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POLICY BRIEF

RECOMMENDATIONS FOR THE NEW ADMINISTRATION

U.S. Fiscal Policy

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One of the most important issues currently confronting the United States is the unsustainable nature of current fiscal policy. In the absence of meaningful reform, current policies will lead to growing budget deficits, long-run increases in the debt-to-GDP ratio, reductions in economic growth, and a less competitive U.S. economy. The Congressional Budget Office's long-term budget outlook shows that in 2016 spending is 21.1% of GDP and revenue is 18.2% of GDP. This implies a deficit of 2.9% of GDP. Over the last 50 years (1966–2015), spending was 20.2% of GDP and revenue was 17.4% of GDP. Thus, in 2016, spending is 0.9% higher and revenue is 0.8% higher than the 50-year average. By 2046, CBO projects that current policies imply that spending will increase to 28.2% of GDP while revenue will increase to 19.4% of GDP. This implies a deficit equal to 8.8% of GDP and a debt-to-GDP ratio of 141%. The rapid growth in the deficit and debt over the next three decades is caused by projected increases in spending on Social Security, Medicare and other health care programs, and interest payments on the government debt. Social Security expenditures are projected to increase from 4.9% to 6.3% of GDP. Government health care expenditures are projected to increase from 5.5% to 8.9% of GDP. Interest payments on the debt are projected to increase from 1.4% of GDP to 5.8% of GDP. Other non-interest, non-entitlement spending is projected to decrease from 9.2% of GDP to 7.3% of GDP. The projected increase in Social Security and health care expenditures is related to demographic changes as the baby boom generation ages, as life expectancy increases, and as health care costs per beneficiary grow faster than GDP.

It is obvious that closing this fiscal gap (the difference between spending and revenues) will require either a reduction in spending or an increase in revenues. While we cannot count on GDP growth alone to close the fiscal gap, increasing GDP growth will reduce the amount that spending must be cut or revenues increased to close the gap, and thus should be a primary concern in addressing the unsustainability of current fiscal policy.

In the United States, several groups have published ambitious plans for fiscal reforms that are designed to address the debt issue through various combinations of expenditure reductions and revenue-increasing tax reforms. These plans typically require sizable reductions in expenditures, which could only be accomplished by major entitlement reform.

These plans also propose an increase in revenues. Note that individual income tax revenue as a share of GDP is projected to increase significantly even before any policy changes are adopted to address the unsustainable nature of the U.S. budget. CBO projects that individual income taxes will increase from 8.8% of GDP in 2016 to 10.5% of GDP in 2046. The growth in revenues is a result of individuals being pushed into higher tax brackets over time as nominal income grows faster than the tax bracket income cutoffs. Unfortunately, these built-in tax increases are negligible relative to the projected increases in

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spending. Whether revenue as a share of GDP remains at the projected level or is increased as part of a grand bargain, it is imperative that the United States reform its tax system to reduce economic distortions and maximize economic growth. Otherwise, the combination of rising taxes as a share of GDP and a relatively distortionary tax system could significantly hamper economic growth. This is particularly important given that, in general, the efficiency costs of economic distortions increase exponentially with the rate of tax.

Indeed, the income tax system in the United States is ripe for reform. The last fundamental reform of the system was the much-celebrated Tax Reform Act of 1986 (TRA86), which followed the classic model of a base-broadening, rate-reducing reform that financed significant corporate and personal rate cuts with the elimination of a wide variety of tax preferences. However, since that reform the top marginal tax rate has increased to 39.6% (with an additional 3.8% rate applied to certain investment income) from the 28% top rate enacted under TRA86, while the number and value of individual tax preferences have grown substantially. The arguments for reform are the same as those made during the debates surrounding the Tax Reform Act of 1986 (e.g., McLure and Zodrow 1987; Diamond and Zodrow 2011): high individual tax rates coupled with widespread tax preferences inefficiently distort decisions regarding labor supply, saving, consumption patterns, and methods of compensation, significantly complicate administration of and compliance with the tax system, encourage tax avoidance and evasion, and result in a tax system that is widely perceived to be fundamentally unfair.

The corporate income tax in the United States is also ripe for reform. The statutory tax rate in the United States is now the highest in the world among the industrialized countries, we no longer have relatively low marginal effective tax rates, and most of our international competitors have moved to "territorial" tax systems, under which the foreign source income of their multinationals is exempt from domestic taxation—in contrast to the U.S. system under which such income is subject to a residual domestic tax. High statutory rates exacerbate all of the inefficiencies of the current tax system, encourage tax avoidance and evasion, and increase administrative and compliance costs. In addition, high statutory tax rates are especially harmful in the modern globalized economy, as they drive capital out of the country and create incentives for income shifting to lower tax jurisdictions that significantly reduces U.S. revenues.

With growing competition from abroad, the U.S. must reform its fiscal policy to reduce debt, maximize economic efficiency—including minimizing the distortions caused by the tax system—and maintain its areas of competitive advantage.

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