Tax Policy, the Current Economic Climate, & the Long-Term Fiscal Crisis

Daniel Shaviro
NYU Law School

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The short-term vs. the long-term crisis

St. Augustine: “Give me chastity & continence, but not yet.”

U.S. budget problems verge on being the exact opposite.

We need “laxity” now to address an ongoing down economy & almost 10% unemployment as Americans go through painful deleveraging.

And we need budgetary “chastity & continence” – i.e., massive retrenchment to head off unsustainable public debt explosion – in the future. (Better still, credibly announce both at the same time.)

But instead, we get calls for austerity now, alongside little willingness to face hard long-term choices.

St. Augustine in reverse?

This critique especially applies to the spending side.

Note the calls for large 2011 spending cuts, whereas restraining Medicare growth = “death panels.”

Tax may be performing slightly better given 2010’s year-end budget deal.

But will any of the unsustainable long-term tax cuts be allowed to expire?

And will further short-term stimulus (such as the payroll tax holiday) be permitted, and at what price, if late-2011 macro-economic conditions warrant?

Taxes generally rise with income; stimulative bang-for-the-buck generally falls with income.

The long-term fiscal problem

Without more, dire projections (like those we've just seen) are merely "statements about statements."

That is, you take a bunch of statements concerning projected policy, add them all up, & prove Herbert Stein's law ("That which cannot happen, will not happen.")

The real problem is not where we're currently headed as such, but the difficulty of changing course (& arguable unlikelihood that we will before things get needlessly ugly).

A "Matryoshka doll" problem of one problem nested inside another? (Though with just 3 of them.)

The first “doll”: demographics & technology

All economically advanced nations have significant retirement & healthcare programs.

US: Social Security, Medicare, Medicaid, income & payroll tax benefits for employer-provided health insurance.

Rising cost profile no surprise with an aging population ...

… reflecting lower birthrates (a byproduct of affluence) & rising life expectancies.

Technology: new treatments improve care but are costly; does the trend reflect incentives in the healthcare industry?

No surprises here – so why shouldn’t smooth policy adjustments take care of it?

The second “doll”: political economy

Many (including me) would argue that our political system has grown gravely dysfunctional & can no longer respond to problems as in the past.

Cf. the bipartisan tax/budget policy triumphs of 1982, 1983, 1984, 1985, 1986, 1988, and 1990.

Clearly the Republicans have changed since then – an important sociological story that remains poorly understood - & with likely implications for how Democrats play the game.

Not just “partisanship” but social discord is rising, undermining cooperative norms & yielding pervasive chicken games at the political party, interest group, & individual voter levels.

But how should financial markets respond to this?

The third “doll”: financial markets

You’d think the bond markets would get nervous & that U.S. borrowing rates would gradually rise.

While this isn’t good as such, at least it offers a signal, helping to encourage a course adjustment before the debt-to-GDP ratio reaches the stratosphere.

But the “bond vigilantes” have been silent about the long-term problem.

Partly from the short-term “flight to quality” (e.g., would you rather invest in Euros?).

But is a wise and farsighted optimism also at work? (Who’s to say the political system *won’t* solve things in time?)

Why no financial market response?

“The markets know best” might have been a more credible position before the 2008 financial markets meltdown.

Repeated bubbles lately (recall Internet stocks before real estate).

A fundamental structural feature of today’s financial markets? Powerfully reinforced by key market actors’ incentives, not just myopia.

Raising the prospects for a very bumpy “hard landing.”

Perhaps there’s a 4th nested “doll” after all.

“I’m Chucky, Wanna play?”

Tax policy implications

At some point, taxes must and will go up …

… although note that repealing tax expenditures isn't substantively a "tax increase" (even if experienced as one).

Possible implications for new tax instruments & existing ones.

New taxes: plenty of ideas out there. E.g., VAT, carbon tax, Tobin or turnover tax on financial transactions.

Existing taxes: also lots of reform ideas. E.g., base-broadening, shift to progressive consumption tax, corporate integration, lower the corporate rate, adopt territorial system.

All *good* ideas should be adopted even in a revenue-neutral setting, but how might the need for revenue affect actual outcomes?

New tax instruments

Adopting carbon taxes is desirable (if other countries follow suit) even if one gives away the revenue.

VATs' advantages are such that ALL of our peer countries have them (not just Europe).

I'm personally a skeptic about Tobin taxes (see Shackelford, Slemrod, & Shaviro 2010), but they have supporters.

Surely revenue needs enhance *long-term* chances of adoption, but 2 key issues to resolve:

(a) What do new taxes pay for? E.g., entitlements vs. income tax rate cuts in a 1986-style tax reform. (Note the Graetz plan.)

(b) How does one deter Congress from spending the new revenue? (Use trust funds or other earmarking?)

Fundamental tax reform

Within the income tax, often defined as swapping (a) tax expenditure repeal for (b) lower marginal rates.

Fiscal pressures may help to motivate (a), but weaken the case for using the revenue to pay for (b).

If tax reform "isn't that good an issue" politically (as per Dick Gephardt in 1986), is it better to focus the case for TE repeal on raising needed revenue?

If politically wrenching revenue-neutral tax reform seems diversionary & even self-indulgent in the face of a huge fiscal gap, this is also bad news for shifting to a progressive consumption tax.

Other tax reform ideas

Lots of good ideas for changing business taxation look like revenue-losers, all else equal.

E.g., (a) corporate integration, (b) lower the U.S. corporate tax rate in response to global tax competition, (c) adopt territorial system if source rules can be adequately improved.

In principle, desirability of these changes has *nothing to do* with overall revenue needs. (Should assess in a revenue & distribution-neutral framework.)

But in the real world of politics, things are not so simple. Pay-fors are tricky to adopt & irresponsible to defer.

Tax policy costs of the long-term fiscal crisis include reduced flexibility.