Defining our Long-Term Fiscal Challenges

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Mr. Chairman and Members of the Committee, I appreciate this opportunity to discuss with you some of the challenges posed by the long-term fiscal outlook. This statement

- **summarizes the current budget situation and the outlook,**
- **explores the roots of the long-run imbalance and some related solutions, and**
- **discusses some aspects of the unavoidable adjustment process.**

The recent fiscal situation and the intermediate outlook.

The recent fiscal situation and the intermediate term budget outlook appear relatively benign. The fiscal 2006 deficit was 1.9 percent of GDP, lower than deficits in all but seven of the last 30 fiscal years. Moreover, in each of the past three years, the actual deficit has come in significantly below the levels that either the Office of Management and Budget or the Congressional Budget Office (CBO) predicted just nine months before the end of the fiscal year. These overly pessimistic estimates have given some policy makers hope that the future will turn out to be better than the experts predict and that watchful waiting may be the appropriate course.

These optimists will also take solace in the latest budget projections. Last week, CBO projected that, under baseline assumptions, today's modest deficits will be replaced

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by a small surplus in 2012 that will grow slowly through the remainder of the fiscal 2008-17 projection period. Even when CBO's projections are unshackled from the unrealistic constraints of the baseline methodology, the fiscal picture does not appear unduly threatening over the next decade. If the baseline were modified to include more realistic estimates for military and other discretionary spending, extension of the tax cuts and indexation of the AMT, the resulting deficits would remain close to the average of the past three decades and under 3 percent of GDP. Another ray of hope for the budget optimists is the President's announcement that his fiscal 2008 budget proposal will show the budget balanced by 2012 while making permanent the tax cuts enacted after 2000.

But the relatively benign intermediate-run budget outlook should be no cause for complacency. As the Congressional Budget Office, the General Accountability Office, the Chairman of the Federal Reserve Board, the Office of Management and Budget and many objective experts have concluded, long-run projections "show clearly that the budget is on an unsustainable path."[1]. If current tax and spending policies are not altered significantly, deficits and debt will gradually grow to unprecedented and unsustainable levels.

Unless American households and businesses increase their saving very dramatically, the continued viability of the nation's economy will depend increasingly on the willingness of foreigners to accumulate ever-larger holdings of dollar denominated assets. While their appetite for such assets might be sustained for a period, the nation will be becoming increasingly dependent on others whose economic priorities and political interests may not coincide with our own. Our ability to conduct economic and foreign policies that are in the

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1 . Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2007, Analytical Perspectives*, page 196.

nation's best interests could be limited by this dependence on foreign capital.

When, as it surely will, the foreign appetite for dollar denominated assets begins to abate, interest rates will begin to rise, capital for productive investment will begin to dry up, and the rise in living standards, which is such an important underpinning of the nation's political stability, will begin to slow.

And so, significant budget adjustments are unavoidable. The question all of us must answer is, "Do we want have control over the timing, pace and composition of these adjustments or do we want to leave such decisions to others or to unpredictable events?" While it is possible that the adjustment process will occur gradually over a number of years, history is replete with examples of overreacting markets or unexpected crises forcing sharp policy changes of this sort. Almost always, such changes occur when other circumstances—like an economic downturn or political turbulence in the world—make them all the more painful.

The Roots of the Unsustainable Budget Outlook

Notwithstanding the rhetoric about "bloated" discretionary spending (both non-defense and defense), "runaway" welfare-related entitlement programs, and "irresponsible" tax cuts, none of these caricatures of reality helps us understand either current deficits or the unsustainable budget outlook. At 7.8 percent of GDP, discretionary spending is a bit above what is was between 1995 and 2003 but well below the levels common from the start of the Cold War through the mid-1990s. Of more importance, most long run budget projections assume that discretionary spending (both non-defense and defense) will grow more slowly than the economy over the next half century leaving discretionary spending as a percent of GDP by 2050 well below even the levels achieved in

the 1990s. Similarly, entitlement programs that don't benefit mainly the elderly and disabled have not been breaking the bank recently nor are they expected to do so over the coming decades. In the long run projections, they too represent a smaller fraction of GDP in the future than do today. Even though the many tax cuts enacted since 2000 have reduced revenues substantially below the amounts needed to pay for the goods and services government provides, at 18.4 % of GDP, revenues were about at their historic average relative to the economy in fiscal 2006. Most long run projections predict that, even if the recent tax cuts are extended, revenues will grow a bit faster than the economy over the long haul as real incomes continue to rise.

Clearly, we must look elsewhere for the roots of the severe future budget imbalance predicted for the future. And those roots are to be found in the retirement-related entitlement programs—Social Security, Medicare, and Medicaid. Together, spending on these three programs will grow to over 20% of GDP by the middle of the century, up from 8.0% of GDP in fiscal 2006 and 6.6% in 1990. It would be reasonable to assume that mainly demography—the retirement of the baby boomers—is driving this dramatic increase. But that would be wrong. Only about one-quarter of the increase in spending above GDP growth is related to the burgeoning numbers of program beneficiaries. The bulk of the increase is explained by the expectation that, as in the past, per beneficiary health expenditures will rise a good deal faster than per capita GDP.

Averaged over the past few decades, per capita spending on health care has grown about 2.5 percentage points faster than per capita GDP. This has been true for government-financed health care programs and for plans financed by employers and workers which should not be surprising considering that workers, their dependents, and

Medicare and Medicaid beneficiaries all use the same providers and access the same delivery systems. Doctors, hospitals, nursing homes and other health care professionals do not practice one type of medicine for those in government-financed programs and another for those who are enrolled in privately-financed plans.

