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THE 2009 BUDGET DEFICIT
How did we get here?

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In March 2009, the Congressional Budget Office (CBO) projected a baseline deficit of $1.67 trillion, or 11.9% of gross domestic product (GDP) for fiscal year 2009. This was up from a deficit of $459 billion in fiscal year 2008, or 3.2% of GDP, and a reversal from surpluses a decade ago. These growing federal deficits are the result of four primary factors: the 2001 and 2003 tax changes; the external effects of the current recession; increased Bush-era spending, including spending on the wars in Iraq and Afghanistan; and the various short-term responses to the recession, including the American Recovery and Reinvestment Act (ARRA) and financial market bailouts. The recession itself is the most important cause, responsible for just under half of the deterioration. The ARRA constitutes less than a tenth of the total deterioration since 2001.

This Issue Brief examines the details and causes of the current budget deficit and the role the current recession has played. The years between 2001 and 2007 saw a large deterioration in the budget balance, which was driven chiefly by legislated policy changes. The Bush-era tax cuts are the largest contributors to this period of policy-induced increases to the federal budget deficit. Despite these policy changes, the federal budget deficit remained relatively modest in 2007. However, since the current recession began in 2008, the contracting economy and the explicitly short-term policy responses enacted to address it have caused an enormous, but temporary increase in the deficit. More specifically, we find that that:

- In 2001, the federal budget was in surplus by $281 billion (2.8% of GDP). Further, the CBO estimated surpluses would continue through 2010 in their baseline projection. (See box below, *A Note on Baseline Projections*). In 2009 the most recent forecast is for a federal budget deficit of $1.67 trillion (11.9% of GDP) — though further economic deterioration may increase this total.

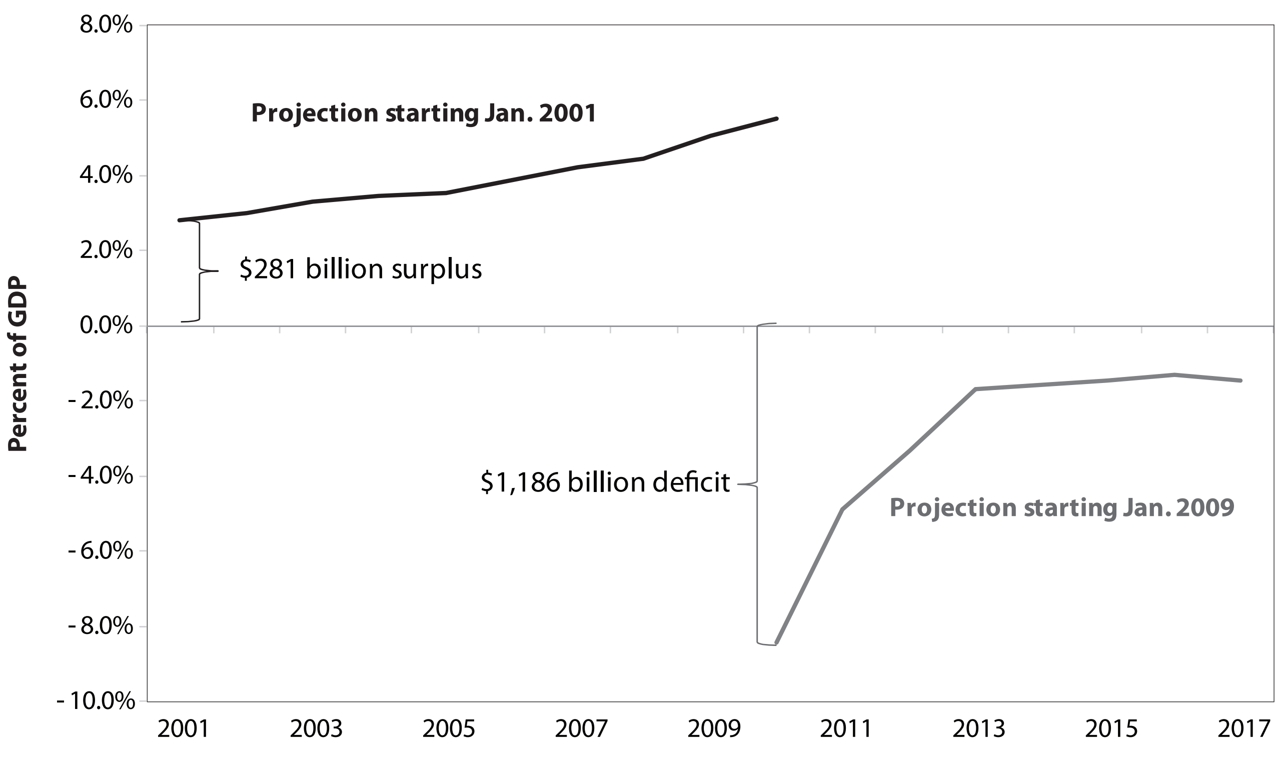
- Of this $2 trillion reversal of fortune, almost half (42%) was due to legislative changes made prior to 2009 (the Bush-era tax cuts explain about a third of these legislative influences), 42% was due to economic and technical factors — a reflection of the recession's effect on the deficit — just since the start of the current recession, while only 7.6% can be accounted for by the American Recovery and Reinvestment Act (ARRA).

