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Update on the Budget Deficit and Tax Reform -- transcript

Donald Marron and Alice Rivlin

Karen Dynan, moderator

Introduction

MS. DYNAN: Good morning. I'm Karen Dynan, vice president and co-director of the Economic Studies Program here at Brookings. It's really a pleasure to have the Forum Higher Ed group back at Brookings.

Many of you have been here before, but I just want to take a couple of minutes to acquaint those of you who don't know Brookings well with us. My co-director, Ted Gayer, and I have been overseeing the Economic Studies Program for about three and a half years. Our goal has been to bridge the research community, the policy community, and the real world. We do this in a couple of ways.

First of all, we hire scholars who have policy experience, and then support them as they do substantive research. We are an independent, nonpartisan institution. Brookings itself does not take policy stands or direct its research; instead, like a university, we hire scholars with a wide range of perspectives and tell them to go out and do excellent research. The product typically is excellent scholarship that does take a stand and has important policy implications.

The second thing we do is we convene. We think a really important way to have impact is to bring lots of people to the table, with the point being that we not only share our perspectives, but that we listen to other people about their ideas and concerns and have a conversation. The idea is that you're not going to move the policy needle unless you're working on issues that have widespread resonance.

I bring all of this up because I think it's relevant to what we're doing today. You're going to hear from several of our scholars, as well as from some of our friends, and you're going to get a variety of perspectives based on the research that we're doing. We're hoping it's going to be more like a conversation than a lecture. We're interested in hearing your thoughts, particularly given the critical bearing that higher ed has on the productive capacity of the economy.

So with that we're going to get started with our first session on the budget deficit and tax reform. It's a topic that needs almost no introduction given the massive amount of ink that's been spilled on the topic in recent months. But I will offer one set of intriguing statistics that came out of a National Journal Survey of Americans done last month. Eighty-three percent said that addressing the nation's debt and deficit problems should be a high priority for our country, yet almost half, 46 percent, said that raising taxes on all Americans would be not effective when it comes to getting our finances under control. People were happy to raise taxes on certain parts of the population, but 46 percent said it wouldn't be effective to raise taxes on all Americans, and almost two-thirds of the respondents, 64 percent, said that reducing Social Security and Medicare benefits would be not effective.

There are lots of ways to contain our deficit challenge, but these two ways I just mentioned are a central part of most experts’ plans for doing so. The statistics illustrate how tough it is politically, and highlight the importance of the work people like our panelists are doing with the policy community to get to a solution.

So, let me introduce our panelists. We have Alice Rivlin here. She is currently a senior fellow at Brookings but has held numerous important policy positions in the past, including being founding director of the Congressional Budget Office, director of the Office of Management and Budget, and vice chair of the Fed. In recent years she has played an important leadership role in a number of bipartisan deficit reform efforts.

We also have Donald Marron from the Urban Institute here. He is director of the Tax Policy Center, which is a joint venture between the Urban Institute and Brookings. Donald also has an impressive background in the policy world, including being a member of the President’s Council of Economic Advisors under George W. Bush and serving before that as acting director of the Congressional Budget Office.

Alice Rivlin

MS. RIVLIN: Thank you very much, Karen. You’ve been meeting here at Brookings since early 2009, and so you’ve heard a lot about the budget deficit and the debt and tax reform. You heard it initially in a much more difficult context though. In 2009, we were in a terrible economic downturn -- the economy was basically in freefall and nobody knew where the bottom was. So we're in much better shape now. The economy is growing. You'll hear more about that later. It isn't growing as fast as most of us would like, but it is well on the track to recovery.

But it is threatened, in my opinion at least, by not so much economic forces as political forces, that is, the failure of our political system to come to grips with several different economic problems, but especially the prospective long-run increase in the federal debt. This is not a new story, but our polarized political system has been in total disarray from the point of view of getting to a compromise that will stabilize the debt over time. The fact that we're in disarray, the fact that our government doesn't seem to be functioning to make quite obvious decisions, is very worrisome and is an economic threat in itself. How can you have confidence if you are a consumer or an investor here or abroad in a country that is run by a government that doesn't seem to be facing up to its basic problems?

So unless we can get this situation behind us, I think we endanger the future growth of the economy for political, as well as economic reasons, and we just look pretty foolish in the eyes of the world. I mean, we aren't the first country to be faced with a rising debt. They're all over the world and there are things that can be done about it. Karen's discussion of the poll is really interesting. Everybody wants to do something about the debt and the deficit but nobody wants to do the two major things that would help, namely raising taxes, raising revenue, and reducing the future growth of spending, which is driven by the entitlement programs.

