The following essay, "***A Broken Federal Fiscal Policy…and How to Fix It***," was written by Center on Budget and Policy Priorities director Robert Greenstein and Brookings Senior Fellow Peter Orszag. It appears as a chapter in ***What We Stand For: A Program for Progressive Patriotism***, a book edited by Mark Green (of the New Democracy Project) and published in 2004 by Newmarket Press. The book includes 16 chapters on issues ranging from foreign affairs, combating terrorism, and nuclear proliferation to economic policy, urban policy, education, health care, environmental policy, civil rights, women's rights, and campaign financing. Authors include (among others) Gary Hart, Anne-Marie Slaughter, Christopher Edley, Samuel Berger, James Galbraith, Ronald Pollack, Ellen Chesler, and Mark Schmitt.

The essay by Greenstein and Orszag was completed in March 2004. Since then, some of the specific budget figures cited in the chapter have changed slightly with the issuance of subsequent budget forecasts by the Congressional Budget Office and other institutions, but the basic analysis and conclusions in the essay are not affected.

A Broken Federal Fiscal Policy…And How To Fix It

Robert Greenstein and Peter Orszag*

Avoid saddling future generations with unsustainable budget deficits—and threatening the ability of the government to function effectively—by increasing revenue, reforming the entitlement programs for the elderly, and enacting new budget rules

When George W. Bush took office a little over three years ago, the nation enjoyed the prospect of budget surpluses for several decades. No longer. Not only do we face large deficits in the years immediately ahead but, over time the combination of substantial tax cuts, the aging of the population, rising health-care costs, and significantly increased defense and anti-terrorism expenditures threatens to produce deficits of alarming proportions. These developments will have direct economic consequences and also have profound implications for the ability of the federal government to continue functioning effectively in the future, outside of a limited number of areas.

Major changes in fiscal policy are imperative. The first step is for the nation's leaders to stop "digging the hole deeper" and enacting legislation each year that makes the nation's long-term fiscal problems markedly worse. The second step is the enactment, possibly in increments, of a major program of fiscal reform that covers taxes, entitlements, and the rules under which the federal budget is crafted.

I. The Problem

The deficit is currently projected to approach $450 billion in fiscal year 2004, or about 4 percent of Gross Domestic Product (GDP), the basic measure of the size of the U.S. economy. If this large deficit were only a temporary phenomenon, it would not arouse concern. However, a forecast issued jointly by the Center on Budget and Policy Priorities, the Concord Coalition, and the Committee for Economic Development in September

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2003 — as well as separate forecasts from Brookings economists, Goldman Sachs, and other analysts — project cumulative budget deficits totaling approximately $5 trillion over the next ten years, even assuming a full economic recovery.

How large are these projected deficits? Sufficiently large that if policymakers decided to balance the budget by 2013, their options would include: raising income taxes by 27 percent, cutting Social Security benefits by 60 percent, terminating Medicare entirely, eliminating three-fourths of defense expenditures, or cutting everything other than Social Security, Medicare, defense, and homeland security by 40 percent. Such actions are politically unimaginable. Yet this barely begins to convey the magnitude of the budgetary crisis that lies ahead. For after 2013, these fiscal problems grow much more severe.

In subsequent decades, the Bush tax cuts (assuming they are extended) will reach their full dimensions, while Social Security, Medicare and Medicaid costs will swell with the retirement of increasing numbers of baby boomers and continued rapid increases in health care costs. Currently, federal expenditures for Social Security, Medicare, and Medicaid equal about 8 percent of the Gross Domestic Product. Twenty-five years from now, if we remain on our current course, these costs will equal 14 percent of GDP.

One might expect that with the demographic changes and increases in health care costs that lie ahead, policymakers would be laying the groundwork for a gradual *increase* in revenues to help defray at least part of the inevitable increase in expenditures. Instead, we have been pursuing the opposite course, instituting major changes in the tax system that are causing revenues to *decline* as a share of the economy.

In 2003, total federal tax revenues, measured as a share of the economy, were at their lowest level since 1959, and revenues just from the income tax were at their lowest level since 1942. This is a remarkable development given that, in 1959, there were no Medicare or Medicaid programs to finance and various other major programs did not yet exist. To be sure, revenues are projected to rise above 1959 levels as the economy fully recovers, but they will not climb much above those levels. If the Bush tax cuts are extended, the average level of revenues over the next decade will remain lower, as a share of the economy, than in the 1970s, 1980s, or 1990s.

We thus are heading toward historically high levels of federal expenditures due to the aging of the population and rising health costs, coupled with historically low levels of revenue due to the Bush tax cuts. This toxic combination will generate spiraling and unsustainable budget deficits that impose significant costs on the economy and inequitable burdens on our children and grandchildren. Although the precise magnitudes of these deficits are uncertain, the existence of a dangerously large long-term fiscal gap is not.

Deficits harm economic growth in the long term because they reduce national saving. National saving is the sum of private saving and public (or government) saving. (Budget surpluses represent public saving; a budget deficit results in negative saving because a portion of private savings must be used to cover the deficit.) Since public saving declines when the budget deficit increases, higher budget deficits reduce national saving, all else being equal. A reduction in national saving means Americans do not accumulate as much capital to invest in new plants, equipment and other enterprises, which deprives future generations of the income that would have been earned on those investments and produces a smaller economy—and lower wages and salaries for U.S. workers—than would otherwise have been the case.

