



# The Emerging Budget Crisis: Urgent Fiscal Choices

Challenges Posed by Federal Budget Deficits

Principles for Budget Policy

Social Security Reform

The Budget Process and Appropriations

Taxes

Health Care

May 2005

A Statement by the Research and Policy Committee of the Committee for Economic Development



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**MAY 2005**

The Emerging Budget Crisis: Urgent Fiscal Choices/ a policy statement by the Research and Policy Committee of the Committee for Economic Development.

Library of Congress Cataloging-in-Publication Data can be found at the Library of Congress.

First printing: 2005  
Paperback: \$15.00  
Printed in the United States of America

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## RESPONSIBILITY FOR CED STATEMENTS ON NATIONAL POLICY

The Committee for Economic Development is an independent research and policy organization of some 200 business leaders and educators. CED is non-profit, non-partisan, and non-political. Its purpose is to propose policies that bring about steady economic growth at high employment and reasonably stable prices, increased productivity and living standards, greater and more equal opportunity for every citizen, and an improved quality of life for all.

All CED policy recommendations must have the approval of trustees on the Research and Policy Committee. This committee is directed under the bylaws, which emphasize that “all research is to be thoroughly objective in character, and the approach in each instance is to be from the standpoint of the general welfare and not from that of any special political or economic group.” The committee is aided by a Research Advisory Board of leading social scientists and by a small permanent professional staff.

The Research and Policy Committee does not attempt to pass judgment on any pending specific legislative proposals; its purpose is to urge careful consideration of the objectives set forth in this statement and of the best means of accomplishing those objectives.

Each statement is preceded by extensive discussions, meetings, and exchange of memoranda. The research is undertaken by a subcommittee, assisted by advisors chosen for their competence in the field under study.

The full Research and Policy Committee participates in the drafting of recommendations. Likewise, the trustees on the drafting subcommittee vote to approve or disapprove a policy statement, and they share with the Research and Policy Committee the privilege of submitting individual comments for publication.

*The recommendations presented herein are those of the trustee members of the Research and Policy Committee and the responsible subcommittee. They are not necessarily endorsed by other trustees or by non-trustee subcommittee members, advisors, contributors, staff members, or others associated with CED.*

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## PURPOSE OF THIS STATEMENT

The Committee for Economic Development (CED) stated two years ago that “America now stands at a fiscal crossroad.” Developments since have made the nation’s choices only more pressing.

In 2003, in *Exploding Deficits, Declining Growth: The Federal Budget and the Aging of America*, we foresaw a decade of significant budget deficits, with concern that enactment of a Medicare prescription drug benefit and the cost of a global war on terrorism could make those deficits even larger. Now, those contingencies have materialized, and the deficit outlook, in an apples-to-apples comparison, has worsened accordingly—and more besides. Further contingencies, including a continued intense war effort, extension of tax cuts and new tax relief, sustained increases in the price of oil and possible continuing weak tax revenues, cloud the outlook. A significant drop in the value of the U.S. dollar relative to free-floating foreign currencies signals possible concern in world financial markets.

Furthermore, though our 2003 statement expressed a less-serious concern about near-term than long-term budget deficits, the long run has grown ever closer. The retirement of the first of the baby-boom generation, on early Social Security benefits, will begin in 2008—just three years from now. The current budget outlook shows no signs of relief before then. Thus, the time that the nation has to right the budget before the inevitable adverse demographic forces bear full force is disturbingly short.

And finally, the pending economic policy agenda includes numerous issues, such as Social Security reform and the extension of expiring tax cuts, which would affect the budget outlook significantly. It is clear that these issues must be considered with full regard for the nation’s fiscal standing.

Accordingly, CED believes that it is important to reiterate its concern about the size of the federal budget deficit, to restate its principles for the nation’s fiscal policy, and to evaluate the policy choices that confront the federal government at this crucial time.

## ACKNOWLEDGEMENTS

We are grateful for the time, effort, and care put into this policy statement by Joseph J. Minarik, CED’s Senior Vice President and Director of Research.

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## Challenges Posed by Federal Budget Deficits

### Deficits Are Now Large and Persistent

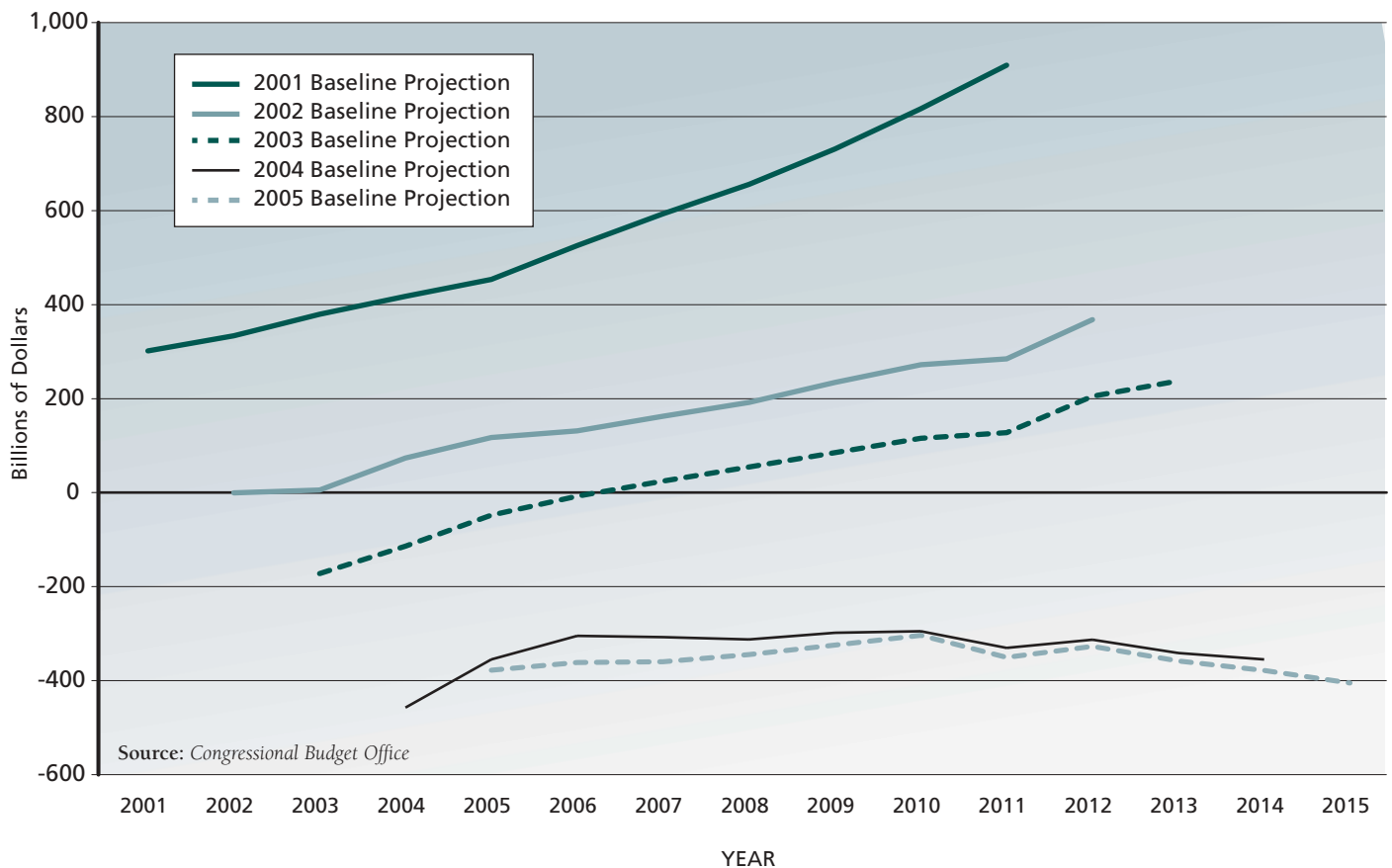
The latest federal budget projections indicate that deficits in the near term are worsening, not improving, while the retirement of the baby-boom generation with its adverse long-range budget pressures is just a few years away. Under current policies, there will be inadequate time to right the budget before the rapid aging of the population could take control out of policymakers' hands.

At the beginning of 2001, budget watchers anticipated substantial and growing surpluses, large enough to end reliance on the vanishing surpluses in the Social Security and Medicare Trust Funds (*see chart 1*). Since that time, mostly as a result of policy action (but with significant economic and technical estimating changes as well), the outlook has deteriorated by more than a cumulative \$10 trillion over fiscal years 2002 through 2011.

