Fiscal Therapy: Curing America’s Debt Addiction and Investing in the Future

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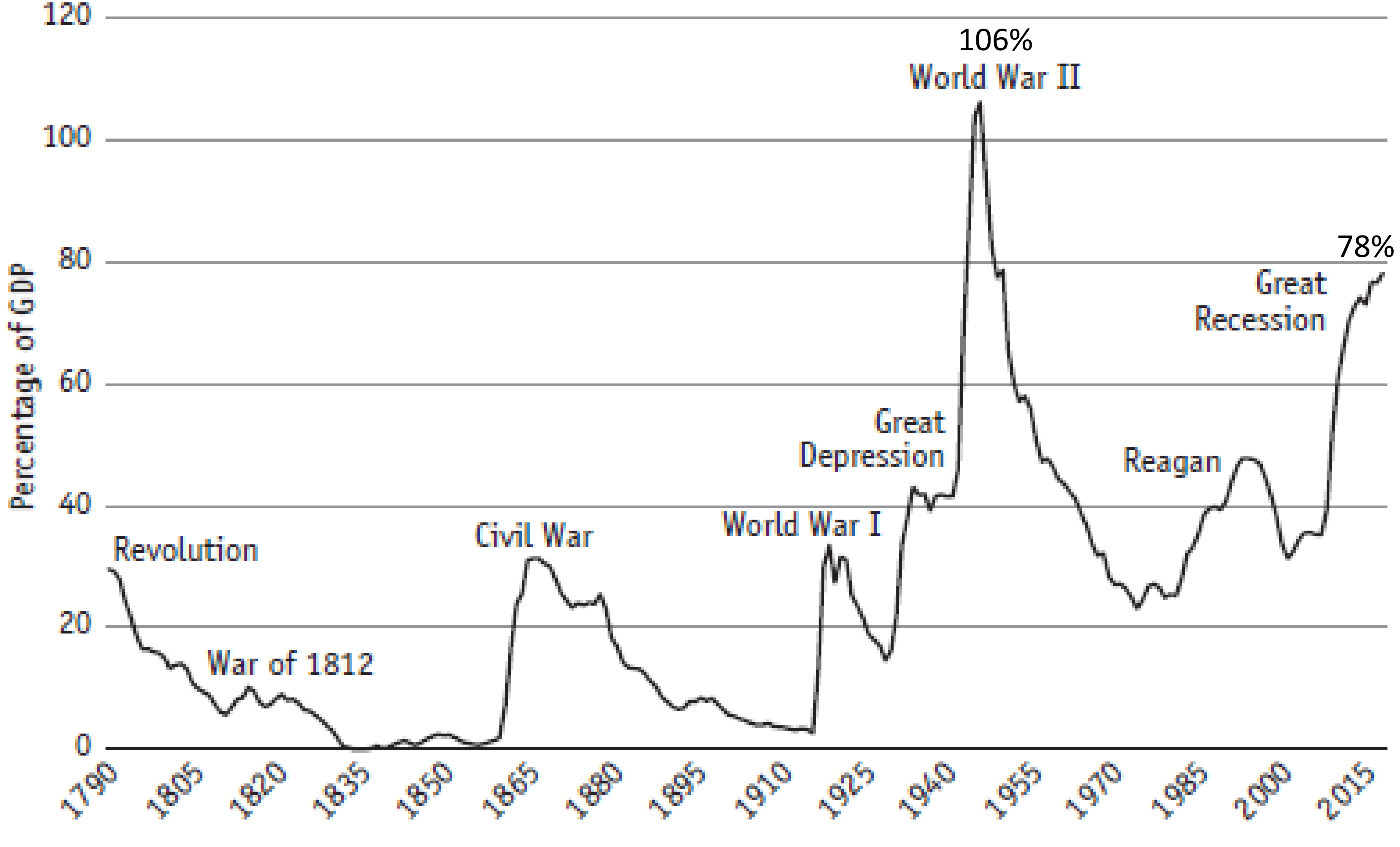
The Bottom Line

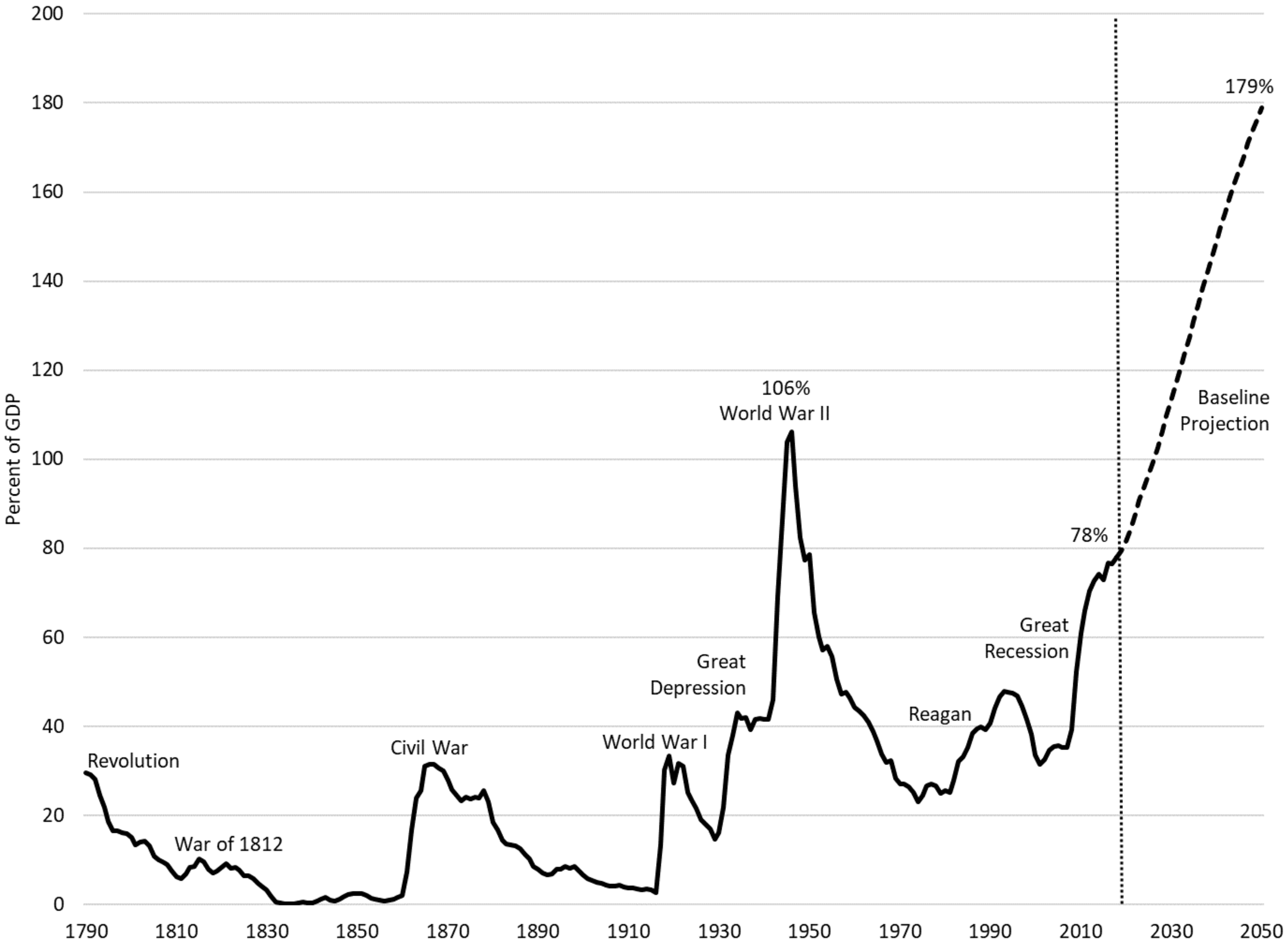
- Two intertwined problems
  - Rising public debt
  - The way we tax and spend.

