Budgeting for National Priorities

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Taming the Deficit

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BUDGET OPTIONS SERIES

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PAPER SUMMARY

Currently projected deficits are unsustainable and pose serious risks to the economy, make us dangerously dependent on the rest of the world, impose an extra "debt tax" on every taxpayer, send the bill for current spending to future generations, and weaken the ability of the federal government to invest in the future or respond to unforeseen emergencies. Both parties in Congress and the president should state unequivocally that deficits do matter and they should be honest with the American public about the nature and magnitude of the challenge. Cutting fraud, waste, and abuse, curbing earmarks, raising taxes on the very wealthy, or streamlining the staffing of the federal government is simply not enough to solve the problem. Congress and the president should make a commitment to restore fiscal balance over the next five years and to put the nation on a sustainable fiscal course over the longer term by reforming entitlements and taxes as soon as possible.

In this paper, we present a number of specific proposals that elected officials might choose to adopt. The purpose is not to suggest that these are the only options but to illustrate what a defensible deficit reduction package might contain. None of us entirely supports every element of the package. We put the proposals forward in the spirit of showing that it is possible for people of good will to come together and produce a deficit reduction plan that gets the job done.

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Other papers in this series:

Restraining Federal Domestic Spending, James C. Capretta

Pruning the Defense Budget, Jeffrey M. Tebbs

Reducing the Deficit Through Better Tax Policy, Diane Lim Rogers

Cost-Effective Investments in Children, Julia B. Isaacs

Budgeting for National Priorities Books:

Restoring Fiscal Sanity: How to Balance the Budget (2004), edited by Alice M. Rivlin and Isabel Sawhill

Restoring Fiscal Sanity 2005: Meeting the Long-Run Challenge, edited by Alice M. Rivlin and Isabel Sawhill

Restoring Fiscal Sanity 2007: The Health Spending Challenge, edited by Alice M. Rivlin and Joseph R. Antos

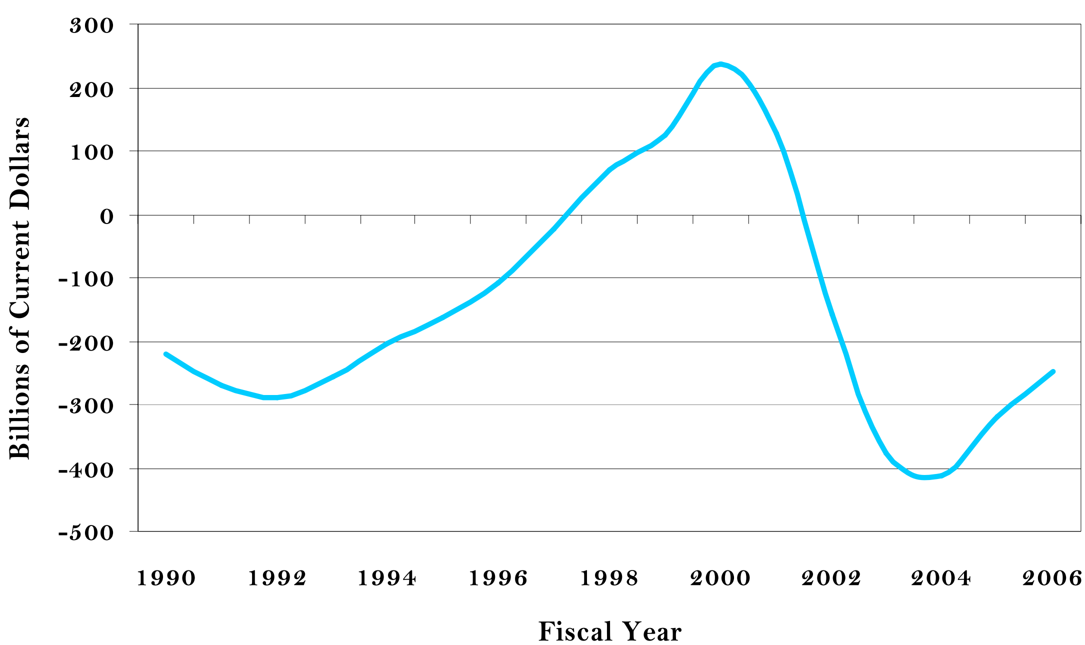
Introduction

The federal government is spending beyond its means. The surpluses of the late 1990s have turned into deficits that hovered around $300 billion to $400 billion a year in the first half of the current decade and fell to $248 billion in fiscal year 2006 (figure 1). Although the picture seemed to be improving somewhat as this paper went to press in early 2007, any good news is likely to be short-lived for several reasons.

First, and most importantly, the retirement of the baby boom generation and rapidly rising health care costs per capita will soon produce substantially larger deficits if no action is taken to reform the major entitlement programs (Social Security, Medicare, and Medicaid). Second, although official projections show the deficit withering away, this rosy outlook is due to the statutory requirement that the Congressional Budget Office (CBO) adopt several unlikely assumptions, including the complete expiration of the tax cuts enacted in recent years. Under a more realistic scenario, deficits could swell to around $535 billion by 2016 and much higher in subsequent decades as the population grows older and health care spending per capita continues to rise (figure 2). By the early 2030s, assuming health care costs per capita grow at their historical rate, the three major entitlement programs will absorb all of the federal government's projected revenues (figure 3). To prevent the elimination of the rest of government, either taxes would have to be raised by 50 percent (to European levels) or the benefits provided to seniors drastically curtailed.

