



It's Time to Hit the Reset Button on the Fiscal Debate

Michael Linden June 6, 2013

Center for American Progress



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Introduction and summary

The federal budget has dominated the policy and political debate in Washington over the past three years. During this time, both the underlying fiscal landscape and the broader economic context for the debate have shifted in very important ways, yet the debate has remained remarkably static. Most policymakers, organizations, and policy leaders seem to be stuck in 2010, as if nothing has changed in the years since.

Much has changed, however, and the debate should change with it. If we are to move forward, it's time to recognize all that has transpired in the past three years and begin the conversation anew. It's time to hit the reset button on the entire fiscal debate.

We have come to a moment in which the prospects for progress on federal fiscal policy appear very dim. President Barack Obama put forward a budget proposal that, by any reasonable standard, goes well beyond halfway to meet the demands of conservatives in Congress.¹ It includes enormous concessions without any promise whatsoever from the president's political adversaries that they will reciprocate. Indeed, even though the president agreed to accept significant benefit cuts in entitlement programs, the Republican leadership rejected his offer out-of-hand because the compromise would also entail somewhat higher revenue levels.² This rejection occurred despite the fact that such revenue would be accomplished not by raising tax rates but by broadening the tax base—a principle that conservatives have hailed repeatedly.

With conservatives calling the president's compromise offer “dead on arrival,”³ we remain stuck in perhaps the worst of all possible fiscal realities. We remain living with the painful, counterproductive, and near-universally derided “sequester” spending cuts. The long-term fiscal challenges remain mostly unsolved. We remain unable to use federal fiscal policy to address immediate economic problems, to say nothing of underlying structural ones. And the budget issue itself remains an obstacle to progress on all manner of unrelated policy areas.

Part of the trouble is that the debate over these issues is stuck in a time and context that no longer exists. First and foremost, the fiscal outlook for both the medium-

term and the long-term has improved substantially compared to what it was just a few years ago. This incredible improvement has been driven by three main factors:

- We have enacted about \$2.5 trillion in deficit reduction with about three-quarters coming from spending cuts.
- Health care costs have slowed dramatically in the past several years.
- We have a better understanding of what is driving the debt in the long-term projections.

There have also been important changes in the economic context that surrounds the entire budget debate. These include:

- The key argument that high debt causes slower growth has crumbled.
- Countries around the world have experimented with austerity, and those experiments have failed spectacularly.
- The U.S. economy has not healed nearly as swiftly as was projected when the budget cutting began.
- The push for immediate debt reduction has resulted in some perverse policy outcomes.

These changes should dramatically affect the debate on federal economic policy in general and the federal budget in particular.

To start with, all of these changes mean that the deficit should no longer be the country's most pressing economic concern. The predictions that the abnormally large deficits of the past several years would inevitably lead to spiking interest rates or ruinous economic collapse have proved to be extraordinarily wrong. More importantly, between the legislated spending cuts and revenue increases and the slowdown in health care costs, the medium-term fiscal projections now look downright tame. Even the long-term outlook appears far less dire than it did just a few years ago. And the argument that higher debt leads to slower growth over a 90 percent of GDP threshold has collapsed. When considered all together, there is clearly no need for deficit reduction to take precedence over every other important issue facing the country. We need to stop allowing deficit concerns to hijack every other policy discussion.

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This is especially true when it comes to the automatic spending cuts known as the sequester. These cuts are economically damaging, shortsighted, and now completely unnecessary, but because of lingering deficit concerns, we remain stuck with them. The dramatic changes in the fiscal and economic landscape should prompt us to revisit the sequester and find a way to fix it before it can do more harm. To that end, we offer a reasonable plan to replace the sequester through 2016.

Second, the experiences of European countries and our own experience here at home have shown conclusively that the drive for deficit reduction itself carries risks and costs. Europe, for example, has learned the hard way that there is no such thing as “expansionary contraction,” the notion that moving swiftly toward deficit reduction could address the looming risks of growing debt, as well as spark a faster economic recovery. Far from promoting recovery, austerity has dragged European economies down and left their budgets little improved.

In the United States we have managed to avoid the scale of austerity implemented by Greece or even the United Kingdom, but we have also suffered from ill-timed and ill-targeted cutbacks and fiscal contraction. In addition, the headlong rush toward debt reduction has resulted in some very odd and counterproductive policy outcomes, especially the large, across-the-board sequester spending cuts. With the economy still on fragile ground and the impact of the sequester only now beginning to be felt, we can no longer afford to act as if deficit reduction has only benefits and no costs.

Putting the federal budget onto a permanently sustainable path is still an important goal; that has not changed. But so much else has changed while the debate around these issues remains stagnant. Conservatives are still calling for draconian spending cuts. Any proposal to invest in either long-term growth or to take measures to spur economic growth is still labeled as unrealistic or relegated to a kind of political penalty box. And many voices continue to insist that debt reduction is our primary economic challenge.

Few policymakers or pundits have adjusted to the current reality. We have already made enormous progress toward debt reduction, and the long-term problems are not nearly as dangerous as previously thought. Furthermore, the push for debt reduction has, at best, made it harder to boost economic growth; at worst, it has actively dragged the economy down. The time has come to recognize and respond to the new reality: It's time to hit the reset button on the entire fiscal debate.

We have enacted a significant amount of deficit reduction, mostly through spending cuts

When the debate over our nation's finances began in earnest more than three years ago, the projections of medium- and long-term deficits were truly disconcerting. In June 2010 the Congressional Budget Office, or CBO, put out its annual long-term budget outlook, and the picture was not pretty. In its "Alternative Fiscal Scenario," which assumed a continuation of fiscal policies in place at the time, deficits were expected to fall from 9.4 percent of gross domestic product in 2010 to a low of 4.1 percent by 2014. But after that, the CBO warned that the deficits would grow every year, reaching 8.3 percent of GDP in 2023. Debt was also expected to rise to essentially unprecedented levels, reaching fully 100 percent of GDP by 2023.⁴

These projections, and others like them from the Office of Management and Budget and from nongovernmental organizations, were the foundation on which the case for deficit reduction was built. And it was a strong case. Never before in modern American history had we seen sustained deficits of the magnitude that the CBO was projecting. And since World War II, we had not seen debt levels as high as what the CBO was expecting.

Five months after the CBO released this troubling budget outlook, the chairmen of the National Commission on Fiscal Responsibility and Reform proffered their own report on "the looming fiscal crisis," as the authors put it.⁵ Chaired by Alan Simpson and Erskine Bowles, the commission was set up through an executive order from President Barack Obama. Often referred to as the Simpson-Bowles commission, it was tasked with building a bipartisan plan to reduce the budget deficit by 2015 and to "meaningfully improve the long-run fiscal outlook."⁶

The commission's final report repeatedly referred to the CBO's projections as evidence for why we must undertake deficit reduction. "The Congressional Budget Office (CBO) projects if we continue on our current course, deficits will remain high throughout the rest of this decade and beyond," wrote Simpson and Bowles. Based on CBO's projections, "Interest on the debt could rise to nearly \$1 tril-

lion by 2020,” they warned. And “[b]y 2025, revenue will be able to finance only interest payments, Medicare, Medicaid and Social Security,” which together would represent about two-thirds of all federal spending.⁷

That was the fiscal situation in 2010, but that is not the situation today. In the intervening three years, the budget projections have improved substantially.

Today, under realistic budget assumptions, the deficit is projected to equal 3.8 percent of GDP in 2014—slightly lower than the CBO’s projection back in 2010. From there, the projections diverge significantly. Whereas three years ago the CBO was expecting deficits to top 8 percent of GDP by 2023, we now expect the 2023 deficit to come in at 3.5 percent of GDP—less than half as large as we thought it would be three years ago. Debt projections have consequently come down substantially as well. Current projections put the debt-to-GDP ratio in 2023 about 25 points lower than was projected in 2010.⁸

What is a “realistic” budget projection?

Budget projections are by their nature uncertain. The Congressional Budget Office produces an official 10-year budget projection three times every year and a longer-term projection once a year. The official projections follow some particular rules; most importantly, they assume that all current laws will remain in place. Thus, if the law as currently written has a tax cut expiring or an automatic spending cut set to go into effect, the CBO’s official projection takes that into account. Second, the CBO’s official projections assume that discretionary spending will grow only with inflation, unless there is something in the law that would prevent it from doing so, such as explicit statutory limits.

Because of these rules, the official CBO projection is not always considered the most “realistic.” Prior to 2012, for example, the official projection assumed that all of the Bush tax cuts would expire, as the law said they would. Given that both President Obama and congressional Republicans wanted to extend most, if not all, of those tax cuts, projections that assumed a massive increase in tax revenues resulting from the full expiration of those cuts were rightly deemed “unrealistic.” For this reason, many outside experts and the CBO itself have cre-

ated alternative projections based on different assumptions—most often that current policies remain in place rather than current laws. Indeed, one such projection, the CBO’s Alternative Fiscal Scenario, became the most widely cited in the fiscal debate.⁹

The “realistic budget projections” in this report are based on the following assumptions:

- The automatic sequester spending cuts will be repealed.
- The war in Afghanistan will wind down.
- The Medicare Sustainable Growth Rate formula will be fixed to avoid large reductions in doctors’ reimbursements.
- Emergency funding for disaster relief related to Hurricane Sandy will not be perpetually extended.
- Certain refundable tax credits set to expire in 2017 will be extended permanently.

