

Six Long-Run Tax and Budget Realities

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In this article, Strain and Viard outline six realities that will likely shape the policy response to the long-run fiscal imbalance: defense spending, entitlements, revenue, consumption taxation, middle-income earners, and bipartisan agreement.

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The United States confronts a severe long-run fiscal imbalance. Federal spending on healthcare programs and other entitlements is projected to outstrip federal revenue over the next 50 years and beyond. The decisions of precisely how and when to address the imbalance will be made through the political process and will reflect the values that the American people express through their elected representatives. Nevertheless, arithmetical, economic, and political constraints restrict the possible decisions. In this article, we outline six realities that will likely shape the broad response of major budgetary components to the long-run fiscal imbalance.¹

¹This article updates and expands the analysis in Alan D. Viard, "Four Long-Term Fiscal Realities," 44 *Bus. Econ.* 143 (2009); and Viard, "Comment on Leonard E. Burman, 'A Blueprint for Tax Reform and Health Reform,'" 28 *Va. Tax Rev.* 325 (2008).

The first three realities involve changes in spending and revenue levels. We believe defense spending will likely continue trending downward as a share of GDP over the long run because defense needs do not rise proportionately to income, and defense will likely be a tempting political target. We conclude that entitlement benefits will be restrained relative to the explosive growth projected under the current-law path because sustaining that growth would lead to intolerably high tax burdens. We argue that revenue will rise as a share of GDP relative to its recent average because the degree of entitlement restraint required to avoid a revenue increase is politically impossible.

The next two realities concern changes in the structure and distribution of the federal tax and transfer system. We argue that as revenue rises relative to GDP, the federal tax system will likely shift toward consumption taxation to some extent and in some form, to limit the economic and political damage inflicted by significantly increasing marginal income tax rates. The most likely, although not most desirable, way for this shift to occur is the introduction of a VAT alongside the income tax. We argue that the middle class, as broadly defined by today's political debate, will bear much of the burden of addressing the fiscal imbalance through entitlement benefit cuts and tax increases. Contrary to the beliefs or hopes of some policymakers, the long-run fiscal imbalance cannot be closed solely by taxing the top 2 or 3 percent of the income distribution or by gutting safety net programs for the bottom 20 percent.

The sixth and final reality addresses the process by which the fiscal imbalance will be addressed. Because it will be difficult for either party to make serious progress alone, the necessary combination of entitlement benefit cuts and tax increases will likely arise through a series of bipartisan agreements. Those agreements may occur under crisis conditions, although it is preferable that they occur sooner and under more stable conditions. Divided government is probably a necessary, although far from sufficient, condition for the latter type of agreement. Despite frequent claims that spending-cut provisions in bipartisan agreements are not implemented, the historical record indicates that this is not a problem if the agreement enacts changes in entitlement benefit formulas.

Although we are using the word “realities,” we obviously do not claim to have a crystal ball. No one can know with certainty what will happen over the upcoming decades. In light of the fundamental economic forces at work and the size of the projected fiscal imbalance, however, we believe that policy will follow the broad directions outlined in this article.

The six realities constrain the policies that can be adopted, but they leave an ample range of policies from which elected representatives must choose. Although the fiscal imbalance must eventually be addressed through significant policy changes, Americans can opt to act quickly or to delay. While a combination of entitlement benefit cuts and tax increases will be necessary, Americans have a choice of how to mix the two policies. Also, Americans can continue the harmful and ultimately futile attempts to address our fiscal imbalance by taxing the top 2 percent and cutting spending for the bottom 20 percent until the failure of that approach becomes undeniable, or they can soon acknowledge that a wider distribution of burdens that includes the broad middle class is required.

Throughout this article, we offer broad recommendations for how to proceed. Because the necessary measures become more painful the longer we wait, we strongly suggest that the hard work of long-run fiscal consolidation begin today. Policies to reduce the long-run deficit should be agreed upon and enacted as soon as possible, to be implemented over a period after the economy recovers from the Great Recession. We particularly warn against waiting to see whether the long-run projections will change. Even if healthcare costs grow at a dramatically slower pace than projected, it is still certain that a large imbalance will need to be addressed. Given the massive size of the projected imbalance, prudence dictates that the projections be taken seriously, if not conclusively, and acted upon. To support robust economic growth, we propose heavy reliance on entitlement cuts rather than revenue increases. We emphatically recommend acknowledging that the broad middle class must bear much of the burden of long-run deficit reduction.

A. Severe Long-Run Fiscal Imbalance

Our focus is on the long-run imbalance — roughly the next 50 years — and not the short-run budget outlook. The deficit, which is estimated to be 4 percent of GDP this year, is projected to be relatively stable over the next decade, fluctuating

between 2.1 and 3.6 percent of GDP. This is a sharp reduction even from 2012, when the deficit was 7 percent of GDP.²

This deficit reduction was achieved somewhat by accident: A combination of so-called sequester cuts to discretionary programs, reduced safety-net spending, increased revenue resulting from a (slowly) recovering economy, and previously scheduled tax increases have brought the deficit to stable territory. The deficit must be reduced as the economy continues to recover from the Great Recession. But we are inclined to agree with our American Enterprise Institute (AEI) colleague John H. Makin, who has written, “American fiscal austerity has been moderate and probably, at the current pace of deficit reduction of about \$300 billion per year over the next half decade, has proceeded far enough for now.”³

Unfortunately, our budget picture is very different beyond 2023. The retirement of the baby boom generation, increases in longevity, and the projected growth of healthcare costs create a dramatic imbalance between revenues and outlays.

Figure 1 illustrates the long-run gap between federal non-interest outlays and revenue under the Congressional Budget Office’s June 2012 alternative fiscal scenario, which corresponds most closely to a current-policy concept. The scenario assumes that revenue will remain fixed at 18.5 percent of GDP, close to recent historical averages. As can be seen, that level of revenue falls far short of what’s needed to cover the spending levels projected to occur under the alternative fiscal scenario, with non-interest spending rising to 26.3 percent of GDP in 2038 and 29.6 percent in 2063.⁴ Although the CBO’s update of the long-term budget outlook in September may show a somewhat smaller long-run fiscal gap, it is clear that the basic picture will not change.

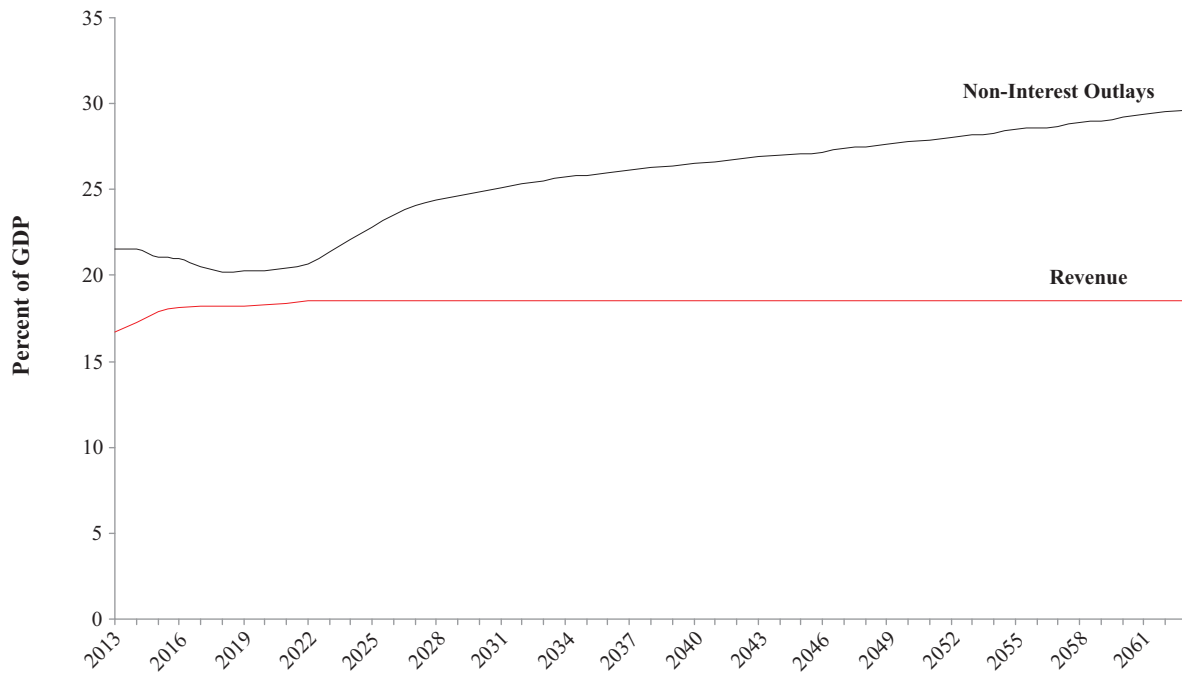
The consequence of this gap is an ever-growing debt burden, as shown in Figure 2. The federal government’s debt, which is 78 percent of annual GDP in 2013, soars to 208 percent in 2038 and

²Congressional Budget Office, “Updated Budget Projections: Fiscal Years 2013 to 2023,” at 8 (May 2013). The projections are more favorable than the projections the CBO made in February.