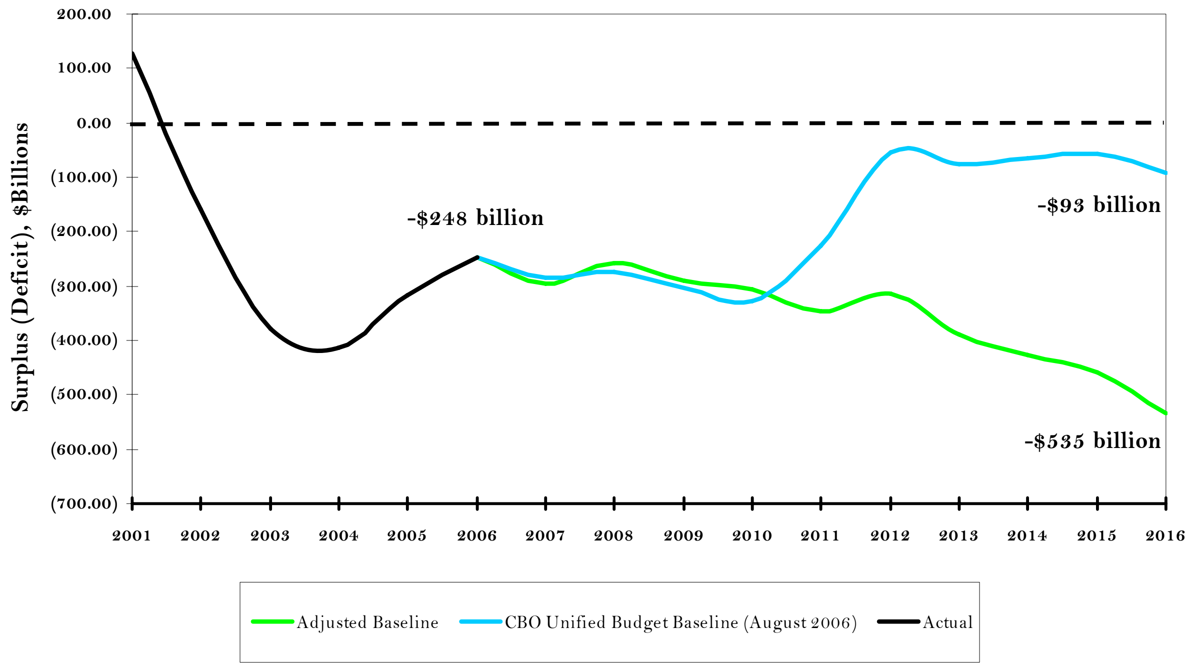
In sum, projected deficits are large and unsustainable, and almost everyone agrees that there is no plausible rate of economic growth that will enable us to grow our way out of the problem.[1] A fiscal tsunami is coming and the sooner we tackle it the less painful it will be.

Figure 1. Deficits and Surpluses, 1990 to 2006



Source: CBO, 2006c, table F-11: Deficits, Surpluses, Debt, and Related Series, 1962 to 2005; CBO, 2006a.

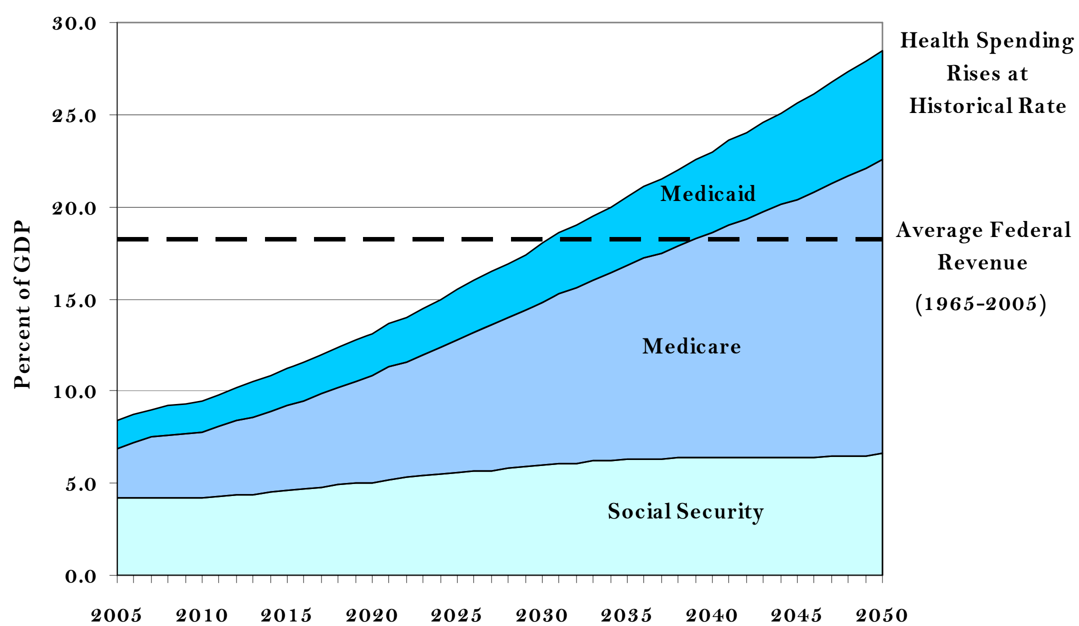
Figure 2. Official and Adjusted Baseline Budget Projections



Note: Adjusted baseline projections assume: 1) Expiring provisions of the 2001-2004 tax cuts are extended. 2) Supplemental appropriations for non-defense discretionary spending (e.g., hurricane relief, avian flu) are removed from the baseline in future years. Non-defense discretionary spending is adjusted for population growth, in addition to adjustments for inflation. 3) Defense spending proceeds according to administration plans, as projected by CBO, 2005c. Supplemental spending for the Global War on Terror slowly phases down according to the "contingency cost risk" scenario.

Source: Author's calculations from CBO, 2006b; CBO, 2005c; Urban-Brookings Tax Policy Center, Budget Outlook Tables, August 2006.

Figure 3. Projected Spending Growth for the Major Entitlement Programs



Source: CBO, 2005b, Scenario 1.

Why Deficits Matter

Why is it important for elected officials to address this issue? First, deficits of this magnitude are a serious threat to the economy. At present, the economic effects of deficits are masked by the willingness of the rest of the world to lend us the money necessary to live beyond our means. The Chinese and others are, in effect, providing us with cheap credit and affordable mortgages. Without this influx of money from abroad, it would be more expensive for both businesses and households to borrow. For example, in the absence of this inflow of foreign capital, interest rates might rise by as much as two percentage points, increasing the cost of a typical thirty-year mortgage on a $225,000 house by more than $2,500 per year.[2]

More than 75 percent of current deficits are being financed by foreigners, including the central banks of China and several other Asian nations and oil-exporting countries in the Middle East.[3] Should foreigners decide to curtail their lending to the United States, interest rates would rise, the value of the dollar would fall, and a recession would likely follow. The exact scenario is unpredictable; there could be a gradual adjustment (soft landing) or there could be a full-scale financial crisis. Either way, our mounting indebtedness to foreign countries means that we are losing control of our economic destiny and that a growing share of our gross domestic product (GDP) will need to be devoted to paying the interest on these foreign financial investments in the United States. The ultimate result is that American economic strength will erode, translating into a lower standard of living than might otherwise be possible.

