Center for American Progress

FLICKR.COM/WALLYG

Deal with It

A Guide to the Federal Deficit and Debt

Michael Ettlinger and Michael Linden September 2009

Center for American Progress

Deal with It

A Guide to the Federal Deficit and Debt

Michael Ettlinger and Michael Linden September 2009

Contents

Introduction and summary

A great deal is being made of the historically large budget deficits currently being run by the federal government. The real problem, however, is not the deficits we're seeing now or next year. Those deficits, though very large, are both inevitable and highly appropriate at a time when the economy is weak and strong government action has been necessary to turn things around. The real challenge is what we face after the recession: significant sustained deficits which, while not quite as eye catching, are equally historic, harder to solve, and pose a greater danger.[1]

There is little dispute that deficits do harm if they are large enough and sustained long enough. High levels of government borrowing can reduce domestic investment, lower future incomes, raise interest rates, and spur inflation. These can damage the economy and hurt people who see their wages fail to keep up with rising costs or find the price of borrowing to purchase a home prohibitively expensive. The threat of sustained deficits could lead to strong reactions by economic actors—investors, workers, consumers, and trading partners—who move to protect themselves from these risks. Such reactions can be damaging in themselves, raising, among other fears, the specter of another financial crisis. And it is politically more difficult to enact needed public initiatives with large deficits and debt looming over the budget process.

The high government debt levels that result from sustained deficits can also leave a nation unable to go further into debt in a time of crisis. High debt levels also mean high interest payments on that debt in the future, reducing government's capacity to make important public investments and provide needed services.

Both the Congressional Budget Office and the Office of Management and Budget project high deficits through 2019, the latest year for which they offer official estimates. It can be debated whether these projections are likely to come true and whether the predicted levels are high enough to cause great harm—but the weight of opinion is currently that the deficit predictions are more likely optimistic than pessimistic. What isn't seriously debated is the fact that we have a long-term structural problem of the cost of government programs outstripping revenues, and that it is a problem we will have to address sooner or later.

There is good reason to set in place measures that will address the projected long-term deficits once the recession is over. But addressing those deficits is not without risks—badly done, the cure could prove to be worse than the disease. There are areas of public expenditures that, if cut excessively, would damage our economy, endanger the public, break important obligations, or wrongly put holes in an already porous social safety net. Poorly designed tax increases could also impinge on economic growth and harm taxpayers.

Just 10 years ago such challenges were not a primary worry. The nation ran a budget surplus in 1998, starting a stretch of surpluses that lasted through 2001. The nation's fiscal house was in order. How then, have we gone from a surplus of 0.8 percent of gross domestic product in 1998 to a situation where CBO is projecting significant deficits for the next 10 years—culminating in a 5.5 percent of GDP mark in 2019?[2]

That 6.3 percent of GDP swing is driven both by decreases in revenues and increases in spending. On the revenue side, the federal government is projected to collect less in personal income taxes, corporate income taxes, and payroll taxes as a share of GDP in 2019 than it did in 1998. As for spending, health care categories are by far the most significant drivers. Interest payments on debt, and Social Security and defense spending will also be higher as a share of GDP by 2019 than they were in 1998. These challenges have long been foreseen—health costs, demographics, accumulating debt in the 2000s, and engaging in two wars while cutting taxes have been a recipe for large sustained deficits. Failure to address these issues in the past while camouflaging them in official budget estimates has dumped the problem in the laps of current policymakers.

Bringing the deficits down to manageable levels is not simple, to say the least. There will be loud voices shouting that the budget can be brought into balance through spending cuts alone—but they are wrong. If we set on a path of spending reductions to bring about a balanced budget in 2014, across-the-board spending in that year would have to be 18 percent lower than currently projected. Even bringing the deficit down to 2 percent of GDP would require slashing all spending by 10 percent.

Across-the-board spending cuts are not likely. Some areas will be spared, which means that cuts in other areas would have to be deeper. The country is not, for example, going to default on its debt payment obligations. If debt service obligations are off the table, everything else has to be cut by 21 percent to achieve balance in 2014, or by 11 percent to get the deficit to 2 percent of GDP in that year. Social Security cuts are also unlikely to be an important part of the mix—existing proposals for Social Security savings do little in the next 10 years as they focus on reducing the rate of growth in benefits, not cutting current beneficiaries. Taking Social Security off the table in addition to debt service would mean the rest of the budget has to be cut by 27 percent to achieve balance, or by 14 percent to knock the deficit down to 2 percent of GDP in that year.

Health care reform would result in substantial Medicare cost reductions, but most of those savings will occur beyond the next 10 years, and some of them are already accounted for in the president's budget plan. Major additional savings in Medicare are therefore unlikely by 2014. If we take Medicare out of the picture along with debt service and Social Security, the rest of the government has to be cut by 35 percent to achieve a balanced budget, or by 18 percent to get the deficit down to 2 percent of GDP.

If we pull defense spending out of the picture—and defense spending certainly isn't likely to be cut by anywhere near 35 percent, or even 18 percent—the rest of the budget needs to be cut by 51 percent to have a balanced budget in 2014, or by 27 percent to get to 2 percent of GDP. The rest of the budget would be devastated, including cuts to health clinics, benefits for federal retirees and veterans, schools, highways, food safety, air traffic control, and much more. Simply put, substantially greater fiscal balance is not going to be accomplished through spending cuts alone.

The possibilities for balancing the budget by only raising more revenue are similarly remote. The federal government would have to collect an additional 22 percent in revenue in order to bring government receipts up to the levels needed to balance the budget in 2014. That means a 22 percent hike in everyone's income tax, gasoline tax, payroll taxes, and other federal charges. Getting the 2014 deficit to 2 percent of GDP would take a 12 percent tax increase across-the-board. If we limit a budget balancing tax increase to corporations and those with incomes over $250,000 per-year, their taxes would have to increase by about 70 percent.

Finding the answer to this problem is not going to be easy. There are too many immovable objects—too many spending areas that can't be cut, too many taxes that can't be raised. And yet these deficits are too large to be tolerated. Something has got to give. And the longer we wait, the harder it gets, as the cost of debt service gets greater and deficits grow.

We need to ask serious questions. Can the United States afford to continue to spend so much more of its national income than the rest of the world on defense? Are we going to pass health care reform that realizes budget savings? Can taxes, beyond what the president has already proposed, be part of the picture? Social Security, agricultural subsidies, social programs, education spending, and everything government does is going to be examined—with everyone having areas they carve out as sacrosanct and areas they don't. It is important that the balance is right so that the solution is not worse than the problem. The sooner we recognize that the set of hard lines that have been drawn make an answer impossible, and some of those lines need to be erased or moved, the sooner we will be on the road to getting to a solution. Pretending the problem doesn't exist, and that it isn't big and difficult, won't get us there.

The good news is that the United States is in a position to solve this problem. Unlike many other countries, the challenge isn't that we can't afford the public programs we choose to have. The challenge is coming to an agreement on what those programs are and how we pay for them. A very big challenge, no doubt. But not an insurmountable one.

The latest estimates and the risk of inaction

Figure 1a: Deficits as a percent of GDP under President Obama's budget, as projected by CBO, June 2009

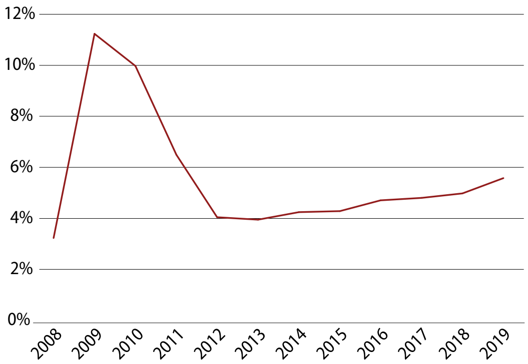
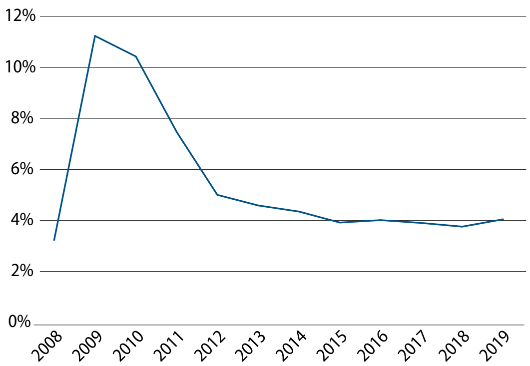


Figure 1b: Deficits as a percent of GDP under President Obama's budget, as projected by OMB, August 2009



Sources: Congressional Budget Office, June 2009, Office of Management and Budget, August 2009

The Congressional Budget Office's June estimates for President Barack Obama's budget plan (its latest) show federal deficits hitting 11.2 percent of gross domestic product in 2009,[3] dropping to 3.9 percent by 2013 as the economic crisis abates, and then rising to 5.5 percent of GDP by 2019. The Office of Management and Budget, the president's budget arm, projected in August that the deficit will gradually drop from its 11.2 percent 2009 peak to 3.9 percent of GDP by 2015 when it stabilizes—ending up at 4.0 percent of GDP in 2019.[4]

The period from 2009 through 2019—by either agency's reckoning—will be the longest streak of consecutive years with deficits exceeding 3 percent of GDP in the nation's modern history. And if Congress does not follow the president's budget plan and instead extends current policies without changes, the long-run deficits will be even larger—as the president's proposed budget cuts and tax increases would not go into effect.[5] The only analog to this period is the 1980s where large sustained deficits aroused great concern and elicited strong ameliorative reaction over the decade that followed.

