

# **U.S. Fiscal Outlook Getting Worse; August Deficit \$132 Billion**

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We expect the U.S. to maintain ultra-loose fiscal and monetary policy through the 2012 election, harming growth. There's little on the policy radar screen that would be helpful for growth or the budget process. With policy expectations low, however, any positive changes – for example, regulatory relief, repatriation of foreign earnings or facilitation of energy production -- would have a bigger-than-normal impact by setting a new direction.

## **Obama speech**

President Obama is expected to lay out a \$300 billion expansion plan in his speech tonight. Only a few proposals will get through Congress. We don't think the result will improve the growth or jobs outlook or the tone of the fiscal debate. Some likely proposals:

- Extend the 2% payroll tax cut for employees; extend 99-week federal jobless benefits; expand job training programs; tax credit to hire returning veterans; pass the Panama-Columbia-Korea free-trade agreements along with a controversial expansion of union-supported trade adjustment assistance; extend the transportation and FAA programs; create an infrastructure bank.
- There will probably be a long list of new spending proposals under the category of infrastructure: school renovation, rural broadband, aid to cities and states, green jobs.

## **Of most interest to us in Obama's speech:**

- Any specifics on regulatory relief. The rescinding of the EPA's tight ozone rules last week was important directionally. The Administration might be able to get out of the South Carolina Boeing problem at NLRB.
- The President's proposals for spending offsets. Under the pay-go rules, what does he propose to cut and in what fiscal years to pay for the new spending.
- Any process changes that would make spending restraint more likely. For example, we think a visible process for cabinet departments (like Commerce, Education, etc) to propose spending restraint would be useful. Similarly, there are over 200 independent agencies, many of which could propose their own wind-down or downsizing if asked by the President.
- The President may urge corporate tax reform, but there's no mechanism for Congress to take it up given the current baselines. Used for scoring purposes, the current

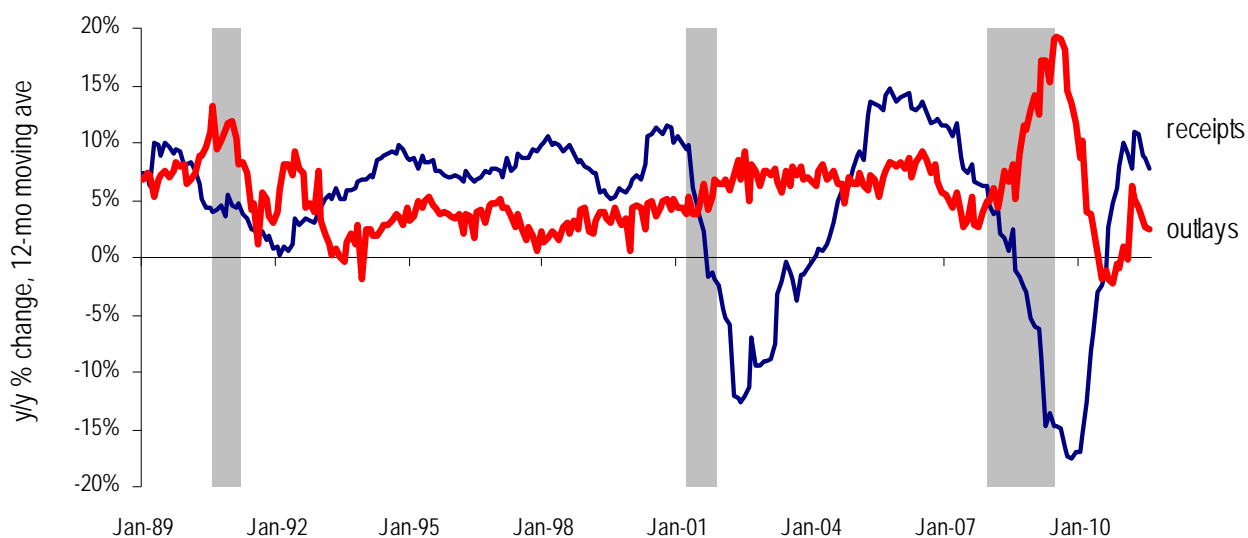
baseline assumes huge tax increases (Bush expiration, AMT inflation patch, expiring tax expenditures like R&D credit). To be “deficit neutral”, a tax reform bill would have to add new taxes to make up for the baseline gap. We think Congress should direct CBO to use an alternative baseline to facilitate a comprehensive tax reform process.

