Evaluating the Ability and Willingness of the United States To Achieve Fiscal Sustainability

By James Kwak

By any conventional measure, the fiscal outlook for the United States has deteriorated significantly in the past four years. In the wake of the global financial crisis that began in 2007 and peaked in 2008, official Congressional Budget Office (CBO) projections of the national debt increased by more than forty percentage points of GDP, largely due to lower tax revenues because of the economic downturn.¹ The federal government ran annual deficits well above $1 trillion in 2009, 2010, and 2011—at 10.1 percent, 9.0, and 8.7 percent of GDP, respectively, the largest deficits since World War II.² The financial crisis and ensuing recession accelerated a long-term increase in the national debt that had already been expected because of an aging population and rising health care costs. According to the CBO’s most recent long-range forecast, by 2035 the federal budget deficit will exceed 15 percent of GDP and the national debt will be approaching 200 percent of GDP.³

Yet, according to bond market investors (the once-feared “bond vigilantes”), the United States government has only become a better credit risk. The yield on 10-year Treasury bonds, which averaged 4.9 percent in the decade preceding the financial crisis (1998–2007), fell to 3.2 percent in 2009 and in 2010.⁴ In the summer of 2011, when a standoff over raising the debt ceiling brought the federal government within a few days or weeks of default, interest rates

¹ The CBO’s baseline projection for publicly held national debt the end of the 2018 fiscal year increased from 22.6 percent of GDP in January 2008 to 67.0 percent in August 2009. CBO, The Budget and Economic Outlook, January 2008, Summary Table 1, p. xii; CBO, The Budget and Economic Outlook: An Update, August 2009, Summary Table 1, p. x. As of August 2011, even after the passage of the Budget Control Act of 2011, the 2018 projection was still at 64.3 percent of GDP. By law, the CBO baseline projection must follow certain rules that make it unrealistic. Because these rules are consistent, however, the CBO baseline projection is often the best way to compare the government’s fiscal position at different points in time.
² OMB, Fiscal Year 2013 Budget of the U.S. Government: Historical Tables, Tables 1.1, 1.2.
³ CBO, CBO’s 2011 Long-Term Budget Outlook, June 2011, Table 1-2, p. 8.
continued to fall, and they fell further after Standard & Poor’s downgraded the Treasury
Department in early August, hovering around 2 percent for the rest of the year.\textsuperscript{5}

Clearly, buyers of Treasury bonds expect to get their money back, with interest (though
not much of it)—despite large annual deficits, slow economic growth, looming Social Security,
Medicare, and Medicaid obligations, and a political system that seems incapable of either raising
taxes or significantly cutting spending. Are they right to have such confidence?

Whether or not a country will pay off its debts depends on a sequence of factors. First, its
economy must be large enough to service its debt without impoverishing the population. Second,
the central government must have the administrative capacity necessary to collect taxes. Third,
the government must have both the legitimacy and the political will to impose sufficient taxes.
And fourth, even if the government can bring in enough tax revenue, it must also be willing to
use that revenue to pay its debts rather than spending it on other priorities.

At the end of the seventeenth century, Great Britain and France began a contest for
predominance in Europe that lasted for more than one hundred years.\textsuperscript{6} At the time, Great Britain
had a smaller population, smaller economy, and smaller military.\textsuperscript{7} Yet Britain was more than
France’s equal, containing Louis XIV and his successors on the Continent while seizing many of
France’s overseas colonies, and ultimately it was the Bourbon Monarchy that collapsed under the
fiscal strain of repeated wars in 1789. Great Britain’s crucial advantage was its superior ability to
raise money through borrowing, amassing debts that seem staggering even by today’s standards,

\textsuperscript{5} Yields on the 10-year bond averaged 2.0 percent from September through December. Ibid.
\textsuperscript{6} For a longer discussion of eighteenth-century Great Britain and France, see Simon Johnson and James Kwak,
17–20.
\textsuperscript{7} Paul Kennedy, \textit{The Rise and Fall of the Great Powers: Economic Change and Military Conflict from 1500 to 2000}
GDP, 1–2008 A.D.,” available at \url{http://www.ggdc.net/maddison/Maddison.htm}. 
exceeding 150 percent of GDP in the 1750s and again in the 1780s. Following the American Revolutionary War, Britain had a larger debt than France; in 1782, interest on the debt consumed 70 percent of government expenditures. Yet Britain still paid lower interest rates than France, which enabled it to bring its debt under control, while France’s inability to finance its debts led directly to the French Revolution.

