Perspectives on Long-Term Budget Deficits

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Chairman Nussle, Mr. Spratt, and Members of the Committee:

Thank you for inviting me to testify today. It is always an honor to appear before this committee. My testimony focuses on five main points.

First, the conventional wisdom is accurate: The United States faces substantial projected fiscal deficits in the coming decades. A big part of the reason why is that increasing life spans, the retirement of the baby boom generation, and changes in health care technology will generate persistent increases in spending on social security, medicare and medicaid that far outstrip the rate of growth of the economy.

Second, there is another big part of the problem: namely, the sunsets that are in the tax code. If all of those sunsets were removed, revenue would fall by 2.4 percent of GDP on a permanent basis. If, in addition, the alternative minimum tax is reduced so that only 3 percent of taxpayers stayed on it--about the current level--revenues would fall by about 2.7 percent of GDP.

These prospective revenue losses are huge. They are more than three times as large as the 75-year actuarial deficit in social security, expressed as a share of GDP. They exceed the 75-year actuarial deficit in the Social Security and Medicare Trust Funds. They are larger than the permanent deficit in Social Security.

These facts imply that the aggressive tax-cutting agenda that the Administration has pursued the last few years deserves equal billing with Social Security and Medicare as "the real fiscal danger." They also imply that the decisions you make about extending the tax cuts, about removing the sunsets, have long-term fiscal implications that are greater than those that arise from fixing the entire social security problem.

[1] Arjay and Frances Fearing Miller Chair and Deputy Director, Economic Studies Program, Brookings Institution; and Co-Director, Tax Policy Center. Much of this testimony is based on collaborative work with Alan Auerbach and Peter Orszag. All errors and omissions are my own responsibility and should not be attributed to any other individual or organization.

Third, there is no hidden pot of gold waiting for us in future revenue from tax-deferred retirement accounts. Recent press reports have grossly overstated the impact of research undertaken by Stanford University Professor Michael Boskin. The press reports and some aspects of Boskin's paper suggest that future revenues from tax-deferred saving plans are (i) omitted in fiscal gap calculations, (ii) large enough to eliminate most or all of the fiscal gap, and (iii) likely to raise $12 trillion in revenues through 2040.

These suggestions are flawed. In fact, the underlying fiscal gap calculations already contain almost all of the projected revenues. As a result, adjusting the conventional estimates for the difference between Boskin's projections and the projections that are built in to the fiscal gap estimates has trivial effects on the estimated long-term fiscal gap and on estimated future budget deficits. Nor are we ever likely to see $12 trillion in net revenues from tax-deferred retirement accounts. After adjusting Boskin's estimates for reasonable parameter values, an error in the computer code, and proper treatment of interest payments, the revenue effect will be either close to zero or possibly negative.

Fourth, the economic effects of persistent budget deficits are gradual but they are debilitating nonetheless. The real problem created by budget deficits is that they reduce national saving, which in turn reduces the assets owned by Americans and hence reduces future national income. These effects can be sizable, especially in the long-term. Conventional estimates, based on models developed by the CEA Chair Gregory Mankiw, indicate that the decline in the fiscal outlook since January 2001 has reduced GDP by at least 1 percent in 2012 and national income per household by $2,300 in 2012. These effects will persist over time. To put it differently, controlling the deficit is a pro-growth policy.

Much of the public debate focuses on how deficits affect interest rates. The impact on interest rates can be an important channel through which deficits matter. But the debate about interest rates is--or should be--considered a sideshow. Persistent deficits reduce national saving and therefore hurt the economy even if they do not affect interest rates. regardless of whether interest rates rise. Nor does it matter if the deficit is completely financed by capital inflows. For example, even if capital flows in to offset the deficit, that only implies that domestic production does not fall. But since Americans would own fewer claims on that production, since they borrowed from abroad, their income would still fall.

Fifth, the fiscal problems the country faces are unlike any other the country has faced in their origin and nature. We will likely have to find a new way of dealing with them. The notion that federal spending can be held to its post-WW II norm of about 18 or 19 percent of GDP seems virtually impossible to maintain without severely cutting the major entitlement programs or eliminating the rest of government. In future years, spending on Social Security, Medicare, and Medicaid alone is anticipated to exceed 19 percent of GDP. The unpleasant implication is that a long-term resolution of these issues that does not destroy the role of the federal government in American society will have to include significant increases in tax revenues as a share of the economy.

The comments above are documented and elaborated in several recent papers, which are attached to the submitted testimony. The papers include:

Alan J. Auerbach, William G. Gale, and Peter R. Orszag. "Reassessing the Fiscal Gap: Why Tax-Deferred Saving Will Not Solve the Problem." Tax Notes. July 28, 2003. Forthcoming. Available at http://www.brookings.edu/views/papers/orszag/20030714.htm.

William G. Gale and Peter R. Orszag. "Fiscal Policy and Economic Growth: A Simple Framework." Tax Notes. February 3, 2003. Available at http://www.taxpolicycenter.org/ research/author.cfm?PubID=1000450.

William G. Gale and Peter R. Orszag. "The Real Fiscal Danger." Tax Notes. April 21, 2003. Available at http://www.brook.edu/views/articles/gale/20030421.htm.

William G. Gale and Peter R. Orszag. "Sunsets in the Tax Code." Tax Notes. June 9, 2003. Available at http://www.brook.edu/views/articles/gale/20030609.htm.