Large deficits breed high national debt. CBO projects that the rise in federal debt that began in 2001 with the end of the Clinton-era surpluses will accelerate over the next 10 years.[6] It expects publicly held debt to rise from 41 percent of GDP in 2008 to 54 percent of GDP in 2009 and then to 82 percent of GDP in 2019. OMB projects the debt in 2019 to be 77 percent of GDP (See figure 2 on page 5). Both of these estimates place the debt in 2019 at levels that haven't been seen since shortly after World War II when the war debt, which peaked at 109 percent of GDP in 1946, was being paid down.

The extreme short-term spike in deficits and sharp jump in the national debt in 2009 and 2010 reflect the huge decline in revenues due to the recession and the bump in government expenditures to jumpstart the economy and help us escape the downturn. The box on page 8 of this report parses the causes of these short-term deficits, but the greater danger comes from sustained deficits beyond the next few years.

Glossary

Deficit and surplus: A deficit occurs when government spending (or "outlays") exceeds government receipts (taxes, fees, etc.) in a given fiscal year. The opposite of a deficit is a surplus—when receipts exceed spending. When the federal government runs a deficit it borrows money, generally by selling Treasury securities, to make up the difference between receipts and spending. These borrowed sums must be paid back with interest.

Publicly held debt: The federal debt is essentially the net sum of all previous deficits and surpluses (although, as is true of most things having to do with the federal budget, it's a bit more complicated than that). "Publicly held" debt does not include money that the government borrows from itself—from the Social Security trust fund, for example.

Gross domestic product: GDP is a measure of total economic output. Deficits and debt are often measured as percentages of GDP rather than as raw dollar numbers. Reporting deficits and debt as percentages of GDP places their size in the context of the wider economy and gives a better sense of scale. In the end, government spending goes into the economy, taxes come out of the economy, and national debt must be paid from the fruits of the economy. Reporting these quantities as a share of the economy gives a better sense of the effect that spending and taxes have on the economy and what level of debt is affordable. It also inherently accounts for changes in the economy and allows for easier comparisons across time.

Figure 2a: Publicly held debt, as a percent of GDP, as projected by CBO

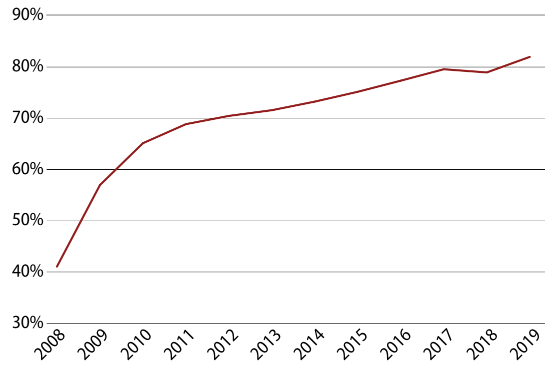
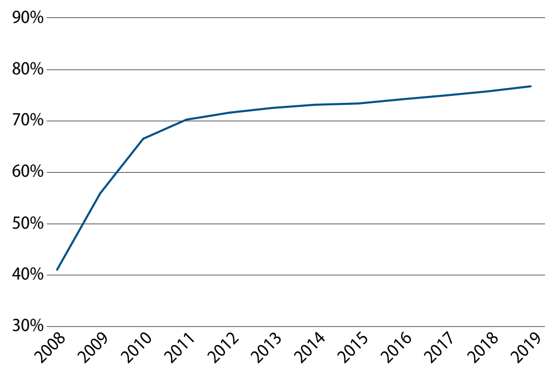


Figure 2b: Publicly held debt, as a percent of GDP, as projected by OMB



Sources: Congressional Budget Office, June 2009, Office of Management and Budget, August 2009

The risks of deficits

There are significant risks to running large sustained deficits. They can reduce national savings, which can adversely affect domestic investment and require borrowing from foreign investors, handing over to them a portion of our future income.[7] Higher interest rates, inflation, and exchange rates are all problems potentially associated with high deficits and debt. These can have economy-wide effects and can create very concrete problems for people who see their wages fail to keep up with expenses, or who find the cost of borrowing to purchase a home slip out of reach—it has been estimated that interest rates are higher by 30 to 60 basis points for every percent of GDP of deficit.[8]

Where did the large 2009 and 2010 budget deficits come from?

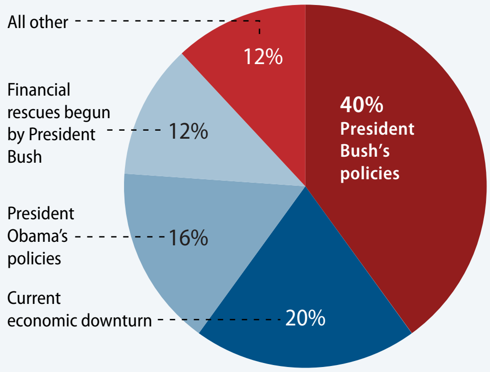
The single most important factor contributing to this year's record deficit is legislation passed during the administration of President George W. Bush. Changes in federal law during that period are responsible for 40 percent of the short-term fiscal problem.

Our analysis in "Who's to Blame for the Deficit Numbers?" estimates that the current deficit would be 4.7 percent of GDP this year, instead of 11.2 percent, if it were not for the Bush tax cut and spending policies—despite the weak economy and the costly efforts taken to restore it. The deficit in 2010, as projected by CBO, would be 3.2 percent instead of 9.6 percent.

The recession that began in 2007 also plays a major and direct role in the deficit picture. It is responsible for 20 percent of the fiscal problems we face in 2009 and 2010. The government response to the weak economy has also contributed to the short-term deficits. The cumulative cost of the financial sector rescue, mostly committed to in 2008, contributes another 12 percent of the problem.

President Obama's policies have also contributed to the federal deficit, accounting for 16 percent of the projected budget deterioration for 2009 and 2010. The 2009 American Recovery and Reinvestment Act, designed to help bring the economy out of the recession, is by far, the largest single additional public spending under this administration.

Figure 3: Contribution to fiscal deterioration 2009 and 2010



Source: Michael Ettlinger and Michael Linden, "Who's to Blame for the Deficit Numbers" (Washington: Center for American Progress, 2009).

There is also the risk that just the prospect of large sustained deficits and high debt, with no plan to deal with them, will cause strong reactions as economic actors move to protect themselves from the real or imagined consequences.[9] The specter of a financial crisis is of particular concern if traders, investors, and creditors lose confidence that government will address the long-term deficit problem. This could lead to a host of challenges as inflation and exchange rate fears make borrowing more expensive for the Treasury, investors leery of U.S. markets, asset prices fall, and borrowing generally more difficult and costly. The exposure of the federal debt to higher interest rates has become even greater as the Treasury has moved to shorter term borrowing over the last two years.[10]

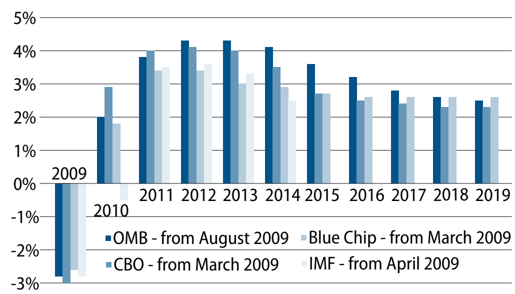
High deficits and large levels of debt also interfere with needed government initiatives. The nation's ability to handle a crisis can be limited by a large level of debt. If the nation had entered the current recession with a larger level of existing debt, it would have seriously constrained our ability to respond. Since economic growth is key to restoring fiscal health, a failure to respond to the crisis and get the economy growing again would have only exacerbated our fiscal problems. Debt service payments also divert government resources in future years from important program priorities. And looming deficits may erect political barriers that block important government activities. The current hue and cry about the fiscal impacts of the economic recovery legislation and health care reform bills are examples of how groups use the threat of sustained deficits in the future as a cudgel against needed government spending now.

Why worry about this now?

It is uncertain what level of deficits and debt, sustained over what period of time, would bring these consequences to fruition. This can be a matter of controversy. And CBO and OMB's projections are just that—projections. Estimates of deficits beyond a handful of years are notoriously unreliable. With all this uncertainty, it is fair to ask the question: "Why worry about this now?"

Long-term deficit projections do have a wide margin of error, but there is reason to believe that the risk that deficits will be worse than projected is greater than the hope that they will be better. These deficit estimates are very dependent on anticipated economic growth. The CBO estimates of the president's budget that we are relying on were made before CBO revised downward its economic projections. So, the 5.5 percent projection we present for 2019, for example, is actually more optimistic than what CBO would project if it were doing its estimate today. The OMB projections are, in general, based on economic projections that are more optimistic than most other analysts. Figure 4 compares the estimates for real GDP growth for 2009 through 2019 for OMB, CBO, the Blue Chip forecast, and through 2014 for the International Monetary Fund.[11] The CBO and OMB estimates over these periods are the most optimistic. The differences may appear small for many of the years, but compounded over the period, differences in the size of the economy grow to be quite substantial. (See Figure 4)

Figure 4: Real annual GDP growth rates, as projected by OMB, CBO, Blue Chip and IMF



Sources: Congressional Budget Office ,Office of Management and Budget and The International Monetary Fund

It is hard to fault CBO or OMB for being excessively optimistic. The CBO forecasts for 2015 and beyond are more pessimistic than any mid-range forecasts they've made since the mid-1990s—forecasts that proved to be overly pessimistic. But the weight of economic opinion right now suggest that it would be prudent to treat the CBO and OMB projections as a genuine cause for concern, not an unlikely worst-case scenario.

Whatever the next 10 years brings, there is little doubt that we do have a major structural problem in our budget—the cost of providing services is simply growing faster than the revenues that pay for them. In particular, without action, health care costs are likely to follow their 30-year pattern of continuous escalation. And there is no avoiding the budget ramifications of the growing number of elderly retirees. Even if the deficits prove to be smaller than anticipated in 2014, 2017, or 2019, the path we're on has long been known, and avoiding it will require action in the not-too-distant future. The Center on Budget and

Policy Priorities projects that if current policies are extended, the federal debt will be more than double GDP in the 2040s.[12] There's no ducking this challenge.

