ISSUE BRIEF

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DANGEROUS TARGETS

Why setting a specific deficit reduction target would worsen the economic and fiscal situation

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For the past few years, the U.S. political system has been inundated with calls for deficit reduction. Yet since January 2011, projected non-interest spending over fiscal 2013–2022 has been cut by $2.4 trillion and projected revenue has been raised by $617 billion, relative to the August 2010 policy baseline (Murray 2013).[1] With interest savings, this will result in $3.6 trillion worth of deficit reduction if sequestration remains in effect. Despite these large policy-induced deficit reductions, there have been repeated calls insisting that more deficit reduction be achieved in the coming decade.

Ten-year deficit reduction targets have proliferated, and even the Obama administration has frequently highlighted the alleged need to undertake roughly $1.5 trillion in deficit reduction in the next 10 years (Wasson 2013).[2] These targets convey the message that policymakers should enact policy changes adding up to specific amounts of deficit savings over 10 years, with the simple level of the target itself being the most important policy variable.

This report argues that these 10-year deficit reduction targets are bad economics and will likely lead to poor policy decisions. It begins by explaining why a better goal is to stabilize the debt ratio—public debt as a share of gross domestic product (GDP)—once the economy returns much closer to full employment. The paper then buttresses this argument

by analyzing why 10-year deficit reduction targets would be so dangerous in present circumstances. It concludes by charting a better path toward fiscal sustainability over both the short term and long term.

Principal findings include:

- Normally sensible fiscal policy rules—such as stabilizing the debt ratio during normal economic times—do not apply to the U.S. economy today, as the economy is abnormally weak and has been for more than five years.
- The impact of deficit reduction on the economy—and thus on the debt ratio—is heavily influenced by the types of policies used to achieve these reductions. Particularly, spending cuts in this economic environment tend to increase the debt ratio, while tax increases are the only policies that reduce the debt ratio.
- If aggressive 10-year deficit reduction targets lead policymakers to enact premature spending cuts, the cuts would likely weaken the economy to the point that the debt ratio actually increases.
- A 10-year, overall deficit reduction target requires any upfront economic stimulus be paid for with larger deficit reductions later in the budget window. But deficit-financed stimulus in the near term actually does not make debt stabilization more difficult to achieve later in the budget window—and might actually make it easier.
- In the long run, the best way to achieve debt stabilization in a manner that boosts, rather than reduces, future living standards is to invest in economic growth, restore tax fairness, and reform health care. These sorts of intelligent reforms are vastly preferable to meeting deficit reduction targets through an arbitrary mix of spending cuts and increased taxes.

The goal should be debt stabilization during normal economic times

Those who advance 10-year deficit reduction targets (including the Obama administration) generally claim the federal budget situation requires a certain minimal amount of savings over that period. "It's just math" has become the rallying cry for those wanting to impose stringent 10-year targets. However, it's not just math—it's also economics; ignoring the economics of today's situation will result in deeply misguided fiscal policy. Given the still-weak U.S. economy, the goal should *not* be a 10-year deficit reduction target. Rather, it should be to boost economic recovery in the near term and to stabilize the debt as a share of GDP once the economy returns to normal.

The goal of debt stabilization

Given the wide range of deficit reduction targets, one would expect there is fundamental disagreement among analysts about the bottom-line standard for fiscal sustainability. But surprisingly, this is not the case. Though politicians often proclaim the virtues of a balanced budget, economists, policy experts, and think tanks are mostly united around three basic ideas.

First, the most economically important measure of fiscal sustainability is publicly held debt as a share of GDP. Publicly held debt refers to debt that the government owes to all external bondholders; this excludes intra-governmental debt, such as the debt held by the Social Security Trust Fund. Only publicly held federal debt measures how much the federal government's debt contemporaneously affects the wider economy, notably by competing with the private sector for loanable funds. Furthermore, this debt should be measured as a share of the overall economy; as previously noted, public debt as a share of GDP is also referred to as the debt ratio. This is a good proxy for the country's ability to repay the

debt. Consider that a $1 million loan would be problematic for the typical American household making $50,000, but not for Bill Gates.

Second, policymakers should not target a specific debt ratio. Indeed, even those advocating larger 10-year deficit targets are clear that "there is no magic number" (CRFB 2013).[3] Instead, the debt ratio should be stable or falling when the economy is at full health. A rising debt ratio would suggest a country's debt is growing faster than its ability to repay said debt at current spending and tax rates, whereas stabilized debt means debt is growing only as fast as the ability to repay it at prevailing spending and tax rates.

Third, debt ratio stabilization should be sought "during normal economic times" (Kogan, Greenstein, and Friedman 2013). Debt ratios that rise during steep recessions are not just benign, they are actively helpful: The increased debt stems from government injecting purchasing power into the economy just as private spending collapses, acting as a shock absorber.

It should be noted that today's significant economic weakness and uncertainty as to how long it will continue means there is no obvious way to operationalize this general standard of stabilizing the debt ratio during normal economic times. Policymakers could, for example, target the slope of the debt path in the last five years of the 10-year window. This last five years is when most forecasters believe the United States will have returned to "normal economic times." Thus, if the debt ratio is lower in 2023 than in 2019, the debt could be considered stabilized. Alternatively, the trough of the debt ratio could be targeted, basically ensuring that the debt ratio is held steady once it reaches its lowest point during normal economic times. Or policymakers could target a particular annual deficit consistent with the debt ratio in the first year that stabilization would begin (once the economy has returned to normal).