Great Britain’s fiscal advantage was not due to a larger economy, but to the second and third factors listed above: administrative capacity and political will. It could collect taxes much more efficiently thanks to a modern centralized bureaucracy, while the French state depended on a host of intermediaries as well as the sale of offices. Furthermore, the British government had the legitimacy necessary to impose higher taxes than those in France because the economic elites who would pay those taxes were part of the dominant coalition in Parliament, and therefore had control over both spending and taxation. It was Britain’s political system that enabled it to raise the vast sums of money necessary to fight the wars of the eighteenth century and ultimately to defeat Napoleon.

The United States began its life in a serious fiscal crisis, missing payments due to foreign governments repeatedly in the 1780s. This should not have been a surprise; the central government lacked both the authority to levy taxes (a power reserved by the states under the

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8 “Time Series Chart of UK Public Spending,” ukpublicspending.co.uk.
Articles of Confederation) and any administrative apparatus to collect them. The fiscal crisis was a major motivation for the Constitutional Convention of 1787 and the ratification of the new Constitution, which gave the federal government the power to impose and collect taxes.\textsuperscript{14} This made it possible for Treasury Secretary Alexander Hamilton to restructure the national debt, effectively swapping outstanding obligations for new bonds that had lower interest rates but were now backed by both tariffs and excise taxes.\textsuperscript{15} The fast-growing American economy could generate the resources necessary to pay off the national debt; once the government had the ability to levy taxes and showed the willingness to do so, investors quickly became convinced that it was a good credit risk.\textsuperscript{16}

Only two decades later, however, the federal government was facing another fiscal crisis. In 1812, at President James Madison’s request, the Democratic-Republican majority in Congress declared war against Great Britain. Since taking power in 1801, however, the Democratic-Republicans had lowered taxes and cut defense spending; when war broke out, the U.S. Navy had seventeen ships, while the Royal Navy had over one thousand.\textsuperscript{17} Nevertheless, Congress refused to vote for the new excise taxes requested by Treasury Secretary Albert Gallatin. As a result, the government struggled to borrow enough money to fight the War of 1812, and in 1813 the Treasury Department had to be bailed out by private banker Stephen Girard, who personally

\textsuperscript{15} Dewey, note 13, above, pp. 94–96.
\textsuperscript{17} Donald R. Hickey, \textit{The War of 1812: A Forgotten Conflict} (University of Illinois Press, 1995), pp. 90–92.
underwrote a loan after it failed to attract enough subscribers.\textsuperscript{18} The United States was barely able to keep its forces supplied through the end of the war in early 1815.\textsuperscript{19}

This time, the United States did not lack the ability to raise the money necessary to support its borrowing. U.S. GDP in 1812 was almost $800 million, almost three times as high as in 1790; the national debt only grew to 15 percent of GDP by 1816, less than half the level (in real terms) that Hamilton had confronted when taking office.\textsuperscript{20} Furthermore, the country had established the administrative apparatus needed to collect both tariffs on external trade and excise taxes on internal commerce. Instead, Congress in 1812 lacked the political will necessary to impose taxes—in particular, because the Democratic-Republicans feared the political consequences of reinstating excise taxes that they had eliminated upon taking power a decade before.\textsuperscript{21} This was the fundamental cause of the fiscal crisis of 1813.

Willingness to pay is, once again, the shadow hanging over the federal government’s credit today. The United States may not be able to regain the levels of economic growth of the three decades following World War II. According to mainstream forecasts, however, the country should be able to sustain levels of economic activity necessary to finance its current debt levels, even given projected increases in government spending. The IMF forecasts that Italy will average real GDP growth of only 0.3 percent from 2012 through 2017, while Spain will average growth of only 0.8 percent, so those countries will need large primary surpluses simply to

\textsuperscript{21} Hickey, note 17, above, p. 50; Hormats, note 18, above, pp. 38–39.
stabilize their national debt levels. The United States, by contrast, is expected to see real GDP growth of 2.9 percent per year.\textsuperscript{22} Since the federal government currently pays a \textit{nominal} effective interest rate of only 2.1 percent,\textsuperscript{23} this means that it could run modest annual deficits while still bringing down the national debt as a percentage of GDP.

