NEW AMERICA FOUNDATION

Ten Big Ideas FOR A New America

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Executive Summary

The recent turnover in Congress, combined with a wide open presidential election cycle, creates a rare opportunity to bring new ideas into the political process. The spirit of this new era will be captured by those—from either party or no party—who embrace innovative yet pragmatic solutions to the foremost challenges facing our nation. We offer this collection of Big Ideas as fuel for an overdue bipartisan debate about how to update our national policies for the common good.

Every Baby a Trust Fund Baby

An American Stakeholder Account (ASA), established for every child at birth, would build a savings and ownership culture in America, promote financial literacy, and fortify the American economy for the long haul. Every child would automatically receive a $6,000 deposit into an ASA at birth—and also be eligible for dollar-for-dollar matching funds for voluntary contributions up to $500 a year. Over time, ASAs will evolve into a broad system of saving accounts that all Americans, and especially low-income Americans, can tap to meet their asset needs throughout their lives, enabling them to invest in higher education and lifelong learning, purchase a first home, start a small business, and build a nest egg for retirement.

Mandatory, Affordable Health Insurance

We need both universal health coverage and a more efficient delivery system. These are not competing objectives; achieving each of these goals is necessary to make the other possible. The most promising and politically feasible path to universal health coverage is to make an adequate level of insurance mandatory and affordable for all individuals. The new system would be citizen-based instead of employer-based, thereby making health insurance fully portable from job to job. Once all patients are insured, providers can be expected to assist—rather than resist—the efficient redesign of our delivery system. This will entail an electronic health information superstructure, performance-based payments, and comparative technology assessment that will enable us to buy and deliver high-quality health care far more efficiently than we do today.

A Universal 401(k) Plan

For those with access, America's private pension system provides powerful saving incentives: tax breaks and employer contributions, as well as the convenience and discipline of automatic payroll deduction and professional asset management. Unfortunately, this employer-based system covers only half of all workers. Moreover, two-thirds of the tax breaks for retirement saving go to the most affluent 20 percent who would save anyway. The solution is a Universal 401(k) plan. All workers would have the option to contribute automatically to their own account by payroll deduction—and the government would match voluntary deposits with refundable tax credits deposited directly into the worker's account. This supplemental system would make retirement saving easier, automatic, fully portable, and fair.

Tax Consumption, Not Work

For more than 70 percent of American families, the payroll tax is the largest tax they pay. Yet the tax is regressive, inefficient, and insufficient to fund the programs it finances. As a 15.3 percent wage tax levied on employers and employees, it deters job creation and depresses wages at the low end of the scale. By replacing the payroll tax with a national and progressive consumption tax, the United States could stimulate job creation, higher wages, and higher levels of personal saving at the same time, all in a revenue-neutral manner. Families would pay taxes on what they spend each year, rather than on what they earn. Higher levels of spending would be taxed at higher rates, encouraging saving, strengthening the economy, and increasing the overall progressivity of the tax code.

An Energy Efficiency Trading System

Reducing the economic and environmental risks of excessive energy use must become one of America's most important national goals. The most promising way forward is to reduce energy demand by spurring a revolution in energy efficiency. Indeed, efficiency is America's largest and most cost-effective potential energy resource. Phasing in tough new energy standards for America's biggest energy users and making energy efficiency tradable—much the way we now trade oil and natural gas—would quickly reduce total energy consumption while limiting carbon emissions. A market for standardized efficiency credits (white tags) will give utilities, builders, and vehicle manufacturers flexibility in meeting strict efficiency goals while stimulating new technologies, creating jobs, and improving the nation's overall productivity and competitiveness.

A College Access Contract

America's financial aid system imposes too much debt on college graduates, provides too much taxpayer support to banks making college loans, and demands too little of students assuming them. A new "College Access Contract" would allow low-income students to graduate with zero federal student loan debt—and middle-class students to graduate with interest-free federal student loan debt—if they: (1) work hard in high school to prepare for college—as evidenced by completing a college prep track or scoring college-ready on a placement exam; (2) work or engage in community service while in college an average ten hours a week; and (3) evidence a minimum level of competency in an academic area upon completing college. The program's cost can be paid for by reducing excess lender subsidies and embracing market mechanisms in the delivery of federal student loans.

Closing the $700 Billion Tax Loophole

While it appears the federal government will spend around $2.8 trillion this year, there is another $700 billion that is "spent" through the tax code in the form of tax expenditures. This shadow budget represents subsidies disbursed by way of taxes *not* collected. While politically popular, tax expenditures are an inefficient, poorly targeted, and needlessly expensive way to achieve the programmatic goals of government. Tax expenditures need to become part of the regular budget and appropriations process. They should be dramatically reduced, consolidated, and capped. The result would be a simpler, fairer, more efficient tax code. Equally important, hundreds of billions of dollars in potential savings can be freed up and redirected to meet the nation's most important needs.

Universal Risk Insurance

In recent decades there has been a massive transfer of economic risk from shared institutional arrangements, such as unemployment insurance and basic benefit coverage provided by employers, onto the fragile balance sheets of families. Yet public programs have largely failed to respond. "Universal Insurance" is a new response to this growing problem. It would provide short-term, stop-loss protection to families whose income (after taxes and public benefits) suddenly declines by a fifth or more due to job loss or catastrophic health expenses. All but the richest families would be eligible, but the program would be most generous for low-income families. This type of broad-based insurance—covering a range of risks but focused on substantial income drops or losses—would provide a flexible new platform of security in a world of rapidly changing risks.

Instant Runoff Voting

Americans want a more representative and responsive government capable of addressing the nation's challenges, yet our electoral system is founded on antiquated practices that inhibit voter choices and encourage a politics of polarization and paralysis. It's time to bring our electoral system into the 21st century by adopting instant runoff voting (IRV). IRV elects winners with majority support in a single election by allowing voters to rank a first, second, and third choice on their ballots. If no candidate wins a majority, and a voter's first choice is eliminated, the vote goes to the voter's second-ranked candidate as his or her runoff choice. IRV encourages more electoral competition, solves the "spoiler" problem, enables voters to choose the candidate they really want, and encourages candidates to win by building coalitions rather than tearing down opponents.

A Capital Budget for Public Investment

The federal budget needs to prioritize spending that will make our economy more productive in the future. Yet, over the last several decades, the portion of the federal budget going to current consumption has increased, while that devoted to public investment has declined. As a result, the federal government does not adequately fund either the physical infrastructure or knowledge capital upon which a more productive economy rests. We are underinvesting not only in traditional infrastructure, but also in high-speed broadband networks, in basic science research and development, and in training skilled workers, scientists, and engineers. Just as private businesses and most states use capital budgeting, a federal capital budget would allow us to separate our nation's public investment, which expands our capacity to grow, from our government's current consumption outlays.

Introduction

The 2006 elections opened the door to a new political era. The conservative domination of Congress that began in 1994 has come to an end. However, the political pendulum has not swung back to traditional liberalism. Rather, it has been reset to a new centrism characterized by a profound public desire for real solutions and bipartisan reform. The elections made clearer than ever before that Americans are fed up with partisan politics as usual. The spirit of this new era will be captured by those—from either party or no party—who embrace innovative yet pragmatic solutions to the foremost challenges facing our nation.

As the recent elections also illustrated, increasing numbers of Americans are now part of what we at the New America Foundation have called the Radical Center. They understand that most of our national problems require active government intervention, yet they are wary of complex government programs that are full of hidden subsidies. They are fiscally responsible yet want the government to invest wisely in our country's future. They demand greater fairness in both our political and economic life but also insist upon greater personal responsibility and respect for traditional American family values. They acknowledge the benefits of globalization but do not believe they should come at the expense of a domestic social contract that gives all Americans their fair share of the American dream.

Since its founding in 1999, the New America Foundation has tried to give voice to this yearning for a new center in American politics by advancing bold yet pragmatic solutions to our nation's problems. With this publication, we have distilled the wide-ranging work of New America's programs and Fellows into ten Big Ideas that can help meet our country's most serious challenges, yet can be readily implemented with bipartisan support.

A number of these proposals fit together into a vision of the next social contract, a new approach to the relationship between government, employers, and individuals that is better suited to the profound transformations the American economy, workforce, and family have undergone in recent decades. Each of the following ideas falls into this category: Len Nichols's outline of the elements of a successful approach to health care for all; Michael Calabrese's plan for automatic 401(k) accounts open to anyone; Jacob Hacker's proposal for universal insurance against devastating drops in income; Ray Boshara's proposal to jump-start widespread asset building by establishing a matched savings account for every child at birth; and Michael Dannenberg's description of a College Access Contract.

The challenge of sustainable and broadly shared economic growth is the other side of the coin, and several of our Big Ideas therefore focus on expanding the economy and extending its benefits. Sherle Schwenninger's proposal to promote public investment through a federal capital budget, Maya MacGuineas's plan to replace the burdensome and regressive payroll tax with a progressive tax on consumption, and Lisa Margonelli's idea to reduce energy demand by trading efficiency gains are all thoughtful and provocative components of a new growth agenda.

Finally, the 2006 elections demonstrated that the American people are demanding not just a change in what government does, but also how it does it. The American political process has created a vicious circle in which the absence of competitive elections, the role of money in politics, and the lack of transparency reinforce and compound one another. Fundamental reforms to the processes of representative democracy are a necessary step toward meeting the other challenges. Here Maya MacGuineas's idea of bringing the vast expenditures hidden in the tax code into public light, and restructuring them so that hundreds of billions of dollars in revenue can be reprioritized and spent more wisely, is essential, as is Steven Hill's proposal to make elections more open and more competitive through Instant Runoff Voting.

The emerging new era of American political life should not be a time of partisan politics, but an era of bipartisan creativity and accomplishment. We offer these ideas in the hope that they can help point the way.

Ted Halstead
President & CEO
New America Foundation

Every Baby a Trust Fund Baby

Ray Boshara

An American Stakeholder Account (ASA), established for every child at birth, would build a savings and ownership culture in America, promote financial literacy, and fortify the American economy for the long haul. Every child would automatically receive a $6,000 deposit in an ASA at birth and be eligible until maturity for dollar-for-dollar matching funds for voluntary contributions up to $500 a year. Over time, ASAs would evolve into a broad system of savings accounts that all Americans—especially low-income Americans—could tap to meet their asset needs throughout life to pursue higher education and lifelong learning, purchase a first home, start a small business, and build a nest egg for retirement.

At present, about a quarter of all white kids and half of all other kids grow up in households with zero or negative assets, apart from possible equity in a house. This means that there are no available assets for any sort of investment. The prospects for achieving economic success of children growing up in such households are pretty dim. Therefore, imagine what it would mean for such kids to have an investment account with their name on it—earmarked for their education, their first home, their retirement. Imagine the enormous effect such a program would have on our failed efforts to educate our kids about financial basics. And just imagine the effects on our economy: it doesn't take an army of economists to tell us that we would reap huge rewards if virtually all young people became owners, savers, taxpayers, and entrepreneurs—and if fewer people depended on the state, local charities, their communities, and their parents for their livelihood and well-being.

Is this pie in the sky? Actually, no. Starting last year, each British baby born after September 1, 2002, receives a "child trust fund" of £250 (about $460), with the poorest third of children receiving twice that amount. The government will make similar "top up" deposits when a child reaches age seven. Parents, relatives, and others can contribute up to £1,200 tax-free every year. With compound interest and ongoing contributions, the account could grow to £40,000 (about $70,000) at maturity on the child's 18th birthday. So far, almost 2 million such accounts have been opened. The idea is to give all kids—regardless of their backgrounds—a shot at economic success, to reduce their reliance on the state, and to foster a savings culture in the U.K.

Whether Britain's Child Trust Fund can deliver all this remains to be seen. But it is already apparent that the program is spurring significant savings—even among poor families. Moreover, the accounts are serving as "magnets" for contributions. The head of Children's Mutual, one of the main providers of the accounts in the U.K., tells of a Child Trust Fund voucher that came back with 30 baptism checks attached to it. British prime minister Tony Blair launched the trust fund to address challenges that are remarkably similar to those facing Americans. Like us, British parents worry deeply about how their children will ever afford to buy a home—the average age of a first-time home buyer in the U.K. is 34—and how they can help their kids pay for college.

Americans accept inequality of outcomes, but they do not accept inequality of opportunity.

The potential of our proposed stakeholder accounts is embodied in a 2005 front-page story in *The Washington Post*, which tells of five-year-old Austin Sambrano, whose own savings account is teaching him and his family about saving and family finances:

> Three weeks shy of his first day of kindergarten, Austin Sambrano is the only person in his family who has a savings account. Living with his parents and older brother in a trailer park near Pontiac, Michigan, he is part of an experiment called the SEED Initiative that is opening investment accounts for children, in an effort to ensure them a college education—and teach their families the habit of putting aside money for the future. Austin Sambrano's mother, Christine Albertson, had a humbler reason for signing up her son for a SEED account. Neither she nor her partner of 12 years, Steven Sambrano, has any savings. On the $400 a week he brings home from his new job driving a truck, "we are barely making the bills as it is," she said. Austin's account, she said, makes him feel special. "He's excited. He knows this is for college."

The *Post* also tells the story of young Brianna Jones. She and her parents have a new attitude about saving and spending because of Brianna's savings account:

> Some parents say that they are learning new habits—and that their children are learning important lessons. "This program here gives me a chance to save. I know it's there. I can't mess with it," said Almedia Jones, of Lexa, Ark., who opened an account in May and made a $20 deposit in June and July. She took her daughter, Brianna, 5, to a SEED class where the children decorated two cans, labeled "savings" and "withdrawal," with butterfly stickers. Brianna began to put her allowance into a can. One day, Jones took Brianna along when she went shopping for a present for another daughter, Brittney, who had just had surgery. Brianna spotted a pretty purse and turned to her older sister. "If you buy me this purse," Brianna said, "when I turn 18, you know I will have money in the bank, and if I go to college, I'll have even more money, and I'll pay you back."[1]

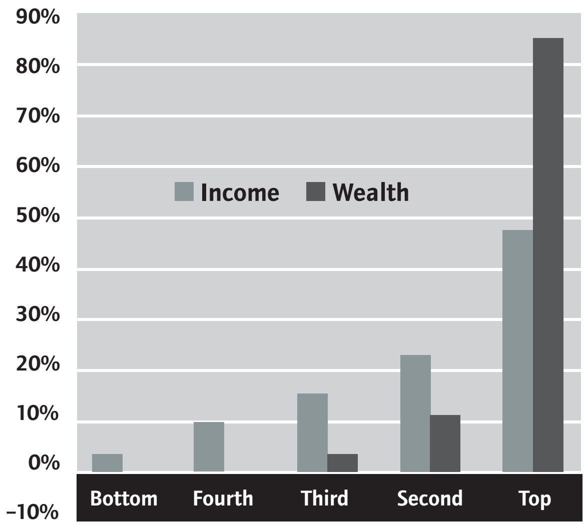
As these stories vividly show, the one-two punch of a owning a savings account, combined with financial education, changes savings habits and the attitudes and aspirations of both children and their parents.

Why American Stakeholder Accounts?

The broader case for American Stakeholder Accounts is compelling.

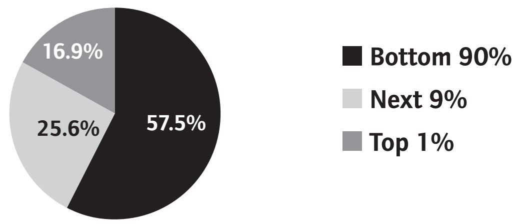
First, stakeholding, as a public policy, has a long and successful history in the United States and around the world. In postwar Japan, land was redistributed to millions of farmers, laying the foundation for broad-based economic success. Singapore has achieved one of the highest rates of savings and home ownership in the world through its Central Provident Fund. In the United States, at least a quarter of adults can trace their family legacy of asset ownership to the Homestead Act, signed into law by Abraham Lincoln, which awarded land in the American West to those pioneers with the courage to settle it. The GI Bill, passed in 1944, has generated returns of up to seven dollars for every dollar invested. And there is the nearly $400 billion

SHARE OF TOTAL INCOME AND WEALTH BY QUINTILE

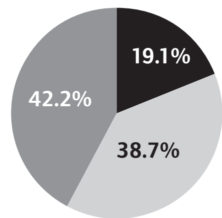


Source: *The State of Working America, 2006/2007*, Economic Policy Institute, 2006.

DISTRIBUTION OF HOUSEHOLD INCOME, 2004



DISTRIBUTION OF NET FINANCIAL ASSETS, 2004



Source: *The State of Working America, 2006/2007*, Economic Policy Institute, 2006.

a year in popular federal tax breaks for homeownership, college, business ownership, investments, and retirement—subsidies that fail, unfortunately, to reach the bottom half of the population.

Second, that failure—combined with antipoverty policies that focus on income and consumption while discouraging asset ownership—contributes to a severe absence of asset ownership among the bottom half of the population. When families lack income, they don't get by; when families lack assets, they don't get ahead. According to New York University scholar Edward N. Wolff's analysis of the most recent Survey of Consumer Finances (conducted by the Federal Reserve), the top fifth of households in 2004 held 84.7 percent of all wealth, while the middle fifth held a mere 3.8 percent, and the bottom fifth actually had negative net wealth—it *owed* 0.5 percent of all wealth. Between 1962 and 2004, the top fifth increased its share of wealth by 3.7 percentage points, while the bottom four-fifths gave up that much. Seventeen percent of all households actually had zero or negative net worth, while 29.6 percent had net worth of less than $10,000. Thus, nearly half of all households in America had net worth of $10,000 or less. However, the challenge is not to reduce the wealth at the top—we should reward creativity and hard work—but rather to actively create opportunities for lower-income individuals to save and accumulate wealth.

Third, assets don't just change people's pocketbooks, they change the way people think and behave. Evidence from around the world shows that owning assets—even among very poor families—is associated with an orientation toward the future, household stability, staying employed, educational attainment for adults and children, local civic involvement, and health and satisfaction among adults. Those with assets are also more likely to stay married, and to see less poverty in future generations.

How American Stakeholder Accounts Could Work

Under the proposed American Stakeholder Account Act, every child born in 2008 and beyond would automatically receive $6,000 in an ASA once a Social

Security number was issued. Children from households below the national median income would also be eligible to receive dollar-for-dollar matching funds for voluntary contributions up to $500 a year. These matching contributions could be deposited directly into the account, or delivered directly on tax returns through a larger earned income tax credit or child tax credit. To encourage good performance in school, as well as community or national service, "merit" and "service" deposits should be offered as well. After-tax voluntary contributions—from family members, churches, corporations, foundations, etc.—should be encouraged, but limited to $1,000 a year from all sources. All funds would grow tax-free.

We don't need an army of economists to know the U.S. would reap huge rewards if virtually all young people became owners, savers, taxpayers, and entrepreneuers.

A typical low-income kid, saving or leveraging about $20 a month and earning about a 7 percent annual return would have over $38,000 by the time he or she reached 18—an amount that would set generations of kids on a lifelong path of saving, investing, and ownership.

Withdrawals from the account prior to age 18 would not be permitted, but kids—in conjunction with their parents and financial educators at school—would participate in investment decisions and watch their money grow. An ASA Fund and its governing board, modeled after the highly efficient Federal Thrift Savings Plan for government employees, would be established within the U.S. Treasury Department to hold and manage the accounts.

At age 18, the beneficiary could choose to keep accumulated savings in the ASA Fund (the default option) or roll it out to a financial institution of his or her choice. However, to preserve the account and a lifetime platform for saving, a $500 minimum balance would have to be retained within the ASA Fund (that is, rollouts to private financial institutions would be permitted above the $500 threshold), with additional contributions governed by existing Roth rules.

ASAs could be used tax- and penalty-free for postsecondary education or for the purchase of a first home, or retained in the account for retirement. If the assets were used for one of these purposes, the account holder would keep all the government-provided funds (those deposited at birth and all the matching funds); if the assets were withdrawn for any other purpose, the account holder would keep all voluntary contributions (minus some taxes and penalties) but lose all the government funds. And to signal that ASAs were not something for nothing—as well as to help endow the next generation of kids—the account holder would have to begin paying back the $6,000 at-birth deposit at age 30, although payments could be spread out over ten years and exceptions would be permitted for hardship.

A Fresh Opportunity for Each Generation

There's no doubt that the American Stakeholder Account program would be costly. But as the stories of Austin and Brianna show, and given the historical returns on asset building in America, this would be money well spent. If we ever hope to address the growing problem of inequality of income and wealth, we must embrace such a program.

It is important to note, however, that ASAs are not meant to combat inequality of *outcomes*, but inequality of *opportunity*: Americans accept inequality of outcomes as a by-product of how we reward the hard work, initiative, and creativity that underpin our much envied economy. But they do not and should not accept inequality of opportunity. Expanding the ownership of assets by means of American Stakeholder Accounts would help to ensure that the inequality of wealth in one generation will not result in inequality of opportunity in the next.❖

[1]Amy Goldstein, "Initiatives to Promote Savings from Childhood Catching On," *Washington Post*, August 20, 2005.

Mandatory, Affordable Health Insurance

Len Nichols

America's health care system is broken and cannot be repaired with timid half-measures. We need both universal coverage *and* a more efficient delivery system. These are not competing objectives; achieving each of these goals is necessary to make the other possible. If we do not make health care more affordable and our delivery system more efficient and sustainable, a majority of Americans will be uninsured by 2020. At the same time, the growing number of uninsured impedes the efficiency gains we must achieve to make health care and health insurance affordable for all. Thus, contrary to conventional wisdom, both universal coverage and delivery system reform must be pursued simultaneously.

Health care costs continue to grow faster than incomes, and more and more working families and employers are finding health insurance unaffordable. Four million Americans have lost private coverage since 2000—bringing the total number of uninsured above 46 million—mostly because they cannot afford the higher contributions their employers' require each year for ever less generous offerings. We may be near the breaking point of our mid-20th-century employer-based system. Forward-thinking labor leaders like Andy Stern, president of the Service Employees International Union, are voicing the compelling reality: the employer-based health insurance system as we have known it is unsustainable in a 21st-century economy. Understanding their impotence to reverse these trends, many employers agree. Corporate leaders like Lee Scott, CEO of Wal-Mart, are searching for ways to jump-start a national conversation about feasible alternatives.

There are only three credible universal financing arrangements: (1) a tax-financed single payer system, such as Medicare for all; (2) employer-plus-individual mandates for the purchase of private health insurance; and (3) individual mandates alone. (The last two would require subsidies for low-income households.) "Medicare for all" is technically feasible but would require a level of trust toward government decision making that simply does not exist at present, nor is likely to be seen in the near future. In addition, most of the administrative efficiencies of a single payer system could be obtained with any program of mandatory coverage that eliminated the profit from refusing coverage to high-risk patients.

The most promising and politically feasible path to universal coverage is to make an adequate level of insurance mandatory and affordable for all individuals. Without purchase mandates, no insurance system can approach the level of efficiency we need because insurers and providers will continue to use up scarce resources trying to avoid high-risk patients, as they do today. Thus, beyond the moral case—the Institute of Medicine estimates that 20,000 uninsured Americans die each year because the lack of health insurance prevents them from obtaining timely routine care—there is a strong economic case for universal coverage.

