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ECONOMIC PERSPECTIVES

Budget Conference 2013: Principles for a Credible Deal

A credible budget conference agreement would take a first step toward improving the nation's dire fiscal outlook and achieve the following:

1. maintain sequester spending levels in addition to—not in exchange for—other spending reductions;
2. begin structural reform of the largest and least sustainable entitlement programs—the key drivers of future spending and debt; and
3. avoid attempts to solve the spending problem by raising taxes.

Regrettably, the goal of this year's budget negotiations appears to have shifted from improving the nation's finances to eliminating the modest spending sequester to which both sides have already agreed. This would be a mistake with lasting repercussions.

Below, Mercatus Center scholars review the principles for a credible deal for the fiscal year 2013 budget.

MAINTAIN THE SEQUESTER

Sequestration was implemented as the consequence of the Budget Control Act of 2011, which raised the federal government's debt ceiling (or the borrowing authority) by approximately $2 trillion. Relative to the nation's fiscal imbalance, the sequester's spending cuts are admittedly tiny. But it is not the size of the sequester that is most important; it is Congress' commitment to its implementation.

Maintaining sequester spending levels is a critical marker of Congress' will to gain control of federal spending (Nita Ghei, "Staying the Course with Sequestration," *Washington Times*, September 8, 2013). It signals that Congress can honor its agreements, and—in following through on this small effort—has the potential to meet the far greater challenge of correcting the nation's longer-term spending and debt crisis.

Despite Washington rhetoric, the sequester's spending reductions are far from "draconian cuts"; the sequester does not even reduce overall spending levels. According to a Mercatus chart produced by Veronique de Rugy, the sequester slightly slows the projected *growth* in overall spending between 2013 and 2023 (Veronique de Rugy, "The Effects of Sequestration on Federal Spending," chart, Mercatus Center at George Mason University, February 27, 2013).

- According to that same chart, **even with the sequester, federal spending will grow by $1.8 trillion—*more than 50 percent*—between 2013 and 2021**, the period during which spending cuts from sequestration will take place.

- de Rugy's chart also shows that total federal spending still increases under sequestration because any spending cuts are up front and fall mostly on the discretionary side of the budget; the main drivers of future spending and debt—entitlement programs—are largely untouched.

BEGIN CREDIBLE ENTITLEMENT REFORM

Maintaining sequester spending levels is the absolute *least* Congress must do. The long-term fiscal imbalance is driven primarily by growth in the costs of Medicare, Medicaid, Social Security, and the new health-insurance exchanges established as part of the 2010 Affordable Care Act (Charles P. Blahous, "Why We Have Deficits: The Policy Decisions That Created Them," Mercatus Research, Mercatus Center at George Mason University, November 14, 2013). Left unchecked, the unsustainable cost growth of these programs will result in considerable tax increases, reduced economic growth, fewer resources for every other federal program, severe benefit cuts in the entitlement programs themselves, or—most likely—some combination of these things (Congressional Budget Office, "Updated Budget Projections: Fiscal Years 2013 to 2023," May 2013; Veronique de Rugy, "Marginal Tax Rates Must Surge to Fund Entitlement Spending," chart, Mercatus Center at George Mason University, August 19, 2013; Veronique de Rugy and Jason J. Fichtner, "Growth in Entitlements Means Less Money to Budget," chart, Mercatus Center at George Mason University, January 14, 2013).

Structural and cost-reducing reforms to the largest entitlement programs need to begin immediately. Any strategy that fails to reform these entitlement programs will inevitably fail to correct the federal government's fiscal imbalance; merely tweaking these programs for short-term political gain only slightly forestalls their inevitable insolvency (Blahous, "Why We Have Federal Deficits," 2013).

DON'T ATTEMPT TO TAX AWAY THE SPENDING PROBLEM

Some in Washington claim the federal spending and deficit problem is solved. While the deficit has been cut in half (from a record high of $1.4 trillion in FY09 to $680 billion in FY13, according to the CBO Historical Budget Data released May 2013), this reduction can be attributed to several singular events, such as the end of the payroll tax "holiday" and higher receipts from Fannie Mae and Freddie Mac. Over the longer term, deficits and debt are projected to continue increasing (Veronique de Rugy, "Despite New Estimates, Spending Continues to Grow over the Next 10 Years," chart, Mercatus Center at George Mason University, September 3, 2013).

Attempting to fix the unsustainable federal spending growth through tax increases would wreak havoc on the economy, as taxes would have to more than double just to fund entitlement spending (Jason J. Fichtner, "The 1 Percent Solution," Working Paper No. 11-05, Mercatus Center at George Mason University, February 25, 2011; Veronique de Rugy, "Marginal Tax Rates Must Surge," 2013). Further, expansive academic research shows the "balanced approach" does not work (Matt Mitchell, "Does UK Double-Dip Prove That Austerity Doesn't Work?," Neighborhood Effects blog, Mercatus Center at George Mason University, April 26, 2012).

- The general consensus in the academic literature is that fiscal adjustments based more on spending cuts were much more likely to achieve successful and lasting reductions in debt-to-GDP ratio than tax-base adjustments. This is particularly true of spending-based adjustments that reform entitlements and public pay, as outlined in Alberto Alesina and Veronique de Rugy's 2013 Mercatus Research paper, "Austerity: The Relative Effects of Tax Increases versus Spending Cuts."
- Data from Greece, Italy, and Japan show that tax increases don't effectively reduce debt levels; evidence from Canada, Germany, and Finland show that cutting spending and implementing structural reforms are the most successful policies (Alesina and de Rugy, "Austerity," 2013).
- Sweden's experience indicates that significantly cutting government spending *without an equivalent increase in taxes* can provide a path to fiscal sustainability, as seen in de Rugy's chart, "GDP Growth Rates: The Swedish Approach."

- Sweden successfully reduced welfare spending and pursued economic stimulus through a permanent reduction in the country's taxes, including a 20-point reduction in the top marginal income tax rate.
- Sweden's recent economic growth has trumped that of every other European country.

- Data from past fiscal adjustments show that while spending cuts will effectively reduce a country's debt, they do not necessarily hurt the economy in the short-term (Alesina and de Rugy, "Austerity," 2013).
  - Evidence shows that if an economic slowdown follows the spending-cut based adjustment, it is generally mild and short lived. Conversely, tax-based adjustments result in significant economic slowdowns (Alesina and de Rugy, "Austerity," 2013).
  - A leading paper in the austerity debate by International Monetary Fund economists shows that while spending cuts can hurt the economy in the short run, they probably don't hurt the economy as much as tax increases do (Jaime Guajardo, Daniel Leigh, and Andrea Pescatori, "Expansionary Austerity: New International Evidence," IMF Working Paper, July 2011).

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