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Dealing with the Deficit

Crushing debt load threatens nation's future

By Maya MacGuineas

With structural budget deficits stretching indefinitely into the future, the mounting national debt and few meaningful budget rules left in place, the chances of the deficit disappearing on its own are about as likely as finding a quick fix for health care. It is no wonder fiscal conservatives are in such a state of despair. Despite numerous warnings from the Congressional Budget Office, the Government Accountability Office, the Federal Reserve and the International Monetary Fund, the past four years have seen a solid deterioration in the nation's fiscal state of affairs. If nothing is done, it may well be financial markets that force action upon us. This is a far inferior alternative to the types of bipartisan budget deals that have led us out of budget messes in the past.

Last year's budget deficit was $412 billion. The Congressional Budget Office projects we will borrow another $1.6 trillion over the rest of the decade. That's before any money is set aside for further operations in Iraq and Afghanistan, reforming Social Security, fixing the Alternative Minimum Tax, or extending any of the expiring tax cuts. Even this far from rosy scenario depends on our borrowing all the surpluses from the Social Security system, and using that additional $1.3 trillion of intra-governmental borrowing to mask the true size of the deficits.

Meanwhile, the nation's largest entitlement programs are clearly on an unsustainable track. The first Baby Boomer will retire in three short years, and quickly, we will transition from a nation where the largest generation is in the midst of its most productive years, to one where the Boomers are on the receiving end of our national entitlement programs—greatly increasing their costs. Though Social Security reform is on the national agenda, Congress has been more focused on debating whether the system faces a crisis than discussing how to actually fix it. The program is over-promised to the tune of $11 trillion. Congress has known about the problem for years, and every year we wait to make changes, the harder the problem becomes. Given that Social Security is by far the easiest of the under-funded entitlement programs to fix, this does not bode well for a fruitful discussion on Medicare.

If changes are not made to the nation's largest entitlements, we are left with two choices: squeeze out virtually all other areas of the budget or allow the government to grow to an unprecedented peacetime size of 25 to 30 percent of GDP. Neither scenario is one we should be proud to pass along to the next generation.

Furthermore, as Gene Steuerle of the Urban Institute has pointed out, we are losing control of the budget as we pre-allocate more and more of the nation's resources. Just as we could not have predicted the major needs of today 50 years ago, it is difficult to anticipate what those needs will be 50 years from now. Yet because of our intergenerational, consumption-oriented, pay-as-you-go entitlement programs, it will be far harder to meet new needs since so much of the budget has already been promised away.

Finally, while seniors are by far the strongest voting block, it is hard to make the case that our current resource allocation of $8 per senior for every $1 on children makes sense. And that ratio will be changing to further favor seniors just at the time when due to the new hyper-competitive global environment we should be investing far more in the next generation of workers.

Turning a Blind Eye

The political class has not yet woken up to the seriousness of these tremendous challenges. Perhaps we are a victim of our past successes. Politicians may hope for a replay of the 1990s, when strong economic growth and a booming stock market helped pull the U.S. budget out of what looked to be a permanent deficit spiral. But many levers were used to generate those budget surpluses: multiple rounds of tax increases, considerable spending constraint, the emergence of the peace dividend, and budget rules that would have prohibited enactment of the tax cut and prescription drug legislation that we have seen in recent years. Moreover, sitting on the precipice of such a large demographic shift, the bar for success is now much higher than it was a decade ago.

It is hopeful that the administration has acknowledged that deficits do matter and, accordingly, has promised to cut the deficit in half before the end of the decade. However, the commitment is unconvincing given the number of executive branch priorities omitted from the President's budget.

Furthermore, the goal is insufficient even if it were realistic. At the bare minimum, sound fiscal policy would involve balancing the budget over the business cycle, running deficits during a downturn and surpluses during periods of economic strength, which is a far more aggressive target than the course the President has laid out. Secondly, the goal should not include the Social Security surpluses, which not long ago, members of both political parties were committed to saving. Finally, in preparation for the upcoming demographic shift, we should have been running large budget surpluses over the entirety of the past decade. Fiscal policy would then have involved a shift between smaller and larger surpluses depending on economic conditions, with the additional savings helping to prepare us for the Baby Boom's retirement. Instead, the budget that Congress just passed, while bold in its willingness to scale back some entitlement spending, actually enlarged the deficit beyond what it would have been if no budget had been passed!

A Financial Market Crisis?

The broader and more troubling question has become not when will Congress come up with a realistic budget deal, but instead, will it be a financial market meltdown that finally forces our hand? While the scenario may seem far-fetched—fiscally driven market crises occur in developing markets and regions, not the home of the global benchmark security—a spiraling chain of events is not out of the question. The United States is now highly dependent on lenders from abroad to finance our massive levels of borrowing. About half of outstanding Treasury bonds are owned by foreign lenders. Particularly troubling is that the composition of lenders has shifted away from private investors seeking out the highest returns, to foreign central banks attempting to prop up their currencies vis-à-vis the dollar. This leaves the United States in the odd situation of being the single strongest superpower and at the same time, the single largest debtor and thus, surprisingly dependent on other nations.

