



C H A P T E R 5

ADDRESSING THE LONG-RUN FISCAL CHALLENGE

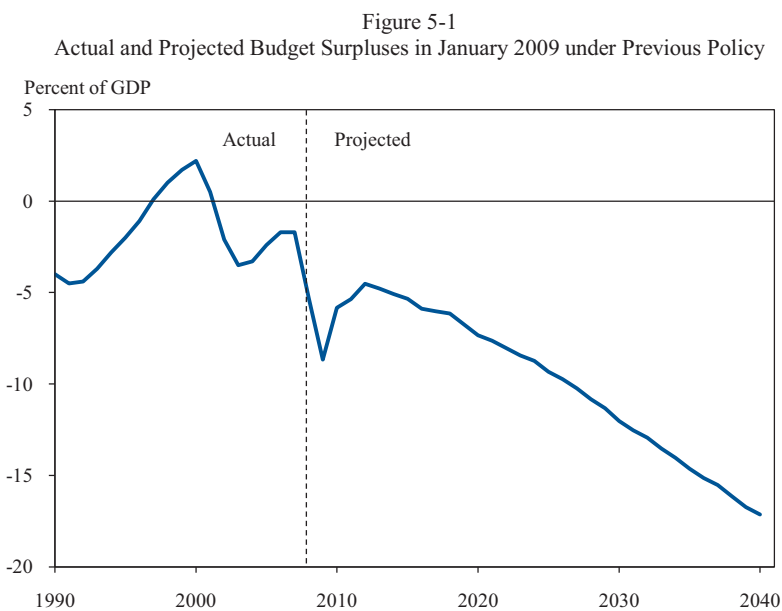
After several years of budget surpluses, the Federal Government began running consistent, substantial deficits in the 2002 fiscal year. Because the deficits absorbed a significant portion of private saving, they were one reason that the economic expansion of the 2000s was led by consumption and foreign borrowing rather than investment and net exports. More troubling than the deficits of the recent past, however, is the long-term fiscal outlook the Administration inherited. Even before the increased spending necessary to rescue and stabilize the economy, the policy choices of the previous eight years and projected increases in spending on health care and Social Security had already put the government on a path of rising deficits and debt. Thus, a key step in rebalancing the economy and restoring its long-run health must be putting fiscal policy on a sound, sustainable footing.

This chapter discusses the fiscal challenges the Administration inherited, the dangers posed by large and growing deficits, and the Administration's measures and plans for addressing these challenges. The Administration and Congress are already taking important steps, most notably through their efforts toward comprehensive health care reform. The legislation currently under consideration addresses rapidly rising health care costs, which are one of the central drivers of the long-run fiscal problem. The fiscal problem is multifaceted, however, and was decades in the making. As a result, no single step can fully address it. Much work remains, and bipartisan cooperation will be essential.

THE LONG-RUN FISCAL CHALLENGE

When President Obama took office in January 2009, fiscal policy was on a deteriorating course. Figure 5-1 shows the grim outlook for the budget projected by the Congressional Budget Office (CBO) under the assumption

that the policies then in effect would be continued.¹ As the figure makes clear, the budget was on an unsustainable trajectory.

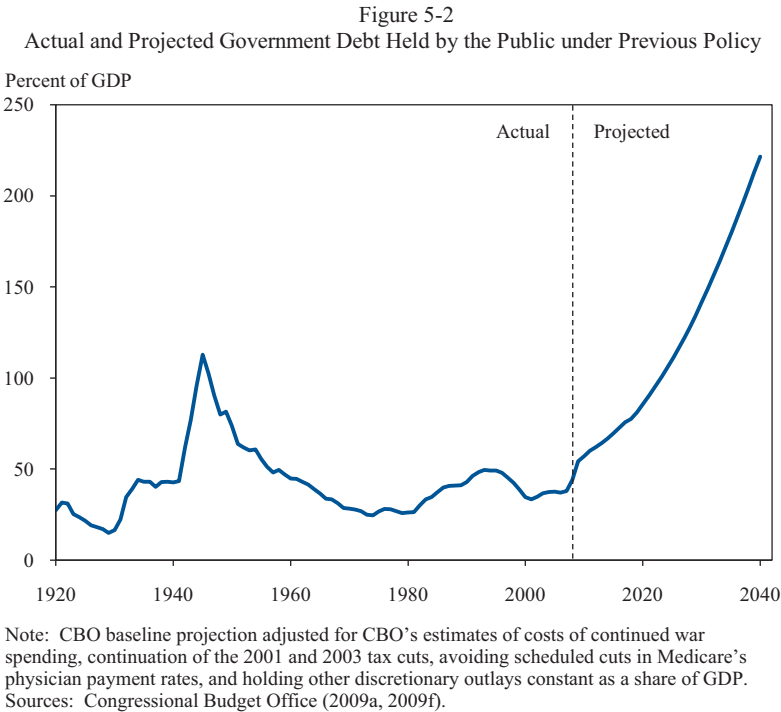


Note: CBO baseline surplus projection adjusted for CBO’s estimates of costs of continued war spending, continuation of the 2001 and 2003 tax cuts, avoiding scheduled cuts in Medicare’s physician payment rates, and holding other discretionary outlays constant as a share of GDP.
Sources: Congressional Budget Office (2009a, 2009f).

The figure shows that CBO projected that the deficit would be severely affected in the short run by the economic crisis. The decline in output was projected to send tax revenues plummeting and spending for unemployment insurance, nutritional assistance, and other safety net programs soaring. As a result, the deficit was projected to spike to 9 percent of gross domestic product (GDP) in 2009 before falling as the economy recovered. It is natural for revenues to decline and government spending to rise during a recession. Indeed, these movements both mitigate the recession and cushion its impact on ordinary Americans.

