

# The US budget deficit

## On an unsustainable path

New  
Economy

WILLIAM GALE

Chair, Federal Economic  
Policy, Brookings  
Institution

PETER ORSZAG

Senior Fellow, Brookings  
Institution

**F**iscal policy in the United States is on an unsustainable path. Under reasonable projections, the budget deficit is likely to amount to about 3.5 per cent of Gross Domestic Product (GDP) in each year over the next decade. Thereafter, deficits are likely to grow much larger, as health and retirement costs mount for the baby boom generation. Over the next 75 years, the nation's fiscal gap could amount to about seven per cent of GDP.

At best, these deficits will gradually harm the future income of Americans. At worst, they could trigger a fiscal crisis, which could accelerate and possibly exacerbate the damage. In this article, we examine trends in US fiscal policy, reasonable projections of future fiscal policy and the implications. We pay particular attention to whether the 2001 and 2003 tax cuts should be made permanent, since that question is being actively debated in the US and the outcome has a substantial effect on the fiscal outlook.

### Recent trends and projections

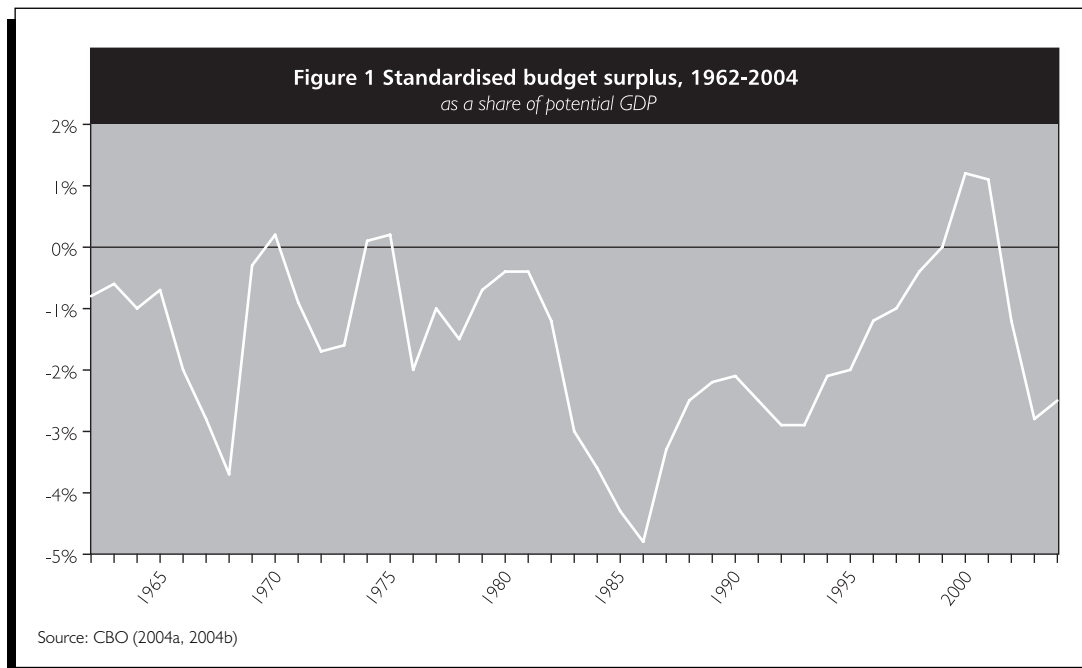
Figure 1 shows the evolution since 1962 of the cyclically-adjusted surplus or deficit in the

unified Federal budget in the US (with adjustments also for unusual events such as the federal bailout of the savings and loans). The deficit relative to GDP rose substantially in the early and mid-1980s, improved dramatically over the course of the 1990s, and then deteriorated in an equally dramatic fashion after 2000. In fiscal year 2004, the cyclically-adjusted deficit is projected to be about four per cent of GDP. As the figure shows, deficits of this magnitude are high relative to historical norms. Even so, the current budget situation would not be a concern if future fiscal prospects were auspicious. Unfortunately, the

*“Under reasonable projections, the budget deficit is likely to amount to about 3.5 per cent of GDP in each year over the next decade”*

budget outlook is dismal.

