Senate Democratic Policy Committee Hearing

"Do Deficits Matter?
The Impact of Long-Term Deficits on Economic Growth and Job Creation"

GENE SPERLING
Center for American Progress

January 20, 2004

Reverse Generational Responsibility

I. Introduction

For decades, policymakers across the political spectrum have shared a fundamental value in the importance of generational responsibility – the notion that each generation feels a responsibility to take the actions and sacrifices necessary to leave their children a more perfect nation in which to live.

For fiscal policy, generational responsibility has taken on special importance as we near the retirement of the baby boom generation. For a long time, we have recognized the fiscal challenges we will face as the large number of retirees promise to put unprecedented strains on our budget. We have also recognized that if we do not start saving in preparation and taking steps to boost long-term productivity and confidence, the full burden of the baby boom retirement will fall on the next generations, who will face tough choices between higher taxes, cutting investments in their children, running up ever-larger amounts of debt, or severe benefit cuts for tomorrow's retirees.

The recent terrorist attacks of 9/11 have reminded us that we also need to be prepared for unexpected challenges. America needs to be in a position where we can respond with strength to both the known and unknown challenges that we will face.

During the 1990s, there emerged a growing consensus that the high-deficit policies of the 1980s was not responsible in light of the oncoming demographic challenge. There was broad bipartisan agreement on the need to reduce deficits and of maintaining a broader ethic of paying-as-you-go for new proposals – even if there was wide disagreement on how to get there. Once we succeeded in getting to surplus, President Clinton's call to Save Social Security ensured this fiscal generational responsibility continued.

II. The Bush Administration's Reverse Generational Responsibility

This stands in sharp contrast to the no-worries-about-tomorrow policy choices that have characterized the Bush Presidency. What is troubling about the Bush Administration's fiscal policy is that it appears to be modeled on *reverse generational responsibility*. They have followed a consistent pattern. First, use deficits now to finance policies benefiting the consumption of today's generation and completely leave the hard choices about how to pay for them to future generations. Second, design their policies to hide the long-term costs of their actions so as to obscure the inherent tradeoffs they are making for future generations.

Hiding Generational Trade-Offs Through Obscuring Long-Term Costs with Cinderella Tax Cut Accounting: A key example is the cynical strategy the Administration has employed of using gimmicks to hide such generational tradeoffs by keeping down the official price tag of their tax cuts, despite the fact that they clearly recognize the higher long-term costs those cuts will entail. In 2001, the Administration claimed that their tax cut would cost $1.35 trillion. But consider what that figure left out. First, it ignored the associated interest costs from the higher debt the tax cuts would leave. Second, it advertised how much each family would receive while explicitly ignoring the fact that these full tax cuts would only be received by millions of families if we added hundreds of billions of dollars to prevent the Alternative Minimum Tax from taking back some or all of the tax cuts from tens of millions of taxpayers. Third, it assumed that the tax cuts would expire at the end of 2010 and, like Cinderella at midnight, tax rates would suddenly revert back to their previous higher levels. Indeed, soon after the 2001 tax cuts were enacted, the IMF found that taking all of its likely costs into account, the total was likely to reach $2.4 trillion, nearly twice the reported price tag.[1]

These sunsets or Cinderella tax cuts have been particularly notable as a key feature of all the Administration's signature tax cuts. And yet neither the Administration nor the Republican Congress has ever had the slightest intention to allow any of these tax cuts to expire. Virtually no time passed between when the Administration enacted the first round of tax cuts in 2001 and when it began calling for those very tax cuts to be accelerated and made permanent. Before the 2003 tax cuts had even been passed, Representative Bill Thomas, chair of the tax writing Ways and Means Committee, said that "No one believes there will be any difficulty in extending them"; the day after the cuts passed Congress, his counterpart in the Senate, Finance Committee Chairman Charles Grassley, was quoted as saying "Will a tax, once eliminated, be re-established? I doubt it." Indeed, the 2001 and 2003 tax cuts were again designed to artificially present a cost figure well-below what the Administration knew the long term costs would be.

Over the last few years we have seen a few corporate leaders seek to use gimmicks and accounting devices to hide their true financial situation when they knew that their shareholders and board would be disturbed by their true level of debt. Yet, while this Administration has rhetorically condemned such practices in the corporate world, their lack of confidence that the public would accept or approve of the full long term costs and possible generational trade-offs inherent in their own fiscal and tax policies have led them repeatedly to rely on the same deceptive practices.

