A Closer Look at the U.S. Public Debt Problem

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Abstract

The sharp rise in the ratio to GDP of U.S. federal debt held by the public and forecasts that this ratio could approach 200 percent by 2035 under current budget policies have raised concerns that current federal fiscal policy is unsustainable. This paper reviews trends and forecasts in U.S. federal debt held by the public, highlighting the key contributions of Social Security and federal health programs, themselves reflecting an aging population and incentives for health care spending, to rising debt-to-GDP ratios. While tax increases and spending cuts scheduled to occur in 2013 (the “fiscal cliff”) could address the debt problem, the resulting sudden shrinkage in the deficit could throw the economy into recession. Various plans, most with combinations of spending cuts and revenue increases, have been offered as alternatives to the fiscal cliff, and several would return the debt-to-GDP ratio to about 60 percent by the mid-2020s. But the leading political parties have had trouble reaching agreement on a plan. Unless a compromise can be reached, the U.S. risks experiencing either the fiscal cliff or, if current provisions are eliminated, a large and increasingly high debt-to-GDP ratio.

I. Facts and Figures on the Problem

There seems broad agreement that the United States has a public debt problem. The Congressional Budget Office (CBO), generally considered a reliable and non-partisan source of U.S. budget information, has noted that, from 2008 to 2011, U.S. federal government debt held by the public rose from 41 to 68 percent of GDP (Figure 1). Indeed, by 2010 federal debt held by the public, as a share of GDP, exceeded maximum levels in all previous periods, except for World War II (Figure 2). The 68 percent of GDP figure (which excludes another 35 percent of GDP in gross debt of state and local governments) exceeds the 60 percent ceiling established for countries within the Euro zone under the Maastricht Treaty, a level often considered to be the “safe maximum” level for public debt in high-income countries.

Most analysts also agree that, if the Congress simply undoes the so-called “Fiscal Cliff” – the expiration of the Bush-era tax cuts plus the spending cuts scheduled in the Budget Control Act of 2011 (BCA 2011) to take effect in January 2013 (see Appendix I) – without enacting an alternative debt reduction plan, the federal debt-to-GDP ratio is likely to rise considerably. The August 2012 CBO forecast of long-term budget trends for the U.S. federal government, described as the “Alternative Scenario” in Figure 3, shows federal debt held by the public reaching 89.7 percent of GDP by the end of fiscal year 2022 if the tax cuts are extended and provisions in BCA 2011 are rescinded. CBO has estimated that maintaining the “Fiscal Cliff,” represented in the “Baseline Scenario” of Figure 3, would reduce federal debt held by the

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1 U.S. Federal debt held by the public excludes federal debt holdings by U.S. government trust funds.
2 IMF staff estimated the gross debt of the U.S. general government sector, which includes the debt of state and local governments and federal debt held by federal trust funds, at 102.8 percent of GDP at end-2011. See IMF (2012), Staff Report for the 2012 Article IV Consultation with the United States (Washington: IMF Country Report 12/213, August), Table 3, page 48, http://www.imf.org/external/pubs/ft/scr/2012/cr12213.pdf.
3 The IMF has used 60 percent of GDP as the target ceiling for public debt in advanced economies when calculating the required change in cyclically adjusted primary balances to achieve fiscal sustainability. See IMF (2012), Fiscal Monitor (April), Statistical Table 10a, page 71, http://www.imf.org/external/pubs/ft/fm/2012/01/pdf/fm1201.pdf.
public to about 58.5 percent of GDP in 2022. However, CBO projects that maintaining the “Fiscal Cliff” would push the U.S. economy into recession in 2013, with real GDP growth falling from 1.7 percent to negative 0.5 percent and the unemployment rate rising from 8.0 percent to 9.1 percent. Economists elsewhere have also forecast sharp declines in real GDP if the fiscal tightening now scheduled for 2013 is not undone. For example, Goldman Sachs has projected an output drop of more than 3 percent during the first quarter of 2013 if current law is maintained (Figure 4); IMF staff view the “Fiscal Cliff” as a fiscal withdrawal of more than 4 percent of GDP. Because of the macroeconomic risks, the IMF, in its 2012 economic consultation with the United States, recommended that the U.S. government replace the currently mandated budget tightening with a more gradual approach that allows some stimulus in 2013 to strengthen the economy in the short-run while setting in place longer-term measures to reduce federal debt. An IMF staff proposal, for example, would reduce federal debt held by the public to about 71 percent of GDP by fiscal year 2022.

