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Summary

The federal budget helps implement Congress's "power of the purse" by expressing Congress's spending priorities among competing aims. The Obama Administration's FY2010 budget described several important changes, including increased funding for certain domestic priorities, major programmatic reforms, and proposed spending cuts in some programs. The current economic climate continues to pose major challenges to policymakers. Federal spending tied to means-tested social programs rose due to rising unemployment, while federal revenues are projected to fall as individuals' incomes have dropped and corporate profits have sunk. Federal deficits, according to OMB and CBO projections, will likely be high relative to historic norms over the next few years, as spending rises and revenues fall relative to previously anticipated levels. FY2009 outlays rose to $3,522 billion (24.9% of GDP) and revenues fell to $2,105 billion (14.7% of GDP), yielding a total federal deficit of $1,417 billion (10.0% of GDP).

Over the past decade, federal spending has accounted for approximately a fifth of the economy (as measured by gross domestic product—GDP) and federal revenues have ranged between just under a sixth to just over a fifth of GDP. In FY2008, the U.S. government collected $2.5 trillion in revenue and spent almost $3.0 trillion. Outlays as a proportion of GDP rose from 18.4% in FY2000 to 21.0% of GDP in FY2008. Federal revenues as a proportion of GDP reached a post-WWII peak of 20.9% in FY2000 and then fell to 16.3% of GDP in FY2004 before rising slightly to 17.7% of GDP in FY2008.

The Obama Administration released the FY2010 budget outline on February 26, 2009, followed by the remaining budget documents on May 7 and 11, 2009. Major policy initiatives included new spending targeted toward health care reform, clean energy, and education. The budget resolution (S.Con.Res. 13), which followed most of the President's initiatives, was agreed to on April 29, 2009. It specified $2,322 billion in revenues and $3,555 billion in outlays, resulting in a projected FY2010 deficit of $1,233 billion. A FY2009 war funding supplemental (P.L. 111-32) was enacted in June 2009. The House passed all 12 regular FY2010 appropriations acts by the end of July 2009. The Legislative Branch appropriations bill (P.L. 111-68) enacted October 1 contained a continuing resolution to extend funding to the end of the month. On October 30, the Interior-Environment bill (P.L. 111-88), which included a second continuing resolution to extend funding until December 18, was enacted. Five remaining bills (Commerce-Justice-Science; Financial Services; Labor-HHS; Military Construction-VA; and State-Foreign Operations) were folded into the Transportation-HUD bill, creating an omnibus spending measure (H.R. 3288; P.L. 111-117) that was enacted on December 16. Finally, the defense bill (H.R. 3326; P.L. 111-118), was signed into law on December 19, finishing the regular appropriations process for FY2010.

The federal government made significant financial interventions aimed at alleviating economic recession. The final costs of federal responses to this turmoil will depend on the pace of economic recovery, how well firms with federal credit guarantees weather future financial shocks, and how much the government loses or gains on its asset purchases. Federal loans or loan guarantee programs may help provide liquidity to distressed financial markets and stimulate economic activity, but may also expose the federal government to substantial credit risks. While many economists concurred on the need for short-term fiscal stimulus despite adverse impact on the deficit, concerns remain about the federal government's long-term fiscal situation. Rising costs of federal health care programs and Baby Boomer retirements present serious challenges to fiscal stability. Operating these programs in their current form may pass on substantial economic burdens to future generations. This report will not be updated.

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The federal budget is central to Congress's ability to assert its "power of the purse." Federal budget decisions express Congress's priorities among competing aims and reinforce Congress's influence on federal policies. The budget also affects, and is affected by, the national economy as a whole. The federal budget over the next few fiscal years will likely face significant challenges to both revenues and outlays as a result of recent turmoil in the economy and financial markets.

Making budgetary decisions for the federal government is an enormously complex process, entailing the efforts of tens of thousands of staff persons in the executive and legislative branches, totaling millions of work hours each year. The budget process allows the President and Congress to negotiate and refine spending plans for the nation's fiscal priorities.[1]

The current budget situation is challenging. The federal government faces very large budget deficits, rising costs of entitlement programs, and significant spending on overseas military operations. The enactment of financial intervention and fiscal stimulus legislation designed to alleviate a credit crunch and to bolster the economy will push up the deficit, shifting fiscal burdens into the future. While GDP grew at an estimated annual rate of 2.8% in the third quarter of 2009, perhaps marking an end to the longest post-World War II recession, most forecasters expect unemployment to remain at high levels for the medium term.[2] The Congressional Budget Office (CBO) projects that the unemployment rate will crest at nearly 10.5% in early 2010, well above some earlier predictions.[3] High unemployment rates would add to government spending through "automatic stabilizer" programs, such as unemployment insurance and income support programs.

The economic downturn has not only pushed federal spending up and revenues down, but also threatens to slow economic growth for the next few years. The federal government has responded to the economic slowdown with an array of policy responses unprecedented in recent decades, including fiscal stimulus and loan programs. These federal interventions have helped stimulate economic activity and reduce dislocation in financial markets, but may also expose the federal government to substantial credit risks.

Concern remains about the federal government's long-term fiscal situation. The rising costs of federal health care programs and the effects of the baby boom generation's retirement present serious challenges to fiscal stability. Operating these programs in their current form may pass on substantial economic burdens to future generations.

Overview

Revenues, Outlays, and Deficits for FY2008

Over the past decade, federal spending has accounted for approximately a fifth of the economy (as measured by gross domestic product—GDP) and federal revenues have ranged between just under a sixth and just over a fifth of GDP, as shown in **Figure 1**. In FY2008, the U.S. government collected $2.5 trillion in revenue and spent almost $3.0 trillion. Outlays as a proportion of GDP

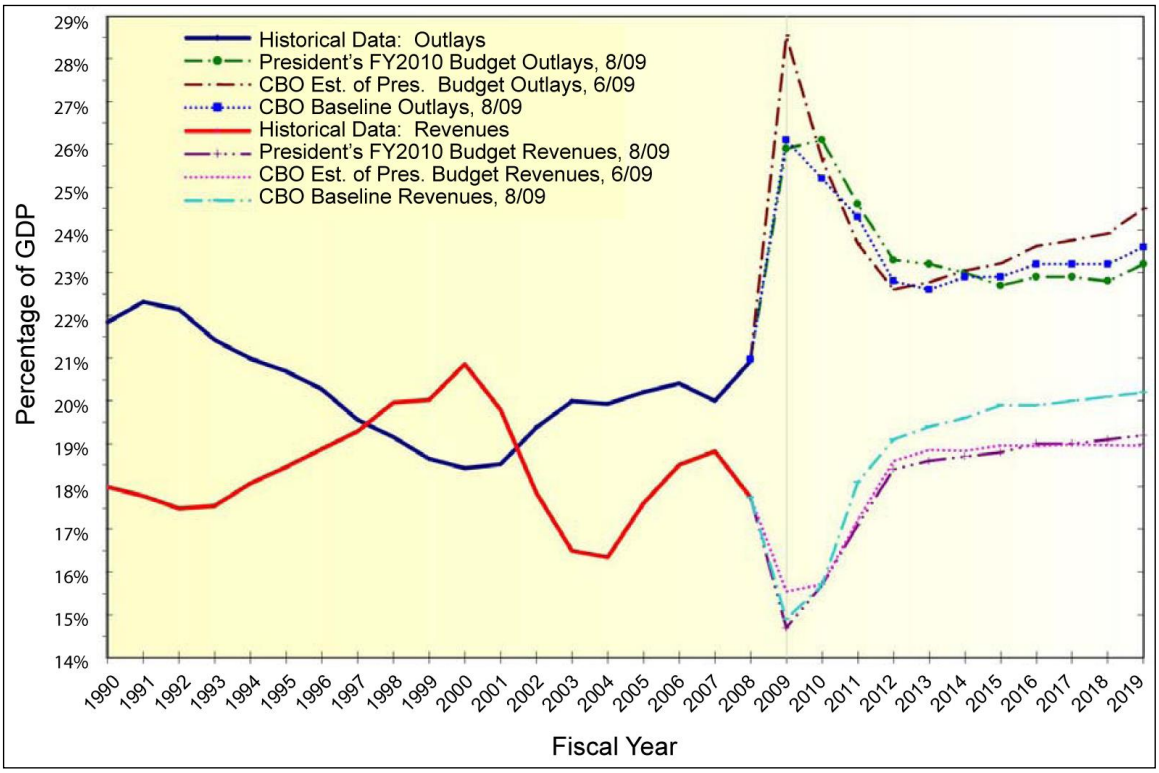
[1] For more information, see CRS Report 98-721, *Introduction to the Federal Budget Process,* by Robert Keith.

[2] U.S. Department of Commerce, Bureau of Economic Analysis, "Gross Domestic Product: Third Quarter 2009 (2nd Estimate)," press release BEA 09-50, November 24, 2009, available at http://bea.gov/newsreleases/national/gdp/2009/pdf/gdp3q09_2nd.pdf.

[3] U.S. Congressional Budget Office, *The Budget and Economic Outlook: An Update,* August 2009, Table 2-1.

rose from 18.4% in FY2000 to 21.0% of GDP in FY2008.[4] Federal revenues as a proportion of GDP reached a post-WWII peak of 20.9% in FY2000 and then fell to 16.3% of GDP in FY2004 before rising to 17.7% of GDP in FY2008.

Figure 1. Total Outlays and Revenues as a Percentage of GDP, FY1990-FY2019



Source: CBO, *Historical Tables*, available at http://www.cbo.gov/budget/historical.shtml; *An Analysis of the President's Budgetary Proposals for Fiscal Year 2010*, June 2009, available at http://www.cbo.gov/doc.cfm?index=10296; *The Budget and Economic Outlook: An Update*, August 2009, available at http://www.cbo.gov/doc.cfm?index=10521; OMB, *Budget for Fiscal Year 2010 Mid-Session Review*, Table S-1, August 2009, available at http://www.whitehouse.gov/omb/budget/MSR/. Data for FY2009 are estimates and data for FY2010-FY2019 are projections.

The annual budget deficit (or surplus) is revenue (i.e., taxes and fees) that the government collects minus outlays (i.e., spending).[5] The total deficit in FY2008 was $459 billion, or 3.2% of gross domestic product (GDP), sharply higher than the FY2007 deficit of $162 billion. The U.S. Treasury Department, on October 16, 2009, announced that the FY2009 total deficit reached $1,417 billion, or 10.0% of GDP.[6] While large by historical standards, the FY2009 deficit was somewhat smaller than the Administration had expected in August 2009 ($1,580 billion, or 11.2% of GDP) and much smaller than the $1,752 billion deficit projected in the President's budget

[4] U.S. Congressional Budget Office, *A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook*, March 2009, available at http://www.cbo.gov/ftpdocs/100xx/doc10014/03-20-PresidentBudget.pdf. Older data were taken from Office of Management and Budget (OMB) historical statistics.

[5] Most economists use data on federal outlays to track larger budget trends, while most program analysts use budget authority to track changes in specific program areas.

