Governance Studies
at BROOKINGS

September 30, 2010

The Future Is Now: A Balanced Plan to Stabilize Public Debt and Promote Economic Growth

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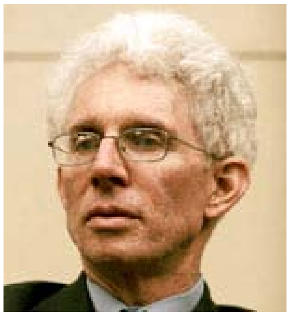
THE NEED FOR CHANGE

Spurred by the financial crisis, a painfully slow recovery, and inexorable demographic change, the federal budget is on an unsustainable path. Debt held by the public, which historically has averaged less than 40 percent of GDP, currently stands above 60 percent and is poised to climb rapidly. Under the President's proposed budget, the budget deficit would average 5.2 percent of GDP over the next decade—a level that would not only fail to help bring the debt back down to pre-crisis levels but would keep it growing much faster than the economy. Under the proposed budget, the public debt to GDP ratio would reach 70 percent by 2011, 90 percent by 2020, and would break the World War II record of 109 percent just a few years after that before soaring to unimaginable levels during the ensuing decades.



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Some downplay deficits and debt as a green-eyeshade concern disconnected from the real economy. We disagree. As we read the evidence, excessive levels of public debt harm the economy in multiple ways.

- As the economy recovers, excessive public debt competes with private sector demands for capital, raising interest rates for all borrowers, including the government, and leading to slower economic growth.
- As debt accumulates and interest rates rise back to historical levels (or beyond), interest payments on the federal debt will soar, competing with other important priorities.
- Because so much U.S. public debt is held by non-American individuals and institutions, interest payments on that debt represent a substantial transfer of income and wealth out of the American economy.
- Excessively high debt levels lead to increased risk of a fiscal crisis in which investor concerns lead to abrupt spikes in interest rates and a vicious debt spiral. By the same token, such debt levels reduce the federal government's ability to respond fully and flexibly to severe crises.

While the economy struggles to recover from the recent recession, it would be premature to start implementing aggressive deficit reduction measures. However, policymakers should commit as quickly as possible to a plan—phased in as soon as the economy permits—to stabilize the debt at a healthier and more sustainable level by the end of the decade and to set it on the kind of downward course we enjoyed for much of the post-World War II period.

Some believe that fiscal discipline would reduce the rate of economic growth. Again, we disagree. The evidence from the United States in the 1990s as well as from many European countries in recent decades suggests that implemented prudently, a plan for fiscal restraint could actually promote long-term economic growth. The reasons are straightforward: not only would interest rates be lower than they otherwise would be, but in addition, the private sector would respond to a more stable and predictable economic climate by making long-term commitments that would not occur in less favorable circumstances.

A final area of disagreement: many political leaders, policy experts, interest groups, and ordinary citizens believe that the fiscal stabilization we recommend will necessarily reduce protections for the most vulnerable members of our society and could undermine the broad-based coalitions needed to sustain core programs of the New Deal and Great Society. We believe, on the contrary, that stabilization done right can actually increase security and decency for those most in need of assistance—without undermining the support of the more fortunate for the programs that make this possible. (We spell out the meaning of "done right" below.)

The main obstacle to a viable debt reduction plan is neither economic nor moral, but political. As most people privately understand (and some publicly admit), such a plan will require significant budgetary changes, including wide-ranging spending cuts and substantial revenue increases. In today's polarized political environment, where even politicians who emphasize the importance of fiscally responsible policies are hesitant to get specific, putting together a comprehensive fiscal plan is extremely difficult.

In this unpromising context, it is useful for outsiders who do not labor under the same political constraints to put forward specific proposals, helping pave the way for a more realistic conversation among policymakers. While every feature of our plan is legitimately debatable, one thing is clear: continuing to focus on manifestly unrealistic policies—whether promising to solve the problem by cutting "waste, fraud, and abuse," making no-tax pledges, or taking the largest areas of spending such as defense or Social Security off the table—will only prolong an era of evasion that has gone on much too long.

We believe that the American people want their leaders to treat them like adults who are capable of accepting the truth. But this cannot happen until our leaders begin to act like adults who are interested in solving problems rather than scoring political points. We offer this plan as a modest contribution to a better conversation about our common future.

Principles for Reform

1. **Promote shared sacrifice.** The gap we face is just too large to close if we declare significant areas of the budget off-limits. Moreover, no plan without bipartisan support will be viable, and neither party is going to sacrifice only the areas of the budget it most cares about in the absence of corresponding concessions from the other side.

2. **Encourage growth.** Although we will not be able to grow our way out of the nation's fiscal problems, higher levels of economic growth will make the task much easier by increasing revenue coming into the Treasury and by making necessary policy changes easier to bear. We should therefore do our best to protect or even increase spending in such areas as public investment and education, that yield the highest economic returns, and we should minimize tax increases on things that we want to encourage, such as work and investment.

