The Legacy of U.S. Fiscal Policy

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I am honored to be giving this year's Ibrahim M. Oweiss address, and am extremely impressed by the energy and dedication that the organizers of the Carroll Round have demonstrated in making this outstanding program a reality. The presence of John Nash at this year's conference only underscores the quality of the programs that you have been able to put together. And I commend all of the student participants here tonight, for your admirable interest in economics and economic policy.

The main point of my talk tonight is that we are at a critical moment in defining the nation's fiscal legacy. Regardless of who wins the November election, debates about making the tax cuts permanent and about entitlement reform will likely be a prominent component of the 2005 agenda in Washington. The outcome of these debates will matter a lot for the world economy and they will matter a lot for you, because you will inherit the consequences. We have become used to thinking about how environmental policy leaves a legacy for future generations. But fiscal policy also leaves a legacy for future generations – in other words, you and your children -- and that is what I want to focus on tonight.

I'll begin by examining the recent history of the macroeconomic saving-investment balance, then turn to a discussion of projected fiscal deficits over the coming decade, and conclude with some thoughts on longer-term entitlement reform.

Saving and investment

Let's start by taking a look at domestic investment. Figure 1 shows net domestic investment – that is, gross investment minus depreciation – as a share of net national product over the past two decades.[2] The higher net domestic investment is today, the

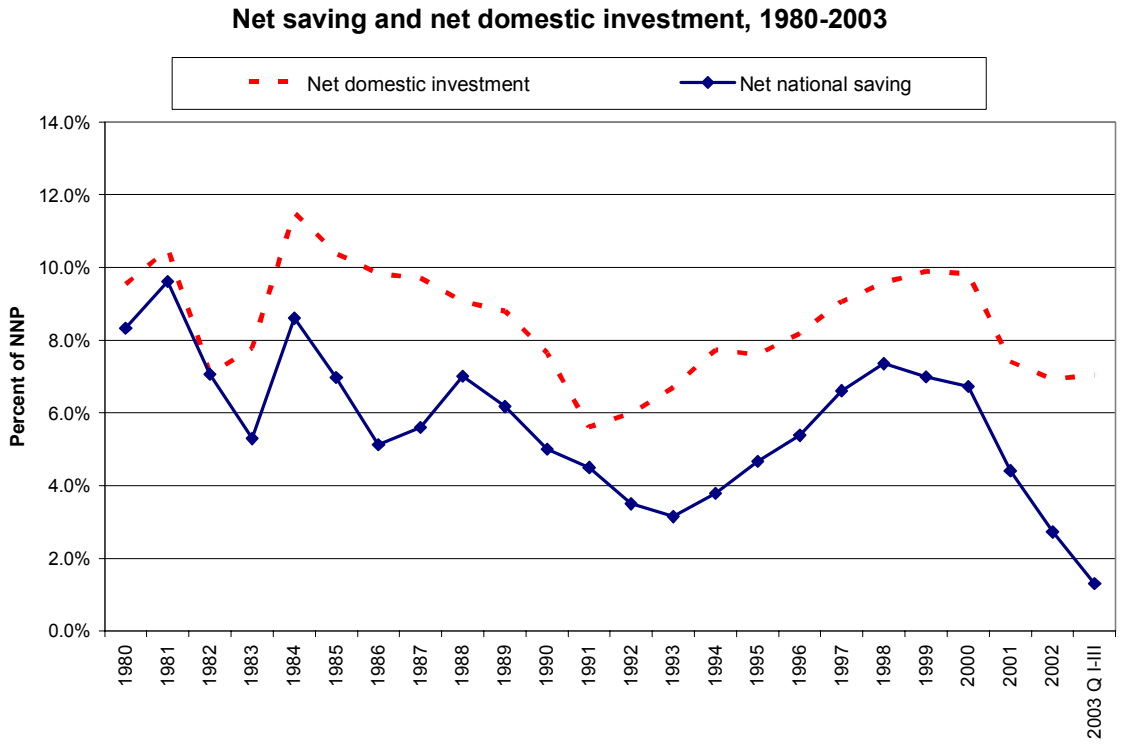
[1] The views expressed are those of mine alone and should not be attributed to the trustees, officers, or staff of the Brookings Institution or the Tax Policy Center. Much of this talk draws upon joint work with Peter Diamond of MIT, William Gale of Brookings, Robert Greenstein and Richard Kogan of the Center on Budget and Policy Priorities, Robert Rubin of Citigroup, and Allen Sinai of Decision Economics, Inc. I also thank Robert Cumby of Georgetown University and David Wilcox of the Federal Reserve for extremely helpful discussions.

[2] Figures 1 and 2 are taken from an address given by Lawrence Summers at the Institute for International Economics in March 2004.

more computers, buildings, and other productive capital we have in the future, and the more productive our future workers will be.

Figure 1 shows that net domestic investment, after climbing steadily during the late 1990s and then declining sharply in 2001 and 2002, has now stabilized at approximately 7 percent of net national product, roughly its level in the mid-1990s. This net domestic investment must be financed either by net national saving or borrowing from abroad. Figure 1 shows that over the past few years, it has increasingly been financed by borrowing from abroad, as net national saving has declined from more than 7 percent of net national product (NNP) in 1998 to 1.3 percent of NNP during the first three quarters of 2003. The increase in borrowing from abroad is reflected in the growing current account deficit, which has increased from 2.4 percent of NNP in 1998 to more than 5 percent in the first three quarters of 2003.

