The Deterioration in the U.S. Fiscal Outlook
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1. Introduction

For more than 35 years, it has been evident that the 2011-2020 period would be one of fiscal stress in the United States as the first baby-boomers began receiving retirement benefits. The federal government has been making 75-year projections of its health and retirement programs for many years, and as early as 1974, these projections showed spending increases similar to the ones that are, in fact, occurring.[2]

In 1983, the U.S. instituted policy changes designed to prepare for this fiscal challenge, setting revenue levels for the Old-Age, Survivors, and Disability Insurance (OASDI) program significantly above spending levels -- with the explicit purpose of reaching our current point in history with a lower debt-to-GDP level than would otherwise have occurred. Facing large deficits in the early 1990s, the U.S. adopted a formal "pay-as-you-go" budget policy to prevent further fiscal deterioration in advance of the retirement of the baby boomers. This policy required that any tax cuts or permanent new spending be offset so as to be deficit neutral or deficit reducing. When budget surpluses emerged in the late 1990s, President Clinton articulated a "save Social Security first" policy of dedicating the budget surpluses to debt reduction in advance of the baby boomer's retirement. The U.S. House of Representatives endorsed this general approach in 2000, voting 381-3 to use the portion of the budget surplus attributable to Social Security and Medicare for debt reduction. Between 1993 and 2001 federal debt as a share of GDP fell from 49 percent to 33 percent.

In 2002, the pay-as-you-go law was permitted to lapse, and what followed was a period of rising deficits. Tax cuts of roughly 2 percent of GDP were enacted without offsetting spending reductions. A significant new social insurance program, subsidizing the purchase of prescription drugs for the elderly and costing approximately 0.4 percent of GDP, was introduced, also without offsetting financing. In addition, spending increased for the security and war-fighting expenses of the post 9/11 period, with no new revenue collected for this purpose. In total, the fiscal balance worsened by about 4 percent of GDP, from surpluses that averaged 1.7 percent of GDP from 1999 to 2001 to deficits averaging 2.5 percent of GDP during the post-9/11, pre-recession years of 2003-2007.

Today rising health and retirement costs associated with the aging of the baby boomers and rising interest costs attributable largely to the direct fiscal impact of the deep recession have led to a further deterioration of the fiscal outlook. If current policies are continued, deficits are projected to exceed 5 percent of GDP at the end of the coming decade. These projections assume budget savings from the discretionary budget caps agreed to by Congress and the

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[2] Detailed 75-year projections of the Old-Age, Survivors, and Disability Insurance program are available beginning in the 1960s, though projections for the year 2050 were already being made in the 1950s. 75-year projections for the Medicare Hospital Insurance Trust Fund began in 1983.

President last year, even though most of the difficult policy choices necessary to bring discretionary spending under the caps have not yet been made.

Stabilizing the debt to GDP ratio at its current level of 70 percent during the current decade will require further policy adjustments of between 2 and 2.5 percent of GDP. Putting the debt to GDP ratio on a downward trajectory and preparing for future increases in government-funded health care costs would require further adjustments. While there is a broad consensus around the menu of policy changes that could achieve the necessary fiscal rebalancing, there is no clear path to the political deal that will be necessary to enact the changes.

This paper begins by reviewing the deterioration in the U.S. fiscal outlook over the 2000 to 2011 period. Next it discusses the outlook for stabilizing the debt-to-GDP ratio over the coming decade, and then turns to longer term issues. It concludes with a discussion of the political economy of fiscal consolidation in the U.S. and the implications of fiscal rebalancing for economic growth.

