Well over a decade of irresponsible fiscal policy has created an unsustainable fiscal situation for the United States. The longer we delay serious consideration of meaningful solutions, the larger the problem will become. This Commission, however, has the historic opportunity to set us on a path to fiscal sustainability.

During the next several months, the Commission will consider many proposals as it forms its recommendations. In order to assist the Commission in evaluating those proposals, as well as to assist Congress and the President in evaluating the recommendations ultimately advanced by the Commission, I propose three criteria that will help evaluate whether those proposals and the Commission’s final recommendations will address our fiscal problems. The criteria are:

1. Do the recommendations include real spending cuts?
2. Do the recommendations prohibit exceptions for politically favored programs?
3. Do the recommendations address accounting tricks and budget gimmicks?

I will address each of these criteria in turn.

**CRITERION 1: DO THE RECOMMENDATIONS INCLUDE REAL SPENDING CUTS?**

There are two ways to interpret the deficit problem. The first concludes that taxes aren’t increasing fast enough and we must adjust tax policy so that it can finance the projected levels of government spending. The second concludes that spending is growing too quickly and that increased spending, not insufficient revenue, drives the gap between the two.

The data support the second interpretation: the United States has a spending problem. Data from the Congressional Budget Office (CBO) indicate an exponential increase in spending over the next 50 years (figure 1). While certain tax increases could bring in new revenue, the amount of tax revenue needed to address the budget shortfall would require such high tax rates that those rates would quickly reach the point of diminishing marginal returns and fall far short of filling the budgetary gap. What’s more, those high tax rates would paralyze our economy along the
way. If the Commission wishes to forestall financial catastrophe, it must recommend that the U.S. government cut spending.

Figure 1: Long-Term Spending and Revenue Trends

Spending Our Way into Debt

According to the CBO, the U.S. deficit for fiscal year 2009, which ran from October 1, 2008 to September 30, 2009, was about $1.4 trillion. A mere 3.2 percent of the Gross Domestic Product (GDP) in 2008, the deficit was a whopping 9.9 percent of GDP by the end of fiscal year 2009, a 209 percent increase, or $943 billion of additional deficit, and a 207 percent increase over the CBO’s September 2008 projections for the fiscal year 2009 deficit.

This is the largest deficit, relative to the size of the economy, since 1945. In 1945, however, the country had just spent four years fighting a world war in two theaters; before that we had struggled with the Great Depression for a decade. It’s easy to understand why the deficit in 1945 was so large, but what’s the reason for the size of our current deficit?

A common explanation asserts that the recession produced the deficit. To be sure, as figure 2 displays, the recession caused lower than expected tax revenue—$419 billion lower, in fact. The recession caused corporations to make less profit and individuals to earn less income, which also meant less money for the government.
Figure 2: Inside the Fiscal 2009 Deficit

But the reality is that this deficit is predominantly the product of government spending. Again look at how figure 2 breaks down the deficit. Spending decisions made in the years preceding 2009 contributed $459 billion. In 2009, the government added an additional $592 billion: $245 billion for the financial bailout and $347 billion for stimulus spending. The only piece of good news comes from the projected cost of the interest we have to pay on the debt. Lower-than-projected interest rates reduced this amount by $61 billion. However, overall, spending accounts for more than $1 trillion of the entire $1.4 trillion deficit.

Evaluating Revenue Solutions: Can we tax ourselves out of the deficit?

Increasing Marginal Tax Rates

For revenue increases to be the solution to the fiscal problem, the relevant question becomes, what level of taxes would be required to meet the United States’s future budget gaps if we do not reform spending?

Representative Paul Ryan (R–WI) asked the CBO that question back in 2008. The CBO response concluded that the federal government would need to raise tax rates by “substantial” amounts to finance projected spending.