Much of this change in the outlook is due to policies already enacted, on both the tax and the spending sides of the ledger. Some is due to reasonable anticipations of future policy decisions, including extensions of expiring tax cuts, response to the rapid extension of the reach of the individual alternative minimum tax (AMT), and expected continued future increases in annual appropriations; such judgments about future policy actions are, of course, inherently uncertain.<sup>1</sup>

But with the most reasonable assumptions, including that the major expiring tax cuts are made permanent (as the Administration's budget proposes), that the AMT is cut back, and that the war effort begins to phase down in less than two years, the budget outlook continues to deteriorate (although by a small margin this year), even though the economy continues to

**CHART 1 CBO Budget Projections**



## 2 The Emerging Budget Crisis: Urgent Fiscal Choices

recover and expand. There are at least two important dimensions to this deterioration.

For one thing, current projections of the deficit for each and every future year are worse now than they were one year ago (that is, the line for the January 2005 budget baseline is everywhere below the line for January 2004 in chart 1). Thus, even though the economy continues to expand, the budget outlook still has not moved in a favorable direction. This troubling lack of improvement, even in a growing economy, casts serious doubt on optimistic statements that we can “grow our way out of the deficit”—that the budget will improve if the economy continues to grow, or that “supply-side” effects of tax cuts will increase productivity growth.

The second troubling aspect of the budget outlook is that the newly projected figures no longer anticipate significant improvement in the later years. The deficit for fiscal year 2005 is expected to be just short of \$400 billion, and possibly to exceed the 2004 largest-ever deficit of \$412 billion. Over the next ten years, the deficit never falls below \$324 billion (in 2010) before rising again. And by the most significant measure for the long run, the nation’s accumulated debt grows as a percentage of the GDP in every year.

Some budget watchers have taken comfort in the fact that the deficits in recent years have not exceeded the very highest past level as a percentage of the GDP (6.0 percent, in 1983). What this optimistic view misses is that the true bottom line, the accumulated debt held by the public, is growing faster than the nation’s capacity to repay it (that is, the GDP). This means that

the deficit is too high, even if it may not be the highest ever. And with the debt growing faster than the nation’s income until and beyond the full force of the retirement of the baby boom—with the first baby boomers collecting early Social Security benefits in 2008, and becoming eligible for Medicare coverage in 2011, and full Social Security benefits in 2012—we have no current prospect of forestalling a destabilizing and self-perpetuating expansion of the debt burden.

CED and other observers have in the recent past expressed much less concern about near-term deficits than those projected for the long run. The sad truth today is that the short-term deficits now extend all the way to the long run—in other words, the deficits have become structural, and will continue even if the economy continues to grow healthily, all the way to and through the onset of the retirement of the baby-boom generation. Clearly, policy must change significantly, and the sooner, the better.

The deterioration in the budget outlook can be defended, in part and in the short run, because some of the increases in expenditures arguably were necessary. Some would contend that the nation’s core defense program was in need of expansion in 2001; many would support the later spending to repair the damage from the subsequent terrorist attacks, and to improve homeland security. However, the fact that expenditures are necessary does not render them free, or devoid of fiscal consequences. Even fully justified drivers of past deficits must be paid for if they extend into the future. In the long run, such costs erode the nation’s savings just like any other, as the following section will explain.

### Deficits Matter

Evidence continues to mount that such sustained large budget deficits will erode U.S. investment, productivity growth, and prosperity for years and even decades to come. In addition, one cannot discount the risk that deficits could seriously threaten economic stability, and force abrupt and painful policy corrections. As CED Trustee Peter G. Peterson has pointed out, if the fiscal imbalance is not corrected, ultimately “the government will face stark options: either draconian cuts in defense, education, transportation, the criminal justice and other programs, or huge tax hikes—or, of course, both.”<sup>2</sup> These risks are at the heart of CED’s concern about the budget.

While there is not unanimity among economists, there are some important principles on which most economists, and CED, agree.

#### ***Reduced productivity growth, reduced future incomes.***

First, we know that the key to long-term economic growth and rising living standards is increasing productivity—that is, the nation’s ability to produce more goods and services with the resources at its disposal. The economy grows when new ideas are developed, when they are reflected in a more productive capital stock and labor force, and when the economy is flexible and adaptive enough to respond to new opportunities.

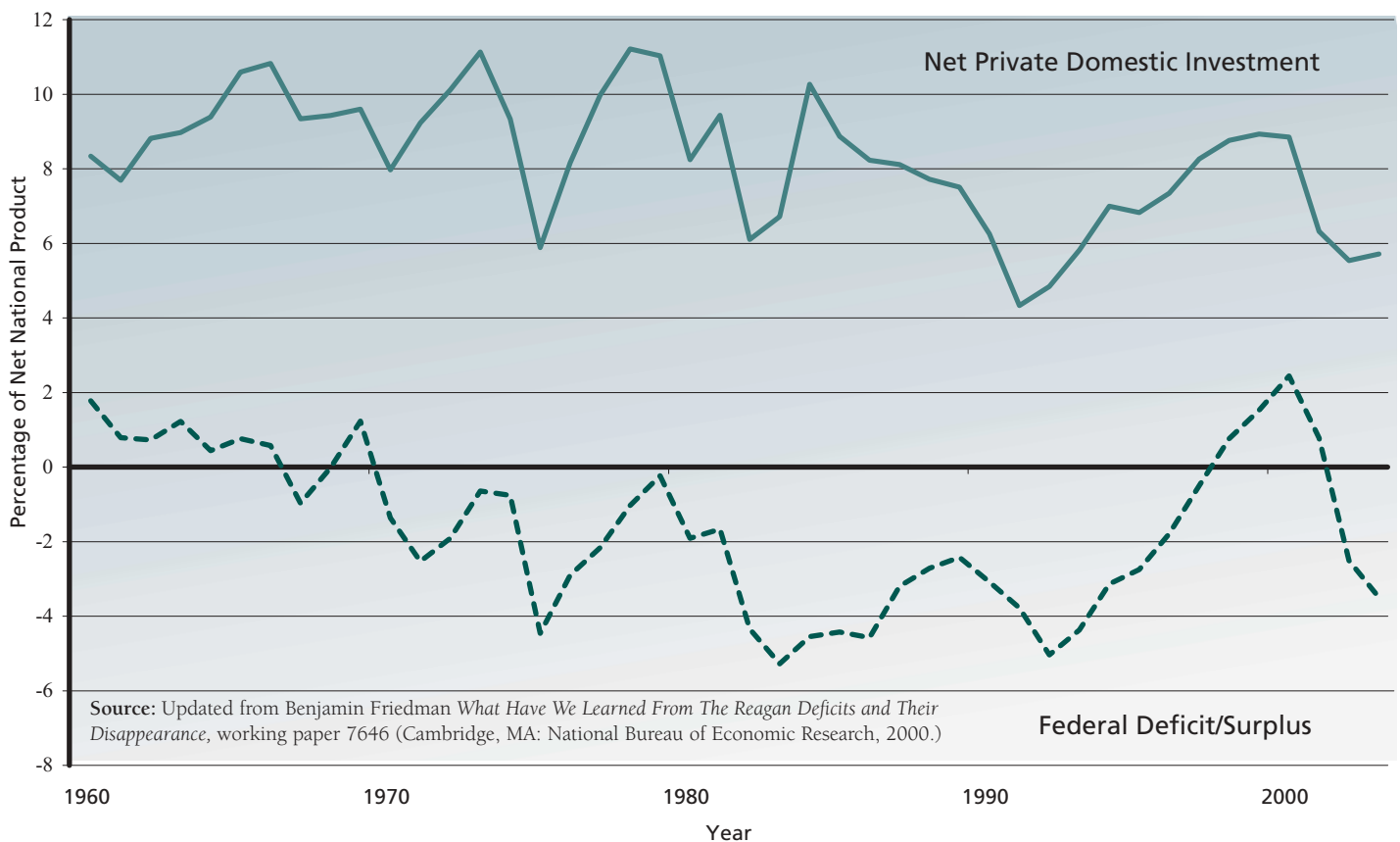
Second, we know that federal budget deficits interfere with this process, primarily by siphoning off funds from private investment (see chart 2), and that deficits may reduce public investment as well. Deficits usurp the national saving (household saving, business profits, and government surpluses) otherwise available for investment; just as the nation's saving is diminished when households borrow to spend more than their income, that saving is also diminished when the government spends more than its revenues. When the government borrows by selling government debt to finance the resulting deficit, it uses the saving otherwise available for private investment at home or abroad.\*

By reducing private investment at home, higher deficits leave the nation with a smaller capital stock, giving its workforce fewer and less-effective tools with which to work—whether computers and software,

machines, transportation equipment, or buildings and other structures. This slows the growth in the productivity of workers, which, in turn, leads to slower growth in living standards. The “crowding out” of domestic investment by federal deficits is not just an abstraction suggested by economic analysis; it has been an historical fact, particularly during the large changes in the deficit during the 1980s and 1990s. (See *Exploding Deficits, Declining Growth*, pp 6-8.)