2. The Deterioration in the Fiscal Outlook.

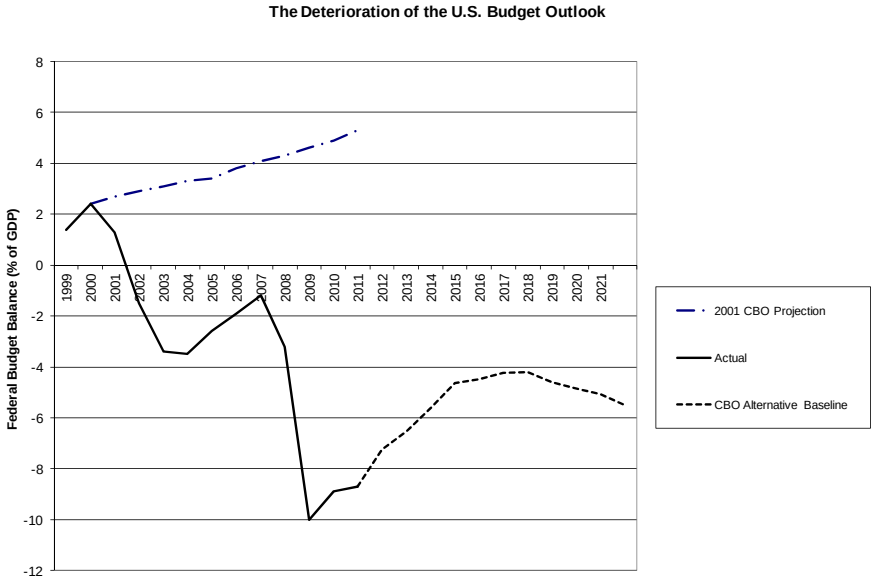
Twelve years ago, the U.S. was running federal budget surpluses equal to two percent of GDP, and projections showed surpluses persisting far into the future. Debt-to-GDP had fallen from 49 percent in 1993 to 33 percent in 2000, nearly undoing the increase in the debt from 26 percent to 49 percent that had occurred between 1981 and 1993. Policy makers were actively debating the implications of the U.S. paying down all of its publicly held debt, raising questions such as whether financial markets could tolerate a world without U.S. Treasury bonds and whether the U.S. government should use surpluses to acquire private sector assets so that it could continue to issue debt to the public.[3]

Today projections are for persistent deficits exceeding 5 percent of GDP, even after the economy has recovered from the 2007-2009 recession. Figure 1 shows the Congressional Budget Office's 10-year budget projections made in January 2001, the actual path of the deficit during that decade, and a projection for deficits in the coming decade if current policies are continued.[4] The figure reveals that if current policies are continued, there will have been a worsening of the budget balance of roughly 7 percent of GDP over a period of 20 years.

[3] For a discussion of the 1990s emergence of budget surpluses see Elmendorf, Liebman, and Wilcox (2000).

[4] The projections for the coming decade are from CBO's Alternative Baseline and assume that the 2001/2003 tax cuts are made permanent, other expiring tax provisions are extended, the Alternative Minimum Tax is indexed for inflation, Medicare's payment rates for physicians' services are held constant at their current level, and that the automatic enforcement procedures specified by the Budget Control Act of 2011 do not occur.

Figure 1



Source: CBO (2001) and CBO (2012c).
Notes: Alternative Baseline assumes that the 2001/2003 tax cuts are made permanent, other expiring tax provisions are extended, the AMT continues to be indexed for inflation, Medicare's payment rates for physicians' services are held constant at their current level, and that the automatic enforcement procedures specified by the Budget Control Act of 2011 do not occur.

Table 1 shows that more than half of the fiscal deterioration happened prior to the recession. Discretionary outlays increased by 1.3 percent of GDP between 1999-2001 and the pre-recession years of 2003-2007 primarily because of spending associated with the wars in the Middle East and the increased homeland security expenditures in the aftermath of the September 11, 2001 attacks. Mandatory spending rose by almost 1 percent of GDP as a new prescription drug program for the elderly was enacted, health expenditures continued to rise, and refundable tax credits (scored as outlays) were expanded. Neither the security spending nor the new drug program was accompanied with any significant offsetting spending cuts or revenue increases. Moreover, revenues were reduced by about 2 percent of GDP via legislation passed in 2001 and 2003. This tax legislation reduced marginal tax rates at all income levels, reduced the preferential tax rates that apply to dividends and capital gains, and expanded middle-class tax expenditures such as child tax credits. The weaker than expected economic performance of this period also contributed to the 2.7 percent decline in revenue as a share of GDP.[5] To a large extent, the fiscal deterioration of this period was a replay of the Reagan years – with tax cuts and increased security spending producing higher deficits.

