THE CONCORD COALITION

1011 Arlington Blvd
Suite 300
Arlington, VA 22209

Tel: (703) 894-6222
Fax: (703) 894-6231
concordcoalition.org

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STRUCTURAL DEFICITS: WHAT ARE THEY, WHY DO WE HAVE ONE, AND WHY SHOULD WE WORRY ABOUT IT?

I. What's a structural deficit?

One possible response to the recent spike in federal budget deficits -- from $161 billion in 2007 to more than $1 trillion in each of the last three years is: Don't worry. It's all caused by the bad economy. When the economy recovers, we'll be fine.

This line of reasoning has led some to conclude that deficit reduction should be deferred while we do things to stimulate the economy, such as tax cuts and new spending, which would actually increase the deficit in the near-term. It's a theory that's only half right, and ignoring the half that is wrong could get us into much deeper trouble.

We do indeed need to be concerned about growing the economy and it's certainly true that a growing economy will help reduce the deficit. Moreover, economic theory suggests that immediate spending cuts or tax increases could hamper the recovery by limiting demand. That does not mean, however, that we should put aside all policy changes designed to reduce deficits over time. Indeed, implementing a credible long-term strategy to bring deficits down to a more sustainable level would likely enhance near-term assistance to the economy.

As Douglas Elmendorf, director of the nonpartisan Congressional Budget Office (CBO) has stated, such steps "would tend to boost output and employment in the next few years by holding down interest rates and by reducing uncertainty and enhancing business and consumer confidence."[1]

To understand the current situation and to choose appropriate solutions, it is important to distinguish between "cyclical" and "structural" components of the deficit.

The cyclical component can be attributed to the weak economy. A recession drives down government revenue because many workers and businesses are no longer earning as much

[1] Statement of Douglas W. Elmendorf, CBO Director, before the Joint Select Committee of Deficit Reduction, September 13, 2011, p.5.

taxable income. At the same time, government spending rises because more people need assistance through programs such as Medicaid, unemployment benefits and food stamps.

In budget parlance, these are known as “automatic stabilizers” because they help to maintain demand in an economy that is not producing enough of it to keep growing. The result is a temporary, or cyclical, increase in the deficit. Once the economy recovers, tax revenue and government spending on assistance programs should return to normal levels.

If government spending exceeds tax revenue even when the economy is strong, then the deficit is deemed to be “structural.” Unlike cyclical deficits, structural deficits reflect a chronic problem that must be addressed through changes in tax and spending policies. The most effective policy changes are those affecting permanent law, such as entitlement programs and tax provisions that run on autopilot. With structural deficits, one-time spending cuts or temporary tax increases may help to relieve the pressure but cannot solve the problem.

The United States currently faces both a cyclical and a structural deficit. The cyclical deficit is caused by the financial crisis and severe recession from which the country is still recovering. The structural deficit reflects a chronic mismatch between government revenue and spending that under current policies will dramatically worsen as health care costs rise and the population ages.

According to the CBO, cyclical factors added $367 billion to the deficit in 2011. This still left a structural deficit of $928 billion, for a total deficit of $1.3 trillion. Meanwhile, debt held by the public rose from 62.8 percent of GDP to 67.7 percent.

II. Why do we have a structural deficit?

A number of non-cyclical factors have contributed to the high deficits of recent years. Some of these are related to (but not caused by) the economic downturn. For example, a combination of temporary spending increases and tax cuts intended to stimulate the economy have been enacted since 2008. Such legislation in 2011 increased the deficit by about $300 billion. These stimulus measures are not expected to have a lasting effect on the deficit because they are temporary, although the recently extended unemployment benefits and payroll tax cut will add $101 billion to the deficit in 2012. (Because of delayed offsets, the package will cost $90 billion over 10 years).

Another factor that is temporarily expanding the deficit is the cost of operations in Iraq and Afghanistan. According to CBO estimates, outlays for these activities totaled $165 billion in 2011 and will cost another $145 billion in 2012.

Significant as these factors have been in pumping up near-term deficits, they are not the most problematic aspect of the structural deficit. Of more concern is the projected growth of the three largest entitlement programs: Social Security, Medicare and Medicaid.