**Higher interest rates...** This linkage between budget deficits and investment usually arises because government borrowing bids interest rates higher than they otherwise would be, thereby discouraging private investment. The current low level of interest rates, however, has raised an issue that has figured prominently in the deficit debate: Do larger deficits really raise interest rates? Elementary economic reasoning

**CHART 2 Federal Deficits Crowd Out Private Investment**



\* The U.S. National Income and Product Accounts (NIPA) include public expenditures on physical capital, such as structures, equipment, and software, in national saving and investment. Other public expenditures that raise future output and income, such as those on research and development, education, and training are not included in saving and investment and therefore add to the computed budget deficit. A comprehensive capital budget would include such expenditures in saving and investment, but the problems in defining genuine investment expenditures are acute.

strongly supports such a relationship, and Federal Reserve Chairman Alan Greenspan has reaffirmed this view.<sup>3</sup> Numerous econometric studies differ on the strength of this relationship. A recent review of these studies, however, finds that, if expectations about future deficits are taken into account, a sustained increase in annual budget deficits of one percent of GDP can be expected to raise long-term interest rates by about 50 basis points (that is, one-half percentage point) after one year. We believe these findings support the common-sense view that deficits, because they increase the demand for credit, raise the price of credit, which is the rate of interest. This in turn reduces domestic investment and impairs long-term economic growth.

*...or increased foreign debt.* Moreover, focusing on the relationship between deficits and interest rates obscures a more fundamental point. As globalization proceeds and capital markets become more integrated, the impact of deficits on domestic interest rates and investment may be muted—but the adverse effects on the nation's future prosperity remain just as great.

Twenty years ago, economists were surprised to discover that the large deficits of the 1980s triggered much more borrowing from abroad and smaller reductions in domestic investment than anticipated. Deficits financed by borrowing from abroad may not have large effects on interest rates, because foreign funds relieve the shortage of domestic saving.

But this foreign borrowing leaves the nation increasingly mortgaged and reduces its future income even if interest rates do not change. If our nation finances its own large budget deficits, the United States can afford fewer foreign assets, whether auto plants in Brazil or stocks issued by enterprises in emerging markets. But even if foreign investors buy the U.S. debt, they acquire claims against the United States. In both cases, the U.S. net international investment position deteriorates—we own fewer assets abroad, and foreigners

own more of our assets. Thus, the nation's wealth becomes smaller, and incomes of Americans in the future will be correspondingly reduced—either because the total income we earn on our foreign assets will be smaller, or because we must pay more debt service to foreigners. In fact, the net international investment position of the United States has deteriorated from a surplus in the 1980s to a \$2.6 trillion deficit at the end of 2003, with more than \$2.0 trillion of that deterioration occurring in the last seven years.

This is a different kind of “crowding out,” but one that reduces the nation's net wealth today and our incomes tomorrow just as surely as reductions in domestic investment do. And these future income reductions are not just financial losses. When we borrow from abroad, we borrow not only financial capital but real goods and services, reflected in larger trade deficits. Ultimately, Americans must “pay back” those goods and services (with interest), either as increased exports or diminished imports, which leaves less for domestic consumption to maintain living standards tomorrow.

Domestic and foreign “crowding out,” therefore, are simply two paths to the same end—a reduction of living standards tomorrow to pay for today's federal deficits and consumption. Thus, deficits do matter, even if we live in a globalized economy that substitutes foreign borrowing for higher interest rates.

The relationship between deficits, saving, and private investment is not the only way that deficits affect long-term growth and the future standard of living. Two other dangers bear mentioning—the effects of deficits on productive public investments\* and on economic stability.

***Crowding out public investment.*** CED has consistently advocated productivity-enhancing public investments such as basic scientific research, improved public schools, and expanded access to quality pre-school education.<sup>4</sup> These public investments are a

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\* While lower national saving must reduce national investment, not all economists agree that larger deficits reduce national saving. A minority argues that if deficits rise, households will increase their saving by a corresponding amount to provide for future tax increases, to be imposed on either them or their descendants. This is an interesting theory, but there is little empirical evidence that households make significant adjustments of this kind. The U.S. household saving rate has been falling more or less continuously since the early 1980s, during periods of both rising and falling deficits. Moreover, this view requires households to have extraordinary foresight; if government and private forecasters have been so continually surprised by rapidly changing deficit forecasts, how are we to assume that the average household can do better? See B. Douglas Bernheim, *Ricardian Equivalence: An Evaluation of Theory and Evidence*, Working Paper No. 2330 (Cambridge, MA: National Bureau of Economic Research, 1987).

needed complement to private investment—basic research builds a store of knowledge that leads to future technological advances, workforce skills make new technologies more productive, and public infrastructure facilitates private business activity. But when budget deficits grow, there is a danger that desirable public investments will be cut back. First, these programs often lack the broad base of public support for the three largest items in the budget: national security, Social Security, and health care. And second, when deficits escalate, federal interest expenses also grow, leaving less of the budget available for “discretionary” uses such as public investment. (See *Exploding Deficits, Declining Growth*, p. 7.) The potential budgetary “crowding out” of these expenditures under the pressure of rising entitlement spending and larger deficits clearly poses a risk for long-term economic growth.

**Potential financial instability.** Finally, deficits that reduce the nation’s net foreign investment and leave a large stock of foreign claims against the United States not only reduce future income but also make the economy (and, indeed, the world economy) potentially less stable. When any country’s obligations to foreign investors grow large relative to its capacity to repay, there is an increasing risk that investors will begin to question the quality of those assets—that is, their total return, including especially the preservation of principal (because of possible adverse shifts in currency values, or increases in interest rates). Such a shift in market psychology can trigger a “run”—that is, an attempt by many investors to dump their assets on the market at the same time. When foreign lenders start dumping a country’s assets, the results for the domestic economy can be disastrous, as recent experience in Asia, Russia, and Argentina testifies.

To be sure, the United States is not Argentina or Russia; the role of the dollar as the preeminent international reserve currency has been unique. But the U.S. economy will not be immune to sudden changes in interest rates, exchange rates, and asset prices if it comes to depend on ever-larger financial inflows, especially as the Euro begins to emerge as a potentially competitive reserve asset. Indeed, the U.S. reliance on foreign investment has become so large that a mere slowing of the flow of foreign purchases of dollar-denominated assets—not even a full-blown run on the dollar—could be enough to shake markets significantly. A decision by OPEC to price its oil in Euros rather than dollars could shock the markets. The decline in the dollar against the Euro and the Japanese yen over the last three years clearly illustrates that this vulnerability is real.

How large the current account deficit and foreign indebtedness can grow before they are perceived to be unsustainable cannot be determined with any precision, and will depend on the circumstances of the time. It is possible that global markets have given us a period of grace because of unrelated economic weakness in other countries, or because of a presumption that the United States will right its financial imbalances in due time. But both common sense and historical evidence suggest that borrowing from abroad cannot be limitless; at some point, foreign lenders will see escalating new borrowing as a threat to the value of their assets and will react, to the detriment of the borrower.

These risks are too great to justify a gamble that we will grow out of these deficits through tax cuts’ “supply-side” effects on productive capacity. As noted earlier, there is as yet no sign of improvement in the budget after the most recent round of tax cuts. Economic studies indicate that, while lower marginal tax rates do increase work and saving incentives for some individuals, the positive effects of these incentives are relatively modest, and in the long term will be more than offset by the growth-reducing effects of the larger deficits they create.<sup>5</sup> An earlier CED study estimated that the rate of productivity growth would have to be about 50 percent higher just to bring the budget into balance by the mid-21st century—and deficits would still be rising for about the next thirty years. We know of no reputable analysis finding that tax cuts would raise long-term productivity growth by anything close to 50 percent; certainly, there are no hopeful signs to date.

We also caution against a gamble that near-term deficits will motivate as yet unspecified spending cuts at some later hour, and thereby rescue the budget. The last onset of large deficits, in the early 1980s, extended for almost two decades. At that time, the retirement of the baby-boom generation was more than two decades away, allowing some hope that this wager could be redeemed if proven wrong. Now, with the retirement of the first of the baby boomers just three years away, we have no such margin for error.

To summarize, failure to save is not necessarily a harbinger of economic collapse; but even if we are spared substantial instability, low saving foreshadows gradual and steady undermining of our nation’s well being, more like termites in the woodwork than a wolf at the door. A society that fails to put aside resources for tomorrow will not have a higher standard of living tomorrow. It is a death of a thousand cuts.

## CED's Proposal to Reform Social Security

The CED plan for reforming Social Security would preserve the current basic system but modify its structure to restore solvency and increase national saving. In addition, it would give workers the opportunity to earn higher investment returns by establishing a "second tier" of privately owned Personal Retirement Accounts, which would be financed without additional government borrowing.