The same is true over the longer term, at least according to commonly cited forecasts. Discussions of the United States’ fiscal sustainability often begin with the CBO’s long-term alternative fiscal scenario. In contrast to the CBO’s extended-baseline scenario, which is closely based on current law, the alternative fiscal scenario incorporates several assumptions intended to make it more realistic.\textsuperscript{24} According to the most recent alternative fiscal scenario, published in June 2011, the national debt will rise to 187 percent of GDP by 2035; updated to incorporate subsequent legislative changes and economic re-estimates, this figure is now 142 percent of GDP—still high by any standards.\textsuperscript{25}

If we take government spending policy as given, however, this high projected debt level can be explained as a result of the United States’ comparatively low tax levels. For the decade from 2000 through 2009, total taxes in the United States averaged 26.9 percent of GDP: 17.6 percent collected by the federal government and 9.3 percent collected by other levels of government.\textsuperscript{26} In the OECD as a whole, total taxes over the same period averaged 34.7 percent of GDP—7.8 percentage points higher than in the United States. Increasing federal taxes by 7.8

\textsuperscript{22} IMF World Economic Outlook Database, April 2012.
\textsuperscript{23} Projected net interest payments for 2012, divided by the average year-end debt levels for 2011 and 2012. CBO, \textit{The Budget and Economic Outlook: Fiscal Years 2012 to 2022}, January 2012, Table 1-3, p. 10.
\textsuperscript{24} For example, the alternative fiscal scenario assumes that various tax cuts will be extended rather than allowed to expire; Medicare payment rates will remain at current levels rather than falling as under current law; and the drawdown of troops from Afghanistan will progress as currently scheduled. Somewhat more controversially, it also assumes that tax revenues will remain constant as a share of GDP in the long term. CBO, \textit{CBO’s 2011 Long-Term Budget Outlook}, June 2011, pp. 3–7.
\textsuperscript{25} The CBO’s long-term forecasts are extensions of its ten-year forecasts. I have updated the June 2011 long-term alternative fiscal scenario by incorporating the ten-year forecast from the CBO’s January 2011 \textit{Budget and Economic Outlook}, using similar assumptions to those in the June 2011 \textit{Long-Term Budget Outlook}.
\textsuperscript{26} Total tax level is from the OECD.StatExtracts database, Revenue Statistics—Comparative Series. Federal tax level is from OMB, note 2, above, Table 1.2.
percentage points would bring them to 25.4 percent of GDP. If federal tax revenues were to stabilize at this level, rather than at the 18.1 percent of GDP specified in my updated version of the alternative fiscal scenario, the national debt in 2035 would be only 45 percent of GDP and falling—even assuming the exact same Social Security, Medicare, and Medicaid obligations that exist today.\(^{27}\)

The general relationship between federal tax levels and the future national debt can be seen in Figure 1, which plots debt levels in 2035 and 2050 against different levels of federal tax revenues. In each case, I assume that government spending policy is the same as in the CBO’s alternative fiscal scenario. I also assume that tax policy is the same as in the alternative fiscal scenario through 2022; that is, the tax level on the X-axis does not take effect until 2023. Even so, it is clear that the national debt could be kept at moderate levels given tax revenues that are only average for the OECD. This is not to say that increasing our taxes to these levels is necessarily good policy. My point is simply that the American economy generates sufficient resources such that, with average tax levels, the United States could manage its current debt levels even given expected growth in entitlement spending.\(^{28}\)

Figure 1 incorporates the basic macroeconomic assumptions of the CBO’s 2011 long-term forecast: a real interest rate of 2.7 percent and a real growth rate of 2.2 percent.\(^{29}\) Given historical experience, these seem like reasonably conservative assumptions. From 1948 through 2011, the average real effective interest rate paid by the Treasury Department was 1.7 percent;

\(^{27}\) In the CBO’s June 2011 long-term alternative fiscal scenario, tax revenues remain constant after 2021 at their 2021 level of 18.4 percent of GDP. I updated the alternative fiscal scenario by incorporating the ten-year forecast published in January 2012, which goes out through 2022; in that year, tax revenues are now projected to be 18.1 percent of GDP. So my updated alternative fiscal scenario keeps tax revenues stable at 18.1 percent of GDP.