In September, the Congressional Budget Office (CBO), the body that Congress relies upon for budgetary analysis, issued new budget projections for the next decade. These projections show a unified budget deficit over the next ten years of \$2.3 trillion, or 1.5 per cent of GDP. The CBO projections are shown in the top line in Figure 2, and they suggest significant improvement in the budget by the end of the decade. Unfortunately, the set of default assumptions about current



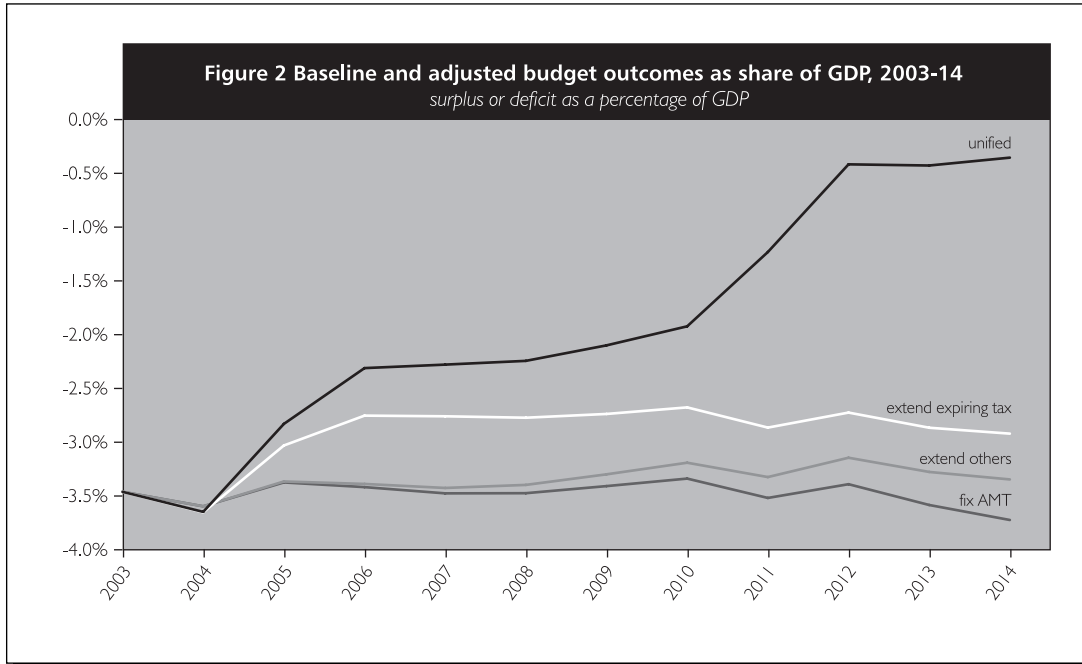
spending and tax policies used to develop the CBO baseline are defined in part by statutory rules and hence are often unrealistic. We therefore have to adjust the CBO projections to more accurately reflect the current thrust of tax and spending policies in order to generate plausible projections.

For example, the CBO projections assume that all temporary tax provisions (other than excise taxes dedicated to trust funds) expire as scheduled. Since all of the tax cuts enacted in 2001, 2002, and 2003 expire or 'sunset' by the beginning of 2011, they are all assumed to disappear. Yet few policy observers expect this to occur. If the 2001 and 2003 tax cuts are instead extended, the budget deficit averages 2.8 per cent of GDP over the next decade (the second line from the top in Figure 2). A variety of other tax provisions – such as the Research and Experimentation tax credit -- that have statutory expiration dates have been and are routinely extended for a few years at a time whenever their expiration date approaches. If these were also extended, the deficit rises to 3.3 per cent of GDP.

The baseline also assumes the Alternative

Minimum Tax (AMT) grows exponentially, a development that few observers regard as plausible. The AMT was enacted following concerns in the late 1960s that very high-income households were engaging in excessive tax sheltering activity. The AMT rests alongside the regular income tax, with a different set of rules for deductions, exemptions, and tax rates; taxpayers pay the higher of the regular income tax or the AMT. Currently, about three million taxpayers in the US face the AMT. By 2009, under current policy, about 30 million will. Avoiding that outcome means even less revenue and even larger deficits: a reasonable AMT reform increases the deficit to 3.5 per cent of GDP over the next decade, as shown in the bottom line in Figure 2.

