



## C H A P T E R 3

# RESTORING FISCAL RESPONSIBILITY

When President Obama took office three years ago, the Administration was given an annual deficit of \$1.3 trillion and a projected 10-year fiscal shortfall of more than \$8 trillion.<sup>1</sup> The Administration has taken many steps to restore fiscal responsibility because large and sustained fiscal imbalances pose one of the Nation's greatest economic challenges. Policymakers are charged with the dual imperative of safeguarding the ongoing economic recovery while simultaneously ensuring that future generations are not burdened with excessive debt and that future government borrowing does not unduly crowd out private investment. In the near term, sharp deficit reduction serves as a drag on aggregate demand and threatens to disrupt ongoing economic growth. In the long term, persistent budget deficits can reduce national saving, raise interest rates, and discourage private domestic investment, even in an economy as dynamic and robust as our own. These seemingly conflicting concerns make deficit reduction a crucial but delicate endeavor.

Recognizing the economic risks associated with sustained large budget deficits, the Obama Administration has made deficit reduction a priority. In February 2010, the President signed the Statutory Pay-As-You-Go Act, a law that restored the commonsense principle of paying for permanent mandatory spending or tax changes—a rule that had lapsed or been waived during the previous decade. In March 2010, the President signed the Affordable Care Act, which both expands health coverage and directly addresses one of the key drivers of the long-term deficits, rising health care costs. Last summer, the President and Congress enacted a \$1 trillion deficit-reduction package in the Budget Control Act of 2011, with a minimum \$1.2 trillion

---

<sup>1</sup> In this chapter only, unless otherwise noted, budget deficits and spending programs are reported in fiscal years and tax receipts are reported in calendar years.

in further reductions scheduled to follow. As a way forward, the President has laid out a balanced plan that would—in combination with the Budget Control Act and other deficit reduction measures taken since the beginning of 2011—cut the 10-year deficit by more than \$4 trillion, bring the budget into primary balance so that revenues cover all noninterest expenditures, and reduce debt as a share of the economy. These steps represent a radical departure from the budget policies of the previous administration, which included a series of sweeping tax cuts skewed toward the wealthiest, establishment of the Medicare prescription drug benefit program, and wars in Iraq and Afghanistan—all enacted without being offset by cuts or additional revenue raised elsewhere in the budget.

This chapter highlights the sources of budget deficits and public debt, describes projected budget outlooks, and outlines the Administration's deficit-reduction plan, a balanced approach that recognizes the need to prioritize spending initiatives while aligning revenues with current spending by asking the highest-income Americans to contribute to deficit reduction, as well as closing loopholes for corporations and special interests. The President's plan acknowledges that balancing the budget on the spending side of the ledger alone would hurt programs that help the middle class and those trying to get into it and put at risk other national priorities, such as investment in infrastructure and education.

The prospective fiscal imbalances have been decades in the making. Restoring balance will necessitate bold and difficult reforms in government programs. Although the Affordable Care Act and the Budget Control Act were the most aggressive Federal deficit-reduction legislation in years, much work remains to be done. Because budget projections show continued fiscal imbalances, it is critical for Congress to work with the Administration to return the Nation to a sound fiscal outlook.

## **DETERMINANTS OF CURRENT DEFICITS**

Under current law and established budget policy, which are reflected in the adjusted baseline of the Office of Management and Budget (OMB), the annual budget would improve rapidly as the economy recovers, falling from \$1.3 trillion in 2011 (8.7 percent of GDP) to \$662 billion in 2014 (3.9 percent of GDP). Despite these projected improvements, the deficits moving forward are expected to remain at unsustainable levels absent additional policy actions. The fiscal shortfall is not primarily driven by countercyclical policies enacted in response to the Great Recession. Instead, recent deficits are principally the result of spending policies enacted during the previous

administration, sweeping tax cuts initiated in 2001 and 2003,<sup>2</sup> and economic conditions. While temporary policies designed to increase aggregate demand, improve business investment, and jump-start employment contributed to annual deficits immediately following the financial crisis, they are less costly than the previous decade's spending and tax policies; most importantly, they are temporary emergency measures projected to have a minimal effect on annual budget deficits going forward.

As noted, spending policies enacted in the early part of the previous decade are one of the primary causes of recent deficits. Wars in Iraq and Afghanistan, substantially more costly than initially announced by the previous administration, added \$1.3 trillion in military spending between September 2001 and December 2011. The Medicare Part D prescription drug benefit, enacted in 2003, has raised Medicare spending by over \$250 billion through calendar year 2011. Increased interest costs associated with these programs have driven deficits even higher.

Tax cuts initiated in the previous decade, including those for the wealthiest individuals, have helped drive down tax revenues to historical lows. In particular, sweeping cuts in income and estate taxes, initially enacted in 2001 and 2003, have reduced revenue and increased interest costs by nearly \$3.0 trillion between 2001 and 2011 (Ruffing and Horney 2011). In 2011, Federal tax receipts amounted to just 14.4 percent of GDP, far below the postwar average of 17.7 percent. Part of this revenue shortfall is attributable to temporary tax cuts designed to aid the economy and create jobs, and part to the slow rebound of wages, investment income, and corporate profits—the income base from which tax receipts are primarily derived. But several ongoing tax policy trends that long predated the financial crisis have also put downward pressure on tax revenue.