- Three-part solution
  - Control entitlements (preserve anti-poverty and social insurance features)
  - Boost children’s programs, human capital, infrastructure, and research
  - Raise and reform taxes

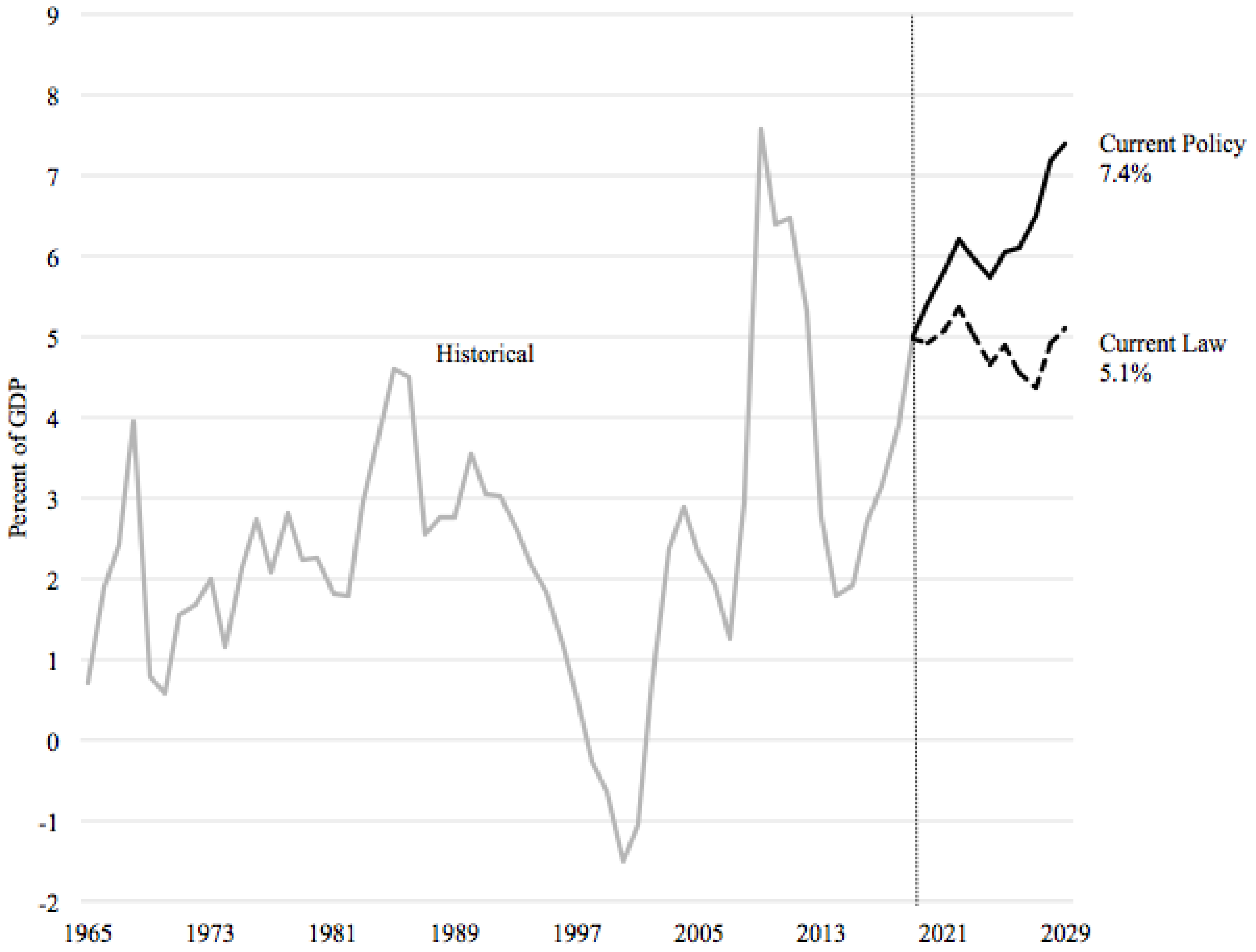
Debt/GDP, 1790-2018



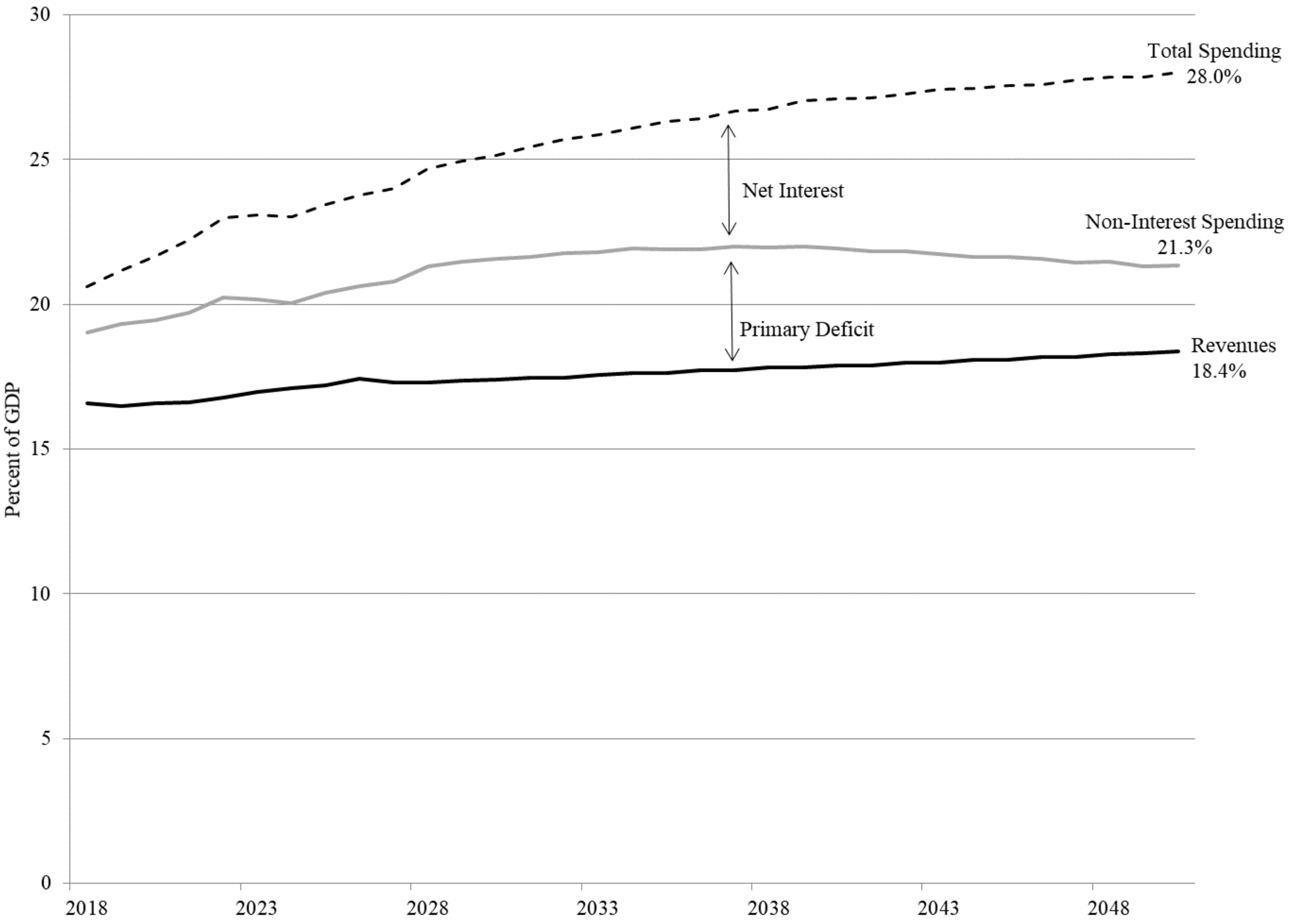
This Time is Different



Full-Employment Deficit, 1965-2029

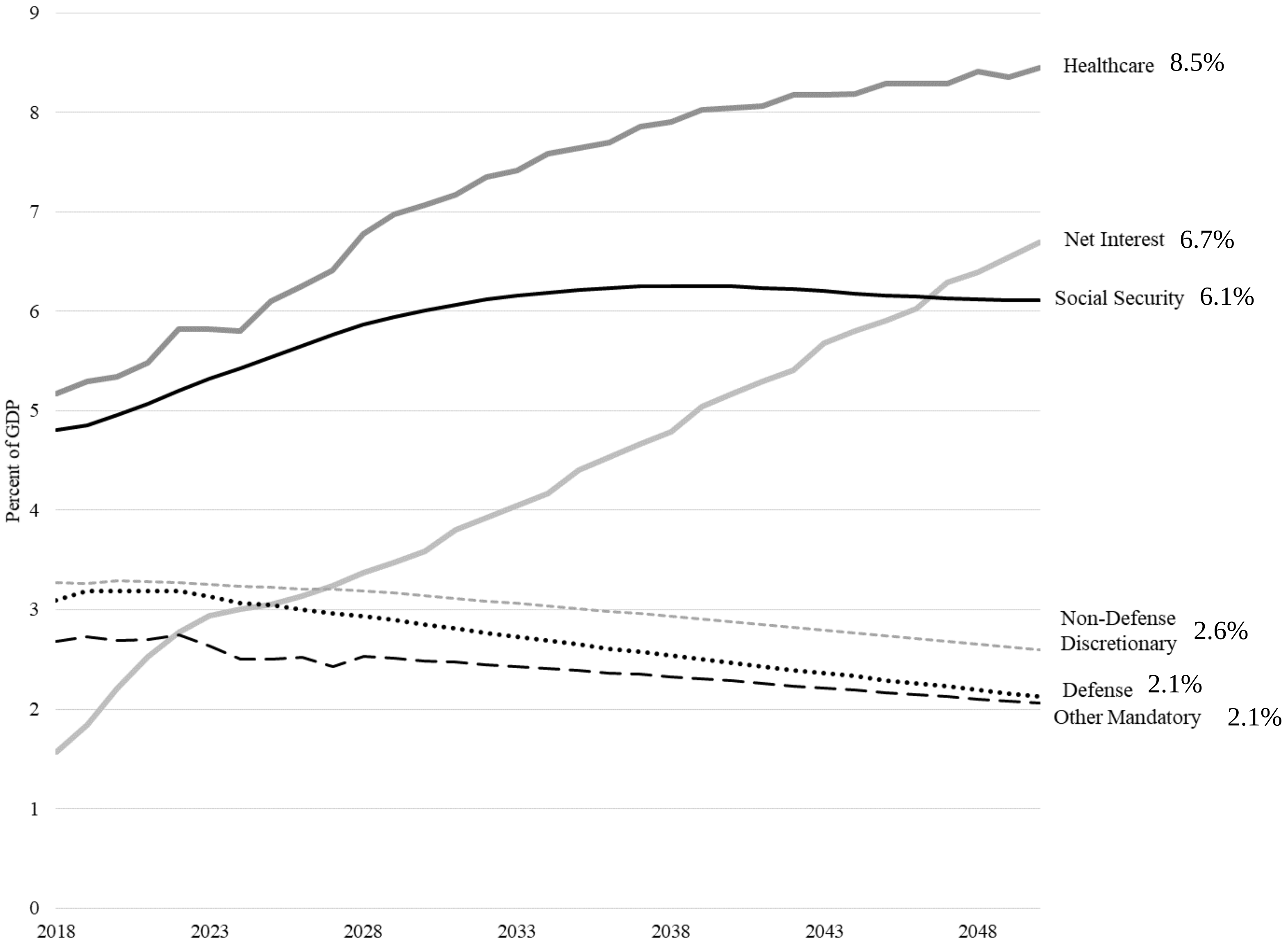


What's Causing the Debt Increase? A Fiscal Policy Rorschach Test



Source: Gale (2019)

The Changing Composition of Spending



Effects of Debt on the Economy

- Not all debt is bad
  - Financing investment
  - Fighting recession

- But that’s not what’s happening
  - Instead, sustained deficits used to finance consumption

- Hemingway (The Sun Also Rises)
  - Character 1: “How did you go bankrupt?”
  - Character 2: “Two ways. Gradually, then suddenly”

The Sudden Scenario

- Some trigger leads to interest rate spike, capital outflow (e.g., Greece)

- Not likely for the US
  - We borrow in our own currency, the world's reserve currency.