\(^{28}\) Note that this analysis does not incorporate any potential macroeconomic effects of higher tax levels, consistent with usual CBO practice.

the real interest rate has not exceeded 2.5 percent since 2002.\textsuperscript{30} From 1982 through 2011, however, the average rate was 3.6 percent, significantly above the CBO’s long-term forecast. This implies that we should attempt to estimate the sensitivity of future debt levels to interest rates. Figure 2 shows the 2050 national debt level as a function of the long-term average real interest rate, assuming real growth of 2.2 percent and a tax level of 25 percent of GDP (the federal tax level that would raise overall taxes to the OECD average).\textsuperscript{31} As can be seen from the figure, higher long-term real interest rates do have a significant impact on future debt levels, but even with interest rates at 4 or 4.5 percent, the 2050 debt remains around current levels.

The CBO’s projected annual real growth rate of 2.2 percent is also consistent with historical experience. From 1948 through 2011, real growth averaged 3.2 percent per year; from 1980 through 2011, growth still averaged 2.6 percent.\textsuperscript{32} The CBO projects lower growth in the future because of its assumptions regarding demographic variables and productivity growth. Its demographic variables are taken from the Board of Trustees of the Social Security trust funds, except that it expects immigration to remain at historical rates; the CBO also expects total factor productivity to grow at an annual rate of 1.3 percent.\textsuperscript{33} These assumptions could turn out to be overly optimistic. For the purposes of this paper, however, there is no easy way to estimate the sensitivity of future debt levels to different estimates of GDP growth because lower growth levels would have many complicated effects on the federal government’s finances.

\textsuperscript{30} Calculated as net interest payments in year N divided by the average of debt held by the public at the end of years N-1 and N, deflated by the annual change in the GDP price index. OMB, note 2, above, Tables 3.1, 7.1; BEA, National Income and Product Accounts, Table 1.1.4.

\textsuperscript{31} Through 2022, I use the effective interest rate produced by the CBO’s alternative ten-year forecast. After that point, I modify the interest rate linearly until it reaches the specified long-term rate (on the X-axis of Figure 2) in 2027. Note that this analysis incorporates only the impact of higher interest rates on the financing of the national debt, not their impact on the overall economy.

\textsuperscript{32} BEA, National Income and Product Accounts, Table 1.1.1.

In summary, the United States has a large enough economy to sustain the federal government’s current spending habits at levels of taxation that are unremarkable by international standards. That economy can reasonably be expected to grow fast enough to keep the national debt at a manageable level, despite the demographic changes and health care inflation that are expected to boost spending in the long term, again assuming tax levels around the OECD average.

The United States also has the administrative apparatus necessary to collect those taxes. In different years, the federal government has collected as much as 10.2 percent of GDP in individual income taxes, 7.2 percent of GDP in corporate income taxes, 6.8 percent of GDP in social insurance contributions, and 3.1 percent of GDP in excise taxes, for a potential total of over 27 percent of GDP. While it might not be good policy to increase all of those taxes to those levels, the government has shown the practical ability to collect the revenue necessary to finance its current debts and future spending.

This brings us to the question of political will: are politicians in Washington willing to increase taxes or reduce spending enough to keep the national debt at a sustainable level? In a recent paper, Jonathan D. Ostry, Atish R. Ghosh, Jun I. Kim, and Mahvash S. Qureshi of the IMF incorporated political willingness to pay—that is, to improve budget balances—in estimating the “fiscal space” available to different countries. The core of their analysis is a “fiscal reaction function” that shows how the primary balance responds to changes in debt levels: over some range of debt levels, as debt increases, countries tend to increase their primary balances in response, which has the effect of lowering the debt. Beyond some point, however,

34 OMB, note 2, above, Table 2.3.
the improvements in the primary balance dictated by the fiscal reaction function will simply not be large enough to compensate for real interest payments on the debt, which will therefore continue to increase. Because creditors are aware of this possibility, they will demand higher interest rates as the debt approaches this point, compounding the problem. Ostry et al. define a country’s debt limit as the level of debt (as a percentage of GDP) beyond which debt becomes unsustainable. Fiscal space is the difference between this debt limit and the current level of debt.

Ostry et al. use the fiscal reaction function to estimate the debt limit for twenty-three different countries. For the United States, they estimate the debt limit to be between 160 and 183 percent of GDP. These figures are based on general government debt, including obligations of state and local governments (but not intra-governmental debt holdings), which is larger than federal government debt. Still, however, the IMF estimates that general government gross debt will only reach 113 percent of GDP by 2017, apparently leaving a considerable buffer. This fiscal space estimate means that, given its past record of responding to debt increases by improving its primary balance, the United States is likely to bring its debt under control so long as it does not exceed 160 percent of GDP. Participants in the credit markets realize this, and therefore they will not demand sharply higher interest rates on Treasury debt until the national debt approaches that level.

