The Federal Budget Deficit and the Public Debt
Why and How to Deal with a Lurking Problem

A Report by the Committee for Economic Development of The Conference Board

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Introduction

The late Arthur Okun, a macroeconomist of considerable note, once drew an analogy between the challenge of fiscal responsibility and that of weight control. One moment’s choice of self-denial will not help very much. Likewise, a contrary decision to overindulge on one occasion will not turn the scales. But the cumulative effect of repeated misbehavior can be catastrophic, and bad habits are easy to build yet hard to break. Hence, the clear merit of an early program of good behavior—and the difficulty of adhering to it.

Lately, Paul Krugman, a Nobel-Prize-winning economist and columnist for the New York Times, has presented an opposite perspective. Today’s economy, Krugman might say using Okun’s analogy, is like an overweight cancer patient. A physician who sets the primary treatment as the establishment of a weight-control program for that patient would be wasting time on a vague long-term risk while ignoring an immediate life-threatening illness. Similarly, according to Krugman, today’s economy is under mortal threat from the slow growth after-effects of the global financial crisis that struck in 2008. That threat—not some years-off danger of an exploding public debt—deserves policymakers’ full attention, says Krugman. Practitioners who focus on the debt problem are fetishists, not rational economists.

Okun is not here to speak for his original analogy—he passed away of a heart attack in 1980—so we must mediate this apparent difference on our own. Which version of this analogy is more pertinent and useful? How should we think about the nation’s reputed fiscal crisis?

We, the members of the Committee for Economic Development, believe that extreme views on this question are unproductive—as extreme views usually tend to be. We 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 believe that the risk 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

Some people think of the nation’s budgetary behavior in terms of the situations of their own families. They likely perceive the federal government as “living beyond its means,” because the most commonly cited indicator—the annual federal budget—is not balanced. We believe that a slightly different perspective gives a better sense of where the nation stands and, more precisely, why the prospects are troubling.

Here are the essentials: 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. Failure to meet that interest obligation can have extreme consequences, including the inability to borrow further, or the imposition of much higher interest rates on new or even existing borrowings.

In the meantime, the falling value of Treasury securities—which financial institutions here and around the globe rely on as reserves and collateral—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.

But the situation of a household and the federal government are not precisely analogous. A family faces specific transition dates, when one generation hands off its financial affairs to the next. Virtually all of us aspire to leave our children and grandchildren with a balance sheet on which assets exceed liabilities.

In the case of a government, failure to meet such obligations 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 (see Chart 1). If the government lost the confidence of its creditors due to 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. Such cuts 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.

In contrast, the nation faces no such specific day of reckoning (we hope). Rather, each generation gradually passes the baton, and the ledger, to its successors. Like each generation of a family, however, we want to leave our children and our grandchildren a better life. But with a less precise transition date, there is no precise moment of truth, and no precise threshold between manageable and catastrophic debt burdens.

For a nation perhaps even more than a family, the legacy we leave is both financial and nonfinancial. The financial legacy is the balance between the nation’s financial assets and liabilities—which is now, and always has been, heavily weighted towards the public debt. The federal government has only limited financial assets and those assets are not readily convertible into cash. But in the case of the nation, it is not improper or necessarily unfair that we carry a debt. Part of the reason is that many of the nonfinancial assets that we leave to succeeding generations—such as our freedom—were purchased at a dear price, including (but certainly not limited to) money. For that reason, incurring debt on such occasions was not a matter of realistic choice, nor is it a cause of current regret. Thus, leaving some of the costs of those nonfinancial assets, that is, a net financial public debt, to our nation's successor generations is not necessarily so inappropriate as it would be, typically, for a family.

So CED's concern about fiscal responsibility is not that the federal government has a net public debt, or that it is running budget deficits. All else equal (which it never is), we of course would wish that the debt were smaller (or nonexistent), and that the annual budget were in surplus. Rather, our concern is that the budget—even acknowledging the acceptability of some annual deficits and some accumulated debt—is far outside of any acceptable standards of fiscal responsibility; the situation is well past where any prudent public official should allow it to be. Understanding why, and what the appropriate standards are, is crucial.

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. A household is judged on the size of its debt relative to its income. Can it make its loan payments in full and on time? If not, its creditors will refuse further credit and, if legally possible, increase the interest rates that they charge to provide compensation for the higher risk of default. The analogous 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.

**What is the maximum acceptable level of debt?**

To cite a reasonable standard by which to judge, the framers of the Maastricht Treaty of 1992 for the creation of the European Monetary Union (the EMU, using the euro as its currency) set 60 percent of each member nation's GDP as the maximum tolerable debt burden. All nations that have since aspired to use the euro as their currency have pledged to maintain their public debt burdens below that 60-percent level. 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 that increase the debt service increase the risk to the lender that debt-service obligations will be rendered difficult or even impossible to meet.
Chart 2 shows this picture in historical perspective. 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. With the highly favorable economic and budgetary conditions at the end of the war—healthy consumer balance sheets, pent-up demand after wartime rationing and shortages, a burgeoning labor force from the return of the troops, the peaceful redirection of newly developed wartime technology, and the substantial budgetary savings from the winding down of the war effort—the debt burden as a percentage of the GDP plunged from that 1946 peak of 106.1 percent to between 27.1 percent and 23.1 percent from 1971 through 1981. The debt almost doubled to 47.8 percent in 1993, fell by more than a third to 31.4 percent in 2001, and then rose again to a range of 34.5 percent to 35.2 percent from 2003 to 2007.

