

Chapter 1

**Growing Deficits and
Why They Matter**

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This book is about the difficult choices that citizens and policymakers must make about the priorities in the federal budget. Its basic theme is: we can't have everything; we have to choose what we want most and how we want to pay for it. Right now, we are trying to have it all: lower taxes *and* increased spending—for Social Security, Medicare, defense, homeland security, and many other programs. The result is a government budget that is out of control and that poses substantial risks for the future. Our government is now borrowing about half a trillion dollars a year. But the important point is that there is no end in sight to this tide of red ink. In fact, matters will get far worse once the baby boom generation begins to retire. If nothing is done, the national debt is projected to increase by \$5.3 trillion in the next decade alone. The interest on this extra borrowing will cost the average household \$3,000 a year, and the economic effects of the deficits will also lower its income an estimated \$1,800.

To be sure, budget projections are very uncertain. They depend on what happens to the economy, on future spending and taxing actions of Congress, and on unpredictable events at home and abroad. No one can claim to know exactly what the future will bring. But intelligent decisions must be based on the most realistic projections that can be made—otherwise they are just blind guesses.

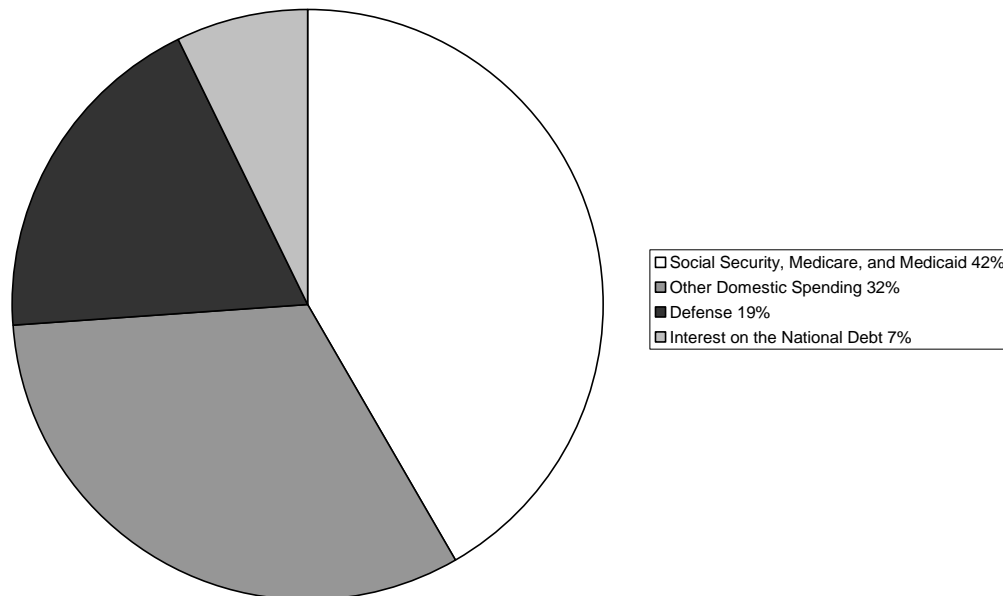
In this chapter we lay the groundwork for the alternatives presented in the rest of the book. We show that on reasonable assumptions about the economy the federal budget is likely to run persistent deficits that reach about \$700 billion a year by the end of the decade and remain at 3 percent or more of GDP. These deficits would be much larger—about 5 percent of GDP—if not offset by short-term surpluses in the major federal retirement programs, Social Security and Medicare. But we know that the short-term surpluses in these retirement accounts will soon turn

into deficits as the baby boom retires, creating an unprecedented and unsustainable fiscal gap that grows larger and larger over the next few decades. The right time to address this problem is now. The longer we wait to get our fiscal house in order, the greater the risks to the economy and the more painful the solutions will be.