Let me say briefly this morning what we ought to do, what we have done or mostly not done, and, finally, ask, where do we go from here? First, on what we ought to do. We actually ought to be paying attention to three economic objectives. First, we need to accelerate this recovery. It's not going fast enough to create enough jobs to bring down our unemployment rate to an acceptable level. Second, we need to invest in future growth. And if I say that to a group of educators you will know that part of what we need to do is invest in higher education in an efficient way, obviously. And invest in science and in many of the things that you do, as well as improve our infrastructure. Third, we need to stabilize the growth of our debt over time. What does stabilize the debt mean? It means the debt looking forward is not growing faster than the economy can grow.

We used to talk about balancing the budget. And back in the Clinton administration we actually did it. I never speak about this subject without reminding people that we actually had a surplus in the late 1990s. I think it's important to remember that because sometimes people feel hopeless and helpless and think that we'll always have a deficit. Well, we won't always have a deficit if we do the right thing.

But right now most of the people who are focusing on what we ought to do about the rising debt are not saying we ought to balance the budget. You may hear people say that but they haven't actually looked at the numbers very carefully to see what you would have to be be done. To do that in the near term would be very destructive. But what they are saying is, we need to get back into a sustainable situation in which our debt is not growing faster than our economy can grow. And that's just common sense. What that means with respect to the deficit -- the annual difference between what we spend and what we take in in revenue -- is that we shouldn't have a deficit that is bigger than the growth rate. That means we need to get this deficit from 9 or 10 percent down to around probably less than 3. We could live with a 1 or 2 percent deficit every year because with any luck on the growth rate, that would mean that we weren't adding to the debt faster than the economy can grow.

Why is that important? Well, it's important because if your debt is growing faster than your economy, it's an endless swamp. Eventually, you get to the point where you're having to raise taxes just to pay the interest on the debt before you can do the things that you want your government to be doing.

So we need to focus on these three economic objectives. Accelerating the recovery is controversial as to how we should do it, but at a minimum it means not having a severe shock to the economy at the moment, a negative shock such as we would have had if we'd gone over the fiscal cliff. The fiscal cliff was the prospect that if the Congress didn't act before the end of the year -- and they didn't but they came very close -- then we would have faced across-the-board tax increases. Everybody's income tax rate would have gone up. At the same time we would have faced mindless across-the-board spending cuts. The combination of those two things would have been a negative shock to this economy, which isn't growing as fast as we'd like it to, and would probably have thrown us back into a recession if it had been allowed to be sustained for a considerable period. The Congressional Budget Office predicted that it would throw us into a recession, and I think they may even have been underestimating. Those were model results, but the prospect of a U.S. government that couldn't even solve a problem it had created for itself might have been a damaging image that might have given us a bad market reaction.

Accelerating the recovery means at a minimum no austerity, and we dodged the bullet for the moment but only for the moment. I think sustaining the recovery really means getting this problem behind us so that we can get on with our lives, get on with investing and consuming, and doing the other things that we want our government to do.

Investing in growth means a lot of things as I said, like education and infrastructure and science. It must be effectively executed. Some of this will create jobs but just doing long-run investment to create jobs is not sensible. We need to do it in a way that actually contributes to long-run growth and we probably need to do it by transferring resources from some of the other things that we are doing, that are not so growth producing, to things that are.

What does stabilizing the debt mean? I think it means doing what has become known as a grand bargain or perhaps a not-so-grand bargain, but something that will give us a stable debt over the next few years and begin to bring the debt down in relation to the size of the economy. We did that after World War II and it's important to remember that. We ended World War II for very good reasons with a very large debt; a debt that was larger than the economy. And what did we do about it? We did not run surpluses in the federal budget very often. We ran a few small surpluses and a lot of small deficits and we grew the economy faster than the debt. It was very effective and it brought the ratio down from over 100 percent to something in the 30s. If you have a debt that's around 30 percent of your GDP, you're not in trouble. You can live with that and you probably don't want it much lower than that. The idea that you pay off the debt and don't have any is not sensible. It's useful to have these Treasury bonds that people can hold as safe assets in their portfolio.

But the reason we have to focus on a grand bargain is that as you look at the debt picture going forward, what you see is that federal spending is driven in the future largely by the fact that we are an aging population and we have promised health care to older people, and the cost of health care is high in the United States and it's been rising faster, as anybody who administers anything knows, than other spending. Medicare, Medicaid, and to a lesser extent, Social Security are driving federal spending. And if we don't do anything about it we will have spending that's rising faster than our economy can grow.

The discretionary spending, the appropriations, the stuff that Congress enacts every year, have not been growing faster than the economy and are not projected to. In fact, domestic discretionary spending on current projections will decline as a percent of the economy and probably the defense component will, too. That's not to say that discretionary spending can't be part of the solution. We are surely spending some money at the federal level both for defense and domestic programs that we could be spending better and make more pro-growth among other things. But it's not the source of the problem.