By comparison, policies enacted to revitalize the economy and stabilize the financial system have contributed only moderately to deficits over the past several years, with a substantially waning impact after 2012. The American Recovery and Reinvestment Act (the Recovery Act) of 2009 cost \$833 billion overall, while the most recent Troubled Asset Relief Program (TARP) cost estimate is just \$68 billion. Other countercyclical measures, including the 2 percentage point payroll tax reduction for workers, have also carried relatively small costs, which have often been offset by other budget measures. For example, the Temporary Payroll Tax Cut Continuation Act of 2011, which temporarily extended the payroll tax cut, unemployment

---

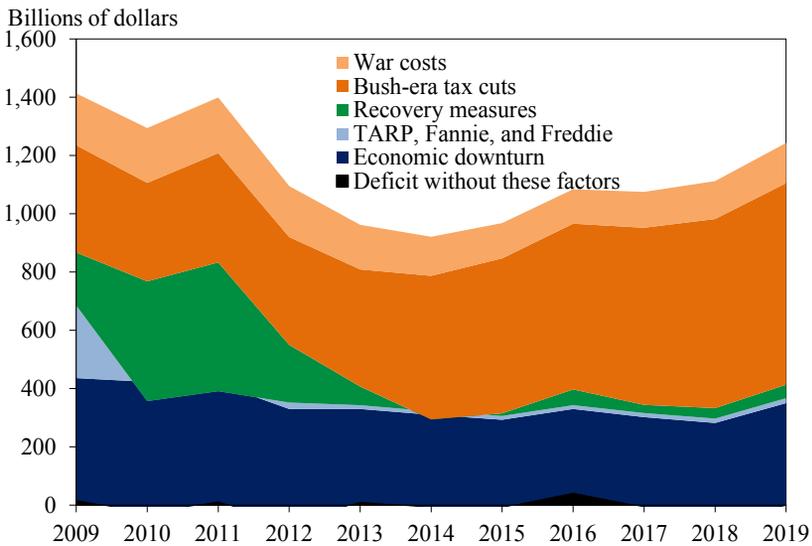
<sup>2</sup> These policies contributed to a historic gap between projected and realized budget outcomes. In 2001, following several years of budget surpluses, the Congressional Budget Office projected a cumulative surplus of \$5.6 trillion between 2001 and 2011 (CBO 2001). No surplus was realized after 2001, and a cumulative deficit of \$6.5 trillion accumulated between 2001 and 2011.

benefits, and certain about-to-expire Medicare provisions regarding physician payments, included offsets that made the bill deficit neutral.

Figure 3-1 compares the incremental cost of various post-2001 determinants of the deficit, including the wars in Iraq and Afghanistan, economic downturns, 2001 and 2003 tax cuts, financial stabilization measures, and economic stimulus initiatives. What the figure does not show is the path the deficit would have taken had the Great Recession persisted. The projections in the figure, based on Congressional Budget Office (CBO) data, incorporate both the direct economic growth owing to countercyclical measures undertaken by the Obama Administration and the subsequent projected economic recovery. If economic growth had turned negative instead of growing throughout 2009–11, or if the financial system had remained in turmoil, the tax base would have eroded further and the fiscal crisis would have been more severe.

The connection between unused countercyclical fiscal policy and stunted economic growth has been shown time and again. From the Great Depression, to Japan’s Lost Decade, to international attempts to enact austerity measures during economic recessions, research has shown that in the absence of countercyclical measures, recessions become even more severe (Auerbach and Gale 2010). As painful as the past three years have been

Figure 3-1  
Selected Components of Deficit Projections: 2009–2019



Note: Based on CBO budget projections. CBO employs different economic assumptions and methodology than OMB. As a result, the projections presented in this figure may differ from those presented by OMB.

Source: Ruffing and Horney (2011).

for the U.S. economy, countercyclical measures brought the downturn to a quicker end and have reinforced the recovery.

While demographic trends and rising health care costs pose serious challenges on the spending side of the ledger, the failure of tax revenue to match Federal spending remains a primary concern.

