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Reducing Deficits and the National Debt: The Devilish Details

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Policymakers have proposed several plans to reduce deficits and stabilize the national debt, both of which are necessary for long-term economic stability. Deficit reduction dominates the public discussion, but stabilization of the national debt is arguably more important (for more information, see *Background on the National Deficit and Long-Term Debt, a Primer*). Current projections show that debt continues to climb well into the future, while the deficits that feed long-term debt are largely short-term concerns. A comprehensive solution must have a long-term goal of stabilizing the federal debt while acknowledging the need for short-term economic stability.

This paper will review the various recommendations that have been put forward and discuss the core principles that should guide public discussions about the nation's fiscal health. Key principles are that a successful plan must include all parts of the budget, balancing spending cuts with revenue increases, and that low-income families be protected.

Guiding Principles for Reducing National Deficits and Debt

As noted in "*Background on the National Deficit and Long-Term Debt, a Primer*" both the nation's deficit and long-term debt generally rise during times of war due to increased expenses. They also rise during times of economic recession, when public revenues fall and when increased expenditures may be necessary to hasten economic recovery. The U.S. is currently experiencing the effects of both, leading to a deficit of nearly 10 percent of gross domestic product (GDP) in fiscal year (FY) 2009 before falling to 8.9 percent in FY 2010. We may need to continue some short-term deficit spending to aid the nation's current, fragile, economic recovery.

Deficit spending, which garners significant public attention, is important, but it is only one component of the nation's long-term public debt. As policymakers and the public consider proposals to address the deficit, it will be critical that these proposals also address the long-term public debt of the nation because fiscal sustainability requires that the nation achieve a stable debt-to-GDP ratio. While the current debt-to-GDP ratio is high, it not unprecedented. However, current projections for future debt show that the debt could reach 180 percent by 2025 – a level that is broadly considered to be unsustainable.

One part of stabilizing the debt is reducing the deficit in such a way that it does not jeopardize economic recovery. That will require thoughtful policy changes that incorporate a balanced approach. Two primary principles could be used to guide this effort:

- **Successful plans will be evenly balanced between spending cuts and revenue increases and will consider all parts of the federal budget.** Drastic spending cuts, made too quickly, could imperil the immediate economic recovery. Long-term deficit reduction that stabilizes the nation's debt-to-GDP ratios will require a balanced approach that both controls spending and increases revenue. True deficit reduction cannot be achieved by limiting spending cuts solely to non-defense discretionary funds because that spending makes up only a small fraction of the federal budget. A stable debt-to-GDP will also require policy changes to entitlement program spending.

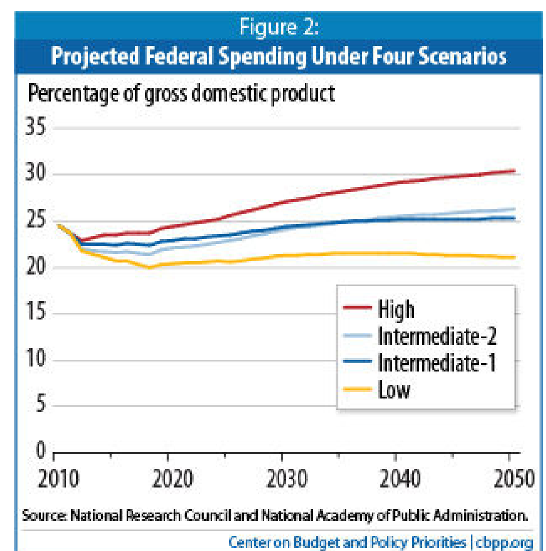
- **Successful plans will protect families with the lowest incomes.** The debt reduction packages of 1990, 1993 and 1997 generally protected low-income Americans, eventually reducing poverty and income inequality while still reducing deficit spending. Yet many public discussions, particularly around current and proposed budgets, focus on mandatory cuts to non-defense, discretionary programs. These are the programs most likely to serve low-income families, including Head Start and Low-Income Home Energy Assistance Program (LIHEAP). The most vulnerable families can't shoulder the entire burden of the near-term spending cuts necessary to reduce the deficit or longer-term changes to entitlement programs.

Several noteworthy groups have released recommendations for addressing these issues. They include the Committee on the Fiscal Future of the United States, the National Commission on Fiscal Responsibility and Reform (Bowles-Simpson), and a commission of the Bipartisan Policy Center (Domenici-Rivlin). In addition, some unique perspectives are offered in a set of recommendations issued by the Peterson-Pew Commission on Budget Reform (Peterson-Pew) and in a proposal put forward by Senators Bob Corker (R-TN) and Claire McCaskill (D-MO).

