

TESTIMONY OF ROBERT GREENSTEIN
Executive Director
Center on Budget and Policy Priorities

before the
Senate Budget Committee

January 30, 2007

I appreciate the invitation to appear before you today. I direct the Center on Budget and Policy Priorities, a nonprofit policy institute that conducts research and analysis on fiscal policy matters, as well as on programs and policies for low-income families and individuals.

Last winter, the Center was asked by the Carnegie Roundtable on Economic Security to review all long-term budget projections that had been conducted, assess their strengths and weaknesses, examine the latest data, and construct new long-term projections. While we presented initial results to the Roundtable in May, this is a task we have worked on for close to a year. As part of this effort, we have shared our methodology and sought comments and recommendations from many of the nation's leading budget experts, including a number of former directors of the Congressional Budget Office. We released yesterday the analysis and projections that are the product of this enterprise, and I am pleased to present them to you today. These new budget projections extend through 2050.

The projections, based heavily on data and estimates from the Congressional Budget Office, are deeply disquieting. They show that the nation's budget policies are unsustainable. Deficits and debt will grow to unprecedented and dangerous levels if policy changes are not made.

The new projections also shed light on the sources of these problems and on the types of changes that would be needed to address them responsibly. Our principal findings are the following:

- The main sources of rising expenditures are rising health care costs (throughout the U.S. health care system) and demographic changes, which together will drive up spending for the “big three” domestic programs — Medicare, Medicaid, and Social Security.
- Increases in health care costs per beneficiary in Medicare and Medicaid essentially mirror increases in costs per beneficiary in the overall U.S. health care system. As Comptroller General David Walker has pointed out, a solution to the long-term fiscal problem will require not only difficult choices to reduce programs and increase revenues, but also fundamental changes in the entire U.S. health care system.
- Tax policy decisions that Congress will face in coming years will have a substantial impact on the magnitude of the long-term problem. If Congress lets recent tax cuts expire by 2010 as scheduled or extends them (in whole or in part) but offsets the costs, the size of the fiscal problem through 2050 will shrink by 60 percent. This is because the resulting deficit reduction would begin in the next few years and have a steadily increasing impact on federal interest payments with each passing year. As a result, it would reduce long-term deficits by increasing amounts over time. Even so, the budget would remain on an unsustainable fiscal path.

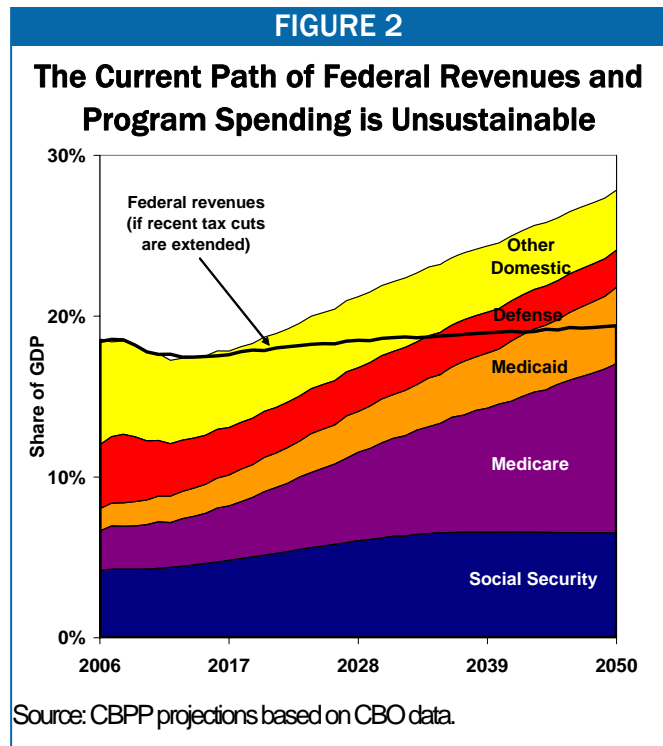
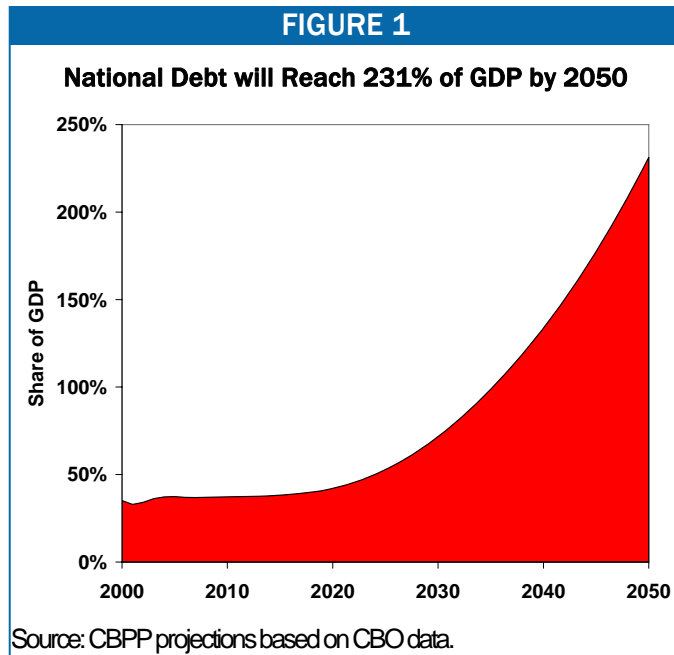
- Federal programs *other than* Medicare, Medicaid, and Social Security — including entitlement programs other than the “big three” — are not expected to grow rapidly. To the contrary, these programs will shrink as a share of the economy and thus will consume a smaller share of the nation’s resources in 2050 than they do today. These programs thus do not contribute to the long-term problem.

