

NOTES FOR REMARKS AT AABPA

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- For about two years, I've been part of a group put together by the strange political bedfellow combination of Brookings and Heritage.
- The idea was to bring together an ideologically diverse group with people of different party affiliations and see if there was anything that they could agree to when it comes to resolving the fiscal crisis that is before us and that may well evolve into a financial crisis if it is allowed to persist over the next 20 years.
- We held a relatively unnoticed news conference yesterday laying out the results of our deliberations.
- I would suggest that the results give some reason to hope and some reasons to despair, but more of the former than the latter.
- First, what did we agree on:
 - We agreed that there was a problem that could only be resolved by reforming Social Security, Medicare, and Medicaid. That may seem pretty simple minded, but it is remarkable how many on both left and right argue

that economic growth can solve the problem. But we budget types know that faster growth only has a small beneficial impact on Soc Sec because of the wage indexing of benefits, and may have negative effects on health programs if, in fact, the income elasticity of demand for health care is greater than one. There is all manner of other myths – end the war or end the Bush tax cuts and we’ll have a bonanza of resources to finance all sorts of things, but unfortunately the arithmetic just doesn’t work and that was the strong conclusion of our group.

- The second area of agreement was that we had to radically change the budget process for Soc Sec, Medicare, and Medicaid. Right now, spending on these programs grows faster than the GDP and tax revenues if the Congress does nothing. The programs are on automatic pilot and that pilot is flying us into a mountain of debt. The group strongly believes that if we are to fly into a mountain, the Congress should have to vote for it explicitly. We suggested three devices. The first would work something like the current budget resolution. The Congress would set 30 year spending targets for the three problem programs. Like a budget

resolution there would not be a detailed set of policies that would get you to the target. I'm personally not optimistic this setting of targets would get you very far, but I went along with the group who seemed pretty keen on the idea. The second component was to have a five year review of the program to see how we were doing vis-à-vis the targets. Of course, you could have such a review of the programs without ever having set the targets. We used to have a quadrennial commission on Soc Sec. Its reports used to get a lot of publicity, but it was a tripartite commission with representatives from labor, business and more academic experts. The last one couldn't agree on anything and maybe that's why we substituted a Social Security advisory commission which meets quite often. It issues a series of reports urging reform of the system, but no one pays any attention. A group voicing alarm every five years might create more drama. A group meeting every five years in Japan has had a very large influence on policy. Of course, they have a very different political and constitutional system, but nevertheless, I think that it would be worth trying here.

- However, it would be worthless to have the group representing various interest groups. They would be unlikely to agree to anything. Better to have an expert group of actuaries and economists. One might set it up like a base closing commission where the expert group would offer policy options to the Congress that had to be voted up or down or if they wanted to amend it a PAYGO rule would apply.
- The third approach to forcing explicit votes that I strongly favor was to create a trigger mechanism that would automatically alter program parameters to curb spending or increase taxes when spending totals strayed from their previously mentioned targets. If you didn't have targets the trigger could be a variable indicating that the program was suffering financial duress. My colleague G Steuerle and I have written at length on triggers – real long length. And I'll return to the details later.
- The fact that the group could agree to the things that I listed was encouraging. But I said there also were some disappointments. The group discussions made it absolutely clear that there is an immense ideological chasm between left and right as to how much of the fiscal problem should be

resolved with cuts in program growth and how much of the solution should involve tax increases. Basically, the right says none of the latter whereas the left would raise taxes to the point that I, not by any means a supply side economist, would worry about the collateral economic damage.

