CHOOSING THE NATION'S FISCAL FUTURE

Statement of

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Mr. Bowles, Senator Simpson and other members of the commission, I would like to thank you for this opportunity to testify on our nation's fiscal future. The commission faces a formidable task. The budget is on a ruinous path and getting off that path involves far more significant policy changes than the American people are used to.

Three programs – Social Security, Medicare, and Medicaid – constitute considerably more than 40 percent of spending in a normal year and all are growing faster than the economy and tax revenues. At the same time Congress has kept the overall tax burden remarkably constant between 18 and 19 percent of the GDP for most of the past 50 years. The combination of three large rapidly growing programs and a constant tax burden inevitably implies a growing deficit if spending for other government spending programs is held to a constant share of GDP. As the deficit increases, the national debt grows faster and faster, and interest on the debt becomes a budget problem in itself. In reasonable projections, the debt passes 100 percent of the GDP in the late 2020s and 200 percent shortly after 2040 under the unrealistic assumption that interest rates and the rate of economic growth remain constant in the face of rapidly growing deficits. It is, however, highly unlikely that world capital markets will tolerate that sort of fiscal profligacy for a long period of time. The market for our debt would collapse long before 2040.

Because of the fickleness of financial markets, it is difficult to predict exactly when a crisis might hit the United States. If one examines fiscal crises in other advanced countries, they have been set off by very different events in different places. In Sweden in the early 1990s, problems began with a financial crisis which quickly caused a recession much more severe than our recent downturn. Plunging tax revenues and soaring safety net expenditures revealed that their budget was in a disastrous state in the short run and things did not get better in the long run because of rapidly growing long-run spending commitments – a situation somewhat more severe quantitatively than that now faced by the United States, but very similar qualitatively. In response, Sweden launched a remarkable series of fiscal reforms, including an ingenious Social Security reform that is being emulated around the world. In Australia and New Zealand, foreign exchange crises provoked fiscal crises and stimulated major reforms. Recently in Ireland, their unsustainable economic boom and a huge housing bubble came to an end abruptly and revealed a dire fiscal situation in the long run that they are fixing with remarkable speed. In Greece, the fiscal house of cards came tumbling down when the government admitted that it had been lying about the fiscal outlook.

It is difficult to point to a single fiscal indicator that signals that a crisis is imminent. The crises described above occurred with a wide range of debt-GDP ratios. Investors look at a wide variety of variables to try to determine how serious a country is about fixing their fiscal problems in the long run. As I travel abroad, I am pleased to find that foreigners are often more optimistic than Americans about us fixing things without a crisis. Or to quote Winston Churchill, "You can count on Americans to do the right thing after they have tried everything else."

Even if we avoid a crisis for a good long time, the large deficits projected in the future will drain away domestic savings that could be better used to finance productive investments in the United States. Without those investments, labor productivity will be lower, wages will be lower, and living standards will be lower than they need be. The fall in investment is mitigated to the extent that we can borrow from foreigners, but then more of future U. S. income has to be devoted to paying interest and dividend abroad and that also reduces future U. S. living standards.

There are many indications of long-run problems in the 2011 budget just issued by the administration. Spending for Social Security, Medicare, Medicaid and interest already equal almost 70 percent of revenues in 2011. Although the absolute level of the deficit declines from 2010 to 2014, it rises thereafter according to CBO estimates and its growth accelerates as a share of GDP after 2018. The debt in the hands of the public rises from 53 to 90 percent of GDP between 2009 and 2020. The interest bill more than quadruples over the same time period.

Many groups and committees have warned of the possibility of a budget-related crisis and described the harm done to our economy by large deficits. John Palmer of Syracuse University and I recently co-chaired a committee on our fiscal future organized by the National Academies of Science and Public Administration. It was financed by the MacArthur Foundation. The membership of the committee spanned a wide range of ideologies. The committee report has the usual diagnosis of our budget problems and a warning about a potential crisis if we do not change policies. However, our report is unique in that it contains a rich range of policy options that can be used to achieve fiscal stability.

