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Here Are the Facts

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President Bush's budget for 2005 has unleashed a widespread debate about the effects of budget deficits and the appropriate policy response to the current deficit projections.

Although fiscal deficits impose a burden on future generations, it would be wrong to respond now with a tax increase. Raising tax rates would hurt the expansion and weaken the incentives that drive long-term growth. Rescinding the Bush tax cuts on high income individuals would not only be economically counterproductive but would also have little effect on future budget deficits. A 15% increase in the taxes of those with incomes over $200,000 (e.g., taking the 35% top rate back to 40%) would reduce future budget deficits by a mere three-tenths of 1% of GDP aside from the adverse effect on long-term growth.

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The medium-term goal for U.S. fiscal policy should, at a minimum, be a constant or declining ratio of debt to GDP. Achieving that goal requires bringing the deficit down to about 2.5% of GDP or less. Recent analysis by the Congressional Budget Office indicates that there is ample time to decide whether more is needed to achieve this than tight controls on spending. The low interest rates on long-term bonds also show that the participants in financial markets have confidence that future deficits will be coming down.

Persistent budget deficits are harmful because they absorb funds that would otherwise be available for private investment in plant and equipment, an important source of economic growth. Although some of this crowding-out of private investment is offset by an inflow of capital from abroad, experience shows that large capital inflows eventually decline as foreign investors become concerned about their international exposure.

Budget deficits impose a further burden on future taxpayers because the resulting increase in interest payments means higher future taxes. The projected 2004 budget deficit of 4.2% of GDP will raise the national debt by that amount. Although some of the future interest payments could be financed by further borrowing rather than by raising taxes, this option is limited by the need to prevent an explosive rise in the debt-to-GDP ratio that would occur if borrowing alone were used to pay future interest costs. Borrowing only postpones the time when taxes have to be paid.

Whenever financial investors become concerned that future budget deficits will continue to rise, long-term interest rates increase and can do so very substantially. In 1984, when the fiscal deficit was 4.8% of GDP and expected to remain high or go higher, the interest rate on 10-year U.S. Treasury bonds was a remarkable 12.4%. Net of the 3.9% inflation rate, the real rate on those bonds was an extremely high 8.5%. Today the 10-year Treasury bond yield is only 4%, the lowest level in 40 years. The real yield on 10-year Treasury inflation protected securities (TIPS) is only 1.8%. All of this implies that the financial markets have substantial confidence that future deficits will decline relative to GDP.

The CBO's recent analysis of the fiscal outlook provides evidence that supports the financial market's confidence. Although the CBO's baseline projections assume no change in current law (implying, for example, that the Bush tax cuts will expire after 2010), the CBO report provides the building blocks for realistic projections. These estimates imply that even if all of the personal tax cuts are extended, a major reform of the Alternative Minimum Tax is enacted to remove most middle-income taxpayers from the AMT, and discretionary spending keeps pace with inflation, the fiscal deficit will decline from 4.2% of GDP in 2004 to 2.7% in 2009 and 2.6% in 2014. Such is the power of moderate growth and a tight control on discretionary spending.

Long-term budget projections are of course subject to substantial uncertainty. The projection that the deficit will decline to 2.6% in 2014 may be too optimistic or too pessimistic. No one in 1995 expected that the 1995 deficit of 2.2% of GDP would change over the next five years to a surplus of 2.4% of GDP. That happened because the large rise in the productivity growth rate after 1995 produced surprisingly strong GDP growth and much more tax revenue than forecasters had anticipated. President Clinton refused to cut tax rates to give that money back to taxpayers while the Republicans in Congress limited any new spending initiatives. The result was a budget surplus.

Looking ahead, one reason why actual budget deficits may be smaller than those implied by the CBO analysis is that the CBO bases its calculations on a projected GDP growth rate of only 2.8%. The improved productivity after 1995 has caused average GDP growth of 3.4% since then despite the recession. Continued growth at that rate for the next decade would reduce the fiscal deficit in 2014 from the projected 2.6% of GDP to just 0.9% of GDP.

Conversely, budget deficits could be significantly higher than this if real discretionary spending on defense and non-defense programs grows rapidly. Raising the growth rate of discretionary spending from the rate of inflation to the rate of growth of nominal GDP would increase the 2014 deficit by 2.4% of GDP, increasing the 0.9% of GDP potential deficit to 3.3%.

How is discretionary spending likely to evolve? The big increases in budget authority during the Bush administration have been in defense and homeland security, rising from 3.3% of GDP in 2001 to 4.3% in 2004 (including all of the supplemental appropriations.) Although this represents a real dollar increase of about 12% a year, the 4.3% of GDP earmarked for defense is still much less than the 5.8% of GDP spent on defense in the '80s or the 8.8% of GDP in the '60s. Going forward, the end of the Afghan and Iraq conflicts and the defense transformation planned by the Pentagon should permit limiting future defense outlays.

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Contrary to the complaints of many who criticize the Bush administration for favoring a continued rapid growth of domestic programs, the administration has actually been quite tough in controlling the budget authority for discretionary spending outside defense and homeland security. These limits on new appropriations will restrain spending growth in the years ahead. But the actual outlays of the past few years increased more rapidly than concurrent appropriations because of the delayed effects of the appropriations passed during the Clinton years.

Here are the facts. The appropriations for discretionary spending outside defense and homeland security rose 16% in the final Clinton budget, propelling future spending on these programs. The Bush administration reduced the growth of these appropriations to 9.2% in 2002 and then to 2.7% in 2003 and 2004. As a result, such appropriations fell from 3.5% of GDP in the first Bush budget to 3.3% in 2004 (including all supplemental appropriations.) The president's latest budget proposes to keep the 2004 dollar amount unchanged in 2005, implying a decline to less than 3.2% of GDP. Despite these tight controls on appropriations, the earlier appropriations caused actual outlays to rise 12.3% in 2002 and kept their growth at 5.8% in 2004. This long-term effect of past appropriations shows that bringing spending under control requires the passage of time as well as tough budget choices.

Shrinking the deficit to a level at which the debt is no longer rising faster than GDP will require tight spending controls or GDP growth at a faster pace than in the past 10 years. There is no reason to consider a tax increase at this time. The big budget challenges for the years ahead are to continue the tough controls on discretionary domestic appropriations, to use the defense transformation to limit the budget outlays for national security, and to start the reforms of Social Security and Medicare that will be needed to avoid a budgetary explosion when the baby boom generation begins to collect retiree benefits.

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