[5] CBO (2012d) tabulates the reasons why the actual surpluses from 2001 to 2011 differed from projections. Looking at the year 2007, there was a 5.3 percent of GDP deterioration in the budget outlook between the 2001 projection and actual experience. 43 percent of the deterioration came from a decline in revenue, with 80 percent of the revenue decline due to legislative changes and 20 percent from economic and technical factors. 43 percent of the deterioration came from increased discretionary spending. 13 percent came from increased mandatory spending. In calculating these percentages, I allocated increased interest on the debt in 2007 to each component of the budget according to that component's share of the cumulative deterioration in the budget outlook between 2001 and 2007.

Table 1
Components of U.S. Federal Spending (share of GDP)

			Current Policy
	1999-2001	2003-2007	2022
Social Security, Medicare, and Medicaid	7.5	8.0	11.8
Interest	2.3	1.5	3.5
Discretionary Spending	6.3	7.6	6.0
Other Mandatory	2.3	2.6	2.8
Total outlays	18.3	19.8	24.1
Revenues	20.0	17.3	18.6
Surplus	1.7	-2.5	-5.5
Unemployment rate	4.3	5.2	5.3

Source: OMB and CBO historical tables and Congressional Budget Office August 2012 alternative baseline.

Before turning to the further deterioration that is projected for the coming decade, it is necessary to discuss the several alternate budget projections that are available for the U.S. The most widely used projections are those of the nonpartisan Congressional Budget Office (CBO), an independent budget agency established by Congress in 1974. The CBO is required to make its projections based upon "current law." In particular, if a tax cut or spending program is scheduled to expire, the CBO assumes in its projections that the policy will indeed expire. This convention has enabled policymakers to mask the true out-year deficit impact of policies by scheduling policies to expire even though they are intended to be permanent. The 2001 tax cuts were scheduled to expire after 10 years for this reason. A large set of business tax preferences expire and are renewed annually, masking their out-year impact on the deficit. In addition, Congress annually indexes the income-thresholds for the alternate minimum tax for inflation, but only for one year at a time, which again obscures the out-year deficit impact. Finally, Congress has legislated a 20 percent reduction in payments to doctors under Medicare. Every year this cut is undone for the current year only – allowing Congress to spend money without showing the out-year deficit impact.

In addition to its baseline budget projection, the CBO prepares a second projection that it refers to as its "Alternative Fiscal Scenario." This alternative projection show the budget path that would occur if the tax and spending policies in place for the current year were extended into the future and is often referred to as a "current policy" projection.[6]

The first two rows of Table 2 show CBO's budget projections for the next decade. The first row contains the official Congressional Budget Office baseline projection which includes the effects of the budget gimmicks described above as well as the impact of the budget sequester which is scheduled to make $110 billion per year of across the board spending cuts beginning

[6] See Auerbach, Gale, and Orszag (2003, 2006) for earlier use of this approach.

in 2013 if Congress does not repeal it or replace it with a specific deficit reduction package. Under these unlikely assumptions, deficits in the second half of the decade fall below 1 percent of GDP, and the debt-to-GDP ratio falls to 59 percent by the end of the decade. The second row shows CBO's alternative fiscal scenario that extends current tax and Medicare policies and removes the sequester. Under these "current policy" assumptions, deficits in the second half of the decade average 4.8 percent of GDP, and the debt-to-GDP ratio reaches 90 percent in 2022.

