

The Hard Road to Fiscal Responsibility

JOHN L. PALMER AND RUDOLPH G. PENNER

The paper describes the current fiscal problems of the United States showing that without significant changes in revenue and spending policies, the country is headed for a sovereign debt crisis similar to that afflicting countries in Southern Europe. Numerous committees and commissions have offered policy options that would stabilize the debt–GDP ratio in the long run. The proposals of the President’s National Commission on Fiscal Responsibility and Reform and the Bipartisan Policy Center’s Deficit Reduction Task Force are described in detail. Elected politicians have not been enthusiastic about the work of these bodies. Only the House has passed a budget that would stabilize the debt and that proposal is analyzed as is the president’s response. The paper goes on to describe the Budget Control Act that was passed after the debt limit debate in the summer of 2011.

The United States is on an unsustainable, long-term fiscal trajectory resulting from a large structural mismatch between current tax and spending policies that will worsen over time with the aging of our population and rising health-care costs. Unless these policies are changed dramatically, the already rapid growth rate of our national debt will accelerate toward the end of the decade and thereafter far outpace that of the economy. Recognition of this prospect, and of its deleterious consequences for our future standards of living, has led in recent years to the formation of numerous groups—under both private and public auspices—to recommend concrete policy options for achieving fiscal sustainability. Addressing the challenge also has become a recent preoccupation of our national political leaders and, due to the starkly different views of the two parties regarding the role

John L. Palmer is a University Professor at the Maxwell School of Citizenship and Public Affairs, 319 Eggers Hall, Syracuse University Syracuse, New York, NY 13244. He co-chaired a committee on “Choosing the Nation’s Fiscal Future” organized by the National Research Council and the National Academy of Public Administration and financed by the John D. and Catherine T. MacArthur Foundation. He can be reached at jlpalmer@syr.edu.

Rudolph G. Penner is an Institute Fellow at the Urban Institute, 2100 M Street, N.W., Washington, DC 20037. He co-chaired a committee on “Choosing the Nation’s Fiscal Future” organized by the National Research Council and the National Academy of Public Administration and financed by the John D. and Catherine T. MacArthur Foundation. He can be reached at publicaffairs@urban.organd.

of the federal government, contributed to the contentiousness and turmoil surrounding Congressional budget-related activity.

The purpose of this paper is to elucidate these concerns. We first elaborate the nature and seriousness of the long-term fiscal challenge. Next we note the more prominent of the groups formed to offer solutions and discuss in detail the recommendations of the two most important ones with membership spanning the ideological spectrum: those formed by U.S. President Barack H. Obama and the Bipartisan Policy Center (BPC). This is followed by a review of how the president and the Congress responded to these reports and otherwise have grappled with the long-term fiscal challenge, with little success, over the past two years. We then discuss the problematic implications of two particular, not well-understood aspects of federal budget policies—their bias against discretionary spending and in favor of temporary measures—before offering brief concluding observations on the prospects for Congressional action.

THE PROBLEM

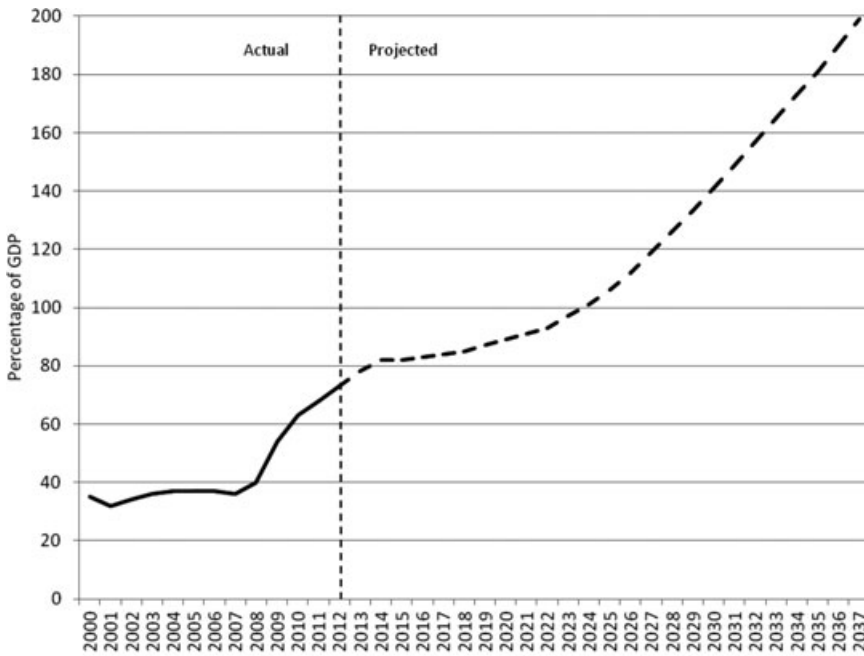
Unless U.S. fiscal policy is changed dramatically, the national debt will grow at an increasing rate and far outpace economic growth. Using a reasonable definition of current policy, the Congressional Budget Office (CBO 2012a) projects the national debt in the hands of the public will reach almost 200 percent of the gross domestic product (GDP) in 2037¹ (see Figure 1) and continue to grow at an increasing rate after that.

As the debt continues to grow relative to GDP, there is growing danger the United States will experience a sovereign debt crisis similar to that now afflicting countries in Southern Europe. Sovereign debt crises are notoriously difficult to forecast and no one can say when one might happen in the United States (Ferguson 2010). But when a crisis does occur, it typically happens very suddenly with interest rates rising 300–400 basis points within days. Such a crisis occurring in the United States would have a powerful negative impact on the entire world economy far exceeding the recent turmoil in capital markets caused by the ups and downs of the Eurozone's problems.

Even if an outright crisis does not hit for a number of years, the U.S. debt–GDP ratio will have to be stabilized eventually or else a crisis is inevitable. Because the problem grows in magnitude every day a solution is delayed, delay implies that the size and abruptness of the necessary changes in spending and tax policies grow through time and become more and more difficult politically. Moreover, as we delay, the deficit draws down national savings.

1. CBO's Alternative Fiscal Scenario is cited and used in figures in this section because it is a more realistic portrayal of what continuation of current spending and taxing policies would entail than is CBO's Extended-Baseline Scenario, which adheres closely to current law and assumes that many adjustments lawmakers have routinely made in the past—such as extensions of temporary tax cuts and changes to the Alternative Minimum Tax and Medicare payments to physicians—will not be made again. After 2022, the Alternative Fiscal Scenario also incorporates modifications to several provisions of current law that CBO believes would be difficult to sustain for a long period of time.

FIGURE 1
Federal Debt Held by the Public Under Congressional Budget Office's (CBO's) Alternative Fiscal Scenario: 2013–2037



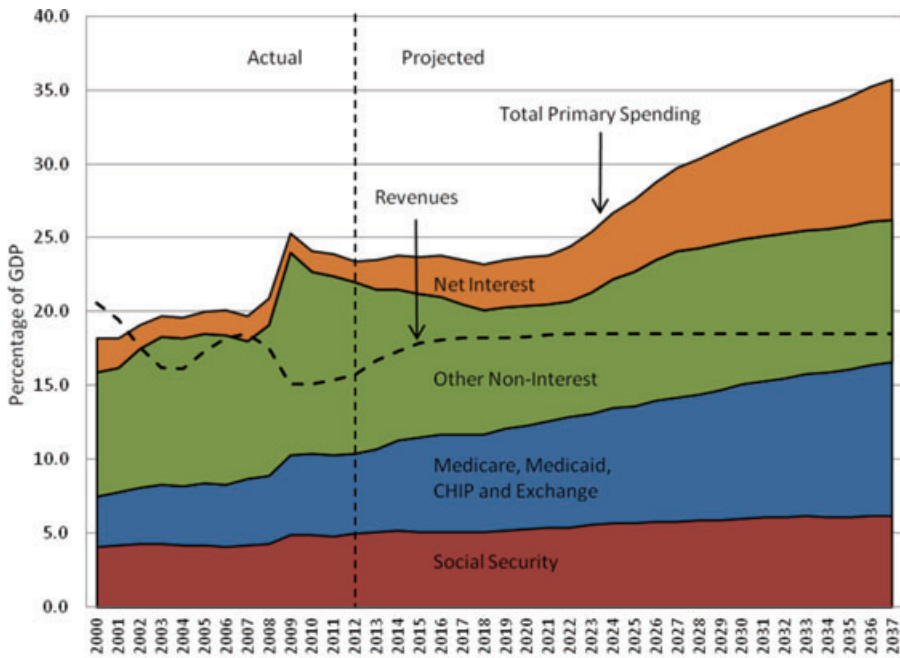
Source: The Long-Term Budget Outlook 2012, Congressional Budget Office

This may not be a serious problem when there is considerable slack in the economy and, indeed, may provide needed economic stimulus. As the economy approaches full employment, however, the deficit more clearly reduces national wealth by reducing the amount of national saving available to finance domestic private investment and by pressuring the United States to replace lost saving by borrowing from foreigners. The crowding out of domestic investment reduces the economy's growth potential and therefore reduces future living standards. The accumulation of foreign debt requires that more and more U.S. production must be devoted to paying interest and dividends to foreigners in the future, thus reducing the amount of income available to Americans.