These are the same assumptions made in baseline budget projections by the Committee for a Responsible Federal Budget, the Center on Budget and Policy Priorities, and the Office of Management and Budget.

The dire predictions contained in the Simpson-Bowles report now seem unlikely to come true. Interest on the debt is currently projected to amount to about \$650 billion in 2020—35 percent lower than Simpson and Bowles warned. And under current policies, revenues will cover between 80 percent and 85 percent of all spending in 2025 rather than just the two-thirds projected in 2010.¹⁰

The budget projections are much improved in large part because Congress and the president took action and put into place about \$2.5 trillion worth of deficit reduction since the start of fiscal year 2011. About three-quarters of this deficit reduction came in the form of spending cuts.¹¹

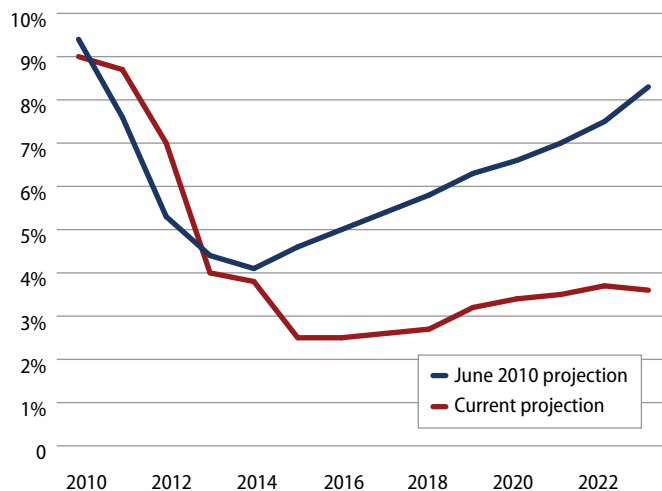
The spending cuts began with the start of the new fiscal year in the fall of 2010, as Congress enacted temporary appropriations bills that set the funding levels for all discretionary spending programs. (see sidebar on page 7) In August 2010 before the budget cutting began, the Congressional Budget Office projected that discretionary spending would total \$14.8 trillion over the subsequent 10 years.¹² This projection was based on the assumption that Congress would simply maintain discretionary spending at its then-current levels, adjusting only for inflation.

Over the course of the fiscal year 2011 appropriations process, however, Congress repeatedly passed temporary appropriations bills that set funding ever lower than real 2010 levels. By the time the process was complete, and final appropriation levels had been set, Congress had cut more than \$585 billion off the CBO’s 10-year projections of discretionary spending.¹⁴

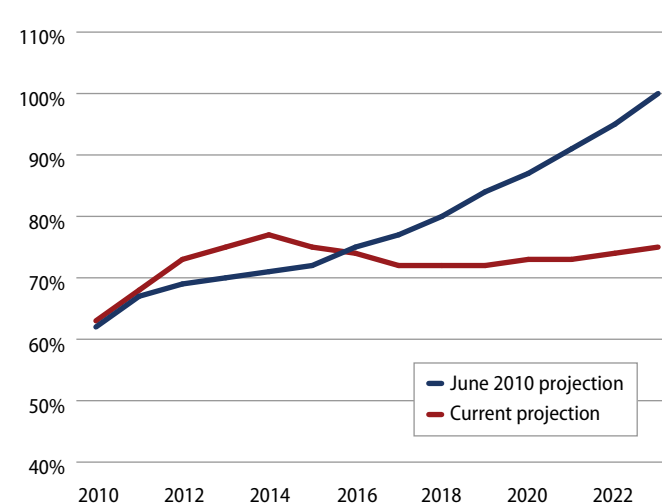
The budget cuts continued several months later when Congress and the president struck a deal to raise the federal debt limit. That deal—known legislatively as the

FIGURES 1 & 2 The medium-term fiscal outlook is much improved

Federal budget deficit as a share of GDP, 2010–2023



Publicly held debt as a share of GDP, 2010–2023



Source: Author's calculations based on Congressional Budget Office projections

What is “discretionary spending”?

Broadly speaking, there are two types of federal spending—spending that requires an annual appropriation from Congress and spending that does not. The former category is called discretionary spending, while the latter is called mandatory. Mandatory spending programs such as Social Security or Medicare do not need to go through the annual congressional budget process. Of course, Congress always has the authority and ability to make changes to these sorts of programs if it chooses to do so, but mandatory spending programs do not require annual approval. Discretionary spending programs, on the other hand, must receive new congressionally authorized spending levels each year.

In fiscal year 2012 discretionary spending made up about 36 percent of the total federal budget—about half of which was devoted to the military and other defense purposes. The other half—the nondefense

portion—was divided among dozens of different federal agencies to carry out hundreds of different programs and activities.

Unlike the mandatory category of federal spending where a handful of programs such as Social Security, Medicare, and Medicaid make up the vast bulk of the spending, no single program dominates the discretionary category. In 2012 the single-largest nondefense discretionary bureau was the Veterans Health Administration with slightly more than \$50 billion in spending, which represented just 8 percent of total nondefense discretionary spending.¹³ Some other large nondefense discretionary programs include highway spending, K-12 education support, the National Institutes of Health, housing assistance, Head Start, the Federal Aviation Administration, national parks, and Customs and Border Protection, among many others.

Budget Control Act—included statutory caps on discretionary spending for the next 10 years. The caps were set even below the already lower 2011 levels, adjusted for inflation. The result was another \$860 billion in cuts to discretionary spending. All told, between the fiscal year 2011 appropriations and the Budget Control Act, Congress cut discretionary spending by about \$1.5 trillion—a nearly 11 percent overall reduction relative to the pre-cut levels.¹⁵

No one should confuse these cuts for mere minor adjustments or just nibbling around the edges. Because of these budget cuts, spending on discretionary programs will decline to the lowest level on record by 2017, measured as a share of GDP. In other words, within five years we will be spending less of our total national resources on this category of the budget than at any time in modern history. And that share will continue to decline in the years after 2017.

Though discretionary spending cuts have made up the vast majority of the legislated deficit reduction enacted over the past few years, they have not been the only measures taken to improve the fiscal outlook. At the end of 2012, Congress and the president reached a deal to avert the so-called fiscal cliff, which included another \$660 billion in direct deficit reduction. That deal kept in place the 2001

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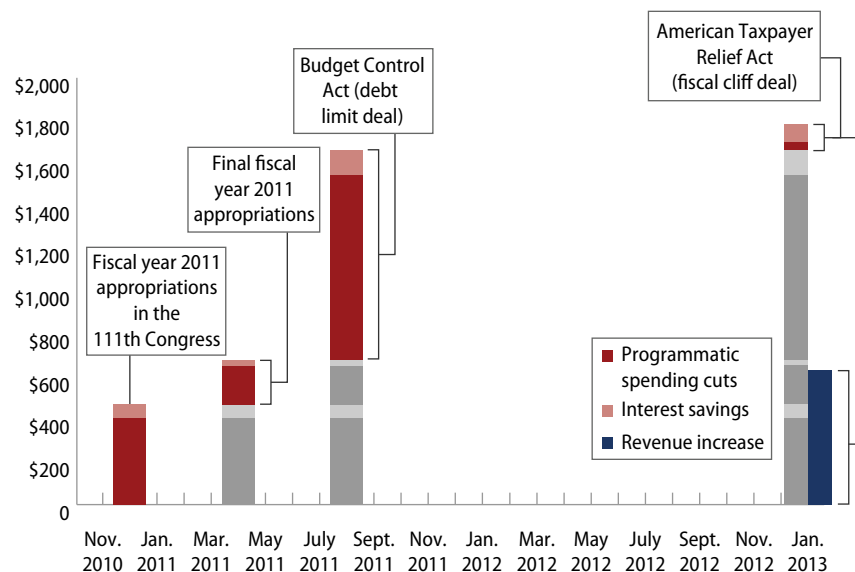
and 2003 tax cuts for all incomes up to \$450,000—\$400,000 for singles—but allowed the remaining tax cuts to expire. That expiration will raise approximately \$630 billion in added revenue over the next 10 years. The fiscal cliff deal also included several minor program changes, which will result in about \$30 billion in reduced spending.¹⁶

Of course, all of this direct deficit reduction has the added fiscal benefit of reducing the expected costs of paying interest on the debt. Since the debt itself will be lower because of the spending cuts and revenue increases, it will also cost less to service that debt. The combined effect of the programmatic spending cuts and the revenue increases will reduce spending on interest payments by about \$400 billion.¹⁷

All told, Congress and the president have enacted about \$2.5 trillion in deficit reduction since the start of the 2011 fiscal year. About three-quarters of that has been cuts to spending, while the remaining quarter has come from revenue increases. This enacted deficit reduction, along with several economic and technical updates to the budget projections, has dramatically improved the fiscal outlook over the next decade.

FIGURE 3
A timeline of recent deficit reduction

Cumulative deficit reduction enacted, in billions of dollars



Source: Authors' calculations based on Congressional Budget Office projections.