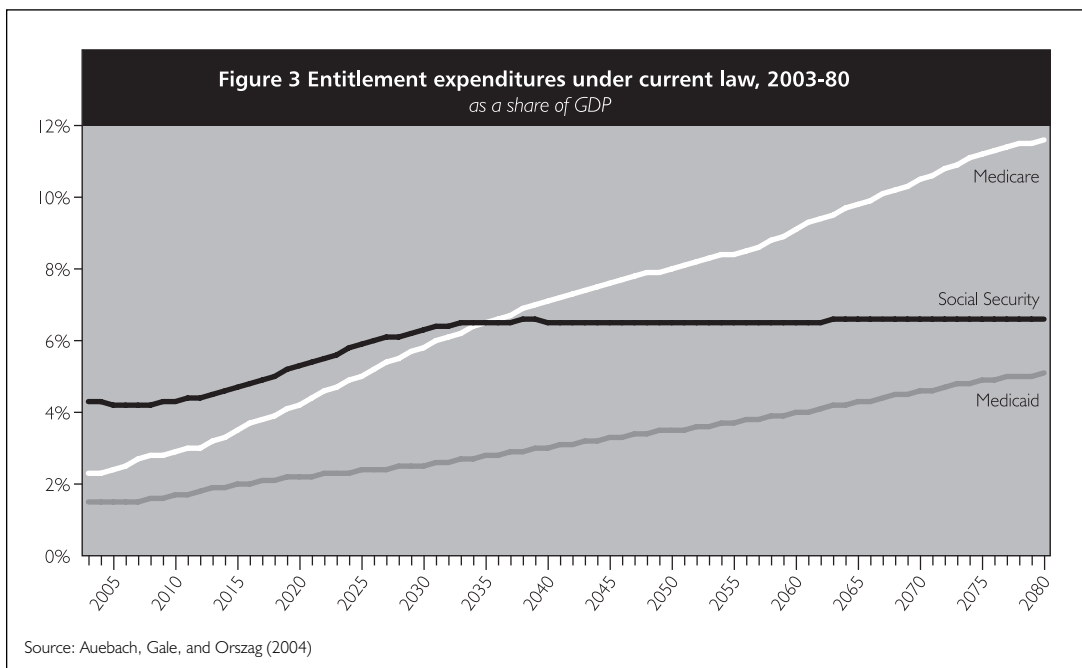
Although the precise figures should not be taken literally due to uncertainty and other factors, the basic trends in the data are clear. While the CBO baseline suggests that the budgetary future features significant declines in the deficit within the ten-year window, our adjusted baseline implies continual and substantial deficits hovering around 3.5 per cent



of GDP in each year through 2014.

Unfortunately, Figure 2 is the good part of the story. Figure 3 shows the projected increases in entitlement costs over the next 75 years. The projected retirement of the baby boomers, ongoing increases in life expectancy, and

growth in health care costs per beneficiary that exceed per capita GDP, combine to drive Federal expenditures on Social Security, Medicare, and Medicaid from eight per cent of GDP in 2004 to a projected ten per cent by 2015, 13 per cent by 2025, and 23 per cent by 2075. The



Source: Auebach, Gale, and Orszag (2004)

figure also shows that the vast majority of the growth occurs in the health-related programs, not in Social Security. Indeed, after about 2030, Social Security costs are roughly stable relative to GDP.

To get some sense of the long-term budget imbalance facing the nation, we rely on the 'fiscal gap.' The fiscal gap measures the immediate and permanent increase in taxes and/or reductions in non-interest expenditures that would be required to establish the same debt-GDP ratio in the long run as holds currently. Along with Alan Auerbach of Berkeley, we have estimated that the US faces a fiscal gap through 2080 of 7.1 per cent of GDP. To close the gap would require an immediate, permanent 40 per cent increase in revenues or 35 per cent reduction in outlays.

Several factors contribute to this fiscal gap. The most important is projected increases in Medicare and Federal Medicaid costs, as shown in Figure 3. Federal expenditures on these two programs are projected to increase by more than ten per cent of GDP by 2070. By comparison, the increase in Social Security costs over the same period is only 2.5 per cent of GDP. Unfortunately, the health-related programs are much more difficult to reform than Social Security.

The recent tax cuts also play a major role in the long-term fiscal gap. If extended and not eroded over time by the AMT, the tax cuts would cost roughly two per cent of GDP over the long term. Even though projected increases in Social Security costs eventually exceed the size of the tax cuts, do not conclude from this that the tax cuts are less expensive than the Social Security increases. The increase in Social Security costs mounts gradually as America ages. The cost of the tax cuts starts immediately, and changes little as a share of GDP over time. In present value, the actuarial deficit in Social Security is only one-fifth

to one-third the cost of the tax cuts over the next 75 years. The tax cuts account for more than a quarter of the fiscal gap over the next 75 years. We therefore return below to the debate over making these tax cuts permanent, after first examining the impact of budget deficits on the economy.

