Policy Forum: A Decade of Reckoning—Fiscal Policy Challenges in the United States

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INTRODUCTION
To observers, both inside and outside, fiscal policy at the federal level in the United States appears to be broken. Elected policy makers have entrenched themselves along partisan lines, making bipartisan compromise through the standard legislative process nearly impossible. Even attempts to forge compromise in smaller groups, such as the Simpson-Bowles commission in 2010 and the so-called supercommittee in 2011, have ultimately not achieved that objective.1 Fiscal policy has been conducted in the shadow of shutdowns and sequesters, rather than through forward-looking legislation. Agreements, when achieved, have been temporary, delaying but not eliminating the next budget cliffhanger. As a general rule, the federal government has not acted until it has been forced to. The exceptions to this rule often involve unfunded expansions, rather than contractions, in projected government deficits.

The United States enjoys the luxury of being the world’s largest economy and the issuer of the world’s most widely held currency. These and other advantages

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1 The report of the Simpson-Bowles commission is The Moment of Truth: Report of the National Commission on Fiscal Responsibility and Reform (Washington, DC: National Commission on Fiscal Responsibility and Reform, December 2010). The formal name for the supercommittee was the Joint Select Committee on Deficit Reduction.
have helped to forestall the most extreme consequences that would otherwise befall a nation whose fiscal policy was conducted with such little regard for the future. Eventually, the grace period for avoiding hard choices will expire, and the United States will find itself with much less favourable alternatives than would have been available had it acted more prudently in its fiscal affairs. There are several reasons to believe that the fiscal reckoning will arrive within a decade.

First, the American Taxpayer Relief Act of 2012, which was the formal resolution of the fiscal cliff that dominated the news at the end of last year, served to make permanent the bulk of the remaining temporary reductions in tax rates that were enacted over the prior 11 years. As I have noted elsewhere, this bipartisan deal transformed a fiscal cliff—the fall from which would not have been too severe—into a fiscal Grand Canyon that will be extremely difficult to cross.

Second, although the need to reform entitlement programs like Social Security and Medicare has been a topic of national debate for over 15 years, the long-term actuarial balance of both programs has deteriorated. Indeed, interventions by policy makers over that time period have generally contributed to that deterioration, whether through the largely unfunded introduction of prescription drug coverage for Medicare in 2003 or through repeated interventions to prevent Medicare payments to physicians from being lowered in accordance with prior reforms. In another 10 years, almost all of the baby boom generation will have reached the age of entitlement to Social Security and Medicare benefits.

Third, the areas of possible bipartisan agreement in the near future seem limited to measures that will reduce outlays or raise revenues only by amounts that are too small to restore fiscal balance. On the outlay side of the budget, policy makers have allowed the automatic cuts legislated as a fail-safe measure in the Budget Control Act of 2011 to go into effect. On the revenue side, policy discussions have shifted from raising tax rates to broadening the tax base. There are certainly some loopholes to be closed and some tax expenditures that could be pared back. However, existing reform proposals fail to distinguish between tax expenditures that are appropriate in an income tax system and those that are not. Most importantly, discretionary spending, as opposed to mandatory spending, is not a large enough share of the budget and the base cannot be broadened enough for these measures to be sufficient to restore fiscal balance.

The remainder of this article provides background and analysis of each of these challenges. It begins with a discussion of the two missed opportunities that will shape US fiscal policy for the coming decade and beyond. The first missed opportunity was the failure to reset the baseline budget to one that would stabilize the ratio of debt to gross domestic product (GDP) in the resolution of the fiscal cliff.

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The second was the failure to use the presence of the baby boom generation in the labour force—in high numbers and in peak earning years—to more actively pre- fund their future Social Security and Medicare benefits. The article then offers an evaluation of current proposals to raise revenue by broadening the tax base rather than increasing marginal tax rates, focusing on both the revenue inadequacy of these proposals and their flawed design.