[6] Press Release from Timothy Geithner, Secretary of the Treasury, and Peter Orszag, Director of the Office of Management and Budget, *Budget Results for Fiscal Year 2009*, October 16, 2009, available at http://www.treas.gov/press/releases/tg322.htm.

submission.[7] The actual FY2009 budget deficit was smaller than previous estimates in large part because the $250 billion included in the Administration's budget proposals for additional intervention in financial markets was not spent.[8]

The total deficit, according to some budget experts, gives an incomplete view of the government's fiscal condition because it includes Social Security surpluses (which are then held in Treasury trust funds until used to pay future benefits). Excluding off-budget items (Social Security benefits paid net of Social Security payroll taxes collected and the U.S. Postal Service's net balance) the (on-budget) FY2008 federal deficit was $642 billion. The August 2009 CBO estimate of the FY2009 on-budget deficit, at $1,720 billion, was even higher. The estimation of federal deficits is complicated by the difficulties in estimating the costs of major federal interventions in the latter half of 2008, such as the creation of the TARP and placing the mortgage giants Fannie Mae and Freddie Mac under conservatorship.[9]

Trends

Federal Spending

Budget enforcement legislation divides federal outlays into discretionary and mandatory spending, as well as net interest.[10] Discretionary spending flows from and is controlled by annual congressional appropriations acts. Mandatory spending encompasses federal government spending on entitlement programs, the Supplemental Nutrition Assistance Program (SNAP; formerly the Food Stamp program), and other spending controlled by laws other than annual appropriation acts.

Outlays rose from 20.6% of GDP in FY2008 to 24.8% of GDP in FY2009. Over time, mandatory spending has generally grown faster than discretionary spending. As **Figure 2** shows, mandatory spending, which equaled 11.2% of GDP in FY2008, totaled 16.1% of GDP in FY2009, or almost two-thirds of total outlays. TARP spending and costs linked to the deprivatization of mortgage giants Fannie Mae and Freddie Mac accounted for much of the increase in mandatory spending. CBO projects that FY2019 mandatory spending will total 13.1% of GDP, reflecting a sharp decrease in financial stabilization costs and long-term growth in entitlement spending. Discretionary spending as a share of GDP fell in the 1990s, but rose from 6.3% of GDP in FY2000 to 8.0% of GDP in FY2008 and 8.8% of GDP in FY2009. By 2019, according to CBO baseline projections (which assume that discretionary spending remains constant in real terms), discretionary spending will fall to 7.0% of GDP.[11]

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[7] U.S. Office of Management and Budget, *Budget for Fiscal Year 2010, Mid-Session Review*, Table S-1, August 2009, http://www.whitehouse.gov/omb/budget/MSR/; "A New Era of Responsibility: Renewing America's Promise," February 26, 2009. A detailed discussion of how the FY2009 deficit has changed since the estimates were last issued is provided later in this report, in the section titled, "Why Did Budget Deficit Estimates for FY2009 Change?"

[8] Stan Collender, "2009 Deficit: I'm Telling You For The Last Time ... ," *Roll Call*, September 13, 2009.

[9] Ibid, pp. 25-27, and Testimony of Elizabeth Warren, Chair of the Congressional Oversight Panel, in Congress, Senate Banking Committee, *Pulling Back the TARP: Oversight of the Financial Rescue Program*, hearings, 111th Congress, 1st sess., February 5, 2009, available at http://banking.senate.gov/public/_files/Warrentestimonyfinal2509.pdf.

[10] For more information on trends in discretionary and mandatory spending, see CRS Report RL34424, *Trends in Discretionary Spending*, by D. Andrew Austin and Mindy R. Levit and CRS Report RL33074, *Mandatory Spending Since 1962*, by D. Andrew Austin and Mindy R. Levit.

[11] U.S. Congressional Budget Office, *The Budget and Economic Outlook: An Update*, August 2009, available at http://www.cbo.gov/doc.cfm?index=10521.

Discretionary outlays increased 4.3% a year on average in real terms from FY1999 to FY2008. The share of discretionary spending as a proportion of total federal outlays rose from 33.6% in FY1999 to 38.0% in FY2008. Higher defense outlays accounted for 64.6% of the increase in discretionary spending over the past decade. On average, from FY1999 to FY2008, defense outlays grew 5.5% per year in real terms, while real non-defense discretionary outlays grew 3.1% per year.

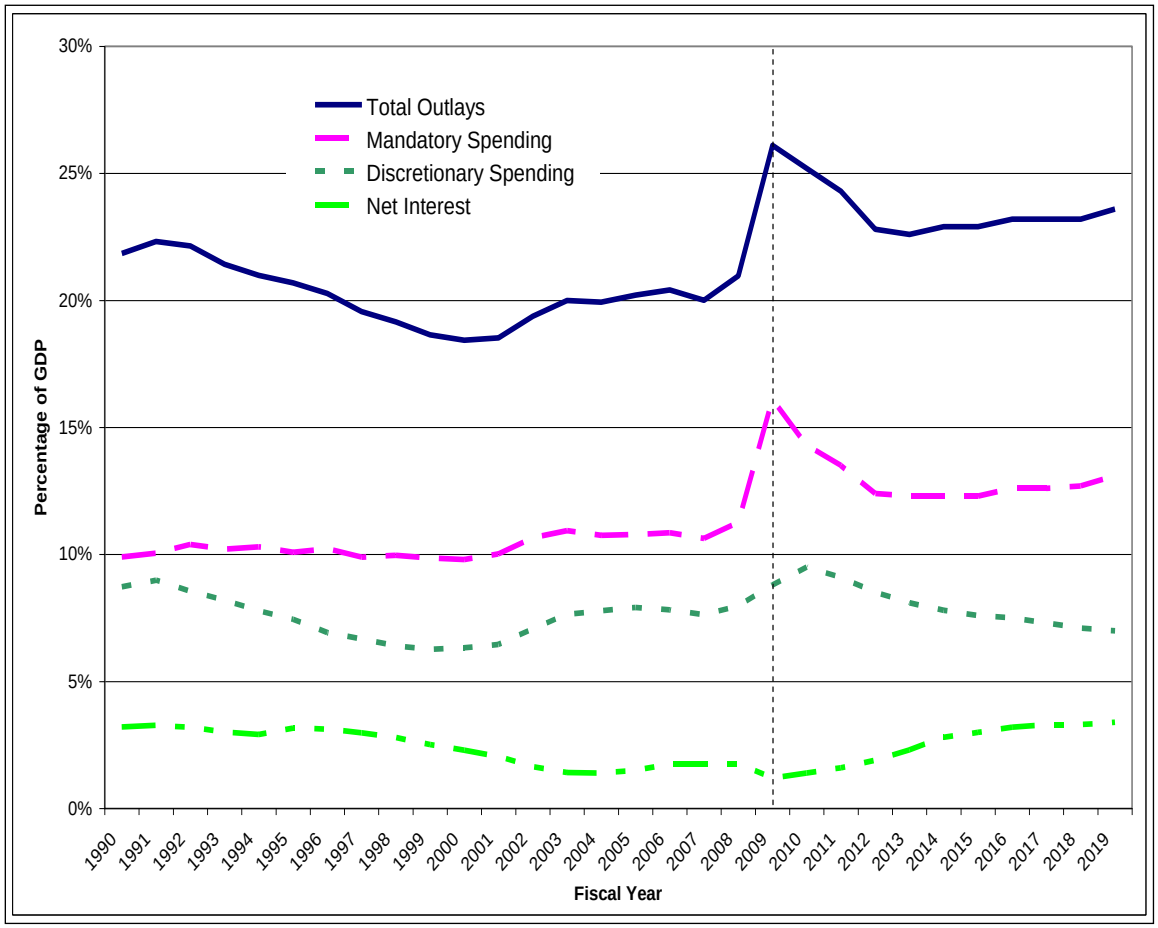
Entitlement programs such as Social Security and Medicare make up the bulk of mandatory spending.[12] Other mandatory spending programs include Temporary Assistance to Needy Families (TANF), Supplemental Security Income (SSI), unemployment insurance, veterans' benefits, federal employee retirement and disability, SNAP (formerly Food Stamps), and the Earned Income Tax Credit (EITC). Congress sets eligibility requirements and benefits for entitlement programs, rather than appropriating a fixed sum each year. Therefore, if the eligibility requirements are met for a specific mandatory program, outlays are made automatically.

Over the past 40 years, mandatory spending has taken up a larger and larger share of the federal budget. In 1962, before the 1965 creation of Medicare and Medicaid, less than 30% of all federal spending was mandatory. At that time, Social Security accounted for about half of all mandatory spending. By FY2008, mandatory spending had grown to 53.7% of total outlays, with Social Security, Medicare, and the federal share of Medicaid alone comprising over 43% of all federal spending. Discretionary spending totaled 38.0% in FY2008. Net interest payments accounted for the remaining 8.3% of total spending.

Because discretionary spending is now at a historic low as a proportion of total federal outlays, some budget experts contend that any significant reductions in federal spending must include mandatory spending cuts. Other budget and social policy experts contend that cuts in mandatory spending would cause substantial disruption to many households because mandatory spending funds important parts of the social safety net.

[12] For more information see CRS Report RS20129, *Entitlements and Appropriated Entitlements in the Federal Budget Process*, by Bill Heniff Jr.

Figure 2. Outlays by Type as a Percentage of GDP, FY1990-FY2019



Source: CBO, *Historical Tables*, available at http://www.cbo.gov/budget/historical.shtml and *The Budget and Economic Outlook: An Update*, August 2009, available at http://www.cbo.gov/doc.cfm?index=10521. Data for FY2009 are estimates and data for FY2010-FY2019 are projections.

Federal Revenue

Individual income taxes have long been the largest source of federal revenues, followed by social insurance taxes. Federal individual and corporate income tax revenues typically track broader trends in the economy. In FY2008, individual income tax revenues totaled $1,146 billion (8.1% of GDP), comprising about 45% of total federal revenues. In FY2009, difficult economic conditions led individual income tax revenue to fall to $918 billion (6.5% of GDP). Corporate income tax revenues fell from $304 billion in FY2008 to $138 billion in FY2009. Federal revenues from other sources fell as well, although much less dramatically.[13]

[13] U.S. Department of the Treasury, "Joint Statement of Tim Geithner, Secretary of the Treasury, and Peter Orszag, Director of the Office of Management and Budget, on Budget Results for Fiscal Year 2009," Press release TG-322, October 16, 2009, available at http://www.treas.gov/press/releases/tg322.htm.

Deficits, Debt, and Interest

The federal government's fiscal stance is often gauged by the annual budget deficit. The budget deficit, however, may give a partial and potentially misleading picture of the government's fiscal condition.[14] Annual budget deficits or surpluses determine, over time, the level of federal debt and affect the growth of interest payments to finance the debt.

Federal Deficits

Deficits can serve as a powerful instrument of fiscal policy. Differences between revenues and outlays determine whether or not the budget is in surplus or deficit, which often serves as a measure of the federal government's fiscal health. Annual budget deficits or surpluses determine, over time, the level of federal debt and affect the amount of annual interest paid to finance the debt. Occasional deficits, in and of themselves, are not necessarily problematic. Deficit spending allows governments to smooth outlays and taxes to shield taxpayers and program beneficiaries from abrupt economic shocks in the short term. Persistent deficits, however, lead to growing accumulations of federal debt that may lead to higher interest payments, tax increases, or spending cuts, and may also have adverse macroeconomic consequences in the long term.[15]

Deficit projections for the next several fiscal years are high relative to historic standards. The deficit reached its peak in FY1943 at 30.3% of GDP. After WWII, deficits remained relatively low until the mid-1980s. In FY1985, the deficit reached 6.0% of GDP. The FY2009 total deficit was $1,417 billion (10.0% of GDP), the largest in proportion to GDP since FY1946.[16]

Federal Debt

Gross federal debt is composed of debt held by the public and intragovernmental debt.[17] Intragovernmental debt is the amount owed by the Federal government to other federal agencies, to be paid by the Department of the Treasury. This amount largely consists of money contained in trust funds, such as Social Security, that has been invested in Federal securities as required by law.[18] Debt held by the public is the total amount the Federal government has borrowed from the public and remains outstanding. This measure is generally considered to be the most relevant in macroeconomic terms because it is the amount of debt sold in credit markets.