There is also no avoiding negative consequences from deficits. Although there is much uncertainty about the level that sustained deficits will have to reach before they start causing the various economic problems associated with them, the predicted levels of deficits are quite high. This makes the probability that we will see an adverse economic impact, potentially a very serious adverse economic impact, more likely. Given the ramifications of very significant economic problems, it would be unwise to risk them.

What's more, some adverse consequences of high sustained deficits are clear. CBO projects that interest payments on the debt will amount to 3.8 percent of GDP in 2019—or 15.5 percent of federal spending. This is a serious diversion of funds from spending that would better serve the nation. Furthermore, the debt level of 82 percent of GDP projected for 2019 would leave the country ill equipped to deal with a national crisis. A jump in debt equal to what we've needed to deal with the Great Recession would bring the debt level to over 100 percent of GDP if we started at 82 percent.

There is good reason to be proactive about addressing the threat of large sustained deficits. There is also, however, some risk in exercising fiscal prudence. There are ways to balance the budget where the cure is worse than the disease. It would be foolish to take action against deficits while still in a recession. It would hurt our country to balance the budget by slashing investments that are critical to economic growth, such as education and scientific research. It would be wrong to balance the budget on the backs of injured veterans, low-income people, or the elderly. It would be simply dangerous to balance the budget by compromising food safety or our national defense. And it would not make sense to balance the budget by raising taxes in ways that undermine the economy.

Yet assuming that the budget is balanced in a sensible way, the case for addressing the threat of large sustained deficits and high debt levels is strong, and there is no substantive reason not to once the economy is growing again. In the unlikely event that we take actions that prove to be more aggressive than necessary, the country will still be left financially stronger and better equipped to handle its longer-run fiscal challenges beyond 2019. On the other hand, if the actions prove to have been needed, we will have avoided a wide range of disruptions and hardship.

Where did these 10-year deficits come from?

Why does the 10-year budget picture suddenly look so bad?

First, and most obviously, is the recession. The recession has (a) caused a level change in the national debt and (b) dampened optimism about future economic growth. This has caused the official 10-year deficit and debt projections to be more pessimistic than in the past.

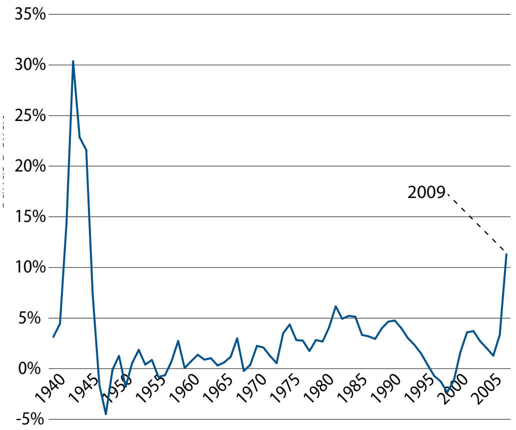
But the appearance of this grim 10-year picture is also a story of a well-documented problem finally being acknowledged. Many have warned of long-term structural deficit problems, but the challenges ahead have been kept out of most official estimates by the prior presidential administration and earlier Congresses.

This has been accomplished by taking advantage of the rules that govern the nonpartisan Congressional Budget Office's estimates. CBO is required by law to produce a yearly "baseline" projection that estimates what will happen to the federal budget under current law, even if it is widely accepted that current law will change. For example, under current law, the Alternative Minimum Tax will apply to millions of additional taxpayers next year because the legal "patch" that prevents the AMT from affecting more people, expires at the end of this year. It is nearly certain that Congress will patch the AMT again this year, or even permanently adjust it as President Obama has proposed, but CBO is required to include these billions of unlikely revenues that would be raised if the current AMT law were to remain unchanged. This makes the "baseline" deficit look lower than the deficit will actually be.

This requirement allowed the past administration to produce budgets that appear more fiscally balanced than they actually were, especially in the long run, by including "sunset" provisions in their proposals. President Bush's signature tax cuts, for example, are set to expire at the end of 2010, making it seem as if later years would have smaller deficits, despite the fact that the Bush administration and Congress were plainly in favor of making those tax cuts permanent and their complete repeal is unlikely. Other reports by CBO and others have given indications of the long-term problem—but not the official estimates.

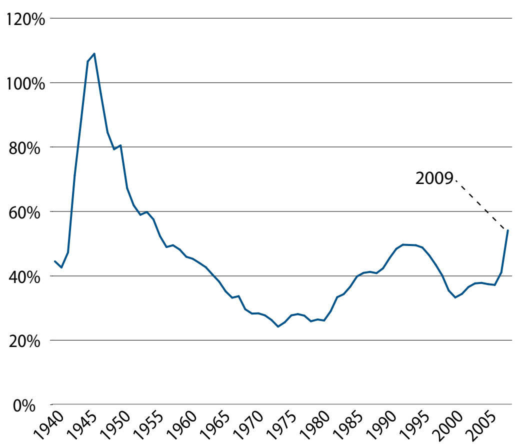
President Obama's budget does not include sunset provisions or other methods of obscuring the real, long-term budget situation. Looming budget deficits that were once hidden are therefore now in full view in CBO's estimates of the president's budget plan. New,

Figure 5: Total federal deficit or surplus, as a percent of GDP (1940-2009)



Source: Office of Management and Budget

Figure 6: Publicly held debt, as a percent of GDP (1940-2009)



Source: Office of Management and Budget

higher long-term deficit projections are certainly due in part to the weaker economic situation, but they also reflect a long-known truth stripped of its camouflage.

America's fiscal background: Deficits and debt in post-war America

Large federal deficits and high debt levels are not unprecedented. They have been necessary during times of national crisis. At other times they have been allowed to creep up. In every instance, however, action has been taken to address the fiscal imbalance.

The modern United States record deficit was set in 1943 at the height of World War II when it hit 30.3 percent of GDP. The federal government's total public debt had risen to 109 percent of GDP by the end of the war. That debt-to-GDP ratio began to fall as the federal government brought deficits down to more sustainable levels. The period through 1974 was marked by surpluses and modest deficits. Deficits only exceeded 2 percent of GDP on three occasions and never exceed 3 percent. Publicly held debt fell to less than 24 percent of GDP by 1975. That year, however, the federal budget deficit rose to 3.4 percent of GDP.

1975 marked the beginning of an era of higher deficits. The deficit remained above 2.5 percent of GDP for a 20-year stretch—with the lone exception of 1979.[13] The highest deficits in this period were from 1983 through 1986, when they ranged from 4.8 percent to 6.0 percent of GDP. These elevated deficits were due, in part, to the double-dip recession of the early 1980's. But they were mostly the result of substantial tax cuts and increases in military spending under President Ronald Reagan. Publicly held debt reached nearly 50 percent of GDP by 1995, a level that had not been seen since 1956 when the war debt was still being paid down.

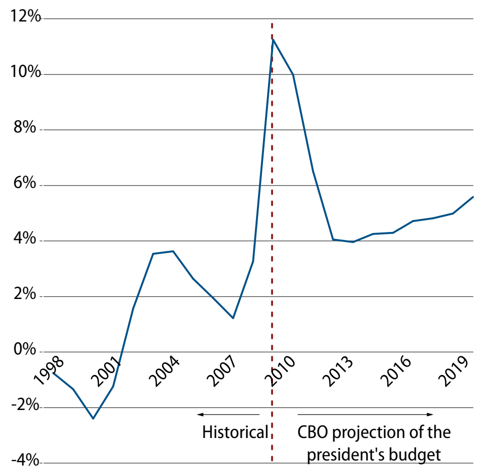
A small deficit drop in 1993, however, marked the first of nine straight years in which the fiscal situation improved. The fiscal turnaround resulted, five years later, in the first surplus in nearly 30 years in 1998. The budget then remained in surplus for four straight years, the longest such run since the 1920's. Debt as a share of GDP declined to 33 percent by 2001 driven by President Clinton's 1993 tax increases, reduced spending as a share of GDP, and strong economic growth. (For more on this see box on page 19)

How did we get from surpluses to sustained large deficits?

The causes of the out-sized deficits for 2009-2011 are straightforward—the economic downturn and the government's policies aimed at ending it, piled on top of a budget that was already out of balance and had been since 2002. This explains the immediate crisis, but what explains the longer-term shift from the hard-won budget surpluses beginning in 1998 to the projected substantial post-recession deficits?

Put simply, when surpluses started in 1998, it was because the federal government collected more taxes and fees than it spent. Federal receipts that year amounted to 20.0 percent of GDP, while total outlays were 19.2 percent of GDP. That 0.8 percent difference translated into a surplus of about $70 billion (0.8 percent of GDP today would be about $110 billion). Yet by 2019, according to CBO's June analysis of the president's budget, federal receipts will be only 19.0 percent of GDP, while outlays will grow to 24.5 percent of GDP, for a deficit of 5.5 percent of GDP.[14]

Figure 7: Federal surplus/deficit, as a percent of GDP (1998-2019)



Source: Congressional Budget Office

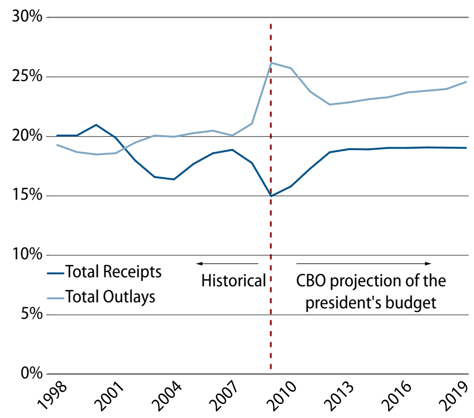
We went from a surplus 10 years ago to sustained deficits for the next 10 years because tax revenue has gone down as a share of economic output, while spending has gone up. More specifically:

1. The decline in receipts stems from an erosion in collections from across the tax code. The federal government will collect less in income tax, payroll tax, and corporate tax as a share of the economy in 2019 than it did in 1998.