FROM FISCAL CLIFF TO FISCAL GRAND CANYON

When Federal Reserve Chairman Ben Bernanke warned of an approaching “massive fiscal cliff” in his testimony to members of the House Committee on Financial Services on February 29, 2012, he did so as an admonition to lawmakers to balance the competing concerns of a fragile recovery with long-term fiscal responsibility. The fiscal cliff emerged over the prior 11 years, starting with the tax cuts enacted under the Bush administration in 2001 and 2003, in a time of relative budget surplus. Critically, the 2001 cuts were enacted under provisions that gave them explicit sunsets within the conventional 10-year budget window. The end of that window arrived during the Great Recession, so Congress and the president extended the tax rate cuts for two years and added other temporary provisions in 2010. The last piece of the cliff was formed with the Budget Control Act of 2011, which arose out of a showdown over the debt ceiling and threatened automatic sequestrers of discretionary outlays, both defence and non-defence, on January 2, 2013 if Congress did not pass a bill reducing the deficit on its own.

In the intervening 10 months, the president and Congress made essentially no progress in averting this fiscal cliff. Amid panic and uncertainty, an 11th-hour compromise was reached on January 2, 2013 that allowed marginal tax rates on the highest-income households to revert to their Clinton-era levels, allowed the temporary payroll tax cut to expire, and delayed the across-the-board spending cuts for two months. Critically, all of the other tax rate reductions from the Bush era were made permanent.

The impact on the medium-term budget projections was notable. Using Congressional Budget Office (CBO) projections, I have previously estimated that, relative to a baseline that would allow all of the temporary policies to expire, the resolution of the fiscal cliff increased the 5-year deficit from $1.6 trillion to $3.3 trillion and

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7 The income thresholds for the higher tax rates are $450,000 for married taxpayers filing jointly and $400,000 for single taxpayers.
the 10-year deficit from $2.3 trillion to $6.3 trillion. Just as importantly, the projected debt held by the public would have been less than 60 percent of GDP and falling at the end of the decade had the temporary provisions expired. With the new legislation, the CBO projects a ratio of debt to GDP of 77 percent and rising at the end of the decade. Thus, the fiscal cliff has become a fiscal Grand Canyon.

In a policy environment in which bipartisan compromise has been hard to achieve, the fiscal cliff was a blessing. Rather than needing both parties to agree on legislation that would both raise taxes and cut spending by significant amounts, restoring solvency through the fiscal cliff required only one entity—the president, congressional Democrats, or congressional Republicans—to decide not to continue to keep taxes low and spending high. The lesson of the failed Simpson-Bowles commission and supercommittee deliberations was precisely that such bipartisan agreement was wishful thinking even in small groups. Astute observers recognized this and recommended going over the fiscal cliff, to reset the budget baseline to one that more closely balanced revenues and outlays. Failure to do so was a missed opportunity.

THE PRESSURES OF OLD-AGE ENTITLEMENTS

The federal government’s resolution of the fiscal cliff was not the only or even the most consequential missed opportunity on fiscal policy. Of the $3.6 trillion in federal expenditures in 2012, about $2.0 trillion was mandatory annual spending on Social Security, Medicare, Medicaid, and other health, retirement, and insurance programs. These expenditures are mandatory in the sense that they are made each year without new authorizing legislation; people qualify for the respective benefits on the basis of various combinations of age, income, health, and disability status. The CBO reports that mandatory outlays for the three largest programs—Social Security, Medicare, and Medicaid—are projected to grow from 10.1 to 11.9 percent of GDP over the next decade.

At the end of that decade (that is, in 2023), the youngest baby boomer will be just three years away from the early eligibility age for Social Security. At that point, the transition of this unusually large cohort from its peak working years to its earliest retirement years will be nearly complete. Figure 1 shows the impact of this transition on Social Security finances. The dotted line is the dependency ratio for Social Security—the number of beneficiaries per 100 workers. In the three decades prior

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8 Supra note 3. All currency references in this article are in US dollars.


