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Remarks From the Second SIEPR Prize Given on December 3, 2012

Dealing with our Fiscal Problems

*By Martin Feldstein**

It is an honor to receive this award and a great honor to be introduced this evening by George Shultz. George is a hero, a mentor, and a model. I have known George for more than 40 years, since the time when he was Secretary of the Treasury for Richard Nixon. I had the opportunity to work with him when he was Secretary of State in the Reagan administration and I was chairman of the Council of Economic Advisers. George had the most demanding job in the government but he always had time to talk with me about economic issues. And while George has done so many things, he never lets you forget that he is an economist as well as a Marine.

As you know, Paul Volcker was the first recipient of this award. That makes me particularly happy to be its second recipient. Every American should be grateful to Paul for what he did as Chairman of the Federal Reserve. He had the wisdom and the courage to move aggressively against double-digit inflation and the skill to reassure the American public that the Fed would maintain price stability in the future.

I'm very grateful to SIEPR for honoring me in this way, especially because SIEPR is such an important contributor to public policy analysis and to the national debate on a wide range of public policy issues. John Shoven has been a great leader in making that happen.

I am delighted to receive this award for my contribution to public policy because, for me, economics has always been about public policy. From my days as an undergraduate at Harvard and a graduate student in Oxford, the attraction of economics was, and still is, its ability to contribute to public policy.

Economics is, of course, not an exact science. There are no critical experiments that unambiguously resolve key issues. And the economy continues to change, making some of the truths in one decade less relevant in future times. But economics is an analytic discipline, a quantitative discipline. We use data and statistical calculations to do research that can improve our understanding of

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* Professor of Economics, Harvard University. These are a revised version of remarks that were delivered at Stanford University on December 3, 2012 at the SIEPR Prize Ceremony.

About The Author

Martin S. Feldstein received the 2012 SIEPR Prize Award from the Stanford Institute for Economic Policy Research. He is the George F. Baker Professor of Economics at Harvard University and President Emeritus of the National Bureau of Economic Research. He served as President and CEO of the NBER from 1977–82 and 1984–2008 and currently serves as a Research Associate. The NBER is a private, nonprofit research organization that has specialized for more than 80 years in producing nonpartisan studies of the American economy.

From 1982 through 1984, Martin Feldstein was Chairman of the Council of Economic Advisers and President Reagan's chief economic adviser. He served as President of the American Economic Association in 2004. In 2006, President Bush appointed him to be a member of the President's Foreign Intelligence Advisory Board. In 2009, President Obama appointed him to be a member of the President's Economic Recovery Advisory Board.

Dr. Feldstein is a member of the American Philosophical Society, a Corresponding Fellow of the British Academy, a Fellow of the Econometric Society and a Fellow of the National Association of Business Economics.

Dr. Feldstein has received honorary doctorates from several universities and is an Honorary Fellow of Nuffield College, Oxford. In 1977, he received the John Bates Clark Medal of the American Economic Association, a prize awarded every two years to the economist under the age of 40 who is judged to have made the greatest contribution to economic science. In addition, he is the author of more than 300 research articles in economics.

the economy and can guide public policy decisions.

I was fortunate to begin my career at a time when the tools for such research were just becoming available. High-speed computers were replacing desk-top calculators. Large machine-readable data sets allowed studying the behavior of households and firms. Statistical methods suitable for the study of economic data were being refined.

I had the good fortune in Oxford to study with a brilliant economist, Terrence Gorman, who taught econometrics and encouraged my econometric research on the British National Health Service. Nuffield College in Oxford provided an environment that emphasized the importance of applying economics to public policy.

When I returned to America and joined the Harvard faculty in 1967 there were so many public policy issues that cried out to be studied with the new tools and data: the effect of taxes on the behavior of households and companies, the impact of insurance on the behavior of hospitals, the way that Social Security affects household saving behavior, the impact of unemployment insurance on the rate of unemployment, and more. Harvard provided colleagues and graduate students who were interested in this work and were helpful to me in getting it done. It couldn't have been better.

So my contribution to public policy has been research and teaching and writing. I've written research articles in professional journals for my academic colleagues and less technical pieces for a broader audience in the Wall Street Journal and other places.

Although I have never been in a position to implement policy like Paul Volcker or George Shultz, I have had the opportunity to provide advice to policy officials including my White House time as President Reagan's chief economic adviser and less formally to George H.W. Bush and to George W. Bush, to members of Congress and to policy staffs in Washington.

In all of this, I think of myself as a teacher. I continue to teach undergraduates and graduate students at Harvard. And I also think of myself as a teacher when I write for the press, appear on television, give lectures, or provide advice in Washington or elsewhere.