Even in 2007, budget forecasters considered the outlook dire. As of that date, the nonpartisan Congressional Budget Office projected figures indicating that the then-current budget policy would send the debt-to-GDP ratio to its danger level of 60 percent by 2022—15 years hence (see Chart 3). Fifteen years would not be a long time to address a problem of that magnitude, given the highly partisan finger-pointing of who should sacrifice to solve the problem going forward (and who was responsible for the problem looking back).
But then the financial crisis hit, and the lurking problem attacked with unexpected speed. The debt burden leapt to 60.9 percent in 2010 and rose further to an estimated 73.6 percent at the end of fiscal 2015.

Thus, the US public debt burden already significantly exceeds the 60-percent warning signal, leading us at CED to fear the types of adverse consequences enumerated above. We believe the nation’s policymakers should face up to this question and begin to formulate and enact a solution.

Others disagree. We have heard a few objections but believe that they do not bear up under scrutiny.

**Frequently heard objections to enacting deficit-reduction policies**

**Objection 1:** You are just deficit scolds. You’ve been crying “wolf” about deficits and debt for the entire duration of the financial crisis and the resulting economic slowdown. The wolf—in the alleged form of higher interest rates and financial panic—hasn’t appeared yet. Your errors so far prove that the wolf is a mere fairy tale. You want deficit reduction all the time, regardless of the circumstances. The economy is still recovering from recession, and now is no time to derail that recovery.

From the onset of the financial crisis, CED has always considered carefully the question of when deficit reduction could begin without undermining the economic recovery from that sharp downturn. Our past discussions of this point have always been explicit about the need to time the fiscal restraint, so as to facilitate sustained economic growth. And we always have been explicit that the arrival date for any future debt crisis is highly uncertain and dependent upon many circumstances (which we seek to explain in even greater detail in this policy statement).

But the substance of this argument today is more important than our institutional historical record. In important dimensions, the economic recovery has progressed significantly—even though it might not reach the full measure of what the nation wants. It has taken disappointingly long to get this far, and every American wants more employment and more economic growth. But the hurdle for action on the public debt problem cannot be an ideal economy, and we cannot allow the argument for delay to become permanent. The Federal Reserve has concluded that it must begin to tighten its monetary policy stance given the improvement in the labor market and other macroeconomic conditions. The criteria for the Fed’s judgment on tightening monetary policy and those of the budgetary authorities for tightening fiscal policy surely should be about the same.

As we made clear at the outset, we do not claim, with certainty, that financial markets will react at a particular moment of a particular hour. No one knows the future, much less with that degree of precision. But the debt burden is already at a worrisome level, and, if allowed to continue to grow, it will eventually become unbearable, causing an adverse reaction in the financial markets. If the existence of any imperfection in the economic outlook is allowed to be a dispositive argument against action on the debt, then the debt problem will never be addressed.

The absence of a financial market reaction to the US public debt buildup thus far is not totally surprising. In today’s open international economy, our fiscal standing looks much less unattractive when compared to other nations.

The fiscal weakness of the rest of the world has rendered our debt benign for a time. As other, smaller developed nations accumulated their own substantial budget deficits, our own fiscal situation—with our longer track record and our globally accepted currency and securities—looked less troubling by comparison.
As many economists have come to say in light of this worldwide pattern of fiscal weakness, the United States is the best-looking horse in the glue factory. Given the choice of nations in which to park their money, investors—including sovereign governments—understandably have continued to choose the United States. This, in company with the Federal Reserve’s stimulative monetary policy, has stabilized our financial markets and held our interest rates down.

Some would argue that our nation’s privileged position in the financial markets—or “American exceptionalism” more broadly—will go on forever. But this inertia in global markets, just like the “boy crying wolf” fairy tale, need not go on happily ever after. American exceptionalism had to be earned, and must continue to be earned. At some point in the future, the economy will have recovered more fully, and interest rates will rise to “normal” levels—orders of magnitude greater than where they are now. (See Charts 4 and 5 for the current interest rate forecasts behind CBO’s budget projections.) How much debt—all of which will have to be rolled over and refinanced at those new and higher interest rates—will we have accumulated by that time? And what will be the impact on our debt service costs?

Source:
Even assuming that interest rates remain within historical bounds, the federal government’s interest costs, after nearly a decade of bargain-basement rates, will increase by a factor of 4 to 5 within 10 years. (See Chart 6.)

If our financial behavior is notably irresponsible, investors could decide to retreat from reliance on Treasury securities at any subsequent moment. That retreat could be a matter of modest degree, with investors demanding somewhat higher interest rates. If past patterns hold, those higher interest rates will be passed on to business and consumer borrowers through relatively constant “yield spreads” above the benchmark Treasury securities for corporate bonds, residential mortgages, and all other species of credit instruments. Those higher interest rates would discourage investment and therefore would erode future productivity, economic growth, and living standards. And the consequent increase in the federal government’s debt-service costs would make it harder for government to finance any and all public services.

Alternatively, the markets might react in a spasm, if news of some shock suggests a quantum worsening of the outlook for the debt. The consequences of such a “rush for the exits” could be far more serious; interest rates could rise quickly and substantially.

A key cause of the risk following from our debt position is the resulting sensitivity of our budget to interest rates. If our ability to service our debt is perceived to worsen, then markets will raise interest rates. And the raising of interest rates will worsen our debt position. The result would be a vicious cycle that could easily spiral out of control. Which reveals the danger of the “just crying wolf” argument. So long as the nation remains convinced of its own invulnerability to its accumulation of debt—perhaps because no harm has come about yet, despite the alleged “crying wolf”—the federal government will continue to accumulate more and more debt.
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The more debt it accumulates, the more leverage interest rates will acquire over the budget and the more vulnerable the nation becomes to any bad news that should arise. We therefore emphasize that the issue is not the certainty of some future calamity, but rather precisely the risk to which greater debt subjects the nation. Prudent stewards of our children’s and our grandchildren’s futures never would submit the nation to such risks. And in fact, the longer we remain complacent—the longer we insist that concern about the debt is “just crying wolf”—the greater that risk becomes, and the closer it comes to an eventual certainty of dire consequences.