³Makin, “Austerity Undone,” *AEI Economic Outlook* (Apr. 2013).

⁴The data are from the CBO, “The 2012 Long-Term Budget Outlook” (June 2012), and the supplemental data spreadsheet. The CBO made projections through 2087. Although we limit our focus to the next 50 years, the trends we describe become even more pronounced in later years.

**Figure 1. Spending Projected to Outpace Revenue
(CBO Alternative Fiscal Scenario)**



Source: CBO, "The 2012 Long-Term Budget Outlook" (June 2012).

exceeds 250 percent in 2043. The CBO does not project the debt beyond that point, on the premise that debt levels that high are infeasible. As shown in the chart, however, the spending and revenue figures in the CBO's alternative fiscal scenario imply debt load greater than 500 percent of annual GDP in 2063. While economists disagree about the effects of moderate increases in debt, there is broad agreement that explosive increases in debt are associated with slower economic growth and less improvement in standards of living and that the markets eventually place an upper bound on the feasible level of debt. Policy changes must be made to ensure that nothing even close to the outcomes depicted in Figure 2 comes to pass.

Because the high debt levels implied by current policies are unsustainable, we are confident that those policy changes will be made. In the words of Herbert Stein, one of our predecessors at AEI, "If something cannot go on forever, it will stop."⁵ In the remainder of this article, we discuss six realities that we think will govern those policy changes.

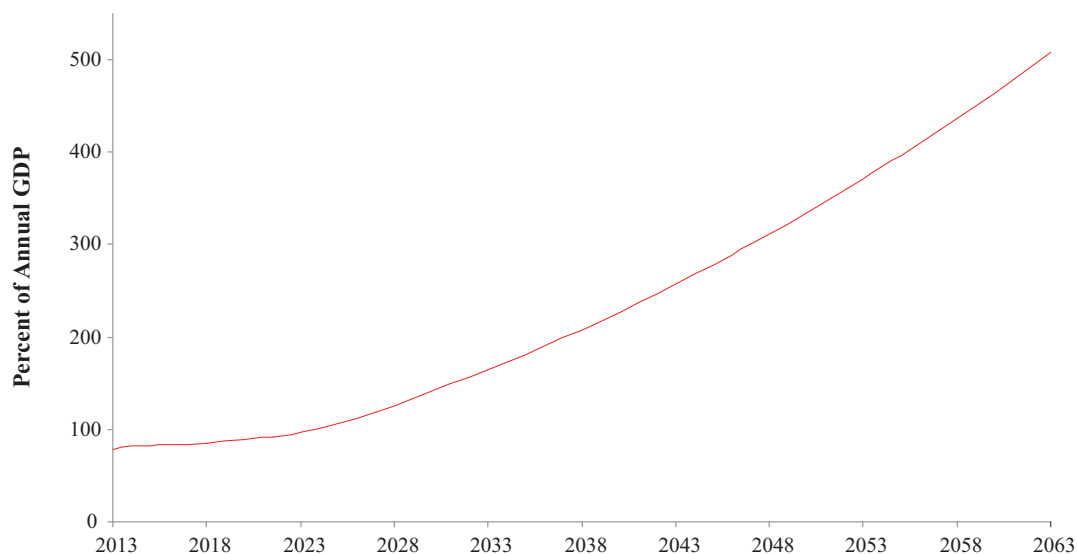
⁵In "Herb Stein's Unfamiliar Quotations: On Money, Madness, and Making Mistakes," *Slate*, May 16, 1997, Stein says he first articulated this (frequently, if sometimes inaccurately, quoted) precept in the 1980s in reference to current-account imbalances. It appeared in the June 1989 issue of *The AEI Economist*.

To set the stage for the realities, Figure 3 shows how the spending growth is projected to vary across different programs. The overall spending growth is driven by Social Security and the health programs — Medicare, Medicaid, and the health insurance exchange subsidies set to take effect in 2014 under the Patient Protection and Affordable Care Act of 2010 (PPACA).⁶ Those programs are slated to grow from 10.6 percent of GDP in 2013 to 16.6 percent in 2038 and 20.8 percent in 2063. They are entitlement programs, which means that Congress has granted them permanent authority to make payments, without further congressional authorization, in accordance with the programs' eligibility rules and benefit formulas.

In contrast to the growth of health and Social Security spending, the CBO projects that other non-interest spending will decline from 10.8 percent of GDP in 2013 to 9.6 percent in 2038 to 8.9 percent in 2063. This category includes some smaller entitlement programs, such as federal employee pensions, unemployment compensation, and food stamps. It

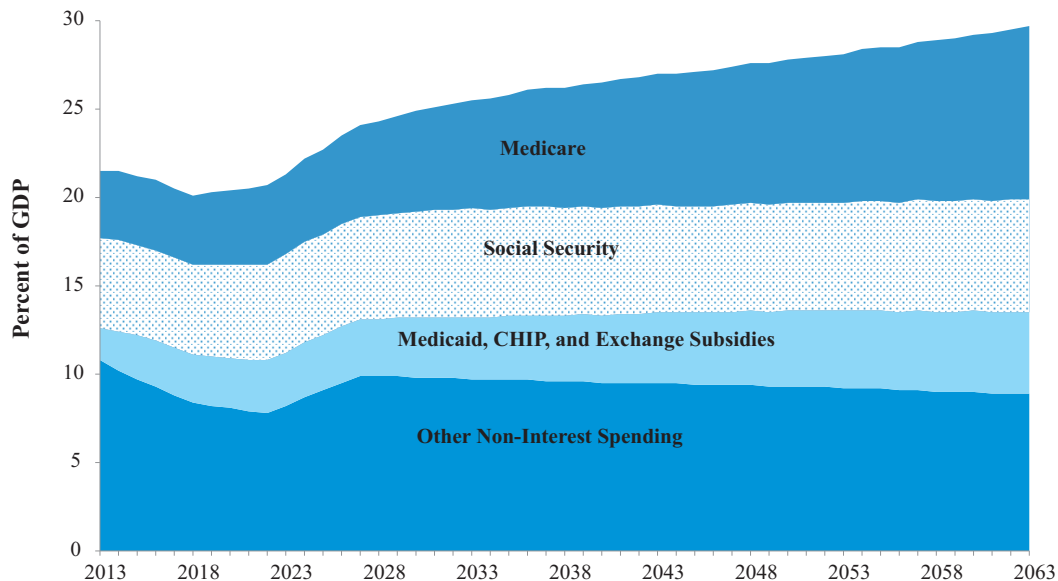
⁶As amended by the Health Care and Education Reconciliation Act of 2010.

**Figure 2. Debt Held by the Public Projected to Soar
(CBO Alternative Fiscal Scenario)**



Source: CBO, "The 2012 Long-Term Budget Outlook" (June 2012). Debt levels after 2042 are authors' computations (available on request) of levels implied by CBO's spending and revenue projections.

**Figure 3. Health and Social Security Drive Spending Growth
(CBO Alternative Fiscal Scenario)**



Source: CBO, "The 2012 Long-Term Budget Outlook" (June 2012).