The source of the problem is those three big entitlement programs, and the reason that most people think we're going to have to slow the growth of the entitlement programs and get some more revenue from somewhere is that it's hard to see how we can accommodate the whole baby boom generation and their health care without growing the size of our government somewhat. Now, you will hear people say, "Well, why can't we go back to the average that we've had over the years of spending around 20 percent in a good year of GDP on the federal government? Can't we get back to that average which served us well over many decades?" Right, it did, but it was not a period in which we had such a large older population entitled to benefits. If you think we can get back to 20, 21 percent of our GDP -- and Donald may differ on this – then you think that we can reduce the benefits substantially and do a really good job of making health care more efficient and/or reduce the rest of what the government does quite drastically.

That didn't seem feasible to the two bipartisan commissions that I served on -- Simpson-Bowles and the one called Domenici-Rivlin. Each came up with very similar packages: reduce the rate of growth of the entitlements, freeze discretionary spending -- domestic and defense -- and reform the tax system in a radical way so that we can raise more revenue in a more pro-growth way and pay a part of that bill.

Now, what have we done? We've had a series of disappointments. Year after year, through 2011, 2012, we've seen a series of missed opportunities, starting with the failure of the President and the Congress to pick up the Simpson-Bowles report. They could have done that and worked out something at that time. There were numerous chances. There were the Biden talks. There were Obama-Boehner talks and there was the Super Committee, which had enormous powers and I thought might actually fix this. But none of these things worked. So what have we done? Well, we haven't done nothing; that's the encouraging part. The thing that some people forget is that at the end of the embarrassing debacle over the debt ceiling in August of 2011, we actually passed something called the Budget Control Act, which froze discretionary spending and saved what otherwise would have been spent from the baseline then in use, about a trillion dollars over 10 years. That's not trivial.

That bill also created the Super Committee, which had the charge to fix the debt or we will impose this thing called the sequester, this mindless across-the-board cut. And we had tax cuts expiring at the same time. Essentially, the Budget Control Act created this artificial thing called the fiscal cliff. We had just gotten past that with a compromise that increased some spending. It extended unemployment benefits, but it also increased taxes in two ways. One, it let the payroll tax holiday expire, which means that all working people will have some increase in their taxes, and two, much more controversially, it raised tax rates at the high end of the income scale. That over the next 10 years should pick up about $660 billion.

With the trillion that we got out of the Budget Control Act, and the $660 billion that we got out of what is called the Taxpayer Relief Act, we've picked up $1.6 trillion. It sounds like a lot, but out of what? Well, in the original discussions of Simpson-Bowles and Domenici-Rivlin, we thought we needed to save about $4 or $4.5

trillion to stabilize the debt. But then we were talking about stabilizing the debt at 60 percent of GDP, and now the debt is up around 73 percent of GDP. If we stabilize where we are now, that sounds pretty risk to me. It would mean saving probably an additional probably 1.4 trillion over time.

So what do we do next? We got by one cliff, but there are three more. There's the debt ceiling. There's the sequester, which is still in the law but postponed. And there's the fact that we didn't fund the government for the whole year, although there's a resolution that runs out for funding the government in February. The thing to be avoided is to bump from one crisis to another and not solve this problem.

What could happen? What ought to happen, I think, is the President and the leadership getting back to a not-so-grand bargain, but something that will raise revenues and slow the growth of entitlements and get us to some kind of stabilization.

We can talk later about whether this is likely to happen, but it's what ought to happen. And in the process we've got to come back to the question of tax reform. That's my lead-in to Donald. I've talked too long; Donald is going to tell you what our prospects are on that front.

Donald Marron

MR. MARRON: Thanks, Alice. It's a great pleasure to be here. Always happy to talk about this set of issues. I'm going to try to be not too pessimistic, recent experience notwithstanding.

I thought what I'd do is take a quick look back at where we are on tax policy and then do a look ahead as to where it appears the debate is going. As Alice already discussed, looking back, the big deal issue in tax policy was the fiscal cliff and the resolution of that. A lot of the media attention and commentary around the fiscal cliff on the tax side focused on the tax cuts that were originally enacted in 2001 and 2003 that were scheduled to expire at the end of the year, but then largely didn't. But one of the things I kept reminding people of is that there were a whole host of other tax issues in there as well: This was not just a fight about the so-called Bush Era tax cuts, it was also about the payroll tax cut; about taxes that were originally enacted as part of the Health Reform Act in 2010; about a long-standing issue of temporary tax cuts on the corporate side; about some temporary tax cuts that President Obama signed into law as part of the 2009 stimulus; and about issues having to do with the estate tax. There was a whole host of issues, and just this enormous uncertainty.