To get a sense of the magnitudes involved, consider the projected deficits of approximately $5 trillion over the next 10 years. Under reasonable assumptions, these projected deficits will reduce income in the United States by more than $200 billion in 2014, or an average of about $1,500 per household. Moreover, the problem is expected to worsen substantially in subsequent decades. Under current policies, deficits are projected to swell from 3-4 percent of the Gross Domestic Product ten years from now to 12 percent of GDP by 2030 and more than 20 percent of GDP by 2040, leading to an explosion of the national debt. Over time, the economic cost of the deficits the nation faces will increase markedly, leaving future generations with a smaller economy and considerably less income.

In addition, because large deficits cause the debt to grow rapidly, an increasing share of the federal budget will have to be devoted to paying interest on the debt rather than financing necessary or worthwhile programs, such as investments in education, children's health, and infrastructure that could improve long-term growth. Interest payments for the ten years from 2002 to 2011 are now expected to be nearly $2 trillion higher than was projected in early 2001. If we continue on the current policy course, interest payments will exceed $450 billion a year by 2013 and continue rising after that.

The projected deficits are now so large that they ultimately could result in what former Treasury Secretary Robert Rubin has called "fiscal disarray." As investors become increasingly concerned that the government could resort to high inflation (to reduce the value of the debt it owes) or that a fiscal deadlock with unpredictable consequences could arise, investor confidence may weaken substantially, interest rates could rise markedly, and the role of the dollar as the primary currency of international exchanges could be threatened. Such developments would have even more serious adverse consequences than those already described.

It is unthinkable that the nation would endlessly pursue fiscal policies that ultimately do such substantial damage to the economy. Sooner or later, something will have to give. And that is what some conservative activists are counting on. They seek to use tax cuts and the specter of massive deficits to "starve the beast"—that is, to force radical shrinkage in the federal government.

This should not be regarded as an idle threat. If we remain on our current tax-cutting course but also seek to prevent deficits from becoming unsustainably large, there will be no alternative to curtailing federal activity sharply in a wide range of areas. We'd have to abandon initiatives to reduce the ranks of the uninsured, combat child poverty, or adequately rebuild the nation's aging schools, roads, and rail lines. In fact, if we proceed down this course, major parts of the Great Society and the New Deal are likely to be dismantled over time. By mid-century, the federal government may be a pale shadow of its current self, with consequent adverse effects on poverty, education, health care, the environment, and other areas of national life.

How did we get to this fiscal precipice? In early 2001, the nonpartisan Congressional Budget Office projected cumulative budget surpluses of $5.6 trillion over the next ten years (2002 – 2011). Today, the projection is for *deficits* of about $4 trillion over the same ten-year period. On a comparable basis, the negative swing in the federal government's fiscal position amounts to more than $9 trillion.

About two-thirds of the swing is due to reduced revenues rather than higher expenditures. The drop-off in revenues stems from both the tax cuts and changes in budget estimates; it now appears that the level of revenues assumed in 2001 was unrealistically high. On the spending side, the increases in projected expenditures have stemmed primarily from defense and homeland security, followed by the costs of the Medicare prescription drug bill. Other increases in domestic spending have generally played only bit roles in the fiscal deterioration.

The tax cuts merit particular attention. When fully in effect, their annual cost will equal nearly five times what the federal government spends on education. Indeed, their annual cost will exceed everything the federal government spends on veterans programs, transportation, housing and urban development, agriculture, food assistance, national parks, environmental protection, the Department of Homeland Security and Department of State *combined*. In the absence of the tax cuts, the budget would reach balance by 2011 rather than facing deficits in that year that are projected to exceed $550 billion.

Moreover, if the tax cuts are made permanent, their cost over the next 75 years will be *triple* the Social Security shortfall. It also will be more than the shortfall in Social Security and Medicare Hospital Insurance combined. In other words, if all the revenue from the tax cuts were instead devoted to Social Security and the Medicare Hospital Insurance program, the entire 75-year deficits in those programs could be eliminated. (We would not recommend such a course; it would go too easy on the large retirement programs while leaving highly insufficient revenues for other priorities.)

Advocates of the tax cuts argue, however, that these tax reductions will increase long-term growth and boost the economy. To be sure, reduced marginal tax rates may, by themselves, have a positive economic effect by increasing incentives for work, investment, and risk-taking, although the available evidence suggests such effects are generally modest. But tax cuts also increase budget deficits and thereby reduce national saving and future national income, an effect typically glossed over by tax-cut proponents.

The net effect of tax cuts on long-term economic growth reflects the combination of any positive effects on economic incentives *and* the negative effects from larger budget deficits. Given the structure of the 2001 and 2003 tax cuts, independent analysts have generally concluded that the positive effects on growth from reduced marginal tax rates will be cancelled out—and, in fact, are likely to be outweighed—by the negative effects from much larger deficits. When Congress's own Joint Committee on Taxation (whose head was appointed by the Congressional Republican leadership) evaluated the 2003 tax legislation, it concluded that "eventually the effects of the increasing deficit will outweigh the positive effects of the tax policy." An array of other economists at institutions such as the Federal Reserve Board and the Brookings Institution has reached much the same conclusion about the 2001 tax cut. Rhetorical claims that the tax cuts will come close to paying for themselves are not supported by any credible evidence. The evidence suggests that, if anything, the net effect of the recent tax cuts will be a reduction in long-term growth, in which case the tax cuts will cost even more than official estimates indicate.