Health care costs have slowed dramatically

In addition to the significant deficit-reduction measures enacted by Congress and the president, a second major factor deserves some credit for the improvement in the medium-term budget outlook: a slowdown in the rising cost of health care. Health care costs have been and continue to be a major driver of federal spending. Because two of the three largest federal budget items are health insurance programs—Medicare and Medicaid—when the underlying costs of providing health care rise, the federal budget feels the pinch. And since health care costs have been on a seemingly intractable upward trajectory for the past several decades, the CBO’s projections of future federal health care spending were troubling, to the say the least.

In their June 2010 long-term outlook, the CBO expected federal health care spending to rise from 5.1 percent of GDP that year to 7.2 percent by 2023. That projection was based on the expectation that underlying, economywide health care costs would continue to increase at about the same rate as they did in the past. The CBO built their projections specifically using “the average rate of excess health care cost growth observed between 1985 and 2008.” Excess health care cost growth was defined as “the increase in health care spending per person relative to the growth of GDP per person after removing the effects of demographic changes in the population’s age distribution.” In other words, the CBO was expecting health care costs to rise about 1.7 percentage points faster than overall economic growth, even after accounting for an aging population.¹⁸

That was a completely reasonable assumption at the time. Health care costs had indeed been rising faster than overall economic growth for decades. And in June 2010 there was little to indicate that trend would not simply continue.

But, in fact, it has not. Over the past few years, health care costs have actually grown far more slowly than the CBO anticipated. From 2009 through 2012 total health care expenditures in the United States have grown only about 0.7 percentage points faster than the economy, and that is before adjusting for the aging of the population. Health care cost increases were even lower in 2012 alone.¹⁹ And

according to the Office of the Actuary in the Centers for Medicare and Medicaid Services, total health care spending grew at its slowest pace on record from 2009 through 2011, the last year for which they have comprehensive data.²⁰

It is unclear the degree to which this recent slowdown in health care cost growth will persist. There are obviously a number of unknowns. For one, some portion of the health care cost slowdown is probably attributable to the economic slowdown we have experienced over the past few years.²¹ As the economy fully recovers, it is possible that health care costs will accelerate again. For another, we do not yet know the effect that the Patient Protection and Affordable Care Act—colloquially known as Obamacare—will have on future health care costs. There are some early anecdotal indications that Obamacare will be successful at keeping cost increases in check, but of course, we will have to wait to find out for sure.²²

Although there is some uncertainty, the evidence that health care costs have slowed was enough to prompt the Congressional Budget Office to substantially reduce its projections of federal health care spending in both their February and May 2013 budget projections. In a post explaining their thinking, the CBO wrote:

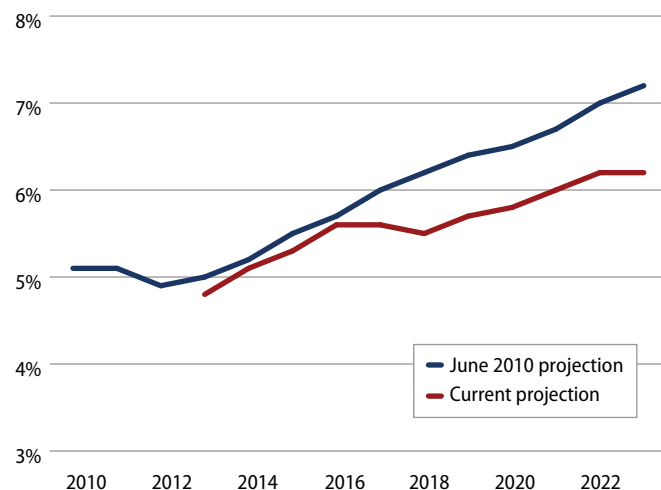
In recent years, health care spending has grown much more slowly both nationally and for federal programs than historical rates would have indicated. ... In response to that slowdown, over the past several years, CBO has made a series of downward adjustments to its projections of spending for Medicaid and Medicare.²³

In fact, the CBO reduced its projections of Medicare and Medicaid spending by a combined \$544 billion relative to its outlook in August 2012. As a result, CBO now predicts that federal health care spending in 2023 will be 6.2 percent of GDP, not 7.2 percent as it thought in June 2010.²⁴

Medicare spending especially is now expected to be far lower than it was when President Obama took office. In its 2009 projections, the CBO expected net

FIGURE 4
Projections of federal health care spending are down significantly

Federal spending on mandatory health care programs as a share of GDP



Note: Current projection assumes the repeal of the sequester and a permanent fix to the Sustainable Growth Rate.

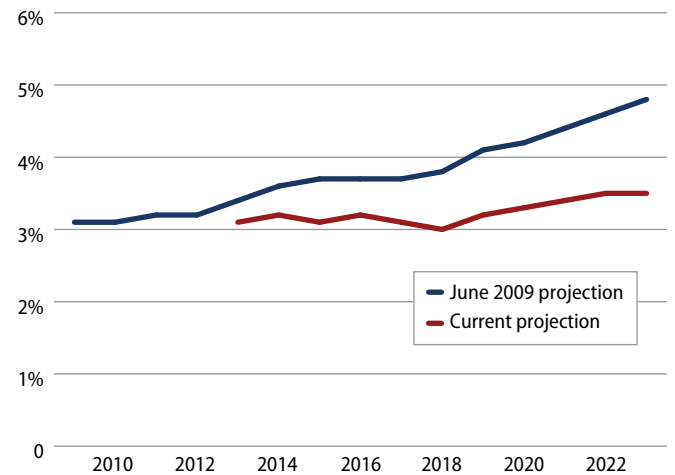
Source: Congressional Budget Office

Medicare spending in 2023 to total about 4.8 percent of GDP. Today's projections for 2023 put Medicare at just 3.5 percent—a full 25 percent reduction from projections four years ago. That is an enormous decline, due in part to the overall slowdown in health care costs and in part due to Obamacare, which will implement hundreds of billions in cost savings in Medicare. (see Figure 5)

Health care spending in general, and Medicare specifically, has featured very prominently in the debate over our fiscal future. It remains the case that health care programs will still be the major source of growth in federal spending over the next several decades. But the size of that growth is now very different from what we expected just a few years ago. It is no longer the case that overall health care spending as a share of GDP is set to grow by nearly 50 percent by 2023. It is instead expected to grow by only about one-fifth, and that includes the effects of adding more than 30 million people to the insurance rolls and the effects of an aging population. In addition, it is no longer the case that Medicare spending will nearly double in size by 2025. Instead, Medicare is now expected to grow by only four-tenths of a percent of GDP over the next decade. Restrained health care spending growth and the legislated deficit reduction have combined to produce a medium-term deficit picture that is far brighter than it was just three years ago.

FIGURE 5
Projections of Medicare spending are down even more

Federal net spending on Medicare as a share of GDP



Note: Current projection assumes the repeal of the sequester and a permanent fix to the Sustainable Growth Rate.

Source: Congressional Budget Office

The long-term debt projections have also improved substantially

It is not just the medium-term outlook that has improved; the long-term debt projections are also much less dire than they were just a few years ago. Of course, part of the improvement flows directly from all the progress we have made over the medium term. Reducing the budget deficit over the next 10 years translates into lower overall debt levels even further out. Instead of starting out with debt levels at about 100 percent of GDP in 2023 as was predicted in the CBO's 2010 alternative fiscal scenario, our debt level is now on track to be 25 points lower. That gives us far more breathing room in the long run. And if the recent health care cost trends continue, that will further improve the long-term outlook.

But there is another important reason why concern over the long-term projections should subside. We now understand that a huge portion of what was driving the massive increases in debt predicted by the CBO over the past few years was not actually underlying demographic and economic factors or exploding program costs. Rather, it was the implicit assumptions that Congresses 10 years in the future and beyond would take affirmative actions to further add to the deficit by both cutting taxes and increasing spending without offsetting either cost. Those assumptions alone—not rising health care costs or the aging of the population—are responsible for approximately two-thirds of the projected increase in debt from 2023 through 2035.²⁵

Let's start with the assumed tax cuts. The Congressional Budget Office's long-term alternative fiscal scenario assumes that revenues, after the end of the traditional 10-year budget window, will stay constant as a share of GDP. But in a November 2012 article in *Tax Notes*, New York University Law Professor David Kamin pointed out that, in fact, absent any change in the law, revenues will actually grow somewhat faster than GDP.²⁶ That is true in part because while most of the tax code is indexed to inflation—tax brackets, for example—income generally grows faster than inflation. There are also other tax provisions that are expected to generate revenue streams that grow faster than GDP over time.²⁷ So for the CBO's assumption that revenue will remain stable as a share of GDP to be true,

Congress would have to repeatedly change the tax code to reduce revenue. In other words, embedded in those dire long-term numbers was the expectation that Congresses starting 10 years hence would repeatedly and consistently pass deficit-increasing tax cuts. In a follow-up article in the *Washington Monthly*, Kamin estimated that reversing this assumption would “reduce the long-term deficit, as projected by the CBO, by roughly one third over the next seventy-five years.”²⁸

There is a similar assumption embedded on the spending side

of the ledger. The CBO’s long-term alternative fiscal scenario assumes that federal noninterest spending on all programs, aside from Social Security and health care, will revert to historical average levels as a share of GDP—about 10.7 percent of GDP—after the 10-year budget window and then remain stable as a share of GDP thereafter.²⁹ Even without sequestration, however, that category of spending is actually projected to decline from about 10.9 percent of GDP today to well under 8 percent of GDP by 2023. Assuming a reversion to the historical average is therefore equivalent to assuming that starting 10 years from now, Congress will dramatically increase spending since the projection in 2023 has this category of spending well below that average.

