

Déjà Vu All Over Again:
On the Dismal Prospects for the Federal Budget

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ABSTRACT

We provide new estimates of the federal budget outlook over 10-year and long-term horizons under three sets of assumptions: the Congressional Budget Office baseline, which assumes no changes in current law; an extended policy scenario, in which it is assumed that future Congresses act more or less like previous Congresses in extending expiring provisions; and the Administration budget. Under either the extended policy or the Obama policy scenarios, deficits are high and rising over the second half of the decade, despite the assumption that the economy is in full employment. In 2020, the deficit is projected to be between 5 and 7 percent of GDP and the debt/GDP ratio is projected to exceed 90 percent. These figures only deteriorate with the passage of time. The long-term fiscal gap – the size of the immediate and permanent change in spending or taxes needed to keep the long-term debt/GDP ratio at its current level – is in the range of 6-9 percent of GDP. Further health care reform can be an important part of reducing the fiscal gap, but the problem is far too large to be solved by plausible reductions in health care spending alone. Postponing the onset of a fiscal package will make the problem even harder: even just a 5-year delay in implementation would raise the required fiscal adjustment by about 0.4 percent of GDP, or almost \$60 billion per year.

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I. Introduction

The United States faces the prospects of large federal fiscal deficits in the immediate future, the next 10 years, and the longer term. The short-term deficits – the result of the tax cuts and spending increases of the last decade, the “Great Recession,” and economic policy adjustments in the past year – are generally thought to be helping the economic recovery. In contrast, the medium-term deficits projected for the next 10 years and the long-term deficits projected beyond 2020 are a source of concern. Even if they do not lead immediately to a “crisis,” they will nevertheless create growing and serious burdens on the economy.

The unsustainability of federal fiscal policy has been discussed at the least since the 1980s. But the problem has increased in importance and urgency in recent years, for several reasons. First, the medium-term projections have deteriorated significantly. Second, the issues driving the long-term projections – in particular, the retirement of the baby boom and the aging of the population and the resulting pressure on Medicare and to some extent Social Security – which were several decades away in the 1980s, are now imminent. Third, there are increasing questions about the rest of the world's appetite for U.S. debt, as the U.S. has changed from a net creditor country in 1980 to a vast net borrower currently. Fourth, many countries around the world and many of the 50 states also face daunting fiscal prospects currently.

In light of these issues, this paper provides new projections of the federal budget over the medium and long terms.¹ The analysis begins with the Congressional Budget Office (CBO) baseline budget projections. CBO (2010b) projects the 2010 deficit to be \$1.4 trillion, about 9.4 percent of GDP. Other than 2009, this represents the largest deficit share of the economy since World War II. For 2011-2020, the CBO baseline (adjusted for the effects of recent health care legislation) projects a cumulative deficit of \$5.8 trillion, with deficits declining sharply to 2.3 percent of GDP by 2014 and remaining below 3.0 percent of GDP through 2020. This would be a reassuring outcome, except that the CBO baseline is not intended to represent likely or probable outcomes. Rather, it reports the implications of the assumption, essentially, that Congress does nothing over the next 10 years. All expiring tax provisions are assumed to expire as scheduled, for example.

A more plausible way to project future outcomes may be to assume that future Congresses will act more or less like previous Congresses, for example in granting continuances to expiring tax provisions. To generate a better measure of where fiscal policy is headed, we alter the CBO baseline assumptions in ways that we believe are more representative of the continuation of current policies. Under this extended policy scenario, we estimate a ten-year deficit of \$11.3 trillion, or 6.0 percent of GDP. As in CBO's baseline, deficits decline in the near term, but only to 4.8 percent of GDP by 2014, and unlike in CBO's baseline, deficits then rise substantially, to 6.8 percent of GDP by 2020.

A third way to project future outcomes is to examine the Administration's budget proposals. These figures are not quite as bad as under extended policy, but are troubling

¹ This paper builds on analysis and conventions we have developed in numerous previous papers including Auerbach and Gale (1999, 2000, 2001, 2009), Auerbach et al. (2003), and Auerbach, Furman and Gale (2007, 2008).

nonetheless. The ten-year deficit under Obama policy is projected to be \$9.0 trillion. The deficit declines to 4.0 percent of GDP by 2014. By 2020, although the economy is projected to have been at full employment for several years, the deficit rises to 5.5 percent of GDP. Spending rises to 24.7 percent of GDP (the highest since World War II, except for the current downturn), the debt-to-GDP ratio rises to 90 percent (the highest since 1947), and net interest payments rise to 4.0 percent of GDP (the highest share ever and larger than defense or non-defense discretionary spending).

All of these figures are poised to rise further after 2020, implying that the situation is unsustainable. The debt-to-GDP ratio will pass its 1946 high of 108.6 percent by 2033 under the CBO baseline, but much sooner – in 2023 and 2025, respectively – under extended policy or Obama policy. Under all three scenarios, however, the debt-to-GDP ratio would then continue to rise rapidly, contrary to its sharp decline in the years immediately after 1946.

To examine these issues more formally, we estimate a long-term fiscal gap – the immediate and permanent increase in taxes or reduction in spending that would keep the long-term debt-to-GDP ratio at its current level. Depending on the time frame employed, the long-term fiscal gap is about 5-6 percent of GDP under the assumptions in the CBO baseline, about 6-8 percent of GDP under the assumptions under Obama policy, and about 7-9 percent of GDP in the extended policy baseline.

Even very substantial and sustained reform of health care will slash only a small share of these estimated gaps. As a result, the budget outlook will create difficult trade-offs for policy makers and the American public.

