

HOW TO THINK ABOUT THE U.S. BUDGET CHALLENGE

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The long-term budget prospects of the United States are grim. Projected spending greatly exceeds projected revenue over the next few decades. Projected growth of health care spending accounts for more than all of the anticipated gap.

Without action to narrow the gap, accumulating deficits will drive up the ratio of debt to GDP. Interest payments will rise correspondingly. At some point, domestic and foreign holders of U.S. debt will come to doubt the capacity of the government to service this debt. At that point, they will demand sharply higher interest rates.

The combination of increasing debt and rising interest rates will cause debt service costs to explode. What follows would be some combination of collapsing investment, declining production, debt default, and inflation—in brief, a calamitous mess. That such a mess will occur is certain if budget deficits as large as those currently anticipated are realized. Precisely when is impossible to forecast accurately.

THE STANDARD SCENARIO

The three preceding paragraphs comprise a budget narrative, now virtually standard among budget analysts. It is reflected in long-term budget projections that the Congressional Budget Office (CBO) has been publishing since 1997 (CBO, 1997, 2009).² It is the basis for the work of at least two currently active national commissions and various reports.

Table 1, which reproduces projections of the Congressional Budget Office, supports this narrative. It shows a large and growing revenue–expenditure gap. Over the next four decades, growth of health care spending accounts for more than all of the gap. The debt/GDP ratio grows geometrically. Table 1 is based on the assumption that real interest rates are unaffected by the debt/GDP ratio. Thus, it omits any increase in borrowing costs resulting from such a loss of investor confidence in the capacity of the government to meet debt service obligations. Whenever any such loss of confidence might occur, the immediate result would be draconian policy changes—default if the country reneges on payment, hyperinflation if it simply prints money to cover debt service. Beyond some point, therefore, the interest rates implicit in Table 1 are too low. And for that reason, Table 1 is an unduly “optimistic” projection of the consequences of doing nothing to close projected budget shortfalls.

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² Congressional Budget Office (1997) is the first full report, although earlier publications had referred to budget challenges beyond the decade over which CBO routinely publishes projections. The most recent version is Congressional Budget Office (2009). CBO follows a number of conventions, not all of which strike other analysts as plausible. Independent projections based on what their authors regard as more realistic assumptions tell a similar story. See Auerbach and Gale (2009) and Ruffing and Horney (2010).

Table 1. Long-term budget projections: Expenditures, revenues, deficit, debt (percent of GDP).

Year	Social Security	Medicare	Medicaid	Other Non-Interest	Total Non-Interest	Interest	Total Spending	Revenues	Primary Deficit	Total Deficit	Debt/GDP
2010 ^a	4.8	3.6	1.9	12.9	23.4	1.4	24.8	14.5	-8.3	-10.3	63.2
2020 ^a	5.2	4.6	2.0	9.3	21.1	4.1	25.2	19.6	-1.5	-5.6	90.0
2020 ^b	5.3	4.3	2.1	10.4	22.1	3.9	26.0	18.6	-3.5	-7.4	87.1
2025 ^b	5.6	5.2	2.3	10.5	23.6	4.6	28.2	18.8	-4.8	-9.4	111.5
2030 ^b	6.0	6.3	2.5	10.4	25.2	5.9	31.1	19.0	-6.2	-12.0	142.9
2040 ^b	5.8	8.1	3.0	10.4	27.3	9.3	36.6	19.4	-7.9	-17.2	223.2
2050 ^b	5.7	9.5	3.2	10.3	28.7	13.5	42.2	19.9	-8.8	-22.3	321.3
Change 2010–2050	+0.9	+6.4	+1.3	-2.6	+6.0	+12.3	+18.3	+3.6			+260.2

Sources:

^a Congressional Budget Office (2010).

^b Congressional Budget Office (2009).

These projections do not indicate when, if policy is unchanged, the crash will come. Nor do they show what would need to be done, or how soon it would need to be done, to prevent a collapse of confidence.