The current economic situation

The most important consideration in applying the concept of debt stabilization to the current economic situation is that the economy is still exceptionally weak and remains far from normal. As of the first quarter of 2013, national output was depressed roughly $953 billion, or 5.6 percent, below potential (i.e., what output would have been if all human and physical capital resources were fully utilized); this is known as the output gap. Similarly, the economic downturn cost Americans just under $1 trillion of income—or over $3,000 per person—in 2012 alone. This output gap has further translated into a jobs gap of 8.8 million—the number of jobs needed to restore the labor market to prerecession health.[4] This economic weakness is driven by the collapse of aggregate demand caused by the burst of the housing bubble, as documented in Bivens, Fieldhouse, and Shierholz (2013) as well as Yellen (2013).

The outlook for a recovery of demand is not terribly positive. Expansionary monetary and fiscal policy in 2009 is largely responsible for ending the Great Recession and stabilizing the economy (Blinder and Zandi 2010), but the economy unfortunately appears stabilized at a still-depressed state. Since the fourth quarter of 2009, state and local fiscal policy has been contractionary (driven overwhelmingly by spending cuts), and federal fiscal policy has slowed recovery since mid-2010 (Bivens, Fieldhouse, and Shierholz 2013). Worse, federal fiscal policy will likely increasingly drag on recovery in 2013 and beyond due to the expiration of past fiscal stimulus (e.g., the payroll tax holiday), and steep spending cuts enacted by the Budget Control Act of 2011 and that year's appropriations legislation.

Moreover, the Congressional Budget Office (CBO) does not expect full economic recovery to materialize until 2017, and CBO's projections for full recovery—routinely four to five years from issuance—have consistently proven overly optimistic (Bivens, Fieldhouse, and Shierholz 2013). So policymakers do not know when the economy will be back to "normal," only that full recovery is almost certainly years away, perhaps much further away if more near-term austerity is enacted.

The problems with 10-year deficit reduction targets in the current context

All of the preceding background should help make clear why committing to 10-year deficit reduction targets would be so dangerous in the present circumstances. More specifically, such targets make unnecessary and imprudent near-term fiscal contraction more likely, which would slow the economy and possibly even increase the debt ratio. Furthermore, such targets pay no attention to the composition of the deficit reductions—particularly the ratio of spending cuts to revenue increases—which is likely to lead to large policy mistakes. Additionally, such targets suggest there is no scope for the near-term fiscal stimulus that is sorely needed in the current economic climate.

Problem 1: Ten-year deficit targets make unnecessary near-term fiscal contraction much more likely

Many of the 10-year targets under debate explicitly assume that deficit reduction would start in fiscal year 2014, which begins in October 2013. This would hinder recovery (as will be detailed shortly) and is unnecessary even for meeting the criterion of debt ratio stabilization during normal economic times. **Figure A** depicts the debt trajectory under the various targets, including those from the Center on Budget and Policy Priorities (CBPP) and the Committee for a Responsible Federal Budget (CRFB). It shows that if deficit reduction begins in 2017 (when CBO projects the U.S. economy will return to normal), stabilization could be achieved with only $1.1 trillion in deficit reduction.[5]

Problem 2: Upfront austerity can actually be counterproductive for debt stabilization

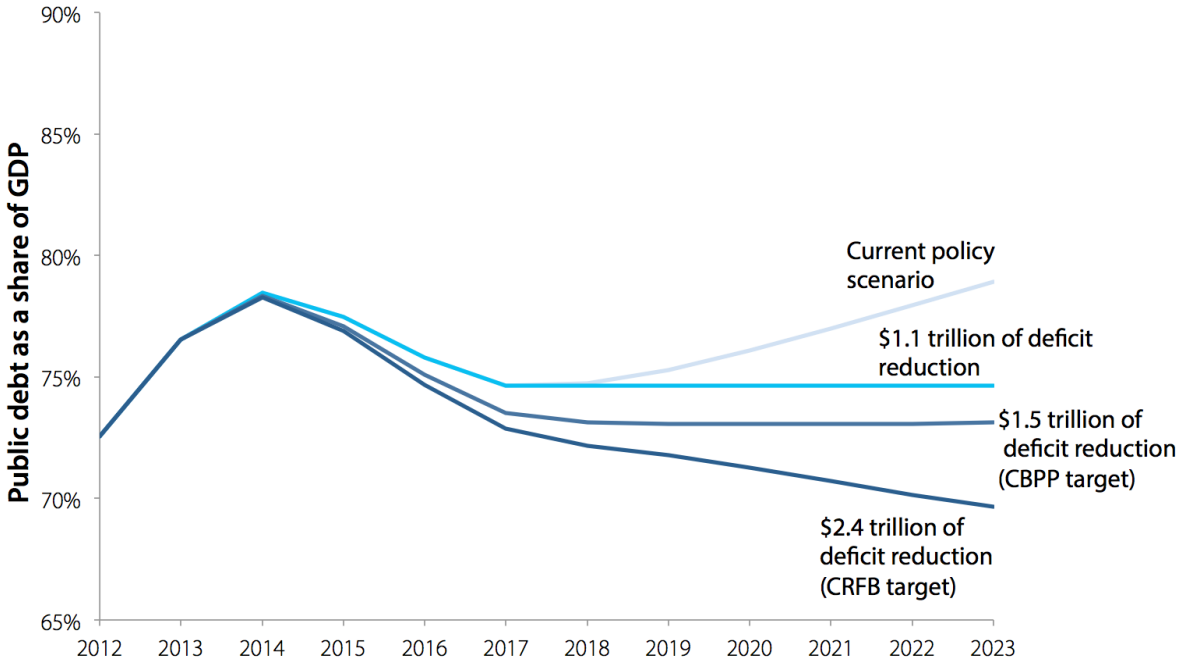
It is widely recognized that fiscal contraction undertaken in a weak economy with interest rates stuck at the zero lower bound will slow economic recovery. This can be seen, for example, in CBO's estimates of the effect of the "fiscal cliff" earlier this year, and in CBO's analysis of the economic effect of the sequester (Bivens and Fieldhouse 2013). It is also widely recognized that economic weakness increases budget deficits, as revenues fall with incomes and safety-net spending rises. As Bivens and Edwards (2010) have noted, each $1 reduction in the gap between actual and potential GDP is associated with a $0.37 improvement in the budget deficit (we refer to this as the "fiscal clawback ratio").

