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Key Elements of the President's Fiscal Year 2015 Budget

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President Obama's 2015 budget seeks to strengthen the economic recovery in the near term; reduce deficits and debt as a share of the economy over the medium and long term through higher revenues, program cuts, and comprehensive immigration reform; help low-wage workers by strengthening the Earned Income Tax Credit; and increase investment in such key areas as research and early childhood education.

With House Budget Committee Chairman Paul Ryan set to unveil in coming weeks what will undoubtedly be a much different budget proposal, policymakers and the country will have two competing visions to consider for what will likely be a far more consequential debate over fiscal policy next year. While major action on budget and tax issues is unlikely in 2014, beyond passage of the annual appropriations bills, budget negotiations are likely to resume in 2015, especially since sequestration is slated to again take full effect on October 1, 2015 (when fiscal year 2016 starts), with harsh impacts on both non-defense and defense programs. Policymakers also could consider tax reform and immigration reform in 2015, with the mid-term elections behind them. The competing Obama and Ryan visions could provide a framework for a year-long debate on what path the nation should follow.

As noted, the budget would strengthen the Earned Income Tax Credit (EITC) for low-income childless workers, and thereby address a glaring shortfall in the EITC with regard to low-wage workers not living with and raising minor children. Currently, these individuals are the only group in America that the tax code taxes into, or more deeply into, poverty. The budget also would make permanent key improvements in the EITC and refundable part of the Child Tax Credit (CTC) that are scheduled to expire after 2017.

In addition, the budget provides significant new resources for high-quality early education and re-proposes a $75 billion initiative from last year's budget to make pre-K available to all low- and moderate-income children. The budget also proposes an added $56 billion in fiscal year 2015 funding for an "Opportunity, Growth, and Security Initiative," evenly split between defense and non-defense discretionary programs. Favored non-defense areas under this initiative include infrastructure, health and science research, and education and training.

Finally, the budget shows deficits and debt declining as a share of the economy over the decade, building on the deficit reduction of recent years. To achieve that, and also to offset the costs of its investment proposals, the President's budget includes: entitlement reforms that include $400 billion in Medicare savings; the scaling back of tax breaks that enable high-income people to inappropriately reduce or eliminate their taxes, as well as other revenue-raising measures (such as a higher tobacco tax); other spending reductions; and enactment of the Senate's comprehensive immigration reform bill.

Expansion of the EITC for Childless Workers

One of the most important proposals in the President's budget would strengthen the Earned Income Tax Credit (EITC) for low-income workers not living with and raising minor children and make permanent key improvements in the EITC and refundable Child Tax Credit that would otherwise expire after 2017.

This proposal builds on the substantial progress that policymakers have made in recent years in strengthening the EITC and the Child Tax Credit to "make work pay" for low-income families with children. Next to Social Security, refundable tax credits keep more people out of poverty than any other program, lifting 10.1 million people (and 5.3 million children) out of poverty in 2012.

Low-income childless workers, however, currently receive little from the EITC. They are the only group of workers that the federal tax code taxes into — and, in many cases, deeper into — poverty. For example, a childless adult working earning $15,000 a year is ineligible for the EITC because his earnings exceed the very low income limit for the tiny EITC for workers not raising minor children.

The President's proposal would expand the childless workers' tiny EITC considerably, fully offsetting the payroll tax burdens of the poorest workers, raising the maximum credit to about $1,000 from its current $500 (for which few childless workers are eligible), and raising the income limit to qualify for the credit from less than $15,000 to about $18,000 in 2015.

The proposal would also allow childless adults aged 21 to 25 to qualify for the EITC. Childless adults under 25 are now ineligible, a serious shortcoming given the importance of encouraging young people to work and gain a toehold in the economy. (It would also raise the upper age limit for the childless workers' EITC, from 65 to 67.) The expansion would benefit 13.5 million people, lift 500,000 people out of poverty, and make 10 million people less poor.[1]

Expanding the childless workers' EITC would help a diverse group of low-wage workers, from store clerks to child care workers to truck drivers to home and office cleaners. Close to half are women, and while many are young workers just starting out, we estimate that roughly 35 percent are at least 45 years old. The Administration estimates that 1.5 million of those benefitting are noncustodial parents — workers with parenting and financial responsibilities to children, which an expanded EITC could help them meet.