Over the longer term, overriding the BCA 2011 and restoring the expiring tax cuts, without alternative plans for fiscal restraint, could raise federal debt far more. CBO’s “Alternative Fiscal Scenario” shows federal debt rising to about 200 percent of GDP by fiscal year 2037 (Figure 5). Other organizations have made similar projections. For example, the Committee for a Responsible Federal Budget (CRFB), which has undertaken many efforts to promote debt reduction, has forecast a substantial, but somewhat smaller, rise in federal debt held by the public under a partial rollback of the BCA 2011 provisions.

II. Factors Responsible for the U.S. Public Debt Problem

What causes U.S. federal debt to balloon if the “Fiscal Cliff” is overridden? In terms of programs, federal health care activities and Social Security seem particularly important. On the assumption that the revenue increases and spending cuts now required are overridden, in June 2012 CBO projected the following:

1. **Expenditures for Medicare**, the federal program providing health insurance for those age 65 and above, were forecast to rise by 0.8 percent of GDP between fiscal year 2012 and fiscal year 2022 and a further 2.2 percent of GDP by fiscal year 2037.

2. **Outlays for other federal health programs**, including Medicaid (care for the poor, including indigent persons in nursing homes), CHIP (health insurance for low-income children), and subsidies for health

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care exchanges under the Affordable Care Act of 2010 were projected to rise by 1.3 percent of GDP from fiscal year 2012 to fiscal year 2022 and a further 0.7 percent of GDP by fiscal year 2037.

3. Spending for Social Security, comprising the Old Age Survivors’ Insurance and Disability programs, would rise by about 0.4 percent of GDP from fiscal year 2012 to fiscal year 2022, and another 0.8 percent of GDP by fiscal year 2037.

All other federal expenditures, excluding interest, were forecast to decline by about 3.8 percent of GDP from fiscal year 2012 to fiscal year 2022 and then rise by about 1.8 percent of GDP by 2037. Revenues were projected to recover by about 2.8 percent of GDP from fiscal year 2012 to fiscal year 2022 and remain at about 18.5 percent of GDP through 2037. However, higher revenues and lower spending for these other programs would not offset the rise in outlays for health care programs and Social Security.

The steady rise in federal debt under this scenario would also lead to large interest payments. Under this scenario, with federal revenues averaging 18.5 percent of GDP and non-interest outlays rising to about 20 percent of GDP by fiscal year 2022 and 26 percent of GDP by fiscal year 2037, CBO forecast that net interest payments would rise by about 2.3 percent of GDP between fiscal year 2012 and fiscal year 2022, and another 5.8 percent of GDP by fiscal year 2037, reaching 9.5 percent of GDP that year.

At a more fundamental level, the main causes of the debt accumulation are population aging and sharp increases in health care costs. In the United States, the percentage of the population age 65 and above is expected to rise from 13 percent in 2012 to about 20 percent in 2037, while the fraction of those age 20 to 64, who would normally finance Social Security and Medicare, is projected to decline from 60 percent to 55 percent. At the same time, the U.S. approach to health care, with considerable “first-dollar” insurance coverage, Medicare and other insurers generally reimbursing providers on a fee-for-service basis, and considerable health care spending during the last year of a patient’s life, has helped health care spending generally to grow much faster than overall GDP. In its 2012 long-term outlook CBO has estimated that population aging explains about 68 percent of the expected rise in Social Security and major health care outlays, with “excess cost growth” explaining the rest. For federal health care spending alone, CBO estimated the “excess cost growth” explains about 48 percent of the increase.

III. Solving the Debt Problem: General Considerations (fiscal sustainability)

Fiscal theory argues that the key to reducing the public debt-to-GDP ratio lies in securing what is called a “primary fiscal surplus”: where government revenues exceed non-interest expenditures. As Ley (2009) and others have demonstrated, the following expression shows broadly the change in the government’s debt to GDP ratio ($d_t$), if public debt is issued in domestic currency:

$$d_t = \frac{r_t - g_t}{1 + g_t} * d_{t-1} - b_t - s_t$$

where

10 Id., p. 13.
12 This explanation, including the form of equation (1), is taken from Greene, Joshua (2012), Public Finance: An International Perspective (Singapore: World Scientific), chapter 5.
\( r_t \) = the average real interest rate on government debt;

\( g_t \) = the real growth rate of gross domestic product (GDP);

\( d_{t-1} \) = the government’s debt-to-GDP ratio at the end of the previous period;

\( b_t \) = the primary (non-interest) fiscal balance, in percent of GDP; and

\( s_t \) = the amount of non-debt-creating flows to the budget during year \( t \), in percent of GDP.