Universal coverage and a more efficient delivery system are not competing objectives; each is necessary to make the other possible.

Among the private insurance alternatives, the "individual mandate alone" option is by far the most congruent with the 21st-century U.S. economy, which must remain flexible and reward mobile workers. Therefore, tying insurance to citizen-workers rather than firms makes perfect sense. The U.S. economy will continue to generate many jobs with productivity levels that simply cannot support compensation that includes both employer-provided health benefits and a market wage. For this reason, mandated employer-provided coverage would be counterproductive to efficient and shared economic growth, for many low-wage jobs would be lost. Finally, the individual mandate is consistent with individual responsibility, a central—but by no means the only—element of a new social contract that could promote opportunity and well-being through redefined social responsibilities.

Universal Coverage Is Not Enough

While mandating universal coverage is an ambitious goal, it is not enough. Our health care system is so inefficient and prone to unsustainable cost growth that to pursue universal coverage without simultaneously seeking to contain costs would very soon add to our mounting fiscal problems.

We spend at least twice as much per capita on health care as our major trading partners, and we finance far more of it through employers, which puts us at a significant competitive disadvantage in the global economy. This is why health care system reform has become a "C-suite" issue: CEOs, COOs, and CFOs are focused on it as never before. Moreover, the health gains from our spending are mediocre compared to the rest of the world. The United States ranks an embarrassing 37th in the World Health Organization's evaluation of health systems worldwide, next to Slovenia and Costa Rica.

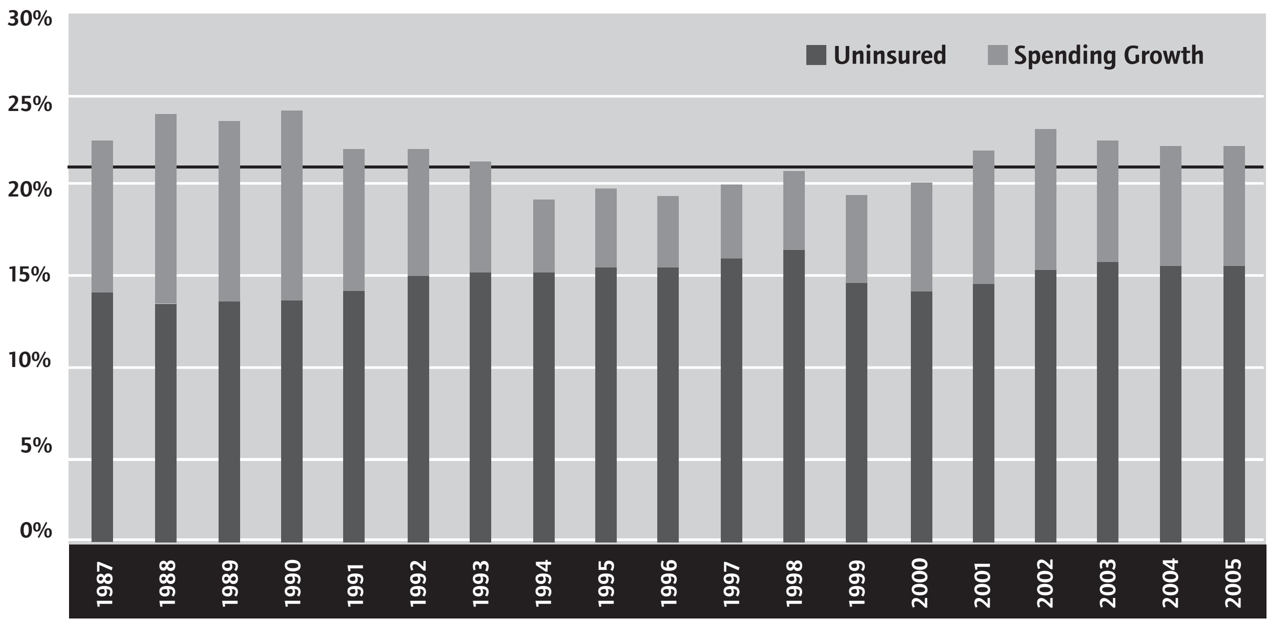
We compare poorly because our three linked problems—high costs, mediocre quality, and unequal access—do not yield to the incremental reforms we have tried to date. Despite our high spending, Americans get appropriate care only about 55 percent of the time. Individuals at the higher income levels get appropriate care only 2 percent more often, while individuals at the lowest income level get appropriate care 2 percent less often. Thus money actually buys very little quality per se. Geographic variation in the quality of care is stunning: an individual living in Utah has a one-third higher chance of surviving cancer than a person living in North Carolina. Ineffective care adds unnecessarily to costs, which reduces coverage and stifles access.

We also suffer over 150,000 unnecessary deaths each year from avoidable errors and substandard care. The average person in Canada, Australia, or France is healthier and will live longer than the average American, and far more equitable access to high-quality primary care is a big part of the explanation. The total economic costs of the uninsured—due to belated care and shifted medical costs, lost productivity from extra absenteeism, and premature death—have been credibly estimated to be roughly equal to the cost of low-income subsidies necessary to finance universal coverage. It is time we made a smarter health economic bargain.

A Changing Political Climate

The first step is to recognize that comprehensive health care reform—achieving universal coverage *and* cost growth containment—is not only necessary, it is possible. We can provide better

HEALTH STRESS INDEX



Source: New America Foundation tabulation of U.S. Census Bureau data and the National Health Expenditure Data from the Center for Medicare and Medicaid Services, Office of the Actuary.

Note: Intensity increases once the Health System Stress Index rises above 21.

care for more people, we can afford the necessary subsidies for our low-income population, and we can bridge the divides in our polarized national debate and politics. It will take leadership, compromise, and hard work, but political leaders in Massachusetts have shown us that it is indeed doable. There, a Republican governor and presidential aspirant was willing to use the word "all," and the Democratic legislature accepted the word "limit," and together they are taking a giant step toward universal coverage by making it mandatory and affordable.

Politically, the possibilities for national reform are greater today than ever before, not least because the barometers of system stress are worse than they were when Bill Clinton became president and health reform was on the agenda. In 1992, there were 33 million uninsured Americans; more than 13 million people have been added to the rolls of the uninsured since then. The average family health insurance premium today claims 19 percent of median family income, compared to 10 percent then.

Three qualitative differences may matter even more.

First, employers are increasingly determined to force politicians to address the question of reform because high health costs make it harder for them to compete in international markets.

Second, as cost growth forces companies to reduce benefits and shift costs to workers, more and more workers worry about losing coverage altogether, even in a strong economy. This is a sea change from the early nineties, when the fear of coverage loss was recession-based. Now it is based on cost growth outstripping income growth, with no end in sight. As presidential aspirants in both parties are learning—in their home districts, in Iowa, and in New Hampshire—voters are deeply worried about unaffordable health care.

Third, and most importantly, growing public awareness of the linkages between cost growth, quality gaps, and losing coverage makes the reform discussion different this time around. The Clinton-era debate was mostly about covering the uninsured and the income redistribution that would have been required to accomplish this. That argument was largely zero-sum: some would gain coverage, and others would have to pay higher taxes to finance it. But if none of us are assured of getting quality care, and if all of us—including employers—are vulnerable to rising costs, then there is a positive-sum or win-win dimension to comprehensive reform now that makes it far more likely.

A Win-Win Formula for Reform

Positive-sum reform provides something for everyone and demands shared responsibility as well. Essentially, it entails building a universal coverage financing system on the backbone of a sustainable delivery system. Therefore it has numerous elements.

- **It must be bipartisan.** Effective reform will require features that moderates in both the Democratic and Republican parties can embrace, a program that preserves enough of the core values of each party's base to permit each side to recognize its own narrative in the outcome. To achieve this, there must be individual responsibility as well as shared responsibility, cost-containment as well as universal coverage.

- **It must create an effective health insurance market or purchasing pool.** Individuals and groups without good options today will benefit from administrative economies of scale and risk pooling. Market rules must be fair to individuals and reasonable for insurers, like those that govern very large employers, employer coalitions, and federal or state worker purchasing pools today.

- **Individuals must be required to purchase health insurance.** Even with subsidies and a functioning marketplace, some individuals will be unlikely to buy health insurance on their own, thereby shifting costs onto others in the event of their need for expensive care. To avoid such "free riding," individuals must be required to pay their fair share toward health access for all. Purchase mandates are therefore essential under any formula for achieving universal coverage. Individuals could purchase insurance through their employers or efficient purchasing pools.

- **There must be substantial subsidies for low-income individuals and families.** Insurance must be required, but in exchange it must also be affordable. This is essential for reasons of equity and efficiency alike. We cannot force people to buy policies they cannot afford. Even if this were politically feasible, it would force them to forgo other necessities, which could have bad health consequences. If we try to mandate insurance without subsidies, some will remain uninsured, and we will continue to pay for their late, inefficient care as we do now.

- **Household subsidies should be financed by a dedicated and limited new tax.** These subsidies can be partially financed, especially over time, with savings from the reform program, but there will need to be additional revenues dedicated to them, at least in the short run. It would be best to fill the gap with a dedicated stream from a new tax (e.g., a progressive consumption tax), that would also serve as a budget constraint. Budget constraints and tax rates can and should be revisited over time as circumstances warrant, but annual budget limits on subsidies may be necessary to construct a majority coalition for comprehensive reform.

- **The new system should be citizen-based, phasing out the employers' role.** There are a number of options here, but it is important that employers should be seen as only one among many possible financing sources for health insurance coverage, with the understanding that they are not likely to be able to continue indefinitely in that role.

The goal ought to be to keep current employer "money" in the game while relieving employers of the burden of negotiating health premium increases every year. A new insurance market pool and subsidy structure could aid such a transition. For example, firms might enroll their workers in a plan through a purchasing pool in year one, while maintaining their historical premium contribution levels. In year two, they could give their workers a raise at least equal to the previous year's premium contribution, plus some agreed-upon inflation factor, and from that higher base the worker would be expected to purchase insurance on his own unless eligible for a subsidy. (Tax preferences could also be converted at that point, perhaps from today's open-ended income and payroll tax exemption for employers and employees, to a fixed tax credit that might vary by income and/or risk class.) This transition would keep the "right" amount of money flowing to health insurance in year two; thereafter cost growth and affordability would be worked out in the political arena between citizens, the government, health care providers, and insurers, with the employer out of the picture.

Delivery System Reform

This brings us to delivery system reform, which is central to the success and sustainability of the entire reform enterprise. In short, we urgently need to reorganize our delivery system to yield far more health "value" per dollar spent. There are three critical elements to a delivery system "culture of value."

- **An electronic health information system.** This would give any clinician anywhere instant access to a patient's medical history, plus diagnosis and treatment options. The system would include Web-based electronic health records, as well as medical decision support tools so that best practices could be applied to every clinician-patient encounter. Today, a Las Vegas casino can determine the precise details of an individual's credit worthiness in real time, but no emergency room doctor in that city (or anywhere else in the United States) can find out what medications an unconscious person is on (unless that individual is being treated in the Veterans Administration system). An electronic information system will help us monitor care, protect patients, and improve the overall quality of health care in the United States.

The most politically feasible path to universal health coverage is to make an adequate level of insurance mandatory and affordable for everyone.

- **Turbo-charged incentives for evidence-based decision making.** We need new payment incentives for both patients and providers. Today, we pay providers for conducting tests and carrying out procedures that may or may not be necessary or effective. And patients are often required to pay no more for expensive tests and procedures than for less expensive but equally effective treatment. This system encourages unnecessary treatments and results in low-value care. Smarter incentives would encourage patients and clinicians to use resources prudently while promoting high-quality, cost-effective care. Incentives for patients and providers should be mutually reinforcing, and they can be if they incorporate the same performance targets. For example, clinicians should be paid more if diabetics under their care obtain all appropriate tests each year, and the patient's co-payment for such cost-effective, evidence-based tests should be zero. We will also need to reform our dysfunctional malpractice legal system. Evidence-based medicine—statistically supported best practices—must be a safe harbor against spurious malpractice claims. Guidelines can be developed and disseminated by private specialty societies and public research agencies to ensure their effectiveness and a smooth transition to evidence-based safe harbors.

- **Comparative technology assessment.** Advances in medical technology have saved lives and improved the quality of life for many, and future advancements are likely to be nothing short of breathtaking in their possibilities. However, the overuse of new technology has been the main culprit in driving up costs. Future advancements are likely to push health system costs even higher, to a level that could be catastrophic for the health of the U.S. economy. We need to establish processes for assessing the clinical value-added of new technologies compared to existing treatment or diagnostic options prior to their widespread adoption and use. The Food and Drug Administration's drug approval process is a case in point. Today, to get a drug approved for a specific use, a manufacturer must simply prove that the proposed new drug did not manifest serious side effects and is more effective than a placebo. We should require a higher standard for approval: new and more expensive drugs should be shown to be better than the best existing treatment for any given patient subpopulation. To compensate for the longer and more expensive trials this would require, we would probably need to lengthen the life of drug patents. We should apply the same logic to medical devices and new diagnostic or surgical techniques. Then we can become far smarter purchasers of costly new technologies.

The Political Groundwork Is Being Laid

The good news is that a critical mass of stakeholders, opinion leaders, CEOs, union officials, and politicians agree that our health care system is on an unsustainable trajectory and must be reformed. Massachusetts has shown that comprehensive and bipartisan compromise is possible, and the American Medical Association's recent call for an individual mandate approach to universal coverage is proof that former adversaries of wholesale reform now see its necessity.

The incoming Congress and forthcoming presidential campaign provide opportunities to renew the debate over larger visions for transforming America's broken health care system. A large majority of voters are willing to pay to ensure that all Americans have access to at least basic health insurance. Announced and potential presidential candidates have heard the rumblings of discontent and fear among the electorate. Our political system can find a bipartisan way for those fears to be addressed and the public's preferences to be translated into affordable and effective heath care for all Americans. The leaders who facilitate this transformation will be highly regarded indeed.❖

How to Fix Our Broken Health Care System

- Create a Health Insurance Market
- Require Everyone to Buy Health Insurance
- Subsidize Low-Income Americans
- Define a Transitional Role for Employers
- Improve Outcomes Using an Electronic Information System
- Offer Turbo-Charged Payment Incentives to Lower Costs
- Provide High-Quality Care Based on Comparative Technology Assessment

A Universal 401(k) Plan

Michael Calabrese

With over $12 trillion in assets, traditional pension trusts and 401(k)-style saving plans account for the vast majority of financial assets accumulated by households in recent years. For those with access, America's employer-based private pension system provides powerful saving incentives—both tax breaks and employer contributions—as well as the convenience and discipline of automatic payroll deduction. Unfortunately, employer-sponsored plans cover less than half of all workers. More than 70 million American workers do not participate in a tax-subsidized, payroll deduction saving plan—and therefore they tend to save very little for retirement. As a result, a projected 40 percent of today's baby boomers are likely to depend almost entirely on Social Security's poverty-level benefit after age 70.

As a nation, we are saving too little and not doing enough to give lower-paid workers the combination of opportunity and security they need to cope with accelerating technological and economic change. We need to facilitate pension portability while simultaneously shifting the burden of subsidizing basic benefits from American business to society as a whole.

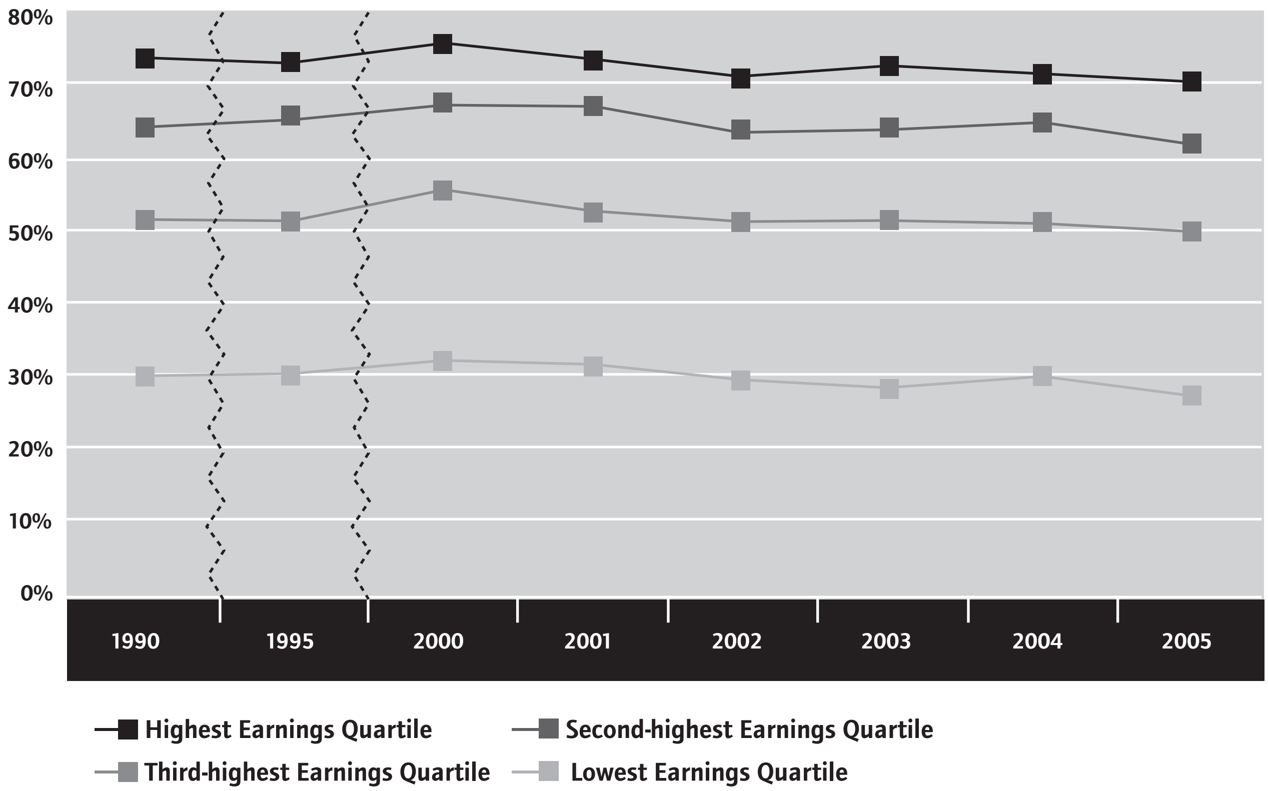
The solution is a Universal 401(k) plan that gives *every* worker access to an automatic, professionally administered retirement saving plan—an Individual Career Account (ICA). The plan would supplement, not supplant, the existing private pension system. All workers not participating in an employer plan, including recent hires and part-time employees, would be signed up to contribute automatically by payroll deduction, although an individual could choose not to save. The government would match voluntary contributions by workers and their employers with refundable tax credits deposited directly into the worker's account. Workers participating in their employer's plan would receive stronger tax incentives to save, but otherwise see no difference. Contributions for workers not participating in an employer plan would be forwarded to a federal clearinghouse, which would manage small accounts at low cost and could even convert account balances into guaranteed income for life at retirement. Individuals could maintain the account throughout their careers, since it would remain open as they moved from job to job. This supplemental system would make saving easier, automatic, and fair.

Limitations of our Industrial-Era Pension System

America's postwar pension system has been a great success in many important respects. From 1945 to the late 1970s, the percentage of private-sector workers covered by pension plans grew rapidly from 20 percent to just above 50 percent. The working and middle classes became shareholders and, with Social Security, accumulated the foundation for a secure retirement. Pension funds also steadily became the world's largest pool of "patient capital," boosting U.S. growth and innovation by underpinning the world's most sophisticated, liquid, and dynamic capital market.

When the landmark Employee Retirement Security Act (ERISA) became law in 1974, its fiduciary, funding, vesting and other provisions were designed to perfect what was then a system of employer-sponsored defined-benefit (DB) pensions. Employers made all the contributions and shouldered all the investment risk, managing pooled trusts subject to government oversight at relatively low cost. Workers—at least those who clocked more than 20 hours per week—were automatically covered and received, at retirement, guaranteed monthly income for life. The federal government insured these traditional pension benefits against employer bankruptcy through the Pension Benefit Guarantee Corporation. Combined with Social Security, these pensions allowed workers who remained at a firm for 30 or more years to replace well over half of their pre-retirement income, with the primary risk being that inflation could reduce the purchasing power of their fixed pension benefit over time (particularly as, in recent years, most firms have stopped giving regular cost-of-living adjustments).

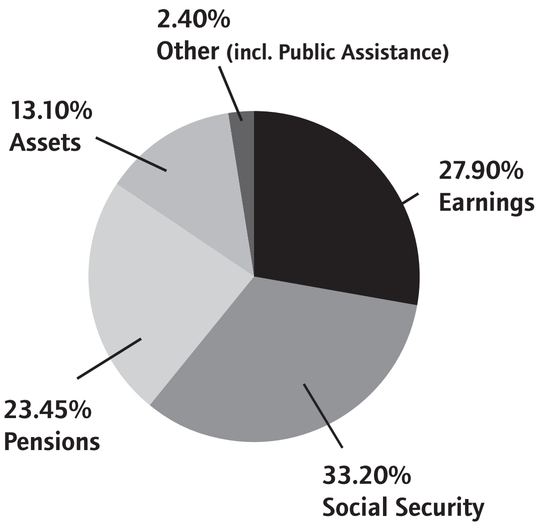
PARTICIPATION IN RETIREMENT PLANS BY ANNUAL EARNINGS
PRIVATE-SECTOR WAGE AND SALARY WORKERS EMPLOYED YEAR-ROUND, FULL-TIME, AGES 25–64



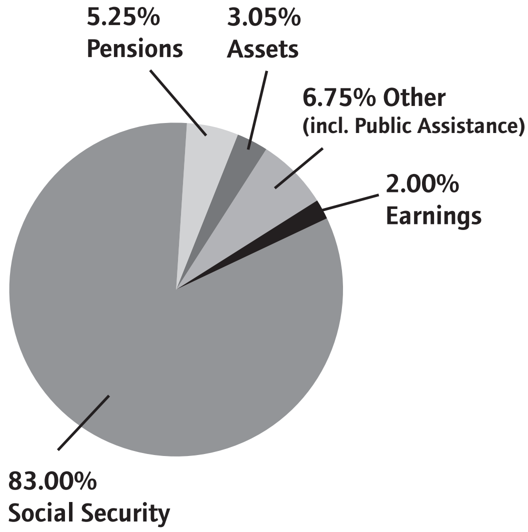
Source: Congressional Research Service Analysis of March 2005 *Current Population Survey.*

SHARES OF U.S. RETIREMENT INCOME BY SOURCE, POPULATION 65 AND OVER, 2004

TOP TWO INCOME QUINTILES (HIGHEST 40%)



BOTTOM TWO INCOME QUINTILES (LOWEST 40%)



Source: Social Security Administration, *Income of Population 55 or Older, 2004*, released May 2006.