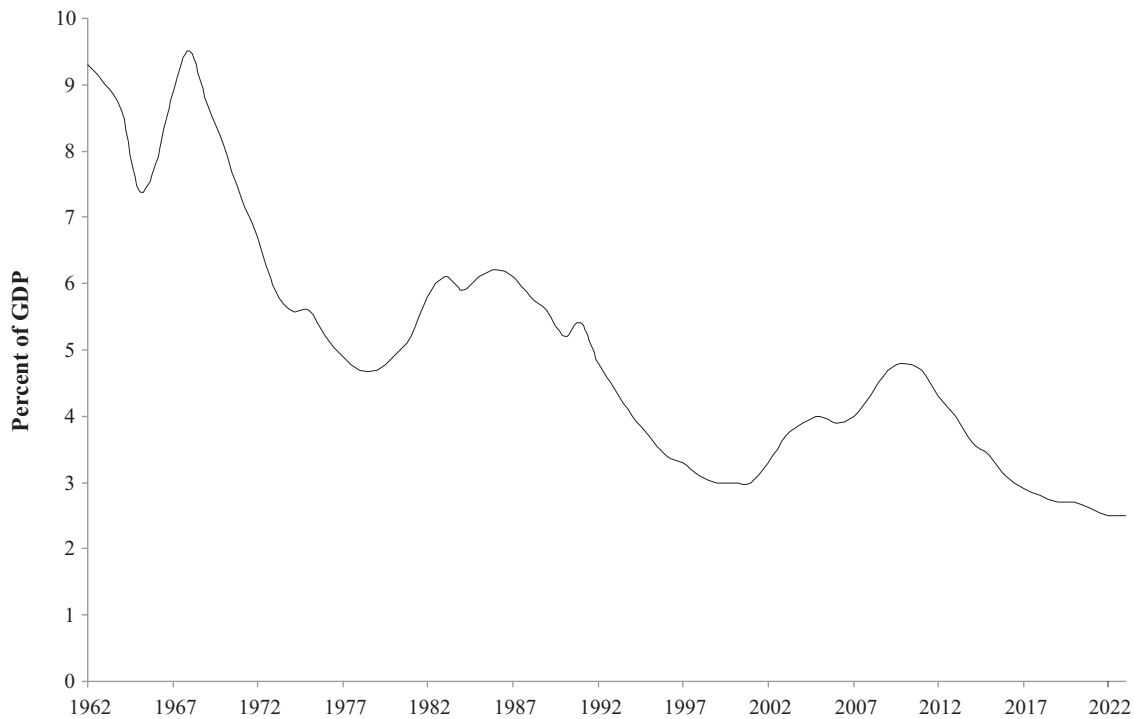
also includes discretionary spending, which refers to programs that must receive annual funding authority from Congress. Discretionary spending includes national defense and a host of non-defense programs, such as highways, national parks, and the FBI.

We begin with three realities that address the levels of spending and taxes.

B. Defense Spending Will Likely Decline

Over the long run, defense spending will likely fall as a share of GDP. That prediction is compatible

Figure 4. Downward Trend in Defense Spending



Source: Office of Management and Budget.

with the experience of the last half-century and with current policy proposals. Figure 4 graphs defense spending for fiscal 1960 through fiscal 2012 and the Obama administration's proposed spending levels for fiscal 2013 through fiscal 2023. Although defense spending rose during the Vietnam War, the 1978-1986 defense buildup, and the Afghanistan and Iraq wars, the overall downward trend is clear and long-standing. Defense spending is only 4 percent of GDP in 2013, even with tens of thousands of soldiers still in Afghanistan, down sharply from the 9.3 percent share posted in 1962.

The future path of defense spending as a share of GDP will likely resemble this historical experience, featuring a downward trend interrupted by temporary increases when military conflicts or international tensions occur. The downward trend has both an economic and a political explanation.

From an economic perspective, the income elasticity of defense spending is probably less than 1, meaning that a 10 percent increase in GDP, all else equal, results in a defense spending increase of less than 10 percent. As national income grows, some share of the surplus income goes to the military, but that share falls as income grows — a 10 percent

increase in GDP does not mean that we need 10 percent more soldiers, aircraft carriers, or fighter jets.⁷

That defense spending needs do not rise proportionately with GDP is confirmed by the fact that even the most ardent proponents of a strong defense do not call for its spending share to return to the 9 percent level observed in previous decades. During the 2012 campaign, for example, Republican presidential nominee Mitt Romney called for a floor on defense spending of 4 percent of GDP, effectively accepting the decline that has already occurred in the defense share and merely seeking to avert further declines.

From a political perspective, even the modest call to sustain defense spending's share of GDP seems unlikely to succeed, since it is difficult to imagine that the military will be untouched in the process of

⁷Goods with income elasticities lower than 1, which are considered necessities, tend to decline as a share of GDP as GDP grows. Food is a prominent example; according to Bureau of Economic Analysis data, the share of GDP spent on food fell from 15.7 percent in 1929 to 10 percent in 1970 to 5.3 percent in 2012.

responding to the fiscal imbalance. The president's budget proposal calls for defense spending to fall to 2.5 percent of GDP by 2023. The budget blueprint outlined by House Budget Committee Chair Paul Ryan, R-Wis., which formed the basis for H. Con. Res. 25, the proposed budget resolution passed by the House on March 21, calls for roughly \$6 trillion in defense spending over the next decade,⁸ which is only 3.8 percent of GDP during that period.

Although we believe there are economic reasons why defense spending will not return to its past GDP shares, we are concerned that political factors may shrink the military beyond what is advisable, in a futile effort to avoid entitlement cuts and tax increases. The fiscal gap cannot be closed solely by cutting defense. Even the clearly impossible policy of reducing defense spending from 4 percent of GDP to zero would not be enough to offset the 10-percentage-points-of-GDP growth projected for health and Social Security spending.

Although we should seek all reasonable savings in the defense budget, we must always provide sufficient funding for the government's most important function: protecting the American people. The United States should maintain a military whose sheer size and capabilities deter foreign adversaries and should never shrink the military to the point that upsizing in a time of need becomes unnecessarily difficult.

The limitations of defense cuts set the stage for the entitlement and revenue implications of the fiscal imbalance.

C. Entitlements Will Likely Be Restrained

1. Current policy features unsustainable growth. The explosive growth projected for the health entitlements and Social Security under current policy, as shown in Figure 3, would require unsupportable increases in tax rates. Tax revenue averaged 17.9 percent of GDP from 1960 through 2013. To cover the scheduled increase in health and Social Security spending, tax revenue as a share of GDP would have to be roughly one-third larger in 2038 and more than one-half larger in 2063 than it is today.

As we discuss in the next section, entitlement benefit cuts are unpopular and face political obstacles. Nevertheless, we believe that the staggering tax increases necessary to fully cover the projected increase in entitlement spending would face even more severe political obstacles. Moreover, those income tax increases would be economically harmful because the steep increases in marginal tax rates

would weaken incentives to work and save and increase incentives for tax avoidance and evasion. Given these political and economic realities, policymakers will likely recognize, however reluctantly, the need to restrain the explosive growth of entitlement spending. Indeed, some policymakers are already showing signs of realizing this. In his fiscal 2014 budget proposal, President Obama proposed to reduce benefit payments under Social Security and some other entitlement programs by basing annual cost of living adjustments on a different measure of inflation, the chained consumer price index.

Because it would be difficult to increase taxes to meet the full amount of projected spending, spending will likely increase less than is projected under current policy. The major entitlement programs will need to be reconfigured to respond in an economically sustainable way to rising healthcare costs and increasing longevity.

2. What if entitlement programs are not reconfigured? It is sometimes argued that Social Security and Medicare Part A, which covers hospital care, cannot add to the deficit because they are financed by earmarked taxes. (In contrast, Medicare parts B and D — which cover outpatient services and prescription drugs, respectively — and Medicaid are financed by general revenue, not by earmarked taxes.) Can deficit reduction require any change to these programs if their costs are fully covered by earmarked taxes? The answer depends on the baseline from which changes are measured.

Social Security and Medicare Part A lack legal authority to pay benefits beyond the amount that can be financed by current and past payroll taxes, as tracked by trust fund accounting mechanisms. If no new legislation is adopted, Social Security will be required to reduce benefit payments by 23 percent in 2033, when the trust fund balance reaches zero. The cutback would not only be permanent but would become slightly larger over time, reaching 27 percent in 2090. For Medicare Part A, payments would need to be cut by 13 percent in 2026, when its trust fund is exhausted, and the cut would grow to 29 percent in 2046.⁹ If those automatic cuts are allowed to happen in the wake of trust fund exhaustion, no further cuts will be required to keep Social Security and Medicare Part A from contributing to long-run deficits.

⁸House Committee on the Budget, "The Path to Prosperity: A Blueprint for American Renewal, Fiscal Year 2013 Budget Resolution," at 62 (Mar. 20, 2012).

⁹The percentage reductions are computed from Social Security Administration Office of the Chief Actuary data available at <http://www.ssa.gov/oact/tr/2013/lr6f2.html>.

The CBO's alternative fiscal scenario, as charted in figures 1, 2, and 3, ignores the trust fund constraint and assumes that Social Security and Medicare Part A will pay full benefits in perpetuity. That would require a change in the law, since Congress would have to grant the programs authority to tap general revenue after the trust funds were exhausted. But the assumption that full benefits will be paid is a realistic description of current policy and retirees' expectations. If that spending actually took place, the programs would significantly add to long-run deficits, as shown in the CBO projections.