Current Budget Policies are Unsustainable

The nation’s budget policies are unsustainable. Our projections show that if current budget policies are continued (e.g., if current laws governing Medicare, Social Security, and other programs remain unchanged, the 2001 and 2003 tax cuts are made permanent, and relief from the Alternative Minimum Tax is continued), deficits will reach about 20 percent of the Gross Domestic Product by 2050, and the national debt will climb to 231 percent of GDP by that year, or more than twice the size of the U.S. economy. Debt-to-GDP ratios in this range are unprecedented in the United States, even during major wars.

Debt at this level would seriously damage the economy. It also would place severe strains on the federal budget. For example, by 2050, simply paying interest on the national debt would consume more than half of annual projected federal revenues.

Another way of measuring the size of the problem is to examine the magnitude of the long-term *fiscal gap*. The fiscal gap represents the amount of program reductions or revenue increases needed over the next four decades to ensure that the debt, measured as a share of the economy, is no larger in 2050 than it is today. Under our projections, the fiscal gap equals 3.2 percent of projected GDP through 2050. Hence, stabilizing the nation’s finances through 2050 would require annual tax increases or budget cuts equal to 3.2 percent of GDP, starting with



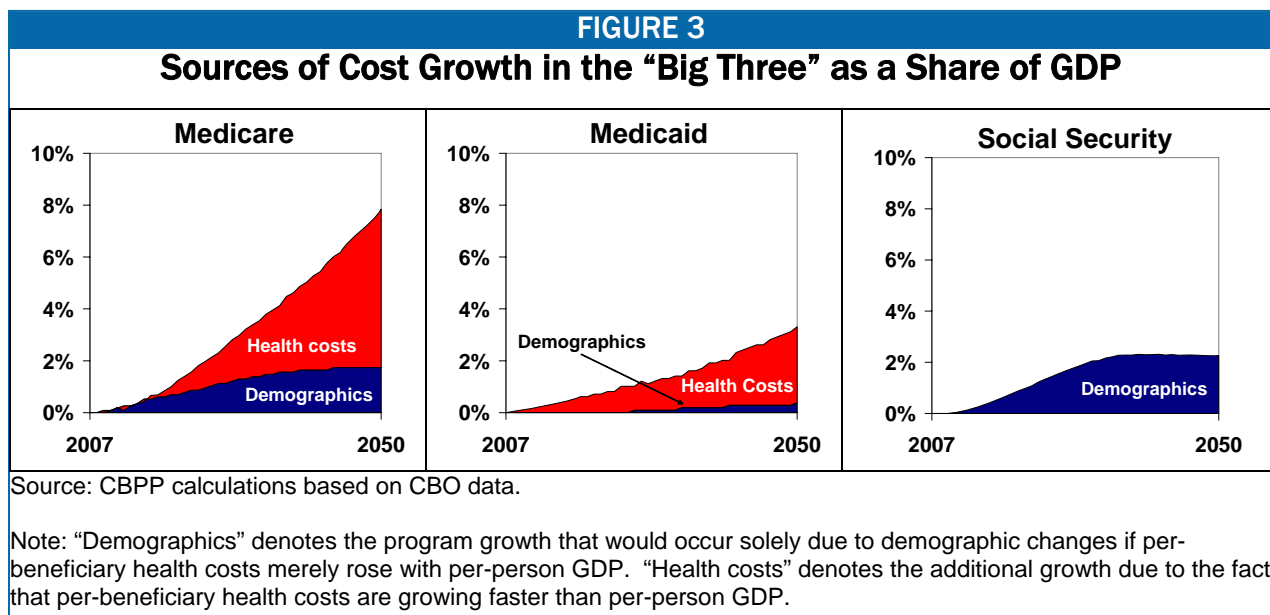
tax increases and budget cuts totaling \$461 billion in 2008 alone. (\$461 billion equals 3.2 percent of projected GDP for 2008.)