Essentially, the future of the entire tax code was uncertain going into the end of last year. The fiscal cliff deal actually resolved some of those uncertainties. So while it's fashionable as a budget wonk here in Washington to be really down on the fiscal cliff deal, I would say one positive thing about it from my point of view is that it's resolved some things that people have been fighting about for a decade. It hasn't resolved them in some deep, philosophical sense, but it's resolved them in the sense that they aren't now going to be front and center as people have tax reform debates.

Among the things that got resolved was the Estate Tax. The Estate Tax had been in a temporary state ever since 2001, with the rules guiding it being subject to expiration. What was passed in 2001 was scheduled to expire at the end of 2010. Then a deal was struck to get through the end of 2012. We now have a permanent estate tax, if you will. Quite obviously, nothing is permanent in Washington. Folks here can change things, but there is no longer any expiration associated with it. Now there's a $5 million exemption, and a 40 percent estate tax rate. Like it or not, that's resolved, at least for now.

Similarly, there's been a longstanding discussion about the alternative minimum tax, the dreaded AMT. Some of you may have had the pleasure or displeasure of experiencing it in your lives. The AMT became a much bigger issue with the passage of the tax cuts in 2001 and 2003, and Congress was worried that it was going to reach too many Americans, rising from roughly 4 million Americans to, according to our projection, possibly 20 or 30 million Americans if left undealt with. Congress dealt with it for many years by doing one- and two-year "patches," where at some point during the year, often well into the year, Congress would say, "You know what? We don't want the AMT to hit 20 or 30 million households. Let's just limit it to 4 million."

One of the things Congress included in the fiscal cliff was doing that permanently. Now there's a permanent patch to the Alternative Minimum Tax. It'll affect roughly 3-1/2 to 4 million households this year and then a slightly rising number over time. So, that also has been taken off a list of things that Congress has to grapple with every year or two. There are still some folks who dislike the Alternative Minimum Tax and would like to see it go away permanently, but the deal clears the deck for more discussion.

Third, as Alice mentioned, the fiscal cliff deal resolved the great debate about the 2001 and 2003 tax cuts. President Obama came into office wanting to extend the vast majority of those, but wanted to allow the cuts for high-income folks -- who he defined as singles earning more than $200,000 and married couples earning more than $250,000 -- to expire.

Obama didn't get everything that he wanted, but a significant amount of the tax cuts did expire. So the top tax rate is now 39.6 percent. That kicks in at $400,000, not down at the $200, $250 thousand level he had in mind. There are also some weird, inside-the-beltway provisions known as PEP and Pease, which in essence phase out the value of your personal exemptions and your itemized deductions if you're at a high enough income. Those kick in at around $250,000. And both capital gains and dividend tax rates rose from 15 percent to 20 percent for high-income folks. The president didn't get everything he asked for on that front, but did get a significant increase on taxes on high-income folks. As Alice said it's just short of $700 billion over the next 10 years.

And the payroll tax cut expired. That cut had always been intended as temporary. The great debate was when it would be allowed to expire, and the political winds and tealeaves lined up so that it will have expired after two years. I think there are a lot of Americans out there who are a little confused that Congress told them they solved this fiscal cliff thing and were only raising taxes on upper income people, but are nonetheless experiencing now, in January, smaller paychecks than they were last year because the payroll tax has come back in its full measure.

The taxes that often get overlooked that were enacted as part of the Health Reform Act -- there's a 3.8 percent tax on net investment income for high-income folks, and there's a 0.9 percentage point increase in the Medicare payroll tax on high income folks. Those went into effect as scheduled on January 1st with little debate. Those were, in essence, baked in the cake, but from a macroeconomic point of view they were certainly part of the fiscal cliff deal.

Some of the other issues were dealt with temporarily, including the credits that were originally enacted in 2009 under President Obama primarily aimed at low and moderate income folks. Of interest to this higher ed community in particular, is extension of the American Opportunity Tax Credit, which is intended to help folks with higher education -- not permanently, but for five years. And the one-year corporate extenders, temporary tax provisions that were out there, were extended for another year.

If you add up all those changes, what's happened? Well, one of my big criticisms and big concerns about the tax code was the ridiculous amount of uncertainty associated with it. It was hard to have a cogent discussion with anyone about what it meant to raise or lower taxes because you always had to calibrate, try to figure out which parts of the code you are assuming are permanent, and which are temporary. That variation is now much smaller. Large pieces of the tax code are now permanent by law, although again Congress can change them. There are still some residual uncertainties. The tax credits that were originally enacted in 2009 are only going to last another five years without further Congressional action. And there’s always this residual issue about the one- and two-year corporate tax breaks that extend a year at a time. But a lot of the uncertainty characterizing our tax code has been resolved at least. Again, my positive spin is that it’s also cleared the deck a bit of debates that we’ve been suffering through for a decade. That in principle should free up mindshare to focus on where we want to go rather than debating about things in the past. So, we’ve got a cleaner baseline.