The benefits of a stronger EITC would go beyond raising these workers' incomes and helping offset their federal taxes. Leading experts from across the political spectrum believe that an expanded credit for those workers would help address some of the challenges that less-educated

[1] "The President's Proposal to Expand the Earned Income Tax Credit," Executive Office of the President and U.S. Treasury Department, March 2014, http://www.whitehouse.gov/sites/default/files/docs/eitc_report_0.pdf.

young people (including young African-American men) face, such as low and falling labor-force participation rates, low marriage rates, and high incarceration rates.[2]

The President proposes to offset the $60 billion cost of the proposal over 2015 to 2024 by eliminating tax breaks that allow some high-income people to use tax-avoidance techniques to pay much lower or no taxes on certain kinds of income. One proposal would close the "carried interest" loophole, which allows hedge fund managers to pay taxes at a lower rate than many middle-income workers. The other would curtail the "S Corporation" loophole (known as the John Edwards/Newt Gingrich loophole), which gives high-income professionals an incentive to convert their earnings into business profits and thereby avoid paying payroll taxes on them.[3] It's worth noting that House Ways and Means Chairman Dave Camp's new tax reform plan also addresses both of these loopholes (although it uses the resulting revenue for very different purposes).

Early Childhood Education

The President's budget includes significant new resources to expand access to high-quality early education for low-income preschoolers, infants, and toddlers, who often start kindergarten well behind their higher-income peers. This increase in funding would expand two efforts that Congress first funded in 2014 — an initiative to bring more high-quality early learning to low-income infants and toddlers through new partnerships between Early Head Start and child care programs, and an initiative to increase state pre-K efforts. (The President includes some additional funding for these efforts in the $56 billion Opportunity, Growth, and Security Initiative.)

In addition, the President proposes a $75 billion initiative, unveiled in last year's budget, to make pre-K available to all low- and moderate-income children. This proposal would also extend the Maternal, Infant and Early Childhood Home Visiting Program (slated to expire at the end of fiscal year 2015), which provides funding to states for evidence-based home visiting programs. These programs are designed to strengthen parents' skills and parent-child relationships and to identify children who are not "on track" in developing physical, cognitive, and social skills so those problems can be addressed early on. The funding must be used for programs that have been shown to be effective through quality research studies.

The budget offsets the cost of this proposal by raising the tobacco tax, a sound policy that has been shown to reduce smoking and other tobacco use. While the tax falls more heavily on low-income people, low-income people would also *benefit* disproportionately from the health benefits of a higher tobacco tax.

Discretionary Programs

Beyond framing the larger debate, the President's budget will have an impact this year on the allocation of funding for annually appropriated programs. As a result of December's budget

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[2] Chuck Marr, Chye-Ching Huang, and Nathaniel Frentz, "Strengthening the EITC for Childless Workers Would Promote Work and Reduce Poverty," Center on Budget and Policy Priorities, updated March 4, 2014, http://www.cbpp.org/cms/?fa=view&id=3991.

[3] For more about these loopholes, see Chuck Marr, Chye-Ching Huang, and Joel Friedman, "Tax Expenditure Reform: An Essential Ingredient of Needed Deficit Reduction," Center on Budget and Policy Priorities, February 27, 2013, http://www.cbpp.org/cms/?fa=view&id=3912.

agreement, both chambers of Congress and both parties have already agreed on the overall amount of funding to provide for appropriated programs (also known as "discretionary" programs) in fiscal year 2015. The President's budget includes program-by-program and account-by-account requests for appropriated programs that add up both to the total amount of funding and to the sub-totals for defense and non-defense discretionary funding agreed to in the December budget deal. The Obama budget reflects not only the Administration's policy priorities but also its insights on specific funding needs, given the executive branch's role in implementing and managing programs. As a result, the President's appropriation requests will likely play an important role in this year's appropriations process.

At the same time, the Administration's budget challenges Congress to consider $56 billion more in 2015 funding, evenly split between defense and non-defense, which it calls its "Opportunity, Growth, and Security Initiative" (OGSI). The $56 billion cost would be offset by savings in mandatory programs and higher revenues.

Such additional funding is warranted. Non-defense discretionary funding in 2015 under the December agreement would be nearly *15 percent below* the 2010 level, adjusted for inflation.[4] (The reduction in defense is roughly the same.) Funding cuts already imposed since 2010 have had a negative impact. Even with the additional funding that the President's budget proposes, non-defense programs would still be 10 percent below the 2010 inflation-adjusted level.

This aspect of the President's budget builds on the December agreement, following its framework of providing relief from sequestration equally to defense and non-defense programs and offsetting the cost with reductions in mandatory spending and higher revenues.[5] The President's proposal goes beyond that agreement, however, by including changes to the tax code to help offset the cost of proposed funding increases; last year's agreement relied only on user fees for its revenue offsets. Specifically, the President proposes to restrict wealthy individuals' ability to use tax-preferred retirement savings accounts as tax shelters by circumventing the contribution limits. The trade-off the Administration calls for here — investing more in areas such as infrastructure, education, and research that have the potential to boost future economic growth, and paying for those investments by reducing tax avoidance and tax sheltering — is one that the nation should seriously debate.