At the end of 2010, a presidential commission, which will be discussed later, estimated that with about \$4 trillion of deficit reduction through 2020, the debt could be stabilized at roughly 60 percent of GDP sometime in the next decade. This has become a common goal as various groups have wrestled with the deficit, and most would like to reduce it below 60 percent of GDP in the very long run.² By some measures, the Budget Control Act (BCA)

2. The National Academies' report specified the same goal (NRC and NAPA 2010).

FIGURE 2
Revenues and Primary Spending, by Category, Under Congressional Budget Office’s (CBO’s)
Alternative Fiscal Scenario: 2013–2037



Source: The Long-Term Budget Outlook 2012, Congressional Budget Office

that emerged from the debt limit negotiations in the summer of 2011 took us half way to the goal—on paper. The credibility of the policies embedded in the act will be evaluated later.

It is, however, important to point out the presumption that a \$4 trillion policy adjustment will achieve fiscal stability is surrounded with great uncertainty. Relatively small changes in the economic and other assumptions necessary to make budget projections can radically change the required adjustment either for better or worse (Penner 2002).

The arithmetic underlying CBO’s projection is extremely simple. Two program areas—Social Security and health care—were responsible for almost 50 percent of total noninterest federal spending in fiscal 2011. Spending in both areas is rising faster than GDP and tax revenues. In 1990, Social Security and health-care spending amounted to only 6.9 percent of the GDP. By fiscal 2008 as we entered the Great Recession, the ratio had risen to 8.8 percent. By 2022, it is projected to be 12.9 percent (see Figure 2).

While Social Security and health-care spending has been growing mightily, tax revenues have been remarkably constant relative to GDP, varying between 17 and 19 percent of GDP for all but 12 of the past 50 years. If programs other than Social Security and health care and the tax burden remain roughly constant relative to GDP, the deficit and national debt

TABLE 1
Explaining Sources of Projected Growth in Federal Spending on Major Health-Care Programs and Social Security by 2013

	Extended fiscal alternative scenario	
	Aging (%)	Excess cost growth (%)
Major health-care programs and Social Security	68	32
Major health-care programs	52	48

Source: Congressional Budget Office (2012a).

will grow rapidly. Eventually, the interest cost of the debt begins to dominate the budget and ultimately the system explodes.

Over the next three decades, the aging of the population is the most important driver of Social Security and health costs, as retiring baby boomers apply for Social Security, Medicaid, and Medicare in large numbers and then draw benefits for decades. But health programs face an additional problem. Health-care costs for every age group have been growing considerably faster than income (see Table 1). Although our health-care system is incredibly inefficient, technological change is the most important source of cost growth in the long run. Medical research constantly develops new treatments and drugs, most of which are extremely valuable. Even when they are not effective, the consumer has little incentive to economize because someone else, such as Medicare or employer-provided health insurance, appears to be paying most of the cost.

Generally, when we think about the aging of the population, we focus on the fact there are more old people and they are living longer. But aging has another dimension. The average age of the population is rising, not only because there are more old people, but because there are relatively fewer young people. Baby boomers and generation X-ers did not have enough children to support them well in their old age. Consequently, the growth of the labor force is slowing, and that implies the growth of tax revenues is also slowing—which, in turn, contributes significantly to our long-run budget problem.

The existence of a long-run budget problem has been apparent for decades, ever since it became clear the abrupt fall in birth rates following the baby boom was a long-lasting phenomenon. However, the problem waxed and waned in the shorter run. At the end of the 1990s and at the beginning of the new century, significant budget surpluses emerged. Indeed, in 2001, both CBO and OMB (Office of Management and Budget) projected future surpluses so large there was talk of paying off the entire national debt.

The surpluses resulted partly from a surge in revenues largely collected from the very rich, many of whom profited enormously from the tech boom. For the first time in U.S. history, revenues exceeded 19 percent of GDP for five years in a row from 1997 to 2001. Spending growth was also restrained. The end of the Cold War held down defense spending and relatively small cohorts of depression babies were applying for Social Security and

Medicare. There were beneficial policy changes as well. The budget deals of 1990, 1993, and 1997 played significant roles in producing a surplus.

The Bush administration responded to projections of large surpluses by proposing a very large tax cut. It was implemented in three steps in 2001, 2002, and 2003. The cuts, combined with a recession and slow recovery, pushed revenues below 17 percent of GDP for the first time since 1959. At the same time, spending began to grow rapidly. A new prescription drug program was created as part of Medicare and wars in Afghanistan and Iraq pushed up defense spending. Nondefense discretionary spending also grew faster than GDP. The budget balance went from a surplus of 2.4 percent of GDP in 2000 to a deficit of 3.4 percent in 2004. But revenues subsequently grew rapidly as the economic recovery accelerated and the administration and the Congress exercised much more restraint in domestic spending during former U.S. President George W. Bush's second term. In consequence, the deficit fell below 2 percent of GDP in 2006 and 2007. Were it sustained there indefinitely, the debt would have been stabilized at well under 50 percent of GDP. But sustaining deficits below 2 percent without raising taxes to unprecedented levels would have been difficult in the long run in the face of the growing costs of health care and Social Security. However, we did not have to wait for the long run for large deficits to reappear. The nation suddenly went into the Great Recession of 2007–2009. The economic downturn automatically caused revenues to plummet and spending on safety net programs to greatly increase. Automatic stabilizers directly added \$1,090 billion to the deficit. A massive stimulus program that further cut tax revenues and added to spending was also enacted. A recent estimate its cumulative cost at \$733 billion over the period 2009–2011 with much smaller amounts spent in future years.³ The national debt grew from 40 percent of GDP at the end of fiscal 2008 to 68 percent by the end of 2011.

Even with a slow economic recovery, deficits have declined substantially as a percent of GDP over the past few years since peaking at 10.1 in 2009. Under current policies, they will continue to decline modestly over the next few years and then level off at about 5 percent of GDP for several years before climbing once again, given the policies president recommended in his 2013 budget. However, as can be seen in Figure 1, total debt as a percent of GDP is projected to continue to climb relentlessly even throughout this decade. With a growing debt and the assumption that interest rates rise modestly, interest costs become a significant part of the budget problem in the longer run.

COMMISSIONS RECOMMEND SOLUTIONS

Numerous committees and commissions have formed to suggest ways of restoring fiscal sustainability. Some come from the political right or left, but the most interesting include members who span the ideological spectrum. Our analysis will focus on the groups who

3. The estimates of the effects of automatic stabilizers and the stimulus program do not include indirect interest costs.

have searched for bipartisan solutions to our fiscal problems. The most important of these was the *President's National Commission on Fiscal Responsibility and Reform* (NCFRR 2010). The commission was created in January 2010 to suggest approaches to reducing the deficit. The president appointed six members drawn from both political parties and Democratic and Republican Congressional leaders each appointed six elected members—three from the House and three from the Senate. The commission's rules stated that if at least 14 of its members supported its recommendations, the Congress had to vote on those recommendations—up or down, without amendment. This ensured at least two elected members from each party had to be on board before the Congress would be forced to act.

Few budget watchers thought the commission had any chance of success, especially after Congressional leaders appointed some members from the ideological extremes of their parties. But commission members and their staffs worked diligently in a collegial fashion. They finally arrived at a solution that stabilized the debt relative to GDP. They recommended a radical, revenue-raising tax reform, a 15-cent increase in the gas tax, comprehensive Social Security reform, a goal of restraining the growth of federal spending on health care with options for enforcing it, and very severe caps on defense and nondefense discretionary spending.

Only 11 members ultimately voted for the commission report, but getting more than majority support was a notable achievement. Moreover, support spanned the ideological spectrum from U.S. Senator Tom Coburn (R, OK), one of the most conservative members of the Senate, to U.S. Senator Richard Durbin (D, IL), a solid liberal. Although the Republican Party has adamantly opposed tax increases, three Republican Senators voted for a plan that contained significant new revenues. The commission claimed that, by 2020, roughly 70 percent of its deficit reduction came from slowing noninterest spending growth and 30 percent from revenue increases.⁴ In the long run, the commission held spending to 21 percent of GDP, a very severe limit given the growing costs of an aging population and ever more expensive health care.

In addition to the president's commission, a number of other prominent groups proposed solutions to the debt problem. The highest profile of these was a bipartisan commission called the Debt Reduction Task Force (DRTF), created by the BPC at almost exactly the same time as the president's commission.⁵ Unlike the president's commission, the DRTF consisted entirely of private citizens. It was headed by former U.S. Senators Pete Domenici (R, NM) and Alice Rivlin, former U.S. President Bill Clinton's director of the Office of Management and Budget. Other members came from both political parties, but were drawn primarily from the ideological center. Like the president's commission, the DRTF's proposals achieved fiscal stability within a decade or so. They recommended radical tax

4. The division of deficit reduction between spending reductions and revenue increases is somewhat arbitrary because it depends on what is assumed for a starting point. The commission created its own baseline. It is very similar to CBO's alternative policy baseline. If they had chosen a baseline with higher spending levels, the estimated proportion of deficit reduction from spending constraints would have been higher.