The changes in the basic system, to be phased in gradually, would include:

- The initial benefit levels of upper- and middle-income workers, which currently rise with wages, would increase more slowly (but continue to rise in real terms).
- The normal retirement age (NRA), currently 65 years, would gradually increase to 70 over a period of 30 years and be indexed to life expectancy thereafter. (The NRA is currently scheduled to rise to 67 between 2003 and 2026.)
- The early retirement age, currently 62 years, would be increased to 65 over this 30 year period and subsequently similarly indexed.
- The years of covered employment included in the calculation of initial benefits would be gradually increased from 35 to 40.
- Benefits from the basic program in excess of contributions made by the worker would be taxed, with the additional revenues to be deposited in the Social Security trust funds.
- A reduction in benefits for nonworking spouses from one-half to one-third of the worker's benefit would be phased-in gradually to improve equity between working and non-working spouses.
- To make coverage universal, all new state and local government employees would be required to participate and current employees could choose to participate.

CED also proposes the creation of privately owned, personal retirement accounts (PRAs):

- Both employers and employees would be required to contribute 1.5 percent of payroll to privately owned personal retirement accounts. (The self-employed would contribute 3 percent.) These mandatory accounts would receive preferential tax treatment similar to 401(k) plans and would be subject to appropriate fiduciary regulations, including a requirement that accumulated funds be preserved for retirement. The Federal Thrift Savings Plan provides a general model for these accounts.

Source: CED, *Fixing Social Security*, 1997; CED, *New Opportunities for Older Workers*, 1999.

In fact, it is entirely fair to characterize large deficits today as delayed tax increases on future workers. All of the ill effects of tax increases, including the direct burdens and the dampening of incentives, will be felt just as surely as if the step were legislated directly. If the debt is incurred without offset, the tax increase is inevitable.

## Principles for Budget Policy

The options for fiscal restraint today are extremely unpalatable. If policymakers consider and reject curtailing homeland security expenditures, restricting military spending, reducing future Social Security benefits, cutting back on Medicare payments, and curbing Medicaid expenditures, as they have in recent years, they have already (considering that net interest costs are impossible to cut directly) placed off limits more than 70 percent of the budget. Extending popular expiring tax cuts eliminates further options, leaving the goal of fiscal sustainability apparently unachievable.

It is therefore hardly surprising that the effective response to the question "what gives?" is usually "none of the above." Similarly, when confronted with such unpalatable choices and their political implications, the response to the question of when a major course correction must be made is: "Later." But time is rapidly running out. To start the process and begin to square this numerical circle, CED believes that it is essential to establish and adhere to guiding principles.

Since CED laid out its principles for budget policymaking in 2003, circumstances have changed somewhat. Most notably, concerns about a substantial near-term weakening of the economy that would abort the then-nascent recovery have lifted. However, we believe that our principles remain valid. And so, as the nation contemplates quantum changes in fiscal policy through revisions to Social Security and taxation, we reiterate our standards for policymaking:

***First, any tenable budget program must address the budget deficit on every front, including both comprehensive spending reductions and alternative or additional revenues.*** The budget choices we face all appear to be untenable: cutting Social Security and Medicare; constraining defense spending; raising taxes. But that is exactly the point. Current budget deficits are so large that none of these measures alone will suffice; all must be brought to the table to construct a workable solution. While reshaping Social Security or

Medicare or raising additional taxes is unattractive, the real choice is between planned and rational policies now, or more rushed and severe steps down the road.

**Second, do no harm.** The first step in climbing out of a hole is to stop digging. We cannot afford economic policy decisions today that further raise deficits tomorrow. Tax and spending proposals should be considered in this longer-term context.

**Third, make long-term budgetary balance and economic growth explicit policy goals.** Without long-term fiscal policy goals, budget policy is adrift. Without an anchor, policy will be driven by the political winds. It is essential that current decisions be taken with full recognition of the harmful consequences that loom ahead on the current budgetary course. We are concerned that recent budget proposals would leave the deficit too high as the retirement of the baby-boom generation threatens to drive the deficit even higher.

**Fourth, give pro-growth policies higher priority.** We must avoid budget cuts that reduce public investments in favor of today's consumption. As the budget deficit

grows, a disproportionate burden of fiscal restraint may fall on education and training programs that build human capital, research and development activities that advance knowledge, and infrastructure investments that support the private sector. In previous reports, CED has noted the importance of such public investments for economic growth.

**Fifth, distribute the costs of pro-growth policies equitably.** Who should bear these costs? Programs with widely shared benefits are preferable to those with benefits tailored narrowly to few recipients. In addition, the burden of fiscal restraint should not be placed disproportionately on low-income families with little political voice. As former OMB Director David Stockman said, in a different era but a similar context, we should resist weak claims, not weak claimants.<sup>6</sup>

We will now apply these five principles to some of the pressing economic policy issues of this year: Social Security; the annual appropriations process of the budget; and tax cuts and tax reform. We will also discuss the biggest player missing from the policy table this year: health care.

## The Fiscal Agenda: Fixing Social Security

By the President's decision, the first and most prominent item on the legislative agenda for this year is Social Security reform. Social Security is of vital importance both in its own right, and because it has substantial impact on the nation's overall fiscal policy. CED issued its own report, *Fixing Social Security*, in 1997, and we believe that the principles and policy recommendations are as pertinent today as they were then. We are concerned today that a misguided approach to Social Security might not only endanger the accomplishments of that program, but also miss an important opportunity to turn the nation's fiscal policy back to the right direction—or even do still further damage to our financial standing at home and in the international marketplace. In short, Social Security legislation could make or break the budget.

Like most Americans, we believe that Social Security is one of the most successful social programs in U.S. history. The basic objective of Social Security—to protect the economic security of retirees—is sound, and the nation must not falter in its commitment to it. Social Security also provides an important safety net for survivors of younger workers, and for the disabled, saving

their families from severe financial distress. It provides financial security for those who live very long lives, with inflation protection that is virtually impossible to obtain from the private sector. The decline in poverty rates for the elderly is strong evidence of the overall beneficial effects of this program. Social Security fulfills all of these functions at minuscule administrative cost. These virtues must be preserved through any proposed reform.

Still, because of the challenge posed by the aging of the U.S. population, substantial change in the Social Security system is inevitable. When the baby-boom generation begins to retire, the system's current operating surplus will begin to decline, after which the trust fund balances will be drawn down at a rapid rate. If no action is taken, the system will be forced to impose a very large, inequitable and economically inefficient increase in the tax burden on future workers, and/or a very sharp and disruptive cut in benefits, at some time in an approximate range of from 2018 (the time when Social Security tax revenues fall short of benefits, according to the Social Security actuary) to 2052 (when the Social Security Trust Fund is exhausted,

according to the Congressional Budget Office). But the problems of the system should not be exaggerated; under current economic and demographic assumptions, and with no additional sources of revenue, Social Security can continue to pay somewhere in an estimated range of from about 73 percent (according to the Social Security actuary) to about 78 percent (according to the Congressional Budget Office) of currently promised benefits in perpetuity.

Fortunately, adverse outcomes are avoidable if reforms are enacted promptly. Because Social Security is so politically sensitive, political leaders have been loath to rectify fiscal imbalances in the past until a crisis appeared imminent. **But it is imperative now that policy makers initiate reforms long before the cupboard is bare, because the cost of restoring fiscal balance rises substantially each year that action is postponed. In addition, workers must be given advance notice about any significant changes in the system, so that they can make appropriate adjustments in their retirement saving and in their career plans that affect the number of years they will continue to work.** Consequently, we applaud the President and other policymakers who seek to address this problem promptly.

**Objectives of Social Security: the safety net.** At the same time, CED emphasizes that prompt action should not be hasty, ill-chosen or incomplete. As we noted above, Social Security's achievements should not be put in jeopardy. If Social Security is to continue to provide a safety net against very old age and inflation, the current defined benefit cannot be reduced too much. Similarly, if accumulations in private accounts are to be annuitized to provide a guaranteed life-long income, they cannot also be bequeathed to the workers' heirs. There are other concerns with respect to disability and survivors insurance, given that workers who pass away or become disabled will by definition have had less than a full working life to accumulate balances in private accounts. These are questions that will require careful consideration.

**Objectives of Social Security: generational equity.** The fiscal imbalance in the Social Security program is not its only problem. Equally important is the fact that Social Security, as currently designed, creates serious inequities between generations. Unlike their parents and grandparents, who benefited greatly from Social Security, many of the present generation of young workers and most of their children will be saddled with a payroll tax burden that will most assuredly exceed the benefits they themselves will receive. Not surprisingly, polls indicate that young people are losing faith in the

Social Security program because they believe that the government cannot keep its promises to them. They correctly perceive that the present system will remain solvent only if benefits are cut, or taxes are raised, and that either change will reduce the investment return they receive from contributions to Social Security.