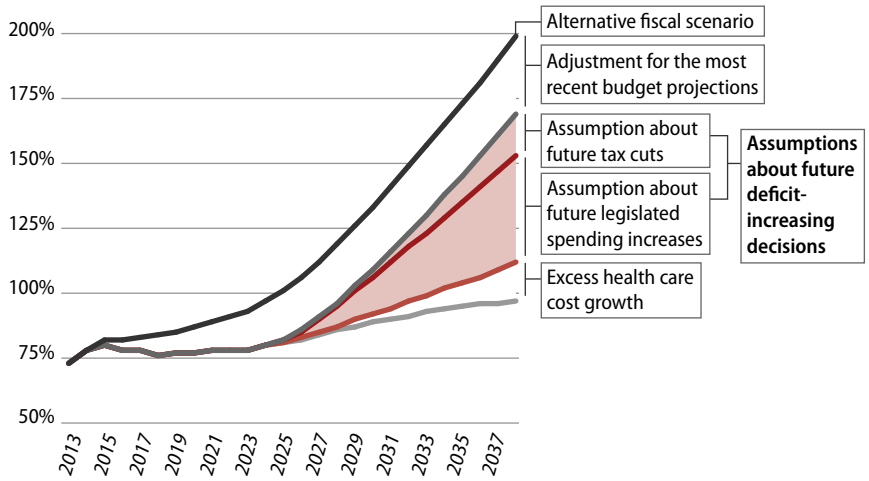
Furthermore, because the vast majority of this “all else” category is made up of discretionary spending, even the simple assumption that it will stay constant as a share of GDP also includes an embedded assumption that Congress will increase appropriations every year faster than inflation and population growth—since GDP growth typically exceeds inflation and population growth. That may have been the case in the past, but that has not been true for the past several years, and it is not expected to be true over the next 10 either.

In other words, just as the long-term projections assumed unpaid-for tax cuts beginning 10 years out, they also assumed unpaid-for spending increases. It is

FIGURE 6

The long-term debt projections rely on assumptions about future deficit-increasing decisions

Publicly held debt as a share of GDP



Source: Michael Linden and Sasha Post, “The United States’ Long-Term Debt Problem Isn’t as Bad as you Thought” (Washington: Center for American Progress, 2013).

no surprise that budget projections built on assumptions of future massive, but unspecified, deficit-increasing policies would show enormous amounts of debt. Those projections may be useful as a warning to future Congresses not to dramatically cut taxes and increase spending without paying for any of it, but they are not particularly useful for determining the fiscal outcome of our current budget path.

Just how much does all of this change the long-term budget projections? In June of 2010 the CBO's alternative fiscal scenario predicted that debt would reach 185 percent of GDP by 2035. After taking into account the medium-term budget improvement and removing the assumptions about future debt-increasing actions, the predicted debt in 2035 drops by more than 80 percentage points. And although debt over 100 percent of GDP is probably still too high, it is an incredible improvement on the projections three years ago. Furthermore, instead of debt exceeding 90 percent of GDP by 2021—a symbolic threshold that, as we will see in the next section, means little or nothing in reality—we can now expect it to remain under that level through 2030. Even if we were concerned about debt at that level, we now have twice as long to address it.

The key argument that high debt causes slower growth has crumbled

For the past three years, we have been warned that debt levels over 90 percent of GDP are extremely risky and present a debt “tipping point” that we should do everything in our power to avoid. These warnings were based on a paper entitled “Growth in a Time of Debt,” written by economists Carmen Reinhart and Kenneth Rogoff.³⁰

In their paper Reinhart and Rogoff used data from dozens of countries over two centuries to investigate the relationship between high debt and slow economic growth. They concluded that, “across both advanced countries and emerging markets, high debt/GDP levels (90 percent and above) are associated with notably lower growth outcomes.”³¹ They argued that the relationship between growth and debt is “non-linear”—meaning that the growth effects were more pronounced at higher debt levels—and that countries may have “debt intolerance ceilings”—meaning that there may be a particular level at which debt becomes particularly dangerous.³²

Reinhart and Rogoff’s finding had a dramatic effect on the public debate over the federal budget. The notion took hold among both policymakers and pundits that there existed a 90 percent debt threshold, which if breached would result in horrible consequences. “Ninety percent” became a kind of mantra for many lawmakers, pundits, and even policy experts. (see sidebar on page 16) It was the rallying cry for those who wanted immediate, decisive action toward reducing the budget deficit.

Before long, the Reinhart and Rogoff conclusion was taken as a given by many, despite the fact that their paper was never peer-reviewed nor did they share their data so others could attempt to replicate their findings.⁴⁰ Furthermore, even if an association did exist between high debt and slower growth, it was not at all clear which way the causation flowed.⁴¹ “Growth in a Time of Debt” nevertheless provided a seemingly empirical basis for moving quickly to control the federal government’s debt, and many policymakers used it explicitly for that purpose.

Three years after Reinhart and Rogoff released the initial version of their paper, we now know that it is badly flawed. Researchers at the University of Massachusetts,

The “90 Percent” Mantra

Sen. Kent Conrad (D-ND), former chair of the Senate Budget Committee: “There was a landmark work done a couple of years ago by Rogoff and Reinhart. They looked at 200 years of economic history and they concluded that once our debt exceeds 90 percent of GDP, our future economic prospects are reduced, and reduced quite significantly: future economic growth reduced by 25 to 33 percent. So this is not just numbers on a page; this is a question of future economic opportunity.”³³

Sen. Rob Portman (R-OH), former member of the Joint Select Committee on Deficit Reduction: “[Reinhart and Rogoff] have shown that once a country’s debt burden reaches 90 percent of the economy, you have a significant downturn in economic growth.”³⁴

Congressman Paul Ryan (R-WI), chair of the House Budget Committee: “Economists who have studied sovereign debt tell us that letting total debt rise above 90 percent of GDP creates a drag on economic growth and intensifies the risk of a debt-fueled economic crisis.”³⁵

Congressman Dave Camp (R-MI), chair of the House Ways and Means Committee: “Independent economists have found that debt loads greater than 90 percent of GDP could result in the loss of up to a million jobs.”³⁶

***New York Times* columnist David Brooks:** “Nations around the globe have debt-to-GDP ratios at or approaching 90 percent -- the point at which growth slows and prosperity stalls.”³⁷

Joe Scarborough, host of “Morning Joe”: “The economics profession is beginning to understand that high levels of public debt can slow economic growth, especially when gross general government debt rises above 85 or 90 percent of GDP.”³⁸

***The Washington Post* editorial board:** “The CBPP analysis assumes steady economic growth and no war. If that’s even slightly off, debt-to-GDP could keep rising—and stick dangerously near the 90 percent mark that economists regard as a threat to sustainable economic growth.”³⁹

Amherst, discovered several important errors in Reinhart and Rogoff’s analysis.⁴² These included a basic coding mistake that resulted in some inadvertently excluded data, as well as the deliberate exclusion of certain data for countries such as Australia, New Zealand, and Canada, all of which experienced relatively good growth during periods of high debt.

After correcting for these and other issues, the Reinhart and Rogoff conclusion vanished. In reporting their “most basic finding,” the University of Massachusetts researchers write that, “contrary to [Reinhart and Rogoff], average GDP growth at public debt/GDP ratios over 90 percent is not dramatically different than when public debt/GDP ratios are lower.”⁴³ In other words, there is no 90 percent threshold.

Reinhart and Rogoff themselves now openly admit this. They now acknowledge some of their errors and insist that they never meant to imply that the 90 percent level was significant. In a *New York Times* op-ed, they wrote that, “Nowhere did we assert that 90 percent was a magic threshold that transforms outcomes, as conservative politicians have suggested.”⁴⁴

They do, however, still maintain that their data, even corrected, shows that there is correlation between higher debt and slower growth. That may or may not be true. The University of Massachusetts researchers report that, “differences in average GDP growth in the categories 30-60 percent, 60-90 percent, and 90-120 percent cannot be statistically distinguished.”⁴⁵ But even if there were a statistically significant relationship, it still does not prove that higher debt causes slower growth. The truth could very well be the reverse, as Reinhart and Rogoff acknowledge. “Our view,” write Reinhart and Rogoff in that same *New York Times* op-ed, “has always been that causality runs in both directions, and that there is no rule that applies across all times and places.”⁴⁶

Perhaps causality does run in both directions, but that is not what another economist, Arindrajit Dube, found when exploring Reinhart and Rogoff’s data for precisely that relationship. Dube asked what he called “a simple question: does a high debt-to-GDP ratio better predict future growth rates, or past ones?”⁴⁷ In other words, Dube tested to see if periods of high debt could reliably foretell slower growth. If so, that would suggest that debt was indeed causing growth to slow. But if it was in fact the other way around and periods of slow growth reliably foretold higher debt, then that would suggest the relationship between the two was the reverse of what Reinhart and Rogoff originally implied. Dube’s results were crystal clear. Slow growth was a far better predictor of high debt than high debt a predictor of slow growth. As he puts it, “this pattern is a telltale sign of reverse causality.”⁴⁸

Reinhart and Rogoff’s famous paper was widely cited and repeatedly used as evidence for why we needed to move immediately to fiscal contraction. Now we know that their paper not only does not support the notion of a debt “threshold” but in fact shows that high debt is the result of slow growth rather than the opposite. At the very least, this new information should spur those who based their policy preferences on Reinhart and Rogoff’s work to re-evaluate their positions. And shouldn’t the entire debate be about how to spark growth rather than how to reduce the debt?