To be sure, *forecasts* are notoriously inaccurate. *Projections*, which are just mindless extrapolations of assumptions CBO analysts regard as reasonable, are not meant to be even as accurate as forecasts. Actual gaps will almost certainly differ from those shown in Table 1, as exemplified by shifts in estimates for 2020 between June 2009 and March 2010 indicate. Even allowing for massive uncertainty, however, it is hard to imagine events, other than explicit and large policy changes, that would close the long-term fiscal gap.

Table 1 also reveals another key point—hyperventilated crisis rhetoric about the anticipated growth of social security receives no support from these projections. Growth of social security as a share of GDP is small—just 1.2 percent of GDP by 2030, followed by actual decline, with a total increase between 2010 and 2050 of just 0.9 percent of GDP. Growth of social security spending is a negligible part of the long-term fiscal challenge.³ So, too, are entitlements other than the “big three.” The Office of Management and Budget estimates that spending on entitlements other than Medicare, social security, and Medicaid, will amount to \$739 billion, or 5 percent of GDP in fiscal year 2010—slightly more than social security (Office of Management and Budget, 2010, Table 8.5, p. 154). This massive but often neglected group of outlays is projected to grow with population and inflation and, hence, to gradually shrink as a share of GDP.

Actually, the long-term projections in Table 1 understate the size of the budget challenge. It is based on projections prepared before the full effects of the current and ongoing economic slowdown made themselves felt. Although most of the budgetary damage done by the recession and efforts to counter its effects are transitory, their effects will linger in the form of increased debt and interest outlays. Furthermore, although the Congressional Budget Office anticipates that the economy will return to the same long-term growth path foreseen before the recession, some forecasters believe that the rebound will be incomplete. If the recession permanently lowered the trajectory of full-employment GDP, it also lowered full-employment revenues, with no obvious impact on government spending (other than a small reduction in social security spending), thereby widening the long-term fiscal gap.

THE PROBLEM: “DEBT,” NOT “DEFICITS”

Concern about the long-term budget challenge is entirely consistent with a belief that nothing should be done to cut current deficits—and even with the view that current deficits should be enlarged. Current deficits impose very real costs—added debt and debt service burdens. But during recession, deficits also generate important benefits. Added spending and reduced taxes can help the unemployed, enable state and local governments to sustain high-priority public services, and stimulate current demand for goods and services. Reasonable people, who share the same objective view of the economy, may disagree on whether the current benefits of deficits during recessions outweigh future costs.

The narrative at the start of this comment made clear that the fiscal challenge is not the *size* of budget *deficit* in any given year, but *unsustainable levels and trends in*

³ Note that Table 1 is based on budget projections. The growth of social security spending between 2010 and 2050 is less than 1 percent of GDP. Official projections of the social security trust funds show a larger gap between earmarked revenues and spending measured as a share of GDP. The principal reason for the difference is that social security revenues are projected to fall as a share of GDP as the proportion of compensation subject to the payroll tax falls with the anticipated increase in tax-exempt compensation, mostly for employer-sponsored health insurance. The projections of social security spending by CBO and the social security actuaries also differ somewhat.

the costs of debt service. For example, the U.S. debt/GDP ratio in 1945, immediately after World War II, was far higher than it is in 2010 or is anticipated to be for several years. But the fiscal situation in 1945 caused far less concern than it does today. To be sure, some economists fretted that depression—then called “secular stagnation”—would return when wartime deficits ended. Those fears seemed to be realized when the economy slumped following demobilization. But such worries vanished as deferred consumption buoyed by oceans of liquid assets accumulated during the prosperous, but consumption constrained, war years propelled the economy to record prosperity. The boom also triggered domestic inflation, which, along with booming real economic growth, lowered the debt/GDP ratio over the next three decades by 78 percentage points—from 1.13 in 1945 to 0.25 in 1974. This erosion of debt occurred despite the fact that the federal budget was in deficit for 21 of those years.

