

# Investing in America's Economy

A Budget Blueprint for Economic Recovery  
and Fiscal Responsibility

NOVEMBER 29, 2010



A PARTNERSHIP OF

Dēmos



THE  
CENTURY  
FOUNDATION



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# About this report

This report was prepared for *Our Fiscal Security*, a collaborative effort of Demos, the Economic Policy Institute (EPI), and The Century Foundation (TCF). The project is dedicated to promoting an economic path that achieves fiscal responsibility without undermining our national strength. The primary authors of the report are Becky Thiess (EPI) and Andrew Fieldhouse (EPI), under the guidance of Greg Anrig (TCF), Tamara Draut (Demos), and John Irons (EPI). Heather McGhee (Demos) contributed to the section on defense spending, Maggie Mahar (TCF) to the section on health care, and Josh Bivens (EPI) to the section relating public investments to economic growth.

This report reflects the belief that the first priority for our nation is to secure the fundamentals of the economy: strong growth and good jobs. In order to reduce our long-term national debt we must refuel the engine of our economy: the middle class. We strongly oppose the idea that America's fiscal challenges should be solved by cutting longstanding social insurance programs that have brought security and prosperity to millions of Americans. Throughout the "Great Recession" and its painful aftermath, those programs have proven to be effective mechanisms for limiting widespread catastrophic hardship.

We believe that a sound fiscal path must follow some basic guidelines:

1. **Jobs first.** Jobs and economic growth are essential to our capacity to reduce deficits, and there should be no across-the-board spending reductions until the economy fully recovers. In fact, efforts to spur job creation today will put us on a better economic path and create a solid revenue base. We believe there should be no consideration of overall spending reductions until unemployment has fallen to 6% and remained at or below that level for six months (Irons 2010a).
2. **Stabilize debt.** Over the long term, national debt as a share of the economy should be stabilized and eventually brought onto a downward trajectory.
3. **Build on economy-boosting investments.** We must build and maintain initiatives that directly support long-term job and economic growth. Failing to invest adequately in these efforts – or sacrificing them to short-term deficit reduction – would be a dereliction of sound public management.
4. **Target revenue increases.** Revenue increases should come primarily from those who have benefited most from the economic gains of the last few decades.
5. **No cost shifting.** Debt reduction must be weighed against other economic priorities. Policies that simply shift costs from the federal government to individuals and families may improve the government's balance sheet but would worsen the condition of many Americans, leaving the overall economy no better off.

Putting our nation on a path of broad prosperity will require generating new jobs, investing in key areas, modernizing and restoring our revenue base, and greatly increasing the cost efficiency of the health care system. Achieving these goals, however, will require an informed and engaged public to help set national priorities.

This report puts forth a blueprint that invests in America and creates jobs now, while putting the federal budget on a long-term sustainable path. We document the hard choices that need to be made and suggest specific policies that will yield lower deficits and a sustainable debt while preserving essential initiatives and investments.

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# Executive summary

Today, the United States faces grave economic problems. Some arose from the recession that began in 2007. Others are part of a long-term trend toward inequality and insecurity that pre-dated the immediate crisis. Currently, nearly one in 10 workers is unemployed. Millions of families that have jobs have exhausted their savings and are living paycheck to paycheck. Worried about job security and incomes, families have cut back on spending, putting further downward pressure on the economic recovery. Even very low interest rates have not induced banks to lend or businesses to invest because of a lack of overall demand.

In this context, the country is having a serious national debate about the best path to restore economic growth and shared prosperity – and the relationship of that core economic challenge to the need for better fiscal balance. The issues include the timing and composition of spending and taxing decisions. If we choose the right path, we can accelerate recovery. But the wrong approach could deepen the slump, inflict more economic pain on families, and make it more difficult to restore fiscal balance.

The federal budget is more than a bunch of numbers in a ledger in an office in Washington D.C. The federal budget represents one of the most concrete and measurable embodiments of the nation's values and priorities. As a nation, the American people value hard work and responsibility. We know that we must all work hard to succeed, and we trust that our fellow citizens – our family and friends, our neighbors, and communities – will do so as well. We ask much of each other: that we be informed voters, that we are responsible consumers and business leaders, and that we pay our fair share of taxes. It is all part of the nation's social compact. Budgetary decisions help to secure that social compact: they can offer solutions to national problems, create economic security for those in need, and expand opportunities for millions.

America's economically vibrant years owe much to the national policies in the postwar era that enabled most workers to share in productivity gains. Investments in infrastructure, technology, public education, and housing – as well as monetary policy that facilitated low unemployment – led to the creation of an unprecedented American middle class. This strong middle class benefited not only the working families within it but the overall economy.

The most pressing economic problem today is the recession. Among our longer-term problems is the unsustainability of the national budget. Bush-era tax cuts and a shrinking economy have led to significant budget deficits. These deficits are expected to decline as the economy recovers; however, national debt is projected to grow to unsustainable levels in the coming decades as rising health care costs lead to rapidly increasing federal expenditures.

National economic policy should be designed to address these dual considerations – the need to create jobs and invest in America today, and the need to place the federal budget on a sustainable path for the future.

*Our Fiscal Security (OFS)*, a collaborative effort of Demos, the Economic Policy Institute, and The Century Foundation, proposes a budgetary path to achieve these goals. This path stabilizes debt as a share of the economy without demanding draconian cuts to national investments or to vital safety net programs. In fact, we believe that job creation and long-term investments should be enhanced now to ensure a strong economy in the future.

Any realistic solution to the long-term budget outlook must confront the real drivers of the growth of the national debt, namely the rapid rise in health care costs and the lack of adequate revenue. Projected increases in health care costs are not just a threat to the national budget, but also to the viability of American businesses and the health of family budgets. We propose a variety of policies that will reduce the growth in health



care costs. These changes would not only help reduce the deficit, but could also improve the quality of care and reduce costs for businesses and families.

On the revenue side, changes in tax policy have significantly eroded federal receipts over the past decade. We cannot face national challenges and meet national priorities without adequate funding. Our suggested path demands responsibility by rebalancing the tax code and increasing tax revenue from those most able to pay. The plan also reduces or eliminates tax preferences while maintaining or increasing tax reductions for low- and moderate-income families.

Our budget path acknowledges that the future path of the economy is uncertain. Beginning deficit reduction too soon risks prolonging high levels of unemployment. The overall stance of policy must thus be expansionary until unemployment is sustained at lower levels; we suggest a benchmark of unemployment at or below 6% for at least six months.

A viable plan must also hit reasonable budget targets. Plans that call for overzealous austerity threaten our currently fragile economy. Deficit reduction and immediate job creation do not have to be competing priorities, but a strong and rapid recovery will not come about if austerity is pursued too early or too quickly. In fact, an immediate reduction in the deficit will harm the already weakened economy and lead to greater job losses. Instead, job creation and greater investment today can contribute to a solid tax base and a strong and growing economy in the future, both of which would help reduce the deficit in the medium term.

Our suggested budget blueprint achieves lower deficits in the medium term and balances the primary federal budget (the year's current revenue and spending, not counting interest payments on past debt) in less than a decade. This path recognizes the need to increase revenue while targeting certain areas for reductions in spending; in particular, our proposed path reallocates spending away from the Department of Defense by adopting common sense spending reductions. Finally, the blueprint protects core priorities such as Social Security and health care from economically counterproductive reductions in benefits.

The net impact of the spending and revenue adjustments we put forth in this blueprint will produce the following short- and long-term results:

- Substantial and sustained increased funding for job creation and investments, especially in the near term;
- A budget path that significantly improves the 10-year budget window;
- A transition from a primary deficit to a primary surplus in 2018, and sustainable debt levels by the end of the decade;
- An improvement in the path for public debt in the long term (stabilizing debt as a share of the economy beyond 2025);
- A solid footing for Social Security, Medicare, and Medicaid for the long term;
- A modernized tax code that raises adequate revenue fairly and efficiently.

Just as an investment-oriented federal policy helped to create a thriving middle class in the postwar period, an ideology of disinvestment has helped to erode it over the past 30 years. Another path is not only possible, but necessary. Although there are many paths to fiscal balance – some of which include drastic spending and entitlement cuts and the continuation of a regressive tax system – only a path that fosters broadly shared economic growth and security will be sustainable in the long run.

## ***The path to a balanced primary budget and sustainable debt***

*Our Fiscal Security's* path begins with targeted revenue increases in order to reduce the deficit and fund public investments. Our plan succeeds in reaching a sustainable budget deficit level and a balanced primary budget by 2018, and also puts public debt on a long-term sustainable trajectory while increasing investments in the economy. Our plan is able to do this because it raises adequate levels of revenue and slows excess health care cost growth beyond 2025.

Our path for overall spending and revenues over the next decade, illustrated in the accompanying table, includes an increase in public investment, making good on our stated desire to fund short-term job creation and long-term investments to grow the middle class. We also show savings from the Department of Defense, which begin gradually and are phased in over time.

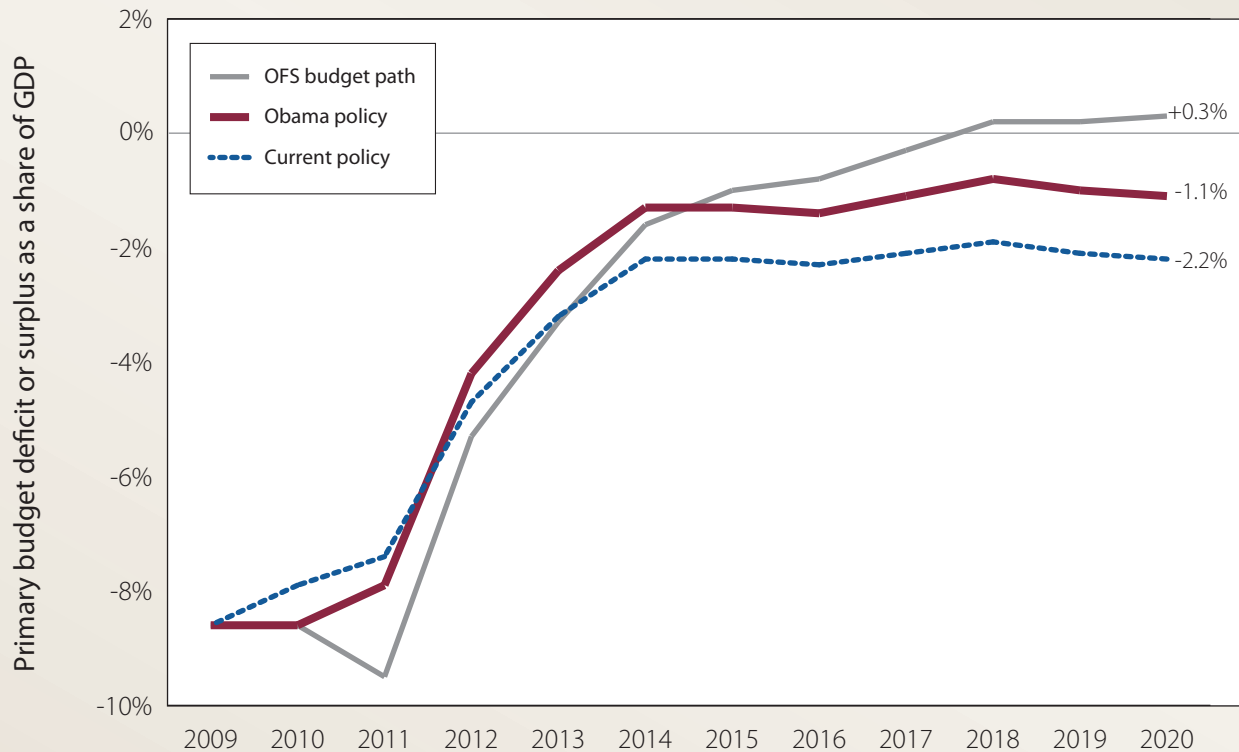


**Our Fiscal Security's budget path, 2011-20** (\$ billions, relative to President Obama's FY2011 budget proposal)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Public investment	250	200	212	225	236	248	259	270	282	294
Defense savings	-17	-35	-52	-70	-87	-105	-122	-140	-157	-175
Revenue increases	0	0	0	100	200	250	300	350	400	450
Total adjustment to Obama policy deficit	-233	-165	-160	-56	51	107	163	219	275	331

Source: Authors' analysis.

**Our Fiscal Security's budget path achieves primary budget balance by 2018**



Sources: CBO (2010a), OMB (2010a), Auerbach and Gale (2010), and OFS calculations.

The accompanying figure contrasts the primary deficit under our proposed path with the deficit as proposed by President Obama's 2011 budget and with a scenario that represents current policy, which includes the full extension of the Bush-era tax changes.

Our revenue increases (net of what is included in the Obama budget proposal) do not begin until 2014 and are phased in over time. By 2020, overall revenue would reach 21.7% of the economy, while all federal spending would reach just over 25%, leaving deficits

at a manageable level. We recognize that there are a number of ways to raise this amount of revenue from the proposals identified in more detail below. The revenue increases assumed in the overall path shown here are much smaller than the total savings from the combined policies we recommend below, meaning that policy makers have room to modify the specific policy parameters we propose.

Our plan also puts public debt on a long-term sustainable trajectory while increasing investments in the economy. Over the long term, reductions in the growth rate of health care costs are the only way to achieve sustainability: our proposed reforms to health care would help to constrain those costs. Under the proposed path, debt levels would reach 83% of GDP in 2020 and then be stabilized at about 90% of GDP in 2025 and thereafter. Debt at these levels is within historical and international experience, and has not been shown to represent a drag on economic growth.

## **The spending path**

In constructing a spending path our goal was not to rework the entire federal budget, but instead to present an illustrative path for spending, focusing on defense and non-defense spending, health care, and retirement policies. We constructed our spending path while keeping in mind that income inequality has worsened not only over the last decade but over the last 30 years, and also that public investment must be a key priority, not only because of the jobs it will create but because of the growth that investing in human and physical capital will create.

## **Health care**

Over the long term, increases in health care costs are the prime driver of unsustainable structural deficits. We propose a variety of specific measures to contain the growth of these costs, many of which build on the recently enacted health care legislation. While this legislation was a good first step toward cost control, additional reforms are not only needed but have the potential to realize significant savings in the future.

These reforms include encouraging or expanding the formation of accountable care organizations, programs to

bundle payments, incentives to increase patient safety in hospitals, and comparative effectiveness research. Acting on recommendations of the Independent Payment Advisory Board would constrain costs as well. To further reduce costs, we also recommend enacting a robust “public option” plan and increased investments in health care information technology.

The proposals would, in many cases, not only reduce the cost of health care but also improve the quality.

## **Social Security**

For 75 years, Social Security has provided an economic lifeline for millions, and it helps to stabilize the U.S. economy during down times when the income of workers is diminished. Currently, 53 million people – not just retirees but also spouses, survivors, and the disabled – receive an average benefit of \$14,000 per year. Among those 65 and older, Social Security benefits are the major source of income for 57% of families.

Social Security is funded by payroll tax receipts and does not yet put pressure on the overall budget. Under current law and based on current projections, full benefits will be paid until 2037, when the trust fund is projected to be exhausted; at that time, benefits will be adjusted to fall in line with payroll receipts. With no changes to policy, income from the program, in 2037, will be sufficient to cover 78% of scheduled benefits after the exhaustion. To prevent a reduction in benefits when the trust fund expires will require additional revenue, either from payroll tax changes or an infusion of general funds.

For these reasons – as well as the projections that future retirees will have less private pension and saving income to supplement Social Security than retirees have now – we do not propose an overall cut to benefits. Rather, we propose raising the cap on earnings subject to Social Security tax. Currently, wage income above a taxable maximum (currently \$106,800) is not taxed at all. Increasing the cap to cover 90% of economy-wide earnings on the employee side and 100% of earnings on the employer side (keeping all of this revenue in the Social Security system) would eliminate about three-fourths of the projected shortfall in Social Security, extend the solvency of the trust fund by decades, and protect promised benefits. We also identify other Social Security options that, if taken together, could more than close the entire shortfall.

## Department of Defense

*Our Fiscal Security* suggests common sense reductions in military spending. Because major military actions and force modernizations over the last decade have caused a substantial increase in defense spending, and because the wars in Iraq and Afghanistan are winding down, a reduction in defense spending is not only warranted but reflects smart budgeting. Overall, the United States spends more than the next 19 highest-spending countries combined on defense (SIPRI 2010). There is broad agreement that the Pentagon has operated without a budget constraint for too long and that substantial savings can be achieved without sacrificing national security. We follow the spending levels as recommended by the bipartisan Sustainable Defense Task Force. The SDTF report identifies targeted cuts in strategic capabilities, conventional forces, operational expenses, procurement strategies, and research and development totaling \$960 billion.

## Strategic public investment

A sound fiscal path must acknowledge that public investments are essential for near-term job creation and for the promotion of long-run economic growth. The recession has led to increased levels of unemployment and poverty, while putting downward pressure on wages and family incomes. Targeted investments would strengthen the economy for the future while repairing the infrastructure systems that serve the country.

The blueprint details a number of areas where we believe increased investment is not only needed, but would boost long-term growth and productivity. These include:

- Early childhood education
- Quality child care
- Infrastructure
- Public transit
- Rural broadband connectivity
- Research and development

Putting increased funds toward these areas would yield a significant return on investment. Our path includes increased levels of public investment in both the short run and over time. These pro-growth investments

will not only strengthen the middle class but will also provide much needed human and physical capital to help rebuild an economy that works for all Americans.

## The path for tax expenditures

*Our Fiscal Security's* blueprint calls for modernizing the tax code by addressing its \$1 trillion worth of deductions, credits, and preferences. The value of these tax expenditures, as a whole, tends to benefit those with higher incomes. We identify savings by eliminating several of these benefits for corporations and individuals and by limiting the value of deductions for those with higher incomes.

Despite having a higher-than-average statutory tax rate, because of preferences embodied in the tax code the United States collects just 2% of GDP in corporate tax revenue, compared with 2.5% across other developed nations. We suggest several changes that would broaden the tax base for corporations, including eliminating fossil fuel production tax credits, limiting the deductibility of financial corporate debt interest payments, closing the dividend loophole for foreign source income, and removing active financing tax deferral for financial firms.

For low-income taxpayers, we suggest making fully refundable the child tax credit and increasing the earned income tax credit. Our recommended tax expenditure reforms are summarized below.

### *Tax capital gains and dividends as ordinary income Savings in 2015: \$88.1 billion*

Taxing both long-term capital gains and qualified dividends as normal income would generate considerable revenue while removing a major distortion of compensation choices from the tax code. Under the current tax code, the wealthiest pay only 15% on their income derived from wealth, while middle-income taxpayers typically pay higher rates, especially once payroll taxes are included. Subjecting capital gains and qualified dividends to the progressive income tax schedule would improve equity by eliminating tax arbitrage opportunities that encourage non-wage compensation; case in point: the “carried interest” earnings of private equity and hedge fund managers that are taxed not as income, but as capital gains.

*Cap the benefit on itemized deductions at 15%, expand the charitable giving credit*

*Savings in 2015: \$87.9 billion*

For taxpayers opting out of the standard deduction, the value of their itemized deductions increases with their marginal tax rate, and hence their income. For high-income earners in the top tax bracket, the benefit (the amount by which their tax liability is reduced) is equal to 35% of their itemized deductions (39.6% if the top marginal tax rate reverts back as scheduled at the end of 2010). These tax code preferences provide no benefit to the majority of taxpayers, predominantly lower-income filers, who take the standard deduction. The president's budget proposes limiting the tax benefit on itemized deductions to 28%, but *Our Fiscal Security's* budget path proposes a further restriction to a 15% marginal benefit on itemized deductions and converting two major itemized deductions – the charitable deduction and the mortgage interest deduction – to refundable credits available to all tax filers.

We propose converting the deduction for charitable giving to a refundable credit at a flat 25% rate, making it available to non-itemizers. This would result in a net increase in the tax incentive to give for more than three-quarters of the population. This proposal would also replace the mortgage interest deduction with a fully refundable tax credit. Under current law, homeowners can deduct interest payments on up to \$1 million in mortgage debt and up to an additional \$100,000 in other loans, such as home equity loans, regardless of their use. The value of this benefit goes disproportionately to upper-income homeowners because of the greater value of their mortgages and because they receive a larger benefit per dollar of mortgage. Making the deduction a refundable credit on up to \$500,000 in mortgage debt would also increase the value of the credit for many homeowners.

*Expand the Earned Income Tax Credit*

*Cost in 2015: \$1.6 billion*

The EITC is the largest cash assistance program, and it plays a critical role in providing opportunity to working families and in fighting poverty. We propose expanding the EITC in three ways: permanently extend the tier created by the Recovery Act for families with three or more qualifying children, permanently extend

the marriage relief provision of the Recovery Act, and increase the credit for filers with no qualifying children.

*Make the Child Tax Credit fully refundable*

*Cost in 2015: \$4.1 billion*

The Child Tax Credit (CTC) is a means-tested, partially refundable tax credit targeted to families with children under 17. The Recovery Act lowered the earnings threshold for the refundable portion of the tax credit to \$3,000 (the threshold was scheduled to increase from \$8,500 to \$12,550 in tax year 2009), greatly expanding access to a partial credit and increasing the number of families receiving the full value of the credit. The president's budget proposed maintaining the CTC threshold at the \$3,000 level. We propose a further expansion to make the credit refundable regardless of earnings.

*Eliminate fossil fuel production credits*

*Savings in 2015: Already included in Obama policy and our baseline*

The president's budget proposed eliminating a handful of tax expenditures that have been carved out over the years for the oil, natural gas, and coal industries. Eliminating these preferences would help clean-energy industries compete on an even playing field with their fossil-fuel competitors, and thus help to create sustainable, green manufacturing jobs. Along with a cap-and-trade system of carbon emission allowances and a higher excise tax on motor vehicle fuel, this proposal would help rebalance the economy away from dependence on fossil fuels and toward a clean-energy economy. The president's budget estimates that eliminating the credit would raise \$4 billion in 2015.

*Limit the deductibility of corporate debt interest payments for financial firms*

*Savings in 2015: \$77.1 billion*

When planning investment strategies, corporations take advantage of a tax preference that encourages debt-financed projects over projects financed by other means. While there are many legitimate reasons for firms to take on debt, limiting the so-called "debt tax shield" for financial firms would generate significant revenues and discourage destabilizing high ratios of financial leverage, which have proven to impose widespread

economic costs. We propose limiting the tax preference on corporate debt interest payments for financial firms to 25%, below the top corporate tax rate of 35%, by making the preference an after-tax credit of 25% rather than a pre-tax expense.

*Close dividend loophole for foreign source income  
Savings in 2015: \$34.1 billion*

The tax deferral on earnings from U.S.-controlled foreign subsidiary corporations (incorporated overseas) enables firms to avoid repatriating foreign earnings. Rather than repatriating earnings from abroad as earned (and subjecting them to U.S. corporate tax rates), firms are taxed only when foreign earnings are received by the U.S. parent company as dividends. We propose eliminating the deferral of income from U.S.-controlled foreign subsidiary corporations.

*Close “active financing” tax deferral for financial firms  
Savings in 2015: \$6.0 billion relative to current policy*

The “active financing” exception for foreign source income allows multinational financial firms to avoid tax on their worldwide income when they establish “captive” foreign financing subsidiaries. Like the dividend loophole for foreign source income, this tax code carve-out deprives the United States of both revenue and business investment. A similar active financing exception was repealed under the Tax Reform Act of 1986 but was reinstated in 1997.

## **The revenue path**

One of the root causes of the structural deficit problem, besides health care cost growth, is the lack of adequate revenue to fund national priorities. By targeting revenue increases on the people who can best afford to pay, we are able to reduce the deficit while maintaining critical investments. We propose a variety of reforms to the tax code that would increase revenue from those most able to afford it, while protecting the vast majority of Americans from any tax increase.

We identify several changes that would, in total, be more than enough to reduce deficits to sustainable levels. These are summarized below.

*Repeal Bush-era tax cuts for top earners  
Savings in 2015: Already included in Obama policy and our baseline*

The Bush-era tax cuts disproportionately benefited the highest earners at a cost of nearly \$2 trillion over a decade. The president’s budget request proposed allowing the Bush tax cuts for top earners – joint filers with incomes above \$250,000 and individuals with incomes above \$200,000 – to expire. These high-income individuals have seen the largest gains in income over the past three decades and can best afford an increase in their tax share.

*Enact an estate tax with a progressive schedule of marginal tax rates*

*Savings in 2015: \$4.5 billion*

The Bush-era tax cuts expanded the exemption for the estate tax from a planned increase to \$1 million (\$2 million for married couples) to \$3.5 million (\$7 million for married couples) and lowered the rate from 55% to 45% in 2009. The estate tax was also fully repealed in tax year 2010, though scheduled to return in 2011 with a \$1 million exemption and a 55% rate. The Obama administration proposes extending the estate tax at the 2009 level. We propose lowering the exemption to \$2 million (\$4 million for married couples) and enacting a graduated rate structure that increases from 45% to 50% for the taxable portion of estates exceeding \$10 million and 55% on the portion of estates worth more than \$50 million. A similar graduated estate tax, sponsored by Senator Bernie Sanders (I-Vt.), included a higher exemption of \$3.5 million (\$7 million for married couples) and a 65% tax bracket for the portion of estates worth more than \$500 million.

*Permanently extend the Making Work Pay tax credit  
Cost in 2015: \$36.0 billion*

The Making Work Pay (MWP) refundable tax credit, enacted as part of the 2009 Recovery Act, increased the take-home pay of 95% of tax filers and had expended \$73.0 billion as of the second quarter of 2010. The credit replaces 6.2% of income up to a maximum of \$400 for working individuals who are not claimed as dependents (\$800 for joint filers), and is gradually phased out at a rate of 2% of adjusted gross income over \$75,000 (\$150,000 for joint filers). A permanent extension of



Making Work Pay helps to maintain the take-home pay of low- and moderate income taxpayers in the aftermath of the recession.

*Green revenue: cap and trade or carbon tax  
Savings in 2015: \$52.0 billion*

A carbon tax would level a charge on energy based upon the carbon content of the fuel source. A cap-and-trade program would either allocate or auction a set quantity of permits to “upstream” energy producers (such as electrical power plants or oil refineries). The president’s budget included a deficit-neutral allowance for climate policy with unspecified revenue intended to fully offset the cost of mitigating the impact of climate change and funding investments in a green-energy economy. *Our Fiscal Security’s* path, on the other hand, recommends enactment of a climate change bill in which half of the revenue is recycled back to consumers in a way that offsets the regressive nature of rising energy costs. The remaining half is used to fund general deficit reduction and green investment.

*Reforms to reduce the tax gap  
Savings in 2015: Already included in Obama policy and our baseline*

In 2005, the Internal Revenue Service estimated that the gross tax gap – the difference between taxes owed and taxes paid – totaled \$345 billion, of which only \$55 billion was expected to eventually be collected as late payments or from tax enforcement. The single largest source of the tax gap is underreporting of individual income tax, primarily from income sources not subject to withholding or strict documentation. Closing even a small fraction of this gap would generate significant revenue.

The administration proposed a number of reforms to reduce the tax gap by improving reporting, encouraging compliance, and strengthening enforcement. Major proposals included requiring recipients of rental income to report all major expense payments, requiring a certified taxpayer identification number for contractors, strengthening rules for the classification of employees as independent contractors, and increasing the penalty for failing to file information returns. Beyond income underreporting, international

tax evasion drains the Treasury of receipts, and steps can be taken to improve tax compliance and modernize the international tax code.

*Financial crisis responsibility fee  
Savings in 2015: Already included in Obama policy and our baseline*

We recommend adopting the president’s proposal to impose a financial crisis responsibility fee designed to recoup taxpayer losses associated with the Troubled Asset Relief Program (TARP), which primarily benefited major financial institutions. The fee would apply only to financial institutions with over \$50 billion in assets (estimated at roughly 60 institutions) and would be equal to 15 basis points (0.15%) of a financial institution’s covered liabilities.

*Financial speculation tax  
Savings in 2015: \$77.4 billion*

While a financial speculation tax would not eliminate speculation or necessarily stave off crises, disincentivizing short-term speculating would be a step toward building a more resilient financial sector. The tax could generate revenue to fund investments to strengthen the economy in the wake of the financial-crisis-induced recession.

*Reinstate phase-out of personal exemptions and limit itemized deductions for high-income earners  
Savings in 2015: Already included in Obama policy and our baseline*

We recommend adopting the president’s proposal to reinstate the personal exemption phase-out and the limitation on itemized deductions for Americans making over \$200,000 (\$250,000 for joint filers). Bush-era changes eliminated a maximum allowance for certain itemized deductions on high-income earners (the limitation was known as Pease, after the former Ohio representative who sponsored it) that had reduced the maximum benefit by 3% of adjusted gross income above a certain threshold, up to a limit.

