The Role of Economic and Political Resilience in Fiscal Reform

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The foresight that Americans demonstrated during the recent Great Recession and the ensuing recovery of household balance sheets are encouraging signs of the resilience necessary for U.S. households to face future fiscal challenges. And significant fiscal challenges are unquestionably on the horizon. While modest changes to U.S. tax and spending policy in 2011 and early 2013 did mitigate near-term federal budgetary pressures modestly, long-run fiscal challenges remain as our entitlement programs and the federal debt are projected to outpace the overall growth of the U.S. economy.

A key aspect of fiscal reform, and entitlement reform specifically, is a proper understanding of how workers and households will respond to changes in government policy. A resilient and adaptive economy can better adjust to changes in federal programs and absorb the shock of even large-scale reforms. Conversely, a static, unresponsive household sector will endure more damage from rapid or significant fiscal consolidation.

The economic resilience of the American household makes for an inspiring story—and an important one given the role that resilience will play in righting our fiscal imbalance. While the resilience of the American household and the American worker is key to tackling our entitlement problems and the fiscal challenges that lay ahead for our country, our elected officials also must demonstrate political resilience. While many American households have responded and will continue to respond wisely to recent economic adversity by preparing for a more uncertain economic future, lawmakers need to strengthen their political courage to reform unsustainable programs, primarily Medicare and Social Security. The good news is that our leaders can both draw on the public’s resilience for inspiration and rely on the American people’s resilience in the face of necessary policy changes.

Economic Resilience

Economic resilience traditionally refers to the ability of a firm, market, or economy to mitigate the impact of an economic shock, which often relates to property damage or disruption to production. An emerging field of academic research has studied the economic impact of natural disasters, the union strike at the ports of Los Angeles and Long Beach, and the September 11 terrorist attacks, among others. Many studies have indicated that the U.S. economy has a great deal of resilience, as production can be rescheduled or relocated and capacity rebuilt. Improvements in technology and other innovations likely contribute to the economy’s “recapture function,” the ability to “catch up” after a natural or man-made shock to the economy.

Professor Adam Rose at the University of Southern California has defined economic resilience as follows:

The inherent and adaptive responses to hazards that enable individuals and communities to avoid some potential losses. It can take place at the level of the firm, household, market, or macroeconomy. In contrast to the pre-event character of mitigation, economic resilience emphasizes ingenuity and resourcefulness applied during and after the event. Also, while mitigation often emphasizes new technology (e.g., seismic warning) or institutions (e.g., insurance markets), resilience has greater behavioral emphasis. It focuses on the fact that individuals and organizations do not simply react passively or in a “business as usual manner” in the face of a disaster.

While most of the research in this area has focused on the response of businesses and geographic regions to shocks such as natural disasters, an additional important component to economic resilience is the response of the household unit. The ability of households to “tighten their belt” and adjust consumption patterns as well as their supply of labor as market conditions shift means that families can better endure the sometimes painful consequences of various economic shocks.
Household Resilience and the Great Recession

The financial crisis in the fall of 2008 shook the entire global economy. Asset prices suffered a shock: The housing bubble burst, sending home prices plummeting, and the stock market saw its biggest one-day drop in two decades. The U.S. economy contracted sharply in the fourth quarter of 2008, which recorded the largest quarterly drop in GDP in 50 years, contracting 8.9% on an annual basis followed by a 5.3% drop in the first quarter of 2009. U.S. employment took a similar dive, with payrolls declining 712,000 per month during the record-breaking period of job losses between October 2008 and March 2009. The unemployment rate jumped from 5% at the start of the recession in December 2007 to a high of 10% in October 2009, several months after the recession technically ended.

But households also demonstrated resilience to this tremendous economic downturn and fiscal shock. This resilience is not only admirable; it is critical. It shows American households’ awareness of and responsiveness to changing fiscal pressures. An understanding and appreciation of this responsiveness will be necessary for policymakers seeking to change programs currently promising retirement benefits to tomorrow’s retirees.

Evidence of household resilience can be seen in many forms, from neighbors helping neighbors to evidence of a spurt in the growth of small business formation (e.g., entrepreneurship rate) as workers adapt to changing labor markets and new opportunities. Here we focus on the response of the U.S. personal savings rate to the recession as well as the rebound of the household balance sheet following the recession.