Figure 1



This enormous borrowing from abroad – of roughly $500 billion a year now – is reflected in our current account deficit, and has spurred a heated debate about whether our large current account deficit is sustainable. Even if one believed that the current account deficit were sustainable, though, it would not be desirable for several reasons:

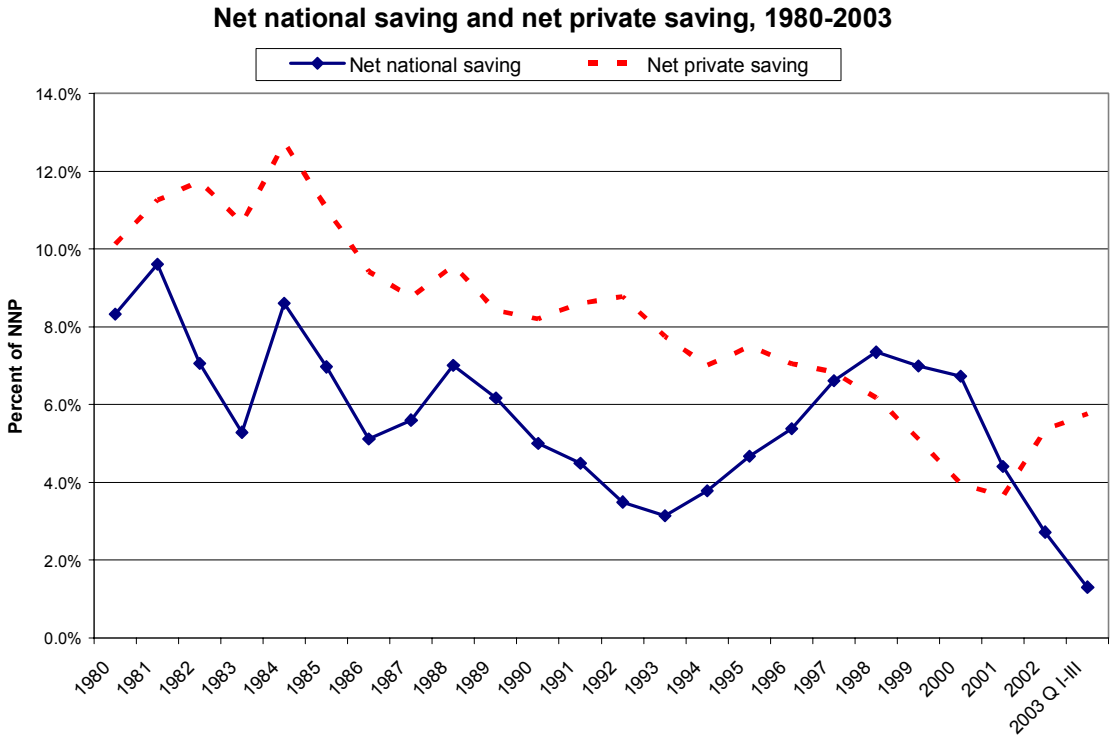
1. First, borrowing from abroad mortgages the future returns from our domestic investment. Foreigners do not lend us money for free. Because we are borrowing from foreigner creditors, we must share at least part of the future returns from our domestic capital stock with them.

2. Second, our current account deficit is increasingly financed by foreign official sources rather than private investors. Increases in foreign official holdings of U.S. assets financed about 20 percent of the current account deficit in 2002, and about 40 percent in 2003. This heavy reliance on foreign official creditors may raise political economy concerns, since it raises the possibility that foreign policy decisions will be distorted by financial considerations.

3. Finally, a large current account deficit, especially in the context of a weak labor market, increases pressure for protectionism. The current debate over outsourcing seems to underscore the risks.

The substantial expansion in the current account deficit reflects a significant decline in net national saving. But why has net national saving declined? It could be due to a decline in private saving or a decline in government saving. Figure 2 shows net national saving as a share of NNP and net private saving as a share of NNP. The difference between the two reflects government saving.

Figure 2



As Figure 2 shows, private saving has been on a downward trend over the past couple decades. The recent deterioration in net national saving, however, has been entirely due to a decline in government saving. Net Federal government saving fell from +2.2 percent of NNP in 2000 to -4.3 percent in the first three quarters of 2003, which more than explains the entire decline in net national saving over that period.