Austerity has failed

Unfortunately, the debate has not been about how to promote growth or how to create good jobs. It has instead revolved mostly around how to cut spending and—to a much lesser extent—how to raise revenues in order to reduce future debt. But now, after three years, even Carmen Reinhart and Kenneth Rogoff themselves believe that, “A sober reassessment of austerity is the responsible course for policy makers,” though, in their view, not for the same reasons their critics contend. They instead say that their “consistent advice has been to avoid withdrawing fiscal stimulus too quickly.”⁴⁹ If, indeed, that has been their consistent advice, many policymakers have ignored it.

In the United States, but especially in Europe, governments have gone far beyond merely “withdrawing fiscal stimulus”; they have been imposing severe austerity measures with the hopes of reducing government debt and eventually putting their countries on sound economic and fiscal footing. Suffice it to say this has not worked.

Take the most extreme example first: Greece. Greece came into this crisis with undeniable fiscal and economic challenges. But austerity has thus far failed to solve the former and has dramatically exacerbated the latter. Over the past several years, Greece repeatedly imposed ever-more dramatic austerity measures. They have raised their retirement age, cut public pensions, cut pay and benefits for public-sector workers, closed schools, cut funding for public health and for defense, reduced subsidies to local services, and laid off thousands of government workers.⁵⁰ The end result is that in 2012, real government spending per person in Greece had fallen by more than 22 percent since 2009. And yet government spending measured as a share of gross domestic product was actually *higher* in 2012 than it was in 2009.⁵¹

How could that be? How does a country cut real spending per capita by about 22 percent in four years and still end up with higher spending as a share of the total economy? It can happen if all those spending cuts send the economy into a tailspin. And that is precisely the trap that Greece finds itself in today. From 2009 to 2012 Greek GDP declined by more than 17 percent, in real terms.⁵²

The consequences of these austerity measures and the attendant economic depression have been devastating. In December 2012 the unemployment rate in Greece was 26.4 percent, highest among all the Organisation for Economic Co-Operation and Development countries.⁵³ Among young people aged 15 to 24, the unemployment rate was an astounding 57.4 percent.⁵⁴ A recent *New York Times* article was headlined “More Children in Greece are Going Hungry.”⁵⁵ All of this suffering in the name of debt reduction, and yet the country’s fiscal problems still have not been solved. The budget deficit in Greece in 2012 was still 10 percent of GDP.

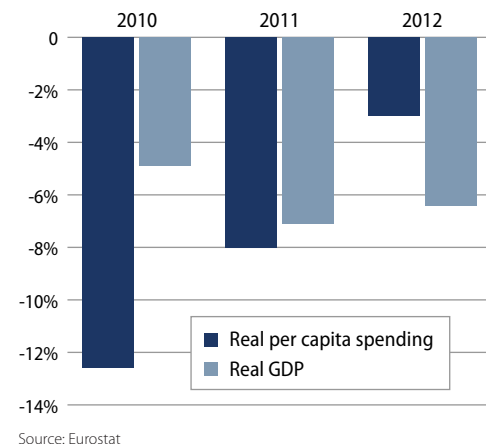
The story of failed austerity begins in Greece but by no means does it end there. A similar story has played out in Spain, which implemented spending cuts only to have its economy contract in each of the past two years. As a result, Spanish government spending and deficits were still higher in 2012 as a share of GDP than they were two years ago.⁵⁶

Of course, Spain and Greece might be considered special cases to some degree since their fiscal and economic challenges are tied to the larger issues of the Eurozone. But the same cannot be said for the United Kingdom, which also turned to austerity and has also suffered economically for it.

Since 2010, with the election of a new government led by the Conservative party, the United Kingdom has prioritized fiscal contraction, implementing a wide range of spending cuts. The new government explicitly argued that high deficits and growing debt presented an immediate and serious danger to the economy, and hence extraordinary measures were required.⁵⁷ Those measures included the largest cuts in government spending in postwar history in the United Kingdom.⁵⁸ The goal was to reduce the deficit such that by 2015, publicly held debt measured as a share of GDP would be falling rather than rising.⁵⁹

So far, despite all of the austerity measures, they are failing to achieve that goal. The latest U.K. budget released in March 2013 projects that the debt-to-GDP ratio will continue rising through 2016 and only begin to decline in 2017.⁶⁰ But the failure is actually far starker than that. In the original austerity budget released in June 2010, the U.K. government projected that, with their austerity policies in place, the debt would peak at 70.3 percent of GDP in 2013 and then begin to fall

FIGURE 7
The consequences of Greek austerity
 Change from previous year in Greek government spending and GDP



in 2014. In fact, the debt-to-GDP ratio in 2013 is now expected to surpass 79 percent on its way to 85 percent by 2016.⁶¹

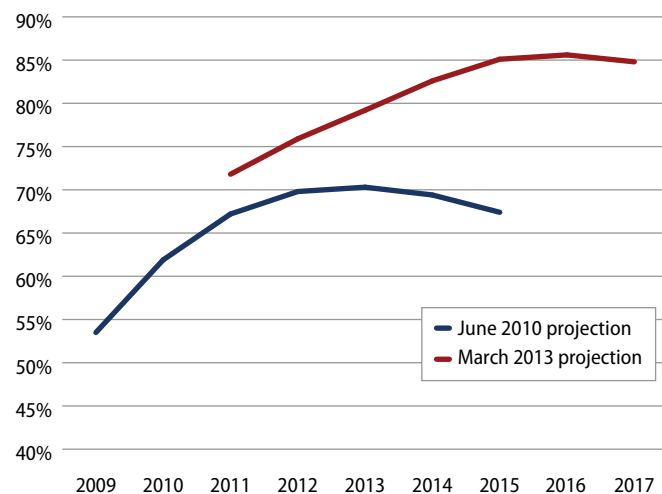
Not only has austerity in the United Kingdom failed to achieve the fiscal goals its proponents presented, but it has also failed to heal the economy as many promised it would.⁶² Instead of putting the United Kingdom on surer economic footing, austerity has produced stagnation. In June 2010 when the austerity agenda was announced, the U.K. government predicted that their economy would grow by 2.4 percent in 2011 and 2.9 percent in 2012 in real terms.⁶³ In fact, the United Kingdom saw almost no growth at all in the past two years with GDP expanding by only 0.7 percent in 2011 and just 0.2 percent in 2012.⁶⁴ The unemployment rate in the United Kingdom has barely changed from what it was in June 2010 when the first austerity budget was released.⁶⁵

The incredibly poor performance of austerity policies is beginning to change the discussion in Europe. In April the International Monetary Fund's Chief Economist Olivier Blanchard publicly encouraged the United Kingdom to re-evaluate its economic approach. Blanchard said, "There is a point at which you actually have to sit down and say, maybe our assumptions were not right and maybe we have to slow down."⁶⁶ And even in Germany—that stronghold of fiscal consolidation—there appears to be a growing understanding that austerity is not working. In his recent acknowledgement that Spain would require more flexibility, German Finance Minister Wolfgang Schaeuble remarked that, "If the economy deteriorates, you don't reinforce the economic downturn through deeper cuts."⁶⁷

Europe's experience should be influential in the United States as well. Their experiments with massive cuts and immediate fiscal contraction have not gone well. And although the United States has thus far not engaged in austerity on quite the same scale as Greece, Spain, or even the United Kingdom, we have moved rather rapidly from fiscal expansion to fiscal contraction. And unfortunately, our experiment has not gone very well either.

FIGURE 8
U.K. austerity failing to hit the target

United Kingdom public-sector net debt as a share of GDP



Source: U.K. House of Commons, "Budget 2013" (2013); U.K. House of Commons, "Budget 2010" (2010).

The U.S. economy has not healed nearly as swiftly as was projected when the budget cuts began

Unlike in Europe, even many of the proponents of deficit reduction in the United States were opposed to immediate fiscal contraction on the grounds that it would hamper the recovery. The Center for American Progress, for example, while endorsing a comprehensive plan to reduce the deficit and eventually balance the budget, also cautioned that the country “must allow time for our economy to fully recover before administering the strongest deficit-slashing medicine. Deficit reduction that is too big, too fast would be counterproductive, stalling growth and worsening our fiscal problems.”⁶⁸ Erskine Bowles and Alan Simpson were similarly concerned. One of the “guiding principles” in developing their now-famous bipartisan plan was, “Don’t disrupt the fragile economic recovery.” They wrote in the final report of the fiscal commission that, “We need a comprehensive plan now to reduce the debt over the long term. But budget cuts should start gradually so they don’t interfere with the ongoing economic recovery. Growth is essential to restoring fiscal strength and balance.”⁶⁹

Much like Reinhart and Rogoff’s supposedly consistent advice not to withdraw fiscal stimulus too quickly, these warnings unfortunately went largely unheeded. As described above, Congress and the president proceeded to cut trillions from the federal budget, including billions that took effect immediately. Those cuts, along with the expiration of fiscal stimulus, have resulted in a substantial decline in federal spending over the past three years. In 2013 overall real per capita federal spending will be approximately 8 percent lower than it was in 2010. That makes 2010 to 2013 the largest three-year reduction in federal spending since the demobilization at the end of the Korean War. And compared to 2009, in the depths of the recession, federal real per capita spending has declined by 12 percent.