These two almost universally recognized economic facts have significant ramifications for estimating the net budgetary impact of fiscal policy decisions made in circumstances such as the present. While spending cuts reduce new debt issuance, they also decrease GDP; thus, the impact on the debt ratio (which is simply debt divided by GDP) becomes a simple arithmetic exercise.

For example, a $150 billion spending cut with a multiplier of 1.5 (e.g., a combination of generic government spending and transfer payments to low-income households) implemented in fiscal 2013 would only decrease the debt by $67 billion after taking into account the fiscal clawback ratio's revenue and spending feedbacks.[6] But it would also decrease GDP by $225 billion, meaning the debt ratio would actually rise by over 0.6 percentage points, from 76.3 percent pro-

FIGURE A

Debt can be stabilized beginning in 2017 with deficit reduction of less than $1.5 trillion



Note: See Appendix for current policy baseline assumptions.

Source: Authors' analysis of Congressional Budget Office (2013) and Kogan (2013)

jected for 2013 to 76.9 percent (Bivens 2012). This effect makes the timing of deficit reduction extremely important. A back-loaded deficit reduction package would indeed lower the debt ratio (assuming the economy is healthy toward the end of the 10-year budget window). Conversely, a package focusing heavily on near-term deficit reduction may actually worsen our fiscal situation. And again, this near-term deficit reduction is much more likely to occur if policy is guided by inflexible 10-year targets.

Empirically, the recent experience of the European Union confirms that austerity is self-defeating even in achieving the most narrow fiscal goals, as shown by Holland and Portes (2012). They find that recent fiscal consolidations across the European Union have actually increased the debt ratios in almost all countries, with fiscal consolidation increasing debt ratios over 2011–2013 by 5 percentage points on average across the European Monetary Union and U.K. This is because multipliers on government spending are particularly high when output gaps are large and interest rates cannot fall to boost demand in the face of a spending cutback. While they do not report the impact of fiscal contraction on debt ratios for the United States, they do report that multipliers in the United States for government spending are likely higher than in all EU countries, save for Greece. (This high U.S. multiplier is driven largely by the much smaller import penetration share in the United States relative to the individual EU countries.) Thus, fiscal consolidation would increase debt ratios to a greater degree in the United States.

TABLE 1

Economic multipliers of various policy options

Policy	Multiplier
Estate and gift tax increase	0.00
Upper-income tax rate increase	0.25
Corporate tax rate increase	0.32
Middle-income tax rate increase	0.35
Capital gains and dividends tax rate increase	0.39
Low-income tax rate increase	0.69
Payroll tax increase	1.25
Sequestration	1.40
Discretionary budget cut	1.40
Unemployment insurance cut	1.52
Food assistance (SNAP) cut	1.70

Source: Zandi (2011), Bivens and Fieldhouse (2012)

Problem 3: Targets ignore composition

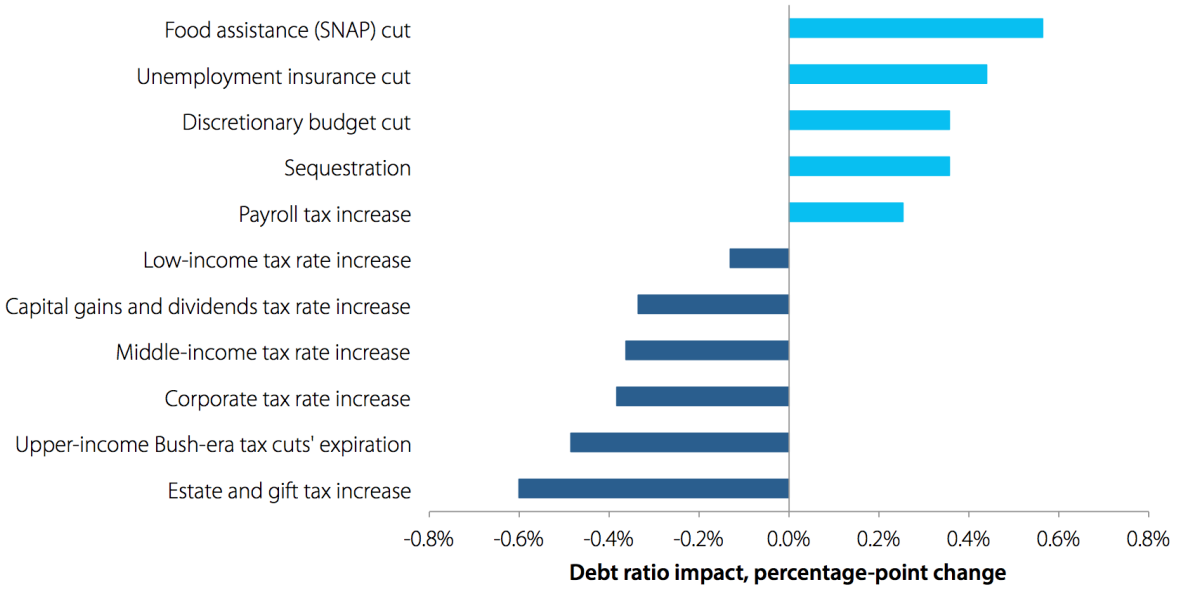
If policymakers are determined to ignore the problems of timing and enact deficit reduction before the economy has fully recovered, it is imperative that any package of deficit savings be constructed so as to minimize any drag on growth. This is possible because the economic impacts of different deficit reduction policies vary considerably.