### Economic effects of budget deficits

The projections above suggest substantial deficits over the foreseeable future in the US. But why do such budget deficits matter? The reason is that they reduce national saving. National saving is equal to private saving minus the budget deficit; so when the budget deficit goes up, national saving goes down.

The federal deficit increased by more than six per cent of national income between 2000 and 2003, which triggered a substantial decline in national saving over that period.

Indeed, in 2003, the net saving rate for the US amounted to less than two per cent of income. This level of national saving was the lowest since 1934.

But why does national saving matter? The reason is that it determines how rapidly Americans accumulate financial and real assets. The returns to those assets have a substantial effect on future income. The bottom line is that a larger budget deficit and lower national saving today reduce income in the future.

Another way of making the same point is that with a saving rate of two per cent of income, there are necessarily only two options.

The first option is that we reduce the amount that is invested in the US to two per cent of income, which would starve future American workers of computers, buildings, and other productive capital. This crowding out of private investment is brought about

*“budget deficits matter because they reduce national saving and thus reduce future national income”*

through higher interest rates. The budget deficit soaks up available private saving, leaving a smaller pool of national saving to finance domestic investment. Firms that want to borrow for investment projects compete for that smaller pool of available funds. In the process, they bid up the interest rate that they're willing to pay. The higher interest rate dissuades some firms from undertaking their investment projects, with the net result that investment declines. A reasonable rule of thumb for the US is that each per cent-of-GDP in anticipated future permanent unified deficits raises forward long-term interest rates by 25 to 35 basis points.

The second option is that if we do invest more than two per cent of our income, we must borrow the difference from foreigners – which would leave future generations of Americans increasingly indebted to other nations. Indeed, as national saving has plummeted over the past few years, US domestic investment has increasingly been financed by foreign borrowing. The increase in such borrowing is reflected in our growing current account deficit, which has expanded from about 2.5 per cent of national income in 1998 to more than five per cent in 2003. This borrowing from abroad, however, mortgages the future returns from domestic investment in the US. Foreigners understandably do not lend us money for free, so we must share at least part of the future returns from our domestic capital stock with them. As a first approximation, borrowing more from foreigners has the same adverse implications for the future national income of Americans as reduced domestic investment does. Furthermore, the associated current account deficit likely stokes protectionist pressures in the US, potentially causing harm for the world trading system.

In sum, budget deficits matter because they reduce national saving and thus reduce future national income. That reduction in future income can occur either because interest rates

rise and domestic investment falls, or because we borrow more from foreigners and therefore owe more to them in the future. Or it could occur through some combination of these two effects.

Even if we include only the deficits projected for the next decade, these adverse effects are significant. Under our adjusted baseline in Figure 2, the unified budget deficit over the next ten years is projected to average about 3.5 per cent of GDP. Empirical results from a forthcoming paper of ours in the Brookings Papers on Economic Activity suggest that these deficits will reduce annual national saving by two to three per cent of GDP. As a result, compared to a balanced budget, the assets owned by Americans will be lessened by roughly 20 to 30 per cent of GDP by 2014. If capital earns a net return of six per cent, those missing assets will reduce national income by one to two per cent in 2015 – or about \$1,500 to \$3,000 per household, on average. The unified budget deficits will also raise interest rates by 80 to 120 basis points – or about \$1,000 per year on a 30-year, \$150,000 mortgage.

The negative consequences of sustained large deficits may be larger and occur more suddenly than this type of traditional analysis suggests, however. Chronic, substantial deficits can cause a fundamental shift in market expectations and a related loss of confidence both at home and abroad. The scale of the long-term fiscal gap is so large that, if left uncorrected, the nation faces a real risk of a fiscal crisis.

### Policy implications

So what should we do about this? We have several suggestions that would start moving the US in the right direction, but we don't pretend to have a complete solution. Indeed, given the complexities involved in reforming the health care market, we are not aware of any serious, complete solution to the nation's projected deficits. Here, we instead focus on

the 2001 and 2003 tax cuts. Repealing those tax cuts, or allowing them to expire as scheduled in 2010 or before, would represent a good first step toward reducing the fiscal gap in the United States.