### *Falling Effective Tax Rates on Upper-Income Taxpayers*

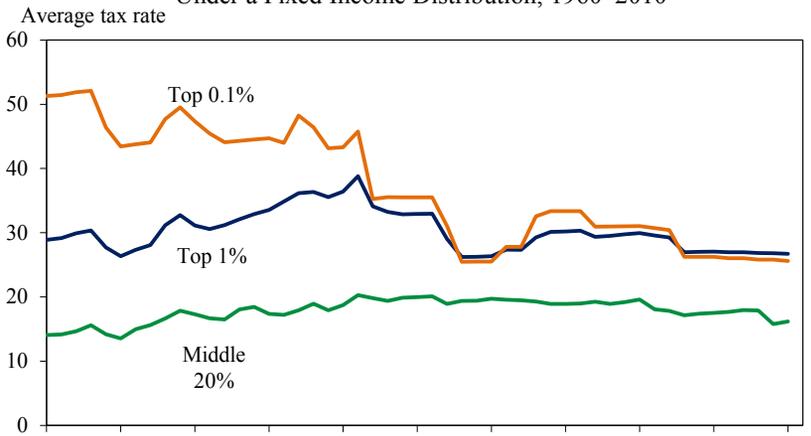
Effective tax rates, also known as average tax rates, are simply the amount of taxes paid as a share of total income. In contrast, marginal rates are defined as the taxes paid on an additional dollar of earnings. Tax preferences, such as preferential rates for investment income or deductions for particular activities, can drive effective tax rates far below marginal tax rates. As a result, effective tax rates have varied over time with periodic tax reforms and a shift in the composition of income among high earners toward business and capital income. Several of the President's tax policy initiatives, including the American Opportunity Tax Credit, the expansion of refundable tax credits for families with children, and the cut in the payroll tax, have provided tax relief for middle-income Americans.

In order to isolate the effects of changing tax policy on effective tax rates, a useful exercise is to track effective tax rates holding income characteristics constant. Under this methodology, as indicated in Figure 3-2, effective tax rates on middle-income Americans rose slightly in the 1960s and 1970s, and then remained mostly flat between 1980 and the start of the Obama Presidency. Effective tax rates for the top 1 percent have varied moderately over the past five decades, peaking in about 1980 before falling back to lower levels between the late 1980s and the present. In stark contrast, the wealthiest taxpayers have seen their effective tax rate plummet over the past five decades because of changes in Federal tax policies. The wealthiest 1-in-1,000 taxpayers pay barely a quarter of their income in Federal taxes today—half of what they would have contributed in 1960.

Although trends in effective tax rates are attributable to a variety of factors, the tax cuts initiated under the previous administration had a notable impact. When the Economic Growth and Tax Relief Reconciliation Act of 2001 cut statutory income tax rates, high-income taxpayers benefited disproportionately, in large part because of the cut in the top rate from 39.6 percent to 35.0 percent. Two years later, in 2003, preferential rates on long-term capital gains and dividends were cut to historical lows of 15 percent, again resulting in large benefits for the upper-income taxpayers who realize the bulk of investment income.

Treasury data show clearly that high-income families benefited the most from the 2001 and 2003 tax law changes. For example, as Figure 3-3

Figure 3-2  
Average Tax Rates for Selected Income Groups  
Under a Fixed Income Distribution, 1960–2010



Note: Average Federal (income plus Federal Insurance Contributions Act) tax rates for a sample of 2005 taxpayers after adjusting for growth in the National Average Wage Index. Source: Internal Revenue System Statistics of Income 2005 Public Use File, National Bureau of Economic Research TAXSIM, and CEA calculations.

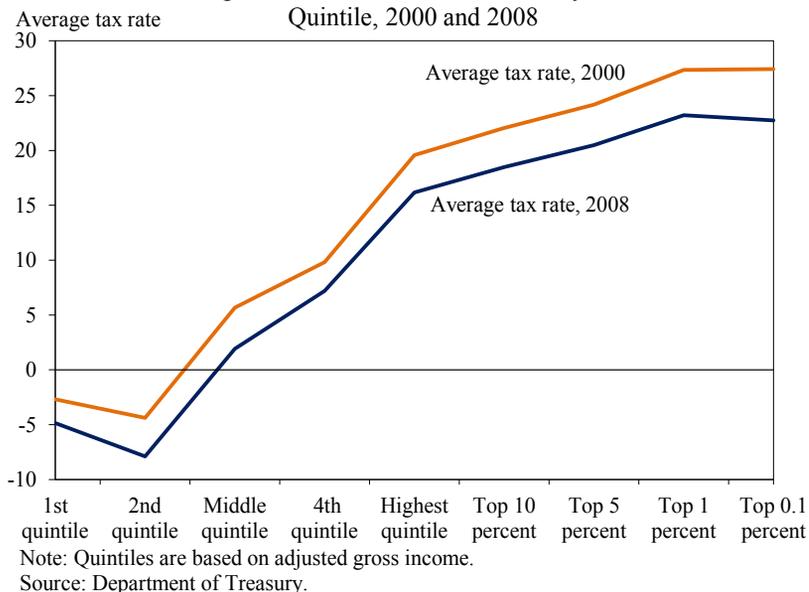
illustrates, between 2000 and 2008, income tax rates fell more for the top 1 percent and top 0.1 percent of the income distribution than for the middle-income quintile. Average individual income tax rates fell by 4.7 percentage points for families in the top 0.1 percent, but only by 3.7 percent for middle-income families.

To help reduce the deficit consistent with the notion of shared responsibility, the President’s Fiscal Year 2013 Budget proposes to let the tax breaks expire for income above \$250,000 a year, reversing a decade-long trend of unequal tax benefits for the wealthy, while making the tax cuts for those families making \$250,000 or less permanent.