The de rigueur, sort of budget-wonk-in-Washington perspective is also to note that you could view the fiscal cliff as one of a series of missed opportunities. We’ve been having this conversation in Washington for years now about how the expiration of X would provide the forcing event, either to lead to overall tax reform or a grand budget bargain. It turns out that doesn’t actually work or has not yet worked. I shouldn’t be overly pessimistic. Obviously, in principle the fiscal cliff deal could have been an opportunity for broader reforms. In practice, not so, which is like many other similar things that we’ve gone through.

One quick thing to note, that I’m not sure that many people have noticed yet, although it’s kind of straightforward if you think about the various provisions: President Obama came to office with a very explicit, very forthright goal of making the tax code more progressive. With the resolution of the fiscal cliff outcome it should be clear that he succeeded at that. On the high end of the scale, the Health Reform Taxes went into effect. Those taxes are almost entirely on folks earning $200,000 or more. And he got tax rates to go up on the high end, and the PEP and Pease provisions. So high-income folks are paying more in taxes, and face higher tax rates, than they did at the beginning of his term of office.

Similarly at the low end he succeeded in extending, at least for five years, a variety of things that reduce tax burdens and actually provide refunds in some cases to folks at the low end. Whether you love it or hate it, Obama has succeeded in making our tax code more progressive than it had been.

So now where do we go? What’s the outlook? Politically, you have to start with the observation that we’ve now lost a catalyst for tax reform. Again, this notion that the expiration of all these things would force us to come together and decide what we want the entire tax code to look like, and fix it up, and address all the things that are wrong with it -- that’s gone. There’s no big, forcing tax catalyst out there in the future. Even our policymakers, I think, share the view that our tax code remains a mess. It’s too complicated. It has a lot of bad incentives in it that many of them believe don’t raise enough revenue. It’s bad for the economy, a whole host of things.

But there also isn’t a lot of consensus about what we want our tax system to ultimately look like. As Alice described, there’s an issue about how big a government you want and then how much money you need to finance it, and Washington has not reached a consensus on that. Tax reform is a hard thing to do if you don’t know what your revenue target is. It’s really much easier to do, as in 1986, when people said, “Hey, let’s be revenue neutral but check the code.” Absent a consensus view about what revenue ought to be, it is hard to get tax reform really going.

One possible implication of that is that we see folks in Washington start talking this year in greater earnest about doing corporate or business tax reform. You saw in the campaign last year that both President Obama and Governor Romney put forward corporate tax reform plans. President Obama wants to lower the top rate, which is currently 35, percent down to 28. Governor Romney proposed lowering it to 25. Dave Camp, the chair of the Ways and Means Committee in the House, also has been talking about lowering the rate to 25 percent. By the standards of things under discussion in Washington, I view the difference between 28 and 25 as a really small difference, which kind of suggests 26.5. There is a quite broad, across-the-board spectrum, including many Democrats and many Republicans, who believe that our top corporate tax rate is way too high.

The canonical talking point on that is that if you include state and local level corporate income taxes we're up around 39 percent combined in the United States, which is the highest in the developed world. People occasionally say it's the highest in the world, but someone told me recently that New Guinea has a higher corporate tax rate. But in any case, it is the highest in the developed world, and that is distortionary. It has economic effects here at home, and it also creates a big incentive for companies to engage in all sorts of things that involve lawyers, accountants, finance companies, and very small island nations, to move income and expenses around in order to avoid U.S. taxes.

I think there is a broad interest in doing corporate tax reform, but it suffers from a problem that all tax reform does, which is that it's easy to get up and talk about the goodies, the lowering the rates, but it's very hard to explain how you're going to pay for it. President Obama wants to go revenue neutral, either corporate or business tax reform. Many Republicans have talked about doing something similar, but if you're going to lower rates, that's going to cost revenue and you're going to have to fill it in somehow. At this point, politicians reach in their pocket and they pull out the word "loophole," and they say let's pay for this by rolling back loopholes. The challenge is, actually, despite all its many flaws and things we in the tax policy community would do to improve it, there aren't actually that many loopholes in the world. The vast majority of challenges in the tax code are consciously chosen social and economic policies -- the treatment of depreciation, a desire to subsidize manufacturing, a desire to subsidize alternative energy, a desire to subsidize fossil fuel energy. And on and on. There are a few narrow ones that seem goofy and loophole like. There is special treatment for NASCAR venues, for example, which doesn't seem to make a lot of sense, seems purely politically motivated. But by and large the big money is in tax provisions that have been chosen and identified for some social economic purpose. They might not make sense, and there might be a better way to pursue those goals, but calling them loopholes doesn't actually work when you get around the table and you try to figure out how to do reform. President Obama, in his proposal, identified specific provisions that might have paid for about 10 or 15 percent of the cost of lowering the corporate rate from 35 to 28 and left the rest unspecified. There's just a very big gap there. So it's a hard thing to do but I wouldn't be surprised if we end up spending a decent chunk of this year at least talking about it.