3. **Protect those in need and increase progressivity.** The problem of growing income inequality in this country is serious. Many segments of our population have not shared in the economic growth over the past generation and are particularly vulnerable right now. We should keep in place—and in some cases beef up—a strong safety net and critical insurance programs to protect the most vulnerable. Consistent with other principles and goals (such as economic growth) changes in both spending programs and taxation should reflect the varying abilities of individuals to bear additional burdens and responsibilities without excessive sacrifice.

4. **Enhance the transparency of our spending priorities.** Important features of our current budget terminology and procedures have the effect of obscuring what is really at stake. For example, much of our tax code represents back-door outlays through "tax expenditures." Restricting tax expenditures is therefore a necessary part of any effort to cut spending as well as a central component of fundamental tax reform.

5. **Acknowledge demographic and health care realities.** Changing demographics and growing health care costs create the major long-term fiscal challenge in this country—as well as in many others. Over the next couple of decades, as the baby boomers retire, the number of elderly Americans will soar both in absolute numbers and as a share of the total population; this trend will continue as life expectancy continues to rise. This will drive up costs in retirement and health care programs. No budget plan will be sustainable if it does not tackle these challenges head on. That said, it is also unreasonable—given the greater dependence of the elderly on public programs—to think that we will be able to keep federal spending at or below historical levels.

Two final points. First, our fiscal challenge calls for more than an arithmetic process of adjusting taxing and spending to meet numerical targets. We have both the need and the opportunity to rethink the way we promote our goals and honor our principles in circumstances very different from those in which our current commitments were made. Our watchword should be not retrenchment but rather reform.

Second: a budget should be just that—a budget. We cannot hope to live within our means unless we are able to determine acceptable levels of taxing and spending and adjust our policies to fit them. Open-ended claims, whether for direct outlays or tax subsidies, are incompatible with effective budgeting. We recognize the need for longer time horizons in both entitlement programs and tax policy. But we cannot afford to place these portions of our budget on auto-pilot and insulate them from unanticipated developments. For this reason, we need mechanisms that require elected officials to make needed adjustments when these crucial sectors diverge from their projected fiscal path.[1]

Getting the Target, Timing, and Balance Right

We believe it is prudent to bring the debt back down to 60 percent of GDP by the end of the current decade and then gradually lower it over time to regain the levels of fiscal flexibility we have enjoyed for most of the post-World War II period. Sixty percent is a standard recognized internationally as a reasonable debt ceiling, and it should be sufficient to reassure global credit markets in the medium-term—assuming the plan is credible. The target should also offer a stable and reasonable framework for businesses considering investments and for financial institutions considering loans.

In order to achieve this target, the projected debt held by the public will need to be reduced by roughly $6.8 trillion over the next decade from the level it would reach if we do not change course, bringing it down from $20.3 trillion (90 percent of GDP) to about $13.5 trillion (60 percent of GDP).[2] This would leave deficits running around 1 percent by the end of the decade—significantly below the 5-6 percent level they would reach on our current course, and low enough allow us to stabilize the debt at a reasonable level so that it does not grow faster than the economy. While this stabilization effort is a very large undertaking, it is not out of line with what we will likely see around the world as developed nations have to deal with both the debt overhang from the recent economic crisis and with the pressures presented by aging populations and growing health care costs.

While a plan should be adopted without delay, the policies should begin only when the economy is strong enough to accommodate the changes, and they should be phased in gradually. We assume most policies would not begin until 2012, although they could begin early or later depending on the strength of the economy. (The difference between potential and actual GDP constitutes one of the

[1] For one example of how to do this, see "Taking Back Our Fiscal Future" (Brookings and the Heritage Foundation, 2008). Although this document applies the new budgetary procedures to entitlement programs, there is every reason to treat tax expenditures in the same manner. That is what we recommend.

[2] This debt projection assumes the President's budget.

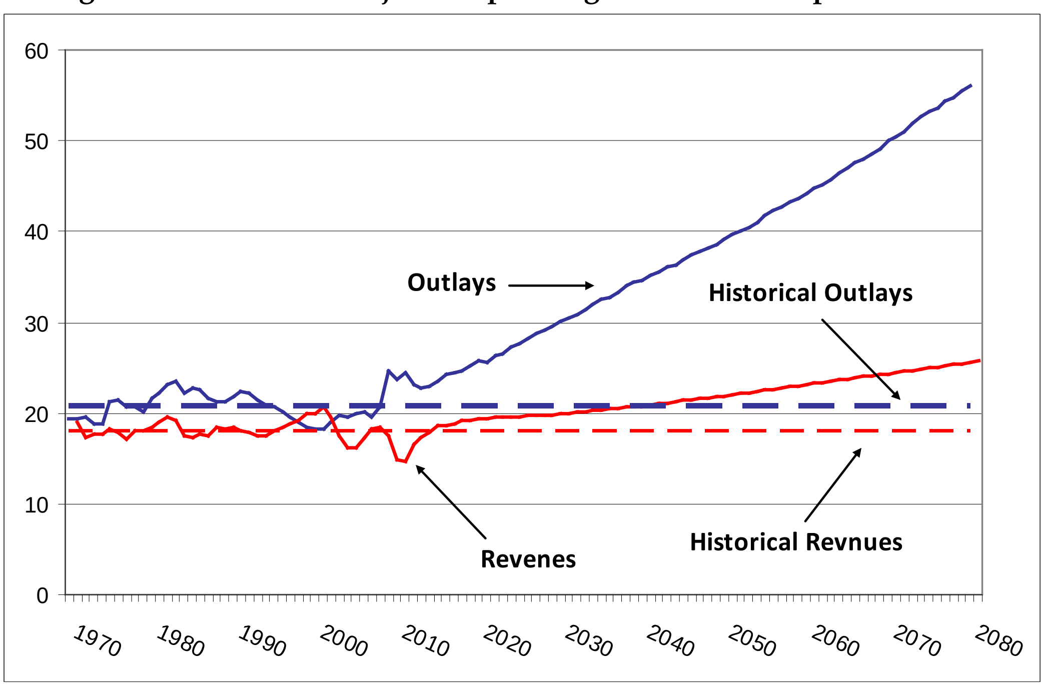
most relevant indicators.) While it is important to be aggressive enough in earlier years to make the plan credible and build momentum for deficit reduction, the plan should be back-loaded to synchronize with the economic recovery and allow people sufficient time to adjust.

