THE BROOKINGS INSTITUTION
The Current

"Government spending, debt, and taxes in the 2024 election"

Wednesday, October 16, 2024

Host: Fred Dews, Office of Communications, Brookings
Guest: Ben Harris, Vice President and Director, Economic Studies

---

[music]

DEWS: You're listening to *The Current*, part of the Brookings Podcast Network. I'm your host, Fred Dews.

Leading up to the U.S. elections in November, Brookings aims to bring public attention to consequential policy issues confronting voters and policymakers. You can find explainers, policy briefs, other podcasts, and more, plus sign up for the biweekly email at Brookings dot edu slash Election 24.

You can also find on our website the new podcast *Democracy in Question*. On *Democracy in Question*, host Katie Dunn Tenpas interviews guests about American politics and the future of democracy. Each episode poses a different question to better understand the contours of our democratic system and what is at stake. You can find more about that show at Brookings dot edu DemocracyInQuestion.

On today's episode. Government spending, debt, and taxes and how those issues are playing out in the 2024 election. Economic conditions are one of the quadrennial top issues for voters and related to economic performance are concerns about the national debt. Taxes and government spending, especially on popular entitlements like Social Security and Medicare.

To talk about the broad contours of these issues, I'm joined by Ben Harris, vice president and director of Economic Studies at Brookings. Ben, welcome to *The Current*.

HARRIS: Thanks for having me, Fred. I appreciate you having me on.

DEWS: So, I'd like to start with a broader question than what's expressed in our theme. And that's given that all of the economic indicators point to the fact that the U.S. economy is really healthy right now. It recovered more quickly than other nations after COVID. It's growing. Inflation is in check. Employment is up. Thousands of new manufacturing jobs have been created in the last two years, etcetera. So, given all that, why do you think so many Americans think the economy is bad and won't give credit to the presidential administration, Biden-Harris, presiding over the strong economy?

[2:00]

HARRIS: So, Fred, this is a a great question and one that I economists don't have the perfect answer to. But let's talk a little bit about what I consider to be the paradox of household sentiment, which is why is sentiment so low when the economy is doing so well?

This paradox, I think, was most acute if you go back towards the middle part of 2022 when a couple of things were happening. So, the first thing was that the U.S. economy was just absolutely on fire. Inflation was coming down. The labor market was still really tight. It was a great time to be a worker. Foreclosures were on the floor. Household wealth was exploding because of increasing stock prices and a really healthy stock market coupled with rising housing equity. People's wages were growing at really fast clips to help deal with residual inflation.

So, the economy was just in great shape in 2022. Also in 2022, we were two years out from being in the recession and we'd be at least another two years until we would hit another recession. Here we are at the end of 2024 and there's no recession in sight.

So, you've got this really strong economy and yet, you can look to one particular poll, which I think highlights the paradox, which was a Morning Consult poll that was conducted fairly regularly throughout 2022. October 2022, two-thirds of respondents, a full two-thirds, majority of respondents, said the U.S. economy was in recession, even though, again, there was no recession, and we hadn't been in recession for at least several years.

So, that suggests that there's something that is going on when it comes to misinformation. When you look at the Michigan Index of Consumer Sentiment, which I think is the most prominent measure of consumer sentiment that we have, three of the five questions that form up that index are really not about a household's own personal financial situation, but they're asking the household how they think the greater economy is doing.

So, they're saying, for example, how do you think about business conditions over the next year? Or what do you expect in terms of inflation over the next year? So, it's really kind of a macroeconomic quiz of respondents. Well, if two-thirds of people think that we're in the middle of a recession when we're not, then how do you interpret consumer sentiment? It makes it really tough to interpret how people think we're doing if they're systemically saying we're doing worse than we actually are.

So, that has led me and I think some other economists to conclude that misinformation is at least part of the reason why we're seeing such low reports of consumer sentiment. So, people are getting their news from really different sources. That's part of this misinformation problem. People are turning to social media, which is unvetted, unchecked. It's not credible. It's often intentionally manipulative.

