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Economic and Fiscal Conditions

Prepared statement by

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Perspectives on Deficit Reduction: A Review of Key Issues

This hearing has been postponed.

Today's policy debate is consumed by a false dichotomy between "jobs" and "austerity." The truth is that we face two severe problems: a very weak labor market right now and an unsustainable fiscal path over the medium- and long-term.

Both problems demand attention and action. The best policy response is thus an additional round of temporary job creation and other measures to bolster the weak labor market in the near term and a substantial amount of permanent deficit reduction enacted now but taking effect only with a delay, to reduce our unsustainable medium- and long-term deficits. The combination of "jobs and austerity" is more powerful than either piece by itself, and for both substantive and political economy reasons they should not be separated.

This analysis includes several policy recommendations:

- If enacted in combination with out-year fiscal consolidation measures, policymakers should provide additional macroeconomic support in fiscal year 2012 to mitigate the harm to the labor market from the significant fiscal tightening currently scheduled to occur between fiscal year 2011 and 2012. Rather than simply extending the existing payroll holiday, however, the best option would be to create a new automatic stabilizer, such as a payroll tax holiday that is not explicitly time-limited but

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rather tied to the level of the unemployment rate (that is, it remains in force when the unemployment rate is elevated and is triggered off as the unemployment rate declines). This option would calibrate its macroeconomic support to periods in which the economy is weak and automatically reduce its fiscal cost as the economy strengthens, even in the face of legislative gridlock (see further discussion below).

- The 2001/2003 tax cuts should not be extended unless their cost is fully offset by other spending reductions or revenue increases. In the absence of an offset, the 2001/2003 tax cuts should expire as scheduled at the end of 2012 unless the unemployment rate remains above 8 percent at that point, in which case they should be temporarily extended for another year on a rolling basis and allowed to expire in full when the unemployment rate declines below that threshold.

- Social Security should be reformed along the lines I propose with Peter Diamond of MIT.

- Policymakers should reform the tort system by providing an evidence-based safe harbor under the medical malpractice laws.

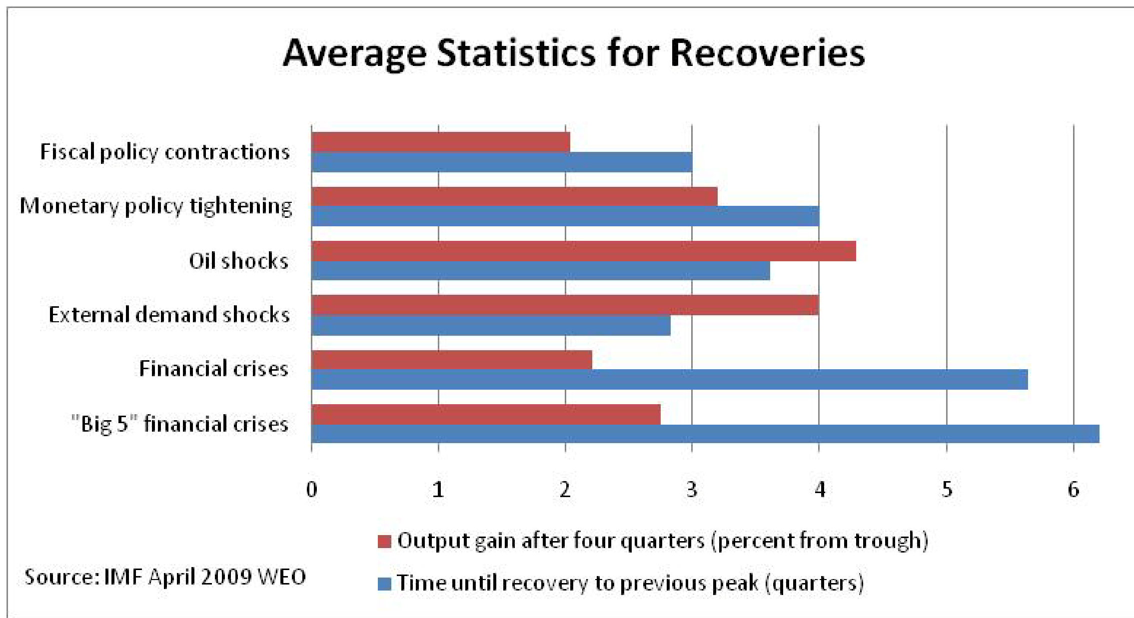
- Policymakers should create more mechanisms, like the Independent Payment Advisory Board and overall deficit or debt targets that are backed by a credible sequestration procedure, to minimize the chances that political gridlock leads to inaction in a structurally polarized nation. Expanding the automatic stabilizers, which automatically provide support to the economy when it is weak and automatically contract to reduce their fiscal cost when the economy recovers, would be consistent with this idea.

Current economic conditions

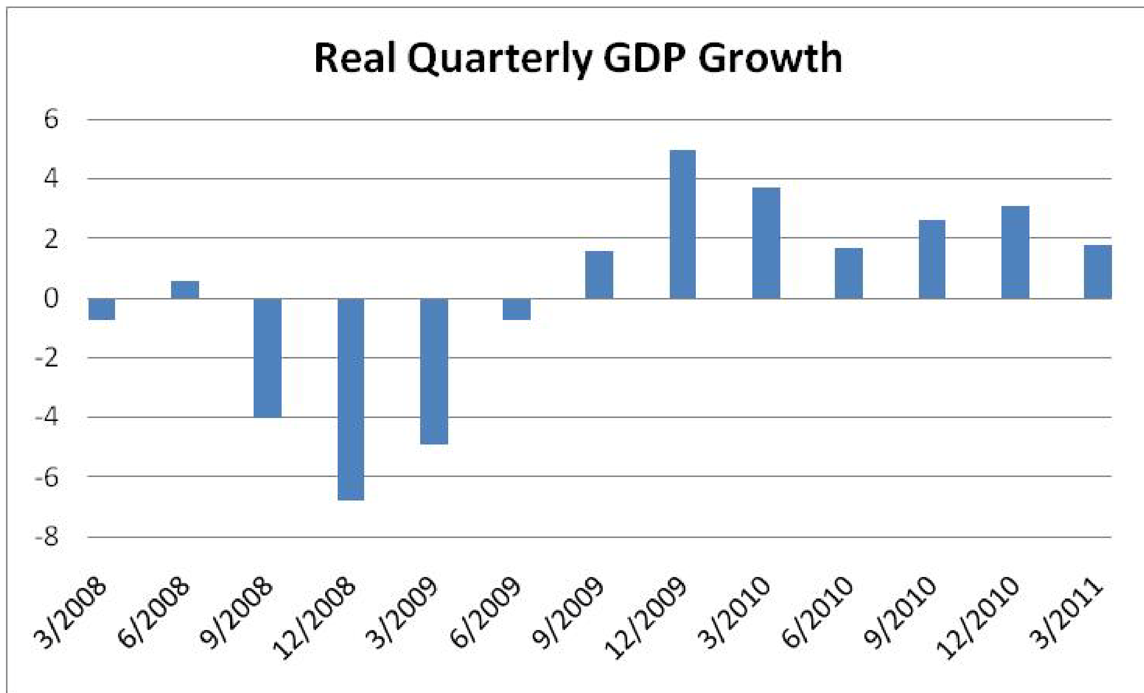
The first problem is the weak economy. In 2007, total private sector borrowing amounted to roughly 28 percent of GDP. In 2009, it was -17 percent of GDP. (By the first quarter of 2011, it had recovered to 0.2 percent of GDP.) Recessions associated with this type of financial disintermediation are fundamentally different than those caused by tightening monetary policy or the inventory cycle, as are the recoveries that follow them.[1] The figure below, taken from the International Monetary Fund, demonstrates the point. Economies recovering from financial crises take substantially longer to recover than economies recovering from other shocks.