We believe that in the medium-term a 50-50 split between program reductions and tax increases strikes roughly the right balance and would create additional spending reductions by lowering interest payments on the debt. Changes in entitlements would have to be phased in gradually, while changes in discretionary spending—including defense—and some revenue sources can occur more quickly. Neither alone will suffice to close the gap.

If our plan were adopted, outlays in 2020 would amount to 22.0 percent of GDP, down from CBO's estimate of 25.2 percent for President Obama's budget. Revenues would total 21.4 percent of GDP, up from 19.6 percent. The deficit would fall from 5.6 percent of GDP to 0.7 percent.

As difficult as these changes may be, the alternative is worse. Global credit markets have become increasingly sensitive to excessive borrowing and unsustainable budget trajectories. It would be unwise to go to the significant trouble of implementing a plan that requires a good deal of political capital to pass but is ultimately insufficient to reassure domestic and international lenders.

Fig. 1: Historical and Projected Spending and Revenues (percent GDP)



Note: Projections based on CRFB Realistic Long-Term Baseline.
(http://crfb.org/document/crfb-medium-and-long-term-baselines)

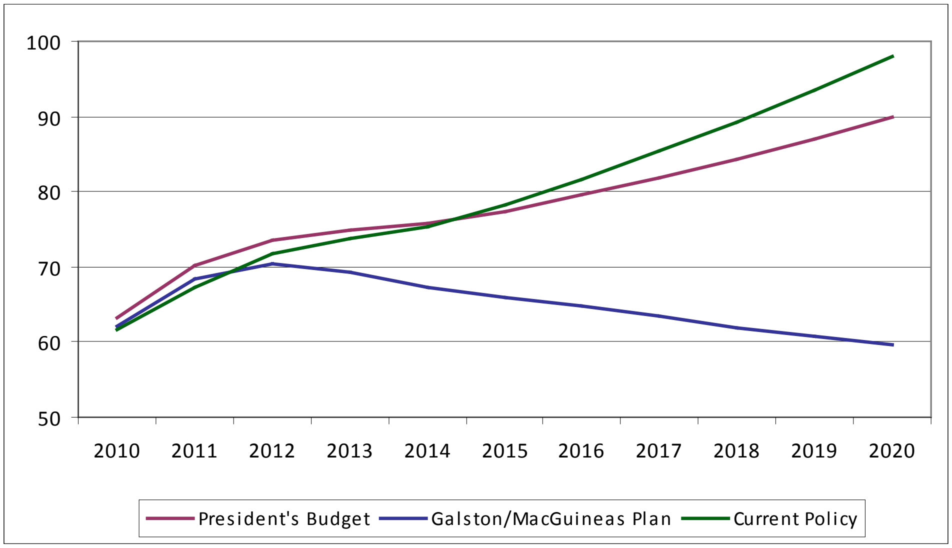
The Plan in Brief

Fig. 2: Summary of Galston-MacGuineas Plan

Policy	**Description**	**Savings in 2020 ($ Bil)**
Defense	• Reduce weapon systems, reform compensation, reform contracting, cover all war costs beyond 2015 with a war surtax	**80**
Domestic Discretionary*	• Freeze domestic discretionary spending for 3 years and limit to inflation for rest of the decade	**60**
Social Security	• Speed up increase in normal retirement age and index early and normal retirement ages to longevity • Switch to the Chained CPI • Use progressive indexation for higher earners • Include state and local workers • Create a minimum benefit and an old-age bonus • Use some proceeds from a carbon tax to reduce the payroll tax and make payroll tax more progressive • Establish mandatory 2 percent add-on accounts with progressive matches for low and moderate-income workers	**75**
Health	• Institute tort reform • Raise Medicare premiums • Index the eligibility age for Medicare • Expand the Medicare Commission • Reduce health subsidies	**110**
Other Spending	• Index federal government salaries to private sector wage growth • Phase out farm subsidies and replace them with insurance against catastrophic income loss • Additional savings from other entitlement programs	**75**
Tax Expenditures	• Reduce tax expenditures by 10 percent and limit growth. • Divide the proceeds between lower tax rates and deficit reduction	**300**
Revenues	• Enact a broad-based carbon tax, with some proceeds going to reduce the payroll tax and the rest to deficit reduction • Enact revenue-neutral corporate tax reform to reduce rates while broadening the base	**100**
	Policy Savings	**800**
	Interest Savings	**300**
	Total Savings	**1,100**