11 Supra note 9, at 16, table 1-3, and 65, table B-2. These figures do not include offsetting receipts.
to 2010, the line was flat, since the labour force participation of the large baby boomer cohort offset the impact of longer life expectancy and earlier retirements among older cohorts. The solid line is the Social Security cost rate—total program outlays as a percentage of the taxable payroll base on which the Social Security tax is levied. Over the same time period, the curve mirrored the dependency ratio—Social Security costs relative to the economy are driven almost entirely by changes in the number of beneficiaries relative to the number of workers. The correlation continues into the future, as the transition of the baby boom generation out of the workforce and into retirement increases the cost rate from about 10 percent to 16 percent of taxable payroll. After the baby boomers have died, the two curves continue to rise at a gradual pace. This is the steady state for an old-age entitlement program based on a birth rate that is projected to be stable (at around 2 children per woman) and life expectancy that continues to rise.

Figure 2 shows the Social Security cost rate in comparison with the income rate. The income rate is defined as the total tax revenues relative to the payroll tax base. It includes the payroll tax of 12.4 percent of payroll plus the revenues collected from the income taxation of Social Security benefits of higher-income beneficiaries. In contrast to the cost rate, there is no demographic shift factor that increases the income rate, which rises only slightly over the next several decades when a greater share of Social Security benefits will be subject to income tax. According to the most recent Social Security trustees’ report, the income rate fell below the cost rate for the first time in 2010 and is projected to remain there over the next 75 years,

**FIGURE 1 Democratic Shifts and the Social Security Cost Rate, 1970-2090**

after which time the annual deficit will be equal to −4.6 percentage points of taxable payroll, or about one-third of revenues collected that year.\textsuperscript{12} The report notes that an additional 2.67 percent of taxable payroll per year in additional revenue or lower benefits is required to eliminate the actuarial funding gap over the next 75 years.\textsuperscript{13} To eliminate this gap over the infinite horizon would require 3.9 percent of taxable payroll, or 1.3 percent of GDP, in perpetuity.\textsuperscript{14}


\textsuperscript{13} Ibid., at 61.

\textsuperscript{14} Ibid., at 65. Medicare’s financial status is similarly precarious. The counterpart to the 75-year Social Security funding gap of 2.67 percent of payroll for Medicare’s hospital insurance program is 1.35 percent of payroll. For Medicare’s supplemental insurance program (which includes the prescription drug benefit), there is no corresponding gap because the program has an immediate claim on general revenues. However, the trustees project that Medicare costs (including both hospital insurance and supplemental medical insurance expenditures) will grow substantially from 3.7 percent of GDP in 2011 to 5.7 percent of GDP by 2035 (that is, when all baby boomers are beneficiaries), and will increase gradually thereafter to about 6.7 percent of GDP by 2086. For further discussion, see United States, Social Security Administration, Social Security and Medicare Boards of Trustees, “A Summary of the 2012 Annual Reports” (www.ssa.gov/OACT/TRSUM/index.html).
The financial condition of the Social Security system has been a topic of active discussion over the last 15 years. It is driven by the drop in fertility associated with the end of the baby boom, which was known for decades, and the gradual improvements in life expectancy, which continue an even longer trend. The notion that reforms were needed was made very public in 1997, when the Social Security advisory council\(^\text{15}\) went so far as to propose three different options for dealing with projected actuarial imbalances. The council’s report ignited a wave of other reform proposals, several of which were from senators or members of the House of Representatives.\(^\text{16}\) None of these proposals has received a vote in the legislature.

Two of the advisory council’s options, and several other reform proposals, have advocated pre-funding a portion of future benefit payments, whether in publicly managed or privately held individual accounts. Other proposals would have gradually increased payroll tax rates and reduced benefit payments over time to restore solvency largely within the current pay-as-you-go system.\(^\text{17}\) In either case, the size of the revenue increases or benefit reductions that need to be imposed is smaller when they can be implemented immediately rather than with delay. The reason is in part that early contributions benefit from compound interest and in part that the financial burden of restoring solvency can then be spread across more cohorts that are in their working years.

