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# THE RIGHT TARGET: STABILIZE THE FEDERAL DEBT

## Long-Term Budget Outlook Is Bleak; Requires Major Changes to Programs, Revenues, and Health Care

## Policymakers Should Set Target of Stabilizing Debt-to-GDP Ratio

By Kathy Ruffing, Kris Cox, and James Horney

### Summary

Deficits and debt will rise to unprecedented levels in coming decades without major changes in federal budget policies, so policymakers should set a goal of stabilizing the debt as a share of gross domestic product over the next decade.

This report presents new Center on Budget and Policy Priorities projections of federal spending, revenues, deficits, and debt through 2050. These projections — like previous projections that we have issued and analyses by other institutions such as the Congressional Budget Office (CBO), the Government Accountability Office, and the Office of Management and Budget — show that without changes in current policies, federal deficits and debt will grow in coming decades to unprecedented levels that threaten serious harm to the economy.

Reducing deficits in the short term, however, would undercut the fragile economic recovery. Policymakers should tolerate large deficits over the next several years in order to maintain strong aggregate demand until the economy is back on its feet. Moreover, they can take comfort in the fact that temporary measures intended to aid recovery add very little to the long-term deficit problem. The increase in deficits for several years pales in comparison to the size of the economy over the long run.

As the economy recovers, however, policymakers will need to demonstrate to the public and the lenders who finance our borrowing needs that they are prepared to move the budget toward a sustainable long-run path. President Obama's initial budget proposal and the health reform packages that the House and Senate have passed represent first steps toward putting the federal budget on a sounder footing. (Health reform is crucial because rising spending for health care is the major force driving the projected future growth in federal deficits and debt.) They are, however, only first steps. Much will need to be done to address the full scope of the long-term budget problem.

It would be advisable for policymakers to act sooner rather than later on a package of credible deficit reductions, while delaying the effective date of some provisions by several years until the economy is in much stronger shape. Policymakers should also expect to return to long-term deficit reduction multiple times over coming decades; the problem is far too large to address in a single legislative package. For one thing, political limitations on the amount of pain that can be delivered in a single dose would make it unlikely that a single package large enough to put the budget on a sustainable long-term path in one fell swoop could be enacted. Just as importantly, uncertainty about key factors — notably about the economy's path and the future growth of health care costs — mean that we cannot judge now the best way to solve the long-run problem once and for all. Nevertheless, policymakers should start soon to work on major policy changes.

The large temporary deficits created by the economic downturn, and the policies enacted in response, have focused welcome attention on the nation's short- and long-term fiscal situation. Policymakers face hard choices about how to address growing deficits and debt. This paper lays out the main drivers of our long-term fiscal problem and discusses a reasonable goal for attaining fiscal sustainability — stabilization of the nation's debt.

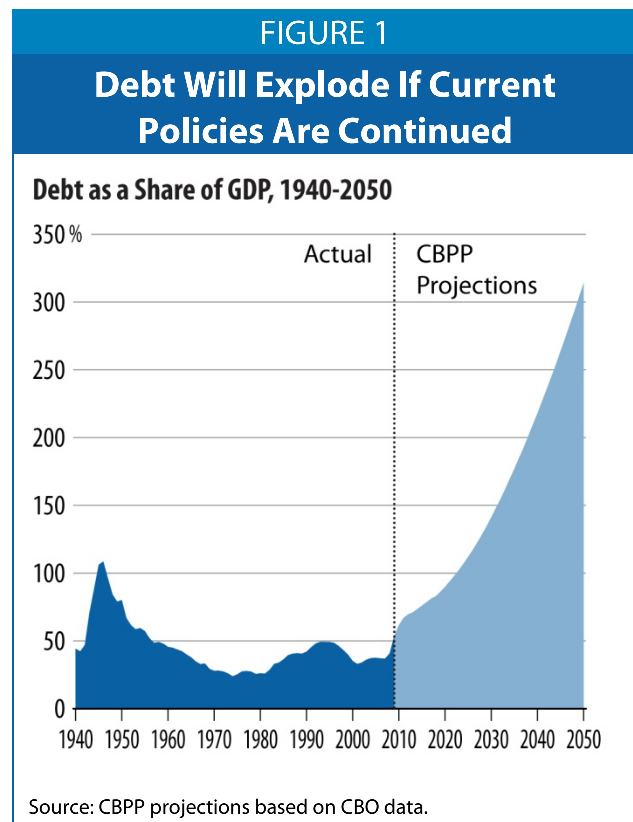
The report's principal findings are:

- **Deficits and debt are headed for dangerously high levels.** If we continue current policies, the federal debt will skyrocket from 53 percent of the gross domestic product (GDP) at the end of fiscal year 2009 to more than 300 percent of GDP in 2050. That would be almost three times the existing record (which was set when the debt reached 110 percent of GDP at the end of World War II) and would threaten significant harm to the economy. (See Figure 1.) In addition, under current policies, the annual budget deficit is projected to exceed 20 percent of GDP by 2050.

  Deficits and debt are projected to grow this much because expenditures — largely driven by rising health care costs — will grow more quickly than revenues as a share of GDP between now and 2050. Without policy changes, we project that *program* expenditures (i.e., expenditures for everything other than interest payments on the national debt) will increase from 19.2 percent of GDP in 2008 to 24.5 percent in 2050.[1] We project that revenues will be at 18.2 percent of

FIGURE 1

**Debt Will Explode If Current Policies Are Continued**



Source: CBPP projections based on CBO data.