Changes in debt held by the public generally track the movements of the annual on-budget deficits and surpluses. Whether or not the movements of gross federal debt will follow those of debt held by the public depends on how intergovernmental debt changes. Higher debt levels could slow investment and lower economic growth.[19]

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[14] See CRS Report RL33623, *Long-Term Measures of Fiscal Imbalance*, by D. Andrew Austin.

[15] Committee for a Responsible Federal Budget, *Good Deficit / Bad Deficit*, April 2009.

[16] U.S. Office of Management and Budget, *Budget for Fiscal Year 2009, Historical Tables*, Table 1-3, available at http://www.gpoaccess.gov/usbudget/fy09/pdf/hist.pdf.

[17] Gross federal debt is also referred to as total debt or total public debt outstanding. Intragovernmental debt is also referred to as intragovernmental holdings or debt held by federal government accounts.

[18] U.S. Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2009, Analytical Perspectives*, Feb. 2008, p. 408.

[19] For more information, see CRS Report RL34712, *Ebbs and Flows of Federal Debt*, by Mindy R. Levit.

Debt Limit

Congress sets a ceiling on federal debt through a legislatively established limit that helps Congress assert its constitutional prerogative to control spending. The debt limit also imposes a form of fiscal accountability that compels Congress and the President to take visible action, in the form of a vote authorizing a debt limit increase, to allow further federal borrowing when nearing the statutory limit. The debt limit can hinder the Treasury's ability to manage the federal government's finances when the amount of federal debt approaches this ceiling. In those instances, the Treasury has had to take unusual and extraordinary measures to meet federal obligations.[20] While the debt limit has never caused the federal government to default on its obligations, it has caused inconvenience and uncertainty in Treasury operations at times.

On February 17, 2009, the American Recovery and Reinvestment Act of 2009 (H.R. 1, P.L. 111-5) increased the debt limit to $12,104 billion. As of October 26, 2009, federal debt subject to limit was approximately $11,898 billion, of which, $7,475 billion was held by the public. CBO had estimated that federal debt subject to limit would reach the limit then in place ($12,104 billion) in the last months of calendar year 2009. In August 2009, according to media reports, Treasury Secretary Geithner wrote Congress to warn that the federal debt would soon reach its legal limit and urged Congress to raise the debt limit.[21] The Treasury, however, announced in November that the debt limit would probably not be reached until mid to late December.[22] Rather than passing the debt limit measure (H.J.Res. 45) automatically generated in the House by passage of the budget resolution, Congress chose to increase the limit by a smaller amount sufficient to let the U.S. Treasury pursue normal debt management policies for two months or so. H.R. 4314, passed by the House on December 16, 2009, and by the Senate on December 24, raised the debt limit to $12.394 trillion when the President signed the measure on December 28.[23]

Net Interest

In FY2008, the U.S. spent $253 billion, or 1.8% of GDP, on net interest payments on the debt. What the government pays in interest depends on market interest rates as well as on the size and composition of the federal debt. Since FY1968, the U.S. spent an average of 2.2% of GDP on interest payments. In FY2004, interest payments dipped to a low of 1.4% of GDP. If the value of the federal debt in real terms were to grow faster than the economy, the burden of paying interest on the debt would grow as well.

Currently, low interest rates have held down net interest payments as a percentage of GDP relative to the historical average. CBO projects net interest payments for FY2009 will fall to 1.2% of GDP, despite increases in borrowing to finance the deficit.[24] Some economists, however, have expressed concern that federal interest costs could rise sharply once the economy recovers, resulting in future strain on the budget.[25]

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[20] General Accountability Office, *Debt Ceiling: Analysis of Actions Taken During the 2003 Debt Issuance Suspension Period*, GAO-04-526, May 20, 2004.

[21] U.S. Congressional Budget Office, *The Budget and Economic Outlook: An Update*, August 2009, p. 21.

[22] David Clarke, "Treasury Gives Congress More Breathing Room on Debt Limit," *CQ Today Online News – Budget*, Nov. 4, 2009; U.S. Treasury Department, "November 2009 Quarterly Refunding Statement," Press release TG346, November 4, 2009.

[23] For further details, see CRS Report RL31967, *The Debt Limit: History and Recent Increases*, by D. Andrew Austin and Mindy R. Levit.

[24] Ibid., Table 1-2.

[25] Carmen M. Reinhart and Kenneth S. Rogoff, "The Aftermath of Financial Crises," *American Economic Review*, vol.

Budget Cycle

A single year's budget cycle takes roughly three calendar years from initial formation by the Office of Management and Budget (OMB) until final audit.[26] The executive agencies begin the budget process by compiling detailed budget requests in the calendar year before the President's budget submission. Many agencies start working on their budgets during the spring and summer—about year and a half before the fiscal year begins. OMB oversees the development of these agency requests. The President, by law, must submit a budget, which is based on OMB's work, by the first Monday in February.[27]

Because this date followed Inauguration Day so closely, the Obama Administration had little time to compile budget documents. In past decades, some new presidents relied on their predecessors' budget teams to outline a budgetary framework for submission in February and then submit their own budget or revisions at a later date.[28] The Obama Administration presented an outline of the FY2010 budget on February 26, 2009, and submitted its full budget proposal on May 7 and 11, 2009.

Congress typically begins formal consideration of the budget once the President submits his budget request. This year House and Senate Budget Committees began work on budget resolutions in March, even though the President's full budget submission had not yet been submitted. The budget resolution sets out a plan, agreed to by the House and Senate, that establishes the framework for subsequent budget legislation.

House and Senate Appropriations Committees and their subcommittees typically begin work on bills that fund discretionary spending programs once the budget resolution is agreed upon. Appropriations Committees review agency funding requests and propose levels of budget authority (BA). Appropriations acts passed by Congress set the amount of BA available for specific programs and activities. Authorizing committees, which control mandatory spending, and committees with jurisdiction over revenues also play important roles in budget decision-making.

During the fiscal year, which begins on October 1, Congress and OMB oversee the execution of the budget. Once the fiscal year ends on the following September 30, the Treasury Department and the Government Accountability Office (GAO) begin year-end audits.

Budget Baseline Projections

The Congressional Budget Office (CBO) provides data and analysis to Congress throughout the budget and appropriations process. Each January, CBO issues a *Budget and Economic Outlook* that contains current-law baseline estimates of outlays and revenues. In March, CBO typically issues an analysis of the President's budget submission with revised baseline estimates and projections. OMB issues a *Mid-Session Review* in July with budget data revised to reflect changes in policy proposals, changed economic conditions, and other factors. In late summer, CBO issues an updated *Budget and Economic Outlook* with new baseline projections.

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99 (2009), no. 2; Alan Auerbach and William Gale, "The Economic Crisis and the Fiscal Crisis: 2009 and Beyond," Tax Policy Center working paper, February 2009, available at http://www.taxpolicycenter.org/UploadedPDF/411843_economic_crisis.pdf.

[26] CRS Report 98-325, *The Federal Fiscal Year*, by Bill Heniff Jr.

[27] The contents of the Presidential budget submission are governed by U.S. Code, Title 31, Sec. 1105.

[28] Additional information on budget during transition is available in CRS Report RS20752, *Submission of the President's Budget in Transition Years*, by Robert Keith.

Due to changing economic conditions and the enactment of major legislation in the early part of 2009, CBO also posted interim analyses as requested by Congress in order to provide more up-to-date projections of the fiscal outlook between the release of its January and March baselines.[29] These legislative changes as well as revised economic assumptions were incorporated into CBO's March 2009 *A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook*.[30] CBO revised its estimates of the President's policies in June 2009 in its report, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2010*.[31] CBO released a revised budget and economic outlook on August 25.[32]

The CBO current-law baseline sets a benchmark to evaluate whether legislative proposals would increase or decrease outlays and revenue collection. Baseline estimates are not intended to predict likely future outcomes, but to show what spending and revenues would be if current law remained in effect. CBO typically evaluates the budgetary consequences of legislative proposals and the Joint Committee on Taxation (JCT) evaluates the consequences of revenue proposals.

CBO computes baseline projections using certain assumptions.[33] Forecasts based on these assumptions typically yield higher revenue estimates and slower growth of discretionary spending relative to scenarios independent forecasters consider likely. More specifically, CBO baseline projections incorporate three legislatively mandated assumptions: that discretionary spending remains constant in inflation-adjusted terms, that the 2001 and 2003 tax cuts fully expire after 2010 (as current law specifies), and that one-year "patches" to the alternative minimum tax (AMT) will lapse even though past Congresses have extended AMT patches year after year. However, CBO does provide projections of these costs separately from its baseline. In addition to these legislative assumptions, macroeconomic assumptions, namely the point at which CBO expects the recession to end, will also affect the baseline estimates and projections especially given the current economic climate.

Previous baseline projections showed substantial growth in receipts after 2010, when most of the tax cuts from 2001 and 2003 expire. Federal deficits are expected to grow rapidly beyond the 10-year forecast window unless major policy changes are made, however, largely because of increased outlays due to rapidly growing health care costs and Baby Boomer retirements.

[29] U.S. Congressional Budget Office, *Estimated Impact on the Deficit of Three Alternative Policy Scenarios as Specified by Speaker Pelosi and Chairman Spratt*, February 23, 2009, available at http://www.cbo.gov/ftpdocs/100xx/doc10003/02-23-ThreePolicyScenarios.pdf and *Estimated Macroeconomic Impacts of the American Recovery and Reinvestment Act of 2009*, March 2, 2009, available at http://www.cbo.gov/ftpdocs/100xx/doc10008/03-02-Macro_Effects_of_ARRA.pdf.

[30] U.S. Congressional Budget Office, *A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook*, March 2009.

[31] U.S. Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2010*, June 2009.

[32] U.S. Congressional Budget Office, *The Budget and Economic Outlook: An Update*, August 2009, http://www.cbo.gov/ftpdocs/105xx/doc10521/08-25-BudgetUpdate.pdf.

[33] While some budget enforcement legislation constraining the computation of CBO baseline estimates has expired, CBO has continued to follow those legislative guidelines.

Budgeting in Tough Economic Times: The FY2009 and FY2010 Budgets

Aside from the specific issues related to the budget in presidential transition years, the current economic climate poses another major challenge to policymakers shaping the federal budget. Federal spending tied to means-tested social programs has been increasing due to rising unemployment, while federal revenues will likely fall as individuals' incomes drop and corporate profits sink.