First, fiscal stability was defined to mean that the debt-GDP ratio should be stabilized. The Congress should set an explicit target for the debt-GDP ratio and not exceed it. Given an explicit target, the American people could judge how well the Congress and administration are doing in their pursuit of fiscal responsibility. The committee further determined that a prudent target would hold the debt to 60 percent of GDP. That ratio should be achieved by 2022 and we should begin implementing the necessary policies by 2012. If the nation experiences good fortune while holding the debt to this level, it would be wise to lower the target further.

Admittedly, the choice of 60 percent as a target is a matter of judgment. The committee had to balance the risks of choosing a higher target against the political difficulty involved in getting to something lower. A higher debt-GDP target means running higher deficits. For example, if the GDP grows at 5 percent per year, a 60 percent target implies holding the deficit to 3 percent of GDP whereas an 80 percent target would imply a deficit of 4 percent. The higher ratio means that the draw on domestic saving would be one-third higher and the economic harm done, as described above, would be one-third higher. A higher debt-GDP ratio also raises the risk of a total meltdown in the bond market. All this suggests that it might be much better to choose a target for the debt-GDP ratio considerably lower than 60 percent. However, when the committee looked at the policy changes necessary to keep the ratio as low as 60 percent, it concluded that it would be politically implausible to choose a much lower target.

Our policy options were grouped into four packages. In one, the committee asked what spending restraint would be necessary to stabilize the debt-GDP target at 60 percent while avoiding significant tax increases. That is to say, the total tax burden is maintained close to its historic level between 18 and 19 percent of GDP. That package is called the low spending option. At the other extreme, the committee estimated what tax increases would be necessary to finance currently promised Social Security, Medicare, and Medicaid benefits while other programs grew as determined by current law. There did eventually have to be some slow down in health costs in this package or ultimately the health programs would consume the whole of the GDP. But such a slowdown could be put off for a long time.

Two middle paths were also delineated. They differed primarily in the degree to which benefits were maintained for the elderly population. In the path that was relatively generous to the elderly, spending on infrastructure, research and other types of spending had to be constrained while in the other middle path non-elderly spending could be treated more generously.

The four packages were put forward for illustrative purposes only. The numerous policy options contained in those packages could be put together in an infinite number of combinations and we do not claim to have considered every policy option ever suggested.

In the package that avoided any significant increase in the tax burden, the rate of growth of Social Security benefits was held to the level that could be financed with the current payroll tax structure.[1] At the same time the actuarial deficit facing the Social Security system was also cured. That required accelerating by 5 years the speed with which the full retirement age reaches 67 and indexing it to longevity thereafter, reducing the indexing of initial benefits for the top 70 percent of earners, and switching to an experimental price index that has been developed by the Bureau of Labor Statistics and that is expected to grow more slowly in the long run than the current index. In assessing such a package, it is important to differentiate an

[1] The committee thanks staff members of the Social Security Administration's Office of the Chief Actuary for providing cost estimates on various proposals contained in the report's illustrative scenarios and for reviewing text for completeness and accuracy.

absolute reduction in the purchasing power of benefits compared to today's level from a reduction in the rate of growth of benefits. Although the package seems severe, it would more than maintain the purchasing power of today's level of benefits for all but the most affluent. It would, however, reduce replacement rates considerably below the levels promised by current law.

The rate of growth of health spending in the low spending option had to be held to that caused only by the aging of the population. That is to say, all other causes of excess health care cost growth had to be wiped out.

Two types of cost reducing options are described in our health chapter. One set includes options whose effects on health costs can be estimated by CBO with some degree of confidence. These are options such as increasing Part B and D premiums, increasing the eligibility age for Medicare, and reducing provider reimbursements. The other set involves options whose effects are so difficult to assess that CBO does not provide estimates. These include such initiatives such as using information technology more extensively to track patients and coordinating the treatment of chronic diseases. It would probably involve using every option mentioned in the chapter to some degree to achieve the health spending target of the low spending path. To the degree that the options with an uncertain effect actually worked, the scoreable options could be implemented less painfully.

