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Our fiscal challenges are big, but manageable

Of all our nation's economic worries, none are scarier than the federal government's record budget deficits and mounting debt load. Unless we find a way to make big changes to Social Security, Medicare, and other government programs, and also fix our tax code, the economy will break. The vitriol of the midterm elections and the seemingly broken political process only add to the anxiety.

It may seem odd given all this, but I'm optimistic. Our problems are big, but they are manageable. As the economy improves (believe me, it will) the deficit will narrow, tax revenue will grow, and the extraordinary government spending used to combat the Great Recession will wind down. Under reasonable assumptions, the annual deficit will shrink from its current $1.3 trillion to $800 billion. Unfortunately, this isn't good enough. We have to knock an additional $350 billion off our annual deficit, otherwise the interest payments on our outstanding debt will swamp us. This will be difficult - for context we spend more than $100 billion a year in Iraq and Afghanistan - but it is doable.

Particularly encouraging is the intellectual consensus now forming. You can see it happening around recent proposals from two different bipartisan commissions formed to tackle long-term federal budget issues. While the proposals will not become law, they lay down important benchmarks and establish the basis for a healthy and ultimately successful debate.

The key point of agreement is that government spending cuts and tax increases are necessary to repair our budget hole. Perhaps more important, both commissions agree that the focus should be on spending restraint. An examination of other periods of fiscal austerity here and abroad suggests that adjusting spending is better for an economy than raising taxes. Where to balance spending restraint with tax increases will be the focus of political battles to come, but judging by the commissions' proposals, an achievable middle ground exists.

The proposals put so-called tax expenditures in the crosshairs. The exclusions, exemptions, deductions, and credits that riddle the tax code cost the government more than $1 trillion each year. The mortgage-interest deduction alone costs more than $100 billion annually. But hundreds of other special provisions fund student expenses, health insurance, child care, local property taxes, and on and on.

These tax expenditures are more properly thought of as government spending than tax cuts. A deduction for local property taxes, for example, is no different from the federal government's sending checks to homeowners. Cutting tax expenditures is thus cutting government spending. Indeed, removing tax breaks for specific purposes is analogous to eliminating congressional earmarks.

Most tax expenditures are also inefficient and regressive. The mortgage-interest deduction doesn't improve housing affordability, its ostensible goal. Any tax benefit is simply "capitalized" into house prices, which rise as the deduction fuels demand. The benefits flow to owners of bigger homes with larger mortgages and higher incomes, who can itemize and thus claim the deduction.

On direct government spending, a growing consensus favors moving Social Security from an entitlement to an insurance policy. People would receive benefits as they are needed. Higher-income earners would pay more in payroll taxes to fund the program and receive less in benefits. There is still debate over whether the retirement age should rise, although given Americans' increasing longevity, a slow increase seems logical.

Government spending on health care would be subject to an explicit budget. As they are currently structured, the large and rapidly growing Medicare and Medicaid programs are uncapped; there is no real mechanism to hold spending to affordable levels. The result, unsurprisingly, is runaway health-care spending. While specific proposals to rein in health-care spending remain elusive, even with the new law in place, the idea is that strict budget caps will force changes that ultimately make government-provided health care more efficient.

No one is arguing that all tax expenditures should be eliminated today, or that every needed spending cut can occur next year. As long as we lay out a credible path soon, we can implement the changes over the next decade. The United States isn't Greece or Ireland, nations that have no choice other than an immediate change in direction; or even France or Germany, where problems must be addressed within the next several years.

Global investors still have faith in America; this is clear from our still very low interest rates, and the fact that investors still run for safety in U.S. Treasury bonds when there is trouble anywhere in the world - even here. Of course this faith can be stretched only so far; if we don't find the political will to map out this credible path soon, our fiscal morass will only deepen and our economy will be significantly diminished. But we are up to the task. I'm optimistic, but it is time to execute.

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