It should not be terribly surprising, therefore, that the economy has not recovered nearly as quickly or as robustly as was predicted before the spending cuts began. In August 2010—less than six weeks before Congress passed its first round of spending cuts, less than three months before Republicans won back the House of

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Representatives, and less than four months before Erskine Bowles and Alan Simpson released their plan for deficit reduction—the Congressional Budget Office released an updated economic outlook. In it they projected that gross domestic product would grow by a cumulative 10.5 percent in real terms over the next three years, reaching \$16,977 billion in 2013. And they projected that the unemployment rate would peak in 2010, fall to 6.6 percent by 2013, and fall again to 5 percent by 2015.⁷⁰

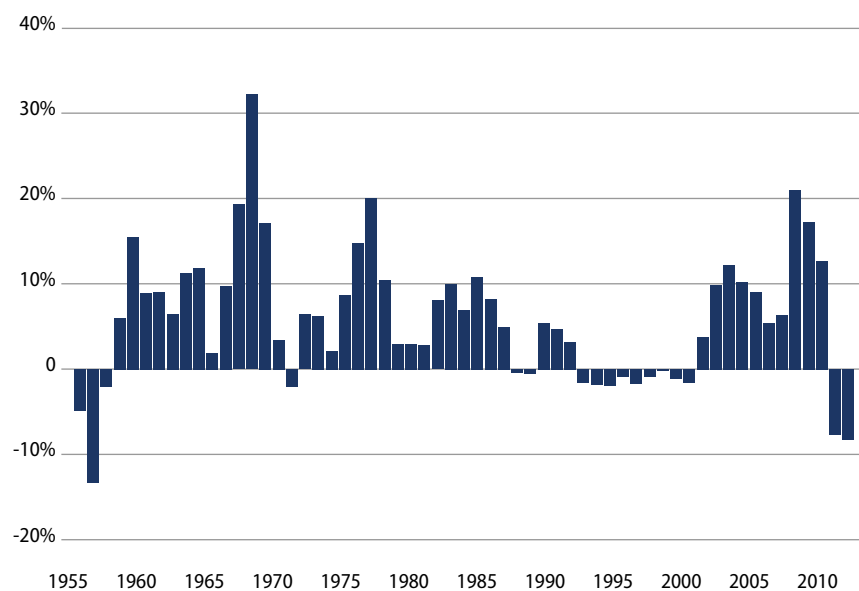
Needless to say, those projections have now proven to be quite optimistic. The CBO currently expects GDP in 2013

to total \$16,149 billion, nearly 5 percent lower than it had projected in August 2010.⁷¹ That means we have experienced real cumulative three-year growth of just 5.5 percent, a far cry from the 10.5 percent the CBO had expected three years ago. And of course, the unemployment rate in April was 7.5 percent not 6.6 percent.⁷²

The economy simply has not rebounded with the speed and vigor that official projections suggested it would. And our fiscal choices over the past several years are at least partly to blame. Janet Yellen, the vice chair of the Board of Governors of the Federal Reserve System, recently pointed out that in past recessions “fiscal policy often helps to support an economic recovery.” This time, however, after the first year of the recovery, “instead of contributing to growth thereafter, discretionary fiscal policy has actually acted to restrain the recovery. ... At the federal level, policymakers have reduced purchases of goods and services, allowed stimulus-related spending to decline, and have put in place further policy actions to reduce deficits.”⁷³ And on May 1, the Federal Reserve’s Open Market Committee put it even more bluntly, stating unequivocally that, “fiscal policy is restraining economic growth.”⁷⁴

FIGURE 9
Recent declines in federal spending are the largest since the Korean War

Cumulative three-year change in real per capita federal spending



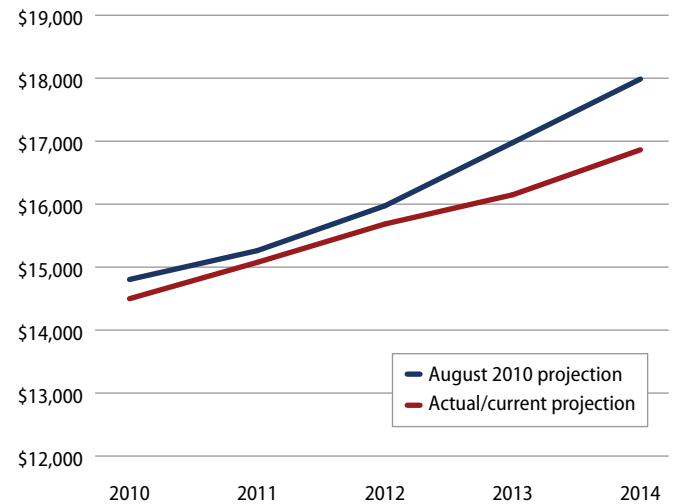
Source: Office of Management and Budget, Bureau of Labor Statistics, U.S. Census Bureau, Congressional Budget Office.

Since many of the deficit-reduction proposals offered over the past several years were designed explicitly with the assumption that the economy would grow far faster than it has and that unemployment would fall far more than it has, one might expect those deficit plans to be rethought accordingly. Unfortunately, that does not yet appear to be happening. Alan Simpson and Erskine Bowles, for example, recently released a new version of their plan for deficit reduction.⁷⁵ With the unemployment rate so much higher and growth so much slower than they expected when they wrote their original plan, does their new plan call for a somewhat higher level of spending for 2014 than they proposed originally? It does not. In fact, the new plan from Simpson and Bowles actually envisions total 2014 federal spending about \$170 billion below the spending level in their original plan.

The new Simpson-Bowles plan is a good example of how the debate has not adjusted to the current realities. Rather than recognizing that the economy is not yet on sure footing and that the rush to fiscal consolidation is partly to blame for that weakness, they continue to push for ever more deficit reduction. Rather than offering a new plan that recommits to one of their original principles—“don’t disrupt the fragile recovery”—they offer one that recommends even more spending cuts. It is almost as if the past three years never happened.

FIGURE 10
Economic growth has not kept up with 2010 projections

Nominal gross domestic product



Source: Congressional Budget Office, Bureau of Economic Analysis.

The push for immediate debt reduction has resulted in some very perverse policy outcomes

The past three years cannot be ignored. And although we have made substantial, positive, and commendable progress toward fiscal sustainability, the clamor for deficit reduction has resulted in some indisputably negative consequences as well.

First and foremost, as discussed previously, the focus on deficit reduction has hampered the economic recovery. Not only did the turn toward spending cuts prevent the federal government from taking further proactive steps to help heal the economy, but the enacted cuts also directly reduced overall economic growth.

In addition to the immediate drag on the economy, there have been other perverse consequences over the past several years that have stemmed from Washington's near obsession with deficit reduction. For the first time in the nation's history, for example, every time we approach the debt limit, we now need to worry whether Congress will allow the U.S. Treasury to pay the country's bills. In the summer of 2011, congressional Republicans refused to authorize an increase in the debt limit without enacting spending cuts to match. They argued that the imperative of deficit reduction made such extraordinary tactics necessary.⁷⁶

The incredible uncertainty and unprecedented nature of the standoff prompted a collapse in consumer confidence, a slowdown in hiring, and a stock market swoon.⁷⁷ Not only that, but it actually increased government costs. The Government Accountability Office found that the "delays in raising the debt limit in 2011 led to an increase in Treasury borrowing costs of about \$1.3 billion in fiscal year 2011."⁷⁸ The Bipartisan Policy Center, using GAO's methodology, estimated the 10-year cost of the debt limit standoff to be nearly \$19 billion.⁷⁹

In early 2013, as it came time again to raise the debt limit, the country braced for another round of disruptive, counterproductive brinksmanship. Fortunately, this time, Congress raised the limit with relatively little turmoil. But it remains to be seen if that will be the case in the fall when the limit will need to be increased yet again.

Unfortunately, uncertainty over the government's ability to pay the bills is not the only perverse consequence of the rush to deficit reduction. The debt limit fight in the summer of 2011 ultimately culminated in legislation known as the Budget Control Act, or BCA. The BCA cut discretionary spending over the following 10 years by placing annual statutory limits on both security and nonsecurity appropriations. It also set up a special committee made up of members of both parties and both chambers of Congress tasked with finding another \$1.2 trillion in deficit reduction, as well as a mechanism to encourage success. That mechanism, known as the sequester, would automatically impose large additional cuts mainly to discretionary spending should the committee fail to agree on the additional deficit reduction. The sequester was deliberately designed to be draconian and blunt, and the hope was that it would never be enacted.