Objection 2: Although the unemployment rate has declined, many workers exited the labor force during the financial crisis and have not yet returned. Economic growth is slow, and productivity growth is slow. We should not tighten budgetary policy during times of such slow growth. This is a finer point of macroeconomic policy, but again, addressing the debt problem cannot wait for economic nirvana. This argument suggests that even with the unemployment rate already low (4.6 percent as of this writing), the fiscal authorities can make the economy grow faster by running large budget deficits. That is most likely not the case. With the growth in the number of jobs and in wages, those former workers remaining out of the labor force have all of the signal they should need to seek work if they so choose. And large budget deficits are most unlikely to result in faster productivity growth in the short run, because firms already are seeking productivity growth to increase their own profits. With interest rates at such low levels, firms have every incentive to undertake productivity-increasing investments if they at all see fit. In the longer run, large budget deficits will inhibit productivity growth, because when interest rates rise they will crowd out private-sector investment.

But more fundamentally, the economic-slowdown-versus-debt-buildup dichotomy rests on a false premise. No law dictates that we may have only one serious economic problem at a time. Indeed, it would be far worse to allow our condition to deteriorate so much that we have two—such that a “Catch-22” relationship renders both of them critical, but with contrary remedies. Within our direct experience, that might be the classic scenario for a business bankruptcy—in which a firm must make investments and other purchases to maintain viable operations, but has lost the trust of the credit markets that is necessary to finance those expenditures. It would be tragic if our entire nation blundered into such a needless dilemma.

We would further note that as the Federal Reserve undertakes its normalization of monetary policy from the “zero rate” extreme of recent years, it could raise rates more slowly and so keep monetary stimulus going somewhat longer while the budget gradually tightens. Such adjustment would be a natural reaction of monetary policymakers to avoid the dilemma posed by slow growth and a soaring public debt at the same time.

In sum, if our economy has high unemployment and slow growth, one can make a strong argument to allow the federal budget deficit to rise. The extra spending by government will cascade into greater demand throughout the economy and will add to employment, and so long as unemployment remains high, budget deficits will not encourage inflation. This is what happened in the wake of the financial crisis, and it arguably arrested what could have been a catastrophic downturn, or even another Great Depression. CED accepted those budget deficits at that time. But if unemployment is relatively low and the economy is growing slowly anyway, it is far from clear that larger budget deficits will accelerate growth. More spending will merely drive employers to bid against each other for the same labor and capital goods, leading to faster inflation, not more growth. What is needed is more innovation and productivity growth—and these cannot be bought with bigger deficits. And that is precisely where the economy is today: unable to shake off the trauma of the financial crisis, and so stuck in a slower trajectory of growth to which deficits are not a remedy.
We cannot allow our nation to turn slow growth from a valid reason for temporary large deficits into an ongoing excuse for perpetual large deficits.

Objection 3: If the financial markets had any fear of the nation’s ability to manage its debt, interest rates would be high and rising. Instead, interest rates are on the floor. This is clear evidence that we are nowhere near a debt crisis.

It is in fact true that a debt crisis will most likely manifest itself early on through a sharp rise in interest rates. And for that reason, it is most likely true that a debt crisis is not yet upon us. However, the more debt we accumulate, the greater the probability of a debt crisis at some point in the future. And the time to ward off a crisis is not after the damage is done but, rather, before the situation becomes critical.

The fundamental reason why interest rates are low is that economic growth remains sluggish in the wake of the financial crisis. The Federal Reserve’s extraordinary response to the economic weakness has held interest rates lower still. The willingness of foreigners to invest in the “safe haven” of the United States, given even worse prospects in the rest of the world, adds still further downward pressure on US interest rates.

This objection implicitly assumes that interest rates can remain low forever—or at least for so long that no reason exists to alter budget policy in the foreseeable future. We believe that this assumption will prove far too optimistic. And in keeping with our core belief that the debt problem confronts our nation with unnecessary and excessive risk, we note that once market participants come to believe that interest rates will rise, they will act to make that happen. Like people who begin to smell smoke in a crowded theater, they will not walk slowly to the exits; they will run—to protect the principal of their investments from the falling value of bonds when interest rates rise. The likelihood of such a panic reaction is an important reason why the nation should steer well clear of such risks.

Objection 4: The ratio of the public debt to the GDP has stabilized. The problem has been solved. Move along, folks; there’s nothing to see here.

One important dashboard indicator of the fiscal state of the nation is the change in the ratio of the debt to the GDP. And the debt-to-GDP ratio has been on a roller coaster ride: roughly 25 percent in the 1970s; up to 50 percent by the early 1990s; down to less than 33 percent by 2001; and rising up to 75 percent after the financial crisis. The budget deficit peaked at $1.413 trillion in 2009, in the teeth of the crisis, but then fell to $439 billion in 2015. However, the Congressional Budget Office’s baseline projections would have the deficit rise to $534 billion in the current fiscal year (2016), accelerating more rapidly after 2018. The debt:GDP ratio will increase consistently after this year—rising from 73.6 percent in 2015 to 85.6 percent in 2026.

