A Budget We Can Believe In

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The signatories to this memo are all members of the "Fiscal Seminar," a group that has been meeting together for several years at the Brookings Institution. The views expressed are those of the individuals involved and should not be interpreted as representing the views of their respective institutions. For purposes of identification, the affiliation of each signatory is listed.

To: President Barack Obama

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Your first budget will be a defining document. It will cast the basic mold of your administration, highlight your key priorities, and specify how you are going to deliver on your most important campaign promises or modify them in light of new developments. The decisions you make in shaping this budget will be among the most consequential of your tenure.

In our view, the overriding imperative for your first budget is to strike a judicious balance between America's short-term and long-term economic needs. To accomplish this, that budget must be strategic as well as tactical. The steps you take to address our short-term problems must not make it harder to achieve our long-term goals. Indeed, they should set the stage both for steady economic growth and a sustainable fiscal future. To be a truly transformative president, you must not allow the urgency of the short-term to crowd out concern for the country's long-term wellbeing.

As you have noted, the key short-term challenges are:

- stabilizing America's financial markets to ensure an ample and affordable supply of credit, which is the lifeblood of our economy; and

- reducing the severity and duration of the current recession and getting Americans back to work.

At the same time, your budget must set in motion measures that deal with two critical long-term challenges to America's economic health:

- controlling the growth of health costs and putting Social Security on a financially sustainable path.

- reforming America's tax system to make it more efficient, fairer and simpler and to raise adequate revenue while maintaining economic growth.

These short- and long-term economic imperatives are inextricably linked. The costs of stabilizing the financial markets and stimulating economic growth will generate a large increase in our national debt. We will have to borrow money in domestic and international capital markets to finance this debt, and without a serious commitment to long-term fiscal restraint, lenders will eventually question the nation's fiscal credibility. They may respond by reducing the share of their portfolios devoted to U.S. government debt or by charging higher interest rates. In the extreme, the reluctance to buy U. S. debt could cause a crisis in international capital markets. No one can describe the risks precisely, but Wall Street's recent troubles demonstrate that the perils of over reliance on debt can come swiftly and in unpredictable ways. What is predictable is that if the long-term problem is not confronted, interest costs will absorb a growing proportion of our budgetary resources and, together with growing health costs and Social Security, will threaten to crowd out spending on programs for the poor, children, and improving the nation's infrastructure. Moreover, our dependence on foreign creditors and the resulting mortgage on future national incomes will diminish American standards of living for generations to come.

We understand full well the myriad considerations that will shape your fiscal proposals for the next fiscal year. We suggest, however, two criteria that a future-oriented budget for fiscal 2010 should meet.

- First, you have pledged repeatedly to scrub every line item in the current budget with an eye to finding items that are either ineffective or outdated. We do not believe that this effort will be credible unless it produces significant savings from both programs and tax expenditures.

- Second, the stimulus package should not worsen the long-term fiscal outlook. To the extent that it includes items that increase the long-term budget deficit, offsetting long-term spending cuts or revenue streams should be proposed.

We believe, moreover, that Congress must re-impose caps on discretionary spending as soon as the economy begins to recover from the recession. The budget documents you submit to Congress should make it clear that you will support such a move.

The long-term budget challenge can be stated succinctly. Three large programs—Social Security, Medicare, and Medicaid—now constitute almost one-half of non-interest federal spending and are growing faster than tax revenues because of soaring health costs and the aging of the population. If we fail to reform these spending programs and insist on maintaining the tax burden where it is has been over the past 50 years (about 18 percent of GDP), deficits will soar, and the public debt is likely to exceed 100 percent of the GDP within 25 years. That compares to 37 percent at the end of fiscal 2007.

It's entirely understandable that public concern over the long-term budget problem has now been swamped by the financial crisis and accompanying recession. But as President you can't afford to lose sight of these inconvenient truths. The budget deficit for fiscal 2009 is estimated at $1.2 trillion by CBO, and this excludes any new spending as part of a stimulus bill. The federal debt owed to the public may increase by considerably more than 50 percent over the next two years. Although large debt increases occurred in the early 1980s, they did not occur as quickly. Moreover, there are two important differences from that era. First, we are now more dependent on foreign private and government investors to buy our debt. Second, relative to the size of the economy (GDP), Social Security, Medicare, and Medicaid are much larger now than they were then, and they are expected to grow more rapidly as the oldest baby boomers begin to retire. Consequently, the budget deficit will contract more slowly than usual as the economy recovers.