**Objectives of Social Security: budget sustainability.** Furthermore, Social Security is a significant underpinning of the nation's now-crumbling fiscal structure; it must not be weakened, but rather its reform should contribute to the strengthening of the government's budgetary standing. For at least the next 13 years, Social Security will be an important source of support for the otherwise deteriorating remainder of the federal budget. After that time, Social Security itself will begin to drag the total budget down. Policies to strengthen Social Security's long-run balance could make an important, and possibly critical, contribution to the overall budget picture for the next three to four decades, and could increase the insufficient flow of total savings for the prosperity of the nation as a whole. On the other hand, policies that hope to strengthen Social Security in the still more distant long run, but in fact weaken its finances for the foreseeable future, could instead portend fiscal collapse within what would have been the sound lifetime of the Social Security program itself.

**Objectives of Social Security: national saving.** Another essential goal of Social Security reform (upheld in CED's proposed program) is to increase national saving. As the population ages, a rising share of the nation's real output must be transferred from workers who produce goods and services to the non-working retired population. Although this shift in resources is inevitable, the burden on future workers can be alleviated by increasing national saving and investment. Additional saving will stimulate economic growth and increase the size of the economic pie that must be shared. Unfortunately, national saving has fallen dramatically in the United States in recent years at the very time when demographic conditions call for more saving (see *Exploding Deficits*, figure 13, page 14). If it is to be effective in easing the burden on future workers, Social Security reform—a once-in-a-decade event, at the very least—must also make a contribution to national saving and economic growth.

In our 1997 policy statement, *Fixing Social Security*, CED recommends a cohesive package of reforms that can deal effectively with both the insolvency and the intergenerational inequity problems while preserving the fundamental goals of the original system. We believe that this can be done without reducing benefits to current retirees, raising payroll tax rates, or placing an unaccept-



able burden on future generations. (A brief description of CED's reforms is presented in the text box on page 6.) But rather than making a detailed case for particular programmatic reforms, this report simply urges that we observe the above-stated broad principles of fiscal responsibility in any renewal of Social Security.

In particular, if we must *do no harm* (as our second principle holds), *then we must not worsen the budget by borrowing still more money today, in the name of saving Social Security in the far-distant future.* The federal budget is in dire straits already; as noted above, the public debt already is growing faster than the nation's income, and current estimates show that the deficit outlook has been progressively worsening, year by year, when comparisons are made on a consistent, apples-to-apples basis. There are inestimable risks to allowing it to grow even worse. And because Social Security and Medicare are running cash-flow surpluses, the deficits in the rest of the budget are even larger, and the budget is in even more danger when Social Security and Medicare turn cash-flow negative in the coming decades.

**Risks: Deficits for decades.** This context is important because some would advocate policies that would be alleged to make Social Security solvent *when measured over an unrealistically long or even an infinite time horizon*, with substantial net budgetary costs and increases in debt (to finance the creation of personal retirement accounts) for several decades offset only in the far-distant future with hoped-for program savings. CED finds such an approach extraordinarily risky—especially when world financial markets already have begun to question our nation's ability and will to control a public debt that already is growing faster than the economy.

CED advocated personal retirement accounts in its Social Security reform proposal. However, CED considered, and rejected, options that would have funded those accounts through diversion of payroll taxes into those accounts, with the lost revenues replaced through increased public debt. Diverting payroll taxes to personal saving accounts would impose a substantial burden on young workers during the transition period because they would be required simultaneously to fund their own retirements and those of current retirees (and older workers who would remain under the current program). It is no favor to those younger workers that the transition costs are postponed; the resulting deficits and debt would burden them for the rest of their lives. The transition costs would continue to mount for decades, and they would bear interest into the even

more distant future. Consequently, the rise in the federal debt would be massive. (If one third of OASDI taxes had been placed in private accounts in 2004, for example—the equivalent of about two percentage points of both employee and employer contributions (four percentage points total)—the federal borrowing requirement for that year alone would have been almost \$250 billion higher.) So although increasing the federal debt might postpone costs, it certainly would not eliminate the burden of “privatization.” In fact, as was argued above, it would constitute a delayed tax increase on future workers.

**Risks: accounting gimmicks.** There are no accounting devices that can eliminate the ill effects of mounting debt. The issue is not what different budget measures are called. Still, the debate thus far has unduly emphasized ways to define away the debt that would be created in a Social Security renewal involving personal accounts.

One suggested accounting approach would be to consider the expenditure of the diverted payroll tax to be “off-budget,” and to raise the cash that would be necessary to replace the payroll tax revenues by issuing “recognition bonds,” which would be counted separately from other publicly held debt. The rationale for such separate accounting would be that costs of so restructuring the Social Security program are really investments that would yield a financially stable system in the future; thus, those costs should not be considered on the same terms as other current government expenditures. Another line of argument for special accounting treatment is that the federal government already has an “implicit liability” for the projected future shortfalls in Social Security, and that costs of addressing that liability are therefore not new debt; rather, such debt is merely the recognition of an existing liability.

In its consideration of its Social Security proposal, CED concluded that the recognition bond approach would not be an attractive option. At bottom, the issue is very simple: Debt is debt, whatever it is called; the federal government must pay interest on all new debt, whatever the motivation of its underlying costs. Also, debt accumulated over the early decades would limit the federal government's flexibility to address any other contingencies that might arise—including, possibly, the need for up-front funding for a vital health-care reform, or a war or other national security emergency.

**Risks: financial instability.** As noted above, some proposals to finance personal retirement accounts with debt have projected substantial net budget costs for three or four decades before anticipated net savings materialize. Advocates have sometimes had to rely on present dis-

counted evaluations over an infinite time horizon to show positive net benefits. Such evaluations may prove far too optimistic to satisfy the financial markets who are focused on the here-and-now. The budget costs of financing individual accounts today are near certain. In contrast, savings from Social Security benefit cuts promised for four or five decades from now must be seen as highly speculative.

Reform approaches that rely heavily on returns from individually managed accounts to make up for substantial cuts in the traditional Social Security defined benefit will be tested in years when the financial markets are weak, and new retirees see much reduced retirement incomes. For example, William Dudley of Goldman Sachs pointed out hypothetically that a new retiree in 2003 with a personal account 50 percent in stocks would receive a monthly annuity payment one-third lower than an otherwise identical new retiree in 2000.<sup>7</sup> Would the political system react to such an episode in the future by providing some relief to the less-advantaged retirees—especially if their traditional defined benefit had been cut significantly, leaving them exposed to potentially poverty-level incomes? Today's financial markets could well question whether the speculative future savings based on those benefit cuts will in fact materialize. If the markets' judgment is negative, the impact on the economy today could be strongly adverse.

The American Academy of Actuaries has already expressed its concern that analyses over infinite time periods "...provide little if any useful information about the program's long-range finances and indeed are likely to mislead anyone lacking technical expertise..."<sup>8</sup> Prudence might suggest that infinite-time analyses might be useful to motivate action to achieve savings to improve the system, but that savings that are projected to materialize in the very long run should not be used to justify spending in the near term.

Similarly, the notion that borrowing to finance the establishment of personal retirement accounts merely substitutes explicit debt for an already existing implicit debt raises the potential of serious disruptions in the financial markets. On the one hand, a distant implicit commitment of the federal government is always subject to change; on the other, actual Treasury securities are backed by the full faith and credit of the United States. Thus, explicit debt, on the one hand, and the concept of implicit debt, on the other, are two very different things. And in practical terms, actors in domestic and foreign financial markets might well consider the implicit commitment to pay future Social Security benefits well in excess of expected revenues as the kind of commitment that almost certainly

would be changed. The examples of past reforms of Social Security (for example, in 1983) that wiped out then-anticipated future shortfalls could give the markets reason to expect the currently forecast trust fund deficits will be eliminated. Instead monetizing those anticipated deficits, and converting them to sovereign debt, could be a shock to the financial markets, not a mere like-kind exchange.

In short, in CED's judgment, debt-financed Social Security restructuring would be a virtually irreversible decision with potentially catastrophic consequences, and with a likelihood of failure that is far too high.

**Risks: insufficient national saving.** Debt-financed Social Security plans fare no better on the essential criterion of increasing national saving.

An optimistic view of a plan to finance personal retirement accounts with borrowing is that it would not decrease national saving—because the increase in the government deficit, a reduction in total saving, would be offset by the deposits in the personal accounts. Some might even claim that by introducing households to the rewards of compound interest and the habit of saving through the deposits in those accounts, there might even be a marginal increase in future household, and thereby national, saving.

CED believes that such plans and claims aim far too low. A major Social Security reform netting only a small increase in national saving would be a tragically missed opportunity. And in fact the claims of a small net positive for national saving could be much too optimistic. If individuals are skeptical about their future returns from the existing Social Security program, and if personal retirement accounts give them confidence that they will receive somewhat more, then all behavioral economics would suggest that they would feel wealthier, and for that reason would increase their consumption. National saving would go down, not up.

Furthermore, financing personal retirement accounts with borrowing would increase a public debt that is already growing faster than the nation's ability to repay it (that is, faster than the GDP). It is unclear that the financial markets would quietly accept such a further burgeoning debt on the account of the largest borrower in the country (and the world), even if it would be numerically offset by millions of small increases in holdings of equities and bonds by individuals. With respect to the risks to financial stability, it is the attractiveness of the paper of that one largest borrower that is in question.