The new health plan adds to the Federal health budget, raises the tax burden, and changes the mix of Medicare and Medicaid spending from that used in our committee's baseline. It contains some uncertain cost containment options, but not enough, in my view, to fundamentally alter the long-run budget problem created by growing health costs. Indeed, the addition of significant health costs to the budget makes it even more urgent to adopt rigid controls.

My own view – not that of the committee as a whole – is that we shall never reliably control the cost of Medicare and Medicaid so long as they have an open-ended budget. Medicare law defines an eligible population and specifies the treatments that they can be given while excluding very few procedures. Then, the government pays for the cost of any eligible that walks in the door. The total cost can only be controlled indirectly and is difficult to forecast with precision.

In contrast, the universal coverage systems of Canada and the United Kingdom work on fixed budgets. In Canada every hospital must work on a fixed budget and physicians are limited as to their gross income. Strong political pressures make it almost impossible to keep the growth of the fixed budgets down to the level of GDP growth, but nevertheless the fixed budgets impose some restraint compared to our open-ended budget. The rationing methods that go with the fixed budgets in Canada and the U. K. are anything but transparent.

A different approach to a fixed budget and one more amenable to American practices would use a voucher system to provide Medicare, similar to one suggested by Mr. Ryan. The voucher would be used by the elderly and disabled to buy insurance and the value of the voucher would vary inversely with income. It might or might not vary with geographic location and age and it could be combined with changes in insurance regulation to do such things as outlaw the use of pre-existing conditions. Medicaid could be put on a fixed federal budget by shifting to a block grant.

Our low spending option also implies severely constraining all other spending. The low spending defense path would allow the Pentagon to maintain current personnel policies, but would allow very little investment in new weapons systems. Although it would allow small foreign interventions, nothing as large as the current effort in Iraq and Afghanistan would be possible. All other nondefense spending would have to be lowered considerably below today's share of the GDP.

In the package that attempts to maintain current law benefits, that is to say, the high spending option, two different financing mechanisms are considered. In one, the existing income tax system is the primary source of additional revenues and all rates are raised proportionately until the top rate hits 50 percent.[2] That happens by 2020. We did not think it prudent to consider a top rate above 50 percent because of the inefficiencies and inequities inherent in the current system.

After the top rate reaches 50 percent, a value added tax of slightly less than one percent is imposed. The value added tax rate must be raised gradually and it reaches 7.7 percent by 2040.

In the other financing approach, the income tax is radically reformed. Almost all tax deductions except those encouraging saving would be eliminated; the employer-provided

[2] The Urban Institute–Brookings Tax Policy Center provided the estimates necessary to construct the revenue scenarios underlying the committee's four policy packages.

health exclusion would be capped. The earned income tax credit and child credit would be retained and there would be two rate brackets, 10 and 25 percent. The standard deduction and size of the tax brackets would vary with the demand for revenues and would be smallest for the high spending path in which the top bracket starts at $44,950. The initial structure of the simplified tax for 2012 was chosen to emulate the distribution of the tax burden under the current system. It would become gradually less progressive over time, but the Congress could easily amend that if it wished by making small changes in the rate structure and standard deduction.

The simplified tax structure results in rapidly growing revenues over time even before considering its beneficial effects on economic growth. Part of the reason is that the capping of the health exclusion becomes more valuable because of the rapid growth in health costs. The revenue growth is so rapid that the simplified tax could finance the highest spending path with minor tax rate increases through 2020 and rates could be reduced after that.

Besides requiring large increases in income tax revenues, the high spending scenario would necessitate a doubling of the Medicare HI tax and considerable increases in the Social Security payroll tax. The payroll tax cap would be gradually raised until it covers 90 percent of earnings; the payroll tax rate would be raised from the current 12.4 percent to 12.7 percent in 2012 and then in steps to 14.7 percent by 2080; and there would have to be a second tier tax beyond the base that would not earn extra benefits. It would start at 2 percent in 2012 and gradually rise to 5.5 percent in 2060.