2. Growth in spending on public programs is driven by increases in spending on the three largest programs: Social Security, Medicare, and Medicaid. Health care costs are, by far, the largest contributor to overall growth in federal outlays.

3. Interest payments on the national debt will be much higher in 2019 than they were in 1998 due in large measure to the disappearance of budget surpluses beginning in 2002.

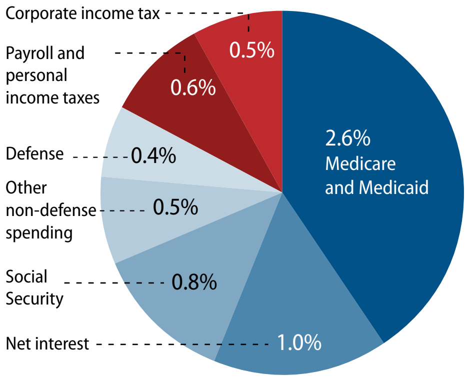
Figure 8: Federal receipts and outlays, as a percent of GDP (1998-2019)



Source: Congressional Budget Office

The sustained high deficits that these shifts add up to have been baked into the budget cake for a long time. The tax cuts of the early 2000s play a role. But President Obama's budget partially addresses that issue. The biggest single factor that remains is what we've known for years it would be—rising health care costs. The country will pay over the next 10 years for the lack of action on that issue

Figure 9: Contributors to fiscal deterioration, measured in change in percent of GDP, 1998-2019

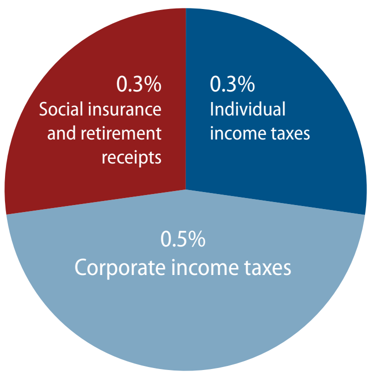


Total deterioration: 6.3%* of GDP

Notes:
Spending categories, values reflect increases in outlays.
Revenue categories, values reflect decrease in receipts.
Other non-defense spending includes both mandatory and discretionary spending.
*Totals will not sum to 6.3 because receipts from "other sources" are projected to be up by 0.1 percentage points of GDP.

Source: Authors' analysis based on data from the Congressional Budget Office and the Office of Management and Budget

Figure 10: Decrease in receipts, as a share of GDP, 1998-2019



Total decrease in revenues: 1%* of GDP

*Slices will not sum to 1% because the category "Other Receipts" increases by 0.1% of GDP

Source: Authors' analysis based on data from the Congressional Budget Office and the Office of Management and Budget

in the past, even if action is taken soon. Garnering net savings from the health care system while improving the quality of health care, including expanding coverage, is not a reform that yields large savings quickly.

What's different now isn't that these basic truths have changed—although certainly the weak economy makes things worse. What's different is that we can no longer sweep them under the rug.

The effect of lower receipts on the long-term budget outlook

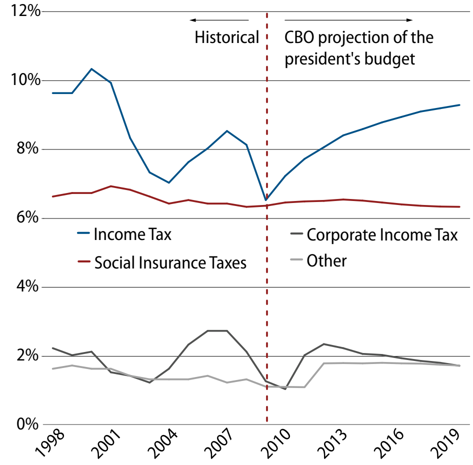
Lower receipts explain part of the shift from a small surplus in 1998 to the significant deficit projected for 2019. Overall receipts are projected to be lower in 2019 than they were in 1998 by about one full percentage point of GDP. Federal revenues were 20.0 percent of the economy in 1998 but dropped to 14.9 percent of GDP as of 2009 due to tax cuts and the crushing recession. CBO projects that under the president's budget plan they will rise back to 19.0 percent of GDP by 2019 due to proposed high-income tax increases and an economic rebound. The overall projected net decline between 1998 and 2019 is attributable to declines in payroll and individual income tax receipts, as well as a larger decline in corporate income tax receipts.

Personal income tax

Personal income tax revenues as a share of GDP will be a full 3.1 percentage points lower in 2009 than they were in 1998—with the recession piling onto the tax cuts passed under President George W. Bush. The federal government in 2009 will collect the lowest amount of income taxes as a share of GDP since 1951. This actually understates the full impact of the last administration's tax cuts on the current deficit. There is an additional ongoing cost to those tax cuts in the interest payments on the debt accumulated over the last eight years because of tax-cut-created deficits.

Personal income tax collections are expected to rebound over the next 10 years so that by 2019 collections will only be 0.3 percent of GDP lower than they were in 1998. The gains from 2009 to 2019 are the result of several factors that will restore much of the revenue decline from 1998 to 2009. Receipts will recover with the end of the recession and the commencement of economic growth. In a healthy economy, receipts tend to grow faster than the economy as a whole as real incomes increase—especially among the well-off who are in the highest tax brackets. President Obama has also proposed allowing some of the Bush tax cuts that apply to those making more than $250,000 to expire at the end of 2010. That action will raise $93 billion in 2019 according to CBO—a bit over 0.4 percent of GDP. Yet President Obama has also proposed cutting taxes for most other families. Those proposals will reduce income tax revenues in 2019 by about $57 billion. President Obama's tax proposals together will raise about 0.2 percent of GDP in additional personal income tax revenue in 2019.

Figure 11: Revenues, by source, as a percent of GDP (1998-2019)



Source: Congressional Budget Office

Corporate income tax

The federal government is also projected to collect less in corporate income tax in 2019 than it did in 1998. Corporate income tax receipts have fluctuated since 1998 as a share of GDP, declining for several years and then rising again starting in 2004 as corporations turned strong profits. Tax cuts and the current recession have decreased corporate income tax receipts substantially. President Obama includes proposals to reform the taxation of multinational corporations in his budget. Those proposals, plus a recovering economy, are projected to boost collections under the president's budget plan, but revenue is still projected to be only 1.7 percent of GDP by 2019, down from 2.2 percent of GDP from 1998—a drop of a half-percent of GDP.

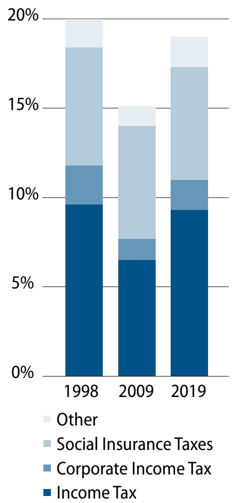
Payroll taxes

CBO projects that payroll tax receipts—the taxes for Social Security and Medicare that are collected from workers, their employers, and the self-employed—will drop by 0.3 percent of GDP from 1998 to 2019. This entire decline occurred between 1998 and 2009. CBO projects that payroll taxes will end up at the same level of GDP in 2019 as in 2009, with some fluctuations in intervening years. The decline from 1998 to 2009 stems mostly from Social Security payroll taxes growing more slowly than the economy over the last 10 years. This is unsurprising given the stagnation of median wages over that period.

Other receipts

The federal government also collects revenue from a wide variety of excise taxes, user fees, custom duties, and other sources. This category of receipts has declined from 1998 to 2009. All of these sources together yielded 1.6 percent of GDP in revenue in 1998. But in 2009 "other receipts" will amount to just 1.1 percent of GDP. Because this category is

Figure 12: Receipts, by source, as a percent of GDP



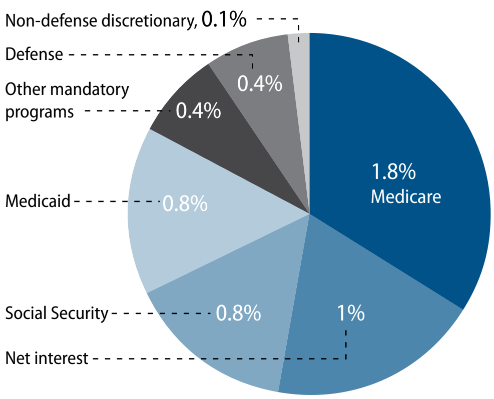
Sources: Congressional Budget Office

made up of so many different sources, there is no one dominant reason for the decline over the past decade. The erosion in receipts from this category stems from small declines across a variety of taxes and fees.

For example, revenues from most excise taxes such as the telephone excise tax and the federal alcohol tax have significantly dropped over the past 10 years as a share of the economy. Receipts from the estate and gift tax have also declined by about 0.1 percent of GDP since 1998. President Obama's budget proposal will offset much of these declines going forward through additional revenues from the sale of emission allowances in a cap-and-trade program. CBO projects that climate change payments will amount to around $80 billion per year, or about 0.4 percent of GDP in 2019. As a result, "other receipts" which includes revenues from climate change policies, is projected to grow from 1.1 percent of GDP in 2009 to 1.7 percent of GDP in 2019, slightly above where it was in 1998. It is important to note, however, that the president's energy proposal doesn't either inrease or decrease the deficit as the climate change payments are all rebated to the public, or used for investments in clean energy technology.