II. The Ten-Year Outlook

A. Three Scenarios

This section presents three estimates of the 10-year budget-outlook. The first estimate is simply the CBO March 2010 baseline (CBO 2010b), adjusted to include the effects of the recent health care reform legislation (The Health Care and Education Reconciliation Act of 2010).²

The second approach, which we call extended policy, examines the implications of continuing the tax and spending policies that are in place currently. Table 1 displays these adjustments relative to the CBO baseline (with annual details in Appendix Table 1). First, CBO assumes that all temporary tax provisions (other than excise taxes dedicated to trust funds) expire as scheduled. The large majority of the tax cuts enacted since 2001 expire or sunset by the beginning of 2011. A variety of other tax provisions that have statutory expiration dates are routinely extended for a few years at a time as their expiration date approaches. We assume that all of

² The CBO (2010d) score for the health care legislation spanned 2009 to 2019 and did not include a specific score for 2020. To approximate the budget effects of the health legislation in 2020, we extrapolated the revenue and spending components of the bill. See footnote 15 for details.

these provisions will be extended.³ We do not, however, assume the extension of tax provisions introduced or substantially expanded by the stimulus package.⁴

Second, the alternative minimum tax (AMT) will grow to affect more than 37 million households by 2020 under current law (see Tax Policy Center 2009). Congress has repeatedly endorsed tax policies that limit the growth in households affected by the AMT. Our estimates reflect the continuation of this choice in two ways. We assume that AMT provisions that expire at the end of 2009 – including higher AMT exemption levels that had been in place since the 2001 tax cuts and the use of personal nonrefundable credits against the AMT, which had been in place for an even longer period – are granted a continuance. We index the AMT exemption amount for inflation starting in 2010.

Third, under current law, payments to physicians under Medicare will decline by about 21 percent in 2010, by 6 percent in 2011, and by about 2 per year through 2020. In the past, however, the Administration and Congress stepped in to postpone such reductions. We assume similar actions will prevail in the future, so we include the costs of freezing physician payment rates under Medicare at their 2009 levels.

The fourth issue involves discretionary spending. Unlike taxes and entitlement spending, which are governed by current law, discretionary spending typically requires new appropriations by Congress each year. The CBO baseline assumes that discretionary spending will remain constant in real dollars at the level prevailing in the first year of the budget period. We divide discretionary spending into three categories and make different assumptions with respect to each. First, we assume (as does the CBO) that discretionary spending in the stimulus package is allowed to expire as scheduled. Second, for non-stimulus, non-defense discretionary spending, we note that maintaining current services often would require increases for both inflation and population growth, rather than just inflation.⁵ Accordingly, we adjust baseline expenditures to allow for population growth. Third, with respect to defense spending, we assume that defense spending will follow the policy outlined in the President's 2011 budget. Such a policy calls for steep decreases in war-related defense funding after 2011. Funding for wars in Iraq and Afghanistan would decrease slightly – from \$161 billion in 2010 to \$159 billion in 2011 – before dropping precipitously to \$50 billion per year through 2020. This adjustment results in a \$338 billion decrease in defense spending relative to the CBO's baseline.

The third estimate of the budget outlook is derived from CBO's estimate of the Administration's budget (CBO 2010b). As can be seen in Table 2 (with annual details in Appendix Table 2), relative to current law (the CBO baseline), the Administration proposes a raft

³ CBO (2010a) reports that the baseline includes \$950 billion in outlays, not including debt service costs, for mandatory spending programs that are assumed to be extended beyond their expiration dates.

⁴ Since the stimulus package expanded some existing tax provisions, judgment is required to make the distinction between stimulus and non-stimulus expiring provisions. Our calculations are similar to those made by Ruffing and Horney (2010).

⁵ In some cases, like veterans' health benefits, even larger increases might be needed to maintain current services (because the number of veterans may rise faster than the population and because health costs may rise faster than the overall price level).

of tax cuts and significant new spending on defense, education, health, and other programs. Although not shown in Table 2, President Obama's policies can be also described and characterized relative to the extended policy scenario.⁶ Relative to extended policy, the Administration's budget proposals include significant increases in taxes on high-income households (including the estate tax, the top income tax rates, capital gains and dividend taxes, and reimposition of the phase-outs of itemized deductions and personal exemptions), tax cuts for lower-income households, closing of corporate income tax loopholes, expansion of the Pell Grant program and recharacterization of the public subsidy for student loans, and increases in nondefense, non-education discretionary spending.⁷

B. Results

The three approaches to the ten-year budget outlook display several important differences. The time paths of deficits differ under the alternative scenarios (Figure 1 and Appendix Tables 1 and 2). All the measures show deficits shrinking sharply relative to GDP through the recovery, but CBO's baseline shows a steeper drop through 2014 and a slower increase in the deficit as a share of GDP after 2014, while the extended policy baseline and Obama policy show more rapid increases in the deficit as a share of GDP over the last six years of the projection. Note also that because the economy is expected to reach full employment by around 2015, all of the deficit figures for subsequent years represent "full employment" deficits.

More specifically, the CBO baseline shows deficits declining by 7 percent of GDP from 2010 to 2014 and then remaining roughly constant thereafter at just under 3 percent of GDP. The sharp decline through 2014 is the result of a recovering economy, but also of the assumptions that scheduled expirations in the stimulus package, AMT extensions, financial interventions, and the 2001 and 2003 tax cuts are allowed to take place. Our extended policy baseline also shows deficits declining sharply, but only to 4.8 percent of GDP in 2014, since the extended policy baseline extends the tax cuts and the AMT provisions. After 2014, however, the deficit in the extended policy baseline starts rising, ending up at 6.8 percent of GDP by 2020.

Obama policy represents an intermediate outcome: deficits fall to 4.0 percent of GDP in 2014, and then gradually rise to 5.5 percent of GDP by 2020. The Administration also called for the creation of a fiscal commission to reduce the primary deficit to zero by 2015, which is roughly equivalent to reducing the unified deficit to 3 percent of GDP by 2015 (White House

⁶ The Administration also develops a "current policy" baseline (showing the effects of continuation of current policies) that is close to our extended policy. The policy differences between the Administration's current policy baseline and our extended policy center on differing assumptions regarding the estate tax, Pell Grant funding, non-stimulus discretionary spending, and funding for domestic disasters.