  - We can pay our debts for decades.
  - 2008 example

- <u>Policymakers</u> could create a politically-induced crisis

- But even with no crisis, there is still a problem; it's just a gradual one

The Gradual Scenario: Deficits Reduce Future National Income

- Higher deficits reduce national saving
  - Schultze "termites in the wood work, not the wolf at the door"
  - → Higher r. Lower investment and lower future GDP and GNP, or
  - → More capital inflows. R, investment and future GDP constant, but future GNP falls b/c we have to pay back foreigners.

- A lot of evidence: growth, investment, interest rates, exchange rates, capital inflows

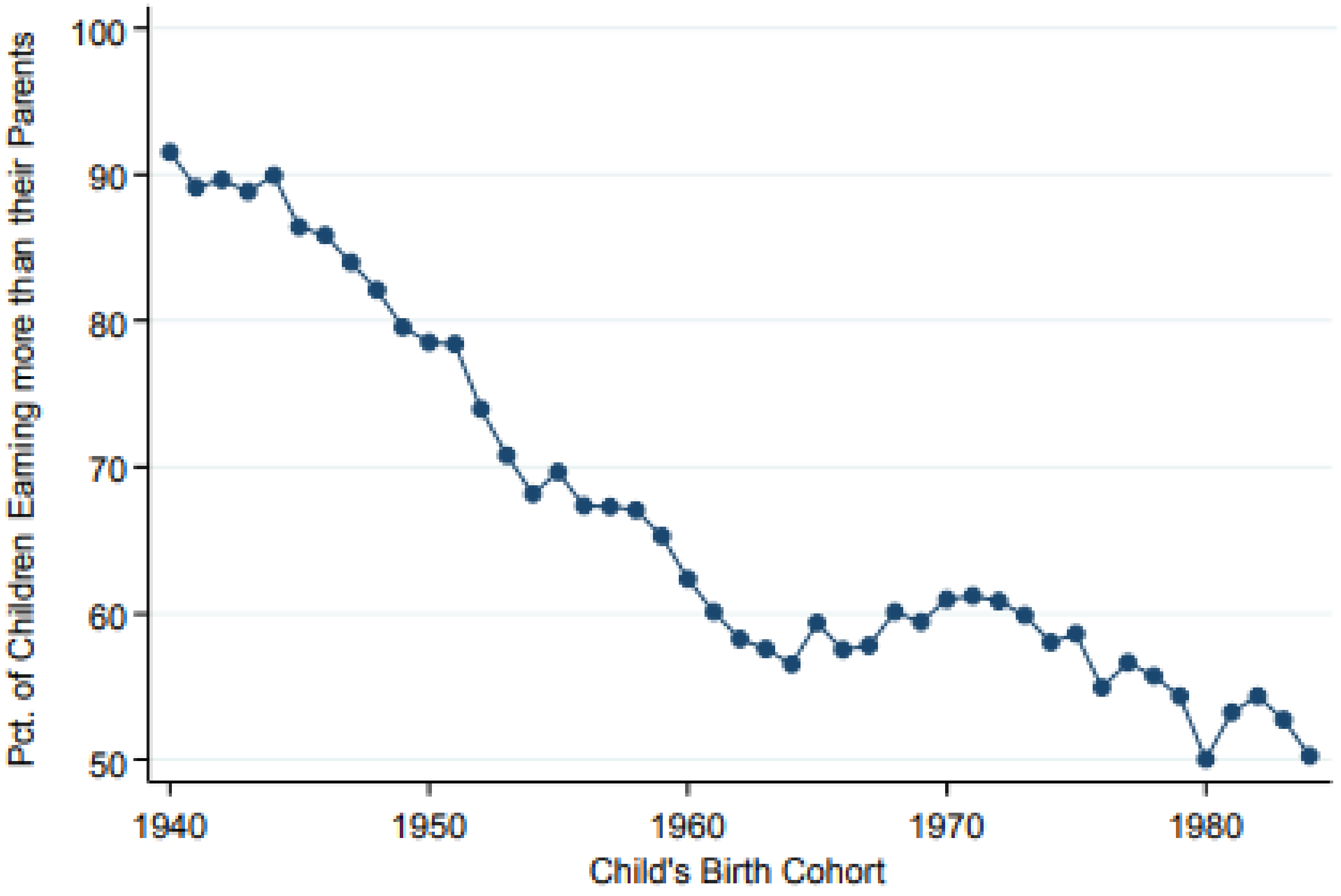
A Debt Target

- 60% of GDP by 2050
  - Average over the business cycle
  - Not zero debt / not a balanced budget rule

- Higher than historical average (36% between 1957-2007)
  - Interest rates likely to be lower than in the past
  - More investment => higher sustainable debt
  - Baseline debt level is so high

