Options to Close the Long-run Fiscal Gap

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Mr. Chairman and other members of the Committee, thank you for the invitation to testify today on one of the most important issues facing our nation: the long-run budget deficit. I currently serve as Director of the Hamilton Project at the Brookings Institution, an initiative dedicated to developing policies that promote broad-based growth and opportunity. Restoring fiscal discipline plays a critical role in achieving these objectives. Note that none of the specific options I am discussing today have necessarily been endorsed by staff, officers, or trustees of The Brookings Institution, or the members of The Hamilton Project Advisory Council.

The Congressional Budget Office (CBO) projects that the unified deficit in fiscal year 2007 will be $198 billion.[1] This amounts to 1.5 percent of Gross Domestic Project (GDP), which is less than the average over the last forty years. This may lull some into a false sense of complacency. It should not. The United States can do a lot better than a $198 billion unified deficit and the United States needs to do much better than a $388 billion non-Social Security deficit. This is especially true in a year when macroeconomic performance is strong and when we face large risks including the private saving rate at its lowest level since 1939, a current account deficit approaching 7 percent of GDP, and major fiscal challenges just around the corner.

Restoring fiscal balance will require three steps:

- Step one: To stem the flow of red ink, restore the PAYGO rules;

- Step two: Take simpler steps to reduce the deficit today;

- Step three: Address Social Security, Medicare, Medicaid and tax reform to bring the government's books into balance over the longer term.

The deficit represents a major economic challenge. It drives down national savings, leading to less investment or more foreign borrowing. In either case, future national income will be lower, either because we will have a smaller capital stock or because more of our capital stock will be devoted to producing income to repay our foreign creditors. This effect is slow and gradual but relentless and inevitable. In addition, the budget deficit and the related large current

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[1] This estimate includes $26 billion additional outlays for Iraq and associated debt service.

account deficit increase the chances of a highly disruptive short-run financial crisis. If America finds itself suddenly unable to borrow 7 percent of GDP, the economy would need to rapidly reallocate a large fraction of the labor force from domestic production to export production. This adjustment process could be painful as millions of workers would be forced to find jobs in new industries in short order.

Even setting aside the economic effects, current tax and spending policies are literally unsustainable. The sooner we act the better for three reasons. First, the sooner we increase revenues or reduce spending, the smaller the eventual adjustments will have to be because we will not accumulate as much debt and thus will save a lot on interest payments. Second, if addressing our long-run fiscal challenge entails altering currently-scheduled benefits for future retirees, more notice about such adjustments will improve workers' ability to prepare. Finally, even if much of the actual revenue or spending changes themselves do not occur for decades, scheduling them sooner may be politically easier than waiting until the necessary changes are imminent.

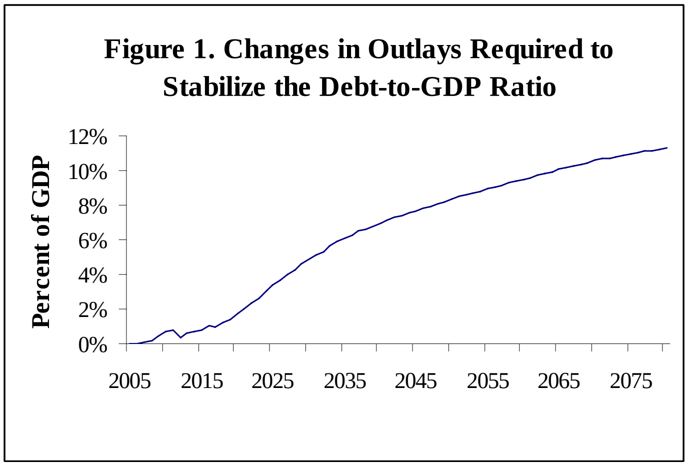
I will first briefly review the sources of our long-run deficit and then discuss the three steps we should take to address it.