Second, continuing deficits enlarge the national debt and require that more tax dollars be devoted to servicing that debt. Interest payments are now the fifth largest category in the federal budget, costing the average family more than $1,600 in 2005.[4] When Americans pay their taxes each year, they are increasingly paying simply for the privilege of borrowing more and forgoing the opportunity to reduce existing tax burdens or to devote these same dollars to defense, education, or other government services.

Third, deficits shift the costs of government from current to future generations. We can pay for government now or we can pay for it later, but we cannot avoid paying for it indefinitely. There are times when borrowing is justified: to cover the costs of a national emergency or to bolster the economy during a recession. While the 2001 recession, the wars in Iraq and Afghanistan, and Hurricane Katrina were expensive, currently projected deficits are structural and not the result of such special needs. By shifting costs into the future we are asking our children and grandchildren to pay for what we have consumed.

Finally, deficits circumscribe and constrain the nation's ability to respond effectively to future emergencies or to make public investments in areas such as national security or education that would strengthen the nation over the longer-run. Should there be an avian flu crisis or a deep recession, for example, the federal government's ability to act would be encumbered by our current red ink.

In short, the nation's current fiscal stance threatens the economy, makes us dangerously dependent on the rest of the world, imposes an extra "debt tax" on every American, sends the bills for current spending to future generations, and weakens the ability of the federal government to invest in the future or respond to unforeseen emergencies.

Solutions to this problem will require that elected officials take unpopular steps to both raise taxes and cut spending. Congressional leaders are well aware of the problem but are hampered by the breakdown of the budget process in recent years and a lack of trust between the two parties. Leadership from the president on this issue has also been missing.

What Elected Officials Should Be Expected to Address

At a minimum, both parties in Congress and the president should:

- State unequivocally that deficits do matter.
- Make a commitment to restore fiscal balance over some reasonable period of time, such as the next five years, and to put the nation on a sustainable fiscal course over the longer term by reforming entitlements as soon as possible.
- Pledge to work in a bipartisan way to achieve this objective since the goal cannot be achieved unless done on a bipartisan basis.
- Be willing to put all options on the table: entitlements, revenues, defense, and all other spending.
- Provide a general outline of the spending cuts and revenue increases needed to achieve short-term fiscal objectives and the types of changes needed in Social Security and Medicare to sustain fiscal discipline over the longer run.
- Be honest with the American public about the nature and magnitude of the challenge. For example, lawmakers should acknowledge that the problem cannot be solved simply by cutting fraud, waste, and abuse, curbing earmarks, raising taxes on the very wealthy, or streamlining the staffing of the federal government.
- Propose reforms to the budget process without assuming that these alone will be sufficient to restore fiscal balance.

In this paper, we present a package of proposals that, taken together, will balance the budget by 2013, five years after a new president takes office in 2009. The purpose is not to suggest that these are the only options but to illustrate what a logically defensible set of proposals might contain. Indeed, none of us entirely supports the package of spending cuts and revenue increases described in this paper. We put them forward in the spirit of showing that it is possible for people of good will to come together and produce a deficit reduction plan that gets the job done.

Toward a Grand Compromise on the Deficit

Our suggested package is predicated on the assumption that serious deficit reduction will require bipartisan support. The enactment and durability of these reforms will therefore depend on respecting certain principles and values that each party holds dear. A viable package must include:

- A balance of spending cuts and revenue increases and an agreement that the bulk of the savings will be devoted to deficit reduction and not to further tax cuts or to increased spending. However, to sweeten the package and in recognition that some high-priority tax reductions (e.g., reform of the alternative minimum tax) and additional funding for selected cost-effective investments can strengthen the nation as much as reducing the deficit can, some of the savings are devoted to these purposes within a fiscally responsible package.

- A sensitivity to conservative concerns that higher marginal tax rates might reduce incentives to work, save, and invest, thereby weakening economic growth, and that in the absence of constraints on spending, government will absorb too large a proportion of national income.
- A sensitivity to more liberal concerns that tax burdens and spending cuts be fairly distributed and that government has a positive role to play in improving the functioning of the economy, providing a safety net for the vulnerable, and making strategic investments undervalued by the private sector.
- An emphasis on improving the efficacy of government through the elimination of poorly performing programs and the reallocation of some funding to more cost-effective uses. The objective is not bigger government or smaller government but smarter and more efficient government.
- A recognition that the non-defense discretionary portion of the budget is small (18 percent) and cannot carry the deficit-reduction load, while entitlement programs, health care in particular, are the driving force behind the growth of spending over the next few decades.

With these principles in mind, the proposals outlined below eliminate the deficit within five years and set the budget on a sustainable and fiscally responsible trajectory for the longer term (table 1). About half of the package consists of reductions in outlays and about half increases in revenue. Over time, spending reductions will come primarily from curbing the growth of Social Security, Medicare, and Medicaid. However, the mix is tilted toward discretionary or non-entitlement programs in the short-run (the next five years) since it will take time to forge acceptable political compromises on entitlement spending and implement reforms in a fashion that does not unfairly harm current beneficiaries. That said, entitlement reform is critical, and a process, such as a set of triggers to constrain future growth, should be enacted now so that such reforms are not delayed indefinitely.

