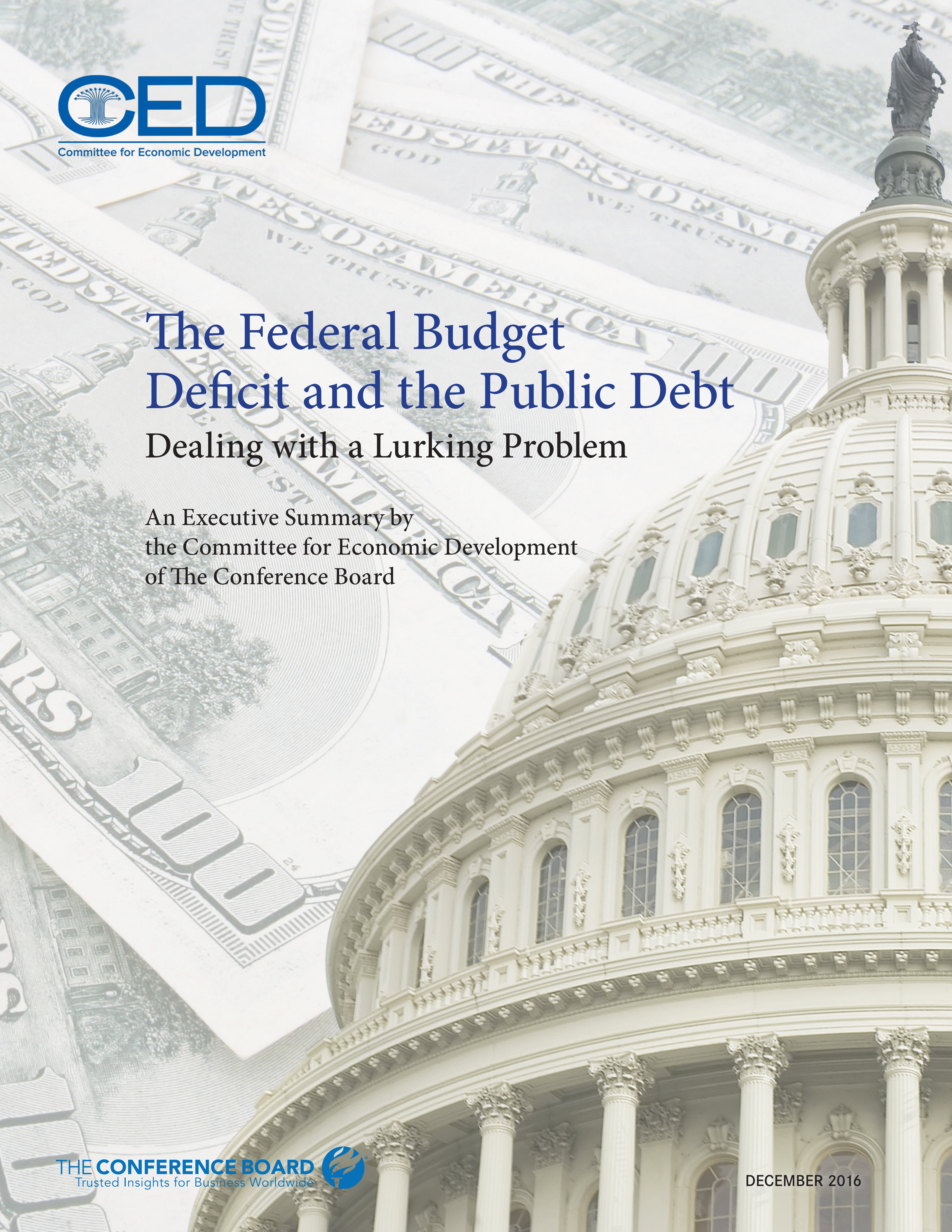

CED
Committee for Economic Development

The Federal Budget Deficit and the Public Debt

Dealing with a Lurking Problem

An Executive Summary by
the Committee for Economic Development
of The Conference Board

THE CONFERENCE BOARD
Trusted Insights for Business Worldwide

DECEMBER 2016

We, the members of the Committee for Economic Development, do not advocate the pursuit of budget deficit reduction reflexively, at all times and under all circumstances, or with any illusion that reducing the deficit is a miracle cure for every economic ailment. However, we firmly believe that the nation's fiscal imbalance is building now to become a critical threat to our world leadership and our prosperity at some unpredictable date in the not-too-distant future.