The Long-run Outlook

The long-run fiscal challenge is a fact, although precise estimates of its magnitude are sensitive to assumptions and projections about the future. The Center on Budget and Policy Priorities recently released an important analysis of the long-run deficit that I recommend to this committee.[2] My own estimates, in preliminary work with economists Alan Auerbach and William Gale, indicate that stabilizing the debt-to-GDP ratio over the next 75 years could be accomplished by an immediate and permanent increase in revenues or reduction in spending of about 6 percent of GDP.[3]

Policymakers do not have to close the entire fiscal gap today. Changes could be phased in slowly over time, or enacted over time. If this is the course we choose to go down, it would be useful to understand what future changes would be required to stabilize the debt-to-GDP ratio on an annual basis. Figure 1 shows preliminary estimates of these changes as a share of GDP. Relatively small changes are needed today, but in the future growing policy changes will be needed, totaling about 1 percent of GDP in 2015, 2 percent of GDP in 2020, 5 percent of GDP in 2030, and 11 percent of GDP in 2080. Ultimately these changes are far larger than what would be required from an immediate adjustment.

[2] Center on Budget and Policy Priorities, "The Long-Term Fiscal Outlook is Bleak," October 11, 2006.
[3] The precise magnitude of the change is very sensitive both to projections about the future and technical assumptions about the evolution of policy in different areas.



These long-run budgetary imbalances stem from a fundamental disconnect between what we expect from our government and what we currently pay for it. The long-run fiscal problems we face do not stem primarily from the government trying to do more for its citizens; instead, the government is simply trying to do the same, but for an aging population and in an era of increasing health spending.

The three main sources of the fiscal gap, in order of importance, are:

- **Rising health spending in both the private and public sectors.** The United States continues to be a leader in developing and using amazing technologies to improve our health, but these technologies are expensive. This innovation creates a financing challenge for both the private and public sectors. Spending in Medicare and Medicaid are comparable to that in the private sector both in level (adjusted for age and health) and growth rate. And, as in the private sector, this spending is rising rapidly. If Medicare and Medicaid stabilized at their current share of GDP – and the simultaneous erosion of income tax revenue due to the rising share of untaxed health insurance were halted – the fiscal gap would be reduced by more than 5 percent of GDP, nearly eliminating it. Although freezing healthcare as a share of GDP would be infeasible and undesirable, it is a useful conceptual exercise to appreciate the magnitude of the health challenge.

- **The tax cuts enacted since 2001.** The tax cuts enacted from 2001 to the present, together with associated relief from the Alternative Minimum Tax (AMT), would total 2 percent of GDP if made permanent. (Without the associated AMT relief the tax cuts would total 1.5 percent of GDP.)

- **The challenge of financing past generosity in Social Security in an environment with fewer workers for every retiree.** Social Security has a large "legacy debt" associated with the fact that the first generations of beneficiaries received substantially more than they paid into the system. This debt – which we inherited from past decisions by past policymakers – must be financed over time. This financing process becomes harder as fertility rates fall and life expectancies increase. As a result, the Social Security system faces a shortfall equivalent to 0.7 percent of GDP over the next 75 years according to the Social Security Trustees.

There is a large range of uncertainty in long-run forecasts. But uncertainty is no excuse for inaction. If the future turns out better than we expect then policymakers will have the luxury of cutting taxes or raising benefits. If the future turns out worse than we expect then at least we will be in a position to address the problems. But uncertainty does have one important implication which I will discuss more below: it makes building robust contingency measures into our long-run budget essential.

Step One: Restore PAYGO Rules – and Stick to Them to Stem the Flow of Red Ink

Remarkably, two-thirds of the fiscal gap is the result of legislation enacted since 2001, either in violation of PAYGO rules or in the absence of these rules. Of the 6 percentage point 75-year fiscal gap, 2 percentage points are due to the tax cuts enacted since 2001 (if they are made permanent along with the associated AMT relief). Another 1 percentage point is due to the establishment of the Medicare prescription drug benefit, the first major entitlement expansion to be enacted without an associated revenue source. Finally, 1 percentage point is due to increased discretionary spending for defense and homeland security (not counting Iraq or Afghanistan).[4]

The surest way to stem the flow of red ink is restoring the PAYGO rules for taxes and entitlement spending, restraining discretionary spending from growing faster than needed to fund current policies (which would likely be higher than inflation due to factors like population growth and health spending that affect some discretionary programs), and ending the practice of using the reconciliation protection afforded by the budget resolution to increase the deficit. But rules are not enough. Policymakers should stick to these rules, including applying them to any reform of the AMT.