We raise revenue through efficiency-enhancing measures, primarily by broadening the base of the tax system, by instituting a new tax on energy use, and by promoting tax compliance. Once the steps needed to achieve balance are in place, a portion of the projected interest savings, which we term a "fiscal responsibility dividend," is earmarked toward initiatives that promise to strengthen the nation, replacing a wasteful form of spending with productive investments. The remainder is reserved for deficit reduction. These proposals are summarized here and more details are provided in a series of discussion papers and books published by the Brookings Budgeting for National Priorities project.[5]

Table 1. Proposed Path to Budget Balance
(in billions of dollars)
Deficits and spending increases shown as negative numbers

		Fiscal Year 2013
Revenue increases		206
Outlay reductions		219
Discretionary spending (nominal freeze)	124	
Social Security, Medicare, and Medicaid reforms	38	
Reduced debt service	57	
Subtotal		**425**
Additional investments[a]		-37
Net impact of proposals		**388**
Projected deficit		-388
Result of proposals		**0**

a. The cost estimates for new investments include the associated additional debt service.

Restraining Spending

The federal government spent close to $2.7 trillion in fiscal year 2006.[6] Polls and focus groups suggest that many members of the public think that the federal budget is bloated, that those in Washington do not spend their money well, and that they would not be adverse to having a smaller federal government overall.[7] Concurrently, various interest groups lobby vigorously to maintain their favored programs and are supported by those in the agencies and Congress that have jurisdiction over these programs. As a result, spending has grown through Democratic and Republican administrations alike, although rarely more rapidly than over the last five years.[8] Scores of programs have accumulated that have had modest impacts at best, have cost far more than they were worth, and have increased burdens on the average taxpayer in order to provide benefits to relatively small but politically powerful groups.

We propose a very simple, if draconian, solution: set a cap on all discretionary programs that would freeze spending at current levels (a so-called “hard freeze”). The cap would permit trade-offs among programs but would require that any increase above current levels be paid for by cutting some other program below current levels. Over the five years from 2009 to 2013, this proposal saves a total of $268 billion, including $124 billion in 2013 alone.[9] These savings, along with some short-run adjustments in the major entitlement programs and revenue increases discussed later in the paper, would balance the budget in five years, at which point the constraints of the nominal freeze might be eased. Enacting such a cap spreads the pain widely, replaces the definition of current policy, and puts the onus on the president or Congress to make the case for any exception to this rule. Congress would retain the flexibility to increase spending in selected areas, but only if they were able to identify and enact offsets to pay for any increase above current levels.[10]

There is no shortage of ideas on where such cuts, or offsets, could be found. In 2004, Brookings published *Restoring Fiscal Sanity: How to Balance the Budget*. That volume laid out a package of domestic spending cuts in its so-called better government plan that totaled $68 billion in 2014.[11] A more recent paper by James C. Capretta, a former associate director of the Office of Management and Budget in the Bush administration, builds on this earlier effort and identifies a similar level of expenditure reductions.[12] In both cases, savings are achieved by reducing government subsidies that distort markets, by rebalancing federal and state responsibilities, by eliminating or curtailing ineffective or marginally effective programs, and by improving efficiency and reducing waste.

It is not just domestic spending that needs to be reigned in. Department of Defense spending totaled $499 billion in fiscal year 2006, with national defense expenditures exceeding the spending totals at the height of the Korean War and approaching a level not witnessed since the Second World War.[13] A significant component of the recent rise is attributable to the Global War on Terror. However, the Department of Defense also continues to fund numerous weapons programs with little regard for their relevance to the nature of current threats or to the performance of those systems on measures of cost-effectiveness, ability to maintain production timelines, or ability to deliver promised capabilities. In a recent paper, Jeffrey M. Tebbs advocates a concrete set of proposals for trimming the defense acquisitions budget that yields savings of $35 billion per year relative to a baseline of administration plans.[14]

Under our proposal to cap discretionary spending at current levels, these identified cuts in both domestic and military spending could be used to protect higher-priority programs from a hard freeze.

Reforming Entitlements

There are good reasons why Social Security, Medicare, and Medicaid are popular programs: They provide direct benefits to a large proportion of the population to meet essential health care and retirement needs. However, these three programs, especially Medicare, are the major reason that we are on an unsustainable course *after* 2013. No amount of reasonable cuts in other programs or revenue increases can fully address the longer-term fiscal challenge. For these reasons, the president and Congress need to address not just ballooning deficits in the short-run (the next five years), but the longer-term challenge as well.

<u>Social Security reform</u>

Although President George W. Bush's attempt to reform Social Security in 2005 met with little success, the need still exists to place the entire system on a more solid financial footing.[15] There is no impending crisis, but benefit payments will exceed payroll tax revenues by 2017.[16] The only way to restore solvency to the system is either to reduce benefits or to raise taxes, but almost no one wants to do so in a way that would harm current beneficiaries.

Many experts believe the solution will need to entail such things as adjusting the age of retirement to reflect the fact that people are living longer, encouraging them to remain in the workforce (for example, by limiting benefits for early retirees), reducing the future growth of benefits for the more affluent (by indexing benefits to inflation rather than to real wage growth) while maintaining current law benefits for those with more modest means, and encouraging (or mandating) everyone to save more for their own retirement in personal accounts outside of Social Security.[17]

In addition to reducing the growth of benefits through delayed retirement or smaller-than-promised benefits for the affluent, revenues can be increased by raising payroll taxes. In particular, removing the cap ($97,500 in 2007) on payroll taxes in combination with a benefit formula for those at the top of the earnings distribution that was modified to allow benefits to grow, but not as fast as under current law, would go a long way toward solving the problem.[18] This additional revenue might also be utilized to lower the payroll tax rate, an option we discuss later in the section related to raising revenue.

Some progress can be made even in the shorter run (over the next five or ten years) by changing the way in which benefits are indexed for inflation, by accelerating the implementation of the already-legislated increase in the normal retirement age from sixty-six to sixty-seven, and by indexing benefits for increased longevity. These changes would yield close to $20 billion in annual savings by the end of a decade.[19]

<u>Medicare, Medicaid, and the health care system</u>

Medicare and Medicaid alone account for 21 percent of total spending at the federal level and that spending has been growing 2.5 percentage points faster than per capita GDP for the past four decades.[20] If this rate of increase were to continue and federal taxes claimed no higher a share of GDP than they do today, federal health spending along with Social Security would absorb all currently projected revenue in about twenty years. To meet this spending challenge, either taxes would need to rise to levels unprecedented in the United States or other federal priorities would need to be scaled back dramatically.