Each group reflects a particular set of assumptions about deficit reduction and stabilizing the national debt. This paper examines how each proposal measures up against these two core principles.

Committee on the Fiscal Future of the United States

The Committee on the Fiscal Future of the United States is a joint effort of the National Academy of Sciences and the National Academy of Public Administration. Their goal was not to issue specific recommendations, but to study a range of policy alternatives that would lead to a federal debt level of 60 percent of gross domestic product (GDP). At one extreme, they relied almost solely on spending cuts to reach that target; at the other extreme, they relied almost solely on revenues. There were two intermediate scenarios.[i]



Achieving the targeted debt-to-GDP ratio, without raising revenues, requires that federal spending be about 21 percent of GDP. Reaching that level would require large cuts in Social

Security benefits, holding Medicare and Medicaid costs to the same rate of growth as GDP and cutting all other programs by 20 percent. [ii]

At the other extreme, the "High" scenario assumes modest changes in spending. This would require substantial growth in revenue, estimated at a 45 percent increase by 2083. The study notes that "There is little doubt that the current tax structure could not be used to collect revenues at these levels, making extensive structural reforms and new revenue sources (such as a value-added tax) necessary."[iii]

This report clearly illustrates the nation's current dilemma, but it also suggests that alternatives exist and provides a context for examining other proposals.

Peterson-Pew Commission

Funded by the Peter G. Peterson Foundation and the Pew Charitable Trusts (Peterson-Pew), the Commission is a "bipartisan, non-profit organization committed to educating the public about issues that have significant fiscal policy impact."[iv] Co-chairs of the Commission were former members of Congress Timothy Penny, Charlie Stenholm, and Bill Frenzel, a former ranking member of the House Budget Committee. Board members included: other past Budget Committee leaders; former staff from the Congressional Budget Office (CBO), the Office of Management and Budget (OMB) and the Government Accountability Office (GAO); members of the Federal Reserve Board; and other public and private sector leaders. The Commission was established in 2009 and ended its work shortly after issuing its recommendations in a report entitled, "Getting Back in the Black" on November 10, 2010.

The Peterson-Pew recommendations focus on the federal budget process itself as a major contributor to large deficits. Immediate measures to stabilize the federal debt at 60 percent of GDP are proposed, and additional changes are recommended after the debt is stabilized. Immediate measures include:

- Enactment of **statutory debt targets** that both the President's budget and the Congressional budget resolution must meet;
- Automatic across-the-board spending cuts and tax increases that would be triggered by a failure to meet the statutory debt targets. The cuts and increases would not exceed one percent of GDP in any single year, and half of the amount needed to reach the one percent target would be from spending cuts and half from revenue increases. [v]

Once the debt stabilizes at 60 percent, Peterson-Pew calls for the implementation of additional long-term changes aimed at reducing overall debt, such as additional budgetary triggers on Social Security, health care spending, and tax expenditures.

While this proposal is tempting in its simplicity, it is difficult to see how it might actually work. As noted by the Center on Budget and Policy Priorities:

> Debating changes in the budget process now would let lawmakers continue to avoid the real work of raising revenues and cutting spending, while requiring them to consider

> many of the same difficult issues…Reaching agreement on what debt targets to establish and how to set up the automatic deficit-reduction mechanism would be little easier than enacting a package of specific tax and spending changes. Enacting automatic tax increases, for example, would generate just as much controversy as other questions of tax policy. As long as the focus was on process rather than substance, Members of Congress could continue to deflect responsibility for their inability to make tough budgetary choices. The likely result would be more delay.[vi]

History shows that changes in process alone are largely unsuccessful. The Gramm-Rudman-Hollings laws of the mid-1980s set deficit targets, but policy makers continued to try to evade, waive, or increase targeted amounts. Gramm-Rudman was ultimately repealed in 1990 because it failed.

Experience also shows that to make a significant impact on deficits will likely require changes in policy, not just in process. Peterson-Pew does call for "policy changes to deal with longer-term drivers of the debt," but not until after its immediate recommendations have been implemented and federal debt is stable at 60 percent.