But PAYGO rules should not be perceived as a policy straightjacket. These goals can be achieved together by designing intelligent policies and making smart and sometimes tough choices about the role we want government to play. For example, The Hamilton Project has released discussion papers on how to improve unemployment insurance by reforming the existing expenditures and will be releasing proposals on how to better utilize our existing funding for higher education. If new expenditures or tax benefits are needed, other unneeded areas of government should be cut or revenues should be raised to cover the costs. A basic test of any new program is that the electorate should think it is worth paying for.

PAYGO rules and discretionary restraint guided President Bill Clinton, Speaker Newt Gingrich and Majority Leader Bob Dole in the 1990s. If they had been maintained in the 2000s we would have a budget surplus today and a considerably smaller long-run fiscal challenge. Ideally both parties in Congress would come together with the President to restore PAYGO and the other budget rules. But in the absence of such an agreement, either branch of government, or even either party, has the ability to ensure that only legislation consistent with PAYGO is

[4] This is a conservative estimate of the impact of budget policy on outlays that does not count outlays for Iraq and Afghanistan and only counts increases in discretionary spending relative to GDP.

enacted. And PAYGO plus discretionary spending restraint would be sufficient to stabilize the debt-to-GDP ratio for the next decade or more.

Step Two: Take Simpler Steps to Reduce the Deficit Today

PAYGO rules are only a first step and more will need to be done to get us out of the hole, including some combination of spending below and revenues above the budget baseline. Accomplishing this will require the support of both political parties. Policymakers can find a range of options in publications like CBO's *Budget Options* and places like The Brookings Institution's "Restoring Fiscal Sanity" initiative. In my testimony today I would like to flag four common-sense options for reducing spending or increasing revenues that are relatively simple to implement and could start reducing the deficit immediately.

- **Do not phase in any more tax cuts.** The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) phased in tax cuts over a ten year period. Several of those tax cuts are not fully in effect, including the repeal of the Personal Exemption Phaseout (PEP), the repeal of the Pease rule that phases out itemized deductions, and the repeal of the estate tax. These cuts were enacted in an era of budget surpluses and before 9/11 brought attention to our homeland security challenges. Now that spending is elevated and budget deficits have returned, further tax cuts do not make fiscal sense. Freezing them at their 2007 values would cause no harm to the economy and, in the case of PEP and Pease, 64 percent of the tax cuts being cancelled would have gone to households making more than $1 million annually.

- **Enact the MedPAC recommendations for Medicare.** MedPAC, a nonpartisan board that advises Congress on issues affecting the Medicare program, has proposed several revisions to Medicare overpayments. For example, the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 increased payments to private Medicare Advantage programs. Although originally intended to save money, private plans in Medicare now cost considerably more per beneficiary than the traditional system. As MedPAC has observed, this "does not create incentives for the efficient provision of high-quality care."[5] In addition, MedPAC has proposed adjusting some payments to providers, both to improve medical outcomes and reduce spending.

- **Reduce the tax gap and close tax loopholes.** The Internal Revenue Service (IRS) estimates the net tax gap was $290 billion in 2001, which extrapolates out to about $5 trillion over the next decade. Better enforcement and simplifications that improve compliance, like requiring financial institutions to report the basis of capital gains, would help reduce the tax gap. The tax gap, however, is not a fiscal panacea, especially since much of the gap stems from cash transactions that are not disclosed to the IRS and cannot feasibly be monitored and enforced by the IRS. The tax gap is illegal evasion, but policymakers should also take steps to curb legal avoidance of corporate taxes. For

[5] Medicare Payment Advisory Commission. *Report to Congress: Issues in a Modernized Medicare Program* (Washington, DC: MedPAC, June 2005).

example, Congress could close corporate loopholes, including codifying the economic substance doctrine and closing the Bermuda loophole.