The tax rate for the lowest bracket would have to be increased from 10 percent to 25 percent; the tax rate on incomes in the current 25 percent bracket would have
to be increased to 63 percent; and the tax rate of the highest bracket would have to be raised from 35 percent to 88 percent. The top corporate income tax rate would also increase from 35 percent to 88 percent.  

Figure 3 breaks down the CBO’s projections by year of increase.

<table>
<thead>
<tr>
<th>Individual Marginal Tax Rates</th>
<th>2009</th>
<th>2050</th>
<th>2082</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>10%</td>
<td>19%</td>
<td>25%</td>
</tr>
<tr>
<td></td>
<td>25%</td>
<td>47%</td>
<td>63%</td>
</tr>
<tr>
<td></td>
<td>35%</td>
<td>66%</td>
<td>88%</td>
</tr>
<tr>
<td>Top Marginal Corporate Rate</td>
<td>35%</td>
<td></td>
<td>88%</td>
</tr>
</tbody>
</table>

*Source: Peter R. Orszag, Director, Congressional Budget Office, letter to Representative Paul Ryan (R-WI), May 19, 2008.*

**Figure 3: Marginal Income Tax Rates Needed to Meet Budget Gaps**

Figure 4 illustrates the point that marginal tax rates must nearly *double* to fund projected spending.

![Figure 4: Marginal Tax Rates Necessary to Fund Entitlement Spending](chart.png)

In its response to Congressman Ryan, the CBO also said:
Such tax rates would significantly reduce economic activity and would create serious problems with tax avoidance and tax evasion. Revenues would probably fall significantly short of the amount needed to finance the growth of spending; therefore, tax rates at such levels would probably not be economically feasible.\(^5\)

In other words, increasing taxes in attempt to balance the budget would add insult to injury. It would reduce economic growth and government revenue, and the budget gap would get wider.

Furthermore, these marginal tax rates projected by the CBO include only federal income taxes—not the marginal tax consequences on state income taxes or federal payroll taxes. As Stuart Butler of the Heritage Foundation notes:

An individual’s actual marginal tax rate is the federal income tax rate plus these other taxes. Assuming that these other taxes will not rise in the future, a middle-income individual subject to a 9 percent state and local tax and 15.4 percent payroll taxes could face a total combined marginal tax rate of 87.4 percent, not just a federal marginal income tax rate of 63 percent. Furthermore, the person facing an 87.4 percent future federal income tax rate could actually incur a total marginal rate of 112.4 percent.\(^6\)

Since the CBO projected these rate increases in June 2008, the federal government has added a lot more to our tab: the health care bill, the American Recovery and Reinvestment Act, the Troubled Asset Relief Package, and other spending bills that are not offset by reductions in the growth of existing programs. As projected spending has increased, so too have the tax rates needed to pay for that spending.

**Instituting a Value Added Tax (VAT)**

The tax increase needed to stabilize our national finances is too great to be achieved through higher income taxes. Tax rates would have to rise to levels that would have severely negative economic effects. That is why economists like Bruce Bartlett are seriously considering a Value-Added-Tax (VAT) to address the country’s need for revenue, arguing that the VAT is the best known way of raising large revenues from low rates with minimal disincentive effects. In economic speak, we say that the VAT, unlike the income tax, has a very small dead weight or welfare cost.\(^7\)

That’s the theory. The data reveal a quite different reality. All taxes reduce the economic activity that is being taxed, and the VAT is no exception. A recent study by Florida State University’s Randy Holcombe looks into the details of the implementation of a VAT.\(^8\) He finds that a VAT would slow economic growth, and as a result of substitution effects on the government revenue side, the net effect on tax revenues following the introduction of the tax would be small.

The study estimates the impact of a VAT on economic growth assuming that the United States would implement a VAT in a manner similar to the VAT implementation in the European Union. The study estimates that if the United States introduced the VAT in a revenue-neutral manner, so
that it took the place of other taxes, a VAT would reduce GDP growth by slightly more than 0.1 percentage point. That is not insubstantial when considering that a 3 percent growth rate is a healthy growth rate for a developed economy. Projecting out ten years, that would result in GDP half a percent lower, because of the impact of compliance and administrative costs a VAT would impose on the economy.