Unless the average real interest rate on government debt is less than the real growth rate of GDP, a primary surplus \((b_t > 0)\) is needed to achieve a continuing decline in the government’s debt-to-GDP ratio, since any revenues from non-debt-creating flows, such as privatization receipts or sales of capital assets, are one-time events and can hardly be expected to provide continuing large amounts of budget revenue. Although during the first few decades of the post World War II period high real growth rates and low or negative real interest rates (as a result of low nominal interest rates and moderate inflation) helped reduce public debt-to-GDP ratios in many advanced economies,\(^{13}\) similar good fortune seems less likely for the United States over the coming decades, even with low inflation, because economic growth rates are likely to be modest – averaging perhaps 2 to 3 percent a year. With \( r_t \) and \( g_t \) roughly equal, the primary balance, \( b_t \), typically must be positive to reduce the debt-to-GDP ratio, with the size of \( b_t \) depending on the values of \( r_t \), \( g_t \), and \( d_{t-1} \). If \( r_t \) exceeds \( g_t \), the required primary surplus will be larger, the larger is the debt-to-GDP ratio at the end of the previous period. This explains why governments are often advised to start on debt reduction programs sooner rather than later, before the debt-to-GDP ratio rises further and even more fiscal adjustment (a larger primary fiscal surplus) is needed.

Although equation (1) helps to indicate the required primary surplus to reduce the debt-to-GDP ratio by a certain amount in a single year, governments with very high debt-to-GDP ratios typically plan for a multi-year period of fiscal consolidation to reduce the ratio to a more sustainable target level. For this purpose, analysts have identified another formula indicating the required primary surplus to achieve each year to reduce the debt-to-GDP ratio to the targeted level\(^{14}\):

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(2) \quad b = \frac{(\beta - 1) \ast (\sigma - \beta^n)}{(1 - \beta^n)} \ast d_0, \text{ where }
\]

\[
\beta_t = \frac{1 + r_t}{1 + g_t}, \text{ and } \beta_t, r_t, \text{ and } g_t \text{ are assumed constant over the period;}
\]

\[
\sigma = \text{the target debt-to-GDP ratio divided by the initial ratio;}
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\[
n = \text{the number of periods to achieve the targeted ratio; and}
\]

\[
d_0 = \text{the initial debt-to-GDP ratio.}
\]


\(^{14}\) This explanation, including the form of equation (2), is also drawn from Greene (2012), op. cit., chapter 5.
For example, suppose the starting debt-to-GDP ratio is 78 percent, close to CBO’s projection for the federal government’s ratio to GDP for debt held by the public at the end of fiscal year 2013 (78.6 percent), and the targeted ratio is 60 percent, making $=0.76923$. Let $r = 1.5$ percent and $g = 2$ percent, so that $\beta = .9951$. Suppose the goal is to achieve a 60 percent ratio at the end of fiscal year 2022, so that $n = 9$. Using the above formula, the required yearly primary fiscal surplus is calculated as follows:

$$\beta - 1 = .9951 - 1 = -.0049;$$

$$\beta^9 = .956738, \quad \sigma = .956738 - .18751;$$

$$1 - \beta^9 = 1 - .956738 = .043262$$

Therefore, $b = (-.0049) * (-.18751) / (.043262) * 0.78 = 0.016566$, or a required primary surplus of nearly 1.7 percent of GDP each fiscal year from 2014 through 2022. That compares to CBO’s forecast primary deficit of about 4.2 percent of in fiscal year 2014 under its alternative scenario, implying the need for fiscal adjustment approaching 6 percent of GDP just in that year.15 CBO’s extended baseline (“Fiscal Cliff”) scenario, in which consolidation begins in fiscal year 2013, forecasts primary fiscal surpluses reaching 1.2 percent of GDP by fiscal year 2022 and remaining around 1.1 percent of GDP in fiscal year 2037. In this scenario, CBO forecasts that federal debt held by the public will decline to about 58.5 percent of GDP in fiscal year 2022, as noted earlier, and to about 53 percent of GDP in fiscal year 2037.16

Since the primary fiscal surplus is the main variable for determining sustainability, any combination of revenue increases and spending cuts achieving the required surplus will yield the desired debt reduction. However, Alesina and Ardagna (2009) claim that fiscal consolidations based on spending cuts typically fare better in reducing deficits and debt than those relying mainly on tax increases.17 Moreover, Alesina, Favero, and Giavazzi (2012) contend that spending-based consolidations have generally hurt output and growth in advanced economies less than consolidations relying more on revenue increases.18 At the same time, raising the growth rate can also reduce the debt-to-GDP ratio. Achieving rapid growth helped Ireland reduce its debt-to-GDP ratio during the late 1980s,19 and growth-enhancing structural reforms helped Sweden reduce its debt-to-GDP ratio after 1993.20

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IV. Alternative Approaches to Resolving the U.S. Public Debt Problem

Many proposals for addressing the U.S. public debt problem have been offered. This section discusses several of the most prominent – bipartisan proposals developed by the National Commission on Fiscal Responsibility (popularly known as the Bowles-Simpson or Simpson-Bowles Commission) and the Bipartisan Policy Center’s Debt Reduction Task Force (called the Domenici-Rivlin Commission); and partisan proposals offered by Representative (and Republican Vice-Presidential candidate) Paul Ryan, President Obama, and Republican presidential candidate Romney. In addition, the section summarizes a proposal offered by Professors Simon Johnson of MIT and James Kwak of the University of Connecticut.