From here, however, it is still a long way to conclude that the United States will find the political willingness to pay its debts. As Ostry et al. emphasize, the fiscal reaction function is

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36 The estimates differ depending on whether they use market interest rates for government debt or a model that estimates how the interest rate will rise as debt approaches the debt limit. In the former case, they calculate the debt limit using both historical and projected interest rates. Ibid., pp. 11–12.

37 Correspondence with the authors.

38 IMF World Economic Outlook Database, April 2012.

39 Ostry et al. do not estimate a separate fiscal reaction function for each country. Instead, they estimate a single fiscal reaction function using observations for all countries. This function includes country-level fixed effects and also includes a number of independent variables that vary across countries such as demographic profile, political stability level, openness to trade, etc. Ostry et al., note 35, above, p. 12.
estimated based on historical data; that is, it projects future responses to increasing debt levels based on past performance. Therefore, this approach necessarily fails to reflect recent changes in domestic political systems. In particular, if there has been a change in the political importance of fiscal responsibility in the past few decades, this change will not be fully incorporated in the estimated debt limit. The federal government may not respond to increasing debt levels as effectively as it has in the past; market participants may be aware of this change, and may demand higher interest rates at lower debt levels than predicted by Ostry et al. For these reasons, this attempt to estimate fiscal space based on historical performance is no substitute for an analysis of current political dynamics.

Since the midterm elections of November 2010, deficits and the national debt have been at or near the top of the political agenda in Washington. At various times, both parties have agreed on the importance of reducing deficits and bringing the debt under control. Republicans have seized on the issue in reaction to what many see as excessive spending by the federal government, urged on by the Tea Party movement. For much of 2011, President Obama agreed to focus on deficit reduction, to the chagrin of some more liberal Democrats, who argued that generating economic growth and reducing unemployment should have been a higher priority. But even with both parties agreeing on the goal, they were unable to make much progress toward either increasing taxes or reducing long-term spending significantly. This should lead us to question whether America’s elected leaders will collectively be able to muster the political will necessary to pay off our growing debts.
When it comes to fiscal policy, the 111th Congress’s main accomplishment since taking office in January 2011 is the Budget Control Act of 2011, enacted in early August in order to avert the potential government default that could have been caused by a failure to raise the statutory debt ceiling. The Budget Control Act imposed statutory limits on discretionary spending in 2012 through 2021, reducing expected outlays by $917 billion over that period. It also created a Joint Select Committee on Deficit Reduction that was mandated to produce a plan to reduce deficits by $1.2 trillion over the same period; because that committee failed to reach agreement, the Budget Control Act required automatic sequesters that reduce spending by almost $1.2 trillion over the 2013–2022 period. Together, these two provisions should reduce spending in 2021 by almost 1.3 percent of GDP (including lower interest payments). Whether they will do so is open to question, however. Whatever Congress can do, Congress can also undo, and both parties have already proposed measures that would undo the automatic sequesters (while replacing them with other deficit-reduction measures). The CBO includes the elimination of these automatic sequesters in its alternative fiscal scenario for the next ten years.

Even if the spending limits in the Budget Control Act take full effect, they apply almost exclusively to discretionary spending (subject to annual appropriations). All of the projected long-term growth in government spending, however, occurs in the much larger category of mandatory spending (required by law until explicitly repealed or amended), which includes Social Security and most government healthcare programs. In addition, given the scale of the United States’ deficits, 1.3 percent of GDP is a relatively small reduction. In December 2010,  

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41 CBO, Letter to the Honorable John A. Boehner and the Honorable Harry Reid, August 1, 2011, Table 3; CBO, The Budget and Economic Outlook: Fiscal Years 2012 to 2022, January 2012, Table 1-6, pp. 18–19.
just months before the debt ceiling standoff, Congress extended the George W. Bush income and estate tax cuts (initially passed in 2001 and 2003) and some of the tax cuts contained in the 2009 American Recovery and Reinvestment Act through 2012, while also adding a payroll tax cut through 2011; that payroll tax cut was later extended through 2012. Those tax cuts, if extended again, will be worth 3.2 percent of GDP in 2021 (including higher interest payments), dwarfing the savings from the Budget Control Act.  