If the United States added a VAT to current taxes in order to increase tax revenues, ten years after their introductions a 3 percent VAT would reduce GDP by 2.1 percent and a 5 percent VAT would reduce GDP by 3 percent. After 20 years a 3 percent VAT would reduce GDP by 3.7 percent; a 5 percent VAT would reduce GDP by 5.6 percent; and a 7 percent VAT would reduce GDP by 7.5 percent. Remember that we would have to institute a 20 percent VAT rate to raise enough revenue to meet our budget gap.

Holcombe’s study also shows that while a VAT is a powerful source of government revenue initially, as the VAT sets in, reduced revenue collection for other taxes offsets much of the VAT revenue. Other economists agree. In a recent article published in National Tax Journal, Michael Keen and Ben Lockwood look into whether the VAT is a money machine. They write:

The final column of Table 2 shows that governments in OECD countries have, indeed, tended to become larger after their adoption of the VAT, in the sense that the proportion of GDP taken in taxes and social security contributions was higher in 2003 than in the year prior to VAT introduction, by nearly six points.

In other words, the VAT raises a lot of money. However, offsets make the VAT a “weak” money machine:

The final column of the table shows that in most cases the increase in the overall tax ratio has been less than the revenue raised by the VAT itself. Thus, the revenue raised by the VAT has been to some degree offset by reduced revenue (at least relative to GDP) from other taxes. It will be seen in the next section that the nature and extent of such offsetting is of central importance in evaluating the money machine notion, and exploring this, controlling for other potential determinants of government size, will be a key part of the later empirical analysis.

Holcombe’s work confirms these findings. With slower GDP growth, federal income tax, state income tax, and sales tax revenues would grow more slowly. Looking two decades out, Holcombe estimates that a VAT would raise almost no additional government revenue, because increases in VAT revenues would be accompanied by decreases in other tax revenues.

“Tax and spend” is far more common than “tax and reduce.”

Even assuming the economy can bear some combination of new taxes, there is no reason to believe that this will address the fiscal imbalance, because historically, revenue increases have been accompanied by further spending increases, not deficit reduction.
The president’s FY2011 budget illustrates this traditional tax-and-spend pattern. The budget would raise taxes by $3 trillion over the next decade—including a $743 billion health-care reform tax, a $843 billion cap-and-trade energy tax, a $968 billion tax on small businesses and upper-income families, and a $468 billion tax on corporations. And yet these $3 trillion in new taxes still won’t keep up with all the new spending (see figure 1). As a result, the Office of Management and Budget projects the deficit will double from $7.5 trillion in 2009 to $18.6 trillion by 2020.

The current tax code leaves much to be desired, and while tax reform is appropriately one consideration of this commission, if it becomes the predominant focus of the recommendations, the commission will have failed to deal with the true driver of our fiscal situation.

The data are clear. No amount or type of tax increase could fix the looming fiscal crisis. The tax levels and the tax rates needed to even begin to address future budget gaps would be so large that they would hinder economic growth and thereby make the crisis even worse. That’s why this commission needs to focus on cutting spending rather than raising taxes. Our fiscal problem is a spending problem, not a revenue one. We must cut spending.

**CRITERION 2: DO THE RECOMMENDATIONS PROHIBIT EXCEPTIONS FOR POLITICALLY FAVORED PROGRAMS?**

Real fiscal reform will require not just a change in the trajectory of government spending, but also a change in the political (or parochial) priorities of elected officials. In order for this Commission to be effective, its solutions shouldn’t treat areas of the budget as untouchable. All parts of the budget must be on the table for review and potential cuts. Failure to do so will jeopardize the goal of addressing our fiscal problems.

