FISCAL CONSOLIDATION IN AMERICA

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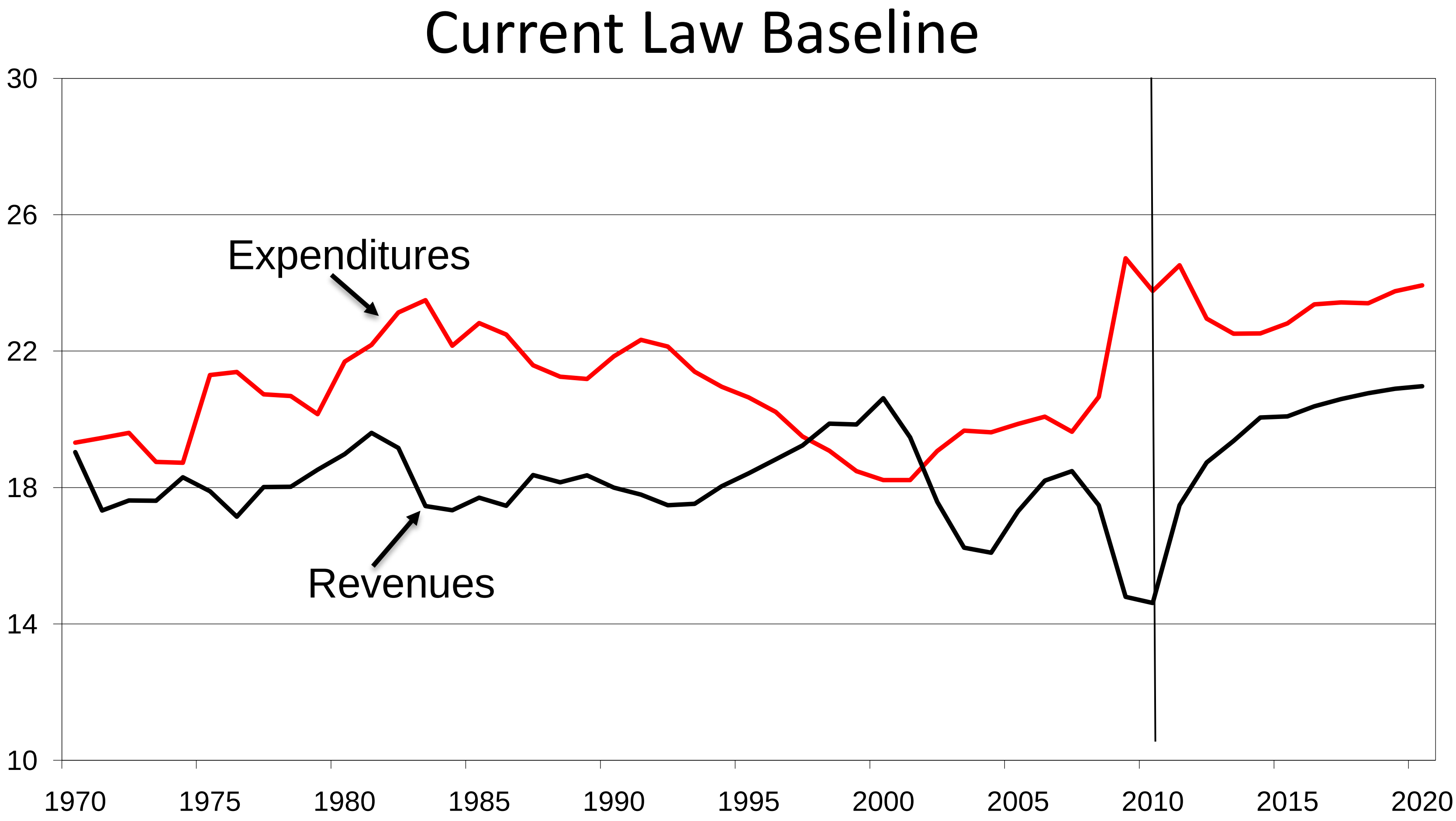
Outline