A second justification advanced for the tax cuts is that they have helped the economy in the short run. Almost any tax cut or spending increase, however, can temporarily boost a weak economy. The challenge for policymakers facing a weak economy is to secure the maximum economic stimulus per dollar of cost to the federal Treasury. But the tax cuts enacted in recent years are costly, will remain in effect and grow larger after the economy has recovered and stimulus is no longer needed, and lead to lower national income in the future because of the large, ongoing deficits they generate. Furthermore, the tax cuts are concentrated primarily on higher-income individuals, a group that is more likely to save rather than spend their tax cuts than people who are less affluent; this makes the tax cuts less effective as immediate economic stimulus. We could have achieved greater short-term stimulus at much lower long-term cost by focusing on temporary fiscal relief to the states, temporary expansions in unemployment insurance benefits, and temporary tax cuts for low- and middle-income families, who are more likely to spend their tax-cut benefits quickly.

II. The Bush Response

The Bush Administration and Congress continue to pursue a course that will make these problems more severe. In the first half of 2003, Congress passed and the President signed a new package of large tax cuts, the cost of which is reflected in the budget figures cited above. In the second half of 2003, Medicare drug legislation was enacted that, according to Congressional Budget Office estimates, will cost approximately $1.3 trillion in the second decade it is in effect and continue rising in cost after that. The design of the Medicare legislation imposes costs far greater than is necessary to pay for the modest, rather patchy drug benefit it provides.

In the first half of 2004, the Administration has proposed yet another round of tax cuts that would have large costs over time: the creation of Lifetime Saving Accounts (LSAs) and Retirement Saving Accounts (RSAs). The LSAs and RSAs would exacerbate the misguided thrust of recent pension changes, which have substantially expanded opportunities for high-income households to shelter more saving and investment income from taxation. The Administration's new proposal would go further and ultimately lead to a very large share of investment income escaping taxation altogether. The proposal would engender mounting revenue losses but generate little new private saving, since high-income households could shift other assets into the tax-subsidized savings and investment accounts instead of having to undertake new saving to make use of the tax breaks. And it would result in mushrooming revenue losses over time. Over the next 75 years, the revenue loss would amount to about *half* of the entire Social Security deficit. In the face of massive projected budget deficits in future decades, forgoing such large amounts of revenue to create major new tax shelters which will subsidize saving that most high-income households would have undertaken anyway seems perverse.

What of the Administration argument that provoking a fiscal crisis will force policy-makers to address long-term "entitlement reform?"

If successful, such a strategy likely would result in larger reductions in Social Security and Medicare benefits for most beneficiaries than would otherwise be needed—as well as in partial privatization of these programs—in exchange for lower taxes primarily for high-income households. Alternatively, the strategy could fail. Although crises do tend to force action, a transparently self-imposed crisis is different from a crisis imposed by external forces, just as an arsonist is different from someone whose house burns down due to lightning.

More than two decades ago, Ronald Reagan's budget director David Stockman declared that in seeking to shrink or eliminate large budget deficits, policymakers should go after "weak claims, not weak clients." The current policy course threatens to stand this sentiment on its head. Powerful clients with weak claims—from the pharmaceutical industry to health insurance companies to HMOs, oil and gas companies, the financial securities industry, large agribusiness firms, and the nation's wealthiest individuals and families—are reaping substantial rewards from legislation enacted in recent years. Meanwhile, weaker clients—especially those with low incomes—are increasingly at risk. Current Administration proposals would begin to erect a structure under which resources for some of the key programs for poor households would likely fail to keep pace with need. This would enable the federal government to save increasing amounts over time but could cause many of the nation's poorest citizens to face growing hardship.

As one example, the Administration has proposed beginning to convert the Medicaid program into a block grant. Medicaid is now an entitlement; all low-income children, parents, elderly, and disabled people who apply and meet their state's eligibility criteria (which are set within federal parameters) are enrolled, and the federal government pays an average of 57 percent of Medicaid health care costs. Under a block grant, the federal government would pay a fixed amount to state Medicaid programs each year. If the costs of providing health care to the low-income population rose more rapidly than federal block-grant funding—because, for example, an increase in job losses has caused more people to lose their health insurance, or as a result of a flu or infectious disease epidemic—the federal government would *not* contribute to covering the higher expenditures, which would fall exclusively on state budgets. The likely result would be that over time, states would feel compelled to scale back health care coverage for low-income households.

The Administration also has proposed to convert the nation's largest low-income housing program to a block grant and to freeze funding for a number of years to come, with no adjustment for inflation, either for it or for a welfare "reform" block grant. This, despite the fact that funding shortages already have led more than half of the states to cut welfare-to-work programs, child care assistance, or similar forms of job-related assistance that were supposed to be the centerpiece of welfare reform.

Taken together, such proposals suggest the Administration may be seeking to convert a growing number of entitlement assistance programs for low-income families and individuals into block grants as part of a slowly emerging "spending control" strategy. To help secure enactment of such proposals, the proposals may be designed to provide adequate funding in the initial years the block grants would be in place. After that, funding for such block grants is likely to fall steadily further behind need. In addition, when full-blown federal budget crises begin to hit at some point in the future, the block-grant funding structure would provide a ready mechanism to ratchet funding for these programs down further.

This fiscal policy course also is likely to result in a further widening of income disparities already at, or close to, their widest levels in decades. The most reliable data on this matter come from the Congressional Budget Office, which combines Census Bureau data with Internal Revenue Service data drawn from federal income tax returns. These data show that between 1979 and 2000 (the most recent year for which the data are available), income inequality grew sharply, as income gains at the top of the income spectrum far outpaced gains in the middle and at the bottom. Average after-tax income increased by nine percent over this period among the bottom fifth of the population (after adjusting for inflation) and by 15 percent for the middle fifth. But average after-tax income rose 68 percent for the top fifth. And for the top one percent, average after-tax income registered a stunning 201 percent increase. Disparities in after-tax income appear to have been wider in 2000 than at any time since 1936, and possibly at any time since 1929. The recent tax cuts will only worsen these trends by raising after-tax incomes by much larger percentages for high-income households than for those in other parts of the income spectrum.