Financial and Economic Turmoil

Financial markets have been in turmoil since August 2007. That turmoil intensified in March 2008 when the investment bank Bear Stearns was forced to sell itself to JPMorgan Chase, and intensified again on September 7, when government-sponsored mortgage guarantors Fannie Mae and Freddie Mac were placed into conservatorship. A week later, on September 15, 2008, the investment bank Lehman Brothers declared bankruptcy. The next day, the Federal Reserve extended an $85 billion loan to the insurance giant AIG to avoid its collapse. AIG subsequently received additional capital injections by the Federal Reserve.[34] In the week following the Lehman bankruptcy and AIG's near-death experience, equity markets experienced sharp declines and money markets and commercial paper markets experienced severe disruptions.[35]

Financial turmoil and declining residential real estate markets in late 2007 soon led to broader economic problems. The U.S. economy, according to the National Bureau of Economic Research (NBER), entered a recession in December 2007, which has been longer and deeper than any other since the Great Depression. Real GDP grew an estimated annual rate of 2.8% in the third quarter of 2009, marking an end to the longest post-World War II recession. The November 2009 Blue Chip consensus forecasts projected that real GDP will grow at a 2.7% annual pace and the unemployment rate will average nearly 10% in calendar year 2010.[36] Most forecasters expect unemployment, which is generally considered a lagging indicator of economic activity, to remain at high levels for the medium term. CBO projects that the unemployment rate will peak in early 2010 just shy of 10.5%.[37]

Federal Response to Turmoil in 2008 and 2009

The federal government has responded to this financial turmoil with an extraordinary set of measures. In February 2008, Congress enacted a $152 billion package (P.L. 110-185, Economic Stimulus Act of 2008) to stimulate consumption that sent refunds to taxpayers and let firms depreciate their capital more quickly. Later in the year, the Federal Reserve created a panoply of lending facilities, such as the Term Auction Facility (TAF), the Primary Dealer Credit Facility (PDCF), and the Term Securities Lending Facility (TSLF), among others. These facilities provide financial institutions with loans in exchange for various types of collateral.

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[34] CRS Report R40438, *Ongoing Government Assistance for American International Group (AIG)*, by Baird Webel.

[35] For a detailed chronology, see the St. Louis Federal Reserve Bank, *The Financial Crisis: A Timeline of Events and Policy Actions*, available at http://timeline.stlouisfed.org/index.cfm?p=timeline#2008-10.

[36] Blue Chip Economic Indicators, "Top Analysts' Forecast of the U.S. Economic Outlook for the Year Ahead," press release, November 10, 2009, available at http://www.bluechippubs.com.

[37] U.S. Congressional Budget Office, *The Budget and Economic Outlook: An Update*, August 2009, Table 2-1.

On October 3, Congress passed the Emergency Economic Stabilization Act of 2008 (EESA; P.L. 110-343), which authorized the Treasury Secretary to use $700 billion (subject to certain congressional restrictions and notifications) to intervene in financial markets or to inject capital into key financial institutions as part of a Troubled Assets Relief Program (TARP). While Treasury Secretary Henry Paulson first proposed using TARP funds to buy mortgage-related securities, those plans were later shelved. Instead, the Treasury Department injected TARP funds to recapitalize banks and financial institutions by acquiring preferred shares. On November 12, Paulson announced that a portion of TARP would fund a new Federal Reserve collateralized lending program, the Term Asset-Backed Securities Loan Facility (TALF), which will take in securities based on "newly and recently originated" loans, such as for education, automobiles, and credit cards. Treasury Secretary Geithner announced details of a plan to use TARP funds, in cooperation with the Public-Private Investment Program (PPIP), to purchase legacy (i.e., troubled) assets in March 2009.[38] By early November 2009, six investment firms had qualified for PPIP and another three firms were reportedly close to qualifying.[39]

Additional efforts to jump-start economic growth came in the form of another stimulus package passed by Congress on February 13, 2009, and signed into law by President Obama on February 17, 2009. The American Recovery and Reinvestment Act of 2009 (ARRA; H.R. 1, P.L. 111-5) includes provisions that, according to CBO, would total $787.2 billion in increased spending and reduced taxes over the FY2009-FY2019 period or just over 5% of GDP in 2008.[40] ARRA includes support for state and local governments in the form of increased infrastructure, Medicaid, school funding, funding for health care IT, extended unemployment benefits, as well as tax cuts and rebates among other provisions.[41]

The size, variety, and complexity of federal responses to financial and economic turmoil present many challenges to budget analysis. The ultimate costs of these responses will depend on how the economy performs, how well firms with federal credit guarantees weather future financial shocks, and whether or not the government receives positive returns on its asset purchases. Estimating how much these responses will cost the federal government is difficult, both for conceptual and operational reasons.

What Counts As an Outlay?

The distinction between outlays and budget authority is important to understanding the budgetary consequences of federal responses to economic and financial turmoil. Outlays are disbursed federal funds. Budget authority, as determined by what Congress appropriates, is what federal agencies can legally spend. Budget authority has been compared to funds deposited into a checking account, which then can be used for federal purposes. Giving federal officials the ability to spend requires budget authority. Until the federal government disburses funds to make

[38] For more information, see CRS Report RL34730, *Troubled Asset Relief Program: Legislation and Treasury Implementation*, by Baird Webel and Edward V. Murphy.

[39] [39] U.S. Department of Treasury, "Treasury Department Announces Initial Closings of Legacy Securities Public-Private Investment Funds," press release, September 30, 2009, http://www.ustreas.gov; Maya Jackson Randall and Jeff Bater, "Update: US Govt Announces Investment In Toxic-Asset Program," *Wall Street Journal*, November 3, 2009.

[40] U.S. Congressional Budget Office, *Cost Estimate For the Conference Agreement For H.R. 1.*, February 13, 2009, available at http://cbo.gov/ftpdocs/99xx/doc9989/hr1conference.pdf.

[41] For more information on the provisions of ARRA, see CRS Report R40537, *American Recovery and Reinvestment Act of 2009 (P.L. 111-5): Summary and Legislative History*, by Clinton T. Brass et al.

purchases, however, no outlays occur. Outlays will not increase until those funds are actually disbursed.

Outlay data are used to assess the macroeconomic effects of the federal budgets, while budget analysis of specific federal programs is typically based on budget authority figures. Appropriations legislation is generally framed in terms of budget authority because that is what Congress can most directly control.

Estimating the precise budgetary impact of programs like TARP is difficult. For example, much of the early amounts of TARP funds were used to purchase preferred equity stakes in major banks. EESA requires those equity purchases to be costed on a net present value basis with an adjustment for market risk, so that the future sale of those equity stakes would offset much of the cost of acquiring them.[42] Under the Bush Administration, OMB argued for a cash basis approach, so that those equity purchases would increase the federal deficit for FY2009 and future sales would reduce deficits in out-years as those equity stakes are sold off. Under the Obama Administration, however, OMB Director Peter Orszag adopted the scoring practices he advocated while head of CBO, thus eliminating some of the previous divergence between CBO and OMB budget estimates. Even though the value of TARP purchases is now being estimated on a net present value basis by CBO and OMB, differences still remain, which illustrate the complexity in evaluating their true cost. OMB estimated TARP outlays on a net present value basis at $235 billion in FY2009 and $70 billion in FY2010 (with further outlays beyond FY2010).[43] CBO estimates the value of these outlays, on that basis, at $133 billion in FY2009 and $80 billion in FY2010.[44]

The final scope of many elements of the financial intervention programs remains unclear given that the Treasury Secretary has been granted wide discretion in how to use these funds. Outside of TARP, other federal agencies have also used their statutory authority to provide relief to the financial sector and credit markets in various ways. The ultimate costs and budgetary implications depend on the strength or weakness of the economic recovery and what, if any, additional federal resources are put toward dealing with the current economic and fiscal issues with or without additional congressional action.[45]

Current Federal Budget Scoring Ignores Some Credit Risks

The federal government has provided credit guarantees to several firms to reduce systematic financial or economic risks to the economy. The cost of making these guarantees to the government, however, may be much less than the value of the guarantees. If economic conditions improve soon, those credit guarantees will not result in new federal outlays. On the other hand, if the economic conditions deteriorate, the government may face major losses. The Federal Credit Reform Act of 1990 (FCRA) requires that the reported budgetary cost of credit programs equal the estimated subsidy cost at the time the credit is provided.[46] FCRA subsidy calculations,

[42] Mandated by Section 123 of the Emergency Economic Stabilization Act (P.L. 110-343).

[43] U.S. Office of Management and Budget, *Budget for Fiscal Year 2010, Mid-Session Review*, Table S-4.

[44] U.S. Congressional Budget Office, *The Budget and Economic Outlook: An Update*, Table 1-4.

[45] President Obama's budget documents for FY2010 included an additional $250 billion as a placeholder for potential future financial stabilization efforts in FY2009. However, in its Mid-Session Review, OMB removed this placeholder.

[46] The Federal Credit Reform Act of 1990 was created as part of the Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508). FCRA defines a subsidy cost as "the estimated long-term cost to the government of a direct loan or a loan guarantee, calculated on a net present value basis, excluding administrative costs." For details, see CRS Report RL30346, *Federal Credit Reform: Implementation of the Changed Budgetary Treatment of Direct Loans and Loan*

however, omit risk adjustments (except for TARP funds, as noted above).[47] The true economic cost of federal credit guarantees can be substantially underestimated when risk adjustments are omitted.[48] CBO and OMB include risk adjustments in estimates of the costs associated with the TARP as mandated by EESA.[49]

Some economists argue that the federal government should not charge for the risks it accepts. That argument, however, properly applies only to diversifiable risks—that is, risks that can be minimized by pooling small risks. For non-diversifiable risks, such as systematic risks to financial markets, governments may spread or redistribute risks, but cannot eliminate them via pooling. Some argued that because the U.S. government can borrow at a risk-free rate, that budget accounting for federal credit programs should not include a risk premium.[50] The U.S. Treasury's ability to borrow funds cheaply, however, derives from the government's ability to tax. The U.S. government can borrow at a risk-free rate not because it can eliminate risks, but because it can transfer risks to taxpayers and program beneficiaries.[51]

Federal responses to financial turmoil and the recession may expose the government to significant credit risks. Large amounts of difficult-to-value financial assets have been put on the Treasury and Federal Reserve balance sheets. Estimating scale and market cost of those risks is difficult because the way some programs will be administered is unclear. Potential costs also depend on how quickly the economy recovers and how the structure of financial markets evolves.[52]

Budget Fiscal Year 2009

Recent economic issues and resulting legislation enacted to reduce the impact of the housing and credit crises have profoundly altered the budgetary landscape. Financial turmoil and the recession will also affect outlay and revenue projections over the next several years. Any additional measures, such as further financial intervention, could impact the budget and budget balance in FY2009 and beyond.

During the past several budgetary cycles, Congress did not pass all of the regular appropriations bills, which determine discretionary spending, before the start of the fiscal year. The FY2009 budget cycle was no exception. Congress provided its budgetary outline in the budget resolution adopted in early June 2008, which called for $1,183 billion in discretionary spending and $1,883 billion in mandatory spending. Although the budget resolution is not law, it constrains spending plans and thus plays a central role in determining budgetary outcomes.[53] Regular appropriations

Guarantees, by James M. Bickley.

[47] While the FCRA calculations include estimates of default costs, they do not discount more volatile income flows, as a private firm would.

[48] U.S. Congressional Budget Office, *Estimating the Value of Subsidies for Federal Loans and Loan Guarantees*, Aug. 2004, available at http://cbo.gov/doc.cfm?index=5751.