The budget lays out some specific areas where the OGSI proposal's additional $56 billion in 2015 would go. For example:

- *A $1.5 billion Community College Job-Driven Training Fund to build new training programs through community colleges to train workers and future workers for high-demand jobs.* This would include a focus on apprenticeship programs, used more widely in other western countries, as a stepping stone

[4] The estimate includes the effects of proposals the Administration has made (and Congress typically accepts) that reduce certain mandatory programs in the annual appropriations bills as a way to accommodate more non-defense discretionary funding under the agreed-on level for 2015.

[5] Joel Friedman, "President's Budget to Propose Building on Murray-Ryan Agreement, *Off the Charts* blog, Center on Budget and Policy, February 20, 2014, http://www.offthechartsblog.org/presidents-budget-to-propose-building-on-murray-ryan-agreement/.

to careers. The proposal seeks to leverage the strengths of community college systems in many communities to improve job training opportunities for those seeking better jobs.

- *Funding for an additional 1,650 research grants in the National Institutes of Health and National Science Foundation.* Publicly supported scientific research is a building block of future economic growth. It's also central to the development of new cures and technologies that can improve this nation's well-being. Taken together, funding for these two research entities would rise by about $1.5 billion under the OGSI proposal.
- *Improving the basic functioning of government through more adequate funding for the Internal Revenue Service and the Social Security Administration.* The additional funding would go to improving basic customer service, such as ensuring that taxpayers and Social Security beneficiaries and applicants can get their questions answered promptly and accurately.

The budget also proposes relief from sequestration in *2016* and subsequent years, again equally divided between defense and non-defense programs. Without this relief, sequestration will impose deep funding cuts starting in 2016. Moreover, some programs, such as veterans' medical care, have traditionally grown at much higher rates than inflation, and funding pressures on programs like Pell Grants are expected to increase. Yet protecting those programs would require squeezing other non-defense programs even more. These factors will heighten pressures to provide relief from sequestration through another budget agreement. Ignoring these funding pressures risks further ill-advised cuts to basic services and important investments.

The President's budget falls short, however, in non-defense discretionary funding after 2016. The budget would add back sufficient funding to eliminate the sequestration cuts to non-defense discretionary programs in 2015 and 2016, but some of the sequestration cuts would return starting in 2017. The basic funding caps that the 2011 Budget Control Act (BCA) set — and that will remain in effect even *without* sequestration — are already very tight; by 2017, they would push non-defense discretionary expenditures to their *lowest level as a share of the economy since 1962*. However, under the President's budget, non-defense discretionary funding would be more than $130 billion below the pre-sequestration level over the 2017-2024 period.[6]

Offering to set discretionary funding at levels *below* the BCA caps may have made sense in the context of the President's negotiations with Speaker Boehner last year on a broad deficit-reduction package that also would include higher revenues. But these low funding levels, while far superior to the post-sequestration levels, are nonetheless inadequate to meet national needs.

Deficit Reduction for the Medium and Long Term

When the Administration announced two weeks ago that the chained CPI proposal would not be in the President's new budget, some castigated the decision as fiscally irresponsible and accused the President of giving up on deficit reduction. Although the Administration made clear the proposal would remain on the table if serious deficit negotiations that include increases in tax revenues restart, its new budget shows that it is continuing to put forth proposals that would help place the budget on a more sustainable course.

[6] The basic caps set by 2011 Budget Control Act are in effect only through 2021. After 2021, the savings are measured relative to the 2021 cap levels adjusted for inflation.

Deficits as a share of the economy would fall by more than half over the decade under the budget, from 3.7 percent of gross domestic product (GDP) in 2014 to 1.6 percent in 2024. Debt held by the public would fall as well, from 74 percent of GDP in 2014 to 69 percent in 2024. And debt held by the public *net* of financial assets (such as the government's massive student loan portfolio) — which we regard as the best measure of federal debt — would fall from 67 percent of GDP in 2014 to 60 percent in 2024.[7] Despite this projected decline, the debt ratio would still remain high relative to postwar levels.

The President's budget includes some modest entitlement reforms. It proposes roughly $400 billion in Medicare cost savings, including some changes affecting beneficiaries. These are much the same as proposals that were in last year's budget and were part of the package that the President offered to Speaker John Boehner. Many of these reforms are designed to help address the nation's longer-term fiscal challenges while largely shielding low- and moderate-income seniors who already have high out-of-pocket medical expenses. And because they would phase in over time, the savings would grow in subsequent decades. Last year, the Administration estimated that its Medicare proposals would save over $1 trillion in the second decade.