As these figures suggest, eliminating a fiscal gap equal to 3.2 percent of GDP would be very difficult. Even so, some may wonder how it is that the nation could reduce the debt in 2050 from 231 percent of GDP to its current level of 37 percent of GDP simply by making annual changes equal to 3.2 percent of GDP. This is possible if the changes *start immediately*. If we instituted these revenue increases or program reductions this year, we would begin running surpluses rather than deficits, which would decrease rather than increase the national debt. The reductions in the debt, in turn, would reduce interest costs in every year through 2050, bringing the “miracle of compound interest” to bear on the budget problem. Compound interest also can work against us, however: if little or no deficit reduction is enacted in the near future, substantially larger deficit reduction will be required later.

Health Care Costs and Demographic Changes — Not Entitlements Generally — Account for Rising Expenditures

The main sources of rising expenditures are rising costs *throughout* the U.S. health care system and demographic changes, with health care costs playing the larger role. Together, these two forces will cause the “big three” domestic programs — Medicare, Social Security, and Medicaid — to grow considerably faster than the economy. Collectively, these three programs are projected to grow by slightly more than 13 percent of GDP between now and 2050. Medicare is by far the largest contributor to the overall growth in expenditures through 2050 because it bears the full brunt of both demographic changes and health care costs. (See Figure 3.)

All other programs, including all entitlement programs other than the “big three,” are projected as a group to grow more slowly than the economy in coming decades and consequently do not contribute to the projected rise in deficits and debt. The new Congressional Budget Office forecast shows, for example, that, taken as a whole, entitlements other than the “big three” are projected to remain constant in real per-capita terms between now and 2017 and to fall slightly as a share of



GDP. This is consistent with the underlying nature and structure of these programs. The slow, gradual decline in these programs as a share of GDP is expected to continue in the decades after 2017.

This is why it is not strictly accurate to speak of a *general* “entitlement crisis” rather than to focus on the projected increases in Medicare, Medicaid, and Social Security costs in coming decades, which, as noted, will be driven by rapidly rising health care costs and demographics.

CBO's Projection of Growth in Various Parts of the Budget as a Share of GDP, 2007-2017	
The “Big Three”	+1.8%
All other Entitlements	-0.3%
Domestic Discretionary Spending	-0.8%

Similarly, domestic discretionary programs as a group have been shrinking as a share of GDP over time and are likely to continue to do so. Moreover, when discretionary programs keep pace with inflation and population growth, they generally maintain their per-person levels of service, even though they are rising more slowly than GDP. It also may be noted that contrary to popular impression, funding for domestic discretionary programs has not risen sharply in recent years; although funding for these programs did rise in the early years of this decade, it now constitutes a slightly *smaller* share of GDP than it did in 2001.

History supports these observations and conclusions. Over the last 30 years, total expenditures for all federal programs other than the “big three” have essentially held constant in real per-capita terms (i.e., after adjustment for inflation and population growth) and have declined as a share of GDP. CBO’s ten-year forecast, the nature and structure of these programs, and historical experience all suggest that this trend will continue in the decades ahead. These programs thus are expected to consume a slightly smaller share, rather than a larger share, of the nation’s resources in coming decades than they do today.