⁷ The President's proposed education policies would have significant impacts on the characterization of outlays and the level of the public debt. Obama's proposal to expand and reform the Pell Grant program – including making all Pell Grant funding mandatory – would boost outlays by a net \$197 billion over 10 years, representing a \$374 billion increase in mandatory spending and a \$177 billion decrease in discretionary funding. In addition, the President proposes to replace the existing guaranteed loan program with direct loans by the Department of Education. This policy would reduce outlays by a modest amount, but substantially increase the public debt due to the higher number of initiated loans. This shift would increase the amount of student loans issued by the Department of Education by approximately \$1.4 trillion over 2011-2020 (CBO 2010c).

Office of the Press Secretary 2010). Our projections do not make any adjustment for the possible effects of the commission.

These differences in time paths turn into substantial annual differences by the end of the decade. By 2020, the CBO baseline deficit is \$663 billion; the deficit is \$863 billion higher under extended policy and \$585 billion higher under Obama policy. As a result of these differences, the overall fiscal shortfalls vary substantially. The CBO baseline projects a ten-year deficit of \$5.8 trillion. In contrast, extended policy shows a ten-year deficit of \$11.3 trillion and the Obama policy shows a decade-long deficit of \$9.0 trillion.

What is perhaps most notable is how problematic the 2020 outcomes are under Obama policy, despite being preceded by several years of full employment. Spending in 2020 would be at 24.7 percent of GDP, the highest level, other than 2009, 2010 and 2019, since World War II and would be rising over time. The deficit would stand at 5.5 percent of GDP and would be rising over time. Other than the deep recession year of 1983 and the current downturn (2009-2012), this would be the highest deficit share of GDP in more than 60 years and, as noted above, would represent a full-employment deficit. The debt-to-GDP ratio would be 90.0 percent, the highest level since 1947, and would be rising.⁸

The rise in spending would occur in mandatory programs, which in 2020 would be at their highest share of GDP ever, except for during the current downturn (in which the financial interventions are recorded as mandatory programs). In contrast, defense spending would fall dramatically and non-defense discretionary spending – in part due to the recharacterization of Pell Grant outlays – would drop to its lowest share of GDP in the past 50 years. These reductions would require significant political discipline. Finally, net interest payments would rise to 4.0 percent of GDP by 2020, the largest figure ever, and larger than non-defense discretionary spending or defense spending in that year.

In summary, while it is clear that the current deficits are expected to represent a temporary surge in government borrowing, the ten-year outlook suggests that the surge may well not subside as much as would be desired. In addition, borrowing will rise again later in the decade in a manner that appears to be unsustainable in the long term. Of course, as shown in Figure 1, as bad as outcomes are under Obama policy, outcomes would be even worse under a mechanical extension of current policies.

III. The Long-Term Outlook

The fiscal gap is an accounting measure that is intended to reflect the long-term budgetary status of the government.⁹ As developed by Auerbach (1994) and implemented in many subsequent analyses, the fiscal gap measures the size of the immediate and permanent

⁸ Debt-to-GDP ratios for Obama policy are derived from CBO (2010b). In addition to changes in the unified deficit, these estimates include higher non-deficit public borrowing for financial interventions, the effects of the recent health care reform legislation, and the proposed shift in mechanism for subsidizing student loans.

⁹ Auerbach et al. (2003) discuss the relationship between the fiscal gap, generational accounting, accrual accounting and other ways of accounting for government.

increase in taxes and/or reductions in non-interest expenditures that would be required to set the present value of all future primary surpluses equal to the current value of the national debt, where the primary surplus is the difference between revenues and non-interest expenditures.¹⁰ Equivalently, it would establish the same debt-to-GDP ratio in the long run as holds currently. The gap may be expressed as a share of GDP or in dollar terms.

A. Initial Assumptions

There are a variety of assumptions necessary to compute the fiscal gap. It is helpful to break these assumptions down into those regarding the ten-year budget period and those regarding the years thereafter, for which no official CBO projections are available. We start with perhaps the simplest approach for the ten-year budget period, following the CBO baseline (adjusted for health care reform legislation) through 2020. We assume that, after 2020, most categories of spending and revenues remain constant as a share of GDP. These long-run assumptions, however, would be seriously misleading for the major entitlement programs and their associated sources of funding, for which recent long-term projections are available. For the Medicare and OASDI programs, projections for all elements of spending and dedicated revenues (payroll taxes, income taxes on benefits, premiums and contributions from states) are available or can be calculated from figures presented in the 2009 Trustees reports (see Medicare Trustees Report 2009; OASDI Trustees Report 2009).¹¹ We use the Trustees' projections of the ratios of taxes and spending to GDP for the period 2020-2085 for OASDI and 2020-2080 for Medicare, assuming that these ratios are constant at their terminal values thereafter. For Medicaid, we assume that spending through 2083 is based on CBO's most recent long-term projections (CBO 2009) and that spending as a share of GDP is constant thereafter.¹²

It is important to understand how to interpret these assumptions. They do not represent a pure projection of current law but instead assume that policymakers will make a number of future policy changes, including a continual series of tax cuts, discretionary spending increases, and adjustments to keep health spending from growing too quickly. For example, if current tax parameters were extended forward, income taxes would rise as a share of GDP. Our forecast implicitly assumes policymakers will cut taxes in response. Conversely, our forecast assumes that a richer society will want to spend more on discretionary spending, going beyond the current services provided by government. Finally, our forecasts for government health programs reflect the intermediate assumptions of the Medicare Trustees and are below the past rate of growth, implicitly assuming policymakers will make changes to reduce spending growth in these programs.

¹⁰ Over an infinite planning horizon, this requirement is equivalent to assuming that the debt-GDP ratio does not explode. See Auerbach (1994, 1997).

¹¹ Details of these computations are available from the authors upon request.

