Bringing The Federal Deficit Under Control

William R. Emmons

October 18, 2011

The views expressed here are mine alone, and do not necessarily represent the views of the Federal Reserve Bank of St. Louis or of the Federal Reserve System.
Pre-Event Survey:
Do you think it is necessary that we cut the federal budget deficit?

- Yes, and with a combination of short term and long term cuts: 69%
- Yes, but in the short term only: 28%
- Not sure: 3%
Which do you think is the most important issue facing the country right now?

1. Economy and jobs
2. Federal budget deficit/National debt
3. Health Care
4. Taxes
5. Educational system
6. Unsure/other
Do you think the federal budget deficit can be reduced without harming the economy?

1. Yes, and the sooner, the better
2. Yes, but it should be done gradually
3. No, but it might be a price worth paying
4. No, and it would cause unnecessary harm
5. Not sure/no opinion
“The United States is facing profound budgetary and economic challenges.”

--Congressional Budget Office (CBO), *The Budget and Economic Outlook: An Update*, August 2011
U.S. Indicators of Fiscal Health

Compare Poorly With Peers

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<tbody>
<tr>
<td>Canada Aaa / AAA/ AAA Stable</td>
<td>-4.6</td>
<td>84.0</td>
<td>35.1</td>
<td>0.7</td>
<td>8.0</td>
<td>-2.8</td>
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<tr>
<td>France Aaa / AAA/ AAA Stable</td>
<td>-6.0</td>
<td>87.6</td>
<td>77.9</td>
<td>2.5</td>
<td>10.0</td>
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<tr>
<td>Germany Aaa / AAA/ AAA Stable</td>
<td>-2.3</td>
<td>80.0</td>
<td>54.7</td>
<td>2.2</td>
<td>5.7</td>
<td>5.1</td>
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<td>Japan Aa3 / AA- / AA- Neg/Stab</td>
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<td>220.3</td>
<td>127.8</td>
<td>1.7</td>
<td>5.7</td>
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<td>UK Aaa / AAA/ AAA Stable</td>
<td>-8.6</td>
<td>77.2</td>
<td>75.1</td>
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<td>13.4</td>
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<td>USA Aaa / AA+ / AAA Neg/Stab</td>
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<td>91.6</td>
<td>72.4</td>
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<td>5.2</td>
<td>-3.2</td>
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Source: Federal Reserve Bank of New York

Heat map colors are relative to countries listed; red highlights troubling fiscal indicators, while green highlights healthier fiscal indicators. IMF WEO April 2011 Estimates for: fiscal balance; gross & net public debt; & cur acct balance. OECD estimates for int exp / GDP as of June 2011. Otherwise, most recent official government figures.

* Gross public debt includes debt issued to federal pension and social security funds
** Net public debt does not include debt issued to pension or social security funds; in the U.S. this is marketable debt
*** Average maturity from Bloomberg

U.S. rank among 6 peer nations

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<th>Interest expense</th>
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**U.S. Looks A Bit Better Against Peripheral European Countries**

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<td>Belgium</td>
<td>Aa1/AA+/AA+</td>
<td>Stab/Neg</td>
<td>-4.0</td>
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<td>82.3</td>
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<td>Greece</td>
<td>Ca / CC / CCC</td>
<td>Neg</td>
<td>-7.4</td>
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<td>7.0</td>
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<td>Italy</td>
<td>Aa2/A+/A-</td>
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<td>Baa2/BBB-/BBB-</td>
<td>Neg</td>
<td>-5.6</td>
<td>90.6</td>
<td>86.3</td>
<td>4.2</td>
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Source: Federal Reserve Bank of New York
“Without significant policy changes, the finances of the federal government will inevitably spiral out of control, risking severe economic and financial damage.”