An Overview of the Federal Budget

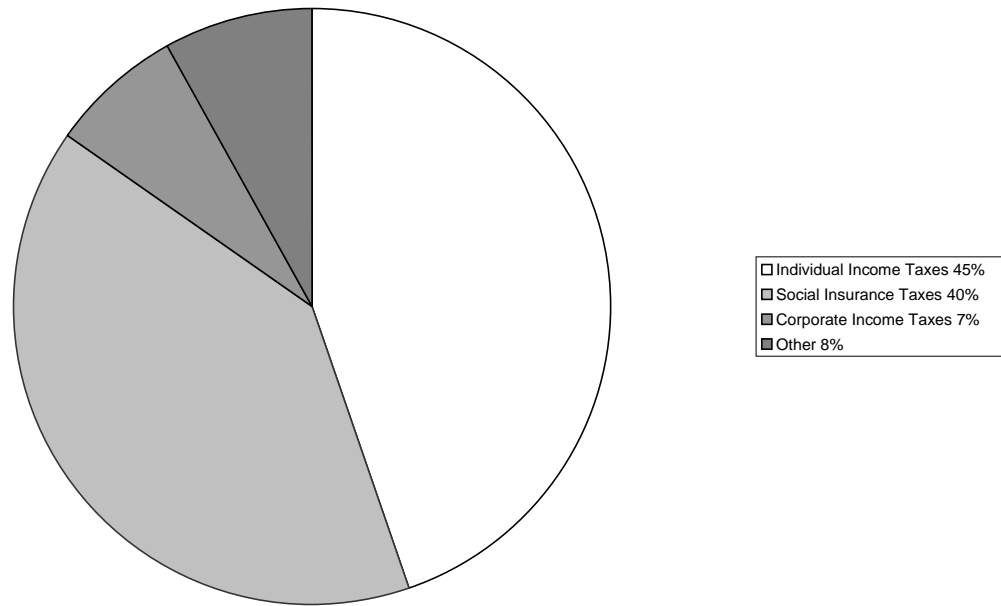
In 2003, the federal government spent \$2.2 trillion. Over two-fifths of this spending was for just three large programs: Social Security, Medicare, and Medicaid (figure 1-1).² About a third of current spending is for other (primarily) domestic programs—everything from unemployment insurance and farm subsidies to national parks, education, and programs for the poor. Many of these programs are funded through the annual appropriations process and, as a result, are referred to as “discretionary” since the funding for them is less automatic than spending on “mandatory” programs, such as Social Security or unemployment insurance. Finally, a significant chunk of the budget goes for defense (19 percent) and for interest on the debt (7 percent).

Figure 1-1. *Federal Spending, 2003 Estimate*



Source: Authors' calculations and Congressional Budget Office, "The Budget and Economic Outlook: An Update," August 2003.

Figure 1-2. Federal Revenue Sources, 2003 Estimate

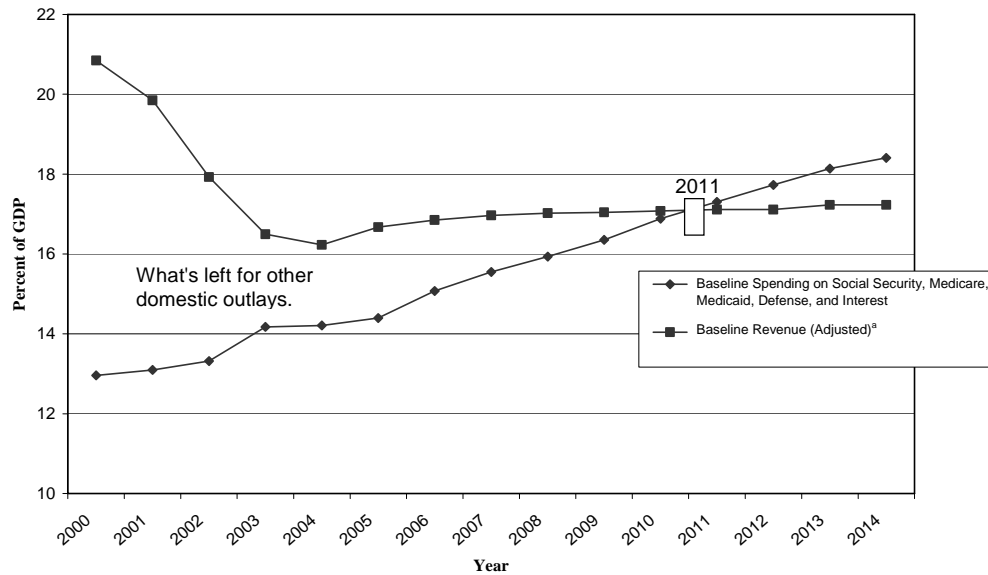


Source: Congressional Budget Office, "The Budget and Economic Outlook: An Update," August 2003

