Time to Face Up
The growing urgency for tackling our nation’s debt
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Executive Summary

For more than a decade, the federal budget has been on an unsustainable path. The promised levels of federal benefits have been rising faster than federal revenues. This process inexorably leads to a projection of rising debt burdens that would at some point exceed the nation’s ability or willingness to pay.

This year the outlook is subtly but significantly worse.

In fiscal year 2020, two years sooner than in last year’s budget outlook—assuming the projections prove true—the budget will record the first $1 trillion deficit since the financial crisis of the last decade. And this is projected to be only the first of an endless string of deficits at $1 trillion and more.

Furthermore—again if the projections prove accurate, and if the nation’s temporary tax cuts are extended—the federal government’s debt to the public will exceed the nation’s collective income in 2028. In other words, the debt-to-GDP (gross domestic product) ratio will exceed 100 percent. This will be the highest our debt burden has been since the end of World War II.

Notably, both of these troubling or even terrifying indicators will occur in peacetime, without severe natural emergencies, and with the economy growing relatively comfortably. To be sure, passing such symbolic markers has no necessary substantive implication. However, the outlook for our financial markets and our economy is dependent upon market psychology. Seeing a good-times budget “baseline” with such strikingly adverse indicators suggests at least a substantial risk that markets could react adversely.

Why Our Nation’s Debt Is Growing Faster

The deterioration of the budget outlook over the last year comes from several sources. But the largest cause is the enactment of H.R. 1, the Tax Cuts and Jobs Act of 2017 (TCJA). Important to note is that the projections take the law at face value and assume that the most important tax cuts for households expire at the end of 2025. If those tax cuts are extended—as many of the Act’s staunchest advocates insist they will be—the cost in revenue will be substantially greater and would build a much higher 2028 deficit-and-debt platform from which the budget must leap into the long term.

Some observers believe that the TCJA will have positive “dynamic” or “supply-side” economic effects and will raise the necessary revenue to at least mitigate the budget problem. (The most optimistic economists tend to stop short of that, asserting only that the new law will not lose any revenue, and thus will not worsen last year’s outlook—which was itself unsustainable.) We are concerned at just how narrow a path this perspective attempts to traverse and just how dangerous a misstep off that path would be. Specifically, our budget situation has been rendered far more perilous simply by the accumulation of the public debt over almost the last two decades. The budget has become far more vulnerable to possible increases of market interest rates.
One more weakness in our current economic and fiscal environment is adverse demographics. The labor force now grows roughly 1 percentage point per year slower than just a few decades ago, and, so, productivity growth must accelerate by roughly 1 percentage point per year just to maintain recent economic growth rates. Achieving still higher growth rates would require even more productivity growth, at rates that most experts find highly unlikely. Postponing budget correction in anticipation of such rapid productivity growth would entail enormous economic risk.

Continuing on our current fiscal path is both costly and dangerous. Big budget deficits “crowd out” both private and public investment, slowing economic growth and diminishing living standards. Also, our fiscal authorities would gradually lose their policymaking flexibility with respect to any contingencies—national security crises, natural disasters, or impending recessions among them. But at the limit, large deficits can yield a genuine crisis. As federal debt and debt-service costs grow exponentially, they eventually will constitute a burden that the taxpayers collectively will be unable or unwilling to bear. Fearing this, our nation’s creditors will react with little warning. Markets will impose a fiscal adjustment on the federal government.

In short, the federal government must achieve a fiscal correction. But that correction will entail far less pain for the citizenry if it is imposed in a thoughtful way rather than in a panic reaction to a sudden shutdown of new credit. And the sooner that correction is undertaken, the milder it can be.

What is the bare minimum of deficit reduction that the markets might demand to remain on an even keel? To stop the growth of the ratio of the federal government’s debt to the nation’s GDP before we reach the 10-year horizon of the projection process would require cumulative policy savings (not counting debt-service savings) of approximately $3.5 trillion. CED believes that deficit reduction of this magnitude is the absolute minimum standard of fiscal responsibility for the Congress and the president at this time. Realistically, a budget remedy of that magnitude must be nonpartisan. Our budget problem has become so large that resolving it requires touching every element of the budget—including items that are strongly favored by one party or the other. Congress should start by focusing on three key areas in which savings are crucial:

**Health care** costs are growing faster than any other operating programs, with the greatest growth in Medicare. Medicare suffers from adverse demographics including population aging and lower birthrates, compounded strongly by “excess cost growth” in the delivery of care to each individual beneficiary. CED believes that a more market-based system is the only sustainable approach. The nation must align the incentives facing consumers, providers, and insurance plans so that they all seek lower-cost delivery of high-quality care in their own interests. Building on refundable tax credits to each household, including both seniors and working-age adults, we would achieve cost-responsible consumer choice among private health care plans. People would save money if they chose plans that deliver high-quality care at lower cost. And providers and insurance plans would need to offer such cost-efficient care to succeed in the marketplace.

**Social Security** is an important issue but of a lesser weight and complexity than health care. Very low-income retirees, especially those with career interruptions (including married women), need higher rather than lower
benefits. The current Social Security minimum benefit, which was intended to aid such seniors, should provide greater support. The maximum amount of taxable earnings should be gradually increased to expand the tax base to 90 percent of all earnings, but Social Security should not “raise the cap” and then refuse to pay benefits on the additional taxable earnings. Americans who remain able to work can help themselves and Social Security by working longer, but many cannot; the earnings formula should be altered not to require more years of work but, rather, to reduce benefits modestly for those who choose to retire early. The benefit-determination formula should reduce benefits somewhat for those with higher earnings. More affluent seniors, but not those with lower incomes, should pay income taxes on all of their benefits. And inflation protection for beneficiaries of Social Security (and all other indexed spending and tax programs) should be based on the “chain-weighted” consumer price index, which takes appropriate account of the ability of consumers to substitute goods and services whose prices are relatively stable for other items that are rising more rapidly in price. Lawmakers should assemble a combination of these steps with the goal to assure that in 75 years (approximately one typical lifetime), the Social Security program has a cash reserve that covers one year of total benefits. This would re-establish the “pay-as-you-go” rationale that has served us (and Social Security) well.

Revenue must be an important part of deficit reduction, especially if the economic growth benefits of the 2017 tax cut do not materialize. CED has recommended true tax reform whose objective should be to maintain as much as possible of the incentive benefit of the 2017 tax cuts, while reducing or even eliminating their revenue cost. It would repeal preferential tax provisions, simplify tax filing for households, reduce tax rates, and reset the federal statutory corporate income tax rate to leave the US system competitive with our international trade partners but recapture most of the lost revenue. It is less than ideal to change the federal income tax twice within a short period of time, but it is far worse to allow the federal budget deficit and the public debt to explode.

We believe that the nation has courted fiscal crisis for far too long, and that we truly have come to the point where the forces of inertia are sufficient to damage our nation irreparably. US and world financial markets likely will fail to recognize the problem until the process of deterioration has gone well past the point of no return. When we all recognize the crisis, it already will be too late.

We implore our nation’s elected policymakers to face up to the building crisis that many of those leaders acknowledge—but only behind closed doors. History will not accept the excuses of partisan politics—that “we would have fulfilled our responsibilities if only the electorate had been wise enough to give our faction total control.” We are running out of time to arrest the resulting inexorably mounting debt.

If the two political parties will cooperate to take the necessary but painful steps together, then at least the political blame for imposing that pain can be shared and defused. Without action soon, the blame will fall on all with full force.
Introduction

As of this moment, this nation’s debt burden (its debt held by the public, as a percentage of the gross domestic product, or GDP) is growing unsustainably—and neither our elected policymakers nor their electorates evidence any concern. It is as if the proverbial boy has grown hoarse crying “wolf,” and the townspeople have turned away—while the wolf lies menacingly just over the horizon.