The heralded slowdown of the debt burden clearly was only temporary. And CBO’s baseline is inherently optimistic in that it assumes that forthcoming budget policy will follow the current law. Current law includes rigorous—some would say unrealistic—future spending cuts. This so-called “sequester” already has been loosened twice—once for two years in a last-minute budget deal in 2013, and again for the succeeding two years in another budget deal that was brokered in late October of 2015. These deals clearly portend more concessions to come in another year. Quite plainly, the Congress cannot write and enact appropriations bills at the low post-sequester levels. Even many small-government advocates in the Congress want more spending on the programs that benefit their districts than can be accommodated within the current-law sequester levels. And allowance for only such bare-bones spending levels in an already high-deficit budget leaves no room for contingencies.
Furthermore, the baseline assumes future tax increases, in the form of expirations of so-called “extender” temporary tax cuts, which are highly unlikely to occur. Even after the budget deal at the end of last year spent more than $600 billion over 10 years to deal with these provisions, still more future tax increases—unlikely to be allowed to take effect—remain hidden in the baseline. Without the continuation of the sequester spending cuts and the expiration of the extender tax cuts, the debt burden would increase much faster than the official baseline. By that time, whether the budget achieves the baseline projections or not, the debt will have grown so large that it, plus interest rates rising from today’s post-financial-crisis-stimulus levels, will have rendered the budget far more vulnerable to any unfavorable developments.

**Objection 5:** The budget and the debt have done better than forecast in the last few years, since the worst of the financial crisis. It would be worth betting that these fortunate budget outlook revisions will continue. Why accept the pain of budget consolidation with spending cuts and tax increases when the problem might solve itself?

We believe that merely hoping for budget outcomes better than what had been forecast would be imprudent; it would be an irresponsibly high-stakes bet, with the well-being of future generations on the table. The economy and the budget might continue to outperform the projections; but they could just as likely underperform them. The consequences if the optimistic view proves wrong could be catastrophic. And the markets could balk even at the budget baseline, which incidentally would be the worst non-wartime debt performance in the history of the republic. We will not know in advance whether the financial markets will perceive the outcome of any such risky policy decision to be excessive debt. But once the markets have reacted, it will already be too late. The damage could be done in weeks, or days, or even hours; after the scars of the financial crisis, the damage could be irreversible. And once our nation’s gilt-edged financial reputation is lost, it will take a long time to recover. Again, this is just too much risk for prudent stewards of the nation’s future to incur.

**Objection 6:** We can live indefinitely with the public debt equal to 75 percent of the GDP. It isn’t so bad. In fact, after World War II, the debt was more than 106 percent of the GDP, and we grew out of that. We can do it again.

The rate of change of the debt burden (the public debt expressed as a percentage of the GDP) is one dashboard indicator of the fiscal status of the federal government. The level of the debt burden is another.

If the nation had entered a recession such as the one that followed the financial crisis with a very low debt burden, the budget deficits that followed would have been a matter of much less concern. When the recession reduced tax revenues and increased safety-net outlays, policymakers would have accepted the fallout as unfortunate but necessary and acceptable. The direction and the rate of change of the debt burden alone were not a definitive warning sign. Much of the blowback over recent deficits arose instead because of the level of the debt; it already was elevated into the danger zone.

The debt burden now has settled, temporarily, at about 75 percent of the GDP—more than double what it was at the start of the financial crisis. Should any other substantial contingency—such as a currency crisis and spiking interest rates and inflation—arise today, the nation will be even more vulnerable to the fiscal consequences and more inhibited in its response. This level of debt burden would have been unthinkable just a few years ago—and we and our fellow citizens should be concerned about its implications for the nation’s ability to respond to any emergencies going forward.
The United States did indeed have a higher debt burden after World War II—peaking at 106.1 percent of GDP at the end of fiscal year 1946. And the nation did grow out of that burden, steadily and rapidly. However, this should be no source of comfort today. The US economy after the war was uniquely poised for growth. The civilian labor force swelled with the returning troops. The civilian-industrial base multiplied itself with the conversion of military production facilities. Wartime technology was turned to increasing private-sector productivity for civilian goods. Much of the rest of the developed world was the devastated battlefield of the war, while the United States, unscathed, could produce and export goods for rebuilding those countries. And perhaps most important, the US household population had healthy, even buoyant balance sheets, because of years of full employment coupled with suppressed spending because of wartime shortages and rationing. The budget capitalized on all of this instant prosperity. Plus, the end of the war effort allowed immediate and substantial deficit reduction as defense spending fell from 36.6 percent of GDP in 1945, to 5.4 percent in 1947, and 3.5 percent in 1948. The result was an immediate drop in federal government spending, to complement the sharp increase in spending and the GDP from pent-up civilian demand.

The situation today is the diametric opposite. Workforce growth has slowed to a near standstill because of the aging of the baby boomer generation (whose oldest members, born in 1946, reached the earliest eligibility age (62) for actuarially reduced Social Security benefits in 2008). It is not the US industrial base that is mushrooming but, rather, the productive capacity of newly competitive nations in the industrializing and the developing worlds, while our higher wage levels and other costs have made it hard for US firms to compete. The US household sector has a balance sheet not flush, as it was after the war, but rather depleted from the burst housing bubble, while the stock market crash of the financial crisis forced many households, especially retirees, to dissipate their nest eggs. And defense spending is only 3.5 percent of GDP and thus cannot possibly provide the magnitude of savings than it did after World War II.

So even though many economists in 1946 did not recognize it, and despite the 106-percent debt-to-GDP ratio, the economy and the budget post-World War II were uniquely well situated. The US budget was on a course for decades of steady and sometimes rapid improvement. Today, in contrast, the budget faces enormous obstacles to progress, and forces of adverse demographics and the rapidly growing cost of health care push it toward continued worsening. The we-grew-out-of-it-before-and-we-can-grow-out-of-it-again slogan is Pollyannaish and naive. Today’s 75-percent debt burden is far too high, and far too risky. It is already several long strides down the slippery slope toward a debt and deficit explosion.