Total revenues to support these activities fell short of total spending by \$374 billion in 2003.³ These revenues come from personal and corporate income taxes, from payroll taxes, and from other smaller sources such as excise and estate taxes (figure 1-2). Over the past few decades the share of expenditures being financed by payroll taxes on workers and employers has grown while the share being financed by taxes on income has shrunk.⁴

After declining for many years as a share of all outlays, the defense budget is slated to grow along with spending for homeland security, both of which are of greatly increased importance in the wake of 9/11 and the war in Iraq. Domestic discretionary programs have been shrinking as a share of total spending and will probably continue to shrink for the foreseeable future.⁵ The three big entitlement programs (Social Security, Medicare, and Medicaid), however, are growing rapidly. Indeed, expected growth in these programs, along with projected increases in interest on the debt and defense, will absorb all of the government's currently projected revenue within eight years, leaving nothing for any other program (figure 1-3).

Although the composition of federal spending has shifted over time, with more money being devoted to paying benefits to the elderly and less to other purposes, the overall size of government relative to the economy has changed little and remains at roughly 20.8 percent of GDP.

Figure 1-3. *The Big Squeeze*

Source: Steuerle, C. Eugene, "The Incredible Shrinking Budget for Working Families and Children," National Budget Issues Policy Brief 1 (Washington: Urban Institute, Forthcoming).

^a Baseline revenue is adjusted to extend expiring tax provisions and to reform the alternative minimum tax.

Where the Deficits Came From

In the 1980s federal deficits grew to worrisome proportions and appeared to be damaging the performance of the economy and confidence in the government's ability to manage its fiscal affairs. Public concern over mounting deficits led politicians of both parties to support aggressive measures to bring them down. President George H. W. Bush worked with a Democratic Congress to pass a budget reduction agreement in 1990. President Bill Clinton dealt with a Democratic Congress in 1993 and a Republican one in 1997 to pass major deficit-cutting packages. These measures, which required many painful compromises, restrained spending and increased revenues. With the assistance of a rapidly growing economy in the 1990s, deficits fell and turned into substantial surpluses by the end of the decade.

But now the surpluses are gone. A weaker economy, tax cuts, and spending increases (especially for defense and homeland security) combined to turn surpluses into deficits again. Revenues fell to 16.5 percent of GDP in 2003, well below the average of recent decades, while spending grew to 20.2 percent of GDP, opening up a deficit gap of 3.7 percent of GDP in 2003.

At the same time, projections of the federal budget outlook have gone through enormous swings from surplus to deficit in the past few years. As recently as early 2001, the Congressional Budget Office was projecting large surpluses in the federal budget, aggregating \$5.6 trillion over

Table 1-1. *CBO Baseline and Adjusted Baseline, 2003-14*
Billions of dollars

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
<i>CBO baseline</i>												
Defense	407	452	472	481	489	506	519	533	552	558	578	599
Appropriated spending	419	448	460	467	479	491	502	515	528	542	556	570
Mandatory spending	1188	1250	1289	1333	1401	1482	1570	1665	1776	1854	1984	2104
Subtotal: spending excluding interest	2014	2150	2221	2281	2369	2479	2591	2713	2856	2954	3118	3273
Net interest	157	155	184	220	255	282	301	312	318	316	305	291
Total spending	2171	2305	2405	2501	2624	2761	2892	3025	3174	3270	3423	3564
Revenue	1770	1825	2064	2276	2421	2564	2723	2880	3165	3430	3634	3815
Deficit or surplus	-401	-480	-341	-225	-203	-197	-169	-145	-9	160	211	251
<i>Adjusted baseline^a</i>												
Defense	407	452	475	489	502	522	541	559	584	595	621	649
Appropriated spending	419	448	464	475	491	507	523	541	559	578	598	617
Mandatory spending	1188	1257	1299	1366	1439	1525	1616	1715	1829	1910	2048	2174
Subtotal: spending excluding interest	2014	2157	2238	2330	2432	2554	2680	2815	2972	3083	3267	3440
Net interest	157	155	185	229	277	318	354	384	414	447	478	514
Total spending	2171	2312	2423	2559	2709	2872	3034	3199	3386	3530	3745	3954
Revenue	1770	1821	1988	2129	2260	2393	2535	2678	2810	2949	3119	3267
Deficit or surplus	-401	-491	-435	-430	-449	-479	-499	-521	-576	-581	-626	-687