*Surcharge on top earners*  
*Savings in 2015: \$53.2 billion*

Millionaires have seen their average income rise much faster than that of the general population; the average after-tax income of the top 1% of earners has skyrocketed – surging 281% since 1979 to \$1.4 million in 2007. A surcharge on millionaires would raise significant revenue while reinforcing a basic principal of fairness in the tax code: those with more resources should pay proportionally higher rates than others. Such a surcharge on high earners had been included as a revenue offset in the House-passed version of the America’s Affordable Health Choices Act but was eventually removed in favor of other offsets. Creating a new marginal tax bracket or “surcharge” for taxpayers with incomes over \$1 million would be a pragmatic option for raising revenue. While such a change would not in itself solve the long-term fiscal problem, it would mean less austerity elsewhere in the budget.

*Increase the motor fuel excise tax*  
*Savings in 2015: \$33.0 billion*

Increasing taxes on motor fuels would raise significant revenues while decreasing negative social externalities such as pollution and traffic congestion. Revenue from the tax would recapitalize the highway trust fund, thus providing badly needed funding for the transportation infrastructure.

## **Conclusion**

A recession is not a time for fiscal austerity but rather a time for investing in jobs and the middle class. Our proposed policies work against the erosion of investment that we have seen over the past 30 years, modernize an antiquated and complex tax code, and achieve fiscal sustainability while preserving Social Security and other vital priorities.

We have a choice when it comes to solving our fiscal and economic challenges. Why not choose the path that actively creates jobs, invests in our future, and demands fiscal responsibility?





# Introduction: an economic crisis, a beleaguered middle class

The economic challenges facing the United States today require a response that is both decisive and forward-looking. The choices we make will shape the future of the country and determine the economic prospects of the next several generations. Within these choices lies a clear path to fiscal security, one that supports job creation and economic growth as well as long-term fiscal responsibility.

Today nearly one in 10 workers are unemployed, and millions of families that have work have exhausted their savings and are living paycheck to paycheck. Worried about job prospects and their incomes, families have cut back on spending, a natural response that nevertheless puts further downward pressure on the economic recovery.

The recession has also led to significant budget deficits. While these are expected to decline as the economy recovers, long-term debt levels, which are driven primarily by rising health care costs, could burden the economy tremendously in the coming decades. National economic policy should be designed to address these dual considerations – the need to create jobs and invest in America today, and the need to place the federal budget on a sustainable path for the future.

A budget is intrinsically a blueprint for balancing priorities and society's needs. Yet the U.S. budget process makes little room for focused and responsible medium- and long-term planning around national priorities. The budgetary strain we are facing now is already prompting calls to move away from national priorities by focusing on cutting or eliminating spending, regardless of the implications for the strength of the U.S. economy or the nation. We believe an alternative path is possible for pursuing our near-term, medium-term, and long-term priorities while both promoting national goals and improving the fiscal picture.

*Our Fiscal Security*, a collaborative effort of Demos, the Economic Policy Institute, and The Century Foundation, proposes a path to achieve both budgetary sustainability and an overarching goal: the creation of a stronger, broader middle class with increased economic security. America's economically vibrant years owe much to federal policies in the postwar era that enabled average workers to share in productivity gains. Investments in infrastructure, technology, public education, and housing – as well as monetary policy that facilitated low unemployment – led to the creation of an unprecedented middle class. This strong middle class benefited not only the working families within it but also the overall economy – while enabling deficits to decline and the national debt to be paid down. Since the 1970s, however, inequality has widened and meaningful economic progress has stalled for the vast majority of working families.

Just as an investment-oriented federal policy helped to create a thriving middle class in the postwar period, an ideology of disinvestment has helped erode it over the past 30 years. Another path is not only possible, but necessary. Although there are many paths to fiscal balance (some of which include drastic spending and entitlement cuts while continuing Bush-era tax cuts for the wealthy), only a path that fosters broadly shared economic growth and security will be sustainable in the long run.

In the short run, policies that raise incomes for the middle class and lower-income families have a stronger impact on economic growth than do policies that diminish working families' spending power. The relative strengths of different economic policies to foster sustainable long-run growth must be taken into account when designing the federal budget, particularly during a period of high unemployment.

The budget path presented in this report allocates greater funding for near-term job creation and public investments, achieves lower deficits in the medium term, and balances the primary federal budget (the year's current revenue and spending, not counting interest payments on past debt) in less than a decade. This path recognizes the need to increase revenue while targeting certain areas for reductions in spending. It also rebalances the tax code by raising additional revenue from those most able to pay and reducing and eliminating wasteful loopholes, while maintaining or increasing many tax cuts for low- and moderate-income families. Almost all of those changes would be desirable from the standpoint of making the government more cost-efficient and equitable, even in the absence of looming deficits. Finally, the blueprint protects core priorities such as Social Security and health care from economically counterproductive reductions in benefits.<sup>1</sup>

The net impact of the spending and revenue adjustments we put forth in this blueprint will produce the following short- and long-term results:

- Substantial and sustained increased funding for job creation and investments, especially in the near term;
- A budget path that significantly improves the 10-year budget window;
- A transition from a primary deficit to a primary surplus in 2018, and sustainable debt levels by the end of the decade;
- An improvement in the path for public debt in the long term stabilizing debt as a share of the economy beyond 2025;
- A solid footing for Social Security, Medicare, and Medicaid for the long term;
- A modernized tax code that raises adequate revenue fairly and efficiently.

This report will lay out the fundamental budgetary challenges in both the short run and long run, and then present a path toward achieving long-run sustainability. We do not attempt to fully articulate every detail of tax and spending policy, but instead endeavor to illustrate clearly the impact of several major changes that can put us on a sustainable, fiscally responsible course. Our approach demonstrates that, contrary to much conventional

wisdom, fiscal responsibility is entirely compatible with sustained support for social insurance programs.

## ***The current state of the economy***

The U.S. economy has continued to feel the impact of the Great Recession in terms of both deficits and high unemployment. Currently, the 2010 deficit (for the fiscal year that ended September 30, 2010<sup>2</sup>) stands at around \$1.34 trillion, or 9.1% of gross domestic product. Around three-quarters of the increase in the federal budget deficit can be attributed to the economic recession and the jobs crisis, specifically the loss of revenue and the increase in recession-related spending (Bivens 2010). As such, as the economy recovers, we can expect to see dramatic improvement in the deficit picture. In fact, by 2015, the target date that has been set for the president's bipartisan National Commission on Fiscal Responsibility and Reform (hereafter referred to as the Fiscal Commission) to reduce the deficit, the economy is expected to have returned to more solid growth and a lower unemployment rate.<sup>3</sup>

Despite the projected recovery, a significant deficit remains likely, especially toward the end of the decade and beyond. Under an extension of current policy, the federal government will run a projected deficit of \$967 billion, or 5.2% of GDP, in fiscal year 2015 (Auerbach and Gale 2010).<sup>4</sup> This deficit is significantly driven by the cost of the 2001 and 2003 tax legislation (i.e., the Bush tax cuts), which were not offset by other cost savings. Combined with a fix to the alternative minimum tax (AMT), and including the interaction effect of the AMT changes and the tax cuts, the cost of these tax changes will represent about 45% of the current policy deficit in 2015.

President Obama has put forth a slightly improved fiscal path, as articulated in his proposed budget for 2011. The Obama policy is projected to lower the deficit to \$786 billion, or 4.2% of GDP, by 2015.<sup>5</sup> The primary deficit, which excludes interest payments on deficits from prior years, would be \$240 billion, or 1.3% of GDP.<sup>6</sup> The president's budget includes a variety of tax changes relative to current policy (including the expiration of the Bush tax cuts for high-income individuals) and a freeze on domestic discretionary spending. **Table 1** shows the deficit impact of the policy changes in the

**Table 1. Federal budget deficit, current policy and Obama policy baselines, FY 2015 (\$billions)**

<b>Current policy baseline deficit</b>	<b>\$967</b>
<b>Revenue proposals in Obama plan (negative numbers represent revenue increases that reduce deficit)</b>	
Modify estate and gift tax rates	-\$33
Modify capital gains and dividend tax rates	-\$7
Modify other tax provisions, including tax rates, AMT	-\$145
Limit tax benefit of itemized deductions	-\$29
Reform international tax system	-\$13
Impose “Financial Crisis Responsibility Fee”	-\$9
Modify and extend Build America Bonds program	-\$7
Extend Making Work Pay tax credit	\$13
Other proposals	-\$2
<b>Spending proposals in Obama plan (negative numbers represent spending decreases that reduce deficit)</b>	
Reduce non-defense spending	-\$30
Extend or expand refundable tax credits	\$41
Modify Pell Grants	\$35
Modify and extend Build America Bonds program	\$8
Other spending	\$10
Interest	-\$13
<b>Obama policy baseline deficit</b>	<b>\$786</b>

Sources: CBO (2010a), OMB (2010a), and Auerbach and Gale (2010).

Obama budget relative to the current policy baseline, and **Figure A** shows the national debt as a share of the economy through 2020. (For more details on alternative baseline scenarios, see Appendix A.)

Relative to the current policy baseline, achieving a primary balance in 2015—the goal articulated in President Obama’s mandate to the Fiscal Commission—would entail a combination of spending cuts and tax increases of \$409 billion, or about 2.2% of GDP, in that year (see **Figure B**). Some of the savings could be achieved by ending various tax cuts or by reducing spending below projected rates.

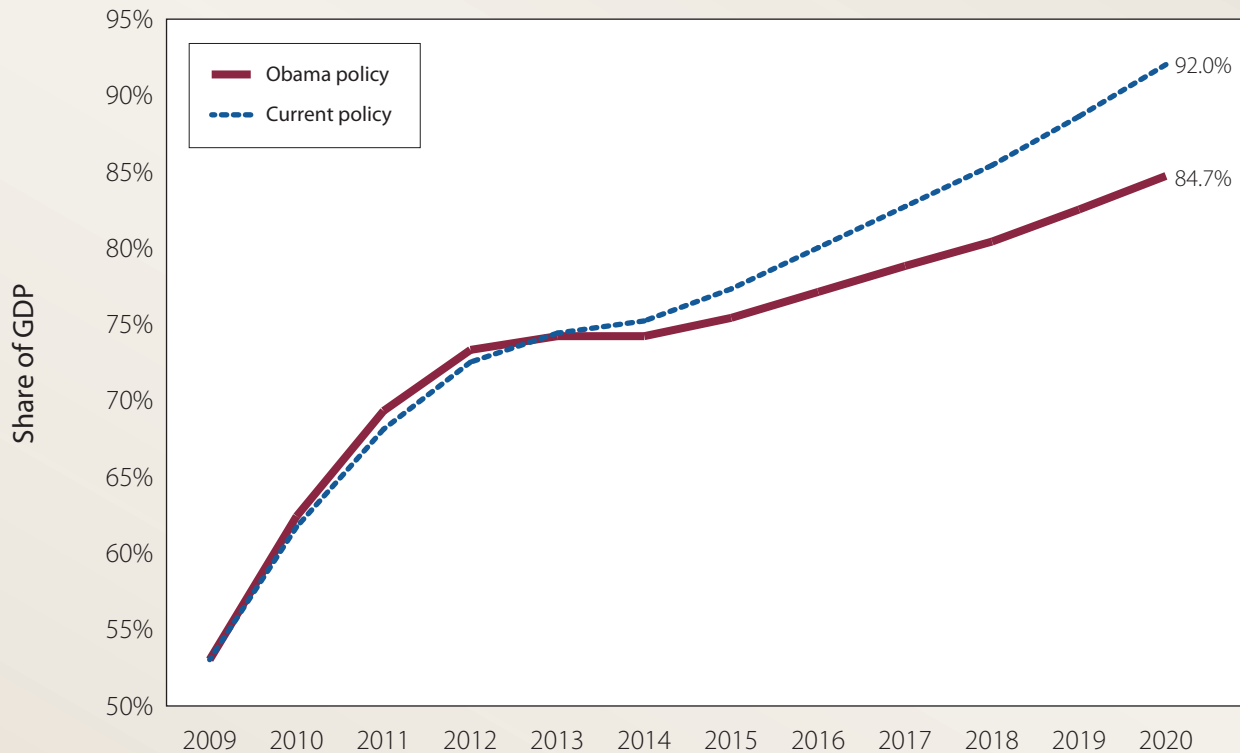
Relative to Obama’s policy proposals, achieving primary balance in 2015 would require a combination of spending cuts and tax increases equivalent to 1.3% of GDP on top of the savings already included in that plan. Focusing all of the adjustment on the spending side would entail spending cuts of \$240 billion in 2015—about 6.4% of primary outlays (excluding net interest) or 17.9% of all discretionary spending, including defense. Placing all of the adjustment on the revenue side would require revenue increases of 6.8% across the board in addition to the proposals already in the president’s budget, including the expiration of the Bush tax cuts for the wealthy, the closure of off-shore tax havens, limits to tax expenditures, and increased enforcement of tax laws.

Obviously, deficit targets that are even more severe than these would entail further spending cuts or tax increases. For example, the 2%-of-GDP deficit for 2015 envisioned in the blueprint proposed by the Peterson-Pew

Commission on Budget Reform<sup>7</sup> would entail cutting spending and/or raising taxes relative to the Obama budget by an additional \$413 billion, or 2.2% of GDP, in 2015 alone—representing a 10.9% cut in primary outlays, or a 30.6% cut in discretionary spending. Relative to current policy, this would entail eliminating \$596 billion of spending or 3.2% of GDP, the equivalent of a 25.4% cut in all spending, including mandatory programs like Medicare and Social Security, or a 43.3% cut in *all* discretionary programs. The required cut would exceed the entire non-security discretionary budget.

FIGURE A

## Projections for debt held by the public as a share of GDP



Sources: CBO (2010a), OMB (2010a), and Auerbach and Gale (2010).

Aside from the impact on individual programs and/or tax liabilities, the policies required to meet these targets and others like it would put the budding recovery at severe risk. The CBO projects that the annual unemployment rate, having peaked at 9.5% in calendar year 2010, will not fall to 5.0% until 2015<sup>8</sup> (CBO 2010a), and even 5.0% does not necessarily represent full employment. As the United States discovered when austerity policies introduced in 1937 prolonged and deepened the Great Depression, placing a fiscal drag on the economy while the economy has not yet fully recovered is economically unwise and fiscally irresponsible.

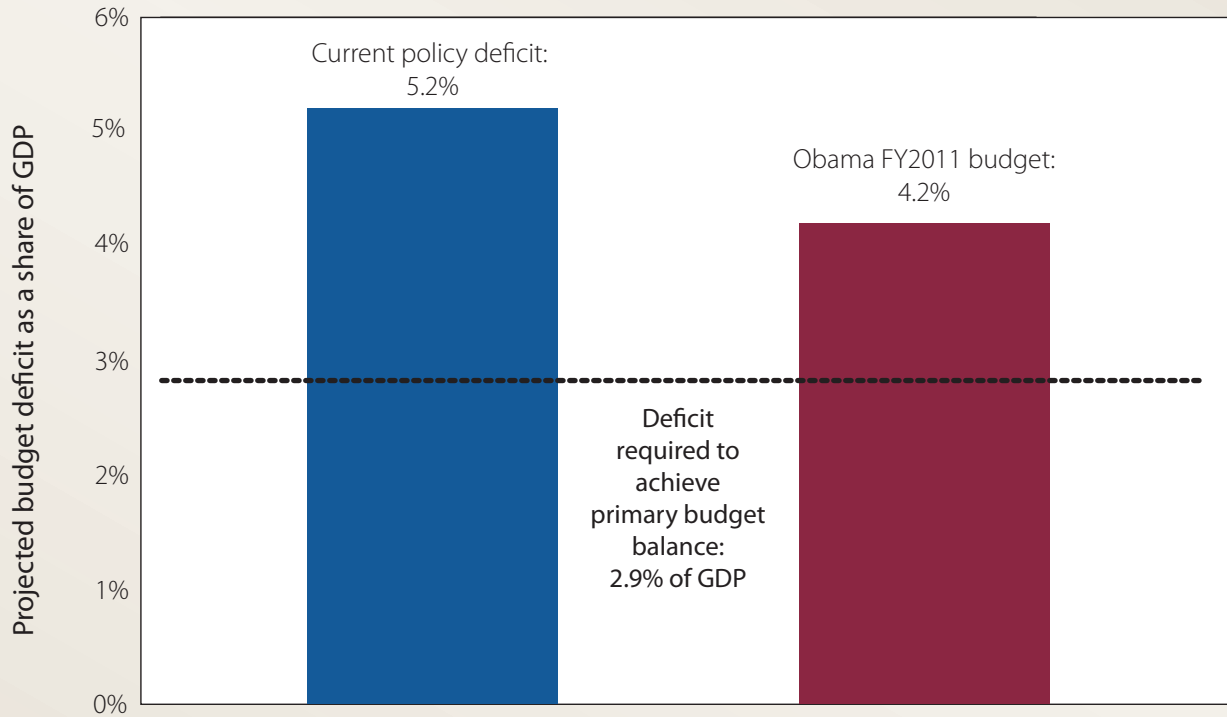
### **The long-run outlook**

Even though the deficit declines in both the current policy and Obama scenarios, over a longer horizon the fiscal outlook is cause for serious concern.<sup>9</sup> Health care costs have historically risen faster than overall economic growth, and so the share of the economy devoted to health care expenditures has risen. Long-term projections assume this historical trend of excess cost growth will continue and will lead to rising expenditures economy-wide as well as for the federal government (CBO 2010c; Board of Trustees 2010).

Health projections are uncertain. Even small changes in the assumed growth rate of health care costs can mean dramatically different projected budgetary paths over the coming decades. The enactment of the Patient Protection and Affordable Care Act of 2010 (hereinafter

FIGURE B

## Projected baseline budget deficits in 2015



Source: CBO (2010a), OMB (2010a), and Auerbach and Gale (2010)

the Affordable Care Act), which includes a multitude of provisions intended to reduce medical cost increases, compounds the uncertainty while creating new hope that past medical inflation levels will moderate.

Social Security is funded by payroll tax receipts and does not yet put pressure on the overall budget. Under current law and based on current projections, full benefits will be paid until 2037, when the trust funds are projected to be exhausted;<sup>10</sup> benefits then will be adjusted to fall in line with payroll receipts. With no changes to policy, income from the program, in 2037, will be sufficient to cover 78% of scheduled benefits after the exhaustion. By 2084, income would be sufficient to cover 75% of benefits.<sup>11</sup> Because benefits will already take a hit under current law, the Social Security system will not contribute to the long-run imbalance unless that law is changed. However, to prevent a reduction in

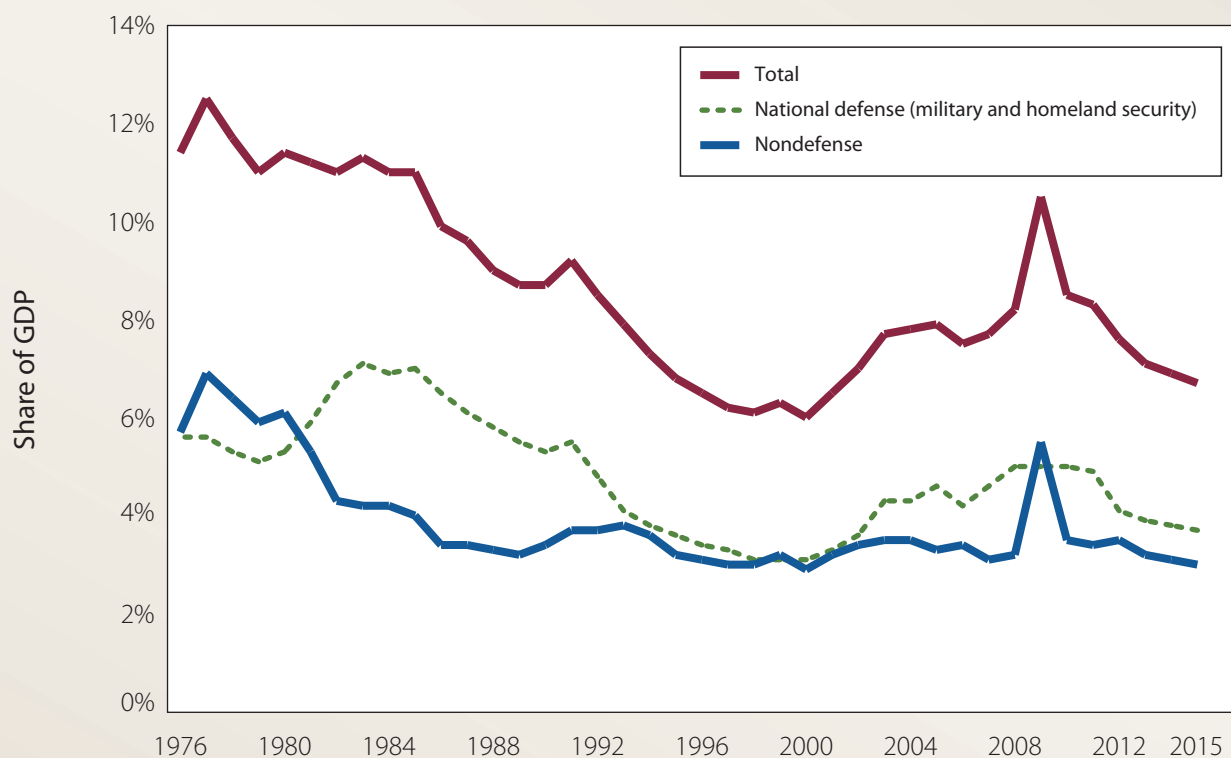
benefits when the trust fund expires, additional revenue will be required, either from payroll tax changes or through an infusion of general funds.

Other parts of the budget have been stable over time and are not projected to be major drivers of the long-term budget imbalance. **Figure C** shows the historical path of federal discretionary spending. Non-security spending in particular has been declining as a share of the economy (with a temporary spike in 2009 as a result of the American Recovery and Reinvestment Act; hereinafter the Recovery Act), and it is expected to fall to about 2.5% of GDP in 2015 under the Obama budget proposal. Overall discretionary spending has risen since the late 1990s as a result of defense spending, primarily on the wars in Iraq and Afghanistan.

Since discretionary spending is appropriated on an annual basis, these programs are not on “auto-pilot” in

FIGURE C

## Discretionary budget authority as a share of GDP, 1976-2015



Source: OMB (2010c; 2010e).

Historical data from 1976-2009; projections for 2010-15.

the same way that mandatory programs are, and they are thus less likely to see substantial growth in excess of annual GDP growth for an extended period. However, although it only makes up roughly 5% or less of total GDP, non-defense discretionary spending is too often what is targeted by many so-called deficit hawks in pursuit of fiscal austerity.

In total, assuming a continuation of current policies, the overall 75-year fiscal gap – the amount of revenue increases and/or spending cuts required to establish debt in the long run at today’s levels – is thought to be around 7-9% of GDP.<sup>12</sup>

This projected trajectory is undesirable and unsustainable over the long term; it risks crowding-out of private investment, affects the ability to adequately respond to crises with countercyclical fiscal policy, and could possibly lead to a fiscal crisis (CBO 2010d). For

these and other reasons, President Obama tasked the Fiscal Commission with stabilizing the debt-to-GDP ratio “at an acceptable level once the economy recovers,” although the president’s budget notes there is much uncertainty as to the magnitude and timing of the policy measures necessary to accomplish such a goal.

There is no way to precisely quantify an acceptable versus problematic level of debt, particularly given the unique role of the U.S. dollar and treasury securities in international financial markets and the relative importance of the U.S. economy to the global economy. If sustainability is measured by the willingness of investors to lend to the Treasury Department at reasonable rates of interest, the sustainability of our public finances has more to do with confidence and expectations than anything else. For this reason, with interest rates on treasury securities at historic lows, the



current level of the debt-to-GDP ratio should be much less of a cause for concern than the projected upward trajectory of the debt in the future.

### ***The revenue problem***

It is important to note that the long-term imbalance is driven by inadequate revenue as well as cost increases. In 2010, as a result of the recession, which has led to less taxable income, revenues are projected to have fallen to 14.6% of GDP (CBO 2010a), their lowest level since 1950 (OMB 2010b). Over the next 10 years, under the president's budget scenario, revenues would recover to average about 19% of GDP – about five percentage points less than spending over that time. Under the current policy scenario, revenue would be even less. The costs of the 2001 and 2003 tax changes (and a fix to the AMT) represent about 45% of the current policy deficit in 2015 and are responsible for a revenue loss of about 2.3% of GDP.

More generally, the federal government is not raising sufficient revenue to cover expenses. Mechanically, revenues can be increased by expanding the amount of income or transactions subject to tax and/or by increasing tax rates. Increasing taxable income can be accomplished by (1) increasing individuals' incomes (e.g., through a more rapidly growing economy), (2) broadening the base to include more sources of income or additional transactions in determining taxable income, or (3) curtailing deductions that reduce taxable incomes.

Increased revenues will affect the long-run deficit in two ways. First and most obviously, additional annual revenue would close the fiscal gap on an annual basis. Second, the additional revenue would allow the federal government to borrow less and help it avoid ballooning interest expenses that compound over time.

# A new blueprint

The United States needs a new plan for its economic future. We need a sound plan that protects the investments we have made over many decades and sets the path forward for renewed economic security. The most responsible approach to tough economic times is to actively pave the way for job creation and economic growth while making sound choices to reduce national budget deficits. With the right set of investments, more people are able to work and the economy becomes more productive, which in turn reduces the level of debt relative to the overall economy. At the same time, we can take concrete steps to place the federal budget on a sustainable path. Smart spending now will bring down deficits tomorrow, but the anxiety that deficits stir up tempts lawmakers to act preemptively. The path we choose on spending and revenue is as important as the destination: simply achieving a target (e.g., debt as a share of the economy by a particular date) is not an end in itself, but rather a part of a broad economic strategy that fulfills national priorities.

This report proposes a concrete target for long-run fiscal policy and sets out a reasonable path to achieve that goal. We begin with several guidelines to follow when constructing a fiscally responsible path:

1. **Jobs first.** Jobs and economic growth are essential to our capacity to reduce deficits, and so there should be no across-the-board spending reductions until the economy fully recovers. In fact, efforts to spur job creation today will put us on a better economic path and create a solid revenue base. We believe there should be no consideration of overall spending reductions until unemployment has fallen to 6% and remained at or below that level for six months (Irons 2010a).
2. **Stabilize debt.** Over the long term, national debt as a share of the economy should be stabilized and eventually brought onto a downward trajectory.
3. **Build on economy-boosting investments.** We must build and maintain initiatives that directly support long-term job and economic growth. Failing to invest adequately in these efforts – or sacrificing them to short-term deficit reduction – would be a dereliction of sound public management.
4. **Target revenue increases.** Revenue increases should come primarily from those who have benefited most from the economic gains of the last few decades.
5. **No cost shifting.** Debt reduction must be weighed against other economic priorities. Policies that simply shift costs from the federal government to individuals and families may improve the government's balance sheet but may worsen the condition of many Americans, leaving the overall economy no better off.

The next section outlines several policy options that, when taken together in whole or in combination, would result in a more secure fiscal outlook.

# Budget path options and details

Just as our spending decisions reflect our priorities, so too do our revenue choices. The sections below outline our proposals for overall levels of spending and tax policy over a 35-year horizon (details of our methodology can be found in Appendix A). Overall, we increase revenue levels over both the current policy scenario as well as over the Obama proposal. Our spending levels show an immediate bump to reflect increased long-term investments and short-term job creation. Other spending reductions, primarily in the Department of Defense, restrain future spending.

Over the long term, we propose a number of policies targeted toward restraining the growth rate of health care costs as a whole. In total, this path leads to a sustainable deficit level by the end of the decade, and significantly reduces debt levels beyond the 10-year budget window.

## **Our Fiscal Security's spending path**

Public investments are essential for economic growth and family security. This section outlines a path for defense spending, non-defense spending, health care, and retirement policies, keeping in mind the notions that (1) income inequality has significantly worsened over not only the last decade but the last 30 years, and policies should reflect an effort to strengthen the middle class and expand opportunities for everyone, and (2) public investment must be a key priority in thinking about current and future spending.

Our summary path contains net levels of spending. There are certainly areas within each of the categories outlined below that can be reduced and where funds are better spent in other parts of the budget. Our goal here is not to rework the entire federal budget, but rather to present an illustrative path for spending. The trend in non-security discretionary spending and the effect of Obama's freeze in his FY 2011 budget are discussed in the box (p. 20), "*Non-security discretionary spending in the Obama policy budget baseline.*"

## **Defense spending**

Major military actions over the past decade have led to a substantial increase in spending on the Department of Defense and related agencies. A reduction from these elevated levels would seem to be warranted given the winding down of the war in Iraq.

