Exploring Solutions To Our Long-Term Fiscal Challenges

Statement Of
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Your Committee's hearing record thus far has documented clearly that following the current outlook of large and continuing budget deficits would be unwise, and even dangerous. The resulting unsustainable accumulation of debt and growing debt-service obligations would raise an ever-present possibility of short-term economic disruptions, and the certainty of a longer-term erosion of our standards of living. In addition, it is morally questionable to shift obligations from our current generation which has enjoyed levels of consumption higher than its income, to future generations which already face potentially costly challenges of our making (such as providing for our retirement and health care, and rectifying greenhouse gas buildups in the atmosphere). Let me stipulate the Committee's record (which we can discuss during questions if you should wish) and move on to address the exceedingly difficult question of how the nation might cure those deficits.

To begin, however, let me make one point of transition between cause and cure. Some say today that tax cuts have made our economy strong and yielded a large revenue boost, which will eventually pull the budget out of deficit. To this view I can only personally observe: Been there, done that. There was a similar, in fact far stronger, revenue boom in the 1990s, following, ironically, a deficit reduction program of which about half was a tax increase. (Incidentally, please note that in the current revenue "boom," nominal individual income tax revenues have only just in 2006 recovered their level of six years earlier, after a precipitous decline.) The economy in the 1990s grew as strongly as, or even more strongly than, the current economic expansion, with a stronger investment boom that laid the foundation for the subsequent increases in productivity and output. However, the rapid revenue growth of that period did not go on forever. In retrospect, it was driven in substantial part by the extraordinary returns in the financial markets at that time, through employee options and bonuses as well as realized capital gains. As seasoned financial market professionals will readily tell you, markets go up, and markets go down. The revenue boom of the 1990s ended, and the current revenue boom will end as well. The difference is that, in the absence of the tax cuts of 2001, the end of the 1990s revenue boom would have left the budget in approximate balance. The end of this revenue boom, in the absence of any future policy change, will drop the budget back into substantial and unsustainable deficit. Having watched all of this happen before at close range, I would urge you not to let temporary fluctuations in revenues delay sound long-term policymaking.

The Committee for Economic Development (CED) is an organization of leaders from the business sector, with a board of trustees numbering approximately 200. The board's Research and Policy Committee approves all CED policy statements by majority vote; trustees are free to register any comment or dissent. In keeping with our unchanged original mission to "improve[e] the growth and productivity of the U.S. economy," CED has considered the budget problem from virtually every angle. Let me provide our conclusions for your consideration, reviewing all of the major components of the budget.

Budget Disciplines

Briefly, first, CED has called on the Congress to reinstate the budget disciplines from the 1990 Bipartisan Budget Agreement, to provide standards of discipline to help to channel policy in a constructive direction. Let me congratulate this Congress for taking a long step forward on that issue, while urging that a full statutory reenactment of those disciplines, including discretionary spending caps and sequestration, would be even better.

Appropriations

Second, the CED trustees have urged the Congress and the Administration to seek out all possible opportunities to weed out waste and duplication in domestic appropriated spending (and also in defense appropriations, which the current war effort obviously complicates). CED has also noted that we have no expectation that there will be nearly enough in discretionary savings to solve the long-term budget problem, especially in light of the national priorities that must be advanced through appropriations. (For example, CED has championed the availability of universal preschool as an important economic investment.) So CED would view management of domestic appropriations as an important step to keep the budget under control, but not as a source of sufficient savings to eliminate the long-term deficit. This judgment would appear to be ratified by the developments of last year, when the Congress failed to enact any domestic appropriations bills (other than homeland security). Presumably, if the passage of significant discretionary spending cuts were feasible, that Congress would have done so, and would have touted that achievement to the electorate. The absence of action would seem to suggest that even the proposed cuts of last year, which would have been only the first slice of the action necessary to subdue the deficit, were and remain simply not viable.

Social Security

This leaves virtually the entire weight of deficit reduction on the remainder of the budget. One program mentioned currently as a possible subject of legislative action is Social Security. Because Social Security as currently configured is not sustainable in the long term, action is needed. Furthermore, the last major restructuring of Social Security, in 1983, helped the unified budget (and therefore reduced the federal government's need to borrow from the public to fund its operations) significantly.

