The Committee for a Responsible Federal Budget

Analysis of the President's FY 2016 Budget
February 2, 2015

Today, the President released his FY 2016 budget, laying out his priorities and proposals for the coming year. The budget includes policies and initiatives to reform immigration, taxes, and Medicare, while promoting early and higher education, reducing low-income and middle-class taxes, repealing a portion of future sequester cuts, and implementing other tax and spending changes.

Our main findings from the budget are:

- The President's budget includes sufficient revenue and spending cuts to pay for his new initiatives and reduce deficits by about ***$930 billion*** relative to current law over the next decade. Relative to the President's baseline, the budget includes $2.2 trillion of deficit reduction.
- Based on its own projections, debt under the President's budget would remain relatively stable as a share of GDP, reaching ***73 percent of GDP*** in 2025 compared to 74 percent today. In dollar terms, debt will rise from about $13 trillion today to over $20 trillion by 2025.
- Deficits under the President's budget would remain steady over the course of the decade at about ***2.5 percent of GDP*** each year.
- Between 2015 and 2025, spending will grow from 20.9 percent of GDP to 22.2 percent and revenue from 17.7 percent of GDP to 19.7 percent. Historically, they have averaged 20.1 and 17.4 percent, respectively.
- Interest costs alone, in the budget, will grow from under $230 billion (1.3 percent of GDP) today to nearly $800 billion (2.8 percent of GDP) in 2025.

The President's budget should be commended for responsibly identifying tax and spending offsets sufficient to pay for new spending and tax cuts, and setting aside additional savings for deficit reduction beyond that.

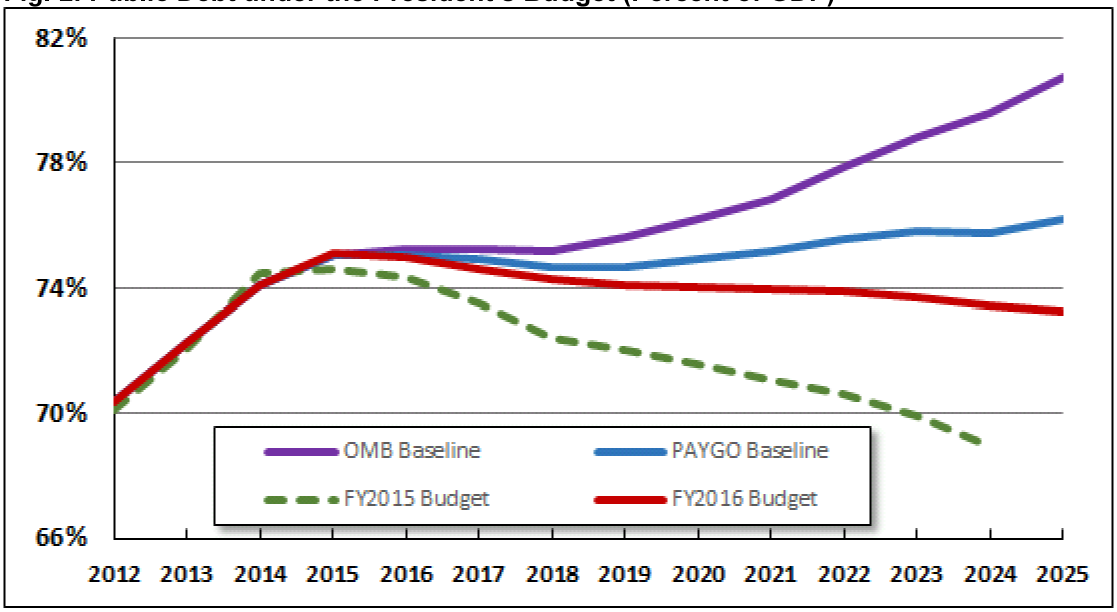
However, the budget does far too little to reduce current debt levels nor slow the growth of entitlement spending over the long-run. Under the President's budget, debt remains roughly twice as high as in 2007 and higher than any time in history other than around World War II. Meanwhile, Social Security and Medicare remain on paths toward insolvency and both programs – along with interest spending – will continue to grow rapidly.