A report from the Sustainable Defense Task Force (SDTF) identified targeted cuts in strategic capabilities, conventional forces, operational expenses, procurement strategies, and research and development undertakings that would save \$960 billion over 10 years (see SDTF 2010, p. vi, and the box (p. 21), "*Options for defense savings*"). While the SDTF report is only one of a number of options available in acquiring DOD budget savings, we firmly believe that the Pentagon has operated without a budget constraint for too long and that savings must be achieved in the realm of defense spending.

Consistent with the savings identified in the task force report, *Our Fiscal Security's* budget path gradually phases in cuts of \$960 billion to the Department of Defense budget over 10 years. The Department of Veterans Affairs, Department of State, and the Department of Homeland Security, all considered part of the broader security budget, would be left unaffected by these cuts, producing a realignment of security policy.

*Our Fiscal Security's* budget also assumes that Congress will enact emergency war supplemental appropriations, following the Obama policy path. This assumption includes a \$159.3 billion request for overseas contingency operations in 2011 and \$50 billion annual placeholders over 2012-20. *Our Fiscal Security's* defense path places a budget constraint only on the base annual appropriations for the Department of Defense; it does not touch supplemental war funding or undercut support for American soldiers abroad. Based on *Our Fiscal Security's* defense path and the discretionary spending path, security spending would be rebalanced to equal 50.4% of total discretionary spending in 2020, whereas security spending is

## Non-security discretionary spending in the Obama policy budget baseline

The president's budget for FY 2011 proposed a three-year non-security discretionary spending freeze. Given the relatively small size of the non-security discretionary budget, the freeze is primarily a symbolic gesture rather than a roadmap to fiscal sustainability. By freezing the non-security discretionary budget rather than letting it grow with inflation, the president's plan would reduce the real (inflation-adjusted) funding of critical public investments, and spending levels would not keep up with population growth. Relative to a current policy budget baseline that allows discretionary spending to grow with inflation, the three-year freeze would save roughly \$20 billion (Irons 2010b). By 2015, \$20 billion represents just 0.1% of projected future GDP, or 2.5% of the projected deficit for that year.

Unlike income supports and entitlement programs, which are set on autopilot by authorizing language, many traditional public goods – including federal investments in infrastructure, research, and education – are largely funded by annual appropriations. According to OMB, adjusted for inflation the total discretionary budget (security and non-security) has averaged growth of 4.5% over 2000 to 2009 (OMB 2010i).

The president's 2011 budget requested \$1.43 trillion for discretionary budget outlays, of which \$900 billion (62.8%) was for the security budget and \$533 billion (37.2%) for non-security discretionary outlays. Largely due to the foreign wars and the investments financed by the Recovery Act, discretionary spending increased to 8.7% of GDP in 2009, up 2.5 percentage points over a decade. While discretionary spending is higher than it has been in recent years, this level is not inconsistent with historical norms; over the last 40 years, discretionary spending

has averaged 8.8% of GDP (OMB 2010k). Under the current policy baseline, discretionary spending is projected to peak at 9.5% of GDP in 2011 and then gradually trend downward to 6.9% of GDP in 2020.

### *Non-security discretionary spending in Our Fiscal Security's budget path*

Our Fiscal Security's path maps an overall level of spending, but there are clearly cuts that can be made throughout the budget. Though a full budget proposal is beyond the scope of this report, the targeted spending cuts included in the president's 2011 budget are assumed in our pathway. Each year, the president's budget includes a list of proposed cuts and terminations. The FY 2010 budget proposed cutting spending on inefficient or ineffective programs by singling out 121 for cuts or terminations that accounted for \$17 billion total (OMB 2009). Congress, which historically rejects a majority of the proposed cuts and terminations, approved 60% of them for a net savings of \$6.8 billion. The FY 2011 budget proposes 126 different cuts or terminations for savings of over \$23 billion in 2011 (OMB 2010i).

In this report, we do not pass judgement on "pork-barrel spending," though we believe there is room for some cuts, such as in farm subsidies. Contrary to popular opinion, eliminating non-defense earmarks would do little to close the fiscal gap. In fact, eliminating all non-security discretionary spending would plug just over one-third of the projected 2011 deficit. While Congress and the president can still look to make government more efficient, we should not be under the illusion that budget sustainability will be achieved through this route alone. (See Appendix D for a discussion of earmarks.)

projected at 65.6% of discretionary spending under the Obama policy baseline.

### **Health care**

Over the long run, the projected high rate of growth in health care costs is the most important factor contributing to future deficits. The recently enacted health care law contained a number of cost-containment provisions, but it is likely that even more needs to be done. The health care bill will allow us to learn more

about what works – and building upon what is learned will be essential for controlling costs in the future.

The Affordable Care Act, according to the CBO, will reduce deficits by about \$143 billion from 2010 to 2019 while expanding coverage to 32 million Americans who are now uninsured. Over the following 10 years (2020 to 2029), CBO estimates that the legislation will further reduce cumulative deficits by half a percentage point of future GDP, or \$116 billion in 2020 and more than \$1.1 trillion over 10 years (CBO 2010e). While the

## Options for defense savings

The Sustainable Defense Task Force report “Debt, Deficits, & Defense: A Way Forward,” which examined how the Department of Defense budget could contribute to deficit reduction efforts without critically compromising national security, identified a series of budgetary options that could save up to \$960 billion over the next decade (SDTF 2010). The targets are based on reductions or eliminations in unreliable or unproven technologies, missions with poor cost-benefit ratios, an overmatch or mismatch of assets to military needs, and management reforms to improve efficiency. We do not necessarily endorse every aspect of the SDTF report, but do believe that savings on the order of those recommended by the task force are reasonable.

### *Strategic weapons systems*

The American nuclear force could be significantly reduced without undermining deterrent and strike capabilities. The Obama administration has made nuclear reduction and non-proliferation a priority, and the New START treaty (if ratified) will reduce the U.S. nuclear arsenal. The U.S. currently has over 5,000 stockpiled weapons and 1,968 operationally deployed strategic warheads. The United Kingdom, France, and China, on the other hand, each maintain arsenals of between 200 and 400 warheads (SDTF 2010). With a scaled-back commitment to nuclear arms, the U.S. should curtail the multibillion dollar investments underway in new nuclear warhead development.

The SDTF report also recommends that the most expensive Defense Department program in history – missile defense, or “Star Wars” – should be revisited, particularly the systems that remain unproven or are poor performers. The SDTF plan would save \$194.5 billion over 10 years from strategic capabilities realignment. The largest component is reducing the U.S. nuclear arsenal, which would save \$113.5 billion over 10 years.

### *Overseas contingency operations*

In June 2010, Afghanistan surpassed the Vietnam War as the longest ongoing military conflict in U.S. history. The U.S. presence has seen a rapid escalation under President Obama, particularly as combat operations in Iraq drew to a close in the summer of 2010. While the U.S. military presence in Iraq is down considerably from the roughly 165,000 troops stationed there during the 2007 “surge,” the Department of Defense plans to keep roughly 50,000 troops stationed in a training and advisory capacity for the Iraqi security forces.

CBO recently estimated that roughly \$1.1 trillion has been appropriated for the wars in Iraq and Afghanistan since 2001 (CBO 2010g). Much of this spending has come from the enlarged base Department of Defense budget and unfunded emergency supplemental appropriations bills. Beyond these previously realized costs and the steadily rising Department of Defense budget, the president’s budget projected (and budgeted for) overseas contingency operations totaling an additional \$609.3 billion over 2011-20. Our Fiscal Security’s path maintains spending levels for these operations as outlined in the Obama budget proposal. Drawing down overseas contingency operations before operations exceed this cost would thus improve the deficit relative to both the placeholders included in the Obama policy baseline and the Our Fiscal Security path.

### *Procurement, R&D, and operations*

As highlighted by the SDTF report, savings can also be achieved by canceling or modifying procurement of specific, controversial big-ticket items, reducing base R&D spending, and reforming procurement procedures. The political reality of defense industry lobbying is such that even assets that are deemed unnecessary by every branch of the armed services (such as the Joint Strike Fighter alternative engine) are successfully defended in Congress (OMB 2010i). (The political argument is unerringly that military manufacturing creates jobs. However, research by Pollin and Garrett-Peltier (2007, 8) demonstrates that military spending creates fewer jobs per investment dollar than other priorities.) The SDTF recommends five large asset cancellations or delays that would save a total of \$85-88 billion over 10 years. The largest of these is the Joint Strike Fighter, at \$47.9 billion.

In addition to specific targets for procurement cuts, the U.S. should pursue more aggressive acquisition reform to ensure the characteristics that mar the target list above – cost overruns, poor performance, lack of supervision – are no longer routine in military contracting. GAO estimates that the 95 largest acquisition programs are an average of two years behind schedule and roughly \$300 billion over budget (Sullivan 2009). Dual-source, competitive contracting was less necessary during the period of low procurement after the Cold War, but the sole-source contracting norm has remained even after contracts have ballooned. In 1998, the Pentagon employed one financial auditor for every \$642 million in contracts. A decade later, there was one for every \$2.03 billion (Singer 2008).



reform package will cost \$938 billion over the next 10 years, CBO calculates that it will more than pay for itself by eliminating waste from health care spending while simultaneously raising new revenues. (See Appendix E for details on the act's major expenses as well as major reductions in health care spending.)

There are significant opportunities for additional health care cost savings beyond those identified in the Affordable Care Act. Additionally, if Medicare reforms lead the way toward creating new efficiencies, private insurers have indicated that they will follow the government's approaches.

Many of the health care act's structural reforms involve pilot projects. It is unclear which ones will succeed, where they will succeed, or how much they are capable of saving. When we look at pockets of value in the health care system, it becomes clear that it is possible to shave costs and improve care at the same time. What follows is a list of provisions in the reform legislation that we believe have the potential to save billions of dollars, while *improving* care. *Our Fiscal Security* endorses these reforms with a belief that they can have a positive impact on the long-term provision of health care. We believe that if collectively implemented, these types of reforms – despite the lack of concrete budget scores – can slow excess health care cost growth by at least 0.5 percentage points annually.<sup>13</sup>

For the purpose of our path, we assume savings in health care costs only after 2025. For more on this calculation and how it impacts our long-term budget projections, see the box “The path of health care costs.” For example, CBO estimated that a public option in itself would reduce the federal budget deficit by \$15 billion in 2020 (CBO 2010g), equivalent to 1.0% of projected Medicare and Medicaid spending in the same year. Below are detailed explanations of the policies we expect will yield additional savings (not reflected in current projections of CBO or the trustees of the Centers for Medicare and Medicaid Services) and additional policies we would implement to further contain health care cost growth.

### *Accountable care organizations*

The most successful large, multispecialty health care programs in the nation demonstrate that it is possible to shave costs and improve care at the same time. Institutions such as the Geisinger Health System, a Pennsylvania system that employs 800 physicians and serves a population base of 2.6 million (with up to 500,000 active patients annually), show that higher quality and lower costs can go hand in hand. For example, Geisinger has reduced the cost of caring for elderly, chronically ill patients by 7% (Dentzer 2010).

As research published in *Health Affairs* earlier this year reveals, large multispecialty organizations such as Geisinger, Intermountain Healthcare in Salt Lake City, Utah, and the Mayo Clinic in Rochester, Minn., tend to provide better care for less by emphasizing a team-based approach to collaborative, evidence-based medicine. When compared with small private practices, these organizations also enjoy economies of scale (Dentzer 2010). Another study (Weeks et al. 2010), which looked at 22 markets and adjusted for patient variables including age, sex, race, income, and a Charlson co-morbidity score (a measure of disease burden that increases as patients have more co-morbidities) found that in most markets, after adjusting for patient factors, multispecialty groups provide higher-quality care at a 3.6% lower annual cost. The authors note: “For Medicare, although a 3.6% cost savings is relatively small, if all physicians could perform at this level, about \$15 billion a year in savings to the Medicare program would be generated. This would amount to \$150 billion over ten years – enough to make a substantial contribution to the \$940 billion estimated cost of the health care legislation.”

Building on such findings, the Affordable Care Act offers to share savings with inpatient and outpatient providers who choose to form accountable care organizations that take on responsibility for delivering quality care for a defined set of patients at lower-than-projected costs. In his new book, *Tracking Medicine* (Oxford 2010), Dartmouth's Jack Wennberg explains that, “Shared savings offer providers a ‘glide path’ – an incentive to improve efficiency coupled with a way of softening the blow of reduced volume of care (and thus reduced revenue)” for providers.

### *Bundled payments*

As part of the effort to move away from fee-for-service reimbursement, the Affordable Care Act calls for a five-year national voluntary program to explore alternative ways for Medicare to pay caregivers. One such method is “bundling” payments to doctors and hospitals involved in a single episode of care. Bundling encourages caregivers to work together as a team and to make system changes that reduce waste.

In the 1990s, a Medicare demonstration project that bundled hospital and physician payments for coronary artery bypass grafting (CABG) surgery saved 10% of the cost for these procedures over a five-year study period. Three of the four original hospital participants made major changes in physician practice patterns and hospital operations to generate savings. On a risk-adjusted basis, participating hospitals had a significantly lower rate of inpatient deaths compared with Medicare’s national averages (Kelley and Fabius 2010). This was another example of a pilot project that Congress refused to expand, despite its success (Mechanic and Altman 2010). Using its research databases, Thomson Reuters calculated the average cost per CABG for both Medicare and commercial patients and then applied the savings rate from the demonstration project to these figures. It concluded that bundled payments could reduce the national cost of CABG procedures by over \$1.4 billion a year (Kelley and Fabius 2010).

### *Incentives to increase patient safety in hospitals*

Avoidable medical errors added \$19.5 billion to the nation’s health care bill in 2008, according to a claims-based study conducted on behalf of the Society of Actuaries (Shreve 2010). Most of that amount, \$17 billion, was the cost of providing inpatient, outpatient, and prescription drug services to individuals affected by medical errors. Authors of the report describe the estimates as conservative, due to the fact that the number includes only errors identified through actual claims data, thus making the total economic impact of medical errors greater than what they reported. The report listed the 10 most expensive types of errors in 2008, the number of errors, the cost per error, and the total cost. At the top of the list were pressure ulcers (374,964 errors, \$10,288 per error, \$3.858 billion total) and

postoperative infections (252,695 errors, \$14,548 per error, \$3.676 billion total) (Shreve 2010).

Not all errors are avoidable, but many, including pressure ulcers (i.e., bedsores) often are. Caregivers need to identify patients at risk, check their skin daily, and move them often. Under reform legislation, beginning in 2015 Medicare will reduce its payments by 1% to hospitals with the highest rate of medical errors and infections.

Patients who pick up infections in hospitals are often discharged prematurely and wind up being readmitted within 30 days. These “preventable readmissions” cost the health care system about \$25 billion every year (Kavilanz 2010). Under the reform legislation, in 2012 Medicare will stop paying hospitals for preventable readmissions tied to health conditions such as heart failure or pneumonia. In 2014, the Department of Health and Human Services will expand that policy to cover four additional health conditions. Finally, in 2015, DHHS will start reporting each hospital’s record for medical errors and infections pertaining to Medicare patients. This could have a significant effect on a hospital’s reputation, and is likely to lead hospitals to invest more in patient safety.

### *Comparative effectiveness research*

The 2009 Recovery Act included \$1.1 billion for comparative effectiveness research (CER). The Affordable Care Act includes a new tax that will translate into annual CER funding that should reach an estimated \$500 million in 2014. In 2013, Medicare and private payers will begin paying a tax on each insured individual, with the proceeds supporting the work of a nonprofit corporation called the Patient-Centered Outcomes Research Institute.

The Affordable Care Act encourages greater use of CER. Accountable care organizations will share in the savings that both Medicare and private insurers realize when they achieve better outcomes at a lower price. This opportunity gives them a strong incentive to take a close look at what the research tells them about treatments that are likely to be most effective for patients fitting a particular profile. Physicians and hospitals that accept bundled payments also will profit if they practice evidence-based medicine. This will be voluntary; physicians will not be forced to follow evidence-based



guidelines. But those who aren't able to improve quality and reduce costs also won't be eligible for bonuses.

### *The Independent Payment Advisory Board*

The health reform act establishes a new Independent Payment Advisory Board with authority to recommend proposals to limit Medicare spending growth. If projected per capita Medicare spending exceeds target growth rates, the board is required to recommend proposals to reduce Medicare spending by specified amounts, with the first set of recommendations due in 2014 for implementation in 2015.<sup>14</sup>

The board is prohibited from submitting proposals that would ration care, increase taxes, change Medicare benefits or eligibility, or increase beneficiary premiums and cost-sharing requirements. These restrictions suggest the board will focus on eliminating waste in the form of medical errors and ineffective, unnecessary care as well as fraud. Congress can veto the recommendations only if it adopts alternative proposals resulting in an equivalent level of savings.

### *A public option*

Congressman Pete Stark (D-Calif.) proposed adding a public insurance plan to the Affordable Care Act. Under his proposal, the plan's payment rates for physicians and other practitioners would be based on Medicare's current rates plus 5%. Going forward, the payments would rise annually to reflect estimated increases in physicians' costs. The plan would pay hospitals and other providers the same amounts they would be paid under Medicare, on average, and would establish payment rates for prescription drugs through negotiation. Health care providers would not be required to participate in the public plan in order to participate in Medicare.

CBO estimates that the public plan's premiums would be 5-7% lower, on average, than the premiums of private plans offered in the exchanges. Those differences in premiums would reflect the net impact of differences in administrative costs as well as the rates paid to providers. (Private insurers typically pay hospitals more than Medicare, and often their reimbursements to physicians exceed Medicare payments by significantly more than 5%). CBO estimates roughly one-third of the people obtaining coverage through the insurance

exchanges would enroll in the public plan, and that the proposal would reduce federal budget deficits through 2020 by about \$68 billion.<sup>15</sup>

It is not likely, however, that Congress will approve a public plan that caps payments to doctors and hospitals across the board. The Affordable Care Act favors adjustments based on the value of the services offered, paring costs with a scalpel, rather than an axe, with an eye to reducing overtreatment and ineffective services while rewarding services that provide the greatest benefit to patients. Medicare now underpays primary care doctors, geriatricians, and general surgeons, among others, and this is one reason the United States is experiencing shortages in these areas.

It is possible that between now and 2014 Congress will add a public option to the reform plan, and that plan will enjoy lower administrative costs. Most likely, some for-profit insurers will decide to drop out of the health insurance system, since new regulations will make it difficult for some to reap the profits their shareholders expect. For that reason, a public option may be needed to provide enough choices in the exchanges. And Congress might decide to let both the public plan and Medicare negotiate for lower prices on drugs and devices.

Some have also suggested that a single payer system would be the most effective form of cost containment economy-wide, noting that other countries with a single payer system also have much lower costs.

### *Health information technology*

Health care reform encourages new investments in health information technology, and over the long run this should save money. Electronic medical records are needed to reduce medical errors and provide more coordinated care, but at the moment vendors are selling doctors and hospitals expensive systems that are needlessly complicated and not well adapted to clinical settings.

As one health IT expert warned, "EMRs can be difficult to implement, upsetting practice workflows. In general, physicians' practices have not adjusted quickly or smoothly to the disruptive nature of the switch from paper to electronic systems for patient care. Implementations can take months or even years to stabilize. And the turmoil associated with the implementation can often have negative revenue

repercussions for the medical practices [EMRs] are intended to help. Physicians routinely report that, during the adjustment period, the number of patients they can see and treat in a day drops by twenty to thirty percent, with a commensurate decline in revenues” (Mahar 2008). Moreover, “EMRs from different vendors are not yet interoperable, meaning that patient information cannot yet be easily exchanged between systems. If America’s physician practices suddenly rushed to install the systems of their choice, it would only dramatically intensify the Babel that already exists” (Mahar 2008). Thus, though electronic medical records and other health IT initiatives offer a promising avenue for public and private investment that can eventually enhance productivity, it is premature to calculate how much health IT might save in the health care sector in the near-term.

## Retirement security

Retirement security has three pillars – personal savings, pension plans, and Social Security benefits. Social Security has kept more seniors and disabled individuals out of poverty than all other social welfare programs combined, and for 75 years it has provided an economic lifeline for millions. In down times the regular disbursements from Social Security can act as an automatic stabilizer.

According to the Office of the Chief Actuary, as receipts fall short of benefits over the next several decades, sometime around 2037 the Social Security trust fund balance will fall to zero. If this point comes, benefits will have to be cut as Social Security cannot engage in deficit spending.

Currently, the average benefit for a Social Security recipient is \$14,000 per year. The 53 million people who now receive benefits include not only retired workers but also spouses, survivors, and the disabled. Among those 65 and older, Social Security benefits are the major source of income for 57% of families. For a third of beneficiaries benefits make up 90% or more of income. (See **Figure D** for sources of income for the elderly, by income quintile.)

Social Security is financed by payroll taxes, levied on employers and employees at 6.2% of income and capped at \$106,800 of earnings (in 2010). The cap, or taxable maximum, is indexed to the growth of average wages

and is adjusted each year. Under current law, the taxable maximum is estimated to rise to \$113,700 in 2012. There is no comparable cap on earnings for Medicare payroll taxes.

A number of options exist to increase the taxable maximum, including eliminating the cap altogether or raising it to cover 90% of income (which was the level achieved after the last major reform, in 1983.) If the maximum were increased to cover 90% of earnings, then approximately \$156,000 of income would be taxable in 2012.

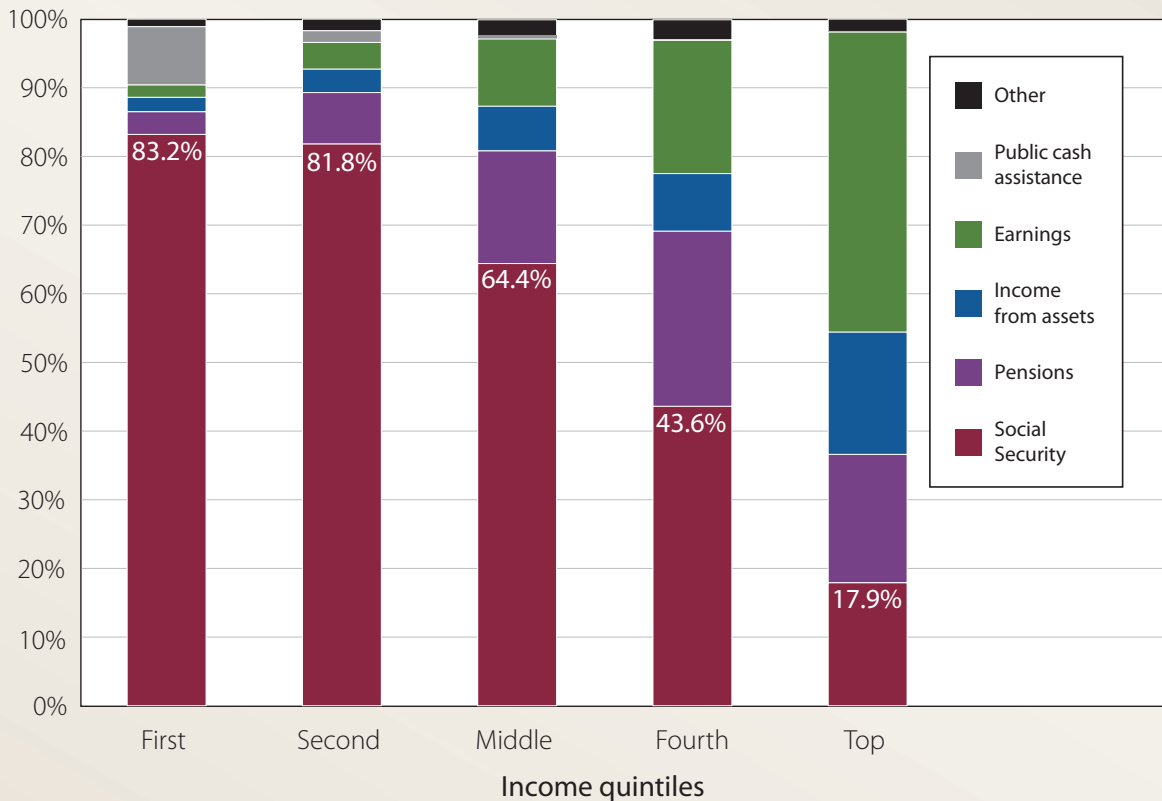
A hybrid option for raising the cap would increase the share of total earnings subject to the payroll tax to 90% on the employee side and eliminate the cap altogether on the employer side, counting all earnings up to the revised cap toward higher benefits. This would result in employers paying a significantly larger payroll tax on very large salaries. For instance, the \$14.5 million salary LeBron James receives from the Miami Heat would be fully taxed on the employer side, meaning the owners would have to pay around \$900,000 in Social Security taxes (Morrissey 2010b). It would also eliminate about three-fourths (74%) of the projected shortfall (71% if the employee cap were raised gradually).

*Our Fiscal Security’s* path includes this option, raising revenues for the Social Security system by \$103 billion, net of increased outlays, in 2015.<sup>16</sup> All additional payroll tax revenue would be dedicated to the Social Security trust fund. (See Appendix F for further discussion on Social Security background and options.) We believe that achieving full solvency in Social Security could be accomplished by either dedicating general revenue to the trust fund (some have suggested dedicating revenue from the estate tax) or by modestly increasing the payroll tax rate. Gradually increasing the payroll tax to offset future increases in population longevity would be a viable approach as well. Another option that would more than close the shortfall would be to treat all employee contributions into salary reduction plans like 401(k)s.

These changes, if adopted, can put Social Security on solid footing without cutting benefits (either through changes in the benefit formula or through other means such as an increase in the retirement age). These changes would also maintain the historic link between employee contributions and benefits.

FIGURE D

## Income composition for the elderly, 2008



Source: Social Security Administration (2010).

### Our Fiscal Security's investment path

Targeted increases in public investments are needed for a number of reasons. First, the recession has led to increased levels of unemployment and poverty, while putting downward pressure on wages and family incomes. Additional action to spur job creation is essential. Second, targeted investments would strengthen the economy for the future while repairing the educational structure, roads, bridges, and other infrastructure systems that serve the country.

Much of the investment in the current budget resides within the non-security discretionary budget and includes critical investments in science, technology, energy, education, and infrastructure. The four largest agencies by non-security discretionary budgets are “the Department of Education, the Department of Health and

Human Services, the Department of Transportation and the Department of Housing and Urban Development (OMB 2010c). Individual agencies such as the Social Security Administration have smaller discretionary budgets to fund the administration of services and prevent abuse of benefits. Agencies funded through the non-security discretionary budget include the National Science Foundation, the Army Corps of Engineers, the Forest Service, the National Oceanic and Atmospheric Administration, the Centers for Disease Control and Prevention, the National Institutes of Health, the Food and Drug Administration, and the Federal Bureau of Investigation, among others. The discretionary budgets of all the non-security agencies combined are smaller than the Department of Defense alone. Investments in education, infrastructure, and basic science have been shown to have large rates of return and should be

expanded. *Our Fiscal Security's* budget path increases non-security spending relative to the Obama budget for two complementary reasons: to strengthen the economic recovery in the near term, and to fill a large shortfall in public investment over the medium and long term. Combined, these two objectives form the core of *Our Fiscal Security's* pro-growth strategy for reinvesting in the future of America and the middle class.

The economic recovery has faltered and more fiscal stimulus is needed. Conventional monetary policy has reached its lower bound of effectiveness; the most effective way to prop up aggregate demand is to increase government spending and investment. In the near term, this investment will produce a faster return for GDP growth, a more rapid return to full employment, and higher tax revenue relative to the current policy or Obama policy baselines. Based on current policy, CBO projects the economy will not return to its GDP potential and unemployment will not return to the neighborhood of full employment until 2015. As the recovery builds momentum and unemployment falls back below a target of 6% (see Irons 2010a), *Our Fiscal Security's* investment path transitions from spurring the economic and labor market recovery (through highly effective stimulus measures such as additional aid to states) to increasing long-term GDP growth.

*Our Fiscal Security's* investment path budgets for greater near-term job creation by increasing non-defense outlays by \$250 billion in 2011 and \$200 billion in 2012. As the economic boost from the 2009 Recovery Act fades at the end 2010 (GDP growth will receive no boost from the act by the fourth quarter of 2010), more job-related spending will be needed to bring unemployment down from its high projected levels (CBO 2010a). In fiscal year 2013 and beyond, this additional investment spending grows at the same rate as the economy, allowing the nation to sustain a higher level of long-run investments. (See Table 4 on page 43 for a 10-year picture of the investment path.)