¹ This figure presents the CBO January 2009 baseline budget outlook through 2019, adjusted to reflect CBO’s estimates of the cost of extending expiring tax provisions including the 2001 and 2003 tax cuts and indexing the Alternative Minimum Tax (AMT) for inflation, reducing the number of troops in Iraq and Afghanistan to 75,000 by 2013, modifying Medicare’s “sustainable growth rate” formula to avoid scheduled cuts in physician payment rates, holding other discretionary outlays constant as a share of gross domestic product, and the added interest costs resulting from these adjustments (Congressional Budget Office 2009a). After 2019, the figure presents CBO’s June 2009 *Long-Term Budget Outlook* alternative fiscal scenario, which also reflects the costs of continuing these policies (Congressional Budget Office 2009f).

The key message of the figure, however, concerns the path of the deficit after the economy’s projected recovery from the recession. The deficit was projected to fall to close to 4 percent of GDP in 2012 as the economy recovers, but then to reverse course, rising steadily by about 1 percent of GDP every two years. Figure 5-2 shows that if that path were followed, the ratio of the government’s debt to GDP would surpass its level at the end of World War II within 20 years, and would continue growing rapidly thereafter. At some point along such a path, investors would no longer be willing to hold the government’s debt at any reasonable interest rate. Thus, such a path is not feasible indefinitely.



Sources of the Long-Run Fiscal Challenge

The challenging long-run budget outlook the Administration inherited has two primary causes: the policy choices of the previous eight years and projected rising spending on Medicare, Medicaid, and Social Security. The policy choices under the previous administration contribute a substantial amount to the high projected deficits as a share of GDP, while rising spending for health care and Social Security is the main reason the

deficits are projected to balloon over time. Both make large contributions to the difficult fiscal outlook.

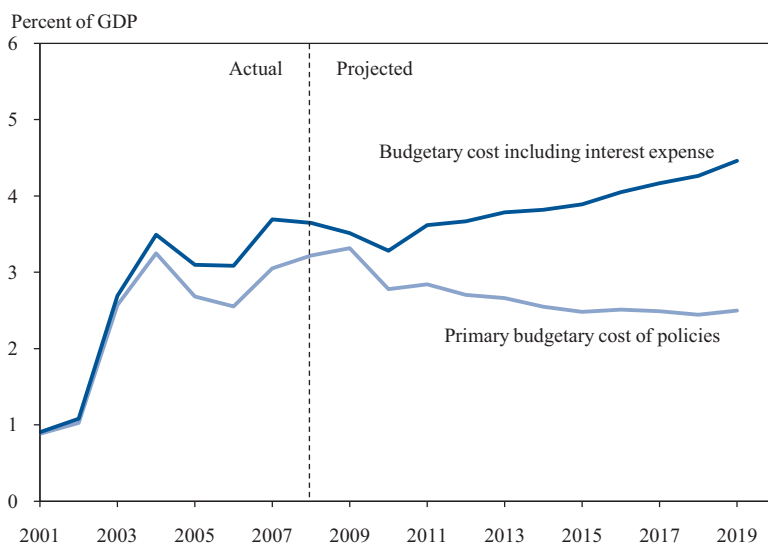
The previous policy choices involved both spending and revenues. On the spending side, two decisions were particularly important. One was the failure to pay for the addition of a prescription drug benefit to Medicare, which is estimated to increase annual deficits over the next decade by an average of one-third of a percent of GDP, excluding interest, and more than that in the years thereafter (Congressional Budget Office 2009g; Council of Economic Advisers estimates). The other was the decision to fight two wars without taking any steps to pay for the costs—costs that so far have come close to \$1 trillion. On the revenue side, the most important decisions were those that lowered taxes without making offsetting spending cuts. In particular, the 2001 and 2003 tax cuts have helped push revenues to their lowest level as a fraction of GDP at any point since 1950 (Office of Management and Budget 2010).

Figure 5-3 shows the impact on the budget deficit of these three major policies of the previous eight years that were not paid for: the 2001 and 2003 tax cuts (including the increased cost of Alternative Minimum Tax relief as a result of those tax cuts), the prescription drug benefit, and the spending for the wars in Iraq and Afghanistan (which for this analysis are assumed to wind down by 2013), both with and without the interest expense of financing these policies.² At their peak in 2007 and 2008, these policies worsened the government's fiscal position by almost 4 percent of GDP, and their effect, including interest, rises above 4 percent of GDP into the indefinite future. The fiscal outlook would be far better if these policies had been paid for. Indeed, Auerbach and Gale (2009) conclude that roughly half of the long-run fiscal shortfall in the outlook described earlier results from policy decisions made from 2001 to 2008.

The other main source of the long-run fiscal challenge is rising spending on Medicare, Medicaid, and Social Security. These burdens stem primarily from the rapid escalation of health care costs, combined with the aging of the population. Annual age-adjusted health care costs per Medicare enrollee grew 2.3 percentage points faster than the increase in per capita GDP from 1975 to 2007. If this rate of increase were to continue, Federal spending on Medicare and Medicaid alone would approach 40 percent of the Nation's income in 2085, which is clearly not sustainable

² The figure shows the annual cost (as a percent of GDP) of supplemental military expenditures for operations in Iraq and Afghanistan through 2009 and CBO's estimate of the cost of reducing the number of troops in Iraq and Afghanistan to 75,000 by 2013 thereafter; the cost of the Medicare Part D program net of offsetting receipts and Medicaid savings; the cost of the 2001 and 2003 tax cuts plus the additional cost of AMT relief associated with those tax cuts, as estimated by CBO; and the interest expense of financing these policies.

Figure 5-3
Budgetary Cost of Previous Administration Policy



Note: Includes supplemental war spending, cost of 2001 and 2003 tax cuts, Medicare Part D net of offsetting receipts and Medicaid savings, and related interest expense.

