The Moscow Times
30 YEARS
INDEPENDENT NEWS FROM RUSSIA

The United States' Misplaced Deficit Complacency

By Martin Feldstein

June 03, 2013

The U.S. still faces a dangerous fiscal deficit, but one might not know it from the complacency that dominates budget discussions in Washington. Regarded as an urgent problem until recently, the federal deficit is now being placed on the back burner of U.S. politics.

The shift was triggered by the revised deficit forecasts recently published by the Congressional Budget Office, or CBO, the independent technical agency responsible for advising Congress on budget issues. According to the CBO's report, the U.S. fiscal deficit will decline from 7 percent of gross domestic product in 2012 to 4 percent in 2013. This reduction reflects the cuts in government spending on defense and nondefense programs mandated by the budget "sequester" that took effect in March, as well as the revenue rise caused by higher rates for income and payroll taxes since the end of 2012.

More striking, the CBO projects that the deficit will continue to decline rapidly, reaching just 2.1 percent of GDP in 2015, before rising gradually to just 3.5 percent of GDP in 2023. That path of deficits implies that the government debt-to-GDP ratio will remain at about the current level of 75 percent for the next 10 years.

The U.S. complaceny about future deficits prevents it from trimming the long-term debt.

Unfortunately, these headline-grabbing numbers are not likely to be borne out in reality; even the CBO does not believe that they represent what will occur. Instead, these forecasts represent a "baseline" scenario that the CBO is required to present. The CBO's "baseline budget" assumes that all of the deficit-reducing features in current law will remain unchanged. These include, for example, an old legislative requirement that payments to physicians in the government's Medicare program be reduced sharply in future years, a requirement that the U.S. Congress has voted each year to "postpone."

To provide better guidance, the CBO presents an "alternative fiscal scenario," in which such very unlikely features are removed from the forecast. The alternative forecast implies that the annual budget deficit at the end of 10 years will be back up to 4.7 percent of GDP, with the debt-to-GDP ratio at 83 percent and rising. And those estimates are based on the optimistic assumption that the economy will have returned gradually to full employment with low inflation and moderate interest rates.

Officials and others who favor stimulating growth through increased government spending ignore the CBO's more realistic alternative scenario. They buttress their argument that the deficit is not an immediate problem by pointing to very low interest rates on long-term government debt, with a 2 percent yield on the 10-year Treasury bond and a negative real interest rate on Treasury inflation-protected bonds. But such low rates do not reflect ordinary market sentiment. Rather, they stem from the fact that the Federal Reserve is now buying more long-term securities than the government is issuing to finance the budget deficit.

Looking further ahead, the CBO warns that the combination of a rapidly aging population and the increase in medical costs will cause the deficit to rise rapidly, driven by the higher costs of pension and health-care benefits for middle-income retirees. According to the CBO, without legislative changes, the fiscal deficit in 2037 will be 17 percent of GDP, while the national debt will increase to more than 195 percent of GDP.

A large, rising national debt is a serious danger to an economy's health. Higher debt-service costs require higher tax rates, which in turn weaken incentives and reduce economic growth. By the end of the decade, the U.S. will have to pay an amount equivalent to more than one-third of the revenue from personal-income taxes just to pay the interest on the national debt.

Foreign investors now hold more than half of that debt. Paying interest to them requires sending more goods and services to the rest of the world than the U.S. receives from the rest of the world. That requires a weaker dollar to make U.S. goods more attractive to foreign buyers and to make foreign goods more expensive to U.S. consumers. The weaker dollar reduces the U.S. standard of living.

A large national debt also limits the government's ability to respond to emergencies, including both military threats and economic downturns. And it makes the U.S. vulnerable to changes in financial-market sentiment, as the European experience has shown.

Reducing future deficits and reversing the rise in the national debt require raising tax revenue and slowing the growth of government pension and healthcare programs. Tax revenue can be raised without increasing marginal tax rates by limiting the tax subsidies that are built into the current tax code. Those subsidies are a hidden form of government spending on everything from home mortgages and health insurance to the purchase of hybrid cars and residential solar panels.

Slowing the growth of the pension and healthcare programs for middle-class retirees cannot be done abruptly. It must begin by giving notice to those who are now a decade away from retirement, which is why it is important to initiate these reforms now.

Unfortunately, the new complacency about future deficits makes it difficult, if not impossible, to enact laws needed to begin the process of trimming the United States' long-term fiscal deficit. It is important for policymakers and the public alike to understand the real fiscal outlook and the damage that high deficits will cause if prompt action is not taken. Merely moving the problem to the back burner will not prevent it from boiling over.

Martin Feldstein, professor of economics at Harvard University and president emeritus of the National Bureau of Economic Research, chaired President Ronald Reagan's Council of Economic Advisers from 1982 to 1984.