In this broad context, the historical evidence would suggest a hard slog of sluggish growth for an extended period of time – most likely years, not quarters – even after our recovery began. Yet despite the burden of this history, we continue to be surprised that unrealistically heightened growth expectations are not realized.

[1] Carmen M. Reinhart and Vincent R. Reinhart, "After the Fall," NBER Working Paper No16334 (2010).



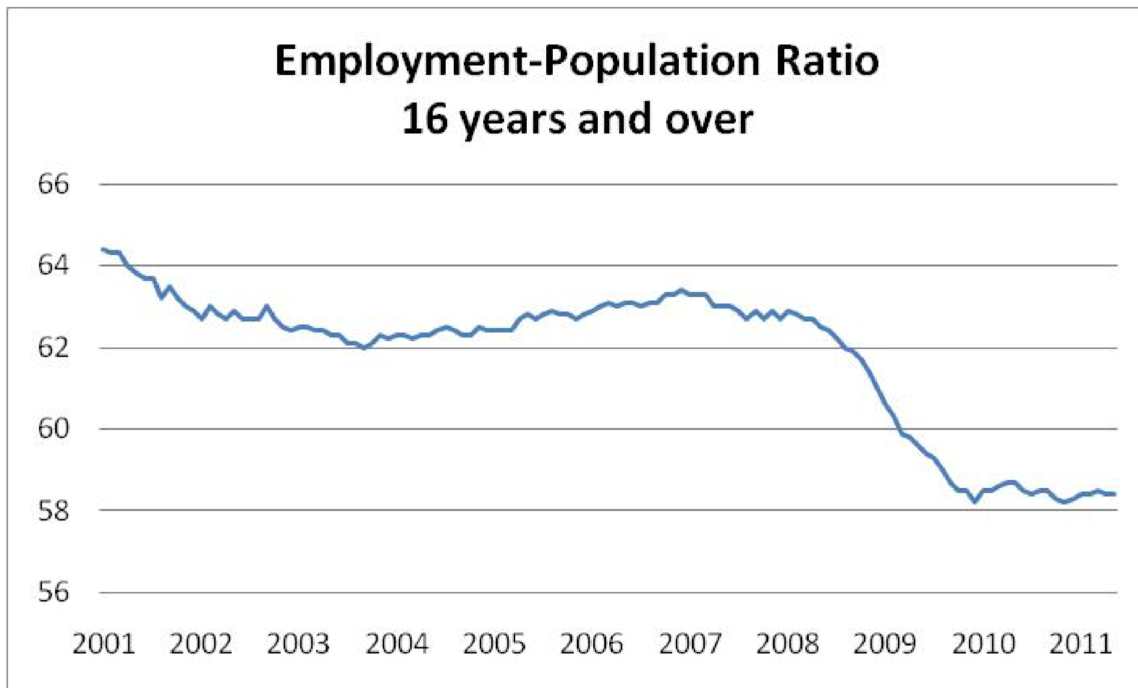
The chart below shows the recent pattern of real GDP growth in the United States by quarter. At the end of 2009 and in early 2010, it appeared that the economy was experiencing a v-shaped recovery, and thus escaping the historical examples illustrated by other financial-led downturns. Our growth, though, was fuelled disproportionately by ephemeral factors – including the Recovery Act and the inventory cycle – and faded before the second stage of a recovery could take hold. Again, at the end of 2010, growth appeared to be picking up and many economists began to expect strong growth for this year; but once again, it appears such expectations are not going to be realized.



Instead of continuing to raise false hopes that we will prove the exception to the historical experiences following downturns like the one we had, we should realize that the most reasonable expectation at this point is a prolonged

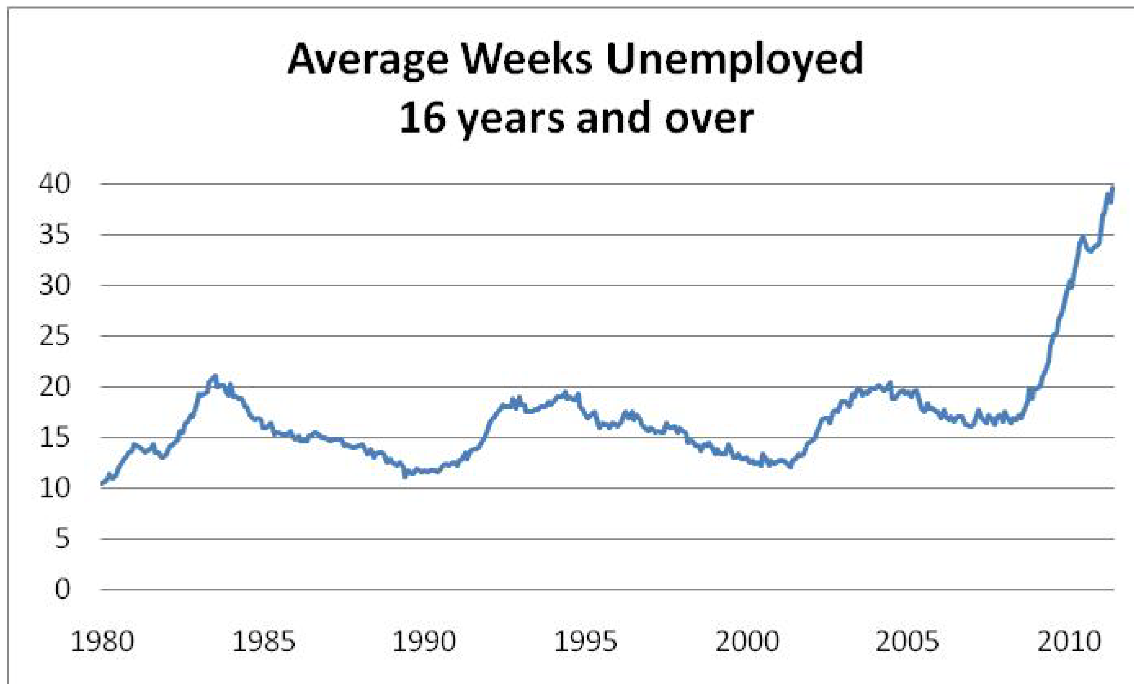
period of relatively slow growth, perhaps in the two to three percent range on an annual basis. And unfortunately at such low growth rates, the unemployment rate will decline only very slowly – if at all.