*Spending exemptions forestall sustainable spending cuts.*

Recall the Balanced Budget and Emergency Deficit Control Act of 1985, commonly referred to as the Gramm-Rudman-Hollings Act after the authors of the original bill. Meant as a fiscal responsibility tool, the act set maximum amounts for the federal deficit. The idea was that each year, deficit targets would decrease until the budget was balanced in FY 1991. If the deficit limits were exceeded, the act required the president to cut spending by a uniform percentage across the board to bring the budget back into balance, a process called “sequestration.”

However, in the process of adopting this law, Congress and the Reagan administration made many political compromises. The Reagan administration got the defense budget exempted from the cuts, and in exchange, the Democrats in Congress got entitlement spending exempted from cuts.

By 1990, it became very clear that Congress had put into place so many loopholes and exempted so much spending from sequestration that the entire Gramm-Rudman-Hollings framework was falling apart. By then, the budget exceeded the deficit limit by nearly $100 billion (8 percent of the budget, at the time), and the deficit targets would have required that the few programs, still on the chopping block, be cut by about one-third. The whole thing failed.
Few lessons were learned from the Gramm-Rudman-Hollings Act’s exemption failure. In fact, the main spending discipline policy put in place in the last ten years has consisted mainly of spending cuts or spending freezes exempting large portions of the budget that made them relatively meaningless.

For instance, after several years of large increases in spending, President Bush started to feel some pressure to impose some fiscal discipline in Washington. It was understandable. In FY2005, total outlays were up an astounding $609 billion from FY2001—a 32.6 percent increase since Bush came into office. After only three years in office, President Bush already had the record as one of the biggest spending presidents—spending in FY2002, FY2003, and FY2004 increased by more than 6 percent each year. By comparison, the average annual increase over the past 40 years is 1.7 percent.

The Bush administration’s justification for the federal spending binge was that national security needs were driving up the budget. Certainly, defense spending had increased dramatically since the late-1990s, particularly since 9/11. However, non-defense spending was growing too.

In response to the pressure, Bush created a whole new spending category: “Non-defense non-homeland security spending.” The move allowed him to claim that his budget request was fiscally responsible since it only included a slow spending increase of “non-defense non-homeland security spending,” even though the request also included massive increases in defense and entitlement spending.

Because “non-defense non-homeland security spending” represents such a small share of the overall budget (one sixth), spending continued to grow almost unchecked during Bush’s two consecutive terms. Defense spending grew by $400 billion, and the president passed a new prescription drug benefit law that added a massive amount of entitlement spending to the deficit. Overall, spending increased by $1.1 trillion in real terms over that period. Bush left office after accumulating over $1 trillion in deficit.

Confirming that the problem is not unique to either political party, President Obama’s latest budget follows in Bush’s footsteps. This year Obama announced in his State of the Union address that he will put the federal government on a diet, by implementing a three-year freeze of “non-defense, non-homeland security discretionary spending” starting in fiscal 2011. This diet, the White House explained, would save taxpayers $250 billion over ten years.

Figure 5 shows which part of the budget the president is targeting.
The “freeze” on the 16 percent of the budget also contains many caveats and loopholes. In the best-case scenario, the three-year freeze on the growth of this small segment of spending will save on the order of $250 billion over the course of ten years, about 0.58 percent of the total federal spending during that period. This is a rather meek savings, especially in light of the CBO data showing ten-year baseline deficits of $6 trillion under current laws.

Moreover, the myriad of new spending programs announced in the same speech vastly overshadow any promise of fiscal responsibility provided by the spending freeze. When Congress finally comes up with a budget for next year, the total cost of all of the measures will add up to much more than the $250 billion cuts over ten years from the freeze.

Like most spending rules, PAYGO doesn’t go far enough.

The statutory “pay-as-you-go” (PAYGO) federal spending rule is another example of illusory fiscal restraint. After a seven-year hiatus, PAYGO is once again the law of the land. Numerous policy makers have touted its benefits while emphasizing their renewed commitment to fiscal responsibility. President Obama recently described PAYGO as a very simple restraint: “Congress can only spend a dollar if it saves a dollar elsewhere.”