Even if Peterson-Pew were successful in the short-term, the long-term risk with automatic, arbitrary controls is substantial because they diminish flexibility, making it difficult to respond effectively during future recessions or other times of national crisis.[vii]

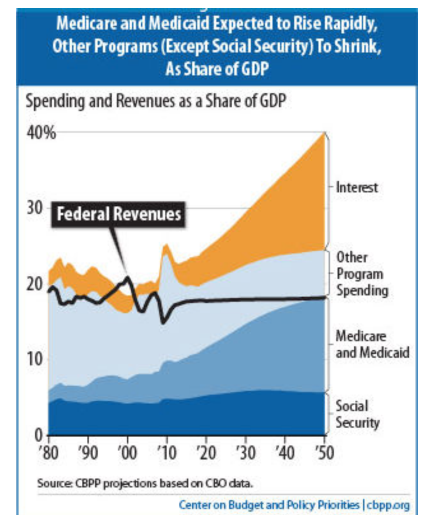
Corker-McCaskill

In February, 2011, Senators Bob Corker and Claire McCaskill introduced a bill that includes several features similar to those in Peterson-Pew. It includes a binding cap on all federal spending, including both discretionary and mandatory spending. Should Congress fail to meet the target, the Office of Management and Budget (OMB) would make across-the-board cuts. A two-thirds vote in both the House and the Senate would be needed to override the binding cap.[viii]

Because it would create a statutory cap, this proposal carries the same risks outlined in the discussion of Peterson-Pew. However, the Corker-McCaskill bill is even more one-sided, focusing exclusively on federal spending and ignoring significant contextual factors that drive increased federal spending.

Corker-McCaskill limits federal spending to 20.6 percent of GDP – a level even lower than the most extreme scenario outlined by the Committee on the Fiscal Future discussed earlier. Their report, cited by the Center on Budget and Policy Priorities, showed that achieving deficit reduction with spending cuts alone would require "very deep cuts in Social Security, Medicare and Medicaid, and reductions of about 20 percent in ALL other spending, including defense, veterans programs and the like. Under this extreme path, federal spending would be slightly higher than the Corker-McCaskill level—about 21 percent of GDP."[ix]

Another concern is that the proposed 20.6 spending limit was calculated based on the average of federal spending from 1970 to 2008 and would be phased in over 10 years, beginning in 2013. The problem with using historical averages is that these are not average times. Key distinctions in the coming decade include:



- An aging population that will increase the nation's health care costs;
- An increase in federal responsibilities including homeland security, prescription drug benefits, No Child Left Behind, and care for veterans returning from Afghanistan and Iraq; and
- Substantially higher spending annually to reduce the federal debt.[x]

National Commission on Fiscal Responsibility and Reform (Bowles-Simpson)

The National Commission on Fiscal Responsibility and Reform was convened by the President and both chambers of Congress to address the nation's long-term fiscal challenges. Erskine Bowles, former White House Chief of Staff, and former Senator Alan Simpson co-chaired the Commission, which included members of both political parties as well as representatives from business and labor. Their report, titled "The Moment of Truth," was released in December, 2010 and is generally referred to the Erskine-Bowles plan.[xi] Its recommendations were not supported by all of its members.

The Bowles-Simpson proposal targets a 60 percent debt-to-GDP ratio as a sustainable level of federal debt. Under the plan, all federal spending is considered, **including cuts in both defense and non-defense discretionary spending**, as well as recommendations for policy changes that would control long-term entitlement spending.

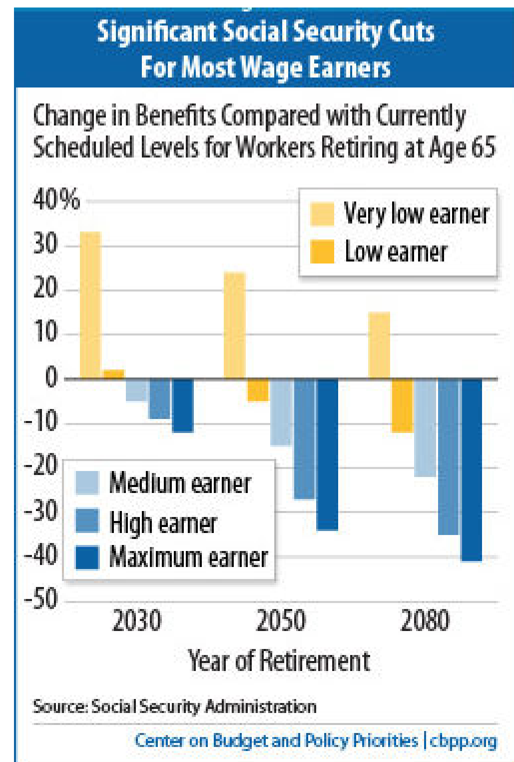
Bowles-Simpson also requires a balance between spending reductions and revenue increases. However, it requires closing the fiscal gap with two-thirds from spending cuts and one-third from revenues, **short of the recommendation that deficit reduction be evenly balanced between spending cuts and revenue increases**.