## Budget Outlook Getting Worse

The growth outlook for 2012 has been deteriorating in recent months. This hasn’t been factored into official deficit and debt estimates. The recent OMB budget forecast assumed strong growth in the early years of the budget window. Early-year growth is critical to the national debt buildup because growth compounds through the spending and revenue forecasts.

- OMB assumes 3.3% growth in 2012 and 3.7% in 2013. CBO has 2.6% falling to 1.7% in 2013 part due to different assumptions about tax increases and spending cuts. OMB projects an FY12 deficit of \$956 billion and FY13 of \$648 billion. However, without rosy growth assumptions, the deficits will be much larger and debt will compound faster across the ten-year budget. We expect the publically-held debt-to-GDP ratio to reach 100% in 2021, way above sustainable levels.
- Due to slow first-half GDP growth, growth in tax receipts has slowed while outlays remain elevated.

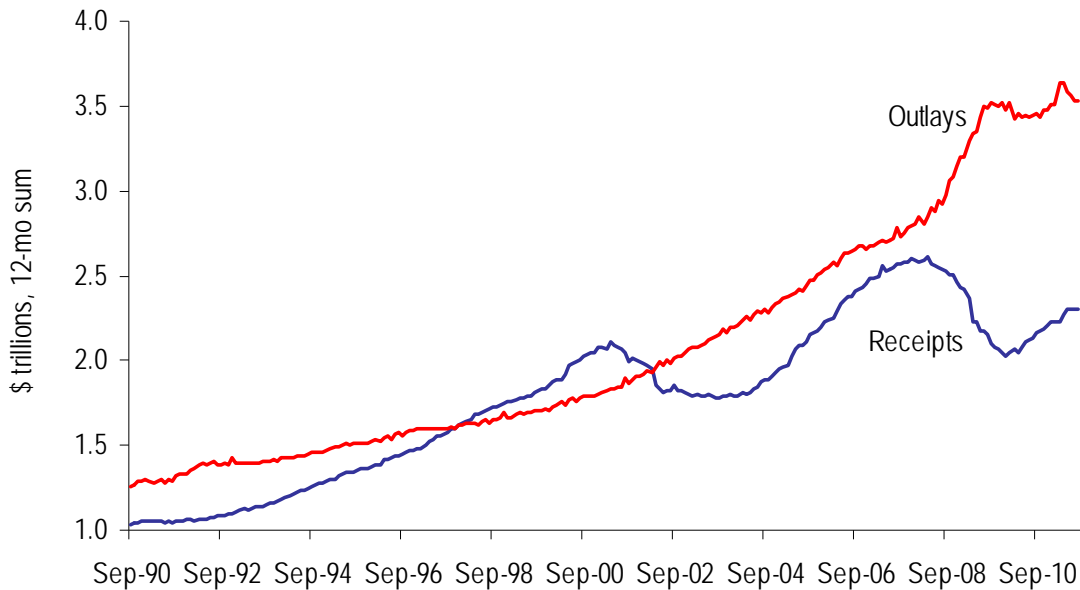
## Federal Revenues and Outlays y/y(last obs. August 2011)



Source: U.S. Treasury; Encima Global

- In August, tax receipts were \$170 billion versus spending of \$302 billion (up from \$255 billion in August 2010, though that was held down by an extra weekend). This caused an August 2011 deficit of \$132 billion, up from \$91 billion in August 2010.