### *Heterogeneity in Effective Tax Rates among High-Income Taxpayers*

The gradual drop in effective tax rates on high-income taxpayers is only part of the story. Effective tax rates on these taxpayers also vary widely because of the tax code’s differing treatment of various sources of income, allowances for changing the timing of taxes paid, and various deductions and credits. For example, a high-income taxpayer who is compensated primarily with cash wages might remit in excess of 30 percent of income in payroll and income taxes, while a high-income taxpayer who receives a large share of compensation in the form of interest in an investment fund (known as “carried interest”) would have a far lower tax rate.

Figure 3-3  
Average Individual Income Tax Rates by Income  
Quintile, 2000 and 2008



In 2012, among taxpayers in the highest income quintile, effective tax rates (including income, payroll, and corporate taxes) are expected to vary between 12.1 percent for those at the 10th percentile (in terms of effective tax rates) to 29.3 percent for those at the 90th percentile. That is, 10 percent of all high-income taxpayers are expected to pay less than 12.1 percent of their income in Federal taxes and another 10 percent are expected to pay more than 29.3 percent (the remaining 80 percent will pay somewhere in between the two rates). For the top 1 percent of taxpayers, the variation in rates is even starker. Among those in the top 1 percent, one in ten taxpayers is expected to pay less than 8.7 percent of their income in taxes, while another one in ten is expected to pay 34.6 percent or more (see Table 3-1).

The variation is perhaps most evident at the very top of the income distribution. In 2008, the most recent year for which data are available, 30 of the 400 highest-earning taxpayers (7.5 percent) paid less than 10 percent of their income in Federal income taxes, while 59 (14.8 percent) paid in excess of 30 percent.

### ***Addressing the Role Of Exclusions and Deductions in Effective Tax Burdens***

As noted, effective tax rates vary widely because of myriad deductions, exemptions, and preferences in the tax code. Moreover, particular streams of income are excluded from taxation entirely. But, as noted, the expanding

Table 3-1  
Distribution of Average Federal Tax Rates

Family cash income group	Average rate at each breakpoint in the rate distribution				
	10th	25th	Median	75th	90th
Lowest quintile	-13.7	0.0	5.4	13.1	15.5
Second quintile	-8.7	0.5	7.2	17.0	20.9
Middle quintile	1.7	5.4	13.3	20.4	23.5
Fourth quintile	7.2	12.1	17.2	22.3	26.2
Highest quintile	12.1	17.4	21.9	26.0	29.3
<i>Total</i>	0.0	5.0	14.5	20.7	25.0
Top 1 percent	8.7	21.2	29.6	32.3	34.6

Note: Calculations assume 2012 tax law with an AMT patch and 2012 income levels, and includes individual income tax, corporate income tax, and payroll tax. For the lowest income quintile, the calculation of average rates and the distribution of average rates do not include families with negative income. These families are included in the total.

Source: Department of Treasury.

array of such tools within the tax code has enabled some high-income taxpayers to reduce their tax liability dramatically. Decades ago, the Alternative Minimum Tax (AMT) was enacted in an attempt to combat the low rates paid by some high-income taxpayers, but its poor design has caused it to fall primarily on upper-middle-income families from high-tax states, as well as on those with many children (Burman 2007). In addition, because the value of a deduction or exclusion is a function of a taxpayer’s marginal tax rate, deductions and exclusions from taxable income are typically worth much more to high-income households—as much as two to three times more—than to low- and middle-income ones.

As a way to combat this “upside-down” system of tax incentives, the President has proposed several principles for tax reform. The President’s proposed Buffett rule would ensure that Americans making more than \$1 million a year would pay no less a share of their income than middle-income families pay—in particular, no less than 30 percent of their income—in taxes. In addition, the President has proposed tax reform that would ensure fair incentives for the middle class, helping to equalize the value of tax expenditures across the income distribution. (For information on how to evaluate effective tax rates based on their progressivity, see Economics Application Box 3-1).

## THE FISCAL OUTLOOK

Without the pro-growth policies of the past three years, future budget shortfalls would be even more severe. Moreover, the policies presented in the Administration’s Fiscal Year 2013 Budget significantly improve

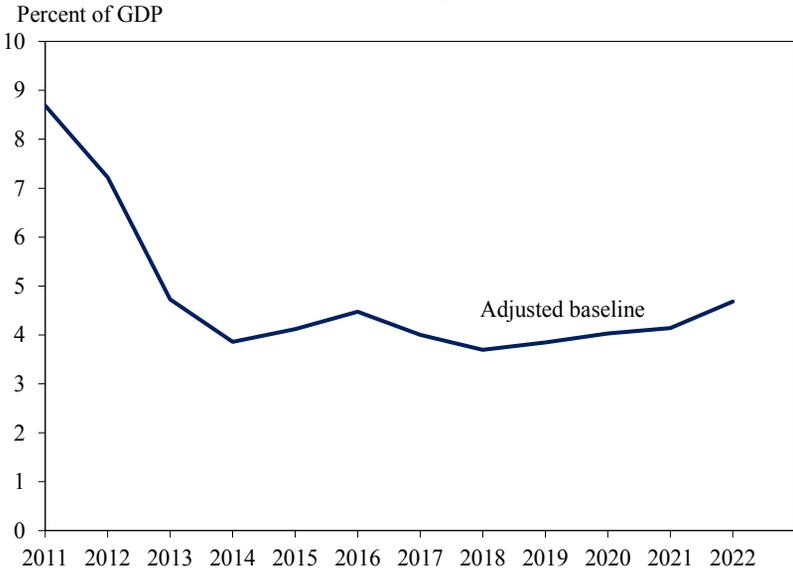
projected medium-term deficits relative to an adjusted policy baseline, and projected long-term public debt continues to rapidly decline over the course of the Obama Administration.