To secure the necessary spending cuts, Bowles-Simpson relies on capping spending at 21 percent of GDP, a figure consistent with the extreme scenario outlined by the Committee on the Fiscal Future of the United States. While this is slightly better than Corker-McCaskill, it still ignores current trends that will add fiscal pressure over the coming decades.

The Bowles-Simpson proposal outlines a series of guiding principles and values, including "**Don't Disrupt the Fragile Economic Recovery**."[xii] Yet plan implementation, including spending cuts, begins in 2012. As noted by the Center on Budget and Policy Priorities, "The proposal to start implementing budget cuts in *fiscal year 2012* — a short 10½ months from now

— runs a substantial risk of impeding the economic recovery. In its most recent economic forecast, the Congressional Budget Office projects that unemployment will still average 8.4 percent in fiscal year 2012 and that the gap between actual GDP and its potential level will not be closed until the end of 2014."[xiii]

Another of the Bowles-Simpson guiding principles is "**Protect the Truly Disadvantaged.**" However, because Bowles-Simpson relies on spending caps, it will likely produce cuts in many discretionary non-defense programs that serve the poor. In the longer term, the changes proposed in entitlement spending, particularly in Social Security, are problematic. While the proposal would increase benefits for the poorest fifth of Social Security beneficiaries, it would reduce benefits for the near-poor and medium wage earners:



- An earner in the middle of the wage scale would see benefits reduced by 15 percent in 2050 and by 22 percent in 2080;
- That worker, retiring in 2010, would receive a benefit of $1,397 per month, only about 55 percent above the poverty line;
- These workers often do not have any other significant source of income;
- So, a 15 – 20 percent cut would likely create financial hardship for many. [xiv]

These same seniors would also be subject to cuts in Medicare and Medicaid under the Bowles-Simpson proposal. Though the details are sketchy, the plan proposes to contain growth in these two programs after 2020. [xv]

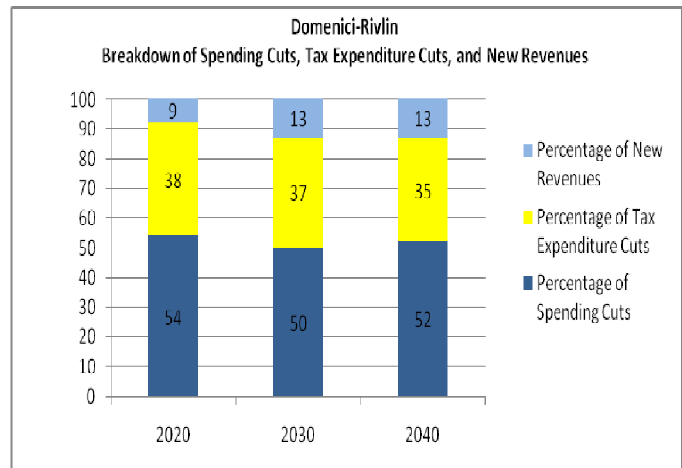
Bipartisan Policy Center Debt Reduction Task Force (Domenici-Rivlin)

In February 2010, the Bipartisan Policy Center convened a Debt Reduction Task Force, co-chaired by former Senate Budget Committee Chair Pete Domenici and former director of the Congressional Budget Office (CBO) Dr. Alice Rivlin. Members of this task force (Domenici-Rivlin) included former cabinet officers, elected officials, academics, senior citizens, and representatives from business, labor and the faith community. Their report, "Restoring America's Future," was released on November 17, 2010.

Like Bowles-Simpson, the Domenici-Rivlin proposal: considers **cuts in both defense and non-defense discretionary spending**, as well as recommendations for policy change that would control long-term entitlement spending, and **targets** a 60 percent debt-to-GDP ratio **as a sustainable level of federal debt.**

However, Domenici-Rivlin takes a more balanced approach in meeting the recommendation that **deficit reduction should be evenly balanced between spending cuts and revenue increases**, as summarized in the graph below. In terms of actual dollars saved between 2012 and 2020:

- Spending cuts would total $2.68 trillion dollars;
- Changes in current tax rules that result in lost revenue (tax expenditures) would generate $1.873 trillion dollars;
- New revenues total $435 billion.[xvi]



In contrast to the spending caps proposed in Bowles-Simpson, Domenici-Rivlin proposes to adjust federal spending to meet a target of 23 percent of GDP in 2020, with increasing percentages thereafter. These target ratios are much more realistic, and allow the flexibility to make adjustments should that be required to meet critical needs.