Hiding the Generational Trade-Offs By Confusing Short-Term and Long-Term Deficits and Debt: The Administration has also sought to obscure the impact of its long-term fiscal deterioration by deliberately confusing the legitimate case for running short-term deficits at times of temporary economic weakness with the illegitimate case for creating long-term deficits to respond to temporary economic weakness. Let's be clear: Everyone agrees that running short-

[1] International Monetary Fund, "Staff Report for the 2001 Article IV Consultation," June 28, 2001.

term deficits in order to offer well-targeted economic stimulus or national security during times of recession or war is certainly justified. Basic Keynesian economic theory dictates that, in a slow economy, it makes sense to use temporary tax cuts or spending increases to boost spending. But the crucial words are "temporary" and "time of economic weakness or war". The need for targeted, temporary tax cuts during an economic cycle simply cannot justify reckless long-term tax cuts that increase deficits for decades to come and leave a huge burden of debt on the next generation.

Let me give an analogy. Consider a family where the parents are saving money for their children’s college education. Suddenly the father is laid off. That unfortunate event may justify the family drawing money out of the college account to support themselves until he finds a new job. But it would be absurd to say that their temporary hard times means the family is justified in taking out huge loans that will take decades to repay and put the family in perpetual debt for purposes unrelated to getting through this family’s temporary period of economic distress.

Yet this is precisely the logic of the Administration’s tax policies. In the name of short-term stimulus, what the Bush Administration has actually done is pass tax cuts with permanent costs that will end up costing us trillions in coming decades. Unless the Cinderella fairytale of expiring tax cuts comes true, the cuts will continue to impose costs on the budget of more than $4 trillion dollars over the next ten years, including interest costs. In 2013 alone, more than a decade after the 2001 recession and the terrorist attacks of 9/11, the tax cuts together with the higher interest costs will be costing us as much as $600 billion a year, or 3.5% of GDP.

The worst thing about this generational tradeoff is that it was totally avoidable. The right policies during the downturn would have been to provide short-term, high bang-for-the-buck stimulus that did not hurt confidence in our fiscal situation by making long-term increases in the deficit and did not hurt generational responsibility by passing on massive amounts of debt to the future. The 2003 Democratic plans in the House and the Senate consisted of these kinds of measures, including temporary extensions of unemployment insurance which would have targeted its benefits on people most likely to spend a dollar they received, and temporary business tax breaks.[2]

Instead, the Administration consistently used the stimulus debate as an opportunity to push through a different agenda of costly tax cuts that would do the most long-term damage while providing the *least possible short-term stimulus*.

In 2001, the Administration offered no direct stimulus in their initial tax cut package despite their claims that they already knew our country was in a recession. Their entire initial focus was on a long-term tax cut which would have virtually no direct stimulus in 2001. Even when they moved somewhat in the direction of Democratic calls for a temporary rebate by proposing and passing a partial advance on the lowest rate reductions, they insisted that the advance be non-refundable – leaving out 34 million low-income taxpayers with the highest propensity to spend and most likely to stimulate the economy. In 2002, the aftermath of 9/11 provided a great opportunity to

---

[2] Sperling, Gene. "Business Incentives Must Get Small Stuff Right," *Bloomberg News*, October 18, 2001; See also “Democrats Try to Tip Debate Toward Economy With Forum,” *Washington Post,* October 12, 2002.

reach across party lines and work together to address a jobs crisis that had already become clear. Instead, the Administration stalled stimulus negotiations by pushing the retroactive elimination of the corporate Alternative Minimum Tax (AMT) and capital gains tax cuts – measures which CBO called "least likely to generate significant stimulus." [3] Both the Administration and many Democrats supported a bonus depreciation deduction as an incentive for businesses to invest. Many people, myself included, argued it should last for only one year so that businesses on the fence about investing would have an incentive to do so immediately instead of postponing it out of uncertainty. CBO stated that offering the tax break for a longer period "would reduce the bang for the buck because it would decrease businesses' incentive to invest in the first year and increase the total revenue cost." [4] Nonetheless, the Administration pushed through a three-year version.

The 2003 tax cuts, too, provided low bang-for-the-buck stimulus. Only 5% to 7% of the tax relief they provide over the first decade took place in the first year, when stimulus was needed the most – leaving much larger costs for the future. And again, the main provisions – the dividend and capital gains tax cuts – had little to do with stimulus. Indeed, Goldman Sachs singled out the dividend provision as "especially ineffective as a stimulative measure, providing only 8 cents on the dollar."[5] In the meantime, until forced to include a small provision in the 2003 bill in order to get enough votes of moderate Senators, the Administration completely ignored the state fiscal crisis, which was causing many families facing increases in state university tuitions and state and local fees and taxes to see a net tax increase. The economic consulting firm Economy.com found that providing state fiscal relief would provide a much bigger bang for the buck than the Administration's proposals – more than ten times that of the dividend cuts. [6] The Administration's failure to provide significant relief for over three years to states to prevent tax increases, tuition hikes and education and health spending cuts is a part of the failure of their long-term economic strategy.