- Since 2007, before the recession began, the CBO baseline projection for fiscal year 2009 has deteriorated by $1.5 trillion, or 10.9% of GDP.
  - Of that change, the largest share can be attributed to the mechanical effects of the recession on taxes and spending, as well as the explicitly short-term policy responses to it: 45% of the $1.5 trillion change was due to economic or technical factors (which include subsidies for Fannie Mae and Freddie Mac); 21% was due to non-recovery act legislative changes; 22% was due to the Troubled Assets Relief Program (TARP); and 12% was due to the American Reinvestment and Recovery Act.
  - Non-recovery related legislative spending increased relative to the March 2007 baseline by just $221 billion, or 1.6% of GDP. The bulk of this increase reflects increased defense spending.

The analysis below first examines the change in budget outlooks from 2001 through 2009 and how this has been influenced by legislation and the economy. Next it examines the details of the more recent estimates of the fiscal year 2009 deficit and how those estimates have changed since the pre-recession estimates in 2007.

FIGURE A

10-year budget baseline projections, 2001 vs. 2009



SOURCE: Congressional Budget Office.

A decade of deterioration

The 2000s began with the federal government running a surplus; in fact, President Bush was the first president in modern times to begin a term with a surplus. The CBO projected at the time that the $281 billion surplus from 2001 would grow to $710 billion in 2009. **Figure A** shows the 10-year budget baseline projections made in 2001 and contrasts this with the projected 2009 deficit made this past January.

Even since the January 2009 estimate (shown in Figure A), the projected 2009 deficit has continued to grow, with the most recent CBO estimate (March 2009) putting the deficit at $1.67 trillion for 2009 — this increase is primarily due to economic and technical factors ($286 billion) and legislation largely enacted to stimulate the economy ($195 billion).