The debt/GDP ratio today is far more troubling today than it was at the end of World War II. At the end of World War II, private households held massive amounts of liquid assets. Government debt was all domestically held. U.S. economic preeminence was unquestioned—the United States produced half of the world’s GDP. The federal government had no major long-term fiscal obligations.⁴

The situation today is quite different. U.S. households are net debtors. The U.S. share of world GDP is half what it was in 1945. Half of U.S. federal debt is held abroad. The greatly increased fluidity of world capital markets means that the U.S. government is powerless to prevent a sharp increase in U.S. borrowing rates should holders of U.S. sovereign debt decide to sell it. The federal government is committed under current law to massive increases in health care spending, which health care reform will, if successful, only gradually reduce. The education level of U.S. workers is stagnating, while that of workers in other nations are increasing. The sources of future U.S. economic growth are unclear.

Furthermore, projected U.S. budget deficits, such as those shown in Table 1, are historically unprecedented, except during major wars. These deficits threaten an explosive growth of debt. Thus, action to close the projected gap between spending and revenues is necessary. But necessity does not dictate either timing or method.

WHEN SHOULD DEFICIT REDUCTION BEGIN?

As to timing, few economists believe that it would be wise to try to narrow budget deficits this year or next or, indeed, until economic recovery is reasonably advanced and solidly established. Immediate spending cuts and tax increases would delay the return of the nation to full employment. The United States made precisely this policy error between 1936 and 1938, when a budget deficit of 7 percent of GDP was eliminated, choking off the economic recovery then under way. For that reason, measures to close the fiscal gap should not be implemented until certain targets have been reached. While there is room for debate about these trigger points, I suggest—for illustrative purposes only—that policies to lower the budget deficit should not be implemented until two conditions are both satisfied: that the unemployment rate is 6 percent or less and economic growth is sufficient to produce further reductions.

While premature *implementation* of deficit reductions would be risky, early *enactment* of deficit reduction policies would be wise. If timed to take effect when recovery targets have been met, they could actually aid recovery. Specifically, sending a clear message to financial markets that deficits in public budgets will not drain private

⁴ Social security at the time was greatly overfinanced, with net reserves accumulating at a rate that was regarded as troublesome. Furthermore, the methods used for determining long-term balance ignored future economic growth and assumed benefits would be unchanged. As a result, annual trustees’ reports “discovered” larger-than-anticipated surpluses, which ultimately triggered significant benefit increases. Medicare and Medicaid did not yet exist.

saving from productive investments would likely help hold down long-term interest rates that play so large a part in housing and other durable investments.

Because the debt/GDP ratio cannot grow without limit without causing either default or pernicious inflation, primary budget deficits must eventually be eliminated. The primary budget consists of all revenues and all expenditures other than interest. If the interest rate equals aggregate economic growth, balance in the primary budget will result in a constant debt/GDP ratio. The practical questions, therefore, are: (1) how soon the primary budget needs to be brought back into balance and (2) by what combination of spending cuts and tax increases.

WHAT SHOULD THE TARGETS BE?

An acceptable debt/GDP ratio is a matter of judgment. The European Union required that new members have a ratio not greater than 0.6. But some members exceeded that standard in 2008 even before the current recession (Belgium, 0.74, and Italy, 0.90), as did Japan (0.84) (OECD, 2009, Annex Table 32). In the wake of the recession, the OECD anticipated that in 2011 the debt/GDP ratio for the entire OECD and euro area would exceed 0.6, headed by Italy (1.03). Japan's debt/GDP ratio was projected to reach 1.13. Each of these countries needed to bring primary budgets into balance, but none was destabilized by debt/GDP ratios well in excess of 0.6. The contemporary problems afflicting Greece, Portugal, and Spain typically involve failures to come to grips with huge budgetary or trade imbalances that portend explosive and unsustainable growth of borrowing.

Major study panels and the President's National Commission on Fiscal Responsibility and Reform have much more ambitious targets than those suggested here. The commission is instructed to recommend how to reach primary budget balance by 2015. The Pew/Peterson Commission on Budget Reform is aiming for a debt/GDP ratio of 0.6 by 2018. The National Academy of Sciences set as its budget target in *Choosing Our Fiscal Future* a debt/GDP ratio of 0.6 by 2022. The Committee for American Progress proposes to balance the primary budget by 2014 and the overall budget by 2022. Even with sizable tax increases, meeting these targets would require massive cuts in pensions and health care benefits for those already retired and nearing retirement. Such cuts would undermine key commitments of the federal government to the elderly, disabled, and poor. Spending cuts and tax increases large enough to meet these targets would require major fiscal restraint immediately and would threaten economic recovery. Because of their draconian nature, they may well be politically unachievable.