In other words, we see not a certain and predictable catastrophe ahead but rather a growing risk. Circumstances could cause that risk to fade somewhat or to grow only slowly for a time. But without a significant change in our nation's policy, we believe that this risk is likely to grow, eventually to the point where serious ill effects would be inevitable. In fact, we fear that this risk could become critical with little warning, and we believe that it already is beyond what a prudent national leadership would accept, and that failure to plan now—and to act soon—would be unacceptably imprudent.

For this reason, we urge our fellow citizens to consider the facts and resolve—in a thoughtful but timely manner—to turn this seemingly unending and inexorable trend around.

Understanding Our Budget Problem

When the nation runs a deficit in its annual budget, it must borrow money to make up the difference between its revenues and its outlays, and to pay its bills. Just like a family's debt—a credit-card balance, for instance—that debt accumulates over time if it is not paid off.

And in particular, the public debt bears interest, which must be paid—just like the interest on a household debt. In the case of a government, failure to meet this obligation could have potentially disastrous consequences to all of the nation's households and employers—particularly in the instance of the United States, which is heavily dependent on lending from other nations. If the government lost the confidence of its creditors because of a perceived lack of fiscal responsibility, the value of the currency could plunge and interest rates and inflation could spike, reducing standards of living. The federal government would be forced to respond with immediate (and therefore hastily chosen and implemented) tax increases and spending cuts, due to its dependence on borrowed money and the need to ensure future borrowing ability. Such sudden cuts and ad hoc tax increases would weigh heavily on all of those who depend on government for business, employment or benefits, and could degrade fundamental public services from national security to food safety.

Meanwhile, the falling value of Treasury securities—which are relied upon as reserves and collateral by financial institutions here and all around the globe—would disrupt financial markets and send many businesses and even households into insolvency. The result would be utter economic chaos—far worse than the recent financial crisis whose impact was so painful.

The key factor is the federal government's ability to service its debt, and to earn and maintain the trust of its lenders that it is both able and willing to do so. Those lenders are governments, individuals and businesses, both in the United States and around the world. The standard through which the national government must demonstrate its ability and willingness to service its public debt is the amount of the debt relative to the nation's collective income—which is ultimately the size of the economy, or the gross domestic product (GDP).

A nation's debt relative to its GDP might be rising, indicating that its situation is worsening or even approaching a danger level. Or its debt relative to its GDP might already be too high, indicating that danger might not be far away. Here our nation's picture is clear—and troubling. Our debt burden would fairly be interpreted as **both** rising **and** already too high, as we document in our full policy statement.

In fact, the US public debt burden today, at more than 76 percent of GDP, already exceeds the 60 percent specified as a maximum prudential limit in the Maastricht Treaty of 1992 for the creation of the European Monetary Union (the EMU, using the euro as its currency). Although any such specific numerical ceiling is somewhat arbitrary, the reason for some limit is fairly clear. Again, that debt must be serviced. The larger the debt, the larger the amount of debt service. Any adverse developments could render that debt-service obligation difficult or even impossible to meet.

The US debt burden is projected to rise steadily and then more rapidly toward and beyond the highest figure in our history: the 106.1 percent of 1946, at the end of the fiscal stringency of World War II. With the US public debt burden already significantly above the 60-percent warning signal, and poised to rise even higher, we at CED fear adverse consequences such as were enumerated above. We believe that the nation's policymakers should face up to this question and begin to formulate and enact a solution.

Others disagree, and argue that the nation need not, or even should not, act against the rising deficits and debt in the foreseeable future. We explain their objections in much greater detail in the body of the policy statement. At bottom, we believe that those arguments do not bear up under scrutiny.

On the "need not" side, some say that "deficit scolds" have been crying wolf for years, and the problem has not yet materialized, and so it must be only a fairy tale. Others say that the low level of interest rates today means that we have plenty of time, perhaps forever, before we need worry about the rising debt. America is exceptional, they say, and so "it can't happen here." The budget has improved over the last few years, just as it did after all of the deficit "crises" of the last several decades, and so the problem has been solved. In particular, the debt burden melted away from its 106.1-percent-of-GDP peak in 1946, and it will do so again without any painful policy intervention.