A continuation of the current policy course poses considerable risks to state and local governments, as well. Federal policy has begun to batter state and local finances through such measures as federal tax cuts that engender *state* revenue losses, due to linkages between federal and state tax codes. (Most state income tax codes use the federal definition of taxable income; shielding more income from the federal income tax consequently causes the same result at the state level, unless states can enact legislation delinking their tax codes from the federal tax changes, which can be difficult politically.) As the federal budget crunch takes increasing hold in coming years and decades, state and local governments also may face declines in federal grants-in-aid, as well as a shift of more responsibilities from the federal government to state and local levels without commensurate federal resources to cover the costs of those responsibilities.

Due in substantial part to the coming retirement of the baby boomers and continued increases in health care costs, long-term fiscal prospects are deeply troubled in many states. Federal policy threatens to exacerbate these problems.

III. Solutions

As this discussion suggests, changing course on fiscal policy and budget priorities is one of the most crucial tasks the nation faces. Indeed, if we do not change course, the resulting fiscal failure is likely to foreclose consideration of many of the other recommendations made in this volume.

Stop Digging the Hole Deeper

The first step is to "stop digging the hole deeper." The key mechanism to achieve this goal is well known: to reestablish the "Pay-As-You-Go" rules that served the nation well through most of the 1990s. Under these rules, all tax cuts and entitlement increases would have to be offset by tax increases or entitlement reductions of equal magnitude. The experience of the 1990s demonstrates such a regimen can work effectively and result in substantial budget restraint.

The Pay-As-You-Go rules should be applied to all future tax cuts and entitlement expansions, except for emergency measures that are strictly temporary in nature (such as temporary tax cuts or unemployment insurance increases during a recession). These rules should apply, for example, to legislation to extend the recent tax cuts, including tax-cut provisions that have broad appeal. If tax cuts are meritorious, their extension should be paid for through offsetting tax or entitlement measures. These rules should similarly apply to efforts to fill gaps in the new Medicare drug benefit.

In reinstating the Pay-As-You-Go rule, policymakers also should close a loophole in the rule. Because budget costs typically are measured over a period of five or ten years, policymakers have become adept in using gimmicks to design tax cuts and other measures so that their costs remain moderate in the first five or ten years, only to explode thereafter. A reinstated Pay-As-You-Go rule should direct the official cost-estimating agencies to estimate the revenue losses from a tax cut or an entitlement expansion over a longer period and require that other budget changes offset the budgetary costs over the extended period.

A "Grand Bargain"

The second step is the most difficult, especially in the current political environment — to craft a "grand bargain" that marries reform in Social Security and several other entitlement programs with revenue-raising measures. A combination of entitlement-restraining and revenue-increasing measures was the hallmark of the 1990 and 1993 deficit reduction packages, which played an important role in erasing deficits in the 1990s. A new package also could establish reasonable limits on discretionary spending, as the 1990 and 1993 packages did. In addition, as in 1990 and 1993, a new package could devote the majority of the savings it generates to getting the budget picture under control but use some of its savings to address critical unmet national needs.

The following are among the elements of such a "grand bargain."

1. Social Security. One of America's most successful and revered government programs, Social Security faces a long-term deficit. Addressing the long-term Social Security deficit would put both the program and the federal budget on a sounder footing. Lawmakers do not, however, have to destroy Social Security in order to save it.

In a new book—*Saving Social Security: A Balanced Approach*—Peter Diamond and Peter Orszag present a proposal that would restore long-term balance to Social Security while preserving the program's basic structure and strengthening its social insurance functions. Their plan would make Social Security solvent for the next 75 years and beyond without drawing on general revenues and further squeezing the rest of the budget. Instead, it combines revenue and benefit changes, reflecting the type of balanced approach adopted in the 1983 Social Security reforms.

The plan addresses the various factors that underlie Social Security's long-term deficit. One factor, for example, is increasing life expectancy. As life expectancy grows, beneficiaries collect Social Security benefits for more years, on average, and that raises program costs. The Diamond-Orszag plan contains modest benefit reductions and payroll tax increases that, between them, finance the increased Social Security costs that the growth in life expectancy will generate.

Similarly, the plan includes measures to counter the adverse effects on Social Security financing of the growing disparities in earnings in the United States. Because of these growing disparities, an increasing share of earnings escapes the payroll tax, which does not apply to earnings above $87,000 in 2003. On a related front, life expectancy is increasing more rapidly among affluent individuals than among those at lower income levels; this tends to increase the total amount of Social Security benefits paid over the course of an individual's retirement more substantially among those on the higher rungs of the income ladder, making Social Security less progressive over time. To address these matters, the Diamond-Orszag plan gradually increases the ceiling on the amount of earnings subject to the payroll tax and also includes a benefit reduction targeted on people with high lifetime earnings. These elements of the plan help restore Social Security solvency in a progressive manner. The plan includes several other adjustments, as well.