The missed opportunity in reforming entitlements was that the baby boom generation went through its peak earning years without contributing at all to this process of restoring solvency. Figure 2 shows that Social Security ran surpluses for most of this period. However, these surpluses were included in the federal government’s budget decisions. While they did build up the trust fund, they did not lower the amount of debt held by the public. Over the past three decades, the presence of the baby boom generation in the workforce made old-age entitlement programs temporarily inexpensive to run in a pay-as-you-go fashion. Within a decade, that generation’s presence as the youngest cohort of beneficiaries will dramatically raise the programs’ costs. Without a larger trust fund or the presence of individual accounts


\(^{16}\) The Office of the Chief Actuary at the Social Security Administration keeps an archive of dozens of reform proposals that it has evaluated, available at “Proposals Addressing Trust Fund Solvency” (www.ssa.gov/OACT/solvency/index.html). It also maintains a list of actuarial estimates of individual changes that could be made to restore solvency, available at “Individual Changes Modifying Social Security” (www.ssa.gov/OACT/solvency/provisions/index.html).

to alleviate the financial burden, these higher costs will be borne through higher taxes on future workers and lower benefits for future retirees.

**BASE BROADENING THROUGH LIMITS ON TAX EXPENDITURES**

As noted above, much of the partisan impasse over budget policy has focused on whether marginal tax rates on income can increase, either back to the levels that prevailed before the Bush administration or some other level. As a response to that impasse, efforts to raise tax revenues by broadening the tax base have gained momentum.

Broadening the tax base is sometimes described as closing tax loopholes. A tax loophole can be defined as “a legal way of avoiding the payment of tax, or part of a tax bill, due to a gap in tax legislation.” An example of such a loophole is the “carried interest” provision by which asset managers are taxed at capital gains rates rather than ordinary tax rates on a portion of their compensation. Many tax loopholes are exploited by corporations in paying (or not paying) their corporate taxes rather than by individuals in filing their personal income taxes.

Other means of broadening the tax base involve limiting tax expenditures. Tax expenditures are defined by the CBO (in accordance with the Congressional Budget and Impoundment Control Act of 1974) as “those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.” In testimony before the House of Representatives on rules to limit tax expenditures, the director of the CBO noted that tax expenditures grew from a revenue loss of $36.6 billion or 4.4 percent of gross national product (GNP) in 1967 (the first year for which an official federal budget was compiled) to $228.6 billion or 8.0 percent of GNP in 1981. The CBO reported

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that by 2012, major tax expenditures totalled more than $800 billion, or 5.3 percent of GDP.\textsuperscript{23}

Tax expenditures can also be calibrated relative to the size of the federal government itself. In 1967, tax expenditures were 20.5 percent of total federal direct outlays, rising to 34.6 percent of outlays in 1981. By 2012, the $800 billion in tax expenditures was about one-third of federal revenues (and thus 21 percent of federal outlays) and exceeded the spending on Social Security, defence, or Medicare taken individually. Like entitlement programs, the size of tax expenditures each year is not something that is decided in the annual budget process unless the tax code is changed, since every taxpayer who meets the criteria for the tax relief can qualify for it.

The largest tax expenditures pertain to health care, pensions, home mortgages, investment income, charitable donations, and state and local taxes paid. Each of these special provisions in the tax code has constituencies that have grown dependent on them; some asset values would fall or some economic transactions would become more expensive if the provisions were removed. One strategy that has been proposed to overcome the resistance to limiting specific tax expenditures is to instead limit the extent to which a given taxpayer can use all tax expenditures to reduce taxable income. For example, Feldstein, Feenberg, and MacGuineas propose capping the tax-reducing impact of tax expenditures at 2 percent of a taxpayer's adjusted gross income (AGI).\textsuperscript{24} Their simulations suggest that this would have raised $278 billion in 2011. Note that even this rather aggressive proposal would cut projected annual deficits by less than half.\textsuperscript{25}

