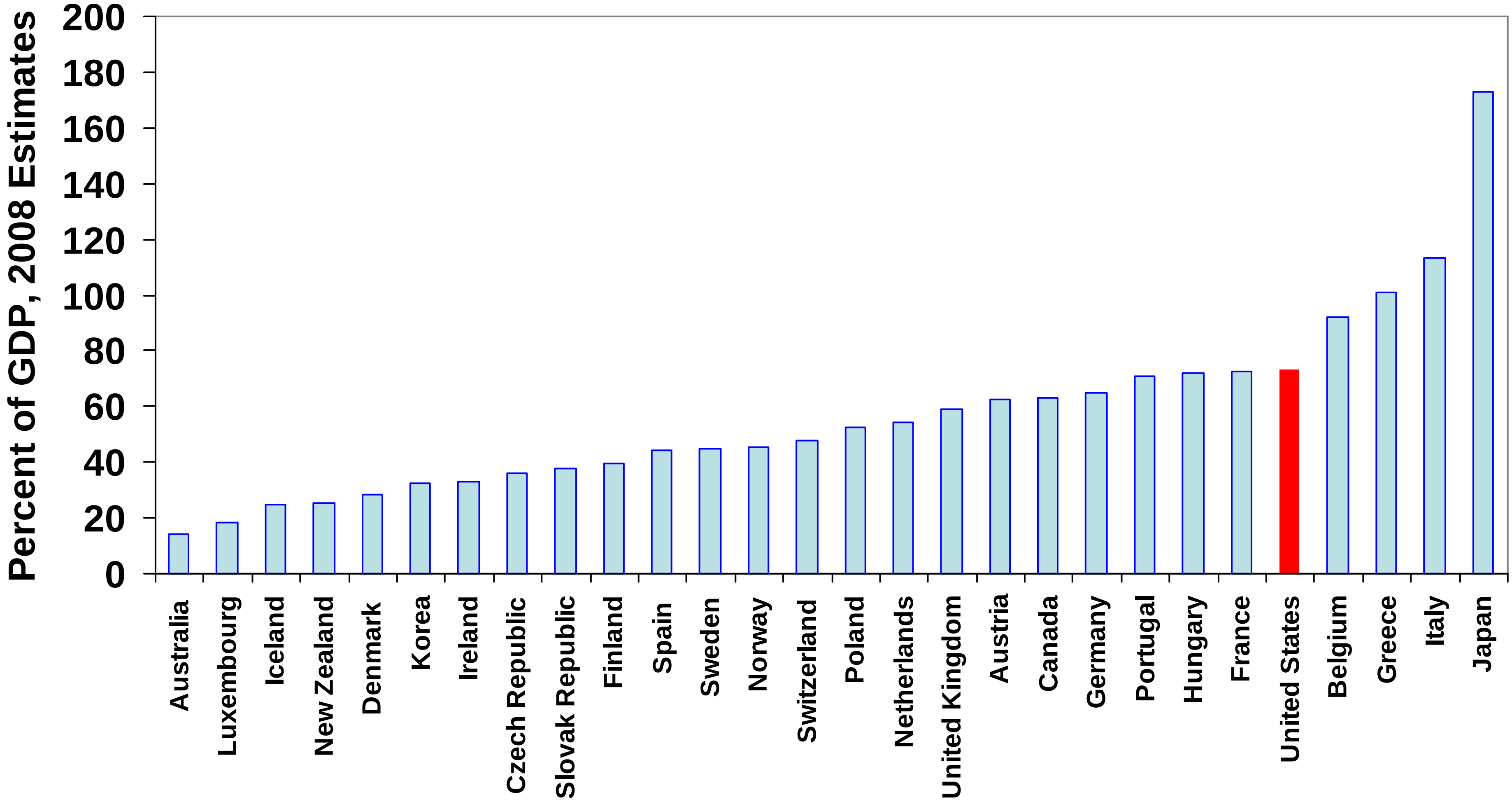
Public Debt Under CBO Baseline and Potential Policy Changes