This industrial-era system was based on assumptions of career-long job tenure, stable corporate structures, pressure from strong unions, and large doses of employer paternalism—conditions, like traditional DB plans themselves, that have been rapidly disappearing over the past two decades. Since the first 401(k) plan emerged out of an unintended tax loophole in 1981, the number of U.S. firms with DB plans has plunged from 100,000 to fewer than 30,000 now. Today, we are a 401(k) nation. More than 60 percent of private-sector workers lucky enough to have any pension benefit work at firms that sponsor only a 401(k)-type contribution plan.

Even as 401(k)s and other defined-contribution accounts emerged as the dominant plan type, the nation's fundamental approach to encouraging pension coverage and retirement saving has not changed. It continues to rely entirely on voluntary plan sponsorship by employers who are offered tax carrots in the form of deductions that disproportionately benefit high-wage earners and are subject to regulatory sticks—antidiscrimination, fiduciary, and reporting requirements—that, however reasonable, discourage small employers in particular from helping their employees save.

What Is Needed

A renewed and updated effort to facilitate saving and retirement security for *all* Americans should be designed to address the following unmet needs:

Improve individual retirement security. America's real retirement security crisis is not about Social Security or the many big companies freezing their traditional pension plans and switching to 401(k)s. The larger problem is that a minority of American adults are participating in *any* retirement plan—whether DB or 401(k) plans or Individual Retirement Accounts (IRAs). Participation in employer plans peaked during the 1970s and has remained on a plateau since. Only 45 percent of all private-sector workers participated in a retirement plan in 2005, according to the Congressional Research Service. While participation is slightly higher among full-time workers (52 percent), it is also strikingly low among workers who are low-income, young, work part-time, or work at small firms. A General Accounting Office study found that 85 percent of Americans without a pension benefit at work shared one or more of these four characteristics. Thus, whereas 65 percent of full-time workers at firms with more than 100 employees participate in retirement plans, that rate sinks to 45 percent at firms with fewer than 100 employees, and it plunges to 25 percent for firms employing fewer than 25.

A projected 40 percent of today's baby boomers are likely to depend almost completely on Social Security's poverty-level benefit after age 70.

Fewer than 60 percent of today's older workers, those aged 47 to 64, are on track to maintain even half of their pre-retirement standard of living during retirement. Too many individuals and families are headed toward retirement age with little more than Social Security's safety net. A great deal of the opposition to partial privatization of Social Security undoubtedly related to the average citizen's keen awareness of how many elderly desperately depend on the program's meager but guaranteed (and inflation-adjusted) monthly payment. Among the elderly, 40 percent rely on Social Security for 90 percent or more of their income—a dependency ratio that is even higher for widows and unlikely to improve for the baby boomer generation, according to government projections.

Boost national saving and investment. Despite the fact that baby boomers—the largest segment of the adult population—are in their prime saving years, the personal saving rate in 2005 was actually *negative* (-0.4 percent) for the first time since 1933, during the Great Depression. If we truly want to promote national saving, reduce dependency on social insurance, and create an inclusive "ownership society," we will need new mechanisms that extend the advantages of private pensions to everyone. After all, retirement plans are how America saves: tax-deferred pension plans (of all kinds) have accounted for more than 80 percent of personal saving in recent years.

Not surprisingly, pension participation is lowest among workers whose savings would truly *add* to net national saving: workers who earn less than the median wage. While the affluent can respond to tax incentives for saving by *shifting* rather than actually increasing their net saving effort, households that would not otherwise save generate net new national saving. Indeed, a majority of middle-to-low-income households are not responding to current incentives. Among the bottom 60 percent of all workers by income—those earning less than $40,000—only about a third (36 percent) participate in employer plans, according to the Congressional Budget Office.

We might at least expect the workers lucky enough to participate in 401(k)-type plans to be accumulating significant savings. Among the subset of high-tax-bracket earners with steady access to a 401(k), this is the case. But participation rates in the bottom two quintiles of the earning distribution are far lower, and the average amount accumulated is barely above $10,000. Even among 401(k) participants in the middle-earning quintile, the average account balance was only about $30,000 in 2001. One reason for the low participation rates and accumulations is that even if a worker has coverage today, he or she may not have access to a plan next year in a new job. Even if the new employer sponsors a plan, new hires are not eligible to participate for at least one year. The result is gaps in coverage. What is needed is a seamless, lifelong saving system.

Even when lower-wage workers have consistent access to an employer plan, the tax incentives for saving are upside-down. The tax break for retirement saving is one of Washington's most expensive programs, costing a projected $134 billion in uncollected federal tax revenue this fiscal year alone. Yet about 70 percent of that subsidy goes to the most affluent 20 percent of taxpayers—and virtually none (2 percent) goes to encourage saving by the lowest-earning 40 percent. The reason is simple but too often overlooked even by liberal policymakers: a program subsidized by tax *deductions*, as opposed to refundable tax *credits*, is highly regressive.

Qualified retirement saving today reduces taxable income, a deduction that is worth 35 cents on the dollar to high-bracket taxpayers who need little incentive to save. In contrast, a tax deduction for saving is worth *zero* to the 35 million low-earning households who pay 15.2 percent in payroll taxes but don't have income tax liability to offset. Indeed, even median-income families in the 10 and 15 percent income tax brackets receive a weak subsidy compared to the 35 percent subsidy rate that applies to those earning over $200,000 a year.

Another way to deliver a subsidy through the tax code is through a credit, which directly reduces taxes due. In fact, the Saver's Credit, enacted in 2001, creates this incentive, although it is limited to very low-income taxpayers with income tax liabilities to offset. The most powerful way to ensure that low-income workers receive an incentive at least as generous as an affluent worker is to make the Saver's Credit *refundable*, as the Earned Income Tax Credit (EITC) is, so that the low-wage worker receives it even if she has only payroll tax and not income tax liability.

Increase benefit portability and workforce flexibility. In yesterday's more stable, goods-producing economy, traditional pensions were designed to reward seniority and to retain older, long-tenured workers with firm-specific skills. Domestic firms were more insulated from foreign competition, unions were stronger, job tenures were longer, and a much higher share of the (predominantly male) workforce occupied standard full-time jobs.

The 21st-century workforce is very different. The service and information technology economy puts a premium on younger, more educated workers with transferable skills. Competition, both foreign and domestic, creates enormous volatility for companies and workers alike. Median job tenure has declined significantly over the past two decades. Even at firms with retirement plans, an increasing number of workers cycle through jobs without earning employer-paid benefits, since it typically takes one year to be eligible to participate and five years to vest. A combination of two-income families and just-in-time labor strategies by firms has increased the share of nonstandard work arrangements. Nearly 30 percent of U.S. workers are working in part-time, temporary, or contract arrangements that rarely include pension coverage. While this emerging "free agent" workforce may be good for flexibility and productivity, it makes the current employer-based pension system increasingly inadequate.

Lighten the social benefit burden on business. It's clear that most small and start-up companies either cannot or prefer not to shoulder the administrative burden and financial risk of sponsoring a pension plan. Indeed, despite the "carrot" of tax subsidies for pension plans, a majority of firms with fewer than 500 employees do not offer one. In addition, even very large companies with a predominantly low-income workforce—the Wal-Marts and McDonalds among employers—have little incentive to sponsor a plan for workers who (a) receive little or no financial benefit from a tax deduction and (b) without a strong incentive would prefer a higher wage now to an employer contribution for retirement. In contrast, big, high-wage employers—the Microsofts and Intels—use retirement plans to steer tens of millions of dollars in pension tax subsidies to their employees every year.

This creates the anomalous situation whereby the federal government provides more than $100 billion in compensation subsidies to the employees of a minority of companies—most of which are large firms with workers paid above-average wages. Meanwhile, companies with a substantial percentage of low-wage workers that *do* offer good benefits (employers like Starbucks) are paternalistically shouldering a cost that should be borne by society as a whole—and which will need to be if we want to achieve universal retirement security. If, instead, contributions by both workers and firms were matched by a refundable federal tax credit, then—as with the EITC—the after-tax value of benefits paid to low-wage workers would be less expensive, rather than more so.

Individual Career Accounts: A Universal 401(k)

Today's private pension system works well for those workers who have consistent access to a plan and choose to save. One big reason retirement plans are effective in generating saving is the powerful incentives provided by immediate tax deductions and employer matching contributions. Another reason is infrastructure: employer-sponsored plans create the positive inertia of automatic payroll deductions while also managing the complexities of investment management at relatively low cost. These two key attributes—incentives and an infrastructure for automatic saving—is what needs to be replicated for all Americans.

An essential step is to give every working American access to a tax incentive and portable savings account *whether or not* his current employer sponsors a retirement plan. The fact that so few workers (less than 10 percent) save regularly in IRAs reinforces what demonstration projects in asset-building have found: it is not primarily access to a savings account that spurs participation, but the three "I's"—Incentives, Infrastructure, and Inertia. The proposed Individual Career Account would recast federal pension policy by adding:

A tax *incentive* for saving that is more inclusive—and potent—by expanding the Saver's Credit, making it refundable and directly deposited into an ICA.

An account-based *infrastructure* that is citizen-based, rather than strictly employer-based, yet enables every worker to opt for regular contributions by automatic payroll deduction.

Default options that convert myopia into positive *inertia*, through automatic enrollment, automatic payroll deduction, automatic asset allocation, and automatic annuitization.

Basic Program Elements: Incentives, Infrastructure, Inertia

A Universal 401(k) system can accomplish the various national policy objectives described above by combining the following basic elements:

1. Incentives: matching, refundable, and deposited credits for new saving. Just as most employers match contributions to 401(k) accounts, the government would match voluntary saving by providing a refundable tax credit that would be deposited directly into the worker's account. This would create a far more powerful saving incentive for middle- and low-wage workers than current law. As noted above, a tax *deduction* is neither an effective nor an equitable means to encourage pension saving among lower-income and younger workers, whether or not they participate in an employer plan. And although the current Savers Credit provides (most commonly) a 10 percent tax credit for retirement saving by low-income taxpayers, the lack of refundability means that millions of working-poor families—who have payroll tax but no current income tax liability to offset—receive no credit at all.

Instead, a refundable credit would operate just like an employer match in a company 401(k) plan. Studies show that workers are far more likely to save if given generous matching credits—and once they develop the habit of saving by payroll deduction, most continue even when the match rate is reduced. A sliding-scale credit could give a greater incentive to low-income workers who are least likely to save. For example, workers in families earning below $40,000 could receive a $1 per $1 (1:1) matching credit on their first $2,000 in savings; whereas workers in families earning above that level could receive a $0.50 per $1 (1:2) matching credit on their first $4,000 in savings. This would give all workers the opportunity to receive as much as $2,000 each year in matching deposits to their accounts, but the higher-wage earners would need to make twice the saving effort.

Like the current Saver's Credit, the refundable credit should apply equally to contributions to 401(k)s and other employer-sponsored plans.

Eligibility for the credit would be reconciled annually through the income tax return process, which would also be used to encourage taxpayers to save all or a portion of their tax refunds.

Matching credits should be available for both individual and employer contributions. This would give employers a greater incentive to make deposits on behalf of their low-wage workers. Yet, by extending pension saving incentives to all workers as individuals, employers would have the option to provide a pension benefit without the need to administer a pension plan. Employers could decide from year to year whether to contribute to their workers' accounts—although in doing so, they should be required to contribute either a flat percentage or a flat dollar amount for all their payroll employees (otherwise ICAs could undermine ERISA antidiscrimination rules to ensure that employers are not using the tax subsidies to favor only their higher-wage employees).

2. Infrastructure: automatic payroll deduction and account administration. Equally important is replicating the retirement plan infrastructure that is key to the success of employer-sponsored 401(k) plans. As with 401(k) plans, every worker should have access to the convenience, discipline, and protections provided by automatic payroll deduction and professional asset management. When a worker fills out the required IRS Form W-4 (used to calculate tax withholding), he or she can simply specify a monthly saving deduction. That's the only decision a worker needs to make—a choice to save.

The sole burden on employers would be to forward this automatic payroll deduction to the employer's own retirement saving plan (if there is one and the employee participates) or to a government clearinghouse. Since most employers today use automated payroll processing services, there would be virtually no cost to forward the deduction to a central clearinghouse. Even employers who do not automate payroll must forward income and payroll tax withholding to the IRS, so including withholding amounts for saving would be a minor burden.

A new entity—a clearinghouse akin to the Federal Thrift Savings Plan (TSP), which manages very low-cost 401(k)-style saving accounts for 3 million federal military and civilian personnel—would receive all deposits and be the default administrator for small accounts. Record keeping would be centralized, but the investment management would be contracted out to private investment firms, as with TSP. The clearinghouse would strive to keep costs and complexity to a minimum. As with TSP, participants should have at most a choice among a small number of very low-cost index funds. Although payroll-deducted savings and matching tax credits would flow through the clearinghouse, the assets should be fully portable and transferable at any time at the worker's request to another qualified financial institution, or to a future employer's pension plan.

Individual Career Accounts would supplement, not supplant, the existing private pension system.

3. Inertia: default options for enrollment, investment and annuitization. The W-4 form required of every worker would provide a simple means of indicating how much an individual wanted withheld and saved each pay period. Even better, the Universal 401(k) system could convert myopia into positive inertia by making participation the default option. (Studies have shown that automatic enrollment has boosted 401(k) participation rates among low-income workers from 13 to 80 percent.) Unless the worker decided to opt out, the W-4 would give notice of the amount to be deducted and saved each pay period. The initial default contribution could be modest—3 or 4 percent of each paycheck—increasing by 1 percent a year thereafter, as pay increased, until it reached a level likely to achieve an adequate accumulation over time.

If a worker did not wish to participate in his employer's plan, the payroll deduction would flow automatically to the federal clearinghouse and into his Individual Career Account. Although the worker should be able to switch, periodically, between a very limited number of broad and low-cost index funds, there would be a default asset allocation for workers who made no choice at all—most likely a life-cycle fund that would automatically adjust the mix of stocks and bonds to match the worker's age and years until retirement age.

Finally, at retirement age, the default option should be monthly payments rather than lump-sum withdrawals to ensure that retirees do not outlive their benefits, replicating the great advantage of a defined-benefit plan. Although individuals could choose to withdraw (or roll over) all or part of their nest egg, there should be incentives to encourage and facilitate annuitization. This annuity benefit could be contracted to one or several private insurers, or taken on by the Pension Benefit Guarantee Corporation, the federal pension insurer that currently manages guaranteed annuity payments each month for millions of private-sector retirees who were participants in a defaulted employer plan.

While Americans clearly support retaining Social Security's defined-benefit safety net, neither Social Security nor the inadequate coverage of today's private pension system is providing enough income in retirement. Thus, a citizen-based, portable, and automatic system—providing those who find it most difficult to save with powerful right-side-up tax incentives—may be exactly the retirement revolution we need.❖

Tax Consumption, Not Work

Maya MacGuineas

The payroll tax takes a bigger bite out of the incomes of more than 70 percent of American families than any other tax. Yet the dedicated tax for Social Security and Medicare has many shortcomings. It is regressive, inefficient, and insufficient to meet the needs of the programs it supports. It makes little sense to attempt only incremental changes in such a problem-plagued tax program. Addressing its shortcomings will require wholesale reform. By eliminating the payroll tax and replacing it with a progressive consumption tax, we could combine the economic benefits of a tax on consumption with the fairer tax structure that comes with progressive rates—creating a rare win-win situation in tax reform.

When the payroll tax was introduced nearly 70 years ago, the tax rate was 2 percent on the first $3,000 of wages. Today, the tax rate is 12.4 percent on the first $94,200 of wages for Social Security, and 2.9 percent on total wages for Medicare.

This regressive tax is levied only on wages, kicks in at the first dollar of earnings, and since it is capped, higher-income earners face lower effective tax rates. Interest, dividends, and capital gains, as well as many forms of nonwage compensation such as health care and pension benefits—all of which go disproportionately to upper income earners—are not taxed.

Nor is the payroll tax adjusted for family size or situation. The income tax is structured to reflect individual family circumstances through dependent deductions, child credits, and numerous other adjustments, but the payroll tax makes no such accommodations for differing family needs. Take two breadwinners, each earning a salary of $75,000. The first is a single, young person, and the second is a working parent with a stay-at-home spouse raising three children. Each faces the same payroll tax liability of $11,475, split equally between employer and employee, irrespective of their strikingly different financial situations. This is one of the least family-friendly tax policies on the books.

Not only is the payroll tax unfair, it is inefficient and creates economic distortions. It is a tax on wages, with half paid by the worker and half paid by the employer. This provides an incentive for workers and employers to place greater value on nontaxable forms of compensation, such as health care benefits, and for employers to skew salary compensation in favor of workers earning over the taxable maximum (since each marginal dollar of pay is not subject to the 12.4 percent Social Security levy). Although it is generally believed that the portion of the payroll tax paid by employers is passed along to employees in the form of lower wages, this is not necessarily the case at the bottom of the income scale and during certain periods in the business cycle. Requiring businesses to shoulder half the burden of the payroll tax deters job creation, particularly for entry-level and low-income workers. Above that level, it hides the true cost of the tax from those who actually bear the burden. Neither is desirable.

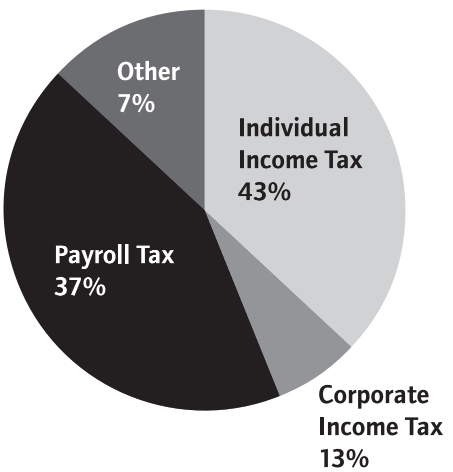
Finally, the payroll tax will not be sufficient to meet the needs of the programs it funds. Social Security spending is expected to surpass revenues in 2017, and Medicare is currently running cash deficits. Ensuring that the revenue base for these two programs is sufficient to meet payments is essential to any reform program.

A Win-Win Tax Swap

While the shortcomings of the payroll tax are apparent, most proposed reforms are incremental in nature and offer only a partial fix. Instead, the payroll tax should be eliminated and replaced with a tax that is both fairer and better for the economy.

However, the payroll tax accounts for over a third of the federal government's revenues, and figuring out how to raise revenues to replace close to $1 trillion in payroll taxes will be a challenge. Generally speaking, the larger the tax, the larger the damage caused to the economy.

THE PAYROLL TAX AS A SHARE OF FEDERAL REVENUES



Source: Congressional Budget Office.

Emphasizing *what* is taxed, however, can help mitigate the negative economic effects. There are only five basic things that can be taxed—people, incomes, wages, wealth, and consumption. The current federal system primarily taxes incomes and wages.

Given that the low level of domestic saving is a serious economic problem, we ought to consider a consumption tax. A higher tax on consumption would encourage citizens to save more and spend less—a change that would have profound and persistent positive effects on the economy.

Individual saving is necessary for people to prepare for large outlays over their lifetime—for buying a home, funding their children's education, and retirement, as well as for the unexpected costs of illness or unemployment.

The cumulative savings of individuals, businesses, and government are also profoundly important in macroeconomic terms. Net national saving provides the capital for productive investment, and over time low saving rates can lead to lower standards of living. In countries where domestic saving is low, either domestic investment will decline or capital has to be borrowed from abroad, leaving the country indebted to overseas creditors. Our dependence on other countries to supply us with investment capital leaves us economically vulnerable. The only way to overcome this vulnerability is to increase domestic saving levels.

The problem with most consumption taxes, however, is that they are extremely regressive. Lower earners spend most, if not all, of their earnings on basic necessities, leaving them with little left over to save, while those with more disposable income have greater flexibility in choosing how much to spend and how much to save. While switching to a flat rate consumption tax would have positive effects on the economy, it would do little to address the unfairness of maintaining the regressive payroll tax during a time of increasing earnings inequality.

Making Consumption Taxes Progressive

There is nothing that says a consumption tax must be a flat rate tax. A progressive consumption tax is a much better idea.

With a progressive consumption tax, individuals would be taxed on what they spend, not what they earn, thereby creating an incentive to spend less and save more. Since lower-income families have to spend a higher share of their earnings on basic necessities, higher levels of spending would be taxed at progressively higher rates. And whereas most consumption taxes are levied at the time of purchase—as with sales taxes or value-added taxes—a progressive consumption tax would be levied on an annual basis, just like an income tax. This is what would allow for the introduction of a progressive rate structure.

Each year, the tax base would be calculated by totaling an individual's income for the year and subtracting the amount that person saved. Progressive tax rates would then be applied to the total level of spending. Tax rates might look something like this:

Spending	*Tax Rate*
$0–$15,000	0%
$15,000–$75,000	12%
$75,000–$200,000	20%
$200,000+	35%

A low-income earner who made and spent $20,000 would have an effective tax rate of 3 percent (12 percent of $5,000); a moderate earner making $50,000 who spent $45,000 would have an effective tax rate of 8 percent (12 percent of $30,000); a well-off individual who made $150,000 and spent $120,000 would have an effective tax rate of 16 percent; and a rich earner who made $500,000 and spent $300,000 would have an effective tax rate of 22.4 percent. The tax rates and brackets could be altered to achieve different revenue and distributional goals.

Spending would be calculated by totaling all forms of income—including borrowing—and subtracting all saving. Any withdrawals from saving would be counted as income for the period. Thus if a worker earned $100,000, deposited $15,000 in a saving account but also withdrew $5,000, his spending tax base for the year would be $90,000.

Spending Equals Taxable Cash Flow...

- Wages, Salaries, and Other Forms of Compensation
- Interest, Dividends, and Capital Gains
- Withdrawals from Saving Accounts
- Gifts, Bequests, and Winnings Received
- Pensions, Social Security, Government Benefits, and Insurance Payments
- Borrowing

...Minus Qualified Saving

- Deposits in Saving Accounts and Investments
- Interest Payments
- Family Allowance and Any Special Allowances
- Gifts and Bequests Made

The payroll tax is regressive, inefficient, and insufficient to fund the programs it finances.

Qualified saving would include things like bank deposits and purchases of stocks and bonds. Consumption investments, such as the purchase of art, stamps, or rare coins would not be counted as saving. First, such purchases are made at least in part for the pleasure of the collector and thus ought to be considered as consumption. Second, their investment characteristics are the result of potential asset appreciation rather than the productive employment of capital to promote economic growth. Since one purpose of a progressive consumption tax is to stimulate national saving and the related macroeconomic benefits, productivity-enhancing investments ought to be favored.

Special allowances would be made for investment in human capital such as education, as well as for certain hardship expenses such as particularly high health care expenses. However, it would be desirable to keep the new tax base as simple and transparent as possible. Since a progressive income tax would run alongside the existing (and, it is hoped, improved) income tax, it would be preferable to make any adjustments for human capital and hardship exemptions in the income tax base where they already exist. The broader the tax base, the fewer distortions there would be. The creation of a new tax should not be an excuse to start peppering the tax code with new targeted tax breaks.

Replacing the payroll tax with a progressive consumption tax would stimulate job creation, higher wages, and higher levels of personal saving.