- Budget outlook
  - Short-run challenge
  - Long-term outlook
- Options for fiscal consolidation
  - Expenditure reductions
  - Revenue increases

Short-run Challenge

- Current-law baseline
  - Bush tax cuts expire
  - No inflation adjustments for AMT
  - Increases in discretionary spending limited to adjustments for price inflation

Federal Revenue and Expenditures, 1970-2020

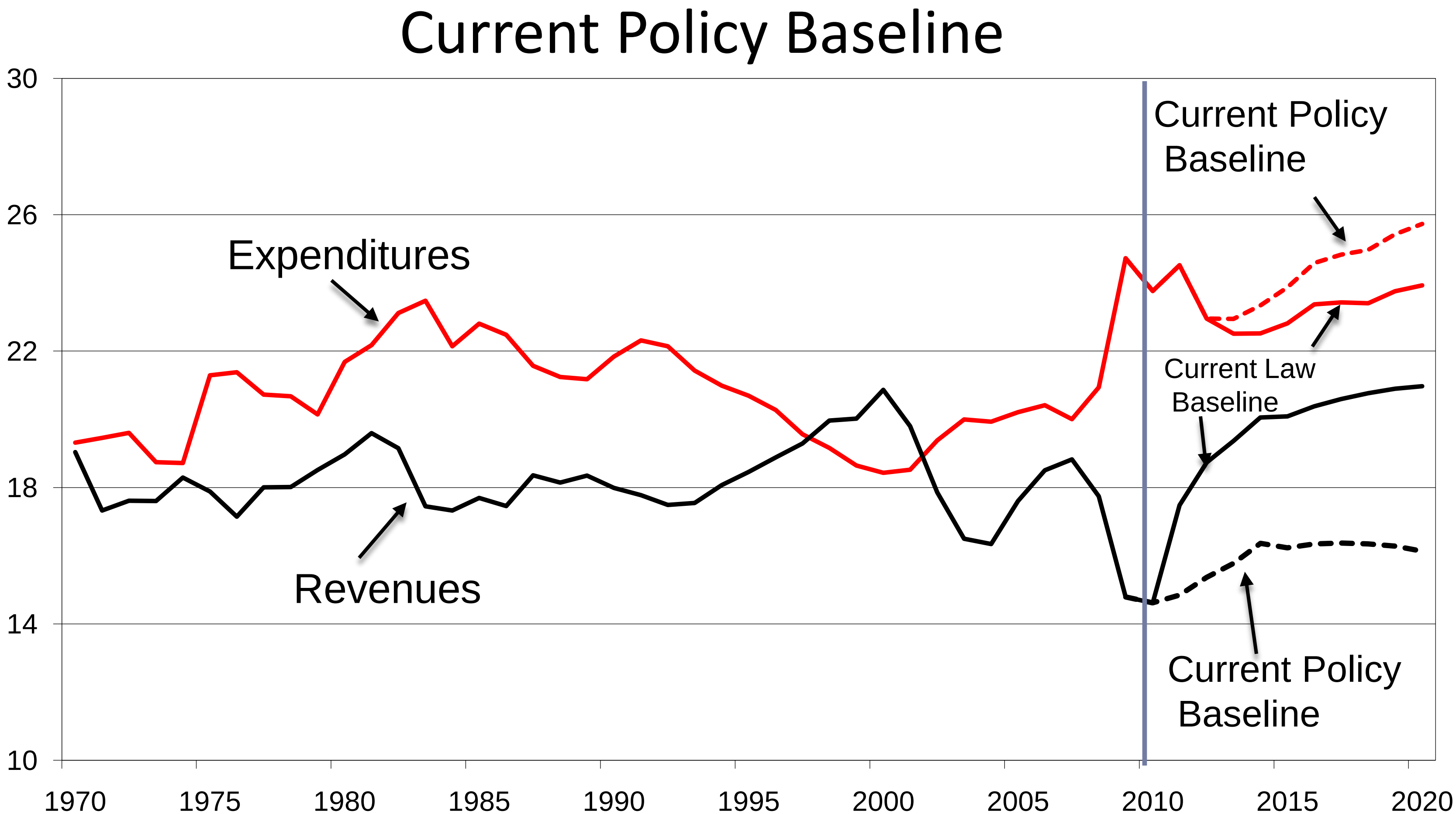


Source: Congressional Budget Office. 2010c.

