

MEETING THE FISCAL CHALLENGE

The Strengthening America's Future Initiative Issue Paper

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The views expressed in this report do not necessarily reflect the views of the individual members of this issue team or their institutions. In some cases issue team members have offered dissents to specific sections of the issue paper.

Principal Project Supporter





Strengthening America's Future Initiative (SAFI)

Meeting the Fiscal Challenge

Summary

The United States faces a growing fiscal crisis that will require major changes to federal spending and tax policy as well as the budget process. This crisis, coupled with the broader economic crisis, poses great challenges, but also historic opportunities for the country. Both parties share blame for the current state of the budget, and bipartisan action is required to address it. This paper offers principles and recommendations to guide policy.

I. Overall Fiscal Policy

Generally, overall fiscal policy should be:

- Countercyclical in the short run
 - Policy options – temporary extension of unemployment compensation, temporary business investment incentives, temporary aid to state governments, immediate infrastructure improvements, and temporary tax cuts for those most likely to spend the money.
- Sustainable and stable in the medium run and long run
 - Ordinarily the debt to GDP ratio should be held constant from peak to peak of the business cycle. However, the huge current deficits and debt share of GDP calls for significant reductions in the deficit over the next few years.

Spending and tax policies should emphasize the following goals:

- Provide necessary public goods and correct externalities
- Provide an effective social safety net
- Generate fair outcomes
- Promote efficiency
- Create systems that are simple, transparent, and administrable

II. Structure of Taxes and Spending

Spending

Possible strategies for addressing projected shortfalls in Medicare/Medicaid include:

Increase the age of eligibility

- Increase premiums, co-pays, and deductibles
- Decrease the percentage of costs covered by government programs
- Reduce the services covered so as to focus on true insurance
- Alter the payment system to reward value instead of volume
- Eliminate or limit the exclusion of employer-provided health insurance from income tax and payroll tax

Social Security: Social Security faces a gap between promised benefits and projected, dedicated revenue. Among the reforms that should be considered are the following:

- Raise the age at which retirees qualify for early retirement (62) or full benefits (now 66 and scheduled to go up to 67)
- Index benefits for longevity
- Reduce the generosity of initial indexing
- Raise the cap on taxable wages
- Make the benefit structure more progressive

Taxes

Income Tax Reform: The income tax base needs to be broadened by eliminating inefficient tax expenditures. The IRS needs to be better equipped to enforce existing tax laws and narrow the gap between taxes owed and taxes collected. Temporary income tax provisions that are intended to be indefinitely extended distort budget projections and need to be addressed as part of tax reform.

Corporate Tax Reform: Firm-level taxation of corporate income is becoming less viable in a globalized economy. If income taxation is retained, business income should be taxed in a neutral manner at the individual level.

Energy Taxes: Adopt, either a tax on carbon emissions (preferred), or a cap-and-trade system with permits auctioned. However, international cooperation is at least desirable, if not necessary, to justify such a move. In the absence of a broad-based energy tax change, another option is to increase the federal gasoline tax.

Value-added Tax: A broad-based value-added tax (VAT) applied to consumer goods and services would provide a relatively efficient means of raising revenue. It is particularly important to consider a VAT if personal and corporate income taxes are not reformed.

III. Budget Process

The budget process can promote transparency and accountability by setting the ground rules for decision making. It should:

Encourage responsible decision making that counteracts political shortsightedness

- Restrict automatic growth of entitlements and taxes
- Provide more information on medium- and long-term implications of fiscal proposals (longer-term CBO scoring)
- Consider a bipartisan commission to send recommendations to Congress or a summit like the one held at Andrews Air Force Base in 1990

Policy options – Discretionary spending caps, pay-as-you-go (PAYGO) rules.