The effect of higher government spending on the long-term budget outlook

Figure 13: Increase in spending, as a share of GDP, 1998-2019



Total increase in spending: 5.3 % of GDP

Sources: Authors' analysis based on data from the Congressional Budget Office and the Office of Management and Budget

Total federal outlays were 19.2 percent of GDP in 1998 when the budget surplus era of the late 1990s began. Spending has leapt to 26.1 percent of GDP in 2009 as GDP has dropped and government efforts to restore the economy have increased spending. CBO's June projections for the president's budget show outlays in 2019 to be 24.5 percent of GDP—making increased spending of 5.3 percent of GDP the predominant factor in the projected shift from surplus to deficit between 1998 and 2019.

Most of this increased spending is not news. It reflects long anticipated growth in the cost of existing programs. But the federal government has put off solving this problem in the past, which leaves the crisis to current policymakers. Most substantially, health care costs have been rising steadily, especially in Medicare. Other areas, such as defense spending, have also risen in response to the September 11 attacks and the wars that followed.

Mandatory spending

Mandatory spending consists of those spending programs that do not require Congress to act each year to continue their funding. The biggest programs in the mandatory category are Social Security, Medicare, and Medicaid.

Mandatory spending is the source of most of the total increase in outlays from 1998 to 2019. Mandatory spending was at 10 percent of GDP in 1998, has temporarily risen to 16.1 percent of GDP in 2009, and is projected to end up at 13.8 percent of GDP in 2019—a rise of 3.8 percentage points from 1998 to 2019.

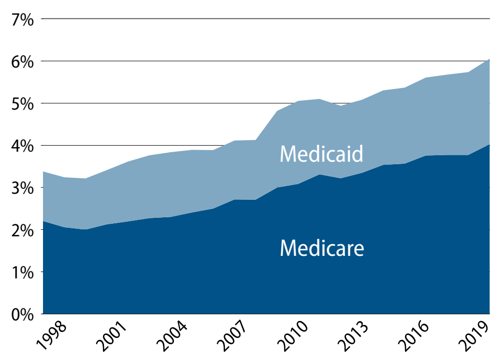
Most of that growth is in Medicare and Medicaid spending. Medicare outlays were 2.2 percent of GDP in 1998 and will be 3 percent of GDP for 2009. CBO projects that Medicare outlays in 10 years will be at 4 percent of GDP. That 1.8 percentage points of growth from 1998 to 2019 represents nearly half of the total growth in mandatory spending. This estimate assumes that Congress adopts proposals by the Obama administration to rein in some Medicare costs, such as instituting competitive bidding in the Medicare Advantage program. If it does not adopt these proposals, or equally effective substitutes, Medicare costs will be even higher.

Medicaid spending grows along a similar pattern, though the pace is far slower. Medicaid spending was 1.2 percent of GDP in 1998 and spending had grown only to 1.4 percent of GDP by 2008. But Medicaid outlays jumped in 2009 to 1.8 percent of GDP as the economic downturn pushed people with health needs and without employer-provided coverage into the program. This raised federal costs and spurred the federal government to extend additional aid to the struggling states that pay for more than 40 percent of the program.[15] CBO projects that Medicaid spending over the course of the next 10 years will revert back to the slower growth of the past several years, resulting in total spending of 2 percent of GDP in 2019—still 0.8 percent of GDP higher than in 1998.

Spending growth in Medicare and Medicaid together account for 2.6 percent of GDP out of the overall 6.3 percent of GDP swing from surplus in 1998 to deficit in 2019. The passage of Medicare Part D in 2004 did contribute to the overall growth in health spending, but the bulk of this growth flows directly from a well-known source—the ever increasing costs of providing health care. Health care cost increases are not limited to the federal government; costs have been rising in the private sector, as well. That is why slowing the rate of growth in health costs through broader health reform is so important to the country's long-term fiscal health.

It is not a new observation that federal health spending has increased dramatically and will continue to do so. Analysts and experts have been predicting just such a rise for decades. The lack of action in the past is a major contributor to the deficit path on which the nation finds itself.

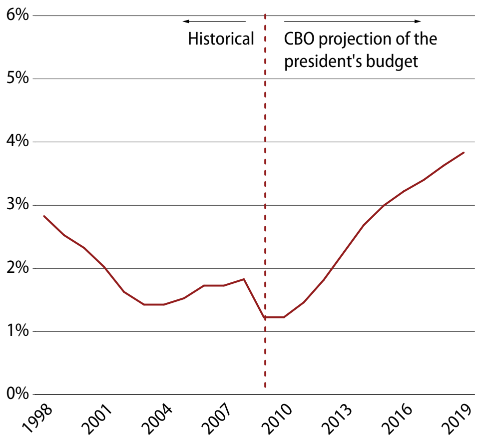
Figure 14: Federal Medicare and Medicaid spending, as a percent of GDP (1998-2019)



Source: Congressional Budget Office

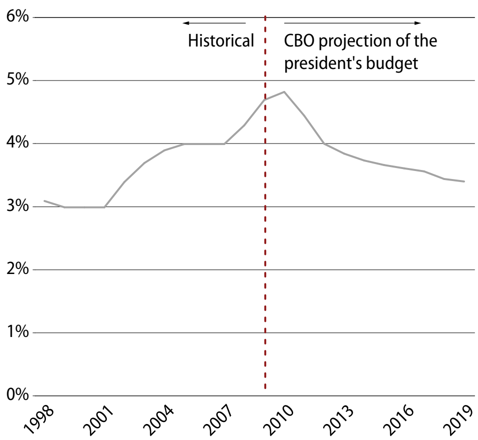
The cost of Social Security—the single largest federal program—is also on the rise as the population ages. But that spending growth is substantially smaller than Medicare's. Social Security outlays were 4.4 percent of GDP in 1998. This year they will

Figure 15: Federal payments for interest on the debt, as a percent of GDP (1998-2019)



Source: Congressional Budget Office

Figure 16: Federal spending on national defense, as a percent of GDP (1998-2019)



Sources: Authors' calculation based on data from the Congressional Budget Office and the Office of Management and Budget

be 4.8 percent of GDP, and in 10 years outlays for Social Security are projected to be 5.2 percent of GDP—0.8 percent of GDP higher than in 1998.

Medicare, Medicaid, and Social Security together make up about three-quarters of all mandatory spending. The rest goes to a myriad of programs such as food stamps, agriculture subsidies, and financial aid for higher education. Spending on all of these remaining mandatory programs will also be higher in 2019 than it was in 1998, though by a much smaller amount than Medicare, Medicaid, and Social Security. Outlays for these other mandatory programs were 2.2 percent of GDP in 1998 and rose to 2.8 percent by 2008. The 2009 total is 8.8 percent of GDP, which is an anomaly resulting from expenditures for various aspects of the financial rescue. CBO projects that spending on other mandatory programs will be down to 2.6 percent of GDP by 2019, which is 0.4 percent of GDP higher than in 1998, but lower than in 2008.[16]

Interest payments on the federal debt

Interest payments on the national debt is another area where spending will increase substantially. Interest payments amounted to 2.8 percent of GDP in 1998, and CBO projects that share will rise to 3.8 percent in 2019. Interest payments on the debt declined substantially from 1998 to 2003, when it bottomed at 1.4 percent of GDP. Several years of surpluses abetted this decline, which allowed the federal government to reduce the national debt and the interest payments owed on it. But the debt began to grow again after deficits returned in 2002 and growth continued in the wake of the Bush tax cuts, and so interest payments have grown, as well. CBO projects that these payments will reach 3 percent of GDP by 2015 and then 3.8 percent by 2019.[17]

Defense

Defense spending was 3.1 percent of GDP in 1998—lower than at any point since before the start of WWII. It stayed near 3 percent of GDP for the next three years. But defense spending grew significantly after the attacks of September 11, 2001 and the start of the war in Iraq. Defense spending reached 4 percent of GDP in 2005, and CBO expects that it will reach 4.7 percent of GDP in 2009. Under President Obama's budget plan, the trend is projected to reverse starting in 2011, when defense spending will begin to decline as share of GDP. CBO estimates that under the president's budget plan defense spending will be at 3.5 percent of GDP by

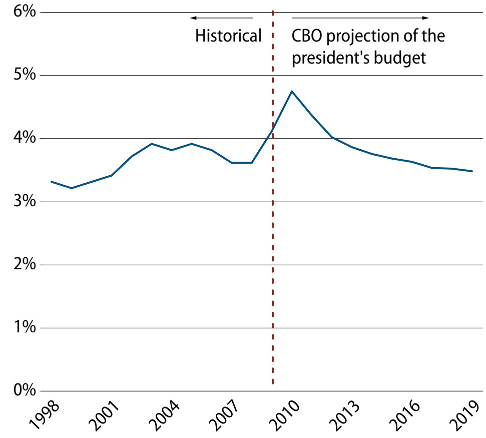
2017, where it will remain through 2019.[18] Yet defense spending will be 0.4 percent of GDP higher in 2019 than it was in 1998 even with these future declines.

Non-defense discretionary spening

Non-defense discretionary spending—the spending that Congress has to appropriate each year, excluding defense spending—follows a similar trend as defense, though somewhat less pronounced. The similarity in this pattern is not a coincidence and the label "non-defense" has increasingly become a misnomer. Most of the increase in this category in recent years has been for homeland security and reconstruction efforts in Iraq that are outside the Defense Department budget.

The federal government spent 3.3 percent of GDP on non-defense discretionary programs in 1998. Spending in this category stayed very near that level through 2001 before it began to rise. It reached 3.9 percent of GDP in 2003. And this category will jump to an estimated 4.7 percent of GDP due to economic recovery investments. But CBO projects that under the president's budget plan non-defense discretionary spending will shrink back to 3.4 percent of GDP in 2019—just 0.1 percentage points of GDP above 1998 levels despite the large investments in homeland security.

Figure 17: Non-defense discretionary spending, as a percent of GDP (1998-2019)



Sources: Authors' calculation based on data from the Congressional Budget Office and the Office of Management and Budget

What is in non-defense discretionary spending?