These trends make reforming the entire health care system (not just the public programs) in ways that slow the growth of spending a very high priority. Reducing expenditures without denying people the benefits that new advances in medicine have made possible poses a major challenge. Some of these benefits are clearly worth more than their costs while others are not. Congress and the president must address this challenge. The task is exceedingly difficult, but the stakes could not be higher. Indeed, one way to view the fiscal problem in the United States is to say that it is, in essence, a health care problem. If one could slow the rapid growth of health care spending—in both the public and the private sector—this would enhance the nation's competitiveness while closing all or most of the long-term deficit.[21]

But what to do? Most experts believe that it is not possible to substantially slow the cost of the public programs without reforming the entire health care sector. They have suggested such steps as collecting more evidence on effective treatments and creating better incentives for both patients and providers to use that evidence; the greater utilization of electronic medical records; more emphasis on preventive care; and better management of chronic diseases such as diabetes or asthma. Analysts have also suggested relying more on prepaid managed care or on high-deductible health plans linked to health savings accounts that would encourage consumers to make better health care choices.[22] Some experts believe that the best way to introduce these or other reforms is to allow states to experiment with new ways of delivering and paying for care.[23]

All of these ideas have merit and could help to reduce health care spending growth, at least temporarily. Moreover, the federal government can and should take the lead. Because the public programs—Medicare in particular—are such large payers, have so much power to influence practice standards or prices, and have so much access to data on the effectiveness of different treatments, if used appropriately they can have a major impact on the entire system.[24]

That said, a number of challenges remain. The first is the large number of Americans who are currently uninsured (46.6 million in 2005).[25] The second is the fact that none of the reforms suggested so far will necessarily constrain costs in a way that solves the long-term budget problem. Even if spending growth is slowed somewhat—or taxes are increased to pay for health care—Medicare and Medicaid are likely to absorb a growing proportion of all available revenues, crowding out other spending for everything from education to national defense. Consideration of more comprehensive reforms is necessary.

A comprehensive reform plan could take many forms, several of which are outlined below. However, the essence of many of these plans is to provide universal coverage, to guarantee a basic (but not unlimited) package of services, to provide some choice of plans, to subsidize the cost of the plan in relation to income, and to cap the total growth of spending over the longer run. The spending limits could be tied to the revenues from an earmarked value-added tax (VAT). In that way, spending could be adjusted upwards only if the public were willing to see their taxes raised to pay for it.

The Center for American Progress advocates a plan that would allow the uninsured to buy into the same private health plans currently offered to federal employees and members of Congress.[26] Such coverage would be made affordable via a refundable tax credit for anyone whose premiums exceeded a certain proportion of their income (for example, 5.0 to 7.5 percent). People would be expected to have insurance and to take greater responsibility for their own health care. The short-run costs for this expansion of insurance to those not currently covered and for the investments in system improvements would be in the neighborhood of $100 billion to $160 billion per year and would be funded by a dedicated VAT of 3 to 4 percent. This plan moves only part way toward a comprehensive solution since it builds on existing public programs as well as the existing employer-based system.

A more far-reaching option, suggested by Victor Fuchs and Ezekiel Emanuel, and in a somewhat different form by Frederick Gluck, would be to replace Medicare and Medicaid as well as the employer-based system with risk-adjusted vouchers or subsidies that would be used to buy insurance covering a basic package of health care from a limited number of competing private health plans. Everyone would be required to have health insurance, and the subsidies would be income-related.[27]

A still more radical plan would require that everyone save more than at present for normal health and retirement needs and purchase insurance to cover very high or unexpected expenses. This plan could entail add-on personal accounts or mandatory purchase of insurance (matched or subsidized by the government for those with limited incomes). By requiring people to save for, or insure against, their own future needs, this option would shift more of the burden of normal or routine health and retirement costs to individuals and reduce public spending. But government provision or organization of broad risk-sharing pools together with subsidies for those unable to afford the required savings or insurance would be retained.[28]

Are such comprehensive reforms even remotely feasible? Many will argue that they are not, but we cannot know whether that is the case without more effort to fully articulate reform designs and put them on the agenda for debate and discussion. The essence of the social contract with the public would be a promise of universal access to care in the short run coupled with some limits on spending in the longer run. The short-run costs of broadened access might be partially offset by the reduction in the over-use of emergency rooms and other forms of care by the uninsured or by lower administrative costs, but realistically broadened insurance coverage will add to public spending, at least in the near-term. That financing could be provided by a new earmarked tax, such as a VAT, by higher premiums or cost sharing from the most affluent, and/or by capping and eventually eliminating the exclusion from taxes of employer-provided health insurance. Over the longer term, benefits covered by public subsidies would be indexed to the growth of the population and some measure of health care costs, but in a way that would gradually slow the growth of spending. This approach would give patients and providers time to adjust, but the spending limits would create pressures for major changes in both the use and delivery of care as well as the type of medical innovations developed over the next several decades. As the experience of some other countries suggests, there is a lot of inefficiency in the current system of health care in the United States, which costs more and delivers fewer benefits than systems in other countries.

Congress and the president should work to educate the public on the nature of the health care problem and possible solutions. Leadership in this arena is critical. Failure to achieve consensus in the past is not a reason to avoid or defer action. Achieving consensus in such a contentious area will be difficult, but there is no reason not to start now.

Raising Revenues

If the proposals set forward thus far in the paper were adopted, discretionary spending would fall nearly 11 percent relative to adjusted baseline projections for 2013.[29] Social Security, Medicare, and Medicaid would each undergo extensive restructuring, yielding modest savings in the near-term ($38 billion in 2013) and substantial savings over the long-term as each of the major entitlement programs assumed a sustainable trajectory.[30]

Unfortunately, the proposed expenditure reductions stanch only half of the budgetary red ink within the five-year time horizon. Limiting spending further would require unfathomable cuts to domestic discretionary spending, imprudent reductions in resources for national security, or reneging on promises to current retirees under Medicare and Social Security. Spending cuts of this sort would almost certainly derail any political compromise between moderates in both parties. As such, a non-negligible component of any effort to balance the budget must involve revenue enhancements. The phrase "revenue enhancement" is not merely a coy term for "tax hikes." Rather, we recognize that any successful compromise will require that increases in tax receipts be structured in a fashion that does not hinder economic growth, but rather improves economic efficiency, simplifies the tax code, and promotes fairness.