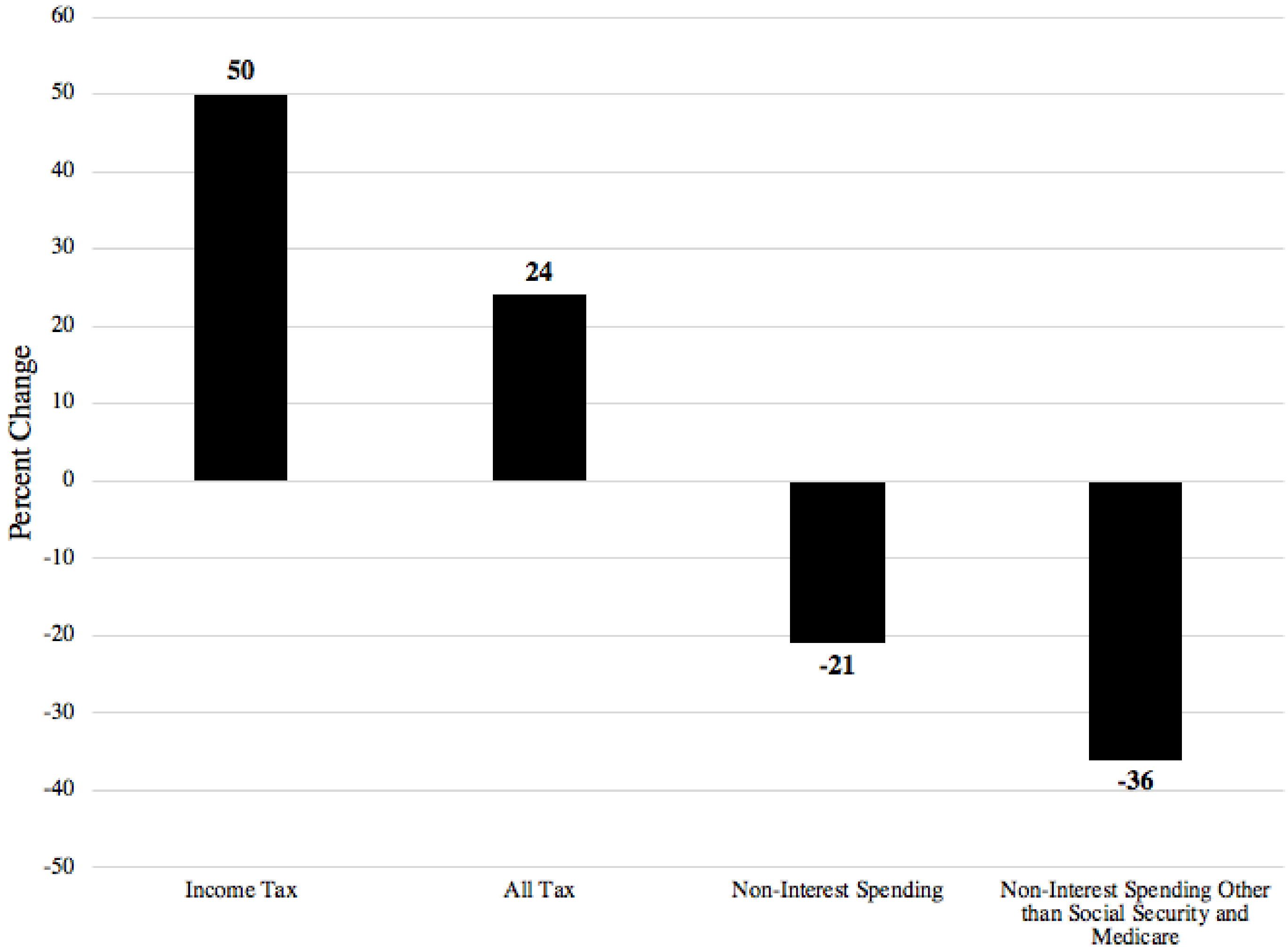
- But not higher because it is not clear how much better off future generations will be

Will Future Generations be Better Off than We Are?



Source: Chetty, et al. (2016)

Fiscal Gap = 4.0% of GDP
(To reach Debt/GDP = 60% by 2050, starting in 2021)



False Solutions

- “Foreign aid”
- Inflation
- Growth – could help, but not enough
- Tax Cuts

Healthcare and Social Security

- Healthcare
    - Expand coverage – reinstate the mandate (or equivalent), provide public option, expand Medicaid
    - Control costs – premium support in Medicare, provider payment reform, let Medicare negotiate drug prices and formulary

- Social Security (BPC Plan)
    - Raise retirement age and index benefits with chained CPI
    - Make annual benefits more progressive
    - Raise payroll tax rates and the payroll tax cap

Invest in the Future

- Extra 1% of GDP to strengthen social policy
  - Invest in children, child care, and education
  - Patch current holes and raise take-up rates
  - Provide job training and (if required for eligibility) jobs
  - Make work pay better

- Infrastructure/R&D
  - Invest an added 0.5% of GDP in infrastructure (to meet ASCE goals)
  - Double federal R&D relative to today’s share of GDP

Tax Proposals

- Carbon tax – $30 per ton rising at 5% above inflation (McKibbin, et. al), with offsets
- Value-added tax – 10% rate, with offsets
- Business taxes
  - Repeal TCJA pass-through provisions (or let them expire)
  - Raise corporate tax to a 25%, convert to “cash flow” tax
  - Revisit international rules
- Personal taxes
  - Close capital gains loopholes, raise capital gains rates
  - Repeal TCJA rate cuts and bracket changes (or let them expire)
  - Replace MID with a first-time homebuyers’ tax credit
  - Estate tax reform/inheritance tax
- Increase IRS funding and enforcement

Tax Effects

- Revenue

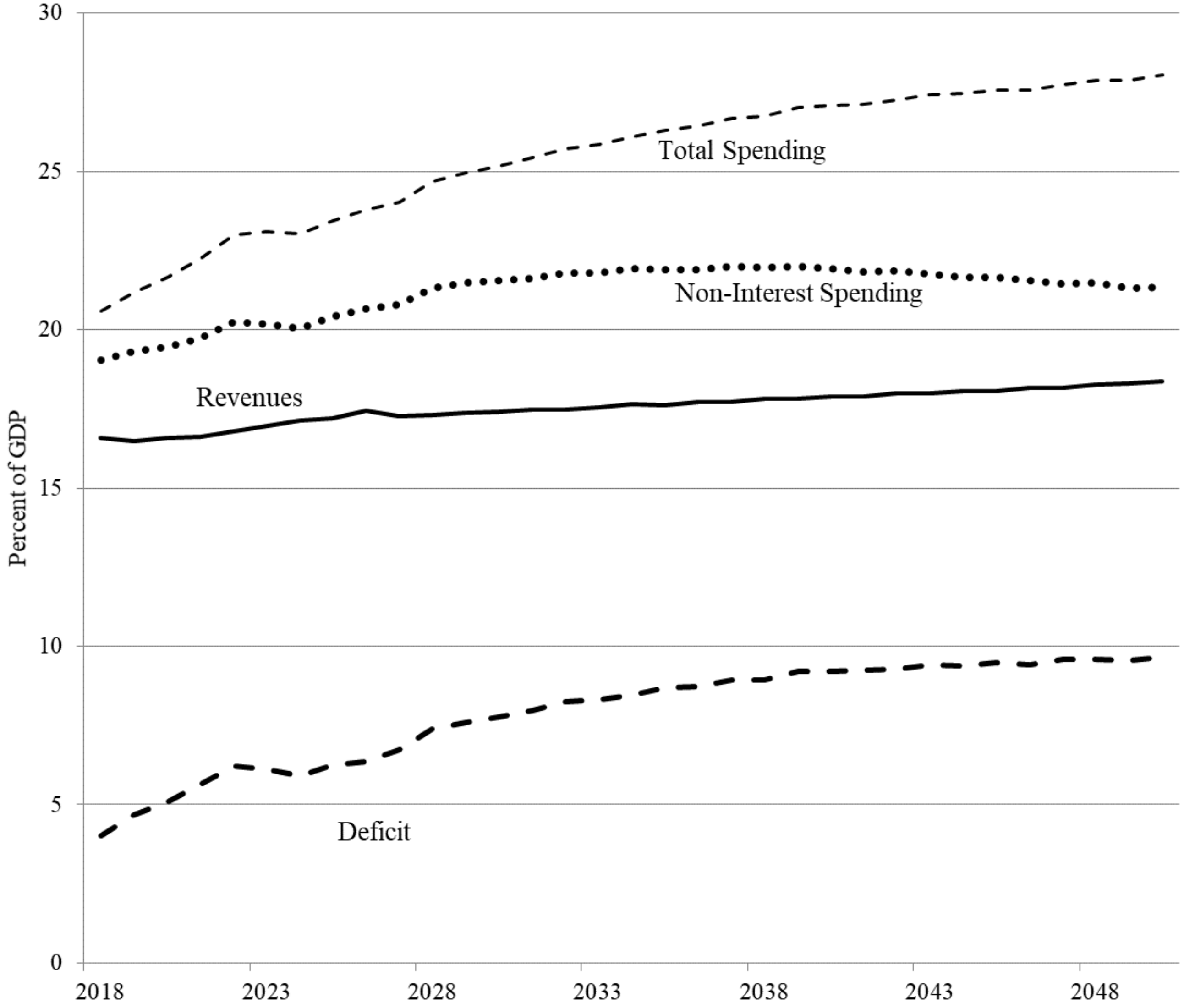
- Efficiency and growth
  - Even more important as revenue levels rise
  - Carbon tax corrects a major externality
  - VAT does not tax saving or investment (but does hit labor supply)
  - Corporate tax move to cash flow → ETR is zero on equity-financed investments
    - → Raising the corporate rate is tax on windfall gains, rents
  - Income tax – close loopholes

