Myron Scholes Global Markets Forum

January 10, 2011

FACULTY PANEL ON BUDGET OPTIONS FOR THE U.S.

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WHY ARE WE HERE TODAY?
Federal Government Expenditures, % of GNP
Federal Government Transfers, % of GNP

- Social Benefits
- Grants to State and Local Govt
REASONS FOR DOING SOMETHING

A. Creating an unsustainable debt to gnp ratio:
   Raises borrowing costs
   Cause a financial crisis
   Creates uncertainty
   Slows growth
   Incentives to create unexpected inflation

B. Imposing costs on future generations by crowding out Investment, and/or reducing Net Foreign Assets

C. Reduce future flexibility for fiscal stimulus
CBO estimates extending Bush tax cuts will lower revenues by 1.2% of GDP in 2011 and 1.7% of GDP in 2012
\[ \Delta \left( \frac{\text{Debt}}{\text{GNP}} \right) = \frac{\text{Primary Deficit}}{\text{GNP}} - \left( \frac{\text{Debt}}{\text{GNP}} \right) \times (\text{Growth Rate of GNP} - \text{Interest Rate}) \]

2010 Debt / GNP: 62%

Predicted Change for 2011: 8% - .62 * (5.5% - 3.5%) = 6.8%

**Steady State**

Debt / GNP = \( \frac{\text{Primary Deficit} / \text{GNP}}{\text{Growth Rate of GNP} - \text{Interest Rate}} \)
Federal Government Surplus/Deficit (-), % of GNP
Growth in a Time of Debt*
December 31, 2009
Carmen M. Reinhart, University of Maryland, NBER and CEPR
Kenneth S. Rogoff, Harvard University and NBER

(i) The relationship between government debt and real GDP growth is weak for debt/GDP ratios below a threshold of 90 percent of GDP. Above 90 percent, median growth rates fall by one percent, and average growth falls considerably more. The threshold for public debt is similar in advanced and emerging economies.

(iii) There is no apparent contemporaneous link between inflation and public debt levels for the advanced countries as a group (some countries, such as the United States, have experienced higher inflation when debt/GDP is high.)
WHAT CAN BE DONE?

A. Cut expenditures, Raise taxes.

How much is a value judgment

Needs to include deadweight loss of taxation

Success in reducing the debt to gnp ratio is more likely

with increased reliance on cutting expenditures

Andrew G. Biggs, Kevin A. Hassett, Matthew Jensen
“A Guide for Deficit Reduction in the United States Based on
Historical Consolidations That Worked” AEI Economic Policy Working
Paper 2010-04, December 27, 2010
WHAT CAN BE DONE?

B. Increase efficiency to minimize pain

   Eliminate tax expenditures

   Deduction for Mortgage Interest

   Employer Contributions for Health Care

   Deduction for Local Taxes

   Deduction for Charitable Contributions

   Change form of taxation; switch from income to consumption

   Predictability and constancy of tax rates

   Reduce Government Employment
Projections of Forgone Revenues from Selected Individual Income Tax Expenditures, Fiscal Years 2009 to 2013

(Billions of dollars)

- Deduction of Mortgage Interest on Owner-Occupied Residences
- Exclusion of Employer Contributions for Health Care, Health Insurance Premiums, and Long-Term Care Insurance Premiums
- Reduced Rate of Tax on Long-Term Capital Gains and Dividends
- Net Exclusion of Contributions and Earnings for Defined-Benefit Pension Plans
- Earned Income Tax Credit
- Deduction of Nonbusiness State and Local Government Income Taxes, Sales Taxes, and Personal Property Taxes

Source: Staff of the Joint Committee on Taxation.

a. Estimate does not reflect enactment of the Patient Protection and Affordable Care Act (Public Law 111-148) and the Health Care Education Reconciliation Act of 2010 (P.L. 111-152).
Net Value Added by Sector

- Govt
- State and Local Govt
- Federal Govt
Employment by Sector

- Govt
- State and Local Govt
- Federal Govt


Percentages: 0%, 5%, 10%, 15%, 20%, 25%
Govt Compensation of Employees

% of Total

%  
0% 10% 20% 25%

WHAT CAN BE DONE?

