COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET

Our Debt Problems Are Still Far from Solved
May 15, 2013

Recently, a number of people have argued that little or no further action is needed to address the nation's growing national debt. The Committee for a Responsible Federal Budget (CRFB) responded to these claims in February with the analysis Our Debt Problems are Far From Solved, which showed that $2.4 trillion in new savings over ten years was needed to put the debt on a clear downward path as a share of the economy. Now, the improved budget projections from the Congressional Budget Office (CBO) have revived this discussion.

The good news is that the latest projections from the CBO show a significant improvement in debt levels. Our latest CRFB Realistic Baseline now shows the debt rising to 75 percent of GDP as opposed to 79 percent by 2023.

However, much of this improvement is due to short-term improvements that will change the *level* but not the *trajectory* of debt. We estimate putting the debt on a clear downward path as a share of the economy will still require at least **$2.2 trillion** of deficit reduction relative to our CRFB Realistic Baseline over the next decade (see Appendix I). If policymakers retain the across-the-board "sequestration" until it expires in 2021, **$1.6 trillion** in further savings will still be necessary to put the debt on a clear downward path.

Progress has been made and it is extremely encouraging to see that deficits are coming down. Yet, despite the progress made in enacting substantial short-term and temporary deficit reduction, policymakers have done little to combat the pressures of population aging, health care cost-growth, and an outdated tax code that will lead to a rising debt trajectory. Whether policymakers replace or retain the sequester, a combination of new spending cuts, entitlement reforms, and tax reforms will be needed to help support long-term economic growth and put the debt on a clear downward path relative to the economy.

This paper describes:

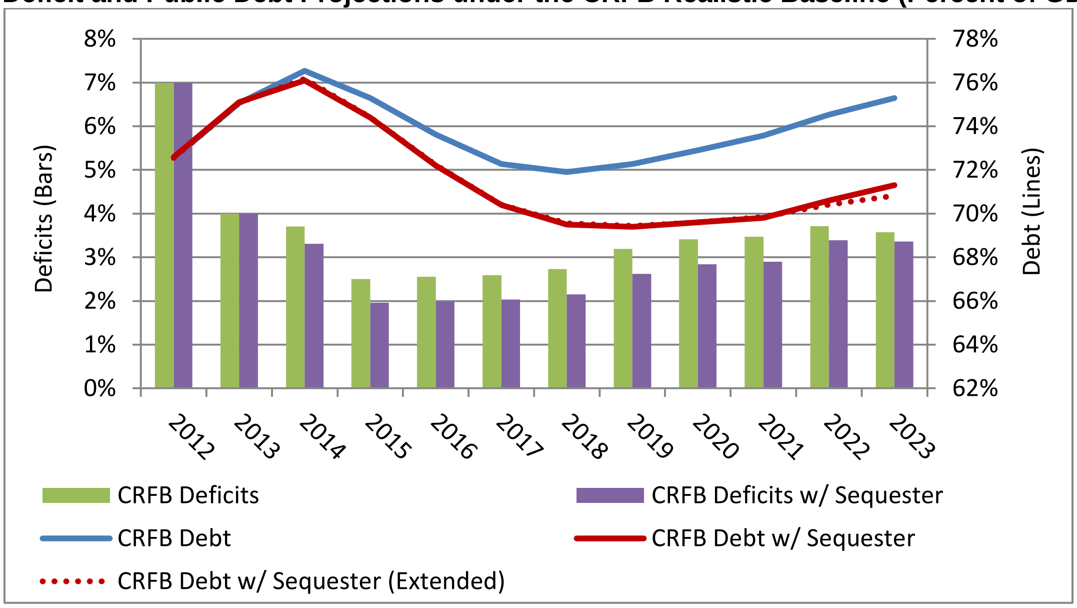
- The recent improvement in the CBO projections
- Why even with improvements, the fiscal situation is still not sustainable
- The CRFB Realistic Baseline (Appendix I)
- The amount of savings we have achieved so far (Appendix II)
- Our proposed minimum debt target (Appendix III)

Improved Debt Levels, but Little Change to Debt Trajectory

The latest projections from CBO show projected debt levels much improved since the February projections. When we adjust CBO's "current law" projections to include more realistic assumptions, there has also been an improvement in the budget. As a result, our CRFB Realistic Baseline now projects debt to rise to 75.3 percent of GDP in 2023 rather than 78.9 percent, and deficits to reach 3.6 percent rather than 3.9 percent.