Tax Policy Choices Will Have a Major Impact on the Long-Term Problem

Tax policy decisions that Congress must make over the next few years will have significant implications for the size of the long-term problem. As explained above, our projections show a fiscal gap of 3.2 percent of GDP. This means that enacting annual revenue increases or program reductions equal to 3.2 percent of GDP would ensure that debt in 2050 was no higher than it is today as a share of the economy. Since allowing recent tax cuts to expire as scheduled — or extending these tax cuts and offsetting their costs — would increase revenues by nearly 2 percent of GDP per year, it would reduce the fiscal gap by three-fifths, shrinking it from 3.2 percent of GDP through 2050 to 1.3 percent. Stated differently, making the recent tax cuts permanent without paying for them would more than double the fiscal gap through 2050, relative to what it would otherwise be. (Measured over a period that extends beyond 2050, allowing the tax cuts to expire would reduce the size of the fiscal problem by a smaller, although still quite substantial, fraction.)

These tax policy decisions will have this large an effect on the fiscal outlook precisely because they will be made soon. Declining to extend the tax cuts, or offsetting the costs of doing so, would quickly reduce deficits by about two percent of GDP and have impacts on debts and interest payments that would compound over time. As a consequence, the downward effect on the deficit would steadily increase with each passing year and ultimately be significantly larger than two percent of GDP. This is an illustration of the basic fact that the sooner that revenue and expenditure

adjustments are made, the larger the positive long-term fiscal effects will be — and the less severe the ultimate size of the budget cuts and tax increases needed to avoid fiscal calamity will have to be.

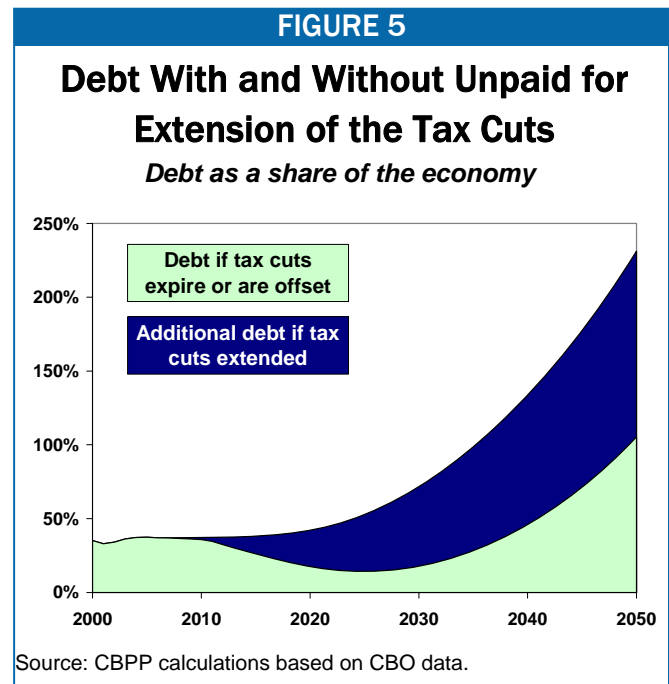
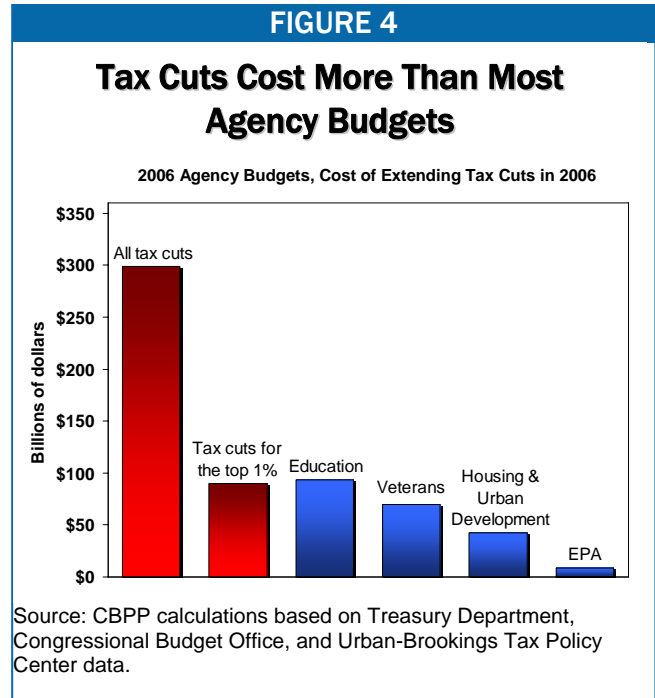
That the recent tax reductions are a major contributor to our long-term fiscal challenges should not be surprising. In today’s terms, the annual cost of the 2001 and 2003 tax cuts will, when fully in effect, exceed the budgets of the Departments of Education, Homeland Security, Veterans’ Affairs, and the Environmental Protection Agency combined.