In order to spread out the cost of large outlays for housing and consumer durables, taxpayers would be able to pay the tax on such items in installments over a longer period of time. It would be preferable not to subsidize housing under a progressive consumption tax in the same way as we now do through the income tax, in that the current structure leads to overconsumption of housing and underinvestment in other areas. The home mortgage interest deduction, which subsidizes borrowing for purchasing a home or using it as collateral, would have to be redesigned to avoid creating a huge loophole whereby individuals could borrow more money than needed to purchase a home and deposit the excess funds in saving accounts, thereby reducing the level of consumption that would be taxed under the progressive consumption tax.

The tax would be adjusted for family size, providing a consumption deduction for each family member. In order to avoid situations where individuals were left with tax liabilities they could not afford at the end of the year, there would be monthly withholding—much like that for income tax—based on the previous year's level of consumption.

In order to avoid any abrupt economic disruptions, the transition from a low-saving to high-saving economy should be managed by gradually phasing in a consumption tax over a number of years. While the tax is not as simple as a flat sales tax, most of the information needed to calculate the tax is already provided for the income tax, and the advantages in terms of both compliance and progressivity make this approach to taxing consumption far preferable.

The Advantages of a Progressive Consumption Tax

Replacing the payroll tax with the progressive consumption tax offers a number of distinct advantages. It will almost certainly increase national saving, probably by a significant amount. Given the economic challenges the country currently faces, from highly overleveraged individuals to record budget deficits, few macroeconomic objectives are more important.

At the same time, the progressive nature of this consumption tax proposal would be a vast improvement over the distributional effects of the payroll tax. If payroll taxes were used to finance individual saving accounts, a flat or even a regressive payroll tax structure might be justifiable, since individuals would receive the full benefit of their own contributions. However, a regressive tax structure used to finance a large portion of entitlement programs—including a number of subsidies that flow from low to high income—as well as other government spending programs, hardly makes sense.

Finally, a progressive consumption tax offers the potential for a workable political compromise. There is an ongoing divide between conservatives and liberals over the priorities and structure of desirable tax reform. Conservatives tend to favor a more efficient consumption base, which is generally associated with flat tax rates, as being better for the economy, while liberals favor a progressive tax structure and place less emphasis on the economic effects of taxes. A progressive consumption tax would allow the more efficient base to be combined with a fairer tax structure, giving both sides something to support.❖

An Energy Efficiency Trading System

Lisa Margonelli

The United States consumes energy so lavishly that the cost is equivalent to nearly 10 percent of our GDP, reducing our competitiveness, constraining our foreign policy, and producing a fourth of the world's greenhouse gases. And because the U.S. economy is far more energy dependent than the economies of other advanced industrialized nations, American industry and families are far more vulnerable to natural catastrophes like hurricanes or political upheavals in oil- and gas-producing countries than industry and families in Europe and Japan. In the coming decade that vulnerability will only increase, as more and more of our energy supply will be concentrated in politically unstable regions. Reducing the economic and environmental risks of excessive energy use therefore must become one of America's most important national goals.

Nearly a century of government efforts to make energy abundant has led many Americans to see cheap energy as a virtual right, creating political rigor mortis with respect to energy policy. Higher energy taxes are unpopular, and manufacturers have fought the imposition of tighter energy standards for appliances and automobiles. So the government has abdicated responsibility for reining in energy use to "market forces." But low prices in the 1990s encouraged consumers to use more—not less—energy. Consequently, they are now spending more money on fuel without being able to cut back.

The government needs to make a fundamental change in the way it approaches energy policy—instead of simply trying to ensure supply, it needs to begin reducing demand by spurring a revolution in energy efficiency. Setting tough energy standards for America's biggest energy users, and making energy efficiency tradable—much the way we now trade oil and natural gas—would quickly reduce our total energy consumption while limiting carbon emissions, stimulating productivity, and creating jobs. Higher taxes on gasoline are political poison, but tougher energy standards have overwhelming support among both Democrats and Republicans—well above 70 percent. Adding a market mechanism to trade efficiency gains would make energy efficiency standards more palatable to industries that have resisted them in the past, at the same time raising economic growth and providing incentives for technological innovation.

Rethinking the Old Supply-Side Bargain

The American way of using energy is based on a grand bargain dating back to the 1930s, in which the government focused on energy supply rather than demand. The goal of American policy was to secure new cheap supplies of energy by providing tax incentives and other forms of government support for producers and by pursuing "oil diplomacy" internationally. Using military power to protect shipping lanes and pipelines, and making special deals with key producers like Saudi Arabia, allowed the United States to promise cheap energy to the world, while offering energy markets to our trading partners. This approach virtually sanctioned waste, with the result that more than 40 percent of the energy the United States uses is lost as waste heat.

Efficiency is America's largest and most cost-effective potential energy resource.

Increasing competition for global oil and natural gas supplies, on the one hand, and declining U.S. reserves, on the other, mean that the old bargain is no longer effective insurance against either price spikes or the exercise of market power by the Organization of the Petroleum Exporting Countries (OPEC). Despite some gains in efficiency in the 1980s, the U.S. economy remains vulnerable to high oil prices. Any increase in gasoline prices acts as an almost instant regressive tax on American drivers, who rely on the automobile much more than their counterparts in other advanced industrialized economies. It also creates an increasing fiscal burden for the American economy, driving up America's international deficit. In the first two quarters of 2006, petroleum imports accounted for nearly a third of the U.S. trade deficit.

Despite higher prices, both oil and electricity demand continues to grow fast. Overall U.S. electrical demand is expected to grow by 19 percent by 2015, while new power generation will expand by only 6 percent. To manage the gap, utilities will have to consider reducing demand. Another barrier to meeting America's expanding need for energy is that the domestic infrastructure for delivering oil and electricity is old, and in some areas pipelines and grids are operating near capacity. Expanding them to carry more energy will be costly and time consuming. Some isolated sections of the electrical grid are actually facing supply shortfalls within the next two years. In these and other cases, reducing demand would solve the bottleneck more quickly than increasing supply.

Reducing energy demand is both cheaper and faster than is the alternative of securing new supplies by exploring new oil fields or building more power plants. Efficiency is America's largest and most cost-effective potential energy resource, and it has already provided three-quarters of our new energy needs since 1970. There is much more efficiency to be found. Conservative estimates suggest that buildings and vehicles could halve their energy use without radical changes in design and construction. Emerging technologies, like sensors and supercomputing, nanotechnology, computational fluid dynamics, and bioengineering hold the possibility of radically changing our relationship to energy and improving standards of living.

Promoting efficiency, however, has been an underutilized policy option. In fact, many current government policies do not reward conservation or, worse, encourage waste. The Internal Revenue Service, for example, creates a perverse incentive to waste energy by allowing commercial landlords to write off their energy costs every year. At the same time, it requires building costs to be depreciated on a 30-year schedule, effectively devaluing investments in energy efficiency. Removing such perverse incentives would help encourage greater efficiency but alone would not be enough to spur the efficiency gains we need. Without positive government incentives, it often does not make sense for individual purchasers to spend more on a more efficient car or building, either because they cannot afford the higher initial investment or because they are not sure they will see a return on their investment given the volatility of energy costs. For example, under most scenarios, it is unrealistic for the purchaser of a hybrid car to expect the fuel cost savings to exceed the higher purchase price. Thus, relying on the market alone does not often yield greater efficiency because it does not take into account the externalities of using energy—pollution, greenhouse gases, road wear by heavy vehicles, energy security costs, and tax breaks to the energy industry—which are borne by society as a whole, but not by the individual purchaser.

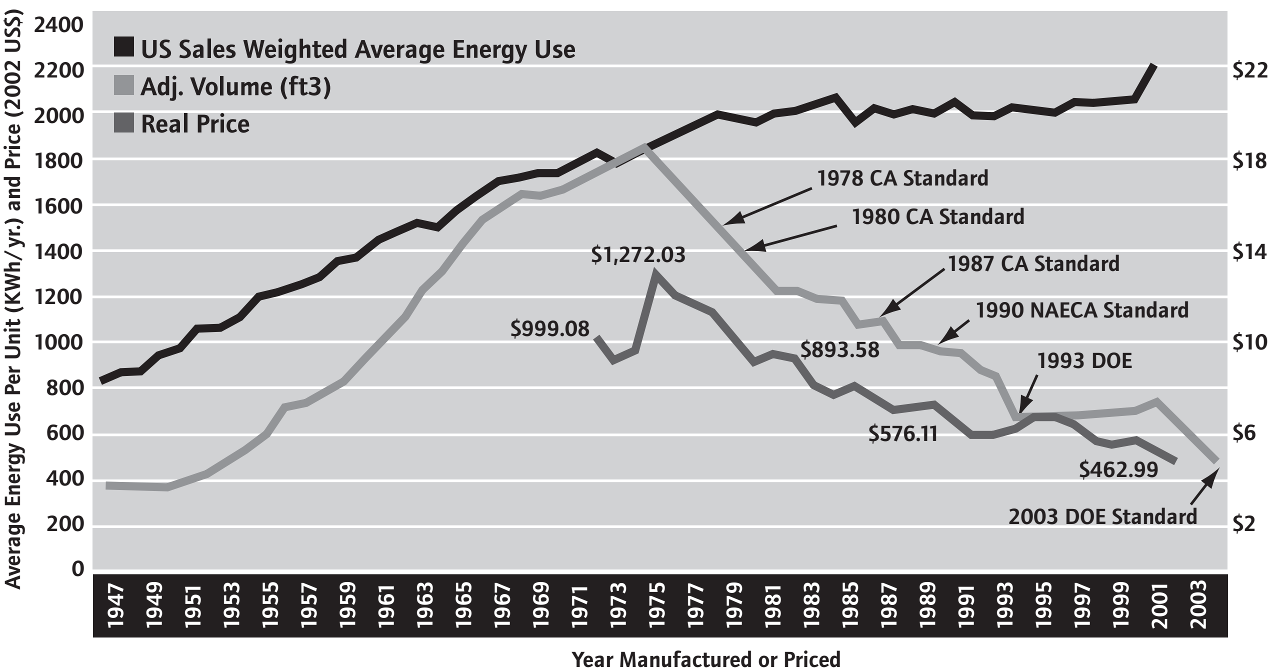
New research from the United States and Europe suggests that improved efficiency brings with it a multiplier value that far exceeds the fuel savings realized by the individual. To return to the metaphor of the hybrid car: its real value may lie not in the energy savings to the individual owner but in the jobs it creates, the technology it stimulates, and the reallocation of capital from energy to investment it encourages. Efficiency is a productivity-enhancing tool, raising the return on capital and increasing GDP output. Reducing energy demand has also lowered energy prices, notably oil prices during the mid-1980s; and forecasts suggest that small drops in U.S. electricity use could precipitate a dramatic fall in the price of natural gas.

One example of the benefits of energy standards can be found in California, which has been limiting electrical demand through efficiency for the past 30 years. Residents now use 30 percent less electricity per capita than the country as a whole and the state has avoided building many power plants. This prevents the emission of an estimated 18 million tons of carbon, while allowing every Californian to spend $400 per year on things other than energy. The state program has stimulated the rapid commercialization of such technologies as compact fluorescent light bulbs and energy-saving refrigerators and air conditioners. New refrigerators use just 25 percent as much energy as the old; even better, their prices have fallen by more than half. The benefits don't stop at California's borders: energy-saving appliances have proliferated everywhere from China to New York.

How to Trade Efficiency

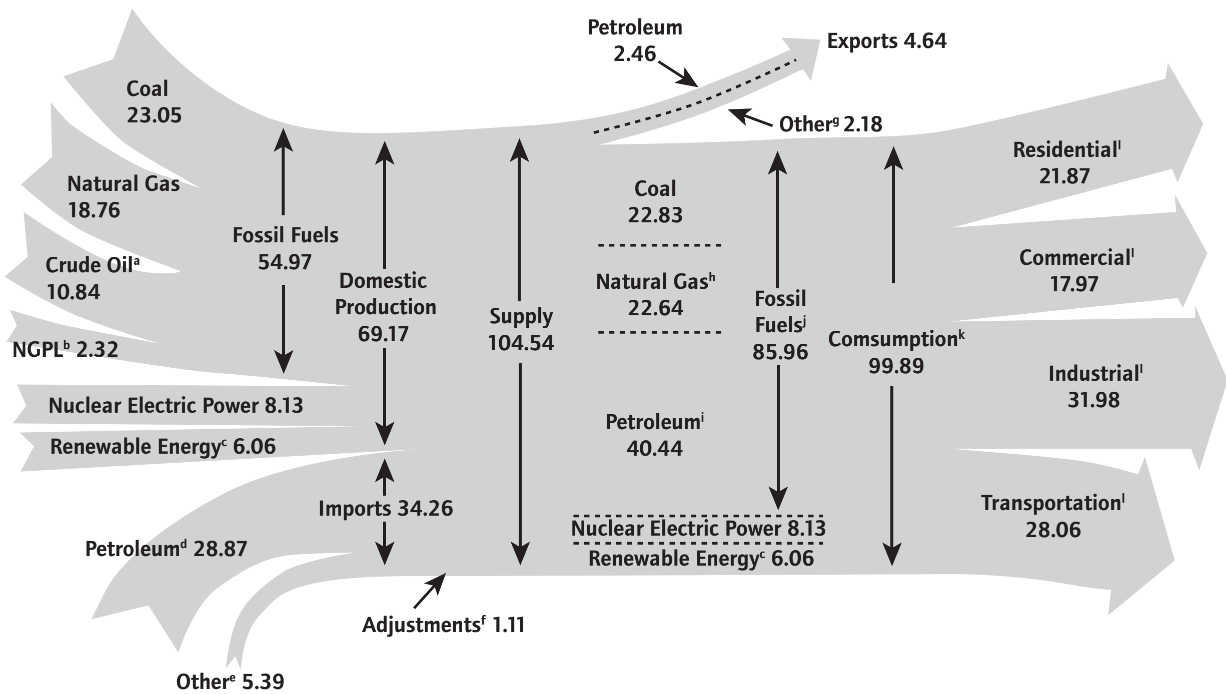
The United States needs to remodel its energy portfolio, abandoning incentives for wasted energy and putting in place a framework to support increasing energy efficiency. Like carbon cap-and-

U.S. REFRIGERATOR ENERGY USE VS. TIME WITH REAL PRICE



Source: David Goldstein, Natural Resources Defense Council.

ENERGY FLOW, 2005



a Includes lease condensate.

b Natural gas plant liquids.

c Conventional hydroelectric power, wood, waste, ethanol blended into motor gasoline, geothermal, solar, and wind.

d Crude oil and petroleum products. Includes imports into the Strategic Petroleum Reserve.

e Natural gas, coal, coal coke, and electricity.

f Stock changes, losses, gains, miscellaneous blending components, and unaccounted-for supply.

g Coal, natural gas, coal coke, and electricity.

h Includes supplemental gaseous fuels.

i Petroleum products, including natural gas plant liquids.

j Includes 0.04 quadrillion Btu of coal coke net imports.

k Includes, in quadrillion Btu, 0.34 ethanol blended into motor gasoline, which is accounted for in both fossil fuels and renewable energy but counted only once in total consumption; and 0.08 electricity net imports.

l Primary consumption, electricity retail sales, and electrical system energy losses, which are allocated to the end-use sectors in pro portion to each sector's share of total electricity retail sales.

Source: *Annual Energy Review 2005,* Energy Information Administration.

Notes: Data are preliminary. Values are derived from source data prior to rounding for publication. Totals may not equal sum of components due to independent rounding.

trade programs, the energy efficiency initiative proposed here would combine setting national limits on energy use with letting the market determine who pays. By instituting efficiency standards that increase over time, the government will be able to guarantee that the country's economy will become more efficient by at least 1–2 percent a year over the next decade and beyond. As with carbon cap-and-trade programs, businesses that exceed their efficiency targets can sell excess credits, while those that fail to meet them can buy credits from other producers or the government. This differs from the policies of the 1970s, when government "command-and-control" regulations essentially picked which products would succeed. The key is to internalize the true costs of energy inefficiency and allow the market to work out which users should produce or consume efficiency gains.

The place to begin implementing standards is with transportation and electricity—together these two sources account for 67 percent of the energy the United States uses. Both vehicle manufacturers and utilities are source producers, able to employ a variety of strategies to reduce energy demand while being relatively easy to identify and regulate. Once standards are in place and trading has begun, standards could be extended to other markets, such as industry and buildings, and trading could be allowed between categories.

Corporate Average Fuel Economy (CAFE) standards have allowed overall fleet efficiency to fall since the late 1980s because there are separate requirements for cars and for light trucks, and none at all for heavy trucks. More effective standards should be set to include all vehicles in the fleet so that the total amount of fuel used is reduced. Fleet efficiency is calculated by multiplying the amount of gasoline consumed by each model car over its lifetime by the number of units sold, so that the targets apply to all the vehicles a company makes. If Ford produces a pickup that gets, say, 22 miles per gallon (mpg), the company would need to buy credits to bring it up to the fleet target of 30 mpg. If, on the other hand, Ford also produces twice as many Escorts getting 40 mpg as pickups, it would be able to cover the "price" of credits for the pickups and still sell extra credits. Gradually, though, the cost of inefficiency would be integrated into the purchase price of the pickup truck, changing the market.

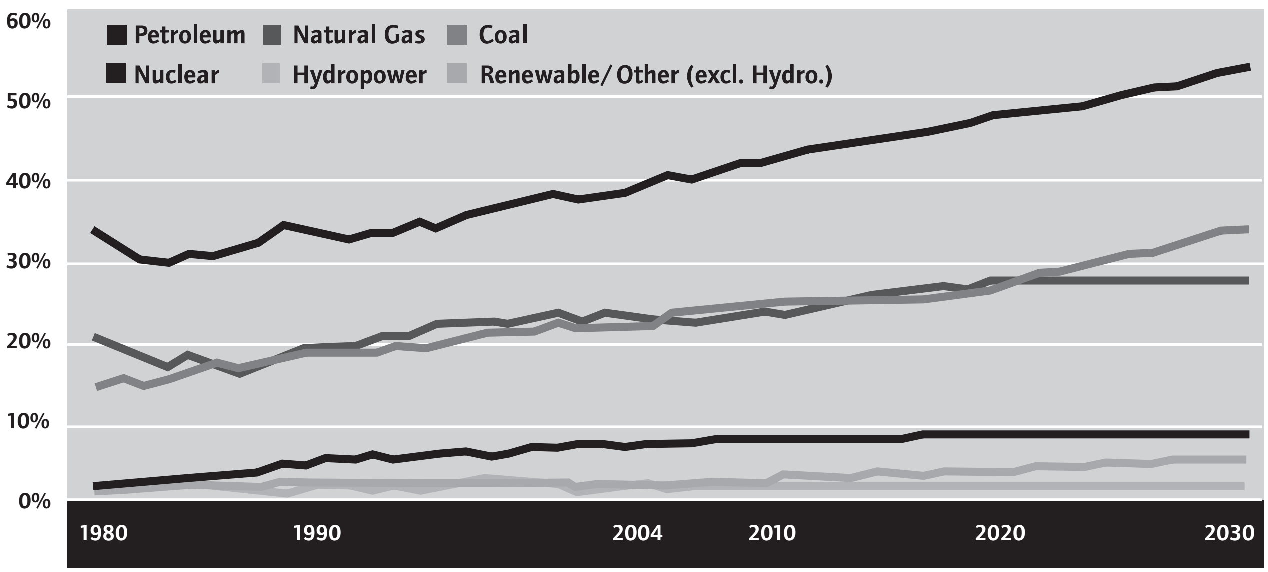
Targets for vehicles will need to be set for at least ten years in advance, requiring perhaps a one mpg improvement a year for the first five years, and a two mpg a year improvement for the second five years. The point of this system is that it is flexible but insures results. As the standards go into effect, and the valuation of efficiency credits begins, the government will be able to influence the price of efficiency credits by selling them, which will give the emerging market a safety valve and prevent prices from getting prohibitively high.

Phasing in tough energy standards for America's biggest energy users – and making energy efficiency tradable – would quickly reduce total energy consumption while limiting carbon emissions.

Vehicle makers will be able to use many strategies to meet the standards—from buying credits to changing marketing and sales practices, substituting more efficient components like air conditioners and tires, changing the way they finance and lease, as well as altering vehicle designs, materials, and power trains. A study by the Congressional Budget Office found that tradable credits would allow automakers to increase the fuel economy of cars and trucks by 3.8 miles per gallon for 17 percent less cost.

As targets for standards, utilities have proven to be powerful actors because they can use efficiency investments to avoid buying peak power and building power plants, both expensive undertakings. The ability to promote more efficient appliances, buildings, and transmission systems among their customers gives utilities extraordinary leverage over consumer markets. Utility standards could be phased in

U.S. ENERGY CONSUMPTION BY FUEL (1980–2030)



Source: U.S. Department of Energy, Energy Information Administration.

so that the first year might require half a percent of reduced demand a year; years two to four, 1 percent a year; years five to seven, 2 percent; and years eight to ten, 3 percent. In addition to reducing demand, utilities also have the ability make their generation facilities and transmission lines much more efficient, and if those goals are added to the program, the targets should be set accordingly.

Utilities that beat their targets can aggregate their savings into bundles of efficiency—usually a megawatt of demand—called *white tags*. European utilities have already begun trading white tags, and Connecticut and Pennsylvania are now preparing to do so. In the late 1990s, the energy service company Enron began experimenting with standardizing and trading efficiency. Now a Georgia-based company called Sterling Planet is launching a system for verifying and trading white tags.

Once these trading systems were in place, a number of related secondary trading systems would become possible. For example, consumers could reduce their energy use and aggregate the savings to sell to a utility much the way a producer of wind electricity might sell back power. A mortgage company like Fannie Mae, which already encourages homeowners to invest in energy efficiency, could start collecting those improvements into credits to sell, providing greater penetration of very high-efficiency buildings. An American city considering a massive neighborhood-by-neighborhood efficiency program to save as much as 20 percent of the region's power would be able to aggregate and sell credits.

While the vehicle and electrical credits would not be immediately interchangeable, it is reasonable to expect to see outside players aggregating credits here too. Cascade Sierra Solutions, an Oregon-based nonprofit, already has a program to help truckers install inexpensive kits to retrofit their long-haul trucks and save as much as 5,000 gallons of fuel a year. United Parcel Service has developed software that saves fuel by optimizing delivery routes, using information about package weights and GPS route setting. Other companies might decide to use their leverage over employees or suppliers to acquire credits. Wal-Mart, for example, might provide scheduled van pools for employees, and bundle and sell the commuter miles saved. (These companies would also save money by not providing employee parking spaces, and see benefits from on-time employees and reduced road congestion.) Auto insurers might start offering low-cost insurance rewarding drivers who limit their miles, aggregating and selling the credits.

The Advantages of the Tradable Efficiency Option

Combining standards and tradable efficiency would have some clear advantages over the conventional Republican and Democratic policy approaches for reducing energy use and greenhouse gas emissions. Unlike voluntary measures, this approach would ensure results; but unlike taxes and the command-and-control strategies often associated with liberal Democrats, it would not constrain the economy or hurt economic growth. While traditional Democratic and Republican approaches to energy have led to policy gridlock, tradable efficiency offers a third way with wider and deeper benefits—and fewer drawbacks—than the commonly discussed alternatives.