5. The Bipartisan Policy Center was founded in 2007. Its current chairperson is Jane Garvey.

reform, enforceable limits on Medicare and Medicaid cost growth, Social Security reform and a stringent approach to discretionary spending (DRTF 2010). However, their deficit savings relied more heavily on tax increases than did the presidential commission, largely because they recommended a new value added tax (VAT) to supplement the existing tax system. A committee convened earlier by the National Research Council and the National Academy of Public Administration (NRC and NAPA 2010) put forward radical tax reform as one of its revenue-raising options and also discussed a VAT, but only in combination with an unreformed tax system.

The Peter G. Peterson Foundation, which is devoted to advocating fiscally responsible policies, asked a number of think tanks, including the BPC, to put together policy packages to achieve fiscal stability. Other than the BPC, the participating organizations tended to lean left or right ideologically.⁶ Consequently, their proposals are less likely to be adopted than something truly bipartisan. That does not mean they are without interest. They indicate the depth of the ideological divide in the country. A description can be found in *The Solutions Initiative* (The Peter G. Peterson Foundation 2011).

While there were many notable policy suggestions in these reports, space does not permit us to review all of them. Because of the prominence of the president's commission and the DRTF, we review the major recommendations of these two groups in the remainder of this section. In doing so, we focus on the four most crucial areas of the budget—health care, Social Security, discretionary spending, and tax policy.⁷

Health Care

The presidential commission report identifies federal spending on health care as “our single largest fiscal challenge over the long run” and offers recommendations for both the near and long term to reduce the growth of such spending and “slow the growth of health care costs more broadly” (NCFRR 2010, 31). The principle concern for the near term is to offset the deficit costs of fixing Medicare's flawed sustainable growth rate (SGR) payment formula for physicians and to reform or repeal the financially unsound Community Living Assistance Services and Support (CLASS) Act, enacted in the health reform Affordable Care Act (ACA).⁸ (The CLASS Act was abandoned by the administration earlier this year because its analysis confirmed the program was not financially viable.)

6. The other participating organizations were the American Enterprise Institute, the Center for American Progress, the Economic Policy Institute, The Heritage Foundation, and the Roosevelt Campus Network.

7. Various committees also made recommendations for the “other mandatory” category of the budget that contains entitlement programs outside of Social Security and health care and other types of mandatory spending. However, these recommendations tended to be relatively minor quantitatively and we do not consider them here.

8. For a discussion of why reducing federal spending on health care is the nation's greatest fiscal challenge, and the problems with the Medicare SGR physician payment formula, see Chapter 5 of National Academies (2010). For a discussion of the fiscal impact of ACA and the CLASS Act, see Palmer and Penner (2010).

To reduce cost growth, the report recommended numerous specific health spending changes estimated to yield nearly \$400 billion in savings from 2012 to 2020. Because the ACA contained many cost saving provisions for Medicare and Medicaid, much of the “low hanging (deficit savings) fruit” from these programs is now off the table. Still, four commission recommendations affecting the Medicare and Medicaid accounted for the lion’s share of total near-term savings: expanding cost-sharing in Medicare (along with instituting a cap on it), increasing pharmaceutical companies’ rebates for prescription drugs for Medicare beneficiaries, reducing Medicare’s subsidies to teaching hospitals for graduate medical education, and restricting states’ ability to artificially inflate reported spending on Medicaid to increase their federal match. Variants of the first two recommendations are also included in the DRTF report.

For the long term (post-2020), the presidential commission report recommends “a process for reviewing total federal health care spending [including the exchange subsidies under ACA and cost of the tax exclusion for health insurance⁹ with the target of holding cost growth to GDP plus 1 percent and requiring action by the President and Congress if the growth exceeds [it]”. This is a very ambitious goal, but a necessary one if total federal spending is eventually to be constrained to a level consistent with the report’s recommended 21 percent of GDP. The report acknowledges that more substantial structural reforms to the health-care system than those in ACA will be required to hit this target unless the latter prove far more successful in slowing the rate of federal health care spending than CBO and the Medicare actuary project. But rather than recommend any particular reforms, it tersely identifies—without content or comment—a grab bag of wide-ranging policy options suggested by commission members. The absence of a long-run reform plan for the health system represents one of the few serious weaknesses in the report.

Many experts believe establishing some sort of fixed budget for at least the major components of federal spending on health care may eventually be necessary to keep spending growth anywhere near the presidential commission target. The DRTF plan moved in this direction by recommending, as the main pillars of a coherent long-term strategy, the adoption of three of the presidential commission members’ bolder suggestions for restraining the long-term growth of federal health care costs. First, its recommended phase out of the tax exclusion for health insurance would totally eliminate this huge tax expenditure as well as foster more cost-conscious choices by purchasers of private health insurance. Second, Medicare would be converted into a “premium support” system, essentially providing beneficiaries with a voucher whose value grows over time at the rate of per capita GDP growth plus 1 percent. The voucher could be used to pay the costs of traditional fee-for-service Medicare or a competing private plan offered on a newly created Medicare Exchange. This change would not only constrain the growth rate of federal spending on Medicare to a level well below current projections, but also dampen underlying health-care cost increases by making beneficiaries who remain in traditional Medicare more cost conscious. (They

9. They include an adjustment for any changes made to the exclusion under the report’s recommended approach to tax reform.

will be forced to pay additional premiums if Medicare costs per beneficiary rise faster than the value of the voucher.) The proposal would also foster competition among plans on the exchange, leading them to manage quality care delivery in a more cost-efficient manner. Finally, the DRTF plan calls for changing the incentives inherent in the current complex financial arrangements in Medicaid between the federal and state governments from cost-increasing to cost-decreasing ones, so as to substantially slow the rate of growth of program costs and limit the federal government's current open-ended Medicaid liability.

Many aspects of the DRTF plan's long-term strategy for health care are worrisome, chief among which is the extent to which its elements—on top of the reforms already set in motion by ACA—actually would slow the underlying rate of growth of system-wide per capita health-care costs. Unless the system-wide rate of growth slows commensurately with that of per capita costs for Medicare and Medicaid, it would be difficult, if not impossible, to achieve the desired savings in the two programs without unduly undermining beneficiaries' access to quality health care. But the DRTF plan at least advances a coherent, concrete, and plausible approach to the health-care cost problem, which experts agree is our “single largest fiscal challenge over the long run.”

Social Security

The presidential commission's plan for Social Security was designed to eliminate the program's 75-year deficit and put it on a financially sustainable path thereafter by both increasing revenues and reducing costs over time relative to those currently scheduled. The financial outlook for Social Security has worsened somewhat since the commission reported, because the Great Recession, higher than expected cost-of-living adjustments (COLAs), and the tepid economic recovery have resulted in cash flow deficits for the Social Security trust fund sooner than previously expected.¹⁰ Those deficits will increase in the future as the ratio of beneficiaries to payroll taxpayers grows and result in a drawdown trust fund reserves until they are depleted in 2033. At that time an across-the-board benefit cut for current and future beneficiaries of 25 percent would be required. Even though these estimates are worse than the commission contemplated, their recommendations would take the system a long way toward financial sustainability.

The following five commission recommendations would improve Social Security's financial outlook.

1. *Modify the benefit formula to slow the growth of future benefits.* The wage-adjusted benefit levels of new retirees, except those with very low covered earnings histories, would decline in a progressive manner relative to those of comparable recipients today. But the modifications would be phased in slowly from 2017 to 2050 and ensure that

10. The temporary, partial cut in payroll taxes in effect for 2011 and 2012 and mentioned in the final section of this paper has no consequences for Social Security's cash flow deficits and trust fund balances since the consequent loss in payroll tax revenues to the trust fund is offset by a commensurate infusion of general revenues.

all future beneficiaries continue to receive higher levels of inflation-adjusted benefits than earlier generations.

2. *Index the normal retirement age (NRA) and the early retirement age (ERA) to life expectancy.* This provision is intended to maintain a constant ratio of years in retirement to years in adulthood as longevity increases. It would raise the NRA (now scheduled to be 67 in 2027 and thereafter) to 68 in about 2050 and 69 in about 2075, with the ERA (currently 62) moving in tandem to 63 and 64.
3. *Increase the amount of wages subject to the Social Security payroll tax.* In the early 1980s, taxable wages under the cap—currently \$106,800 and indexed to the average growth of covered wages—were 90 percent of all wages. Since then, wages below the cap have grown more slowly than those above it, such that barely 82 percent of all wages will be subject to the payroll tax by 2020. This provision would gradually increase the cap to the 90 percent mark by 2050.
4. *Substitute the chained consumer price index (CPI).* This is a more accurate measure of inflation, for the current version of the CPI used to calculate annual COLAs to Social Security benefits.¹¹
5. *Phase in coverage of the one-quarter of the state and local workforce currently outside Social Security.*

Four other recommendations would modify Social Security, at modest or no cost, to better support the most vulnerable recipients and to introduce new flexibilities and protections in conjunction with an indexed retirement age.

