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Paying Back America's Debt

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As countries around the world struggle to get their fiscal houses in order, the crucial debate is whether to raise taxes or cut expenditure. Either approach generates winners and losers, so it might seem difficult to choose. Yet tax hikes differ from expenditure cuts in one key respect: tax increases will shrink the economic pie, but expenditure cuts can expand it.

A fundamental conclusion of economic theory, consistent with common sense and mountains of evidence, is that high tax rates are bad for the economy. Taxes on wages or salaries discourage work versus leisure, while taxes on capital income – interest, dividends, and capital gains – discourage savings relative to consumption. The implication is that taxes distort economic decisions, implying a less efficient economy and a lower level of output.

Thus higher tax rates raise revenue for any given amount of output, but this is partially offset by lower output. Research by my colleagues Greg Mankiw and Matthew Weinzerl, for example, suggests that the increased revenue from capital income taxes might be only 50 percent of what would be raised absent the output-depressing effects of these taxes. Mankiw and Weinzerl do not account for tax evasion and avoidance, moreover, which would lower net revenue even more. Large tax hikes can even reduce revenue by moving the economy to the wrong side of the Laffer curve.

Tax hikes are therefore a terrible way to address a fiscal crisis. The right expenditure cuts, in contrast, can both enhance economic productivity and shrink the debt, so they make sense independent of the fiscal outlook.

A higher age of eligibility for Social Security, for example, would both scale back federal expenditure and spur people in reasonable health to work longer. This is desirable from an efficiency perspective because it pushes people to work until their productivity declines. Under Social Security, many people retire when their productivity is still high because taxpayers are subsidizing this retirement.

Phasing in a higher age of eligibility – say by the increase in life expectancy since Social Security began in 1935 – would also restore Social Security to its original goal: providing a backstop for people who have outlived their own productivity. A similar adjustment in Medicare would reduce expenditure still further and have the same beneficial impact on the incentive to work. People whose productivity declines before the higher age of eligibility would fall back on Disability Insurance and Medicaid, as occurs now.

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A different way to reduce expenditure while raising productivity is to incorporate more co-pays and deductibles into Medicare. A crucial problem with insurance is that when patients do not pay the full price of procedures, tests, and medications, they demand anything their doctors recommend without regard for cost. This means excessive use of scarce health care resources and a less efficient health care sector.

Private insurance moderates this moral hazard problem with co-pays and deductibles. Medicare includes these, but it could do far more without imposing an undue burden. Hospital stays, for example, have a deductible of only about $1,100 and no co-pays for stays of up to 60 days. Since the poor are covered by Medicaid, not Medicare, it is both efficient and reasonable to insist that Medicare recipients kick in more of their own dollars. This reduces expenditure directly and encourages health care decisions that balance costs and benefits.

Many other cuts, such as for agricultural subsidies or pork barrel spending, can also improve economic efficiency while shrinking the deficit. Some of these programs are small potatoes, but since they are bad for the economy regardless of the debt, cutting them is a no-brainer. Other significant cuts – in drug prohibition enforcement or the occupations of Iraq and Afghanistan – should also be on the table, although these will be more controversial.

A fact everyone must accept is that the United States has made promises to future generations that it cannot keep, so someone has to take a hit to restore fiscal balance. In choosing where to impose this burden, we should recognize that expenditure cuts expand the economic pie, while tax hikes shrink it. That should make the choice easy, from both economic and political perspectives.

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