Again, this does not necessarily mean that the December 2010 tax cut was bad policy, or that the Budget Control Act should have mandated larger spending cuts. It simply shows that Congress and the White House, while publicly emphasizing the importance of cutting the deficit, have been unable to achieve significant long-term reductions in the national debt, and what reductions they have achieved have been outweighed by other measures that are likely to increase the national debt.

What accounts for this wide gulf between words and deeds? One possible explanation is that politicians in Washington have no interest in fiscal sustainability and only pay it lip service for political reasons, and there is no doubt some truth to that. At least since President Reagan in the 1980s, politicians have railed against deficits while enacting policies that increase deficits. But President Barack Obama and House Speaker John Boehner went to considerable lengths last summer attempting to forge a large, bipartisan deficit reduction package. Furthermore, the “it’s all politics” explanation only raises the question of why politicians believe it is in their interests to avoid doing anything about the national debt, even when it has become a front-page issue. Deficits and the national debt are routinely considered one of the top two economic issues facing

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44 Ibid., Table 1-6, pp. 18–19. This figure includes the effect of extending the 2001 and 2003 tax cuts and indexing the AMT for inflation; it does not include extension of the payroll tax cut.
the United States (along with “jobs” or “the economy”), and leaders of both parties have gone out of their way to elevate their perceived importance among the public. If politicians nevertheless believe that they are better served by doing little or nothing about the issue, there must be some factors in the political environment that make inaction the smart strategy.

Logically speaking, there are two main ways to reduce deficits and therefore the national debt: increasing taxes and reducing spending. At present, there are powerful political constraints against increasing taxes and against reducing the most important categories of government spending. The political dynamics are particularly clear on the tax side. Opposition to tax increases, as well as support for tax cuts whenever possible, has become the central unifying feature of the Republican Party. This goes beyond mere ideology. The party’s legislators have effectively committed to block any tax increase by signing the Taxpayer Protection Pledge, conceived of and monitored by Grover Norquist and Americans for Tax Reform, which requires them to oppose any bill that would increase tax rates or tax revenues. At present, a clear majority of the House of Representatives and more than forty members of the Senate have signed the pledge, effectively blocking tax increases in either chamber. The pledge is enforced by the threat to “primary” a legislator who breaks it—that is, to support a right-wing challenger in the next Republican primary election. This is a credible threat because Americans for Tax Reform and like-minded groups such as the Club for Growth and Americans for Prosperity can mobilize large amounts of money to support challenges to Republicans whom they consider insufficiently conservative. In 2010, candidates associated with the Tea Party upset Republican incumbents or establishment candidates in six Senate primaries; although breaking the Taxpayer Protection

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Pledge was not an issue in those elections, this performance showed the political costs of failing to toe the conservative line.48

As a result, proposals that would increase tax revenues are effectively off the table in Washington. During the debt ceiling negotiations, Boehner at one point offered $800 billion in higher tax revenues over ten years, but this tax “increase” came with two big caveats. Much of those revenues would exist only on the assumption that lower tax rates would generate additional economic growth49—an assumption that many economists question. In addition, the $800 billion was only an increase from a baseline that assumed the extension of the 2001 and 2003 Bush tax cuts, which were (and are) scheduled to expire at the end of 2012. In other words, Boehner’s offer was for a large tax cut relative to current law. There is controversy about exactly what happened, but it appears that Obama asked for an additional $400 billion in tax revenues, which Boehner said he could not get his caucus to approve; Obama may have then decided to settle for $800 billion at the last minute, which Boehner also rejected. In the “supercommittee” negotiations that followed the passage of the Budget Control Act, Republican members proposed $300 billion in additional tax revenues, but thirty-three Republican senators insisted that there should be no net tax increase and powerful House Majority Leader Eric Cantor refused to endorse the proposal.50 Even that $300 billion offer was only possible because of the impending expiration of the Bush tax cuts, which made it possible for Republicans to frame it as a way to avoid a large tax increase.51

48 The Senate primaries were those in Alaska, Delaware, Florida, Kentucky, Nevada, and Utah.
49 Wallsten, Montgomery, and Wilson, note 45, above.
The bottom line is that few people think it would be possible to pass more than a modest tax increase, and any such increase would be from the baseline set by the 2001 and 2003 tax cuts. This is why major bipartisan budget reduction proposals such as Domenici-Rivlin and Simpson-Bowles reduce tax rates even further from current (George W. Bush) levels; they claim to increase taxes, but tax revenues would remain closer to George W. Bush levels than to the Bill Clinton levels that are scheduled to resume in 2013. Once the fate of the 2001 and 2003 tax cuts is resolved, it is likely that even the small amount of flexibility Republicans have shown during the past year would vanish, since they will no longer be able to excuse a small tax increase on the grounds that it is better than the expiration of those tax cuts. For these reasons, the idea that future budget deficits can be reduced through significant tax increases seems farfetched.