In sum, borrowing to establish personal retirement accounts, especially with the budget already in serious deficit, is at best too big a gamble. Success would require that the financial markets accept planned, substantial and sustained federal budget deficits and borrowing with an air more relaxed than in any episode on record. On top of the existing budgetary problems, and fiscal uncertainties ranging from life expectancies through retirement choices; to advances in health care technology and utilization; to productivity

growth, inflation, and energy prices; to war, terrorism, and the aftermath of the 1990s stock market bubble and revenue boom, the nation cannot afford an outlook of decades of financial uncertainty of our own creation. Markets cannot wait that long for confirmation of the success of a Social Security reform; there would always be the risk of a sudden adverse reaction and a rush for the exits hanging over every business decision, no matter how large or how small. Prudent stewardship would reject such a course.

## The Fiscal Agenda: The Budget Process and Appropriations

**A**s noted above, the budget remains in large and worsening deficit outside of Social Security; and so whether or not Social Security is addressed this year, policymakers must deal seriously with the rest of the budget.

There is no question that, since the years of the large budget surpluses in the late 1990s, the budget process has broken down: the Congress has on two occasions produced no budget resolution at all; necessary annual appropriations bills routinely have been produced after the beginning of the fiscal year; and in far too many instances, appropriations have been enacted in massive multi-agency omnibus bills, which are far too likely to accommodate ill-considered spending, waste and abuse. However, as one long-time budget watcher once observed, “The process is not the problem; the problem is the problem.” The best budget process—noting that the same process that we had in the first years of recurring and widening deficits in this decade worked quite well in the 1990s—cannot yield responsible decisions if there is no political will.

CED continues to recommend budget process reform, and renewal of the recently expired procedures that in the past worked reasonably well. But we recognize that policymakers first must acknowledge and understand the danger of current budget deficits, and then must address the array of individual, complex program issues in the budget. Without such a frank review, no process will succeed.

CED’s very first principle of fiscal responsibility holds that savings will be needed in every part of the budget. That principle provides a cautionary note for every policymaker. For those who would prefer to protect the annual appropriations from playing a role in deficit reduction, it is clear that the deficit is so large that no spending category can be spared. CED notes this reality

while acknowledging our own longstanding support of public investment that contributes to economic growth and national well being—including education, notably at the pre-school level; basic research; and physical infrastructure. But CED recognizes that the federal budget is now so tight that there is not a single dollar to waste; and so savings must be achieved even in programs that nominally pursue these essential goals, including “earmarks” that might be ineffective.

Still, the valid role for federally funded public investment carries a cautionary tale for the other side of the budget debate. The nation cannot totally abandon such essential contributors to future growth as the funding for measurement-based education in the No Child Left Behind Act, or domestic security through adequate support of first responders. Such legitimate needs will limit the savings that can be achieved from the annual appropriations in the budget. And even before any line-by-line analysis, the facts and figures strongly indicate that annual appropriations cannot possibly be the sole source of deficit reduction. For example, in the fiscal year just ended (2004), domestic appropriated outlays (including homeland security) comprised less than 18 percent of the budget, according to the Congressional Budget Office. The total of such outlays was only \$407 billion, or less than the total budget deficit of \$412 billion (and far less than the non-Social Security deficit of \$572 billion). Thus, there simply is not enough blood in the domestic appropriations rock to heal the budget. So it would be most unwise to engage in other policies that would worsen the deficit in vain anticipation that unspecified savings from future appropriations would somehow make up the shortfall.

Following are brief discussions of CED’s perspectives on key issue areas in the annual appropriations of the budget.

### **National and Homeland Security Expenditures:**

The commanding reality of this budget year is clearly the engagement of our troops in Iraq and Afghanistan. It goes without saying that they must be equipped and supported without reservation until circumstances allow their safe return. In the meantime, there remain issues regarding the underlying standing military force, and the maintenance of homeland security.

The terrorist attacks of September 2001 have inevitably raised both federal and state and local government expenditures on public health and safety, and the expanded U.S. international role that has emerged since then has produced a sharp increase in current and planned military expenditures. As we argued shortly after the attacks, while a significant reallocation of public resources is undoubtedly necessary to deal with these new responsibilities, “we must not let these security concerns eclipse the need for sound economic policies, both domestic and international. In the long term, the health of our economy will largely determine the well being of our society, including our capacity to provide safety and security.”<sup>9</sup>

In the current environment, there is a temptation to assume that budget constraints are no longer operative where security is concerned and that we must “spend whatever it takes.” However, with the understanding of the special status of our troops in the field, quite the opposite is true: Reconciling large, immediate public needs with other public goals, and with private consumption and investment demands, will require more stringent budget discipline, not less. Policies must distinguish carefully between what we genuinely need for an adequate defense and the wish lists of the military and its suppliers.

Early in 2001, the Administration discussed restructuring the defense budget by eliminating or reducing programs and activities that reflected outdated Cold War defense requirements. It suggested, therefore, skipping a generation of expensive weapons systems.<sup>10</sup> However, there has been little evidence of such restructuring in the defense budget since. The high costs and inefficiencies of the ongoing operations and maintenance activities of the military also give us concern as business leaders. And these problems go well beyond the expensive continuing operation of unnecessary military bases driven by Congressional politics.

We claim no special expertise on national security needs, but given the fiscal outlook we believe that the claims of respected defense analysts that we could

secure a greater capability from the standing force (apart from the units in Iraq) for less than what was recently projected for the end of the decade deserve serious examination.<sup>11</sup>

**The defense budget must be cost-effective and focused sharply on the new national security situation. We urge the Administration and the Congress rapidly to establish national defense priorities and program reforms to accomplish this. The current budget request should mark the beginning of a careful review of defense needs.**

With respect to homeland security, it is evident that spending should and will rise substantially over time as we develop greater capability to protect against and respond to terrorist attacks. Here again, however, it is essential that we prioritize, even though it is politically very difficult to do so. We cannot protect against all eventualities. Some attacks are more likely than others, some are potentially far more damaging than others, and we must allocate scarce resources to minimize risk. In making these choices, we should also remember that the benefits of stronger homeland security often involve higher costs to the economy as well as to the budget.

Decision making for homeland security may be especially problematic, because it will be principally the responsibility of the new Department of Homeland Security, which is attempting to combine many previous federal departments and agencies, with very different missions, into a single effective organization. (The new Department will handle about two-thirds of total homeland security spending.) It will be very difficult, at least initially, for such an organization to set priorities that appropriately reflect the overall security situation rather than the various missions of the former agencies. This will create strong pressures to increase the budget to cover more contingencies. An additional budgetary problem will arise because of the difficulties in preventing duplication of functions and personnel, in spite of the additional managerial flexibility provided for the new Department.

**For all these reasons, we believe that homeland security expenditures will require special attention and scrutiny in the next few years, and we urge the Administration and Congress to provide this.**

Finally, should another terrorist attack be made in the United States, it is likely that, once again, those responding to it will not be primarily federally trained

experts or the armed services, but local police, fire, and other personnel.<sup>12</sup> These community forces are the front line in our national battle against terror, and the federal government must ensure that they have the resources needed to do the job.

**Non-Security Discretionary Spending:** Given the political difficulties in reducing expenditures on “permanently” funded entitlement programs in comparison with programs funded with annual appropriations, it is not surprising that the latter have been the favored targets for controlling federal expenditures. The last quarter-century has seen an inexorable “crowding out” of discretionary spending by entitlement programs, which have expanded from about 51 percent of total non-interest federal expenditures in the late 1970s to 61 percent in 2004, while discretionary spending has fallen commensurately from about 49 percent to 39 percent. Most of this decline, however, has occurred in defense discretionary spending, which has experienced a decades-long slide relative to the total budget and the size of the economy. Since the 1960s, defense spending has fallen from about 8.5 to 3.5 percent of GDP (rising fractionally with the current war effort). By comparison, non-defense discretionary spending in relation to the budget and the economy is roughly the same as it was 40 years ago. Defense spending obviously cannot continue to fall at this rate relative to GDP in the future, so either the growth of non-defense discretionary spending relative to GDP must fall, or that of total discretionary spending will rise.

Clearly there are many low-priority domestic discretionary programs, and reductions in them have been entirely appropriate. (Indeed, it is unfortunate that so few have actually been eliminated.) We hold no brief for protecting these programs in general, and especially the politically “earmarked” spending that rewards narrow interests. **We can and should bring the rate of growth of non-security discretionary spending below its historical level, and continue the reduced rate of growth of the past two years.**

As a result of the current intense budgetary pressures, it will be difficult to sustain investment programs that support economic growth. Two areas of investment—public education and research and development—cause us particular concern.

