

Testimony submitted to the House Ways and Means Committee, hearing on “Tax Reform and Consumption-based Tax Systems,” July 26, 2011 (embargoed until 10am).

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Main Points

- 1) This is a precarious moment for the world economy. Growth is likely slowing in China and other emerging markets, at the same time as a serious sovereign debt crisis continues unresolved in Europe’s euro area. Financial markets remain unsettled as they work through the implications of a default on government debt in Greece and how that will spread to other countries.²
- 2) In this context, even a partial shutdown of federal government in the United States would have a major negative effect on the economy. In the aftermath of any major financial crisis, government spending plays a significant stabilizing role. The private sector – particularly small business – would be greatly damaged by any lack of clarity about when and how the government will pay for goods and services purchased or make the transfer payments promised to consumers.
- 3) Even worse, a failure to increase the U.S. debt ceiling could seriously and permanently undermine our standing in credit markets, increasing interest rates, and worsening the budget deficit. This would have an immediate negative effect on all parts of the private sector. The debt ceiling impasse so far has already created a degree of uncertainty that is not helpful to job creation.
- 4) Standard solvency analysis confirms there is no prospect of an immediate fiscal crisis in the United States, in the sense that there is plenty of “fiscal space” – meaning there is strong global demand for Treasury obligations in the foreseeable future.³ This is reflected in the fact that, until the debt negotiations became stuck, long-term interest rates were low and remarkably stable. U.S. government securities are a safe haven for international investors – until they see a rising probability that we will not pay our debts as contracted.
- 5) Over the CBO’s 10-year forecast window, assuming the “Bush tax cuts” expire at the end of 2012 (as scheduled), there is no serious budget problem.⁴ Under realistic assumptions, the primary budget balance (before interest payments) will be a small surplus and debt will have stabilized around 75 percent of GDP. There is no fiscal emergency over this time horizon.

¹ This testimony draws on joint work with Peter Boone and James Kwak. Underlined text indicates links to supplementary material; to see this, please access an electronic version of this document, e.g., at <http://BaselineScenario.com>, where we also provide daily updates and detailed policy assessments for the global economy.

² See Peter Boone and Simon Johnson, “Europe on the Brink,” Policy Brief 11-13, Peterson Institute for International Economics, <http://www.iie.com/publications/interstitial.cfm?ResearchID=1883>.

³ Comparative cross-country estimates are provided in Jonathan D. Ostry, Atish R. Ghosh, Jun I. Kim, Mahvash S. Quereshi, “[Fiscal Space](#),” IMF Staff Position Note, September 1, 2010, SPN/10/11.

⁴ See James Kwak, “The Weirdness of 10-Year Deficit Reduction,” <http://baselinescenario.com/2011/07/21/the-weirdness-of-10-year-deficit-reduction/>.

- 6) Our most important budget problems come *after* the ten-year horizon, because Medicare spending accelerates due to an aging population and increasing health care costs. We should aim to find a way to control healthcare costs as soon as possible – every year of high health care cost inflation makes the problem worse.
- 7) The United States is in the midst of a significant demographic transition. We need to invest in education and ensure access to affordable healthcare to everyone if we are to increase productivity as the population ages. Ultimately, this is the only way to ensure that older, retired workers can receive a sustainable level of reasonable benefits (including pensions and healthcare).
- 8) In this context and over the coming decades, the United States needs to make a longer-term fiscal adjustment. Part of that should include additional tax revenues.⁵
- 9) Most other industrialized countries also have to engage in a process of fiscal adjustment and for related reasons.⁶ Compared with other countries at roughly our income level and with similar demographics, the United States has a major advantage in the sense that we collect relatively little in taxes; in addition, our tax system is relatively antiquated and would benefit from modernization. Using the IMF's numbers – which are for “general government” (i.e., the entire government sector, including federal, state, and local) – the US collected 31.8 percent of GDP in 2000 (compared with the UK at 38 percent, Germany at 46 percent, and France at 50 percent).⁷ In both 2009 and 2010 the US collected 30.4 percent of GDP; over the cycle, our revenue relative to other leading industrialized countries remains about the same.
- 10) Even Greece, in the midst of severe economic crisis in 2011 and with a badly broken revenue system, is expected to have general government revenue at 42.6 percent of GDP. The United States general government revenue will likely be just 30.5 percent this year.⁸

⁵ Scrapping the existing tax system would not make sense, for example under the so-called “Fair Tax” proposal – this would be a huge undertaking with big downside risks. The benefits of such a system have been greatly exaggerated by some of its proponents. See Bruce Bartlett, “Why the Fair Tax Won’t Work,” *Tax Notes*, December 24, 2007, pp.1241-1254, and Chapter 9 in the President’s Advisory Panel on Tax Reform (http://govinfo.library.unt.edu/taxreformpanel/final-report/TaxPanel_8-9.pdf), a report prepared during the administration of President George W. Bush.

