Facing Up to Budget Realities

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The views expressed in this paper are my own and do not necessarily represent the views of the Investment Company Institute or its members.

Introduction

I would like to start my talk today by first saying that it has been a great honor for me to serve as president of the National Tax Association. I consider the NTA to be my professional home. In my current job, few of the people with whom I interact on a regular basis are tax economists, so I look forward to both the Spring Symposium and the Annual Conference where I can be amongst my people—people who understand me. Which is not to say that you all agree with me, but, rather, that you know exactly why it is you disagree with me.

My plan for today's speech requires a little context. I spent the first half of my career to date as a staff economist working for the government and the second half as the rough equivalent of a career government economist outside of the government. In neither capacity have I been encouraged to speak in public about my views on a wide range of policy issues.

As such, I decided to use the opportunity of my NTA presidential address to subject you, my captive audience, to such an exercise. I am not confident that you will find my talk of great value, but I am pretty confident that I will find it cathartic and therapeutic.

Recent Elections Have Offered Voters a False Choice

As I look around the room today, I see many familiar faces and many faces that are not as familiar. So, I have decided to begin my policy review by discussing this week's election. (Discussing politics with a group of people who may not know me very well is a little tip I picked up at a Dale Carnegie course.)

There were many facets of the recent election process to dislike. One that has already been discussed quite a bit is the tone of the election. And the tone of the election was unfortunate—not only for parents of school-age children, but for anyone who cares deeply about public policy, who understands that the country faces some tough choices, and who realizes that there are fundamental and legitimate differences of opinion on the path the country should take.

That said, my biggest concern about the election was not the tone, but the discussion of fiscal policy. (Which is a fortunate coincidence, given that I am speaking to the National Tax Association.) Specifically, my concern is that we have had yet another election in which voters were faced with a choice of either: raising taxes on the top half of one percent of the population; or cutting waste, fraud and abuse in the federal government. And that is not the choice that we, as a nation, face.

The Choice We Face

The choice we face is that either the federal government has to collect more in taxes (as a percentage of GDP) than we have ever collected in our history, or it has to cut back popular programs that people have come to depend upon.

Why do I characterize the choice this way?