Workers who are 55 or older in 2004 would, under the plan, experience no change in benefits from those promised under current law. A worker age 45 today who earns average wages over his or her career would experience a benefit reduction of less than one percent. An individual who is 25 today and earns average wages would face a benefit reduction of less than nine percent. (The benefit reductions are larger for those who are younger today because the reductions phase in gradually.) The payroll tax increases also would be modest. Today's 25-year-old average wage-earner would face a payroll tax increase equal to less than 0.3 percent of his or her lifetime wages.

In addition to these benefit reductions and payroll tax increases, the plan contains a series of improvements in Social Security's financial protections for particularly vulnerable beneficiaries, such as workers with low lifetime earnings, widows and widowers, disabled workers, and young survivors of deceased workers. The Diamond-Orszag plan demonstrates that it is not necessary to replace part of Social Security with individual accounts—which would bring a new and serious set of problems—to restore long-term, sustainable solvency to this valuable program.

2. Superlative CPI. Many government benefit programs (including Social Security) and various provisions of the tax code (including the personal exemption, standard deduction, and the marginal tax bracket ranges) are indexed each year to inflation. Research has shown that the index used to adjust these amounts each year, the Consumer Price Index, slightly overstates inflation. The consequence is that revenues are lower and benefit payments higher than they would be if a more accurate index were used.

The Bureau of Labor Statistics has now developed a "superlative" Consumer Price Index that measures inflation more accurately than the traditional Consumer Price Index does. Using the improved index in the future would reduce measured inflation by an estimated two-tenths of one percent per year. Applying the more accurate index to both benefit programs and the tax code would reduce the deficit by tens of billions of dollars a year. Over time, the positive effects on deficits would become very substantial.

3. Restraining the Rate of Growth in Health Care Costs. Among changes in Medicare should be the elimination of excessive subsidies to private health plans such as HMOs. Under the recently enacted prescription drug legislation, HMOs will be paid approximately 25 percent more to serve Medicare beneficiaries than it costs the regular Medicare program to provide equivalent services. Unwarranted subsidies of this nature essentially constitute an unacceptable form of corporate welfare. Subsidies that Medicare provides to teaching hospitals also have been found to be larger than is necessary and can be reduced. In addition, Medicare should use its purchasing power to lower the amounts it pays for prescription drugs and certain other items such as durable medical equipment. Finally, given the gravity of our long-term fiscal problems, Medicare premiums may need to be raised. Lower-income beneficiaries and state governments should be shielded from such premium increases.

Medicare and Medicaid costs will rise rapidly, however, even with changes such as these. Making further progress in moderating expenditure growth entails moderating health care cost growth *systemwide*—that is, in the public and private sectors alike. To reduce cost growth substantially in Medicare and Medicaid without similarly restraining expenditure growth in the private health-care sector would require poor, old, and disabled people to pay excessive amounts to use covered health care services, deny them coverage altogether for some important services, make significant categories of poor, old, and disabled people ineligible for these programs and thereby increase the ranks of the uninsured—or institute cost-control measures that lower the costs of public-sector programs primarily by shifting costs to the private sector.

The United States spends considerably more on health care than other industrialized nations, without corresponding increases in health care quality and coverage. Achieving change in the structure of the U.S. health care system is a daunting task. It may prove critical, however, to efforts to maintain a federal government that provides adequate levels of service in other areas. (See also Chapter ____, by Ronald Pollack.)

4. Defense, Agriculture, and Other Budget Savings. Savings also can be sought in some other areas. Work by various defense analysts, including

Lawrence Korb—a leading defense analyst who served as a former assistant secretary in the Pentagon during the Reagan Administration—suggests that significant savings can be achieved in the Defense Department without reducing national security. Farm price supports and related agricultural subsidies are another target for savings, as are certain business subsidies sometimes referred to as "corporate welfare" that can distort economic activity and do not benefit the overall economy.

5. Tax Reforms. Restoring fiscal discipline will require raising substantial revenue. Closing the projected budget deficit largely or entirely through program cuts is implausible; the public will not stand for cuts in basic benefits and services of the depth that would be required. Relying largely or entirely on budget cuts also would be undesirable, as the steep cuts that would result could lead to outcomes such as increased poverty, more Americans without health insurance, further deterioration of the nation's physical infrastructure, and weaker environmental and health and safety protections.

Revenue-raising measures can help reduce the budget deficit and thereby increase national saving. As a result, carefully designed revenue increases can have a beneficial long-term effect on the economy. Just as deficit-financed tax cuts can *reduce* long-term growth, so can well-designed revenue increases that shrink deficits *enhance* long-term growth.

This raises several questions. If a Pay-As-You-Go-Rule is instituted under which the cost of extending the recent tax cuts must be offset—as we recommend—which tax cuts should be extended and which jettisoned? And how can we raise additional revenue as part of a long-term deficit reduction plan? Here are some guidelines for revenue measures that warrant consideration.

- Cancel the income tax cuts not yet in effect, which overwhelmingly benefit high-income households. In addition, once the economy has recovered, either discontinue certain income-tax cuts already in effect or allow them to expire, particularly tax cuts that are costly and provide benefits disproportionately to affluent households (such as upper-bracket rate cuts and the reductions in tax rates for dividends and capital gains).

- Reform rather than repeal the estate tax. The 2001 tax-cut legislation eliminates the estate tax in 2010. A sound way to retain tens of billions of dollars of badly needed revenue would be to preserve the estate tax but only for estates with assets above $3 million or so. Such an estate tax would apply only to the estates of about five decedents of every 1,000—or approximately 10,000 estates out of the more than two million people who die each year. (Another option is to replace the estate tax with an inheritance tax, which would contain exemptions for inheritances up to some level, such as $1 million per heir.)