The labor market remains quite weak. The chart below shows the share of the population aged 16 and over who are working. As it shows, the share of Americans working declined substantially during the downturn, and it has not recovered since. Compared to the level ten years ago, about six percent less of the population is working now, which translates into roughly 15 million fewer people working now than would be the case if the employment-population ratio had remained steady.



At two to three percent GDP growth, it is unlikely that the labor market will strengthen significantly. For example, a popular version of Okun's law – the historical relationship between the change in unemployment and the growth in GDP – suggests that even 3 percent growth would reduce the unemployment rate by only about 25 basis points a year (e.g., from 9 percent to 8.75 percent).

The risk from a prolonged period of such weak labor markets is that workers will lose their attachment to the workforce and have their skills atrophy, creating a longer-term problem in terms of GDP per capita. Already, 6.2 million Americans have been unemployed for more than six months, and 4 million for more than 12 months. The median and mean duration of unemployment is 22 and 39.7 weeks respectively.



Another metric of the problems in the labor market is the sharp rise in applications for disability insurance. Over the past four years, DI applications are up almost 40 percent. It is implausible to me that, even with the effect from aging baby boomers, the underlying incidence rate of disability has increased by 40 percent within a five-year period. Instead, much of the increase is likely tied to poor labor market prospects – and research suggests this has occurred over a longer period of time as well.[2] In effect, when the economy is strong, a substantial number of people who could qualify for DI instead continue to work; when the economy is weak and their work prospects are diminished, they instead opt for DI. Unfortunately, people going onto disability insurance almost never leave the ranks to re-enter the workforce, in part because the system creates strong disincentives against doing so.

One significant risk we thus face is that we could suffer similar problems as continental Europe experienced during the 1980s. A temporary downturn led to a long-lasting problem in the labor market as workers' skills atrophied, their attachment to the workforce diminished, and more people went on disability benefit.

Given such weakness in the labor market, it is particularly important that policymakers avoid overly hasty fiscal consolidation. Official projections show fiscal tightening in excess of 2 percent of GDP under the Administration's budget between fiscal year 2011 and fiscal year 2012 (see table below).

To put those figures in context, the fiscal tightening in the U.K. – which has received so much attention in the press – amounted to less than 1.5 percent of GDP between 2010 and 2011. In other words, the tightening scheduled for next

[2] For example, see Mark Duggan and Scott Imberman. "Why Are the Disability Rolls Skyrocketing?" in *Health in Older Ages: The Causes and Consequences of Declining Disability among the Elderly.* David Cutler and David Wise, eds. University of Chicago Press, 2009. See also David Autor and Mark Duggan, "Supporting Work: A Proposal for Modernizing the U.S. Disability Insurance System," Center for American Progress and The Hamilton Project, 2010.

year in the U.S. is substantially more than the tightening already done in the U.K., which has proven to be so controversial.

Table: CBO Analysis of President's Budget, April 2011

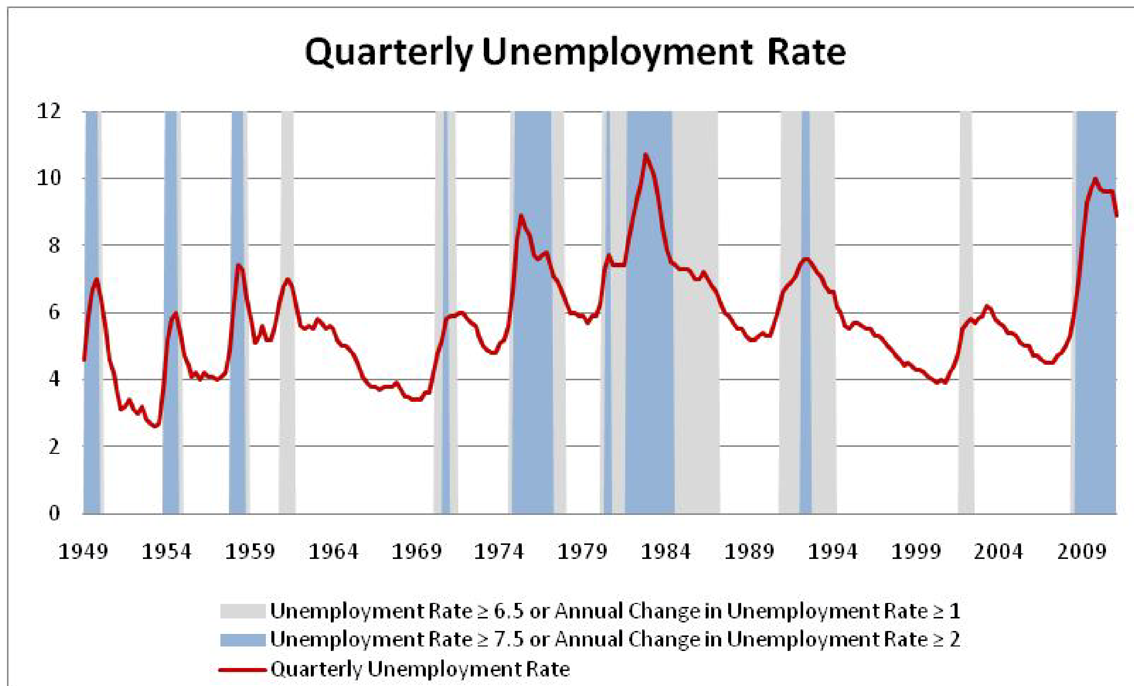
	2010	2011	2012
Total Revenues, % of GDP	14.9	14.8	16.2
Total Outlays, % of GDP	23.8	24.3	23.6
Total Deficit, % of GDP	**-8.9**	**-9.5**	**-7.4**

The Administration's budget suggests that the bulk of the projected adjustment is structural (that is, not caused by the slowly recovering economy). Although there are reasons to believe that the Administration's calculations may overstate the structural components of the budget adjustment, there is little doubt that a significant structural fiscal adjustment is in store between 2011 and 2012 under current policy.