⁶ See Table 6 in the IMF’s May 2010 Fiscal Monitor for budget deficit financing needs across advanced countries (<http://www.imf.org/external/pubs/ft/fm/2010/fm1001.pdf>). The US has relatively short maturity debt (4.4 years by this measure), but it is broadly comparable with other industrialized nations on this and other deficit measures. Table 11 in the same report provides estimates of effects from raising revenue in various sources across the advanced G20 economies. Again, the US is in the middle of the pack – there is nothing unusually difficult (on paper) about the adjustment required. However, our projected increase in healthcare costs as a percent of GDP through 2030 is on the high side relative to comparable countries. See also “From Stimulus to Consolidation: Revenue and Expenditure Policies in Advanced and Emerging Economies,” International Monetary Fund, Fiscal Affairs Department, April 30, 2010.

⁷ Statistical Table 5 in the IMF’s May 2010 Fiscal Monitor has general government revenue as a percent of GDP since 2000 and forecast through 2015; in the April 2011 edition of the Fiscal Monitor, the series starts in 2006 and the forecasts run through 2016 (Statistical Table 6).

⁸ International Monetary Fund, Fiscal Monitor, April 2011, Statistical Table 6, p.126.

- 11) Collecting some additional revenue from a Value Added Tax could make sense, but only if this is implemented using a sensible design – for example, New Zealand’s VAT system may provide a useful model.⁹ This would be a relatively efficient way to raise several percentage points of GDP in additional revenue.¹⁰
- 12) By itself, VAT is typically regressive and would be significantly more regressive than our existing income tax system. It should be supplemented with an increase in the earned income tax credit and with other adjustments (for people who are retired or otherwise do not work) that reduce the burden on those at the lower end of the income distribution.¹¹
- 13) It is striking the extent to which income inequality has increased dramatically since the last tax reform in 1986.¹² From 1986 to 2006, there was little change in average income for the bottom 90 percent of wage earners while the top 1 percent experienced a gain of around 50 percent. The gains for the top one-tenth of one percent were even higher.
- 14) The returns to higher education have greatly increased over this time period and there are not good income prospects for anyone with only a high school education (or less). If anything, the tax system should lean towards becoming more progressive – and investing the proceeds in public goods that are not sufficiently provided by the private sector, like early childhood education and the kind of preventive healthcare that helps prevent disruption to education (e.g., due to asthma).
- 15) At the same time, we must not lose sight of the very large fiscal risks posed by the nature and structure of our financial system. The recent increase in government spending is due almost entirely to the way the financial sector imploded and damaged the rest of the private sector in 2007-08.¹³

⁹ Most European VAT systems are less attractive as design models; we should particularly avoid systems that have different VAT rates for different kinds of goods and services. See Ian Crawford, Michael Keen, and Stephen Smith, “Value Added Tax and Excises,” Chapter 4 in the *Mirrlees Review: Dimensions of Tax Design*, <http://www.ifs.org.uk/mirrleesReview/dimensions>, published in 2010. For more background on how VAT systems operate around the world, see “The Value Added Tax: Experiences and Issues,” paper prepared for the International Tax Dialogue Conference on the VAT, Rome, March 15-16, 2005, <http://www.itdweb.org/vatconference/Documents/VAT%20-%20EXPERIENCE%20AND%20ISSUES.pdf>.

¹⁰ The cross-country evidence suggests that “the VAT has proved to be a particularly effective form of taxation” and it has also been used, to some extent, to reduce the use of less effective tax instruments (Michael Keen and Ben Lockwood, “Is the VAT a Money Machine?” *National Tax Journal*, Vol. LIX, No. 4, December 2006, p.925). Similar conclusions were reached during the George W. Bush administration by the President’s Advisory Panel on Federal Tax Reform (Chapter 8: Value-Added Tax, http://govinfo.library.unt.edu/taxreformpanel/final-report/TaxPanel_8-9.pdf).

¹¹ For more discussion, see William G. Gale and Benjamin H. Harris, “A Value-Added Tax for the United States: Part of the Solution,” Brookings Institution and Tax Policy Center, July 2010.

¹² For more details and discussion of what accounts for the increase in inequality, see David Autor and Daron Acemoglu, “Skills, Tasks and Technologies: Implications for Employment and Earnings,” <http://econ-www.mit.edu/files/5571>.