### ***Medium-Term Budget Projections***

Under the OMB adjusted baseline, medium-term deficits gradually decline as a share of GDP—projected deficits fall from 8.7 percent of GDP in 2011 to 4.7 percent of GDP in 2022, as Figure 3-4 indicates. This adjusted baseline represents a medium-term scenario in which current policies continue throughout the decade. The scenario includes the continued indexation of AMT parameters, extension of the 2001 and 2003 tax cuts, and extension of the estate tax parameters at their current levels, as well as a continuation of current levels of spending for Overseas Contingency Operations and physician pay rates under Medicare.

This improved fiscal outlook is due in large part to a recovering economy and the fiscal steps the Administration has already taken, including the Affordable Care Act and the Budget Control Act. Nonetheless, this adjusted baseline remains problematic and represents a fundamental imbalance between government spending and revenues. The President’s plan to rebalance revenue streams and spending priorities is detailed later in the chapter.

Figure 3-4  
Projected Medium-Term Budget Deficits, 2011–2022



Note: See text for policies incorporated in OMB's adjusted baseline.

Source: Office of Management and Budget (2012a).

### **Economics Application Box 3-1: Measuring Progressivity in the Tax Code**

Tax changes are typically evaluated based on several key criteria, including efficiency, simplicity, ease of compliance and administration, impact on economic activity, and progressivity. Progressivity is the measure of how a particular policy affects households with differing levels of income or resources. Fairness is the essence of progressivity; many taxes—particularly income taxes—are designed to ensure a lighter tax burden for households with less income and lower ability to pay.

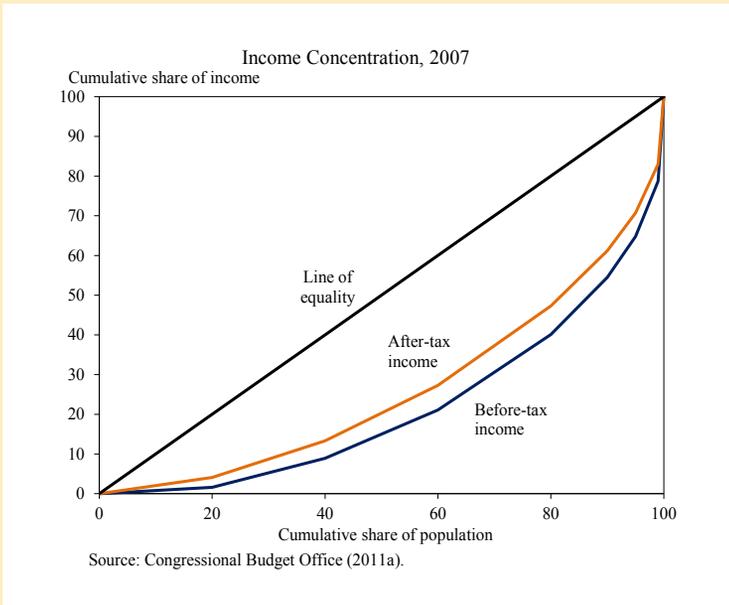
Economists typically define a progressive tax as one that has average tax rates that increase with income; under a progressive tax code, higher-income taxpayers devote a higher share of their income to taxes than other taxpayers. A progressive tax change is one that lowers average tax rates more for low- and middle-income households relative to others or raises average tax rates more for high-income households relative to others. For example, the recent 2 percentage point cut in the payroll tax is considered progressive because it reduces average tax rates more for low- and middle-income families compared to high-income families.

Other measures of progressivity, such as measures that refer strictly to dollar changes in taxes paid or to the percentage change in taxes paid, can be misleading. For example, a tax cut might reduce taxes paid by low-income households from \$100 to \$50 (a change of 50 percent), and reduce taxes paid by high-income households from \$500,000 to \$400,000 (a change of just 20 percent). Some might argue that this change is progressive because it reduces taxes paid by low-income households by proportionately more than it reduces taxes paid by high-income households, but this measure is actually inconclusive because it tells us nothing about the change in average tax rates. Along these same lines, metrics that focus on the share of taxes paid are not useful because they do not incorporate information on average tax rates by income group.