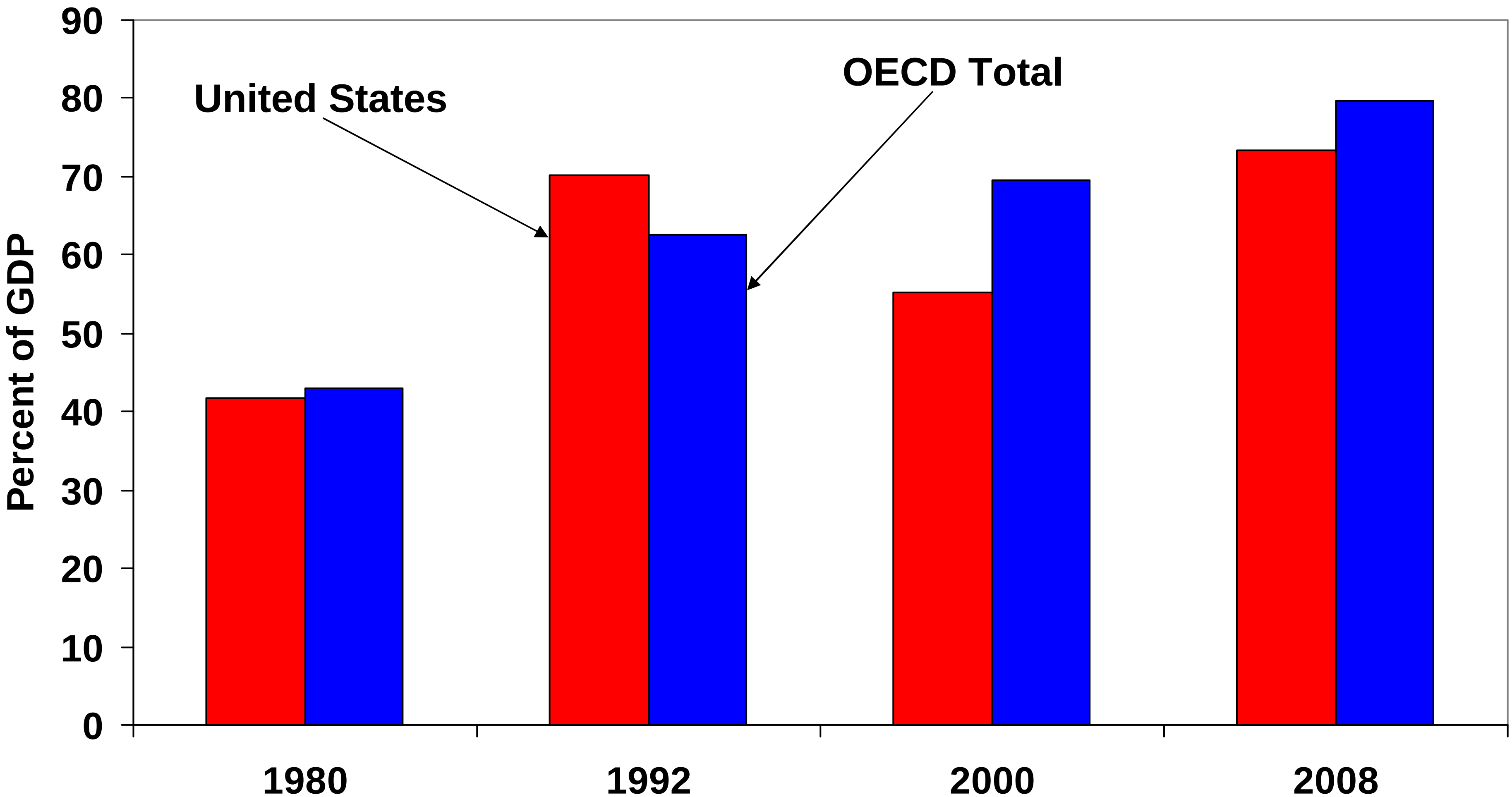
A Longer-Term View:
Debt Approaches World War II Levels



U.S. Already Ranks High in Debt Relative to the Developed World



U.S. Loses Debt Advantage Over Rest of Developed World



How will the Obama Budget compare with the CBO baseline?

- The Budget will include all of the President's proposals as if enacted, not the current law as CBO is required to do.
- So if the President proposes some of the "likely policies" identified above, his deficits will ***look*** larger than CBO's.
- Presidents can propose unlikely budget savings to make their deficits ***look*** smaller.

How will the Obama Budget compare with the CBO baseline? Continued

- Presidents can manipulate the timing of their proposals – front-loading savings, and slowly phasing in costs.
- The Administration’s economic assumptions will differ somewhat from CBO’s.

How will the Obama Budget compare with the CBO baseline? Continued

- The Budget may count ***all*** TARP spending, rather than the estimated present value of future losses, in the deficit. This will be contrary to CBO practice (and to the law that authorized TARP). It will make the Administration’s deficit look worse at first, but better when any subsequent receipts come in.

How will the Obama Budget compare with the CBO baseline? Continued

- CBO decided to consider Fannie Mae and Freddie Mac as parts of the federal government. That caused a $218 billion charge to the budget in 2009 (for expected future losses) without an increase in the debt. OMB may or may not follow CBO on this decision.

Conclusions

- Even though no one is thinking about the budget deficit now, the deficit and debt problem has never been so truly critical.
- Thirty years ago, we could brush off criticism of our fiscal behavior because there was plenty of time to mend our ways. The baby boom began to retire last year.
- Thirty years ago, the debt was 25 percent of GDP. Now it is 50 percent, and rising.

Conclusions, Continued

- This recession is like a cancer, and current fiscal policy – the stimulus bill – is like chemotherapy (in its debt consequences). The cancer forces us to do something that under other circumstances we never would. But the side-effects of the therapy are terrifying – a veritable poisoning of the immune system.
- Unless we follow up this therapy with the most conscientious care, the consequences will be dire…

Next Steps

- Public leaders must explain the current situation, the steps that it requires, and the consequences of those steps.
- Leaders must motivate urgency without causing panic.
- Leaders must explain why the best responses in the short run and the long run, though seemingly contradictory, are both consistent and essential.

This is a time
for business statesmen.

Watch this space.