Short-run Challenge

- Current-policy baseline
  - Bush tax cuts *extended*
  - *Inflation adjustments* for AMT
  - Increases in discretionary spending *in line with growth of GDP*

Federal Revenue and Expenditures, 1970-2020

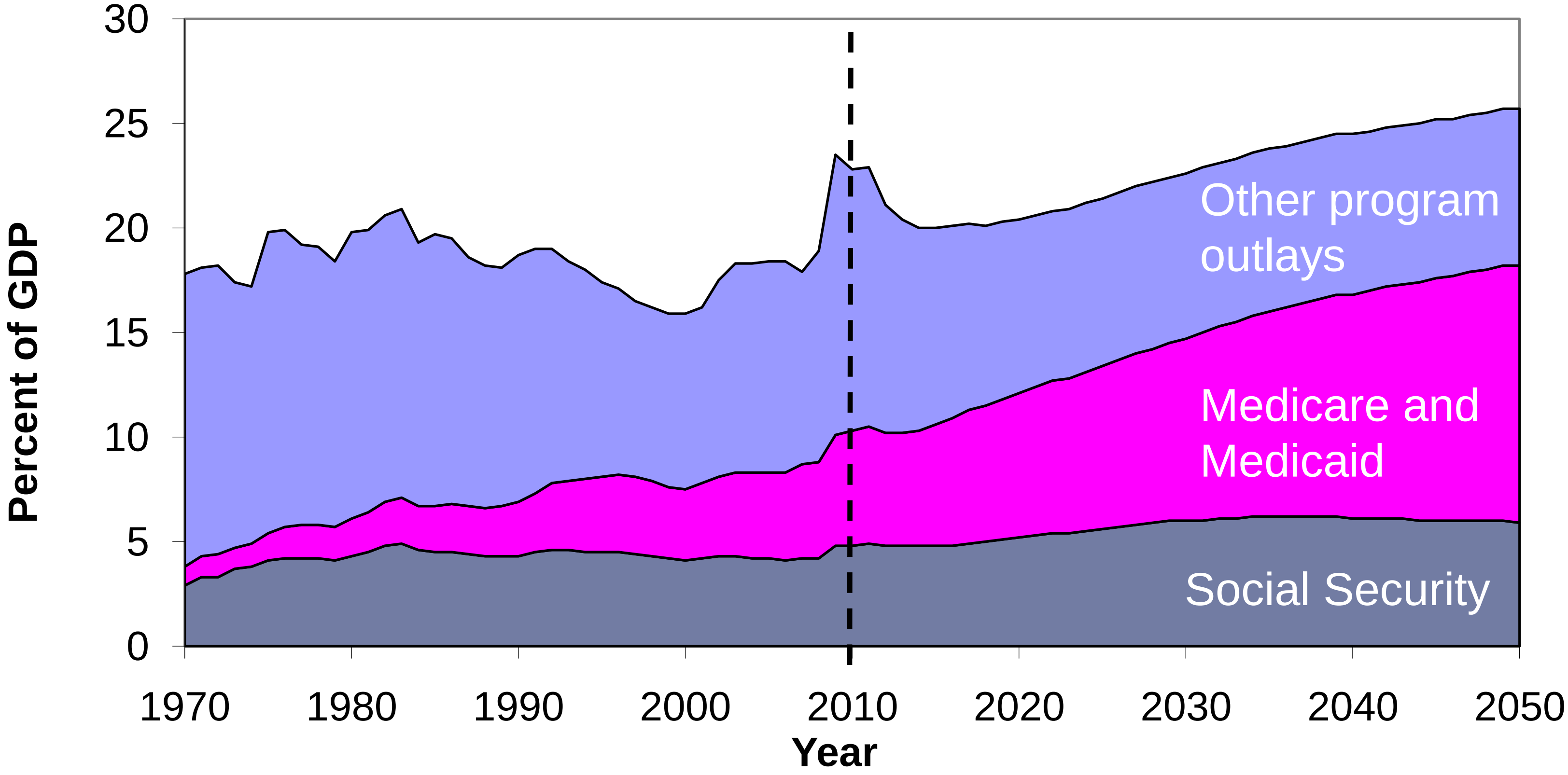


Source: Congressional Budget Office. 2010c.

Long-term Budget Outlook

- Less than 40% of federal outlays subject to annual appropriations and control
  - Will fall to a projected 30% by 2020
- Rising health care costs and Social Security will dominate long-run budget outlook
  - Almost all increase in outlays accounted for by rise in spending on medical care

Projected Federal Expenditures, 1970-2050



Budget Expenditures By Major Category, 1980-2020

	Discretionary Spending	Mandatory Spending	Net Interest	Total Outlays
1980	10.1	9.6	1.9	21.7
1990	8.7	9.9	3.2	21.8
2000	6.3	9.8	2.3	18.4
2008	8.0	11.2	1.7	20.9
2010	9.3	13.1	1.4	23.8
2015	7.7	12.4	2.6	22.8
2020	7.0	13.6	3.4	23.9

Source: CBO 2010c, Current Law Baseline

Note: 2015 and 2020 reflect CBO assumption that economy has returned to full employment and short-term interest rates will rise back to 5%.

Options for Expenditure Reductions

- Population aging and health care costs are driving forces behind budget challenge
- Social Security
  - Not a contributor to medium-term fiscal problems…
    - but faces long-run financing deficit equal to nearly 2% of taxable payroll.
  - Choices are simple (increase contributions, reduce benefits, or combination)…
    - but intensely political and technically complex.

Options for Expenditure Reductions

- Medical care programs
  - Same demographic problems as Social Security…
    - but additional pressure from historic trend of increases in costs per enrollee in excess of average growth in per capita incomes.