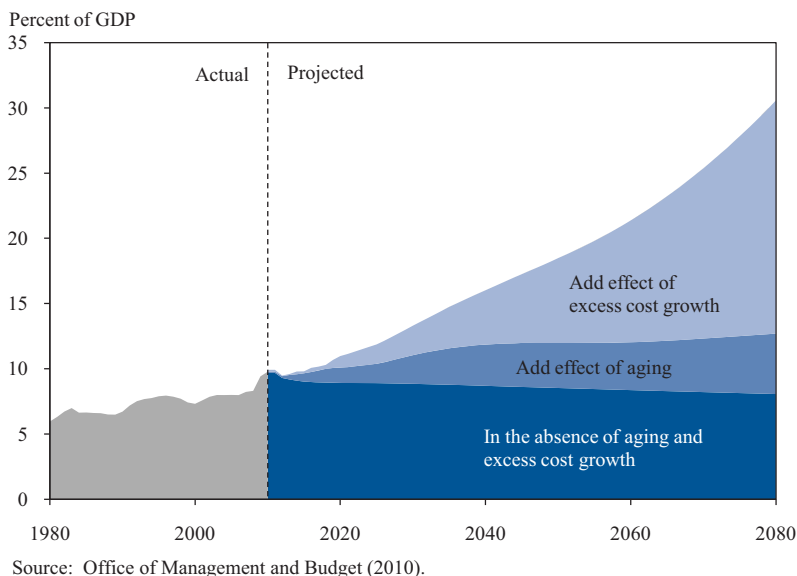
Sources: Belasco (2009); Congressional Budget Office (2009a, 2009g); CEA estimates.

(Congressional Budget Office 2009f). In addition, as a result of decreases in fertility and increases in longevity, the ratio of Social Security and Medicare beneficiaries to workers is rising, straining the financing of these programs.

Figure 5-4 projects the growth in spending in Medicare, Medicaid, and Social Security. Spending on the programs is projected to double as a share of GDP by 2050. Over the next 20 years, demographics—the retirement of the baby boom generation—is the larger cause of rising spending. But throughout, rising health care costs contribute to rising spending, and over the long term, they are by far the larger contributor to the deficit.

Other important factors have also contributed to the increase in entitlement spending. For example, the fraction of non-elderly adults receiving Social Security Disability Insurance (SSDI) benefits has approximately doubled since the mid-1980s, and the fraction of Social Security spending accounted for by SSDI benefits has increased from 10 to 17 percent. Beneficiaries of SSDI are also eligible for health insurance through Medicare. Total cash benefits paid to SSDI recipients were \$106 billion in 2008 and an additional \$63 billion was spent on their health care through Medicare. One contributor to the increase in disability enrollment was a 1984 change in the program’s medical eligibility criteria, which allowed more applicants to qualify for benefits in subsequent years (Autor and Duggan 2006).

Figure 5-4
Causes of Rising Spending on Medicare, Medicaid, and Social Security



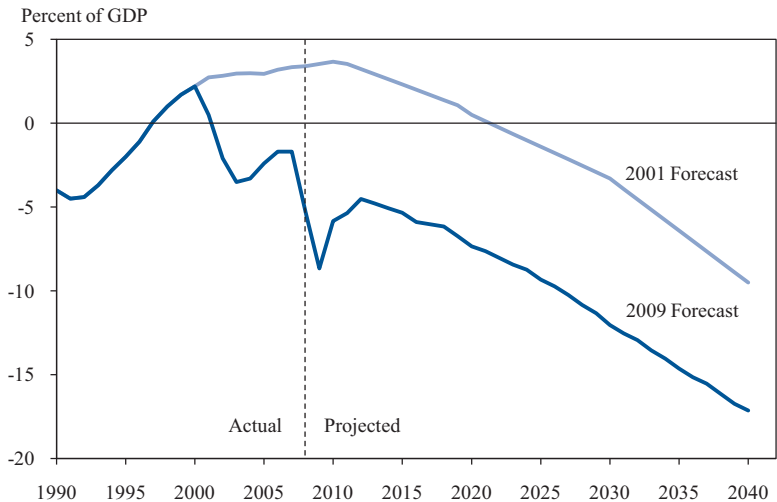
The potential challenges to the budget from these three entitlement programs have been clear for decades. Yet, policymakers in previous administrations did little to address them. For example, in October 2000, CBO warned that spending on Medicare, Medicaid, and Social Security would more than double, rising from 7.5 percent of GDP in 1999 to over 16.7 percent in 2040; nine years later, their forecast for spending on these programs remains virtually unchanged (Congressional Budget Office 2000, 2009f).

All told, the Obama Administration inherited a very different budget outlook from the one left to the previous administration. Figure 5-5 compares the budget forecast in January 2001 (Congressional Budget Office 2001) with the budget outlook in January 2009 described above.³ In 2001, CBO forecast a relatively bright fiscal future. After a decade of strong growth and responsible fiscal policy, the budget was substantially in surplus, and CBO analysts projected rising surpluses over the next decade, even under their more pessimistic policy alternatives. Rising health care costs would squeeze the budget only over the long term, and the retirement of the baby boom generation was still more than a decade away. The intervening time could have been used to pay off the national debt and accumulate

³ The 2001 forecast includes the January 2001 baseline forecast adjusted to reflect CBO's estimated cost of holding nondiscretionary outlays constant as a share of nominal GDP. Starting in 2012, the deficit evolves according to the intermediate projection in the October 2000 *Long-Term Budget Outlook* (Congressional Budget Office 2000).

substantial assets in preparation. But policymakers chose a different path. They enacted policies that added trillions to the national debt and doubled the size of the long-run problem. Combined with a deteriorating economic forecast and technical reestimates, the result was a much worse budget outlook in January 2009 than in January 2001.

Figure 5-5
Budget Comparison: January 2001 and January 2009



Note: CBO 2001 baseline projection adjusted for the cost of holding nondiscretionary outlays constant as a share of nominal GDP; CBO 2009 baseline projection adjusted for costs of continued war spending, continuation of 2001 and 2003 tax cuts, avoiding scheduled cuts in Medicare’s physician payment rates, and holding nondiscretionary outlays constant as a share of nominal GDP.

Sources: Congressional Budget Office (2000, 2001, 2009a, 2009f).

