# The Economic Agenda

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Thank you. I am delighted to be here. As you know, this is an exciting time in economic policy. Earlier this month, the President highlighted his second-term agenda in his state of the union speech. The President's budget was released about a week ago, and the Economic Report of the President will be released later this week.

Let me give you a sneak preview. This year's Economic Report features eight chapters. The first two chapters are about the business cycle, looking at the current recovery and comparing it to past ones.

The other six chapters cover more specific topics—the options of tax reform, the economics of immigration, the role of property rights and ownership in expanding individual choice and control, the importance of innovation in our increasingly information-driven economy, the global HIV/AIDS crisis, and the role of free international trade in raising living standards around the world. I encourage you all to get a copy and read it.

As by now should be clear to everyone, the President has an ambitious economic agenda for his second term. Today, I would like to take this opportunity to talk with you about three parts of that agenda: tax reform, reducing the budget deficit, and Social Security reform.

**Tax Reform**

I will start with tax reform. The current tax code is a drag on the economy, discouraging saving and investment, and requiring individuals and businesses to spend billions of dollars and millions of hours each year to comply with the system. The President has stated that his goals are to make the tax code simpler, to make it more fair, and to further promote growth and job creation. Let me talk a bit about each of these goals.

Simplicity is the easiest goal to understand. Anyone who has ever completed his own tax return would agree that the tax code is a complicated mess. A simpler tax code would lower compliance costs, which are estimated to range up to $100 billion per year.

The growing reach of the alternative minimum tax threatens to further complicate tax preparation, as filers would have to make two separate tax calculations. The Administration and Congress have taken actions over the past several years to limit the number of taxpayers subject to the AMT. These fixes, however, have only been temporary. Under the present tax system, it is only a matter of time before the AMT hits many tens of millions of taxpayers—far more than it was ever intended to affect. In light of the looming AMT problem, tax reform is more than a desirable goal: It is almost a necessity. As the enormity of the AMT issue becomes more fully

appreciated by the broader policy community, it should provide a crucial catalyst for action, moving the tax reform agenda forward.

Fairness, unlike simplicity, is an elusive concept, as much in the realm of political philosophy as economics. The President has said that, in his view, maintaining a progressive tax system is an essential element of fairness. One fact that is insufficiently appreciated is that his tax policy to date has made the system more progressive. A box in this year's Economic Report uses estimates from the Congressional Budget Office to illustrate this fact. Americans with the highest 20 percent of incomes are expected to pay 64.6 percent of all federal taxes in 2004, up from 64.0 percent without the tax cuts. Each of the bottom three quintiles is paying a lower share of federal taxes as a result of the Administration's tax relief.

Let me now turn to the third goal of tax reform—promoting economic growth. As a general matter, the less the tax code distorts decision-making, the better the allocation of resources, and the more prosperous the economy will be. Standard economic theory indicates that the distortion of any tax rises with the square of the tax rate. That is why the standard mantra for economists interested in tax reform is "broaden the base, lower the rates."

A large literature in public finance has pointed out that another way to improve the tax code would be to reduce the bias against saving and investment inherent in the current system. This literature suggests that the optimal tax system would use consumption, rather than income, as the tax base. Under an income tax, a person who immediately spends all his wages pays lower taxes over his lifetime than his neighbor who earns the same amount but chooses to save

and invest in order to enjoy a more prosperous retirement or to leave a bequest to his children. By contrast, under a consumption tax, these two families would pay the same tax in present value. Savers would no longer be disadvantaged relative to spendthrifts. The result would be greater saving, increased capital accumulation, and higher growth in productivity and wages.

At first, the idea of taxing consumption rather than income can sound like a radical change from the status quo. But the idea seems more natural when one realizes that the current tax code, while nominally an income tax, is actually a hybrid of an income tax and a consumption tax. Over the past several decades, Congress has amended the income tax many times to encourage saving. Policies such as individual retirement accounts and 401K plans exempt saving from taxation and, in doing so, move the tax base from income toward consumption. Similarly, the 2003 Jobs and Growth Bill lowered taxes on dividends and capital gains; by reducing the double taxation of income from corporate capital, that bill can also be seen as taking a step toward taxing consumption.