	Dollars (millions)	Share of GDP
Total non-defense discretionary spending, 2007	**$496,714**	**3.6 %**
Education, training, employment and social services	$80,706	0.6 %
Transportation	$68,865	0.5 %
Income security*	$59,011	0.4 %
Health**	$56,387	0.4 %
Administration of justice	$40,310	0.3 %
Community and regional development	$38,328	0.3 %
Natural resources, environment and energy	$37,247	0.3 %
International affairs	$36,071	0.3 %
Veterans benefits and services	$32,441	0.2 %
General government and other	$23,851	0.2 %
General science, space and technology	$23,497	0.2 %

Source: Office of Management and Budget

* Discretionary income security programs include housing assistance (0.29 percent of GDP), the Special Supplemental Nutrition Program for Women, Infants and Children (0.04 percent of GDP), a portion of Unemployment Insurance (0.02 percent of GDP), and the Low Income Home Energy Assistance Program (0.02 percent of GDP), among others.

** Discretionary health programs include the National Institutes of Health (0.2 percent of GDP), the Center for Disease Control (0.04 percent of GDP), Indian Health Services (0.02 percent), and the Food and Drug Administration (0.01 percent of GDP), among others.

Note: Homeland Security expenses are primarily in the Administration of Justice and Transportation categories. Non-defense spending for Iraq is contained in the International Affairs category.

Getting to a solution

Many decisions and choices have been made since 1998, when four years of hard-won fiscal surpluses began, that have lead to the projections today of a period of large sustained deficits and debt levels through 2019. And we know that the problem does not stop then. The question is what to do about it. This is not an easy problem to solve.

To put it in perspective, let's take as a hypothetical goal, eliminating the budget deficit by 2014. This is a year that should be safely beyond the current recession and in the heart of the next period of recovery. It is soon enough that we reap the benefits of the lower debt levels from the lower ongoing deficits for the rest of the period through 2019 in the form of lower debt service payments. It is far enough away that one can imagine a path of gradual policy adjustment to get there. What does such a goal imply for 2014?

CBO projects that the president's budget plan will put total government revenues in 2014 at 18.8 percent of GDP, or just over $3.2 trillion, and total outlays will be 23.0 percent of GDP, or a bit under $4.0 trillion. The anticipated deficit for that year is 4.2 percent of GDP, or $726 billion. It takes only simple arithmetic to see that completely eliminating the deficit in 2014 through spending cuts alone would require slashing the entire federal budget by $726 billion—or an 18 percent cut in all spending. Similar arithmetic reveals that eliminating the deficit solely through tax increases would require an across the board tax hike of 22 percent.

Of course, it may not be necessary to completely eliminate the deficit. Small deficits are relatively harmless—they don't saddle the country with an outsized debt burden or necessarily trigger any of the major harms attributed to large deficits. Furthermore, the debt-to-GDP ratio will actually decline if the deficit is in the range of 2 percent of GDP.[19] Indeed, the Untied States has had an average federal budget deficit of 1.9 percent of GDP since WWII, and the debt as a share of GDP dropped in nearly every year in which the deficit was under 3 percent of GDP.

But there really isn't much of an excuse for running deficits during periods of economic growth. It is during these periods when it is wise to pay down accumulated government debt to better position the country to deal with the next economic downturn or national crisis. Nevertheless, cutting the deficit to 2 percent of GDP would be a tremendous accomplishment given the magnitude of the problem and uncertainty regarding

Turning it around: How we got from deficits to surpluses in the 1990s

In 1992, the federal budget deficit was 4.6 percent of GDP, and was projected to remain well above 4 percent for the following decade. Just six years later, what was supposed to have been a deficit of 4.5 percent of GDP, was actually a surplus of 0.8 percent of GDP. The fiscal turnaround was a product of substantially increased individual and corporate income tax revenues, spurred by tax rate increases, a strong economy and strong income growth, combined with significantly reduced spendingas a share of GDP, especially in the area of national defense.

Total receipts amounted to 17.5 percent of GDP in 1992, and outlays were 22.1 percent of GDP. Six years later, receipts were up to 20 percent of GDP and outlays were down to 19.2 percent. Receipts increased on the strength of big gains in personal and corporate income taxes. In 1992, the federal government collected just 7.6 percent of GDP in personal income taxes and only 1.6 percent in corporate income taxes. As a result of tax increases and strong economic and income growth, those receipts grew by 2 percentage points of GDP and 0.6 percentage points of GDP, respectively.

While revenue was increasing, spending was declining—especially defense spending. In 1992, spending on national defense amounted to 4.8 percent of GDP (still an elevated level as a result of the Cold War and the Persian Gulf War). Over the next six years, that share dropped to 3.1 percent. Non-defense discretionary spending also dropped, though by a much smaller 0.4 percentage points of GDP. Spending on Social Security declined slightly, from 4.6 percent to 4.4 percent of GDP, but that decline was more than balanced by small increases in spending on Medicare and Medicaid. Spending on other mandatory programs declined from 2.9 percent of GDP in 1992 to 2.2 percent of GDP in 1998. Finally, because of the improving budget situation, interest payments in 1998 were lower than they were in 1992 (by 0.4 percentage points of GDP). All together, the federal government was spending 2.9 percent of GDP less in 1998 than it had six years prior.

With spending down by 2.9 percent of GDP and revenues up by 2.5 percent of GDP, the federal budget ran its first surplus in decades, the first of four consecutive yearly surpluses. The turnaround was accomplished through a combination of increased taxes and reduced spending in a variety of areas, and with much help from robust economic growth.

the economy. But accomplishing this solely through budget cuts would mean decreasing spending by 10 percent below what is currently projected for 2014. Achieving it all through tax increases would require taxes to be 12 percent higher across the board from what is projected for 2014.

Fiscal balance through spending cuts

Solving the long-term fiscal problems exclusively through across-the-board spending cuts is simply impractical. Bringing the 2014 budget into balance by only slashing spending would require a true across-the-board spending cut of 18 percent. Such an enormous cut would be devastating. It would mean cutting by nearly a fifth all air-traffic-control funding, interest payments on the debt to the nation's creditors, food and product safety inspections, veterans' health care, Social Security payments, Medicare, national defense, food stamps, education funding, infrastructure projects, and job training programs, to name just a few. There would be substantial consequences for public health, safety, and well-being. Even if the target is a 2 percent of GDP deficit rather than a completely balanced budget, a 10 percent across-the-board cut would be required, which is still a huge blow.

Of course, the likelihood of an across-the-board spending cut is infinitesimal. Spending in many areas is deemed either highly desirable or outright essential. Some spending is rightly seen as more important than other spending. But leaving one part of the budget off the chopping block means the rest has to be cut more.

One area of spending that almost certainly wouldn't be cut is interest payments on the national debt. The nation must maintain its credit-worthiness and these are non-negotiable obligations to our creditors. Interest payments would therefore be exempt from even an "across-the-board" spending cut. Taking interest payments off the table means that the rest of the budget, including all of the programs mentioned above, would have to be cut by 21 percent to balance the budget by 2014 and by 11 percent to get the deficit down to 2 percent of GDP.

Other substantial areas of federal spending also fall into categories that would be very difficult to cut substantially. Various plans have been offered to reduce costs in Social Security, for example, but they save very little in the next 10 years. Most of their reductions affect future retirees and the rate of growth in future benefits. This makes sense since those currently receiving benefits, as well as those who are about to receive them, have acted in reliance on certain benefit levels. It would be offensive to appreciably reduce those benefits; it would violate a strong national commitment and be politically challenging, especially for cuts upwards of 20 percent. But if we take Social Security off the hit list on top of interest payments, the rest of the budget would have to be cut by 27 percent to balance the budget and by 14 percent to get the deficit down to 2 percent of GDP by 2019.

Medicare is one program where we know there are potential savings—but the president's budget plan already accounts for some such savings. There is the potential for significant further savings in Medicare in the context of national health care reform. Some of these savings can, indeed, help with deficit reduction, although they mostly will be seen beyond 2019. Additional savings by 2014 are possible, but they would be relatively small and dedicated to the overall objective of improving the health care system. If we take additional Medicare savings effectively off the table, along with Social Security and interest payments, we would then need a 35 percent cut in the rest of the federal budget to balance the budget by 2019, and a 18 percent cut just to get the deficit down to 2 percent of GDP. That would mean major cuts in highway funding, special education programs, veterans' health care, all military spending, and so on.

The prospects for cutting defense spending by 35 percent are vanishingly small. In fact, President Obama's budget plan already reduces the share of GDP going to defense spending over the next 10 years. The president is projecting that defense spending will be lower by 1.2 percent of GDP in 2019 than it is in 2010. It is projected to be 3.7 percent of GDP in 2014. Further constraint may be possible—our defense needs do not necessarily go up as fast as our economy grows—but not 35 percent or even 18 percent. If we deem it unlikely or undesirable to further reduce defense spending, along with the other areas we have already roped off, then the rest of the budget would have to be cut by 51 percent to balance the budget and by 27 percent to get to a deficit of 2 percent of GDP by 2014.