To mitigate the harm on the labor market from this fiscal drag, policymakers would be well-advised to provide additional macroeconomic measures in 2012 (again, if enacted alongside deficit reduction measures for later years). One clear possibility is to extend or modify the existing measures – such as the payroll tax holiday and unemployment benefit expansions and extensions – that are currently scheduled to expire at the end of the year. Temporary measures of roughly 1 to 1.5 percent of GDP in fiscal year 2012, if enacted in conjunction with out-year deficit reduction steps, would be warranted.

A much better approach, however, would be to create a new automatic stabilizer – a payroll tax holiday explicitly linked to the unemployment rate. The benefit of this approach is that it automatically calibrates itself to economic conditions by providing support when the economy is weak and fiscal consolidation as the economy recovers (without the need for continued legislative action, which as I discuss further below is a major advantage); furthermore, it can be designed to provide an automatic and relatively smooth phase-down.

For example, policy-makers could enact a system under which the payroll tax would be reduced for the subsequent six months by two percentage points whenever the quarterly average unemployment rate exceeded 7.5 percent or had increased by more than two percentage points over the previous year. It would be reduced by one percentage point for the subsequent six months whenever the unemployment rate was higher than 6.5 percent or had risen by more than one percentage point. The chart below shows when this support would have been triggered in the past.

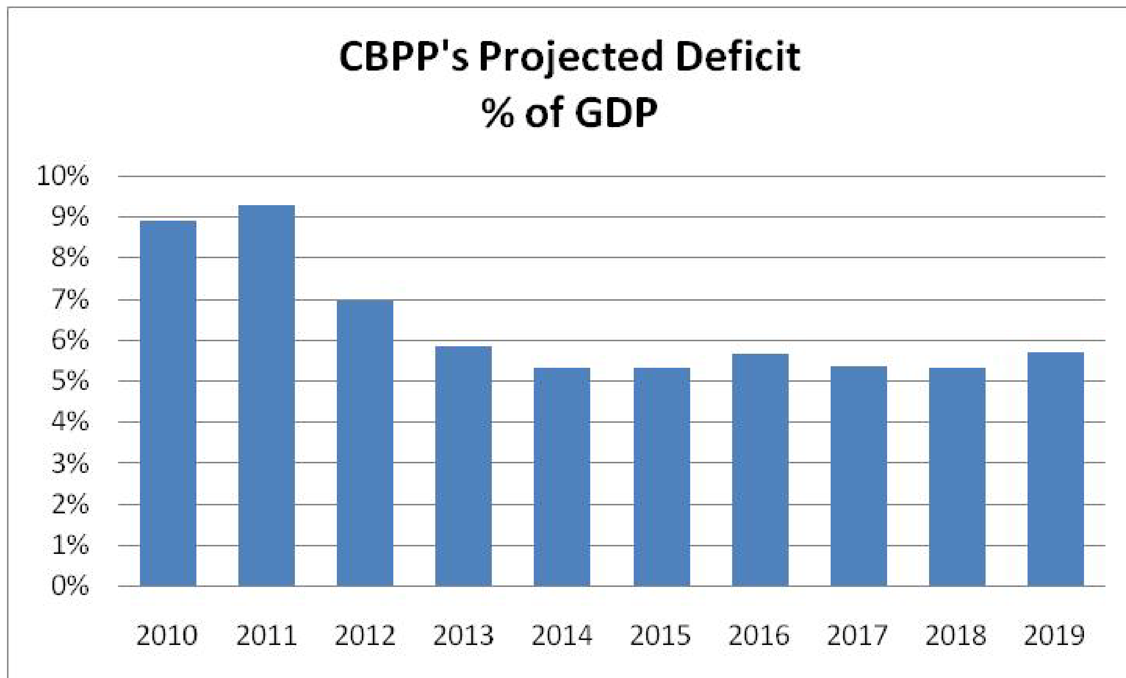


If necessary, this new automatic stabilizer could be made budget-neutral in expectation by raising the underlying payroll tax rate. The holiday could be provided on the employer or employee side, or split. On balance, I would opt for the employee side.

Fiscal trajectory

Additional macroeconomic support in the short run is needed but enacting it by itself would be a serious mistake. The reason is that we face a second serious problem: an unsustainable long-term fiscal course. In the face of a substantial medium- and long-term deficit problem, it is better for both substantive and political economy motivations to combine additional macroeconomic support with credible and significant out-year deficit reduction that is enacted now but takes effect in a few years. In the absence of being combined with medium- and long-term deficit reduction, additional macroeconomic support today would be at least partially impaired by continuing uncertainty and concern about our fiscal trajectory. *Although deficit reduction that takes effect immediately would be problematic, there is no substantive argument against enacting measures now to reduce the deficit over the next decade and thereafter.*