Introduction

Without significant changes in tax and spending policies, the United States will face an increasingly unmanageable fiscal problem. The only way to resolve the problem is through major and potentially painful overhauls of *both* spending programs and tax rules. Addressing the fiscal imbalance will therefore pose enormous political and economic challenges. At the same time, however, it offers historic opportunities to develop new solutions. In addition, fixing the fiscal imbalance would improve the long-term economic performance of the United States, reduce the burdens on future generations, and help maintain America's standing as a leader in the world economy.

As difficult as it would be to fix the long-term budget problem under normal circumstances, the problem is made all the more challenging by the recent economic downturn. Policy makers face the difficult task of recovering from a deep recession—which justifies a stimulative fiscal policy—while simultaneously needing to rein in the long-term structural imbalance. Properly calibrating this delicate balance between short-term stimulus and long-term discipline is crucial.

Indeed, recent hopeful signs suggest that the economy has begun to recover. If so, the budget deficit will recede somewhat from its current high level even without policy changes because revenue will rise and spending on safety net programs will decline. This does not mean, however, that our fiscal problems will be resolved. Regardless of how the economy performs in the near term, the federal government will face a growing and unsustainable gap between revenue and expenditures that will require politically difficult changes to tax and spending policies.

The fiscal situation is not the fault of any one political party or president, and neither party nor the current administration should be solely responsible for solutions. It is necessary, however, for those now in power to act. Therefore, we urge the President to follow through on his promise to propose a plan for dealing with these challenges in his fiscal year 2011 budget, and we urge leaders of both parties in Congress to consider recommendations from the Administration and other sources to reach a solution.

In that spirit, we offer some principles and applications to guide fiscal choices over the coming years. Because the members of this group represent a diverse set of viewpoints, our recommendations focus on areas where there is substantial agreement among the participants and we note where particular members do not agree with the group statement.

I. Overall Fiscal Policy

General Principles

Fiscal policy needs explicit goals to encourage trade-offs among competing priorities. Without this discipline, the political popularity of higher spending and lower taxes can overwhelm the less immediate economic gains to be had from a more balanced approach. In normal economic circumstances, fiscal policy should be:

- Countercyclical in the short run

- Sustainable and stable in the medium run and long run

Setting different standards for different time frames best reflects the diverse challenges ahead. It recognizes that any response to the extraordinary cyclical circumstances we are now experiencing must not deepen the preexisting long-term structural fiscal imbalance. Failure to distinguish between short- and long-term problems will merely make it harder to solve either. A short-term policy of fiscal austerity could delay economic recovery by withdrawing needed fiscal stimulus, which in turn could worsen the long-term outlook; ignoring the long-term imbalance could also hurt the economy by leading to higher interest rates or possibly a crisis in international financial markets.

Applications

Short-term counter-cyclical policy: This principle is limited in application to circumstances where fiscal stimulus (i.e., higher deficits) can be justified by lack of demand in the private sector. Whether accomplished through higher spending or lower taxes, policies in this regard should be targeted to produce the most “bang for the buck,” designed to take effect swiftly and to be phased out once the immediate need has subsided. Such policies may include temporary extension of unemployment compensation, temporary business investment incentives, temporary aid to state governments, immediate infrastructure improvements, and temporary tax cuts for those most likely to spend, rather than save, the money.¹

Medium-term and long-term fiscal balance: In normal economic circumstances, a reasonable medium-term goal would be to have the debt-GDP ratio stay constant from peak to peak of the business cycle. (This debt measure should include all of the federal government’s explicit and implicit debt.) Maintaining this goal would allow the debt-GDP ratio to rise during downturns and decline during expansions. Maintaining this goal in the medium term, through every business cycle, would be sufficient to maintain it in the long term as well.

Medium-term fiscal policy in the current situation: As noted above, in normal economic circumstances, a stable policy would maintain debt-to-GDP ratios from peak to peak of each business cycle. Clearly, the economy is not currently in a normal economic circumstance: The deficit in 2009 was the largest share of the economy since the Second World War, and federal debt rose to its highest level relative to the economy since 1955.² Therefore, to maintain, or reestablish, moderate levels of debt-to-GDP, the debt and deficits would need to fall dramatically over the next few years. Of course, as the economy returns to full employment over the next several years, the deficit will decline—even in the absence of policy changes—because of increases in revenue and reductions in safety net spending. Nevertheless, policy changes could also potentially play a major role in the medium-term evolution of the deficit and the debt.

