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ObamaCare's Crippling Deficits

The higher taxes, debt payments and interest rates needed to pay for health reform mean lower living standards.

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While the deficits caused by the fiscal stimulus package will end in 2011 and will help to sustain a fragile recovery in 2010, the deficits projected for the longer term are a threat to our economic future. The starting point for controlling those future deficits is for Congress to abandon the administration's health-care plan—a plan that will cost more than $1 trillion.

The deficits projected for the next decade and beyond are unprecedented. According to an assessment released in March by the Congressional Budget Office (CBO), the president's budget implies that deficits will average 5.2% of GDP over the next decade and will be 5.5% of GDP in 2019. Without the president's proposals, the budget office forecasts a 2019 deficit of only 2% of GDP.

The CBO's deficit projections are based on the optimistic assumptions that the economy will grow at a healthy 3% pace with no recessions during the next decade; that there will be no new spending programs after this year's budget; and that the rising national debt will increase the rate of interest on government bonds by less than 1%. More realistic assumptions would imply a 2019 deficit of more than 8% of GDP and a government debt of more than 100% of GDP.

Such enormous deficits would crowd out productivity-enhancing investments in new equipment and software as the government borrows funds otherwise available to private investors. The result would be slower economic growth and a lower standard of living.

In the nearer term, the projected deficits could cause interest rates on bonds and mortgages to rise sharply if bond investors fear that the government will not prevent inflation. This is a greater risk now that more than half of the U.S. government debt is held by the Chinese and other foreign investors. Such an interest rate rise could kill a recovery in 2010 or 2011 and depress growth in the years that follow.

Dropping the Obama health plan would significantly reduce fiscal deficits over the next decade and help restore public confidence in the ability of Congress to control spending. The CBO estimates that the House committee versions of the Obama health plan would add more than $1 trillion to federal deficits over the next decade. But the actual costs would be much higher.

For starters, $1 trillion of extra debt-financed spending would cause the government to pay about $300 billion of extra interest in the next decade. Moreover, the CBO's method of estimating the cost of such a program doesn't recognize the incentives it creates for households and firms to change their behavior.

The House health-care bill gives a large subsidy to millions of families with incomes up to three times the poverty level (i.e., up to $66,000 now for a family of four) if they buy their insurance through one of the newly created "insurance exchanges," but not if they get their insurance from their employer. The CBO's cost estimate understates the number who would receive the subsidy because it ignores the incentive for many firms to drop employer-provided coverage. It also ignores the strong incentive that individuals would have to reduce reportable cash incomes to qualify for higher subsidy rates. The total cost of ObamaCare over the next decade likely would be closer to $2 trillion than to $1 trillion.

The administration's claim that the health-care plan would be "self-financing" is both false and irrelevant. It is false because it would only be self-financing if one counts a variety of President Obama's proposed tax increases—and even those would produce much less revenue than is assumed in the budget calculations. The claim is irrelevant because those tax increases have nothing to do with health care and could be used instead to reduce other projected deficits.

For example, the administration and the congressional designers of ObamaCare say they would finance a substantial part of health reform with the revenue from new taxes on corporate foreign profits and on high-income individuals. The likely revenue from these tax changes would be much less than the official estimates because of the induced changes in taxpayer behavior that the estimators ignore.

Previous experience with changes in the marginal tax rates of high-income individuals implies that the current proposal to raise the marginal tax rate to about 50% from today's 40% would produce only about half of the official revenue estimates. No one knows how much of the estimated extra tax revenue on foreign profits would be lost as the resulting fall in international competitiveness reduces profits, and as businesses sell their overseas subsidiaries or shift their profits in other ways.

While abandoning health reform would be an important step, it would not be enough to limit the exploding level of future deficits and debt. That requires substantial reductions in existing spending programs, if large tax increases are to be avoided. Since Medicare is the largest contributor to the explosive growth in government spending, a good way to start shrinking government outlays would be by restructuring Medicare to shift more of its costs to supplementary private insurance, perhaps on an income-related basis.

Given the perceived need for significant additional tax revenue to shrink future fiscal deficits, there is now talk in Washington of introducing a value-added tax (VAT), the kind of national sales tax that European governments use to finance their welfare states. That would be a triply bad idea. Although it is a tax on spending, a VAT effectively raises marginal tax rates. Like the income tax, it reduces the reward for work and entrepreneurship by adding a tax to the prices of all goods and services. A VAT would also be grossly unfair to those whose lifetime savings would now be subject to a new tax when they start to spend those savings.

A VAT would open the door to an explosion of new spending programs. That's because, no matter how low the initial rate, the tax rate would be drawn inevitably to European rates of more than 15%—on top of existing income and payroll taxes.

The key to raising revenue without raising marginal tax rates or creating a new tax is to reduce or eliminate some of the "tax expenditures" that now lower tax revenue by special deductions and exclusions. Ending the current exclusion from taxable income of employer payments for health insurance would increase income tax revenue by more than $1 trillion over the next five years and nearly $3 trillion over the next decade. Eliminating this subsidy would also lead to a restructuring of private health insurance that would give patients the incentive to seek more cost-effective care and thereby bring down the overall cost of health care.

Restructuring Medicare and reforming tax rules would be politically difficult. But a failure by Congress to address the exploding path of fiscal deficits would be morally irresponsible.

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