[49] U.S. Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2009 to 2019*, January 7, 2009, pp. 25-26, available at http://www.cbo.gov/ftpdocs/99xx/doc9957/01-07-Outlook.pdf; Testimony of Elizabeth Warren, Chair of the Congressional Oversight Panel, in Congress, Senate Banking Committee, *Pulling Back the TARP: Oversight of the Financial Rescue Program*, hearings, 111th Congress, 1st sess., February 5, 2009, available at http://banking.senate.gov/public/_files/Warrentestimonyfinal2509.pdf.

[50] U.S. government is widely regarded as having no default risk, although government securities may carry other risks, such as interest rate risks and for foreign holders, exchange rate risks.

[51] U.S. Congressional Budget Office, *Estimating the Value of Subsidies for Federal Loans and Loan Guarantees*, Aug. 2004, p. 4.

[52] For details, see CRS Report RL34427, *Financial Turmoil: Federal Reserve Policy Responses*, by Marc Labonte.

[53] The Congressional Budget Act sets April 15 as a target date for Congress to adopt a budget resolution. In some years,

bills for Defense, Homeland Security, and Military Construction were included in the Consolidated Security, Disaster Assistance, and Continuing Appropriations Act of 2009 (P.L. 110-329), which was signed into law on September 30, 2008, the day before the start of FY2009. The act also provided continuing appropriations for other parts of the government until March 6, 2009. To complete FY2009 funding, the House passed the Omnibus Appropriations Act of 2009 (H.R. 1105) on February 25, 2009, on a 245-178 vote. Passage in the Senate was delayed, requiring an additional stop-gap measure (H.J.Res. 38, P.L. 111-6) to provide funding until March 11, 2009. The Senate passed the omnibus bill on a voice vote on March 10, 2009, and the President signed it the next day (P.L. 111-8), which completed regular FY2009 appropriations.

FY2009 Supplemental Appropriations

War Funding[54]

Costs of the wars in Iraq and Afghanistan have been funded for the most part by emergency supplemental appropriations since 2001. By contrast, most of the funding for the Vietnam war after the first few years was provided in regular appropriations.[55] Since 2004, war funding has been requested in two parts: an emergency "bridge" fund to cover the first part of the year that has been included as emergency appropriations in the Department of Defense's (DOD's) regular appropriations and a supplemental that has been submitted later in the fiscal year. The Supplemental Appropriations Act, FY2008 (P.L. 110-252) provided both the second part of war funding for FY2008 bringing the annual total to $187 billion, and $66 billion to cover the first part of FY2009.[56]

On April 9, 2009, the Obama Administration requested $83.4 billion for a FY2009 supplemental including $75.5 billion to fund DOD's war costs in Afghanistan and Iraq, $7.1 billion for primarily war-related foreign aid, and $0.4 billion for other needs.[57] Coupled with previously appropriated war funding, the request would bring the DOD total for FY2009 to $141.4 billion. Presumably this request reflects the President's decision to send an additional 21,000 troops to Afghanistan "to stabilize a deteriorating situation" and to reduce the number of Brigade Combat Teams in Iraq by two, a decrease of about 18,000 troops in FY2009.[58] According to OMB, this

that target date was not met. For more information see CRS Report 98-814, *Budget Reconciliation Legislation: Development and Consideration*, by Bill Heniff Jr.

[54] Section written by Amy Belasco, CRS.

[55] CRS Report RS22455, *Military Operations: Precedents for Funding Contingency Operations in Regular or in Supplemental Appropriations Bills*, by Stephen Daggett, pp. 5-6. For a discussion of how war funding may affect the federal budget, see CRS Report RL31176, *Financing Issues and Economic Effects of American Wars*, by Marc Labonte and Mindy R. Levit.

[56] CRS Report RL33110, *The Cost of Iraq, Afghanistan, and Other Global War on Terror Operations Since 9/11*, by Amy Belasco.

[57] Office of Management and Budget, "Letter to the President on the FY2009 Supplemental," Estimate No. 1, 111th Congress, April 9, 2009, available at http://www.cq.com/flatfiles/editorialFiles/temporaryItems/2009/supp-omb-letter.pdf; Office of Management and Budget, FY2009 Supplemental Request, Estimate No.1, 111th Congress, April 9, 2009, available at http://www.whitehouse.gov/omb/assets/budget_amendments/supplemental_04_09_09.pdf.

[58] OMB, *A New Era of Responsibility: Renewing America's Promise*, February 26, 2009, pp. 53-55 and Table S-7; "Responsibly Ending the War in Iraq," Remarks by President Barack Obama at Camp Lejeune, North Carolina, February 27, 2009, available at http://www.whitehouse.gov/the_press_office/Remarks-of-President-Barack-Obama-Responsibly-Ending-the-War-in-Iraq/; White House, Blog, "A New Strategy for Afghanistan and Pakistan, March 27, 2009, available at http://www.whitehouse.gov/blog/09/03/27/A-New-Strategy-for-Afghanistan-and-Pakistan/.

should be the last war-related supplemental. Funding for war costs in FY2010 was submitted along with the regular budget on May 7, 2009.

The Administration submitted three additional requests for supplemental funds including funds for pandemic flu preparedness and response measures, to cover potential risks to the Treasury from expanding the U.S. contribution to the borrowing authority of the International Monetary Fund, and additional funds for unanticipated needs for influenza. Together with the initial April 9 proposal, this brought the total Administration request for the FY2009 supplemental to $92.145 billion. By June 18, both the Senate and the House passed the final version of the bill (Supplemental Appropriations Act 2009; H.R. 2346), totaling $105.9 billion.[59] As often happens with supplementals, the FY2009 supplemental included not only much of the additional funding requested by the Administration, but also other funding added by Congress. President Obama signed the FY2009 supplemental (P.L. 111-32) on June 24.

Supplemental war appropriations complicate the budget process. First, some argue that war funding should be included in DOD's regular appropriations. DOD and others have suggested that war costs remain fluid and that combining regular and war appropriations could make the administrative and budgetary segregation of war funding and the costs of DOD's baseline peacetime program more difficult. Some contend that the George W. Bush Administration used supplemental appropriations to obscure the costs of wars in Iraq and Afghanistan to the public. Second, the irregular timing of supplemental appropriations requests complicates comparisons of baseline budget forecasts. Supplementals have also been criticized for making it easier to add unrelated spending items that would be more difficult to pass individually, which is particularly the case for supplemental acts that provide funds to support troops engaged in war.

According to the terms of budget enforcement conventions, CBO baseline presumes that discretionary spending levels will continue, as enacted, for the following fiscal year in real (i.e., inflation-adjusted) terms. If these projections are run when Congress has only enacted bridge funding to cover part of the year, the baseline is likely to understate the full amount of spending for the Department of Defense. On the other hand, if the baseline is run after a supplemental is passed and an overall decline in U.S. military operations is anticipated because the drawdown in Iraq is expected to be greater than the increase in Afghanistan, then assuming the same level of war funding may overstate total defense spending. In either case, when the amount for defense spending includes war funding, it overstates the amount needed to carry on DOD's ongoing baseline peacetime program, and will not capture any changes in U.S. military operations for overseas contingencies.

Finally, many in Congress have questioned whether after seven years, war appropriations are appropriately categorized as "unanticipated" emergencies not subject to caps in annual congressional budget resolutions. Although Congress required a full year's war request starting in FY2008, the Bush Administration failed to submit one for FY2009 (Sec. 1007, P.L. 110-364).

"Cash for Clunkers"

In addition to the war funding supplemental discussed above, the House passed a second supplemental appropriations measure (H.R. 3435) to extend the "Cash for Clunkers" program on July 31 on a 316-109 vote. The Senate approved the measure on August 6 on a 60-37 vote and it

[59] *Congressional Record*, "Supplemental Appropriations Act 2009 (H.R. 2346) Conference Agreement (H.Rept. 111-151), June 16, 2009, pp. H6871-H6905; see also CRS Report R40531, *FY2009 Spring Supplemental Appropriations for Overseas Contingency Operations*, coordinated by Stephen Daggett and Susan B. Epstein.

was signed into law by the President on August 7, 2009 (P.L. 111-47).[60] To pay for this extension, Congress transferred $2 billion of ARRA funds into "cash for clunkers." This program was successful in stimulating auto sales, however some have expressed skepticism of any fuel efficiency gains that will be generated. The program, initially planned to end November 1, 2009, only lasted until August 24, 2009, due to concerns that the program would run out of funds.

Why Did Budget Deficit Estimates for FY2009 Change?

Both CBO and OMB revised their budget deficit estimates for FY2009 downward in their August releases of *The Budget and Economic Outlook: An Update* and the *Mid-Session Review*, respectively. In its baseline figures issued in March, CBO had estimated an FY2009 deficit of $1,667 billion. A revised CBO estimate released in August 2009 put the FY2009 federal deficit at $1,587 billion. The $80 billion reduction in the estimated federal deficit between March and August was in large part due to changes in estimated TARP subsidy costs, which fell by $203 billion. On the other hand, estimated revenues also fell by $85 billion between March and August, while legislative changes increased estimated defense outlays by $25 billion.[61]

The revisions in the OMB proposed budget deficit estimates, from a May FY2009 deficit estimate of $1,841 billion to an August estimate of $1,580 billion, are largely a result of the elimination of the $250 billion placeholder for additional financial stabilization efforts. OMB determined that the increased stability in the financial markets provided indication that the placeholder was no longer needed. In addition, OMB also reduced projected outlays for FDIC's deposit insurance program by $78 billion due to improved conditions in the banking industry. Offsetting these lower outlays is an $83 billion decline in revenues due to revised economic and technical assumptions.[62]

Budget Fiscal Year 2010

The Obama Administration released an outline of the FY2010 budget on February 26, 2009, the full budget proposal on May 7 and 11, 2009, and the Mid-Session Review on August 25, 2009. Using the President's February outline, Congress began its consideration of the FY2010 budget in late March 2009. Versions of the budget resolution were agreed to in the House (H.Con.Res. 85) and Senate (S.Con.Res. 13) on April 2, 2009. The Conference Report on the budget resolution (S.Con.Res. 13) was agreed to on April 29, 2009.

As of July 30, 2009, the House had passed all 12 regular appropriations acts. As of November 24, the Senate had passed nine regular appropriations acts, and of those, five have been signed into law. The Legislative Branch appropriations bill (P.L. 111-68), enacted October 1, 2009, contained a continuing resolution to extend funding to the end of the month. The Agriculture appropriations bill was enacted on October 21, followed by the Homeland Security and Energy-Water appropriations bills, which were both signed into law on October 28, 2009. On October 30, 2009, the Interior-Environment appropriations bill (P.L. 111-88), which included a second continuing

[60] For further details on the program, see CRS Report R40654, *Accelerated Vehicle Retirement for Fuel Economy: "Cash for Clunkers,"* by Brent D. Yacobucci and Bill Canis.

[61] U.S. Congressional Budget Office, *The Budget and Economic Outlook: An Update*, Table A-1. Further details explaining the changes in the baseline deficit estimates between March and August are explained in Appendix A of that report.

[62] U.S. Office of Management and Budget, *Budget for Fiscal Year 2010, Mid-Session Review*, Table 1, p. 2, and p. 15.

resolution to extend funding until December 18, became the fifth regular appropriations bill to be signed into law.[63]

Five of the remaining regular appropriations bills (Commerce-Justice-Science; Financial Services; Labor-HHS; Military Construction-VA; and State-Foreign Operations) were folded into the Transportation-HUD bill, creating an omnibus spending measure (H.R. 3288). The House agreed to the conference report on the omnibus bill by a vote of 221-202 on December 10, and the Senate agreed to the measure on December 13. The President signed the bill on December 16, which became P.L. 111-117. The defense bill (H.R. 3326), the last regular appropriations bill to pass, was approved through an exchange of amendments between the House and Senate that concluded on December 19. The President signed the bill on the same day, which became P.L. 111-118, finishing the regular appropriations process for FY2010.