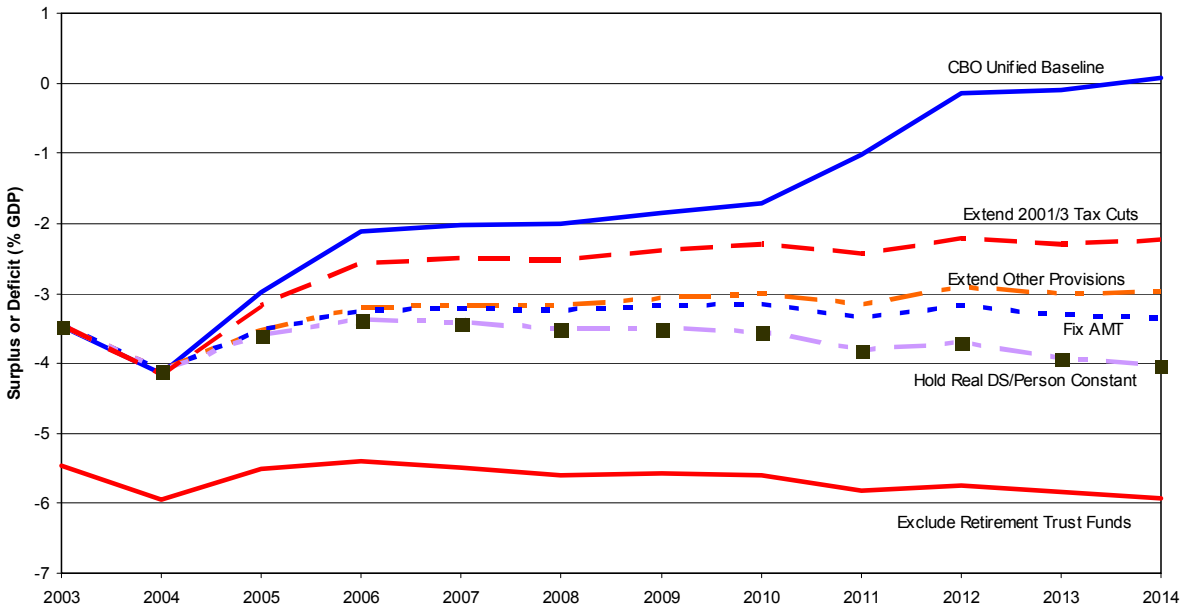
The basic story thus far, as shown in Figure 1 and Figure 2, is that the increase in the Federal budget deficit has reduced net national saving and expanded the current account deficit.[3] This would not be of much concern if these conditions were expected to be temporary. Yet there is little reason to expect private saving to rise markedly, and the most reasonable projections of the budget deficit also suggest little improvement over the next decade.

The budget outlook over the next decade

The top line of Figure 3 shows the January 2004 budget baseline issued by the Congressional Budget Office. That baseline suggests significant improvements in the unified deficit (that is, the overall budget, including both the Social Security and non-Social Security component) over the next 10 years, which would be heartening if it were predicated on credible assumptions about the current thrust of budget policy. Unfortunately, statutory and other restrictions prevent the CBO from adopting reasonable assumptions in its baseline.

Figure 3

Figure: Baseline and Adjusted Budget Outcomes as Share of GDP, 2003-2014



[3] This linkage between the Federal budget deficit and the current account deficit is consistent with more sophisticated analyses. Empirical estimates for the United States suggest that private saving offsets perhaps one-quarter of changes in the budget deficit. Over the long term, estimates also suggest that between 25 percent and 40 percent of changes in national saving tend to be offset by net international capital flows. In other words, an increase in the budget deficit of $100 reduces national saving by about $75, and that $75 reduction in national saving is reflected in a $25 increase in borrowing from abroad and a $50 reduction in domestic investment.

Figure 3 adjusts the CBO baseline in several ways. First, the baseline assumes that all expiring tax provisions will sunset as scheduled. All of the tax cuts enacted in 2001, 2002, and 2003 officially expire in 2010 or before. Extending these tax cuts and other expiring tax provisions dramatically changes the fiscal outlook, as Figure 3 shows.

The second issue involves the alternative minimum tax (AMT). The AMT was enacted following concerns in the late 1960s that very high-income households were engaging in excessive tax sheltering activity. The AMT rests alongside the regular income tax, with a different set of rules for deductions, exemptions, and tax rates; taxpayers pay the higher of the regular income tax or the AMT. Currently, about three million taxpayers face the AMT. By 2009, under current policy, about 30 million will. Avoiding that outcome means even less revenue and even larger deficits.

The AMT also artificially hides the cost of the 2001 and 2003 tax cuts, since tax cuts in the regular income tax don't apply to those on the AMT. One-sixth of the income tax cuts from the 2001 and 2003 legislation would be erased by the AMT by 2006 and one-quarter by 2009 (Table 1). Extending the tax cuts would cost about $400 billion in 2014 alone with a reasonable AMT reform; it would cost $250 billion if the AMT were somehow allowed to take back an increasing share of those tax cuts. The effect is particularly prominent for those making between $75,000 and $500,000 per year.

Table 1: Effect of the AMT on the Administration's Tax Cuts[1]

AGI Class (thousands of 2003$)	Percent of Cut Taken Back By AMT		
	2006	2009	2014
All	17.0	25.9	39.6
50-75	2.0	8.0	22.4
75-100	14.9	27.6	53.1
100-200	34.4	50.9	75.6
200-500	51.8	61.7	70.1
500-1,000	9.5	12.7	16.0
More than 1,000	4.1	5.1	6.2

Source: Tax Policy Center Microsimulation Model.

(1) Baseline pre-EGTRRA law. Tax cuts include those currently in place and those the Administration has proposed extending.

The third adjustment in Figure 3 involves discretionary spending. The CBO baseline assumes that real discretionary spending per capita will decline by 8 percent by 2014. Figure 3 shows the path of the deficit if instead real discretionary spending per person were kept constant.