The Role of the Recovery Act and Other Rescue Operations

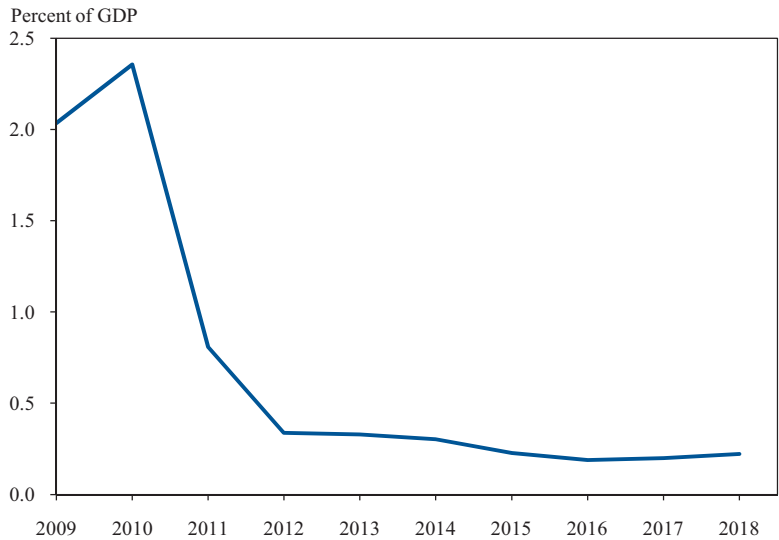
One development that has had an important effect on the short-term budget outlook since January 2009 is the aggressive action the Administration and Congress have taken to combat the recession. By far the most important component of the response in terms of the budget is the American Recovery and Reinvestment Act of 2009. The Recovery Act cuts taxes and increases spending by about 2 percent of GDP in calendar year 2009 and by 2¼ percent of GDP in 2010.

Crucially, however, the budgetary impact of the Recovery Act will fade rapidly. As a result, it is at most a very small part of the long-run fiscal shortfall. By 2012, the tax cuts and spending under the Recovery Act will be less than one-third of 1 percent of GDP. Other rescue measures, such as extensions of programs providing additional support to those most directly

affected by the recession, also contribute to the deficit in the short run. But these programs are much smaller than the Recovery Act. And like the Recovery Act, their budgetary impact will fade quickly.

Figure 5-6 shows the overall budgetary impact of the Recovery Act and other rescue measures, including interest on the additional debt from the higher short-run deficits resulting from the measures. The impact is substantial in 2009 and 2010 but then fades rapidly to about one-quarter of 1 percent of GDP. Moreover, because these estimates do not include the effects of the rescue measures in mitigating the downturn and speeding recovery—and thus raising incomes and tax revenues—they surely overstate the measures’ impact on the budget outlook.

Figure 5-6
Effect of the Recovery Act on the Deficit



Source: Congressional Budget Office (2009b).

AN ANCHOR FOR FISCAL POLICY

The trajectory for fiscal policy that the Administration inherited, with budget deficits and government debt growing relative to the size of the economy, is clearly untenable. Change is essential. But there are many alternatives to the trajectory the Administration inherited. In thinking about what path fiscal policy should attempt to follow, it is therefore important to examine how deficits affect the economy and what policy paths are feasible.

The Effects of Budget Deficits

Two factors are critical in shaping the economic effects of budget deficits: the state of the economy, and the size and duration of the deficits. Consider first the state of the economy. A central lesson of macroeconomics is that in an economy operating below capacity, higher deficits raise output and employment. Transfer payments (such as unemployment benefits) and tax cuts encourage private consumption and investment spending. Government investments and other purchases contribute to higher output and employment directly and, by raising incomes, also encourage further private spending.

In the current situation, as discussed in Chapter 2, monetary policymakers are constrained because nominal interest rates cannot be lowered below zero, and so they are unlikely to raise interest rates quickly in response to fiscal expansion. As a result, the fiscal expansion attributable to the Recovery Act is likely to increase private investment as well as private consumption and government purchases. Finally, in a precarious environment like the one of the past year, expansionary fiscal policy may make the difference between an economy spiraling into depression and one embarking on a self-sustaining recovery, and so have a dramatic impact on outcomes. As described more fully in Chapter 2, these benefits of fiscal expansion were precisely the motivation for the Administration's pursuit of the Recovery Act and other stimulus policies over the past year.

When the economy is operating at normal capacity, the effects of higher budget deficits are very different. In such a setting, the stimulus from deficits leads not to higher output, but only (perhaps after a delay) to a change in the composition of output. To finance its deficits, the government must borrow money, competing against businesses and individuals seeking to finance new productive investments. As a result, deficits drive up interest rates, discouraging private investment. Hence, deficit spending diverts resources that would otherwise be invested in productive private capital—new business investments in plant, equipment, machinery, and software, or investments in human capital through education and training—into government purchases or private consumption. To the extent that the private investments nonetheless occur but are financed by borrowing from abroad, the country has the benefit of the capital, but at the cost of increased foreign indebtedness. The result is that Americans' claims on future output are lower.

In sum, in normal times, higher budget deficits impede the rebalancing of output toward investment and net exports described in Chapter 4; lower deficits contribute to that rebalancing. In addition, budget

deficits were one source of the “global imbalances” discussed in Chapter 3 that have been implicated by some analysts as part of the cause of the financial and economic crisis. Finally, higher budget deficits and the higher levels of debt they imply may reduce policymakers’ ability to turn to expansionary fiscal policy in the event of a crisis.

Although determining the impact of large budget deficits on capital formation and interest rates is a difficult and contentious issue, the bulk of the evidence points to important effects. For example, several studies find that increases in projected deficits raise interest rates (Wachtel and Young 1987; Engen and Hubbard 2005; Laubach 2009). A careful review concludes that the weight of the evidence indicates that budget deficits raise interest rates moderately (Gale and Orszag 2003). Examining the international evidence, another study reaches a similar conclusion (Ardagna, Caselli, and Lane 2007).

The economic impact of budget deficits depends not only on the condition of the economy but also on their magnitude and persistence. A moderate period of large deficits in a weak economy will speed recovery in the short run and leave the government with only modestly higher debt in the long run. Even in an economy operating at capacity, a temporary period of high deficits is manageable, as the experience of World War II shows compellingly. Once full employment was reached, the high wartime spending surely crowded out investment and thus caused standards of living after the war to be lower than they otherwise would have been. But that cost aside, the enormous temporary deficits that reached 30 percent of GDP at the peak of the war created no long-run problems.