We know, and I'm not citing causation here, but we know that when people who get their news from social media are asked about consumer sentiment, they tend to report feeling less good about the economy than those that get their news from more traditional sources. We also know from academic papers that the local news sentiment has been declining fairly regularly over the past several decades. That could also be part of it. And then also, part of the reason could be that over the past four or five years, it seems that the major economic news outlets are becoming systemically more negative, which is following the same trend as local news.

And so, we've done some research here at Brookings where we say, okay, conditional on the state of the macro economy, where would we expect the national news sentiment to be? So, we're talking about major news outlets like, I don't know, think like the *Wall Street Journal* and outlets like the *LA Times* or similar news outlets. And so, when we look at what the San Francisco Fed has constructed in terms of an economic news sentiment, which is just a single measure of how the various newspapers are talking about the news, we're finding that it's much lower or has been much lower the past few years than we would expect based on the macro economy. So based on stock prices, based on unemployment, based on economic growth, and other indicators.

So, it does seem like the news is becoming systemically more negative and that people are turning to less reputable news sources to get their information. And that's probably driving an overly pessimistic view of the U.S. economy, which, because measures of consumer sentiment depend on how people feel about the macro economy, is driving down sentiment.

So, it's a bit of you know, it's a bit of a, you know, it's a bit of a chain that's kicked off by misinformation, but does feel to be like it's at least a major part of the paradox around sentiment.

DEWS: That is really fascinating. And I'm sure that we will know how sentiment is going to play out in the election in just a few weeks from now after the election ends. So, Ben, let's move on to some of the other big questions for this episode. The first is the national debt. Is the national debt something that voters should care about at all?

[7:25]

HARRIS: Yeah, well, I think that Americans should care about the national debt for a handful of reasons. One is that the size of the debt will often determine future economic growth. So, economists have this term, it's called "crowd out," which means when public debt starts getting larger and larger, it starts crowding out private sector debt.

Now there's a time and place for public debt. And historically, the time for the public debt has been we find ourselves in a recession and we want to rely on what we call countercyclical measures to get us out of this. And so, we saw this in 2008, in the heels of the great financial crisis, when you saw policymakers from both sides of the aisle come in and offer support for households and businesses alike. You saw this in spades in the pandemic era when, again, both Republican and Democratic lawmakers passed really large recovery packages that gave money to U.S. households and businesses to help them recover from the pandemic. So, this has been a fairly consistent feature of U.S. policymaking for a long time. So, there is a place for public debt.

The problem is that we have this systemic mismatch between revenues and spending even in normal times. And that's that's led to a fairly sharp acceleration in the stock of public debt. And when we run deficits and we run this these large persistent deficits year after year, the Treasury Department has to go ahead and auction off the debt and investors go ahead and buy it. And when investors are buying U.S. debt, it means they're not investing in other things that are productive. They're not investing in U.S. companies; they're not investing in U.S. people. So, there is this concern around crowdout.

That concern, I think, is more acute as we see interest rates rise higher and higher. And, you know, over time, this can mean that we see depressed economic growth and a lower standard of living moving forward. So, I think voters should care about this for traditional reasons.

There's also two other threats that are associated with rising debt. One is that politicians may feel that they need to take drastic measures to push back on too high debt. And I think one of the most salient examples is around the debt ceiling and the potential for the U.S. to breach the debt ceiling and fail to either make payments on U.S. Treasury securities or to take another just incredibly rash decision like not making promised payments under Social Security. I think that's a real risk and that's a risk that has been rising over time with federal debt.

The other risk, I think, to a growing federal debt has to do with financial sector stability. And so, if you saw interest rates rise really quickly because investors are starting to lose their taste for U.S. treasuries, and you have to have higher interest rates as a sort of price mechanism for making those types of investments more appealing, that could lead to a situation where we see a real threat to financial stability like we saw with the Silicon Valley Bank crisis of a few years ago, where sharply rising interest rates, coupled with a few other really severe problems with the management of that bank and a few others was a real threat to financial stability.

So, to answer your question, yes, voters should absolutely care about the public debt. Over time, it will road future standards of living and economic growth. It could push politicians to making some really dumb decisions like breaching the debt limit and failing to make promised payments. And it could also be a threat to financial stability. And we've seen similar threats over the past couple of years.