While the Administration has tried to present the strong economic growth in the third quarter of 2003 as proof that their tax cuts have worked, more effective, higher bang-for-the-buck stimulus could have been accomplished far earlier, with far lower long-term costs. Even the 2003 tax cut is more of a vindication of progressive policies than an example that the Administration's tax cut agenda has been at all effective in stimulating the economy. Economy.com has estimated that the tax cuts were responsible for only 13 percent of the growth in the third quarter – meaning that we still would have seen GDP growth of about 7 percent without the tax cut. [7] Even that modest contribution was predominantly due to its short-term, targeted components – the child tax credit and the temporary bonus depreciation for business investment – that Democrats always supported. And even if one generously assumes that the final round of tax cuts in 2003 added $30 billion to the economy in the third quarter, it is hardly enough to justify its trillion dollar cost over the next decade.

---

[3] CBO, Economic Stimulus: Evaluating Proposed Changes in Tax Policy, January 2002.
[4] *Ibid.*
[5] "Fiscal Policy – In Search of Balance, Creativity, and Grit," Goldman Sachs US Economics Analyst, May 2, 2003.
[6] "The Need For Federal Government Aid to State Government," Economy.com, February 2003.
[7] Mark Zandi, "The Virtuous Cycle Has Begun," November 13, 2003.

III. What Are the Tradeoffs?

A. Reducing our preparation for the retirement of the baby boomers

As is well understood, we are entering a period where demographic factors will place an unprecedented strain on the budget and the economy. Increasing life expectancies, combined with the retirement of the large baby boom generation, will lead to an explosion in the retiree population. In 2002, there were 39.1 million retirees collecting Social Security; by 2015, there will be there will be 49.8 million, and by 2030 there will be 71.3 million, or 82 percent more than in 2002. By 2045, the number will have more than doubled. Over the same period, the number of workers will have grown by only a quarter. In other words, there will be fewer workers for each beneficiary. Since about 1975, there have been about three workers paying into the Social Security system for each beneficiary. By 2025, that ratio will have fallen to only 2.3 workers for each beneficiary, and to 2.0 by 2045.

With fewer workers paying into the system for every retiree who is collecting benefits, Social Security faces a long-term financing shortfall. Over the next 75-years, that shortfall is equal to $3.8 trillion, adjusting for inflation and interest (what economists call net present value), or 0.73% of GDP. For each year we go without addressing the shortfall, it will deepen. The aging population and rising health care costs mean that there is also a shortfall in the Medicare system – estimated to be $6.8 trillion in net present value, or 1.11% of GDP.

At the end of the 1990s, people may have had different conceptions about the best way to address the financing problems in Social Security, but there was broad bipartisan agreement on the principle of addressing the challenge in a generationally responsible way. President Clinton's Save Social Security First policy was an articulation of this principle, and not only was it met with widespread approval; it led to a competition for who could actually save more and pay off debt the fastest. For example, before the release of President Clinton's last budget, Speaker of the House Denny Hastert instructed House Budget Committee Chairman John Kasich to put together a plan to eliminate all federal debt by 2015.

This commitment not only worked to increase savings – in the years covered by President Clinton's last four budgets the government ran surpluses adding up to $559 billion, a $2.3 trillion improvement compared to what was projected when Clinton took office – but made possible the prospect of responsible long-term Social Security reform. Every serious proposal to reform Social Security confronts a fundamental problem: how to fund the transition to a long-term solution without steep payroll tax increases or benefit cuts. The large surpluses projected in the 1990s provided a historic opportunity to increase national savings and commit surpluses for Social Security and Medicare solvency without having to make other painful generational trade-offs such as steep payroll tax increases or dramatic benefits cuts or squeezes on education or other vital investments in our future. Nearly all Social Security proposals during this period, whether or not they involved individual accounts, relied in someway on the dedication of general revenue surpluses.

The Bush Administration's choices have traded off the opportunity for generationally responsible Social Security reform. Not only have they squandered the surplus, but the long-term costs of their tax cuts are *more than three times the 75-year Social Security shortfall*, and *more than the combined shortfalls of the Social Security and Medicare systems*. The fiscal deterioration under the Bush Administration has taken most serious efforts to confront the fiscal problems presented by the baby boom retirement off the table.

In March 21, 2001, I wrote an op-ed in the New York Times called "The Reforms a Tax Cut Ruins" where I warned that whether you were for or against individual accounts that the expensive long-term costs would sacrifice most viable efforts for Social Security reform. It now turns out that Bush's Treasury Secretary was only months later making the same arguments against further tax cuts. In a recent interview with 60 Minutes, Secretary O'Neill described that "it was not just about not wanting the tax cut, it was about how to use the nation's resources to improve the condition of our society. And I thought the weight of working on Social Security and fundamental tax reform was a lot more important than a tax reduction that was branded in."[8]

When President Bush took office in January 2001, CBO was projecting that government's net debt held by the public would be only $36 billion in 2008, the year the baby boomers begin to retire. That would be the equivalent of about $500 per family of four. Now, joint projections by the Concord Coalition, the Center on Budget and Policy Priorities, and the Committee for Economic Development suggest that the government will face debt of $6.2 trillion in 2008, or $84,600 per family of four. In other words, in only three years, the debt burden that each family will face when we enter the period of the baby boom retirement has grown by $84,000.