Ultimately, significant entitlement reforms will be necessary to put the debt on a sustainable path. And the longer we wait to enact these reforms, the larger and more abrupt they will need to be.

Spending, Revenue, Deficits, and Debt in the President's Budget

Under the President's Budget, OMB estimates debt would continue to grow in nominal dollar terms in the President's budget – from about $13 trillion today to over $20 trillion by 2025 – and will fall very slightly as a share of the economy. Specifically, OMB projects the debt to GDP ratio would decline from 74 percent of GDP at the end of 2014 to about 73 percent by 2025. By comparison, 2025 debt levels would be nearly 81 percent of GDP in 2025 under the OMB baseline and 76 percent under current law with the President's war drawdown.

Fig. 1: Public Debt under the President's Budget (Percent of GDP)



* PAYGO baseline assumes continuation of current law, including inflation adjustments of the 2021 post-sequester discretionary levels, along with a drawdown in war spending as in the President's budget.

Relatively stable debt levels under the President's budget result from budget deficits that would remain at about 2.5 percent of GDP over the course of the decade, falling from 3.2 percent in 2015. In order to maintain these deficit levels, both spending and revenue would grow significantly over the coming decade.

Spending under the President's budget would rise from 20.9 percent of GDP in 2015 to 21.7 percent by 2020 and 22.2 by 2025. This growth is the result not only of new spending initiatives in the President's budget, but also rising entitlement costs as the population ages as well as growing interest costs. Indeed, Social Security, Medicare, and Medicaid together under the President's budget will grow by 1.3 percent of GDP over the next decade, while interest spending will grow by 1.6 percent of GDP.

Revenue under the President's budget would also grow substantially, rising from 17.7 percent of GDP in 2015 to 19.7 by 2025. The bulk of this increase comes from the individual income tax, both as a result of "real bracket creep" built into the code as well as a number of tax increases proposed in the President's budget.

At 19.7 and 22.2 percent of GDP in 2025, respectively, revenue and spending would both be well higher than the 50-year historical averages of 17.4 and 20.1 percent of GDP. They would also both be higher than if the administration's proposals were not enacted; under current law with the President's war drawdown, revenue and spending would be 18.7 and 22.0 percent of GDP, respectively. A portion of this difference – 0.3 and 0.2 percentage points of GDP, respectively – is due to the higher revenue and spending from demographic changes under immigration reform.

Fig. 2: Budget Projections (Percent of GDP)