Is the debt threat just a fairy tale? Many pundits and talking heads clearly think so. And for the voters, the notion that “deficits don’t matter” is clearly comforting. It facilitates all manner of pleasurable activities and, at least, postpones toil and pain.

The Trustees of the Committee for Economic Development (CED) fear that the old-fashioned truths are still true. They are, to be sure, seemingly out of place within a new and radically changed environment. The economy is, for this moment, growing satisfactorily. Interest rates are rising, but fairly slowly, and at least in part because growth is reasonably good. But we believe that the old truths, these laws of physics, still apply, and if ignored for too long they will impose their pain in an enduring fashion. Acceptable growth and interest rates at one moment do not guarantee financial stability ever after. Our elected policymakers need to prepare for the arrival of the wolf. Its coming may take some time, but it will appear—because we will tempt it to if we do not guard the nation.

Perhaps the wolf metaphor is characteristic of our nation’s awareness problem. Our leaders—and their leaders, the voters—seem to think of the threat only in terms of an as yet hypothetical cataclysm. But while the wolf lingers just out of sight, the termites gnaw at the town walls. The termites by themselves can threaten our safety and our prosperity. If the wolf arrives as the walls collapse, we are truly undone.

The Nature of the Problem

Why call attention to the nation’s fiscal imbalance now? The country hasn’t experienced a colossal explosion, and to many actors in this economy, the budget outlook might seem relatively unchanged in the recent past, with financial markets apparently stable going forward. At a fairly broad level of examination, that might appear to be true. But we fear some subtle changes of inflection that without purposeful action will compound themselves over time.

Not quite one year ago, the federal budget already was set on an unsustainable path. Some analysts warned of a “structural mismatch” between the nation’s outlays and its revenues. The aging of the population, including both the retirement of the oversized baby-boom generation and the lengthening lifespans of most of the nation’s demographic groups, raises the promised levels of federal benefits faster than productivity and workforce growth raise federal revenues. And the resulting added debt raises debt-service costs, perpetuating and even compounding the imbalance. This process inexorably leads to a projection of rising debt burdens that would at some point exceed the nation’s ability or willingness to pay.
Starting from the unsustainable platform of one year ago, the president and Congress last year took actions that were, according to conventional economic analysis, adverse—that will make the outlook deteriorate even faster. Charts 1 through 3 illustrate the estimated result. As of one year ago, over the then-current 10-year budget horizon, the cumulative budget deficit was projected to be $10.1 trillion, and by the year 2022, the nation was projected again to see a deficit of the once-unthinkable amount of $1.0 trillion. The debt held by the public was projected to rise from 77.0 percent of the GDP as of the end of FY 2016 to 91.2 percent of GDP as of the end of FY 2027, and the nation’s debt-service cost was expected to more than double, from 1.3 percent of GDP to 2.9 percent of GDP over those 10 years.

But today, less than one year later, the comparable cumulative deficit projection has reached $12.4 trillion—$2.3 trillion higher. In fiscal year 2020, two years sooner, the deficit will again reach $1 trillion, and annual deficits will rise in almost every succeeding year, reaching $1.5 trillion in 2028. We will have trillion-dollar deficits as far as the eye can see—or more precisely, until the deficit inevitably exceeds $2 trillion. By the end of 2028, the debt held by the public is now projected to reach 96.2 percent of the GDP, and the nation’s annual debt-service obligations are now projected to grow over 10 years to 3.1 percent of GDP. Just 27 years earlier, at the end of FY 2001, the public debt was only 31.4 percent of the GDP, and it, and the debt in dollar terms for that matter, were falling. Since that time, we have reversed course, and crossed and left far behind the 60-percent-of-GDP prudential limit that is recognized by a broad range of economists (and that is imposed by the Maastricht Treaty on member nations of the European Monetary Union).

**Chart 1**

**US Budget Deficit**

**Billions of dollars**

Source: The Budget and Economic Outlook: 2018 to 2028 (April 2018) and An Update to the Budget and Economic Outlook: 2017 to 2027 (June 2017), Congressional Budget Office (CBO); CED calculations.
Chart 2
Debt Held by Public
Percent of GDP

Source: The Budget and Economic Outlook: 2018 to 2028 (April 2018) and An Update to the Budget and Economic Outlook: 2017 to 2027 (June 2017), Congressional Budget Office (CBO); CED calculations.

Chart 3
Debt Service Cost
Percent of GDP

Source: The Budget and Economic Outlook: 2018 to 2028 (April 2018) and An Update to the Budget and Economic Outlook: 2017 to 2027 (June 2017), Congressional Budget Office (CBO); CED calculations.
The Perilous Path Forged by the Tax Cuts and Jobs Act

The deterioration of the budget outlook over the last year comes from several sources. But the largest cause is the enactment of H.R. 1, the Tax Cuts and Jobs Act of 2017 (TCJA). The tax cuts plus their debt-service cost add $1.7 trillion, or almost 79 percent of the total worsening from legislative sources (not including debt service), to the 10-year budget deficit projection. Important to note is that these figures take the law at face value and assume that the most important tax cuts for households expire at the end of 2025. If those tax cuts are extended—as many of the Act’s staunchest advocates insist they will be—the cost in revenue will be substantially greater. CBO estimates separately from its baseline forecast that extending those tax cuts will add almost $0.8 trillion to the cumulative 10-year deficit not counting the additional debt-service cost. This is almost half again as much as the measured 10-year cost of the tax cut, but more significantly, it is an almost $300 billion increase in the revenue cost in the single year of 2028. (Because of the expirations of the key tax cut provisions, the measured cost of the tax cut in 2028 is virtually zero.) Extending the tax cuts would build a much higher deficit-and-debt platform from which the budget must leap into the long term. The deficit in 2028 will be $1.9 trillion, instead of $1.5 trillion if the tax cuts expire; the debt held by the public will be $29.9 trillion, instead of $28.7 trillion; and that debt will equal a disquieting 100.5 percent of GDP, instead of “only” 96.2 percent.

A secondary cause of the budget worsening was the bipartisan agreement to increase the statutory caps on annual appropriations—“discretionary” spending, which funds the federal agency operations and keeps the government from “shutdown”—for fiscal years 2018 and 2019. Some members of Congress wanted more spending on defense, while others wanted more spending for nondefense functions, and, so, they compromised (as often happens) by taking both. These higher appropriations caps could prove to be a jumping-off point to future deficit increases if Congress raises the remaining caps for fiscal years 2020 and 2021. Other economic and technical developments contributed as well.

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1 One important tax cut for businesses—expensing of the costs of investments rather than depreciation over several years—expires at the end of 2022. Assuming that this provision will expire is also perhaps optimistic. This tax cut was made temporary so that businesses would accelerate making investments before it expires, which is logical. However, its expiration will be viewed as a tax increase by the affected large businesses, which will likely argue for its extension, probably on the ground that its expiration will lead to a reduction of investment that will harm the economy. We have a political model in a similar provision, called Section 179, limited to smaller businesses. Section 179 was originally enacted in 1958 as an incentive for business investment. In 2003, the amount of investment eligible for expensing was temporarily increased (through 2005), with an expiration date to induce businesses to invest while they had the temporary tax benefit. In 2004, this incentive was extended through 2007. In 2005, the incentive was extended through 2009. In 2007, the temporary maximum amount of investment eligible for expensing was temporarily increased through 2010. In 2008, the maximum amount of investment was increased still further, but only through that year, after which the temporary maximum would revert to its previous temporary level. In 2009, the 2008 temporary increase was extended through 2009. In 2010, the 2009 temporary increase was extended through 2011. In 2011, the 2010 temporary increase was retroactively increased for 2012, and continued through 2013. In 2014, the 2013 temporary increase was extended once again, through 2014. In 2015, the then-expiring incentive was made permanent. Thus, although it is impossible to know the future, the temporary unlimited expensing incentive in the TCJA will not necessarily expire on schedule. For purposes of this statement, we consider expensing as likely to be extended permanently. We also include in our estimates the other, smaller temporary tax cuts remaining in the law.
Tax Cuts, Interest Rates, and Demand: Which Affects Growth Most?