The definition of income or well-being can also be important when measuring progressivity. Some forms of compensation—such as employer contributions to a retirement account or health insurance premiums paid by an employer—may not be considered income for tax purposes but might in principle be considered as income for measuring taxpayer resources. Similarly, income transfers such as unemployment compensation or Social Security benefits could be included in income when measuring progressivity.

The extent to which the tax code equalizes income is expressed graphically by the Lorenz curve in the box, which shows the cumulative

distribution of income before and after taxes. The 45 degree line represents a perfectly equal distribution of income; the closer the Lorenz curve to that line of equality, the more equal the distribution of income. A progressive tax code is one that shifts the income distribution closer to the 45 degree line. In 2007, the tax code helped to improve the progressivity of the income distribution, as illustrated by the graph, by making after-tax income more equal than before-tax income. However, even the after-tax Lorenz curve was well below the 45 degree line, meaning that the distribution of after-tax income was highly skewed towards the highest-income taxpayers.



### *The Vital Role of Economic Growth in Future Fiscal Outcomes*

Budget discipline is nearly impossible to achieve in practice without healthy economic growth. Budget outcomes are sensitive to weak economic conditions. Deteriorating economic conditions resulting from the financial crisis are one of the most important determinants of projected medium-term deficits, accounting for \$3.9 trillion in expected deficits between 2009 and 2019 (as shown earlier in Figure 3-1). OMB (2012b) projects that a 1 percentage point drop in GDP growth in 2012, not matched with a subsequent boost in GDP in later years, would increase the deficit by \$720 billion over 10 years. Similarly, CBO (2011b) projects that an ongoing 0.1 percentage point

### **Data Watch 3-1: Data from the IRS Statistics of Income Division**

The Statistics of Income (SOI) Division of the Treasury Department's Internal Revenue Service produces informative annual statistics. The resulting information is an important input to the National Income and Product Accounts and has been invaluable for the evaluation of economic and tax policies, as well as for business decisions.

One advantage of SOI statistics is that they are available for a long period of time: historical data series cover the period from 1916 to the present. Of particular interest are tabulations of selected items by county and ZIP Code, such as migration patterns. Extensive data also are available on businesses, including corporations, partnerships, and sole proprietorships. In response to increased globalization, for example, SOI produces regular reports on both foreign-owned U.S. corporations and U.S.-owned corporations operating in other countries.

More than 14,000 detailed tables and regular reports are available to the public online through the Tax Stats pages located at [www.irs.gov](http://www.irs.gov). Periodic special reports have examined topics such as pensions, foreign earned income, and noncash charitable contributions. Users may create custom tables using a table wizard application. Importantly, SOI painstakingly safeguards the confidentiality and anonymity of the underlying information it draws on. Statistics derived from the SOI provide a rich source of information for policymakers, business people, researchers, and public interest groups, among others.

decrease in real GDP growth compared to its baseline forecast will add \$310 billion to the projected 2012–2021 deficit.

The link between economic growth and fiscal stability is, in fact, central to the rationale for countercyclical measures like the Recovery Act and the American Jobs Act. Although the countercyclical measures in these bills may impose an initial fiscal cost,<sup>3</sup> the cost can be considered a down payment on future economic growth, which in turn can lead to a more stable fiscal policy. Economic growth leads to a sound fiscal outlook.

### ***Improvement in Long-Run Budget Projections***

Although the need for long-run deficit reduction is evident, recent Administration policies have already helped to partially close the long-run fiscal imbalance. As noted, the Budget Control Act of 2011 reduced Federal spending by \$1 trillion over the next decade by making cuts to discretionary spending, with an additional \$1.2 trillion in deficit reduction scheduled to

---

<sup>3</sup> The President's proposed American Jobs Act is deficit-neutral; all provisions are more than fully paid for.

come. The Administration regards this legislation as a down payment on deficit reduction, and last fall proposed to Congress an additional \$3 trillion deficit-reduction package that would, by the middle of this decade, mean that current spending is no longer adding to the debt, and that debt is falling as a share of the economy.

Health care legislation passed in 2010 is a key factor to gains in long-run deficit reduction. The Affordable Care Act addressed the Nation's most profound long-run budget challenge by limiting the growth in health care costs in several ways. (Chapter 7 discusses Health Insurance Exchanges as well as other provisions of the Affordable Care Act and existing health programs.) The Act includes Medicare payment reforms that will restrain spending growth by rewarding improvements in health care productivity. It established the Center for Medicare and Medicaid Innovation, which will fund and test new strategies for providing high-quality care more efficiently, and the Independent Payment Advisory Board, which will recommend policies to reduce the growth in Medicare spending, without limiting beneficiaries' access to care. The projections presented in this chapter assume that the provisions of the Affordable Care Act are fully implemented, limiting Medicare costs in the long run compared with previous law. The Medicare Trustees estimate these gains to be substantial, slowing the average long-range annual growth in Medicare spending per enrollee to just 0.2 percentage point a year above the growth in GDP per capita. This growth rate is significantly smaller than previous Medicare Trustee projections—a reduction that is largely attributable to the Affordable Care Act. These trends indicate that in the absence of recent health care reform, long-run budget projections would be substantially worse.