Tonight’s Agenda

- The long-term federal budget outlook
- Bringing future deficits under control
- Your questions and comments
Part 1

- The long-term federal budget outlook
Annual Federal Budget Balances

CBO projections through 2021 reflecting current law and provisions related to the Congressional Joint Select Committee on Deficit Reduction (“Super Committee”)

Source: Congressional Budget Office (CBO)
Annual Federal Budget Balances

CBO projections through 2021 reflecting current law and provisions related to the Congressional Joint Select Committee on Deficit Reduction ("Super Committee")

CBO projections through 2021 under an "alternative fiscal scenario" that reflects provisions related to the "Super Committee" but assumes the continuation of certain policies

Source: Congressional Budget Office (CBO)
# Facts About the Deficit and Debt

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Sources: Office of Management and Budget (OMB), Congressional Budget Office (CBO), U.S. Treasury, Census Bureau, Macroeconomic Advisors
Why GNP vs. GDP?
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Debt Held By the Public

Percent of GNP

Actual debt-to-GNP ratio through 2011

Sources: Office of Management and Budget (OMB), Congressional Budget Office (CBO)
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Two Scenarios for Debt Held By the Public

Percent of GNP

Debt-to-GNP ratio under CBO's "extended baseline scenario"

Actual debt-to-GNP ratio through 2011

* Aug. 2011 CBO baseline updated to reflect effects of provisions related to the Congressional Joint Select Committee on Deficit Reduction

Sources: Office of Management and Budget (OMB), Congressional Budget Office (CBO)
Two Scenarios for Debt Held By the Public

Percent of GNP

- Additional percentage points of debt under CBO's "alternative fiscal scenario"
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DIALOGUE with the FED: Beyond Today's Financial Headlines

FEDERAL RESERVE BANK of ST. LOUIS
Two Scenarios for Debt Held By the Public

- **Current policy**
- **Current law**
- **Alternative fiscal scenario**
- **Extended baseline**

Additional percentage points of debt under CBO's "alternative fiscal scenario"
Debt-to-GNP ratio under CBO's "extended baseline scenario"
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* Aug. 2011 CBO baseline updated to reflect effects of provisions related to the Congressional Joint Select Committee on Deficit Reduction

Sources: Office of Management and Budget (OMB), Congressional Budget Office (CBO)
Two Scenarios for Debt Held By the Public

More likely, according to CBO

Less likely, according to CBO

Current policy

Current law

Alternative fiscal scenario

Extended baseline*

Additional percentage points of debt under CBO's "alternative fiscal scenario"

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Gross National Product (closely related to Gross Domestic Product) includes CBO’s “alternative fiscal scenario.” Does not reflect provisions related to the “Super Committee.”
The Extended Baseline: Current Law

- CBO must project current laws into the future under an “extended-baseline scenario”

- This scenario assumes all provisions will take effect as written
  
  - All temporary revenue-reducing measures expire on schedule
  
  - All temporary outlays expire on schedule
  
  - Discretionary spending caps are enforced
The Extended Baseline: Tax Changes

1. Expiring 12-31-2011:
   - The two-year extension of provisions limiting the reach of the AMT (alternative minimum tax)
   - The one-year reduction in the payroll tax

2. Expiring 12-31-2012:
   - Certain provisions of the 2010 tax act originally enacted in 2001, 2003, and 2009, including:
     - Extensions of lower marginal tax rates
     - Expanded tax credits and deductions

Source: Congressional Budget Office
Marginal Income-Tax Schedules

Marginal tax-rate schedule in 2000; income levels adjusted for inflation

Marginal tax-rate schedule in 2011

Taxable income of married household filing jointly, in 2011 dollars

Marginal tax rate in percent

$17,000

$69,000

$139,350

$212,300

$379,150

$0

$50

$100

$150

$200

$250

$300

$350

$400

$450

$500
An Example

- A household with taxable income in 2011 of $100,000 pays $17,250

\[17,000 \times 0.10] + [52,000 \times 0.15] + [31,000 \times 0.25] = $17,250\]

- Using indexed 2000 tax brackets that same household would pay $20,720 (a 20% increase)

\[56,000 \times 0.15] + [44,000 \times 0.28] = $20,720\]

- Current law imposes this change after 12-31-2012
The Extended Baseline: Spending Changes

3. Effective 1-1-2012:
   - Sharp reduction in Medicare’s payment rates for physicians’ services (-30%) due to smaller deferred annual cuts that have been accumulating since 2003
   - Extended unemployment compensation ends

4. 2011 Budget Control Act (BCA) provisions to be implemented during the next decade:
   - Funding for discretionary spending declines over time in real terms, in accordance with BCA caps
   - Additional deficit reduction of $1.2 trillion or more as required under the BCA; details determined by the “Super Committee” or sequestration if no agreement

Source: Congressional Budget Office
Is Current Law Sufficient To Solve the Problem?