- Ensure that the temporary business tax cuts enacted as part of the 2002 stimulus legislation are not extended. These provisions were intended to spur business investment during the recession, not to serve as a permanent subsidy. They should expire when the economy recovers, just as the temporary program of federal unemployment benefits will.

- Close corporate loopholes and broaden the tax base. Broadening the tax base would generate additional revenue without increasing tax rates. It also could improve economic efficiency by lessening the degree to which investment and other economic decisions are distorted by differential tax treatments for otherwise similar types of activities. For example, the corporate tax code provides subsidies, through special depreciation schedules and other measures, to the mining, timber, and oil and gas industries. Many of the tax-subsidized activities are environmentally detrimental. Removing unwarranted subsidies such as these could both raise revenue and protect the environment. Corporations also are able to reduce their tax liabilities through "corporate inversions," under which they move their official headquarters to foreign tax havens. While policymakers have adopted some restrictions on corporate inversions, more stringent rules are needed to prevent such tax avoidance.

- Reform the Alternative Minimum Tax in a deficit-neutral manner. The AMT was originally designed to collect taxes on higher-income filers who aggressively sheltered much of their income but is on course to extend to an ever-growing number of taxpayers over time. Without changes, 35 million filers will have to pay the

AMT by 2010, up sharply from the two to three million taxpayers who are subject to the AMT today. The AMT could be redesigned in a deficit-neutral manner so it accomplishes its original goal without burdening ever-growing numbers of middle-income filers. This could be done by freeing most middle-income filers from the AMT, while making it more robust and effective with regard to high-income filers, who largely escape the AMT today.

- Improve IRS enforcement. The Internal Revenue Service lacks sufficient resources to enforce tax obligations effectively, and many taxpayers do not pay the taxes they owe. Providing the IRS with the resources it needs to collect taxes that people owe would cost approximately $2 billion a year and could boost revenues by roughly $30 billion a year.

- Increase "sin" taxes. The excise tax on cigarettes raises the price of cigarettes and discourages smoking; an increase in this tax would help cut smoking, particularly among teenagers, who are more sensitive to the price of cigarettes. Similarly, taxes that raise the price of alcohol discourage drinking, even among heavy drinkers. Raising the excise taxes on alcohol and tobacco products could promote better health but would be regressive. To offset the regressivity, such tax increases could be coupled with progressive tax reductions, such as improvements in the Earned Income Tax Credit or the low-income component of the Child Tax Credit.

- Reinstitute a luxury tax. At times in the past, the United States has levied a luxury tax on the purchase of such items as yachts, private airplanes, and items such as very expensive automobiles and jewelry. Reinstitution of such a reasonable levy could be considered.

- Another possibility is to introduce a value-added tax (VAT) in the United States to help reduce long-term budget deficits. Most developed nations and all members of the European Union impose a VAT. A broad-based VAT (one that excludes only small businesses, education, religion, and health care) would generate revenue equal to about one-half of one percent of GDP for each one percentage point of the tax. By itself, a VAT would be regressive, so it would need to be accompanied by other tax-code changes to maintain the overall progressivity of the code.

5. Addressing Priority Needs. A portion of the savings from the measures just outlined should be devoted to meeting critical needs. The list of competing demands (and competing interest groups) far exceeds what can be afforded, however, so only high-priority initiatives would be able to be funded. Many desirable proposals and program initiatives will not "make the cut."

Determining the highest priorities for new resources lies beyond the scope of this chapter, but the following are among the areas that represent strong candidates for priority designation.

- Increase international assistance. Roughly three billion people across the globe live on $2 a day or less. More than one billion people live on $1 a day or less. Targeted investments—for example, in fighting AIDS, malaria, tuberculosis and other global health problems and in adequately funding the Millenium Challenge Account initiative that targets aid to low-income countries—could reap large rewards. Yet the U.S. spends only about 0.6 percent of the federal budget on international development and humanitarian assistance, well below its historical average and much smaller as a share of the economy than other industrialized nations.

- Reduce substantially the ranks of the uninsured. It's untenable both that 44 million people in the United States lack health insurance and that, in the typical (or median) state, the income cut-off for working-poor parents to qualify for public health insurance through Medicaid is only 71 percent of the poverty line, or $10,840 a year for a family of three (in 2003). Expanding Medicaid and the State Children's Health Insurance Program, and establishing a counter-cyclical matching formula for Medicaid so the federal share of Medicaid costs increases during recessions, would be a good first step.

- Boost in child care assistance for low- and moderate-income working families. Only about one in seven children in low- and moderate-income families that meet the federal eligibility criteria for child care assistance received such assistance in 2000. Inadequate assistance can limit participation in the work force. It also can lead to young children being placed in low-quality care that can hinder their educational development. In this vein, expansions and improvements in early childhood education, Head Start, and Early Head Start would represent sound investments.

- Reduce child poverty and related problems of hunger and homelessness. Child poverty—affecting one in every six children—remains substantially higher in the United States than in Canada or Western Europe. In addition, the number of households seeking emergency food assistance continues to rise, and nearly five million low-income households face what HUD terms "worst case housing needs." These households pay more than 50 percent of their income for housing, live in severely substandard housing, or both. The need for these households to pay such large percentages of their small incomes for housing can leave them with insufficient funds for other necessities such as food and can push some families into homelessness.