Although CBO’s budget projections are the standard resource for experts in public finance, they are not accepted universally. These estimates are prepared under the conventional methodologies that have been used by the legislative (CBO) and executive (OMB) budget offices for many years. That is, they are generally characterized as “static” estimates, which in the interpretation of some “do not take into account the effects of budget (or particularly tax) policy on the economy.” (CBO does undertake “dynamic” analysis to capture behavioral change.) Some find such budget estimates unsatisfying, or even frustrating. Many such observers believe that changes in tax policy (in particular) can have profound effects on economic activity, and for many of those persons, the TCJA would be the quintessential example of a tax cut with positive “dynamic” or “supply-side” economic effects.

The US tax system prior to the TCJA was widely recognized as deficient on many scores. Despite differences of opinion, there was some measure of consensus. Many observers would agree that the tax treatment of US multinational corporations was out of step with that imposed by virtually all other nations on their multinational firms. Other critics believe that our tax system did not raise sufficient revenue, contributing (along with other issues on the spending side of the budget) to our large budget deficits and mounting public debt problem. Putting these two allegations together, some would argue that making the US tax system more hospitable to multinational business would accelerate economic growth and thereby raise the necessary revenue to at least mitigate the budget problem.

For some optimistic observers, the TCJA on its own is enough to augur faster economic growth for the foreseeable future. The lower statutory corporate tax rate will make the United States a more attractive place to locate production, yielding more jobs and income. The temporary (through 2022) expensing of new investment will provide a reason to spend on equipment in that window (and new equipment is often thought to “embody” new technology and, therefore, to cause faster productivity growth).

Some other optimistic perspectives lean on, but do not rest entirely upon, the TCJA. One such view is that a continuing transformation of the economy to a greater utilization of technology will lead to faster economic growth. This thought rings true with many, but it does not explain why that trend of several decades’ standing has not helped the budget for the last 10 years but is expected to do so suddenly now.

Yet another perspective might answer that question. This view is that the slow growth of demand following the financial crisis left firms with substantial excess capacity and therefore little reason to invest—even in productivity-enhancing equipment. With less demand, firms had no need to try to squeeze every last bit of available output from their operations. So from this perspective, the new, “hotter” economy, driven in part by the push of the TCJA’s tax cuts to increase consumption spending—along with the lower unemployment rate today—will force firms to try everything possible to

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increase efficiency and productivity to increase output and cut costs. In particular, low unemployment will drive firms to use technology to replace labor—which is the very definition of productivity improvement. That will make real for the federal budget the longstanding promise of greater economic growth and tax revenues through technology. (Even this promising image is not necessarily reality, however. An alternative perspective would be that firms under the pressure of the financial crisis surely were struggling to save every penny of cost just to survive. The flip side of this coin would be that today’s better-off customers would be willing to pay more, and, therefore, that there would be less, not more, pressure on productivity.)

Policy observers and lawmakers have many different visions of future productivity and economic growth, often pointing toward faster income growth and better budget outcomes than heretofore projected. But it is important to understand just how narrow a path this perspective attempts to traverse and just how dangerous a misstep off that path would be. Specifically, our budget situation has been rendered far more perilous simply by the accumulation of the public debt over the last nearly two decades, and the resulting arithmetic is unyielding.

How interest rates cancel out (some) growth

Interest rates are determined by many factors (including Federal Reserve policy), but in general, faster economic growth is associated with higher interest rates. This is true for at least two reasons. First, faster growth generally means that markets are tighter, which gives sellers more power to increase prices. The resulting faster inflation leads lenders to seek higher returns to protect themselves from higher future prices, and also encourages borrowers to accept higher interest rates, because they will pay off their loans with cheaper future dollars. (The hotter the US product and services markets become, the greater the prospects for inflation become, and the greater the likelihood that the Federal Reserve will act preemptively to head off an acceleration of inflation by raising interest rates.) And second, faster growth means that the rate of return on physical and intangible capital investments is higher, and so investors are willing to pay higher interest rates to access available funds to finance their now-more-profitable planned investments.

In short, if some observers were to argue that the budget authorities have underestimated future economic growth caused by the TCJA, then those same observers ought to accept that, for the same reasons, the budget authorities might well have underestimated interest rates too.

So suppose that the optimists about the TCJA are correct, and it leads to a 1-percentage-point increase in economic growth, for the reasons outlined above—the theory being that better treatment of US multinational firms might increase US economic growth and tax revenues. The tax cut might give an upward jolt to consumer spending, and in so doing might enliven the economy’s “animal spirits,” which were so thoroughly dampened by the pain of the financial crisis. But suppose also, as a result, that the faster growth leads to a bidding up of interest rates by 1 percentage point. What would be the consequences for the budget?
If Washington had run this policy exercise and achieved this outcome 19 years ago, in 1999, the one percentage point increase in growth—considered separately—would have reduced the federal budget deficit by just over 3 percent of GDP after 10 years, according to the contemporary estimates of the CBO (Chart 4). The increase in interest rates would have consumed some of that budget improvement, but barely rounding above zero—less than 0.1 percent of GDP. So on net, the growth improvement would have netted about 3 percent of GDP in budget improvement per year after 10 years. Not bad.

But we find ourselves in 2018, not 1999. Even one year ago, before Congress passed the TCJA, CBO estimated that a 1 percentage point increase in productivity growth\(^3\) would improve the budget outcome, 10 years out, by only 2 percent of GDP—so somewhat less than it did in 1999 (Chart 5). But probably more important—and far less widely appreciated—a commensurate 1 percentage point increase in interest rates would have worsened the budget far more than before—by almost 1 percent of GDP after the same 10 years, wiping out virtually half of the extra growth’s benefit to the budget. With present-day interest rates starting from a base so low, they could certainly increase even more substantially in the years ahead.

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\(^3\) CBO changed its reporting convention for these “rule-of-thumb” estimates of the effects of the economy on the budget to reflect changes in productivity, not output in isolation. This makes the example cited here even more telling, because along with the increase in productivity, CBO assumes both slower inflation and lower interest rates.
The unavoidable conclusion of this thought exercise is that the federal government’s finances have become far more vulnerable to possible increases of market interest rates—and that even potentially beneficial policy changes could be undone by adverse reactions in the money markets.

A Growing Risk: Why Interest Rates Matter More Now

The reason for this dramatic shift is quite clear. In 2000, when the nation was contemplating its second exercise of substantial tax cuts in 20 years, the budget was unprecedentedly strong. The federal government was running annual budget surpluses and was literally buying—rather than selling—bonds in the open market. The public debt burden had fallen from about 48 percent to about 31 percent of GDP in eight years. And in fact, if policy had not changed, the budget outlook was that the public debt would have been virtually paid off within a decade. Under those circumstances, it was no great surprise that interest rates were becoming a nonfactor in the federal budget picture. The power of compound interest was converting from our enemy into our friend.