The ultimate size of spending cuts and tax increases necessary to stabilize the debt/GDP ratio is dictated by the laws of arithmetic and differs only marginally depending on the ratio chosen and the date at which it is to be achieved (see Table 2). But the size and acceptability of a deficit reduction *program* depends sensitively on those choices. If between 2015 and 2025 the United States cuts the primary budget deficit by 5 percentage points of GDP, the debt/GDP ratio would be stable in 2025 at 0.8. *Trying to achieve budget balance in the near future would not only threaten the economic recovery, but would also reduce the likelihood that Congress would agree to a program that will deal effectively with a problem that must be solved and can be addressed on a reasonable timetable.*

WHAT WOULD A DEFICIT REDUCTION PROGRAM LOOK LIKE?

The choice of the date by which the primary budget is brought into balance is of critical importance in shaping the feasible content of a deficit reduction package and the likelihood that agreement can be reached to implement it. Implementing a deficit reduction program before 2015 and aiming to stabilize the debt/GDP ratio before 2025 implies budget shifts so large and starting so soon that they could threaten economic recovery or the capacity to sustain high employment once

Table 2. Implications of various deficit reduction targets: How much would spending have to be cut and/or taxes raised in 2015, 2020, and 2025 to achieve the indicated budget targets?

Target	Spending Cuts/Tax Increases by Target Year (Excludes Effects of Economic Recovery)		
	2015	2020	2025
Peterson-Pew: Debt/GDP = 0.6 in 2018	-549	-1,174	-1,544
NAS Debt/GDP = -0.6 in 2022	-451	-952	-1,117
CAP Primary balance 2014, full balance 2022	-487	-1,289	-1,589
Debt/GDP = 0.8 in 2025, begin process in 2015	-82	-599	-1,381

Peterson-Pew = The Peterson-Pew Commission on Budget Reform.

NAS = National Research Council and National Academy of Public Administration (2010).

CAP = Center for American Progress.

Table 3. Reduction in fiscal gap, selected nations, various periods.

Nation	Period	Fiscal Swing Percent of GDP
Australia	1992–1999	7.5
Canada	1992–2000	11.1
Finland	1992–2000	12.3
New Zealand	2000–2006	5.9
Sweden	1993–2000	14.9
United Kingdom	1993–2000	11.7
United States	1992–2000	7.4

attained. Furthermore, members of Congress of both parties have repeatedly shown themselves unwilling to make large changes in social security or Medicare affecting those who are currently retired or “near retirement,” typically defined as those over age 45 to 55. *This quite understandable position means that next to no savings can be achieved through changes in these programs before 2020 and very little by 2025.* So the paradoxical implication of an aggressive deficit reduction stance—such as those of the President’s Commission on Fiscal Responsibility and Reform, the Pew/Peterson Commission on Budget Reform, and the National Academy of Sciences (*Choosing Our Fiscal Future*) is that, as a practical matter, virtually all of those savings would have to be achieved through tax increases. Whether it would be possible to develop a bipartisan coalition for deficit reduction around such a program is quite doubtful.

FIVE PERCENT IS FEASIBLE

Compared with revenue and spending shares shown in Table 1, a swing of 5 percent of GDP in the primary budget appears formidable. The difficulty of such shifts should not be minimized. But the record indicates that several nations, including the United States, have achieved fiscal swings of this size or larger (see Table 3). The large budget swings shown in Table 3 all include deficit reductions associated with recovery from recession as well as discretionary shifts in policy. For that reason they are best compared with the primary budget deficit of 8.3 percent of GDP which CBO has estimated for the 2010 budget of the Obama Administration.