Note: President Obama's FY2011 budget serves as the baseline.
*Savings would be higher compared to more realistic growth trends, but the President's baseline already assumes relatively low levels of discretionary spending.

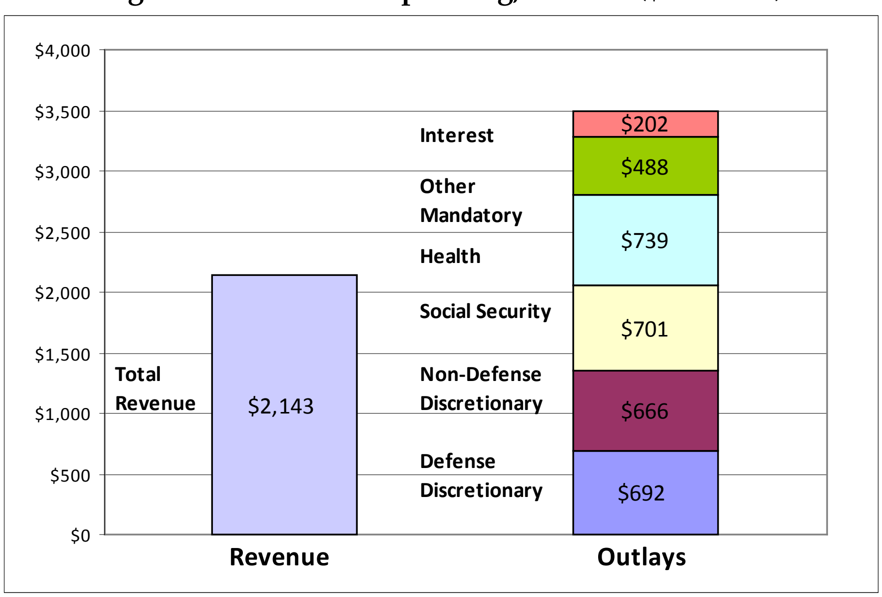
Fig. 3: Debt Projections under Various Budget Paths (percent GDP)



Specific Policies in More Detail

The $3.5 trillion federal budget can be broken down into: defense (20 percent), domestic discretionary (19 percent), Social Security (20 percent), health spending (21 percent), other mandatory spending (14 percent), and interest (6 percent). At about $2.1 trillion, revenues account for only 61 percent of spending—an uncharacteristically low level due to the recession. Tax expenditures (many of which are backdoor spending programs) result in lost revenue of more than a trillion dollars. We take each of these areas in turn.

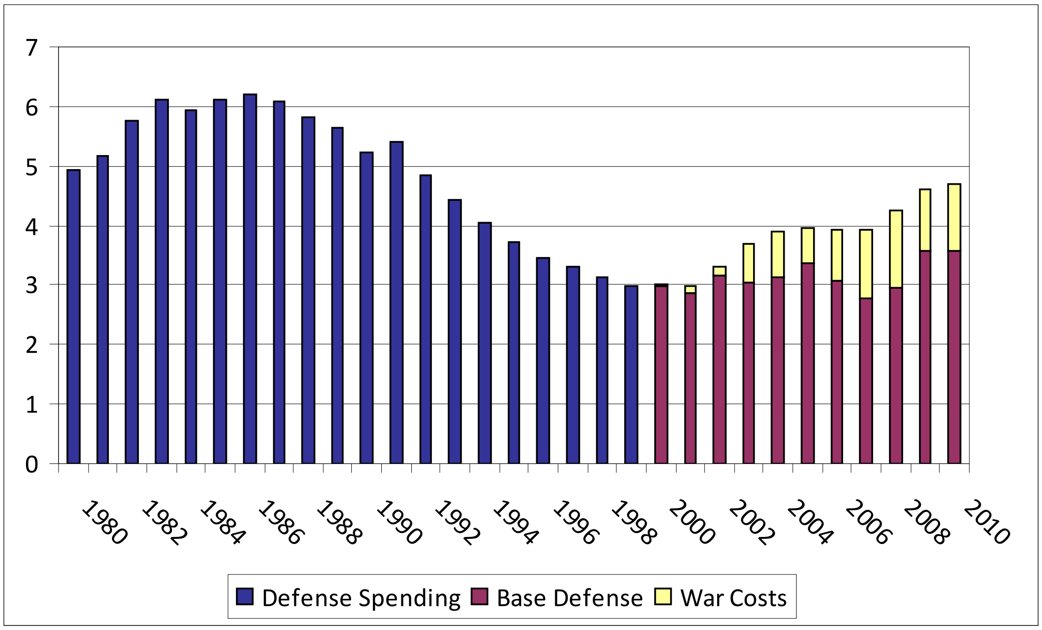
Fig. 4: Revenues and Spending, FY 2010 ($ Billions)



Defense

Defense spending sustains one of the core missions of government: keeping the country safe. We believe the defense policy should be based on security needs rather than budgetary constraints. At the same time, defense spending—not including war costs—has grown as a share of the economy, compared to the reductions we were experiencing prior to the war.