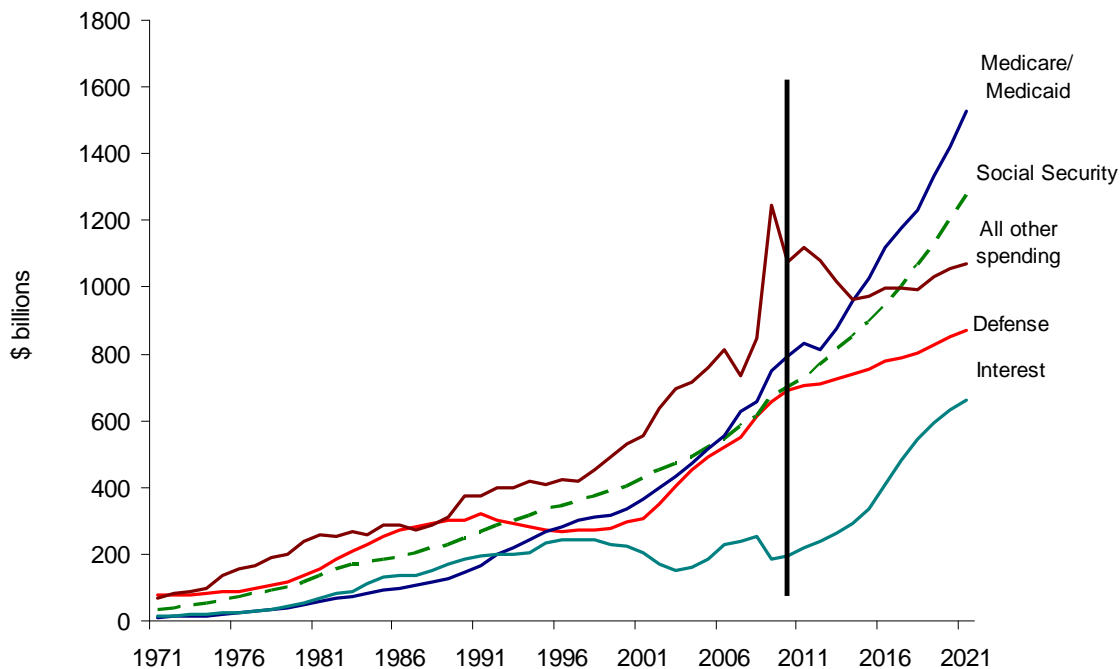
## Federal Revenues and Outlays (last obs. August 2011)



Source: U.S. Treasury; Encima Global

- CBO projects 2021 spending at \$5.4 trillion (up from \$3.6 trillion in FY11, with no assumption for Super Committee cuts). Of this, Medicare is \$966B, Medicaid \$561B, social security \$1.3T, defense \$872B and interest \$663B, with all other spending \$1.1T.

## Federal Spending by Major Categories (last obs. 2010, CBO projections to 2021)



Source: CBO; Encima Global

- The U.S. stands out around the world in having no process to restrain spending and debt. Entitlements, debt service and tax expenditures go up automatically. Discretionary spending is now controlled by the continuing resolution process where controversial cuts aren't possible because an impasse causes a government shut-down. Similarly, debt goes up automatically (as we saw in August) because the current debt limit process forces a black-and-white choice between increasing the debt or defaulting on it.

## Congressional process

Clouding the fiscal outlook, the debt limit increase in August left the focus of fiscal policy on Congress rather than the executive branch. This freezes the process through the 2012 election. The 12-member Super Committee isn't likely to get 7 votes for much in the way of spending restraint. The sequester doesn't start until 2013 – we don't think it will cut spending much because: 1) the sequester hits defense and Medicare hard making it politically unpopular; and 2) the election comes first, making changes to the sequester likely.

As discussed in our earlier pieces, there will be a few more opportunities for fiscal restraint, but we don't think they will be any more successful than the ones in 2011.

- By Oct. 1 Congress will be renewing the continuing resolution that funds the government. We expect only minimal spending restraint because an impasse causing a government shutdown. We don't expect many program terminations, layoffs, reductions in government activities or asset sales.
- The Super Committee's output is due in November. We expect it to agree on some minor spending cuts.
- At year-end 2011, the employee portion of the payroll tax is scheduled to increase to 6% from 4%. Also the 99-week federal unemployment benefits are scheduled to expire, causing a cutoff in checks to the long-term unemployed in January 2012. The AMT tax patch has to be enacted before 2012 along with an extension of the R&D tax credit and numerous other expiring provisions. It's possible some spending restraint could be attached to these year-end provisions.
- There will be an even bigger showdown on taxes after the 2012 elections, fighting the same battles as in December 2010 and providing an opportunity for restraint and process change.
- Then, in early 2013, there will have to be another debt limit increase, with the battle lines established in the November 2012 elections but almost sure to include tax increases versus spending cuts, little willpower for asset sales and a reluctance to tackle entitlement reform.

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