On this adjusted basis, the unified baseline shows a deficit of at least 3.4 percent of GDP in every year through 2014. These budget deficits will impose significant and growing economic costs. Reasonable rules of thumb, for example, suggest that the deficits will reduce annual national income after 10 years by about $250 billion, or more

than $2,000 per household per year. The adverse effect will persist and grow over time. This type of conventional analysis, moreover, may understate the costs associated with large, ongoing deficits because of the possibility that such deficits will spark a crisis of confidence in financial markets.[4]

The debate over the 2001 and 2003 tax cuts

A key factor in Figure 3 is the effect of extending the 2001 and 2003 tax cuts. Let me therefore spend a few minutes talking about them.

Many policy-makers seem to be under the illusion that the tax cuts can be paid for indefinitely by borrowing. Ultimately, though, continuing to finance the tax cuts by running up the budget deficit will be unsustainable. To avoid a fiscal crisis, a permanent tax cut has to be financed either with lower spending or higher revenues from other sources. Alan Greenspan is one of the few supporters of the tax cuts who acknowledges the necessity of paying for them with offsetting policy changes, which he would prefer to do on the spending side.

Even Mr. Greenspan, however, has not put forward proposals that would come close to financing the tax cuts. Perhaps that is understandable: The tax cuts are so large that the required reductions in government programs are simply too large, both substantively and politically. Paying for the full tax cuts in 2014, for example, would require a 12 percent reduction in all non-interest government spending. If the reductions were focused on specific programs, paying for the full tax cuts in 2014 would require a 48 percent cut in Social Security benefits; complete elimination of the federal part of Medicaid; or an 80 percent cut in all domestic discretionary spending (such as for environmental protection, education, and health research).

My view is that the tax cuts are simply not affordable and therefore should be substantially scaled back or repealed altogether. Other perspectives only strengthen this conclusion:

- Income distribution. The direct effect of the tax cuts is unquestionably to widen after-tax income inequality. If the tax cuts were extended, after-tax income will rise by more than 9 percent for households in the top 1 percent of the income distribution, by between 2 and 3 percent for households in the middle 60 percent, and by only 0.1 percent for households in the bottom quintile.[5]

[4] See Robert Rubin, Peter R. Orszag, and Allen Sinai, "Sustained Budget Deficits: Longer-Run U.S. Economic Performance and the Risk of Financial and Fiscal Disarray," Paper presented at the AEA-NAEFA Joint Session, Allied Social Science Associations Annual Meetings, The Andrew Brimmer Policy Forum, January 2004.

[5] The reason the tax cuts are regressive is that by and large they reduce taxes on capital – estates, dividends, capital gains, and so on. For most of the population, though, wages and salaries represent the vast majority of income. Capital income looms much larger as one moves up the income distribution. The top 1 percent of the population earns about one-tenth of total wage and salary income, but almost half of all capital income. Shifting away from a tax on all income and toward a tax just on wages thus moves the tax burden down the income distribution.

- Economic growth. The net effect of the tax cuts is likely to be a reduction in growth over the medium term. Deficit-financed tax cuts have offsetting effects on economic growth. The tax cuts themselves can have a modest positive direct effect on the economy, for example by reducing marginal tax rates and encouraging people to work or save more. But tax cuts also increase the budget deficit, which reduces national saving and eventually has a negative effect on economic growth. Given the structure of the 2001 and 2003 tax cuts, all the studies of which I am aware suggest that the net effect is likely to be negative in the medium term.[6]

- Tax reform. Some advocates of the tax cuts argue that they represent a piecemeal approach to a consumption tax. A consumption tax, though, is intended to raise national saving, whereas the tax cuts will undoubtedly reduce national saving; a consumption tax imposes a significant tax on the owners of existing capital when they ultimately consume that capital, whereas the tax cuts are providing windfall gains to such owners; and a consumption tax would prohibit deductibility of borrowing costs, but the tax cuts do not do this. The tax cuts are moving the nation toward a tax on wages, not a tax on consumption. The result is the worst of all worlds: all the regressivity associated with a consumption tax and none of the potential macroeconomic benefits.[7]

- Starving the beast. Some have argued that the tax cuts will help to restrain discretionary spending and force long-term entitlement reform. Granting large tax cuts to some groups, however, may make it *less* politically feasible to rein in the desires of other constituencies to obtain increases in spending programs. The result may be that abandoning fiscal discipline on one side of the budget induces a period of fiscal irresponsibility on both sides of the budget. It is thus not even clear whether tax cuts impose more or less restraint on spending increases, let alone sufficient restraint on spending to offset the cost of the tax cut itself.