¹³ Over the past decade, foreign wars also contributed to increased government spending. But the negative fiscal effect of the financial crisis was much larger than the cost of the Iraq and Afghanistan wars combined.

- 16) To see the fiscal impact of the last finance-induced recession, look at changes in the CBO's baseline projections over time. In [January 2008](#), the CBO projected that total government debt in private hands—the best measure of what the government owes—would fall to \$5.1 trillion by 2018 (23% of GDP). As of [January 2010](#), the CBO projected that over the next eight years debt will rise to \$13.7 trillion (over 65% of GDP)—a difference of \$8.6 trillion.
- 17) Most of this fiscal impact is not due to the Troubled Assets Relief Program – and definitely not due to the part of that program which injected capital into failing banks. Of the change in CBO baseline, 57% is due to decreased tax revenues resulting from the financial crisis and recession; 17% is due to increases in discretionary spending, some of it the stimulus package necessitated by the financial crisis (and because the “automatic stabilizers” in the United States are relatively weak); and another 14% is due to increased interest payments on the debt – because we now have more debt.¹⁴
- 18) We should be attempting to strengthen the safeguards in the Dodd-Frank financial reform legislation. Repealing or rolling back that legislation poses a major fiscal risk.¹⁵ The fact that this is not currently scored by the Congressional Budget Office does not reduce this risk or make it any smaller.
- 19) In effect, a financial system with dangerously low capital levels – hence prone to major collapses – creates a nontransparent contingent liability for the federal budget in the United States.¹⁶ This can only lead to further instability, deep recessions, and damage to our fiscal balance sheet, in a version of what the Bank of England refers to as a “[doom loop](#)”.
- 20) The remainder of this testimony reviews in more detail: the catastrophic outcomes likely if there is any kind of default on US government debt; why spending cuts – either from a government shutdown or from some immediate form of immediate austerity – will be contractionary in the current US context; and why the US fiscal balance sheet and efficient provision of public goods remains threatened by a dangerous financial system.

Effects of Defaulting on US Government Debt

The consequences of any default on the US debt would, ironically, actually increase the size of government relative to the US economy.

The reason is simple: If the government defaults, this will destroy the credit system as we know it. The fundamental benchmark interest rates in modern financial markets are the so-called “risk-

¹⁴ See also the May 2010 edition of the IMF's cross-country fiscal monitor for comparable data from other industrialized countries, <http://www.imf.org/external/pubs/ft/fm/2010/fm1001.pdf>. The box on debt dynamics shows that mostly these are due to the recession; fiscal stimulus only accounts for 1/10 of the increase in debt in advanced G20 countries. Table 4 in that report compares support by the government for the financial sector across leading countries; the US provided more capital injection (as a percent of GDP) but lower guarantees relative to Europe.

¹⁵ See Simon Johnson and James Kwak, *13 Bankers: The Wall Street Takeover and The Next Financial Meltdown*, Pantheon, 2010.

¹⁶ See Anat Admati, Peter DeMarzo, Martin Hellwig, and Paul Pfleiderer, “Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is *Not* Expensive,” Stanford University, March 2011 (revised), <https://gsbapps.stanford.edu/researchpapers/library/RP2065R1&86.pdf>.

free” rates on government bonds. Removing this from the picture – or creating a high degree of risk around US Treasuries – would disrupt many private contracts and all kinds of transactions.

In addition, many people and firms hold their “rainy day money” in the form of US Treasuries. The safest money market funds, for example, are those that hold only US government debt. At least, these are the funds perceived as safe – if the US government defaults, all these funds will “break the buck”, meaning that they will be unable to maintain the principal value of money that has been placed with them.

The result would be a flight of capital – but to where? Banks will have a similar problem; many of their balance sheets will be destroyed by the collapse in US Treasury prices (the counterpart of an increase in interest rates on such debt, as bond prices and interest rates move in opposite directions).

There is no company in the United States that would be unaffected by a government default – and no bank or other financial institution that could provide a safe haven for savings.

There would be a massive run into cash, with everyone withdrawing as much as possible from their banks. Imagine the lines at ATM machines and teller windows – something we have not seen on a grand system since the Great Depression.

And private credit would disappear from our economic system, which then gives the Federal Reserve an unpleasant choice. Either it can step in and provide an enormous amount of credit directly to households and firms – very much as the central bank, Gosbank, did in the Soviet Union. Or the Fed can stand idly by while GDP falls 20-30 percent, the kinds of decline we have seen in modern economies when credit suddenly dries up.

With the private economy in free fall, consumption and investment would decline sharply. Our ability to export would also be down – foreign markets would likely be affected also and, in any case, if firms trying to export cannot get credit then most likely they cannot produce.