### **The virtues of public investment**

By creating the roads, dams, sewers, and bridges that we rely on daily, public investment is one of the smartest ways to both boost growth in the short run and expand economic capacity in the long run. The legacy of public

investment in the 1930s, 1940s, and 1950s was a strong middle class, national prosperity, and America's standing in the world as an economic powerhouse.

After World War II and the subsequent building of the interstate highway system under President Eisenhower, public investment dropped off. There is ample evidence of the large deficit in needed physical infrastructure investments in the U.S. economy, and even stronger evidence of the enormous returns to GDP that can be wrought from physical capital investments in highways and mass transit, green-economy investments that mitigate carbon emissions, and human capital investments like high-quality early childhood education. (See Appendix G for a review of the economic connection between public investment, productivity, and GDP growth.) The more front-loaded these investments, the better it will be for an American economy that may otherwise be saddled with high unemployment for years to come. But even after the jobs crisis, the case for public investment on its own terms remains strong and needs to be funded. Any plan to reduce the deficit that does not accommodate this needed improvement in the public capital stock is economically irresponsible. Several example areas that would benefit from increased public investment are discussed below.

### **Early childhood care and education**

Child care is not a luxury but a necessity, and one that is vital to economic growth and future competitiveness. Today, nearly two-thirds of mothers with young children have jobs (Boushey and O'Leary 2009). Working families need access to affordable and high-quality child care, from early infancy to preschool, in order to meet their families' basic needs. However, investing in child care will also meet a basic national need by ensuring that children can develop their full potential to become critical thinkers and engaged citizens.

In recent decades, current policy and budget priorities have left these needs unmet. Early Head Start, which reaches low-income children under 3, is funded only to reach less than 3% of eligible families. Head Start, which is aimed at 3- and 4-year olds, is funded to reach just 40% of eligible preschoolers. Child care subsidies to help low- and middle-income families are too modest to make high-quality care affordable for most

of these households. Furthermore, subsidized child care slots often have long waiting lists.

Investing in the critical first three years of life has been shown to be essential for a strong cognitive and social foundation (Shonkoff and Phillips 2000). Reaching vulnerable children at birth is especially critical in preventing early and persistent learning gaps. The benefits of high-quality child care continue through toddlerhood and well into adulthood. Dozens of studies have determined that investments in high-quality child care yield long-lasting benefits for society and the individual.<sup>17</sup> For example, children who benefit from early care and education programs are less likely to engage in criminal behavior later in their lives and are more likely to graduate from high school and college. Higher graduation rates translate to higher incomes upon entering the labor force, the long-term benefits of which include higher tax revenue, which might be considered a return to the public's investment in that child.

Multiple cost-benefit analyses conducted on three of the intensive educational programs that have been studied long term – Abecedarian, Perry Preschool, and ChildParent Center – have found that the public benefits far exceed the costs of the programs; benefits range from \$6 to \$13 for every \$1 spent on the programs (Public Policy Forum 2010).

To harness the economic and social potential of the next generation, we will have to significantly expand our investment in the educational pipeline that begins with child care and preschool. *Our Fiscal Security's* path includes a comprehensive upgrade and expansion of child care from birth to preschool so that all children can reap the benefits of high-quality early learning and care. Our path provides revenues to pay for the package of investments recommended by a collaboration of national and state organizations to improve quality, access, and affordability of child care (CLASP 2010). The blueprint includes: the provision of resources to upgrade the quality and training of providers; expansion of tax credits for moderate- and middle-income households; and new investments to ensure all low-income families who wish to participate can enroll in Early Head Start and Head Start. The estimated cost of investing in a high-quality early care system would average \$88 billion per year.

Investing in early childhood programs produces significant benefits for children, families, and taxpayers, and can make the workforce more productive, strengthen the economy, and in the long run provide budget relief. And though in this section we have focused on child care and education, a child's welfare is an essential public investment as well. (See the box (p. 29), "*Poverty, children, and food insecurity.*")

## Transportation

With more people driving than ever before, the transportation infrastructure needs to be both repaired and revamped. Investing funds into a modern, interconnected, and affordable public transit system could both reduce our dependency on fuel and increase productivity by reducing the amount of time people sit in traffic. Investment in repairing existing roads and building new and modern public transit systems could also create a significant number of jobs.

Because transportation costs are regressive (low-income families on average spend a higher share of income on transportation), rising gas and oil prices have hit lower-income earners hardest. Public transportation systems cost less to use than owning, operating, and parking a private vehicle, yet millions of people have no access to mass transit. In places where these systems do exist, ridership is disproportionately high for people with lower incomes, youths, the disabled, immigrants, and students. Those making less than \$20,000 annually, in fact, make up 63% of the riders in small transit systems, 51% in medium-sized systems, and 41% in large systems (Litman 2010).

Studies have shown that urban transit travel produces about 5% as much carbon monoxide and half as much carbon dioxide per passenger mile compared to the average car (Shapiro, Hassett, and Arnold 2002). Thus, if Americans made more frequent use of public transportation systems, we could reap greater energy savings and environmental benefits. If a typical household either switched from owning two cars to owning one car, or moved from an auto-dependent community to a transit-oriented community, that household would reduce its total greenhouse emissions by 25-30% (Davis and Hale 2007). Investing in the transportation infrastructure has rippling economic



## Poverty, children, and food insecurity

Between 2008 and 2009, the poverty rate increased by over 1% of the population to 14.3%. A total of 43.6 million people lived in poverty in 2009, including 15.5 million children; their poverty rate in 2009 was 20.7% (Gould and Shierholz 2010). The percentage of children living in low-income families in general has been on the rise for the past decade after declining in the 1990s. From 2000 to 2009, the number of all children increased by around 4%, while the number of low-income and poor children increased by 17% and 33%, respectively (Chau, Thampi, and Wight 2009).

The latest Census figures also show a record high share of the population – 6.3% – living below half the poverty line. The poverty rate for working age people is the highest it has been in 50 years, at 12.9%.

Food insecurity, which refers to the lack of availability

of food or one's access to it, is up sharply as well. In 2008, 16.7 million children lived in houses that were food insecure, up from the 12.4 million in 2007 (Gould and Shierholz 2010). It tends to be higher for Hispanic and African American households than for non-Hispanic white households. Food insecurity can lead to poorer health among children, a higher rate of hospitalization, behavioral problems, lower physical function, and greater levels of anxiety and depression (Nord 2009).

Food stamp usage, which has increased by 24% between 2008 and 2009, reflects the rise in food insecurity. In his budget President Obama proposed \$9.9 billion to reauthorize funding for child nutrition and the Special Supplemental Nutrition Program for Women, Infants, and Children; these requests are reflected in *Our Fiscal Security's* budget path.

benefits. Estimates suggest that each billion spent on transportation infrastructure creates up to 47,000 jobs and generates up to \$6 billion in additional economic activity (Mishel et al. 2008).

### Roads, bridges, and water systems

According to one study (Zandi 2010), spending on infrastructure creates on net \$1.57 of additional economic benefit for each dollar spent. Much of this benefit comes from job creation – each job supported in the construction industry, for example, supports two additional jobs. Global Insight estimates that \$2.50 of economic growth occurs for each \$1 invested in highway construction (Lotke, Carter, Dockstader, Beckwith, and Swartz 2008). Investment in infrastructure spending is 33% more effective than spending for generic tax cuts and 10-15 times more effective than spending on most business tax cuts (Pollack 2009).

Economic benefits aside, the nation's infrastructure is in drastic need of repair. The American Society of Civil Engineers estimates that two-thirds of U.S. roads are in poor or mediocre condition, costing drivers \$54 billion per year in repairs and operating costs (Lotke, Carter, Dockstader, Beckwith, and Swartz 2008).

The problem only begins with roads: bridges, levees, and sewers are collectively falling apart. Thirteen percent of all U.S. bridges are “structurally deficient,” another 14% are “functionally obsolete,” and most levees were built over 100 years ago; each year new breaches to sewer systems must be closed, at a cost of \$2 billion per year (Lotke, Carter, Dockstader, Beckwith, and Swartz, 2008). Deferring maintenance projects can prove to be costly in the long run. According to the Nevada Department of Transportation, for example, investing in the rehabilitation of a section of highway in the state would cost \$6 million this year but \$30 million in two years and more thereafter, with the extra costs attributed to the continuing deterioration of the road. The American Society of Civil Engineers estimated the total need for investment in America's infrastructure to be \$2.2 trillion, with the most urgent category in need of investment being drinking water systems, which currently face a shortfall of \$11 billion per year (not taking into account the growth in demand for drinking water over the next 20 years).

### Health information technology

Despite the short-run challenges in its effective implementation, health IT can help improve the

management of patient care. It can give doctors access to accurate and complete information on a patient's health, improve the coordination of patient care, and allow for the secure sharing of patient information. Health IT reform can help reduce medical errors and help doctors provide safer and more efficient care at an ultimately lower cost.

Automating and standardizing health care information has many benefits, including increasing the transparency of hospital resources, minimizing paperwork, and improving overall efficiency. The increase in productivity due to health IT reforms often pay off the initial investment within two to four years while also improving the health outcomes of patients (which cuts costs down the road) (McKinsey 2010). McKinsey estimates that the total savings from revamping health IT across the U.S. provider landscape could be as much as \$40 billion annually.

In spite of health IT's enormous practical benefits, many providers lack the information systems needed to efficiently coordinate a patient's care with other providers and to manage and improve performance. The Obama administration has committed \$2 billion to improve health IT and provide electronic health records to all citizens by 2014. Much of this money has been distributed through the Recovery Act of 2009.

### **Rural broadband connectivity**

The U.S. is falling behind globally in broadband deployment and adoption, and this divide is most acute in both distressed urban areas as well as less densely populated regions. The Pew Internet and American Life Project found that about half of rural Americans do not have access to a broadband connection in their home (Smith 2010).

The public benefits of high-speed broadband networks include job creation, economic growth, higher-quality education, and the ability to compete in global markets. Broadband-enabled health IT can help people improve care and lower health care costs. Broadband is also an increasingly essential component of business infrastructure, and many businesses cannot thrive without connectivity.

States have encouraged the development of broadband infrastructure by creating authorities to

serve as intermediaries between federal funding agencies and local projects. States have also leveraged existing assets like roadways and buildings in placing the telecommunications infrastructure.

Nationally, the Recovery Act appropriated \$7.2 billion to expand broadband access across the United States. In August 2010, the administration announced specific Recovery Act investments in broadband projects totaling \$1.8 billion that would create jobs and promote productivity in 37 states. Additionally, the Federal Communications Commission issued its "National Broadband Plan" this year, the goal of which is to ensure that every American has access to broadband capability. The FCC's plan would be revenue neutral, if not revenue positive; its spectrum auction recommendations would likely offset any potential costs. The majority of the plan's recommendations focus on increasing efficiency and streamlining processes, rather than requiring new government funding (FCC 2010).

### **Fundamental R&D**

Investing in fundamental research and development, or R&D, is crucial to promoting innovation that will help keep productivity high and keep the United States competitive globally. R&D refers to resourceful work performed on a regular basis that increases knowledge and efficiency and drives the creation of new applications. Greater investment in R&D can also drive down the price of new technology, thereby enabling its availability to a larger swath of the population. For instance, since 1975 the cost of computer chips has come down significantly; indeed, it has been estimated that if today's chips cost the same as they did in 1975, an Apple iPod would cost \$1 billion (American Energy Innovation Council 2010).

The United States falls behind seven other countries – Israel, Sweden, Finland, Japan, South Korea, Switzerland, and Iceland – in terms of R&D spending as a percent of GDP (OECD 2008). President Obama has proposed that the research and experimentation tax credit, which has been extended by Congress 13 times since its creation in 1981, be expanded and made permanent, at a cost of about \$100 billion over the next decade. The administration has justified this cost by citing the need to keep high-skilled jobs in the United States and to promote business certainty as well as future productivity



and growth. The Chamber of Commerce has supported the extension and expansion of the credit.

Another way besides tax credits to promote R&D is direct increases in spending on R&D projects and grants. The American Energy Innovation Council, a group consisting of business chairmen, including Bill Gates, has called for reforming and strengthening U.S. investment in energy innovation. Its five-part plan includes the formation of a National Energy Strategy Board, increased investment of \$16 billion annually in clean energy research and development, the establishment of centers of excellence in energy innovation (requiring funding in the range of \$150-250 million annually), an annual grant of \$1 billion to the Advanced Research Projects Agency-Energy program, and the establishment of a New Energy Challenge Program for large-scale demonstration projects (American Energy Innovation Council 2010). Fundamental academic research as supported by various agencies, including the National Science Foundation, National Institutes of Health and National Endowment for the Humanities, can also contribute to our nation's economic potential.

## **Our Fiscal Security's path for tax expenditure reform**

The revenue collected under the current parameters of the tax code is inadequate to fund our national priorities.

The U.S. tax code contains more than 150 "tax expenditure" provisions that will result in forgone federal revenue in each of the next five years. Both the Office of Management and Budget and the Joint Committee on Taxation, which issue annual line-item lists of tax expenditures, define tax expenditures as deviations from the "normal" tax structure for corporations or individuals. The sum of all individual tax expenditures' projected cost totals \$1.1 trillion in forgone revenue in 2011, equivalent to 7.0% of GDP (although the savings from eliminating all tax expenditures would vary due to interaction effects).

Over the next five years, the value of these tax expenditures is projected to climb 7.0% per year on average, considerably faster than projected GDP growth. By 2015, the sum of individual tax expenditures is projected to reach \$1.4 trillion, or 7.5% of GDP.

While tax expenditures often behave like spending initiatives in terms of policy objectives, their impact on the federal budget is a permanent drain on revenue that is not subject to annual appropriation or reauthorization by an authorizing committee. Curbing tax expenditures will generate significant revenue and allow the federal government to fund priorities without raising marginal tax rates on personal income, corporate income, or capital formation.

The president's budget proposes a host of reforms to tax expenditures, such as eliminating tax preferences for profitable energy companies and limiting the tax benefit of itemized deductions. In some cases, *Our Fiscal Security's* path endorses Obama policy proposals, many of which have stalled in Congress, but we also propose more aggressive tax expenditure reform. We measure all tax expenditure reform proposals net of Obama policy.

The changes to tax expenditure policy proposed by *Our Fiscal Security* and the associated gains and losses in federal revenue are summarized in **Table 2**.

## **Core tax expenditure reforms**

### *Tax capital gains and dividends as ordinary income*

Taxing both long-term capital gains and qualified dividends as ordinary income would generate considerable revenue while removing a major distortion of compensation choices from the tax code. Under the current tax code, the wealthiest pay only 15% on their income derived from wealth, while middle-income taxpayers pay higher rates, especially once payroll taxes are included. Subjecting capital gains and qualified dividends to the progressive income tax schedule would improve equity by eliminating incentives to move compensation to non-wage compensation categories; an example of this current distortion is the classification of "carried interest" earnings of private equity and hedge fund managers.

The Tax Policy Center estimates that taxing capital gains and ordinary dividends as ordinary income would generate \$95.5 billion in 2015 relative to current law (TPC 2007). Extrapolating from this score and adjusting for Obama policy, we estimate that taxing capital gains and ordinary dividends as ordinary income would generate \$88.1 billion in 2015 and \$917.6 billion

**Table 2. *Our Fiscal Security's* path for tax expenditure reform in 2015, net of Obama policy**

Core tax expenditure reforms	
Tax capital gains and dividends as ordinary income	\$88.1 billion*
Cap the benefit on itemized deductions at 15%	\$87.9 billion*
Expansion of refundable tax credits	
Permanently expand Earned Income Tax Credit	-\$1.6 billion
Make Child Tax Credit fully refundable	-\$4.1 billion
Additional recommended tax expenditure reforms	
Eliminate fossil fuel production tax credits	(Obama policy)
Limit deductibility of financial corporate debt interest payments	\$77.1 billion*
Close dividend loophole for foreign source income	\$34.1 billion
Close "active financing" tax deferral for financial firms	(Obama)
<b>Total of core tax expenditure reforms in 2015</b>	<b>\$170.3 billion</b>
<b>Total of tax expenditure reforms in 2015</b>	<b>\$281.5 billion</b>

\* Revenue impact in 2015 estimated from available budget scores due to availability limitations.

Source: Authors' analysis.

over 2011-20. This proposal would also help to restore fairness to the tax code because the cost falls largely on those who can best afford to pay. In 2007, the Tax Policy Center estimated that 83.3% of the incidence of taxing capital income as ordinary income would fall on the top 1% of earners, while an overwhelming 93.7% would fall on the top 5% of earners (TPC 2008b). Taxing capital gains and dividends can work to plug a considerable portion of the long-term budget shortfall while improving equity in the tax code.

*Cap the benefit on itemized deductions at 15%, expand charitable giving credit*

For taxpayers opting out of the standard deduction, the value of their itemized deductions increases with their marginal tax rate, and hence with their income. For high-income earners in the top tax bracket, the benefit (the amount by which their tax liability is reduced) is equal to 35% of their itemized deductions (39.6% if the top marginal tax rate reverts back as scheduled at the end of 2010). These tax code preferences provide no benefit to the majority of taxpayers (predominantly

lower-income filers) who take the standard deduction. The president's budget proposes limiting the tax benefit on itemized deductions to 28%; *Our Fiscal Security's* budget path proposes a broader restriction to a 15% marginal benefit *and* converting two major itemized deductions to refundable credits that are available to all tax filers.<sup>18</sup>

The Joint Committee on Taxation estimates that capping the limit on itemized deductions at 15% would save \$141.5 billion in 2014 and \$524.2 billion over 2010-14.<sup>19</sup> Extrapolating from this score and netting out Obama policy, we estimate that limiting the benefit of itemized deductions to 15% in itself would generate savings of \$119.2 billion in 2015 and \$1.2 trillion over 2011-20.

As part of this proposal, however, we would suggest treating charitable deductions differently than other provisions. In particular, we would propose converting the deduction to a refundable credit at a flat 25% rate, making it available to non-itemizers. This would result in a net increase in the tax incentive to give for more than three-quarters of the population. Based on current estimates of charitable contributions and assuming no net behavioral change in giving, a nonrefundable tax credit for 25% of charitable giving would cost \$31.3 billion in 2015 relative to capping the benefit on itemized deductions at a 15% rate. As a nonrefundable credit, this proposal would generate \$87.9 billion in 2015, although these savings would be slightly lowered by our proposal to make the charitable giving credit fully refundable.

This proposal would also replace the mortgage interest deduction with a fully refundable tax credit. Under current law, homeowners can deduct interest payments on up to \$1 million in mortgage debt and up to an additional \$100,000 in other loans, such as home equity loans, regardless of their use. Value of this benefit goes disproportionately to upper-income homeowners

because of the greater value of their mortgages and because they receive a larger benefit per dollar of mortgage debt. Making the deduction a refundable credit would increase the value of the credit for many homeowners.

The deductibility of mortgage interest on owner-occupied homes is projected to cost \$149.6 billion in 2015, or \$637.6 billion over 2011-15.<sup>20</sup> We propose converting the deduction to a refundable tax credit of 15% of interest on up to \$500,000 in mortgage debt, which in itself would save \$51.6 billion in 2014 and \$387.6 billion over 2010-19.<sup>21</sup> The proposal to limit the benefit on itemized deductions to 15% incorporates some of these savings, but lowering the limit on mortgage debt would generate additional savings to offset the additional expense of making the credit refundable.

### *Expand the Earned Income Tax Credit*

While most of the emphasis on tax expenditure reform focuses on curbing expenditures that have been carved out of the tax code for the sake of political expediency, the tax code is in some cases the most efficient way to deliver certain benefits. In particular, the tax code is a logical way to deliver means-tested income support to low-income earners, a key element of the social safety net and the effort to reduce poverty. To strengthen income support to low-income populations and abate poverty, particularly for children, we endorse expanding several refundable tax credits.

(The limitation of tax credits in fighting income deficiency is that they are based on work; obviously, the absence of work can be the source of the income problem. This dilemma is discussed in the box (p. 34), “*The limits of work-based tax solutions.*”)

Unlike most tax expenditures, the EITC is a progressive refundable tax credit targeted toward low-income populations. Currently the largest cash assistance program, the EITC plays a critical role in providing opportunity to struggling working families and fighting poverty. As one of the few refundable tax credits in the tax code, tax filers claiming the EITC will receive a payment if their EITC exceeds their income tax liability. *Our Fiscal Security’s* budget path proposes expanding the EITC in three ways: permanently extend the tier created by the 2009 Recovery Act for families with three or more qualifying children, permanently extend the act’s

marriage relief provision, and increase the credit for filers with no qualifying children.

The EITC is targeted to provide greater income support to families with more children. The Recovery Act created a new tier for couples with three or more children, raised the matching rate from 40% to 45% for these families, and raised the maximum credit amount from \$5,028 to \$5,657 (OMB 2010g). The Center on Budget and Policy Priorities estimates that the EITC kept 6.6 million Americans – half of them children – out of poverty in 2009 (CBPP 2009a). Additionally, the income threshold for the phaseout of the EITC for joint filers was extended by \$5,000 to provide marriage penalty relief. Both of these expansions of the EITC are scheduled to expire at the end of 2010. Extending the EITC expansion included in the Recovery Act would increase the number of qualifying children eligible for the credit by 1.4 million to 13.5 million in 2011 (TPC 2010c).

Low-income workers with no children, on the other hand, are eligible for a credit of only 7.65% on the first \$5,970 of earned income, whereas a family with a single qualifying child receives a credit of 34% on the first \$8,950 of earned income in tax year 2009 (Edelman et al. 2009). Thus, the maximum credit amount jumps from \$457 to \$3,043 for families with a single qualifying child. Of the 5.5 million returns applying for the EITC by individuals with no qualifying children, more than three-quarters of the tax filers were making under \$10,000 annually (IRS 2010a), which is below the poverty line for either a one- or two-person family with no children (Census Bureau 2010a). Expanding the EITC, both in matching rate and income threshold, for filers with no qualifying children would help to alleviate poverty, a critical concern in light of high unemployment and the effects of the Great Recession on low-income populations. We propose gradually expanding both the maximum amount of earned income and the phaseout threshold for the EITC for workers without qualifying children. By 2015, the maximum amount of earned income would be expanded to \$7,550, for a maximum credit amount of \$578. Relative to the president’s budget, this expansion of the EITC would cost \$1.6 billion in 2015 (TPC 2008b).

## The limits of work-based tax solutions

While the tax code may be an efficient way to provide means-tested benefits to wage earners, it is important to note two failings of relying on the tax code to distribute cash assistance. The first problem is related to the business cycle. The Personal Responsibility and Work Opportunity Reconciliation Act of 1996, better known as welfare reform, focused on replacing federal cash assistance programs with a “welfare to work” model designed to encourage labor supply. When the broad underemployment rate holds above 16% for more than a year (BLS 2010b), and when underemployment is significantly higher for black and hispanic workers, linking income supports to work is not effective.

Secondly, poverty remains a problem for many citizens outside of the labor force, including children and the elderly. The Child Tax Credit and the EITC attempt to address the former by increasing disposable income for low-income households with children. And Social Security addresses the challenges facing the elderly population that has left the workforce; the Census Bureau estimates that Social Security kept roughly 14 million retirees out of poverty in 2009 (Census Bureau 2010b). The fact that means-tested cash assistance programs are largely disbursed on the basis of wage income offers yet another argument against cutting Social Security benefits, particularly for lower-income retirees.

### *Make the Child Tax Credit fully refundable*

The CTC is a means-tested, partially refundable tax credit targeted to families with children under the age of 17. The Recovery Act lowered the earnings threshold for the refundable portion of the tax credit to \$3,000 (the threshold was scheduled to increase from \$8,500 to \$12,550 in tax year 2009), a move that greatly expanded access to a partial credit and increased the number of families receiving the full value of the credit. The president’s budget proposed maintaining the CTC threshold at the \$3,000 level. We propose a further expansion to make the credit refundable regardless of earnings. The additional cost would be \$4.1 billion in 2015 (TPC 2008c).

### **Additional recommended tax expenditure reforms**

In addition to the policies above that *Our Fiscal Security* endorses and which are included in our calculations of the fiscal impact of our blueprint, additional options have been proposed that could complement our recommended changes. We are generally supportive of these ideas as well, and others may prefer to substitute policies on this list for our top choices. These policies could also be modified by, for example, choosing different parameters to match revenue needs and policy makers’ preferences.

### *Eliminate fossil fuel production credits*

The president’s budget proposed eliminating a handful of tax expenditures that have been carved out over the years for the oil, natural gas, and coal industries, but these cuts met opposition in Congress. Presently, the tax code allows for the expensing of some oil drilling costs and provides deductions for the highly profitable production of oil, natural gas, and coal.

According to JCT, eliminating all preferential tax treatment of the fossil fuels industry would save \$4.3 billion in 2015 and \$40.7 billion over 2011-20 (JCT 2010). Eliminating these preferences would also help clean energy industries compete on an even playing field, thus helping to create sustainable, green manufacturing jobs. Along with enacting a cap-and-trade system of carbon emission allowances and increasing the excise tax on motor vehicle fuel (see *Our Fiscal Security’s* revenue path), this proposal is endorsed by *Our Fiscal Security* as a means of rebalancing the economy away from dependence on fossil fuels and toward clean energy.

### *Limit the deductibility of corporate debt interest payments for financial firms*

When planning investment strategies, corporations take advantage of a tax preference that encourages debt-financed projects over projects financed by other means. Interest payments on corporate debt are counted as a business expense and are thus paid from pre-tax income.



Requiring that interest payments be made from after-tax income, as dividend payments and stock repurchases are made, would encourage corporate financing using retained earnings or new equity. While there are many legitimate reasons for firms to take on debt, limiting the so-called “debt tax shield” for financial firms would generate significant revenues and discourage destabilizing high ratios of financial leverage, which have proven to impose significant economy-wide costs.

We propose limiting the tax preference for corporate debt interest payments for financial firms to 25%, below the top corporate tax rate of 35%, by making the preference an after-tax credit of 25% rather than a pre-tax expense. We estimate that limiting the tax preference to 25% of interest payments would generate \$77.1 billion by 2015.<sup>22</sup> Less revenue would be collected if there were a large reduction in borrowing resulting from this policy, but the policy objective of decreasing systemic financial risk would be furthered and capital would be freed up for more productive, less speculative investment.

This proposal gives policy makers significant scope to adjust the parameters. Extending the 25% proposed limitation of the tax preference on interest payments to nonfinancial corporations, for example, would generate additional revenue of \$38.0 billion in 2015. This variant of the proposal would help to level the playing field between firms that rely on equity financing and firms reliant on debt financing, but taxing nonfinancial sector debt would not come with the added benefit of dampening speculation and reining in systemic financial risks.

#### *Close the dividend loophole for foreign source income*

The tax deferral on earnings from U.S.-controlled foreign subsidiary corporations (incorporated overseas) enables firms to avoid repatriating foreign earnings. Rather than repatriating earnings from abroad as earned (and subjecting them to U.S. corporate tax rates), firms are taxed only when foreign earnings are received by the U.S. parent company as dividends. We propose eliminating the deferral of income from U.S.-controlled foreign subsidiary corporations; according to OMB this move would save \$34.1 billion in 2015 and \$169.1 billion over 2011-15 (OMB 2010f).

#### *Close “active financing” tax deferral for financial firms*

The “active financing” exception for foreign source income allows multinational financial firms to avoid tax on their worldwide income when they establish “captive” foreign financing subsidiaries. Like the dividend loophole for foreign source income, this tax code carve-out deprives the United States of both revenue and business investment. A similar active financing exception was repealed under the Tax Reform Act of 1986, but it was reinstated in 1997.

According to OMB, eliminating the active financing deferral from U.S.-based financial firms would save \$6.0 billion in 2015 and \$29.9 billion over 2011-15 (OMB 2010f), relative to current policy.

## **Our Fiscal Security's revenue path**

President Obama's 2011 budget request proposed increasing revenue relative to current policy primarily by allowing tax rates and tax preferences for high-income individuals to revert to their pre-2001 levels. Despite these increases, revenue levels will still remain below what is needed to achieve budget sustainability in the medium term; new revenue sources are needed, and more revenue must be obtained from the existing tax structure.

The tax policies endorsed by *Our Fiscal Security* and their associated revenues and costs are listed in **Table 3** and discussed in the following sections.<sup>23</sup>

#### *Repeal the Bush-era tax cuts for top earners*

The Bush-era tax cuts disproportionately benefited the highest earners at a cost of nearly \$2 trillion over a decade (Ruffing and Horney 2010). The president's budget request proposed allowing the Bush tax cuts for top earners – joint filers with incomes above \$250,000 and individuals with incomes above \$200,000 – to expire. These high-income individuals have seen the largest gains in income over the past three decades (see the box (p. 37), “*The siege of the middle class and the poor*”) and can afford an increase in their tax share.