As explained previously, the current economic weakness is due to a shortfall of aggregate demand; businesses and consumers have restrained their spending in the wake of the housing crash, a phenomenon that has prevented a full economic recovery. Accordingly, a deficit reduction policy's impact on economic growth (i.e., its fiscal multiplier) is determined by how much demand it will remove from the economy relative to its sticker price. Policies with the biggest impact on demand tend to be cuts to programs that go directly to low-income households (such as food assistance) and/or low-savings households (such as unemployment insurance). Cuts to these types of transfer programs reduce these households' disposable income, causing them to cut their consumer spending on a nearly one-to-one ratio—translating to a multiplier well above 1.0 with the respending effect for these high-marginal-propensity-to-consume households. Direct government spending (such as public investment and infrastructure projects) also has large multiplier effects; hence, direct spending cuts impose a large drag on economic recovery. In contrast, tax increases on high-income households and corporations cause far less economic drag because in the short term they tend to have little impact on demand (because upper-income households have the lowest relative marginal propensity to consume).

While the precise multipliers vary a bit from source to source, the ranking of multipliers is essentially uniform across all estimates. A common finding is that spending cuts—particularly those to transfer programs benefiting low-income households—hurt the economy far more than tax increases on high-income households and corporations. **Table 1** shows the multipliers that EPI uses.

FIGURE B

Debt ratio impact of illustrative $100 billion in savings from various policies if implemented in 2014



Source: Authors' analysis of Zandi (2011) and Bivens and Fieldhouse (2012)

These multipliers are a key parameter in determining whether a given deficit reduction policy would increase or decrease the debt ratio. For 2013, any deficit reduction driven by a policy or cuts in a policy with a multiplier over 0.9 would *increase* the debt ratio, while any policy with a multiplier below 0.9 would reduce the debt ratio.[7] **Figure B** displays each policy's impact on the debt ratio. Because spending cuts exhibit multipliers above 0.9, they uniformly *increase* the debt ratio, while tax increases, which generally have multipliers below the 0.9 threshold, cause the debt ratio to fall.

The U.K. example

The United Kingdom's recent economic situation is a perfect example of the danger of ignoring timing and compositional concerns when engaging in deficit reduction. At the beginning of the recession, the economic situations of the United Kingdom and the United States were similar: Both countries had experienced similarly sized initial economic shocks, and both countries' central banks engaged in responses of similar magnitude. And these economies' recoveries ran at a similar pace between mid-2009 and mid-2010, at 2.1 percent real annualized growth for the U.K. and 2.5 percent growth for the United States (OECD 2013).

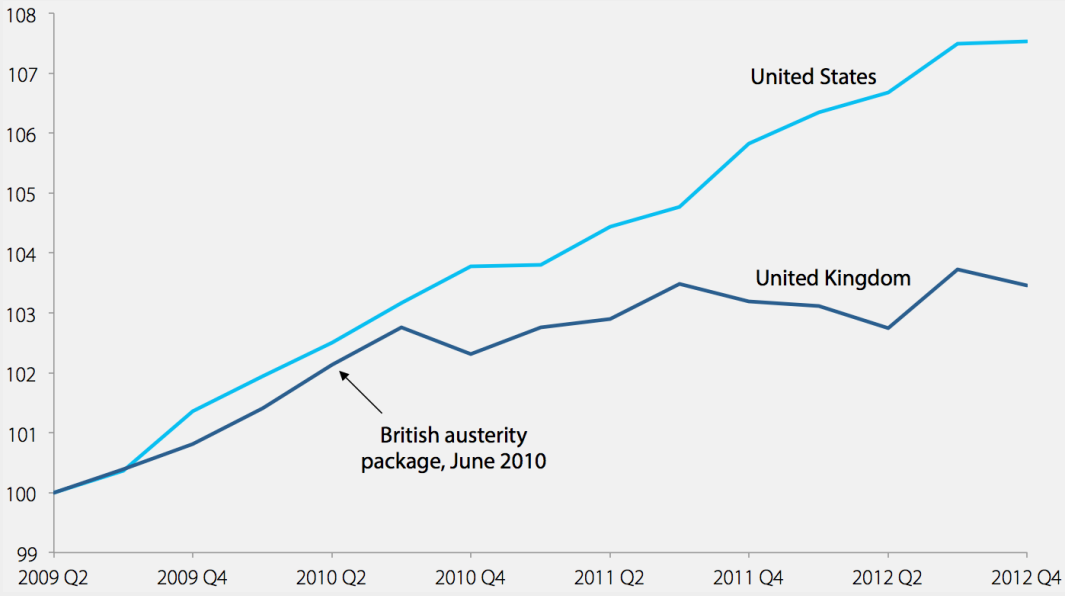
But in summer 2010, the newly elected Conservative-led coalition government headed by David Cameron passed a massive austerity budget, largely composed of spending cuts (non-health domestic departmental

spending was scheduled to be cut 25 percent by 2014–2015) (Economist 2010a). When enacted, this budget brought total austerity up to a staggering 6.3 percent of projected GDP by 2014–2015 (Economist 2010b).