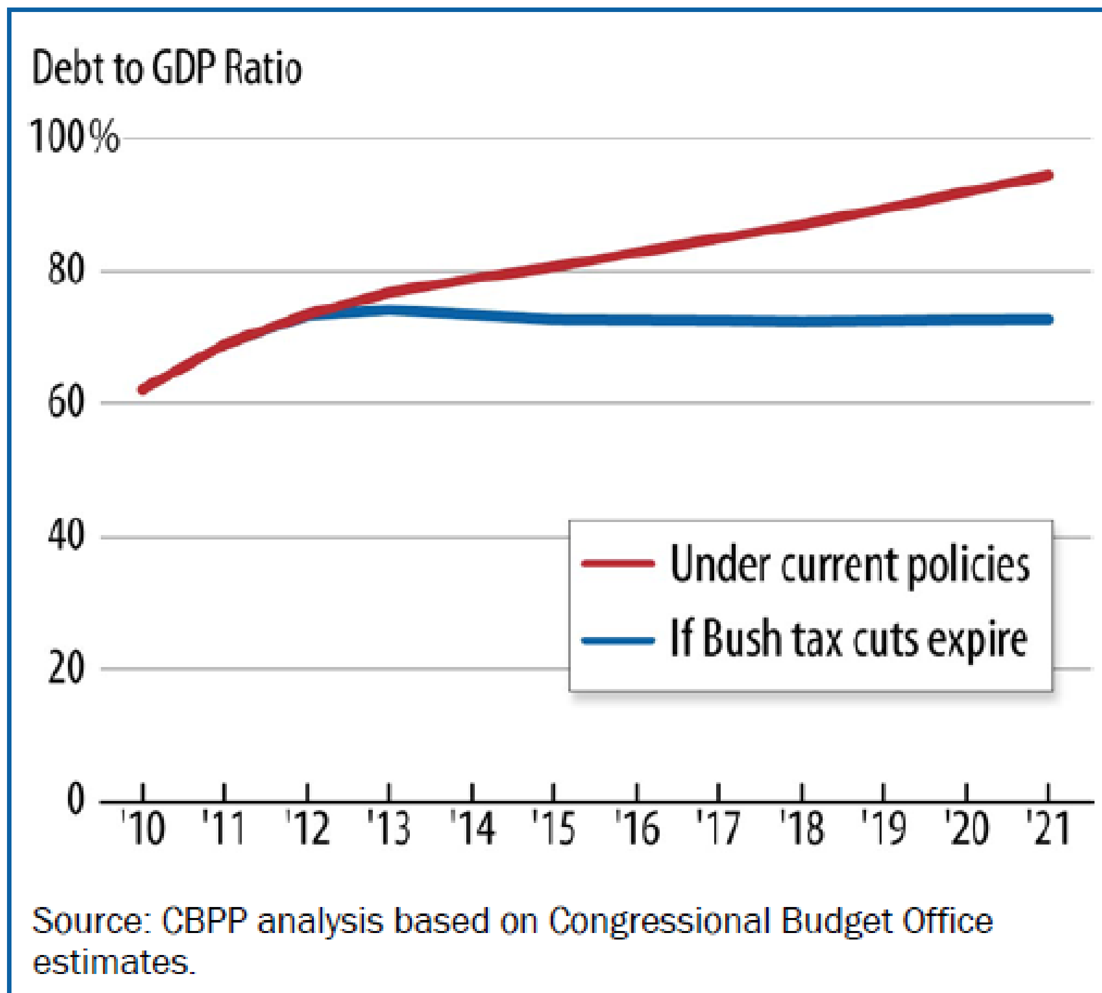
How should we address the medium- and long-term deficit problems? The deficit problem is different in 2015 than it is in 2050. The chart below, based on projections from the Center on Budget and Policy Priorities that adjust the official CBO projections for items such as the likely extension of expiring tax provisions, illustrates the 2015 problem. As the economy recovers, the deficit is projected to decline from about 10 percent of GDP to about 5 to 6 percent of GDP. (These projections, by the way, assume a more robust recovery than may occur in the wake of a financial-led recession. To the extent that the economic recovery is in the range of 2 to 3 percent rather than the 4 to 5 percent assumed by CBO for the next few years, the projected deficit will be even higher than shown here.)



A deficit of 5 to 6 percent of GDP implies continued upward drift in debt as a share of GDP. Stabilizing debt as a share of the economy requires a deficit more in the range of 3 percent of GDP. We thus face a 2 to 3 percent of GDP gap in 2015 between the projected deficit and the deficit that would be consistent with a stable fiscal trajectory.

Given the inevitable phasing in of any changes to entitlement programs, I am skeptical that more than about 0.5 percent of GDP can come on the spending side of the budget by 2015. The implication is that a substantial revenue piece will be necessary.

There is no easy way to obtain the necessary revenue. Among the difficult choices, I continue to believe that the best approach is to insist that the cost of the 2001 and 2003 tax cuts be offset through other measures if they are extended. If the requisite offsets cannot be found, the tax cuts should be allowed to expire in full. That approach has three significant benefits. First, it is the only substantial revenue increase that requires only 34 votes in the Senate. Every other substantial revenue increase requires either 50 or 60 votes. Second, it has the benefit of familiarity: it would return the tax code to roughly the form it had in the 1990s. That tax code was far from perfect, but at least it provides real-world assurances that adopting it would not lead to economic disaster. Finally, it would raise roughly enough revenue to stabilize the debt, as the chart below illustrates. (Note that extending the tax cuts but offsetting their cost through other measures would achieve the same result.)



Health care and the 2050 deficit problem

The 2050 deficit problem is driven disproportionately by health care costs. CBO projects that between now and 2050, Medicare, Medicaid, and other Federal spending on health care will rise from 5.5 percent of GDP to more than 12 percent.

Social Security costs, by comparison, are projected to increase from 5 percent of GDP to 6 percent over the same period. Although Social Security is not a significant contributor to the fiscal deficit in either 2015 or 2050, it would still be desirable to put the system on a more sound footing. Professor Peter Diamond of MIT, a Nobel prize winner in economics, and I have put forward an approach to doing so in *Saving Social Security: A Balanced Approach.*[3]

[3] Peter A. Diamond, and Peter R. Orszag, *Saving Social Security: A Balanced Approach,* Brookings Institution Press, Revised Edition, 2005.

With regard to health care, as I argue in a new *Foreign Affairs* article, there are four basic approaches to reducing costs over time:[4]

- The first approach is to simply reduce payments to providers -- hospitals, doctors, and pharmaceutical companies. This blunt strategy can work, often quite well, in the short run. It is inherently limited over the medium and long term, however, unless accompanied by other measures to reduce the underlying intensity (i.e., quantity per patient) of services provided. If only Medicare and Medicaid payments were reduced, for example, providers would shift the costs to other patients, and also accept fewer Medicare and Medicaid patients, creating access problems for such beneficiaries. This, in turn, would make the approach politically unviable.

- The second approach is direct rationing, whereby the government decides which services will be offered and which not. This approach is not remotely politically viable in the United States, where people have grown accustomed to access to new technology and procedures and where anti-government sentiment is strong. Single payer systems use some combination of the first and second approaches to generate both a lower level of and slower growth of costs than in the United States.