1. *A new special minimum benefit* would provide full-career workers (with 30 or more years of covered earnings) with a benefit no less than 125 percent of the poverty line starting in 2017 (and indexed to wages thereafter), with a proportionately lower guaranteed benefit for workers with 10–29 years of covered earnings.
2. *A benefit enhancement for the long-lived and long-time disabled*, who are at risk of outliving their own retirement resources, would bump up their benefit levels 20 years after initial eligibility by 5 percent of the average benefit level.
3. *A new option for retirement claiming* permitting collection of up to half of benefits as early as 62, with the applicable actuarial reduction, and the other half at a later age would provide a smoother transition for those interested in phased retirement or for households in which one member has retired and the other continues to work.
4. *An early retirement hardship exemption* for those who may not qualify for disability benefits but are physically unable to work beyond the current ERA. The proposal would allow them to continue to claim benefits at age 62 as the ERA and NRA increase without any additional actuarial reductions.

11. The chain index would also be used for other indexed spending programs and to index the brackets of the individual income tax. For a discussion of its use to index Social Security benefits, see “Adjusting Social Security Benefits for Changes in the Cost of Living” (Penner 2010).

The presidential commission plan relied more heavily—and more so over time—on benefit cost reductions than on revenue increases to ensure Social Security’s long-run solvency. More than three-fifths of the improvement in the program’s finances over the next 75 years would be due to provisions directly affecting benefit levels; by the 75th year this ratio rises above four-fifths (Goss 2010). As a result, most new retirees would experience benefit reductions, compared to those promised, of increasing amounts over time. By mid-century those in the middle quintile would have their benefits reduced by an average of 9 percent; for those in the top quintile, the reduction would be 19 percent.¹² These reductions are relative to currently scheduled benefits that grow in real terms. Even after the reductions, average benefits would continue to grow in real terms, albeit at a lower rate than now scheduled. Lower lifetime covered earners would be well protected by other plan provisions, with the lowest actually receiving a benefit more than one-third higher because of the new special minimum. So concern about the plan’s benefit reductions would likely focus on future beneficiaries in the broad middle of the lifetime earnings distribution, as well as on those with more limited lifetime earnings not well-protected by the special minimum due to long absences from the labor force resulting from unemployment, illness, etc. Both groups are likely to remain highly dependent upon Social Security to maintain their pre-retirement standard of living while also facing out-of-pocket health-care costs (including Medicare premiums) growing faster than their inflation-adjusted benefits. Nonetheless, they would likely be much better off in the long run than they would be if program solvency is not restored and overall budget deficits are allowed to spiral out of control.

The DRTF’s plan for Social Security provides an interesting contrast, since it entails a set of provisions similar to those of the president’s commission plus several others. But its progressive benefit formula reduction affects only high lifetime earners and yields far less savings, while its supplementary provisions provide additional revenue of a bit more than 1 percent of taxable payroll—principally by phasing out the income and payroll tax exclusions for employer-sponsored health insurance. As a consequence, in contrast to the president commission’s plan, the Social Security reforms in the DRTF plan rely more equally on reduced costs and increased revenues over time and result in more moderate benefit reductions.¹³ However, the presidential commission’s plan is designed to ensure Social Security’s solvency as a stand-alone proposal and the report indicates that any additional trust fund revenue resulting from tax reform “will provide flexibility to moderate the changes in benefits or taxation recommended by the Commission” (NCFRR 2010, 54). Thus, were the tax exclusion for health insurance phased out, the consequent fiscal flexibility could be used to soften the impact of benefit reductions on selected groups of future beneficiaries of most concern.

12. These are broad averages. A 65-year-old new retiree at the median of lifetime covered earnings would experience a benefit reduction of 13 percent in 2050 and 19 percent in 2080, and benefit reductions for many high lifetime earners would be far larger than 19 percent by mid-century. [Percentages in text are from fig. 13 of Commission report; those in this footnote are from table 2 of Goss (2010).]

13. The DRTF plan’s benefit reductions are also more moderate because it eliminates only 88 percent of the 75th year shortfall, whereas the Commission’s plan totally eliminates this shortfall.

Another interesting point of contrast between the two plans is the different means by which they adjust the level of future retiree benefits to increases in life expectancy. Under the DRTF plan both the early entitlement age (EEA) and NRA would remain the same as under current law, while the formula for calculating initial benefit levels would be indexed to achieve the same result as would indexing the NRA. This could be a more politically palatable approach to indexing to longevity, since it still allows retirees to claim all their benefits at age 62—albeit with a larger actuarial reduction than under current law. It also eliminates the need for the commission’s hardship exemption from the higher EEA, which would be difficult to implement in practice. However, the value of more clearly signaling to today’s younger generations the need to plan on working longer in order to adequately provide for retirement would be lost.¹⁴

Finally, we note neither plan includes any form of individual accounts, a cornerstone of President Bush’s proposed reform of Social Security. The subsequent Great Recession and accompanying stock market collapse have reduced the appeal of individual accounts, but they still appear in some form in some other budget reform plans. For example, the proposal offered by William Galston and Maya MacGuineas (2010), the road map of House Budget Committee Chairman, Paul Ryan (2010), and the plans put forward by the conservative Americans for Tax Reform (2010), the Heritage Foundation, and the American Enterprise Institute all include some version of individual accounts.¹⁵

Discretionary Spending

The presidential commission’s reforms of Social Security are phased in very slowly and its major savings in health programs are not achieved until after 2020. As a result, the commission has to hit discretionary programs very hard to achieve significant deficit reduction in the medium term without large tax increases. They propose caps on discretionary spending that would cut 2015 spending levels by \$38 billion in nominal terms compared to spending in 2009 and by about 10 percent in real terms.¹⁶ By 2020, real discretionary spending is almost 18 percent below 2009 levels. After 2020, discretionary spending is allowed to grow with the CPI. Although 2009 spending was somewhat inflated by the stimulus program, the recommended cuts are very severe given that the demand for public services will grow with the population. Discretionary spending cuts account for over 45 percent of the deficit reduction proposed for 2015 relative to the commission’s baseline while revenue increases account for about 25 percent and associated interest savings for 9 percent. The remaining small amount comes from the early effects of Social Security and health reform and reforms

14. An additional loss would be the additional income tax revenues generated by their working longer.

15. The latter two organizations’ proposals are in The Peter G. Peterson Foundation (2011).

16. Author’s calculation based on CBO’s most recent forecast of the GDP deflator. The CBO August forecast is slightly different than the forecast underlying the commission’s baseline.

to other mandatory spending programs. The commission's caps are enforced by points of order and by automatic spending cuts if points of order are not upheld.¹⁷

In suggesting approaches to getting under the cap, the commission does not identify specific program cuts or eliminations in the body of their report. Instead, it takes the indirect approach of advocating a three-year civil service pay freeze, a reduction in the size of the civil service, a reduction of travel and vehicle expenses and symbolic cuts in Congressional and White House budgets. Such savings amount to over \$35 billion for 2015, or only about 20 percent of the \$172 billion in savings necessary to get under the 2015 cap.¹⁸ On its website, the commission provides options for saving \$100 billion in defense and the same amount in nondefense programs. Most of the defense options are quite specific and many would cut weapons systems, such as the V-22 Osprey aircraft. The nondefense list also contains a number of program cuts, such as eliminating the Overseas Private Investment Corporation, but also lists options whose effects are harder to discern, such as creating a Cut and Invest Committee that would have a goal of saving \$11 billion. Both the president's commission and the DRTF suggest the need for more public investment. However, increases in investment spending would have to be offset by reductions in current spending to stay under the discretionary spending caps.

The commission's severe spending caps obviously become more feasible politically if you can avoid naming explicit program cuts and arousing the programs' constituencies. But the commission's indirect cuts are hard to evaluate. It is clear that some civil servants are overpaid and some underpaid, but it is important to ask what a pay freeze will do to the quantity and quality of civil servants who are recruited. Similarly, the commission's reduction in the size of the civil service and the reduction of their travel expenses is probably warranted in some agencies, but may be more dubious for those charged with evaluating disability claims or enforcing tax laws. Moreover, reducing staff by attrition, as the commission recommends, may not be the most efficient approach because those staff who choose to leave may not always be those who are the least productive or least needed.

The DRTF follows a similar strategy to controlling discretionary spending, but the implied cuts from baseline levels are much less severe. The report advocates a four-year nominal freeze of nondefense discretionary spending for the period 2012–2015. Subsequently the programs are allowed to grow with the economy. This compares to the real absolute cuts advocated by the presidential commission. For defense, the DRTF advocates a five-year freeze and growth with the economy thereafter. Like the president's commission, the task force seems reluctant to recommend specific program cuts, but provides a very long list of illustrative examples. There is much overlap between their list and the commission's.

17. Sixty votes are required to waive a point of order in the Senate. In the House only a simple majority is necessary, but it must be done using a separate, non-amendable vote.