- However, in the discussions of the group, I felt there was a glimpse of possible ways around the impasse regarding taxes. I emphasize that these ideas are not in the committee report.
- Among right and left intellectuals, I think there is some inclination to discuss converting the social insurance programs of the current day into true insurance programs. That is to say, for example, health insurance programs that would not cover small expenditures, but rather be insurance against disasters.
- There may be some widespread acceptance of the idea that purchases of true insurance and annuities be mandated. We see that in the Clinton health plan; we saw it in a bipartisan fashion in Mass., and Stuart Butler of Heritage, an ardent opponent of tax increases of any kind, has written favorably about mandates for the purchase of health and pension protection.
- I'm not a big fan of mandates in that I see them as a highly regressive tax. They don't reduce the wellbeing of rich

people very much in that they just force them to buy things that they would have bought anyway, whereas they can be a true burden on the poor -- even when subsidized -- as we are now seeing in the Mass. health plan. But I would swallow them as a partial or whole resolution to this fiscal crisis, if that was the only way out.

- Another way out is to income relate more and more of the social insurance system. You see that already in setting the Pt B premium in Medicare. There are also numerous proposals for so-called progressive indexing of Soc Sec benefits.
- You have to be very careful how you design such things or else you greatly reduce the incentives for people to save for their own retirement, but it is a notion for which I see much sympathy on the right and left.
- There is a political problem, however. There is a segment of the left that clings to the old FDR notion that you have to give money to rich people in order to have them support giving money to poor people. I've never thought there was much to that notion. Carried to an extreme it would seem to imply that we should have a flat tax in order to be sure that rich people support government activity of any kind.

- However, it is a notion that leads many liberals to oppose making Soc Sec more progressive and I think they have to get over it, because making it more progressive is one of the few options that seem remotely politically feasible.
- I'd like to go back to triggers for a moment because that is the part of our proposal that I support most strongly.
- A GAO analysis differentiates soft triggers where the action sets in motion a process – forces the pres to make proposals and the Congress to consider them expeditiously, e. g. prescription drug – from hard triggers where some change in policy happens automatically, e. g. an increase in the full retirement age in Soc Sec or a change in the payroll tax's wage base. Actually, the language is a bit misleading. A hard trigger could be easier politically than a soft trigger. The latter requires the Congress to do something. The former causes things to happen without Congressional action.
- This is not a new idea. Triggers can be found in the budget processes of a large number of democracies. Hard triggers have been adopted as part of fundamental Soc Sec reform in Sweden, Italy, Canada, Germany and Japan. Triggers can also be found in our own budget – some work well and some work not so well.

- The most important point to make about triggers is that it is very difficult – and perhaps impossible -- to design one that would lead to completely rational policy outcomes if it was pulled year after year.
- If the Congress did not like the policy results of a long lasting trigger, we hope that they would be induced to change it by voting explicitly for reform. Of course, we are under no illusions. They may totally waive the trigger and go back to the original unsustainable path. But our whole point is to get the Congress to make their decisions explicit. If they explicitly vote for irresponsibility then we are stuck with it.
- But one hopes to avoid this outcome and one can reduce the probability of it happening by carefully designing the trigger.
- There are two crucial related design issues. What variable should be used as a trigger and what action should result when it is pulled.
- On the first, you do not want to use a variable that is erratic and hard to predict, so that the trigger goes on and off in a surprising manner. The budget deficit is a bad trigger because it jumps all over the place depending on economic conditions and other factors. It was the trigger used in what may have been the mother of all trigger laws – GRH of 1985. That law specified targets for the budget deficit and if the

target was not achieved, spending was to be cut sufficiently using an automatic formula to bring the deficit in line with the target. Unfortunately, deficits turned out to be considerably higher for economic reasons than envisioned when the law was written and the required spending cuts were too large to be thinkable politically. The deficit targets were first raised and then abandoned altogether.

- One might say that this trigger failed miserably, but in a sense it led to just the kind of outcome desired by our committee. The Pres and Congress did not feel that they could totally abandon the law. This, in turn, led to the negotiation of the 1990 budget agreement, a huge bipartisan deficit reduction package consisting of both tax increases and spending restraints. That agreement was protected by the Budget Enforcement Act that contained the pay-as-you-go rules and discretionary spending caps that were partially – not wholly – responsible for the budget surpluses of the late 1990s.
- Nevertheless, it would be preferable to choose a trigger that is more stable than the annual deficit. Not the group, but Gene Steuerle I suggest for Soc Sec the finding of an actuarial deficit by the Soc Sec trustees or for Medicare

projected spending over the next five years exceeding GDP growth plus say one percentage point.

