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

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The Bottom Line

• America faces two intertwined problems
  • Rising debt
  • Lagging investment

• 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

World War II: 106%
Great Recession: 78%
A Fiscal Policy Rorschach Test

Source: Gale (2019)
The Changing Composition of Spending
Effects of Debt on the Economy

• Not all debt is bad

• Not a crisis

• But our long-term debt situation is still a problem
  • Economic
  • Political / Fiscal space
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
Raise and Reform Taxes

- 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
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)
Fiscal Outcomes under the Proposal
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
Interest payments, 1950-2050

[Graph showing interest payments over time as a percentage of GDP, with three lines representing historical, current policy, and current policy with flat interest rates, reaching significantly higher values by 2050.]
Politics

• Debt reduction is a classic “Olson” problem
  • Concentrated costs, diffuse benefits
  • Schultze: Hippocratic Oath for politicians
• Public opinion is conflicted
• No New Taxes pledge complicates any discussion
• Structure of government makes major change difficult
• 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.”