Table 2. Projections of the U.S Budget Balance

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
CBO August 2012 Baseline	-7.3	-4.0	-2.4	-1.2	-1.0	-0.6	-0.4	-0.6	-0.6	-0.6	-0.9
CBO August 2012 Alternative Fiscal Scenario	-7.3	-6.5	-5.6	-4.6	-4.5	-4.2	-4.2	-4.6	-4.8	-5.1	-5.5
President's February 2012 Budget (CBO analysis)	-8.1	-6.1	-4.2	-3.1	-2.8	-2.5	-2.5	-2.8	-2.8	-2.9	-3.0
Bowles-Simpson Plan	-6.0	-3.9	-2.6	-2.3	-2.2	-1.8	-1.4	-1.3	-1.2		
Bipartisan Policy Center Plan	-6.0	-2.5	-1.4	-1.2	-1.3	-1.2	-1.3	-1.6	-1.4		
House Budget Resolution	-7.6	5.0	3.0	1.7	1.3	0.9	0.8	1.0	1.0	0.9	1.2

Returning to Table 1, we see that the deterioration in the "current policy" budget outlook from the pre-recession period has two components. First, spending on the big social insurance programs, Medicare, Medicaid, and Social Security, is projected to grow by 3.8 percent of GDP over this period as the baby boomers begin to retire. Second, interest on the debt is projected to grow by 2 percent of GDP, reflecting rising debt levels and the resulting higher interest rates.[7] These rising interest levels are mostly the result of the direct effects of the recession – of falling revenues and increased automatic stabilizer spending on programs like unemployment insurance. Less than one-fourth of the rise in interest costs can be attributed to the Recovery Act and other stimulus efforts.[8]

Whereas spending on social insurance and interest is projected to rise rapidly over this decade, discretionary spending, the 30 percent of spending that is appropriated annually, is projected to fall by 2 percent of GDP from 7.6 percent of GDP in the prerecession period to 6.0 percent of GDP in 2022. Moreover, the projection of 6.0 percent assumes that spending on military activities in Afghanistan continues at current levels. If activities in Afghanistan wind down as currently planned, discretionary spending would fall to 5.5 percent of GDP, the lowest share of GDP spent on discretionary spending in more than 40 years. Part of the decline is discretionary spending is due to spending cuts that have already occurred. Between 2000 and 2008, nominal discretionary budget authority grew at an annualized rate of 9.2 per year. In inflation-adjusted dollars it grew at a 6.1 percent rate. In contrast, between 2008 and 2012 nominal discretionary budget authority grew at an annualized rate of 0.3 percent and in real dollars it has fallen at a 0.8 percent annualized rate.[9] In addition, last fall Congress and

[7] CBO projects interest rates on the ten-year Treasury note of 5.4 percent in 2022 under the alternative fiscal scenario compared with 5.0 percent in the baseline scenario. Debt to GDP in 2022 is 89.7 percent under the alternative fiscal scenario 58.5 percent in the baseline scenario.

[8] These calculations ignore any feedback between the stimulus policies and economic output Delong and Summers (2012) show that in severely depressed economies in which interest rates are constrained by the zero lower bound, temporary fiscal expansions may actually be self-financing.

[9] Due to the Recovery Act, there was a temporary 26 percent spike in discretionary budget authority in 2009.

the President agreed to caps on discretionary spending for future years. Because these caps call for discretionary spending to rise at a rate that below the inflation rate and well below the GDP growth rate, discretionary spending is projected to fall as a share of GDP. Below I discuss the history of past efforts to constrain spending using discretionary caps.

3. Prospects for Medium Term Fiscal Consolidation

The final four rows of Table 2 show the deficit targets set in President Obama's February 2012 budget, in two bipartisan deficit reduction plans, and the budget resolution of the Republican-controlled House. While these deficit paths are not strictly comparable -- for example the bipartisan deficit reduction plans were estimated under 2010 economic assumptions rather than the current ones -- and the plans vary considerably in the amount of specificity provided about intended policy changes with the President's budget giving the most detail and the House budget resolution providing the least detail, the paths illustrate that policy adjustments of between about 2 percent and 4 percent of GDP are contemplated.[10]

