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

[Graph showing economic data with labeled events: Revolution, War of 1812, Civil War, World War I, Great Depression, World War II, Great Recession, Reagan, Baseline Projection, and significant percentage increases in GDP.]
Full-Employment Deficit, 1965-2029
What’s Causing the Debt Increase? A Fiscal Policy Rorschach Test

Source: Gale (2019)
The Changing Composition of Spending

- Healthcare: 8.5%
- Net Interest: 6.7%
- Social Security: 6.1%
- Non-Defense Discretionary: 2.6%
- Defense: 2.1%
- Other Mandatory: 2.1%
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

• Policymakers 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”
  • \( \rightarrow \) Higher \( r \). Lower investment and lower future GDP and GNP, or
  • \( \rightarrow \) 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 $\rightarrow$ ETR is zero on equity-financed investments
    • $\rightarrow$ 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

[Graph showing fiscal outcomes including Total Spending, Non-Interest Spending, Revenues, and Deficit over time from 2018 to 2048. Source: Gale (2019)]
Fiscal Outcomes under the Proposal

![Graph showing fiscal outcomes under proposed policy changes, including trends for Total Spending, Non-Interest Spending, Revenues, and Deficit over the years 2018 to 2048. Source: Gale (2019).]
Fiscal Outcomes under the Proposal

[Graph showing trends in Total Spending, Non-Interest Spending, Revenues, and Deficit from 2018 to 2048.]

Source: Gale (2019)
Fiscal Outcomes under the Proposal

Source: Gale (2019)
Fiscal Outcomes under the Proposal

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); Siemrod and Bakija (2017)
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.”