I was president of the National Bureau of Economic Research from 1977 to 2008. From the very beginning, I saw that position as an opportunity to encourage other economists to do useful work on public policy issues.

The Budget Deficit

There are many subjects that continue to occupy me these days, including the state of the U.S. economy and the use of monetary policy, Europe and the Euro, and China and its new domestic and international policies.

But tonight I want to talk about a subject that should concern everyone in this room – the budget deficit now and in the future. I have been thinking about the best way to deal with the deficit and I want to share some of my thoughts with all of you. And when I am finished, I look forward to your questions.

Five years ago our budget deficit was 1.5 percent of GDP and our national debt was 36 percent of GDP. This year the deficit will exceed $1 trillion or 7 percent of our GDP. The debt ratio has doubled to 73 percent of GDP. Why has that happened?

Although the weakness of the economy contributes by depressing taxes and increasing transfer payments, the cyclical component of the deficit is just 2 percent of GDP, according to the most recent IMF estimate. That's consistent with the projections of the Congressional Budget Office that, without significant reforms, the deficit will still be more than 5 percent of GDP a decade from now even if the economy is operating at full capacity with the unemployment rate at about 5.5 percent.

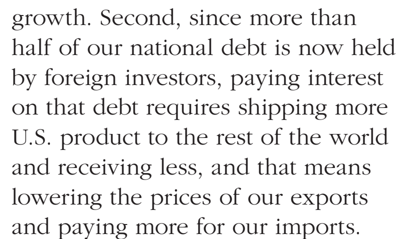
The large deficit is also not due to increased interest on our national debt, since the fall in interest rates has made the government's net interest bill lower today as a share of GDP than it was in 2007.

And the defense share of GDP is up less than one percent since 2007 (from 3.6 percent to 4.4. percent) and is projected to be lower a decade from now than it was when our deficit was just 1.5 percent of GDP, a dangerous direction for our defense budget and a bad signal to our allies and potential enemies.

The higher future deficit and the rising debt reflect a trillion dollars of new spending on health programs, other new and enlarged transfer programs to individuals, and a variety of transfers to state and local governments.

A sustained future deficit of five percent of GDP would soon drive the debt ratio up to more than 100 percent, causing interest rates to rise. Looking ahead, we are likely to see further increases in the government's cost of borrowing because today's major buyers of Treasury bonds – China, Japan, the oil producers of the middle east, and the Federal Reserve -- will no longer have the demand for our debt that they do today.

A high ratio of government debt to GDP creates five serious problems for any economy. Most obviously, paying the interest on that debt will require higher taxes that hurt incentives and weaken



growth. Second, since more than half of our national debt is now held by foreign investors, paying interest on that debt requires shipping more U.S. product to the rest of the world and receiving less, and that means lowering the prices of our exports and paying more for our imports.

A third adverse effect of a large debt is that it causes a decline in business investment and therefore in productivity and growth. This usually occurs because a large debt raises interest rates and the cost of investing. While that will happen in the future if our deficits persist, business investment is depressed today by the fear of higher taxes and of economic weakness.

Fourth, a large national debt reduces the government's room for maneuver. The U.S. may want to increase government spending in the future for any of a variety of reasons, including countercyclical policy and national security. The ability to do so at that time could be constrained by the size of the national debt.

Finally, a large national debt increases our economic vulnerability, particularly to upward shocks in interest rates. It also makes such shocks more likely, as European experience demonstrates, when foreign debt holders lose confidence in the government's ability to control its fiscal deficits or to continue financing its debt in international markets.

Social Security and Medicare

The predicted rise of the debt during the next 10 years is just a prelude to the debt explosion that could occur in the more distant future because of the increasing cost of Social Security and Medicare. I'll comment on both of these before returning to the problem of the current decade and the more imminent problem of the fiscal cliff.

The Congressional Budget Office warns that the aging of the population and the rising cost of medical care imply that the budget cost of these major middle-class entitlement programs – Social Security and Medicare – will rise from 8.7 percent of GDP now to 12.2 percent of GDP in 2037 – 25 years from now.

Paying for these increased costs with higher taxes would require taking the tax share of GDP from the historic average of 18 percent to nearly 22 percent. Many individuals who comment on our long-term fiscal outlook say that such a tax increase is inevitable because the future population will be relatively older than it was in the past. They conclude that it is wrong to hope that we can avoid a larger tax share.

I disagree. While the population is getting older, it is also becoming more affluent. The right programs for the affluent seniors now and in the future are not the same as the programs that were created in the 1930s and 1960s. Future programs need not have the same budget impact as a continuation of the current arrangements.

