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We Cannot Tax Our Way out of the Entitlement Crisis

By R. Glenn Hubbard

In a recent Wall Street Journal *article, Barack Obama's economic advisers, Jason Furman and Austan Goolsbee, illustrated the changes that their candidate would make to the tax code if he is elected. The new plan rolled back some of the tax increases called for earlier in the campaign, specifically proposing a more modest payroll tax increase and a smaller increase in the dividends tax rate. Yet, after accounting for lost tax revenue, it seems impossible that Obama could pay for his proposed fiscal agenda, particularly his guarantee not to cut Social Security benefits. It is clear that the funding would have to come from other tax increases.*

Given the hearty support Democratic presidential candidate Barack Obama received in Europe last month, he must have noticed the surprise and skepticism among some Germans when he asked Europeans to contribute more money for defense. Many Europeans argue that they cannot afford such an additional expenditure.

They are right. And therein lies a cautionary tale for the United States because continental Europe has been following something similar to Obama's plans for spending and taxes.

Obama has revealed his plans in stages. First, on his campaign website, he indicated that he would solve the long-term solvency of Social Security, which is a good thing. In a September 21, 2007, op-ed in Iowa's *Quad-City Times*, he ruled out benefit cuts to achieve solvency and looked first to payroll taxes, which is a bad thing. Last week, in the *Wall Street Journal*, his top economic advisers, Jason Furman and Austan Goolsbee, clarified his evolving tax proposals.

The spending shortfalls in Social Security and Medicare are large. According to the Congressional Budget Office, Social Security and Medicare spending left unchecked would—after a generation—consume about ten percentage points more of GDP than it does today.

Simple arithmetic suggests that with this increased percentage of GDP taken up by the two entitlement programs, all federal taxes—on average—would have to be raised by more than 50 percent to make up the funding shortfall. Research by economists Eric Engen of the Federal Reserve Board and Jonathan Skinner of Dartmouth College suggests that such a tax increase would reduce long-term GDP growth by about a full percentage point. This is no small matter: think of it as reversing all of the gains in our long-term growth rate from the productivity boom of the past fifteen years.

Now it is easy to understand European concerns about higher defense spending. Large entitlement budgets almost certainly cannot be financed through growth-chilling taxes alone. Spending on other areas—including defense, education, and research—must also be adversely affected.

In their op-ed, the Obama economic advisers noted that taxpayers whose incomes exceeded $250,000 would face an additional Social Security

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payroll tax increase of four percentage points (in addition to a five percentage point increase in the top marginal income tax rate). This new payroll tax plan would affect the top 3 percent of earners.

The new payroll tax hike is more modest than the one Obama hinted at last fall, which might have uncapped the payroll tax entirely. But it would also do very little to shore up Social Security since it means that no more than 15 percent of Social Security's long-term funding gap would be closed. Thus, if Obama is indeed opposed to reductions in Social Security spending growth, he is necessarily committed to large payroll tax increases or general income tax increases in the future.

And what of those other tax increases? In May 2007, Obama proposed to offset costs of his health care plan in part by allowing the Bush tax cuts on Americans earning over $250,000 to expire. But Furman and Goolsbee suggested that dividend and capital gains tax rates would be raised to 20 percent—well below levels (for dividends) prior to the 2003 tax cut. While praise is due for this tempering of a tax increase, one can infer from the candidate's earlier statements that he had counted on these revenues to offset health care spending and to pay for middle-class tax cuts.

Obama has articulated a plan for higher federal spending, leaving open the question of what tax increases are next. If Obama is going to increase spending, will he raise the money through higher business taxes instead of higher individual taxes? He has already distanced himself from John McCain's call to reduce America's corporate tax rate, and he is committed to raising tax rates on successful small business owners, who pay individual, as opposed to corporate, income taxes. Does this mean he will raise tax burdens on individuals with annual incomes less than $250,000?

In a June 26, 2008, interview on Fox Business, Obama said he wanted to roll back the Bush tax cuts for those in the top 5 percent of incomes—that is, about $145,000 per year. He also voted for the Democrats' fiscal year 2009 budget resolution, which would raise taxes on individuals earning $42,000 or more.

There is another fiscal way. Balancing the federal budget without a tax increase is possible but will require strong fiscal restraint. To achieve full-employment budget balance by the end of the next president's term in office, federal nondefense spending growth needs to be restrained to 2 percent per year instead of the currently projected 4.5 percent. Modest defense spending increases to fund costs of needed improvements in national security are possible.

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We can also secure a firm financial footing for Social Security and Medicare without choking off economic growth or curtailing our flexibility to pursue other spending priorities. Three actions are essential: reduce entitlement spending growth through some form of means testing, eliminate all nonessential spending in the rest of the budget, and adopt policies that promote economic growth. This complete difference from Obama's fiscal plan forms the basis of McCain's priorities for spending, taxes, and health care.

The problem with Obama's fiscal plans is not that that they lack vision. On the contrary, the vision is plain enough: a larger welfare state paid for by higher taxes. The problem is not even that they imply change. The problem is that his plans are statist. While the candidate is sending a fiscal "Ich bin ein Berliner" message to Americans, European critics of his call for greater spending on defense are the whistle-blowers for what lies ahead with Obama's vision for the United States.