



## CBO's Forecast Shows Long-Term Deficit Reduction Should Be the Top Budget Priority

By James C. Capretta

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Achieving the Trump administration's goal of eliminating annual federal budget deficits within 10 years will be difficult unless the administration adjusts some key commitments that President Donald Trump made during the campaign. The US economy does not need stimulus at this point. The US is already rushing toward a fiscal reckoning, driven by rising spending on entitlement programs. The administration should propose a major fiscal course correction, focused on long-term entitlement reform.

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The Trump administration is expected to release in May a full budget proposal that covers all aspects of federal spending and revenue (Reuters 2017). White House Budget Director Mick Mulvaney has indicated that he is pushing to produce a plan that would eliminate annual deficits within a 10-year window.

Achieving the goal of balance within 10 years will be difficult unless the administration adjusts some key commitments that President Donald Trump made during the campaign. Financial markets have been assuming for months that a Trump budget would be stimulative, particularly in the near term: a net tax cut of some sort, higher defense spending, new spending on infrastructure, and little restraint on the entitlement programs that are driving up federal spending. The budget would include deep cuts in annually appropriated accounts, but Congress is not expected to enact most of those proposals.

There is not anything particularly wrong with widening the federal budget deficit in the short run; it would probably not hurt the economy if it were temporary and small.

But the US economy does not need stimulus at this point. Growth is below what Americans would like and have come to expect, but the economy is growing and has been since mid-2009 (St. Louis Fed 2017). The unemployment rate is now very low (4.5 percent in March), inflation is inching toward normalcy, and interest rates are rising (BLS 2017). In short, the economy is beginning to function more normally after a long period of financial repair during the years after the deep recession of 2007 to 2009.

What would be disastrous is a large, sustained increase in federal deficits over the medium and long run, on top of the massive deficits that will occur under current law. As the latest long-term budget forecast from the Congressional Budget Office (CBO), released in March, shows, the US is

already rushing toward a fiscal reckoning of some sort; what is needed at this point is a major fiscal course correction, not additional unfinanced spending or large tax cuts that push federal revenue below the historical norm (CBO 2017b).

## Entitlement Spending Is the Problem

The primary fiscal problem confronting the United States is uninterrupted rapid growth of the nation's largest entitlement programs. In 1972, the federal government spent a combined 4.2 percent of gross domestic product (GDP) on Social Security, Medicare, and Medicaid. By 2016, spending on these programs was 10.4 percent of GDP. As entitlement spending has increased rapidly, Congress and successive administrations have squeezed annually appropriated accounts to keep federal debt from rising even faster than it has. The budgetary pressure from entitlement programs is a primary reason that defense spending is now well below what many experts believe is necessary for the nation's security and leadership position in the world.

And the entitlement problem is about to get much worse. As the US population ages and health costs continue to rise faster than general inflation, federal spending on Social Security, Medicare, Medicaid, and the subsidies for insurance contained in the Affordable Care Act will jump from 10.4 percent of GDP this year to 13.5 percent in 2030 and 15.6 percent in 2047. Entitlement spending growth and rising net interest costs on federal debt will push total federal spending from 20.7 percent of GDP this year to 26.0 percent in 2037 and 29.4 percent in 2047.

CBO projects that federal revenue will also rise as a share of the national economy, but not nearly enough to keep up with the surge in entitlement spending. This year, federal tax collection will total 18.1 percent of GDP—roughly equal to the average annual tax collection by the federal government over the past four decades (CBO 2017a). CBO expects tax receipts to rise to 19.0 percent of GDP in 2037 and 19.6 percent of GDP in 2047.