To see why it will be challenging to enact policy adjustments of the targeted size, it is helpful to return once again to Table 1. In 2022, almost two thirds of government spending will be for interest costs, Social Security, Medicare, and Medicaid. And these categories of spending are projected to account for more than 100 percent of the increase in spending since 2003-2007. But the amount of spending cuts achievable in these categories during the 5 to 10 year horizon for stabilizing debt to GDP is quite limited. Spending on interest costs can be affected only indirectly. Social Security is funded primarily with a dedicated revenue stream, and the solvency of the system is usually judged on a 75-year basis. Social Security reform proposals almost always phase in benefit cuts and tax increases gradually so as to exempt current retirees and near-retirees from benefit cuts and current workers from immediate tax increases. Thus, even a Social Security reform that was projected to produce long-run financial stability for the program would likely do little to improve the medium term fiscal outlook. For example, the Social Security plans in the Bowles-Simpson Commission report and the Bipartisan Policy Center Report reduce the deficit by just 0.2 percent of GDP in 2020.

It will similarly be challenging to make a significant dent in Medicare and Medicaid spending over the medium term. The 2010 Affordable Care Act (ACA) included $455 billion in spending reductions in these programs over the coming decade. In theory, it would be possible to “double down” on the cost savings provisions in the ACA, for example, by accelerating some of the payment reforms that are currently scheduled to be rolled out gradually as pilots. In practice, Congressional Republicans are trying to repeal many of the provisions of the ACA, and it will challenging to maintain the cost savings that have already been legislated, much less to introduce significantly more aggressive policies to reduce costs. The President's budget contains about 0.2 percent of GDP in additional savings from health care programs, and the two bipartisan commission plans contain a similar amount. All three of these plans also reduce spending on other mandatory programs such as agriculture subsidies and civil service pensions, but these additional spending cuts total less than 0.2 percent of GDP. Thus, if these proposals can be taken as representative of what is politically

[10] The targeted policy adjustments are somewhat below the targeted reduction in deficits because interest costs fall when the deficit is reduced.

feasible, achievable savings on the mandatory side of the budget over the coming decade are likely to be around 0.5 percent of GDP.

With policy adjustments of at least 2.0 percent of GDP necessary to reach the fiscal sustainability targets set in these plans and only around 0.5 percent of GDP of adjustment likely to come from mandatory spending, the remainder will need to come from discretionary spending and increases in revenue. As noted above, discretionary spending under the discretionary caps is already projected to decline from the 7.6 percent of GDP of the pre-recession years to 6.0 percent of GDP by 2022. A wind down of operations in Afghanistan could save another 0.5 percent of GDP and reduce discretionary spending to 5.5 percent of GDP, assuming the caps hold.

Whether the cap levels will actually be achieved is unknowable. The conventional wisdom about the discretionary caps of the 1990s is that when they were set at "reasonable" levels, Congress and the President abided by the caps. But when, toward the end of the decade, the caps were set at levels that many legislators perceived as being unrealistically low, the appropriations process simply ignored the caps.[11]

Overall, while there are conceivable scenarios in which spending reductions exceeding 2 percent of GDP are achieved by the end of the decade, it seems more likely that the political process will produce savings of about 1.0 percent of GDP. Moreover, the savings achieved over the next 5 years are likely to be toward the low end of this range. This observation implies that additional revenue of at least 1.5 percent of GDP will be needed by the middle of the decade to start to reduce the debt to GDP ratio. Three of the four deficit reduction plans -- the President's budget and the two bipartisan plans -- contain additional revenues of roughly this amount.[12]

There are three main approaches to raising revenue that are currently receiving significant attention in the U.S., all of which could raise at least 1.5 percent of GDP in additional revenue. The first approach is to let the 2001/2003 tax cuts expire as scheduled at the end of 2012. Doing so would raise roughly 2 percent of GDP in new revenues and would not require policy action. If Congress and the President simply do nothing, the result will close about two-thirds of the gap between the current fiscal projection and the scenario under which the debt to GDP ratio is stabilized. This scenario is unlikely, however, as neither major

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[11] Elmendorf, Liebman, and Wilcox (2000) note a key difference between the unsuccessful efforts at deficit reduction during the 1980s and the successful efforts during the 1990s. The Gramm-Rudman-Hollings deficit reduction law of 1985 set explicit annual deficit targets that declined to zero over several years, but it did not specify the policy actions to achieve the deficit reduction. When the target proved too difficult to meet in 1987, the targets were raised. Starting in 1990, however, deficit reduction efforts included specific actions to reduce the deficit rather than a set of deficit targets. The lesson that unrealistic deficit reduction targets are unlikely to bind policy makers was learned a second time in the late 1990s. While discretionary spending caps were an important component of the 1990 and 1993 budget legislation, when caps were set at levels that many legislators perceived as unrealistically low in the 1997 budget agreement, they were simply ignored.

