Tax Reform Implications of the Risk of a U.S. Budget Catastrophe

Daniel Shaviro

NYU Law School

Presentation for Louisville Law Review Symposium, 10/22/11

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.

The long-term fiscal problem

Especially after the deliberate near-default of mid-2011, it's hard to deny the possibility of a catastrophic budget crisis.

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

First doll: demographics & technology (rising life expectancies, baby bust, unsustainable healthcare growth relative to GDP).

But this is predictable: everyone sees it coming; in principle easy to adjust.

Second doll: severe political dysfunction (Republicans have gone mad; broader collapse of cooperative social norms at the political party, interest group, and individual voter levels).

Third doll: financial market response may be sudden & discontinuous.

Tax policy implications

The risk of a budget catastrophe casts an important shadow over tax policy.

I swiftly discuss (w/ 25-page cap) 2 main categories: the existing income tax, & some possible new tax instruments.

The obvious point: repealing income tax expenditures can raise A LOT of revenue (an estimated $1.3T in 2011).

Three less obvious points: (a) In general it's correct that TE repeal should be viewed as "cutting spending," not as "raising taxes."

(b) But – strangely enough – this means we actually need to think about what "taxes" & "spending" might mean. Some official TEs probably aren't (and this is NOT a matter of "rules I like").

(c) In current circumstances, 1986-style tax reform – using TE repeal to fund lower rates – makes no sense (at least for individuals).

Just say no to1986-style tax reform

Why would we cut individual income tax rates as part of a base-broadening process dedicated to addressing the fiscal gap?

NOT to overly avoid increasing “taxes” if TE repeal is best classified as a spending cut.

The only good reason would be if it’s sufficiently better policy to be worth the tradeoffs elsewhere in the budget.

My view: it’s not: (a) political process too flawed to support giving away “low-hanging fruit” (budgetary gain from repealing bad TEs).

(b) lots of good economic arguments that have gained prominence in the last 25 years may lower one’s estimate of the efficiency cost (if the base is suitably broad). See discussion in Shaviro, *1986-Style Tax Reform: A Good Idea Whose Time Has Passed*. 131 Tax Notes 817-842 (May 23, 2011).

(c) high-end distributional changes in the U.S. over the last 30 years.

Other possible revenue-losing income tax reforms

(a) Replacing the income tax with a progressive consumption tax – I support this in principle, but fiscal gap issues increase the political frivolousness of devoting much effort to this.

(b) Corporate tax reform: given global tax competition (re. investment & taxable income reporting), the case for 1986-style reform is stronger here than under the individual income tax.

But revenue is a big concern, better to address debt bias directly?, transition issue, effects on individual income tax (owner-employees).

(c) International tax reform: one can't seriously argue that the optimal tax rate on "resident" corps' foreign source income is 0 – but a case for exemption since the system is so bad (from deferral + FTCs).

But in that case, should address transition & the source rules.

New tax instruments

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

Adopting carbon taxes is clearly desirable if other countries follow suit. Short of that, coal taxes & increased gas taxes?

I'm personally a skeptic about Tobin taxes (see Shackelford, Slemrod, & Shaviro 2010), which do not coherently address an externality or other market failure, even though these may be rife in financial markets.

The IMF's financial activities tax (FAT) may be more promising, though design isn't challenge-free.

The idea: exempt the financial sector's "normal" return but tax high rates of return (even if paid out as executive compensation).

Two alternative rationales: tax on rents; tax on bets with hidden, low-probability tail risk that the bettors don't bear.

Concluding thoughts

A U.S. budget catastrophe is easy to avoid – but that doesn't mean it will be avoided. It depends on our political system.

Lots of budgetary improvement could result from repealing tax expenditures that are bad policy.

No particular reason to give away the budgetary improvement by lowering individual income tax rates.

Potentially revenue-losing income tax reforms that are easily affordable in theory may be harder to rationalize in practice, given pervasive flaws in our political system.

Various new tax instruments that could raise significant revenue look good on policy grounds (VAT, carbon tax, FAT).

Two closing quotes

(1) "The fault lies not in our stars, but in ourselves."

Demographic & technological changes – desirable on balance; who wouldn't want better (if costlier) healthcare and to live longer? – are not the problem, since in principle it's easy to respond.

(2) "What you mean 'we,' Kemo Sabe?"

The problem is pervasive political failure – but I certainly don't think it's MY fault!

Academics (e.g., my colleagues at this conference) have done a great job for years in analyzing and warning about these issues – unlike, say, mainstream economics & the 2008 financial crisis.

Let's keep up the good work & hope for the best (though I'm not very hopeful; cf. the political failure to address unemployment).