[1] Automatic stabilizers — safety net programs whose outlays rise during recessions — along with temporary expenditures needed to stabilize the financial system and provide additional stimulus to the economy caused program expenditures to surge to 24.9 percent of GDP in 2009. Expenditures are projected to remain elevated for several years while the economy recovers. Thus, we use 2008, a more normal year, as the benchmark here.

GDP in 2050, which is below their average of 18.4 percent of GDP over the 30 years through 2008, a level that was insufficient to cover expenditures during most of that period. The federal budget was balanced only four times in those 30 years, and in all four of those years, revenues stood at 20 percent to 21 percent of GDP.

- **A stable debt-to-GDP ratio should be the goal for achieving fiscal sustainability.** The "fiscal gap" — defined here as the average amount of program reductions or revenue increases that would be needed every year over the next four decades to stabilize the debt at its 2010 level as a share of the economy — equals 4.9 percent of projected GDP. That is a very large amount. To eliminate that gap would require a *28 percent* increase in tax revenues or a *22 percent* reduction in program (non-interest) expenditures over the entire 40-year period from now to 2050 (or, more realistically, a combination of tax increases and spending cuts).

  It is, of course, both unrealistic and unnecessary to solve the next four decades' problem all at once. But policymakers should act soon to start stabilizing the debt as a share of the economy in the medium term (i.e., over the next decade). The longer they wait after the economy has recovered, the more painful and severe the budget and tax policy changes ultimately will need to be.

  Practically speaking, this will entail trimming deficits by about half — to about 3 percent of GDP — over the coming decade; at that level, the debt will no longer be rising faster than the economy. Shrinking the deficit to 3 percent of GDP at the same time that the baby boom generation — the huge cohort born between 1946 and 1964 — will begin to retire in large numbers and swell the Social Security and Medicare rolls will be no easy task.

- **Rising health care costs are the single largest cause of rapidly rising expenditures, and ongoing reform of the health care system is absolutely fundamental to any solution.** The two main sources of rising federal expenditures over the long run are rising per-person costs throughout the U.S. health care system (both public and private) and the aging of the population. Together, these factors will drive up spending for the "big three" domestic programs: Medicare, Medicaid, and Social Security. Growth in those programs accounts for *all* of the increase in federal spending as a share of GDP over the next 40 years (and beyond).

  Health care costs are by far the biggest single factor. For the past 30 years, costs per person throughout the health care system have been growing approximately two percentage points faster per year than per-capita GDP. Our baseline projections assume this pattern will continue through 2050. Over time, the fiscal consequences of this rate of growth in health costs are massive.[2]

  Rising costs throughout the health care system exacerbate the long-term budget problem in two ways. As is well known, they increase federal spending directly by raising the cost per beneficiary of providing health care through Medicare and Medicaid. Less well understood is that rising health costs raise deficits even further by eroding the tax base. Because of tax

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[2] CBO judges that the health reform bills would reduce the deficit in the current decade and in subsequent decades, but it is difficult to quantify the resulting change in health care cost growth over the long run with much certainty. Historical trends strongly suggest that, even with reform, substantial additional steps to slow the rise of health care costs will be necessary in coming decades.

preferences for employer-sponsored health coverage and certain other health care spending, when health care costs grow faster than the economy, the share of income that is exempt from taxation increases and the revenue base shrinks.

Our knowledge about ways to constrain health cost growth while improving the quality of care system-wide is limited. As discussed further below, both the House- and Senate-passed health care bills take essential steps to begin addressing this problem, in part by funding demonstration projects that will expand our understanding of what works. As we learn more, policymakers will need to revisit the issue — almost certainly more than once — to act on the findings.

- **Upcoming tax policy decisions will have a major impact on the size of the problem.** If policymakers were to allow all of the 2001 and 2003 tax cuts to expire as scheduled at the end of 2010 — or fully offset the cost of extending those tax cuts they choose to extend — this alone would shrink the fiscal gap by almost two-fifths, from 4.9 percent of GDP to 3.0 percent. The effect is this substantial because the budgetary benefits would start almost immediately (in 2011), and those benefits would reduce projected interest payments by a growing amount with each passing decade. But even if Congress were to allow all of the tax cuts to expire or to offset the full cost of extending them (which is extremely unlikely), the budget would still remain on an unsustainable long-run path.

- **The recession and programs enacted to spur economic recovery are *not* an important factor with regard to the long-term fiscal problem.** CBO forecasts that the economy will return to its potential by 2013. As a result, the deep recession that the nation is now experiencing is not responsible for a significant portion of the long-run budget gap. Nor are the policies that Congress enacted in response to the recession; the American Recovery and Reinvestment Act enacted in February 2009 has added only very slightly to the long-run gap, because its provisions are strictly temporary. Likewise, additional expenditures to support economic recovery of the magnitude that is now being considered would have only a tiny effect on the long-term picture. (See the box on page 6.)

- **Federal spending for programs other than the "big three" is not responsible for the long-term imbalance.** Total spending for all federal programs other than Medicare, Medicaid, and Social Security — which includes federal entitlement programs other than these "big three" — is projected to *shrink* as a share of the economy in coming decades. These programs will consume a smaller share of the nation's resources in 2050 than they do today. As a result, they are not part of the cause of the long-term fiscal problem. Statements that we face a *general* "entitlement crisis" thus are mistaken.

The bottom line is that, as the economy recovers, policymakers should begin to implement a balanced approach to addressing the nation's long-term fiscal problem, through a combination of sustained reforms of the U.S. health care system, reductions in federal expenditures, and increases in federal tax revenues.