This change would yield an estimated savings of \$629 billion over 10 years relative to the current policy baseline. Our path would mirror this policy by extending the middle-class tax provisions without extending tax cuts for the top 2% of earners.

**Table 3. *Our Fiscal Security's* path for modifications to the regular tax code in 2015, net of Obama policy**

Core general revenue tax policies	
Repeal Bush-era tax cuts for top earners:	(Obama policy)
Reform estate tax with progressive schedule of marginal tax rates	\$4.5 billion*
Permanently extend Making Work Pay tax cut	-\$36.0 billion*
Green revenue: cap and trade or carbon tax (diverting 50% as rebates)	\$52.0 billion
Reforms to reduce tax gap	(Obama policy)
Financial crisis responsibility fee	(Obama policy)
Financial speculation tax	\$77.4 billion*
Additional recommended general revenue tax policies	
Reinstate PEP and Pease for high-income earners	(Obama policy)
Surcharge on top earners	\$53.2 billion
Increase motor fuel excise tax	\$33.0 billion*
<b>Total of core revenue proposals in 2015</b>	<b>\$97.9 billion</b>
<b>Total of general revenue proposals in 2015</b>	<b>\$184.1 billion</b>

Off-budget core tax policies	
Eliminate Social Security payroll tax cap on employer side, raise cap on earnings on employee side to 90%	\$115.5 billion**

\* Revenue impact in 2015 estimated from available budget scores due to availability limitations.

\*\* Gross revenue impact: budgetary impact is \$103.2 billion net of increased outlays. Budget savings are fully dedicated to Social Security program.

Source: Authors' analysis.

### *Enact an estate tax with a progressive schedule of marginal tax rates*

The Bush tax cuts expanded the exemption for the estate tax from a planned increase to \$1 million (\$2 million for married couples) to \$3.5 million (\$7 million for married couples) in 2009, gradually reduced the marginal rate from 55% to 45%, and fully repealed the tax in 2010. But the law directed that these cuts expire on December 31, 2010, after which the exemption would return to the once-planned \$1 million individual/\$2 million married-couple level. The Obama budget proposes permanently extending the estate tax at 2009 levels, which would result in forgone revenues of \$28.0 billion in 2015 and \$253.3 billion over 2010-20 relative to current law, according to the Joint Committee on Taxation (JCT 2010).

The *Our Fiscal Security* path proposes exempting the first \$2 million from taxation (\$4 million for married couples) and enacting a graduated rate structure of 45%, increasing to 50% on the taxable portion of estates worth more than \$10 million and 55% on the portion of estates worth more than \$50 million. A similar graduated estate tax sponsored by Senator Bernie Sanders (I-Vt.), which included the higher exemption of \$3.5 million (\$7 million for married couples) and a 65% tax bracket for the portion of estates worth more than \$500 million, would generate roughly \$4.5 billion in 2015 relative to the Obama policy.

With a \$2 million individual/\$4 million married-couple exemption level, the vast majority of decedents would owe no tax. When that level of exemption was in place over 2006-08, 99% of decedents' estates were fully shielded from the estate tax (AFET 2010). Most that did pay would avoid large tax bills because of the exemption. In

2009, the average tax rate for those who inherited these sizeable fortunes was only 20.2%, almost half the top marginal rate for income.

### *Permanently extend the Making Work Pay tax credit*

The Making Work Pay (MWP) refundable tax credit, enacted as part of the Recovery Act, increased the take-home pay of 95% of tax filers and has spent \$73.0 billion as of the second quarter of 2010 (Recovery.gov 2010). The credit replaces 6.2% of income up to a maximum of \$400 for working individuals who are not claimed as dependents (\$800 for joint filers), and is gradually phased out at a rate of 2% of adjusted gross income over \$75,000 (\$150,000 for joint filers).



## The siege of the middle class and the poor

Since the end of World War II, the middle class has been the engine of American economic growth, and its strength has been often derived from deliberate and proactive policy choices. National policies in the postwar era enabled average workers to share in productivity gains, but many of these initiatives are now under threat in the name of fiscal austerity and tax cuts for the rich.

Generally, middle-class incomes stagnate during recessions but then regain strength during the ensuing recovery. A major exception was the jobless recovery of the 2000s under President George W. Bush; middle-class incomes fell through much of the recovery and were particularly slow to recover. By 2007, the share of after-tax income for each of the middle three income quintiles stood at their lowest level since 1979 (CBO 2010f). Thus, the first year of the recession that began in December 2007 was particularly painful for families that had not yet recovered from the decade's first recession.

Bush-era tax changes did little for the middle class. The cuts contributed to a drop in revenues as a share of GDP to the lowest levels since 1950, and they completed the shift from budget surpluses to deficits. The Bush tax cuts alone were not responsible for the chasm of economic inequality seen today; both the recession in the early part of the decade and the current recession have had severe impacts on poverty and inequality, and long-term trends have pointed to outsized income gains at the top.

The Great Recession that began in December 2007 has caused a painful surge in impoverishment; the number of Americans in poverty increased by 6.3 million between 2007 and 2009 (Census 2010c). Historically, when an economy falters, there is a correlating rise in poverty levels. However, part of what has made this recession so painful is that the recovery from the last recession – which began early in George W. Bush's presidency – was never strong enough to lift out of poverty the people who had suffered during it. In fact, most of the post-recession economic expansion benefited those who least needed the help.

After the 2001 recession, employment never returned to pre-downturn levels (when adjusted for population growth), and wage and income growth underperformed relative to all but one post-war expansion (Bivens and Irons 2008). Moreover, poverty was more widespread after the recession of 2001 than it was during. In 2001, 11.7% of Americans were living in poverty; in 2006 that number had jumped to 12.3%. By 2009, poverty had climbed to 14.3%,

the highest level in 15 years (Census 2010d). Although people of all income classes were hit hard – the number of millionaires in the country plunged 18% in 2008 (IRS 2010c) – the stock market has bounced back and the rich appear to have largely recovered from their financial losses in 2009 (Spectrum Group 2009).

Another crisis facing the poor and the middle class is the chronic nature of unemployment in this recession. In October 2010, 41.8% of unemployed workers had been actively looking for work for over six months, down from 46.0% in May 2010 – a rate not seen since the Great Depression (BLS 2010a). The underemployment rate, which includes jobless workers who have given up looking for work and people who want full-time jobs but have had to settle for part-time work – has held above 16% for a year and a half (BLS 2010b), and is much higher for minorities and those with a high school degree or less.

While middle-class incomes have not seen robust growth in decades, income growth at the top rose sharply in the last decade (see **Figure E**). In the 1960s, as the economy expanded, roughly two-thirds of income gains were reaped by the bottom 90% of U.S. households. Today, it is just the opposite. Since the end of the 1970s, the average after-tax income of the top 1% of earners has nearly quadrupled, to \$1.4 million; for the top quintile overall it nearly doubled, growing by 95%. By comparison, the middle fifth of the population saw increases of 25%, and income for the poorest fifth of the population rose only 16% – an average equivalent gain of \$2,540 (CBO 2010f; 2007 dollars adjusted to September 2010 dollars using CPI-U-RS (NSA)). In this decade we have seen not only the rich pulling away from the middle but also the very rich pulling away from the merely rich. These trends should have implications in the budget and the tax code and in the way we prioritize spending and revenue collection. The current debate over spending and tax reform has not adequately taken into account the income trends we have experienced.

The Bush-era tax cuts conferred disproportionate benefits on the highest-income households during this time when income was already concentrated at the top. Between 2001 and 2007, the income share of the 400 richest taxpayers doubled as their tax rates fell. In 2004, households making over \$1 million received cuts averaging \$123,600, which allowed their after-tax income to rise

*continued >*

*The siege of the middle class and the poor (continued)*

by 6.4% (Friedman and Shapiro 2004). In the same year, millionaires received 15.3% of all tax cuts. As a share of GDP, federal revenue fell while spending rose. Between 2001 and 2007 revenue averaged 17.6% of GDP and outlays hovered at 19.5%. In the six years prior, revenue averaged 19.5% of GDP, outlays 19.4% (OMB 2010b).

Proponents argued that the tax cuts would stimulate the economy; the slowdown (later determined to be a recession) was a rationalization for tax cuts that the administration wanted all along, but on a dollar-for-dollar basis the packages were poorly designed for this purpose. Alternative policies, for the same budgetary cost, would have had a much greater stimulative effect, and the hefty opportunity cost of the tax cuts negatively affected job creation during the ensuing recovery.

There was a much-heralded “middle-class component”

to the tax cuts that included the establishment of the 10% tax bracket, the expansion of the child tax credit, and tax relief for married couples, but these provisions helped upper-income households as well. In 2004 the middle-fifth of households received an average tax cut of \$647 from these provisions, while the top 1% of households received an average tax cut of \$34,992 (Friedman and Shapiro 2004). Extending the tax changes due to sunset in 2010 would benefit the super wealthy in a disproportionate manner. The top 1% of earners would receive an average tax cut of \$25,179; the top 0.1% would receive \$310,140. Those in the middle fifth, on the other hand, would receive an average tax cut of only \$1,016. If the tax changes were scaled back along the lines that the administration has proposed, those in the top 1% and 0.1% would still see cuts of \$14,022 and \$61,510, respectively. The bottom 95% would receive roughly the same size tax cut as they would if all the cuts were extended (Looney 2010).

The president’s budget proposes extending the MWP credit for tax years 2011 and 2012 at a cost of \$29.7 billion and \$30.4 billion, respectively. The Tax Policy Center estimates that extension would provide a tax cut to at least 60% of tax “units” in each quintile, but the relative value of the credit increases noticeably for lower-income workers (TPC 2010a).

A permanent extension of Making Work Pay helps to maintain the take-home pay of low- and moderate income taxpayers in the aftermath of the recession.

*Green revenue: cap and trade or carbon tax*

Climate change is a real and growing problem, and the question is not whether to limit greenhouse gases but rather how to impose the limits. A carbon tax or a cap-and-trade program would harness market forces to efficiently reduce greenhouse gas emissions.

A carbon tax would level a charge based upon the carbon content of the fuel source. A cap-and-trade program would either allocate or auction a set quantity of permits to so-called upstream energy producers such as electrical power plants or oil refineries.

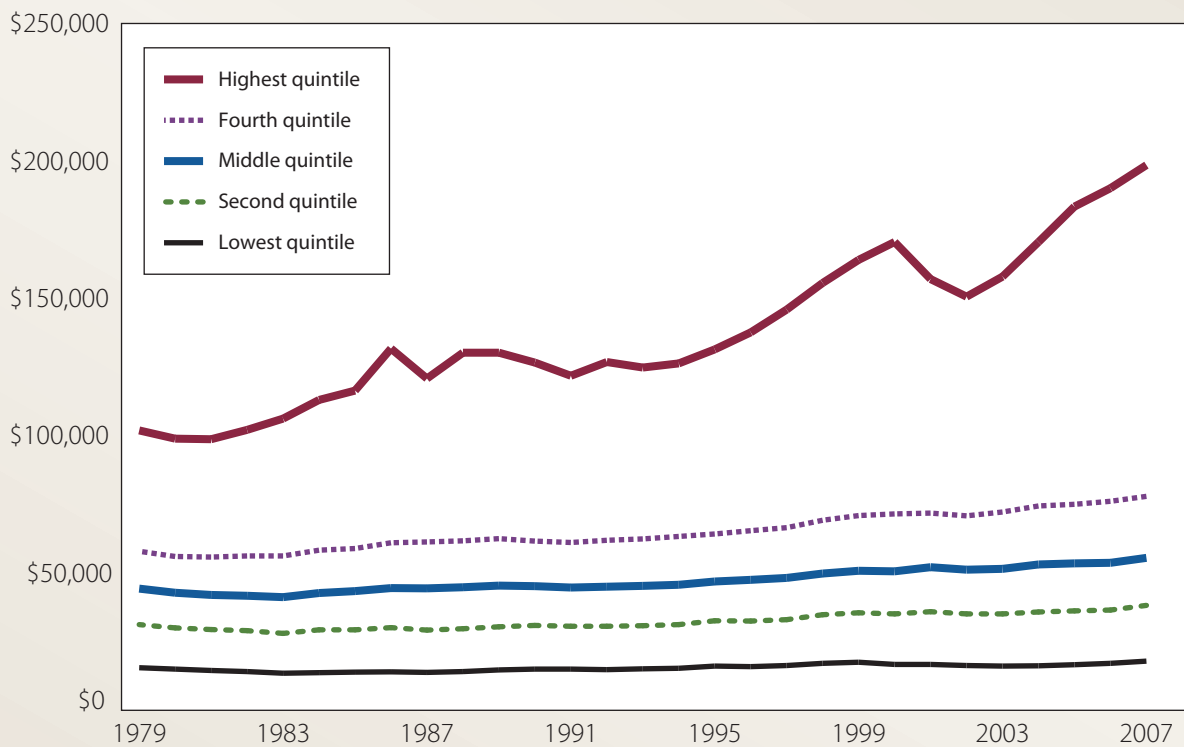
In a review of the literature, the Congressional Budget Office estimated revenue potential in the range of \$50 billion to \$300 billion annually by 2020.<sup>24</sup> CBO estimates that the American Clean Energy and Security

Act (H.R. 2454), better known as the Waxman-Markey Act, would raise \$104.0 billion in 2015 and \$845.6 billion over 2010-19. On net, Waxman-Markey was projected to reduce the deficit by only \$1.8 billion in 2015 and \$24.4 billion over 2010-19, largely because of free emissions allowances to states and other entities and energy rebates and refundable tax credits for low-income earners.<sup>25</sup> An earlier cap-and-trade bill, the America’s Climate Security Act of 2007 (S. 2191), better known as the Lieberman-Warner Act, was estimated by CBO to raise \$167.2 billion in 2015 and \$1.19 trillion over 2009-18.<sup>26</sup>

The president’s budget included a deficit-neutral allowance for climate policy with (unspecified) revenue intended to fully offset the cost of mitigating the impact of climate change and funding investments in a green energy economy. *Our Fiscal Security’s* path, on the other hand, recommends enactment of a climate change bill in which half of the revenue projected under Waxman-Markey is recycled back to consumers to offset the regressive nature of rising energy costs. The remaining half is used to fund general deficit reduction and green investment, which is booked separately in *Our Fiscal Security’s* investment path.

FIGURE E

## Average after-tax income by quintile, 1979 – 2007



Source: CBO (2010f).

### Reforms to reduce the tax gap

In 2005, the Internal Revenue Service estimated that the gross tax gap – the difference between taxes owed and taxes paid – totaled \$345 billion, of which only \$55 billion was expected to eventually be collected as late payments or from tax enforcement (U.S. Treasury 2009). The single largest source of the tax gap is underreporting of individual income, primarily income from sources not subject to withholding or strict documentation. Closing even a small fraction of this gap would generate significant revenue.

The administration proposed a number of reforms to reduce the tax gap by improving reporting, encouraging compliance, and strengthening enforcement. Major proposals included requiring recipients of rental income to report all major expense payments, requiring a certified taxpayer identification number for contractors,

strengthening rules for the classification of employees as independent contractors, and increasing the penalty for failing to file information returns.

Beyond domestic income underreporting, international tax evasion drains the U.S. Treasury of receipts. While it is impossible to close the entire international tax gap, estimated between \$30 billion and \$70 billion annually (Sawicky 2005), steps can be taken to improve tax compliance and modernize the international tax code.

The president's budget proposes 11 measures to reform the international tax system that would provide cumulative savings projected at \$13.1 billion in 2015 and \$117.0 billion over 2011-20. In addition to these reforms, increasing budgetary resources for tax enforcement would be an effective way to generate net budgetary savings. Tax enforcement revenue totaled

\$48.9 billion in 2009 (not including revenue received by deterring non-compliance), an amount equal to more than four times the entire budget of the IRS (IRS 2010b).

### *Financial crisis responsibility fee*

We recommend adopting the president's proposal to impose a "financial crisis responsibility fee" designed to recoup taxpayer losses associated with the Troubled Asset Relief Program (TARP), which primarily benefited major financial institutions. The fee would apply only to financial institutions with over \$50 billion in assets (estimated at roughly 60 institutions) and would be equal to 15 basis points (0.15%) of a financial institution's covered liabilities.<sup>27</sup> The fee proposed in the president's budget is projected to raise \$9 billion in 2015 and \$90 billion over 2011-20, and it will continue until all of the costs associated with TARP are repaid. The Congressional Budget Office estimates that the fee would have a negligible effect on economic growth.

### *Financial speculation tax*

While a financial transactions tax would not eliminate speculation or necessarily stave off financial crises, instituting disincentives to short-term speculating would be a step toward building a more resilient financial sector. The tax could generate revenue to fund investments to strengthen the economy in the wake of the financial-crisis-induced recession.

In 2004, the Congressional Research Service estimated that a 0.5% tax on stock transactions would raise roughly \$65.6 billion a year, assuming no reduction in trading volume (Shvedov 2004). Adjusting for nominal GDP growth and assuming a 25% reduction in transactions, we estimate that a financial transactions tax would raise \$77.4 billion by 2015. Expanding the tax to derivative financial products would generate significantly more revenue, but *Our Fiscal Security's* path assumes only the conservative revenue estimate above. The Let Wall Street Pay for Wall Street's Bailout Act (H.R. 1068) financial transaction tax bill – which would tax stock, options, futures, and swap transactions – was estimated to raise roughly \$150 billion a year.

The United States used to have a financial transactions tax, and many advanced economies,

including Great Britain, collect revenue from financial transactions without any noticeable harm to economic performance. This policy would complement the financial crisis responsibility fee, discussed above, and revenue from the tax could be used to invest in jump-starting the broader economy.

## **Additional recommended general revenue tax policies**

Beyond the policies above that *Our Fiscal Security* endorses and which are included in our calculations of the fiscal impact of our blueprint, additional options have been proposed that could complement our recommended changes. We are generally supportive of these ideas as well, and others may prefer to substitute policies on this list for our top choices. Each of these policies could also be modified by, for example, choosing different tax rates to match revenue needs.

### *Reinstate the phaseout of personal exemptions and limit itemized deductions for high-income earners*

We recommend adopting the president's proposal to reinstate the personal exemption phaseout (PEP) and the limitation on itemized deductions for Americans making over \$200,000 (\$250,000 for joint filers). Bush-era tax changes eliminated a maximum allowance for certain itemized deductions on high-income earners. The itemized deduction limitation, known as Pease after former Ohio Rep. Don Pease (who sponsored the limitation), had reduced the maximum benefit by 3% of adjusted gross income (AGI) above a certain threshold, up to a certain limit.<sup>28</sup> Reinstating both PEP and Pease for high-income earners (with income thresholds indexed for inflation) is estimated to save \$20.2 billion in 2015 and \$204.8 billion over 2011-20 (OMB 2010a).

### *Surcharge on top earners*

Millionaires have seen their average income rise much faster than that of the general population. The average after-tax income of the top 1% of earners has skyrocketed – surging 281% since 1979 to \$1.4 million in 2007 (CBO 2010f).<sup>29</sup> A surcharge on millionaires would raise significant revenue while reinforcing a basic principal of fairness in the tax code: those with more resources should pay proportionally higher rates than others.

Such a surcharge on high earners was included as a revenue offset in the House-passed version of the America's Affordable Health Choices Act (H.R. 3962), but it was eventually removed in favor of other offsets. Creating a new marginal tax bracket or surcharge for taxpayers with incomes over \$1 million would be a pragmatic option for raising revenue; while such a change would not in itself solve the long-term fiscal problem, it would mean less austerity elsewhere in the budget. A surcharge of 5.4% of joint filers' adjusted gross income exceeding \$1 million would generate revenue of \$53.2 billion in 2015 and \$460.5 billion (JCT 2010b) over the next decade, more than enough to fund child nutrition, foster care, and children's health insurance programs over the period (OMB 2010h). Given the historic pace of income growth for millionaires, it would take just one year on average for them to recoup this

modest tax increase.<sup>30</sup> A millionaire surcharge would impact only those who have benefited the most from the opportunities afforded by American economic policy over the last several decades.

#### *Increase the motor fuel excise tax*

Increasing taxes on motor fuels would raise significant revenues while decreasing negative social externalities such as pollution and traffic congestion. Revenue from the tax would recapitalize the highway trust fund, thereby providing badly needed funding for transportation infrastructure.

Including state and local taxes, CBO estimates that the average national tax rate per gallon of fuel is 40.3 cents on gasoline and 46.6 cents on diesel. CBO projects that raising federal fuel excise taxes by 25 cents a gallon would generate \$305.1 billion over 2010-19 (CBO

## The VAT as an alternative revenue source

A potential revenue source often discussed is the value-added tax, a consumption tax levied on goods and services at various points of production. The revenue potential of a VAT is significant: a 1% VAT in the United States would raise approximately \$50 billion per year, with some variance depending upon implementation. The Tax Policy Center estimates that a broad-based VAT (excluding education expenditures, rent, housing, and religious and charitable services) of 5% would generate \$340.0 billion in revenue in 2015 and \$3.28 trillion over 2010-19 (TPC 2009). Beyond its potential as a source of revenue, it is often noted that the United States is the only OECD member nation that has not enacted a VAT and that, in theory, taxing consumption could be less distortionary than taxing income or capital if implemented properly.

Counterbalancing the enticing revenue potential of a VAT is the regressive nature of taxing consumption. Since lower-income consumers tend to spend a much greater share of their income on consumption, they will pay a greater percentage of their income on a VAT than would a high-income consumer. In much of Western Europe, a VAT is used to fund progressive benefits, such as universal health care and higher education; enactment of comparable initiatives to offset the regressive incidence of a VAT would add to its appeal.

We believe that a VAT should only be enacted if it is coupled with other progressive reforms to the tax code, such as a significant expansion of the Earned Income Tax Credit, conversion of nonrefundable tax credits to refundable credits, and/or reductions in marginal income tax rates for low-income consumers and the middle class.

While a VAT could close a substantial portion of the fiscal gap, *Our Fiscal Security's* path achieves a sustainable budget trajectory without assuming any revenue from a consumption tax. More than most of the tax policy proposals assumed under *Our Fiscal Security's* path, responsible enactment of a VAT hinges upon the implementation of a number of offsets for low-income populations and an expansion of the social safety net. The absence of a consumption tax in our budget path also leaves considerable flexibility for policy makers should they prefer a VAT to more progressive revenue raisers. Finally, a revenue path contingent upon a VAT may be less politically plausible than a revenue path that uses more conventional means to achieve a sustainable debt trajectory.

Regardless of the appeal of a VAT, it is clear that the current tax code needs to be modernized, and a VAT should not be used as a way to avoid making needed changes.



2009); adjusting CBO cost projections for nominal GDP growth, we estimate that roughly \$33.0 billion would be raised in 2015. This is a policy option with significant scope for congressional adjustment based on the severity of the undercapitalization of the highway trust fund. Raising federal fuel excise taxes by 50 cents a gallon, for example, would generate \$604.8 billion over 2010-19 (CBO 2009).

### Summary of revenue impact

The *Our Fiscal Security* revenue path is highly progressive and has been crafted to address the economic legacy of the Bush tax cuts for the wealthy, the Great Recession, and decades of widening income inequality. It will increase the average after-tax income of low-income and middle-class Americans, and increase the share of tax drawn from the highest-earning individuals and financial corporations.

The core tax policies endorsed here would result in net revenue of over \$377.7 billion in 2015 if fully implemented, of which \$213.4 billion would result from modifications to the regular tax code and \$164.3 billion would result from tax expenditure reform.<sup>31</sup> A number of America's economic competitors have turned to a value-added tax as a way to raise comparable or greater revenue as a share of the economy. *Our Fiscal Security's* path does not rely on a VAT, for reasons explained in the box (p. 41), "*The VAT as an alternative revenue source.*"

We recognize that many of these policies may not be popular with many politicians and lobbyists. As a result, we are conservative in our revenue projections: the *Our Fiscal Security* budget path assumes only a net

revenue increase of \$200 billion in 2015 relative to the Obama policy baseline, leaving a sizeable placeholder for downside risks to revenue estimates (a worse-than-expected economic recovery, for example) and ample room for policy makers to be flexible in crafting policy. By 2020, our budget path assumes a revenue increase of \$450 billion; core general revenue and tax expenditure reform policies are projected to raise a comparable \$476.0 billion. The general revenue policies and tax expenditure reforms would generate up to \$749.4 billion in 2020 if the additional recommended policies were also implemented.

By 2020, our budget path assumes revenue at 21.7% of GDP, compared with 19.8% of GDP proposed in the Obama budget.<sup>32</sup> This revenue path combines receipts from new revenue sources and savings associated with elimination or reform of tax expenditures or carve-outs that decrease the revenue collected under current tax rates.

While this increase in revenue will do much to plug the nation's budgetary shortfall, most Americans will likely see their tax bill drop as a result of these policies. With half of the revenue from proposed carbon pricing earmarked for energy rebates and tax credits for low- and moderate-income populations, *Our Fiscal Security's* budget path seeks to fully offset the higher cost of energy for the lowest 60% of earners. Proposals to expand the EITC and the child tax credit, permanently extend the Making Work Pay credit, and convert the itemized deductions for charitable giving and home mortgage interest to refundable tax credits would raise the after-tax income of low- and middle-income earners.



## Adding it up: *Our Fiscal Security's* budget path

Based on the policies detailed above, we have formulated an illustrative budget path meant to rebalance the federal budget while providing for up-front public investments. It balances revenue and spending policies with the short-term needs of the struggling economic recovery, the medium-term needs of deficit reduction, and the long-term needs of increased public investment, slowed health care cost growth, and a stable debt-to-GDP ratio.

Based on the nation's evolving fiscal priorities, *Our Fiscal Security's* budget path assumes set revenue increases, spending decreases, and placeholders for public investment. **Table 4** outlines our illustrative path for spending and revenues relative to the Obama policy baseline.

Because of increased job creation spending and investments to support a sustainable economic recovery, the *Our Fiscal Security* budget path results in higher near-term deficits when compared with either the Obama policy<sup>33</sup> or current policy<sup>34</sup> baseline in the near-term. However, this is precisely the prescription needed to resuscitate the economy, which still falls 5.8% below its potential.<sup>35</sup> By 2014, however, the deficit under the *Our Fiscal Security* budget path falls below the current policy deficit; by 2015 it falls below both current policy and Obama policy. This improvement in the medium-term fiscal outlook results from stabilizing our additional public investment as a share of GDP, increasing revenue after the economy has recovered,

and escalating savings from the defense budget. Under *Our Fiscal Security's* budget path, the projected deficit falls from 11.0% of GDP in 2011 to 3.7% of GDP in 2020. In terms of the primary deficit, the budget flips from deficit to surplus in 2018. By 2020, *Our Fiscal Security's* budget path is projected to run a primary surplus of 0.3% of GDP, whereas primary budget deficits of 1.1% and 2.2% of GDP are projected under the Obama policy and current policy baselines, respectively. **Figure F** shows the path for the primary deficit under the three budget scenarios; **Figure G** shows a similar path for the unified budget deficit (including interest payments); and **Figure H** illustrates the beneficial impact of *Our Fiscal Security's* budget path for stabilizing debt held by the public as a share of the economy.

It is not enough to look just at the magnitude of the deficit; the composition of what is being financed matters. For example, long-lasting investments in national infrastructure such as transportation will leave a lasting benefit while creating jobs now. Under *Our Fiscal Security's* path, discretionary spending totals 7.2% of GDP in 2020 (or less, depending upon specific division of investments between discretionary and mandatory programs). By contrast, the Obama policy budget baseline invests only 6.6% of GDP in discretionary spending in 2020.