In contrast, today, as a result of changes in policy plus, especially, the fallout of the financial crisis, the debt burden has risen to about 78 percent of GDP. The budget deficit, which had fallen from its colossal peaks in the worst years of the financial crisis, is again rising unsustainably. Our elected policymakers seek to extricate themselves from budget-based political standoffs by spreading money all across the ideological

Chart 5
Estimated Effects of a 1-Percentage-Point Increase in Productivity Growth and in Interest Rates
Decrease in deficit as a percent of GDP, as of January 2017

Source: The Budget and Economic Outlook: 2017 to 2027 (January 2017), Congressional Budget Office (CBO); CED calculations.
spectrum—defense, domestic; appropriations, entitlements; and tax cuts. In this environment, interest rates acquire ever-increasing leverage over our fiscal and economic future—as is evident from the estimates presented above.

Some might object to this comparison on the ground that today is a very different financial and economic environment than 2000. But upon careful reflection, that is precisely the point. In 2000, the government’s financial status was far more robust and resilient. Today, the consequences of any fiscal misstep will be far more serious. So as much as some of the structural changes in the TCJA may have been warranted on their own account, the failure to remain within any reasonable budgetary bounds will tend to undermine any ultimate economic benefits.

And consider one more weakness in our current economic and fiscal environment, which arises from demography. The first wave of the nation’s enlarged baby-boom generation has retired, but almost two-thirds of that group is still in the process of exiting the labor force. Because of slowing birth rates following the boomer years, new entries to the labor force are fewer relative to the number of new retirees. Economic growth is essentially the sum of labor force growth and productivity growth. With the labor force growing roughly 1 percentage point per year slower than the average earlier in the post-World War II era, productivity growth must accelerate by roughly 1 percentage point per year just to maintain historical economic growth rates. That 1 percentage point acceleration of productivity growth would be a massive improvement over recent levels.

Some optimists would go even further and assume that output growth can rise to the approximately 4.0 percent per year that we enjoyed in the early post-World War II years. But that would require a truly massive increase in productivity growth to offset the drop from the much higher workforce growth of the post-War era (Chart 6).

With all the confidence in the world in the TCJA and the new technologies being employed today, it would be a striking achievement if US economic growth could overcome the demographic headwinds and power tax revenues and the budget all of the way out of the danger zone. And in keeping with our theme of unnecessary risk, the consequences of betting on such robust growth but then coming up snake eyes would be somewhere in the range from painful to catastrophic, as we explain below.

**Why Worry About Growing Deficits Now?**

Many bad personal habits result in a slow—sometimes almost imperceptible—diminution of the quality of life. Eventually—depending on many other factors, including genetics, the living environment, and others—the bad behavior might lead to a catastrophic event. But it is in the nature of human health that prediction of an ultimate catastrophe is subject to enormous error—much greater than the potential error in an estimate of the slow diminution of capability that almost inevitably follows from such bad habits.

Likewise for the federal government’s fiscal condition. Big budget deficits “crowd out” both private and public investment, slowing economic growth and diminishing living standards. Greater federal credit demands, satisfied through sales of bonds at auction, absorb savings that otherwise could go to potentially productivity-enhancing private investment. The subsequent debt-service costs displace federal spending on
infrastructure, education and research that are needed by the private sector to undergird its own investment. Over time, the resulting neglect will, with certainty, slow economic growth and the advance of living standards. This is not so much a “risk” as a known cost of malfeasance. It is one risky, painful scenario that will play itself out if we fail to address our growing debt.

Many pooh-pooh the notion that interest rates will rise, choking off private and public investment. They point to a past half-dozen years of low and stable interest rates in the presence of large budget deficits as proof that the future will always mirror the recent past. And they point to more than three decades of concern over high deficits and exponentially rising debt burdens without any serious market reaction as proof that “deficits don’t matter,” and that we can “just grow out of it.”

To be sure, central bankers over much of the developed world—and notably here in the United States—have taken much of the wind out of inflation’s sails by keeping price expectations anchored through steady policies. The United States will not face a debt crisis so long as our creditors around the world are willing to trust unlimited sums to “the best-looking horse in the glue factory,” as some actors in the financial markets refer to our federal government. But those days may not go on forever. Even while they do, the resulting rising federal debt burden will squeeze US investment—public and private—ever tighter. The heart attack may be postponed, but the economy will wheeze along at a slower and slower rate, rendering our quality of life ever more unsatisfying—and
our Treasury ever more worrying to our creditors. Meanwhile, policymakers of different ideologies will wonder why their supply-side-spending and supply-side-tax-cut silver bullets keep misfiring.

A troubling fallout of this process would be that our fiscal authorities would gradually lose their policymaking flexibility with respect to any contingencies—national security crises, natural disasters, impending recession—that might arise. The nation's debt burden could become heavy enough that it would preclude a vigorous policy response by the president or Congress to a costly emergency. The world leader could be rendered powerless by shaken credit markets—and therefore no longer a leader.

Those are the high-probability risks—ranging from near-certainties to likely consequences of the nation continuing its bad behavior. But at the limit, this process can yield a genuine crisis. As federal debt and debt-service costs grow exponentially as a share of the nation's GDP, they eventually will constitute a burden that the taxpayers collectively are unable or unwilling to bear—or that our nation's creditors perceive will not be serviced in a timely manner.

How High Can the Deficit Get Before Markets Rebel?

Economics is a behavioral science, dependent upon uncoordinated but collective decisions of crowds of individuals that are as indeterminable as hypotheticals in psychology, for example. Some critics might ask economists to fall back on history to point to a precise future tipping point when markets will reject US Treasury securities. But (perhaps fortunately) history provides very few examples of world superpowers vastly overspending their means. (The Roman Empire would likely be the clearest instance, but its history sheds little light on the workings of instantaneous global electronic commerce and communications.)

Some would leap from this lack of hard science to the conclusion that we will never experience a national debt crisis—that “deficits don’t matter.” That reassuring and convenient conviction is, again unfortunately, almost certainly false. Take that nostrum to its absurd extreme. If the nation’s debt were somehow allowed to continue to grow exponentially and without limit, then eventually the federal government’s annual debt service cost would come to exceed the economy’s GDP. Surely, our creditors would take that level of debt and debt service as a signal that further lending to the federal government might be unwise.

The “deficits-don’t-matter” caucus likely would react that such an example is totally unrealistic and absurd. It is—because with absolute certainty, lending to the federal government would have been cut off by the financial markets far short of that point. In other words, there is indeed a wall out there—the economics profession simply does not, and cannot, know precisely where it is. But the cautionary lesson of this reductio ad absurdum is that by the time markets react at some point short of that absurd limit, it will be far too late—a collective panic reaction will impose unspeakable costs on our economy.
How a Deficit Crisis Would Play Out

What, precisely, will those costs be, and how will they be felt? Again, there has never been such an episode precisely fitting that description, and so economics—even aided by history—cannot offer a precise answer. However, it is clear that the result will be an instance of collective panic. Investors who begin to sense among their fellows a fear of plunging Treasury security prices (that is, rising interest rates) will be like theater attendees who begin to smell smoke. Sensing the consequences, no one will want to be the last person out the door. And so people will not walk toward the exits in an orderly fashion; they will run.

This crisis most likely will occur with little warning. For a model, think of the onset of the 2008 financial crisis. The nation awoke on a Monday morning to discover that a financial meltdown might or might not occur when the markets opened, depending on the skill of financial policymakers and the cooperation of elected officials and leaders of private institutions. Continued fiscal malfeasance and nonfeasance could leave the nation similarly exposed. But with one important difference: continued fiscal misbehavior could tie the hands of our elected and appointed policymakers to the extent that they could not exercise the control that spared the nation of much of the potential harm in 2008.

At that point, markets will impose a fiscal adjustment on the federal government. Investors will react first by refusing to buy Treasury securities—that is, denying credit. Finding itself with legally binding payment commitments and with far too little cash to honor them, the nation will be forced to bring its spending and its revenues immediately into closer alignment. In such a crisis, with a very limited time to achieve large adjustments in the federal budget, much of the weight of adjustment inevitably will fall on higher taxes. Spending reductions that lawmakers can impose quickly include reductions in the large benefit programs—Social Security, Medicare, and Medicaid. Senior citizens will rebel at that notion.