While these improved debt levels are a welcome improvement, they unfortunately do little to change the *trajectory* of debt growth over the long-term. Under CRFB's Realistic Baseline -- which assumes sequestration does not continue beyond 2013 -- debt levels will now fall to a low of 71.9 percent of GDP in 2018. Beyond 2018, however, debt levels will begin to rise rapidly; reaching 75.3 percent in 2023 and continuing to grow thereafter.

Fig. 1: Deficit and Public Debt Projections under the CRFB Realistic Baseline (Percent of GDP)



Debt will continue to rise beginning late this decade. The improvements we are seeing are the result of the recovering economy, the winding down of remaining stimulus and the war in Afghanistan, various recently-enacted discretionary cuts and revenue increases, and continued slowing of health care costs and other spending programs. Yet, health care costs will continue to rise faster than the economy and the baby boom population is retiring in droves. These trends will put upward pressure on Social Security, Medicare, and Medicaid – pressure that policymakers have done nothing to alleviate in their deficit reduction efforts over the past two years. As federal borrowing grows later in the decade, so too will the interest burden.

In addition to these underlying trends pushing deficits and debt up over the long-term, it turns out that about half of the reductions in debt projections are due to short-term improvements that will affect debt *levels* rather than sustained changes in the *trajectory* of future debt. In 2023, the CRFB Realistic Baseline now projects debt to be $960 billion (3.7 percent of GDP) lower than was projected in February. Nearly half of that improvement, a full $450 billion, is due to changes occurring in fiscal years 2013 and 2014 alone (along with the resulting interest savings). Of that, about $100 billion comes from anticipated one-time dividend payments from Fannie and Freddie, $145 billion from higher than anticipated revenue over the next few years, and $70 billion from allowing the 2013 sequester to go into effect.

Fig. 2: Changes in CRFB Realistic Baseline Since February 2013 (2023 Debt Impact)

	Billions	Percent of GDP	Percent of Total Change
February CRFB Realistic Debt	**$20,470**	**79.0%**	**N/A**
Fannie/Freddie Dividends	-$100	-0.4%	10%
Higher Revenue Collection	-$145	-0.6%	15%
Sequester Taking Effect in 2013	-$70	-0.3%	7%
Other Changes	-$15	-0.1%	2%
Net Interest Changes	-$120	-0.5%	13%
Subtotal, 2013-2014 Changes	**-$450**	**-1.7%**	**47%**
Higher Revenue Collection	-$55	-0.2%	6%
Slower Health Care Growth	-$155	-0.6%	16%
Slower Social Security Growth	-$80	-0.3%	8%
Other Changes	-$90	-0.3%	9%
Net Interest Changes	-$105	-0.4%	11%
Subtotal, 2015-2023 Changes	**-$485**	**-1.9%**	**51%**
Other Technical Adjustments	**-$25**	**-0.1%**	**3%**
Total Changes	**-$960**	**-3.7%**	**100%**
May CRFB Realistic Debt	**$19,510**	**75.3%**	**N/A**

Note: Numbers are rounded.

Putting the Debt on a Downward Path

Policymakers should set a minimum goal of putting the debt on a clear downward path relative to the economy. While more ambitious goals, such as balancing the budget are admirable, a minimum a measure of sustainability is to keep the debt from growing faster than the economy – which can occur even with a small gap between spending and revenue.

However, just barely stabilizing the debt and declaring victory would be a serious mistake. We make the case for why it is necessary to put the debt on a downward path in detail in Our Debt Problems Are Far From Solved. In summary, settling for only sufficient deficit reduction to hold debt constant as a share of GDP carries several risks, including:

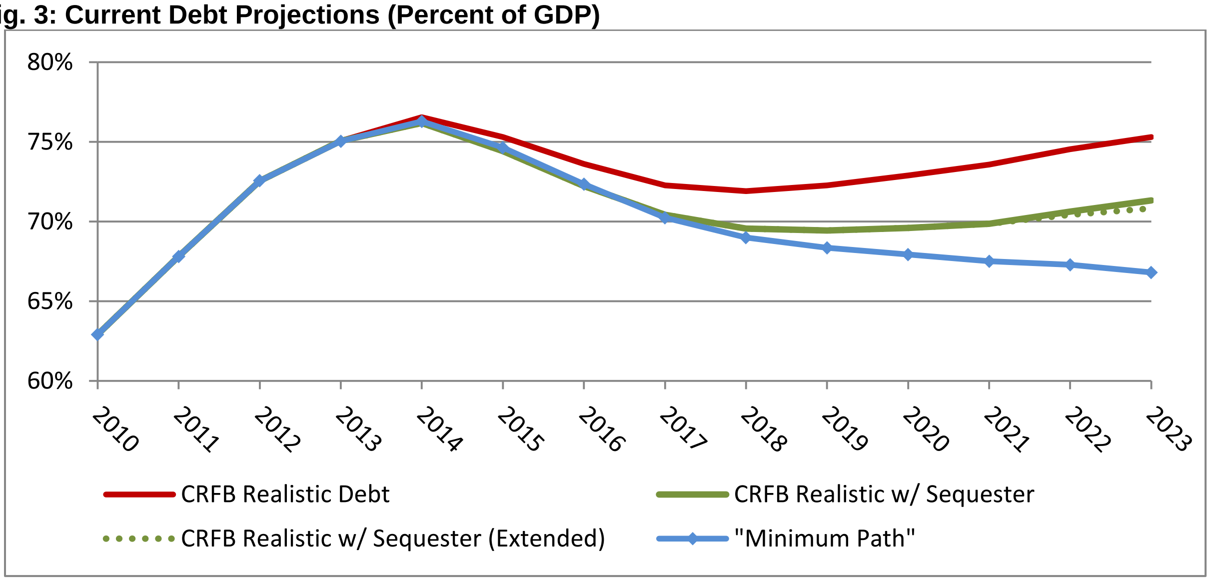
- **No Room for Error** if economic projections are too rosy or policymakers enact future deficit increasing policies.
- **No Long-Term Sustainability** since the deficit reduction necessary to achieve stability this decade is *highly unlikely* to keep debt stable in future decades.
- **Slower Economic Growth** as a result of the higher debt burden and the subsequent "crowding out" of productive investment.

- **No Fiscal Flexibility** in the case of natural disasters, security needs, or an economic downturn.

The actual deficit reduction necessary to put the debt on a clear downward path will depend on the timing of the policies. To calculate a reasonable savings target, we construct a relatively likely phase-in path. We then calculate the amount of savings over ten years necessary, under that path, to ensure the debt is declining between 2021 and 2023. Finally, we test the robustness of these savings to ensure debt is on a *clear* downward path. We do so by evaluating the savings against (1) a scenario where deficit reduction is phased in more rapidly; (2) a scenario where economic growth is modestly slower; and (3) a scenario where policymakers enact modest additional deficit-increasing policies. Appendix III explains these three tests in detail.

To put the debt on a clear downward path relative to our baseline (see Appendix I), we estimate it is likely to require about **$2.2 trillion** in additional deficit reduction through 2023. Assuming the sequester stays in effect, **$1.6 trillion** would be necessary – heavily back loaded – or **$1.4 to $1.5 trillion** assuming sequestration reductions continue after the sequester's expiration in 2021.

Fig. 3: Current Debt Projections (Percent of GDP)



Note that the total new deficit reduction if the sequester stays in effect would be $2.6 trillion ($1 trillion from the sequester plus the additional $1.6 trillion) as opposed to $2.2 trillion in additional savings if lawmakers were to replace the sequester with a gradual plan. More deficit reduction is needed if the sequester remains in place because the sequester cuts are too front-loaded to ensure fiscal sustainability later in the decade and beyond.