In contrast, the effects of large deficits and debt that grow indefinitely and without bound relative to the size of the economy are very different—and potentially very dangerous. If a government tried to follow such a path, eventually its debt would exceed the amount investors were willing to hold at a reasonable interest rate. At that point, the situation would spiral out of control. Rising interest costs would worsen the fiscal situation; this would further reduce investors’ willingness to hold the government’s debt, raising interest costs further; and so on. Eventually, investors would be unwilling to hold the debt at any interest rate.

Feasible Long-Run Fiscal Policies

Investors have no qualms about holding some government debt. Indeed, many desire the safety of such an investment. And crucially, in an economy in which private incomes and wealth, as well as the government’s tax base, are growing, the amount of debt investors are willing to hold also

grows. Thus, the key to a sustainable deficit path is a fiscal policy that keeps the level of debt relative to the scale of the economy at levels where investors are willing to hold that debt at a reasonable interest rate. Most obviously, paths where the ratio of the deficit to GDP and the ratio of the debt to GDP grow without bound cannot be sustained. Equally, however, paths that would lead the debt-to-GDP ratio to stabilize, but at an extremely high level, are also not feasible.

Historical and international comparisons, as well as the very favorable terms on which investors are currently willing to lend to the United States, show that the Nation is not close to such problematic levels of indebtedness. In 2007, before the recession, the debt held by the public was 37 percent of nominal GDP. In 2015, because of the direct effects of the recession and, to a lesser extent, the fiscal stimulus, the President’s budget projects the public debt (net of financial assets held by the government) will be 65 percent of GDP. By comparison, it was 113 percent of GDP at the end of World War II; in the United Kingdom, the ratio at the end of World War II was over 250 percent. Table 5-1 shows the projected 2010 government debt-to-GDP ratio (including state and local government debt) for a wide range of developed countries. Japan’s debt-to-GDP ratio is 105 percent, Italy’s is 101 percent, and Belgium’s is 85 percent, and all of these are projected to rise. None of these countries enjoys the same depth and breadth of demand for its debt as the United States does, yet none has difficulty financing its debt. Thus, although it is hard to know the exact U.S. debt-to-GDP ratio that would begin to pose problems, it is clearly well above current levels.

Table 5-1
Government Debt-to-GDP Ratio in Selected OECD Countries (percent)

	2010
Belgium	85.4
Canada	32.6
France	60.7
Germany	54.7
Italy	100.8
Japan	104.6
Spain	41.6
Sweden	-13.1
United Kingdom	59.0
United States	65.2
Euro-area average	57.9
OECD average	57.6

Note: Numbers include state and local as well as Federal net government debt.
Source: Organisation for Economic Co-operation and Development (2009).

The Choice of a Fiscal Anchor

It is essential that the United States follow a fiscal policy that stabilizes the debt-to-GDP ratio at a feasible level. In thinking about the specific level of that ratio that policymakers should aim for, it is useful to think about the implications that different levels of the budget deficit have for the level of government debt in the long run. In particular, consider paths where the deficit as a percent of GDP stabilizes at some level. If the deficit-to-GDP ratio and the growth rate of nominal GDP are both steady, the debt-to-GDP ratio will settle down to the ratio of the deficit-to-GDP ratio to the growth rate of nominal GDP.⁴ For example, if the deficit is 1 percent of GDP and nominal GDP is growing at 5 percent per year, the debt-to-GDP ratio will stabilize at 20 percent. Similarly, if the deficit-to-GDP ratio and the growth rate of nominal GDP are both 4 percent, the debt-to-GDP ratio will stabilize at 100 percent. Instead of thinking about various possible long-run targets for the debt-to-GDP ratio, policymakers can consider possible targets for the deficit-to-GDP ratio and their accompanying implications for the long-run debt-to-GDP ratio.

The choice among different deficit-to-GDP ratios involves tradeoffs. Lower deficits, and thus lower debt in the long run, have obvious advantages: a higher capital stock, lower foreign indebtedness, smaller global imbalances, and more fiscal room to maneuver. But lower deficits have disadvantages as well. They require smaller government programs, higher taxes, or both. Because Medicare, Medicaid, and Social Security will grow faster than GDP in coming decades even after the best efforts to make those programs as efficient as possible, significant cuts in government spending would impose substantial costs. And higher taxes can reduce incentives to work, save, and invest.

Based on these considerations, the Administration believes that an appropriate medium-run goal is to balance the primary budget—the budget excluding interest payments on the debt. Including interest payments, this target will result in total deficits of approximately 3 percent of GDP. With real GDP growth of about 2.5 percent per year and inflation of about

⁴ To see this, consider the case where the deficit-to-GDP ratio equals the growth rate of GDP. Then the dollar amount of debt issued in a year (that is, the deficit) equals the dollar increase in GDP. If the debt-to-GDP ratio is 100 percent—the amount of debt outstanding equals GDP—then the percent increase in debt exactly equals the percent increase in GDP, and the debt-to-GDP ratio holds steady at 100 percent. If, however, the amount of debt outstanding is less than nominal GDP, then adding a dollar to the debt results in a larger percentage increase in the debt than does a dollar added to GDP. Hence, the debt-to-GDP ratio will rise. If the amount of debt outstanding is more than nominal GDP, then the percent increase in debt is smaller than the percent increase in GDP and the debt-to-GDP ratio falls. Thus, the debt-to-GDP ratio converges to the ratio of the deficit-to-GDP ratio to the growth rate of GDP, which in this case is 100 percent.

2 percent per year, nominal GDP growth will be about 4.5 percent per year in the long run. Thus a target for the total deficit-to-GDP ratio of 3 percent implies that the debt-to-GDP ratio will stabilize at less than 70 percent. Because the debt-to-GDP ratio is projected to rise to about 65 percent in a few years, such a target implies that the debt-to-GDP ratio will change little once the economy has recovered from the current recession. A debt-to-GDP ratio of around two-thirds is comfortably within the range of historical and international experience. It represents substantial fiscal discipline relative to the trajectory the Administration inherited. Stabilizing the ratio rather than continuing on a path where it is continually growing is imperative, and stabilizing it at around its post-crisis level has considerable benefits and is a natural focal point.