Obama Administration FY2010 Budget

The Administration's FY2010 budget contains five volumes: (1) *A New Era of Responsibility: Renewing America's Promise*; (2) *Historical Tables*; (3) *Analytical Perspectives*; (4) *Appendix*; and (5) *Terminations, Reductions, and Savings*.[64] These documents lay out the Administration's projections of the fiscal outlook for the country, along with spending levels proposed for each of the federal government's departments and programs. The *Historical Tables* volume also provides significant amounts of budget data, much of which extends back to 1962 or earlier.

In an attempt to present a full picture of the current and future fiscal outlook, the Obama Administration provided three separate deficit projections.[65] First, OMB projected a Budget Enforcement Act (BEA) baseline, using methods that mirror those CBO uses to project its current-law baseline. The BEA baseline presumes that discretionary spending remains constant in real (i.e., inflation-adjusted) terms, the 2001 and 2003 Bush Administration tax cuts expire in 2010, and that the alternative minimum tax (AMT) will not be "patched."[66] Many budget analysts believe such current law projections offer an overly rosy scenario of the long term budget pictured.[67] Under this scenario, the FY2010 deficit was projected to total $1,426 billion.

The Obama Administration also projected a Current Policy Baseline, which in its view, provides a more transparent and realistic reflection of the federal government's current fiscal situation. They also propose to continue using this methodology as a base for future budget enforcement purposes and as a mechanism for understanding how new policy choices effect the fiscal outlook, essentially replacing the current BEA baseline. The Administration's Current Policy Baseline presumes that the 2001 and 2003 tax cuts will be extended, that the alternative minimum tax (AMT) will be "patched," that certain Medicare physician payments will not be cut. This baseline also includes costs for overseas contingency operations and estimated average annual costs of

[63] For details on the progress of appropriations bills, see the CRS Appropriations Status Table, available at http://crs.gov/products/appropriations/appover.shtml. The Congressional Budget Office's "Discretionary Appropriations Status Tables" are available at http://www.cbo.gov/budget/approps.shtml.

[64] *A New Era of Responsibility: Renewing America's Promise* is the budget overview document released in February. The summary tables in this document were updated in May in the publication titled *Updated Summary Tables*. The other four volumes were released in May. The President's budget proposals can be found on the OMB website at http://www.whitehouse.gov/omb/budget/.

[65] For details of these projections, see U.S. Office of Management and Budget, *Budget for Fiscal Year 2010, Mid-Session Review*, Tables S-1 (Proposed Budget) and S-7 (BEA Baseline and Current Policy).

[66] The tax cuts were enacted in the Economic Growth and Taxpayer Relief Act of 2001 (EGTRRA; P.L. 107-16) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA; P.L. 108-27).

[67] For a discussion of budgetary enforcement legislation, see CRS Report 98-721, *Introduction to the Federal Budget Process*, by Robert Keith.

major disasters, as well as an adjustment for the conversion of Pell Grants from discretionary to mandatory spending. The deficit under this scenario would reach $1,449 billion in FY2010.

The final deficit projection, the Proposed Budget, illustrates the impact on the budget outlook if all of the policies of the Obama Administration are implemented. In FY2010, the Administration projects that the deficit would reach $1,502 billion. Both the Current Policy Baseline and the Proposed Budget project deficits throughout the 10-year budget window, with deficits peaking in FY2009 and then remaining stable, as a percentage of GDP, in the out-years.

In his budget for FY2010, President Obama also presented a wide ranging policy agenda. The main policy initiatives he emphasized include significant spending and investment targeted toward health care reform, clean energy, and education.

Health Care Reform

In its budget documents, the Obama Administration argues that achieving health care reform is necessary to stabilize the federal government's fiscal condition for the long-run. Spending on health programs, such as Medicare and Medicaid, is projected to comprise a larger and larger proportion of the federal budget.

Congress continues to consider major reforms of the health insurance and health care system, designed to expand access to health insurance and health care, to improve the quality of health care, and to slow the growth of health care costs.[68] The House passed the Affordable Health Care for America Act (H.R. 3962) on November 7 by a 220–215 vote, and the Senate passed the Patient Protection and Affordable Care Act (H.R. 3590) on December 24. Some, however, have expressed doubt that current legislative proposals would significantly reduce the trajectory of health care costs.[69]

A Clean Energy Future

Funding for clean energy investment is contained in the President's Research and Development (R&D) budget request. These initiatives for a new energy economy include reducing U.S. dependence on oil, creating "green" jobs, and reducing the impact of climate change by supporting renewable energy and energy efficiency technologies and limiting carbon emissions and their impact. Additional funding for these initiatives was also contained in ARRA (H.R. 1, P.L. 111-5). The President has proposed the creation of a cap-and-trade system, whereby emission allowances will be auctioned, to provide future funding for these investments.

Education

The President is proposing to increase outlays for education and training with the goal of developing a more skilled and productive labor force. Funding will be provided at both the federal level as well as via grants to state and local governments for individual programs such as Head Start and aid for higher education. Additional outlays for education and training purposes are earmarked for physical investment and research and development.

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[68] For more details, see CRS Report R40581, *Health Reform and the 111th Congress*, by Hinda Chaikind; and CRS Report R40517, *Health Care Reform: An Introduction*, coordinated by Bernadette Fernandez.

[69] Ceci Connolly, "Health Bills Too Timid On Cutting Costs, Experts Say," *Washington Post*, November 4, 2009, p. A1.

The federal government also assists individuals and families with the financing of higher education by providing grants, loans, and loan guarantees through various programs. As a result of tight credit markets, Congress enacted legislation to enhance the authority of the Secretary of Education with respect to purchasing student loans made under the Federal Family Education Loan (FFEL) Program and to make other programmatic changes.[70] Building on these reforms, the FY2010 budget proposes to finance future loan originations through the William D. Ford Federal Direct Student Loan Program, generating programmatic savings by eliminating subsidies to FFEL lenders.[71] In addition, the Administration proposes to move Pell Grant outlays from the discretionary spending category to the mandatory spending category. The President also recommends an increase in the maximum award amount for the Pell Grant program. On September 17, 2009, the Student Aid and Fiscal Responsibility Act (H.R. 3221), which incorporates many of the Administration's proposals, passed the House on a 253–171 vote.

Congressional Consideration of the FY2010 Budget Resolution[72]

The House Budget Committee approved its budget resolution (H.Con.Res. 85) on March 25, 2009, on a 24-15 vote. The Senate Budget Committee approved its budget resolution (S.Con.Res. 13) the next day on a 13-10 vote. The House (on a 233-196 vote) and Senate (on a 55-43 vote) agreed to their versions of the budget resolution on April 2, 2009. The conference agreement on the budget resolution (S.Con.Res. 13) was passed in the House (on a 233-193 vote) and in the Senate (on a 53-43 vote) on April 29, 2009.

The House budget resolution provided for revenue levels of $2,328 billion and outlays of $3,550 billion in FY2010, differing slightly from the Senate budget resolution levels of $2,288 billion in revenues and $3,534 billion in outlays. The House budget resolution also included reconciliation instructions to allow for health care and education initiatives, while the Senate did not include any reconciliation instructions. There were some other differences in the House and Senate budget resolutions, including assumptions regarding future legislation concerning estate tax rates and the number of years for which the alternative minimum tax (AMT) would be patched, as well as the number of reserve funds.[73]

A budget resolution conference agreement was filed on April 27, 2009, and included $2,322 billion in revenues and $3,555 billion in outlays for FY2010, resulting in a projected deficit of $1,233 billion. Further, it allowed for $1,086 billion in new, non-war discretionary budget authority, of which $556 billion is allocated for national defense and $530 billion for non-defense discretionary spending. An amount of $130 billion in new budget authority is also provided for overseas deployment and other activities (i.e., war costs). By FY2014, the budget resolution cuts the projected deficit by half to $523 billion. The conference agreement passed both the House and Senate on April 29, 2009.

The conference agreement also assumes three additional years of AMT relief (through FY2014), a two-year extension of expired and expiring tax provisions, and a new incentive for retirement

[70] For more information on recent Congressional action regarding these programs, see CRS Report RL34452, *The Ensuring Continued Access to Student Loans Act of 2008*, by David P. Smole.

[71] For more information on the FFEL and William D. Ford Federal Direct Student Loan Program, see CRS Report R40122, *Federal Student Loans Made Under the Federal Family Education Loan Program and the William D. Ford Federal Direct Loan Program: Terms and Conditions for Borrowers*, by David P. Smole.

[72] For more information on consideration and the policies of the Congressional Budget Resolution, see CRS Report R40559, *S.Con.Res. 13: The Budget Resolution for FY2010*, by Megan Suzanne Lynch and Mindy R. Levit.

[73] Details of the House-passed budget resolution are available at http://budget.house.gov/menu_congress.shtml. Details of the Senate-passed budget resolution are available at http://budget.senate.gov/democratic/senatebudres.html.

savings. The agreement supports the permanent extension of tax relief first enacted in 2001 and 2003 for middle-income taxpayers (the resolution does assume the expiration of the current top two income tax rates, which will rise to 36 percent and 39.6 percent in 2011) and the continuation of current estate tax rates. The conference agreement does not include any assumptions regarding whether President Obama's Making Work Pay tax credit would be made permanent beyond FY2010.

While legislation addressing these policies is accommodated in the budget resolution conference agreement, such legislation may be constrained by other House and Senate rules, specifically the pay-as-you-go (PAYGO) rules in each chamber (House Rule XXI, clause 10, and Section 201 of S.Con.Res. 21, the FY2008 budget resolution). The budget resolution, however, does provide (in Section 421) that in the House any projected increase in the deficit resulting from certain legislation, relating to the Medicare payment system for physicians, middle class tax relief, reform of the AMT, and reform of the estate and gift tax, up to specified amounts, not count for PAYGO purposes if the House has passed legislation reinstating a statutory PAYGO requirement, or such requirement is in the legislation. The budget resolution conference agreement does not include a similar provision that would apply in the Senate.[74]

President Obama's major initiatives on health care and education reform, clean energy, and infrastructure investment are provided for in separate deficit-neutral reserve funds in the conference agreement. Deficit-neutral reserve funds provide that a committee may report legislation with spending in excess of its allocations, but require the excess amounts be "offset" by equivalent amounts of tax increases or spending cuts.[75]

Reconciliation instructions are also included for health care and education reform initiatives, which directed the committees of jurisdiction in the House and Senate to submit legislative language to their respective Budget Committees by October 15, 2009. Reconciliation instructions are in the form of a directive to a specific committee to recommend legislative changes. These instructions are specific and include (1) the committee responsible for making the change, (2) the dollar amount of the change, and (3) the period over which this change should be measured. Reconciliation instructions also include a deadline for the committee to submit such recommendations. Reconciliation legislation, once reported, is considered under special procedures that limit what matters may be included in reconciliation legislation, prohibit certain amendments, and encourage completion in a timely fashion.[76] The House Education and Labor Committee responded to reconciliation directives by reporting H.R. 3221 on July 21, 2009, and the House Ways and Means Committee responded by reporting H.R. 3200 on October 15, 2009.