Beyond the Sequester

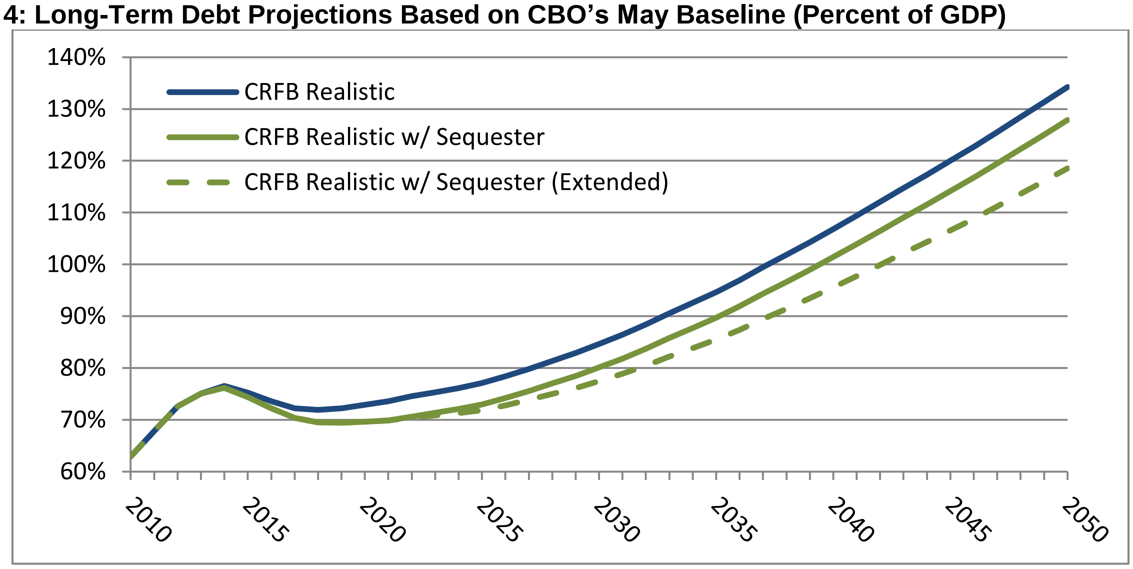
Although projected improvements alone cannot justify abandoning deficit reduction, some have argued that the spending cuts from sequestration render further deficit reduction unnecessary. Yet, while sequestration contributes substantially to deficit reduction over the next few years, it would be preferable to replace it with larger, gradually phased in, and more targeted savings that generate long-term fiscal improvements. This is true for a number of reasons:

Sequestration Is Too Small to Stabilize the Debt – because although it would generate about $1 trillion of savings through 2023 including interest, or $1.2 trillion if you assume its effects continue beyond 2021, this falls far short of the $2.2 trillion needed to put the debt on a clear downward path relative to the economy. As discussed above, keeping the sequester will ultimately require more deficit reduction to put the debt on a downward path given the upfront nature of the cuts.

Sequestration Does Not Change the Long Term Debt Trajectory – because cuts are focused almost entirely on discretionary spending instead of the parts of the budget where there will be the most growth. Discretionary spending was projected to grow by about 25 percent between 2014 and 2023. By comparison, the sequester *exempts* Social Security and Medicaid, and makes only very minor reductions to Medicare, when those three programs are projected to grow by roughly a combined 75 percent over the next decade. On top of this, the sequestration cuts do not increase over time, and ***the sequester ends in 2021.***

Indeed, by 2023 the sequester only saves $50 billion in direct and interest savings, compared to roughly *$350 billion* in the President's deficit reduction offer and *$500 billion* in the new Simpson-Bowles plan, "A Bipartisan Path Forward." Ultimately, the sequester would change the *level* but not the growth *trajectory* of the debt.

Fig. 4: Long-Term Debt Projections Based on CBO's May Baseline (Percent of GDP)



Note: CRFB has not updated its long-term model, but rather incorporated CBO's updated baseline projections into its 2012 model. Projections should be viewed as very rough.

Sustainability of the Sequester Is in Question – because it was *not* designed to be implemented and because Democrats and Republicans have both criticized it for numerous reasons. Budget proposals put forward from the House, Senate, and the Administration all repeal or modify the sequester in a significant way, suggesting a lack of support. History suggests it may prove difficult to retain very tight discretionary caps over the years, particularly under new Congresses and new Administrations. The last thing we should do is build-in policies we do not intend to keep as we have done previously with the SGR.

__Sequester Is Bad Growth Policy__ – since it does not phase in policy changes gradually, as an intelligently designed savings plan would do. Additionally, a pro-growth debt plan would include better incentives for work, investment, and innovation in both the tax code and entitlement programs. By contrast, the sequester is very front-loaded; cuts deeply into education, R&D, and other investments; and includes no pro-growth reforms.