How the United States achieves such a fiscal swing, and whether it will be able to do so, will depend on political negotiations that will be complex and fractious. But achieving balance over a ten-year period starting in 2015 is decidedly doable. It does

not require radical changes in budgetary policy. For example, a combination of social security benefit cuts and earmarked tax increases amounting to 1 percent of GDP, a slowdown in the growth of health care spending by 0.5 percent of GDP by 2025, a reduction in other non-interest (defense) spending by 0.5 percent of GDP, and additional general revenue taxes of 3 percent of GDP, would do the job. The added taxes could come from a new tax on value added, from changes in tax “expenditures” that currently reduce revenues by more than \$1 trillion annually, or from increases in income tax rates.

This menu is only illustrative, but it carries two implicit messages. First, even over a period of 15 years, a shift in the primary budget balance totaling 5 percentage points of GDP by 2025 cannot be achieved entirely, or even mostly, through spending cuts.

Health. Official estimates indicate that health care reform legislation will change baseline federal spending only marginally by 2020. In the five years thereafter, a reduction of 0.5 percent of GDP in annual federal health care spending would be a formidable achievement.

Pensions. Even if sizable reductions in social security benefits were enacted, most proposals have called for grandfathering workers over age 55. Cutting the growth of the share of GDP devoted to social security benefits by even as much as 0.5 percentage points of GDP by 2025 would mean cutting by more than half the 0.8 percentage point increase in social security projected over this period, a period during which the number of beneficiaries will rise from 53 million to 77 million, an increase of 46 percent.

There are those who argue that current benefits for the elderly and disabled are overly generous. Citing present discounted values of expected lifetime benefits, some allege that benefits, at least for those who are financially comfortable, should be cut or eliminated by means testing. In fact, current pension benefits are not generous. The ratio of pensions to average earnings—replacement rates—in the United States is 68 percent of the OECD average and ranks 25th among 30 OECD nations. Cash replacement rates are trending down because of increases in the age at which full benefits are paid and because premiums for Medicare Supplemental Medical Insurance, which are subtracted before checks are mailed, have been rising and are expected to rise faster than earnings. Actual incomes of the elderly suggest the savings that might be achieved by curbing their benefits would contribute little to solving the long-term budget challenge. Median income of aged units in 2008 was just \$24,857 (and among those aged 80 or over, the median was just \$19,412). Fewer than one aged unit in four had income exceeding \$50,000, a group whose social security benefits are already subject to income tax.

The political acceptability of even larger reductions in pension outlays by 2025 is quite unlikely, and the risk that such cuts would jeopardize the adequacy of benefits is high.

After 2025

The goal I have outlined—reducing federal spending or boosting federal taxes by a total of 5 percentage points of GDP by 2025—would stabilize the deficit/GDP ratio. Current projections (summarized in Table 1) suggest that will not be the end of the story. Current projections indicate the budget gap will keep on growing, largely because of the presumed increase in per-person health care spending. In fact, however, no one has any very good idea about whether health care technology will continue to push up spending or whether the health care systems reforms recently enacted will have slowed the growth of spending. Whatever may happen *after* 2025, however, budget deficits must be curtailed long *before* then. Put simply, rising health care spending accounts for more than all of the increase in projected long-term deficits, but curbing health care spending cannot be the only solution to the medium-term budget challenge that the nation faces. Nor are projections of what may happen

beyond 2025 sufficiently certain to justify curtailing spending or raising taxes now to deal with such distant possibilities. If the annual gap between growth of health care spending and of income remains as large as it has been in recent decades—about 2.5 percentage points—additional measures will be necessary in the 2020s to hold down spending or raise taxes. But that is not the current challenge.

SUMMARY

The messages are, I believe, quite clear:

- Curbing deficits, once the economy is solidly on the path to economic recovery, is of urgent importance.
- Health care spending is the largest single cause of projected deficits, but reductions in health care spending cannot be the principal instrument for closing those deficits between now and 2025.
- Cuts in social security, Medicare, and Medicaid benefits cannot—and should not—be large enough to contribute in a major way to achieving the deficit reductions required by 2025.
- To avoid ruinous increases in debt, taxes must be increased soon, and the sooner opinion leaders, including elected officials, recognize that fact and start to educate the public, the better for the nation.

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