Personal Savings. The personal savings rate, which had been in decline for decades, rose sharply as the economy sank into recession. Chart 1 illustrates how the rate more than doubled from an average of 2.6% in 2005, prior to the recession, to an average of 5.6% in the first half of 2009, as the recession wound down. While the drop in consumption exacerbated the recession, households’ willingness and ability to tighten their belts and work toward insulating themselves from the risk of job loss is a perfect example of the resilience of the American household.

Unfortunately, the rise in the personal savings rate has abated as an improvement in household confidence since the depths of the recession has led to a boost in consumption. Economists debate the importance of this measure and note that an alternative methodology—change in net worth as indicated by the Federal Reserve’s Flow of Funds data—yields a rosier picture in recent years. But it remains true that the resilient savings response observed in the household sector during the Great Recession was temporary.

Balance Sheet Repair. The Great Recession and the related implosion of the U.S. housing market caused significant damage to U.S. household balance sheets. Total household net worth—the difference between household assets and liabilities—declined from $68 trillion to $52 trillion from the third quarter of 2007 to the first quarter of 2009. The value of residential housing stock dropped more than $6 trillion from 2006 to 2009. And the household share of equities dropped more than $5 trillion from 2006 to 2008.

But since 2009, a clear repair of household balance sheets has been under way. Though the labor market has been tepid and unemployment, particularly long-term unemployment, remains stubbornly high, households have reduced their debt burdens and have increased asset values. Low interest rates have played an important role as households with sufficient equity in their homes rushed to refinance at lower rates, sometimes also with shorter borrowing periods. Since 2008, the average rate for a 30-year conforming mortgage has dropped from 6.5% to a low of 3.5% in November 2012. It now stands at 4.5% in September 2013.
Chart 2 illustrates the strong rebound in household balance sheets. At the end of the second quarter of 2013, household net worth was $74.8 trillion, slightly above the level in 2007 prior to the recession.\textsuperscript{11}

Both an increase in asset values and a decline in liabilities contributed to this rebound (see Charts 3 and 4). Household debt declined modestly but steadily from 2008 through 2011 and was almost flat in 2012. Total financial assets increased from $46.6 trillion in 2008 to $61.9 trillion in the second quarter of 2013.\textsuperscript{12} Corporate equities and mutual fund shares increased in value from $9.2 trillion in 2008 to $17.3 trillion in the most recent quarter.\textsuperscript{13}

### Remaining Challenges for Many Households

An important caveat to this analysis is that the data presented represent the aggregate trends in personal savings and household assets and liabilities. At the individual level, the story can vary considerably. Deflation of the housing bubble in the United States was particularly damaging for young families (defined as those with heads of household younger than age 40). Research on young families published by the Federal Reserve Bank of St. Louis, using data from the Survey of Consumer Finances, concludes that the average level of wealth for these households declined by roughly 44%, or $68,070, between 2010 and 2007—far greater than the impact on older households.\textsuperscript{14} The St. Louis Federal Reserve Board economists who conducted the analysis find that this disparate impact is the result of the downturn in the housing market, as young households had higher concentrations of their wealth in residential real estate.

The impact of the Great Recession and the current recovery on household wealth also vary considerably by region. Home values, often the largest household asset, plummeted in certain states and regions but dropped only modestly in others. Similarly, the rebound in home prices has been unequal. As a result, many homeowners in states such as Arizona, Florida, Georgia, Michigan, and Nevada still have negative equity in their homes, thereby making it difficult to refinance, sell, or relocate.

According to data from Freddie Mac, national home prices were still 16% lower on average in June 2013 than in June 2006.\textsuperscript{15} And recently published data from the Census Bureau indicate that, excluding home equity values, median household net worth has been rebounding since 2009 but on net has not yet fully recovered.\textsuperscript{16}
Need for Political Resilience to Face Our Fiscal Challenges

The fiscal challenges our economy faces in the coming decades cannot be resolved only by increased levels of thrift and financial buffering among the public. While many American households responded to the recent downturn in the economy by building reserves and increasing personal savings in an effort to ride out the recession, resolving our fiscal challenges is not solely the direct responsibility of citizens. It requires political action, which in itself requires a particular sort of resilience.

As seen in Chart 5, our country has experienced large fiscal deficits in recent years as a result of increased federal spending and temporarily depressed tax revenues due to the weak economy. But the deficit challenges in the coming decade are of a distinctly different sort.