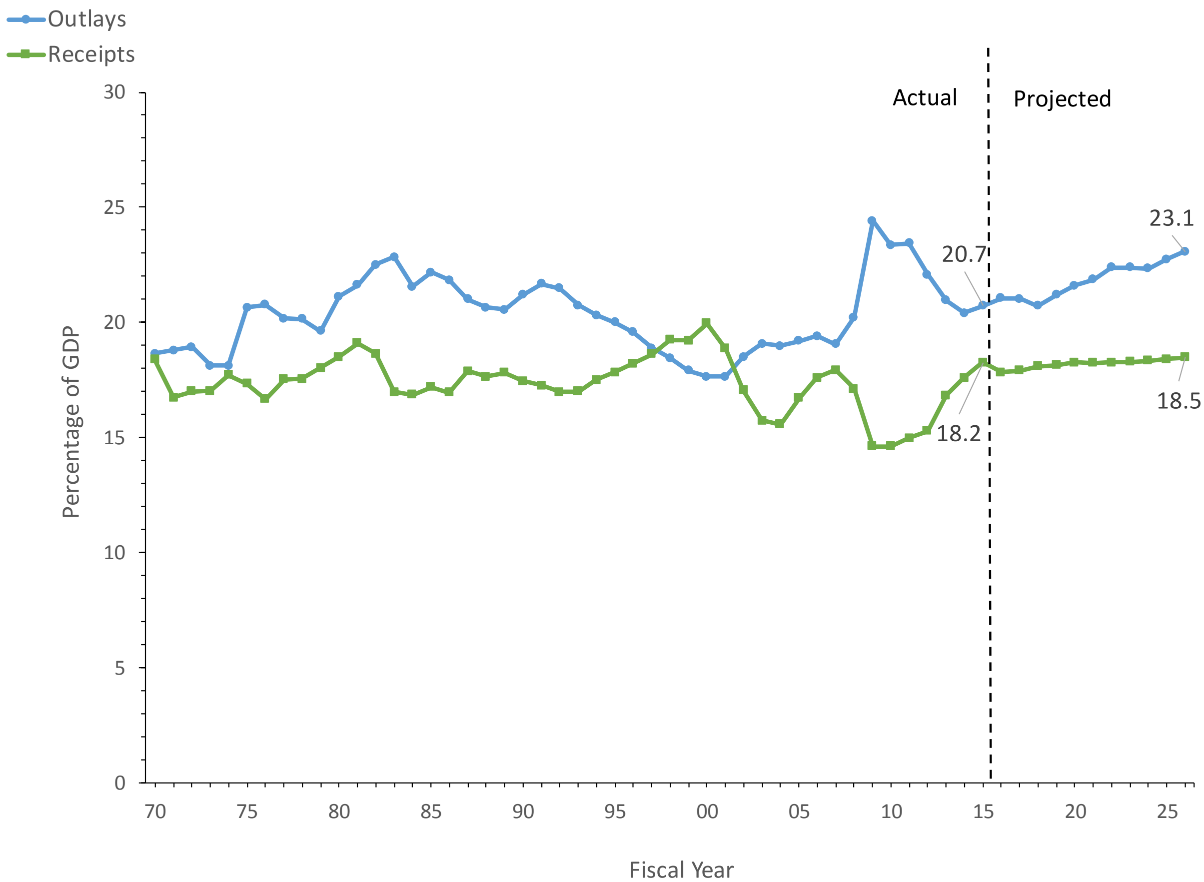
The Budget Outlook

The Congressional Budget Office (CBO) projects that federal spending will increase from 20.7 percent of GDP in 2015 to 23.1 percent of GDP in 2026, while federal revenue will remain fairly flat over this period, increasing slightly from 18.2 percent of GDP in 2015 to 18.5 percent of GDP in 2026 (Figure 1). As a result, deficits are projected to increase from 2.5 percent of GDP in 2015 to 4.6 percent of GDP in 2026. And the projected increase in deficits is arguably overly optimistic as it represents the "current-law" baseline, not the "current-policy" baseline that is often the starting point for many tax reform proposals.

Figure 1

Annual Deficits Are Projected to Increase Under Current Law

Percentage of GDP, 1970–2015 (actual) and 2016–2026 (projected)



Source: Congressional Budget Office, "An Update to the Budget and Economic Outlook: 2016-2026," August 2016

Even if we meet these optimistic deficit projections, debt held by the public—which more than doubled from 35 percent of GDP at the end of fiscal year 2007 to 74 percent of GDP at the end of fiscal year 2015—will increase to 86 percent of GDP at the end of fiscal year 2026 (Figure 2).

The extended period of high debt-to-GDP projected by CBO would be unprecedented and, absent any change to policy, the ratio is likely to continue to increase outside the projection window. The only time in US history that debt held by the public has exceeded 86 percent of GDP was the four-year period from 1944 to 1947, and the only time in US history that debt held by the public has exceeded 74 percent of GDP was the seven-year period from 1944 to 1950. Note that, after the run-up in debt during World War II, the debt-to-GDP ratio declined rapidly: after peaking above 100 percent of GDP in 1946, the ratio was reduced by half within a decade.

