SENATE COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS

Examining the Root Causes of America's Unsustainable Fiscal Path

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Testimony of Henry J. Aaron[1]

Chairman Johnson, Ranking Member Peters:

Thank you for your invitation to appear today on this important topic. Projected fiscal shortfalls pose an important *long-term* challenge to U.S. policy makers. Important though debt and deficits may be, *the best current economic analysis suggests that the problem of fiscal imbalance is not as urgent as it appeared to be in the past*. Furthermore, this problem must take its place among the many challenges that require immediate and urgent attention. That list includes:

- restoring and upgrading the nation's infrastructure;
- increasing resources devoted to scientific research and training;
- increasing investments in early childhood education to create a better educated and more productive citizenry;
- establishing better ways to provide and pay for the explosive increase in long-term care that will be necessary as the baby-boom ages;
- fulfilling current commitments to the elderly and people with disabilities through Social Security and Medicare and improving the structure and adequacy of these programs to help offset the consequences of rampant growth in economic inequality; and
- taking effective steps to curb emissions of greenhouse gasses and combat global warming.

Given the importance and prospective costs of meeting these challenges, the first and most important implication is that cutting taxes was, and remains, not just unwise but foolhardy.

Let me be clear, in making that statement I am not defending the current design of the U.S. personal or corporate tax system. It is riddled with perverse incentives and

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inequities. *Tax reform is needed. Tax cuts are not.* More revenue, not less, will be needed if the United States is to address the menu of challenges it faces today.

It is worth noting that *a tax on carbon, supported by economists aligned with both major parties, is one of those rare policy instruments that would help solve one problem and provide revenue to help pay for solutions to others*. It would encourage private sector investors and consumers to reduce greenhouse gas emissions even as it narrows the prospective gap between spending and revenues.

Deficit Reduction

Simple arithmetic tells us that when the budget deficit, measured as a percent of gross domestic product (GDP), exceeds the growth of GDP, the ratio of debt to GDP increases. Doug Holtz-Eakin kindly presents this arithmetic in his testimony. Doug also refers to the analysis of distinguished economist Olivier Blanchard, who pointed out in his presidential address to the American Economic Association that nominal interest rates are now below, and are expected for many years to remain below, the annual growth of nominal GDP. *Low interest rates create fiscal elbow room and reduce the threat that deficits and debt will create economic problems.*

Blanchard did not argue – and I am certainly not arguing – that low interest rates render harmless any amount of debt, however massive. What Blanchard said, and what I am saying, is that *low interest rates enable the nation to carry more debt without harm than it could if interest rates were high*. And that means that worries about growing debt should shrink in comparison to worry about the harms from failing, out of a fear of deficits, to address other urgent problems.

The point at which deficits or debt become imprudently large is a matter of judgment. We are clearly nowhere near such a point. Financial markets, which are not infallible but are the best source of information about future prospects, confirm that the United States is expected to remain a safe and low-risk place in which to invest. Interest rates reflect expectations about inflation and default risks. Rates on thirty-year bonds are low and differ little from those for short term assets.

If you believe, as I do,

– that the problems I listed at the start of my testimony are urgent,

– that solving them will be costly,

– that other nations, with far fewer resources than the United States, have carried debt much larger than our own, and

– that low interest rates have reduced the risks that deficits and debt pose, then I believe you should conclude that efforts drastically to lower deficits now reflect misplaced priorities. *Not further increasing deficits through pay-go rules is desirable. So is narrowing the primary budget deficit (that is, the deficit excluding interest payments), and there are ways to do so consistent with addressing the nation's most urgent problems. <u>But reducing the debt/GDP ratio is tomorrow's goal</u>.*

<u>Social Security</u>

For at least three decades we have known that accumulated reserves and current revenues dedicated to Social Security will be sufficient to pay all scheduled benefits until sometime during the fourth decade of this century. *<u>We have also known that when reserves are depleted, balance can be restored by increasing revenues, reducing benefits, or some of both by about 1 percent of GDP.</u>* That change is not large by historical standards–we have boosted spending and revenues on Social Security by more than 1 percent of GDP on two previous occasions over periods much shorter than the interval now before us. *<u>From an economic standpoint</u>, establishing sustainable solvency in Social Security is not a heavy lift.*

The story is rather different from a political standpoint. Although most analysts–including, I suspect, all of us here today–have long thought that early action to assure sustainable balance is desirable, it has been the revealed preference of elected officials to leave to their successors that task of either raising taxes or cutting benefits.