Federal entitlement spending on both health care (primarily Medicare and Medicaid) and retirement security (Social Security) is on unsustainable fiscal footing. These programs are fully functional at present, but they are projected to grow beyond their means.

The Social Security and Medicare trustees recently issued their annual reports outlining the size of these programs and their projected growth. The forecast is bleak. The causes of the problems are a mix of both demographic changes and excess cost growth. Particularly in light of the recent heated debates in Washington over spending and taxes, solutions to these problems will demand political resilience as well as political compromise.

Entitlement Crisis Part 1: Medicare

With the continued retirement of the baby boomers, which began in 2011, Medicare enrollment is expected to increase drastically in the next two decades—from 50.7 million beneficiaries in 2012 to an estimated 86.5 million in 2035. This nearly 60% increase in enrollment combined with per capita health care costs rising faster than the overall economy will drive an enormous increase in spending. According to the Medicare trustees’ report:

"Total Medicare expenditures were $574 billion in 2012. ... Under current law, expenditures will increase in future years at a somewhat faster pace than either aggregate workers; earnings or the economy overall and that, as a percentage of GDP, they will increase from 3.6% in 2012 to 6.5% in 2087."

Source: Congressional Budget Office (CBO) 2013 Long-Term Budget Outlook.

Notes: The extended baseline generally adheres closely to current law, following CBO’s baseline budget projections through 2023 and then extending the baseline concept for the rest of the long-term projection period. The projections shown here do not reflect the economic effects of the policies underlying the extended baseline.
Furthermore, the report projects that if Congress continues to override scheduled cuts in physician reimbursement for Medicare services and postpones or repeals other large scheduled cuts in health care reimbursement, "then Medicare spending would instead represent roughly 9.8% of GDP in 2087. Growth of this magnitude, if realized, would substantially increase the strain on the nation’s workers, the economy, Medicare beneficiaries, and the Federal budget." Arguably that's an understatement.

Chart 6 illustrates the trustees’ projected growth in Medicare and the projected growth in noninterest income available to fund the program. The graph illustrates three concerning trends. First, the size of this program is expected to nearly double as a share of the overall economy. Second, general revenue transfers are projected to increase dramatically. Third, despite the fact that Medicare funding will increase by roughly 2.5 percentage points of GDP, it still will not be enough to keep pace with the growth of expenditures.

Taking together all the projected income and costs in the Medicare program over the next 75 years and discounting future receipts and outlays, the present value of the actuarial balance of Medicare is −$4.8 trillion. While these numbers, like any prediction over a 75-year period, are somewhat uncertain, there is no plausible scenario whereby one can conclude that the status quo represents a sustainable path.

Entitlement Crisis Part 2: Social Security

The Social Security situation is similarly dire. The gap between the cost of Social Security and the noninterest income to the program is projected to be 0.9% of GDP over the next 75 years, rising to and remaining at 1.4% of GDP in the long run. According to the Social Security trustees:

For the combined OASI [Old-Age and Survivors Insurance] and DI [Disability Insurance] Trust Funds to remain solvent throughout the 75-year projection period: (1) revenues would have to increase by an amount equivalent to an immediate and permanent payroll tax rate increase of 2.66 percentage points (from its current level of 12.40% to 15.06%); (2) scheduled benefits during the period would have to be
reduced by an amount equivalent to an immediate and permanent reduction of 16.5% applied to all current and future beneficiaries, or 19.8% if the reductions were applied only to those who become initially eligible for benefits in 2013 or later; or (3) some combination of these approaches would have to be adopted.\textsuperscript{21}

Chart 7 shows the widening gap between the Social Security benefits that are scheduled to be paid in the coming years (costs) and the projected Social Security revenue from the payroll tax (noninterest income). Until recently, revenues exceeded costs, but that has now reversed. Costs are projected to increase from 4.4% of GDP in 2008 to 6.2% of GDP in 2035. Payroll tax revenues will increase slightly from 4.6% to 4.9% of GDP by 2022 but then return to 4.6% in the long run.