Fiscal Year	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	Ten-Year^
REVENUES													
FY2016 Budget	17.5%	17.7%	18.7%	19.1%	19.1%	19.2%	19.3%	19.3%	19.4%	19.5%	19.6%	19.7%	19.3%
OMB Baseline	17.5%	17.7%	18.2%	18.2%	18.2%	18.2%	18.2%	18.4%	18.5%	18.6%	18.7%	18.7%	18.4%
PAYGO Baseline*	17.5%	17.7%	18.2%	18.1%	18.2%	18.1%	18.2%	18.3%	18.5%	18.6%	18.7%	18.7%	18.4%
CBO Baseline	17.5%	17.7%	18.4%	18.2%	18.1%	18.1%	18.0%	18.1%	18.1%	18.2%	18.2%	18.3%	18.2%
FY2015 Budget	17.3%	18.3%	18.6%	18.9%	19.0%	19.0%	19.2%	19.4%	19.6%	19.8%	19.9%	N/A	19.2%
OUTLAYS													
FY2016 Budget	20.3%	20.9%	21.3%	21.4%	21.5%	21.6%	21.7%	21.9%	21.9%	22.0%	22.0%	22.2%	21.7%
OMB Baseline	20.3%	20.9%	21.1%	20.9%	20.9%	21.2%	21.5%	21.7%	22.4%	22.4%	22.4%	22.9%	21.7%
PAYGO Baseline*	20.3%	20.8%	20.9%	20.7%	20.6%	20.9%	21.1%	21.3%	21.7%	21.6%	21.5%	22.0%	21.3%
CBO Baseline	20.3%	20.3%	20.8%	20.7%	20.7%	21.1%	21.4%	21.6%	22.0%	21.9%	21.8%	22.3%	21.5%
FY2015 Budget	21.1%	21.4%	21.4%	21.1%	20.9%	21.3%	21.4%	21.5%	21.7%	21.6%	21.5%	N/A	21.4%
DEFICITS													
FY2016 Budget	2.8%	3.2%	2.5%	2.3%	2.3%	2.4%	2.5%	2.6%	2.6%	2.5%	2.4%	2.5%	2.5%
OMB Baseline	2.8%	3.2%	2.8%	2.8%	2.7%	3.1%	3.3%	3.3%	3.9%	3.8%	3.7%	4.1%	3.4%
PAYGO Baseline*	2.8%	3.2%	2.7%	2.6%	2.5%	2.8%	2.9%	3.0%	3.2%	3.0%	2.8%	3.3%	2.9%
CBO Baseline	2.8%	2.6%	2.5%	2.5%	2.6%	3.0%	3.3%	3.5%	3.9%	3.8%	3.6%	4.0%	3.3%
FY2015 Budget	3.7%	3.1%	2.8%	2.3%	1.9%	2.3%	2.2%	2.1%	2.1%	1.8%	1.6%	N/A	2.2%
DEBT													
FY2016 Budget	74.1%	75.1%	75.0%	74.6%	74.3%	74.1%	74.0%	74.0%	73.9%	73.7%	73.5%	73.3%	N/A
OMB Baseline	74.1%	75.1%	75.2%	75.2%	75.2%	75.6%	76.2%	76.8%	77.9%	78.9%	79.6%	80.8%	N/A
PAYGO Baseline*	74.1%	75.0%	75.1%	74.9%	74.6%	74.7%	74.9%	75.2%	75.6%	75.8%	75.8%	76.2%	N/A
CBO Baseline	74.1%	74.2%	73.8%	73.4%	73.3%	73.7%	74.3%	75.0%	76.1%	76.9%	77.7%	78.7%	N/A
FY2015 Budget	74.4%	74.6%	74.3%	73.5%	72.4%	72.0%	71.6%	71.1%	70.6%	69.9%	69.0%	N/A	N/A

* PAYGO baseline assumes continuation of current law, including inflation adjustments of the 2021 post-sequester discretionary levels, along with a drawdown in war spending as in the President's budget.

Proposals in the President's Budget

Although the President's budget does too little to put debt on a downward path over the medium- and long-term, it sets and maintains and important precedent by paying for its new proposed initiatives. Abiding by pay-as-you-go rules will be important in the coming year, not only with regards to new tax cuts and spending increases, but when paying for the re-instatement of existing provisions as will be necessary in many of this year's upcoming fiscal speed bumps.

The President's budget includes a number of policies and offsets. Relative to his own baseline, the budget includes $1.2 trillion of costs and $3.4 trillion of savings, for net deficit reduction of $2.2 trillion. Relative to a "PAYGO baseline"[^] which reflects current law with a war drawdown, the budget includes $1.8 trillion of costs and $2.7 trillion of savings, for net deficit reduction of $930 billion. Below we describe some of the major policies.

New Spending Initiatives – The President's budget includes several major initiatives. Among them, it would work to establish universal pre-school, expand access to child care, provide federal funding for community college tuition, reform unemployment benefits, and fully fund as well as increase spending from the highway trust fund through 2021. The budget also identifies offsets for these initiatives – an increase in the cigarette tax to fund universal pre-school, a one-time tax on foreign income as part of business tax reform to pay for transportation spending, and various tax changes to fund the other initiatives.