Instead, some elected policymakers would surely propose shrinking “the size of government” and would consider that preferable. But sudden, massive layoffs of federal employees face significant legal impediments. And to the extent that significant cost savings in that arena are pursued on short order, it is worth recalling that the vast majority of federal employees work in the uniformed military (roughly 1.3 million, typically tallied separately); civilian positions in the Department of Defense (35 percent of the civilian total federal full-time-equivalent employment of not quite 2.1 million, not including the Postal Service); veterans health care and other service delivery (17 percent); homeland security (9 percent); and scattered personnel in Social Security administrative offices, Internal Revenue Service customer service, and law enforcement (as much as 18 percent of total civilian employment). In short, the vast majority of federal government employees are engaged in activities that would be missed, and whose sudden disruption would be counterproductive, highly painful to the electorate, or both.

To the extent that investors return to the Treasury securities market after such a panic, it will be upon solid reassurances that their risk has been reduced. Beyond higher taxes and lower spending, that means higher interest rates (plus, for foreign investors, a lower-valued dollar that is less likely to decline further in the near future).
In sum, the US budget problem continues to worsen, urged along by policy steps such as the 2017 tax cuts and the 2018–2019 appropriations deal. Elected policymakers show no sign of awareness of the potential seriousness of this deteriorating budget outlook and the risk that it will begin to feed on itself to the detriment of our economy and our prosperity. Perhaps the growing market turbulence since February of 2018 will shake our elected policymakers into consciousness, but they have yet to react thus far. Overcoming this awareness barrier will be a steep climb. But it is a necessary climb as well.

The essence of the problem, as we have noted before, is risk—the risk of continuing slow growth, eroding our nation’s prosperity, world leadership, and capacity to react to economic, national security and natural emergencies—leading inexorably toward an eventual financial crisis. One argument heard last year was that the budget problem would never be solved without faster economic growth, and that therefore there was nothing to lose in a speculative tax-cut experiment. But there is in fact much left to lose. If that experiment fails, the nation’s fiscal state will be even more perilous. A safer strategy would be to take more-prudent, lower-risk steps toward moving the budget in the right direction.

In short, the federal government must achieve a fiscal correction. But that correction will entail far less pain for the citizenry if lawmakers impose it in a thoughtful way rather than in a panic reaction to a sudden shutdown of new credit. And for that matter, the sooner that correction is undertaken, the milder it can be.

**How Much in Tax Increases and Spending Cuts Will It Take?**

Future budget outcomes will depend substantially on the economy. No one knows the future, and economic forecasting is among the most difficult arts. Most economic forecasters will readily admit that the one thing they know for certain about their forecasts is that they will be wrong. But it is impossible to create a budget strategy without an economic forecast. A prudent forecast will, at the very least, prevent underestimating the problem, which could cause the financial markets to question the federal government’s resolve and, therefore, to shun US Treasury securities in the marketplace.

The CBO has a long history of creating middle-of-the-road economic forecasts as a basis for budget planning. Its current forecast is built on a reasonable analysis of US economic prospects, including, importantly, the role of changing demographics in the prospects for our nation’s growth. CBO also links its economic forecast with the budget “baseline”—that is, future spending and revenues if the current law is left unchanged. This combined economic and budget outlook is created expressly to give Congress a yardstick by which to measure alternative budget policies, and, therefore, we use CBO’s outlook to assess the problem.

How much must we do to take our budget outlook out of danger? What is the bare minimum that the vast majority of policy analysts would demand? One idea: Before we reach the 10-year policy horizon—the end of the budget “window” as budgeteers typically refer to it—stop the growth of the ratio of the federal government’s debt to the nation’s GDP and make it begin to fall. Our debt burden expressed in these terms is already far too high. Some budget followers therefore would be far more ambitious. And as a first preference, so would we.
But the clear direction of the policy process in Washington is to do absolutely nothing. We think of our standard as a bare minimum, something that no elected policymaker on principle could refuse. No reasonable person could deny that we must bend the debt-burden curve downward. Continued increases inevitably and inarguably lead to disaster. If Washington cannot agree to take this step, then we cannot ultimately achieve a truly responsible budget posture. We believe that the business community could present this standard to our elected policymakers and demand action.

Furthermore, lowering the debt-to-GDP ratio is not merely damage avoidance. Many economists and budget experts would likely contend that sufficient action to achieve our objective would improve national saving and thereby facilitate investment and economic growth—aiding in the objectives of the TCJA. Financial market participants might add that any action to make the budget sustainable would send a calming signal and would justify interest rates lower than otherwise, thereby reinforcing the deficit reduction through still-lower debt-service costs.

The CBO budget outlook and economic assumptions can show the amount of deficit reduction that would turn the rising public debt burden (expressed as a percentage of the GDP) downward by the end of the 10-year horizon. One estimating approach would be to create year-by-year targets for deficit reduction, with policy savings (exclusive of debt-service savings) that would grow at approximately the same rate as the most recent deficit-reduction action taken by the Congress and the president in 1997. Those savings could be scaled up or down to find the minimum amount that would slow the growth of the debt-to-GDP ratio until it would finally begin to decline by the end of the 10-year budget window. Again, to be clear, this would constitute a fair absolute-minimum standard for the deficit-reduction program that is clearly called for by the current unsustainable budget outlook.

What we find through this straw-man calculation is that Congress and the president would need to enact cumulative policy savings (again, not counting debt-service savings) of approximately $3.5 trillion over the next 10 years (starting in fiscal year 2019, because fiscal year 2018 is already half over) to essentially stabilize the debt burden over the last four years of the current budget horizon. (Note that these savings would be in addition to the savings that would be achieved by letting the temporary tax cuts expire.) The savings would rise to about 1.8 percent of the GDP in each of the last three years, which is about half again as much as the total effect of the provisions of the actual 1997 bipartisan budget agreement in its final year. Under the new CBO baseline, but assuming that expiring tax cuts in the current law are reenacted, the deficit in fiscal year 2028 would be $1.9 trillion; the public debt at the end of the fiscal year would be $29.9 trillion, and that debt would equal 100.5 percent of the GDP—and it would be rising (from 97.5 percent of the GDP at the end of fiscal year 2027). With deficit reduction in the amount established here as a standard for behavior for Congress and the president, the deficit in fiscal year
2028 would be $0.9 trillion (having never reached $1.0 trillion); the public debt at the end of the fiscal year would be $25.1 trillion, and that debt would equal 84.3 percent of the GDP. All substantial, and far too high, but, crucially, the debt relative to the GDP would be falling (fractionally, from a slightly higher 84.3 percent of the GDP at the end of fiscal year 2025).

Again, given the unprecedentedly perilous state of the nation’s finances, and the potential consequences of continued unsustainable growth of the public debt burden (expressed as a percentage of the GDP), CED believes that deficit reduction in the magnitude that we posit above is the absolute minimum standard of fiscal responsibility for the Congress and the president at this time. We further believe that the vast majority of trained economists and budget analysts would say that the Congress and the Administration should agree to this amount of deficit reduction or more.

**How Can We Do It?**

Many observers of the federal budget believe that solving the deficit problem by cutting spending would be easy. The federal bureaucracy is huge, this view holds, and merely shaving off 1 or 2 percent of appropriations each year should have no perceptible consequences and would save a lot of money. We fear, however, that the old economist joke is pertinent on this question: If it were easy, someone would have done it long ago.