So what happened? As depicted in **Figure C**, growth in the U.K. economy immediately ground to a halt, while the U.S. economy continued its anemic but consistent growth (slowed slightly by its own mild austerity). In fact, since the third quarter of 2010, the U.K. has grown at a real annualized rate of 0.3 percent, roughly one-seventh its previous growth rate and one-sixth U.S. growth over the same period. In fact, the U.K. economy has contracted in five of the last nine quarters (including the most recent quarter), while the United States has not experienced a single quarter of negative growth in that time. And crucially, the U.K. debt ratio has continued to rise. Since mid-2010, U.K. net public debt (excluding temporary effects from financial interventions) as a share of the economy rose from 59 percent to 75 percent (Office of National Statistics 2013).

FIGURE C

Real economic growth of the United States and United Kingdom, 2009Q2–2012Q4



Source: Organisation for Economic Co-operation and Development public data series (2013)

The U.K. clearly ignored the negative impact that deficit reduction could have on the economy, incorrectly assuming that the government operates in a closed system and that deficit reduction mechanically leads to reduction in the debt ratio. This led it to implement deficit reduction immediately and to rely heavily on spending cuts, two mistakes that imperiled both its economy as well as efforts to reduce its debt load. By ignoring timing and compositional factors, deficit reduction targets encourage policymakers to make similar mistakes.

And policymakers must accept that large aggregate demand shocks will force up near-term debt ratios regardless of fiscal policy responses when monetary policy is at or near the zero lower bound. The real question at hand is the value of replacing structural budget deficits with bigger cyclical budget deficits (i.e., austerity), versus deliberately targeting a healthier economy (i.e., stimulus).

Problem 4: Targets suggest there is no room for near-term stimulus

The final problem with promoting an aggressive 10-year deficit reduction target is that it suggests stabilization acts as a hard budget constraint. It thus lends credence to the notion that upfront stimulus—such as infrastructure investment, unemployment insurance, refundable tax credits, and state and local budget relief—would make stabilizing the debt more difficult because meeting the target would require greater deficit reduction in "out years."

This suggestion, however, is misguided, for two reasons. First, even ignoring the economic impact of stimulus and just assessing its first-round impact, stimulus increases debt ratio *levels* but does not necessarily change the debt ratio's *trajectory*. This is an important distinction because the goal is to stabilize the debt, not to hit a specific debt threshold (CRFB 2013).

To illustrate this point, **Figure D** shows two scenarios. The first is CBPP's proposed $1.5 trillion in total savings, including $1.3 trillion in policy savings plus roughly $200 billion in interest savings.

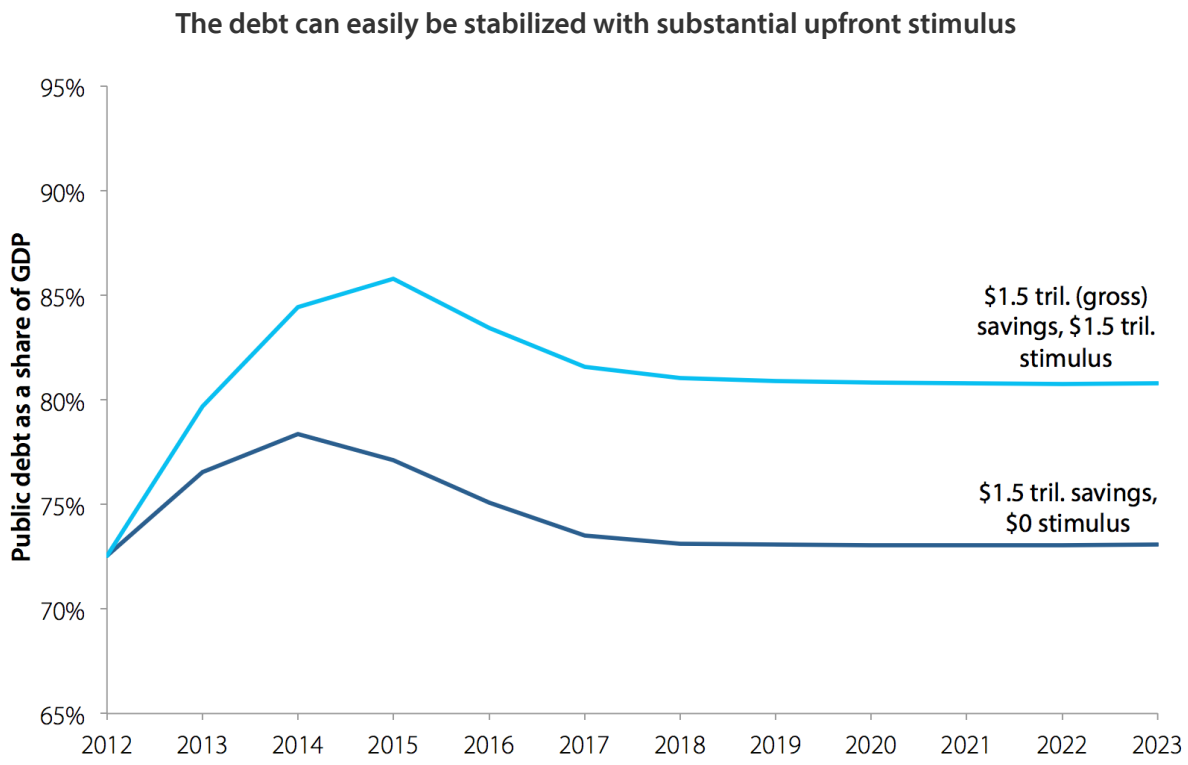
The second scenario adds $1.5 trillion of stimulus spread evenly over the first three years (2013–2015). The graph clearly shows that while the debt stabilizes at a higher ratio under this scenario, *it is still stable* even though the net deficit *increases* $485 billion over 10 years, relative to current policy.[8]

This point deserves reiteration: The debt ratio can actually be stabilized with *no net deficit reduction whatsoever* relative to the current budget trajectory. This directly contradicts the entire concept of deficit reduction targets, which claim a minimum amount of deficit reduction is necessary. They are, in fact, only necessary if one believes there is indeed a hard debt ratio threshold the economy should not cross—but as noted previously, no such threshold exists.