A. Bipartisan Proposals

During 2010 two commissions, each with prominent representatives from both the Republican and Democratic parties, developed comprehensive proposals to address the federal debt problem. One, the National Commission on Fiscal Responsibility and Reform (Bowles-Simpson Commission), was appointed by President Obama and chaired by former U.S. Senator Alan Simpson and former OMB director Erskine Bowles. The other, the Bipartisan Policy Center’s Debt Reduction Task Force (Domenici-Rivlin Commission), was co-chaired by former U.S. Senator Pete Domenici and former OMB director and long-time Brookings Institution senior fellow Alice Rivlin.

1. Bowles-Simpson Commission. The Bowles-Simpson Commission comprised 18 eminent officials, nine Democrats and nine Republicans, including six members of the U.S. House of Representatives and six Senators. The Commission’s final report, issued in December 2010, included a comprehensive set of revenue increases and spending cuts designed to reduce federal debt held by the public to about 60 percent of GDP by 2023 and 40 percent by 2035. The final report received only 11 of the 14 votes needed to be sent to Congress. However, it attracted considerable attention in the U.S. media and inspired efforts by six Senators to develop a bipartisan plan that the U.S. Senate could endorse.

The Bowles-Simpson plan assumed the end of the Bush-era tax cuts for taxpayer couples earning more than US$250,000 yearly (US$200,00 for singles) and envisioned about US$3.9 trillion in further budget savings, excluding savings from Social Security reforms, over an eight year period (fiscal years 2012-2020).21 Of this total, about US$2.2 trillion came from lower spending, including cuts in mandatory expenditures slightly below US$0.6 trillion. Another US$1.0 billion came from revenue increases, mainly from eliminating tax expenditures (exemptions, credits, deductions, exclusions, and other provisions that cause tax law to differ from a simple tax on household income or corporate profits) and using part of the gains for debt reduction (the rest would go toward reducing marginal tax rates), plus higher gasoline taxes. The remaining savings, about US$0.7 trillion, came from lower interest payments. Apart from interest payments, about 69 percent of the savings were to come from spending cuts, with the rest

from revenue increases. An update to the Bowles-Simpson report estimated eight-year savings at about US$3.8 trillion, and the Committee on Budget and Policy Priorities (CBPP) has estimated the savings relative to current policy, excluding savings from Social Security reforms, at close to US$6.3 trillion over the ten fiscal years 2013-2022, including US$1.1 trillion from expiring tax cuts already assumed in the proposal. According to the CBPP, of the US$6.3 trillion in savings, the U.S. Congress has already enacted about US$1.5 trillion of spending cuts, yielding about US$0.2 trillion in interest savings. Thus, enacting the remaining elements of Bowles-Simpson would save a further US$4.6 trillion.

The Bowles-Simpson plan included extensive reforms to most parts of the U.S. federal budget. Among the most important were the following:

- Major changes to the Social Security program, including further raising the age for obtaining full benefits; reducing the benefit indexing formula; raising benefits for lower-income but lowering benefits for higher-income recipients; and raising the income limit on which payroll taxes apply;
- Cuts in Medicare, including a speed-up in cuts to the Medicare Advantage program and reforms in provider reimbursements, copayments, and malpractice law;
- Reforms to Medicaid, including moving more beneficiaries to managed care;
- Limiting the rise in total federal health care spending to the growth in GDP plus 1 percent;
- Extensive cuts in discretionary non-defense spending, including a two-year freeze in civil service salaries and moves to reduce the federal work force;
- Major cuts in defense spending; and
- Tax reform designed to simplify the tax code and allow lower marginal rates by eliminating most or all tax expenditure while allocating some revenue gains to deficit reduction.

By 2035, the plan was intended to achieve a balanced federal budget, with revenues and expenditures both equal to 21 percent of GDP.

Perhaps because of its breadth and willingness to address both revenues and mandatory spending programs, the Bowles-Simpson proposal received extensive criticism. Many American “liberals” attacked the cuts to Social Security benefits and the focus on spending reductions, while “conservatives” attacked the revenue increases. Some economists also questioned the quick implementation of budget

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cuts in a weak economy. In March 2012 the U.S. House of Representatives defeated a variant of the proposal with smaller revenue increases and bigger spending cuts by a vote of 382 to 28.  