What are the consequences for future generations? Instead of making the modest sacrifices today that would have helped reduce the burden of the baby boom retirement on future generations, we are instead forcing ourselves into a position where we will need to dig out of a huge fiscal hole at precisely the moment when the baby boomers begin retiring, and will be forced to accept even deeper benefit cuts for future generations of retirees or steeper tax increases or excessive debt for our children and grandchildren.

B. Undermining Confidence in the Economy and Savings

A key component of generational responsibility is ensuring that we are passing on a more productive and prosperous economy to our children. A fiscal policy that inspires confidence in our economy, provides a sufficient pool of capital on which investors can draw, and keeps interest rates low is crucial for sustaining long-term productivity growth. The current outlook of continuous, massive deficits, on the other hand, threatens to drive up interest rates, undercut confidence, weaken future productivity growth and leave a less prosperous smaller economy and fewer opportunities for future generations.

The Bush Administration has tried all along to play down the negative effects of deficits as a way of denying the long-term economic damage their tax cuts will cause. Until recently, they waged an absurd campaign to deny that deficits had any harmful effect on interest rates at all. This flew in the face of the views of most mainstream economists, including top conservatives

[8] 60 Minutes, January 11, 2004.

such as Harvard professor Martin Feldstein, current Treasury undersecretary John Taylor, Federal Reserve Chairman Alan Greenspan, and the Councils of Economic Advisers under President Reagan and the first President Bush. [9]

While nominal interest rates are still quite low, the full negative impact of the deficits on interest rates may be an eventuality when our economy finally reaches a strong recovery. According to Alan Greenspan, "history suggests that an abandonment of fiscal discipline will eventually push up interest rates, crowd out capital spending, lower productivity growth, and force harder choices upon us in the future."[10] The prospect that interest rates will move substantially higher raises the risk of dampening or cutting short an economic recovery. This is the opposite of what we saw in the 1990s. By creating a larger pool of savings, fiscal discipline maintained a virtuous cycle of modest interest rates for new investment, and because surpluses were being saved, additional capital was being provided even when the economy heated up and investment demand took off. According to a Goldman Sachs analysis in April 2000, "the swing in federal budget position from a deficit of $290 billion in 1992 to a surplus of $124 billion in 1999 - roughly matching the improvement in the general government position - has lowered equilibrium bond yields by a full 200 basis points." [11] With lower interest rates, businesses were able to borrow more to finance their investments, and business investment soared, growing between 8.7% and 12.1% in every year from 1993 through 2000, the best peacetime investment expansion in history. In turn, this investment expanded our nation's productive capacity: productivity growth averaged only 1.4% annual growth from 1973 to 1995, but averaged 2.5% from 1995 to 2000. The continued high level of productivity growth is further evidence that this is a higher trend rather than a blip or a bubble. However, sustained deficits that boost interest rates and discourage investment could eventually sow the seeds for a slowing of the trend, reducing the potential output of the economy we leave to our children and grandchildren.

The perception that we have a fiscally unsustainable future can decrease confidence in our economic management and increase the perceived risk of investing in the United States. When our fiscal house is in order, as it was during the late 1990s, foreign investors demand a smaller risk premium for investments in the U.S. But if our fiscal condition deteriorates sufficiently to cause concern among investors, the results could be dire. Last June, the Bank for International Settlements – the organization of the world's central bankers – issued a warning that the Bush tax cuts had "not been helpful" in promoting global confidence in U.S. public finances.[12] Former Treasury Secretary Robert Rubin and economists Allen Sinai and Peter Orszag recently wrote, "The inability of the federal government to control the budget deficit could be interpreted as a broader failure of the nation to address its economic problems, and thus prompt a loss of

---

[9] See Martin Feldstein, "Budget Deficits, Tax Rules, and Real Interest Rates," NBER Working Paper No. 1970, July 1986; John B. Taylor, "Monetary Policy Implications of Greater Fiscal Discipline," in *Budget Deficits and Debt: Issues and Options*, Kansas City: Federal Reserve Bank of Kansas City, 1995; Alan Greenspan, "Current Fiscal Issues", Testimony Before the Committee on the Budget, U.S. House of Representatives, September 12, 2002; *Economic Report of the President*, February 1984; and *Economic Report of the President*, February 1991.
[10] Current fiscal issues, Before the Committee on the Budget, U.S. House of Representatives, September 12, 2002.
[11] Goldman Sachs, "GSWIRE Undistorted by the Budget Surplus," April 14, 2000.
[12] Bank for International Settlements, *73rd Annual Report: 1 April 2002-31 March 2003*, June 30, 2003.

business and consumer confidence, which would undermine capital spending and real economic activity." [13]