- Current laws plus 2011 Budget Control Act would shrink long-run deficits and reduce debt levels relative to GNP after 2013. However:
  
  - Tax revenues as a share of GNP would continue rising forever due to the restoration of higher marginal rates, “bracket creep”, and the AMT which is not indexed for inflation
  
  - Rising federal health-care costs would be passed through to taxpayers
Projected Federal Outlays and Revenues Under CBO’s Extended-Baseline Scenario

Percent of GNP

Total outlays under extended-baseline scenario

Total revenues under extended-baseline scenario

Note: Does not reflect provisions related to the 2011 Budget Control Act, which reduces deficits

Source: Congressional Budget Office (CBO)
CBO:

Certain Provisions of Current Law Are “Widely Expected To Be Changed”
Or
“Might Be Difficult to Sustain For a Long Period”

Provisions Likely to Change

- Most important: Assumptions about revenues

  - Under the extended-baseline scenario, federal tax revenues would increase at double-digit percentage rates for each of the next three years, then continue growing faster than the economy.

- All planned spending cuts may not occur

  - Medicare payment rates scheduled to fall 30 percent
  - All non-interest, non-defense federal spending is scheduled to decline at an annual rate of one percent for the next three years.

Economic Impacts

- Policy changes assumed under the extended-baseline scenario could affect the recovery

1. Projected tightening of fiscal policy over three years (2012-14) would be 6.3 percentage points of GDP
   - Relative to the size of the economy, these cuts would be nearly as large as those made during 1947-49, which may have contributed to a recession at that time
2. Higher tax rates might reduce incentives to work, save, and invest – harming growth potential
3. On the positive side, lower deficits and debt might reduce interest rates, boosting growth

The Alternative Fiscal Scenario: Current Policy

- CBO projects what it believes is more likely to happen based on recent experience—what CBO terms “current policy”—under an “alternative fiscal scenario”

  - Alternative scenario assumes no painful fiscal provisions will be allowed to come into force, ever
    - None of the temporary revenue-reducing measures expire on schedule
    - None of the temporary outlays expire or spending caps bite on schedule

The Alternative Fiscal Scenario: Current Policy

Policy actions under CBO’s alternative fiscal scenario would result in a large and growing mismatch between revenues and outlays, regardless of how strongly the economy grows.

- Outlays grow rapidly with our aging population, rising health-care expenditures, and spiraling interest payments on debt.
- Tax revenues are frozen at their historical average level relative to GNP, completely unrelated to the aging population or rising health-care outlays.

Projected Federal Outlays and Revenues Under CBO’s Alternative Fiscal Scenario

Note: Does not reflect provisions related to the 2011 Budget Control Act, which reduces deficits

Source: Congressional Budget Office (CBO)
Current Policy: Debt Could Exceed WW II Levels Within 20 Years

Sources: Office of Management and Budget (OMB), Congressional Budget Office (CBO)

Additional percentage points of debt under CBO's "alternative fiscal scenario"

Debt-to-GNP ratio under CBO's "extended baseline scenario"

Actual debt-to-GNP ratio through 2011

* Aug. 2011 CBO baseline updated to reflect effects of provisions related to the Congressional Joint Select Committee on Deficit Reduction
Extended Baseline: Tax Burden Rises Forever; Alternative Scenario: Budget Deficits Rise Forever

Total outlays under alternative fiscal scenario

Total outlays under extended-baseline scenario

Total revenues under alternative fiscal scenario

Total revenues under extended-baseline scenario

Note: Does not reflect provisions related to the 2011 Budget Control Act

Source: Congressional Budget Office (CBO)
Conclusions About The Long-Term Federal Budget Outlook

1. The “extended baseline scenario”—current law—would stabilize our long-term fiscal situation within the next few years. But these actions might hamper the economy, both in the short-term and long-term.