The Congressional Budget Office (CBO) is even less optimistic about Social Security. In the agency’s latest Long-Term Budget Outlook, the forecast for Social Security has changed for the worse. As noted by my colleague Andrew Biggs, former principal deputy commissioner of the Social Security Administration, the new 75-year deficit projection is nearly twice last year’s—3.9% of taxable payroll compared with last year’s projection of 1.9%.\textsuperscript{22}

**Proposals for Reform**

A variety of policymakers and researchers have offered proposals to address the pending entitlement challenges. In testimony before the Senate Finance Committee, I offered three incremental policy changes to the Social Security program that would resolve a significant portion of its long-term funding challenges.\textsuperscript{23} While these reforms would not ameliorate the funding gap, they are, I believe, sensible first steps:

1. Increase both the normal and early retirement ages.
2. Pursue one or more benefit formula modifications to slow the growth of benefits while maintaining progressivity.
3. Use a chain-weighted consumer price index, which more accurately reflects true cost of living, to calculate the annual Social Security cost-of-living adjustment.

In addition, these changes would have broader benefits to the economy generally as they could reasonably be expected to boost personal savings and increase work. For example, increasing the early retirement age from 62 to 65 would encourage labor market participation. The result could be an increase in GDP of up to 5%\textsuperscript{24}

Reforms to Medicare to slow the growth of spending and create a fiscally sustainable program are generally more complex. Medicare’s financing challenges are not merely the product of increased life expectancies and an increase in the number of retirees. Rising per capita health care costs contribute significantly to the projected growth of this program. Health care inflation, new but costly health care innovations, and increases in chronic diseases are all contributing factors.

Some simple options do exist. For example, CBO estimated that increasing the eligibility age for Medicare to 67 to match the Social Security retirement age would yield federal savings of $148 billion from 2012 through 2021.\textsuperscript{25} Increasing the co-insurance and combining the Part A and Part B deductibles in Medicare would also reduce federal Medicare spending. More fundamental reform options exist as well, such as the premium support model in Medicare, which would transform Medicare Part A and Part B in a manner consistent with the market-oriented structure of Medicare Part D (Medicare’s prescription drug program). A recent CBO report analyzed several of the proposed options for premium support. If premium support were implemented in 2018, CBO estimates a net reduction in 2020 federal Medicare spending of as much as $45 billion.\textsuperscript{26}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{chart7.png}
\caption{Chart 7. OASDI Cost and Noninterest Income (\% of GDP)}
\end{figure}

\textsuperscript{Source: 2013 Social Security Trustees Report, Figure II.D4.}
Conclusion: Time for a Resilient Political Agenda

The two largest entitlement programs operated by the federal government are on unsustainable paths. Medicare is projected to grow faster than the overall economy over the next 75 years, which necessitates ever-increasing taxes. Soon, Social Security will only have enough resources to pay 77% of its promises.

These challenges, however, are not new. Lawmakers have known for decades that these programs are not sustainable as currently structured, yet they have continually shirked their responsibilities to enact necessary programmatic changes. From time to time, bold proposals have been made, but we have yet to see an attempt at reform gain traction.

A number of factors are obvious impediments to political action. Many lawmakers worry that the consequence of political courage—voting to restrain the growth of entitlements—will be harsh attacks by rivals in the next election cycle. Other lawmakers worry that such reforms will lead to inadequate health care for seniors or increases in poverty and financial risk. But the fear that future seniors will be uncared for should these programs be made sustainable, in whole or in part, through reductions in future benefits is misplaced. Why? The resilience of the American worker, family, and household. A carefully planned and communicated change to Social Security and Medicare that slows the growth of benefits will undoubtedly be met with an increase in personal savings. Critical to the success of such a reform is gradual change, and that requires an immediate start to the reform effort.

Our leaders can draw inspiration from the resilience of the American people and channel it into political resilience to do what is necessary—and most effective—to reform entitlement programs. In addition to inspiration, the public’s resilience can also assure policymakers that citizens can withstand necessary financial sacrifices. This can bolster leaders’ resolve to finally take action to return our country to fiscal health—before resilient citizens become beleaguered citizens.
Endnotes

1. This paper is adapted from an article originally published in Business Horizons Quarterly Issue 8 (2013).


3 Bureau of Economic Analysis, Table 1.1.1. Percent Change from Preceding Period in Real Gross Domestic Product, retrieved June 17, 2013.


8 Federal Reserve Board, Flow of Funds, Data Download Program, accessed June 18, 2013.


10 Ibid.


13 Ibid., “L.100 Households and Nonprofit Organizations,” p. 66.


19 Ibid., p. 8.

20 Ibid., p. 72.


22 Ibid., p. 4–5.


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