Rather, experience indicates that there are no easy but meaningfully large savings to be found in the budget. Substantial savings must be found, to be sure—and they will be, either through leadership or imposed in crisis. But the idea that sufficient spending cuts would be imperceptible is not supported by the facts. Several age-old truisms apply.

Every dollar of spending was enacted by a majority of members of Congress and approved by the president. And every dollar of spending remains in the budget because a significant number of members of Congress want it there. It is far from unusual for advocates of spending cuts in concept to differ strongly over precisely which spending to cut in actuality—based on the particular interests that are important to them and their constituents.

Every dollar of spending is someone’s income. And every dollar of taxes reduces someone’s income. The politics of taxation remains toxic.

The appropriations agreement reached in February of this year increased amounts of spending in both defense and domestic categories. Many members of Congress favored both. And as demonstrated by the fact that the deal achieved a majority in Congress, many of those who favored the defense spending only felt strongly enough to accept increases in domestic spending in exchange. And many of those who favored only the domestic spending increases were equally willing to accept the increases in defense spending to get what they wanted.

It is arguable—persuasively—that the spending in that agreement, both defense and domestic, is highly valuable. The problem is that it may not be affordable. Our accumulation of debt over the last two decades has limited our options and our flexibility to respond to such needs.
Realistically, a meaningful budget remedy must be nonpartisan. Our budget problem has become so large that it can be addressed only by touching every element of the budget—including items that are strongly favored by one party or the other. Addressing all of those partisan priorities will require acceptance of shared sacrifice. So it is likely that even with a resort to parliamentary “reconciliation” legislation to allow passage with a simple majority in the Senate, that simple majority will need to include votes from both parties if adequate deficit reduction is to be achieved.

Even though this analysis sets a low bar for the minimum action required by Washington, the budget savings just outlined would be enormous—once more, half again the budget savings (ignoring the compensating tax cuts) in the 1997 bipartisan budget agreement. This will require careful targeting on the parts of the budget that are responsible for spending growth. It will be difficult, because the actual source of the problem is often misunderstood.

**Why Appropriations Are Not the Problem**

Washington’s annual soap opera of late has been a months-long struggle over the annual appropriations bills to fund the various government agencies—and avert a “shutdown.” From the now-routine rhetoric surrounding these occasions, you would think that the fate of the nation’s finances hung on the outcome. But in fact, the annual appropriations—the so-called “discretionary” spending in the budget—has been a generally declining share of the budget and of the economy for decades (see Chart 7). It has rather been the “mandatory,” or “entitlement,” part of the budget that has been growing, and has been the source of the growing deficits and the mounting debt.

![Chart 7: Historical Spending (Percent of GDP) and Revenue](chart.png)

*Source: Historical Tables, Table 8.4 and Table 1.2, Office of Management and Budget.*
And that trend will continue or even accelerate (see Chart 8). CBO’s latest budget update shows that, even after the recent appropriations “deal” (again to avert a government shutdown) raised the appropriations caps in the law, entitlement spending will unmistakably be the primary force driving spending upward over the next 10 years.

But with a twist. Over the last 10 years—since the financial crisis—rock-bottom interest rates have flattened the interest owed on the debt. This was all the more remarkable because during all this time the debt was piling up at a fearsome pace. Troublingly, that benign trend of interest cost is about to end. With the economic recovery maturing, and inflation becoming more than an idle threat, interest rates are beginning to rise. The market and the Federal Reserve are reinforcing each other in driving rates up. And with the debt already so extraordinarily large and with the debt largely financed through short-term or soon-to-mature older longer-maturity securities (see Chart 9), debt service will very quickly become the fastest growing line item in the budget. When interest on the debt begins to grow that fast, the budget will truly begin to leave our control.

Debt service costs cannot be cut directly. The only way to restrain net interest payments is to reduce spending, increase revenues, and regain the confidence of the financial markets that our budget is being managed responsibly—so that interest rates remain moderate and stable. That requires pinpointing the major problems in the budget, and addressing them effectively.
And it is clear that the annual appropriations are not the primary cause of the problem, but the problem has become so large that every part of the budget must be a part of the solution. And beyond the magnitude of the needed budget savings, public perceptions of fairness require that all constituencies that can bear the consequences must participate in the effort.

The role of savings from appropriations

The current statutory discretionary spending caps will drop precipitously in fiscal years 2020 and 2021 to levels that are unrealistically low. Those caps were originally set as an unthinkable penalty to motivate action by the “Supercommittee” created by Congress in the 2011 debt-limit crisis. Those appropriations caps were never intended to take effect; the presumption was that the Supercommittee would attain a $1.5 trillion 10-year deficit reduction package, and thereby avoid the drastically reduced “sequester” appropriations spending caps. But the Supercommittee failed to agree to act, and the caps did become law. Still, they have never actually been observed. The Congress always has superseded those caps at the last minute in the appropriations process.

Reversion to the 2020 and 2021 caps would not allow government to fulfill its legitimate functions, in either national security or domestic fields—as demonstrated by repeated failures to comply with those caps over almost a decade. CED does not recommend an attempt to implement the sequester-level caps. Rather, we believe that the Congress, as part of a comprehensive budget solution, should freeze the total amounts of both defense and nondefense appropriations at current levels for three years.5 This would allow time for the Congress gradually to identify the necessary savings to contribute to deficit reduction. Discretionary savings will by no means be sufficient to solve the long-term problem, but the problem is so massive that they will be necessary.

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The Source of the Long-Run Budget Problem Is Health Care

Viewed from the 35,000-foot level, the long-term problem with the federal budget is entitlements. But that term is over-broad to describe in a useful form the facts at ground level.

The federal government’s miscellaneous entitlements (largely means-tested low-income programs) have not been growing markedly, relative to the size of the economy (the GDP). (The low-income programs obviously rise and fall with the economy, and rose sharply in the wake of the financial crisis, but their costs have subsided since.) Even Social Security costs, driven by the retirement of the baby-boom generation, lengthening lifespans and low birth rates, are fiscally manageable (though making the necessary repairs will be exceedingly painful politically). But the costs of providing health care are growing faster than those of any other entitlement programs, with the greatest growth in Medicare (see Chart 10 and Table 1). Medicare suffers from the same demographic developments that afflict Social Security—the retirement of the baby-boom generation, generally longer life spans, and lower birthrates that slow the growth of the working-age population—compounded strongly by “excess cost growth” in delivering care to each individual beneficiary. Over the very long run, the exponential growth in health care costs, again driven primarily by Medicare, will increase annual deficits, which, in turn, will add increasing amounts to the accumulated debt. Then that debt interacts with rising interest rates to grow debt-service costs even faster than the original motive force of health care costs.

It follows that we do not have a choice of accepting the status quo in health care and paying for the rising costs with tax increases. We would have to increase taxes year after year, essentially without limit, to keep up with the current trends in both the cost of delivering health care and our unfavorable demographics. We must instead make the delivery of quality health care less costly.

But limiting health care cost growth is not a simple matter of controlling prices. Medicare reimbursement rates for health care providers are already challengingly low. Providers find ways to make up for low Medicare reimbursements by charging private insurers and patients more. The margin between private and Medicare prices cannot be allowed to grow ever wider; the consequences for the quality of and access to care for our seniors would be unacceptable.

Furthermore, it will not be possible to address the rising cost of health care in Medicare alone, or even in all federal government programs. It is not realistic that patterns of practice can be markedly different between the public and private sectors, just as reimbursement rates between the public and private sectors for the same practice of medicine cannot diverge without limit. And the private sector is being squeezed along with the public sector by rising health care costs. The nation needs more efficient, higher-quality health care for all.

