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Stopping America's Federal Debt Explosion
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CAMBRIDGE — The US Congressional Budget Office (CBO) has just delivered the bad news that the national debt is now rising faster than GDP and heading toward ratios that we usually associate with Italy or Spain. That confirms my view that the fiscal deficit is the most serious long-term economic problem facing US policymakers.

A decade ago, the federal debt was just 35% of GDP. It is now more than double that and projected to reach 86% in 2016. But that's just the beginning. The annual budget deficit projected for 2016 is 5% of GDP. If it stays at that level, the debt ratio would eventually rise to 125%.

Even that projection assumes that interest rates on the national debt will rise slowly, averaging less than 3.5% in 2026. But if the US debt ratio really is on the fast track to triple-digit levels, investors in the US and abroad may rightly fear that the government has lost control of the budget process.

With debt exploding, foreign bondholders could begin to worry that the US will find a way to reduce its real value by stoking inflation or imposing a withholding tax on all government bond interest. In that case, investors will insist on a risk premium: higher interest rates on Treasury debt. Higher interest rates, in turn, would increase the deficit – and thus the future level of the debt ratio – even more.

The high and rising level of the national debt hurts the US economy in many ways. Paying the interest requires higher federal taxes or a larger budget deficit. In 2016, the interest on the national debt is equal to nearly 16% of the revenue from personal income tax. By 2026, the projected interest on the national debt will equal more than 31% of this revenue, even if interest rates rise as slowly as the CBO projects.

Foreign investors now own more than half of net government debt, and that proportion is likely to keep growing. Even if they are now willing to accept newly issued bonds when interest and principal on outstanding ones are due, the time will come when the US will have to pay the interest by exporting more goods and services than it imports. And boosting net exports will require a weaker dollar to make US products more attractive to foreign buyers and foreign goods more expensive to US buyers, implying a loss in Americans' standard of living.

Increased borrowing by the federal government also means crowding out the private sector. Lower borrowing and capital investment by firms reduces future productivity growth and growth in real incomes.

So it is important to find ways to reduce the budget deficit and minimize the future debt ratio. The good news is that a relatively small reduction in the deficit can put the debt ratio on a path to a much lower level. Cutting the deficit to 2% of GDP, for example, would cause the debt ratio eventually to reach 50%.

Deficit reduction requires cutting government spending, increasing revenue, or both. Neither is politically easy; but neither should be impossible. Cutting spending is made more difficult by the reductions in relative outlays that have already occurred. The share of GDP devoted to defense has fallen from 7.5% of GDP in 1966 to 3.2% of GDP this year, and the CBO projects it to fall to 2.6% during the next decade. That would be the lowest GDP share since World War II, representing a level of spending that military experts believe is dangerously low.

Other spending is split between the annually appropriated amounts (known as non-defense discretionary spending) and the programs in which spending follows from established rules that are not subject to annual review (known as the "mandatory" spending programs, primarily Social Security retirement benefits and health-care spending).

The non-defense discretionary spending is also heading toward 2.6% of GDP – also the smallest share of GDP since WWII. It is the mandatory programs that have grown rapidly, driving up the deficit. The mandatory programs' share of GDP, only 4.5% in 1966, is now 13.3% and projected to reach 15% in 2026. These programs are largely benefits for middle-class seniors and not welfare programs targeted at the relatively poor. That's why most experts agree that slowing the rise in these so-called "entitlement" programs has to be part of reducing future deficits.

Federal taxes now take 18.3% of GDP and are projected to remain at that level for the next decade, unless tax rules or rates are changed. The rate structure for personal taxation has changed over the past 30 years, with the top tax rate rising from 28% in 1986 to more than 40% now. The corporate rate of 35% is already the highest in the industrial world.

Higher marginal tax rates would weaken incentives and distort economic decisions. That's why I and others who think about shrinking the deficit focus on changing tax rules to limit the special features known as "tax expenditures," which represent government spending built into the tax code. These items range from small ones, like the $7,500 tax credit that goes to a buyer of an electric car, to large (for example, the deduction for mortgage interest and the exclusion from taxable income of employer payments for employee health insurance).

The mortgage deduction alone will reduce tax revenue in 2016 by $84 billion, or more than 5% of the personal income tax collected. The exclusion of health insurance premiums from employees' taxable income will reduce revenue by more than $200 billion, or about 15% of receipts from the personal income tax.

Nothing to start shrinking the deficit will happen before this year's presidential election. But tackling the spending and revenue components of deficit reduction should be high on the agenda when the new president takes office next year.

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