The short-term environment today may be beset by the same kind of threatening imbalance between good (past) and likely bad (future) news. The economy (taken as a whole) has benefitted from a significant drop in the price of oil; that cannot be repeated, but it could be partially reversed. The economic and financial troubles elsewhere in the world have driven capital here and held our interest rates down; that push is probably more likely to fade out than to amplify further. The global geopolitical situation, though far from tranquil, has not caused any major economic disruptions in the last few years; if that changes, it is more likely to be because of some conflict than an outbreak of peace. In short, though there is no certainty, an adverse shock on the budget could not be ruled out, while any favorable news is more likely already in the bank, so to speak.

This is not to belittle the importance of economic growth in ultimately working our way out of our budget problem. Sustained faster growth could contribute importantly, while continuing growth slower than now anticipated could make the problem virtually unmanageable.
But for all of the allegedly growth-increasing ideas that have actually been implemented with great fanfare at the federal government level over the past few decades, we still find ourselves on the cusp of an unprecedented debt crisis today. It would seem most imprudent to assume that replaying some of those same ideas would result in a different outcome going forward.

The nation surely should invest for future growth—through a more highly skilled workforce, better infrastructure, and reformed health care and tax systems. But we must not fall into the same trap as past political campaigns in assuming robust increases in growth from such initiatives, and then spending the full amount of the assumed budgetary bonus up front, even before the growth benefits materialize. Even a successful growth initiative, if fully dedicated to higher spending or tax cuts up front, would leave us on the same steep adverse budgetary slope where we perch precariously today. The cost of any proposed investments in future growth must be added to the savings needed to achieve national financial stability—not pursued instead of fiscal sustainability.

And consider the inherent risks in complacency about the budget with today’s already elevated debt burden. If our policymakers decide that they can live with a debt as large as 75 percent of our GDP, and therefore develop no plan to reduce that debt burden when the economy is growing and the news is good, then only one kind of news will be left to influence our debt situation—and that is bad news. The debt will quickly get out of hand, inevitably, when interest rates rise, other spending increases, or revenues fall—that is, as soon as anything goes wrong.
And what could go wrong for the sovereign government of the world’s greatest economy and greatest superpower? Sadly, recent history provides numerous examples.

**National security emergencies** The United States continues to face serious national security challenges. After the September 11 attacks when the United States went to war in the Middle East, a presidential adviser was fired for discussing hypothetically the consequences if the effort cost the federal government $200 billion. Many analysts today would estimate that the total cost of that commitment ultimately will reach multiple trillions of dollars.

Our point here is not either that the Mideast war was justified or that it was not. Nor is it to consider whether the relative consequences if the war had not been undertaken would have been worse, financially or otherwise. We raise this issue only because our nation could quite conceivably find itself faced with another substantial national security challenge, and that the financial cost when layered on to an arguably excessive debt could present our elected policymakers with an impossible choice between financial and geopolitical harm. This is why Ret. Adm. Mike Mullen, a former Chair of the Joint Chiefs of Staff, has identified the national debt as the greatest threat to our security. It is conceivable that a replay of an emergency of the magnitude of the Gulf War could raise such doubts about our ability and willingness to service our public debt as to cause serious instability in the financial markets.

We would note additionally that our excessive debt burden arguably calls into question the entire notion of our national sovereignty. A nation that is indebted—including to nations that are not geopolitically friendly—beyond historical standards certainly puts its international stature into serious question.

**Natural disasters** The United States has not incurred a natural disaster whose cost would compare with the Gulf War. However, our nation has faced serious weather events and earthquakes, for example, such that some members of Congress have argued that any national response would have to be offset by cuts in other spending because of the consequences otherwise for our budget. When delay in an emergency situation would threaten life and property, misgivings because of the fiscal implications would raise questions not only about our nation’s financial stability but also about our status as a true world leader.

**Domestic economic events** As explained at the outset of this statement, the recent financial crisis added trillions to the public debt over a matter of only three fiscal years, more than doubling its burden as a percentage of the GDP. If those events were to repeat themselves now, with no plan in place to undo the buildup of debt, it would take that debt burden to unprecedented levels—and in an economy that has shown limited signs of strength. The consequences are beyond contemplation.

Consider also that circumstances could arise under which the federal government would need to make financial commitments to resolve failing financial institutions to prevent their collapse from cascading into even more widespread failures. Financial markets can be more easily calmed when it is clear that a lender of last resort can make such commitments. If the financial markets were to question the ability of the federal government to act because its debt already was excessive and growing, it could encourage the eruption of panic. This is not a question of arguing over alleged bailouts of the unworthy; it is rather a concern over the federal government’s ability to provide liquidity to innocent institutions whose viability would be threatened by forces beyond their responsibility and control.
Serious financial fallout could result from a more straightforward economic downturn, one caused by a simple excess of inventories in particular sectors of the economy, such as the recessions in the post-World War II era prior to the financial crisis. Such a downturn today could easily add hundreds of billions of dollars to the debt. A painful scenario would be a recession that added to the debt at the same time as financial markets became skeptical about the nation’s ability and willingness to service that debt, such that interest rates would rise and would inhibit the borrowing and investment that would be needed to restore economic growth. The rapid rise of the debt caused by a deep recession could pose a “Catch-22” dilemma: it could demand fiscal stimulus to arrest the downturn, while at the same time frightening the lenders who would be called upon to finance the resulting budget deficits.

Global economic events The United States could find itself threatened by financial events in other countries, beyond this nation’s fiscal and regulatory control. In today’s world, US financial institutions are reliant upon other institutions in other nations to make good on their commitments. The federal government could be called upon to provide liquidity as a result of potential failures of institutions abroad that would have consequences for our economy as well as their own. Again, if the ability of the United States to provide such support were subject to question—because of an excessive buildup of public debt—it could make the eruption of a financial crisis more likely.