6 “Excess cost growth” is the excess of the growth of the cost of delivering care to the typical beneficiary over the growth of per capita GDP.
Chart 10
CBO Budget Baseline Projections, Mandatorv Spending by Category
Percent of GDP

Table 1
Sources of Budget Worsening, 2018–2028
Percent of GDP

<table>
<thead>
<tr>
<th>Source of Spending</th>
<th>2018</th>
<th>2028</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Social Security</td>
<td>4.8</td>
<td>5.9</td>
<td>1.1</td>
</tr>
<tr>
<td>Other (Non-Health)</td>
<td>2.7</td>
<td>2.5</td>
<td>-0.2</td>
</tr>
<tr>
<td>Social Security plus Other (Non-Health)</td>
<td>7.5</td>
<td>8.4</td>
<td>0.9</td>
</tr>
<tr>
<td>Medicare</td>
<td>2.9</td>
<td>4.2</td>
<td>1.3</td>
</tr>
<tr>
<td>Medicaid</td>
<td>1.9</td>
<td>2.2</td>
<td>0.3</td>
</tr>
<tr>
<td>Other Health</td>
<td>0.4</td>
<td>0.4</td>
<td>0.0</td>
</tr>
<tr>
<td>Health</td>
<td>5.2</td>
<td>6.8</td>
<td>1.6</td>
</tr>
<tr>
<td>Total Non-Interest</td>
<td>12.7</td>
<td>15.2</td>
<td>2.5</td>
</tr>
<tr>
<td>Net Interest</td>
<td>1.6</td>
<td>3.1</td>
<td>1.5</td>
</tr>
</tbody>
</table>

Source: The Budget and Economic Outlook: 2018 to 2028 (April 2018), Congressional Budget Office (CBO); CED calculations.
So in sum, it will be impossible to achieve a sustainable fiscal posture without fundamental reform of the US health care system, both public (largely Medicare) and private (the market also served by the ACA). The two must be improved in tandem. CED believes that a more market-based system is the only sustainable approach. The nation must align the incentives facing consumers, providers and insurance plans, so that they all seek lower-cost delivery of high-quality care in their own interests. We believe that this can be done through a combination of steps that would create the same aligned incentives for the purchase and delivery of care for both the working-age population and Medicare-eligible seniors. We doubt that anything short of fully aligned incentives will suffice in the long term, although incremental moves toward reimbursement on the basis of outcomes rather than the volume of services may be all that we can achieve in the short run.

There may be several ways to make incremental progress, but we have expressed our own preferred long-term path in the following terms:

Reform the Affordable Care Act:

- Replace the ACA’s complex subsidy mechanism, which puts a heavy compliance burden on (and may mislead) families with modest incomes and has proved difficult to administer accurately.
- Restructure the ACA exchange system to align more closely with cohesive geographic health care market areas.
- Broaden the exchange populations to increase the numbers of enrollees and also the risk diversity, especially in small geographic areas.
- Expand the ACA’s increase in consumer choice of insurance plans—which is the key to competition and innovation.
- Replace the ACA’s income-conditioned premium subsidies with a “fixed-dollar” refundable tax credit, usable only to purchase insurance.
- With coverage affordable to all with those credits, eliminate the unnecessary individual and employer mandates.
- Reform the tort system, using new data and analysis to formulate rebuttable standards of sound practice. Create specialized expert courts to facilitate more timely and less costly decisions.

Reform Medicare:

- Eliminate the Medicare Advantage price benchmark (which is based on traditional Medicare’s fee-for-service cost), and provide enrollees with a premium subsidy.

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• Increase the income-conditioning of Part B and Part D premiums, including a temporary Part B premium reduction for lower-middle income seniors.

• Risk-adjust premium revenue for plans.

• In rural areas, allow Medicare beneficiaries to enroll in traditional Medicare at no additional out-of-pocket cost, until Medicare Advantage plans meet a minimum threshold of availability.

The sum and total of these changes would be cost-responsible consumer choice among private health care plans. For seniors, traditional Medicare would remain an option, but if private Medicare Advantage plans can deliver more-comprehensive care at lower cost—as they currently show every evidence of doing—then Medicare enrollees would be able to save money by choosing those more efficient plans. The same opportunity to save money would be available to all households currently covered by employer plans, the individual market, and the ACA marketplaces. Medicaid-eligible households would continue to have coverage, including potentially through more efficient, high-quality private plans.

The alignment of incentives would allow consumers to save money by searching among available health plans for the best quality at the lowest costs. Plans would be driven to deliver efficiency and quality. They, in turn, would judge providers on their quality and efficiency; and so providers who currently respond to the perverse incentives of fee-for-service medicine will need to change their practice patterns and cost structures for the better. We find this approach far more promising than the often-discussed alternative of calling on the federal government to provide micro-management of the practice of medicine through the kind of price scheduling that is currently utilized in Medicare. We do not believe that government would prove to be the best source of ideas to improve the practice of medicine, and, to the extent that a conventional single-payer system would displace some of the pressure to innovate in the private sector, we fully believe that the ultimate result would be perverse. In contrast, providing incentives for every participant in the health care system to deliver higher quality care at lower cost should yield better results.

Employing incentives for value improvement in health care cannot guarantee specific quantitative budget savings for the federal government, any more than market incentives in the private sector can guarantee specific quantitative reduction in the prices for goods and services. In this regard, some in traditional government roles might find such market-based reform as risky, compared to other steps like simple reimbursement cuts that typically “score” for federal budget purposes. However, we have more confidence in market forces than we do in command-and-control policies such as those that currently drive Medicare. We would note that Medicare has been subject to such traditional reimbursement cuts for years, and yet its costs still have grown beyond our nation’s ability to pay. We urge policymakers to think creatively on this crucial issue, and to recognize that private providers of health care services—the same providers who deliver care for Medicare today among them—will deliver high-quality care at low cost because that will be what the market will reward under CED’s vision.
Social Security Is a Secondary Cause of Budget Deficits

Just a few decades ago, budget experts saw rising Social Security costs arriving with the retirement of the baby boom generation as the primary threat to the sustainability of the federal budget. Then health care costs began to mount even faster. Today, Social Security remains an important issue but of a lesser weight than health care.

For its own sake and for the sake of our seniors—virtually all Americans are seniors, only at different points in time—we need to keep Social Security sound and stable, just as we must protect Medicare for the same reasons.

Beyond being smaller in ultimate size, Social Security is simpler to analyze and understand than is health care.

1 Social Security does not generate the “excess cost growth” that arises from health care. Unlike health care, whose delivery costs rise rapidly and unpredictably from year to year, Social Security benefits increase only for inflation after the initial benefit determination at the time of retirement.

2 Older Social Security beneficiaries are not more expensive than younger ones. This second point is related to the first, but it is not identical. Medicare “excess cost growth” is based implicitly and in part upon the increase in the cost of caring for, say, a 68-year old this year versus the cost of caring for a 68-year old last year. But beyond that narrow definition, there is an added weight on Medicare in that the typical 69-year-old is more costly to care for than the typical 68-year old—and the typical 89-year-old is far more expensive than either. Thus, as the population ages—and the average age of the over-65 population is rising even faster than that of the entire population—the cost of medical care for the senior population is growing faster still. By contrast, the cost of Social Security benefits for a typical 89-year-old today is lower than that of a 69-year-old because on average older retirees earned lower wages than their younger counterparts.

3 Reducing the cost of Medicare, in the final analysis, amounts to reducing the cost of delivering health care, without reducing access or the quality of care. This will be devilishly complex. (We believe that our approach is the best that we have seen.) In contrast, Social Security has no such efficiency or quality dimensions. (The administrative cost of Social Security is extremely low. The only material factor is the number of dollars of benefits, an easily identifiable sum.) All of the possible steps entail increasing tax revenues or reducing benefits, and those alternatives have been analyzed in full detail. Balancing the burden on payroll taxpayers with that on beneficiaries will entail painful decisions, but the tradeoffs are clear and relatively predictable.

