The theme of this conference involves difficult choices. Most politicians feel the same way about difficult choices as I do about broccoli – something to be avoided. We prefer what Herb Stein called the “hot fudge sundae diet” – guaranteed to lose weight until it doesn’t.

Today, the world abounds in difficult choices from ISIS through Ukraine to climate change. But I specialize in the depressing field of fiscal policy, so that’s where I’ll focus my remarks.

It’s best to start by describing where we stand today. We have just witnessed an extremely rapid fall in the deficit from almost 10 percent of GDP in 2009 – in the depths of the recession and the height of the stimulus program – to less than 3 percent in 2014. Alas, even if the
deficit persists at that low level, it would not be low enough to significantly lower the debt-GDP ratio. In the CBO budget baseline the ratio stays slightly above 70 percent for the next few years – the highest level since we were bringing down the massive debt accumulated during WWII. What’s worse, the CBO has the deficit rising again after 2018 – admittedly two elections and therefore light years away for elected officials.

There is, however, some good news. When I last spoke at a NABE conference in Denver in October 2010, I talked about being on an unsustainable fiscal path that could only lead to a sovereign debt crisis if we did not change policies. The main culprits putting on that path were Social Security and health programs. Both were afflicted by the aging of the baby boom and health had the added problem that costs per beneficiary were rising considerably faster than income per capita. My forecast was in the mainstream of the economics profession, but as so often happens to economic forecasts, this one went astray. Health care
cost growth has slowed precipitously and CBO has continually been lowering their estimates of future Medicare spending.

We don’t fully understand the slowdown, but when a consensus forecast goes badly wrong it is often because of a whole bunch of little things that analysts did not foresee. The $64 trillion question is whether the flattening relative to GDP will be long lasting or is it temporary, soon to be followed by a restoration of rapid growth. Or should we forecast something in between.

CBO has chosen the last option, but not because they fully understand what’s going on. No one does.

However, we do understand some things and many look like temporary phenomena. Medicare has saved large amounts of money by substituting generic for much more expensive brand named drugs. This was enabled by the patent cliff. A large number of widely used drugs went off patent in 2012. It is not likely that will be repeated.

Obamacare reduced Medicare reimbursements and subsidies for Part C Medicare. That is also a one shot deal.
Obamacare has also been successful in limiting hospital re-admissions. It is not clear whether or not the resulting savings will continue to grow.

There is much disagreement among experts about the effects of the Great Depression. Did it reduce demand for health care and therefore lower prices? The health cost slowdown began before the recession and CBO does not believe that Medicare costs were affected. But if the recession was important, its impact is clearly temporary.

Those, who are optimistic that something more fundamental is going on, point to the possibility that we are slowly departing from fee-for-service medicine – an enormously inefficient method of delivering health care. New medical school graduates are going into individual or small group practices less frequently than in the past. Instead of being in a situation where their well-being depends on persuading patients to visit often, they are joining large organizations like hospitals or groups like Kaiser where they are salaried, have a more predictable schedule, and have large numbers of administrators who take care of the astounding
amount of paper work required by insurance companies. Costs are also being lowered significantly by high deductible policies buttressed by health saving accounts. Such arrangements are spreading rapidly, but have a long way to go before they cover a majority of the labor force.

Health experts could probably describe other efficiencies, but I think it clear that we have a mixture of some effects that are clearly temporary and others that could be longer lasting. Given the uncertainty, it seems to me that CBO has taken a prudent approach by assuming that things are changing; they should reduce their estimates of future cost growth; but not below the assumed rate of growth of GDP. That still leaves us with an unsustainable fiscal policy as we march toward a sovereign debt crisis. But we are marching more slowly than earlier believed.

Even if there will be a lasting slowdown in cost growth, there are three reasons that we have to keep working on health reform:
1. Things may have become more efficient, but they are still terribly inefficient. It is clear that we should be able to obtain the same quality of health care at a much lower cost.

2. Since it is quite possible that health costs will again start growing at a rapid pace, it would be good to have an insurance policy that promises to impose some limits on whatever growth occurs.

The third reason for continued reform efforts is more complicated. It is clear that the fundamentals of our long-run budget problem have changed significantly over the past few years. Health costs look less menacing. But the huge deficits caused by the Great Recession and the stimulus program have doubled the debt-GDP ratio and so made us very vulnerable to a rise in interest rates. It may be difficult to forecast health costs for 10 years, but that is easy relative to forecasting interest rates for 10 years.

In their 10-year baseline CBO assumes a modest rise in interest rates starting yesterday and stabilizing at 4.6 percent for the Treasury
10-year yield by 2020. As CBO points out that is lower than would be suggested by the historical average through the stable period 1990 to the Great Recession. Nevertheless, it’s a sufficient rise to make interest costs the fastest growing expenditure in the budget, more than tripling by 2025.