Political realities always put economic considerations in a secondary position, but there are weaknesses in the individual cap on tax expenditures that are nonetheless quite important. Each of the largest tax expenditures on the individual income tax comes in the form of a deduction or exclusion from income. Consequently, they benefit higher-income taxpayers more than lower-income taxpayers, in part because marginal tax rates rise with income, in part because higher-income taxpayers are more likely to itemize deductions, and in part because higher-income taxpayers


\textsuperscript{25} See Diane M. Lim, “Proposal 7: Limiting Individual Income Tax Expenditures,” in \textit{15 Ways To Rethink the Federal Budget} (Washington, DC: Brookings Institution, February 2013) (www.hamiltonproject.org/papers/limiting_individual_income_tax_expenditures/), for a discussion of alternative ways to limit individual income tax expenditures; and Daniel Shaviro's Policy Forum article immediately following, for a comparison of the tax expenditure approach with other proposals for raising taxes on high-income individuals.
tend to engage in more of the activity that is subsidized (such as health care, pension saving, home ownership, and charitable giving). Four considerations are relevant to how tax expenditures are pared back.

First, some tax expenditures do serve a social purpose that increases with the amount of the expenditure. For example, the tax deduction for charitable giving acknowledges that taxpayers should not pay taxes on income that they may earn but that they redistribute to others. It is appropriate to exclude such income from taxable income, and the appropriateness of doing so is independent of any other provision that may reduce taxable income. A similar case could be made for the deduction for state and local income and property taxes, which have a strong redistributive element.26

Second, some tax expenditures do not serve a social purpose that rises with income (if any). For example, the largest tax expenditure is the exclusion of employers’ contributions for health care, health insurance premiums, and long-term care insurance premiums from taxable income and the payroll tax base. However, a very small portion of private health-care expenditures has a connection to public health, in the sense of externalities that one person’s poor health imposes on another person’s health. A more plausible case can be made that, given the government’s existing support for health care in old age through Medicare, it should also subsidize pre-retirement health care, so that people are healthier when they arrive at old age and become Medicare beneficiaries. To the extent that this is a valid reason for the subsidy, it does not necessarily vary with the income of the individual. Thus, the same objective could be achieved by allowing a tax credit for some portion of personal health-care expenses rather than a deduction from income. The same rationale could be applied to the income tax exclusions of net pension contributions and earnings, in light of the government’s support of old-age income through Social Security.

Third, tax expenditures are defined to be based on gross income, but it is not obvious that gross income is the appropriate basis for taxation. If a taxpayer incurs costs in the process of earning income, then only the net income is appropriate to include in the tax base. This consideration is relevant to the home mortgage interest deduction. The home is an asset, and the mortgage is debt incurred to obtain the asset. Were the home rented out, the interest expense of the mortgage would be treated as an expense and would be deductible from the rental income before taxes were applied. The real tax expenditure associated with home ownership is that the “imputed rent”—the rent that a homeowner implicitly pays himself—is not treated as income for tax purposes. In recent years, tax changes have also reduced or eliminated the tax levied on the sales of owner-occupied housing. This weakens the case for making mortgage interest deductible, but it also points to other tax distortions.

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26 To the extent that taxpayers benefit from the public goods supported by these state and local taxes, or are simultaneously the recipients of transfers funded by these state and local taxes, the appropriate tax treatment would be to include these benefits as taxable income. They would then be treated similarly to unemployment insurance benefits received or alimony paid or received.
as the reasons why housing escapes taxation rather than the mortgage interest deduction per se.\textsuperscript{27}

Fourth, there is some confusion among analysts in the way the standard deduction is regarded. For example, in discussing the regressivity of the deduction for charitable giving, the CBO notes:

