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LOOKING AHEAD:

MEMOS TO THE NEXT PRESIDENT

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LOOKING AHEAD:

MEMOS TO THE NEXT PRESIDENT

When the next president takes office, he or she will have an important opportunity to put our nation on a sustainable fiscal path and create the conditions for a more prosperous American economy. In the pages that follow, two former directors of the Congressional Budget Office (CBO) share their views about the next president's opportunities for improving America's fiscal and economic policies. Douglas Holtz-Eakin and Robert Reischauer offer advice to the incoming administration, which will be faced with competing priorities and a finite window of time for addressing our nation's long-term fiscal imbalance and securing our economic future.

DOUGLAS HOLTZ-EAKIN

Douglas Holtz-Eakin has a distinguished record as an academic, policy adviser, and strategist. Currently he is the president of the American Action Forum and recently was a commissioner on the congressionally chartered Financial Crisis Inquiry Commission. Since 2001, he has served in a variety of important policy positions. In 2001 and 2002, he was chief economist of the President's Council of Economic Advisers. He was the sixth director of the Congressional Budget Office from 2003 to 2005. During 2007 and 2008, he was director of domestic and economic policy for the John McCain presidential campaign.

Dr. Holtz-Eakin began his career at Columbia University in 1985 and moved to Syracuse University from 1990 to 2001. At Syracuse, he became trustee professor of economics at the Maxwell School, chairman of the Department of Economics, and associate director of the Center for Policy Research.

ROBERT REISCHAUER

Robert Reischauer is a distinguished institute fellow and president emeritus of the Urban Institute, which he led from 2000 to 2012. His research interests and expertise focus on the federal budget, health policy, Medicare, Social Security, and income distribution.

Before joining Urban, Reischauer served as the director of the Congressional Budget Office from 1989 to 1995. He helped Alice Rivlin set up CBO between 1974 and 1981, serving in a number of capacities including deputy director. He was a senior fellow in the Economic Studies Program at the Brookings Institution from 1986 to 1989, and from 1995 to 2000.

Reischauer was one of two public trustees of the Social Security and Medicare Trust Funds from 2010 to 2015. He is a founding member of the National Academy of Social Insurance, which recognized him with the Robert M. Ball Award in 2012. He is a member of the American Academy of Arts and Science, the Institute of Medicine, and the National Academy of Public Administration. He was a member of the Medicare Payment Advisory Commission, serving as vice-chair from 2001 to 2009. Reischauer, who serves on the boards of several non-profit organizations, was a member of the Harvard Corporation from 2002 to 2014, serving as the senior fellow from 2010 to 2014.

Reischauer holds an A.B. from Harvard University as well as an M.A. in international affairs and a Ph.D. in economics from Columbia University.

JANUARY 1, 2017

MEMORANDUM TO: The 45th President and 115th Congress

FROM: Douglas Holtz-Eakin

SUBJECT: Policy Priorities

Debt in the hands of the public is over $14 trillion—total federal debt is $19 trillion—and growing rapidly. The latest Congressional Budget Office (CBO) budget projections show that by 2024—the end of your second term—it will rise by 50 percent to $21 trillion. At the same time, the deficit will widen to over $1 trillion, of which over $700 billion will simply be the interest cost on the exploding debt.

Put simply, the federal budget is a danger to the U.S. economy, which is already projected to grow at a rate of only about two percent per year. Doing nothing is not an option, as your legacy would be to bequeath to the next generation a standard of living unworthy of this nation.

POLICY RECOMMENDATIONS

A brighter future is achievable by focusing on what is driving the structural budgetary challenges confronting the nation. Addressing the rapid growth of health, retirement, and other entitlement programs; the nation's broken tax code; the rising regulatory burden; and the U.S.'s irrational immigration system will improve the nation's fiscal outlook and growth potential. These should be the top priorities of the administration.

Entitlement Reform

The primary causes for our growing debts have been largely untouched by recent deficit reduction efforts. Discretionary spending—capped by the Budget Control Act—and tax revenue—recently hiked—are not driving debt. Mandatory spending and interest payments are. Mandatory spending has been growing as the nation ages, health costs grow, and policy-makers create new entitlements and expand old ones. In 1974, mandatory spending was 41 percent of the budget. By 2025, it will be 64 percent. Meanwhile, interest payment on the debt will continue to crowd out the budget as the debt portfolio remains outsized and interest rates normalize.

These pressures reflect legacy costs—past promises—crowding out investment in the future in the form of infrastructure, basic research, and education. This budget pressure strains the capacity to adequately fund what should be the first priority of the federal government: national defense. Absent restraint on entitlement programs, the United States will be unable to budget for these priorities.