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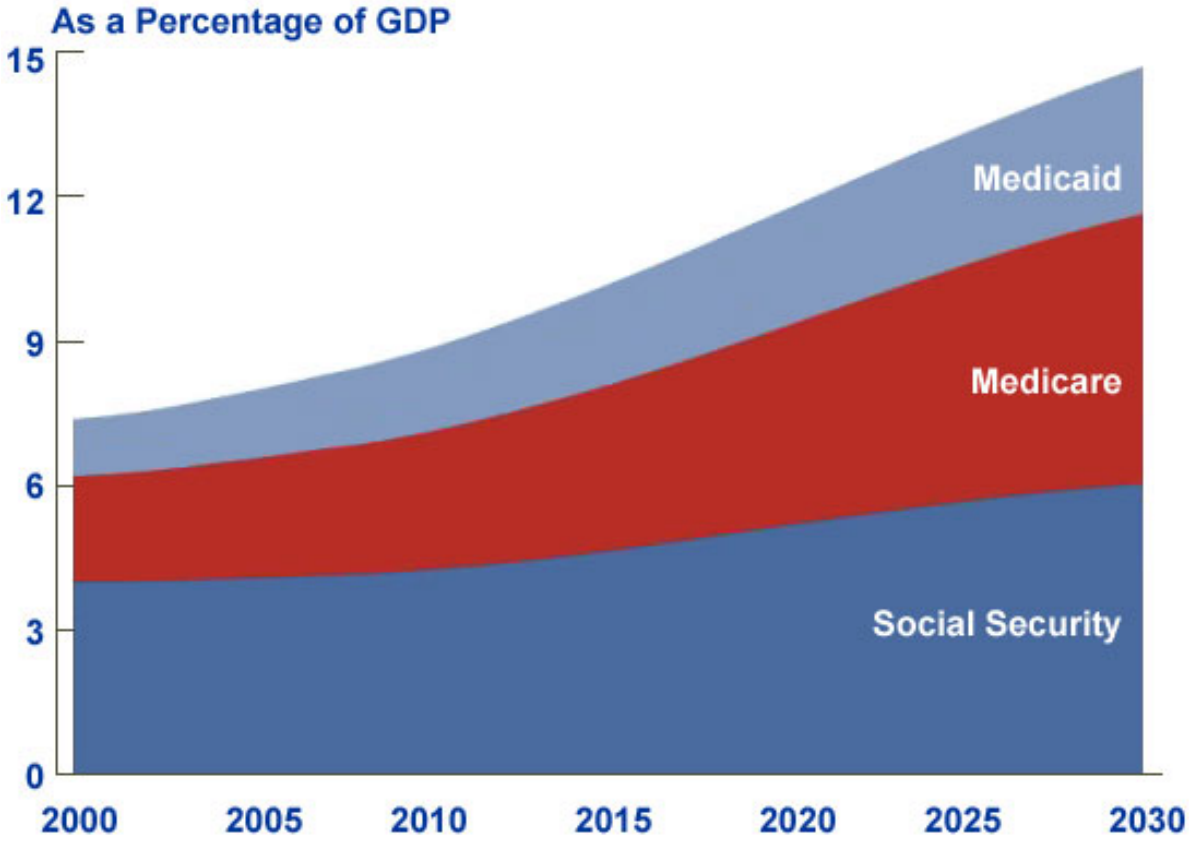
[6] William G. Gale and Samara R. Potter, "An Economic Evaluation of the Economic Growth and Tax Relief and Reconciliation Act of 2001," *National Tax Journal*, March 2002, pp. 133-86; Douglas W. Elmendorf and David L. Reifschneider, "Short-Run Effects of Fiscal Policy with Forward-Looking Financial Markets," *National Tax Journal,* May 2002, pp. 357-386; Alan J. Auerbach, "The Bush Tax Cut and National Saving" *National Tax Journal,* May 2002, pp. 387-408; and Peter R. Orszag, "Marginal Tax Rate Reductions and the Economy: What Would Be The Long-Term Effects of the Bush Tax Cut?" Center on Budget and Policy Priorities, March 2001.

[7] Furthermore, tax reform always combines gain and pain. The tax cuts do the easy part of tax reform but ignore the difficult part. Just like it's not possible to cross a chasm in two jumps, the Administration's incremental approach is problematic because it prematurely gave away the sweeteners that will be necessary to make an overall tax reform package work.

The budget outlook over the longer term

As our horizon extends beyond 2014, the cost of entitlement programs looms ever larger. CBO projections from a few years ago suggested that Social Security, Medicare, and Medicaid expenditures are expected to rise from about 9 percent of GDP in 2010 to about 15 percent by 2030 (Figure 4); given the recent addition of the Medicare prescription drug benefit, the projected increase would be even more substantial now.

Figure 4



One of the factors increasing the cost of these programs is longer life expectancy. Life expectancy at age 65 has risen by four years for men and five years for women since 1940, and it is expected to continue rising in the future. Increasing life expectancy raises the value of Social Security and Medicare benefits to workers, but also adversely affects the financing of the programs, because beneficiaries are expected to collect benefits over a longer period.

In this context, one trend that has not received sufficient attention is the extent to which life expectancy has been rising particularly rapidly for people with higher earnings relative to those with lower earnings. Many demographers expect the differential trend to continue, since expensive life-extending technologies may fail to trickle down the income distribution and since health behavior seems to be more responsive to suggested lifestyle

changes at the top of the education distribution than at the bottom. This increasing gap in life expectancy exacerbates the financing shortfall in Social Security and perhaps in Medicare. It also makes the systems less progressive on a lifetime basis, since higher earners will collect benefits for an increasingly larger number of years, relative to lower earners.

Saving Social Security

Social Security faces a long-term deficit, which contributes to the nation's long-term fiscal gap. As I explain below, however, the Social Security deficit is not the primary explanation for the nation's long-term budget imbalance.[8] Restoring long-term financial balance to Social Security is therefore necessary, but it is not necessary to destroy the program in order to save it.