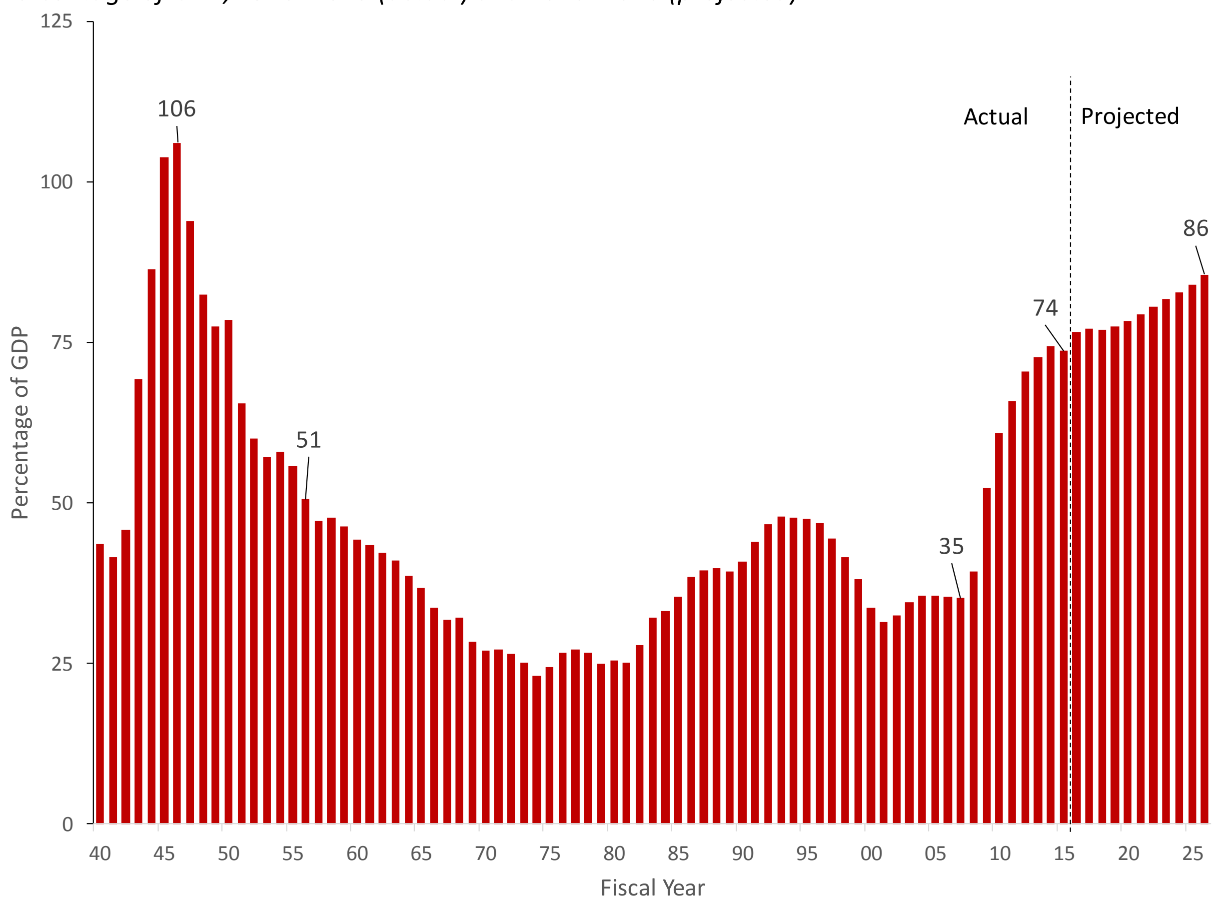
Options to Restore Fiscal Balance

Provided GDP continues to grow, we do not have to run budget surpluses to bring down the debt-to-GDP ratio, but it will require revenue and spending that are much more closely aligned.

Figure 2

Federal Debt Held by the Public Is High by Historical Standards and Heading Higher

Percentage of GDP, 1940–2015 (actual) and 2016–2026 (projected)



Sources: Office of Management and Budget, "Historical Tables," February 2016; and Congressional Budget Office, "An Update to the Budget and Economic Outlook: 2016-2026," August 2016

What would it take to raise the revenue needed to fund projected spending of 23.1 percent of GDP?

The answer is: federal revenue that is higher as a percentage of GDP than has ever been experienced in our nation's history. Since 1946, federal government revenue has averaged just over 17 percent of GDP. Projected 2026 revenue of 18.5 percent of GDP would actually be toward the high end of recent historical experience. Anything close to 23 percent would be unprecedented. Federal government revenue has been 20 percent of GDP or higher only twice in our history—hitting 20.5 percent in fiscal year 1944 and hitting 20.0 percent of GDP in fiscal year 2000.