- Enhance retirement security. Many households are not accumulating sufficient assets to finance a dignified retirement and pay for the long-term care they may need. Instead of continuing to increase the amounts that high-income households can save in tax-subsidized accounts, policymakers should expand an existing tax credit that can help modest-income families save for retirement and make the credit (known as the Saver's Credit) refundable—that is, make it available to workers who earn too little to owe federal income tax. Policymakers also should encourage the spread of pension plans in which workers are automatically enrolled (unless they object) and should seek to enhance financial literacy.

- Improve higher education. In recent years as state budgets have come under increasing pressure, funding for state colleges and universities has been scaled back. Tuition has risen, often sharply. There also has been a slow deterioration in the quality of public higher education. With roughly three-quarters of college students enrolled at public institutions, the implications are serious for both students and the economy. Significant additional resources, including increased resources for financial aid to low-income students, are necessary. The federal government also should simplify the process of applying for financial aid to make the process less intimidating for low-income households.

The United States has lost its fiscal bearings. The tax cuts enacted under the current Administration will reduce long-term growth, exacerbate income inequality, and impose an unfair burden on our children and grandchildren. Rather than continuing to provoke a fiscal crisis, policymakers should seek a "grand bargain" in which pay-as-you-go budget rules are reinstated, revenue increases instituted, and the large entitlements for older Americans reformed.

"A Broken Federal Fiscal Policy…and How to Fix It," by Robert Greenstein and Peter Orszag

Much of this chapter draws on joint work with Richard Kogan, William Gale, Isaac Shapiro, and David Kamin, and Henry Aaron, but the views expressed here represent those of the authors alone.

Change in the long-term budget forecast, page 1: The first Bush Administration budget, submitted in February 2001, projected budget surpluses every year through about 2035. By contrast, the Bush budget submitted in February 2003 projected deficits every year in perpetuity under Administration policies.

Projections that deficits will total $5 trillion over the next decade, page 1: These forecasts were designed to capture the effect of remaining on the current policy course; they assume extension of the Bush tax cuts, full funding of the President's defense program, and maintenance of funding for other non-entitlement programs at today's levels, adjusted for inflation and population growth. Center on Budget and Policy Priorities, the Committee for Economic Development, and the Concord Coalition, "The Developing Crisis — Deficits Matter" and "Mid-Term and Long-Term Deficit Projections," September 29, 2003; Ed McKelvey, "The Federal Deficit: A $5.5 Trillion Red Elephant," Goldman Sachs, September 9, 2003; William G. Gale and Peter R. Orszag, "The Budget Outlook: Baseline and Adjusted Projections," *Tax Notes*, September 22, 2003.

Magnitude of the policy changes needed to balance the budget by 2013, page 1: CBPP, CED, and the Concord Coalition, *op. cit.*

Tax revenue over the next decade, relative to the 1970s, 1980s, and 1990s, and on the size of the long-term deficits, page 2: CBPP, CED, and the Concord Coalition, *op.cit.*

Possibility of fiscal disarray, page 3: Robert E. Rubin, Peter R. Orszag, and Allen Sinai, "Sustained Budget Deficits: Longer-Run U.S. Economic Performance and the Risk of Financial and Fiscal Disarray," Paper presented at the AEA-NAEFA Joint Session, "National Economic and Financial Policies for Growth and Stability," January 4, 2004.

$9 trillion swing, page 3: CBPP, CED, and the Concord Coalition, *op. cit.*

Causes of the fiscal deterioration, pages 3-4: Richard Kogan, "Swelling Deficits: Increased Spending Is Not the Principal Culprit," Center on Budget and Policy Priorities, October 27, 2003.

Relative size of the tax cuts, page 4: Calculations by Richard Kogan, Center on Budget and Policy Priorities.

Studies of the economic effects of the 2001 tax cut, page 4: The Congressional Budget Office has concluded that "the revenue measures enacted since 2001…will probably have a negative effect on saving, investment and capital accumulation over the next 10 years." Similarly, William Gale and Samara Potter of the Brookings Institution have estimated that the 2001 tax cut is more likely to reduce than to increase the size of the economy over the long run, because the negative effect of the decline in national saving that will result from the enlarged budget deficits that the tax cut will engender will outweigh the positive effect of reduced marginal tax rates. Douglas Elmendorf and David Reifschneider of the Federal Reserve. Alan Auerbach of the University of California at Berkeley, and Peter Orszag have all found similar results. See: Joint Committee on Taxation, *Macroeconomics Analysis of H.R. 2, The "Jobs and Growth Reconciliation Tax Act of 2003,"* 108th Congress, 1st session, 2003; Congressional Budget Office, *The Budget and Economic Outlook,* August 2003. Douglas W. Elmendorf and David L. Reifschneider, "Short-Run Effects of Fiscal Policy with Forward-Looking Financial Markets," prepared for the National Tax Association's 2002 Spring Symposium; William G. Gale and Samara R. Potter, "An Economic Evaluation of the Economic Growth and Tax Relief and Reconciliation Act of 2001," *National Tax Journal* 54 No. 1 (March 2002), pp. 133-86; Peter R. Orszag, "Marginal Tax Rate Reductions and the Economy: What Would Be The Long-Term Effects of the Bush Tax Cut?" Center on Budget and Policy Priorities, March 2001; and Alan Auerbach, "The Bush Tax Cut and National Saving," prepared for the 2002 Spring Symposium of the National Tax Association, May 2002.

Rhetorical claims about tax cuts paying for themselves, page 4: Even the President's own economists have acknowledged that the tax cuts will not pay for themselves. Council of Economic Advisers, *Economic Report of the President* (Washington, D.C.: United States Government Printing Office), February 2003.