The federal budget deficit in 2017 is expected to be 2.9 percent of GDP—the same as the

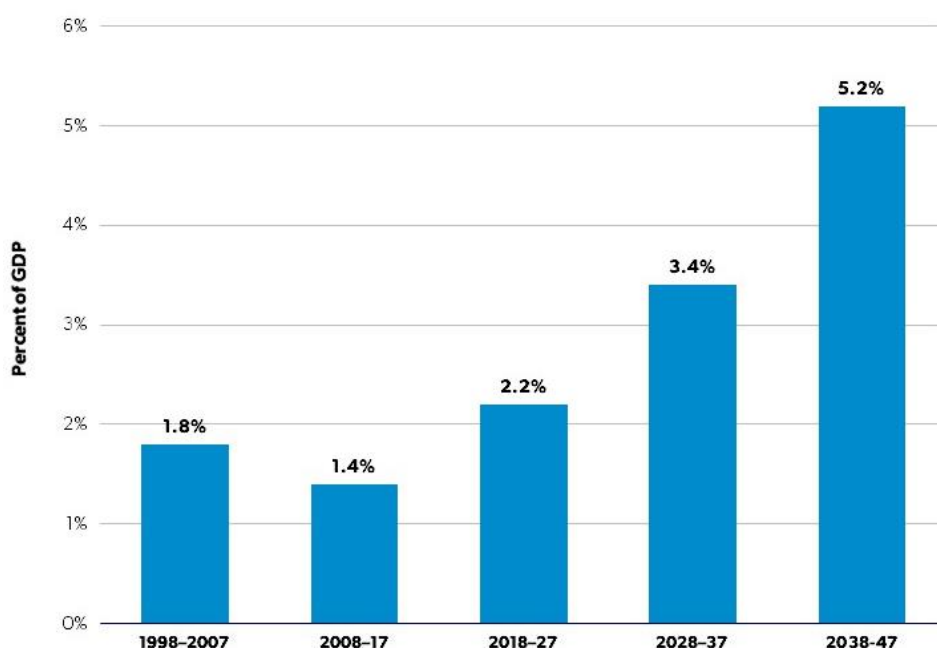
average deficit over the past 40 years. But in CBO's forecast, the gap between total federal spending and total federal revenue is expected to widen to 5.0 percent of GDP by 2027, and that assumes no recession and continued economic growth. The deficit will continue to increase steadily in the ensuing years.

As bad as CBO's base-case scenario is, it is almost certainly too optimistic. It assumes spending on all other programs besides the major entitlements will fall from 8.9 percent of GDP today to 7.6 percent in 2047. A reduction of this size would necessarily mean further deep cuts in defense spending as well as in many federal domestic programs that are financed with annual appropriations, such as the National Institutes of Health and education programs. Given the many and various threats to national security, the most likely path for defense spending is up relative to the size of the economy, not down. Further, many in Congress from both parties already believe key domestic programs are underfunded; the likelihood of permanent deep reductions in that small slice of the budget is extremely remote as well.

There is even reason to doubt CBO's projection of a modest rise in tax receipts in coming years. Some of the projected increase in revenue is from the "Cadillac tax" on high-cost insurance plans contained in the Affordable Care Act. The tax requires employers to pay an assessment of 40 percent on the value of any insurance premium payments above designated thresholds, starting in 2020. CBO expects this tax to generate substantial revenue in the coming decades because the thresholds are indexed to consumer inflation while premiums are expected to grow commensurate with more rapid health care cost inflation. But both parties in Congress voted overwhelming in 2015 to delay the initiation of the tax from 2018 to 2020, and Republicans were poised to delay it to 2026 in the American Health Care Act before the legislation was pulled back from a vote in the House. There is little reason to believe this tax will generate the revenue bump now assumed in CBO's baseline.

Adjusting CBO's forecast even modestly for higher defense spending, or lower federal revenue, would accelerate the projected run-up in

**Figure 1. Average Annual Federal Net Interest Spending**



Sources: CBO 2017a and 2017b.

debt and increase the size of the fiscal correction necessary to lessen the risk of a crisis.

## **The Fiscal Consequences of Interest Rate Normalcy**

The fiscal consequences of the large run-up in federal debt since the 2007–09 recession began have been partially obscured by the abnormally low interest rates payable on Treasury securities since the financial crisis. In 2008, when federal debt was at 39 percent of GDP, federal spending on net interest payments was 1.7 percent of GDP. This year, net interest payments will be less—just 1.3 percent of GDP—even though federal debt has nearly doubled since 2008 and is now 77 percent of GDP. The modest level of net interest payments is due to the low, and historically abnormal, borrowing costs attached to Treasury debt since 2009.