2. **Domenici-Rivlin Commission.** The Bipartisan Policy Center’s Debt Reduction Task Force, better known as the Domenici-Rivlin Commission, also developed a comprehensive plan encompassing both revenue increases and spending cuts. The Domenici-Rivlin plan focused slightly more on revenue increases than on spending cuts, claiming to obtain about half its savings from each. While claiming larger absolute savings during the period 2012-2020, the plan aimed to reduce federal debt held by the public to about 60 percent of GDP in 2020 and 52 percent in 2030 and afterward, slightly above the Bowles-Simpson targets. In 2020, the plan would limit outlays to 23 percent of GDP and revenues to about 21.4 percent.

Like Bowles-Simpson, the Domenici-Rivlin plan would cut discretionary outlays for both defense and non-defense programs; curb spending for Medicare and Medicaid; trim Social Security outlays while raising the income ceiling on which Social Security taxes are levied; curtail tax expenditures; and use some of the resulting new revenue to reduce the deficit, while also reducing marginal tax rates. The Domenici-Rivlin plan specifies new marginal rates, while Bowles-Simpson offers alternatives, depending on how much tax expenditures are reduced. Other differences from the Bowles-Simpson plan include:

- Instituting a one year payroll tax holiday, to help stimulate the economy and create jobs
- Converting Medicare into a premium support program, keeping Medicare as the default option but allowing competition from private plans and limiting the growth in covered premiums to the growth rate in GDP plus 1 percent; and
- Establishing a federal-level Debt Reduction Sales Tax.

The Domenici-Rivlin proposal also received considerable attention when released but has attracted less interest than the Bowles-Simpson plan. Some “liberal” commentators found elements of the proposal more attractive than Bowles-Simpson, because of its one year payroll tax holiday and its new federal sales tax. Others, however, attacked the proposal’s reform of Medicare, although Alice Rivlin noted that the proposal maintains Medicare as an option for seniors.

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B. Partisan Plans

Major political figures have also offered debt reduction plans. Among the most prominent are those of House Budget chair Rep. Paul Ryan, President Barak Obama, and presidential candidate Mitt Romney.

1. Ryan plan. Before being chosen the Republican Vice Presidential candidate in 2012, Representative Paul Ryan developed several variants of a plan designed to reduce the federal debt-to-GDP ratio to 60 percent or below by 2022. Unlike the bipartisan plans, his focuses on cutting spending, to allow federal revenues to be limited to about 18.5 percent of GDP over time. Ryan’s plan would sharply reduce discretionary federal outlays, change Medicaid to a block grant program and sharply reduce its expenditures, and convert Medicare for those under age 55 in 2012 to a voucher program, with those seniors receiving a voucher that can be used to finance for their choice of competing health insurance plans, much like the health care exchanges to be established in 2014 under the Affordable Care Act (“Obamacare”). Ryan’s plan would set the voucher at the cost of the second least expensive plan and limit the rise in voucher support to the growth in GDP plus 0.5 percent, less than under the Domenici-Rivlin proposal. CBO has projected that seniors would likely pay more out of pocket for health care under the Ryan plan because the private plans that would replace Medicare typically have higher administrative costs and, by 2030, the ceiling on federal premium support would noticeably constrain the level of support. 

By converting Medicaid into a block grant, with a comparable ceiling on spending increases, the Ryan plan would also sharply reduce federal outlays for Medicaid. As regards revenues, the Ryan plan would reduce marginal tax rates, replacing the current set of rates with just two – 10 and 25 percent. The plan would also eliminate taxes on capital gains, dividends, and interest. To offset the resulting revenue losses, the remaining tax expenditures would be reduced by about 3 percentage points of GDP, although critics have noted that the plan fails to identify which provisions would be reduced.

On the assumption that tax expenditures equivalent to about 3 percent of GDP are identified, the Bipartisan Policy Center has estimated that the Ryan plan would reduce the federal government’s debt-to-GDP ratio toward 60 percent by 2022, arguably more than other major plans (Figure 6). In fiscal year 2022, federal revenues would be about 18.7 percent of GDP, and federal expenditures would be about 19.8 percent of GDP. Both numbers are noticeably below estimates for the Bowles-Simpson and Domenici-Rivlin plans (Figure 7). Ryan’s budget would have federal expenditures decline as a share of

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30 Id.


GDP during a period when an aging and the consequent pressure for spending on Social Security and Medicare have led some observers to expect a rising expenditure-to-GDP ratio.  