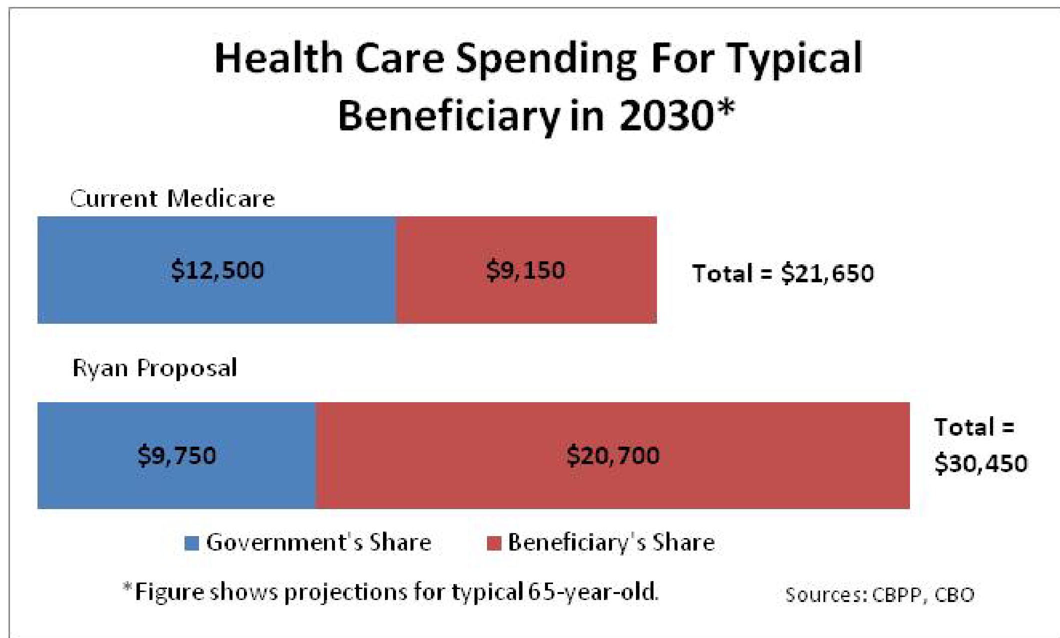
- The third approach -- consumer-directed health care -- could be a useful component of a cost-reduction strategy, but its benefits are often exaggerated. The emphasis in consumer-directed health care is to give consumers stronger financial incentives to reduce their own spending and more information and control over their health care. The goal is to ensure that patients have a greater stake in keeping costs down through increased co-payments and other forms of cost-sharing.

  If most health care spending were driven by discretionary decisions among relatively healthy people with low costs, this approach could cut costs dramatically. The core problem with the consumer-directed approach, however, is that health care costs are instead heavily concentrated among a small number of very ill patients. The top five percent of Medicare beneficiaries ranked by cost, for example, account for more than 40 percent of total Medicare spending, and the top 25 percent account for more than 85 percent of total costs. Financial incentives can have some effect on these people's decisions, but under virtually all consumer-directed proposals, they would still be covered by generous third-party insurance for their high-cost procedures -- which is, after all, the whole point of insurance.

  The consumer-directed approach is at the heart of a reform to Medicare put forward in April by Representative Paul Ryan (R.-Wisc.), the chairman of the House Budget Committee. Under Ryan's approach, Medicare would be transformed into a "premium support" plan, whereby the government would pay the premium for private health insurance plans chosen by beneficiaries. Ryan's plan appears to save substantial sums for the federal government, but it is far less clear that it will substantially reduce overall health care costs because it may not do enough to affect high-cost cases. Indeed, a preliminary analysis of the Ryan plan by the Congressional Budget Office found that total health care costs would actually increase -- by an astonishing 40–67 percent by 2030 -- because the benefit of more consumer "skin in the game" is limited and because

[4] Peter R. Orszag, "How Health Care Can Save or Sink America: The Case for Reform and Fiscal Sustainability," *Foreign Affairs*, July/August 2011, Vol. 90, No. 4.

private plans have far higher administrative costs and less negotiating leverage with providers than does Medicare. (See chart.) For the nation, such a result would clearly be major step in the wrong direction. The goal should not be to simply slosh costs around, and especially not to *increase* total national health costs; it must be to reduce them overall.



If policymakers were interested in pursuing more consumer-directed approaches, two directions seem promising. The first involves more "consumer skin in the game," as highlighted by the Ryan plan, but done through a value-based insurance framework. The idea, which is already operational in some commercial settings, is to encourage higher value in health care through differentiated consumer cost-sharing – more cost-sharing for those services with less value and vice versa. Second, another consumer-directed approach that should be explored involves expanded use of *voluntary* advance directives – in which individuals provide guidance about how they would prefer their end-of-life care to be delivered. Gundersen-Lutheran Health System in Wisconsin, for example, has adopted a "community-wide advance care planning program which makes voluntary advance directives available to every person, ensures they are available wherever and whenever patients need them and ensures healthcare professionals comply with the patient's treatment choices." It coordinates this care using electronic medical records. The results have been encouraging: Gundersen Lutheran has been shown to provide high-quality, low-cost care to patients.

- The fourth approach, the provider-value approach, is perhaps the most promising. Instead of reducing costs indirectly by having patients put pressure on doctors, the provider-value approach focuses on giving doctors more information and making changes so that payment is based on the quality of service they provide -- not the quantity. The goal is to boost the use of evidence-based medicine and narrow the variation in treatment methods across the United States, improving outcomes and lowering costs by reducing the number of expensive but unnecessary procedures. The *Foreign Affairs* article discusses this approach in more detail.

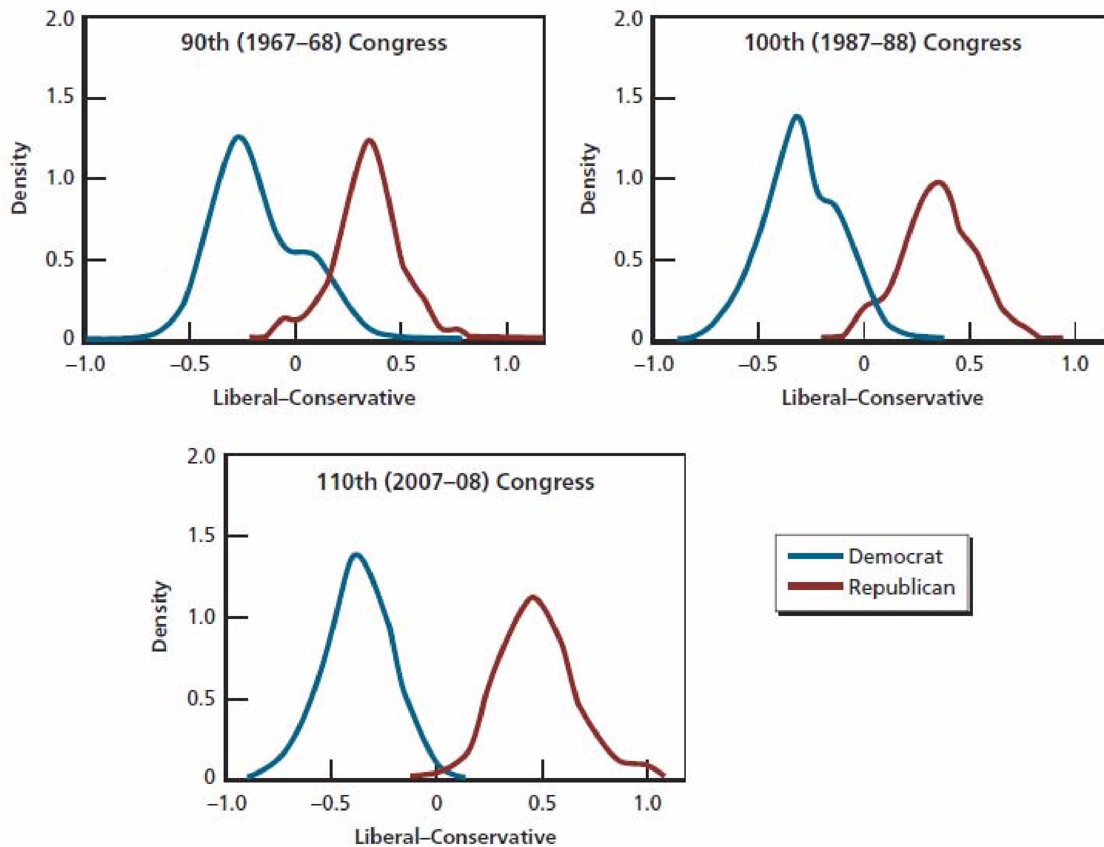
One significant gap not addressed in the 2010 health act, and that policymakers could adopt now, involves tort reform. The academic literature generally concludes that medical liability laws do little to raise costs, although some recent studies suggest modestly larger effects. The literature also suggests that variation in the medical malpractice laws across the United States explains very little of the variation in health care costs. What this literature largely misses, however, is the fundamental problem with the laws' standard of "customary practice," the norm that protects doctors if they can be found to have treated their patients the way most other doctors in the area do. This basis for malpractice creates a contagion effect among doctors, because legal liability is minimized by doing what the doctor down the hallway is doing**.** The strength of the contagion effect may not be substantially influenced by whether the tort laws are slightly more stringent in one area relative to another.