Second, taking into account the economic impact of stimulus could actually cause the debt ratio to fall. As noted previously, reducing the deficit through cuts in policies with high multipliers can cause the debt ratio to increase rather than decrease. The reverse is also true: Engaging in fiscal *expansion* through increasing spending or cutting taxes can, if the multipliers are large enough, actually reduce the debt ratio. For example, $1.0 trillion in stimulus spread evenly over two years would result in a debt ratio at the end of 2013 that is 1.8 percentage points lower than it would be without that stimulus, and a debt ratio 0.4 percentage points lower in 2014.[9]

Moreover, CBO's economic forecast that the economy would return to full health by 2017—meaning cyclical budget deficits would disappear—would be much more plausible if another $1.5 trillion in stimulus were financed over the next three years. Bivens, Fieldhouse, and Shierholz (2013) estimate that ensuring full economic recovery by the end of 2015 would require between $1.5 trillion and $2.2 trillion of expansionary fiscal stimulus over this period. This would

FIGURE D



Source: Authors' analysis of Congressional Budget Office (2013) and Kogan, Greenstein, and Friedman (2013)

help mitigate the budgetary risk of economic underperformance, as cyclical budget deficits will persist into 2017 and beyond (contrary to present forecasts) if the economy has yet to recover by then.

How to really achieve debt stability

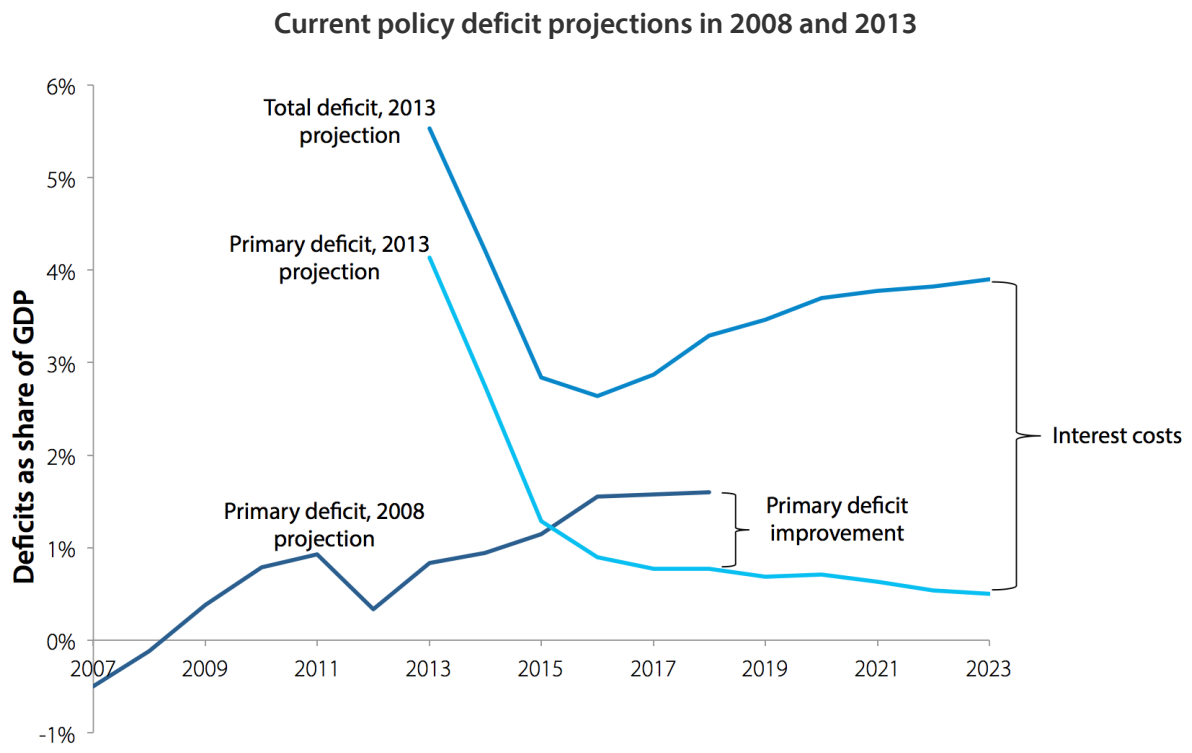
There are real fiscal challenges in both the short and long term. But they are not the ones dominating the current debate, and they involve a deeper understanding of economics than is usually displayed in budget debates. In the short term, policymakers should spur economic growth through effective fiscal stimulus. Over the long run, the focus should be on restraining health care costs, sustaining economic growth, and raising revenue.

Stabilizing the debt in the short run

To understand how to reduce the historically high deficits of recent years, it helps to understand why these deficits grew so large. The answer is simple: Large deficits were both a symptom of and a useful policy response to the Great Recession.

Before the Great Recession began, budget deficits were actually quite low—easily consistent with sustainable debt ratios. In 2006 and 2007, for example, the deficit averaged roughly 1.5 percent of GDP, and public debt averaged 37 percent of GDP. And CBO projections of deficits—even under its pessimistic "alternative fiscal scenario"—were still consistent with a stabilized deficit and debt, as long as the economy remained healthy. To be clear, there was much about fiscal

FIGURE E



Source: CBO (2008) and CBO (2013)

and economic policymaking between 2001 and 2007 that was deeply irresponsible. But poor policymaking during that time did not leave unsustainable deficits over the following decade.