In short, Social Security and Medicare Part A cannot honor the promises embedded in their current benefit formulas without adding to the deficit. To keep the programs from doing so, their spending must be reduced from the levels promised by their benefit formulas to the lower levels that can be financed by their earmarked taxes. The default option for doing that is to automatically reduce Social Security and Medicare Part A payments when their trust funds run dry in 2033 and 2026, respectively. The automatic payment reduction would result in an abrupt cut in benefit checks and a disruption of healthcare delivery — longer wait times, access to fewer tests and procedures, and the like — to Medicare recipients.

We believe that even if Congress taps general revenue after the trust funds run dry, spending on Social Security and Medicare will fall relative to current policy because the tax increases required to sustain current policy will not be tolerated by the American people. Instead of allowing Social Security and Medicare Part A to suddenly collapse, we should change the structure of the programs to avert the automatic reductions while still reducing spending relative to currently policy. It is conceptually straightforward, if politically difficult, to adjust Social Security and Medicare for rising longevity. Raising eligibility ages could forestall an increase in the length of time that recipients receive benefits from these programs. Alternatively, the level of benefits could be reduced to offset the longer period over which benefits are received.

Dealing with rising healthcare costs is more difficult.

3. Cutting healthcare costs. Some analysts accept that entitlement *spending* must be restrained but contend that there is little need to restrain entitlement *benefits*, because policy changes can and should slow or halt the increase in the relative price of healthcare. Of course, everyone would welcome measures that would magically reduce the costs of healthcare without sacrificing quality. Unfortu-

nately, proposals seeking to bend the cost curve in that manner will likely have limited efficacy.

Measures such as using better information technology, curbing unnecessary treatments, expanding the use of comparative-effectiveness research in evaluating treatments and procedures, promoting preventive care, or limiting medical malpractice lawsuits may modestly reduce costs (although that is far from certain for some of the measures) and may well be desirable.

Other measures are more promising because they alter the underlying incentives of providers and patients. For example, the tax exclusion for employer-provided health insurance has inefficiently increased the level of healthcare costs, and limiting the exclusion would be an efficient way to reduce the level of costs.¹⁰ Healthcare costs have also been increased by the dominant use of third-party payments, a structure that many reform proposals seek to adjust. Some healthcare experts believe that the increasing use of deductibles in health insurance plans is already slowing the growth of health spending.

But even those measures are unlikely to permanently change the underlying trajectory of cost growth, which is driven by fundamental economic forces.¹¹

The demand for healthcare — at least for society as a whole, if not for every individual — likely has an income elasticity greater than 1, so that demand rises more rapidly than income.¹² Also, healthcare spending has risen because remarkable advances in healthcare technology and medicine have made healthcare a more desirable good. At the same time, the healthcare sector has seen little of the cost-reducing technological progress that has occurred so dramatically in the manufacturing sector. The growth rate of healthcare costs is largely a rational response to underlying economic forces, and efforts to arbitrarily reduce the growth rate may sacrifice

¹⁰A 40 percent excise tax on high-cost employer-provided health insurance, indirectly offsetting part of the income tax exclusion, is scheduled to take effect in 2018, under section 4980I, which was adopted as part of the PPACA.

¹¹For general overviews of the economic forces, see Amitabh Chandra and Jonathan Skinner, "Technology Growth and Expenditure Growth in Health Care," 50 *J. Econ. Literature* 645 (2012), and Council of Economic Advisers, "2013 Economic Report of the President," at 163-167.

¹²Robert E. Hall and Charles I. Jones, "The Value of Life and the Rise in Health Spending," 122 *Q. J. Econ.* 30 (2007), argue that as income rises, individuals will devote an increasing part of their additional resources to goods that will extend their life spans.

beneficial advances in medical technology. A recent study by two distinguished economists concludes that the increase in longevity that the United States has experienced since 1970 is worth \$3 trillion per year to Americans.¹³

In any event, it would be irresponsible to base budget policy on the assumption that healthcare costs will somehow be altered to the extent that structural changes to health entitlement programs can be avoided.

Congress's past efforts to limit federal health spending through legislative fiat, without changing the structure of health entitlements, have clearly failed. In 1997 Congress adopted legislation setting Medicare physician payment rates under a sustainable growth rate (SGR) formula that was designed to keep expenditures per beneficiary for physicians' services growing at roughly the same rate as per-capita GDP.¹⁴ In each of the last 10 years, however, Congress has adopted "doc fix" legislation to avert the full application of the SGR formula because the required cuts would deter physicians from participating in Medicare. The CBO's alternative fiscal scenario, graphed in figures 1, 2, and 3, realistically assumes that Congress will continue to avert full application of the SGR.

The PPACA takes this flawed strategy to a new level. That law calls for an arbitrary adjustment that will purportedly slash Medicare payments to a wide range of healthcare providers (relative to prior-law levels) by increasing amounts over time. As the Medicare trustees and the CBO have noted, the adjustment is unsustainable over the long term unless unprecedented productivity improvements occur in the healthcare sector.¹⁵ Productivity growth

cannot simply be demanded; if it could, why not demand it from the entire economy rather than only one sector? The CBO's alternative fiscal scenario reasonably assumes that the adjustment will not be fully implemented beyond 2023.

4. Hard choices. Because there is no magic bullet that will slow overall healthcare costs, entitlement restraint will likely require that the federal government pay a smaller share of healthcare costs than under current policies. That approach is often derided as cost shifting and contrasted unfavorably to the reduction in overall healthcare costs ostensibly achieved by bending the cost curve. That terminology puts things exactly backward. In a free society, the costs of goods and services are, as an initial matter, borne by the individuals who consume them. Those costs can be shifted to the government, and that shifting is highly desirable in some cases, including the provision of necessary medical care to those who cannot afford it. Reducing the federal government's share of healthcare costs is therefore best described as *reducing* the shifting of costs from recipients to taxpayers, not as shifting costs *from* taxpayers to recipients. The challenge will be to reduce cost shifting to taxpayers in a way that ensures the availability of medical care to those in need.

Ryan's budget plan turns to Medicare premium support to reduce federal exposure to health expenses. Seniors would receive a fixed amount of federal money — essentially a voucher — to spend on health insurance. If a senior wanted more generous healthcare than could be purchased with the voucher, she would be free to supplement the voucher with her own funds.

Premium support will likely lower the price of healthcare in the market by creating a strong incentive for health insurers to offer plans at or below the value of the voucher, encouraging insurers to discover what it is that seniors really want to buy and providing those services as cheaply as possible. Also, with less generous insurance coverage, seniors will likely be more cost-sensitive in their purchases of some medical care. Premium support, therefore, should reduce overall healthcare costs.

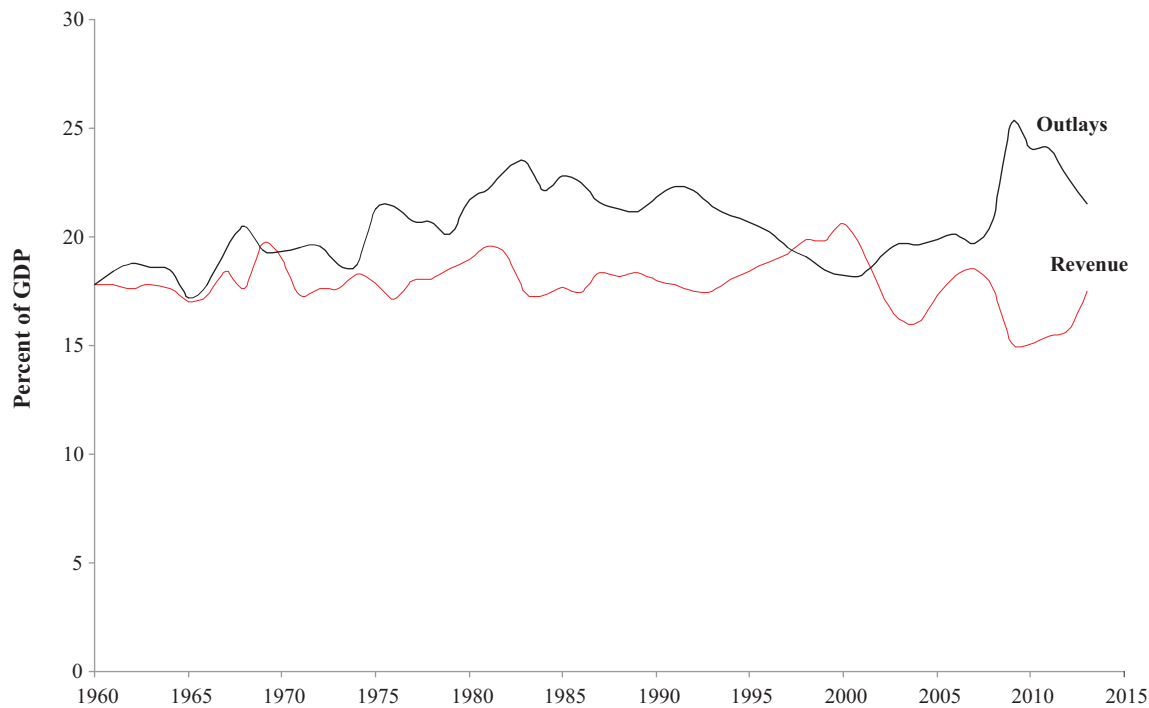
Over the long haul, however, a significant part of the savings from premium support will likely come from the backup provision limiting the growth rate of the voucher to the GDP growth rate plus 0.5 percent per year.¹⁶ If that provision is implemented, it would hold down the federal government's share of costs and ultimately require recipients to bear more of the costs. Of course, premium support is no panacea. It is unclear whether Congress would

¹³Kevin M. Murphy and Robert H. Topel, "The Value of Health and Longevity," 114 *J. Pol. Econ.* 871 (2006).