A NOTE ON BASELINE PROJECTIONS

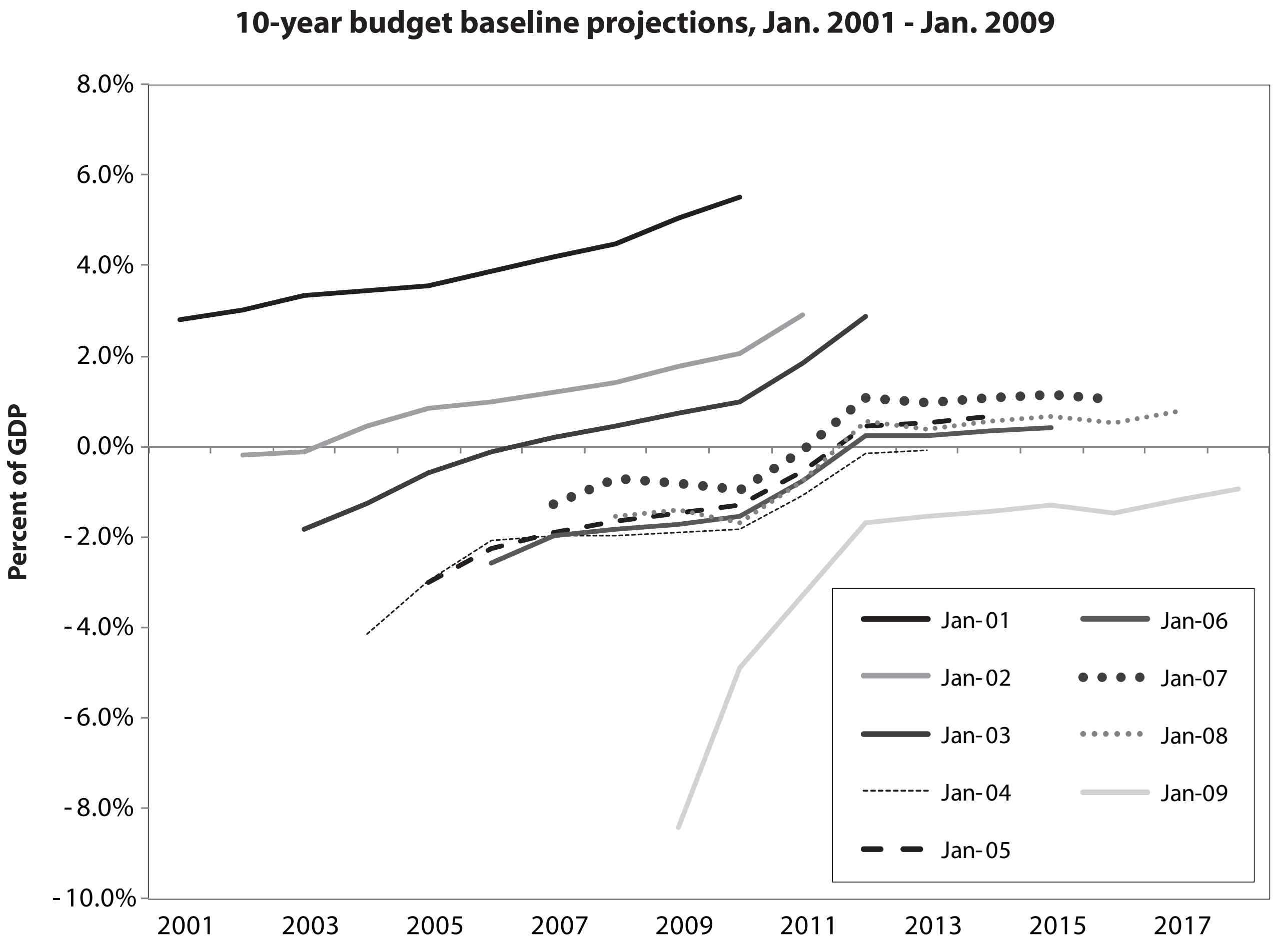
When looking at the difference between CBO baseline estimates and actual budget outcomes, it may appear that the CBO is simply bad at projecting. While many economic forecasts by both private and government economists are indeed often wrong, the CBO baseline should not be confused with a predictive forecast. A forecast is a prediction of some measure of economic performance, whereas the CBO baseline is intended to be a reflection of the budget *under current law*. It shows what would happen to the budget over a certain time period without any changes to policy. Baselines, then, are a tool by which we measure the incremental budgetary affects of changes to policy.

It is important to note, however, that in order to make the 10-year projections, CBO must include an economic forecast, since economic performance affects the budget through revenue collections or spending. Each year the CBO adjusts the budget baseline to not only reflect new laws, but also to include an updated economic outlook. That means that changes to the baseline are caused by either new legislation or a different economic environment. **Figure B** shows the evolution of January baselines from 2001-09.

The majority of change in 10-year outcomes through 2008 occurred between 2001 and 2004, each year progressively worse than the one prior. Between 2005 and 2008, there was little change to the baseline. In 2009, the baseline falls primarily due to the change in economic conditions and the policy response to those changes.