CBO and most outside forecasters expect the interest rate environment to gradually return to something approaching normalcy in the coming years. In CBO’s baseline forecast, the interest rate on 10-year Treasury notes is expected to rise from

2.3 percent this year to 3.0 percent in 2019 and 2020 and 3.6 percent during the period 2021 to 2027.

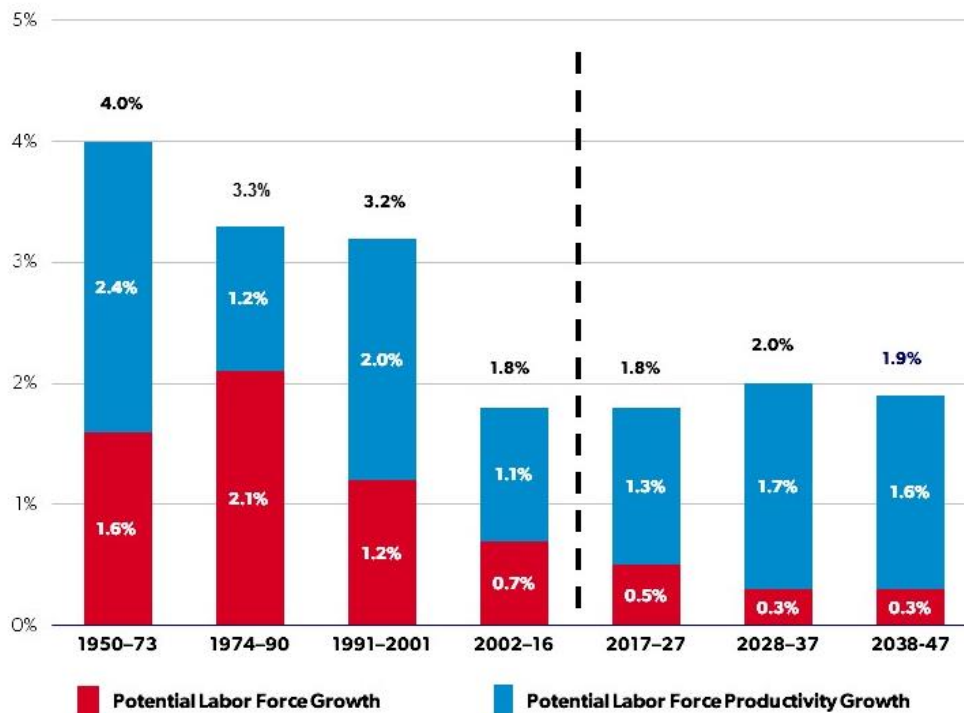
As interest rates rise and the federal debt continues to grow, the government will need to spend an ever-growing amount to service the debt. As shown in Figure 1, federal net interest payments averaged 1.8 percent of GDP from 1998 to 2007 and 1.4 percent of GDP from 2008 to 2017. Over the next decade, however, CBO expects net interest payments to jump to an average of 2.2 percent of GDP annually and then to 3.4 percent from 2028 to 2037 and 5.2 percent from 2038 to 2047.

## **An Aging Population Drives Up Spending and Slows Growth**

It is tempting to believe the nation’s fiscal problems can be solved with higher levels of economic growth. There would be more revenue and thus less need for restraint in popular spending programs.

But CBO’s analysis shows it would be unwise to count on growth to solve the nation’s fiscal

**Figure 2. Average Annual Growth Rates in Potential GDP**



Sources: CBO 2017b.

problems. The same demographic forces driving up entitlement spending—longer lifespans and lower fertility rates—are also contributing to a slowdown in potential GDP growth.

Potential GDP is a function of the size of the labor force and the output per worker. As the population ages and women have fewer children, the growth rate of the labor force slows. As Figure 2 shows, from 1950 to 1973, US GDP grew at an average annual rate of 4.0 percent, driven by a 1.6 percent annual growth in the labor force. CBO's forecast shows growth in the labor force slowing to just an average annual rate of 0.3 percent over 2028–47. Higher rates of productivity growth cannot easily offset a drop in the growth rate of the labor force in excess of 1 percent annually, and building fiscal policy on such an unrealistic expectation would be imprudent.