Source: Congressional Budget Office, “The Budget and Economic Outlook: An Update,” August 2003; Brookings-Urban Tax Policy Center; authors’ calculations.

^a These numbers include CBO estimates for discretionary spending that have been inflated for population growth and CBO estimates for mandatory spending that have been increased for Medicare reforms, including the drug prescription benefits. Revenues are based on the Tax Policy Center model, assuming an extension of the 2001, 2002, and 2003 tax cuts beyond 2010 and assuming an amendment to the alternative minimum tax. See text for more details.

ten years. Now our adjusted projections (explained below) show that these aggregate surpluses have disappeared and been replaced by aggregate deficits over the next ten years of \$5.3 trillion. To the average person these wild swings seem incomprehensible and suggest that no projections should be taken seriously.

There is, however, no mystery about how projected surpluses turned into projected deficits so quickly. The reasons are: (1) the recession of 2001 and the slow recovery, (2) tax cuts, (3) increased spending, and (4) more realistic assumptions about future budget policy. Although

the recession was the primary culprit in 2002, most of the deterioration in the budget projections between 2002 and 2010 is caused by the recent tax cuts and associated increases in interest on the debt.

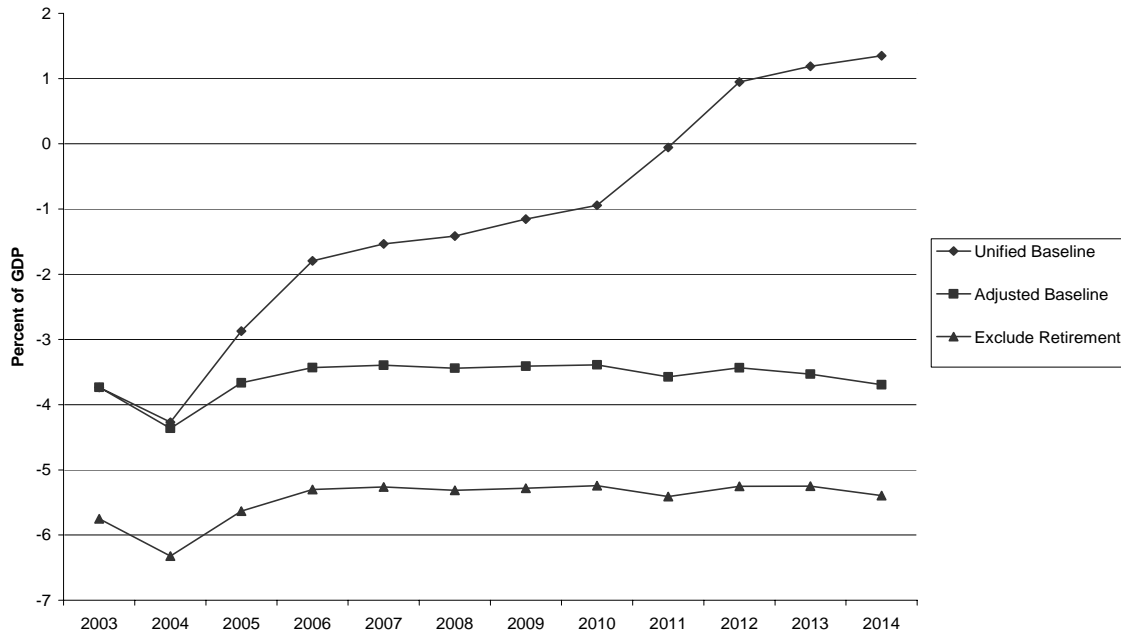
The Budget Course for the Next Ten Years