__Waiting Until 2019 Will Be Too Late__ – and the risk is that while the sequester would reduce debt levels through 2019, it leads to suggestions that we should wait until later in the decade to pursue further deficit reduction. This would be ill-advised because to simply keep the debt stable between 2019 and 2023 would likely require well over $450 of primary savings over that time period. However, implementing that level of savings over such a short time frame may be unrealistic. Most deficit reduction measures with any level of political viability generate savings by slowing or freezing growth in various programs or provisions; or else by phasing in reductions gradually. Additionally, various "curve bending reforms" take time to truly have an effect, and savings from lower interest payments take time to accrue. Policymakers should enact a gradual plan as soon as possible, especially because of the risk that certain populations (i.e. current retirees) could be exempt from changes the longer we wait, making large amounts of deficit reduction incredibly difficult if not nearly impossible to implement quickly.

The Right Approach Forward

Pursuing a large, intelligent deficit reduction plan would be far better than continuing on our current path. Such a plan should include discretionary controls, but should focus on discriminately reducing low-priority spending rather than relying on across-the-board cuts, tackling the long-term pressures of health care cost growth and population aging, and reforming the tax code to promote growth and reduce deficits.

The recent plan put forward by former Senator Alan Simpson and Erskine Bowles, *A Bipartisan Path Forward to Securing America's Future*, demonstrates this point well. The plan calls for $2.5 trillion in deficit reduction over ten years – more than twice as much as the sequester – but also reduces the short-term impact of the sequester by 70 percent. Unlike the sequester, the plan would put deficits and debt on a downward path over the long-term while easing the upfront cuts – outcomes that are much more targeted for strong economic growth in the short and long-term. It also includes comprehensive tax and entitlement reform aimed at improving economic growth. As a result, we estimate the plan would increase the size of the economy by at least 0.2 percent in 2014 and 1.5 to 2 percent by 2023.

Policymakers should welcome the latest fiscal improvements, but they should not declare victory or become complacent about our long-term debt challenges. The sooner policymakers agree to implement thoughtful changes to the budget that deal with the real problems, the more likely the economy is to undergo a full and sustainable recovery.

Appendix I: The CRFB Realistic Baseline

The CRFB Realistic Baseline makes budgetary projections over the next decade based on what it considered to be the best reflection of our current path. Unlike CBO's official "current law" baseline that largely assumes the law occurs as written, the CRFB Realistic Baseline assumes certain legislative changes. As compared to CBO's baseline, the baseline makes the following adjustments:

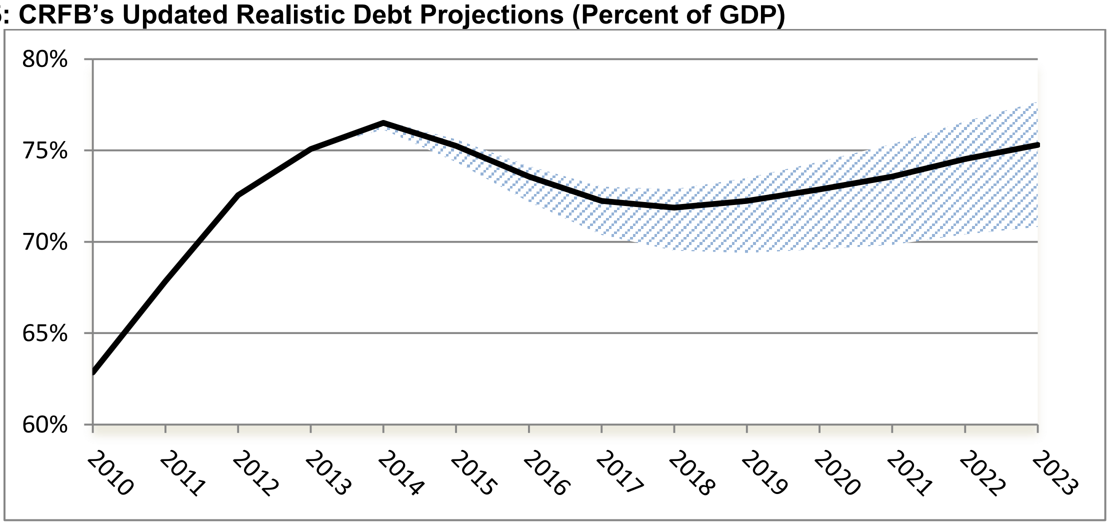
- A repeal of the sequester after 2013, with the sequester remaining in place for 2013
- A permanent extension of several tax credit expansions scheduled to expire in 2017
- A repeal of the Sustainable Growth Rate, which mandates a 25 percent reduction to Medicare physician payments in 2014 (the repeal is often referred to as the "doc fix")
- A drawdown of war spending more in line with current timetables (current law convention assumes current spending levels grow with inflation)
- A correction of the CBO current law projection of disaster relief, removing the assumption that temporary spending on Hurricane Sandy will grow annually with inflation