Tax Reform

Fundamental modernization and simplification of the tax system has been an elusive dream for congresses and administrations over the past 30 years. Indeed, over the 100-year history of the U.S. income tax system, only a handful of meaningful simplification efforts have seen success. This administration should defy history and enact comprehensive tax reform. This effort should be even more ambitious than the 1986 Tax Reform Act. Instead, this administration should pursue a wholesale rewrite of the tax code, one that moves toward taxing consumed income that, while retaining progressivity, spurs savings and investment and imposes taxes on commerce in the least harmful way.

Regulation Reform

The rapid increase in burdensome regulations comes at considerable cost to American businesses, consumers, workers, and the economy as a whole. To date, the Obama Administration has finalized 2,724 regulations at a cumulative $770 billion in compliance costs and an estimated 476 million net paperwork burden hours on American businesses and individuals. This has doubtlessly contributed to the sluggish recovery from the Great Recession and the declining rate of birth of new firms. The cumulative effect of regulation is significant and should be accounted for when writing new rules. A wholesale reevaluation of existing regulations, starting with the most burdensome, duplicative, and costly, should be undertaken to limit the negative impact on employment and prosperity.

Immigration Reform

The demography of the nation is graying. Low U.S. birth rates are falling short of the aging of the population. As the baby-boom generation continues to reach retirement age, the U.S. labor force will face additional downward pressure, and with it, the economy as a whole. A rational immigration system that refocuses on economic goals could help reverse this trend by raising population and labor force growth, and thus economic growth as a whole.

In addition to the mere mechanics of raising the U.S. population, immigrants have displayed entrepreneurial rates above that of the native-born population. New entrepreneurial vigor embodied in new capital and consumer goods can raise the standard of living.

CONCLUSION

In the absence of fundamental reforms to every major federal policy area and on both sides of the nation's ledger book, the United States faces the threat of debt-driven financial crisis and stagnant trend economic growth. The incoming administration should prioritize four important reforms: entitlement, tax, regulatory, and immigration.

JANUARY 1, 2017

MEMORANDUM TO: The 45th President and 115th Congress

FROM: Bob Reischauer

SUBJECT: Some Unvarnished Generic Advice about the Fiscal Challenge Facing Your Administration.

In late October when you were busy with the final flurry of campaign activities, the Office of Management and Budget released the budget results for the fiscal year which ended on September 30. As the Congressional Budget Office (CBO) and the Obama Administration had projected, the deficit increased both in dollar terms and as a percent of GDP after six years of steady declines. Although budget deficits and debt did not seem to be important issues for the voters in November, the public, fiscally conservative members of Congress, and markets are likely to become increasingly concerned if deficits continue to rise as they are projected to do under a continuation of current policies. While your Administration promises to modify current policies, virtually all of the specific policy proposals you made during the campaign would raise, not lower, future deficits and debt relative to GDP. Growing deficits and increasing debt levels will reduce the nation's capital stock, slow the growth of productivity and wages, limit policy makers' ability to employ fiscal policy to combat future recessions, and expose the nation to greater risk of fiscal crises. Thus it is imperative that your first budget include a credible plan to address the projected increase in the deficit as you strive to fulfill your campaign promises.

As a first step you should establish goals below the baseline path for the debt to GDP ratios for the last full fiscal year of your first term (FY 2020) and the last budget of your second term (FY 2025). These goals should be achievable and defined relative to specified sets of reasonable economic assumptions that are close to the CBO or Blue Chip consensus forecasts. It should be made clear from the start that these goals will be adjusted upward if the economy does not perform as well as assumed or if expensive natural disasters or national security crises occur. Such explicit goals will send a clear signal to department and agency heads, as well as Congress, outside advocates, and the public of the overall fiscal constraints your administration will seek to adhere to.

Do not feel constrained to specify a monotonic path towards attaining these goals. Because all new administrations have initiatives that they seek to get under way quickly and because fiscal restraints should be phased in gradually, it is not unreasonable to have the debt to GDP ratio rise a bit above the baseline path for the first few years before declining in later years to achieve the goals.

While a goal of keeping the debt to GDP ratio from rising during your presidency might sound like a very modest objective, given the political environment, the rigidities imbedded in federal programs and the promises made during the campaign, such goals will be very difficult to meet. They would imply cumulative deficit reduction from the current baseline of about $390 billion during your first term and roughly $2.3 trillion over your eight-year presidency. Properly constructed, the policies needed to bring the projected FY 2025 baseline debt to GDP ratio of 83.9 percent down to the 75.4 percent level experienced in FY 2016 will put the ratio on a downward trajectory well beyond 2025.