¹⁴Balanced Budget Act of 1997, sections 4502 and 4503 (amending 42 U.S.C. section 1395w-4).

¹⁵In their 2013 annual report, the Medicare trustees assumed that the adjustment will be implemented but conceded that implementation will be feasible only if "health care providers are able to realize productivity improvements at a faster rate than experienced historically" and acknowledged that if those productivity gains cannot be attained, the reimbursement reductions will cause "the availability and quality of health care received by Medicare beneficiaries" to fall over time. The trustees noted that by 2087 the adjustment would reduce payments by 55 percent, relative to levels under prior laws, and that without the unprecedented productivity improvements, Medicare payments for inpatient hospital service will be less than 40 percent of the rates paid by private insurers in 2087 and that negative profit margins would result for 40 percent of hospitals, skilled nursing facilities, and home health agencies as early as 2050. The CBO noted in its original cost estimate that the adjustment "might be difficult to sustain over a long period of time" and that it was "unclear" whether the required cost savings could be achieved.

¹⁶"The Path to Prosperity," *supra* note 8, at 39.

Figure 5. Revenue Has Fluctuated Between 15 and 21 Percent of GDP

Source: Office of Management and Budget.

really hold the voucher growth rate to the specified rate, so it is possible that the government would have substituted one expensive entitlement for another.

But the fundamental reality remains the same: Healthcare costs will continue to rise, the public will not fully fund the increases through higher taxes, and so federal health spending will fall over time relative to current policy. The only question is whether we make a futile effort to keep health entitlements in their current form or acknowledge that spending will fall and restructure the programs to ensure that the American people get the biggest bang for their buck.

We conclude that some entitlement benefit restraint will likely be adopted. From the standpoint of economic growth, the more the better. But we also recognize that the extent of entitlement restraint will likely be limited, a fact that has important implications for revenue.

D. Revenue Is Likely to Rise as a Share of GDP

The revenue share of GDP, graphed in Figure 5, averaged 17.9 percent from 1960 through 2013, fluctuating between a low of 15.1 percent (in 2009

and 2010) and a high of 20.6 percent (in 2000). The 2013 value is estimated to be 17.5 percent. As a result of the growth of entitlement spending, future revenue shares will probably be higher than the historical values.

The revenue share could remain at current levels if health and Social Security spending were kept at their current shares of GDP. The CBO projections make clear, however, that keeping entitlement spending at its current share would require dramatic and ever-deeper reductions relative to the benefit levels implied by current policies. Keeping these programs at 10.6 percent of GDP, rather than growing to 20.8 percent in 2063, for example, would require that benefits be cut in half from the level implied by current policy.

The political feasibility of that strategy depends on the public's willingness to support dramatic reductions in entitlement spending (relative to the levels promised by current policy) as an alternative to tax increases. Countless polls make clear that that willingness does not exist. For example, in a 2003 survey about how to reduce the long-run Social Security deficit, only 5 percent of the public favored relying mainly on benefit cuts, whereas 30 percent

supported relying mainly on payroll tax increases and 34 percent called for a mix of the two measures.¹⁷ In a 2012 survey, only 9.7 percent said they would support major Social Security cuts as a way to reduce the deficit, and only 11.8 percent said they would support major Medicare cuts. Support for spending cuts was low even among Republicans, 13.5 percent for Social Security and 15.5 percent for Medicare; support for cuts was actually higher among independents, at 13.9 and 17.5 percent.¹⁸

The polls strongly suggest that the public will not allow entitlement spending to be cut to the point that revenue increases are not required. The actions of elected leaders, which are more compelling than poll data, confirm the unpopularity of entitlement benefit cuts in striking and surprising ways. On several occasions, Republicans have publicly championed higher entitlement spending than Democrats. For example, Republicans — including the Romney-Ryan 2012 presidential campaign — have attacked the Medicare provider payment cuts in the PPACA, not because they were concerned that the provisions will fail to actually cut Medicare spending (as discussed above), but because they were opposed to cutting Medicare spending. Also, the head of the National Republican Congressional Committee recently attacked Obama for, in his words, “trying to balance this budget on the backs of seniors.”¹⁹

And it’s not always just words. In 2003 a Republican president, Republican-controlled Senate, and Republican-controlled House significantly expanded Medicare by adding prescription drug coverage without any offsetting spending cuts.²⁰ The prescription drug benefit was the largest expansion of the welfare state since Lyndon Johnson. It is revealing that President George W. Bush was able to secure passage of legislation increasing Medicare spending but was unable to push through his 2005 proposal to reduce Social Security spending growth by changing the benefit computation for future retirees.

On a more promising note, the Republican Party, under Ryan’s leadership, has proposed converting

Medicare to a premium support model, as discussed above. Ryan has also proposed block-granting Medicaid to limit federal spending on healthcare for the poor, as further discussed below. Those reforms have passed the House in recent years on party-line votes. As bold as Ryan’s Medicare plan is, it does not take effect until 2024 and then applies only to new beneficiaries (those born in 1959 or later).²¹ Even this plan rejects reducing Medicare benefits for anyone who is currently 55 or older.

As discussed above, entitlement reductions will be part of the fiscal solution, and the most growth-friendly approach to fiscal consolidation would go heavy on spending cuts and light on tax increases. But public and political attitudes make it clear that it will be possible to secure significant entitlement reductions only if they are accompanied by tax increases. Democrats’ opposition to entitlement cuts and Republicans’ ambivalence about them make a budget strategy that relies entirely on entitlement cuts politically unviable. Therefore, revenue will have to rise to restore fiscal balance. Indeed, the only significant entitlement benefit reduction in recent years, the benefit cuts in the 1983 Social Security legislation, were part of a bipartisan agreement that also included tax increases, as further discussed below.²²

Democrats strongly support increasing revenue as a share of GDP. And Republicans are starting to accept this as well. Ryan’s budget proposal calls for revenue to rise to 19.1 percent of GDP by fiscal 2023, significantly above the 1960-2013 average of 17.9 percent.²³

E. Likely Shift Toward Consumption Taxation

The rise in federal revenue will place additional strain on the income tax system by magnifying its economic and political costs. That will create pressure to shift toward consumption taxation in some form, and to some extent, sometime in the (possibly distant) future. The most likely, although not the most desirable, outcome is the eventual introduction of a VAT alongside the income tax.

The distinctive economic inefficiency of income taxation is that it penalizes saving. (Income taxation also penalizes work, but that is equally true for consumption taxation.) Consider two individuals, Patient and Impatient, each of whom earns \$100 of wages today. Impatient wishes to consume only today, whereas Patient wishes to consume only at a

¹⁷Alan S. Blinder and Alan B. Krueger, “What Does the Public Know About Economic Policy, and How Does It Know It?” 35 *Brookings Papers on Economic Activity* 327, 375-381 (2004).

¹⁸Survey conducted April 26 through May 2, 2012, by YouGov (formerly Polimetrix), results available at <http://www.dartmouth.edu/~benv/files/poll%20responses%20by%20party%20ID.pdf>.

¹⁹For further discussion, see Viard, “Both Parties Defend Medicare, None the Taxpayer,” *Real Clear Markets* (Oct. 24, 2012), and Strain and Viard, “Republicans Against Entitlement Cuts? Seriously?” *AEIdeas* blog (Apr. 11, 2013).

²⁰Medicare Prescription Drug, Improvement, and Modernization Act.

²¹“The Path to Prosperity,” *supra* note 8, at 39.

²²Social Security Amendments of 1983.

²³“The Path to Prosperity,” *supra* note 8, at 77.

distant future date. Savings can be invested to obtain a 100 percent rate of return between now and the future date.