It should be emphasized, however, that allowing the tax cuts to expire or paying for the costs of extending them would fall far short of what is needed to place the nation on a sustainable fiscal path. Even if the tax cuts expired or were fully offset, debt in 2050 would still stand at more than 100 percent of GDP. In addition, after 2050, debt would continue to rise.

Tough Changes, Including Health Care Reform, Will be Required

In light of the grim budget outlook, very tough choices will have to be made. As explained above, eliminating the fiscal gap through 2050 would require tax increases or program cuts totaling 3.2 percent of GDP annually through 2050, if the process started immediately.

It would be politically implausible (as well as inadvisable on policy grounds) to try to eliminate the fiscal gap solely by raising taxes or solely by cutting programs. Doing so would require the equivalent of an immediate and permanent 18 percent increase in tax revenues or an immediate and permanent 15 percent reduction in all programs, including Social Security, Medicare, defense and anti-terrorism activities, education, veterans’ benefits, law enforcement, border security, environmental protection, and assistance to the poor. Thus, it is crucial that *both* sides of the budget — revenues and expenditures — be on the table when serious conversations about deficit reduction begin.

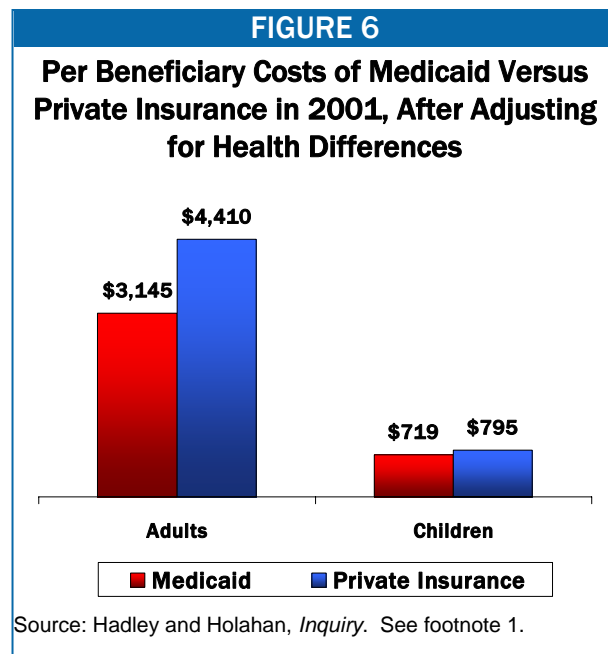


An important finding of our projections, however, is that responsibly addressing the nation’s budget problems will require more than making changes to both sides of the budget. Addressing the nation’s fiscal problem also will require fundamental reforms to the U.S. health care system as a whole. Health care costs are the single largest contributor to the long-run budget problem, and cost growth in Medicare and Medicaid tends to mirror — and is driven to a large extent by — cost growth in the health care system as a whole, including private-sector health care. Indeed, for the past 30 years, the average annual rates of increase in Medicare and Medicaid costs per beneficiary have been very close to the average rate of increase in health care costs per beneficiary system-wide. (Also of note, research by scholars at the Urban Institute has shown that costs per beneficiary in Medicaid are significantly below the costs per beneficiary in private-sector health care for people in comparable health¹; see Figure 6.)

As a result, trying to slow public-sector health care cost growth appreciably *without* addressing private-sector health care cost growth would require draconian cuts in Medicare and Medicaid that would have severe effects on the poor, the elderly, the chronically ill, and those with serious disabilities. Moreover, such cuts would, to some extent, simply shift public-sector health care costs onto the private sector, such as by forcing health care providers to give greater amounts of uncompensated care, the costs of which would be passed on to private-sector employers and patients.

For these reasons, any reforms aimed at reducing the rate of growth of Medicare and Medicaid must be part of a package of reforms designed to slow cost growth throughout the health care system. This is a point that Comptroller General David Walker has forcefully made. As Mr. Walker has stated:²

[F]ederal health spending trends should not be viewed in isolation from the health care system as a whole. For example, Medicare and Medicaid cannot grow over the long term at a slower rate than cost in the rest of the health care system without resulting in a two-tier health care system. This, for example, could squeeze providers who then in turn might seek to recoup costs from other payers elsewhere in the health care system. Rather, in order to address the long-term fiscal challenge, it will be necessary to find approaches that deal with health care cost growth in the overall health care system.



