Joint Economic Committee Republicans
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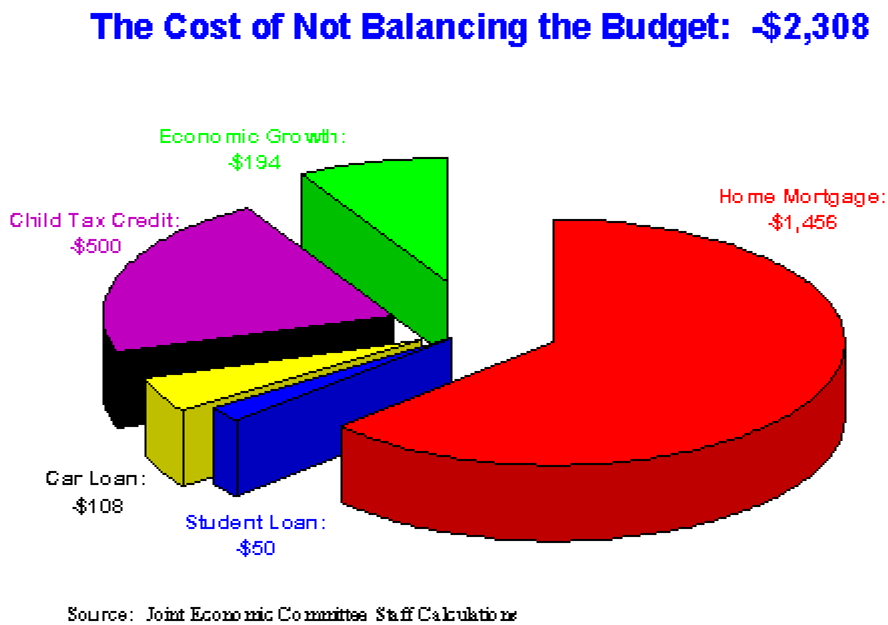
The Price of Failure:
The Costs of Not Balancing the Budget

Introduction

For the first time in 25 years, the U.S. Congress has passed a credible plan to balance the budget. The Congressional Budget Office has estimated that the Republican proposal will actually generate a budget surplus in the year 2002. President Clinton, however, has vetoed the plan passed by Congress, advocating more spending and additional debt accumulation. Such an action could end up costing a typical American family more than $2,300 a year.

President Clinton has come out publicly in favor of balancing the budget within seven years, as proposed by the Republicans. However, at various times Clinton has also pledged to balance the budget within five years, within nine years, and within ten years. Unfortunately, Clinton has yet to submit a budget proposal that comes anywhere near balance at any point, much less within seven or even ten years.

While the budget battle persists in Washington, the pernicious effects of not balancing the budget will be felt all across America by working men and women and their children. The pervasive and detrimental effects of continued deficit spending will affect families through higher interest rates, slower economic growth, and higher than necessary taxes. In light of the fact that the economic well-being of families will be lower if the budget is not balanced, Clinton's current delaying tactics on the budget suggest that he is more interested in partisan politics than in policies to help middle class families.



This analysis estimates the consequences of not balancing the budget for a middle class family, the Bakers, in the year 2000. The Bakers are a typical young family: a married couple with one child falling in the 15 percent income tax bracket. This family in the year 2000 has a new home mortgage with a loan amount of $100,000. They also have a new $15,000 car loan and are five years into a ten-year, $11,000 student loan.

This report finds that continued deficit spending and debt accumulation will cost the Bakers $192 each month, or $2,308 a year, unless the budget is balanced. The five year cumulative loss will amount to over $12,000.[1] Clearly this would be a substantial decrease in the economic well-being of the Baker family. If the Bakers have a second child, the price of not passing the Republican balanced budget plan increases to $234 per month, or $2,808 annually. Over a five year period, the loss attributable to not balancing the budget would total over $14,500 for a Baker household with two children.

Interest Rates

For the Bakers, higher interest rates due to *not* balancing the budget mean that payments on their home mortgage and student and car loans will be higher than they would otherwise be. Two organizations, the Congressional Budget Office and the independent consulting firm DRI/McGraw-Hill, have produced forecasts of interest rates both with and without the Republican balanced budget plan in place. Based on these estimates, it is possible to quantify the impact of higher interest rates on the Baker family.

Home Mortgage Interest Costs

The Bakers have a $100,000 mortgage on a new home they purchased in 2000. Under the Republican balanced budget plan, the fixed mortgage rate in 2000 will be 5.92 percent, giving the Bakers a monthly payment of $594. If the budget is not balanced, the fixed mortgage rate is expected to rise 2.22 percentage points, to 8.14 percent, from its projected level under a balanced budget plan. At this higher rate, the monthly mortgage payment increases $149 to $744. After the effect of tax deductions are accounted for, higher interest rates would cost the Bakers an additional $121 per month. [2]

Student Loan Interest Costs

The Bakers also have a student loan worth $11,000 that they began paying off in 1995. In 2000, the Bakers will have already repaid five of the ten years on the loan. If the budget is balanced and the Bakers are able to take advantage of declining interest rates, their monthly student loan payment would be $123. However, if the budget is not balanced, the resulting increase in interest rates will cost the Bakers $252 in higher loan payments over the remaining five years. On a monthly basis, higher interest rates due to more deficit spending and debt accumulation will cost the Bakers $4 each month. [3]