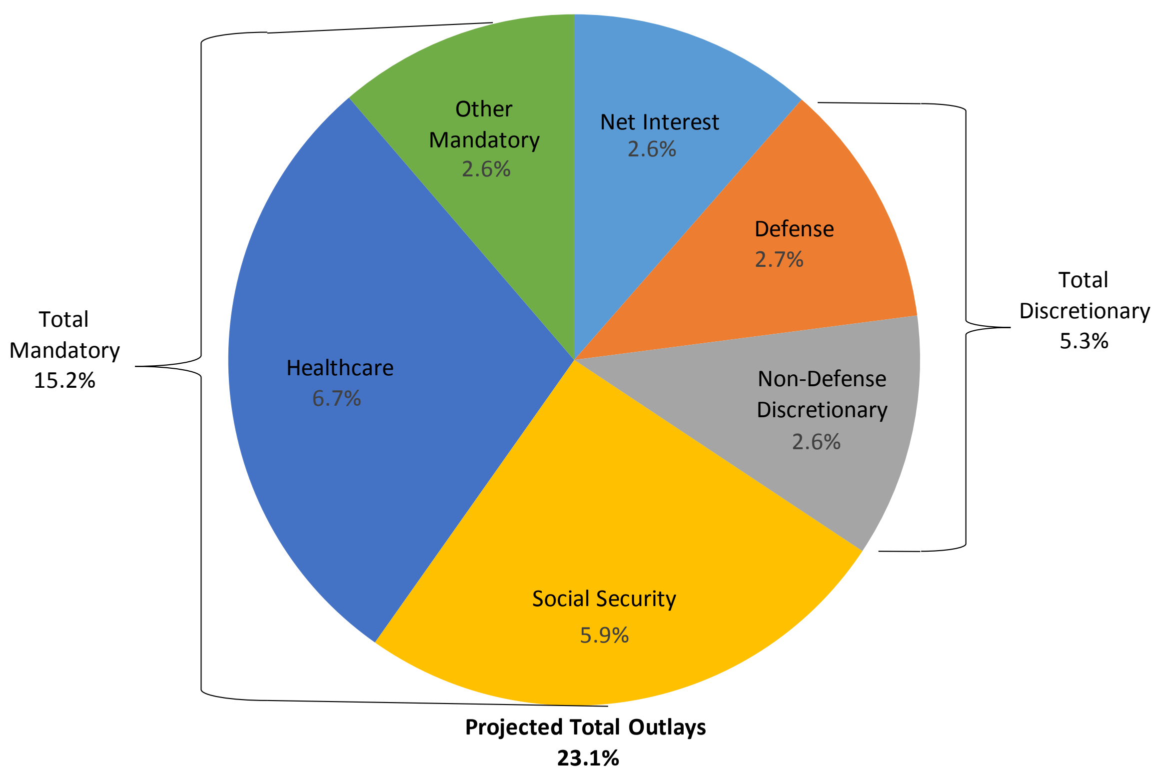
Conversely, what would it take to bring spending in line with projected revenue of 18.5 percent?

The answer is: cuts to popular entitlement programs. Mathematically, there would be a budget deficit in 2026 even if non-defense discretionary spending was completely eliminated. (Of course, revenue forecasts would have to be revisited if we eliminated the IRS). The bulk of projected spending is on mandatory programs (which include spending on Social Security and Medicare) at 15.2 percent of GDP in 2026 (Figure 3). As Gene Steuerle has argued in his book *Dead Men Ruling,* programs established decades ago and essentially put on autopilot account for an ever-growing share of federal spending. Without changes to entitlement programs, there is no plausible way to get spending in line with projected revenue.

Figure 3

Mandatory Programs Represent the Bulk of Federal Expenditures

Projected 2026 federal outlays as a percentage of GDP



Source: Congressional Budget Office, "An Update to the Budget and Economic Outlook: 2016-2026," August 2016

In fact, it is not clear that the projected level of discretionary spending can be achieved, much less reduced. Discretionary spending is projected to account for only 5.3 percent of GDP in 2026, split about equally between defense and non-defense spending (Figure 3). This projected share is well below recent historical experience: it would represent the lowest share of GDP spent on national defense since 1940, the lowest share of GDP spent on non-defense discretionary programs since 1961, and the lowest share of GDP spent on the combination of defense and non-defense discretionary programs since the early 1930s.

In short, we have two status quos that are incompatible. We can keep federal revenue as a share of GDP in its historical range, or we can maintain popular government entitlement programs in their current form, but we cannot do both.