Republican solutions to energy issues tend to encourage energy supply while leaving demand management to the market or voluntary initiatives. But without new incentives and penalties, neither industries nor consumers are likely to become more efficient. In 1998, utilities in Texas voluntarily saved a modest 300 million kilowatt hours of electricity. By 2003, under a utility efficiency standard signed by former Governor George W. Bush, they saved 5 billion kilowatt hours, greatly exceeding their targets. Although the efficiency programs were cost-effective, the utilities were reluctant to adopt a new business model without being pushed.

Market choices do not always favor efficiency, either because manufacturers have other priorities or because consumers lack information. Take cell phones, for example. Because consumers are focused on features, manufacturers save money by using inefficient chargers that draw 2–5 watts per hour, even when they are not charging. Highly efficient chargers use just half a watt, and cost slightly more, but who chooses a phone by the charger? Left to individual choice, consumers end up buying power vampires whether they want to or not. Imposing standards on the billion chargers (for phones, computers, and other appliances) used in the United States would save as much as $2 billion in electrical costs and eliminate a million tons of greenhouse gases, according to the Environmental Protection Agency. This kind of market failure is best fixed by a combination of standards and marketable efficiency because it discourages manufacturers from cutting corners on energy efficiency, while allowing the market to decide which combination of price and efficiency works best.

The ability to trade efficiency gains would make energy efficiency standards more palatable to industries that have resisted them in the past.

Many Democrats favor raising energy taxes to encourage consumers to conserve. But this idea does not make either political or economic sense. A regressive tax on fuel will hurt not only businesses but also poorer working families and rural drivers without access to public transportation while doing little to reduce the amount of gasoline middle-class consumers use. Although they complain vociferously about fuel prices, American drivers do not use significantly less gas when prices are high. And high fuel costs do not consistently inspire them to buy fuel-efficient cars. Even in Europe, where taxes make gasoline very expensive, governments have still found it necessary to institute voluntary fuel economy targets for automakers. A program that combined fuel economy standards and tradable efficiency would produce much better results because manufacturers would need to ensure that the fleet's fuel consumption falls, thus making fuel-efficient cars less expensive and fuel-inefficient ones more expensive. It might also lead to more transportation choices for many poor and rural families because governments would have more incentive to provide public transportation for these populations.

Limiting greenhouse gas emissions through a cap-and-trade system is another favorite liberal idea. But it is not a substitute for an efficiency trading system and in fact would work best if it were combined with one. One problem with carbon cap-and-trade proposals is that the initial value of carbon credits may be too low to change energy-use patterns. Thus they tend to encourage responses that put the emphasis on carbon mitigation rather than on energy reduction. This may encourage a different choice of energy—natural gas rather than coal—but not result in new technologies to reduce energy use in any significant way. When tradable efficiency is combined with cap and trade, however, companies would be able to leverage both efficiency credits and emissions credits to achieve their goals faster.

One of the clear benefits of a standards-and-efficiency trading system is that it will spur both technological innovation and the diffusion of that technology more rapidly than other policy alternatives. Already there is evidence that combining standards with tradable credits can speed up the commercialization of cutting-edge technology. A fuel-cell generator normally has a payback time of more than three years, which most companies consider to be too long to justify the investment. With tradable efficiency credits soon to be available in Connecticut, one large company found that the payback time for the fuel cell fell to just over two years, making it a much more feasible investment.

A standards-and-efficiency trading system has other advantages as well. For one thing, it is business friendly in that it gives businesses more ways to meet their targets, encouraging both experimentation and innovation. For another, it is market oriented in that it begins the process of reallocating the price of inefficient energy use to the purchase price of a product, thus changing buying patterns by use of the market. Thirdly, energy service companies, new industries, and even nonprofits like cities and states may begin to bundle efficiency, taking advantage of synergies between efficiency and other economic and social goals. And finally, when it is more thoroughly financialized and packaged as a credit, efficiency has the potential to become a powerful productivity-enhancing tool in the same vein as supply-chain management, just-in-time production, and financial instruments like derivatives. Just as the potential for new technology to save energy is unknown, the potential uses of tradable efficiency may be much greater than we can grasp now. Failing to encourage efficiency, by contrast, may have a high opportunity cost for U.S.-based manufacturers because the European Union, Japan, South Korea, and China all have committed themselves to aggressive energy standards.

An Opportunity for a New Grand Bargain

Energy is an intensely politicized subject in the United States. Steep gasoline prices have led to the defeat of at least one president, while California's electricity crises caused the recall of one governor. The high political stakes of another crisis and public anxiety about energy security make this a fertile time to make a new grand bargain. The standoff between liberals and conservatives on the topic of energy makes America vulnerable to a crisis of cripplingly high prices. In the longer term, energy prices will be volatile, and the costs of emitting carbon (whether explicit carbon credits or implicit rising temperatures) will become very high.

Tradable efficiency, coupled with high standards, is a grand bargain that combines the security of regulation with the creativity of the market. This plan not only reduces U.S. exposure to high energy costs, it offers considerable economic and environmental benefits. The objection to most demand-side energy proposals is that they could be "forced downsizing," but a market-based efficiency program will stimulate productivity. Tradable efficiency has the potential to remodel the American economy by harnessing emerging technologies and new tools for managing information and finances to tackle one of our most intractable problems.

James Schlesinger, former secretary of energy, once said that the United States has two modes regarding energy: complacency and panic. Adopting energy efficiency is a smart third mode, and it would steadily lead us toward greater economic and environmental security.❖

A College Access Contract

Michael Dannenberg

America's financial aid system provides too much taxpayer support to banks making college loans and demands too little of students assuming them. The system fails to reward rigorous college preparatory work in high school and penalizes students who hold jobs while in college. Lenders make extraordinary profits, while young people leave college burdened with massive debt and, more often than not, without the degree or skills necessary for a good-paying job that will enable them to repay that debt absent significant economic hardship.

A new College Access Contract would harness the free market so that students get more aid and banks get less. Students from low-income families would have the opportunity to graduate debt-free (up to the maximum of $23,000 in cumulative federal student loan debt), while students from middle-class families could graduate with interest-free federal student loan debt, but *only if* they: (1) work hard in high school to prepare for college, (2) work or perform community service while in college, and (3) evidence a minimum level of academic work or competency upon completing their postsecondary studies.

The three student behavior conditions associated with a new College Access Contract would address three key problems in higher education—inadequate preparation in high school, the college work penalty, and unsatisfactory college completion rates and curricular rigor. All three contribute to the difficulty students confront in repaying their college debt. To finance the contract, the student loan system could be reformed to embrace market mechanisms and save billions. Philosophically, this approach joins progressive goals and market principles. Politically, it embraces traditional values like hard work, service, and reciprocity.

Excess Subsidies to Student Loan Providers

Forty years ago, banks were reluctant to make student loans to young people with little credit history or collateral. The government intervened to guarantee student loans against default *and* to provide banks with a subsidy payment on top of borrower interest payments. Currently, 99 percent of a student's loan principal is guaranteed against default. In addition, banks are guaranteed a profit equal to the prevailing market interest rate for commercial borrowing, plus 2.34 percentage points. That's a far larger subsidy than most people realize.

A 2.34 percentage point boost on top of a bank's core cost of commercial borrowing—which has been reported to be 5.4 percentage points for student loan giant Sallie Mae—translates into a *43 percent* profit on capital. There are reasons Sallie Mae's stock has increased by 2,000 percent in the last decade, and those reasons are a government guarantee against risk and very large government subsidies.

Government subsidies to student loan banks are excessive in part because of political lobbying, but also by design, because the government wants to be certain that banks will make loans available to college students. The problem is that no lobbyist, no economist, and certainly no member of Congress knows what the right subsidy level is—one just high enough to ensure banks make loans, but low enough so taxpayers' costs are minimized.

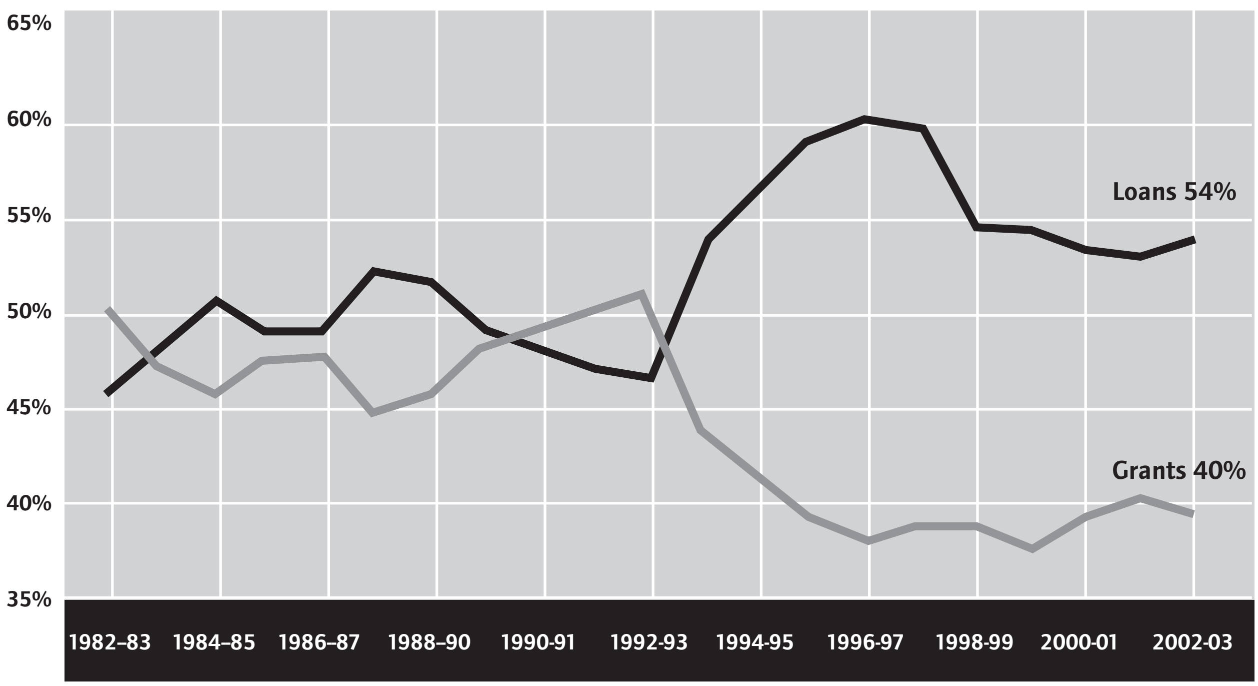
In fact, there is consensus that setting lender terms by congressional fiat has been wasteful. President Bush's 2006 budget pointed to "evidence of significant cost inefficiencies in the [guaranteed student loan] program." According to the Congressional Budget Office, student loan bank subsidy rates could be reduced by "as much as 13 percent" without affecting loan availability. And according to the Government Accountability Office, "billions of dollars" could be saved each year by making student loan programs more efficient.

Perverse Incentives and Exploding Debt

On top of excess subsidies to student loan providers, America's financial aid system is rife with perverse incentives. Lenders have little reason to put resources into collecting payment from delinquent borrowers because student loans carry a 99 percent government guarantee. The federal government and states have little reason to increase grant aid to keep up with rapidly rising college costs because student loans are available to back up aid reductions and tuition hikes.

A particularly perverse incentive in our financial aid system is the *penalty* that exists for students who try to work their way through college, even though

GRANTS VS. LOANS, PERCENT SHARE OF TOTAL AID, 1982–83 TO 2002–03



Source: The College Board, *Trends in Student Aid,* 2003.

attending and completing college is more challenging for lower-income students than their upper-income peers. There is a reduction in federal financial aid of 50 cents for every dollar a student earns above approximately $3,000 over the course of a calendar year. A typical lower-middle-class student who works to pay for college gets zero federal grant aid.

Because of the work penalty, students have to assume larger student loans. In fact, students are borrowing more than ever. According to the Project on Student Debt, two-thirds of students graduating from four-year colleges accumulate an average of almost $20,000 in college loan debt, more than double the average college loan debt of ten years ago. At private, nonprofit colleges, three-quarters of all students graduate with student loan debt. One-fourth graduate with almost $30,000 in student loan debt, while 10 percent accumulate debt in excess of $40,000. Since federal student loan borrowing is capped for undergraduates at $23,000 over five years, borrowing above that level is in the form of high-interest, non-government-guaranteed private loans. The interest rate on those private loans reaches as high as 16 percent a year on top of up-front fees of up to 10 percent of principal borrowed.

High School Matters More Than Money

In addition to perverse incentives that discourage college students from working outside of school, high school students are not asked to work very hard academically before going to college. In general, federal financial aid for postsecondary education is available to any student accepted by any university, college, community college, or trade school without regard to how prepared the student is for postsecondary work. Under this policy, higher education is broadly accessible. A large share of high school graduates may not go immediately to college or attend a traditional four-year college. But three-quarters of Americans between the ages of 18 and 24 participate in some form of postsecondary education, be it attending a private or public university, community college, or a proprietary program, such as a cosmetology school.

Unfortunately, federal financial aid often pays for students to learn in college what they should have learned in high school. Approximately 40 percent of college students need to take at least one remedial course while in college. These students, who are disproportionately low-income and minority, are also twice as likely to drop out of college, according to the National Center on Education Statistics. If they do complete college, it will take them longer to do so because of the need for extra remedial coursework. Consequently, their total college costs and borrowing are inflated.

Young people leave college burdened with massive debt and too often without the degree or skills necessary for a good-paying job.

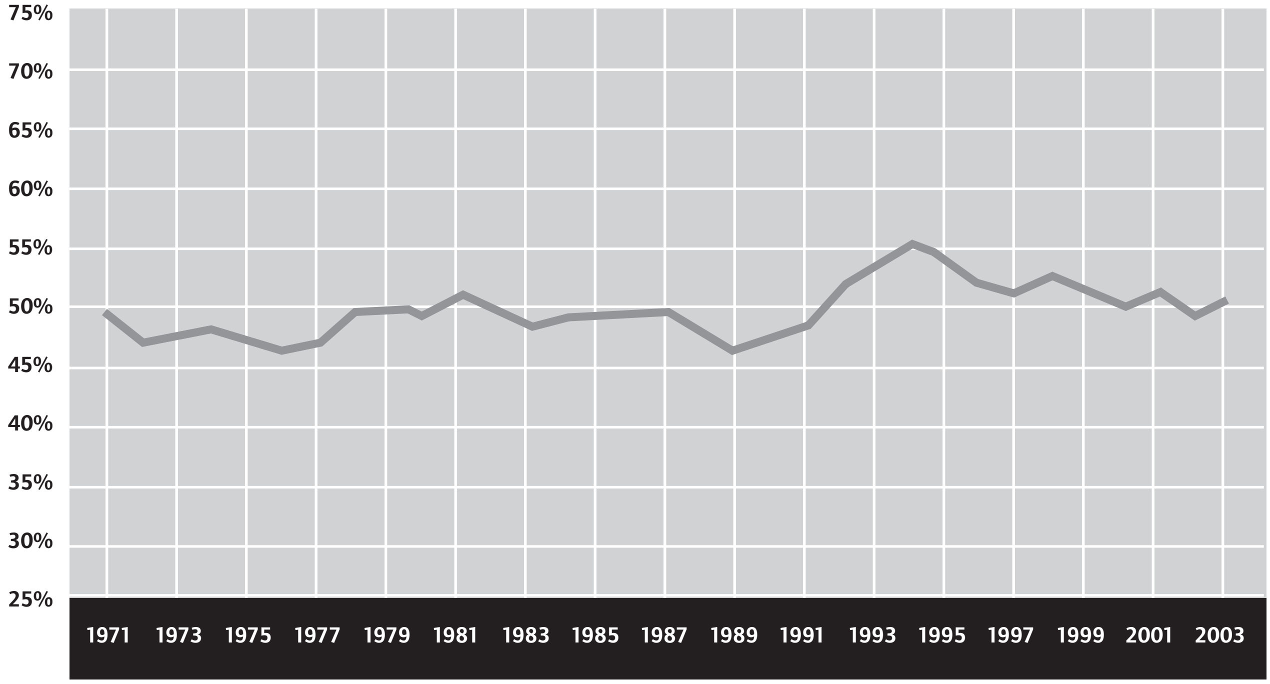
Colleges Are Failing Students

The excess taxpayer payments to student loan banks, the work penalty, the grant/loan imbalance, and the disregard for academic preparation in high school all might be tolerable if college students were learning the skills they will need in the workplace. But too many students are not working hard academically in college either, and too many colleges are failing students. Consequently, students leave postsecondary institutions ill-prepared for work and thus less able to pay off their student loan debt.

First, an unacceptable number of college students are leaving school without a degree. Approximately one out of three students attending a four-year institution of higher education fails to obtain a bachelor's degree within six years of initial enrollment. For minorities and students from low-income backgrounds, the college dropout rate is over 50 percent. Dropout rates for two-year community college students are even higher.

Second, and more troubling, a majority of students who complete college do not appear to have gained the skills that might be expected of a college graduate. Over two-thirds of students graduate from college unable to comprehend ordinary narra-

PERCENTAGE OF STUDENTS WHO COMPLETE COLLEGE DEGREES, 1971–2003



Source: U.S. Department of Commerce, Census Bureau, Current Population Surveys, October, various years.

Note: The rate was computed by dividing the number of students with "some college" by the percentage who had "college degrees." Until 1990 the definition of the category "some college" was one year or more of postsecondary schooling; after 1990 the category included individuals with any amount of postsecondary schooling.

tive texts, such as a newspaper article, according to the National Assessment of Adult Literacy. Twenty percent of college graduates have only basic quantitative skills, meaning, for example, that they are unable to perform even a simple task, such as calculating the cost of ordering office supplies, according to the American Institutes for Research. Fewer than one in five college graduates enter the labor force with the writing and communication skills that employers say they need, according to the Conference Board, a respected business research firm.

Make Work Pay: A College Access Contract

What America needs is a College Access Contract that gives less to banks and asks more from students. A meaningful College Access Contract would guarantee that low-income students can graduate from college free of federal student loan debt—and that middle-class students can graduate with zero interest federal student loans—if they: (1) work hard in high school to prepare for college, as evidenced by completing a rigorous college preparatory track or scoring college-ready on a recognized placement exam; (2) work or perform community service while in college for an average of ten hours a week each semester; and (3) evidence a minimum level of academic work or competency upon completing college. By rooting out inefficiencies in the federal student loan system, we could offset the cost of this new contract with young Americans.

The College Access Contract would:

- **Require students to complete a rigorous college prep curriculum in high school.** The single greatest change we could make to improve college graduation rates would be to ensure that all students take a rigorous college preparatory curriculum in high school. High school curricular rigor is the number one indicator of college completion—more important than race, family income, or parent education, according to two major Department of Education studies. Getting high school students to complete a college preparatory curricular track in high school would significantly improve college completion rates, not to mention high school achievement.

  The quickest way to get high schools to upgrade curricula is to get parents to demand it. High schools and school district administrators respond to active parents, and active parents of high school students tend to be driven by college requirements and concerns about college cost. A College Access Contract that would reduce the federal student loan burden, conditioned on completing a college preparatory curriculum in high school, could inspire parents on a mass scale to demand more rigorous curricula in their local high schools. Not only would participating students be more likely to leave college with a reduced student loan debt burden, they would also be more likely to actually earn a degree because they would be better prepared for the demands of college work.

- **Reward work instead of penalizing it.** A College Access Contract should condition new federal student loan debt relief on a manageable but mandatory work or community service requirement. In exchange for debt reduction, students should be required to work at a paid job or perform community service for an average of ten hours a week while in college. Regular earnings would reduce the total amount that students needed to borrow. Beyond that, however, a work or service requirement mitigates the moral and political hazard associated with guaranteeing debt-free college or zero-interest borrowing. Loan forgiveness in the absence of reciprocal responsibility on the part of students encourages more borrowing.

  Moreover, politically, Middle America is more apt to embrace the idea of extending additional taxpayer financial aid to students if it sees its values reflected in student behavior. It is not enough that a better educated workforce is in everyone's interest. Young people should demonstrate that they are willing to work to get extra help for college.

A new College Access Contract would harness the free market so that students get more aid and banks get less.

  Equally if not more important, a work and service requirement is likely to help students do better academically in college. Students who work up to 15 hours a week while in college report that they manage their time better and study more effectively, according to the U.S. Public Interest Research Group. Fifteen hours a week is the tipping point: more than that, students' studies suffer. But ten hours of paid work a week leads to improved grades. Nothing makes a young person appreciate college like hard work.

  Ideally, students would work or perform community service on or near campus in an area linked to their major field of study in jobs that combine earning and learning—placements that colleges and states should be encouraged to facilitate. But, administratively, it would be simpler to let students fulfill their College Access Contract obligation by working or serving anywhere. They should have to prove to participating states that they have fulfilled their contractual obligation by providing wage receipts, end of the year tax returns, or IRS nonprofit certified service organization filings. Service organizations already confirm participation for AmeriCorps awards.

- **Require degree completion or demonstrated academic competence.** Finally, a College Access Contract should also require minimum student competency in an academic area, with participating colleges required to publicly report results. Public reporting would inspire institutions of higher education to pay more attention to the quality of teaching and learning. An existing higher education accrediting agency, the U.S. Department of Education, or some other body would have to define "minimum competency." This might simply mean graduating with a degree in an academic major from a rigorously accredited institution or, in other cases, passing a critical analysis and communications skills competency test, such as the existing Collegiate Learning Assessment. Regardless of the indicator selected, institutions that fail to prepare students to a minimum competency level would have to improve or face a loss in consumer demand.

Only the free market, by means of an auction, can ensure the government subsidy to student loan providers is as low as possible.

How to Pay for the Contract

Infusing market mechanisms into the student loan delivery system can save taxpayers billions each year. The highest published estimate of savings to be garnered from heightened student loan delivery efficiency is $60 billion over ten years. An effective approach would be to construct a "rights-based auction" for the delivery of Federal Family Education Loans. Only through an auction can the government ensure that taxpayer subsidies to student loan providers are as low as possible.

Under a rights-based auction, the government would put out to bid the right to originate government-guaranteed student loans at a group of schools or the right to be the "presumed," but not sole, government-guaranteed lender at a group of schools. Lenders would compete for business by offering the government the highest bid of payments for the right to originate guaranteed loans, or by putting forth the lowest bid of subsidies that they would be willing to accept from the government in return for originating loans. Members of Congress would no longer write into law student loan bank subsidy amounts. Instead, the market would determine the most efficient subsidy level.

A rights-based auction for student loans would not change the terms or conditions of federal college loans for borrowers, which are established by statute, or their availability. Winning bidders would be required to make the same government-guaranteed loans available to all eligible students at schools to which they won the authority to provide federally backed loans. That authority and the group of schools covered would be determined by the government in advance and last throughout each student cohort's attendance at those schools. Such a system would allow lenders to spread fixed costs over time and students to make payments to just one lender for each school they attend. In the event of poor service to students or schools, colleges and students would retain the option of shifting to the government's own Direct Loan program, which provides the same loans under the same terms and conditions as the bank-subsidized alternative.

