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# CBO ANALYSIS SHOWS ECONOMIC BENEFITS OF FISCAL SUSTAINABILITY ARE LARGE AND NEARLY THE SAME WHETHER TAXES ARE RAISED OR SPENDING IS CUT

By Chad Stone

The economic benefits of reducing long-run deficits are very large, and there is only a modest difference between the economic effects of shrinking deficits by raising taxes and doing so by cutting expenditures. This is the key conclusion of a recent Congressional Budget Office response to a request from Senator Judd Gregg (R-NH), the ranking member of the Senate Budget Committee, for an analysis of the potential economic effects of relying on higher taxes alone to finance projected increases in federal expenditures in coming decades.[1] (Several key excerpts from the CBO report are in the box on page 4).

Although Senator Gregg's request was for an analysis of a particular, extreme case that is not (and is likely never to be) on the table in serious discussions of how to address the country's long-term fiscal problems,[2] CBO's analysis has several important implications for what *should be* on the table in such discussions. In particular, the CBO analysis shows that:

- alternative ways of addressing the nation's long run budget problems differ in their economic effects, but those differences "pale in comparison" to the economic

**KEY FINDINGS**

- Most assessments of the long-run fiscal outlook conclude that higher revenues will need to be a part of any serious effort to prevent budget deficits from growing to unsustainable levels.
- A recent CBO analysis shows that the economic benefits of achieving fiscal sustainability are substantial, and that the difference between the economic effects of reducing the deficit through tax increases and doing so through spending cuts would likely be very small by comparison.
- CBO also finds that any negative economic effects of tax increases can be mitigated by relying more on policies that broaden the tax base than on increases in marginal tax rates. CBO suggests that the economic effects of raising revenue by broadening the tax base can be similar to the effects of cuts in government benefit programs.
- CBO's analysis also indicates that no policy to restore long-term fiscal sustainability is likely to be successful if the rate of growth in health care expenditures is not reduced.

[1] Congressional Budget Office, "Financing Projected Spending in the Long Run," July 9, 2007.

[2] In another recent report, CBO agreed with other budget analysts in concluding that "Attaining fiscal stability in coming decades will almost certainly require some combination of reductions in the growth of spending and increases in taxes as a share of the economy." The *Budget and Economic Outlook: An Update*, August 2007, p. 19.

benefits of achieving fiscal sustainability (hence raising more revenue can reasonably be regarded as part of the solution);

- any negative economic effects of tax increases can be mitigated by using measures that broaden the tax base without requiring sharp increases in marginal tax rates; and

- slowing the excess growth of health expenditures is essential for preventing budget deficits from rising to unsustainable levels.[3]

## Differences in Economic Effects Among Alternate Approaches to Achieving Fiscal Sustainability Are Modest Compared with the Costs of Letting Budget Deficits Rise to Unsustainable Levels

Without action to reduce federal spending, increase revenues, or both, the federal deficit and debt will rise to unsustainable levels in future years, due largely to rising health care expenditures and the aging of the population.[4] President Bush and others have argued that keeping taxes low is essential to keep the economy growing, and they reject any role for tax increases in achieving fiscal sustainability. CBO's analysis shows that this stance is misguided.

CBO compares the economic effects of relying on tax increases alone to achieve fiscal sustainability to the economic effects that would result under a "base scenario" where revenues and spending as a share of the economy are held constant at their 2006 levels. As CBO notes, this base scenario would require not only massive reductions in expenditures for federal programs, compared with what would take place under current law, but also tax cuts to keep revenues from rising somewhat as a share of the economy, as they are projected to do under current law (as a result of real income growth and the scheduled expiration of various current tax cuts).

In the base scenario, the economy would more than double in size by 2050 (to 255 percent of its size in 2006). CBO's analysis shows that even if *all* of the deficit reduction were accomplished by raising revenues, and *none* by cutting programs, the economy would still more than double in size over this period. The growth in the economy would be somewhat less in CBO's tax-increase scenarios than it would be in the base scenario, but CBO's analysis shows that maintaining a strong economy does not require the combination of tax cuts and Draconian reductions in government programs implicit in the base scenario.

CBO produced a range of estimates, based on different models of how tax increases affect the economy and on two different scenarios about how the assumed tax increases would be

[3] "Excess growth" in health care costs is the difference between the annual growth in health care costs per beneficiary and annual growth in per capita GDP. The average annual growth rate in costs per beneficiary in Medicare and Medicaid has been about 2.5 percentage points higher than the average annual growth in per capita GDP over the past 40 years. The growth rate per beneficiary in Medicare and Medicaid costs has essentially mirrored the growth rate in health care costs in the overall U.S. economy.

[4] See Richard Kogan, Matt Fiedler, Aviva Aron-Dine, and James Horney, The Long-Term Fiscal Outlook is Bleak: Restoring Fiscal Sustainability Will Require Major Changes to Programs, Revenues, and the Nation's Health Care System, Center on Budget and Policy Priorities, January 29, 2007 (http://www.cbpp.org/1-29-07bud.pdf_

implemented. The estimated expansion in the economy by 2050 was between 1 percent and 16 percent less in the tax-increase scenarios than in the base scenario. Put another way, the gross domestic product (GDP) in 2050 would be between 2.14 and 2.52 times as large as it was in 2006 in the tax-increase scenarios, compared with 2.55 times as large in the base scenario. In other words, even under the worst-case estimate, real GDP still would be more than twice as large in 2050 as it was in 2006. Looking at how modest the impact on projected growth would be in the tax-increase scenarios, relative to the base scenario, CBO drew the following conclusion:

> [T]he reductions in GDP estimated by CBO are relatively small in comparison with how much the economy could grow if the budget was put on a sustainable path. If fiscal sustainability was not achieved, however, budget deficits would continually mount and eventually cause a persistent decline in economic growth and the standards of living in the United States.[5]

## Broadening the Tax Base Can Reduce the Economic Impact of Tax Increases

The tax-increase scenario with the expansion of the economy closest to that in the base scenario is one in which statutory tax rates are not increased at all. Revenue still rises as a share of the economy because economic growth pushes more people into higher tax brackets and because some provisions of the tax code are not indexed for inflation and their real value erodes over time. The tax-increase scenario that produces the largest negative economic effects, in contrast, is one that assumes the sharpest increases in marginal income tax rates. CBO draws the following implication from these results:

> The first scenario does not raise effective marginal tax rates as much because real economic growth substantially reduces the proportion of individual income that is exempted from taxes because of the personal exemption and credits. In other words, maintaining current law embodies a form of base broadening. The contrast between the scenarios highlights the fact that raising taxes can take a wide variety of forms that significantly affect the economic outcome.[6]

Broadening the tax base, in order to keep rates lower than they would be with a narrower tax base, is an important principle of tax policy, because excessively high marginal tax rates can have incentive effects that dampen economic activity. A system of graduated tax rates is, however, an important feature of the progressive U.S. income tax system. Finding the right balance between progressivity and macroeconomic effects will be an important consideration in any plan to put the budget on a sustainable basis. But exaggerated fears about the economic damage from any tax increases should not be. Increases in marginal tax rates are not the only way to raise revenue. As CBO observes, "…in general, other mechanisms for raising revenues would impose lower macroeconomic costs but may also be less progressive."

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[5] CBO, *op. cit.*, p. 6.

[6] *Ibid*, p. 7.

Excerpts from the CBO Report

"Thus, the costs of failing to put the budget on a sustainable path are potentially very large: Failing to address the fiscal gap ultimately puts at risk the nation's long-term economic growth itself, whereas the differences among various approaches for eliminating that gap typically represent only a modest share of such growth." (page 6)

"Differences in the economic effects of alternative policies to achieve a sustainable budget in the long run are generally modest in comparison to the costs of allowing deficits to grow to unsustainable levels. In particular, the difference between acting to address projected deficits (by either reducing spending or raising revenues) and failing to do so is generally much larger than the implications of taking one approach to reducing the deficit compared with another." (page 1)

"Alternative ways for resolving the nation's long-term budget problems carry different implications for the economy, but those economic differences pale in comparison to the economic costs the nation would face in the long run if federal debts were allowed to grow faster than the economy for extended period of time. If the budget was on a sustainable track, real GDP could more than double between now and 2050, CBO estimates. Failing to achieve fiscal sustainability, however, could put the long-run growth of the economy at risk—so moving the budget toward a sustainable track provides substantial economic benefits in the long run." (pages 10-11)

## Controlling Excessive Growth in Health Care Expenditures is Critical for Achieving Budget Sustainability

Like many other analysts, CBO has concluded that health care cost growth is the most important factor affecting the amount of revenue needed to finance projected federal expenditures over the long term, and is "significantly more important than other commonly cited factors, such as the aging of the population." The budget office's strongest conclusions about how modest the differences are among alternative approaches to achieving budget sustainability are reached under the assumption that excess health care cost growth in coming decades is 1 percentage point per year (i.e., that health care costs per beneficiary rise, on average, one percentage point faster than per capita GDP growth). CBO concludes that if, instead, health care cost growth per beneficiary continues to exceed per capita GDP growth by *2.5* percentage points per year, as it has on average over the past 40 years, then relying on higher marginal tax rates alone might not even be feasible and could cause significant economic damage.

One implication of this analysis is that finding a way to control the growth of health care expenditures — not just in Medicare and Medicaid, but in the overall U.S. economy — is a necessary condition for putting the budget on a sustainable long-run path. But a second implication is an amplification of the previous conclusion that focusing on increases in marginal tax rates can exaggerate the economic effects of using revenue increases as part of a balanced policy for budget sustainability. CBO draws the following implication at the conclusion of its analysis of the impact of increases in marginal income tax rates on the economy:

> Alternative tax policies could be employed that would mitigate the economic effects delineated above. In particular, policies that relied less on marginal income tax rates could have substantially smaller effects on the economy. Indeed, tax policies that reduced the

> income of households but did not affect the marginal incentives to work and save would have similar effects on the economy as reductions in government benefit payments to households to the extent that those benefit payments and the tax payments were made to and from the same households.[7]

In other words, CBO concludes that raising revenues by broadening the tax base can have effects on the economy similar to (rather than more deleterious than) the effects from cutting government benefit programs.

## Conclusions

It is hard to identify a realistic policy for achieving fiscal sustainability in the long run that does not involve some increases in revenues. CBO's analysis of policies that rely exclusively on tax increases shows that the effects on the economy of tax increases that are part of a balanced deficit-reduction strategy are likely to be small, relative to the costs of failing to keep budget deficits from rising to unsustainable levels. In addition, any adverse effects of tax cuts on the economy can be mitigated by emphasizing base-broadening policies rather than increases in marginal income tax rates, although such policies could be less progressive than increases in marginal rates. Finally, no strategy to restore long-term fiscal sustainability is likely to be successful unless excess health care cost growth is reduced.

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[7] *Ibid*, p. 7.