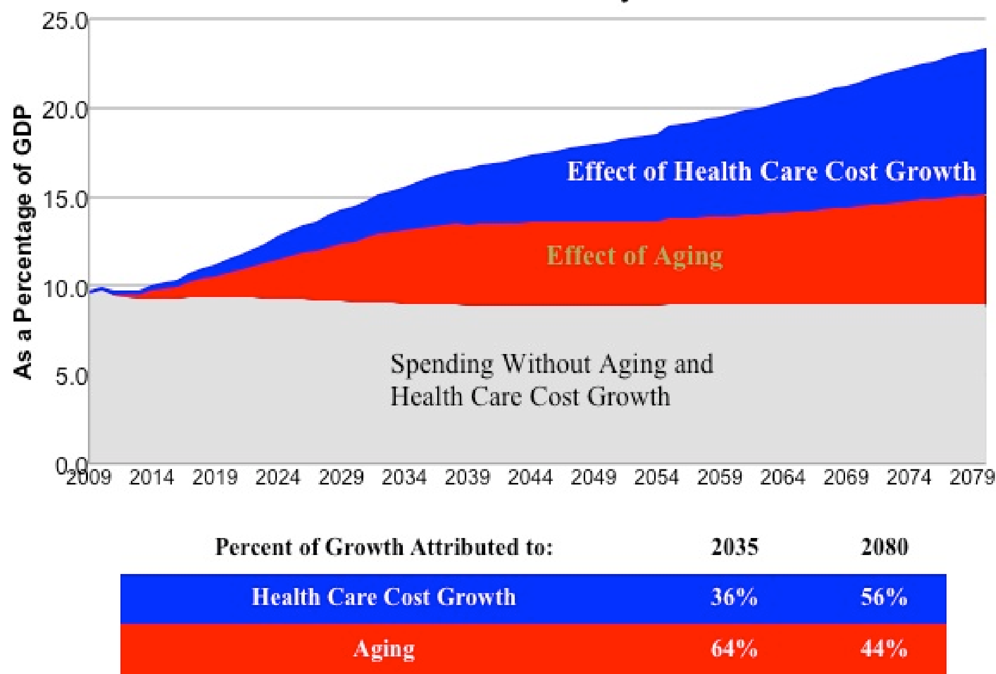
The basic facts are a matter of arithmetic, not ideology. Two factors stand out: demographics and

health care costs.

Over the next 25 years, the number of Americans aged 65 and up is expected to jump from 13 percent of the population to 20 percent. This alone will drive up the cost of the big three entitlement programs, which already comprise 42 percent of all federal spending.

Demographic change, however, is only part of the problem. For several decades, health care costs have consistently outpaced economic growth. If this phenomenon persists, it will greatly compound the growing fiscal pressure.

In short, there will be many more seniors consuming a product (health care) that tends to grow faster on a per-beneficiary basis than economic growth. According to CBO, 64 percent of the cost growth for these three programs through 2035 is attributable to population aging and the remaining 36 percent to rising health care costs.



Percent of Growth Attributed to:	2035	2080
Health Care Cost Growth	36%	56%
Aging	64%	44%

Source: Congressional Budget Office, June 2010 & 2011.

Borrowing our way through this is not a viable option because the rising cost of Social Security, Medicare and Medicaid is not a temporary blip. It gets bigger with time. Incurring permanently rising debt would result in staggering interest costs and ultimately a total debt burden that would crush the economy.

The best way to view the problem is to look at spending, revenues, deficits and debt as a share of the gross domestic product (GDP) over time. Doing so provides context by showing the timing and magnitude of the problem measured against the size of the economy.

Over the past 40 years:

- Federal spending has averaged 21 percent of GDP.
- Revenues have averaged 18 percent of GDP.
- Deficits have averaged 3 percent of GDP.
- Debt held by the public has averaged 37.4 percent of GDP.

This contrasts with where we are headed under current law. Using CBO's June 2011 Long-Term Budget Outlook as a guide, by 2035:

- Federal spending will rise to 27.4 percent of GDP.
- Revenues will rise to 23.2 percent of GDP.
- Deficits will increase to 4.2 percent of GDP.
- Debt held by the public will rise to 84 percent of GDP.

The main components of spending growth are clear. According to CBO, by 2035:

- Medicare will grow by 2.2 percent of GDP.
- Social Security will grow by 1.3 percent of GDP.
- Medicaid and other health programs will grow by 1.6 percent of GDP.
- In total, these programs will add 5.1 percent of GDP to federal spending by 2035.

Adding 5.1 percent might not seem like a lot but in terms of GDP it is quite substantial. Consider that in 2011 defense spending (including war costs) was 4.7 percent of GDP. That means the projected cost increase of the major entitlement programs could not be fully offset even if all defense spending were eliminated. The same is true for all non-defense appropriations, which totaled 4.3 percent of GDP in 2011.