In addition, there's a whole separate set of issues which I'm happy to discuss in Q&A, although they become ridiculously complicated, having to do with the way we tax multinational corporations and the issue of how to tax their earnings overseas. That's another topic that will get a great deal of discussion.

On the individual side -- and this may just be me projecting -- the vibe I get is one of policy fatigue from fighting about the Bush Era tax cuts forever, fighting about the AMT, fighting about the estate tax, the fiscal cliff deal. That's resolved for the moment and we can all take a deep breath, it's a little hard to build up the enthusiasm for touching all of those things again. Particularly since tax reform is often framed as this idea of broadening the base and lowering the rates, yet the President just signed into law an act that raises the top rate to 39.6%. It's hard to see how the political system comes together to do a deal in which he lowers that back down. That's not impossible, but there's a lot of fatigue on that front. On the other hand, there is still interest in the notion that our tax code has too many preferences in it. Again, the politicians call them loopholes but they're really broad-based social policies. We have very large tax subsidies for health insurance, for mortgage interest, for charitable giving, for state and local taxes, for our saving for retirement. All of those deserve a second look to think about ways to make them more efficient, to make the distributional implications of them look more reasonable, and to possibly to raise money. So we'll see discussion of all that, but it's hard to see how we get to yes on that front.

Outside the box, in the policy wonk chattering world, the idea of a carbon tax has sort of caught fire. That's probably a bad metaphor. People who are brought up and trained in economics all sort of impulsively like the idea of taxing bads rather than goods. If you grab a random economist they're almost always in favor of taxing things we don't like, to discourage them, rather than taxing things we do like, like working, saving, and investing. Post Hurricane Sandy, and I don't know how many you've noticed but, a couple weeks ago Australia was forced to add colors to its weather map because its now hotter there than it has ever been before, so they had to add pink and purple. I'm not a climate scientist, and I'm sort of humble about to what extent we can connect the dots from any particular climate event to any particular forcing, but there does seem to be a rising sense of concern in the policy community about climate change, and a rising sense that a carbon tax offers a lot of attractive ways of dealing with it.

The idea that politicians in the United States are about to embrace a carbon tax is not something I'm here to sell you today. It is a hard sell on the Republican side of the aisle for all the traditional concerns about taxes, and it is a hard sell on the Democratic side of the aisle in part because of concerns about taxes, and in part because of painful memories of trying to do energy taxes back in the 1990s. So it's not as though we're all going to burst out and have a carbon tax by the end of the year.

Nonetheless, it is something that the policy wonk community is talking more and more about, and it is something that be a "two birds, one stone" sort of thing: It could raise a significant amount of revenue in a way that isn't part of the traditional fight over the tax system. That revenue could be used for deficit reduction or it could be used to help finance some of the other reforms that people want to make. There's interest, for example, in combining a carbon tax with doing corporate tax reform or at least bringing down the corporate rate. It's something that's attractive to the center right of the political spectrum, if you will. It has significant distributional challenges. If you think about it, a carbon tax would be regressive -- it would hit low-income folks harder than high-income folks, and cutting the corporate income tax, while it would benefit all Americans, would benefit high-income systematically more than low-income Americans. So there's a distributional concern for doing that kind of swap, but it is something I would expect that at least in policy circles you'll hear more about this year.

The basic story is there's plenty to do in the world of tax and budget. We've got to figure out where we want to be, how big we want our government to be. We have to figure out how to finance it. As Alice said, if we decide we want a government that's 22 percent of GDP at the federal level, we're going to have to raise revenues that are at least 19 or 20 percent and then scale it up. We're probably not talking about a great, grand bargain plan to balance the budget anytime soon, but we really do need to get back to a world in which we pay for all of our primary spending and at least some of the interest so the debt doesn't grow faster than the economy. Again, there's still lots to do on tax reform, and I'm happy to hear what's on your minds.

Discussion

SPEAKER: Can you talk about employment and the cost that that imposes on the economy? If we were to grow out of this current recession or, in Dr. Rivlin's words, "accelerate this recovery from the recession," what impact does just being at full employment have on the deficit? There's no question that not having those people working and paying taxes, plus paying them unemployment benefits -- all those things add to the deficit.

MS. RIVLIN: Well, full employment helps, and the faster the economy grows, the more tax revenue we raise, and that helps on the deficit. But remember, recovery is already built into the forecast. There is a dispute about what the potential growth of the economy going forward is. My friends at the Congressional Budget Office are a little more pessimistic than some people about the potential growth. But even if you assume recovery and reasonable growth going forward, we've still got the problem of the debt rising faster than the economy. It's still there. It doesn't go away. There is no feasible growth rate that would solve this problem by growth alone.