In addition the combination of large fiscal deficits in combination with historically-high current account deficits together create both excessive dependence on foreign debt and increased risk of a painful adjustment in the future. The IMF recently warned that "the possible global risks of a disorderly exchange rate adjustment, especially to financial markets, cannot be ignored. Episodes of rapid dollar adjustments failed to inflict significant damage in the past, but with U.S. net external debt at record levels, an abrupt weakening of investor sentiments vis-à-vis the dollar could possibly lead to adverse consequences both domestically and abroad."[14] Some economists have been raising this specter of the worst case scenario – a so-called "hard landing." The Committee on Economic Development, in an excellent analysis of the consequences of our increasing deficits, pointed out that "The U.S. economy will not be immune to sudden changes in interest rates, exchange rates, and asset prices if it comes to depend on ever-larger financial inflows, especially if the Euro begins to emerge as a competitive reserve asset."[15] Indeed, in a 1995 paper, current Chairman of the Council of Economic Advisers N. Gregory Mankiw and Johns Hopkins professor Laurence Ball wrote that "despite the vagueness of fears about hard landings, these fears may be the most important reason for seeking to reduce budget deficits… If policymakers are prudent, they will not take the chance of learning what hard landings in G-7 countries are really like." [16]

Even over the last few years, as recession, historic monetary easing and weak investment demand have kept nominal interest rates seemingly low, many independent analysts have pointed out that even now interest rates would be lower without the massive fiscal deterioration that has taken place under this Administration's watch. In early 2002, Goldman Sachs's chief strategist Abby Cohen noted long-term interest rates had not dropped as much as expected and that "the reason is that many investors are concerned about the long-term implications of the change in fiscal policy... The very large tax cut that was implemented just a few months ago really puts us toward the edge of ... losing all of the surplus that we might have enjoyed." [17] Federal Reserve Chairman Alan Greenspan had a similar assessment, noting that "some of the firmness of long-term interest rates probably is the consequence of the fall of projected budget surpluses and the implied less-rapid paydowns of Treasury debt."[18]

Financial analysts at the top investment banks have recently echoed the view that even now deficits have been keeping long-term rates higher than they otherwise would be. In November, David Rosenberg of Merrill Lynch wrote that "the current fiscal stimulus is masking is an

---

[13] Robert E. Rubin, Peter R. Orszag, and Allen Sinai, "Sustained Budget Deficits: Longer-Run U.S. Economic Performance and the Risk of Financial and Fiscal Disarray," paper presented at the AEA-NAEFA Joint Session, Allied Social Science Associations Annual Meetings, The Andrew Brimmer Policy Forum, "National Economic and Financial Policies for Growth and Stability," January 4, 2004.
[14] International Monetary Fund, "U.S. Fiscal Policies and Priorities for Long-Run Sustainability," January 7, 2004.
[15] Committee for Economic Development, "Exploding Deficits, Declining Growth: The Federal Budget and the Aging of America" March 2003.
[16] Laurence Ball and N. Gregory Mankiw, "What Do Budget Deficits Do?" *Budget Deficits and Debt: Issues and Options*, Federal Reserve Bank of Kansas City, p. 117.
[17] *Face the Nation*, January 6, 2002.
[18] Remarks At the Bay Area Council Conference, San Francisco, California January 11, 2002

undeniable rise in real long-term interest rates – up more than 100 basis points in the past year after adjusting for the trend in the core CPI."[19] Similarly, Ed McKelvey of Goldman Sachs recently noted that the spread between long-term interest rates and short-term rates is "extraordinarily steep" and that the "steepening occurred at a time when official projections of the deficit were rising sharply, among other things."[20]

C. Leaving future generations less prepared for unexpected challenges

The massive deficits the Bush Administration has run up will also leave future generations in a poorer position to respond to the unforeseen rainy days in an uncertain world. A major reason that our government was able to respond so easily to the concurrent challenges of a recession, the aftereffects of a terrorist attack, and the war in Afghanistan and Iraq, was President Clinton's policy of saving surpluses. When the current Administration took office, there was a $359 billion <u>surplus</u> projected for 2003. In actuality, 2003 came in with a $374 billion <u>deficit</u>. In other words dues to a weak economy, terrorism and war and tax cuts – we saw a swing of nearly 7% of GDP – from a surplus of about 3.3% of GDP to a 3.5% deficit. While large, a deficit of this magnitude is not dangerous if it is temporary. But imagine if the previous Administration had been satisfied to leave this Administration with a projected deficit of $374 billion. In that case, the fiscal swing we witnessed would have left us with deficits in excess of $1 trillion, or 10% of GDP. While one would have expected our recent national experience to bolster the sense of the importance of savings to ensure we can always respond with strength to unexpected crisis, this Administration has if anything used it to suggest that fiscal prudence is a trite and unnecessary concern if it comes at the expense of a new round of excessive and long-term tax cuts.