## **THE IMPORTANCE OF RESTORING FISCAL SUSTAINABILITY**

Reducing the deficit while the economy continues to recover requires a delicate balance. Looming fiscal shortfalls can seem a distant concern in the face of high unemployment and sluggish economic growth. But as a result of continued growth since 2009 and a gradual recovery from the financial crisis of 2008, the Administration maintains its view that short-term economic support and long-term fiscal responsibility can be complementary policies. Although reducing the deficit is a difficult task, it is critical to the Nation's future. As the debt-to-GDP ratio has steadily risen, economists have become increasingly concerned about the consequences of persistent deficits.

Not all types of deficit spending yield identical effects on the budget. The net economic effect of budget deficits depends critically on the

characteristics of the underlying spending. Public borrowing to finance productive investment, including investment in infrastructure, technology, and education, can yield positive fiscal returns in the future. A more productive private sector will lead to higher profits and stronger wage growth, which will ultimately prove to boost revenues and reduce spending in later years. As such, government spending that makes the private sector more productive is distinctly different from spending devoted to consumption in the current period.

Prolonged fiscal shortfalls also tend to raise interest rates. Today's historically low interest rates may make that link between interest rates and deficits seem tenuous, but in typical economic circumstances, budget deficits drive interest rates higher by increasing the demand for saving. The consensus view among economists is that a 1 percent increase in the deficit relative to GDP leads to a 20- to 60- basis-point rise in interest rates (Gale and Orszag 2003). Higher interest rates depress interest-sensitive consumption (such as housing and durable goods) and diminish asset values and household wealth.

Of perhaps greater concern is the potential for prolonged budget deficits to impact domestic private investment via elevated interest rates. All else equal, higher interest rates can divert savings away from productive domestic investment towards government securities; higher interest rates also encourage domestic and foreign savers to increase their net investment in the United States. Thus, higher budget deficits can be financed by a combination of reduced domestic private-sector investment, increased domestic saving, and additional lending by foreign investors. Although there is no consensus among economists on the relative share of each of these factors, studies often assume that about 25 percent of the increase in the budget deficit is met with increased private-sector saving (Elmendorf and Liebman 2000) and about 20 to 40 percent through increased foreign lending (Engen and Hubbard 2005).

An active research agenda has considered how government debt affects the economy. According to research by economists Carmen Reinhart and Kenneth Rogoff (2010), "high debt/GDP levels (90 percent and above) are associated with notably lower growth outcomes." Several aspects of this finding warrant mention. First, although slow growth and debt are correlated, high debt does not necessarily cause stagnant growth. In fact, some have theorized that stagnant growth leads to higher levels of debt, rather than the other way around (Irons and Bivens 2010). Second, some question whether the 90 percent threshold is appropriate for the largest economy in the world, especially given the ongoing appetite of foreign and domestic investors for Treasury debt and the relative attractiveness of investment in

the United States. Finally, some have argued that the key factor in measuring the impact of debt on the economy is debt held by the public, rather than total debt (including intragovernmental debt; see Data Watch 3-2 for further explanation).

Although the precise impact of government debt on economic growth is subject to debate, economists agree that confidence is paramount in the relationship between government debt and financial markets. A long-term commitment to sound fiscal policies will reassure investors that the government can service its debt. More importantly, sound fiscal policy and a commitment to living within our means and investing in the future will ensure better access to capital by domestic investors, as well as higher standards of living for future generations.

## **THE PRESIDENT'S BALANCED APPROACH TO DEFICIT REDUCTION**

The President's proposed framework for deficit reduction, laid out in the Fiscal Year 2013 Budget, represents a balanced approach along several dimensions. Deficit-reduction measures are phased in gradually to avoid disrupting the economic recovery. Ineffective spending programs are eliminated, while tax expenditures on the Nation's wealthiest taxpayers are limited. Targeted investment initiatives, including those for education, infrastructure, and personal saving, are paid for by eliminating ineffective tax cuts to high-income taxpayers. Most importantly, the President's Budget charts a sustainable fiscal course, ensuring that the budget deficit will fall to a sustainable level in the next 10 years and beyond. In sum, the President's Budget represents a critical first step toward a stable and prosperous economic future and ensures that the American economy will remain competitive and vibrant for decades.

The cornerstone of the President's approach to deficit reduction—and perhaps the way in which it differs most from plans offered by others—is the balance it strikes between sustainable tax revenues and spending cuts. A deficit-reduction framework based on spending cuts alone would preclude the provision of basic protections provided to the Nation's most vulnerable citizens and investment in the Nation's future. The balanced approach of the President's Budget preserves the basic functions of the Federal Government. Medicare and Medicaid are strengthened, ensuring health care for the nation's elderly, low-income families, and individuals with disabilities. Social Security continues to provide a reliable, steady stream of income for retirees. The military continues to receive funding to serve American interests at home and abroad. Veterans continue to receive the support they

### Data Watch 3-2: Measuring Government Debt across Countries

Differences in government accounting practices and in the types of assets held by central governments complicate the comparison of government debt across countries. These complications can lead to confusion over the most appropriate measure of government debt and the relative levels of debt for different countries.