That hope was dashed on March 1 when the sequester did in fact kick in. The sequester is the poster child for the perverse consequences of deficit fever. The policy itself has virtually no supporters; few would argue that it makes sense to cut such a wide array of public services, benefits, programs, and investments across the board without regard for actual impact. And those impacts are indefensible: children are randomly removed from their Head Start program;⁸⁰ cancer patients are turned away;⁸¹ courts are backed up; public defenders are furloughed;⁸² and layoffs abound—lots and lots of layoffs.⁸³

In addition to its bluntness and severity, another ridiculous aspect of sequestration is the simple fact that it predominantly affects only the portion of the budget that has already been cut and was already projected to decline to historically low levels. Indeed, the repeated cuts to discretionary spending— especially nondefense discretionary spending—are themselves another perverse outcome of the debt debates.

Nondefense discretionary spending was never a major factor in the medium- or long-term budget challenges. In all of the dire debt projections from the summer of 2010, discretionary spending as a share of GDP was already expected to shrink not grow.⁸⁴ It was other parts of the federal ledger—namely entitlement programs and continued tax cuts—that were primarily responsible for the projected run-up in debt. But because it proved to be politically difficult to enact the kind of entitlement or tax reforms that would address the underlying fiscal problems, Congress instead repeatedly returned to the relatively easy and politically painless approach of cutting the broad nondefense discretionary category. As a result, nearly all of the spending cuts enacted up until this point have been to discretionary spending.

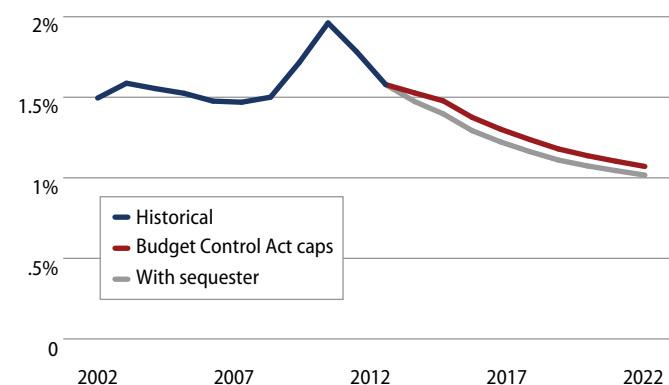
The sequester is the poster child for the perverse consequences of deficit fever.

This is even more absurd given that the vast majority of the federal government’s investments in future economic growth can be found in the nondefense discretionary category including transportation infrastructure spending, federal support for pre-K-12 education, and funding for scientific research. Because of the Budget Control Act—and even without the sequester—discretionary spending on economic investments is currently projected to decline from 1.6 percent of GDP in 2012, which also happens to be the average amount spent over the past 50 years, to just more than 1 percent of GDP by 2022. With the sequester, spending on these investments will fall below 1 percent of GDP by 2022, lower than at any point since 1963.⁸⁵ Surely, when we began the process of cutting the deficit, our intention was not to also undercut the country’s ability to invest in the future. But that is what has happened.

Fiscal sustainability is an admirable and important goal, and we have gone a long way toward achieving it. But the headlong rush to deficit reduction has also produced several unintended policy consequences including the uncertainty over the debt limit, the disproportionate cuts to discretionary spending, and of course, the sequester. All of these are painful, counterproductive, and shortsighted. Any positive gains that we might enjoy from our improved fiscal situation are at least partially offset by the negative effects of these harmful byproducts.

FIGURE 11
Federal economic investments headed to historic lows

Discretionary spending on economic investments as a share of GDP



Source: Michael Linden, "Budget Cuts Set Funding Path to Historic Lows" (Washington: Center for American Progress, 2013).

Reversing the sequester and investing in growth

The good news is that some of these negative effects can be reversed. Indeed, any additional deficit reduction should be conditional upon first addressing some of the harmful byproducts of previous deficit-reduction efforts—the sequester primary among them.

As previously discussed, the sequester is widely derided as a terrible method for deficit reduction.⁸⁶ It was never intended to actually be implemented but was meant only as an incentive to push Congress to come to an agreement. The sequester was deliberately designed to be draconian and painful, so as to encourage both sides to compromise in order to avoid it.⁸⁷ It cuts the very investments and basic public services that are most critical to economic growth, and it cuts the very programs and protections that have already been subject to large reductions.

What makes the sequester even more absurd is the simple fact that we do not need it to achieve the goal of a sustainable federal budget over the next 10 years. None of the medium-term fiscal improvement described in this report is dependent in any way on the implementation of the sequester. One of the assumptions underlying the current “realistic” projection is that the sequester will be repealed in its entirety without offsetting deficit reduction. In other words, even without the sequester, the budget is already on relatively sustainable ground throughout the next 10 years.

Furthermore, the current budget picture *without* the sequester is actually far better than what it was projected to be *with* the sequester when the Budget Control Act was originally enacted in the summer of 2011. In August 2011 the federal budget deficit from 2013 to 2021 was projected to total \$6.2 trillion with the sequester in place for an average of 3.4 percent of gross domestic product.⁸⁸ Today, without the effects of the sequester, the deficit is projected to total \$5.6 trillion over the 2013–2021 period for an average of 3.1 percent of GDP. In other words, if we simply repeal the sequester in its entirety, our projected budget deficits would still be lower than what they were expected to be after the sequester was originally passed into law.

Even without the sequester, the budget is already on relatively sustainable ground throughout the next 10 years.

In a rational world, that is exactly what we would do: simply repeal the sequester. It is harmful, shortsighted, and totally unnecessary. Unfortunately, we do not live in that world yet. There are too many policymakers who have yet to internalize all of the important changes in the fiscal and economic landscape, and they therefore would not embrace simple repeal. As a result, the most realistic approach to fixing the sequester at this point is to replace it with smarter deficit reduction—even if that deficit reduction is largely unnecessary right now.

To that end, we offer one such reasonable plan. Our approach is built on the following four precepts.

Keep it manageable

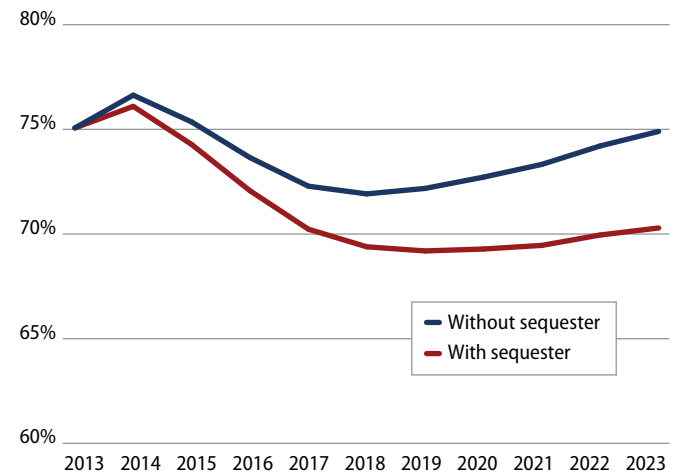
If the past three years have proven anything, it is that Republicans and Democrats cannot agree on a large package of deficit reduction. If we hold out for \$1 trillion in deficit reduction to replace the entire 10 years of the sequester, we may find ourselves waiting forever. There is no need, however, to replace the entire 10 years right away. In time, as our fiscal situation continues to improve and as political conditions change, it will hopefully be easier to replace or even get rid of the sequester. But we should not let the perfect be the enemy of the good. For now, our plan would replace three years of the sequester, taking us through 2016.

We have already paid for 60 percent of the sequester

The original intent of the sequester was to ensure that, no matter the outcome of the so-called super committee, there would be \$1.2 trillion in additional deficit

FIGURE 12
Debt is stabilized without the sequester

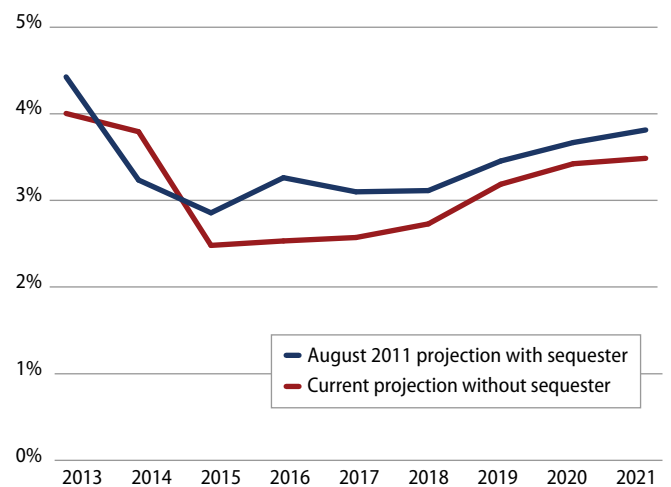
Publicly held debt as a share of GDP



Source: Congressional Budget Office.

FIGURE 13
The sequester is unnecessary to achieve deficit reduction targets

Budget deficit as a share of GDP



Source: Congressional Budget Office.

reduction. As already noted, the deficit picture has actually improved much more substantially than that even without the sequester. But even if we consider only legislated deficit reduction, we have actually achieved part of the goal as well. The American Taxpayer Relief Act, better known as the fiscal cliff deal, enacted about \$800 billion in deficit reduction from 2013 to 2023, or about 60 percent of the total deficit reduction achieved by the sequester over that period.⁸⁹ Had that same deficit reduction come about through the super committee process, it would have reduced the impact of the sequester to only about \$500 billion rather than the currently projected \$1.3 trillion. Recognizing this, our plan offsets only the remaining 40 percent of the sequester that has not been paid for already.

