A Tax Lawyer's Observations on Scary Numbers, Politics, and Irresponsibility: A Commentary on Shaviro's Reckless Disregard

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A TAX LAWYER'S OBSERVATIONS ON SCARY NUMBERS, POLITICS, AND IRRESPONSIBILITY: A COMMENTARY ON SHAVIRO'S RECKLESS DISREGARD

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Abstract: The fiscal gap is filled by the issuance of government debt, an increasing portion of which is held by foreigners. Although foreigners still seem willing to absorb large amounts of U.S. debt, international organizations express concern over U.S. budgetary deficits. A significant source of the fiscal gap is the Social Security system. Two changes that might resolve Social Security funding issues include raising the minimum age to receive full retirement benefits to seventy years old and raising the taxable wage base. Politically, however, adopting either of these changes soon seems impossible. In addition, current Medicare costs will exceed current tax revenue in 2004 for the first time in recent history. Congress could bring long-term expenditures and revenues into balance by, for example, immediately raising the tax rate from 2.9% to 6.02% or immediately reducing benefits by 48%. If Congress defers taking action to address the problem, however, the rate increase or benefit reduction will need to be more substantial.

INTRODUCTION

The organizers of this symposium did not make a good choice in asking me to comment on Professor Daniel N. Shaviro's very interesting and significant article. In this task, I suffer from at least two handicaps. First, I have no more than a layperson's knowledge and understanding of the issues he discusses. My expertise is in federal income tax law. I claim no expertise in budgetary policy or in Social Security and Medicare, the two programs Professor Shaviro identifies as the root causes of the fiscal gap. Although I am familiar with the technical, legal consequences of the Bush administration's tax cuts, the tools in my professional tool chest are of little help in analyzing

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the many factors that will determine their effects on the economy in either the short term or the long term. My comments, therefore, must be taken only as those of an educated layperson.

Second, and perhaps even more importantly, I am an inadequate commentator on the paper because I fully agree with the thrust of Professor Shaviro's arguments. The architects of the morass he describes doubtlessly would not agree with his conclusions or my characterization of our fiscal situation as a morass. I would like to hear what a competent fiscal analyst in sympathy with policy developments since the 2000 elections would say about his arguments.

At least some economists sympathetic to the Bush administration's economic policies seem to view the resulting deficits as no more than an unpleasant side effect. Their explanations, however, do not address the long-term effects of these deficits. For example, in a recent op-ed piece in the Wall Street Journal, Wayne Angell, an appointee of President Ronald Reagan to the Federal Reserve Board of Governors and a former chief economist of Bear Stearns, made the startling claim that a principal cause of the recession plaguing the first several years of the Bush administration was excessive fiscal restraint by the Clinton administration. He argues that by allowing the federal debt to fall from 46% of gross domestic product ("GDP") in 1997 to 34% in 2001, the Clinton administration overlooked "the first principal [sic] of macroeconomics—output growth is not sustainable without a growth of total credit and debt." In response to this reduction, Wayne Angell argues, the Federal Reserve Board adopted monetary policies that prompted an unhealthy increase in household debt from 67% of GDP in 1997 to 86% in 2003:

For the sake of my children and grandchildren I hope for a less hysterical view of debt—an understanding that high debt levels compared to the ability to service the debt is a disadvantage to households as well as to governments... Only hysteria, an outburst of emotion and fear, could produce the irrational response of the Congress and the public to the

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3 See id.
4 See id.
supposed danger of federal debt left to our children and grandchildren.\textsuperscript{5}

Notwithstanding this reference to children and grandchildren, Wayne Angell’s arguments focus on economic trends over less than half a decade and seemingly assume that what is good for Americans in the short term is also good for their children and grandchildren.\textsuperscript{6}