Sequestration – Under current law, discretionary spending caps for 2016 through 2021 are set by the sequestration cuts in the Budget Control Act of 2011, and for FY 2016 are scheduled to rise by about $2 billion relative to the caps set by the Ryan-Murray Bipartisan Budget Act for FY 2015. The President's budget would repeal the non-defense discretionary sequester cuts for FY 2016 and 70 percent of the defense sequester cuts, for a total increase of $74 billion, split evenly.

Beyond 2016, the President's budget would grow discretionary spending somewhat slower than inflation, continuing to spend more than under sequestration but by decreasing amounts over time. By 2021, the last year of the sequester, the budget would effectively retain 65 percent of the defense sequester and 45 percent of the non-defense discretionary sequester. Beyond 2021, discretionary spending would grow by about 2 percent annually.

The President would also fully repeal the sequester cuts to mandatory spending, including the 2 percent reduction in Medicare payments to providers and insurers.

Savings in other parts of the budget – including reductions in farm subsidies and the closure of the "carried interest" loophole – would offset the cost of sequester relief.

[^] PAYGO baseline assumes continuation of current law, including inflation adjustments of the 2021 post-sequester discretionary levels, along with a drawdown in war spending as in the President's budget.

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Fig. 3: Fiscal Impact of Proposals in the President's FY 2016 Budget (2015-2025)

	OMB Baseline	PAYGO Baseline^
New Spending Initiatives	**$530 billion**	**$530 billion**
Fund universal pre-K, other children's initiatives	$90 billion	$90 billion
Expand access to child care	$80 billion	$80 billion
Offer free community college, increase higher ed spending	$100 billion	$100 billion
Increase surface transportation spending	$115 billion	$115 billion
Reform unemployment benefits	$55 billion	$55 billion
Other Spending Increases	$90 billion	$90 billion
Sequester Relief	**$280 billion**	**$590 billion**
Reduce discretionary sequestration cuts	$325 billion	$325 billion
Grow discretionary spending by ~2% after 2021	-$230 billion	$80 billion
Repeal mandatory spending sequester	$185 billion	$185 billion
New Tax Breaks	**$310 billion**	**$475 billion**
Extend expiring child tax credit expansion	$0 billion	$80 billion
Extend and expand EITC	$65 billion	$90 billion
Reform, extend, and expand education tax breaks	$45 billion	$105 billion
Expand child care incentives, provide second-earner credit	$140 billion	$140 billion
Enact other tax breaks	$60 billion	$60 billion
Revenue Increases	**-$1,845 billion**	**-$1,845 billion**
Limit Value of Tax Preferences for High Earners	-$640 billion	-$640 billion
Use one-time tax on foreign income for highway shortfall	-$270 billion	-$270 billion
Reform and Increase Estate Tax	-$215 billion	-$215 billion
Increase and reform capital gains taxes	-$210 billion	-$210 billion
Impose a financial fee	-$110 billion	-$110 billion
Reduce the tax gap	-$85 billion	-$85 billion
Reform and increase unemployment taxes	-$60 billion	-$60 billion
Increase tobacco taxes and index to inflation	-$95 billion	-$95 billion
Other revenue	-$160 billion	-$160 billion
Health Care Reforms	**-$400 billion**	**-$290 billion**
Reform Sustainable Growth Rate (SGR)	$45 billion	$155 billion
Reduce Spending on Prescription Drugs	-$155 billion	-$155 billion
Reduce spending on post-acute care	-$105 billion	-$105 billion
Increase means-testing of Medicare premiums	-$65 billion	-$65 billion
Increase cost-sharing in Medicare	-$10 billion	-$10 billion
Enact delivery system reforms, strengthen IPAB	-$75 billion	-$75 billion
Reduce bad debts, GME, and MA spending	-$95 billion	-$95 billion
Make health care investments and other health changes	$55 billion	$55 billion
Other Mandatory Savings	**-$120 billion**	**-$120 billion**
Reduce Farm Subsidies	-$15 billion	-$15 billion
Increase PBGC premiums	-$20 billion	-$20 billion
Improve program integrity	-$35 billion	-$35 billion
Other savings	-$45 billion	-$45 billion
Additional Cuts and Reforms	**-$695 billion**	**-$155 billion**
Enact Immigration Reform	-$160 billion	-$160 billion
Reduce Overseas Contingency Spending from Baseline	-$555 billion	$0
Other Adjustments	$20 billion	$5 billion
Net Interest	**-$265 billion**	**-$120 billion**
Total Change in Deficit	**-$2,205 billion**	**-$930 billion**

