The Federal Budget Deficit and the Public Debt
Dealing with a Lurking Problem

A Policy Brief by the Committee for Economic Development of The Conference Board
Introduction

The US federal government’s finances are on an unsustainable path—with annual spending exceeding revenues and annual deficits adding to the accumulated stock of debt at a pace exceeding the rate of growth of the economy. Unfortunately, this isn’t just “the government’s” problem. It’s a problem for all of us.

Whether as taxpayers or as beneficiaries of government services, all Americans have a stake in the federal budget, as will our children and grandchildren. If our nation’s debt continues to mount at this pace, sooner or later taxpayers and those who benefit from government services, including the dependent elderly and children, will pay a dear price. As the federal debt and the interest on that debt rise so rapidly, they inevitably divert our nation’s economic resources from more productive uses.
Understanding our budget problem: How we got here

The largest and fastest-growing components of federal spending are the major health care programs (especially Medicare) plus other so-called “entitlement” or “earned benefit” programs (including Social Security). Fundamental demographic trends are driving increased spending on these programs. Eligibility for the largest of these programs is primarily restricted to older citizens, whose numbers are growing rapidly. Meanwhile growth in the working-age population that pays the taxes funding these programs has slowed. Additionally, for Medicare and other health care programs, rising per-capita health costs have contributed significantly to higher program spending.

In contrast, discretionary spending, which Congress determines through annual appropriations, is a much smaller share of the budget. Both defense and nondefense spending have declined as shares of the GDP and the budget over time and are projected to decline still further.

Taking these trends together, total federal spending has been rising faster than GDP and is projected to do so throughout the foreseeable future. Meanwhile, revenues are projected to be roughly flat by the same metric. The deficit, as a result, is projected to rise as a share of the GDP over the next decade and into the indefinite future. That means that the nation’s accumulated debt will also grow faster than our economy, which ultimately provides the “income” to service and re-fund the debt.

Interest will soon be the fastest growing component of federal spending—doubling as a share of GDP in the next 10 years (Chart 1). Interest is inherently the most “mandatory” form of government spending, in that the federal government has no choice but to pay it, and nothing can be done directly to alter it. It can be controlled only by getting the rest of the budget in order.

![Chart 1: Annual Net Interest Costs](source: Congressional Budget Office)
How has the nation’s fiscal standing come to a point of such peril? It is not the mere existence of an annual budget deficit, defined as the difference between annual outlays and annual revenues. The federal government has almost always run deficits—but usually in some moderation. Over the last 50 years, deficits have averaged about 3 percent of GDP (Chart 2). During the 1990s, deficits shrunk dramatically and briefly turned into surpluses. Thereafter, deficits initially increased due to new policies (tax cuts, a new Medicare prescription drug program, and the war on terrorism), then declined as the economy grew and the wars wound down, only to be driven to an unprecedented size by the Great Recession and the fiscal stimulus enacted to combat it.
As the economy has recovered, deficits have fallen briefly and slightly below the historical average. But long-term demographic pressures, rising health care costs, and the power of compound interest are about to start driving deficits and the national debt upwards again—seemingly inexorably.

And that is at the heart of the growing fiscal and financial risk. Given current economic parameters (especially economic growth and interest rates) and when the annual deficit exceeds about 3 percent of the GDP, the nation’s accumulated debt will tend to increase faster than the GDP. (Compare the top and bottom halves of Chart 2.) And it is out of our GDP that our outstanding debt instruments (Treasury bills, notes and bonds) must be serviced and redeemed upon maturity. This cannot continue indefinitely without an eventual financial crisis.

This growing public debt burden is unsustainable, because more and more of the federal budget, and of our nation’s current production, must be devoted to interest on the debt. Rising interest payments coincide with rising health care costs and growing demographic pressures that are driving increased spending on retirement and health care entitlement programs, which in turn increases deficits and interest costs even more. This vicious circle already is squeezing out other federal spending and will spill over into the private sector of the economy, crowding out productive investment.