¹² Initially, we assume that the effects of health care reform legislation remain constant as a share of GDP after 2020, although we consider below the effects of alternative scenarios.

B. Estimates

Under the CBO baseline assumptions, we estimate that the fiscal gap through 2085 is now 4.60 percent of GDP (Table 3).¹³ This implies that an immediate and permanent increase in taxes or cut in spending of 4.60 percent of GDP – about \$671 billion per year in current terms – would be needed to maintain fiscal balance through 2085. In present-value dollars, rather than as a share of GDP, the fiscal gap through 2085 under these assumptions amounts to \$35.0 trillion. The fiscal gap is even larger if the time horizon is extended, since the budget is projected to be running substantial deficits in years approaching and after 2085. If the horizon is extended indefinitely, for example, the fiscal gap rises to 6.40 percent of GDP under the CBO baseline, or \$92.7 trillion.¹⁴

The fiscal gap is substantially larger under the extended policy scenario. These assumptions lead to a lower level of revenue and a higher level of spending than the CBO baseline. Under extended policy, the fiscal gap through 2085 amounts to 7.21 percent of GDP, or 2.61 percent of GDP more than under the CBO baseline. In present-value dollars, the fiscal gap under this scenario amounts to \$54.8 trillion through 2085. Over the infinite horizon, the fiscal gap under the extended policy baseline is 9.07 percent of GDP, or \$131.2 trillion.

The results based on the third ten-year scenario, which starts with CBO's estimate of Obama policy, are moderately less dire than those of the adjusted baseline, with fiscal gaps through 2085 and over the infinite horizon of 6.35 percent and 8.16 percent, respectively. Thus, the Administration's proposals, if adopted, would leave the economy on an unstable path.

Figure 2 shows the implied debt-GDP ratios. Under the projections based on the CBO baseline, the economy would pass its highest-ever debt-to-GDP ratio (108.6 percent, in 1946) by 2033. This benchmark would be passed much sooner – in 2025 and 2023, respectively – under Administration policy or extended policy. And, in all three cases, the following years would see very rapid further growth of the debt-GDP ratio. Indeed, the projected debt-GDP ratios rise to astronomical levels later in the century under all three scenarios.

Figure 3 shows projected revenues and non-interest expenditures through 2085 under all three scenarios, the CBO baseline, the extended policy baseline, and Obama policy. Both alternatives to the CBO baseline project lower paths for revenues and higher paths for expenditures, with the Obama policy projections for revenues and expenditures being higher than those for the extended policy baseline.

¹³ The discount rate in these calculations is based upon the intermediate assumptions of the Social Security trustees, which assume a nominal interest rate of 5.7 percent.

¹⁴ These measures represent a slight improvement in the fiscal gap since our previous estimates (Auerbach and Gale 2009), when we projected an infinite horizon gap of 6.93 percent of GDP. Most of the gain is due to lower projected spending on discretionary programs and other entitlements as a share of GDP in 2020 (and, by our assumptions, in all subsequent years). A small additional gain comes from the adoption of health care legislation, which under the CBO baseline is slightly better than revenue-neutral during the budget period (and thereafter, under our convention).

C. The Role of Health Care Spending Growth and the Impact of Health Care Reform

Some have suggested that the long-term fiscal gap is not a general fiscal problem, but a medical care spending problem. Consistent with that, all three sets of projections in Figure 3 illustrate a mismatch in the growth rates of spending and revenues, rather than constant differences between the levels of the two series. As is well known, this spending growth is to a large extent associated with Medicare and Medicaid. But the fact that health care spending growth is important in an accounting sense does not imply that attempts at closing the fiscal gap should focus solely or even primarily on reducing health care spending growth. The issue is which spending reductions and/or tax increases, relative to the baseline projections, would have the least negative effects on the economy and society. The fact that health care spending growth is projected to be higher than other spending growth does not imply that this is an area where cuts are most appropriate. Even if it is determined that health spending should be cut, however, it is simply implausible that cutting health care spending growth alone can solve the long-term fiscal imbalance. Under the projections using Obama policy (and leaving aside for a moment the future effects of the recent health care legislation), to eliminate the long-term gap through reductions in health spending growth alone, the growth rate of spending on Medicare and Medicaid would need to be reduced by 2.7 percentage points annually over the next 75 years. That is, expenditures that have been growing far faster than GDP for decades and are currently projected to grow at a rate nearly 2.5 percent *faster* than GDP during the next ten years would instead have to begin *falling immediately* as a share of GDP.

Although such large reductions in health care spending growth may not be feasible, the recent health care debate did focus on the potential of the new law to generate budget savings in future decades. In its final analysis of the legislation's revenues and expenditures, CBO (2010d, p. 12) estimated that the legislation would reduce federal budget deficits over its second decade by roughly 0.5 percent of GDP, larger effects than those over the first decade. These savings would come from more rapid projected growth in revenues and cost-saving provisions than in the gross cost of health care expansion, which roughly offset each other during the initial 10-year budget period. Applying the methodology CBO laid out in more detail in December (CBO 2009c, 2009d) to the final health care bill,¹⁵ we find that that the infinite-horizon fiscal gap under the Obama policy scenario would be reduced by 0.42 percent of GDP (from 8.16 to 7.74) if indeed this differential growth occurred as projected over the legislation's second decade, but not beyond that, i.e., assuming that the effects of these differential growth rates would be sustained in the years after 2029 but that the differential growth itself would cease. Adding another decade of differential growth would subtract another 0.79 percent of GDP (to 6.95 percent) from the fiscal gap, this effect being larger than the previous one because of the cumulative effects of differential growth rates. But it would take more than four decades of this differential growth

¹⁵ In particular, we assume that the gross cost of health care expansion grows at 8 percent per year, the excise tax on high-premium insurances policies grows at 12.5 percent a year (the midpoint of CBO's range of 10-15 percent), that other revenue effects grow at 7 percent a year, and that changes to the Medicare program and other spending changes not associated with health care expansion grow at 12.5 percent a year (the midpoint of CBO's range of 10-15 percent). See CBO (2009c, p. 16) and CBO (2009d, p.1). This is the same methodology we use above in projecting the effects of the health care legislation for 2020, the last year of the ten-year budget period. This one-year extrapolation was needed because the budget estimates for the health care legislation were provided only through 2019.