Car Loan Interest Costs

In order to purchase a new car in 2000, the Bakers obtain a 5-year, $15,000 loan. With the Republican balanced budget plan in place, the monthly car payment for the Bakers will be $300. Failure to balance the budget, however, will cause interest rates to be higher, raising the monthly car payment to $309, a loss of $9 per month. [4]

Taxes

A central component of the Republican balanced budget plan is a package of middle class tax cuts, of which 80 percent of the benefits go to households making under $100,000. [5] The Bakers will most directly benefit from the tax cuts through the $500 child tax credit. With a single child, the Bakers will average $42 in savings each month due to their reduced tax burden. With two children, the tax savings amount to $83 per month. However, if the Republican balanced budget plan is not implemented, the Baker's tax burden will be $42 higher per month with one child, and $83 higher per month with two children.

Economic Growth

Continuing along the present path of unrestrained deficit spending and debt accumulation will reduce the Baker's family income by slowing economic growth. Higher levels of spending and debt hurt the economy by shifting resources away from the more efficient private sector to the inefficient, wasteful government sector. Moreover, without the savings and investment incentives in the tax cut package, economic growth will suffer even further. This aggregate slowdown in growth is crucial for the Bakers, since family income cannot grow unless the whole economy grows.

Failure to balance the budget hurts economic growth, and ultimately the Bakers, in two principal ways. First, higher levels of government spending hinder the productive energies of the private sector. By displacing private sector initiatives, government spending distorts the price signals of the free market, limits improvements in efficiency, and reduces productivity growth.

Reducing the growth of spending, as the Republican balanced budget plan proposes, is the most reliable and productive way to eliminate the deficit, both because reduced spending growth helps the economy and is more effective than raising taxes.

The second way the Republican balanced budget plan helps economic growth is through the improved treatment of savings and investment. One of the central tenets of economic theory is that higher levels of savings and investment produce a stronger and more robust economy. The tax component of the balanced budget plan would encourage savings and investment by cutting taxes on capital gains and estates, as well as expanding opportunities for IRAs. These tax provisions help all Americans by fostering the economic growth that ultimately produces jobs and raises incomes.

Several economists have estimated the effect that lower taxes on capital have on economic growth. [6] Estimates of the impact of lower taxes on capital range from 0.25 percent to 1.8 percent higher real economic growth, depending on the economic model and the specific tax change. The Bakers can expect this added economic growth to increase their take-home pay.

However, the failure to balance the budget would prevent this extra take-home pay from ever reaching the Bakers. A conservative estimate of the effect of not balancing the budget indicates that the Bakers would lose $194 per year due to slower economic growth. If the impact of continued deficit spending turned out to be greater, as numerous studies show, then the loss could actually reach much higher.

Conclusion

The facts presented in this analysis lead to but one conclusion: the price of higher spending and greater debt accumulation is far too high to not balance the budget. Refusing to bring spending in line with revenue will cost a typical American family $192 per month and over $2,300 yearly.

Of even greater concern is the fact that these negative effects are expected to increase in magnitude over time. The estimate of $2,308 in annual costs is for the year 2000. As budget deficits persist, they will push interest rates even higher, further slow economic growth, and place a greater debt burden on future generations. Over a five year period, the Bakers will lose $12,000 if we fail to balance the budget. Ultimately, the longer it takes to balance the budget, the more it will cost middle class families.

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Endnotes:

1. Estimate represents the cumulative total costs over 2000-04. It should also be noted that the figure of $2,308 is for 2000 only. The estimated costs in subsequent years are even higher (reflecting the increasing losses from slower economic growth), yielding a five year total that is actually greater than the first year loss times five.

2. Estimate compares the monthly payment on a 30-year fixed-rate $100,000 mortgage under two interest rates. Since the comparison is based on two different new mortgages, there are no refinancing charges to consider. The analysis assumes a 1995 household income of $40,000 and a marginal tax rate of 15%. The analysis also takes into account reduced taxes due to an increased tax deduction (since there is more home mortgage interest to deduct from taxable income). Baseline and balanced budget interest rates are from DRI/McGraw-Hill, "The Economic Impact of Balancing the Federal Budget," October, 1995.

3. Estimate assumes a 10-year loan based on the 10-year Treasury note rate. The baseline and balanced budget forecasts of interest rates were prepared by the Congressional Budget Office.

4. Estimate assumes an interest rate 200 basis points above the 5-year Treasury note rate. The baseline forecast of interest rates was prepared by the Congressional Budget Office. The balanced budget forecast of interest rates was based on analysis by the Congressional Budget Office and JEC calculations.

5. The distributional analysis of the tax cuts was prepared by the Joint Committee on Taxation.

6. Estimates of the effects of the Republican budget come from DRI/McGraw-Hill, "Economic Impact of Balancing the Federal Budget," October, 1995; DRI/McGraw-Hill, "Growth and Budget Repercussions of the Republican *Contract with America,* " February, 1995; Laurence D. Meyer, "Macroeconomic Aspects of the Republican *Contract with America,* " March, 1995; and Gary and Aldona Robbins, "Putting the Economy Back on the Growth Track: Six Steps to 'Upsize' the Economy," Institute for Policy Analysis, Report No. 128, September, 1994.