Analysts have noted that the largest reductions in the Ryan plan involve federal health care programs other than Medicare (notably, Medicaid and CHIP) and non-defense spending. The Bipartisan Policy Center has estimated that the Ryan plan would limit federal health care spending to about 5 percent of GDP during fiscal years 2012-2022, while health outlays under other plans would rise to between 6 and 7 percent of GDP by 2022.  

Non-defense discretionary spending would fall to less than 2 percent of GDP by fiscal year 2022, 0.5 to 1.0 percentage points of GDP less than in other plans and far below the historical minimum of 3.2 percent of GDP observed since 1970. Indeed, James Kwak has argued that, if federal defense spending is kept to 3 percent of GDP, non-defense discretionary expenditures under the Ryan plan would fall from around 8 percent of GDP in fiscal year 2012 to barely 4 percent in fiscal year 2022 and steadily less as time continues. Critics have also commented that Ryan’s tax proposals would dramatically reduce tax liabilities for upper-income taxpayers and raise them for those with the lowest incomes. Indeed, some have argued that the plan would focus cuts mainly on the poor.

2. The Obama Administration Plan. The Obama Administration has also set forth a plan to address the U.S. public debt problem. Like the two bipartisan plans, it includes both revenue increases and spending cuts. It also includes about US$450 billion in additional spending to promote employment. For revenues, the Obama plan would repeal the 2001 and 2003 (“Bush”) tax cuts and limit deductions and exclusions for taxpayers with incomes over US$250,000 a year. In addition, a further US$300 billion in tax expenditures would be eliminated, yielding an estimated US$1.6 trillion over a ten fiscal year period. On the spending side, the Obama plan would maintain the US$1.2 trillion in discretionary spending cuts enacted under the Budget Control Act of 2011 (BCA 2011); provide US$320 billion in savings from federal health care programs, including US$248 billion in Medicare cuts and US$72 billion in savings from Medicaid and other health programs; and make US$250 billion in cuts to other mandatory spending programs, including cuts in farm subsidies and changes in pension plans for federal employees. The plan also claims savings of about US$1.1 trillion from the reduction in overseas military forces as a result of the end of U.S. combat operations in Afghanistan and about US$430 billion in interest savings. Altogether, the plan would reduce federal deficits to about 2 percent a year in fiscal year 2021 and limit federal debt held by the public to about 73 percent of GDP at the end of that year, somewhat above the

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34 Adler, Loren, and Shai Akabas, op. cit., Note 27.


levels claimed by the Bowles-Simpson, Domenici-Rivlin, and Ryan plans. The Bipartisan Policy Center, which has slightly higher estimates of the debt-to-GDP ratios for these and the President’s plan (see Figure 7), agrees that federal debt held by the public in fiscal year 2022 would be higher under the President’s plan than under the three above-mentioned alternatives.

Analysts reviewing the President’s plan have agreed that it combines revenue increases and expenditure savings. However, there is broad agreement that the magnitude of savings is noticeably less than in other prominent plans. The Committee for a Responsible Federal Budget (CRFB) has argued that, relative to current policy, the President’s plan provides only US$3.5 trillion in genuine savings, including savings achieved by maintaining the cuts in BCA 2011 (which are estimated as saving about US$920 billion on a “current policy” basis), because current policy already includes the winding down of overseas military operations included in the plan. The CRFB notes that the President’s plan does not address the shortfalls in Social Security (although subsequent versions have made a general statement urging the Congress to put Social Security in a sound financial position). In addition, the proposed changes in Medicare provide only limited savings during the first ten fiscal years, although the latest version of the plan calls for the policy board overseeing Medicare (IPAB) to reduce the growth in Medicare spending per beneficiary to the growth rate of GDP plus 0.5 percent, rather than GDP plus 1.0 percent, as before. Thus, there is concern that the plan may not provide a permanent reduction in the debt-to-GDP ratio. Finally, analysts have noted that maintaining the so-called “Bush tax cuts” for taxpayers earning less than US$250,000 is quite costly. Comparing the alleged savings from repealing the cuts for those with incomes of US$250,000 or more (about US$850 billion) with the cost of eliminating cuts for all taxpayers (about US$2.8 trillion), maintaining the tax cuts for those with incomes less than US$250,000 would add nearly US$2 trillion to U.S. federal debt by fiscal year 2022, based on CRFB estimates.