Some believe that the problem will solve itself. The US has reached and survived a higher debt-to-GDP ratio. The nation accumulated the heaviest debt burden in its history, estimated at 106.1 percent of our GDP, at the end of World War II. But economic and budgetary conditions were highly favorable at the end of the war—surprising many who had vivid memories of the Great Depression. Consumer balance sheets were healthy following the wartime economy, when, despite full employment and robust wages, consumer spending had been suppressed by rationing and shortages. Returning troops formed a burgeoning labor force, which helped to drive robust consumer spending. Peaceful redirection of recently developed wartime technology and relatively easy conversion of defense factories met those consumer needs. And perhaps most notably, the nation realized enormous budgetary savings from the winding down of the war effort, including defense spending that quickly plunged from 35 percent to under 5 percent of the GDP until the outbreak of the Korean War. As a result, the debt burden as a percentage of the GDP dropped from that 1946 peak of 106.1 percent to 65.5 percent within five years. The current situation is almost the diametric opposite on all counts: the oversized baby boomer generation retiring from the labor force, many household balance sheets weakened by the recent housing crisis, aggressive economic competition from abroad, and defense spending already so low that it cannot be cut by anywhere near as much as it was after World War II.

Because the current debt-to-GDP trajectory is already heading upward fast, the phenomenon of compound interest makes the most compelling case for acting sooner rather than later to reverse or slow these unsustainable trends. We need to find solutions that help to control the growth in mandatory spending programs and raise revenue in ways that support economic efficiency and income growth and benefit Americans broadly. We need to distribute the costs of deficit reduction fairly across those of different means and generations. To become political reality, any policy changes must achieve a broad consensus. That requires that proposed solutions are consistent with the philosophies, ideologies, and policy goals of adherents of both major political parties—as difficult as that may appear today.
Policy choices to reduce the debt burden

To put the federal budget on a more sustainable fiscal path we simply must restrain spending and raise revenues. Both spending cuts and tax increases involve pain and sacrifice, which means that fiscal sustainability is as much a political challenge as it is an economic one.

The problem is simply too large to be solved on one side of the ledger alone; and the necessary broad political consensus can be achieved only through sacrifice shared across every segment of the society. Similarly, the problem is too large for policies that address only small or limited areas of the federal budget. Major programs must be reformed. In sum, the choices are hard—just the kind of challenge that elected officials would prefer to postpone until after the next election, and then the one after that. But meanwhile, the debt mounts, and the choices only get more painful.

There is no silver bullet for deficit reduction, but by the same token there is not much mystery to it. The budget deficit is the difference between revenues and spending. There is no way around that mathematical reality or the resulting painful requirement that the nation reduce its spending and increase its revenues, but there are better and worse choices. CED has offered detailed policy recommendations for all major categories of the budget, which we enumerate and explain below. We believe that the deficit reduction process should begin now—first by building consensus around a macroeconomically prudent but firm schedule of budgetary savings.
Spending Cuts and Reforms

Resolving the long-term fiscal imbalance requires sensible adjustments to nearly all discretionary and mandatory spending programs. But the large mandatory entitlement programs for health and retirement are the foremost contributors to the excessive and rapidly rising debt burden.

Mandatory programs

Health Care. Retirement-age programs such as Medicare and Social Security face demographic pressure due to increasing longevity, declining birth rates, and the aging and retirement of baby boomers. In addition to these demographic trends, health care programs such as Medicare and Medicaid face further pressure due to the rising cost of health care. CED seeks to reduce the growth in per-person health care costs while improving the quality of and access to care. The demographic pressure is unalterable; we can reduce the nation’s long-term fiscal imbalance only by slowing unsustainable growth in health care costs. The federal government already plays a significant role in our health care system, both private and public. That role must be made more constructive, not only to reduce budget deficits but to help restrain the growth in health care costs and improve health care quality system-wide.

CED proposes reforming the Medicare Advantage program (the existing private alternative to traditional Medicare) so as to establish competition on the basis of quality and price among traditional Medicare and Medicare Advantage plans. Under CED’s proposal, the federal government would provide a credit to each elderly beneficiary to purchase coverage. The size of the credit would be based on the cost of the second-least-expensive plan in the beneficiary’s area, regardless of whether it was traditional Medicare or a Medicare Advantage private plan. Using the credits they receive, beneficiaries would be able to purchase those low-cost plans at no out-of-pocket cost. Alternatively they could choose a more expensive plan that better meets their needs and preferences by paying the incremental cost. The growth of the per-beneficiary federal support will be restrained by competition, which has proved successful when applied through consumer cost-responsible choice among health care plans, and which will encourage greater efficiency throughout the health care system.