Because Social Security benefits are financed by a pay-as-you-go system, the projected increase in Social Security benefits under current law, from five percent of GDP now to 6.2 percent of GDP in 2037, would require raising those earmarked taxes by 25 percent. That tax rate increase could be avoided if future benefits grow more slowly, bringing the benefit levels in 2037 to about 80 percent of what they would be under current law.

Here's the important point. Even if benefit growth is slowed in that way, the level of real benefits in 2037 would still be about 40 percent higher in that year than they are now, because individual earnings will grow by about 1.7 percent a year.

There are a variety of ways to slow the growth of benefits by 20 percent over the next 25 years: raising the age at which full benefits are paid, changing the inflation indexing, or modifying the formula that links benefits to the level of preretirement earnings. These options would have different effects by age, by cohort, and by income level, but the average level of benefits would still be about 40 percent higher in 2037 than they are today without any increase in tax rates.

Dealing with Medicare is a more difficult challenge. The CBO forecasts the cost of Medicare will rise from 3.7 percent of GDP now to 6.0 percent in 2037 and would continue rising after that. Fortunately, there is general agreement among policy makers and health experts that government spending on Medicare (and government health programs more generally) has to be slowed to avoid either exploding deficits or large tax increases.

The recent election highlighted two approaches to achieving that slowdown. The Weyden-Ryan plan would specify the benefits for Medicare participants and would give premium support payments to seniors to allow them to pay for Medicare or a private alternative. Private insurers would compete for patients and the second lowest price offered by these competing firms would set the value of the voucher. In contrast, the Obama plan maintains just the traditional Medicare program. While both approaches would set limits on the future growth of Medicare outlays, the Weyden-Ryan plan uses competition to force efficiency in the Medicare program and, more important, allows individuals to choose more expensive plans if they prefer.

The key conclusion is that the growth of government outlays for the non-poor seniors through Social Security and Medicare must be — and no doubt will be — slowed to avoid higher future tax rates. But even without any increase in the tax rates used to finance these programs, the value of the benefits will continue to grow as incomes rise.

Tax Reform and the Current Budget Problem

But while that is good news for the longer run, it cannot help much in the current decade. Since the Social Security and Medicare benefits can be slowed only gradually, entitlement reform will do little to tame the sharp rise in the deficit over the coming decade.

Preventing the deficit from reaching 100 percent of GDP will require increases in tax revenue. It would be very good if that extra revenue could come from the faster growth that could result from tax reform. But that won't happen without reductions in marginal tax rates and improvements in corporate taxation that the Democrats are now unlikely to accept. Raising revenue through tax reform will have to mean reducing the special deductions and exclusions that now lower tax receipts.

Although we need revenue now to avoid the ballooning of the national debt, that doesn't have to mean higher tax rates. Revenue can be raised by limiting tax expenditures in ways that also improve incentives. And tax rates can decline in the future if we avoid increasing government spending as a share of GDP.

How is that future rate reduction possible? The key is that the revenue generated by the income tax rises faster than GDP because of the structure of tax rates. If GDP rises by 20 percent over the next decade, personal income tax revenue will rise by about 26 percent even if there is no change in tax rates. So future tax rates could be cut across the board to bring the ratio of personal taxes to GDP back to its current level. And because cutting tax rates causes a further increase in taxable income, all tax rates could be cut by about 8 percent to get back to today's revenue as a share of GDP. That would mean bringing the 35 percent rate to 32 percent and the 20 percent rate to about 18 percent.

But that is for the future and will be true only if we succeed in keeping government spending from increasing as a share of GDP. For now we need to raise revenue to reverse the rising ratio of debt to GDP.

The wrong way to achieve that extra revenue is to go over the fiscal cliff, with rising tax rates on personal earnings, dividends, capital gains and corporations. Combined with the mandatory spending sequester, that would reduce demand in 2013 by a total of $600 billion – about four percent of GDP – and by larger sums in future years. The Congressional Budget Office rightly predicts that would push the economy into a new recession.

President Obama's proposed alternative to the fiscal cliff would substantially raise tax rates and limit tax deductions for the top two percent of earners, a group that already pays more than 45 percent of total personal income taxes. His budget would also increase taxes on corporations. Together these changes would significantly lower total demand in 2013. And the higher marginal tax rates would reduce incentives to work and invest, further hurting economic activity. All of that could be fateful for an economy that is now struggling to sustain a growth rate of less than two percent.

A better way to raise revenue would be to broaden the tax base by putting an overall tax expenditure cap on the tax reduction that each taxpayer can achieve through deductions and exclusions. An overall cap would allow each taxpayer to retain all of his existing deductions and exclusions but would limit the amount by which he could reduce his tax liability in this way. Note that this tax expenditure cap is not on the size of the deductions and exclusions but on the resulting tax benefit to the individual.