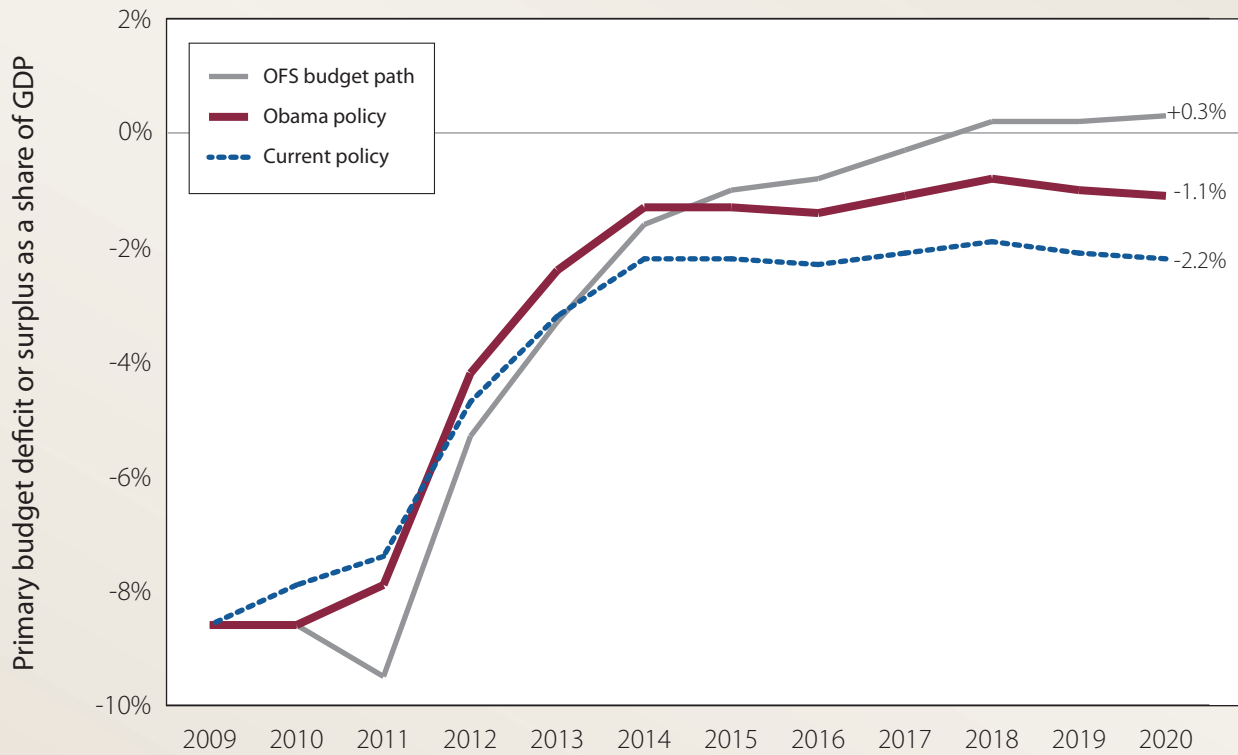
**Table 4. *Our Fiscal Security's* budget path, 2011-20** (\$ billions, relative to President Obama's FY2011 budget proposal)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Public investment	250	200	212	225	236	248	259	270	282	294
Defense savings	-17	-35	-52	-70	-87	-105	-122	-140	-157	-175
Revenue increases	0	0	0	100	200	250	300	350	400	450
Total adjustment to Obama policy deficit	-233	-165	-160	-56	51	107	163	219	275	331

Source: Authors' analysis.

FIGURE F

## Our Fiscal Security's budget path achieves primary budget balance by 2018



Sources: CBO (2010a), OMB (2010a), Auerbach and Gale (2010), and OFS calculations.

In short, *Our Fiscal Security's* baseline budget path shows a noticeable improvement in the fiscal outlook relative to current policy and Obama policy baselines over the 10-year budget window. In the last three years it shows primary surpluses.

Beyond the 10-year window, escalating health care costs and rising net interest costs (resulting from persistent deficits) drive rapidly rising debt levels under both the current policy and Obama policy baselines. This upward trend in the debt-to-GDP ratio cannot plausibly be curbed without slowing the growth in health care.

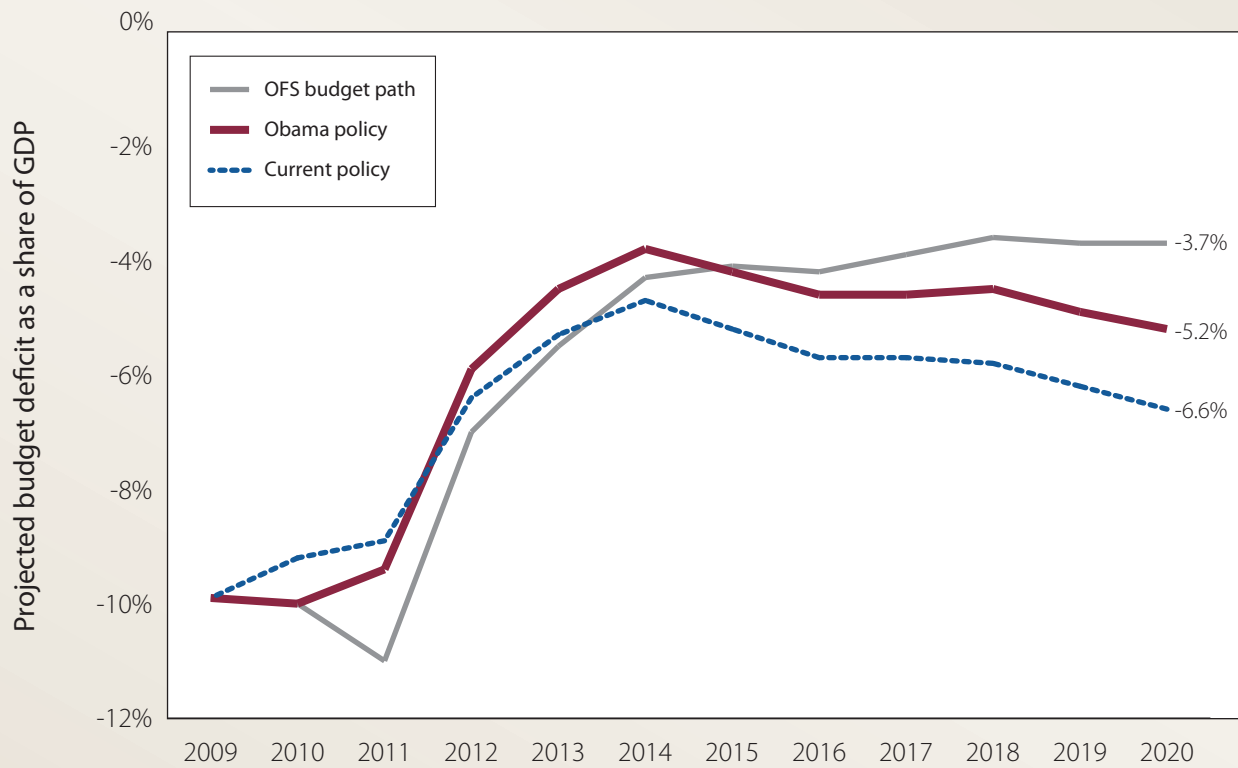
Over this longer horizon, *Our Fiscal Security's* budget path places the public debt on a considerably more sustainable path than either Obama policy or current policy (Figure I). If there is no slowdown in health care

costs and other government spending keeps pace with the overall economy, by 2045 debt held by the public under *Our Fiscal Security's* path would reach 136.6% of GDP, 72 percentage points below the current policy baseline and 38 percentage points below the Obama policy baseline.

However, our path also contains proposals that would likely reduce the growth rate of health care expenses and hence reduce the growth of Medicare and Medicaid spending. Under reasonable assumptions about the effectiveness of these measures, we would expect the debt-to-GDP ratio to hold under 90% for the full 35-year budget window. In particular, if the growth rate of health care costs were reduced on average by 1.6 percentage points per year beyond 2025, *Our Fiscal*

FIGURE G

## ***Our Fiscal Security's* budget path invests in a strong economic recovery and achieves sustainable budget deficits by 2018**



Sources: CBO (2010a), OMB (2010a), Auerbach and Gale (2010), and OFS calculations.

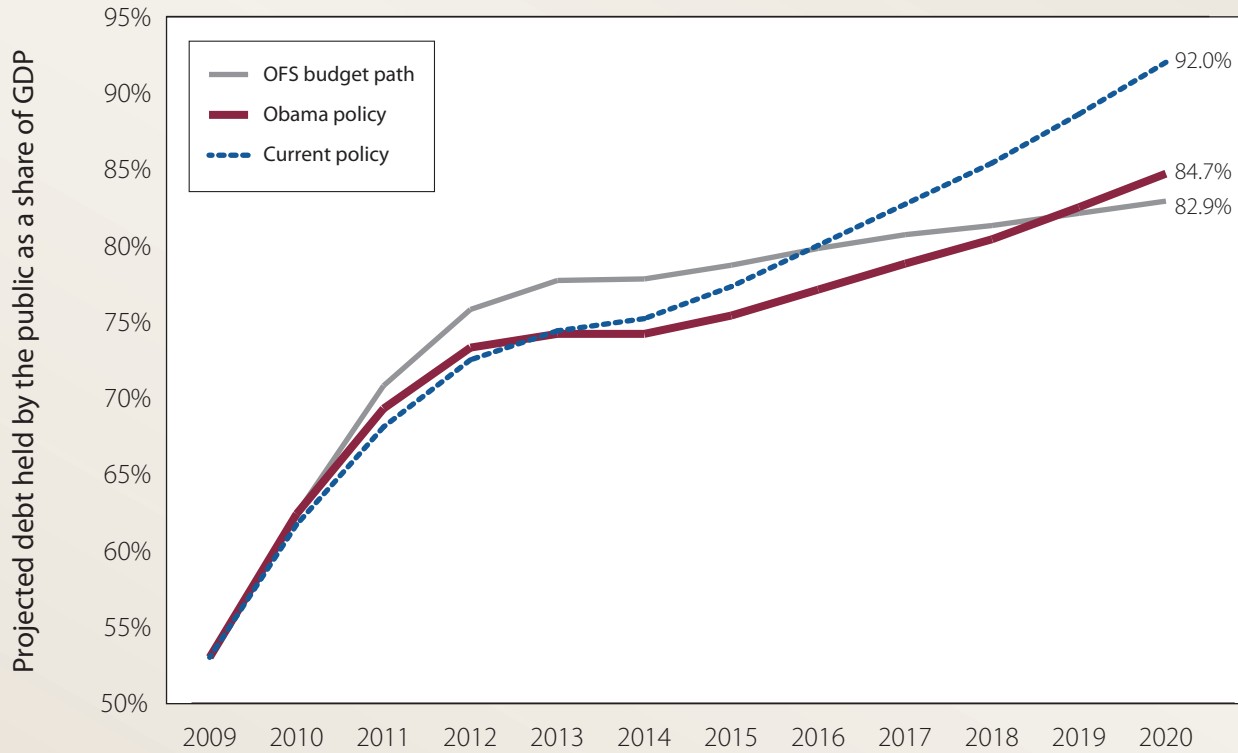
*Security's* debt path would be stabilized at 2025 levels, just under 90% of GDP. If savings of this magnitude did not materialize, this same sustainable path could be achieved with a smaller 0.5 percentage point annual reduction in health costs combined with a slightly slower growth path for discretionary spending (see the box (p. 48), “*The path of health care costs*”).

Not only does *Our Fiscal Security's* budget path stabilize public debt in the medium term and put it on a more sustainable trajectory in the long term, it also does so while increasing investment in a number of critical national priorities. *Our Fiscal Security's* path invests in job creation and a strong economic recovery; we propose investing \$450 billion over 2011-12 to put Americans back to work and support economic

growth as the Recovery Act winds down. We target public investments that create jobs now *and* lay the foundation for long-term economic growth, particularly in the realms of education and infrastructure. As the economy strengthens, *Our Fiscal Security's* path maintains expanded public investments in critical, underfunded areas such as early childhood education, quality child care, infrastructure, public transit, rural broadband connectivity, and research and development. Public investments have proven time and again to generate long-lasting benefits, often with high return; thus we believe our pro-growth investments will strengthen the middle class while rebuilding an economy that works for all Americans.

FIGURE H

## ***Our Fiscal Security's* budget path invests in a strong economic recovery while placing the public debt on a sustainable trajectory**



Sources: CBO (2010a), OMB (2010a), Auerbach and Gale (2010), and OFS calculations.

### ***Investing in faster growth***

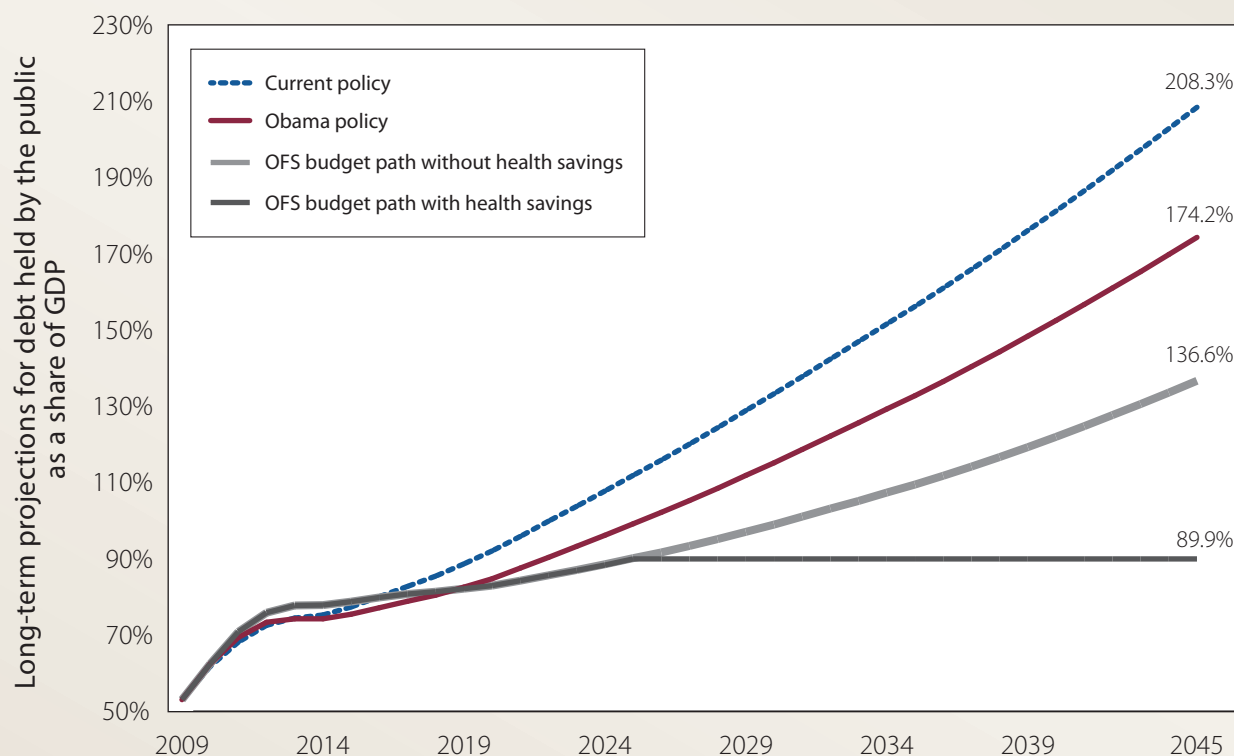
While economists generally agree that we cannot outgrow our budgetary challenges, faster growth will unequivocally improve the future budget outlook as a stronger economy makes it easier to afford our liabilities. Beyond the 10-year budget window, debt is fairly responsive to changing assumptions about trend growth, since these changes compound over time.<sup>36</sup>

Based on a review of the literature, we estimate that our path for additional public investment will gradually increase the rate of nominal economic growth by 0.5 percentage points, a conservative estimate (see Appendix G for a discussion of the empirical evidence on public

investment and productivity growth). Specifically, we assume that additional public investments starting in 2011 will begin to gradually raise trend nominal GDP growth, from a 0.1 percentage-point increase in 2021 to 0.5 percentage points by 2025. By 2045, projected nominal GDP increases by 11.6% relative to our baseline growth assumptions. By 2045, an accelerated path of GDP growth spurred by robust public investment would reduce *Our Fiscal Security's* budget path debt-to-GDP ratio from 89.9% to 78.4% (Figure J). These calculations adjust revenue, discretionary spending, and “other mandatory” spending for the faster rate of growth, while spending on Medicare, Medicaid, and Social Security are held at baseline growth levels.<sup>37</sup> Assuming the revenue

FIGURE 1

## ***Our Fiscal Security's* budget path stabilizes the public debt by raising adequate revenue and slowing excess health care cost growth**



Sources: CBO (2010a, 2010c), OMB (2010a), Auerbach and Gale (2010), Board of Trustees (2010a), and OFS calculations.

increases and new health care reforms proposed in *Our Fiscal Security's* budget path succeed in stabilizing the debt-to-GDP ratio beyond 2026 under baseline growth assumptions, accelerated growth resulting from expanded public investment would result in a gradual decrease in the debt-to-GDP ratio. Timely investments in education, scientific research, and transportation, electric, and telecommunications infrastructure could result in more dynamic economic growth, easing pressures on the federal budget.

## The path of health care costs

By increasing revenue, freezing military spending, and containing health care cost growth, Our Fiscal Security's budget path stabilizes the debt-to-GDP ratio at the 2025 level of 89.9%. The assumed reduction in health care cost growth begins to be phased in after 2025, allowing sufficient time to establish a robust public option to further contain health care cost growth and/or to implement other health care reforms proposed in our fiscal plan.

We have recommended a variety of policies to contain cost growth. Most notably we recommend a non-profit public option that would compete with private sector health care providers and harness economies of scale to control costs of drugs and procedures. (See the health care section for further discussion.)

Holding the path for discretionary spending and non-health care mandatory spending constant, stabilizing debt-to-GDP beyond 2025 would require reducing the average projected rate of federal health care spending growth from 6.0% to 4.4%. This would amount to a 27.7% reduction in federal Medicaid and Medicare outlays by 2045, the equivalent of 2.9 percentage points of future GDP. Significantly larger savings would accrue from reduced net interest outlays because of a lower stock of public debt (largely resulting from health care cost growth containment); under *Our Fiscal Security's* path, net interest would represent only 3.9% of GDP in 2045 compared with 7.3% projected under Obama policy and 8.7% projected under current policy.

This 1.6 percentage-point reduction in excess health care cost growth is plausible if we implement a strong

public option and make recommended investments in comparative effectiveness and health information technology, but there is much uncertainty regarding health care cost growth projections. Alternatively, the public debt could be stabilized with a smaller reduction in excess health care cost growth if discretionary spending were indexed to inflation rather than GDP growth. Assuming the entire discretionary budget were indexed to the consumer price index (CPI-U) plus 0.5% beyond 2025, stabilizing debt-to-GDP would require only a 0.5 percentage-point reduction in excess health care cost growth. This would mean reducing federal Medicare and Medicaid spending by 2045 by 10.4% relative to projections of CBO and the Centers for Medicare and Medicaid Services trustees, a reduction equal to 1.1 percentage points of future GDP.

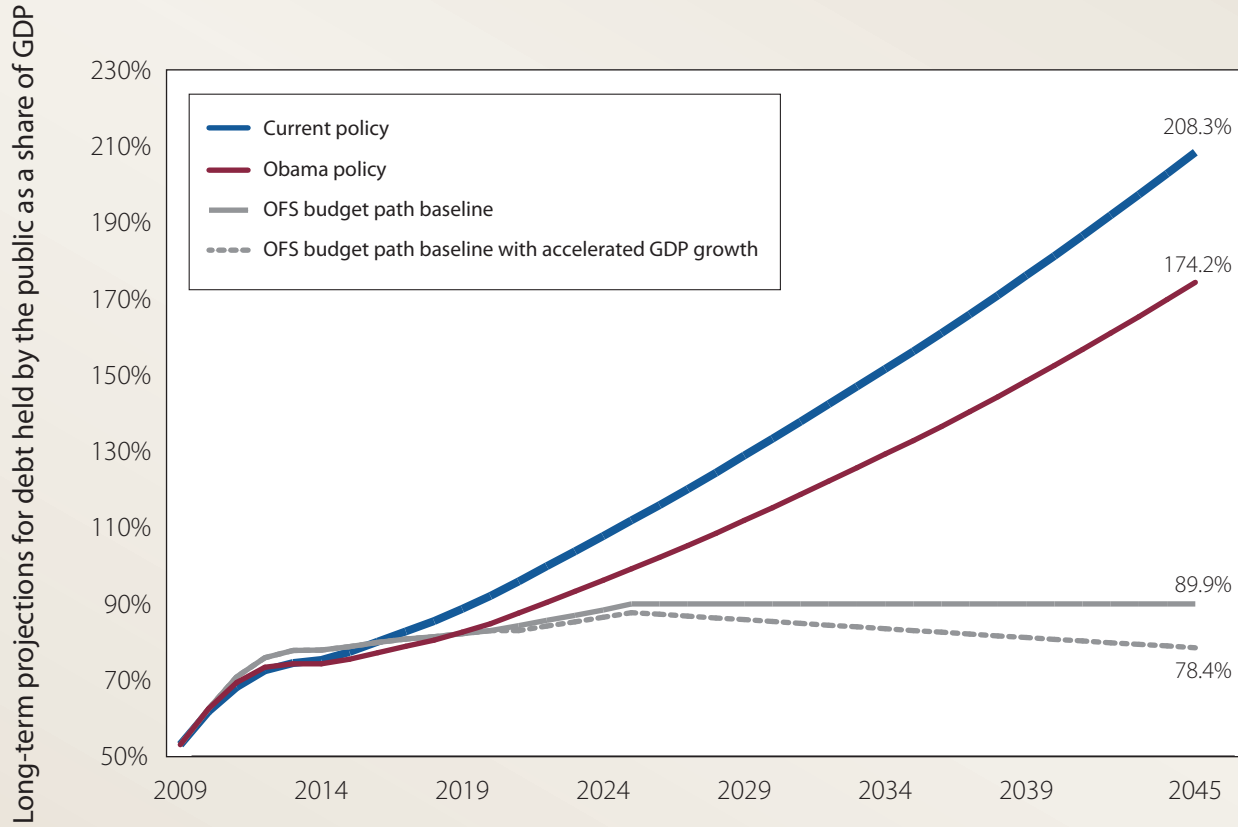
Slowing health care cost growth would improve the fiscal outlook in two ways: (1) federal expenditure on Medicare, Medicaid, and employee health care coverage would decrease, and (2) gross domestic product would see a boost. The Council of Economic Advisers estimates that a 1.5 percentage-point reduction in health care cost growth would increase GDP by 2% in 2020 and 8% by 2030 (CEA 2009).

The federal budget will not find a long-term sustainable path without slowing excess cost growth in health care coverage. The Affordable Care Act was a step in the right direction, both in terms of reforming the provision of care and improving our fiscal future. But these are continuous processes.



FIGURE J

## Investments that increase trend economic growth would significantly improve the long-term budget outlook



Sources: CBO (2010a), CBO (2010c), OMB (2010a), Auerbach and Gale (2010), Board of Trustees (2010a), and OFS calculations.

# Conclusion

*Our Fiscal Security's* path achieves fiscal sustainability while increasing investments in important national priorities. We believe sustained investment in the economy will provide a strong foundation for job creation and future economic growth.

Our path achieves budgetary balance while promoting a stronger, broader middle class. A strong middle class will not only benefit the working families within it but also the overall economy as well, and growing productivity in turn can help us work toward trimming deficits and paying down the national debt. But the middle class has been under economic assault the last few decades; inequality has widened, and meaningful economic progress has stalled.

The blueprint includes increases in domestic investments in the first 10 years, but also brings debt levels down significantly in comparison with projected debt levels. Indeed, the blueprint meets our stated goals of stabilizing the debt while creating jobs and maintaining national investments. It does so mainly by targeting those in society with the highest incomes for revenue increases, and it avoids cost shifting and “band-aid” solutions.

We believe the current recession is not a justification for fiscal austerity, but rather a chance to show how investing in the middle class can help us grow our way out of tough fiscal times. Our policies work against the erosion of investment we have seen over the past 30 years while modernizing the tax code.

Americans have a choice about how best to solve our long-term fiscal challenges. Some will suggest that severe fiscal austerity and cuts to national investment are the only way out of the current situation. We believe there is another way: as a nation we can instead make the decision to actively create jobs and to rebuild America while demanding fiscal responsibility.

# Appendix A: Baselines and assumptions

While fiscal experts agree that rising debt levels are almost certain, measuring the exact trajectory of U.S. fiscal policy is a difficult task, one that requires many assumptions about the future path of the economy and the policy decisions that will be made along the way.

## **The CBO current law baseline**

The Congressional Budget Office (CBO) is statutorily required to score all legislation and issue budget outlooks based on current law. Consequently, the CBO baseline does not reflect the host of annual legislative fixes that have become the status quo in Washington, such as patching the alternative minimum tax to prevent it from affecting increasingly more Americans. Similarly, CBO projections assume all the Bush tax cuts will expire as scheduled at the end of 2010, whereas a full sunset looks unlikely given the state of the economy and the stated preferences of many policy makers.

A current law budget baseline provides consistency but offers an incomplete depiction of likely spending and tax policies. For that reason, the president's budget request offers much better insight into national budgeting priorities and the likely fiscal path. The White House Office of Management and Budget (OMB), which compiles the president's budget, issues its own set of economic assumptions – sometimes more optimistic than those used by CBO – when scoring the administration's own budget request. The CBO re-estimate of the president's budget is generally considered a more objective assessment. We use this latter measure as the basis for our analysis.

## **The Obama policy baseline and the 'current policy' baseline**

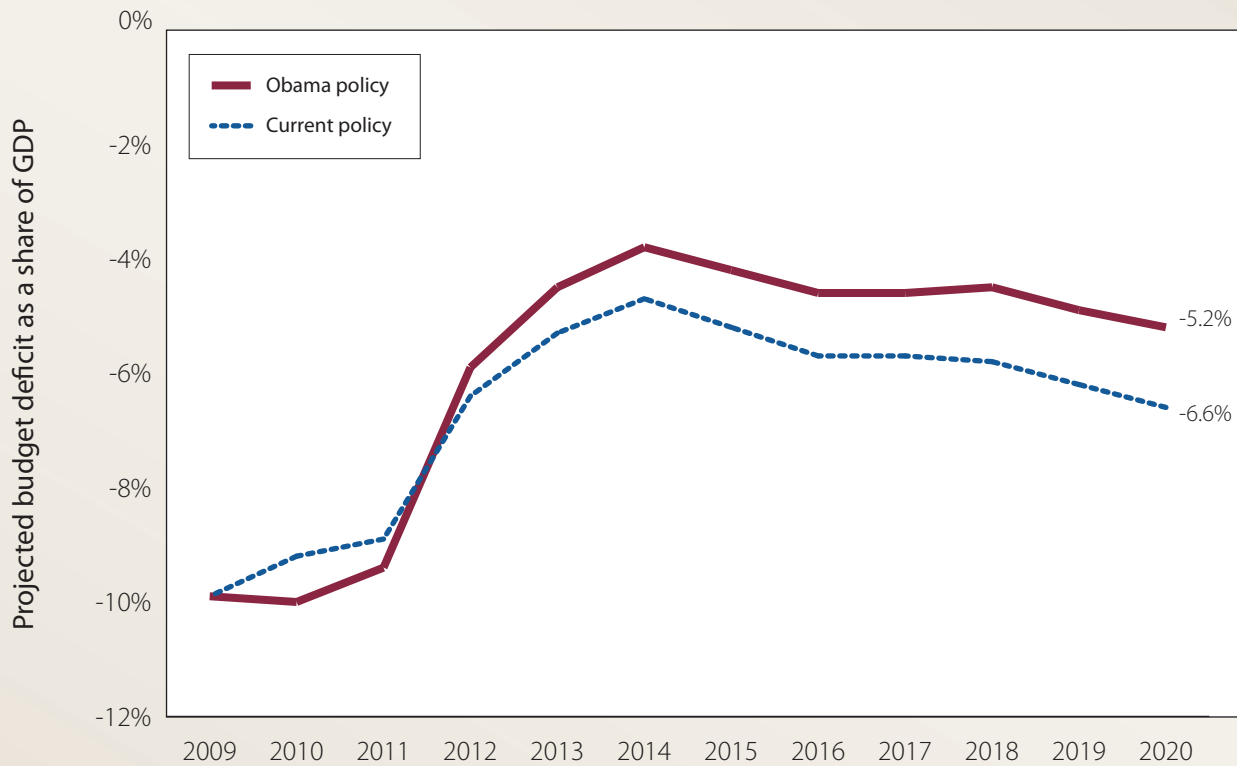
This paper uses two paths as the comparative baselines for U.S. fiscal policy.

The first is the president's request embodied in the *Budget of the United States Government, Fiscal Year 2011* and re-estimated by the Congressional Budget Office. *Our Fiscal Security's* budget path for Obama policy makes tax and spending policy adjustments (and the corresponding adjustments to debt service) to the August 2010 *Budget and Economic Outlook* (CBO 2010a), which offers the most current economic projections.<sup>38</sup> This baseline reflects the passage of the Affordable Care Act of 2010, which was signed into law after the president's budget submission.