Fig. 5: Defense Spending (percent GDP)



War Spending. We do not take a position on what future policies towards Iraq and Afghanistan should be. Our budget assumes the President's policies of increasing military operations and intelligence activities in Afghanistan and Pakistan while continuing to draw down troop levels in Iraq. While we do not know how long these commitments will continue, we do believe that any war costs beyond 2015 should be paid for through a war surtax. This is the only time in our nation's history that we have been engaged in a protracted war without a tax increase to help finance the costs, and a return to past practice is long overdue.

Weapons Systems. Outside of war spending, there are other areas of the defense budget where significant savings can be found. First we recommend reducing outdated, ineffective, and excessively expensive weapons systems. Security experts have recommended a number of items that could be reduced or eliminated without compromising U.S. national security policy.[3]

[3] Sustainable Defense Task Force. "Debt, Deficits, and Defense." June 2010.

The list includes:

- **Reduce the nuclear arsenal.** Significantly reduce U.S. nuclear arsenal from current stockpile size of over 5,000, and scale back related delivery systems.

- **Cancel unneeded programs.** Cancel the Expeditionary Fighting Vehicle, the V-22 Osprey, further missile defense development, the 2nd Virginia class submarine, and the 3rd Zumwalt-class destroyer, and retire at least one Navy aircraft carrier.

- **Scale back several programs and fleets.** Keep offensive-based space weapons in R&D phase, scale back the Future Combat Systems program, reduce purchases of F-35s and slow down production, reduce the size of U.S. Navy from the current fleet of about 286 ships, and build and operate fewer ballistic missile and tactical submarines.

Compensation. A second area for reform is military compensation. Over the past decade, military pay—including non-combat pay—has grown faster than in private sector and now exceeds the 75th percentile in earnings for civilians with similar education levels and experience.[4] A better policy would be to limit the rate of increase to that prevailing in the civilian economy. Additionally, the calculation of civilian-military pay parity raises should take into account non-wage compensation, such as cash allowances and tax advantages.

Additionally, spending on health care in the Department of Defense has more than doubled over the last decade, and—as in the rest of the budget—will be one of the largest drivers of growth going forward. We recommend controlling costs by reforming TRICARE—the program that provides health care for military personnel and retirees—through higher enrollment fees and cost sharing. TRICARE enrollment fees, copayments, and deductibles are extremely low and have not increased at all—not even in nominal dollars—since the program was established in 1995. Moreover, the current structure of the program creates incentives for families to enroll in subsidized TRICARE even when they have other options available from their employer. It also encourages over-utilization of care by largely shielding beneficiaries from cost-sharing. Such a system is not affordable even today and cannot be continued in the future as health care costs continue to rise.

Contracting reform. Significant savings could also come from reforms to the procurement system within the DoD—focusing not on what DoD purchases, but rather on how it makes purchases and enters into contracts. With more than $400 billion a year spent on goods and services, changes in acquisition policy should be

[4] Congressional Budget Office. "Evaluating Military Compensation." http://www.cbo.gov/ftpdocs/114xx/doc11463/04-28-MilitaryPay.pdf

able to yield savings of at least 5 percent. Allowing costs to play a larger role when setting requirements and entering into larger contracts, incorporating more fixed-price contracts, and entering into more multi-year contracts could all begin to improve the DoD acquisition process while driving costs down.

Spending on research and development also constitutes a sizable portion of all defense spending and is set to average more than $70 billion over each of the next few years. Reducing this amount by a few percentage points each year could yield significant savings.

Finally, trimming the layers of bureaucracy and civilian personnel within DoD also would contribute to overall savings. Secretary of Defense Robert Gates recently noted that management levels within DoD have grown tremendously, with the result that there may now be up to 30 levels of staff between him and an officer in the field.

Fig. 6: Defense Savings

	Savings in 2020 ($ Bil)
Reduce weapons systems	30
Reform compensation and TRICARE	20
Contracting reform	20
Scale back research and development activities	5
Total	**75**
War surtax as necessary	N/A

Domestic Discretionary

It is generally believed that because future growth in the budget will come from the entitlement portion of the budget, reductions in domestic discretionary spending will not yield large savings. But because this sector amounts to 19 percent of the budget, relatively small changes can in fact yield significant results. And the growth in this area of the budget over the past decade has been quite significant.