[12] The House budget resolution does not raise additional revenues. Instead it sets a target for spending of 19.8 percent of GDP, a reduction of 4.5 percent of GDP relative to the baseline. The resolution does not fully specify which spending would be cut to reach this target.

political party has advocated this approach. Specifically, the Republican Party is committed to making all of the tax cuts permanent, and President Obama favors extending the tax cuts for taxpayers with incomes below $250,000.

The second approach to raising revenue is to broaden the tax base by reducing tax expenditures. The U.S. tax code excludes many items from taxation that would be included in an ideal (Haig-Simons) income tax base – for example, compensation received in the form of employer-provided health insurance is not taxed. It also contains expensive tax deductions for items like mortgage interest and state and local taxes paid. Finally, it administers spending-like programs through the tax code, such as tax credits for college tuition. Cutting back on tax expenditures offers the opportunity to raise revenue without raising tax rates, while simplifying the tax code and, in some cases, eliminating the economic inefficiencies that come from the deviations from the ideal tax base. The challenge here is that most of the largest tax expenditures are quite popular. Recently there has been discussion of an approach that would allow most of the existing tax expenditures to remain, but cap the total amount of tax expenditures that a taxpayer may claim (Feldstein, Feenberg, and MacGuineas, 2011; Baneman, Rosenberg, Toder, and Willians, 2012). This approach is likely to be more politically feasible than attempting to directly eliminate any specific tax expenditure.

The third approach is to introduce a Value Added Tax (VAT) to supplement existing revenue sources. The U.S. is the only OECD country without a VAT. Because Americans are accustomed to paying retail sales taxes assessed by state governments and because the VAT has negative connotations of being associated with European social welfare states, proposals for a U.S. VAT generally describe it as a "national retail sales tax." In the short term, the VAT appears much less likely to be enacted than the other two revenue approaches. The idea has received little serious discussion outside of academia and think tanks, and it would be perceived as more radical by most Americans.

It is, of course, possible to combine the three approaches to raising revenue. The President's budget proposal would allow the 2001/2003 tax cuts to expire for income ranges above $250,000, while limiting tax expenditures both by capping the rate at which itemized deductions can be claimed and by eliminating subsides for fossil fuel production. The two fiscal commission proposals aggressively cap tax expenditures and overshoot their revenue target so as to allow marginal tax rates to come down.[13] The Bipartisan Policy Center proposal includes a 6.5 percent "Debt Reduction Sales Tax" as well.

In general, the political feasibility of revenue increases is no greater than that of the more aggressive spending cuts. In particular, a large fraction of Republican elected officials have publicly committed to opposing any tax increases. However, there are two considerations that may make it possible to achieve an increase in revenue. First, the fact that the 2001/2003 tax cuts are scheduled to expire creates some ambiguity about what qualifies as a tax increase. Relative to CBO's current law baseline which assumes expiration of the tax cuts, letting the tax cuts expire does not increase revenue. Second, because tax expenditures can be interpreted as government spending that occurs through the tax code, there appears to be some opportunity for a bipartisan agreement on tax expenditures that would allow

[13] The Bowles-Simpson plan also raises tax rates on income from capital

Republicans to claim that they are reducing this large category of government "spending" and Democrats to claim that they have managed to increase government revenue.

4. The Longer-term Outlook: Demographics and Health Care Expenditures

Even if the U.S. is successful at stabilizing or reducing the debt to GDP ratio within the next five to ten years, longer-term fiscal challenges associated with population aging and rising health care expenditures will remain.