Wayne Angell does not advocate endless, unrestrained deficits but advises his readers to “[s]ave your outbursts for reining in the growth rate of government spending.”\textsuperscript{7} By restraining the rate by which government spending increases, he argues, “we will be able to keep tax rates conducive to faster increases in output and thereby add to both the well-being of our people and to future tax receipts available to the Congress.”\textsuperscript{8} Economists William Gale and Peter Orszag, however, assert that the Bush administrations proposal to make permanent the tax cuts enacted in 2001 and 2003, which advocates of low tax rates such as Wayne Angell presumably endorse, could be financed only by spending reductions far beyond political feasibility.\textsuperscript{9}

In sum, I am not able to provide a much-needed perspective in this discussion. Professor Shaviro, William Gale, and Peter Orszag depict Americans as lemmings rushing toward the sea, but others characterize this depiction as “hysteria.” I would like to hear a full explanation of why I should not be hysterical.

I. U.S. INDEBTEDNESS TO FOREIGN PERSONS

The fiscal gap that Professor Shaviro discusses is plugged by the issuance of government debt. He warns in the second paragraph of his paper of “a major possibility of an Argentina-style meltdown in the U.S. government’s position as a borrower in world capital markets,

\textsuperscript{5} Id.
\textsuperscript{6} See id.
\textsuperscript{7} Angell, supra note 2, at A16.
\textsuperscript{8} Id.
\textsuperscript{10} Id.
potentially yielding chronic inflation, unemployment, and bank and currency crises.\textsuperscript{11} It is relevant to this possibility that an increasing portion of the U.S. government's debt is held by foreigners. The percentages of marketable U.S. Treasury securities held by foreign persons, as shown by Treasury Department surveys, are as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Percentage Owned by Foreigners</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 1974</td>
<td>14.7</td>
</tr>
<tr>
<td>December 1978</td>
<td>12.0</td>
</tr>
<tr>
<td>December 1984</td>
<td>13.5</td>
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<tr>
<td>December 1989</td>
<td>22.0</td>
</tr>
<tr>
<td>December 1994</td>
<td>19.4</td>
</tr>
<tr>
<td>March 2000</td>
<td>35.2</td>
</tr>
<tr>
<td>June 2002</td>
<td>40.7</td>
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</tbody>
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The rising percentage of foreign ownership of U.S. debt is a vote of confidence by foreign investors in the soundness of the U.S. government and economy. It also signals, however, that a sudden loss of this confidence would be traumatic for the U.S. economy and for world capital markets. Already, there are indications that private investors are less willing to absorb new Treasury debt, a reluctance that has been masked thus far by large purchases of such debt by foreign central banks, raising additional economic and foreign policy concerns.\textsuperscript{13}

Although foreigners still seem willing to absorb large amounts of U.S. debt, international organizations express concern over U.S. budget deficits.\textsuperscript{14} In its 2004 economic survey of the United States, the Organisation for Economic Co-operation and Development (the "OECD") states the following:

\textsuperscript{11} Shaviro, \textit{supra} note 1, at 1289.


\textsuperscript{13} Greg Ip, \textit{Could Overseas Financing Hurt the U.S.}, WALL ST. J., Apr. 30, 2004, at A2 ("Foreign central banks, led by China's and Japan's, now hold close to $1 trillion of Treasury bonds and bills, almost a quarter of publicly held U.S. debt. That serves their economic interest, but it also gives them a potential financial lever.").

\textsuperscript{14} \textit{ORG. FOR ECON. CO-OPERATION \& DEV., ECONOMIC SURVEY: UNITED STATES 2004: ENSURING FISCAL SUSTAINABILITY AND BUDGETARY DISCIPLINE}, \textit{at} http://www.oecd.org/document/11/0,2940,en_2649_201185_31458443_1_1_1_1_00,html (last visited Oct. 15, 2004) (presenting data from \textit{ORG. FOR ECON. CO-OPERATION \& DEV., 2004/7 OECD ECON. SURVS. UNITED STATES 10–12} (May 2004)).
The federal budget has moved from a surplus of nearly 1 1/2 per cent of GDP in fiscal year 2001 to a deficit of 3 1/2 per cent in 2003 and a projected 4 1/4 to 4 1/2 per cent this year. This rapid deterioration is attributable to sharply reduced tax receipts following the recession and the demise of the stock market bubble combined with tax cuts and the rapid expansion of defence, "homeland security" and other discretionary outlays. While the cyclical drag on public finances should fade soon, recent policy changes on both the revenue and outlay sides imply that, under realistic assumptions and absent corrective action, the deficit will remain substantial over the next ten years by both US historical and international standards. At that time, the retirement of the baby boom generation will be in full swing, putting enormous pressure on entitlement programmes. Now that the recovery has taken hold, measures to reduce the deficit are urgently needed if the beneficial effects on long run national income from recent marginal tax rate cuts are not to be outweighed by the adverse consequences of the fall in public and national saving.\(^\text{15}\)