REACHING THE FISCAL TARGET

Bringing the primary budget into balance and keeping it there will not be easy. Noninterest spending outstrips tax revenues by a large margin in the budget inherited by the Administration. More importantly, the trajectory of policy implied that spending would continue to exceed revenues even after the economy had recovered and that the deficit would rise steadily for decades to come. The economic developments and policy decisions that put fiscal policy on that course took place over many years. Thus, moving policy back onto a sound path will not happen all at once.

General Principles

In broad terms, the right way to tackle the long-run fiscal problem is not through a sharp, immediate fiscal contraction, but through policies that steadily address the underlying drivers of deficits over time. Large spending cuts or tax increases are exactly the wrong medicine for an economy with high unemployment and considerable unused capacity: just as fiscal stimulus raises income and employment in such an environment, mistimed attempts at fiscal discipline have the opposite effects. Any short-run fiscal contraction can best be tolerated at a time when the Federal Reserve is no longer constrained by the zero bound on nominal interest rates, and so has the tools to counteract any contractionary macroeconomic impacts.

The dangers of a large immediate contraction are powerfully illustrated by America's experience in the Great Depression. In 1937, after four years of very rapid growth but with the economy still far from fully recovered, both fiscal and monetary policy turned sharply contractionary: the veterans' bonus program of the previous year was discontinued, Social Security taxes were collected for the first time, and the Federal Reserve doubled reserve

requirements. The consequences of this premature policy tightening were devastating: real GDP fell by 3 percent in 1938, unemployment spiked from 14 percent to 19 percent, and the strong recovery was cut short.

The impact of actions taken today to gradually bring the long-run sources of the deficit problem under control would be very different. Such policies do not involve a sharp short-run contraction that could derail a nascent recovery. Because the effects cumulate over time, however, they can have a large effect on the long-term fiscal outlook.

Policies that provide gradual but permanent and growing deficit reduction have another potential advantage. By improving the outlook for the long-term performance of the economy, they can improve business and consumer confidence today. As a result, deficit-improving policies whose effects are felt mainly in the future can actually boost the economy in the short run. There is considerable evidence that such “expansionary fiscal contractions” are not just a theoretical possibility (see, for example, Giavazzi and Pagano 1990; Alesina and Perotti 1997; Romer and Romer forthcoming).

In keeping with these general considerations, the Administration is taking actions in three important areas that will have a material impact on the deficit in the medium and long terms.

Comprehensive Health Care Reform

The first and single most important step toward improving the country’s long-run fiscal prospects is the enactment of comprehensive health care reform that will slow the growth rate of costs. Beyond the obvious importance for Americans’ well-being and economic security, the health reform legislation being considered by Congress would save money. The rapid growth of health care costs is a central source of the country’s fiscal difficulties. CBO has estimated that both the bill passed by the House in November 2009 and the bill passed by the Senate in December 2009 would significantly reduce the deficit over the next decade (Congressional Budget Office 2009e, 2009d). But the more important factor for the long-run fiscal situation is that, as discussed in more detail in Chapter 7, the bills contain crucial measures that experts believe will lead to lower growth in costs while expanding access to coverage, increasing affordability, and improving quality. Given the central role of rising health costs in the long-run deficit projections, these measures would therefore lead to substantial improvements in the budget situation over time.

In November 2009, CBO’s analysis of the Senate health care bill found that “Medicare spending under the bill would increase at an average annual

rate of roughly 6 percent during the next two decades—well below the roughly 8 percent annual growth rate of the past two decades” (Congressional Budget Office 2009c). In December, the Council of Economic Advisers estimated that the fundamental health care reform in the Senate bill would reduce the annual growth rate of Medicare and Medicaid costs by a full percentage point below what it would otherwise be in the coming decade, and by even more in the following decade (Council of Economic Advisers 2009b). These reductions reflect specific measures directed at identifiable sources of wasteful spending and fraud combined with institutional reforms that will help counter the forces leading to excessive cost growth.

Such a reduction in the growth rate of health care costs would have a more profound effect on the long-run fiscal situation of the country than virtually any other fiscal decision being contemplated today. Even if the slowdown in cost growth held steady at 1 percentage point annually rather than rising in the second decade, it would reduce the budget deficit in 2030 by about 2 percent of GDP relative to what it otherwise would be. In today’s terms, this is equivalent to almost \$300 billion per year. Most of these savings reflect the direct impact of lower health care costs on Federal spending. To the extent that health care reform also slows the growth of private sector health insurance costs, which are tax preferred, employees in the private sector will benefit from higher wages and the Treasury from increased revenues; this becomes a second source of budget savings. And these direct savings are magnified by lower interest costs resulting from the reduced debt accumulation in the years preceding 2030 (Council of Economic Advisers 2009a). The need to expand coverage would reduce the overall impact of health care reform on the budget deficit somewhat. However, these costs of expansion would be more than offset even within the coming decade. Thereafter, reform will lower the deficit by increasing amounts over time.

Restoring Balance to the Tax Code

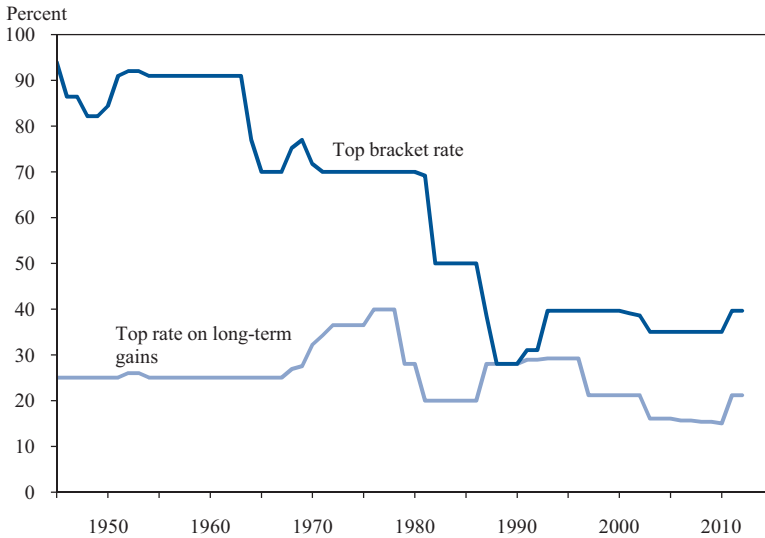
The second major step the Administration is taking to address the long-run fiscal challenge is restoring balance to the tax code that has been lost since 2001. The 2001 and 2003 tax cuts disproportionately favored wealthy taxpayers. According to estimates from the Urban-Brookings Tax Policy Center (2010), in 2010 the 2001 and 2003 tax cuts will increase the after-tax income of the poorest 20 percent of the population by 0.5 percent (about \$51), the middle 20 percent by 2.6 percent (\$1,023), and the top 1 percent by 6.7 percent (\$72,910). About 67 percent of the tax cuts went to the top 20 percent of taxpayers, and 26 percent to the top 1 percent.