At least twice a year, the Congressional Budget Office publishes baseline projections of the federal budget for Congress to use in making budget decisions. These projections are designed to provide a neutral answer to the question: what will happen to federal spending and revenues if current laws and policies remain unchanged? Congress prescribes certain rules that the CBO must follow in making baseline projections—for example, the CBO is not allowed to assume that most expiring tax provisions will be extended, even if they deem the extensions highly probable. These rules must be kept in mind in interpreting the projections.

The CBO's most recent projections, published in August 2003 and soon to be updated, show the budget deficit increasing in fiscal years 2003 and 2004, but declining thereafter and reaching a surplus of more than \$200 billion by the end of ten years (table 1-1). These projections assume that the current economic recovery continues and that real GDP grows an average of 3 percent a year. This is a reasonable economic forecast, roughly in line with the average views of private forecasters. We will explore below the effects of faster growth on future deficits.

Although the CBO's economic projections are reasonable, their budget projections are distorted by congressional rules. The CBO is required to assume that whatever current law requires will actually happen. For example, CBO projections assume that long-standing provisions of the tax code, such as the research and development tax credit, expire and are not extended. If these provisions were to expire, the deficit would be smaller, but Congress is unlikely to allow them to do so. More important, the CBO projections assume—because the law says so—that tax cuts enacted in 2001 expire at the end of 2010 and all tax rates return to their pre-2001 levels. For example, the estate tax would be fully phased out in 2010 and then be reinstated in 2011. The additional tax cuts enacted in 2002 and 2003 also expire within the ten-year window. Congress is likely to correct this erratic policy. Indeed, President George Bush has asked that the new tax provisions be made permanent. The projections also assume that increasing numbers of taxpayers—as many as 33 million in 2010, compared with roughly 2.4 million today—pay the alternative minimum tax (AMT), although Congress is almost certain to amend the law to reduce the number of AMT payers substantially. Moreover, the CBO projections assume that discretionary spending—the money that Congress appropriates on an

Figure 1-4. Baseline and Adjusted Outcomes as Percent of GDP, 2003-14



Source: Authors' calculations and Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2003).

annual basis—increases only enough to keep up with inflation even though the population is growing.

To give a more realistic picture of how both spending and revenues might grow over the next ten years, we have altered the assumptions in the following ways and extended the projections for one more year to fiscal year 2014 (figure 1-4 and table 1-1).

We assume that:

- discretionary spending increases in line with population growth as well as inflation; that is, we assume that real discretionary spending per person is held constant;
- Congress will extend temporary tax provisions now on the books and make the 2001, 2002, and 2003 tax changes permanent; and
- Congress will restrict the growth of the number of taxpayers subject to the alternative minimum tax.

We also added the cost of the prescription drug benefit and other changes in Medicare enacted at the end of the first session of this Congress.

These adjustments transform the deficit outlook. Instead, of moving toward balance over the decade, the deficit averages more than 3 percent of GDP over the ten-year period and remains at \$687 billion in 2014. Moreover, the major retirement programs (Social Security, Medicare, and the government's own programs for federal employees) run substantial cash surpluses in this period. If these surpluses are excluded, the annual deficits average more than 5 percent of GDP and reach more than \$1 trillion in 2014.

Deficits beyond 2014

Although the deficits expected over the coming ten years are very large, they pale beside those projected in subsequent decades if policies do not change. As the generation born after World War II retires, longevity continues to increase, and medical costs keep rising, federal spending for retirement programs will accelerate rapidly. The CBO projects that if benefits are not changed, spending for Social Security will rise from 4.2 percent of GDP in 2010 to 5.9 percent by 2030 and 6.2 percent by 2050.⁶ Even if medical care costs rise only 1 percent faster than per capita GDP—an optimistic assumption in view of recent increases—expenditures for Medicare and Medicaid would rise from 4.8 percent of GDP in 2010 to 8.4 percent in 2030 to 11.5 percent in 2050. Unless Americans are willing to shoulder a continuously rising tax burden, they must find ways to reduce these exploding costs before rising debt and interest costs engulf the budget and sap the economy's strength.