There is no political bar against spending cuts analogous to the Republicans’ commitment to oppose tax increases, but the prospects of significant reductions in future spending are also relatively bleak. The underlying constraint is that most government spending programs are popular. Majorities of Americans oppose cutting spending not only on Social Security and Medicare, but also on anti-poverty programs and even funding for the arts and sciences. Despite this, it is politically feasible to reduce discretionary spending. Because discretionary spending is subject to annual appropriations, Congress does not have to affirmatively vote to eliminate or cut back a popular program; instead, it can simply appropriate less money for that


program. This is why the Budget Control Act placed caps on discretionary spending in future years.

The problem, from the standpoint of fiscal sustainability, is that there is not that much discretionary spending, and it is declining already. Discretionary spending averaged 12.5 percent of GDP in 1962–1969 but only 7.5 percent of GDP in 2000–2009; even before the Budget Control Act, it was already projected to fall to 6.1 percent of GDP in 2021. Deep cuts in defense spending, which currently makes up more than half of all discretionary spending, are also politically difficult. All of the projected growth in government spending comes in mandatory programs, particularly in Social Security and in federal health care programs, including Medicare, Medicaid, and the new health insurance subsidies mandated by the Affordable Care Act of 2010. Reducing this spending is always politically treacherous. These programs are very popular—especially Social Security and Medicare, which benefit large numbers of people and are widely seen as earned entitlements. In addition, their benefits are set by law for decades into the future, so reducing spending requires a politically dangerous vote to cut those benefits.

Looking solely at the two most important entitlement programs, Social Security and Medicare, recent history has amply demonstrated the political hurdles standing in the way of significant spending cuts. The most recent attempt to modify Social Security was undertaken by President George W. Bush in 2005. While no final proposal was ever released, the administration floated the idea of diverting a portion of workers’ payroll taxes into individual accounts, with a corresponding reduction in their statutory benefits. This proposal would have required large

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54 OMB, note 2, above, Table 8.4.
amounts of additional borrowing in the short term (to pay benefits to current retirees) but might have improved the program’s long-term financial outlook by reducing its mandatory obligations (statutory benefit payments). Opponents easily attacked the proposal as reducing benefits and shifting investment risk onto individual workers; despite majorities in both the House and the Senate, Republican congressional leaders declined to bring the issue to the floor.

Medicare provides an even more clear example of the difficult of reducing entitlement spending. In order to pay for its expanded coverage provisions, including health insurance subsidies and an expansion of Medicaid eligibility, the Affordable Care Act of 2010 included several provisions that would reduce growth in Medicare spending by about $400 billion over ten years. Among others, these included a reduction in payments to Medicare Advantage plans, changes to the formulas for calculating reimbursement rates, increasing Part B premiums for higher-income beneficiaries, and reducing payments to disproportionate share hospitals. Before and since its passage, Republicans have attacked the Affordable Care Act for cutting Medicare, with presumptive presidential nominee Mitt Romney recently claiming that President Obama “has taken a series of steps that end Medicare as we know it.”

In 2011, the House Budget Committee, led by Representative Paul Ryan, proposed converting Medicare into a program where beneficiaries would receive vouchers they could use to buy coverage from private insurers—but the vouchers would grow in value considerably more slowly than likely health care inflation, shifting both costs and risks onto beneficiaries. In 2012, the same committee issued a slightly modified proposal in which vouchers would increase in value with growth in per capita GDP plus 0.5 percent points, again more slowly than expected.