2. The “alternative fiscal scenario”—a continuation of current policies—would result in large and growing future budget deficits and debt.

3. Neither scenario is likely to play out as described.
Part 2

- Bringing future deficits under control
Our Apparent Fiscal Dilemma: Higher Taxes or Higher Debt?

- **Higher taxes:** The extended-baseline scenario
  - Most households’ income-tax burdens would rise over time under current law
  - Incentives to work, save, and invest could be harmed
Current Federal Revenue Sources

Percent of federal revenues, fiscal year 2011

- Individual income tax: 47.1%
- Corporate income tax: 3.1%
- Social-insurance taxes: 35.3%
- Excise taxes: 0.4%
- Estate and gift taxes: 5.9%
- Other revenues: 8.3%

Personal-income-based tax revenues = 82.4% of total
Pre-Event Survey:
Do you favor raising the tax burden on all citizens to help reduce the federal deficit?

- Favor: 61%
- Oppose: 36%
- Not sure / No opinion: 3%
Pre-Event Survey:
Would you favor or oppose raising revenues by limiting tax deductions for households with incomes above $250K?

- Favor: 61%
- Oppose: 39%
Our Apparent Fiscal Dilemma: Higher Taxes or Higher Debt?

- **Higher debt**: The alternative fiscal scenario
  
  - Budget deficits and debt rise forever if current policies are continued
  
  - At some point, investors might refuse to buy the expanding stock of Treasury debt, resulting in a debt crisis, which could push interest rates sky high
  
  - If the Treasury cannot roll over its debt, the Federal Government must raise taxes and/or cut spending
Projected Composition of Federal Outlays Under CBO’s Alternative Fiscal Scenario

Outlay category as percent of GNP

Source: Congressional Budget Office (CBO)
Projected Shares of Federal Outlays Under CBO’s Alternative Fiscal Scenario

Outlay category as percent of total outlays

- Interest payments on Treasury debt
- Everything else
- Social Security
- Health care

Source: Congressional Budget Office (CBO)
Is There Any Alternative To Ever-Rising Taxes Or Ever-Rising Debt?
Should a plan to reduce the federal budget deficit include only tax increases, only spending cuts, or a combination of both?

1. Only tax increases
2. Only spending cuts
3. Combination
4. Not sure/no opinion
Raise Taxes Only, Cut Spending Only, Both?

"Do you think any plan to reduce the federal budget deficit should include only tax increases, or only spending cuts, or a combination of both tax increases and spending cuts?"

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<th>Percent responding:</th>
<th>Only tax increases</th>
<th>Only spending cuts</th>
<th>Combination</th>
<th>Unsure</th>
</tr>
</thead>
<tbody>
<tr>
<td>All respondents</td>
<td>3</td>
<td>21</td>
<td>71</td>
<td>5</td>
</tr>
<tr>
<td>Republicans</td>
<td>1</td>
<td>39</td>
<td>57</td>
<td>3</td>
</tr>
<tr>
<td>Democrats</td>
<td>7</td>
<td>9</td>
<td>82</td>
<td>2</td>
</tr>
<tr>
<td>Independents</td>
<td>1</td>
<td>19</td>
<td>70</td>
<td>10</td>
</tr>
</tbody>
</table>

Poll: CBS News/New York Times, Sept. 10-15, 2011; 1,452 adults nationwide, margin of error plus or minus 3 percentage points

Pre-Event Survey:
Would you favor or oppose cutting Social Security to help reduce the federal deficit?

- Favor: 63%
- Oppose: 22%
- Not sure / No opinion: 15%
Is There Any Alternative?