3. Romney plan. Presidential candidate and former governor Mitt Romney has put forward a recovery, growth, and jobs plan. His plan calls for reducing federal government spending to 20 percent of GDP by 2016 (although defense spending is to be kept at 4 percent of GDP, above the fiscal year 2012 level of 3.4 percent). He also advocates a revenue neutral tax reform, eliminating many tax expenditures, particularly for upper-income taxpayers, to allow a 20 percent cut in marginal tax rates at all levels. Some critics have estimated that Romney’s spending cap, which excludes Social Security and core defense programs, would require massive cuts in other federal spending programs. Their estimates show spending for these other programs declining by 34 percent in fiscal year 2022, if Medicare is subject to cuts, and 53 percent if Medicare is shielded from cuts. Other critics have questioned

Romney’s proposed tax reform, which maintains tax expenditures for savings and investment and leaves many details unspecified. Although Romney and economists supporting him argue that his tax reform will boost economic growth, others have found little evidence that revenue neutral cuts in tax rates have generated much of a rise in growth in the United States.

C. Other Proposals

1. Simon-Kwak plan. In their recent book (White House Burning) on the long history of U.S. government debt, Professor Simon Johnson of the Massachusetts Institute of Technology (MIT) and Associate Professor James Kwak of the University of Connecticut’s Law School offer their own plan to address the federal government’s long-term debt problem. Based on IMF research, and arguing that another financial crisis could potentially add 50 percentage points to the federal debt-to-GDP ratio, they advocate reducing federal government debt to 50 percent of GDP. Unlike President Obama, they recommend eliminating all the Bush-era tax cuts, including those for taxpayers with incomes under $250,000. As noted earlier, eliminating all these cuts, plus the BCA 2011 spending reductions, would reduce federal debt to about 58 percent of GDP in fiscal year 2022. If the expiring tax cuts are made permanent, Simon and Kwak note that they would add about 0.5 percent to the budget deficit in fiscal year 2021, leaving federal debt at about 80 percent of GDP. On the assumption that the tax cuts will be made permanent, Simon and Kwak contend that revenue increases and expenditure cuts totaling about 5.5 percent of GDP each year to reduce the federal debt-to-GDP ratio to about 50 percent by fiscal year 2030. In response, they offer a series of revenue and expenditure measures that would jointly reduce yearly deficits by about 6 percent of GDP.

Perhaps because they assume implementation of the BCA 2011 spending cuts and a continuation of the Bush-era tax cuts, Johnson and Kwak focus their debt reduction proposals on revenue increases. For Social Security, they would raise the ceiling on taxable earnings, increase the payroll tax rate by 1 percentage point, and cover newly hired state and local employees, besides gradually raising the retirement age. For health care, they would phase out the exclusion from tax of employer health insurance payments, raise the Medicare payroll tax by 1 percentage point, and increase certain Medicare premiums. They would raise the gasoline tax and introduce a new carbon tax, rebating half the proceeds to lower-income households. They would also impose new fees on very large financial institutions and tax unusually high profits and compensation levels in the financial sector. They would


47 Id., page 180.

48 Id., page 190.

49 Id., Table 7-1, page 222-223.
introduce a new, 5 percent value added tax, rebating half the proceeds to lower income households. They would also eliminate many of the remaining individual and business tax expenditures, showing estimated savings from different options. According to their estimates, revenue increases for Social Security would contribute about 0.9 percent of GDP in savings; those for health care, 1.2 to 1.5 percent of GDP; for energy, 0.6 percent of GDP; and for finance, 0.2 to 0.4 percent of GDP. The VAT would generate about 0.9 percent of GDP in additional revenues, while the cuts in individual and business tax expenditures, excluding the phase out of the employer exclusion for health insurance, would raise revenues about another 1.9 percent of GDP.50

The Johnson-Kwak book only appeared in the spring of 2012, and few academics or policy analysts have thus far commented on their suggestions. Critics have noted that the proposals are heavily tilted toward raising revenue, which has been unusual among those advocating debt reduction.51 More generally, the orientation of these proposals may make them hard to be adopted in a political environment in which power is shared between two political parties with very different philosophies.

V. Conclusions

Current projections for a large and continuing rise in the ratio of U.S. federal debt to GDP if the so-called “fiscal cliff” is eliminated without implementing an alternative debt reduction plan have led many analysts to question the sustainability of U.S. fiscal policy. The expiration of tax cuts and reduction in expenditures now scheduled if the Congress does not act would put the federal debt-to-GDP ratio on a downward path. However, many economists have forecast that allowing the “fiscal cliff” to occur could push the U.S. economy into recession. In addition, the scheduled spending cuts would leave unaddressed the main causes of rising federal expenditures: the forecast expansion in Social Security and federal health care programs.