Long-Term Budget Concerns Are Already Affecting Discretionary Spending

There does not appear to be a pressing need to reduce budget deficits in the short-run: to date, interest rates have remained low despite the runup in government debt and the economy currently does not show signs of over-heating. But let me highlight one reason I think we need to address our long-term budget imbalance sooner rather than later.

Although budget deficits are more of a long-term concern, I am concerned about the impact deficits are already having on non-defense discretionary spending. Discretionary expenditures fund activities that most economists consider legitimate government functions, although they may have different opinions on the optimal amount that should be spent on them. One of these legitimate functions—providing for the national defense—has many powerful advocates. I am more concerned about funding other legitimate government functions, which include promoting public health and safety, funding basic research, building and maintaining infrastructure, and the provision of other public goods.

I will touch briefly on one government function that impacts the work done by many in this room—the production of national statistics.

I am very concerned about the quality of our national statistics. To be clear, I am <u>not</u> concerned about the accuracy of our national statistics because I am a conspiracy theorist who believes that career government employees are cooking the books for the benefit of their political overlords. I am concerned about the accuracy of our national statistics because I am a microeconomist who believes that government household surveys suffer from substantial non-response and imputation error. My own research using administrative tax data, which I will be presenting later in the conference, illustrates that government household survey data greatly understate the income retirees get from pensions, annuities, and individual retirement accounts (IRAs).

I don't want to imply that this problem is a direct result of recent budget developments, as the federal government has underinvested in data collection and analysis for decades. When I worked on national statistics earlier in my career, I suspected—although I had no hard data—that the amount of money spent by Wall Street and academia analyzing data from the Federal Reserve Board and the Bureau of Economic Analysis swamped the amount that the government spent to collect the data. But certainly, the current budget situation makes it unlikely that the federal government will increase the amount of resources devoted to our national statistics any time soon.

My fear is that we are making policy decisions without truly knowing the facts. A further concern is that simply spending more money on data collection is unlikely to solve the problem. It will take both a commitment from policymakers to prioritize improving our national statistics and innovative leadership within the statistical agencies to develop new methods of collecting and processing data. But having accurate statistics on which to base policy decisions seems to be a worthwhile use of government resources.

At this point you may ask, "How does the discussion of national statistics relate to the NTA?"

The answer is that administrative tax data offer the possibility of improving the quality of our national statistics, and NTA members are at the forefront of efforts to use these data. To be clear, Congress would need to change the law to allow the sharing of information between the IRS and other government statistical agencies before tax data can be used systematically in creating our national statistics. In the meantime, I suggest that NTA members do what we can to make policymakers aware of the importance of the work being done by the IRS Statistics of Income (SOI) division, which is celebrating its 100th anniversary this year and has been at the forefront of efforts to provide non-government researchers access to administrative tax data for policy analysis.

Comprehensive Analysis Can Help Inform Policymakers

I certainly have my own opinions as to how we should bridge the gap between government revenue and government expenditures. But I don't think sharing my personal deficit reduction ideas with you would do much to advance the policy debate.

Instead, I would like to share with you my thoughts on the type of policy analysis NTA members should engage in to assist in the process. Although elegant solutions to our fiscal imbalances are certainly welcome, I think analysis that helps policymakers, and ultimately voters, understand policy options, and the tradeoffs between those options, can add the most value. And there are few voices in our national debate—on either side of the aisle—making it clear to voters that there are no easy solutions, only difficult choices.

Specifically, I think that the debate about fiscal policy is best served by analysis that is as comprehensive and holistic as possible. For example, although it may be legislatively expedient to pursue a reform of the corporate income tax without making any changes to the individual income tax, a comprehensive analysis of any such reform should consider its effect on, and the need for subsequent legislative changes to, the individual income tax. Similarly, legislative proposals to fix the long-term financing of Social Security may only affect payroll taxes and benefit payments, but a comprehensive analysis of any such proposal would consider its impact on the overall composition of federal revenue and expenditures.