The cumulative changes from 2001 through 2009 have led to a total deterioration equal to 17% of GDP for fiscal year 2009 (see **Figure C** and **Table 1**). Of that increase, 42.3% of the total was due to economic and technical factors (i.e., adjustments made to the baseline because of changes in economic conditions or changes in CBO methodology): a reflection of the current recession; 9.3% was due to increased defense spending, chiefly for the wars in Iraq and Afghanistan; and 20.6% was due to other spending. The ARRA and TARP programs added 7.6% and 7.7% of the total, respectively. From 2001 through 2008, the deterioration of the baseline is primarily a result of the policies enacted before the current crisis occurred — and still account for 42.4% of the fiscal year 2009 deficit deterioration since 2001.

FIGURE B



SOURCE: Congressional Budget Office.

Recent events

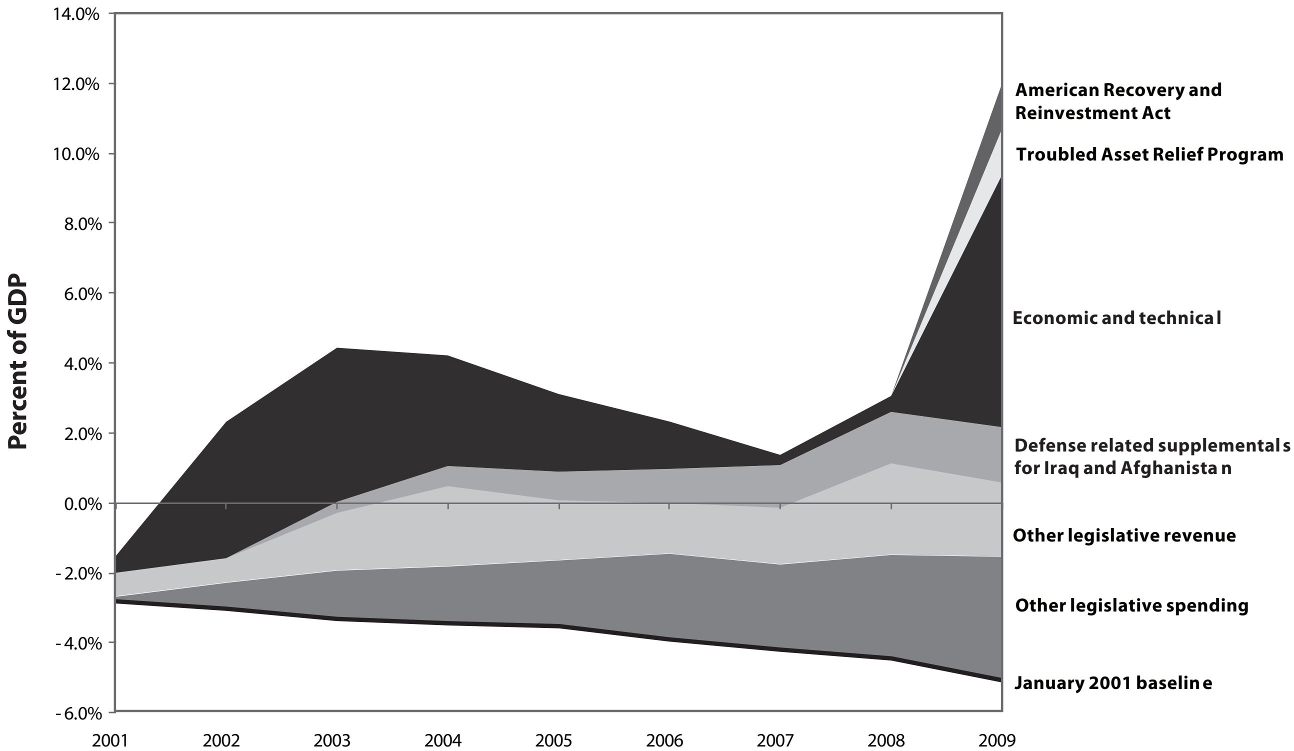
As noted above, the current economic downturn is having a significant impact on the deficit. Looking only at more recent changes in the baseline estimates, we find that 44.9% of the deterioration of the 2009 deficit since first estimated in March 2007 — pre-recession — is due to economic and technical factors, including the subsidy costs of Fannie Mae and Freddie Mac. ARRA, by itself, represents only 11.8% of the deterioration. Measures enacted in response to the economic crisis — namely ARRA, TARP, and Fannie Mae and Freddie Mac subsidies — represent 51.4% of the total. **Table 2** presents more details.