DEWS: Let's drill down a little bit more on this topic through the lens of the budget deficit. You talked about that a few minutes ago, the discrepancy between government spending and government revenue, government revenue being mostly taxes and some other things. I want to ask, and this is something I've always been very interested in, what is the contribution of tax cuts but specifically lowered marginal tax rates over time to the budget deficit? And I know there have been times in U.S. history where the highest marginal rate—so the tax on that portion of the highest income earners—has been over like 90%.

[11:58]

HARRIS: Yes. So, I think the start it's important to understand that we have about a six-percentage point of GDP gap between what we spend and what we bring in. So, outlays or spending by the federal government in recent years has totaled around 23% of GDP; revenues have totaled the total around 17% of GDP. So, you have this about six percentage point of GDP gap between what we spend and what we bring in. And as long as you run that gap year after year and we've got fairly stable growth in the order of 2.5% to 3.5% or even lower, we're just never going to grow our way out of this deficit hole and it's going to continue to accumulate and continue to be a problem.

Now, there is this notion that we can kind of grow our way out of this debt. And so, for people who are supply side economists or who believe in supply side economics, they'll say, no, all you really need to do is drop marginal tax rates on labor and investment to low levels, and that will induce this big economic boom, which will then push down the debt and will push down annual deficits.

So, it is true that as the size of the economy grows, any sort of given stock of public debt becomes less and less of an issue because we have more and more resources to make payments on that debt. But unfortunately, it's not true that we've been able to grow ourselves out of big, steep tax cuts in the past. The 2017 Tax Cuts and Jobs Act I think is a really good example of that, where the scorers at federal agencies like the Congressional Budget Office and the Joint Committee on Taxation initially put the score of that bill at about $1.5 trillion. A couple of years later, we realized it was closer to about $2 trillion. But the point is, is that claims that we could grow our way out of that cost proved to be untrue.

And while I think that tax cut did and do some additional economic activity, it was nowhere near large enough to pay for the cost of all that lost revenue. And here we are today, 7 or 8 years after that tax cut had been passed and we're still looking at these long-term imbalances between revenues and outlays. And as long as we continue to fail to have a tax code which brings in sufficient revenue, we're going to see debt continue to grow.

DEWS: I'm glad you brought up that 2017 Tax Cuts and Jobs Act. This is the law that was signed by then-President Trump in 2017. Some of its provisions actually expire at the end of 2025. But Trump has suggested on the campaign trail that he would like to let the provision of the SALT deduction cap expire. But Vice President Kamala Harris on the campaign trail has opposed any tax increases on those making less than $400,000 a year. So, about a year from now, some provisions will expire. What do you expect could be the impact of any of these policy ideas on the budget deficit?

[15:12]

HARRIS: Well, the expiration of the Tax Cuts and Jobs Act and how Congress the administration chooses to deal with that, I think will set up our fiscal trajectory for the next ten years, if not longer. So, that was that was a sweeping tax bill. It cut the corporate tax rate from 35% down to 21%, and then introduced a slew of other tax cuts and tax changes for households. Virtually every taxpaying household was affected by the Tax Cuts and Jobs Act.

At the time, it was passed through reconciliation, which is a process by which Congress can essentially write itself a blank check. And as long as it reports legislation that doesn't cost more than that blank check, you can push it through the Senate with only 50 votes. And so, in 2017, Republicans had President Trump in the White House. They had control of the House, but they only had, I believe, 52 votes in the Senate. So, they needed to pass the bill through reconciliation.

My sense is that it would require another reconciliation bill to be passed, you know, when it's when it's addressed in 2025. So, you know, we'll know how much it cost based on the blank check that Congress writes itself. If you look at estimates. Various scorekeeping entities, they're putting the cost of a wholesale extension at around $5 trillion. It really is an incredibly expensive bill in terms of lost revenue. There's really no hope will even come close to growing our way out of that hole.