Distributional analysis is one area where I believe a comprehensive approach is particularly important. It is generally accepted that it is important to consider the potential distributional impact of any tax reform proposal. But, ideally, distributional analysis would be even more holistic, measuring the incidence of both taxes and expenditures. For example, looking at the incidence of OASDI payroll taxes in isolation suggests that the Social Security system is regressive. But the regressive payroll taxes are paired with highly progressive expenditures in the form of disability benefits and retirement benefits. And, the net benefits workers get from the Social Security system over their lifetime (that is, the present value of OASDI benefits received less OASDI taxes paid) are progressive.[1]

Along the lines of the Social Security system, I thought Len Burman had an interesting proposal to establish a value-added tax to finance federal health care expenditures (although it appears no one outside of this room shared my opinion). It too would have used a regressive tax to fund a progressive benefit. A narrow distributional analysis of the proposal that only considered the incidence of the tax would conclude that the proposal was regressive, but the net effect of the program—including both revenues and expenditures—would be progressive.

<u>Focus on "Microprogressivity" Is Misplaced</u>

One type of distributional analysis I hope does not play a large role in future tax policy debates, however, is distributional analysis of tax expenditures.

Let me stress that I am not opposed to distributional analysis in general. I worked for Jim Nunns when I was at Treasury and I still consider Jim to be a close friend. If I thought that distributional analysis was of little value, I might not have such an affinity for Jim and his work, and I am not so sure that Jim would think all that highly of me. Indeed, it would be difficult to assess any reform proposal without understanding how it would affect incidence—that is, how it would change who bears the burden of federal taxes.

In recent policy debates, there appears to be a new interest in the progressivity of specific tax code sections—which for expositional ease I will refer to as *microprogressivity*. Although there are arguments in favor of making the overall tax system progressive, none of these rationales support the goal that every provision within the tax code should be progressive.

In fact, focusing on microprogressivity can lead one astray.

For example, many appear to be concerned that, because they face higher marginal tax rates, higher-income workers get more tax benefits than lower-income workers on every dollar they contribute to a retirement plan. There is certainly some truth to this line of reasoning.[2] To the extent an individual's marginal tax rate does not change over time, investment returns earned in a tax-deferred retirement account are effectively taxed at a zero rate. And, because investment income would otherwise be subject to tax, those with higher marginal tax rates benefit the most from the effective zero rate.

The most direct solution to this "problem"—that is, the problem that individuals with higher marginal tax rates benefit more from the effective zero rate of tax—would be to tax all investment income generated outside of retirement accounts at the same rate regardless of a taxpayer's income. This could be achieved either by increasing the tax rate on investment income earned by lower-income workers, or by decreasing the tax rate on investment income earned by higher-income workers. Either change would ensure that all taxpayers get the same tax benefits on every dollar of investment income to which the effective zero-rate

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[1] Congressional Budget Office, "Is Social Security Progressive?" *Economic and Budget Issue Brief* (Washington DC: Government Printing Office, 2006).

[2] It turns out that the benefits of tax deferral are not a simple function of a worker's marginal tax rate and depend on a number of other factors. See discussion of the issue in Peter Brady, *The Tax Benefits and Revenue Costs of Tax Deferral* (Washington: Investment Company Institute, 2012).

applies, and thus would increase microprogressivity. Either change would also make the tax system, as a whole, less progressive.

To illustrate the distinction between *distributional analysis* and *distributional analysis of tax expenditures*, consider the legislation that increased the top marginal tax rate starting in 2013.

- A comprehensive *distributional analysis* of the legislation would produce the headline "Congress Increases Taxes on the High Income".
- A *distributional analysis of tax expenditures* that looked at the effect of the legislation would produce the headline "Congress Expands Tax Breaks for the High Income".

I find that the former, comprehensive, distributional analysis provides useful information, but the latter does not.

If a comprehensive reform of the federal income tax is undertaken it is important that policymakers consider how all the changes included in the reform would affect the progressivity of the overall tax system. The effect of specific tax provisions on progressivity should not be a concern. Tax provisions that address legitimate policy concerns can be included in a reformed income tax even if they are not, by themselves, progressive.

One Policy Recommendation: Do Not Means Test Social Security

Before I conclude my remarks, let me renege on my earlier promise not to discuss my own opinion on specific policy options. As much as I have tried, I simply cannot resist the temptation to comment on potential changes to a crucial component of the US retirement system: Social Security.