- The more difficult design question involves the type of action that is triggered. Ideally, it should be significant enough to make a difference to the financial health of the program and perhaps painful enough to induce the Congress to choose some more rational alternative. But it can't be so painful as to make it look as though the Congress is doing the public a big favor by simply waiving the trigger. The latter problem afflicts an existing trigger in our budget process. That is the so-called sustainability factor that would automatically cut physician fees to improve the financial health of Medicare. It is too harsh. There would not be any physicians around to serve Medicare beneficiaries were it to go into effect. So Congress routinely waives it.
- The \$64 T question is why would the Congress adopt such a trigger mechanism? First, other democracies have adopted them. Second, our own Congress has done it as well, e.g. GRH and some triggers in the current budget process that I do not have time to describe.
- A trigger provides one layer of political insulation. If the trigger is pulled and spending is restrained or taxes raised, it happens by immaculate conception. It does not require an

explicit vote. If the Congress chooses to substitute a more rational action in place of the trigger, they appear to be doing the public a favor and not voting to hurt them by cutting the growth of benefits or raising taxes.

- How might the next president react to the fiscal crisis? Would he or she favor a trigger approach? So far the campaign is not reassuring. Going the wrong way, both Clinton and Obama have promised not to raise the retirement age. McCain has been somewhat more specific about there being a major problem, but he is far from detailed about what he would do about it. Mostly, all three have pretty successfully tried to avoid the issue.
- Why might any of the three reconsider upon being elected president?
- Between economic weakness and the stimulus program, it appears that we are headed toward a very, very large deficit this year – probably around ½ trillion. -- \$500 B.? I suspect that the first deficit greeting the new president -- that of fiscal 2009 will be well over \$300 B. I further suspect that the longer run deficit projections made by CBO and OMB in January of 2009 will show that it will take a very long time to dig out of this hole in large part because of the inexorable growth of Soc Sec, Medicare and Medicaid. I suspect that

will be like a cold shower to the next pres. whether it is Clinton or Obama promising to expand health insurance coverage or McCain promising to extend every element of the pres tax cut.

- Much attention is given to when the Soc Sec trust fund starts to run a cash flow deficit, i.e. when it stops financing any of the deficit in the rest of government. That doesn't happen for about ten years. But the budget problem posed by Soc Sec really starts to hurt, not when it stops financing the rest of the government's altogether, but when it starts financing less of it each year and that has just started.
- Also consider this. The fiscal year before pres Bush took over (2000), Soc Sec, Medicare, and Medicaid absorbed 7.6 percent of the GDP. In this fiscal year, the last before he leaves office, it will be 9.0 percent of GDP. If that had been actually financed with tax increases, the total tax burden would have had to be raised about 8 percent above the historical average of 18.3 percent. That doesn't sound like much, but I think that it would have been sufficient to cause howls of anguish. Conversely, it could have been financed by cutting the rest of noninterest spending about 15 percent across the board. That most certainly, would have caused howls of anguish. Instead, we had a tax cut and we took our

chances with the deficit. That actually worked out pretty well through fiscal 2007 given the good fortune of collecting massive revenues from the hyper rich and corporations in recent years. That's not going to work this year and next.

- Should the next pres have hopes of serving two terms, the projections suggest they'll look forward to Soc Sec, Medicare and Medicaid absorbing another 1.5 percent of the GDP compared to 2008 levels. That's still equivalent to an 8 percent increase in taxes compared to historical levels and about a 19 percent cut in other noninterest baseline spending probably somewhat less than that compared to actual. And I don't think financing the increase thru increased deficits is going to look very attractive if the deficit outlook is as bad as I expect it to be.
- So my basic point is that the incentive for reform will be very powerful if the next president does not want to spend the term in office being handcuffed.
- Whether the incentive is large enough to get them to grasp the nettle is another question. If they do, they may not have to worry about a second term, but they will have done a great service for the country.