With the passage of the American Taxpayer Relief Act of 2012 (ATRA) the fiscal cliff was averted. The debt ceiling limit also appears to be remedied, at least temporarily. However, without further negotiations between Democrats and Republicans the automatic spending cuts scheduled for March will take place.

The ongoing legislative battles are an enduring vestige of the Budget Control Act from August 2011. Back in August of 2011, legislators were facing a debt ceiling limit and they passed legislation that established and empowered the “Super Committee” to reduce the debt. Ultimately, the Committee was deadlocked and no proposal was offered for a vote. As a backup plan, the Budget Control Act also set in place tax increases and the automatic spending cuts scheduled to begin this year. Had they all remained in place, they would have dramatically cut the deficit. The dramatic deficit reduction from the Budget Control Act as well as the expiration of the tax cuts passed at the end of 2010 was given the “fiscal cliff” moniker.

So, a practical move toward balancing the federal government’s books was tagged with an ominous name, and a bill that raises taxes is known as a tax relief act. In addition, the tax relief act undid the scheduled cuts in Medicare payments to doctors. These cuts were necessary to keep Medicare growth “sustainable,” but this year’s override of the sustainable growth rate mechanism follows the pattern of the last decade.

Is there any hope that the coming debate over the automatic spending cuts will force the two sides to meaningful and enduring legislation? Maybe something called the Budget Control Act – Part II? Unfortunately, one side argues that spending is too high and that taxes are OK, while the other argues that the spending level is OK and tax revenues must rise. This is, of course, a simplification of the two sides’ positions. Balancing the budget in the long run requires that revenues match spending, but debt reduction requires that revenues exceed spending. How can we balance the budget and reduce the debt when there is such entrenched disagreement over spending and taxes?

A long-run view of federal spending and taxes will help us understand how the present mismatch in revenues and spending compares to the past. Figure 1 depicts federal spending and taxes since 1960 as a percent of GDP. What is remarkable is that the federal government only ran a surplus in 6 of the 49 years from 1960 and 2008 - before the current economic downturn. Over this period, federal spending averaged 20.2 percent of GDP, and federal revenues averaged 18.1 percent, for average deficit spending of 2.1 percent of GDP. Thus, even at the end of the four surplus years between 1998 and 2001, the debt held by the public was 33 percent of GDP.

For the years during and following the economic downturn, 2009 to 2012, tax revenues averaged 15.4 percent of GDP while spending averaged 24.4 percent. After years of deficit spending, the debt held by the public stands at 73 percent of GDP.

Is it that spending is too high or that tax revenues are too low? If we consider just the last four years the answer is that we have both a spending and a revenue problem. But what is the source of the problem in the future? The figure also depicts two sets of forecasts for 2013 to 2022. One is based on the Congressional Budget Office’s (CBO) Baseline Budget projections and indicate that revenues would have
Determining whether we have a spending or a tax revenue problem can be assessed by comparing the ATRA forecasts with the federal government’s long-run spending of 20.2 percent of GDP by 2022. The projected spending is 2.3 percentage points higher than the long run average and revenues are 1.1 percentage points lower than the long run average spending – though they are higher than the long-run average tax revenues. Thus, running a balanced budget of 20.2 percent of GDP, requires spending cuts of about 10 percent and tax revenue increases of about 6 percent. This means that the spending problem is larger than the revenue problem.

But, who says federal spending of 20 percent of GDP is optimal? Should it be higher or should it be lower? The figure only indicates that over the past 50 years spending has fluctuated around the 20 percent mark. However, the entitlement programs as currently structured will require higher future spending. For more than two decades, policy wonks of all stripes have warned that with the retirement of the Baby Boom generation, our elderly entitlement programs – Social Security and Medicare – would either engulf the entire federal budget or lead to a permanent increase in government spending as a share of the economy. The Baby Boom generation has already begun its retirement; the oldest members turn 67 this year. Though the march toward higher federal spending on elderly
entitlements has begun, there are avenues worth exploring that limit future growth.

A Social Security specific financing crisis back in 1983 led to long- and short-range adjustments to the program. At that time, the short-run adjustments were primarily on the revenue side through higher taxes on workers and on benefits, while the spending constraints resulting from the increase in the retirement age were delayed for twenty years. Given that we do not have the luxury of favorable demographics and because the financing crisis is government-wide, the reforms to Medicare and Social Security cannot be postponed.

Of the recent Social Security reform ideas, only the cost of living adjustment would affect current and near-retirees. The other reforms are typically phased-in over time. The ideas gaining traction on both sides of the aisle include accelerating the increase in the retirement age, letting it eventually rise to 70 and then indexing it with longevity gains. The retirement age adjustment is often paired with reducing the percent of higher income retirees’ incomes replaced by Social Security benefits. Together these reforms can ultimately achieve spending levels comparable to current spending as a percent of GDP.

On the Medicare front, the Affordable Care Act (ACA) dramatically reduced forecasted Medicare spending. The Act’s provisions along with the assumption that the sustainable growth rate mechanism remains in force (not a reasonable assumption given the past legislative history overriding it) suggests that Medicare spending per capita will grow at about the same rate as per capita GDP growth.

This forecast is largely the result of the ACA’s productivity adjustment provision requiring that hospitalization insurance payments are reduced by the productivity growth in the economy. Thus, on paper, the ACA squeezes the excess growth in health care spending out of Medicare. If this were to actually occur, the Medicare spending problem would be largely eliminated.

The long run per capita growth rates in the two annual Medicare Trustees Reports produced after the passage of the Act were in the neighborhood of per capita GDP growth, but the most recent Trustees Report had a slightly higher forecast. While these forecasts suggest that future Medicare spending is under control, all three of the post-ACA Trustees Reports have been careful to point out that the spending ceilings would result in severe access to care problems for Medicare patients, and that the forecasts are extremely favorable. Nonetheless, the provisions that produced the favorable forecast were in the ACA legislation, and, as such, the forecast is implicitly the budgetary goal of the ACA supporters.

The price ceilings that produce the ACA’s spending target may not be reasonable, but there are alternative ways to achieve the same spending. Namely, adjusting the retirement age to conform with the Social Security retirement age, as suggested above, combined with a means-tested, defined Medicare benefit can achieve the same spending as in the President’s two most recent budgets.

While the Social Security and Medicare reforms reduce the growth spending relative to the spending with no reform, overall federal spending as a share of the economy will grow nonetheless. Assuming Medicare spending follows the pre-ACA path, that Social Security is not reformed, and that the rest of federal spending remains at its pre-recession share of GDP, federal spending will grow to almost 28 percent of GDP by mid-century. The reforms outlined above would only reduce federal spending to 25 percent of GDP by mid-century.

Thus, even with elderly entitlement reforms, additional revenues and/or lower spending elsewhere in the budget are necessary for a balanced budget. Collecting more revenues without additional adverse incentive effects requires revamping the tax code. Ideally we would move to a consumption-based tax and thereby reduce the many distortions caused by the current code. In the approaching deliberations about the automatic spending cuts, forward-looking changes to the tax code and entitlements can break the present cycle of legislative uncertainty hampering the economic recovery.