The President has not yet decided what further reforms he will advocate. To spur progress on this issue, the President has named a bipartisan panel to work with the Treasury Department to develop reform proposals. It might interest this group to know that the panel includes two prominent economists—Eddie Lazear of Stanford and Jim Poterba of MIT.

**The Fiscal Challenge**

Another fiscal policy challenge the United States faces is the budget deficit. Most fundamentally, budget deficits are a mechanism whereby one generation of taxpayers passes the

buck for its spending on to future generations. Deficits also can put upward pressure on interest rates and crowd out investment. This crowding out of investment offsets some of the expansionary effects of tax cuts, both in the short run and in the long run. This is why, as the President has said, deficit reduction and spending restraint are so vital.

The deficits we have seen in recent years are an understandable response to the recession and to the spending required for the war on terror. But as the economy continues to recover from the recent recession, it is crucial to have a plan to reduce the deficit over time relative to the size of the economy. This is the case under the President's policies. Under the budget the President has just released, the deficit as a share of GDP is projected to fall from 3.5 percent of GDP in 2005 to 1.5 percent of GDP in 2009.

To meet this target, Congress must abide by two of the President's stated priorities. First, tax reform must be revenue-neutral relative to the President's budget. Second, government spending must continue to be restrained. In the President's new budget, growth in discretionary spending is kept to 2.1 percent in fiscal year 2006—a bit under the projected rate of inflation. Discretionary spending other than defense and homeland security is reduced by nearly 1 percent in nominal terms—the first such proposed cut since the Reagan administration.
If we are going to reduce the budget deficit over time without raising taxes, such spending discipline is essential.

**Social Security Reform**

The greatest fiscal challenge facing the nation, however, is beyond the standard five-year budget window. As the population ages and the baby-boom generation retires, the entitlement programs for the elderly will put gradual but substantial pressure on federal spending. The President has correctly called this "the real fiscal danger."

The fiscal challenge in the Social Security system reflects two factors. The first is simple demographic reality. Compared to past generations, Americans are having fewer children and living longer. As a result, the elderly are representing an ever larger share of our society. In 1950, there were 16 workers paying into Social Security for every person receiving benefits. Now there are 3.3, and that number will fall to 2 by the time today's young workers retire.

The second driving force is that, under current law, each generation of retirees receives higher real benefits than the generation before it. This stems from the indexation of the initial level of benefits to wages, which over time grow faster than prices. A person with average wages retiring at age 65 this year gets an annual benefit of about $14,000, but a similar person retiring in 2050 is scheduled to get over $20,000 in today's dollars. In other words, even after adjusting for inflation, today's 20-year old worker is promised benefits that are 40 percent higher than what his or her grandparent receives today.

This current system of indexing initial benefits to wages has not been part of Social Security since its inception. In fact, it was introduced by the Carter Administration in 1977. At the time, some leading experts on Social Security objected to this change, arguing that it would

put Social Security on an unsustainable path. In a prescient letter in the New York Times (published on May 29, 1977), Peter Diamond, James Hickman, William Hsiao, and Ernest Moorhead wrote, "the wage indexing method calls for a much larger growth in benefits for future retirees at a time when the country may not be able to afford it….Only a Social Security system without a large deficit on the horizon can have the flexibility to deal with this and other needs. It would be sad if the legacy of a particularly forward-looking President [Carter] were a political nightmare." Despite their advice, President Carter signed into law the indexation regime with which we are still living.

Just as this group of economists and actuaries predicted in 1977, the current benefit structure is colliding with demography to make the system unsustainable for the long term. Benefits rising with wages could be sustained if we had a stable number of workers for each retiree, because economic growth raises real payroll tax revenues and thus makes available more resources to pay benefits. Conversely, the demographic shift of a declining number of workers for each retiree could be accommodated by economic growth if each worker was not required to support a benefit that grew as rapidly as currently scheduled. But the combination of large benefit increases and a growing elderly population puts the Nation on an unsustainable path.