This oversimplification, however, ignores the very limited scope of the rule. PAYGO is full of exceptions. First, it doesn’t apply to discretionary spending, which represents roughly 40 percent of the budget. This year, $1.2 trillion, or one-third of federal spending in 2009, went toward
discretionary programs. A rule that exempts so much spending cannot address the nation’s long-term fiscal imbalance.

Second, it applies only to new or expanded entitlement programs that may increase the deficit. It does not apply to existing programs, such as Medicare, Medicaid, and Social Security. Even without new legislation, overall spending will grow by more than 63 percent from 2009–2020, with mandatory spending growing by 52 percent. Estimates by the Government Accountability Office show that Medicare, Medicaid, and Social Security alone could consume about 25 percent of the U.S. economy by 2080.

As the director of the Office of Management and Budget and former director of the Congressional Budget Office, Peter Orszag, explained in 2007, “Although PAYGO may help to prevent deterioration in the fiscal picture, it only applies to new policy changes rather than the effects of existing policy.” Therefore, PAYGO will do nothing to remedy the nation’s pre-existing fiscal imbalance, which is driven largely by rising expenditures on Social Security, Medicare, and Medicaid.

The PAYGO legislation recently signed by the president also contains a list of over 100 mandatory-spending programs that are exempt from PAYGO requirements. CBO analysis of a previous but similar PAYGO bill showed that various exceptions and nuances in the law would allow Congress to increase the deficit by several trillion dollars without triggering a sequestration.

It is important that any budget reform that comes out of this commission apply to the entire federal budget, not just to a small portion of it. A solution that begins by taking over 80 percent of the options off the table is not a solution. (Defense spending represents roughly 20 percent of the budget and entitlement spending represents over 50 percent of total spending.) Exemptions such as these allow politicians to appear as though they are addressing the fiscal problem, when in reality the problem continues to grow.

**Criterion 3: Do the recommendations address accounting tricks and budget gimmicks?**

Economists argue that a key ingredient to fiscally responsible governmental policy is the setting of an explicit target for publicly held debt, such as the 60 percent of debt-to-GDP ratio and the 3 percent of GDP deficit targets set by the Treaty on European Union. Similarly, it has been suggested recently that the way out of the unsustainable fiscal path on which many countries have found themselves is to set such targets (such as a 60 percent of debt-to-GDP ratio by 2018), find enforceable mechanisms, and adopt policies (tax increases or spending cuts) that will achieve the target.

Goals are good, but there is more to fiscal responsibility than setting spending limits. For every attempt to cap spending by regulation or statute, lawmakers seem to find new and creative accounting techniques that allow them to continue spending recklessly. As economist Donald Marron notes, “[setting] a measurable target isn’t enough. You also need to make sure that the government doesn’t game the accounting to hide its liabilities.”
In fact, there is evidence that creative bookkeeping is at the center of many countries’ financial troubles. Take Greece, for example. As a member of the European Union (and particularly as a member of the Eurozone), it is supposed to meet a 60-percent-of-debt-to-GDP target and 3 percent of GDP deficit target set by the European Growth and Stability Pact. However, according to the *New York Times*, with the help of Goldman Sachs, JPMorgan Chase, and a wide range of other banks, Greece has managed to skirt the debt limits for years by using various accounting tricks.

“In dozens of deals across the Continent,” the *Times* explains, “banks provided cash upfront in return for government payments in the future, with those liabilities then left off the books. Greece, for example, traded away the rights to airport fees and lottery proceeds in years to come.” The hidden liabilities misled investors and regulators about the extent of the country’s liabilities and enabled Greek lawmakers to mask additional borrowing.