- **Correct the indexing of Social Security, the tax code, and other programs.** Policymakers indexed Social Security benefits, the tax brackets, and other parameters of tax and spending programs to adjust for the cost of living. The Consumer Price Indices currently used for indexation employ an outdated procedure that overstate inflation. Specifically, they ignore the fact that consumers partially insulate themselves from shifting prices by switching to goods whose relative price is falling. Although policymakers should not substitute their judgment for the nonpartisan professionals at the Bureau of Labor Statistics (BLS), policymakers should pick a more accurate measure of the cost of living. A good candidate is the Chained CPI-U (C-CPI-U) that BLS started releasing on a monthly basis in 1999. To date this index is running 0.5 percentage point lower than the traditional CPI. If all federal programs and taxes were switched to the C-CPI-U by the end of a decade the government would save more than $40 billion, with the bulk of the savings divided roughly equally between preventing *de facto* Social Security benefit increases and tax cuts that Congress never intended. Over time the savings would continue to grow.

All four of these steps are simple and, though not without controversy, could be implemented relatively easily. But more is needed to solve the long-run fiscal deficit.

<u>Step Three: Address Social Security, Medicare, Medicaid and Tax Reform to Bring the Government's Books Into Balance Over the Longer Term</u>

Solving our long-run fiscal problems is not just a matter of reducing spending and increasing revenue. We can also use the opportunity to improve Social Security, the health system, and the tax system. I will briefly sketch some ways to make our social insurance and tax systems more effective and more cost-effective.

Social Security

Social Security contributes less to the long-run deficit than the health system or the recent tax cuts. It would be wrong to use its long-run challenges as a pretext for undercutting the program by, for instance, diverting payroll taxes into private accounts, a step that would increase short- and long-term fiscal risks and would not contribute to solvency or benefit levels.

But this does not mean we should ignore the financing challenges facing our nation's most popular public program. Especially since the solvency options are well-understood and many Social Security experts are not very far apart in their reform efforts. The mere fact that Social Security outlays are projected to be larger than Medicare outlays for several decades suggest that Social Security's taxes and benefits should not be isolated from a broader fiscal solution.

Moreover, anyone who wants to maintain the highest feasible Social Security benefits should want to act sooner rather than later. The Social Security trust fund is projected to be exhausted in 2040, according to its Trustees. If we postpone reform until then, the future Social Security Commissioner would be legally required to limit benefit payments to payroll tax collections, a measure that would result in a roughly 25 percent reduction for *all* Social Security recipients. A 62 year old who starts collecting benefits this year would expect to get a 25 percent benefit cut on her 95th birthday.

Acting sooner would allow us to bring more revenues into the system to minimize the eventual benefit cuts. And, to the degree there were reductions in benefits, phasing them in over time would reduce their eventual magnitude and give workers more time to plan accordingly.

According to standard neoclassical economics, there is no economic reason to prefer broad-based benefit cuts (including an increase in the full-benefit retirement age) to tax increases. Both would increase economic distortions (although the magnitude of the distortions is uncertain but unlikely to be very large). Cutting benefits, for example, means that workers will get less for their taxes, effectively increasing the portion of the Social Security payroll tax that is a true tax rather than a form of forced savings and insurance. Put another way, a worker could adjust his or her savings to achieve the identical stream of pre-retirement and post-retirement consumption under a tax increase or a benefit cut of similar magnitude. As the American Enterprise Institute's Kevin Hassett explained to this Committee last year, "a benefit reduction is as much of a tax hike to a rational individual as an explicit tax hike."[6] And for less than fully rational individuals, which is probably a good description of most of us, there is a strong rationale for Social Security to provide robust benefits that help ensure a reasonable level of retirement security.

You can find large menus of options for Social Security reform maintained by both the Social Security Administration's Office of the Chief Actuary and by the CBO.[7] I want to emphasize one important consideration. In addition to achieving sustainable solvency, policymakers should attempt to achieve *robust* solvency. Uncertainty about the future of Social Security should not be used as an excuse not to act. But it should be a motivation to provide for foreseeable contingencies. If the future is much better than we expect, benefit reductions and/or tax increases should automatically be smaller. If it is much worse than we expect, the opposite should happen automatically without having to wait for Congress to act.