The revenue package respects these principles and has four components.[31] The first is an effort to collect more of the taxes already owed. The second involves broadening the tax base by eliminating or curbing various deductions and exclusions. The third imposes a new tax on energy consumption, designed to combat global warming and improve energy security. The fourth is reform of the alternative minimum tax (AMT). If allowed to persist along its current path, the AMT will impose higher tax rates on an increasing proportion of households. By recommending a revenue-neutral reform of the AMT, we can create a fairer and more sensible tax structure for the long run.

Promoting compliance with existing tax law

Collecting taxes that are lawfully owed should be a high priority. In its most recent review, the Internal Revenue Service (IRS) estimated a noncompliance rate of 13.7 percent for 2001, resulting in $290 billion of missing revenue in that year. "Tax gaps" of this magnitude necessitate higher tax rates to make up for the revenue shortfall and could induce a downward spiral of decreasing compliance, as honest taxpayers abandon what they perceive to be an unfair system.

Not all of the tax gap can be closed, but some portion of it is amenable to collection. The IRS should be provided with the statutory authority to require additional third-party information reporting and withholding. For instance, brokers should be required to report the cost basis for securities transactions, and corporate taxpayers ought to be subject to the same 1099-MISC requirements as unincorporated businesses.

In addition, more resources should be devoted to enforcement. The number of IRS enforcement personnel declined from 22,000 in 1996 to a mere 14,000 at the end of 2005. In 2002, then–IRS Commissioner Charles O. Rossotti stated that $2.2 billion in additional enforcement funding would enable the IRS to collect $30 billion from noncompliant taxpayers it had currently identified but could not contact with existing resources. Research indicates that the indirect effects on voluntary compliance would be sizeable, estimated at between six to twelve times the dollar value of direct enforcement actions. On the other hand, no firm estimates of the revenue raising potential of tougher enforcement exist and many tax experts remain skeptical about the efficacy of such measures, unless undertaken as part of a broader reform that simplifies the system. In the end, we assume $25 billion in additional net revenue from better enforcement.

Broadening the tax base

We turn next to the goal of broadening the base of the tax code, which has become riddled with additional exclusions, exemptions, deductions, credits and preferential tax rates since the Tax Reform Act of 1986. Indeed, since 1986 more than 14,000 changes to the tax code have been enacted. From 1974 to 2004 the number of tax expenditures reported by the Treasury Department more than doubled, climbing from 67 to 146. As President Bush's Advisory Panel on Federal Tax Reform concluded, "we have lost sight of the fact that the fundamental purpose of our tax system is to raise revenues to fund government."[32] Tax expenditures distort decision-making in ways that often undermine economic efficiency. They introduce complexity, needlessly raising the costs of compliance. They provide few or no benefits to the two-thirds of households who do not itemize. They are regressive because they provide the greatest benefits to those in the highest tax brackets. They conceal subsidies, most of which would be unacceptable if structured as spending programs. (Would we be willing to subsidize the housing costs of the wealthy if this was done on the spending side of the budget?) And they often end up giving tax breaks for behavior that would have occurred in the absence of the tax benefit. Consider the fact that the revenue loss from savings incentives in the tax code is greater than total personal savings in the United States.[33]

There are a number of different ways to broaden the tax base. One would be to simply eliminate most itemized deductions and replace them with a standard deduction for everyone, with just a few exceptions.[34] This would greatly simplify the system, enable return-free filing for most people, increase compliance, improve equity, and raise large amounts of revenue. However, its political feasibility is another matter. A less radical alternative, and the one we propose here, would be to turn almost all itemized deductions into a 15 percent credit against taxes.

We also propose to limit the exclusion from income of employer-paid health insurance premiums and a few other health-related tax expenditures. The limit could be set at the average premium paid in the year of enactment and assuming the limit was not indexed over time, it would gradually increase the incentive for both employers and employees to make better health care choices.

In combination, these proposals would raise about $140 billion per year by 2013 as detailed in table 2.

Finally, we could raise the taxable income threshold for the Social Security payroll tax. The additional revenues could be used to shore up the financing of Social Security benefits in a relatively progressive fashion or they could be used to finance a small reduction in the payroll tax rate (from 6.20 percent to 5.35 percent for both employers and employees) in an effort to increase take-home pay for workers and the overall fairness of the tax system.

<u>Instituting an energy tax to combat global warming and reduce dependence on imports</u>
While increased tax compliance and base-broadening measures should close most of the revenue shortfall, a non-negligible gap remains. We propose eliminating the remaining deficit with an energy tax designed to promote energy efficiency, reduce dependence on oil imports from unstable parts of the world, and combat global warming. The current level of energy taxation in the United States is anemic by the standards of the industrialized world, measuring only two-thirds the average of the countries in the Organization for Economic Cooperation and Development.

Experts from Resources for the Future, the Brookings Institution, and the World Resources Institute have all endorsed the idea of a carbon tax, administered upstream, where fuels containing carbon are imported or produced. We recommend that the United States institute a modest carbon tax of $15 per metric ton of carbon equivalent, phased in over a three-year interval. Once implemented, this carbon tax is projected to produce a revenue stream approaching $35 billion per year. To garner additional political support, the carbon tax could be operated under a cap-and-trade system with a "safety valve" pricing mechanism.[35] The government would place a cap on total permissible emissions, but allow firms to buy and sell allowances among themselves. When the price reached the safety-valve level, the government would auction off additional allowances at a price that would bring in additional fees or revenues.

<u>Implementing a revenue-neutral reform of the alternative minimum tax</u>
Originally designed to prevent high-income households from evading federal taxes, the AMT is now slated to engulf nearly 30 million taxpayers by 2010.[36] In the past several years, Congress has delivered a series of short-term patches, but a more permanent fix is needed. We suggest a revenue-neutral reform or repeal of the AMT. Full repeal is substantially more expensive, in terms of lost revenue, than reform, and would require rolling back some existing income tax cuts. Reforming the tax such that it keeps the number of filers who must pay the tax more or less constant is less expensive and could be paid for by freezing the estate tax at its 2009 exemption levels ($3.5 million per individual, $7 million per couple) with a 45 percent rate of

taxation. With these parameters, less than one-half of one percent of estates would be subject to this tax. The goal would be to prevent the AMT from pushing a rising proportion of middle- and upper-middle-income households into a higher rate bracket over time.

