Five Myths About Cutting the Deficit

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Suddenly, debt commissions —and commissioners, and reports, and even draft reports — are everywhere. The president's bipartisan National Commission on Fiscal Responsibility and Reform is due to vote on its final recommendations by Dec. 1 (its co–chairs having put forward a draft plan earlier this month). And earlier this month, another commission — the Bipartisan Policy Center's Debt Reduction Task Force led by economist Alice Rivlin and former senator Pete Domenici — reported its own plan.

Budgets may be boring, but the stakes before us are exceedingly high. As we go about reducing the deficit, who will pay which taxes? How will we defend our country? And how will we treat our elderly? Unfortunately, questionable thinking and outright distortions by critics from across the political spectrum are getting in the way of these and other difficult decisions.

1. The United States is on the verge of a fiscal crisis.

Not really. Greece faced a fiscal crisis earlier this year when it had to slash its deficit immediately or risk capital flight and economic collapse. Ireland is in the same straits now, and Portugal may soon be headed that way. The United States faces a very different situation. Long–term interest rates on government debt are low. Investors are not fleeing U.S. capital markets; instead, America continues to be a magnet for capital from around the world.

Of course, the lack of an imminent crisis hardly means there is no problem. If our current policies continue, by 2020 net interest payments on the national debt will exceed $1 trillion, 20 percent of federal revenues, annually – enough for rating agencies to downgrade the quality of U.S. debt, which in turn would raise borrowing costs and increase the deficit further.

Even in the absence of a crisis or a downgrade, the effects of persistent deficits are substantial. For example, the International Monetary Fund has found that for every 10 percentage–point increase in the national debt relative to the size of the overall economy, economic growth in an industrialized country will fall by 0.15 percentage points.

That may not sound like much, but the United States is on a path for its debt–to–GDP ratio to rise from about 40 percent in 2008 to about 90 percent in 2020. That means that our annual growth rate could fall by more than 0.75 percentage points – with major negative consequences for employment and standards of living.

Just because there is no crisis right now, however, doesn't mean we can afford to wait. If we address our fiscal challenges sooner, we can make gradual – if difficult – changes. If we wait too long, we really will be facing a crisis, and the necessary adjustments will be far more severe and sudden.

2. The deficit commissions should propose reforms that are politically viable.

No solution to this problem is going to be politically popular. But even if Congress disregards the current proposals, dismissing them as politically unfeasible, that will not mean the commissions' efforts will have failed.

By publicly proposing deficit solutions, these commissions already have fulfilled their main function: to start a serious national conversation. While the combination of spending cuts and tax reforms recently suggested by Erskine Bowles and Alan Simpson – the co–chairs of the president's deficit commission – may not even win the support of all the panel's members, they might induce the commission's anti–tax and pro–spending forces to release their own proposals. This would allow voters and policymakers to compare plan against plan – and that is exactly the discussion the country needs to have.

Any eventual solution to the deficit problem will involve measures currently considered politically impossible. For example, anti–tax advocates have objected that the co–chairs' plan would constitute a tax increase – even though Congress would raise more revenue by doing nothing for the next 10 years than it would by enacting the plan. Social Security supporters, meanwhile, have heaped criticism on Bowles and Simpson for their proposal to raise the early and normal retirement ages by one year per generation for the next two generations – even though the average lifespan will probably increase even faster, so retirement periods would still grow.

Objecting to these proposals without proposing alternatives is not productive.

3. Social Security has a surplus, so it shouldn't be cut.

Supporters of Social Security argue that the program's 2010 surplus, combined with its projected 27–year solvency, should exempt it from the budget axe.

But ruling out cuts is a bad idea. First, Social Security faces a long–term deficit. And even if the program were running a long–term surplus, the simple arithmetic of the overall fiscal situation dictates that everything – everything – should be on the table.

Simply reducing earmarks; limiting waste, fraud and abuse; or cutting back on government workers won't come close to solving the problem. Social Security, Medicare, Medicaid, defense and net interest payments typically account for 70 percent of federal spending and are on course to account for 80 percent by 2020. Any serious effort on the spending side needs to address each of these items.

Medicaid and Medicare pose the biggest challenges to long–term fiscal conditions, of course, but defense cuts are also critical. (While we're on the topic of defense, it's worth noting that officials such as Secretary of State Hillary Rodham Clinton and the chairman of the Joint Chiefs, Adm. Mike Mullen, have said that the deficit itself poses a threat to national security.)

Finally, keeping Social Security reform on the table isn't just good fiscal policy, it's good politics. It underscores the importance of shared sacrifice. If we are to find a solution that is politically sustainable, we cannot exempt large segments of society from pitching in.

4. We can balance the budget without raising taxes.

Although it is mathematically possible to balance the budget without raising taxes, it is impossible in a political sense.

Budget discipline works only when it is imposed on both sides of the ledger. In 1990 and 1993, the last time we faced a serious fiscal crunch, Congress did just that, slashing spending and raising taxes. In contrast, in 1981 and 2001, massive tax cuts did not lead to reduced spending, despite the hopes of those who espouse the "starve the beast" theory of fiscal reform.

Instead, the tax cuts were accompanied by big increases in spending, thus boosting the deficit from both sides. The logic is clear: If some politicians reward their constituents through tax cuts, other politicians will see no reason that they can't reward their own constituents through more spending. It is only when fiscal discipline is comprehensive and coordinated that it works and endures.

Moreover, we shouldn't balance the budget without tax increases – they are the only way to ensure that high–income households pay a fair share of the deficit burden. Without higher taxes as part of the fiscal reform package, middle– and low–income households – which tend to feel spending cuts most acutely – will end up bearing almost all of the burden.

The nation rapidly raised tax revenues and rates during World War II; for a long time, those rates persisted, and the economy performed well. Well–designed tax increases could help the economy and the budget now, too. We should cut the mortgage interest deduction, which is expensive and regressive and helped deepen the housing crisis. We should impose taxes on greenhouse gases, for revenue and for the environment. And we need to tax consumption, to reduce our propensity to overspend.

5. A new short–term stimulus would be fiscally irresponsible.

The Rivlin–Domenici plan proposes higher near–term deficits as a means of economic stimulus, to be followed by cuts down the line. Some may see this as Washington–style "business as usual" – always putting off cuts until tomorrow – but it makes sense economically. With the recovery stalling, spending more and taxing less now to get the economy going is perfectly consistent with the need for medium– and long–term fiscal discipline. A strong economy can do the budget a lot of good by boosting tax revenues and reducing spending on unemployment benefits and other need–based programs.

As always, there is a balancing act between immediate and longer–term concerns. Fiscal responsibility requires that we spend stimulus funds wisely on projects with the biggest bang for the buck. According to the Congressional Budget Office, these would include infrastructure spending, aid to the states, higher unemployment benefits, hiring credits and a payroll tax holiday.

The other key to a responsible stimulus package is timing. Short–term stimulus cannot become long–term policy. Congress should explicitly legislate an end date for any new stimulus and couple it with a medium–term deficit–reduction package. Together, these policies would do more to spur the economy and curb the deficit than either would alone.

Other Publications by the Authors

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