Note: Numbers rounded to the nearest $5 billion and may not add due to rounding. Negative numbers reduce the deficit. Estimates by CRFB staff, utilizing OMB projections.

New and Continued Tax Breaks – The President's budget would extend several existing tax breaks, while creating a number of new ones. The budget would make permanent or expand several tax credits, including the child tax credit, EITC, and education tax credit expansions expiring in 2017. Specifically, it would continue a larger EITC for families with three children, prevent the return of an EITC marriage penalty, and increase the refundable portion of the American Opportunity Tax Credit (AOTC) for college tuition. Although the President's budget does not offer a specific pay-for for the extension of existing tax breaks, it includes sufficient revenue to fully pay for these costs.

The budget would also triple an existing tax credit for childcare expenses and revive a "second earner" tax credit that was removed in 1986. These new provisions would be paid for mainly by reducing the benefits of tax expenditures for high earners, increasing taxation of capital gains (including by reducing the benefit of "step up basis" at death), imposing a tax on large financial institutions, and closing various tax loopholes.

Revenue Increases – The budget includes substantial new revenue to pay for the President's new initiatives and help reduce the deficit. In addition to the changes to capital gains, cigarette taxes, and financial fees mentioned earlier, the budget would reduce tax preferences broadly for higher earners by limiting the benefit of certain tax deductions and exclusions to the 28 percent bracket, imposing a "Buffett Rule" to ensure very high-earners pay at least a 30 percent tax rate. In addition, the budget would raise the estate tax back to its 2009 levels, reduce a variety of tax breaks and loopholes, improve tax compliance, and make other changes.

Business Tax Reform – The President's budget calls for business tax reform that is revenue neutral over the long-run, proposing several business tax expenditures to cut to pay for a lower business tax rate. The budget would permanently extend or expand several breaks for businesses, research, and clean energy. Internationally, the budget proposes a 19 percent minimum tax on worldwide earnings and a one-time 14 percent rate on previously untaxed foreign earnings as part of the transition to the new international system. The one-time revenue from the international provisions is used to fund the President's transportation initiatives, as described earlier.

Health Care Reforms – The budget includes a number of changes to Medicare, Medicaid, and new investments in the health care workforce, composed almost entirely of policies from previous budgets. The President's budget calls for replacing the Sustainable Growth Rate (SGR) formula – which is set to cut Medicare physician payments by 21 percent in April – with one that promotes new payment models and more efficient delivery of care, in a manner similar to the recent bipartisan, Tricommittee replacement bill, at a cost somewhat higher than a simple payment freeze.

Importantly, in line with precedent, the President offers sufficient health care savings to offset this new cost, plus another $290 billion to help slow the growth of federal health care costs. Nearly all of the savings come from the Medicare program, including delivery system reforms new to this year's budget to reform incentives to provide care in the least-intensive ambulatory settings ($30 billion) and reforms to improve patient engagement in the Accountable Care Organization programs.