However, the kind of action now often contemplated, partial privatization, would make our overall budget predicament enormously worse. The simple reason is that the current Social Security operating surplus, which is held by the federal Treasury in cash and therefore reduces borrowing needs, would have to be diverted in significant measure to capitalize the individual accounts. That would constitute a net loss to the Treasury for decades. The President, in his proposal for partial privatization, has maintained, very rightly, that those over 55 years of age should be able to receive Social Security benefits according to the current law. This is only fair, because older workers who already have begun to execute proximate plans for retirement cannot make substantial adjustments; they need fair warning of lower retirement benefits so that they can choose employment opportunities that will allow them to work longer, and so that they have time to save more on their own. However, this means that there will be no benefit-reduction savings from the President's plan for almost a decade, and those savings will begin only very slowly – while deposits into private accounts must be made at full speed from the very beginning. As a result, a unified budget that is about to move into substantial deficit would add on even more debt. It is of absolutely no consolation that the Social Security plan, taken on its own, would be actuarially sound over 75 years or even longer. The federal government's finances would be dead long before then.

To convey the shape of this problem, note that others have estimated that the President's plan would add $17.7 trillion to the public debt by 2050 – almost 20 percent of the projected GDP for that year, or an increment of more than half the level of the total debt today – and would increase annual debt-service costs in that year by 1.1 percent of projected 2050 GDP – or more than two-thirds of the amount of total interest costs in today's budget. The savings from reduced benefits would trail behind this added debt and debt-service. My own calculations of several years ago suggested that the Social Security partial privatization plan would not recover to a net break-even for the unified budget for more than half a century. I know of no serious observer of the federal budget, certainly not the President's own Office of Management and Budget (in its "Stewardship" chapter of the *Analytical Perspectives* volume of the Budget), who would contend that the federal government's finances will remain healthy without serious restructuring much sooner than 50 years from now. And yet Social Security privatization would add enormously to these problems. Clearly, anyone who believes that partial privatization is the right way to go must acknowledge that it would make the problems of the unified budget significantly worse, and would require far greater spending cuts and tax increases than otherwise to keep the debt from exploding.

CED issued a statement on Social Security reform in 1997, and we reaffirmed our position in 2005. We took the more conventional view seeking a Social Security reform that would improve, rather than weaken, the unified budget. Specifically, we recommended gradual reductions in benefits that would yield permanent solvency for the system, with a margin of safety in those calculations. The benefit reductions would include changes in the benefit formula, increases in both the normal retirement age and the age of earliest eligibility, and the income taxation of 100 percent of benefits. (A full description of the CED recommendations is available on our website, www.ced.org.) These reductions would of course leave benefits lower than they would be under current law, but higher in inflation-adjusted dollars than they are today. The reductions would be progressive in the sense that benefits would be reduced more for higher-wage beneficiaries. To compensate for these benefit reductions, we would add private accounts. These private accounts would be mandatory, and would be funded by contributions equal to 3.0 percent of covered payroll (1.5 percent each from employer and employee). The contributions would belong to the employee, and would be placed in purely private accounts, without being handled by the federal government. The CED trustees believed that this would give wage earners the best reason to be willing to make those contributions and to trust in the system and the process.

Again, these recommendations would leave the Social Security system permanently sustainable under current assumptions, would increase national savings (because at least part of the contributions to the private accounts would be a net addition to private savings), and would improve, rather than deplete, the unified budget. Let me commend that statement to your attention.

Health Care

Close observers of the federal budget will be quick to note that the long-term budget problem is to a much greater extent driven by health-care costs – Medicare and Medicaid – than by Social Security. In fact, some might go so far as to characterize Social Security restructuring as mere batting practice for the real contest against rising health-care costs. We do need our batting practice, and fixing Social Security could be an important confidence-builder before the main event. But we must move on to the inevitable big game with health care.

Let me offer two cautionary notes with respect to health-care costs. First, it is difficult to conceive of policies to cut the federal government's health-care costs without restructuring of the health-care system as a whole. One could not imagine physicians under Medicare and under the private market practicing side by side for very long at significantly different and diverging reimbursement rates or levels of productivity. Furthermore, our health-care system is no more sustainable for private employers, who pick up the bill for much of the working-age population and their dependents, than it is for the federal government, which is responsible for much of the bill for the elderly. Thus, to fix the health-care system for the elderly, we almost certainly must fix it for everyone.