IV. The Pattern of Reverse Generational Responsibility Continues: Super Back-Loading

There are today significant signs that the Administration plans to continue their same fiscally reckless pattern: employ policies of reverse generational responsibility, and as usual, employ devices to hide the true nature of the generational trade-offs. Indeed, they seem to be going even further in their efforts to hide the true trade-offs by employing what one might call "super back-loading." While usually back-loading strategies involved hiding the true long term costs by not showing the full costs for five or ten years, this new strategy involves designing proposals to have virtually no cost today, while back-loading enormous costs not just 5 or 10 years from now, but decades into the future. It is crucial that responsible policymakers and journalists expose and force debate on the true costs and tradeoffs of such proposals.

A. The New Bush Savings Accounts Proposals

When I was in the White House, we used to have a joke that an easy way to balance the budget this year would be to make everybody an offer: you can get 50% off next year's taxes if only you

[19] Merrill Lynch, "Forecast Addendum: 4% in 2004!," Economic Commentary, November 10, 2003.
[20] Goldman Sachs, "Daily Financial Market Comment: Potential Instability from Large Budget Deficits," January 7, 2004.

pay them today. The problem, of course, was that accelerating expected revenues to make today's fiscal problems easier was a the expense of creating shortfalls in the future.

The Administration's proposal to create new Retirement Savings and Lifetime Savings Accounts appears to be taking this joke seriously. Last year, the Administration advertises the accounts as costing the federal government next to nothing – only $2.0 billion over ten years. But when we expose the true back loaded costs of these accounts, we see that, over time, they would seriously undermine the long-term budget outlook. *Brookings Economist Peter Orszag has estimated that the full costs over the long term would create a new hole ½ as large as the current Social Security shortfall.*

Under the proposal introduced last year, all traditional and Roth IRAs would be replaced by Retirement Savings Accounts (RSAs) – essentially Roth IRAs with higher contribution limits and no income limits, that would allow each individual to contribute up to $7,500 a year. It also creates a new type of account, Lifetime Savings Accounts, which allow individuals to contribute an additional $7,500 a year in tax-sheltered accounts that they can withdraw from at any time without any restrictions.

By eliminating traditional IRAs – where contributions are tax free but withdrawals down the line are taxed – and only giving people the option of contributing to Roth-style IRAs – where taxes are paid upfront – the proposal quite literally takes for today the taxes that our budget projections are assuming will be collected 10, 20, or 30 years down the line. In other words, it holds down the price tag for our generation by shifting even more of the costs onto future generations. And because individuals would receive all the compounding interest and returns that build up in their account tax free, the costs would balloon over time. While the Administration could, of course, be open about these long-term costs and propose an offset to pay for them, so far the Administration has never practiced such a pay-as-you-go discipline involving any tax cut they have proposed.

<u>Little effect on private savings:</u> Proponents of the accounts may respond that the loss in public savings will be compensated by an increase in private savings, since the accounts are meant to help people save more for their future. But in fact, the accounts are likely to encourage little new private savings. Academic evidence shows that the upper-income individuals overwhelmingly respond to new savings incentives by shifting existing savings to capture tax windfalls, rather than increasing their overall savings.

In a review of the academic literature by the Congressional Research Service, Jane Gravelle concluded that "in general … neither conventional economic theory nor the empirical evidence on savings effects tends to support an expectation that increased IRA contributions are primarily new savings."[21] The same applies to the Bush proposals, whose main effect is to raise the

[21] Jane G. Gravelle, "Individual Retirement Accounts (IRAs): Issues, Proposed Expansion, and Retirement Savings Accounts (RSAs)," September 15, 2000. See also Eric M. Engen and William G. Gale, "The Effects of 401(k) Plans on Household Wealth: Differences Across Earnings Groups," NBER Working Paper No. 8032, 2000, William G. Gale and John Karl Scholz, "IRAs and Household Saving," American Economic Review, December 1994, Orazio P. Attanasio and Thomas De Leire, "IRA and Household Saving Revisited: Some New Evidence," NBER Working Paper No. 4900, 1994, and Eric Engen, William G. Gale, and John Karl Scholz, "Do Savings Incentives Work?" Brookings Papers on Economic Activity, 1994.

maximum amount a family can contribute each year to tax-preferred savings accounts. A CBO analysis of the proposals found that "Most taxpayers would simply save the same amount in one of the new accounts as they would have saved in one of their current tax-free accounts. Moreover, people who currently have assets in taxable accounts could reduce their tax liability by selling those assets and putting the cash from the sale into the tax-preferred accounts--an action that would have no effect on private saving."

<u>Does nothing to fix our upside-down system or fill gaping retirement savings gaps</u>: It is worth noting that for all its long term costs, this proposal does not do anything to help those who in our current system have the most difficulty saving begin to prepare for their retirement. Consider that only about 5% of workers are currently making the maximum contribution to the IRAs or 401ks available to them. The other 95% either do not save enough to "max out" their accounts, or do not save at all. In any given year, 92 percent of the working poor—and 74 percent of all Hispanic workers—lack an employer-provided retirement account. And a disturbing 86 percent of part-time workers and 83 percent of employees working in small firms have no 401(k)-type account.