Infrastructure deficiencies It is a natural reflex for entities under financial stress to defer maintenance and investment. The United States has so behaved for many years. We would not endorse any single cost number for the US backlog of repair on its physical infrastructure, but we have no doubt that the number is very large. Likewise, the need for new construction to keep pace with a growing population and changing technological standards is surely substantial. And maintaining our competitive edge and the health of our population must require significant investments in human knowledge and skills.

As we noted earlier, economic growth is not a silver bullet, but it is a prerequisite for solving our deficit-and-debt problem. Accordingly, our nation needs to keep current on its economic-growth dues for infrastructure, human, and scientific investment—which we cannot do if our budget is being stripped bare by debt-service costs. Perhaps the worst of all possible worlds would be for the budget to be driven—such as by some nightmarish infrastructure failure—to panicked reductions that do more harm than good, especially to long-term growth. Cuts to infrastructure and to knowledge investment would be particularly sad entries on that list.

Political miscalculation The tragedy of World War I occurred because opposing monarchs called each others’ bluffs until they reached a standoff where pride did not allow anyone to back down. The United States has experienced similar political games of “chicken” with respect to its statutory debt limit, and also the annual appropriations to fund the various executive agencies. The greatest threat to our nation’s financial stability comes from a failure to increase the debt limit and thereby to allow the Treasury to borrow the cash it needs to fulfill its obligations. The appropriations standoffs have less direct impact on our financial standing, although they do detract from global public respect for the nation and thereby have an indirect impact. They also sometimes are scheduled to occur at the same time as a crisis over the debt limit and therefore complicate the debt-limit dispute.

In October and November of 2013, as the Treasury approached the date at which it had announced that it would run out of cash and borrowing authority to pay the federal government’s bills, there were identifiable impacts on the interest rates that investors would accept on the Treasury securities that would have been affected, costing the Treasury substantial sums in additional debt service (see Chart 7 on page 17). Partisans squabble over whether a cash-short Treasury could “prioritize” and avoid falling behind on interest payments or redemption of maturing securities while delaying the payment of other obligations.
However, a Treasury that was picking coins out of the figurative sofa to avoid a formal default could easily arouse a reaction in the financial markets to the full adverse effect of a default by the strictest definition. The markets rely on Treasury securities as fully secure; any manipulation to skirt narrowly defined default could harm the nation’s financial status, even if it succeeded and certainly if it failed.

**Market sentiment** Financial markets run on psychology. Markets have been known to turn on the skimpiest of evidence or on no evidence at all. The Dow Jones Industrial Average on “Black Monday,” October 19, 1987, lost almost 23 percent of its value. Needless to say, nothing happened on the weekend preceding Black Monday that would have indicated that the US corporate sector was suddenly worth 23 percent less than it had been at the close of the trading day on the preceding Friday. But should serious questions be raised about the reliability of the United States of America as a debtor, that realization could easily have such a magnitude of impact on markets and on the value of Treasury securities.

Again, it is by no means our intent to forecast or predict a panic in the financial markets. 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 the following pages we suggest some concrete policy steps to do so.
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.

In our most recent detailed research on the key budget issues, CED contributed actively in 2010 as the Bipartisan Policy Center (BPC) convened a Debt Reduction Task Force (DRTF) of 19 former elected officials and experienced citizens with diverse backgrounds and from across the political spectrum. CED participated in the deliberations and provided ideas from our previous policy statements and recommendations. CED’s Fiscal Health Subcommittee considered, and endorsed, the DRTF recommendations—the “Domenici-Rivlin Plan,” named after the Task Force cochairs, former Senator and Budget Committee chair Pete V. Domenici (R-NM), and former OMB and CBO Director (and CED Member) Alice M. Rivlin.

The DRTF reached three fundamental conclusions, which were in line with those of CED:

1. The US federal government cannot sustain the present debt trajectory, which poses grave dangers to the American economy;

2. Policymakers must make difficult decisions to get our fiscal house in order;

3. Any realistic solution must include structural reforms to entitlements and fundamental tax reform that raises significant new revenue.

Those bipartisan proposals increased awareness of the nation’s severe fiscal problems.

Later, Congress passed components of these plans into law—most notably, the caps on annually appropriated spending contained in the Budget Control Act of 2011. But the 2011 law failed to achieve the full measure of savings needed in other components of the budget, and the DRTF, again with CED participation and input, updated its proposals.

Here, we update and summarize the combined CED and DRTF recommendations. These recommendations remain timely—sadly, because so little serious reform has been undertaken since.

**Four categories for recommended reform**

The federal budget problem is so large that any true solution will have to touch virtually every line on both sides of the ledger. However, the major drivers of the problem can be subdivided into four parts, enumerated below. More comprehensive discussions of these issues follow.

1. **Restrain defense and nondefense discretionary spending**

   Of the original recommendations from CED and the Debt Reduction Task Force, those regarding the federal government’s annual agency appropriations represent the one area that Congress and the president have fully addressed. 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 that recommended by the Domenici-Rivlin plan.

   Sequestration, which was intended as an unthinkable motivator to drive the “Supercommittee” (which subsequently failed), was scheduled to go into effect in January 2013 to slash discretionary spending far below the levels recommended by the DRTF. 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. 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 route to 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, and instead allows the market to allocate resources through lower tax rates that sharpen 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, 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.

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

Social Security reform should not be approached from the vantage point of deficit reduction but rather with the goal of securing and strengthening 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.