18. There are other savings as well, such as eliminating earmarks (\$16 billion).

Tax Policy

It is almost impossible to imagine a compromise solution to the long-run budget problem that does not involve revenue increases. Since neither major party is sufficiently dominant to impose a solution, compromise likely also will be necessary on the composition as well as amount of any revenue increases. Virtually all experts agree that one of the least desirable ways of generating very substantial new revenues is to raise the marginal tax rates in our current highly inefficient and inequitable individual and corporate income tax systems. This leaves two options. Our income tax systems could be radically reformed to raise revenues more equitably and efficiently with lower marginal tax rates, or revenues could be raised using some other forms of taxes. The presidential commission and the DRTF suggest both options in very different proportions. The National Academies committee suggested radical tax reform as one revenue-raising option and a number of other committees recommend less dramatic tax reforms.¹⁹

Radical tax reform involves eliminating or greatly reducing the value of the many deductions, credits, special rates, and income exclusions that riddle our individual and corporate income tax system. These are known as tax expenditures and their estimated current annual value is at \$1 trillion (Rogers and Toder 2011). The proceeds from reducing the value of tax expenditures can be divided into two portions. One can be applied to deficit reduction, while the other is used to reduce marginal tax rates. The tax system then becomes fairer, because those in a position to easily utilize tax expenditures have their relative advantage reduced or eliminated. The system becomes more efficient because incentives are improved as the reform reduces the amount taxed from each extra dollar earned from work or received from savings. Moreover, choices are distorted less by tax provisions that favor one form of economic activity over others.

The president's commission recommends applying \$80 billion of the proceeds from tax reform to deficit reduction in 2015 and an annual amount of \$180 billion by 2020. Its analysis is particularly useful, because the trade-offs between eliminating and reducing particular tax expenditures and the marginal tax rates required to raise the target amount of revenues are clearly illustrated. For example, the commission estimated if every single tax expenditure were eliminated and their target amount of new revenues dedicated to deficit reduction, the top marginal individual rate could be lowered to 23 percent²⁰ and the top corporate rate from 35 to 26 percent. If the earned income tax credit and the child credit were retained because of their particular value to the poor, however, the top individual rate could be lowered to only 24 percent. The commission provides an illustrative tax plan that retains politically sensitive tax expenditures, such as the charitable and mortgage interest deductions, but limits their value. Under this variant, the top rate falls only to 28 percent. In the commission plan, capital gains are taxed at the same rate as ordinary income and 15

19. See NRC and NAPA's (2010) report *Choosing the Nation's Fiscal Future*.

20. When the commission reported the top rate was scheduled to rise to 39.6 percent in 2011. The increase has since been postponed to 2013. The commission's revenue estimates are based on a top rate of 39.6 percent and a penultimate rate of 36 percent rather than the 35 and 33 percent that will prevail through 2012.

cents per gallon is added to the gas tax. The commission's tax reform is highly progressive, mainly because it eliminates tax preferences for capital gains and dividends.

The tax reform proposed by the DRTF is more complicated, but follows the same philosophy. Most tax expenditures are eliminated, but a few politically sensitive deductions are retained. As in the president's commission plan, tax expenditures are modified to reduce the revenue loss. The tax treatment of lower income groups is simplified as are the many provisions related to retirement and other savings. Capital gains are taxed the same as ordinary income. The top tax rates on both personal and corporate income are lowered to 27 percent.

The most important difference between the presidential commission's and the DRTF plan is the latter imposes a 6.5 percent VAT, which they call a national "Debt Reduction Sales Tax" (DRTF 2010, 38). The committee estimates that it would raise over \$3 trillion cumulatively through 2020. As a result, the DRTF plan relies considerably more on revenue increases to solve the deficit problem than does the presidential commission's. Parallel to their treatment of annual COLAs for Social Security benefits, both plans use the more accurate chained CPI²¹ to index tax brackets instead of the currently used CPI. This produces more revenue over time, since the chained index is expected to grow more slowly than the CPI.

Tax reform is extremely difficult politically, because many will perceive themselves to be losers—those who now rely heavily on tax expenditures to reduce their tax burdens—even though they may ultimately benefit from the reduced probability of a fiscal meltdown due to deficit reduction. Revenue-neutral tax reform is hard enough. Revenue-raising tax reform is even more difficult, because the number of perceived losers is increased. The proposals of the president's commission and the DRTF are extremely important, because they have taken proposals that seem politically implausible on the surface and made them seem plausible. That is because they have clearly described the most important benefit of reform—more revenues can be raised with lower marginal tax rates. This is particularly important to conservatives—particularly in the House—who now adamantly oppose revenue increases. Radical reform that allows more revenue to be generated with lower marginal rates is likely the only way to get this group to accept revenue raising. But while such reform is likely to be necessary to sell them, it may not be sufficient. Employing a new tax, as does the DRTF proposal, will also be a hard sell.

The output of the president's commission and various committees is extremely valuable. Their reports offer a rich variety of policy options that will be useful to have on the table when we finally act on our budget problems, as we must eventually. The existence of radical tax reform proposals in more than one report renders an option that earlier seemed implausible worthy of discussion. Perhaps most important, the experience of the president's

21. The traditional CPI assumes that households spend a constant share of their income on each category of goods and services and weights price changes using those shares. The chained CPI tracks change in the share spent and take an average of the share spent in the previous and the most recent period. Because it is likely that a household will reduce the share of income spent on a good whose price is rising, relative price increases get a lower weight in the chained index and it has risen less than the traditional CPI historically.

commission and the DRTF demonstrates there are policy packages that are sufficiently bold to achieve fiscal sustainability while still garnering bipartisan support in an intensely partisan era.

THE PRESIDENT AND THE CONGRESS FAIL TO ACHIEVE FISCAL SUSTAINABILITY

So far none of the commission or committee reports have received enthusiastic support from elected officials. Efforts to address the long-term deficit problem, such as the House Budget Resolution (HBR), had little chance of being passed by the entire Congress. The president has been tepid in his support of his own commission, looking favorably only on their tax reform suggestions. Former U.S. Speaker Nancy Pelosi (D, CA) dubbed an earlier version of the president's deficit commission report "unacceptable," and U.S. Speaker John Boehner (R, OH) has said very little about it. A bipartisan group of senators, led by U.S. Senators John Warner (D, VA) and Saxby Chambliss (R, GA) and dubbed "the gang of six," attempted to translate the presidential commission's recommendations into detailed legislation, but could only agree on the broad outlines of a reform proposal.

In December 2010—the same month that the presidential commission issued its report—the Congress agreed to extend the Bush tax cuts for two years and reduced the payroll tax rate by two percentage points for one year. It also extended other tax cuts and the time-limited expansion of unemployment insurance benefits, while passing other measures to stimulate the economy. In other words, the Congress significantly enlarged the deficit relative to current law, albeit temporarily in the name of supplying a fiscal stimulus.

While budget watchdogs and advocates of fiscal responsibility remained hopeful throughout 2011 and into 2012, so far there has been no indication of any serious effort to reach consensus on a long-term budget plan that achieves sustainability. Rather than take advantage of opportunities, both the Congress and the president have continually declined to do so.

The 2011 Deadlock and Debt Ceiling Debate

The president's budget for fiscal 2012, issued in February 2011, did not meaningfully attack the long-run budget problem. The first comprehensive proposal to do so from elected officials came from Congress and was designed by Paul Ryan, the Chairman of the House Budget Committee. It was ultimately passed in April 2011 by the House of Representatives as its Budget Resolution for fiscal year 2012. It claimed cumulative deficit reductions of more than \$4 trillion compared to the president's budget and would have continually lowered the debt-GDP ratio after 2013, reaching 67.5 percent by 2021 and less than 50 percent by 2040 when the budget would be essentially balanced.

The HBR avoided tax increases, but advocated a radical tax reform to broaden the income tax base and allow a significant reduction in marginal tax rates. Its most important

and contentious deficit reductions came from subjecting Medicare and federal spending for Medicaid to strict budget constraints that would restrain per capita expenditure growth to the increase in the CPI—a far, far slower rate of growth than they have experienced historically. (It also called for repeal of most of the ACA, including the provisions expanding insurance coverage.) For Medicare, long-term budget restraint was accomplished by creating a premium support system. Beneficiaries would be given vouchers, whose value would vary inversely with income, to use toward the purchase health insurance in a competitive market. The structure of the proposal was quite similar to that of the DRTF, but the budget constraint for the House plan was very much less generous. Only those 55 and under would be affected by this dramatic reform. For Medicaid, budget discipline would be imposed by creating block grants for states, budgeted in such a way that over time states would have to cover a growing share of Medicaid costs or greatly reduce the generosity of their programs.

Because the slowdown in Medicare cost growth would not occur for some time in the Ryan plan and it included no revenue increases, the plan had to be quite stringent with regard to discretionary spending to make significant progress against the deficit in the short run. Relative to official baseline projections of spending, the stringency was less severe for defense than nondefense spending.

The president responded to the House plan by blasting its Medicare proposal and putting forth his own “framework” for long-term deficit reduction of a magnitude much larger than that proposed in his FY12 budget. The president set a goal for annual per capita Medicare cost growth equal to GDP growth plus 0.5 percentage point. He hoped to achieve this goal using the reimbursement limits and other provisions of the ACA. That act created the Independent Payment Advisory Board (IPAB) to make recommendations for reducing Medicare cost growth. But there are many things IPAB cannot recommend, including rationing, more cost sharing by beneficiaries and further payment cuts to hospitals and hospices (beyond those already specified in the ACA) until 2020. (Physician reimbursements can be cut.) The president wanted to expand its powers to cover hospital and hospice fees and to design programs to reward things such as value-based benefit designs.²²

Many question whether the reimbursement limits in the ACA are practical, let alone additional cuts that might be recommended by IPAB. They could drive many providers out of the Medicare program, thereby jeopardizing millions of elderly Americans’ access to mainstream medical care.