The U.S. has a more favorable demographic outlook than many European countries. The U.S. total fertility rate has averaged slightly above two for the past twenty years, and current projections from the OASDI actuaries are for a long run fertility rate of 2.0. With immigration rates projected to continue to exceed one million per year, the U.S. labor force is expected to increase by 0.5 percent per year between 2019 and 2050 (OASDI Trustees Report, 2010).

As discussed above, the retirement of the baby boom generation is leading to a dramatic rise in social insurance spending. But the demographic burden is projected to stabilize within the next 15 years. The number of workers per OASDI beneficiary is falling from 3.3 in 2007 to 2.3 in 2025. But beyond 2025, this ratio falls very gradually – reaching 2.1 in 2065. OASDI spending as a share of GDP is rising from 4.2 percent in 2007 to 5.8 in 2025. Between 2025 and 2065 expenditures on these old age and disability benefits are projected to remain nearly constant – reaching only 5.9 percent of GDP in 2065 (OASDI Trustees Report, 2010).

Unlike Social Security spending, government spending on health care is not expected to level off anytime soon. Since 1975, expenditures per beneficiary on the two main government health care programs, Medicare and Medicaid, have grown at an average annual rate of 2 percent faster than per capita GDP. The Congressional Budget Office projects that federal spending on health programs will increase by 2.9 percent of GDP between 2022 and 2037 under its extended alternative fiscal scenario (CBO, 2012b). By comparison, the primary deficit in 2022 under the alternative fiscal scenario is 1.5 percent of GDP.

Spending a higher share of society's resources on health care over time can be a rational response to rising income levels. Hall and Jones (2007) show that with diminishing returns to consumption in any given period, an important way to increase lifetime utility is by adding extra periods of life. Moreover, with rising income levels, it is possible to simultaneously spend a rising fraction of income on health care and to increase consumption (although at a slower rate) of non-health care goods and services. Research suggests that the average benefits of increased health care spending in the U.S. have exceeded the average cost (Cutler, Rosen, and Vijan, 2006). Nonetheless, there are reasons to believe that a significant portion of U.S. health care consumption is inefficient (Garber and Skinner, 2008) and the extent to which U.S. health care spending exceeds that of other counties is extraordinary even after adjusting for levels of per capita income (Reinhardt, 2008). Even if rapidly increasing health care spending were optimal, it would still create a fiscal challenge. Since about half of U.S. health care spending is government financed, such a path would imply steadily increasing tax rates.

In recent years, health care experts in the U.S. have suggested a long list of changes to eliminate inefficiencies in the system (Engelberg Center for Health Care Reform, 2009). These include moving the payment regime away from paying based on the quantity of

services delivered and instead paying on a capitated basis, or based on measures of health care quality outcomes. They also include investing more in learning about the clinical effectiveness of different treatments and pricing unproven treatments differently than proven ones. And they also include streamlining administration, eliminating the tax incentive to overconsume health insurance, reforming the medical malpractice system, standardizing insurance plans to facilitate quality and price based competition, and investing in health information technology and electronic medical records. The 2010 Affordable Care Act (ACA) contained elements of all of these recommendations, though in many cases only in a pilot form. The Congressional Budget Office estimates that the ACA reforms will reduce the deficit by over $1 trillion in its second decade of operation. Some health care experts think that with proper implementation, these reforms could produce much greater savings (Cutler, 2010). Other experts suggest that many of the cost savings provisions will not be politically sustainable and will be repealed before they go into effect (Holtz-Eakin and Ramlet, 2010).