II. Structure of Taxes and Spending

General Principles

Spending and tax policies should be redesigned to emphasize the following goals:

- Provide necessary public goods and correct externalities
- Provide an effective social safety net

- Generate fair outcomes
- Promote efficiency
- Create systems that are simple, transparent, and administrable

The basic principles apply to both tax and spending policy. The government often has a choice of whether to pursue its policy goals through an explicit spending program or through provisions in the tax code. In each instance, the government should choose the method that best promotes the principles stated above, with spending and tax initiatives given equal scrutiny.

Applications

Medicare and Medicaid: Any serious effort to address the fiscal imbalance will require changes in Medicare and Medicaid, the principal sources of projected long-run increases in non-interest federal spending as a share of the economy. Constraining cost growth will require changes in the practice and financing of medical care, as well as in patient expectations. The current fee-for-service system rewards providers for the volume of services they provide rather than the medical value of those services. Patients have little incentive to economize because “Medicare pays the bills.” Costs go unchecked because they are paid as an entitlement with no budget or regular review process. Among the strategies required to control federal cost growth in health care are the following:

Increase the age of eligibility

- Increase premiums, co-pays, and deductibles
- Decrease the percentage of costs covered by government programs
- Reduce the services covered so as to focus on true insurance
- Alter the payment system to reward value instead of volume
- Eliminate or limit the exclusion of employer-provided health insurance from income tax and payroll tax

There will be important interactions between health care reform in the private sector and reductions in government spending on health, because standards of care and practice are not likely to vary considerably across private and public sectors. Given the size and influence of Medicare and Medicaid, which together represent roughly one-third of the nation’s total health care expenditures, the government can use changes in these programs as guideposts in helping to reform the private health care sector as well.³

To ensure that projected savings are actually achieved, we believe that a standing Medicare commission should be created to monitor the program’s spending growth and recommend changes that may be necessary if spending grows higher than anticipated. These recommendations should be guaranteed an up-or-down vote in Congress.

Social Security: Social Security faces a gap between promised benefits and projected, dedicated revenue. Among the reforms that should be considered are the following:

- Raise the age at which retirees qualify for early retirement (62) or full benefits (now 66 and scheduled to go up to 67)
- Index benefits for longevity
- Reduce the generosity of initial indexing (which is currently tied to wages during the worker’s career)

- Raise the cap on taxable wages
- Make the benefit structure more progressive

Income tax reform: If the income tax is retained, the *sine qua non* of meaningful tax reform is to clean out and rationalize the exclusions, exemptions, deductions, and credits. A tax system with a broader base would treat various activities on an equitable basis, make the system simpler and more efficient (by “leveling the economic playing field”), and allow for lower rates to achieve a given revenue target. The current tax code is replete with provisions that work against these goals through so-called tax expenditures. Some of these provisions favor particular business activities, while others favor desired activities on the part of individuals. Together, tax expenditures narrow the revenue base by nearly \$1 trillion annually, costing the federal government nearly as much as the total of discretionary spending.⁴ Another chief concern is tax compliance. The Internal Revenue Service estimates that the gap between taxes owed and taxes paid is nearly \$300 billion per year.⁵ This “tax gap” robs the government of revenue, requires higher tax rates on complying taxpayers and businesses, and breeds distrust and resentment about paying taxes. A meaningful reform plan would equip the IRS with the resources to enforce and administer the tax system as well as impose strict safeguards to ensure that abuse does not occur.