MR. MARRON: Economic growth is the number one best thing one could have to deal with these issues, but there's no scenario -- absent Chinese-like growth rates -- that seems to be a way to address the long-run challenges by itself. I would say in many ways the best thing would be unexpectedly strong economic growth so that we wake up one morning and are surprised with the tax revenues coming in. It turns out, in general, tax revenues grow faster than the economy, so if you get strong economic growth, you get extra strong revenue growth and that would be great.

MS. RIVLIN: We had that in the 1990s. One of the reasons that we got to a surplus then was not that we had intended to get to a surplus. We were intending to balance the budget, but the economy grew faster than our assumptions had predicted.

MS. DYNAN: Can I build on that question a bit? Economists talk about why it's undesirable to have a rising debt-to-GDP ratio, and how high it can get to be. What are your thoughts on that? What do you see as the worst of the bad things that could happen if our debt-to-GDP ratio doesn't stabilize?

MR. MARRON: I don't know if I want to go to the worst of the bad that could happen because then I'll be talking about Zimbabwe or somewhere. The United States is blessed, for a whole host of reasons, to have the reserve currency of the world — people want to buy our Treasuries. It's not as though we're in a great fiscal crisis today. You know, if we continue on this trajectory there may well come a time when we start having to pay higher interest rates, which then start to balloon on themselves and we feel like the world financial markets are punishing us for being profligate. But we aren't there yet, which is actually one of the reasons why these issues are relatively harder to address.

For me, I would say one of the lessons of the last few years is that there is no federal rainy day fund. It's hard to get states to have rainy day funds. At the federal level we have no rainy day fund except our ability to issue vast quantities of debt, which we have done. Right?

So it started raining back in mid-2007, and since then we've issued vast quantities of debt and the debt-to-

GDP ratio has gone up from 40-ish percent to 70-ish percent. And what happened to interest rates? They plummeted. Now, there are a whole host of reasons for that, but it was good to be in that circumstance. I think if you take the long view, the goal is to make sure that we are in a financial situation such that when the next storm comes we're going to be able to tap our rainy day fund, and at some point we have to build that back up. We know that a 40 percent debt-to-GDP ratio works. We were able to issue another 30 percent, almost double the ratio over the course of a couple of years, and have managed our affairs relatively well. I think one of the key goals is to not leave ourselves in a situation where we have a very high debt level and then something bad happens and it's hard to respond to it.

MS. RIVLIN: Let me just give you an illustration. In 1993, when the Clinton administration came in, the debt level in relation to the GDP was much lower. I can't remember exactly, but it was under 40 percent. We were worried because interest rates were much higher then. We were actually worried that if we didn't reduce the rate of growth of the deficit over the next few years that we would get into a situation where the debt service was going up so fast that we had to raise taxes to pay it. Now, that didn't happen but it was a concern. It was a concern because even with a much lower debt, the high interest rates were putting us in a vulnerable position. So imagine now, with a much bigger debt in relation to our economy, what would happen if interest rates on federal debt doubled or tripled, which they easily could under some circumstances. Then we're in really serious trouble.

SPEAKER: I want to ask about the balance sheet of the United States government. I've seen some huge numbers indicating the level of unfunded liability associated with the entitlement programs. How does that factor into your thinking? Very often we would think of liabilities as a sum of obligations, and sometimes we would think of debt as a surrogate for an unfunded liability. Have those issues been factored in, and how do they affect your calculations?

MR. MARRON: First, I'd like to do some PR for an often overlooked but fascinating if you're a wonk report: the federal government does issue financial statements that are similar in spirit to financial statements of private organizations. The latest ones came out a week or two ago. It turns out we're in the hole. There's a parlor game of rolling out the biggest, scariest number possible, so you hear numbers, like we have $75 trillion of unfunded liabilities, $100 trillion of unfunded liabilities. Those numbers are based on long-term projections that have some underlying assumptions about the growth rate of health care costs and the demographics of the nation. I use those numbers with great care since they're very sensitive to assumptions we make about the future. Further, that balance sheet tends to ignore an important asset of the United States, which is its capacity to collect tax revenues. There's also, of course, the opportunity to change those trajectories. I served on FASAB, the board that sets the financial accounting standards for the federal government, sort of the equivalent of FASB, for a while and we had a very long discussion about whether Social Security and Medicare warrant the same treatment as a liability as, say, the debt. There was much back and forth on that, but there was a strong view that they aren't quite the same and we should be careful about adding them to the other numbers because, of course, we can change them. We can change those trajectories and we should view them not so much as something that's absolutely going to happen but as a signal of the challenge that we face.

