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America's Deficits and Debt

The Congressional Budget Office (CBO) of the United States recently published its latest analysis of the US federal budget deficit and debt over the long term, to 2035, an annual event. Their numbers are not good news.

CBO is an independent, non-partisan government agency that works directly for Congress (America's legislature), not for the US President. It regularly analyzes proposed budgets and changes in taxation, and it can respond to requests from Congress for quantitative analysis of other proposed actions. It thus serves as an independent source of information regarding proposed changes in economic policy and other matters. (The range of its reports can be seen on its website, www.cbo.gov)

Its latest work on the US federal budget involves two scenarios running to 2035, the first involving an "extended baseline" that assumes no further major changes in legislation that impact the federal budget. (Each of the fifty US states has its own budget and revenues, determined independently from the federal budget except for programmatic transfers, e.g. for health care, from the federal government to the states.)

The CBO projects the US economy to grow at 2.2 percent a year after full recovery from the 2008-2009 recession, an assumption that is important for estimating future revenue. Both income taxes and payroll taxes are sensitive to the size of the economy. It also assumes that certain features of the current tax law expire, as called for current law, at the end of 2012. This expiration would raise tax revenues significantly in 2013, by 2.9 percent of GDP. Even so, the federal budget deficit would continue at between three and four percent of GDP (down from 9.3 percent this year). Government debt held by the public (that is, excluding debt held by other government accounts, such as the Social Security Trust Fund) would grow slowly from the current 69 percent of GDP to 84 percent of GDP in 2035, receding slowing to around 75 percent thereafter. Debt rises both because of the continued deficits and because higher interest rates are assumed to prevail after the US economy recovers fully from its current slump.

These levels of debt, while troublesome and higher than the United States experienced over the past half century, are not unsustainable. They are comparable to levels in other major countries. Among the G-7, Canada has the lowest net debt-to-GDP ratio at 35 percent; Japan has the highest, at 128 percent, followed by Italy (101 percent), France (78 percent), Britain (75 percent), and Germany (55 percent). China is somewhat more complicated, since directly acknowledged central government debt is only 15 percent of GDP. But if one includes central bank debt and debt of major Chinese enterprises that the government clearly stands behind financially, such as the China Development Bank and the Chinese national railways, along with an allowance for future non-performing loans by the major state-owned banks arising from the frantic lending of 2009-2010, analysts have concluded that the national government's total debt exposure is around 80 percent of GDP, in the same general vicinity of the United States and several other large countries.

An alternative CBO scenario assumes that the lower tax rates currently prevailing will be extended, following past practice, beyond 2012, and that certain planned savings in the recently enacted health care program do not materialize. Under this scenario budget deficits are higher and debt held by the public "explodes" to 101 percent of GDP in 2020, to 186 percent of GDP in 2035, and on upward trend beyond that – a path that is clearly not sustainable.

Under both scenarios, traditional public goods – government expenditures for law enforcement, defense, infrastructure, basic research, collection of information on weather and on the economy, and so on – decline relative to GDP. In short, transfer programs for pensions and health care crowd out traditional public goods.

The CBO does not advise on policy; its work is descriptive and analytical. But even its more benign scenario underlines the need for significant increases in tax revenue and/or cuts in expenditure to place the federal budget on a comfortable trajectory.

It should be noted that among the rich countries of the world Americans (along with Japanese) enjoy the lowest total tax burden relative to their income. There is thus room, compared with other countries, for a significant increase in taxation. But Americans (like most people) dislike taxes, and any politician that proposes them risks defeat in the next election. A presidential panel chaired by Erskine Bowles (a democrat) and Alan Simpson (a republican) proposed some sensible revenue-increasing changes in the tax code last December, focusing on reduction of the many expenditures that are now deductable from taxable income, but most Republican politicians refused to endorse them. Even the Bowles-Simpson report represented a political compromise that is in some respects unsatisfactory. Much bolder action needs to be taken.

CBO's alternative scenario is truly alarming, suggesting that the US Congress cannot pursue business as usual. But it will take unusual political courage, or another financial crisis, to break out of that habit. The American political system, in contrast to a parliamentary system, is not designed for quick and efficient decision-making – even normally, but especially when different parties control the presidency and the two houses of Congress, as they do now with a democratic president and Senate, and a republican-controlled House of Representatives. Let us hope that they can reach some agreement before another financial crisis forces action.

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