Many countries use hard budget caps to limit health care spending, setting aggregate budgets at the provincial or hospital level and requiring providers to deliver care within that cap. A plan consistent with this approach has recently been promoted by Rep. Paul Ryan, the Republican chair of the House Budget Committee, along with Alice Rivlin, one of President Clinton's budget directors. The Ryan-Rivlin plan would replace the current U.S. system of government provided health insurance for seniors with a new system in which Medicare recipients would receive a fixed sum and purchase insurance from private insurance companies. Under the Ryan-Rivlin plan, the government contribution, and therefore Medicare costs per beneficiary, would grow at GDP + 1 percent, essentially cutting excess cost growth in half. Under this system, seniors would bear the risk associated with health care costs growth exceeding GDP+1 as they would be responsible for paying the portion of the insurance premium that was not covered by the government.[14]

Most likely the coming decade will be one of messy innovation in the U.S. health care system, as different states use the flexibilities and financial incentives provided in the Affordable Care Act to try different approaches to cost control and quality improvement. In the U.S., state governments are often described as the laboratories of democracy, since successful innovations demonstrated in one state can be expanded nationwide. If at least a few states find a way to reorganize to provide higher quality care at a lower cost, then the approach of learning what works and testing different payments systems may continue to be the main policy response to health care cost control for the U.S. in the near future. However, if excess cost growth persists at 2 percent a year for another decade, then the blunter approach of directly setting expenditure levels could emerge as a politically viable alternative.

5. The Political Economy of Reform

There is relatively recent precedent for the U.S. correcting a fiscal imbalance. From 1982 through 1997, the U.S. faced what appeared to be an intractable budget deficit problem. It required three pieces of deficit reduction legislation -- in 1990, 1993, and 1997 -- each of

[14] Over the past two years, Representative Ryan has released new versions of his plan, no longer supported by Alice Rivlin, in which the vouchers would grow more slowly. The newer versions would accomplish more deficit reduction, while shifting more health care costs to seniors.

which reduced deficits by approximately 1 percent of GDP, along with the good fortune provided by a booming economy, to turn the persistent budget deficits into surpluses.

None of the budget deals were easy. The tax increases in the 1990 deal contributed to President George H.W. Bush's defeat in 1992. Several first term Democratic members of Congress who voted for the 1993 deficit reduction package lost their seats in the 1994 election in part due to this issue. And the path to the 1997 budget deal involved a three week government shut down in December 1995. This history is a useful reminder that the U.S. political system does not need to be perfect in order to accomplish a fiscal rebalancing. Congress and the President can fail to accomplish deficit reduction in two out of three years and in the successful years make only one-third of the targeted amount of adjustment – and still the U.S. could end up with sufficient policy changes over a decade to produce a declining debt to GDP ratio.

In the comparative budget policy literature, it is a bit of a puzzle as to why the U.S. political system has historically done as well as it has in keeping budget deficits low. As a presidential country with a frequently divided government, the U.S. and its 'checks and balances' system has a bias toward inertia that, in theory, should make it difficult to address fiscal imbalances. In contrast, parliamentary coalition governments can use fiscal contracts among coalition partners to implement fiscal consolidations, with the contracts enforced by the threat of the government falling. Parliamentary majority governments can vest decision making in the finance minister (Von Hagen, 2006). Yet, the U.S. political system managed to enact major deficit reducing legislation in 1983, 1990, 1993 and 1997 and to produce a federal debt to GDP ratio of 36 percent before the recent recession. Eichengreen et al (2011) speculate that U.S. voters are not focused solely on minimizing their tax payments and maximizing the government spending they receive; they also care deeply about the health of the economy, and therefore reward elected officials who correct those imbalances.

6. Conclusion

The policy adjustments that will be required for the U.S. to stabilize its debt-to-gdp level over the next decade and start it on a downward path are not large relative to policy adjustments that have occurred in the recent past. If past history is a guide, the political system will ultimately make the needed adjustments. But fiscal policy is not simply about satisfying the government's intertemporal budget constraint. It has large implications for the health of the economy. In the short run, policy makers face the challenge of accomplishing fiscal consolidation without choking off the economy's recovery from the recent recession. While the December 31, 2012 expiration of the 2001/2003 tax cuts and the early-2013 effective date for the automatic spending cuts could provide the impetus to overcome political inertia, they also raise the risks to the economy if political deadlock occurs. In the longer run, choices about which spending gets cut and how additional revenue gets raised will affect the economy's growth rate.

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