Although we are rightly absorbed by our short-term problems, the long-term budget situation ultimately poses graver challenges to the success of your presidency. Social Security, Medicare, and Medicaid are expected to constitute 1.8 percent more of the GDP in 2016 than they did in 2008. That may not sound like much, but if the growth were to be financed entirely with tax increases, it would imply an overall tax increase of almost 10 percent above historical levels—and that would only be the first of many tax increases to follow. If it were financed by cutting all other non-interest programs including defense, the across-the-board reduction would have to be more than 20 percent compared to baseline levels. Even if a number of inefficient and low priority programs are eliminated, it would not be possible to fulfill your election promises—to expand health insurance coverage or to increase public investment in education, infrastructure, and research on alternative energy sources, among many others—without digging our long-term fiscal hole even deeper.

Your budget should make it very clear that you take the long-term budget problem seriously. It must quantify the cost of our long-term promises and explicitly state the goal of achieving fiscal sustainability. As a first step, we should stabilize the ratio of debt to GDP while creating an atmosphere conducive to economic growth. The budget could, for illustrative purposes, specify two or three combinations of target revenue and spending paths that would achieve this initial goal.

We believe you should do more than express your concern about the danger of escalating future deficits. You should move quickly to reduce them without endangering near-term economic recovery. First, you should give high priority to putting Social Security on a sound fiscal basis to reduce future deficits and show our creditors that we are taking serious steps to manage our national finances. Second, you should take quick action to reduce the growth of Medicare by shifting to payment systems that reward effective treatments and discourage wasteful spending.

The long-term fiscal problem is complicated by the fact that it is difficult to contemplate increased revenues being part of the solution so long as the public rightly remains highly distrustful of our inequitable and economically inefficient tax system. Tax reform is always difficult, but it will be necessary to achieve a rational solution to our long-term problems. Hundreds of billions of dollars worth of tax expenditures in the federal code must be evaluated and eliminated where they inhibit economic growth, are inefficient, have undesirable distributional consequences, or are difficult to administer.

Throughout your campaign, you pioneered new ways of involving the American people in our nation’s political life, and you have signaled your determination to continue that commitment as president. Our long-term economic and fiscal future is an issue that cries out for just such public engagement. Congress is unlikely to cooperate in undertaking such painful reforms so long as the general public remains unaware of the magnitude and urgency of the long-term fiscal challenge. Therefore, we recommend that you launch an intensive public education campaign. This could include a series of town hall meetings across the country or fireside chats to explain the problem and lay out options for solving it to the American public. Although you could send surrogates around the country, you should personally take part in some of these meetings to underscore their vital importance, as President Clinton did a decade ago. If Americans grasp how essential budget reform is for the wellbeing of their children and grandchildren, they will be more likely to accept the sacrifices necessary to get the budget under control.

One additional (and crucial) point: it makes no sense to undertake a challenge of such magnitude unless it yields structural changes that are enduring. To that end, we recommend two key shifts in our budget procedures.

- Once an agreement for tax and long-term spending reform is in place, it must be enforced by pay-as-you-go rules that require that all tax cuts or entitlement increases be financed by some combination of tax increases and entitlement cuts. Without such rules, a painfully negotiated agreement is likely to erode over time.

- In addition, targets for entitlement spending and tax expenditures should be budgeted for the long run, say, 30 years. If unexpected events push spending or tax expenditures above targets, automatic triggers could be used to slow spending growth, increase revenues, or some combination of the two.

We have outlined a formidable task. It may be possible to muddle through another eight years without facing the long-term challenge. To evade it, however, would be to squander an historic opportunity to set our economy and governing institutions on a sound and sustainable course. To be remembered as a truly transformative president, you must boldly confront—and master—the toughest problems of your time.