Although the overall spending and revenue amounts are enforceable, the policy assumptions underlying the budget resolution are non-binding, leaving Congress and the Administration with some flexibility in making longer-term policy choices.

Considerations for Congress

Congress faces extraordinary budgetary challenges in FY2010 with both short-run and long-run budget priorities that may conflict in critical ways. In the short term, economic issues may

[74] For more information on PAYGO requirements, see CRS Report RL34300, *Pay-As-You-Go Procedures for Budget Enforcement*, by Robert Keith.

[75] For more information on reserve funds, see CRS Report R40472, *The Budget Resolution and Spending Legislation*, by Megan Suzanne Lynch.

[76] For more information on reconciliation legislation, see CRS Report 98-814, *Budget Reconciliation Legislation: Development and Consideration*, by Bill Heniff Jr.

dominate policy debates, creating pressure for higher deficit spending. In the long term, increasing federal health care costs are expected to keep mandatory spending rising.

Short-Term Considerations

Although estimates for the third quarter of 2009, which put GDP growth at an annual rate of 2.8%, may signal an end to the economic recession, economic conditions remain weak due to budget challenges facing state and local governments, high levels of consumer debt, and continuing weakness in many real estate markets. Most economists expect unemployment rates to remain elevated for the medium term. Congress may choose to enact more government spending in response to the state of the economy. While the power of debt-financed government spending to provide fiscal stimulus is independent of how those funds are spent, clearly taxpayers and beneficiaries of federal programs gain more when that spending reduces households' economic vulnerabilities or promotes future economic efficiency.

Soon after the 111th Congress was sworn in, work began on a major fiscal stimulus package, the American Recovery and Reinvestment Act of 2009 (H.R. 1, P.L. 111-5) , which was enacted February 17, 2009. The $787.2 billion package (according to CBO) includes extended unemployment benefits, aid to state and local governments in the form of higher infrastructure, Medicaid, school spending, health care information technology funding, as well as tax cuts and rebates. The **Appendix** to this report discusses the macroeconomic policy options available to combat economic downturns and details reasons for enacting fiscal stimulus when monetary policy options are no longer available.

Apart from any additional stimulus spending, the U.S. auto industry, facing the worst downturn in auto sales in 15 years and a significant loss in market share, asked for $34 billion in loans through TARP or through other means to revitalize and restructure its companies. The 110th Congress did not pass proposals to provide additional aid to automobile manufacturers in late 2008, but on December 19, 2008, the Bush Administration announced a plan to provide $17.4 billion in loans to General Motors and Chrysler using funds from the Troubled Asset Relief Program (TARP).[77] General Motors and Chrysler have said they would likely have filed for bankruptcy protection if they had failed to receive federal aid. In order to further stabilize the industry, on March 19, 2009, Treasury Secretary Geithner announced a program to provide auto suppliers with up to $5 billion in credit to help ensure the continuation of their operations in the face of slow sales to the struggling auto industry. This program is intended to ensure that suppliers receive payment for their parts shipments regardless of what happens to the downstream car companies. Despite federal aid provided in late 2008 and early 2009, the Chrysler company filed for bankruptcy on April 30, 2009, and General Motors filed for bankruptcy on June 1.[78] On July 10, 2009, a reorganized General Motors emerged from bankruptcy and Chrysler was sold to the Italian car maker Fiat.[79]

[77] John D. McKinnon and John D. Stoll, "U.S. Throws Lifeline to Detroit," *Wall Street Journal*, December 20, 2008; U.S. Department of Treasury, "Secretary Paulson Statement on Stabilizing the Automotive Industry," Press release HP-1332, December 19, 2008, available at http://www.ustreas.gov/press/releases/hp1332.htm.

[78] See CRS Report R40003, *U.S. Motor Vehicle Industry: Federal Financial Assistance and Restructuring*, coordinated by Bill Canis.

[79] Micheline Maynard, "A Primer on the New General Motors," *New York Times*, July 10, 2009; Michael J. De La Merced And Micheline Maynard, "Fiat Deal With Chrysler Seals Swift 42-Day Overhaul," *New York Times*, June 11, 2009, p. B4.

General Budget Issues

Congress may wish to consider some general budgeting issues beyond short term considerations of annual funding requests and fiscal stimulus.

Managing Federal Credit Risks

FCRA requires that federal loan and credit program costs be recorded on a net present value basis. The calculations mandated by FCRA, while an advance over previous practices, do not take into account risks borne by the federal government, and indirectly, risks borne by taxpayers and program beneficiaries. Federal responses to economic and financial turmoil expose the government to substantial credit risks. Congress may opt to consider methods to undertake a systematic accounting of risks undertaken by government activities.

Stimulate and Stop

While some economists contend that sharply rising unemployment rates signal the need for more fiscal stimulus, President Obama said in late June 2009 that a second stimulus package was not yet necessary.[80] In October 2009, however, the President proposed increasing Social Security benefits by $250 for most beneficiaries.

Debt-financed fiscal stimulus measures, like ARRA, eventually must be paid for through higher taxes or future cuts in government programs. Banks and other financial institutions must eventually be weaned off Federal Reserve and Treasury borrowing facilities. After the economic recovery begins, Congress may use oversight authority to rein in spending as soon as is appropriate.

Budget Transparency

The budget, reflecting the size and complexity of the federal government, is complicated and detailed. The budget books that OMB compiles provide an enormous amount of information, and other budget data reported by federal agencies provide even more detail on federal spending plans. The Federal Funding Accountability and Transparency Act of 2006 (P.L. 109-282) included several measures to increase the accessibility of budget information. For example, as a result of that act, OMB now runs the USAspending.gov website, which provides detailed information on federal spending. Some, however, have raised concerns about quality of those data. Moreover, it is not clear that those data are thoroughly coordinated with other federal budgeting data systems.

Congress and the President have undertaken additional efforts in an attempt to improve transparency in light of the large amounts of spending currently occurring as a result of economic stabilization efforts and federal financial interventions. Websites, such as Recovery.gov, were launched to track stimulus spending. The Congressional Oversight Panel was established in EESA to oversee TARP spending. Despite this, criticisms remain and requests for greater transparency continue.

In certain cases, despite the large amount of data provided by OMB and other government agencies, it can be difficult to answer relatively simple budget questions. Critics maintain that the federal government in general and OMB in particular should take steps to make data on federal spending more transparent to taxpayers and more useful to policymakers. Congress may consider

[80] *New York Times*, "President Obama's Press Briefing," June 23, 2009, available at http://www.nytimes.com/2009/06/23/us/politics/23text-obama.htm.

requiring these changes to provide more organized and transparent budget data to citizens and to itself.

Budget Enforcement Measures

The Budget Enforcement Act and other budget enforcement legislation was widely credited for laying the groundwork for the federal government's surpluses in the late 1990s. The Budget Enforcement Act, which imposed certain "Pay-as-you-go" (PAYGO) rules, expired in 2002. PAYGO rules discourage or prevent the enactment of mandatory spending and revenue legislation that is not deficit neutral (i.e., legislation that would cause, or increase, a deficit or reduce a surplus).[81] The House and Senate in the 111th Congress have enacted modified forms of PAYGO procedures. In June 2009, President Obama encouraged Congress to reinstitute statutory PAYGO rules.[82]

When the economy starts to grow again, attention may turn to deficit reduction efforts, in which case PAYGO procedures could become more important. Some budget experts, however, warn that while PAYGO rules in the past have helped enforce stricter budgetary discipline, PAYGO is not a cure-all for fiscal challenges.[83]

Long-Term Considerations

Annual budget deficits or surpluses are not always the best indication of long-term fiscal stability. Most economists agree that, under certain conditions, running a budget deficit may be necessary to provide economic stimulus or pull an economy out of recession. A large budget deficit, in itself, does not necessarily indicate a longer term problem. The federal government, however, faces serious long-term budget challenges. Some measures of fiscal solvency in the long term indicate that the U.S. may face a major future crisis, specifically as it relates to rising healthcare costs and the likely impact on government financed health care spending.

CBO, GAO, and OMB agree that the current mix of federal fiscal policies is unsustainable in the long term. The nation's aging population, combined with rising health care costs per beneficiary, seems likely to keep federal health costs rising faster than per capita GDP. CBO has concluded that "under any plausible scenario, the federal budget is on an unsustainable path," extending well into this century. In their August 2009 budget reports, OMB and CBO identified fiscal challenges related to future healthcare costs as a major issue affecting the country's long-term budget outlook.

Keeping future federal outlays at 20% of GDP, approximately its current share, and leaving fiscal policies unchanged, according to CBO projections, would require drastic reductions in all spending other than that for Medicare, Social Security, and Medicaid or reigning in the costs of these programs. A former CBO Acting Director stated that, "by 2030 ... spending for those programs [Medicare, Social Security, and Medicaid] is projected to reach roughly 15 percent of GDP.... If that increase happened ..., the rest of the budget would have to be cut by more than half" to keep overall spending close to its current level.

The Social Security, Medicare, and Medicaid programs present different challenges to the long-term fiscal position of the federal government. Estimates of the long-term fiscal gap between

[81] See CRS Report RL34300, *Pay-As-You-Go Procedures for Budget Enforcement*, by Robert Keith.

[82] White House, "President Obama Calls for Restoring Statutory Pay-As-You-Go Requirements," press release, June 9, 2009, available at http://www.whitehouse.gov/the_press_office/President-Obama-Calls-for-Restoring-Statutory-Pay-As-You-Go-Requirements/.

[83] Stan Collender, "PAYGO Is Just a Condiment, Not the Main Ingredient," *Roll Call*, June 23, 2009.

Social Security (OASDI) outlays and Social Security revenues as a proportion of long-term GDP are generally much smaller than estimates of the long-term fiscal gap between Medicare (HI, Part B, and Part D) outlays and revenues as a portion of long-term GDP. These long-term estimates of fiscal imbalances are sensitive to changes in assumptions regarding productivity growth and interest rates. Spending projections for Medicare and Medicaid are sensitive to medical inflation. Past projections that medical inflation would slow have proved to be overly optimistic.

The call for health care reform has grown. The Obama Administration laid out a reserve fund in their FY2010 budget intended as a down payment to fund future health care reform. The FY2010 budget conference agreement also contained provisions to allow for health care reform legislation. Both House Speaker Pelosi and Senate Majority Leader Reid had indicated that they intended to pass health care reforms in 2009. While the House passed the Affordable Health Care for America Act (H.R. 3962) on November 7 by a 220–215 vote, and the Senate passed the Patient Protection and Affordable Care Act (H.R. 3590) on December 24, it appears that Congress will continue to consider health care reform into 2010.

When the economy recovers, Congress may focus more effort on balancing the budget and reining in the debt. This would require less spending, increases in revenue collections, faster than average economic growth, or a combination of these things. Many economists agree that having some federal debt is a good thing because it builds credit which allows for more favorable borrowing terms. It encourages investment within the country because federal debt is seen as relatively low-risk and safe. Debt is not free, however, and requires interest payments that strain budgets. High debt levels could limit the government's flexibility in meeting its obligations or in responding to emerging needs of its citizens. Ultimately, failing to take action to reduce the projected growth in the debt potentially might lead to future insolvency or government default.[84]

[84] Recent trends in the credit default swap market imply an increased market perception of the likelihood of default on certain Treasury securities. In past years, Treasury securities were typically regarded as risk-free. See Alan Auerbach and William Gale, "The Economic Crisis and the Fiscal Crisis: 2009 and Beyond: An Update," Tax Policy Center working paper, September 2009, available at http://www.brookings.edu/~/media/Files/rc/papers/2009/06_fiscal_crisis_gale/06_fiscal_crisis_gale_update.pdf.