While the Domenici-Rivlin plan would begin in 2012, it does not begin with spending cuts. Domenici-Rivlin assumes that a robust economy is the best solution to long-term debt and takes steps to spur job creation and economic activity. Those steps, including $650 billion in tax cuts, would actually increase short-term deficits on the way to long-term economic recovery.[xvii]

Because the Domenici-Rivlin recommendations are more balanced in terms of spending cuts and revenue increases, they are less likely to harm low-income working families. Their long-term proposal for Social Security is similarly balanced. "Benefits cuts represent less than half of the improvement in solvency over 75 years and about half in the 75th year." [xviii] However, Domenici-Rivlin proposes large cuts to the health care budget, approximately $600 billion over ten years. That is significantly more than the $482 billion reduction recommended by Bowles-Simpson. Those reductions come from: increasing Medicare premiums and cost sharing; conversion of Medicaid into a voucher program for beneficiaries; and capping Medicaid growth.[xix]

Recommendations

These proposals are just that, proposals. But Congressional action on reducing the deficit and stabilizing the national debt is imminent. The most prudent policy options to address the deficit will use a balanced approach that does not jeopardize economic recovery and will incorporate two core principles:

Successful deficit reduction will be evenly balanced between spending cuts and revenue increases and will include all parts of the federal budget. The immediate need to bolster the economic recovery must be recognized and may require reasonable levels of deficit spending for several more years. Long-term deficit reduction will require a balanced approach, reining in spending while increasing much-needed revenue. Proportions should closely align with those in

Domenici-Rivlin. Moreover, true deficit reduction cannot be achieved by limiting spending cuts to non-defense discretionary spending. This principle was recognized in both Domenici-Rivlin and Bowles-Simpson. Both also acknowledge the need to focus on the public debt-to-GDP ratio. Statutory spending caps are an inefficient and potentially dangerous way to achieve spending discipline. Achieving spending targets may require caps, but they should only be used as one part of a comprehensive plan that includes revenue increases. Any use of caps should also be thoughtful and applied to specific parts of the budget, rather than as across-the-board reductions.

Successful deficit reduction will protect low-income families. Discussions of current and pending budget proposals have largely focused on mandatory cuts to non-defense, discretionary programs, which make up less than 14 percent of the federal budget. These are the programs most likely to serve low-income families, including Head Start and the Low-Income Home Energy Assistance Program (LIHEAP). Low-income families should not bear the brunt of near-term spending cuts necessary to reduce the deficit or longer-term changes to entitlement programs. By requiring across-the-board spending cuts, the Peterson-Pew and Corker-McCaskill proposals will disproportionately harm low-income families. While Bowles-Simpson and Domenici-Rivlin both deem to protect families with the lowest incomes, this concept is more fully realized in Domenici-Rivlin.

None of the current proposals are perfect. Domenici-Rivlin comes closest to the core principles articulated here, but requires changes in the recommendations for health care. With those changes, of the current proposals, it has the most chance of success in moving the nation toward a stable debt-to-GDP ratio, without compromising the economic recovery or causing undue harm to low-income families.

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[ii] Ibid.
[iii] Choosing our Fiscal Future. (2010). "Choosing the Nation's Fiscal Future." Retrieved from http://www.ourfiscalfuture.org/wp-content/uploads/chapter9_multiple_paths_to_sustainability.pdf, February2011.
[iv] Peterson-Pew Commission on Budget Reform, "About Us", Retrieved from http://budgetreform.org/about-us-0, February 2011.
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[viii] Office of Claire McCaskill. (2011), McCaskill & Corker Introduce Bill to Cut Spending Over 10 Years, Press release. Retrieved from http://mccaskill.senate.gov/?p=press_release&id=1183, February 2011.
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[xvii] Horney, J., Van de Water, P. & Greenstein, R. (2010). "Rivlin-Domenici Defict Reduction Plan is Superior to Bowles-Simpson In Most Areas," Center on Budget and Policy Priorities, November 30, 2010.
[xviii] Ibid.
[xix] Ibid.