Additional reforms to Medicare and health care (e.g., policies to focus pay on performance, to combat obesity, to improve access to generic drugs, or to reduce the incentives in the malpractice system to practice “defensive medicine”) can also help reduce costs while increasing efficiency and improving quality.

Social Security. True reform of the Social Security system must preserve and strengthen the program for future generations. It should aim to achieve sustainable solvency—that is, it should leave the program with an adequate reserve balance at the end of the customary 75-year projection period, while increasing currently inadequate benefits for workers with persistent low wages or interrupted work histories. And any reform should maintain retirement options for those who worked in physically debilitating jobs. CED recommends the following reforms that meet these criteria:

- Gradually raise payroll taxes to cover 90 percent of all wages and maintain coverage at that level permanently. The Social Security reforms undertaken in 1977 subjected 90 percent of all employee compensation to tax by 1981, but the share quickly declined and has fallen to about 80 percent currently.

- Use a more accurate calculation of inflation to determine annual cost-of-living adjustments (COLAs). The consumer price index (CPI) does not take into account the ability of households to replace products and services whose prices are rising rapidly with lower-priced alternatives. For the purpose of adjusting program benefits, an index that accounts for the ability to substitute makes more sense.
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- Implement modest additional means testing for high-income beneficiaries. The burden of making Social Security financially sound should be shared fairly.

- Restructure and increase the minimum Social Security benefit, to protect workers with low wages or interrupted careers. Under the current law, many workers with low wage histories—those who need the most help to put together a decent retirement—are at a particular disadvantage.

- Index the benefit formula for increases in life expectancy. Due to advances in public health and in personal health care, most workers today can expect to have longer retirements. But some workers whose careers emphasized physical labor are less fortunate and need the opportunity to retire when their ability to work is depleted. One way to reconcile these conflicting imperatives is to retain the option of early retirement while strengthening the program through measured benefit reductions for workers of considerable means who choose to retire early.

- And finally, cover all newly hired state and local government workers under Social Security. All Americans should contribute to, and benefit from, the national retirement program.

Other Mandatory Spending. Many other programs are not subject to annual appropriation, but rather run on autopilot—in recent years with little or no recurring oversight by Congress. These include farm programs, veterans' benefits, civilian federal employee retirement programs, low-income support programs, subsidies for low-wage workers, and others. Such programs comprise little more than 10 percent of total federal spending, as they have for half a century or more. They are not the source of the budget problem, and they are too small to be the full solution. But like all federal spending, they should be reviewed and reformed to contribute to a complete solution. Especially (though not exclusively) in the agricultural and retirement programs, targeting federal dollars toward true need could help reduce spending.

Annually appropriated programs

Domestic Discretionary Programs. Domestic discretionary spending consists of activities of the federal government that are funded through annual appropriations bills. These are services that taxpayers may take for granted, but which would be conspicuous by their absence if funding were not provided. They include homeland security, domestic law enforcement, food safety inspection, air traffic control, highway construction, student loans for higher education, passport issuance, disaster response, and a host of other activities—along with grants to state and local governments for elementary and secondary education, public safety, infrastructure, and much more.

The Budget Control Act of 2011 (BCA) imposed 10 years of caps on this category of spending. Those caps are roughly consistent with the restraint recommended by CED and other authorities on fiscal matters. But in addition to those limits, the BCA called for further reductions in the event that Congress and its "supercommittee" failed to achieve a subsequent $1.2 trillion deficit reduction plan. Most experts saw these further discretionary spending cuts as an unthinkable threat intended to force Congress into action. But Congress did fail, unfortunately, and as a result these additional discretionary spending cuts, which came to be known as "the sequester," became law. CED does not believe that these additional sequester cuts, which Congress never intended to implement, would be prudent; in fact, the Congress has failed to pass annual appropriations bills in compliance with the sequester levels thus far. We believe that Congress and the President should implement the prior discretionary spending caps but not the excessive sequester cuts. Lawmakers can always find some additional efficiencies in some individual programs, and should pursue them through careful program oversight (which has been lacking in recent years). But additional priorities and contingencies—such as the need to fund infrastructure and research—will present themselves as well. In sum, CED does not believe that counting on the annual appropriations to provide significant additional savings for deficit reduction is prudent.
Defense. Defense spending—for uniformed personnel salaries and benefits, operations and maintenance, procurement of hardware, research and development for defense systems, and many smaller functions—generally figures more prominently in the public mind than domestic discretionary spending. The BCA established 10 years of caps on defense spending, just as it did for domestic discretionary spending. CED generally agrees with these levels. Substantial reductions in total defense appropriations would require reductions in the missions that we assign to our military (for example, in how many and which parts of the world we will station troops for deployment on very short notice).