Figure D shows the changing baseline estimate for the 2009 deficit over two years of forecasts, beginning in March of 2007. Clearly, the weakening economy is the largest factor in driving the 2009 deficit . CBO describes the decrease in estimated economic revenue as a result of a sharp fall in economic activity, lowered salaries and taxable incomes, fallen corporate profits, and a general decrease in withholding and payroll taxes. Additionally, CBO's projections show an expected increase in spending on unemployment compensation and SNAP (food stamps).

Subsidies for Fannie Mae and Freddie Mac make up a large portion of estimated technical changes, increasing the deficit projection by about $270 billion between January 2009 and March 2009. Outlays due to the large number of failed banks, thrifts, and credit unions are also estimated to add to the deficit. According to CBO's January 2009

FIGURE C

Federal budget deficits baseline estimates and cumulative sources of change since January 2001



SOURCE: Authors' analysis of CBO baseline estimates, 2001-09.

economic outlook, lower projected technical revenues are mostly a result of the fall in the stock market with a decrease in estimated capital gains by individuals and corporations, lower individual retirement account distributions, and a decrease in wealth subject to estate tax.

Other legislative changes to the 2009 deficit projection that do not include TARP and ARRA have a very limited role in the increasing deficit since January 2009 and are also largely related to the deteriorating state of the economy. CBO's estimated spending from policies enacted since January 2009 include the Unemployment Compensation Extension Act of 2008 and the reauthorization of Children's Health Insurance Program (CHIP), with both of these measures totaling only about $11 billion.

The Troubled Asset Relief Program (TARP) accounts for about $336 billion added to the current 2009 deficit estimate, while ARRA accounts for about $181 billion. It is also important to note that TARP and the stimulus are designed as short-term policies that will have the greatest impact in fiscal years 2009 to 2011, but will taper off after that.

In total, the bulk of these changes to the most recent 2009 projections are a result of the poor economic climate, while policy measures such as TARP and ARRA make up a much smaller portion.

Conclusion

Given the dire economic situation, the very large increase in the federal budget deficit of the past year and a half is both unavoidable and economically necessary. It is unavoidable because most of the recent deterioration is due to a drop in revenue — from 18.8% of GDP in 2007 to an estimated 15.5% of GDP in 2009 — which is primarily a result of the

TABLE 1

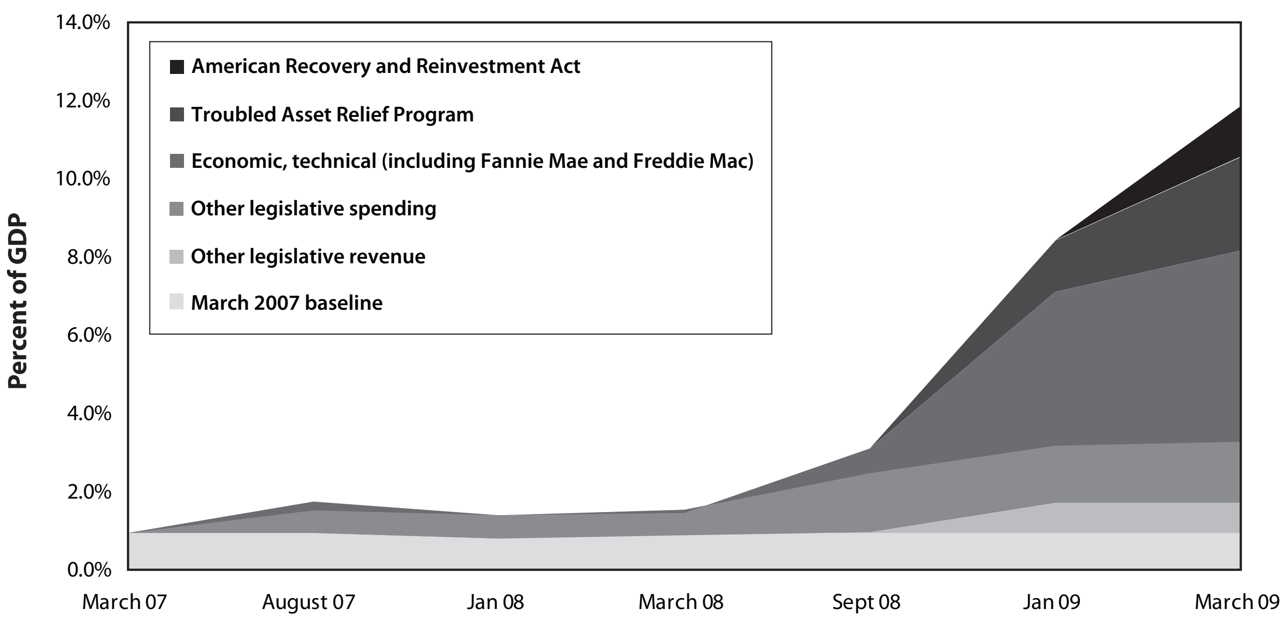
Cumulative sources of change in FY2009 deficit relative to baseline as projected in January 2001