Why Deficits Matter

Unless the public is convinced that deficits matter and matter quite a lot, political leaders have little incentive to do much about them. They may talk about the need for fiscal discipline and even propose small measures that move the federal budget in that direction, but serious deficit reduction is not likely to be a winning political strategy.

Democrats have learned that hair-shirt policies don't win them any friends and may even backfire. The Clinton administration spent eight years trying to bring the deficits it inherited under control only to see the surpluses that emerged at the end of their time in office used to finance a large tax cut that primarily benefited a Republican constituency. Republicans, for their part, have gone from being the party of fiscal discipline to the party that sees deficits as a useful tool for constraining federal spending and shrinking the size of government. The public, in the meantime, is confused. They hear in one speech that deficit-producing tax cuts are exactly what we need to produce jobs and growth and in another that tax cuts are a risky strategy that ultimately reduces standards of living. They are no longer sure what to believe. The problem is

that deficits may be good when the economy is operating below its capacity with a lot of unemployment but bad once it has recovered. For countries, as for families, borrowing to meet emergencies is different from borrowing on a sustained basis to live beyond one's means. As President Bush has noted, deficits during wartime or recession may be entirely appropriate. For this reason, current deficits are beneficial in the short run because they are stimulating the economy and putting people back to work. Very little of the rising debt burden projected over the next decade, however, is related to temporary economic stimulus or short-run emergencies such as the war in Iraq. These deficits will persist for the foreseeable future, because spending is projected to grow faster than revenue.

So just how bad are deficits, and how can the long-term damage they create be better communicated to the public? Here we consider five arguments in favor of greater fiscal responsibility.

Effects on Long-term Growth. Our colleague Charles Schultze once likened deficits not to the wolf at the door, but to termites in the woodwork. By this he meant that deficits gradually weaken the ability of workers to produce goods and services, thereby constraining wage increases and the growth of family incomes. Wage increases depend on how fast worker productivity grows. A major key to productivity growth, in turn, is investment in expanded business facilities and know-how—everything from robotics on the factory floor to a computer on every desk.⁷ But when governments run deficits, they must compete with businesses for scarce financial capital, driving up its cost or reducing its availability to the private sector.⁸ Just how much damage currently projected deficits will do depends on several assumptions, such as how much money we are able to borrow from abroad. But a conservative estimate is that a \$5.3 trillion accumulation of additional debt over the next ten years would reduce national income by \$212 billion annually at the end of the period. This translates into about \$1,800 less annual income for the average household than they otherwise would have earned.⁹

Household Finance. Households as well as businesses will find it more difficult to borrow to buy a home, a car, or a college education for their children. Interest rates are likely to rise at least 1 percentage point, based on estimates from a variety of studies.¹⁰ This translates into higher costs for most households. For example, monthly payments on a thirty-year fixed-rate mortgage of \$250,000 rise from \$1,500 to \$1,663 when interest rates rise from 6 percent to 7 percent. Over the life of the loan, this household ends up paying about \$2,000 a year in extra interest payments to the lender.¹¹ Some industries, such as housing, automobiles, furniture, and appliances will be more affected than others. In addition, younger households that are still buying and furnishing

their homes are likely to be adversely affected while retirees with substantial assets will gain by earning more on their fixed-income investments.

Dependence on the Rest of the World. When government borrowing is growing faster than American domestic saving, domestic investment will be squeezed *unless* Americans are able to borrow from other countries. In recent years foreigners have provided much of the capital that has enabled American productivity to rise. In 2002, foreigners purchased 58 percent of new Treasury debt.¹² But such borrowing is costly. To begin with, part of our future income will be owed to the citizens of other countries. Second, high rates of borrowing from abroad that increase our net indebtedness to the rest of the world create risks for the economy. We are now borrowing to the tune of half a trillion dollars a year.¹³ One danger is that foreigners will lose confidence in the United States and stop sending us their money. The value of the dollar would then fall—indeed some decline has already occurred—and our living standards would suffer as we had to pay more, by way of increased exports, for the goods we buy from abroad. Although the fall of the dollar would likely be gradual, there is some chance of a precipitous drop, which could lead to a sharp interest rate spike and possibly trigger a recession. An even more pessimistic scenario would be a financial crisis similar to those experienced when investors lost confidence in Argentina, Mexico, or East Asia. Finally, this dependence on the rest of the world for inflows of capital is not only risky for the United States, but also bad for the rest of the world. It is ironic, and some would say immoral, that the wealthiest nation in the world is forced to borrow from other countries to maintain current consumption.¹⁴