As in previous budgets, the largest savings this year come from prescription drugs, primarily through requiring minimum drug rebates for low-income Part D enrollees, followed by significant reductions to annual payment updates for post-acute care providers. The budget would also reduce subsidies to high-income Medicare beneficiaries by increasing means-tested premiums, enact a few reforms to the Medicare benefit structure, and reduce Medicare provider payments in a number of areas. Additionally, the budget would pursue a number of delivery system reforms to improve incentives in the Medicare program, such as bundling payments for post-acute care, eliminating loopholes to the in-office ancillary services exemption, and fixing payment for Part B drugs to remove the current incentive to administer the highest-cost drug available.

Other Mandatory Savings – The budget's savings in other mandatory programs include reducing subsidies in the crop insurance program, allowing the Pension Benefit Guaranty Corporation to raise premiums to remain solvent, and increasing aviation fees to cover a greater portion of security costs. Finally, there are dozens of proposals with small amounts of savings to reduce fraud, inefficiencies, and overpayments, including in the Social Security program.

Immigration Reform – The President's budget calls for comprehensive immigration reform, along the lines of the 2013 Senate-passed bill**.** By increasing the size of the population and labor force, immigration reform should increase both spending on those individuals as well as revenue collected from them. As a result, OMB assumes revenue would rise by nearly $460 billion over the next decade and spending by $300 billion, resulting in just under $160 billion in total savings.

War Spending –The President's budget requests $58 billion for overseas contingency operations for FY 2016, somewhat less than the $73.5 billion appropriated this year. Beyond 2016, the budget assumes $27 billion of war spending a year through 2021 and $0 of spending beyond that, reflecting the continued withdrawing of troops from abroad. Because baseline conventions assume spending will grow with inflation, the budget counts spending below the baseline as deficit reduction. However, these savings should be treated with skepticism for two reasons. First, a large portion of these savings reflect a war drawdown already in place rather than new additional spending cuts. And secondly, the spending levels may be unrealistically low in the longer-term and not reflective of a policy that this President nor his successor is able to abide by, particularly the assumption that the U.S. will never spend on any war effort after 2021. We will address these issues further in future analysis.

Economic Assumptions

Economic projections and assumptions are an important determinant of the country's fiscal health, and OMB's projections of robust economic growth are likely a major contributor to the projections of a declining debt-to-GDP ratio.

Over the next decade, OMB projects average real growth of 2.5 percent per year, compared to CBO's estimate of 2.3 percent. This difference is due to a combination of factors, including that OMB projects a more robust recovery than CBO, assumes the economy reaches potential (CBO assumes it remains modestly below potential to account for the likelihood of a recession), and assumes faster growth in potential GDP – due at least in part to its immigration reform policy.

In 2015 and 2016, OMB projects real GDP will grow by 3.1 and 3.0, respectively, compared to 2.9 and 3.0 percent in CBO's projections, 3.2 and 2.9 percent in the Blue Chip consensus estimates, 2.8 and 2.8 in Federal Reserve projections, and 3.5 and 3.3 percent assumed by OMB in last year's Mid-Session Review. By the end of the budget window, OMB projects annual growth of 2.3 percent, whereas CBO projects growth closer to 2.1 percent.

Fig. 4: Economic Projections (Calendar Year)