With no taxes, Impatient consumes \$100 today, whereas Patient saves \$100, earns \$100 interest, and consumes \$200 in the future. With a 20 percent income tax, Impatient pays \$20 tax on his wages and consumes \$80, which is 20 percent less than in the no-tax world. Patient pays \$20 tax and saves the remaining \$80. She earns \$80 interest, on which she must pay \$16 tax. Along with the \$80 principal, Patient consumes \$144, which is 28 percent less than in the no-tax world. Under the income tax, Patient faces a higher tax burden than Impatient, 28 percent rather than 20 percent, solely because she saves. Income taxation penalizes saving and thereby tends to impede capital accumulation. Because a growing capital stock increases overall economic growth, a tax on savings lowers living standards for future generations.

In contrast, a consumption tax is neutral if the tax rate is constant over time. Consider a consumption tax with a 25 percent rate, so that the tax is 20 percent of the combined amount devoted to consumption and taxes. After earning \$100 of wages, Impatient consumes \$80 and pays \$20 tax. Patient saves the entire \$100 and owes no tax today. She earns \$100 interest, thereby accumulating \$200. At the future date, she consumes \$160 and pays \$40 tax. Both individuals face the same 20 percent tax burden, demonstrating that consumption taxation avoids the penalty on saving. The neutral treatment of saving generally makes consumption taxation economically superior to income taxation.²⁴

If the rise in federal revenue discussed above comes solely from higher income taxes, the penalty on saving will be enhanced, magnifying the economic costs of the income tax. Further, political constraints require that income tax rates can go only so high. At some point, the need to raise additional revenue without increasing income tax rates will likely prompt a movement away from income taxation. The corporate income tax — for which we have the highest statutory tax rate among OECD countries — is particularly likely to wither away because it features a multitude of economic distortions. In addition to penalizing saving, it encourages investment to be located outside the United

States, penalizes equity relative to debt, and penalizes corporations relative to noncorporate businesses.

The most probable way to shift toward consumption taxation is the introduction of a VAT alongside the income tax. This arrangement is common for industrialized democracies; all OECD countries other than the United States have a VAT. The adoption of a VAT could forestall the expansion of the income tax that would otherwise occur and could even be used to finance a reduction of the income tax below its current levels. Michael J. Graetz and Leonard E. Burman have each presented plans that would introduce a VAT while reducing the top income tax rate to 25 percent or less.²⁵

The enactment of a VAT, which does not penalize saving, to partially replace an income tax that does penalize saving would yield a significantly more efficient tax system. Of course, the gains would be diminished to the extent that the VAT removed pressure to restrain entitlement spending. The gains would also be diminished if the VAT exempted many goods or services.

Although a partial replacement of the income tax with a VAT is the most likely outcome, it is not the most economically desirable. Larger efficiency gains would be available from a complete replacement of income taxation by consumption taxation, a policy that would also permit significant simplicity gains. Complete replacement by a conventional VAT or a retail sales tax would not be desirable or politically feasible, however, because that replacement would shift too much of the tax burden downward to middle-income earners. Although the response to the fiscal imbalance is likely to feature heavier burdens on the middle class, as discussed below, it is unlikely to include a policy that increases taxes on middle-income earners while lowering taxes for the rich.

The distributional problems can be avoided by replacing the income tax with a progressive consumption tax such as a Bradford X tax or a personal expenditure tax. The X tax is a graduated rate version of the flat tax advocated by Robert Hall and Alvin Rabushka. Businesses are taxed at a high flat rate on their business cash flow, and households pay tax at graduated rates on their wages, with exemptions and refundable credits for low-wage households. The personal expenditure tax imposes tax at graduated rates on households' consumer spending, which households would compute on

²⁴Of course, a full comparison of the two tax systems is complex. As Joseph Bankman and David A. Weisbach, "The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax," 58 *Stanford L. Rev.* 1413 (2006), discuss at length, however, the superiority of consumption taxation holds under relatively broad assumptions.

²⁵Michael J. Graetz, *100 Million Unnecessary Returns: A Simple, Fair, and Competitive Tax Plan for the United States* (2008); Leonard E. Burman, "A Blueprint for Tax Reform and Health Reform," 28 *Va. Tax Rev.* 287 (2008).

their annual tax returns as income minus net saving.²⁶ Despite the conceptual appeal of the X tax and the personal expenditure tax, they are unfamiliar tax systems and their enactment is unlikely. The most probable outcome is the less attractive policy of adopting a conventional VAT alongside the income tax.

F. Likely Burden on Broad Middle Class

Any solution to our long-run fiscal imbalance cannot rely primarily on raising taxes on the richest Americans or on cutting safety net programs for the poor. Instead, the broad middle class must bear much of the burden of deficit reduction.

1. Who is a middle-income earner? Listening to the public debate, it is easy to be confused about which households are in the middle class. It is natural to think that the middle class should be defined as the middle 60 percent or so of households by income. But the tax policy debate considers only the top 2 or 3 percent of households by income to be rich. (This means that a household with income greater than 97 percent of all households is considered middle class.) We will likely continue to define middle class quite broadly, even if the specific definition changes over time. The broad definition may reflect the widespread view that a household with, say, \$245,000 of income is in a different social class from a household with \$1 million of income. In any case, the broad definition of middle class reinforces the need for the middle class to bear much of the burden of deficit reduction.

Because raising taxes on or cutting benefits for the broad middle class — the overwhelming majority of voters — is politically unattractive, policymakers have a strong incentive to seek other solutions, such as raising taxes on the top 2 or 3 percent or significantly cutting the safety net programs for the bottom 20 percent. But neither of those flawed approaches offers enough savings to close the long-run fiscal gap.

2. Raising taxes on the top 2 or 3 percent won't be enough to solve the problem. Obama and congressional Democrats often claim that the deficit is driven by inadequate taxes on the rich. "We made the [deficit] problem worse," argued the president in April 2011, "with trillions of dollars in unpaid-for tax cuts — tax cuts that went to every millionaire and billionaire in the country; tax cuts that will force us to borrow an average of \$500 billion every

year over the next decade."²⁷ The president's remarks were misleading because they juxtaposed the mention of tax cuts for millionaires and billionaires with the \$500 billion annual total cost of the 2001 and 2003 tax cuts, most of which did not go to millionaires and billionaires. Indeed, roughly three-quarters of the revenue loss was the result of tax cuts for the broadly defined middle class. The president successfully pushed to make those tax cuts permanent, even as many of the tax cuts for high-income households were allowed to expire.²⁸

The focus on taxing the top 2 percent has continued. Under the PPACA, an increase in the Medicare payroll tax on high-paid workers and a new unearned income Medicare contribution tax on high-income savers took effect in January 2013. The president's fiscal 2014 budget proposal calls for significant additional tax increases on the wealthy, including limits on itemized deductions and other tax preferences, and a minimum Buffett tax on millionaires that would effectively raise taxes on qualified dividends and long-term capital gains.

Those proposals may seem appealing at first glance because the rich do earn a large share of national income, larger than in the past. The CBO reports that the top 5 percent of households earned 26 percent of pretax income in 2009.²⁹ But despite the high share of national income enjoyed by the top 5 percent of households (3 percentage points of which are, according to the tax policy debate, actually in the middle class), we cannot solve our long-term deficit solely by increasing their taxes.

Economists at the Urban-Brookings Tax Policy Center calculated in March 2012 that if no other policy measures were adopted, raising the top two ordinary income brackets to more than 95 percent would not be enough to bring the ratio of debt to annual GDP down to 60 percent by 2035, even ignoring changes in taxpayers' behavior.³⁰ Under those oppressive tax rates, the tax base would shrink and economic growth would suffer, since high-income households would work less and save less, engage in tax avoidance and evasion, or even move overseas. Moreover, increases of that magnitude are politically unrealistic. And treating the top few percent of households as a revenue-generating mechanism for the broad middle class poses serious ethical issues.

²⁷Remarks made at George Washington University, Apr. 13, 2011.

²⁸The American Taxpayer Relief Act of 2012.

²⁹CBO, "The Distribution of Household Income and Federal Taxes, 2008 and 2009," at 13 (July 2012).

³⁰Eric Toder et al., "Reducing the Deficit by Increasing Individual Income Tax Rates," Urban-Brookings Tax Policy Center (Mar. 2012).

²⁶For a discussion of the X tax, see Robert Carroll and Viard, *Progressive Consumption Taxation: The X Tax Revisited* (2012). For a discussion of the personal expenditures tax, see Laurence A. Seidman, *The USA Tax: A Progressive Consumption Tax* (1997).