The government has significant experience with auctions. It currently runs 37 different auction programs for everything from spectrum license sales to timber cutting and offshore oil drilling rights to Treasury security sales. According to the Congressional Budget Office, a rights-based auction for student loans would be simple to put into place because it would require little change in the current delivery system for student loans, no change in students' terms and conditions, and minimal additional investment by lenders.

Taxpayer savings generated by embracing student loan auctions could finance both student loan debt (or interest) forgiveness and the operative conditions of the College Access Contract. Instead of needlessly going into bank coffers, saved taxpayer funds would go to states to pay down the debt of students and upgrade local high schools, particularly high schools serving concentrations of low-income students that disproportionately need better curricula and teachers. To ensure that states do not merely reduce their own education funding as a result of additional federal dollars, they would be required to maintain a fiscal effort for education. Because inflation-adjusted reductions in state aid to higher education are the single greatest contributor to tuition increases nationally, a "maintenance of effort" condition would have the added effect of keeping public college cost increases down.

Something for Something

America's entire approach to education from preschool to graduate school needs to be revamped if we are successfully to prepare youth for the global competitive challenges that lay ahead. A new College Access Contract that would reduce the student loan debt burden is a good place to start. It addresses a pressing issue for the middle class. And there is more agreement among policy experts on what needs to be done with respect to college affordability and student loans than on improving elementary and secondary education. The high school/higher education nexus is a policy vacuum; businesses need an educated workforce, so they have a vested interest in students' collegiate success.

But the main reason to embrace the College Access Contract is to teach young people that in this life, you don't get something—even a college education—for nothing. You have to work for it.❖

Closing the $700 Billion Tax Loophole

Maya MacGuineas

The combination of chronic budget deficits and Congress's reluctance to cut spending or raise taxes leaves many potentially productive initiatives unfunded. We must find a way to come up with new resources to meet the challenges and opportunities of the coming decades. Promisingly, there is a huge "shadow budget" that absorbs significant resources, delivers benefits poorly, and could be redirected to fund other important needs.

The federal government will spend $2.8 trillion this year. But these figures for direct government spending do not begin to tell the tale of how budgetary resources are allocated. There is an additional $700 billion buried in the budget that is "spent" through the tax code. This shadow budget represents subsidies disbursed by way of taxes *not* collected and is in many ways more similar to spending programs than tax cuts.

The shadow budget, which is made up of targeted tax breaks woven through the tax code, encourages and rewards everything from having children to buying vacation homes to preserving historic buildings. Most often, you can recognize tax expenditures as the tax laws that start with the word "if": If you have a child and meet certain income qualifications, you receive the child credit. If you save money in a 401(k), you receive preferential tax treatment. If you opened up your home to someone displaced by Hurricane Katrina, you received a temporary tax break. And so on.

This fast-growing area of the budget includes the home mortgage interest deduction, deductions for many employer-provided benefits, and a slew of other exemptions, deductions, and credits that are popular with taxpayers, businesses, and politicians. But popularity does not necessarily reflect sound policy. Tax expenditures tend to be regressive, as well as extremely complex. They pay people to do what they would do anyway. And they do not receive sufficient oversight at inception or on an ongoing basis.

While the politicians who deliver these goodies are happy to market them as tax cuts—because let's face it, who doesn't like tax cuts?—in truth they are far more similar to everyday government spending programs. Take, for instance, the home mortgage interest deduction (a policy as beloved by homeowners as it is reviled by economists). It is quite simply a government program to help subsidize the housing costs of homeowners who take out mortgages. Homeowners are allowed to deduct a portion of their mortgage interest costs from their tax bill on mortgages up to $1 million. The same goal could be accomplished by sending checks—just as we do for Social Security or other forms of welfare—to homeowners to cover a portion of their mortgage interest costs, making the tax break a spending program. Spending programs lead to government outlays, tax expenditures to a loss of revenues for the government. Either way, the bottom line is the same: either spending has to be cut, taxes have to go up, or the deficit increases.

The political benefits of labeling a spending program a tax cut are clear. In our highly polarized and partisan political environment, agreeing on tax expenditures is one of the few ways that politicians of different parties seem to be able to come together to get things done. Democrats tend to like these spending programs dressed up as tax cuts because the social or economic goals they promote—helping families to save or purchase health care or invest in education—reflect their priorities. By voting for tax expenditures, they can pursue their goals without being labeled as "big spenders." Republicans like them because they lower the tax burden on American families—at least on the surface. And no politician of any stripe would consider crafting a spending program when the same policy could be dressed up as a tax cut—certainly not if his political advisors had a say in the matter. If, for instance, a politician wanted to develop a policy to help defray the cost of long-term care insurance, he would likely offer a tax deduction or a tax credit to the individual or employer purchasing the insurance rather than by providing long-term care directly, or by creating a voucher system to cover the costs.

The $700 billion "shadow budget" represents subsidies disbursed by taxes *not* collected.

Why Tax Expenditures Are a Bad Idea

Tax expenditures have a lengthy list of shortcomings.

First, they do not undergo nearly the same level of scrutiny as do spending programs. When a new government program is created or resources are directed toward a policy initiative, many questions need to be asked: Is this an important objective? Is this something the government should be doing? Will this program be effective? Is there a better way to achieve the policy goal?

But discussions about new tax cuts tend to focus almost solely on their costs and distributional effects. Billions of targeted tax cuts for education, to encourage saving, and for health care were enacted in the past few years with little or no discussion of their cost-effectiveness in achieving stated policy goals. No wonder so many tax policies are ineffective or badly directed. If sufficient thought went into creating tax entitlements, would we have a program that subsidizes millionaires who buy second homes?

Second, once tax breaks are in place, they are rarely reviewed with the kind of rigor that should be applied to government programs. The discretionary portion of the budget requires the authorization and appropriation of funds on an annual basis, whereas entitlement programs, such as Social Security and Medicare, do not. In this sense, tax expenditures work like entitlements: once created, they continue pretty much on automatic pilot. However, entitlement programs generally have actuaries and trustees devoted to them who warn Congress when the programs need review. Tax entitlements, on the other hand, are buried in the pages of complex tax legislation and are subject to little or no oversight. Because the Senate and House tax-writing committees have virtually exclusive jurisdiction over targeted tax breaks for housing, health care, education, retirement saving, and so on, the oversight committees with substantive expertise in these areas rarely assess their cost-effectiveness.

Third, there is little impetus and no real constituency for change. While spending programs fall into well-defined categories—defense, international affairs, education, among others—tax expenditures are not classified clearly or analyzed along with the rest of the budget. The lack of transparency with respect to tax expenditures distorts the entire spending picture. Consider, for example, federal spending on housing. Most experts, looking at the federal budget, would put annual spending on housing at $50 billion. But what they don't take into consideration is the additional $125 billion spent through the tax code.

While tax expenditures are hidden in a budgetary sense, those who receive them are keenly aware of them. Come tax time, they leave many taxpayers feeling grateful to the government for giving them a way to shrink their tax bill. Just as there is a strong preference for spending on programs that send benefits directly to voters, such as Social Security and Medicare, over spending on such things as research and development or infrastructure, tax breaks that people see directly have become one of the most popular and protected areas of the budget. And politicians of course like to be on the side of helping taxpayers—no matter the effect on the rest of the budget or the ineffectiveness of the policies. With accountants, taxpayers, and politicians all on the side of targeted tax breaks, there is no rallying cry against them.

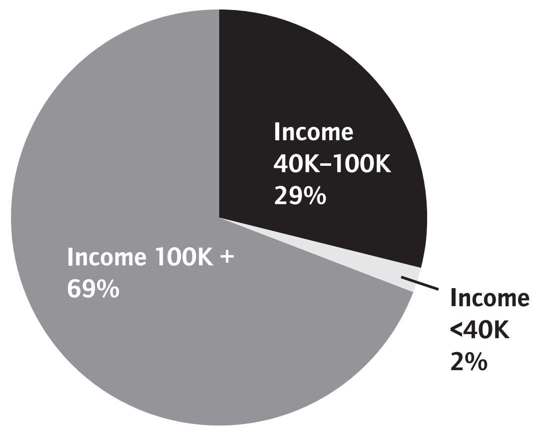
Fourth, not only are tax expenditures poorly constructed and monitored, they tend to be regressive—certainly much more so than other spending programs. In many cases, only more affluent taxpayers who itemize (rather than taking the standard deduction) realize any savings, and individuals in higher marginal tax brackets save more. A particular policy might be worth 35 cents on the dollar to a wealthy person, who is paying taxes at the 35 percent marginal rate, and nothing to someone at the bottom of the income scale, whose marginal tax rate is 10 percent or even zero. It is hard to imagine a politician trying to sell a housing program to help the rich a lot, the middle class a little, and those who can only afford to rent not at all—and yet that is exactly what the home mortgage tax break does.

The perverse effect of many of these policies is to drive up the cost of the item that is being subsidized—such as housing or health insurance—which ultimately prices out many of the poorest people most in need of help. Indeed, whenever economists propose ending or limiting the mortgage interest deduction, builders and realtors complain that home prices would plunge.

Fifth, it is tax expenditures that make the tax code an impenetrable mess. Many people mistakenly think it is the existence of multiple tax rates that makes the tax code so complex—a misconception that has led to the popularity of "flat tax" schemes. But it is the base (what is taxed), not progressive rates, that makes the tax code so difficult to navigate. The current maze of complicated and overlapping tax breaks accounts for many of the payment errors in any given year, and compliance costs are a significant drain on the economy.

The simplifying tax reforms of 1986 dramatically reduced tax expenditures and broadened the tax base, which in turn allowed lower tax rates. But since then, politicians have not been able to resist the temptation to layer them back in: a tax break here for film and television productions, another there for railroad maintenance, another for sanctioned whaling activities, and another for motorsport racetrack complexes. (And that was in just one year.) The Government Accountability Office found that the number of tax expenditures increased from 67 to 146 between 1974 and 2004, and that the inflation-adjusted costs of these policies increased from $240 billion to $730 billion. Only the smartest taxpayers, or the ones with the best accountants, can navigate this expanding and dizzying maze.

SHARE OF HOME MORTGAGE INTEREST DEDUCTIONS
GOING TO TAXPAYERS IN DIFFERENT INCOME CLASSES



Source: Joint Tax Committee, U.S. Congress.

Finally, these poorly targeted programs often pay people to do what they would do anyway: having a child, buying a home, or saving for retirement. The poor targeting of hundreds of billions of dollars creates little positive behavioral or economic effect, while draining significant funds from the Treasury. In many years, the total revenue loss from tax expenditures is larger than the government's entire discretionary budget.

Hundreds of billions of dollars in potential savings can be freed up and redirected to meet the nation's most important needs.

What to Do?

Given tight fiscal conditions and the urgent unfunded needs of the country, the tax expenditures area of the federal budget is ripe for reform.

1. Streamline, simplify, consolidate, and eliminate. A thorough review of all tax expenditures is long overdue. Tax breaks for dependents, education, and saving, among other things, should be consolidated. In the category of education alone, we find the exclusion from normal taxation of scholarship and fellowship income, the HOPE tax credit, the Lifetime Learning tax credit, Education Individual Retirement Accounts, the deductibility of student-loan interest, the deduction for higher education expenses, favorable treatment of education-related bonds, the parental personal exemption for students aged 19 or over, the exclusion of employer-provided educational assistance, and the discharge of student loan indebtedness. Surely a streamlining of these policies is in order.

Tax expenditures that are not achieving their purpose or have become outdated should be eliminated. Others should be dramatically scaled back and more precisely targeted to the people who need them the most or to those who are most likely to change their behavior in response to incentives. Many existing breaks should be capped and/or turned into credits—a change that could save hundreds of billions of dollars a year while instantly increasing the progressivity of the tax code. For instance, the home mortgage deduction could be reduced significantly without a negative impact on homeownership. (More fundamentally, it is not clear we should be encouraging homeownership to the extent that we do.) Deductions for health and pension benefits could be turned into refundable credits, to both save money and help promote universal health insurance and retirement saving. Education and family tax breaks could be better targeted to provide benefits for those who most need them. Finally, many business tax breaks that amount to little more than corporate welfare should be eliminated.

2. Fully integrate tax programs with the rest of the budget. Not only should these tax policies be reformed, but how they are treated in the budget needs to be addressed. Tax programs should be better integrated with the rest of the budget. They should be clearly classified using the same categories as spending programs, and there ought to be a comprehensive budget showing the entirety of spending on housing, education, commerce, etc. Such a presentation should also make clear how much of the budget is discretionary and subject to the appropriations process, and how much is on automatic pilot.

3. Classify spending as spending. In addition, where appropriate, budget conventions should be changed so that tax expenditures that are clearly spending programs are recorded as such. Scoring certain tax expenditures as government outlays would better reflect the true size of government and the amount of resources going to different policy objectives. It would also end the bias that comes with running spending programs through the tax code. At present, attempts by lawmakers to reform or reduce tax expenditures can generally be derailed simply by labeling them as "tax increases." If the same reforms were put forward as spending cuts, which is a better description of what they are, they would be more likely to be considered on their merits.

4. Improve oversight. Finally, along with improving the transparency of the tax side of the budget, Congress should integrate better oversight mechanisms into the annual appropriations process to monitor tax programs. Specific congressional committees should be made responsible for ensuring that these programs are operating as intended, and outside experts should be consulted as to their effectiveness. It many instances, the total resources spent on tax programs should be capped, just as with discretionary spending programs, to comply with budget restrictions.

5. Redirect the revenue. Making these changes could free up hundreds of billions of dollars annually. Redirecting even half of the revenue lost from tax expenditures would be sufficient to fund affordable universal health care coverage, a universal 401(k) retirement saving plan, and an asset-building account for every child at birth—three proposals detailed elsewhere in this volume. This is particularly feasible since existing, but poorly targeted, tax expenditures for employer-sponsored health insurance and pension saving plans alone cost the federal government more than $250 billion annually. Thus, critical national needs could be addressed primarily by redirecting revenue already being spent less effectively for the same general purpose.

Under past reform efforts—notably in 1986—the trade-off was a cleaning up of the tax base in return for a lowering of tax rates. This time around however, there are other competing claims on resources. Reducing the $250 billion federal budget deficit should come before further tax cuts. In 1986, many of the tax breaks that were removed were corporate and individual loopholes. Today, exemptions and deductions are often linked to specific social and economic policies—illustrating that much of the expenditure budget now falls on the tax side of the ledger. Reforming this area of the budget should be seen as spending reform as much as tax reform, and redirecting resources to where they are needed most should be a central part of the exercises. For example, redirecting the savings from eliminating or reducing the exclusion of employer-provided health care from taxation could be used to help cover the uninsured. Consolidating and eliminating many of the overlapping saving incentives could provide resources to help cover the cost of Social Security reform.

If Congress were to take the courageous step of cleaning up the haphazardly constructed tax base, the ensuing debate over the best use of the freed-up resources could return us to fiscal prudence and engender an honest budgetary debate with various options competing on equal footing. The result would be a more coordinated budget with resources allocated more sensibly, fairly, and transparently—as well as the freeing up of a significant funding stream that could be directed toward the country's most urgent needs.❖

Universal Risk Insurance

*Jacob S. Hacker**

Over the past generation, the economic risks faced by American families have increased dramatically. Yet public programs have largely failed to adapt to these new and newly intensified risks, and private workplace benefits have substantially eroded. As a result, risks have increasingly shifted from government and corporations onto the balance sheets of American families. This "Great Risk Shift" not only creates anxiety, but also threatens opportunity by undermining the security that families need in order to feel optimistic about their futures and to recover when economic shocks occur.

Perhaps the most telling evidence of increased insecurity is the growing risk of large drops in family income. About half of American families experience a drop in real income over a two-year interval, a share that has remained steady over time. However, the size of the median decline rose from around 25 percent of income in the early 1970s to around 40 percent by the late 1990s and early 2000s. Meanwhile, the predicted probability (based on a multivariate analysis) that an average working-age individual will experience at least a 50 percent drop in family income also increased substantially—from 7 percent at the beginning of the 1970s to nearly 17 percent by 2002.

One probable reason for these growing drops is that the character of job loss has changed. Once, unemployment was largely cyclical: workers lost a job when the economy slowed, but they returned to a similar position when the economy regained steam. Increasingly, however, unemployment is structural: persistent, perhaps even permanent, and often requiring changes in job types and work skills.

Unfortunately, this transformation is completely missed by the unemployment rate. In recent years, for example, unemployment has remained low. Yet the chance that workers will involuntarily lose a job over a three-year period has been rising steadily and is now essentially where it was in the early 1980s—during the steepest recession since the Great Depression. The earnings loss associated with job separations has also risen. Meanwhile, the share of workers experiencing unemployment for longer than six months has tripled since the 1960s, comparing business cycle peak to business cycle peak. And in each of the last two recessions, long-term unemployment has approached crisis levels, rising higher than ever recorded and persisting for many months after recovery commences. Contrary to the common impression, the long-term unemployed are likely to be professionals and the educated, not workers with limited skills and education.

Despite the shift toward structural unemployment, however, unemployment insurance has eroded dramatically. Between 1947 and 1995, the share of workers in covered employment who actually received benefits fell from 80 percent to less than 40 percent. Low-wage workers are particularly unlikely to receive unemployment benefits. In 1995, only about 18 percent of unemployed low-wage workers were collecting anything from unemployment insurance. Moreover, unemployment insurance is poorly equipped to deal with structural unemployment. Unless Congress extends it, it lasts only six months, and it is not designed to deal with permanent job loss—to make up for the diminished earnings and benefits that plague workers whose skills are no longer needed, or to help with retraining. In short, the declining reach of unemployment insurance is emblematic of the way in which existing benefits are both eroding and increasingly out of step with the needs of the new world of work and family.

Rising income volatility is not the only evidence of increased insecurity. Personal bankruptcy has also become more common, with the number of households filing for bankruptcy rising from fewer than 290,000 in 1980 to more than 2 million in 2005. Health care costs also pose substantial financial risks. Medical costs and crises are a factor in perhaps as many as 46 percent of all personal bankruptcies. These various risks combine to create a greater sense of insecurity than any one of them alone would generate. Perhaps not surprisingly, then, poll after poll shows that the majority of Americans today are concerned that their economic security is slipping away.

The Rationale for Universal Insurance

The ideals and institutions of economic security need to be refashioned for the 21st century. The starting point is a simple but forgotten truth: economic security is a cornerstone of economic opportunity. Like businesses, people invest in the future when they have basic protection against the greatest downside risks of their choices. The worker who fears being laid off at any moment may be more productive in the short run. But in the long run, insecure workers tend to underinvest in specialized training; they are more reluctant to change jobs; they try to minimize their sense of job commitment to protect themselves against psychological loss. Similarly, the family barely scraping by may work more hours, but in the long run insecure families are not going to be able to make the investments in education and other keys to their future that they should.

In sum, the increased income volatility and insecurity faced by many families imposes costs not just on those families, but also on the economy as a whole. Substantial economic insecurity may impede risk taking, reduce productivity by failing to help families that have suffered an adverse shock get back on their feet, and feed demands for growth-reducing policies. While some measure of financial risk can cause families to respond with innovation and prudence, excessive insecurity can cause them to respond with caution and anxiety. As a result, families lacking a basic foundation of financial security may fail to make the investments needed to advance in a dynamic economy.

Perhaps the most important of these investments—and the hardest to insure privately—is investment in human capital. Human capital is by far the most lucrative asset in the portfolio of most Americans. Yet it is an investment that is not only much more costly than it used to be, but also much more risky than we commonly assume. There is a huge range of possible outcomes for those who have gained the same amount of education, and this range (known as "within-group inequality") is growing. For example, while the earnings of a full-time worker with a bachelor's degree in 2000 were $1,700 a week at the 90th percentile, similarly educated workers were earning only $423 a week at the 10th percentile.

Furthermore, human capital is an exceedingly difficult asset to insure on one's own, not least because we cannot generally commit the future returns of our human capital to others. Because human capital is essentially a nontradable asset, diversification of its risks is extremely difficult in the private market. It requires public risk pooling.

It has long been recognized that policies that encourage risk taking can benefit society as a whole because, in their absence, individuals may be unwilling to undertake valuable investments that involve high levels of risk. This is all the more true because people are highly "loss averse," meaning that they fear losing what they have more than they welcome the possibility of substantially larger but uncertain gains. Moreover, the gains of risky investment may entail positive externalities, that is, benefits that are not exclusive to the individual making the investment, but that accrue to others outside the transaction. When investments involve large positive externalities, individuals may not have sufficient incentive to invest in achieving these societal gains.

Providing a basic level of security appears even more economically beneficial when considered against some of the leading alternatives that insecure citizens may otherwise back. Heavy-handed regulation of the economy, trade protection, and other intrusive measures may gain widespread support from workers when they are buffeted by economic turbulence. Yet these measures are likely to reduce growth. The challenge, then, is to explore ways of protecting families against the most severe risks they face, without clamping down on the potentially beneficial processes of economic change and adjustment that produce many of these risks.

Universal Insurance in Brief

Universal Insurance is one approach to providing protection against severe risk. It would insure against major economic shocks stemming from unemployment, ill health, disability, and the death of a family breadwinner. Its benefits would be generous enough to help families truly get back on their feet.

The label "Universal Insurance" is meant to connote two key features of the program. First, Universal Insurance would cover almost every citizen with any direct or family tie to the labor force, providing at least some direct benefits to virtually all families that experience the risks against which it insures. Second, Universal Insurance would cover a wide range of risks to family income. The philosophy of Universal Insurance is that Americans should have at least some protection against the major threats to their economic well-being, regardless of whether those threats fit neatly into existing program categories. Universal insurance is not a health program, a disability program, or an unemployment program. It is an income security program.

Universal Insurance would aim to fill the gaps left by existing social insurance programs, rather than to substitute for those programs. It would thus be similar to private stop-loss insurance purchased by corporations to limit their exposure to catastrophic economic risks.

The starting point is a simple but forgotten truth: economic security is a cornerstone of economic opportunity.

By providing limited protection against large and sudden income declines that can cripple family finances, Universal Insurance would enhance economic security. Although the protection it would offer would be relatively modest in order to target resources and avoid incentive problems, it would nonetheless provide a more secure backstop against catastrophic economic loss than Americans now enjoy. Universal Insurance would provide this backstop, moreover, through the popular and successful method of inclusive social insurance, pooling risks broadly across all working families.

Under Universal Insurance, all workers and their families would be automatically enrolled through their place of employment, paying premiums in the form of a small income-related contribution (preferably, a levy that included capital gains as well as labor income). In return for their premiums, workers would receive coverage for four potential shocks to family labor income that are large, serious, primarily beyond individual control, and incompletely protected against by present policies: (1) unemployment, (2) disability, (3) illness, and (4) the death of a family earner. In addition, Universal Insurance would provide coverage against catastrophic health costs—a leading source of economic strain. This coverage would apply to all families whose income was below a relatively high threshold (the 95th percentile of state family income), and would be available to families with assets as well as those without assets (however, families with very extensive assets would not be covered).