Discretionary spending comprises hundreds of small programs in areas ranging from energy to education to transportation to general government. Many of these programs are outdated, redundant, or ineffective and thus ripe for elimination or reform. Because it is dauntingly hard for outside analysts to evaluate and compare this many programs, it is preferable to let recommendations for change originate from the legislative committees and executive agencies that oversee and implement them.

Discretionary freeze. To energize this reform process, we recommend a three year domestic discretionary spending freeze during which individual agencies would propose reductions and work with Members of Congress to generate savings. This freeze would go further than the White House proposal because it would include funding for homeland security, the State Department, the VA, and Pell grants – all of which are exempted from the President's freeze. After the three-year period, we recommend that spending growth be capped at inflation for the remainder of the decade.

In order to ensure that spending cuts are made in a thoughtful manner, we recommend protecting programs that most help vulnerable populations and focusing resources on areas such as education and infrastructure while eliminating outdated or ineffective programs and pet projects. We recognize that this is easier said than done. Nonetheless, an overall budget ceiling will spark changes that are long overdue.

Social Security

Because of the economic slowdown, Social Security is running cash flow deficits this year. After very small surpluses in the next few years, it is projected to return to cash flow deficits indefinitely. The program's dedicated trust funds, which contain only Treasury debt that the federal government must repay, are expected to be depleted by 2037. As the Trustees warn every year, the program is on an unsustainable path, and the sooner we make needed changes, the better. Already, the ongoing delay in phasing in gradual changes will mean that future benefit and tax shifts will have to be larger and more abrupt than they otherwise would have been.

Social Security is the foundation of retirement security for many program participants, with about 34 percent of beneficiaries relying on the program for 90 percent of their retirement income. We believe the program should be reformed while continuing to provide (and in some cases, expand) the necessary protections for those who are most dependent on it.

Our Social Security reform plan would include savings from indexing the normal and early retirement ages for changes in longevity, slowing the growth of benefits for middle- and higher-earners, and fixing the formula used to calculate cost-of-living adjustments. In addition, we propose new sources of revenue, in part from bringing state and local employees into the system, but also from instituting a broad-based energy tax and using some of its proceeds to relieve pressure on the payroll tax.

Retirement age. As life expectancy continues to grow, it only makes sense that those who can work longer should do so. Not only does staying in the workforce longer help shore up Social Security's finances through higher payroll tax contributions and benefit payouts over a shorter number of years, but also it contributes to the overall economy through a larger labor force and higher output. We propose speeding up the currently scheduled increase in the normal retirement age to 67 and then indexing it to ongoing increases in life expectancy. We would also index the early retirement age, currently set at 62, for longevity. An expanded disability program for workers who cannot work until the required retirement ages would avoid undue hardship. While many people are rightly concerned about the effects an increase in the retirement ages would have on manual laborers who may be physically worn out, it makes more sense to structure additional insurance for those cases—which are the minority—rather than continuing to encourage the retirement of those who would be able to remain in the workforce somewhat longer.

Slower indexing. Second, we would slow the growth of benefits for medium-and higher-income earners through "progressive price indexing" which would index benefits for the highest earners only to prices, rather than prices and wages, and would index mid-level benefits to a hybrid of the two indices. To avoid turning monthly payments into a flat rate benefit, we would turn off the change in indexing once sufficient savings had accrued.

Fix the CPI. Third, we would change the consumer price index (CPI) measure used to calculate Social Security benefits (as well as other federal programs and tax brackets) to better reflect the effects of inflation on participants. Currently, the CPI overstates inflation by not fully accounting for consumers' tendencies to switch their consumption patterns as the relative prices of goods change. Directing that a more accurate measure of inflation—the Superlative CPI—be used would represent a more accurate adjustment for the changes in the cost of living and would not lower participants' living standards.

Include new state and local workers. We also support expanding the Social Security program to include new state and local workers who currently are not part of the nearly universal system. Although this would not make significant improvements to the long-term finances of the system because benefits eventually would be paid to the new participants, it would however provide a short-term infusion of cash while benefit changes are phased in more slowly. Moreover, with the demise of defined benefit plans in the private sector and the likely scaling back of such plans for state and local public sector workers, this proposal would help diversify retirement income for those workers currently not included in Social Security.

New targeted benefits. We believe the system should be strengthened for those who most depend on it and we would do so in two ways. First, we would create a new minimum benefit, which would provide a floor of an above-poverty level benefit for any worker who had contributed for at least 35 years. Second, to address the problem of high levels of poverty among the oldest Americans, we suggest a one-time bump-up in benefits at age 85.

Add-on accounts. We also recommend establishing mandatory retirement savings accounts, financed by 2 percent of wages for every worker, which the federal government would match on a progressive basis for low and moderate earners. These matches would be financed by additional funds that would flow to Social

Security as a result of some of the other tax changes we recommend. For example, broadening the tax base through tax expenditure reform would increase the proceeds from payroll taxes.

Payroll tax. Finally we recommend making revenue-neutral changes to the revenue side of Social Security, which would include enacting a carbon tax and dedicating some of the revenues to replace a portion of the payroll tax while making the remaining Social Security tax more progressive, by creating an exclusion at the bottom and increasing the cap. (The remainder of the carbon tax would be devoted to deficit reduction, as we spell out in the revenue section of this report.)