We are not alone in recognizing that taxing the rich is not a full solution to the fiscal gap. Economists and analysts from across the ideological spectrum have made the same point, including Henry J. Aaron and Isabel V. Sawhill of the Brookings Institution, C. Eugene Steuerle of the Urban Institute, 2008 Nobel economics laureate Paul Krugman, *Tax Notes* contributing editor Joseph J. Thorndike, and analysts at Third Way.³¹ Although most or all of those analysts favor raising taxes on the rich, they recognize that other measures will also be necessary.

While some look solely to the top 2 or 3 percent for the necessary money, others look solely to the bottom 20 percent. That approach is also flawed.

3. Cutting the safety net for the bottom 20 percent won't be enough to solve the problem. There's not enough money in safety net programs and health programs for children and the poor to address the long-term imbalance. CBO data show that only 41 percent of federal transfer payments went to the 20 percent of households with the lowest market incomes in 2009.³² In 2012 non-Medicare federal health programs and safety net programs made up only about one-fifth of non-interest federal spending.³³ Even deep cuts to safety net programs, Medicaid, and the children's health insurance program (CHIP) will not generate enough savings to solve our structural deficit problem.

Moreover, the safety net programs are on a slower growth trajectory than Social Security and Medicare, the two large middle-class entitlement programs, as can be seen by referring back to Figure 3. To be sure, the CBO projects that the healthcare portion of the safety net, consisting of Medicaid, CHIP, and PPACA exchange subsidies, will increase by 2.8 percentage points of GDP from 2013 to 2063. Although that growth is significant and worrisome, it is not the biggest driver of the long-run fiscal imbalance. Much of that growth is projected to be

offset by a decline of 1.9 percentage points of GDP in other non-interest spending, consisting of the remaining safety net programs, defense, and non-defense discretionary spending. In contrast, Medicare rises from 3.8 percent of GDP to 9.8 percent and Social Security rises from 5.1 percent to 6.4 percent from 2013 to 2063. The 7-percentage-points-of-GDP increase in Social Security and Medicare spending far overshadows the growth of the safety net programs.

Those numbers make clear that any solution to our long-term structural deficit must include reductions in entitlement spending enjoyed by middle-income earners.

Republicans are sometimes tempted to deny that reality, as illustrated by the Ryan budget plan. The proposed budget balances in 10 years, relying on \$3.9 trillion in non-interest savings during that time. Eliminating the Medicaid expansion and exchange subsidies called for by the PPACA generates 45 percent of that amount. Another 25 percent comes from cutting outlays on "other mandatory" programs, with specific mention of significant cuts in food stamps. And 21 percent comes from additional Medicaid cuts (beyond the elimination of the PPACA expansion), which would be attained by turning Medicaid into a block grant with very slow funding growth, and cuts to CHIP.

The House budget, then, achieves balance largely by eliminating PPACA expenditures and significantly reducing safety net spending. In contrast, it leaves the two big middle-class entitlement programs largely untouched over the next 10 years, with only 3.3 percent of the savings coming from Medicare and none from Social Security. From 2014 to 2023, the plan calls for annual nominal spending growth of 5.8 percent for Social Security and 6.1 percent for Medicare, but only 2.1 percent for Medicaid and other health programs.³⁴

On the positive side, the Ryan plan includes much-needed structural Medicare reform. But the plan waits until 2024 to implement premium support and then applies it only to new beneficiaries, a forbearance not extended to Medicaid and food stamp recipients, who are hit with budget cuts almost immediately. We shouldn't be placing the overwhelming majority of the burden of deficit reduction over the next 10 years on the shoulders of the poor while asking so little of the broad middle class, particularly the elderly middle class. And

³¹Aaron and Sawhill, "Bend the Revenue Curve," *The Washington Post*, Oct. 13, 2009; Steuerle, "Teddy Roosevelt Redux?" Urban Institute (Dec. 14, 2011); Krugman, "Climate of Change," *The New York Times*, Feb. 27, 2009; Thorndike, "What You Can't See Might Hurt You," *Tax Notes*, Mar. 30, 2009, p. 1527; David Brown et al., "Necessary but Not Sufficient: Why Taxing the Wealthy Can't Fix the Deficit," *Third Way* (Sept. 2012).

³²CBO, *supra* note 29, at 5.

³³Safety net programs are unemployment compensation (subfunction 603), housing assistance (604), food and nutrition assistance (605), and other income security programs (609). Major federal programs in those categories include unemployment insurance, food stamps, Temporary Assistance to Needy Families, Supplemental Security Income, school lunch programs, section 8 housing, the refundable portion of the earned income tax credit, and the Low Income Home Energy Assistance Program. Function 550 outlays include Medicaid and CHIP. See Office of Management and Budget Historical Table 3.2.

³⁴"The Path to Prosperity," *supra* note 8, at 79-80.

cutting spending on low-income households alone over the next several decades will not bring balance to our fiscal situation.³⁵

4. Politics, ethics, and arithmetic. Of course, the above analysis does not necessarily imply that taxes on the rich shouldn't be increased or that spending on the safety net shouldn't be reduced. For example, the growth of Medicaid and the PPACA exchange subsidies will need to be examined. But relying exclusively on taxing the rich and cutting the safety net is not viable. For political, ethical, and arithmetic reasons — any one of which is sufficient — bringing our long-term deficit to a sustainable level will require that the broad middle class bear much of the burden.

G. Bipartisan Agreement Likely Required

1. Neither party can act alone. Serious steps to control the long-term fiscal imbalance likely will be adopted with bipartisan support. Tax revenue will rise as part of an eventual deficit reduction package, but for political reasons Republicans can't propose the increase and Democrats hesitate to propose broad-based tax increases. Medicare spending will have to be significantly reduced, but political reality means that Democrats can't propose those reforms and Republicans have often hesitated to do so — for example, the Ryan budget exempts anyone who is currently 55 or older from Medicare cuts. The parties will have to work together to take these steps.

In a bipartisan agreement, each party accepts some of the other party's ideas that it previously opposed. And in many cases, each party accepts some ideas that *both* parties previously opposed. The 1983 bipartisan Social Security agreement vividly illustrates the latter phenomenon. On July 14, 1981, the Senate voted 98 to 0 to adopt a nonbinding resolution stating that Social Security benefits should remain exempt from income tax. Yet the bipartisan Social Security agreement adopted less than two years later made benefits partly taxable. A policy measure that was overwhelmingly unpopular with both parties in isolation was adopted as part of a bipartisan response to a widely recognized problem.

The VAT may be a relevant example in the current debate. On April 15, 2010, the Senate voted 85 to 13 to adopt a nonbinding resolution condemning the VAT, with Democrats supporting the resolution 43 to 12, Republicans 40 to 1, and independents 2 to 0. Based on the Social Security experience, the passage

of the anti-VAT resolution, which commanded 13 fewer votes than the 1981 resolution, should not be interpreted as precluding the adoption of a VAT as part of a bipartisan agreement to address the long-term fiscal imbalance.

Whether it is a VAT or other policies, any bipartisan agreement will likely include some measures that neither party previously supported.

2. Circumstances in which agreement may be reached. It is much easier to predict what will be included in a deal than to predict how it will pass both houses of Congress and be signed into law by the president.

A bipartisan deal could take place after a catastrophe, when the market decides that Treasury bonds are no longer safe, panic ensues, and credit evaporates. Or the deal could occur in response to a less drastic crisis, in which demand for Treasury bonds decreases, causing interest rates to increase and GDP growth to slow. The federal government, often moving at a snail's pace and characterized by gridlock, can react quickly in situations such as these, as illustrated in the early days of the recent financial crisis. On September 29, 2008, after the House failed to pass a bailout package, the Dow Jones industrial average fell 777 points — the biggest point drop in history.³⁶ A few days later, the House passed a bailout package.³⁷ The 1983 Social Security agreement was also adopted under relatively urgent conditions, as the Social Security trust fund was approaching exhaustion.

It would be far better, of course, for a fiscal agreement to be reached before a crisis hits, because the problem becomes worse every day that we wait. It is possible to reach an agreement in the absence of a crisis, as illustrated by the landmark 1986 tax reform.³⁸ That law is not a perfect parallel because it did not reduce the deficit. But, in exchange for reductions in statutory tax rates, it did narrow or eliminate an array of tax breaks that had previously been viewed as untouchable. "The odds against genuine tax reform" in 1986 "were astronomically high," wrote the late professor Robert Lekachman.³⁹ He said:

Reform entailed massive assault upon the array of tax preferences and shelters lovingly created by alliances between lobbyists for developers,

³⁶Camilla Webster, "Dow Sinks 777 Points as Bailout Plan Fails," *Forbes.com* (Sept. 29, 2008).