Calendar Year	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	Ten – Year^
Real GDP Growth												
FY2016 Budget	3.1%	3.0%	2.8%	2.6%	2.4%	2.3%	2.3%	2.3%	2.3%	2.3%	2.3%	2.5%
CBO (January)	2.9%	3.0%	2.7%	2.2%	2.1%	2.2%	2.2%	2.2%	2.1%	2.1%	2.1%	2.3%
Blue Chip	3.2%	2.9%	2.7%	2.5%	2.4%	2.4%	2.3%	2.3%	2.3%	2.3%	2.3%	2.5%
Federal Reserve†	2.8%	2.8%	2.9%	N/A								N/A
FY2015 OMB MSR	3.5%	3.3%	2.8%	2.5%	2.4%	2.4%	2.3%	2.3%	2.3%	2.3%	N/A	2.6%
Inflation (CPI)												
FY2016 Budget	1.4%	1.9%	2.1%	2.2%	2.3%	2.3%	2.3%	2.3%	2.3%	2.3%	2.3%	2.2%
CBO (January)	1.1%	2.2%	2.3%	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%
Blue Chip	0.8%	2.2%	2.3%	2.4%	2.3%	2.3%	2.3%	2.3%	2.3%	2.3%	2.3%	2.2%
Federal Reserve*	1.3%	1.9%	1.9%	N/A								N/A
FY2015 OMB MSR	2.0%	2.1%	2.2%	2.3%	2.3%	2.3%	2.3%	2.3%	2.3%	2.3%	N/A	2.2%
Unemployment Rate												
FY2016 Budget	5.4%	5.1%	4.9%	4.9%	5.0%	5.1%	5.2%	5.2%	5.2%	5.2%	5.2%	5.1%
CBO (January)	5.6%	5.4%	5.3%	5.4%	5.5%	5.5%	5.5%	5.5%	5.4%	5.4%	5.4%	5.4%
Blue Chip	5.5%	5.1%	5.2%	5.2%	5.3%	5.3%	5.4%	5.4%	5.4%	5.4%	5.4%	5.3%
Federal Reserve†	5.3%	5.1%	5.1%	5.2% to 5.5%								N/A
FY2015 OMB MSR	5.7%	5.5%	5.4%	5.4%	5.4%	5.4%	5.4%	5.4%	5.4%	5.4%	N/A	5.4%
Gross Domestic Product (Fiscal Year, Trillions)												
FY2016 Budget	$18.0	$18.8	$19.7	$20.6	$21.5	$22.5	$23.5	$24.5	$25.5	$26.6	$27.8	N/A
CBO (January)	$18.0	$18.8	$19.7	$20.6	$21.4	$22.3	$23.3	$24.3	$25.3	$26.4	$27.5	N/A

^ Ten-year figures refer to 2016-2025 for CBO, FY 2016 budget, and Blue Chip data and 2015-2024 for the MSR.

* Numbers reflect PCE index, which is on average 0.2 to 0.3 percentage points lower than the CPI.

† Figures for the Federal Reserve's growth and unemployment projections for 2015-2017 reflect average of the central tendency. Growth is Q4 to Q4.

As a result of this growth, OMB projects the unemployment rate will fall from 5.6 percent today to roughly 4.9 percent by 2017 and then stabilize at about 5.2 percent. By comparison, CBO projects the unemployment rate will settle between 5.3 and 5.5 percent, as do the Blue Chip consensus estimates.

Overall, the President's economic projections are somewhat more optimistic than CBO's -- likely in large part due to immigration reform – and may therefore project modestly better debt numbers than what CBO would find in a re-estimate.

Conclusion

The President's budget responsibly identifies offsetting revenue increases and spending reductions to pay for new initiatives. Encouragingly, the President's budget also goes beyond these offsets by proposing health, tax, and immigration reforms that would reduce deficits further.

Yet despite this, medium-term debt levels remain far too high under the President's budget, barely declining from current record-high levels not seen other than briefly after World War II. Meanwhile, the budget does almost nothing to address Social Security and too little to slow health care cost growth, the drivers of rising long-term debt.

Failure to make our entitlement programs sustainable and put the debt on a clear downward path over the long-run will ultimately slow economic growth, increase cost of living, reduce the nation's flexibility to address future needs, leave benefit levels of important support programs in jeopardy, and increase the ultimate risk of fiscal crisis.

Though the President deserves much praise for paying for all of his new initiatives – and we strongly urge Congress to follow his lead – his budget simply doesn't do enough to put our record-high debt levels on a sustainable long-term path.

We hope that Congress and the President will work together over the next year, combining the best parts of this budget with other reforms in order to truly restore the country's fiscal and economic health.