Instead, there was an ignored housing bubble whose burst caused the Great Recession, which drove historically high deficits, rising from 1.2 percent of GDP in 2007 to 10.1 percent of GDP in 2009. The deficit has fallen rather significantly since then as the economy has regained some footing. However, still-high deficits have caused the debt ratio to climb from 36 percent of GDP in 2007 to 54 percent in 2009 to 74 percent in 2013.

These high deficit and debt levels fueled *exclusively* by the economic downturn (and explicitly temporary measures meant to counteract it) also eroded the projected fiscal situation over the next decade. **Figure E** shows that the most recent projection of the primary deficit (excluding interest costs) from 2015 on is actually *lower* than projections made in 2008, prior to the brunt of the downturn. Only when factoring in the interest costs from the debt accrued from the economic downturn does the fiscal picture in the medium run look worse than it did in 2008.

In other words, the main cause of recent high deficits and debt ratios (and projections of high debt ratios) is the economic downturn. Accordingly, boosting economic growth through effective fiscal stimulus can help smother cyclical budget deficits, which will pay off in lower debt service payments once the economy recovers. Again, however, this effect is entirely dependent on the *type* of stimulus. Take, for example, the upper-income Bush-era tax cuts (for households with income over $250,000), which had an estimated multiplier of 0.25. Their full continuation would have cost roughly $52 billion in calendar year 2013, and with only a $5 billion fiscal clawback would have increased the debt

by roughly $47 billion (Bivens and Fieldhouse 2012). Yet it would have only spurred roughly $14 billion in additional economic activity. All in all, a dollar of efficient stimulus has an economic impact four to seven times greater than inefficient stimulus and ends up costing half as much.[10]

Why this isn't the old "dynamic scoring" controversy redux

This claim that short-run fiscal expansion either partially or completely "pays for itself" even in narrow fiscal terms is often greeted skeptically, even by those who do not deny the efficacy of fiscal expansion in boosting short-term growth. Some might even argue that this claim is equivalent to conservatives' claims that tax cuts pay for themselves.

These objections, however, are unfounded. First, there is little question that short-run fiscal expansion boosts economic growth. This isn't just an academic consensus; it's also as close to a political consensus as is feasible on an issue as contentious as fiscal policy. CBO believes it, the "budget hawks" such as Bowles-Simpson and the Committee for a Responsible Federal Budget believe it, and even congressional Republicans believe it (though only when it comes to tax cuts and defense spending). But if fiscal expansion boosts the economy, *then it must also be partially self-financing*; there is simply no way to square a belief in the former without belief in the latter. The question then just becomes, "To what degree?"

Second, past controversies about the issue of "dynamic scoring" largely pertained to how the CBO calculates official budget impacts ("scores") of legislation, with conservatives arguing that these scores should include the long-run effect of tax cuts in revising baseline economic forecasts. We are not making the same demand; CBO should continue to calculate its budget scores using only the "first-round" impacts of these fiscal changes on the budget. And during normal economic times, there will be little difference between these scores and estimates that include economic impacts. It is only during times of extreme economic weakness—such as the last few years, and likely the next few years as well—that the incomplete measurement that these first-round scores provide is problematic.

Stabilizing the debt in the long run

In the short run, then, we should focus on boosting economic growth through effective fiscal stimulus, which would reduce the debt ratio and improve people's lives. But what about long-run debt issues, which projections show are driven overwhelmingly by health care costs?

The most obvious solution is to directly target lowering per capita health care costs. The Affordable Care Act is already helping to control health care costs, and many of its provisions could potentially do far more in this regard than initially estimated (Pollack 2012). In fact, there is mounting evidence that health care cost growth is slowing: In contrast to the 1961–2007 period in which health care costs significantly outpaced economic growth, the growth rate over the last few years has fallen such that health care's share of the economy has remained stable (Hartman et al. 2013).

More can be done to arrest health care costs, but these reforms should be limited to those that actually create efficiencies in the system rather than simply shifting costs from the federal government to states and households. In fact, a wide range of research indicates that public health programs actually constrain overall health costs more effectively than private insurance (Boccuti 2003). Thus, moving these costs off of public balance sheets and onto the balance sheets of households and businesses would actually worsen overall health costs' societal burden and reduce future living standards.

Economic growth should be part of the solution as well. The Great Recession has already resulted in the forfeiture of trillions of dollars of economic activity because productive resources—workers and physical capital—have remained idle. The longer this persists, the more permanent scarring this inflicts on the economy. Therefore, the sooner the economy fully recovers, the smaller the permanent economic drag (Irons 2009). More economic growth means lower deficits and a greater ability to handle them (i.e., a higher debt ratio denominator). Further, to make up for a generation of neglect and to kick-start the capital formation that was stunted because of the Great Recession, a 10-year campaign of significant increases in public investments should be undertaken.

Lastly, revenue must be raised. Many revenue raisers—e.g., eliminating or capping tax expenditures and instituting a carbon tax—can actually enhance efficiency or reduce distortions in addition to helping stabilize the debt ratio. (See Thiess 2013 for an overview of potential revenues from progressive tax policies.) Even simply raising top marginal rates causes much less loss of economic output and has more potential for generating revenues than is generally acknowledged (see Fieldhouse 2013).

Given this, the way forward seems clear. EPI's most recent budget blueprint, *Investing in America's Economy*, includes tax and health policy reforms that collectively stabilize the long-run debt ratio near 76 percent of GDP by 2023 and under 70 percent of GDP by 2037 (Bivens et al. 2012). The plan would first return the economy to full health by immediately implementing roughly $1.5 trillion in fiscal stimulus over the next three years. It also includes health reform policies such as Medicare drug price negotiation, a public option, Medicare payment reforms, and accelerated generic drug availability. It also incorporates revenue policies such as tax expenditure reform, a carbon tax, and a financial transactions tax. In short, it shows that near-term recovery can be ensured, and long-term fiscal sustainability can be made consistent with preserving growth and fostering broad-based economic security.