Covering the added cost with new revenue would require the equivalent of an 80 percent hike in individual income taxes over the 40-year average. Even this, however, would not stop the debt from growing as a percentage of the economy because it would not cover the cost of rising interest payments on the debt.

Deficits add to spending by increasing interest costs. Under CBO's current law baseline, interest costs will add another 2.7 percent of GDP to the budget, growing from 1.4 percent of GDP in 2010 to 4.1 percent in 2035.

If all this sounds like a daunting challenge, it is. But it is far from a worst-case scenario. In fact, it is quite optimistic because it is based on a series of assumptions about current law that range from questionable to extremely unlikely.

For example, current-law projections assume that major tax cuts first enacted in 2001 and 2003

on a temporary basis will expire on schedule at the end of 2012 and that no further relief will be granted from the Alternative Minimum Tax (AMT). These assumptions produce a revenue windfall that neither political party seems prepared to accept.

On the spending side, the current-law baseline assumes that appropriations, including defense, will grow no faster than inflation; that Medicare physician reimbursements will be cut by about 30 percent in the coming years; and that the provisions of the 2010 health care reform bill (Affordable Care Act, or ACA) will be fully implemented and effective.

Altering these assumptions to better reflect continuation of current policy rather than strict application of current law reveals an even more troubling outlook.

For illustrative purposes, CBO has produced an alternative scenario in which tax cuts for households below $250,000 of annual income are extended (consistent with the President's proposal), AMT relief is extended, appropriations keep pace with economic growth, Medicare physician payments are not cut and the cost-saving provisions of the ACA are not fully implemented.

In that alternative scenario, by 2035:

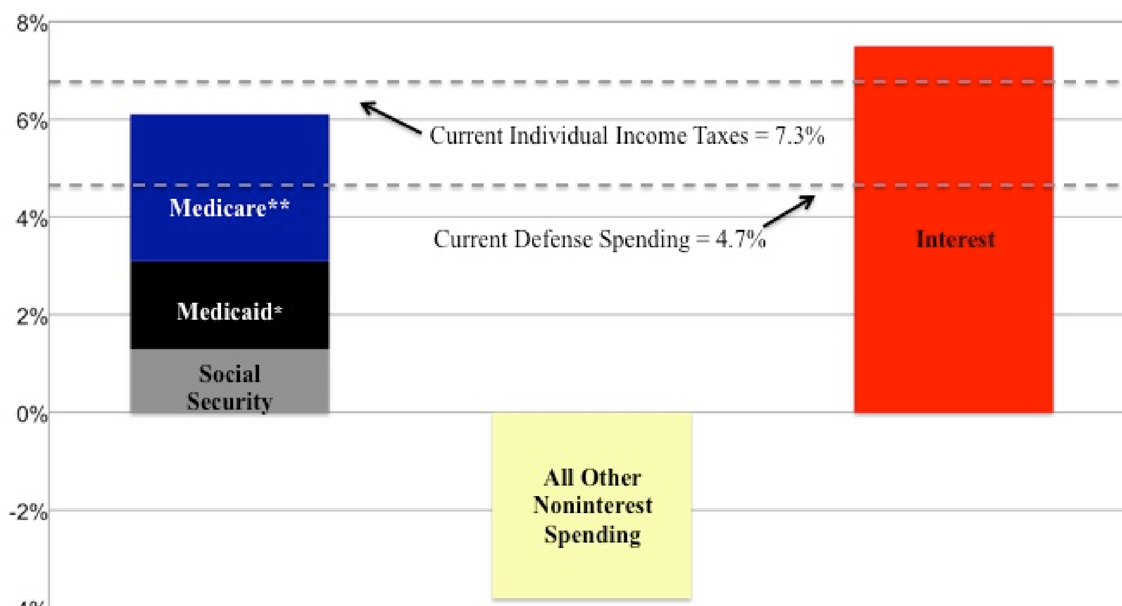
- Federal spending rises to 33.9 percent of GDP.
- Revenues remain near the 40-year average at 18.4 percent of GDP.
- The deficit increases to 15.5 percent of GDP.
- Debt held by the public rises to 187 percent of GDP.

The main components of federal spending growth are even more apparent. Between 2011 and 2035:

- Medicare grows by 3 percent of GDP.
- Social Security grows by 1.3 percent of GDP.
- Medicaid and other health programs grow by 1.8 percent of GDP.
- In total, these programs add 6.1 percent of GDP to federal spending by 2035.