(after the current decade) to wipe out the entire fiscal gap. Although it is hard to characterize the types of budget cuts and tax increases this would involve, the previous calculation of the necessary sustained reduction in health care spending growth suggests how unlikely such a policy trajectory is, even if various measures included in the legislation to help control underlying health care cost growth are successful.

D. The Costs of Delay

Although the long-term fiscal imbalance appears to have received increased attention in recent months, serious attempts to address it still lie in the future. All of the fiscal gap estimates presented in this section have referred to the required magnitude of immediate and permanent policy responses. But what if responses are delayed, as they surely will be?

Delays will simply increase the magnitude of required responses, as more debt will have accumulated and the demographic transition will have progressed further before action is taken. For example, under the Obama policy baseline, the long-term gap rises from 8.16 percent of GDP to 8.57 percent if a response is delayed by just five years; a ten-year delay would increase the fiscal gap to 9.00 percent of GDP. That is, a delay of just ten years would increase the size of the required response by 0.84 percent of GDP, or by more than 10 percent of the fiscal gap based on the assumption of immediate response. Waiting another ten years would increase the fiscal gap to 9.93 percent of GDP, an increase of 22 percent. Given how difficult it will be to make the adjustments implied by the assumption of immediate action, these further increases make quite clear how unrealistic an option a “wait and see” approach is. In particular, one should take little comfort in the prospect that annual deficits will decline in the near term as a share of GDP. Waiting until they begin to rise again, toward the end of this decade, will make the task we face much more daunting.

IV. Conclusions

The current U.S. fiscal deficit is enormous, but its enormity is temporary – or at least is expected to be. The real concerns lie in the ten-year projection and long-term outlook. The medium-term and long-term budget shortfalls will create growing burdens on the economy. These burdens can happen gradually or suddenly. In the gradual scenario, budget shortfalls will reduce national saving. In the absence of increased capital inflows, the reduction in national saving will raise interest rates, reduce investment and reduce future national output. Increased capital inflows from abroad can mitigate or eliminate the increase in interest rates and/or the decline in investment. This in turn will offset some of the decline in future national income, but of course the inflows create increasing claims on the domestic capital stock and hence still reduce future national income. In either case, under the gradual scenario, sustained large deficits will reduce future national income and living standards. In the sudden scenario, long-term budget shortfalls could trigger a political or market reaction that leads to a sudden change in interest rates, exchange rates, capital outflows, etc. Avoiding these outcomes will require significant and sustained changes to spending and revenue policies in the very near future.

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Table 1

**Federal Budget Surplus (Deficit)
CBO Baseline and Extended Policy 2011-2020^{1,2}**

| | <u>Dollars (billions)</u> | <u>Percent of GDP</u> |
|--|---------------------------|-----------------------|
| CBO baseline | -5,984 | -3.2 |
| Health care legislation | 164 | 0.1 |
| CBO baseline adjusted for health care legislation | -5,820 | -3.1 |
| Adjustments for tax policy | | |
| Extend estate and gift tax repeal | -571 | -0.3 |
| Extend 15 percent rate dividends and capital gains | -348 | -0.2 |
| Extend other provisions of EGTRRA, JGTRRA | -1,648 | -0.9 |
| Extend other non-stimulus expiring provisions | -524 | -0.3 |
| Extend and index AMT exemption amounts for inflation | -558 | -0.3 |
| Interaction effect of indexing AMT | -606 | -0.3 |
| Subtotal | -4,255 | -2.3 |
| Adjustments for spending policy | | |
| Adjust non-stimulus non-defense DS for population growth | -268 | -0.1 |
| Adjust defense spending | 338 | 0.2 |
| Freeze Medicare physician payment rates | -286 | -0.2 |
| Subtotal | -216 | -0.1 |
| Net Interest | -1,012 | -0.5 |
| Extended policy | -11,302 | -6.0 |

¹Columns may not sum to total due to rounding.

² See Appendix Table 1 for sources and notes.

Table 2

**Federal Budget Surplus (Deficit)
CBO Baseline and Obama Policy 2011-2020^{1,2}**

| | <u>Dollars (billions)</u> | <u>Percent of GDP</u> |
|---|---------------------------|-----------------------|
| CBO baseline | -5,984 | -3.2 |
| Health care legislation | 164 | 0.1 |
| CBO baseline adjusted for health care legislation | -5,820 | -3.1 |
| Adjustments for tax policy | | |
| Extend estate and gift tax at 2009 levels | -253 | -0.1 |
| Create 20 percent rate on dividends and capital gains | -238 | -0.1 |
| Extend other provisions of EGTRRA and JGTRRA, and income tax rates, but revert to 36 and 39.6 rates | -1,169 | -0.6 |
| Provide marriage penalty relief | -306 | -0.2 |
| Extend and index AMT exemption amounts for inflation | -577 | -0.3 |
| Extend and expand the Making Work Pay and Child Tax Credit | -162 | -0.1 |
| Jobs Initiatives | -24 | 0.0 |
| Limit the rate at which itemized deductions can reduce tax liability | 289 | 0.2 |
| Reform the international tax system | 122 | 0.1 |
| Impose a "Financial Crisis Responsibility Fee" | 90 | 0.0 |
| Modify and extend the Build America Bonds program | 80 | 0.0 |
| Other proposals | -39 | 0.0 |
| Subtotal | -1,444 | -0.8 |
| Adjustments for spending policy | | |
| Adjustment for non-defense discretionary outlays | -11 | 0.0 |
| Adjustment for defense outlays | 338 | 0.2 |
| Freeze Medicare physician payment rates | -286 | -0.2 |
| Modify and extend the Build America Bonds program | -88 | 0.0 |
| Modify Pell Grants | -374 | -0.2 |
| Direct spending for student loans | 67 | 0.0 |
| Extend or expand refundable tax credits | -401 | -0.2 |
| Jobs initiatives | -38 | 0.0 |
| Other proposals | -139 | -0.1 |
| Subtotal | -935 | -0.5 |
| Net Interest | -803 | -0.4 |
| Obama policy | -9,001 | -4.8 |

¹Columns may not sum to total due to rounding.