Annual spending on Social Security will exceed the system's tax revenue in 2018, with deficits increasing from there. The Social Security trust fund will be empty in 2042, at which point the system will be insolvent. Under current law, the benefits the system will be able to pay from that year on will be only as great as the revenues coming in. Retirees would receive only

about 75 percent of scheduled benefits. In total, Social Security has made promises that exceed its resources by more than $10 trillion in present value.

The United States is, of course, not unique in facing the fiscal challenges of an aging population. Most developed countries face similar or even larger increases in the ratio of elderly to the labor force. But the United States is unusual in not responding to this development with significant reform in recent years. Since 1990, several nations, including Germany, Italy, and New Zealand, have raised the eligibility age for their public pension systems. Australia, Sweden, and the United Kingdom have all undertaken reforms that included personal retirement accounts.

Without reform, the United States will face little choice but vastly higher taxes and the resulting drag on economic growth. Putting Social Security permanently on a sustainable basis through higher taxes alone would involve raising the tax rate from 12.4 percent of taxable payroll to 15.9 percent—a 28 percent increase, equal to $1,400 for a family making $40,000 a year. Delay only makes the tax increase that would be needed to bring the system into balance even larger.

Such large tax increases would have serious adverse effects on the overall economy. Nobel Prize winning economist Ed Prescott has written in a recent paper that a large part of the difference between our economy and those in Europe is that Europeans work less because they are taxed more. Raising taxes to solve the Social Security shortfall would, in essence, make the U.S. economy more like those of Europe. With nations in Western Europe lagging the United States in growth and job creation, that is not the direction we should be heading.

In one of his last acts in public life, the late Patrick Moynihan, the former Democratic Senator from New York and a former Harvard professor, co-chaired the President's Commission to Strengthen Social Security. The commission proposed a number of possible reforms to fix the system. The commission's proposals are consistent with the President's principles for reform. They do not alter benefits for current retirees and those near retirement. They do not raise taxes. And they offer voluntary personal accounts to younger workers so they would have the opportunity to receive the benefits of long-term investing.

**Beware of the Sophists**

As the nation debates alternative proposals, you should be careful to avoid the sophistry of those opposed to reform. In particular, be wary of those who argue that there is no Social Security problem or that only small changes are needed to address it. The truth is that Social Security faces fundamental financing challenges. Just ask the Social Security Trustees, the Congressional Budget Office, or any other group of nonpartisan analysts. Reasonable people can debate what kinds of reforms are best, but don't let the Ostrich Caucus convince you to put your head in the sand.

Some will argue that these problems are far in the future and that there is no need to address them today. Imagine if a financial planner offered the same counsel to his 30-year-old client: "Don't worry Joe, retirement is 35 years away, you don't need to save anything." That planner would be guilty of the grossest malpractice.

The economics here would be understood by any parent who has contemplated saving for his or her child's college education. The sooner you start preparing for that future expenditure, the easier it is, and the better prepared you will be.

This President recognizes that his job is to take the long view and to plan for our nation's "retirement." He is rightly committed to acting now.

You should also be wary of comparisons between a new, reformed Social Security system and current law. The benefits now scheduled for future generations under current law are not sustainable given the projected path of payroll tax revenue. They are empty promises. Unless a listener is discerning, empty promises will always have a superficial appeal.

By contrast, the proposals of the Social Security Commission recognize the need for reform. Under these plans, future retirees receive benefits at least as high as those retired today, and they have the option of investing in a personal account and taking advantage of the higher return that accompanies equity investment. But the plans do not promise more than the System has the ability to pay.

Let me conclude by quoting the words of a President. "This fiscal crisis in Social Security affects every generation. We now know that the Social Security trust fund is fine for another few decades. But if it gets in trouble and we don't deal with it, then it not only affects the generation of the baby boomers and whether they'll have enough to live on when they retire, it raises the question of whether they will have enough to live on by unfairly burdening their children and,

therefore, unfairly burdening their children's ability to raise their grandchildren." That was President Clinton speaking on February 9, 1998. President Clinton was most definitely not a member of the Ostrich Caucus.

It is time to confront head-on the challenges facing Social Security. President Bush has begun to lay out his preferred approach, and he has put many ideas on the table that could be part of the final reform. One thing is certain: President Bush is committed to fixing Social Security System now, so it is on a firm foundation for generations to come.

Thank you.