  - Dominant source of rise in budget outlays (will double as share of GDP between 2000 and 2020)
  - Key to achieving budget saving is slowing rate of excess cost growth…
    - but slowing growth is not straightforward and enacting cost containment measures has been highly unpopular.
    - Measures to introduce various forms of rationing to control costs have been strongly opposed in U.S.

Options for Expenditure Reductions

- Other spending programs
  - Defense spending has grown rapidly in recent years
    - Sharply reducing operations in Afghanistan and Iraq could cut discretionary spending by ½ - ¾ percent of GDP
  - Nondefense discretionary spending has held constant (except for stimulus program)
  - Wide range of budget options
    - Need review mechanism to generate cost savings

Revenue Outlook

- Under current law baseline
  - Revenues increase rapidly to historic high of 21% of GDP in 2020
  - Almost doubling in proceeds from individual tax
    - Expiration of Bush tax cuts, expansion of AMT, real bracket creep, projected increase in taxable retirement income, recent health care legislation, revenues associated with projected economic recovery
- What if Bush tax cuts do not expire?

Increase in Deficit under Current Policy Baseline

Percent of GDP

	2011	2015	2020
Current law baseline deficit	**-7.0**	**-2.7**	**-3.0**
Extend Bush tax cuts	-0.8	-1.7	-2.1
Index the AMT	-0.5	-0.3	-0.6
Extend other expiring tax provisions	-1.3	-1.4	-1.6
Current policy baseline* Extend Bush tax cuts, index AMT, and extend other expiring provisions	**-2.6**	**-3.9**	**-4.8**
Current policy deficit	**-9.6**	**-6.6**	**-7.8**

Source: CBO (2010c), Table 1-7.
*Note: Figures do not add due to interactions effects between extending the tax cuts and indexing the AMT.