The traditional approach to tort reform involves imposing some limit on damages. The problem with such an approach, however, is that it leaves the customary practice problem untouched. A far better strategy would be to provide a safe harbor for doctors who follow evidence-based guidelines. Under this approach, a doctor would not be held liable if he or she followed the recommended course for treating a specific illness or condition under guidelines put forward by professional associations such as the American Medical Association or the Institute of Medicine.

POLARIZATION

Let me close on a topic that is of significant concern to me: polarization.[5] In the late 1960s, significant overlap existed in votes cast by the most conservative Democrats in Congress and those cast by the most liberal Republicans. By the late 1980s, the common ground had diminished. Today, it has virtually disappeared. (See chart.)

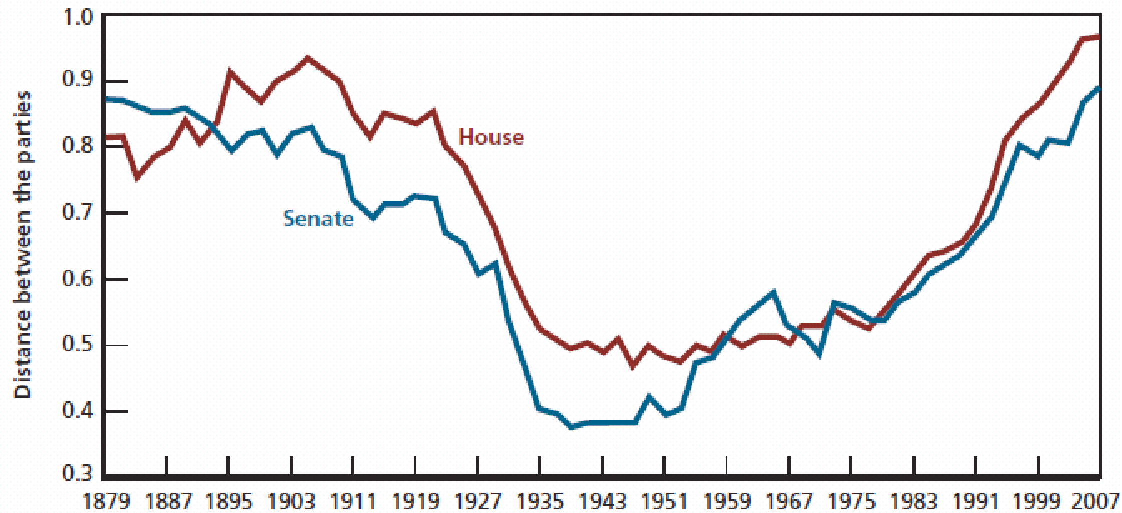
[5] Peter R. Orszag, "Won't You Be My (Hyper-Partisan) Neighbor?", *Bloomberg View,* June 8, 2011.



What is causing this? Many people have said the problem is that Congressional districts have been redrawn to be as partisan as they can be, to keep politicians from each party in office as long as possible. A closer look at Congress, however, shows that redistricting is not a major cause of our polarization.

Compare, for example, historical trends in the House and the Senate. Senate districts are states, so they aren't continually redrawn as congressional districts are. And yet the polarization patterns in the House and Senate have broadly tracked each other (see chart below). Polarization between the two parties was relatively high in both houses for the first three decades of the 20th century. It dipped in the House and Senate alike from the mid- 1930s until the late 1970s, and then began climbing to record highs today.