Because spending is higher and revenues are lower in this scenario, the impact of interest costs on the debt is even more devastating, adding 7.5 percent of GDP to federal spending by 2035.

In other words, absent change, the structural deficit under current policies produces a vicious cycle of higher deficits, debt and interest costs that spirals upward in perpetuity. No plausible level of economic growth can change this dynamic. It requires a legislated solution.



III. Why should we worry about our structural deficit?

The most basic reason to be concerned about the structural deficit is that it is projected to grow faster than the economy. Even assuming a strong economy (i.e, no cyclical deficit), current policies (i.e., the structural deficit) will produce a steadily rising debt-to-GDP ratio for as far as the eye can see. Eventually, the debt burden would become too great to bear. Although it is impossible to say exactly when that would happen, it would be foolish to risk finding out.

While cyclical deficits can assist the economy to get back on track (or at least smooth out the bumps), large chronic deficits pose significant risks in many ways. For one thing, deficits tend to divert savings away from more productive investments in the growth capacity of the economy. The strength of the future economy depends on an educated workforce, productive capacity, sources of energy and solid infrastructure. If there is no financial slack in public budgets because a rising share of available resources are already committed to programs for older people and to paying interest on the national debt, it will be harder to invest in children, research and development, transportation and communication, and other factors that will promote future growth.

As noted above, interest costs on the debt are projected to balloon over the coming decades and could grow even larger if investors in government bonds become concerned that policymakers have no plan to get the nation on a more sustainable path. Today, the federal government is able to borrow vast sums at remarkably low interest rates because the United States is still considered a safe haven. But as we have seen in other nations, interest rates can rise and the cost of servicing the debt can expand correspondingly when investors become nervous.

Beyond fiscal imbalance, the policies embedded in today's budget threaten to place ever-tighter constraints on the ability of future generations to determine their own fiscal priorities or to meet challenges that cannot be foreseen. As the share of federal resources pledged to retirement and health care benefits grows, it will leave shrinking amounts for all other purposes.

Worse yet, the economic pie itself may shrink. According to CBO, lower levels of savings and investment caused by deferring action on a credible deficit-reduction plan could reduce the size of the economy by 0.3 to 1.9 percent of GDP by 2021.[2]

Many economists recommend increasing our low level of national savings to better fund productive investments that will help grow the economy. A larger economy would make the looming fiscal burden more affordable. Deficits, however, decrease national savings. Unfortunately, Americans' personal savings rate has steadily declined since the early 1990s. Net national saving (private and public) has plummeted from 8.5 percent of our gross national income 25 years ago to essentially flat during the current economic slowdown.[3]

The savings gap has been filled with capital from abroad. The portion of the government's privately held debt owned by foreign investors has risen dramatically since 2001-- from 37 percent to 55 percent.[4] Reliance on foreign borrowing increases the budget's exposure to international capital markets and decisions made by foreign interests. A reduction in lending to the United States by foreign investors and central banks, for whatever reason, could drive down the value of the dollar and drive up interest rates. Moreover, interest payments on debt held by foreign investors acts as a growing mortgage on future national income.

No nation can prosper without investing, nor can it invest for long without saving, nor can it save for long without a responsible fiscal policy.

To be sure, many variables contribute to a rising living standard. But clearly capital formation is a necessary condition. Moreover, it is the one condition a society can directly control. We cannot legislate technological breakthroughs -- or even a higher private savings rate. But we can legislate a responsible fiscal policy to end the drain on national savings caused by budget deficits.

[2] ibid. p. 33.

[3] Reflects final 2011 numbers revised on February 29, 2012.

[4] Measured from June 30, 2001 through September 30, 2011. Table OFS-2 U.S. Treasury, Monthly Treasury Bulletin, December 2011.

Structural deficits will persist so long as policymakers continue to spend more than they tax. It is a matter of simple arithmetic. Closing the structural deficit means coming to grips with the forces that are driving spending and revenues farther apart and with the magnitude of the changes that must be made to rein in the resulting deficits.

CBO Director Elmendorf succinctly summarized the situation in testimony before the deficit reduction super committee last September: “The nation cannot continue to sustain the spending programs and policies of the past with the tax revenues it has been accustomed to paying. Citizens will either have to pay more for their government, accept less in government services and benefits, or both.”[5]

[5] Elmendorf, p.7.