Universal Insurance would provide short-term, stop-loss protection to families whose income suddenly declines by a fifth or more.

Although nearly all families would be protected, Universal Insurance would be especially generous for lower-income families, which are most likely to experience large financial shocks and be most in need of help when they do. Lower-income families generally have little or no wealth to protect their standard of living when income declines, and they are least likely to have access to workplace health or disability insurance. Not surprisingly, therefore, unemployment has a much larger effect on the consumption patterns of lower-income families than it has on those of higher-income families.

Administration and Structure

Universal Insurance would be administered primarily by the Internal Revenue Service, which would assess income, authorize checks, and evaluate tax filings to ensure that workers actually qualify for benefits they receive (much as is now done with the Advance Earned Income Tax Credit). The IRS would work in cooperation with the U.S. Department of Health and Human Services and the U.S. Department of Labor, as well as with state governments. State governments would be required to maintain existing programs that provide benefits in areas covered by Universal Insurance. Although some of the administration of Universal Insurance could be contracted out, the federal government would play the core role in pooling risk across all working families and regulating the system.

Universal Insurance would insure all legal residents and their families with direct or family ties to the workforce. It would require at least four quarters of employment before an individual would be eligible to receive benefits for the first time. In addition, in order to qualify for benefits at the time of application, workers would have to have minimum earnings equivalent to 20 hours of work at the minimum wage in at least two of the last four quarters, or the same level of earnings for all three months of the most recent quarter. When two or more members of the family work and contribute, they would receive coverage for their combined incomes.

To the extent possible, triggering events that lead to substantial income loss or catastrophic health costs would create automatic coverage. For instance, employers would report to federal authorities when they terminate workers; those authorities would then contact employees to advertise coverage. Similarly, health providers and insurers would be required to provide information about filing for Universal Insurance to families that have been struck with illness. And state unemployment and workers' compensation programs, as well as the federal disability program, would assist in reaching out to the unemployed and disabled. To be sure, any significant degree of automaticity would require substantial advances in IRS and other government agency computing power and capabilities.

Even if those investments were successfully made, some families would still have to file for help themselves. People would be more likely to file for Universal Insurance than many other programs, however, for at least two reasons. First, Universal Insurance would cover a wide range of risks, so people would likely be aware of the option to file for help. Second, because the program would be universal, wage-related, contributory, and structured similar to private insurance, there would likely be little stigma associated with applying for coverage. Families would be able to apply online, at their local post office, or through companies contracting with the government to handle applications.

All beneficiaries of Universal Insurance would be required to file tax returns for years during which they receive benefits. If losses determined at the time of qualification were different from actual subsequent losses, the IRS would collect the difference, preferably in the form of additional withholding. Universal Insurance benefits would be taxable as income.

Benefits

Universal Insurance would mimic private insurance in its basic features: a premium (in this case, related to wages), a coinsurance rate that varies with family income, and a deductible (that is, a threshold expenditure or drop in income that must be reached to trigger compensation). As shown in the table below, the deductible is 20 percent of income. In other words, in the case of income losses, family income must fall by at least 20 percent relative to the prior year. This relatively high threshold reflects the desire to target assistance to those experiencing the most severe economic shocks. Once this threshold is reached, additional losses are partially covered on a sliding scale. The replacement rate for losses above the threshold would be 35 percent for a family with median income. For families that, after the loss, are below the 25th percentile of state family income, the rate would be 50 percent—the maximum replacement rate for losses in excess of 20 percent. The replacement rate would gradually taper to 20 percent for families between the 75th and 95th percentile of state family income. Families with income above the 95th percentile, or with wealth that places them above the 95th percentile of household wealth, would not be covered. Initial maximum annual benefits would be $10,000; this maximum would be updated in line with average family income in subsequent years.

Out-of-pocket catastrophic health costs also represent a severe economic shock that is not always well covered by existing public and private insurance. Universal Insurance would therefore provide coverage on the same sliding scale to families whose out-of-pocket health costs in any year exceeded 20 percent of family income. Thus, for example, Universal Insurance would cover half of out-of-pocket health costs that exceeded the threshold of 20 percent of family income for families with incomes in the lowest quartile.

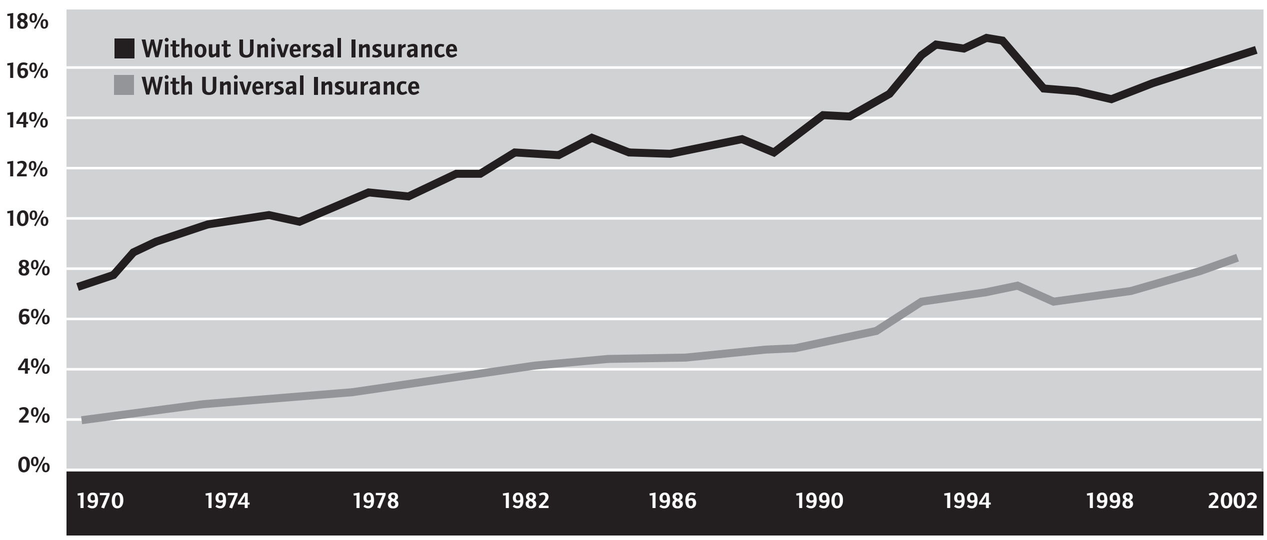
A crucial point is that determination of benefits would be based on family income after other public programs were taken into account. In other words, Universal Insurance would apply only if existing public policies did not adequately protect family incomes. Because Universal Insurance is an income-protection program, it would not take into account in-kind benefits such as Medicaid and subsidized childcare. Moreover, Universal Insurance benefits would not be counted in the determination of eligibility for means-tested antipoverty assistance, although they would be counted as taxable income.

The duration of Universal Insurance benefits would be similar to the duration of benefits currently provided by related categorical programs. In the case of an unemployed individual, or an individual who is unable to work due to a disability, Universal Insurance would continue for up to six months, as long as the policyholder continues to look for work (unemployment) or the debilitating condition remains (disability). In the case of

COINSURANCE RATES FOR UNIVERSAL INSURANCE

	FAMILY PAYS	UNIVERSAL INSURANCE PAYS
Initial 20 percent drop in income or expense	100 percent	0 percent
Remaining loss/expense for...		
Families between 95th & 75th percentiles (inclusive)	80 percent	20 percent
Families from 75th percentile to median (inclusive)	80–65 percent	20–35 percent
Families from median to 25th percentile (inclusive)	65–50 percent	35–50 percent
Families below 25th percentile	50 percent	50 percent

PREDICTED PROBABILITY OF 50 PERCENT OR GREATER INCOME DROP, 1970–2002



Sources: Panel Study of Income Dynamics, University of Michigan; Cross-National Equivalent File, Cornell University.

Note: Probabilities are based on the time trend from a logistic regression, with all other variables set at their annual means. Variables include age, education, race, gender, income (mean of five prior years), and a series of events (such as unemployment and illness) that affect income. The time trend is highly significant and robust to the inclusion of fixed effects; all standard errors are robust and adjusted for clustering.

temporary unemployment due to illness, Universal Insurance would continue for up to 12 weeks. In the case of the death of a spouse, insurance payments would last one year, or until income rebounds, whichever comes first. Health costs would be covered in any year for which they exceed 20 percent of family income.

Cost and Effects

Based on an analysis of the Panel Study of Income Dynamics (PSID), the total annual cost for the income-loss components of Universal Insurance would be just over $27 billion in 2005 dollars. These figures are admittedly uncertain. On the one hand, they assume 100 percent participation, which may lead to overestimating the true cost. On the other hand, the PSID estimates do not take into account any potential behavioral effects of Universal Insurance, which could push up costs. But this upward pressure on costs would be limited by key features of Universal Insurance that militate against the problem of false or induced claims.

The main cost of the income-protection portions of Universal Insurance would be benefits for the disabled and unemployed (43 percent and 42 percent of total benefits, respectively), followed by benefits for the spouses of deceased workers (13 percent), and 12 weeks of coverage for income losses due to sickness (2 percent).

The costs of coverage for catastrophic health expenditures cannot be estimated from the PSID. To estimate them requires using the Medical Expenditure Panel Survey (MEPS), a nationally representative survey of medical use and costs. According to the MEPS (author's calculations), in 2003 more than 7.7 million households had out-of-pocket medical expenditures that exceeded 20 percent of family income. Coverage of all of these expenses under the terms of Universal Insurance—that is, with a deductible of 20 percent of income and the same sliding-scale coinsurance rate—is estimated to cost slightly over $7 billion (in 2005 dollars). In sum, the annual cost of Universal Insurance given the specific parameters proposed would amount to roughly $35 billion.

Despite the targeting of the proposed program to severe economic losses and its temporary and partial assistance to families even in those cases, Universal Insurance would still have a major positive effect on the incomes of the families it helped. For example, according to the PSID, more than a third of the households affected by the four categories of income risk covered by Universal Insurance—more than 3 million Americans in total—end up below the federal poverty line even after receiving public transfers. Although the small numbers of such households in the PSID make any estimates of insurance effects uncertain, the PSID suggests that Universal Insurance would essentially eliminate poverty among these least-advantaged households.

Universal Insurance would have a more limited, yet still substantial, effect on the risk of large income drops among nonelderly adults. If Universal Insurance had been in place in 2002, according to the PSID it would have roughly cut in half the predicted chance of a 50 percent or greater income drop.

The Road Forward

Today, many see the ideal of economic security as dated, yet the opposite is true. The big economic trends of the past generation—deregulation, deindustrialization, increased foreign competition, the decline of unions, the transformation of the family—have unleashed new and newly intensified economic risks. Americans are facing much more dramatic income swings. As economic insecurity has intensified, moreover, it has moved up the income ladder, affecting middle-class Americans who once were relatively insulated from economic turbulence and hardship.

Universal Insurance responds to this new economic insecurity in a way that is likely to promote broad-based growth. Although it aims to cushion major economic shocks, it is not just about preventing financial disaster. It also has a more optimistic goal: to help families get ahead. Just as businesses and entrepreneurs are encouraged to invest and take risks by basic protections against financial loss, so Universal Insurance aims to encourage families to make the sacrifices necessary for economic opportunity and advancement. In doing so, Universal Insurance would provide a necessary cushion against the sharp edges of a dynamic capitalist economy—a cushion that is far preferable to the more intrusive measures that anxious citizens might otherwise demand, such as extensive regulation of the economy or restraints on international trade and finance.❖

**An expanded version of this paper was originally prepared for The Hamilton Project at The Brookings Institution and is available at www.hamiltonproject.org.*

Instant Runoff Voting

Steven Hill

The U.S. political system has been shaken in recent years by increasing partisan polarization, unresponsive government, and ethical scandals—all of which have resulted in a crisis of confidence in our elected officials. Opinion polls routinely reveal the public's disdain for Congress and both major political parties, and grave concern about the direction of the country. Despite the high stakes in the 2006 elections over which party would control Congress, a mere 40 percent of eligible voters bothered to vote. Americans need a broadly representative and responsive government that can build a political consensus capable of addressing the nation's challenges, yet our political system is founded on antiquated practices that produce this polarized, paralyzed politics.

Our outdated electoral methods and institutions are greatly responsible for the widening chasm between the electorate and those who hold office. Plurality-wins-all elections allow "spoiler" candidates and "lesser of two evil" dilemmas to bedevil voters. Party primaries empower the political extremes in each party and discourage moderates, creating legislatures that are unable to reach compromise and are subject to gridlock. A plurality-wins-all system also discourages competition from independent and third-party candidates.

It's time to bring our electoral system into the 21st century by adopting modern electoral methods, including instant runoff voting (IRV), which will result in leaders who better represent the broad range of Americans. IRV produces winners with majority support in a single election by allowing voters to rank first, second, and third choices on their ballots. If a voter's first choice cannot win and is eliminated from the runoff, his or her vote goes to the candidate he or she ranked second; this is the voter's runoff choice. Instant runoff voting liberates citizens to vote for the candidates they really like instead of the lesser of two evils. And IRV encourages candidates to campaign by building coalitions rather than tearing down opponents. If used in party primaries, IRV would empower the political center because candidates would need to win with a majority of votes, and politically moderate candidates would thus have a greater chance of advancing to the general election.

Using instant runoff voting to elect members of the U.S. House and Senate will expand voter choice, inaugurate a new era of bipartisan cooperation in Congress, and encourage pragmatic problem solving over partisan bickering on countless issues. Using IRV for congressional primary elections would loosen the stranglehold party extremists have on the nomination process.

The Problem

When asked whether they would prefer to have more political choices on Election Day, including independent and third-party candidates, a clear majority of Americans say yes. Yet our 18th-century electoral methods perpetuate the two-party system and restrict voters' choices. That's because under our current electoral system, three's a crowd. Our plurality election process, in which the candidate with the most votes wins—even if that candidate receives less than a popular majority—can produce skewed results when more than two candidates run for the same office. For example, in a three-way race, a candidate with only 37 percent of the vote can win, even though 63 percent of the voters wanted a different candidate.

Plurality-wins-all elections allow "spoiler" candidates and "lesser of two evil" dilemmas to bedevil voters.

This is not merely a theoretical consideration. In three of our last four presidential elections, the winning candidate in a multi-candidate field did not have a majority of the national popular vote. Since 2000, the governors of 20 states have won without a majority of the popular vote, five governors in 2006. From 1994 through 2004, there were 247 plurality wins in U.S. House primaries and 35 in U.S. Senate primaries (with 77 more House plurality winners and 14 more Senate plurality winners avoided by the use of second-round runoff elections).

Our plurality-wins-all electoral system leads to the following problems:

- **Nonmajority winners.** We can send a man to the moon, we can map the human genome, yet we use an electoral method that cannot guarantee that the candidate with the most support will win. This undermines majority rule, one of the cornerstones of our democracy.

- **Spoiler candidacies.** Plurality-wins-all elections are vulnerable to spoiler candidacies. In such cases, the votes of like-minded voters are split between candidates with similar positions, resulting in their least favorite candidate winning. Independent and less popular candidates thus feel pressure not to run or, even worse, their candidacy helps elect someone whom a majority of voters oppose. This dynamic tends to suppress new candidates and their ideas, which in turn suppresses political debate. This alienates voters who get tired of voting for the lesser of two evils instead of for candidates they really like.

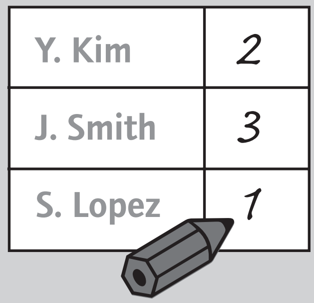
- **Partisan primaries and loss of moderates.** Primary elections are typically restricted to registered party voters (though specific rules differ from state to state) and usually have very low turnout. In our plurality-wins-all system, candidates can win their party's nomination with low percentages of the vote, relying on a narrow core of voters. As a result, the extremes in each party have an influence over national politics that is far out of proportion to their actual numbers in the electorate. Candidates with politically moderate views have a much more difficult time winning primary elections and advancing to the general election. Yet since moderate politicians play a crucial role as legislative bridge builders, their absence leads to a polarized government in which representatives have great difficulty working together.

- **Mudslinging campaigns.** Plurality-wins-all elections encourage negative campaigns, where often the winning strategy consists of driving voters away from an opponent by mudslinging rather than attracting voters by building coalitions and consensus. The head-to-head combat of plurality-wins-all elections inevitably leads to bruising, attack-style campaigns that alienate voters, lower public trust in government, and damage the eventual officeholder. The winner of a divisive election is likely to have to work much harder to gain the public trust that is essential to strong leadership.

HOW INSTANT RUNOFF VOTING WORKS

You vote for your favorite candidate, just like you do now. But you also RANK your runoff choices at the same time – 1, 2, 3, on your ballot. If a candidate has a majority of first rankings, he or she wins. If not, the second and third rankings are used to determine the majority winner – instantly – in a single November election.

Instant Runoff Voting has been used for years in many places – including San Francisco. It is a proven way to improve democracy.

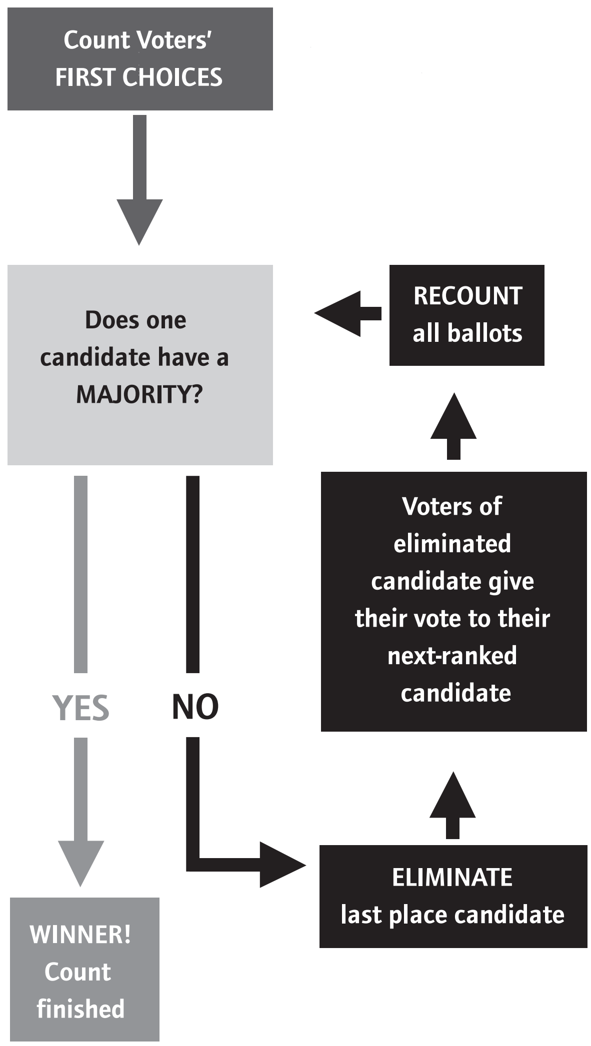


The Solution: Instant Runoff Voting

Instant runoff voting is a reliable and tested solution to our broken plurality-wins-all politics. It produces winners with majority support in a single election. You rank candidates in order of preference: a first ranking for your favorite candidate, a second ranking for your next favorite, and so on. If a candidate wins a majority of first-choice rankings, he or she wins the election. If not, the "instant runoff" begins.

The candidate with the fewest first-choice rankings is eliminated, and voters for the eliminated candidate have their ballots counted immediately for their second-ranked candidate—i.e., the candidate they would have supported if forced to come back to the polls for a traditional two-round runoff. All ballots are recounted, and if a candidate has a majority, that candidate is the winner. If not, the process is repeated until one candidate has majority support. In other words, voters are ranking their runoff choices at the same time as they are indicating their first choice, and these runoff rankings are used to determine instantly which candidate has support from a popular majority in a single election.

With IRV, voters are liberated to vote for the candidates they really like instead of the lesser of two evils, and they don't have to worry about spoiler candidates splitting the vote. IRV would help moderate candidates break the stranglehold that partisan



voters now have on the congressional primary process. Instead of congressional elections being dominated by the most partisan Democratic and Republican nominees, more centrist candidates would have a chance of making it through the primary gauntlet and ending up on the November ballot.

In effect, instant runoff voting asks the voters to reveal more of their political thinking. Okay, you're a moderate Republican, but what about this moderate Democratic candidate? Might that candidate be acceptable as your second or third choice? Or maybe you are a Libertarian Party or a Green Party supporter—which would be your second or third choice if your Libertarian or Green candidate can't win? Voters can think more about which candidates they like regardless of partisan labels. This in turn fires the synapses of voters and liberates them to send a message with their first rankings in ways that the current system can never do. The nation receives a much better snapshot of where the electorate really stands.

This is not some academic exercise. Instant runoff voting can change outcomes and produce fairer results. If IRV had been in place for the 1992 presidential election, President George H. W. Bush might have won enough second-choice rankings from Ross Perot supporters to have beaten Bill Clinton, who won the presidency with only 43 percent of the popular vote. And if, in 2000, the nearly 100,000 Ralph Nader voters in Florida had had the option of ranking a second choice, probably thousands of them would have turned to Al Gore, who would have been the recipient of all their runoff rankings, most likely winning Florida and the presidency.

The Benefits of Instant Runoff Voting

There are many good reasons for using instant runoff voting, but the following are especially important.

- **Majority winners.** With IRV, a number of candidates can run and not worry about the split votes that lead to nonmajority winners, and majority winners are elected in a single race.

- **No more spoiler dilemmas.** With IRV, voters are liberated to vote for the candidates they really like without worrying about spoilers wasting their vote. If your first choice can't win, your vote moves to your second choice, so you aren't forced to vote for the lesser of two evils. Election results will more accurately reflect the level of support for all candidates. Like-minded candidates can form coalitions without splitting the vote and knocking each other off. This in turn will attract a higher caliber of alternative candidates, giving voters a broader range of choices.

- **Increased political debate.** The spoiler dynamic suppresses new candidates and their ideas, which in turn suppresses political debate. Third parties and independent candidates have often played an important role in the American political system as "laboratories for new ideas." Third parties and independents first proposed the abolition of slavery (Free Soil Party), prohibition (Prohibition Party), the income tax (Populist Party), the New Deal coalition (Progressive Party), balanced budgets (Reform Party), women's suffrage, the 40-hour workweek, food and drug safety laws, public libraries, direct election of U.S. senators, and government regulation of monopolies.

  Third parties and independent candidates not only introduce new ideas and issues but also a new type of candidate who speaks directly to various constituencies and mobilizes them with a personal touch that only an authentic voice can provide. Ross Perot, during his two candidacies in 1992 and 1996, gave expression to the frustrations of a Middle America fed up with budget deficits and an indifferent two-party tango, and wanting to "toss the bums out." IRV would open up the electoral system and empower voters to support such candidates—and their ideas—without the unintended consequences of spoiling. And that would encourage more political debate, which would be good for America.

