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Higher Taxes or Smaller Entitlements: What Should Voters Choose?
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Standard and Poors shifted its outlook for medium- and long-term U.S. fiscal policy from "stable" to "negative" -- implying a one-in-three chance that that the U.S. debt rating itself may be downgraded within two years.

The reasons cited by S&P analysts include

- Ballooning U.S. deficits and debt;
- Heavy US dependence on external finance;
- The wide gap between fiscal reforms proposed by key policymakers implying low likelihood of a budget deal until after the 2012 elections;
- The possibility of financial sector weakness causing additional large public assistance packages; and
- Large imbalances in Social Security, Medicare, and Medicaid that remain unresolved.

But the S&P analysts took "no position" on the mix of spending and revenue measures the Congress and the administration might conclude are appropriate. The S&P can punt -- but policymakers won't have that luxury.

The budget deal to resolve prospective deficits must necessarily address entitlement reforms because those programs are the main deficit drivers in the medium- and long-term. And how prospective U.S. debt growth is resolved matters just as much as how soon it's resolved. Given the multi-generational nature of entitlement programs, the weight given to tax-versus-spending-side fixes will become entrenched in our fiscal policies for a long time, making the choice between the alternative visions proposed by President Obama and House budget committee chairman, Paul Ryan (R-Wisc.), crucially important.

Of course, retirees view entitlements as good -- as necessary protection against key financial risks that they face because many of them cannot work any longer. But there is such a thing as buying too much insurance through the government -- because such insurance isn't free.

The bottom line is that both entitlement benefits and payroll taxes used to fund them have negative economic effects.

Entitlements and the taxes to fund them both alter key economic decisions that individuals and households make -- and these "distortions" result in costs which add up. More generous and early entitlement benefits induce earlier retirement by the most experienced workers. Larger entitlement benefits and higher payroll taxes also induce workers to work and save less. Retirees also consume their wealth faster leading to lower national saving. With shorter working life spans, younger generations choose to acquire less education and skills, opting instead to enter the work force early at lower wage levels. So, adopting more generous entitlements with higher taxes leads to economic choices that are socially and economically undesirable -- choices that favor getting less education, working less, saving less, and retiring earlier. This is the case even when those choices may be the right ones for individuals and households given the incentives from government policies that they face.

The alternative is a system requiring greater individual responsibility in the provision of retirement, health, and other household needs throughout each person's lifetime -- not just during retirement. Scaling back entitlement support would permit a low-tax and pro-growth economic environment. It would incentivize individuals and households to acquire more education and skills, and work and save more to provide for their own consumption, health care, and other needs today and in the future.

A more educated domestic labor force will improve U.S. competitiveness and higher domestic saving will reduce U.S. dependency on foreign capital, helping to retain future earnings at home rather than be used to service external debt.

Higher domestic capital accumulation will also create the financial means for today's workers to provide for their own retirement needs. And more capital per worker would increase labor productivity, increasing national output available for those workers to purchase when they are retired. Greater individual responsibility for retirement would also incentivize workers to remain in the work force until later, which would keep the most experienced workers in the labor force, and increase overall productivity. And workers in physically taxing occupations would have the flexibility to retire earlier than permitted under today's retirement programs that deny so many, especially minorities, from recouping their payroll taxes.

Finally, if a larger share of health care spending is through private sources, more price conscious consumers would induce competition among health care providers, helping to reduce health care cost growth -- the key driver of fiscal imbalances.

How well future budget reforms succeed in restoring vitality to the U.S. economy depends crucially on the weight placed on tax-versus-benefit-side measures. Ignoring this issue -- as S&P analysts have done -- is a politically safe option, but it won't inform the public and policymakers of the crucial importance of the choice they are facing.

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