Peter Diamond of MIT and I have recently written a book, in which we put forward a progressive reform that combines modest benefit reductions and modest revenue increases to restore sustainable solvency to Social Security while strengthening its social insurance protections. That plan is summarized in a recent policy brief posted on the Brookings website, and I'd be happy to answer questions about it.

Rather than going through the details of our proposal, though, I'd rather spend the final part of my talk discussing why we did not include individual accounts -- especially given the apparent popularity of individual accounts as a "solution" to Social Security's financing problems among college-aged people.

Individual accounts

Individual accounts within Social Security have two problems: They raise a substantial financing challenge, and they are unlikely to be a particularly effective mechanism for delivering the core layer of financial security during times of need.

First, let's examine the financing problem. If Social Security revenue were diverted into individual accounts without any corresponding reduction in benefits, Social Security's financial condition would clearly be worsened. To avoid this, individual accounts financed by payroll revenue must be linked in some way to a reduction in traditional benefits sufficient to offset the cost of the diverted revenue.

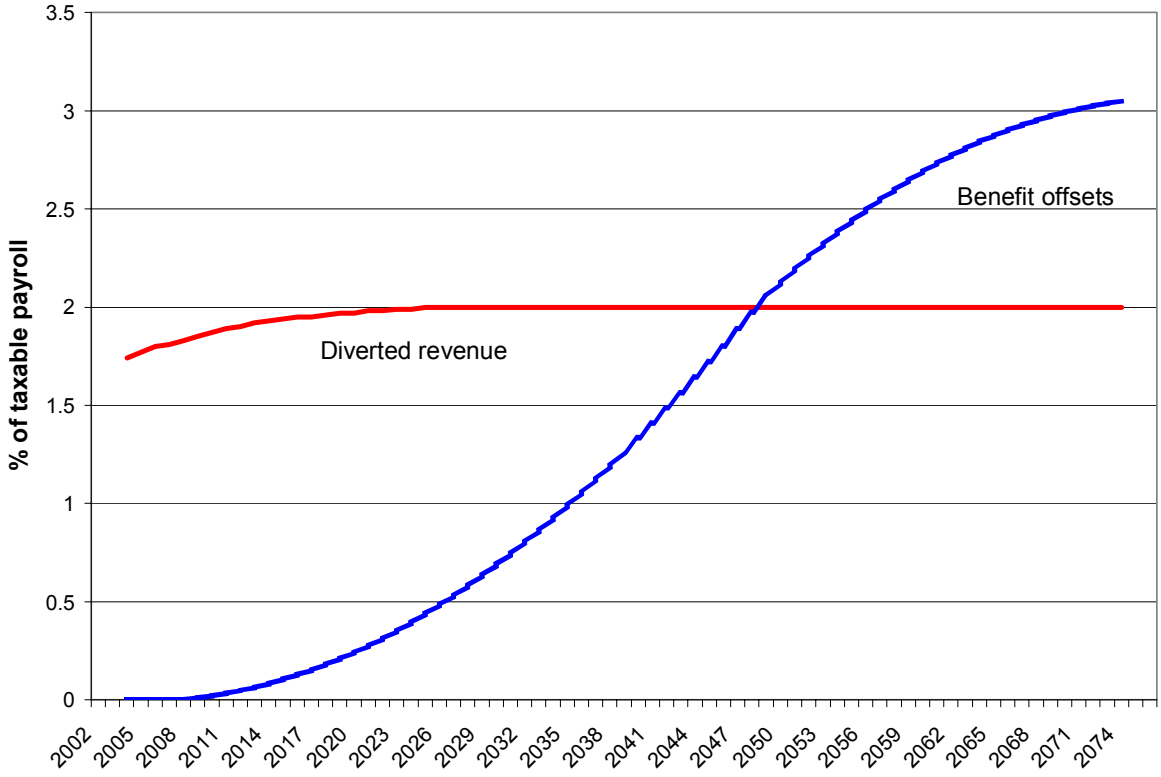
Imagine that traditional benefits that would otherwise be paid to the individual accountholder were reduced in such a way that traditional Social Security finances were

[8] Over the next 75 years, the actuarial deficit in Social Security amounts to 1.9 percent of taxable payroll. (One interpretation of this number is that it indicates what payroll tax increase would be sufficient to eliminate the actuarial deficit over the 75-year horizon, provided the increase began immediately and remained in force for the full 75 years: Raising the combined employer-employee Social Security payroll tax from 12.4 percent to about 14.3 percent would be sufficient to eliminate the 75-year deficit in Social Security.) As a share of GDP, the actuarial deficit over the next 75 years is 0.7 percent.

unaffected over the accountholder's lifetime.[9] Even in this case, the revenue diverted into the individual accounts would precede by many years the offsetting reductions in traditional benefits. Look at this from the perspective of an individual worker: The benefit offset for, say, a worker age 25 would occur after about 40 years.

The aggregate pattern of revenue diversion and benefit offsets depends on the age-earnings profile and demographic patterns. Using the Social Security actuaries' projections, we can examine this aggregate pattern. If two percent of payroll were diverted to individual accounts, with an offsetting reduction in traditional benefits for accountholders upon retirement, the aggregate cash flow from the individual accounts would be negative over a period of more than four decades (Figure 5). The delay between the revenue flow and the corresponding benefit reductions poses a significant problem for the Social Security system.