Fig. 7: Social Security Savings

	Percent improvement needed to achieve solvency
Raise the retirement age	25 percent
Reduce higher-income benefits	50 percent
Fix the cost of living adjustment	25 percent
Include state and local workers	10 percent
New benefits	-10 percent
Add on accounts	N/A
Payroll tax reform (replace part of tax with carbon tax and make the remaining tax more progressive)	N/A

Health Reform

We will need to do much more to slow the growth of health care costs than was accomplished in the legislation enacted earlier this year. We suggest starting with some known cost savers that were left out of the first reform package—malpractice reform, increasing cost sharing, and indexing the eligibility age for Medicare.

Malpractice reform. One cost saver that was notably omitted from health care reform was reforming the nation's malpractice laws, which lead to the excessive use of defensive medicine. A number of reforms have been proposed that we would support, including limiting pain and suffering awards and creating specialized health courts that would bring more expertise to bear on medical assessment of liability cases.

Cost sharing. Under current law, the Medicare Part B premium is set to cover 25 percent of the program's costs for most seniors. We would increase premiums for the well-off so that a total of 35 percent of the program's costs would be covered. We would also raise Medicare copayments slightly to make participants more price sensitive, with exemptions for the lowest income retirees.

Retirement age. One of the more important contributions of the recent health care legislation was the creation of "exchanges." With the new exchanges (and "exchange subsidies"), it will be much easier for those who were previously unable to purchase health insurance—including the elderly—to do so. This is especially true in light of the "age rating" which prevents insurance companies from charging older participants more than 3 times as much as younger participants. Given this, we believe it is now possible to adjust the eligibility age for Medicare without imposing undue burdens. Accordingly we recommend gradually increasing the eligibility age for Medicare benefits from 65 to 67 – beginning in 2014 when the exchanges go into place – and indexing it for longevity thereafter so that it would be coordinated with changes in Social Security.

Medicare commission. We would also strengthen the newly created Independent Payment Advisory Board (IPAB) – also known as the Medicare commission. Though IPAB is designed to recommend automatically-enacted spending cuts in case Medicare grows too quickly, it is largely limited to reducing provider payments (and through this decade, only payments of certain providers). Over time, we worry this may prove unsustainable when superimposed on the provider payments already scheduled by law. To remedy this, we would expand those powers to include changes to hospitals, participant cost-sharing, and benefits. These changes would allow IPAB a wider reach and a great likelihood of success. Given this expanded power, we would direct IPAB to find additional savings over the next decade.

Exchange subsidies. Health reform included subsidies for individuals purchasing insurance with incomes between 133 percent and 400 percent of the poverty line. We would scale back subsidies for people on the higher end of the earnings scale.

Long Term. While the changes we recommend would meet our targets for 2020, more will have to be done in the following decades to restrain otherwise unaffordable increases in health care spending. We believe, as do many health care experts, that in the long-run we cannot succeed unless we replace the currently dominant fee-for-service reimbursement system with one that aligns health care spending around need and quality rather than quantity. We also believe that the model of open-ended health care commitments will not be sustainable, and that the federal government will have to have to use new budgetary mechanisms to ensure that health spending and revenues remain in alignment with prior estimates.[5]

[5] For details on how such a procedure might work, see "Taking Back Our Fiscal Future."

Fig. 8: Health Savings

	2020 ($Billions)
Malpractice reform	10
Increased premiums and cost sharing	30
Increase the retirement age	20
Expand Medicare Commission	10
Reduce subsidies for health exchanges	40
TOTAL	**110**
Create a health care budget	N/A

Other Spending

There are other policies that should be reformed even though they are not the underlying drivers of the debt problems as are health care, tax expenditures, and retirement programs. For example, we recommend drastically reducing farm subsidies and replacing them with programs that insure farmers against catastrophic income loss. In addition, we believe that overall compensation for federal workers should be keyed to trends in the private economy.

Tax Expenditures

Perhaps the single area in the budget most in need of reform is the "tax expenditure" portion. Tax expenditures are the targeted deductions, exemptions, exclusions, and credits that honeycomb the U.S. tax code. They are immensely popular with elected officials: What politician would not prefer to provide a benefit through a "tax cut" rather than a new spending program? Predictably, this incentive has sparked a tremendous expansion in the use of tax expenditures, which now amount to more than $1 trillion *per year*.

We suggest bringing tax expenditures together in a tax expenditure budget, cutting that budget by 10 percent and capping the growth thereafter. Policies that could be included in such a tax expenditure reform package include:

- Gradually phasing down the home mortgage deduction from $1 million to $500,000 and eliminating the tax break for vacation homes
- Phasing out the deduction for state and local taxes
- Replacing the employer-provided health care exclusion with a flat credit
- Consolidating tax breaks for education
- Consolidating tax breaks for saving
- Eliminating unproductive corporate subsidies

We also suggest a new strict "PAYGO for tax expenditures" under which no new tax breaks could be added without offsets from that area of the budget. This would slow if not halt the current reliance on spending through the tax code as the default strategy for policymaking.