But when you look at the individual provisions that add up to those 5$ trillion, you've got things like lower rates on taxpayers across the board. That costs a little over half the cost of that $5 trillion. You've got things like addressing the alternative minimum tax, which is a really poorly designed tax, but that is phased out. That costs about another $1.5 trillion or so. And then you have a slew of other tax cuts, like what's called the 199 Cap A, which is a tax cut for pass-through entities, things like large partnerships, and then also some small businesses. That costs around $800 billion.

And then you also have some targeted tax increases that were used to offset some of the costs of this bill. And one of the more notable ones is the one you just mentioned, Fred, which is a $10,000 cap on deductibility of state and local taxes paid. So prior to the TCJA, if you had a high income tax bill because you lived in a state with high income taxes, or maybe you're just a high, high income taxpayer, or if you lived in a state where you paid a lot in property taxes—for example if you lived in a New York suburb or a suburb of Chicago or some places in California—you were going to have a lot of deductions in the form of state and local taxes paid. So, to help offset the cost of this bill, Congress capped the amount you could deduct at $10,000. And this applied whether you were a single taxpayer or whether you were a married taxpayer.

In effect, this meant that those households that already had high state and local tax bills were going to fare disproportionately worse relative to those that didn't. And so, this was a really contentious bill in Congress, particularly for those representatives from high tax states like New York, Illinois, New Jersey, California, who wanted to see their constituents continue to be able to write off state and local taxes paid.

So, this has become a bit of a political football, not really so much because of the economic impacts, but I think more because there's just a lot of diversity in terms of who pays this. And so, you see taxpayers on the coasts benefiting more from the deduction relative to those that live away from a coast. So, it's certainly become a political football.

You know, if you see Republican control, I think the chances for seeing any sort of SALT consideration go down markedly relative to a situation where you might see a Democratic coalition in Congress fight to go ahead and preserve at least some sort of deductibility for state and local taxes paid. Now, maybe it's not an across the board. You can deduct, you know, an unlimited amount. You've seen some proposals come and say, well, look, $10,000 deductibility is too low, but let's have something more like $80,000 or $100,000 per household. But I think it really depends on the leverage that the coalition from high tax states has in Congress and whether or not that coalition is needed to pass a TCJA expiration. You know, that will be the determining factor when it comes to the SALT deduction.

DEWS: Ben, you've talked a lot about the supply side idea that we could grow our way out of the debt. And you've talked about how the tax cuts counterbalance that. What about reducing spending, cutting government programs, as a way to reduce the budget deficit and therefore reduce the national debt? Is that feasible?

[20:32]

HARRIS: It's certainly feasible and should be part of any conversation. Look, I think when it comes to getting our nation on a better fiscal trajectory, you really don't want to take anything off the table. But when you look at the composition of spending moving forward, the U.S. has been in a long-time period of transition where we're spending more and more on entitlement programs, mainly Social Security, Medicare, and Medicaid, and less on what we call discretionary spending, which is a catchall for any spending that goes to the appropriations process. But this tends to be roughly 50% of it goes towards the military, and the other 50% of discretionary spending goes towards things which we often consider to be sort of public goods. So, things like intelligence and spending on education and spending on infrastructure and transportation and science and technology.

So, when we look at the composition of what we're actually spending this 23% of GDP on, you see that we're spending about two-thirds or 14% of that on mandatory programs. Social Security comprises about 5% of GDP. Major health programs like Medicare, Medicaid, the Chip program—that comprises about 6% of GDP. And other mandatory makes up the difference.

Discretionary spending, which is, again, this big catch all term, only makes up about 6% of that 23% of GDP we're spending on all federal spending. And that discretionary spending share has been going down over time. So, the average over the course of my lifetime was about 8% of GDP. So, now it's down to about 6% of GDP, and the expectation is it will fall even lower.

So, you know, when you hear people talk about cutting government spending, a lot of times they're talking about cutting this discretionary bucket, which is getting smaller and smaller over time. And they're not talking about cuts to things like Medicare, Social Security, Medicaid, and other mandatory spending that really that relates to health.

You might have a situation where some sort of grand bargain means that we bring in Social Security into the conversation or we bring in Medicare into the conversation. But these are … A, these are really popular programs that are difficult to cut. I think that there's probably a very high political price to be paid for cutting such popular programs. And B, these require a lot of foresight. So, you can't practically cut Social Security for beneficiaries today. That's really not fair for people who have planned their retirements around having that paycheck every month, or it's really not fair to people who have depended on Medicare for their health care.