Other major areas of federal spending, 2007 (excluding Social Security, Medicare, Defense and Interest Payments)	Dollars (Millions)	Share of GDP
Medicaid	$190,624	1.4%
Federal employee retirement and disability	$103,916	0.8%
Education, training, and social services	$91,676	0.7%
Other health	$75,811	0.6%
Transportation	$72,905	0.5%
Veterans benefits and services	$72,847	0.5%
Food and nutrition assistance	$54,458	0.4%
Earned Income and Child Tax credits	$54,433	0.4%
Other income security	$42,659	0.3%
Administration of justice	$41,244	0.3%
Housing assistance	$39,715	0.3%
Supplemental Security Income	$35,687	0.3%
Unemployment compensation	$35,107	0.3%
Natural resources, environment and energy	$30,899	0.2%
Community and regional development	$29,567	0.2%
International affairs	$28,510	0.2%
General science, space and technology	$25,566	0.2%
General government and other	$17,936	0.1%
Agriculture	$17,663	0.1%

Source: Office of Management and Budget

We have thus far exempted from major cuts interest payments, Social Security, Medicare, and defense spending. The table above shows what's left: most basic government-provided services including benefits for veterans, long-term health care for the elderly and disabled, assistance programs for the working poor, roads, bridges and mass transit, homeland security, benefits that federal retirees have earned, the national parks, education, the Centers for Disease Control, the Federal Aviation Authority, the entire Department of Agriculture, air traffic controllers, and food inspectors. Cuts to many of these areas on the levels that would be necessary to achieve fiscal balance, or close to it, are as difficult to imagine as cuts to interest payments, defense, or Social Security.

The bottom line is that one doesn't have to be a "tax and spend liberal," or be particularly sympathetic to the poor, or love road-building, or believe in a huge military and homeland security apparatus to recognize how intolerable it would be to solve our fiscal problems entirely through spending cuts.

Fiscal balance through tax increases

Balancing the budget in 2014 entirely by increasing taxes would require an across-the-board tax increase of 22 percent. This would mean a hike on every tax and charge collected by the United States government. Everyone who pays the personal income tax, payroll tax—employer or employee—gas tax, corporate income tax, and all the rest would have to pay 22 percent more. Achieving a 2 percent of GDP deficit would require a 12 percent tax increase across the board.

Much is said about the economic effect of tax increases, but it is worth noting that there is little risk of the United States becoming economically disadvantaged relative to other advanced economic nations by raising its aggregate tax levels. We have the fifth lowest taxes as a share of GDP among economically developed nations (counting all federal, state, and local taxes). If we raised taxes in aggregate to a level that would safely balance the budget, the United States would still be in the bottom 10 out of 30.[20] That is not a likely or necessarily desirable policy. And specific taxes could certainly be raised excessively to the point of causing economic harm.

A 22 percent across-the-board tax increase would obviously catch people's attention. Concentrating the tax increases on narrower subcategories would make the tax hikes on those who bear them that much larger. For example, if the tax hike were limited to the Corporate Income Tax and those with Federal Adjusted Gross Income of greater than $250,000 per year, it would require an approximate 70 percent tax increase on each—a 70 percent hike on corporations and a 70 percent increase in the personal income tax for those making more than $250,000 per-year—in order to balance the budget in 2019. This is on top of the tax increases already in the Obama budget blueprint. A tax hike of this size done purely through rate increases implies a 30-percentage point increase on top marginal rates for affected individual taxpayers. This would push the marginal tax rate for ordinary income over 70 percent and the rate for capital gains and dividends above 50 percent. The corporate tax rate would go up by about 25 points, bringing the rate on corporate profits to about 60 percent.

Using tax increases on those making over $250,000 and corporations to lower the deficit in 2014 to 2 percent of GDP would require about a 40 percent hike in their taxes. Such a hike implies an increase of about 20 percentage points in the top tax rates for individuals and a corporate rate hike of about 15 points.

One doesn't have to be vehemently anti-tax to recognize that balancing the budget solely with such tax increases is both unlikely and unwise.

Conclusion

The United States is facing significant and sustained deficits for years to come. There is a broad agreement that these deficits must be brought down to more manageable levels. Yet there is little agreement over how to achieve that goal. Many areas of government spending are deemed essential and immune to cuts, while tax increases are similarly labeled out of bounds.

We are in a situation where there are many seemingly immovable objects and yet, some of them will have to move. Spending cuts in many of the largest spending categories are seen as not only undesirable, but impossible, even on a far more modest scale than outlined above. Any significant tax increases beyond what President Obama has already proposed are, likewise, dismissed as extremely difficult to accomplish.

We need to ask serious questions: Can the United States afford to continue to spend so much more of its national income than the rest of the world on defense? Are we going to pass health care reform which, while not offering large savings in the next 10 years, can put us on a better long-run fiscal path and make the imperative for low, or no, deficits over the next 10 years less critical? Can taxes beyond what the president has already proposed be part of the picture?

Everything the government does will have to be examined—from Social Security to agricultural subsidies, social programs, and education spending—and everyone will have areas they carve out as sacrosanct and areas they don't. This will clearly require a balanced approach, and it is important that the balance is right so that the solution is not worse than the problem.

It will not help the situation to yell and scream that we can't raise taxes. Nor will we move closer to fiscal prudence by declaring all government spending absolutely untouchable. In all seriousness, responsible people know that additional revenue has to be part of the mix even if they believe in lower taxes in general. And those who believe that government investments and spending are critical to our economic and social well-being, and favor progressive taxation, recognize that tax increases on the wealthiest and corporations are not going to solve the whole problem.

The steps that are needed will likely excite a harsh response. But that will not serve the country well. Anger and political points won't change the arithmetic—they will only make it more challenging to solve the equation as the shots are fired and policymakers duck for cover.

But challenging is not the same thing as impossible. The good news is that the United States can afford to take whatever path it chooses. Other nations have faced far worse fiscal challenges and had few options—they simply have not had the wealth to address their needs. We are not in such a situation. Stepping back, looking at the situation dispassionately, this is far from an insoluble problem if we have the will to solve it.

Appendix 1: Federal revenues and expenditures as a percent of GDP, 1998-2019

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Total receipts	20.0	20.0	20.9	19.8	17.9	16.5	16.3	17.6	18.5	18.8	17.7	14.9	15.7	17.2	18.6	18.9	18.8	19.0	18.9	19.0	19.0	19.0
Individual income taxes	9.6	9.6	10.3	9.9	8.3	7.3	7.0	7.6	8.0	8.5	8.1	6.5	7.2	7.7	8.0	8.4	8.6	8.8	8.9	9.1	9.2	9.3
Corporation income taxes	2.2	2.0	2.1	1.5	1.4	1.2	1.6	2.3	2.7	2.7	2.1	1.2	1.0	2.0	2.3	2.2	2.0	2.0	1.9	1.8	1.8	1.7
Social insurance and retirement receipts	6.6	6.7	6.7	6.9	6.8	6.6	6.4	6.5	6.4	6.4	6.3	6.3	6.4	6.5	6.5	6.5	6.5	6.4	6.4	6.3	6.3	6.3
Other	1.6	1.7	1.6	1.6	1.4	1.3	1.3	1.3	1.4	1.2	1.3	1.1	1.1	1.1	1.8	1.8	1.8	1.8	1.8	1.8	1.7	1.7
Total outlays	19.2	18.6	18.4	18.5	19.4	20.0	19.9	20.2	20.4	20.0	21.0	26.1	25.7	23.7	22.6	22.8	23.0	23.2	23.6	23.8	23.9	24.5
Defense	3.1	3.0	3.0	3.0	3.4	3.7	3.9	4.0	4.0	4.0	4.3	4.7	4.8	4.5	4.0	3.8	3.7	3.7	3.6	3.5	3.5	3.5
Nondefense discretionary	3.3	3.2	3.3	3.4	3.7	3.9	3.8	3.9	3.8	3.6	3.6	4.1	4.7	4.4	4.0	3.8	3.7	3.7	3.6	3.5	3.4	3.4
Social Security	4.4	4.2	4.2	4.3	4.4	4.4	4.3	4.2	4.2	4.3	4.3	4.8	4.8	4.8	4.7	4.7	4.8	4.8	4.9	5.0	5.1	5.2
Medicare	2.2	2.1	2.0	2.1	2.2	2.3	2.3	2.4	2.5	2.7	2.7	3.0	3.1	3.3	3.2	3.3	3.5	3.6	3.8	3.8	3.8	4.0
Medicaid	1.2	1.2	1.2	1.3	1.4	1.5	1.5	1.5	1.4	1.4	1.4	1.8	2.0	1.8	1.7	1.7	1.8	1.8	1.9	1.9	2.0	2.0
Other mandatory programs	2.2	2.4	2.4	2.3	2.7	2.8	2.6	2.7	2.8	2.3	2.8	6.5	5.0	3.6	3.1	3.0	2.8	2.7	2.7	2.6	2.5	2.6
Net interest	2.8	2.5	2.3	2.0	1.6	1.4	1.4	1.5	1.7	1.7	1.8	1.2	1.2	1.4	1.8	2.2	2.7	3.0	3.2	3.4	3.6	3.8
Surplus/Deficit	0.8	1.4	2.4	1.3	-1.5	-3.5	-3.6	-2.6	-1.9	-1.2	-3.2	-11.2	-9.9	-6.5	-4.0	-3.9	-4.2	-4.3	-4.7	-4.8	-4.9	-5.5

Source: Authors' calculation based on data from the Congressional Budget Office and the Office of Management and Budget. See endnote 8.

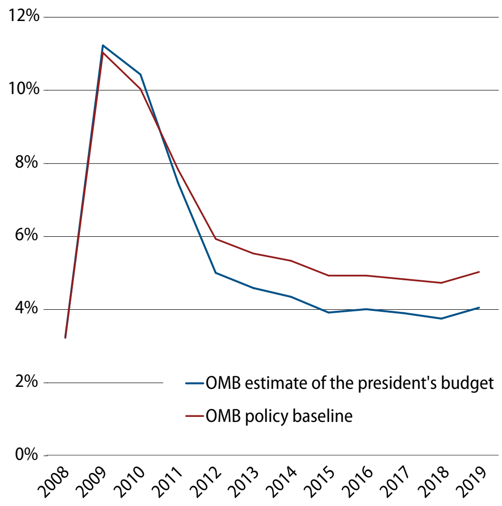
Appendix 2: The president's budget compared to the OMB policy baseline

In addition to evaluating the president's budget, the Office of Management and Budget also produces a baseline estimate of the budget, based on the assumption that current policies will remain in effect, regardless of "sunset provisions" or other prescheduled changes. The tax cuts of 2001 and 2003, for example, are assumed to be retained in the future, rather than expiring at the end of 2010. This is in contrast to CBO's "current law" baseline, which assumes that if certain policies are set to change or expire at some point in the future, they will do so as scheduled.