Medicare prescription drug legislation, page 5: For example, the legislation prohibits the federal government from using Medicare's vast purchasing power to negotiate lower prices for drugs, as the Department of Veteran's Affairs does. And in an effort to draw more private health care plans into Medicare, the bill subsidizes HMOs to the point that they will be paid over 25 percent more than it costs the traditional Medicare program to provide the same types of services. See Jeanne Lambrew, "Medicare Legislation: Think Twice," Center for American Progress, November 14, 2003; and Transcript of the Medicare Payment Advisory Commission Meeting, October 9, 2003.

LSAs and RSAs, page 5: The estimate provided here of the long-term cost of LSAs and RSAs, relative to the size of the Social Security deficit, is based on the proposal in the Administration's FY 2004 budget.

Effects of the proposal to block-grant Medicaid, page 6: See Cindy Mann, Melanie Nathanson and Edwin Park, "Administration's Medicaid

Proposal Would Shift Fiscal Risks to States," Center on Budget and Policy Priorities, April 22, 2003; and John Holahan and Alan Weil, "Block Grants Are the Wrong Prescription for Medicaid," Urban Institute, May 27, 2003.

State cuts related to welfare reform, page 6: See Sharon Parrott and Nina Wu, "States Are Cutting TANF and Child Care Programs," Center on Budget and Policy Priorities, June 3, 2003.

Income disparities, page 7: See Congressional Budget Office, *Effective Federal Tax Rates, 1997-2000,* August 2003.

Recent tax cuts and inequality, page 7: Analysis by the Urban Institute-Brookings Tax Policy Center finds that extending the income-tax cuts enacted in the past three years will raise after-tax income in 2013 by an average of six percent for the top one percent of households but only 0.1 percent for the bottom fifth of households.

State revenue losses, page 7: Most state income tax codes use the federal definition of taxable income; shielding more income from the federal income tax therefore tends to have a parallel result at the state level. See Iris J. Lav, "Federal Policies Contribute to the Severity of the State Fiscal Crisis," Center on Budget and Policy Priorities, October 17, 2003.

Extending the budget rules beyond 10 years, page 8: Long-term revenue losses are typically estimated by assuming a constant share of GDP after the tenth year, although other procedures will be needed in cases where tax or entitlement changes are designed in such a way that significant increases in revenue losses or entitlement costs will result *after* the tenth year. The long-term revenue losses and entitlement costs would be measured in "present value," which is the immediate amount that, with interest, matches the future flow of revenue losses or entitlement cost increases each year in the future. The offsets also would be measured in present value.

Social Security reform, pages 8-9: See Peter A. Diamond and Peter R. Orszag, *Saving Social Security: A Balanced Approach* (Washington DC: Brookings, 2004).

Medicare subsidies to teaching hospitals, page 10: See Henry J. Aaron and Peter P. Orszag, "Social Security, Medicare, and Medicaid," in Alice Rivlin and Isabel Sawhill, *Restoring Fiscal Sanity* (Washington DC: Brookings, 2004) .

Securing savings in the Pentagon, page 10: See Testimony of Lawrence J. Korb before the House Budget Committee, February 12, 2002; Michael E. O'Hanlon, "Limiting the Growth of the U.S. Defense Budget," (Washington, DC: Brookings, 2002); and Testimony of Steven Kosiak, Center for Strategic and Budgetary Assessments, before the House Budget Committee, February 27, 2003.

Tax reforms, page 10: See Henry Aaron, William Gale, and Peter Orszag, "Meeting the Revenue Challenge," in Rivlin and Sawhill, *op. cit.*

IRS enforcement, page 12: Leonard Burman, "Tax Evasion, IRS Priorities, and EITC Precertification," Statement before the United States House of Representatives Committee on Ways and Means, July 17, 2003.

Other tax changes, page 12: Another desirable tax policy change would be to repeal the provision of the Medicare drug bill that establishes Health Savings Accounts. These accounts represent an unprecedented and fiscally dangerous type of tax shelter, since deposits into the accounts are tax deductible *and* withdrawals from the accounts are tax free. HSAs also represent ill-advised health policy. Healthier, more affluent workers may elect to enroll in HSAs in substantial numbers in coming years and to withdraw from comprehensive health insurance. (HSAs may be used only in conjunction with high-deductible health insurance; people with comprehensive health insurance policies may not use HSAs.) If healthier workers withdraw from comprehensive insurance, the pool of workers remaining in comprehensive insurance will become older and sicker, on average, thereby forcing premiums for comprehensive insurance to rise. That could lead to erosion in the affordability, and even the availability, of comprehensive employer-based insurance. See Robert Greenstein and Edwin Park, "Health Savings Accounts in Final Medicare Conference Agreement Pose Threats Both to Long-Term Fiscal Policy and to the Employment-Based Health Insurance System," Center on Budget and Policy Priorities, December 1, 2003.

U.S. spending for international assistance, page 12: Nancy Birdsall, Isaac Shapiro, and Brian Deese, "How Significant are the Administration's Proposed Increases in Foreign Development Aid?," Center for Global Development and Center on Budget and Policy Priorities, May 20, 2003. The 0.6 percent of GDP level, which was proposed in the President's fiscal year 2004 budget, will be temporarily exceeded as a result of the costs of reconstruction in Iraq.

Households with "worst case housing needs," page 13: U.S. Department of Housing and Urban Development, *A Report on Worst Case Housing Needs in 1999: New Opportunities Amid Continuing Challenges* (Washington DC: United States Government Printing Office, January 2001).