In order to escape its financial constraints, Greece also excluded a large portion of its military spending from deficit calculations. The *Wall Street Journal* explains, “In 2000, Greece reported that it spent €828 million (US$1.13 billion) on the military—about a fourth of the €3.17 billion it later said it spent. Greece admitted to underreporting military spending by €8.7 billion between 1997 and 2003.”

Other examples include Portugal, which “classified subsidies to the Lisbon subway and other state enterprises as equity purchases” in 2001. France “arranged a deal with the soon-to-be privatized France Telecom in 1997 under which the company paid the government a lump sum of more than €5 billion. In return, France agreed to assume pension liabilities for France Telecom workers, which did not show up as a liability. The billions from France Telecom helped to narrow France’s budget gap.”

These strategies or budget gimmicks are common in the United States as well. There are powerful incentives for using tricks to disguise the size of the budget deficit and to bypass formal budget process requirements. The outcome is that we end up with more spending, more deficits, and more debt. But we can pretend these don’t exist—at least until the time comes when we can’t pretend anymore.

Budget gimmicks, however, have consequences beyond letting lawmakers get away with spending money. With a limited budget, policy makers—like nearly everyone else in the world—must prioritize spending. They must choose the best policies to adopt based on available funds and forgo other projects. When legislators manipulate numbers in order to fund programs that might not otherwise pass muster, they are not obligated to show that the programs serve genuine social or financial policy objectives.

As a result, this Commission must make sure that it fixes some of the most prevalent budget gimmicks that U.S. government officials use to hide the size of deficits, debts, program costs, and revenue losses. Some of these strategies include pretending the spending does not exist by keeping it explicitly or implicitly off-the-record, pretending that non-emergency spending is an emergency, pretending the spending is smaller than it is, pretending that spending is really an investment, pretending the tax revenues will be bigger than should reasonably be expected,
and/or pretending that future pension liabilities do not exist. And this list is by no means exhaustive.

Given the many spending limits in place that elected officials nonetheless manage to avoid, few methods will successfully cap spending. Nevertheless, if this Commission does not address the accounting tricks and budget gimmicks that undermine spending rules, no matter how well intentioned the proposed reforms are, we should have no confidence that they will work to address our fiscal challenges. In the near term, serious, strict, and unavoidable budget rules need to be put in place to tie Congress’ hands and restore fiscal discipline.

**CONCLUSION**

The Commission faces difficult challenges, and my testimony provides some difficult truths about the reality of the situation and the ineffectiveness of previous attempts and conventional wisdom to address it. As the Commission considers new proposals and makes its own recommendations, it should keep in mind the three criteria:

1. Do the recommendations include real spending cuts?
2. Do the recommendations prohibit exceptions for politically favored programs?
3. Do the recommendations address accounting tricks and budget gimmicks?

Upon the release of the Commission’s recommendations in December, the American people can ask these same questions about the Commission recommendations in order to determine whether those recommendations will yield meaningful reform. If the answer to any of these questions is “no,” then this Commission will have missed a genuine opportunity to reverse our irresponsible and unsustainable fiscal course.

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8 Randall G. Holcombe, “The Value Added Tax: Too Costly for the United States” (working paper, Mercatus Center at George Mason University, Arlington, VA, 2010).
9 Ibid, 29.
12 Ibid, 146.
14 Veronique de Rugy, Republican Spending Explosion, Cato Institute Policy Brief.
15 For instance, the freeze won’t apply to the $513 billion in unspent stimulus funds. Nor will it apply to the $247 billion of Troubled Asset Relief Program funds or to any of the programs that cash from repaid TARP funds will pay for, such as the $30 billion to prop up community bank lending to small businesses proposed by the president during his speech.
23 Statutory Pay-As-You-Go Act of 2010


31 Ibid.


33 Ibid.

34 Veronique de Rugy, “Budget Gimmicks or the Destructive Art of Creative Accounting” (working paper, Mercatus Center at George Mason University, Arlington, VA, 2010).