One source of misunderstanding is the distinction between public debt and total government debt. Public debt refers to government debt held by private investors, including individuals, pension funds, mutual funds, and corporations. Total government debt is the sum of public debt and intragovernmental debt—government debt held in government accounts, such as government securities held in the U.S. Social Security and Medicare trust funds. Economists widely recognize public debt as the more relevant measure since it is government borrowing from the private sector that can be expected to interact with credit markets.

In most Organisation for Economic Co-operation and Development (OECD) countries, there is little intragovernmental debt. In the United States and Canada, however, budgetary conventions give rise to large accumulations of such debt. At the end of December 2011, U.S. debt totaled \$15.2 trillion, of which \$10.5 trillion was held by the public and \$4.8 trillion was intragovernmental debt. Intragovernmental debt is similarly important in Canada. Including intragovernmental debt when making international comparisons leads to an exaggerated impression of government indebtedness in the United States and Canada relative to other OECD nations.

A second source of confusion is the distinction between gross debt and net debt. The OECD measures gross debt as total liabilities outstanding, including securities issued on behalf of the government (such as Treasury securities), currency, and liabilities to government employee pension funds. Net debt is measured as gross debt minus government-owned financial assets. The importance of this distinction varies across countries. In Japan, for example, the difference is stark: gross government debt equaled 220 percent of GDP in 2010, while net government debt was just 117 percent of GDP.

A final source of misunderstanding concerns the particular government sector being measured. The OECD presents measures of general government debt, which encompasses debt at all levels of government, including State and local governments in the United States, and central government debt. Both of these measures carry economic significance, but the distinction matters insofar as central governments generally are not liable for debt incurred by other levels of government.

deserve. Investments in education, infrastructure, and innovation continue to be a priority. Many other deficit-reduction plans fall short in these areas.

While the President's Budget makes and maintains critical investments in areas important to growth and competitiveness, it also institutes broadly shared sacrifices to reduce the deficit. The Administration proposes to achieve \$1 trillion in discretionary spending savings over the next 10 years through the budgetary caps established by the Budget Control Act; \$30 billion in deficit reduction through cutting or consolidating ineffective, duplicative, or outdated Federal programs; adopting a new defense strategy that cuts defense spending by 9 percent relative to the Fiscal Year 2012 Budget; limiting funding for Overseas Contingency Operations to \$450 billion through 2021; a \$60 billion fee on large financial firms; adjustments to the Medicare and Medicaid programs to make them more efficient and cost-effective; and a reform of the Federal civilian workers' retirement plan that saves \$21 billion over the next decade.

As the President's deficit-reduction strategy cuts long-run deficits, it also supports the economic recovery. The cornerstone of this support is the American Jobs Act, one of the boldest pieces of pro-employment legislation in decades. At the end of 2011, the President signed into law several key parts of the American Jobs Act, including a short-term extension of both the payroll tax cut and extended unemployment benefits that were set to expire at the end of 2011. Extending the payroll tax cut into 2012 added an average of \$40 to each paycheck of 160 million American workers. If continued through 2012 as the President favors, extended unemployment benefits will save 5 million job seekers from depleting their benefits and will create nearly 500,000 jobs through 2014 as workers spend their extra income. To bolster labor market conditions and spur near-term economic growth, the President proposes pushing ahead with elements of the American Jobs Act and with additional job-creating measures. Among those proposals are an initial \$50 billion investment in roads, rails, and runways through surface transportation reauthorization legislation; aid to states and localities to rehire teachers and first responders; additional incentives for Americans to invest in energy-saving home improvements through the Homestar Bill; incentives to private industry to upgrade offices, stores, universities, hospitals, and commercial buildings through the Better Buildings Initiative; a 10 percent income tax credit to encourage small businesses to hire new employees and to increase wages; the halting of an automatic increase in student loan interest to ease the burden on students; funds to modernize at least 35,000 schools; a renewed Build America Bonds program to help finance the modernization and upgrading of America's infrastructure; reauthorization of Clean Energy Manufacturing Tax Credits to spur the creation of manufacturing jobs

in the advanced energy technology sector; continuation of provisions to allow businesses to write off the full amount of new investments next year; and enactment of Project Rebuild, a series of policies aimed at connecting unemployed workers in distressed communities with efforts to rehabilitate residential and commercial properties.

The President's deficit-reduction framework also calls for tax reform that will simplify the tax code and lower rates, cut unfair and unnecessary tax expenditures, increase growth and job creation in the United States, observe the Buffett rule, and raise \$1.5 trillion from the highest-income Americans to be devoted to deficit reduction. To begin a national conversation about tax reform, the President has offered a detailed set of measures to close specific tax loopholes, broaden the tax base, and allow the high-income tax cuts of the past decade to expire. With this conversation, the President's Budget begins to reclaim the Nation's fiscal future and restore fiscal responsibility by making balanced and necessary policy decisions.