By 2040 the tax increases required by the high spending option would raise the overall Federal tax burden by 50 percent compared to the 17.7 percent of 2008 and it would continue to rise after that. I know of no state and local budget projections that go out as far as Federal budget projections, but it is safe to say that if state and local tax burdens are added for comparability, the U. S. total tax burden, which is now considerably below the OECD average, would be higher than today's OECD average by mid-century and within a few years after that we would be the highest taxed nation on earth.

The intermediate package that has the lower spending path would solve two-thirds of Social Security's long-run financial problems by cutting benefit growth and one-third by raising payroll tax rates. Solving Social Security's long-run financial problem also helps lower the unified budget deficit along the way. In this intermediate package, Medicare and Medicaid spending is allowed to grow to 7.2 percent of GDP by 2030 compared to 6.5 percent in the low spending package. Spending, other than that for interest, Social Security, Medicare and Medicaid totals 8.9 percent of GDP compared to 6.8 percent in the low spending path and 10.8 percent in 2008. The increase is devoted to defense and domestic spending on things like research and infrastructure.

The intermediate path with the higher spending devotes a large portion of the spending increase to Social Security, Medicare, and Medicaid. All other non-interest spending is lower than in the first intermediate path.

If revenues for the two intermediate paths are raised using the current income tax structure, the top rate never has to exceed 50 percent. Consequently, there is no need for a value added tax. Of course, a value added tax could be used with any of the four packages to lower the income tax rates necessary for fiscal sustainability. Tax rates in the simplified tax could eventually be lowered below 10 and 25 percent while providing sufficient financing for any of the three lowest spending paths.

Although no one believes that changes in the budget process can ensure that the Congress makes the difficult choices necessary to attain fiscal sustainability, our committee felt that there were some reforms that could help the Congress deal with the problem. The main deficiency in the current process is that it is too shortsighted. Most of the effort is concentrated on formulating the budget for the next fiscal year. If the Congress set a long-term goal for the debt-GDP ratio, it would be forced to pay more attention to the long-run impact of policy decisions and it would provide a benchmark for judging whether policies were moving toward sustainability.

Although CBO and OMB make long-run budget projections, those of CBO are produced separately from the *Budget and Economic Outlook,* which plays an important role in today's process. OMB's long-run projections are provided deep in *Analytic Perspectives* and few readers get that far. We believe that long-run projections should be fully integrated into the main budget documents. Other documents may also be helpful. Australia produces a report every three years examining the effect of budget policies on different generations. Apparently it provokes much public discussion that draws attention to the effect of policies in the long run. In addition, it may be useful to require the president to report every year on the long-run fiscal health of the nation.

The committee discussed how long-run budget targets might be enforced. Automatic triggers present one option. An automatic sequester of spending was used to enforce Gramm-Rudman-Hollings, but it was not well designed. A trigger cannot impose too much political pain or else Congress will change it. But it should be demanding enough to encourage the adoption of more rational policies.

Conclusions

The following conclusions are my own and I know that not all members of the Academies committee would share them. It seems to me that a basic point screams out of our analysis. Regardless of how big you want government to be, there are enormous advantages to be derived from greatly simplifying our income tax system. You can increase fairness, however perceived. You can greatly increase economic efficiency by significantly lowering marginal rates and you can thereby create an environment conducive to economic growth. Moreover, you can design a structure that produces a rapidly growing stream of revenue without imposing inordinate pain.

There are equally beneficial structures that could be devised that are different from ours. For example, you could move the tax burden more toward consumption and ease the burden on saving and investment. But even a pure income tax would be much more efficient than our current mess. This is also a particularly propitious time for reform. The alternative minimum tax should be fixed permanently; we have to decide what to do about the Bush tax cuts; corporate taxation is in severe need of reform; and we certainly should settle the estate tax question.

As for the proper size of government, we all have our own views about that. I like to think of myself as a fiscal conservative, but I find it hard to imagine a majority vote for the smallest government example put forward by our Academies committee. But I would sure work hard for something like the second smallest.

Getting back to our committee, I would like to thank its members for the hard work they put into producing our report and also thank the very able staff led by Stevens Redburn who made it all possible. A diverse set of ideologies was represented on the committee, but the group was very congenial and all debates were rational. Few committees are that pleasant. I hope that yours has as much fun.