The Economic Agenda

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Thank you. I am delighted to be here. I would like to take this opportunity to talk about three of the initiatives the President has made high priorities for his second term: 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. According to estimates from the Congressional Budget Office, 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, last year's 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 this morning announced a bipartisan panel to work with the

Treasury Department to develop reform proposals. This audience may be interested to know that two of the nine members of this panel are members of the American Economic Association: James Poterba and Edward Lazear.

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. The deficit as a share of GDP is projected to diminish by more than half over the next five years.

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 most recent budget, growth in discretionary spending was kept to 4 percent. Discretionary spending other than defense and

homeland security was kept to less than 1 percent—below the rate of inflation. You should expect to see continued spending discipline in the President's future budgets.

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 of Social Security and Medicare 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. 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, a typical person's benefits are scheduled to rise by over 40 percent.

This current system of indexing initial benefits to wages has not been part of Social Security since its inception. It was introduced by the Carter Administration in 1977. It might be

interesting to this audience to know that a panel of leading economists -- Peter Diamond, James Hickman, William Hsiao, and Ernest Moorhead -- objected to this change at the time. On May 29, 1977, these economists published a prescient letter in the New York Times, writing, "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. Use of the price indexing method would permit moderate tax and benefit increases to aid those recipients with greatest need as perceptions of those needs arise…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 these economists predicted in 1977, this benefit structure is colliding with demography to make the current system unsustainable for the long term. Benefits rising with wages could continue if the demographic shift were not occurring, because economic growth raises real payroll tax revenues. Conversely, the demographic shift could be accommodated by economic growth if real benefits were growing at a slower pace. But the combination of scheduled benefit increases and a growing elderly population puts the nation on an infeasible 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. In total, Social Security faces an unfunded liability of more than $10 trillion in present value.

Without reform, the nation 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. Delay only makes the problem worse. Waiting until 2042 to fix the system would require a 7 percentage point increase in the payroll tax rate (to 19.4 percent).

Such large tax increases would have adverse effects on the overall economy. 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. 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 put the system on a sustainable basis for future generations.

Let me state clearly that there are no free lunches here. As the Administration works with Congress to fix the Social Security system, there will be hard choices to make. But without

any reforms, starting in 2042, the system will not be able to pay retirees the full benefits scheduled under current law.

As the nation debates alternative reform measures, you should be careful to avoid the sophistry of those opposed to reform. In particular, 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 plans examined by the Social Security Commission recognize the no-free-lunch principle. 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 take advantage of the higher return that accompanies equity investment.

The President is now developing the specifics of the Social Security reform he will advocate. One thing is certain: His proposal, like those examined by the Social Security Commission, will be a credible plan that puts the Social Security System on a firm foundation for generations to come.

Thank you.