Bridge from Current Law to CRFB Realistic Baseline (Billions)	2014-2023 Cost/Savings (-/+)
CBO Current Law Deficits	**-$6,340**
Repeal Sequester after FY2013 (and Extrapolated Savings)	-$960
Extend Temporary Tax Credits	-$140
Repeal SGR and Freeze Physician Payments	-$140
Assume War Drawdown and Remove Sandy Aid Extrapolation	$885
Net Interest Effect	-$85
CRFB Realistic Baseline Deficits	**-$6,780**

Note: Some adjustments are based on February estimates and will be updated when new data is available.

Under the CRFB Realistic Baseline, deficits would total almost $6.8 trillion between 2014 and 2023 and debt levels would exceed 75 percent of GDP by 2023. This is based on the assumption that while the sequester remains in place for 2013, it is not continued in future years.[1] Importantly, debt could be as low as 71 percent of GDP in 2023 assuming the continuation of the sequester through 2021 (and for discretionary levels beyond 2021). On the other hand, debt could also feasibly be as high as 78 percent of GDP if normal business extenders were continued on a deficit-financed basis.

Fig. 5: CRFB's Updated Realistic Debt Projections (Percent of GDP)



[1] We retain this assumption based on the fact that sequestration was never intended as policy and the House, Senate, and President's budget would all increase discretionary sequester levels in significant ways.

Appendix II: Enacted Savings to Date

Although there are a number of ways to measure enacted savings, CRFB typically does so by looking at the 2014-2023 period and identifying the total reductions from major pieces of legislation since August of 2010. By that measure, our realistic baseline incorporates roughly $2.7 trillion of enacted savings; a number that would rise to $3.9 trillion if the sequestration remained in effect through 2021 and its discretionary reductions were continued in subsequent years.

These savings were created or codified based on two pieces of legislation: the Budget Control Act of 2011 (BCA) and the American Taxpayer Relief Act of 2012 (better known as the fiscal cliff deal). The BCA put in place discretionary spending caps from 2012-2021 to lock in and deepen previous discretionary reductions. It also put in place the automatic sequestration to put pressure on finding additional savings. The American Taxpayer Relief Act allowed various tax cuts to expire for wealthier Americans while also enacting modest further spending reductions.

Fig. 6: Deficit Reduction Enacted So Far

	2014-2023
American Taxpayer Relief Act	**$850 billion**
Revenue from higher earners	*$680 billion*
Reduction in discretionary caps	*$10 billion*
Roth 401k conversion provision	*$15 billion*
Reductions in health spending	*$30 billion*
Unemployment benefit extension	*-$10 billion*
Tax extenders	*-$5 billion*
Interest savings	*$130 billion*
Budget Control Act	**$1,075 billion**
Discretionary savings	*$910 billion*
Interest savings	*$170 billion*
Continuing Resolutions in FY2011	**$760 billion**
Discretionary savings	*$635 billion*
Interest savings	*$130 billion*
Sequester Savings from FY2013	**$50 billion**
Automatic discretionary, Medicare, and other cuts	*$40 billion*
Interest savings	*$10 billion*
Total Enacted Savings (w/o Sequestration)	**$2.7 trillion**
Sequestration	**$1.14 trillion**
Discretionary savings (through 2021)	*$695 billion*
Mandatory savings	*$120 billion*
Interest savings	*$200 billion*
*Extrapolated discretionary savings (2022-2023)**	*$125 billion*
Total Enacted Savings (w/ Sequestration)	**$3.9 trillion**

Source: CRFB calculations based on CBO and JCT data.
Note: Numbers may not add due to rounding, and have been updated since original posting to reflect model corrections.
* Assumes discretionary spending grows from sequester levels after 2021, as in CBO's baseline.