But Congress cannot attack interest costs directly. They can only do it indirectly by lowering the debt-GDP ratio through reducing the rate of growth of spending or raising taxes. To reduce the rate of growth of spending, they have to take a cue from Willie Sutton. He robbed banks because that’s where the money is. The money in the budget is in Social Security and health. And so we get back to health. Social Security, Medicare, and Medicaid accounted for 49 percent of total spending in 2014.

Reforming Social Security is conceptually easy and politically excruciating. Available options for improving its financial health include raising the normal retirement age, modifying the indexing of benefits, and a variety of ways of raising payroll tax revenues. We have a very
good idea of the effects of different options on different groups of people and the incentives and disincentives that they create.

Health is both conceptually and politically much more complicated. The effectiveness of various approaches to reform are much more uncertain. Our approach to financing health insurance and health care is most peculiar. The national health systems in countries like Canada and the United Kingdom have a budget. Health providers have to live within the budget. That often involves the terrible word “rationing” and the ways that they do it are anything but transparent. But ultimately they live within their budgets most of the time.

In this country, taking Medicare as an example, laws define the eligible population while laws and regulations determine the treatments that are available. Then we pay for everyone who comes in the door. The program is sometimes said to be uncontrollable. We do try to control it with a price control system that would make the old Soviet Union proud, but our price control system works about as well as theirs did.
Imposing a strict budget on Medicare is politically implausible, but we might be able to move in that direction by imposing stricter controls. I would like to move toward income related subsidies for buying health insurance. The subsidies would not be indexed, so they would become relatively less generous over time. The Congress could increase them periodically with the generosity of the increases depending on the availability of budget resources. The structure would be very similar to the structure of exchanges under Obamacare. When Paul Ryan proposed it, it was called “premium support”. He was, of course, demagogued in the 2012 campaign and ads showed him pushing an old lady in a wheelchair off a cliff. That’s an indication of the political difficulty of pushing any reform in Social Security or Medicare – probably the two most politically popular programs ever invented.

The irony is that Ryan and President Obama had exactly the same goal for Medicare cost growth – GDP growth plus one-half percentage point. President Obama would have attained the goal very differently using something called IPAB that was supposed to recommend cost
reducing measures. The process for implementing their recommendations is complicated and I won’t describe it here. The point is that both Ryan and Obama were moving to impose limits on Medicare growth – something like a budget. The Obama-Ryan goal seemed harsh at the time, but Medicare has not risen faster than GDP since 2009. The Obama-Ryan goal would have turned out to be extremely generous.

Although the main culprits causing our budget problems are health and Social Security, the main efforts to contain total spending in recent years have focused on discretionary spending – not a source of our budget problems. It is mainly controlled by annual appropriations. Spending caps have been imposed on defense and nondefense appropriations and they are very stringent. It was politically easy for the Congress to impose overall caps because they did not have to specify which individual programs would be affected. They left that painful task up to the appropriations committees. The caps are effective through 2021. Both the defense and nondefense caps grow less rapidly than the rate of inflation. The caps were relaxed to some degree in 2014 and 2015
as the result of a budget deal negotiated by Rep. Paul Ryan and Sen. Patty Murray, then chairs of the House and Senate Budget Committees.

Defense has an uncapped account called Overseas Contingency Operations (OCO) that financed the wars in Iraq and Afghanistan and is now financing the air war against ISIS. This gives defense a bit of flexibility because I would forecast that the Congress will finance expenditures using OCO that are only tenuously related to fighting wars. Nevertheless, I doubt if the defense cap will last through 2021. The world is too dangerous and Chinese defense spending is soaring.

With less certainty I would expect the nondefense cap to be violated as well. The fall in real spending implied by the cap will collide with a higher demand for services by a growing population. But it won’t be that easy to wiggle out of the cap because so many Republican House members and Senators won office in the last election by promising to curb spending. We may see some very creative accounting before it’s all over.
There are a lot of budget issues that I haven’t touched on. There is the debt limit which will probably become an issue next summer. I thought that Republicans would be so eager to show that they could govern that the debt limit would be increased smoothly. But with the flap over homeland security, we see that Republicans are perfectly capable of marching briskly into a blind alley without any exit strategy.

Business tax reform is not very likely. Some of the difficult choices involve inversions. The Camp proposals, backed by many Republicans, moved us toward a territorial system; the president’s budget moves vigorously in the opposite direction. The ideological gap on this and other issues is so huge that I can’t imagine bridging it in this administration or with this Congress.

Looking at the longer run, the next president, whoever he or she may be, would be well advised to confront difficult budget choices early and try to settle long-term budget issues once and for all with a bipartisan agreement. Otherwise the budget will be squeezed by Social Security, interest costs and probably still to some degree by health
spending. There will be little room for other initiatives whether they be in infrastructure, education or anything else.

Do I expect the next president to do that? Not really.

I began by saying that my field of specialization was depressing. I hope that I have proved my point.