Figure 5



Even if it were not for these financing issues, individual accounts would still not make sense within Social Security in my view. Despite whatever advocates might like to believe, it is unlikely that real-world individual accounts would require that benefits keep

[9] It is worth noting that many recent Social Security reform plans, including both Model 2 and Model 3 put forward by the President's Commission to Strengthen Social Security, would *not* hold Social Security harmless over the life of worker who chooses to divert funds to an individual accounts. Instead, these proposals entail lifetime subsidies to the accounts, and corresponding permanent costs to the government.

pace with inflation, last as long as the beneficiaries are alive, or protect surviving spouses as well as the current system. There would also likely be intense political pressure to allow withdrawals prior to retirement, which would undermine the role of the accounts in providing retirement security. These pressures would be accentuated by the "ownership" rhetoric used to promote individual accounts: If they are "your" assets, and your children are sick and you need a new car, why shouldn't you be allowed to pull the funds out prior to retirement? Experience with IRAs and 401(k)s suggests a strong political economy tendency for such early withdrawals. Furthermore, the assets in the accounts are subject to financial market risks.

As a result, individual accounts are simply inappropriate for the basic tier of income during retirement, disability, and other times of need. One-fifth of elderly beneficiaries receive *all* their income from Social Security, and nearly two-thirds receive the majority of their income from Social Security. The average Social Security benefit amounts to slightly more than $10,000 a year, and 20 percent of beneficiaries receive $7,000 a year or less. Especially as the private retirement system on top of Social Security shifts from a defined benefit to a defined contribution one, it makes little sense to engineer a shift to individual accounts within the core layer of financial security provided by Social Security.

The deceptive "rate of return" comparison

Some advocates of replacing part of Social Security with individual accounts argue that it would raise the rate of return on Social Security contributions. Most professional economists are skeptical of this assertion. Indeed, as one of the members of President Bush's own Social Security commission has written in a co-authored article, "A popular argument suggests that if Social Security were privatized, everyone could earn higher returns. We show that this is false."[10]

The ostensibly higher rates of return under individual accounts are substantially reduced if not eliminated by incorporating two key factors. The first reflects the "legacy debt" accumulated by the program's history, which explains why the future return on Social Security is below the government bond interest rate. The second is an adjustment to reflect the risks associated with the stock market, which explains why the government bond interest rate is below the expected equity return.

Early generations of Social Security beneficiaries, including most of those receiving benefits today, received larger benefits than could have been financed from their contributions plus the returns on those contributions at a market rate of interest. Our generosity to earlier generations imposes a "legacy debt" on future beneficiaries of the program. As a result of the legacy debt, benefits for later generations will be smaller

[10] John Geanakoplos, Olivia Mitchell, and Stephen P. Zeldes, "Social Security Money's Worth," in Olivia S. Mitchell, Robert J. Myers, and Howard Young, *Prospects for Social Security Reform* (University of Pennsylvania Press: Philadelphia, 1999).

than their payroll contributions accumulated at a market rate of interest.[11] This is the key reason that future implicit returns on Social Security are lower than the real interest rate on government bonds.

The simple rate-of-return comparison ignores the cost of financing the legacy debt, even though the creation of individual accounts would not undo our history and therefore would not make the legacy debt disappear. Put another way, even if we created individual accounts, we would still need to pay benefits promised under the current system to current beneficiaries and near retirees. But if these benefits were maintained, workers must continue to pay taxes to support them regardless of whether the nation partially replaces the existing Social Security system with individual accounts for younger workers. The rate-of-return comparison implicitly assumes that 100 percent of Social Security revenue would be available to deposit into individual accounts, even though roughly three-quarters of that revenue is already committed to paying benefits for current retirees and would need to remain devoted to that purpose for many years under individual accounts.

The second piece of the rate-of-return comparison involves risk. Individual accounts would allow workers to be invested in a combination of stocks and bonds, whereas the existing system is invested in special-purpose Treasury bonds. A diversified portfolio comprising both stocks and bonds would be expected to yield higher returns than a portfolio consisting solely of bonds, and the higher expected return may make the individual accounts seem relatively attractive. It is important to remember, however, that in an efficient financial market, higher expected returns are earned only by taking on greater risks. Most investors do not like risk. To induce risk-averse investors to place money in riskier assets, those assets must offer higher expected average returns.

Risk is one of the principal reasons that stocks tend to have a relatively higher expected rate of return than government bonds. The issue then becomes whether the entire differential in expected rates of return can be explained by risk. For someone already holding a diversified portfolio, the risk adjustment that is appropriate suggests that stocks are worth no more than Treasury bonds. On the other hand, workers with so little financial wealth that they are holding no stocks at all may experience a small gain from the opportunity to hold stocks. Even for such workers, though, the opportunity does involve taking on additional risk, and *some* risk adjustment is therefore appropriate.

The simple rate-of-return comparison ignores both the legacy debt and financial market risk, and it is therefore misleading.