¹ See Jack Hadley and John Holahan, “Is Health Care Spending Higher under Medicaid or Private Insurance?” *Inquiry*, 40 (2003/2004): 323-42. Similar comparisons are impossible for Medicare since private insurers do not provide Medicare-like coverage to a population comparable to Medicare beneficiaries.

² “Long-Term Fiscal Issues: The Need for Social Security Reform,” Statement of David M. Walker, Comptroller General of the United States, before the Committee on the Budget, U.S. House of Representative, February, 2005, page 18.

It also should be understood that even with major reforms, it is likely to prove virtually impossible to hold health care expenditures in either the public or private sector to their current levels as a share of the economy. While the U.S. health care system contains significant inefficiencies that raise its costs, the *rate of growth* in health care costs is driven largely by medical advances that tend to improve health and lengthen lifespans but also increase costs. It is inconceivable that Americans will not want to avail themselves of the medical breakthroughs that will occur in the years and decades ahead, even if those breakthroughs entail significant costs. Furthermore, ongoing economic growth will raise incomes in coming decades, and it would not be unreasonable for Americans to elect to invest a substantial share of that increase in securing better health and longer lives.

The challenge therefore is to pursue major reforms that eliminate inefficiencies in the health care system and restrain costs in the system to the greatest extent possible without unduly constraining medical progress. Of course, if, as seems likely, Americans conclude that better health and longer lives merit a somewhat larger share of their income in the future, it will be necessary to pay for these added costs, rather than simply pile up ever-mounting levels of debt. In terms of the federal budget, that means that increases in federal health-care costs as a share of GDP that occur even after health-care reforms have been instituted will need to be financed by increased revenues, reductions in other projected expenditures, or combination of the two.

In sum, solving the nation's long-term budget problems will require that political leaders enact *both* program reductions and revenue increases and, perhaps most difficult of all, substantial, system-wide health-care reforms.

Implications For Congress

These disquieting budget projections underscore the need for policymakers to take action. The remainder of this testimony offers some observations and recommendations regarding the daunting task you face.

1. *Protective barriers against measures that would make the problem even more severe.*

Two important initial steps are restoration of the Pay As You Go rules on entitlements and taxes and creation of a barrier against use of the reconciliation process for legislation that would increase deficits. Whether on the tax or the entitlement side, it needs to become significantly harder to enact legislation that would dig the hole deeper.

2. *Social Security:* There is no shortage of options regarding how to close the Social Security shortfall and restore long-term solvency. If this is done without transferring revenues from the general budget (unless such transfers are financed by new general revenues or new reductions in other programs), it will reduce long-term deficits as well.

There are no “free lunches” here. The task is essentially the same as that which the Greenspan Commission confronted in 1983 — to develop an equitable blend of benefit and tax changes that will close the gap. Two of the best discussions of the available options can be found in a book co-authored by my fellow panelist at today's hearing, Bob Reischauer, and Brookings economist Henry Aaron (*Countdown to Reform: The Great Social Security Debate*) and a book co-authored by the newly

appointed CBO director Peter Orszag and M.I.T. economist Peter Diamond (*Saving Social Security: A Balanced Approach*).

3. Health Care: This is by far the toughest challenge. Unlike with respect to Social Security, options for how to reduce projected health care costs markedly while still taking advantage of medical breakthroughs that push up costs, and while providing adequate coverage for all Americans, have not been identified.

Some initial steps are available; Congress can modestly reduce Medicare costs by adopting the recommendations of the Medicare Payment Advisory Commission. The fundamental task, however, is reform of the overall U.S. health care system.

There is a “first principle” to system-wide reform: any reform should ensure that health insurance is provided that effectively pools healthy individuals with those who are sicker. In the absence of such pooling, insurance will be inaccessible or unaffordable for Americans with various health conditions.