These tax cuts for the wealthiest Americans took place when the incomes of ordinary Americans were stagnating and inequality was reaching almost unprecedented levels. In other words, the tax cuts exacerbated the broader trend rather than mitigated it.

The President has consistently maintained that the tax cuts went too far in cutting taxes for people making more than \$250,000 per year and that the country could not afford the tax breaks given to that group over the past eight years. That is why one important plank of his fiscal responsibility framework is to rebalance the tax code, so that it is similar to what existed in the late 1990s for those making more than \$250,000 per year. Specifically, the Administration has proposed letting the marginal tax rates on ordinary income and capital gains for people making more than \$250,000 per year return to the levels they were in 2000. It has also proposed setting the tax rate on dividends for high-income taxpayers to the same 20 percent rate that would apply to capital gains—which is lower than the rate in the 1990s—and letting all other features of the 2001 and 2003 tax cuts expire for these taxpayers. In addition, it has proposed limiting the rate of deductions for high-income taxpayers to 28 percent, so that the wealthy do not obtain proportionately larger benefits from their deductions than other Americans do. None of these changes would take effect until 2011, so they would not affect disposable incomes as the economy recovers in 2010. Nonetheless, they would raise nearly \$1 trillion over the next 10 years and even more over the longer run. Equivalently, they would reduce the budget deficit by more than 0.5 percent of GDP in the medium run and somewhat more over time.

As just discussed, most of these changes would merely bring the tax rates on high-income taxpayers back to their levels in the 1990s. To the extent that some go further, on balance they are more than offset by the fact that some common types of income—dividends, for example—will have rates significantly lower than in the 1990s. Looking at tax policy over U.S. postwar history more broadly shows even more clearly how moderate the proposed changes are. Figure 5-7 shows the top marginal tax rates on ordinary income and capital gains over time and their levels under the Administration's proposals. For ordinary income, a top rate of 39.6 percent, while higher than in the past eight years, is not high compared with the rates that prevailed during most of the past several decades and even during most of the Reagan administration. For capital gains, the 20 percent rate is lower than in many previous periods and is certainly not unusual. And for dividends, the 20 percent rate proposed by the Administration would be lower than under any other modern president save the last.

Figure 5-7
Top Statutory Tax Rates



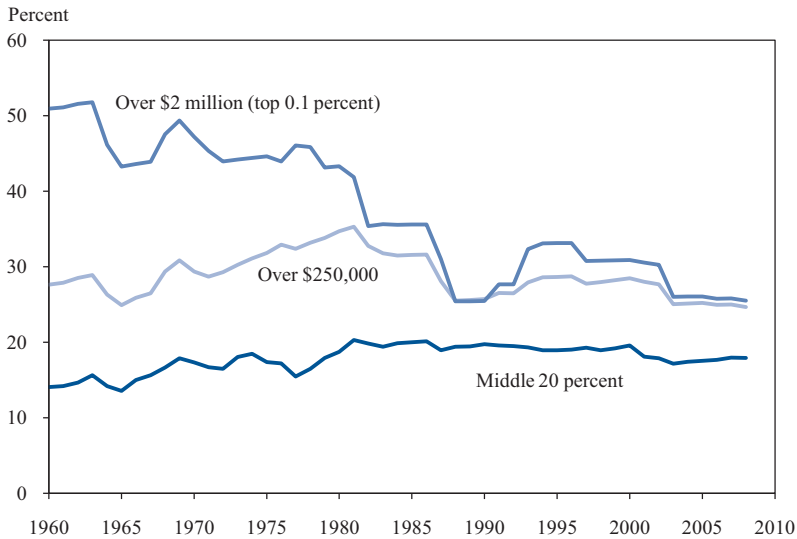
Note: The top rate on qualified dividends is equal to the top bracket rate until 2003; thereafter, it is equal to the top rate on long-term capital gains.

Source: Department of the Treasury, Internal Revenue Service (2009); Department of the Treasury, Office of Tax Analysis (2010).

Statutory marginal tax rates, however, provide only a partial picture of how the progressivity of the tax system has changed over time. The number of tax brackets has declined and the thresholds at which statutory bracket rates apply have changed; different sources of income, such as capital gains and dividends, are now treated differently in the tax code and taxed at lower rates; and exemption amounts and standard deductions have been adjusted. Moreover, the distribution of income across taxpayers and the composition of taxpayers' sources of income have changed significantly over time, making it difficult to disentangle the effects of statutory changes in the tax system from economic changes. To illustrate the impact of historical statutory tax changes in isolation, Figure 5-8 applies the tax rates for each year from 1960 to 2008 to a sample of taxpayers who filed returns in 2005, after adjusting for average wage growth.⁵ The purpose is to show both how current taxpayers

⁵ Average tax rates are calculated for nondependent, nonseparated filers with positive adjusted gross income in tax year 2005. Dollar figures are adjusted to the appropriate tax year using the Social Security Administration national average wage index (Social Security Administration 2009), and the tax due is estimated using the National Bureau of Economic Research's TAXSIM tax model. This tax model incorporates the major tax provisions affecting the vast majority of taxpayers and taxable income, and provides estimates of tax liabilities that closely match the historical distribution of taxes actually paid. However, the tax calculation ignores certain small tax provisions and certain accounting changes that broadened the definition of taxable income over time.