President Obama's budget proposal would yield larger deficits in 2010 compared to current policies, but smaller deficits after 2010.

The Congressional Budget Office does not produce an official "current policy" baseline, but it does offer a projection of the costs of extending some of the more significant policies that are set to expire. One could apply these costs to CBO's baseline in order to roughly approximate a "current policy" baseline. Comparing CBO's projection of the president's budget to this rough policy baseline instead of comparing it to the official "current law" baseline results in the same conclusion as comparing OMB's estimate to its policy baseline. The president's budget yields smaller deficits over the next 10 years compared to current policy.

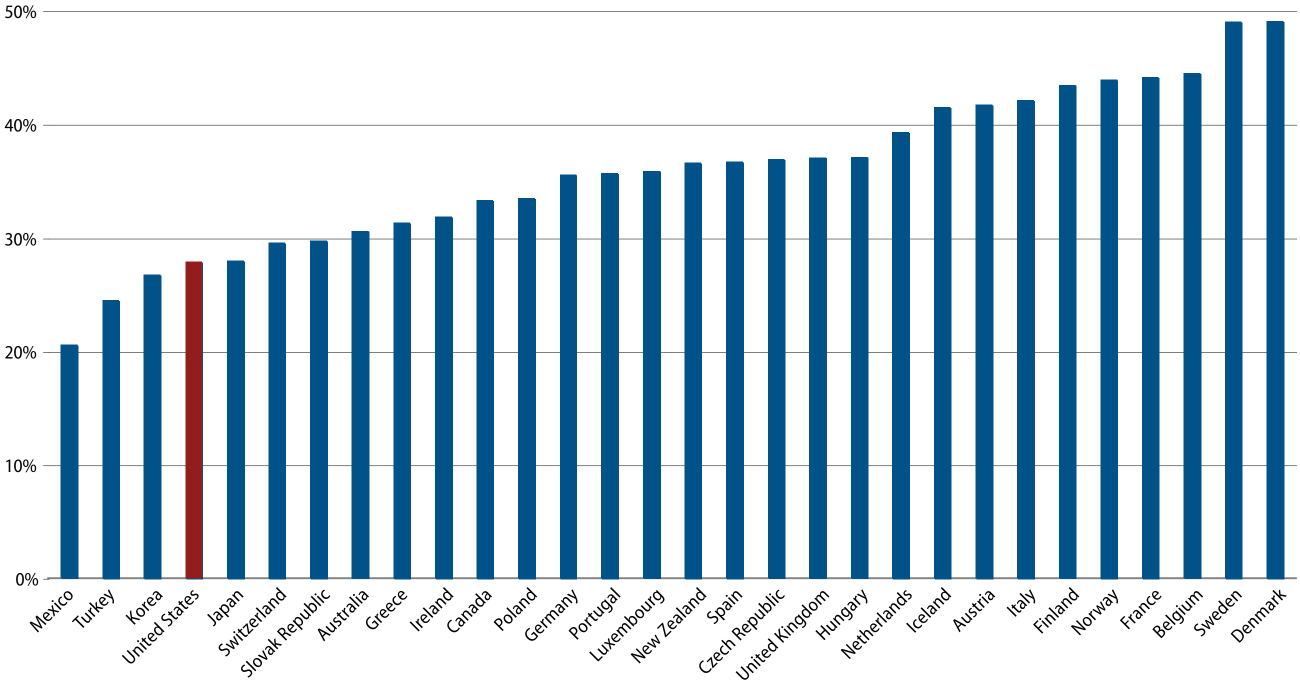
Projected deficit as a percent of GDP under President Obama's budget and OMB policy baseline



Source: Office of Management and Budget

Appendix 3: Tax revenues among Organization for Economic Co-operation and Development Countries

All levels of government



Endnotes

1 Beyond the next 10 years, which are the focus of this paper, the deficits are projected to again become "eye-catching." See: Kris Cox, Jim Horney and Richard Kogan, "The Long-Term Fiscal Outlook is Bleak: Restoring Fiscal Sustainability Will Require Major Changes to Programs, Revenues, and the Nation's Health Care System" (Washington: Center on Budget and Policy Priorities, December 2008).

2 Congressional Budget Office, "An Analysis of the President's Budgetary Proposals for Fiscal Year 2010" (June 2009). This is the CBO projection, made in June 2009, of the deficit under President Obama's budget plan. In August 2009, CBO released its updated baseline and economic projections, but did not release an updated scoring of the president's budget. Given CBO's less optimistic economic projections in August, an updated scoring of the president's budget would show worse deficits than its June estimation.

3 Ibid.

4 Office of Management and Budget, "Mid-Session Review: Budget of the U.S. Government" (August 2009).

5 OMB has, in addition to analyzing the president's budget, prepared a current policy budget that shows what deficits would look like if currently policies were extended through 2019. Under that scenario, the deficit would be 1 percent of GDP higher in 2019. See Appendix 2.

6 In 2001 the debt held by the public was at an 18 year low of 33 percent of GDP.

7 Government dissaving through high levels of borrowing is particularly problematic for the United States because our rate of private savings is lower than found in other countries.

8 See for example, Robert E. Rubin, Peter R. Orszag, and Allen Sinai, "Sustained Budget Deficits, Longer-Run U.S. Economic Performance and the Risk of Financial and Fiscal Disarray" (Washington: Brookings Institute, 2004); William G. Gale and Peter R. Orszag, "The Economic Effects of Long-Term Fiscal Discipline" (Washington: Tax Policy Center, 2002).

9 Robert E. Rubin, Peter R. Orszag, and Allen Sinai, "Sustained Budget Deficits, Longer-Run U.S. Economic Performance and the Risk of Financial and Fiscal Disarray" (Washington: Brookings Institute, 2004).

10 The risk has become greater as Treasury bills, representing funds borrowed for a year or less, have risen from under 20 percent of the portfolio to close to 30 percent. Thus, if interest rates go up the share of debt that will be new borrowing, subject to those higher rates, will be more substantial than it has been in the past.

11 International Monetary Fund, "World Economic Outlook: Crisis and Recovery" April 2009, available at http://www.imf.org/external/pubs/ft/weo/2009/01/index.htm.

12 Cox, Horney and Kogan, "The Long-Term Fiscal Outlook is Bleak: Restoring Fiscal Sustainability Will Require Major Changes to Programs, Revenues, and the Nation's Health Care System."

13 Under the Carter administration the deficit dropped from 4.2 percent of GDP in 1976 to 1.6 percent in 1979, but the 1980 recession drove it back up to 2.7 percent of GDP the following year.

14 Obviously, any analysis of our future fiscal situation is dependent on the specific projection one chooses to employ. Going forward, this analysis will focus on CBO's scoring of President Obama's budget, for two reasons. First, though Congress will certainly have plenty of input and a large impact on any proposed changes in revenue or spending, President Obama's budget gives us a good sense of the general fiscal plan going forward. It will, no doubt, be altered in a myriad of ways, but for now, the administration's plans are the benchmarks against which other proposals will be measured. Second, CBO's projections are generally more widely accepted than OMB's. This is not necessarily because CBO is more accurate, or that CBO's underlying economic assumptions have more validity. CBO is, however, independent from the administration whose budget it is analyzing, whereas OMB is of part of that administration. This being the case, we will rely on CBO's estimates to avoid any concerns over partiality.

15 In 2007, the latest year for which data are available, state spending on Medicaid totaled $138.3 billion, and federal spending totaled $181.4 billion. "Federal and State Share of Medicaid Spending, FY2007," available at http://www.statehealthfacts.org/comparemaptable.jsp?ind=636&cat=4 (last accessed September 2009).

16 The decline in other mandatory spending from 2008 stems mostly from the fact that the benefits for certain programs for low-income workers are not indexed to inflation, and will therefore stagnate in nominal terms, and decline in both real terms and as a share of GDP.

17 Currently interest payments are quite low, only 1.2 percent of GDP. This is due, in large measure, to the fact that interest rates are very low. Both CBO and OMB currently place the three-month Treasury Bill rate at 0.2 percent.

18 Because CBO does not publish a specific projection of defense and non-defense discretionary spending under the President's budget, only a projection of overall discretionary spending, projections of defense and non-defense discretionary spending in this report are based on a hybrid of CBO and OMB's projections. We applied OMB's breakdown between defense and non-defense to CBO's total discretionary outlays.

19 The debt-to-GDP ratio rises when deficits are large enough such that the debt is growing faster than the economy. During periods of economic growth, small deficits result in falling debt-to-GDP ratios because, with small enough deficits, the rate at which the economy grows is faster than rate at which the debt grows. In general, 2 percent of GDP deficits have been small enough to produce this result. The exact point at which a deficit becomes large enough to push the debt-to-GDP ratio upwards depends on specific circumstances, but it is likely that a deficit approaching 3 percent of GDP would cause the debt to rise as a share of the economy.

20 See Appendix 3.

The Center for American Progress is a nonpartisan research and educational institute dedicated to promoting a strong, just and free America that ensures opportunity for all. We believe that Americans are bound together by a common commitment to these values and we aspire to ensure that our national policies reflect these values. We work to find progressive and pragmatic solutions to significant domestic and international problems and develop policy proposals that foster a government that is "of the people, by the people, and for the people."

Center for American Progress

1333 H STREET, NW, 10TH FLOOR, WASHINGTON, DC 20005 • TEL: 202-682-1611 • FAX: 202-682-1867 • WWW.AMERICANPROGRESS.ORG