Conclusion

The nation's fiscal challenges are real, but are not the ones often identified in public tax and budget debates. In the near term, spending cuts would damage economic recovery and would actually cause the debt ratio to rise. Revenue increases that fall heavily on high incomes would do much less damage to economic recovery, and thus be more effective in lowering the debt ratio. Further, given the uncertainty inherent in economic projections, the timing of deficit reduction should not be determined by the calendar, but rather by economic conditions. We have in the past endorsed the principle that fiscal contraction should only begin when the unemployment rate has been below 6 percent for six months. This remains sound policy.

That does not mean deficit reduction cannot be enacted before then. A financial transactions tax paired with a three-year program of substantial infrastructure investments would enhance growth in the short term while locking in longer-run deficit reduction.

But the 10-year deficit reduction targets informing the current debate—including that of the Obama administration—are deeply damaging to the prospects of good policy outcomes. They focus on a single unimportant detail—how much deficit reduction to seek over 10 years—at the expense of the important details, such as the timing and composition of deficit reduction, as well as whether upfront stimulus will be used. As such, they should be disregarded.

In the near term, we should at least stop harming the economic recovery through fiscal contraction; more concretely, the sequester should be repealed, even if no offsets can be found. In the long term we should preserve public investment and concentrate efforts on the real driver of deficits: too-fast growth of per capita health costs driven by our private health care system.

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*— The **Economic Policy Institute** is a nonprofit, nonpartisan think tank that seeks to broaden the public debate about strategies to achieve a prosperous and fair economy. EPI stresses real-world analysis and a concern for the living standards of working people, and it makes its findings accessible to the general public, the media, and policymakers through books, studies, and popular education materials. **The Century Foundation** conducts public policy research and analyses of economic, social, and foreign policy issues, including inequality, retirement security, election reform, homeland security, and international affairs. With offices in New York City and Washington, D.C., The Century Foundation is nonprofit and nonpartisan and was founded in 1919 by Edward A. Filene.*

Endnotes

1. All years in this report are federal fiscal years (October through September) unless specified otherwise.

2. The range of 10-year deficit reduction demands is generally bracketed by the Center on Budget and Policy Priorities' $1.5 trillion target ($1.3 trillion in policy savings) and the Committee for a Responsible Federal Budget's $2.4 trillion target, both over 2014–2023 (Kogan, Greenstein, and Friedman 2013; CRFB 2013).

3. It should be noted, however, that some groups do claim there are certain thresholds beyond which debt levels become problematic, notably by slowing economic growth. The academic work underlying these claims has been debunked, particularly with respect to reverse causality, on both theoretical and empirical grounds (Bivens and Irons 2010; Herndon, Ash, and Pollin 2013). More importantly, these thresholds are not relevant to the debt stabilization discussion because few proposals would bring debt up to the thresholds.

4. See http://stateofworkingamerica.org/charts/jobs-shortfall/ for an ongoing tracking of this jobs gap.

5. All deficit reduction targets include net interest savings. The current policy baseline depicted in Figure A assumes that scheduled reductions to Medicare physician reimbursement rates would be prevented (i.e., the "doc fix" would be continued), the automatic sequester from the Budget Control Act of 2011 will be repealed, and force deployment and supplemental appropriations for overseas contingency operations would gradually decrease instead of growing with inflation. Consistent with CBPP and CRFB baselines, it also assumes that the remaining tax extenders (roughly 80 expiring tax provisions routinely extended on an annual basis) either expire or are paid for. Note that using a current policy baseline that excludes financial assets held by the government (such as student loan debt and equity stakes from the Troubled Asset Relief Program) would reduce the debt levels in the baseline and proposals by 6.1 percentage points in 2013 and by 7.6 percentage points in 2023, but would not change the findings of this analysis.

6. $67 billion is the first-round borrowing impact minus the feedback loss. Loss is calculated as 37 percent of the $225 billion economic impact ($150 billion x 1.5 multiplier), which is $83 billion. The first-round borrowing impact of $150 billion minus the $83 billion feedback is $67 billion.

7. The starting debt ratio does matter, but not much. For example, over the 2013–2017 period, the threshold multiplier moves only within a range of 0.88 to 0.91. Thus, 2013's 0.9 threshold is also a fairly accurate rule of thumb for the entire period that CBO projects the economy will be weak.

8. The savings are assumed to use the same phase-in rate that CBPP uses: Savings are phased in from 2014 to 2019 using step basis (2014 savings double by 2015 and triple by 2016), and after 2019 savings are assumed to equal the deficit reduction necessary to hold the debt ratio constant.

9. Calculations assume a general government spending multiplier of 1.4 and account for fiscal clawback ratios, as well as additional debt service from deficit-financed stimulus.

10. DeLong and Summers (2012) make the case even more strongly. They argue that when one factors in the beneficial impacts of near-term fiscal stimulus in avoiding long-run economic scarring (or hysteresis), efficient fiscal stimulus may not simply lower the debt ratio—it may well pay for itself in strictly dollar terms. Most of the parameters they use in their analysis are not particularly contested, with the exception of their estimate of the damage caused by long-run scarring that occurs when inadequate demand reduces the economy's long-run potential as productive resources go unused and atrophy (e.g., shuttered factories and forgotten labor skills). This view finds considerable empirical support in Ball (2009) in the context of high European unemployment in the 1980s and 1990s.

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