[11] The legacy debt is similar to the U.S. public debt, which reflects the accumulated difference between spending and revenue from America's beginning to the present; because spending has exceeded revenue in the past, we are left with a public debt. The cost of financing that debt requires some future combination of higher taxes and lower spending. So, too, the legacy debt within Social Security reflects the accumulated difference between benefits and revenue for previous and current beneficiaries, and financing that debt requires higher taxes and lower benefits than the system could otherwise afford for future generations.

Health care and the long-term deficit

One additional point about Social Security involves the relative magnitude of the Social Security deficit. The Social Security deficit is a contributing factor, but only a relatively minor one, to the nation's long-term fiscal gap. The easiest way to see this is to examine Figure 6. It shows baseline unified deficits that are very close to those presented by the Administration in this year's *Economic Report of the President.* As the figure shows, the long-term budget outlook does not change markedly under the type of Social Security reform favored by the Administration. (The specific reform shown reflects "Model 2" as proposed by the President's Commission to Strengthen Social Security. This reform was also the basis for Chart 6-6 in this year's *Economic Report of the President*, which shows a very similar pattern to Figure 6.)

Figure 6: Unified budget deficit

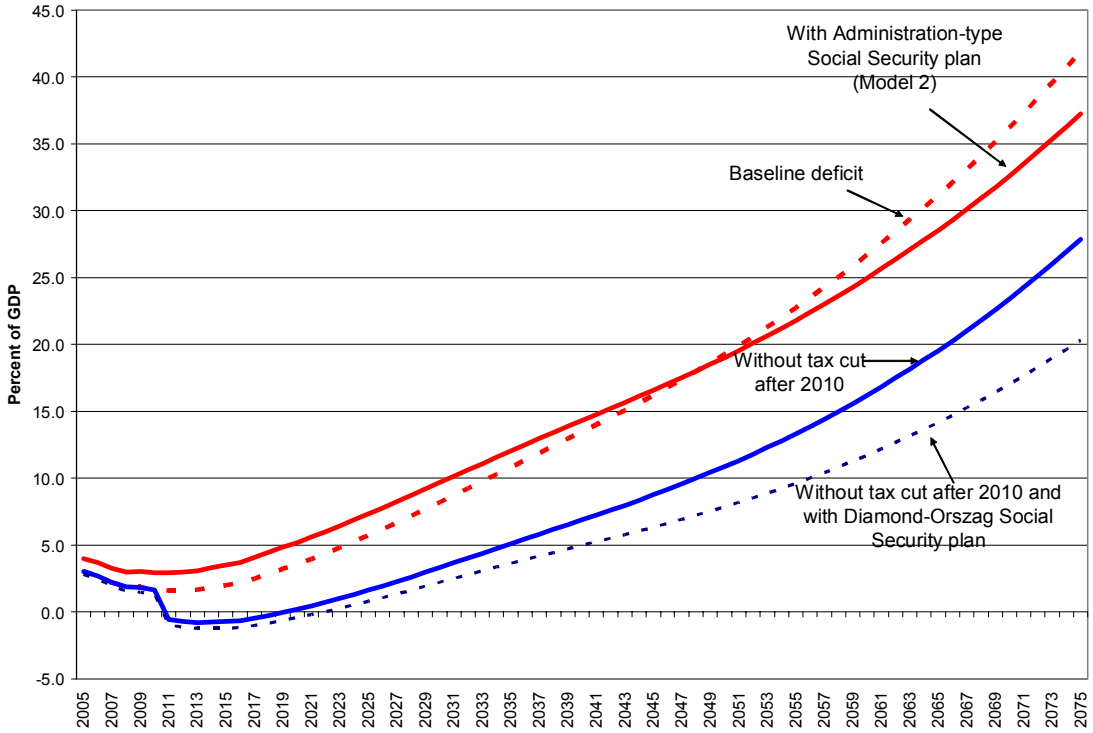


Figure 6 shows that extending the tax cuts after 2010 exerts a somewhat more significant influence on the projected deficit: By 2075, the reduction in the unified deficit amounts to 13 percent of GDP, almost three times the reduction from the Administration's type of Social Security reform in that year.

The figure also shows, though, that even under the scenario in which the tax cuts are not extended past 2010 and in which a Diamond-Orszag type of reform to Social Security is enacted, a significant fiscal gap remains in the long term. The reason is that Medicare and Medicaid together grow substantially in cost over time. Reforming those

programs will be even more difficult -- both politically and substantively – than reforming Social Security.

Conclusion

Let me conclude merely by praising the hard work and dedication that has gone into making the Carroll Round a success, and note that your presence here tonight indicates an exceptional interest in economic issues. I have no doubt that many of you will wind up being the ones at the forefront of addressing whatever legacy today's policy-makers leave for you. For that very reason, we should do better by you than perpetuating a saving rate of 1.3 percent of national income and a current account deficit that amounts to 5 percent of GDP.

Perhaps current policy-makers can be excused from addressing the long-term deficit in Medicare and Medicaid, since so much uncertainty surrounds the proper course of reform in those programs. But we should do better by you than failing to eliminate the long-term deficit in Social Security, where the basic issues are well understood. Failing to act now on Social Security would merely push the politically difficult choices into the future and make the problem all the harder to address. In reforming Social Security, though, we should preserve its core insurance protections, even if some -- or perhaps most -- of you will not sufficiently value the insurance until it is needed.

Thank you for your attention tonight.