Distributional effects

- Within generations/Raise taxes on high-income, high-wealth households
  - Only way to get them to share the fiscal burden
  - ATR has been constant relative to 40 years ago, despite rapidly rising income
  - Most likely to benefit most from new economic growth
  - Reduces the change that fiscal reform will raise inequality
  - Reduces the role of luck in the system
  - By reducing rent-seeking, could actively help other groups
  - Need not constrain growth

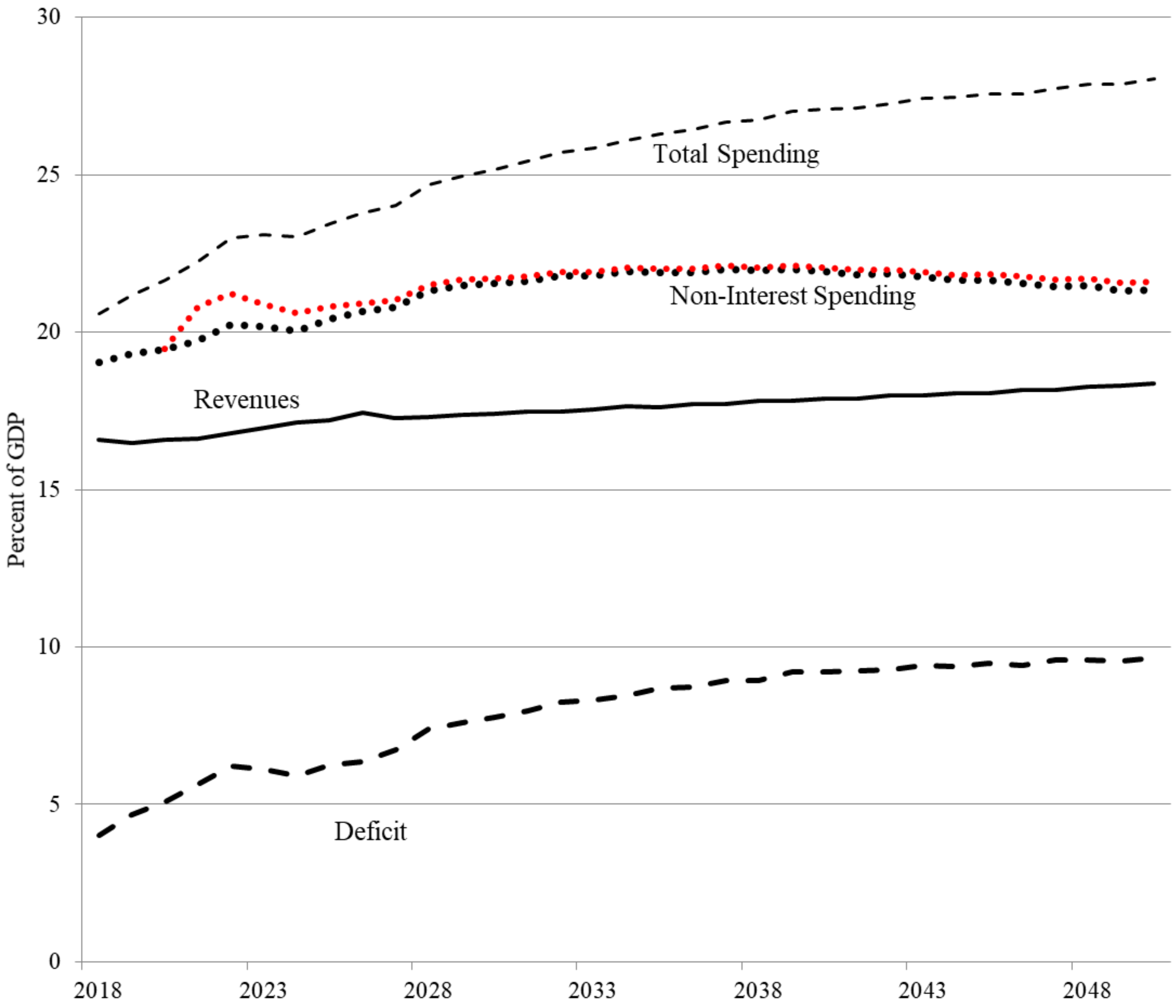
- Across generations
  - Reduce burden on future generations

Fiscal Outcomes under the Baseline



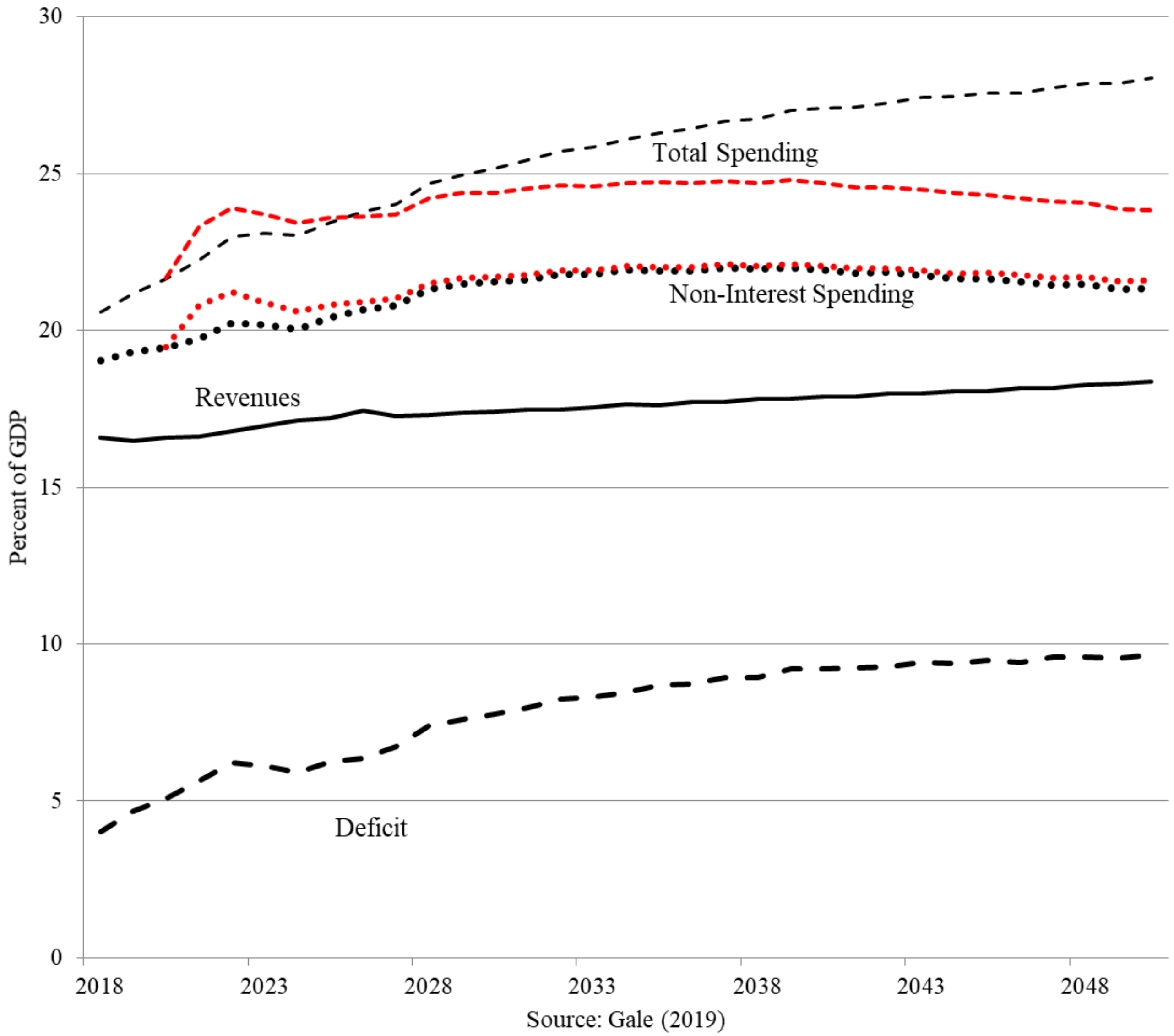
Source: Gale (2019)