- Yes, according to the Bowles-Simpson Deficit Commission (Dec. 2010) and many others

- A medium-term strategy should emphasize:
  - Cuts in both mandatory and discretionary spending
  - Health-care cost control
  - Tax reforms that increase revenues and efficiency
  - Enhanced progressivity on taxes and benefits
Fiscal-Reform Principles
Suggested By Fed Chairman Bernanke

1. Over-arching objective: Achieve long-run fiscal sustainability
2. Avoid abrupt fiscal actions that could impede the economic recovery
3. Choose reforms that promote long-term growth and economic opportunity
4. Improve the process for making long-term budget decisions

Source: Ben S. Bernanke, “Economic Outlook and Recent Monetary Policy Actions”, before the Congressional Joint Economic Committee, Oct. 4, 2011
More Specifically: What Some Economists Recommend

- An appropriate medium-term fiscal goal: Stabilize the debt-to-GNP ratio within five years
  
  - Achieved by stabilizing the budget deficit at about 2 to 3 percent of GNP

Source: International Monetary Fund
More Specifically: What Some Economists Recommend

- Components of a growth-promoting fiscal-consolidation strategy
  - Cut mandatory spending, including entitlements
  - Continue planned cuts in discretionary spending
  - Increase revenues and improve the efficiency of the tax system through tax reforms
    - Reduce tax expenditures (deductions, loopholes)
    - Implement a national value-added tax (VAT) or sales tax
    - Consider imposing a carbon tax

Source: International Monetary Fund
Current Federal Outlays

Percent of federal outlays, fiscal year 2011

- National defense: 19.4%
- Health: 10.4%
- Medicare: 13.5%
- Social security: 16.7%
- Income security: 19.8%
- Other: 20.2%

Source: Congressional Budget Office (CBO)
“Other” Federal Outlays

Percent of federal outlays, fiscal year 2011

- International Affairs
- General Science, Space & Technology
- Energy
- Natural Resources & Environment
- Agriculture
- Transportation
- Community & Regional Development
- Education/Training/Employment/Social Services
- Veterans Benefits and Services
- Administration of Justice
- General Government
- Interest less Commerce and Housing Credit and Undistributed Offsetting Receipts

Source: Congressional Budget Office (CBO)
Axing All “Other” Non-Interest Federal Outlays Cuts Less Than ½ of Deficit

Fiscal year 2011 "Other" non-interest federal outlays vs. total budget deficit (dollars)

- Fiscal year 2011 "Other" non-interest federal outlays: 576,177,000,000
- Fiscal year 2011 budget deficit: 1,298,613,000,000

Source: Congressional Budget Office (CBO)
Projected Shares of Non-Interest Federal Outlays Under CBO’s Alternative Fiscal Scenario

Outlay category as percent of total non-interest outlays

- **Health care**: 40%
- **Social Security**: 60%
- **Everything else**: 80%

Source: Congressional Budget Office (CBO)
Pre-Event Survey:
Would you favor or oppose cutting Medicare as a means of reducing the federal deficit?

- Favor: 46%
- Oppose: 39%
- Not sure / No opinion: 8%
Controlling Health-Care Spending Will Be Important

- Health-care inflation is expected to continue outpacing most other categories unless significant reforms are instituted.

- Both public and private health-care insurance programs have weak cost-control features, at best.

- There is mounting evidence that both outcomes and cost-effectiveness of health care can be improved significantly and simultaneously.
Improving the Policymaking Process

- Procedural and technical features to increase the likelihood of success
  - Congress should explicitly endorse a medium-term consolidation strategy in its entirety
  - Impose and enforce multi-year expenditure caps as a “failsafe” mechanism to stay on track
  - Use conservative economic assumptions when preparing annual budgets

Source: International Monetary Fund
Evidence of A Need For Improvement

- Standard and Poor’s (Aug. 5, 2011):

  “The downgrade [of long-term U.S. Treasury debt] reflects... our view that the effectiveness, stability, and predictability of American policymaking and political institutions have weakened.”
Cut Spending and Raise Tax Revenues? The View From the IMF

- International Monetary Fund (Sept. 19, 2011):

  “For a country like the United States where... the tax pressure is not particularly high, ... it is necessary that the medium-term fiscal adjustment plans also look at the revenue side given the magnitude of the overall adjustment that is needed....”
Conclusions About Bringing Future Deficits Under Control

1. Neither current law nor a continuation of current policies are palatable outcomes.

2. The Bowles-Simpson Commission (and many others) advocate broad-based spending cuts, including entitlement programs, as well as efficiency- and revenue-enhancing tax reforms.

3. Health-care reforms that reduce cost growth are critical for achieving long-term fiscal sustainability.

4. Budget-process improvements are highly desirable.
Part 3

- Your questions and comments