We believe that the most important considerations in a Social Security refinancing are: ⁹

- Very low-income retirees, especially those with career interruptions (including married women), need higher rather than lower benefits relative to the current

system. The current Social Security minimum benefit, which was intended to aid such seniors, should be reformed to provide greater support.

- The maximum amount of taxable earnings was intended to be high enough for 90 percent of all earnings to be taxed, but it has not kept up with the growth of top-end wages. The taxable maximum should be gradually increased to expand the tax base to 90 percent of all earnings, and should thereafter be increased explicitly to continue to meet that standard. At the same time, taxpayers should receive benefits on the basis of all of their taxable earnings; Social Security should not “raise the cap” but then refuse to pay benefits on the additional taxable earnings. We fear that would be a long stride toward converting Social Security into a “welfare program,” which we believe would break down the political consensus behind this vital support for seniors, the disabled, and survivors of contributing workers.

- Americans by and large remain healthier longer than years ago, and so those who remain able to work can help themselves and Social Security by working longer and continuing to contribute to the system—while earning higher benefits. However, many Americans do not fit this description, and, because of issues of health, obsolescence of skills, or other factors, are forced to retire before they wish to. Such adverse circumstances are particularly likely to afflict those who earn their livings by physical work. These disparate circumstances can be accommodated if the earnings formula is altered not to require more years of work, but rather to reduce benefits modestly for those who choose to retire early. This, plus the reforms to the minimum benefit mentioned earlier, will maintain a safety net for those who cannot continue to work, while strengthening the financing of the system through greater contributions by those who can work to older ages.

- At the same time and in the same general way, the benefit-determination formula should be made more generally progressive, to reduce benefits somewhat for those with higher earnings.

- At present, more-affluent seniors pay income taxes on part of their benefits. The system would be more financially sound if all seniors included all of their benefits in their incomes for tax purposes, while the income tax provided an exclusion for low-income seniors to protect them from income taxation.

- Inflation protection for Social Security beneficiaries (and under other spending and tax programs) should be based on the “chain-weighted” consumer price index, which takes appropriate account of the ability of consumers to substitute goods and services whose prices are relatively stable for other items that are rising more rapidly in price.

A combination of these steps should be assembled with the goal to assure that 75 years (approximately one typical lifetime) from now, the Social Security program has a cash reserve that covers one year of total benefits. This was the standard that was enforced over much of the history of the program. Its “pay-as-you-go” rationale enforced appropriate discipline on lawmakers, who would never accept the label of having hurt the Social Security Trust Fund. We would benefit from going back to that now seemingly quaint standard of behavior. Over many years, it served us (and Social Security) well.
Other Entitlement Programs Should Contribute

Apart from Social Security and health care, the remaining entitlement programs are small and not growing particularly rapidly. Therefore, they cannot contribute much to reducing the federal budget deficit. But they should contribute because the problem is so large. A few limited steps would have some merit. As part of a comprehensive program where all constituencies would contribute, federal government employees could bear a somewhat larger share of the costs of their retirement program. And as part of a meaningful program of training and employment, federal low-income program beneficiaries who are physically able and do not have family care responsibilities could engage in training and work. But the worst outcome in these programs, to be avoided at all costs, would be to drive low-income households with serious life issues away from obtaining regular health care. The costly chronic illnesses that would arise without quality care for all would both defeat the purpose of deficit reduction and destroy lives, not just those of adults but also those of their children.

We need to seek sound savings in every part of the budget. But again, the miscellaneous entitlement programs would make only a minor contribution to overall budget savings. It would be a wasteful diversion of time and energy to succumb to the preconception that the nation can solve a large budget problem through misguided cuts to small programs.

Revenue Will Be an Important Part of Deficit Reduction

The Congress just passed a substantial tax cut. As one result, the budget outlook has worsened substantially. Some observers believe and have argued that the tax cuts will enhance economic incentives and accelerate growth. We should see relatively soon whether that growth will materialize. However, perhaps the most enthusiastic advocates of the tax cuts have argued that they might pay for themselves. In other words, even with the most optimistic growth outcome from the tax cuts, perhaps the most that we can hope for is that the budget will be as unsustainable in the future as it was assessed to be one year ago. That outcome is not acceptable.

In 1981, President Ronald Reagan proposed and obtained a substantial tax cut that was touted to accelerate economic growth, increase revenues, and eliminate the then-feared budget deficit. Shortly after the enactment of those tax cuts (along with the substantial spending cuts that the President also requested) the deficit and the public debt exploded. President Reagan recognized the problem and cooperated with the Congress on a bipartisan basis to raise taxes and to eliminate some ill-conceived provisions of his tax bill. We should expect no less realism and bipartisanship from our current executive and congressional leadership.

The policy objective should be to maintain as much as possible of the incentive benefit of the 2017 tax cuts, while reducing or even eliminating their revenue cost. CED has recommended for some time a true income tax reform that would repeal preferential tax provisions, simplify tax filing for households, reduce tax rates, and cut the federal statutory corporate income tax rate to make the US system competitive with our international trade partners. We fear that the recent TCJA will increase budget deficits so much that it will defeat the purpose of its tax rate reductions, reducing the nation’s savings so much as to yield less private business investment rather than more. The
result could be slower economic growth and higher deficits, rather than the budget improvement that was promised. The approach that we advocate will do better for both corporations and households when tax burdens and economic performance are considered in tandem.

Under the system that we contemplate, the corporate income tax rate could be cut to 28 percent under the worldwide international system that prevailed prior to the TCJA (rather than the TCJA’s 21 percent). At that level, the United States would be fully competitive with our major trading partners. After eliminating the tax preferences for corporate dividends and capital gains, the individual income tax could have a simple two-bracket rate structure of 15 and 28 percent. A reform of the low-income relief provisions could create an “earnings credit” to replace the current earned income tax credit and the standard deduction. The earnings credit would not need to be phased out, eliminating a strong disincentive to work (and considerable complexity) on the part of lower- and lower-middle wage workers.¹⁰

It is less than ideal to change the federal income tax twice within a short period of time. But it is far worse to allow the federal budget deficit and the public debt to explode. It is incumbent upon advocates of Medicare and Social Security to cooperate in deficit reduction. But it is equally the responsibility of advocates of large tax cuts to accept that they must share in the sacrifices needed for deficit reduction. The body politic is almost equally divided on ideological grounds. If either segment of the population insists that it must have every issue settled fully in its own preferred way, there will be no progress, and US world economic leadership will sooner or later come to an end. We do not believe that the world will be a better place in that sorry eventuality.

Conclusion

We often hear that this great nation addresses its problems either through leadership or in crisis. We believe that the nation has courted fiscal crisis for far too long, and that we truly have come to the point where the forces of inertia are sufficient to damage our nation irreparably. US and world financial markets likely will fail to recognize the problem that our nation’s leadership has created until the process of deterioration has gone well past the point of no return. When we all recognize the crisis, it already will be too late.

We implore our nation’s elected policymakers to face up to the building crisis that many of those leaders acknowledge—but only behind closed doors. History will not accept the excuses of partisan politics—that “we would have fulfilled our responsibilities if only the electorate had been wise enough to give our faction total control.” We are running out of time to arrest the resulting inexorably mounting debt.

If the two political parties will cooperate to take the necessary but painful steps together, then at least the political blame for imposing that pain can be shared and defused. Without action soon, the blame will fall on all with full force.

¹⁰ Committee for Economic Development, The Federal Budget Deficit and the Public Debt; Bipartisan Policy Center, Domenici-Rivlin 2.0.