Table 2. Revenue Proposals
(in billions of dollars)

	2009	2010	2011	2012	2013
Revenue-raising measures					
Narrow the tax gap	25	26	27	29	30
Broaden the base*	98	128	133	136	139
Limit itemized deductions to 15 percent	50	68	70	71	71
Limit exclusion on employer-paid health insurance	49	60	63	66	69
Carbon tax	10	21	33	34	36
Net effect*	**133**	**176**	**193**	**199**	**206**
Revenue-neutral reform of the alternative minimum tax					
Index AMT exemption levels	-1	-2	-4	-5	-7
Freeze estate tax at 2009 level (fiscal years)	0	16	18	19	21
Net effect	**-1**	**14**	**14**	**14**	**13**

Note: For estimates related to the estate tax, fiscal year revenue numbers assume a 75 percent to 25 percent split of calendar year values. The AMT reform produces revenue over the next five years, but is revenue-neutral over a longer time frame.

* Components may not sum to totals due to rounding.

Source: Urban-Brookings Tax Policy Center, Tables T07-0032, T07-0034, T07-0035, T07-0036, T06-0214, and T06-0124; Rogers, 2007.

Reinvesting a Portion of the Fiscal Responsibility Dividend

The proposals outlined above would slow the accumulation of debt and reduce the associated interest costs.[37] This "fiscal responsibility dividend" would total about $57 billion by 2013, which is more than sufficient to close the remaining fiscal hole. We propose devoting about $20 billion of the dividend to deficit reduction. The remaining $37 billion would be devoted to making some needed investments in the nation's future.

Although the nation needs to get its fiscal house in order, smaller deficits are not the only path to a stronger nation and a more competitive economy. Investments in children, in supporting low-wage working families, in improved transportation and communication, and in the kind of international assistance that may help to prevent terrorism over the longer run are examples of areas where the nation should arguably be investing more of its public funds.

Not only are these sound investments from a public policy perspective, but by incorporating them into a deficit reduction package, they make it somewhat more politically palatable. In short, this is not a big government spending plan. Instead, it is a reallocation of funds now spent on debt service to more productive purposes. However, none of this money could be spent until CBO certified that Congress had taken actions that reduced the deficit by the amount needed to produce the dividend.

What kinds of investments might be a good use of this dividend? A menu of possibilities can be found in several earlier books from the Budgeting for National Priorities project and in a new paper by Julia Isaacs that focuses on investments in the younger generation, almost all of which produce benefits that vastly exceed their costs.[38]

One example is investments in high-quality early childhood education for three- and four-year-olds with full federal subsidies for low-income children and partial subsidies for all other children at an estimated cost of $18 billion in 2009 and $97 billion over five years. Recent research suggests that even under the most conservative assumptions about the likely benefits of such programs they will still return more than $2 in benefits for every $1 in costs.[39]

Another very different example would be to provide additional international assistance to less developed nations as the nation's best bet for combating terrorism over the long run.[40]

Still a third example would be to pay for investments in health care research, electronic medical records, and covering the uninsured as a prelude to introducing a more comprehensive restructuring of the entire health care system as argued above.

The Politics of Deficit Reduction and Process Reforms that Could Help

In the current environment it has been almost as difficult to get agreement on *how* to proceed as on *what* to do. Although process reforms are no substitute for political leadership, they could help provide some political cover for the tough choices that need to be made and thus help to break the current stalemate on the budget deficit.

President Bush called for a bipartisan entitlement commission in his 2006 State of the Union address. Democrats have balked at participating primarily because taxes were not part of the deal. But many people are still hopeful that under the right circumstances such a group could play a positive role. It would need to have a well-respected set of co-chairs (similar to the 9-11 Commission), an equal number of Democrats and Republicans, a mandate to tackle not only entitlements but also tax reforms that could produce additional revenues, and a requirement that a supermajority of the members support its recommendations in order to insure bipartisan support. In addition, it would help if Congress and the president agreed to consider its recommendations on a fast-track basis, either accepting them or substituting a different set of proposals with comparable savings.[41]

A somewhat different procedure may be needed to deal with discretionary programs. As noted earlier, if the president were to propose and Congress were to enact a hard freeze in this area, the savings would be very large. The administration, along with the House and Senate Budget and Appropriations Committees, would be allowed to suggest program increases, but only if they found offsets either from other discretionary programs or from entitlements outside of the major three.

Whatever agreement can be achieved on reducing currently projected deficits, there is a need to maintain fiscal discipline and, above all, not to dig the hole any deeper. For these purposes, many people have suggested bringing back the kind of pay-as-you-go rules in addition to caps on discretionary spending that existed in the 1990s. Under such budget rules, no increase in entitlement spending or reduction in taxes can be enacted unless a way is found to pay for it.

Other process reforms are also worth considering. These include presenting the long-term costs of present commitments in budget documents, giving the president enhanced rescission authority (a modified line-item veto), creating a rainy day fund in lieu of using supplemental appropriations to fund emergencies, and tightening up on the definition of emergencies. Reforms could also include biennial budgeting and appropriations, automatic continuing resolutions when Congress fails to pass appropriations bills, and simplification of committee structures.

Conclusion

Deficits have declined modestly in recent years, but the impending retirement of the baby boom generation means a fiscal tsunami is on the horizon and elected officials must address how to bring the nation's books back into balance. This paper has offered a set of principles that can guide Congress and the president as they work toward restoring fiscal sanity, along with a package of solutions they can use to eliminate the deficit over the next five years and to establish fiscal sustainability for the long term.