A mini wake-up call occurred when the South Korean central bank let it be known that they were considering shifting part of their reserves to currencies other than the U.S. dollar, leading to a temporary stomach-lurching decline in the dollar. It is easy to envision a more permanent scenario where concern over America's fiscal position would lead to a selling off of dollars, stocks and bonds, rising interest rates, the bursting of the housing market bubble, and a slowdown in not just our economy, but the world's economy.

While it is true that the Asian central banks have a strong interest in not letting the dollar drop to avoid taking a big loss on their existing holdings, it is little comfort that this co-dependent relationship could ultimately produce two sets of losers. Japan, India and Russia have all recently made rumblings about diversifying their reserve currencies, and when they speak, U.S. Treasury officials must now listen.

Another unsettling scenario is that private rating agencies, such as Moody's and Standard & Poor's, downgrade the United States' debt based on our high levels of borrowing and unfunded liabilities, much as they did Canada's in the mid-1990s when their fiscal policies were deemed overly reckless. A downgrade would surely cause bondholders to dump their debt, leading to

an abrupt jump in interest rates and potentially setting off an unwelcome economic spiral.

No one knows if any of these scenarios will materialize. Certainly, no one knows when. Clearly, however, this is one of those times when we would rather not find out if the crisis predictions are accurate. Even if there is no financial crisis, or it is closer to a blip than a meltdown, ongoing budget deficits drain the economy of investment capital, lead to lower standards of living in the future and squeeze out other areas of the budget as interest payments mount. In short, deficits are a reflection of our spending more than we can afford and forcing our children to pay the bill.

The best scenario to stave off any potential crises and the right one in terms of generational responsibility is to take preemptive action rather than waiting until action is forced upon us. The gap between revenues and spending is large enough that a few tweaks here and there will not come close to doing the trick: a real budget deal is called for.

A Grand Fiscal Bargain

Any effective deal will have to be bipartisan to give both parties political cover on the tough choices that will inevitably be involved. Moreover, a bipartisan and balanced compromise has a far better chance of sticking, even if power in the House, Senate or White House changes hands. In order to reassure forward-looking financial markets, the deal will have to address both the short and long-term challenges.

While it is hard to picture what sort of deal could come out of this highly polarized and partisan environment, the numbers paint a pretty compelling picture of where to begin. Federal revenues have ranged from about 17.5 percent to 21 percent of GDP over the past few decades. Today they stand at a 46-year low of 16.3 percent. Meanwhile, federal spending has been in the range of 18.4 percent to 22.9 percent over the past 20 years. On its current path, spending is expected to grow to between 25 and 30 percent. Even for those who don't worry about the inefficiencies caused by taxation at current levels, such exorbitant growth is cause for concern.

One possibility would be a grand fiscal bargain: Raise taxes in the short-run and rein in entitlement spending in the long-run so that both are more in line with historical norms. Such a balanced approach has a far better chance of success than any of the alternatives. Neither party will particularly relish the plan because both will have to give something up. But real budget deals are never easy.

First, let's take taxes. Initially, there was concern that surpluses would grow so large they would consume all the outstanding debt, prompting calls for tax cuts. Then, as the economy stalled, the case for fiscal stimulus made sense. (Though using both arguments to justify the same tax package was a bit of a stretch.)

The subsequent rounds of tax cuts, however, from a fiscal perspective were inexcusable. With the looming costs of the Baby Boom around the corner, we should have been using the government's excess funds to pre-fund the major retirement and health care programs. Moreover, once the budget surpluses vanished, the tax cuts merely exploded the deficit further. Republicans had their chance to reduce the size of government, but chose not to. Accordingly, neither the argument that the tax cuts were part of a plan to scale back government or increase economic efficiency holds. Either the President's tax cuts could be repealed, or a new revenue stream—such as a progressive consumption tax or environmental and energy taxes—could be added. But given the current budget picture, taxes will have to go up.

Meanwhile, Democrats must give up on the notion that entitlement programs cannot be changed, updated, or cut. We have greatly over-promised this area of the budget and have no plan for how to pay for all these promises. What did we do with Medicare, the most challenging of the problems? We expanded it by adding the prescription drug plan with virtually no regard for the tremendous long-term costs.

Entitlement programs will have to be reduced. The most sensible way to do so is to progressively scale back benefits for those who do not need them. The President's plan to reduce promised Social Security benefits for wealthier retirees, for instance, while protecting those who depend on the program, makes an awful lot of sense. Same goes for means-testing health care benefits, through reduced benefits or higher premiums for the well-off elderly. The other option of course is to employ across-the-board benefit reductions, which would do great damage to the recipients who truly depend on these programs. But surprisingly it is Democrats who tend to object to redesigning these programs in a way that would make them more progressive, fearing that it would undermine their political support. The argument that we should dole out generous middle-class benefits in order to buy political support, particularly when the cost falls squarely on the backs of workers, many of whom are less well-off, is not only excessively inefficient and costly: it is not in keeping with what progressives should stand for.

Both parties have put politics in front of principles, and this will have to change. In order to directly confront the country's major fiscal challenges, both the eras of big government conservatism and anti-progressive progressivism will have to come to an end. If we are not willing to enter into some kind of a grand fiscal bargain where everything is on the table, and both parties are willing to give up something, more than likely, financial markets will end up forcing our hand.

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