The survey further asserts the following:

Restraining both discretionary and mandatory spending, while necessary, is unlikely to be sufficient to restore the budget to balance over the longer term. To the extent that revenues have to be raised, this should be done primarily by broadening the tax base rather than by reversing recent reductions in marginal tax rates.\(^\text{16}\)

The staff of the International Monetary Fund (the "IMF") has expressed similar concerns, noting that growth of the deficit "creates a need to service higher U.S. debt and debt payments to the rest of the world over time, which erodes the value of the dollar, lowering consumption in the United States and increasing it elsewhere."\(^\text{17}\) The IMF staff observes that the change from 2001 to 2004 in the ratio of the budget surplus or deficit to GDP was "the largest such deteriora-

\(^{15}\) Id.

\(^{16}\) Id.

tion over such a short time span since World War II and equal to about 6 percent of world gross savings."18

Increased foreign ownership of Treasury securities is not simply a product of growth in the federal deficit. The United States has had a deficit in the balance of trade in goods and services for every year after 1975.19 This deficit has exceeded $100 billion for every year after 1995, $200 billion for every year after 1998, $300 billion for every year after 1999, and $400 billion for every year after 2001.20 The United States, as a nation, ultimately must pay for all imported goods and services. Most imports are paid for by exports, but the trade deficit represents imports not paid for in this manner. The trade deficit is paid for by transferring American factories, office buildings, and residential developments to foreign ownership and by issuing debt to foreign persons.

Foreign ownership of U.S. assets has increased steadily in recent decades, both in dollar amounts and in relation to U.S. ownership of U.S. assets. In June 2002, foreign persons held long-term securities of U.S. issuers of $3,926 billion, up from $3,558 billion in March 2000, $1,244 billion in December 1994, $847 billion in December 1989, and $99 billion in December 1978.21 The June 2002 holdings included $908 billion of U.S. treasury securities, up from $39 billion in December 1978.22 In June 2002, foreigners owned 7.8% of all U.S. equity securities (up from 5.1% in December 1994), 10.2% of U.S. government agency securities (up from 5.4% in December 1994), and 15.7% of debt issued by U.S. corporations (up from 7.8% in December 1994).23 Perhaps Americans should be concerned that the higher taxes on future generations predicted by Professor Shaviro, William Gale, and Peter Orszag will go, in large part, to foreign holders of U.S. debt and that the persons burdened by these higher taxes will have to pay them, in large part, from salaries and wages received from foreign employers.

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18 Id. at 64.
20 Id.
23 Id. at 5.
II. SOCIAL SECURITY FUNDING

As Professor Shaviro notes, the Social Security system is a significant source of the fiscal gap. Problems with the funding of Social Security benefits are, in my opinion, a leading example of the damage being inflicted on this country by political gridlock. Social Security programs are funded with taxes specifically earmarked for this purpose (FICA taxes). These programs could be funded easily and fairly by these taxes indefinitely. Presently, the taxes ($632 billion for 2003) exceed benefit payments ($471 billion for 2003). The difference is accumulated in two trust funds, invested in Treasury securities, which were $1,500 billion at the end of 2003. Although recipients of current benefits are increasing steadily, both in absolute number and in relation to the number of FICA taxpayers, the trust funds are expected to continue growing until 2018. Thereafter, benefits will continue to grow in relation to taxes, and given the taxes and benefits provided by current law, the trust funds are expected to be exhausted by 2042. At present rates, the dedicated taxes will be sufficient to pay only 73% of scheduled benefits for 2042 and 68% of scheduled benefits for 2078.