Temporary Income Tax Rules: Many current income tax rules face expiration dates even though they were never intended to be temporary; they were crafted and passed that way simply to artificially hold down their official costs. The proliferation of expiring tax provisions is the primary reason that the official current-law budget baseline is a poor projection of the costs of current policy. The 2001 and 2003 “Bush tax cuts” and relief from the Alternative Minimum Tax are prime examples. These issues will need to be addressed as part of any broader tax reform.

Corporate Tax Reform: Firm-level taxation of corporate income is becoming less viable in a globalized economy. Moreover, U.S. rules on measurement of business income feature numerous provisions that tax different types of income at widely different rates. One major distortion is the favorable treatment of debt, relative to equity. If income taxation is retained, business income should be taxed in a neutral manner at the individual level.

Energy Taxes: Government policy should create better incentives to reduce consumption and produce cleaner energy by imposing either a tax on carbon emissions or developing a cap-and-trade system with permits auctioned. While this group prefers a carbon tax to a cap-and-trade system, both systems have significant advantages over current practices. Either system would produce wide-ranging benefits: the societal cost of producing and consuming carbon would be included in the price of goods like gasoline and electricity; energy security would rise; environmental damage would decline; and federal revenue would increase. Either system would also provide significant incentives for development of alternative energy sources and would render unnecessary the existing panoply of targeted energy subsidies. However, it is important to weigh the risks of a unilateral move to such a system. International cooperation would be more desirable and possibly necessary to justify such a move. In the absence of a broad-based energy tax change, another option is to increase the federal gasoline tax. A hike in the gas tax would discourage energy consumption, reduce dependence on foreign oil, and help pay for infrastructure investments. It would also incentivize the expanded use of alternative energy.

Value-added Tax: A broad-based value-added tax (VAT) applied to consumer goods and services would provide a relatively efficient means of raising revenue and would have a smaller negative impact on economic growth than increased income taxation. Unlike the income tax, a VAT would not favor consumption over saving. It would be less progressive than the current income tax, but if this is deemed to be a problem, its rate could be set high enough to finance offsetting refundable income tax credits for lower income groups. It is particularly important to consider a VAT if personal and corporate income taxes are not reformed. It has been argued above that some added revenue will be necessary to solve the long-run budget problem. It would be extremely inefficient to try to raise that revenue by simply increasing marginal tax rates within the current income tax system. The efficiency and equity of the current system has been severely compromised by all its exemptions and special deductions. If a VAT is adopted, it is vitally important to keep a broad base by avoiding reduced rates and exemptions for particular goods and services.

Some members of the group would prefer to replace income taxation with a progressive consumption tax, such as the X tax (a modified form of the VAT) proposed by the late David Bradford.⁶

Reducing “Waste”: Wasteful and inefficient spending and tax subsidies divert resources from more pressing national needs, and they increase public cynicism about the fairness of the federal budget. Before Americans will accept major policy sacrifices, such as cuts in Social Security and Medicare and tax increases, they want to be reassured that resources are not being allocated wastefully or for political gain. The process of going through both sides of the budget to identify and eliminate outdated or ineffective spending programs is unlikely to generate enough money to close the fiscal gap, but it is critical in helping to regain public confidence in how government is spending its money. Reducing waste and inefficiency is a subjective process. One person’s idea of waste may be another’s idea of an important government service or tax subsidy. Nevertheless, a thorough scouring of both sides of the budget is in order, with particular emphasis on agricultural subsidies, defense spending, transportation, and natural resource subsidies (such as timber, grazing, and mining).