I've analyzed an overall cap equal to two percent of each individual's adjusted gross income, applying the cap to the taxpayer benefits from all itemized deductions and from excluding municipal bond interest and the value of employer payments for high-value health insurance (greater than $8,000 per taxpayer). That 2 percent cap would raise about $150 billion at the 2013 level of income, about one percent of GDP.

If it were up to me, I would modify this overall cap to retain the current deduction for charitable gifts. Unlike most other deductions and exclusions, charitable gifts do not benefit the taxpayer. The increased giving generated by tax deductibility is important for maintaining private support for universities, churches, hospitals, and cultural institutions. If all charitable gifts remain deductible, the 2 percent cap would still produce revenue in 2013 of about $130 billion. So the annual cost of retaining the charitable deduction is less than $20 billion.

The limit on deductions would cause the number of taxpayers who

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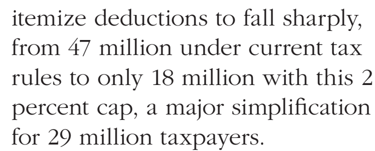

itemize deductions to fall sharply, from 47 million under current tax rules to only 18 million with this 2 percent cap, a major simplification for 29 million taxpayers.

The cap would increase overall progressivity — reducing after tax income more for higher income taxpayers than for those with lower incomes. And about two-thirds of the $130 billion of extra revenue would be collected from the 20 percent of taxpayers with incomes above $100,000.

There is a danger that the resulting $130 billion of extra revenue could be too much for the economy to swallow in 2013, particularly if combined with concurrent reductions in government spending. That risk could be avoided by starting with a higher cap and gradually reducing it over several years. A four percent cap on the tax expenditure benefits would raise only about $65 billion in 2013.

The Fiscal Cliff

All of this seems a reasonable approach. At least it does to me. It raises substantial revenue over a decade without increasing tax rates. It simplifies tax compliance and reduces the distorting effects of deductions and exclusions while letting everyone keep some benefit from those tax expenditures. A substantial part of the extra burden falls on higher income individuals — one-third of the extra tax would be paid by the top 2 percent of taxpayers who are already paying more than 45 percent of personal income taxes.

But in the end it may be rejected by the budget negotiators and the economy may go over the fiscal cliff. There are two critical problems. First, President Obama wants to avoid any extra tax on individuals with incomes below $200,000 while raising tax rates on individuals above that level. Republicans want to preserve the current tax rates for everyone but appear willing to accept higher revenue achieved through tax reform if it is combined with entitlement reform. Second, the Republicans want to use those entitlement reforms to achieve substantial reductions in future deficits while the President wants to leave Social Security unchanged and make only small changes in Medicare.

In this confrontation, the President may believe he holds the winning cards. He can wait until after January 1st, allowing the economy to fall over the fiscal cliff. At that point, tax rates would be automatically raised on high-income taxpayers. The President can then offer legislation to cut taxes for the 98 percent of taxpayers with incomes below $250,000, daring the Republicans who control the House of Representatives to vote against such a broad tax cut.

That could be a winning strategy, but not necessarily. Since the Republicans control the House of Representatives, they can prevent the President's plan from coming to a vote. Instead, they can propose and pass a tax cut for everyone that would reinstate the 2012 tax rates. If the President rejects that and the country slides into recession, the Republicans can blame it on Obama's desire to raise tax rates rather than pursue reforms that would raise revenue by broadening the tax base.

Republicans may resist the President's proposal for reasons of both politics and principle. The political reason is the Republican members of the House have to worry about their next primary campaign. Voting to raise tax rates now, after promising not to do so in the recent campaign, could leave them vulnerable to a challenge from the right.

There is also a matter of principle. Distributional fairness is in the eyes of the beholder. The line between a fair distribution of the tax burden and spiteful egalitarianism is unclear. But many of us believe that placing the full burden of deficit reduction on the top two percent of taxpayers goes too far. After all, if 98 percent of the voters can exempt themselves while raising taxes on just the top two percent — who already pay 45 percent of all personal income taxes — where will the process stop?

There is of course a limit on the amount that can be extracted from the top two percent. But the 95 percent of the voters could exempt themselves and raise taxes on the top five percent. Or the 90 percent could shift the entire tax burden to the top 10 percent.

One possible resolution to the current impasse would be for the budget negotiators to avoid the immediate tax rate increases and the sequester, substituting a new fallback plan that would be triggered six months from now if alternative budget legislation is not enacted. My candidate for that fall back plan would be the basic cap on tax expenditures that I have been discussing.

So we now have to watch the budget negotiations and the process of tax reform to see where the line will be drawn. I hope it will not require going over the fiscal cliff to find out.

Thank you.

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