A large part of the problem is that we have an upside-down savings system based on tax deductibility that operates according to the motto: "The easier it is for you to save, the more we help; the harder it is for you to save, the less we help." A family who makes $500,000 and is in the 35% tax bracket gets an immediate 35¢ tax break for every dollar it saves, while a family who makes $50,000 and is in the 15% bracket gets only 15¢ on every dollar it saves. And a hardworking family of four, making $25,000 and among the 33 million taxpayers who do not make enough to owe income taxes, gets no incentive to save whatsoever.

The Bush proposals do nothing to turn the system right-side up or to plug the holes in our system. Because the main feature of the proposal is to raise the contribution limits on tax-free savings accounts, it benefits only those lucky 5% who would have been contributing the maximum to their accounts, and does virtually nothing for the other 95%.

In addition, the Bush plan will likely lead to even less small business employees being covered by a 401k plan. With the LSA and RSA plan a small business owner with two kids could put away $45,000 and never pay taxes on the earnings without providing a single penny of assistance to their workers. As Small Business Council President Al Martin stated, "there would be little incentive for a new small business owner to establish a plan…it would gut the small business retirement system."

B. Social Security Reform

It is also crucial that those who care about fiscal responsibility keep a close eye for similar super back-loading or free lunch Social Security reform proposals by this Administration and their allies. While the Administration contemplates its next steps on rolling out a reform agenda, we have seen a number of recent reform proposals that are serious cause for concern. Not only do they practice reverse generational responsibility, but they turn the very logic of Social Security reform on its head.

The fundamental rationale behind generationally responsible Social Security reform is that we need to save more resources today to help reduce the burden on future generations. Whatever type of reform you support, the idea of taking action today is to find a way to address the inevitable future costs early on, so that tomorrow's workers will face less severe choices between painful benefit cuts or tax increases. In the 1990s, even many proponents of individual account plans – which entail so-called "transition costs" of financing traditional benefits while diverting a share of payroll taxes into individual accounts – were willing to acknowledge these costs and use the large surpluses to pay for them up front.

Today, we are seeing a series of plans that not only fail to acknowledge the future costs associated with reform, but actually make our future shortfall bigger, and then use gimmicks and tricks to say they have solved the problem. Take, for example, the recent proposal by an Institute for Policy Innovation economist, which has been touted as demonstrating that a Social Security reform plan involving individual accounts makes it possible to close the long-term financing gap without benefit cuts or tax increases.[22] A close look at the plan reveals that the individual accounts themselves have nothing to do with closing the gap – in fact, the Social Security Actuary's analysis of the plan shows that the individual accounts in the proposal actually *worsen the gap by nearly half*. Instead, the plan assumes that the gap will be covered by massive general revenue transfers – totaling $6.9 trillion in present value, or close to double the size of the existing Social Security gap – and gives no indication where such resources might be found.[23] The Center on Budget and Policy Priorities points out that the necessary cuts could equal half the non-defense discretionary budget, excluding homeland security.[24]

A similar plan put forward by Representative Jim DeMint would "solve" Social Security in part by taking out massive loans from the future. The plan envisions the Social Security system selling bonds to help ensure that the Social Security trust fund maintains enough cash on hand to pay benefits while transitioning to individual accounts. The cash balance of the Social Security system remains positive, but only by incurring huge debts that the system will have to pay off later. Because of those debts, the plan does not actually succeed in restoring actuarial balance to the system. (The DeMint plan also relies on general fund transfers, to the tune of $3.5 trillion in net present value.) Similarly, during President Bush's 2000 campaign, economic advisor Larry Lindsey noted that the Social Security plan discussed by the campaign might have to rely on what he called "a bridge loan."

These Alice-in-Wonderland plans are reverse generational responsibility in its purist form. Instead of saving more now to help ease the burden on future generations, these proposals borrow from future generations to help ease an ideological victory for those who support carve-out individual accounts at any costs. As a nation, we always have the bad option of solving Social Security by simply taking out more and more debt. Plans that restore solvency by simply

---

[22] See Ferrara, Peter. "A Progressive Proposal for Social Security Private Accounts" IPI Policy Report # 176, June 13, 2003.
[23] Steve Goss, "Estimated Financial Effects of the 'The Progressive Personal Account Plan," Social Security Administration, December 9, 2003.
[24] Greenstein, Robert and Richard Kogan. "The Ferrara Social Security Plan." *Center on Budget and Policy Priorities,* December 22, 2003.

promising hundreds of billions of dollars of additional borrowing contribute nothing that could not be done through complete government irresponsibility.