Importantly, there are a number of alternative ways to measure enacted savings depending on what is included and relative to what time period. Far more important than what has been enacted is the question of what will be necessary to put the debt on a sustainable path going forward.

Appendix III: Deriving the Minimum Debt Target

The minimum goal for any deficit reduction effort should be to put the debt on a clear, downward path as a share of the economy. The trajectory of the debt is far more important than the amount of deficit reduction, and also trumps the specific debt level at any given time, when aiming to produce a sustainable path.

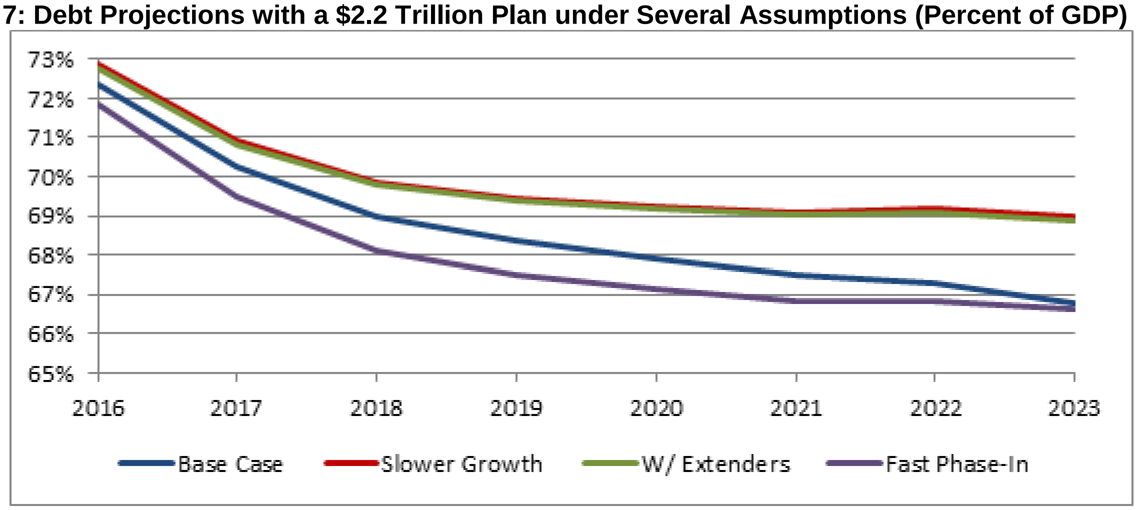
Determining whether a given deficit reduction plan leads to sustainability will require understanding the size, scope, path, and compensation of the proposed policy changes. Looking only at the size of the deficit reduction package, however, we find that a minimum of $2.2 trillion in deficit reduction is necessary to conclude the debt is on a downward path with some confidence. Those additional savings would bring the debt down from a peak of 76 percent of GDP in 2014 to below 67 percent in 2023.

CRFB reached this conclusion by examining several illustrative deficit reduction packages of varying sizes, testing both how they would affect the debt under our best estimate and how robust they were to deviations from that base case estimate. Specifically, we tested robustness against three models:

- **A fast phase-in model** where the same amount of ten-year savings would be achieved, but after phasing up quickly by 2017 and growing only with inflation thereafter.
- **A slower growth model** where the same amount of ten-year savings would be achieved, but economic growth would be 0.1 percentage points slower each year.
- **A fiscal irresponsibility model** that assumes policymakers enacted a bit more than $500 billion of deficit-financed measures over the next decade – the equivalent of continuing the normal "tax extenders" through 2023 outside of the deficit reduction package.

An illustrative package of $2.2 trillion in further savings would be sufficient to put the debt on a downward path under our base case but also under all three alternative scenarios.

Fig. 7: Debt Projections with a $2.2 Trillion Plan under Several Assumptions (Percent of GDP)



By comparison, a package of $2 trillion in further savings would result in only a stable path under the "fast phase-in" model and an increasing debt ratio under the other two models.