The size of the force will be largely determined by those missions, and a significantly smaller force must shed some of the responsibilities it currently is asked to bear. However, we also agree with experts from across the political spectrum who believe that, in particular, the procurement, retirement, and health care components of the US defense budget require major reforms that could produce helpful additional budget savings. We do not believe, however, that such reforms, however beneficial, would provide major additional deficit reduction on anywhere near the scale needed to address our overall budget problem absent major reductions elsewhere.
**Tax Reform and Revenue Increases**

Policymakers are often reluctant to reduce the deficit by raising taxes. Their intuition is that increasing government revenue necessarily harms overall economic activity and productivity. Furthermore, they know that their constituents will look askance at tax increases.

But the budget problem is too large to be solved without additional revenues. And economic performance need not suffer.

Government can raise revenue in two fundamentally different ways: by increasing the scope and size of the tax base, or by increasing the rates at which the base is taxed. Broadening the tax base often increases economic efficiency and growth by treating all forms of activity more similarly. Leveling the playing field in this way allows resources to flow to their best uses in the marketplace, negating current-law incentives that drive them to follow the dictates of political influence. In contrast, merely raising marginal tax rates aggravates the tilt of the playing field between fully taxed and tax-favored activities. That hurts economic efficiency and growth.

Fortunately, combining the two approaches creatively offers a win-win opportunity. Broadening the base by reducing tax expenditures holds the greatest potential for bipartisan appeal. It would reduce the overall size and reach of government while cutting government subsidies in a distributionally progressive way. Because high-income, high-tax-bracket households currently benefit disproportionately from preferential tax breaks, reducing such tax expenditures will raise more revenue from high-income households, both in dollars and as percentage of income. This raises the possibility of reducing tax rates for those taxpayers most affected in a fashion that strengthens their incentives for productive economic activity, driven by returns in the marketplace more than they are today.

Thus, tax reform to support deficit reduction would be an honorable compromise in the truest sense. Different political interests would get something they want, but also would have to sacrifice in other ways for the common good. Such an approach could be truly bipartisan. It is worth noting that the most recent major US tax reform was enacted under divided government in 1986. At that time both political parties contributed to an outcome that was viewed as more than the sum of its parts.

Done right, tax reform will help achieve fiscal sustainability. It could simplify the current tax code and raise additional revenue to supplement the spending reductions specified above. CED recommends the following specific steps as part of an overall tax reform strategy of broadening the tax base, reducing tax expenditures, raising revenue, and enhancing tax progressivity.

- Reduce and flatten marginal tax rates:
  - Create a **two-bracket income tax with rates of 15 percent and 28 percent**. Because there is no standard deduction or personal exemption under CED’s proposal, the 15-percent rate would apply to the first dollar of income.
  - Reduce the **corporate tax rate to a flat 28 percent** in place of the current 35 percent top rate.

- Raise marginal tax rates on capital income to be equal to tax rates on labor income:
  - Capital gains and dividends will be taxed **as ordinary income (with a top rate of 28 percent)**, excluding the first $1,000 of realized net capital gains (or losses).
• Simplify and unify tax credits for families. In place of the overly complex Earned Income Tax Credit (EITC), personal exemptions, the standard deduction, and the child credit:
  — Establish a flat **refundable per child tax credit of $1,600** (which is higher than current law).
  — Retain the child and dependent care credit.
  — Establish a **refundable earnings credit** similar in structure to the recent Making Work Pay credit but substantially larger. In a key innovation in this proposal, the earnings credit would not need to be phased out as income rises due to its coordination with other proposed reforms. A major weakness of the current EITC is that its phase-out features create both disincentives and confusion for low-income working families who increase their earned income.