Options for Revenue Increases

- Increase individual income tax rates
  - Raising substantial revenue from current individual tax system requires marginal tax rates that are politically infeasible
  - Example:
    - Raising revenue to reduce deficit to 3% of GDP by 2015 under current policy baseline requires a 30% across the board increase
      - Protecting low and moderate income taxpayers from these marginal tax increases requires top two rates to increase to 84 and 89 percent (from 33 and 35 percent)

Options for Revenue Increases

- Increase individual income tax rates
- Increase revenues from corporate tax
  - Especially difficult in global economy
    - U.S. already has second highest statutory corporate rate
  - Will do little to buy down deficit

Options for Revenue Increases

- Increase individual income tax rates
- Increase revenues from corporate tax
- Tax expenditure reform
  - In 2011, will total more than $1 trillion --- more than ¾ of revenue forecasted to be raised from income tax
  - Broadening base will raise revenue, simplify system, increase transparency, enhance efficiency, improve fairness
  - Biggest expenditures are the most popular…
    - but are the ones that must be cut to raise significant revenue

Options for Revenue Increases

- Increase individual income tax rates
- Increase revenues from corporate tax
- Tax expenditure reform
- Adopt the VAT

Adopt the VAT

- U.S. only OECD country without VAT
  - virtually only country in world without VAT!
- VAT could help address medium and long-term shortfalls
- Benefits
  - Efficient tax
  - Can adopt best practices from around the world
  - Can use portion of revenues to lower income tax rates
  - Would reduce pressure on measurement of income and income shifting
  - Could stimulate economy if pre-announced
  - Could lead to improvements in sales taxes at state levels

Adopt the VAT

- Concerns
  - Distributional effects
    - Regressive when measured as percent of current income
    - Regressivity could be relieved through refundable credits run through individual income tax
  - Revenue impact
    - Both base and rate matter for revenues
    - Five percent VAT on broad base could raise 2.3 percent of GDP
      - Adding refundable credit would decrease this revenue gain to about 1.4 percent of GDP

Adopt the VAT

- Interaction with the states
  - States would view VAT as intrusion on traditional sales tax base
  - Canadian experience particularly relevant to U.S.
    - All provinces but one had retail sales taxes similar to those found in U.S. states when Canada adopted VAT in 1991
    - Some have converted to VAT with federal base, some have converted to VAT with provincial base, some have kept sales taxes
    - While a bit messy, functions well
  - Existence of state sales taxes should not be relevant to decision of whether to adopt a VAT
  - Could lead to improved state sales taxes

Options for Revenue Increases

- Increase individual income tax rates
- Increase revenues from corporate tax
- Tax expenditure reform
- Adopt the VAT
- Environmental taxes

Environmental taxes

- Potentially significant revenue source
- Addresses important environmental externality
- Congress and President have put forward cap-and-trade proposals
  - But have either given away revenue or used it for purposes other than deficit reduction
- Raising tax on gasoline may be more feasible
  - Would also correct an environmental externality
  - With state and local taxes, current average tax rate is about 40 cents per gallon for gasoline and 47 cents per gallon for diesel
  - 50 cent per gallon increase would generate about .4 percent of GDP

Options for Revenue Increases

- Increase individual income tax rates
- Increase revenues from corporate tax
- Tax expenditure reform
- Adopt the VAT
- Environmental taxes
- A package of reforms
  - Broaden the individual and corporate tax base (raise 2% of GDP)
  - Add a 5 percent VAT with rebates (raise 1.4% of GDP)
  - Raise gas tax by 50 cents (raise .4% of GDP)

Conclusions

- Weakness of recovery makes it difficult to decide when to begin to address budget deficit
- Continuation of current policy will lead to rapid growth of public debt as share of GDP
- Balancing budget will require large structural changes in expenditures and revenues
- U.S. will need to consider broader range of new revenues sources including VAT and environmental taxes