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56 CBO, Letter to the Honorable Nancy Pelosi, March 20, 2010, Table 5.
health care inflation—a plan that Romney endorsed.\textsuperscript{59} President Obama responded by saying that the plan would “end Medicare as we know it.”\textsuperscript{60}

This is not the place to discuss which Medicare proposal is better policy. The point here is that each party positively relishes the opportunity to attack the other for cutting Medicare. When Romney first signaled his support for the Ryan plan, one Democratic operative’s response to a reporter was: “Rejoicing.”\textsuperscript{61} And so far, it seems to be a viable strategy. Republicans successfully used Medicare spending cuts (among other things) to demonize the Affordable Care Act, which helped them win the November 2010 midterm elections. In May 2011, Democrat Kathy Hochul won a seat in Congress from a conservative New York district, coming from far behind by making the special election all about the recently released Ryan plan.\textsuperscript{62} These are only individual data points, but there seems little reason to believe that significant cuts to Medicare spending, no matter how principled or well thought out, can be a winning political issue. This is all the more true given the increasingly negative tone of American political campaigns in the super PAC era, when attacking your opponent as a cold-hearted scourge of the elderly—or having an “independent organization” attack her for you—is a familiar formula for electoral success.

For these reasons, the prospects for major reductions in future entitlement spending seem slim. Ultimately, this is not simply a matter of clever politicking. Medicare, as well as Social Security and even Medicaid, is a very popular program. Furthermore, many people see it as a benefit that they earn by paying payroll taxes, even though a typical person’s lifetime

\textsuperscript{59} CBO, “The Long-Term Budgetary Impact of Paths for Federal Revenues and Spending Specified by Chairman Ryan,” March 2012, p. 3.
\textsuperscript{60} “Remarks by the President at the Associated Press Luncheon,” Washington, D.C., April 3, 2012.
contributions do not come close to covering the actuarially fair value of Medicare coverage. (Medicare Parts B and D are largely funded by contributions from general revenues.) The fact that Medicare has a dedicated funding mechanism (payroll taxes and beneficiary premiums) that is insufficient to cover its costs may have created the perverse situation where participants feel as entitled as if they were paying their full costs, even though they are paying only a modest fraction of those costs directly.

There are plausible grounds for worrying about whether our elected officials can muster the political will necessary to increases taxes or cut spending sufficiently to put the national debt on a sustainable footing. Washington’s failure to address the national debt reflects the attitude of the American electorate at large, which stands ready to punish politicians either for raising taxes or for slashing popular social insurance programs.

The United States is extremely unlikely to explicitly default on its debts anytime soon. If the fiscal situation deteriorates, some sort of debt restructuring deal would be the most likely outcome. If all else fails, the Federal Reserve could resort to monetizing the debt, because it is denominated in dollars.

The more pressing question is whether the United States will adopt policies that will make the national debt sustainable without experiencing a deep fiscal crisis that would require negotiations with creditors or sharp austerity measures. Current political dynamics do not appear encouraging, since there appears to be an insuperable barrier preventing tax increases and a strong presumption against significant cuts in entitlement spending. Still, as mentioned earlier, the credit markets remain remarkably sanguine about U.S. debt, with the yield on 30-year
Treasury bonds barely above 3 percent.\textsuperscript{63} It is possible that interest rates are so low because of “non-economic” investors, such as foreign central banks, that are primarily concerned with safety and liquidity and do not see other promising places to stash their money. It is also possible that investors are relying on the saying attributed to Winston Churchill: “We can always count on the Americans to do the right thing, after they have exhausted all the other possibilities.” Markets may be betting that today’s levels of polarization and gridlock cannot continue in the face of growing debts.

In the current political environment, if there is to be a solution, it is more likely to be along Republican lines than Democratic ones. In the Taxpayer Protection Pledge and the threat of attack from well-funded conservative groups, anti-tax advocates have found an effective way of locking the Republican Party into a “no new taxes” position; Democrats have no such device to protect entitlement programs. Furthermore, early anecdotal evidence implies that recent changes in campaign finance law are likely only to strengthen the position of conservative pressure groups, making it even harder to increase tax revenues. The growing national debt may also make reductions in those programs more politically feasible. In 1995, a Republican proposal to partially privatize Medicare was a major reason for their defeat in the budget showdown with President Clinton;\textsuperscript{64} today, at least some party leaders have decided that a similar proposal has political potential. Still, there have been numerous political realignments in American history, and the specter of the national debt could provide the motivating force for another one in the next decade or two. It is the contours of the American political system that will determine whether and how the United States deals with its long-term debt problem.

\textsuperscript{63} Federal Reserve Statistical Release H.15.