Endnotes

1. According to the Congressional Budget Office (CBO), an increase in the growth rate of real GDP of one-half of one percent per year for each of the next five years would reduce the deficit by only $75 billion. See CBO, 2006c, appendix C, p. 123.
2. Authors' calculations assume a 20 percent down payment on a thirty-year fixed-rate mortgage that is compounded monthly. Housing value of $225,000 approximates the median sale price in 2005 for an existing single family home as reported by the Joint Center for Housing Studies at Harvard University, "The State of the Nation's Housing 2006" (www.jchs.harvard.edu/publications/markets/son2006/index.htm [October 2006]).
3. Authors' calculations from U.S. Treasury Department, "Major Foreign Holders of Treasury Securities," through August 15, 2006; U.S. Bureau of the Public Debt, "Monthly Statements of the Public Debt," through July 31, 2006.
4. Authors' calculations based upon: Census Bureau, 2006a, table 57; CBO, 2006b, table 1-3.
5. Capretta, 2007; Isaacs, 2007; Rivlin and Sawhill, 2004; Rivlin and Sawhill, 2005; Rogers, 2007; Tebbs, 2007.
6. CBO, 2006a.
7. Rosell, Furth, and Gantwerk, 2006.
8. From fiscal year 2002 to fiscal year 2006 (estimated), total federal spending grew at a faster inflation-adjusted rate than during any presidential administration since Lyndon Johnson. Authors' calculations from *Fiscal Year 2007 Budget of the United States Government*, tables 1.3, 4.1, and 8.2.
9. Authors' calculations from the CBO 2006b, tables 1-3, 1-8; Urban-Brookings Tax Policy Center, "Outlook Tables," August 2006; CBO, 2005c. Baseline assumptions regarding discretionary spending are explained in figure 2.
10. The offsets could come from either other discretionary programs or entitlement programs outside of the major three.
11. The total cuts were $115 billion but included some cuts in Social Security and Medicare, which are discussed later in this paper.
12. Capretta, 2007.
13. *Fiscal Year 2007 Budget of the United States Government*, table 3.2.
14. Tebbs, 2007. This paper utilizes a Congressional Budget Office projection of the resources necessary to fulfill the president's plans as articulated in the Future Years Defense Program and other official administration documents. Contingency spending for Iraq and Afghanistan is assumed to slowly phase down through 2010 and then stabilize at twenty to twenty-five billion fiscal year 2007 dollars per year.
15. Whatever one thinks about the merits of "carve-out" private accounts, they do not address the fiscal challenges facing the current system, and instead would only make matters worse for a number of decades since the diversion of payroll taxes into private accounts would leave the current system of benefits under-funded, requiring more borrowing to make up the difference.
16. Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds, 2006, p. 2.
17. A range of other possible solutions, and their fiscal implications, was described in a chapter by Peter R. Orszag and John B. Shoven in *Restoring Fiscal Sanity 2005*. Each of these authors has put forward a reasonable plan for closing the financing gap and the chapter also analyzes a range of other options. See Orszag and Shoven, 2005. Also see Liebman, MacGuineas, and Samwick, 2005; Pozen, Schieber, and Shoven, 2004.
18. Social Security Administration, "Contribution and Benefit Base," October 18, 2006 (www.ssa.gov/OACT/COLA/cbb.html).
19. Aaron and Orszag, 2004, p. 99.
20. CBO, 2006a; CBO, 2005b, box 1-3, p. 6.
21. Aaron and Newhouse, 2007.
22. Rivlin and Antos, 2007; Aaron and Meyer, 2005.
23. See Henry J. Aaron and Stuart M. Butler, "How Federalism Could Spur Bipartisan Action On The Uninsured," *Health Affairs*, Web Exclusive, March 31, 2004. However, the most notable example of state-based reform to date—the one being implemented in Massachusetts—contains little in the way of real cost containment and thus may not be an ideal model for the nation as a whole.
24. Rivlin and Antos, 2007
25. Census Bureau, 2006b.
26. The plan also calls for many of the other improvements described above such as investing more in research designed to assess the comparative effectiveness of different treatments, in preventive care, and in information technology or other improvements in the delivery of care. Center for American Progress, 2005.
27. Fuchs and Emanuel, 2005; Gluck, 2007.

28. Fuchs, 2000; Galston, 2007. We are also indebted to Stuart Butler and Maya MacGuineas for discussions of these issues as part of the Brookings-Heritage fiscal seminars.
29. Again, some of these cuts might be offset with reductions in domestic entitlement programs outside of Social Security, Medicare, and Medicaid.
30. In *Restoring Fiscal Sanity: How To Balance the Budget*, Brookings scholars offered a series of Medicare reforms designed to yield budgetary savings within a ten-year time frame. These proposals included increasing supplemental medical insurance premiums, reforming indirect teaching payments, reducing overpayments to managed care plans, reforming the Medicare payment formula for home health care, and reforming and reducing payments to disproportionate share providers. We assume a similar level of expenditure reduction is possible with these or other reforms. See Rivlin and Sawhill, 2004, pp. 103–108.
31. For a full discussion of these components and several variants, see Rogers, 2007.
32. President's Advisory Panel on Federal Tax Reform, 2005.
33. Gale and Steuerle, 2005, p. 108.
34. Exceptions could be retained for those with unusually high expenditures for, say medical care, charitable giving, or work-related expenses as a proportion of their income on the grounds that extraordinary expenses of this sort reduce one's tax-paying ability.
35. In conjunction with the carbon tax, the president and Congress could also move to eliminate harmful, inefficient, and redundant tax subsidies related to energy. These include, but are not limited to, expensing of exploration and development costs for extractive industries, corn-based ethanol subsidies, and the "percentage depletion" rules for extractive industries. These additional measures should recover $15 billion to $20 billion in revenue each year.
36. Joint Committee on Taxation, 2005.
37. In part the interest savings occur because of the reduction in the accumulation of debt, and in part because interest rates are likely to be lower in response to less borrowing. We conservatively include only the first of these effects.
38. Isaacs, 2007.
39. Isaacs, 2007.
40. The cost of achieving the millennium development goal of spending 0.7 percent of GDP on foreign assistance by 2015 is $79 billion. This goal was established with the aim of halving extreme poverty in developing countries.
41. Companion bills introduced in 2006 by Representative Frank Wolf (H.R. 5552) and Senator George Voinovich (S. 3491) contain many, but not all, of these provisions.

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