### **Four Reasons Excessive Public Debt Threatens the United States**

US Treasury debt remains the standard for a safe, risk-free investment. It is easy for the federal

government to borrow money. But there is a point beyond which even the US faces risks from elevated levels of debt. CBO identifies four concerns with persistent, excessive borrowing (CBO 2010):

- **Lower savings means slower income growth.** Federal deficits reduce total savings and investment, thus leading to slower income growth. In the short run, deficits can help with a recession or exceptionally slow growth. But over the medium and long run, persistent large deficits make sustaining strong growth more difficult.
- **Rising interest costs squeeze out other spending priorities.** Large debt forces current and future taxpayers to finance excessive consumption by previous generations at the expense of making larger public investments that could boost economic prospects for the future.
- **There is less fiscal flexibility in a crisis.** If the federal government runs large

deficits even during times of benign economic conditions, it will be less able to adjust public policy in response to a crisis, such as an economic downturn or a war. As a result, policymakers might be reluctant to act decisively even if the circumstances call for it.

- **There is a higher risk of a debt-induced economic crisis.** It cannot be ruled out that, at some point, excessive debt will create a sudden and disruptive reevaluation of the safety of investing in Treasury debt. If that were to occur, interest rates could spike, and it could become harder for the US to secure the funds it needs to meet its obligation. This is the point at which other countries have faced deep crises threatening their political institutions.

## Delaying Action Will Make the Needed Correction More Painful

For many years we have known that the aging of the population would require a significant adjustment in the largest federal spending programs. More than 20 years ago, President Bill Clinton established the Kerrey-Danforth Commission to recommend changes in entitlement and tax policy to close the long-term fiscal gap between projected federal revenues and spending. That was followed a few years later by a commission headed by Senator John Breaux (D-LA) and Representative Bill Thomas (R-CA) to reform Medicare. Neither commission resulted in meaningful action in Congress. President Barack Obama and Speaker of the House John Boehner engaged in extensive negotiations on a long-term budget framework, but that effort also failed to produce a legislative agreement.

As the years have gone by, the problem has grown, and the solutions required to return to a sustainable fiscal trajectory have become more dramatic.

CBO estimates that, to keep federal debt at its current proportion of the economy (77 percent of GDP), Congress would need to impose an immediate and permanent combined spending cut and tax increase of 1.9 percent of GDP. If Congress and the president wait for another

decade, the combined spending cut and tax increase would need to be 2.9 percent of GDP. Bringing aggregated federal debt down to the postwar norm of around 40 percent of GDP would require even more severe spending cuts and tax increases, totaling 3.1 percent of GDP annually if implemented immediately and 4.6 percent of GDP annually if implemented beginning in 2028.

## A Budget to Fit the Times

OMB Director Mulvaney has said the Trump administration wants a budget plan that reaches balance within 10 years. That will not be possible with the spending cuts in the administration's preliminary budget (OMB 2017). That budget covered only the annually appropriated spending accounts, not entitlement programs or tax receipts. While the administration did propose deep reductions in most domestic agencies to pay for an increase in defense funding, most of those cuts are too indiscriminate and lacking in a clear rationale to survive in Congress. They are also far too small to close the large deficits expected in the coming decade.

While aiming for balance within 10 years is admirable, it is less important to reach that goal than to stay focused on federal finances over a longer period of time.

As the administration and Congress develop their budget plan, some key considerations should guide its development:

**Revenue Neutrality.** Pro-growth tax reform should be close to revenue neutral over the long term. Federal tax law badly needs reform, but not because revenues are too high. In 2016, total federal revenue was 17.8 percent of GDP, exactly equal to the average annual amount over the past four decades. The fundamental problem is that current tax law distorts economic decisions in ways that slow economic growth, especially by favoring consumption over saving and investment. The ideal tax reform plan would lower corporate and individual rates and would broaden the tax base sufficiently to keep the total revenue at roughly the historical level of 18 percent of GDP.