The current system is designed to be largely immune from changes in productivity growth, since both taxes and benefits are effectively linked to productivity. Linking benefit reductions to the difference between wage growth and price growth, as is done in price indexing and progressive price indexing, would add to the instability of the system, delivering larger benefit reductions when economic growth was stronger and smaller benefit cuts when growth was weaker. Indexing benefit levels for longevity, the retirement age, or the payroll tax rate goes

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[6] Kevin Hassett, Testimony Submitted to the United States Senate Committee on the Budget, September 28, 2006, http://www.senate.gov/~budget/republican/hearingarchive/testimonies/2006/2006-09-28hassett.pdf.
[7] See http://www.ssa.gov/OACT/solvency/index.html and http://cbo.gov/publications/collections/socialsecurity.cfm#pt3.

in the right direction – delivering larger adjustments as people live longer – but only captures a small part of the uncertainty about the future.

One way to introduce more robustness into the Social Security program would be to use *dependency indexing* which links changes in replacement rates or payroll tax rates to changes in the ratio of workers-to-retirees.[8] In a pay-as-you-go system, the dependency ratio is the variable that determines the payroll tax rate needed for any given replacement rate.[9] It is a function of current and past fertility rates, mortality rates, and immigration. And it changes gradually over time, ensuring that any program changes are also gradual and largely moving in the same direction. If, contrary to current predictions, Social Security does not face any financing problems, a measure like this would effectively shut off any benefit reductions or tax increases.

Health Reform

We face three major challenges in the area of healthcare: covering the 47 million people that do not have insurance, ensuring that we are efficiently spending the right amount of money on health (which is likely to be less than what we are spending today), and paying for the care we choose to consume.

Unlike Social Security reform, there is no place to find readily quantifiable menus of options for health reform. The choices facing individuals, companies, and the government are not nearly as simple or well understood.

The federal government plays an important role in these issues for three reasons. First, it directly pays for one-third of all healthcare, or an estimated $740 billion in 2006.[10] Second, public programs, especially Medicare, have so much market power that they set a major example – for good or for ill – for the entire private healthcare system. And third, the Federal government provides a $200 billion tax subsidy for employer-sponsored insurance that has profound effects on the form and nature of coverage in the private sector.

Improving the health system is a process that will involve the private sector and the public sector working along many different dimensions. I want to highlight one important dimension that is at the intersection of both the private and public sector: the tax treatment of employer contributions to health insurance. Reform, done right, has the potential to advance all three of the goals simultaneously: expanding coverage, reducing spending while improving its

[8] A number of countries, including Germany, Japan, and Sweden, have introduced forms of dependency indexing in recent years. U.S. Government Accountability Office, "Social Security Reform: Implications of Different Indexing Choices," September 2006, http://www.gao.gov/new.items/d06804.pdf.
[9] In general, when a pay-as-you-go system is in balance the following holds:

$$\text{Payroll Tax Rate} = \text{Dependency Ratio} \times \text{Replacement Ratio}$$

So, for example, if the payroll tax rate is 10 percent and the dependency ratio is one retiree for every three workers, then the replacement rate can be 30 percent. If the dependency ratio falls to two workers per retiree, then payroll taxes need to rise to 15 percent, the replacement rate needs to fall to 20 percent, or perhaps some combination like a tax rate of 12.5 percent and a replacement rate of 25 percent.
[10] Center for Medicare and Medicaid Services, NHE Projections 2005-2015, Forecast Summary and Selected Tables, http://www.cms.hhs.gov/NationalHealthExpendData/downloads/proj2005.pdf.

cost effectiveness, and reducing the long-run deficit. But reform done wrong would risk undermining the employer-sponsored system without creating a robust alternative in its place, shattering risk pooling and either increase the total number of Americans without insurance or push sicker people into the ranks of the uninsured.