III. Budget Process

General Principles

The budget process can promote transparency and accountability by setting the ground rules for decision making. It should:

Encourage responsible decision making that counteracts political shortsightedness

- Restrict automatic growth of entitlements and taxes
- Provide more information on medium- and long-term implications of fiscal proposals
- Consider a bipartisan commission to develop a fiscal package on which Congress would vote or a summit like the one held at Andrews Air Force Base in 1990

Applications

Discretionary Spending Caps and PAYGO: A first step in countering the political incentives to ramp up spending, cut taxes, and borrow to fund priorities is reinstating discretionary spending caps and statutory pay-as-you-go rules (PAYGO). Discretionary spending caps and PAYGO

work together to ensure that all aspects of the budget, appropriations, entitlements, tax cuts, and tax expenditures receive scrutiny. While the annual Congressional budget resolution includes a cap on discretionary spending and both houses of Congress have now adopted PAYGO rules, neither of these enforcement provisions has the force of law. The original version of caps and PAYGO, established in the 1990 Budget Enforcement Act, was statutory and could be enforced through sequestration (automatic cuts).

Statutory caps and PAYGO, along with sequestration, would not, in and of themselves, improve the budget situation. They fall short of addressing the central long-term budget challenge, which is constraining the cost of existing entitlement programs. PAYGO requires Congress to offset the cost of new programs or expansions of existing programs. It does not apply to current law benefits and thus does nothing to control the automatic growth of these programs. To improve transparency and accountability, Congress should establish a periodic review mechanism for all existing entitlements and tax expenditures designed to bring long-term benefit promises better in line with projected revenue. This should include an automatic adjustment mechanism (trigger) to cut spending and/or raise taxes that would go into effect, subject to economic conditions, unless Congress takes other action designed to achieve the same objectives. Alternatively, the trigger could force action by an independent commission (see below).

Long-term Scoring: Congress should also consider more long-term scoring by the Congressional Budget Office of selected, major changes to entitlement and tax programs. A good example of this is the twenty-year estimate of the budgetary effects of the Senate Finance Committee's health care reform bill in September 2009.

Fiscal Commission or Budget Summit: Because the regular legislative process has been incapable of dealing with the impending fiscal crisis, some have suggested that a bipartisan commission be appointed. An alternative to a commission would be a budget summit consisting of Congressional and Executive Branch officials. Either could be a useful mechanism to break the gridlock, but only if it recognizes fiscal and political realities. The process must be truly bipartisan and have a broad mandate to examine all aspects of fiscal policy without preconditions. Public engagement is also critical. Finally, any such special process should include a commitment for legislative action, including an expedited procedure, similar to BRAC, the military base closing process, that guarantees legislative consideration of the commission's recommendations. The last thing Washington needs is another Commission to nowhere. Similar criteria should apply to a budget summit.

Endnotes

¹ Alan Viard, a member of the group that wrote this document, does not agree with the inclusion of “immediate infrastructure improvements” as a policy to be considered, although he would support consideration of repair and maintenance spending.

² The Concord Coalition, “Debt Facts,” June 8, 2009, <<http://www.concordcoalition.org/issues/debt-facts>>.

³ CSPC calculations based on Medicare, Medicaid, and total national expenditures on health care:

Kaiser Family Foundation, “Medicare Spending and Financing,” May 2009, <<http://www.kff.org/medicare/upload/7305-04-2.pdf>>.

and, Kaiser Family Foundation, “Medicaid Facts,” November 2008, <http://www.kff.org/medicaid/upload/7235_03-2.pdf>.

and, Kaiser Family Foundation, “U.S. Healthcare Costs,” July 2009,

<http://www.kaiseredu.org/topics_im.asp?imID=1&parentID=61&id=358>.

⁴ Robert Carroll et al., “Moving Forward with Bipartisan Tax Policy,” New America Foundation,

<<http://www.newamerica.net/files/Bipartisan%20Tax%20Policy.pdf>>.

⁵ U.S. Department of the Treasury, “Update on Reducing the Federal Tax Gap and Improving Voluntary Compliance,” July 8, 2009, <http://www.irs.gov/pub/newsroom/tax_gap_report_final_version.pdf>.

⁶ Robert Carroll, Alan D. Viard, and Scott Ganz, “The X Tax: The Progressive Consumption Tax America Needs,” American Enterprise Institute, December 2008, <http://www.aei.org/docLib/20081217_No423752TPOg.pdf>.