(This, in fact, is the Achilles’ heel of the President’s new proposal. That proposal places the current tax treatment of employer-based insurance on the table, a step many analysts welcome. But the plan would lead to the erosion of employer-based coverage — which does pool healthier and sicker workers — and to the shifting of many people who currently have employer-based coverage into the deeply flawed individual health insurance market, which discriminates rather aggressively against those in poor health.³)

There are a number of possible approaches to health-care reform. Such approaches will need to find ways to reduce inefficiencies in the U.S. health care system and to slow the rate of health-care cost growth while covering all Americans and pooling risk across healthy and sick individuals alike.

Finally, some areas of health care will require additional resources, such as the State Children’s Health Insurance Program (SCHIP). The budget baseline for SCHIP is frozen at \$5 billion a year. Yet health care costs continue to rise. The actuaries at HHS have estimated that if SCHIP is frozen at the \$5 billion a year baseline level, the number of low-income children insured through the program will fall by 1.5 million — or more than one-third — by 2012. Moreover, funds are needed not merely to close this SCHIP shortfall but to reach more of the low-income children who remain uninsured. Some 5.6 million low-income children in our nation remain without health insurance today, a situation not found in any other western industrialized country.

4. Revenues: As this testimony indicates, revenues must be part of the equation. It is inconceivable that Congress will cut key domestic programs as deeply as would be needed to address the long-term fiscal problem without additional revenues. (Doing so also would produce various undesirable effects.)

The argument is sometimes made that one cannot raise taxes above their current levels, or touch any of the 2001 and 2003 tax cuts, because doing so would seriously damage the economy and

³ The President’s plan would enable states to redirect some resources away from hospitals that provide uncompensated care to the uninsured and to shift those resources to state programs such as “high-risk” pools. Those high-risk pools have not been very effective, however, because they pool sick individuals with even sicker individuals. What is needed are mechanisms that effectively pool the healthy and the sick.

thereby actually reduce revenue collections. The claim also has been made that the recent tax cuts are responsible for the nation's current economic health and, far from costing money, are producing a revenue boon.

Such claims do not stand up under scrutiny. The economy has *always* grown in the recoveries that follow recessions, regardless of whether or not taxes have been cut. Indeed, the current recovery is somewhat weaker than the average post-World War II recovery with respect to an array of key indicators, including overall economic growth, investment growth, job growth, and wage and salary growth. Moreover, the current recovery is not stronger than the recovery of the 1990s was, and that recovery followed two significant tax increases.

Nor has revenue growth been remarkable. Revenues have grown strongly the past two years, but this robust growth essentially represented a rebound from several years of extraordinary revenue declines. Revenues declined in nominal terms for three straight years from 2001-2003, the first time that has occurred since before World War II.

Among the best ways to measure current revenue growth is to examine how revenues have fared over the current business cycle. Such an examination reveals that revenues in 2006 were merely at the same level in real per-capita terms as they had been at the start of the business cycle five years earlier. In contrast, by this point in the average post-World War II business cycle, revenues have risen 10 percent in real per-capita terms.

Finally, most economists believe that large, deficit-financed tax cuts can yield short-term stimulus but can *reduce* growth over the long term, because of the effects of the resulting increases in deficits and debt in soaking up capital that could otherwise be invested. CBO, the Joint Committee on Taxation, the Congressional Research Service, economists at the Federal Reserve, and economists at Brookings have all found that if major tax cuts are deficit financed, long-term economic growth is as or more likely to be reduced than to be increased.⁴

Steps to raise more revenues should, where possible, be taken in conjunction with tax reform, since various ways of raising revenues can have differing economic effects. One first step that Congress could take would be to examine carefully the numerous options presented in an important study the Joint Committee on Taxation issued in January 2005 and the additional options described by the Joint Tax Committee in a follow-up report prepared for the Senate Finance Committee in August 2006.⁵ These studies presented numerous recommendations for curbing unintended or unproductive tax breaks and for narrowing the "tax gap." A number of these measures would raise revenues while simplifying the tax code.

⁴ See, for example, Alan J. Auerbach, "The Bush Tax Cut and National Saving," *National Tax Journal*, Volume LV, No. 3, September 2003; and 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 Gale and Peter Orszag, "Bush Administration Tax Policy: Effects on Long-Term Growth," *Tax Notes*, October 18, 2004; Gale and Orszag, "Deficits, Interest Rates, and the User Cost of Capital: A Reconsideration of the Effects of Tax Policy on Investment," Urban Institute-Brookings Institution Tax Policy Center, August 19, 2005; Congressional Budget Office, "Analyzing the Economic and Budgetary Effects of a 10 Percent Cut in Income Tax Rates," December 2005; and Joint Committee on Taxation, "Macroeconomic Analysis of Various Proposals to Provide \$500 Billion in Tax Relief," JCX-4-05, March 1, 2005.