CED has long advocated both reforms and increased investments in public education, especially in improving poorly performing schools in many low-income

communities, and in moving towards universal preschool.<sup>13</sup> We must improve the achievement of children attending low-performing schools both to support economic growth and to promote equal opportunity. We have argued that improvements in learning will require more attention to, and accountability for, educational outcomes, and for that reason have supported federal legislation and state initiatives designed to do this. But we have also noted the serious difficulties likely to arise in implementing such accountability measures.<sup>14</sup>

We are now at a critical juncture in these reform efforts. The states have been given a task of raising the achievement test scores of all students, which would be enormously difficult in the best of circumstances. In the circumstances they actually face, many states and communities are ill-prepared to meet these goals, and the continuing fiscal stringency facing most states will severely limit the resources they can draw upon to do so. **We believe that education reform is too important to be allowed to fail; the federal government, which has mandated a national effort, is obligated to assist the states in making it work. We urge the Administration and Congress to provide the funding needed to do so.**

CED found in an earlier study that basic research in science and engineering has made a major contribution to the growth of the U.S. economy. Economic returns on investments in basic research are very high. In addition, the returns to the nation from basic research investments are substantially higher than the returns to private firms, because advances in fundamental knowledge tend to be widely dispersed and exploited in innovations that deliver substantial economic benefits over a lengthy period.<sup>15</sup>

Publicly funded basic research is critical to private sector innovation. Although private industry conducts basic research, these efforts are primarily to “fill-in-the-gaps” within broader programs of applied research aimed at new product development. Industry depends on the intellectual foundations provided by basic researchers in the nonprofit and public sectors for innovative products and services; 73 percent of research publications cited by industrial patents have been found to be derived from government-funded research.<sup>16</sup> **Because federal support is essential for a thriving basic research enterprise, we urge the Administration and Congress to make basic research a high priority in the federal budget.**

As noted above, expenditures on discretionary non-defense spending have grown at about the same rate as the economy for many years. We are certainly no admirers of formulaic budgeting, and support the reduction and elimination of low-priority programs whenever possible. But budgetary history suggests there are significant social and political limits to such reductions. In light of the need to continue high-priority programs, and in particular public investments, we believe it would be imprudent to assume that domestic discretionary expenditures in the aggregate will grow significantly more slowly than the economy in the future.

### **A Framework for Long-Term Budgetary Decision**

**Making:** As noted above, the Congressional budget process effectively self-destructed after fiscal year 1998. In two years, no budget resolution was adopted; in others, resolutions were honored more in the breach than observance; and in many instances they were rendered ineffective by unrealistic spending targets and estimates. Perhaps more important, appropriation bills have been repeatedly delayed and sometimes never completed, giving rise to “omnibus” ad hoc spending legislation that greatly impedes rational planning both by public agencies and private recipients of government funds. Such legislation also provides fertile ground for narrow, self-interested spending projects. In addition, policymakers are now beginning their fourth annual cycle after the expiration of the legislated budget control mechanisms limiting discretionary spending, entitlement expansion, and tax cuts. Though these mechanisms created by the 1990 Budget Enforcement Act (BEA) were not perfect—no process could be—they had bipartisan support and worked reasonably well in the early and mid-1990s to structure and enforce budget decisions. Budget decisions are now adrift, without fiscal goals to anchor them or enforceable rules to discipline them.

**CED believes it is urgent to implement a disciplined budget process that can address the long-term fiscal issues that face us. First, Congress**

**must restore rationality to the appropriations process. Second, we should implement annual joint budget resolutions, agreed to by the Congress and the President and enacted into law, that anticipate, precede, and control all spending and tax legislation. Finally, to enforce the budget decisions of the joint resolution, we should restore caps on discretionary spending and the requirement that changes in tax and entitlement programs be “deficit-neutral.”** We expressed our concern at the appearance of proposals to apply the “pay-as-you-go” rule to entitlement spending only, omitting controls on taxes, in the course of the fiscal year 2005 budget cycle, and are unhappy to note that this deficient proposal has been repeated in this year’s budget.

In addition to an effective process for decision making, rational budgeting today requires goals that are consistent with long-term growth. Even though the budget has fallen well out of immediate reach of what seemed reasonable goals five years ago, policymakers must not forget where they ultimately want to go. Thus, we recommend that **the President and Congress should establish a goal of balancing the budget (or producing a surplus) excluding the “off-budget” Social Security accounts over a rolling five-year horizon. The joint budget resolution should make clear how the budget policies of the resolution would promote this goal, even though we cannot immediately move to a balanced budget given the large current fiscal hole.**

**And in addition, the joint budget resolution should also provide statistical measures of long-term fiscal balance (such as the “fiscal gap” and unfunded government liabilities) and explain how the policies of the resolution would affect those measures and future levels of taxes or public debt.** Such accounting could inhibit immediate budgetary deceptions such as enacting tax cuts that are to be “temporary” for several years but are assumed by all to be made “permanent” later.

## The Fiscal Agenda: Taxation

CED has for many years, and in many policy statements, taken the position that the federal government should balance its budget, averaged over years of economic strength and weakness.<sup>17</sup> As explained above, we strongly believe that deficits do matter to long term growth and prosperity. We do not believe that we should deliberately run budget deficits as a means to discipline spending. This has not worked in the past and is a counsel of despair. Deliberately hamstringing future Congressional decision making cannot be good public policy; Congress should, and can, budget effectively with the decision making framework described above.

**We believe that additional reductions in federal revenues would be inconsistent with the goal of long-term budgetary balance.** The analysis above shows that realistic projections of federal expenditures and revenues, when combined with continued tax

reductions, produce deficits that remain far too high during the coming decade and explode thereafter.

**After reviewing the size of the long-term fiscal imbalance and the broad possibilities for spending reductions in Social Security, Medicare, national defense, homeland security, and other domestic programs, CED believes it extremely unlikely that the long-term budget problem can be solved without additional revenues. We therefore urge the Administration and Congress to forgo at this time any additional tax reductions (including the permanent extension of the Economic Growth and Tax Relief Reconciliation Act of 2001) that would further reduce long-term revenues. Moreover, we should use this opportunity to begin to explore alternative or additional long-term sources of revenue and taxation systems that support long-term growth objectives.**

## The Fiscal Agenda: Health Care

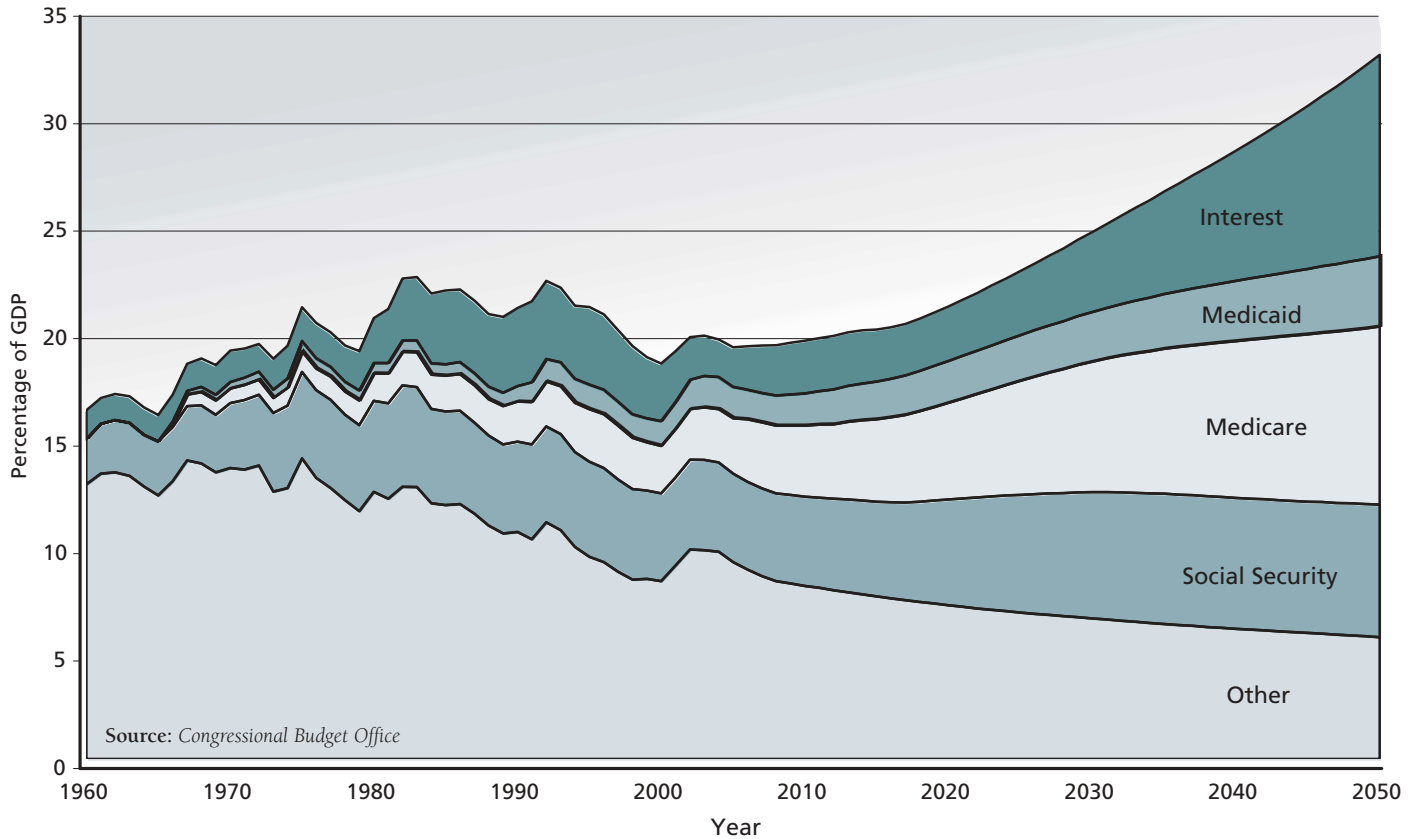
In this year's budget deliberations, the unacknowledged elephant sitting alone in the corner of the room will be health care. There is a reason why health care will be the missing player in the debate. And that reason is a cautionary tale with respect to other issues that do have a role in the decisions.