Debt-Servicing Costs. Interest obligations of the federal government are slated to grow from \$155 billion in 2004 to \$514 billion in 2014, or by \$359 billion. These extra costs are the result of both rising interest rates and increased borrowing by the federal government. By 2014, more than one out of every five dollars collected in individual income taxes (or all of corporate income taxes collected) will be needed just to pay these *added* debt-servicing costs, leaving less revenue to pay for the other things that government provides.¹⁵ For example, just the projected *increase* in annual interest payments between now and 2014 would be enough to finance more than half of all projected defense spending in that year.

Imposing a Burden on Future Generations. There is no way to avoid paying the costs of government forever. Lower taxes now mean higher taxes later on. Today's children and young adults and their descendants will have to pay the bill. Meanwhile, deficits are likely to put downward pressure on spending for education, nutrition, and health care that could make today's children more productive and thus better able to pay these future bills.

Can We Expect to Grow out of the Deficits?

Deficits are very sensitive to the rate of economic growth. Official CBO projections (and the adjusted baseline used in this volume) are based on the assumption that the economy will grow at an average annual real rate of 3 percent over the next decade.¹⁶ This forecast reflects the effects the CBO expects recent tax cuts to have on both short- and long-term growth.

A faster or slower rate of economic growth than the CBO (and most private forecasters) project could change the deficit picture materially. For example, a real growth rate of 4 percent rather than 3 percent would eliminate the deficit at the end of ten years.¹⁷ On the other hand, a slower rate of growth than that forecast would have the opposite effect, ballooning deficits to much higher levels.

How likely are these alternative economic scenarios and the different deficit pictures they imply? First, it must be noted that all projections, including the CBO's, are often wrong. Second, projections have as frequently been too optimistic as too pessimistic. Finally, although the economy has often averaged much more than 3 percent real growth for a quarter or even for a year, it has done so over an entire decade only once since World War II—and that was during the 1960s, when the economy managed to survive the entire decade without suffering an economic downturn. The annual real growth rate during the decades of the 1970s, 1980s, and 1990s averaged close to 3 percent.

Many people believe that recent tax cuts may encourage more work, more saving, and more investment by increasing the after-tax return for such activities. At the same time, tax cuts may make some people feel wealthier than they were before and, as a result, may cause them to work, save, and invest less. Finally, tax cuts that are deficit-financed absorb savings by households and businesses that could otherwise go into private investment and thus tend to affect economic growth adversely.

Most studies, including those done by scholars, by the CBO, and by the Congressional Joint Committee on Taxation, find that the net effects of recent tax cuts on longer-term economic growth are negligible. For example, the CBO concludes that “the revenue measures enacted since 2001 will boost labor supply by between 0.4 and 0.6 percent from 2004 to 2008 and up to 0.2 percent in 2009 to 2013 ... but the tax legislation will probably have a negative effect on saving, investment, and capital accumulation over the next 10 years.... The tax laws' net effect on potential output ... will probably be negative in the second five years.”¹⁸

The effects of tax cuts might be more positive if more of the revenue loss were offset by cutting back other spending or raising other revenues. As it is, it's hard to escape the conclusion that recent tax cuts have done little if anything to improve the nation's long-term growth

prospects and may have harmed them. What is needed to enhance long-term growth is higher national saving—not the lower saving generated by bigger deficits.