So, you have to be more forward looking if you're going to cut entitlements at all. And that means planning in advance. And so, those those programs they're expected to see their trust funds become exhausted in the not-too-distant future. So, if they are going to get brought into the conversation it really needs to happen now and not when we're on the doorstep of the exhaustion of the trust fund balance.

So, this is a very long-winded way, Fred, of saying, yeah, I think that that spending should absolutely be on the table. But it's getting harder and harder because the share of spending that goes to the really popular programs that define U.S. retirement like Social Security and Medicare is just becoming larger and larger. And maybe the part that it's considered to be easy to cut—the discretionary side of things—is getting smaller and smaller.

So, we're at the point now where it's just it's not enough to say, oh, let's just cut discretionary spending. That has real consequences for growth over time because a lot of these programs are for things like education, which, you know, help determine the productivity of our labor force. There's just really no way to cut down discretionary spending as a way of balancing the budget as a standalone strategy.

DEWS: Ben, I'm going to wrap up this conversation by going to something that you just were talking about. And you talked about it, too, at an event held in April for the Election '24 series. You were one of the panelists on this very topic. And it has to do with we need to be planning now especially around managing Social Security, Medicare 10 years from now, 15 years from now. We can't wait. We can't do this piecemeal. It was kind of a scary set of policy choices. Setting aside who wins the presidential election, setting aside who runs Congress, what in your view are the policy directions when thinking about the national debt, budget deficits, and taxes?

[25:30]

HARRIS: So, in terms of broad choices, there really are not silver bullets. I think we're just going to have to accept that anything we do will have a certain level of of sacrifice and perhaps economic pain associated with it, which is why you want to do it over time. You want to do it gradually. You don't want to have a situation where you just jack up taxes overnight and have this big shock to the system, or where you just cut popular, reliable spending programs overnight and then force people to make tough, tough adjustments quickly.

But in broad terms, I think that one of the things that we can look to is raising more money from the corporate sector. We saw, I think I mentioned at the outset, the sharp cut in the corporate tax rate. We've seen corporate revenues plummet as a result. You can get about 1% of GDP from going back to more traditional, a more traditional tax code for our corporate sector. So, that should certainly be part of the conversation.

I think that we have big holes in our tax administration. And so, it's part of a pay for in the Inflation Reduction Act. You saw Congress allocate more money for the IRS to reverse these long-standing cuts we saw to the agency. That meant that the tax code was becoming essentially a sort of voluntary tax code, particularly for people who didn't get their income through work. Maybe you're running a business and you get your income that way, or maybe you're an investor and you get your income that way. And when the IRS doesn't have the money to do its job, you're starting to see the tax code become more voluntary for certain types of taxpayers. And no one would ever say this is a fair system where you have workers are mandated to pay their taxes and becomes optional from everyone else. So, that's another pay for which I think is both fair and fairly appealing.

And in terms of cutting spending, you know, I generally just don't favor, like I just said, looking at non-defense discretionary spending as a popular source of cutting just because that type of spending is so instrumental to determining our future standards of living. I'd rather we see some sort of grand bargain around the big entitlement programs. And that is to say you don't need to cut Social Security as a first sort of strategy. You can have a more balanced approach where you're looking to potentially raise more in payroll taxes and put in place long-term, more reasonable adjustments to Social Security.

So, you could pretty much get us back on track if you wanted to. For example, tax upper income wages above $400,000 at the same rate as those who are making less than the Social Security cap or tax. And you want to go ahead and couple that with, say, some adjustments to the benefit formula. You can push out the Social Security Trust Fund exhaustion date by ten, 15, 20 years by making a series of reasonable tweaks.

[music]

DEWS: All right. Ben, we'll put a pin in it there. I want to thank you for sharing your time and expertise today in this very fascinating and important conversation.

HARRIS: Happy to be on, Fred. Thanks for having me.

DEWS: And I'll remind listeners that you can learn more on our website at Brookings Edu slash Election 24.