Many proposals to address the looming debt problem have been offered. Those proposed by the Bowles-Simpson and Domenici-Rivlin commissions have included both of revenue increases and spending cuts, with the goal of reducing the federal debt-to-GDP ratio to about 60 percent in the early 2020s. The best-known Republican plans focus on reducing expenditures, with most cuts involving discretionary non-defense and health care programs, mainly Medicaid and other programs assisting low-income households. The main Democratic plan combines spending cuts and revenue increases. However, most analysts believe it would generate smaller savings than would other leading plans.

Because no one political party appears likely to control both the Presidency and the Congress, any budget solution to replace the “fiscal cliff” will likely require the two main political parties in the U.S. to compromise. Thus far, compromise has proved elusive. Nevertheless, a number of legislators continue to seek a “grand bargain,” encompassing spending cuts and revenue increases, that can attract broad Congressional support. The hope is that such a comprise can be achieved.

50 Ibid.
References


Figure 1. U.S. Federal Government Debt Held by the Public as a Percent of GDP

Source: Reproduced from Concord Coalition (2012).

Figure 2. U.S. Federal Debt Held by the Public Since the Founding of the United States

Figure 3. Forecast U.S. Federal Debt Held by the Public under Current Law (“Baseline”) and with Repeal of the Tightening Mandated by the Budget Control Act of 2011 (“Alternative Scenario”)

Federal Debt Held by the Public, Historically and As Projected in CBO’s Baseline and Under an Alternative Fiscal Scenario
(Percentage of GDP)

If current laws governing taxes and spending remain in effect (CBO’s baseline projection), debt held by the public will fall from 73 percent of GDP in fiscal year 2012 to 56 percent of GDP in 2022. If policymakers altered those laws to maintain many policies that have been in effect in recent years (CBO’s alternative fiscal scenario), debt would climb to 90 percent of GDP by 2022. In either case, debt would be relatively high by historical standards.


Figure 4. Goldman Sachs Forecast of the Effect of Fiscal Tightening in 2013

Source: Reproduced from Goldman Sachs, GS Global ECS Research.
Figure 5. CBO’s Long-Term Projection for U.S. Federal Debt Held by the Public


Figure 6. Estimated Impact of Competing Debt Plans on the Federal Debt-to-GDP Ratio

Source: Reproduced from Bipartisan Policy Center.
Figure 7. Projected Revenues and Expenditures in Competing Debt Reduction Plans

Above figure reproduced from Bipartisan Policy Center.
Appendix I: The “Fiscal Cliff”

The so-called “Fiscal Cliff” represents the combination of expiring federal tax measures and spending cuts mandated under the Budget Control Act of 2011 (BCA 2011) now scheduled to take effect January 1, 2013. According to the Congressional Budget Office (CBO), these measures include the following:

- Expiration of the cuts in tax rates and expansion of tax credits and deductions originally enacted in 2001 and 2003 (the so-called “Bush” tax cuts) and in 2009 and then extended in 2011;
- Expiration of the 2 percentage point cut in the Social Security payroll tax;
- The sharp (27 percent) reduction in Medicare payments for physicians;
- The end of emergency unemployment benefits approved in 2011; and
- The automatic enforcement mechanisms created under BCA 2011 to reduce both defense and non-defense expenditures.

According to the CBO, the expiration of tax cuts and mandated spending reductions will together reduce the federal budget deficit by about 2.5 percent of GDP, in fiscal year 2013, as compared to a budget without these measures. Over the ten fiscal years from 2013 through 2022, CBO estimates that current law (the “Fiscal Cliff” scenario) would generate budget deficits averaging about 1.1 percent of GDP, enough to reduce debt held by the public to about 58 percent of GDP in 2022. Under its Alternative Fiscal Scenario, CBO projects budget deficits to average 4.9 percent of GDP a year, yielding debt to the public of about 90 percent by 2022.

The CBO forecasts that the currently scheduled tax increases and spending cuts would gradually raise federal revenues from about 15.7 percent of GDP in fiscal year 2012 to 21.4 percent of GDP in 2022, while spending cuts would reduce expenditures from 22.9 percent of GDP in fiscal year 2012 to 21.9 percent of GDP in fiscal year 2022. The overall budget deficit would average about 1.1 percent of GDP during the period. More importantly, the primary fiscal balance – federal revenues minus non-interest spending – would show a steady surplus, as revenues would exceed spending with interest payments excluded (see Appendix Figure 1, reproduced from CBO (2012), Long-Term Budget Outlook). As noted in Section III, achieving a steady primary surplus is important for reducing the public debt-to-GDP ratio, so long as the real rate of GDP growth is not significantly larger than the real rate of interest.

Appendix Figure 1. Federal Revenues Less Noninterest Expenditures in the CBO’s Baseline Forecast

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53 Ibid.
54 Ibid., Table 1.6.