MS. RIVLIN: Let me just add that Donald and I are both economists, so we tend to think in percent of GDP and such. I do a lot of work with Dave Walker, who is an accountant, a former GAO head, and he likes to use these big unfunded liability numbers — I think partly because he's an accountant and partly because they just sound so scary. But they really are equivalent. I'm scared by our debt rising faster than the GDP, he's scared by umpteen trillion of unfunded liabilities, but we're both saying the same thing.

SPEAKER: I'd like to follow up on your comments about interest rates. The first question is, in the forecast that you talked about in terms of targets to get the deficit to a certain ratio, what are we assuming about long-term interest rates? Are we assuming that they essentially continue as they are, or are we assuming those levels will rise, and if so, when? Second, do you think that the current policy of holding interest rates down has become a kind of self-fulfilling requirement? That is, the government has to keep rates down because the government itself can't afford it if rates go up?

MR. MARRON: CBO will come out with a new analysis on February 4th, so we'll see what they have to say then. Past analyses have assumed some normalization of interest rates inside the 10-year window — so they don't stay this low this long or that long. That's been a subject of ongoing analysis and consideration. So there are these deep, hard questions, which other people in the room can answer better than me about, say, what should we learn from the Japanese experience and how long is it actually plausible to expect interest rates to remain low? But there certainly is some normalization, some increase in, say, 10-year interest rates built into the forecasts.

MS. RIVLIN: But not very drastic ones, just within what are generally considered the normal range for this country, which has always paid its debts. We don't have an experience of what would happen if we went into default, or if we don't get our rising debt under control over a period of years.

MS. DYNAN: Well, I need to say that we're running out of time, so what I want to do is, if you could ask your questions and then we'll let the panelists take them as a group, that would be great.

SPEAKER: You talked about investing in economic growth. I wonder if you can comment on what are the investments that would be most likely to impact economic growth in the short and medium term. And also, I was wondering if you could comment on the Joseph Stiglitz article from a few days ago talking about income inequality itself as a hindrance to economic growth.

SPEAKER: I have a two-part question. On one side you have massive fiscal stimulus, both in the form of trillion and a half dollar deficits, and roughly zero percent interest rates. And Alice, you just said that the economy is in pretty good shape — if Washington on both sides of the aisle could behave. So that's one part. Where would the economy be without all this stimulus? And isn't it possible that the stimulus has reached such a level that it has generated quite a bit of apprehension in the world, affecting capital formation and hiring, because there's so much unprecedented stimulus in the economy?

MS. DYNAN: Okay. And was there one more question on this side?

SPEAKER: So now that we've settled some of the federal tax questions, Don, I was wondering if you had any thoughts about the implications on state tax policy and where things might go next in some of the states?

MS. DYNAN: Okay. So there are some issues for you, Alice and Don.

MS. RIVLIN: I'll start. First, on the stimulus, we had very considerable stimulus in 2009 and 2010 at the federal level. We had anti-stimulus throughout that same period at the state and local level. State and local governments have been laying off people and to some small extent raising taxes. And now the stimulus is gone at the federal level. It was spent in 2009 and 2010, and a little bit in 2011, but the stimulus is gone and the net effect of the two levels of government actions together has been a drag, not a stimulus, on the economy recently.

MR. MARRON: Let's see. In no particular order: On the state-level tax policy issue, there are several states that are now making happy noises or weird noises. California is using the s-word, surplus, which strikes me as peculiar and dangerous. I believe it is in Louisiana where the governor is talking about eliminating the income tax and replacing it with an expansion of the sales tax. You have the governor in Virginia talking about getting rid of the gas tax. So there is currently some state foment going on.

I would say coming out of the Great Recession, one of the big lessons and challenges for states is that if they want to have a progressive income tax, as California has, there's a significant cost to that, which is you're buying yourself a lot of volatility because there's enormous volatility at the high-end of the income distribution. And so to the extent that the economy is recovering and states can think a little more about what they want their long-run tax system to look like, they're going to have to decide how to manage that. I If they want to have a progressive income tax, they're going to have to think more about how to build resilience into that so they can manage downturns.

MS. RIVLIN: We didn't speak to the investment question. The question was, what are the most productive investments the country can make for short and medium-term growth. I would submit that's the wrong way to think about it. We really want to look at how we can grow our economy over the long run, and probably the best thing we can do is improve the skills of our workforce. That doesn't have a quick payoff, even at the college level, but especially not where I think we need it most — in the elementary, secondary, and technical training realm. But I think that's what we need to do most. Science is good. Modernizing infrastructure is good, but we don't usually do it in the best possible way. Investment for growth doesn't just mean let's build a lot more highways.

MS. DYNAN: I want to thank Donald and Alice. Thank you so much for coming and taking the time to talk to us.