³⁷Emergency Economic Stabilization Act of 2008. See Eric Martin, "U.S. Stocks Drop as Recession Concern Outweighs Bailout Passage," *Bloomberg* (Oct. 3, 2008).

³⁸The Tax Reform Act of 1986.

³⁹Lekachman, "And They Said It Couldn't Be Done," *The New York Times*, July 5, 1987.

³⁵For further discussion, see Strain and Viard, "The Ryan Budget: A Start, but Not an End," *The Daily Caller*, Mar. 13, 2013; and Viard, "True Entitlement Reform Will Hit Middle and Upper Income Classes," *Real Clear Markets* (May 23, 2012).

oil and gas entrepreneurs, life insurance companies, defense contractors and numerous other special interests, and the Congressmen whose campaigns for re-election they generously financed. Dan Rostenkowski, chairman of the Ways and Means Committee . . . [had previously been] an enthusiastic supporter of more rather than fewer tax shelters. His Senate counterpart as chairman of the Finance Committee was Bob Packwood, who confessed at the outset that he rather liked the existing tax code.⁴⁰

The 1986 tax reform was not only difficult to predict; it is difficult to explain, even with the benefit of hindsight. Jeffrey H. Birnbaum and Alan S. Murray's book-length description recounts that the law was nearly dead on several occasions, only to be revived by random and unexpected events.⁴¹ As Thorndike recently noted, "1986 was an outlier and even today we don't know why the stars aligned the way they did."⁴² The stars could align again for a deficit reduction package. Bipartisan agreements that make tough choices in the absence of a crisis never happen — except when they do.

We believe that divided government is necessary, but far from sufficient, for a bipartisan agreement to occur, at least in the absence of a crisis. When one party controls the White House and both chambers of Congress, it has no incentive to make concessions to the other party, and the other party has no incentive to help the party in power govern. In that context, divided government is a blessing, not a curse. It is no accident that the 1983 Social Security agreement and the 1986 tax reform occurred when Republicans controlled the White House and the Senate and Democrats controlled the House.

More than one agreement will be needed to fully address the long-term fiscal imbalance. Even a grand bargain that achieves \$4 trillion of deficit reduction over 10 years will not be enough to close the long-run fiscal gap, although it would represent significant progress.

3. Bipartisan tax and entitlement agreements are sustainable. Reaching a bipartisan agreement to increase taxes and reduce entitlement benefits will do little good if the agreement later unravels. Concern about this possibility has been frequently expressed by Republicans, who fear that only the tax increases, not the entitlement cuts, will take place. Grover Norquist, the president of Americans for Tax

Reform, frequently asserts that Democrats never carry through on the promised spending cuts.⁴³ History demonstrates, however, that entitlement benefit formula changes adopted in bipartisan agreements will likely stick.

The 1983 Social Security compromise included significant benefit reductions, which are being implemented without challenge or controversy. In some ways, the agreement almost seemed to invite Democrats to renege. The tax increases — a higher payroll tax rate, a significant rise in the self-employment tax rate, and coverage of new federal government employees — were slated to take effect within the decade after the law's enactment. Although some benefit-reduction measures (a six-month delay in COLAs and taxability of benefits) took effect promptly, the biggest benefit restraint (an increase in the normal retirement age, at which full benefits may be claimed, from 65 to 67) was slated to be phased in over several decades, allowing ample time in which Congress could backtrack on the changes.⁴⁴

Yet, that benefit restraint is being implemented without controversy. The first stage of the retirement age increase, from 65 to 66, took effect with no fanfare, and there has been no effort to block the second stage of the retirement age increase, from 66 to 67, which will begin applying to new beneficiaries in just a few years.⁴⁵

Norquist and others have pointed to the 1982 and 1990 budget agreements that combined tax increases and discretionary spending cuts as examples in which the agreed-on spending cuts did not fully occur. That outcome is hardly surprising, because discretionary spending levels must be voted on each year and are sensitive to changing national needs. As discussed above, efforts to cut Medicare provider payment rates have also not been implemented. Similarly, it is easy to renege on mere promises to enact future legislation to change entitlement benefit formulas. But those experiences

⁴³See, e.g., his remarks, as quoted by Ramesh Ponnuru in "Grover Norquist's Endless Campaign," Bloomberg (June 18, 2012).

⁴⁴The legislation left the normal retirement age at 65 for workers born in and before 1937. It raised the normal retirement age to more than 65, but less than 66, for workers born in 1938 through 1942 (for example, 65 years and 6 months for those born in 1940). The law set a normal retirement age of 66 for workers born in 1943 through 1954; more than 66, but less than 67, for those born in 1955 through 1959; and 67 for those born in and after 1960.

⁴⁵Workers born in 1955, who are eligible to begin drawing reduced Social Security benefits at age 62 in 2017, will face a normal retirement age of 66 years and 2 months. The higher normal retirement age diminishes the size of the benefits they can claim at younger ages.

⁴⁰*Id.*

⁴¹Birnbaum and Murray, *Showdown at Gucci Gulch: Lawmakers, Lobbyists, and the Unlikely Triumph of Tax Reform* (1987).

⁴²Thorndike, "Baucus Retirement Marks the End of a Bipartisan Era," *Tax Notes*, May 6, 2013, p. 596.

have little relevance for agreements that include legislated changes to benefit formulas. Ryan Ellis, the tax policy director of Americans for Tax Reform, has acknowledged that there is a “distinction between vague and ultimately unenforceable discretionary spending cuts on the one hand, and a defined Social Security benefit formula change on the other” and agreed that “the latter is far, far easier to see through.” Ellis said, correctly, “If you want the most likely to happen spending cuts, look to the growth of entitlement programs.”⁴⁶

H. Conclusion

We have argued for the existence of six long-term tax and budget realities: Defense spending will decline as a share of GDP; entitlement benefits will be restrained relative to current policy; revenue will rise as a share of GDP; a shift toward consumption taxation will occur in some form; much of the burden of fiscal consolidation will fall on the broad middle class; and consolidation will be achieved through bipartisan agreement.

Of course, any exercise of this nature contains some degree of speculation; no one can say with certainty what will happen over the next 50 years. We do not claim to know the future.

A prolonged and expensive arms race with an adversarial country could occur, which would result in defense spending rising as a share of GDP for many years. Consumption taxation may prove politically infeasible, even as revenue needs rise. A new political dynamic could emerge, enabling a single political party to enact fiscal consolidation on its own, perhaps during a major crisis. The growth of overall healthcare costs could dramatically slow without fundamental policy changes, as some analysts have suggested. That could occur as the result of a significant slowing of the pace of innovation, advances in preventive care and cost-effectiveness methods, increased use of cost-saving technology, or changes in Medicare payment practices. The American people, perhaps in response to major

economic or cultural conditions not present today, could become far more tolerant of entitlement benefit reductions than they currently are and far more reluctant to increase revenue. Fifty years, after all, is a long time.

We believe, however, that these eventualities are improbable and that for the reasons detailed above, our six realities will come to pass. It seems unlikely that an arms race would be sufficiently prolonged to offset the underlying income elasticity of defense spending. Healthcare costs are driven by fundamental economic forces that will likely strengthen as both income and longevity increase. The resulting projected growth rate of entitlement benefits under current policy is simply too large to be sustained, implying that entitlement spending will have to be cut. The degree to which it will have to be cut, combined with the unpopularity of benefit cuts, strongly suggests that tax increases will be part of any consolidation package. The political and economic harm from significantly increasing income tax rates suggest that the United States will follow other developed countries and institute some sort of consumption tax. The sheer size of the imbalance requires that the broad middle class be heavily affected by any deficit-reduction effort. Finally, it is unlikely that the rules of politics will change such that one political party can own placing such a significant burden on the vast majority of voters.

As we write, Washington is celebrating new budget projections showing lower deficits through 2023 than were previously projected. Although that is good news, it does nothing to mitigate the need for long-run fiscal consolidation. The United States has accidentally enacted moderate, short-run fiscal austerity. We believe that given the weakness in the overall economy, and especially in the labor market, deficit reduction has proceeded far enough for the next few years. But we must move to address our real fiscal problems, which occur in the long run. Even if the long-run projections are wildly off, we will still face a serious imbalance, and prudence dictates acting on the projections. We should agree on, and sign into law, long-run policies, to be implemented after the economy recovers, to address those problems as soon as possible.

⁴⁶Quoted by Ponnuru, “Dealing With Budget Deals,” *National Review Online* (June 21, 2012). For further discussion, see Viard, “Norquist Organization Admits That Some Entitlement-Cuts-and-Tax-Increase Deals Can Be Enforced,” *AELideas blog* (June 25, 2012).