Appendix. The Budget and Macroeconomic Policy

Governments typically strive to keep economic growth steady and employment high while maintaining price stability.[85] Macroeconomic policy instruments are often divided into three components: monetary policy (i.e., control of monetary base and short-term interest rates), fiscal policy (government borrowing and spending), and structural factors. Structural factors include regulation and competition policies that may enhance the efficiency of an economy. While these standard macroeconomic policy tools have been highly effective in moderating economic fluctuations over the past few decades, the financial turmoil and credit crunch in FY2009 present special challenges that led the government to consider other types of responses.

The Limits of Monetary Policy

Monetary policy has several important advantages in macroeconomic stabilization. The Federal Reserve, the central bank of the United States, can deploy traditional monetary policy tools such as open-market interventions that help control certain key short-term federal interest rates. The independence of the Fed insulates it from political pressures and allows it to act quickly in response to new developments in the economy. The Fed, in conjunction with the Treasury Department, developed innovative responses to the financial turmoil that broke out in August 2007. As economic problems deepened in 2008, the Fed redoubled its efforts to unfreeze critical areas of credit markets.

In the current economic situation, traditional monetary policy initiatives appear to have neared their effective limits.[86] In their December meeting, the Federal Reserve set a target range for the federal funds rate between zero and ¼ % and cut the rate on discount window loans (made to commercial banks and other financial institutions) by 75 basis points to ½ %.[87] Thus, the Federal Reserve has little room for further cuts. In addition, declining investment demand and investors seeking a safe harbor for funds have pushed short-term interest rates on federal Treasury securities to very low levels.

Furthermore, many economists doubt that pushing those interest rates even lower would spur much additional lending when banks and other lenders worry about the solvency of financial counterparties. Monetary policy loses much of its effectiveness in such a "liquidity trap," as banks' reluctance to lend frustrates the Fed's efforts to expand the money supply. Moreover, while new Federal Reserve lending facilities may improve credit conditions or at least limit further deterioration, those programs were not designed to address the larger macroeconomic issue of stimulating economic growth.[88] Finally, while the Fed responses in 2008 and early 2009

[85] The Humphrey-Hawkins Act (P.L. 95-523) specifies price stability and full employment as goals of national economic policy. Most economists interpret full employment to mean the highest level of employment consistent with a sustainable macroeconomic policy. See John. P. Judd and Glenn D. Rudebusch, "The Goals of U.S. Monetary Policy," *FRBSF Economic Letter* 99-04, January 29, 1999, available at http://www.frbsf.org/econrsrch/wklyltr/wklyltr99/el99-04.html.

[86] For example, Jan Hatzius, Chief Economist for Goldman Sachs's U.S. Research Department, wrote that "with riskless short-term interest rates now close to zero, conventional monetary policy is becoming ineffective." "Macro Policy in a Liquidity Trap," *US Economics Analyst*, issue 08/46, November 14, 2008.

[87] Federal Reserve Bank Board of Governors, Press Release, December 16, 2008, available at http://www.federalreserve.gov/newsevents/press/monetary/20081216b.htm.

[88] These credit facilities, according to the Federal Reserve, were created to increase the availability of credit and to reduce interest rate spreads to more normal levels. While these facilities have greatly expanded the Federal Reserve's balance sheet, they do not appear to have had significant effects on monetary aggregates. See "Term Asset-Backed

have been aggressive and creative, there may be limits to what additional programs can accomplish.

Logic of Fiscal Stimulus

The context for fiscal policy begins with national income accounting. The national income, as measured by GDP, is the sum of expenditure categories. Specifically, the national income accounting identity is

$$Y \equiv C + I + G + \text{Net Exports}$$

where

Y = national income (GDP)
C = private consumption
I = private investment
G = government spending.

The identity implies that national income falls when private consumption and investment fall unless offset by increases in either government spending or net exports. In the current economic environment, government spending increases have become the focus of attention as a source of stimulus as consumption and investment continue to decline. While some measures of economic activity remained resilient in the first half of 2008, despite rapidly rising unemployment and sharp drops in asset prices and in housing prices in many areas of the country, most forecasters predict sharp decreases in key economic indicators in 2009.[89]

Private consumption fell in the last half of 2008 for several reasons. Rising unemployment rates left some households with lost earnings, and prompted others to increase savings to cushion against possible future job losses. Some households that had borrowed using home equity credit lines, credit cards, or other types of credit became unable to continue borrowing, thus requiring cutbacks in consumption. Other households became unable to afford mortgage payments, contributing to increasing foreclosure rates and reducing consumption. Auto sales, an important component of private consumption, fell drastically as financing became harder to obtain and gas prices rose in mid-2008.

Private investment falls when businesses believe that demand for what they sell is falling or will fall. Non-residential investment, a component of private investment, has been weak relative to historical levels since the mid-1990s, although information technology investment was strong until the collapse of dot-coms in 2000. The Federal Reserve then sharply lowered short-term interest rates. Capital inflows, especially from East Asia, pushed down market interest rates. Low interest rates helped housing prices rise and stimulated new residential construction and development, boosting fixed residential investment.

As housing prices in many areas of the country reached their peak or began to decline in 2007, investors who once had thought that home prices would continue to rise backed away.

Securities Loan Facility: Frequently Asked Questions," December 19, 2008, available at http://www.newyorkfed.org//markets/talf_faq.html.

[89] For example, the December 2008 Blue Chip Consensus Forecast, compiled from predictions of 50 economists, foresees a 1.1% decline in real GDP. Blue Chip Economic Indicators, *Top Analysts' Forecasts of the U.S. Economic Outlook for the Year Ahead*, vol. 33, no. 12, December 10, 2008. Most of the forecasters surveyed by Blue Chip based their predictions on the presumption that Congress will pass a major fiscal stimulus package. The January 2009 CBO baseline, which does not presume a fiscal stimulus package will pass, projects a 2.2% decline in GDP in FY2009. U.S. Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2009 to 2019*, January 7, 2009, available at http://www.cbo.gov/ftpdocs/99xx/doc9957/01-07-Outlook.pdf.

Additionally, many investors began to fear that residential mortgage-backed securities (RMBS) were much riskier than anticipated, and capital markets became reluctant to put more money into the residential sector. A credit crunch, partially sparked by concerns over RMBS, emerged in August 2007. Foreclosure rates have climbed, as refinancing options for many homeowners dwindled, putting added downward pressure on home prices. High levels of fixed residential investment over the past decade have created large inventories of new houses, which may dampen incentives for future construction. All of these variables contributed to declines in private investment, which are not expected to reverse in the near term.

The United States has run trade deficits since the mid-1980s. In recent years, the trade deficit has narrowed (so that net exports are less negative) in part because the dollar has weakened relative to most major currencies. Sharply higher energy prices in 2008 offset many of those gains, but falling energy prices in late 2008 may help shrink the trade deficit further. As trading partners have begun to face their own economic problems, demand for American exports may fall. American consumers, however, may buy fewer imported goods during the recession. The combined effect on net exports is likely to be mixed, causing them to be an ineffective source of stimulus.

Most macroeconomists believe that reductions in private consumption and investment will cut economic growth unless debt-financed government spending increases to provide substantial fiscal stimulus. Other measures, such as investment incentives or broad tax cuts may also promote economic growth, although some economists believe debt-financed government spending is a more effective stimulus to aggregate demand in a recession.

Applying Fiscal Policy

Standard applied macroeconomic theory suggests that fiscal policy is more effective when short-term interest rates are extremely low. Fiscal policy therefore plays an especially important role in economic policy during economic downturns. The amount and composition of the federal spending along with the size of the federal deficit are key fiscal policy instruments.

During economic downturns, government revenues fall and expenditures rise as more people become eligible for unemployment insurance and income support programs, causing deficits to increase or surpluses to shrink. These effects, known as “automatic stabilizers,” provide a countercyclical stimulus in the short run without the need for new legislative action. Automatic stabilizers, however, probably cannot provide enough fiscal stimulus to pull the current economy out of a recession.

Higher government spending financed by borrowing, above and beyond the automatic stabilizer effects, provides a powerful fiscal policy tool that can help counteract recessions. A countercyclical fiscal policy, in which taxes are cut or spending is increased, can dampen economic fluctuations and limit the depth of economic downturns.

Debt-financed government spending is one component of Keynesian demand management—the theory that government can stabilize the economy, or at least moderate economic fluctuations by using fiscal policy to offset changes in private consumption and investment. The federal government, according to that theory, can shift buying power from future to the present more easily than firms and households, and is therefore better able to maintain stable economic conditions. In the view of most macroeconomists, Keynesian demand management, as one component of a well-designed macroeconomic policy regime, can increase economic efficiency by preventing labor and capital goods from becoming unnecessarily idle during economic downturns.

Reducing government deficits when economic growth is robust is another key component of a well-designed macroeconomic policy regime. In this respect, responsible fiscal policy requires that spending in economic downturns be paid for by future spending reductions and/or tax increases. Of course, higher taxes in the future reduce private consumption and cuts in future government programs reduce consumption of publicly provided goods and services. If debt is not reduced, higher interest rates may reduce future investment.

Caveats Regarding Fiscal Stimulus

Some economists have criticized the logic of Keynesian demand management and the discretionary application of fiscal spending by governments. Some have contended that Keynesian fiscal policy arguments do not take sufficient account of choices made by firms and individual households. Others argue that Keynesian demand management policies can create administrative problems and note that mustering the political will to maintain a sustainable fiscal policy by reducing spending over the economic cycle can be hard.

Some economists have argued that not just the government, but also households can shift spending through time via borrowing and saving. Thus households, according to some, may counteract government fiscal policies by saving during economic downturns, thus further reducing consumption. Other economists note that many households are not in a position to choose between saving and consuming and that the low interest rates typically found in economic downturns may weaken incentives to save. Some evidence suggests that high-income households may take savings measures that offset government fiscal policies, but low-income households are, in general, less able to rearrange their finances in ways that would reduce the effectiveness of fiscal policy.

The argument for Keynesian demand management presumes that governments run surpluses during economic expansions to repay debt accumulated when applying fiscal stimulus during economic downturns. Critics of deficit-financed fiscal policy argue that policymakers are more willing to raise government spending when economic growth slows than to cut spending when growth accelerates.[90] Certain federal programs or increased spending, enacted during economic downturns, may remain in place after they are no longer necessary because of the interests of influential beneficiaries rather than overall economic welfare. On the other hand, some programs created during the Great Depression such as Social Security, have helped make many families less vulnerable to economic shocks.

Few economists believe that large changes in fiscal policy designed to counterbalance short-term economic downturns can be timed precisely. Certainly, macroeconomists are more skeptical about the ability to fine-tune fiscal policy than their predecessors a generation ago. Most macroeconomists nonetheless believe fiscal policy is an important tool during deep or prolonged periods of slow or negative growth.

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[90] Milton Friedman, *Capitalism and Freedom* (Chicago: Univ. of Chicago Press, 1962), pp. 75-84.

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