Figure 2 shows that a key aspect of the projected fiscal imbalance in the US is the effect of extending the 2001 and 2003 tax cuts. The debate in Washington currently is over whether we should 'pay for' extending these tax cuts through other offsetting policy changes. This debate seems somewhat artificial, since in the long run there is no alternative to paying for the tax cuts: fiscal accounting and arithmetic demand that a permanent tax cut be financed either with lower spending or higher revenues from other sources.

Alan Greenspan is one of the few supporters of the tax cuts who acknowledges the necessity of paying for them with offsetting policy changes, which he would prefer to do on the spending side. Even Mr. Greenspan, however, has not put forward proposals that would come close to financing the tax cuts. Perhaps that is understandable: the tax cuts are so big that the required reductions in government programs are simply too large, both substantively and politically. Paying for the full tax cuts in 2014, for example, would require an 11 per cent reduction in all non-interest government spending. If the reductions were focused on specific programs, paying for the full tax cuts in 2014 would require a 45 per cent cut in Social Security benefits; complete elimination of the federal part of Medicaid; or a 75 per cent cut in all domestic discretionary spending (such as for environmental protection, education, and health research).

These figures suggest that the tax cuts are simply not affordable and therefore should be

substantially scaled back or repealed altogether. Other perspectives only strengthen this conclusion:

■ *Income distribution* The direct effect of the tax cuts is unquestionably to widen after-tax income inequality. If the tax cuts were extended, after-tax income will rise by more than six per cent for households in the top one per cent of the income distribution, by between two and three per cent for households in the middle 60 per cent, and by only 0.1 per cent for households in the bottom quintile. These figures, furthermore, do not include the cost of financing

the tax cuts. Any plausible financing scheme would involve aggregate losses for the bottom 80 per cent of the population, and gains for the top 20 per cent. In other words, the tax cuts and their financing would mean a substantial transfer of resources from the bottom to the top of the income distribution.

■ *Economic growth* The net effect of the tax cuts is likely

to be a reduction in growth over the long term. Deficit-financed tax cuts have offsetting effects on economic growth. The tax cuts themselves can have a modest positive direct effect on the economy, for example by reducing marginal tax rates and encouraging people to work or save more. But tax cuts also increase the budget deficit, which reduces national saving and eventually has a negative effect on economic growth. Given the structure of the 2001 and 2003 tax cuts, all the studies of which we are aware, including our own, suggest that the net effect is likely to be negative in the long term.

■ *Tax reform* Some advocates of the tax cuts argue that they represent a piecemeal approach to a consumption tax. A consumption tax, though, is intended to raise

*"the most important consequence of Social Security reform may be to take the issue off the table, so that policy-makers, analysts, and the public can focus on the real problem – health care"*

national saving, whereas the tax cuts will undoubtedly reduce national saving; a consumption tax imposes a significant tax on the owners of existing capital when they ultimately consume that capital, whereas the tax cuts are providing windfall gains to such owners; and a consumption tax would prohibit deductibility of borrowing costs, but the tax cuts do not do this. The tax cuts are moving the nation toward a tax on wages, not a tax on consumption. The result is the worst of all worlds: all the regressivity associated with a consumption tax and little or none of the potential macroeconomic benefits.

- *Starving the beast* Some have argued that the tax cuts will help to restrain discretionary spending and force long-term entitlement reform. In fact, since the tax cuts have been enacted, spending has skyrocketed, and the tax cuts themselves may be responsible for some of the breakdown in fiscal discipline. Granting large tax cuts to some groups may make it less politically feasible to rein in the desires of other constituencies to obtain increases in spending programs. The result may be that abandoning fiscal discipline on one side of the budget induces a period of

fiscal irresponsibility on both sides of the budget. It is thus not even clear whether tax cuts impose more or less restraint on spending increases, let alone sufficient restraint on spending to offset the cost of the tax cut itself.

### Conclusion

Significant changes in fiscal policy are needed to deal preemptively with the costs from low national saving and the risk of a fiscal crisis. The sooner we begin, the better.

Scaling back or repealing the tax cuts would be a step in the right direction. We also need to reform Social Security. One recent proposal, designed by Peter Diamond of MIT and Peter Orszag, involves a progressive reform that combines benefit reductions and revenue increases to restore sustainable solvency to Social Security while strengthening its social insurance protections (see *Saving Social Security*, Brookings 2004). Interestingly, given how much more important Medicare and Medicaid are to the long-term budget picture, the most important consequence of Social Security reform may be to take the issue off the table, so that policy-makers, analysts, and the public can focus on the real problem – health care ■