²See Appendix Table 2 for sources and notes.

Table 3
Fiscal Gaps¹

| Baseline | CBO Baseline | | Extended Policy | | Obama Policy | |
|--|-------------------------|------------------|-------------------------|------------------|-------------------------|------------------|
| | Through 2085 | Permanent | Through 2085 | Permanent | Through 2085 | Permanent |
| As a Percent of GDP | 4.60 | 6.40 | 7.21 | 9.07 | 6.35 | 8.16 |
| In Trillions of Present-Value Dollars | 34,964 | 92,668 | 54,794 | 131,245 | 48,216 | 118,161 |

¹Source: Authors' calculations

Appendix Table 1

Federal Budget Surplus (Deficit)
CBO Baseline and Extended Policy 2011-2020^{1,2}

| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2011-2020 |
|---|---------------|---------------|-------------|-------------|-------------|-------------|---------------|---------------|---------------|---------------|---------------|----------------|
| 1. CBO baseline | -1,368 | -996 | -642 | -525 | -463 | -472 | -513 | -521 | -534 | -641 | -684 | -5,984 |
| Health care legislation ³ | -6 | -1 | 10 | 56 | 51 | 20 | -3 | -4 | 5 | 15 | 21 | 164 |
| 2. CBO baseline adjusted for health care legislation as percent of nominal GDP | -1,374 | -997 | -632 | -469 | -412 | -452 | -516 | -525 | -529 | -626 | -663 | -5,820 |
| as percent of nominal GDP | -9.4 | -6.6 | -4.0 | -2.8 | -2.3 | -2.5 | -2.7 | -2.6 | -2.5 | -2.9 | -2.9 | -3.1 |
| Adjustments for tax policy | | | | | | | | | | | | |
| Extend estate and gift tax repeal | 0 | -16 | -44 | -49 | -54 | -59 | -63 | -66 | -70 | -74 | -77 | -571 |
| Extend 15 percent rate dividends and capital gains | -2 | -15 | -16 | -32 | -34 | -37 | -39 | -41 | -43 | -44 | -46 | -348 |
| Extend other provisions of EGTRRA, JGTRRA | -1 | -83 | -156 | -162 | -168 | -172 | -175 | -178 | -181 | -184 | -188 | -1,648 |
| Extend other non-stimulus expiring provisions ⁴ | -8 | -26 | -32 | -38 | -46 | -52 | -57 | -61 | -66 | -70 | -74 | -524 |
| Extend and index AMT exemption amounts for inflation | -7 | -69 | -31 | -35 | -39 | -44 | -50 | -58 | -66 | -77 | -88 | -558 |
| Interaction effect of indexing AMT | 0 | -13 | -43 | -48 | -53 | -59 | -64 | -71 | -78 | -85 | -93 | -606 |
| Subtotal | -18 | -222 | -323 | -364 | -395 | -423 | -449 | -475 | -503 | -534 | -566 | -4,255 |
| as percent of nominal GDP | -0.1 | -1.5 | -2.1 | -2.2 | -2.2 | -2.3 | -2.3 | -2.4 | -2.4 | -2.4 | -2.5 | -2.3 |
| Adjustments for spending policy | | | | | | | | | | | | |
| Adjust non-stimulus non-defense DS for population growth ⁵ | 0 | -5 | -9 | -14 | -19 | -24 | -29 | -35 | -40 | -46 | -47 | -268 |
| Adjust defense spending ⁶ | -8 | -33 | 1 | 36 | 49 | 50 | 50 | 48 | 47 | 46 | 44 | 338 |
| Freeze Medicare physician payment rates ⁶ | -6 | -15 | -19 | -22 | -23 | -26 | -29 | -32 | -35 | -40 | -45 | -286 |
| Subtotal | -14 | -53 | -27 | 0 | 7 | 0 | -8 | -19 | -28 | -40 | -48 | -216 |
| as percent of nominal GDP | -0.1 | -0.4 | -0.2 | 0.0 | 0.0 | 0.0 | 0.0 | -0.1 | -0.1 | -0.2 | -0.2 | -0.1 |
| Net Interest | 0 | -3 | -10 | -25 | -49 | -71 | -100 | -131 | -167 | -206 | -249 | -1,012 |
| as a percent of nominal GDP | 0.0 | 0.0 | -0.1 | -0.2 | -0.3 | -0.4 | -0.5 | -0.7 | -0.8 | -1.0 | -1.1 | -0.5 |
| 3. Extended Policy Baseline | -1,407 | -1,274 | -992 | -859 | -848 | -946 | -1,073 | -1,149 | -1,227 | -1,406 | -1,526 | -11,302 |
| as a percent of nominal GDP | -9.6 | -8.5 | -6.3 | -5.1 | -4.8 | -5.1 | -5.6 | -5.7 | -5.9 | -6.5 | -6.8 | -6.0 |

GDP⁶ 14,595 14,992 15,730 16,676 17,606 18,421 19,223 20,036 20,823 21,667 22,544 187,718

¹Columns may not sum to total due to rounding.

²Unless otherwise noted, the source of these estimates is CBO (2010a), Table 1-5 and Supplemental Tables.

³CBO (2010d) and authors' calculations.

⁴Authors' calculations based on CBO backup data.