During the campaign you endorsed many policies that would either increase spending or reduce revenues. This long list must now be subjected to an exercise of fiscal and political triage. Initiatives should be ranked on at least four dimensions—first and foremost, according to your priorities; second, by their short- and long-term budgetary impacts; third, on their ability to garner Congressional support; and fourth, on their potential to boost economic growth and the wages of middleclass and lower skilled workers.

With the exception of a handful of high priority proposals, initiatives should be subject to a deficit-neutral budget constraint. This could be accomplished by requiring the various transition teams to come up with savings from existing programs in their areas of responsibility at least equal to the cost of any proposed initiatives.

With respect to the handful of initiatives that might get a budgetary "home free" pass, a major infrastructure initiative should be at or near the top of the list. Overall, with considerable pressure to increase defense spending and maintain many domestic programs, together with your initiatives, it is unlikely that you will be able to achieve significant savings below baseline-level discretionary spending during your presidency. This leaves increases in revenues and curbs on the growth of entitlement programs as the wells from which deficit reduction must be drawn.

During the campaign there was general agreement that the tax code was badly in need of fundamental reform. Some hope that reform could generate increased revenues, if not in the short run, at least by your second term. Major reform is unlikely without strong presidential leadership. However, even with such leadership there is very little chance that fundamental reform that is deficit neutral or revenue generating will be viable given the unavoidable redistribution of tax burdens inherent in reform, the composition of the Congress, and the instability of the political environment. While Congressional leaders should be encouraged to continue their efforts to craft a bipartisan reform bill, you should not expend your political capital leading on this issue.

Both you and your opponent expressed some support for raising taxes on those with very high incomes. Such policies should be pursued because new revenues will be needed if the nation is ever going to put itself on a sustainable fiscal path. Base broadening probably offers the best approach in this area. A word of warning, however: higher taxes on the rich will never constitute more than a modest contribution to putting our fiscal house in order.

While there was no real discussion during the campaign of taxing carbon emissions and little public support for such a policy, some form of levy on greenhouse gases probably lies in the nation's not-to-distant future. You should take care not to get locked into positions that would have to be reversed if this is the case, and you should keep your eye out for the opportunity to move in this direction. It is better to impose taxes on activities we want to discourage (pollution/global warming) than on ones we want to encourage (work/ saving and investing/entrepreneurship), as we do now.

During the campaign, neither you nor your opponent suggested how your administration would deal with the challenges facing Social Security and Medicare, notwithstanding the fact that the demographically-driven increases in spending on these programs are largely responsible for the increases projected in the deficit and debt. Instead, you emphasized how you would protect or enhance benefits. But time is running out. CBO estimates that the Medicare Hospital Insurance Trust Fund will be depleted around 2026 and the Social Security Trust Funds about four years later. Lacking the legal authority to borrow when the Trust Funds are depleted, program benefits will have to be reduced to match payroll and designated income tax revenues, which would imply benefit cuts of about 25 percent in Social Security and 15 percent in Hospital Insurance. While elected policymakers will take steps to ensure such cuts don't occur, the sooner such unavoidable measures are enacted, the more options can be considered, the more gradual and less disruptive the program changes can be, and the more generations can be asked to share in the burden.

A presidential entitlement reform proposal to Congress would probably prove politically suicidal. However, were you to invite the bipartisan congressional leadership to the White House shortly after your inauguration to explore the possibility of initiating an Executive-Legislative process that could craft packages of policies to stave off trust fund depletion, it would be an unexpected and potentially consequential act of fiscal, social, and economic leadership. Moreover, it would have few downside political risks.

It is tempting to resort to gimmicks, chicanery, and subterfuge to avoid tough and unpopular budget decisions. Don't. Your administration will lose its fiscal credibility quickly and never recover. One such device is the "Rosy Scenario"—the claim that your policies will lead to a significant and sustained increase in economic activity that will improve the budget outlook. Unfortunately, at this stage in the economic cycle you are likely to get little bounce from the economy, which is approaching full utilization of its current capacity. With the labor force growing very slowly and anemic improvements in productivity, most macroeconomists expect the economy to grow at about 2.5 percent in real terms over the next two years and a bit less going forward. While your policies to stimulate growth can improve this outlook, they will take a number of years to bear fruit and that fruit will be only modest in size—a few tenths of a percentage point increase in the growth rate at most.

A second tactic is to put the enforcement of fiscal discipline in the hand of some extra-legislative process like a Constitutional Amendment requiring a balanced budget or the sequestration process of the Gramm-Rudman-Hollings era. Such hammers not only won't work but run the risk of making matters even worse by encouraging irresponsible behavior.

In our democracy, successful fiscal policy requires that the Chief Executive and a majority of Congress agree that there is a problem that requires fixing. It also requires a consensus among these decision makers about the appropriate policies to effectuate the fix. Only the first of these conditions exists today.