Balance is a necessary component

Nearly three-quarters of the legislated deficit reduction to date has come in the form of spending cuts.⁹⁰ And while additional spending cuts may be required to offset the sequester, so too will some additional revenue. In the past the requirement for additional revenue has been the main stumbling block to a deal, as conservatives in Congress have refused to consider even relatively modest revenue enhancements. Because of our first two principles, however, conservatives will only need to agree to a very small amount of additional revenue to achieve the goal of fixing the sequester. Our plan would increase total revenues over the next 10 years by less than 0.4 percent.

Focus on the economy

The main objective in seeking to fix the sequester is to avoid further economic damage. The economy is on fragile ground, and although there have been some optimistic signs of progress, unemployment remains unacceptably high, wages remain unacceptably stagnant, and growth remains unacceptably slow. Federal Reserve Chairman Ben Bernanke recently all but begged Congress to address the deleterious economic effects of the sequester.⁹¹ But Congress could and should do more than simply prevent the sequester from doing harm. It can actively take steps to boost job creation and lay foundations for future economic growth. That is why our plan includes room for roughly \$80 billion in investments that Congress could enact today that would help improve the economic outlook and make it easier to address what remains of our fiscal problems in the long term.

With these four principles in mind, we offer the following sequester replacement plan.

Repeal the sequester for fiscal years 2014, 2015, and 2016

The total “cost” to the federal bottom line would be approximately \$315 billion not including increased debt service costs.⁹² But because we have already paid for 60 percent of the sequester, we need only offset about \$126 billion.

Implement competitive bidding more broadly throughout federal health care programs

Competitive bidding for medical equipment and devices, for clinical laboratories, and in Medicare Advantage will lower prices for the federal government, resulting in nearly \$50 billion in savings over 10 years.⁹³

Better alignment of Medicare payments to actual costs

Medicare payments for services from a number of different providers—including home health providers, skilled nursing facilities, and some hospitals—are currently substantially higher than the actual costs of treatment. Bringing those payments down to reflect the providers’ true costs will reduce federal spending by approximately \$50 billion over 10 years.⁹⁴

Reduce agriculture subsidies

Our current system of agricultural subsidies is outdated and costly. Reforming this system along the lines proposed by President Obama would save approximately \$40 billion over 10 years.⁹⁵

Implement the “Buffett Rule”

Overall, our federal tax system is progressive—meaning that higher-income households on average pay a greater share of their income in taxes than do middle- and low-income households. This is not always true, however. There are many very high-income households who are able to avoid paying even middle-class rates. The Buffett Rule would ensure that millionaires are paying at least the same tax rates as most other high-income households. It would raise approximately \$100 billion over 10 years.⁹⁶

Repeal fossil-fuel industry tax subsidies

The fossil-fuel industry currently receives numerous tax breaks. Given the profitability of leading fossil-fuel companies, these tax subsidies are entirely unnecessary. Repealing them would save about \$40 billion over 10 years.⁹⁷

Invest in job creation and growth

Our plan also includes room for a little more than \$80 billion in investments that would spark faster growth today and lay the foundations for faster growth tomorrow. These include a \$20 billion down payment for the first five years of the president’s early childhood initiative, a \$50 billion investment in infrastructure, and a \$12 billion investment in the “Pathways Back to Work Fund,” which would help provide employment opportunities for the long-term unemployed, young people, and low-income people.⁹⁸

This plan would avoid the economic damage caused by the sequester and replace it with smarter and better-timed deficit reduction. The plan would also spark faster job creation right away and allow us to begin to make important investments in our future.

TABLE 1
How to replace the sequester

Deficit effect, 2014-2023, in billions

Remaining cost of sequester repeal through 2016	125
Spending Cuts	
Competitive bidding	-48
Better align Medicare payments with costs	-50
Agriculture subsidy reform	-40
Revenue enhancements	
Buffett Rule	-99
Fossil fuel tax subsidy repeal	-44
Investments	
Early childhood	20
Infrastructure	50
Pathways Back to Work fund	12
Debt service	15
Net deficit effect	-59

Conclusion

Three years ago, our fiscal future seemed bleak. Official projections showed debt spiraling out of control, and respected economists were warning of the potentially dire economic consequences of allowing the debt to get out of hand. Some policymakers and pundits argued that deficit reduction not only would avoid those dire consequences but also could help give a struggling economy a boost.

The fiscal situation looks far different today. The debt projections over the next 10 years look downright tame, and even the long-term picture looks far less daunting than it did just a few years ago. Health care costs have slowed dramatically, though it remains to be seen how permanent that trend will be. Those same economists who were warning that we might be approaching a debt tipping point are now insisting that there is no such thing as a magic debt threshold. Austerity measures have been tried and have resulted in exactly the sorts of dire economic consequences they were meant to avoid. And our own deficit-reduction push has produced as many negative outcomes as it has positive ones.

Yet with all the changes in the fiscal and economic situation, the budget debate seems largely unchanged. Many in Washington are still operating as if the deficit and debt should be the government's one overriding concern, and many—especially conservatives—are still pushing for enormous spending cuts. Not only that, but all discussion of proactive measures to help spark better growth or produce job creation is immediately dismissed as “unrealistic,” a prediction that becomes self-fulfilling. This is clearly an unacceptable situation. If we are going to make further progress, we need to start by resetting the debate.

What does it mean to reset the debate? First, it means starting from the understanding that there is no longer a looming fiscal crisis—if there ever even was one. It is true that over the past few years, the federal government has run larger budget deficits and taken on more debt than at any time since World War II. But that has not sparked runaway inflation. In fact, the Federal Reserve recently announced that they expect “inflation over the medium term likely will run at or below [the] 2

percent objective.”⁹⁹ Nor has it put upward pressure on interest rates. The average yield for a 10-year Treasury bill in April, for example, was less than 1.8 percent. By comparison, the yield in 2000 when the budget was balanced averaged 6 percent.¹⁰⁰ And the large deficits and increased debt certainly has not led to any kind of financial calamity.

There simply is no evidence that we are on the precipice of a debt-induced economic crisis. Furthermore, with the medium- and long-term deficit outlook vastly improved, we are unlikely to arrive at such a precipice at any time in the foreseeable future. This means that we do not need to treat deficit reduction as if it is the single-most important issue facing the country. Up until now, most other national issues have been forced to take a backseat to the budget debate. After the reset, that should no longer be the case.

Second, resetting the debate means discarding other fiscal theories that have fared poorly over the past several years. In 2010 and 2011 conservatives put their faith in research from economists Alberto Alesina and Silvia Ardagna who claimed to show that under some circumstances, spending cuts could lead to better growth.¹⁰¹ This approach was dubbed “expansionary contraction,” and conservatives in Congress explicitly cited this research as they pushed for massive spending cuts.¹⁰²

In Europe, of course, the countries that experimented with expansionary fiscal contraction have ended up with neither economic expansion nor even much fiscal contraction since the poor economic situation has overwhelmed any fiscal improvement they might have enjoyed. Here in the United States, we passed spending cuts of our own, and far from boosting growth, they have dragged it down.¹⁰³ It is time to put this theory aside.

Third, we must recognize that there are costs to elevating deficit reduction above all other concerns. There is no question that deficit reduction was an important challenge to address. But it was given a special status above all other national challenges. As a result it became much more likely that we would end up with negative

FIGURE 14
Interest rates are unusually low

10-year Treasury constant maturity rate



Source: Federal Reserve Bank of St. Louis, “10-Year Treasury Constant Maturity Rate” (2013).

unintended consequences, as policymakers weighed the benefits from reducing the debt much more highly than any costs. And negative unintended consequences are exactly what we got.

Congressional Republicans used the imperative of deficit reduction as justification for leveraging the debt limit to gain a political advantage. The imperative of deficit reduction allowed Congress and the president to repeatedly cut less-politically protected nondefense discretionary spending even when they could not agree on an approach to address the true drivers of the debt. The imperative of deficit reduction gave us the sequester under the theory that deficit reduction was so important, it was worth threatening the country with damaging, painful cuts.

But we can no longer afford to pretend as if the benefits of deficit reduction always, in all circumstances, outweigh the costs. And we cannot allow the continued perception of a deficit-reduction imperative to prevent us from fixing the sequester and avoiding more economic damage.

It is time to reset the entire budget debate. No more pretending that the sky is falling. No more rash actions to cut the deficit without regard for real-world impacts. No more calls for an ever-elusive grand bargain. No more super special committees or draconian automatic punishments intended to force action. Improving our national finances is still an important goal—that has not changed. But so much else has, and the debate must change too.

About the author

Michael Linden is the Managing Director for Economic Policy at American Progress. Michael’s work focuses on the federal budget and the medium- and long-term deficits. He has co-authored numerous reports on the causes of and solutions to our fiscal challenges, including “Path to Balance,” which first proposed primary balance as an intermediate goal, and “A First Step,” which included a detailed plan for achieving that goal. Michael also coined the phrase “deficit peacock.” His work has been cited by *The New York Times*, *The Washington Post*, and National Public Radio, among others.

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