**A Budget-Neutral Infrastructure Plan.** The Trump administration is preparing a large new investment plan for the nation's infrastructure. This would come a little more than a year after Congress passed a large highway reauthorization program (Laing 2015). The case for a massive injection of federal money is not strong; the legislation could easily descend into an exercise in wasteful, congressionally directed projects that would not be approved absent political intervention. If there is an infrastructure plan, it should not add to the nation's budget deficit or to long-term liabilities.

**Significant, Long-Term Medicaid Reform.** The administration and Congress could take an important step forward on entitlement reform by enacting a modified version of the Medicaid reform plan contained in the House GOP's American Health Care Act (AHCA) (US House of Representatives 2017). The AHCA was pulled before it was voted on in the House due to a number of concerns with its current design. Nonetheless, if enacted, the Medicaid reform in the legislation would dramatically improve the long-term budget outlook by moving away from the traditional, open-ended federal matching system that finances Medicaid today. Under the AHCA, the federal government's contribution to Medicaid would be capped on a per-person basis, based on historical spending patterns. The caps would then be indexed to medical inflation (and to medical inflation plus 1 percentage point for the elderly and disabled). States would have more flexibility to manage the program within the federal per-person payments.

The per capita payment system would give the states strong incentives to improve the program's efficiency because the federal contribution would be limited. However, the proposal is unlikely to be enacted in its current form because of the large reduction in federal support for states that adopted the Medicaid expansion under the Affordable Care Act. CBO estimates the AHCA would reduce Medicaid spending by \$839 billion over 10 years (Hall 2017).

The administration and Congress should pursue a compromise national eligibility level in Medicaid that strikes an appropriate balance between the states that expanded the program

and those that did not. A compromise of this kind would be entirely compatible with the structure of reform proposed in the AHCA.

**Social Security Disability Reform.** President Trump pledged not to alter Social Security benefits in a significant way, but that is compatible with taking steps to prevent the insolvency of the disability portion of the program. The number of monthly disability insurance beneficiaries of the disability insurance program has grown dramatically over the past two decades, due to changes in the eligibility rules and in how they are implemented. As a result, program spending has soared, and the program's trust fund is now scheduled to be depleted by 2022.

There is no simple fix for the program's flaws. A comprehensive reform plan could emphasize a return to work for those well enough to do so, and a revision to the system for determining eligibility for benefits that ensures funds are targeted to the truly disabled.

**Medicare Savings.** Like Social Security, President Trump has vowed not to touch Medicare. But many things can be done to improve the program's efficiency while leaving benefits intact. Using existing administrative authority, the administration can improve the system beneficiaries use to select their Medicare coverage and can inject more competition and consumer choice into the "delivery system reforms" put in place by the Obama administration. These reforms would constitute a first step in lowering the long-term costs of the program to a more manageable level.

**Higher Defense Spending, and a Freeze on Domestic Appropriations.** There is widespread agreement that a large adjustment is needed to raise defense spending to a level commensurate with the military risks prevalent around the world. That is a necessary but expensive spending commitment that needs to be included in a revised budget framework.

The Trump administration is trying to pay for this necessary increase in military resources with cuts in other appropriated accounts, but that is unlikely to work because the cuts cannot be easily justified.

A more realistic approach would combine a revised, multiyear commitment to defense with a revised multiyear freeze in other appropriated spending, followed by increases tied to general inflation. A temporary freeze of three to five years would require most agencies to find 2 or 3 percent savings in their budgets each year during that period—for cumulative savings of perhaps 10 to 15 percent after several years of reforms, which is a reasonable goal. Overall discretionary spending would increase, but that increase could be covered by the Medicaid and other entitlement reforms contained in the rest of the plan.

## Conclusion

The Trump administration has inherited a relatively strong economy that is near full

employment and a federal budget that is badly out of balance over the long run. Increasing the pace of long-term economic growth should be the top priority and is a necessary condition for making progress on a range of issues. But promoting growth is not inconsistent with improving the long-term budget outlook at the same time. The country does not need a massive stimulus that exacerbates the long-term debt problem.

Indeed, with the economy near full employment, now is the time to phase-in adjustments that lower the spending trajectory of the major entitlement programs. The current political environment is especially conducive to passing a significant reform of the Medicaid program. Congress and the administration should not let this opportunity slip away.

## About the Author

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