The president’s framework reduced the growth of discretionary spending programs, although not as much as the House plan. It also raised taxes significantly, in large part by ending the Bush tax cuts for individuals with incomes above \$200,000 and couples above \$250,000. The House budget and the president’s framework were both silent with regard to explicit reforms to Social Security, testifying to the immense political popularity of that program. However, both stated the need for future reforms to address the program’s long-term financial deficits.

22. The recommendations of the IPAB are to go into effect unless the Congress proposes program changes providing equal savings.

The democratically controlled Senate never passed a budget resolution for fiscal 2012.²³ Consequently, there was never a formal opportunity in a conference to compromise between Republican and Democratic visions for the future of fiscal policy. They likely would never have reached agreement anyway. The vast ideological gap between the House budget and the president's framework made it clear that compromise would not come easily. Nevertheless, the Congress and president were forced to take action in the summer of 2011, because U.S. law limits the amount of debt that can be issued by the Treasury and that limit was approached in July. Either they had to raise the debt limit or immediately balance the budget to prevent the issue of more debt.²⁴ Although a few members of Congress advocated the latter, the vast majority believed immediately balancing the budget was unthinkable because of the negative shock it would impart to the economy and to taxpayers and/or beneficiaries of government programs.

The debt limit law is totally irrational. It imposes a ceiling on the gross national debt unrelated to spending and revenue decisions already made and, consequently, it is usually completely inconsistent with those decisions. But a failure to increase the limit would have forced the United States to default²⁵ on its debt or immediately balance the budget. The latter would have required a cut of about 40 percent in noninterest spending, something the Treasury claims the authority to do in order to avoid a default. The possibility of such traumatic events gives the Congress immense bargaining power in negotiations with the president over raising the debt ceiling—bargaining power that tends to be exploited most vigorously when one or both houses of Congress are controlled by a different political party than the president's.

The debate over the debt limit was a low point in the history of U.S. budgeting. There were many starts and stops with aborted deals and much posturing. It was impossible to predict from day to day where the debate would go, and, at times, the unthinkable—a default on U.S. sovereign debt—seemed quite possible. House Speaker Boehner held fast to a goal of reducing the deficit dollar for dollar for any increase in the debt limit. (It was never clear over what period the deficit reduction was supposed to occur.) For most of the negotiations, the speaker insisted that the entire deficit reduction come from spending cuts, although for a brief period he and the president were discussing a very large deficit-reduction package that would include some tax increases. Meanwhile, the president wanted a big enough increase in the debt ceiling limit to preclude the issue having to be revisited before the 2012 presidential election.

In the end, Congress and the president agreed to the BCA of 2011. This act has two parts. The first imposes caps on discretionary appropriations through 2021 that save a cumulative

23. They later claimed that the BCA was their budget.

24. Debt held by the trust funds counts toward the debt limit. If the trust funds have a surplus, the unified budget, which records transactions with those outside of government, must run a surplus to retire debt in the hands of the public in order to make up for the increase in debt held by trust funds.

25. Without immediately balancing the budget, the United States would be unable to pay interest on its old debt and so be in default.

\$756 billion starting in 2012²⁶ and makes changes in student loans and Pell grants that save a cumulative \$5 billion over the same period. For 2012 and 2013, the BCA has separate caps on appropriations for security and nonsecurity spending. After 2013, a single cap applies to total discretionary appropriations and Congress will have to determine how to apportion it between security and nonsecurity spending on a year-by-year basis. The discretionary caps in the BCA are somewhat more lenient than the caps in the HBR. The BCA's discretionary caps and education reforms will result in additional interest savings of \$134 billion.²⁷ In total, the first part of the BCA will reduce the cumulative deficit by \$895 billion from 2012 through 2021.

The second part of the BCA created a Congressional Joint Select Committee on Deficit Reduction, dubbed the "super committee," which consisted of 12 members: three Republicans and three Democrats from each of the House and Senate. Committee members were instructed to reduce the deficit by a cumulative \$1.5 trillion from 2012 through 2021. In the end, they could not agree to any deficit reductions at all. According to the BCA, the super committee's failure requires additional deficit savings of \$1.2 trillion over 10 years starting in January 2013 through an automatic, across-the-board cut in budget authority,²⁸ unless Congress comes up with an equal amount of saving before the sequester takes effect. Half of this cut is to come from defense budget authority and half from nondefense budget authority.²⁹ However, Social Security and a number of programs focused on poor people are exempted from the cut, and the cut to Medicare is capped at 2 percent and limited to provider reimbursement. After 2013, the part of the sequester applying to discretionary spending takes the form of a further reductions in the caps defined by the first part of the BCA. If the caps from the first part of the BCA hold and the sequester is imposed, the total deficit reduction will be over \$2 trillion in the next 10 years. Were that to occur, the country would be about half way to the goal of stabilizing the debt-GDP ratio. However, later we shall ask whether these spending reductions are plausible.³⁰

CBO has provided estimates of the cuts in appropriations and in mandatory programs that will occur if the sequester is implemented (CBO 2011a). The automatic cut in

26. Caps can be increased for war spending, disaster relief, other emergencies, and monies spent to reduce improper benefit payments in several programs providing transfer payments. The law also requires that the Congress vote on a balanced budget amendment to the Constitution. Both houses voted on such an amendment in 2011; neither was able to muster the two-thirds vote necessary to send the amendment to the states for ratification.

27. The estimate of interest saving is based on CBO's interest forecast of August 2011 and therefore differs from the March 2011 baseline assumptions used in the first part of this paper. See CBO (2011a, 2011b).

28. For discretionary programs, budget authority is provided by appropriations that are most often passed annually. For entitlements, budget authority is often created by dedicated revenues, such as the payroll tax that finances Part A Medicare.

29. There is a curious anomaly in the law. While the initial caps are divided into security and nonsecurity portions for 2013, the sequester is divided equally between defense and nondefense activities. The main difference is the budget for homeland security is not included in the defense function.

30. The CBO has included the effects of the initial caps in its definition of current policy used for Figures 1 and 2. But it has not included the effects of the sequester.

TABLE 2
Effects of the Budget Control Act, 2012–2021 (Billions of Dollars)

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Effects of spending cap	–25	–47	–59	–67	–74	–81	–89	–97	–104	–112
Educational provisions	3	6	3	–2	–2	–2	–2	–2	–2	–3
Effects of sequester										
Defense		–55	–55	–55	–55	–55	–55	–55	–55	–55
Nondefense mandatory spending		–12	–17	–17	–18	–18	–19	–20	–21	–22
Reduction in the cap on nondefense discretionary budget authority		–43	–35	–37	–36	–36	–36	–34	–34	–33

Note: Indirect interest effects are not included.

Source: The Budget and Economic Outlook: An Update.

appropriations for defense discretionary spending would be 10 percent below the baseline in 2013 and then gradually fall in percentage terms each year to 8.5 percent by 2021. The cumulative reduction over 10 years is \$492 billion. The annual cuts in nondefense discretionary spending and in the nonexempted, nondefense mandatory programs would start out at 7.8 percent in 2013 and gradually fall to 5.5 percent in 2021. The total reduction in budget authority is \$492 billion, identical to that in the defense budget. The 2 percent cut in Medicare accounts for \$123 billion of this amount. Indirect debt service savings amount to \$169 billion. In total, the automatic cut in budget authority leads to cumulative outlay savings of \$1.1 trillion. The cut in outlays is less than the required \$1.2 cut in budget authority because of time lags between the creation of budget authority and the actual payment for goods and services (see Table 2).

Since the failure of the super committee, a number of Republicans and Democrats have argued the across-the-board cuts now scheduled for the defense budget would dangerously weaken national security. U.S. Senator John McCain (R, AZ) has introduced legislation to suspend those cuts. It is hard to believe Congress and the president could agree on suspending the defense cuts without doing the same for the nondefense cuts.

The president has responded that the cuts must be implemented and has vowed to veto any legislation to suspend them. He apparently hopes this threat will force the Congress to return to the bargaining table and agree to a more sensible outcome than across-the-board cuts.

Although it is hard to find anything to be encouraged about after the super committee's abysmal failure, there is a very small chance a return to the bargaining table could yield some success. The most important positive development during the committee's deliberations was an offer by the Republicans to open the door a tiny crack to tax increases. It was particularly significant that the vehemently antitax committee member U.S. Senator Pat Toomey (R, PA) put the offer on the table. He joined U.S. Republican Senators Michael Crapo (R, ID)

and Coburn and then U.S. Senator Judd Gregg (R, NH) who endorsed tax increases as members of the president's fiscal commission.

More Proposals and Continued Deadlock in 2012

In contrast to his 2012 budget, President Obama's 2013 budget, issued in February of 2012, embodied a more aggressive attack on the long-term deficit problem in the spirit of his framework from the prior spring and the plan he subsequently offered to the super committee.³¹ He claimed its adoption would reduce deficits by \$4.0 trillion over 10 years, but unfortunately that total included savings from ending the wars in Iraq and Afghanistan, thus reducing the credibility of his proposal. He also included savings stemming from the BCA. OMB estimates that, under the president's budget, the debt-GDP ratio would rise from 68 percent in 2011 to 77 percent by 2013 and ultimately stabilize at 76 percent during the period 2018–2022.³² Beyond that period the debt-GDP ratio would again increase, reaching 93 percent by 2035 and 125 percent by 2050.