As we explain at greater length in the body of the statement, we find those arguments wanting. No one can foretell the future, and so no one can predict a precise time when our accumulated debt will become problematic. But by the estimates of all of the authoritative budget and economic observers, the brief period of deficit and debt relief that followed the worst of the financial crisis is over. Of course, we all hope that the economy will recover more vigorously at some point. When it does, interest rates will rise. The more debt that we have accumulated by that time, the more that the federal government's debt service cost will rise; and there is unquestionably a limit to the debt service cost that the nation can and will pay. The more debt service, the higher taxes must be, or the deeper spending cuts must be (or, most likely, both). No one can deny that at some point debt service cost would become intolerable. We will need to stop the process of debt accumulation, preferably sooner rather than later.

But some of the skeptics say that the nation actually should not try to reduce the deficit and the accumulation of debt. Those arguments hold that the economy, in the wake of the financial crisis, is too weak today. Fiscal contraction—either cutting spending or raising taxes—would constrain growth and weaken the economy even further. The cost in production, employment and wages would be intolerable. Deficit reduction would crowd out necessary public investment in research, education and infrastructure. We must put off deficit reduction until the economy is much stronger.

We certainly believe that the timing of future deficit reduction would be important, and that monetary policy must be coordinated with fiscal policy to maintain growth. But the nation must not compound its slow growth problem with a debt crisis; and we must not choke off essential public and private investment in the long term with burgeoning debt-service costs. Growth has been steady, though slower than we would like; and interest rates are beginning to rise. With all possible care, and again with careful coordination with the monetary policy authorities, it is time to reassure the financial markets with signs of awareness of and concern about the danger of our rising debt, lest something go seriously wrong.

This Way Down…to a Debt Crisis

And what could go wrong for the sovereign government of the world's greatest economy and superpower? Sadly, recent history provides numerous examples. The United States has suffered from:

- **National security emergencies**, which have disrupted our economy and inflated our budget.
- **Natural disasters** have created budget emergencies, and some members of Congress have delayed a national response to argue that costs be offset by cuts in other spending because of the consequences otherwise for our budget.
- **Domestic economic events**, such as the recent financial crisis, have added trillions to the public debt over just a few years and have forced the federal government to make financial commitments to dispel market fears of financial contagion.
- **Global economic events** have had similar effects, and are increasingly imaginable in our interconnected world.
- In the long run, the nation must meet the cost of our growing **infrastructure deficiencies**.
- **Political miscalculation** over our statutory debt limit or the budget itself could cause a crisis.
- **Market sentiment** can swing on the flimsiest of causes, and once in motion can be impossible to reverse short of a serious crisis.

Again, it is by no means our intent to forecast or predict a financial panic over our public debt. No one knows the future; and based on the past, the United States remains the bedrock of the international economy and the global financial system. But given our nation's recent accumulation of public debt, and our elected policymakers' clear unwillingness to contemplate any remedy, the risk of a serious financial and economic dislocation is far greater than prudent public stewardship would allow. We at CED believe that responsible policymakers should set aside their partisan differences and begin at once to build both mutual trust and a plan to address the fiscal problem. In our full policy statement we suggest come concrete policy steps to do so.

Policy Recommendations to Reduce the Debt Burden: Four Challenges

CED has a rich history of advocacy for fiscal responsibility. We have issued policy statements on the major budgetary issues from the perspective of the nation's interest.

We find that the federal budget problem is so large that any true solution will have to touch virtually every line on both sides of the budget ledger. However, the major drivers of the problem can be subdivided into four parts, enumerated below. More comprehensive discussions of these issues are presented in the body of the policy statement that follows.

1. Restrain defense and nondefense discretionary spending

The federal government's annual agency appropriations is the one area that Congress and the president have addressed aggressively. The caps placed on defense and nondefense discretionary spending—enacted as part of the Budget Control Act of 2011—along with previous spending cuts, have placed discretionary spending on a path similar to what we have recommended.

Sequestration, which was intended to be an unthinkably deep additional reduction that would motivate the "Supercommittee" (which subsequently failed), was scheduled to go into effect in January 2013 to slash discretionary spending far below the levels we recommend. We believe that this sequestration should be avoided. Subsequent developments have confirmed that those sequester levels are not sustainable. Both political parties have rejected them—because every line in the appropriations law has many members of Congress who believe that it is somehow exceptional and should be protected.

The Congress has backtracked on those excessive cuts in two subsequent partial budget agreements, with which we concur—although those agreements did little to replace the sequester's unattainable but nonetheless assumed future savings.