⁵Authors' calculations using Census 2000 projections of population growth and discretionary spending from CBO (2010a).

⁶CBO (2010b).

Appendix Table 2

Federal Budget Surplus (Deficit)
CBO Baseline and Obama Policy 2011-2020^{1,2}

| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2011-2020 |
|---|---------------|---------------|-------------|-------------|-------------|-------------|-------------|-------------|---------------|---------------|---------------|---------------|
| 1. CBO baseline | -1,368 | -996 | -642 | -525 | -463 | -472 | -513 | -521 | -534 | -641 | -684 | -5,984 |
| Health care legislation ³ | -6 | -1 | 10 | 56 | 51 | 20 | -3 | -4 | 5 | 15 | 21 | 164 |
| 2. CBO baseline adjusted for health care legislation | -1,374 | -997 | -632 | -469 | -412 | -452 | -516 | -525 | -529 | -626 | -663 | -5,820 |
| as percent of nominal GDP | -9.4 | -6.6 | -4.0 | -2.8 | -2.3 | -2.5 | -2.7 | -2.6 | -2.5 | -2.9 | -2.9 | -3.1 |
| Adjustments for tax policy | | | | | | | | | | | | |
| Extend estate and gift tax at 2009 levels | 0 | 5 | -18 | -21 | -25 | -28 | -30 | -32 | -33 | -35 | -37 | -253 |
| Create 20 percent rate on dividends and capital gains | 0 | -5 | -16 | -20 | -22 | -25 | -27 | -29 | -30 | -32 | -33 | -238 |
| Extend other provisions of EGTRRA and JGTRRA, and income tax rates, but revert to 36 and 39.6 rates | 0 | -67 | -99 | -106 | -113 | -118 | -123 | -128 | -133 | -138 | -143 | -1,169 |
| Provide marriage penalty relief | 0 | -18 | -26 | -28 | -30 | -31 | -32 | -33 | -34 | -35 | -36 | -306 |
| Extend and index AMT exemption amounts for inflation | -6 | -66 | -32 | -36 | -41 | -46 | -52 | -60 | -70 | -81 | -93 | -577 |
| Extend and expand the Making Work Pay and Child Tax Credit | 0 | -35 | -25 | -12 | -13 | -13 | -13 | -13 | -13 | -13 | -13 | -162 |
| Undertake Jobs Initiatives | -16 | -24 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | -24 |
| Limit the rate at which itemized deductions can reduce tax liability | 0 | 7 | 22 | 24 | 26 | 29 | 31 | 34 | 36 | 38 | 41 | 289 |
| Reform the international tax system | 0 | 6 | 12 | 12 | 13 | 13 | 14 | 14 | 8 | 14 | 15 | 122 |
| Impose a "Financial Crisis Responsibility Fee" | 0 | 8 | 8 | 9 | 9 | 9 | 9 | 9 | 9 | 10 | 10 | 90 |
| Modify and extend the Build America Bonds program | 0 | 0 | 2 | 4 | 5 | 7 | 9 | 10 | 12 | 14 | 16 | 80 |
| Other proposals | -36 | -41 | -6 | 9 | 5 | 2 | 0 | 0 | -2 | -2 | -3 | -39 |
| Subtotal | -58 | -230 | -178 | -165 | -186 | -201 | -214 | -228 | -250 | -260 | -276 | -1,444 |
| as percent of nominal GDP | -0.4 | -1.5 | -1.1 | -1.0 | -1.1 | -1.1 | -1.1 | -1.1 | -1.2 | -1.2 | -1.2 | 0.0 |
| Adjustments for spending policy | | | | | | | | | | | | |
| Adjustment for non-defense discretionary outlays | -1 | 4 | 9 | 8 | 3 | -1 | -4 | -5 | -5 | -7 | -14 | -11 |
| Adjustment for defense outlays | -8 | -33 | 1 | 36 | 49 | 50 | 50 | 48 | 47 | 46 | 44 | 338 |
| Freeze Medicare physician payment rates | -6 | -15 | -19 | -22 | -23 | -26 | -29 | -32 | -35 | -40 | -45 | -286 |
| Modify and extend the Build America Bonds program | 0 | -1 | -3 | -4 | -6 | -8 | -10 | -11 | -13 | -15 | -17 | -88 |
| Modify Pell Grants | -2 | -14 | -33 | -35 | -38 | -37 | -39 | -41 | -43 | -46 | -49 | -374 |
| Direct spending for student loans | 1 | 6 | 8 | 7 | 7 | 7 | 7 | 6 | 6 | 7 | 7 | 67 |
| Extend or expand refundable tax credits | 0 | 0 | -61 | -42 | -42 | -41 | -42 | -42 | -43 | -44 | -45 | -401 |
| Undertake Jobs initiatives | -12 | -25 | -8 | -3 | -2 | 0 | 0 | 0 | 0 | 0 | 0 | -38 |
| Other proposals | -47 | -57 | -9 | -12 | -12 | -10 | -10 | -9 | -8 | -7 | -6 | -139 |
| Subtotal | -75 | -135 | -115 | -67 | -64 | -66 | -77 | -86 | -94 | -106 | -125 | -935 |
| as percent of nominal GDP | -0.5 | -0.9 | -0.7 | -0.4 | -0.4 | -0.4 | -0.4 | -0.4 | -0.5 | -0.5 | -0.6 | -0.5 |
| Net Interest | -1 | -5 | -14 | -27 | -45 | -61 | -81 | -103 | -128 | -155 | -184 | -803 |
| as a percent of nominal GDP | 0.0 | 0.0 | -0.1 | -0.2 | -0.3 | -0.3 | -0.4 | -0.5 | -0.6 | -0.7 | -0.8 | -0.4 |
| 3. Obama Policy | -1,508 | -1,367 | -938 | -728 | -706 | -780 | -888 | -941 | -1,001 | -1,147 | -1,248 | -9,001 |
| as a percent of nominal GDP | -10.3 | -9.1 | -6.0 | -4.4 | -4.0 | -4.2 | -4.6 | -4.7 | -4.8 | -5.3 | -5.5 | -4.8 |
| GDP | 14,595 | 14,992 | 15,730 | 16,676 | 17,606 | 18,421 | 19,223 | 20,036 | 20,823 | 21,667 | 22,544 | 187,718 |

¹Columns may not sum to total due to rounding.