The president's budget provides more details than either his framework or plan submitted to the super committee. There are very specific recommendations for reducing payments to providers and subsidies to medical schools under Medicare. Considerable amounts are saved for Medicare Part D by having drug companies provide rebates similar to those in the Medicaid program. Newly enrolled Part B recipients would face higher deductibles, and the more affluent would pay higher Part B and D premiums. Over three years starting in 2013, civil servants are expected to contribute a higher proportion of their wages to their defined benefit retirement plans, and military personnel and retirees and their dependents are expected to pay a higher cost share for their health plan. Numerous increases in fees and insurance premiums are proposed, as are sales of government properties. It is impossible to convey the richness of the budget's details in a short discussion; for that, the reader is referred to the president's budget (OMB 2012).

The budget accepts the caps on discretionary spending stipulated by the BCA and counts the associated spending cuts toward its saving target. It also identifies savings to replace the \$1.2 trillion sequester. The president repeats the call for radical tax reform that appeared in his earlier framework, but—recognizing that such tax reform will take a long time to pass and implement—he advocates generating additional revenues in the near term by limiting

31. In responding to the BCA, the president urged the super-committee to “go big” and exceed the legislated goal of \$1.5 trillion in deficit savings over 10 years. The plan he offered for its consideration reflected some modifications to his earlier framework and became the basis for his far more detailed 2013 budget.

32. In analyzing the president's budget the CBO uses somewhat less optimistic economic assumptions and estimates that the president's policies would stabilize the debt-GDP ratio at 80 percent around the end of the decade (CBO 2011b). However, the CBO bases its economic forecast on current law, implying that the Bush tax cuts end at the end of 2012 along with other measures that would otherwise stimulate the economy. This assumption artificially depresses economic growth whereas the president would continue most of the Bush tax cuts and that justifies a somewhat more optimistic economic outlook.

itemized deductions and adopts other base-broadening initiatives for both individuals and corporations.

There are two significant changes from the president's earlier tax proposals. First, the president now advocates raising the tax on dividends from Bush's 15 percent to a taxpayer's ordinary marginal rate. He had earlier limited the increase to 20 percent. Second, he proposes a new "Buffett rule," under which those with more than \$1 million in income would pay a minimum tax rate of 30 percent. This is in response to Warren Buffett noting that his average income tax rate is lower than his secretary's.

The president's proposal to the super committee and his budget have a somewhat different enforcement mechanism than did his earlier framework. The latter focused on sequesters that would hit a deficit goal. In the new plan, enforcement is centered on goals for the debt-GDP ratio. To set goals, the baseline debt-GDP ratio is estimated for 2013 and then reduced 0.2 percentage points a year. If Congress does not adopt policy changes sufficient to achieve the goals for the debt-GDP ratio, a sequester of spending modeled on the one in the BCA goes into effect. Most important, an equal amount is obtained from the revenue side by a proportional reduction in itemized deductions and exclusions for couples with more than \$250,000 in income and singles with more than \$200,000. The enforcement process is temporarily suspended in times of economic weakness.

As noted previously, the specific program proposals in the president's plan would stabilize the debt-GDP ratio around 76 percent in the 2018–2022 period and then increase thereafter. In contrast, the aforementioned enforcement mechanism requires a continual reduction in the debt-GDP ratio. Thus, Congress would have to pass spending cuts and/or tax increases going considerably beyond those specified in the president's plan.

The most important Republican response to the president's budget took the form of an HBR for 2013, again formulated by Paul Ryan's budget committee. This resolution embodies a very austere budget that significantly reduces the deficit and continually reduces the debt-GDP ratio without any tax increases. By 2022 the 2013 HBR would have revenues at 18.7 percent of GDP and outlays at 20.1 percent, in comparison to revenues at 20.1 percent and outlays at 22.3 percent in the president's budget.³³ The HBR debt-GDP ratio is 62 percent by 2022 compared to the president's 76 percent. The HBR calls for a radical revenue-neutral tax reform that would eliminate tax expenditures and use all the proceeds for lowering marginal tax rates. It is silent, however, about which tax expenditures would be reduced or eliminated, leaving that task up to the Ways and Means Committee.

While the fiscal 2013 HBR also converts Medicare to a premium support structure, it makes two very important changes to the HBR proposal for fiscal 2012. First, it increases the annual per capita target growth rate for the Medicare budget to GDP growth plus 0.5 percentage points—the same target earlier adopted by the president and one far more generous than holding Medicare per capita cost growth to CPI growth (as did the 2012 HBR). Second, the 2013 HBR allows beneficiaries to stay in traditional Medicare if they

33. The HBR and the president's budget are based on somewhat different economic assumptions, but this does not have a large impact on the differences in their revenue and output ratios for 2022.

so choose, although the per capita budget for traditional Medicare would also be held to GDP growth plus 0.5 percentage points. Its Medicare reform proposal thus becomes very similar to the DRTF proposal, except with a slightly lower annual cost growth target. The 2013 HBR also unrealistically assumes that the Sustainable Growth Act will cut physician reimbursements in Medicare by 27 percent, despite the Congress continually preventing such cuts from occurring in recent years, and holds cost growth for Medicaid block grants to a very stringent population-plus-CPI growth.

The 2013 HBR also continues the earlier HBR's austerity with respect to other mandatory and discretionary spending. The discretionary spending path is lower than that agreed to in the BCA by a tiny \$19 billion in 2013, but by increasing amounts thereafter that become quite significant by 2022. The path for defense spending is somewhat higher than in the BCA, implying that nondefense discretionary has to be squeezed much tighter. Mandatory spending outside of the main health-care programs and Social Security is also hit very hard—with Supplemental Nutrition Assistance (food stamps) converted into a block grant with work requirements, much as AFDC was converted into the TANF program in the Clinton administration. No specific reforms are proposed for Social Security, but the 2013 HBR once again calls for the president and Congressional leaders to develop a plan to reform Social Security to put it on a sound financial footing over the long run.

A bipartisan budget plan that updated the presidential commission proposals was introduced in the House by Jim Cooper (D, TN) and by Steven LaTourette (R, OH). It received only 38 votes about equally split between Democrats and Republicans. The small vote for this balanced proposal provides further evidence of the reluctance of the two parties to compromise on fiscal matters. Democratic leaders also introduced a budget resembling that offered by President Obama and another more liberal budget was offered by the Progressive Caucus. Yet another plan was proposed by the Black Caucus. All were soundly defeated.

THE BIAS AGAINST DISCRETIONARY SPENDING AND IN FAVOR OF TEMPORARY MEASURES

It is commonplace to observe that, as far as addressing the country's long-term fiscal woes goes, Congressional action on the budget over the past few years amounts to little more than "kicking the can down the road." Much less understood are the problematic consequences of the ways in which the can has been kicked: namely, with a bias against discretionary spending and in favor of temporary measures.

One of the ironies of the BCA is, despite its exclusive focus on achieving deficit savings by cutting expenditures, it did little to curb the major entitlements that are the source of all future growth in program spending. Social Security and Medicaid are totally exempted from cuts and the automatic cut in Medicare is limited to 2 percent. Not counting the debt service saving that indirectly results, almost 90 percent of the BCA's deficit reduction over 10 years comes from the caps on discretionary spending and the automatic cuts associated

with the sequester. In 2012, discretionary spending accounts for less than 40 percent of noninterest spending.

The strong bias against discretionary spending undoubtedly occurred because the BCA drafters never had to specify in any detail what programs will be cut to abide by the spending caps. This will be up to the appropriations committees at some later date—very probably after the 2012 election. In contrast, if specific reforms had been proposed for Social Security or Medicare, who would be affected would be completely transparent very quickly.

The bias against discretionary spending in the BCA comes on top of a longer lasting bias in the traditional budget process. Almost all discretionary spending must be approved each year in the annual appropriations process. If appropriations do not keep up with the rate of inflation, discretionary spending is said to be cut. In contrast, entitlements are not considered every year and their budgets are open-ended. That is to say, the law defines an eligible population and the benefits to which they are entitled. The government then pays the consequent cost for all program participants. If an entitlement program is reformed to reduce its costs—and that occurs infrequently for most—the program is said to be “cut” if, say, its annual cost growth is reduced from 7 to 6 percent, even though the average beneficiary may still be enjoying a significant increase in the real value of benefits. The end result has not been good for discretionary programs over the very long run. After reaching a peak of 5.2 percent of GDP during the Carter administration, nondefense discretionary spending fell to 3.6 by 2008 before being temporarily bloated by the stimulus program. If the provisions of the BCA are implemented, it is likely to fall to less than 3 percent of GDP over the next decade—the lowest level since World War II.

The focus on limiting discretionary spending growth very probably distorts our view of the seriousness of the long-run budget problem. CBO estimates the BCA and various less important measures cut 2014 discretionary spending 12 percent from stimulus-enhanced 2010 levels and then increase it by only 1.8 percent per year in nominal terms through 2022—or slightly slower than the assumed rate of inflation. Is it realistic to expect this degree of austerity to be maintained through a number of Congresses and elections in the face of the growing demands resulting from a continually growing population? Moreover, the BCA contains no provision for contingencies, whether they involve terrorist attacks, natural disasters, an increase in international tensions, or a significant recession. Although it is foolish to expect any policy to last forever, or perhaps even for 10 years, a true reform in entitlements or permanent increase in revenues is likely to produce a more lasting improvement in the fiscal outlook than unrealistic promises regarding the future of discretionary spending.