Limits on tax expenditures should go hand in hand with an effort to fundamentally reform the tax code, which is outdated, overly complex, and a hindrance to growth and competitiveness. There is broad agreement that broadening the tax base while lowering rates, as we did in 1986, would promote key national objectives. For that reason, we recommend dividing the revenues from tax expenditure reform between lowering the deficit and reducing both individual income tax rates. Additionally, we strongly support revenue neutral corporate income tax reform to bring down the corporate tax rate.

New Revenue

The final piece of a balanced budget reform plan will have to be new revenues. There is no credible plan that we can envision that can reach sustainable deficit and debt targets from spending reductions alone, and although increasing revenues from reforming tax expenditures is one of the most sensible and efficient ways to approach tax reform, it is unlikely to be sufficient to close the gap on its own.

New revenue sources should focus on taxing what we want less of while creating incentives for what we want more of. To this end, we propose a broad-based carbon tax as a means of raising additional revenue, improving the environment, and promoting the transition to a balanced sensible energy policy. We assume an emissions tax phased in starting at $23 per ton of CO_2, increasing at 5.8 percent per year. If the proceeds from this tax are divided between deficit reduction and cuts in the payroll tax, which is what we recommend, it should foster growth in output and employment as well.

Conclusion

There are many ways to reform the federal budget to set the deficits and debt on a sustainable course. We put out this plan as one possible suggestion—not the only acceptable approach—in the hope that it will contribute to a broad and long overdue national conversation. We hope that it succeeds in this modest goal.

In the course of developing this plan, we reached a number of conclusions.

1. ***The long-run is now.*** Because we have waited so long to address our fiscal problem, changes that would have been relatively small and easy a decade ago are now larger and harder—and far more urgent. We need to credibly

commit to budget reforms as quickly as possible and phase them in as soon as economic circumstances allow.

2. ***Not only does everything have to be on the table, nearly everything has to be part of the solution.*** Although we do our best to protect and even bolster important areas of the budget—including benefits for the least well-off and public investments—it is impossible to hold harmless any large area of the budget. Through our evasion and delay, the problem has just grown too large for any single solution.

3. ***We should start with spending cuts and fill in the remaining gap with revenues.*** We are dismayed by the widespread opposition to any and all tax increases, which has led to irresponsible promises on both sides of the aisle. If we want to spend more, taxes rather than borrowing should support that preference. If they do not, we are just evading our responsibility and shifting the burden to future generations. However, we do believe that the fiscal problems we face beyond the end of this decade result from projected spending increases in programs most affected by demographic shifts and rising health care costs and that the tax increases needed to sustain this rise would be so high as to undermine economic growth. We therefore began with what we regard as realistic spending cuts and then filled the gap between those cuts and our debt reduction target with tax reforms and new revenues.

4. ***The design of spending cuts and tax reforms matters.*** Economic growth will not solve the fiscal problems the nation faces, but without growth, it will be nearly impossible to climb out of our current fiscal hole. We therefore focus on developing a plan that reduces the deficit and debt in ways that would be consistent with economic growth. We try to protect public investments, focus on tax reforms that would promote long-run growth, and limit—so far as possible—the overall level to which revenues would grow as a share of the economy.

5. ***We must go after the big ticket items.*** Every line-item in the federal budget has its own sponsors and defenders. Experience has taught us that it is often as difficult to change small items as it is large programs. While we have no objection to scrubbing every line in the budget (which nearly every new administration promises to do), there is no reason to believe that the sum of small reforms will equal the large shift we need. In addition, smaller items often offer an unattractive trade-off between fiscal gains and political costs. However difficult it may be, we concluded, there is no choice except to tackle head-on the major building-blocks of the federal budget.

6. ***History isn't destiny.*** Along with everyone involved in recent fiscal discussions, we are aware of demands that revenues and outlays be held to the average level of recent decades. We do not believe that this represents a realistic objective. Unless we are prepared to discard the genuine policy achievements of the past century, we must accept that demographic shifts and rising costs for health care imply some increase in both spending and revenues as a share of our GDP. Our task is not to resist this process altogether, but rather to limit it so as not to stall the engine of long-term economic growth.

7. ***It is time to stop jockeying and start compromising.*** Most politicians (and interest groups) are still jousting for short-term political advantage. Privately they may acknowledge that revenues have to rise, retirement benefits need to be trimmed, defense spending growth has to be controlled, and health care costs must be restrained. But their public stance reflects the intransigent demands of their core supporters. The longer this continues, the harder the necessary changes will become. The underlying reality is plain: the plan that is ultimately adopted will not be anyone's first choice. Compromises are inevitable. The sooner we start making them, the easier it will be to get our country back on track. The alternative—years of debilitating gridlock—will only weaken our economy, demoralize our society, and give our international competitors a heaven-sent opportunity to race ahead. Surely the world's greatest democracy can do better.

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Editor
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Production & Layout
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The authors wish to thank Jason Peuquet and Todd Zubatkin for their excellent research assistance.

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