Of course, economic growth rates are quite unpredictable. U.S. growth might turn out to be higher than expected for any number of reasons. If that should happen, taking actions now to make sharp reductions in the budget deficit would still be good policy. The chances that we would somehow “overdo” deficit reduction are tiny to begin with, particularly when we take into account that ten years from now, even with substantially higher growth, the budget deficit outside of the government retirement programs will still be very large. Politically, measures strong enough to slash the deficit radically, while devilishly difficult to enact, are easy to undo. In the unlikely event that deficit reduction threatens to go too far, removing the threat will be no problem. But a mistake in the opposite direction gets harder to correct the longer deficits persist.

Deficit Goals and Policy Choices

Almost no one thinks that currently projected deficits are a good thing. But there is disagreement about how much priority should be given to reducing them and what our deficit reduction goals should be.

A limited objective would be to reduce deficits to 1 percent or 2 percent of GDP on the grounds that the nation has lived with deficits of this size in the past and could survive living with them in the future. A more ambitious goal would be to eliminate the deficit excluding the trust funds for Social Security, Medicare, and government pensions. These programs have their own dedicated revenues and are now producing large cash-flow surpluses that are masking the size of the deficit in the rest of the government. These retirement program surpluses, however, will soon begin to disappear, so it seems shortsighted to allow them to hide the true magnitude of the deficits that will confront us in the future. The deficit projected for 2014, excluding the retirement accounts, is just over \$1 trillion.

In this volume, we take a middle ground and focus on reducing the deficit in the unified budget to zero over a ten-year period. Even this relatively modest goal will require difficult choices and strong political will. The budget deficit problem cannot be solved in the abstract. It will require choosing to take specific actions that have political risks. The purpose of the next chapter is to give concrete illustrations of the type of spending cuts or tax increases that would be required to achieve budget balance in a decade. We hope these illustrations will give the reader a sense of the magnitude of the policy changes that would be required to balance the budget and stimulate serious discussion of different ways of doing so.

ENDNOTES

1. The authors are much indebted to William Gale and Peter Orszag for much of the analysis in the chapter and for their comments on an earlier version.
2. Congressional Budget Office, "The Budget and Economic Outlook: An Update," August 2003, pp. 4-10.
3. Richard W. Stevenson and Edmund L. Andrews, "No Escaping The Red Ink As Bush Pens '04 Agenda," *New York Times*, November 29, 2003, p. A10.
4. William G. Gale and Peter R. Orszag, "The Budget Outlook: Analysis and Implications," *Tax Notes*, October 6, 2003, pp. 145-57.
5. Gale and Orszag, "The Budget Outlook."
6. U.S. Congressional Budget Office, *The Long-Term Budget Outlook* (December 2003).
7. Council of Economic Advisers, "Economic Report of the President," February 2003.
8. Increased saving by Americans (in response to higher interest rates or in anticipation of the need to pay higher taxes in the future) or borrowing from abroad can cushion this effect. But more saving requires that people reduce their consumption now, and more borrowing requires that they earmark more of their future incomes to compensate foreigners for financing our investment.
9. Based on same method as on p. 147 of Gale and Orszag, "The Budget Outlook." National savings reduced by two-thirds of $5.3 = 3.53$ trillion*.06 = \$212 billion/ 119 million households = \$1,782 per household in 2014.
10. William G. Gale and Peter R. Orszag, "The Economic Effects of Sustained Budget Deficits," *National Tax Journal*, Sept. 2003. Deficits equal to 3 percent of GDP would raise interest rates by between 60 and 180 basis points with a mean of 120.
- 11 See www.interest.com for mortgage calculators.
12. Gale and Orszag, "The Budget Outlook," p. 153.
13. www.bea.gov. The U.S. current account deficit is \$278.1 billion for the first half of 2003.
14. Kenneth Rogoff, "The Debtor's Empire," *Washington Post*, October 20, 2003, p. A.23. Editorial.
15. Personal income taxes will be around \$1.6 trillion in 2014. \$359 billion in interest obligations is 22.4 percent of these taxes.
16. Congressional Budget Office, "The Budget and Economic Outlook: An Update," August 2003, p. 43.
17. Gale and Orszag, "The Budget Outlook," p. 153.
18. Congressional Budget Office, "The Budget and Economic Outlook: An Update," August 2003, p. 45.