⁵ Joint Committee on Taxation, "Options to Improve Tax Compliance and Reform Tax Expenditures," January 27, 2005, and Joint Committee on Taxation, "Additional Options to Improve Tax Compliance," August 3, 2006.

Congress also needs to address the growing problems presented by the Alternative Minimum Tax. Given the daunting fiscal problems the nation faces, Congress needs to find ways to address these problems in a revenue-neutral manner.

- AMT repeal would cost \$800 billion over the next ten years (2008-2017), if the 2001 and 2003 tax cuts are not extended, and \$1.5 trillion if they are extended, according to estimates by the Urban Institute-Brookings Institution Tax Policy Center. It is more costly than estate tax repeal.
- Continuing the current practice of providing an AMT “patch” each year without covering the costs is becoming increasingly expensive and fiscally imprudent. Continuing on this course will cost \$70 billion *a year* by 2010 and more in the years that follow.

Last week, the Tax Policy Center issued a study presenting options for revenue-neutral AMT reform that would protect middle-class taxpayers without swelling deficits and debt. The study merits close consideration.

Finally, Congress should seriously consider freezing tax cuts that are not yet in effect, particularly tax cuts that will exclusively benefit people at the top of the income scale. In particular, two tax cuts that President Bush did *not* request, but that were added on top in 2001, are only partially in effect now. These two tax cuts are slated to *triple in size* between now and 2010. Analysis by the Tax Policy Center shows that almost two-thirds of the benefits of these two tax cuts will go to the 0.3 percent of U.S. households with incomes exceeding \$1 million a year, a group that the Tax Policy Center says already is receiving average tax cuts of more than \$100,000 a year. Some 98 percent of these two tax cuts will go to the 4 percent of households with incomes over \$200,000, the Tax Policy Center reports.

If these two tax cuts are held at today’s levels rather than permitted to triple in size, about \$13 billion would be saved over the next several years. This is about the cost of averting the cuts that would occur in the State Children’s Health Insurance Program over the next five years and take 1.5 million low-income children off the program if funding for SCHIP is frozen at the baseline level.

5. A measure to secure savings simultaneously on both the spending and tax sides of the budget: Some measures can both restrain expenditures and enhance revenues. Most experts believe that the Consumer Price Index slightly overstates inflation. To address this overstatement, the Bureau of Labor Statistics has developed an alternative CPI. Most analysts across the political spectrum believe the alternative measure is superior. On average, the alternative measure (sometimes referred to as the “superlative CPI”) rises a few tenths of a percentage point more slowly per year than the traditional CPI.

Congress should move to adopt the use of the superlative CPI on both the expenditure and revenue sides of the budget. Such a step likely would be attacked by some as cutting Social Security benefits or raising taxes, but such attacks would be unwarranted. The intention of the Social Security Act and the Internal Revenue Code is to adjust for inflation, not to *overadjust*. This change would meet those intentions.

This change would produce small savings initially. But the savings would grow over time and become significantly larger in the years when the fiscal problems we face will be extremely serious.

6. Discretionary programs: I have placed this part of the budget last for two reasons. First, I do not have expertise in the defense budget and will not discuss it here. Second, opportunities for substantial savings in non-defense discretionary programs are quite limited.

Non-defense discretionary programs (including international affairs and homeland security) have declined from 5.2 percent of GDP in 1980 to 3.6 percent of GDP today, and they constitute a shrinking portion of the budget. These programs make up 18.1 percent of the budget today. Under CBO's projections, they will constitute 14.5 percent of the budget by 2017.

This is not to say there is no fat anywhere in the discretionary side of the budget. But there also are substantial unmet needs that will require more resources from this part of the budget, and savings in some discretionary programs likely will need to be reinvested in other discretionary areas. Two examples of areas where the resources are needed were cited by the President in his State of the Union address — the need for increased resources to fight disease and ease poverty and debt in some of the world's poorest countries, and the need for more resources for alternative energy research. Other areas where additional discretionary resources are warranted include IRS enforcement, child care for children in low-income working families, and housing vouchers for low-income families, to name just a few.

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That concludes my testimony. I would be happy to address questions the Committee may have.