If policymakers wish to address discretionary spending further, they should reform the budget process. We recommend a regular, systematic analysis by Congress of each area of discretionary spending to identify those programs that deserve reauthorization and those that can be made more efficient. (For just one example, analysts from across the political spectrum have called for reform of procurement within the Department of Defense.) Such periodic reviews would improve the effectiveness and accountability of government.

2. **Reform the corporate and individual tax codes by eliminating or curbing nearly all tax expenditures, reducing marginal rates, and raising significant new revenues for deficit reduction, while maintaining progressivity**

Every plausible formula for long-term fiscal sustainability includes substantial additional revenue. At the same time, however, we can reform the tax code to spur solid long-term economic growth through a simpler system that stops picking winners and losers through preferential provisions that benefit particular industries and activities. Instead, a better system would allow the market to allocate resources under lower tax rates that sharpen economic incentives to work, invest, and take risks. The relevant congressional committees should build broad, bipartisan support around such a reform.

3. **Reform health care entitlements to bend the cost curve, transitioning from volume-based reimbursement toward rewarding quality and positive health outcomes**

We currently face immense budgetary pressures from the combination of rising per-capita health care spending and an aging cohort of baby boomers. To reduce the growing pressure on all budgets—federal, state/local, business, and household—we must control the growth of health care spending. Fee-for-service reimbursement, which dominates health care delivery today, rewards volume of services rather than quality and effectiveness, and leads to waste, duplication, and poor coordination of care. As the country's largest health care payers and spending drivers, Medicare and Medicaid urgently need reform and could help transform the whole health care system. In fact, unless we truly "bend" the health care cost curve, no other savings can possibly be sufficient to ward off a budget explosion in the foreseeable future.

Our proposal for Medicare (described in more detail below) improves the cost effectiveness of traditional Medicare through innovations in reimbursements and other incentives while strengthening competition among comprehensive, integrated health plans. Increasing competition and reducing government overpayments—using Medicare Advantage (MA) as a vehicle (through the application of competition among traditional Medicare and private MA plans)—can produce savings while simultaneously improving quality and preserving the Medicare guarantee. We describe our recommendations for the private health care system in our recent policy statement, *Modernizing Medicare*.

4. **Pass a balanced package of policies that achieves long-term solvency of Social Security**

Social Security reform should not be approached for deficit reduction but rather to secure and strengthen a critical foundation of retirement for future generations. Without adjustments, the program will soon reach a point at which benefits must be slashed across the board, or large transfers from general funds or large revenue increases will be required. Accordingly, both parties in Congress should work with the President to adjust benefits and enhance revenues to set the program back on sound financial footing, in a purposeful and thoughtful process rather than one driven at the last minute by emergency and panic.

Fiscal Responsibility Objectives

What is fiscal responsibility? It is a sound balance of our nation's income and expenditure—ultimately, its debt—relative to economic risk. Today, the nation's debt is rising faster than its income. At the absolute minimum, that must be reversed. We do not believe that it is acceptable to seek a stable debt-to-GDP ratio anywhere near the current excessive level. If the debt-to-GDP ratio is constant and at the border of the acceptable in good times, then there is considerable risk for our nation's finances if there are any adverse economic developments.

Therefore, our full fiscal health proposal would achieve a downward trend of the ratio of the debt to the GDP for the indefinite future. A reasonable intermediate target would be to return to the internationally cited prudential limit of 60 percent in about 10 years after a debt-reduction program is put in place. A standard guideline for continuing prudent fiscal policy thereafter is to maintain a balanced budget on average, with modest surpluses in good times (to contribute to the nation's savings and capital formation) offsetting modest deficits in hard times (to stabilize the economy). Following that guideline, we would see a continual slow decline in the ratio of the debt to GDP beyond reaching the 60 percent intermediate target.

Conclusion

CED's recommendations address the nation's fiscal problem in a balanced and workable way. We show that the challenge can be met if lawmakers demonstrate leadership and put everything on the table. The changes we suggest are not easy, but they improve the quality and efficiency of government and strengthen the economy for all Americans. Still, despite literally millions of words deployed on analysis, legislative proposals, and recommendations, the policy changes to achieve fiscal sustainability and strengthen the American economy have not yet been made.

The nation needs substantial fiscal reforms soon. Time is running out. The options are clear. Now our leaders must show the courage to take risks and make hard decisions, and the American people should support those who do. We stand ready to help.

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Committee For Economic Development of The Conference Board
1530 Wilson Blvd
Suite 400
Arlington, VA 22209
202.296.5860
www.ced.org

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