The subsidy for charitable giving is concentrated among high-income taxpayers to an even greater extent than donations are. . . . \textit{The difference in the tax subsidy occurs because higher-income people are more likely to itemize deductions (and thus to receive a tax subsidy for donations) and because higher-income people generally pay higher marginal tax rates and thus receive a larger subsidy (relative to other itemizers) per dollar of donation.}\textsuperscript{28}

In discussing the benefits of their proposal, Feldstein et al. note:

The 2 percent cap would also cause substantial simplification by inducing more than 35 million taxpayers to shift from itemizing their deductions to using the standard deduction [a reduction from one-third of all taxpayers itemizing to just 9 percent of all taxpayers itemizing].\textsuperscript{29}

Both statements are true: tax compliance is simpler when taxpayers do not itemize, and tax payments are more progressive when low-income taxpayers are allowed to claim the standard deduction rather than the (lower) amount of their actual deductions. However, it is clear that the distortion is not induced by taxpayers itemizing their deductions, but by taxpayers claiming the standard deduction. As Pappas argues, the standard deduction allows taxpayers to claim deductions for expenses that they did not incur or for making charitable donations that they did not make.\textsuperscript{30} It is arbitrary that the reduction in tax revenues is measured from a base that allows a standard deduction rather than only deductions for payments that taxpayers have actually made. Claiming the standard deduction rather than itemizing deductions is the real tax expenditure.

Not all tax expenditures are created equal. Current reform proposals implicitly treat gross income and the standard deduction as the broadest possible base. In an

\textsuperscript{27} See Alan D. Viard, “Proposal 8: Replacing the Home Mortgage Interest Deduction,” in \textit{15 Ways To Rethink the Federal Budget}, supra note 25 (www.hamiltonproject.org/papers/replacing_the_home_mortgage_interest_deduction/), for a recent proposal to convert the mortgage interest deduction into a credit.


\textsuperscript{29} Feldstein et al., supra note 24.

income tax system, a more appropriate base would be net income and only itemized deductions. Even measured relative to the latter definition, some of the larger tax expenditures, such as the subsidies for health care, pension saving, and home mortgage interest, do merit changes in tax treatment. However, by the more appropriate definition, the current system has state and local taxes paid, and particularly charitable donations, characterized appropriately.

**CONCLUSION**

Fiscal policy in the United States is being shaped by two fundamental shifts. The first is the decline in bipartisan cooperation on matters that restore (as opposed to undermine) fiscal balance in the federal government’s revenues and outlays. The second is the transition of the baby boom generation from work to retirement, which at first retarded but will soon accelerate the fiscal consequences of an aging population.

In light of these shifts, it is clear that the United States did not use the opportunity of the fiscal cliff—or the Simpson-Bowles commission or any other self-imposed deadline—to reset the federal budget baseline to balance over the next decade. Doing so going forward will require either an extreme external event to force policymakers to work together or a period of willing bipartisan cooperation that has not been observed in decades. It is also clear that the United States did not take advantage of the working years of the baby boom generation to adequately pre-fund or otherwise prepare for the financial costs of their retirement. Over just the next decade, mandatory outlays for the three largest programs—Social Security, Medicare, and Medicaid—will grow by nearly 2 percentage points of GDP. As with the discretionary revenues and outlays, some bipartisan arrangement will need to emerge, to allow decisions to be made on tax increases and/or benefit cuts. Perhaps one day there will be a commission or committee that can finally succeed.

To the extent that policymakers are currently engaged in discussions about increasing revenues, the focus has been on broadening the tax base by limiting tax expenditures rather than restoring marginal tax rates to levels that had previously achieved budget balance. While this generally moves fiscal policy in a more responsible direction, there is also the potential to act with a policy that is too coarse—one that does not distinguish between appropriate tax expenditures (those that are based on either costs of earning income, or gifts or taxes that redistribute income) and inappropriate tax expenditures (those that simply subsidize a given activity or asset). Additionally, even if this effort were to succeed, no current proposal comes close to restoring balance even in the part of the budget that does not deal with mandatory outlays.