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A Perspective on the Budget Deficit and Revenues

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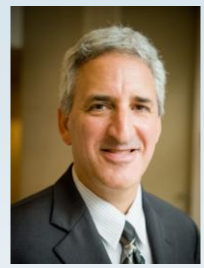

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Ron Haskins highlights two distinct problems: a slowly recovering economy and our country's medium- and long-term fiscal challenges. I share the view that our government must prioritize full employment and that fiscal stimulus could help. I want to focus here, however, on how tax policy can help resolve the medium- and long-term deficit problem for the next administration.

Any sustainable fiscal solution will involve revenue increases, for several reasons.

First, historical revenue levels will not be sufficient to fund the federal government in the future. Eventually, we will need to deal with the ballooning costs of Medicare, Medicaid and Social Security. Even if very substantial cuts are made to these programs, the facts remain that their enrollment will be growing, costs per enrollee have been rising and prior deficit spending has created higher interest payments. Additional revenue will be needed.

Second, past major budget agreements ultimately included both revenue increases and spending because cutting deficits using both sides of the budget provides a sense of fairness and shared sacrifice. Although spending cuts do not require significant sacrifice from high-income households, tax increases do. Interestingly, raising taxes to pay for current spending has proved more effective at restraining spending than allowing the government to finance its outlays with deficits. Every trial to restrain spending by cutting taxes failed. In the 1980s under President Reagan and in the past decade under President George W. Bush, taxes fell but spending rose. The only time in the past 30 years when spending fell was in the 1990s, under President Clinton, when taxes were also raised.

Finally, a combination of tax increases and spending cuts honors the wishes of the American public. Time and again, public opinion polls show that Americans find a balanced approach preferable to spending cuts alone.

Raising taxes will not destroy the economy. In 1993, top income tax rates rose to 39.6 percent, and the economy flourished for the rest of the decade. Even the massive tax increases during and after World War II—amounting to a permanent rise of 10 to 15 percent of GDP—did not hamper U.S. economic growth.

A good tax system should raise the revenues needed to finance government spending in a manner that is as simple, equitable, stable and conducive to economic growth as possible. Virtually no one thinks the current system is good.

There are better ways for the next administration, working with Congress, to raise revenues. The general goal is to broaden the tax base by reducing the number of specialized credits, deductions and loopholes. This minimizes the extent to which tax rates need to increase. For example, limiting the tax benefit of itemized deductions to 15 percent would affect mostly high-income households. Yet, it would not raise their official marginal tax rate, and it would raise more than a $1 trillion over the next decade, according to the Congressional Budget Office.

Rising revenues levels should come from progressive taxation, which means the tax burden on high-income, high-wealth households needs to rise. Last year's debt deal contained only spending cuts and has little or no impact on high-income households. Instead, the entire burden of closing the fiscal gap is borne by low- and middle-income households.

It is not as if high-income households cannot afford to contribute. Over the past 30 years, the share of total household income for households in the top one percent of the income distribution more than doubled; meanwhile, real income for middle-class workers barely budged.

Proposed taxes on high-income households always seem to generate two responses: they will hurt small business, and they constitute class warfare.

The first argument is overstated. First, most of the income for high-income households is not business income. Second, the proposed rates would not affect most small businesses. A recent Treasury report shows that just 1 percent of small business owners would be affected by a "millionaire's surtax." Even for small businesses with income exceeding $1 million, it is unclear how much their after-tax business income would change given that the effective tax rate on small business income is likely to be zero or negative. After all, small businesses can immediately and fully deduct the cost of new investment, and they can also finance it with debt, the interest payments of which are tax deductible. Furthermore, they can deduct wage payments in full, so the marginal tax rate should have minimal impact on hiring.

The "class warfare" argument is unfounded. It seems reasonable to ask for some new sacrifice from a group that (a) is very well off, (b) has seen huge income gains relative to the rest of the population over the past 30 years, and yet (c) has seen its average tax burden fall, not rise, during that period. The wealthiest have thus far been spared the burden of closing the fiscal gap, and tax increases can ensure shared sacrifice.

In addition to income tax reform, our leaders should move the United States toward a system that taxes consumption (using a value-added tax, for example) and nonrenewable and polluting energy use (by increasing gasoline taxes or implementing a carbon tax).

Although it would be new to the United States, the VAT exists in about 150 countries worldwide, including every other OECD member-state. Its prevalence is a testament to its virtues: it can raise substantial revenue, is easily administrable and is minimally harmful to economic growth. In addition, a VAT has benefits for the current economic situation: a pre-announced, phased-in VAT could accelerate economic recovery, and it can help states address their own fiscal issues. Concerns about regressivity and transparency can easily be addressed, and concerns that it would fuel an increase in government spending are overstated.

Long-term challenges related to energy production and consumption and long-term fiscal challenges can be addressed together. A far-reaching, upstream carbon tax is a no-brainer for economists. It can curb negative externalities like traffic congestion, increased health costs resulting from pollution and the destructive effects of climate change. At the same time, it can raise revenue.

A carbon tax would have many benefits: it can reduce the deficit, reduce our dependence on foreign oil, protect the environment, lower the costs of health care and encourage the development of clean, sustainable energy sources without the need for costly, inefficient energy subsidies.

Another option is to raise taxes on gasoline. Although a modest excise tax on gasoline exists, it is substantially lower than the level justified by studies of the external cost of gasoline use and, indeed, much lower than gasoline taxes in developed countries around the world.

None of this means the United States needs to move to European levels of taxation. But between the very low tax revenues we raise now—the lowest share of the economy in six decades—and the high levels of taxation in other developed countries, there is plenty of room to raise revenue in a way that achieves serious deficit reduction and supports a reasonable level of government.

Of course, revenue increases should phase in as the economy recovers.