Government spending would contract in real terms, without a doubt. But what would fall more – government spending or the size of the private sector? Almost certainly the answer is the private sector, because this is so dependent on credit to buy its inputs. Think about the contraction that happened in fall 2008 but multiply by 10.

The government, on the other hand, in the last resort has access to the Federal Reserve and can therefore get its hands on cash money to pay wages. With the debt ceiling not increased, this would require some legal sleight of hand. But the alternative would clearly be a collapse of US national security – the military and the border guards have to be paid; the transportation system needs to operate, and so on.

Issuing money in this situation would almost certainly be inflationary but, the Fed would reason, perhaps not – because we have never been in this situation before, credit is now imploding, and the desperate credit expansion measures in fall 2008 proved not to be as bad as the critics feared.

This is what a US debt default would look like. The private sector would collapse, unemployment would quickly exceed 20 percent and, while the government would shrink, it would also remain the employer of last resort.

Anyone who does not want to raise the debt ceiling is playing with fire. Some people expressing this position are also advocating a policy that would have dire effects – and do the exact opposite

of what they want to the structure of our economy. The government would become more important, not less important.

Spending Cuts Would Be Contractionary

Immediate spending cuts would, by themselves, likely slow the economy. The IMF's comprehensive recent review of cross-country evidence concludes: "A budget cut equal to 1 percent of GDP typically reduces domestic demand by about 1 percent and raises the unemployment rate by 0.3 percentage point."¹⁷

The contractionary effects of spending cuts can sometimes be offset by other changes in economic policy or conditions, but these are unlikely to apply in the United States today

If there is high perceived sovereign default risk, fiscal contraction can potentially lower long-term interest rates. But the US is currently one of the lowest perceived risk countries in the world – hence the widespread use of the US dollar as a reserve asset. To the extent there is pressure on long-term interest rates in the US today due to fiscal concerns, these are mostly about the longer-term issues involving healthcare spending; if this spending were to be credibly constrained (e.g., in plausible projections for 2030 or 2050), long rates should fall. In contrast, cutting discretionary spending would have little impact on the market assessment of our longer-term fiscal stability.

It is also highly unlikely that short-term spending cuts would directly boost confidence among households or firms in the current US situation, particularly with employment still around 5 percent below its pre-crisis level. The US still has a significant "output gap" between actual and potential GDP, so unemployment is significantly above the achievable rate. Fiscal contractions rarely inspire confidence in such a situation.

If monetary policy becomes more expansionary while fiscal policy contracts, this can offset to some degree the negative short-run effects of spending cuts on the economy. But in the US today, short-term interest rates are as low as they can be and the Federal Reserve has already engaged in a substantial amount of "quantitative easing" to bring down interest rates on longer-term debt. It is unclear that much more monetary policy expansion would be advisable or possible in the view of the Fed, even if unemployment increases again – for example because fiscal contraction involves laying off government workers.

Tighter fiscal policy and easier monetary policy can, in small open economies with flexible exchange rates, push down (depreciate) the relative value of the currency – thus increasing exports and making it easier for domestic producers to compete against imports. But this is unlikely to happen in the United States, in part because other industrialized countries are also undertaking fiscal policy contraction. Also, the preeminent reserve currency status of the dollar means that it rises and falls in response to world events outside our control – and at present political and economic instabilities elsewhere seem likely to keep the dollar relatively strong.

¹⁷ *World Economic Outlook*, October 2010, Chapter 3, "Will It Hurt? Macroeconomic Effects of Fiscal Consolidation," p.113. This study has important methodological advantages, in particular because it focuses on policy intentions and attempts to implement spending cuts and revenue increases.

The available evidence, including international experience, suggests it is very unlikely that the United States could experience an “expansionary fiscal contraction” as a result of short-term cuts in discretionary federal government spending.

The Real Dangers and Costs of Fiscal Crisis

The advisable debt limit, relative to GDP, for the United States is subject to considerable debate and is not knowable with a high degree of precision. There is no precise debt-GDP level at which a crisis is triggered, but with net debt relative to GDP in or above the range of 90-100 percent, a country becomes much more vulnerable to external shocks – particularly if it is relying on foreign investors to buy a substantial part of its debt.

If any shock throws the economy into recession, fiscal policy in most industrialized countries will to some degree automatically counteract the effect – as spending increases (on unemployment benefits and other forms of social support) and taxation declines (as GDP falls). Such automatic stabilizers are generally helpful as they prevent the recession from becoming more serious – or even some form of prolonged collapse, which was the pre-1945 experience of many countries.

