The Daily Dish

The Fiscal Challenge and the 2025 Tax Debate

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Readers of Eakinomics are well aware that the federal budget is on an unsustainable trajectory, with ever-rising deficits and debts. So, there is a temptation in some quarters to conclude that policymakers should simply let the Tax Cuts and Jobs Act (TCJA) sunset at the end of 2025, thereby closing deficits by roughly $5 trillion over the next 10 years.

There are two problems with this. First, the United States also has a growth problem and undoing the beneficial tax reforms made in 2017 is a firm step in the wrong direction. Second, it sends the message that somehow the fiscal problem is a taxing problem. Wrong. There is no real, permanent solution to the debt threat without serious attention to spending reforms.

Here is the budgetary arithmetic. Over the next 10 years, the Congressional Budget Office (CBO) baseline indicates that Social Security and Medicare will account for $36 trillion of the $71 trillion of non-interest spending – more than 50 percent from those two programs alone. So, the notion that one cannot touch those two key pieces of the social safety net and make real progress on the deficits and debt is numerically baseless.

Moreover, these programs grow very rapidly. CBO anticipates that Social Security spending will grow at an average annual rate of 5.5 percent, while Medicare will average 7.0 percent. In contrast, revenue typically grows at the rate of the nominal economy. If the United States averages 2.0 percent real growth and inflation hits the 2.0 percent target, then revenue will grow at 4.0 percent per year. (The actual growth in the CBO baseline is 4.3 percent.)

There's the problem: Social Security spending is projected to grow at 5.5 percent and Medicare spending at 7.0 percent versus the economy at 2.0 percent and revenue at 4.0 percent.

In short, the demands of the largest federal spending programs are outstripping the resources to fund them by a greater margin every year. Now, it would be possible to close the gap with a large tax increase (putting at risk the goal of better growth), but having done so, what would happen? The two largest entitlement programs would continue to grow at 5.5 and 7.0 percent and revenue would still grow at 4.0 percent. The gap would widen each year, and the deficits and debt would re-appear and increase. Again, there is no solution to the federal debt challenge without serious spending reforms.

What, then, should be the budgetary framework for the 2025 debate? At the very minimum, the legislation should not worsen the fiscal outlook. This amounts to using a current-policy baseline and making sure that the legislation is revenue neutral. As a practical matter, it means that any deviation from a straight-up extension of the TCJA must be paid for. In particular, should Congress seek to add any of the pricey vote-buying tax proposals from President-elect Trump – no tax on tips, no tax on Social Security, full-deductibility of state-local taxes, deductibility of interest on auto loans, no tax on overtime, and so on – it should offset these revenue losses with other tax increases or mandatory spending cuts.