



Deal with It

A Guide to the Federal Deficit and Debt

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Introduction and summary

A great deal is being made of the historically large budget deficits currently being run by the federal government. The real problem, however, is not the deficits we're seeing now or next year. Those deficits, though very large, are both inevitable and highly appropriate at a time when the economy is weak and strong government action has been necessary to turn things around. The real challenge is what we face after the recession: significant sustained deficits which, while not quite as eye catching, are equally historic, harder to solve, and pose a greater danger.¹

There is little dispute that deficits do harm if they are large enough and sustained long enough. High levels of government borrowing can reduce domestic investment, lower future incomes, raise interest rates, and spur inflation. These can damage the economy and hurt people who see their wages fail to keep up with rising costs or find the price of borrowing to purchase a home prohibitively expensive. The threat of sustained deficits could lead to strong reactions by economic actors—investors, workers, consumers, and trading partners—who move to protect themselves from these risks. Such reactions can be damaging in themselves, raising, among other fears, the specter of another financial crisis. And it is politically more difficult to enact needed public initiatives with large deficits and debt looming over the budget process.

The high government debt levels that result from sustained deficits can also leave a nation unable to go further into debt in a time of crisis. High debt levels also mean high interest payments on that debt in the future, reducing government's capacity to make important public investments and provide needed services.

Both the Congressional Budget Office and the Office of Management and Budget project high deficits through 2019, the latest year for which they offer official estimates. It can be debated whether these projections are likely to come true and whether the predicted levels are high enough to cause great harm—but the weight of opinion is currently that the deficit predictions are more likely optimistic than pessimistic. What isn't seriously debated is the fact that we have a long-term structural problem of the cost of government programs outstripping revenues, and that it is a problem we will have to address sooner or later.

There is good reason to set in place measures that will address the projected long-term deficits once the recession is over. But addressing those deficits is not without risks—badly done, the cure could prove to be worse than the disease. There are areas of public expen-

ditures that, if cut excessively, would damage our economy, endanger the public, break important obligations, or wrongly put holes in an already porous social safety net. Poorly designed tax increases could also impinge on economic growth and harm taxpayers.

Just 10 years ago such challenges were not a primary worry. The nation ran a budget surplus in 1998, starting a stretch of surpluses that lasted through 2001. The nation's fiscal house was in order. How then, have we gone from a surplus of 0.8 percent of gross domestic product in 1998 to a situation where CBO is projecting significant deficits for the next 10 years—culminating in a 5.5 percent of GDP mark in 2019?²

That 6.3 percent of GDP swing is driven both by decreases in revenues and increases in spending. On the revenue side, the federal government is projected to collect less in personal income taxes, corporate income taxes, and payroll taxes as a share of GDP in 2019 than it did in 1998. As for spending, health care categories are by far the most significant drivers. Interest payments on debt, and Social Security and defense spending will also be higher as a share of GDP by 2019 than they were in 1998. These challenges have long been foreseen—health costs, demographics, accumulating debt in the 2000s, and engaging in two wars while cutting taxes have been a recipe for large sustained deficits. Failure to address these issues in the past while camouflaging them in official budget estimates has dumped the problem in the laps of current policymakers.

Bringing the deficits down to manageable levels is not simple, to say the least. There will be loud voices shouting that the budget can be brought into balance through spending cuts alone—but they are wrong. If we set on a path of spending reductions to bring about a balanced budget in 2014, across-the-board spending in that year would have to be 18 percent lower than currently projected. Even bringing the deficit down to 2 percent of GDP would require slashing all spending by 10 percent.

Across-the-board spending cuts are not likely. Some areas will be spared, which means that cuts in other areas would have to be deeper. The country is not, for example, going to default on its debt payment obligations. If debt service obligations are off the table, everything else has to be cut by 21 percent to achieve balance in 2014, or by 11 percent to get the deficit to 2 percent of GDP in that year. Social Security cuts are also unlikely to be an important part of the mix—existing proposals for Social Security savings do little in the next 10 years as they focus on reducing the rate of growth in benefits, not cutting current beneficiaries. Taking Social Security off the table in addition to debt service would mean the rest of the budget has to be cut by 27 percent to achieve balance, or by 14 percent to knock the deficit down to 2 percent of GDP in that year.

Health care reform would result in substantial Medicare cost reductions, but most of those savings will occur beyond the next 10 years, and some of them are already accounted for in the president's budget plan. Major additional savings in Medicare are therefore unlikely by 2014. If we take Medicare out of the picture along with debt service and Social Security,

the rest of the government has to be cut by 35 percent to achieve a balanced budget, or by 18 percent to get the deficit down to 2 percent of GDP.

If we pull defense spending out of the picture—and defense spending certainly isn't likely to be cut by anywhere near 35 percent, or even 18 percent—the rest of the budget needs to be cut by 51 percent to have a balanced budget in 2014, or by 27 percent to get to 2 percent of GDP. The rest of the budget would be devastated, including cuts to health clinics, benefits for federal retirees and veterans, schools, highways, food safety, air traffic control, and much more. Simply put, substantially greater fiscal balance is not going to be accomplished through spending cuts alone.

The possibilities for balancing the budget by only raising more revenue are similarly remote. The federal government would have to collect an additional 22 percent in revenue in order to bring government receipts up to the levels needed to balance the budget in 2014. That means a 22 percent hike in everyone's income tax, gasoline tax, payroll taxes, and other federal charges. Getting the 2014 deficit to 2 percent of GDP would take a 12 percent tax increase across-the-board. If we limit a budget balancing tax increase to corporations and those with incomes over \$250,000 per-year, their taxes would have to increase by about 70 percent.

Finding the answer to this problem is not going to be easy. There are too many immovable objects—too many spending areas that can't be cut, too many taxes that can't be raised. And yet these deficits are too large to be tolerated. Something has got to give. And the longer we wait, the harder it gets, as the cost of debt service gets greater and deficits grow.

We need to ask serious questions. Can the United States afford to continue to spend so much more of its national income than the rest of the world on defense? Are we going to pass health care reform that realizes budget savings? Can taxes, beyond what the president has already proposed, be part of the picture? Social Security, agricultural subsidies, social programs, education spending, and everything government does is going to be examined—with everyone having areas they carve out as sacrosanct and areas they don't. It is important that the balance is right so that the solution is not worse than the problem. The sooner we recognize that the set of hard lines that have been drawn make an answer impossible, and some of those lines need to be erased or moved, the sooner we will be on the road to getting to a solution. Pretending the problem doesn't exist, and that it isn't big and difficult, won't get us there.

The good news is that the United States is in a position to solve this problem. Unlike many other countries, the challenge isn't that we can't afford the public programs we choose to have. The challenge is coming to an agreement on what those programs are and how we pay for them. A very big challenge, no doubt. But not an insurmountable one.

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