Figure 5-8
Evolution of Average Tax Rates



Notes: Average tax rates calculated each year for a sample of 2005 taxpayers after adjusting for average wage growth. Dollar figures in 2009 dollars.

Sources: Department of the Treasury, Internal Revenue Service, Statistics of Income Public Use File 2005; National Bureau of Economic Research TAXSIM (Feenberg and Coutts 1993); CEA calculations.

would have fared under the tax rates that applied historically and how the tax rates that applied to different income groups have changed over time.

This analysis suggests that the effective tax rates that applied to high-income taxpayers reached their lowest levels in at least half a century in 2008. Under the tax laws that applied from 1960 to the mid-1980s, today's taxpayers earning more than \$250,000 would have paid an average of around 30 percent of their income in Federal income and payroll taxes, with modest variations from year to year. Moreover, while the tax rates that applied to these "ordinary" rich have fallen considerably, tax rates for the very rich have declined much more. Figure 5-8 shows that taxpayers whose real incomes put them in the top 0.1 percent of taxpayers today—the one-in-a-thousand taxpayers with incomes above about \$2 million in 2009 dollars—would have paid more than 50 percent of their incomes in taxes in the early 1960s.

Average tax rates on high-income groups fell precipitously in the mid-1980s, with the sharp decline in statutory marginal rates. At the same time, the tax rates that would have applied to today's middle-income taxpayers (the middle 20 percent of taxpayers in 2005, those making between about \$29,500 and \$49,500 per year) increased, on balance, over the last half century. The result is a compression in the tax burdens applied to taxpayers

with different incomes—the difference between the average tax rates on high-income groups and those on middle-class households is narrower than at any other time in modern history. All told, because of legislative changes in the tax code, the after-tax income of the very-high-income group—their disposable income and purchasing power—is more than 50 percent higher than it would have been under historical tax rates and brackets, while that of the middle class is slightly lower.

Under the Administration's proposals, tax rates on taxpayers earning more than \$250,000 would be very close to the levels that prevailed in the 1990s, leaving statutory tax rates on higher-income taxpayers far below the levels that prevailed until the mid-1980s. The rebalancing of the tax code would not affect middle-class taxpayers—except, of course, to the extent that a better fiscal picture enhances medium- and long-term prospects for economic growth.

The need to restore balance is also evident in our corporate tax system, which encourages businesses to move jobs overseas and to transfer profits to tax havens abroad in order to avoid taxes at home. The Administration's plan to reform international tax laws would reduce these incentives.

Balance also requires that the largest and most highly levered financial firms reimburse taxpayers for the extraordinary assistance provided to them through the Troubled Asset Relief Program. The President has proposed a modest Financial Crisis Responsibility Fee to ensure that the cost of the financial rescue is not borne by taxpayers. Moreover, the fee would provide a deterrent against the excessive leverage that helped contribute to the crisis.

Eliminating Wasteful Spending

The third step the Administration is taking to confront the long-term deficit is cutting unnecessary spending. The President pledged to eliminate programs that are not working. Last year, the Administration either proposed or enacted cuts to 121 specific programs; these proposed cuts totaled \$17 billion in the first year and hundreds of billions of dollars over the 10-year budget window. They include billions of dollars in terminations of defense programs such as the F-22 fighter aircraft and the new Presidential helicopter, cuts in subsidies for large, high-income agribusinesses, and more than \$40 billion in savings over the next 10 years from eliminating unnecessary subsidies to financial institutions in the private student loan market.

In its fiscal 2011 budget, the Administration is proposing another important measure for spending restraint: a three-year freeze in all nonsecurity discretionary spending starting in 2011. The freeze would be a tough

measure of shared sacrifice. By 2013, it would reduce overall nonsecurity funding by \$30 billion per year relative to current inflation-adjusted funding levels.

The President also strongly supports restoring the pay-as-you-go requirement (PAYGO) that was in place in the 1990s. This law, which requires that lawmakers make the tough choices needed to offset the costs of new nonemergency spending or tax changes, helped move the government budget from deficit to surplus a decade ago. PAYGO is an important tool to force the government to live within its means and move the budget toward fiscal sustainability.

These measures mean that once the temporary rise in government spending necessitated by the economic crisis has ended, spending will be on a lower path than it otherwise would have been. Moreover, both the multi-year freeze and steps to identify additional unnecessary spending each year make the reduction gradual rather than sudden. As a result, the cumulative reduction is substantial, yet there is never a sudden, potentially disruptive drop in spending.

CONCLUSION: THE DISTANCE STILL TO GO

The actions the Administration has taken and is proposing would reduce deficits by more than \$1 trillion over the next 10 years and by even more after that. These actions are significantly bolder steps toward deficit reduction than any taken in decades, and they will face serious opposition by those with vested interests. Even with these actions, however, the primary budget is forecast to remain in deficit in 2015. And the longer-run fiscal problem facing the country still centers on the growth of health care costs and the aging of the population. Thus, barring a substantial and sustained quickening of economic growth above its usual trend rate, further steps will be needed to get the deficit down to the target in the medium and long run.

Regardless of the form they take, these additional steps to reduce the deficit will involve sacrifices by a broad range of groups and significant compromise. Thus, a bipartisan effort will be essential. That is why the President is issuing an executive order creating a bipartisan fiscal commission to report back with a package of measures for additional deficit reduction. The charge to the commission is to propose both medium-term actions to close the gap between noninterest expenditures and tax revenues and additional steps to address the longer-term issues associated with rising health care costs, the aging of the population, and the persistent deficit. The commission's recommendations will form an important foundation on which to base policy decisions moving forward.

The Administration understands that addressing the long-run fiscal challenge will be a long and difficult task requiring commitment and shared sacrifice. But the President also believes that Americans deserve for and expect policymakers to deal with the ever-rising deficit. The changes eventually enacted will be central to the long-run preservation of both America's financial strength and the standards of living of ordinary Americans.