Spending cuts and reforms

Given the magnitude of our budget problem, the only realistic way to close the gap between how much the federal government spends and how much it collects is to reduce outlays in a broad range of spending programs and to increase revenues. On the spending side, in addition to structural reforms to the major health entitlement programs, this requires sensible adjustments to nearly all discretionary and mandatory spending programs.
Domestic Discretionary The Budget Control Act of 2011 (BCA) already imposed 10 years of caps on the annually appropriated domestic category of spending—reductions that are roughly consistent with the restraint recommended by our original Domenici-Rivlin Task Force plan. We do not feel that the further sequester cuts would be prudent; Congress and the president should implement the existing caps, but not the additional sequester cuts. Additional efficiencies in some individual programs can always be found, but additional priorities and contingencies—such as infrastructure and research—will present themselves as well. In sum, we do not believe that it would be prudent to count on the annual appropriations to provide significant additional savings for deficit reduction.

Policy instead should be directed toward careful program oversight—which has been lost in recent years as spending has been legislated by tardy omnibus continuing resolutions, rather than by complete individual appropriations bills. A sound appropriations process will direct the reduced domestic discretionary aggregates more toward the economic growth prerequisites of investment in human capital, physical infrastructure, and research. These functions are easy to belittle or ignore, but they are the essential foundation for economic growth.

Defense Similarly, the BCA also established 10 years of caps on defense spending similar to the DRTF proposal. Experts from across the political spectrum believe that the procurement, retirement, and health care components of the US defense budget require major reforms. We agree on the need for these changes and believe that they can produce some additional savings from the Department of Defense. We do not believe, however, that they will provide major additional deficit reduction in the near term.

Health Care Most (if not all) of the nation’s long-term fiscal imbalance is the result of unsustainable growth in health care costs. Demographic forces far beyond our control will drive spending higher under the best of circumstances.

The federal government already plays a significant role in the workings of 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.

The centerpiece of CED’s Medicare reform proposals is to establish competition on the basis of quality and price among traditional Medicare and all Medicare Advantage plans. Public and private plans will compete in a way such that the cost and quality of all plans will be presented clearly to beneficiaries.

The federal contribution to each beneficiary will be based on the cost of the second-least-expensive plan or traditional Medicare, whichever is less expensive, and the growth of the per-beneficiary federal support will be restrained by competition. The competition among plans would be introduced as part of a reform of Medicare Advantage.16

Introducing a single-purpose refundable tax credit will encourage efficiency in the private sector, as we describe elsewhere, so that individual households can choose the health care plan that best meets their needs.17

The DRTF also proposed a variety of additional reforms to traditional Medicare to encourage greater efficiency, quality, and consumer protections. These reforms would modernize the benefit structure to have uniform cost sharing and, for the first time, implement an out-of-pocket maximum to protect beneficiaries from catastrophic costs. It would end first-dollar supplemental coverage, increase Part B premiums over five years from 25 percent to 35 percent of total program costs, and use Medicare’s buying power to reduce the program’s drug costs. It would bundle Medicare payments for post-acute care to encourage care coordination and reward efficiency.
Other proposals improve parts of the health system where costs are particularly high. To address public health and the rising costs of obesity, the DRTF would establish a 2-cent-per-ounce excise tax on sugary beverages. It would cap medical liability awards for noneconomic damages and launch large-scale tests, including safe harbors for following professional guidelines and administrative claims processing systems. It would accelerate savings in the Medicare home health program and reduce special Medicare payments that cover bad debts, graduate medical education, and rural hospitals, all of which will benefit from expanded coverage from the Affordable Care Act and CED’s reforms to it. The DRTF would increase TRICARE premiums and drug copayments. It would limit Medicaid reimbursement for durable medical equipment to Medicare rates. Finally, it would crack down on “pay for delay” agreements that restrict access to generic drugs and shorten the exclusivity period for brand name biologics.

Other Mandatory Spending Many other programs run on autopilot, with no recurring oversight by Congress. The DRTF proposed reforms to constrain the growth of these programs and improve their effectiveness:

- Implement a package of farm program reforms;
- Adjust the age at which career military can retire to be consistent with federal civilian retirement;
- Reform civilian retirement by calculating benefits based on a retiree’s annual salary from his or her highest five years of government service, and increase employee contributions to the defined retirement benefit to be more consistent with the private sector;
- Raise fees for aviation security;
- Adopt a more accurate inflation measurement (the so-called “chained CPI”) to calculate cost-of-living-adjustments (COLAs) for all federal programs;
- Cease production of dollar bills and the one-cent piece, while increasing production of dollar coins;
- Index mandatory user fees to inflation;
- Restructure the power marketing administrations to charge market rates, and sell nonhydropower Tennessee Valley Authority electric utility assets to private investors;
- Reform the Postal Service; and
- Sell unneeded federal property.

Social Security The DRTF’s balanced package of policies achieves sustainable solvency; that is, it would leave the program with an adequate reserve balance at the end of the customary 75-year projection period. (Previous efforts, including the 1983 emergency reform law, have created a temporary 75-year actuarial balance that would erode well before that period ended.) Even more importantly, it preserves and strengthens the program for future generations. It increases currently inadequate benefits for workers with career-long low wages or interrupted work histories, and maintains retirement options for those with careers of potentially debilitating physical work. Changes include:

- Gradually raise payroll taxes to cover 90 percent of all wages, and maintain that coverage permanently;
- Use a more accurate calculation of annual COLAs (the “chained CPI,” which would apply to all indexed programs, including the tax code);
- Implement modest additional means testing for high-income beneficiaries;
- Increase the minimum benefit, to protect workers with low wages or interrupted careers;
- Index the benefit formula for increases in life expectancy; and
- Cover all newly hired state and local workers under Social Security.
Tax reform and revenue increases
In 2005, CED released a major policy statement on tax reform—which remains highly pertinent today. The Domenici-Rivlin task force largely followed the CED recommendations, while adding important features to the package. We believe that this proposal was one of the DRTF’s most important contributions to the budget debate and could be an essential and effective element of a comprehensive long-term fiscal stability program.