For instance, the proposal to raise Medicare premiums for beneficiaries with incomes above $85,000 for individuals and $175,000 for couples would affect only about 8 percent of beneficiaries starting in 2018. But these thresholds would not be indexed for inflation until one-quarter of beneficiaries faced income-related premiums. Similarly, the proposed increases in certain Medicare co-payments would only apply to new beneficiaries, so the savings would start small but grow over time.

These reforms are more sensible than the across-the-board cuts imposed by mandatory sequestration, of which a 2 percent cut in Medicare provider and plan payments is the largest component. The Administration's budget would eliminate the sequestration of Medicare and other mandatory programs.

The President's budget also calls for enactment of the Senate immigration reform bill, which would reduce deficits over the long term according to both Congressional Budget Office (CBO) and Administration estimates. The Administration has incorporated CBO's estimates of the deficit reduction that the Senate bill would produce into its budget for the first decade, showing savings of $158 billion. In the second decade, CBO estimated savings of $685 billion. These savings result because the bill would expand the labor force and thereby the revenue base, so higher tax payments by immigrants would significantly exceed the increased costs the bill would generate.

Spending under the President's budget is constrained, helping to lower deficits. Over the next ten years, total program spending, excluding interest payments, would actually *decline* as a share of the economy, from about 20 percent of GDP in 2014 to 18.5 percent in 2024. This decline would be driven by the drop in discretionary funding, which would fall by over 2 percentage points as a share of GDP over the decade. Except for Social Security, which would rise modestly as a share of the economy over the decade (reflecting the retirement of the baby boomers), all other mandatory spending would be largely stable as a percent of GDP over the period. Growth in the cost of health

[7] The Administration's economic assumptions are somewhat more optimistic than those the Congressional Budget Office (CBO) is currently using. While both sets of assumptions are within the range of mainstream economic forecasts, when CBO reestimates the Administration's proposals, it may show somewhat higher deficits and debt.

care programs would be muted, reflecting the continuation of recent trends of slower health care cost growth and the implementation of Medicare savings under health reform, as well as the other proposals in the President's budget to restrain health care spending.

The Administration proposes a range of efficiency-enhancing tax reforms to fund initiatives and investments highlighted in the budget as well as to reduce budget deficits. For instance, to pay for the EITC initiative, it would close several loopholes, including the one related to "carried interest," that high-income people use to avoid paying taxes. Temporary revenues from corporate tax reform would be channeled into infrastructure upgrades. The budget's largest revenue raiser (nearly $600 billion over ten years) would limit the value of itemized deductions and certain other tax expenditures to 28 percent. This would help address the "upside down" nature of these tax breaks, which provide the largest subsidy rate to people with the highest incomes without a solid economic rationale for doing so. This limitation in the budget is similar to a provision in the tax reform proposal that Chairman Camp recently released.[8] A key difference is that the President's budget dedicates the revenue to deficit reduction, while the Camp proposal uses all of it to pay for lower tax rates.

The President's proposed revenue-neutral framework for corporate tax reform would not generate any deficit reduction, a position the Administration has taken for some time. But the President's budget sets out an important principle: corporate tax reform should not *add* to *long-run* deficits by using revenues that shrink or disappear over time to "pay for" permanent corporate rate cuts. In other words, corporate tax reform needs to be revenue neutral in subsequent decades, not just in the initial decade.

Finally, the President's budget adheres to the principle that policymakers should pay for the continuation of any "tax extenders" — the several dozen tax breaks (mostly for corporations) that Congress perennially extends and that cost about $50 billion a year. The budget proposes making some particular "extenders" (such as the Research and Experimentation Tax Credit) permanent. But it proposes sufficient savings from limiting or eliminating *other* corporate tax breaks to fully cover the cost of those "extenders" it maintains.

Conclusion

The coming year may hold few prospects for progress on key budget issues, in part because no events are on the horizon to spur lawmakers to act, particularly given the two-year budget agreement reached last year. But even if many elements of the President's budget — and the budget that House Budget Committee Chair Paul Ryan is expected to release shortly — won't become law this year, the visions those budgets put forward will help frame debates over fiscal policies and priorities.

The vision reflected in the Obama budget will provide a much sounder course than the one we'll likely see in the Ryan budget. That's because the Obama budget curbs lower-priority spending and unproductive special-interest tax breaks in order to make investments that the nation needs for future prosperity, reduce poverty and better reward low-paid work, and give many young children a better chance of success, while reducing mid-term and long-term deficits at the same time.

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[8] Chuck Marr, "Camp Plan's Tax Expenditure Cap Marks Step Forward," *Off the Charts* blog, Center on Budget and Policy Priorities, http://www.offthechartsblog.org/camp-plans-tax-expenditure-cap-marks-a-step-forward/.