A long term Social Security and Medicare solvency plan may indeed need to rely on some general revenue financing, but the test should be whether it explicitly identifies the specific source of revenues or spending that will be directed toward Social Security – so that we do not have a plan based solely on new borrowing from the future and so we can evaluate the trade-offs being made as opposed to leaving them to those in the future. One proposal I have made is to make one part of a Social Security reform a 3% across-the-board surcharge on all income over $200,000 devoted to Social Security reform.

I. <u>Restoring Generational Responsibility</u>

The only way to undo the damage done by the Bush Administration's revenge on generational responsibility is to restore to Washington a bipartisan commitment to shared responsibility in creating an economic agenda for shared growth and fiscal responsibility.

Beyond their budgetary and economic impact, the Bush Administration's fiscal policies have undermined the basic commitment to a fiscally responsible pay-as-you-go framework that had such broad bipartisan support in the 1990s. They have put even those who would like to compromise and make the tough choices necessary to start addressing pressing issue today in an impossible position. How can a Democratic member of Congress look a constituent in the eye and tell them that in order to address Social Security solvency or Medicare reform in a generationally responsible way, there is simply no choice but to ask them for some sacrifice when in the past few years the Congress and Administration was willing to support dramatic long-term tax relief for the most well-off? This cynical fiscal reality has had a chilling effect on any viable effort to make progress on long-term entitlement reform.

A renewed commitment to generational responsibility should start with a willingness of all sides to demonstrate the necessary sacrifices to move forward. At a minimum, we should roll back the components of the Bush tax cut aimed at the most well-off, including the top two rate cuts and capital gains cuts for the well-off, and only do dividend tax relief as part of a revenue-neutral corporate tax reform. In addition, while we should be willing to raise the estate tax exemption to $5 million per couple, complete repeal for even the wealthiest estates is beyond sound justification. With a $5 million per couple exemption, we could ensure that 99.5% of estates would be completely exempt, while saving over $100 billion in the coming decade and about $500 billion between 2014 and 2023. We should also be open to larger tax reform ideas that seek to close our large fiscal hole while making our tax code simpler and more progressive.

<u>Expanding Access to Savings and Wealth Creation – A Universal 401k:</u> Finding policies that address our nation's declining savings rate while increasing the number of savers in our country is critical both for putting tomorrow's retirees in a better position to cover the costs of their retirement and for increasing savings and long-term productivity in our economy. As explained above, Bush's retirement savings proposals do the opposite – they would create little new private savings, while blowing a huge hole in long-term deficit and doing little to address the fundamental upside down nature of our savings system.

To get serious about putting the country on a generationally responsible path for retirement security, we need to turn savings right-side up. A first step could be to fund a bold new program of universal 401(k) accounts to help all Americans build a better future for themselves and their children. Such accounts could provide matching contributions through refundable tax cuts on the first $1,000 that middle-income individuals deposited into the accounts each year, and offer extra two-to-one matches to help the poorest families save.

Such a plan would not only help tens of thousands of families become part of the savings and wealth creation class, but it would ensure a positive contribution to private savings. By targeting incentives at those who are currently struggling to save, the new accounts would actually create new savings, rather than simply encouraging high-income individuals to shift their existing savings to gain tax windfalls. A Universal 401k should be revenue neutral over time. It could be substantially financed in the future by limiting the estate tax exemption to $5 million per couple and using the revenue that the Administration is seeking to use for complete repeal to fund the Universal 401k instead. This would ensure that the new accounts not only increased private savings but net national savings as well. And if financed n this manner, a Universal 401k would essentially turn a tax cut for the wealthiest 0.5% of families in the US into a refundable tax credit for tens of millions of families.

Some conservatives will object to the government providing a matching contribution for savings as a new entitlement program. Such a criticism not only ignores the value of such an initiative as an investment in reducing the burden of retirement on future generations, but also ignores that such an "entitlement" is exactly what the government currently offers every member of Congress and the Administration right now.

<u>Progressive Investments in Children</u>: Taking a generational responsible view also means not letting the Bush Administration's strategy crowd out critical investments in our children. Not do we have a moral obligation to address the lingering problem of child poverty in the US – which in 2002 stood at 16.7% for all children and an unconscionable 32% and 29% for black and Hispanic children respectively – but there is consistent and compelling evidence that such investments can significantly increase the future productivity of our economy.

Targeting high-return investments in our children is an important way that we can invest in our future, rather than borrow from it. Consider the issue of universal quality preschool. A growing body of evidence has shown that early interventions are critical for developing the basic cognitive capacities that increasingly define success in our dynamic, flexible workforce. In addition, providing a safe learning environment for young kids makes their parents more productive by giving them more flexibility in the workforce. Launching a bold new effort to achieve universal preschool in the US could end up with a big price tag, in the $30 billion a year range. This is a significant expense, but is only 10% of what all of the Bush tax cuts will together be costing us each year in the coming decade. And investments in universal preschool, afterschool, and early intervention strategies to get more disadvantaged kids into college are the types of productivity enhancing investments in our children that we should not allow to be crowded out by reverse generational responsibility elsewhere in our fiscal policy.