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Perilous Economic Stalemate

By Martin Feldstein

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The United States appears trapped in a dangerous economic stalemate. The refusal by both Republicans and Democrats to give ground on the budget is preventing the government from dealing with its massive fiscal deficit and rapidly rising national debt. Indeed, the Congressional Budget Office projects that the national debt could increase to 82 percent of gross domestic product over the next 10 years — more than double the debt ratio as recently as 2008.

That forecast, moreover, is based on quite optimistic assumptions of strong economic growth and low interest rates. With slower growth and more normal interest rates, the debt ratio could easily exceed 150 percent by 2030.

A major reason for the accelerating growth in government debt is the United States' rapidly aging population and the resulting increase in the cost of the universal pension and health-care programs — Social Security and Medicare. Most experts believe that limiting the rise in debt will require slowing the growth of these "entitlement" programs and increasing taxes as a share of GDP.

But President Barack Obama and the congressional Democrats oppose any reduction in future entitlement programs, while the Republican presidential candidates and their party's congressional delegation oppose any increase in tax revenues. The result is the current stalemate in reducing the fiscal deficit and reversing the growth of the national debt.

Republicans argue that the national debt's growth should be limited only by cutting government spending. Although some cuts in traditional outlays should be part of efforts to rein in spending, this approach should be supplemented by reducing "tax expenditures" — the special features of the tax code that subsidize health care, mortgage borrowing, local-government taxes, etc. Limiting tax expenditures could reduce the annual deficit by as much as 2 percent of GDP, thereby reducing the debt-to-GDP ratio in 2021 by more than 25 percentage points.

Republicans generally reject this form of spending reduction because it results in additional tax revenue. While this method does indeed increase total revenue, the economic effect of limiting tax expenditures is the same as it is under any other method of cutting spending on those programs. But the Republicans' opposition to anything that raises revenue means that this key to breaking the budget stalemate won't be implemented.

The budget cost of Social Security pensions could be gradually reduced by substituting annuities generated by investment-based personal retirement accounts for part of the current tax-financed benefits. But even though such a reform could maintain income levels for retirees, Democrats oppose it because it lowers traditional government benefits.

The two parties' hard-line stances anticipate the upcoming congressional and presidential elections in November 2012. The Republicans, in effect, face the voters with a sign that says, "We won't raise your taxes, but the Democrats will." The Democrats' sign, by contrast, says, "We won't reduce your pension or health benefits, but the Republicans will."

Neither side wants ambiguity in their message before the election, thus ruling out the possibility of any immediate changes in tax expenditures or future pensions. But for the same reason, I am optimistic that the stalemate will end after the election. At that point, both Republicans and Democrats will be able to accept reforms that they must reject now.

Another post-election route to deficit reduction would be to lower marginal tax rates and balance that revenue loss with cuts in tax expenditures. Official analyses downplay the effect of lower marginal tax rates on taxable income, but experience shows that taxable income rises substantially as taxpayers respond to lower marginal rates by working more, taking more of their compensation in taxable cash than in fringe benefits, and reducing their tax-deductible consumption. Reducing tax expenditures while lowering marginal tax rates can produce substantial revenue by increasing the level of taxable income.

The current economic stalemate is troubling because financial markets could react adversely and because delays in addressing the fiscal deficit means a higher national debt. I may be too optimistic, but I think there is good reason to believe that the current budget stalemate reflects election posturing and that the U.S. political system will prove more effective at making progress on fiscal consolidation once the election is past.

Martin Feldstein, professor of economics at Harvard University, was chairman of U.S. President Ronald Reagan's Council of Economic Advisers and is former president of the National Bureau for Economic Research. © Project Syndicate