BROOKINGS

Get the Fiscal House in Order

By William G. Gale
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The Cato Institute has organized an online forum to debate pro-growth economic policy reforms. Tax Policy Center co-director Bill Gale was asked to contribute to the discussion.

As policy makers search for ways to raise economic growth and improve the living standards of future generations, a major priority should be to get our long-term fiscal house in order.

Judging by the lack of political attention to deficits and debt in 2014, one might think that the fiscal problem has been solved. While it is true that long-term fiscal prospects have improved over the last few years – as a result of the spending cuts in 2011, the expiration of most of the 2011-12 tax cuts in 2013, and a reduction in projected health care cost growth – there is still a long way to go. The underlying fiscal imbalance may be forgotten, but it is far from gone.

Even ignoring projections for the future, the *current* debt-GDP ratio of 74 percent is far higher than at any time in U.S. history except for a brief period around World War II. The painful budget deals in 1990 and 1993 occurred when the debt-GDP ratio was 25 percent of GDP lower than it is now. The ratio averaged 37 percent in the 50 years before the Great Recession of 2008-9, and it was at 35 percent in 2007. There is little mystery why the debt-GDP ratio grew substantially since then – largely the recession and, to a smaller extent, countercyclical measures. And, although the stimulative measures have helped the economy, the higher debt load will burden the economy in the future.

Reasonable projections of the effects of continuing current policy indicate that the debt ratio will rise higher over time, to about 82 percent by 2024, about 100 percent by 2033 and 200 percent by 2059. Asking about the “cause” of this increase is tantamount to asking which side of the scissors does the cutting. At the risk of oversimplifying, conservatives blame rising entitlement spending, especially in Medicare, Medicaid, and Social Security, and see cutting spending as the solution. Liberals view the problem mostly as an imbalance between what the government has promised and what it has committed to collect in revenues and see the solution as reconciling those imbalances through a combination of spending cuts and tax increases.

The budget projections are marked by significant uncertainty, which is sometimes used as a reason not to do anything; after all, the debt might drop on its own accord. But uncertainty cuts both ways; we might also find debt significantly higher. After all, the budget projections assume there will be no recessions, no wars, and no new programs.

It is worth emphasizing that our fiscal situation is not a crisis. The government has the overall resources to pay its bills for the foreseeable future. We are not in danger of a Greek-style financial meltdown, unless policy makers are foolish enough to trigger a default by failing to raise the debt limit in a timely manner.

Nevertheless, the magnitudes are large. Getting the economy back to the long-term debt/GDP average of 36 percent by 2040, would require permanent spending cuts and/or tax increases that totaled 3.1 percent of GDP starting in 2014, a figure which rises to 3.9 percent of GDP if the changes are delayed until 2019.

Rising long-term debt reduces prospects for future economic growth. Long-term growth occurs through expansion of the quality and quantity of the labor force and the capital stock. But sustained increases in federal deficits and debt reduce net national saving – the combined saving of the private and public sector.

This could result in less investment or higher inflows of capital from abroad to help finance investment here. To the extent that investment declines, there will be less improvement in the quality and quantity of physical capital and possibly in human capital as well. Slower investment turns into slower growth of domestic output, which reduces the growth of household income over time.

To the extent that we stem the reduction in investment by borrowing more from the rest of the world, there will be increased future debt payments to foreigners. With a growing share of output that would be channeled to foreigners, the growth of U.S. household income would still be held back.

The theory behind these effects is well-thought-out. There is no economic model that suggests that sustained deficits and debt, where the spending is not all invested, would be anything but growth-retarding. But how big are the effects?

A number of studies suggest significant effects. Illustrative calculations by Greg Mankiw and Douglas Elmendorf suggest that a national debt of 50 percent of GDP reduces net output by more than 3 percent. A study by IMF researchers suggests that, for each additional 10 percentage points in the debt/GDP ratio, growth in subsequent years falls by 0.15 percentage points. The Congressional Budget Office has estimated that increasing deficits by $2 trillion over the next 10 years (that is, by just under 1 percent of GDP) would decrease GDP by 7.5 percent over 25 years. All of these estimates suggest substantial impacts on long-term economic growth of having the debt/GDP ratio rise from 35 percent in 2007 to 74 percent in 2014, and to 100 percent over the next 20 years.

Economic growth, however, is not the same thing as improving living standards for the vast bulk of the population. Although growth and living standards moved hand-in-hand for a very long time, over the past 30 years they have moved discordantly. Growth has continued, but the benefits of that growth have disproportionately gone to high-income groups while many middle- and low-income groups have seen few if any gains.

If fiscal reform can boost growth, but the benefit of that growth will accrue disproportionately to high-income households, then the burdens of fiscal retrenchment should be placed disproportionately on high-income households. One such example would be to means-test Social Security and Medicare, or otherwise adjust benefits downward for high lifetime income earners. But in practice, having the rich pay more means tax increases, since neither the major entitlements nor any other government spending program affect the very wealthy that much. The notion of tax increases will cause horror in some circles, but a wide variety of evidence suggests that taxes are only weakly related to economic growth.

Higher tax burdens have not adversely affected economic growth. In the United States' own history in the years before World War II to the years after the war, federal tax revenues rose on a permanent basis by more than 10 percent of GDP, with no observable impact on the annual rate of growth. Cross-country evidence tells a similar story. Over the past 40 years, revenues at all levels of government have averaged about 8 percent of GDP more in the OECD and the G7 than in the US. Yet, the U.S. had the identical growth rate of per capita income as the OECD and G7 over the same period.

Much public attention has been given to the role of the top income tax rate – faced by high-income earners – in determining growth. But there is little relation over time in the U.S. between the top marginal income tax rate and the rate of economic growth. Likewise, studies show substantial differences in how countries have changed the top marginal income tax rate over time, but little connection of those changes to differences in annual growth rates.

Nor have tax rate cuts in the U.S. stimulated much growth. Martin Feldstein, chair of the Council of Economic Advisers during part of the Reagan Administration and a proponent of supply-side policies, concluded that the vaunted 1981 tax cuts contributed little to growth. The 2001 and 2003 tax cuts do not appear to have generated new economic growth. Even with expansive monetary policy, growth was lackluster from 2001 to 2007, and the growth was focused mainly in housing and finance, two sectors not aided directly by the Bush Administration tax cuts.[13] The 1993 increases in the top marginal rate did not stop the economy from enjoying a booming decade.

And what about tax reform? The 1986 Tax Reform Act, the standard bearer in terms of broadening the base and reducing the rates, generated little impact on growth.

Putting the four pieces of the puzzle together – that is, sustained deficits and debt will prove harmful, the burden of debt reduction should be placed largely on high-income households because they will garner most of the benefits, higher tax burdens are the only real way to get the wealthy to finance a significant portion of closing the fiscal gap, and higher tax burdens do not significantly slow the economy in the long run – leads directly to the conclusion that the bulk of the solution should come from higher taxes in general, and higher taxes on high-income households in particular. This could be implemented in several ways such as limiting the value of tax expenditures—a concept that has been championed by leading members of both parties and a wide variety of analysts. Other options include value-added taxes and carbon taxes, each with generous cash payments to low and lower-middle class households designed to eliminate the regressivity of such policies. Both of these offer side benefits besides deficit reduction. A VAT

may encourage saving, which is exempt from the tax. And a carbon tax is a market-oriented approach to reducing greenhouse gases. Revenues from these changes could be used to finance tax reform and existing programs as well as to pay down the debt.