• Pare back deductions in a progressive manner. In place of the current system of itemized deductions, which disproportionately subsidizes the housing and charitable giving of upper-income taxpayers:
  — Provide a flat **15-percent refundable tax credit for charitable contributions** and for up to $25,000 per year (not indexed) of **mortgage interest on a primary residence**. (These refundable credits would begin at 20 percent, and then phase down to 15 percent over five years.)
  — Eliminate the deduction for state and local taxes.
  — Provide a flat, **15-percent refundable tax credit** or a deduction (for those in the higher tax bracket) for **contributions to retirement savings accounts** of up to 20 percent of earnings or a maximum of $20,000.

• Broaden the personal income tax base by including benefits in taxable income, and reducing some deductions:
  — Include 100 percent of Social Security benefits in taxable income, but:
    — Create a nonrefundable credit for Social Security beneficiaries equal to 15 percent of the current standard deduction; and
    — Create a nonrefundable credit equal to 15 percent of an individual’s Social Security benefits.
  — Cap and then phase out over 10 years the tax exclusion for employer-sponsored health insurance benefits.
  — Limit the deduction for medical expenses to the amount exceeding 10 percent of adjusted gross income (AGI) (unchanged from current law).
  — Limit miscellaneous itemized deductions to the amount exceeding 5 percent of AGI (increased from 2 percent in current law).

• Increase excise taxes:
  — Increase the federal gasoline tax by 15 cents and index it to inflation, dedicating the revenue to the highway trust fund.
  — Increase federal taxes on tobacco and alcohol.
Conclusion

The nation’s fiscal imbalance is already growing at a pace where it could pose a critical threat to our world leadership and prosperity in the not-too-distant future. CED sees a growing risk—not a certain and predictable catastrophe—ahead. Circumstances could cause that risk to fade or to grow slowly for a time. But without significant change in our nation’s policy, we believe that this risk is likely to grow to the point where serious ill effects eventually become inevitable. In fact, CED believes that the risk already exceeds what a prudent national leadership should accept and that failure to plan and act now is unacceptably imprudent.

The solutions CED recommends in this policy brief address the nation’s fiscal problem in a balanced and workable way. Lawmakers can meet the challenge if they demonstrate leadership and put everything on the table for negotiation. The changes we suggest are not easy. But if enacted, they would improve the quality and efficiency of government and strengthen our economy for all Americans.
Endnotes


3 Beneficiaries will be responsible for the equivalent of the current-law premiums for Medicare Part B and prescription drug (Part D) coverage.


6 Previous efforts, such as the 1983 emergency reform law, created temporary actuarial balance that eroded well within the 75-year period.

7 All new federal employees, including the President and members of Congress, have been covered by Social Security since the Social Security Amendments of 1983.

8 Tax expenditures are spending through the tax code. These tax breaks and provisions provide preferential treatment to some groups or activities relative to others, effectively subsidizing the preferred activities or groups.

9 The 28 percent rate applies approximately to income above $51,000 for single filers and $102,000 for couples.

10 $500 for singles and heads of household.

11 The refundable earnings credit is equal to 17.5 of the first $20,000 of earnings.

12 This tax credit provides low-income relief for retiree recipients of private pensions or income from personal savings.

13 This tax credit provides low-income relief for Social Security beneficiaries.

14 Enactment of CED’s health care reform program (see Adjusting the Prescription) would allow immediate elimination of the exclusion.

15 CED’s 2005 tax reform policy statement recommended a value-added tax (or VAT) as a supplement to the income tax. We believed that especially in light of the need for additional revenue, shifting some of the tax burden onto consumption would encourage additional household saving while allowing somewhat lower income tax rates to sharpen economic incentives. However, we do not favor the mere addition of a VAT on top of the current deficient income tax system and in the absence of our proposed spending reform, because we believe that it would dampen economic growth. If political objections made enactment of our recommendations impossible and given the size of the current debt problem, we believe that still further additional spending cuts and additional revenue would be needed to achieve a sustainable fiscal posture.
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