Converting the current tax exclusion for employer-sponsored insurance into a tax credit or a voucher would make the subsidy more progressive, provide a bigger incentive for people to get insurance, remove the incentive to have more generous insurance and make the financing of healthcare more transparent. In the process, the policy could also be designed to reduce the long-run deficit. But all of this would work *only* if it were done at the same time as major steps were taken to strengthen pooling arrangements and expand health insurance coverage, through some combination of retaining some tax advantage for employer sponsored insurance or enacting new subsidies for small businesses, an expansion of public programs, and the creation of new buy-in arrangements for people without access to affordable care.

Tax Reform

Unless policymakers want to reduce outlays in Social Security, Medicare, Medicaid, and other spending by 6 percent of GDP over the next 75 years, higher revenues will be needed to close some of the fiscal gap. At a bare minimum, the top two rates should be restored to what they were at the beginning of the decade. This would cause minimal, if any, economic harm. In fact, the associated deficit reduction could well contribute to a stronger economy for all Americans, just as it did in the 1990s.

But we can do even better by using the fiscal challenges and the expiration of the tax cuts in 2010 as an impetus to undertake a broader reform of the tax system. If revenues have to increase over time, it will become more important than ever to raise them in the most economically efficient manner. This is one lesson of Peter Lindert's important book *Growing Public* which pointed out that many European countries have substantially higher taxes than the United States but collect those taxes in a much less economically distortionary manner.[11]

One promising strategy for tax reform would be to go beyond the tax gap and corporate loopholes to a more substantial broadening of the corporate income tax base. In the last budget the Treasury listed a total of $104 billion in tax expenditures for corporations, nearly one-third as much as the corporate tax revenue that was actually collected.[12] The President's Advisory Panel on Federal Tax Reform included a comprehensive proposal to eliminate many of these tax expenditures, arguing this would improve economic efficiency while raising more revenues.[13] These proposals, and others, merit serious consideration.

[11] Peter Lindert, *Growing Public: Social Spending and Economic Growth Since the Eighteenth Century,* (Cambridge, UK: University of Cambridge Press, 2004).
[12] Note that this total is indicative of the extent of tax expenditures but is not an estimate of the revenue that would be raised by repealing these tax expenditures because it ignores behavioral effects and the interaction of tax expenditures with other provisions in the tax code and other tax expenditures.
[13] Note there are substantial corporate tax expenditures even relative to a consumption tax base. Many of the existing tax expenditures also apply to a consumption tax base and, in addition, measuring tax expenditures against a consumption tax base would show the deductibility of interest as a tax expenditure.

A second promising strategy would be to turn individual income tax expenditures into credits, possibly as part of a base broadening process. Tax credits are more progressive and put more money into encouraging the activity they were designed to encourage (e.g., purchasing health insurance, owning a home, going to college, or saving for retirement) and less money into subsidies for upgrades (e.g., purchasing *more generous* health insurance, owning a *larger* home, or going to a more *expensive* college) or into economically inefficient windfall subsidies to people who would have undertaken the same activities in any event.

A third promising strategy for tax reform is to rely more on taxes that correct distortions and improve the functioning of markets. For example, as N. Gregory Mankiw has argued, "A tax on carbon is the best way to deal with global warming."[14] There are legitimate concerns that such a tax, by itself, would be regressive and disproportionately affect low- and moderate-income families. These concerns, however, could and should be addressed by combining a carbon tax with other tax cuts that compensate low- and moderate-income families. Or, alternatively, a carbon tax reform could be combined with tax cuts in such a manner that it was both revenue neutral and distribution neutral, although in this case it would not have the benefit of reducing the long-run deficit and thus would not reduce the need for other revenue increases or benefit cuts. Finally, another variant of the same price mechanism could be implemented though a cap-and-trade system for carbon, with appropriate rules for auctioning off permits.

Concluding Reflections

The fiscal problems this Committee is trying to address are very difficult, both economically and politically. Thank you for the opportunity to contribute to these important efforts. I look forward to answering your questions.

[14] N. Gregory Mankiw, "Mr. Paulson's Challenge," *Wall Street Journal*, May 31, 2006.