To be clear, these are my own views and not those of my employer, the Investment Company Institute (ICI). For the record, ICI's official position is that the Social Security system is an important component of the US retirement system and that policymakers should work to put the program on sound financial footing. But ICI does not take an official position on whether fiscal balance should be achieved by raising taxes, reducing benefits, or a combination of the two. The only specific policy option that ICI opposes is the establishment of private individual investment accounts within Social Security.

Based solely on the math, I believe it is likely that cuts to scheduled Social Security benefit payments will be proposed at some point in the next few years. The incoming President has vowed not to cut benefits, but there is some ambiguity as to whether that pledge refers to scheduled benefit payments, inflation-indexed benefit payments, or nominal benefit payments.

Although I am not opposed to cutting scheduled benefit payments as part of an effort to bring the Social Security system into balance, I am opposed to one particular method of cutting benefits: by imposing a means test.

For years, those to the left-of-center have opposed means testing Social Security out of concern that it would undermine public support for the program. The fear is that means testing benefit payments would turn Social Security into a welfare program, and welfare programs typically do not fair very well in the appropriations process—a fear that I believe has some validity.

For full disclosure, I do not consider myself to be left-of-center. I am opposed to means testing Social Security for a completely different reason—the effect it would have on incentives and horizontal equity.

In the past few years I have had the opportunity to learn more about retirement systems around the world, and this has given me a greater appreciation of the strengths of the US retirement system.

Most retirement systems have at least two components. The first component is a safety-net program for the elderly with broad eligibility (typically residency) that provides a flat, means-tested benefit. The second component is a contributory pension for workers. The two programs typically interact over some range of incomes, with every dollar of income an individual receives from their pension reducing the benefits paid to the individual from the safety-net program.

In many countries, there are concerns about how the overlap between these two components of the retirement system affect the incentive to work, save, and invest. For example, Australia has a means-tested safety net program for those age 65 or older (the Age Pension) and a contributory pension for workers in the form of mandatory individual saving accounts (superannuation funds or retirement savings accounts) which allow withdrawals beginning at age 55. There are concerns that the system provides the incentive for workers to spend down their mandatory savings prematurely (perhaps by stopping work before age 65 and living off the assets accumulated in the mandatory savings accounts) or to shift their retirement savings into assets not counted under the asset test (such as owner-occupied housing) so that they become eligible to receive the Age Pension after age 65.

Whether by design or accident, the US retirement system avoids many of these adverse incentives. The US has a safety-net program for the elderly that pays a flat, means-tested benefit—it is called Supplemental Security Income (SSI). It also has a mandatory contributory pay-as-you-go pension that covers 94 percent of all workers—it is called Social Security.[3] In addition, the US has a voluntary employer plan system, where employers can choose to offer their workers a retirement plan. For workers who reach retirement age after having steady employment, Social Security benefits alone make them ineligible for SSI and, thus, the SSI means test does not affect their incentive to work, save, or invest.

Not only would instituting a means test for Social Security benefits reduce the incentive to work and save, and possibly encourage the shifting of assets, it would arguably make the system less fair. The Social Security benefit formula is already progressive—replacing a higher percentage of earnings for those with lower lifetime earnings. A means test would introduce differences in benefit payments even among workers with similar lifetime earnings, penalizing those who choose to work longer or save more.

It is certainly reasonable to suggest that any benefit cuts should be greater for those who are better off. For those who wish to accomplish this goal, I would recommend that it be achieved by flattening the benefit formula (which is a function of average lifetime earnings) rather than instituting a means test (which would be a function of current annual income and current assets). Lifetime earnings are a better measure of economic wellbeing than annual income, and much more difficult to manipulate.

[3] Most workers not covered by Social Security are exempt because they are government employees covered by alternative government employee pensions.

Conclusion

Thank-you for allowing me to engage in this meandering discussion of public policy. I found it therapeutic. I hope you found it of some value.

In closing, let me once again say that it has been an honor to serve as NTA president. And, as chair of the *109th Annual Conference on Taxation*, here's hoping that the NTA is still going strong when it is time for the 218th.