Source	Surplus (+) or Deficit (-) Dollar value (in billions of dollars)	Surplus (+) or Deficit (-) Percent of GDP	Percent of total change since January 2001
January 2001 Baseline	$710	5.1%	
American Recovery and Reinvestment Act	-181	-1.3%	7.6%
Troubled Asset Relief Program	-184	-1.3	7.7
Economic and technical changes	-1011	-7.2	42.3
Other Legislative changes	-1015	-7.2	42.4
Revenue	-299	-2.1	12.5
Spending	-715	-5.1	29.9
Defense supplementals for Iraq and Afghanistan	-221	-1.6	9.3
Other	-494	-3.5	20.6
March 2009 Baseline	-1667	-11.9%	
Economic	-1011	-7.2%	42.3%
Policy	-1730	-12.3	72.3
Policy without Troubled Asset Relief Program and stimulus	-1365	-9.7	57.1

SOURCE: Authors' analysis of CBO baseline estimates, 2001-09.

FIGURE D

Baseline estimates of FY 2009 deficit cumulative sources of change since March 2007



SOURCE: Authors' analysis of CBO baseline estimates, 2007-09.

TABLE 2

Cumulative sources of change in FY2009 deficit since March 2007

Source	Surplus (+) or Deficit (-) Dollar value (in billions of dollars)	Surplus (+) or Deficit (-) Percent of GDP	Percent of total change since March 2007
March 2007 Baseline	-$134	-1.0%	
American Recovery and Reinvestment Act	-181	-1.3%	11.8%
Troubled Asset Relief Program	-336	-2.4	21.9
Economic and technical changes (including Fannie Mae and Freddie Mac)	-687	-4.9	44.9
Other Legislative changes	-328	-2.3	21.4
Spending	-221	-1.6	14.4
Defense supplementals for Iraq and Afghanistan	-93	-0.7	6.1
Housing and Recovery Act of 2008	-26	-0.2	1.7
Net Interest	-20	-0.1	1.3
Unemployment compensation extension	-17	-0.1	1.1
Other	-65	-0.5	4.2
Revenue	-107	-0.8	7.0
Emergency Economic Stabilization Act of 2008	-105	-0.7	6.8
Other	-2	-0.01	0.2
Total	-1667	-11.9	
Economic	-687	-4.9%	44.9%
Policy	-845	-6.0	55.2

NOTE: Columns may not sum due to rounding.

SOURCE: Authors' analysis of CBO baseline estimates, March 2007 to March 2009. JCT budget effect estimates of tax provisions in Emergency Economic Stabilization Act of 2008.

economic downturn. It is necessary because, in order for the federal government to *decrease* the deficit, it would be forced to enact counterproductive funding cuts or to raise revenues at an economically vulnerable time.

Some concern about the deficit is justified — we're a long way from the 2001 surplus optimism — and the level of the deficit in 2009 would be much lower absent the Bush-era tax cuts and unpaid-for increases in spending.

The evidence presented here is consistent with what is known about the impact of recessions — they have large and lasting effects on federal deficits. The prime driver of the current deficit is the economic slowdown. The top priority going forward — from a budgetary perspective — should be to spur the economy.