According to the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance (the "OASDI") Trust Funds, "[o]ver the full 75-year projection period the actuarial deficit estimated for the combined trust funds is 1.89 percent of taxable payroll." This deficit could be eliminated by immediately raising the combined FICA tax rate for employers and employees by 1.89% (0.945% each), from the present combined rate of 12.4% to 14.29%. Alternatively, the deficit could be eliminated by immediately reducing present and future benefits by 13%. If Congress waits until the trust funds are exhausted in 2042, however, it could continue the benefits provided by

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24 See Shaviro, supra note 1, at 1299.
26 See id.
27 Id. at 16. The Board of Trustees estimates future costs and benefits under three sets of assumptions: a low-cost alternative, an intermediate alternative, and a high-cost alternative. Id. at 6. The figures in the text are taken from the intermediate alternative.
28 See id. at 8.
29 Id.
31 Id.
32 Id.
existing law only by raising the payroll tax rate to 16.91% and continuing to raise it thereafter to 18.31% in 2078. Without raising taxes, Congress would have to reduce benefits by 27% in 2042, and continue reducing them thereafter, with reductions reaching 32% in 2078.

According to the Board of Trustees, "[t]he projected trust fund deficits should be addressed in a timely way to allow for a gradual phasing in of the necessary changes and to provide advance notice to workers." Two changes might solve Social Security funding issues for at least the seventy-five year window for which Social Security funding is evaluated. First, the minimum age for receiving full retirement benefits should be raised to seventy. Presently, the age at which a person may begin collecting full retirement benefits is sixty-five years for persons born before 1938, sixty-six years for persons born during the years 1943–1954, and sixty-seven years for persons born after 1959. The retirement age is increased by two months annually for persons born in the years between these points. Congress could continue to increase the retirement age by two months for each year after 1960 (e.g., sixty-seven years and two months for persons born in 1961, sixty-seven years and four months for those born in 1962, and so on) until the age reaches seventy. This change would not affect anyone currently over the age of forty-five, and the full impact of the change would affect only persons who are now quite new to the labor force. Because this change only would reflect the increase in life expectancy rates partially, the age may have to be raised again if life expectancies continue to rise.

Given the means by which Social Security is funded, the issue of retirement age is: for how many years at the end of life should one be allowed to consume income produced by younger generations? When the program was developed nearly seventy years ago, the answer was only a few, because life expectancies were not substantially beyond the retirement age. The answer has changed in the intervening years, not because of an affirmative policy choice, but because no policy

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23 Id.
24 Id.
25 2004 SOCIAL SECURITY REPORT, supra note 25, at 17.
choice was made in response to changing life expectancies. The issue now should be confronted directly.

Second, Congress should raise the taxable wage base (the dollar ceiling on wages subject to the FICA taxes) with the goal of eventually subjecting all wages to the FICA taxes. The dollar ceiling already has been eliminated for the Medicare hospital insurance portion of the FICA taxes and it also should be eliminated for the OASDI portion of the taxes. Elimination of the ceiling may raise enough revenues to allow the tax rates to be reduced. At least for those who believe in progressive taxation, expanding the tax base and lowering the rates would enhance the fairness of the system.

Politically, however, adopting either of these changes soon seems impossible. Republicans are unwilling to make any change to Social Security without diverting some of the funding into private accounts, which many Democrats refuse to consider for fear that the diversion of funding would weaken the redistributive aspect of the present system. Democrats will not vote to reduce entitlements (such as a raise in the retirement age) without Republicans sharing the blame, and vice versa. In other words, no political faction is willing to consider anything now, when the Social Security funding problem is quite manageable, except proposals that have no realistic chance of success.