There is little reason to expect that we will see any marked slowdown in per capita health care spending absent significant restructuring of our health care delivery system or radical changes in the way health care is financed. While some of the increase experienced over the past four decades is attributable to ever more generous insurance coverage, most is related to technological advances that have provided more effective and less invasive treatments for diseases and disabling conditions. If anything we should expect an even more rapid increase in the capabilities and cost of medical care as the genomic era progresses and nano technologies are more fully employed.

<u>The search for solutions.</u>

Rapidly rising health care costs are, of course, not just a problem facing government. Employers are struggling with the ballooning cost of the health benefits many provide their workers and those workers are reeling under exploding premiums, higher cost sharing, and depressed wage growth.

To the extent that solutions are sought for soaring Medicare and Medicaid costs, they can not be found solely within the public sector programs. Durable solutions will probably require significant restructuring of the nation's health care delivery system and the mechanisms used to finance it. While we build up the resolve to undertake such a restructuring, a number of more incremental approaches are being pursued. But compared to the challenge, these efforts are relatively small in scale, disorganized, and

uncoordinated. While many hold some promise for improving the quality of care, their impacts on both the level of costs and the growth of cost are far more uncertain. For example, pay for performance schemes usually focus on improving clinical quality and, as such, are likely to push up costs as care improves. If pay for performance plans could also reward efficiency, as the IOM has recommended, some cost savings may develop but it is extremely difficult to measure and reward efficiency across episodes of care in our fragmented and uncoordinated delivery system.

Some hint of the extent to which improved efficiency might lead to reduced costs can be garnered from the work of Elliot Fisher and his colleagues at Dartmouth. They have found that, after adjusting for input price differences and underlying health risks, per beneficiary Medicare costs vary almost two to one across the nation's hospital referral districts. And health outcomes, if anything, seem to be negatively correlated with higher spending and service use. Unfortunately, these differences are deeply imbedded in the practice patterns of each region's medical professionals and the expectations of each area's patients. And both are reinforced by the region's institutional infrastructure and its desire not just to survive, but also to thrive. In short, it seems that all medicine, like all politics, is local and it will take much work and many years to change that situation.

One important ingredient needed to convince medical professionals and patients that more is not always better is increased, high quality information about which interventions work best for which types of patient under what circumstances. Studies of comparative effectiveness and cost effectiveness are essential. Such studies are a public good and it makes no sense to have individual insurance carriers, professional associations, research organizations and academic health centers all dabbling duplicatively in this arena.

A national effort, coordinated if not funded by the federal government, is called for.

It is doubtful that even the most radical restructuring of the nation's health care system could slow the growth of health related spending sufficiently to match the growth of the economy. Nor is it clear that this would be a desirable objective. New, often costly, medical technologies bring obvious benefits that all societies should want more of especially as their incomes increase. In the public sector, taxes will have to be raised or other public services scaled back to accommodate these desires. In the private sector, increases in cash wages and no-health fringe benefits will have to be slowed. The challenge we face is determine how to balance our desire for improved health against our other priorities. We can not have it all and ask our children and grandchildren to pick up the tab.

<u>The Adjustment Process</u>

The budget adjustments that are required to achieve some reasonable fiscal target—such as keeping public debt from growing faster than the economy—are so daunting that it is tempting to procrastinate. But the longer policy makers wait to act, the more wrenching the adjustments will have to be, the greater the risk that external forces will dictate the process, and the fewer will be the options available for sharing the unavoidable sacrifice broadly. For example, if better-off elderly are going to be asked to bear a bit more of the burden of financing their Medicare benefits, it would be unfair and politically impossible to decide to impose that change after a majority of the baby boomers had already retired and relatively ineffectual to impose such a policy only prospectively on those yet to enroll in the program.

Notwithstanding the past precedents of enacting large omnibus balance budget bills,

it is important to realize that there is no requirement that all of the medicine needed for the cure be swallowed at once. Certainly, partial solutions are better than none at all and many solutions could—in fact, should—be phased-in over a number of years or adopted on a piecemeal basis. It is particularly wise to phase-in policy changes that cut entitlement benefits for the elderly, disabled or other vulnerable populations. For example, if policy makers decide to index Social Security's normal retirement age to increased longevity or accelerate the increase from 66 to 67 in the normal retirement age that, under current law, will take place for those turning 62 between 2017 and 2022, the decision should be made immediately to provide those affected sufficient time adjust their saving and work plans.

Piecemeal changes may be acceptable when there is considerable uncertainty about the programmatic or budgetary impacts of a policy change. Excessive change can prove to be counter productive because it can generate a backlash that repeals too much of the initial adjustment. This occurred with the Medicare cuts made by the Balanced Budget Act of 1997. Weighing against any reluctance to do too much is the reality that it is far harder to enact than to scale back after the fact a deficit reducing policy.

In the past, it has proven acceptable to make the decision to profoundly change policy long before the change is to be implemented. Although the decision to raise Social Security's normal retirement age was made in 1983, it was not until some 17 years later in 2000 that the first beneficiary received a reduced benefit payment. Similar steps should be considered anew.

When considering ways to make the fiscal situation more manageable, Congress should also consider adopting trigger mechanism that would automatically shave spending or boost revenues by small amounts when the fiscal train began to leave the tracks. The

indexing provisions of the tax code and entitlement programs offer obvious places to insert such adjustments. Often many small nibbles spread over time are often more acceptable than one large bite. Households, communities, businesses and sub-national units of government need time to adjust.

As the Chinese proverb states, "A journey of a thousand miles begins with a single step" and, notwithstanding the relatively benign fiscal situation that we seem to be enjoying today, that first step is overdue.