It is important not to oversimplify fiscal concerns into precise cut-offs for “dangerous” debt levels. Recent European experience provides ample illustration that countries can run into trouble refinancing their debts at a wide range of debt-to-GDP values.

Greece ran into trouble in 2010 with gross debt relative to GDP of 142 percent; its debt levels in 2006 and 2007 were around 105 percent. This is a classic case of too much debt by any measure – although the full extent of the debt and underlying deficits were not completely clear until market perceptions shifted against Greece.

Portugal faces a fiscal crisis with gross debt at 90.6 percent of GDP in 2011, but its debt was only 62.7 percent in 2007. The issue for Portugal is low achieved and expected growth relative to fiscal deficits – the markets have become unwilling to support debt that continues to increase as a percent of GDP.

Ireland, the third eurozone country that currently has an IMF program, is a different kind of fiscal disaster. In this case, the on-balance sheet government debt was low (25 percent of GDP in 2006-07 for gross debt) but there was a big build up in off-balance sheet obligations – in the form of implicit support available to a banking system that was taking on large risks. Bailing out the banks in fall 2008 and supporting the economy during severe recession has pushed up gross debt to 114 percent of GDP in 2011 and debt levels will reach at least 125 percent (in our estimates, even higher) before stabilizing.

Compared with other industrialized countries, Japan stands out as an extreme. Government debt relative to GDP is expected to reach 229.1 percent in 2011 (on a gross basis) and rise to 250.5 percent in 2016. On a net basis – taking out government debt held by other parts of the public sector – the equivalent figures are 127.8 percent in 2011 and 163.9 percent for 2016. But nearly 95 percent of Japanese government debt is held by residents – and, at least for the time being, Japanese household and business savings remain high. Countries with greater reliance on foreign savers, such as the US (where nonresidents held over 30 percent of general government debt in 2010) and the UK (nonresidents held 26.7 percent of general government debt in 2010)

need to be much more careful. Within the eurozone, as a result of greater financial integration combined with the mispricing of risk, foreigners typically hold 40-90 percent of all outstanding government debt (mostly held by other eurozone financial institutions).

The increase in debt relative to GDP in industrialized countries from 2007 to 2011 was about 28 percent (of GDP; unweighted average across countries, as calculated by the IMF) – most of which was due to automatic stabilizers, i.e., the increase in spending and fall in taxation that occurs whenever a country goes into recession.

Seen in that context, the increase in the US gross debt – from 62.2 percent of GDP in 2006 to 91.6 percent at the end of 2010 – was very much in line with experience in other countries. But the current trajectory of debt now, rising to 111.9 percent in 2016, is on the high end (the average debt-GDP for industrialized countries is projected to rise by about 5 percent over this period.)

In terms of net general government debt held by the private sector, at the end of 2011, the US is expected to have around 72.4 percent of GDP – up from 42.6 in 2007. This is not yet at a dangerous level but the future projections are not encouraging – this number will rise to 85.7 percent in 2016, according to the IMF. And in the Congressional Budget Office's longer-term projections, the future costs of healthcare cause a rise in debt to Japanese levels or beyond by 2030 or 2050.

The role of the US dollar as the world's preeminent reserve currency means there is a strong demand for our government securities in the foreseeable future. But it is not clear how far this will carry us – particularly as alternative reserve assets typically develop in a diverse world economy with competing national interests. It would be wise to undertake medium-term fiscal consolidation. Rising healthcare costs and a weak tax base could well undermine our long-term potential growth.

In addition, the United States continues to face very large implicit liabilities in the form of implicit support available to the financial sector, both directly – if “too big to fail” global banks get into trouble – and indirectly, in the form of automatic stabilizers that will always kick in when the economy declines sharply due to a banking crisis.

If a financial crisis due to the mispricing of risk causes a fiscal crisis, including immediate spending cuts and tax increases, this has major distributional consequences. The financial sector executives and traders who do well during a financial boom are highly paid; typically this is on a return-on-equity basis without appropriate adjustment for risk, so they take on too much debt. When the downside risks materialize, the costs of the crisis are borne by those who lose jobs and suffer other collateral damage. If sharp spending cuts follow that reduce public services (e.g., government-funded education), this effectively transfers the costs of dangerous compensation schemes for the financial elite onto the middle class and relatively poor people.

There is nothing pro-market or pro-private sector about an inefficient redistribution scheme that allows a few people to become richer due to implicit government subsidies for “too big to fail” global financial institutions. Such firms are likely to damage themselves with some regularity – their executives have little incentive to be sufficiently cautious. If the consequent crises undermine public goods, such as access to effective education and quality healthcare, this is likely to permanently lower growth rates through undermining the human capital of the US workforce.