III. MEDICARE FUNDING

As Professor Shaviro notes, the issue of Medicare funding is more serious and intractable than the issue of Social Security funding. The hospital insurance portion of Medicare (known as HI, or Medicare Part A) is designed to be funded by payroll taxes, presently 2.9% of wages (1.45% by employees and 1.45% by employers). In the recent past, these taxes have exceeded disbursements, and the excess has accumulated in a trust fund. According to the 2004 report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds, however, current costs will exceed cur-

39 See Shaviro, supra note 1, at 1293, 1299-99.
rent tax revenue in 2004 for the first time in recent history.\textsuperscript{41} Costs are projected to exceed revenues for all subsequent years, and according to intermediate projections, the trust fund will be exhausted in 2019, fifteen years from now.\textsuperscript{42} Congress could bring long-term expenditures and revenues into balance by, for example, immediately raising the tax rate from 2.9\% to 6.02\% or immediately reducing benefits by 48\%.\textsuperscript{43} If Congress defers action addressing the problem, the rate increase or benefit reduction will be more substantial.\textsuperscript{44}

The remainder of the Medicare program, Supplementary Medical Insurance ("SMI"), consists of Medicare Part B, which pays for physician, outpatient hospital, home health, and other services for the aged and disabled, and the recently enacted Part D, which initially provides prescription drug discount cards and transitional assistance to low-income beneficiaries and, beginning in 2006, will subsidize voluntary drug insurance coverage for all beneficiaries and premium and cost-sharing subsidies for low-income enrollees.\textsuperscript{45} Apart from premiums paid by beneficiaries, Parts B and D are funded entirely by general revenues of the federal government.\textsuperscript{46}

According to the Medicare Trustees, the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, which introduced Part D and made significant changes in Parts A and B, has major financial implications.\textsuperscript{47} Total Medicare expenditures, which were 2.6\% of GDP in 2003, will rise to be 3.4\% of GDP in 2006, after implementation of the new prescription drug benefit, and thereafter will


\textsuperscript{42} Id. For 2003, HI taxes were 98\% of HI expenditures, but this percentage is expected to decline to 81\% of costs in 2019 and 26\% in 2078. Id.

\textsuperscript{44} See id. at 21 ("Consideration of . . . reforms should occur in the relatively near future. The sooner the solutions are enacted, the more flexible and gradual they can be.").

\textsuperscript{46} For 2003, 38.5 million people were enrolled in Supplemental Medical Insurance ("SMI"), and SMI revenues included premiums of $27.4 billion and general revenues of $86.4. 2004 MEDICARE REPORT, supra note 41, at 3 tbl.1.C1. There is an SMI trust fund consisting of any excess of general revenue appropriations and premium payments over expenditures. Id. at 1. The balance in this trust fund was $34.3 billion at the end of 2002 and $24 billion at the end of 2003. Id. at 3.

\textsuperscript{47} Id. at 2. The introduction of Part D "will add substantially to the overall cost of Medicare . . . and increase the proportion of such costs that are financed from general revenues." Id. at 20.
"increase rapidly to 7.7% by 2035 and to 13.8% by 2078."48 Medicare taxes covered only two-thirds of expenditures for 2003 and will cover only 55% of expenditures for 2012.49 According to the Trustees' projections, Medicare costs will exceed Social Security expenditures by 2024 and will be almost double the latter's expenditures by 2078.50

The problems of Medicare funding are, of course, only one aspect of a larger set of problems with healthcare in the United States. Employer-sponsored plans have accustomed most Americans to healthcare on demand at minimal out-of-pocket cost. The Medicare system derives from congressional acceptance of public expectations that the healthcare available to working people must continue in retirement. Cost pressures are driving employers to thrust more and more healthcare expenses on their employees. Eventually, Congress will have to respond to these cost pressures, and the American public will have to accept that unlimited expenditures to meet one person's health needs may diminish the life experiences of everyone, including the recipient of the health services.

48 Id. at 2. Table II.A2 of 2004 report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds provides more complete data. See id. at 26 tbl.II.A2.
49 See id. at 1.
50 Id.