Fiscal Outcomes under the Proposal

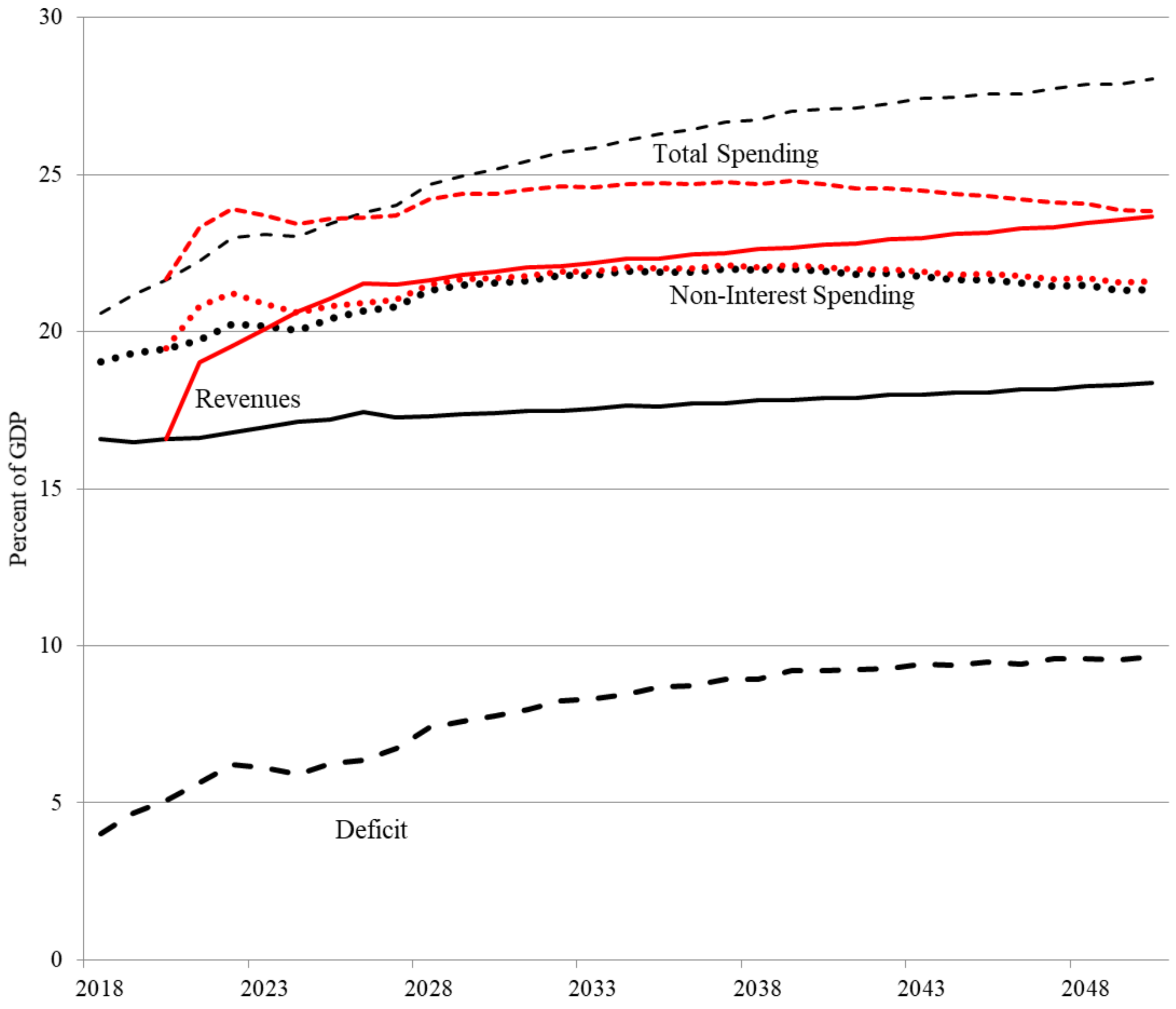


Source: Gale (2019)

Fiscal Outcomes under the Proposal



Fiscal Outcomes under the Proposal



Source: Gale (2019)

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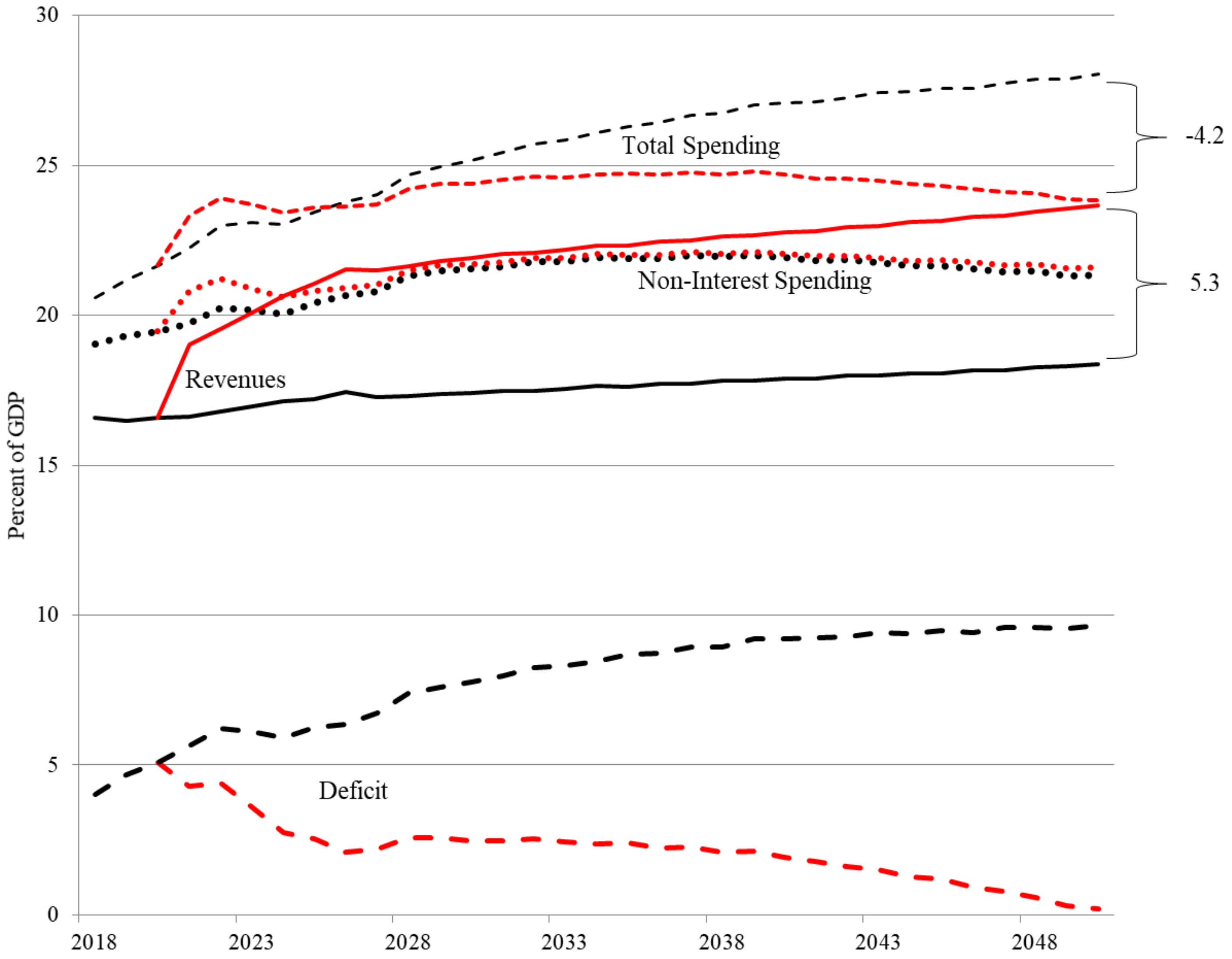
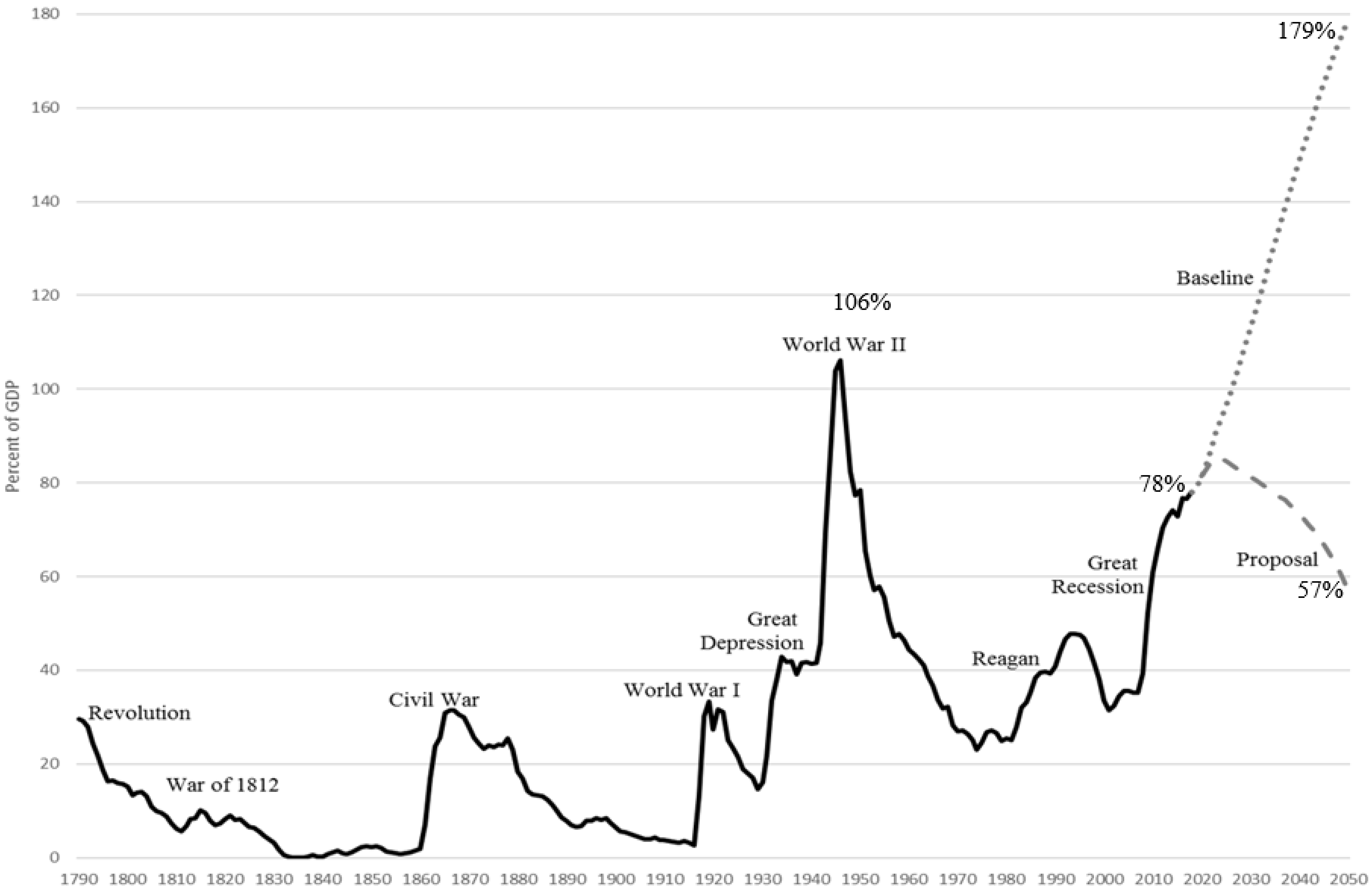