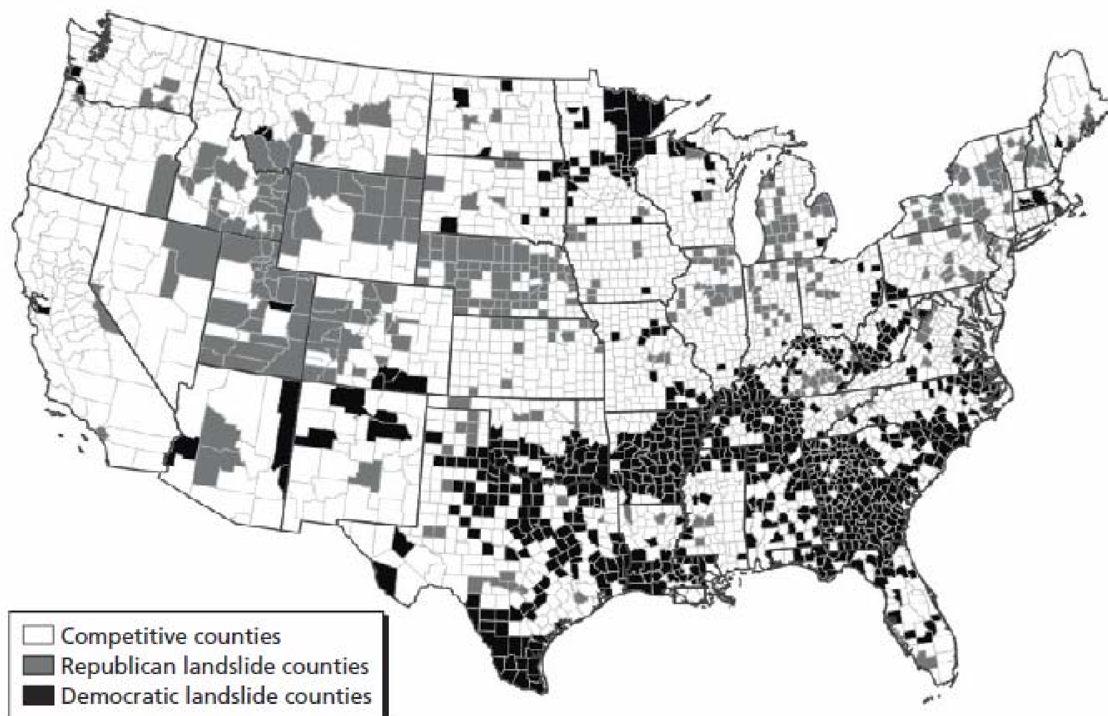
Party Polarization, 1879–2007



SOURCE: McCarty, Poole, and Rosenthal, "Polarized America" Web site, no date.
RAND *OP291-8*

If redistricting isn't the primary force behind polarization, what is? One crucial cause, as documented in *The Big Sort*, a path-breaking book by Bill Bishop and Robert Cushing, is increased residential segregation by political party. We are voluntarily separating ourselves into Republican and Democratic neighborhoods. Today's media and blogosphere, which increasingly filter news according to their point of view, exacerbate and reinforce the effect.

Two maps (see accompanying maps: 1976 Election and 2008 Election), taken from a recent paper by James Thomson of the RAND Corp., show the U.S. broken down by county (county lines have also not been redistricted). The dark-shaded counties are those that have swung hard one way or another in a presidential election, and so are considered polarized, while the light counties are politically mixed. The difference from 1976 to 2008 is striking: The number of light counties has fallen sharply. Roughly 25 percent more of the U.S. population now lives in a landslide county than did in the 1970s.

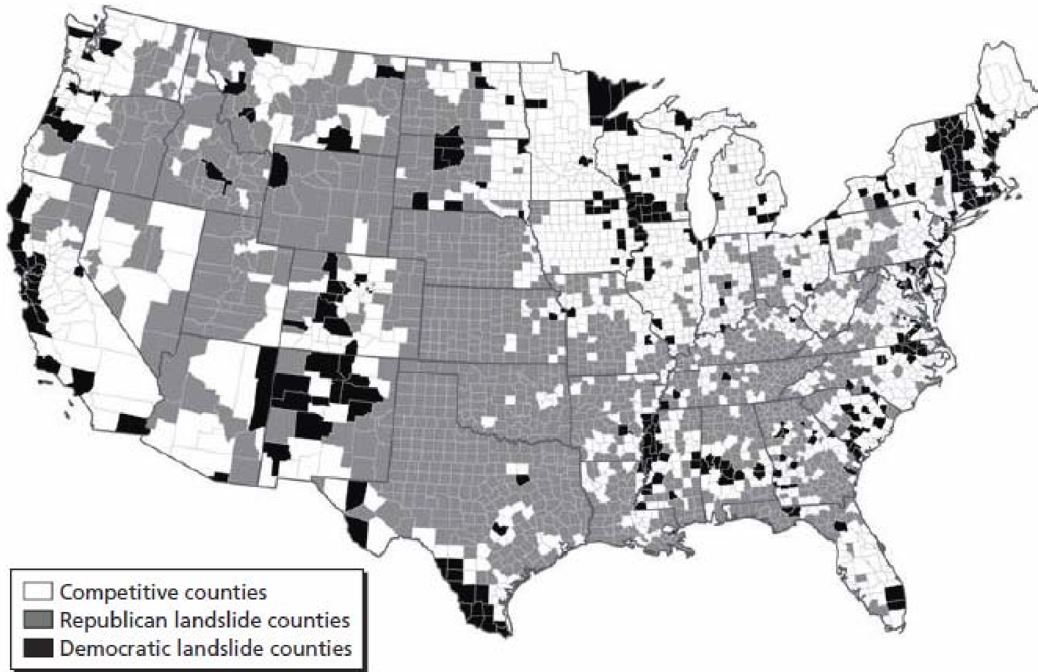


The consequences are far-reaching. The social psychology literature clearly shows that when like-minded people are put together, they move to extremes -- both because they rarely hear opposing viewpoints and because each person is at least somewhat inclined to prove he is the true believer in the group.

The behavior is observed even among people who otherwise strive to be quite objective, such as judges. Cass Sunstein, the legal scholar who is now administrator of the White House Office of Information and Regulatory Affairs, documents in his 2006 book, *Are Judges Political? An Empirical Analysis of the Federal Judiciary*, that judges appointed by Republican presidents are more likely to vote in extreme ways if they are grouped with other Republican-appointed judges than if they are grouped with Democratic-appointed judges, and vice versa.

So Americans are voluntarily creating red and blue neighborhoods, and their divergent perspectives are reinforced by the right-left divide found on television (Fox News versus MSNBC) and online (Huffington Post versus Hot Air). The polarization that results makes our political system, which was never particularly good at dealing with any problem before it became a crisis, suffer even more inertia.

The best bet on what will happen in Washington is, therefore, nothing -- until and unless it has to. The Big Sort generates gridlock, making it increasingly difficult for lawmakers to tackle anything from climate change to budget balancing.



Clearly, redistricting reform won't help us much. Instead, we should try to create a new set of rules and institutions that can use legislative inertia to our benefit, just as a growing body of tools in the private sector (such as automatic enrollment 401(k) plans) are using inertia there to produce better outcomes.

The Independent Payment Advisory Board, created to constrain cost growth and improve quality in Medicare, without new legislation, is one example of trying to leverage legislative inertia. The key is that inaction by Congress allows the IPAB's recommendations to take effect. Another example is the backstop fiscal trigger currently being discussed as part of the debt-limit negotiations. With this mechanism in place, congressional inaction would lead to automatic spending cuts and/or revenue increases (and, by the way, the trigger really should include both). Here again, legislative inaction wouldn't mean failure to address a problem. Finally, the new automatic stabilizer (a payroll tax holiday linked to the unemployment rate) I propose above is also consistent with this theme.

The era of gridlock government is unlikely to disappear overnight. We might as well figure out how to function with it.