Unfortunately, as the battle has waged over the budget, rather than changing the laws governing taxes and entitlement programs to improve the long run fiscal outlook, the Congress all-too-often has passed measures that increase budget deficits and obfuscate their likely long run costs. It does this by making these deficit-increasing measures temporary even though they are extremely likely to be extended again and again. By making such measures temporary, the Congress does not have to show the long-run negative impact on the deficit in the official budget baseline because the baseline largely follows current law. If

the law says a particular tax provision will expire at the end of the year, the baseline shows it expiring even though common past practice may have been to repeatedly extend it. This tendency is enhanced when pay-as-you-go rules are in effect—as a version of currently is. Such rules force the Congress to fully offset any tax cut or increase in entitlements with some other tax increase or entitlement cut. It is much easier to offset short-term extensions than those scheduled to last for many years.

Over time the number of temporary laws has accumulated and we face a deluge of expirations at the end of 2012. All the Bush tax cuts and the payroll tax cut passed to stimulate the economy expire. Temporary action to provide relief from the Alternative Minimum Tax also expires, as do dozens of other temporary tax cuts of lesser but still significant impact, such as the research and experimentation tax credit. On the spending side, a 27 percent cut in physician reimbursements for Medicare is scheduled for 2013, as is the end of enhanced unemployment insurance benefits passed originally as part of the stimulus. In addition, the BCA automatic sequester begins to occur in January. If the Congress were not to act and allow all temporary measures to expire on December 31, 2012, the fiscal contraction in fiscal 2013 would amount to about 4 percent of GDP³⁴ and almost certainly cause a recession—not a pretty picture given that the year is likely to begin with unemployment still near 8 percent.

CONCLUSION

At the time of this writing, it appears extremely unlikely any action with significant consequences for the nation's fiscal outlook will occur before the November elections. There is nothing to require it, and both major parties hope to emerge from the elections with a stronger hand for subsequent budget negotiations. After that, it is anyone's guess as to just and when and how our long-term deficit and debt problem will be meaningfully redressed.

The expiration of the Bush tax cuts and numerous other temporary tax and spending provisions at the end of 2012, along with the probable need to again raise the debt limit before the year is out, offers another opportunity for productive bargaining. If the adamant Republican opposition to tax increases continues to weaken and Democrats can be persuaded to entertain lasting reforms to Social Security, Medicare, and Medicaid that would substantially slow the future rate of growth of program spending, there is some hope of a balanced solution for America's fiscal woes in the near term. However, the hope is a slim one. The two parties undoubtedly will remain far apart in their views and much compromising will be required to reach a viable solution. Unfortunately, a short, lame duck session of Congress is hardly conducive to the resolution of such complex and controversial matters. The best that can be hoped for it is probably the continued temporary extension of many of the expiring provisions—so as not to dramatically tighten fiscal policy while the economic

34. The contraction between calendar 2012 and 2013 is even greater, amounting to over 5 percent of GDP (CBO 2012b).

recovery is still so fragile—but within an agreed-upon framework for future comprehensive action.

One way or another 2013 is likely to be a crucial year for our fiscal future. If numerous temporary measures are not extended, the economy will be in perilous condition. But if they are, and very substantial progress is not also made on long-term deficit reduction, financial markets will doubt the resolve of our political leaders to ever tackle the problem. Some believe this will provoke a further downgrade of our debt by S&P and lead Moodys and Fitch to follow suit.

As evident from our earlier accounting of the various proposals and plans, the ongoing debate over the future size and shape of the federal budget does not suffer from a lack of policy options to achieve long-term fiscal sustainability. They have been lobbed into the discussion from many different ideological and institutional directions. Although different sides in the debate put forward visions for the future of fiscal policy that differ considerably, one would think there is room for compromise. Indeed, by some accounts, the president and the Speaker of the House came very close to agreeing to a reasonably balanced package during the 2011 debt ceiling negotiations that would have increased revenues modestly while reforming Medicare and Social Security without dramatic cuts in either. However, whether such a package could have ultimately achieved Congressional approval is another matter.

The problem lies in the fervor with which many members of Congress in the rank and file of the two parties hold to their ideological positions—no tax increases on the part of Republicans and no substantial changes to Medicare or Social Security benefits on the part of Democrats. It may be debated whether there is a lack of political leadership, but there is no doubt about a lack of followership. Meanwhile, the nation continues on a path toward a sovereign debt crisis. Unless we break through the current impasse, there is a Greece in our future.

ACKNOWLEDGMENTS

This article draws heavily on two publications: “Committees Tackle the Deficit” February 1, 2011 and “Controlling the Deficit: The Debate Continues,” December 31, 2011. Both are Urban Institute publications that can be found at <http://www.urban.org/expert.cfm?ID=RudolphGPenner>. It also draws on an article by Penner, “Will It Take A crisis to Fix Fiscal Policy,” *Business Economics*, February 2011. All these articles were financed by the MacArthur Foundation. The views expressed are those of the authors and should not be attributed to the Urban Institute, its trustees, or its funders.

REFERENCES

- Congressional Budget Office (CBO). 2011a. *The Budget and Economic Outlook: An Update*. Washington, DC: Congressional Budget Office.
- . 2011b. *An Analysis of the President's Budgetary Proposals for Fiscal Year 2012*. Washington, DC: Congressional Budget Office.
- . 2012a. *The Long-Term Budget Outlook*. Washington, DC: Congressional Budget Office.

- . 2012b. *Economic Effects of Reducing the Fiscal Restraint That Is Scheduled to Occur in 2013*. Washington, DC: Congressional Budget Office.
- Ferguson, Niall. 2010. “*Fiscal Crises and Imperial Collapses: Historical Perspectives on Current Predicaments*.” Event Transcript, Ninth Annual Niarchos Lecture, Peterson Institute for International Economics, Washington, DC, May 13. Accessed April 20, 2012. <http://www.petersoninstitute.org/publications/papers/niarchos-ferguson-2010.pdf>.
- Galston, William A. and Maya Macguineas. 2012. *A Balanced Plan to Stabilize Public Debt and Promote Economic Growth*, Committee for a Responsible Federal Budget. Accessed August 20. <http://crfb.org/blogs/my-view-maya-macguineas-and-bill-galston>.
- Goss, Stephen C. 2010. Chief Actuary, Social Security System. December 1, 2010. Letter to Erskine Bowles and Alan Simpson.
- Office of Management and Budget (OMB). 2012. *Budget of the U.S. Government, Fiscal Year 2013*. Washington, DC: U.S. Government Printing Office.
- National Commission on Fiscal Responsibility and Reform (NCFRR). 2010. *The Moment of Truth*. Washington, DC: National Commission on Fiscal Responsibility and Reform.
- National Research Council and National Academy of Public Administration (NRC and NAPA). 2010. *Choosing the Nation’s Fiscal Future*. Committee on the Fiscal Future of the United States. Washington, DC: The National Academies Press.
- Palmer, John L. and Rudolph G. Penner. 2010. *Have Recent Budget Policies Contributed to Long-Run Fiscal Stability?* Washington, DC: The Urban Institute. Accessed June 19, 2012. <http://www.urban.org/uploadedpdf/412268-recent-budget-policies.pdf>.
- Penner, Rudolph G. 2002. “Dealing with Uncertain Budget Forecasts.” *Journal of Public Budgeting and Finance*. 22(1), 1–8.
- . 2010. *Adjusting Social Security Benefits for Changes in the Cost of Living*. Washington, DC: The Urban Institute. Accessed June 20, 2012. <http://www.urban.org/uploadedpdf/412168-adjusting-social-security.pdf>.
- Rogers, Allison and Eric Toder. 2011. *Trends in Tax Expenditures, 1985–2016*. Washington, DC: Urban-Brookings Tax Policy Center.
- Ryan, Paul D. 2010. *A Roadmap for America’s Future, Version 2.0. A Plan to Solve America’s Long-Term Economic and Fiscal Crisis*. Washington, D.C. U.S. House of Representative’s Committee on the Budget. Accessed August 13, 2012. <http://www.roadmap.republicans.budget.house.gov/UploadedFiles/Roadmap2.Final2.pdf>.
- The Debt Reduction Task Force (DRTF). 2010. *Restoring America’s Future*. Washington, DC: Bipartisan Policy Center. Accessed June 20, 2012. <http://bipartisanpolicy.org/sites/default/files/BPC%20FINAL%20REPORT%20FOR%20PRINTER%2002%2028%2011.pdf>.
- The Peter G. Peterson Foundation. 2011. “*The Solutions Initiative*.” 2011 Fiscal Summit: Solutions for America’s Future, New York, NY: The Peter G. Peterson Foundation. Accessed June 20, 2012. <http://pgpf.org/Issues/Fiscal-Outlook/2011/01/20/PGPF-Announces-Grants-to-Six-Institutions-to-Develop-Solutions-to-Americas-Fiscal-Challenges.aspx>.