Source: Gale (2019)

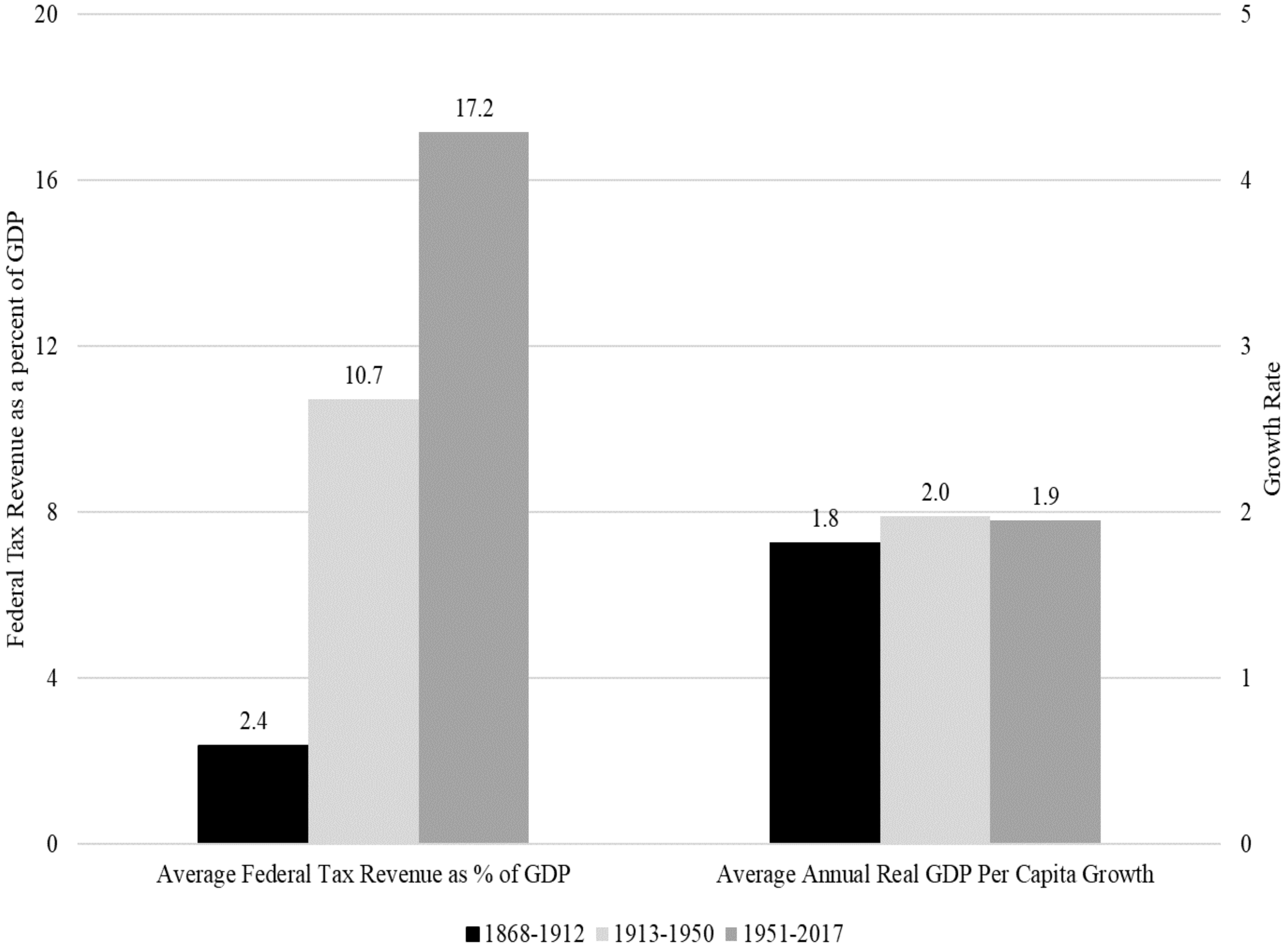
Debt/GDP under the Proposal



Effects

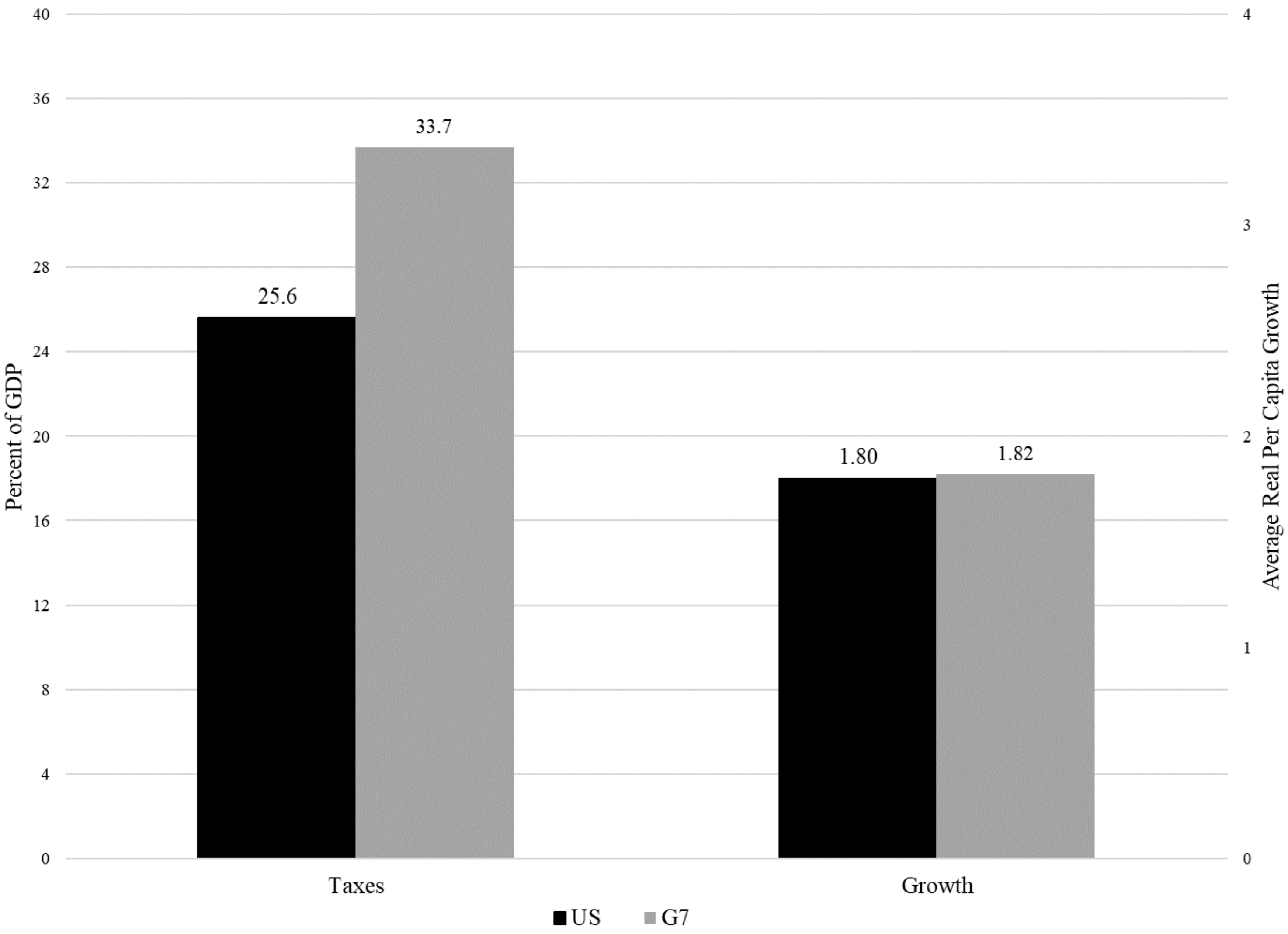
- Raise Growth
  - Reduced debt
  - Corporate tax changes
  - Increased infrastructure and R&D
  - Increased investment in children, safety net, jobs/education
- Reduce inequality and increase mobility
  - Progressive tax changes
  - Increased investment in children, safety net, jobs/education
- Honest/transparent plan
  - Specified changes
  - Realistic and administrable reforms
  - No growth effects included in budget estimates

Figure 3. Taxes and Growth by Time Period



Source: Gale (2019); Slemrod and Bakija (2017)

Tax and Growth, Across Countries
US vs G7, 1970-2015



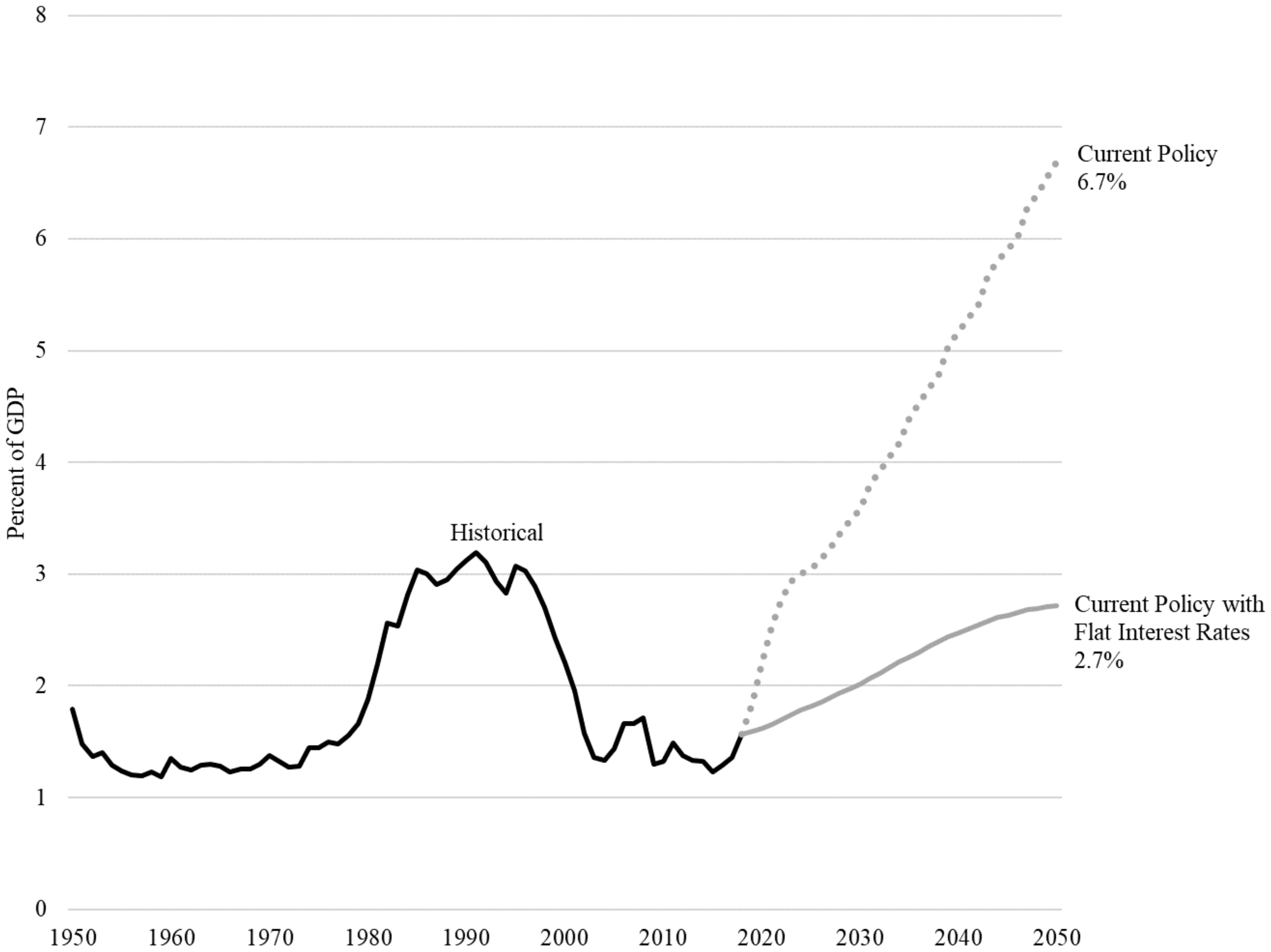
Changes in Top Tax Rates and Growth, 1960-1964 to 2006-2010

Liberal Critiques

- Fiscal outlook is not a problem because:
  - We print our own currency
  - We owe it to ourselves
  - Interest rates are low

- Fiscal outlook is a problem but other problems/constraints are more important right now
  - ZLB / Economy is more important than the budget
  - But if not now, when?

Interest payments, 1950-2050



Fiscal Outlook with r flat for 30 years

- Debt/GDP in 2050 = 132% (compared to 180% under current policy and projected interest rates)

- Net interest/GDP in 2050 = 2.7% (6.7%)

- Fiscal gap, start 2021, end 2050, 60% target = 3.0% (4.0%)

- Fiscal gap, start 2021, end 2050, 100% of GDP target 1.2% (2.6%)

Politics

- Debt reduction is a classic “Olson” problem
  - Concentrated costs, diffuse benefits
  - Schultze: Hippocratic Oath for politicians
- Structure of government makes large changes difficult
- Public opinion is conflicted
- No New Taxes pledge complicates any discussion
- Partisanship, polarization, tribalism … no trust
- No crisis
- No leadership

Cause for Hope?

- Fiscal sustainability is consistent with both conservative and liberal goals
- There is much to be gained from fiscal reform
- Two alternative paths:
  - “Get rid of the deductions that don’t affect me.”
  - “You can always count on Americans to do the right thing … after they have exhausted all of the other options.”