C. Establish Rules

Democrats: Must pay for tax cuts

Republicans: Must pay for spending increases

Modified Lazear Rule to limit expenditures as % of GNP
WHAT CAN BE DONE?

Lazear Rule:

In any year when the ratio of government expenditures to GDP exceeds 18% Congress could increase spending only by the last three years’ inflation rate, minus one percentage point.

In emergencies, Congress could pass a one-year suspension of the rule with a 60% vote of both houses. The base, then, would return to the budget levels of the year before the suspension.

Limit budget growth in any year that is under the target ratio to no more than twice the prior year's increase.

WHAT CAN BE DONE?

Lazear Rule Modification:
The 18% reference point can be changed if (i) The tax rates are credibly changed simultaneously and (ii) It hasn’t been changed in last 4 years.

Likely Outcome:
Means Tested Transfers
Allow Majority to Use Market Solution for Retirement and Health Care
HOW FAST SHOULD THINGS BE DONE?

Credibility more important than speed, though tied together
Decide now, changes implemented gradually

On Revenue Side Phase out:
  Mortgage Interest Deduction
  Employer Contributions for Health Care
  Deduction for Local Taxes
  Charitable Donations

On Expenditure Side Phase in:
  Increased Retirement Age
  Means Tested Social Security and Medicare Benefits
  Minimize Effects of Increase in Marginal Tax Rate

Utilize Employer Based Voluntary Retirement Accounts
HOW FAST SHOULD THINGS BE DONE?

Lazear Rule:

Congress should begin by enacting a budget that brings spending for fiscal year 2012 at least halfway back to where it was in 2008.

Such a rule would get us back to 2008 ratios by fiscal year 2014.

HOW FAST SHOULD THINGS BE DONE?

White House's deficit-reduction commission report, "The Moment of Truth" from Democrat Erskine Bowles and Republican Alan Alan Simpson, who head the National Commission on Fiscal Responsibility and Reform

“U.S. deficit-panel chiefs urge big changes in spending, taxes”  
*Wall Street Journal*, Dec 2, 2010

The proposal would achieve nearly $4 trillion in deficit reduction through 2020, reduce the deficit to 2.3% of gross domestic product by 2015, overhaul the tax code, cap government revenue at 21% of GDP and reduce debt to 40% of GDP by 2035, the co-chairmen said.
Total Revenues and Outlays, Fiscal Years 1970 to 2020

(Percentage of gross domestic product)

Source: Congressional Budget Office.

Source: Trends in Federal Tax Revenues and Rates
Statement of Douglas W. Elmendorf Director of Congressional Budget Office before the Committee on Finance United States Senate December 2, 2010
## CBO’s Projections of Federal Debt, 2010 to 2020

(Billions of dollars)

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<th>Actual</th>
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<td>Debt Held by the Public at the</td>
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<tr>
<td>Beginning of the Fiscal Year</td>
<td>7,545</td>
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<td>Changes to Debt Held by the</td>
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<td>Public:</td>
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<td>Deficit</td>
<td>1,294</td>
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<td>Other means of financing</td>
<td>179</td>
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<tr>
<td>Debt Held by the Public at the</td>
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<tr>
<td>End of the Fiscal Year</td>
<td>9,018</td>
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<tr>
<td>Debt Held by Government Accounts</td>
<td>4,509</td>
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<tr>
<td>Gross Federal Debt</td>
<td>13,527</td>
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<tr>
<td>Debt Subject to Limit(^a)</td>
<td>13,511</td>
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**Memorandum:**

Debt Held by the Public as a Percentage of Gross Domestic Product

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<tr>
<td>62.2</td>
<td>65.7</td>
<td>68.1</td>
<td>68.1</td>
<td>67.0</td>
<td>67.1</td>
<td>67.5</td>
<td>67.8</td>
<td>68.1</td>
<td>68.6</td>
<td>69.2</td>
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</table>

Source: Congressional Budget Office.

\(^a\) Differences from gross federal debt primarily because most debt issued by agencies other than the Treasury and the Federal Financing Bank is excluded from the debt limit. The current limit is $14,294 billion.

Source: Federal Debt and Interest Costs – A CBO Study

December 2010