Mr. Paulson's Challenge

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When Hank Paulson replaces John Snow as Treasury secretary, he will be taking stewardship of an economy that is enjoying low unemployment and brisk growth. But while Mr. Snow helped steer the economy through a recessionary storm, he leaves for Mr. Paulson a more daunting task -- getting the long-term fiscal numbers to add up.

To understand the challenge that Mr. Paulson faces, let's start with a fact about which every serious policy analyst agrees: The government budget is on an unsustainable path. Americans are living longer and having fewer children. Together with advances in medical technology that are driving up health-care costs, this demographic shift means that a budget crunch is coming when the baby-boom generation retires. The promises made to my generation for Social Security, Medicare and Medicaid are just not affordable, given the projected path of tax revenue.

Policy analysts diverge, however, on what to do about it. Those on the political left want to raise taxes to fund all those promises. Some want to go even further by expanding entitlements, such as providing taxpayer-financed national health insurance for all Americans. That is a feasible choice, as many European nations demonstrate, but it is not advisable. As we economics professors never tire of explaining, market economies allocate resources efficiently (with a few exceptions, which I will return to in a moment). Taxes distort incentives and debase market outcomes. In technical terms, they cause "deadweight losses." In less formal terms, taxes shrink the size of the economic pie, leaving most people with a smaller serving of prosperity.

Some supply-siders like to claim that the distortionary effect of taxes is so large that increasing tax rates reduces tax revenue. Like most economists, I don't find that conclusion credible for most tax hikes, and I doubt Mr. Paulson does either. Yet the supply-siders are right about one thing: Because higher tax rates reduce the size of the tax base, raising taxes generates less revenue than the "static" revenue estimates assumed in Washington would suggest.

One of Mr. Paulson's first briefings from the Treasury staff should be about what high taxes have done to the economies of Europe. According to research by Nobel laureate Edward Prescott and by economists Steven Davis and Magnus Henrekson, the high tax rates in Europe have reduced work effort and distorted the industrial mix. The Davis-Henrekson study reports that a tax increase of 12.8 percentage points (a change of one standard deviation) reduces work for an average adult by 122 hours per year. It also reduces the employment-population ratio by 4.9 percentage points and increases underground economy by 3.8% of GDP. As Mr. Paulson works to resolve the fiscal imbalance, he should keep the European experience firmly in mind.

President Bush confirmed his commitment to low taxes when he announced Mr. Paulson's nomination: "One of Hank's most important responsibilities," he said, "will be to build on this success by working with Congress to maintain a pro-growth, low-tax environment." Avoiding tax hikes, however, does not mean avoiding hard choices. The only alternative to large tax hikes is large spending cuts. Politically, this option may be even harder, but it should be the focus of public debate and Mr. Paulson's attention.

Many economists, including myself, would recommend that the nation consider a gradual but substantial increase in the age at which people become eligible for taxpayer-financed benefits for the elderly, including both Social Security and Medicare. We face three options: raising taxes on those who are still working; reducing benefits for the very old; or reducing benefits for the relatively young old. I would rule out the first option on grounds of economic efficiency, the second on the grounds of social compassion, leaving the third as the best of a bad lot. If we raise the age of eligibility for retirement benefits, people could still retire early, but they would do so on their own nickel, rather than the taxpayer's.

The fiscal problem we now face arises largely because the age of eligibility bears little relation to demographic reality. When Franklin Roosevelt established Social Security, he set a fixed age of retirement; when Lyndon Johnson established Medicare, he followed suit. Imagine if, instead, Roosevelt and Johnson had set up an entitlement system in which the youngest 90% of the population agreed to support the oldest 10% -- and those percentages were fixed over time. Such a system would have been better able to withstand the changes in demography that have occurred over time.

There is still time to correct their mistake, taking an approach adopted in a small way in Ronald Reagan's 1983 Social Security reform. Congress could pass a law increasing the age of eligibility by, say, two months every year. That increase would continue until the Trustees for Social Security and Medicare (a group that includes the Treasury secretary) declared the programs in long-term fiscal balance. Those already retired or near retirement would not be affected, but those of us now middle-aged would have to work longer or save to finance our own early retirement. The beneficiaries of such a reform would be our children, who would not have to inherit European-style tax rates.

Although the fiscal gap could be completely closed with reduced spending, a realistic political compromise will likely include higher revenues as well. Even here, however, rather than consider a reversal of the Bush tax cuts, the new Treasury secretary should look for more efficient revenue sources.

Economists have long noted that while most taxes distort incentives and shrink the size of the economic pie, others improve incentives and enlarge it. A higher tax on gasoline, for example, is better than CAFE standards as a policy to improve the fuel efficiency of the American car fleet. It would also encourage people to drive less by, for instance, living closer to where they work. A tax on carbon is the best way to deal with global warming. These are called Pigovian taxes, after the British economist Arthur Pigou, an early advocate of using taxes to correct market imperfections.

Similarly, economists have increasingly viewed "sin taxes" as a good way to raise revenue. While Pigovian taxes aim to protect innocent bystanders from the actions of others, sin taxes aim to protect people from themselves. To the extent that people have problems with self-control, sin taxes can be welfare-enhancing. Economists Jonathan Gruber and Sendhil Mullainathan report evidence that smokers are happier when cigarette taxes are higher. Of course, non-smokers won't object to shifting the tax burden to others. Maybe we should consider higher taxes on smoking, drinking, gambling and other activities about which people lack self-control.

Finally, even if the income tax is to be used to increase revenue, we should broaden the base rather than raise rates. Last November, the President's Advisory Panel on Federal Tax Reform offered several good suggestions when it handed its report to John Snow. Mr. Paulson should continue talking about tax reform and insist that these ideas get more attention from Congress than they have gotten so far. For example, the panel proposed eliminating the deductibility of state and local taxes. This makes sense. Under current law, if one town enacts high local taxes to finance a municipal pool while a neighboring town does not, the first town gets a federal subsidy at the expense of the second. That outcome is neither efficient nor equitable.

The President's Advisory Panel also proposed scaling back the mortgage-interest deduction. The federal tax system now tilts the playing field toward residential capital at the expense of corporate capital, which in turn reduces productivity and real wages. Even if one believes that policy should promote homeownership over renting (a debatable claim), there is no reason to encourage people to buy ever larger homes. Let's lower the cap on subsidized mortgages well below its present $1 million level.

There are many options for dealing with the long-term fiscal imbalance while keeping tax rates low. The main reason the problem is not yet resolved is that the American people have not put enough pressure on their elected representatives to take the issue seriously. The sooner they do, the better. If Hank Paulson wants to leave the nation's finances in better shape than he found them, his main job will be to focus attention on the problem.

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