Second, it is hard to imagine a simple "CBO-scorable" fix for Medicare or Medicaid – short of a reduction of program coverage that would be not much less dramatic than offering the very ill only an icy lake and a canoe with no paddle. The federal government's experts already have learned that reductions of reimbursement rates of the depth that would be necessary to balance the system in the long run would elicit almost equally sharp increases in the volume of services provided – through which providers would attempt to maintain their incomes. Moreover, such reimbursement reductions would not be sustainable in the context of our mixed public and private system; large numbers of physicians simply would refuse to serve Medicare patients.

Therefore, to solve our impending federal health-cost crisis, we will need a fundamental restructuring of the entire health-care system, along lines that will yield a qualitative, not just a measurable and quantitative, change in the way health care is delivered. CED looked at these issues in 2002, and we now conclude that we underestimated the magnitude of the structural change required. Accordingly, we are revisiting the issue. We are starting with the employment-based health-care system for working-aged persons and their dependents, in a way that we believe will have important synergies with federal programs for the elderly. Although our deliberations are not yet complete, we have tentatively settled on a system that would give to the working-aged population a menu of choices similar to those available today to federal workers under the Federal Employees Health Benefits Program (FEHBP), and to a few consortia of private employers around the country. An independent government agency (perhaps structured like the Federal Reserve Board of Governors) would play the regulatory role of the Office of Personnel Management (OPM) in the FEHBP – including, for example, setting minimum standards for the insurance policies that are included in the menu. Persons would receive defined contributions such that everyone could obtain the low-priced plan that meets the appropriate standards, but those who want more expensive coverage would be responsible for the incremental cost out of their own pockets. Issuance would be guaranteed, regardless of preexisting conditions; insurers' premium revenues would be risk-adjusted, so that insurers who for whatever reason attracted disproportionately good risks would compensate those who took on the burden of caring for the more-costly risks.

Beyond universal coverage, the goal of this approach would be to encourage consumers to be cost-conscious choosers of their health-insurance plans, rather than of individual medical services. We believe that it is feasible for consumers to make informed responsible choices of insurance plans during an annual open season, with the help of an impartial regulator – just as federal employees are generally satisfied with the choices given them by the OPM and the FEHBP. In contrast, we find it implausible that consumers would shop successfully for lower prices for individual medical treatments while subject to serious illnesses. Note in this context two important factors: First, the great bulk of health-care spending is undertaken by persons spending far more than any feasible deductible amount for a High Deductible Health Plan (sometimes also known as a Consumer Directed Health Plan). In other words, the people who are spending most of the money under CDHPs will have no incentive to economize on their spending. Second, medical decisions under serious illnesses can be far more complex than the issues involved in the choice of a health-care plan.

We believe that consumers making cost-conscious choices of health insurance plans will drive both insurers and health-care providers to improve efficiency, so that they will be able to offer better service at lower prices, and thereby attract more customers – just as every other industry in the U.S. economy has learned to seek greater efficiency so as to remain competitive. In fact, we believe that such efficiency, diffused through the health-care sector from the coverage of the working-aged population to the federal programs for the elderly, is the only way in which the nation as a whole can enjoy high-quality and affordable health care.

Revenues

The remaining major component of the budget is revenues. No one likes the prospect of higher taxes. However, we should consider three incontrovertible realities:

First, as the U.S. population ages, there will be needs for greater funds for the federal government's largest programs – Social Security, Medicare and Medicaid. Some have suggested that the aging of the population should be a budget-neutral change, because as the federal government provides for the more-numerous elderly, it can spend relatively less on children, who will be a correspondingly declining share of the population. The problem with this logic is that the elderly are more expensive than children. Children generally come with parents attached, to provide their basic support. Furthermore, children are generally healthy. Thus, government's cost of providing for children is usually comparatively modest. In contrast, support for the elderly often includes the equivalent of full subsistence through Social Security, because our society has not shown itself willing to put responsibility for our elderly directly on their own children. In addition, the elderly in general have developed far greater medical needs than children. As a result, as the population ages, the nation will need significantly more in revenues to provide the kind of government support and services that we now expect.

Just do the math: Assume for sake of argument that the nation solves the rapid growth of the per-person cost of medical care for the elderly – which we are far from accomplishing thus far. It is widely understood that the ratio of the elderly to the working-aged population over the next 30 to 40 years will rise from about one to three, to one to two. That fact alone would suggest an increase in the relative cost burden of the elderly of about one third (taking the elder from about 25 percent of the adult population to about 33 percent, an increase of about one third). For that very simple reason, the federal government is likely to need a somewhat larger revenue base than it has had in the post-World War II years to date.