As fully developed, the DRTF Tax Reform Plan radically simplifies the current tax code and raises additional revenue to supplement the spending reductions specified above. To best explain it, forget what you know about the complex current tax system, and start fresh. Outlined below are the core elements of the plan.

- A two-bracket income tax with rates of 15 percent and 28 percent. Because there is no standard deduction or personal exemption, the 15-percent rate applies to the first dollar of income.\(^{18}\)

- The corporate tax rate would be a flat 28 percent, instead of the current 35 percent top rate.

- Capital gains and dividends would be taxed as ordinary income (with a top rate of 28 percent), excluding the first $1,000 of realized net capital gains (or losses).\(^{19}\)

- To replace the overly complex Earned Income Tax Credit (EITC) and the personal exemptions, the standard deduction and the child credit, the BPC Plan would:
  - Establish a flat refundable per child tax credit of $1,600 (higher than current law);
  - Retain the child and dependent care credit; and
  - Establish a refundable earnings credit\(^{20}\) similar in structure to the recent Making Work Pay credit, but substantially larger. In a key innovation, the earnings credit would not need to be phased out as income rises (through its coordination with other major features of the overall income tax reform proposal). A major weakness of the current EITC is that as it phases out with rising earnings, causing a substantial increase in the marginal tax rates that apply to low-income working families, which in turn causes both disincentives and confusion.

- Instead of the current system of itemized deductions, which disproportionately subsidizes the housing and charitable giving of upper-income taxpayers, the BPC Plan would:
  - Provide a flat 15-percent refundable tax credit for charitable contributions and for up to $25,000 per year (not indexed) 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 bracket) for contributions to retirement savings accounts up to 20 percent of earnings or a maximum of $20,000.

- 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. Enactment of CED’s health care reform program\(^{21}\) would allow immediate elimination of the exclusion.

- 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 the gas tax by 15 cents and index it to inflation, dedicating the revenue to the highway trust fund.

• Increase taxes on tobacco and alcohol.

The DRTF Tax Reform Plan enormously simplifies the tax code by aligning the top individual, capital gains and dividend tax rates with the significantly reduced corporate tax rate, while eliminating the Alternative Minimum Tax. Additionally, most individuals would no longer have to file an annual tax return beyond an initial declaration of status because the most commonly taken deductions are either converted into refundable credits, determined solely based on the number of children and earnings, or can be deducted only above a substantial floor. Despite a low top rate of 28 percent, the DRTF tax system would increase progressivity through the rate schedule and the tax credits, and would raise the requisite revenue to achieve our debt-reduction goal.

Value-Added Tax 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. We further believed that in coordination with the elimination of many preferential provisions of the tax law, income tax rates and tax credits for low- and moderate-wage workers could be designed to maintain progressivity and fairness with the VAT. Although we heard concerns that an additional tax (perhaps especially a value-added tax) would encourage unwarranted increases of government spending, we provided our own recommendations to reduce spending and to keep it under control. Any policy compromise—involving either spending or tax policy—could be altered at some later date. To reject a budget deal today out of fear of some future change is to accept the status quo—which assures eventual disaster. We must find our way to principled compromise in which both sides contribute for the common good.

The initial Domenici-Rivlin report concurred with CED’s proposal and included an equivalent of a VAT (which was called a “deficit-reduction sales tax”). The later revised version of the DRTF recommendations modified the income tax proposal to allow dropping the VAT.

Today we believe that a VAT combined with fundamental income tax reform, including lower tax rates, would attain both better economic efficiency and a simpler tax system. We do not favor the mere addition of a VAT on top of the current deficient income tax system 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.
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 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, coupled with the Domenici-Rivlin Debt-Reduction Task Force plan, 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.

The experience of CED Members and DRTF participants—business leaders, former elected officials, cabinet secretaries, senior congressional staff members, and senior executive branch officials (including staff from CED)—informs these recommendations, which also benefit from the work of the Congressional Budget Office and other experts. But 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.

To answer the questions that we asked at the outset, we believe that our nation’s debt problem has advanced to the stage where it can pose an existential threat—like a serious excess of weight that would render a near-term heart attack unsurprising. And while in the immediate wake of the financial crisis economists could credibly make an argument that a failed economic recovery was a more immediate and even compelling threat, the subsequent improvements in output and in the labor markets have mooted that concern. The patient is ready for a weight-control program, and a responsible physician will make that point forcefully.

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.
Endnotes


3 Budget of the United States Government, Fiscal Year 2017, Historical Tables, Table 7.1 (https://www.whitehouse.gov/omb/budget/Historical). The dollar amount of the debt at the end of fiscal year 1946 is known with precision. However, the amount of the GDP has been estimated from historical economic data, and is revised periodically; hence this historical number changes over time.


5 This comparison may have been drawn first by Nariman Behravesh of IHS.


8 See Tackling Economic Inequality, Boosting Opportunity: A Blueprint for Business, Committee for Economic Development.

9 For a more-detailed discussion of what could befall our debt-laden government and economy, see This Way Down To a Debt Crisis, Committee for Economic Development (https://www.ced.org/reports/single/this-way-down-to-a-debt-crisis).


13 Compounding financial market concern about our excessive debt level in the near and medium term could well be the already elevated size of the Federal Reserve’s balance sheet.


16 Quality, Affordable Health Care for the Nation’s Elderly, Committee for Economic Development.

17 Adjusting the Prescription, Committee for Economic Development.

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

19 $500 for singles and heads of household.

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

21 Adjusting the Prescription, Committee for Economic Development.

22 According to Tax Policy Center projections, only 50 percent of tax units would be required to file tax returns, as opposed to 88 percent under the current tax system.
The Federal Budget Deficit and the Public Debt
Why and How to Deal with a Lurking Problem
Report

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