The Takeaway

Policy Briefs from the Mosbacher Institute for Trade, Economics, and Public Policy

Deficit Reduction: $38 Billion Won't Cut It

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Washington is awash in red ink, and no one seems willing to make the hard choices needed to set our fiscal house aright. Congress' recent boast of cutting spending by $38 billion makes the problem seem just about solved. On the left, talk of letting the Bush tax cuts expire for those with annual incomes over $250,000 gives the false impression that only very rich taxpayers need sacrifice. And even that timid approach couldn't get past a lame-duck Congress. On the right, many newly elected Tea Partiers claim that we can simultaneously cut expenditures and taxes.

OUR PROBLEM IS HUGE

At a recent Mosbacher Institute event, a panel of fiscal policy experts took stock of the nation's budget problems. Peter Orszag, former director of the Office of Management and Budget under President Obama and first recipient of the Mosbacher Institute Good Governance Award, was joined by Dennis Jansen, professor of economics at Texas A&M University and George Zodrow, editor of the *National Tax Journal* and professor of economics at Rice University, for a frank discussion of the policy options.

What emerged was not a pretty picture. We face a huge and tenacious deficit problem, so severe that if current tax rates remain unchanged and expenditures grow as projected, by 2020 the

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WHAT'S THE TAKEAWAY?

The deficit problem is huge and fixing it will affect us all

Cuts in Medicare, Medicaid, and Social Security must be part of any solution

Even with big spending cuts, tax increases are inevitable

Only a return to compromise and sacrifice can secure our fiscal future

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national debt will approach 100% of Gross Domestic Product (GDP). As the figure below illustrates, the debt has not reached these levels since the World War II years.

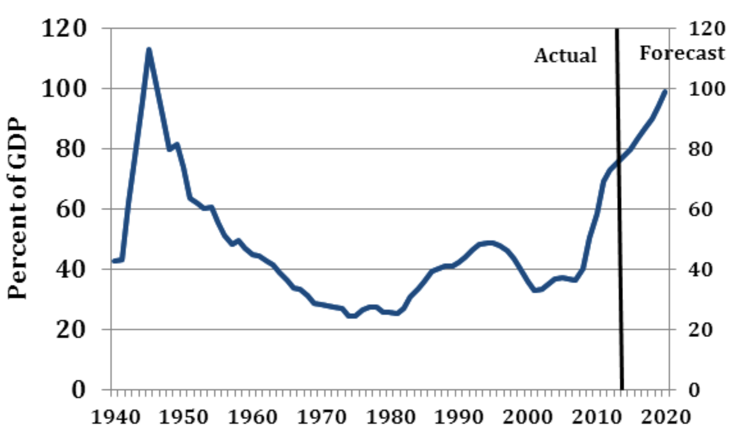
WHY IS THIS SO BAD?

An oft-posed question. There are two compelling answers. First, paying interest on so much debt leaves fewer dollars in the federal budget for worthwhile public investments. The federal government already pays more in interest each year than it pays for transportation and education, combined. If deficits persist, then by 2020 federal interest payments will exceed what we pay for national defense!

Second, heavy government borrowing crowds out private investment, which in turn implies dampened future economic growth and poorer future generations. Simply put, we baby boomers would leave our children and grandchildren with a huge credit card debt held by the Bank of China – and a slower-growing economy to boot.

We calculate that unless something changes, the cumulative deficit over the next 10 years could be as high as $13.6 trillion. Yes, annual deficits over the next few years should shrink as the economic recovery generates more tax revenues. But increases in Social Security, Medicare, and Medicaid spending beyond 2014 will expand the deficit thereafter. Long-term, we face a persistent imbalance between tax revenues and expenditures, as baby boomers retire and healthcare costs keep growing faster than our ability to pay for them.

DEBT AS A PERCENTAGE OF GDP



Note: 2011-2020 assumes a continuation of the status quo.

> *Long-term, huge deficits make a country and its people poorer*

OPTIONS FOR CUTTING EXPENDITURES

Of all the targets for spending cuts, Peter Orszag pointed to Medicare and Medicaid as the best place to start. Per capita expenditures on Medicare patients vary widely across hospital regions in the U.S., ranging from $5,310 to $16,352 per patient. Yet, the quality of care and its cost do not seem to be correlated, suggesting a potential for cutting costs without cutting quality. Furthermore, 5% of Medicare beneficiaries account for over 40% of the expenditures, and many of those expenditures occur in the last 6 months of life.

Possible solutions include mandated price reductions for certain procedures, outright rationing, consumer-directed healthcare plans, and provider information and incentives. None of these will be popular. But some combination is needed to rein in expenditures—and the amount we save will depend upon the mix of options chosen. If a 25% cut in Medicare expenditures were the outcome, we would see a $1.8 trillion saving over the next 10-year period. As shown in the figure on page 3, a 25% cut in Medicaid could add another $0.9 trillion.

While a $2.7 trillion saving is a decent start, to fix a $13.6 trillion deficit we have a long way to go. Let's consider other targets for spending reductions. A 25% cut in Social Security spending, which would require an increase in the retirement age or a substantial change in benefit structure, could raise another $2.3 trillion. A 25% cut in defense spending could add another $1.7 trillion, while simply cutting defense deployments could add $1 trillion. A 25% cut in discretionary, non-defense spending could add $1.5 trillion.