²The source of these estimates is CBO (2010b), Table 1-3.

³CBO (2010d) and authors' calculations.

Figure 1. Alternative Projections of the Deficit, 2010-2020

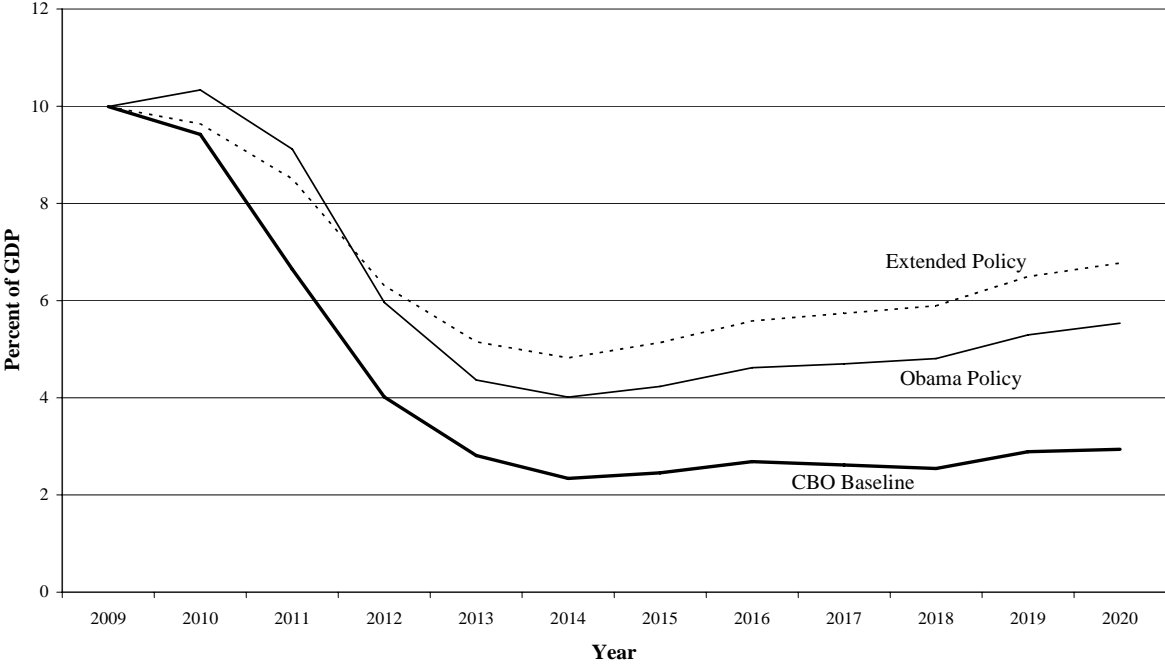


Figure 2. Alternative Projections of the National Debt, 2010-2085

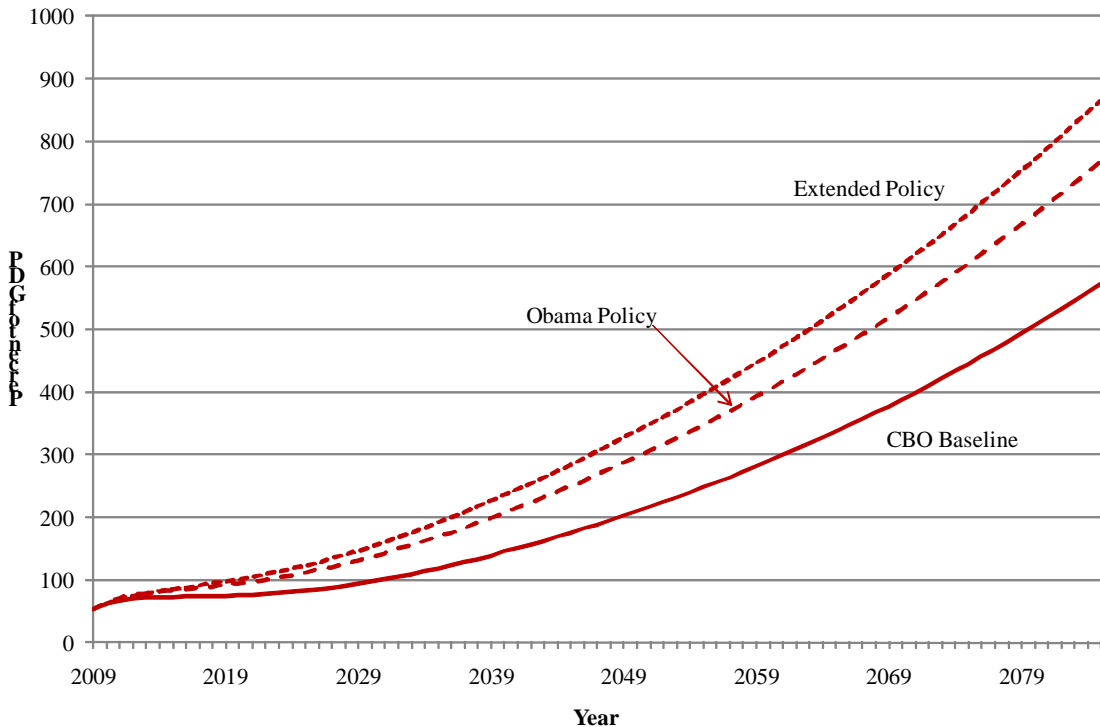


Figure 3. Alternative Projections of Revenues and Non-Interest Outlays, 2010-2085