- **Less mudslinging.** IRV would also cut down on the negative campaigning that has become a fixture of American political campaigns. That's because currently in our winner-take-all elections, candidates win as easily by driving voters away from their opponents as by attracting them to their own candidacy. The last candidate standing wins, so the optimal campaign strategy becomes attacking your opponent and taking as few stands on issues as possible to avoid alienating a potential bloc of voters. This strategy is greatly augmented by the use of polling and focus groups to figure out what sound bites will work most effectively against an opponent, as well as what the least risky positions are on the most pressing issues. Unsurprisingly, our elections are sorely lacking in substance, and alienating to many.

Instant runoff voting discourages this sort of negative campaigning. In order to win under this system, a candidate may need to attract the second or third rankings from the supporters of rival candidates, so candidates will have to be more careful about what they say about each other. IRV will result in a major shift in campaign strategy because finding common ground and building coalitions with other candidates, rather than tearing them down, will pay dividends at the polls. In San Francisco, where instant runoff voting is used to elect local officeholders, some races have seen candidates endorsing their opponents, sharing slate mailers, and cosponsoring fundraisers. One *New York Times* headline read: "New Runoff System in San Francisco Has the Rival Candidates Cooperating." Such coalition building in the midst of a campaign is certain to benefit the eventual winner in governing. For those tired of polarized politics and mudslinging campaigns, IRV has much to offer.

Empowering the political center. Instant runoff voting provides a solution to the problem of partisan primaries. With IRV, candidates who can build coalitions by attracting support beyond their core supporters are more likely to be successful. In party primaries, candidates would need to win with a majority of votes, so politically moderate candidates would have a greater chance of advancing to the general election in November.

An even better idea would be to get rid of partisan congressional primary elections entirely and hold a single election in November with instant runoff voting. This structure would mimic a blanket primary (sometimes known as an open primary), which was very popular with voters in several states but was eliminated following an adverse U.S. Supreme Court ruling. The blanket primary, which allowed voters to choose from all candidates regardless of party affiliation, gives voters more choices. Getting rid of the low-turnout primary elections would save the tens of millions of tax dollars currently spent to administer them. Since the Supreme Court has ruled that a political party's primary is a private affair and that a state cannot force parties to open their primaries to all voters, why should taxpayers foot the bill? Let the parties pay for a primary or a caucus themselves, and nominate as many or as few candidates as they wish for each race in November. And then instant runoff voting can be used to elect the majority winners in a single election.

Instant runoff voting produces a more robust political debate and gives voters more choices and a greater voice in the American political process.

Eliminating primaries will also spare candidates the burden of raising money for a second election. Having to raise money for two elections instead of one gives the advantage to incumbents and other well-connected candidates who can raise more money, undermining the good that comes from campaign finance reform. Eliminating party primaries and electing congressional representatives using instant runoff voting would transform our politics. Together, these reforms would significantly boost voter choice, reduce mudslinging, improve political debate, inaugurate a new era of bipartisan cooperation, and save the taxpayers money.

IRV Is Gaining Momentum

Instant runoff voting favors neither the left nor the right; it is a nonpartisan reform measure that seeks simply to make our electoral process more democratic and efficient. It has been used for decades to elect the president of Ireland and Australia's House of Representatives. It is also used to elect the mayor of London and the presidents of Malta and Sri Lanka. India uses IRV to indirectly elect its president. And it has been used to good effect in divided societies: ranked ballots have been instrumental in facilitating cross-ethnic or cross-tribal coalitions in troubled nations like Bosnia, Fiji, and Papua New Guinea.

Outdated electoral methods and institutions are greatly responsible for the widening chasm between the electorate and those who hold office.

Instant runoff voting is also used by many organizations, including the NCAA, the International Olympic Committee, the Academy of Motion Picture Arts and Sciences, and the Federal Reserve board (to elect regional directors). In Utah, the Republican Party has been using IRV to nominate candidates for congressional seats and for governor to ensure that its choices have support from a majority of GOP voters. The Conservative Party in Canada uses IRV in electing its leadership, as do numerous American colleges and universities in electing student or faculty governments, including Harvard, Stanford, MIT, Princeton, UCLA, UC-Berkeley, Georgetown, Duke, Dartmouth, Cornell, and Caltech. The American Political Science Association also uses IRV to elect its president—and its members know a thing or two about elections.

The movement toward use of instant runoff voting in government elections is gaining momentum throughout the United States because it answers a real need. In the November 2006 elections, IRV was passed by voters in four different locations: Oakland, California, with 67 percent of the vote, Minneapolis with 65 percent, Davis, California, with 55 percent and Pierce County, Washington, with 53 percent. What is interesting about the four victories is that they occurred in quite different locations. Oakland is a very diverse, working-class city; Minneapolis is a Midwestern values city; Pierce County is mostly a rural county with large numbers of independent voters that replaced a partisan primary with a single November election using IRV; and Davis is a smaller university town. Yet in every place instant runoff voting provided a unique solution to problems with representative government and democracy.

Like San Francisco, Burlington, Vermont, has adopted IRV for its mayoral elections, and this has spurred the introduction of several bills in the Vermont state legislature for its use in state elections. The city council of Takoma Park, Maryland, approved the use of IRV in local elections following a city referendum in which 84 percent of voters said yes to the idea; it will be used for the first time in November 2007 to elect the mayor and city council members. Cambridge, Massachusetts, has been using a ranked ballot method very similar to IRV to elect its city council and school board since 1941. The voters in Ferndale, Michigan, Vancouver, Washington, Santa Clara County, California, and in the California cities of San Leandro and Berkeley have overwhelmingly approved the use of IRV for local offices. These measures will be implemented as soon as issues with respect to voting equipment and election administration have been resolved.

IRV has broad, bipartisan support and has been endorsed by Sen. John McCain as well as by Democratic National Committee Chairman Howard Dean; Alaska's Republican Party and California's Democratic Party have both endorsed it. It also has support from good government and advocacy groups like Common Cause, the League of Women Voters, California PIRG, the Greenlining Institute, the Asian Law Caucus, the National Latino Congress, and Southwest Voter.

The state of North Carolina has passed groundbreaking legislation that allows instant runoff voting to be used for elections to fill vacancies for judicial offices to ensure that winners have majority support without requiring a separate runoff election. The North Carolina law also allows IRV to be used in ten cities and ten counties for local elections. Driving the interest in IRV in North Carolina (and other states) are elections like the runoff in 2004 for the Democratic nominee for the state's superintendent of public instruction. The election cost $3.5 million and produced a voter turnout of only 3 percent. Recently Louisiana, Arkansas, and South Carolina, which already use traditional two-round runoff elections for various races, decided to begin using IRV for their military and civilian overseas voters in state and federal primary elections since there is not enough time to mail a second ballot to their overseas voters when a runoff election is required. Colorado recently became the first state to use IRV to fill a vacancy in a state legislature. To date, bills for IRV have been introduced in the legislatures of 22 states.

Our current plurality-wins-all voting system is a horse and buggy relic of the 18th century. It does not meet the most basic requirements for fair and efficient elections in the 21st century. Instant runoff voting is an idea whose time has come. It will produce a more robust political debate, and it will give voters more choices and a greater voice in the American political process.❖

A Capital Budget for Public Investment

Sherle R. Schwenninger

A strong and productive economy is the key to meeting our future fiscal challenges, from providing unmet entitlements to reversing our current account deficit. We need therefore to establish budgetary priorities that will make our economy more productive in the future. The government's current pattern of spending, however, does not reflect this imperative. Over the last several decades, the portion of the federal budget going to current consumption has increased, while that devoted to what might legitimately be called public investment has declined. Indeed, the federal budget does not even officially distinguish between spending on productivity-enhancing investment and spending on current consumption.

As a result, the federal government currently does not adequately fund investment in our nation's physical infrastructure or knowledge capital upon which a more productive economy rests.

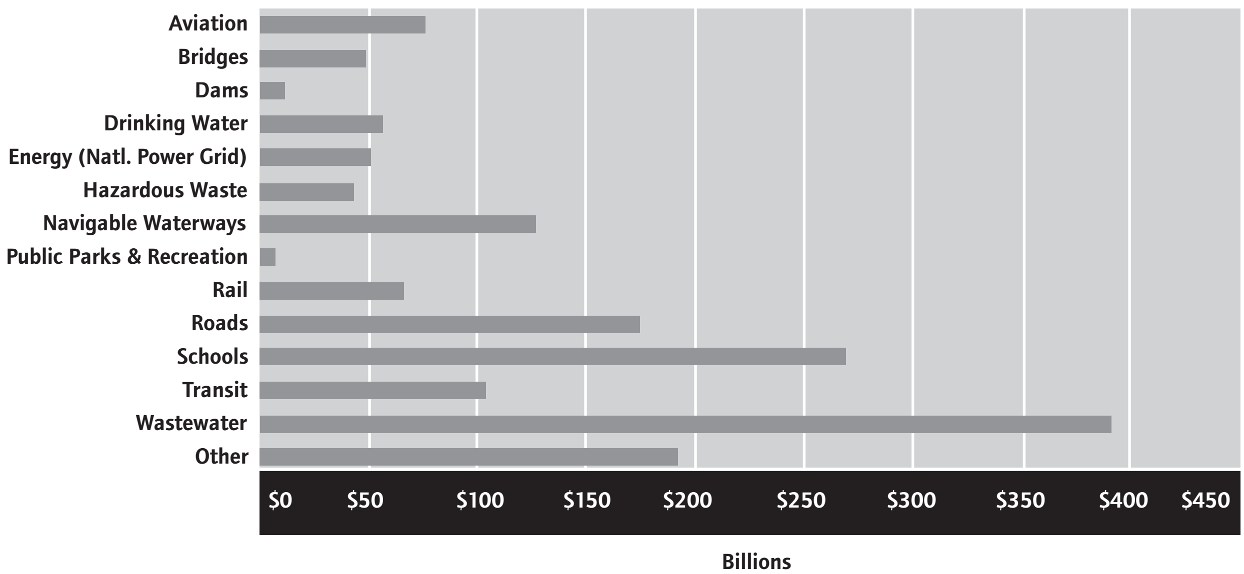
America Is Falling Behind

From 1950 to 1970, we devoted 3 percent of GDP to spending on infrastructure—roads, bridges, waterways, electrical grids, and other essentials of a modern and competitive economy. Since 1980, we have been spending well less than 2 percent, resulting in a huge accumulated shortfall of needed investment. Not surprisingly, infrastructure bottlenecks—traffic-choked roads, clogged-up ports, uneven broadband access—are undermining our nation's efficiency. The biannual report of the American Society of Civil Engineers offers these and other examples of an inadequate public infrastructure:

> Over a quarter of the nation's bridges are structurally deficient or functionally obsolete.
>
> Most of our airports will not be able to accommodate the new jumbo jets scheduled for introduction later this decade or handle the expected growth in the number of small regional jets necessary for commerce for smaller business centers.
>
> Nearly 50 percent of the 257 waterway locks operated by the U.S. Army Corps of Engineers are functionally obsolete.
>
> Poor road conditions cost U.S. motorists \$54 billion a year in automotive repairs and operating costs; these same motorists spend a total of 3.5 billion hours a year stuck in traffic.

We are also now lagging behind in the infrastructure of the information age. Only 33 percent of households have access to broadband, which is increasingly

INFRASTRUCTURE INVESTMENT NEEDED



Source: American Society of Civil Engineers.

critical for successful commerce. The United States now ranks 16th in the world in broadband penetration. And the costs of broadband in the United States are rising relative to those in other countries, putting American-based companies at a disadvantage. U.S. consumers, for example, are forced to pay nearly twice as much as their Japanese counterparts for connections that are 20 times slower.

We have also underinvested in basic science and research and development. Basic science research is important because it makes possible the technological breakthroughs that could revolutionize the economy and the way we live. It is also responsible for the innovation from which American companies derive premium returns on capital. But research and development spending as a share of GDP has declined over the last two decades, as the federal government's support for research and development has shrunk.

Finally, we have not kept up with other countries in the training of skilled workers, particularly scientists and engineers. The United States now graduates fewer engineers per capita than nearly all other advanced industrialized countries. Some American firms are thus beginning to complain about the shortage of skilled workers in some sectors of the economy, forcing them to rely more on outsourcing than they would like. In sum, underinvestment in research and development, a less than world-class infrastructure, and an inadequately trained workforce are acting as a drag on American economic growth and thus on future living standards.

How to Fix the Problem

Correcting this problem by ensuring that public investment is adequately funded in the future will require institutional reform. The United States underinvests in public capital in part because it neither properly accounts for its public capital expenditures nor properly finances them. The U.S. federal government is virtually the only government among the world's advanced industrialized countries not to have a formal capital budget that separates public investment outlays from current consumption expenditures. And unlike state and local governments, which use special purpose bonds to fund specific capital needs, the federal government finances public infrastructure projects out of general government revenues or out of special trust funds, like the Highway Trust Fund. This makes no sense since public investment is different from current government expenditures in both character and economic consequences. Most public investment, especially most public infrastructure projects, should be paid for over the useful life of the investment, and the fact that it earns a return on investment in the form of higher productivity and increased tax revenues should be reflected in how we account for it.

The first step, then, in correcting our public investment deficit would be to establish a formal capital budget. A federal capital budget would not alone correct the problem of chronic underinvestment in public capital. But it would make our government more accountable for its spending priorities and give us the tools to finance public investment in a way that is fiscally responsible. A federal capital budget would separate in a transparent way our nation's public investment from our government's current outlays. Capital budgets are used by private businesses—as well as by most cities and states—because they help management distinguish between ordinary operating expenses that a company routinely incurs during the course of doing business and extraordinary ones that add to a business's capacity to grow and thus should be depreciated over a number of years.

Discipline, Fiscal Responsibility, and Flexibility

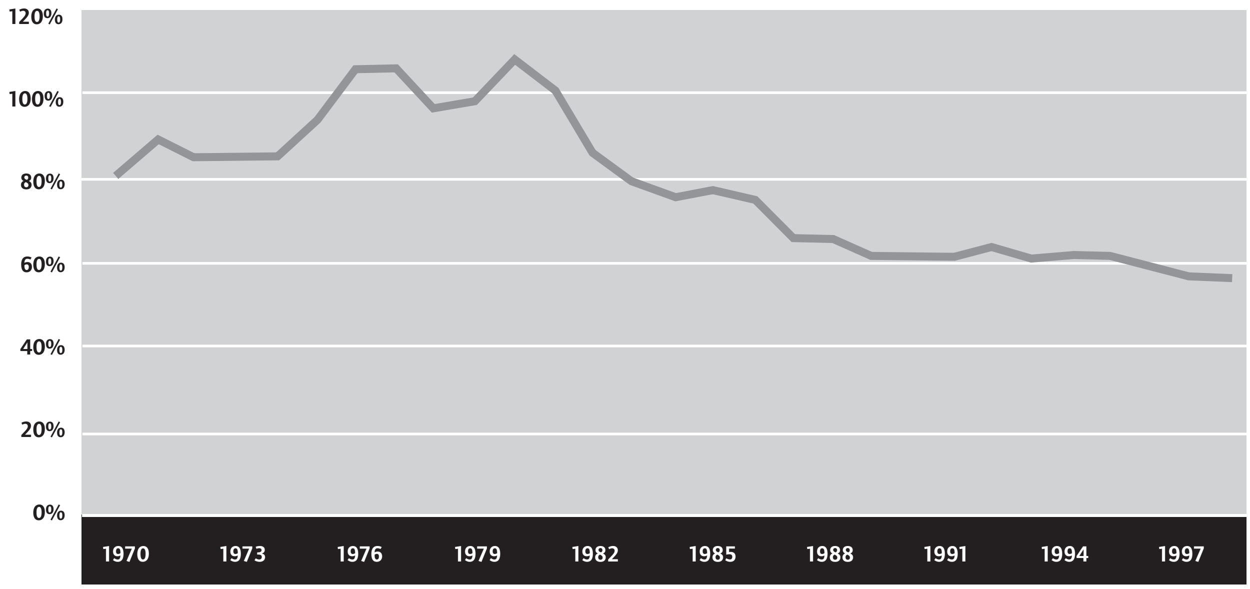
Constructing a capital budget would help improve American government in three ways:

First, it would impose some necessary discipline on the discussion of our nation's budget and public debt. It is now too easy to become alarmed by growing deficits, on the one hand, or too complacent about shrinking deficits, on the other. Because the current budget makes no distinction between consumption and investment, it does not allow us to make intelligent choices about our spending priorities. The introduction of a capital budget would force a different and more productive debate over the budget. Above all, it would enable us more easily to ask the right questions: Spending for what purpose? Borrowing for what purpose? Without a capital budget, we are unable to differentiate good spending from profligate spending, virtuous debt from vicious debt. But with a capital budget, the public discourse would shift the discussion to a much more fruitful discussion of public spending for consumption versus public spending for investment. There will of course still be disagreements about the level of government spending, and the amount of public investment needed, but at least the debate will more likely address the right issues.

Underinvestment in research and development, a world-class infrastructure, and an adequately trained workforce act as drags on U.S. economic growth.

Second, it would allow us to develop a more sophisticated and more useful approach to fiscal responsibility. Today, the notion of fiscal responsibility tends to mean either a balanced budget or a balanced budget over a business cycle. Again, this overly simplistic idea fails to distinguish between the very different nature of capital expenditures and ordinary ones. With a capital budget, it would be easier to develop a consensus over some broad fiscal principles. In general, it would be reasonable to get centrists from both parties to agree that the current expense budget should be balanced over the economic cycle. And based on sound economic principles it would also be reasonable to be able to develop a consensus that a capital budget could be financed in part by government borrowing, which would be paid back over a period of years. Capital outlays would be seen for what they are—net additions to the government's capital stock, which like the capital assets of a company, would be depreciated over their useful life. Thus, with the initiation of a capital budget, additions to the national federal debt would be matched by additions to our national federal assets. Accordingly, the capital budget

FEDERAL SPENDING FOR INFRASTRUCTURE AS A PERCENTAGE OF GROSS DOMESTIC PRODUCT, 1970–98



Source: Congressional Budget Office.

would provide a basic guideline for government borrowing. Any deficit that was incurred beyond the capital budget would need to be justified either as a matter of macroeconomic policy to stimulate the economy or as a matter of a national emergency. And over the years, the greater part of our national debt would gradually become the financial counterpart of our public productive capital, as the late eminent economist Robert Heilbroner suggested.

Third, it would also give us more flexibility for financing needed public investment in our nation's future while helping us maintain fiscal discipline over current expenditures. Today, we try to ensure a certain level of infrastructure spending by using trust funds with dedicated revenue streams, such as the highway and airport trust funds. But while this may ensure that these programs are insulated from budget-cutting pressures, it also ties the government's hands, reducing its ability to finance the optimal level and mix of public investment. Trust funds thus reduce the government's flexibility, and are subject to abuse by powerful political constituencies that can skew government spending. A capital budget would give the government much more flexibility to match government spending with our public investment needs while at the same time ensuring that public investment was adequately funded. It would allow us to reduce federal spending on highways if that was warranted and increase spending on broadband without the current constraints imposed by designated trust funds.

How to Finance a Capital Budget

A capital budget in any given year could be financed by a combination of tax revenues and government borrowing. The exact amount of government borrowing would depend in part on the macroeconomic conditions prevailing at the time and in part on the projections relating to the return on public investment. The other institutional innovation needed to help correct our public investment relates to the way government borrows for purposes of funding government activities.

As in accounting for government expenditures in general, the government currently makes no distinction between borrowing for general current expenditures or for particular investment projects.

But this may not be the best use of the capital markets. State and local governments routinely use special-purpose bonds to finance needed capital improvements and investments, and so should the federal government. Special purpose bonds, for example, could be used for certain new infrastructure improvements and for certain new energy development programs that could pay for themselves over time.

Congress should therefore ask the Treasury Department to develop a new class of 30- to 50-year bonds to finance public infrastructure and other public investment projects. This new class of bonds would technically increase the national debt, but because they would fund public investment projects that would have positive returns for the economy they would not have the same consequences as other deficit spending.

There is a strong case for the introduction of long-term special purpose bonds at this time, given the big backlog of public investment needs and the availability of relatively cheap capital. Issuing long-term bonds for specific designated projects would be a financially wise use of debt because the federal government would be able to take advantage of historically low interest rates to replenish key parts of America's public capital. The higher economic growth rates that would result from these investments in turn would increase tax revenues and expand the country's tax base, reducing the burden of future government programs, including Social Security and Medicare. Thus, the returns on this faster economic growth would far exceed any increased government borrowing costs.

The Heart of Sound Modern Government

Together, these two institutional innovations—a federal capital budget and special purpose long-term bonds—would give policymakers the tools they need to correct America's public investment deficit. The idea of a capital budget is not a new idea. Nor is it a conservative or liberal idea. First proposed by Franklin Roosevelt in 1939, a federal capital budget was seriously considered by both the Johnson and Reagan administrations. The principal objection to the idea over the years has been the fear that capital budgeting would open the door to fiscal profligacy in which spending was redesignated as investment. The idea of capital expenditure, some have argued, is an inherently vague notion subject to political abuse. But this concern can be addressed in a responsible way. In the case of private business, we have been able to develop accounting rules and procedures for determining whether an expenditure is an ordinary expense or a capital investment, and if the latter how quickly it should be depreciated. So we should be able to develop similar rules for government spending. Indeed, the Office of Management and Budget (OMB) already publishes an annual breakdown of what it considers to be public investment. The OMB's methodology, while not flawless, could be a starting point for an expert commission to develop clearer guidelines for capital budgeting.

Just as private firms and most states use capital budgeting, a federal capital budget would separate public investment, which expands our capacity to grow, from current consumption outlays.

The overarching notion guiding whether an expenditure should be included in the capital budget would be similar to the one already used by the OMB in its annual breakdown of government expenses—namely, whether a particular expenditure is a public investment or an ordinary operating expense. On average, as noted earlier, a public investment produces a positive return to the economy and increases future tax revenues as a result of stronger and more sustained economic growth. In general, three major categories of expenditures would meet this criterion of productivity-related investment that would increase future tax receipts: research and development; capital expenditures for infrastructure such as roads and bridges; and education and training. These investments are capital assets, and should be treated as such, and each year in keeping with good accounting principles the interest costs and depreciation expenses relating to these initial capital investments should be written off as part of the normal operating budget. By contrast, most military, health care, and transfer-program spending would be categorized as current consumption. Again, a bipartisan body would need to develop some standard rules for the depreciation of different kinds of public investment, just as we have developed rules for the write-off of research and development by private companies.

Overcoming the opposition to the establishment of a public capital budget will not be easy. But reintroducing the idea in itself would help spur a much needed debate about our nation's spending priorities and about the proper level of government debt. The public investment deficit has received much less attention than the budget deficit, but it threatens our economic future all the same. Properly accounting for what the federal government spends its money on and how it finances government expenditures goes to the very heart of sound modern government. For a nation that considers itself on the cutting edge of international commerce, it is an anomaly of historic proportion that we continue to deny ourselves this indispensable tool of modern capitalism.❖

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