Center on Budget and Policy Priorities

820 First Street NE, Suite 510
Washington, DC 20002

Tel: 202-408-1080
Fax: 202-408-1056

center@cbpp.org
www.cbpp.org

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TESTIMONY OF ROBERT GREENSTEIN, EXECUTIVE DIRECTOR
and
JIM HORNEY, DIRECTOR OF FEDERAL FISCAL POLICY
before the
COMMISSION ON FISCAL RESPONSIBILITY AND REFORM

Members of the Commission,

Thank you for giving us the opportunity to speak to you today.

The Center on Budget and Policy Priorities is a nonpartisan research and policy institute that focuses both on fiscal policy and on programs and policies of particular importance to low- and moderate-income Americans. We have long argued that the federal budget is on an unsustainable path under current policies — we are among the few policy institutes that regularly develop and issue long-term budget projections — and have for some time urged lawmakers to begin taking the steps necessary to deal with the problem.

So we salute the President for establishing this commission to develop a plan to improve the medium- and longer-term budget outlook. We would like to make a few suggestions about important matters for you to keep in mind as you move forward in this process.

First, we think that the President's emphasis on the goal of stabilizing the ratio of debt held by the public to Gross Domestic Product around the middle of this decade is the right goal. Achieving that goal — which under current projections could be achieved if deficits are reduced to about three percent of GDP — would be a major accomplishment. It would send an important message to the American public and world financial markets that policymakers are serious about getting our fiscal house in order. However, putting in place policies that would achieve that goal by 2015 may prove extremely difficult for several reasons.

In addition, we would urge the Commission to keep in mind the President's recent admonition against too much fiscal restraint while the recovery is still fragile and unemployment remains so high. It would not be wise to have significant fiscal retrenchment take effect in the next couple of years. To the contrary, the economy now badly needs the federal government to extend measures such as extended unemployment benefits and state fiscal relief; failure to do so will further weaken the economy and *delay* the point at which serious fiscal consideration measures can safely be instituted. This reality, combined with the usual desirability (for both policy and political reasons) of

phasing in program cuts and tax increases, may make it difficult to achieve sufficient deficit reduction to hit the target by as early as 2015. Doing so may require a few additional years.

Furthermore, even aside from the problem of what year to start phasing in savings — which will depend upon the nature and pace of the recovery — it is likely to be very hard to get substantial savings by 2015 in the three biggest federal programs. In the long run, it will prove impossible to put the budget on a sustainable path if we do not significantly reduce the rate of growth of Medicare and Medicaid. (Let me note that we think the only way to do that in a sensible fashion is to slow the rate of growth of per-person health care costs systemwide — that is, to slow cost growth in privately-funded care as well as publicly-funded care.) But the recently-enacted health reform legislation included almost every measure for Medicare savings that health experts have agreed makes sense at this time; for instance, most of the proposals that MedPac — the Medicare Payment Advisory Commission — had been proposing for years were adopted as part of health reform. That legislation also included many significant provisions — research projects, pilot programs, and experiments in alternative methods or organizing and paying for health care — that should help inform policymakers about further changes in the health care system that could slow the rate of growth of health care costs in coming decades. As the results of these studies become available, further changes must be made in the health care system to slow the rate of cost growth. But we won't have these results in time to secure significant savings by 2015, and as a result, it is hard to see how significant savings in Medicare can be achieved in time to help hit a 2015 deficit target.

Similarly, it is hard to see how savings in Social Security could make a significant contribution to deficit reduction by 2015. Unlike some others, we believe there are good reasons why the commission could consider policy changes that would strengthen the finances of Social Security, and in so doing, also improve the long-term outlook for the budget as a whole. But under any sensible approach, such changes would likely be phased in slowly (there is wide agreement that it would be inappropriate to make changes that would significantly affect people who are either currently collecting benefits or are about to become eligible for the program). That means changes in Social Security will not provide significant savings by 2015.

Certainly, it should be possible to find some savings by 2015 in some other mandatory programs and in discretionary programs. But without significant savings from Medicare and Social Security, there is a limit on how big program savings will be.

This means that to hit a 3-percent-of-GDP target by 2015, increases in revenues almost certainly will have to account for a considerably larger share of the total deficit reduction in 2015 than in the longer run, when the savings from health care, and to a lesser degree Social Security, will grow. That would not represent unreasonable policy. But you are constrained by the need to reach agreement within the commission and the desire to submit a proposal that has a chance to be enacted by the current Congress. It likely will be hard to get agreement if increases in revenues account for a significant majority of the proposed savings in 2015. If that turns out to be the case, we believe that — rather than trying to make deeper cuts by 2015 in Medicare, Social Security, or other programs (which probably also would make it impossible for the Commission to agree to a plan that could be enacted) or giving up on reaching agreement among commissioners — you should be willing to move the 3 percent of GDP target back if you need to. It would be far preferable to propose a balanced and politically feasible plan to stabilize the debt starting in 2017 or 2018 than to reach a deadlock in your deliberations or adopt a plan with big program cuts that would be very harmful if enacted and likely would be unacceptable on Capitol Hill in any case. Stabilizing the debt within a

few years after 2015 would still represent a tremendous accomplishment that signals seriousness about getting deficits and debt under control. Once policies have been put in place to accomplish that goal, policymakers could begin to consider further efforts to ensure that deficits do not start growing again in subsequent years and, perhaps, achieve reductions in the size of the debt relative to the economy.