The second fiscal path is the "current policy" baseline compiled and regularly updated by Auerbach and Gale, most recently detailed in "The Federal Budget Outlook, Chapter 11" (Auerbach and Gale 2010). For the current policy baseline, the tax policy adjustments include extensions of the estate and gift tax repeal, a permanent 15% rate on capital gains and dividends, other extensions of the Bush-era tax cuts, indexation of the AMT exemption for inflation, and an interaction effect for indexing the AMT. On the spending side, non-defense discretionary spending is adjusted for both inflation and population growth (CBO adjusts only for inflation), defense discretionary spending is assumed to follow the path in the president's budget (resulting in a decrease from CBO projections), and the scheduled reduction in Medicare physician payment rates is assumed not to occur (the so-called "doc fix" continues). Like the CBO budget baseline, the Obama policy and current policy baselines highlight projections over a 10-year budget window, ranging from 2011 to 2020, with the recently ended fiscal years included for reference. The current policy baseline depicts a more

FIGURE K

## Projections for the budget deficit as a share of GDP



Sources: CBO (2010a), OMB (2010a), and Auerbach and Gale (2010).

challenging fiscal outlook than the Obama policy baseline over most of the 10-year budget window.

The two 10-year budget baselines are depicted in **Figure K**. The current policy baseline deficit is projected to be smaller than the Obama policy deficit in 2010 and 2011, but surpasses and gradually diverges from Obama policy in the remaining years of the budget window. In the very near term, the Obama policy budget deficit is widened by proposed extensions of Recovery Act provisions that include temporary job creation measures, an extension of the higher Federal Medicaid Assistance Percentage, and an extension of the Making Work Pay tax credit. By 2012, the Obama policy baseline deficit begins to fall relative to current policy, largely due to higher projected federal receipts.

### ***Divergent revenue assumptions***

Obama policy assumes the top two marginal tax rates revert to 36% and 39.6%, the estate tax is reinstated under its 2009 parameters, and the rate on capital gains and dividends reverts to 20% for high earners, whereas the current policy baseline assumes a full extension of all the Bush tax cuts. Beyond the Bush tax modifications, Obama policy assumes new revenue sources, such as a financial crisis responsibility fee, a cap on the rate at which itemized deductions reduce tax liability, and reforms to the international tax system, which more than offset the reduction in revenue associated with the proposed extension of the Making Work Pay tax credit and child tax credit.

## **The 10-year picture**

As tax increases take effect and the adverse budgetary impact of the recession recedes, the budget deficit under Obama policy narrows to 3.8% of GDP in 2014. Excluding net interest costs, this represents a primary budget deficit of 1.3% of GDP.

The current policy baseline deficit, in contrast to the Obama policy baseline, falls back to a higher 4.7% of GDP, or a primary deficit of 2.2% of GDP, in 2014, a diminished drop in the deficit that largely reflects the full cost of extending all of the Bush-era tax changes. Beyond these years, the respective budget baselines widen as net interest payments balloon and mandatory outlays grow faster than revenues. By 2020, the current policy deficit is projected at 6.6% of GDP, while the Obama policy deficit is projected to reach 5.2% of GDP. At 2.2% of GDP, the primary deficit under current policy is twice the primary deficit under Obama policy. Debt service reaches 4.4% of GDP under the current policy baseline and 4.1% of GDP under Obama policy.

Under each scenario, debt service approaches two-thirds of total discretionary spending and significantly exceeds non-security discretionary spending. Also under each scenario, total discretionary spending steadily declines as a share of GDP beyond 2011. Discretionary spending in 2020 is projected to fall to 6.6% of GDP under Obama policy and 6.9% of GDP under current policy; in either scenario this would represent the lowest level of discretionary spending as a share of GDP since 2001. By 2020, revenue under Obama policy reaches 19.8% of GDP, whereas revenue is projected at 18.5% of GDP under the current policy baseline. This revenue gap accounts for most of the 1.4 percentage-point difference between the projected deficits in 2020 under the two budget baselines.

## **Public debt trajectory**

As a result of projected budget deficits, the debt held by the public, measured relative to the size of the economy, is projected to rise steadily over the next decade. From a starting point of 53.0% of GDP in 2009, debt held by the public is projected to climb to 84.7% of GDP under Obama policy and 92.0% of GDP under current policy (see Figure A in the body of this report). Under Obama policy, the debt-to-GDP ratio stabilizes in 2014 – as the

deficit falls to a six-year low – but begins to rise again as the deficit begins to widen in 2015. Under the current policy baseline, 2014 also represents an inflection point; up to 2014 the debt-to-GDP ratio is leveling off, then begins to bend upward at an exponential rate. Much of the long-term upward bend to the projected debt-to-GDP ratio stems from excess cost growth in health care expenditure; over 2015-20, federal spending on Medicare and Medicaid is expected to grow on average by 7.2% annually, whereas average nominal GDP growth is projected at only 4.4% a year. Rising debt service costs are also a major contributor to the long-run deterioration in the debt-to-GDP ratio, partially because real interest rates are projected to rise after the economy recovers from the Great Recession. As the debt-to-GDP ratio continues to rise exponentially, an ever-increasing share of national income will be diverted to repaying the Treasury Department's creditors, both foreign and domestic.

## **The long-term budget outlook**

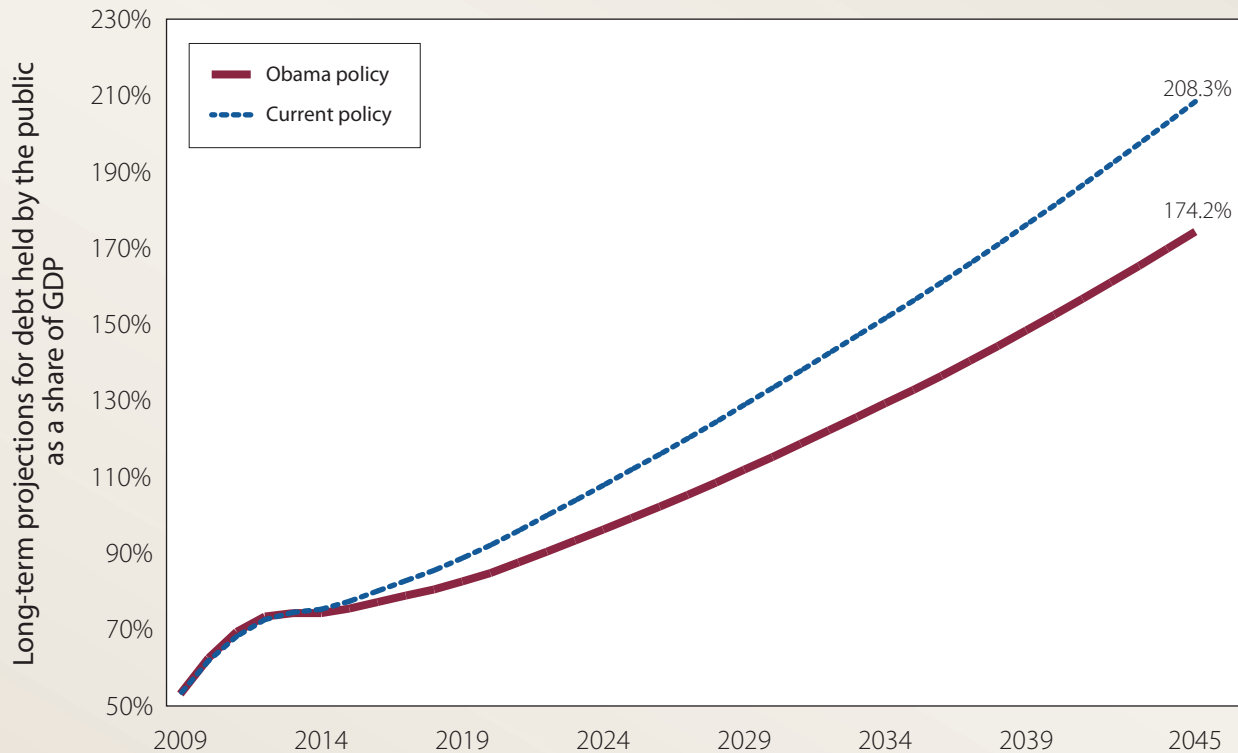
Driven by excess health care cost growth, the upward trajectory of the debt-to-GDP ratio extends well beyond the 10-year budget window (see Figure L). Under the Obama policy baseline, debt held by the public will surpass 100% of GDP in 2026; it passes this point in 2023 under the current policy baseline.<sup>39</sup> By 2045, the debt-to-GDP ratios are projected to climb to 174.2% under Obama policy and 208.3% under the current policy baseline. Under Obama policy in that year, the nation is running a deficit of 11.4% of GDP and a primary deficit of 4.1% of GDP, while 7.3% of national income is being spent on debt service. Under the current policy baseline, the deficit in 2045 is projected at 13.9% of GDP, representing a primary deficit of 5.1% of GDP and 8.7% of national income being diverted to debt service.

Under either scenario, debt service dwarfs total discretionary spending. It is important to remember that these projections assume nothing more is done to curb health care excess cost growth.

This projected trajectory is undesirable and unsustainable over the long term; it risks the crowding out of private investment, the inability to adequately respond to crises with countercyclical fiscal policy, and

FIGURE L

## Long-term budget outlook for debt held by the public, 2009-45



Sources: CBO (2010a, 2010c), OMB (2010a), Auerbach and Gale (2010), Board of Trustees (2010a), and OFS calculations.

possibly a fiscal crisis (CBO 2010d). For these and other reasons, President Obama tasked the Fiscal Commission with stabilizing the debt-to-GDP ratio “at an acceptable level once the economy recovers,” although the president’s budget notes that there is much uncertainty as to the magnitude and timing of the policy measures necessary to accomplish such a goal.

There is no way to precisely quantify what is an acceptable versus problematic level of debt, particularly given the unique role of the U.S. dollar and Treasury securities in international financial markets and the relative importance of the U.S. economy to the global economy. If sustainability is measured by the willingness of investors to lend to the U.S. Treasury at reasonable rates of interest, the sustainability of U.S. public finances has more to do with confidence and expectations than

anything else. For this reason, the current level of the debt-to-GDP ratio should be much less of a cause for concern than the projected upward trajectory of the debt in the future.

### **CBO’s long-term budget outlook**

Every year, CBO issues a long-term budget outlook that extrapolates two sets of budget projections out over a 75-year window (CBO 2010c). The first budget baseline is an extension of the baseline budget, with several areas of the federal budget – including discretionary spending and corporate tax revenue – assumed to be frozen as a share of GDP beyond 2020. As noted earlier, the CBO baseline is a reflection of current law rather than current policy, and tends to seriously overestimate



federal receipts and underestimate outlays. The second budget projection is the alternative fiscal scenario, which is meant to be a better reflection of current policy. The alternative fiscal scenario assumes that the estate and gift taxes and exemptions are frozen at 2009 rates (adjusted for inflation), the Bush income tax cuts are extended for all but the top two brackets, and AMT relief is extended.

Beyond 2020, these revenue sources are then frozen as a share of GDP, as are revenue sources assumed to follow current law. Consequently, the alternative fiscal scenario assumes that revenue is frozen at 19.3% of GDP in years 2020-75, an unreasonable assumption given the realities of demographic changes, excess health care cost growth, and projected deficits. The alternative fiscal scenario also assumes that the direct impact of health care reform on cost growth and outlays will last only a decade (through 2020), and CBO extrapolates out-year projections based on only these 10 years. Many of the provisions in health care reform do not take effect until 2014 or 2018, and the CBO score of the final bill showed projected cost savings significantly ramping up in the second 10-year budget window (CBO 2010e). Because revenue is implausibly constrained and much of the cost controls embedded in health care reform are ignored, we consider the alternative fiscal scenario, like the extended CBO baseline, to be a poor projection of current policy. Consequently, we constructed our own long-term budget outlook. Because of the limited explanatory power of long-term budget projections, however, we extrapolate the Obama policy and current policy baselines only to 2045.

### ***Why we extrapolated beyond the 10-year window***

Long-term budget extrapolations are subject to much greater uncertainty than the 10-year budget window, which is also of limited predictive power due to economic and legislative uncertainty.<sup>40</sup> Nonetheless, long-term budget projections play an important role in fiscal planning, largely because the projected rise in health care costs exceeds projected GDP growth – a problem that compounds rapidly in the long-term budget outlook. Excess cost growth threatens to crowd out the rest of the federal budget and bring total expenditure to an unsustainable level. Because health

care expenditure is on an unsustainable path for both the private and public sectors, it necessitates changing the provision of health care in this country rather than merely shifting costs to states, consumers, and private businesses.

However, because the major federal entitlement programs have made commitments for many decades to come, long-term budget projections are needed to score the impact of certain pieces of legislation. For example, the health care reform bill, which is being slowly phased in between now and 2018, is projected to save \$143 billion in the CBO 10-year budget window, but CBO estimates savings of roughly half a percentage point of GDP beyond 2020, resulting in over \$1 trillion in savings over the second 10-year window (CBO 2010e). Long-term budget projections are also important for tweaking other mandatory programs to ensure sustainability. The projections of the Social Security Actuaries help guide policy makers to ensure the long-run solvency of the program. Bearing in mind the limitations of long-term economic and budget projections, we extrapolate the two budget baselines out to 2045 using economic and budgetary assumptions in the CBO “Long-Term Budget Outlook” (CBO 2010c) and the 2010 “Social Security and Medicare Boards of Trustees Report” (Boards of Trustees 2010).<sup>41</sup>

## Appendix B: Interaction effects and *Our Fiscal Security's* budget path

A host of interaction effects impact the cost savings associated with reforming or eliminating tax expenditures. Beyond tax expenditures, interaction effects are embedded across the range of ordinary, investment, and corporate income tax policy proposals. *Our Fiscal Security's* revenue path does not assume a set interaction effect or attempt to estimate interaction effects between each combination of revenue proposals, but we do have good reason to assume that the total impact of tax interaction effects in our path is revenue positive. Here are the major interaction effects we assume would impact our revenue proposal:

- Adding an additional marginal tax bracket (the millionaire surcharge) and taxing capital gains and qualified dividends as ordinary income would generate additional savings (a revenue positive interaction effect) because high earners would pay an even higher rate on capital income. Similarly, the relatively higher rates on capital gains and qualified dividends would shift compensation away from stock options and toward ordinary income, increasing the revenue from the millionaire surcharge.
- Taxing capital gains and dividends as ordinary income would increase savings associated with capping the benefit on itemized deductions at 15% because compensation would be shifted away from stock options and toward ordinary income.
- Adding an additional marginal tax bracket (the millionaire surcharge) and taxing capital gains and dividends as ordinary income would, with time, decrease the revenue impact of a graduated estate tax because less wealth would accumulate to estates under a more progressive tax code.
- Creating a flat 25% refundable credit for itemized deductions would reduce the savings associated with capping the benefit on itemized deductions at 15%.
- Replacing the mortgage interest deduction with a refundable tax credit would reduce the savings associated with capping the benefit on itemized deductions at 15%, although this would be largely (if not fully) offset by lowering the threshold on mortgage debt from \$1.1 million to \$500,000.
- Imposing a financial transactions tax and limiting the deductibility of corporate debt interest payments for financial firms would generate a negative interaction effect on revenue because the incentive to take on highly leveraged positions would be decreased twice over for financial firms.

## Appendix C: Budget process changes

*Our Fiscal Security's* budget blueprint takes into account that certain budget process changes need to be made. The process currently lacks a realistic framework for how government plans to spend in the short term and plan for entitlements and taxation in the longer term. Congress ends up spending most of its budgetary focus on discretionary spending, and there is a lack of adequate oversight of vast areas of the budget such as tax expenditures.

Changes need to be made in the budget process. But some proposed changes would prove to be dangerous. A few examples of budget process changes to either avoid or embrace are below.

### **Balanced budget amendment**

The passage of a balanced budget amendment (BBA) would generally mean that Congress would not be able to use the powers of the federal government to deficit-spend; that is, the government could not outlay more money than it had collected in revenues in a given year.<sup>42</sup> The immediate fallout would be fiscal policy resembling a “starve the beast” strategy called for by those on the right such as Grover Norquist. With a BBA, programs relying on discretionary spending would face unpredictable and potentially deep cuts, particularly if the economy were in a recession. A BBA would prioritize short-term budget goals over policy priorities, which include everything from funding national parks to ensuring health care access to children in poverty. Thus, socially speaking, a BBA would be detrimental to society. It would from time to time severely hurt or halt thousands of programs, while also causing sudden interruptions to services and public sector employment.

A BBA would be a disaster from an economic standpoint as well as a social one. During periods of weak economic growth, a BBA would compel legislators to cut spending on social programs just as the need for them would be rising. Indeed, if the government were not able to respond with countercyclical spending

during times of recession, the economy's downturn would intensify; automatic stabilizers currently kick-in during recessions to increase aggregate demand. Since revenues fall and transfers rise during hard economic times, a recession requires a temporary increase in deficit spending. A constitutionally mandated balanced budget, on the other hand, would demand the opposite to occur. The government would have to cut spending or raise taxes, which most economists would agree would deepen rather than shorten any given recession. Finally, proponents of a BBA perpetuate the myth that government budgeting operates similarly to how an individual must budget; that is, when times are tough cuts need to be made. While this may be necessary for an individual facing difficult financial times, the government has an obligation to be the economic support of last resort and the access to credit markets to play such a role. The ability to deficit-spend to promote productivity and growth during down times is essential, as was proven during the Great Depression.

### **Entitlement caps**

Entitlement caps would generally establish spending limits for entitlement programs for each year; if entitlement costs were projected to exceed the cap, Congress would have to enact legislation to cut these programs. Failure to do so would result in automatic cuts to many entitlement programs. Entitlement caps are designed to enforce immediate cuts in entitlement programs; specific legislation proposed by Rep. Mark Kirk (R-Ill.) in 2005 would have required a 10-year cut of around \$450 billion (Greenstein et al. 2005).

Not only would entitlement caps require deep cuts in programs, but they would misdirect many of those cuts at programs whose costs are not rising significantly, in order to make up for the massive rise in health care costs, which is driving growth in entitlement spending. Yet the formula used in entitlement cap proposals has generally indexed the cap to the inflation rate; this does

not take into account that health care costs (in both the private and public sectors) are rising faster than the inflation rate (or even nominal GDP growth). The result would be that, to meet these caps, the cuts would unfairly punish other programs, such as food stamps or the Earned Income Tax Credit, all to keep pace with rising health care costs. Thus, programs whose costs are not rising significantly would bear the brunt of general entitlement caps. It would be politically impossible to cut Medicare and Medicaid to the level it would take to comply with such caps. Again, this is a blunt policy proposal designed to “starve the beast,” without paying regard to the impact of across-the-board cuts.

## **PAYGO**

PAYGO, or pay-as-you-go, refers to a government budgeting enforcement mechanism which requires that legislation impacting direct spending<sup>43</sup> or revenue not increase the budget deficit. PAYGO was first established in the Budget Enforcement Act of 1990, and came about because the government had not been successful in meeting the deficit path targets set out in the 1985 Balanced Budget and Emergency Deficit Control Act. Extended in the Budget Enforcement Act of 1997, statutory PAYGO operated – along with discretionary spending limits – from 1991 through 2002 (Keith 2010).

During the early part of the Bush administration, when Republicans held control of the Senate and the House, statutory PAYGO lapsed and was not restored. While reinstatement was proposed from time to time, disagreement over whether to apply PAYGO to both spending and revenue legislation, as opposed to just direct spending legislation (favored overwhelmingly by Republicans) meant that PAYGO as it was known in the 1990s was never restored. When both the House and Senate swung back into Democratic control in the 110th Congress, PAYGO rules were reinstated but they had no statutory enforcement mechanism (they were enforceable only by parliamentary points of order). Shortly after President Obama took office, he announced he would submit a statutory PAYGO proposal to Congress that would apply both to direct spending and revenue legislation.

Statutory PAYGO, in its current form, was signed into law by the president in February 2010.<sup>44</sup> The costs and savings of legislation, including either direct spending or revenue changes, are recorded on a PAYGO “scorecard,” which is finalized at the end of each congressional session. If a violation of PAYGO has occurred, the administration must issue a sequestration order that implements across-the-board cuts in nonexempt direct spending programs.<sup>45</sup>

PAYGO excludes certain costs from the scorecard. For instance, the PAYGO process does not address deficit increases stemming from changes in spending or revenue levels that are projected to take place under current law. Additionally, PAYGO exempts any costs designated as emergencies. Finally, the current PAYGO act sets forth exclusions – with specified constraints – for four specified areas of current policy: Medicare physician payments, the estate and gift taxes, the alternative minimum tax, and the middle class tax cuts enacted in 2001 and 2003.<sup>46</sup> Congress can thus enact legislation extending these current policies without having to offset the significant costs of doing so. The periods in which these policies can be extended under PAYGO varies from two years (for the estate and gift taxes) to permanently (for the middle class tax cuts). Current policy treatment of Medicare physician payments can be extended for five years.

## **Progressive PAYGO**

*Our Fiscal Security's* budget path would benefit from a “progressive PAYGO;” that is, one that strives for budget discipline while keeping to stated priorities. A progressive PAYGO would accomplish a number of things:

- A progressive PAYGO would, first and foremost, apply PAYGO's enforcement mechanism equally to direct spending, tax expenditures, and general revenue. As it stands, if Congress adjourns at the end of a session with net costs on the PAYGO scorecard, the administration is required to implement across-the-board cuts to nonexempt mandatory programs. A progressive PAYGO would alter that enforcement mechanism to consist of a fair balance of cuts to nonexempt mandatory spending, reductions in tax expenditures (excluding refundable credits), and increases in general revenue.

- A progressive PAYGO would exclude any changes to education programs that fall within mandatory expenditures. It would exclude these under the premise that investments in education end up having greater long-term benefits to society than costs; cuts up front only end up costing society more in the long term (see our discussion of public investments for more on this topic).
- A progressive PAYGO would end the exemption for Medicare physician payments, which has grown costlier with each passing year and facilitated inaction on health care cost growth. Instead, Congress would be forced to adequately budget for the “doc fix,” preferably by enacting a public option to reform provision of care or raising sufficient revenue to fund current policy.

### **Subject tax expenditures to budget discipline**

Tax expenditures – currently running at around \$1 trillion in one year – are government spending programs implemented through the tax code. Tax expenditures are made up of various tax exemptions, credits, exclusions, deductions, deferrals, and preferential rates (OMB 2010f). Because they behave as spending programs administered through the tax code – on things like promoting retirement savings, homeownership, and corporate investment in research and development – they are essentially devoid of the oversight they might be subject to in the normal budget process. Congress does not regularly review tax expenditures and the budget process basically ignores them, which, among other things, makes tax expenditures an attractive vehicle for many lawmakers. Due to both their popularity and the fact that they run on autopilot, the total cost of tax expenditures has grown enormously and is slated to continue growing. In absolute terms, they disproportionately benefit high-income taxpayers, though relative to the amount of taxes paid they tend to more often benefit low-income taxpayers (Burman et al. 2008).

Regardless of the merits of particular tax expenditures, there needs to be greater oversight of all deviations from the ordinary tax structure. Reform could start by simply designating a list of major tax expenditures that should be brought under annual review. This list could include some of the largest tax expenditures – such as the employer-provided health care exclusion, the deduction for state and local taxes, and the host of retirement savings incentives – which make up a majority of the total costs of tax expenditures.

Going even further, however, reform could come in the way of a cap on tax expenditures, which could be designed as an alternative to a discretionary spending cap but with significantly higher savings. This could be required either on an annual basis or every five years, in a manner similar to the farm bill. Burman (2010) argues that capping tax expenditures for three years at 2012 levels and indexing the cap for inflation after that (as President Obama proposed for non-security discretionary spending in this year’s budget) could save \$3.5 trillion. That is well over 10 times what President Obama’s three-year discretionary freeze is projected to save.

## Appendix D: Earmarks

On the stump, politicians on both sides of the aisle routinely disparage the discretionary budget for its inclusion of earmarks, or funds directed for specific projects in certain states or districts. Although taxpayer dollars should never be wasted, the political and public obsession with Washington “pork” is misleading in the context of overall deficit reduction, much to the detriment of public finances. The fixation with earmarks reinforces the widespread public belief that the budget can be balanced by eliminating “waste, fraud, and abuse.” This diverts attention from spiraling health care cost growth and chronically insufficient revenue, which most public finance experts will agree represents the real fiscal challenge.

Citizens Against Government Waste, a watchdog group, estimates that 9,129 appropriated projects costing \$16.5 billion were earmarked in 2010; this sum represents just 1.2% of the Obama policy discretionary budget request and 1.1% of the projected budget deficit (CAGW 2010).<sup>47</sup> Furthermore, banning earmarks would not decrease the deficit because the discretionary

budget allocation would be unchanged. While earmarks often only benefit a single constituency, they are subject to annual appropriation, which provides significantly more scrutiny than much of the budget process. Tax expenditures, on the other hand, are somewhat akin to an indefinite earmark. They tend to benefit a small subset of corporations or individual tax filers, but once they are enacted many annually evade congressional scrutiny. Unlike earmarks, the total sum of line-item tax expenditures is projected at \$998.3 billion in 2010 (this does not necessarily reflect the net cost due to interaction effects), more than 60 times the cost of all earmarks in the same year (OMB 2010f). Looking to the tax code would be a much more effective way of cutting corporate welfare and the budget deficit.



# Appendix E: Expenses and savings in the Patient Protection and Affordable Care Act

Major expenses of the health care reform law of 2010 include:

- \$434 billion for expansion of Medicaid and Children's Health Insurance Plans enrollment
- \$464 billion for subsidies to fund insurance for individuals and families up to 400% of the federal poverty level
- \$40 billion for small-employer tax credits

Among the legislation's reductions in wasteful health care spending and revenue increases are:

- Trimming overpayments to Medicare Advantage Plans by \$132 billion
- Cutting Medicare and Medicaid disproportionate share (DSH) payments by \$36 billion<sup>48</sup>
- Collecting \$210 billion in new Medicare taxes on wages and self-employment income (0.9%) and on investment income (3.8%) from taxpayers earning over \$200,000 (\$250,000 for couples)
- Collecting \$32 billion from taxes on high-cost health plans in 2018 and 2019
- Collecting \$60 billion in fees from insurance companies (2014-18), plus \$14 billion per year plus adjustment thereafter
- Collecting \$27 billion in fees on manufacturers and importers of branded pharmaceutical (2010-19)
- Collecting a 2.3% excise tax on medical devices
- Reducing administrative costs in the health exchanges; insurers will be covering larger groups, will have less need to market or advertise and will no longer be "underwriting" policies (calculating how much to charge based on a patient's pre-existing conditions)
- Collecting penalties from individuals and employers who do not buy insurance.

# Appendix F:

## Retirement security: background and options

Social Security is a self-sustaining program, funded mostly on a pay-as-you-go basis but able to accrue large surpluses in order to address future challenges such as the retiring of the baby boom generation. Income is generated from two primary sources: payroll tax payments that are levied on the first \$106,800 of income (in 2010), and income taxes on benefits. About 97% of dedicated tax revenues come from the payroll tax.

These dedicated revenues are credited to the two Social Security trust funds, known as the Old Age and Survivors Insurance (OASI) and the Disability Insurance (DI) funds, and used to finance the program's activities. Both benefits and administrative costs come out of these funds. Interest on the funds' balances is also credited to the funds. Currently, after many years of tax revenues exceeding benefit payments, the funds have accrued over \$2.5 trillion in balances. Cash generated by surpluses is turned over to the Treasury in exchange for securities; the Treasury uses the funds to pay for ongoing government activities. If the trust funds' receipts are less than its outlays, the securities are redeemed for cash as needed.

Workers are eligible to begin receiving retirement benefits before the normal retirement age (NRA). If workers begin collecting retirement benefits early, they receive only a portion of what they would receive if they retired at the normal retirement age, which is currently 66 and rising to 67 as set forth in the 1983 Social Security reforms. Benefits are determined using a formula based on the highest 35 years of covered earnings over a person's lifetime. Though high earners generally contribute more (up to the taxable maximum) and receive higher benefits, the benefit formula is progressive, so they receive somewhat lower monthly benefits as a share of pre-retirement earnings. (In part, this structure serves to offset longer life expectancies.)

### ***The payroll tax cap***

Prior to the reform of the Social Security Act in 1977, the payroll tax cap was raised only through specific statutory increases, resulting in a decline over time of earnings covered by the program. Since 1983, when the cap was restored to cover around 90% of earnings, it has been indexed to average wages. However, due to an increase in earnings inequality, by 2009 the percentage of taxable earnings had declined to around 83% (CBO 2010i). CBO estimates that raising the cap to about \$156,000 in 2012 (rather than the \$113,700 estimated under current law) would cover 90% of earnings (CBO 2010i).

### ***Options for extending the long-term stability of Social Security***

#### **Eliminate or increase the payroll tax cap**

The taxable maximum could be eliminated completely, meaning all income would be subject to the 12.4% payroll tax. According to the latest CBO Social Security options report, eliminating the taxable maximum completely (if the additional taxable earnings are not included in benefit computations) would increase Social Security's total revenues by around 0.9 percentage points of GDP in 2040. If this option were introduced in 2010, it would more than eliminate the 75-year Social Security deficit (Special Committee on Aging 2010), though it would require workers making over the cap to pay considerably more in taxes in a given year.