Second, consider that any plan to cut the costs of the major entitlements for the elderly – Social Security, Medicare and Medicaid – will take some years to bear fruit. As noted earlier, the President very correctly maintained that reductions in Social Security benefits cannot fairly be imposed even on those several years away from retirement, because people deserve fair warning so that they can make workable plans. That postpones the realization of savings from any plan to strengthen Social Security's finances. Likewise, the health-care sector is a massive share of the U.S. economy, with substantial long-lived investments in equipment and buildings, and substantial lags in the training of new personnel with new and different skills. Any efforts to change this very large sector of the economy will take time. Accordingly, once the retirement of the baby boom and the aging of the population begin to have their effect, the nation is likely to run larger deficits and accumulate more debt for some time before even the best spending reduction policies begin to have their effect.

Third, as debt accumulates, it breeds debt service obligations. Debt and debt-service are the prime forces behind every financial disaster. Even granting that the major long-term budgetary problems facing the United States are Social Security, Medicare and Medicaid, it should be clear that the nation will need to use other tools to reduce its accumulation of debt in the near and intermediate term – to "buy time" until repairs for Social Security and Medicare can become effective.

The role of debt service in the gloomy long-term budget outlook should not be underestimated. In the middle-of-the-road path in its most recent long-term budget projections (December 2005), CBO projected that total budget outlays in 2030 would be 27.1 percent of GDP – of which 4.6 percentage points of GDP would be spent on interest. Consider also that even if a budget were sent into deficit solely by insufficient revenues, it would eventually look like a spending problem – because the insufficient revenues would cause budget deficits, which would accumulate into a larger debt, and cause interest expense to grow. The interest expense, of course, is counted in the budget as outlays, no matter what the cause of the corresponding debt.

And for those who most abhor the prospect of a tax increase, I can only suggest that they consider the tax increases that await their children and grandchildren if the nation procrastinates in facing up to the budget problem. Economists from all over the political spectrum acknowledge that future generations will be burdened by current deficits. We sometimes hear people say that they resent paying taxes because they do not believe that they receive anything in return. Apart from all of the often-forgotten services that we receive in whole or in part because of federal activity or subsidies – from national security to clean water – people do in fact receive "nothing" in return for their taxes to the extent that they pay those taxes to service the public debt. As the debt grows and our children pay higher and higher taxes to service the debt that we are accumulating because we do not have the maturity to pay our own way, they may become cynical about government – but more appropriately, they ought to be cynical about us.

Please note that already in fiscal year 2006, debt service was the fastest growing major spending category in the federal budget – increasing by 23.2 percent in just one year.

CED has considered the interest in fundamental tax reform in the context of the federal government's broader fiscal predicament. We have concluded that the federal income tax is no longer strong enough to carry its recent share of the burden. Accordingly, we have recommended that the federal government adopt a value-added tax, while restructuring the income tax and its low-income support provisions (such as the earned income tax credit) to maintain fairness and progressivity. The combined yields of the two taxes should be sufficient to put the federal budget back into surplus, thereby reducing rather than increasing the debt-service burden as the baby-boom generation moves into retirement. The nation should shed its apparent phobia for debt reduction, which contributed to the decision to dissipate the hard-earned budget surpluses of the 1990s. This would give us the time to find, enact and implement the most effective reforms for Social Security and – especially – health care, so that we keep our nation's finances sound and sustainable, and avoid much heavier tax burdens for the generations to follow us.

How To Get There

Finally, a brief note on process: With one exception, all of the major successful deficit-reduction efforts in this country have been achieved on a bipartisan basis, through comprehensive negotiations. I see no reason to doubt, and every reason to believe, that shared responsibility and compromise will again provide the greatest possibility of success. Controlling the deficit will require painful choices, and for a majority to act, both sides must accept a stake in the process. Those who care about the future of this country will look for a way to reach a workable compromise that both sides will accept and from which neither side will profit at the expense of the other. Of course, the American people, in their wisdom, always ultimately recognize and reward the true leaders.

I hope that CED's work on these issues will prove helpful to you in your deliberations, and I thank you for the opportunity to bring our findings to your attention.