Summing the combined cuts, a 25% "cut" in spending would save about $8 trillion. Even so, we would be well short of the $13.6 trillion target. We could completely zero out discretionary spending (defense and non-defense) by the end of the decade and still not hit the target. In other words: we can't balance the budget, much less make a dent in the national debt, without substantial cuts in entitlement spending and/or substantial increases in revenue.

OPTIONS ON THE REVENUE SIDE

George Zodrow presented the menu of options on the tax side. Most startling was his estimate that if the Bush tax cuts were allowed to expire across all income groups, the additional tax revenue generated would be approximately $2.5 trillion. If the cuts expire only for people with income above $250,000, the added revenue would be only $0.7 trillion. Many economists have advocated removing the tax advantage of employer-provided insurance, which could add $2.7 trillion in tax revenues (see figure). Removing all itemized deductions could add $2.6 trillion.

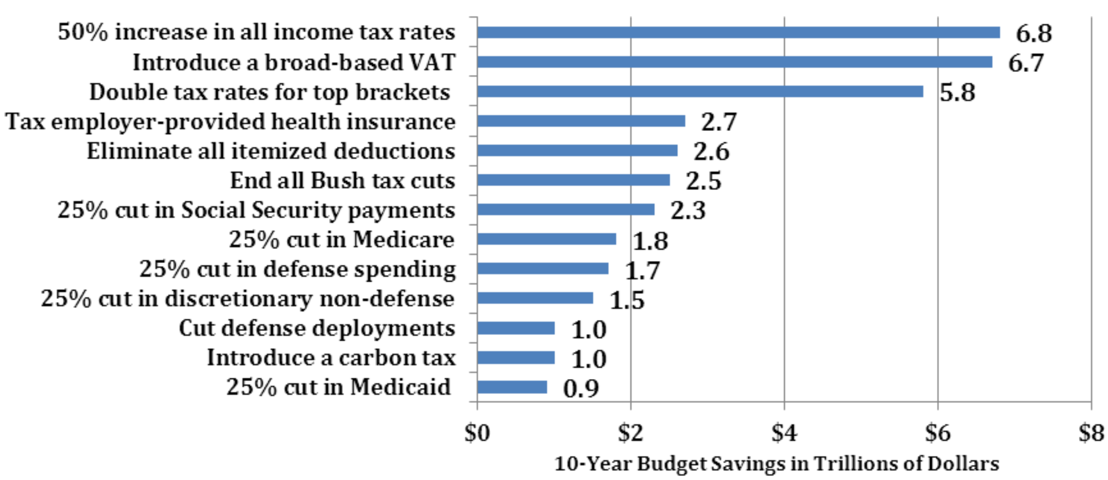
Another option would be to raise the tax rates of the existing tax code. While this one would raise a lot of revenue, it would also exacerbate the inefficiencies of the code. For example, boosting all tax rates by 50% (so that, for example, the 10% tax bracket becomes the 15% tax bracket and the 35% tax bracket becomes the 52.5% tax bracket) potentially could raise $6.8 trillion; doubling the tax rate of the top 3 rates (so that the 28% tax bracket becomes the 56% tax bracket, the 33% tax bracket becomes the 66% tax bracket and the 35% tax bracket becomes the 70% tax bracket) might raise as much as $5.8 trillion if nothing else changed. However, Zodrow cautioned that tax rates of this magnitude may not achieve their revenue targets because they will discourage work, savings, and investment.

> *Balancing the budget and taming the debt will take serious cuts and more revenue*

If we want to go for more revenue, perhaps now is the time to consider widespread reform of the tax system. Zodrow pointed out that the U.S. might consider adopting a form of value-added tax, or VAT. A VAT is simple to collect, has big revenue potential, and avoids taxing what Americans do too little of—saving. A broad-based 10% VAT tax is estimated to raise $6.7 trillion.

Another possible step would be to introduce a carbon tax, which would raise revenue while steering the economy to a low-carbon fuel mix. A carbon tax starting at $10 per ton (implying $.10 per gallon) and rising at inflation plus 4%, would generate $1 trillion over the next 10 years.

HOW DO WE CLOSE A $13.6 TRILLION GAP?



STALEMATE, COMPROMISE, OR MARKET PUNISHMENT?

The current mood in Washington seems to favor stalemate, with each party claiming that the other won't compromise. Indeed, a recent study suggests that the Senate and the House are more polarized now than at any time since 1879, when polarization is first measured.

But we must act, and the solution to our fiscal mess will be painful. The recent $38 billion cut can hardly be claimed a victory for fiscal responsibility. Compared to the looming deficits, it is insignificant. The real test lies in dealing with entitlements such as Medicare, Medicaid, and Social Security.

Even with sweeping reductions in expenditures, tax increases appear inevitable. Rather than putting Band-Aids on the current system, let's look for other revenue sources that encourage savings and provide environmental benefits.

In the absence of real compromise, we will muddle along for a while. But that is only a temporary and illusory solution. World credit markets will ultimately punish us, just as they did Greece. The punishment probably will not come soon, but it will come. It will come unexpectedly, with the fall of the dollar as the major world reserve currency. When this happens, all the TARPs and Stimulus bills in the world will not be able to rectify the situation.

Our view of the solution is that compromise and sacrifice are the magic words that have been lost from the Washington conversation. A failure to compromise has real costs, and without sacrifice now, the costs later will be much greater. We can't afford to fiddle around the edges of the budget while Washington burns.

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