The clear purpose of the TRUST Act (S. 2733) is to nudge Congress into action. *<u>Senators Romney and cosponsors deserve credit for trying to encourage attention to long-term gaps in major trust-funded programs</u>*. I shall comment in a moment on the TRUST Act. My purpose now is simply to point out that the fiscal challenge posed by Social Security is not large. The United States can easily afford to pay scheduled Social Security benefits–and larger benefits, as well, if the American public wants them.

<u>Health Care</u>

Health care spending poses more serious problems for two reasons. *<u>First, there is general agreement that Americans now spend more than they need to for the services that they receive</u>*. This problem afflicts both public and private budgets. Indeed, it a bigger problem for private than for public budgets, as Medicare and Medicaid have done a better job of controlling spending per person than have private payers.

<u>Second, projected increases in public health care spending is the principal cause of the growing gap between government expenditures and revenues. Projected growth of public spending on health care dwarfs that on Social Security</u>. Increased Social Security spending is traceable entirely to a growth in the number of beneficiaries. But

the growth of spending on Medicare and Medicaid is traceable also to an increase in expenditures per person.

Much of this increase is desirable. *The nation has committed to providing the elderly and the disabled health care commensurate to that enjoyed by the rest of the population*. I hope that this commitment is unbreakable and that no member of Congress disagrees. Furthermore, much of the projected increase in health care spending will go for medical advances that all of us will celebrate.

While the overall rise in health care spending has generated enormous benefits, too much of current and projected future health care spending goes to pay for over-priced drugs and medical equipment and for services that provide little or no benefit to patients. This hearing is not the place to try to diagnose the myriad features of the U.S. health care system that cause this over-spending.

But it is the place to note that *when Congress has the chance to make some progress in curbing over-pricing, as it does in this session with respect to drug prices, it should act to do so.* The indefensible behavior of some drug companies in jacking up prices on old drugs and in pricing new drugs at astronomical levels has created a political opportunity to enact legislation that, according to estimates of the Congressional Budget Office, could save as much as half a trillion dollars over the next decade. One can only hope that Congress will not fail to act.

The TRUST Act

Early action to put the major 'trust-funded' programs on sustainable long-term footing is desirable. The beneficiaries of the major social insurance programs deserve the assurance that commitments now being made will be honored. Other things equal, it is better to act soon than to delay in addressing projected imbalances in these programs.

These programs merit attention for reasons in addition to the looming depletion of the trust funds. For example, over the past four decades, since Social Security was last the subject of major legislation, economic inequality in the United States has skyrocketed. The relative economic position of men and women has changed. The population of the very old, many of whom have exhausted their savings, has risen. The proportion of Americans claiming disability benefits first rose gradually and is now falling precipitously for reasons that are poorly understood. It is long past time to consider what changes in these programs should be made.

- Should long-term, low-wage workers be provided with more generous benefits than Social Security now provides? If so, how?

- Should long-term beneficiaries be provided some protection against the likely erosion of other assets?

- Should Social Security benefits be modified because life-expectancy of high earners has risen but life-expectancy of low earners has stagnated or fallen?

- In light of the growing recognition of the importance of early childhood development, should Social Security provide some credit to parents of young children who remain at home?

Modifying Social Security in light of these changes is not just a matter of trust fund balance. Issues such as these should be considered along with trust fund balance and in a venue that will encourage their consideration. The rescue committee envisioned in the TRUST Act is not such a venue.

The committee envisioned in The TRUST *Act, in my view, is a particularly poor venue for designing changes in Medicare*. A large part of the projected growth of Medicare spending depends on the progress of medical science. Anticipating the state of medical science seventy-five, or even twenty-five years, in the future is a proper subject for science fiction, not legislators. No one can reliably forecast the medical interventions that will be available fifty or seventy-five years from now. It would be indefensible to determine the medical services available now to the elderly or people with disabilities based on assumptions that can be little more than guesses about the medical technology that will be available decades in the future and what it will cost. But that is just what the committee that would be created under the TRUST Act would be asked to do ... and under expedited legislative procedures.

To be sure, the Medicare actuaries now make seventy-five-year projections and publish estimates of trust fund balance over that period. But Congress has had the good sense not to let these projections govern Medicare legislation. Congress has taken care to assure that Hospital Insurance is adequately funded, typically for ten to fifteen years, sometimes a bit more or less. When imbalance has moved uncomfortably close, Congress has taken action to maintain program integrity. *Wisely, Congress has never legislated to achieve actuarial balance based on a long-term projection that, despite the best efforts of capable professionals, contains little of informational value.* And, I very much hope that it never will.