Eliminating the taxable maximum and adjusting benefits (which would result in higher benefits for the higher-earning workers affected by the tax) would improve the 75-year actuarial balance by 0.6% of GDP, nearly closing the 75-year shortfall. Specifically, the system would take in increased revenues of 0.9 percentage points by 2035, but would pay out an

additional 0.3 percentage points. CBO projects that the trust fund exhaustion date would be pushed out to 2083.

A more incremental approach would be to increase the payroll tax cap so that it would cover a greater percentage of income. Increasing the cap so it again covers 90% of earnings would put the maximum at about \$156,000 in 2012. CBO estimates that this policy would reduce the projected shortfall by about a third (0.2 percentage points of GDP) and would delay the exhaustion of the trust fund by 11 years, while increasing payable benefits, particularly to those receiving benefits after 2040.

### **Gradually raise the payroll tax**

In 2009, payroll taxes dedicated to Social Security and Medicare accounted for 40% of all federal revenue (OMB 2010a). The share of revenue constituted by the payroll tax grew sharply after the advent of Medicare in 1965 and after reforms were made to the Social Security program in 1983.

Social Security's long-term shortfall could be fixed by simply raising the payroll tax. In fact, each year the Social Security Trustee's Report presents the 75-year actuarial deficit in payroll tax terms. The 2010 report stated a 75-year actuarial deficit of 1.92% of payroll, meaning that raising payroll taxes 1.92% – or .96% on both the employer side and the employee side – would close the long-term shortfall.

### **Increase the payroll tax by 1%**

Increasing the payroll tax by 1% in 2012 – 0.5 percentage points on both the employer and the employee side – would increase the overall payroll rate to 13.4%. This option would close over half of the projected shortfall, and extend the trust fund exhaustion date by 17 years (CBO 2010i).

### **Increase the payroll tax more gradually**

The payroll tax could also be increased at a more gradual rate. One option is to raise it by 2 percentage points over 20 years. Specifically, this option would raise the tax rate by 0.1 percentage points, or 0.05 percentage points each for employers and employees, each year from 2012 through 2031. By 2031 the payroll tax would be 14.4%, which would improve the 75-year actuarial balance by

0.6% of GDP, nearly closing the projected shortfall, and push back the trust fund exhaustion date to 2083.

Increasing the payroll tax rate by 3 percentage points over 60 years would improve the long-term actuarial balance by 0.5% of GDP. This option would increase the combined employer and employee payroll tax rate gradually, by 0.05 percentage points every year from 2012 through 2071. The final payroll tax rate would stand at 15.4%, or 7.7% on both the employer side and the employee side.

### **Link the payroll tax rate to longevity**

Some proposals would index benefits or revenues in new ways. One proposal would gradually increase the payroll tax rate by .01 percentage points annually (or .02 percentage points combining the employer and employee tax) beginning in 2025 in order to offset projected gains in life expectancy. If the projected longevity gains do not materialize, the scheduled increase could be adjusted accordingly.

When fully implemented, the gradual increase in the retirement age under current law from 65 to 67 will be equivalent to a 13% cut in monthly benefits for workers retiring at 65. Though these changes will offset gains in life expectancy for participants born between 1938 and 1960, the Social Security Administration projects that longevity gains for later cohorts will reduce the actuarial balance by 0.40% of taxable payroll, or about a fifth of the projected 75-year shortfall (Special Committee on Aging 2010).

Prior to the 1983 reforms, gains in life expectancy were offset by periodic increases in the payroll tax rate. This proposal would return to the earlier system of increasing revenues rather than reducing benefits to offset longevity gains, since Social Security benefits are already modest. However, these tax increases would be tied to longevity rather than enacted in an ad hoc fashion, as before.

The Economic Policy Institute estimates that a 0.01 percentage-point increase in both the employer and employee payroll tax every year from 2025 to 2084 (a gradual payroll tax increase of 0.6% for both sides combined) would offset projected longevity gains. This amounts to a gradual payroll tax increase of 0.6% (or 1.2% combining the employer and employee tax). This

option would reduce the long-run shortfall by 20% and, assuming the rest of the shortfall was addressed through other means, would gradually increase the payroll tax from 6.2% to 6.8% over 60 years. Given that over this 60-year period real wages are projected to double, 0.6% of the increase in the real wage would go toward higher payroll taxes. (Morrissey 2010).

Raising the payroll tax rate is certainly a viable option to consider in order to ensure that Social Security can pay full benefits to beneficiaries not just for the next 25 years but in the longer term as well. These options improve Social Security's financing without cutting benefits for anyone or changing the benefits structure.

### **Broaden the tax base**

Broadening the tax base could include subjecting employee contributions into salary reduction plans to the payroll tax, an option that would reduce the 75-year shortfall by 0.25% of taxable payroll (Special Committee on Aging 2010). Under the 1983 Social Security reforms, employees pay Social Security and Medicare taxes on what they contribute to retirement accounts, but they do not pay these taxes on payments into other types of salary reduction plans or flexible savings accounts.

### **Options to avoid**

#### **Don't index benefits to changes in longevity**

This option would reduce benefits for newly eligible retired workers in proportion to the increases in life expectancy at age 62, beginning in 2017. For instance, if life expectancy at age 62 were 8% longer in 2040 than it was in 2016, as CBO projects, initial benefits would be reduced by about 8% in 2040.

This option, which would affect people born after 1955 who are currently in their mid-50s and younger would reduce benefits more than necessary to offset longevity gains, both because the normal retirement age was already raised to offset gains for people born between 1938 and 1960, and because it would freeze lifetime benefits rather than maintaining the same ratio of work years to retirement years as life expectancy grew.

*Our Fiscal Security* does not endorse any changes that would reduce future benefits for retirees, particularly those that would do little to forestall the trust funds'

exhaustion and would likely increase other federal spending, such as higher outlays for disability insurance and tax subsidies for private retirement plans.

### **Don't raise the retirement age**

Raising the retirement age has become a hot topic among many in Washington. One option would raise the retirement age from 67 to 70, incrementally, after it reaches 67 in 2022. This change would result in Social Security's total outlays decreasing by 0.4 percentage points of GDP in 2040, 6% below current scheduled outlays. The long-range actuarial balance would improve by 0.3 percentage points of GDP, yet this option would extend the trust fund exhaustion date marginally, if at all.

Raising the retirement age to age 70 has gotten significant press in the last few months, as proponents argue that Social Security expenses are increasing because people are living longer. In actuality, the increase in life expectancy that has occurred as well as the pressures from the retirement of the baby boom generation were fully anticipated by the Social Security actuaries. By 2022, the normal retirement age will be 67, having risen two years from 65 since the 1983 reforms. Life expectancy by that time is expected to have increased three years, meaning that the normal retirement age has actually kept pace to maintain the historic roughly 2:1 ratio between working years and retirement years. In other words, Americans who reach age 65 in 2022 will likely live three years longer than they would have 30 years ago, but they will have to work an additional two years to receive the same benefits.

Raising the retirement age even marginally amounts to a benefit cut, since people are forced to contribute to the system for a longer period and spend a shorter amount of time as a beneficiary. Depending on when exactly one claims benefits, a one-year increase in the retirement age results in a reduction of one's retired monthly benefits of 5-8%. For instance, if the retirement age is 67 and a worker retires at 62, he or she would receive a benefit cut of 30% for retiring early. However, if the retirement age were moved up to 68 and the worker retired at 62, the benefit cut for retiring early would increase to 35% (SSA 2010a). While the logic to this option is based on increasing life expectancy, it is still often true that it is difficult for many older Americans to

remain employed. For many older Americans being out of the workforce is not a choice. Many retire sooner than planned, due to either job loss, illness, or the need to care for a sick spouse. In fact, data from 2006 show that, while almost half of all baby boomers expected to work past age 65, only 13% of them had actually done so. Of those who retired earlier than they had initially planned, 56% did so due to personal health reasons or to care for a sick spouse. The rest left due to a job loss or downsizing (Rotenberg, McKinsey, et al. 2006).

Furthermore, workers have trouble reentering the workforce if they are laid off from their jobs later in life. Men age 50-61 who get displaced from the workplace are 39% less likely to be reemployed each month than those age 25-34. Those over 62 are 51% less likely to be reemployed. Women age 50-61 fare a little better; they are 18% less likely to be reemployed than those age 25-34. Women over 62, however, are 50% less likely to find a new job (Johnson and Mommaerts 2010).

An important distinction to make with life expectancy is that it is not rising significantly for all groups. Life expectancy for men in the bottom half of the earnings distribution grew only one year between 1982 and 2006, whereas life expectancy grew five years for those in the top half of the earnings distribution (Waldron 2007). Thus, life expectancy for men in the bottom half of the earnings distribution actually grew less than the scheduled increases to the retirement age that came about in the 1983 reforms. This strongly supports the argument that an additional increase to the retirement age would disproportionately hurt those in the bottom half of the earnings distribution. It would act as a benefit cut in disguise by forcing all to work longer even though not all are living longer.

## Appendix G: Evidence on public investment and growth

A substantial economic literature, sparked by the work of economist David Aschauer in the late 1980s and early 1990s, has attempted to quantify the growth benefits of public investment. Aschauer (1989a-c and 1990) provided evidence to show that more than half of the rapid decline in productivity growth that had begun in 1973 could be attributed to slowing public investment.

Aschauer essentially used national-level data and ran regressions using changes in the public capital stock (often disaggregated by type) as an explanatory variable and various outcome measures (productivity growth, productivity growth in the private sector, the return to private sector investments) as independent variables. He found a large and significant positive relationship between growth in the public capital stock and in these private sector output variables.

Separately, Munnell (1990a-b and 1992) looked at national, time-series relationships between changes in the public capital stock and private-sector productivity growth and returns to capital, and found a significant and positive relationship.

Both the Aschauer and Munnell work demonstrated that public investment was in fact more likely to crowd-in private investment than to crowd it out. And both suggested that the declining rate of public investment was a prime culprit behind the productivity growth slowdown that began in the early 1970s.

A criticism of these initial studies was that their relatively simple time-series orientation led them to pick up spurious trends in their explanatory and independent variables. As neither public capital stock growth nor productivity growth is “stationary” – meaning that their average (and variance) change over time – then a simple regression relating one to the other might just be picking up a common but non-causal trend affecting both. The critics further argued that when the relevant series were “de-trended” (usually by first-differencing), the strong

relationships between public investment and private sector growth outcomes were greatly weakened.

While the criticisms of the earlier Aschauer and Munnell work had some merit, the proposed solutions did not, so the conclusions drawn from de-trending should be rejected. Nobody really argues that there should be an *immediate* short-run relationship between public investment in, say, the first quarter of 2009 and productivity growth in that same quarter. De-trending the series by definition removes the possibility of finding the kind of long-run equilibrium relationship between public investment and growth that the theory calls for; instead it can only capture short-run adjustments of private-sector growth to public capital.

More importantly, subsequent research that explicitly dealt with some of the criticisms of the first round of public investment research re-established strong findings that public investment aids growth – both total and even *private-sector* growth.

For example, when researchers like Munnell (1992) examined variations across regions and states, they likewise found a durable link between public investment and productivity growth. While some researchers argued that this link was weakened by the inclusion of state fixed effects, Shioji (2001) found positive and significant effects of public investment even when including these fixed effects.

Fernald’s (1999) work looked at the effect of targeted public investments (say, improvements in roads and highways) on the productivity of industries most likely to benefit from a higher-quality public capital stock (trucking in the case of highway improvements) and found that public capital improvements indeed led to significant increases in the private sector industries most likely to be affected by them.

Heintz (2010) has undertaken the most recent re-working of Aschauer’s national-level results,



incorporating and correcting many of the criticisms made of the original papers. He finds, after using up-to-date data and addressing the statistical issues raised in the earlier rounds of the debate, that the public capital and growth link may even be stronger than originally identified by Aschauer.

However, in a sense many of these methodological refinements to the earlier wave of public investment research came too late to have the effect on policy that they should have, because the rapid increase in productivity growth that began roughly in 1995 and which has persisted through the Great Recession led to a loss of interest in this agenda. While productivity growth has not grown as strongly as it did between 1947 and 1973, it has accelerated rapidly compared to the period between 1973 and 1995.

### **Re-emerging interest in public investment**

The removal of public investment from the policy agenda is premature. For one, just because productivity growth has performed better since 1995 than in the 20 years before doesn't mean that further improvements are impossible. For starters, since the productivity growth rate between 1947 and 1973 was higher than what we have seen since 1995, there is no reason to believe that we have hit a ceiling on productivity growth. Further, while the picked-up growth rates in productivity between 1995 and 2000 were broadly shared throughout the wage and income distribution, this has not been the case since the end of the 1990s expansion.

Also worth noting is that the slowdown in public investment that began in the early 1970s was temporally associated not just with slower overall growth but with growth that was much less equally distributed than previously. In short, public investment can improve both the rate of growth and how broadly it is shared. Intuitively this makes sense, as public investment is devoted predominantly to investment in goods that are at least partially public – that is, goods whose consumption is non-rival and/or non-exclusionary.<sup>49</sup>

Further, one of the greatest challenges facing the United States and world economies going forward is global climate change, and this is a pure public *bad* – it is completely non-rival and non-excludable. This argues

that carbon mitigation to stop (or at least slow down) climate change is a global public good and hence a prime candidate for addressing (at least partially) through public investments.

Foley et al. (2009) have made the case that public investment in climate change mitigation can provide a way out of the intergenerational conflict posed by mitigation strategies that do not invest in mitigation. These intergenerational conflicts have been the focus of intense debate (Stern 2007, Weitzmann 2009, and Nordhaus 2006) in the discussion over how best to respond to the challenge of global climate change. Foley et al. (2009) point out that allowing for investment in mitigation can actually make *both* current and future generations richer when compared to a baseline business-as-usual approach to climate change.

### **The payoff to ramped-up public investment**

The research relating public investment and overall economic growth gives us a defensible range of estimates about the growth payoff to the public investment commitment included in our fiscal blueprint. We would just note again that these benefits constitute the absolute low-end of the payoff from stepped-up public investment – the benefits of public investment for the *distribution* of economic growth and as insurance against climate-change-induced catastrophes are not readily quantifiable.

Given that the estimate by Heintz is the among the latest and one which has absorbed and addressed many of the criticisms made of the first-wave of public investment studies, it is a useful benchmark. Heintz (2010) finds that a sustained 1% increase in public capital growth translates into an increase in the growth rate of private sector GDP of roughly 0.6 percentage points. The example that Pollin and Baker (2009) give of these findings is that, if overall public investment had grown by 3.8% instead of 2.8% between 1998 and 2007, U.S. GDP would have been 0.6% higher (roughly \$64 billion) in 2007.

In our fiscal blueprint we set aside roughly 1.3% of overall GDP for public investments, or roughly \$294 billion in 2020. By contrast, increasing the rate of growth in public investment from 3.1% (the rate during the decade before the Great Recession) to 4.1% would

have required an increase in public investment of just \$17 billion in 2007, not even a tenth of that called for in our fiscal blueprint.

If one assumes that public investment flows absent a specific commitment to increase them would roughly equal their share in GDP that has characterized the last 10 or 20 years, one would see growth in (nominal) public investment of roughly 5.1% annually between 2010 and 2045. If one takes the difference between the Obama policy baseline and *Our Fiscal Security's* budget in terms of increments to non-security domestic discretionary spending as the additional public investment commitment signified by *Our Fiscal Security's* fiscal blueprint, this annual growth rate rises to over 7%.

Using Heintz's estimate, this two percentage-point increase in the annualized rate of public investment growth would translate into private sector GDP growth of roughly 1.2%. Given that the private sector accounts for roughly 80% of overall GDP, this translates into roughly a 1% per year increase in the growth rate of overall GDP.

It should be noted that Heintz's estimate, while large, is roughly in line with several other estimates in the literature. For example, Aschauer (1990) has estimated that, if 1% of the value of the private capital stock had been invested in public capital from 1970 to 1986, then productivity growth would have been 1.0-1.5% higher annually over that time. Since the private capital stock is roughly 1.5 times as large as overall GDP, this translates into almost exactly the same 1% boost to GDP growth that we would get by following *Our Fiscal Security's* public investment agenda as opposed to following the Obama policy trajectory.

While other more recent estimates (like Shiojo 2001) have magnitudes only about half as large as the Heintz (2010) and earlier Aschauer (1991) estimates, it seems clear that the 1.3% of GDP that *Our Fiscal Security's* fiscal blueprint is devoting to public investment would, according to a deep body of economic literature, lead to a marked increase in overall economic growth. We use the conservative estimate that *Our Fiscal Security's* public investment commitment gradually ramps up overall GDP growth starting in 2021, peaking and leveling off at a 0.5 percentage-point increase in overall GDP growth between 2025 and 2045.

## ***Non-traditional public investments have payoffs at least as large***

Estimates like Aschauer's generally examine the effects of investment in public *physical* capital. While this kind of estimate generates large social and economic returns, there are also large potential payoffs to be had from investment in human capital. Lynch (2007) estimated that a program of universal, high-quality pre-kindergarten education costing roughly \$40 billion annually (in today's dollars) could provide *net* benefits leading to GDP being roughly 2% higher in 2045 than it would be without this investment, with a benefit-to-cost ratio of nearly 8 to 1.

The Council of Economic Advisors similarly noted that reforms to the health care sector (say, perhaps those aided by investments in health information technology) that shave 1.0 percentage point from the projected long-run growth rate of health care costs would boost GDP 5% by 2030 and also lower the deficit in that year by 2.0 percentage points (CEA 2009).

In short, even outside the traditional investments in physical public capital that yield high returns, there are numerous potential areas for public investment to make the economy richer (and more equitable) in the future that should not be sacrificed to a program of budget austerity.

# Endnotes

1. To illustrate both short-term and long-term effects, we modeled our budget path and the relevant budget baselines out to 2045. For more on how we modeled our budget path and relevant baselines, please see Appendix A.
2. All years pertaining to budget projections are fiscal unless otherwise noted.
3. The recession's scars will linger nevertheless; see Irons (2009).
4. This estimate is based on the Auerbach and Gale (2010) extended policy scenario, which assumes the extension of the 2001 and 2003 tax changes, indexes the alternative minimum tax for inflation, and makes permanent other temporary policies that are routinely extended by Congress. This estimate is also close to the current policy estimate made by OMB, which estimates a \$985 billion current policy deficit in 2015. See OMB (2010a), Table S-3.
5. This estimate is based on the Auerbach and Gale (2010) administration budget scenario, which is modeled off of administration policy relative to the August 2010 "Budget and Economic Outlook: An Update" (CBO 2010a). This estimate is very close to CBO's March estimate that the deficit under the president's budget would be smaller than under current policy, at \$793 billion, or 4.3% of GDP, by 2015 (CBO 2010b).
6. The primary budget deficit represents the gap between revenues and mandatory and discretionary outlays; equivalently it represents the federal budget deficit excluding debt service outlays. The primary budget deficit or surplus is an important indicator of the budget outlook because a primary surplus means that no borrowing is needed to finance current government expenditure on services and investments.
7. The Peterson-Pew Commission on Budget Reform, "Red Ink Rising," December 2009, available at [http://www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/Economic\\_Mobility/40543%20FR\\_R1.pdf?n=7003](http://www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/Economic_Mobility/40543%20FR_R1.pdf?n=7003).
8. Contrary to CBO's August forecast, unemployment averaged 9.7% in the first 10 months of 2010. There is good reason to believe that CBO's economic projections err on the optimistic side and that the unemployment rate will not reach 5.0% in 2015 without further economic stimulus.
9. See, for example GAO (2010).
10. See Social Security Administration (2009). Note that projections are from the intermediate cost scenario.
11. See Board of Trustees (2010, 17).
12. Auerbach and Gale (2010) estimate a 75-year gap of 7.1% of GDP for administration policy and 8.1% for current policy, while GAO (2010) produces a slightly higher estimate.
13. For more on this calculation and how it impacts our long-term budget projections, see the box (p. 48) "*The path of health care costs.*"
14. Prior to 2018, the target growth rate is the projected five-year average rate of change in the Consumer Price Index for All Urban Consumers [CPI-U] and the CPI for Medical Care [CPI-M] averaged together. In 2018 and beyond, the target growth rate is the projected five-year average percentage increase in nominal per capita GDP plus one percentage point.
15. The budget savings over 2010-20 are estimated at \$68 billion, but almost all of the savings are booked in the second half of the budget window after the health insurance exchanges are up and running. By 2020, the annual savings would reach \$15 billion. These savings represent an increase in tax revenue resulting from changes in compensation and employment-based coverage as well as a decrease in insurance exchange subsidies, partially offset by an increase in health care subsidies to small businesses.
16. Payroll tax revenue of \$115.5 billion would be partially offset by increased benefit payments of \$12.4 billion (Morrissey 2010b).
17. See, for example, L.A. Karoly, M.R. Kilburn, and J.S. Cannon, 2005, "*Early Childhood Interventions: Proven Results, Future Promise*," Santa Monica, Calif., RAND Corporation; and W.S. Barnett, 1998, "Long-Term Effects on Cognitive Development and School Success," in W. S. Barnett and S. S. Boocock, eds., "*Early Care and Education for Children in Poverty: Promises, Programs, and Long-Term Results*," Albany, N.Y.: SUNY Press, pp. 11-44.
18. The president's 2011 budget request proposed limiting the tax rate at which itemized deductions reduce tax liability to 28% for Americans making over \$200,000 (\$250,000 for joint filers). That proposal would save \$29.4 billion in 2015 and \$292.2 billion over 2011-20.
19. CBO, 2009, "Budget Options," Vol. 2, p. 192.
20. OMB, 2009, "Analytical Perspective: Federal Receipts," p. 210.
21. CBO, 2009, "Budget Options," Vol. 2, p. 187. The budget score phases in the policy change in 2013 after the economy has strengthened, so the five-year budget window yields savings of only \$64.3 billion; the outer five years would yield savings of roughly \$323.3 billion.
22. The Federal Reserve Flow of Funds data show domestic financial sector borrowing at \$14.7 trillion in the second quarter of 2010 (Federal Reserve 2010). We assume an average financial sector corporate interest rate equal to the effective cost of borrowing for the federal government and calculate that this policy would generate revenue equal to 10% of projected financial sector corporate interest payments. This is a static estimate (it assumes financial sector demand for debt is largely unresponsive to changes in the price of borrowing, so there is no major reduction in financial sector borrowing).
23. Policy descriptions are limited in this section to the *Our Fiscal Security* revenue path. See Appendix B for a discussion of potential interaction effects between proposals included in the *Our Fiscal Security* budget path.

24. CBO, 2007. Trade-Offs in Allocating Allowances for CO2 Emissions. [http://www.cbo.gov/ftpdocs/89xx/doc8946/04-25-Cap\\_Trade.pdf](http://www.cbo.gov/ftpdocs/89xx/doc8946/04-25-Cap_Trade.pdf).
25. CBO Cost Estimate, 2009, American Clean Energy and Security Act of 2009. <http://www.cbo.gov/ftpdocs/102xx/doc10262/hr2454.pdf>.
26. CBO Cost Estimate, 2007, America's Climate Security Act of 2007, available at <http://www.cbo.gov/ftpdocs/91xx/doc9120/s2191.pdf>.
27. Defined as assets less tier 1 capital less FDIC-assessed deposits and/or insurance policy reserves. See CBO Letter to Sen. Grassley, March 2010, available at [http://www.cbo.gov/ftpdocs/110xx/doc11046/03-04-Ltr\\_to\\_Grassley\\_on\\_FCRF.pdf](http://www.cbo.gov/ftpdocs/110xx/doc11046/03-04-Ltr_to_Grassley_on_FCRF.pdf).
28. As originally enacted, Pease set a maximum reduction of 80% of selected itemized deductions (medical expenses, investment income, and several other deductions were fully excluded). Before the Bush tax modifications fully repealed Pease in 2010, the threshold for phasing out itemized deductions was set at \$166,800 for married couples, and the reduction was restricted to one-third of the original 80% maximum limitation (TPC 2010d).
29. 2007 dollars adjusted to September 2010 dollars using CPI-U-RS (NSA).
30. Assuming after-tax income growth continues at the average rate of growth over the last 28 years (CBO 2010f).
31. The OFS revenue path is illustrated relative to Obama policy, meaning that all the revenue proposals in the president's budget request – including the expiration of the upper-income Bush tax cuts – are already booked as savings, unless otherwise specified.
32. After 2020, the OFS revenue assumptions are frozen or modeled as a share of GDP (due to political, budgetary, and economic uncertainty), so the OFS revenue path remains 1.9 percentage points of GDP higher than the Obama policy baseline.
33. This is defined as the "President's Request for the Budget of the U.S. Government for Fiscal Year 2011," as re-estimated by CBO and adjusted by Auerbach and Gale (2010) for CBO's August 2010 "Budget and Economic Outlook: An Update" (CBO 2010a).
34. This refers to the current policy baseline compiled and regularly updated by Auerbach and Gale (2010).
35. Based on CBO's estimate of potential GDP for the third quarter (CBO 2010a) and the Bureau of Economic Analysis' preliminary reading of third quarter nominal GDP (BEA 2010).
36. Our baseline budget path assumes the nominal GDP levels as projected in CBO's "Budget and Economic Outlook" (CBO 2010a), after which we assume nominal GDP increases at a rate of 4.5% annually, the average of nominal GDP growth rates imputed from CBO's "Long-Term Budget Outlook" economic projections (CBO 2010c). In our long-run budget extrapolations, receipts and outlays related to Medicare, Medicaid, and Social Security are modeled as a function of GDP (based on projections from the 2010 "Social Security Trustees' Report" and CBO's Long-Term Budget Outlook), so changing assumptions about growth change the projected receipts and outlays in dollars but not as a share of the economy. Other revenue sources and non-interest spending are fixed as a share of GDP at 2020 levels, so they are also unaffected by assumptions regarding GDP growth. What *are* affected by growth assumptions are the public debt and the cost of servicing the debt. Everything else being equal, faster growth decreases the relative size of debt service and the related buildup of additional debt.
37. When modeling accelerated growth resulting from a productivity shock, we assume revenue would be highly responsive to increased economic activity. Medicare, Medicaid, Social Security, and offsetting receipts, on the other hand, are largely modeled off of demographic and actuarial estimates rather than wealth, so outlays would not be highly responsive to increased economic activity.
38. As modeled by Auerbach and Gale (2010).
39. This is also true under the alternative fiscal scenario in CBO's "Long-Term Budget Outlook" (CBO 2010c).
40. In January 2001, CBO projected a \$5.0 trillion surplus over 2001-10 with a surplus of \$796 billion in 2010 alone (CBO 2001); CBO currently projects a deficit of \$1.3 trillion for 2010 (CBO 2010a).
41. Payroll taxes, Medicare, and Social Security are modeled as a share of GDP in accordance with the 2010 trustees report. Individual income tax revenue is modeled as a share of GDP in accordance with the CBO "Long-Term Budget Outlook" projections, with Obama policy and current policy adjustments (Auerbach and Gale 2010) frozen as a share of GDP beyond 2020. The discretionary budget, corporate tax revenue, and other revenue sources are frozen as a share of GDP.
42. Some proposals would make limited exceptions if approved by an overriding supermajority vote or if emergency conditions, such as times of war or recession, were met.
43. This refers to mandatory, as opposed to discretionary, spending.
44. The law states no expiration date for this version of PAYGO.
45. Some mandatory programs are excluded, including Social Security, most unemployment benefits, veterans' benefits, federal retirement, Medicaid, SNAP (formerly food stamps), and Supplemental Security Income. If sequestration does occur, non-exempt programs are set to experience cuts for one year, at the same levels. The one exception is Medicare payments, which cannot be reduced by more than 4%.
46. The Recovery Act modifications expanding the child tax credit and providing EITC marriage penalty relief were also considered part of the exempted current policy baseline for PAYGO purposes.
47. Citizens Against Government Waste noted this year that earmarks are down considerably in number and cost since peaking at \$29 billion under a Republic Congress in 2006 (CAGW 2010).
48. Since hospitals will be treating fewer uninsured patients, they will no longer need as much DSH funding.
49. It may be more accurate to say that many of the goods and services provided by public investment have less extreme rivalry and/or excludability than most purely private sector goods. For example, automobiles are privately provisioned and they are purely private – if you own the car I cannot drive in it without your permission. Highways are generally publicly provisioned and are at least partially public in character – both of us can use the highway at the same time without each other's explicit permission, though doing so marginally decreases the utility for both by increasing traffic and congestion.



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