As I noted earlier, such efforts will have to include steps to slow the rate of growth of health care costs. Given that the only way to achieve significant savings in Medicare and Medicaid without undercutting the important role that those programs play in ensuring quality health care for the elderly and poor in this country is to slow the rate of growth of costs systemwide, we strongly supported the excise tax on high-cost employer-provided health insurance plan. We believe that the federal government in the future should take further steps in this direction and should also put in place strong incentives for private health care plans and medical professionals to provide, and consumers to demand, more cost-effective delivery of health care.

In Social Security, we think the plan developed by current OMB Director Peter Orszag (before he became head of CBO and then OMB) and noted MIT economist Peter Diamond provides a good starting point for reform. One element not included in their plan that we would endorse is to change the measure of inflation used in the annual adjustment to Social Security and other program benefits and in the adjustment of various parameters of the tax code to a chained CPI. Many analysts believe the chained CPI is a more accurate indicator of inflation than the regular CPI. We believe strongly that the savings from this step should be devoted to deficit reduction, not to offset the costs of tax cuts or program increases (except that a small amount of the savings should be devoted to providing some relief for lower-income Social Security and SSI beneficiaries who live to age 80 or thereabouts, as they already face a struggle to get by on currently-promised benefits and would be impacted by the chained CPI).

We also would note that Social Security benefits are much more modest than many people realize. The average Social Security retirement benefit is now only $1,170 a month, or about $14,000 a year. Social Security checks now replace about *39 percent* of an average worker's pre-retirement wages — significantly less than similar programs in most other Western countries. And because of the currently scheduled increase in the normal retirement age and the projected rise in Medicare premiums (which are deducted from Social Security checks), that figure will gradually fall from 39 percent to about 32 percent over the next two decades, under current law.

Over 90 percent of the aged receive Social Security, and on average it accounts for nearly two-thirds of their income. It provides over 90 percent of income for nearly one-third of its beneficiaries. In considering changes in Social Security, policymakers should keep these realities in mind.

We believe that an increase in revenues also is an essential part of any package to put the budget on a sustainable path. As I already mentioned, we believe increased revenues will have to represent the major share of savings needed to get the deficit down to three percent of GDP in this decade, and they will need to make a substantial contribution to the required long-term deficit reduction as well.

Revenues can be increased to levels significantly above the historical average without harming the economy if the revenue-raising procedures are well designed. The average level of total taxes raised

in other developed countries relative to the size of the economy is significantly higher than in the United States (taking taxes at all levels of government into account) without discernible negative effects on their economies. If we are careful about the way we raise revenues — for instance, by curbing tax expenditures (which Alan Greenspan once termed "tax entitlements") that encourage the inefficient allocation of resources — we can raise revenues without sacrificing economic growth. In the case of corporate income taxes in particular, claims that the tax burden on American firms in general is too high and makes those firms less competitive are misguided. It is true that the top *statutory* tax rate on corporate income in this country is higher than in most other developed countries. But because a host of special tax preferences reduce the size of our corporate tax base more than in other large developed economies, the total amount of revenues raised from corporate taxes relative to GDP or corporate income (i.e., the average effective tax rate on corporate income) is not out of line with the rates in other countries. With sensible base broadening, we can reduce the inequities and inefficiencies in the corporate income tax code, lower the top corporate rate, boost competitiveness, and raise somewhat more revenues. We certainly should *not* take steps that would reduce the amount of corporate taxes collected.

We believe that high-income taxpayers in this country should pay higher taxes than they are paying now. The first step is certainly to allow the 2001 and 2003 tax cuts for high-income taxpayers to expire as scheduled. While further steps should be taken to raise revenues from the most well-off Americans (particularly by curbing inefficient tax expenditures), we do not believe it will be possible to raise the revenues needed to fund the benefits and services that Americans will expect and demand in coming decades if we protect all taxpayers with income below $250,000 a year from any tax increase.

Finally, in developing a proposal to reduce the deficit, the Commission should take special care to protect the most vulnerable people in this country. The Commission should strive to ensure that the policies it proposes taken together, would not push more Americans into poverty or make those already in poverty worse off. The big deficit reduction packages enacted in 1990 and 1993 succeeded on this front — they avoided harming those at the bottom of the income spectrum. In fact, those packages contained provisions that improved the situation of some of the most vulnerable people in the country and thereby reduced deficits and poverty at the same time. We would encourage you to do as the negotiators of the 1990 budget agreement did and request from the Congressional Budget Office a distributional analysis that would show the overall impact on Americans, by income category, of the major elements of any package of proposals you are seriously considering. Such analyses will help you to develop proposals that can achieve the necessary fiscal retrenchment without making struggling low-income families and individuals worse off.