Demographic changes will have a huge impact on the growth of Medicare and Medicaid expenditures—even greater than that on Social Security (these three programs together constitute 42 percent of federal spending). Medicare is expected to grow more rapidly than Social Security and to run out of funds much sooner. A rough indication of the potential burden is provided by CBO's projections indicating that between the fiscal year just ended (2004) and 2050, outlays for the OASDI system will grow by 1.9 percent of GDP, from 4.3 percent to 6.2 percent, while Medicare will grow by 5.7 percent of GDP, from 2.6 percent to 8.3 percent, and Medicaid by 1.8 percent of GDP, from 1.5 percent to 3.3 percent. These projections show that these entitlement programs have put federal fiscal policy on an explosive, unsustainable path. (See chart 3, which shows that spending exclusive of Social Security, Medicare and Medicaid is projected to decline as a percentage of GDP, but that outlays for those three programs will grow rapidly—and as a result, net interest costs will balloon.)

Although health care plays an unmistakable, commanding role in the projected long-term deterioration of the budget, the health-care issue is in many ways far from clear. For example, despite so much discussion of the “burdens” involved in health-care expenditures, the 20th century saw enormous improvements in the quality of life, and in some cases longevity, for many elderly. It has been estimated that improvements in the health status of the population during the 20th century made as large a contribution to economic welfare as all other consumption increases combined.<sup>18</sup> Health care is highly valued by the American public, and it is entirely appropriate that we devote an increasing proportion of national income and output to it as the society grows more affluent and new technology improves possibilities for treatment.

Despite this progress, it is clear that the U.S. health care system is unsustainable, and that overuse, underuse, and misuse of health care services produce both adverse medical outcomes and unnecessary costs, as we argued in *A New Vision for Health Care: A Leadership Role for Business* (2002). The health-care industry, while making dramatic technological advances in diagnosis and treatment, is extremely inefficient in delivering care. Patients have little stake in costs and insufficient awareness of wide differences in provider quality.<sup>19</sup> The U.S. now spends twice as much on health care, per capita, as other nations with equal or longer life expectancies. We

**CHART 3 Federal Spending**



*do not claim to know the “right” proportion of the national income that should be spent on health care in the future, but we firmly believe the resources we do provide should lead to higher quality and more cost-efficient care.*

A major source of unnecessarily high costs of health care is the lack of incentives to seek higher quality and lower costs on the part of both providers and purchasers of care. We have recommended improving those incentives for businesses, but public purchasers such as Medicare (the largest purchaser of health care) and some state governments also are ineffective purchasers of care. Fee-for-service Medicare is required by law to be a passive payer of providers’ bills and has no authority to reward providers of high quality and effectively managed care. While the Center for Medicare and Medicaid Services (CMS) has begun to make information on quality of care available to Medicare enrollees, the program lacks financial incentives to select the best performing providers.

It is clear that significant health-care savings relative to current projections must be achieved relative to the

current baseline if the budget deficit is to be contained. As a part of that effort, we reiterate our earlier recommendation **that Medicare be restructured along the lines of the Federal Employee Health Benefit Program (FEHBP)**. FEHBP, a highly successful plan covering nine million federal workers and their dependents, has adopted a defined contribution model that creates incentives for workers to select cost-effective health plans with affordable employee contributions. Many states have developed for their public employees, and in some cases for Medicaid enrollees, health care programs similar to FEHBP, with contribution structures that encourage choices based on appraisals of quality and cost. **CED also urges states that have not adopted such programs to do so as a means of improving both the quality of health care and the efficiency of its delivery.** At the same time, CED recommends strengthening initiatives to reduce fraud and abuse in Medicare and Medicaid, and capping the currently open-ended federal tax exclusion of employer contributions to promote cost discipline and equity, which could also provide some funding for policies to expand access.



We caution, however, that even with reforms in Medicare that improve its efficiency, policymakers are unlikely to find long-term savings that greatly reduce the long-term costs currently projected—and this is perhaps the primary reason why health care will not find a place at this year’s budget negotiating table. As noted above, the health-care system must acknowledge among its inefficiencies underuse and lack of coverage, as well as overuse. The prospect of significant savings based on the fact that a high percentage of medical expenses arise in the last year of life does not appear to be practical. Evidence on the roles of tort costs and defensive medicine is mixed. Even reforms aimed specifically at achieving efficiency are difficult to assess. Indeed, both the Administration and the CBO have estimated that the market reform provisions of the Medicare prescription drug legislation will in fact add to costs over the foreseeable future.

In short, knowledge of potential health-care savings policies is limited. Health care may be the most technologically dynamic sector in the economy, leaving

enormous uncertainty about costs even five years from now, much less 50 or 75. We simply cannot yet identify cost-related policies that could promise specific savings over a long-term actuarial horizon. Accordingly, until such knowledge is developed, we can expect budget policies relating to health care to be incremental, and less than definitive or satisfying. And it would probably be unwise to postpone addressing the long-run shortfall in Social Security, even though the projected health-care shortfalls are even larger, because the state of knowledge in health care is not sufficiently far advanced at this time.

And hence the cautionary tale: We must assume going forward that the pressures on non-health budget issues will be even more intense, given the difficulty of achieving savings in health care. And given the state of knowledge at this time, we cannot assume that some silver-bullet policy will save us through massive cost reductions in projected health-care outlays. Once more, the lesson of a sober assessment of the disturbing budget situation is prudent action; we must begin now, but we must do no harm.

## Conclusion

**I**n sum, America does stand at a fiscal crossroad. And if there has been any change since CED’s last statement on this issue, it is that the nation’s current standing is even more perilous. The federal government’s fiscal position looking out over the next decade has deteriorated still further, and we are even closer to the onset of powerful demographic changes that will make the budget situation even more difficult to control. CED and other observers have long said that the real deficit problem lies in the long run; and now, with the structural nature of the deficit and the beginning of the retirement of the baby boom just three years away, the long run is upon us.

We must begin now, working across the broadest front, to turn the budget around, so that our nation does not enter the retirement of the baby boom with a public debt already growing faster than its ability to repay it. And viewing the budget agenda for this year, our most urgent message is that we must not risk making the deficit even worse through irreversible policies with questionable and far-distant benefits. This is a time for prompt and prudent action.

## Endnotes

- 1 Comparisons of budget baselines can vary from year to year because of artifacts of the budget law and procedures. As a prime example, the budget baseline for fiscal year 2005 (released one year ago) had its spending artificially inflated because it was required by law to assume the reenactment in every future year of a large supplemental appropriations bill that funded the peak level of military operations in Afghanistan and Iraq. In contrast, and as a result of the accident of the timing of the passage of war funding, the baseline for fiscal year 2006, the budget currently under consideration, includes no such future costs whatever. For purposes of comparison, CED has standardized those two baselines to include the same current CBO estimate of longer-term costs of the global war on terrorism (GWOT) (which assumes that the deployment of forces around the world will decline gradually after 2006 to a level of about one fifth of the peak in 2011 and thereafter). Also for purposes of comparison over time, the baseline deficits for fiscal years 2003 and thereafter have been increased to include the costs of extending recently enacted temporary tax cuts that were ostensibly scheduled to expire, but that were proposed by the President's budget to be made permanent. Likewise, the baseline deficits for fiscal years 2004 and thereafter have been increased to include the costs of a significant easing of the growth of the individual alternative minimum tax (AMT). Leading policymakers have stated emphatically that, in the current policy environment, relief from the expanding reach of the AMT is all but inevitable.
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- 7 Goldman Sachs Economics, "Daily Financial Market Comment," February 1, 2005.
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